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Monthly
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Newsletter

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Glovista Global Perspectives

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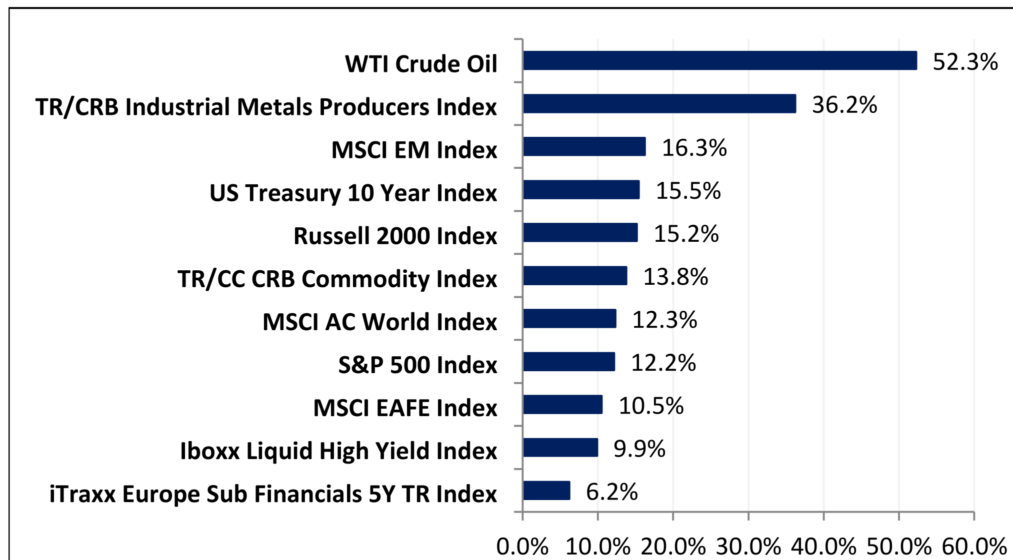
Risk Markets Rally Sharply on Rising Crude Prices, Dovish FOMC Meeting, Weaker US Dollar and Expanded ECB QE Program; Glovista Sustains Cautious Stance towards Developed Equities on Cycle and Valuation Considerations

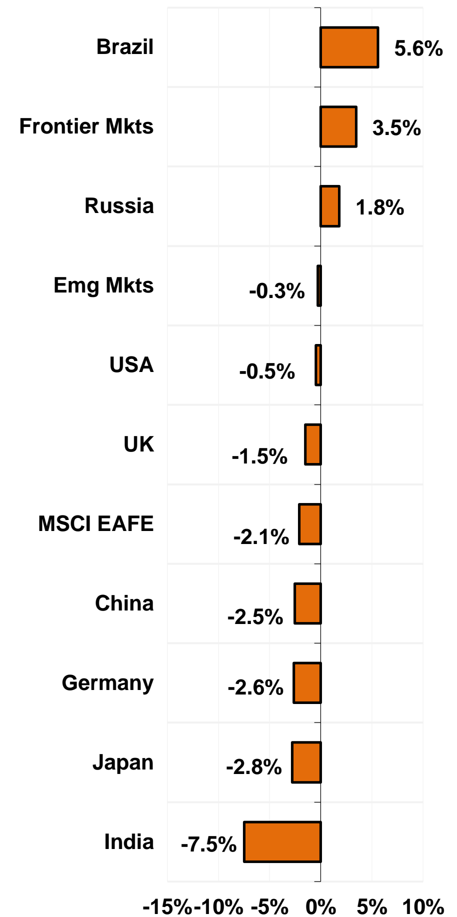
Since the release of our previous monthly column, risk asset prices globally have rallied sharply. Figure 1 illustrates the total return performance recorded by major asset groups since the low levels reached by the MSCI AC World index around February 11. Moreover, as highlighted in Figure 2, the post-February 11 world market rally has been led by cyclical asset groups, with lagging performance on the part of defensive markets and sectors. Interestingly, such cyclical beta performance leadership has cut across the equities, fixed income, and currency divide, as shown in Figure 2.

Figure 1. World Risk Markets Rally Sharply from Low Levels Reached on Feb. 11 (February 12th to March 21st, 2016)



