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Introduction

The past 12 months were brutal for many assets, especially commodities, emerging markets and high-yield bonds. China, America, India and Japan, the world’s four largest economies, measured at purchasing-power parity, were far from immune to the global turmoil. But the market mayhem should not entirely obscure some promising signs of progress in these four economies, which we have called the G4.

Despite a strong dollar and a worrying manufacturing slowdown, the United States added 2.7 million jobs in 2015 on top of the 3 million it had created the year before — the two biggest additions this century 1. Despite choppy GDP figures, Japan’s economy continued to reflate: its nominal GDP grew by 2.6 percent in the first three quarters of 2015, compared with a year earlier 2. India, a member of the “fragile-five” emerging economies less than three years ago 3, became the world’s fastest growing major economy, despite sluggish private investment and legislative gridlock. Even China — the source of much global anxiety in 2015 — arguably caused more trouble than it itself suffered. Its currency has fallen over the last 12 months, but by far less than those of most emerging economies. Growth remained remarkably robust, according to the official statistics, and seemed to regain some year-end momentum even according to less rosy, unofficial metrics.

What lies ahead for these economies in the next 12 months and what implications should investors draw? In this white paper — the fourth of a series — we collect some thoughts on the G4’s prospects from across BNY Mellon Investment Management. Our company comprises multiple boutiques, each with their own deeply held investment philosophy, and it prides itself on the diversity of thought that results. It makes no effort to impose a “house view” on its investment strategists and portfolio managers — except for the conviction that “groupthink” is dangerous.

As a result, the contributors to this paper — W. Charles Cook and Gaurav Patankar of The Boston Company Asset Management, Miyuki Kashima of BNY Mellon Asset Management Japan and Simon Cox of BNY Mellon Investment Management Asia Pacific — do not necessarily agree with each other. Nor do they all subscribe to the avowedly optimistic G4 scenario explored in the previous papers in this series — a scenario in which India grows by 8 percent on average for the rest of this decade, China grows by 7 percent, the US by 3 percent and Japan by 2 percent. The contributors are nonetheless each cautiously optimistic about the G4 economy they know best.

Earlier papers in this series argued that the G4 economies were all operating within themselves, leaving them room to grow faster if demand strengthened. That remains true, even if circumstances have so far conspired against them fulfilling that potential. Growth has been mediocre in the past year (with the partial exception of India). If that slow growth had been accompanied by above-target inflation, we would concede that we had overestimated the G4’s potential — we would conclude that their gentler pace of expansion was as fast as they could go. But the G4’s subdued growth has in fact been accompanied by equally subdued inflation. That is a sign that these economies are underheating not overheating. They have not yet breached their “speed limit”. After the setbacks of recent years and weeks, it is natural to expect another year of disappointing growth. But it’s not yet necessary to accept it.

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1 Bureau of Labor Statistics
2 Japan’s Cabinet Office
China

In the past 12 months, investors have been grimly fascinated by China's hapless stockmarket rescue, its embryonic currency policy and the troublesome interplay between the two. It can be argued that China's monetary easing in the midst of the summer stockmarket sell-off contributed to downward pressure on the yuan, culminating in the August devaluation. The sight of Beijing's "national team" (the government's proxies in the securities markets) wading back in to the market at the start of 2016 to prop up shares may have also eroded confidence in the yuan on January 6th. That prompted the authorities to set a conspicuously weaker benchmark parity for the currency the following morning, triggering another bout of global market turmoil.

Currency-watchers do not know whether the authorities want a weak yuan (as the August devaluation and January 7th benchmark move would suggest), a market-driven yuan (as the August policy statement suggested, with its announcement that the morning benchmark would henceforth respect the previous day's trading) or a yuan that is stable against a broad basket of currencies (as subsequent statements have insisted). In my view, they want the third of these options: to keep the yuan reasonably stable against a basket of 13 currencies.

That seems a reasonable ambition for a country with a healthy trade surplus, a sizeable stock of foreign-exchange reserves (enough to buy all of Manhattan's real estate eight times over!) and a stable share of global export markets. But achieving that aim would be easier if investors knew for certain that it was indeed Beijing's aim. Instead, the authorities have allowed investors to suspect that they secretly want to engineer a sizeable devaluation — to boost their exports, preserve their foreign-exchange reserves and win greater monetary flexibility. That suspicion is motivating large capital outflows, which are making the authorities' job harder than it should have been.

These bets against the yuan are understandable given the weakness of China's economy. It is struggling to cope with the dramatic slowdown in construction and heavy industry after its post-crisis building boom. The shock is most visible in the evolution of nominal GDP over the last few years. Having grown by almost 20 percent as recently as 2011, nominal GDP grew more slowly than real GDP in 2015, suggesting a worrying build-up of deflationary pressure.

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4 See the currencies and weights revealed by the China Foreign-Exchange Trading System in December http://www.chinamoney.com.cn/fe/info/15851379
5 China's foreign-exchange reserves amounted to $3.33 trillion at the end of 2015, according to SAFE. Manhattan's real estate was worth $389.7 billion in the 2015-16 fiscal year, according to New York City Department of Finance.
6 Some of those capital outflows represent companies repaying dollar debts. China’s external debt fell by $150.3 billion to $1.53 trillion in the third quarter of 2015. bit.ly/1IDKyaL
China's real, nominal and dollar GDP growth

It is nonetheless possible to draw some consolations from the evolution of China's economy in the past couple of years. To calm rattled investors, stabilize demand and deleverage corporate balance sheets, China's economy must rely less on credit-financed investment spending and more on income-financed consumer spending. It is therefore reassuring that consumption (public and private) has contributed more than investment to China's growth for the last eight quarters in a row.

