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GLOVISTA INVESTMENTS

Glovista Global Perspectives

This Issue:

Asset Prices Decline Sharply on Risk Premium Spike tied to Concerns over Peak Earnings, Reduced FED/ECB Liquidity, Italy Debt Contagion and Crude Price Softness; Glovista Cuts Stocks Exposure Sharply Early in October on Risk Management Protocols

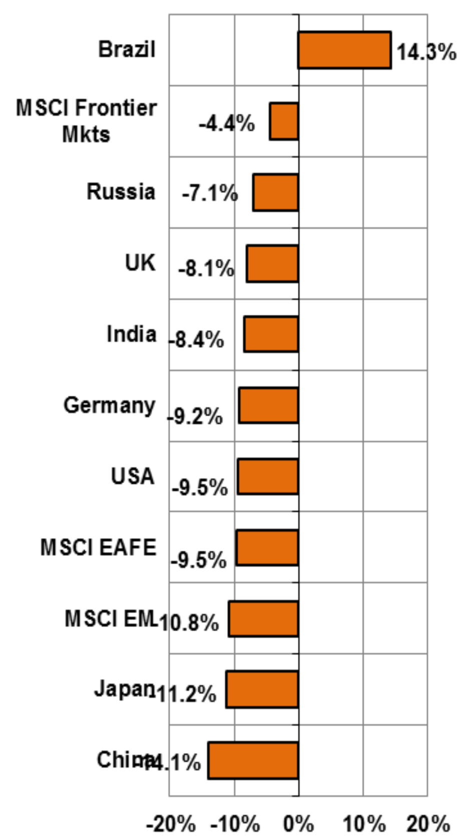
In October, risk indices globally have recorded among the largest monthly performance declines in six years (Figure 1 and Figure 2). In contrast with February of this year, we do not believe this month's sell-off to have been driven predominantly by technical factors (such as the volatility exposure imbalances that prevailed early in February as bond equity correlations reversed suddenly and sharply) but rather by a succession of fundamental developments resulting in a sharp spike higher in risk premium levels.

Further below, we outline multiple factors underlying October's large sell-off in risk markets; as a result, risk premium levels have risen across asset categories including equities and credit. In our view, some of those developments are tied to policy dynamics whose final resolution is uncertain with regards to their timeline. As such, early in October our analysis led us to the conclusion that such developments carried the potential for exerting undue downward price pressure across risk asset categories. Consequently, early in the month, we significantly reduced our portfolios' overall exposure to risk asset categories including equities and credit. Such prompt reduction in risk asset exposures have resulted in a considerably smaller drawdown in our managed portfolios' net asset value from what would have obtained under a passive approach.

In our view, some of the developments fueling this month's sharp sell-off in risk assets include the following:

- Heightened investor concerns that unfolded early in the month over peak earnings as semi-conductor companies (widely viewed as early cycle stocks) posted considerably softer than expected earnings and sales guidance for 2019 (Figure 3).

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



Source: MSCI & Bloomberg

**As of October 29th, 2018*

S&P500 Monthly Sector Performance – October MTD 2018*

Sectors	% Change	FY1 PE Ratio
Energy	-13.83%	16.8
Materials	-12.66%	13.9
Industrials	-13.33%	15.5
Cons Disc	-13.81%	20.0
Cons Stap	1.02%	18.7
Technology	-11.22%	16.5
Healthcare	-7.98%	16.2
Financials	-7.69%	12.1
Utilities	2.79%	17.6
Telecom	-10.19%	16.2
Real Estate	-2.01%	36.2
S&P500	-9.36%	16.2

