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This Issue:

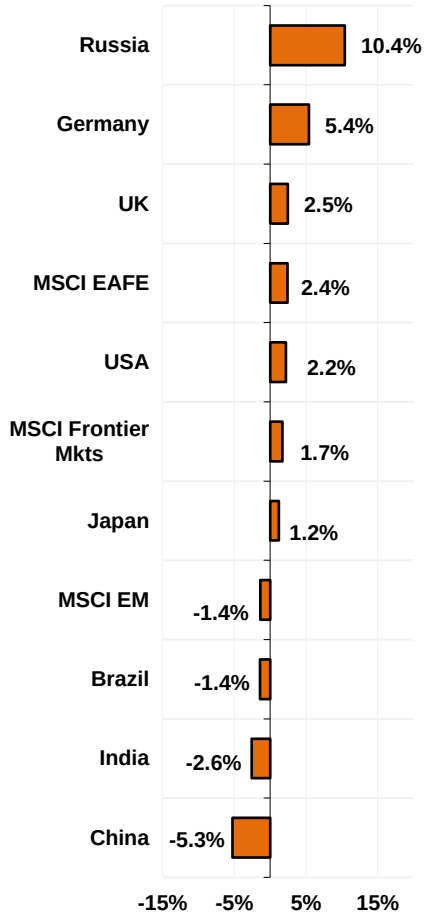
2017 Year-Ahead Outlook: Tactical Approach Emphasized as Volatility Likely to Escalate on US Policy & Europe Political Uncertainty, China Slowdown, Stretched US Equity Valuations and US Central Bank Policy Rate Hikes

As is customary for this column, the December issue is devoted to a review of global market and macro developments for the year that is drawing to a close, and an outline of our investment team's expectations surrounding the global macro baseline case for 2017 along with our investment strategy stance across asset classes and regional blocs. We turn our discussion immediately below to a retrospective look at 2016, followed by a prospective outlook of 2017 with a specific focus on the macro and financial market foundations behind market developments we foresee for the coming year.

2016 Year Review: European Markets Underperform Sharply on BREXIT, Eurozone Bank and Political Sector Concerns; US Dollar Sells Off Versus Most EM Currencies and Strengthens versus G10; Industrial/Energy Commodities and Value Equities Outperform

As illustrated in Figure 1, 2016 has brought about a much welcome recovery to a large number of asset markets that recorded large price declines in 2015, including those in the commodities, credit and equities space. Notwithstanding the constructive return performance logged for the year, 2016 proved to be exceedingly difficult to navigate for a large number of active portfolio managers, particularly those whose mandate entails a core focus on mitigating downside volatility in an attempt at protecting investment capital. Specifically, 2016 witnessed a succession of major economic, policy and political surprises, including the following:

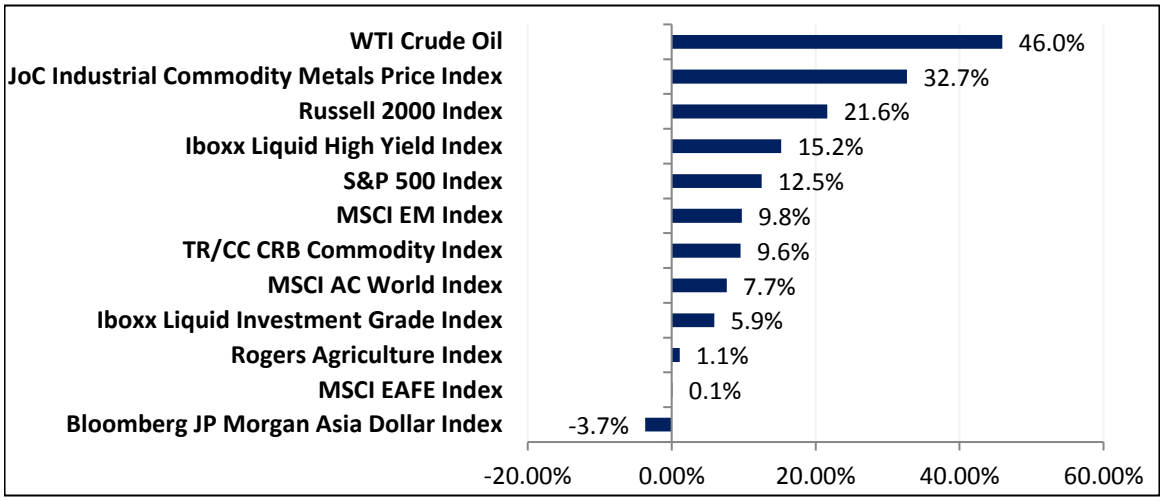
Country-wise Monthly Performance in USD terms (Dec MTD 2016)*



Source: MSCI & Bloomberg

**As of December 28th, 2016*

Figure 1. Price Reflation, the Norm for a Large Number of Asset Markets in 2016 (January 1st, 2016 to December 28th, 2016)



Source: Bloomberg

S&P500 Monthly Sector Performance – Dec MTD 2016*

Sectors	% Change	FY1 PE Ratio
Energy	2.33%	139.0
Materials	0.60%	19.5
Industrials	0.77%	18.6
Cons Disc	0.98%	19.2
Cons Stap	2.97%	20.0
Technology	2.56%	17.3
Healthcare	0.87%	15.4
Financials	4.27%	15.0
Utilities	3.82%	16.3
Telecom	8.18%	13.5
Real Estate	1.98%	27.8
S&P500	2.32%	18.5

