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Glovista Global Perspectives

This Issue:

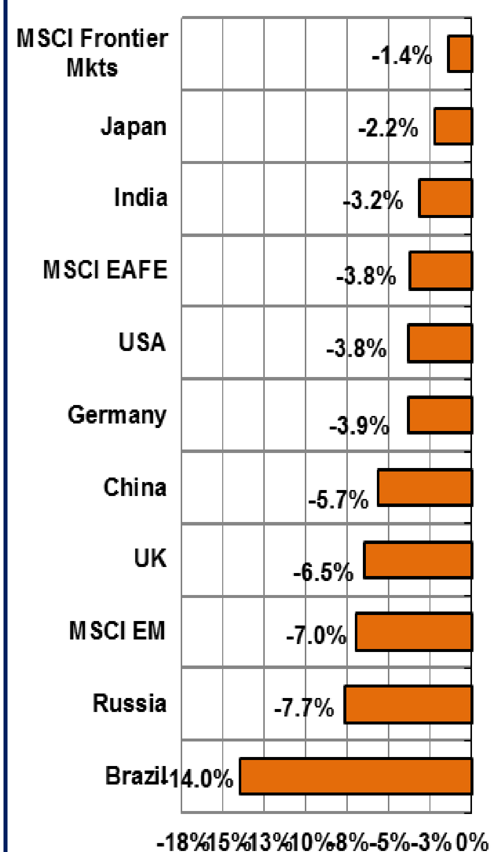
Escalating US-China Trade Tensions Fuel Risk Markets Sell Off on Recession Concerns; Glovista Sustains High Quality Factor Exposures; Solid Personal Consumption Spending Dynamics at Odds with Capex Slowdown

In August, risk markets have sold off sharply, including equities, credit and foreign exchange. For example, Figure 1 illustrates the sharp August month-to-date sell-off recorded by strong cyclical asset groups during the month, that has cut across the global equities, credit and currency market divides. For example, Figure 1 illustrates the -3.7%, and -4.0% declines recorded by global equities (as represented by the MSCI ACWI index) and the highly cyclical Australian Dollar-Japanese Yen exchange rate cross, respectively, among others.

As we discuss further below, we attribute the August month-to-date sell-off in risk markets to be driven primarily by the sharp escalation in US-China trade frictions following US President Trump's decision to further raise the quantum of tariff rates applied on Chinese goods imports as well as the potential for a mandated pull-out of US business operations out of China (August 23rd), a threat he has gradually pulled back from in the earlier part of the week starting on August 26th. Figure 2 illustrates the almost unprecedented spike in geopolitical risk these past several weeks, approaching the highest levels in the last five years.

From an investment perspective, the above mentioned deterioration in the globally crucial US-China trade relations manifests itself in an unusually large spike in asset risk premium levels, such as displayed in the blow-out in the so-called 'yield gap' between stocks and bonds, captured in the current highly elevated spread between global equities' earnings yield levels against bond yields – Figure 3.

Country-wise Monthly Performance in USD terms (August 2019)*



Source: MSCI & Bloomberg

***As of August 27th, 2019**

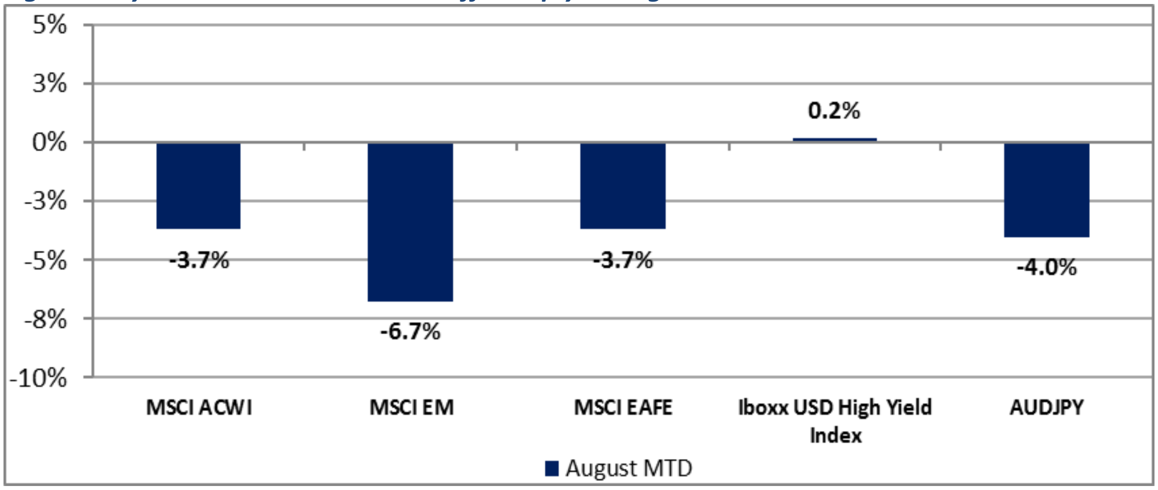
Sectors	% Change	FY1 PE Ratio
Energy	-11.35%	17.4
Materials	-5.66%	18.2
Industrials	-6.04%	16.7
Cons Disc	-3.37%	21.6
Cons Stap	0.87%	20.4
Technology	-3.47%	20.0
Healthcare	-2.31%	15.3
Financials	-7.67%	11.7
Utilities	4.21%	20.1
Telecom	-3.25%	16.9
Real Estate	3.40%	37.9
S&P500	-3.73%	17.3

