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Glovista Sustains Defensive Portfolio Tilts as September FOMC Rate Hike and Protracted China Economic Deceleration Become Increasingly Likely

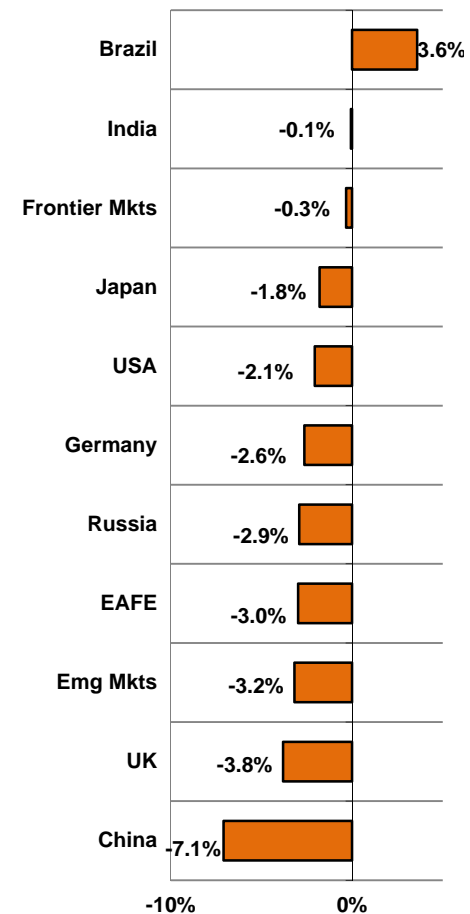
The past several weeks have brought about some of the most momentous global macro and market developments since the Great Recession period of 2007-2009. For example, as illustrated in Figure 1, global equity, bond, commodity and currency markets have experienced some of the sharpest bouts of realized volatility in multiple years, entailing outsized cumulative price declines when computed from 2015 year-to-date high levels.

Price Declines Across Asset Markets Likely Reflect Investor Reaction to Softening Activity Momentum, Low Productivity Growth and Cost-Push Inflation Concerns in the USA

The Glovista investment team views the recent sharp sell-off across asset markets as the result of investors’ reaction to an undoubtedly toxic cocktail represented by macro developments unfolding over the past several weeks, including the following:

- ***Broad-based deceleration of economic momentum across multiple geographic regions.*** Such loss of economic momentum is illustrated in Figure 2 which illustrates the weakening consensus expectation for 2015 Global GDP growth. The softening economic momentum is reflected both in the steady downward revisions to 2015 consensus US GDP growth estimates since January of this year (including almost a 1/3 reduction in calendar year GDP growth forecasts) as well as in the collapse of commodity prices across sectors (Figure 3).

Country-wise Monthly Performance in USD terms (June 2015)



Source: MSCI & Bloomberg

Figure 1: Equity, Bond, Currency and Commodity Indices Record Outsized Cumulative Price Declines till July 29th from YTD High Levels

Instrument	Return Since YTD High	Date of YTD High
Brazilian Real Spot	-29.4%	27-Jan-15
Turkish Lira Spot	-21.3%	14-Jan-15
Generic 1st WTI Crude Future	-20.6%	10-Jun-15
Silver Spot \$/Oz	-19.2%	22-Jan-15
GOLD SPOT \$/OZ	-15.8%	22-Jan-15
MSCI EM Index	-15.6%	28-Apr-15
New Zealand Dollar Spot	-14.9%	09-Jan-15
ISHARES 20+ yr Treasury Bond ETF	-12.7%	30-Jan-15
Mexican Peso Spot	-12.4%	14-Jan-15
Canadian Dollar Spot	-11.5%	01-Jan-15
CRB Commodity Index	-11.3%	14-May-15
Australian Dollar Spot	-11.3%	16-Jan-15
DAX INDEX	-9.4%	10-Apr-15
Euro Spot	-9.3%	01-Jan-15
DJ Transportation Index	-8.3%	24-Feb-15
Liquid Investment Grade Index	-4.6%	17-Apr-15
MSCI EAFE Index	-4.5%	15-May-15
MSCI ACWI	-3.9%	21-May-15
DJ Industrial Average	-3.1%	19-May-15
Liquid High Yield Index	-2.7%	27-Apr-15
Asian Dollar Index	-2.6%	28-Apr-15
Barclays US Agg Total Return Index	-1.8%	02-Feb-15

