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GLOVISTA INVESTMENTS

Glovista Global Perspectives

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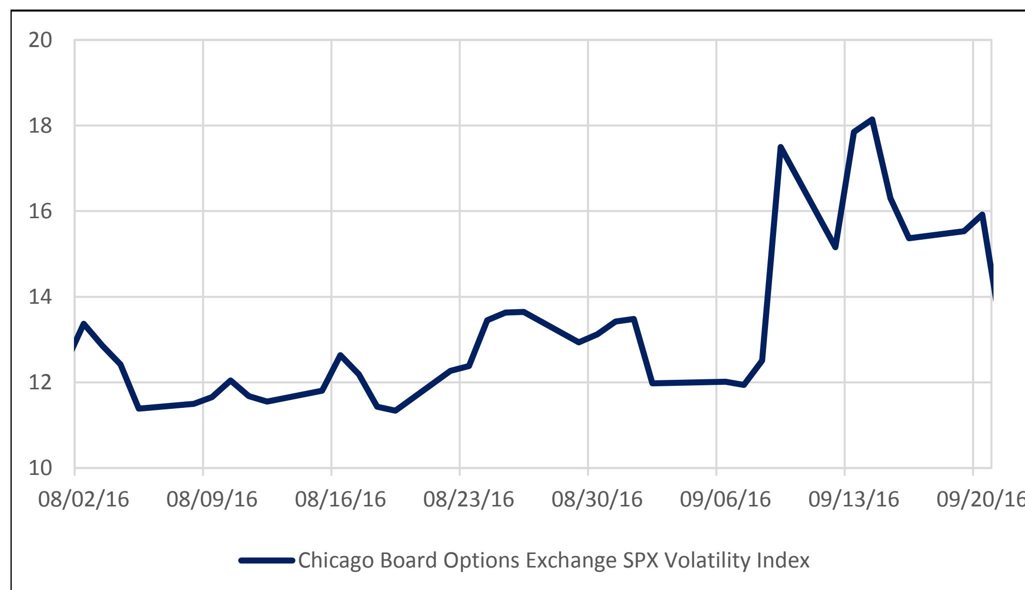
Important Interest Rates P.4

Bank of Japan's September 21st Policy Shift Likely Marks End of Low Volatility Period in Global Markets; Glovista Sustains Longstanding Cross-Asset Portfolio Tilts

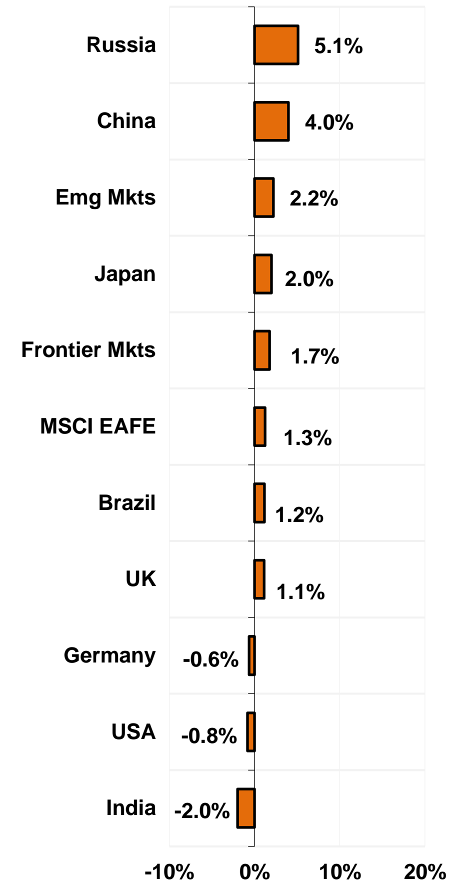
The month of September has brought about a marked rise in financial volatility following several months of inordinately subdued levels (Figure 1). In our view, the recent rise in volatility reflects increased investor demand for downside protection in risk markets (e.g. equities, commodities, FX and credit) as monetary policy uncertainty has risen considerably over the past several weeks surrounding scheduled central bank meetings held by the European Central Bank (September 8th), Bank of Japan (September 21st) and the US Federal Reserve (September 21st).

Figure 1. Implied Equity Volatility Rises Early in September Ahead of Scheduled ECB/BOJ/FED Central Bank Meetings



Source: Bloomberg

Country-wise Monthly Performance in USD terms (September MTD 2016)*



Source: MSCI & Bloomberg

***As of September 29th, 2016**

We believe the outsized importance conferred by global investors on those three key central bank meetings is warranted owing to several considerations, including the following:

- *European Central Bank*: investor attention on the ECB's September meeting centered on the arguable need for the ECB to escalate the quantum and pace of its ongoing quantitative easing program ahead of the politically consequential Italy constitutional referendum scheduled for December 4th. In the process, the September 8th ECB meeting underwhelmed consensus expectations in that the ECB chose NOT to cut the reference deposit rate, NOT to announce an extension in the duration of its ongoing QE program, nor increase the quantum of its asset purchase program. The consensus investor view called for an intensification in the ECB's QE program on the basis of the considerable economic deceleration experienced by the Eurozone region (Figure 2) together with the still unresolved undercapitalization status of the Eurozone region's banking system – a politically charged issue in Italy, a dynamic also manifesting itself in persistently elevated deflationary expectations for the Eurozone region (Figure 3).