Source: Bloomberg

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



Source: MSCI & Bloomberg

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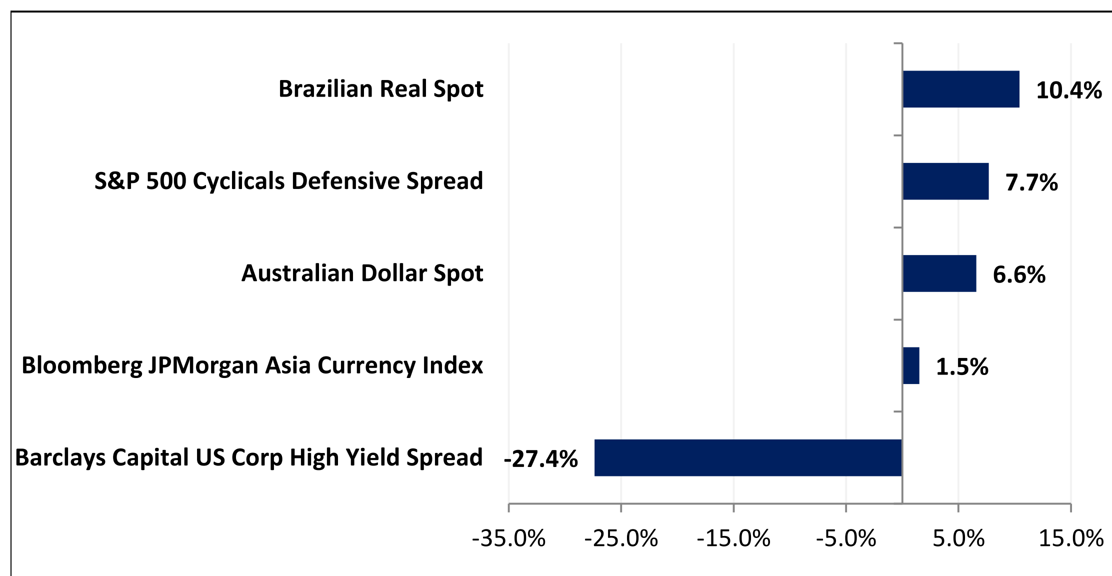
Figure 2. Cyclical Asset Markets Lead Post-February 11 Rally, cutting across the Equities, Fixed Income and Currency Divide (February 12th to March 21st, 2016)



Source: Bloomberg

S&P500 Monthly Sector Performance – February 2016

Sectors	% Change	FY1 PE Ratio
Energy	-2.56%	54.8
Materials	7.31%	16.7
Industrials	3.50%	15.2
Cons Disc	0.24%	17.4
Cons Stap	0.06%	20.9
Technology	-1.53%	15.7
Healthcare	-0.71%	14.9
Financials	-3.17%	12.4
Utilities	1.37%	16.5
Telecom	2.69%	13.2
S&P500	-0.41%	16.2

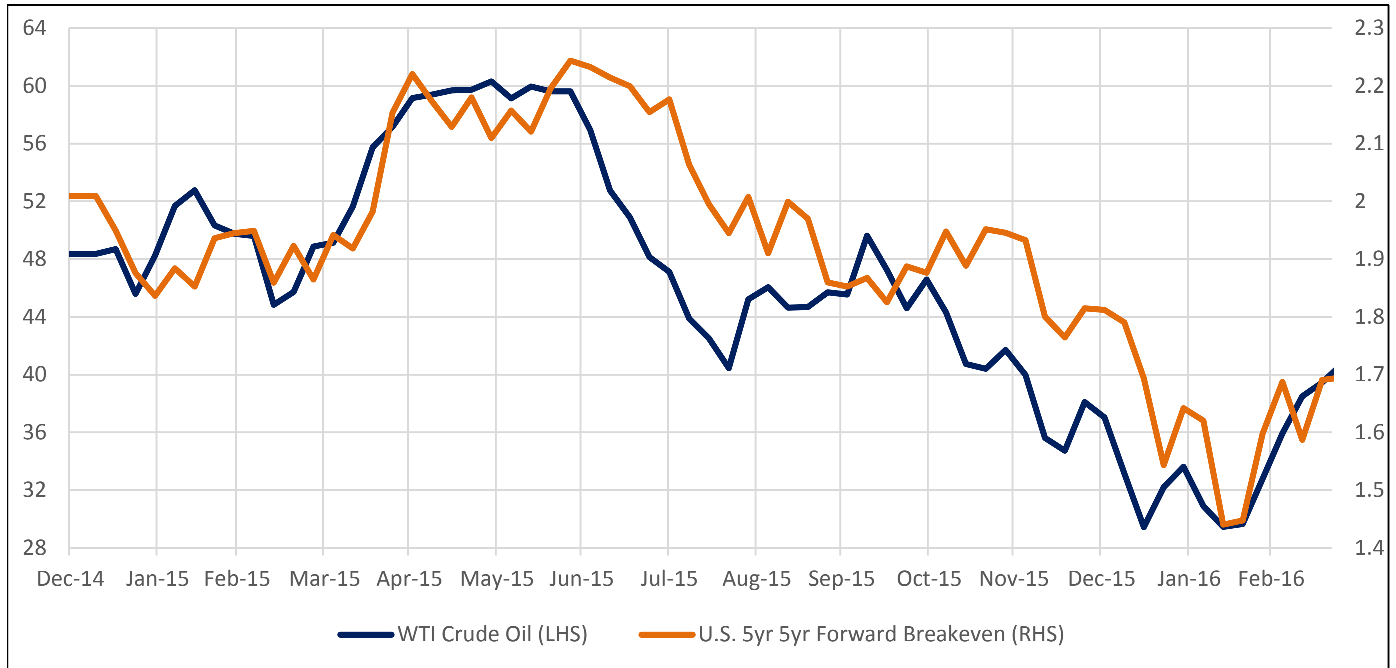
Source: S&P

We attribute the sharp post-February 11 bounce in world asset markets to a set of reinforcing technical, policy and short-term cyclical economic factors that have unfolded over the past several weeks. Some of those factors include the following:

- ***Sharp rally in crude prices.*** As illustrated in Figure 3, front month crude (WTI) prices have spiked around 52 percent over the past 30 days, fueled by signs of declining rig production in the US shale industry and supportive chatter emanating from OPEC and non-OPEC countries suggesting a firmer disposition towards supporting $50 per barrel prices through output quotas.

