Issue
97
January/18

Monthly
Market
Newsletter

GLOVISTA INVESTMENTS

Glovista Global Perspectives

This Issue:

Risk Indices Post Sharp January Gains on Diminished Korea Geopolitical Risk, US$ Breakdown and Upward Earnings Revisions tied to Tax Cut Passage; Glovista Tilts Unchanged

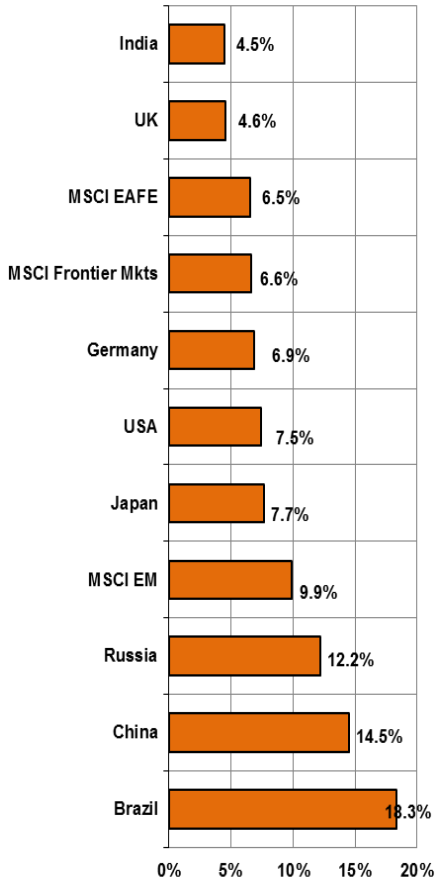
In January, risk markets globally have rallied strongly on the back of several favorable reinforcing political, economic, financial and policy developments. Figure 1 illustrates solid January monthly return performance figures posted by bellwether indices across the equities, credit and commodity markets divide, as of this column's production date January 29th, 2018. We credit risk markets' strong January performance to several developments, including:

- **Political**: The beginning of January witnessed a sharp decline in geopolitical risk following the North Korean regime's decision to seek friendly discussions with the South Korean regime. As a result, risk asset prices globally benefited owing to the resulting decline in risk premium levels.

- **Financial**: In January, the US Dollar has posted a meaningful breakdown versus most of the world's currencies (Figure 2). A weaker US Dollar sets of reflationary dynamics across the global economy via the resulting upward commodity price pressures that ensue. In turn, reflationary developments are risk market friendly as reflation carries over positively to companies' nominal revenue and earnings growth dynamics with favorable implications on equity and credit asset prices, particularly against a backdrop of limited wage growth acceleration.

- **Policy**: The US Trump administration's sponsored tax reform legislation, passed on December 22nd, takes effect on January 1st of this year. Given the unprecedented speed between the passage and implementation of the tax reform legislation, the largest since 1986, Wall Street analysts have taken quickly to the task of revising earnings per share (EPS) estimates for US corporates for 2018 and 2019. The net result of such developments has been a close to 5 percent upward revision to 2018 US corporate EPS estimates

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



Source: MSCI & Bloomberg

**As of January 26th, 2018*

between December 31st 2017 and today, an order of magnitude comparable to the January monthly return performance recorded by the S&P 500 index. The US market's status as the world's largest and most expensive implies that such investor-friendly development leading to a rerating of the US market carries over positively to non-US markets around the world.

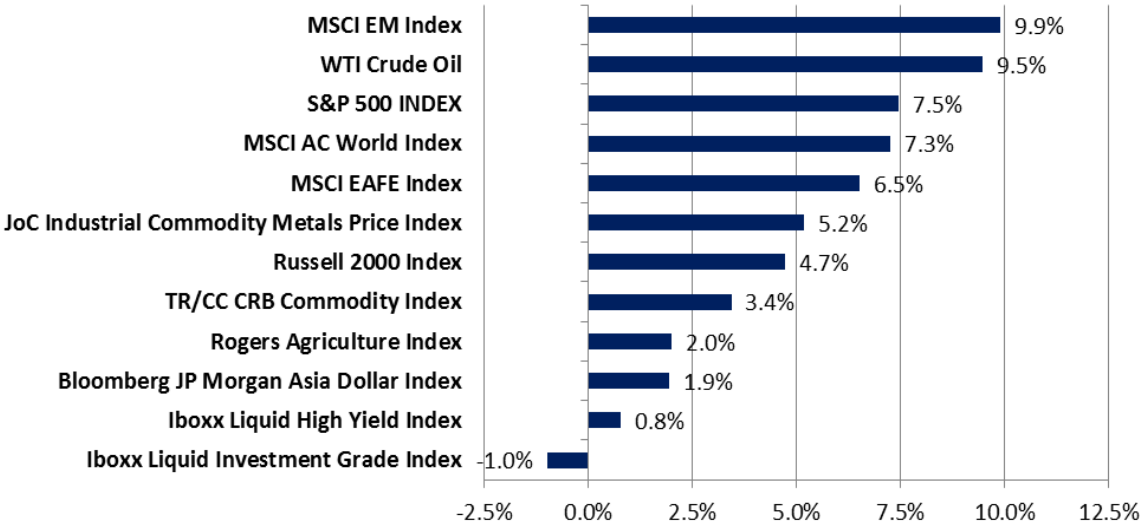
S&P500 Monthly Sector Performance – January MTD 2018*

Sectors	% Change	FY1 PE Ratio
Energy	7.47%	23.7
Materials	5.98%	18.6
Industrials	6.42%	19.3
Cons Disc	10.53%	22.2
Cons Stap	3.04%	20.1
Technology	8.83%	19.5
Healthcare	10.77%	17.4
Financials	8.05%	14.5
Utilities	-3.08%	16.8
Telecom	0.49%	11.6
Real Estate	-2.35%	38.7
S&P500	7.45%	18.6