S&P500 Monthly Sector Performance – August MTD 2019*

**As of August 27th, 2019*

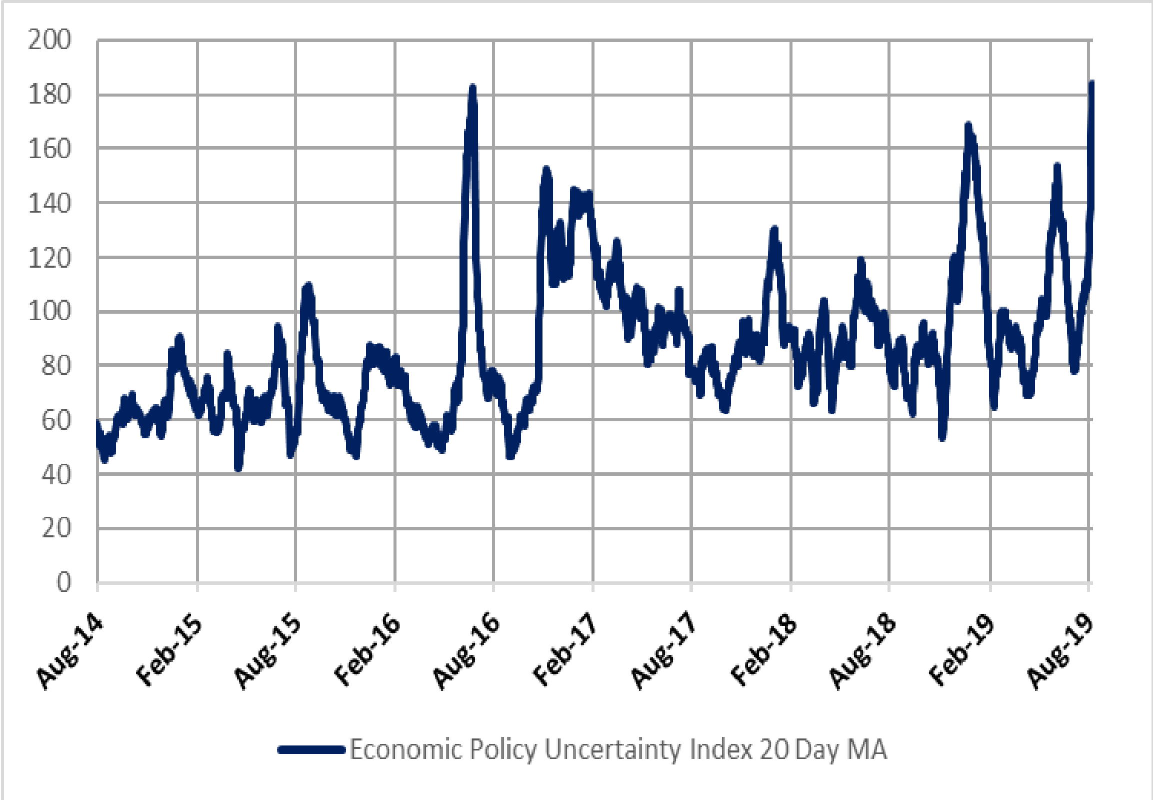
Source: Bloomberg

Figure 1. Cyclical Asset Markets Sell Off Sharply in August



Source: Bloomberg, MSCI & Glovista Calculations

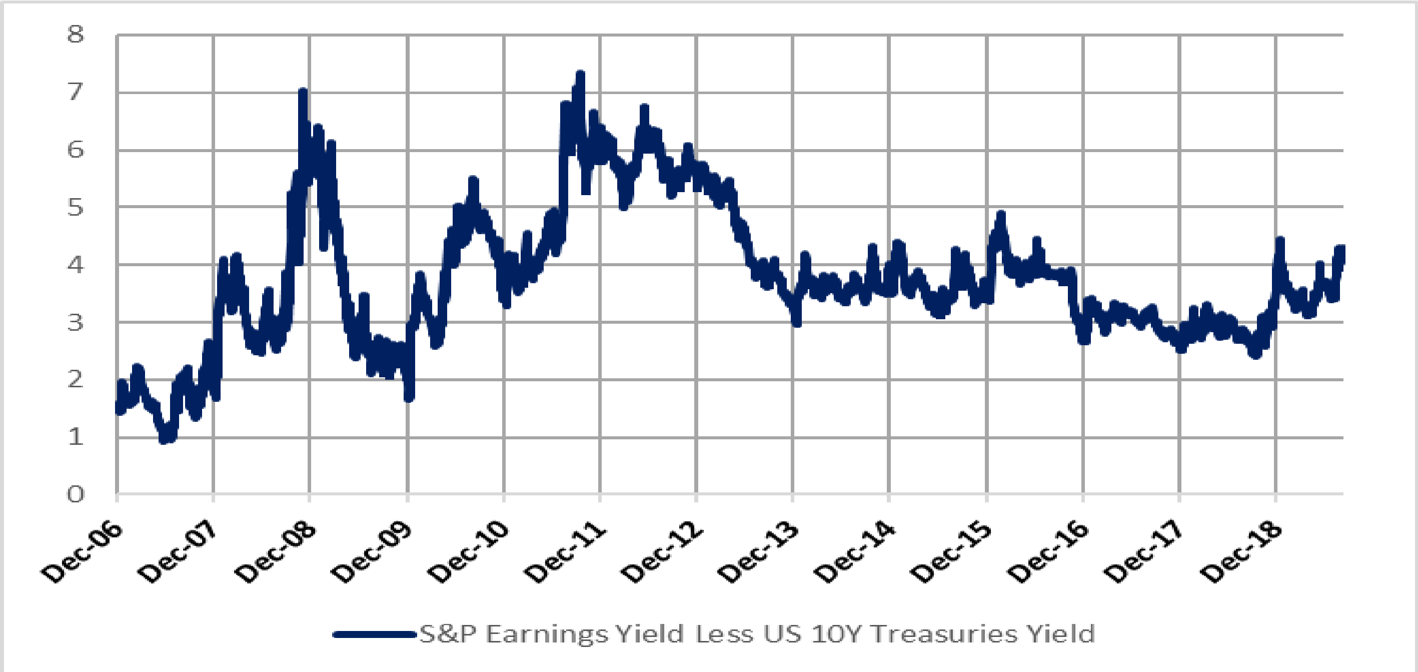
Figure 2. US Economic Policy Uncertainty Index Spikes to Highest Level since Mid-2016



