

20180910

ASIA CONVERSATION

This week we catch up with Bill Hensch, US Small Caps Portfolio Manager, Royce & Associates.

Key Takeaways

- 1) US Small Caps have performed well amid the strong US Economy.
- 2) Industrials look attractive from a valuation point of view while Healthcare and Software appear expensive.
- 3) A favourable outcome from US-Sino trade negotiations and US Mid-term elections could lift the valuation cap for US Small Caps.

Q) What is your sense of how US Small Caps are performing in the current economic backdrop?

On the bright side, gross domestic product is expanding, consumer confidence is high while unemployment is at decade lows. Add to that, 10 year bond yields are at levels that are not choking off growth but instead spurring on economic activity. On the corporate front, US Small Caps are experiencing better than Large-Cap earnings growth that is being supported by repatriated profits, tax cuts and increasing domestic consumption.

However, not all is well and certain in the world. There remains nagging uncertainty stemming from the Trump administration renegotiating global and regional trade agreements. A certain level of decision has been recently achieved with members of the North Atlantic Trade Agreement, but the world at large is eyeing the back and forth between the US and China.

While all these are happening, US Small Caps have outpaced broad US equities and international equities cumulatively over the last one, two and three years¹. This is a major endorsement of US economic growth and profitable US Small Caps. Nevertheless, when you add US-Sino trade tensions to Emerging Market fragility in the context of upcoming US midterm elections, the valuation on smaller US companies remains constrained.

Q) Where in US Small Caps do you see opportunity?

The value proposition in US small caps is an area which has yet to be appreciated by investors. Industrials highlight a value driven opportunity which stand to gain in a firm and expanding economy. Energy is also a sector which contains names that have non-stretched, healthy balance sheets and good cashflow.

Financials were touted to benefit from the rise in rates, but markets were not convinced, instead, piling into Healthcare (biotech) and Software in tandem with rising mergers and acquisitions. The crowded trade has extended the valuations for the Healthcare and Software sectors and we look to add very selectively from them.

Infrastructure related names remain a work in progress as the Tax Cuts and Jobs Act of 2017 had a real and almost immediate impact on corporate earnings while infrastructure spending is understandably taking a while to realize.

Q) How will the following factors affect US Small Caps in the foreseeable future?

US-Sino trade renegotiation – It is in the best interest of parties involved to carve out an agreement eventually. And if that happens, that's one handcuff taken off US Small Cap valuations. With the removal of the overhanging tensions, uncertainty involving costs, production and demand will be reduced. US Small Caps is one way to gain from an orderly resolution of trade negotiations.

Emerging Market fragility – Emerging Markets are going through a tough time right now due to a combination of both external and idiosyncratic factors. From a US Small Cap perspective, the higher exposure to the domestic economy, to a certain degree implies less dependence on non-US events and less concerned by fluctuations in the USD.

US midterm elections – The economy is doing well, and it has not been this robust for long time. In spite of President Trump's lack of visible popularity, he is presiding over one of the strongest US economies in recent memory. From the ground up, consumer habits are portraying a satisfied population and businesses are prospering. From a US Small Cap point of view, the current administration has done well to reinvigorate small businesses and what is relevant, regardless of what happens in November, is that a pro-business environment be sustained. However, the freely spending administration could run into fiscal concerns somewhere down the line. Right now, the incumbent administration is managing to keep most people happy.

