Issue
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Monthly
Market
Newsletter

GLOVISTA INVESTMENTS

Glovista Global Perspectives

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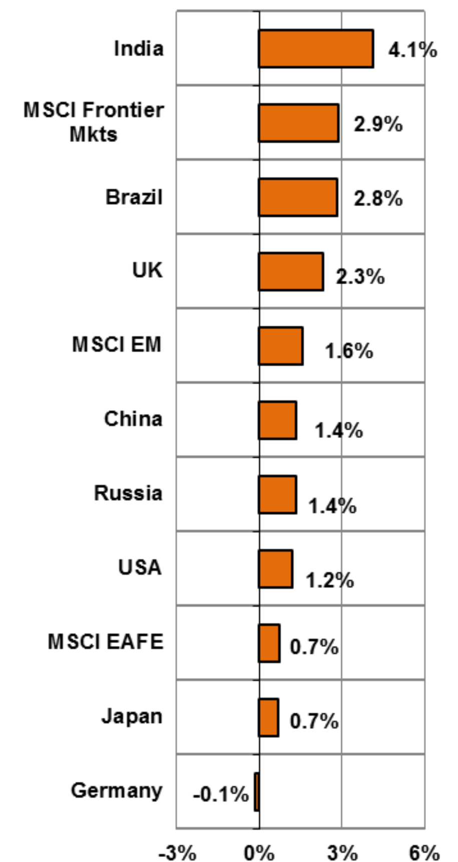
2018 Year-Ahead Outlook: Volatility to Rise as Aging US Expansion Meets Higher US Policy Rate Environment under New FED Leadership; Glovista Expects Further US$ Weakness, Favors Value/Non-US Equities

As is customary, we devote each December column to a retrospective and prospective analysis of the macro and market environments that shaped the year that is drawing to a close and the new year that is fast approaching. In that tradition, we provide such accounts in the sections that follow immediately below.

2017 Review: Risk Markets Edge Higher, Fueled by Sentiment Boost from Eurozone Election Results, Trump Tax Agenda, China's H1 Fiscal Stimulus and ECB's Unprecedented Loose Rate Stance; Equity Volatility Falls to Multi-year Lows vs. Bonds, Fueling Equity Valuation Multiple Expansion

In 2017, risk asset prices have rallied considerably, fueled by the world economy's continued expansion, the absence of meaningful inflationary pressures in the Developed economies and a sustained decline in equity market volatility to the lowest levels in several years, particularly versus bonds (Figure 1). Out of such set of risk asset price supportive factors, we believe the sharp decline in equity absolute and bond relative volatility levels are especially meaningful, stemming mainly from G3 central banks' (especially the ECB and BOJ) unjustifiable extension of their unprecedented non-traditional monetary programs at a juncture in which levels of slack in factor markets have faded considerably while nascent wage and overall inflation pressures are beginning to mount across the core Eurozone region and Japan.

In our view, other factors underpinning the sharp decline recorded by equity volatility this year include the investor-friendly outcomes to the succession of general elections held across the Eurozone region, including Austria, Netherlands, France and Germany. In addition, China's front-loaded (during the year's first half) fiscal stimulus program also helped anchor investors' 2017 economic growth expectations early in the year.



Source: MSCI & Bloomberg

**As of December 26th, 2017*

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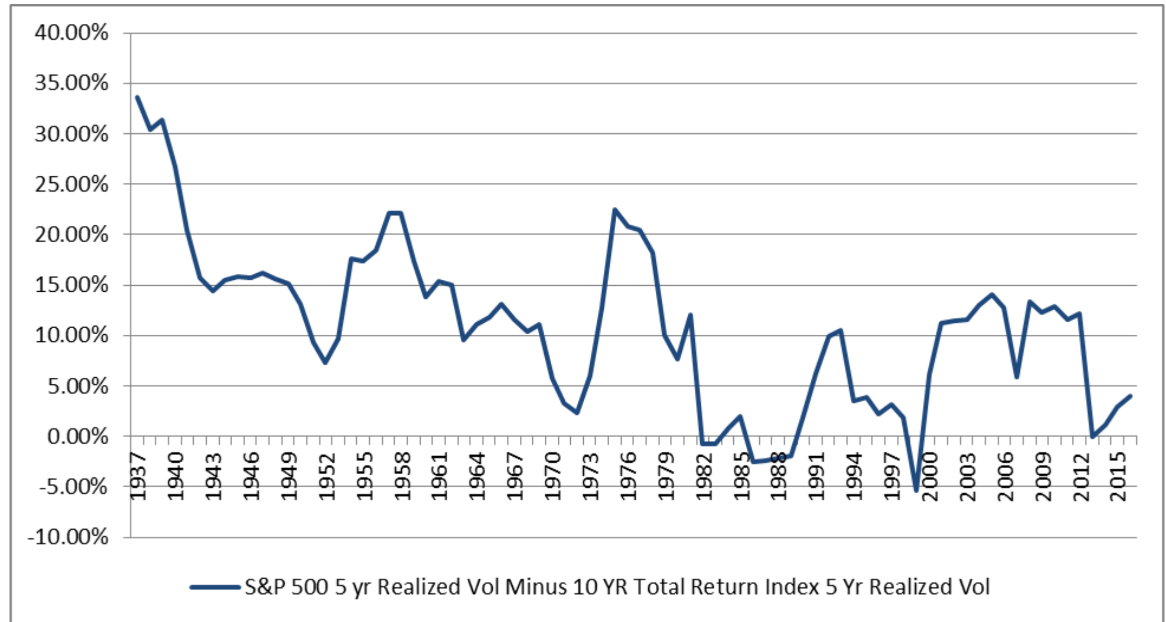
Sectors	% Change	FY1 PE Ratio
Energy	5.39%	35.7
Materials	1.54%	21.5
Industrials	1.65%	21.0
Cons Disc	2.90%	22.2
Cons Stap	2.21%	21.2
Technology	0.32%	19.2
Healthcare	-0.31%	17.7
Financials	2.06%	17.4
Utilities	-7.18%	18.1
Telecom	6.43%	13.5
Real Estate	-1.76%	36.8
S&P500	1.24%	20.0

