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Glovista Global Perspectives

This Issue:

2018 Review and 2019 Year-Ahead Outlook: High Quality, Value, Income Oriented Approach as Markets Increasingly Discount Earnings Recession Amidst Deleveraging Phase

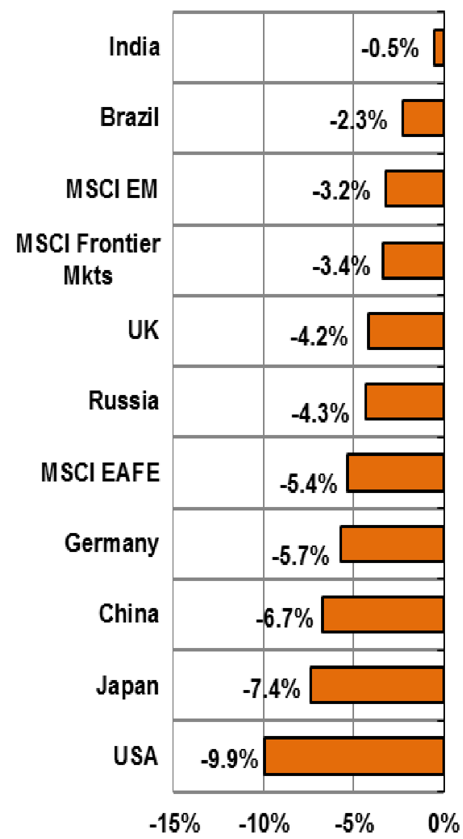
As we look ahead to the 2019 global macro and market outlook, it is opportune to provide a brief account of the more salient macro and market developments of 2018 as the year draws to a close. We provide such discussion in the section immediately below followed by an outline of the principal considerations anchoring Glovista's 2019 global macro and market outlook. We conclude with a discussion of our market outlook for 2019 along with portfolio strategy views for the beginning of the year.

2018 Review: Non-US Growth Slowdown in Year's First Half followed by US Deceleration in Second Half as Liquidity Conditions Tighten, Trade Decelerates on US/China Tensions, Brexit/Italy/China/Energy Risk Premium Levels Remain High and Crypto Bubble Deflates

Global markets started off the year with heightened optimism over the 2018 economic outlook, boosted by the expansionary effects stemming from the implementation of major US fiscal stimulus measures - in the form of government expenditure increases along with the largest corporate tax cuts in several decades. In addition, the market outlook was also supported by the traction gained by Emerging Market economies throughout 2017.

As we look back at the year-to-date period, we identify a number of major economic, policy and political developments that have carried a material, largely adverse, impact on global macro and market dynamics, as illustrated in the generalized negative return performance figures recorded by a large sleeve of global asset markets (Figure 1). Some of those developments include the following:

Country-wise Monthly Performance in USD terms (December 2018)*



Source: MSCI & Bloomberg

**As of December 28th, 2018*

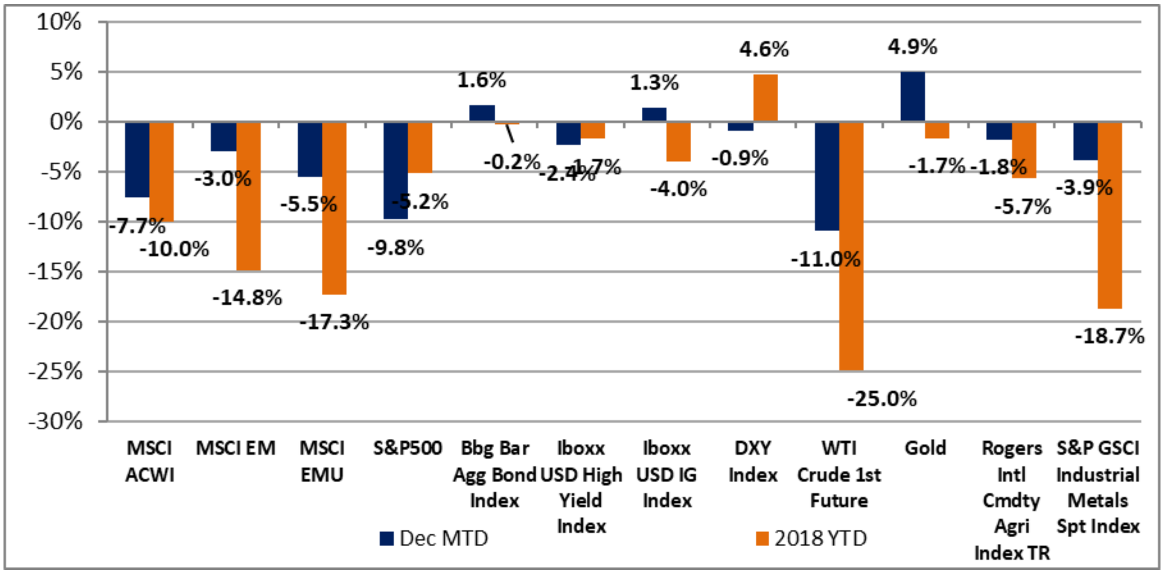
S&P500 Monthly Sector Performance – December MTD 2018*

Sectors	% Change	FY1 PE Ratio
Energy	-13.21%	14.6
Materials	-7.92%	14.2
Industrials	-11.70%	14.8
Cons Disc	-9.43%	18.9
Cons Stap	-9.82%	17.4
Technology	-9.40%	15.6
Healthcare	-9.97%	15.7
Financials	-12.31%	11.3
Utilities	-4.50%	17.0
Telecom	-7.65%	15.4
Real Estate	-7.94%	33.2
S&P500	-9.94%	15.3

*As of December 28th, 2018

Source: Bloomberg

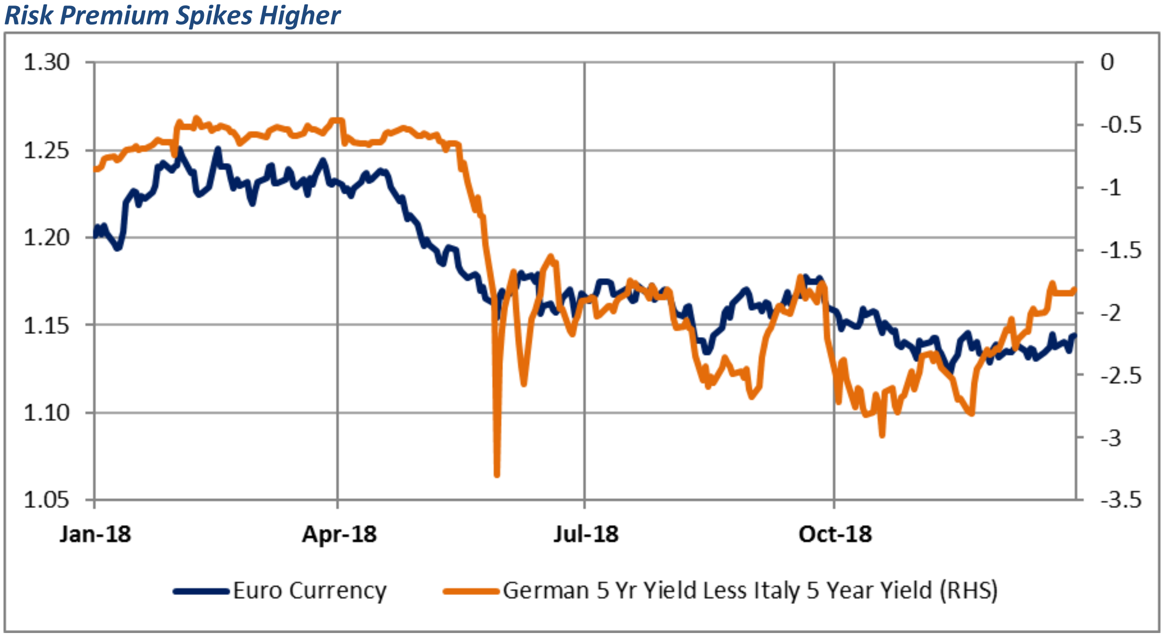
Figure 1. Policy, Political and Geopolitical Factors Pressure Risk Asset Indices to the Downside in 2018



