AXIOM INVESTORS

Midyear Investment Outlook

June 2016

		Positives	Negatives
A.	Economic	Moderate global expansion continues. World +3.0E in 2016 with DM +1.7E and EM +4.3E. Global inflation remains low at 3.1%E in 2016 with DM at 1.0%E and EM at 6.3%E lifted by 'challenged' economies in Latin America, Europe and Africa. Unemployment in many geographies moving lower with labor markets, particularly in many developed regions, near 'full' employment as reported. Floating currencies in much of the world have allowed for adjustments to occur without dramatic 'devaluation' events improving terms of trade and national balance sheets in many distressed regions. Credit conditions have remained within historic ranges despite stresses in in various sectors and regions and currently are at generally supportive levels.	Global growth albeit positive continues to decelerate and disappoint. Global GDP of 3.1% in 2015, and 3.4% in 2014, was well below initial expectations. 2016 has already fallen from 3.3%E at start of year to 3.0%E now, setting markets up for a second year of sequential global GDP deceleration. Major economies US, China and Japan especially disappointing with 1Q16 US GDP 0.5%, China 6.7%, and Japan 0.2%, all well below forecasts. A second half recovery is unlikely to materialize leading to further global GDP forecast cuts. Corporate investment spending is slowing dramatically in major economies -- for instance US 1Q16 -3.5% -- contributing to a manufacturing recession in much of world. Deflation continues to be in evidence in many parts of the world and monetary stimulus increasingly viewed as 'failed policy' that contributes to deflation not reflation. Demographic headwinds progressively intensifying in many regions.
B.	Monetary	Monetary policy remains extremely supportive in much of the world as the primary policy response to weak growth. As much as $10 trillion dollars or about 40% of global sovereign debt now offers negative interest rates, with even 10 year bonds offering negative yields in both Japan and Switzerland. Interest rate cuts are ongoing in many regions of the world.	Declining transmission to the real economy due to risk aversion, regulatory tightening and collapsing monetary velocity so to some degree monetary policy is perhaps now just turning up the speed on the monetary treadmill. Certain challenged economies, particularly emerging markets such as Peru, Mexico and Colombia have been forced to raise rates to defend their currencies and ward off accelerating inflation. Negative interest triggering unintended consequences. For instance, in Japan and Switzerland deflation and currency strength has perhaps accelerated in the context of negative yields contrary to the 'helicopter money' theories.
C.	International	Currency movement has left terms of trade generally more favorable outside the US. Margins outside the US still biased upwards whereas US margin appear to have peaked. International earnings yield spreads very attractive both absolute and relative to history. PE's, P/CF and such also generally more attractive outside the US, particularly in Emerging Markets and Japan. Equity	Non-US indices typically have higher exposure to cyclical sectors including commercial banks, energy and materials. Emerging markets have been a headwind for the past few years, although we might be in the early stages of a positive inflection in many key geographies. Corporate governance typically less shareholder oriented than in the US.

