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Monthly
Market
Newsletter

GLOVISTA INVESTMENTS

Glovista Global Perspectives

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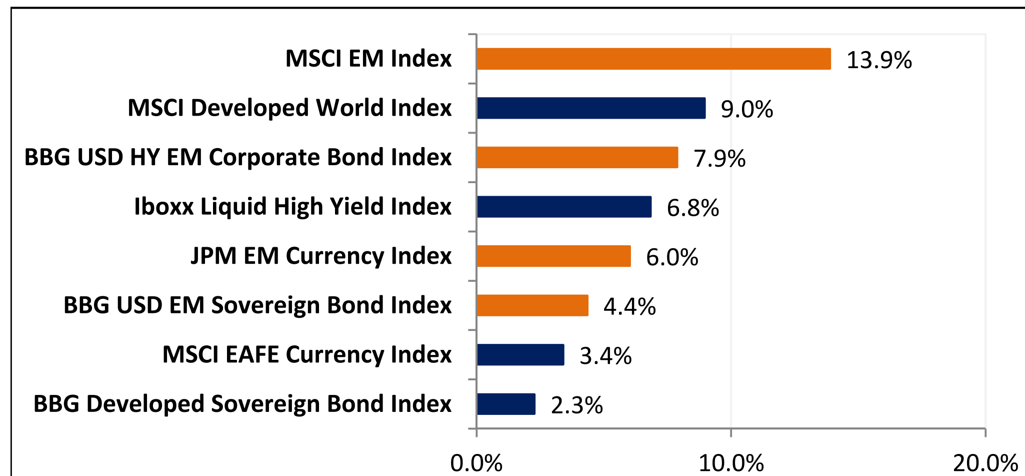
Risk Markets Rally on Back of Reflationary Effects from Broad Developed Country Currency Weakness; EM Asset Prices Likely on Cusp of Protracted Outperformance Vs. Developed Peers

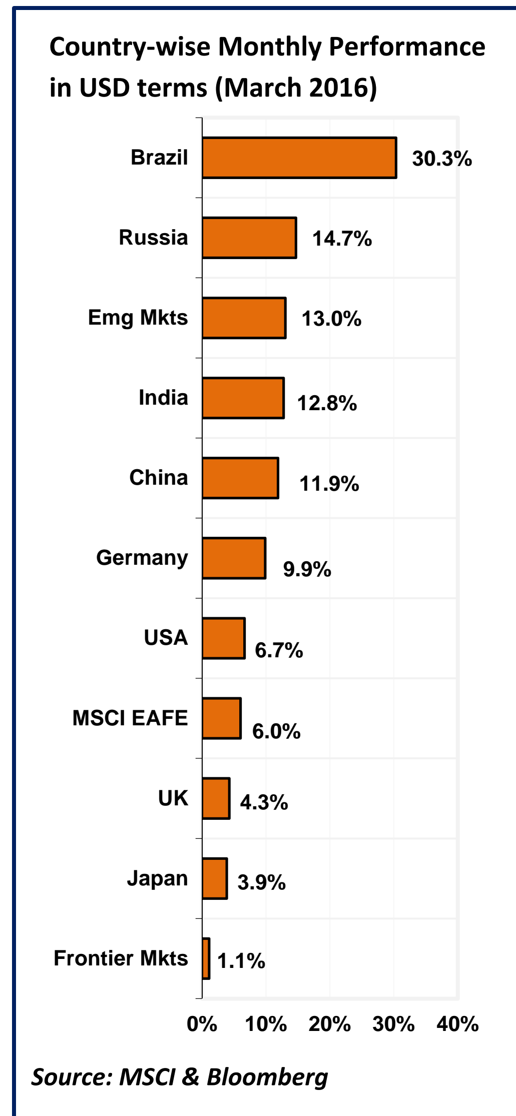
Over the past four weeks, risk market indices have bounced strongly across the equities, credit, commodities and currency divide. Figure 1 illustrates the return performance recorded by a number of benchmark indices during the period ranging between February 29th and April 27th, 2016. We credit the strong bounce in risk indices mainly to the reflationary effects resulting from the generalized Developed country currency weakness that has defined the year-to-date period. In turn, we attribute the recent weakness in Developed country currencies versus their Emerging Market brethren to a succession of significant policy and economic developments that are likely to persist over the balance of this year and possibly further out. As a result, we expect an important cross-section of Emerging Market asset markets to be on the cusp of what is likely to be a long period of relative return outperformance versus their Developed Market peers.