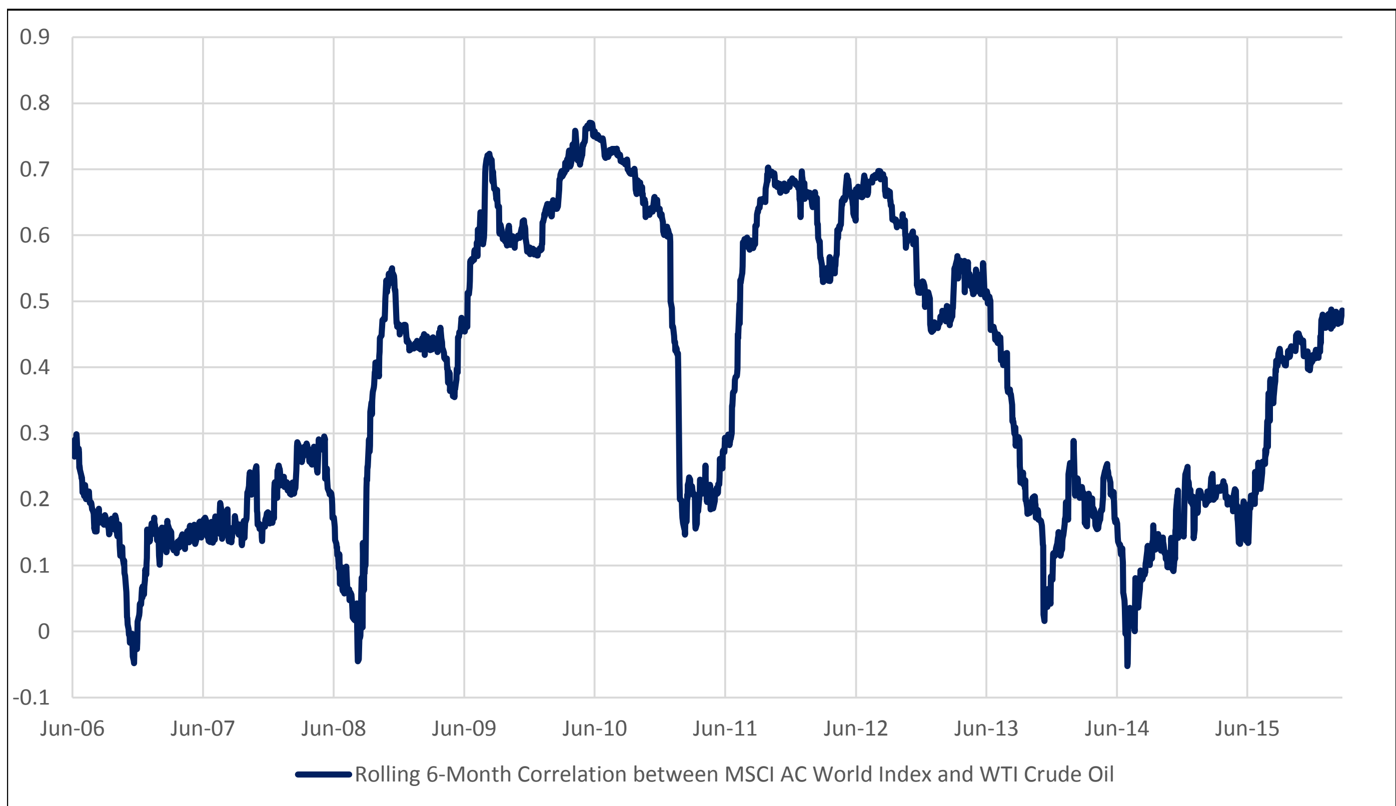
  Crude price dynamics are of consequence to global markets well beyond the impact exerted on energy commodities and energy equity prices. Specifically, as highlighted in Figure 3, long-term inflation expectations and spot crude prices harbor an exceedingly tight statistical nexus, a point noted by Fed Chair Yellen and ECB President Draghi on multiple occasions. Such state of affairs implies that crude price increases carry benign reflationary expectations at the global level. In the post- Great Financial Crisis period, an upturn in reflationary expectations amounts to a welcome development in the eyes of global investors owing to the confluence of: persistently large levels of domestic debt (public, corporate and household) across a large number of countries; recent multi-year deceleration of world nominal GDP growth; multi-year declines in long-term inflation expectations to historically low levels; and the prevalence of zero or negative nominal policy interest rates across a growing number of advanced economies. The above discussion accounts for the historically high positive correlation between world equity indices and crude prices (Figure 4).