		dividend yields generally at or above 10 year yields, especially outside the US, with corporate dividends offering upside potential.	
D.	Technical	Reduced allocations to public equities in favor of illiquid securities, cash and fixed income have all structurally reduced equity market volatility and fragility. Contradictory movements toward indexation, 'smart beta' factor allocation, and high frequency trading all are disruptive developments adding volatility and inefficiency to markets creating medium to long term opportunity at the expense of short-term visibility. Funds flows turning positive in Emerging Markets after a few years of underperformance and net outflows. High growth Emerging Markets with structural tailwinds trading below historic valuation levels. US Dollar rally appears to have lost momentum after a 2-3 standard deviation surge. Crowded currency hedged trades belatedly falling back out of favor. Emerging Market currencies in particular appear to be stabilizing after multiple years of sharp losses as floating currencies have naturally rebalanced terms of trade finding a new equilibrium. Key caveat, the Chinese Yuan, as the last remaining key pegged currency continues to represent instability and a risk.	US Corporate Profits in decline. US Corporate Profit Margins declining on y/y basis. Unit Labor Costs growing faster than Productivity in US. After strong rally, US dollar now weighing on corporate revenues and profits. Questions regarding 'quality' of earnings, particularly in the US. Buybacks fueling EPS growth, large restructuring 'one-offs' lead to large spread between GAAP and Non-GAAP reported earnings. US buybacks decelerating in face margin headwinds and renewed maintenance capex pressures. Outside the US, the pace of corporate governance improvements has been choppy and often disappointing.
E.	Other (political, etc.)	Fed likely to remain dovish. Possibility of tax and regulatory reform in the US. Latin America appears to be in the early stages of moving back toward market oriented policies.	US Elections remain a major source of uncertainty. Violence in the Middle East and tensions in Asia continue. Fed continue to 'talk up' rate hikes. Rising concern about autocratic rule in China. Renewed cold-war style tensions as US influence continues to wane.
F.	Investment Strategy Conclusions for Equities Public equities remain attractive relative to fixed income and cash. Earnings and dividend yield spreads, while off their post crisis peaks, remain at historically attractive levels versus benchmark 10-year yields. Indeed, even dividend yields are typically above 10 year yields. Indeed, about 10 trillion dollars or approximately 40% of sovereign bond yields are now negative spread across 14 different countries. Real and sometimes even nominal cash yields are now negative as well. Non US equities are relatively more attractively valued than US equities on these earnings and dividend yield 'spread' measures as well as on simple P/E's, P/CF's and normalized P/E's. Emerging Markets are particularly attractive on these measures, whereas the US market generally appears to be less attractively valued. Many headwinds remain. Corporate revenue and earnings growth continue to be challenged by low nominal global GDP growth. Margins offer less upside now than in prior years. In the US, margins actually seem to have passed a historic peak and outside the US the pace of any productivity gains tends to be much slower for political and cultural reasons. Commodities, while still down year-on-year, do not seem to represent a significant upside lever looking		

	forward. Many economic sectors, particularly finance, are contending with ever rising regulatory and political burdens. Post financial crisis and Arab spring, the global commitment to globalization and open borders appears to be ebbing, diminishing the outlook for trade and weighing on potential growth. Deteriorating investor appetitive for highly levered enterprises, subordinated debt and IPO's represent a headwind for both private equity and financial engineering driven earnings growth. In this context, we continue to believe the high quality, sustainable public equities offering superior and undervalued growth represent a significant absolute and relative return opportunity.
G.	Investment Strategy Conclusions for Fixed Income Securities Rates continue to confound consensus expectations as the US 10-year yield has moved from 2.53% in mid-2014 to 2.35% in mid-2015, and more recently to below 1.85%. Yields are near multiyear lows in Germany, the UK, Switzerland, Japan, Australia and Korea. Curves have flattened. For instance, the US 2 year/10 year spread is now only 90bps, the lowest level since 2007. Fears that aggressive monetary policies including quantitative easing would create reflationary pressures driving longer term yield up have proven at best wildly premature. Fixed income bulls can continue to point to strong deflationary pressures, risk aversion, and demographics among other factors to argue that prudent investors maintain at least low-end of the range allocations to high quality fixed income in markets still offering positive yields. Bears continue with increasingly stale arguments about rate hikes and low yields. Assets such as multi-strat hedge funds have typically failed to deliver as viable alternatives to traditional core fixed income allocations reinforcing the importance of some core fixed income. Equities with bond like qualities such as blue-chip dividend stocks have generally been satisfactory choices, albeit too volatile and correlated to fully substitute for traditional high quality fixed income. Credit products such as high yield and structured notes have been very volatile as well. For instance, spreads widened meaningfully between mid-2014 and early 2016 with the BBB/10 year spread expanding almost 100bp and high yield spreads expanding over 500bp as credit fears in the energy sector pervaded the market in late 2015 again underscoring that while credit might offer incremental return the cost in potential volatility is high so perhaps 'bond like,' dividend paying, stable growth, equities are preferable risk assets. In general, while we would maintain low-end allocations to fixed income in part to manage portfolio volatility, we view the total return upside of dynamically growing, earnings compounding equities as strongly preferable.