Figure 1. Risk Indices Post Solid Return Performance in March and April, led by Emerging Markets (From February 29th to April 27th, 2016)



Source: Bloomberg. Orange bars represent Emerging Market asset classes and blue bars represent Developed Market asset classes

Country-wise Monthly Performance in USD terms (March 2016)



Source: MSCI & Bloomberg

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Reflationary Phase in Global Markets Fueled by Newly Dovish FED Stance, Intensified ECB and BOJ QE Programs: Sharp EM Rally Ensues

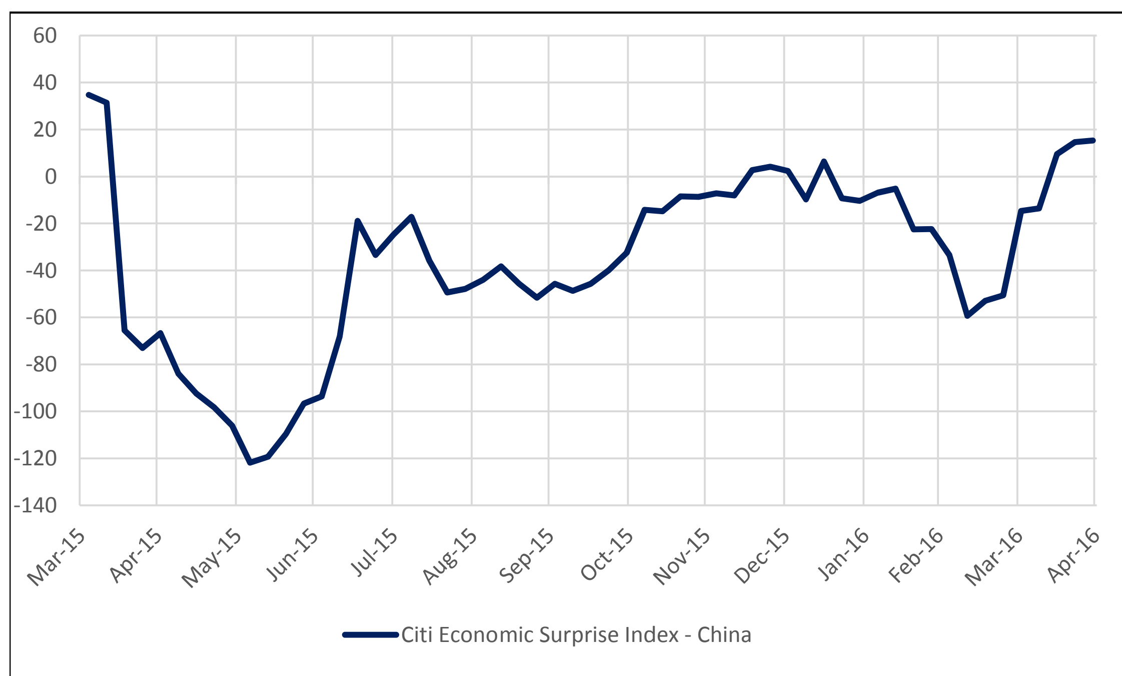
S&P500 Monthly Sector Performance – March 2016

Sectors	% Change	FY1 PE Ratio
Energy	9.18%	75.0
Materials	7.37%	18.0
Industrials	7.02%	16.4
Cons Disc	6.48%	18.5
Cons Stap	4.32%	21.7
Technology	9.10%	17.1
Healthcare	2.59%	15.4
Financials	7.09%	13.6
Utilities	7.69%	17.9
Telecom	6.26%	14.1
S&P500	6.60%	17.5

Source: S&P

In our view, the most significant global macro development this year is found in the policy domain, not in the economic calendar; specifically, the US Federal Reserve's newly embraced dovish stance. The Federal Reserve's dovish stance soon after its implementation of the first policy rate hike in nine years – this past December 2015 – has come as a significant surprise to us and markets. This is because such dovish stance comes at a juncture in which Emerging Market countries are posting a considerable firming in economic momentum, led by China (Figure 2). As our readers may recall, the economic softness and financial fragility that permeated much of the Emerging Markets world this past year (particularly, China) lay at the epicenter of the FED's concerns during much of the second half of 2015; being cited as a key reason in the deferment of policy rate increases.