Source: Bloomberg

S&P500 Monthly Sector Performance – June 2015

Sectors	% Change	FY1 PE Ratio
Energy	-3.55%	28.3
Materials	-4.17%	17.8
Industrials	-2.73%	16.4
Cons Disc	0.46%	20.0
Cons Stap	-2.16%	19.9
Technology	-4.37%	16.4
Healthcare	-0.41%	18.4
Financials	-0.48%	14.4
Utilities	-6.28%	15.5
Telecom	-2.32%	13.3
S&P500	-2.10%	17.5

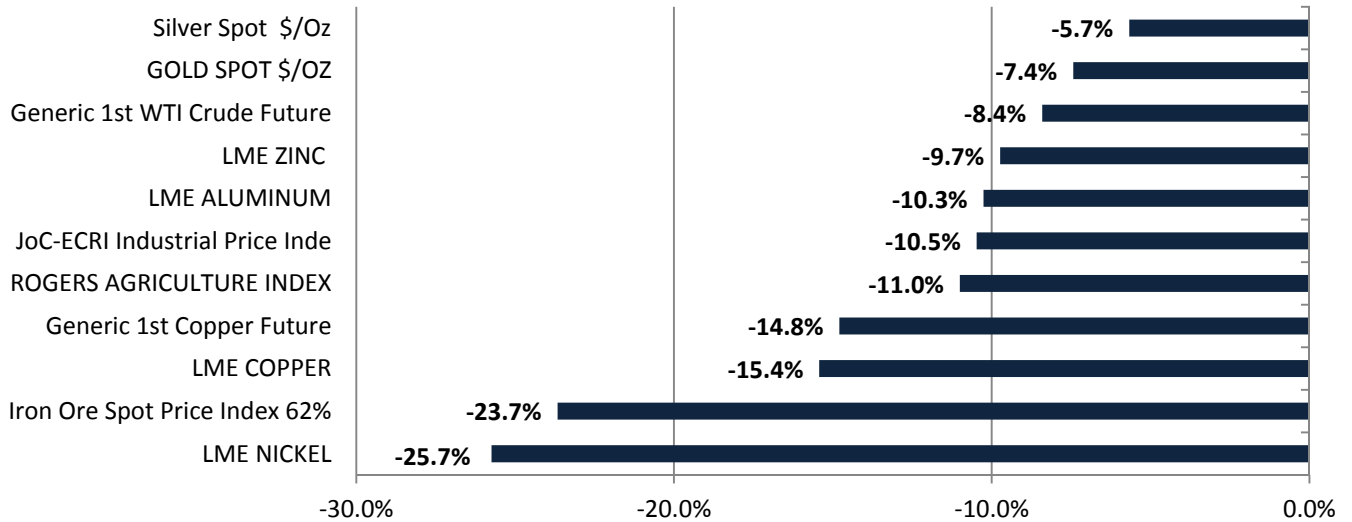
Source: S&P

Figure 2: Economic Momentum Softens Across Several of the World's Principal Regions (Chart: World 2015 GDP Forecast (Annual YoY %), Weighted Average of Countries)