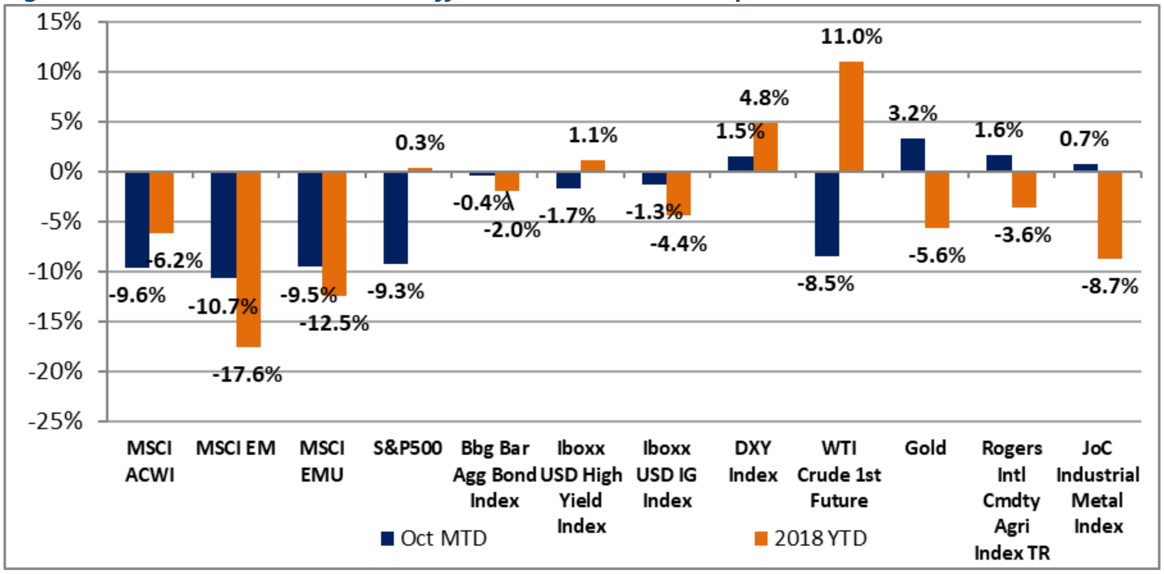
**As of October 29th, 2018*

Source: Bloomberg

Figure 1. October Equity Volatility Spikes to Highest Levels since March

Source: Bloomberg

Figure 2. Generalized October Sell-off Across Risk Asset Groups



Source: Bloomberg & Glovista Calculations

Escalation of investor concerns over a potential Itexit (Italy's exit from the Euro currency area) scenario over the medium-term as early in October the new Italian government submitted to the European Commission a 2019 budget that vastly exceeded deficit limits. Such dynamic laid in motion a potential unprecedented clash between Italy and Brussels. That Italy's debt market is the world's third largest renders a rescue scenario for the Italian public sector a much more challenging proposition than what obtained with Greece earlier this decade. Moreover, global investor concerns were further heightened by the timing of the current Italian debt crisis in light of the European Central Bank's (ECB) commitment to trim considerably its asset purchase program (including the purchase of Italian public debt instruments) starting in the second quarter of 2019. As a result of these considerations, investor concerns have led to a massive spike in Italian government yields, setting in motion a vicious cycle of low confidence towards the Italian public debt market (Figure 4). In the process, several of the major rating agencies have cut Italy's sovereign credit debt rating, raising the specter of a cut to junk status. Such developments have exerted an adverse effect across the Eurozone banking system as a number of large Eurozone banks hold considerable levels of Italian public debt.

Figure 3. Semi-conductor Stock Prices Sell Off Sharply Early in October, carrying Market-wide Concerns over the Potential that Q3 Marks Peak Earnings for the Cycle

Source: Bloomberg

Figure 4. Rekindled Italy Debt Sustainability Concerns Fuel Spike in Yields, Setting Off Vicious Cycle of Confidence and Concerns over Itexit Scenario

Source: Bloomberg

- Investor concerns over the medium-term world economic growth outlook as semi-conductor stocks, one of the more reliable indicators of leading economic conditions, sold off sharply early in October. The sharp sell-off in semi-conductor stocks resulted from highly adverse revenue growth guidance for 2019 out of some of the leading names in the sector such as Micron Technologies, AMD and Texas Instruments.

