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Monthly Market Newsletter

Glovista Global Perspectives

This Issue:

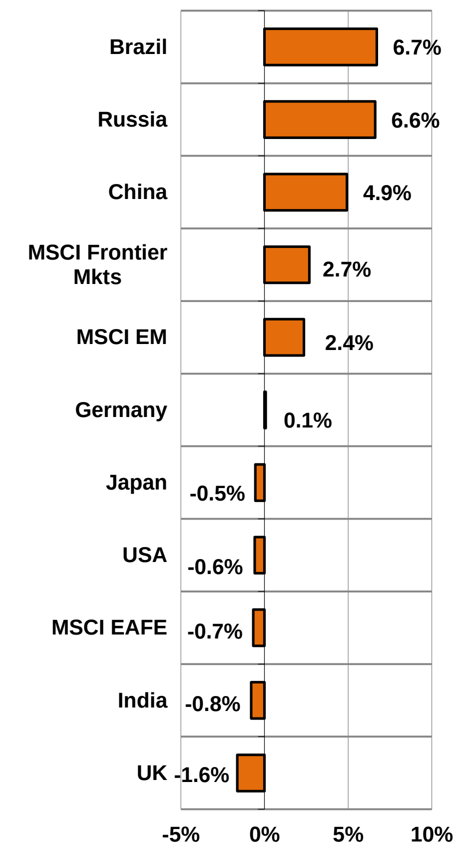
Glovista Sustains Defensive Portfolio Stance on Stretched Equity Valuations, Declining Earnings Revisions, Heightened Policy Risks and Expected Liquidity Tightening

The month of August has brought about a marked increase in realized equity volatility as benchmark equity indices have recorded the largest intra-month price declines since the beginning of the year. For example, August price declines have pushed several key equity benchmarks, such as the US Russell 2000 and German DAX indices, below their respective 200-day moving average levels, a key intermediate-term reference (Figure 1).

Figure 1. Russell 2000 and German DAX Indices Pierce 200 day Moving Average in August

Source: Bloomberg

Country-wise Monthly Performance in USD terms (August 2017)*



Source: MSCI & Bloomberg

**As of August 30th, 2017*

In our view, the recent pull-back in risk indices along with the strong price rise recorded in safe haven assets such as gold and government bonds reflect the market's growing awareness and sensitivity to several principal dynamics including:

- stretched equity valuations, particularly in the US;
- declining 2018 earnings revisions;
- prospects of G2 central bank liquidity tightening over the coming months, including a projected increase in the US Federal Funds rate by December 2017 and an upcoming October announcement by the ECB on the tapering of its quantitative easing program;
- signs of equity investors' overbought positioning as reflected in the negative asymmetric price response to Q2 US earnings releases (between those companies beating and others missing consensus estimates);
- decelerating US share buyback volumes, a development that amounts to liquidity tightening vis-à-vis the US equity space.

S&P500 Monthly Sector Performance – August MTD 2017*

Sectors	% Change	FY1 PE Ratio
Energy	-6.20%	33.6
Materials	-0.05%	19.5
Industrials	-0.53%	18.7
Cons Disc	-2.48%	20.1
Cons Stap	-1.32%	20.5
Technology	2.50%	19.6
Healthcare	-0.05%	17.2
Financials	-1.85%	14.6
Utilities	2.66%	19.0
Telecom	-2.58%	13.0
Real Estate	0.35%	38.8
S&P500	-0.51%	18.8

**As of August 30th, 2017*

Source: S&P

Figure 2. Gold Price Breaks Out of Long Multi-month Basing Pattern

Source: Bloomberg

The recent pullback in equity prices, particularly of those segments of the equity universe facing the sharpest deceleration of earnings momentum, has been accompanied by a meaningful break-out in the price of precious metals prices, especially gold (Figure 2) as well as a continued flattening in the US government bond yield curve (Figure 3) at a juncture in which US inflation expectations hover well below YTD high levels (Figure 4).