Source: Legg Mason, Royce & Associates, as at 10 September 2018. All data and estimates as at 31 August 2018 unless otherwise stated. ¹ US Small Caps refer to the Russell 2000 Index. Broad US Equities refer to the S&P500 Index. International Equities refer to the MSCI Developed Markets Index, MSCI Emerging Markets Index and the STOXX 600 Europe Index. Returns in USD as at 31 August 2018 (Refer to the chart on the following page)

ONLY FOR USE WITH ALL INVESTORS IN HONG KONG AND SINGAPORE, THE PRC INVESTORS INVESTING IN THE QDII PRODUCT OFFERED BY PRC'S COMMERCIAL BANK, DISTRIBUTORS AND EXISTING INVESTORS IN KOREA, DISTRIBUTORS IN MACAU AND ALL INVESTORS IN TAIWAN. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

Equity returns, USD, Ending 31 August 2018

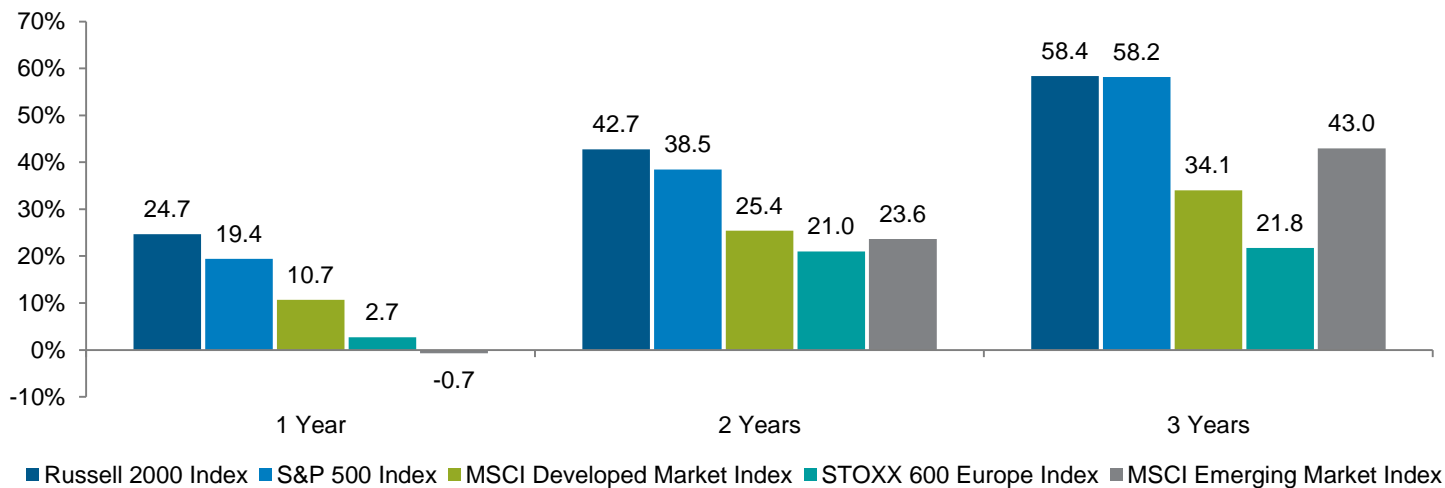


Chart Sources: Legg Mason, Bloomberg as at 31 August 2018.

Source: Legg Mason, Bloomberg. All data as at 31 August 2018 unless otherwise stated.

ONLY FOR USE WITH ALL INVESTORS IN HONG KONG AND SINGAPORE, THE PRC INVESTORS INVESTING IN THE QDII PRODUCT OFFERED BY PRC'S COMMERCIAL BANK, DISTRIBUTORS AND EXISTING INVESTORS IN KOREA, DISTRIBUTORS IN MACAU AND ALL INVESTORS IN TAIWAN.

IMPORTANT INFORMATION:

This document is based on an update from Royce and Associates, a subsidiary of Legg Mason. The views expressed are opinions of Bill Hench, US Small Caps Portfolio Manager as of the date of this material and are subject to change based on market and other conditions without notice and may differ from other investment professionals or from those of the firm as a whole.

Source: Legg Mason, Royce & Associates, as at 10 September 2018. All data and estimates as at 31 August 2018 unless otherwise stated.

All investments involve risk, including possible loss of principal.

