Issue
69
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Monthly
Market
Newsletter

GLOVISTA INVESTMENTS

Glovista Global Perspectives

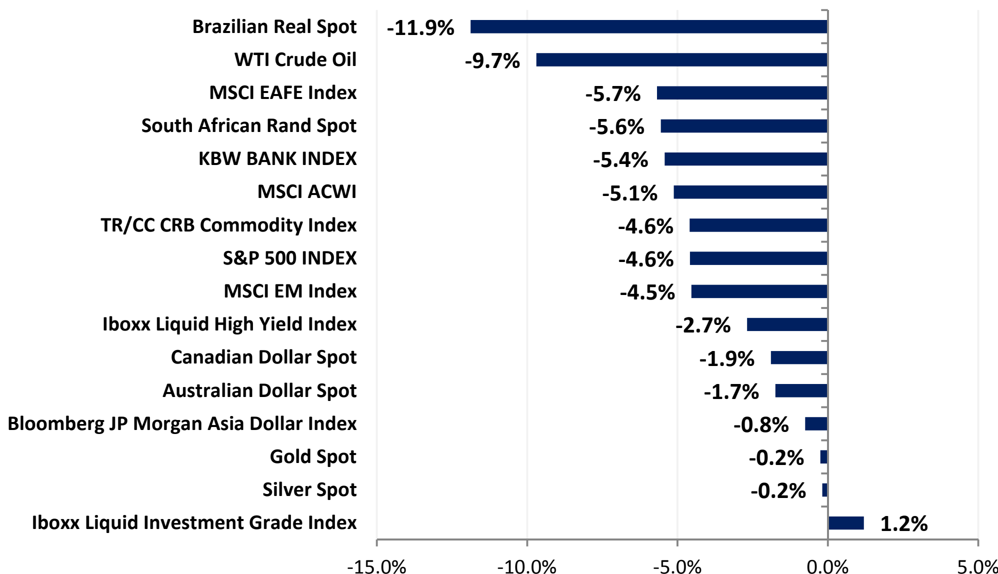
This Issue:

S&P Sector Performance P.2
Ccy and Cmdty Performance P.4
Important Interest Rates P.4

Global Markets Sell Off Sharply in September on Concerns of FED Policy Mistake and Rising Downside Risks to Economic Outlook; Glovista Sustains Defensive Portfolio Stance

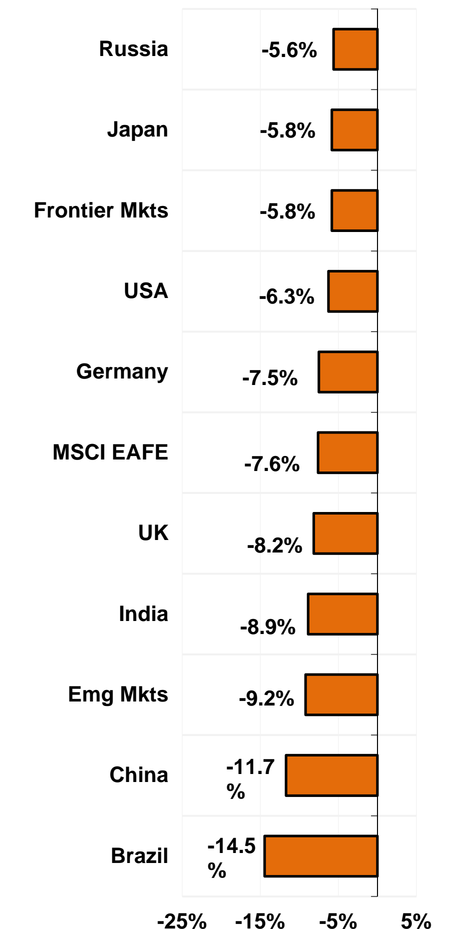
Thus far in September, risk markets have recorded sharp price declines as illustrated in Figure 1. The sell-off have extended across asset classes, including equities, credit, commodities and cyclically oriented currencies. During much of September we have maintained minimal exposure levels to global equities in our managed portfolios owing to the multiple considerations laid out in prior monthly commentaries. As discussed further below, the Glovista investment team continues to view most of the factors underlying our longstanding defensive portfolio stance as relevant for the immediate investment horizon. As a result, we continue to maintain a highly defensive portfolio stance across and within asset classes, as summarized below.

Figure 1. Risk Asset Classes Record Sharp Price Declines in September



Source: Bloomberg

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



Source: MSCI & Bloomberg

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Investor Concerns over Potential for FED Policy Mistake and Heightened Downside Risks to Economic Outlook are Culprits Behind September Global Market Sell-Off

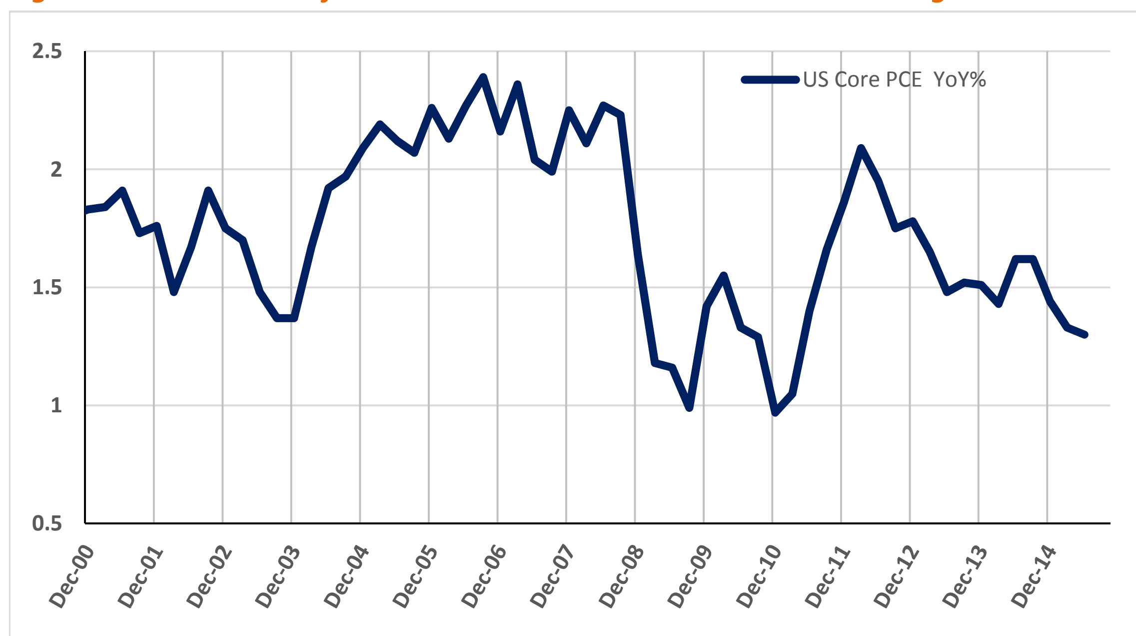
S&P500 Monthly Sector Performance – August 2015		
Sectors	% Change	FY1 PE Ratio
Energy	-4.69%	25.6
Materials	-5.78%	16.1
Industrials	-5.64%	15.6
Cons Disc	-6.56%	19.5
Cons Stap	-6.00%	19.7
Technology	-5.82%	15.8
Healthcare	-8.05%	17.1
Financials	-6.94%	13.9
Utilities	-4.01%	15.6
Telecom	-3.36%	12.5