Source: Bloomberg

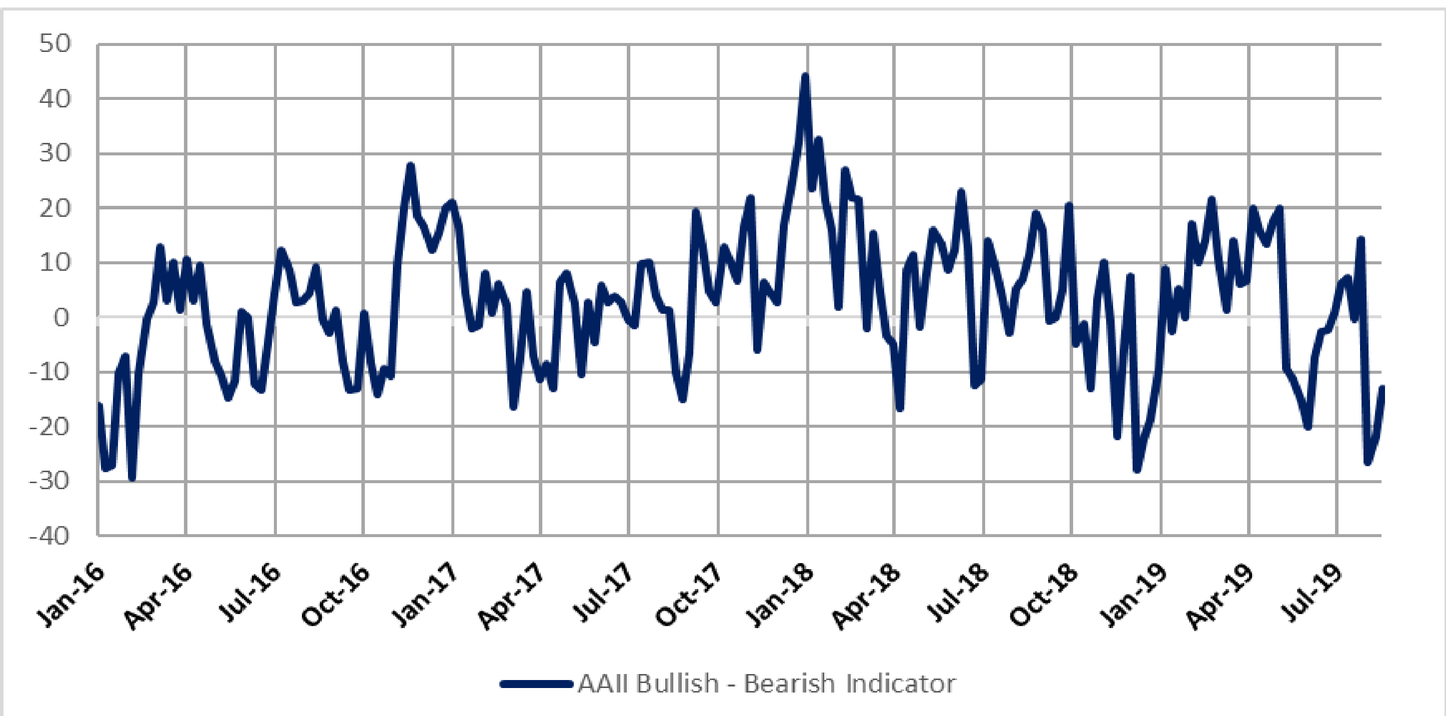
The recent spike in risk premium is also evident in the sharp deterioration recorded in US retail investor surveys, such as the AAII bull versus bear sentiment readings – Figure 4.

Figure 3. Stocks' Valuations Versus Bonds Approaches Cheapest Levels since 2007-2009 Great Financial Crisis and 2011-2012 Eurozone Crisis Periods, Fueled by Spike in Risk Premium Levels



Source: Bloomberg & Glovista Calculations

Figure 4. Spike in Risk Premium Levels also Reflected in Deterioration of Retail Investor Sentiment Readings to the Most Negative Levels since Q4 of 2018



Source: American Association of Individual Investors

Decline in Investor/Business Sentiment Levels, While Consistent with Softened Capex Dynamics, Stands at Odds with Resilient Consumption Expenditure Dynamics Globally

As we review recent global economic conditions, with the purpose of ascertaining the possible role of weakened demand conditions on the recent decline in risk asset valuations, we find a stark divergence between the state of personal consumer and business investment expenditure conditions. Specifically, the economic calendar for the second quarter shows global retail sales and other indicators of personal consumption expenditure to have grown at close to the fastest pace since 2010 for the case of large regions of the US and north Asia (Figure 5 for the US case and Figure 6 for the case of Japan) while proxy indicators for business investment spending (including US core capital goods orders) have displayed clear signs of deceleration these past several months (Figure 7)