Figure 3. US Treasury Curve Flattening Extends to YTD Low Levels

Source: Bloomberg

Figure 4. US Inflation Expectations Hover Well Below YTD High Levels

Source: MSCI and Glovista Calculations

As investors look ahead, particularly vis-à-vis the US equity market, we believe the baseline case that emerges is one of (a) unimpressive economic and earnings growth, (b) diminished inflation pressures and (c) increased policy and political uncertainty. Our assessment reflects:

- signs of weakened consumer expenditure dynamics (new homes and autos – Figure 5 and 6);

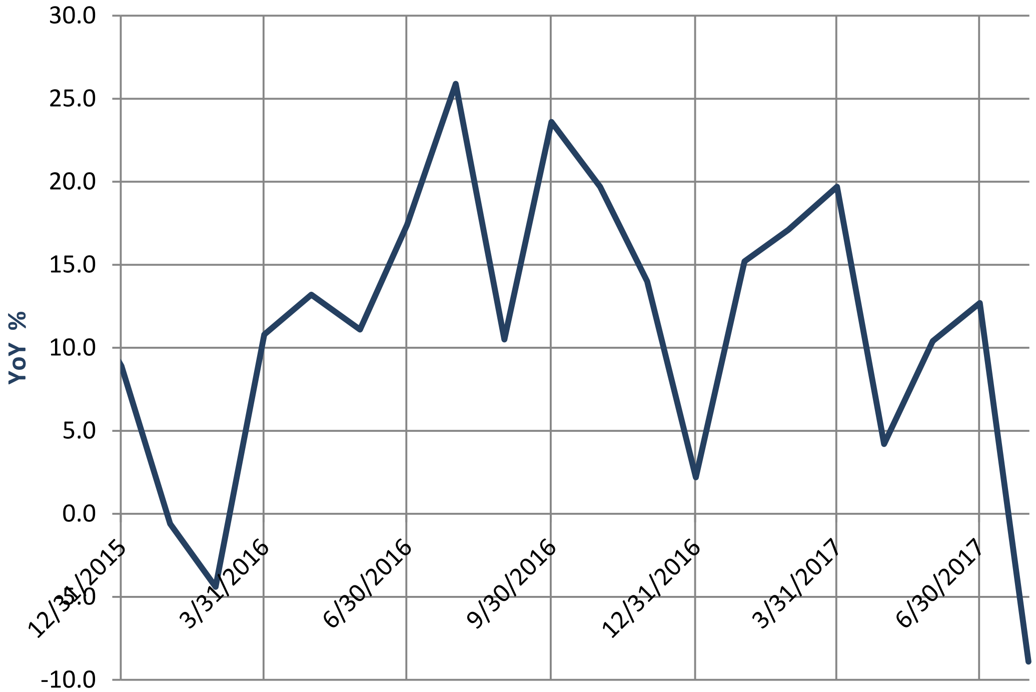
	August 30th 2017	August MTD Change
Gold	1308.64	3.1%
Silver	17.4403	3.6%
Oil	45.96	-8.4%
EUR	1.1884	0.4%
JPY	110.24	0.0%
GBP	1.2925	-2.2%
CHF	0.9636	-0.3%
CAD	1.2621	1.1%
AUD	0.7905	-1.2%
BRL	3.1596	1.1%
MXN	17.7173	0.5%

Source: Bloomberg

Rates	August 30th Level
1 Yr CD	0.73%
5 Yr CD	1.45%
30 Yr Jumbo Mortgage	4.12%
5/1 Jumbo Mortgage	3.94%
US Govt. 10 Year	2.1309%
10 Yr Swap Spread	-5.4%

