Richard Bernstein Advisors

Uncertainty = Opportunity®

Richard Bernstein,
Chief Executive and Chief Investment Officer

Time to look at South Korea

Richard Bernstein Advisors

- *Independent investment advisor with a unique top-down, macro approach to investing with quantitative security selection.*
- *$3.3B AUM/AUA as of 3/31/15*
- *Strategies include global asset allocation, global equity allocation, income, and promising undiscovered investment themes.*
- *Investment themes focus on disparities between fundamentals and sentiment.*

Time to Look at Korea

Our global investments continue to focus on the secondary effects of the deflating global credit bubble. The bubble's deflation has left the world awash in capacity, and we expect countries to fight for market share as a result of that overcapacity.

South Korea may be the next stock market to benefit from this secular theme. The Korean Won (KRW) might start weakening in response to the country's lost market share. Just as the Japanese Yen has already helped Japan's corporate profits, a cheaper KRW could significantly benefit Korean companies' competitiveness and corporate profits.

China's competitiveness might continue to wane because China does not have Japan's or South Korea's exchange rate flexibility.

Chart 1:

The KRW has gradually strengthened since 2009, hurting South Korean competitiveness, market share, and corporate profits. A weaker Won might lie ahead.

Source: Bloomberg LLP

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Richard Bernstein Advisors

Uncertainty = Opportunity®

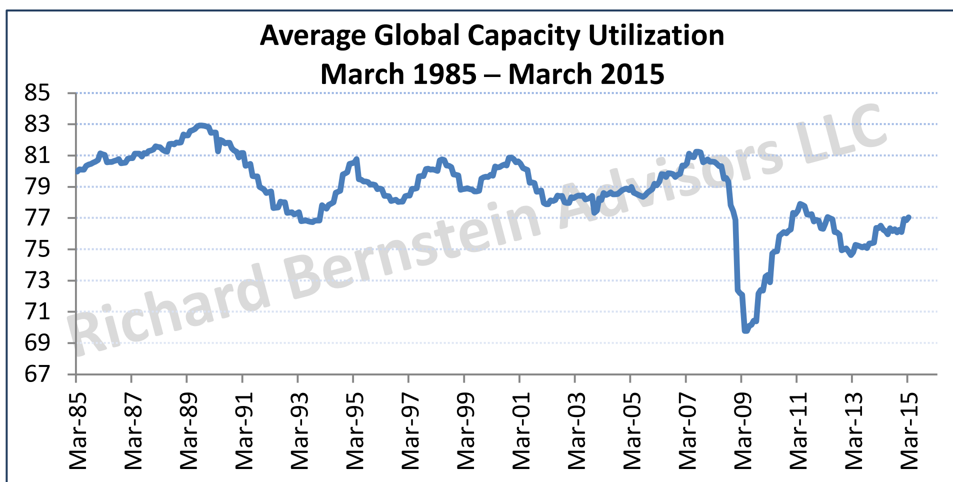
The deflation of the global credit bubble

Bubbles create capacity that is typically no longer needed once a bubble deflates. For example, towns sprung up in California during the 1840s gold rush as prospective miners from across the country moved to California to search for gold. However, those towns quickly became ghost towns when the gold rush ended. (Might Williston, ND, with its fracking "rush" eventually be a modern-day version of a ghost town?)

The global credit bubble has left a similar wake, and the global economy is now awash in productive capacity that really isn't needed anymore. Investors who a decade ago argued that the emerging markets were "decoupling" from the developed world did not seem to understand the influence the global credit bubble was having on emerging market economies. While it was certainly true that emerging market economies were going through a period of rapid economic growth, those economies were becoming more dependent on the developed world's credit-stimulated demand for goods produced in the emerging markets. Demand subsequently weakened as the availability of credit contracted. Thus, the emerging market economies never decoupled as many asserted. Rather, emerging market economies were probably the biggest beneficiaries of the global credit binge. Global overcapacity is now the hangover.

