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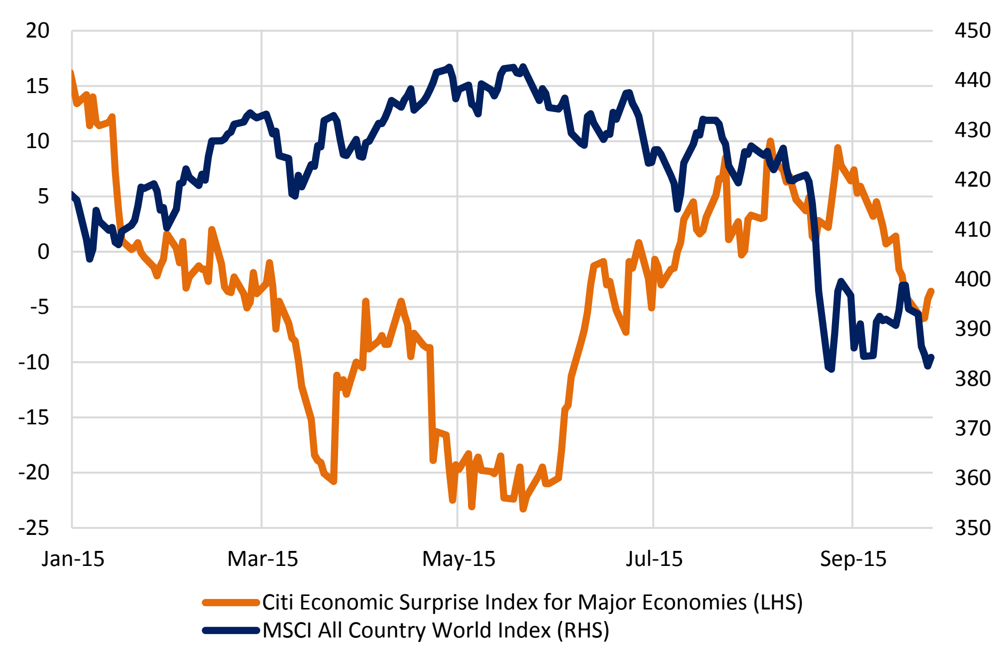
Glovista Global Perspectives

This Issue:

Risk Markets Rally Sharply on Improved China Macro Calendar and Reduced Risks of FED Policy Mistake following Marked Softening of US Employment Conditions

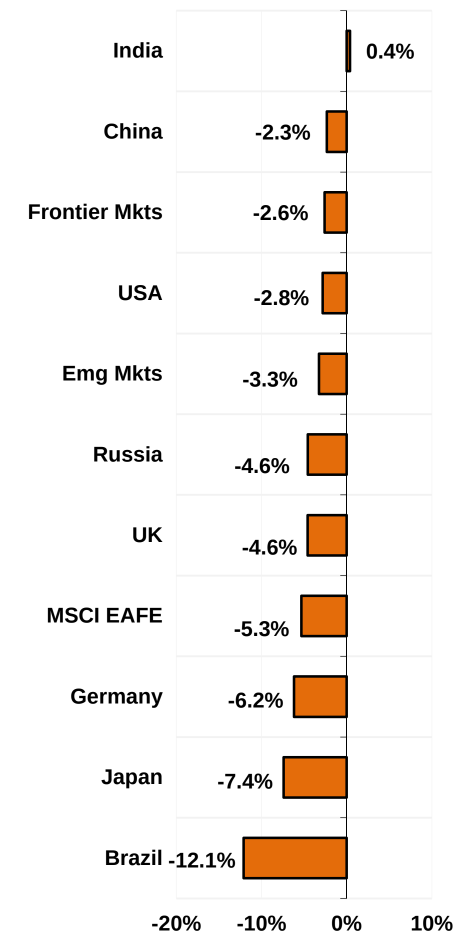
In our September column, we attributed the sharp sell-off in risk markets that unfolded between the middle of August and the end of September of this year to the escalation of investor concerns over the global economic outlook (Figure 1). In particular, we identified two specific macro dynamics as underlying investor concerns:

Figure 1. August-September Sell-off in Risk Markets Fueled by Downside Revisions to World Economic Outlook: (January1st 2015 – September 25th 2015)