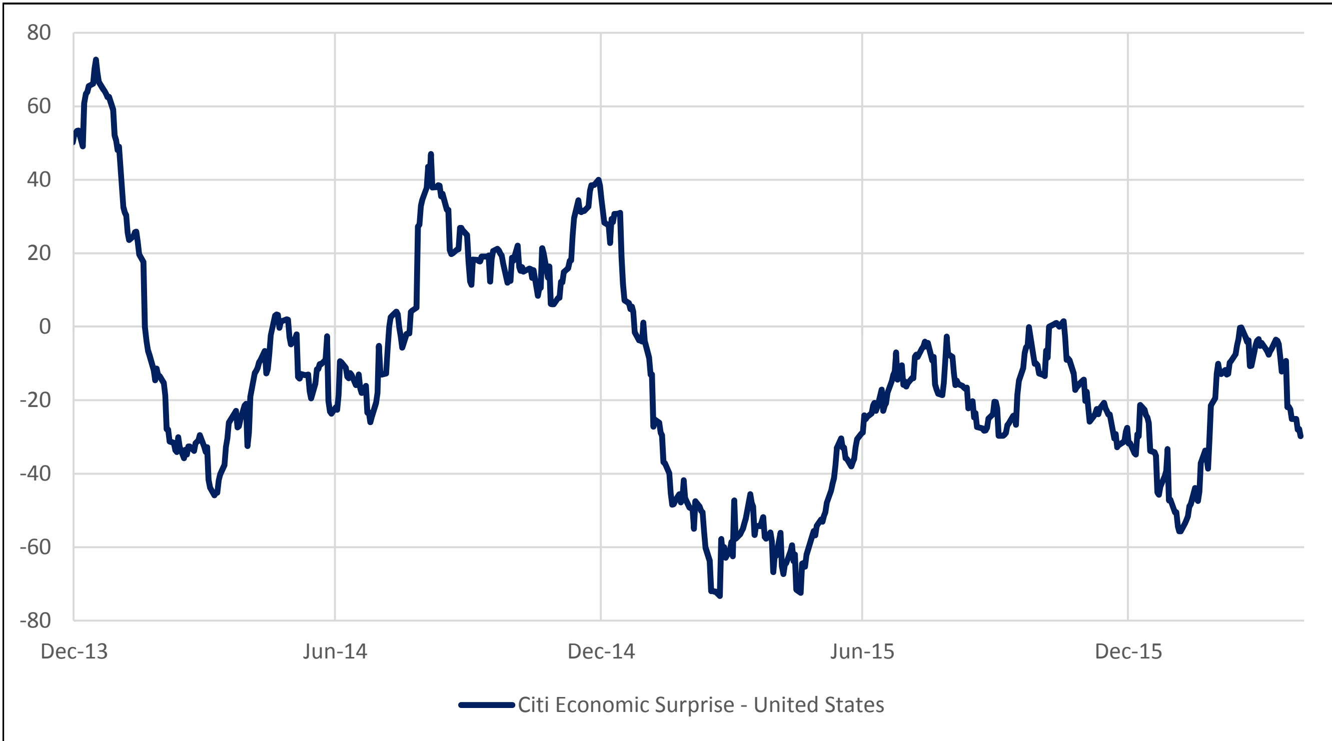
Figure 2. China's Economic Momentum Firms Up Early in 2016



Source: Citigroup Global Markets

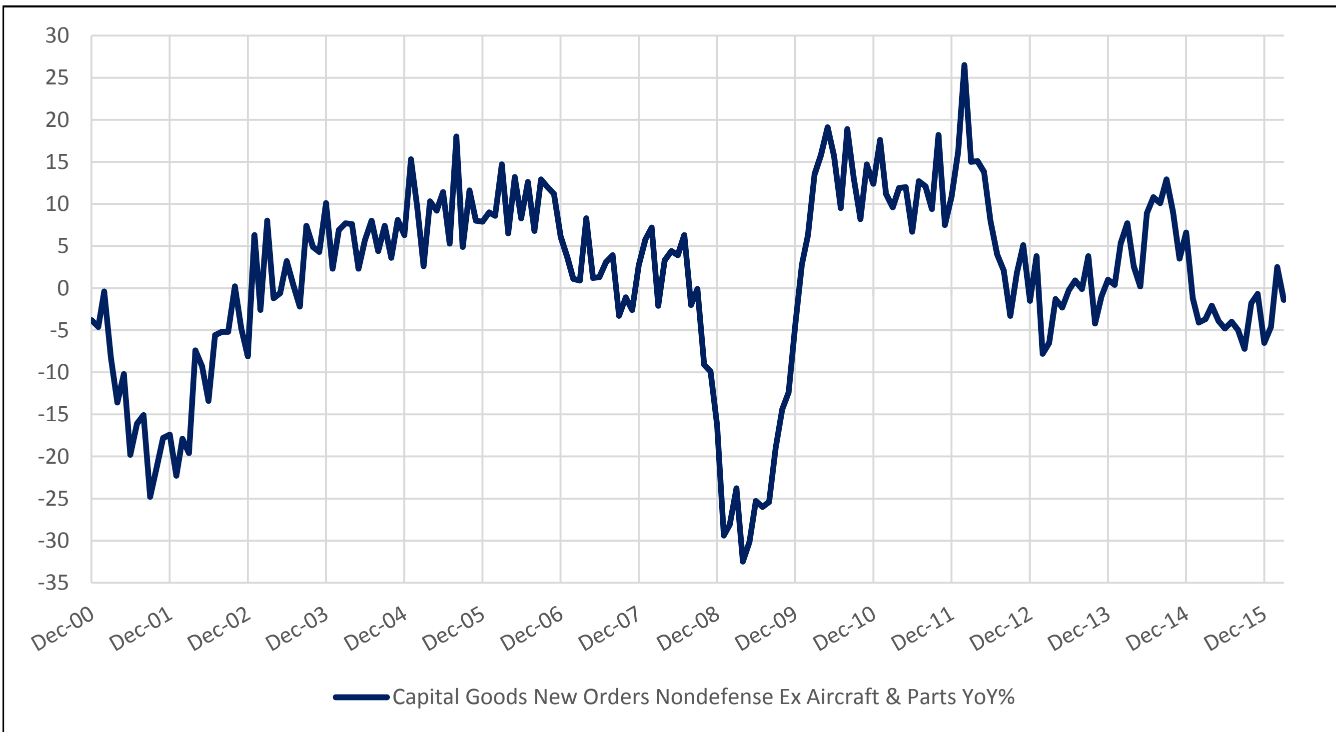
That the FED has embraced a dovish stance over the past several weeks, against the backdrop of a sustained improvement in economic momentum across the developing world, is difficult to reconcile not only with the prevailing narrative at the FED during the second half of 2015 but also with the stable, though unimpressive, economic calendar out of the US these past several months. In particular, thus far this year the US economic calendar has been unimpressive (Figure 3 and Figure 4), displaying continued decelerating momentum along with less than 30 percent recession risk in 2017, in our opinion. The latter, coupled with continued productivity growth deceleration, relative labor market tightness and increasingly higher sequential energy price inflation, renders a material risk of an inflation uptick over the coming quarters.

