GLOVISTA INVESTMENTS

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Monthly Market Newsletter

Glovista Global Perspectives

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Growth and Inflation Expectations Come under Pressure on Data & US Policy Developments; Glovista Sustains US $ Underweight and Defensive Sector Tilts, Raising Duration and Precious Metals Exposures

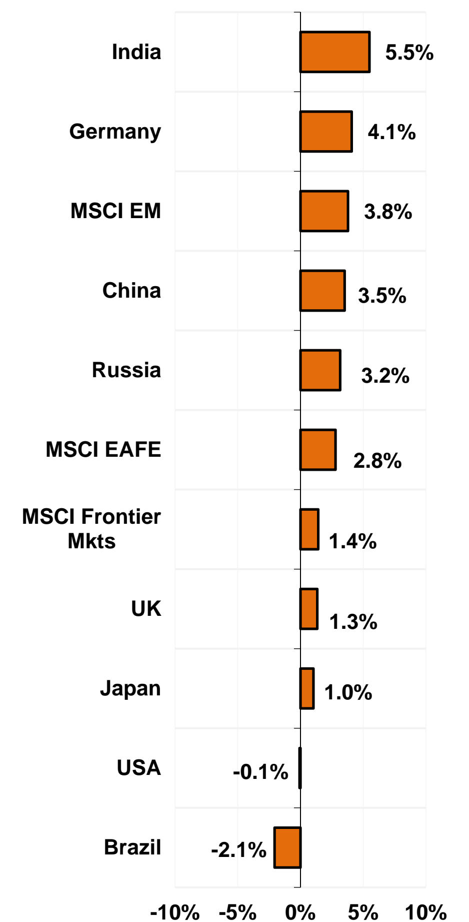
The month of March has brought about a continuation of the 2017 year-to-date global equities' return outperformance of fixed income markets. Notwithstanding this recent outperformance of bond peers, the Glovista investment team believes there is sufficient cause for embracing a defensive overall portfolio stance both at the cross-asset market, sector and duration levels. Such view is predicated on a number of observations including:

- a close examination of the recent meaningful divergence (the largest in several years) between euphoria-type levels reached in business and consumer sentiment indicators (soft data) and underwhelming economic releases (hard data), illustrated in Figure 1 and Figure 2, and;

- notable compositional changes taking place within the global equities domain these past several weeks, whereby defensive sectors (low economic cyclicality) continue to outperform cyclically oriented sectors (with the exception of information technology).

We believe these developments are sufficiently important so as to impact global markets over the coming months. We discuss these dynamics in the balance of this monthly column, outlining how we incorporate such considerations in managing our GTAA portfolios at the asset class, sector and duration levels.

Country-wise Monthly Performance in USD terms (Mar MTD 2017)*



Source: MSCI & Bloomberg

**As of March 29th, 2017*

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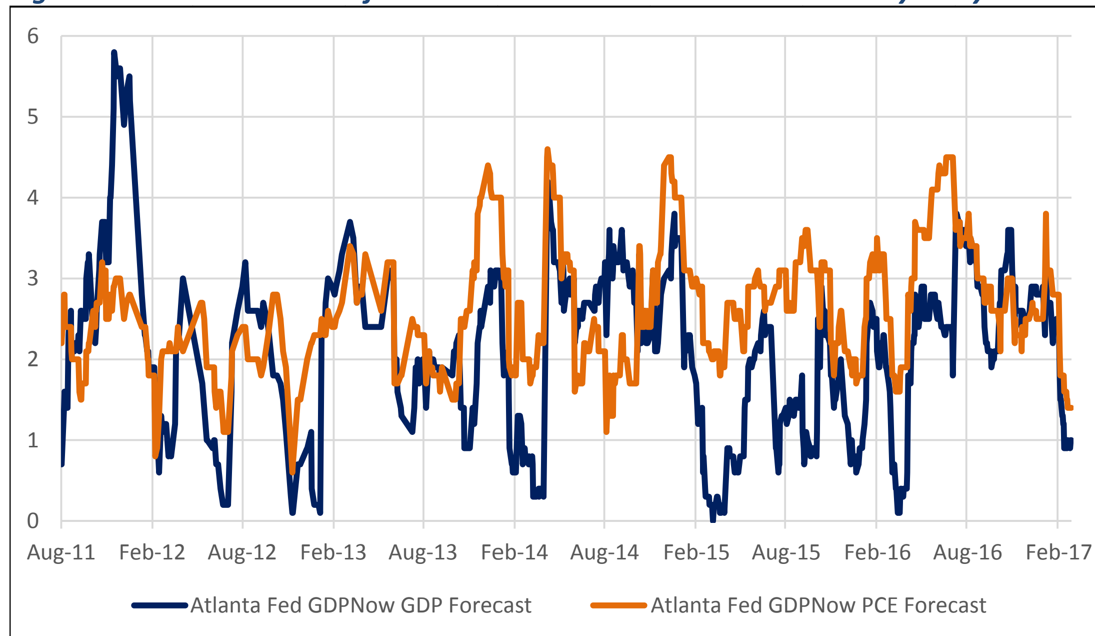
S&P500 Monthly Sector Performance – Mar MTD 2017*

