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Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 27 October 2017.***

Why Abe's Victory Could Help Lift Japanese Stocks: Shinzo Abe's coalition victory in the 22 October snap election helps pave the way for his fourth term as Japanese prime minister. Here, Templeton Global Equity Group's Cindy Sweeting and Alan Chua give their take on what Abe's pro-growth policies could mean for Japan's investment landscape.

Are Hedge-Fund Strategies Entering a "Silver Era"?: The backdrop for hedge-fund strategies appears to be turning more positive, according to Brooks Ritchey, head of portfolio construction, K2 Advisors. Here, he explains why hedge-fund strategies may be entering a "silver era," and why the US Federal Reserve's (Fed's) projected interest-rate normalisation could present opportunities in this sphere.

Why the Indian Equity Market May Need to Swallow a Bitter Pill: A slew of government reforms may have disrupted the Indian stock market in the short term. However, Sukumar Rajah, managing director and chief investment officer, Asian Equity, believes those reforms and a growing Indian middle class could present opportunities for long-term investors.

Why Abe's Victory Could Help Lift Japanese Stocks

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Japanese Prime Minister Shinzo Abe's decision to dissolve the country's lower house for a snap election on 22 October appears to have paid off.

His Liberal Democratic Party and its coalition partner Komeito retained the two-thirds majority in the lower house that secures them power. The victory helps pave the way for Abe's fourth term as prime minister.

Abe called an election, nearly a year before his previous term of office had expired, in a bid to capitalise on an uptick in his approval rating after he took a more hawkish stance against North Korea and the precarious state of his opposition. His traditional opposition, the Democratic Party of Japan, is in disarray. Also, Tokyo Governor Yuriko Koike—widely considered to be Abe's main challenger—decided not to run for parliament.

In our view, it was difficult for Abe's challengers to claim he has failed on the economic front. Japan's unemployment rate is at record low levels, and gross domestic product (GDP) has expanded for six straight quarters—the longest sustained bout of growth since before the 2007–2009 global financial crisis.

What's more, Japanese corporate profits recently have been rising faster than GDP, assisted by an undervalued yen. With the corporate sector generating positive cash flow, we think companies have room to boost capital spending and dividend payouts.

At the same time, Japan’s labour market has been tightening. We believe tighter labour conditions could help boost income and lead to increased consumption.

For these reasons, we think Japanese equities have the potential to continue to do reasonably well and the domestic economy should continue to improve. Against this backdrop, we see select investment opportunities across a wide variety of Japanese sectors, including automobiles, electronics, factory automation, industrials, materials, oil and gas exploration, real estate and telecom.

In our view, Abe’s victory could lead to four more years of pro-growth policies and the possibility of a second term for the ultra-dovish Bank of Japan (BOJ) Governor Haruhiko Kuroda.

We believe the near-term effect of more fiscal stimulus should be more positive for the economy.

That being said, Japan has relied heavily on massive monetary easing, central-bank balance sheet and asset buying, and an overarching policy of asset price inflation. The BOJ now owns two-fifths of the country’s sovereign debt and two-thirds of its domestic ETF market.

Although these purchases have been a pillar of support for Japanese equities and have kept the currency rate quite favourable, we believe this creates long-term challenges. In our view, it raises the risk of reduced liquidity and increased volatility at some point down the road.

Are Hedge-Fund Strategies Entering a “Silver Era”?

Brooks Ritchey
Senior Managing Director
Head of Portfolio Construction
K2 Advisors

The macroeconomic backdrop for hedge-fund strategies hasn’t been ideal for a number of years. Now, we think this may be changing. Monetary policy looks to be shifting in some countries, currencies are becoming more volatile and geopolitical risks have intensified of late. We think these fundamental elements could drive hedge-fund strategies’ alpha[1] and open up new opportunities for investors in this space.