**As of January 26th, 2018*

Source: Bloomberg

Figure 1. Risk Indices Post Strong January 2018 MTD Return Performance



Source: Bloomberg & Glovista Calculations

Figure 2. US Dollar Breaks Down in January, Piercing Key Support Levels (Chart: US Dollar Index)

Source: Bloomberg

In summary, the turn of the year has brought about a powerful, risk market-friendly cocktail for global asset prices via multiple expansion drivers (e.g. decline in risk premium levels courtesy of vastly diminished tensions in the Korean peninsula), top-line revenue growth drivers (e.g. weaker US Dollar versus Developed and Emerging Market currency peers) and bottom-line growth developments (e.g. lower taxes for US corporates, courtesy of the Trump tax cuts).

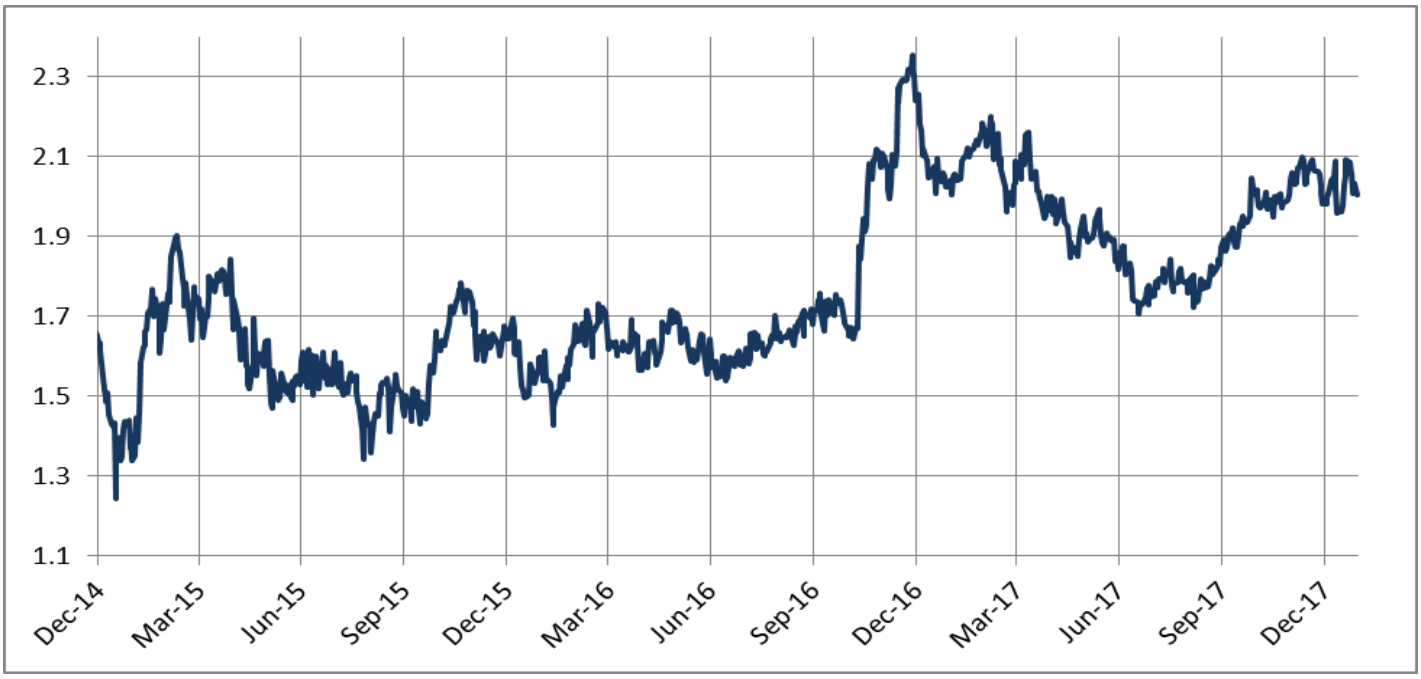
As we look ahead, we view January market developments to conform closely with Glovista's 2018 investment thesis calling for further US Dollar weakness, overweight exposure to value-oriented sector equities, overweight non-US equities and underweight fixed income allocations. At the margin, recent developments – particularly with regard to currency markets - help us gain

increased comfort in raising commodity sector exposures. We discuss these dynamics further below along with the accompanying risk factors conditioning the outlook, especially the potential for central bank policy mistakes.

US$ Breakdown and Larger Breadth of Global Recovery, led by the Eurozone and EM Economies, Support Overweight Equities, Underweight Bonds Thesis as Policy Rate Hikes Likely to Lag Inflation Momentum in 2018

A review of recent economic indicators from around the world lends further support to our thesis calling for further US Dollar weakness, underweight fixed income allocations and overweight equities allocation, particularly to non-US markets and value-oriented sectors. Specifically, recent economic releases continue to highlight economic growth leadership momentum out of the Eurozone region, Japan and the Emerging Markets (ex-China's industrial sector) with lagged growth momentum out of the US, the UK, Canada and China's industrial sector.