Despite the notable decline in the working-age population, urban employment is still expanding at a respectable clip. China added 11 million urban jobs last year, according to figures from the National Bureau of Statistics (and 13.2 million, according to alternative numbers from the Ministry of Human Resources and Social Security).

Strong hiring has helped to shore up household income, which has contributed to resilient consumer spending. The aggregate disposable income of all households grew by 9.5 percent in 2015 (thanks to a combination of modest population growth and brisk income growth), much faster than nominal GDP, which grew by only 6.4 percent. Inequality also narrowed a little: the 80/20 ratio, which compares the disposable incomes of the richest and poorest fifth of households, fell from 10.7 to 10.4. Services accounted for over half of GDP for the first time in decades, a trend that was hastened by the unsustainable stockmarket bubble, but which predated it and will no doubt outlast it.

The biggest threat facing China in 2016 is deepening deflation. Many commentators argue that deflation is the inevitable consequence of Chinese overcapacity. But that argument confuses a microeconomic problem (overcapacity) with a macroeconomic one (deflation). Overcapacity requires a drop in relative prices: products in excess supply need to become cheaper relative to other items. There is no need for the price level as a whole to drop. To help restructure its economy, China needs a different growth mix. It does not necessarily require a lower growth rate.
The onset of deflation suggests instead that China is suffering from inadequate demand. To revive spending, China’s monetary authorities cut interest five times in 2015 as well as lowering reserve requirements. Further monetary easing will be necessary in 2016. But monetary stimulus can have a number of unwelcome side-effects. It can put downward pressure on the currency and encourage further borrowing in an economy that is already highly leveraged. More importantly, monetary easing has not proved terribly effective in raising demand.

The obvious alternative is fiscal stimulus. Tax cuts or higher spending would support demand without pressuring the currency or tempting companies into further debt. The Communist Party’s Central Economic Work Conference held in December called for an increase in the central government’s budget deficit, which could rise well above 3 percent of GDP, according to some analysts. That fiscal impulse will be accompanied by another large debt swap to lower interest costs for local governments, and further bond-financed lending by China’s policy banks.

In principle, this “proactive” fiscal stance should support growth. But does fiscal policy still work in China? Government spending did, after all, grow by over 15 percent in 2015 (excluding debt repayment) without preventing a further slowdown in growth. Some commentators speculate that Xi Jinping’s clampdown on corruption and extravagance has gummed up the fiscal machinery.

There is some anecdotal evidence of this kind of policy paralysis. But on closer inspection, the economy does seem to be responding to stronger government spending. This uptick in the underlying economy has, however, been obscured by the slowdown in the financial-services sector as the stockmarket frenzy ebbed. Subtracting the financial sector from China’s GDP provides a more intuitive portrait of 2015 growth (see chart). It slowed in the first half of the year, then picked up in the last two quarters. That pattern matches the trajectory of fiscal policy, broadly measured. In the first part of the year, China suffered a fiscal tightening, as Lou Jiwei, the finance minister, tried to impose new discipline on the borrowing of local governments. In the latter half of the year, the central government relaxed the new fiscal rules, local-government land sales picked up, and the fiscal impulse turned positive.

### China’s GDP (with and without the financial sector)

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<tr>
<th>Year</th>
<th>GDP excl. financial sector</th>
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<tr>
<td>Q1 2013</td>
<td>6.0</td>
<td>6.0</td>
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<tr>
<td>Q2 2013</td>
<td>6.5</td>
<td>6.5</td>
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<tr>
<td>Q3 2013</td>
<td>7.0</td>
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<td>Q4 2013</td>
<td>7.5</td>
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<tr>
<td>Q1 2014</td>
<td>8.0</td>
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<td>Q2 2014</td>
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<td>Q3 2014</td>
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<td>Q4 2015</td>
<td>6.0</td>
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Source: National Bureau of Statistics

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7 See “China – Q4 growth lacklustre; policy support to stay”, by Lan Shen and Shuang Ding, Standard Chartered, 19 January 2016
8 National Bureau of Statistics
9 Local-government land revenues rebounded by 19.9 percent year-on-year in the fourth quarter of 2015, according to the Ministry of Finance
10 See also “GDP breakdown suggests policy support is gaining traction”, by Capital Economics, 20 January 2016
It is therefore reasonable to hope that China will enjoy stronger growth in 2016, thanks to a more supportive fiscal stance. The prospect of a convincing recovery in China is not priced into global markets, which seem resigned to a further mild slowdown at best and an outright collapse at worst. A pleasant surprise in the Middle Kingdom would no doubt help the shares and currencies of most emerging markets, which are vulnerable to periodic bouts of China anxiety, whether or not they are tightly linked by trade to the world’s second biggest economy. This relief would, however, be felt most strongly in markets like Taiwan, where value-added exports to China amount to over 9 percent of GDP and, Malaysia (8.4 percent). Singapore is also highly exposed to China’s growth: a recent World Bank study concluded that a one percent growth shock in China translates into a 1.2% growth shock in Singapore.

The prospect of further stimulus will, however, fill some observers with dread. They believe that any effort to revive spending will only make China’s problems worse, adding to overcapacity and bad debt. These fears will continue to play on investors’ minds in 2016.

