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Monthly
Market
Newsletter

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INVESTMENTS

Glovista Global Perspectives

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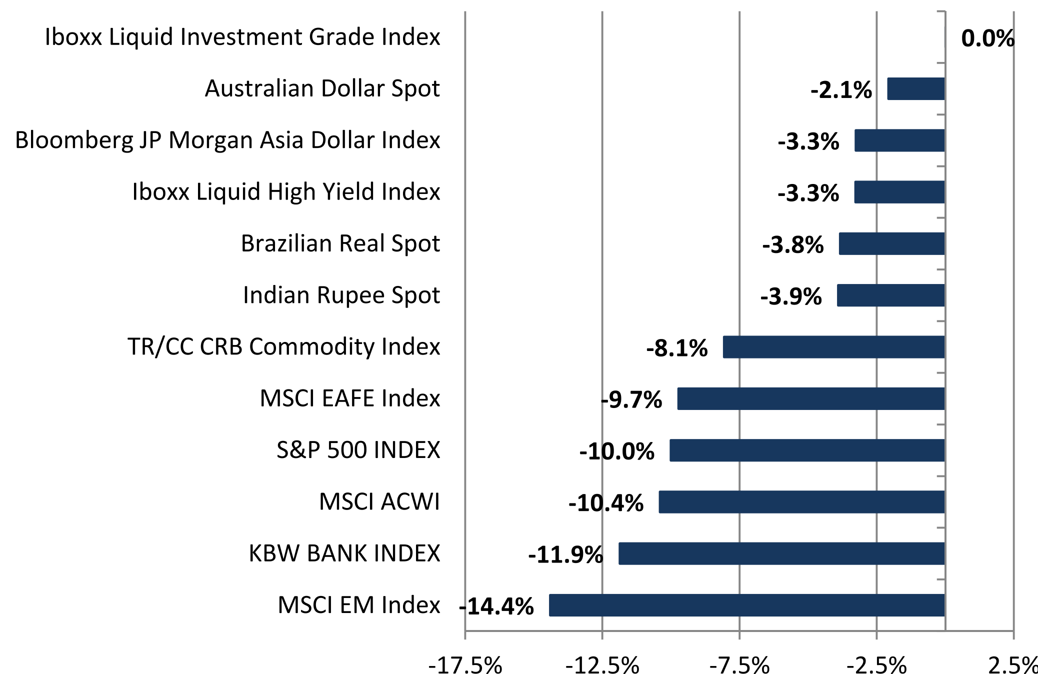
China's August 11 Devaluation Sets Off Sharpest Global Sell-off since 2008; Glovista Sustains Defensive Portfolio Stance

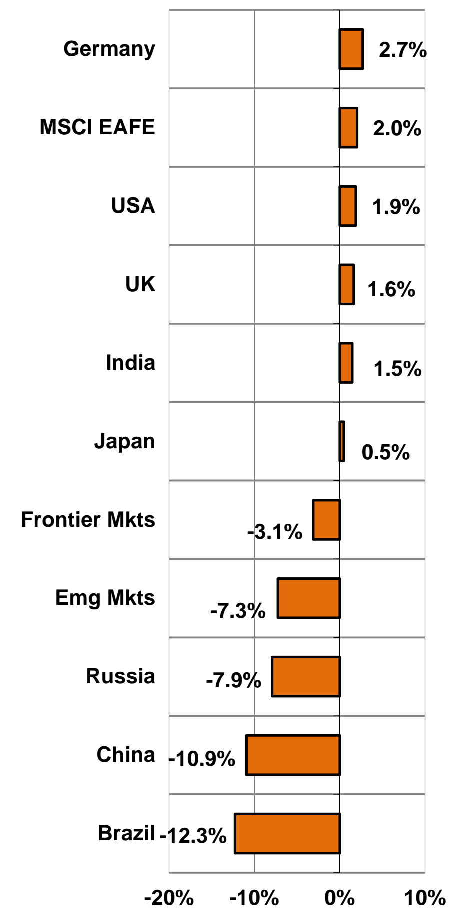
Over the past few weeks, risk markets globally have sold off sharply, including credit, commodities and equities, recording some of the sharpest short-term price declines since 2008. As illustrated in Figure 1, between August 1 and recent low levels recorded by risk indices on August 24th, global equities – as represented by the MSCI AC World index - sold off 10.4% while commodities – as represented by the CRB index –declined 8.1% and benchmark US high yield index spreads widened by 83 basis points.

