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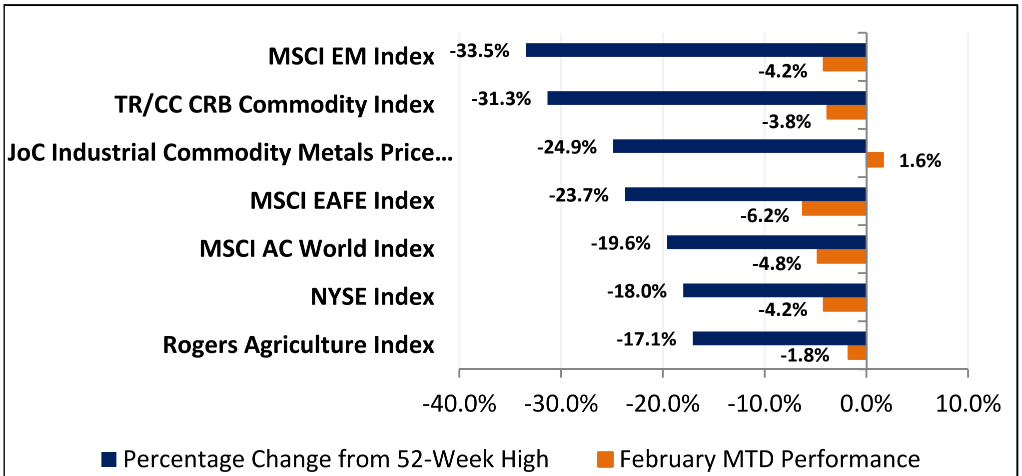
Glovista Global Perspectives

This Issue:

Global Financial Conditions Tighten Measurably in February, Fueling Further Price Declines across Risk Markets; Glovista Sustains Defensive Portfolio Stance

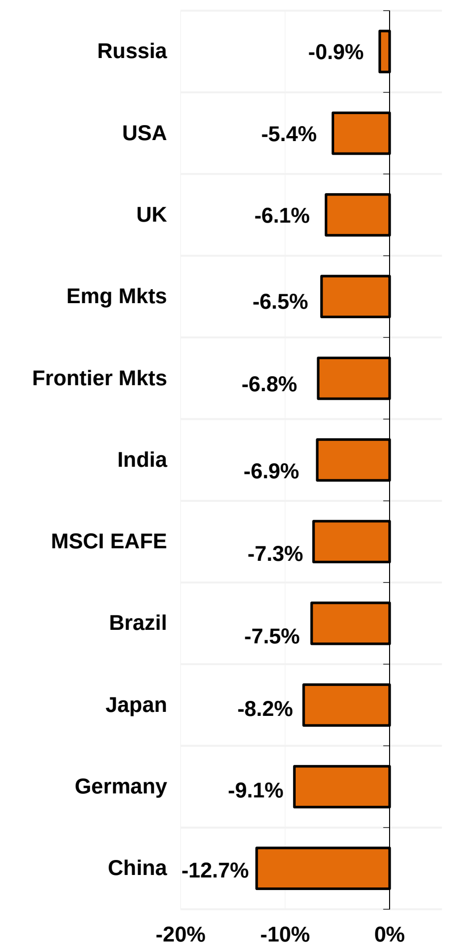
Thus far in February, risk markets globally have extended their sharp January monthly price declines (Figure 1). In our view, the ongoing extension of broad-based price declines across risk markets responds primarily to a material deterioration in global financial conditions over the month of February. Admittedly, other issues have also been at play, including policy, political cycle and commodity market related factors. The focus of this monthly column is to outline the anatomy underlying the deterioration in global financial conditions, the role of other factors in the ongoing downward asset price spiral and a list of possible policy actions and economic developments that carry the potential for arresting the current 'risk-off' phase in global markets. We conclude our column with a reiteration of our continued defensive portfolio stance at the asset class level.

Figure 1. February Month-to-Date Price Declines across Asset Markets Push a Growing Number of Risk Indices into Bear Territory (February 1st to February 12th, 2016)



Source: Bloomberg

Country-wise Monthly Performance in USD terms (January 2016)