Sectors	% Change	FY1 PE Ratio
Energy	-1.20%	30.0
Materials	0.27%	18.6
Industrials	-1.01%	18.7
Cons Disc	1.60%	19.3
Cons Stap	-0.23%	21.0
Technology	2.46%	18.2
Healthcare	-0.29%	16.2
Financials	-3.38%	14.6
Utilities	-0.13%	18.2
Telecom	-1.14%	13.9
Real Estate	-2.17%	39.8
S&P500	-0.11%	18.3

*As of March 27th, 2017

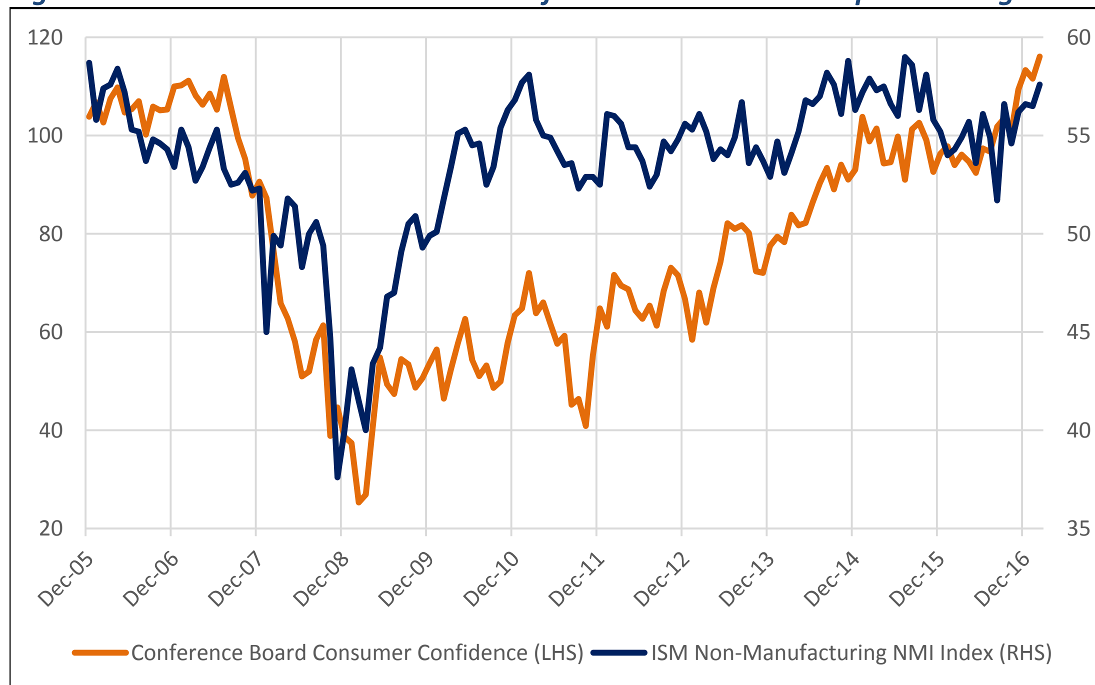
Source: S&P

Figure 1. US Growth and Inflation Momentum Weakens Measurably Early in 2017



Source: Federal Reserve Bank of Atlanta

Figure 2. US Business and Consumer Confidence Levels Reach Euphoric Ranges



Source: Conference Board and Institute for Supply Management

Inflation Expectations Pull Back as US Data Calendar Softens, Crude Prices Decline, China Tightens Financial Conditions and Europe Holds Pivotal Election Calendar

As is well known, price (including inflation) and economic activity dynamics exert first-order effects on major asset prices, cutting across the equities, fixed income, commodities and currency domains. In that vein, it is especially meaningful to note the significant retracement in inflation expectations these past several weeks, as illustrated in Figure 3.

