

Half Yearly Investor Report

Magellan Global | December 2015

- Magellan Global Fund
- Magellan Global Fund (Hedged)
- Magellan Global Equities Fund (ASX:MGE)
- Magellan Global Equities Fund (Currency Hedged) (ASX:MHG)



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I am delighted to write to you as an investor in the Magellan Global Fund (the 'Global Fund' or the 'Fund'), the Magellan Global Fund (Hedged), the Magellan Global Equities Fund and the Magellan Global Equities Fund (Currency Hedged) for the 6 months ended 31 December 2015.

Over the past 6 and 12 month periods, the Magellan Global Fund returned 5.2% and 15.3%, in Australian dollar terms after fees. Over the past 3 and 5 years, it has returned 25.2% and 20.6% per annum, respectively. It has returned 11.9% per annum since its inception (1 July 2007). We believe that

the Fund's investment returns have been more than satisfactory, having exceeded our longer-term objective of 9% per annum after fees. We feel strongly that people cannot retire on "relative investment returns"; only by generating investment returns that exceed the rate of inflation (ideally by a satisfactory margin) will investors increase their wealth. As such, we are happy to be judged by the Fund's absolute returns over time.

On 1 July 2013, we launched the Magellan Global Fund (Hedged)¹. Over the past 1 year and 2 years, the Magellan Global Fund (Hedged)

Figure 1: Performance to 31 December 2015 in AUD:

Yearly Results (Financial Years)	Magellan Global Fund (%)	MSCI World Net Total Return Index AUD (%) ¹	Difference (%)
2007/08	-17.2	-21.0	3.8
2008/09	7.1	-16.3	23.4
2009/10	13.9	5.5	8.4
2010/11	2.5	3.0	-0.5
2011/12	18.2	-0.8	19.0
2012/13	39.7	32.8	6.9
2013/14	11.7	20.3	-8.6
2014/2015	29.5	24.6	4.9
6 months ended 31/12/2015	5.2	2.0	3.2
Annual compound results (% per annum)			
1 Year	15.3	11.5	3.8
3 Year	25.2	23.4	1.8
5 Year	20.6	15.2	5.4
Since inception (1 July 2007)	11.9	4.4	7.5

¹Hedged to movements in the Australian dollar, relative to the currencies of stocks' domiciles.

returned 6.1% and 8.3%, respectively.

We launched the Magellan Global Equities Fund and the Magellan Global Equities Fund (Currency Hedged), in March and August 2015, respectively.

Beware of Quantitative Tightening

We have written in recent investor updates ('The Great Compression' in August 2014 and 'The Great Disagreement' in April 2015) about the risks associated with the massive compression of risk premia² in markets over the past few years and the potential for these risk premia to unwind as the US Federal Reserve (the 'Fed') normalises interest rates. The Fed's decision to raise US interest rates by 25bps in December was a first step along the path of interest rate normalisation.

In our view, the current risk pricing environment for high quality assets is quite extraordinary in a historical context. Pricing for sovereign credit, high quality corporate and financial credit and other high quality defensive assets is at, or near, record highs at present. The pricing of high quality assets reflects the prevailing environment of ultra-low policy rates and massive Quantitative Easing (QE) programmes over the past eight years by the G4 central banks (Fed, the Bank of England (BOE), the Bank of Japan (BOJ) and the European Central Bank (ECB)) and the accumulation of foreign exchange reserves by China, Saudi Arabia and Switzerland, which have had policies to peg their currencies to either the US Dollar or the Euro. We refer to these collectively as the G7 Central Banks.

The G7 Central Banks have bought around US\$10 trillion of sovereign bonds and other high grade credit/assets over the past eight years. This represents approximately 70% of the total increase in government debt by the US, Euro nations, the UK and Japan over this period.

