FIS GROUP

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MARKET OUTLOOK
Q1 2016

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2015 IN REVIEW – A FORGETTABLE YEAR

TABLE 1 IMF Economic Forecasts: Another year of growth disappointments *Annual % growth in real GDP*

	October 2015 Forecast		October 2014 Forecast		Change in 2015 Forecast	Change in 2016 Forecast
	2015	2016	2015	2016		
World	3.1	3.6	3.3	3.8	-0.2	-0.2
Advanced Economies	2.0	2.2	1.8	2.3	0.2	-0.1
U.S.	2.6	2.8	2.2	3.1	0.4	-0.3
Euro Area	1.9	1.9	1.4	1.8	0.5	0.1
Japan	0.6	1.0	0.9	0.8	-0.3	0.2
Emerging Economies	4.0	4.5	4.4	5.0	-0.4	-0.5
China	6.8	6.3	7.4	7.1	-0.6	-0.8
Annual G7 Inflation Rate	0.2	1.1	1.7	1.8	-1.5	-0.7

Source:: IMF

For the most part, 2015 was a forgettable year as growth anemia and disappointment, enduring characteristics of the post GFC period, continued. At 3.1%, global growth once again underperformed IMF forecasts from October 2014 with most of the disappointment emanating from the Emerging world that is most exposed to the slowdown in China and the end of the commodity super-cycle. With notable exceptions of commodity producers such as Brazil and South Africa, inflation also underperformed the 2014 forecast, underpinned primarily by weak demand and the precipitous decline in commodity prices.

TABLE 2 Market Performance *%*

	U.S. Dollar Terms				Local Currency			
	2015 Total Return	2015 Price Change	P/E change	Earnings Growth	2015 Total Return	2015 Price Change	P/E Change	Earnings Growth
All World Country Index	-0.25	-2.74	5.44	-7.76	1.81	-0.70	5.44	-5.71
EAFE Index	-0.21	-3.30	13.29	-14.65	5.78	2.69	13.29	-8.65
Emerging Markets (EM) Index	-14.83	-16.96	-5.59	-12.04	-5.40	-8.02	-5.59	-2.86
Frontier Market (FM) Index	-14.66	-17.32	-8.70	-9.44	-9.35	-12.78	-8.70	-4.52
U.S. (S&P 500 Index)	1.37	-0.73	0.02	-0.75	1.37	-0.73	0.02	-0.75
S&P Growth	5.51	3.75	3.66	0.09	5.51	3.75	3.66	0.09
S&P Value	-3.14	-5.59	-2.00	-3.67	-3.14	-5.59	-2.00	-3.67
Small Cap	-2.01	-3.36	-7.29	4.24	-2.01	-3.36	-7.29	4.24
Euro Area	-2.24	-5.31	12.47	-15.81	8.89	5.47	12.47	-6.22
Japan	9.25	7.09	1.00	6.57	10.30	8.12	1.00	7.05
U.K.	-7.25	-10.91	29.73	-31.33	-1.92	-5.88	29.73	-27.45
Canada	-23.03	-25.41	2.33	-27.11	-8.36	-11.06	2.33	-13.09
China (Shanghai Composite)	6.36	4.69	19.31	-12.25	11.15	9.41	19.31	-8.29
Emerging Asia	-9.80	-11.78	-6.22	-5.92	-5.50	-7.90	-6.22	-1.83
Emerging Latin America	-30.87	-32.92	-3.62	-30.40	-8.48	-11.26	-3.62	-8.37

Source: Bloomberg, MSCI and FIS Group professional estimates

TABLE 3

10-Year Government Bond	2015 Return (%)	One year change in Yield
U.S.	N/A	0.10
Germany	N/A	0.09
Japan	N/A	-0.06
Emerging Markets	-0.04	0.98
U.S. Corporate Bond Returns		
Investment Grade	-0.01	0.52
High Yield	-0.03	1.79
	2015 Return (%)	**Level at 12/31/2015**
Brent Oil (% change)	-34.97	37.28
Gold (% change)	-10.41	1061.10
Trade-Weighted Dollar (% change)	10.96	94.46