Source: S&P

In our assessment, the depth and breadth of the global market sell-off during the month of September reflects a number of factors, both of a fundamental and technical nature. However, we believe that three fundamental factors have been especially important in the recent sell-off:

- **Investor concerns over the potential for a Federal Reserve policy mistake.** Such concerns stem from the FOMC leadership's continued insistence on its confidence the first policy rate hike since 2006 will take place before the end of the year at a time in which core PCE inflation (Figure 2) is far below the FED's target level and powerful disinflationary forces are at play as a result of weakening foreign economies and continued US Dollar strength (Figure 3);

Figure 2. US Core PCE Inflation Remains Well Below 2 Percent FED Target

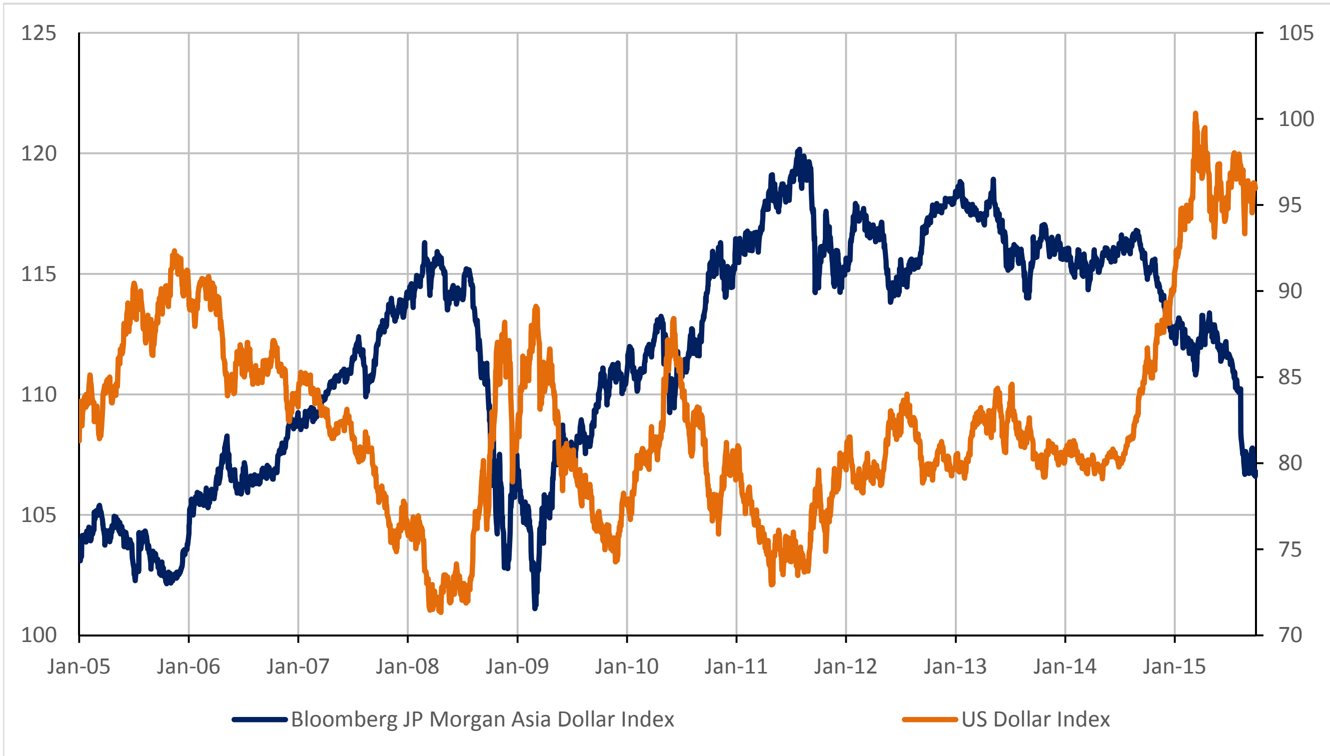


Source: Bloomberg

- **Widening softness of economic momentum across several of the world economy's major regional blocs**, particularly on the supply side. For example, as illustrated in Figure 4, the past several weeks have witnessed decelerating economic momentum across several of the world's major economies, not just China, the media's focus of attention (Figure 4);