Chart 2 shows the average capacity utilization rate through time of about 30 countries. The capacity hangover seems apparent as capacity utilization rates globally are generally lower post-bubble than they were for the twenty years before the bubble.

Chart 2:



Source: Richard Bernstein Advisors LLC, OECD, Factset

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Uncertainty = Opportunity®

Economists adhering to the "Austrian school" of economics would argue that excess capacity should simply be shut down in order to reallocate resources to more productive uses. While in theory we agree with such statements, it seems unrealistic to expect governments to allow or even encourage massive capacity shutdowns because of the resulting unemployment, voter discontent, and potential political instability. Instead, governments are more likely to structure policies designed to boost production and utilize excess capacity.

We see several on-going investment themes associated with the political realities of global overcapacity:

1) **The US dollar is likely to continue to strengthen**. For RBA, this is a secular investment theme that began several years ago, and we believe the dollar's strength is in its infancy. Just as companies might lower prices to undercut the competition and fight for market share, we expect countries to directly or indirectly depreciate their currencies to gain market share.
2) **Investing outside the US will increasingly require currency hedging.** Investors have not had to worry about currency hedging when investing internationally because the US dollar was either depreciating, flat, or mildly appreciating. If we are correct in #1, then the dollar's strength will become a more significant drag on non-US returns than it was during the past decade.
3) **US inflation expectations are probably too high**. Although an increase in oil and gasoline prices are likely to filter through to higher CPI figures in the US, we find it difficult to reconcile higher inflation expectations with market share competition. After all, fighting for market share typically involves cutting prices and not increasing them.
4) **We think Japan and Korea are big winners in Asia.** Japan has already started competing for market share, and their corporate profits are benefitting accordingly. Korea may soon follow the same path.
5) **Greece remains in the Euro.** As we wrote at the beginning of the year, we think Greece is likely to stay in the Euro because Germany and other core European countries need the peripheral countries to remain in the Eurozone in order to keep the Euro from appreciating. Germany, France, and other core countries are not productive enough to compete with a strong currency in the global economy we envision. We doubt Germany would actually like Greece to exit and have the Euro become a strong pseudo-Deutsche Mark. Rather, it would help the German economy more if Greece stayed in the Eurozone and the Euro was weaker.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Richard Bernstein Advisors

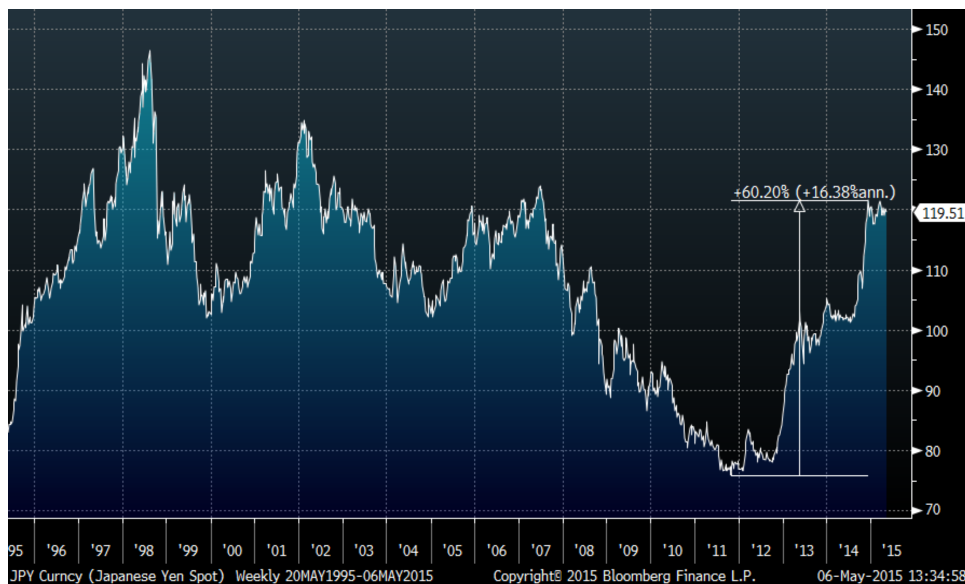
Uncertainty = Opportunity®

Japan: first mover advantage?