The value of investments and the income from them can go down as well as up and investors may not get back the amounts originally invested, and can be affected by changes in interest rates, in exchange rates, general market conditions, political, social and economic developments and other variable factors. Investment involves risks including but not limited to, possible delays in payments and loss of income or capital. Neither Legg Mason nor any of its affiliates guarantees any rate of return or the return of capital invested.

Equity securities are subject to price fluctuation and possible loss of principal. Fixed-income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index.

Unmanaged index returns do not reflect any fees, expenses or sales charges.

The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, recommendations or advice. Statements made in this material are not intended as buy or sell recommendations of any securities. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. This information has been prepared from sources believed reliable but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data. Individual securities mentioned are intended as examples of portfolio holdings and are not intended as buy or sell recommendations. Information and opinions expressed by either Legg Mason or its affiliates are current as at the date indicated, are subject to change without notice, and do not take into account the particular investment objectives, financial situation or needs of individual investors.

The information in this material is confidential and proprietary and may not be used other than by the intended user. Neither Legg Mason or its affiliates or any of their officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this material or its contents. This material may not be reproduced, distributed or published without prior written permission from Legg Mason. Distribution of this material may be restricted in certain jurisdictions. Any persons coming into possession of this material should seek advice for details of, and observe such restrictions (if any).

This material may have been prepared by an advisor or entity affiliated with an entity mentioned below through common control and ownership by Legg Mason, Inc. Unless otherwise noted the "\$" (dollar sign) represents U.S. Dollars.

All Investors in Hong Kong and Singapore:

This material is provided by Legg Mason Asset Management Hong Kong Limited in Hong Kong and Legg Mason Asset Management Singapore Pte. Limited (Registration Number (UEN): 200007942R) in Singapore.

This material has not been reviewed by any regulatory authority in Hong Kong or Singapore.

Intended recipients in the People's Republic of China ("PRC")(excluding Hong Kong, Macao and Taiwan for the purpose of this document):

This material is provided by Legg Mason Asset Management Hong Kong Limited to intended recipients in the PRC. The content of this document is only for the PRC investors investing in the QDII Product offered by PRC's commercial bank in accordance with the regulation of China Banking Regulatory Commission. Investors should read the offering document prior to any subscription. Please seek advice from PRC's commercial banks and/or other professional advisors, if necessary. Please note that Legg Mason and its affiliates are the Managers of the offshore funds invested by QDII Products only. Legg Mason and its affiliates are not authorised by any regulatory authority to conduct business or investment activities in China.

This material has not been reviewed by any regulatory authority in the PRC.

Distributors and existing investors in Korea:

This material is provided by Legg Mason Asset Management Hong Kong Limited to eligible recipients in Korea.

This material has not been reviewed by any regulatory authority in Korea.

Distributors in Macau:

If this document is distributed in Macau, this may not be used other than by the Distributors.

This document has not been reviewed by the Monetary Authority of Macao in Macau.

Issuer: Legg Mason Asset Management Hong Kong Limited.

All Investors in Taiwan:

This document is provided by Legg Mason Investments (Taiwan) Limited (Registration Number: (98) Jin Guan Tou Gu Xin Zi Di 001; Address: Suite E, 55F, Taipei 101 Tower, 7, Xin Yi Road, Section 5, Taipei 110, Taiwan, R.O.C.; Tel: (886) 2-8722 1666) in Taiwan. This document is for information only and does not constitute an offer or invitation to the public to purchase any shares in any fund in Taiwan.

Neither Legg Mason nor any officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this document or its contents. The information in this document is proprietary. This document may not be reproduced, distributed or published without prior written permission from Legg Mason. Any person coming into possession of this document should seek advice for details of, and observe, such restrictions.

If the Press would like to re-edit the press release from their own point of view, it should base on the public information provided by the Legg Mason Investments (Taiwan) and the information contained in such press release shall be not over-promising or exaggerating.

Legg Mason Investments (Taiwan) Limited is operated and managed independently