Source: Citigroup Global Markets and MSCI

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



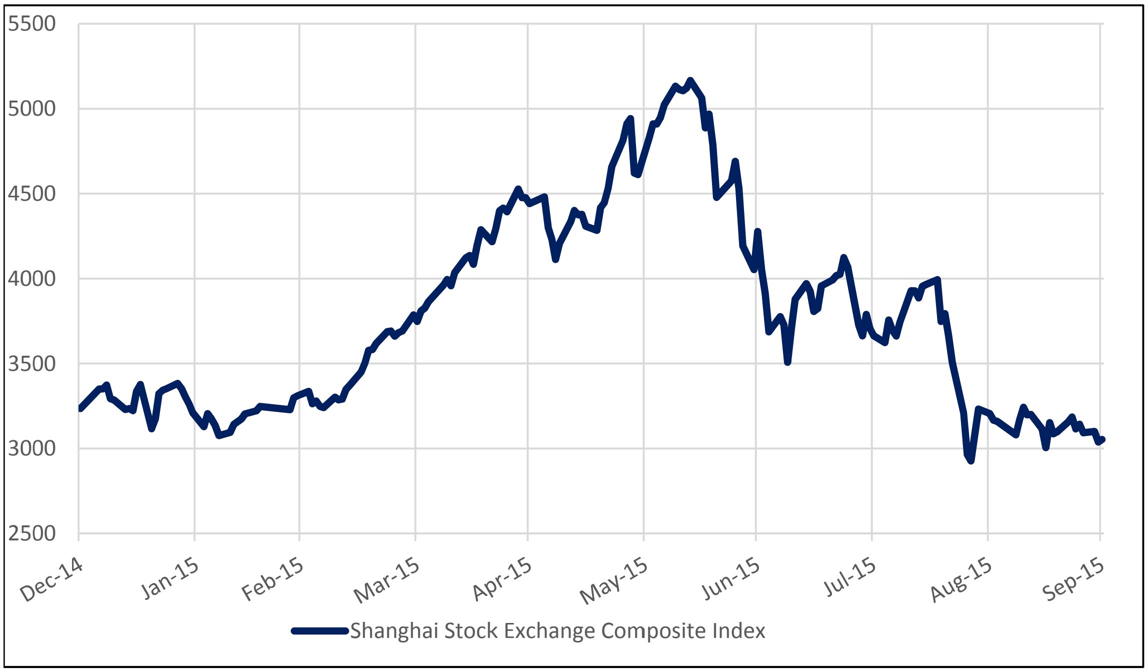
Source: MSCI & Bloomberg

S&P500 Monthly Sector Performance – September 2015		
Sectors	% Change	FY1 PE Ratio
Energy	-6.79%	25.7
Materials	-7.62%	15.0
Industrials	-2.02%	15.0
Cons Disc	-0.79%	19.3
Cons Stap	0.13%	19.5
Technology	-1.05%	15.7
Healthcare	-5.83%	16.2
Financials	-3.17%	13.5
Utilities	2.59%	16.0
Telecom	-3.70%	12.0
S&P500	-2.64%	16.3

Source: S&P

- ***risk of further deceleration in China's economic momentum***, along with the global economic repercussions resulting from such scenario. Such investor concern stemmed from the then steady softening of Chinese economic indicators, including house price data, as well as the likely deflationary implications resulting from the collapse in Chinese equity prices that obtained through September month-end (Figure 2). That China's economic calendar weakened further throughout July and August was of particular significance to the investor community given that considerable monetary and financial policy stimulus was implemented by Chinese authorities since earlier in the year;

Figure 2. China Equity Price Declines into Late September as Amplifying Factor behind Investor Concerns over Further China Economic Deceleration



Source: Bloomberg

- ***risk of a significant monetary policy mistake in the form of the US Federal Reserve, the world's largest central bank, raising its reference policy rate (Federal Funds rate) extemporaneously***. Such investor concerns derived from the higher pitched commentary emanating from Fed governors at important scheduled speeches over the past few months at which senior Fed officials spoke of their institution's growing inclination to raise the Federal Funds rate later this year. Such commentary was at odds with the view espoused by the average institutional investor who remains concerned over the pace of deceleration in world nominal GDP growth, the ongoing pace of commodity price declines, and the persistently high leverage levels around the world at a time in which core inflation remains well below target for all of the world's major economic regions. In that context, a Fed policy mistake scenario would be perceived to be of first-order consequence to the global market outlook owing to multiple considerations, including:

- ***adverse earnings effect on US large cap stocks resulting from a further US Dollar strength*** given US large cap stocks' substantial foreign revenue and earnings shares, upwards of 40 percent each. US equities' dominant share of world market capitalization (at close to 50 percent) implies such adverse dynamics would carry global implications at the market level;

- ***adverse effect on US corporate profit margins,*** as a result of: (a) the higher financial costs faced by corporate issuers following an increase in the (policy) interest rate; (b) increased (spread) financial costs on debt issuers owing to the increased risk premium levels that would likely result in a scenario in which the Fed were perceived to raise the policy rate extemporaneously, and; (c) adverse effects on financials' interest margin should the interest rate curve flatten beyond the quantum already discounted in forwards, a likely scenario should market participants view a rate hike as a policy mistake (curve inversion);

- ***adverse economic growth effect resulting from the spike in financial and macro volatility*** that would accompany an extemporaneous Fed interest rate hike. Market volatility would spike in such scenario as a result of the increased uncertainty surrounding the future path of policy rates, entailing the potential for a succession of (arguably also extemporaneous) policy rate hikes in the months following the first rate hike (likely to be this December). A spike in financial volatility amounts to a further tightening of global financial conditions, a troubling proposition, at a juncture in which a number of foreign economies are under recessionary phases (e.g. Canada, Brazil, Russia, among others). In turn, such state of affairs implies the escalation of probability for recession scenarios in the USA and other major economies.

Against the backdrop delineated above and discussed at length in our September column, Glovista kept overall equities exposure at close to zero across most of our separately managed global tactical asset allocation portfolios, a stance we maintained throughout much of August and September. As discussed at length in the balance of this monthly commentary, on October 2nd we lifted our cautious portfolio stance by raising our overall equities exposure from close to zero to around 50 percent following the release of horrific September US employment numbers and a succession of economic releases out of China that signaled a notable moderation in the pace of deceleration of economic activity. In short, starting on October 2nd we implemented material rebalancing actions across asset classes in our global tactical asset allocation strategy by raising overall exposure to equities and credit at the expense of cash levels and government fixed income. We have maintained such overall asset class exposures throughout much of October, through the date of publication of this column. In our concluding section, we discuss at length our favored sector exposures within equities and fixed income asset classes at the global level.

Upturn in China's Economic Calendar Together with Overly Weak September US Jobs Report Soothe Investor Concerns, Fueling a Compression in Risk Premium and Spike in Asset Prices

Starting around the September 30th date, with the release of several stronger than expected readings for China manufacturing and service sector sentiment diffusion indices, global markets began to stabilize as one of the principal macro factors anchoring investor concerns began to abate. It is not a coincidence that US equity volatility peaked around that date (Figure 3).