Figure 1. Risk Markets Record Sharp Price Declines in Immediate Aftermath of China's Historic August 11th Currency Devaluation: August 1-24 Return %



Source: Bloomberg

Monthly Performance by Country in USD terms (July 2015)



Source: MSCI & Bloomberg

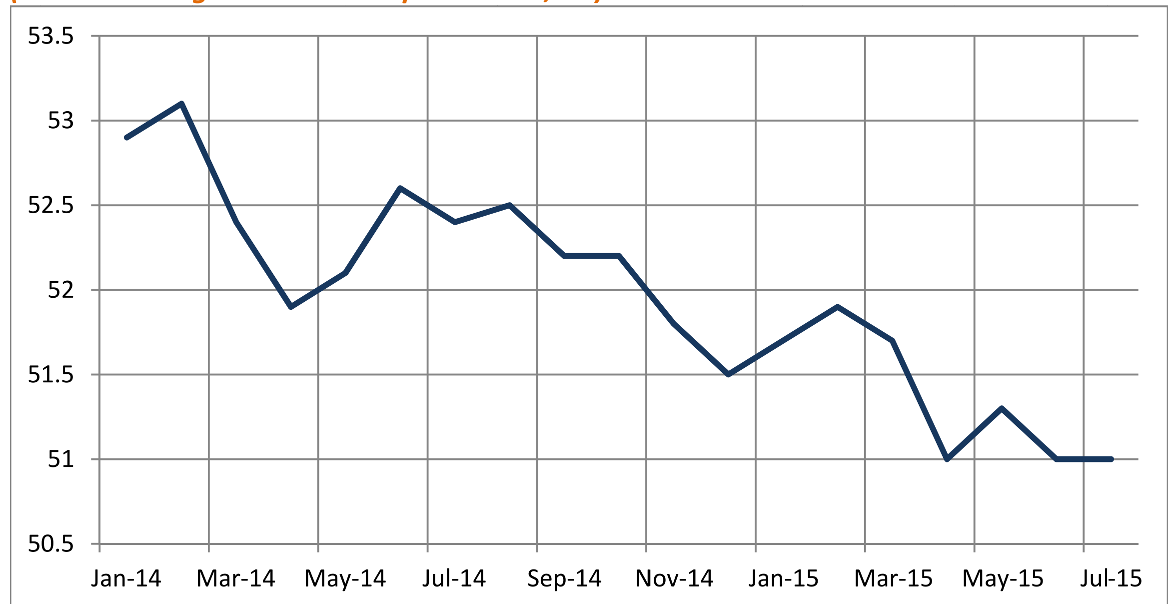
S&P500 Monthly Sector Performance – July 2015

Sectors	% Change	FY1 PE Ratio
Energy	-7.81%	26.0
Materials	-5.03%	16.9
Industrials	0.14%	16.6
Cons Disc	4.71%	20.9
Cons Stap	5.30%	20.8
Technology	2.92%	16.8
Healthcare	2.73%	18.7
Financials	3.01%	14.9
Utilities	6.01%	16.2
Telecom	-1.15%	12.9
S&P500	1.97%	17.8

Source: S&P

The recent sell-off in global markets conforms to the defensive portfolio stance embraced by us these past several months, the rationale for which has been laid out in our most recent monthly columns. In our view, the recent sell-off in risk markets owes much to heightened concerns over the world economic outlook both in terms of activity and price dynamics, following a succession of underwhelming economic releases out of some of the world's major economic blocs (Figure 2), together with the global macro and market implications stemming from China's historic currency devaluation and shift in exchange rate regime announced on August 11th. The People's Bank of China (PBOC) announced that the fixing of the midpoint of the Chinese Yuan against the US Dollar each day should refer to the closing rate of the inter-bank market on the previous day, in conjunction with and adjustment for the prevailing demand and supply conditions in the foreign exchange market including exchange rate movements of major currencies.

