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# Glovista Global Perspectives

**This Issue:**



## *Risk Markets Bounce on Signs of End to Q1 Economic Soft Patch; US $ Rallies on Rising US-Europe Interest Rate Differentials and Italy Political Risks; Glovista Sustains Overweight Equities Tilt*

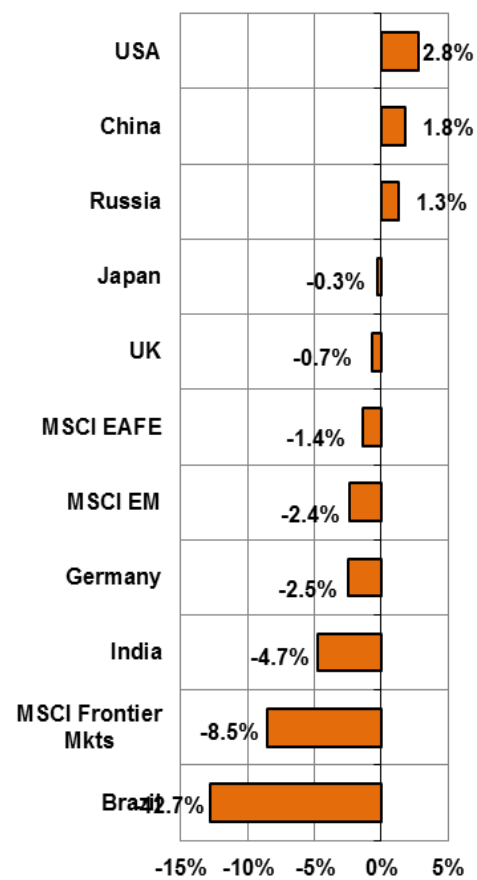
Thus far in May, global equity prices – as represented by the MSCI ACWI index – have recorded modest gains along with a rising US Dollar, rallying energy prices and falling bond prices – the latter two dynamics having reversed themselves late in the month on the back of mounting Italy political risks. Figure 1 illustrates the month-to-date return performance for a number of major asset groups at a global level.

In our view, a close examination of global macro developments offers a clear account of recent cross-asset price dynamics. Specifically, we believe the recent bounce in global equity prices responds primarily to signs of economic re-acceleration at a global level following the recent period of economic softness around the world, along with moderation of wage pressures in the US.

In previous monthly columns, we have attributed much of the weakness in this year's Q1 global macro calendar to transitory factors and calendar effects, including this year's particularly adverse winter conditions in the world's northern hemisphere, the timing of this year's China New Year and sizable inventory correction factors covering the cross-over from Q4 of 2017 into Q1 of 2018. In that regard, recent economic releases have done much to allay investor concerns over the world's economic outlook for the balance of the year. For example, Figure 2 illustrates the recovery in US and Eurozone region economic growth expectations these past several weeks while Figure 3 illustrates the strong bounce in business new orders expectations for the US service sector, the US economy's largest.

In May, investor appetite for equities has also strengthened on the back of (a) a solid Q1 corporate earnings season out of the US, Europe, Japan and emerging markets as well as (b) clear signs of moderation in wage pressures out of the United States, thereby allaying one of investors' longstanding concerns, that of an acceleration in US inflation

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




***Source: MSCI & Bloomberg***

**As of May 25th, 2018*

## S&P500 Monthly Sector Performance – May MTD 2018*

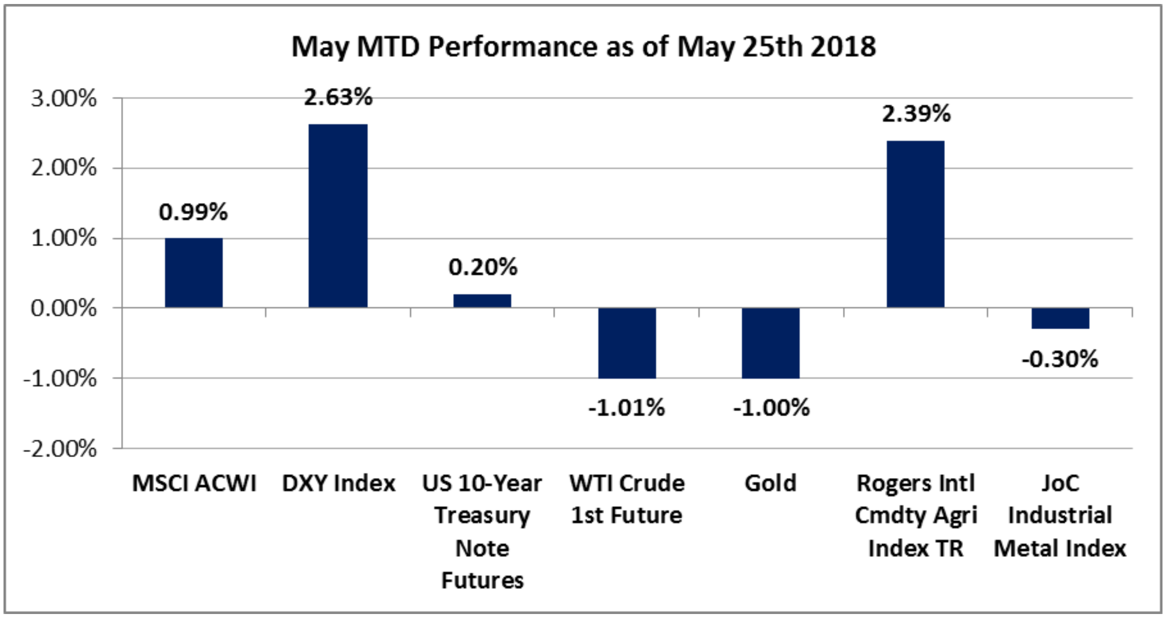
| Sectors | % Change | FY1 PE Ratio |
|---|---|---|
| Energy | 0.59% | 19.5 |
| Materials | 3.45% | 16.6 |
| Industrials | 4.63% | 17.6 |
| Cons Disc | 2.32% | 20.4 |
| Cons Stap | -1.30% | 17.2 |
| Technology | 7.04% | 18.9 |
| Healthcare | 0.77% | 15.5 |
| Financials | 1.29% | 13.4 |
| Utilities | -2.59% | 16.2 |
| Telecom | -1.18% | 10.3 |
| Real Estate | 0.70% | 37.7 |
| S&P500 | 2.77% | 17.1 |