**As of December 28th, 2016*

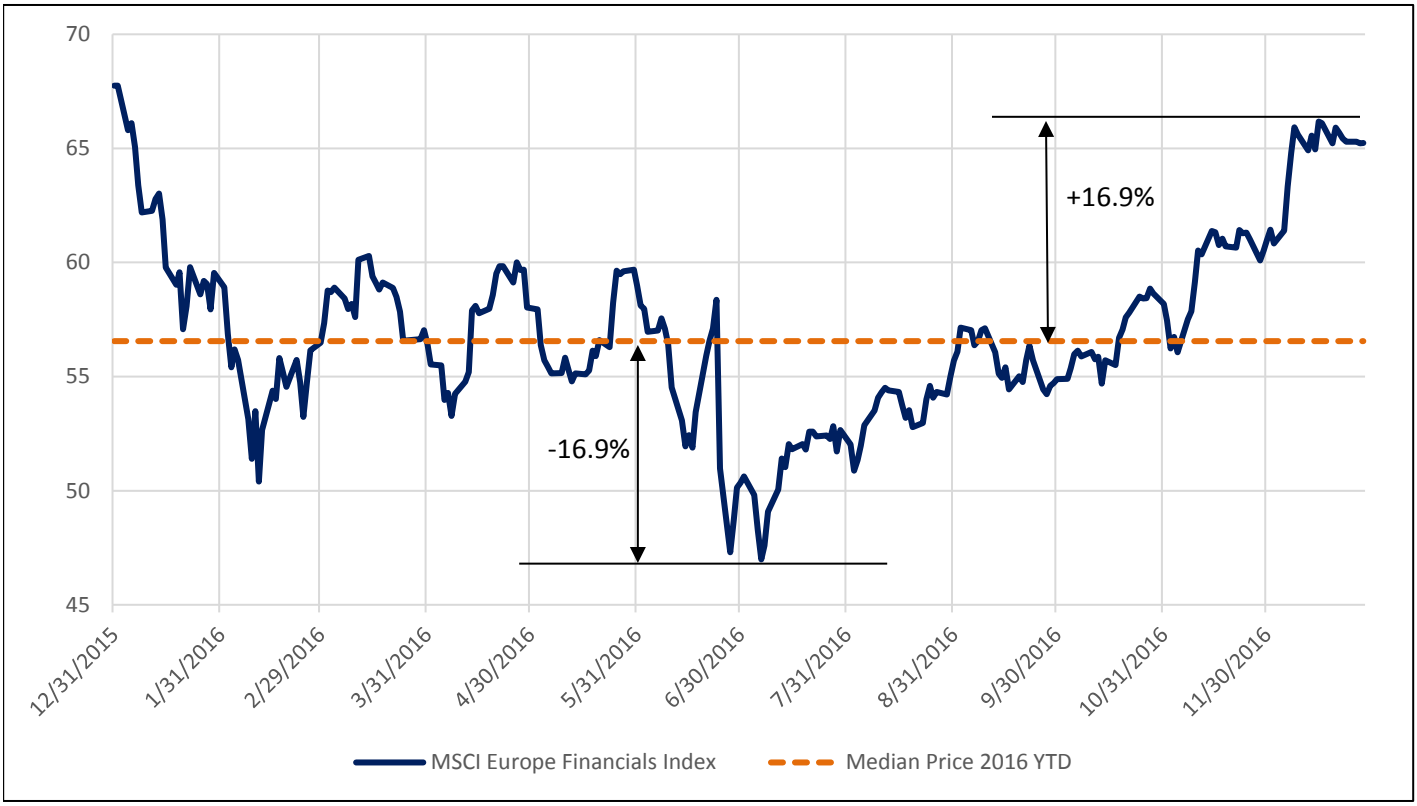
Source: S&P

- Concerns over the viability of the European banking system, stemming from the persistently large stock of non-performing loans that plague the sector in the face of continued low capitalization levels – said concerns have centered on some of the periphery countries, especially Italy, but have also extended to some core countries (e.g. Germany's Deutsche Bank). Admittedly, said concerns reached an apex during the earlier part of the year, bringing about outsized price declines in excess of 40 percent for a number of tier-1 banking sector stocks including UniCredito, Intesa, Deutsche Bank and Credit Suisse. Figure 2 illustrates the sharp percentage gyrations recorded by the MSCI Eurozone financial sector index year-to-date. In the process, global equity prices (MSCI ACWI) recorded a whopping 6 percent decline during the month of January.

- Concerns over an accelerated China economic downturn escalated during the year's first quarter. Said concerns emanated out of investor concerns over the prevailing combination of tight monetary conditions and a slowing domestic economy. Figure 3 illustrates the sharp deterioration in economic indicators during the year's first quarter. Such concerns abated considerably during the year's second quarter as the Chinese authorities embarked upon a combination of fiscal and monetary policy stimulus measures.