Figure 2. World's Economic Activity Indicator Continues to Underwhelm (Chart: JPMorgan Global Composite PMI, SA)

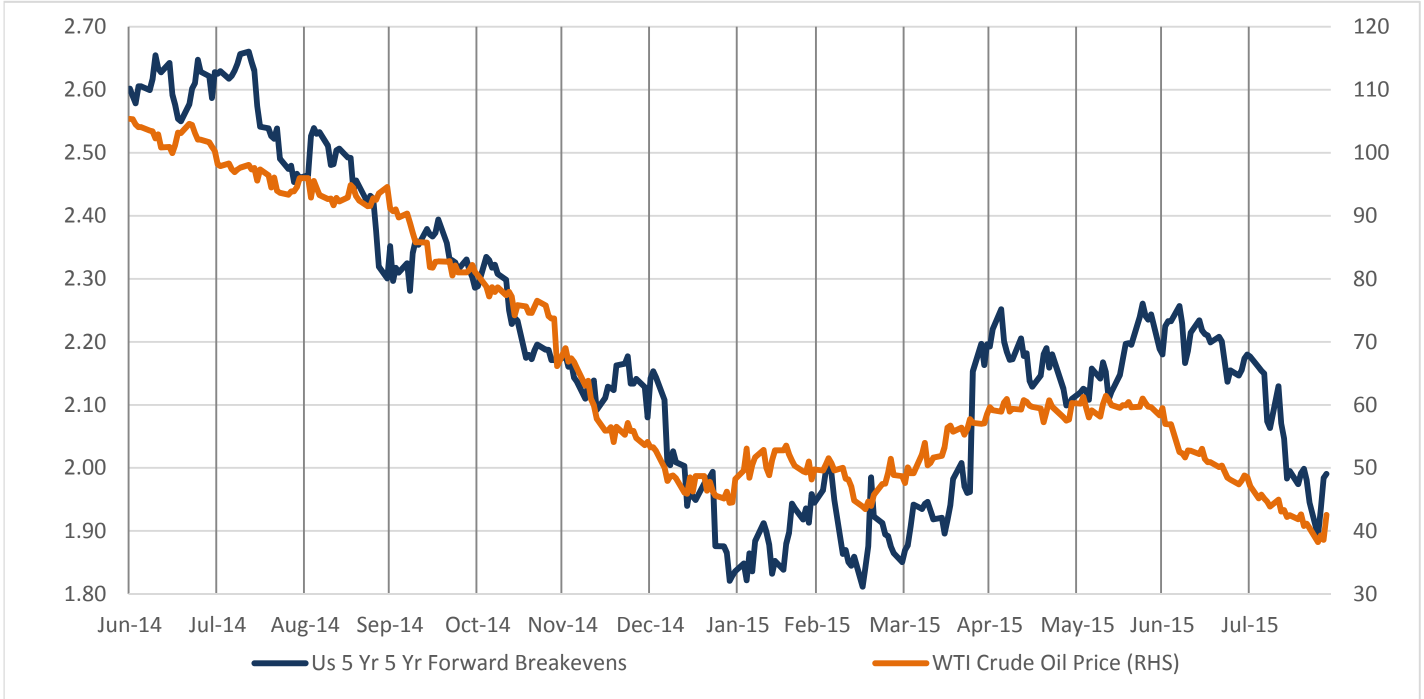


Source: Markit

We believe the world economic calendar's underwhelming overtones together with China's August 11 historic policy announcement have combined to heighten global investor concerns over the potential for deflationary pressures alongside a weaker than previously expected economic outlook to take hold in the coming months. These concerns are reflected across multiple financial indicators, including inflation expectations (Figure 3) and sharp relative underperformance of cyclically oriented equity sectors, such as materials and industrials (Figure 4).