Source: Bloomberg, MSCI and FIS Group professional estimates

Most asset classes finished the year in flat or negative territory with commodity and emerging markets exposure eliciting the greatest degree of pain for investors. Among developed markets, Japan was again the standout as a result of strong corporate profits and a stable yen; whilst equity gains in Europe were mostly wiped out (for U.S. dollar investors) by the fall in the euro. The biggest sources of market volatility in 2015 was the fallout from energy price declines and China, which sparked a brief panic after a clumsy intervention to cushion the mid-year stock-market collapse and an unexpected currency devaluation in August. However, by the end of the year the Shanghai index was still up nearly 5% in U.S. dollar terms. Apart from the fallout from its relative exposures to financials and commodities, the EM LatAm index was further exacerbated by MSCI's changes in the constitution of its global indices. By allowing companies trading outside their country of classification to be eligible for inclusion in future review, MSCI's Emerging Market indices began to include large Chinese ADRs for the first time (with Alibaba and Baidu being the largest additions). This resulted in several companies being rather abruptly removed from the index altogether. Six stocks were deleted from Brazil, three in Colombia and one in Chile. After the November 30 rebalancing, LatAm's weight in the MSCI EM index was reduced by 4.6%, with the largest reduction impacting Colombia, whose weight was reduced by 14.8%!

Finally, 2015 closed with the Fed beginning to hike the discount rate, after years of speculation, debate and angst. Now the focus shifts to the pace of rate hikes. In 2016, the Fed's primary focus on the labor market in the lead up to the first rate hike will shift to changes in U.S. wages and underlying PCE inflation. Fed Chair Yellen has emphasized that she will proceed "gradually", as specified by the 'dot plot'. The problem is that investors appear to believe that "gradual" means something much slower. The median 'dots' foresee four quarter-point rate hikes in each of 2016 and 2017, compared to half that amount implied by the bond market. As discussed below, this disparity as well as its attendant impact on the U.S. dollar is one of the key potential disruptors to risk assets in 2016.

Reviewing the performance of our primary forecasts for 2015 from our January 2015 report (see PAGE 4 of our 2015 Q1 Outlook) we thought that global equity markets during the year would be dominated by the five principal themes delineated below. We fear that our accuracy grades set an unrealistically high bar in 2015; but we will keep swinging for the fences! Additionally, for the performance of our global completion overlay portfolios, please see PAGE 17.

	FIS Group's Forecast Theme for 2015	What happened?	Grade
1	Continued (albeit more modest) appreciation of the U.S. dollar.	During the 2015, the trade-weighted U.S. dollar increased by 9.26%.	✓
2	Increasing volatility (particularly in the U.S.), as the markets transition from a liquidity supported to a growth supported market.	During 2015, the average price of the VIX was 16.5% vs. 14.07% in 2014. The average weekly return in 2015 was 2.17% vs. 1.74% in 2014.	✓
3	Continued decline in commodity resources prices, which will impair commodity intensive countries and sectors.	During 2015, the CRB index decreased by 17% and Brent crude prices decreased by almost 35%.	✓
4	Gradual rotation of earnings leadership to non-resource dominated and developed non-U.S. markets, fueled by continued U.S. dollar appreciation, increased import demand from U.S. consumers and accommodative policy settings outside of the U.S. Because of the attendant currency dynamics, this theme should be implemented through dollar hedged positions.	Japan outperformed U.S. equities in both U.S. dollar and local currency terms. European equities outperformed U.S. equities on a currency hedged basis. Both developed markets outperformed Emerging Markets. The underweight to Emerging Markets (and the expression of our EM weights through positions in China consumers and IT as well as India small caps) was also accretive to performance. We had no positions in the more commodity intensive LatAm, Russian or South African bourses.	✓
5	Within U.S. equities, a rotation to domestic focused and/or non-cyclical sectors.	The quarterly average return of cyclical sectors during 2015 was -1.52% vs. 0.87% for defensive sectors and 1.11% for interest rate sensitive (which are primarily domestically focused) sectors.	✓

These themes were implemented in FIS Group's tactical completions strategies. The performance of our strategies is shown on page 17.