Source: Bloomberg

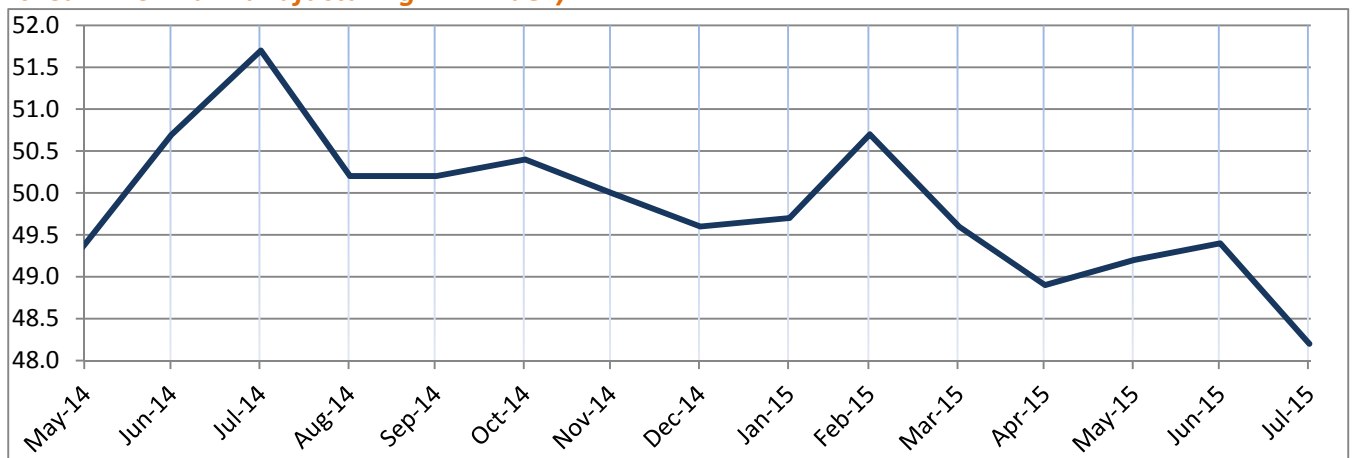
Figure 3: Broad-based Commodity Price Declines Suggests Underlying Weakness in World Demand Conditions



Source: Bloomberg

- Weakening of Chinese economic momentum despite the application of outsized monetary and fiscal policy stimuli earlier this year (Figure 4).** The sharp deceleration recorded by several key China economic indicators over the past several weeks is of special importance to the global economic and market outlooks owing to that economy’s inordinately large contribution to world GDP growth over the past 15 years. Moreover, that the Chinese economy has weakened over the past several weeks is an additional source of concern given (a) the implied ineffectiveness of the outsized economic policy stimuli implemented by China’s economic policymakers earlier this year and the potential for (b) adverse consumer confidence effects, resulting from the crash in equity prices over the past six weeks (Figure 5), fueling a further slowdown in demand growth.

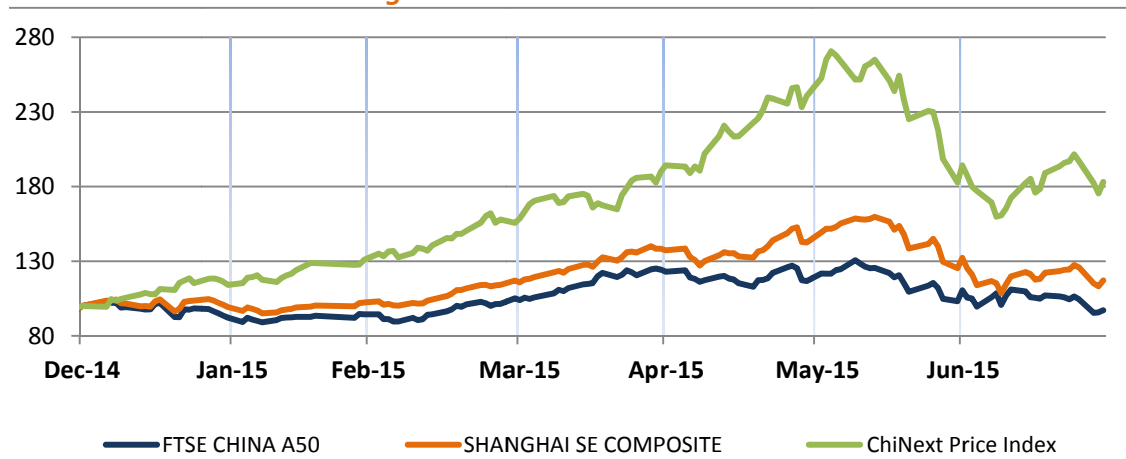
Figure 4: China’s Economic Deceleration Intensifies Despite Recent String of Policy Stimuli (Chart: Caixin China Manufacturing PMI Index)



Source: Markit

- Rising prospects of a September policy rate increase on the part of the US Federal Reserve.** Such policy rate action would mark the first hike in the US Federal Funds rate in close to 10 years. This move may cause further heightened macro and financial market volatility owing to several considerations, including:
 - Further strengthening of the US Dollar (Figure 6),** a development that would likely result in further downward price pressure on commodities and accompanying downside economic risks facing commodity export-oriented countries and sectors of the global economy, such as energy, that have attracted a considerable share of world capital spending over the past ten years.