Forecast of Economic Statistics

2016

		US	EU	JP	AP	LA	DM	EM	World	Comment
Real GDP	2015A	2.40	2.00	0.60	4.80	(0.50)	2.00	4.30	3.10	Revised down throughout the year
	2016E	1.80	1.80	0.50	4.70	(1.40)	1.70	4.30	3.00	Down from 3.3% to lowest level since 2009; US started at 2.5%
	2017E	2.30	1.90	0.50	4.70	1.90	2.00	4.90	3.20	
CPI	2015A	0.10	(0.10)	0.80	1.90	14.20	0.40	5.00	2.80	Revised down throughout the year
	2016E	1.30	0.40	0.20	1.70	24.60	1.00	6.30	3.10	Down modestly from 3.2 as CPI skewed higher by a few 'basket cases'
	2017E	2.00	1.50	1.70	2.50	18.40	2.00	5.20	3.30	More signs of renewed deflation than inflation despite commodity rallies
Prime/Bank Rate	2015A									
	2016E	3.50		1.46						
	2017E									
90 Day Bills	2015A									
	2016E	0.88	(0.01)	(0.06)						
	2017E	1.23	0.06	(0.07)						
10 Year Treasuries	2015A									
	2016E	2.14	1.17	(0.08)						Lower and flatter despite monetary easing and expected reflation
	2017E	2.42	1.41	0.02						
	2015A									
30 Year Treasuries	2016E	2.97								
	2017E	3.25								
Unemployment Rate	2015A	5.30	9.20	3.40	3.90	6.70	6.50	5.30		
	2016E	4.80	8.80	3.20	4.00	8.90	6.20	5.40		Underlying detail reveals declining participation, more part time, flat wages
	2017E	4.70	8.50	3.20	4.00	9.30	6.00	5.40		General expectation of further gains might be too rosy
Corp. Profit Growth %	2015A									
	2016E	(1.20)	2.20	3.80	3.70	31.10	2.40	2.90		Anemic underlying profit grwoth especially in US before financial engineering
	2017E	3.00	14.30	10.80	10.80	20.30	13.60	13.30		
Profit Margin	2015A	7.80	5.14	5.13	7.15	3.53				
		SPX	BE500	NKY					ACWI World	
	2015A	117.57	15.57	1,018.24					24.63	
EPS	2016E	117.61	14.48	1,012.02					24.46	Profit estimates have come down significantly for 2016
	2017E	133.49	16.46	1,114.05					27.75	
	% Chg ('15)	-2%	3%	11%					-6%	Corporate profits ended down -6% having started the year close to +15%E
	% Chg ('16)	14%	14%	10%					13%	
2016 P/E		18.0	15.9	16.4					16.5	Non-US markets offer more attractive valuation ratios

Direction of U.S. Dollar

Consensus expects the USD to strengthen a little bit more with the widely quoted 'DXY' anticipated to rally from current level of 95.5 to 97 by year end and 97.5 by the end of 2017. The USD is expected to be neutral vs the Euro, strengthen vs the Japanese Yen and weaken vs the British Pound. A "stay" vote would improve prospects for the British Pound. The Canadian Dollar is not expected to make a dramatic move versus the Dollar. We believe that the two and a half standard deviation rally in the dollar that unfolded between mid 2014 and mid 2015 has lost momentum and that the dollar is likely to remain range bound as inconsistent policy and economic forces keep the dollar within a narrow range versus other developed market currencies. Outside of China where the currency peg has prevented a proper mark-to-market, emerging market currencies seem to be biased higher. China remains a very big risk to global financial stability. Chinese authorities appear to be working towards currency stability and policy support.

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