2016 OUTLOOK

The post GFC period has engendered many paradoxes that have bedeviled forecast and fundamental stock selection models that rely on historical relationships. One such paradox is the inability to engender pre GFC growth rates and inflation despite (in the case of the U.S.) six years of extreme monetary accommodation. For investment managers, the other is the overwhelming impact of macro factors relative to traditional fundamental factors. At the beginning of this year, we revisit key secular trends to help gain clarity amidst the cacophony of mostly misguided short-term prescriptions and to anchor our investment strategy; such that we do not veer too far from the headwinds and tailwinds emanating from these secular dynamics. This is why we have divided the outlook among 3 secular trends and 6 cyclical trends that we believe will move markets in 2016. We close this paper with an assessment of 3 key risks that could substantially disrupt risk assets in 2016 as well as summary of our Q1 strategy on PAGE 16.

A summary of the themes that are discussed herein are delineated below:

Summary of FIS Group's 2016 Cyclical Themes and Risks

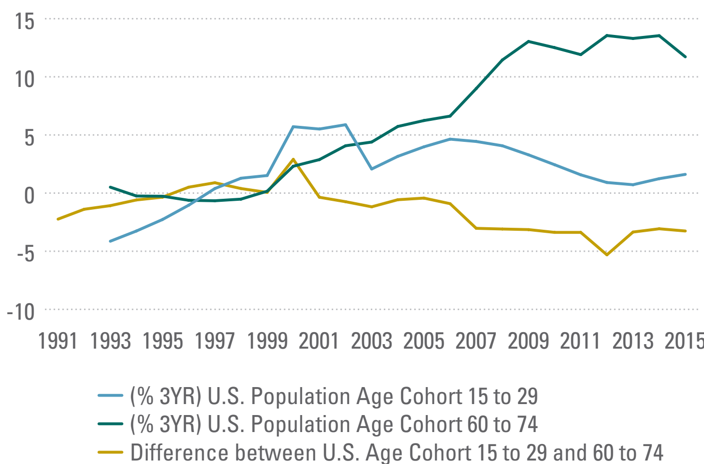
	Secular Themes	Page Reference
1	Lower trend growth among G7 countries that primarily emanates from changing demographics will continue to force central banks to remain relatively accommodative.	4
2	The U.S. is beginning to be impacted by monetary policy exhaustion in that there are diminishing marginal benefits from monetary accommodation for real economic growth. With a fundamentally weak growth backdrop and more vulnerable valuation levels (particularly in the U.S.), the probability of a systemic tail risk event has increased. The 3 most likely sources of negative tail risks are dilineated below.	4
3	Demographics and the increasing service intensity of world economic growth will reorder the economic winners and loser among sectors and regions. On the sector front, service sectors, particularly the health and IT service intensive economy will outperform sectors that have been buoyed by mining, manufacturing and merchandise trade volumes. This will present a secular headwind for production and trade dependent components of EM that have been grown by servicing Chinese demand for capital goods, while providing a bid under technology intensive and service oriented sectors and regions.	5
	Cyclical Themes	**Page Reference**
1	Stocks outperform bonds despite Fed tightening. Despite widely held negative sentiment based on the belief that China is on the brink of economic disaster and that the dollar will continue to appreciate against all other currencies. As discussed below, neither scenario is our base case. We believe that most of the dollar's appreciation will be confined to the EM world and will be in only a modest upward trend relative to Euro and Yen. While Chinese risk assets will be vulnerable to its inevitably messy restructuring and growth slowdown as well as policy missteps; we do not believe that they pose a system risk to the developed world. We believe that the next two to three years will look more like the 2005 though 2007 prior tightening period, where developed Asia and European assets outperformed bonds and U.S. equities.	5
2	Peaking U.S. earnings that have already been challenged by the U.S. dollar's strength will be further strained by increasing wages and interest costs. Japanese equities are our highest conviction overweight followed by European equities.	6
3	EM not a screaming buy and faces more earnings and performance disappointments in 2016	9
4	China's growth reduction (to around 6.5%) and restructuring, as well as the gradual depreciation of the RMB as it decouples from the dollar peg will be fraught with mixed growth signals and policy missteps. The Chinese financial system, however, remains fenced off from the rest of the world by capital controls and is highly liquid, so the risk of systemic financial crisis remains low. If the renminbi does decline by another several percent, the main losers will be other emerging markets, especially Asian exporters that compete with China. That is not great news, but presents a lesser risk to global growth than the rising probability of a U.S. recession.	10
5	The U.S. dollar will have limited upside relative to the yen, euro and sterling but will meaningfully appreciate relative to most EM currencies. A rising U.S. dollar as well as continued stress in the commodity complex paints a bearish picture for commodity related sector earnings prospects. Therefore, we will be favoring defensive over cyclical sectors for the year ahead.	12
6	Within the context of a reduced weight to U.S. equities, our sector positioning for U.S. portfolios is more narrowly focused on defensive sectors and Financials. For non-U.S. portfolios, our sector focus is on consumer oriented and early-cyclical sectors.	12
	High Potential Market Disruptors	**Page Reference**
1	The Fed raising rates too quickly relative to market expectations which would engender a rapid/steep appreciation in the U.S. dollar.	13
2	Non-financial credit event. This risk is particularly acute among commodity exposed countries and companies.	14
3	Disorderly fall in oil prices (below the $25 threshold). Our base case for oil is to balance between $40/bbl and $50/bbl at around the end of the year. The risk is the possibility of a credit event before we get there.	14

