ARE COUNTRY EFFECTS MAKING A COMEBACK IN INTERNATIONAL INVESTING?

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As global economies continue to decouple, policymakers are left with primarily two options to stimulate growth – fiscal and monetary policies. There is limited scope for fiscal stimulus as many governments are not in a position to undertake this path either because of political disagreement about its benefits, or concerns over rising indebtedness. Hence, many countries have chosen the simpler route of expansionary monetary policy. Furthermore, the recent deflationary backdrop is more conducive for monetary easing. But what if interest rates are already low and there is no room for further cuts? There are many countries facing this dilemma today, and unconventional monetary policy has become quite popular. We believe active use of monetary policy – conventional or unconventional -- could lead to increased currency volatility. An increase in currency volatility, coupled with the rise in adverse geopolitical risks could increase the importance of country influences in international investing. As a result, we believe that country effects could increase in significance relative to sector effects -- similar to what was seen in the 1990s before the advent of the euro.

What could be the implications of the rise in country specific influences on international investing, and how do we as investors position ourselves to take advantage of them? First, proper fundamental analysis will have to include an assessment of the inherent risks and benefits of operating in a given country or region. In order to be of value the analysis will have to go beyond strategic industry and product positioning, to the point of understanding country exposures. Second, risk management is going to have to focus more on country and perhaps, less on sector allocation. Third, should country influences continue to increase significantly, it raises the question of whether research departments should go back to being organized along geographic lines rather than global sectors.

It should be added that this paper is meant to be an intellectual thought piece focusing on changing dynamics in international investing. We want to be aware of the changes that could be taking place in the international markets, but it does not mean that we are changing our process. If anything, we at HCM are dedicated to ensuring that we continue to stay true to our investment process. Our investment process focuses on bottom-up stock selection, but also benefits from macroeconomic analysis. We continue to focus on identifying the most attractive companies in each region, sector and industry, and optimally constructing a portfolio which contains them. Attractive companies are defined as those that are priced attractively relative to the returns that they have proven to be able to generate. In trying to understand the sustainability of returns, we analyze industry dynamics and market positioning as well as geographic exposure.

In this paper, we first compare country and sector effects in developed and emerging markets. Then we analyze the active use of monetary policies in major economies followed by a discussion on the current inflation environment, increase in currency volatility as well as rise in geopolitical risks.

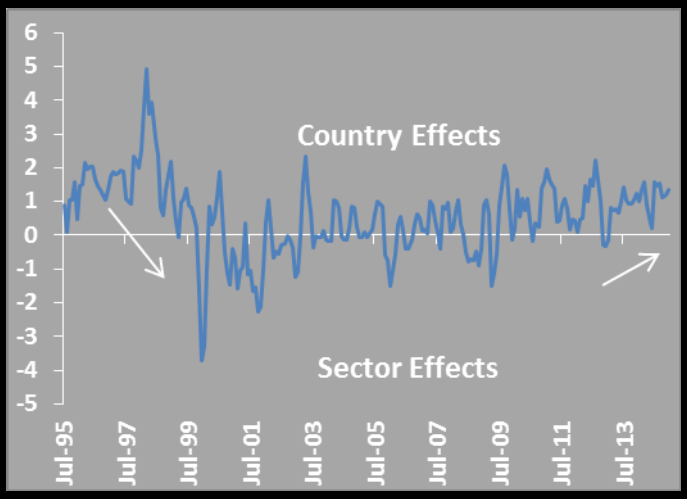
Country versus Sector Effects in International Investing

We present country versus sector effects for developed markets in Exhibit 1. The line in this chart denotes the difference in dispersion between country returns and sector returns; when country dispersion is higher than sector dispersion, the line is positive and vice versa. The analysis is based on monthly MSCI data from January 1995 to December 2014. As depicted in this chart, country effects were more important in the 1990s. There were several reasons for this. In 1993, Germany went into recession after reunification, followed by a sharp slowdown in China, when GDP growth declined from 14.2% in 1992 to 7.6% in 1999. Additionally, the Mexican Peso crisis in 1995 was followed by the Asian contagion in 1997 and the Russian monetary crisis in 1998. These events had a strong impact on certain countries and regions that disproportionately affected select equity markets, thus increasing country dispersion.