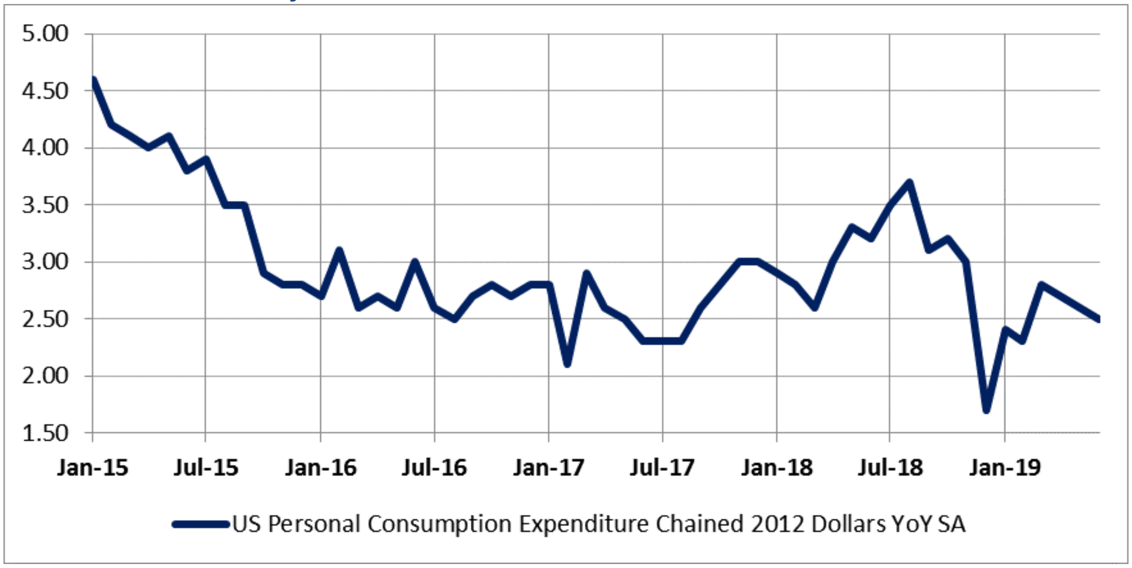
	August 27th 2019	August MTD Change
Gold	1542.81	9.1%
Silver	18.201	11.9%
Oil	54.93	-6.2%
EUR	1.109	0.1%
JPY	105.75	-2.8%
GBP	1.229	1.1%
CHF	0.9815	-1.3%
CAD	1.3283	0.7%
AUD	0.6752	-1.4%
BRL	4.1311	8.4%
MXN	19.9845	4.4%

Source: Bloomberg

Rates	August 27th Levels
1 Yr CD	1.46%
5 Yr CD	1.75%
30 Yr Jumbo Mortgage	4.21%
5/1 Jumbo Mortgage	3.84%
US Govt. 10 Year	1.4711%
10 Yr Swap Spread	-0.09%

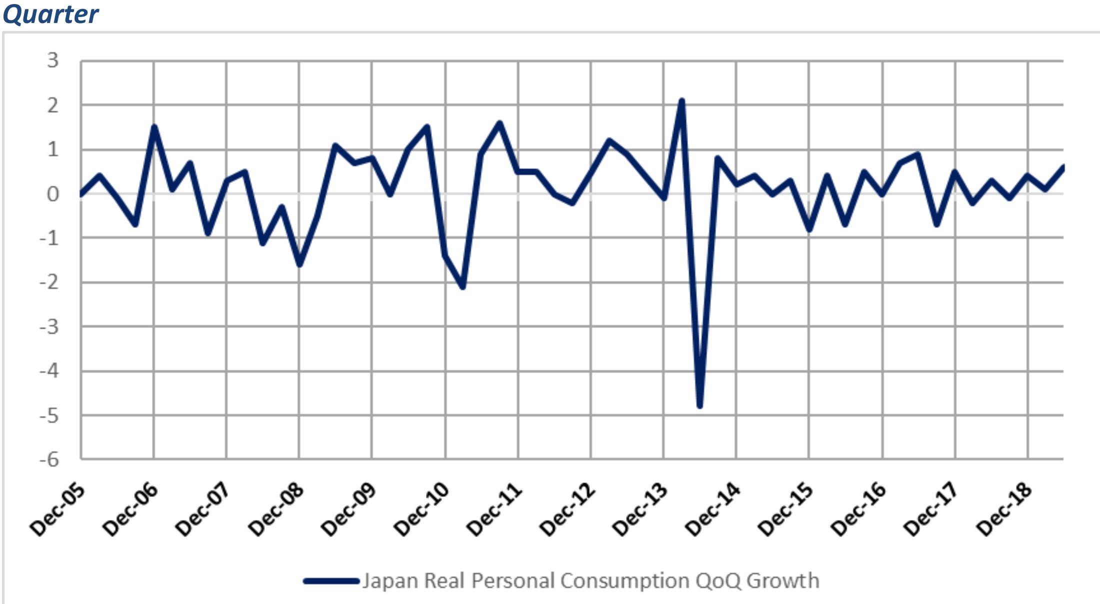
Source: Bloomberg

Figure 5. US Real (Inflation adjusted) Personal Consumption Growth Remains Strong well into the Third Quarter of 2019