Source: Bloomberg

- In late January and extending into the beginning of February, US equities sold off sharply on the back of adverse market technical imbalances in the form of heightened leverage along with sudden investor concerns over an inflation spike fueled by higher than expected US wage data released late in January.
- Italian general elections held in March led to the eventual formation of an unstable government coalition between far right and far left political parties all of which have embraced populist fiscal policies at a juncture in which Italy's economy continues to weaken and the European Central Bank looks poised to withdraw liquidity early next year. Such state of affairs has resulted in a weaker than expected Euro currency throughout much of this year along with elevated equity and credit risk premium levels (as illustrated in Figure 2).

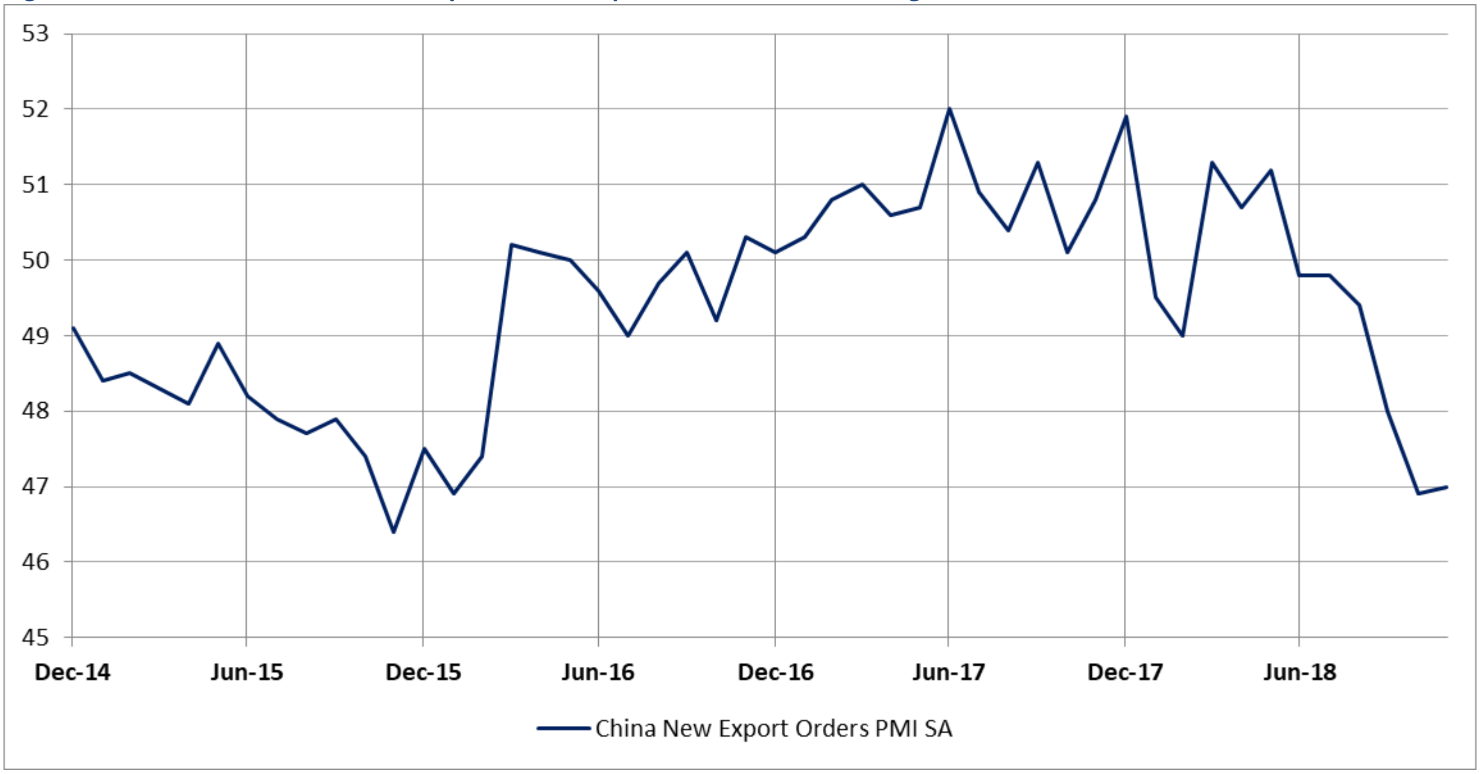
Figure 2. Euro Currency Weakens Throughout 2018 as Eurozone Periphery Sovereign Credit Risk Premium Spikes Higher



Source: Bloomberg & Glovista Calculations

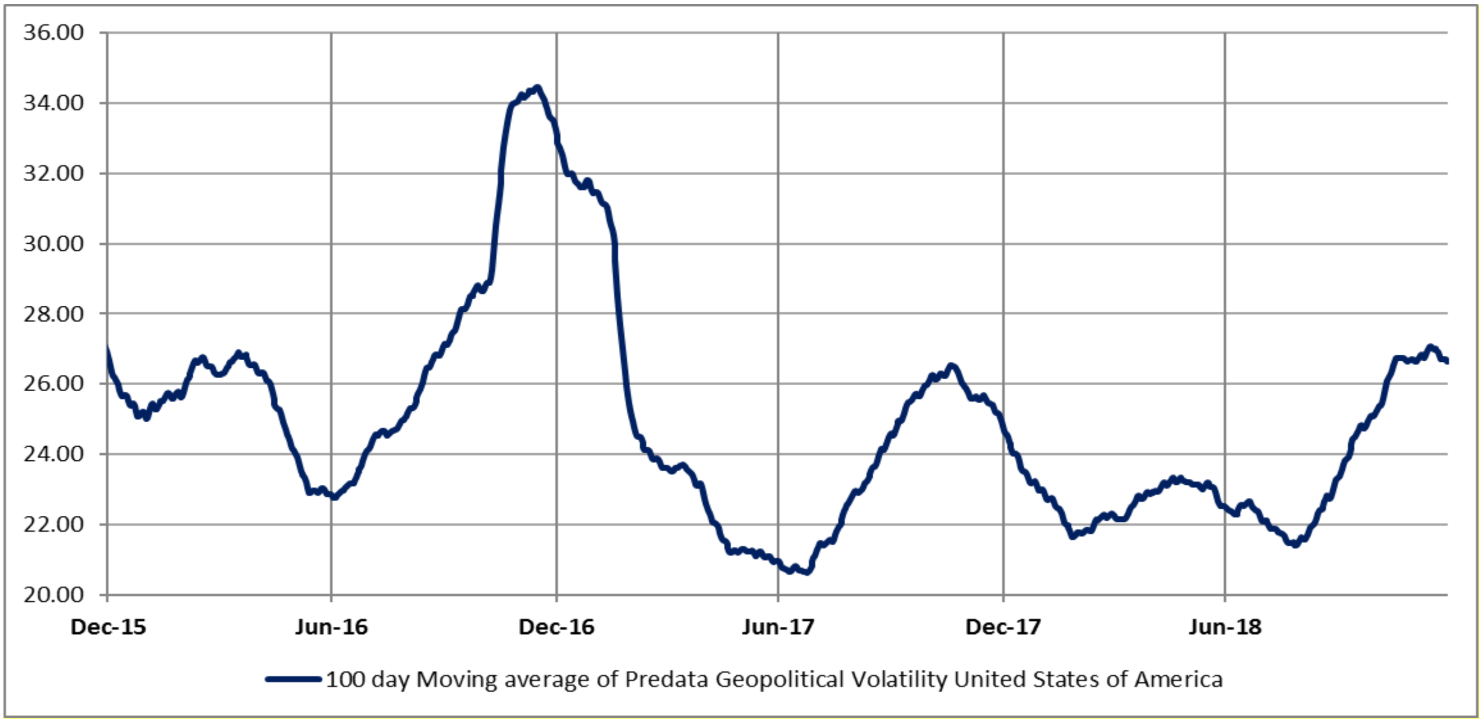
- Trump Administration led China-US trade war. While the first signs of the US government's shift in trade policy became apparent during the first quarter of the year, the specific quantum of tariff measures applied on US imports from China were announced around the middle of the year, impacting trade data towards the early part of the fourth quarter of the year (Figure 3).