S&P500 Monthly Sector Performance – September MTD 2016*

Sectors	% Change	FY1 PE Ratio
Energy	1.63%	118.2
Materials	-2.18%	18.8
Industrials	-1.10%	17.6
Cons Disc	-1.23%	18.5
Cons Stap	-2.69%	21.6
Technology	1.84%	18.0
Healthcare	-1.67%	16.3
Financials	-4.23%	15.3
Utilities	0.83%	17.5
Telecom	-0.65%	14.2
S&P500	-0.91%	18.5

***As of September 29th, 2016**

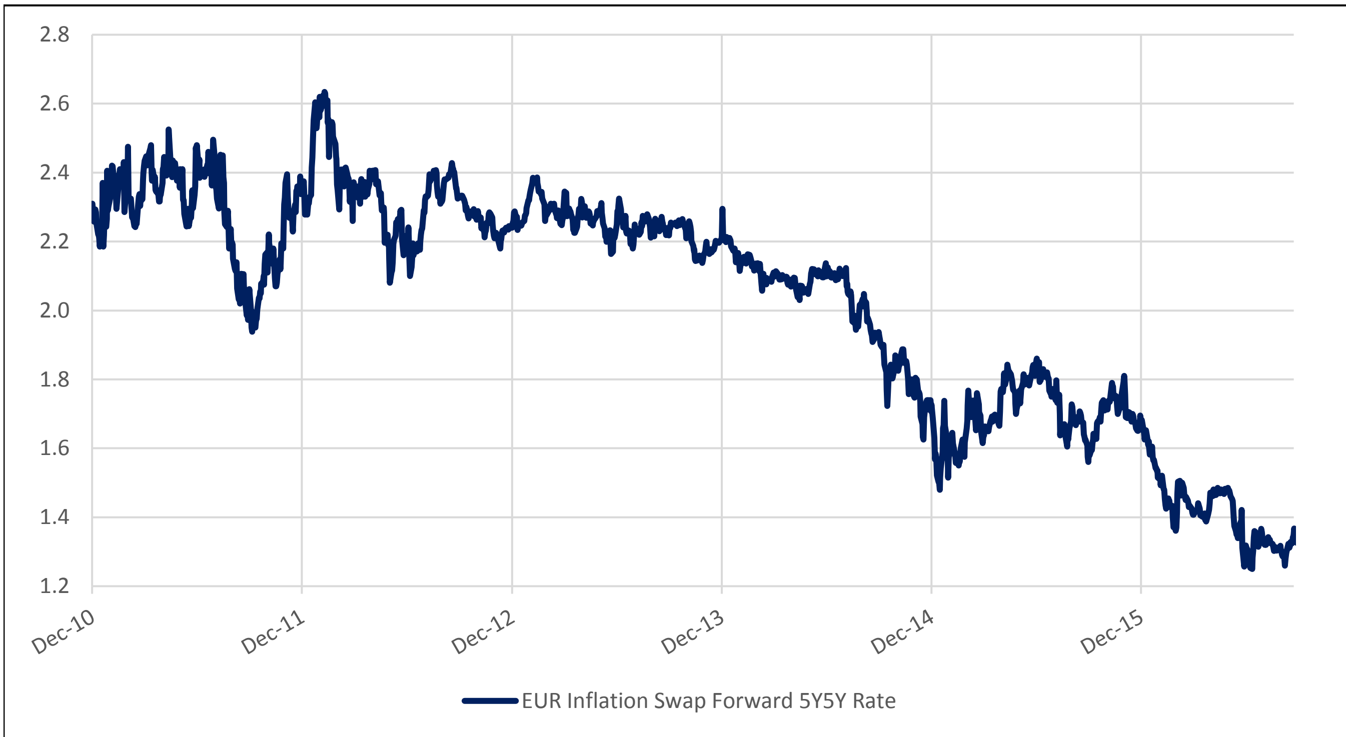
Source: S&P

Figure 2. Eurozone Region's Economic Momentum Weakens Further on the Heels of BREXIT: Citigroup Economic Activity Surprise Index

Source: Citigroup Global Markets

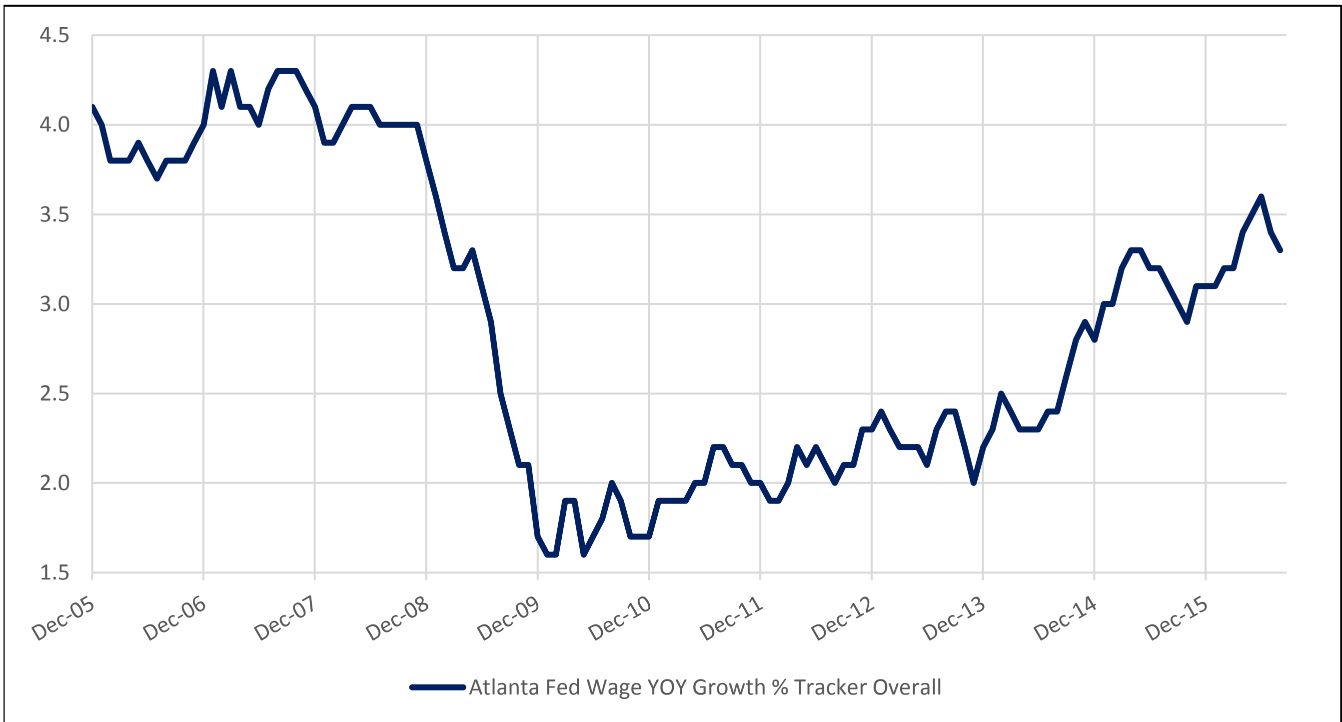
- *US Federal Reserve:* investor attention on the September meeting derived from the recent hawkish chatter emanating from a number of sitting Fed governors as well as a recognition of the narrowing US output gap at a juncture in which unit labor costs have posted larger percentage increases than expected (Figure 4). In addition, investors had also focused attention on the September FED meeting as one of only two remaining actionable meetings left in the year (the other one corresponding to the December 13th to 14th meeting) given the upcoming US November presidential elections and the FED's likely reticence to shift policy rates so close to the November 8th elections.