	October 29th 2018	October MTD Change
Gold	1229.39	3.1%
Silver	14.4575	-1.6%
Oil	67.04	-8.5%
EUR	1.1373	-2.0%
JPY	112.37	-1.2%
GBP	1.2793	-1.8%
CHF	1.0019	2.1%
CAD	1.3134	1.8%
AUD	0.7055	-2.3%
BRL	3.7199	-8.2%
MXN	20.062	7.2%

Source: Bloomberg

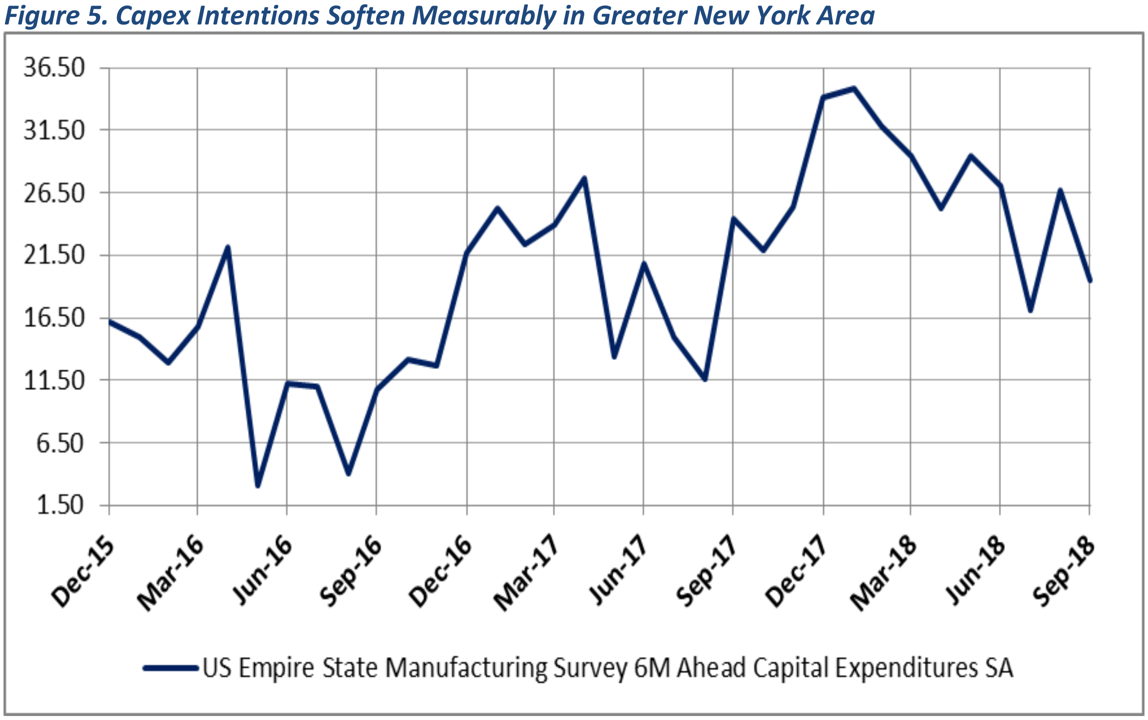
Rates	October 29th Level
1 Yr CD	1.33%
5 Yr CD	1.91%
30 Yr Jumbo Mortgage	4.77%
5/1 Jumbo Mortgage	4.15%
US Govt. 10 Year	3.0849%
10 Yr Swap Spread	6.51%

Source: Bloomberg

- Investor concerns over the potential for the corporate earnings cycle to have reached a peak phase as the softening in semi-conductor stocks coincides with a softening in US business and consumer confidence indicators. Such concerns, raise questions over the so-called "American economic growth exceptionalism" registered this year. For example, Figure 5 illustrates the continued decline in capex intentions out of regions as large as the Greater New York area. Said concerns over the robustness of the US economic outlook in 2019 effectively unleashed a de-rating of US asset prices, including the sudden compression in US equity valuation in October.