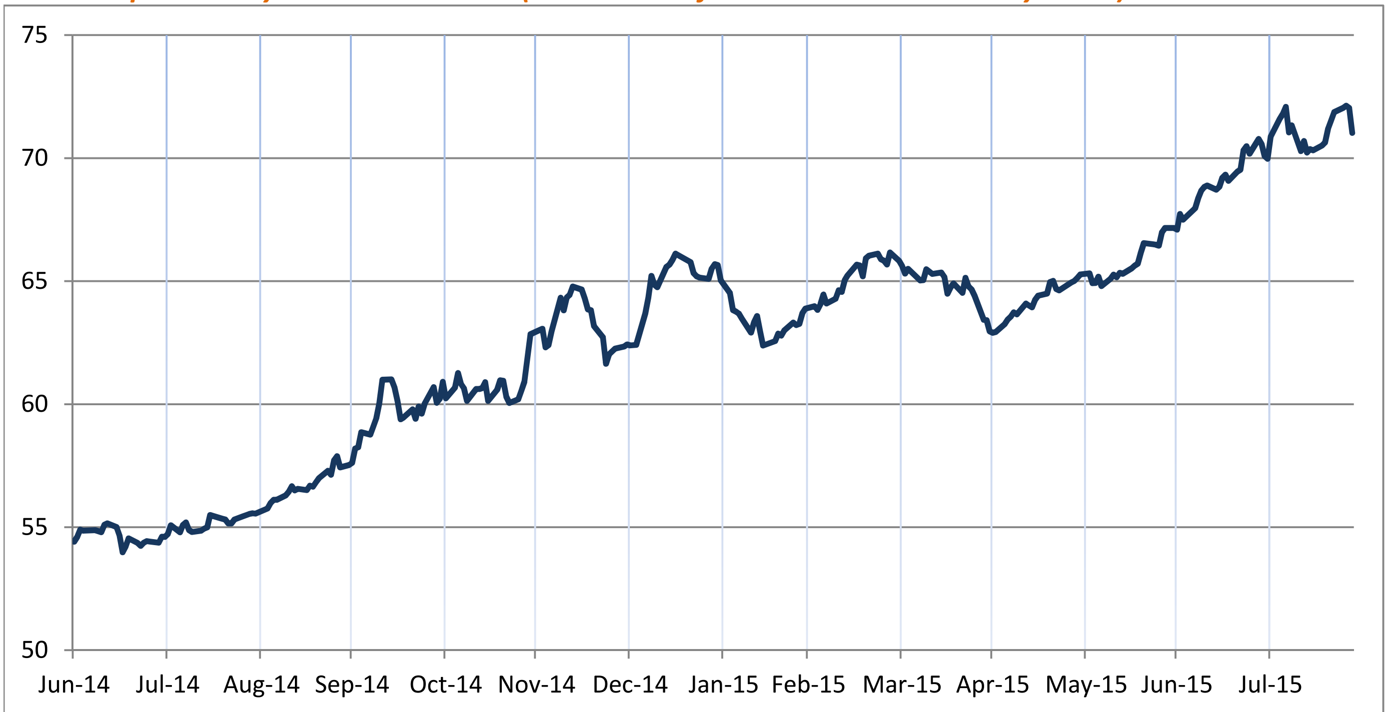
We believe China's recent historic announcement carries lasting material implications for the world economic outlook, both at the activity and price levels, owing to China's status as (a) the world's second largest economy, (b) the single largest contributor to world economic growth this past decade, and (c) the world's largest commodity consumer. More specifically, the Glovista investment team identifies multiple transmission channels through which China's recent shift in exchange rate regime is likely to impact the rest of the world economy. These channels include the following:

Figure 3. US Medium-term Inflation Expectations Fall Sharply following China's August 11 FX Policy Announcement amid Declining Commodity Prices



Source: Bloomberg

Figure 4. Investor Concerns over World Economic Outlook Evidenced in Defensive Sectors' Performance Leadership versus Cyclical Sector Peers (Chart: US Defensives Relative to US Cyclicals)



Source: Bloomberg & Glovista Calculations

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	July'15	July Change
Gold	1095.82	-6.5%
Silver	14.7825	-6.1%
Oil	47.12	-20.8%
EUR	1.0984	-1.5%
JPY	123.89	-1.1%
GBP	1.5622	-0.6%
CHF	0.9663	-3.3%
CAD	1.3091	-4.8%
AUD	0.7308	-5.2%
BRL	3.4214	-10.3%
MXN	16.1088	-2.4%