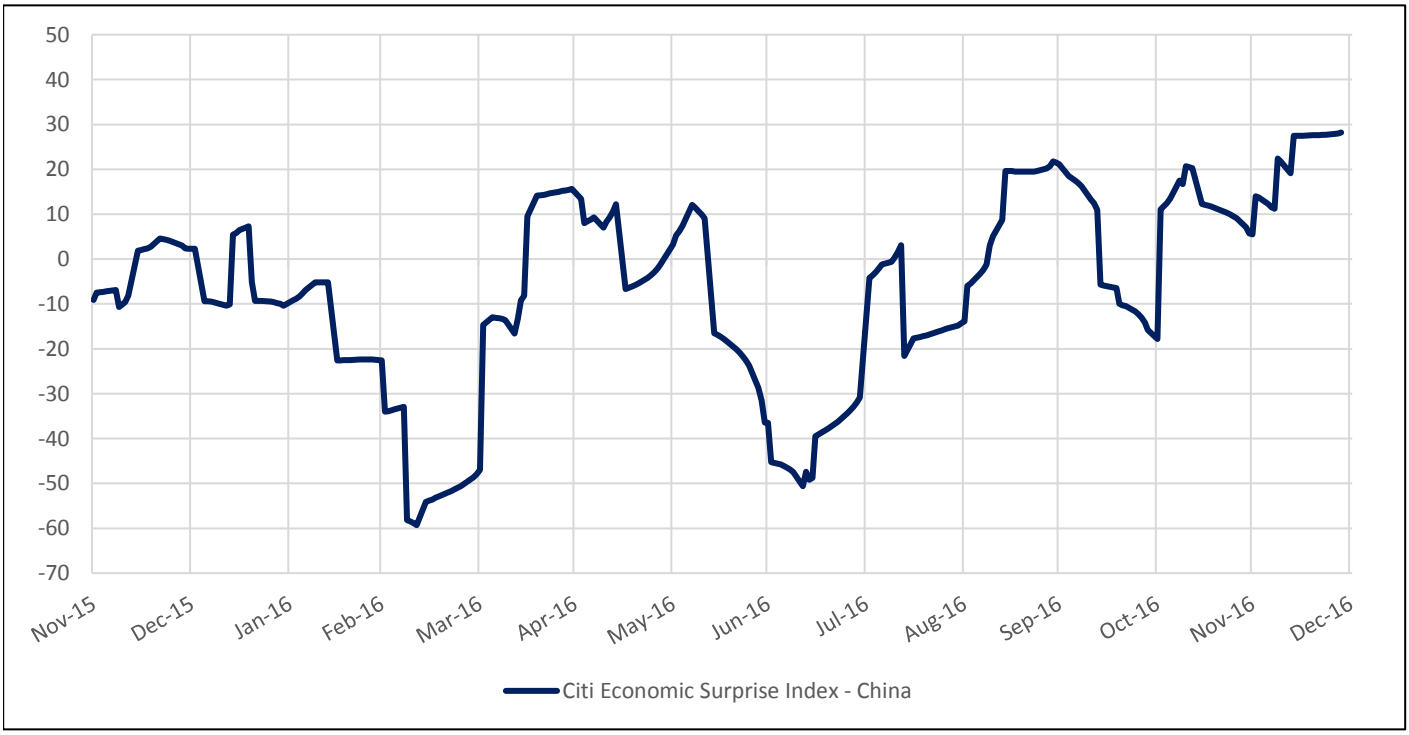
- Escalating deflation concerns during the year's first quarter. For example, Figure 4 illustrates the sharp decline in 5 year US inflation break-evens – a measure of intermediate term inflation expectations -that unfolded during the beginning of the year as European banking sector concerns and declining oil price dynamics took hold. Such expectations were arrested and eventually reversed as European banking system concerns abated and crude prices recovered to 2015 levels. The outsized decline in inflation expectations helped propel a new round of quantitative easing by the Bank of Japan and the European Central Bank. In turn, such measures helped push a large percentage of the developed world government bond market to negative yield territory, at the tune of around 8 trillion US Dollars.

Figure 2. European Financial Stocks Record Rollercoaster Ride in 2016, Fueled by Solvency Concerns Plaguing Periphery and some Core Markets



Source: MSCI, Bloomberg and Glovista Calculation

Figure 3. China Economic Deceleration Concerns Peaked in Q1 of 2016: Policy Stimulus Measures Announced Shortly Thereafter