- The timing of October's weakening in cyclical economic indicators and rise in systemic risk premium levels (via the ongoing Italian debt confidence crisis) coincided with the month of October marking the first month when the European Central Bank (ECB) has reduced the pace of expansion of its balance sheet since the inception of its quantitative easing period. Specifically, during the month of October the US FED raised its monthly rate of quantitative tightening to US$50 billion while the ECB cut its quantitative easing program in half to US$15 billion per month. Such central bank balance sheet tightening dynamics exert a material effect on investor confidence as a large number of market participants embrace the thesis that the outsized levels of central bank liquidity – courtesy of the quantitative easing processes launched after the 2007-2009– have exerted a material impact on the expansion of asset valuation multiples, particularly those of the US equity market for which share buybacks have been monumental in boosting the EPS performance of US stocks.

Figure 5. Capex Intentions Soften Measurably in Greater New York Area



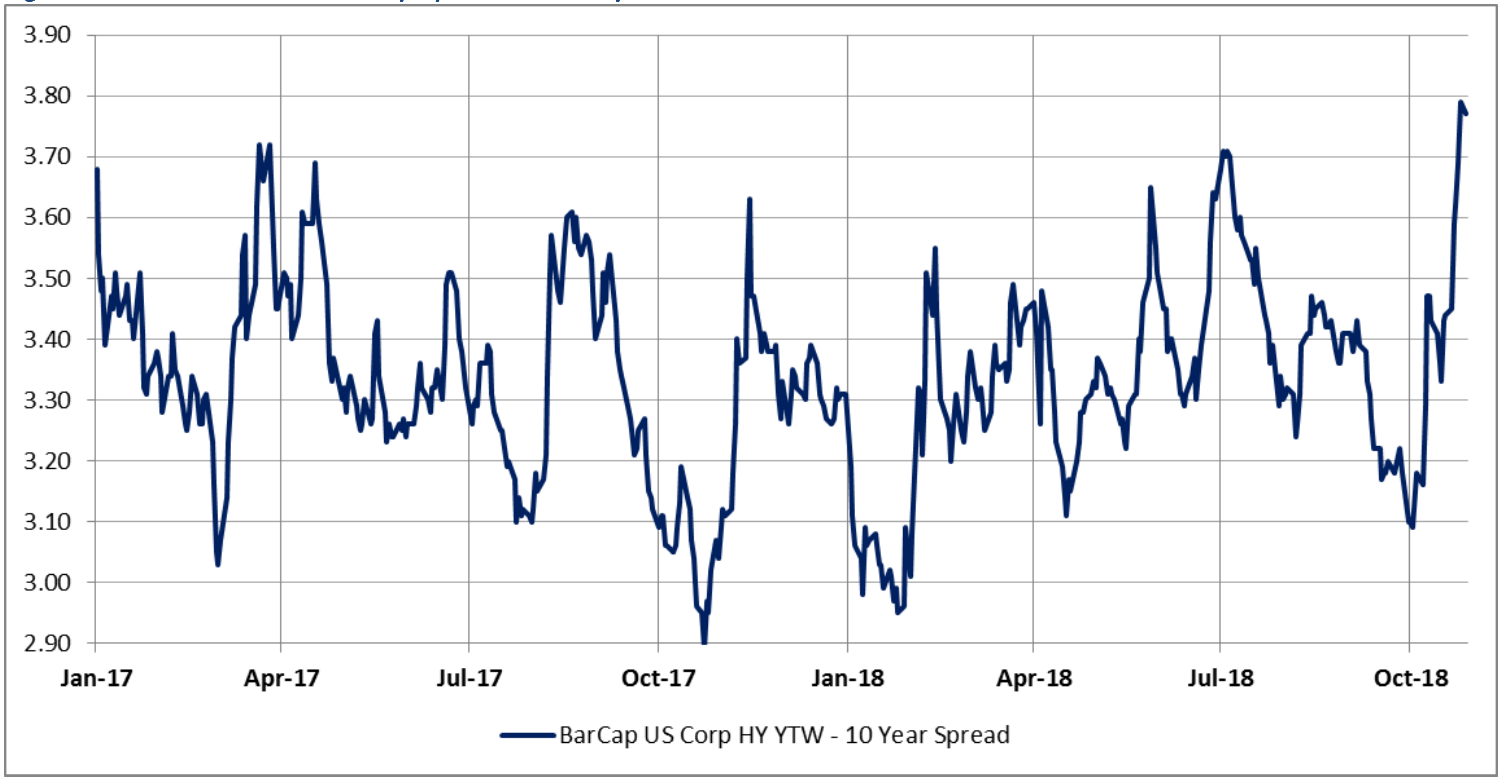
Source: Federal Reserve Bank of New York