Figure 3. US Economic Calendar Continues to Underwhelm in 2016



Source: Citigroup Global Markets

Figure 4. US Capex Cycle, an Engine of Growth during the Ongoing Expansion, Continues to Decelerate: (Chart: Capital Goods New Orders Non-Defense ex Air YoY)



Source: U.S. Census Bureau

	March 2016	March Change
Gold	1232.71	-0.5%
Silver	15.4375	3.6%
Oil	38.34	13.6%
EUR	1.138	4.7%
JPY	112.57	0.1%
GBP	1.436	3.2%
CHF	0.9618	3.7%
CAD	1.3004	4.0%
AUD	0.7657	7.2%
BRL	3.5922	10.6%
MXN	17.279	4.7%

Source: Bloomberg

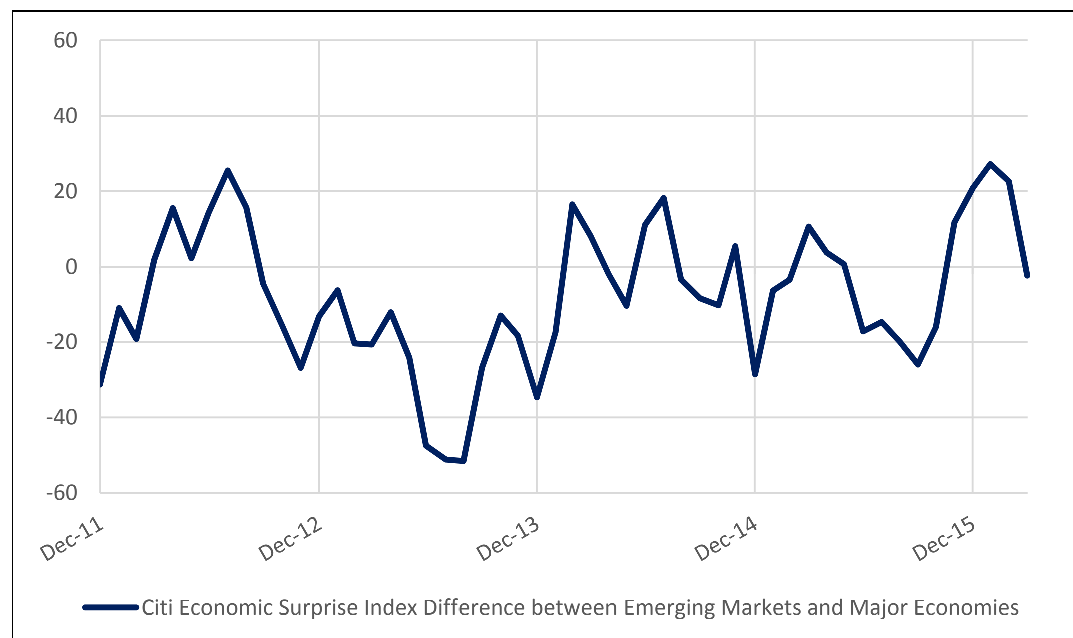
Rates	March 31st Level
1 Yr CD	0.56%
5 Yr CD	1.28%
30 Yr Jumbo Mortgage	4.01%
5/1 Jumbo Mortgage	3.89%
US Govt. 10 Year	1.7687%
10 Yr Swap Spread	-0.1313%

Source: Bloomberg

The US FED's newly embraced dovish stance is not this year's sole policy surprise. The European Central Bank (ECB) and the Bank of Japan (BOJ) have also surprised investors, including our investment team, with the vast expansion in their respective quantitative easing programs announced over the past several weeks. For example, besides the March 10th announcement by the ECB of a series of expanded measures in its QE program, discussed in our previous monthly column, at its most recent meeting held on April 21st, the ECB widened the spectrum of bond instruments eligible for purchase in its QE asset purchase program. Similarly, at its January 29th scheduled meeting, the BOJ announced the following additional measures: (a) cut in interest rates to negative 0.10% on a portion of bank's reserves; and, (b) adjustments to existing asset purchase program of 80 trillion Yen a year ($666 billion) including extension of maturity of Japanese bonds from 7 - 10 years to 7 - 12 years, addition of further 30 billion Yen a year in ETF purchases to an existing amount of 300 billion Yen a year and an increase in the maximum amount of REITs the BOJ can purchase, up to 10% of each issue from a prior 5% .