Figure 3. US-China Trade Frictions Impact China Export Orders Data Starting in the Third Quarter 2018



Source: China Federation of Logistics and Purchasing

Figure 4. Geopolitical Risk Measures Have Risen throughout 2018, Partly Impacted by Trade War between the US and China



Source: Predata and Glovista Calculations

	December 28th 2018	December MTD Change
Gold	1281.1	4.8%
Silver	15.381	8.5%
Oil	45.33	-11.0%
EUR	1.1444	1.1%
JPY	110.27	-2.9%
GBP	1.2699	-0.4%
CHF	0.9846	-1.3%
CAD	1.3638	2.6%
AUD	0.7047	-3.5%
BRL	3.8764	0.2%
MXN	19.6587	-3.5%

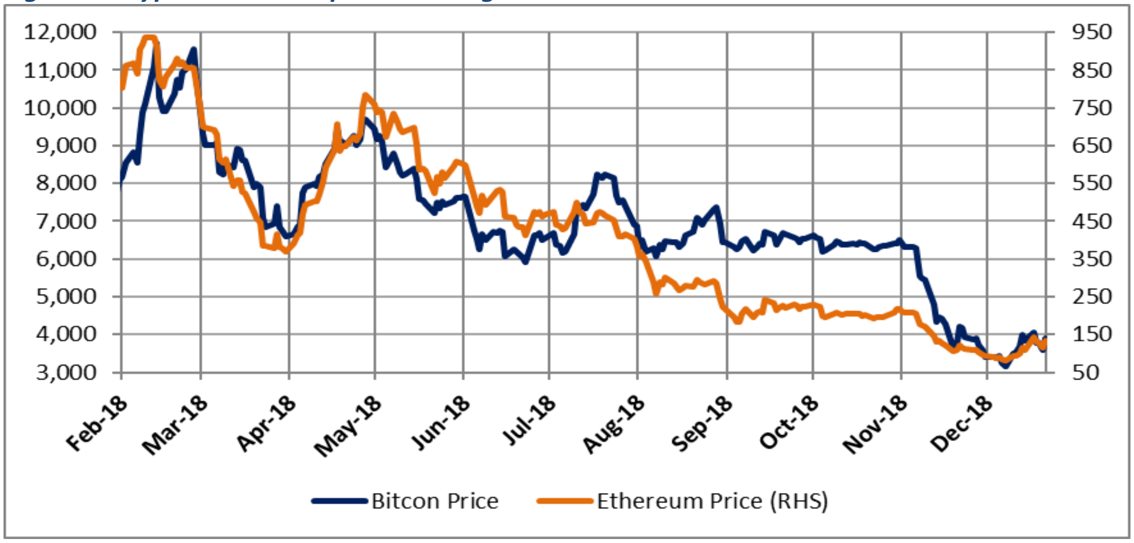
Source: Bloomberg

Rates	December 28th Level
1 Yr CD	1.35%
5 Yr CD	2.02%
30 Yr Jumbo Mortgage	4.44%
5/1 Jumbo Mortgage	3.89%
US Govt. 10 Year	2.7182%
10 Yr Swap Spread	2%

Source: Bloomberg

- Ousting of moderates from Trump administration (Cohn, Kelly, Mattis and others) and dominance of China hawks, such as Navarro. As a result, geopolitical risk premium levels have risen markedly, adversely impacting risk asset multiples (Figure 4).
- Sustained crash in cryptocurrency markets (Figure 5) have impacted retail investor sentiment as well as several segments of the IT sector, as evidenced by recent adverse earnings and revenue results and guidance for 2019, including by major IT names such as Nividia.

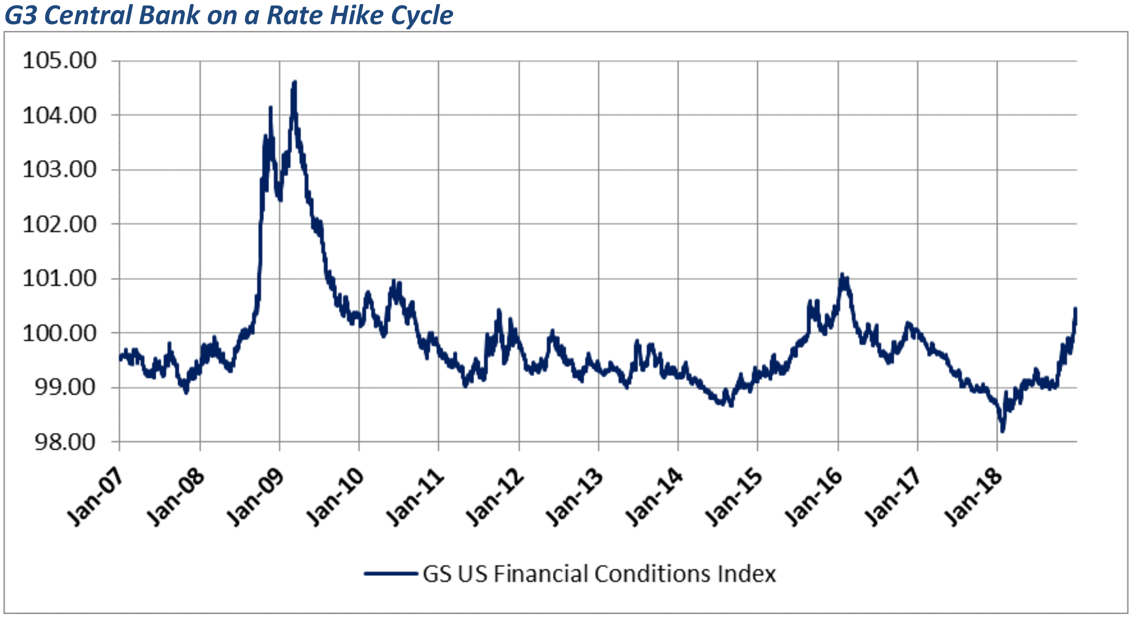
Figure 5. Crypto Market Implodes during 2018: Bitcoin and Ethereum



Source: Bloomberg

Against a backdrop of adverse policy and political dynamics, as discussed above, the year has also entailed a sustained tightening of financial conditions, primarily of the US Dollar market as the US Federal Reserve has remained on a sustained policy rate hike phase. Specifically, since the beginning of 2018, the US FED has hiked its Fed Funds policy rate by 100 basis points on a cumulative basis. Moreover, as of the writing of this column, the US FED continues to signal the markets its expectation of at least two additional 25 basis points policy rate hikes in 2019.