Figure 3. US Inflation Expectations Retrace Much of the Rise Recorded since the US November Elections: 5 year-5 year Forward Inflation Breakeven

Source: Bloomberg

We credit investors' downward revisions to inflation expectations both to the soft US economic releases published over the past several weeks together with the historically important effect crude price changes exert on inflation expectations. As for the latter, the past several weeks have witnessed sharp crude price declines which, if sustained, will result in an accentuation of significant year-on-year percentage price declines over the balance of 2017 – Figure 4.

As for the activity outlook, the rather underwhelming start of 2017 for the US economy - as illustrated in the significant downward revisions of projected Q1 GDP growth to around 1 percent – is of concern on least at two important levels:

- the first quarter has benefitted from the mildest, and therefore most economically favorable, winter weather conditions recorded in many years;

- the first quarter of this year has witnessed the strongest consumer and business confidence ("animal spirits") conditions in many years, courtesy, in part, of the much publicized reflation-economic acceleration agenda favored by the newly elected Trump administration.

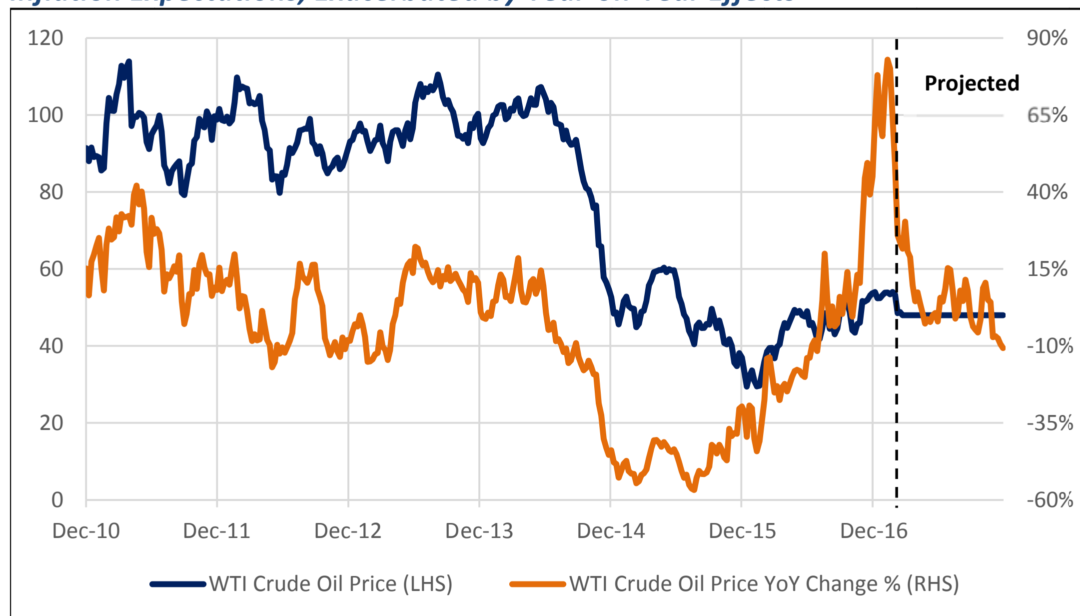
	Mar 29th 2017	Mar MTD Change
Gold	1253.52	0.4%
Silver	18.2455	-0.4%
Oil	49.51	-8.3%
EUR	1.0766	1.8%
JPY	111.04	1.5%
GBP	1.2434	0.4%
CHF	0.9965	0.9%
CAD	1.3326	-0.2%
AUD	0.767	0.2%
BRL	3.1197	0.3%
MXN	17.7068	7.0%