Figure 6. October Swoon in Risk Markets Push Global Equities Below Key Intermediate-term Support Levels, Resulting in Notable Technical Damage

Source: MSCI & Bloomberg

The above developments during the month of October combined to push global equities, as represented by the MSCI AC World Index, below key intermediate-term support levels (Figure 6). Such technical damage has not been limited to global equities but has also extended to other asset classes, including credit, as illustrated by Figure 7 which captures the yield spread differential between the Barclays High Yield Corporate Index and comparable US Treasuries in the 10 year maturity.

Figure 7. October Market a Sharp Spike in Credit Spreads



Source: Bloomberg

Against the backdrop discussed above, particularly the recent unfolding of market-unfriendly policy and technical developments, it is opportune to outline the set of macro, policy and technical factors that could result in a restoration of stability to global markets and also a potential durable shift in style or geographic return performance dominance – e.g. US versus international, growth versus value. We discuss these considerations in the section immediately below.

Factors Conditioning Market Outlook Following October Correction: FED Policy, Relative US Momentum, US Dollar, Productivity, US Mid-term Elections and Investor Positioning

As we look ahead over the near term, we envision a number of significant downside risk factors, the foremost of which is investor positioning. Specifically, high frequency indicators point to poor breadth (advance declines) along with volume activity that signals continuing high levels of investor optimism (buying on the dips mindset), especially on the part of US equity investors. Moreover, a number of bellwether equity indices have broken important intermediate-term support levels which is of significance to high frequency traders and total return investors.

Against a challenging market technical backdrop facing especially US equities over the near term, the Glovista investment team intends to retain small exposure levels to equities until such time a combination of the following developments unfolds:

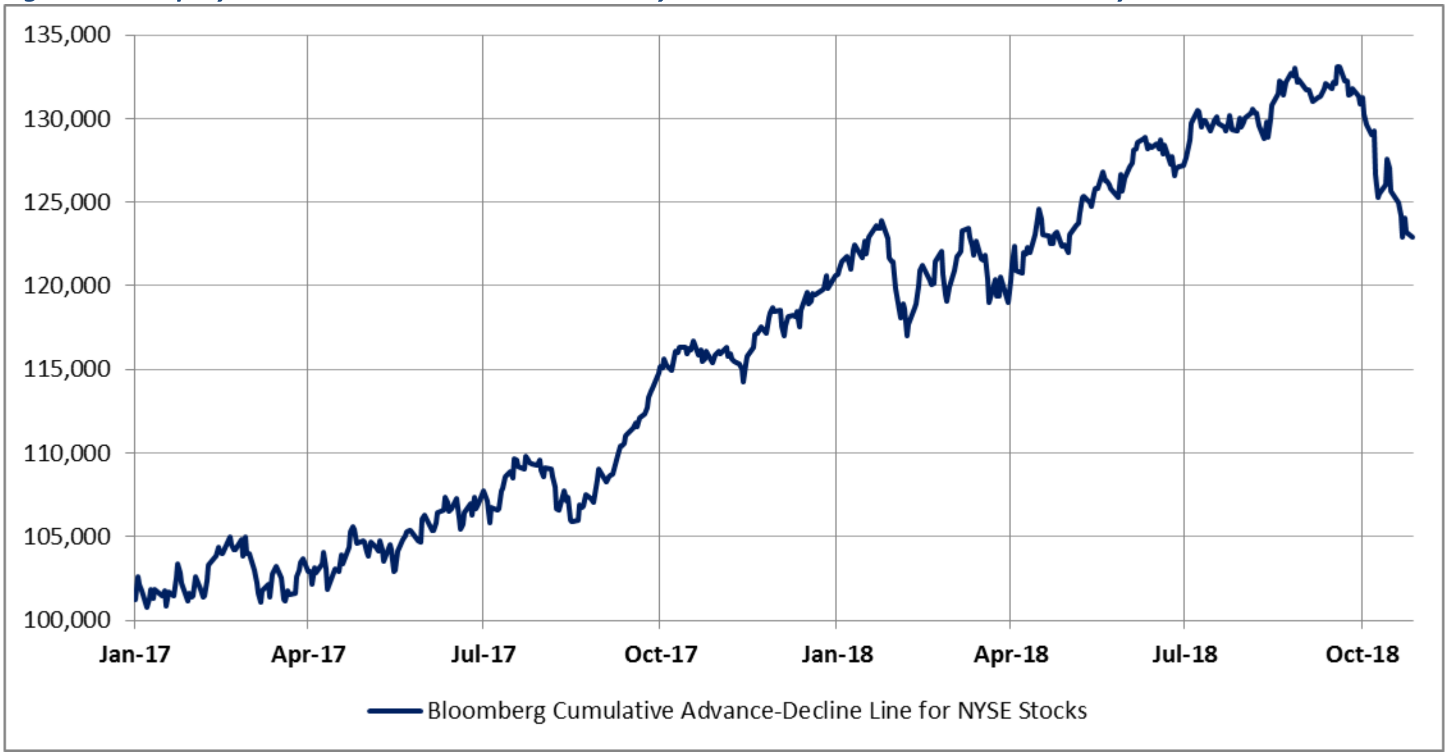
- Weakening US Dollar;
- Even US mid-term election results across party lines, without any one party commanding power across both chambers of Congress;
- A dovish shift in the direction of US FED policy;
- A meaningful turn in global economic momentum away from the US;
- Shift in investor positioning backdrop, indicative of a medium-term bottom (a reversal of breadth deterioration witnessed recently, Figure 8).

Of the above listed pool of potential catalysts for a market upturn, we believe a weaker US Dollar is likely to await an upturn in global economic momentum away from the US while a cleaner investor positioning backdrop is likely to obtain only after a further decline in equity prices. As for the likely outcome to the US November mid-term elections, the latest polls appear to indicate a split Congress as the most likely outcome. As for the likelihood of a dovish shift in direction on the part of the FED, we deem such prospects as low given the new leadership team's need to assert its anti-inflation credentials particularly at a juncture in which the US President is exerting unprecedented moral suasion in favor of a reversal in the current policy rate hike cycle stance.

Glovista Holds Defensive Portfolio Exposure, including High Cash Levels, Overweight Investment Grade Debt and High Quality, Low Volatility Stocks

Against the above described macro and market environment, particularly the unquestionable deterioration in market internals, the Glovista investment team holds a defensive portfolio exposure across macro, sector, maturity, credit and balance sheet factors so that we favor overweight exposures to: cash, high quality/low volatility stocks as well as short to intermediate duration investment grade bonds as well as gold commodity and gold miners.