Figure 6. US Financial Conditions Tighten Throughout the Year as the FED Remains the only G3 Central Bank on a Rate Hike Cycle

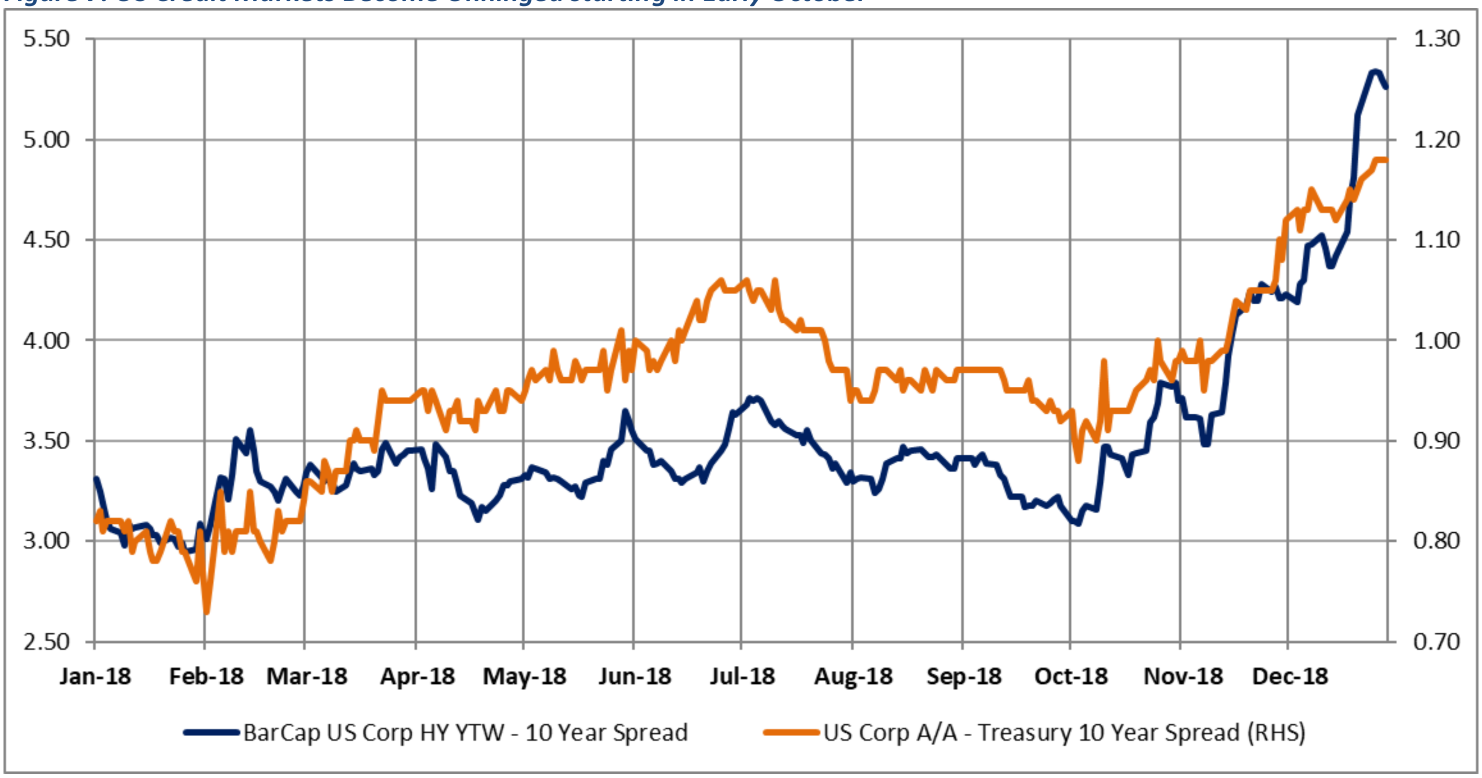


Source: Goldman Sachs

Against such backdrop of steady FED policy rate hikes, the strengthening US Dollar throughout the year has also resulted in a tightening of US financial conditions (Figure 6). In our view, the strengthening US Dollar has been the result of three principal factors: (a) this year's market unfriendly election developments in Europe (Italy), as discussed above, resulting in a spike of Euro currency risk premium levels, (b) the US FED's solo rate hike stance vis-à-vis its peers in the Eurozone and Japan, and (c) the US Dollar bid surfacing out of a number of small Emerging Market countries with weak credit fundamentals that have been the focus of speculative attacks this year (e.g. Argentina and Turkey) .

The strengthening US Dollar, weakening global trade growth momentum and tightening financial conditions ultimately impacted global activity indicators to the downside. Up until the beginning of October of this year, the US economy had been deemed to exhibit an 'exceptional' attribute as it had remained an island of economic strength in the midst of a global market environment in which many international equity indices had recorded negative return performances throughout the first half of the year. In October, US credit markets became unhinged as illustrated in Figure 7. Specifically, Figure 7 captures a massive widening of credit costs facing the strongest (A rated Investment Grade) and weakest (high yield) segments of the US credit markets. In addition, crude oil – one of the most cyclical commodity groups at a global level – recorded a massive price implosion starting in early October, of around 40 percent within less than 12 weeks, signaling a potential slowdown in the global economy in 2019 (Figure 8).

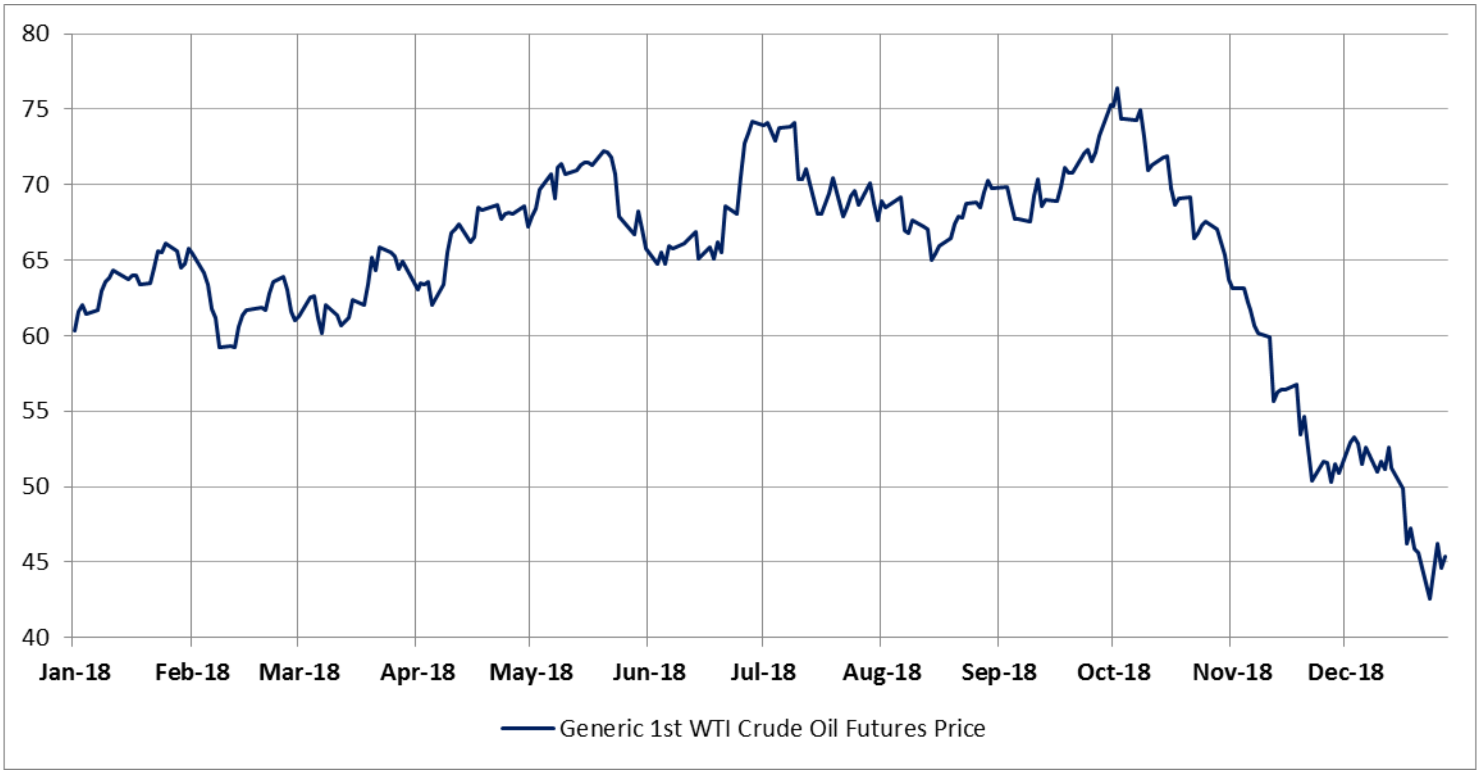
Figure 7. US Credit Markets Become Unhinged starting in Early October