Source: Bloomberg

Rates	Mar 29th Level
1 Yr CD	0.61%
5 Yr CD	1.29%
30 Yr Jumbo Mortgage	4.54%
5/1 Jumbo Mortgage	3.56%
US Govt. 10 Year	2.3765%
10 Yr Swap Spread	-0.0175%

Source: Bloomberg

Figure 4. Recent Crude Price Declines to Exert Meaningful Downward Pressure on Inflation Expectations, Exacerbated by Year-on-Year Effects



Source: Bloomberg

Figure 5. US Commercial and Industrial Loan Growth Deceleration on a Multi-month long Stretch

Source: Federal Reserve

As we ascertain the momentum of the US economy, particularly on the demand sector of the economy, including credit and employment conditions, the picture is one of continued deceleration of economic growth. For example, Figure 5 illustrates the months long deceleration in US commercial bank credit growth to the commercial and industrial sector while Figure 6 illustrates the deceleration in US employment growth, on a year-on-year basis. Likewise, Figure 7 depicts the flat-lining - since the US November elections - in the pace of capex intentions embraced by the small business sector which is the widely projected growth engine for the US economy in the coming years. Finally, Figure 8 illustrates the continued anemic state of real wage growth conditions in the USA. Such a cocktail of economic indicators is not one depicting an economy on the cusp of accelerating at an above trend growth, not unless government policy stimulus is imminent and meaningful in its quantum.