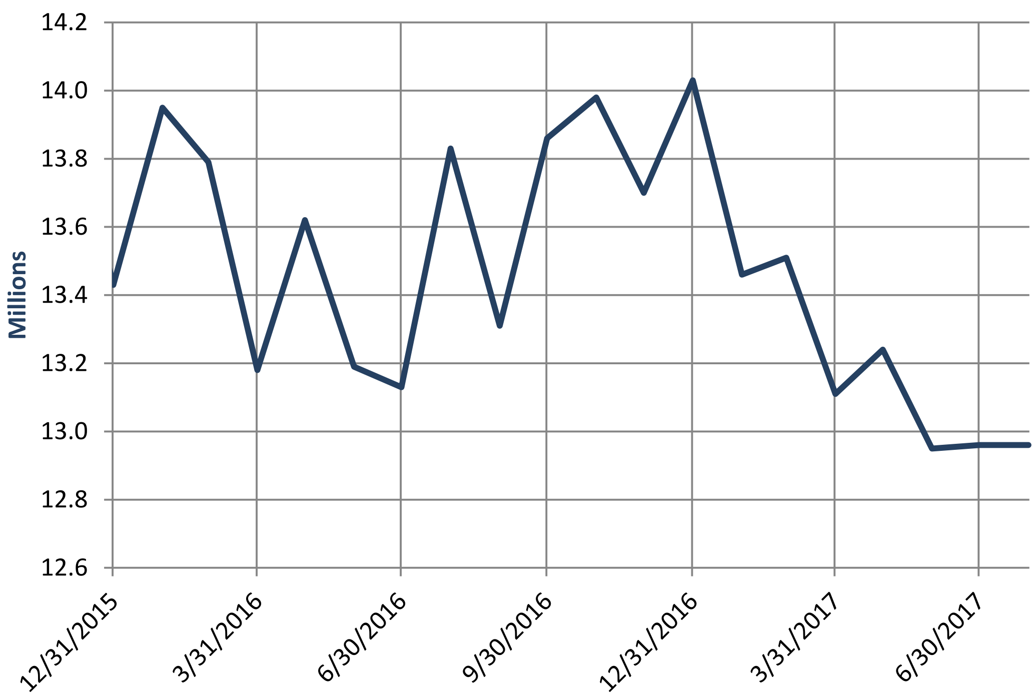
Source: Bloomberg

Figure 5. US New Home Sales Growth Weakens Sharply Despite Low Financing Costs



Source: MSCI and Glovista Calculations

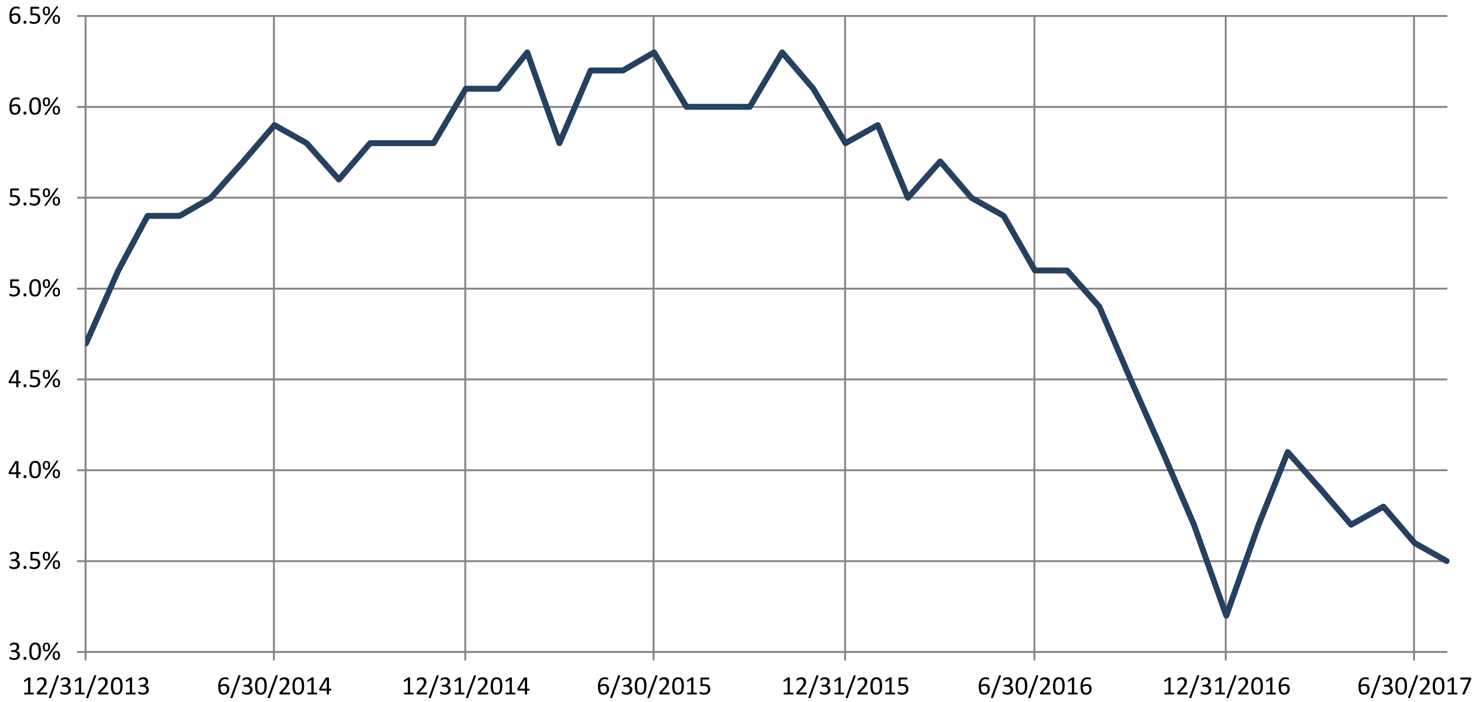
Figure 6. US Domestic Auto Sales Momentum Weakens Markedly YTDs



Source: MSCI and Glovista Calculations

- US households' vulnerable liquidity condition as attested by the current low personal savings rate level (Figure 7);

Figure 7. US Consumers Hold Small Cushion to Weather Economic Deceleration as US Personal Savings Rate Hovers at Lowest Level in Several Years