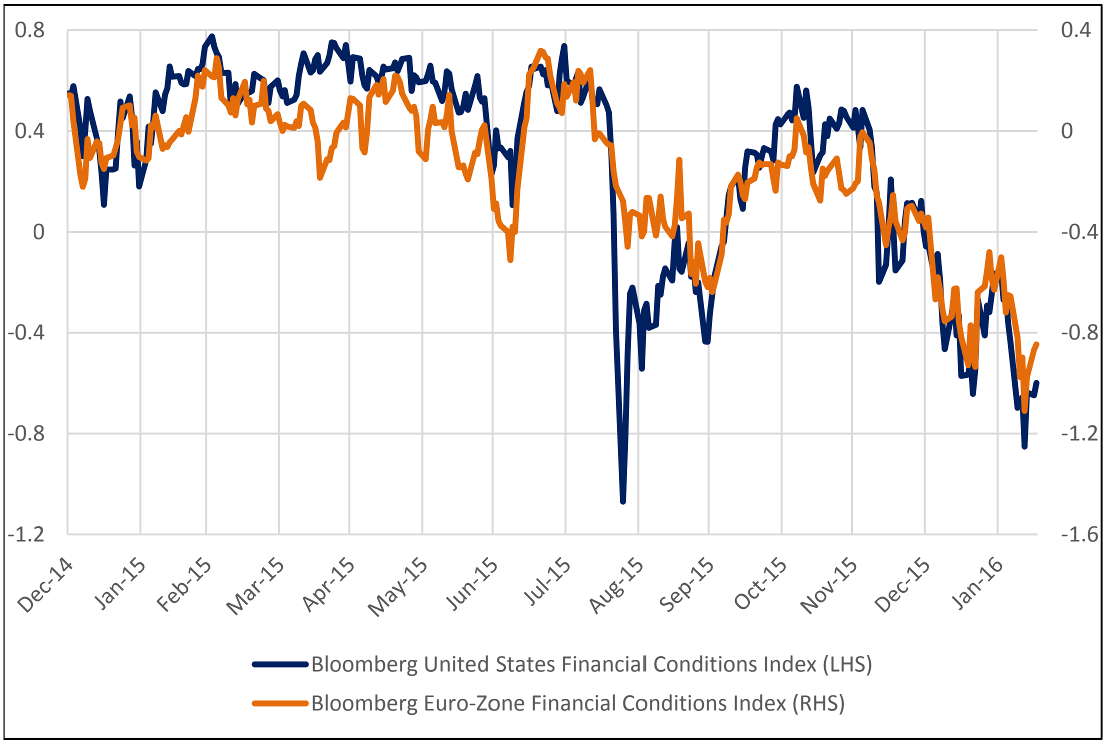
Source: MSCI & Bloomberg

GLOVISTA INVESTMENTS

Anatomy of Tightening in Global Financial Conditions: Crash in Eurozone Financial Sector Asset Prices; Continued Oil Price Softness; Euro and Yen Currency Strength Despite Negative Interest Rates

Figure 2 illustrates the sharp tightening of financial conditions in Europe and the US over the past several weeks, particularly in Europe. That financial conditions have tightened so significantly in Europe and Japan, including through the strengthening of the Japanese Yen versus most currencies in the period immediately following the January 29th introduction of negative interest rates by the Bank of Japan, calls into question the effectiveness and credibility of standing monetary policy by both the ECB and the BOJ.

Figure 2. Financial Conditions Tighten Measurably in Europe and the USA, Fueling Generalized Price Declines across Global Risk Markets



Source: Bloomberg

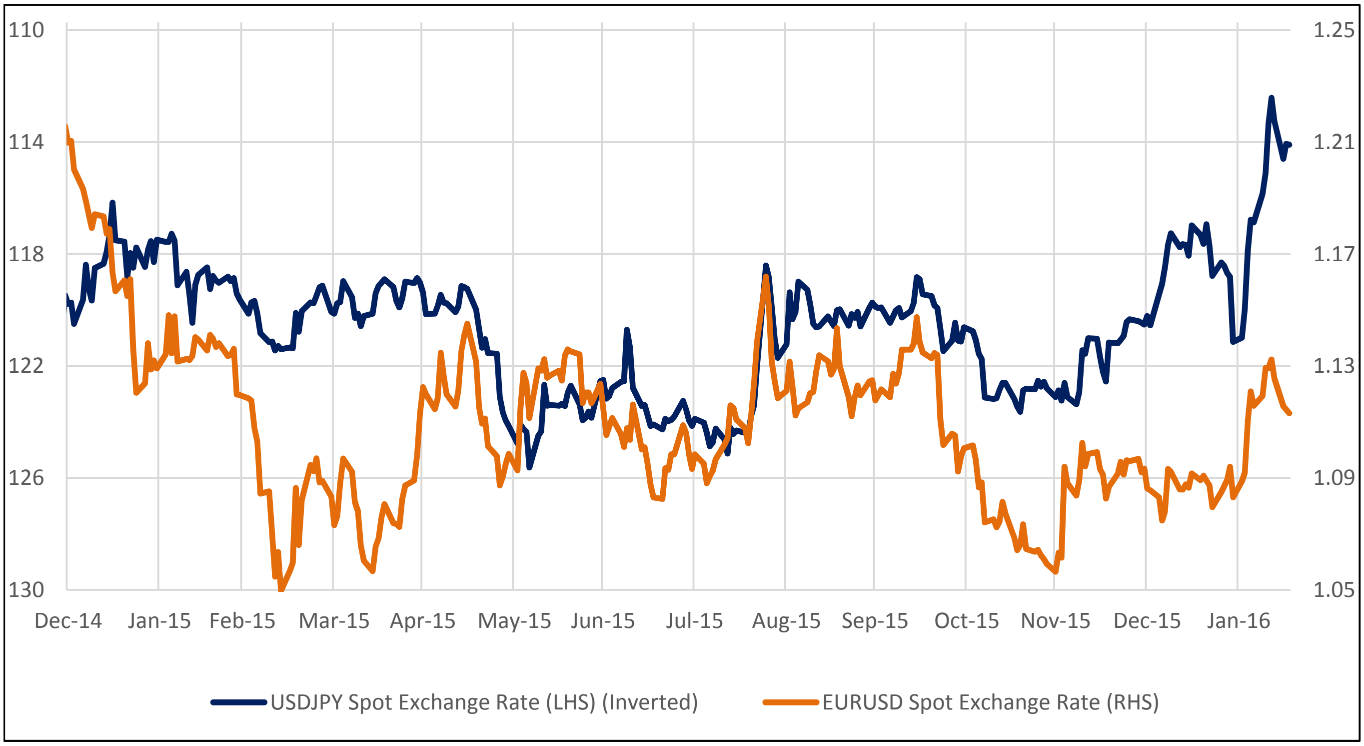
Investor concerns surrounding the credibility of NIRP (negative interest rate policy) may mean sustained higher financial volatility levels (Figure 4) and therefore higher risk premium levels. In turn, said dynamics carry adverse implications on asset prices via the resulting compression in valuation multiples on equities and credit. Said dynamics reinforce the tightening of financial conditions at a time of decelerating world economic growth.