**As of May 25th, 2018*

***Source: Bloomberg***

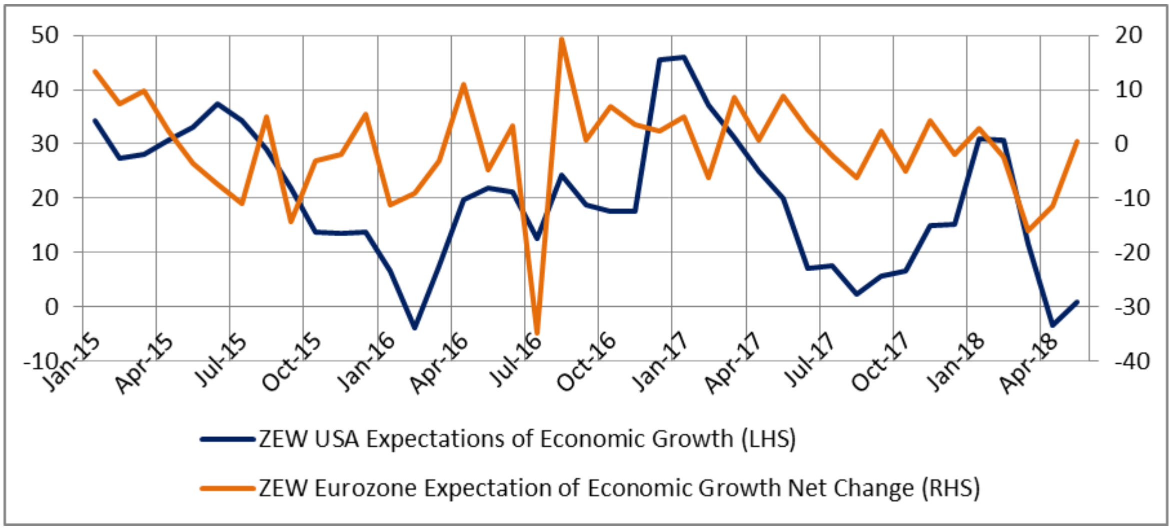
dynamics that could fuel a more restrictive monetary policy stance than is currently discounted in interest rate futures markets. For example, Figure 4 illustrates the recent decline in US average hourly earnings and unit labor costs (both on a year-on-year basis – recent data releases came out lower than expected by the consensus) while Table 1 compiles the magnitude of the beat factor tied to US, European and Japanese corporate earnings and revenues for the first quarter vis-à-vis consensus estimates.