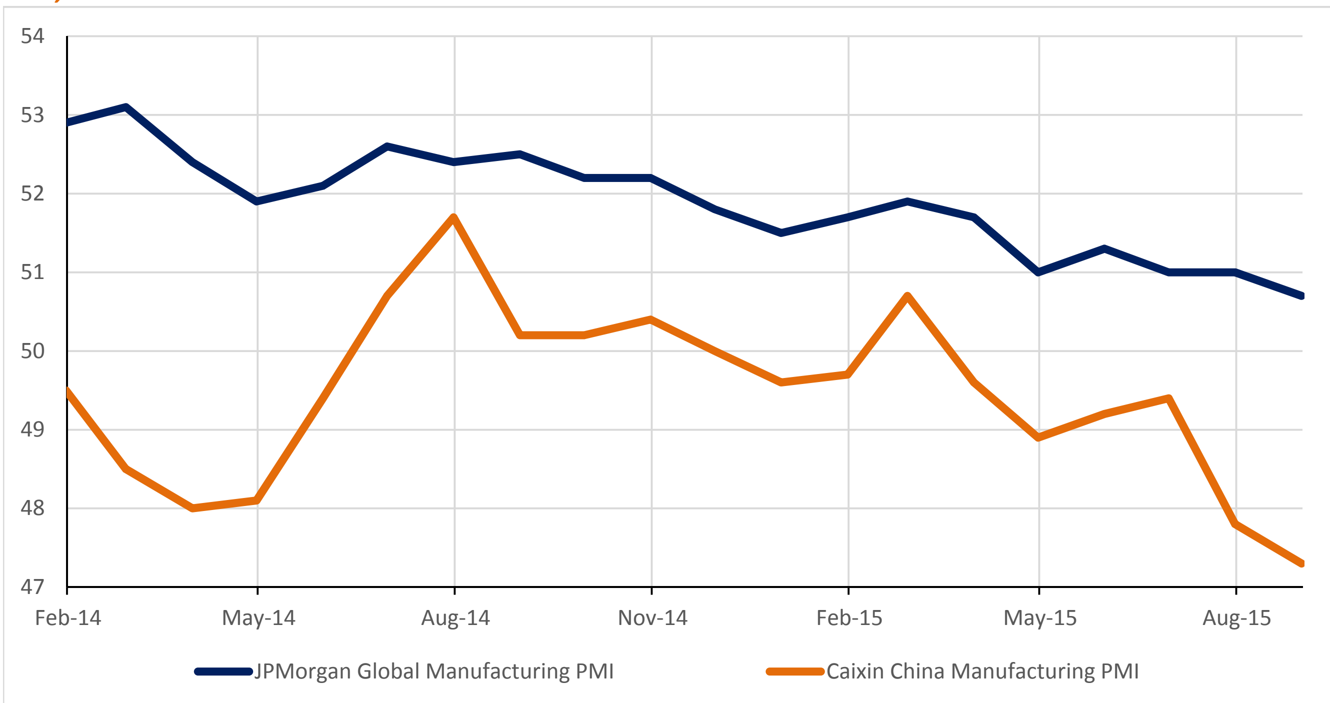
- **Significant tightening of US financial conditions these past several weeks.** Figure 5 illustrates the significant tightening of US financial conditions these past several months and weeks, the result of several factors including the effects of continued US Dollar strength, widening credit spreads (Figure 6) and higher financial market volatility. Such tightening of financial conditions represents a considerable source of investor concern over the potential for a policy mistake by the Federal Reserve should it proceed to raise the policy rate (Fed Funds rate) later this year.

Figure 3. US Dollar Strength Exerts a Key Role in the Ongoing Tightening of Financial Conditions Globally



Source: Bloomberg

Figure 4. Softening Economic Momentum as Global Phenomenon these Past Several Weeks: Manufacturing PMI, SA



Source: Markit

	August'15	August Change
Gold	1134.8	3.6%
Silver	14.625	-1.1%
Oil	49.2	4.4%
EUR	1.1211	2.1%
JPY	121.23	2.1%
GBP	1.5345	-1.8%
CHF	0.9673	-0.1%
CAD	1.314	-0.4%
AUD	0.7113	-2.7%
BRL	3.6205	-5.8%
MXN	16.7503	-4.0%

Source: Bloomberg

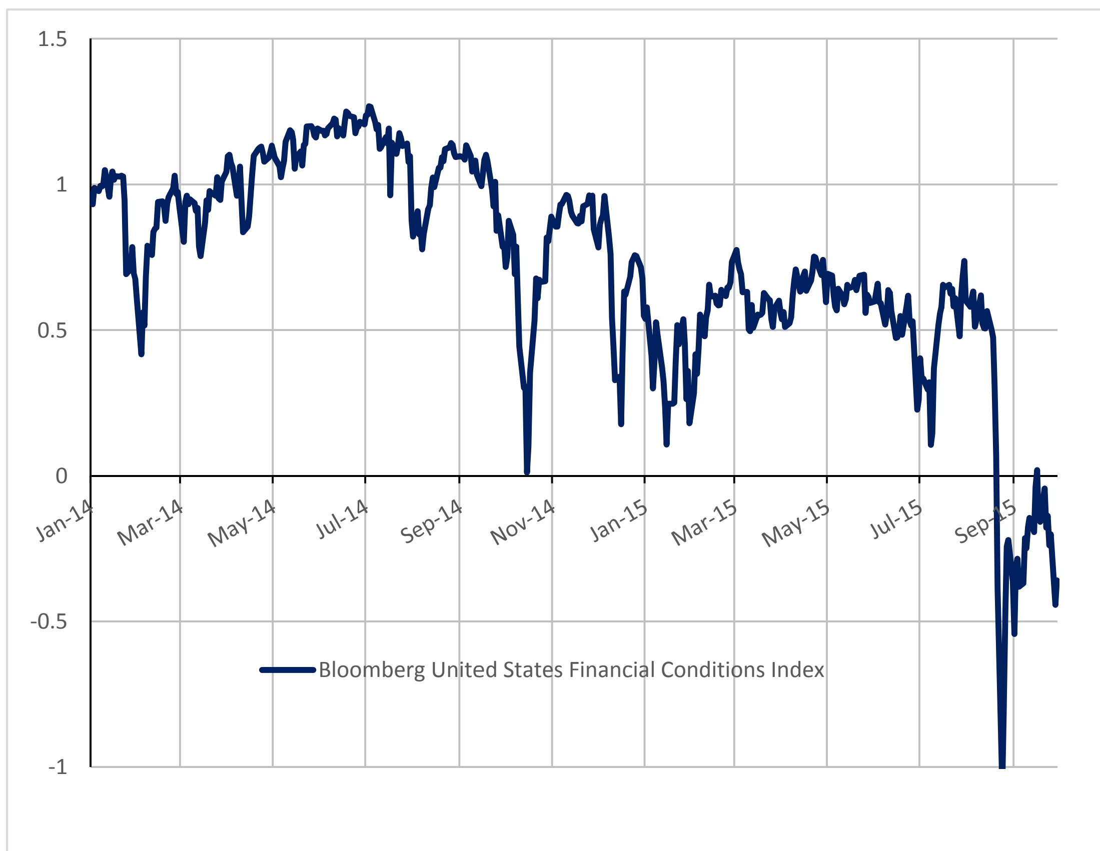
Rates	August 31st Level
1 Yr CD	0.61%
5 Yr CD	1.45%
30 Yr Jumbo Mortgage	4.27%
5/1 Jumbo Mortgage	3.84%
US Govt. 10 Year	2.22%
10 Yr Swap Spread	5.43%