S&P500 Monthly Sector Performance –January 2016

Sectors	% Change	FY1 PE Ratio
Energy	-3.07%	43.3
Materials	-10.6%	14.9
Industrials	-5.81%	14.7
Cons Disc	-5.19%	17.6
Cons Stap	0.45%	20.4
Technology	-4.90%	15.9
Healthcare	-7.65%	14.9
Financials	-8.96%	12.5
Utilities	4.90%	16.2
Telecom	5.48%	13.0
S&P500	-5.07%	16.1

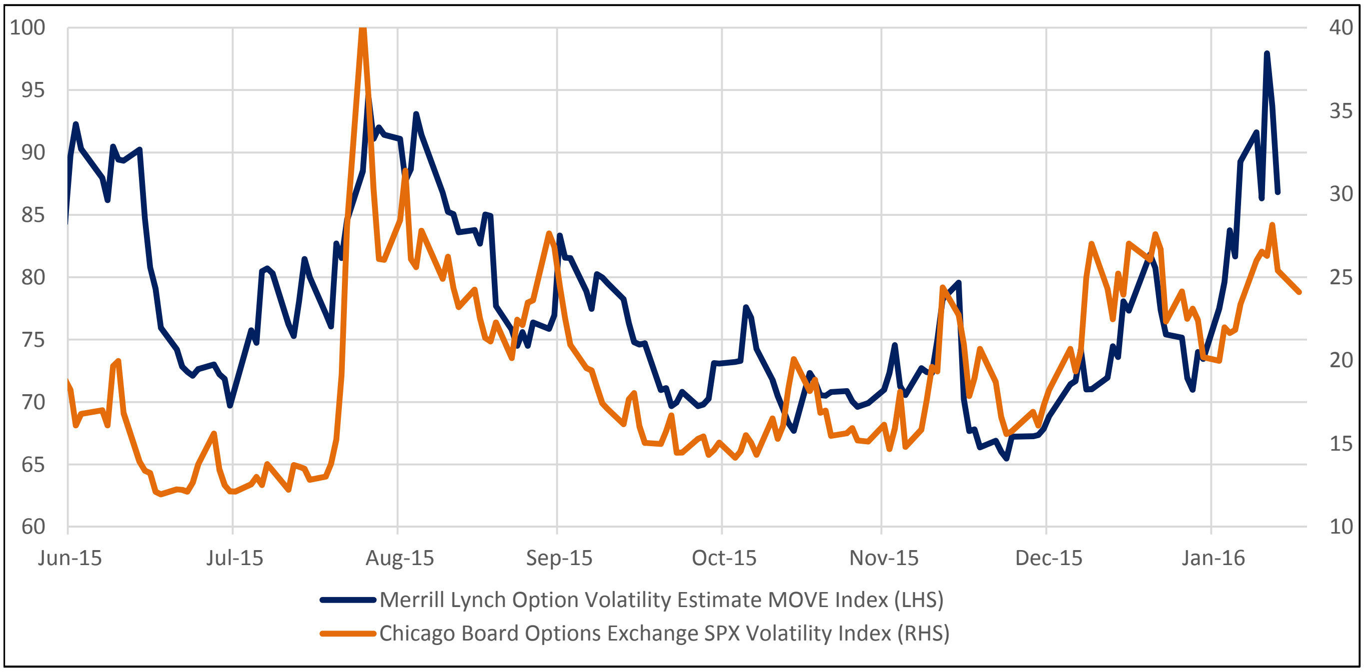
Source: S&P

Figure 3. Euro and Japanese Yen Strengthen to 12 to 16 Month High Levels versus US Dollar, Fueling Concerns over Credibility of Negative Interest Rate Policy (NIRP)



Source: Bloomberg

Figure 4. Bond (MOVE) and Equity (VIX) Implied Volatility Levels Spike on Back of Tightening in Global Financial Conditions



Source: Bloomberg

	January 2016	January Change
Gold	1118.17	5.3%
Silver	14.2615	2.9%
Oil	33.62	-9.2%
EUR	1.0831	-0.3%
JPY	121.14	-0.8%
GBP	1.4244	-3.3%
CHF	1.0231	-2.1%
CAD	1.3976	-1.0%
AUD	0.7084	-2.8%
BRL	3.9992	-1.0%
MXN	18.1065	-5.2%

Source: Bloomberg

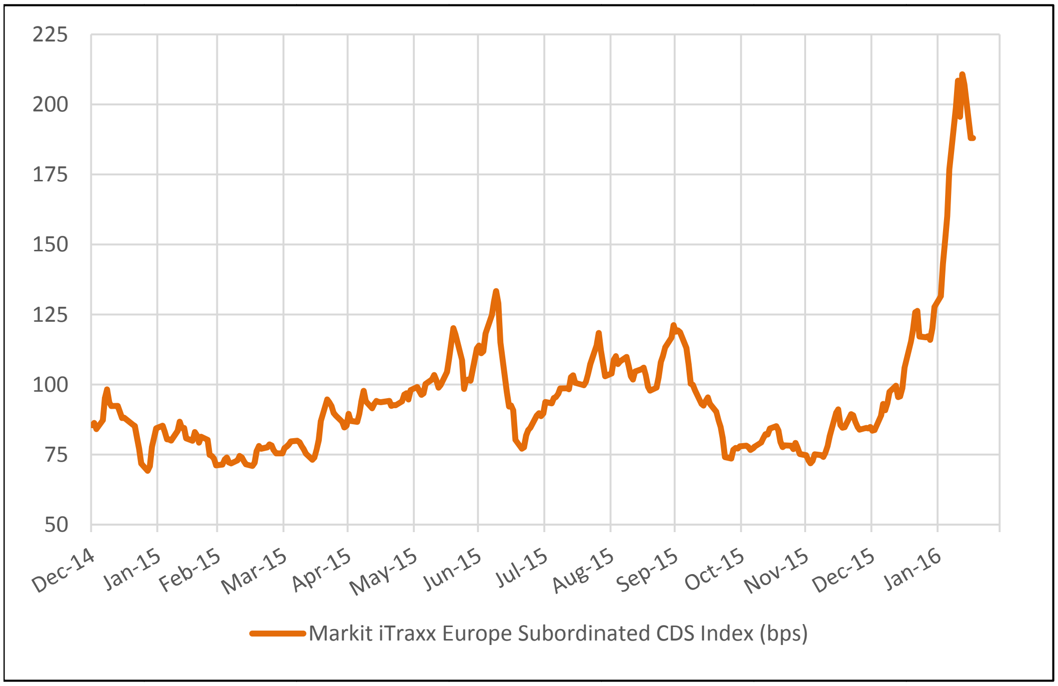
Rates	January 31st Level
1 Yr CD	0.54%
5 Yr CD	1.29%
30 Yr Jumbo Mortgage	4.12%
5/1 Jumbo Mortgage	3.38%
US Govt. 10 Year	1.9209%
10 Yr Swap Spread	-0.1254%