Source: Bloomberg

The shift in global investor sentiment that unfolded in early October was the result of a succession of weaker than expected economic releases out of the US, including adverse IT companies' earnings and revenue guidance for 2019, that called into question the US economy's so-called exceptionalism during a period of tightening financial conditions and weakening world economic growth. As a result, staring in early October defensive stocks (including consumer staples, healthcare and utilities) have begun to outperform cyclical sectors stocks (including industrials and information sector stocks), as illustrated in Figure 9. In short, 2018 has been a tale of two halves – before and after October 1st. Similarly, a shift in relative performance between growth and value stocks has become evident starting in early October (Figure 10).

Figure 8. Crude Oil Price Implodes by 40 Percent between Early October and Late December, Signaling Weaker Growth in 2019

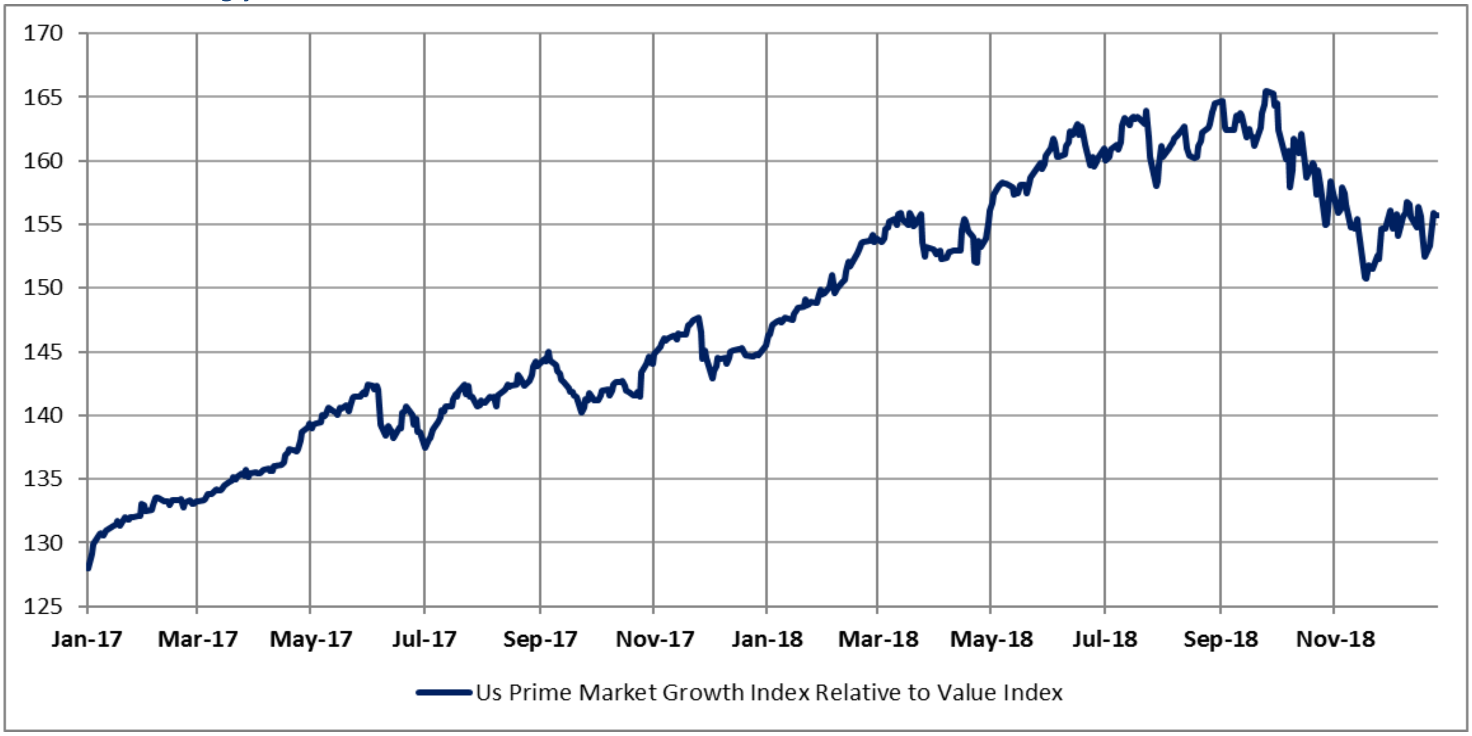


Source: Bloomberg

Figure 9. Early October Marks a Shift in Relative Performance Leadership between Defensive and Cyclical Sector Stocks as Markets Increasingly Discount Weaker Growth in 2019