S&P500 Monthly Sector Performance – December MTD 2017*

*As of December 26th, 2017

Source: Bloomberg

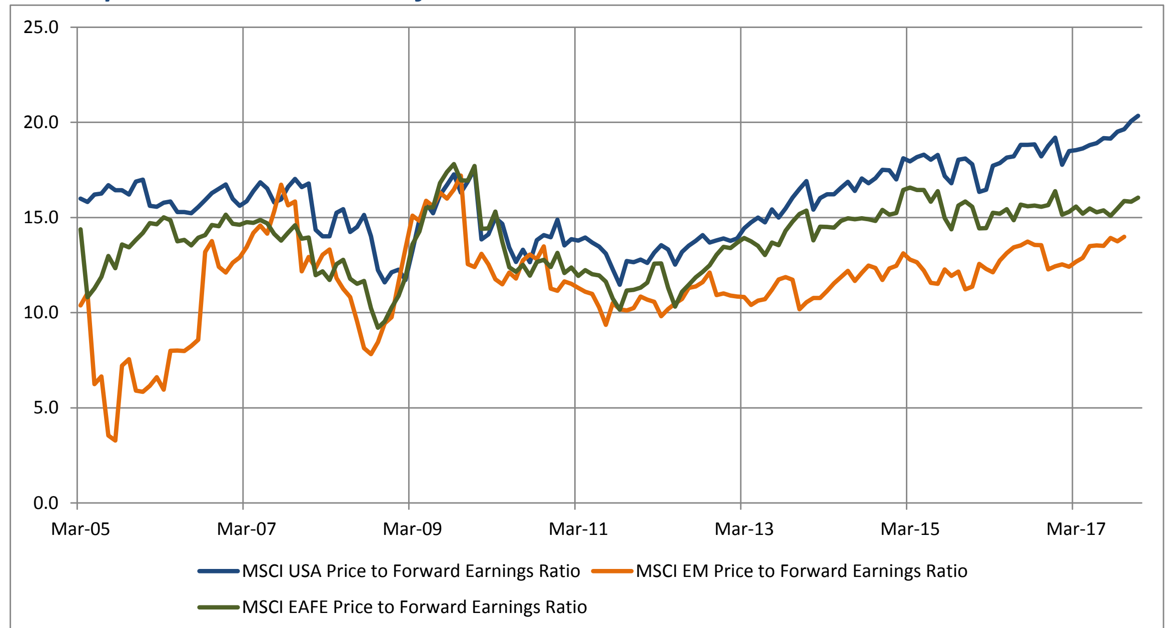
Figure 1. Equity Volatility Relative to Bond Volatility: Near Lowest Levels Since the 1930s



Source: NYU Stern (Prof. Ashwath Damodaran), Glovista Calculations

In our November monthly newsletter, we laid out our strong conviction pertaining the unjustifiable nature of continued levels of unprecedented monetary stimulus (particularly in the Eurozone) that carry potentially adverse implications for the world economy over the intermediate term. Specifically, we view the ECB's current monetary policy stance as the principal global anchor factor to a state of disequilibrium in the pricing of core asset markets, including equities, fixed income, volatility, private equity, commodities, art and credit.

Figure 2. Investor Sentiment-driven Valuation Expansion as Key Driver behind 2017 Solid Equities' Total Return Performance

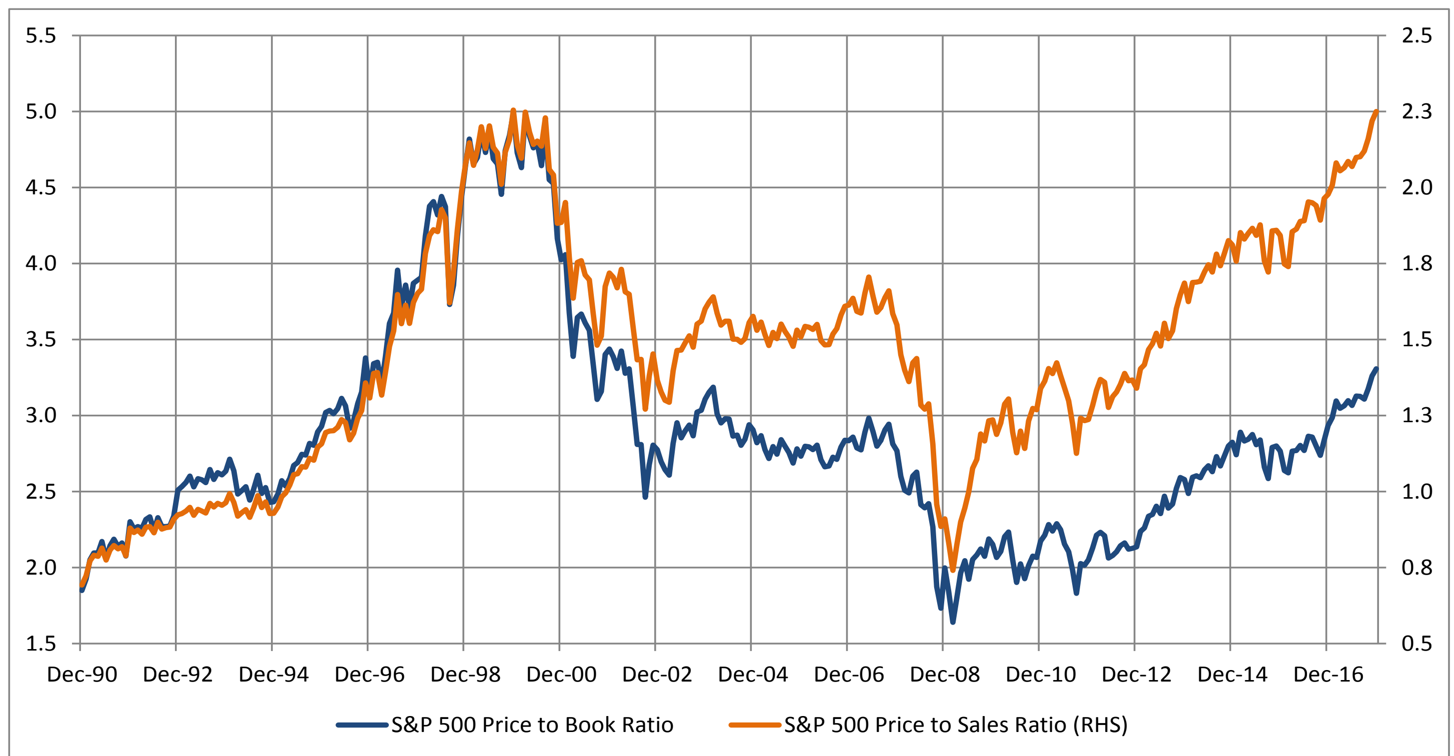


Source: Bloomberg & Glovista Calculations

A key implication emanating from the above mentioned thesis is that risk assets, in general, are overvalued while so-called 'risk-free' assets (such as German government bonds whose longer maturity paper command negative nominal yields through 7 year maturity) to be anything but 'risk-free'; if anything, such government debt should be viewed as return-free risky investments, in line with the characterization given by famed bond investor, Bill Gross.