Source: Bloomberg

In our view, two principal factors underlie the outsized deterioration in global financial conditions these past several weeks:

- heightened investor concerns over the European banking sector's credit outlook (Figure 5). Said concerns have derived from two distinct dynamics:
    - unwelcome response given by credit investors to the January 1st implementation of the European Union's Bank Recovery and Resolution Directive (BRRD). Such adverse investor response has been partly affected by the investor unfriendly precedent set this past December by the Bank of Portugal via the imposition of losses on bond holders (including Blackrock and PIMCO) of paper issued by a troubled Portuguese bank;
    - rising concerns over the integrity of Italy's financial system given the government's difficulty in putting forth a credible resolution framework to the estimated 330 billion Euro non-performing loan problem plaguing the sector. In particular, such concerns have increased recently on the back of a local Tuscan court ruling insolvency status for a small regional bank that was bailed out by the government last year. As a result of such ruling, investors are concerned over the prospect of lengthy legal battles facing the government in its efforts at putting together restructuring initiatives of specific banks.

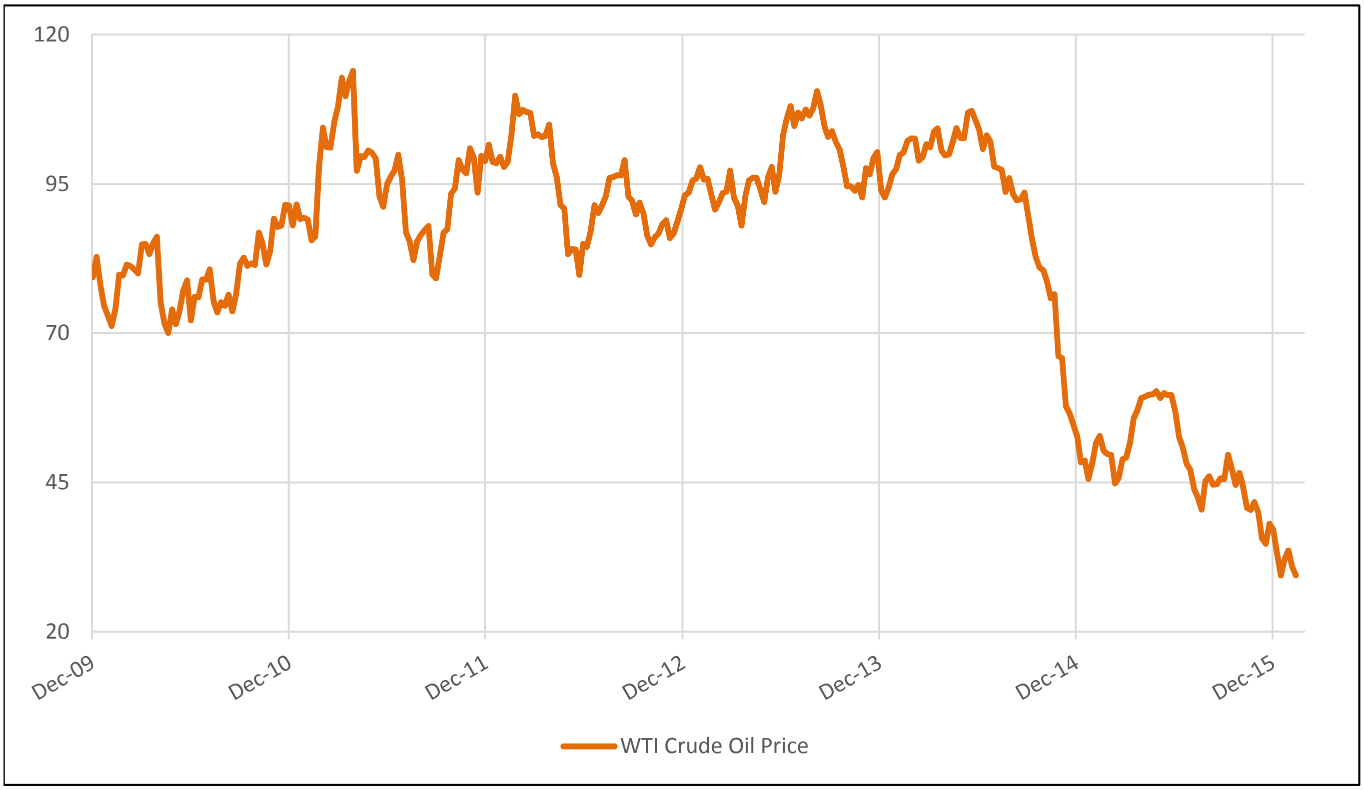
Figure 5. Eurozone Financials' Credit Outlook Deteriorates Sharply in February's first Half



Source: Markit

- continued crude price declines, a dynamic that carries adverse implications on global credit markets given the large growth in energy sector debt origination recorded these past several years. Such increase in debt origination has been tied to the vast increase in capex channeled to the sector up until 2014 courtesy of $100 plus per barrel crude price levels up until the third quarter of that year – Figure 6.