Source: Citigroup Global Markets

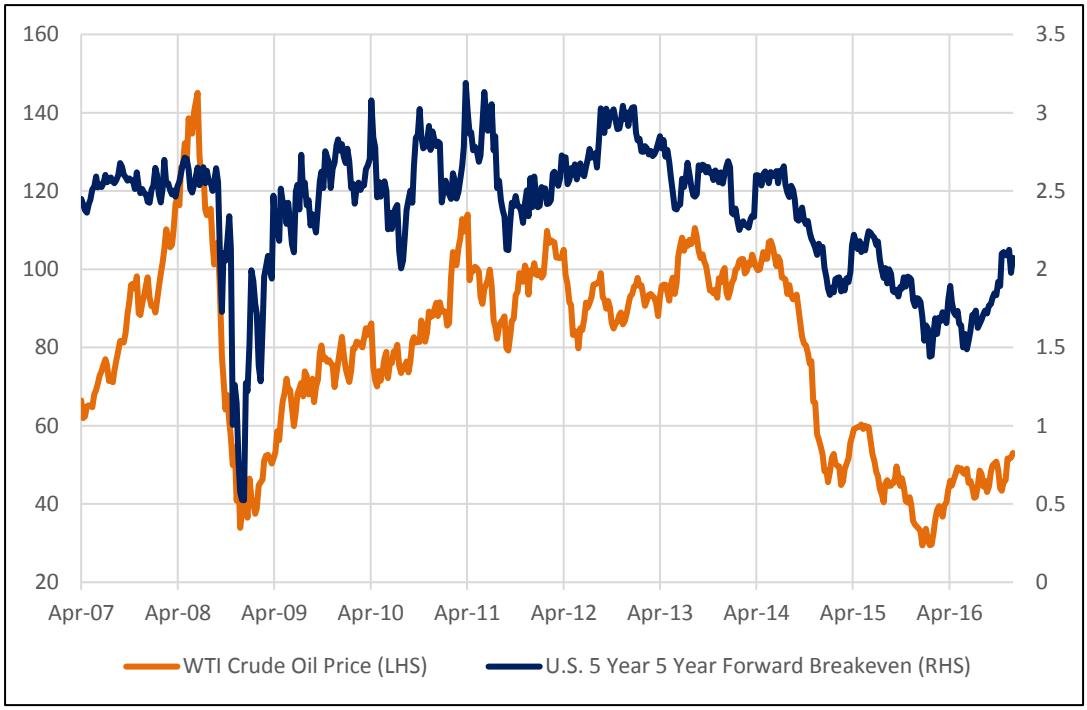
	Dec 28th 2016	Dec MTD Change
Gold	1141.74	-2.7%
Silver	16.08	-2.7%
Oil	54.06	9.3%
EUR	1.0413	-1.7%
JPY	117.26	-2.4%
GBP	1.2226	-2.2%
CHF	1.0284	-1.1%
CAD	1.356	-0.9%
AUD	0.7177	-2.8%
BRL	3.2778	3.2%
MXN	20.7543	-0.9%

Source: Bloomberg

Rates	Dec 28th Level
1 Yr CD	0.59%
5 Yr CD	1.22%
30 Yr Jumbo Mortgage	4.62%
5/1 Jumbo Mortgage	3.89%
US Govt. 10 Year	2.508%
10 Yr Swap Spread	-0.105%

Source: Bloomberg

Figure 4. Year's First Quarter Records Decline in US Inflation Expectations to Lowest Levels since 2007-2009 Great Recession Period, as Oil Prices Revisit 2003 Lows



Source: Bloomberg

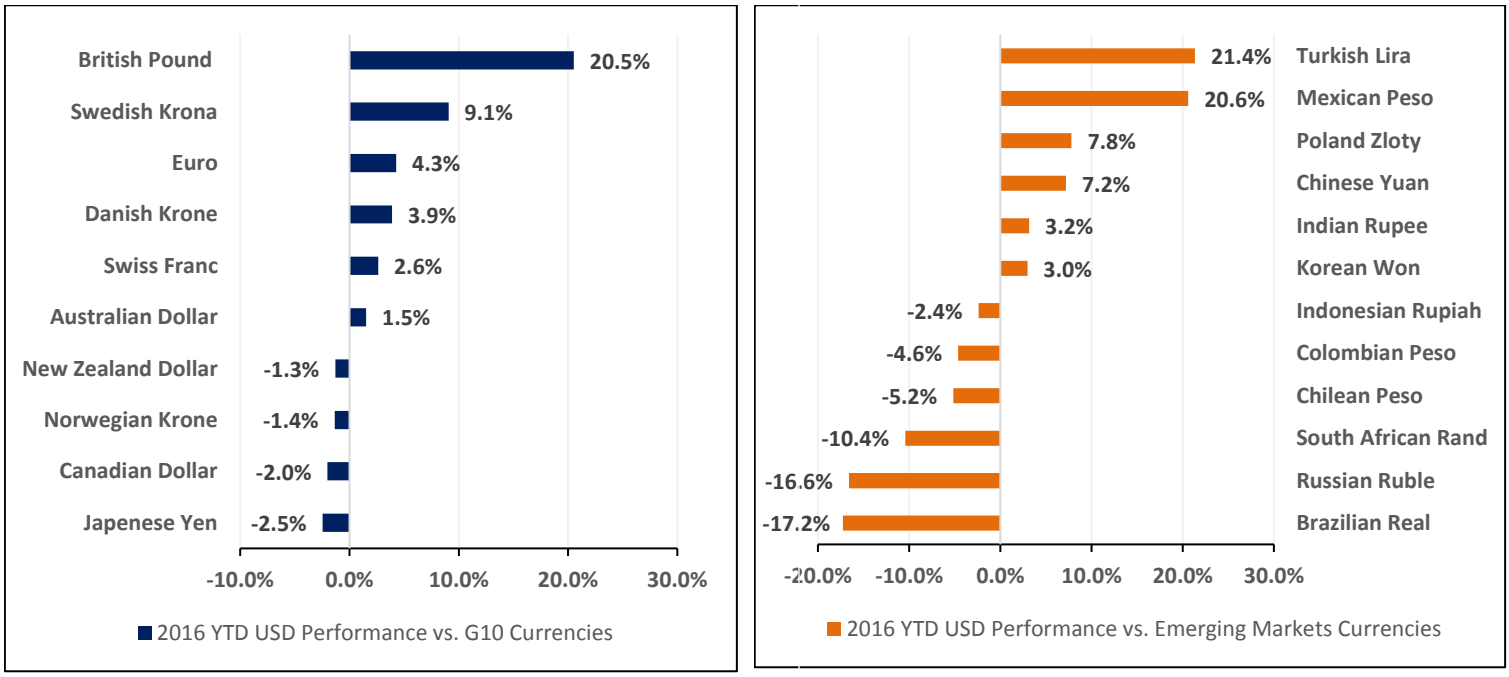
- BREXIT result. The result shattered most analysts' consensus expectation of a NO vote win. As we have discussed at length in prior monthly columns, BREXIT redefines the economic, geopolitical and financial landscape of Europe. For example, an EU ex-UK becomes a far less reliable ally of the US in international circles. Second, the UK's decision to exit the EU lowers the cost of exit from the EU on the part of existing EU members and may dissuade potential future EU members from crystallizing their membership in the union. Third, the UK's decision to exit the EU weakens the UK economy's resilience to foreign economic and trade shocks while weakening the country's allure to foreign direct investment. The UK's large current account deficit raises the potential for a sustained period of low economic growth in the coming years as the Pound Sterling is likely to remain weak for longer and asset deflation is likely to ensue as foreign capital rebalances its UK holdings to lower levels versus historical averages.