***Figure 1. US Dollar and Equities Post Solid Gains in May***




***Source: Bloomberg***

***Figure 2. US and Eurozone Economic Growth Expectations Stabilize following Recent Period of Economic Softness***



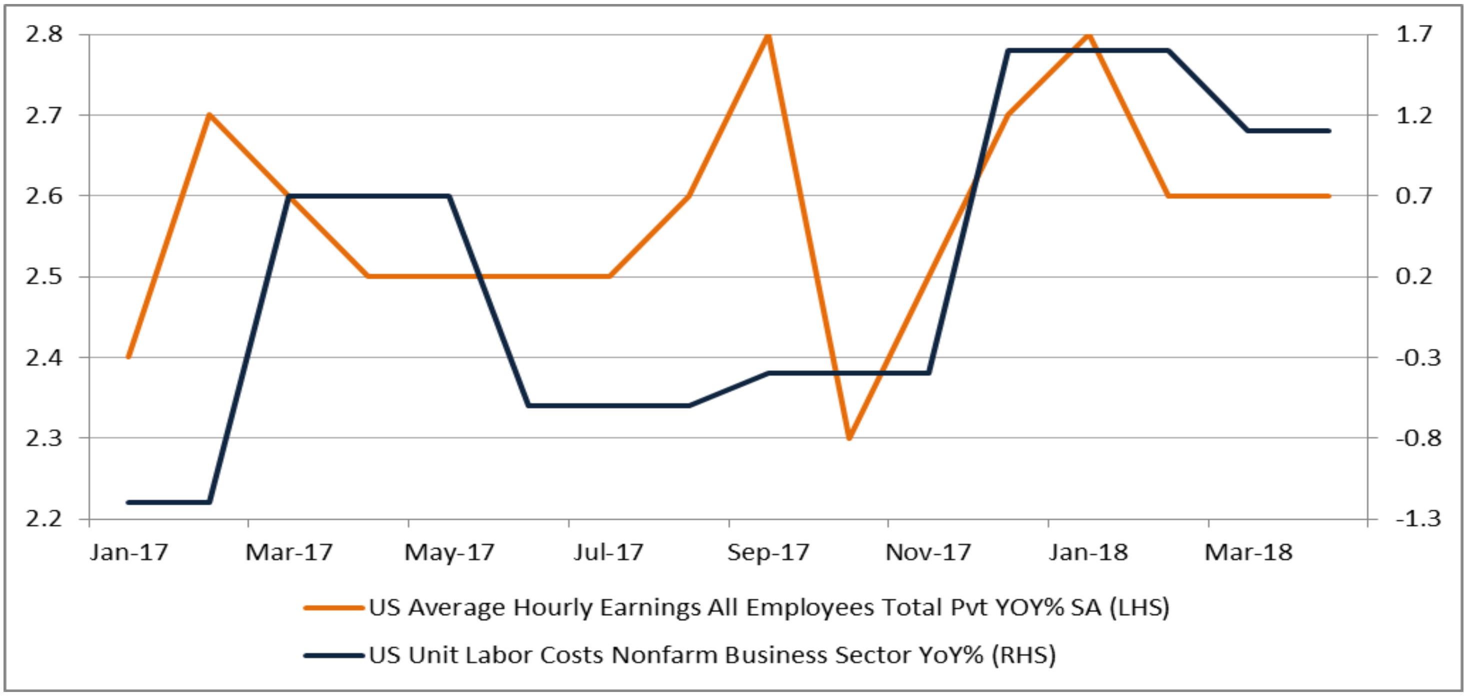

***Source: Zew***

It is reasonable to expect global equities to respond positively to the combination of upside economic and earnings surprises along with an accompanying moderation of wage pressures. Both set of macro developments provide the impetus to upward revisions to earnings estimates along with an expansionary effect on equity valuation multiples.

***Figure 3. US Service Sector Business New Orders Expectations Bounce following Recent Period of Consolidation***


***Source: Institute for Supply Management***

***Figure 4. US Unit Labor Costs and Average Hourly Earnings Momentum Surprise to the Downside, Lending Support to Equity Prices during the Month of May***




***Source: US Bureau of Labor Statistics***

| | May 25th 2018 | May MTD Change |
|---|---|---|
| Gold | 1301.7 | -1.0% |
| Silver | 16.51 | 1.1% |
| Oil | 67.88 | -1.0% |
| EUR | 1.1651 | -3.5% |
| JPY | 109.41 | 0.1% |
| GBP | 1.3309 | -3.3% |
| CHF | 0.991 | 0.0% |
| CAD | 1.2973 | 1.0% |
| AUD | 0.7548 | 0.2% |
| BRL | 3.6536 | 4.2% |
| MXN | 19.5435 | 4.4% |

*Source: Bloomberg*

| Rates | May 25th Level |
|---|---|
| 1 Yr CD | 1.06% |
| 5 Yr CD | 1.71% |
| 30 Yr Jumbo Mortgage | 4.63% |
| 5/1 Jumbo Mortgage | 4.28% |
| US Govt. 10 Year | 2.9313% |
| 10 Yr Swap Spread | 4% |

*Source: Bloomberg*

*Table 1. Global Q1 Corporate Earnings Season Surprises to the Upside.*

| | Q1 EPS | | Q1 Revenue | |
|---|---|---|---|---|
| | Actual YoY Growth | % Surprise vs Consensus | Actual YoY Growth | % Surprise vs Consensus |
| | | | | |
| USA - S&P 500 | 23.53% | 6.86% | 8.08% | 1.14% |
| Euro-Zone - Euro Stoxx 50 | 2.35% | 4.26% | -1.32% | -0.52% |
| Japan - Nikkei 225 | 14.72% | -3.66% | 3.10% | 0.66% |
| UK - FTSE 100 Index | 15.26% | 2.74% | 12.76% | 2.74% |

*Source: Bloomberg*

In our view, the recent bounce in global equity prices these past several weeks has been restrained by the rallying US Dollar and the rise in government bond yields along with mounting Italy political risks that fuel temporary rises in asset risk premium levels globally. We address the rallying US Dollar and rising government bond yield dynamics immediately below along with our assessment of their outlooks as both factors condition the outlook on global equity prices looking ahead to the balance of the year. Given last year's strong mandate in favor of the Euro, voiced last year in election results across much of the Eurozone, we view the current Italy political dynamics as purely a credit event impacting Italian asset prices, a non-systemic development.