Source: Bureau of Economic Analysis

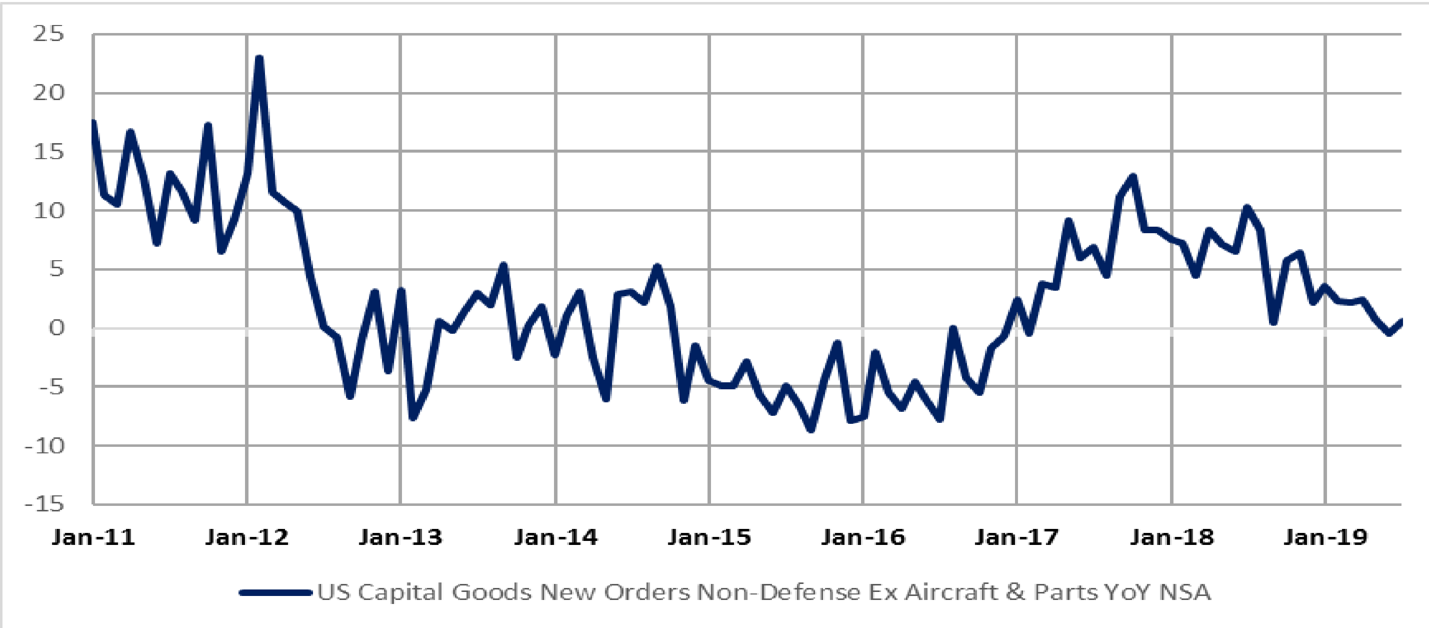
Figure 6. Japan Real Personal Consumption Growth Remains Solid into the Year's Second Quarter



Source: Bloomberg

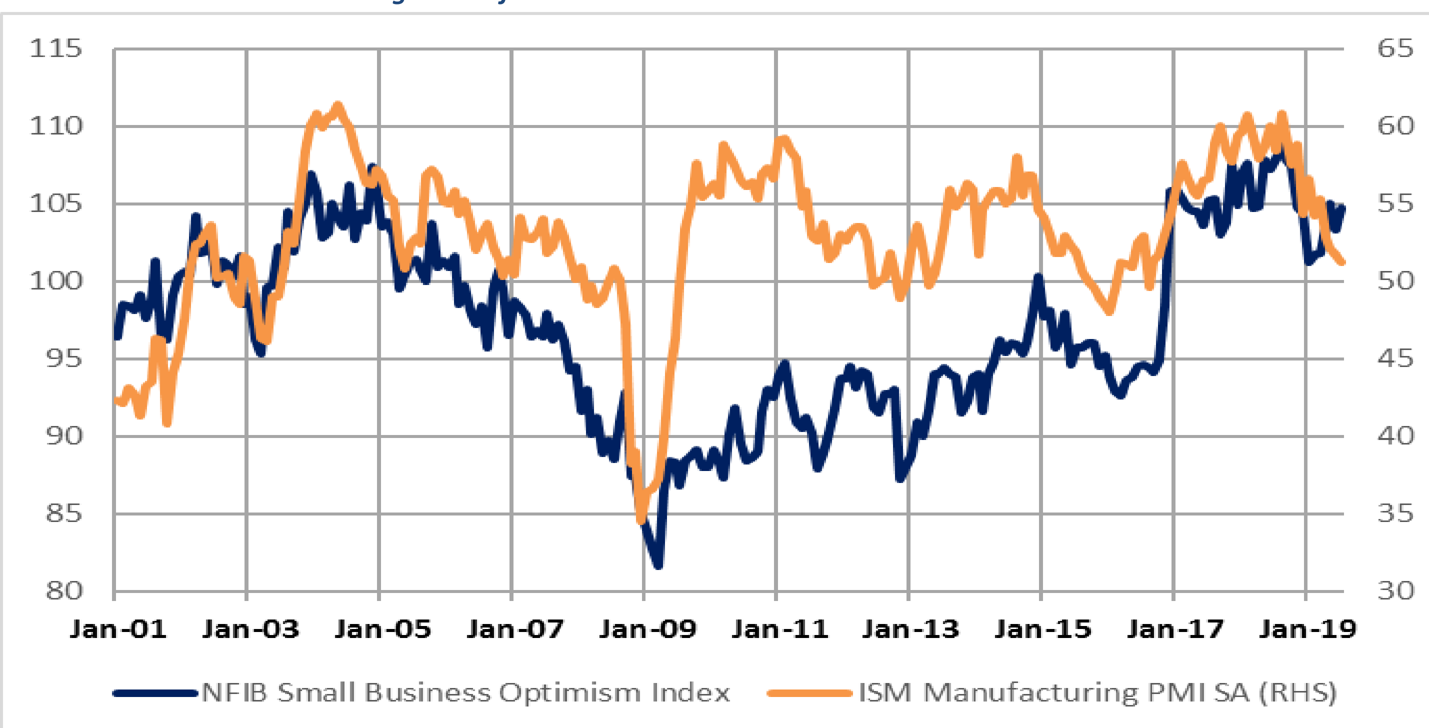
The current divergence between the growth momentum between personal and business investment spending (at a global level) is among the widest in the past ten years. In that context, Glovista's investment team attributes such divergence, particularly the softening in business investment spending intentions, to the significant dislocations unleashed on the global production chains by the escalating US-China trade tensions that began in earnest during the second half of 2018. That such geopolitical concerns can be especially relevant to larger business groups explains, in our view, the resilience of US small business optimism levels versus those of their larger peers (Figure 8). A similar conclusion can be arrived at from exploring the varying dynamics between US service and manufacturing sector companies' new order sentiment readings.