Figure 6. Crude Oil Price Declines Extend Further in February, Pressuring Further High Yield Debt and Loan Markets

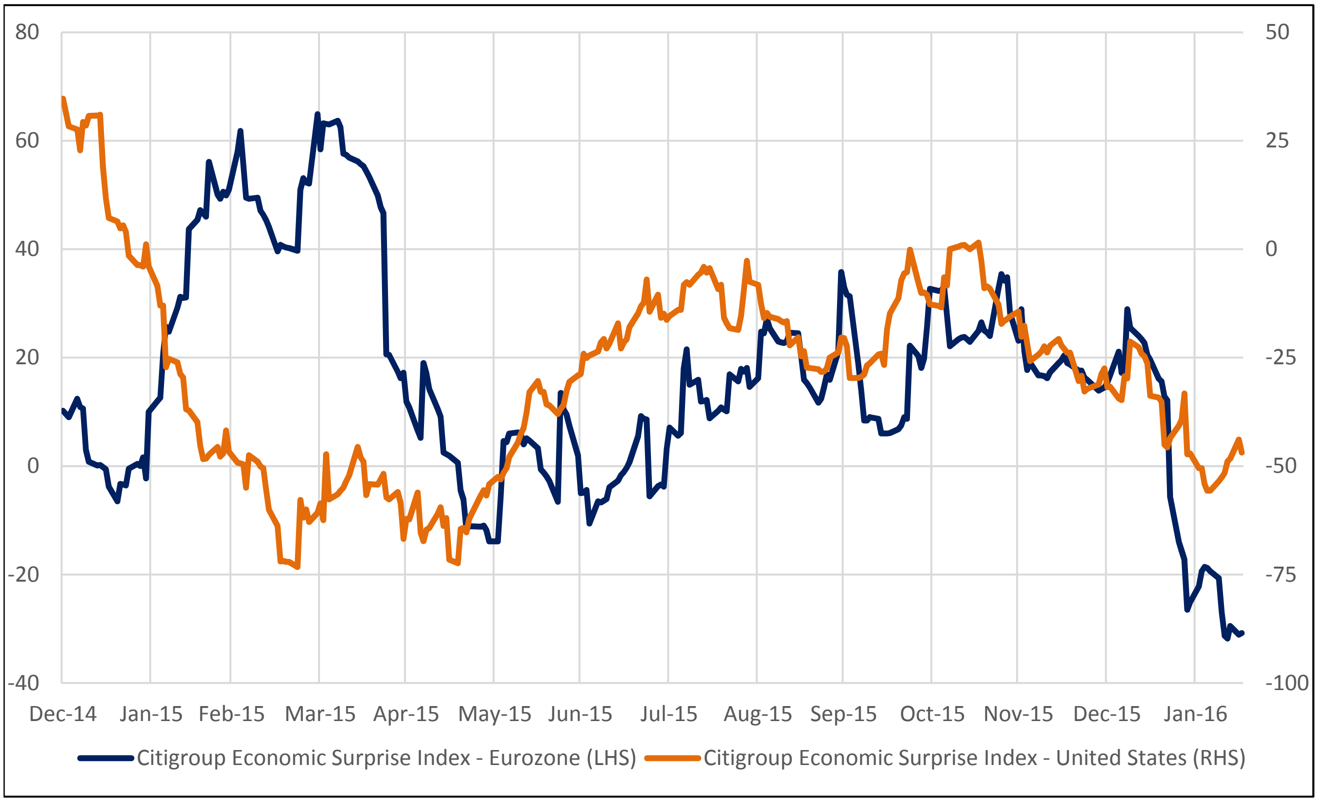


Source: Bloomberg

The tightening of global financial conditions together with the erosion in central bank credibility, discussed above, carry material implications for the global investment and macro outlooks. At the investment level, these dynamics are adverse to risk markets' asset price outlook via the compression in valuation multiples resulting from increased risk premium levels.