Figure 8. US Equity Market Breadth Deterioration Early in October: Advance Decline Ratio Dynamics



Source: Bloomberg

As we look ahead, we envision the potential for further market weakness followed by a recovery in global equity indices under a new style leadership, away from US large cap growth to international value oriented peers. The process is likely to require time as well as a reversal in economic growth leadership away from the USA, a scenario we expect to materialize as the 'sugar high' US growth impetus afforded by the Trump tax cuts/government spending increases introduced earlier this year fade by the second quarter of 2019 while US fiscal fundamentals are guaranteed to weaken markedly, entailing annual budget deficits north of 5 percent of GDP over the coming years, starting in 2019.

While third quarter US corporate earnings have been reported as strong, thus far investors are minimizing their relevance for 2019 as concerns over the sequential weakening of revenue and earnings growth stemming from the fading of the Trump tax cuts and the impact of a strong US Dollar as well as import tariffs (borne by US households and corporates) become evident in recent earnings calls.

Glovista Emerging Markets Perspectives

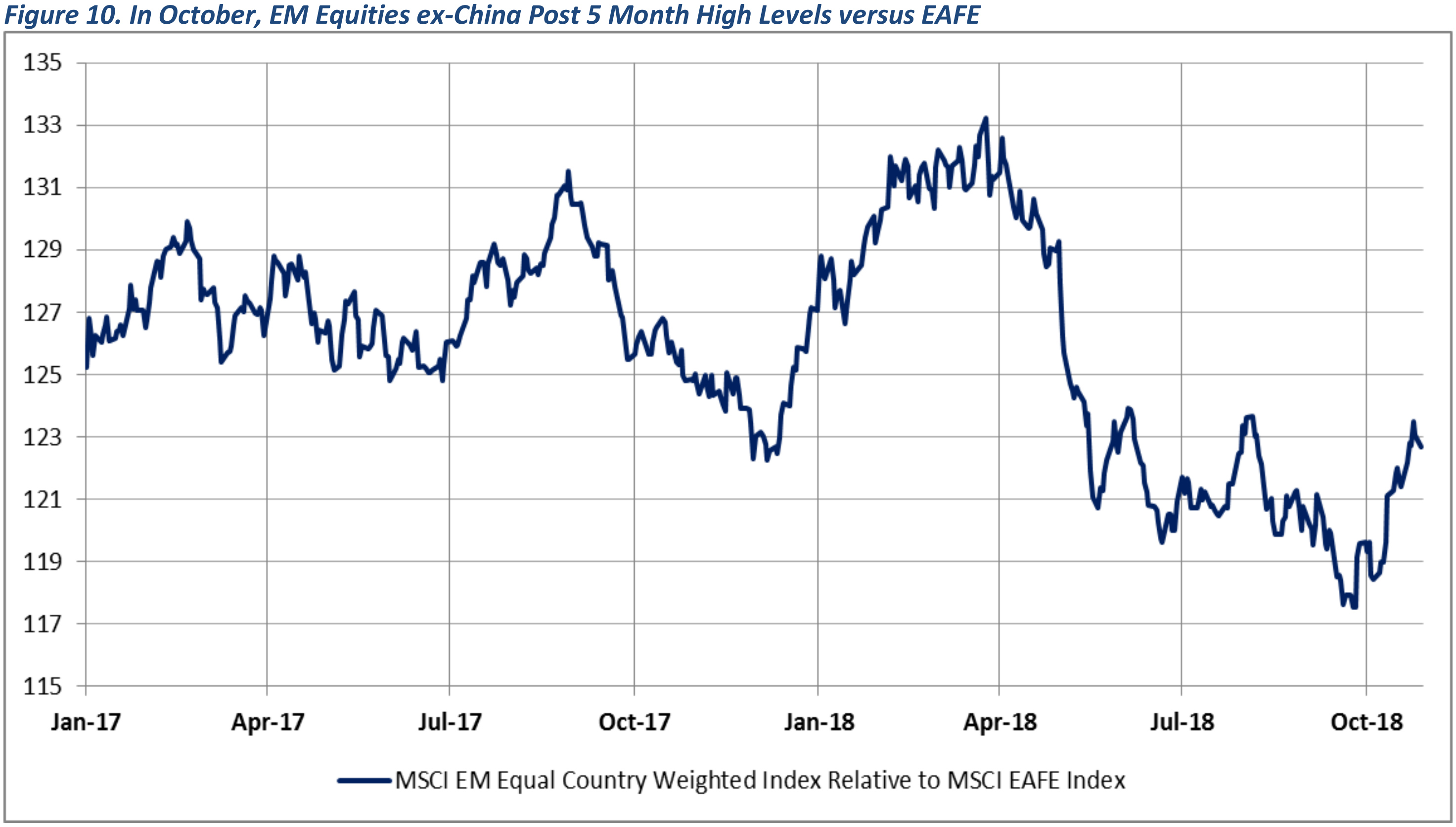
EM Equities, Ex-China, Extend Incipient 2 Month and 5 Month Outperformance vs. US & EAFE Peers; Weakening US Economic Growth vs EM to Fuel Further EM Outperformance