Source: Bloomberg

The ongoing tightening of financial conditions has been of especial concern to global investors owing to the factors underlying the continued US Dollar strength and the widening of credit spreads. Specifically, we view such conditions as exacerbating the potential for downside risks to the economic outlook as opposed to as validation of ongoing strength of the US economy.

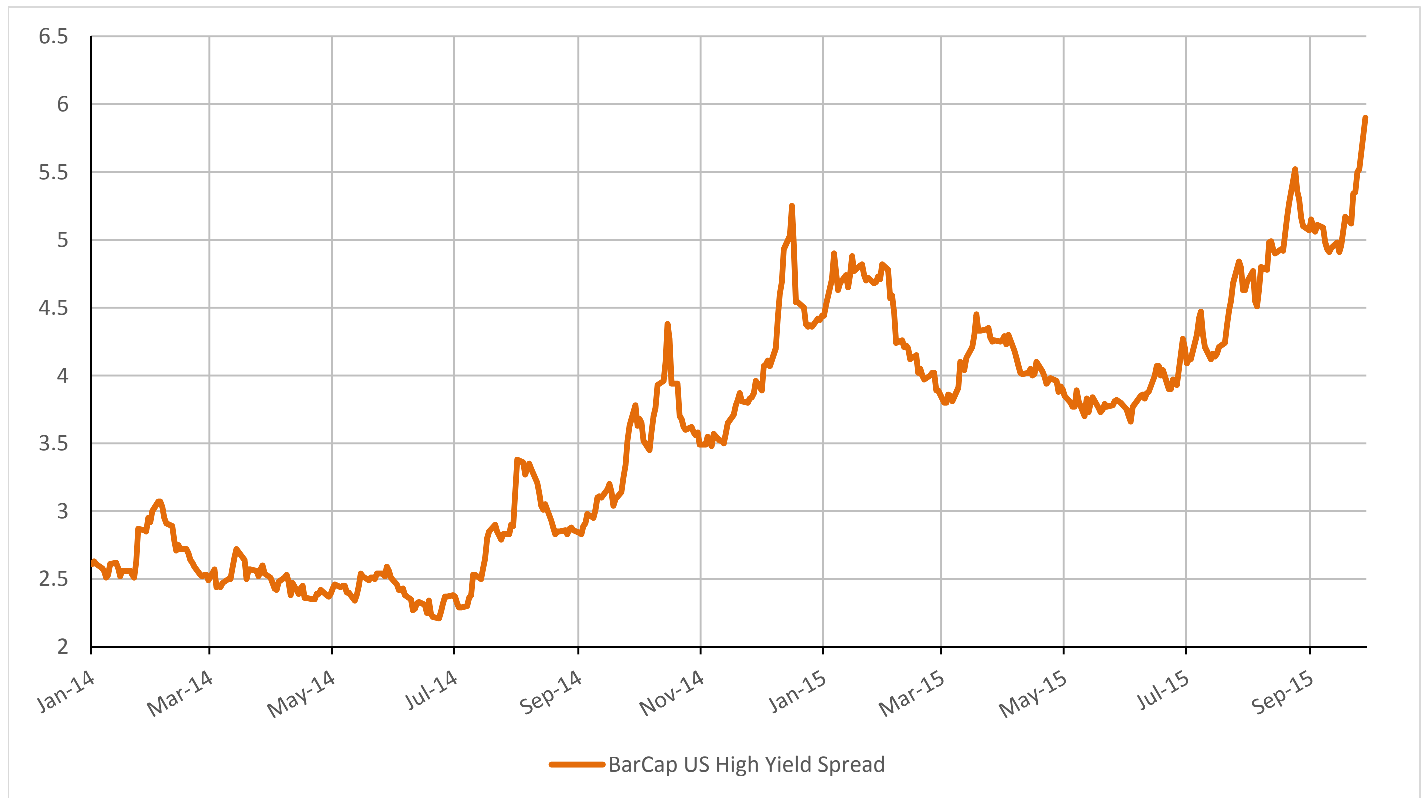
In our view, we believe the ongoing period of US Dollar strength is largely the result of the desynchronized monetary policy stances embraced by the US FED vis-à-vis the Bank of Japan and the European Central bank as opposed to fundamental strengthening of the US economy. The strong dollar may in-turn act as a potential propagator of economic weakness for the USA. Likewise, we view the ongoing widening of credit spreads as the result of both the adverse balance sheet impact on industrial and energy sector companies that ail from (a) adverse demand-side shocks resulting from a softening Chinese economy and (b) supply-side shock stemming from the excess supply resulting from the shale oil revolution in the USA. Again, similar to the case of the underlying factors behind the current period of US Dollar strength, the widening of credit spreads is extraneous to the US business cycle stage – not reflective of above trend US growth momentum - and is, more importantly, a potential propagator of economic weakness for the USA.