Given the above discussion, in 2017 the demand for equities has resulted in an expansion of equity valuation multiples as a principal driver behind equities' solid YTD return performance, with earnings growth falling behind as a contributing factor. As regards earnings growth, especially in the USA, corporates' balance sheet expansion has remained an important boost factor to corporates' EPS growth through the reduction in corporates' share count as well as favorable year-ago comparisons facing energy sector stocks. More generally, an assessment of the US equity market, across a broad number of valuation parameters, shows US equity valuations to be exceedingly stretched from a historical and cyclical perspective (Figure 3 and Figure 4). This is especially true of median valuations.

Figure 3. US Equity Valuations Hover at Historically High Levels: P/B, P/S



Source: Bloomberg and Glovista Calculations

In summary, as we look back at 2017 we view the rise in risk asset prices as predominantly the result of valuation multiple expansions fueled by (a) misguided central bank policies, in time likely to be deemed by history as policy mistakes, as well as (b) a succession of political events and politically-driven policy actions, including in China and the USA, which are likely to prove non-recurrent (in the case of China's fiscal stimulus early in 2017) and intermediate-term counterproductive (in the case of the Trump tax cut reforms, given their implementation at such an advanced stage in the current US business cycle expansion). Specifically, some of the events unfolding in 2017, fueling asset valuation multiple expansion, included:

- Trump administration's focus, early in Q4, on the passage of a sizable tax cut reform agenda to be implemented in 2018. The ultimate passage of said reform bill was accomplished a few days ago, thereby explaining the recent strong rally in equity prices. While the short-term implication of the Trump tax reform agenda is (a) unambiguously expansive on activity (at the tune of 30 bps in annual GDP growth acceleration) and profit levels (close to 10% EPS bump in 2018), and thereby on risk markets, (b) the medium-term implications are ambiguous at best, given the bill's adverse budgetary implications and the timing of its implementation so late in the current US economic cycle (risk of inflation). As a result, we believe the Trump tax agenda carries the potential of unleashing a more hawkish FED stance in the coming months should the FED or the data calendar show an acceleration of inflationary pressures as a result of the tax bill. In such vein, a tighter FED stance could pressure equity valuation multiples lower in 2018 even as earnings continue to grow;

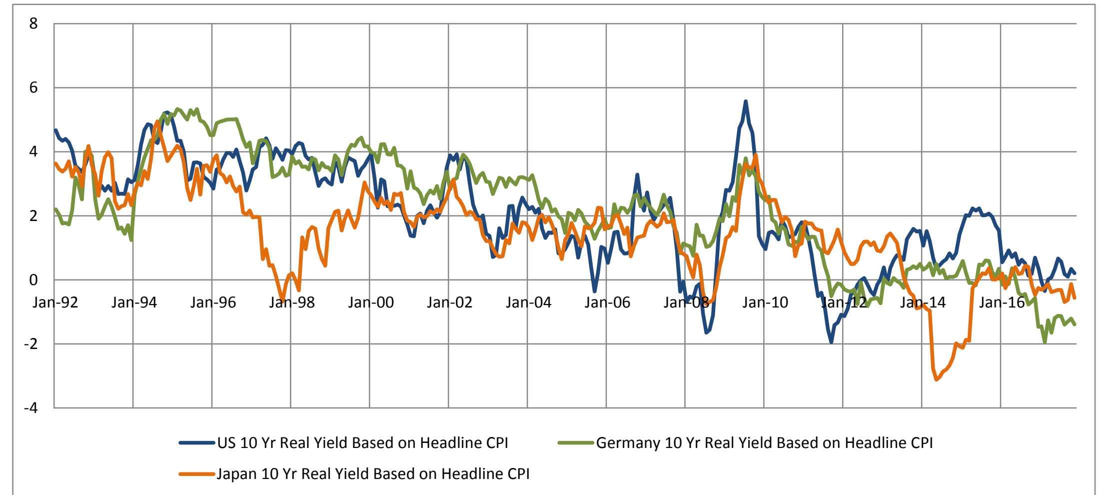
	December 26th 2017	December MTD Change
Gold	1283.02	0.6%
Silver	16.5465	0.7%
Oil	59.97	4.5%
EUR	1.1858	-0.4%
JPY	113.23	0.6%
GBP	1.3374	-1.1%
CHF	0.9893	0.6%
CAD	1.2687	-1.6%
AUD	0.7728	2.1%
BRL	3.3092	1.3%
MXN	19.8658	6.6%

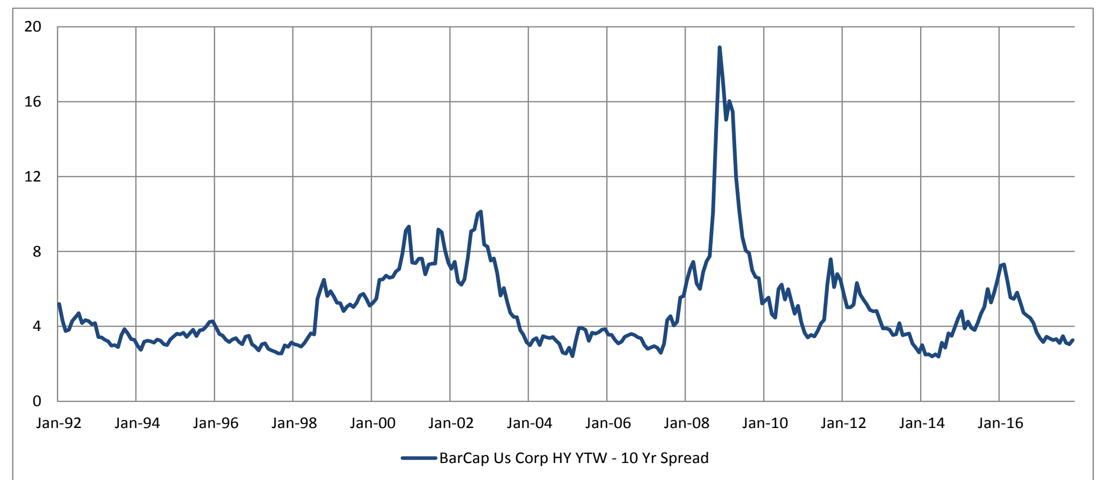
Source:Bloomberg

Rates	December 26th Level
1 Yr CD	0.8%
5 Yr CD	1.48%
30 Yr Jumbo Mortgage	4.17%
5/1 Jumbo Mortgage	3.7%
US Govt. 10 Year	2.4756%
10 Yr Swap Spread	-2.75%