Figure 3. Crude Price Bounce Accompanied by Upturn in Long-term Inflation Expectations



Source: Bloomberg

Figure 4. World Equity Prices – Crude Price Nexus: At High Levels



Source: Bloomberg

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	February 2016	February Change
Gold	1238.74	10.8%
Silver	14.9023	4.5%
Oil	33.75	0.4%
EUR	1.0873	0.4%
JPY	112.69	7.0%
GBP	1.3917	-2.3%
CHF	0.9984	2.4%
CAD	1.354	3.1%
AUD	0.7141	0.8%
BRL	4.0159	-0.4%
MXN	18.136	-0.2%

Source: Bloomberg

Rates	February 29th Level
1 Yr CD	0.55%
5 Yr CD	1.30%
30 Yr Jumbo Mortgage	4.04%
5/1 Jumbo Mortgage	3.38%
US Govt. 10 Year	1.7347%
10 Yr Swap Spread	-0.1613%

Source: Bloomberg

- ***European Central Bank (ECB) announces significantly more aggressive than expected expansion of ongoing quantitative easing (QE) program.*** Specifically, at its scheduled March 10th meeting, the governing council of the ECB announced the implementation of a number of considerably more aggressive than expected measures expanding its ongoing QE program. In particular, the ECB announced the following measures: (1) the interest rate on the main refinancing operations of the Eurosystem will be decreased by 5 basis points to 0.00%; (2) the interest rate on the marginal lending facility will be decreased by 5 basis points to 0.25%; (3) the interest rate on the deposit facility will be decreased by 10 basis points to -0.40%; (4) the monthly purchases under the asset purchase program will be expanded to €80 billion starting in April; (5) investment grade euro-denominated bonds issued by non-bank corporations established in the euro area will be included in the list of assets that are eligible for regular purchases; and (6) a new series of four targeted longer-term refinancing operations (TLTRO II), each with a maturity of four years, will be launched, starting in June 2016. Borrowing conditions in these operations can be as low as the interest rate on the deposit facility. As a result of such measures, European credit markets have rallied sharply over the past several weeks, most notably lower rated issues as highlighted in Figure 5.

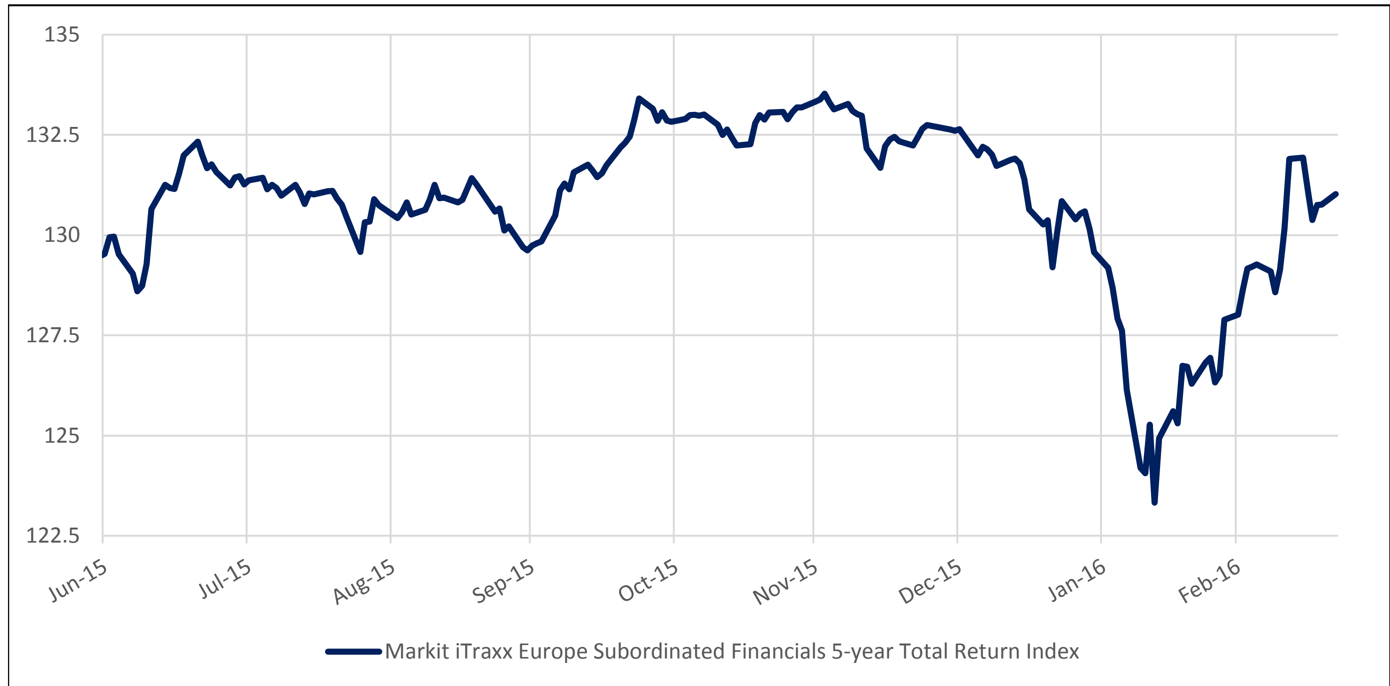
  We believe the above listed measures announced by the ECB to be of consequence for global asset markets owing to several considerations. First, the larger than expected expansion in the size of the ECB's asset purchase program further reinforces the benign reflationary expectations fueled by the recent rise in crude prices. Second, the expansion of the ECB's asset purchase program to include high grade non-financial corporate debt amounts to the introduction of a "Greenspan put" in support of not only the European but also the US high grade debt market via the portfolio balance effect. In turn, the beneficial effect exerted by the ECB's purchase of high grade debt on high quality debt instruments carries over positively on equity prices for the sector, partly as a result of the increased likelihood that such high quality corporates may be more inclined to implement debt-funded share repurchase programs over the coming quarters, particularly in Europe. Third, the ECB's introduction of TLTRO II program amounts to the extension of a lifeline in support of the Eurozone banking system's weaker financial institutions, most of which are domiciled in the periphery of Europe. Such dynamics amount to a loosening of Eurozone regional financial conditions, further reinforcing the spike in reflationary expectations derived by the recent increase in crude prices.