In our view, the string of G3 policy actions and guidance announced over the past several weeks amount to a material loosening of financial conditions via the currency channel as G3 central banks indirectly signal a stronger tolerance for the cheapening of their currencies. This is because such heightening of QE programs comes at a juncture in which economic momentum in Emerging Market economies is picking up materially (Figure 5) and a large number of the historically financially fragile EM economies are no longer posting large current account deficits. Such changing macro conditions in the Emerging Markets space have helped bring about a bottoming/reversal in the longstanding period of currency weakness that defined much of the past several years (Figure 6). As a result, at a time in which

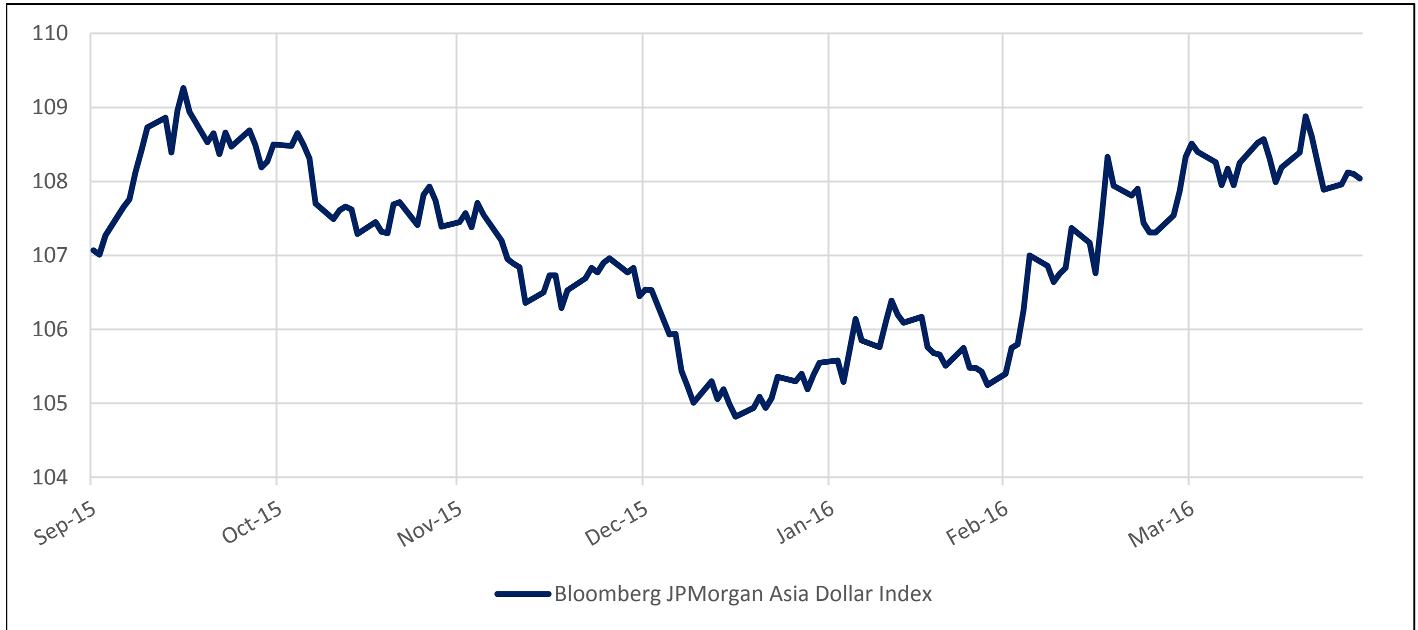
Figure 5. EM Economic Momentum Firms Up Early in 2016, even versus Developed Country Peers



Source: Citigroup Global Markets

disinflationary dynamics are well ingrained across much of Emerging Markets, the incipient period of currency strength combined with low inflation and improved balance of payments position may represent a preamble to a sustained reversal in economic momentum between advanced economies and Emerging Market countries.