Source: Bloomberg

Rates	July 31st Level
1 Yr CD	0.63%
5 Yr CD	1.49%
30 Yr Jumbo Mortgage	4.29%
5/1 Jumbo Mortgage	3.85%
US Govt. 10 Year	2.18%
10 Yr Swap Spread	0.09%

Source: Bloomberg

- Disinflationary impact on the rest of the world economy as China is the world's largest manufacturing country and a weaker currency will translate into lower goods price inflation globally;

- Secular increase in financial market volatility as China's exchange rate regime actions amount to an important first step on the road to full exchange rate liberalization. As is well established in financial history, exchange rate volatility correlates closely with fixed income and equity volatility so that our expectation for a secular increase of financial market volatility is not limited to foreign exchange volatility. Moreover, higher volatility is well known to impact adversely equity valuation multiples, an issue discussed in greater detail further below in reaffirming Glovista's longstanding defensive portfolio strategy stance;

- Increased potential for multinationals, domiciled across multiple regions of the world, to face increased competition in the coming quarters and years as China has signaled eloquently the end of a 20 year period of secular revaluation of its currency. In turn, these dynamics are likely to support a scenario of secular return outperformance, all else held constant, for Chinese multinationals versus an important subset of competing multinationals in third markets. Our investment team identifies a number of Korean, Taiwanese, Japanese, US, German and French multinationals among the most at risk;

- Likely deferment in the timing of policy rate hikes orchestrated by the US Federal Reserve and the Bank of England in the coming months alongside a diminution in the overall number and quantum of succeeding policy rate hikes as potent goods disinflationary pressures take hold.

Against such backdrop, global equities, credit and commodity prices have declined sharply, including the recent participation of US equities in the declining price momentum. Over these past several weeks only a handful of market sectors have averted these downward price spirals. Such few sectors include precious metals (especially gold) and so-called developed country funding currencies, such as the Euro, Japanese Yen and Swiss Franc.

Glovista's investment team identifies both fundamental and technical factors in the recent sell-off of risk markets globally. At the fundamental level, China's historic shift in its exchange rate regime represents an unambiguously adverse development on global equity prices over the short- and possibly medium-term because of several considerations, including:

- The policy action's signal of Chinese government authorities' diminished confidence in the pace of economic momentum over the coming months;

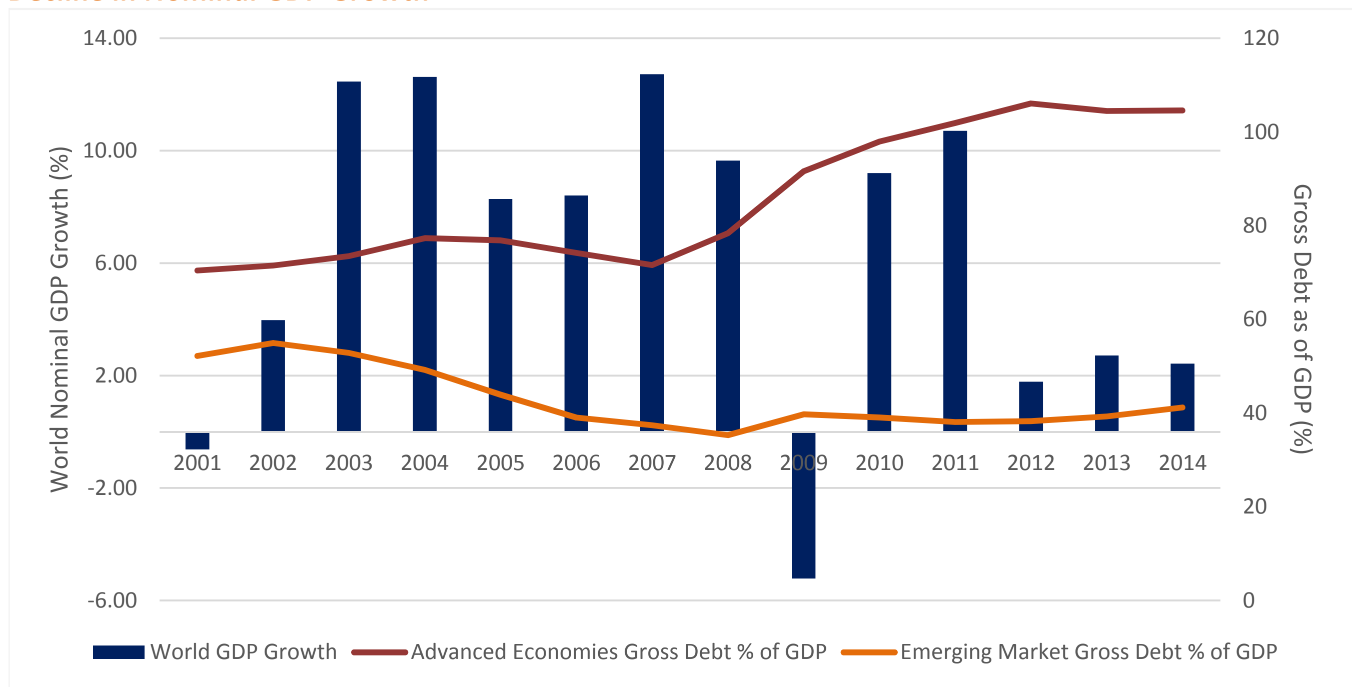
- The policy action's unambiguous implication in fueling a reset of world financial market volatility to higher levels, an adverse development for equity and credit risk premia – thus for equity valuation multiples;