As discussed above, the month of October has been exceedingly unkind to risk assets globally. Despite the conclusion any frequent reader of the financial press may reach as to how Emerging Market equities have fared during the ongoing October downturn in risk assets, the facts are rather different: Emerging Market equity prices have proven rather resilient versus Developed peers. Specifically, as illustrated in Figure 9 and Figure 10, excluding Chinese equities (a market still heavily impacted by trade frictions with the US) thus far in October Emerging Market equities have extended a 2 month period of return outperformance versus US equities (as represented by the SP500 index) and a 5 month period of return outperformance versus international developed equities (as represented by the MSCI EAFE).

Figure 9. In October, EM Equities ex-China Post 2 Month High Levels versus SP500

Source: Bloomberg and Glovista Calculations

Figure 10. In October, EM Equities ex-China Post 5 Month High Levels versus EAFE



Source: Bloomberg and Glovista Calculations

That EM equities (ex-China) have been able to outperform Developed peers over the past several months is rather impressive as the recent period entails a number of developments typically adverse to EM equities' return outperformance, including the following:

- Spike in equity risk premium globally

- US Dollar strength (Figure 11).

In our view, EM equities' recent period of return outperformance responds not only to the asset class' exceedingly under-owned status on the part of global investors but also to its outsized valuation cheapness (close to all time low levels versus Developed peers) and a slow yet steady reversal in US economic momentum versus Emerging Market economies as the US growth impetus stemming from the Trump tax cuts and government spending increases decelerate into 2019. Figure 12 illustrates the slowdown in relative economic momentum for US economic surprise indicators versus those of Emerging Market economies. We expect such trend to assert itself into 2019.

Figure 11. US Dollar Index Spikes Higher during October Sell-Off

Source: Bloomberg

Figure 12. US Economic Momentum Leadership versus EM Economies Softens around the month of August

Source: Citigroup

Against the above discussed backdrop, we have maintained an overweight allocation to ASEAN markets (including Indonesia, Philippines and Malaysia) as well as Latin America (Brazil and Chile) while reducing our exposure to Mexico and Russia on account of valuation and geopolitical risk considerations, respectively. In the North Asia region, we recently took profits on our longstanding underweight allocation to Taiwan given relative valuation and currency considerations while maintaining an underweight allocation to South Korea and a neutral allocation to China along with allocation to some Chinese telecom sector names. Earlier this month we took profits in our underweight China country allocation on valuation considerations as well as our assessment of the potential for meaningful counter-cyclical policies to be enacted by the Chinese authorities. In the process, earlier this month the Chinese government – via multiple agencies including the securities commission, central bank and public finance ministry – have announced an imminent implementation of fiscal, monetary and financial stimulus measures.

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