This buying activity by the G7 Central Banks has had a major influence on sovereign bond yields around the world:

- Yields on 10-year US treasuries

²The return spread, or margin, investors expect to earn over the "risk free rate", which is typically the yield on 10-year sovereign bonds

have fallen from around 4.4% (five year average prior to 2008) to around 2.2%

- Yields on 10-year UK gilts have fallen from around 4.7% (five year average prior to 2008) to around 1.8%

- Yields on 10-year German bunds have fallen from around 3.9% (five year average prior to 2008) to around 0.5%

- Yields on 10-year Australian bonds have fallen from around 5.6% (five year average prior to 2008) to around 2.7% and

- Two-year sovereign bond yields in numerous European countries (Germany, France, Spain, Italy, Belgium, Switzerland and the Netherlands) are currently or were recently negative.

The pricing of sovereign credit reflects more than the current subdued economic outlook. In our view, buying activity by the G7 Central Banks has not only distorted the pricing of sovereign credit but has affected the pricing of all risk assets. Asset purchases by the G7 Central Banks affect asset pricing in the following ways:

- The first effect is to push up prices of sovereign bonds which are being purchased by the central banks, thus lowering yields

- The second effect is to push up the price of high grade non-sovereign domestic credit as investors become attracted to their higher yields, relative to sovereign bonds

- The third effect is to push down the currency of the nation which has implemented QE. This occurs as investors reach for yield abroad, requiring investors to sell local currency and buy foreign currency.

- As the central banks continue to pump liquidity, the cascading search for yield continues until

all assets eventually get repriced upwards, including equities, credit and commodities.

This is what happened over the past eight years as displaced sovereign bond investors were effectively forced into higher risk assets. As more and more liquidity was pumped into the system, investors were pushed out along the risk spectrum and bought emerging market assets, commodities and high yield debt.

The following chart (figure 2) sets out the 1-year forward price/earnings multiple of the major consumer staples companies in the US and Europe over the past 10 years. The chart indicates that major consumer staples companies are currently trading at around 20 times forward earnings, which is materially above the historical average.

The question we all need to ask ourselves is whether asset prices predominantly reflect the current economic reality of lower growth and inflation, or are they being significantly distorted by the extraordinary monetary policy (including asset buying) and foreign exchange policies of the G7 Central Banks?

We believe, as central bank asset purchases diminish over the coming years, there is potential for material price declines in some assets. We refer to this reversal as Quantitative Tightening (QT).

It is likely that we have seen the first "canary in the coal mine" of QT. Over the last 12 months, we have seen a change in the foreign exchange policies of China, Saudi Arabia and Switzerland:

- China has commenced selling foreign exchange reserves in response

Figure 2: Source: Thomson Reuters and Magellan Asset Management Limited



to capital outflows and a slowing economy (China's foreign exchange reserves have fallen approximately US\$500 billion over the past 12 months)

- Saudi Arabia's foreign exchange reserves have shrunk by around US\$100 billion over the past 12 months, in response to its ballooning budget deficit due to the collapse in the oil price
- On 15 January 2015, Switzerland ended pegging the Swiss franc to the Euro, which has ended the policy of accumulating foreign exchange reserves by the Swiss National Bank.

This has resulted in a progressive decrease in monthly bond buying activity by the G7 Central Banks over the last two years. Having peaked at around US\$200 billion per month in 2H 2013, G7 Central Bank bond buying fell to approximately US\$150 billion in 1H 2014, US\$75 billion per month in 1H 2015, and most recently US\$50 billion per month in 2H 2015. The reduction in the buying activity of the G7 Central Banks has coincided with a material repricing of the riskiest assets in the world:

- Major emerging markets (outside of China) have experienced major falls in their currencies. In the year to 31 December, the Brazilian real has fallen 33%, the Russian rouble has fallen 16%, the Turkish lira has fallen 20%, and the Mexican peso has fallen 14% against the US dollar.

- US CCC corporate (junk) bond credit spreads increased by approximately 670 bps in the year to 31 December, and junk bond funds likely had their first annual loss since the global credit crisis. These funds are also experiencing significant outflows, with the Third Avenue Focused Credit Fund freezing redemptions in December 2015.

- Major industrial commodities (iron ore, coal, copper, zinc) have been in free fall.