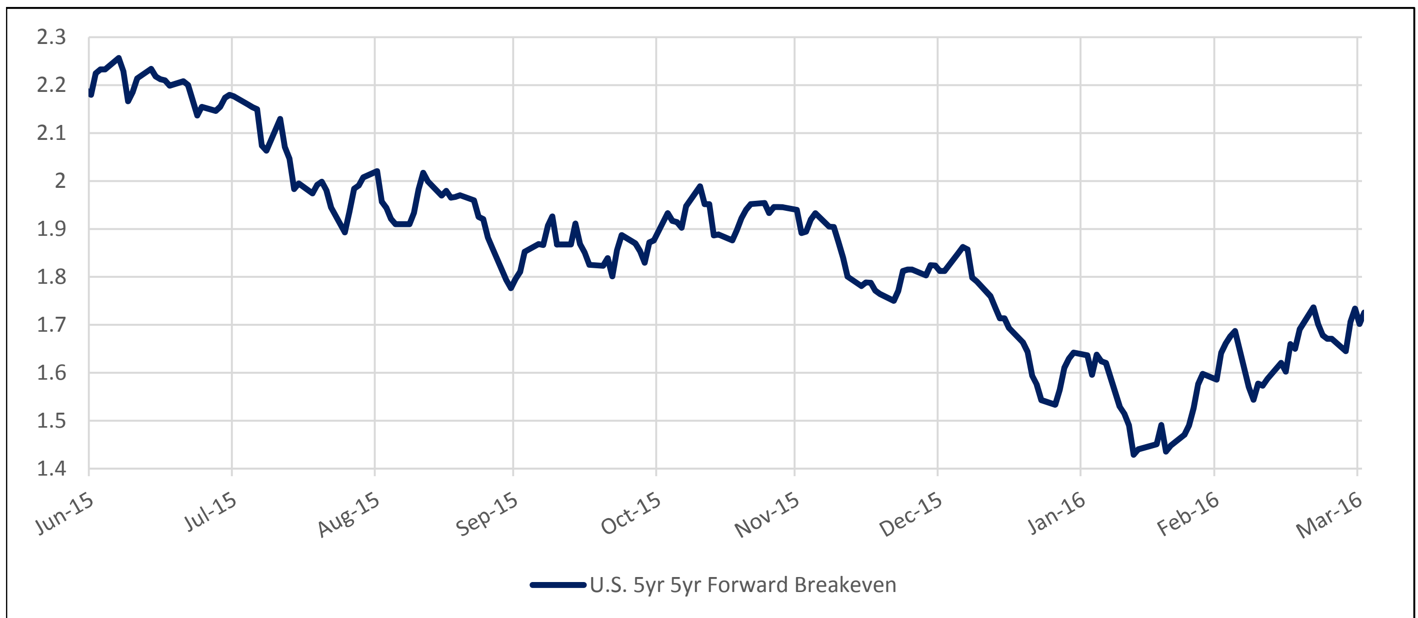
Figure 6. Key Emerging Market Currencies Bounce Strongly in 2016 as Balance of Payments Positions Improve Markedly and Growth Momentum Picks Up



Source: Bloomberg

The loosening of world financial conditions resulting, in first instance, from the FED's newly embraced dovish stance as well as the ECB's and BOJ's expanded QE programs is illustrated eloquently in the sustained recovery of inflation expectations (Figure 7) and strong recovery in commodity prices (Figure 8).

Figure 7. US Inflation Expectations Bounce Strongly YTD



Source: Bloomberg

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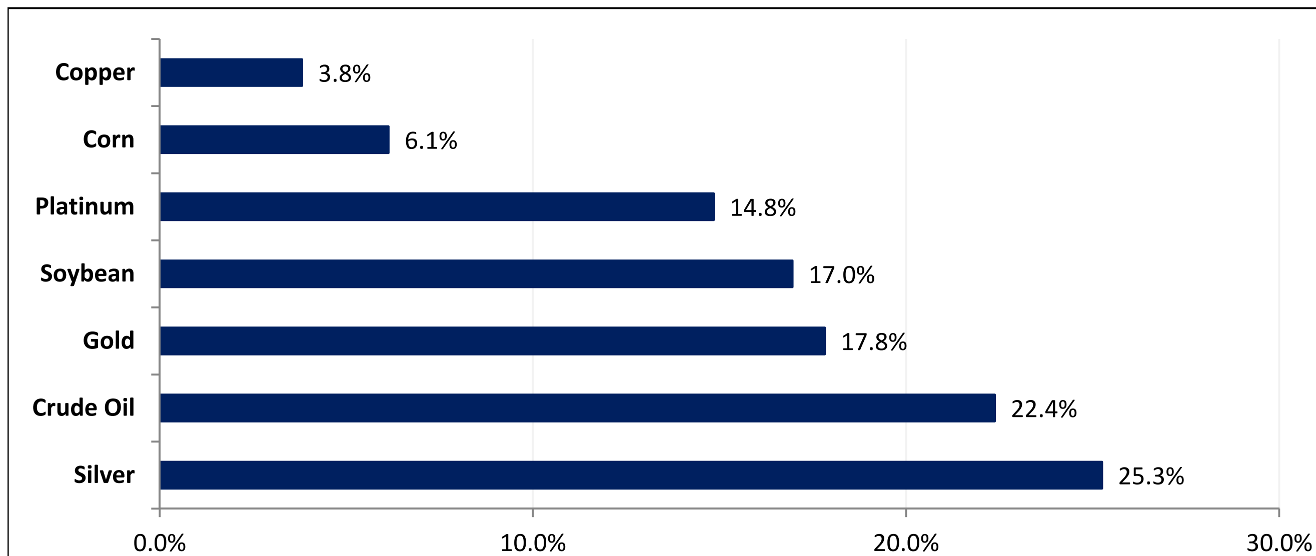
Figure 8. Commodity Prices Post Solid Increases Year-to-date (As of April 27th, 2016)



Source: Bloomberg

Recent Macro/Policy Developments Signal Impending Upturn in Market Leadership Away from Developed in favor of EM Markets

Against a backdrop of improving relative economic momentum in favor of Emerging Market economies versus Developed Market peers and a marked loosening of financial conditions, it should come with little surprise that Emerging Market asset prices have posted sharp sustained return outperformance versus Developed peers across the equities, currencies and fixed income divide.