- ***Dovish overtones of March 16th FOMC meeting, versus consensus expectations.*** Most Wall Street economists and investors view the recent FOMC meeting as unambiguously dovish owing to the following considerations: (1) reduction in guidance of the median policy rate at the end of 2016, so-called FED dots, from 1.375% to 0.875%; (2) downward revision in FED's staff estimates of 2016 GDP growth rate from 2.4% to 2.2%; (3) reduction in long run Fed funds rate estimate from 3.50% to 3.25%; and (4) specific acknowledgement that global economic and financial developments pose a risk to US economic activity.

  First, the meeting's dovish overtone carried a bearish impact on the US Dollar (Figure 6). In turn, a weaker US Dollar exerted a positive price effect on global commodity and

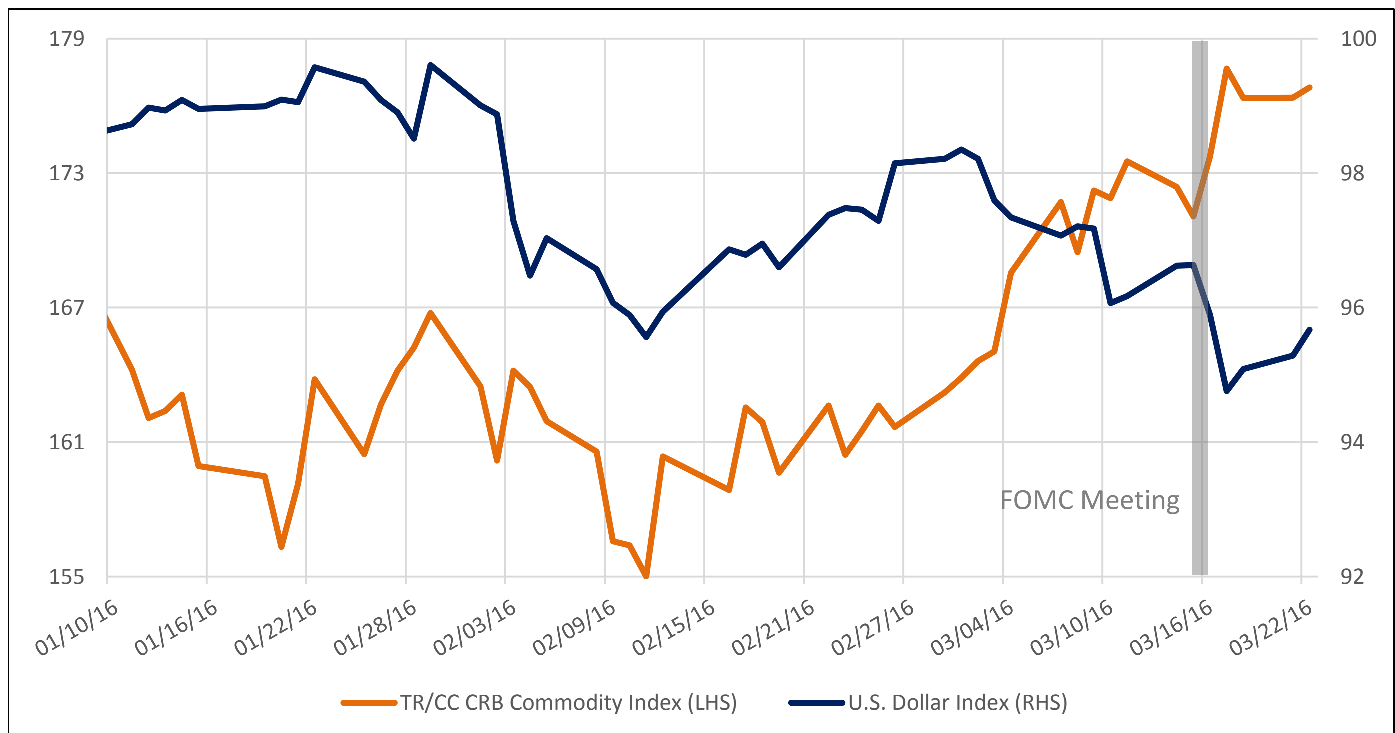
equity prices. In that light, the FOMC meeting served to reinforce the reflationary effects fueled by the ECB meeting and the crude price rise.