Figure 3. US Dollar Breaks Down in January despite Widening of US-German Yield Differentials to Historically High Levels (Chart: US 10 year Yields Less German 10 year Yields)



Source: Bloomberg and Glovista Calculations

In our view, the recent breakdown in the US Dollar index (Figure 2), unfolding at a juncture in which long-term government bond yield differentials between the US and the Eurozone hover at historically high levels supportive of US Dollar strength (Figure 3), reflects financial markets' growing confidence over the Eurozone region's ability to post considerably stronger sustainable economic growth momentum versus the USA in the coming years. Such views reflect the Eurozone region's smaller private sector leverage levels, higher levels of labor market slack and its economy's less advanced stage (versus the US case) in the current business cycle. For example, recent US housing sector economic indicators have come out below consensus estimates (including December US existing home sales and housing starts), possibly an indication of several factors, including:

- still anemic year-on-year average hourly earnings growth (Figure 4);
- exceedingly low US personal savings as a percentage of disposable personal income, currently hovering at multi-year low levels (Figure 5);

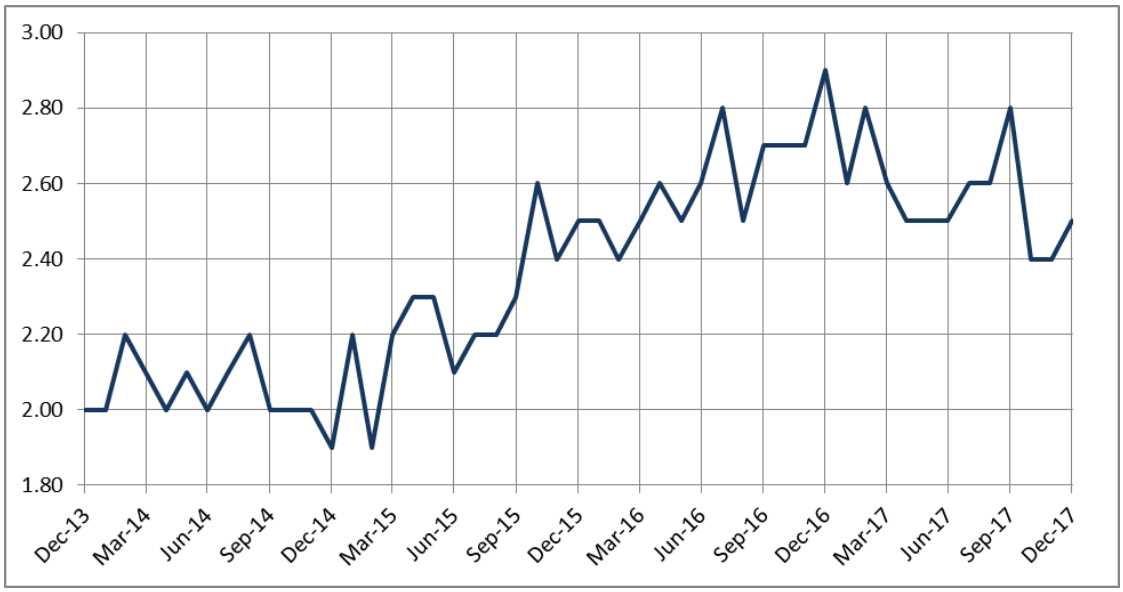
	January 26th 2018	January MTD Change
Gold	1349.7	3.6%
Silver	17.405	2.7%
Oil	66.14	9.5%
EUR	1.2427	3.5%
JPY	108.58	-3.6%
GBP	1.416	4.8%
CHF	0.9324	-4.3%
CAD	1.2308	-2.1%
AUD	0.811	3.9%
BRL	3.1478	-5.0%
MXN	18.4901	-5.9%

Source:Bloomberg

Rates	January 26th Level
1 Yr CD	0.66%
5 Yr CD	1.33%
30 Yr Jumbo Mortgage	4.26%
5/1 Jumbo Mortgage	3.39%
US Govt. 10 Year	2.2098%
10 Yr Swap Spread	-5.94%

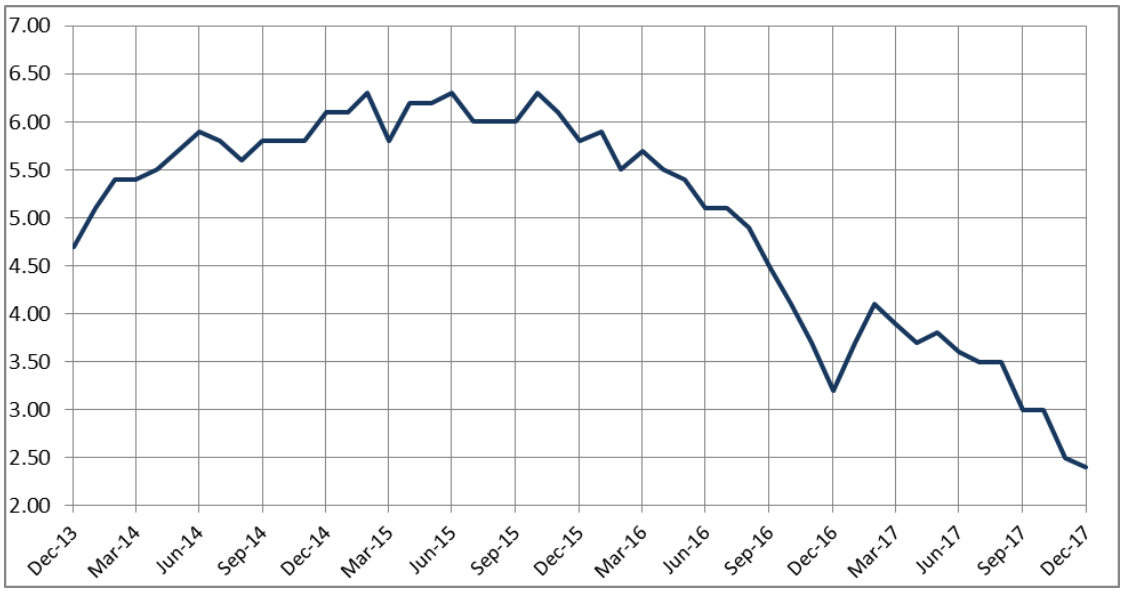
Source:Bloomberg

Figure 4. US Average Hourly Earnings Growth Remains Modest, even in Nominal (Non-Inflation Adjusted) Terms