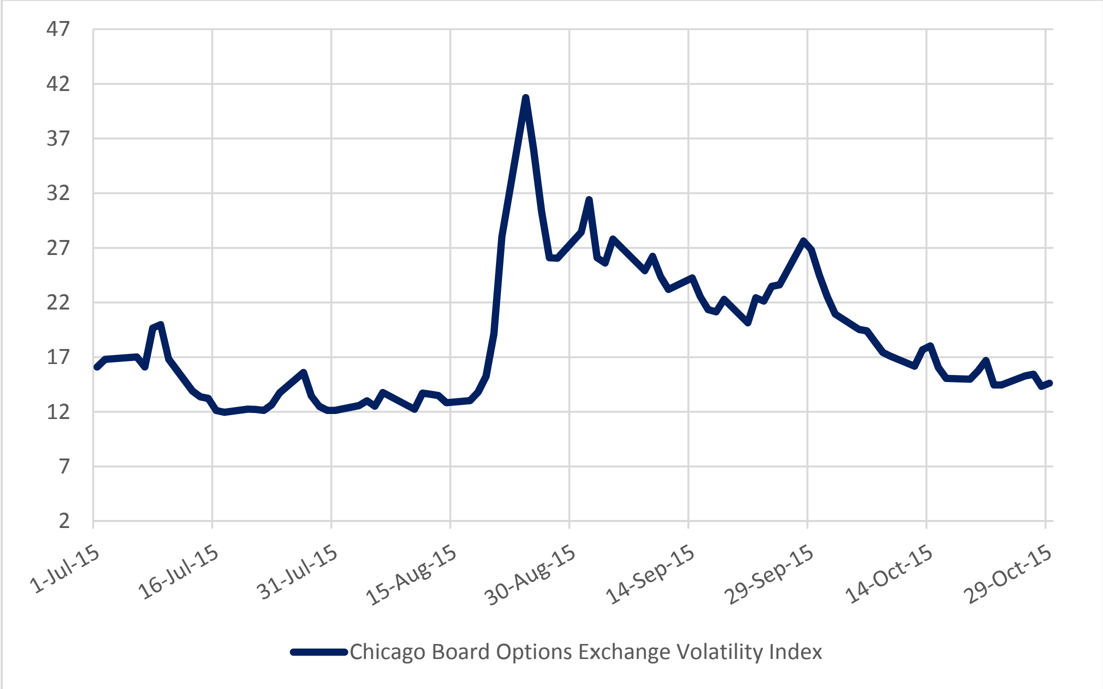
	September 2015	September Change
Gold	1115.07	-1.7%
Silver	14.519	-0.7%
Oil	45.09	-8.4%
EUR	1.1177	-0.3%
JPY	119.88	1.1%
GBP	1.5128	-1.4%
CHF	0.9733	-0.6%
CAD	1.3313	-1.3%
AUD	0.7018	-1.3%
BRL	3.9475	-9.0%
MXN	16.9177	-1.0%

Source: Bloomberg

Rates	September 30th Level
1 Yr CD	0.61%
5 Yr CD	1.47%
30 Yr Jumbo Mortgage	4.21%
5/1 Jumbo Mortgage	3.62%
US Govt. 10 Year	2.04%
10 Yr Swap Spread	-0.035%

Source: Bloomberg

Figure 3. US Equity Volatility Levels Topped Out Shortly Before the Release of Major China Goods and Service Sector Indicators on September 30