Figure 7. US Core Capital Goods Orders (Investment Spending Indicator) Have Weakened Thus Far in 2019



Source: Bloomberg & US Census Bureau

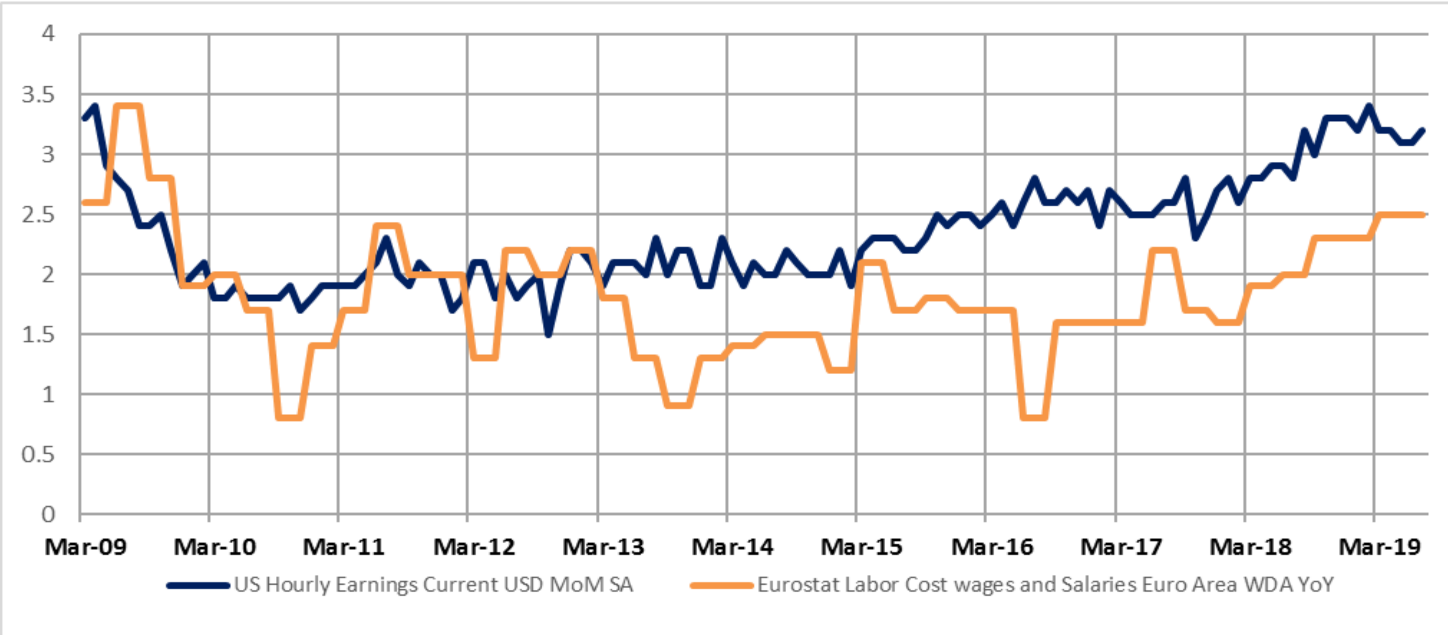
Figure 8. US Small Business Optimism Levels Remain Strong Throughout the Recent Period of Escalating US-China Trade Tensions in Stark Contrast to Large Manufacturers' Sentiment Index



Source: National Federation of Independent Business & Institute for Supply Management

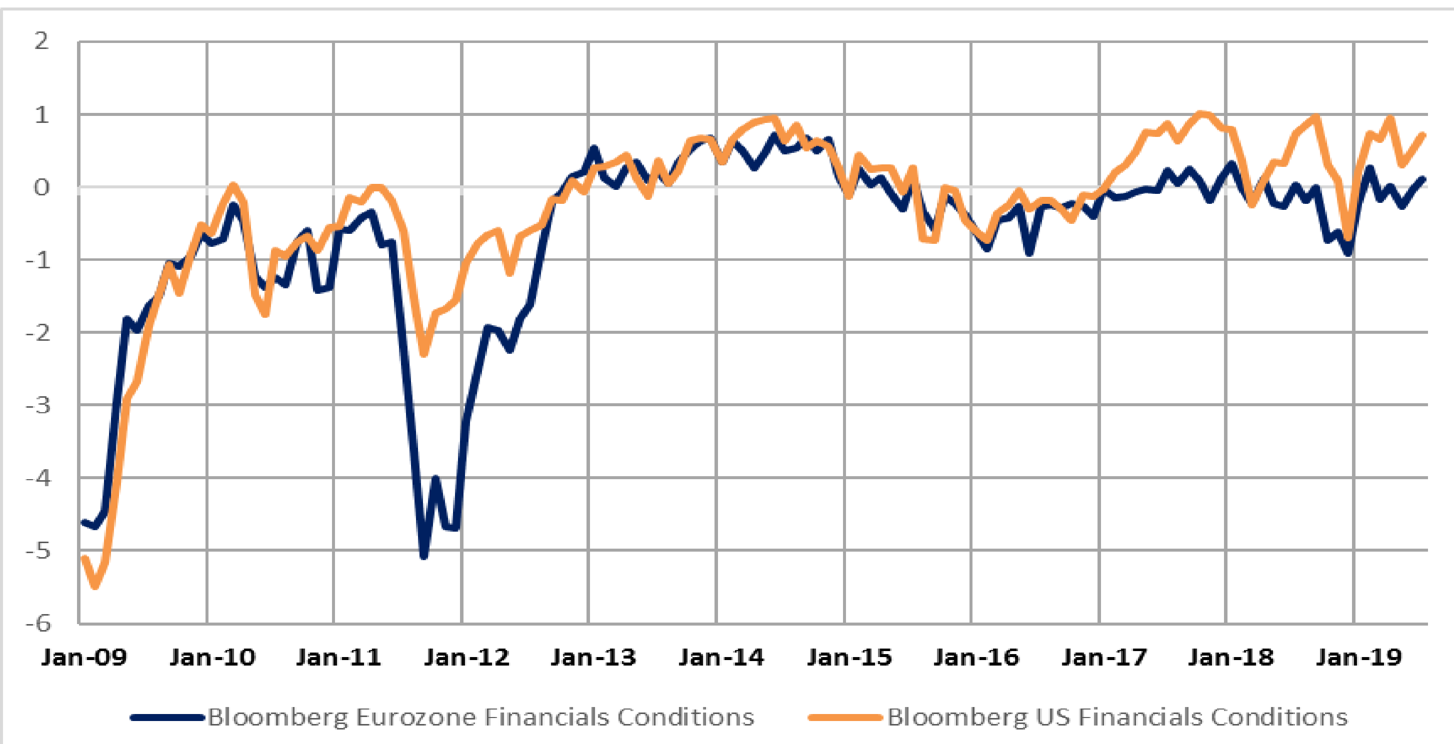
As we review the US and also international (including the Eurozone's) household sector environment, we find resilience in terms of disposable personal income growth dynamics (Figure 9). In addition, in contrast to the adverse credit market conditions unfolding during the fourth quarter of 2018, thus far in 2019 financial conditions remain loose in the world's major economic blocs, including the US and Europe (Figure 10).