Figure 3. Eurozone Region's Inflation Expectations Hover at Continued Low Levels as Economic Softness Persists and Financial Conditions Tighten Further



Source: Bloomberg

Figure 4. US Unit Labor Costs Rise Early in 2016 as Output Gap Narrows and Productivity Growth Remains Low: Fuel for Rise in Inflation Expectations?



Source: Federal Reserve Bank of Atlanta

GLOVISTA INVESTMENTS

	Sept 29th 2016	Sept MTD Change
Gold	1320.36	0.9%
Silver	19.1025	2.4%
Oil	47.83	7.0%
EUR	1.1222	0.6%
JPY	101.03	2.3%
GBP	1.2968	-1.3%
CHF	0.9662	1.8%
CAD	1.3146	-0.3%
AUD	0.7636	1.6%
BRL	3.2597	-1.0%
MXN	19.5213	-3.9%

Source: Bloomberg

Rates	Sept 29th Level
1 Yr CD	0.57%
5 Yr CD	1.19%
30 Yr Jumbo Mortgage	4.34%
5/1 Jumbo Mortgage	3.78%
US Govt. 10 Year	1.5599%
10 Yr Swap Spread	-0.1413%

Source: Bloomberg

- *Bank of Japan:* with little doubt, investor attention on the Bank of Japan's scheduled September 21st policy meeting was markedly larger than that given to the ECB and Fed meetings also held in September. Said larger investor attention given to the BOJ meeting derived from these principal considerations:

  - Ahead of the BOJ's September meeting, the BOJ's QE (so-called QQE) program was one of only two ongoing QE programs (together with the ECB's) as the FED's and BOE's QE programs have already begun to be unwound;

  - Since the initiation of the QE era in 2009, the quantum of the BOJ's QE program has far exceeded those implemented by the FED, the BOE and the ECB, when measured in terms of the the size of central bank balance sheets expressed as percentage of GDP;

  - the BOJ's pre-announcement of a comprehensive reassessment of the BOJ's ongoing QQE program, partial guidance to which was made public a few months in advance;

  - Finally, the September BOJ meeting's agenda would likely test the extent of the BOJ's loss of credibility, a serious concern given the unintended market response that followed the BOJ's previous consequential meeting, held on January 29th, when the BOJ cut the excessive bank reserves policy rate to minus 0.1 percent. In the weeks following the January meeting the Japanese Yen recorded a considerable strengthening versus the US Dollar as opposed to the expected weakening targeted by BOJ policymakers.

Bank of Japan's September 21st Policy Meeting as Likely Accelerant in the Resumption of Higher Financial Volatility as QQE with Yield Curve Targeting to Set Off QE-Tapering and Reversal Phases

At its scheduled September 21st meeting, the Bank of Japan rattled financial markets by announcing the following:

- No cuts to its deposit interest rate nor enlargement of its asset purchase program. Instead, the BOJ announced a material shift in its standing monetary policy stance.

- Specifically, the BOJ announced a replacement of its 'QQE only' program with a 'QQE with yield curve targeting' framework that targets specific levels and segments along the Japanese sovereign's yield curve. Undoubtedly, said shift in policy stance is not only the most significant at the monetary but also at a broader economic policy level since the launch of Abenomics as, for the first time, a G3 central bank is seeking to impact the entire sovereign yield curve, not just short term rates or base liquidity.

- Under the new 'QQE with yield curve targeting' program, the BOJ targets a 10 year government bond yield level of 0 percent while eliminating the 7-12 year average maturity target for its JGB purchase program. The latter adjustment would afford the BOJ greater latitude over where on the sovereign's debt curve it executes its purchases.

To us, the BOJ policy shift is of first-order importance to the global macro and market outlooks, owing to several considerations including the following:

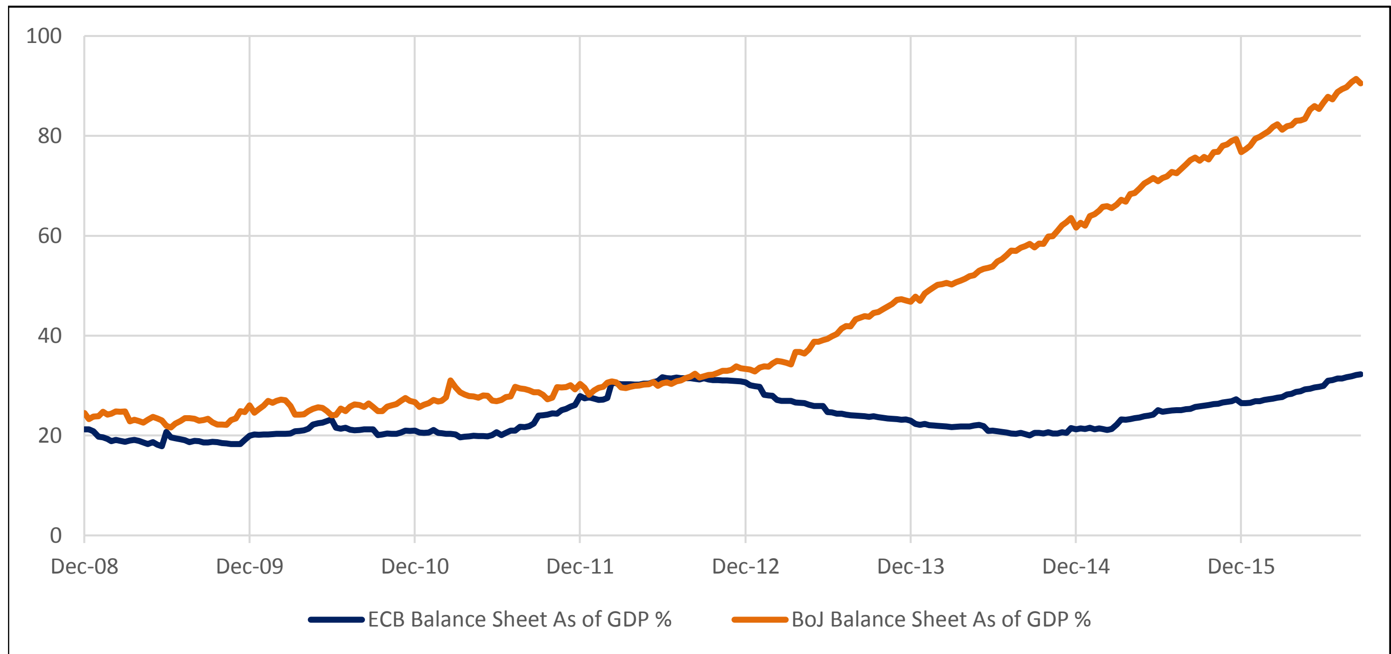
- The policy shift raises the potential for QE tapering – reduced asset purchases – or QE reversal – outright reduction in the BOJ's balance sheet – as in future recessionary phases market participants may test the BOJ credibility in protecting its 0 percent 10 year yield target so that a credible meeting of such test would require the BOJ to outright sell JGBs.

- We believe it is particularly significant that such policy shift was implemented by the BOJ as opposed to the ECB (the only other major central bank with ongoing QE policies leading into this past week's BOJ meeting as the Bank of England and the FED had already brought their QE programs to a close, via tapering, in 2014 and 2015) because the size of the BOJ's QE program has been the most aggressive of all QE programs in the advanced world (as a percentage of country GDP), in particular far larger than the ECB's (Figure 5) .

- The policy shift is an implicit recognition by one of the world's three largest central banks of the limits to QE, in terms of exerting further control over short term rates, as the protracted period of low or negative interest rates exerts unintended negative consequences on the broad advanced economies.

- Some of the unintended consequences from QE programs onto the broad advanced economies' collective take the form of de facto capital calls facing important financial sector intermediaries such as the insurance, pension and money center banking industries. In turn, such de facto capital calls result from the underfunded status plaguing a large cross-section of the pension and insurance industries as well as from the massive yield curve flattening that has accompanied QE, with adverse effects on the money market industry (an important player in the financial intermediation process of advanced countries) and the banking industry.

Figure 5. ECB's QE Program Pales in Comparison with the BOJ's: Central Bank Balance Sheet Sizes as Percentage of GDP

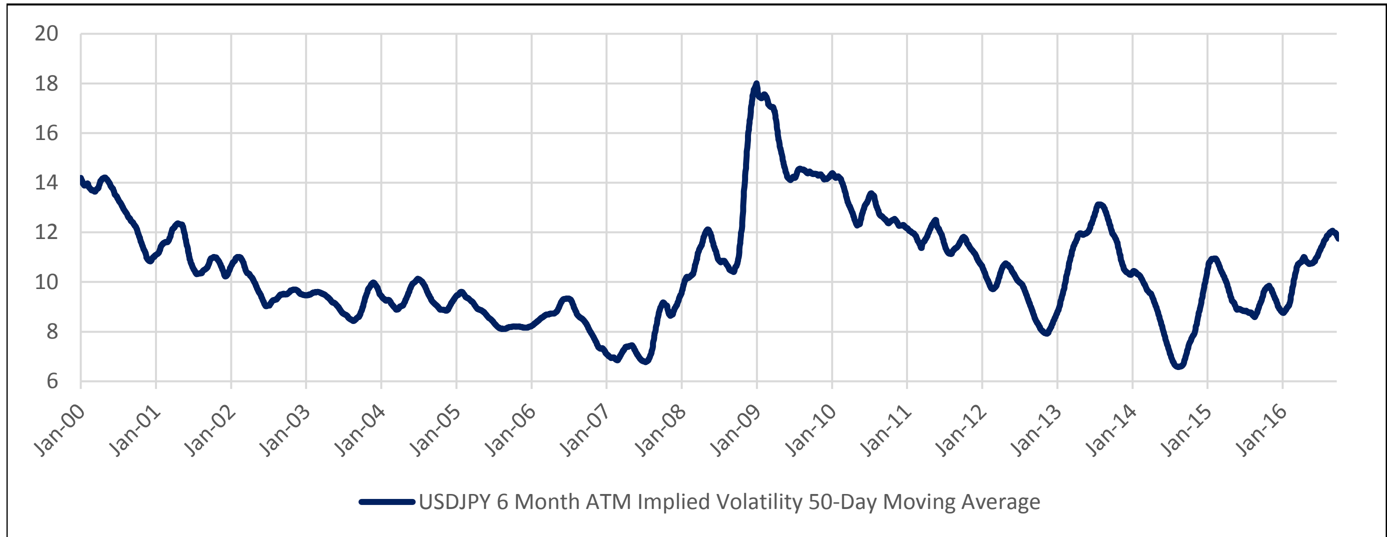


Source: Bloomberg

We believe the Bank of Japan's recent policy shift, coupled with the BOE's and US FED's tapering of their QE programs starting in October 2014, carries a number of important global macro and market implications. In particular, we expect financial volatility to rise from current levels at an earlier time than previously expected bringing an end to the multi-year period of artificially low volatility brought about by QE.