Source: MSCI and Glovista Calculations

The investment implications stemming from the US macro baseline case delineated above are immediate:

- Continued downward pressure on the US Dollar (Figure 8). The US Dollar index is driven primarily by the Euro US Dollar exchange rate. We remain of the view that real yield differentials between the USA and the Eurozone (Figure 9) remain unjustifiably high as domestic economic momentum in the Eurozone far outpaces that of the USA while inflation momentum remains stronger in the Eurozone;

Figure 8. US Dollar Index Likely to Record Additional Declines

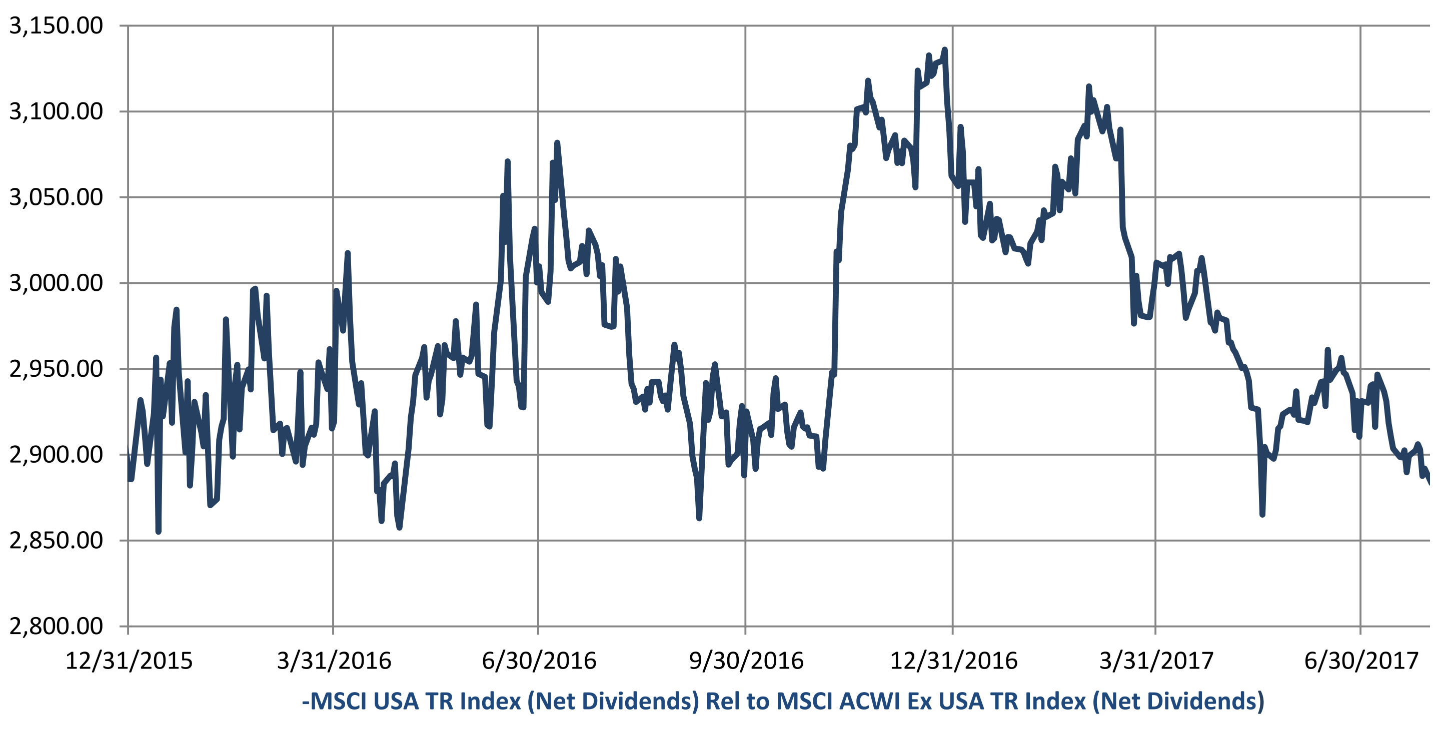
Source: MSCI and Glovista Calculations

Figure 9. US vs German Real Long-term Interest Rate Differentials Likely to Compress Further, Lending Support to Further US Dollar Weakness

Source: Bloomberg

- Strong prospects for continued US equity underperformance of international peers (Figure 10);

Figure 10. US Equities Likely to Extend Multi-month Underperformance versus International Peers



Source: Bloomberg

- Heightened prospects of a meaningful US equity market correction as the US Fed proceeds to raise short-term rates further in short order and the ECB signals an end to its quantitative easing program (by October). Such central bank actions carry the prospects to fuel an undesired rise in real short-term interest rates, especially in the US case, at an arguably vulnerable stage of the US business cycle. Such concern partly reflects the disinflationary implications resulting from recent energy price dynamics. Specifically, the continued decline in energy prices, likely the result of a secular shift in long-term supply demand dynamics for hydrocarbons, exacerbates the continued absence of meaningful inflation pressures, especially in the USA owing to the heavier weighting energy prices carry within the US headline CPI index and also given the US economy's much higher level of income inequality versus Europe's.