- US November election results, entailing non-consensus presidential victory by Donald Trump and congressional mandate by the Republicans. Even more so than the BREXIT vote result, the US election results are bound to prove far more consequential for global markets, the global economy and the world's geopolitical balance of power, among other areas of the world's social, economic, financial, trade and environmental domains. We have discussed a number of these implications in the November monthly column.

Insofar as the world currency markets is concerned, our 2016 year-ahead outlook report released in December 2015 laid out our expectation the US Dollar would likely top out in 2016. In the process, 2016 has witnessed the US Dollar weaken versus a large number of Emerging Market and commodity-oriented G10 currencies (Figure 5) despite the US Federal Reserve's continued focus in engineering a succession of policy rate hikes and the newly elected US Republican administration's endorsement of a supply-side economic platform at a juncture in which both houses of Congress will be dominated by Republican Party representatives.

The US Dollar has strengthened versus a narrow set of currencies including the Euro and Euro-linked currencies (such as the Swiss Franc and the Danish Crown) owing to the sharp misalignment of central bank policies with the US Federal Reserve as the European Central Bank (ECB) has reaffirmed its longstanding quantitative easing (QE) program. Other currencies that have weakened versus the US Dollar includes the Mexican Peso and Chinese Renminbi, both official currencies of the two countries singled out by the Trump campaign as targets of trade policy directives to be implemented in the coming years so as to redress US bilateral deficits characterized as examples of 'unfair trade' by the newly elected US administration.

Figure 5. US Dollar Weakens versus Most EM and Commodity G10 Currencies in 2016, Strengthens versus Pound Sterling (BREXIT) and Euro / Euro–linked Currencies (Diverging Monetary Policies and Upcoming Euro Area Elections), January 1st 2016 to December28th 2016



Source: Bloomberg

With regard to risk markets, our 2016 year-ahead outlook report laid out our view that a selection of commodities and credit indices offered much value, dubbing those as 'value buys'. In particular, we favored those sectors over equities for the 2016 calendar year on account of valuation considerations and downside risk characteristics given (a) the extended nature of the US profits cycle, (b) the feeble flows backdrop anchoring the ownership of US equities given the massive share repurchases funded via the issuance of corporate debt these past five years, and (c) the scheduled string of events entailing considerable two-sided risk (e.g. BREXIT vote, US November elections, implications of December 2015 Italian courts' ruling on the ability of Italian bank institutions in accessing private debt capital markets during 2016). In the process, commodities sharply outperformed equities, fixed income and credit. Moreover, credit markets generated 2016 equities-like year-to-date returns at a fraction of the downside volatility recorded by US and international equities.

2017 Year-Ahead Outlook: Tactical Approach Emphasized as Volatility Likely to Escalate on US Policy & Europe Political Uncertainty, China Slowdown, Stretched US Equity Valuations and US Central Bank Policy Rate Hikes

Looking ahead to 2017, our investment outlook is conditioned most significantly by our expectation macro and financial volatility will rise on a sustained basis. Such expectation is predicated on the widely documented close statistical nexus between changes in policy uncertainty and changes in economic/financial volatility. Specifically, 2017 harbors a number of highly consequential yet uncertain policy and political events including the following:

- General elections scheduled in the Netherlands, France and Germany. The Dutch and German elections carry the potential for anti-Euro political forces gaining ground or overall control in Parliament. Moreover, the potential for elections to be called in Spain, where a minority government currently rules, cannot be discarded while in Italy, popular support for the Euro is low compared to the Euro regional average. That the Italian debt market is the world's third largest makes an "Itexit" scenario a fatal proposition for the persistence of the Euro. Consequently, global markets will continue to focus on Italian domestic political developments, impacted considerably by the pace of domestic economic conditions.

- Announcement, deliberations, legislation and guidance on the implementation of trade and tax reforms supported by the incoming Trump administration. The calendar will be filled with such deliberations starting as early as late January. Little is known in terms of the precise configuration and magnitude of future (a) trade policies, (b) infrastructure expenditure bills, (c) tax cuts for small businesses, corporations and individuals, (d) extent of tax holidays or tax rates applied to foreign capital repatriation.

- Magnitude and timing of future US FED policy rate hikes.

- Potential for geopolitical events stemming from frictions between the US and China, North Korea, Iran and perhaps even Russia. Even the relationship between the USA and India could be jeopardized by Mr. Trump's recent overtures to the Pakistani regime.