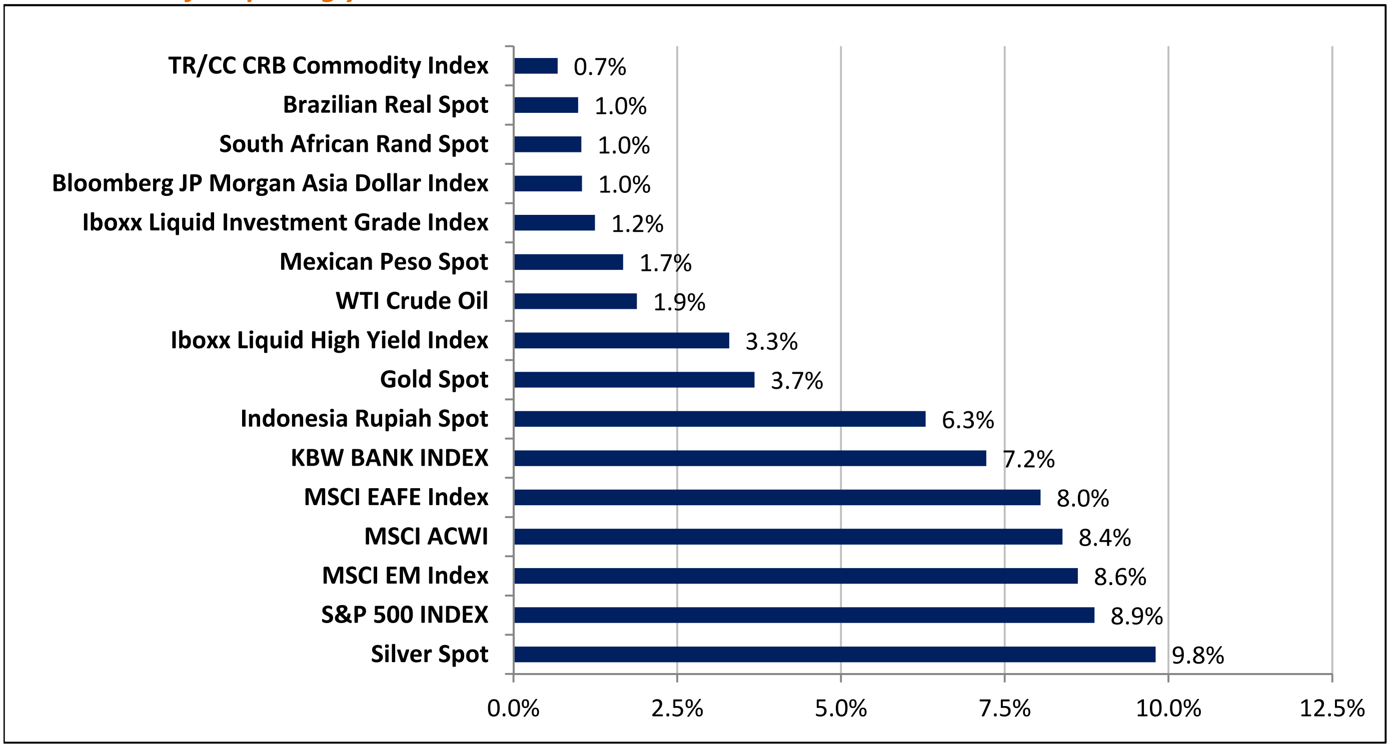


Source: Bloomberg

The decline in risk premium levels that followed the release of stronger than expected China economic indicators, extended sharply in the period following the October 2nd release of a considerably weaker than expected September US employment report. Specifically, September's US employment report entailed the generation of only 118 thousand jobs versus a consensus estimate of 197 thousand jobs. In addition, the August private sector payrolls figure was downwardly revised from an initial 140 thousand jobs to 100 thousand jobs. Moreover, other elements of the employment report signaled an undisputed softening in labor market conditions, including a lower than expected average hourly earnings figure and a reduction in labor force participation.

From a market perspective, the release of a horrifically soft September US jobs report was so weak as to be market friendly to risk assets inasmuch as the softening of US labor market conditions resulted in a sudden unmistakable downsizing of investor expectations surrounding the prospects, timing and quantum of Fed policy rate hikes for the balance of this year and next. In the process, the October 2nd release of US jobs data marked the inception of a sharp sustained rise in equity and credit asset prices, as illustrated in Figure 4.

Figure 4. Risk Markets Rise Sharply as Expectations Decline over FED Rate Hike Prospects Following October 2nd Release of Surprisingly Weak US Jobs Data



Source: Bloomberg

Reduced Downside Risks to Global Growth Lead Glovista to Raise Equities Exposure Sharply, With a Non-US Focus, While Sustaining Bullish US Dollar Outlook

The last few days of September and first few days of October brought about an unmistakable lifting of the two principal risk factors anchoring our then prevailing cautious investment outlook. In the process, we speedily rebalanced our managed portfolios through the purchase of equities exposure on October 2nd and October 5th from around zero percent to close to 50 percent allocation. Within global equities, we favor Eurozone, Japanese, a selection of US large cap and regional bank sector indices together with a selection of Emerging Market country indices. Within global equities, we hold an underweight US, overweight non-US equities exposure.