Figure 9. US and European Households' Earnings Power Remains Resilient, along with Employment Conditions, Lending Visibility to Continued Domestic Demand Growth Momentum in the Rest of 2019



Source: Bureau of Labor Statistics, Eurostat

Figure 10. Global Financial Conditions Remain Loose Compared to Q4 of 2018: US and Europe



Source: Bloomberg

While Continuing to Favor Healthy Exposures to Equities, Glovista Sustains Defensive Portfolio Tilts, Emphasizing Quality, including Precious Metals

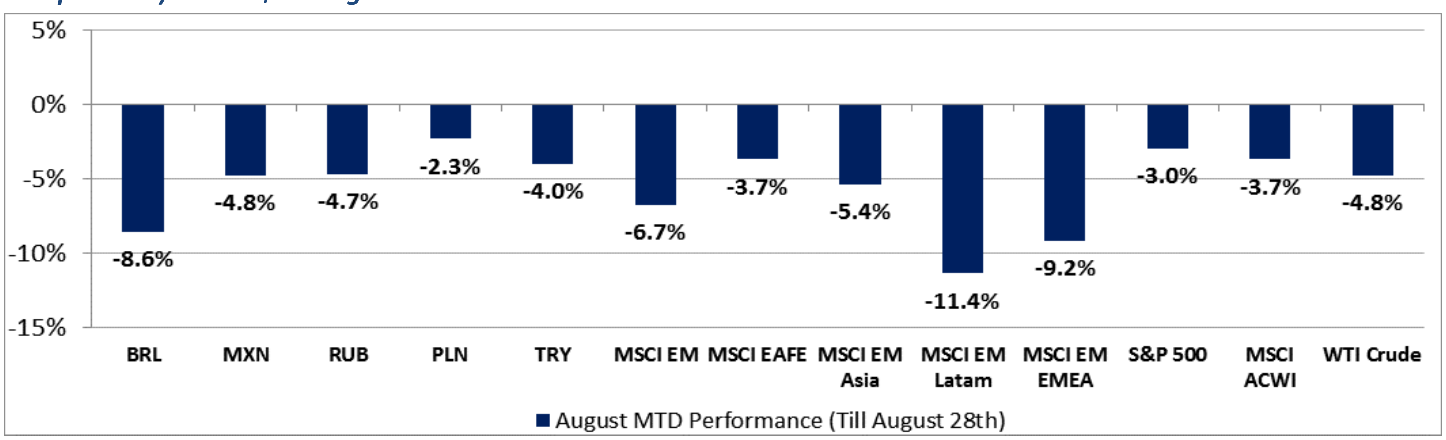
As we reconcile the above mentioned dynamics - defining the real economy - against the role of policy and political risk in the decline of asset valuations these past several weeks, we find risk assets to be attractively valued versus bonds. Moreover, given continued loose financial conditions globally along with our expectation that the US FED and the European Central Bank will cut reference policy rates in September along with continued expansion of their balance sheets, the Glovista investment team continues to favor healthy exposures to global equities. However, for the same considerations outlined in prior monthly columns (including relative valuations and the advanced stage of the current business cycle expansion, especially in the USA) we continue to favor high quality factor tilts both in equities as well as fixed income. Finally, owing to diversification considerations as well as the likelihood of continued low real (inflation adjusted) interest rate environment in much of the developed world (where close to 35 percent of public debt trades at negative nominal yield levels) we continue to favor modest exposure to precious metals, including gold and silver.

Emerging Markets Perspectives

EM Equities Strongly Underperform Developed Peers in August, Led by Escalating US-China Trade Tensions and US$ Strength Fueled by Heightened Global Recession Concerns; Glovista Sustains Overweight Value Country Tilts

In August, EM equities have solidly underperformed developed market peers (Figure 11), fueled by combined effects stemming from (a) a sharp spike in global risk premium tied to the escalation of US-China trade tensions, and (b) a new wave of US Dollar strength fueled by growing investor concerns over the potential for a global recession in 2020.