Source: Bureau of Labor Statistics

Figure 5. US Personal Savings Rate Hovers at Multi-year Low Levels despite Modest Wage Growth: Indication of Elevated Consumer Confidence Levels (Chart: US Personal Savings as of % of Disposable Personal Income)



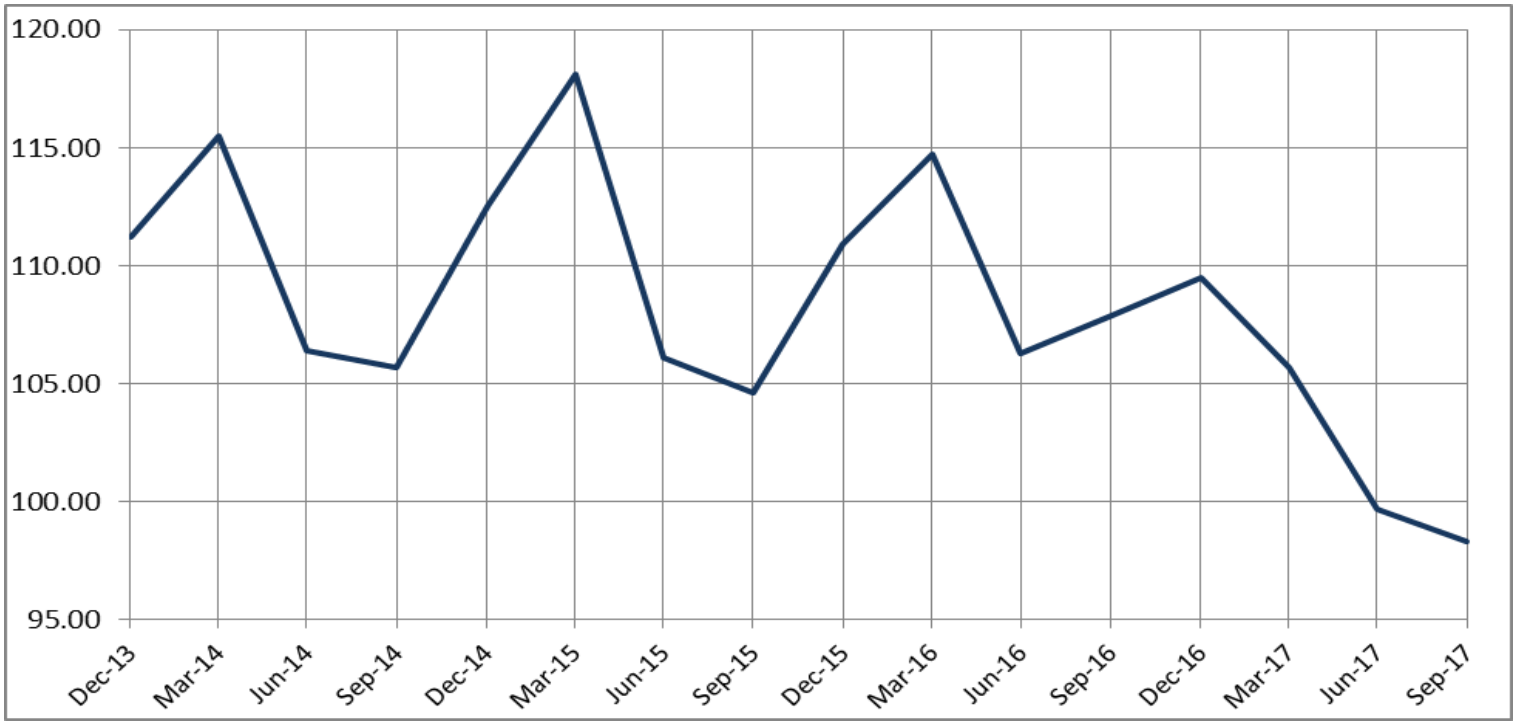
Source: Bureau of Economic Analysis

- low housing affordability levels for first-time home buyers (Figure 6);
- mortgage loan interest rates have rocketed higher in January, likely depressing further US housing affordability (Figure 7).

In the Euro region, recent economic releases show continued broadening of consumer and business confidence levels ('soft data' indicators), similar to recent US 'soft data' indicator readings. However, in contrast to the US case, the overriding share of January Eurozone region economic releases point to a sustained and broad strengthening of 'hard data' indicator readings for the Eurozone. Such pool of economic releases include: (a) Germany: stronger than expected January releases – along with upward revisions to prior monthly readings - for November retail sales, factory orders, industrial production, exports; (b) France: stronger than expected economic releases for December employment and