## *US $ Bounces on Policy, Political and Geopolitical Events along with Widening US-Europe Rate Differentials; Glovista Expects Resumption of US$ Decline and Stabilization of Long-term US Bond Yields*

Over the past several weeks, the US Dollar has posted a strong bounce versus most of the world's currencies along with rising US Treasury yields. We view these dynamics as interconnected. Moreover, we view these dynamics as correcting in nature as we expect the US Dollar to resume a weakening trend versus most of the strong balance sheet economies in the Eurozone and emerging market countries over the coming months and quarters.

As for the recent bounce in the US Dollar, a dynamic we have been expecting to unfold these past several months and noted in previous monthly columns, we identify a number of policy, political and geopolitical events as driving factors. Specifically, the past several weeks have brought about heightened investor concerns over political risks in Italy, rekindled trade frictions between the USA and China as well as NAFTA neighbors (Canada and Mexico). Furthermore, the elevated interest rate differentials between the US and the Eurozone as well as Japan have resulted in weaker demand for US Treasurys on the part of foreign investors as the costs of foreign exchange hedging of such Treasury purchases have become exceedingly large.  Finally, the technical backdrop facing the US $ has been supportive of a technical bounce these past several months on the back of speculators' large net short US $ positions.

As we look ahead, we expect each of the factors noted above – supportive of the recent US$ bounce - to reverse themselves or diminish in order of importance. Specifically, the following offers the underlying rationale for such view:

- Italy political risks, tied to the Fifth Star-League coalition's efforts at forming a new government later this year – following the coalition's recent failure to do so at this time – represent a credit risk event for Italy as opposed to a dynamic that could set off an Italexit scenario. This view reflects the Italian population's continued support for the Euro and the Euroskeptic coalition parties' (Fifth Star and League) decision earlier this year to embrace a stance in favor of Italy's permanence in the Euro common currency area. In our view, the major significance of a Fifth Star-League government to be shaped later this year centers on the coalition's anti-immigrant political orientation and its focus on loosening fiscal conditions (at the cost of violating Euro area's fiscal guidelines) as a means to boost economic momentum.

- US trade negotiations with China and NAFTA partners are currently at the point of maximum uncertainty, in our view. By most indications, the US will define the status of its trade relationship with China and NAFTA partners over the coming months. In so doing, uncertainty levels should diminish, thereby supporting a more sustainable decline in risk premium levels. Such dynamics, if they materialize, should prove US$ unfriendly.

- The elevated levels of US-Euro area interest rate differentials reflect the European Central Bank's (ECB) lagged response, versus the US FED, in initiating a normalization of policy interest rate levels (especially in inflation adjusted terms) following a number of years of unprecedented monetary loosening, in the form of quantitative easing (QE). To us, it is only a matter of 'when', not 'if', for such interest rate differentials to turn in favor of the Euro currency.

As for our view concerning the potential for additional upside to intermediate and long-term US Treasury yields, we continue to believe that additional upside is rather limited. First, we continue to embrace our longstanding view that long-term fair value levels on the 10 year US Treasury note hovers in the 3- 3.25 percent range as sustainable annualized growth rates (on a combined basis) for labor and productivity lie in the vicinity of 0.75 % to 1.25 % while the FED's longstanding inflation target remains 2%.

Evidently, asset prices do not always trade on top of long-term fair value levels – trading either on the cheap or expensive sides. Given the global economic expansion's continued breadth and strength – despite pockets of weakness in Canada, Australia, the UK and a number of smaller sized economies in the developed and emerging market world – it is possible that Treasury yields trade above long-term fair value in the months to come. However, the additional upside to yields from current levels is small compared to the cumulative rise recorded since the beginning of September 2017.

## *Glovista Sustains Bullish Equities Outlook on Attractive Valuations, Ownership Status, Breadth of Global Economic Expansion and Mild Inflation Pressures*

Despite lingering policy and political risk factors – Italy, Iran, international trade, new FED leadership – we remain constructive towards the equities asset class. We hold such view on the back of valuations, economic momentum and moderate inflation pressures in the USA.

Within global equities, we continue to favor emerging markets, IT software stocks in the US and high quality strong macro balance sheet stocks in the developed world. On the fixed income side, we continue to favor short-duration exposure to high quality US Dollar denominated corporate bonds. Over the past several weeks, we trimmed our international developed equities exposure levels on account of risk management considerations.

## Glovista Emerging Markets Perspectives

# Glovista Reaffirms Bullish Outlook on EM Equities, Viewing Post-March 21 Period of Underperformance versus Developed Peers as an Unusually Attractive Buying Opportunity: Recent Cautious Market Narrative Ignores Strong Macro Resilience of Large EM Equity Benchmark Constituents

Over the past several weeks, Emerging Market (EM) equities have retraced about a third of the massive relative return outperformance recorded versus Developed Market (DM) peers since the generational low levels reached in early January 2016 (Figure E-1). Specifically, since March 21, 2018 the MSCI EM index has underperformed the MSCI World index by 6.79 %.