Figure 5. Ongoing Tightening of Financial Conditions as Cause of Investor Concern given FED's Focus in Raising the Fed Funds Rate in the Coming Weeks



Source: Bloomberg

Figure 6. Steady Rise of US High Yield Debt Spreads as Driver of Tightening in Financial Conditions

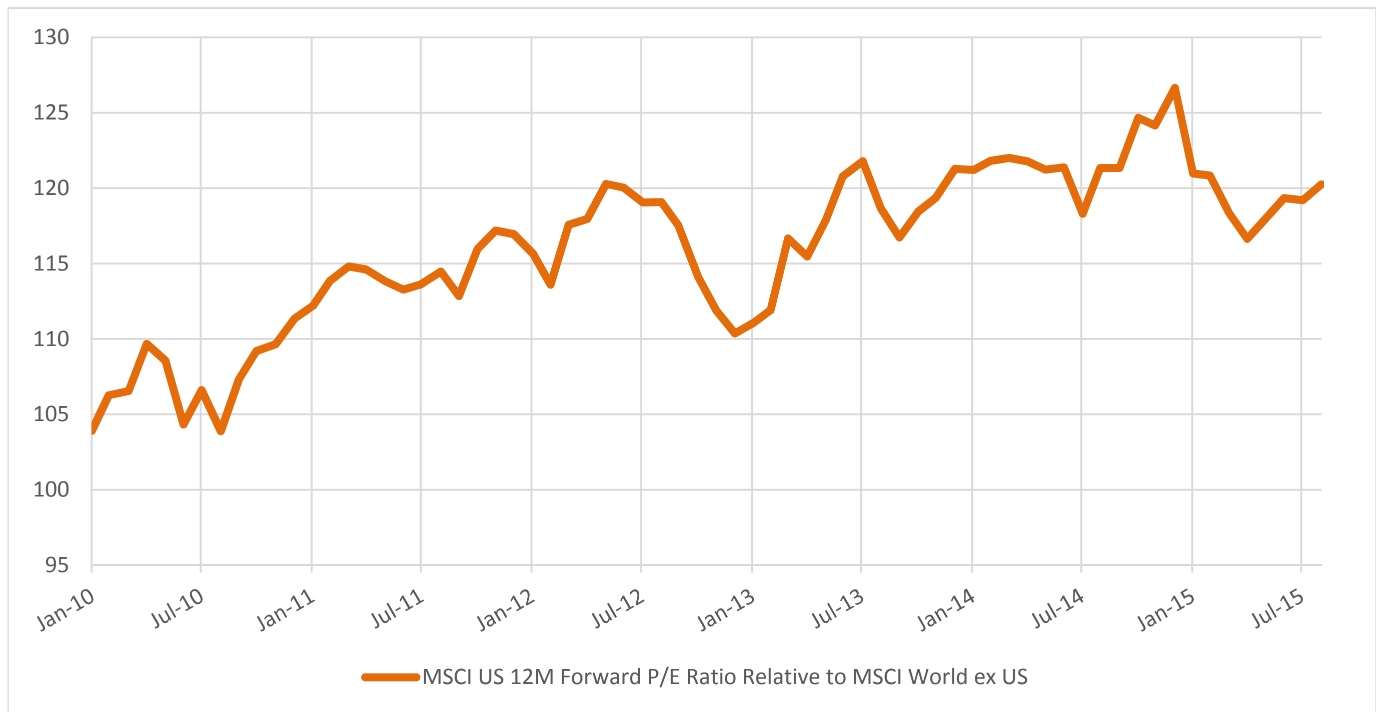


Source: Bloomberg

An examination of the factors driving the ongoing widening of credit spreads in the USA must also account for the multi-year long period of weakening balance sheet conditions resulting from the 'musical chairs' game run by US corporations in funding outsized (close to a quarter of a trillion US Dollars per year) stock buyback programs via the issuance of corporate debt. We have discussed such dynamics repeatedly over the past two years and noted that such 'musical chairs' game has been a US only affair, and has in a major way accounted for US equities' strong relative return outperformance versus foreign peers these past several years; much of US equities' relative outperformance has derived from relative earnings valuation multiple expansion and not from earnings outperformance.

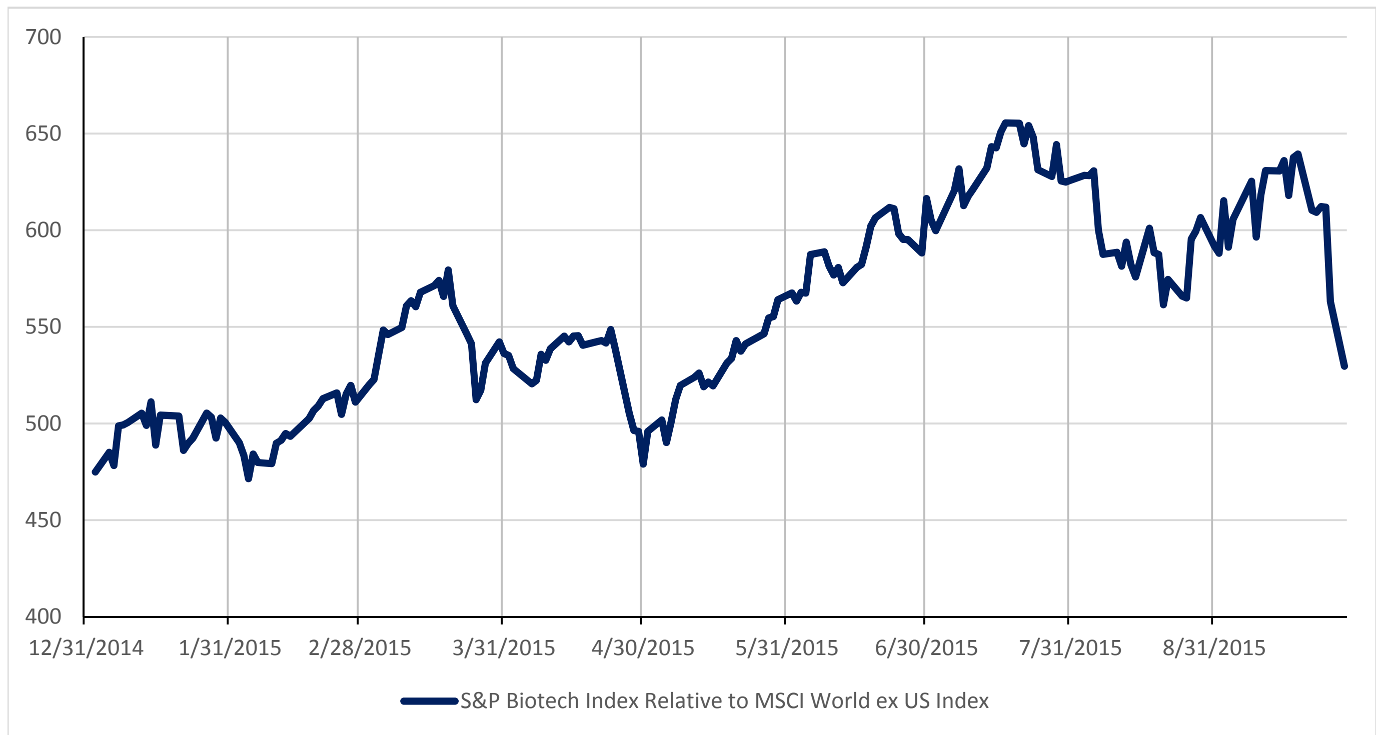
Although US corporates have been the largest net buyers of US equities these past several years, recent economic releases capturing flow of funds within the US economy establish the significant deceleration of debt funded share buyback programs over the past several weeks. As the cost of debt capital has gone up significantly these past several months and corporate balance sheets are increasingly stretched, we believe that one of the most powerful technical factors accounting for the resilience of US equities' price performance versus foreign peers is increasingly behind us. As such, absolute and relative price momentum is likely to weaken for US equities which, coupled with unattractive relative valuations versus world peers (Figure 7), is likely to result in a bottoming process of relative price performance for attractively valued non-US equities, including selected Emerging Market, European and Japanese indices. An illustrative example of US equities' recent loss of relative price momentum leadership versus foreign peers is that of US biotech, a group that has lost close to 25 percent of its value within less than three months; moreover, as shown in Figure 8, US biotech stock prices' relative outperformance of non-US stocks have retraced back to year-ago levels within less than 2 weeks.