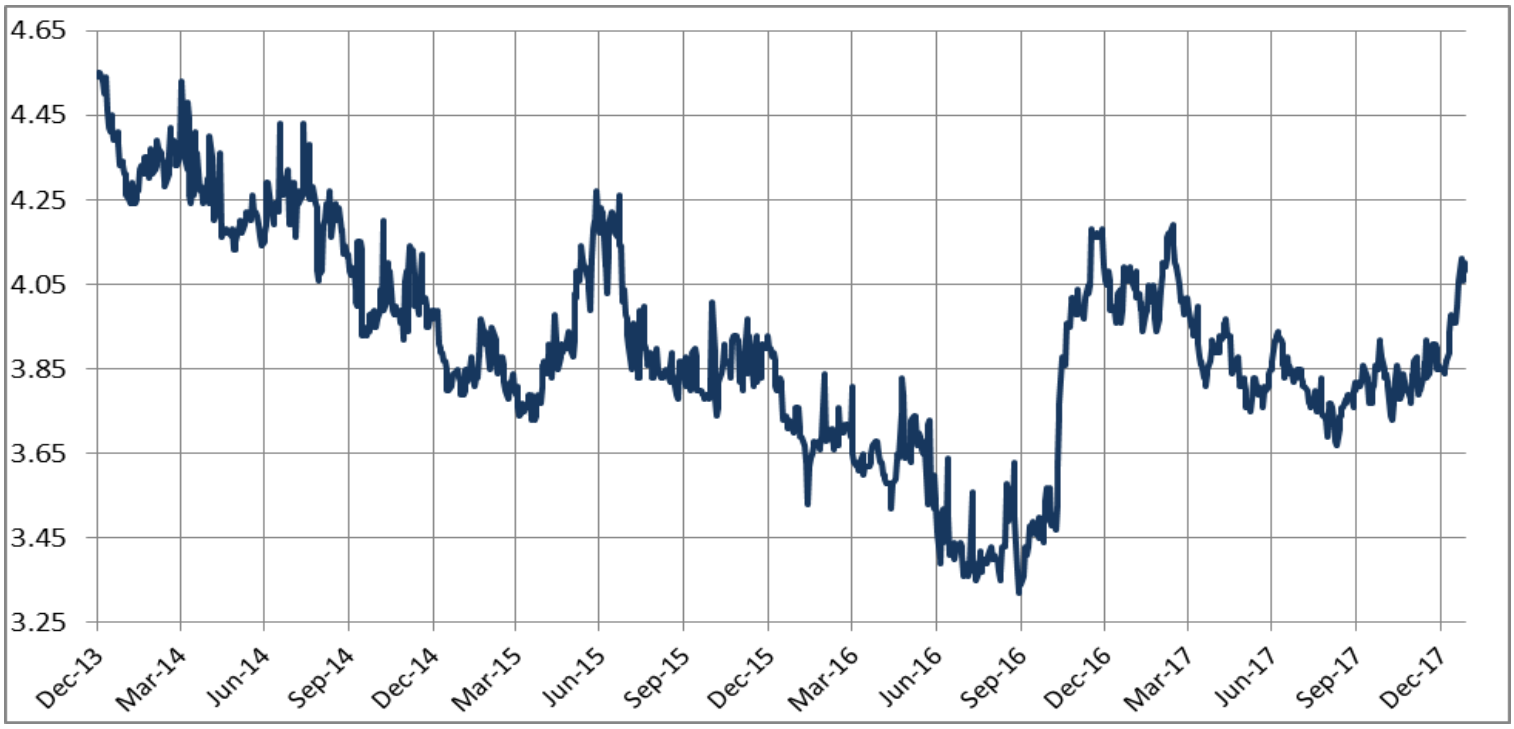
manufacturing production levels. Conversely, the January US economic calendar has been mixed, containing areas of weakening momentum, including: (a) weaker than expected December employment, in line December average hourly earnings along with downward revisions to November readings, softer than expected December existing and new home sales along with downward revisions to November figures, weaker than expected December preliminary core capital goods orders.

Figure 6. US Housing Affordability for First-time Buyers Likely to Have Declined Further in Q4 (Chart: Housing Affordability Index for First Time Home Buyers)



Source: National Association of Realtors

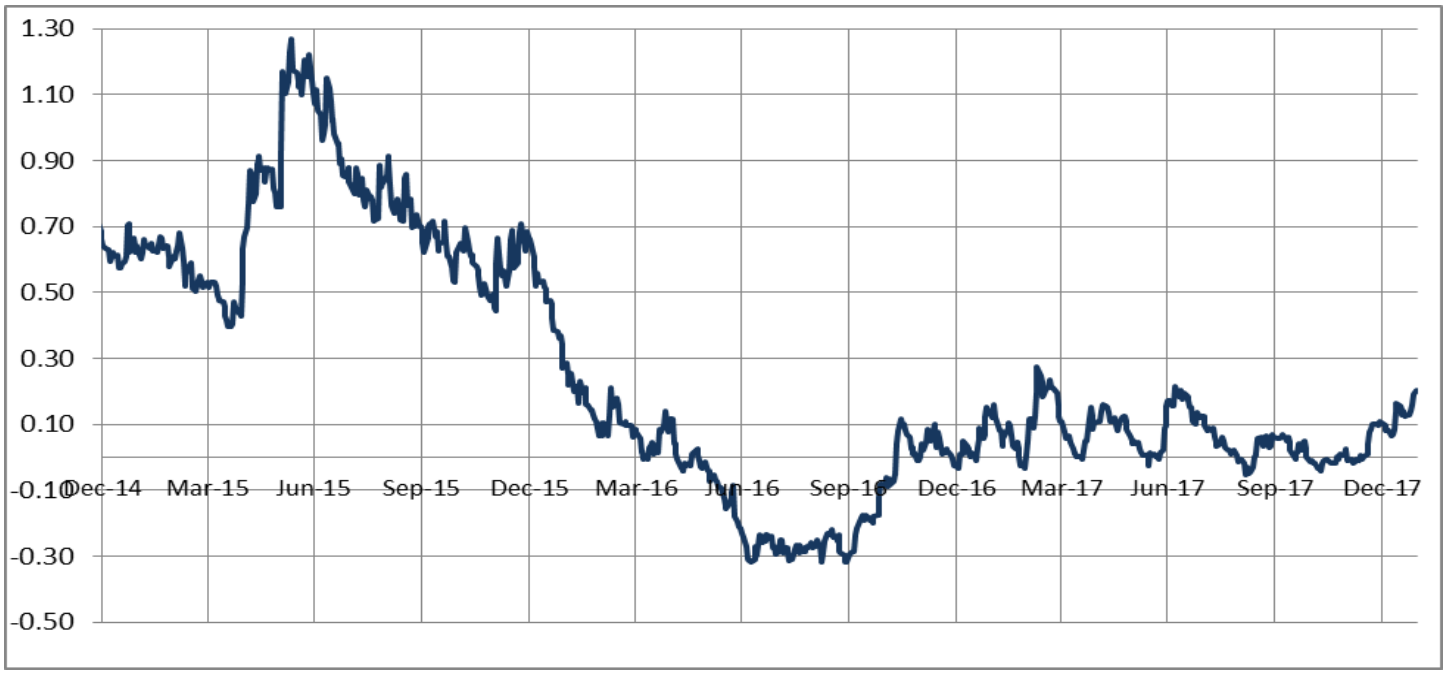
Figure 7. US Long-term Fixed Mortgage Loan Rates Rise Sharply in January (Chart: Bankrate.com US Home Mortgage 30 Year Fixed Naitonal Average)