We do not believe that China, Saudi Arabia or Switzerland are about to change course and commence accumulating foreign exchange reserves again in the near future. The likelihood of a material rebound in emerging markets, junk bonds or industrial commodities is also low, in our view.

Notwithstanding the dramatic

repricing of some riskier assets seen recently, prices of developed world sovereign bonds, high grade credit and high quality defensive equities remain at, or near, 20-year highs. We believe a key reason for this is the continued massive asset purchasing programmes by the ECB and BOJ (approximately US\$120 billion per month) and the fact that the Fed and BOE have not yet commenced programmes to shrink their balance sheets.

While investors are expecting that the Fed will gradually increase the Fed Funds rate over the next few years, the futures market is currently pricing US 10-year Treasury yields at only 3.1% in 2025, compared with the current yield of around 2.2-2.3%. This would be a low 10-year Treasury yield by recent historical standards and we believe that the market's expectations for such a low yield to prevail in 10 years' time reflects anchoring bias to current rates (that are distorted by the aforementioned policies) rather than our view of the more likely outcome of US 10-year Treasury yields in the range of 4-5%. This suggests a reasonably large range of outcomes (from 3-5%) and the bookends are likely to have very divergent consequences for investors. Where the market lands in this range will depend in part on the asset accumulation or divestment strategies of the G7 Central Banks.

In order to assess the possible outcomes, it is necessary to understand the steps central banks will take to tighten monetary policy following QE:

- Step 1 is to cease asset purchases; the Fed ceased its asset purchases in October 2014.
- Step 2 is to increase the cash rate; the Fed commenced lifting the Fed Funds rate on 16 December 2015.
- Step 3 is to shrink the central bank's balance sheet; this is likely to start by ceasing reinvestments of maturing bonds.

While the market is myopically focussed on the speed and direction of the cash rate, we believe the impact on the "flow of liquidity" via steps 1 and 3 is probably more important to the ultimate level of long term interest rates and, hence, asset values overall. We believe that it is likely that the Fed and BOE will commence shrinking their balance sheets, via ceasing their reinvestment policies, over the

next three years, as they continue to gradually tighten monetary policy. We estimate that ceasing reinvestment policies will tighten global liquidity initially by around US\$240-US\$400 billion per annum (US\$20-33 billion per month). As demand for bonds weakens, this will place upward pressure on longer-term bond yields.

The real elephants in the room are what the ECB and BOJ will do over the next three years. Together, the ECB and BOJ are currently purchasing approximately US\$1.4 trillion of bonds and other assets per annum (approximately US\$120 billion per month). Our base case scenario is that the BOJ will continue its asset purchasing programme almost indefinitely, as sensible policy options are no longer available, and the ECB will cease its asset purchase programme within the next three years as the European and global economic outlook stabilises.

We regard the following three events as the "essential trinity" of QT:

1. The reversal of the foreign exchange reserve accumulations by China, Saudi Arabia and Switzerland;
2. The cessation of reinvestments by the Fed and the BOE; and
3. The end of asset purchases by the ECB

When these three events occur, cumulative net purchases by the G7 central banks should fall further. Already having fallen from a peak of roughly US\$200 billion per month in 2H 2013 to US\$50 billion per month in 2H 2015, these net purchases could become net sales in the next three years. This could result in materially higher long-term bond rates than the market is currently expecting, and a repricing downwards of assets globally.

While investors appear solely focused on the Fed, in our view the most significant issue to weigh is the actions of the ECB over the next three years. The ECB is likely to be the biggest swing factor in the level of net purchases by the G7 Central Banks and therefore where longer-term bond rates and asset prices may be headed.

If the ECB continues its QE programme for the next 3-5 years then it is likely long term bond rates will remain lower (probably in line with current market expectations), even if the Fed and the BOE commence a programme to

tighten monetary policy and shrink their balance sheets. If the ECB ceases its QE programme this will result in a material change in the aggregate demand for sovereign bonds. Combined with the likely tightening by the Fed and the BOE, this would likely lead to materially higher bond yields than the market is currently anticipating (probably 10 year US Treasuries yields of around 4-5%).