Japan appears to have been the first country to recognize the new, more competitive global economy, and has taken considerable positive strides. The Yen is down about 60% versus the USD. Anecdotal evidence increasingly suggests Japanese companies are starting to gain market share and corporate profits have significantly improved.

Chart 3:

The Japanese Yen depreciated 60% versus the US dollar in the last three years, and Japan is starting to reap the benefits.



Source: Bloomberg LP.

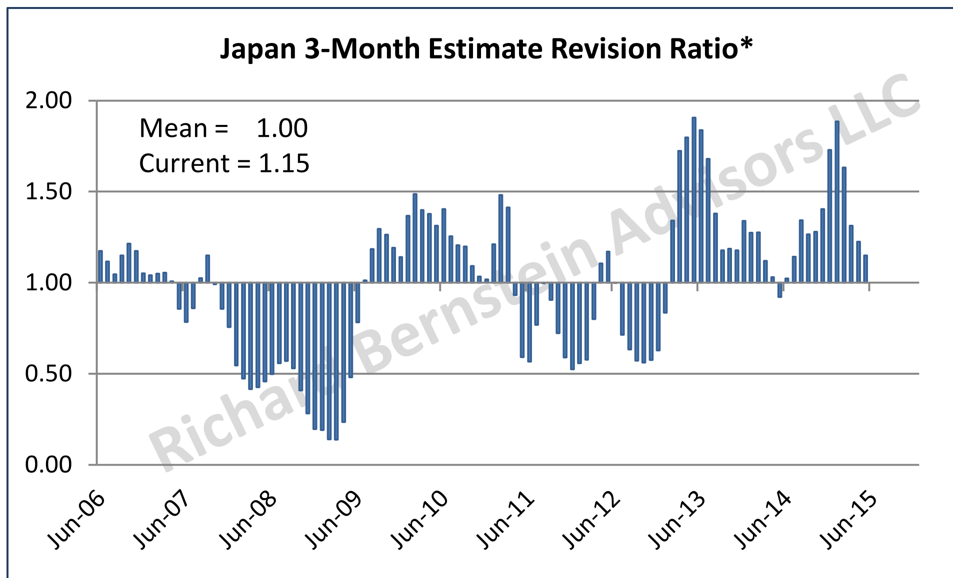
Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

Richard Bernstein Advisors

Uncertainty = Opportunity®

Chart 4:

The weaker Yen has had a positive impact on Japan corporate profits.



* Rolling 3-month estimate revision ratio of next 12-months consensus EPS. A ratio of > 1.00 indicates more analyst estimates upgrades than downgrades over the period.
Source: Richard Bernstein Advisors LLC, Factset.