Source: Glovista

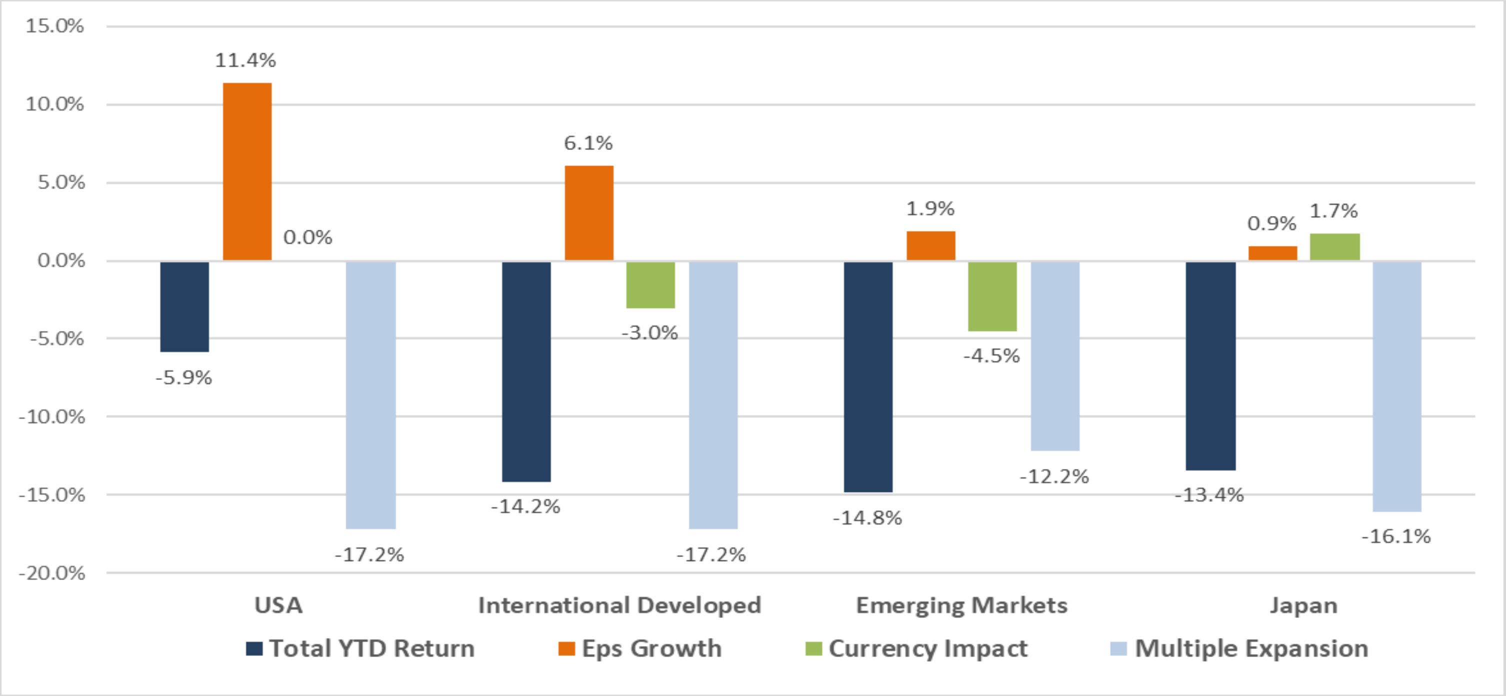
Figure 10. Early October Marks a Shift in Relative Performance Leadership between Growth and Value Sector Stocks as Markets Increasingly Discount Weaker Growth in 2019



Source: Bloomberg & Glovista Calculations

Figure 11 illustrates global equities' total return decomposition for 2018 across earnings, valuation multiple and currency factors and for the world's principal equity index groups. US equities' outperformance reflects primarily the strong US Dollar and the one-off boost to US corporates' 2018 earnings per share on account of the outsized corporate tax cut implemented this year. As discussed in the outlook section immediately below, we expect the various tailwind factors supportive of US equities' return outperformance of international peers during 2018 to turn into headwinds.

Figure 11. Global Equity Indices' Total Return Decomposition: Earnings, Currency, Valuation Multiple



Source: Bloomberg, MSCI and Glovista Calculations

Finally, the 2018 widening financing costs facing global corporates, both high yield and investment grade rated, has been the result both of the increased cost of money resulting from a succession of US FED policy rate hikes along with a downward revision to 2019 world economic growth expectations along with a number of adverse policy and political developments resulting in a spike of risk premium levels, including for corporate bonds. We discuss further below our assessment of the relative value imbedded in corporate bond valuations as 2018 draws to a close.

2019 Outlook: *Global Activity Slowdown, Increased Risks of Earnings Recession, Over-owned US Equities Status and Tightened Credit and Liquidity Conditions Support High Quality, Value, Income Oriented Portfolio Strategy Approach*

As we look ahead to 2019, we expect the global economy to decelerate yet avoid recession largely on account of the following considerations:

- US economy is likely to decelerate owing to (a) lagged effects from a strong US Dollar and considerable tightening in credit and liquidity conditions, (b) adverse capital expenditure effects from sharp energy price declines, (c) deceleration of interest rate-sensitive sectors (including housing and autos), along with (d) the fading of growth momentum tied to the large tax cuts implemented in 2018 and (e) lagged adverse personal consumption effects from recent sharp declines in asset prices (equities, bonds and housing). However, the US economy is unlikely to contract in 2019 owing to still prevailing low inflation-adjusted borrowing costs facing corporate and household borrowers while cyclical sectors' (e.g. housing, autos, capex) overall GDP shares are considerably lower than at previous pre-recession levels.

- China's economic growth momentum is likely to decelerate further on the back of adverse lagged effects from the implementation of trade tariffs by the US and the Chinese government's decision to allow a faster debt restructuring process on the part of state-owned enterprises. However, the Chinese economy is unlikely to contract owing to the presence of countervailing developments including the recent introduction of counter-cyclical fiscal policy measures, the already escalation in personal savings rate levels over the course of 2018 as household consumer sentiment was impacted by trade frictions with the USA and supply-demand imbalances in China's housing market are being significantly worked off.

- The Eurozone economy's growth outlook remains under pressure around the turn of the year given the adverse growth effects stemming from (a) the considerable slowdown in global trade growth, (b) Brexit, (c) tightening credit conditions throughout the Eurozone given political developments in Italy, discussed above, and (d) the prospects of reduced liquidity conditions in 2019 as the European Central Bank embarks on a quantitative tightening process. The combination of tighter liquidity conditions along with a slowdown in overall economic activity momentum is likely to keep Euro currency risk pressures elevated throughout 2019.

While Emerging Market economies (outside of China) are likely to post a strengthening economic momentum versus 2018 levels, the orders of magnitude of such growth outperformance are unlikely to be large enough so as to offset the deceleration of economic growth from larger economic peers in the Developed world. Moreover, while we do not expect the global economy to enter into a recession phase during 2019, we envision considerable risks of an earnings recession along with the potential for a number of credit events across both the Developed and Emerging economies. In 2018, we already witnessed a number of credit developments out of the developed world (e.g. Deutsche Bank, Italian banks, General Electric) and Emerging Market countries (e.g. Argentina, Turkey, local Chinese corporates).

While the 2019 global economic outlook remains challenged, we are fully aware of a number of offsetting economic and financial developments that introduce upside risks to the outlook as we approach the middle of next year. Foremost amongst these is the potential for a sustainable turn (lower) in the US Dollar cycle as the US Federal Reserve brings about a fast end (than expected) to its multi-year long rate hike cycle as Europe and Japan do the opposite and tighten liquidity conditions, albeit modestly.

Figure 12. EM Asia Currencies Recoup Strongest Levels versus US$ since Early August

Source: Bloomberg

Market and economic history remind us that a weakening US Dollar helps bring about potent reflationary effects on the global economy and markets. It is encouraging to note the sustained US Dollar weakness that has obtained these past several months versus a number of Emerging Market currencies (Figure 12) even through the sharp sell-off period in global equities this Fall as well as the deceleration in US Dollar strength versus Developed currency peers (Figure 13).

While we remain confident the US Dollar is likely to weaken versus most currencies in 2019, continued stress in global credit markets around the beginning of the year may defer a period of sustainable US Dollar weakness until later in 2019. Owing to those considerations, we believe a key tenet of one's global portfolio strategy in 2019 is emphasis on quality, income and value, as discussed in the section immediately below.