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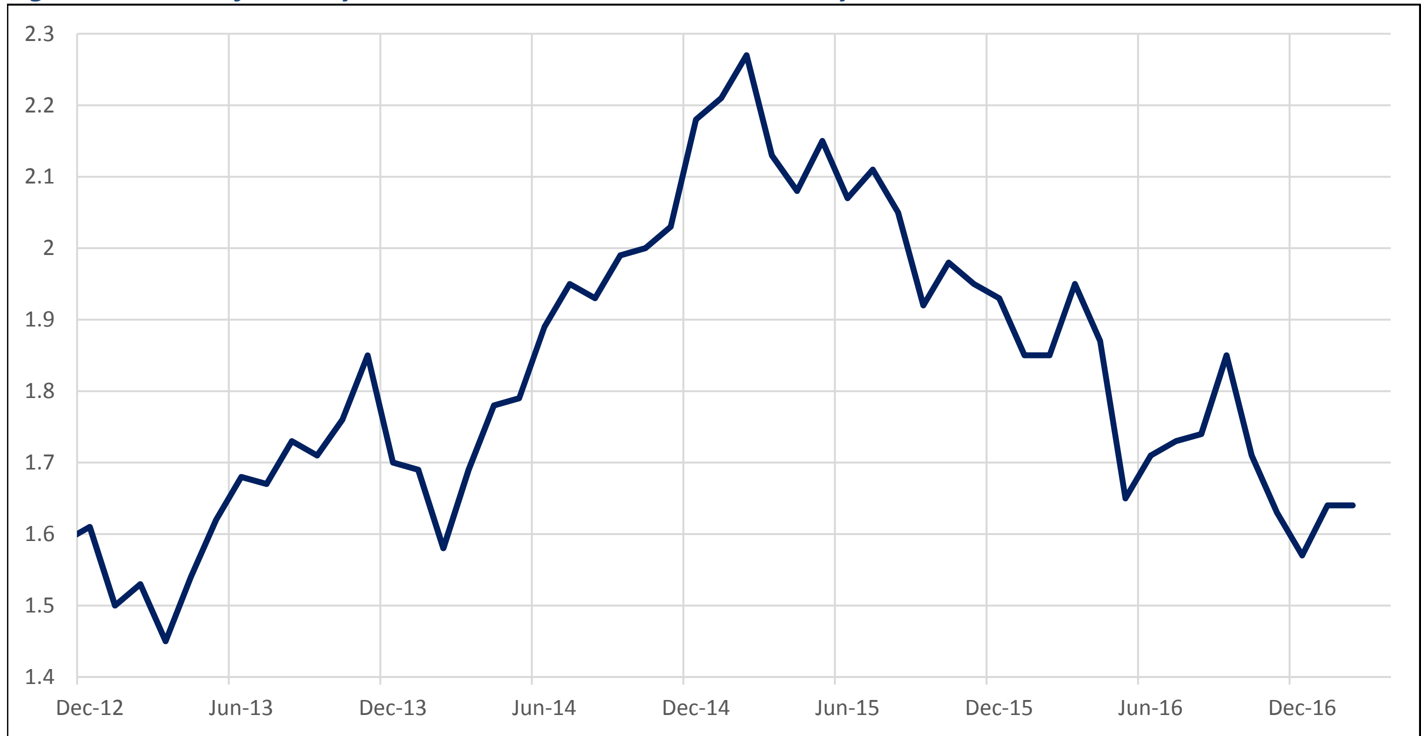
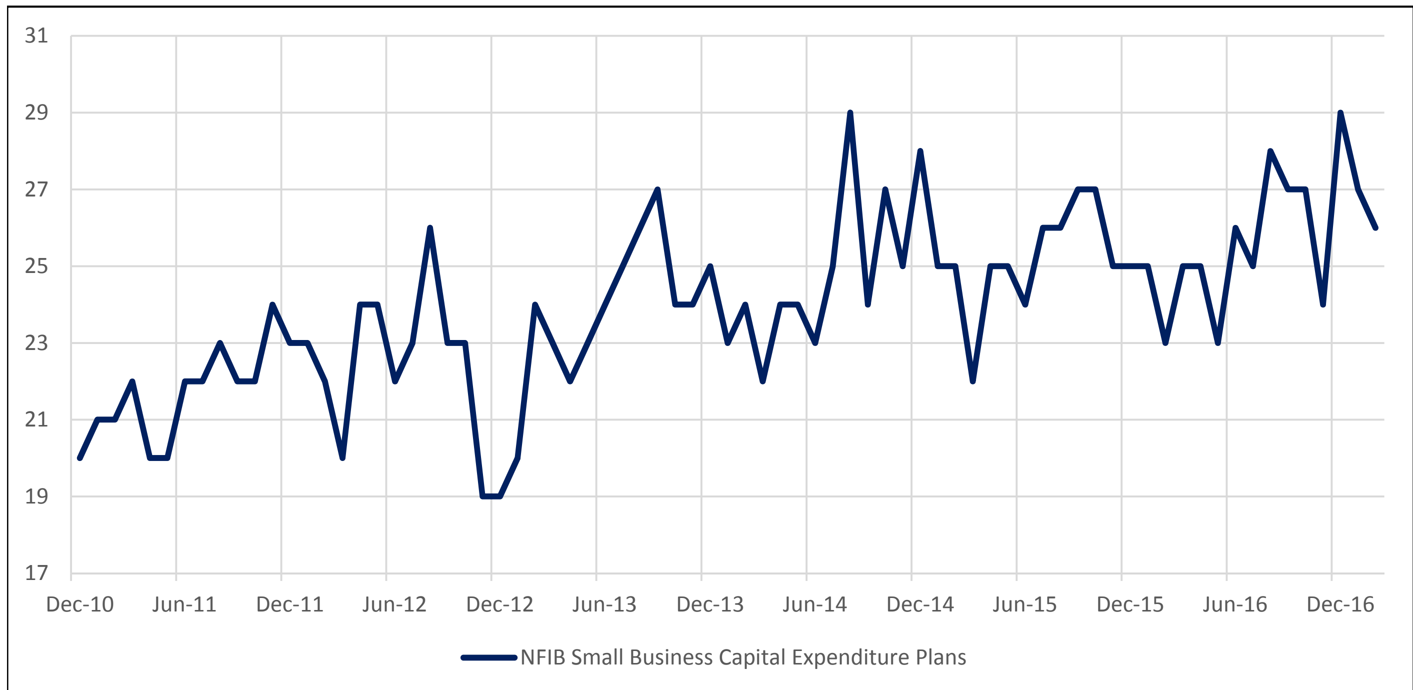
Figure 6. US Non-farm Payroll Growth Rate Decelerates Steadily in 2016 and 2017