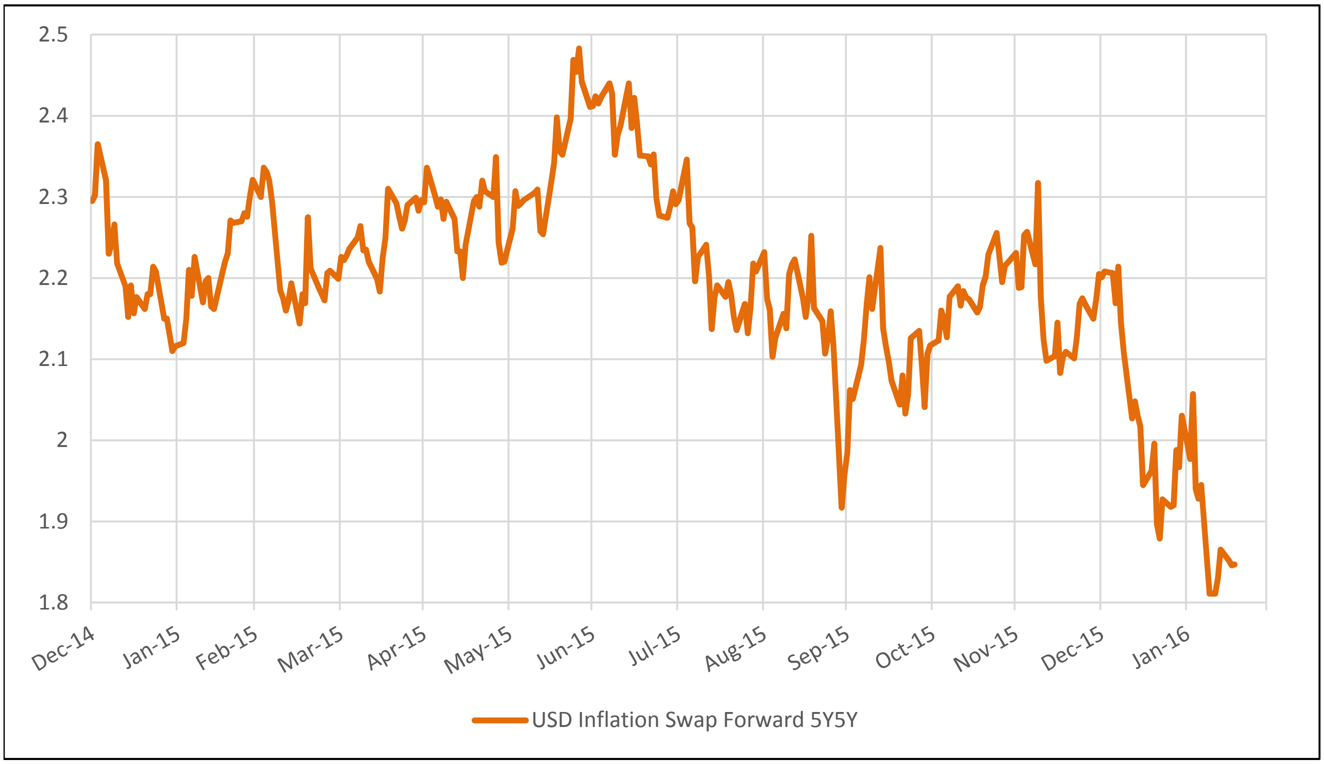
At the macro level, the dynamics of tighter financial conditions and eroding central bank credibility exert perverse effects at a juncture in which economic momentum in advanced economies continues to underwhelm (Figure 7). This is because of the resulting downward pressure on long-term inflation expectations to historically low levels not only in Europe but also in the USA (Figure 8). Given that nominal policy interest rate levels hover around zero, and even negative in some developed economies in Asia and Europe, downward pressure in long-term inflation expectations translate into a rise in implied real interest rate levels. In turn, an increase of implied real interest rate levels at a juncture in which economic momentum is softening results in a further tightening of financial conditions.

Figure 7. Eurozone and US Economic Calendars Continue to Underwhelm



Source: Citigroup Global Markets

Figure 8. Tightening in Financial Conditions and Anemic World Growth Press Long-term Inflation Expectations to Multi-year Low Levels, even in the USA



Source: Bloomberg

Finally, we believe that a number of qualitative factors also have exerted a role in recent asset price declines across the world. These include an increased polarization of local politics in Europe and the USA as well as rising geopolitical tensions in North Asia (North Korea). Specifically, increased polarization in US and European politics result in increased uncertainty over the future of economic policy at a challenging time in the world economic cycle, as discussed above. For example, over the past several months left-of-center coalitions have been elected into office in Portugal and Spain, while inward-looking nationalist parties have gained increased representation in France and Germany. Finally, in the USA non-establishment candidates in the presidential campaign (Sanders and Trump) have made notable advances in the polls. Moreover, the contrast in policy stance between a Sanders and Trump presidency could not be starker (increased uncertainty).

Glovista Sustains Defensive Portfolio Stance, Maintaining Overweight Exposure to High Quality Intermediate Duration Corporate Debt and Raising Exposure to Precious Metals

Against the global macro and investment backdrop discussed above, we have sustained our longstanding defensive portfolio stance entailing minimum exposure to cyclical equities, higher than average cash levels and overweight exposure to intermediate-duration US Dollar denominated high grade corporate debt. In the past several weeks, we have taken on exposure to the precious metal group, both directly as well as through precious metals mining stocks. Said increased exposure to the precious metals sector is predicated on the robust statistical relationship between precious metals commodity prices and financial sector risk measures. We are managing such position tactically at this time.

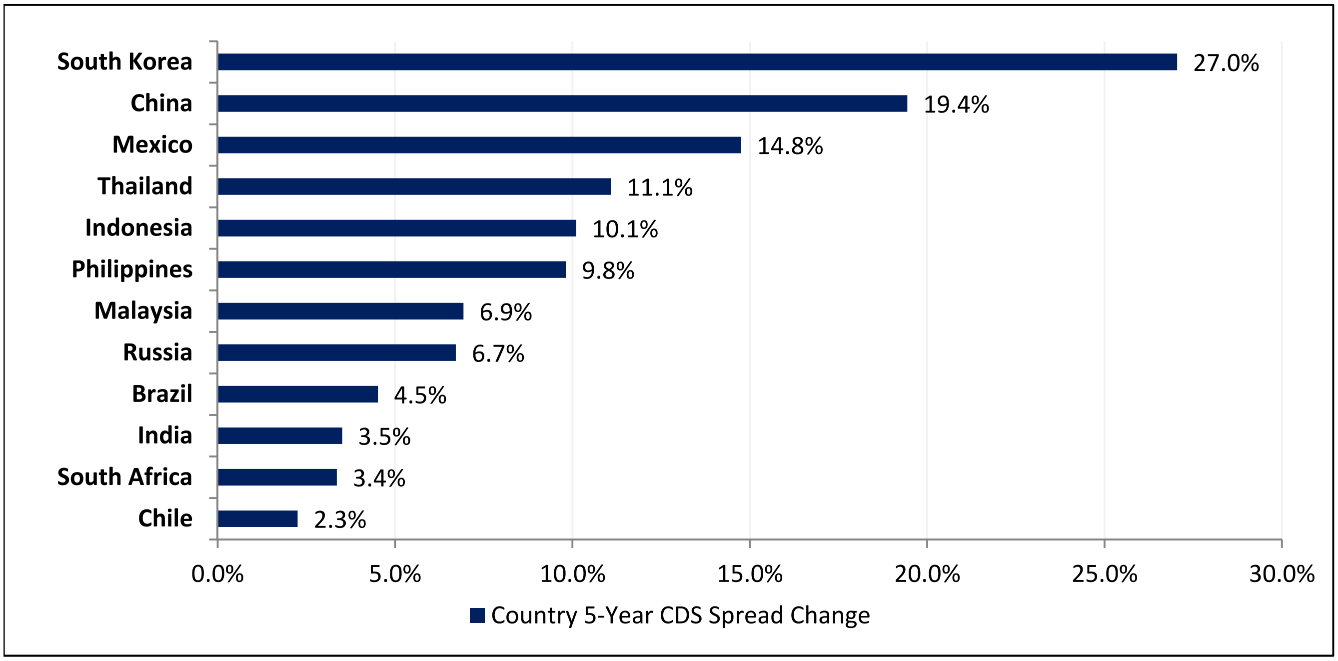
Finally, as we look ahead at the coming weeks we identify two scheduled events that carry the potential for lending support to risk markets globally. These two events include the G20 finance ministerial and central bank gubernatorial meeting scheduled for February 26-27 in Shanghai and the March 5th National People's Congress in China. The first event carries the potential for major announcements on exchange rate policy, possibly entailing coordinated policy actions across major central banking institutions, while the second event is likely to bring about greater clarity on the future path of Chinese government policy throughout the rest of 2016, including the release of details on China's 13th five year plan. As a result, both of these events may provide increased clarity and therefore lower uncertainty level on the global policy outlook. To that extent, risk premium levels globally may come down from current elevated levels, thereby lending support to risk asset prices.