Glovista Sustains Defensive Portfolio Stance, including Overweight International and Quality Stocks, Short-Duration High Quality Fixed Income and Precious Metals

Our macro thesis summarized above, entailing a cautious stance towards the US economic and US equity market outlooks, is reinforced by a cautious economic view of other regions including the UK and the Middle East. We remain far more constructive towards the core Eurozone economic bloc as well as a number of Emerging Market economies. In our view, China's economic momentum is likely to extend its secular deceleration and this year's second half is likely to be softer than the year's first half.

Against such macro backdrop, Glovista continues to favor non-US equities, short-duration high quality fixed income and precious metals. While equities' earnings yield still far outpaces corporate debt yields, the so-called carry-to-volatility advantage equities have commanded these past 12 months is unlikely to sustain itself over the coming quarters. Therefore, on a risk-adjusted basis, we find a defensive portfolio investment stance to be most attuned to our clients' needs at this time.

Emerging Markets Perspectives

EM Equities Outperformance versus DM Peers Breaks Out to 2-Year High Levels; Glovista Expects Continued Outperformance on Valuation, Earnings Momentum and Positioning Considerations

In August, Emerging Market (EM) equities have posted sufficiently solid return outperformance metrics versus Developed Market (DM) peers so as to edge the MSCI EM benchmark index to 2-year high levels versus the Developed Market benchmark, as represented by the MSCI World index (Figure 11). Despite EM equities' strong return outperformance of DM peers since the beginning of 2016, the Glovista investment team expects continued solid return outperformance for the EM asset class given valuation, earnings momentum and positioning considerations. We discuss each of these issues further below as well as our principal country and sector tilts at the portfolio level along with the accompanying rationale behind each of those portfolio tilts.

On valuation grounds, emerging market equities continue to hover at close to 10-year low levels versus developed peers despite their strong 2-year relative outperformance. Such state of affairs is accounted for by EM equities' solid EPS growth outperformance of their DM counterparts these past two years. As we have discussed in prior monthly comments, various macro factors have been at play in accounting for such earnings outperformance including EM currency revaluation, EM corporate profit margins' continued upside potential against DM corporate margins' extended levels, EM economies' solid and accelerating nominal GDP growth (a close proxy to sales growth) against anemic nominal GDP growth in DM economies.

Figure 11. EM Equities' Outperformance versus DM Peers Breaks Out to two year High Levels

Source: Bloomberg

As a result of the above, not only are Emerging Market valuations exceedingly cheap versus DM peers but also the strength as well as earnings and sales growth visibility are markedly stronger than their DM peers'. Finally, despite EM equities' solid return outperformance versus DM peers, US institutional investors – the world's largest – remain exceedingly underweight the EM asset class. In summary, our thesis calling for continued solid return outperformance of EM versus DM equities reflects valuation, earnings momentum, sales momentum and positioning/ownership considerations.

As for our EM portfolios' principal sector and country tilts, we continue to favor new China sector exposure, tied particularly to the Chinese ecommerce and IT sector names. Recent earnings results for the sector have been nothing short of impressive both at the top line as well as bottom line levels. Valuations are no longer exceedingly cheap but at a juncture in which predictable high quality growth opportunities have become increasingly scarce around the world, we believe the sector deserves the modest valuation premium it currently commands.

Outside our preference for China IT sector names, we continue to favor a number of EM country indices dominated by non-tradable sectors, such as retail and banks, and in which we hold a bullish currency view. Said country group includes Turkey, Poland and Chile. In South Africa, we continue to favor precious metals mining companies along with IT sector plays while maintaining underweight allocations to the banks. In South East Asia, we continue to hold underweight allocations, on valuation grounds, with the exception of Thailand as we continue to favor the currency and our sector analysts favor a number of that market's largest constituent stocks. In North Asia, we hold approximately neutral allocations as the attractiveness of those markets' IT sector exposures is counterbalanced by unattractive currency valuations and the resulting lack of impetus passed onto those markets' non-tradable sector constituents.

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GLOVISTA INVESTMENTS

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