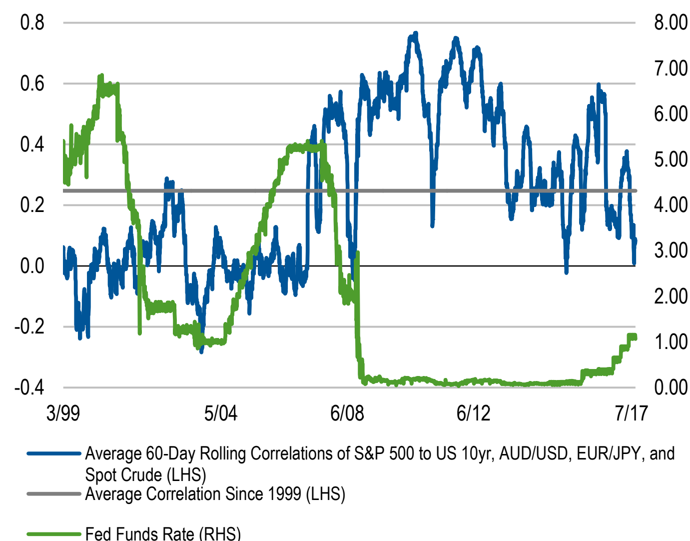
We’d like to debunk a myth that all hedge-fund strategies are super-charged and high-octane. We would argue hedge-fund strategies are actually meant to be dull, with low volatility. But hedge-fund strategies can also provide diversification and long-term capital growth potential.[2]

In our view, low interest rates are often an overlooked factor in regard to hedge-fund strategy performance. Now, as US interest rates are making slow but steady strides upward from historic lows, we think certain hedge-fund strategies may be finding new opportunities to show their mettle.

If the Fed continues to raise interest rates this year and next, we think it could cultivate an environment for certain hedge-fund strategies to flourish. Rising interest rates have historically been associated with lower cross-asset correlations, creating more alpha opportunities for hedge funds.

Cross Asset Correlations vs. Interest Rates

March 1999–July 2017



Source: Bloomberg. The S&P 500 Index is an index of 500 large-cap stocks and is seen as a leading indicator of US equities. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.**

Additionally, rising interest rates have typically led to future periods of above-average alpha, as represented by the Hedge Fund Research Index Fund Weighted Composite Index (HFRIFWI).[3]

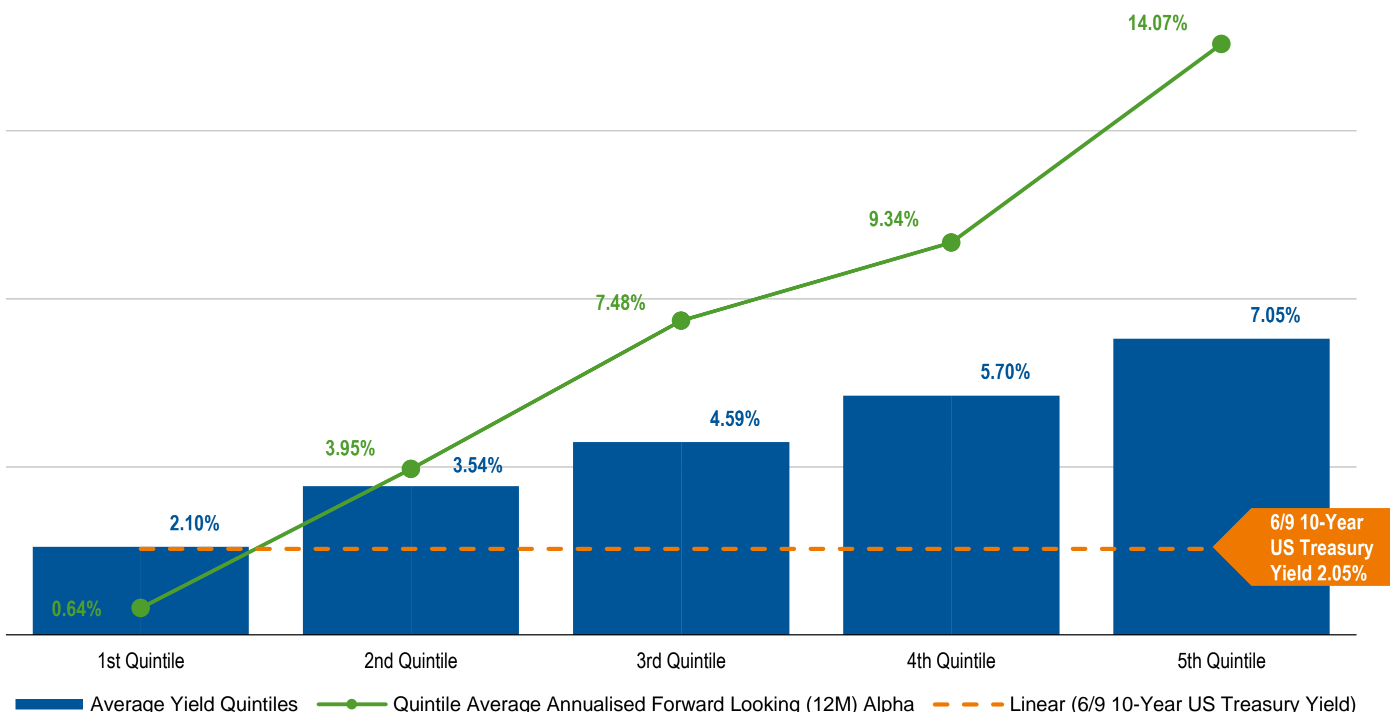
The illustration below shows a positive correlation between alpha and interest rates. The average level of alpha rose to the highest level at 14.07% during the measured period, when the 10-year US Treasury note's yield stood at 7.05%.[4] Based on what we've seen in the past, we think hedge-fund managers could have the opportunity to capture that alpha, or outperformance, as US interest rates continue to rise.