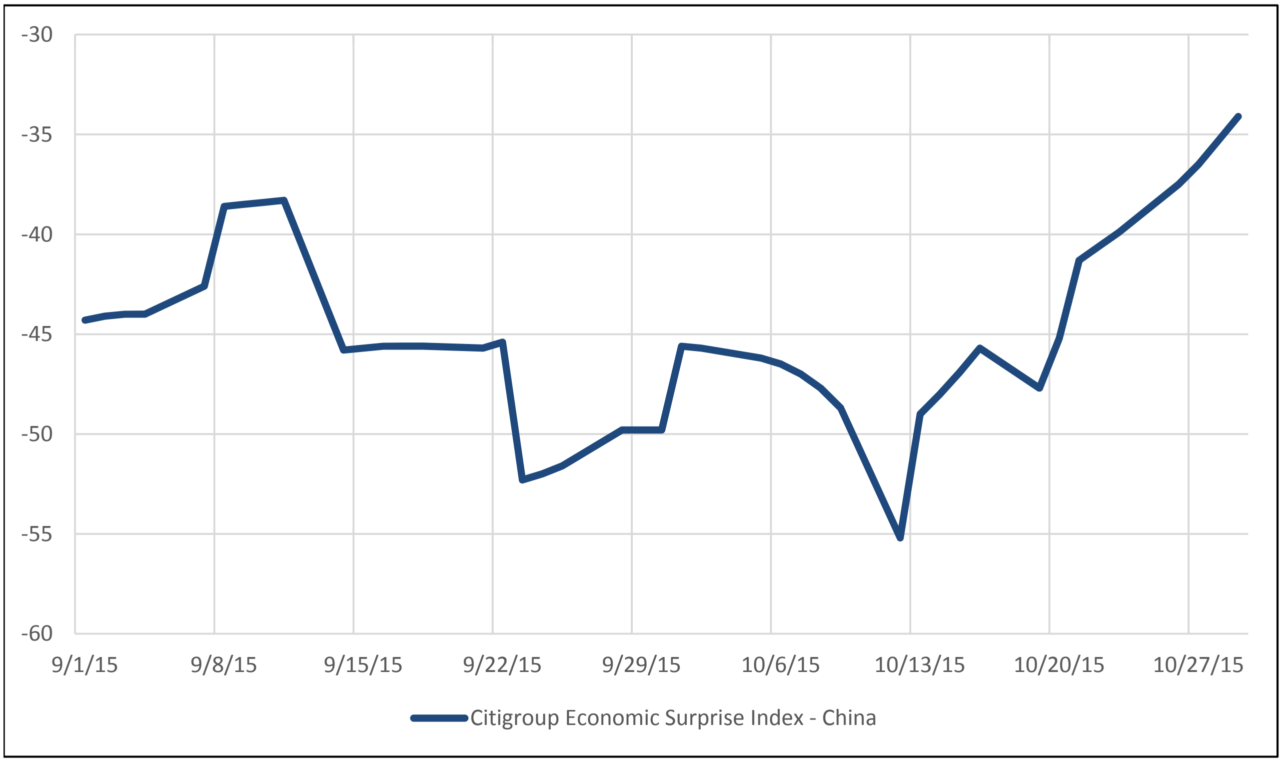
In fixed income, we are underweight duration, favoring short- and intermediate-duration exposure to US Dollar denominated debt instruments, especially US non-energy sector high yield on valuation considerations. We maintain a bullish US Dollar outlook based on our continued premise that US monetary policy is likely to prove the first to undergo tightening among the developed economies. Moreover, the ongoing market-driven tightening of global financial conditions, fueled by global and country-level deleveraging considerations, are unambiguously US Dollar bullish. Finally, within the commodities sector we continue to favor selected exposure to precious metals, particularly through exposure to mining stocks.

Emerging Markets Perspectives

EM Equities Post Strong October Outperformance versus EAFE Peers as China Economic Calendar Strengthens and Risk of Protracted Fed Policy Rate Hike Scenario Declines

The global macro and policy backdrop facing risk markets globally, of which Emerging Markets is one of the most cyclically oriented segments, has improved markedly since the very end of September. Specifically, since September 28th not only have risks of a sharp economic deceleration in China abated meaningfully (Figure 5) but so too have risks of a Fed policy mistake unfolding in the form of a policy rate hike that would set off a succession of multiple rate hikes throughout 2016.