Figure 5. ECB's Expanded QE Program Unleashes Sharp Tightening of Credit Spreads in the Eurozone, Most Notably in Lower Rated (Junk) Issues



Source: Markit

Figure 6. Dovish FOMC Meeting Fuels Near-term Sell-off in US Dollar and Increase in Commodity Prices



Source: Bloomberg

Glovista Sustains Defensive Portfolio Stance owing to Cross-Asset Valuations and Cyclical Macro Considerations

As the Glovista investment team looks ahead, we retain a defensive portfolio stance, entailing overweight allocations to precious metals, US high grade corporate debt and non-US equities. Our defensive portfolio stance, particularly with regard to US equities, is predicated on a number of cyclical macro, technical and relative valuation considerations, including the following:

- Current contrarian bearish US equity market investor sentiment levels, following sharp post-February 11 rally in risk assets as a result of which implied equity volatility levels and volatility skews have come down to exceedingly low levels;
- Unusually bullish 2016 consensus earnings estimates on S&P500 companies, including an expected 7.4% percent year-on-year EPS growth rate and 1.9% percent year-on-year revenue growth rate. Our macro baseline case for 2016 suggests those expectations are subject to considerable downside revision risks over the coming months, both in terms of downward pressure on margins and top line growth;
- US equities' unattractive valuations versus non-US peers and also versus other asset classes, most notably US high grade corporate debt;
- Signs of incipient softening in US labor market, evident in recent economic indicators including weekly jobless claims, and service ISM and NFIB surveys as well as the potential moderation in labor demand growth stemming from the ongoing deceleration in capex growth;
- The potential for adverse payback effects on US Q2 2016 GDP resulting from this year's extraordinarily benign winter weather conditions in the Northern hemisphere favorably impacting Q1 economic releases;
- Potential for market-unfriendly political headline risks in the US and Europe as nationalist candidates garner stronger support in the polls (e.g. USA) and regional elections (e.g. Germany);
- Lingering potential for a snapback rally in the US Dollar, fueled by the statistically large divergence between recent exchange rate movements and interest rate differentials between the Eurozone and the USA. In addition, over the past several months investor positioning towards the Greenback has shifted dramatically in the direction of excessive bearishness, a contrarian bullish condition (e.g. CFTC reports).

Emerging Markets Perspectives

EM Equities Rally Sharply versus EAFE Peers, Recovering Cumulative Losses since 2013 YE Levels; Rally Sustained by Improving Earnings and FX Momentum as well as Rate Cut Prospects, Attractive Valuations and Under-owned Status

Over the past three months, Emerging Market equity prices have rallied sharply versus developed market (EAFE) peers, leading to a full recovery of cumulative losses recorded versus EAFE peers going back to the beginning of 2014 levels (Figure 7). We attribute Emerging Market equities' improved return performance, in both absolute and relative terms versus developed peers (both EAFE and US equity indices), to multiple factors, including the following:

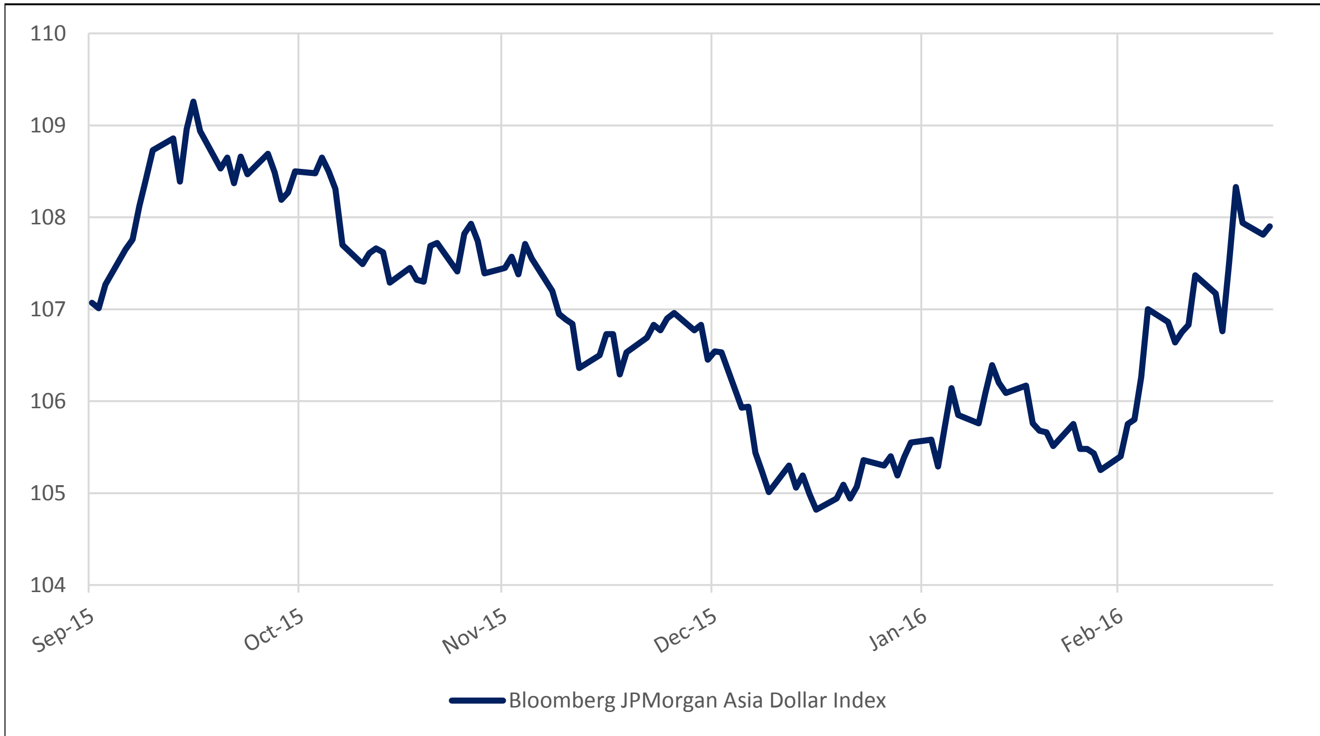
Figure 7. EM Equity Price Relative Index versus EAFE Peers: Rally leads to Recovery of Cumulative Losses Back to Beginning of 2014

Source: MSCI and Glovista Calculation

- *EM currency strength versus US Dollar thus far in 2016* (Figure 8). Such development, if sustained, is supportive of the broad EM space, but especially EM Asia regional markets, owing to the increased likelihood of policy interest rate cuts across the region later this year. This is because EM Asia, in contrast to Latin America and the EMEA region, enjoys a benign inflation backdrop together with robust central bank international reserve levels. Consequently, exchange rate stabilization, the sole remaining factor holding back EM Asia regional central banks from implementing policy rate cuts this past year, would no longer be present. Recent EM currency strength owes much to the ECB's expansion in its QE program together with the dovish overtones conditioning the most recent FOMC meetings, fueled by a slowing international economy and well anchored US inflation expectations. That interest rate differentials between the US and the Eurozone versus EM peers remain exceedingly large in favor of EM currencies is but an additional consideration anchoring our constructive outlook on EM Asia regional equity prices. In our view, some of the EM Asia region's central banks likely to implement policy rate cuts later this year include India, Taiwan, China, Malaysia and Indonesia, among others.

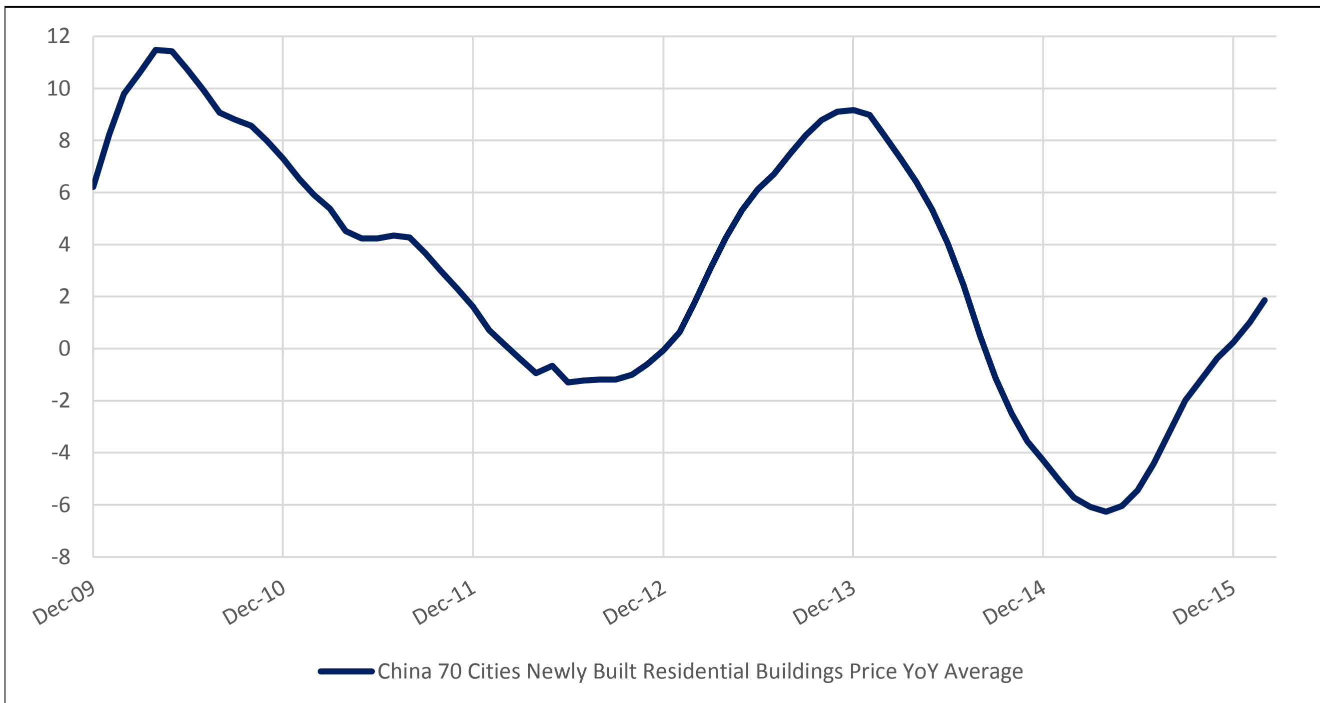
- *Improving earnings momentum, across a number of industries and sectors*, including the semi-conductor space as well as the energy and commodities groups. Such improved momentum comes on the back of stabilizing commodity prices and reduced downside tail risks afflicting the Chinese economy (as evidenced in improving housing sector data and improving price indicators, Figure 9) as well as a more constructive backdrop on the Apple supply chain early in the year, with beneficial impacts on semi-conductor stocks globally.