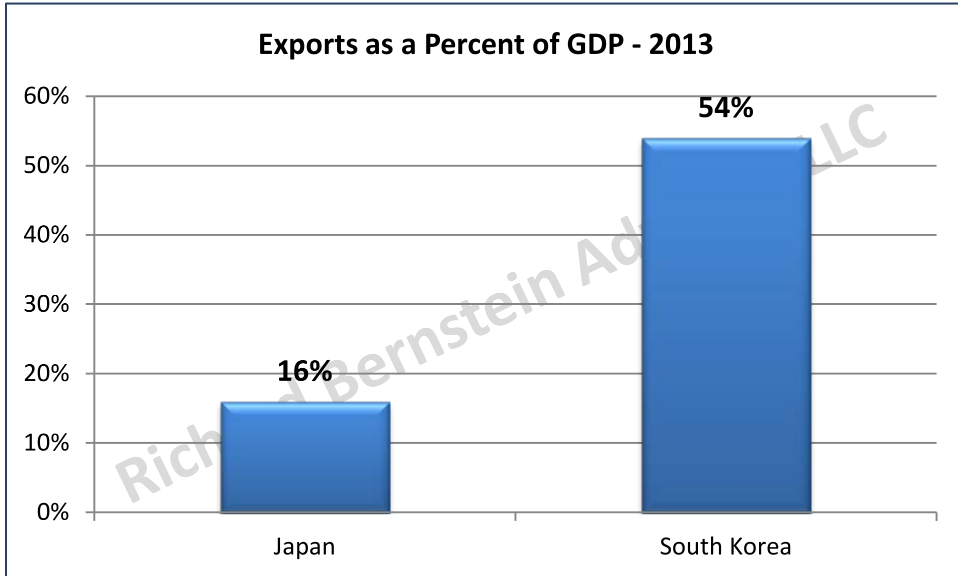
South Korea might be next

South Korea could be the next country to initiate policies to gain market share. The South Korean Won has appreciated versus the US dollar and versus the Japanese Yen, and South Korea's competitiveness has been hurt by that appreciation. Exports comprise more than 50% of the South Korean economy (more than three times the proportion Japan's exports contribute to Japan's GDP), so a lack of competitiveness can significantly hurt Korean corporate profits.

Richard Bernstein Advisors

Uncertainty = Opportunity®

Chart 5:



Source: The World Bank

Chart 6:

South Korean companies are losing market share to Japanese ones because the KRW has significantly appreciated versus the JPY.

Source: Bloomberg LP.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

Richard Bernstein Advisors

Uncertainty = Opportunity®

South Korea's industrial production grew around 7% per year during the credit bubble (excluding booms and busts), but it has growth only about 0.3%/year during the post-bubble period. The combination of a strong currency and overcapacity has clearly impacted the Korean economy. Earnings estimates for Korean stocks have been consistently negative and below average for several years.

We think the South Korean government will start to take action to defend Korean companies' market share. Clearly, lowering interest rates to allow the KRW to weaken would be an initial step, and we think the central bank has the flexibility to do so. South Korean inflation is presently the third lowest since 1966 (0.4%).

Chart 7:

The strong KRW has hampered competitiveness and industrial production.

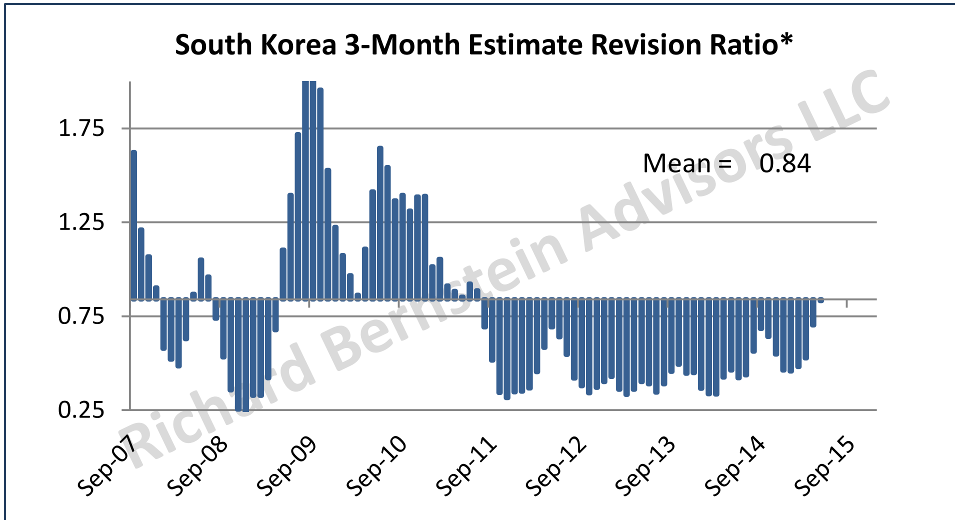
Source: Bloomberg LP.