Insofar as our baseline global macro outlook for 2017 is concerned, we foresee:

- Modest acceleration of US economic growth for 2017 on the back of the favorable expectations effect (animal spirits) associated with the supply-side economic measures to be sponsored by the Trump administration including tax cuts and deregulation measures. Such measures' direct impact will obtain only in 2018 owing to implementation considerations. We estimate the GDP growth effects from policies sponsored by the Trump administration to be capped at 1 percent given the offsetting implications on GDP growth resulting from a strengthening US Dollar versus major currencies such as the Euro and the Japanese Yen. Moreover, the cyclical stance at which the Trump supply-side measures will find the US economy is sufficiently strong (e.g. low levels of slack in factor markets, especially labor) so as to keep the US FED on alert at offsetting (via additional rate hikes) any fiscal expansionary measures deemed excessive by the US central bank authorities.

- Continued economic softness in the Eurozone and the UK as the region faces a number of key elections in core countries while the UK's economy rebalances to the new economic reality implied by its exit from the EU.

- Continued deceleration of economic growth facing China, the world's second largest economy, as government authorities unwind a number of large fiscal and monetary policy stimulus measures implemented earlier this year. We expect continued capital flight out of China along with continued currency weakness.

Against a backdrop of sustained rise in policy/political uncertainty, financial volatility, US supply side economic reforms, lackluster China and European economic momentum (versus trend), the Glovista investment team favors the following investment strategy for 2017:

- Tactical asset allocation stance to become even more important in 2017 than in the 'rollercoaster' 2016: As discussed above, we hold this view on the basis of the unusually high level of policy and political uncertainty looming ahead as the incoming Trump administration goes about introducing key legislative pieces before Congress with material impact on the economic, financial, environmental and social fronts, and as core Eurozone countries hold general elections (Netherlands, Germany and France). That US equity valuations currently discount unusually high long-term earnings growth expectations – having spiked following the recent US November elections - is but an additional consideration anchoring our decision to sustain a tactical asset allocation stance looking into 2017, especially with regard to global equities.

- Currency markets: We expect continued US Dollar strength versus the Euro and other European currencies at the beginning of the year, given (a) continued wide interest rate differentials between the Greenback and the Euro as markets await details of the supply-side reforms to be sponsored by the incoming Trump administration, and (b) markets' continued focus on the upcoming Dutch, French and German elections that are scheduled to begin at the end of the first quarter (Netherlands). Insofar as Emerging Market currencies is concerned, we expect last year's low levels versus the Greenback to hold as most Emerging Market countries' balance of payments positions have strengthened considerably, inflation levels have come down and domestic economic momentum has begun to pick up. There are several important exceptions of Emerging Market countries for which the currency outlook versus the US Dollar is likely to entail additional weakness, most notably China. Specifically, we expect continued Chinese currency weakness versus the US Dollar both as a result of the continued capital flight dynamics that have been in place these past two years but also due to the richening effect exerted by a strengthening US Dollar versus the Euro on the multilateral currency basket targeted by the Chinese central bank.

- Equities: On medium-term valuation grounds, we favor Japanese equities, a selection of Emerging Market country indices, US small and mid-caps, utilities, energy and telecoms. Over the short-term, US financial stocks may extend recent strong relative performance as US Dollar strength versus the Euro persists into the first half of the year.

- Commodities: We maintain our constructive outlook towards the energy complex, particularly over the first half of the year. We also favor a gradual reinstatement of neutral allocations to gold.

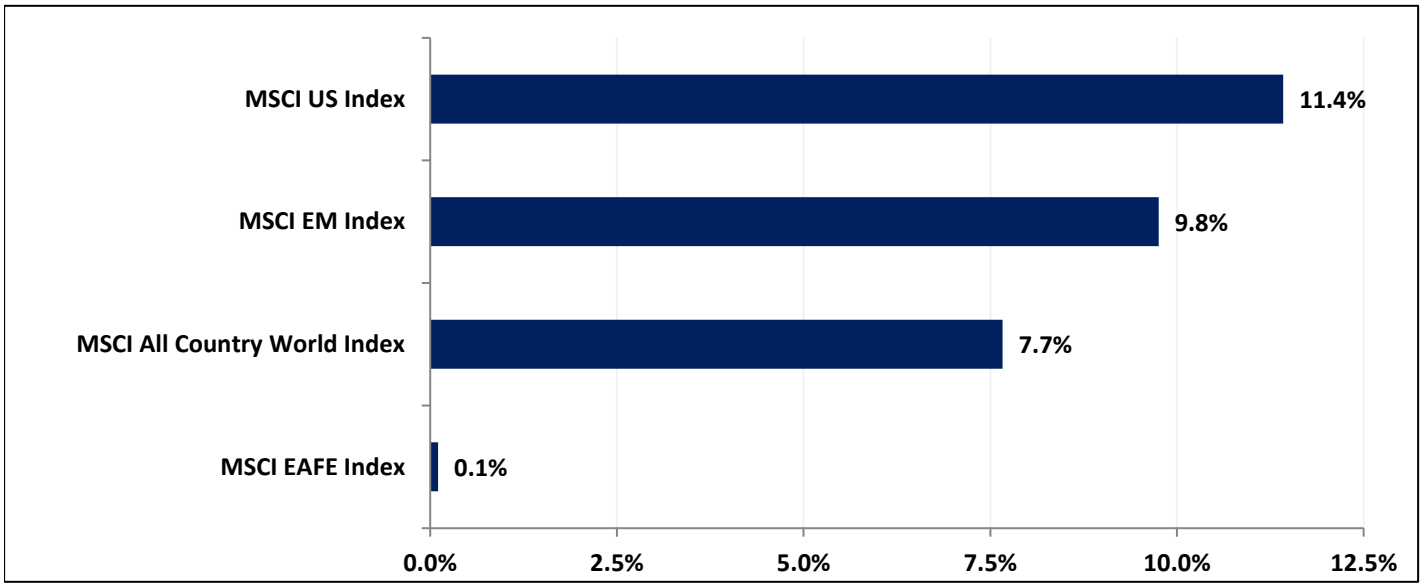
- Fixed income: We maintain our longstanding preference for US Dollar denominated corporate debt. Looking into 2017 we favor intermediate-duration, high yield debt. As for government debt markets, we continue to avoid exposure to the sector on valuation grounds.