What the ECB does will depend on economic developments in Europe and globally over the next three years. Our base case outlook for the next three years assumes a continued recovery in the United States with modestly rising inflation, a continued slowdown in China (but not a financial crisis or hard landing), and an improvement in the economic outlook for Europe. In these circumstances we believe it is likely that the ECB will take the first steps towards monetary tightening by ceasing its QE programme at some point in the next three years.

Of course, there are outlook scenarios where the global and European economies deteriorate and the ECB continues to extend its asset purchases, suppressing global bond yields and supporting higher asset prices (particularly for high quality assets). However, the situation is fluid and no one knows what will transpire. It is our view that there is greater than a 50% probability that markets are mispricing the medium-term outlook for bond yields. It is prudent to remain cautious on asset prices in this environment.

In April, we increased the cash weighting of the Fund to approximately 15% (cash weighting at 31 December 2015 is 15%). The cash weighting increases the defensiveness of our portfolio and should act as a partial hedge to increasing interest rates. In addition, we have reduced our exposure to emerging markets and euro earnings. We have also materially reduced our exposure to high quality defensive equities, as they are particularly exposed to higher than expected bond yields as relative pricing is very stretched.

Portfolio Summary

On 31 December 2015, the Fund

held investments in 25 companies (compared to 24 at 30 June 2015). The top 10 investments represented 45.8% of the Fund, while they represented 51.6% at 30 June 2015 (figure 3).

Over the six months to 31 December 2015, the three investments, continuously held to the end of the period, with the strongest returns in local currency, were Alphabet (formerly Google) (+48.2%), Microsoft (+27.1%), and Home Depot (+20.0%) while the investments with the weakest returns were Tesco (-29.7%), Qualcomm (-19.1%) and Yum! Brands (-18.1%). On an absolute basis, the three largest contributors to the Fund's return, in local currency, were Microsoft, Alphabet and eBay which added +1.8%, +1.2% and +0.9% respectively. Conversely, the three bottom contributors were Tesco, Yum! Brands and IBM which detracted -1.2%, -0.9% and -0.7%, respectively.

The following table sets out some key statistics for the Fund's portfolio as at 31 December 2015:

Average market capitalisation (US\$ billion)	167
Average daily liquidity (US\$ million)	791
Number of companies	25
Concentration of top 10 Investments (%)	45.8
PE – 1 year forward ³	15.5x
Average return on equity (%) ³	36.6
Beta ³	0.79

³Magellan Asset Management Limited estimates

Equity markets have become more challenging and value has become harder to find as share prices have continued to rise. While nothing is certain in investing, we predict that the next three years will be challenging for equities.

Figure 3: Source: Magellan Asset Management Limited

Global funds as at 31 December 2015 (%) - Top 10 Holdings			
Microsoft Corp	6.8	IBM Corp	4.0
Visa Inc	5.0	eBay Inc	4.0
Intel Corp	4.8	Oracle Corp	4.0
Lowe's Co Inc	4.7		
Paypal Holdings Inc	4.2	Other	39.4
Wells Fargo & Co	4.2	Cash	14.8
Yum! Brands Inc	4.1	TOTAL	100.0

We feel comfortable with the Fund's overall risk profile and construction. We believe it is likely to deliver satisfactory returns over the next investment cycle, while it is also likely to exhibit below-benchmark downside risk in the event that there is a major downturn in markets.

The Fund continues to be exposed to the following major investment themes:

• Technology/software:

We believe that entrenched global software companies boast enormous competitive advantages and exhibit attractive investment characteristics. On 31 December 2015, 26.8% of the Fund was invested in the technology/software companies such as Microsoft, Intel, IBM, Qualcomm and Oracle.

• US housing:

A recovery in new housing construction, together with investment in existing housing stock, should drive a strong cyclical recovery in companies exposed to the US housing market, while providing a boost to the overall economy. Our major exposure to this theme is via Lowe's and Home Depot, the home improvement retailers as well as our investment in Wells Fargo. These investments represented approximately 12.5% of the Fund at 31 December 2015.