Figure 8. EM FX Valuations Strengthen versus US $ during 2016 YTD Period, Lending Support to Prospective Interest Rate Cut Scenario across EM Asia



Source: Bloomberg

Figure 9. Stabilization in China's Housing Prices Reduces Downside Tail Risks for the Chinese Economy



Source: National Bureau of Statistics of China and Bloomberg

- *Attractive relative valuations versus developed peers*. It is rather surprising to note that (1) despite developed equity markets' current above trend profit margin and top-line sales growth, boosted by multi-year long quantitative easing programs across the G4; and (2) EM equity markets' below trend profit margin and top-line sales performance (courtesy of a strong US Dollar, capital outflows and some home-grown policy mismanagements these past several years), EM equity valuations currently hover at multi-year low levels versus developed market peers (Figure 10). Given those considerations, especially the highly divergent state of the cyclical earnings cycle (especially in US Dollar terms) versus developed and EM equities, we believe EM equities have rarely offered as much value versus developed peers as at the present time.

Figure 10. EM Equity Valuations Hover at Close to Multi-year Low Levels: P/CE Relative Multiple versus MSCI AC World

Source: MSCI and Glovista Calculation

- *EM Asset Class' under-owned status within global balanced portfolios*. Survey data compiled by a number of large Wall Street houses point to the exceedingly large under-owned status of Emerging Market equities within global balanced portfolios. The same does not hold true for Emerging Market fixed income securities whose ownership status on the part of global balanced programs is close to historical average levels, largely the result of the continued search for yield on the part of bond investors in a ZIRP and NIR world. Evidently, EM equities' highly under-owned status represents a contrarian bullish condition for the asset class.

Against such backdrop, we remain close to fully invested in our dedicated Emerging Market equity managed portfolios. Moreover, at the regional level, we continue to maintain an overweight tilt towards the EM Asia region on valuation, relative earnings and prospective currency performance considerations. Specifically, we continue to favor overweight exposure to North Asia markets (Taiwan and Korea) as well as "New China" sectors, especially those in the information technology and e-commerce space. Over the past several weeks, we have reinstated India country exposure to solid overweight on our increased expectations of policy rate cuts to be implemented by the RBI as well as on improved relative valuations following a multi-month period of lackluster relative performance of Indian equities versus their EM peer group.

Outside the Asia region, we maintain underweight allocations to Latin America, including Brazil, and EMEA, with the exception of Russia. Our underweight exposure to Brazil these past several weeks has resulted in notable performance detraction during the first half of March, a period in which EM value stocks, particularly those in Brazil, have massively outperformed their EM peer groups. In the case of Brazilian equities, the recent rally owes much to increased prospects of a successful impeachment scenario of President Rousseff. We believe the recent rally in Brazilian asset prices is unsustainable as any successor administration will face an exceedingly challenged macro and financial environment, a scenario not reflected by current equity valuations. Moreover, the recent rally in Brazilian and Russian equities responds significantly to the sharp sell-off experienced by the US Dollar globally these past several weeks as the US Federal Reserve has toned down the hawkish rhetoric leading to this past December 2015 rate hike in the Fed Funds. At present, the US Dollar valuations versus the Euro and Yen stand at odds with value measures (interest rate differentials and relative growth momentum in domestic economic sectors) and technical positioning indicators (CFTC report). Consequently, we continue to believe the US Dollar has yet to undergo at least one additional phase higher to post-2013 high levels. Under such scenario, Brazilian equity prices are likely to come under significant downward pressure relative to their EM peers.

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