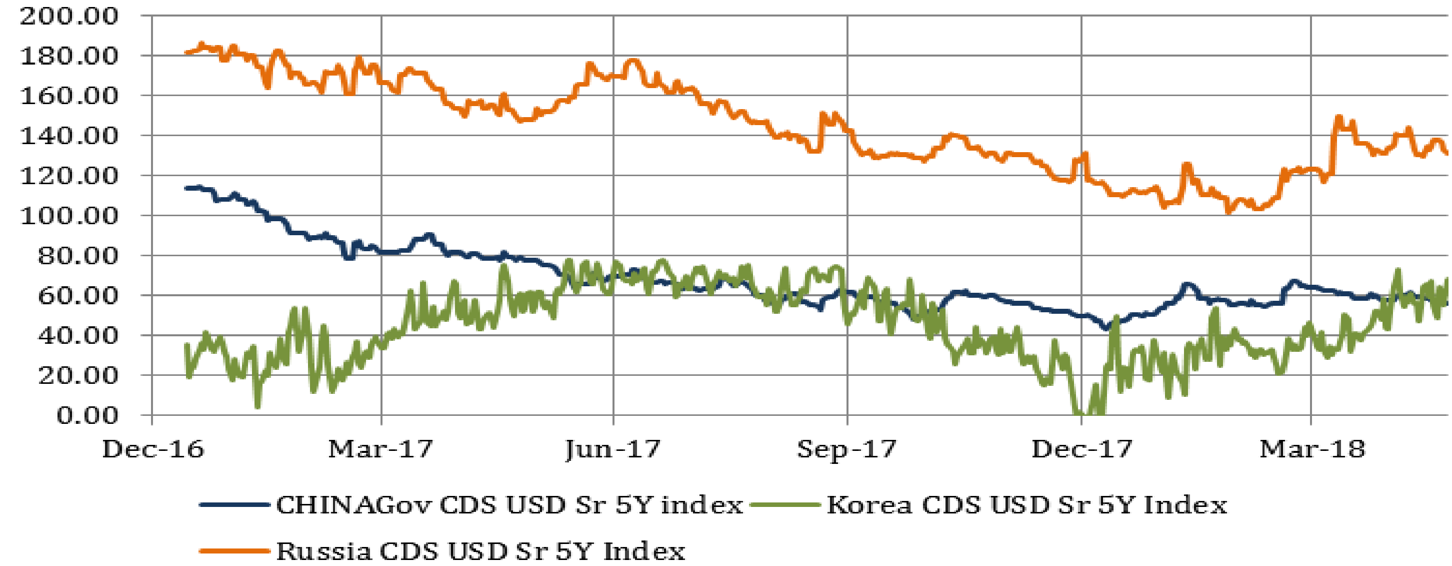
As is widely known, the dictum “narrative follows price” rings true quite generally when reading across most financial media sources. We believe the past few days represents one such example in the form of arguably misguided commentary – from a context and historical perspective –by a number of economists and reporters who have sought to extrapolate recent signs of credit stress in a number of Frontier and small EM countries (e.g. Argentina and Turkey) as symptomatic – or perhaps even a harbinger– of macro and financial mishaps that could unfold in a larger number of EM countries over the coming months.

***Figure E-1. Since March 21, 2018 EM Equities Retrace about a Third of Return Outperformance Posted Versus DM Peers since Early January 2016 Low***


***Source: MSCI and Glovista Calculations***

We believe a cursory look at the country-level configuration of today’s EM equity benchmarks, vastly dominated by strong macro credits such as Taiwan, South Korea and China, leads to a vastly different conclusion. Moreover, when reconciling the recent period of return underperformance for the EM equities with the strength of the fundamentals (at the sovereign credit, cyclical backdrop and absolute as well as Developed Market relative valuation levels) one arrives at the inescapable conclusion that the recent period of underperformance for the asset class represents a compelling buying opportunity.

*Figure E-2. Sovereign CDS Yields for China, Korea and Russia*




***Source: Bloomberg***

We agree with the observation that a number of Frontier (e.g. Argentina) and exceedingly small EM countries (e.g. Turkey) do present considerable fragilities at the macro and financial levels (e.g. outsized current account and fiscal deficits along with heavy short-term external debt service payment calendars) at a juncture in which global financial conditions may be tightening over the coming months, via a continuation in the Federal Reserve policy rate hike cycle. However, even when factoring in future policy rate hikes by the US FED (as reflected in the Eurodollar curve), implied real (inflation adjusted) yields remain exceedingly low on a historical basis (less than 1 percent). Moreover, the pool of EM national economies that display vulnerabilities to even a modest tightening of global financial conditions is a rather limited one. Specifically, such pool of EM countries is limited to a handful of Frontier markets (Argentina along with African countries and former Soviet republics) and small EM countries (e.g. Turkey along with a number of Eastern European countries and smaller ASEAN countries, such as Malaysia) all of which account for only a small percentage of the EM benchmark capitalization (MSCI and FTSE).