Figure 7. US Equities' Relative Forward P/E Valuations versus Global Peers at Close to Historical Highs



Source: Bloomberg

Figure 8. US Biotech Stocks, a Leading Group of Post-2009 Bull Market, Lost Entire YTD Relative Outperformance versus Non-US Stocks in Less than 2 Weeks



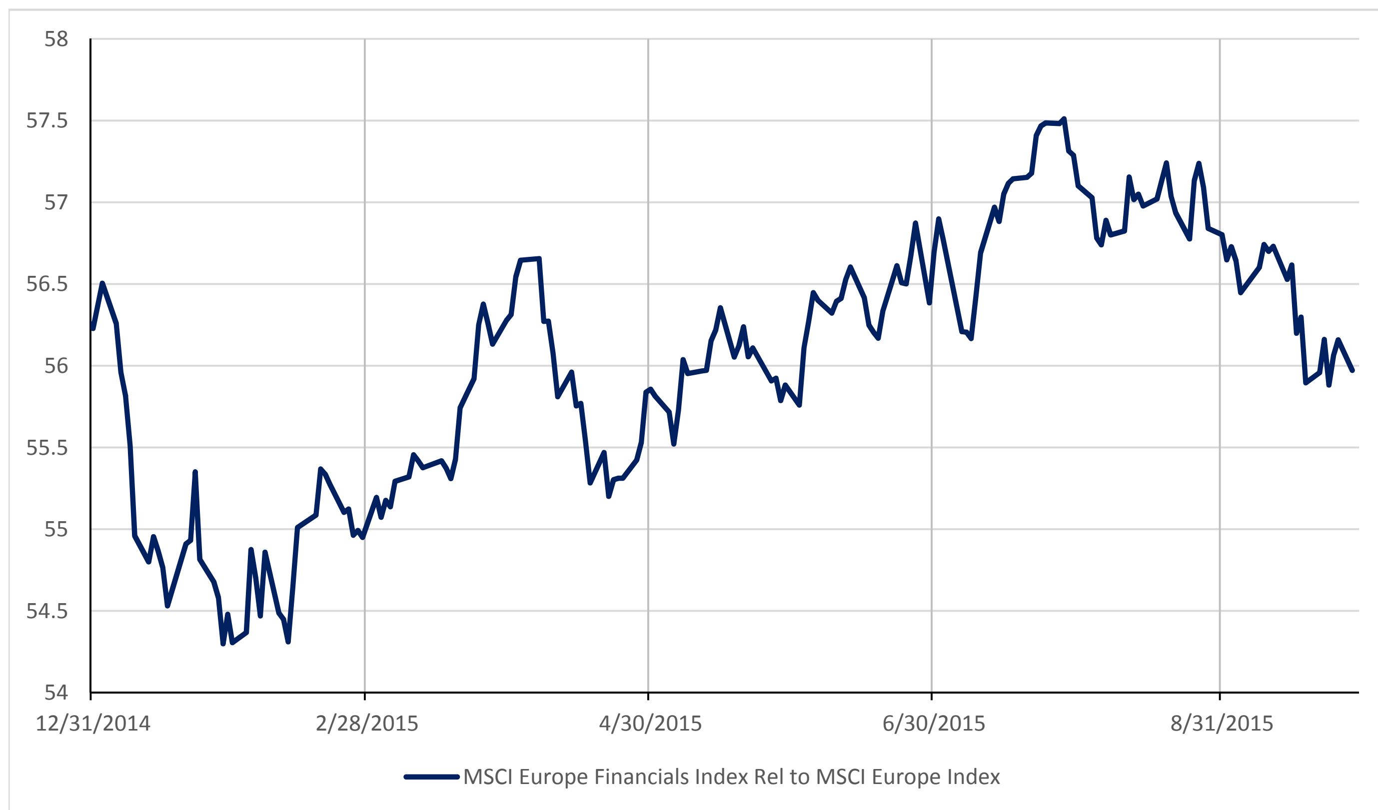
Source: Bloomberg

Glovista Sustains Defensive Portfolio Stance, entailing Overweight Cash, Short-duration Corporate Bonds, Japanese Yen and Gold

Owing to the considerations laid out above, we sustain a defensive portfolio stance in our managed accounts. Given our GTAA strategy's strong focus on capital preservation and absolute return performance, our cautious stance translates into minimal equity market exposure, overweight cash and short-duration corporate debt exposures. We continue to avoid excess exposure to long-duration assets owing to the increased opacity of FED policy and FED 'speak'.