Figure 6 provides an eloquent example of the sustained rise in medium-term (6 month) implied volatility for the critically important USD Japanese Yen exchange rate cross since the US Federal Reserve initiated the tapering of its QE program in October 2014. Since that time, USDJPY volatility has remained on an upward trajectory The FX market, the world's most liquid, typically responds to changing global macro regimes prior to fixed income and equity markets.

Figure 6. USD Yen 6 Month ATM Implied Volatility on a Steady Rise since October 2014, the date of the US FED's tapering of its QE Asset Purchase Program



Source: Bloomberg

Glovista Sustains Overweight Credit, Underweight Equities Portfolio Tilts on Consequential BOJ Policy Shift, Valuation Considerations and Event Risks tied to Upcoming US Elections and Italy's Referendum

In September, Glovista's investment team has chosen to sustain our managed GTAA portfolios' defensive stance owing to several key considerations, including the following:

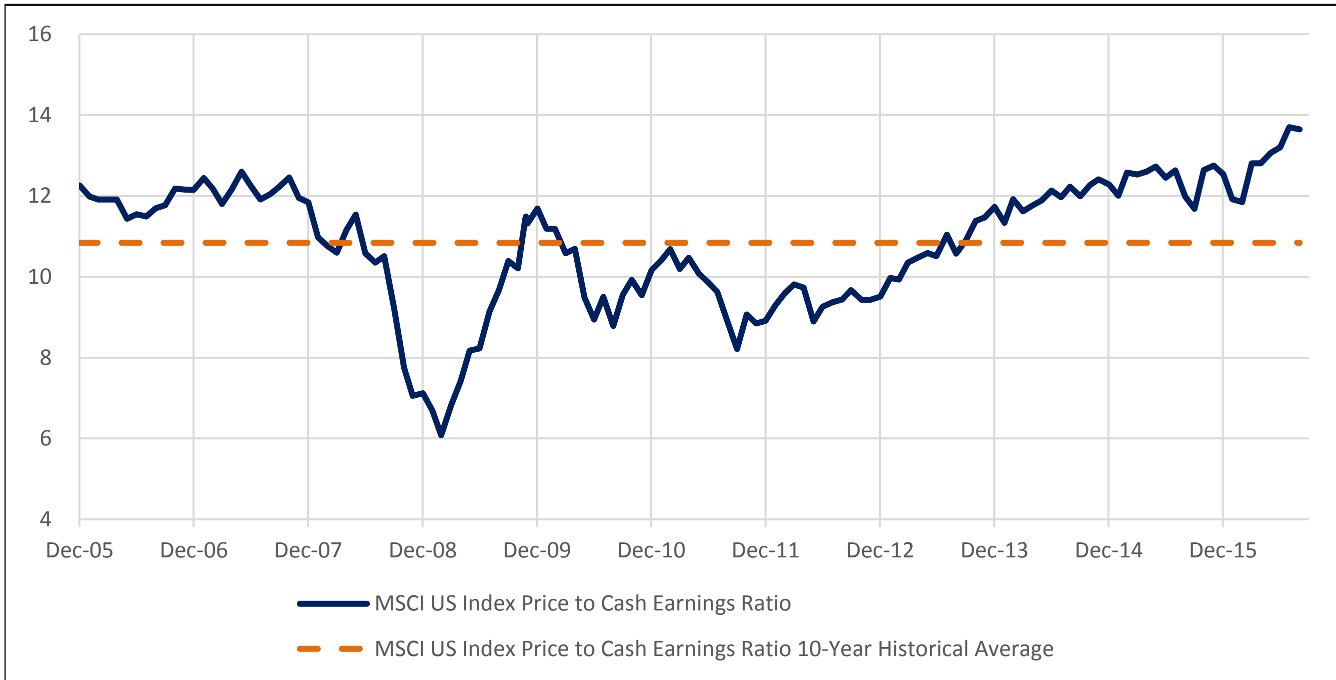
- *Fast approaching event risks that carry the potential for raising risk premium considerably from current levels.* Specifically, the US November presidential elections and the December 4 Italy constitutional referendum exhibit binary-like characteristics. First, in the case of the US November presidential elections the fiscal, trade, immigration and security policy outlooks under a Trump presidency are likely to be diametrically different from those sponsored under a Clinton administration. Second, in the case of Italy's December 4 constitutional referendum, the national vote will amount to a plebiscite on Italy's permanence in the Eurozone as a "No" vote would result in the ouster of the Renzi government and its likely replacement by a coalition to include vocal anti-Euro parties such as the Fifth Star Movement.

- *Potential for market uncertainty to rise steadily on the back of the recent momentous shift in the Bank of Japan's monetary policy stance, discussed above.*

- *Increased downside risk potential facing US equities* given the fast-approaching start (middle of October) of the Q3 earnings season at a juncture in which US equity valuations hover well above historical average levels, even on a non-cycle adjusted basis (Figure 7).

- Increasingly challenged flow-of-funds backdrop supporting the US equities space as the quantum and breadth of share buyback program decelerates. In turn, said deceleration in the quantum and breadth of US share buyback programs - by far the most important flows factor underlying the purchase of US equities since 2009 – likely is the result of (a) the ageing of the current US business cycle expansion, manifested in the compression of US corporate profit margins and deceleration of top line growth, and; (b) the accompanying erosion in balance sheet quality of US corporates from the duration of said debt-financed share buybacks.