However, in the 2000's we saw country effects decline while sector effects increased. What led to the rise in sector effects? First, there was the advent of the euro. At the end of 1998 when 12 EU countries did away with their legacy currencies and adopted the euro as their common currency, the result was that a major source of country and currency volatility disappeared from the marketplace. In such an environment it is easy to see how sector came to play a more dominant role. Also playing a key role was the Technology, Media and Telecom (TMT) bubble when there was great interest in dot-com, internet or network related companies. It did not seem to matter to investors where these companies were domiciled; they commanded high valuations in the late 1990's up until 2000. Nortel

Networks in Canada, Deutsche Telekom in Germany and Kyocera in Japan are just a few examples of such TMT companies. Nortel Networks declared bankruptcy in 2009 while, even after 15 years, the stock prices of Deutsche Telecom and Kyocera are still trading at a fraction of where they were during the bubble. In the run up to the TMT bubble and the subsequent crash in March 2000, it was important to pick the right sector or avoid certain sectors, in order to be able to generate alpha.

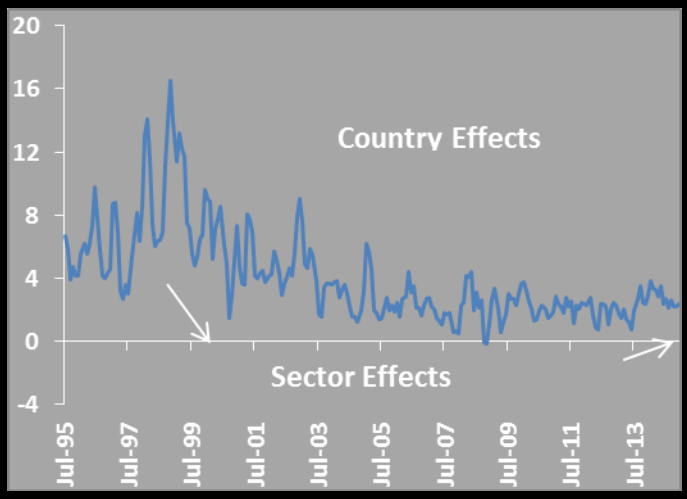
Exhibit 1. Country versus Sector Effects for MSCI EAFE



Source: Bloomberg, MSCI and Herndon Capital Management, LLC.

The TMT bubble was quickly followed by the commodity super cycle in the last decade, when commodities from iron ore to nickel to aluminum, to name just a few, saw all-time high prices on the back of a new growth paradigm in China, as well as a 40% depreciation in the value of the dollar against major world currencies. Companies with exposure to commodities such as Fortescue Mining in Australia or Arcelor Mittal based in Luxembourg saw sky high prices as infrastructure and fixed investment demand from China was thought to be unlimited.

Exhibit 2. Country versus Sector Effects for MSCI Emerging Markets



Source: Bloomberg, MSCI and Herndon Capital Management, LLC.

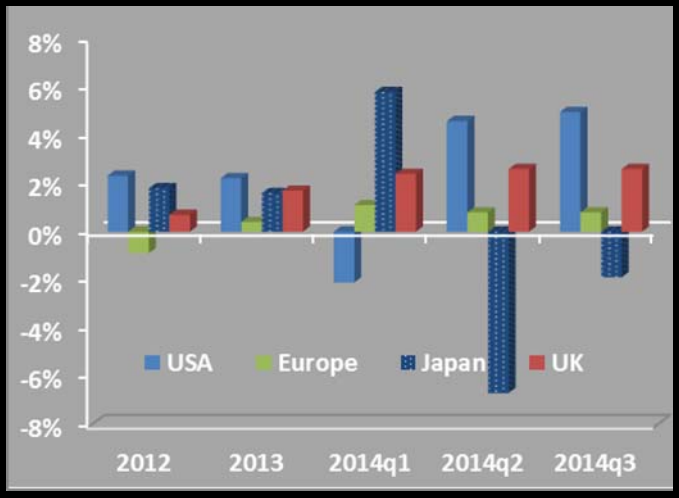
In Exhibit 2, we present country and sector effects in emerging markets. Interestingly, country effects have always been more important in emerging markets given the heterogeneity of these markets. For practitioners investing in emerging markets equities, it has always been important to be aware of the business cycle and macroeconomic developments in each country. However, over time, the rise in sector influences has diminished the importance of country effects, even in emerging markets.