To dig deeper into the overcapacity problem, economists at China’s central bank recently carried out a survey of 696 industrial enterprises in Jiangsu province. It confirmed the intuitive notion that overcapacity is most prevalent in capital-intensive industries using expensive plant and machinery that governments are reluctant to consign to the scrapheap. But it also pointed out that China often suffers from overcapacity and undercapacity in the same sector. Its solar-panel makers, for example, are far from self-sufficient in polysilicon, prompting the government to ban imports in an effort to wean local producers off their dependency on foreign suppliers. In another, trivial example, Li Keqiang complained that China makes 80 percent of the world’s ballpoint pens, but must still import high-quality steel balls and casings from Switzerland.

Peak overcapacity

Source: National Bureau of Statistics

11 World Bank Global Economic Prospects, Regional Integration and Spillovers, East Asia and Pacific, January 2016
China does not suffer from overcapacity in everything. Far from it. The bulk of the problem is concentrated in five industries (coal mining, cement-making, flat-glassmaking, iron smelting and rolling, and aluminum smelting) that together employ 10.7 million people (or less than 3 percent of urban employment) 14. Light on labor, these industries are however, heavily encumbered by liabilities. According to Mali Chivakul and W. Raphael Lam of the IMF, just 50 companies (mostly in real estate, construction, mining and utilities) accounted for about half of the debts of China’s listed firms, based on 2013 data.

The opponents of stimulus assume that any attempt to revive the pace of spending must also replicate the pattern of spending that created China’s problems in the first place. They fear another round of purblind investment in moribund mines, mills and smelters. But contrary to these fears, the mix of China’s spending is already evolving. The past year’s government spending includes an additional 26 percent spent on environmental protection and energy conservation. The composition of China’s investment spending has also changed dramatically. Every one million yuan of fixed-asset investment now uses 44 tonnes of cement and 13 tonnes of steel 15. Five years ago, it used 74 tonnes and 25 respectively. Thus the cement- and steel-intensity of China’s fixed-asset investment has dropped by over 40 percent in five years.

In principle, therefore, China’s government can increase demand and reduce excess capacity at the same time. At the Central Economic Work Conference in December, removing excess capacity was listed as one of the five priorities for the year ahead (alongside reducing housing inventory, cutting corporate costs, deleveraging and shoring up backward industries and locales). But the conference also called for a moderate expansion of overall demand 16. Many will question the government’s resolve to shutter or consolidate superfluous plants. They fear that vested interests will combine to prevent any harm befalling favored state-owned enterprises. This kind of resistance has, for example, thwarted previous high-profile efforts to clear excess capacity, such as the State Council’s October 2013 guidelines, announced with some fanfare on the eve of the third plenum. Of the 696 Jiangsu firms surveyed by China’s central bank, 63 percent said that the 2013 plan had little or no effect, partly because local governments showed no enthusiasm to implement it.

However, the evidence of the past year contradicts the notion that state-owned enterprises will not be permitted to suffer. Little noticed by the media, China’s state-owned industry has suffered the kind of “hard landing” many have long predicted for the economy as a whole. In September, the production of China’s industrial SOEs shrank by 1.4 percent year-on-year, their worst month ever recorded in data going back to 1999 17. In 2013 and 2014 combined, employment in industrial state-owned enterprises fell by 7.7 percent, according to the National Bureau of Statistics, including a scarcely believable 72 percent decline in state-owned mining jobs.

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14 CICC, based on a data series that was discontinued in 2013. Citi Research has calculated that three of those industries—steel, coal, and cement—employed over 12 million people in 2015.
15 “Agony of De-Capacity”, Citi Research, 11 December 2015
16 http://www.chinadaily.com.cn/china/2015-12/22/content_22777189.htm
China’s industrial output (gross value-added)

China may also be nearing “peak overcapacity”. In 2015 production of crude steel fell by 2.3 percent, cement by 4.9 percent, plate glass by 8.6 percent, raw coal by 3.5 percent and pig iron by 3.5 percent. Capacity utilization in China’s steel and aluminum industries bottomed out in 2014, according to Citi research, and will do so in copper next year. In Jiangsu, utilization has increased in shipbuilding, photovoltaics and wind-power manufacturing, according to the PBOC survey (see charts).

In December, 14 of China’s biggest aluminum smelters said that they would not restart mothballed plants nor would they add new capacity in 2016. According to Citi Research, 25 steel mills with capacity worth 46.4 million tonnes were shuttered in 2015, and in January, the State Council announced plans to cut another 100-150 million tonnes 18. Further SOE consolidation, along the lines of China Minmetals’s acquisition of China Metallurgical Group, also appears likely 19.

The renewed effort to curb overcapacity will be painful for China’s metals and materials sector, as well as the banks that lend to them. The combination of capacity cuts and fiscal easing in China might, however, offer a glimmer of light for some of the country’s hard-pressed foreign competitors over the medium term, especially in countries such as Japan, Mexico and (to a lesser extent) South Korea that have benefited from currency declines against the yuan. If Beijing fails to follow through on its commitment to cut capacity, hoping instead to export its way out of trouble, these competitors can also hope that their own governments will raise anti-dumping duties to protect them.

18 http://www.reuters.com/article/china-economy-steel-idUSL8N1580D2
http://www.reuters.com/article/us-china-aluminium-cuts-idUSKBN0TU0YG20151211

Citi estimates that China’s excess steel capacity amounts to 250 million tonnes.