Glovista's investment team believes the recent period of EM return outperformance versus DM peers represents but the early stages of what is likely to be a sustained period of outperformance. Such expectation is grounded on a number of considerations that cut across the valuation, policy, activity and technical market dimensions. We have already addressed the policy dimension above. Insofar as valuations are concerned, Figure 9 illustrates Emerging Market equities' considerable valuation attractiveness versus Developed Market peers even without controlling for the all important caveat that Developed (especially US) earnings cycles exhibit multi-year peak characteristics while the Emerging market earnings cycle manifests multi-year trough features. Such differentiation emanates not only from the observation that business cycles for advanced economies are well extended (as evidenced by labor market tightness and profit margin levels) but is also evidenced in relative real exchange rate levels.

Insofar as technical considerations supportive of the thesis in favor of continued EM asset market outperformance of DM peers, there is no dearth of such indicators, including current extended discount to NAV levels displayed by some of the largest EM closed-end funds as well as indicators of relative ownership levels for US listed Emerging Market securities versus market capitalization measures of underlying local markets.

Figure 9: EM Equity Valuations Hover at Close to Multi-year Low Levels versus Developed Peers Despite Sharp Contrast in Relative Earnings and Margin Cycle Stages

Source: MSCI, Bloomberg and Glovista Calculation

Glovista Takes Profit in Long Duration Fixed Income, Raising Exposure to EM Equities, Selected Developed Country Equities and Precious Metals/Energy Commodities

Over the past several weeks, we have rebalanced our GTAA managed portfolios across as well as within asset classes. In fixed income, we have lowered duration exposure owing to a number of considerations, including:

- reduced term premium levels as investors lower their expectations over the number of future rate hikes;
- rising risks of positive inflation surprises in the USA following the sharp reversal recorded by energy prices these past several months as well as the release of economic data ratifying the continued low rate of US productivity growth thus far this year.

Within our managed portfolios' fixed income sleeves, we continue to favor exposure to US Dollar denominated high grade debt of intermediate duration. Likewise, we have significantly cut overall exposure to US Treasury securities, favoring ownership of corporate debt instead.

In equities, we have taken profits in defensive sector names domiciled in advanced economies, particularly in utilities and consumer staples. We have favored the purchase of exposure to the following sectors: Emerging Market equities, mining stocks, selected pharmaceuticals, European financials and energy. All of those sectors, with the exception of pharmaceuticals, represent investment plays on the global reflationary theme we embrace as part of our global investment thesis, discussed above. In addition, these sectors favored by our investment team offer considerably attractive valuations, both in absolute as well as relative terms versus global peers.

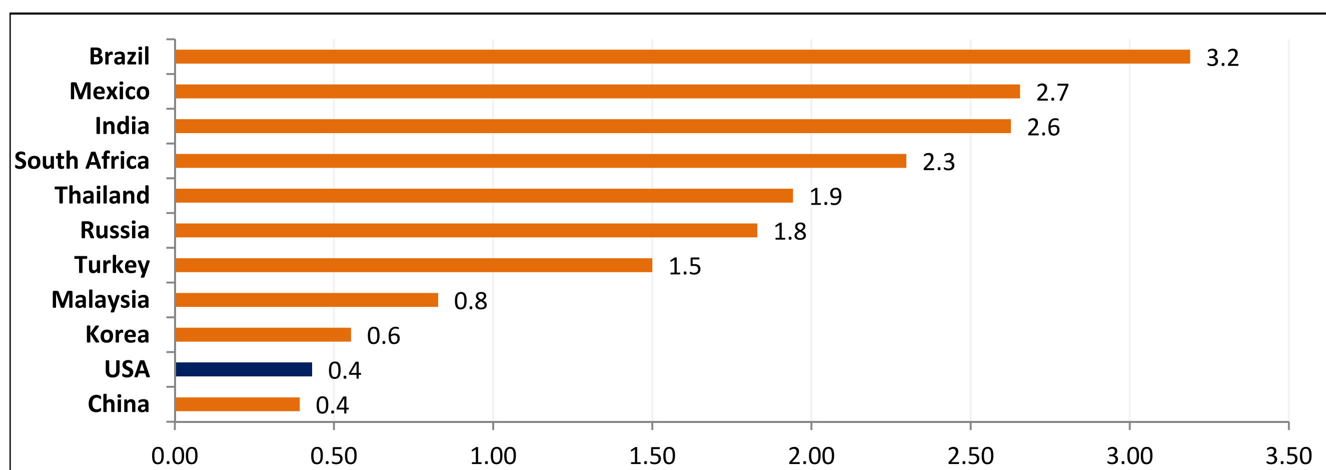
In commodities, we recently cut exposure to precious metals, switching exposure to energy commodities. We continue to avoid exposure to soft commodities on volatility considerations.