It is a fact that the overriding majority of EM countries represented in widely followed equity index benchmarks (e.g. MSCI EM) display exceedingly strong macro balance sheets and balance of payments positions (e.g. current account balances, net international reserve positions) along with a vastly stronger cyclical stance (e.g. ongoing economic expansions) versus prior periods of global financial stress (such as 2008). Furthermore, from a longer-term perspective, previous periods of policy rate hikes in the USA – usually accompanied by a rising US Dollar along with considerably higher real US Dollar interest rate levels – proved detrimental to EM equities on account of the then prevailing sector composition of the EM equity benchmark (e.g. materials/energy sector weightings comprising 31.8% in 2008 versus 13.7% in 2016) as well as then considerably higher levels of US Dollar real interest rates combined with weak current account balances of mostly Latin America country constituents. By way of contrast and clarification, today the combined market capitalization weighting of China, Taiwan, India, Russia and South Korea equities comprise 68.3% of the MSCI EM index. Figure E-2 illustrates the exceedingly resilient and strong macro credits those countries represent in global financial markets, a rather stark contrast with the fragile credit profiles displayed by then (10 to 20 years ago) high capitalization weighed markets such as Argentina, Brazil and Mexico.

In the spirit of delving further on the credit-worthiness issue permeating the EM universe of 2018, it is relevant to focus not only on credit strength but also on the potential for liquidity-driven stress periods. In that regard, the scheduled debt service payment obligations for the EM universe, between May of this year and the end of 2019, is estimated at around $250 billion, of which China accounts for close to US$ 100 billion with Brazil and Mexico accounting for around US$ 25 billion each. We are confident in stating that China's ability and willingness to service such external debt service obligations is exceedingly strong, not only on account of the size of the country's international reserve position (in excess of US$ 3 trillion) but also the government authorities' ample arsenal of policy tools (fiscal, monetary and commercial) they are able to avail themselves of in responding to a hypothetical high stress scenario at the global level. Insofar as Brazil and Mexico is concerned, both economies' cyclical positions (e.g. balance of payments) are exceedingly strong with Brazil posting a balanced current account position (e.g. 0.5% of GDP deficit) and Mexico running a small deficit of around 1.5% of GDP. Of the US$ 100 billion that remains for the overall pool of EM external debt service payment obligations through the end of 2019, Argentina (a Frontier Market) accounts for US$ 20 billion. Consequently, it follows – purely on account of the numbers – that the external debt service sums facing EM countries that populate the EM equity index benchmarks, through the end of 2019 is not going to be a source of liquidity driven stress.

Against what amounts to a 'blue sky' macro backdrop facing EM sovereign credits, as represented in the EM equity benchmarks, an observer would rightly question the driving factors behind the post-March 21 period of return underperformance recorded by EM equities versus developed peers. In our view, three factors account for the recent period of relative return underperformance, including:

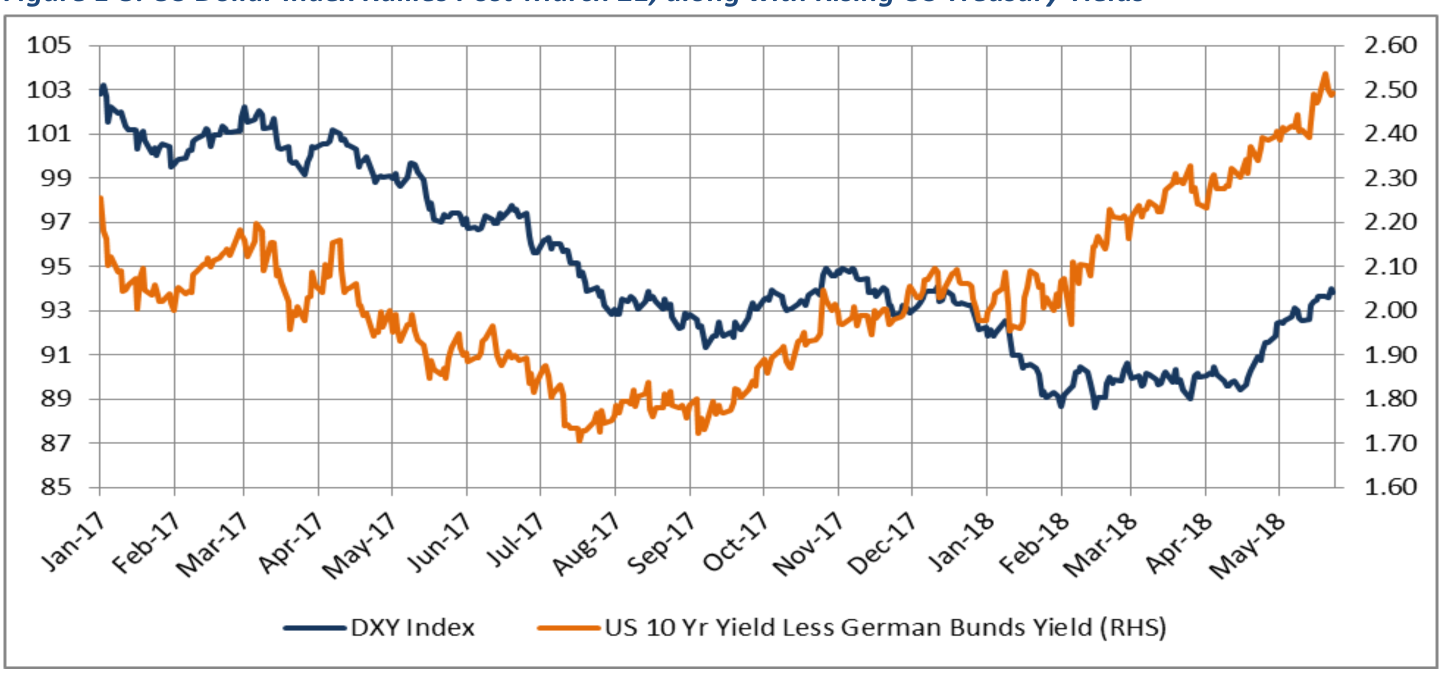
1. Counter-trend rally in the US Dollar (Figure E-3)