Richard Bernstein Advisors

Uncertainty = Opportunity®

Chart 8:

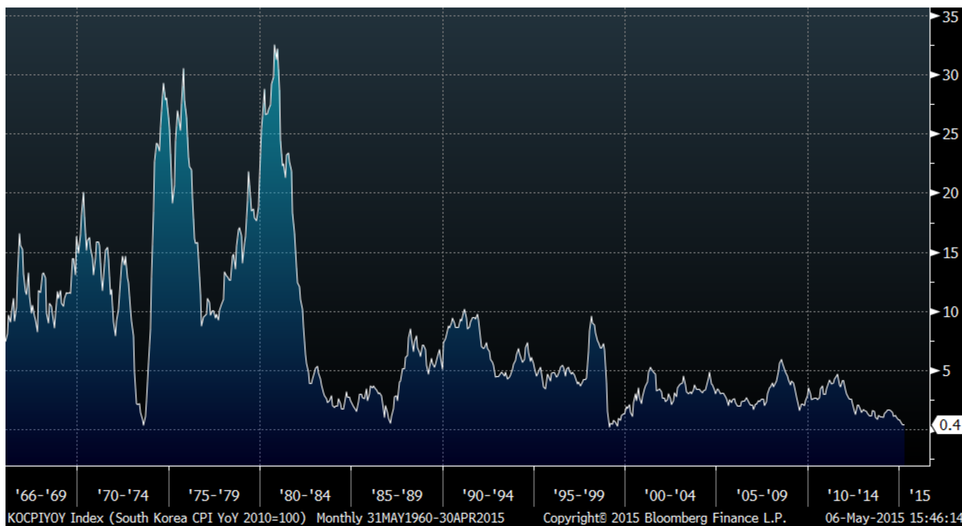
South Korean profits have been revised down for about four years!



* Rolling 3-month estimate revision ratio of next 12-months consensus EPS. A ratio of > 1.00 indicates more analyst estimates upgrades than downgrades over the period.
Source: Richard Bernstein Advisors LLC, Factset.

Chart 9:

South Korea's Central Bank has lots of currency flexibility.
The country's inflation rate is presently the 3rd lowest over 50 years!



Source: Bloomberg LP.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

Richard Bernstein Advisors

Uncertainty = Opportunity®

China at a disadvantage

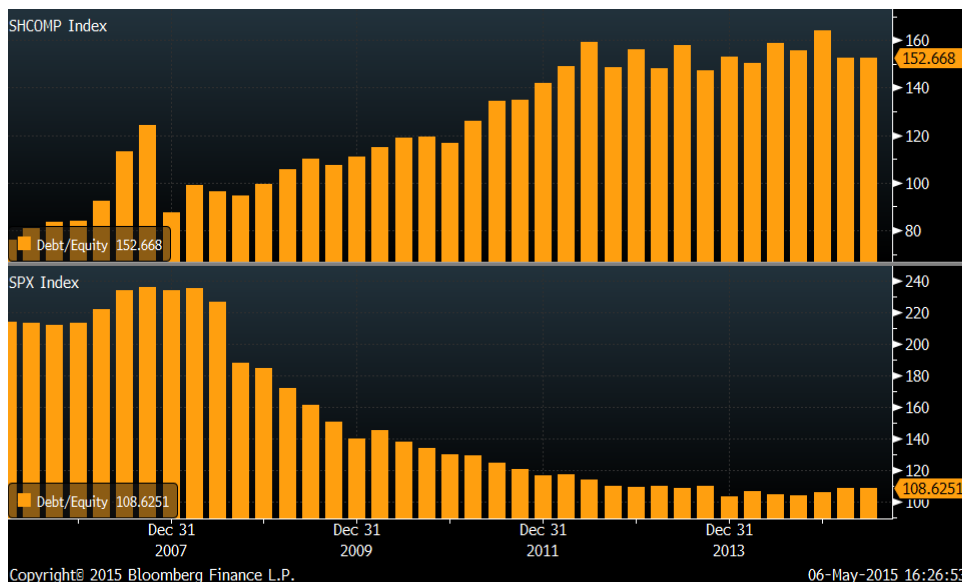
From which countries do Japan and Korea probably gain market share? We think China will lose share because China does not have the pricing flexibility to compete in a market share game. Consider the following:

1) If China were to devalue the CNY, there could be considerable political backlash in many countries. Protectionist sentiment could be stronger if China devalued their currency than if Korea or Japan devalued. Consider that Japan has devalued the Yen about 60% without general awareness. We strongly doubt a similar devaluation of the CNY would be equally overlooked.

2) Although US companies have generally been de-levering, Chinese corporations have substantially increased their leverage during the post-bubble period. Importantly, much of that debt is reportedly dollar-denominate debt. If the USD were to substantially appreciate versus CNY, Chinese corporations' cash flows might not cover their increased debt burdens.

Chart 10:

Whereas US corporations have generally de-levered, Chinese companies have increased leverage. Reportedly, much of that additional debt is US dollar-denominated.



Source: Bloomberg LP.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Uncertainty = Opportunity®

Time to look at South Korea

The global credit bubble continues to deflate and influence global asset performance. Global overcapacity is causing countries to fight for market share. As do corporations that fight for market share, some countries are lowering prices (i.e., devaluing their currencies) as a main tool in that fight. Undercut the competition and gain share seems considerably more important in today's economy than is the current focus on corporate margins.

Japan was the first success story, and their market share gains continue. South Korea seems to be starting to recognize their lack of competitiveness in today's global economy, and government policies to increase competitiveness seem on the horizon. We expect South Korean corporate profits to strengthen considerably if such policies are enacted.

However, China seems to be at a significant disadvantage relative to other countries because China does not have the exchange rate flexibility that other countries might have. A depreciation of the CNY could result in protectionist backlash, and could make Chinese corporate sector dollar-denominated debt considerably riskier.

We think South Korea could make a very exciting investment theme. Our portfolios are structured accordingly.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

Uncertainty = Opportunity℠

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Richard Bernstein Advisors LLC
120 West 45th Street
19th Floor
New York, NY 10036

Uncertainty = Opportunity®

© Copyright 2015 Richard Bernstein Advisors LLC. All rights reserved.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Nothing contained herein constitutes tax, legal, insurance or investment advice, or the recommendation of or an offer to sell, or the solicitation of an offer to buy or invest in any investment product, vehicle, service or instrument. Such an offer or solicitation may only be made by delivery to a prospective investor of formal offering materials, including subscription or account documents or forms, which include detailed discussions of the terms of the respective product, vehicle, service or instrument, including the principal risk factors that might impact such a purchase or investment, and which should be reviewed carefully by any such investor before making the decision to invest. Links to appearances and articles by Richard Bernstein, whether in the press, on television or otherwise, are provided for informational purposes only and in no way should be considered a recommendation of any particular investment product, vehicle, service or instrument or the rendering of investment advice, which must always be evaluated by a prospective investor in consultation with his or her own financial adviser and in light of his or her own circumstances, including the investor's investment horizon, appetite for risk, and ability to withstand a potential loss of some or all of an investment's value. Investing is subject to market risks. Investors acknowledge and accept the potential loss of some or all of an investment's value. Past performance is, of course, no guarantee of future results. Views represented are subject to change at the sole discretion of Richard Bernstein Advisors LLC. Richard Bernstein Advisors LLC does not undertake to advise you of any changes in the views expressed herein.

About Richard Bernstein Advisors:

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $3.3 billion collectively under management and advisement as of March 31, 2015. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and the Eaton Vance Richard Bernstein Market Opportunities Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF and the First Trust RBA Quality Income ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS, Merrill Lynch, Morgan Stanley Smith Barney and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at www.RBAdvisors.com.