Source:Bloomberg

Figure 4. G3 Real Government Bond Yields and High Yield Spreads Hover at Multi-year Low (Expensive) Levels





Source: Bloomberg & Barclays

- the Chinese government's decision, early in 2017, to introduce sizable fiscal and monetary stimulus for political purposes ahead of this year's October's Party Congress, China's version of its election cycle held every 5 years;

- the European Central Bank's (ECB) decision this past October, against most observers' expectations (ourselves included), against signaling a normalization of monetary conditions at a juncture in which output, price and factor market dynamics strongly suggest the need for embracing a normalization stance at this time. A discussion of said dynamics was the main focus of our November column, in which we contend that the Eurozone government bond market is one of the largest financial bubbles in modern times, carrying first-order implications for the global market and the macro outlooks;

- investor-friendly results from the string of Eurozone general elections held throughout 2017, especially in Austria, Netherlands, France and Germany. Despite the election results' unambiguously investor-friendly outcomes across the board, it is nevertheless the case that anti-establishment political parties gained material advances in their levels of parliamentary representation, a nontrivial risk factor conditioning the intermediate-term macro and market outlooks for the Eurozone.

We believe the distortions afflicting cross-asset valuations, as a result of the current state of artificially high levels of liquidity and low rates, is evident not only in current high valuation multiples but also in the prevailing state of historically and cyclically misaligned relative valuation levels that cut across different sector and styles of the global markets domain. For example, as discussed in our November column, the continued flattening of the US yield curve – anchored largely on the ECB's stance – accounts for an important share of growth stocks' (especially IT) current high valuations versus value peers. Such dislocations at the style and sector levels carry over to relative equity valuations across the geographic domain. For example, the Eurozone equities universe holds a relatively small growth style weighting (owing largely to the low IT sector weighting in the overall Eurozone market index) while Japanese equities are heavily tilted to the financial and industrial sectors. Conversely, US bellwether indices (such as the S&P 500) carry a considerably larger growth style (owing to the S&P 500 index's large IT sector weighting) than Japanese and Eurozone peers'.

As we look ahead to 2018, we expect value stocks' performance to strengthen relative to growth peers. In that vein, we expect Eurozone, Emerging Markets and Japanese equities to outperform US peers in 2018. With that, we turn our discussion to the prospective section summarizing our 2018 Year-ahead outlook.

2018 Outlook: Volatility to Rise as Aging US Expansion Meets Higher US Policy Rate Environment under New FED Leadership; Glovista Expects Further US$ Weakness, Favoring Value/Non-US Equities

As we look ahead to 2018, absent the onset of unforeseen first-order geopolitical events (e.g. nuclear war in the Korean peninsula or escalation of tensions in the Middle East) we expect the global economic expansion to extend. As in the case of our 2017 year-ahead outlook, in 2018 we expect the US economy to lag its global peers in terms of economic growth performance despite the growth impetus afforded by the recent legislative passage of the Trump tax cut agenda – whose 2018 and 2019 GDP growth contribution is likely to be of the order of 30-40 basis points on an annual basis.

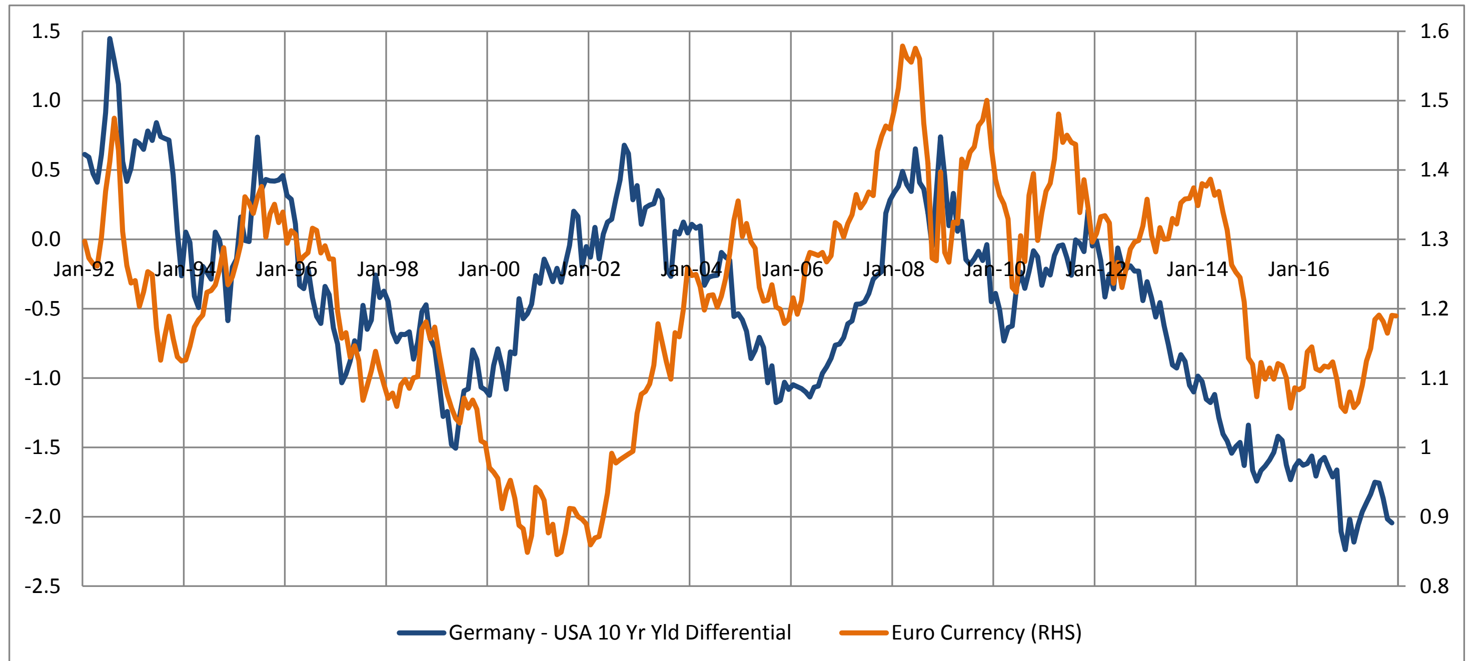
At a global level, we expect the Eurozone, Emerging Markets and Japan economies to lead the global expansion, with the UK, Australia, Canada and US economies lagging. From a market perspective, we expect the following:

- A continuation of US Dollar weakness versus most of the world's currencies, a view we have held for Developed currencies (especially the Euro) since early 2017 and for Emerging Markets (since early 2016). Our expectation of further US Dollar weakness is predicated on several grounds, including the following: (a) further US GDP growth underperformance versus global peers; (b) US Federal Reserve interest rate hikes versus those put forth by the ECB over the coming 24 months not to exceed what is priced into the forward curve (Figure 5 illustrates long-term yield differentials between the Euro and the US Dollar); and (c) absence of global economic recession scenario in 2018. However, over the short-term, investor positioning appears US Dollar supportive, as a result of which the US Dollar weakening trend may not establish itself in force till the second quarter of the year;

- Emerging Market equities to outperform Developed Market equities as the Developed world (especially US) economic expansion stands at a more advanced stage of the cycle than EM peers', injecting stronger growth visibility to EM corporates' top-line and profit margin dynamics. Moreover, EM equities' ownership status - on the part of US investors - remains depressed, as reflected in the latest readings of indicators that capture US investor exposure levels to different geographic markets. Finally, EM equities' relative valuation multiple versus DM peers remain close to historical low levels despite almost 2 years of relative outperformance (Figure 6);

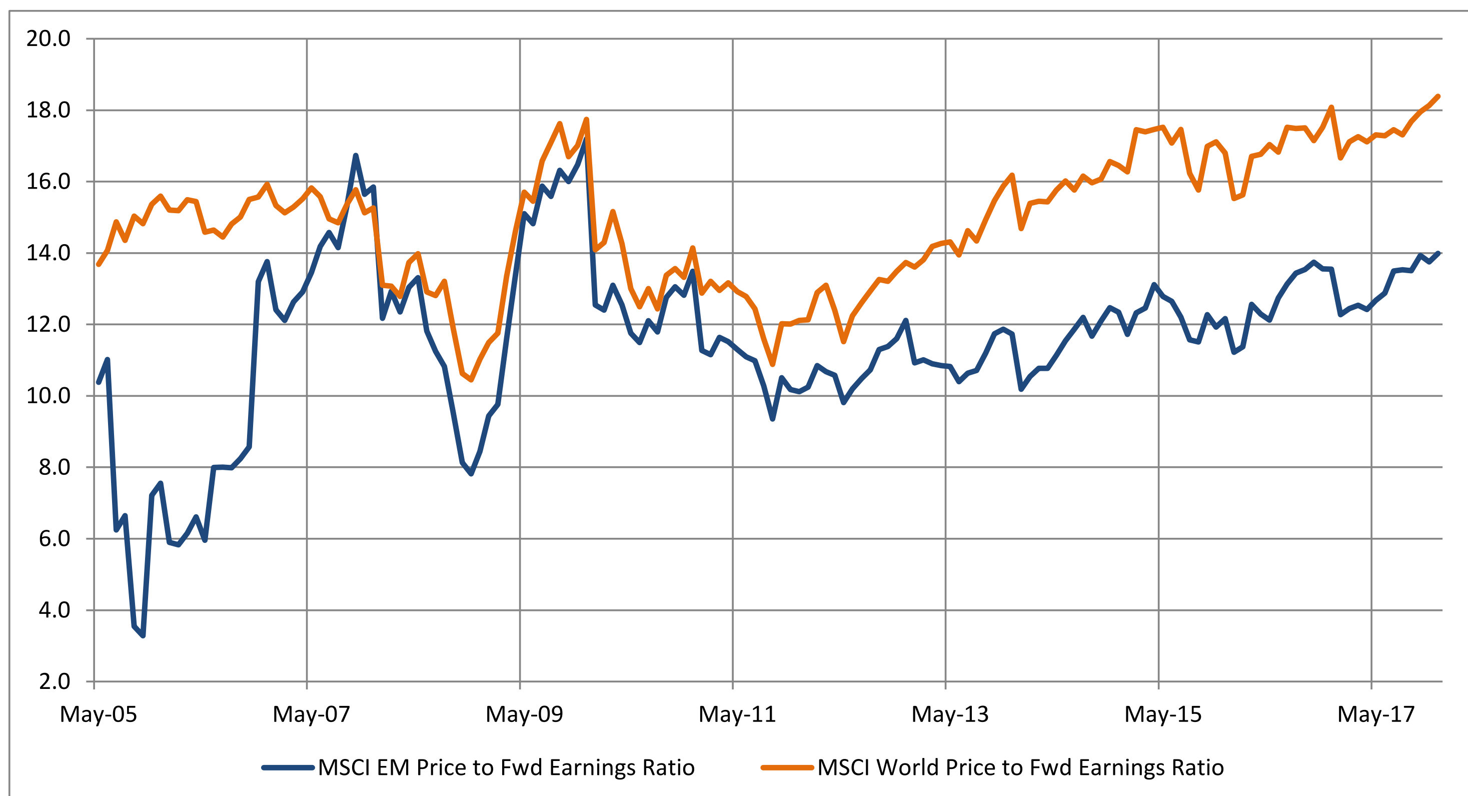
- Short fixed income duration exposure. As discussed in our November newsletter, our investment process leads us to the assessment that fixed income duration, especially in the Eurozone, represents one - if not the most significant - asset market mispricing (bubble) in modern financial history - courtesy of G3 central banks' non-traditional monetary programs' overextended status following the onset of the 2007-09 great financial crisis. As a result, we continue to favor short- to intermediate-duration exposure to (largely US) corporate debt paper;