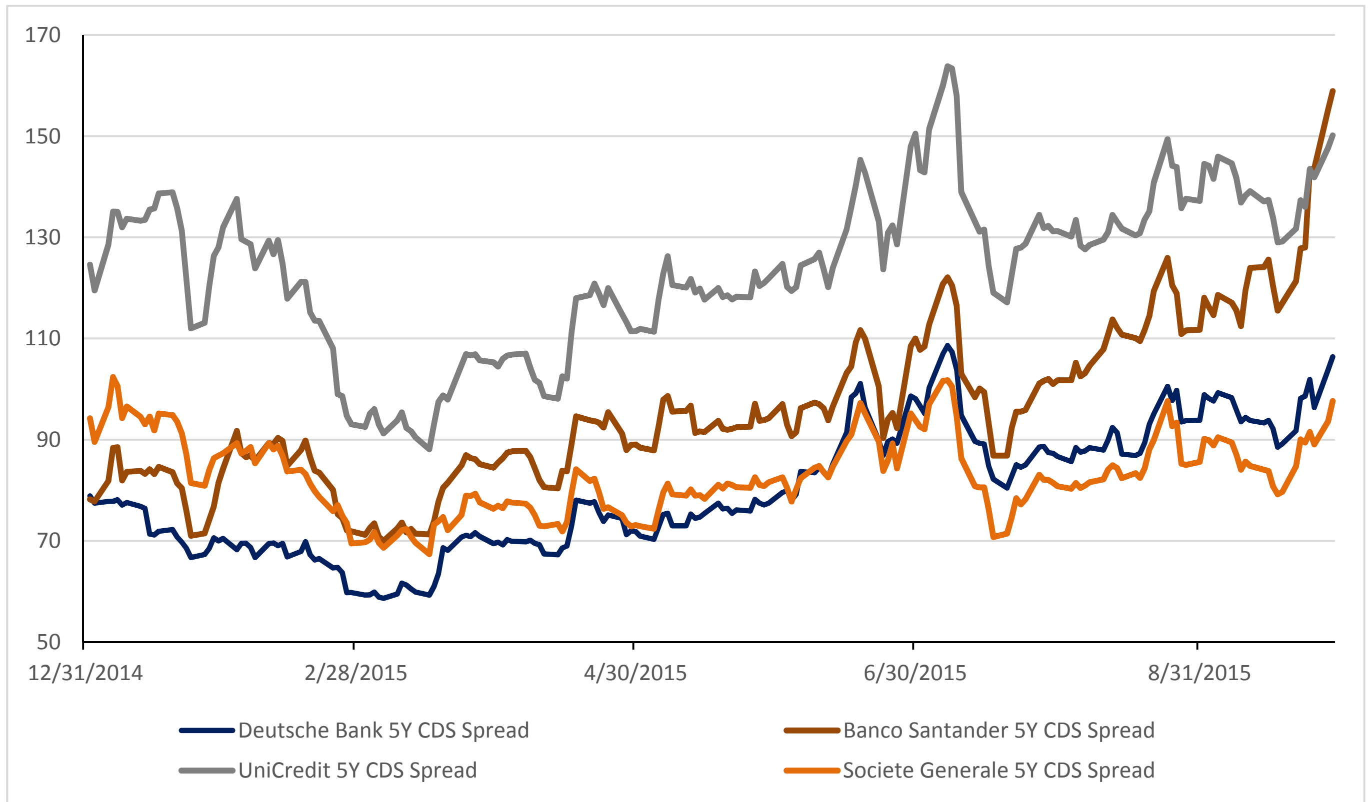
Our longstanding US Dollar bullish thesis leads us to hold only US Dollar denominated debt securities at this time. On the commodities market side, over the past several weeks we have taken on exposure to the price of gold for the first time in many months given increased signs of financial sector stress, particularly in Europe, as evidenced in the sharp market relative price underperformance of Eurozone regional bank stocks (Figure 9) and sizable widening of CDS spreads for the sector (Figure 10). We attribute such compression in European financial sector valuations to the region's trade and financial linkages to Asia, Latin America and the Middle East as well as loan exposures to the industrial and energy groups whose credit profiles have become significantly impaired owing to the sharp price declines experienced in those two areas (Figure 10).

Figure 9. Eurozone Bank Stocks De-rate Meaningfully versus Market Peers



Source: Bloomberg

Figure 10. European Bank CDS Yields Blow Out Sharply over Past Several Weeks: Signs of Stress?