Global geopolitical risk is another element that we believe should drive a change in the landscape for hedge-fund strategies. On the back of recent geopolitical tensions, major currency spreads have widened, and historically wider spreads have benefitted hedged strategies' alpha. This is particularly noticeable within the Group of Seven (G7)[5] economies, since they coordinate and attempt to manage major exchange rates in a way that leaves their currencies closely linked.

Hedge Strategies' Historical Alpha vs. Nominal Interest-Rate Levels

HFRIFWI Index Alpha at Different US 10-Year Treasury Yield Levels

January 1990–July 2017



Source: K2 Advisors, Bloomberg. Data: January 1990–July 2017. Alpha calculated relative to the S&P 500 Index. The HFRI Fund Weighted Composite Index (HFRIFWI) is a global, equal-weighted index of over 2,000 single-managed funds that report to Hedge Fund Research Inc. database. All indexes are unmanaged and you cannot invest directly in an index. Unlike most asset classes, HFR Index returns reflect fees and expenses. **Past performance is not an indicator or a guarantee of future performance.**

As a result, we might not yet be in the golden era for hedge-fund strategies—the most-ideal environment for managers to capture alpha—but we could be approaching the silver era, where favourable opportunities are starting to appear.

Factors Influencing the Capture of Alpha

- **Interest Rates:** Higher interest rates have historically benefitted and supported alpha in hedged strategies. When interest rates are low, there’s little incentive for companies to clean up balance sheets and restructure debt.
- **Large G7 Currency Movements:** Hedge-fund managers may benefit from increased currency volatility via spread and pairs trades, as well as from greater price dispersion in securities globally.
- **Wide Variances in Equity Sector Price-to-Earnings (P/E) Ratios:** The wider the gap, the bigger the opportunity for managers to potentially benefit from equity sectors that show a below-average P/E ratio,[6] which indicates that a sector may be undervalued, or conversely from above-average sector P/E ratios, which may indicate inflated value.

Allocating Towards Market Themes

Not all hedge strategies will fare equally as conditions change. We expect the event-driven hedge-fund space, for example, may face headwinds as central banks globally begin to normalise interest rates. Event-driven hedge funds often seek to profit from merger-and-acquisition corporate activity, which could be diminished as interest rates rise.

Global macro strategies, however, may benefit from rising rates. The global macro space has seen an increase in trading volume over the last two months, and we anticipate this trend will continue.

To conclude, we’ve seen evidence that the current market landscape could become a nurturing environment for certain hedge-fund strategies, but we’re only just at the beginning and believe more opportunities could crop up during this silver era.

Why the Indian Equity Market May Need to Swallow a Bitter Pill

Sukumar Rajah
Managing Director and Chief Investment Officer
Franklin Local Asset Management, Asian Equity

There has been much uncertainty surrounding India’s recent reforms and how they may impact the economy and stock market. Some observers have argued that the government’s move to remove cash from circulation to thwart corruption has been a failure. And, some say the implementation of the new Goods and Services Tax could be more disruptive than expected.

While it is still too early to be certain exactly how these reforms will play out, our belief is that over the longer term, comprehensive reforms should likely overhaul the current system and improve efficiency.