Source: Bankrate.com

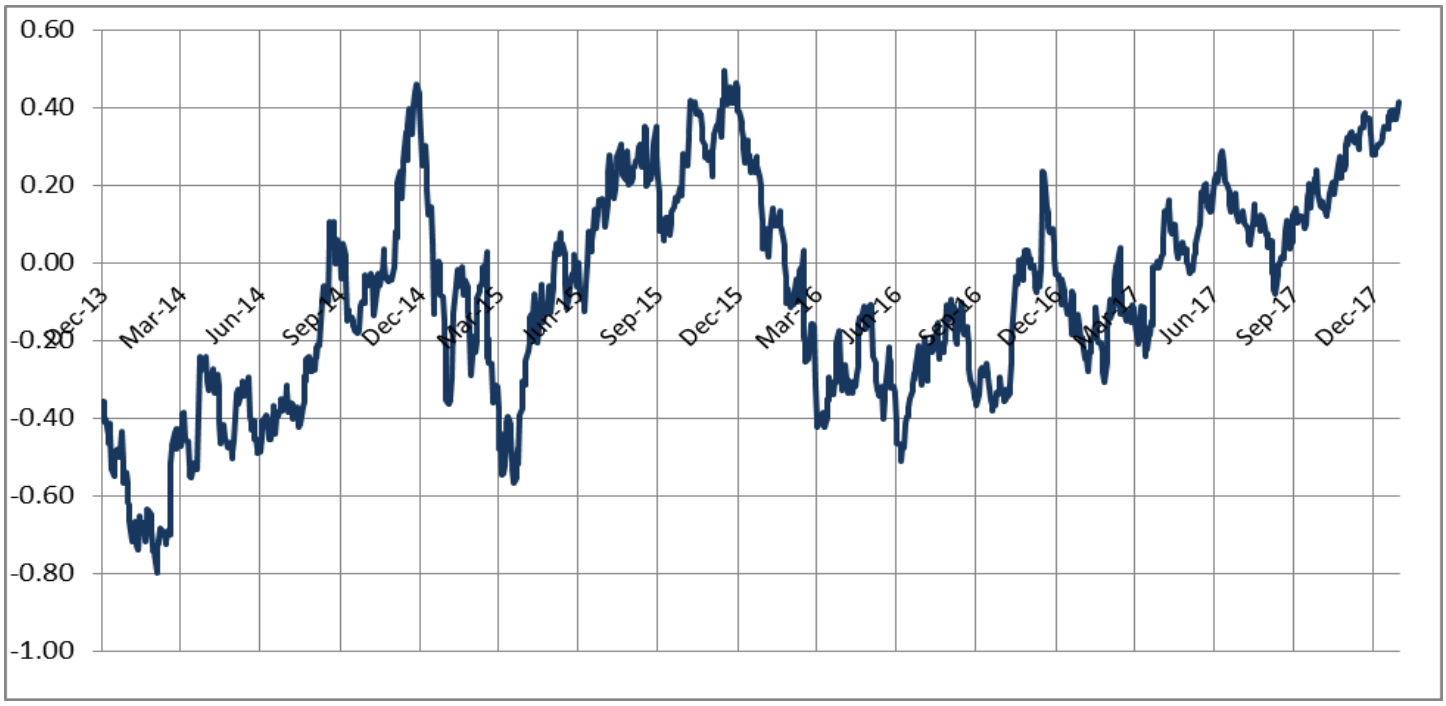
Along with the continued firming of the Eurozone region's economic calendar, both in absolute as well as relative terms versus the US, over the past several weeks global investors have assigned a markedly higher probability to the scenario in which the European Central Bank (ECB) initiates a more aggressive policy rate normalization effort by 2019. For example, Figure 8 illustrates the considerable reset higher in December 2019 three-month Euribor futures yields.

Figure 8. Interest Rate Futures Market Increasingly Discounts ECB Rate Hike Calendar in 2019 (Chart: Yields Implied by 3 Month Euro Euribor December 2019 Future)



Source: Bloomberg

Figure 9. Weaker US Dollar and Breadth of Global Recovery Fuels Rise in Inflation Expectations (Chart: US Generic Govt Yields TII 5 Year)



Source: Bloomberg

The above discussion regarding the heightened visibility of superior economic momentum emanating out of the Eurozone and other regions including Japan and the Emerging Markets, lead us to reinforce our investment thesis calling for continued US Dollar weakness as well as our overweight equities versus fixed income allocations and overweight value tilt imprinted on our portfolio allocations both at the sector and geographic levels.