19 Will this kind of M&A activity reduce production—or will it just reduce the number of firms? According to economic theory, monopolists produce less than duopolists, which produce less than competitive firms. Consolidation should therefore help reduce overcapacity, https://en.wikipedia.org/wiki/Cournot_competition
The past 12 months have shown that China's internal policy dilemmas can have dramatic global spillovers in the financial markets. I expect that will remain true in 2016. But those spillovers need not always be bad. If Beijing can revive inadequate demand and curtail excess supply at the same time, the global ramifications could provide some promising investment opportunities.
The United States

US equities were flat for 2015 and have tumbled in the early weeks of 2016. According to W. Charles (“Chuck”) Cook, Portfolio Strategist for the Large-Cap Value team at The Boston Company Asset Management (TB CAM), corporate earnings fell short of expectations for a variety of reasons, including weak economies overseas, a strong US dollar, and the dramatic decline in energy prices. Investors have been uncertain about the timing and pace of Fed tightening. They have also been unsure about the US economy’s ability to withstand global turmoil. Those twin sources of uncertainty have led to several bouts of volatility and heightened risk aversion over the past 12 months.

The US recovery has nonetheless been strong enough to prompt tighter monetary policy from the Federal Reserve. As investors braced themselves for this tightening, the relentless rise of risk assets came to a halt. “Risk and multiple expansion were no longer the primary drivers of return,” notes Chuck. Yield also lost some of its appeal last year as investors realized they were overpaying for it. Instead of these factors, earnings and business momentum assumed greater importance. “Such an environment is conducive to active management,” Chuck points out, with stock selection driving strong relative performance.

Chuck’s team believes that the US economy will continue to grow at a modest pace. It expanded by 2 percent in the second half of 2015, compared with a year earlier 20, and could grow faster in 2016 21. “There’s a lot of stimulus in this economy that really hasn’t been felt yet,” Chuck notes.

“The strong labor market, low levels of consumer debt, and low energy prices have given the consumer the spending firepower to satisfy their pent-up demand for housing, autos and other products and services,” Chuck argues.

US growth has been restrained in recent years by overseas weakness. But the massive reflationary response in Europe and Japan will likely stabilize those economies, Chuck believes. China’s policymakers have also turned to a mix of pro-growth fiscal and monetary policies designed to ease the country’s transition to a more consumer-led economy.

The US Federal Reserve is tightening monetary policy, but at a gradual pace that will not derail growth. “As long as they’re not raising interest rates because of inflation, we’re not too nervous about the Fed hiking cycle,” Chuck says. Inflation does not appear to be a threat. We’ve seen some “very modest hints of wage gains”, Chuck notes, but not the dramatic acceleration of wages that might raise concerns about a wage-price spiral.

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20 Bureau of Economic Analysis, “Advance” Estimate

“Even though hiring has improved considerably, there’s still slack in the job market,” Chuck says. Many Americans who lack jobs have also stopped looking for work, resulting in an unusually low labor-force participation rate that is well below “what it once was when the economy was hotter”. In addition, while US monetary policy is tightening, fiscal policy is poised to loosen as the United States approaches the 2016 elections.

To the financial markets, such robust growth would be a surprise, to put it mildly. “The economic situation that’s discounted by the markets, particularly if you look at bond yields, is pretty dire: a sustained period of weak economic growth; low, low, low inflation and even deflation in some cases,” Chuck notes.

Chuck’s confidence in the US economic recovery translates into an optimistic outlook for US stocks in the years ahead. “We continue to believe that the equity market can deliver high single-digit to low double-digit total returns over the long term,” Chuck says. “We think the current market multiple is fair. But in a low inflation, low interest rate environment, the market multiple often exceeds its average. So you could see some modest expansion of the multiple. However, we think most of the returns are going to come from a combination of the dividend yield and earnings growth, which we think can improve this year. If you have a dividend yield of 2.2 percent (its level at the end of 2015), and you have earnings growth of 5-7% that will generate total returns in the high single digits. If you get multiple expansion as well, that takes returns into the low double digits.”

The opportunities for stock selection remain “fertile” in 2016, he argues. Whether or not the market as a whole is fairly priced, valuations within it are highly dispersed. Some industries (such as utilities) are generously valued, compared with their own past. Others, such as financial companies, are trading at substantial discounts to their historical averages. Companies within the same industry also trade at very different multiples. “The dispersions in valuations between sectors is as big as I’ve seen in my career,” notes Chuck’s colleague, Brian Ferguson, senior portfolio manager of TBCAM’s Dynamic Large-Cap Value strategy.

New technologies will also create winners and losers that can be identified through fundamental analysis, Chuck argues. “We’re in a time, I think, of tremendous technological innovation. The car companies, for example, are rapidly pursuing self-driving cars, which is combined with improvements in energy efficiency, the electrification of the fleet and the growth of the ride-sharing economy.

Amid this dispersion, growth stocks outperformed value stocks by a large margin over the last 12 months. This divergence was partly due to the troubles of the energy and materials sectors, which are heavily represented among “value” stocks. At the same time, the positive performance of growth stocks reflected the outsized impact of a narrow group of technology companies. Despite this recent pattern, “we believe that value stocks will outperform growth over the long-term,” Chuck says, “as they have done for the past 100 years.”

Chuck’s team favors economically sensitive, attractively valued sectors over expensive, defensive ones like Utilities (which has a zero weight in their portfolio). They have a favorable view of

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23 The price-earnings ratio of the utilities sector is well above its long-term average, according to Fundstrat.

24 The price-book ratio of firms in the financial sector is substantially below the long-term average, according to Empirical Research Partners Analysis.
Information Technology, finding attractively valued companies that will benefit from compelling product cycles. Similarly, 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.