Figure 5. In 2017, Euro Strengthened Sharply versus US$ Despite US-Euro Interest Rate Differentials Remaining Close to Highest (Most US$ Supportive) Levels in Years: Euro GDP Growth Outperformance Trumps Rate Differentials

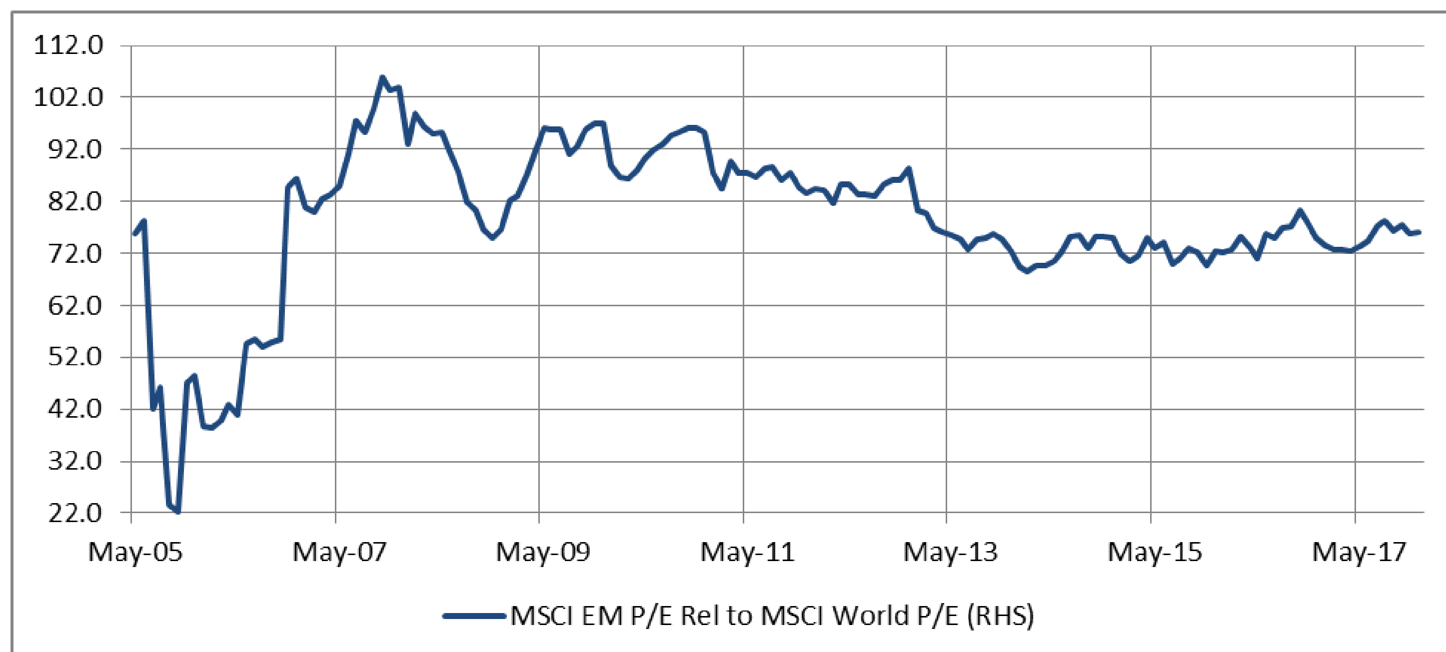


Source: Bloomberg & Glovista Calculations

Figure 6. EM Equities' Relative P/CE Valuation Multiple versus DM Peers Close to Multi-year Low Levels Despite 2 Year-long Period of Outperformance



Source: Bloomberg



Source: Bloomberg & Glovista Calculations

- Rotation of equity market leadership to value sectors/country indices, away from growth peers. As discussed in our November newsletter, starting in November we began to rotate our investment portfolios in favor of value factors, given a number of considerations, including: growth stocks' overextended relative valuations versus value peers; value stocks' return performance impetus in 2018 likely to result from a normalization of fixed income term premium levels as the ECB shifts its stance next year in response to the economic calendar and as the Trump tax cut lends support to value sectors within the US market; and growth stocks' over-owned status on the part of the international investment community;

- The geographic expression of a 2018 rotation of return performance leadership in favor of value stocks is likely to entail Eurozone, Japanese and Emerging Market equities' stronger return performance leadership over US stocks;

- Moderately bullish commodity price outlook as (a) central banks' interest rate normalization efforts are likely to lag inflation performance, implying continued low real interest rate levels, and; (b) the global economic expansion extends further. Moreover, by historical standards, global investors' exposure levels to the asset class remain low providing, a bullish technical factor supportive of the asset class' 2018 outlook.

Of course, the 2018 investment outlook is not bereft of risks. Some of these include:

- Meaningful escalation of geopolitical tensions in the Korean peninsula and the Middle East;

- Resurfacing of trade tensions between the US and some of its major trading partners, including China and Mexico, should ongoing negotiations between the US and North Korea advance further and also as the proximity of US mid-term elections in the Fall 2018 render presidential attention to domestic affairs less rewarding to Mr. Trump when viewed through a political lens;

- G3 central bank policy mistakes, especially the potential for a US FED policy mistake – under a new leadership team – as the new FED decides to implement an excessive number of rate hikes should it find the need or desire to establish hawkish credentials early in the new Chair's tenure, particularly if inflation surprises to the upside next year. Such over-hiking scenario could help bring about a