Emerging Market Perspectives

US$ Cycle Peak versus EM FX Likely in Place Fueling Potential for Sustained Outperformance of Value versus Growth; Glovista Raises Energy, Financials at Expense of Technology and Discretionary

As discussed above, our investment team views the US Federal Reserve's newly embraced dovish stance so soon after this past December's first policy rate hike in nine years to be this year's most surprising macro development. Moreover, that such dovish stance unfolds at a juncture in which Emerging Market economies are: (a) recording significant cyclical acceleration versus their Developed country peers, and; (b) posting stronger current account balance positions, while; (c) experiencing benign inflation backdrops, has helped raise the allure of Emerging Market fixed income and equity instruments for global asset allocators, not only on valuation but also carry considerations (Figure 10).

Figure 10. Real Bond Yields for a Selection of Emerging Market Currencies alongside the US Dollar (Real Bond Yield Calculated Using Nominal 5-Year Bond Yield adjusted for Trailing 12 Months Inflation)

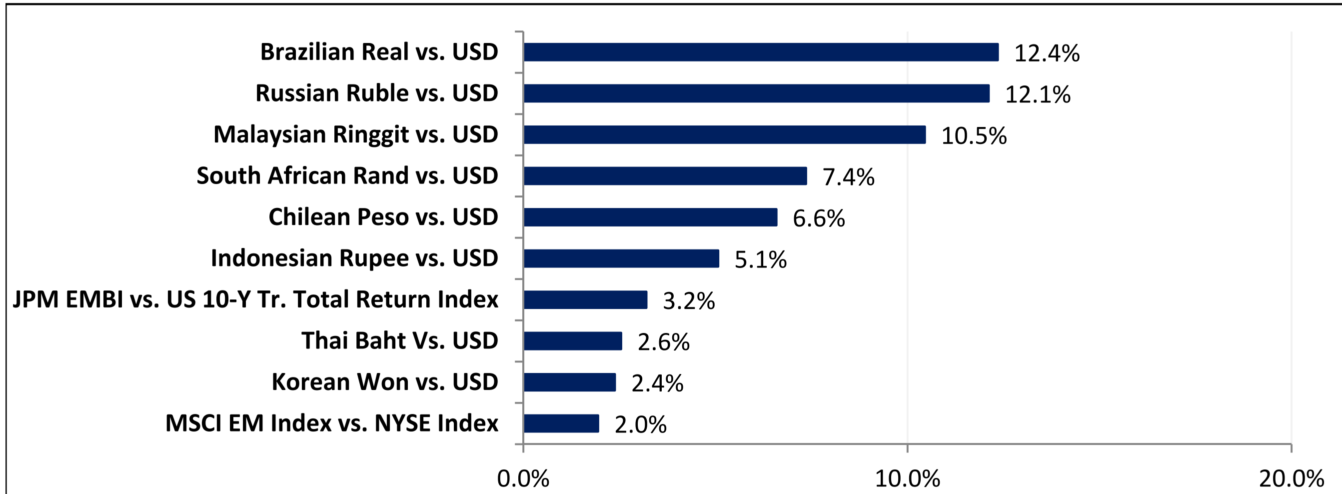


Source: Bloomberg and Glovista Calculation

The above listed constellation of macro and financial developments has helped bring about a sustained sharp return outperformance by Emerging Market equities, bonds and currencies versus Developed country peers these past several weeks. Figure 11 illustrates 2016 year-to-date relative return performance for the broad EM space, by asset class, versus US benchmarks.

The hunger for yield and value on the part of global investors has found no clearer destination than value sector plays in the EM space, including financials and energy. Our investment team's strong conviction that the EM economic cycle has already bottomed versus developed peers, not only on the basis of the incipient economic acceleration in EM economies but also the continued softness in the US and Eurozone cycle, leads us to the equally consequential conclusion that EM currencies (with a number of exceptions) have already bottomed (for this cycle) versus developed country peers. As a result of this newly embraced thesis, we believe a number of value sectors across a cross-section of Emerging Market countries carry a significant potential for relative return outperformance versus the EM benchmark in the quarters ahead.

Figure 11. EM Asset Prices Sharply Outperform US Peers during 2016 (December 31st, 2015 to April 27th, 2016)



Source: Bloomberg and Glovista Calculation

As a result of the above considerations, over the past several weeks we have implemented a number of country- and sector-level rebalancing actions across our managed EM portfolios resulting in: upgrades of China, Russia and Chile at the country level; downgrades of Korea, Taiwan and India at the country level; upgrades of Energy at the sector level, and; downgrades of Technology, Industrials and Telecoms, at the sector level.

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