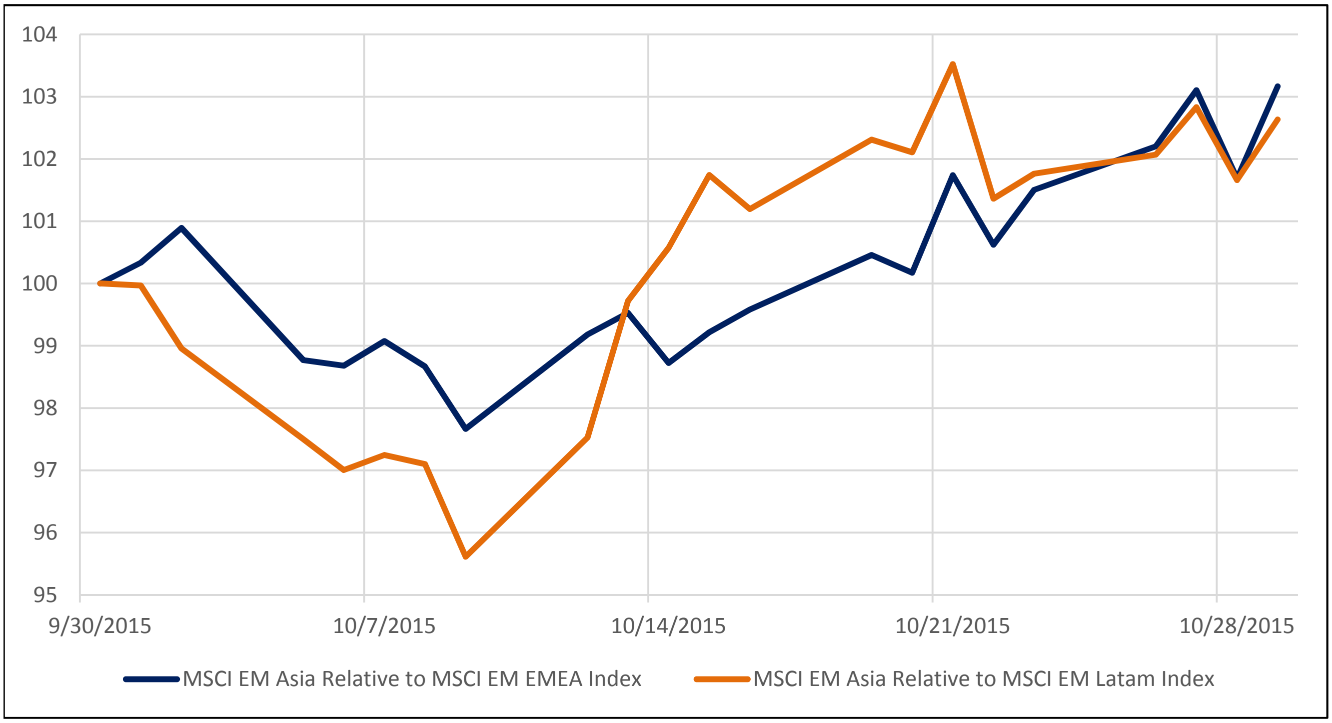
Figure 5. China's Economic Surprise Indicator Bounces Strongly from September Month-End Levels



Source: Citigroup Global Markets

Against a backdrop of mitigated downside risks to global economic growth and lessened prospects of a policy mistake by the US Federal Reserve, it is not surprising that over the course of October (a) risk markets have rallied sharply, including equities, credit, commodities and cyclically oriented currencies, and (b) Emerging Market equities, as a cyclically oriented segment of global markets, have posted solid return outperformance versus Developed Market peers.

Figure 6. EM Asia Equities Post Solid October Month-to-date Outperformance of Latam and EMEA Peers despite Latin America/EMEA Currencies Sharper Revaluation versus US Dollar during the Period