Figure 7. US Equity Valuations Hover Well Above Historical Average Levels even on an Earnings/Revenue Cycle-unadjusted Basis



Source: MSCI, Bloomberg and Glovista Calculations

Given the above mentioned near-term risk factors, we have chosen to sustain our overall portfolio tilts at the asset class level, reflecting our baseline case outlook of no-recession in the world's major economies over the coming quarters. Specifically, we continue to maintain (a) an overweight portfolio allocation to US Dollar denominated credit markets, including high grade and sub-investment grade intermediate duration corporate bonds as well as preferred securities, while (b) underweighting overall equities exposure. Within global equities, we continue to favor Emerging Markets over Developed peers; within Developed Market equities, we favor IT, industrials and selected material sector stocks, particularly high quality mining stocks.

Emerging Markets Perspectives

EM Equities Further Extend YTD Outperformance versus Developed Peers on Currency Strength, Attractive Relative Valuations and Upturn in Growth Differentials

In September, EM equities – as represented by the MSCI EM benchmark index – further extended by 2.4 percent for the month their year-to-date return outperformance of Developed peers, as represented by the MSCI EAFE index (Figure 8). Of interest, EM equities' solid September monthly outperformance of Developed peers unfolded despite the month of September bearing witness to a sharp spike in market volatility, fueled by investor concerns surrounding the momentous G3 central bank meetings scheduled for the month, as discussed in the above sections.

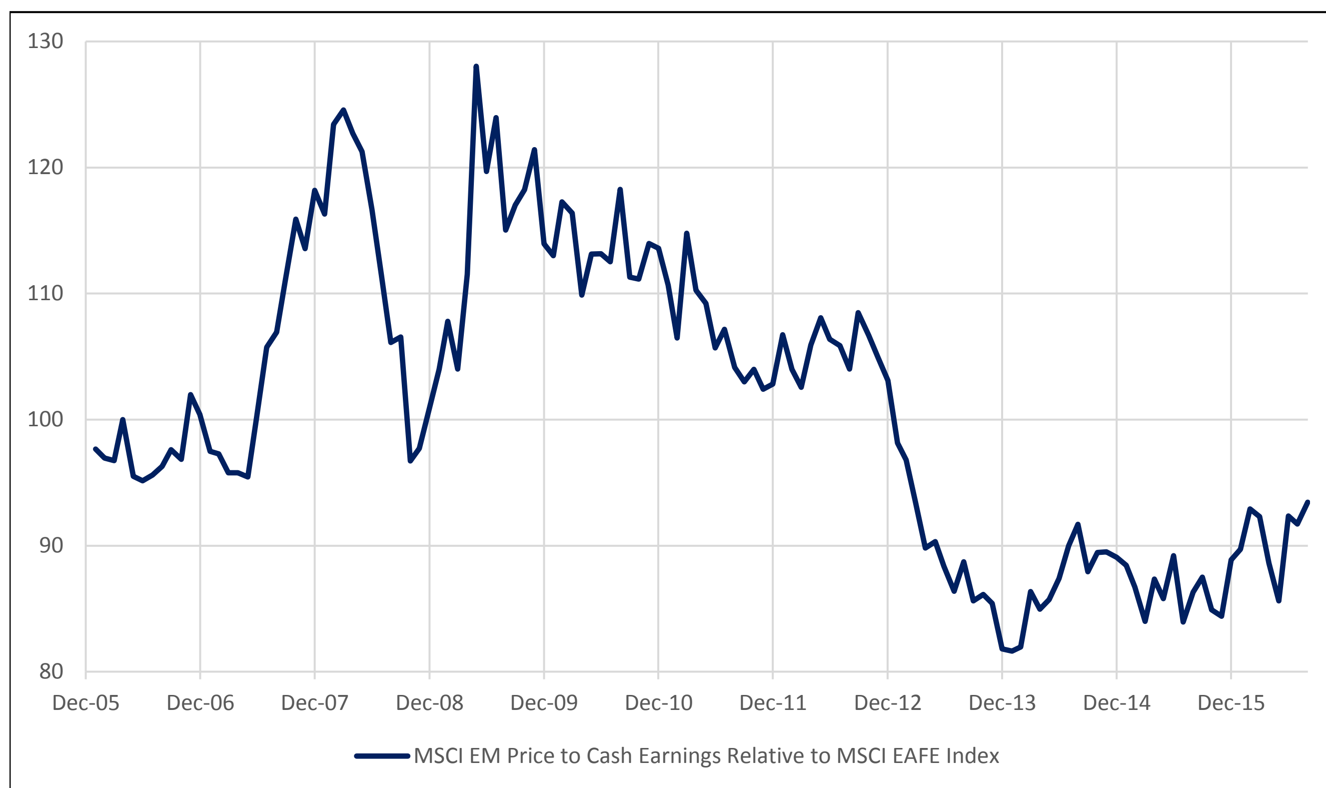
Figure 8. September Marks Further Extension of YTD Outperformance by EM Equities of Developed Peers

Source: MSCI, Bloomberg and Glovista Calculations

Glovista's investment team continues to favor fully invested allocations within dedicated EM equity programs as we expect a continuation of the virtuous cycle that began in the first quarter of this year – discussed in prior monthly columns – consisting of expanding earnings and top-line revenue growth accompanied by continued EM currency strengthening versus the US Dollar. Under such macro factor configuration, inflation momentum has turned increasingly benign across a large number of EM national economies, thereby paving the way for a number of EM central banks' embrace of policy rate cuts. The latter, in turn, has reverberated positively in an acceleration of EM consumer expenditure growth trends.

We continue to expect EM equities to extend their 2016 YTD outperformance of Developed peers well into next year owing to the visible combination of value, growth and ownership factors highly supportive of EM versus DM equity peers. Figure 9 illustrates EM equities' continued attractive relative valuations versus EAFE peers while Table 1 captures the considerably higher real interest rate levels across a number of large EM countries along with the modestly sized external financing requirements facing those countries, as reflected in the countries' current account balances expressed as percentage of those countries' GDP.