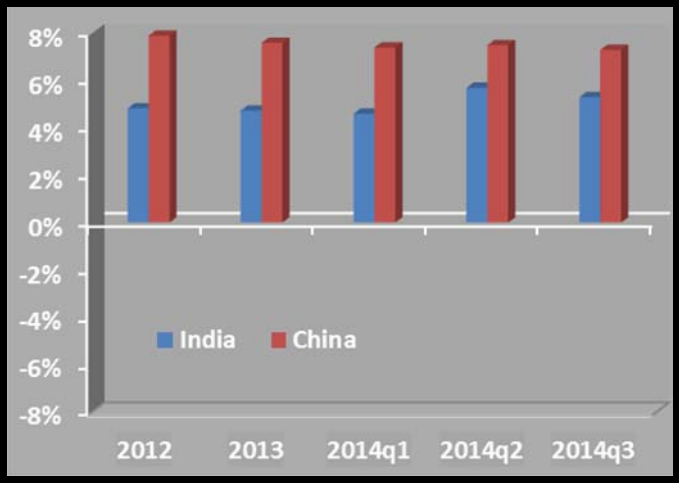
As presented in Exhibit 1 and 2 above, sector effects have diminished in the last few years. We believe this is related to the divergent responses on the part of governments and central banks to provide stimulus since the Global Financial Crisis in 2007-08. We believe these country influences are likely to become more pronounced as we see continued divergence in growth, with global growth even more dependent on central bank policies as economies try to contain deflation, and geopolitical risks move to the forefront.

Active Use of Monetary Policy

We present growth rates in select countries and regions in Exhibit 3. As shown in the first chart, US GDP growth has accelerated over the last few years reaching an 11 year high of +5% in the third quarter of 2014. By contrast, Japan went into technical recession and the Eurozone barely expanded at +0.2%. In the second chart below, we compare the growth rates in China and India. While the growth rate in China is higher than in India, China's growth rate has decelerated to the slowest pace in 24 years at +7.3%. By contrast, India has experienced faster growth. The International Monetary Fund recently lowered the global growth outlook for 2015 to 3.5%, a downward revision of 0.3%.

Exhibit 3. Gross Domestic Product Growth: Select Countries and Regions





Source: Bloomberg

As economies continue to decouple, with countries like the US, the UK and India growing faster, slower growth economies such as Europe, Japan and China are left with two choices to stimulate growth – expansionary monetary and fiscal policies. But as we present in Appendix 1, government debt is already high in major economies. For example, government debt in Japan is at 234% of GDP while Italy is at 139%. Hence, the obvious choice is monetary easing, and the simplest stimulus is to cut policy rates. But, what if interest rates are already low? As presented in Appendix 2, many economies are facing this very dilemma. Thus unconventional monetary easing such as quantitative easing (QE) has taken center stage.

The United States was one of the first countries to start QE in the aftermath of the Global Financial Crisis in 2007-08. Hence, after six years, the US is actually at the tail end of its QE program. The Bank of Japan, on the other hand, just ramped up its monetary easing program while Europe is only just getting started. At the end of October, in a surprise move, the Bank of Japan raised its QE target to ¥80 trillion from ¥60-70 trillion. The ECB on the other hand, has been slow in increasing its balance sheet. ECB President Mario Draghi finally announced that the bank will purchase €60bn worth of bonds per month from March 2015 to at least September 2016, which amounts to a minimum of €1.1tn. This includes purchases of covered bonds, asset backed securities, as well as sovereign bonds. The ECB plans to buy sovereign bonds in proportion to the relative size of its member countries.

Many countries have followed conventional monetary policy by cutting their policy rates. China has had three rounds of monetary stimulus in the last four months. The People's Bank of China cut the one year lending rate twice by a total of 65bps to 5.35% and the reserve requirement by 50bps to 19.5%. More recently, numerous countries have cut their policy rate; for example, Australia, Singapore, Denmark, Canada, Norway, Switzerland, Egypt, India, Indonesia and Turkey.