The United States has been “underinvesting”, Chuck says, because of uncertainty about the global recovery. That has left a lot of “pent-up demand” for capital expenditure and residential investment, he argues. Young people, for example, are eager to move out of their parents’ homes and start households of their own. That will help homebuilding. The government also recently passed a big highways bill (known as the FAST Act 25), which will raise infrastructure spending. Other kinds of fiscal spending also enjoy bipartisan support. “In the run-up to elections, both parties like to agree on the need for higher defense spending,” Chuck notes. His team is therefore overweight defense companies and construction-aggregate companies that benefit from US economic strength 26.

Chuck’s investment thesis rests on stronger consumer spending as well as pent-up capital spending. His team is overweight Consumer Staples, an industry that is consolidating and cutting costs dramatically, under the pressure of activist investors, following a template laid down by Warren Buffett and 3G, a Brazilian private-equity firm. His team has accumulated holdings that are attractively valued and sensitive to a pickup in GDP growth.

Robust economic growth will eventually invite higher interest rates, even if the tightening remains gradual. That 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 — one of several reasons why the sector appeals to his team. Financials are trading at significant discounts to their book value due to concerns about a global economic slowdown and energy-related loans. However “the balance sheets of these companies are as strong as they have ever been,” Chuck says. “They are capable of withstanding severe economic and capital-market weakness— well beyond the stresses we anticipate.” Other reasons to favor financials include attractive valuations and the prospect of faster earnings growth, driven by expanding loanbooks and brisker activity in the capital markets, including a “reasonably firm” pace of mergers and acquisitions.

Chuck’s team acknowledges that their optimistic outlook for equities faces a number of risks. The rest of the world’s economies might continue to struggle, hurting US exports and corporate earnings. If the US economy outperforms, the dollar is likely to strengthen further, eroding the earnings of US multinationals. However, they believe that the weakness overseas has been heavily discounted by the market and that several overseas economies have responded with a potent mix of fiscal and monetary measures which will gradually lead to stronger growth.

The oil price also poses dangers. On balance, cheaper oil should benefit the US economy. However the benefits percolate through the economy slowly while the damage hits the energy industry immediately. This dynamic has dampened earnings and stock prices and might continue to do so. Furthermore, if energy remains excessively cheap for a long period, it could spur geopolitical turmoil in some oil-exporting emerging markets.

The G4: Undiminished Expectations Investment Opportunities
India

India’s economy grew by an impressive 7.4 percent in the third quarter of 2015 and should remain robust in the next fiscal year, according to the professional forecasters surveyed by India’s central bank. Its recovery owes a lot to macroeconomic good fortune. The drop in oil prices has been “tactically beautiful,” notes Gaurav Patankar, Portfolio Manager at The Boston Company Asset Management, providing a “strong tailwind”. The country’s import bill for crude has fallen by 40% in dollar terms. That has curbed India’s current-account deficit and tamed inflation, allowing its central bank to ease rates, and giving the government significant “breathing room”. Indeed, India may be one of the few economies that has enjoyed the textbook benefits of cheaper crude that seem to have eluded other large oil consumers around the world.

Some economists estimate that the bonanza added as much as 1.3 percentage points to India’s growth over the 12 months ending in September. That tailwind may not last: if energy prices do not keep falling, they cannot keep adding to growth. Gaurav worries that the government has taken its good fortune for granted — it has not, for example, taken advantage of bargain-basement prices to build a strategic petroleum reserve or any similar buffer. In some ways, cheap oil has made the trade deficit and fiscal deficit “look a little too good too soon,” Gaurav argues. If these twin deficits had remained an urgent macroeconomic worry, the government might have done more to rationalize public spending, raise revenue and promote exports. “Like any other politicians, India’s leaders get complacent. They don’t do anything, unless they have to do it.”

Thus even as outside investors have been pleasantly surprised by the speed of India’s macroeconomic rebound, they have been frustrated by the pace of structural reform. Gaurav is more philosophical. He thinks reform expectations were always too high: the Bharatiya Janata Party’s election victory in May 2014 — which gave it the first single-party majority in 30 years — was “a pivotal moment for India,” Gaurav says, but the turn was always going to be gradual. “You cannot change somewhere as complex as India by flicking a switch,” he points out.

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27 https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=16891#CI8. India’s fiscal year begins on April 1st
28 Over the last 9 months of 2015 compared with a year earlier. http://commerce.nic.in/tradestats/PressRelease.pdf
The government led by prime minister Narendra Modi has the right long-term goal, Gaurav says, which he characterizes as a sharp focus on “de-bottlenecking” — removing binding constraints to investment and growth. Progress may be slower than naïve optimists expected. But a faster pace may not be possible given the political constraints any Indian government faces. They are moving as fast as they can, if not as fast as many hoped.

Several ministries are making headway. The Minister for Road Transport and Highways (Nitin Gadkari), the Railway Minister (Suresh Prabhu) and the Minister for Power, Coal, New and Renewable Energy (Piyush Goyal) have political clout, as well as administrative energy. They are keen on monitoring progress, keeping bureaucrats, investors and contractors on their toes, and removing obstacles in their path. Gadkari aims to muster 7 trillion rupees-worth ($104 billion) of investment in roads by March 2019. The railways ministry for its part hopes to drum up more than $140 billion over five years. Some of this money will take the form of foreign-direct investment, which is now uncapped in many parts of the railway service, including high-speed rail, rolling stock and passenger terminals. As experienced politicians with some standing in their party, Gadkari, Prabhu and Goyal know how to overcome political impediments to progress. “You need politicians doing it; you can’t have technocrats,” Gaurav says. “This is not Singapore.”