2. Back-up in US Treasury yields, with the 10-year Treasury yield piercing the 3 percent level and Eurodollar yields approaching the so-called FED dots

3. Positioning unwind on the part of 'fast-money' investors, including Hedge Funds as those investor types sought to protect unrealized profits on long EM short Developed equity pair trades.

4. Chinese IT stocks' sell-off in sympathy with global social media stocks which sold off starting on March 15 on the back of privacy concerns involving Facebook, Google and other global IT leaders (Figure E-4).

***Figure E-3. US Dollar Index Rallies Post-March 21, along with Rising US Treasury Yields***

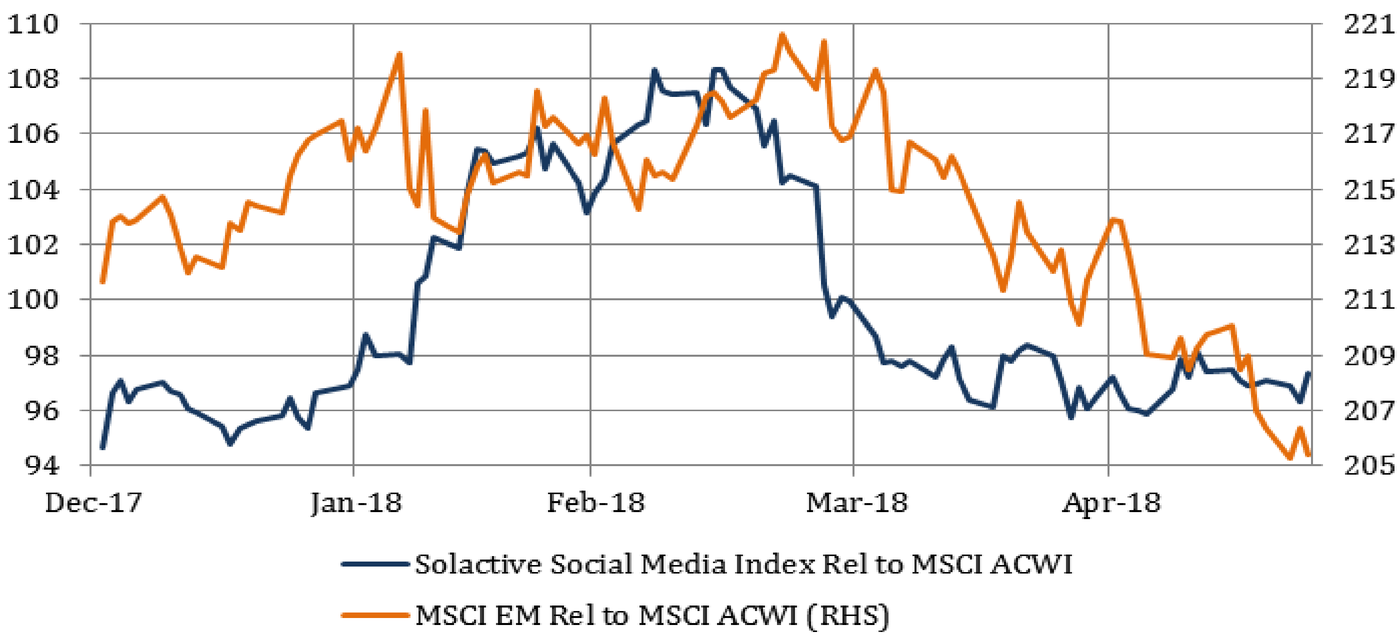



***Source: Bloomberg***

As we have discussed in recent Glovista monthly newsletter columns, we have been expecting the US Dollar to post a counter-trend rally these past several months only to be followed by a resumption of the US Dollar bear cycle that was initiated early in 2017. Our expectation for a resumption of the US Dollar bear trend reflects the aging of the US economic expansion in comparison to the nascent economic expansion in the Eurozone and much of EM countries, following the 2011-2016 period of economic stagnation blanketing the Eurozone and EM blocs – a period of stagnation that was driven by a then overly tight ECB monetary policy stance, existentialist Euro currency concerns tied to local political dynamics that have been resolved in a market friendly manner throughout 2017 and the commodity bear market and domestic economic rebalancing that much of the EM national economies went through during such five year period.