By contrast, there are only a few countries that have increased their policy rates of late. Russia and Brazil are the notable few, which have increased rates to support their currencies. Brazil increased their policy rate by 125bps in the last two months while Russia increased their rate by 675bps in one fell swoop from 10.5% to more than 17%. However, in a haphazard manner, Russia

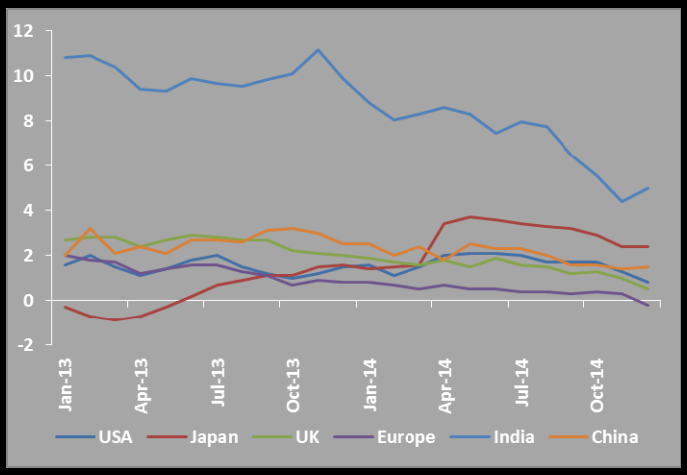
reversed course by cutting their policy rate by 200bps at the end of January 2015.

As economies are awash in easy money, it begs the question of whether monetary easing alone will be able to stimulate growth to an adequate degree. Also, as many countries find themselves in a low interest rate environment, the bigger question is whether unconventional monetary policy will lead to higher growth? The United States and the UK, two economies that are experiencing higher growth, were also the first to embark on QE. The Fed quadrupled the size of its balance sheet over three cycles of QE, while the Bank of England followed with three rounds of gilt purchases totaling £375bn. Martin Weale with the Bank of England found that 1% worth of asset purchases boosted UK GDP by 0.18% and inflation by 0.3%. Similarly, John Williams with the San Francisco Fed concluded that quantitative purchases helped reduce US unemployment by 1.5% in 2012, and also prevented the US economy from falling into deflation. However, there remains a great deal of uncertainty on the effects of QE. The ECB's Mario Draghi has repeatedly said that quantitative easing by itself is not enough. Japan had one round of QE, which did not result in higher growth, but Japan also introduced fiscal tightening as the consumption tax was increased from 5% to 8% last April. We will have to wait and see how effective QE is in Europe and Japan. Nevertheless, as growth continues to decouple and some major economies experience slower growth, we believe there will be plenty of monetary easing and monetary policy will remain unsynchronized. This we believe will lead to divergent performances amongst equity markets in different countries.

Current Inflation Environment

We present the inflation rate in select countries and regions in Exhibit 4. As shown in this chart, the current inflation environment is benign and perhaps, even disinflationary. The inflation rate in the US dipped to 0.8% in December while inflation in Japan has fallen to 2.4% despite substantial quantitative easing. Similarly, Chinese inflation is at 1.5%. The Eurozone, on the other hand, has slipped into deflation with CPI declining -0.2%. The oil price decline in the second half of 2014 has had a negative impact on inflation; energy is on average 10% of the CPI basket in OECD countries (Appendix 3). According to Bank of America Merrill Lynch, 76% of developed markets today have inflation below 1%. Hence, expansionary monetary policy is needed not only to jump start growth, but we believe, also to prevent economies from falling into deflation. In a disinflationary or deflationary environment, the central banks will essentially be tightening if they do not lower policy rates.

Exhibit 4. Inflation Rate



Source: Bloomberg, IMF, World Bank

Increase in Currency Volatility

We believe active use of monetary policy to promote growth, as well as to prevent deflation, is likely to lead to higher currency volatility. QE has done one thing in Europe and Japan – the Euro and Yen have depreciated. In the 2 months after the Bank of Japan announced another round of quantitative easing, the Japanese Yen depreciated -9% from ¥110 to ¥120. Similarly, the Euro is close to an 11 year low versus the US dollar. The trade-weighted dollar increased from 76 to 85 in the last six months.

The depreciation in the Euro and the Yen has caused a ripple effect in the markets. On Jan 15, 2015, the Swiss National Bank (SNB) scrapped the so called "minimum exchange rate" with the Euro at €1.20/CHF. The Swiss franc strengthened 17% against the Euro and closed at €0.97/CHF. In Dec 2014, SNB restated its commitment to the target and introduced a negative bank deposit rate to support the currency ceiling. The ceiling was introduced in September 2011, to ward off deflation and support Swiss exporters from a loss of competitiveness, as the Swiss Franc appreciated steeply, as investors looked for safety during the Global Financial Crisis. In supporting the exchange rate, the Swiss National Bank accumulated domestic currency – reserves increased from CHF257bn at the end of 2011, to CHF 459bn at the end of 2014, which was equivalent to 75% of GDP.