In particular, we will be closely watching the Indian government’s response to a growing number of bad bank loans—so-called “non-performing assets.”

Government authorities and the Reserve Bank of India have begun to take steps to clean up the system and consolidate affected companies. This has proved a challenge for many Indian companies’ immediate earnings and growth prospects. It’s a bitter pill to swallow, but a necessary one, in our view. We think this reform process should prove positive for long-term investors.

Behind the Highs

In our view, the Indian stock market owes its positive performance so far this year to major developments in government reforms and the spending habits of the growing middle class.

Indian equities are currently trading near all-time highs on the back of a stellar run this year, which may lead some investors to

worry they could be too richly valued. However, valuations are not too much of a concern for us right now. We think robust growth over the short term could underpin confidence in Indian equities. Additionally, the pockets of overvaluation lie primarily in small- and mid-cap stocks—an area which has a heavy concentration of domestic liquidity.

Local investors have historically underinvested in equities. However, we've seen a recent increase in local investors' appetite for stocks, which has driven the lower end of the market in the small- to mid-cap space. As a result, we think an increase in momentum could be the beginnings of a multi-decade trend.

While Indian equity valuations in general are near all-time highs, the market-cap-to-Indian-GDP ratio currently sits around the long-term average, which could indicate there is still more upside for stocks and room for growth.

Consumer Discretionary Sectors to Benefit from Rising Middle-Class Population

The changing Indian landscape, particularly its rising middle-class population, provides reason for us to believe specific sectors can continue to be transformed. These include industrials and consumer discretionary, including clothes, entertainment and leisure.

We've previously championed the information technology (IT) sector. However, we think room for growth in the IT sector is currently limited and, as a result, we think the outlook for growth could be challenging.

In some ways, we view the pharmaceutical sector in a similar way we view the IT sector. Indian pharmaceutical companies that sought to gain market share in the vast US pharmaceuticals space have found themselves with limited room for expansion. Short-term issues, including manufacturer disputes, have had some detrimental impact on the sector. As a result, we expect longer-term growth to be much lower compared with what we've seen over the last 10 years.

Why Demographics Matter

The growing number of domestic Indian investors has changed the landscape of its equity market. Better information and education, along with an increasing middle-class population with a growing savings pool, have propped up demand for equity investments.

The size of the middle class in India is growing fast. By 2022, India's middle class could overtake the United States to become the second-largest middle-class market in the world.[7] As its size increases, demand for retail, services and leisure activities should also increase and drive these sectors of the market going forwards.

In our view, Indian equities look attractive for a number of reasons, including government reforms, demographics and a growing middle-class population. India's favourable demographics could create a tailwind and drive demand to specific consumer-driven sectors in the market.

For now, we believe the agenda for the Indian market is to deal with the aftermath of the changes the government has implemented, and wait for earnings growth to accelerate.

What Are the Risks?
All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. The identification of attractive investment opportunities is difficult and involves a significant degree of uncertainty and there is no assurance any such alternative investment strategies will be successful. It is always possible that any trade could generate a loss if the manager's expectations do not come to pass. An investment in these strategies is subject to various risks, such as those market risks common to entities investing in all types of securities, including market volatility. Hedge-strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk of any strategy or sub-strategy. Conviction sentiment is determined by the K2 Advisors' Research group based on a variety of factors deemed relevant to the analyst(s) covering the strategy or sub-strategy and may change from time to time in the analyst's sole discretion.

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1. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.
2. Diversification does not guarantee profit or protect against risk of loss.
3. Alpha calculated relative to the S&P 500 Index. The HFRI Fund Weighted Composite Index (HFRIFWI) is a global, equal-weighted index of over 2,000 single-manager funds that report to Hedge Fund Research Inc. Database. All indexes are unmanaged and you cannot invest directly in an index. Unlike most asset classes, HFR Index returns reflect fees and expenses. **Past performance is not an indicator or guarantee of future performance.**
4. Alpha is calculated against the S&P 500 index.
5. The Group of Seven consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
6. The P/E ratio for an individual stock compares the stock price to the company's earnings per share.
7. Source: Homi Kharas, Global Economy and Development at Brookings, Working Paper 100, The Unprecedented Expansion of the Global Middle Class, February 2017.

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