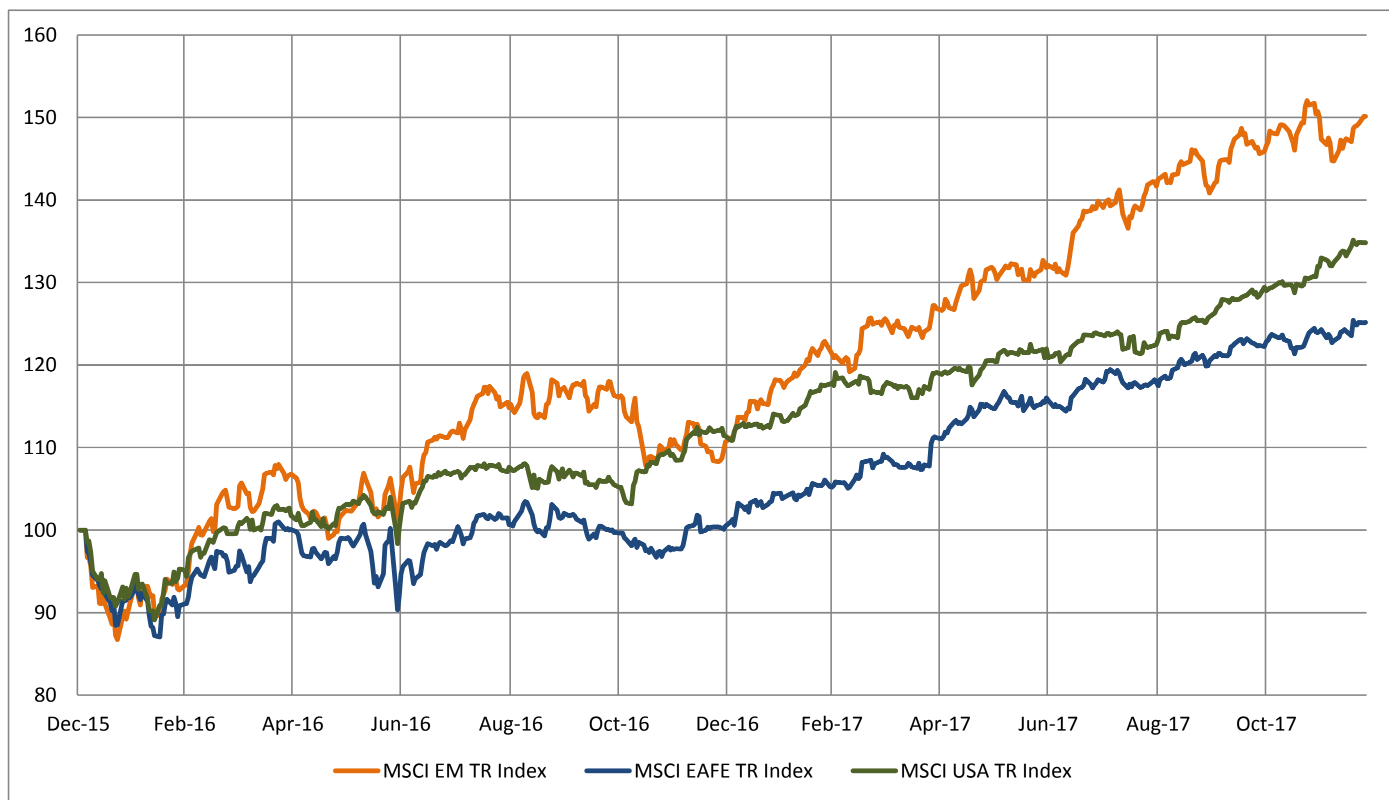
recession scenario over the ensuing year and a half period. Under such scenario, risk markets - including equities - could begin to discount such scenario sometime in 2018.

Emerging Markets Perspectives

2018 EM Year-Ahead Outlook: EM Equities to Extend Outperformance versus DM Peers on Re-rating Dynamics, Under-Owned Status and Superior Top-line and Margin Growth Potential; Value to Outperform Growth

In 2017, Emerging Market equities, as represented by the MSCI EM index, extended the period of strong return outperformance versus Developed Market peers that began in January 2016 (Figure 7). Figure 8 provides total return performance decomposition for EM equities across the earnings and valuation multiple factor levels, both for 2017 and 2016, against the corresponding components for the Developed markets' peer group. The data shows EM equities' solid return outperformance of DM peers for 2017 sprung mainly from the currency and earnings growth factors as opposed to multiple expansion. Earnings growth was the main driver of EM outperformance in 2017 whereas multiple expansion was the primary driver of EM outperformance in 2016.

Figure 7. EM Equities Extend Outperformance vs. DM Peers for a 2nd Consecutive Year



Source: Bloomberg & Glovista Calculations

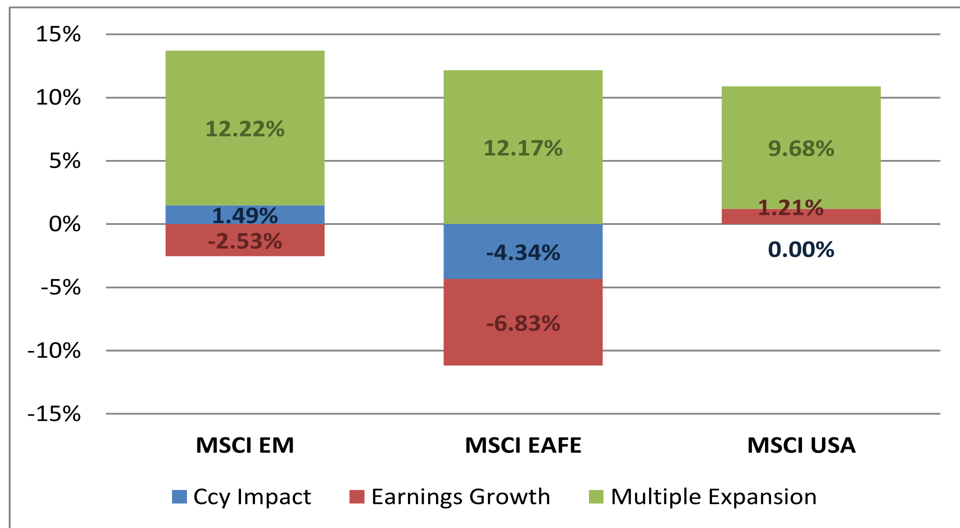
As suggested in Figure 8, in 2017 EM equities' strong relative outperformance versus DM peers responded to a number of sector and macro factors, including the following:

- EM growth stocks' stellar earnings performance and favorable re-rating dynamics throughout 2017, largely as a reflection of Chinese IT corporate names, along with EM growth stocks' larger percentage participation in the MSCI EM benchmark as compared to five or ten years ago (Figure 9).