Figure 5: Recent Crash in China's Equity Market Carries Potential of Exacerbating Demand Weakness in Coming Months



Index	Return Since YTD High	Date of YTD High
FTSE China A50 Index	-25.7%	8-Jun-15
Shanghai Composite Index	-26.7%	12-Jun-15
ChiNext Index	-32.4%	3-Jun-15

Source: Bloomberg and Glovista Calculations

Figure 6: US Policy Rate Hike in September Likely to Result in Renewed US Dollar Strengthening



Source: Bloomberg

- Higher levels of financial market volatility – both in bonds and equities – as the Fed’s first rate hike prompts investors to reassess the odds of additional policy rate hikes (Figure 7). This higher volatility scenario carries the potential of fueling persistently higher credit spreads and overall borrowing costs of capital facing corporates and sovereigns. In turn, such dynamics would exert downward pressure on both growth and US equity multiple expansion potential. Corporates have been the largest net buyers of US equities these past several years via a monumental share buyback program, funded through debt issuance, at the average annual tune of around 300 billion US Dollars.

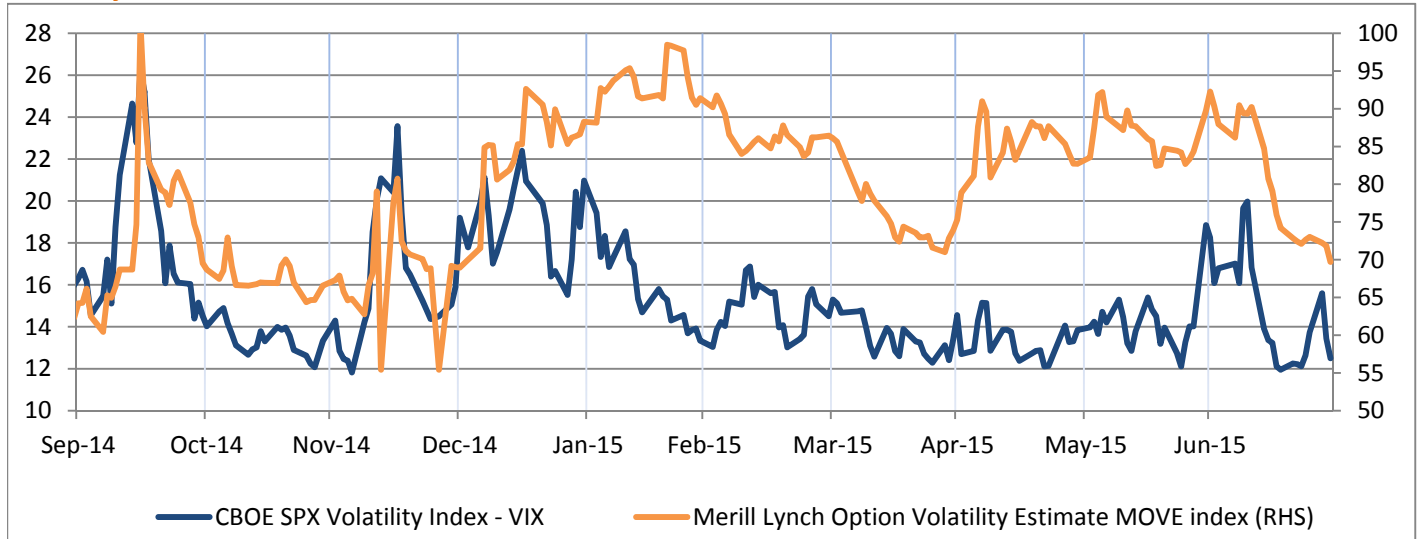
	June'15	June Change
Gold	1172.4	-1.5%
Silver	15.7355	-6.1%
Oil	59.47	-1.4%
EUR	1.1147	1.5%
JPY	122.5	1.3%
GBP	1.5712	2.8%
CHF	0.9355	0.5%
CAD	1.2494	-0.3%
AUD	0.7707	0.8%
BRL	3.103	2.4%
MXN	15.739	-2.3%

Source: Bloomberg

Rates	June 30 th Level
1 Yr CD	0.60%
5 Yr CD	1.46%
30 Yr Jumbo Mortgage	4.35%
5/1 Jumbo Mortgage	3.61%
US Govt. 10 Year	2.35%
10 Yr Swap Spread	0.11%