Emerging Market Perspectives

EM Year-Ahead Outlook: EM to Extend Relative Outperformance versus DM Peers in 2017, Supported by Cheap Valuations and Upturn in Top-line Growth

Following a dismal 2015, Emerging Market equities have recorded strong relative return outperformance versus most Developed Market peers during 2016 (Figure 6). Emerging Market equity prices bounced very strongly during the first quarter of the year at the time the soft economic patch impacting the world's economy came to pass. The soft patch impacting world economic indicators entailed not only soft economic activity releases but also a massive escalation in deflation concerns, discussed in the section above. That Emerging Market equities bottomed both in absolute as well as relative terms versus Developed peers at the time world economic concerns topped out is unsurprising given Emerging Market asset prices' large sensitivity to the global economic cycle.

Figure 6. EM Equities' US$ Total Return Outperforms Developed Peers in 2016 (January 1st 2016 to December December28th 2016)



Source: MSCI and Bloomberg

A decomposition of EM equities' total return performance for the year-to-date period sheds light on the principal drivers behind EM equities' relative return outperformance of developed peers. We discuss such dynamics immediately below, followed by an outline of the multiple considerations upon which we harbor a bullish outlook towards Emerging Market equities versus Developed peers in 2017.

Figure 7 provides a decomposition of EM equities' – 9.8 percent 2016 year-to-date (as of December 28th, 2016) performance across the regional domain along with the corresponding regional index weightings, trailing 12M earnings growth and P/E valuation multiples. The figure enables us to draw a number of salient conclusions, including the following:

Figure 7. EM Equities' 2016 Total Return Regional Performance: Earnings Growth and Valuation

	Performance*	Index Weight
MSCI EM Latam	29.3%	13.1%
MSCI EM Asia	4.9%	71.1%
MSCI EM EMEA	17.7%	15.7%
MSCI EM	9.8%	100%

*Performance is in USD term from 1/1/2016 to 12/28/2016 and is not annualized

	MSCI EM Latam	MSCI EM Asia	MSCI EM EMEA	MSCI EM
Forward P/E Ratio (Dec 2015)	12.5	11.3	9.6	11.1
Forward P/E Ratio (Current)	14.5	12.2	9.8	12.0
Trailing 12M EPS Growth (Current)	8.3%	-9.7%	-0.2%	-6.2%

Source: MSCI and Bloomberg

- The MSCI EM index's strong YTD performance has been driven primarily by commodity-linked economies, such as Brazil, Russia, South Africa and Peru, that have benefited from the solid performance recorded by the commodities group this year, led by the industrial metals and energy complex. Those countries' bourses are heavily dominated by value-oriented sectors, including energy, financials and materials sector stocks.