And now we are left to wonder if other central banks will abandon their peg similar to the Swiss. The Czech central bank also has a Swiss like cap of 27 Koruna/€. Similarly, Denmark has a peg to the Euro and the Krone is meant to trade within ±2.25% of DKr7.46/€.

The Danish central bank spent DKr 106.5bn ($16.4bn) in the month of January to defend the peg, increasing its balance sheet to a record level at 30% of GDP. The central bank has also cut interest rates into negative territory to deter currency speculators and just reduced the deposit rate to -0.5%!

Another risk to consider is that the depreciation in the Euro and Yen leads other countries to depreciate their own currencies. A weaker currency helps exporters while a stronger currency hurts them. For example, a weaker Yen has helped Japanese exporters, as their products have become more price competitive in the global market. By contrast, a stronger currency undermines the competitive advantage of exporters. For a country dependent on exports, a weaker currency would be another way to stimulate growth. This begs the question if we are going to see countries proactively depreciate their currencies. This is a key point for US dollar-based investors as their returns are hurt by such depreciation. Will this currency volatility lead to a currency war? The big country in question is China. As presented in Appendix 4, China is a major node in world trade, but China has long managed its foreign exchange and does not have a floating exchange rate. The Yuan is pegged to the US dollar at a daily reference rate set by the People's Bank of China, plus an allowable trading range. Unfortunately, when it comes to currencies, one country's gain is another country's loss. Hence, sudden currency depreciation in China could lead to a financial contagion similar to what we saw in the 1990s. Thus, we could see an increase in country dispersion.

Rise in Geopolitical Risks…& The Oil Price

We at HCM see geopolitical risk becoming a much more meaningful determinant of equity market performance. Russia's decision to attempt annexation of Crimea was part of a series of events that turned out to be a huge negative for Russian stocks, as the MICEX index underperformed the MSCI Emerging Markets index by 40% in dollar terms last year. Events in Russia also had a negative impact on the European markets, as Russia is a significant trading partner for some of them. Russia presents an economic and strategic threat to Europe. If economic problems linger then some type of Russian default cannot be ruled out. Such a default would be a big blow to the European banks with exposure to Russia. Furthermore, Russia is a major supplier of the natural gas which is used for heating in large parts of Europe. Yet another potential problem for Europe is the renewed possibility of a Greek exit from the Eurozone. The likelihood of this event occurring has become a topic of concern for equity market participants as the leftist Syriza party emerged victorious in the most recent elections. The double dip recession in Europe along with a general fatigue with the austerity measures imposed by the Eurozone Troika, has given rise to radical leftist groups such as Podemos in Spain, Syriza in Greece and Livre in Portugal as voters have become frustrated by the policies of the mainstream centrist parties.

Other geopolitical challenges around the world are more dispersed but seem to derive from similar sources. From "Je Suis Charlie" in France to "I am Kenji" in Japan, there are multiple sets of terrorist activities brewing around the world, and they all have tended to focus around the topics of Muslim fundamentalism and the ill-fated attempts at regime change in the Middle East. In Nigeria, deaths related to Boko Haram have risen to 2,000, and in the Middle East, Syria and Libya have deteriorated to the point where their governments are nearly in a state of collapse. Similarly, Yemen, Jordan and Iraq are not far behind. Recently, the group known as the Islamic State has even gone so far as to attack Coptic Christians in Egypt. However, the world's political problems are not solely centered on these topics, as the recent hacking at Sony (rumored to have been funded by North Korea) shows that there may be political risks even in cyber space.

When the topic of discussion turns to geopolitical events, the issue of the price of oil is highly likely to come up, and this paper will not prove an exception to that rule. We believe that last year's dramatic decline in oil prices adds a whole new dimension to the geopolitical risk, and complicates matters further for investors. There really cannot be any reasonable argument with the assertion that in the long run the price of oil is determined by the laws of supply and demand; the supply side of the equation is deeply rooted in world politics. First, more than 40% of the world's oil supply is controlled by OPEC, the oil producer's cartel and in particular, Saudi Arabia. Why is it that late last year Saudi Arabia decided they did not want to reduce their oil production in order to support the oil price as they have done historically? The United States has been responsible for 65% of the new production in the last few years, and it is widely believed that Saudi Arabia does not want to lose market share, so the Saudis apparently felt that it was in their long term interest to allow a freefall in the price of oil, believing that such an event would likely force a reduction in production from high-cost producers such as the new entrants from North America.