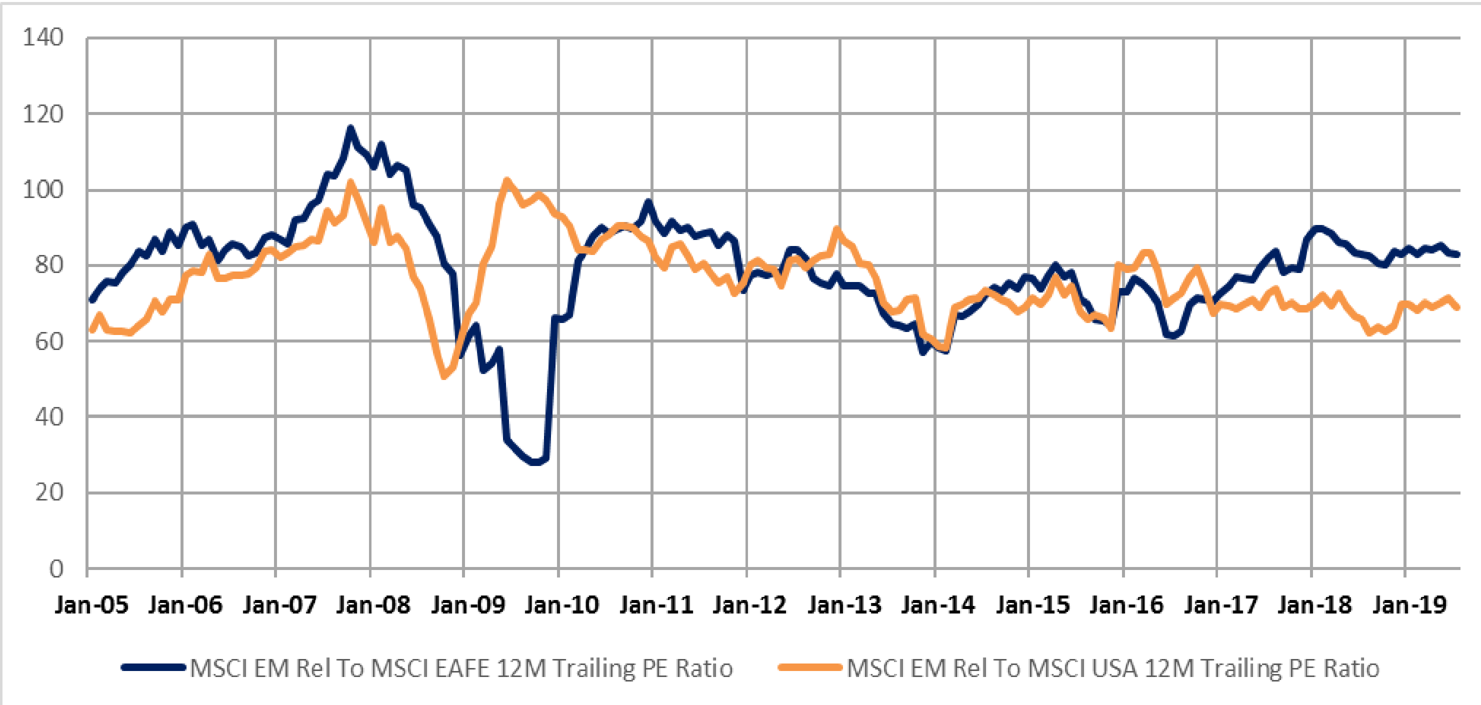
Figure 11. EM Equities Underperform Developed Peers Solidly in August, Fueled by Risk Premium Level Spike (Multiple Compression) and US$ Strength



Source: Bloomberg, MSCI and Glovista Calculations

As for the recent spike in asset risk premium levels globally, we outlined above various considerations anchoring the Glovista investment team's sustained thesis calling for no global recession scenario over the intermediate term but rather an ongoing manufacturing sector slowdown, largely the result of dislocations associated with the ongoing US-China trade tensions that started in Q2 of 2018 along with dislocations tied to the ongoing Brexit episode in Western Europe. As for the global market implications resulting from the escalating US-China trade tensions, we believe recent events from both the official China and US sides confirm the respective governments' disposition to prevent further escalation of tensions. Moreover, we believe that the prolonged nature of the trade dispute is understandably feeding downward revisions to 2020 US and China GDP growth estimates though the orders of magnitude appear to us to remain manageable (in the vicinity of 75 basis points) unless current friction levels escalate measurably from here. A worst case scenario to us would correspond to the implementation of a US government-led restriction on US companies' operations in China. The magnitude of US corporates' presence in China, as measured by the cumulative quarter trillion US Dollar foreign investment, would qualify such scenario as a credit event almost on a global scale. At present, such scenario appears to carry a very low probability weight.

Figure 12. EM Stocks' Relative P/E Valuations versus Developed Peers Sits at Close to Multi-year Low Levels



Source: Bloomberg, MSCI & Glovista Calculations

As we look ahead, the investment case underlying Emerging Market equities remains as solid as ever, if not more. First, the economic growth leadership commanded by EM countries versus Developed peers, as measured by robust GDP growth differentials, remains considerable. Second, Emerging Market countries' sovereign credit fundamentals – as measured via current account, budget account and net public debt ratios – both in absolute, historical and relative terms versus Developed peers are at exceedingly strong levels, with few exceptions found in third tier countries. Third, Emerging Market equities' relative valuations versus Developed peers sits at close to multi-year low levels (Figure 12). Fourth, the recent several weeks have witnessed some of the largest rounds of liquidation on the part of passive Emerging Market equity vehicles (including EEM and IEMG ETFs), strongly suggestive of retail investor capitulation towards the asset class, a historically powerful indicator of a long-term bottoming process.

As a result of the above, and (a) taking into account our standing macro thesis calling for an upturn in cyclical indicators over the coming months as risk premium levels normalize to lower levels and also considering the (b) ongoing succession of fiscal and monetary stimulus measures from around the world (e.g. US, Eurozone, China, South Korea, Japan) that are likely to exert stabilizing effects on aggregate demand with a lag, we expect EM equities to post strong absolute and relative return performance versus Developed peers.

Notwithstanding our bullish EM equity market outlook, summarized above, the Glovista investment team continues to favor a defensive portfolio stance within the EM space, sustaining overweight allocations to strong macro balance and corporate balance sheet markets that display low exposures to global trade linkages adversely impacted by the ongoing (and still opaque as to its duration) period of trade tensions between China and the US. At the country level, we continue to favor overweight exposures to India, Indonesia, Russia and Brazil while continuing to underweight a number of North Asian, Middle Eastern and Central European markets.

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