• The move to a cashless society:

There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments such as credit cards, debit cards, electronic funds transfer and mobile payments. In our opinion, the explosion of smart and internet-connected, mobile devices will accelerate this shift on a global basis. We believe that there are only a limited number of companies that are well positioned to directly benefit from this structural shift. These companies are typically highly attractive, with strong

network effects, low capital intensity, high barriers to market entry and high returns on capital. On 31 December 2015, approximately 12.1% of the Fund was invested in the payments space through exposure to companies such as PayPal, MasterCard and Visa.

• US interest rates:

In our view, it is likely that US short- and long-term interest rates will “normalise” over the next two years as the US economy recovers. Now that the Fed has ended its QE programme, this may occur alongside the shrinking (or sterilisation) of its balance sheet, as well as the normal monetary policy action of lifting the Federal Funds Rate (FFR). We own three US financial institutions investments likely to benefit from the increase in US interest rates, Wells Fargo, Bank of NY Mellon and State Street. These investments represented approximately 8.2% of the Fund on 31 December 2015.

• Emerging market consumption growth:

The Fund gains its exposure via investments in multinational consumer franchises. Approximately 7.2% of the Fund is invested in multinational consumer franchises, which generate around 40% of their revenue in emerging markets. On 31 December 2015, the Fund’s largest investments in multinational consumer franchises are Yum! Brands, Nestle and Unilever.

Macroeconomic Commentary

Our views on the world’s largest economic zones have evolved modestly since my last investor letter (June 2015). China’s growth continues to slow, with risks centred on the property market and shadow banking system. The United States’ economic recovery continues, and growth in the Eurozone is improving but remains modest. The prospect of “Abenomics” solving Japan’s intractable problems appears as uncertain as ever. Finally, emerging markets and commodities-linked economies face a period of heightened uncertainty as China slows and the Fed moves towards normalising interest rates.

United States

A range of economic indicators show that the US economy continues to recover, albeit with some headwinds.

The household sector is buoyed by strengthening labour markets, rising house prices, falling commodity prices and low interest rates. Households are approximately US\$900 a year better off from lower oil prices. Average weekly earnings increased by 2.0% over the year to November 2015 and the number of people employed is now 149 million, 2.8 million more than the previous peak in November 2007. The household sector is supporting a growing corporate sector via higher goods and services consumption. This includes a significant pick up in housing starts to 1.2 million per year in November 2015, up from less than 0.5 million in April 2009. Indeed, as household formation increases we expect housing starts to grow further to at least 1.3-1.4 million per annum, this being our estimate of normalised demand. The improvements in the household and corporate sectors are flowing through to the banking sector, with total loans and leases outstanding increasing by 8.5% per annum and, notably, commercial and industrial loans increasing by 11.5% over the year.

Meanwhile, the government sector’s drag on the economy has abated. Indeed federal government spending may modestly contribute to growth in the next few years as a result of the recently passed Bipartisan Budget Act. The Congressional Budget Office previously forecast the federal deficit to remain fairly stable at 2-2.5% of GDP over the next few years.

Although the US economy is facing some headwinds at the moment, most are likely to be transitory. Headwinds include the impact of recent US dollar strength and a weaker global economy on trade-exposed industries, energy-related capital investment declines, and weakness in industries and regions reliant on oil and gas investment.

Despite the appreciation of the real trade-weighted US dollar, US wages remain highly competitive and energy costs very low compared to global peers, and household consumption is likely to be boosted by lower

prices of imports. In addition, the US is a predominantly domestically-driven economy, with a relatively low reliance on exports (which account for approximately 13% of GDP).

We expect consumption growth to strengthen as the US labour market continues to recover. Tighter labour markets will lead to faster growth in real wages and potentially lower profit margins for businesses without pricing power.

Meanwhile, considerable scope remains for further job creation due to the prevalence of underemployment and the cyclically depressed participation rate. The ‘U6’ unemployment rate, which includes part time workers who want a full time job and those marginally attached to the labour force, has been falling steadily since the crisis but remains elevated at 9.9%⁴. The U6 has fallen to 8% or lower in previous cycles. Furthermore, the proportion of 25-54 year olds in the labour force has fallen from just over 83% before the crisis, to under 81% as at November 2015.