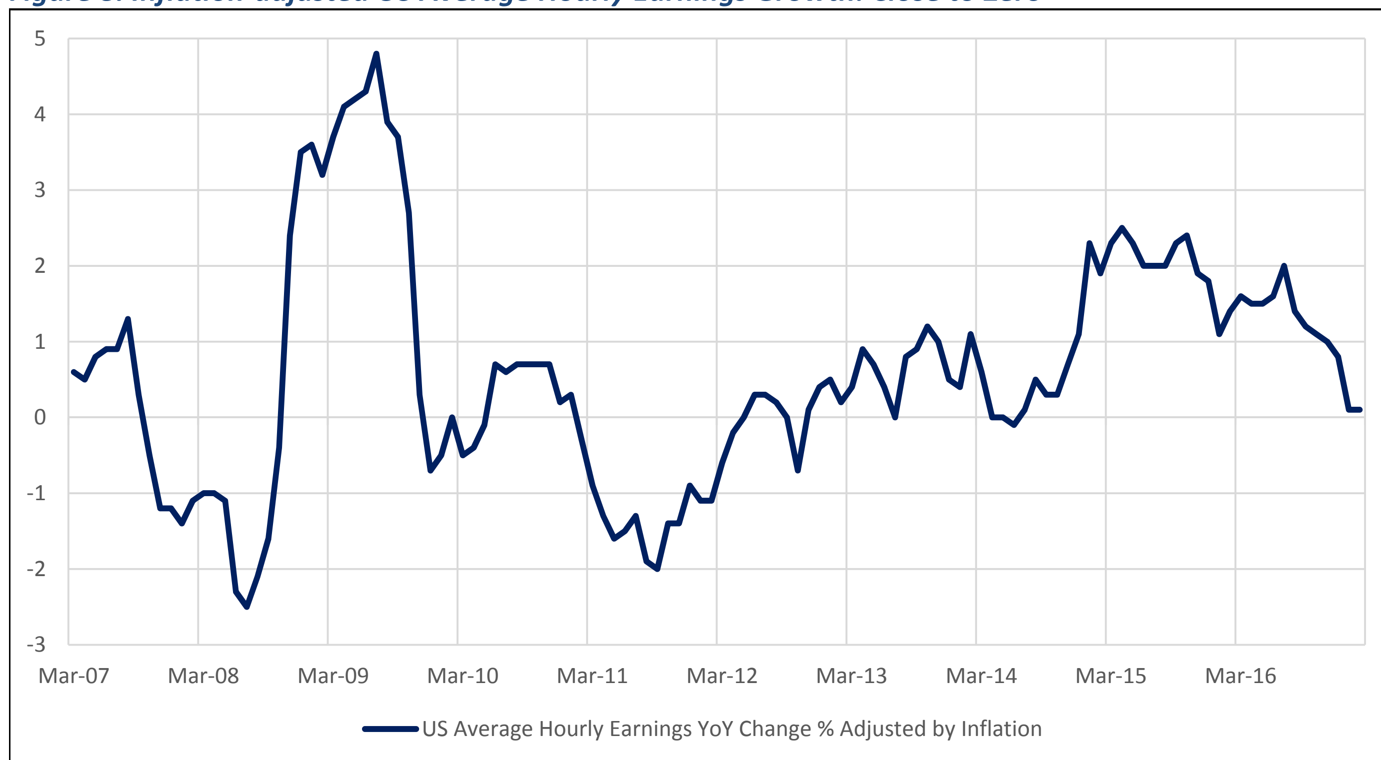
Source: Bureau of Labor Statistics

Figure 7. Despite Sharp Bounce in Confidence Levels, US Small Business Sector's CAPEX Intentions Remain Subdued since US November Elections