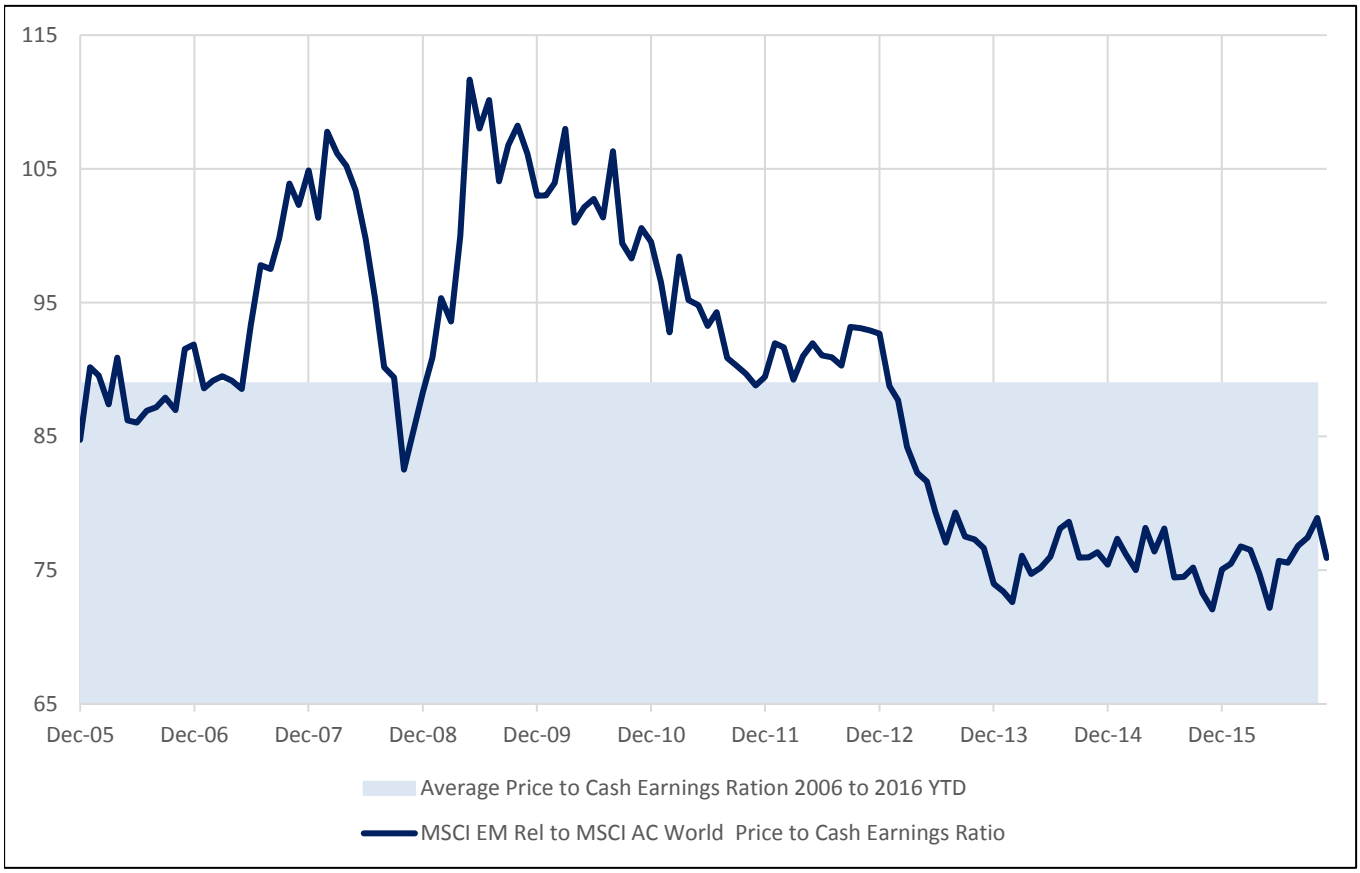
- At the factor level, the MSCI EM index's solid YTD performance was driven by the multiple expansion factor and currency appreciation as opposed to EPS Growth. Latin America was the only region that exhibited both Multiple expansion and earnings growth for 2016. The negative earning growth for EM Asia was impacted primarily by lack of earnings momentum out of China.

- EM currencies posted solid YTD performance versus the US Dollar with few exceptions, including the Mexican Peso, the Turkish Lira, the Chinese Renminbi, the Philippine Peso and the Polish Zloty. That most EM currencies strengthened considerably versus the US Dollar through the BREXIT vote result and the Trump election victory attests to the EM countries' vastly strengthened balance of payments position and non-inflationary domestic economic growth impetus following several years of economic softness. The Mexican Peso and Chinese Renminbi were impacted by the threat of tariff actions leveled by the Trump campaign while the Turkish Lira was impacted by geopolitical concerns surrounding the Syria crisis and the Philippine Peso depreciation reflected the investor-unfriendly chatter emanating from the newly elected Duterte administration. Finally, the Polish Zloty's weakness has been a result of the currency's sensitivity to external and domestic factors including the BREXIT vote results, and the lingering issues resulting from the non-performing loan problems tied to the local banking system's exposure to Swiss Franc denominated credit extended to the household sector.

- EM 2016 YTD earnings recovery was fueled by the virtuous economic growth dynamics unleashed by strengthening currencies, declining interest rates, bottoming of world economic momentum around the year's first quarter at a juncture in which profit margins are cyclically high owing to the soft labor market conditions prevailing across most Emerging Market countries following a multi-year period of economic softness.

Surprisingly, despite Emerging Market equities' strong relative return performance versus Developed peers in 2016, the asset class remains exceedingly under-owned and considerably undervalued from a global equities' perspective. For example, Figure 8 illustrates EM equities' relative P/CE multiple versus developed country peers while a compilation of net investor flows into Emerging Market ETFs and mutual funds, listed in the USA – the world's most liquid market – documents the asset class' exceedingly under-owned status. A similar conclusion can be arrived at from a compilation of a ratio put together by JPMorgan researchers – the indicator compiles the ratio of (a) all US listed EM ETFs and mutual funds to the pool of all US listed world equity ETFs and mutual funds, as a percentage of (b) the market capitalization ratio of all EM equity indices to the market capitalization of all of the world's equities.

Figure 8. EM Equities' P/CE Multiple Hovers at Multi-year Lows Vs. World Peers



Source: MSCI, Bloomberg and Glovista Calculation

Looking ahead into 2017, we expect EM equities to extend their 2016 YTD relative outperformance versus Developed peers on the back of EM equities' attractive valuations, upturn in EM domestic economic cycles, EM currencies' resilience versus Developed currencies, and EM equities' under-owned status on the part of global asset allocators. As always, country selection is of the essence when it comes to investing in EM. In that regard, looking into 2017, we favor EM country indices that harbor the following characteristics: strong macro balance sheets at a juncture in which the US FED may be hiking its policy rate several times throughout the year, and with exposure to value sectors (e.g. financials and energy) as opposed to growth oriented stocks (especially IT), with several exceptions. In the overweight direction, we favor allocations to Russia, Chile, Thailand and IT sector plays in China (strong balance sheet sector, increasingly commanding an international footprint). In the underweight direction, we expect the following EM country indices to underperform in 2017: Gulf regional markets, Malaysia, Philippines, Korea, Indonesia and Mexico.

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