Two questions loom over the year ahead, in Gaurav’s view. Will the government finally pass the Goods and Services Tax? And will it revive credit by repairing the public-sector banks?

In answering the second question, Gaurav draws an interesting contrast between the government’s bold approach to electricity and its tentative approach to credit. Both electric power and bank lending are vital economic inputs and both suffer in India from frequent interruptions and diversions in supply. Both sectors require a combination of rescue and reform: rescue from past mistakes and reform to prevent future ones. The government’s latest attempt to improve electricity distribution tries to do both. When it comes to the public-sector banks, however, things are different. The government’s desire to reform them seems to have delayed its efforts to rescue them.

The government is keen to improve the flow of electricity, hoping to replicate, on a national scale, the success Modi achieved in his previous position as chief minister of Gujarat. To do so, Delhi first has to tackle the debts weighing on India’s electricity distribution companies, most of them owned by state governments. Under Goyal’s leadership, the ministry for power has unveiled a plan to clean up the distribution companies’ 4.3 trillion rupees of liabilities and prevent their recurrence.

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31 http://dipp.nic.in/English/acts_rules/Press_Notes/pn8_2014.pdf
32 http://pib.nic.in/newsite/PrintRelease.aspx?relid=130261
The plan will bring three quarters of the outstanding debt on to the state governments’ balance sheets. This legacy debt will not count against the state governments’ deficit and debt targets, but future liabilities will. That should deter state governments from repeating their mistakes by doling out underpriced electricity to favored groups — because the costs will appear on their own books rather than hiding on the ledgers of the distribution companies. The debt relief will also allow these firms to resume buying and distributing power, unclogging a vital economic artery.

Unfortunately, this comprehensive electricity plan has not been matched by an equally ambitious solution to India’s clogged credit system. The country’s state-owned banks (public-sector banks or PSBs) are struggling to digest the non-performing loans left on their books by a wave of ill-advised investment in the boom years. That has made them reluctant to lend, which has, in turn, stifled further investment.

To absorb their lending losses, the public-sector banks will require 1.8 trillion rupees or $26.6 billion of extra capital over the next three years, according to the government’s estimate. Other unofficial estimates are even higher. Last summer, India’s government outlined its plan for recapitalizing the banks. But it set aside only 700 billion rupees ($10.4 billion) over four years to fill the capital shortfall. That amounts to “peanuts”, according to Gaurav. To be successful in restoring confidence, a bank rescue plan has to be big enough to “shock and awe” the market, he argues.

One way to repair the PSBs would be to move their non-performing loans into a “bad bank”. In addition, the government could encourage mergers and acquisitions, laying out a long-term vision for consolidation. A further, more imaginative approach would be to unlock the hidden value of the banks’ real assets, above and beyond their loan books. By Gaurav’s back-of-the-envelope calculation, the 24 PSBs between them own real-estate, including branch properties, worth about $100 billion, which is several times the size of the capital shortfall in the system. These assets are not typically carried on their books at anything like their market value. Gaurav is not suggesting that the PSBs could sell this real estate en masse. But by calculating its value and publishing the results, the banks would provide a more reassuring portrait of their underlying solvency, which might encourage outside investors to stump up further capital.

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33 http://pib.nic.in/newsite/PrintRelease.aspx?relid=124107
34 By way of comparison, India’s government estimates that the public-sector banks will require 1.8 trillion rupees or $26.6 billion of extra capital in the years up to March 31st 2019. http://pib.nic.in/newsite/PrintRelease.aspx?relid=124107
To its credit, the government wants to combine a bank rescue with bank reform, changing the incentives that led to poor lending decisions in the first place. But those incentives are deeply entrenched. They extend beyond the banks to encompass the politicians who cajole the banks into making dud loans and the businessmen who receive them. Modi’s government may not have time to reform the banks before rescuing them. If he wants to win a second term in 2019, the economy will need to be growing vigorously by 2018, Gaurav points out. For the economy to enjoy brisk growth by 2018, credit needs to flow freely in 2017. And if credit is to flow freely next year, the government will have to repair the public-sector banks’ balance sheets this year.

The other big question facing India in 2016 is the fate of the long-awaited Goods and Services tax (GST), first recommended by an expert panel in 2004. The GST will replace a patchwork of indirect taxes collected by the central government and the states, including the notorious “octroi”, charged on goods entering some states from elsewhere in the country, and the Special Additional Duty, or SAD, levied on imports. These taxes leave the Indian market highly fragmented: It is six times as expensive to trade across Indian state lines as across US state lines. Trucks cover only a third as much ground per day, partly because they have to stop and wait to pay each state’s border taxes. “I have seen so many trucks lying around at octroi checkpoints doing nothing,” Gaurav notes.

The new tax will help to unify India as a single market, allowing firms to serve the entire nation from wherever in the country suits them best. The GST should also boost investment by allowing a broader range of firms to claim credits for the tax they pay on capital goods. The ultimate benefits to growth are easy to imagine but not easy to calculate — estimates vary from 0.5 percent to 1.5 percent of GDP.

The GST has been stuck thanks to some “nitty-gritty political maneuvering,” Gaurav notes. But it commands a broad consensus of support across parties and should pass. “It has to happen,” Gaurav insists. “Modi has invested too much political capital in it to abandon it now.”