Source: Nat'l Fed. of Ind. Business

Figure 8. Inflation-adjusted US Average Hourly Earnings Growth: Close to Zero



Source: Bureau of Labor Statistics

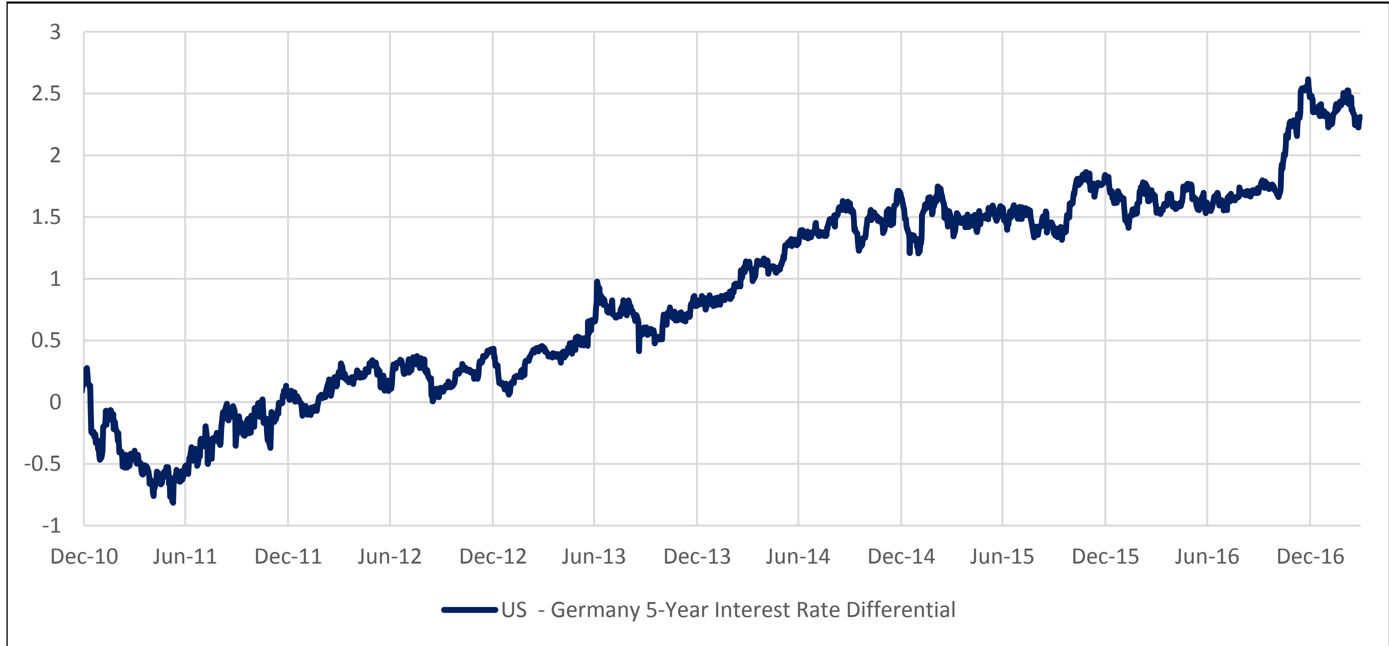
As we look ahead at the pace of US economic momentum in the rest of 2017 and 2018, government policy stimulus – in the form of increased government spending and tax cuts – represents a key source of upside risk. In that regard, the Trump administration and Congressional Republicans' failure, earlier this month, to pass their self-defined key healthcare legislative bill represents an important source of downside risk to the economic outlook. This is because the Trump administration's ability to put forth sizable tax cut legislation through Congress later this year is perceived by political analysts to have been significantly weakened.

Against such weakened US economic outlook, the Chinese economic momentum remains at risk owing to the deceleration of fiscal impulse throughout the economy following the massive fiscal stimulus plan enacted early in 2016. In addition, Chinese financial conditions have been tightened considerably these past several months, including via interest rate hikes, both as a means to forestall continued capital flight as well as a means to bring about a more efficient capital allocation to inefficient pockets of the Chinese industrial sector. Moreover, real interest rates in China had declined to negative levels - an unsustainable development. These dynamics impacting the Chinese economic outlook are of global relevance given China's status as the world's second largest.

As regards the Japanese economy, the world's third largest, economic momentum has remained stable though the recent strengthening of the Japanese Yen versus the US Dollar and other major currencies represents an important source of downside risk to the outlook. This is because of the industrial sector's dominant share of the Japanese economy including its traded sector.