Over the past several weeks, bellwether IT corporates in EM (including Alibaba and Tencent) have reported exceedingly strong earnings and revenue figures along with robust guidance for the coming quarters. Consequently, we view the recent period of price weakness in the sector – derived predominantly by sentiment tied to the sell-off of major US peers on the back of privacy concerns - as a buying opportunity.

***Figure E-4. March 21st Start-date of EM Equities' Price Correction Followed Global Social Media Stocks' Price Declines Set Off on March 15th***



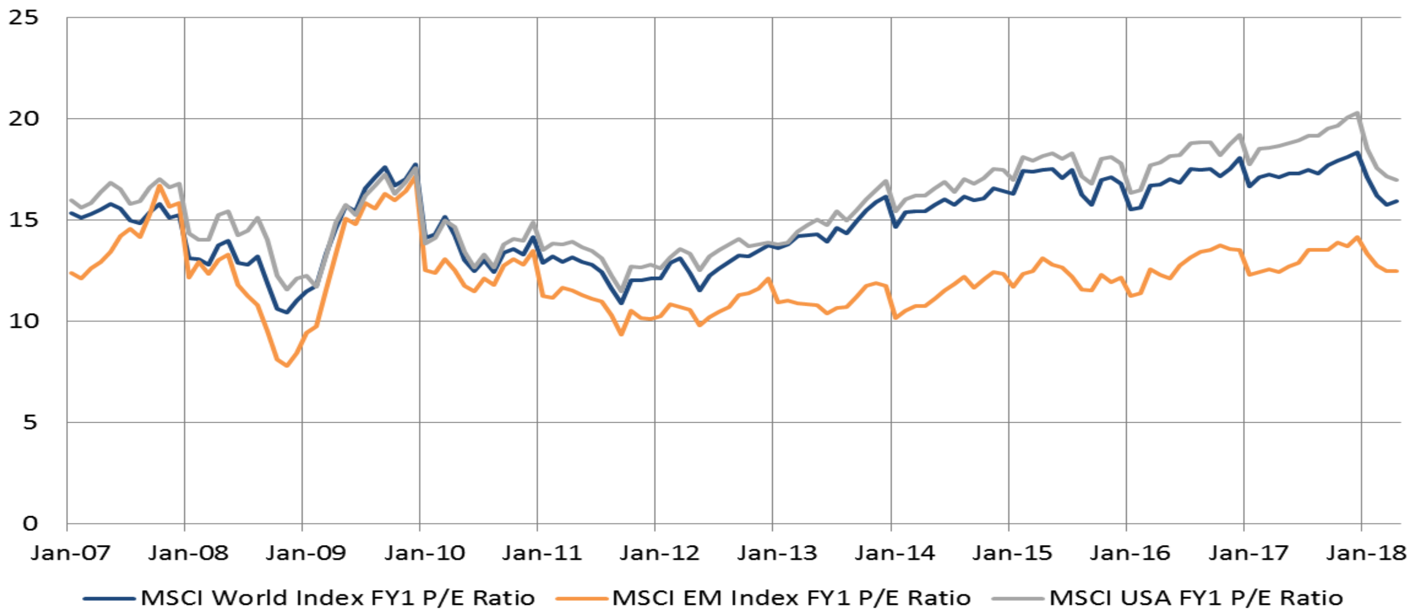

***Source: Bloomberg***

Finally, we address immediately below the compelling investment case for global asset allocators to take advantage of the recent period of relative underperformance for EM equities versus Developed peers in raising exposure to the EM asset class:

- **Valuation:** Following the recent period of return underperformance, EM equity valuations hover at close to multi-year low levels versus US and EAFE peers

- **EM corporates' stronger and more visible earnings growth outlook than those of DM peers:** In our view, EM corporates command a markedly more favorable 2018 & 2019 earnings growth outlook than their DM peers on several considerations, including: (a) EM economies' stronger top-line growth than DM peers' following years of below trend growth across EM economies, covering the 2010-2016 period and (b) EM corporates' high and strengthening profit margin levels looking into 2018, owing to EM economies' higher levels of slack versus DM peers whose economies display tight labor market conditions

***Figure E-5. EM Equities' FY1 P/CE Valuations versus US and EAFE Peers***




***Source: Bloomberg***

- **EM equities' under-owned status**, particularly on the part of US institutional investors. While US institutional investors have remained underweight EM equities, local investors in large EM countries, including India and China, have been sizable buyers of their local equity market shares.

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