THE G4:

UNDIMINISHED EXPECTATIONS

INVESTMENT OPPORTUNITIES

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PREPARED FOR PROFESSIONAL CLIENTS ONLY

Executive Summary

In a series of white papers, BNY Mellon has been exploring what might happen if China, the United States, India and Japan (the four largest economies in the world, measured at purchasing-power parity) fulfill their economic potential over the rest of this decade. In this paper, we examine how they might fare in the year ahead, drawing on the expertise of portfolio managers and investment strategists from across BNY Mellon Investment Management.

These four economies, which we call the G4, have been far from immune to the global turmoil of recent weeks and months, but the market mayhem should not obscure the progress they have made. US job growth has remained strong; Japan has pulled out of deflation (consumer prices, excluding energy and fresh food, rose by 1.3 percent, year-on-year, in December)[1]; India has become the fastest growing major economy in the world; and even China, the source of much anxiety, has arguably caused more trouble than it itself suffered. Its growth remained robust and better balanced, according to the official statistics. It also regained some year-end momentum according to less rosy, unofficial metrics.

[1] www.boj.or.jp/en/research/research_data/muipre.pdf

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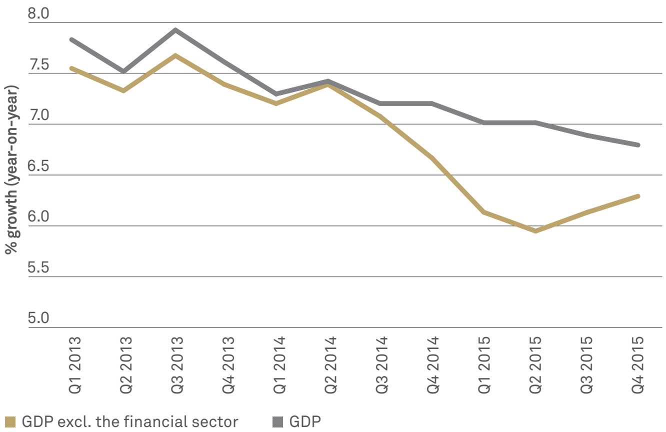
China

Interpreting China's economy has been even harder than usual in recent quarters, according to Simon Cox, Managing Director and investment Strategist of BNY Mellon Investment Management Asia Pacific. The 2015 stockmarket bubble and bust obscured what was going on in the rest of the economy, and China's budget figures obscured a pronounced swing in its fiscal stance. Beijing's effort to rein in local-government borrowing led to a sharp fiscal tightening in the first half of 2015 that was relaxed thereafter. China's economy, outside of the financial sector, responded as one would expect: slowing sharply in the first half, then regaining momentum in the second. But this growth trajectory was camouflaged by frenetic stockmarket turnover, which boosted financial-services output in the first half, before ebbing in the second (see chart).

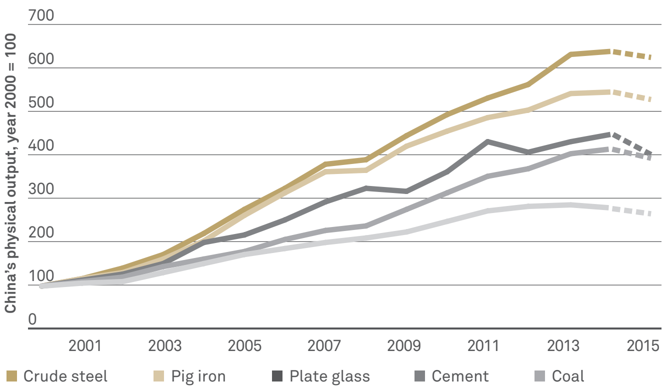
China's GDP (with and without the financial sector)



Source: National Bureau of Statistics

Simon expects the fiscal easing to continue in 2016, providing a much-needed stimulus to the non-financial economy. Overall GDP growth may be no faster this year than last, but it will feel faster, because it will not be concentrated in stock-broking. That will help to lift some of the gloom shrouding emerging markets, especially those tightly linked to China's fortunes.

Peak overcapacity



Source: National Bureau of Statistics

Stronger demand will be accompanied by cutbacks in overcapacity. Beijing's promises to shutter mines, mills and smelters are not always convincing. But recent events show that China's government is willing to tolerate an unusual degree of pain in state-owned industry. According to official statistics, state-owned industrial firms suffered their worst month on record [2] in September 2015, with production falling by 1.4 percent year-on-year. China's output of crude steel, cement, plate glass, raw coal and pig iron all fell last year, suggesting that China may be nearing "peak overcapacity". A determined effort to restrain Chinese overcapacity will be painful for China's mining and metals sector, Simon concludes, but might offer some relief to its hard-pressed competitors overseas.

United States

Despite growing fears of a recession, the US economy should grow faster in 2016 than in the second half of 2015, according to W. Charles ("Chuck") Cook, Portfolio Strategist for The Boston Company Asset Management (TBCAM). Fiscal policy is loosening, thanks to bipartisan agreement on greater spending for highways and defense in an election year. Low oil prices have inflicted immediate pain on energy companies, but should lead to stronger consumer spending in time. "There's a lot of stimulus in this economy that really hasn't been felt yet," Chuck argues.

Chuck's confidence in the US economic recovery translates into an optimistic outlook for US stocks in the long term. Earnings growth of 5-7 percent and an unchanged dividend yield would generate total returns in the high single digits, Chuck points out. Whether or not the market as a whole is fairly priced, valuations within it are highly dispersed, with some industries (such as utilities) generously valued [3], and others (such as financial companies) trading at substantial discounts to their historical averages [4].