Figure 9. EM Equities' Relative P/CE Valuation Discount versus EAFE Peers Remains Well Below Multi-year Average Levels



Source: MSCI, Bloomberg and Glovista Calculations

Table 1. Selection of EM Country Indices: Most Recent Real Interest Rates and Current Account Balances

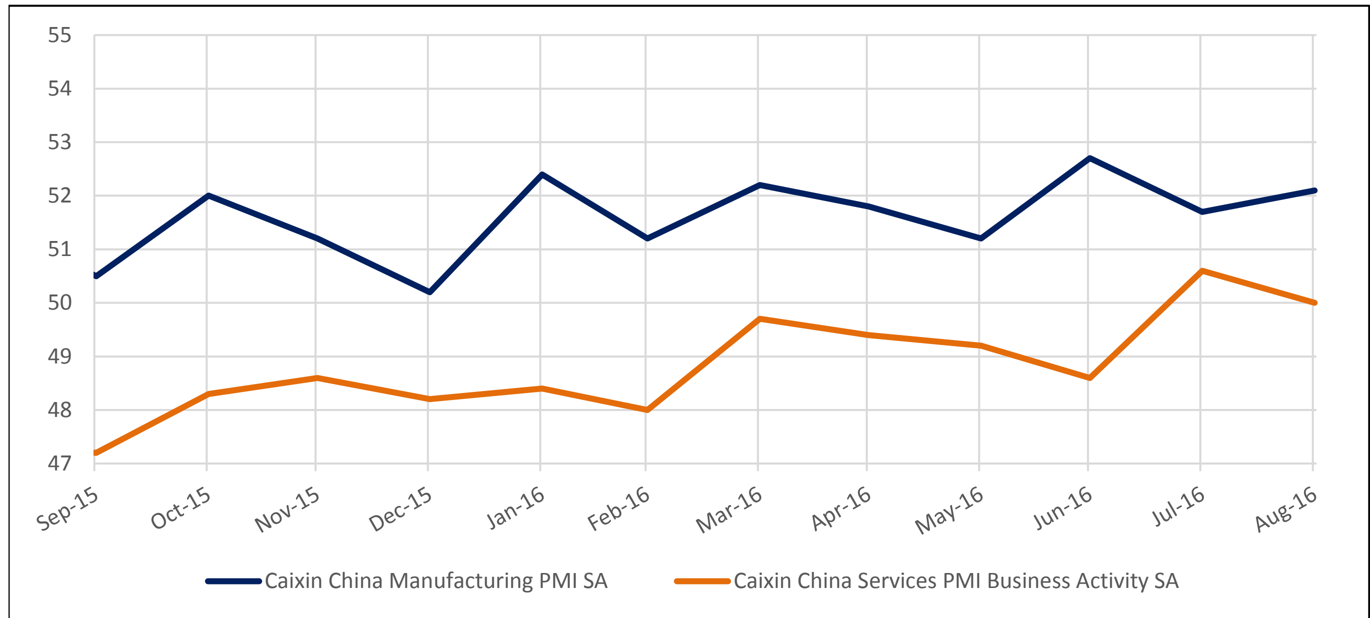
	Real Interest Rate*	Current Account Balance as % of GDP
China	3.05%	2.39%
South Korea	0.85%	7.75%
India	0.95%	-0.77%
Malaysia	1.50%	1.90%
Thailand	1.21%	11.12%
Indonesia	3.71%	-2.14%
Mexico	2.02%	-3.15%
Brazil	5.28%	-1.84%
Chile	0.10%	-2.19%
Russia	1.35%	3.08%
South Africa	1.10%	-3.10%

Source: Bloomberg

**Real interest rate is calculated as Central Bank Policy Rate minus Country latest YoY Headline CPI*

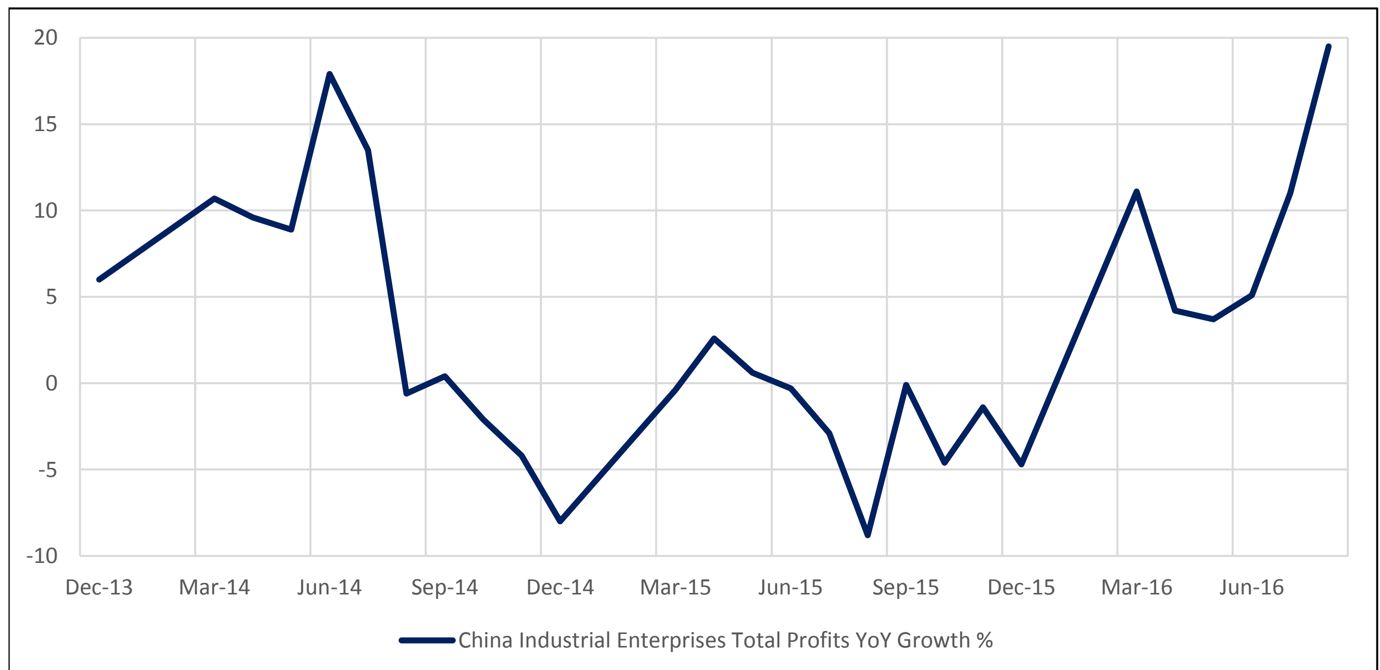
Interestingly, the most recent major EM country to record improving economic activity momentum is none other than China. For example, Figure 10 illustrates the consolidated strengthening of activity momentum across China, both at the goods and service sector levels. The strengthening of China's consumer sector-led momentum holds the potential of becoming self-sustained given the considerable strengthening of industrial profits momentum as deflation concerns abate and labor costs remain under control (Figure 11).