Several transitory factors have been keeping inflation below the Fed’s 2% target. However, as the oil price bottoms out, the US dollar stabilises, and the labour market continues to tighten, wage growth and inflation pressures are likely to normalise. This will require the Fed to tighten monetary policy, probably more so than the market is expecting. In 2004, core PCE inflation returned to the Fed’s 2% target by June, having ended 2003 at just 1.4%. This was around the same time as the U6 unemployment rate dropped below 10% and the Fed started increasing interest rates. The continued fall in the U6 may be one of the reasons the Fed decided to increase the Fed Funds rate in December and they are now “reasonably confident” that inflation will return to target over the medium term.

We consider that the US economy will continue along its path of a steady and solid recovery over the next few years, barring unforeseen events.

Eurozone

Real GDP growth in the Eurozone has improved but remains modest (around 1.6% p.a. in aggregate since

⁴Marginally attached to the labour force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months.

September 2014). The periphery economies of Spain and Ireland are bouncing back with growth of 3.4% and 6.8% p.a. respectively, following deep recessions. Meanwhile, Greece's economy has stagnated. The Eurozone as a whole is likely to continue benefitting from a weaker currency, a stronger US economy, lower oil prices, and an improvement in borrowing conditions and credit flows in an environment of ultra-low interest rates. However, the pace of Eurozone growth is likely to remain modest for the foreseeable future as high levels of government debt, political and economic impediments, and an emerging markets slowdown hold back the economy.

In December, the ECB announced the extension of its QE programme (€60 billion per month) by six months to March 2017, or until "a sustained adjustment in the path of inflation" is achieved towards the ECB's target of just below 2% inflation. Public debt securities eligible for purchase by the ECB were expanded to include regional and local government debt. The ECB also announced a further cut in the deposit rate to -0.3%, to encourage banks to lend rather than hold reserves at the ECB. Eurozone core inflation remains low but fairly stable around 0.9% p.a., despite the dramatic fall in the price of oil and other commodities over the past year or so.

Labour markets are gradually recovering in the Eurozone although considerable slack still remains. Aggregate employment increased 2.7 million to 151 million from June 2013 to September 2015, but remains below the pre-GFC peak of 154.4 million. Meanwhile, the aggregate unemployment rate has fallen from 12.1% in May 2013 to 10.7% in October 2015. Over the past year the unemployment rate has fallen in Germany, Portugal, Ireland, Greece, Italy and Spain, while it has risen in France.

The difficult policy choices facing governments, as well as the long period of recessionary environments and accompanying high levels of unemployment, have supported the rise of Eurosceptic political parties in a number of Eurozone countries. These parties often threaten an exit from the Eurozone (and a dispensing of the

euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets. Recent tensions related to the Syrian refugee crisis and the strong performance of Podemos at the Spanish general election highlight the ongoing political risks to Eurozone stability.

The combined effects of high government debt, private sector debt levels and unfavourable demographics are likely to present ongoing headwinds for growth.

The Eurozone remains vulnerable to major shocks, such as an escalation of the Russia/Ukraine crisis, the election of Eurosceptic parties, a hard landing in China or a disorderly unwinding of QE in the US. Each of these scenarios could trigger a dramatic uplift in periphery Eurozone sovereign bond yields and would heavily test the resolve and mandate of the ECB.

China

We remain concerned about the short to medium-term economic outlook for China, principally due to risks in its property market and shadow banking system. Weakness in China is starting to flow through to asset markets around the world, particularly commodity and currency markets.

China's rapid economic growth in recent years has been unsustainable. When demand for Chinese manufacturing exports deteriorated in the global financial crisis (GFC), a credit-fuelled domestic investment boom took over. Almost half of China's credit growth since the GFC (or around 50% of GDP) may have gone towards financing property market activity, resulting in a massive oversupply.