Chuck favors economically sensitive, attractively valued sectors over expensive, defensive ones like Utilities (which has a zero weight in his team's portfolio). Although his team is underweight Industrials as a whole, it favors companies within the category that will benefit from increased defense spending and broader US capital expenditure.

Robust economic growth will eventually invite somewhat higher interest rates, even if the tightening remains gradual. Higher rates will hurt sectors such as Utilities or REITs, which have served as "bond proxies", offering generous dividends and predictable, steady returns to investors hungry for yield, Chuck argues. Higher rates will, however, help financials, which are now trading at large discounts to their book value, despite strong balance sheets.

[2] The statistics go back to 1999.
[3] The price-earnings ratio of the utilities sector is well above its long-term average, according to Fundstrat.
[4] The price-book ratio of firms in the financial sector is substantially below the long-term average, according to Empirical Research Partners Analysis.

India

In India, unlike the United States, the macroeconomic benefits of lower oil prices have been immediate and conspicuous, contributing to surprisingly fast improvements in inflation and the current-account deficit. But although India's macroeconomic stabilization has been surprisingly quick, structural reform has been frustratingly slow. Gaurav Patankar, Portfolio Manager at TBCAM, thinks reform expectations were too high: Narendra Modi's government is proceeding as quickly as India's fractious politics allows. Several of his ministers — in charge of power, railways and roads — have shown the right combination of political nous and administrative rigor, he argues. His government has lifted FDI caps in many parts of the railway service and drummed up significant investment in roads. It has also introduced a promising plan to resolve the bad debts of India's power distribution companies whilst also preventing their recurrence.

Unfortunately, the government has not offered a similarly sweeping plan to repair the country's public-sector banks (PSBs), setting aside insufficient capital for the task. The finance ministry may be hoping to reform the PSBs before recapitalizing them in full. But India cannot afford to wait that long, Gaurav argues. If Modi wants to win re-election in 2019, India's economy will have to prosper in 2018. That will require credit to flow more freely in 2017, which will, in turn, require PSB repairs this year.

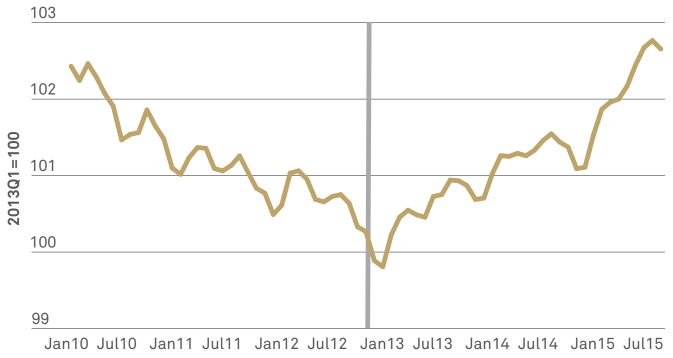
The other big issue facing the government this year is passage of the much delayed goods-and-services tax (GST), which will replace India's elaborate patchwork of indirect and interstate taxes, providing a substantial boost to growth. Delayed by "nitty gritty political maneuvering," the tax should nonetheless pass in 2016, Gaurav says: "Modi has invested too much political capital in it to abandon it now."

Amid widespread disillusionment with emerging markets, India remains relatively popular with overseas investors. "No other major economy can hope to deliver 7-8 percent real growth over the medium term," Gaurav argues. India's trailing P/E ratio, which is significantly higher than its five-year average, may diminish slightly. But Gaurav also expects corporate earnings to pick up, benefiting from increased government spending, benign inflation, and the early benefits of "de-bottlenecking". India's growth and reform prospects are good, Gaurav believes. "The market may be pricing them as if they were excellent. But that's because everywhere else is horrible."

Japan

The Bank of Japan appears determined to win its fight against deflation, as its experiment with negative interest rates shows. Although it has fallen well short of its 2 percent target, that is partly because oil prices have dropped so precipitously. Remove energy and fresh food from the consumer basket — as the Bank of Japan now recommends — and prices have clearly stopped falling and changed course since Abenomics began (see chart).

Japan's consumer prices



■ Consumer-price level, excluding fresh food & energy* ■ Abe returns to power

* Adjusted for the consumption-tax hike
Source: Thomson Reuters Datastream, Bank of Japan, Statistics Japan

The wage hikes offered by Japan's large, unionized companies have been modest. But wage-setting in these companies has always been somewhat insulated from market conditions, points out Miyuki Kashima, Head of Japanese Equity Investments at BNY Mellon Asset Management Japan. A more sensitive barometer of wage pressure may be the pay of temporary workers. Their hourly wage, as measured by Recruit Jobs, a temporary recruitment agency, has increased by 8.4 percent since December 2012, when Abe returned to power.

Over that period, nominal GDP has grown at its fastest rate this century, reaching 500 trillion yen (at an annual pace) in the third quarter of 2015. Lifting it to 600 trillion yen is now an official goal. "Once the government has that kind of target, if growth does dip below expectations, you can expect a policy response," Miyuki says. "There's still a reasonable chance the 2017 consumption-tax hike will be postponed."

This unusually rapid growth in nominal GDP should translate into healthier corporate results. "On the base scenario that nominal GDP does grow at 2-3 percent or so, the earnings outlook still looks reasonably good," Miyuki argues. The post-2009 rebound in corporate earnings was never fully reflected in the stockmarket, she says. And after its recent setbacks, "there is still quite a big gap between where the market is and where the market could potentially go."

Conclusion

The opinions in this paper from various parts of BNY Mellon Investment Management add up to a cautiously optimistic view of global growth in the year ahead. If each of these four large economies proves as resilient as our contributors suggest, global output will escape the synchronized slowdown or recession that many investors now seem to fear. If that proves to be the case, the year should finish better for equity investors than it started.

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