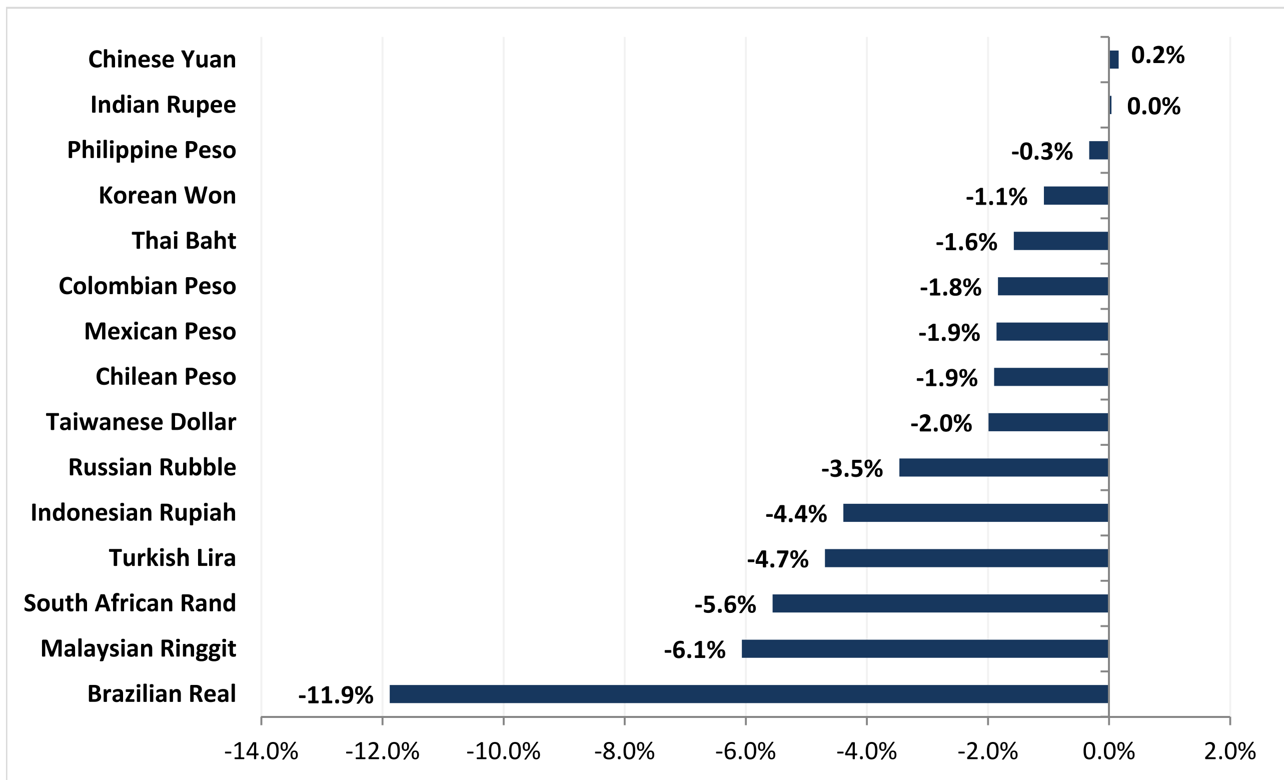
Source: Bloomberg

Emerging Market Perspectives

Glovista Further Raises Macro Balance Sheet and Cuts High Beta Cyclical Market Factor Exposures amidst Weakening World Growth and Tightening Financial Conditions

As noted above, we believe a number of Developed equity markets, including the USA, appear especially susceptible to downside price pressures owing to the lack of valuation support and fragile technical backdrop. In addition, a number of Emerging Market country indices look poised to embark upon what could prove to be the initial stages of a multi-year relative outperformance versus a number of Developed equity market peers. As noted in our December 2014 year-ahead outlook report, our bullish stance towards Emerging equity markets remains a qualified one, with strong emphasis on a number of markets, primarily Asia based, displaying a number of characteristics including strong macro balance sheet, beneficiary status from declining commodity prices, visible secular economic growth drivers, strong or improving corporate governance practices and attractive valuations on a cycle-adjusted basis. In that regard, the recent intensification of investor concerns over the world economic momentum and tightening financial conditions in the Developed world lead us to reinforce our portfolio's factor tilts at the macro levels, as discussed further below.

Figure 11. Make-up of EM Currency Performance Reflects Relative Sovereign and Corporate Credit Fundamentals within EM: (September MTD performance till September 28th)



Source: Bloomberg

Figure 11 and Figure 12 represent powerful exhibits of the highly efficient manner in which, over the past several weeks, market forces have differentiated Emerging Market assets (credit and foreign exchange with knock-on effects on equities) at the country level. Specifically, Figure 11 highlights the larger percentage depreciation moves since September 1st recorded by a number of especially fragile Emerging Market currencies including the Brazilian Real, the South African Rand, the Malaysian Ringgit and the Indonesian Rupiah. All of these countries share a common factor: their corporate sectors have been among the largest net issuers of foreign currency denominated debt since 2007.

Figure 12 shows a similar pattern as that illustrated in Figure 11 but in terms of the credit de-rating unfolding at the sovereign level for those countries whose corporate sectors have issued a disproportionately large stock of foreign currency denominated debt these past eight years expressed in terms of a country's international reserve level or overall export revenue generating capacity.

Figure 12. Countries Recording Largest Widening of CDS Spreads in September Include those Displaying Highest Fragility to Debt Rollover Risk

	Country CDS Spread		
	on 8/28/2015	on 9/28/2015	% Change
Brazil	332.5	545.0	63.91%
Malaysia	169.9	231.6	36.31%
Mexico	145.5	187.0	28.52%
Chile	119.4	148.4	24.28%
Turkey	261.8	323.8	23.69%
Colombia	219.0	265.0	21.00%
South Africa	247.0	298.0	20.65%
Indonesia	228.2	272.3	19.33%
Peru	174.5	205.0	17.48%
Philippines	114.29	133.41	16.73%
Thailand	141.50	164.61	16.33%
South Korea	65.58	75.49	15.11%
China	111.67	126.16	12.98%
Russia	377.0	378.3	0.33%

Source: Bloomberg

Against such global macro backdrop, we have further reinforced our managed portfolios' exposures to strong macro balance sheets, attractively valued currencies, attractively valued equities, visible economic growth and improving earnings momentum. Over the past several weeks, we have reinstated a strong overweight allocation to India and China, both of which benefit from declining commodity prices and whose macro balance sheets remain strong by global standards. Within China, we continue to favor exposure to the consumer sector. Outside China and India, we continue to hold a strong overweight allocation to Chile on relative valuation, governance, and improving relative earnings momentum. We have taken profit in our strong overweight allocation to Mexico, having used the proceeds as a funding source for our increased allocation to India. Finally, we continue to favor moderate overweight exposure to Korean equities, on a Won hedged basis, and underweight allocation to Taiwanese stocks owing to their high beta to the global industrial production cycle at a juncture in which downside risks to world economic growth have risen measurably these past several weeks. We continue to hold strong underweight allocations to Eastern Europe (unattractive relative valuations), the Middle East (downside risks to growth and domestic liquidity), South East Asia (unattractive relative valuations), South Africa and Brazil (economic growth concerns).

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