- The policy action's likely adverse impact on competing multinational firms' revenue and earnings outlook on activities in third markets in which competition with Chinese corporates is likely to escalate in the coming months and years;

- The policy actions' likely adverse impact on world multinational firms' future sales and earnings growth potential as a secular weakening of a more volatile Chinese Yuan is likely to translate into a corresponding weakening of a large number of currencies around the world, both in Emerging Markets and selected Developed countries. These dynamics are important as multinationals' revenues and earnings are a sizable share of some of the world's largest indices.

At the technical level, indirect effects of the shift in China's exchange rate regime reinforce the powerful bearish trend facing commodity markets globally. In turn, such dynamics exert deflationary effects globally, a negative for world markets at a time in which nominal GDP growth hovers at rather low levels when viewed from a long-term perspective especially given the persistently high levels of leverage at the global level (Figure 5). Moreover, the timing of China's shift in exchange rate regime has proved detrimental for risk markets as the world economic calendar has continued to underwhelm, not only in China but also in the Eurozone, Australia, France, Canada, the USA and Japan, as well as a number of Emerging Market countries, particularly Brazil and selected Eastern European nations.

Figure 5. World Economy's Balance Sheet Remains Stretched as a Percentage of GDP and given Steady Decline in Nominal GDP Growth



Source: World Economic Outlook Database from IMF

Insofar as our investment strategy stance is concerned, both at the Global and Emerging Market levels, our views remain largely unchanged from those exposited in our most recent monthly newsletter.

At the Global level, within the confines of our GTAA program, we have further tightened our longstanding defensive stance by maintaining minimal equity market exposures owing to persistent headwind factors while choosing credit market instruments as a more attractive risk space, particularly US Dollar denominated instruments. Some factors especially challenging to Developed equity markets' outlook, identified by our investment team, include the following:

- Declining US profit margin dynamics, owing to adverse lagged effects on top line growth stemming from a strengthening US Dollar and weakening growth pace of foreign economies, at a time when US equity valuations remain stretched by historical standards;

- Potentially adverse economic and profit margin effects on Japanese equities resulting from a strengthening of the Japanese Yen likely to result from a more aggressive ECB policy stance on the quantitative easing front as well as the Japanese Yen's well proven safe haven status during periods of increased volatility;