Source: Bloomberg

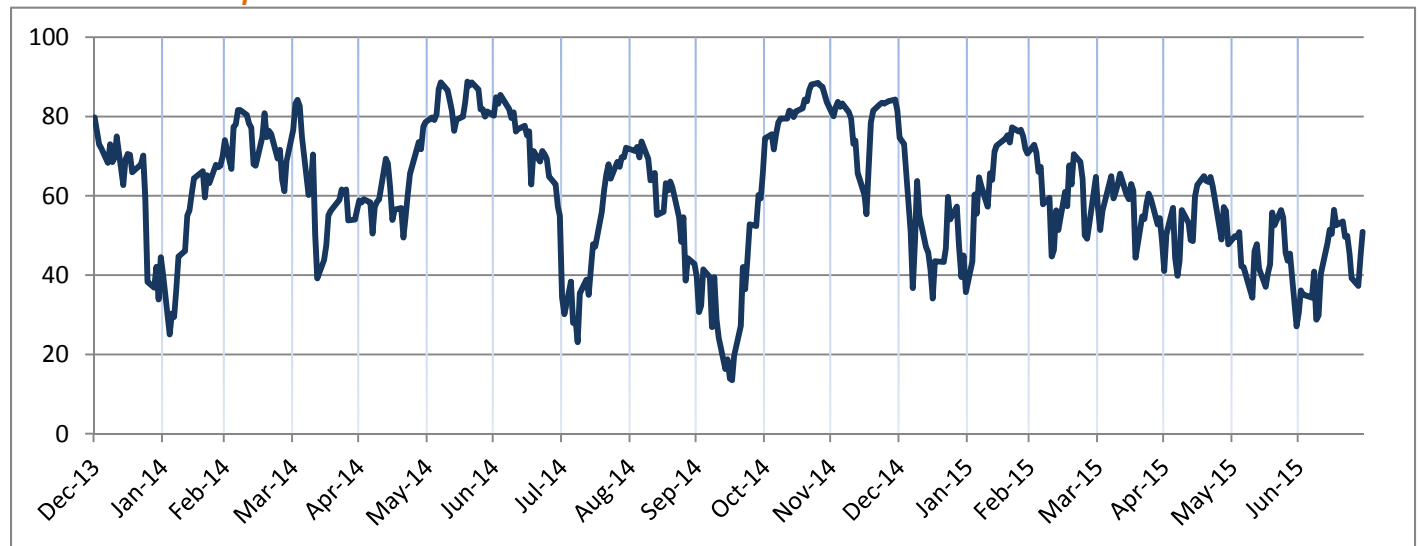
Figure 7: Start of US FOMC Rate Hike Cycle Carries Potential of Fueling Persistently Higher Financial Volatility Environment



Source: Bloomberg

- *Global equities' weakening internals* as much of the recent market leadership has been centered on an increasingly narrow base of sectors (e.g. healthcare and technology in the case of the US market) and stocks (e.g. some of the megacap stocks in the case of the US technology sector). Figure 8 represents a graphic example of global equities' weakening market internals.