We believe that there may be approximately three to four years of excess housing supply in China, comparable to recent property booms in the US, Spain and Ireland. According to the China Household Finance Survey, 22% of urban housing in China is vacant. Meanwhile vacant floor space on developers' books has increased by over 500% since 2007.

The potential implications of China's property oversupply are serious. Real estate and related industries account for 20-25% of China's GDP, while the housing sector directly represents approximately 10% of GDP (approximately 50% more

than a comparative US measure pre 2007). Fiscal positions are vulnerable, particularly local governments, who have relied on land sales for 35-40% of revenues. A large contraction in China's property construction sector would cause a major slowdown in the economy and perhaps even a recession.

The oversupply in China's housing market has started to feed through to other linked sectors, and a range of indicators suggest that China's economy is slowing somewhat more quickly than official figures imply. Weakness is most apparent in the industrial space (43% of GDP), a large portion of which is linked to property. National house prices grew 0.9% in the year to November 2015, with strong price growth in Tier 1 cities masking weakness in lower tier cities. Meanwhile urban housing completions are down 6% for the year to November 2015. The evidence of a slowing business sector includes electricity consumption growth of 0.6% over the year to November 2015, compared to 8% per annum in 2012 and 2013. Steel and cement production have also slowed significantly (or are contracting).

Furthermore, import data suggest that domestic demand in China is weak, while slowing export growth could be due to a weak global economy and/or competitiveness problems associated with an appreciating renminbi and rising wages. However, Chinese trade data should be treated with caution as it can be volatile and may be affected by illicit capital flows disguised as trade flows.

Since 2010 China is estimated to have directly contributed around a quarter of total global economic growth, despite its economy only representing around 13% of world GDP. We are cautious about the prospect of adverse knock-on effects, including currency movements, linked to changing economic fortunes in China. A number of commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. In some cases these economies may also be vulnerable to the unwinding of commodities-linked domestic credit booms.

The outlook for the Chinese renminbi,

which has appreciated around 50% on a real trade-weighted basis since 2005, is uncertain and difficult to predict. Domestic economic weakness has led to an intensification of capital outflows from China, and forced the People's Bank of China (PBOC) to sell foreign currency reserves to keep the renminbi's managed-peg to the US dollar intact. As countries cannot simultaneously have a fixed exchange rate, an open capital account and operate independent monetary policy – a concept known as the 'impossible trinity' – China faces some difficult policy choices. On the one hand the PBOC may want the renminbi to depreciate to provide support to domestic industry and to enable the PBOC to more aggressively cut interest rates, while on the other hand, a strong renminbi, effectively pegged to the USD, may be strategically important from a geopolitical perspective.

We believe a large depreciation of the RMB is unlikely as it would force other emerging market economies into competitive depreciations which would be counterproductive. The August devaluation of the RMB was probably driven by the Chinese government's desire to repatriate foreign exchange reserves for domestic stimulus purposes, rather than competitiveness reasons, in our view.

The good news is that the Chinese authorities are aware of the problems within China's economy and appear to be taking steps to slow credit growth and manage the housing market correction. Furthermore, almost all of China's debt is held domestically, which makes it easier for the government to manage large-scale defaults as it did in the late 1990s. The difference this time is that much of the credit growth has occurred in the poorly-regulated shadow banking system, and it could prove more challenging for the government to bail out this part of the financial system. Although the Chinese government has substantial resources at its disposal, there remains a "fat tail" risk of a sharp slowdown in growth, or a recession, if the returns on incremental spending and investment are sufficiently low.

Stock in Focus:



PayPal is the leading global digital wallet and a leader in mobile and ecommerce payments. It operates a proprietary global technology platform that connects merchants and consumers around the world. PayPal has approximately 173 million active customer accounts. Last year, it processed over US\$235 billion of payments in nearly 4 billion transactions, 1 billion of which were made on mobile devices. PayPal operates across more than 200 markets, processing transactions in over 100 currencies.