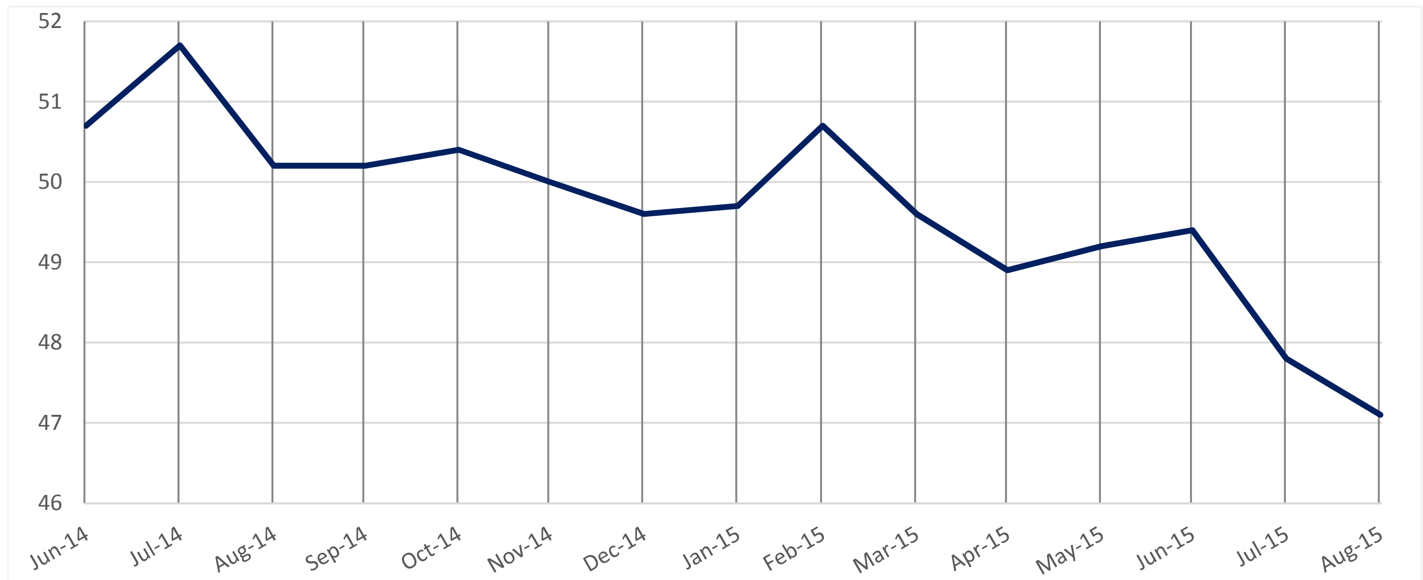
- Adverse industrial sector implications on European equities due to softening economic momentum in China and the Middle East (courtesy of a vastly lower crude price), both of which are core export markets for European corporates, compounded by detrimental foreign exchange translation implications stemming from the Euro currency's sharp revaluation versus Emerging Market currencies these past several weeks.

Prior to raising our portfolios' equity exposure levels materially, we await greater clarity on the economic and policy front (including the upcoming September US FOMC meeting and the US third quarter earnings season). Insofar as the currency market outlook is concerned, we remain strong US Dollar bulls. We view recent price declines for the Greenback versus the Euro, Yen and Swiss Franc as predominantly the result of market technical considerations, specifically short squeeze dynamics on crowded carry trades held by levered players. A similar interpretation applies to the price of gold.

Regarding Emerging Markets, China's historic shift in its exchange rate regime accelerated a number of non-trivial rebalancing actions at the country level in our Emerging Market portfolios. From a directional perspective, Emerging Market asset prices have come under significant downward pressure these past several weeks owing to a number of mutually adverse reinforcing developments, stemming from China's August 11 devaluation:

- Implication about the pace of Chinese economic momentum, the world's second largest and a major trading partner of some of the largest Emerging Market economies in Asia, Latin America and EMEA (Figure 6);