Our decision to sustain overweight equities, underweight bond allocations stems both out of (a) value considerations - equities' superior yield versus bonds', and (b) increased visibility surrounding the 2018 global economic outlook given the passage of the Trump tax cuts and growing signs of a broad ongoing global economic expansion.

Recent economic releases, affording higher clarity to the global economic outlook and increased prospects for continued US Dollar weakness, suggest an increased likelihood for a faster policy rate normalization scenario out of the US FED and the ECB in 2018 and 2019. For example, Figure 9 illustrates the recent rise in US medium-term inflation expectations while the strengthening price momentum out of the commodities complex has expanded further these past several weeks, now extending to agriculture commodity groups, important components of headline CPI indices around the world (Figure 10). In short, such configuration of economic activity, price dynamics and relative value lead us to sustain our overweight equities, underweight fixed income portfolio allocations. At a bottom up level, the broadening global economic expansion has manifested itself in the lowest volatility rise in global earnings revision dynamics since 2007 (Figure 11).

Figure 10. Global Inflation Momentum Edges Higher in January with Agriculture Commodity Price Rally (Chart: Rogers International Commodity Agriculture Index Total Return)

Source: Diapason Commodities

Figure 11. Non-US Equities' Outlook Supported by Steady Recovery in Global Earnings Revisions (Chart: JP Morgan Forecast Revision Index Global)

Source: JP Morgan

Emerging Markets Perspectives

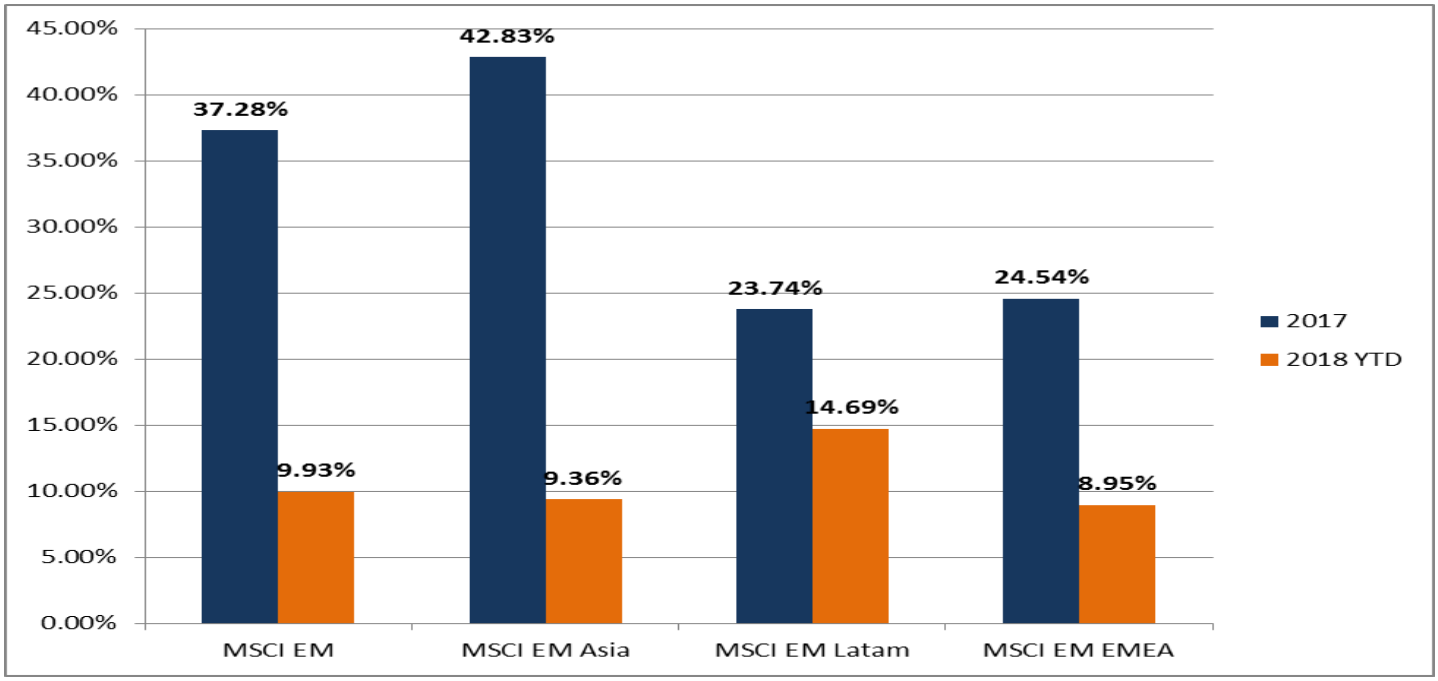
EM Equities Extend Relative Return Outperformance versus DM Peers Early in 2018; EM Value Gains Traction versus Growth Peers, Boosted by Earnings Momentum out of Materials, Energy and Financials Sector Stocks

In January, Emerging Market (EM) equities have extended their two-year long period of relative return outperformance versus Developed Market (DM) peers. In absolute terms, at 9.93% (as of the publication of this report on January 26th) Emerging Market equities' January month-to-date return performance corresponds to the strongest monthly return performance for the asset class since March of 2016.

A simple return decomposition exercise helps shed light on potentially nascent shifts in cross-regional and -sector relative return performance dynamics that appear to gaining traction within the EM asset class, conforming to Glovista's 2018 investment thesis at the regional and sector levels. Specifically, Figure 12 breaks down Emerging Market equities' January month-to-date performance across the three principal regional indices comprising the MSCI EM benchmark and contrasts such performance metrics against corresponding 2017 annual return performance. Figure 13 runs the same decomposition exercise as Figure 12 for the case of the 11 sectors populating the MSCI EM index.