Emerging Market Perspectives

Eurozone Banking Sector Concerns Reinforce Glovista's Focus on High Quality Visible Growth Plays in EM: Downgrades in India, Mexico, Turkey and ASEAN Fund Larger North Asia Overweight Tilts

Within an Emerging Markets context, the tightening of global financial conditions has manifested itself through multiple channels, most notably via the widening of sovereign and corporate debt yields denominated in foreign currency, especially US Dollar (Figure 9). Such dynamics serve to reinforce the Glovista team's continued preference for exposure to strong macro balance sheet markets in the EM space, particularly those in the North Asia region.

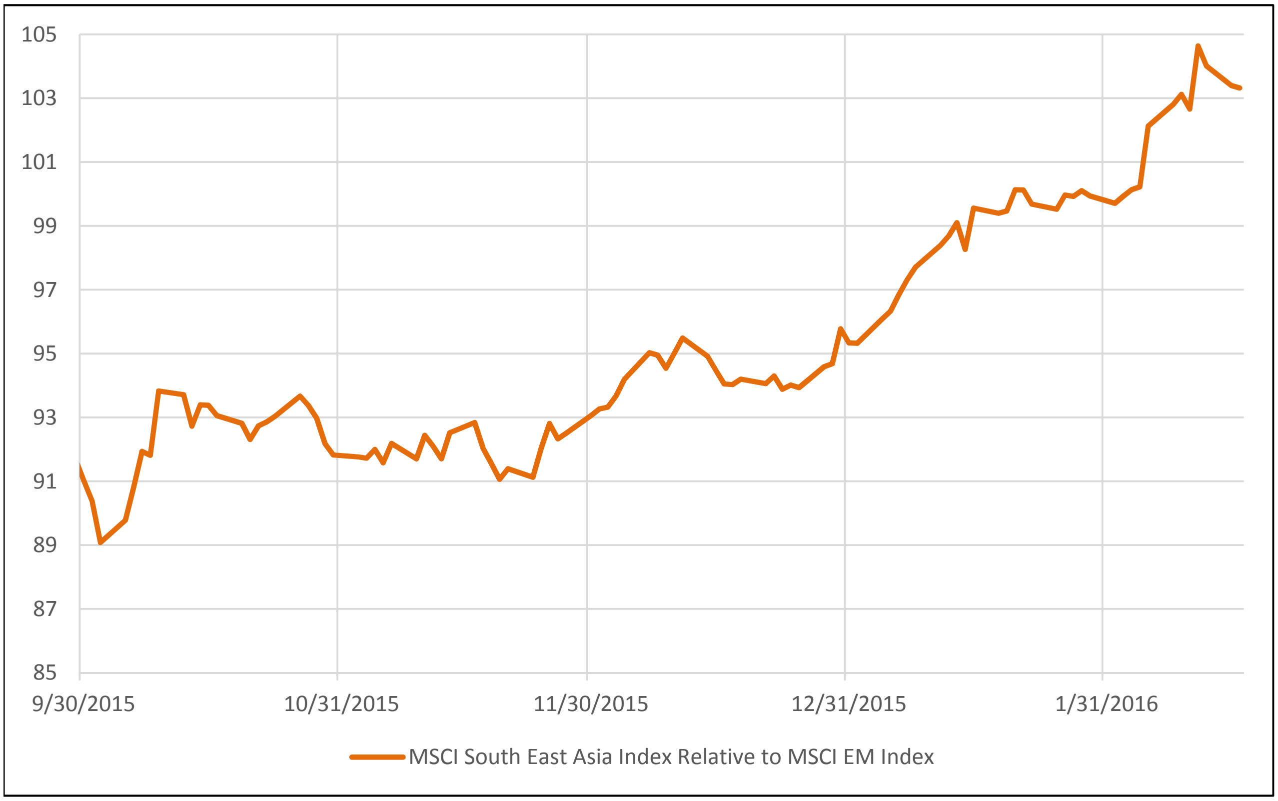
Figure 9. Tightening of Global Financial Conditions Fuels Widening of EM Sovereign Yield Levels (February 1st to February 12th, 2016)



Source: Bloomberg

Over the past several months, we have maintained exposure to ASEAN markets (e.g. Thailand, Philippines, Malaysia and Indonesia) at close to neutral not because of the region's attractive equity valuations but rather because of its healthy balance of payments position, including surplus current account balances for a number of those countries (e.g. Thailand, Philippines and Malaysia). In our view, the ASEAN regional economies' solid current account balance position accounts for the regional equity indices' solid relative outperformance versus the EM benchmark index (Figure 10).