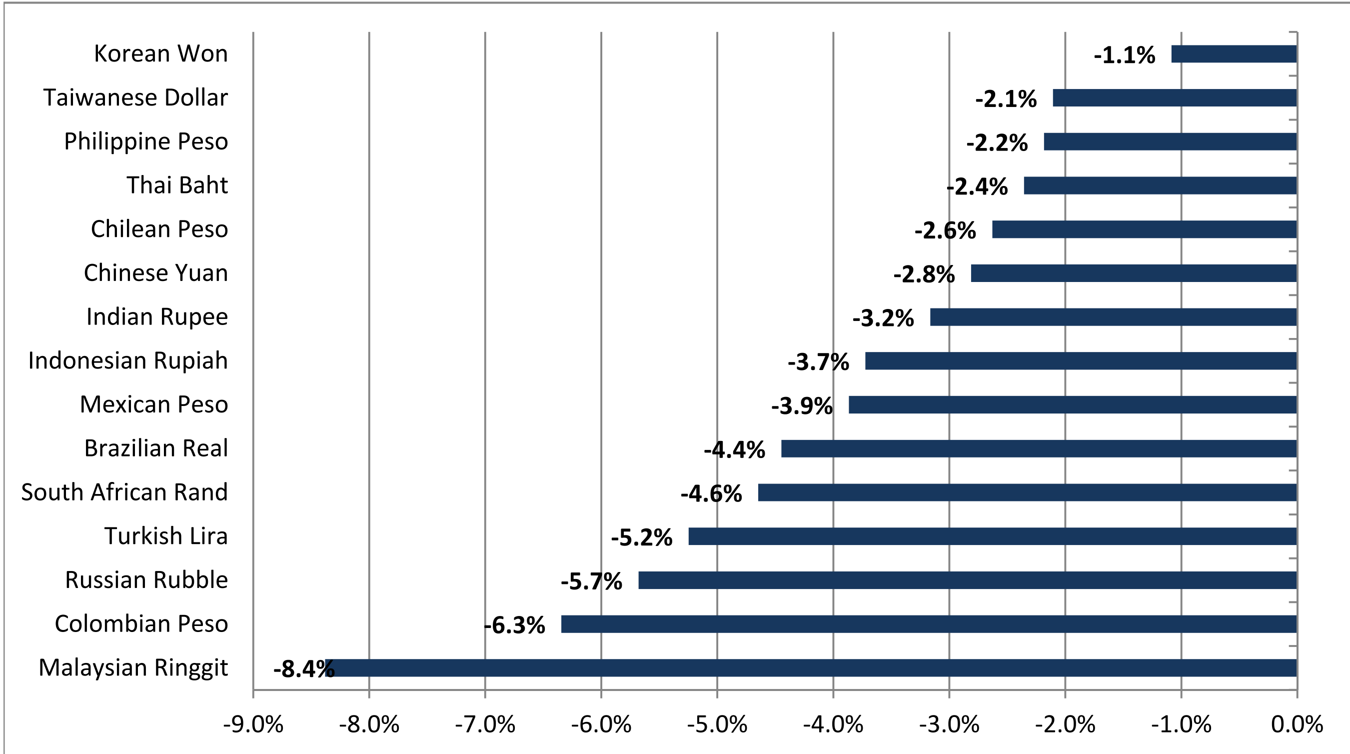
Figure 6. China's August 11th Devaluation as Coincident Development with Ongoing Deceleration of Economic Growth Momentum: China's PMI Index



Source: Bloomberg

- Knock-on effect on a large number of Emerging Market currencies that have experienced sudden sizable devaluations in the immediate aftermath of China's August 11th devaluation. Such wave of currency devaluations has spanned across all of the world's geographic regions as illustrated in Figure 7;

Figure 7. EM Currencies Undergo Sizable Devaluations in Immediate Aftermath of China's August 11th Devaluation: (August 1- August 27 2015)



Source: Bloomberg

- Underwhelming world economic growth momentum, as illustrated in Figure 2, together with sharp commodity price declines impacting a number of major Emerging Market commodity exporting countries (Figure 8).

Figure 8. 3rd QTD Crash in Crude Prices, the Largest in Seven Years: First-Order Impact to a Number of Major Energy Exporting Countries

Source: Bloomberg

Against this backdrop, our stance towards the Emerging Market asset class remains unchanged from that laid out in our December 2014 year-ahead outlook column. Specifically, we believe investors should continue to embrace a differentiated approach towards Emerging Market equities, particularly at the country and sector level, as macro factors increasingly command a dominant role in relative return performance dynamics across country indices. Furthermore, we believe that a growing number of Emerging Market country indices hold considerable potential to outperform EAFE and US equities over the coming months, particularly those countries displaying a number of differentiated characteristics including: strong macro balance sheets, benign inflation dynamics, beneficiary status from declining commodity prices, modest foreign investor participation in local debt markets.

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1 Evertrust Plaza Suite 1102
Jersey City NJ 07302
Tel: 212-336-1540
Website: www.glovista.net