Figure 10. China Service and Manufacturing PMI Indices Flash Improving Confidence Levels



Source: Markit

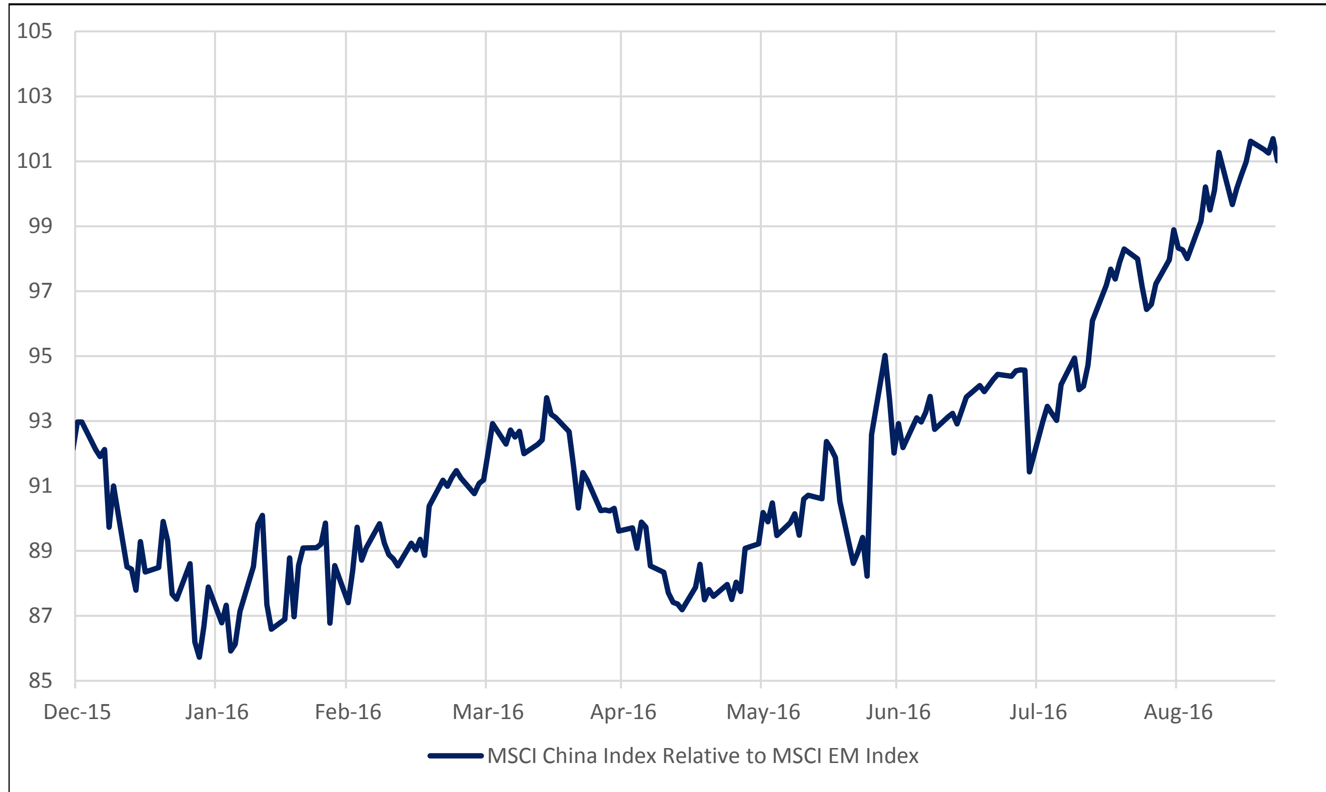
Figure 11. China's Industrial Profits Growth Accelerates YTD as Pricing Power Rises and Labor Costs Remain under Control



Source: National Bureau of Statistics of China

Against the backdrop of an improving Chinese economy, it is no surprise that Chinese equity prices have sharply outperformed EM peers starting around the middle of August (Figure 12). Within our EM equity portfolios, we have maintained our overall country exposures approximately unchanged these past several weeks, maintaining overweight allocations to North Asia markets, including Taiwan and China. We continue to underweight Latin America, Central European and Middle Eastern regional exposures owing to their unattractive relative valuation and earnings outlooks. We favor a number of ASEAN markets, especially Thailand and Indonesia primarily on currency and relative equity valuation considerations. Finally, our constructive outlook towards crude prices has resulted in a continued overweight Russia country exposure.

Figure 12. Chinese Equities Sharply Outperform EM Peers Starting in Mid-August.



Source: MSCI, Bloomberg and Glovista Calculations

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