PayPal allows consumers to purchase online with convenience and security by entering their financial information only once and never divulging this information to merchants. PayPal offers consumers flexibility of payment sources, allowing its digital wallet to be loaded with credit cards, debit cards and consumers' transaction bank accounts. Consumers then have the flexibility of choosing which payment source to use to pay. PayPal offers merchants a convenient means of accepting payments and reduces online shopping cart abandonment by streamlining transactions. PayPal is particularly attractive to smaller merchants that would otherwise have greater difficulty and expense in obtaining similar payment services through banks.

PayPal's business model is primarily driven by payment volumes through its digital wallet and the spread it makes between negotiated acceptance fees paid by merchants (a percentage of each transaction) and the fees PayPal then has to pay to the consumers' payment source (eg credit card issuers). PayPal's operating margins are lowest when customers choose credit cards to pay since it has to pay higher credit card-related fees through to the issuer of the consumer's credit card. Margins are highest when customers use transaction bank accounts to pay, as the fees it pays to banks for this are negligible.

In July 2015, PayPal was spun out of eBay as a standalone company. This has created an opportunity to focus on the core capabilities of the business to support future success in an increasingly fluid competitive market. PayPal continues to benefit from its former parent eBay through a transitory service agreement that recognises their relationship is mutually beneficial to growing PayPal's business as well as supporting the myriad of small merchants on eBay.

A privileged payment network exposed to secular growth tailwinds

PayPal is a member of a select group of global payment networks, alongside Visa, MasterCard and American Express. PayPal is the only new successful global payment network since the launch of MasterCard in the 1960s. It is extremely difficult to establish a payments network, because there needs to be simultaneous acceptance of the network by both consumers and merchants. This requires mass awareness, simplicity of payment, technology ubiquity, fulfilment of arduous customer and merchant servicing needs, as well as strict regulatory requirements.

In a decades-long global trend, the means of payment continues to shift from cash and cheque towards electronic payments. This is being driven by various factors, including convenience, necessity as commerce shifts to online and public policy. This trend has a long way to go. The number of cash payments in many developed economies still comprises more than 50% of transactions and in developing countries more than 90% of transactions. This trend supports growth rates in electronic payments which are a multiple of nominal GDP growth.

Leading the digital payment revolution

PayPal's competitive strength is in online payments, where it has built a very strong brand position with consumers and merchants. Indeed, it has recently been recognized as a top 100 global brand, by Interbrand, for the first time. Recognition and increasing usage is reflected in extraordinarily high payments volume growth of 26% over the last year. Indeed, over the

last 3 years, PayPal has experienced over 20% compound growth in both revenue and operating profit.

PayPal continues to invest in its online and mobile capabilities, having purchased Braintree and Paydiant, which provide merchants with leading capabilities in mobile payments and loyalty. It is also rolling out its One Touch functionality globally, which further simplifies the payment process on all devices and operating systems. However, PayPal has struggled to build an offline presence, ie in physical stores, where the "card" networks dominate. The growth of mobile payments, and increasing "multi-channel" payments & loyalty schemes increasingly supported by large retailers, may help accelerate PayPal's entry into offline.

Competition in the payments sector is increasing, however, with the digital explosion of the past 15 years encouraging the big players of the technology sector to expand their capabilities in the mobile payment space. Apple Pay, Samsung Pay, and Android Pay are all offering mobile and in-app payment facilities via their mobile handsets and through over 1,000 applications. Microsoft and Facebook also have plans to develop their own payment methods. These tech companies do not have direct payments relationships with consumers and merchants, rather these payment capabilities piggyback the existing payments infrastructure of the payment networks, banks and

merchants. Nonetheless, they do compete with PayPal for transactions, particularly in the mobile payments area.

Conclusion

PayPal is a highly scalable business. As strong growth continues and PayPal benefits from its global payment infrastructure and customer base, we expect that, over time, operating margins will expand materially.

PayPal is well placed to benefit from the secular shift to electronic payments, and is progressing well in the mobile space. It has various call options in play across the payments value chain, and is extending into balance sheet lending through its relatively small credit programs. We expect coming years to evidence the operating leverage within the business, where we anticipate margins to expand over time, which will drive earning growth ahead of revenue growth over the medium term.



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