The geopolitical events driving the oil price have to be on the radar screen for investors as they will likely have a significant impact on stock prices. This new normal of lower oil prices, if it persists, will probably prove to be less kind to oil producers, and more kind to oil importers such as Japan which, with its nuclear power plants turned off, is more exposed to the favorable effects of the falling oil price than any major world economy.

Historically, oil producers, flush with petrodollars, have suppressed social concerns with handouts. Saudi Arabia ramped up spending to meet social demand for development and employment. Shortly after the 2013 Egyptian

coup against the Muslim Brotherhood, the second government change in that country in a year, Saudi Arabia and the United Arab Emirates sent Egypt a $12bn aid package. Similarly, Tehran is estimated to have been spending more than $1bn a month supporting Syria; Iran is Syria's ally in the region and Tehran has acknowledged sending military advisers to assist in the fight against rebels and militants. The falling oil price is particularly painful for Russia and Venezuela. Given what is going on between Russia and Ukraine, one could argue that there are many countries that would be happy with oil at $50 rather than at $100, since this could be seen as making it more difficult for Vladimir Putin to engage in further mischief. It seems reasonable that the United States would be in this camp. Under President Maduro, the nation of Venezuela appears to be almost overrun by political unrest, unthinkable during the days of Hugo Chavez…and oil prices close to $100 a barrel. If the petrodollars spigot runs to a trickle, many formerly suppressed issues could resurface. Not only will we see economic balance shift from oil producers to oil consumers, but also latent issues in many markets will start to resurface.

APPENDICES

APPENDIX 1. Public Debt to GDP Ratio

As of 2Q14	Govt Debt/GDP
Japan	234%
Greece	183%
Portugal	148%
Italy	139%
Belgium	135%
Spain	132%
Sweden	129%
Ireland	115%
France	104%
UK	92%
USA	89%
Netherlands	83%
Germany	80%
Finland	65%

Source: World Bank, McKinsey & Company

APPENDIX 2. Policy Rates in Select Countries and Regions

Country / Region	Policy Rate	3M Chg	6M Chg	1Y Chg
Switzerland	-0.75%	-75	-75	-75
Sweden	-0.10%	-10	-35	-85
Denmark	0.05%	-15	-15	-15
Euro zone	0.05%	0	-10	-20
Singapore	0.08%	5	4	5
Israel	0.10%	-15	-40	-90
Japan	0.10%	0	0	0
U.S.	0.25%	0	0	0
Hong Kong	0.50%	0	0	0
U.K.	0.50%	0	0	0
Canada	0.75%	-25	-25	-25
Norway	1.25%	-25	-25	-25
Taiwan	1.88%	0	0	0
Poland	2.00%	0	-50	-50
South Korea	2.00%	0	-25	-50
Thailand	2.00%	0	0	-25
Hungary	2.10%	0	0	-60
Australia	2.25%	-25	-25	-25
Chile	3.00%	0	-50	-125
Mexico	3.00%	0	0	-50
Malaysia	3.25%	0	0	25
New Zealand	3.50%	0	0	100
Jordan	3.75%	-25	-25	-25
Philippines	4.00%	0	25	50
Iceland	5.25%	-75	-75	-75
China	5.35%	-25	-65	-65
South Africa	5.75%	0	0	25
India	6.75%	-25	-25	-25
Indonesia	7.50%	0	0	0
Turkey	7.50%	-75	-75	-250
Pakistan	8.50%	-150	-150	-150
Vietnam	9.00%	0	0	0
Egypt	9.75%	-50	-50	50
Brazil	12.25%	125	125	175
Argentina	14.00%	-900	400	375
Russia	15.00%	700	700	950
Venezuela	16.82%	6	-144	18
Ukraine	19.50%	550	700	1300

Source: Bloomberg, Central Banks

APPENDIX 3. Energy as a Percentage of CPI basket*

Country	2013
Austria	8.8%
Belgium	11.8%
Brazil	4.1%
Canada	9.0%
Czech Republic	13.9%
Denmark	9.0%
Estonia	17.4%
France	8.8%
Germany	10.7%
Greece	14.1%
Hungary	17.6%
India	9.5%
Indonesia	5.9%
Ireland	10.3%
Italy	8.6%
Japan	7.8%
Mexico	8.9%
Netherlands	9.5%
New Zealand	10.4%
Norway	6.4%
Poland	17.9%
Portugal	7.9%
Spain	12.1%
Sweden	8.7%
Switzerland	6.5%
United Kingdom	8.0%
United States	9.5%
Average	10.1%