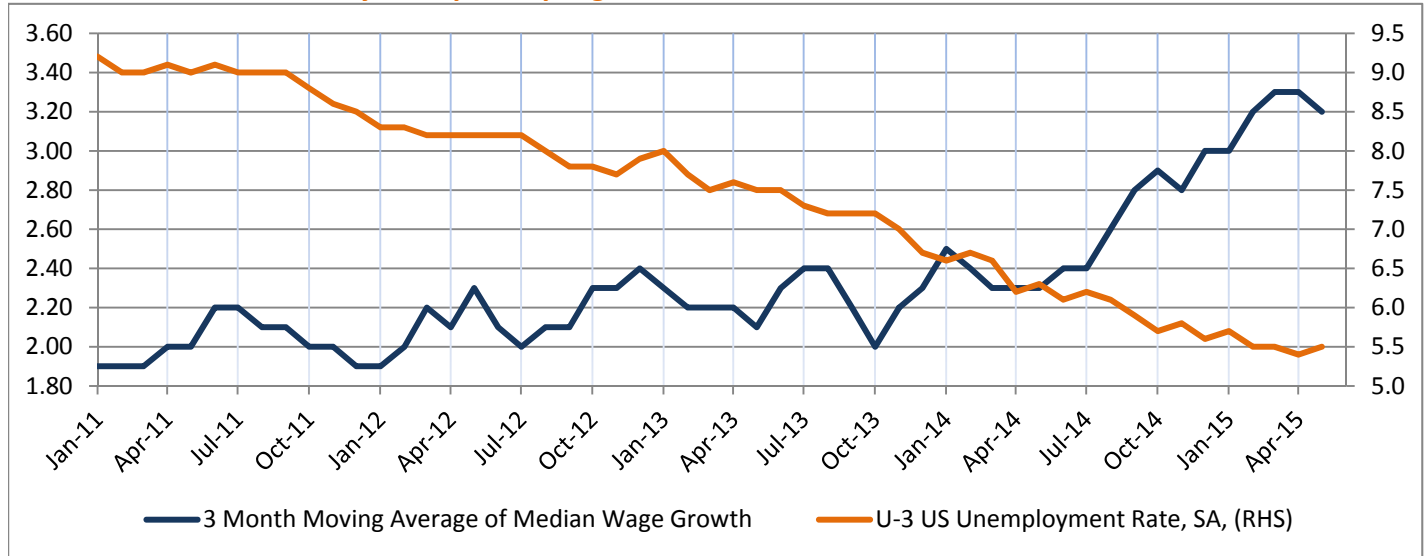
Figure 8: Percentage of S&P500 members trading above 50 day Moving Average as Example of Equities' Narrow Leadership Base over the Past Several Months



Source: Bloomberg

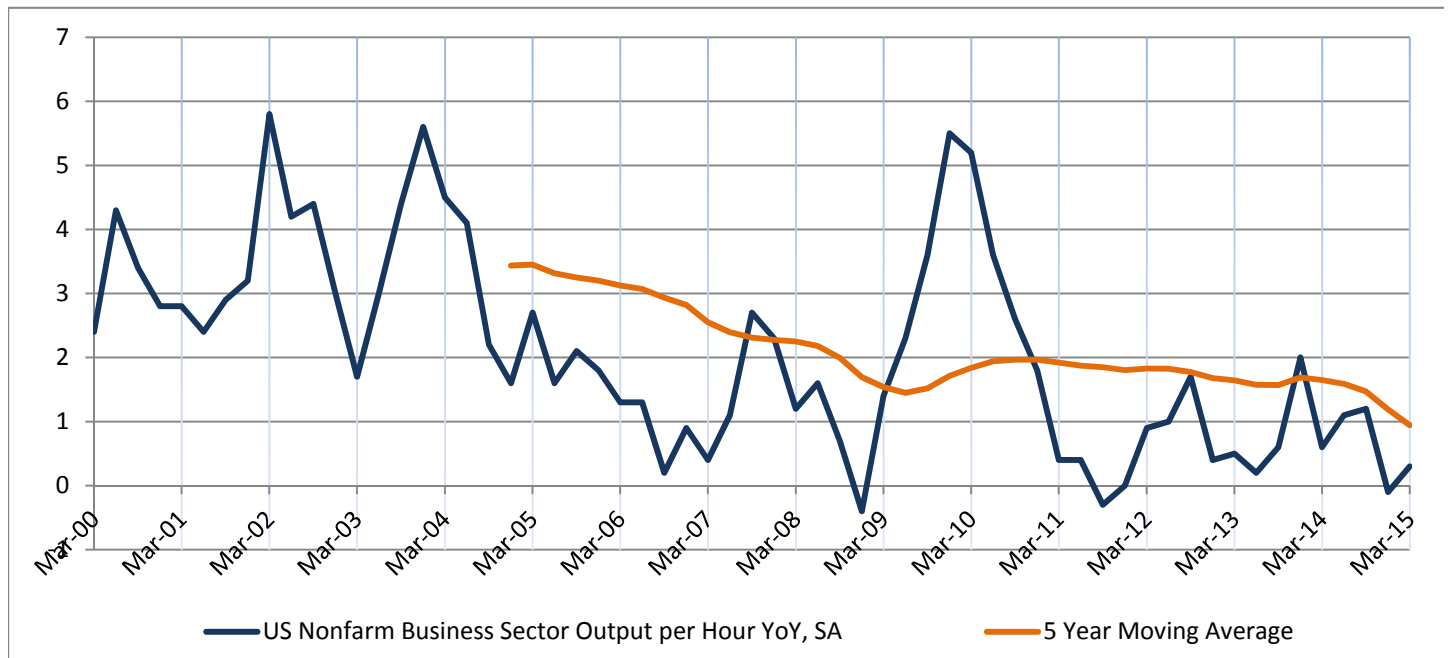
- *Incipient signs of US nominal wage growth acceleration* (Figure 9) at a juncture when (a) US productivity growth continues to underwhelm (Figure 10), (b) the output gap is shrinking and (c) headline risks to US cyclical economic growth escalate (e.g. lagged effects from strong US Dollar and weakening foreign economies), despite the tax cut-like effect of lower energy prices. In contrast to virtually all prior US policy rate cycles of the post-war period, when the Federal Reserve's rate hikes were the result of accelerating demand conditions, in this cycle (an unusual one, to say the least, as it is conditioned by the application of unprecedented non-traditional monetary policy actions for close to 6 years), the Federal Reserve will be raising its reference rate as part of a normalization process following the multi-year long QE program.