35 http://finmin.nic.in/reports/5.pdf
36 http://www.finmin.nic.in/the_ministry/dept_revenue/Report_Revenue_Neutral_Rate.pdf
Amid widespread disillusionment with emerging markets, India remains relatively popular with overseas investors. “Positioning has been heavy,” Gaurav acknowledges. The country’s appeal is hardly surprising given that no other major economy can hope to deliver 7-8 percent real growth, over the medium term. These growth rates look even more impressive in comparison with sluggish expansions elsewhere. The combination of India’s economic size and its growth gap justifies the foreign attention it has received, Gaurav believes. Its trailing P/E ratio is significantly higher than its five-year average and he expects that multiple to diminish slightly. But he 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

It may be hard to remember now, but Japan was one of the best performing major stockmarkets in 2015—even in dollar terms. That surprised many critics of Abenomics, the campaign to reflate Japan’s economy named after Shinzo Abe, prime minister for the past three years. Abenomics has entailed aggressive monetary easing, some reshuffling of taxes, and piecemeal structural reforms, including improvements in corporate governance, with the aim of lifting spending, wages and prices. According to conventional wisdom, progress has been mixed at best. Growth has been choppy and headline inflation remains low. According to its critics, Abe’s signature policy has succeeded in weakening the currency, but little else. As 2015 began, many investors believed that Japanese share prices might rise in response to further easing from the country’s central bank. But they assumed that any local-currency gains would be offset by yen falls.

As it turned out, the Bank of Japan kept its monetary policy largely unchanged in 2015 (with the exception of a December tweak in the maturity of its bond purchases and the size and scope of its ETF purchases). The yen ended the year almost flat against a strong dollar. Despite this, share prices rose by over 9% in 2015, according to the Tokyo Stock Exchange.

In the first months of 2016, the inverse correlation between the yen and the stockmarket has reasserted itself with a vengeance. After the Bank of Japan introduced a negative interest rate on new bank reserves, the yen weakened and stocks rose. This pattern then sharply reversed itself—with the yen rising and stocks falling—as investors around the world began to worry that negative interest rates in Europe and Japan would harm banks more than they helped the economy. The conclusion for investors seems to be that Japan’s shares can thrive without a weak yen, but they cannot thrive with a strong one.

Although it has been overshadowed by its giant neighbor, Japan remains a prosperous, sophisticated country. Doomsayers like to talk about Japan’s mountainous public debt. Less often discussed is the country’s impressive stock of national wealth, which amounted to 635 percent of its annual GDP at the end of 2014, according to a comprehensive measure by Japan’s Cabinet Office. That figure includes real assets like land and property, as well as the world’s largest stock of net foreign assets, which exceed even China’s, according to figures reported to the IMF.

Japan’s equity markets still account for almost 9 percent of the widely followed MSCI World index. Those markets also seem to offer substantial diversification benefits to global investors: in a 2014 comparison of 16 developed-country equity markets, Japan’s was the least correlated with the rest of the world’s markets.
The authors of that study (“Correlation Dynamics and International Diversification Benefits” by Peter Christofferson of the University of Toronto, Vihang Errunza of McGill University, Kris Jacobs of the University of Houston, and Xisong Jin of the University of Luxembourg) went on to construct a stylised portfolio of global equities that seeks only to maximize the benefits of international diversification. In such a portfolio, Japan would warrant a weight of over 20 percent in the most recent period studied (see chart).

**Japan’s optimal weight in a portfolio that maximizes the benefits of international diversification across equity markets**

![Graph showing the optimal weight of Japan in a portfolio maximizing international diversification benefits over time.](source: peter christofferson, vihang errunza, Kris Jacobs, Xisong Jin)

Despite these virtues, Japan has suffered from a peculiar macroeconomic predicament over the past two decades. Thanks to stubborn deflation, its nominal GDP (the yen value of its annual output, without making any adjustment for changing prices) has remained more or less flat for over 20 years. It was about 500 trillion yen (at an annual pace) in the third quarter of 2015 (according to Japan’s Cabinet Office) and it was much the same amount in the third quarter of 1994. This flatness is a macroeconomic oddity: it is hard to find another economy quite like it. Even a country like Italy, which is often portrayed as sclerotic and greying, nonetheless managed to raise its nominal GDP by 85 percent over a similar period.

The unbearable flatness of Japan’s nominal GDP is not because real growth has been unremittingly weak. The economy has enjoyed periodic booms in real output over the past two decades, most notably the Koizumi boom before the global financial crisis. Nor is Japan’s stagnation simply the inevitable result of demographic decline, although that has not helped. The failure of Japan’s nominal GDP to grow is instead the consequence of chronic deflation. If, instead of falling, Japan’s prices had risen by just 2 percent a year over the past two decades, its nominal GDP would now be over 70 percent higher than it is, all else equal.
Why does this nominal flatness matter? Surely people only care about “real” variables, like real GDP and real wages, which strip out the effect of changes in prices. However, according to Miyuki Kashima, Head of Japanese Equity Investments at BNY Mellon Asset Management Japan, the stagnation of Japan’s nominal GDP has inflicted insidious damage on the real economy. It has distorted corporate behavior and household sentiment, as well as enlarging Japan’s debt burden and neutering its monetary policy. In many ways, Japan’s nominal GDP feels more “real” than the inflation-adjusted number. If pay packets are getting thinner, households will feel inhibited in their spending, even if shopping bills are also shrinking. Likewise, if corporate revenues are contracting in nominal terms, bosses will be reluctant to borrow and invest, even if wages and costs are also falling. In the deflationary era, Japan’s corporations have proved to be inveterate hoarders, accumulating over 1 quadrillion yen in financial assets, including cash, rather than investing in capital expenditure, paying higher wages, or returning profits to shareholders.