Source: OECD, Indian Central Statistics Office, Indonesian Central Bureau of Statistics

**Energy includes gasoline, energy commodities, fuel oil, energy services, electricity, etc.*

APPENDIX 4. World Trade*

IMPORT PARTNERS	
Australia	China 18.4%, USA 11.7%, Japan 7.9%, Singapore 6%, Germany 4.6%, Thailand 4.2%, South Korea 4.1%
Brazil	China 15.3%, USA 14.6%, Argentina 7.4%, Germany 6.4%, South Korea 4.1%
Canada	USA 50.6%, China 11%, Mexico 5.5%
China	South Korea 9.4%, Japan 8.3%, Taiwan 8%, USA 7.8%, Australia 5%, Germany 4.8%
France	Germany 19.5%, Belgium 11.3%, Italy 7.6%, Netherlands 7.4%, Spain 6.6%, UK 5.1%, China 4.9%
Germany	Netherlands 12.9%, France 7.6%, China 6.3%, Belgium 6.1%, Italy 5.3%, UK 4.6%, Austria 4.3%, USA 4.2%
Hong Kong	China 44.5%, Japan 8%, Taiwan 6.8%, South Korea 5.5%, USA 4.9%
India	China 10.7%, UAE 7.8%, Saudi Arabia 6.8%, Switzerland 6.2%, USA 5.1%
Japan	China 21.3%, USA 8.8%, Australia 6.4%, Saudi Arabia 6.2%, UAE 5%, South Korea 4.6%, Qatar 4%
South Korea	China 15.6%, Japan 12.4%, USA 8.3%, Saudi Arabia 7.6%, Qatar 4.9%, Australia 4.4%
Russia	China 16.6%, Germany 12.2%, Ukraine 5.7%, Japan 5%, USA 4.9%, France 4.4%, Italy 4.3%
South Africa	China 14.4%, Germany 10.1%, Saudi Arabia 7.7%, USA 7.4%, Japan 4.6%, India 4.5%
Switzerland	Germany 28.2%, Italy 10.5%. France 8.5%, USA 6.1%, China 5.8%, Austria 4.4%
UK	Germany 12.6%, China 8%, Netherlands 7.5%, USA 6.7%, France 5.4%, Belgium 4.4%, Norway 4%
USA	China 19%, Canada 14.1%, Mexico 12%, Japan 6.4%, Germany 4.7%

EXPORT PARTNERS	
Australia	China 29.5%, Japan 19.3%, South Korea 8%, India 4.9%
Brazil	China 17%, USA 11.1%, Argentina 7.4%, Netherlands 6.2%
Canada	USA 74.5%, China 4.3%, UK 4.1%
China	Hong Kong 17.4%, USA 16.7%, Japan 6.8%, South Korea 4.1%
France	Germany 16.7%, Belgium 7.5%, Italy 7.5%, Spain 6.9%, UK 6.9%, USA 5.6%, Netherlands 4.3%
Germany	France 9.2%, USA 7.9%, UK 6.5%, Netherlands 6.3%, China 5.9%, Italy 5.1%, Austria 5%, Switzerland 4.3%
Hong Kong	China 57.7%, USA 8.9%, Japan 4.2%
India	UAE 12.3%, USA 12.2%, China 5%, Singapore 4.9%, Hong Kong 4.1%
Japan	China 18.1%, USA 17.8%, South Korea 7.7%, Thailand 5.5%, Hong Kong 5.1%
South Korea	China 24.5%, USA 10.7%, Japan 7.1%, Hong Kong 6%, Singapore 4.2%
Russia	Netherlands 14.6%, China 6.8%, Germany 6.8%, Italy 6.2%, Turkey 5.2%, Ukraine 5.2%, Belaru 4.7%
South Africa	China 11.8%, USA 8.3%, Japan 6%, Germany 5.7%, India 4.2%
Switzerland	Germany 18.5%, USA 11.6%, Italy 7.6%, France 7%, UK 5.7%%
UK	Germany 11.3%, USA 10.5%, Netherlands 8.8%, France 7.4%, Ireland 6.2%, Belgium 5.1%
USA	Canada 18.9%, Mexico 14%, China 7.2%, Japan 4.5%

Source: CIA World Factbook

**For 2012 or 2013, based on data availability.*