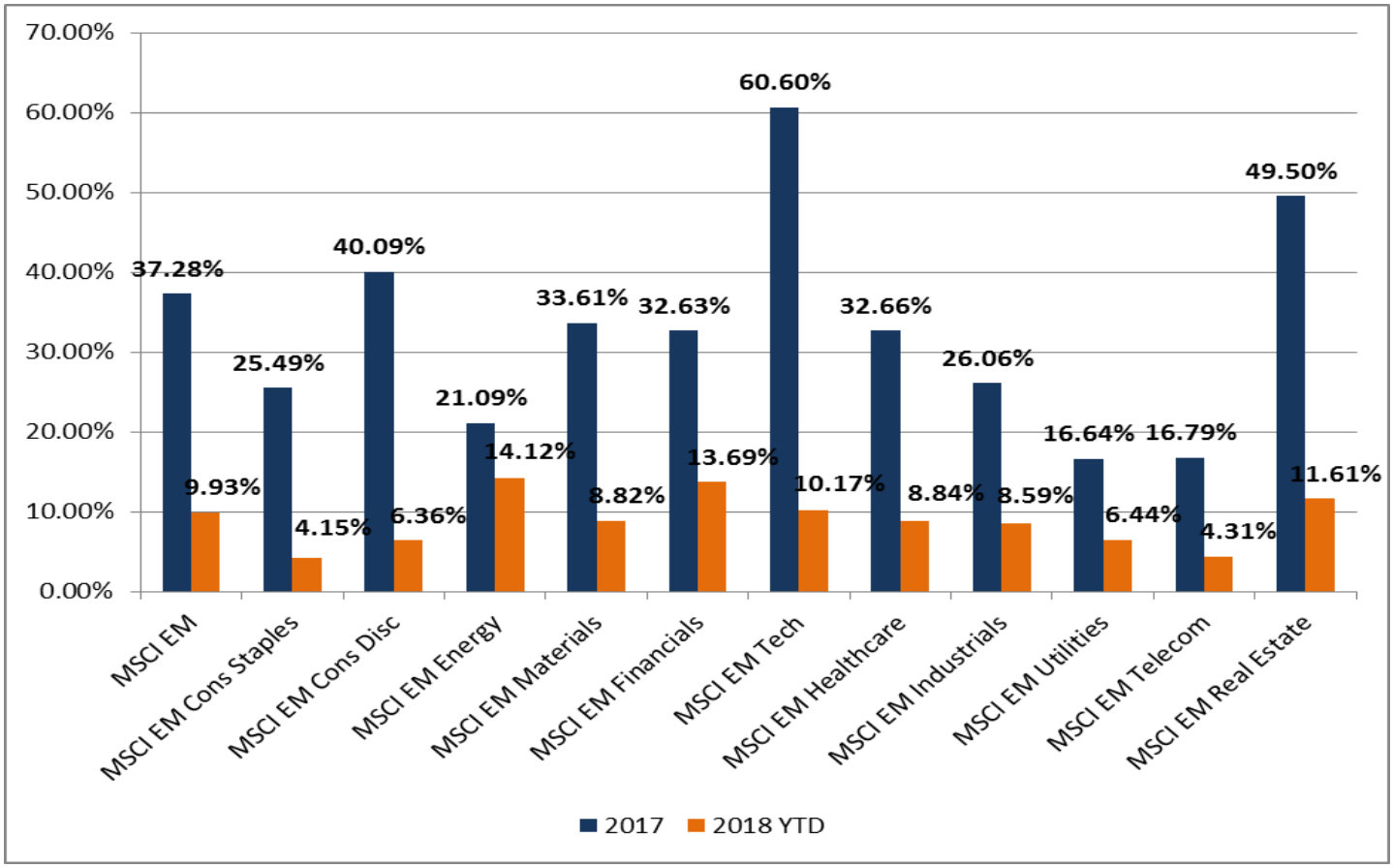
The month of January has witnessed a strong performance leadership out of the Latin America and EMEA regions, with emerging Asia regional markets lagging behind. Said relative return performance accords closely with the considerably stronger upside surprises and upward revisions tied to value-oriented sectors more heavily represented by the Latin America and EMEA regional indices, such as energy, materials and financials. Moreover, some of the largest downside earnings surprises and downward earnings revisions for the month of January have emanated out of some North Asian national market indices, such as South Korea's (e.g. autos and consumer discretionary stocks) and Taiwan's. The Chinese equity market has performed strongly during the month of January, supported by a strengthening currency and continued industrial sector revenue growth. In turn, these developments along with a stronger than expected Renminbi have fueled strong price performance on the part of Chinese financial sector stocks.

Figure 12. EM Equities' Regional January MTD Performance versus 2017



Source: MSCI

Figure 13. EM Equities' Sectorwise January MTD Performance versus 2017



Source: MSCI

Our bullish EM equities' outlook, both in absolute and relative terms versus DM peers, for the balance of the year is largely immune to two risk factors of concern to a number of investors. Those two risk factors include (a) rising prospects of more hawkish policy rate actions by the US FED and ECB, as discussed in the adjoining *Global Perspectives* column, and (b) lingering concerns over a China economic slowdown. As for the former mentioned risk factor, we point to the historically low starting levels for real (inflation adjusted) short-term interest rates in the US and the Eurozone - negative rates, while as for the latter mentioned risk factor, we are encouraged by recent China economic releases pointing to accelerating revenue growth out of the industrial sector while the service sector economy continues to expand at a healthy clip.

Over the past several weeks we have further raised our EM portfolios' value tilt by cutting North Asia market exposure to the benefit of country allocations in the ASEAN region and Latin America.

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