Figure 10. ASEAN Regional Markets Post Solid Relative Outperformance versus EM Benchmark YTD

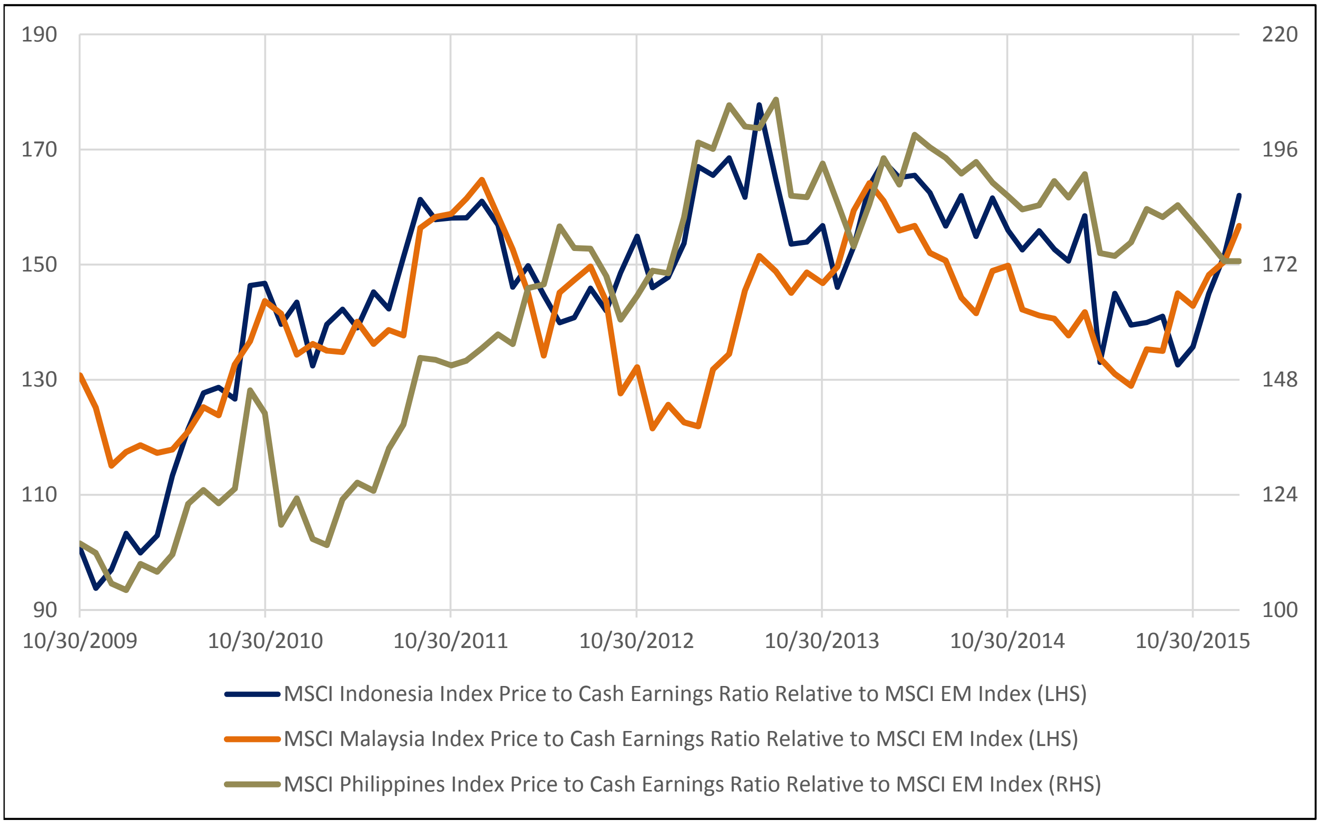


Source: MSCI and Glovista Calculation

Over the past several sessions we have implemented a number of country-level rebalancing actions within our managed EM portfolios. In particular, we have cut exposure to the ASEAN regional markets as well as to Turkey and Mexico, all of which have been cut to strong underweight, in favor of increased exposure to 'new' China service sectors, currency hedged-Korea country and Taiwan country exposures, respectively. At present, our portfolios' exposure to China, Korea and Taiwan hovers at overweight levels. Within China, we continue to underweight exposure to goods-oriented, 'old' China sectors, favoring exposure to service sectors both on account of the notably higher growth visibility displayed by service sectors as well as service sector companies' markedly stronger balance sheet fundamentals. Our exposure to the Korean equity market, on a currency hedged basis, is predicated on our expectation the Bank of Korea will take on a more dovish stance in the coming weeks whilst the corporate sector's fundamentals, particularly those of the country's export-oriented multinationals, continue to strengthen as a number of important investor-friendly governance reforms has been instituted over the past several quarters. Finally, our bullish Taiwanese equity market thesis continues to be driven by our strong comfort level with the economy's credit fundamentals as well as the corporate sector's uniquely strong positioning to partake in the secular bullish trends permeating the IT sector globally.

Our decision to cut exposure to the ASEAN market is based primarily on the regional market's stretched relative valuations versus the EM peer group (Figure 11), particularly vis-à-vis similarly high visibility growth sectors elsewhere in Asia. Our decision to cut Turkey market exposure reflects our assessment that the Turkish Lira is vulnerable to additional devaluation risks as the Bank of Turkey's stance remains overly easy and the central bank's pursuit of both low real interest rates and stable exchange rate remains an unsustainable proposition, in our view. Finally, our decision to cut Mexico and India equity market exposure to underweight reflects those market's stretched relative valuations versus EM peers.

Figure 11. ASEAN Market's Relative Valuations versus EM Benchmark at Multi-year High Levels



Source: MSCI and Glovista Calculation

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