Figure 9: US Nationwide Nominal Wage Growth Accelerates at a Juncture in which Productivity Growth Underwhelms and Economy's Output Gap Tightens Further



Source: Bureau of Labor Statistics & Federal Reserve Bank of Atlanta

Figure 10: US Economy's Weak Productivity Backdrop a Concern for Long-term Growth and Inflation Risks



Source: Bureau of Labor Statistics

Amidst Heightened Macro and Policy Risk Outlook, Glovista Sustains Defensive Portfolio Tilts, including High Cash Levels, Selected Exposure to US Corporate Debt, Eurozone/Japanese Equities

Against a much heightened global macro and policy risk backdrop, the Glovista investment team has tightened the portfolio strategy's defensive tilts by raising further cash levels, continuing to avoid the commodities sector altogether and limiting equities exposure to strong governance markets that present attractive valuations and favorable top- and bottom-line growth prospects. Courtesy of governance reforms implemented over the past several years as well as the favorable competitiveness effects afforded by currency cheapening, core Eurozone and Japanese (large caps) comprise important focus markets in our managed portfolios' equities sleeve.

Emerging Market Perspectives

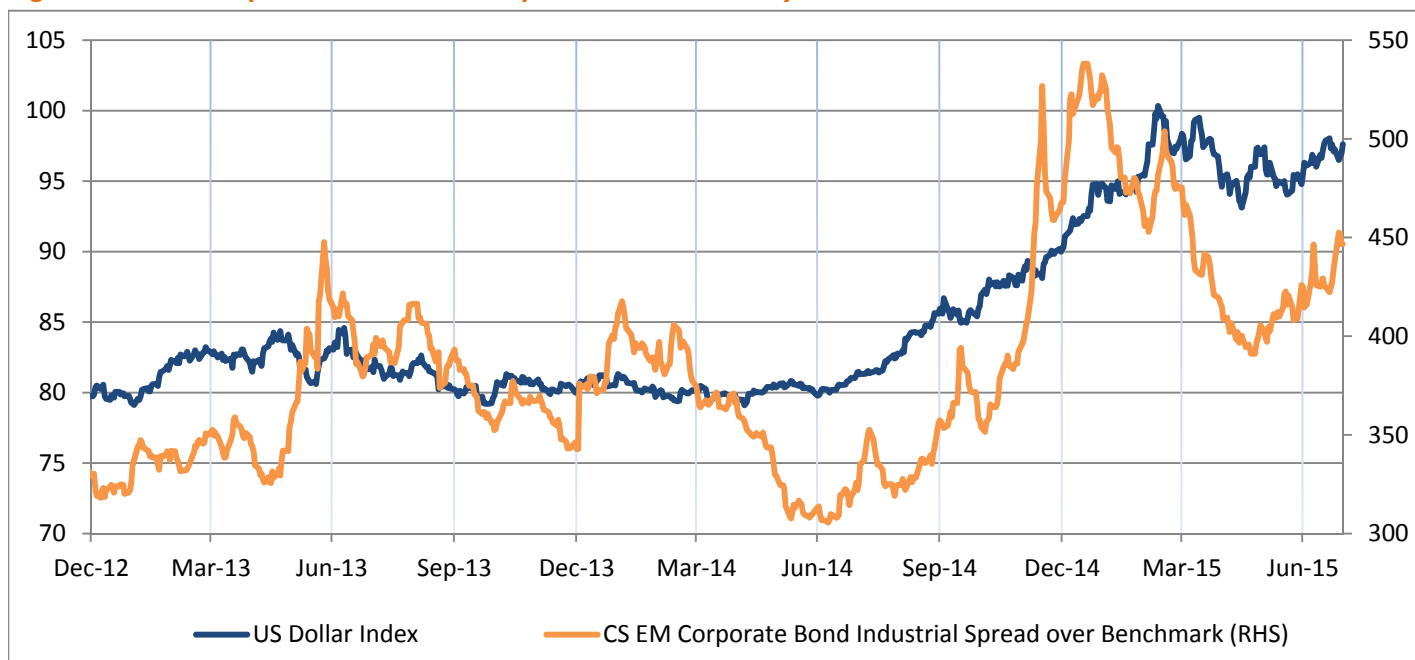
Glovista Raises EM Portfolio Tilts to Capture Further US\$ Strength and Rising Debt Cost of Capital