With regard to Europe, the past several weeks have been kind to the core economies including Germany, France and the Netherlands. Labor market conditions, retail sales and confidence indicator releases have come out on the stronger end of consensus estimates. The contrast between solid European economic releases with the underwhelming US economic calendar has helped bring about a powerful breakdown in the US Dollar versus Developed country peers, a scenario we discussed at length in our January column. Such contrast in economic momentum stands at odds with the historically wide spreads in 5 year interest rate differentials between the Eurozone and the US (Figure 9). As European elections in France and Germany come to pass, we expect financial markets increasingly will reprice lower such interest rate differentials between the Eurozone and the US, thereby opening a new leg lower for the US Dollar versus the Euro.

Figure 9. US-German 5 Year Interest Rate Differentials at Multi-year High Levels



Source: Bloomberg

In our view, Emerging Market economies especially those harboring commodity export sectors with moderately robust international financial positions and high real interest rates are likely to outperform in the coming quarters, both economically as well as at the market level.

Of course, risk factors condition the above outlook, most notably those of potentially adverse election outcomes in France and Germany –not our baseline scenario. As has been the case for several years, an Itexit (Italy's exit from the Euro area) event, following snap elections, remains the 'black swan' event to monitor.

Glovista Sustains Defensive Portfolio Stance, Raising Fixed Income Duration and Precious Metals Exposures

Against the changing global macro and policy backdrop discussed above, the Glovista investment team has sustained the defensive portfolio stance in place since the middle of December 2016. However, we have implemented a number of rebalancing actions including the following: (a) cuts in defensive US equity positions, funding increased international equity exposures; (b) raising exposure to precious metals, via the purchase of gold mining stocks; (c) increased duration exposure, including to government and high grade corporate debt paper.

Glovista Emerging Markets Perspectives

EM Equities Extend YTD Outperformance versus DM Peers; Glovista Raises Value Tilts at Expense of N. Asia Exposures

In March, Emerging Market equities have extended their 2017 year-to-date relative outperformance versus Developed Market peers. We reaffirm our longstanding thesis calling for EM equities' continued return outperformance of DM peers well into the next two years. Such thesis is predicated on three principal pillars:

- *Strengthened cyclical momentum on the earnings front:* 2016 was the first year of EM equities' solid EPS growth outperformance of their DM peers since the top in global commodity prices in 2011. As DM economies are far closer to full employment and a tightening of financial conditions, a mirror image backdrop of their EM peers, such important cyclical macro factors are likely to prove a tailwind for further EM equities' EPS momentum while representing a headwind for their DM peers;

- *Relative valuations:* DM equities, especially US equities, are trading at multi-year high valuation multiples, on cycle high earnings points while EM equities are trading either at average or below average valuation multiples on cycle low earnings points. In relative terms, as illustrated in Figure 10, EM equities are trading at close to 12 year low levels versus DM equities peers.

Figure 10. EM Equity Valuations Hover at Multi-year Low Levels versus DM Peers

Source: MSCI, Bloomberg and Glovista Calculations

- *Under-ownership status:* Most investor surveys, together with the monitoring of net asset values of US listed EM equity securities relative to DM securities, point strongly to an outsized under-ownership status of EM equities on the part of both retail and institutional investors, a contrarian bullish condition.

Over the past several weeks we have raised portfolio exposure to Mexico, Thailand, Indonesia, Russia and Chile, fueling those upgrades with cuts in exposure to North Asia markets including China, Korea, Taiwan as well as Poland. These rebalancing actions reflect a number of considerations including: increased bullish outlook towards the Mexican peso, in place for the past several months; increased earnings momentum and attractive relative valuations of Chilean equities; our interest to raise exposure to energy sector plays, particularly via Russia and Thailand country exposures, following the recent sharp crude price declines earlier in the month; the decision to take profits in our previous Poland country strong overweight allocation following the market's strong return outperformance during the first quarter. Within the Chinese equity market, we have continued to shift exposure away from "old China" to "new China" sector plays owing to relative valuations and risk adjusted earnings momentum favoring the latter.

Our decision to cut exposure to other (outside China) North Asia markets, such as Taiwan and Korea, as a means to fund our country upgrades listed above reflects North Asian markets' strong cyclical beta at a juncture in which global PMI indices are hovering at cycle high levels and, as noted in our accompanying *Glovista Global Perspectives* above, a meaningful divergence between soft and hard economic indicators have begun to surface these past several weeks.

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