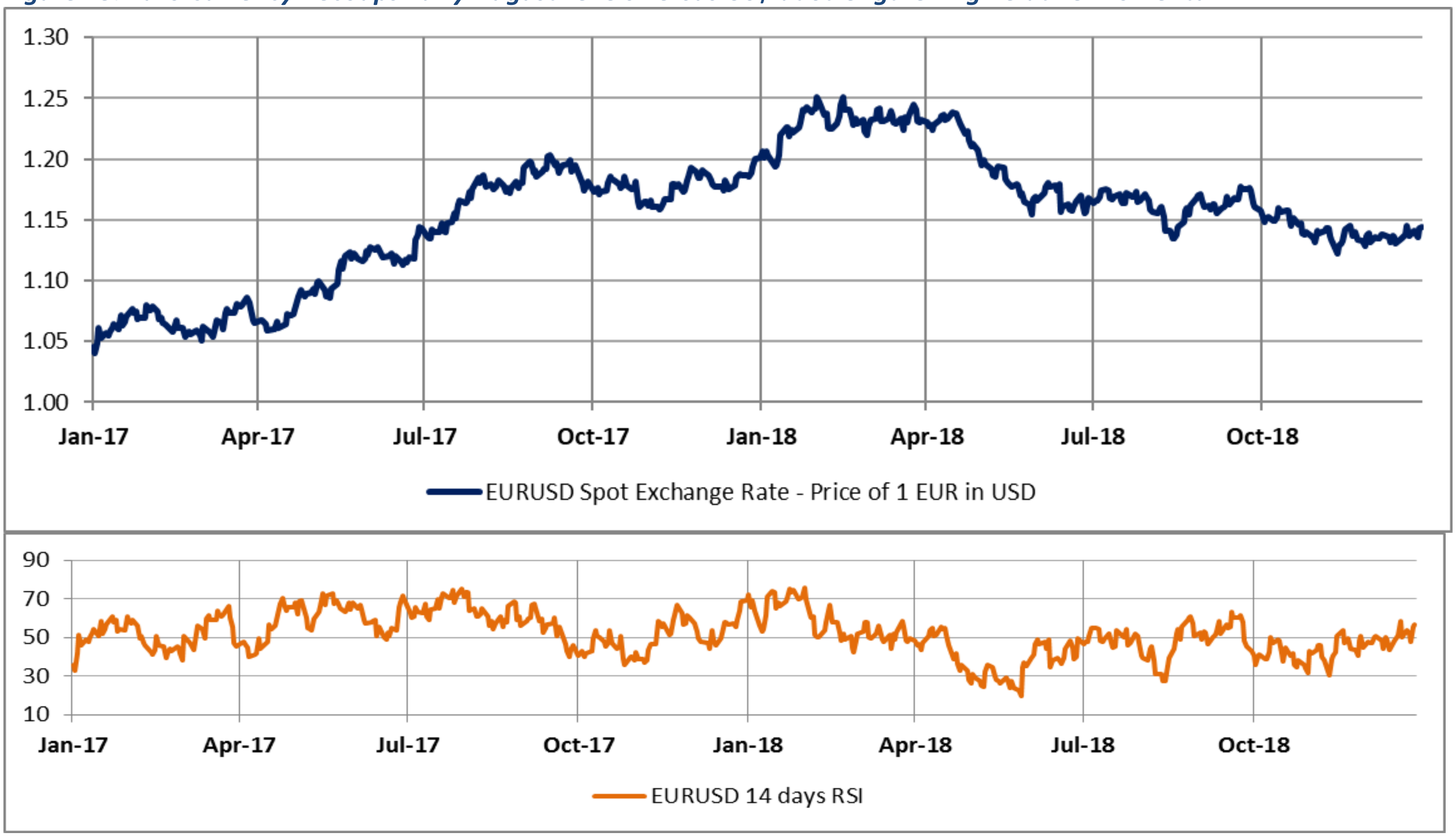
Glovista Portfolio Strategy at the Turn of the Year: Overweight High Quality, Cheap Value, Income-oriented Opportunities

Against the global macro and market backdrop discussed above, the Glovista investment team has positioned global portfolios around the turn of the year in such a manner so as to emphasize high quality, cheap value and income-oriented opportunities.

At the cross-asset class level, we maintain an underweight equities allocation, overweight cash and overweight high quality fixed income, with an emphasis on senior loans and investment grade rated corporates as these are already discounting a high probability of recession in 2019. Within equities, we continue to favor cheap value segments including Emerging

Markets, and recently took on modest exposure to US MLPs and large cap value following the sectors' cheapened valuations following the crash in energy prices and value stocks year-to-date derating versus growth peers. Within the US equity market, we favor exposure to defensive sectors including consumer staples and healthcare. Within the commodities space, we favor exposure to gold price given the commodity's defensive status during periods of elevated risk market volatility, its under-owned status and the heightened prospects for a turn lower in the US Dollar cycle over the balance of 2019.

Figure 13. Euro Currency Recoups Early August Levels versus US$ at Strengthening Relative Momentum



Source: Bloomberg

Glovista Emerging Markets Perspectives

2018 Review and 2019 Outlook: Glovista Expects Value Markets to Extend Outperformance versus North Asia; EM Equities to Extend Nascent Outperformance versus DM

The 2018 year-to-date period has been an exceedingly challenging one for risk markets globally, including Emerging Market equities, as discussed in the adjoining *Global Perspectives* column. In looking back at the 2018 YTD period and assessing EM equities' relative return performance versus developed peers, the data points to 2018 as a tale of three periods (Figure 14), comprised of two periods of EM equities' relative return outperformance (January thru March 21st, and October 1st til the date of the writing of this report) and one period of relative return underperformance of developed peers, consisting of March 21st – October 1st.

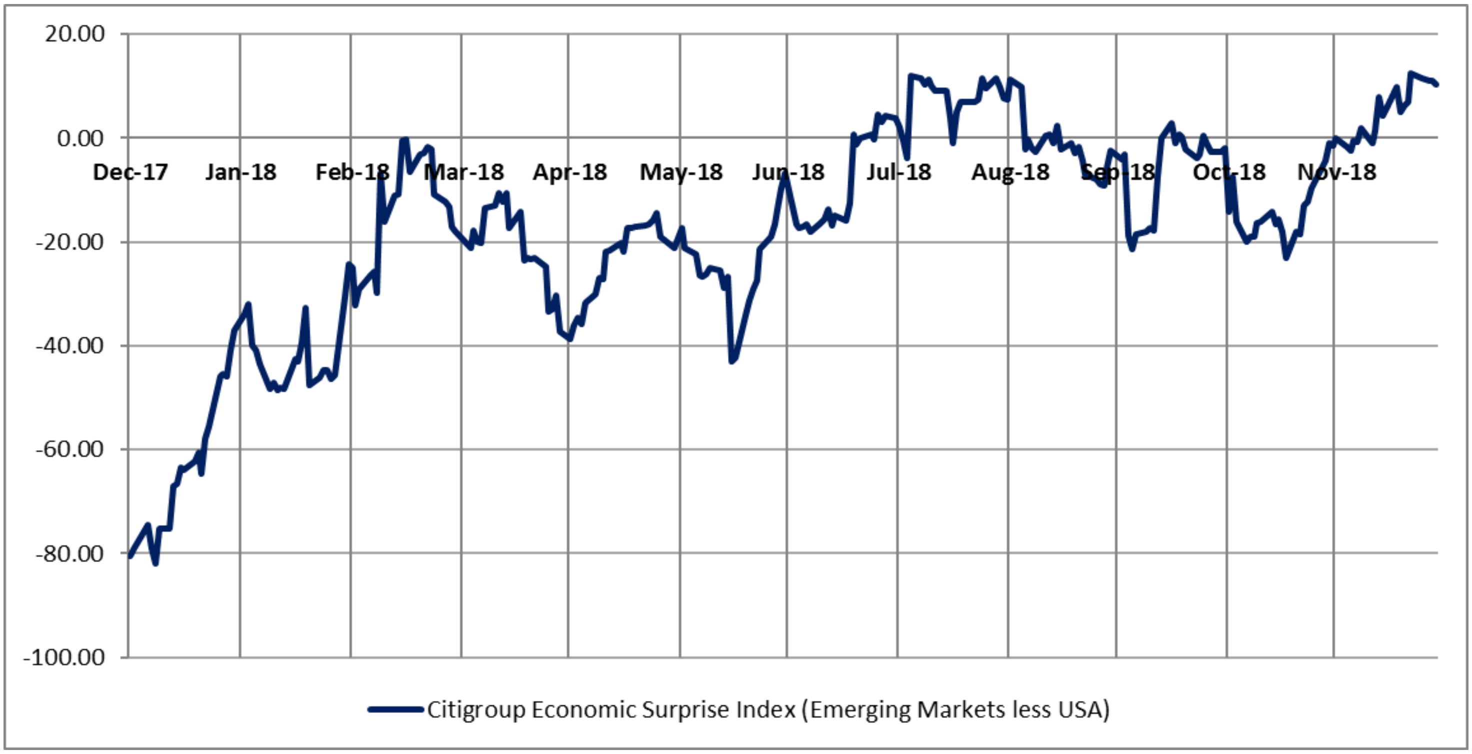
In our assessment, an account for the swings recorded by EM equities' relative return performance versus developed peers during 2018 includes the following:

- De-rating of EM valuation multiples versus developed peers, especially US, following the unfolding of Trump administration-led trade frictions with China during the month of March, escalating into the early part of the year's second half;

Figure 14. EM Equities' Relative Performance versus Developed (EAFE) Peers: A Tale of Three Periods (Jan-Mar), (Mar-Oct) and (Oct-present)

Source: MSCI Bloomberg and Glovista Calculations

Figure 15. EM Equities' Return Outperformance versus US Equities Coincides with EM Economies' Strengthening Activity Momentum versus the US



Source: Citigroup and Glovista Calculations

- De-rating of EM valuation multiples versus US peers, up until the beginning of October, as US based investors embraced the thesis of US economic growth 'exceptionalism' vis-à-vis the rest of the world's economic blocs. Such thesis appeared to ignore the sustained deceleration recorded by US interest-rate sensitive sectors throughout 2018 (including autos and housing) as well as lessons of US Dollar cycle tops around periods of undue US fiscal policy stimulus (prior episode occurred in the 1985-1986 period). Figure 15 illustrates EM economies' improving strengthening economic activity surprise momentum versus US economic indicators since the early part of the Fall period;

- The impact exerted by US Dollar strength on EM equities' US Dollar relative return performance versus developed peers during the March-October period, as illustrated in Figure 11. As the US Dollar has been topping out versus EM currencies around the month of August, so has EM equities' relative return performance been bottoming out versus US peers.

As we look ahead to 2019, we expect EM equities to solidly outperform Developed peers on account of several considerations, including:

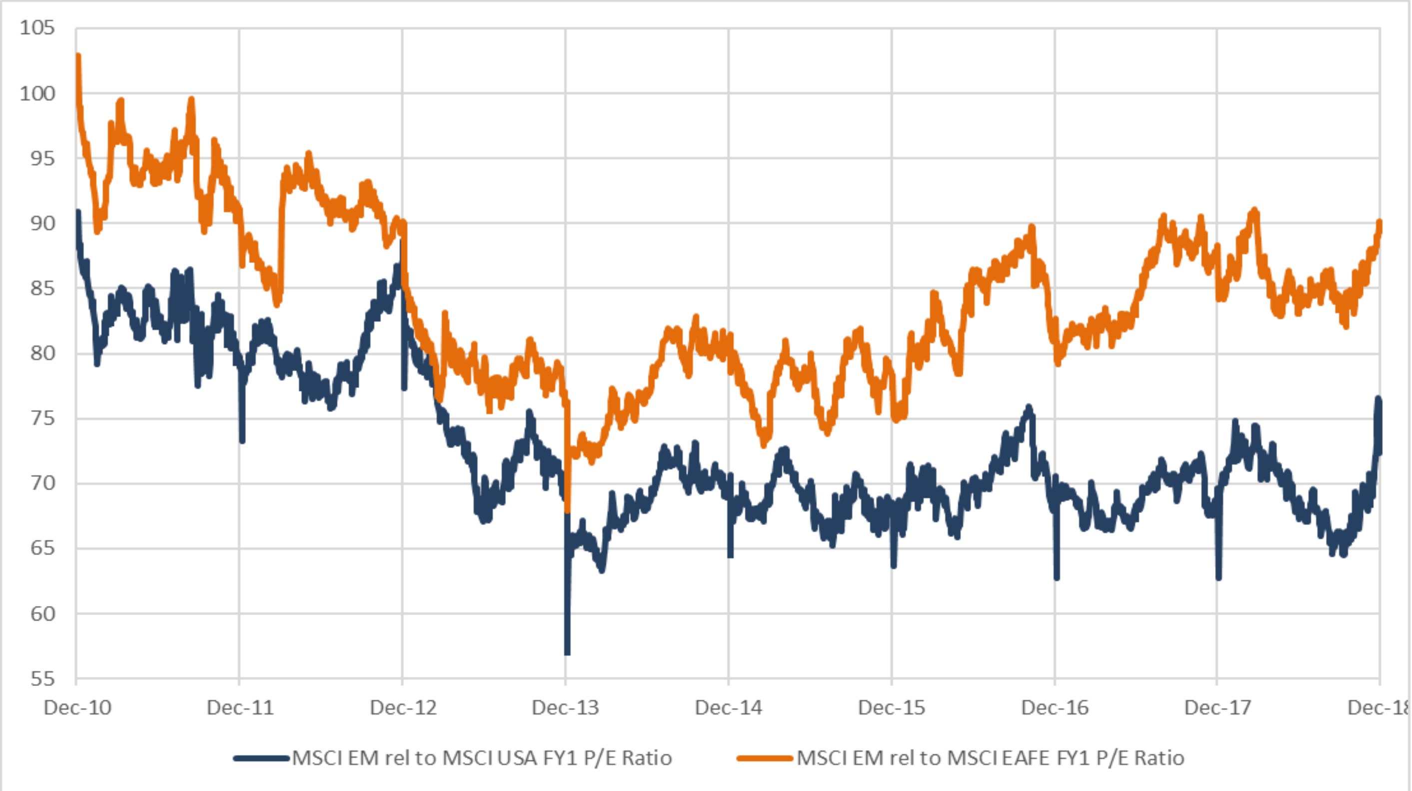
- Strengthening relative economic momentum versus developed peers, with some notable exceptions including China and South Korea, whose economies are undergoing homegrown economic decelerations amplified by ongoing frictions with global trade which we expect to abate by the year's second half;

- EM currencies' beneficiary status from a potential turn lower for the US Dollar, as discussed in the adjoining *Global Perspectives* section;

- EM equities' under-owned status, especially on the part of US based investors;

- EM equities' attractive relative valuations versus developed peers, with forward P/E multiples currently hovering at close to a 25 percent discount versus US peers (Figure 16).

Figure 16. EM Equities' Cheap Relative Valuations versus Developed Peers: FY1 P/E Valuation Discount to MSCI USA and MSCI EAFE INDEX



Source: Bloomberg, MSCI and Glovista Calculations

Within an Emerging Markets only portfolio, we are positioning our managed portfolios along the same tilts we have been embracing these past several quarters – underweight North Asia markets, overweight ASEAN and India, underweight EMEA and selective overweight allocations to Latin American markets, including Mexico and Brazil. We expect North Asian markets to gain stronger sponsorship around the middle of 2019 once greater clarity obtains on the state of global trade and trade policy between the US and China.

We take this opportunity to thank our clients for their continued loyal support and also extend our very best wishes to all and your loved ones in the New Year.

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