Thankfully, this long period of nominal stagnation appears to be ending. Although headline inflation remains low in Japan, that is largely the result of falling energy costs. Remove energy as well as fresh food from the index and consumer prices have clearly turned around since Abenomics began.

About two-thirds of the items in Japan’s consumer basket are now becoming pricier, including ketchup — to cite one famous example — which has risen in price for the first time in 25 years. The official index may also understate the turnaround because it is slow to reflect changing consumption patterns. A more timely index, based on point-of-sale data in stores, published by Nikkei and the University of Tokyo, suggests consumer prices rose by almost 1.3% year-on-year in December.
The end of deflation, coupled with fitful real growth, has begun to rouse Japan's nominal GDP out of its long slumber. Indeed, over the entire period since Abe returned to power, nominal GDP has grown at its fastest rate since 1997, expanding, year-on-year, for the past ten quarters in a row. That should translate into healthier top-line corporate revenues and more generous pay packets for workers. “The fact that nominal GDP is now growing provides our base case, from a top-down point of view, to be positive about Japan,” says Miyuki.

To build on this progress, Abe in September 2015 set an ambitious target to raise nominal GDP to 600 trillion yen (from about 500 trillion now) by early in the 2020s. To grow that quickly in nominal terms, Japan will require a combination of monetary and fiscal accommodation as well as structural reform. The target therefore subsumes Abe’s original three arrows: he will need all of them to reach it. It is not yet clear how seriously the government will take this target. “It’s probably not that important that we get to 600 trillion yen right on the dot in 2020, but the direction matters,” Miyuki says.

“Once the government has that kind of target, if growth does dip below expectations, you can expect a policy response, whether fiscal policy or monetary policy.” The BoJ’s experiment with negative interest rates is one example. There’s also “a reasonable chance the 2017 consumption-tax hike will be postponed,” Miyuki says.

Japan’s nominal GDP growth (Trailing 11 quarters)

The encouraging progress in nominal GDP has not yet translated into equally convincing wage gains. Early indications ahead of Japan’s spring wage negotiations suggest that Japan’s lynchpin companies will raise wages no faster this year than they did last year. But although Japan’s large companies may generate disappointing wage headlines, their core staff tends to be fairly insulated from pay pressures, whether upward or downward. It is the smaller companies, employing less entrenched workers, that perhaps provide a more sensitive barometer of prevailing conditions. Miyuki notes that, according to Recruit Jobs, a temporary worker agency, the hourly wage of temporary workers has increased year-on-year for 31 months in a row. It is now 8.4 percent higher than it was when Abe returned to power in December 2012.
Although wages gains have been spotty, corporate profits have recovered vigorously in the Abenomics era. “On the base scenario that nominal GDP does grow at 2-3% or so, the earnings outlook still looks reasonably good,” Miyuki argues, “especially given lower oil prices.” The post-2009 rebound in corporate earnings was never fully reflected in the stockmarket. And after the equity market’s recent setbacks, “the gap between the recovery in earnings and the rally in the stockmarket is still quite big. There is still quite a big gap between where the market is and where the market could potentially go.”
The G4: Undiminished Expectations
Investment Opportunities
Conclusion

The opinions expressed 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 the four biggest economies in the world proves as resilient as our contributors suggest, global output will escape the synchronized slowdown or recession that many investors seemed to fear at the start of 2016. In some of these economies, growth may even prove faster this year than last.

If growth were to quicken in 2016 it would not in itself guarantee good investment returns, of course. The relationship between economic expansion and financial-market performance is notoriously mercurial. Some researchers have even reported a negative correlation between GDP growth and equity performance 37.

However, this counterintuitive finding should be handled with care. It was documented and disseminated by Elroy Dimson, Paul Marsh and Mike Staunton in their classic book, ‘The Triumph of the Optimists’. In a later article, the three authors acknowledge that their finding is frequently misconstrued.

“[O]ur cross-sectional evidence might have led some investors to conclude that economic growth is of no value to investors. This would be a misinterpretation of our research, but it is an opinion that we have read and heard.” 38

Their evidence showed a negative correlation between equity returns and contemporaneous growth. As they point out, economic growth is often priced in to forward-looking equity markets before it occurs — or at least before it appears in the official data. The three authors did not show that equity returns are negatively correlated to unanticipated future growth. On the contrary, their subsequent work shows the opposite.

“Buying the equities of economies that are going to have high growth over the years ahead would have generated a far higher annualized real return than buying into economies that are going to suffer poor growth...

“...a perfect prediction of economic growth for the current year also offers investment value. Needless to say, such forecasts are not easy.”

For the past few years, growth has consistently surprised on the downside, forcing abashed economists to cut their forecasts as the year progressed. After an unusually ugly start to 2016, expectations have fallen again. The possibility of quicker-than-forecast growth is not, it is fair to say, given much weight in the markets. If it were to materialize, it would therefore move prices, lifting equities and bond yields out of their current torpor. The four contributors to this paper all express measured confidence in the individual G4 economy they were asked to reflect upon. If that confidence proves well placed, the year should finish better for equity investors than it started.

37 ‘Triumph of the optimists: 101 Years of Global Investment Returns’, by Elroy Dimson, Paul Marsh and Mike Staunton.
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THE G4: UNDIMINISHED EXPECTATIONS

INVESTMENT OPPORTUNITIES