The past several weeks have proven rather momentous for the global economy and markets, carrying implications for future global economic activity, interest rate and inflation dynamics. The Glovista investment team expects the global economy’s fast-changing dynamics to result in a period of further US Dollar strength and rising debt cost of capital as the US Federal Reserve embarks on its first policy rate hike in almost ten years.

For Emerging Markets, the global macro implications derived from the fast-changing economic developments delineated above are of first-order importance especially at the country- and sector- levels. Specifically, our expectation for a resumption of US Dollar strengthening is likely to impact adversely a number of fragile Emerging Market countries from a macro balance sheet position. Some of those countries include Brazil, South Africa and Indonesia. Moreover, the resumption of US Dollar strength, together with our expectation for a sustained rise in borrowing costs globally (credit spreads), carries material credit implications at the corporate level for a number of issuers out of several Emerging Market countries, including Brazil, Indonesia, Malaysia, Russia and China (Figure 11). In acknowledgement of such heightened risks facing a number of EM countries and EM bellwether corporate names, the Glovista investment team has chosen to maintain significant underweight allocations to the majority of those countries.

Recent developments in China merit an updated discussion. As noted in prior columns, we have held a cautious stance towards the more speculative segments of the Chinese equity market (e.g. A Share and Chinext indices) on account of exceedingly expensive valuations. We continue to avoid exposure to such speculative sectors of the Chinese market on account of persistently expensive valuations. However, our work, including that of our sector analysts, cautions us against avoiding exposure to important sectors of the Chinese market, particularly tied to fast growing, underpenetrated service sectors for which the visibility of growth is very high and for which growth-adjusted stock valuations are attractive. Consequently, we continue to hold exposure to Chinese equities, particularly those belonging to the New China sectors.

Figure 11: EM Corporate Bond Credit Spreads are Positively Correlated with the US Dollar



Source: Bloomberg and Credit Suisse Securities

With regard to our take on the potential for a sharp deceleration of the Chinese economy, entailing recession-like episodes, we continue to impute low probability weighting to such scenarios. Our view stems from (a) our recognition of the recent implementation of outsized fiscal and monetary policy stimuli, the results of which on the broader economy have not been fully obtained, (b) the potential for additional interest rate cuts supporting households' and corporates' funding programs as real interest rate levels (particularly for corporates) remain significantly high by historical and international standards, (c) China's beneficiary status from declining energy and overall commodity prices as China remains a net-importing country.

From an EM regional perspective, we have maintained our longstanding overweight EM Asia, underweight EMEA and underweight Latin America allocations. However, over the past several weeks we have implemented a number of intra-Asia country rebalancing actions motivated partly by profit-taking considerations (downgrade of India from strong overweight to neutral and Taiwan from strong overweight to moderate overweight) as well as our decision to realign our overall EM portfolio to strengthening US Dollar and rising debt cost of capital factor tilts. As a result of the latter, we have further increased our longstanding underweight Brazil country allocation to maximum underweight, increased our Korea country exposure on a Korean Won currency hedged basis as well as accessed off-benchmark exposure in the form of Israel, a market likely to prove resilient in a strong US Dollar, rising interest rate environment.

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