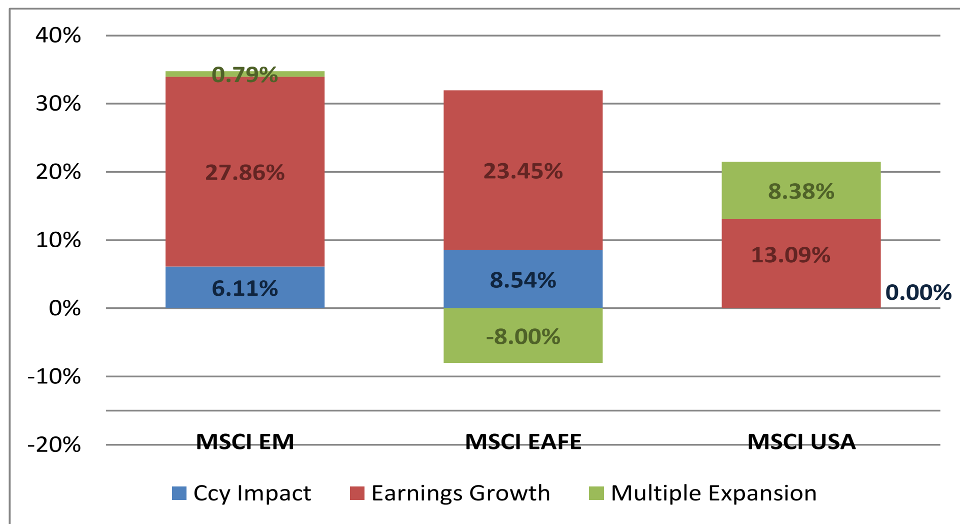
- EM currencies' continued revaluation versus the US Dollar (Figure 10).

Figure 8. Total Return Performance Decomposition for 2017, 2016: EM versus DM

2016



2017



Source: Bloomberg & Glovista Calculations

- Earnings performance resilience on the part of Latin America and EMEA regional stocks, despite a year filled with challenging political developments in Turkey, Mexico, Brazil, Poland and South Africa. In our view, that Latin America and EMEA stocks performed approximately in line with EAFE peers during a year defined by investor unfriendly political developments in some of the larger countries in those regions represents a powerful testimony to the compelling value proposition inherent to those regional equity markets. As we look ahead to 2018, we believe the Latin American and EMEA markets are likely to post some of the strongest relative return outperformance metrics versus developed peers.

As we look ahead to 2018, we expect a rotation of EM return performance leadership away from growth-oriented markets (mostly domiciled in the North Asia region) to the benefit of value-oriented peers (mostly domiciled in the Latin America and EMEA regions). We embrace such thesis on the back of our constructive global macro outlook for 2018 and the extended relative valuations commanded by EM growth stocks following their powerful 2017 relative performance over value peers.

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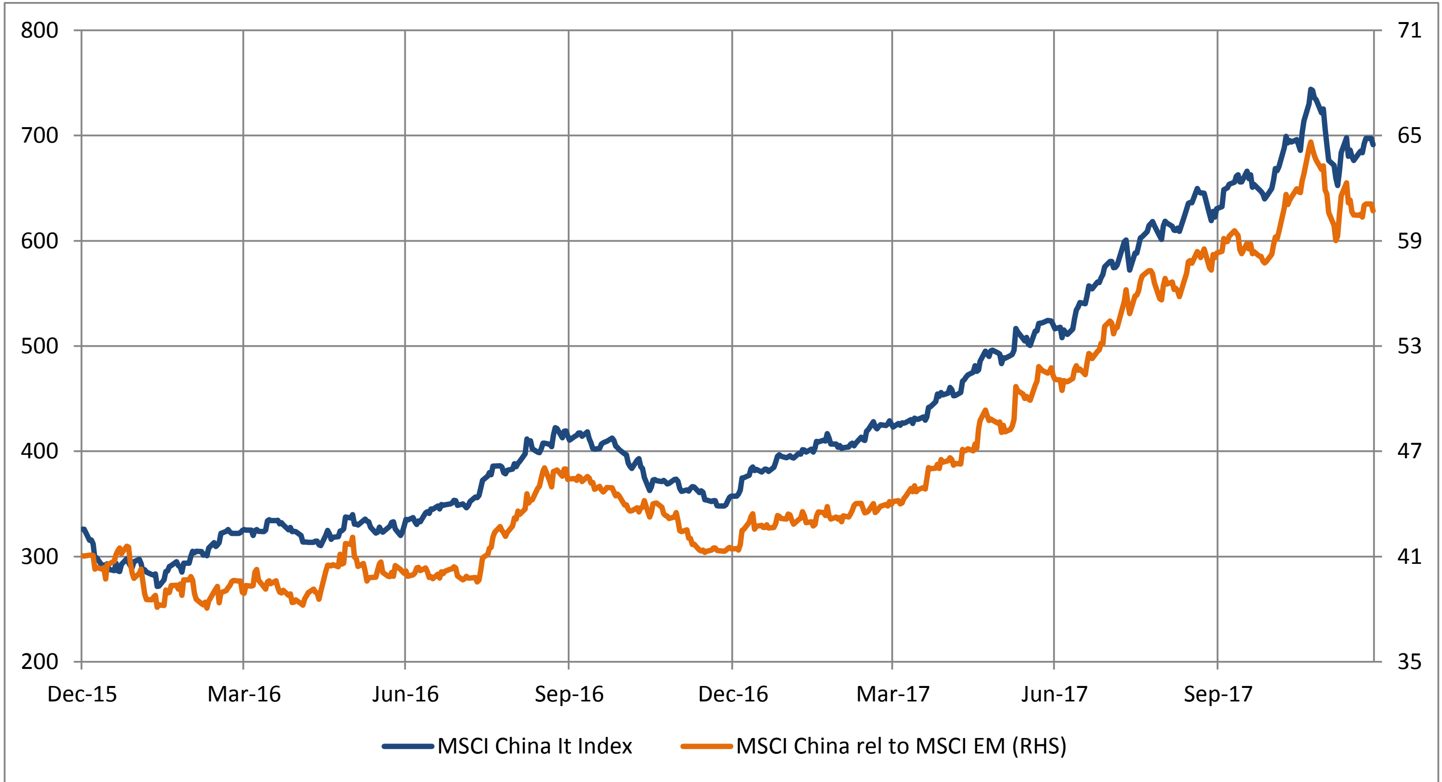
Figure 9. Chinese IT Stocks' Strengthening Earnings Fundamentals and Re-rating as Anchor Factor Underpinning EM Stocks' Solid 2017 Return Performance



Source: MSCI, Bloomberg & Glovista Calculations

Figure 10. In 2017 EM Asia Currencies Posted Strong Revaluation versus the USD, in contrast to the Weakening Period that Defined 2016

Source: Bloomberg

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