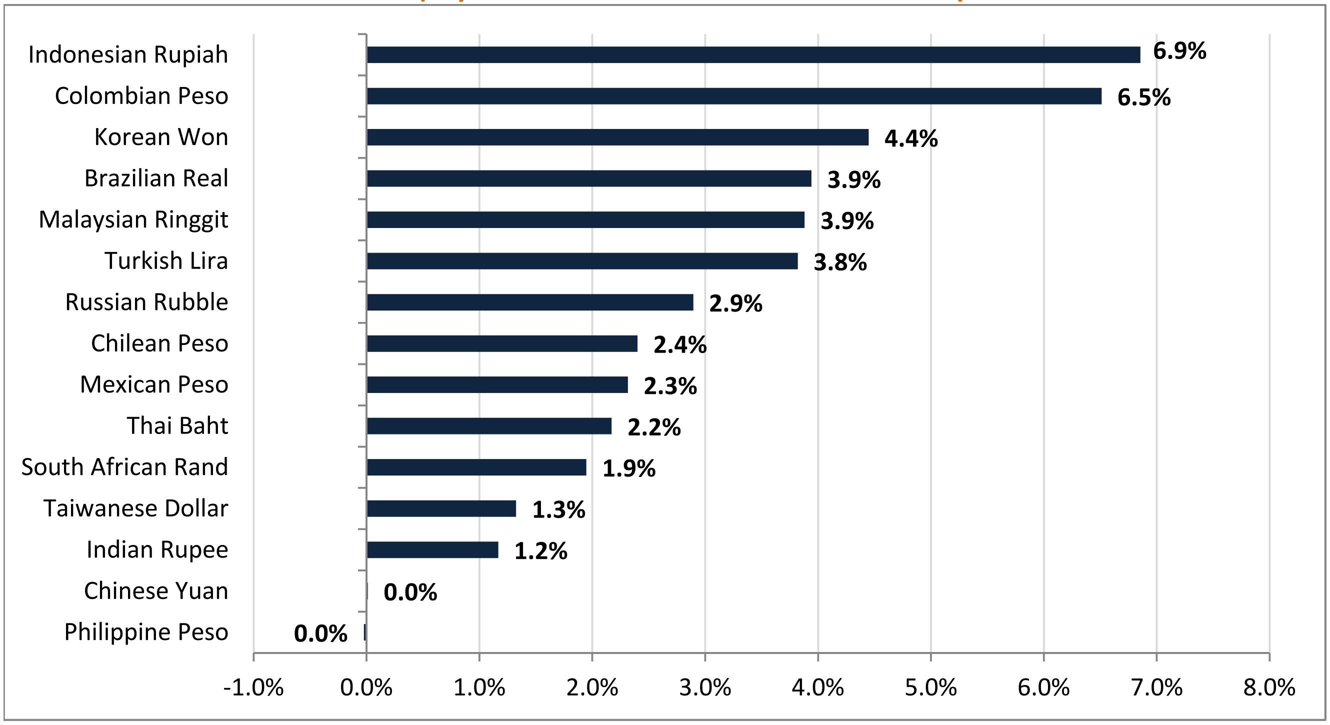


Source: MSCI and Glovista Calculations

Notwithstanding EM equities' relative return outperformance of Developed Market peers these past several weeks, our investment team continues to embrace the thesis that prospective EM equity market performance leadership is likely to remain driven by country factors as (a) we continue to expect the US Dollar bull phase to play out to a final conclusion (at least to 104 level in the DXY index), and (b) a number of EM countries still need to work off domestic macro and financial sector imbalances, particularly commodity export-oriented countries.

We believe the October month-to-date intra-EM return performance dynamics – especially EM Asia outperformance of Latin America/EMEA peers - is rather illustrative and confirming of our thesis (Figure 6). Specifically, it is unusual for EM Asia equities to outperform EMEA and Latin America peers during time periods, even brief ones such as the last five weeks, during which risk premium levels globally have compressed sharply and during which EMEA and Latin America currencies have revalued most sharply versus the US Dollar (Figure 7). We believe such statistical 'divergence' provides a powerful indication of EM Asia equities' superior earnings and revenue growth potential as well as relative valuation appeal at the currency and credit levels versus EMEA and Latin America peers.

Figure 7. EM Currencies Strengthen Sharply versus US Dollar since end of September, led by Latin America and EMEA Currencies: (September 29th 2015- October28th 2015)



Source: Bloomberg

Given the above considerations, over the past several weeks we have rebalanced our country exposures by raising overall regional exposure to Emerging Asia at the expense of EMEA and Latin America. Specifically, our strongest overweight country tilts center around exposure to the (a) Chinese consumer and technology sector given the sector's high visibility, attractive valuations and balance sheet strength, (b) Korean equities, on a currency hedged basis, (c) Chilean equities, given attractive stock valuations, strengthening revenue growth, cheap currency valuation, and (d) Selective frontier markets, especially Vietnam. Conversely, our most significant underweight allocations comprise (a) the ASEAN region, given stretched relative valuations, (b) Latin America, particularly Brazil given a challenging economic and policy environment together with unimpressive valuations, and (c) EMEA, given Middle Eastern markets' large exposure to the domestic economy at a challenging stage in the local business cycle for the region due to the continued decline in energy commodity prices, and South Africa, given unimpressive relative valuations and a challenging domestic economic and policy environment.

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