On the secular front, we believe that:

1. **Lower trend growth among G7 countries as a result of deteriorating demographics will continue to force central banks to remain relatively accommodative.**

   This is because secularly lower growth is principally a function of demographics and a workforce that can no longer grow through increased participation of under-employed women. This is why the Japanese government's attempt to increase female participation in the work force potentially provides a positive (or less negative) demographic tailwind. In the U.S., the first of the baby boomers will turn 70 this year. This means that the gap between the population of those in prime retirement age (60 to 74) and the younger population entering the labor force (ages 15 to 29), whose 3 year growth rate crossed at the end of 2002, will continue to widen. (See CHART 1).

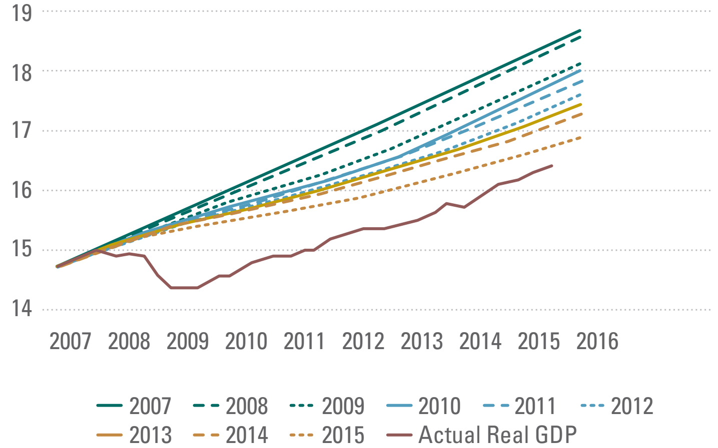
CHART 1 Difference Between Prime U.S. Age Cohorts for Workforce Entry and Exit



Source: FactSet and FIS Group professional estimates

The U.S.'s 3.5% average GDP growth in the latter half of the 20th century was supported by labor force growth of 1.25% to 2.75%; but according to the BLS, labor force growth is projected to add just 0.7% to growth in the next couple of decades. This is why the 3.25% real growth rate that was considered normal between the end of World War II and the 2008 global financial crisis, will likely range between 2.25% and 2.5% for a considerable period. Appreciation of the structural, as opposed to cyclical (or regulatory), causes of the growth slowdown has been only slowly been accepted, as depicted in CHART 2, which shows enduring down-grades to U.S. growth estimates since 2007 by the CBOE; while actual GDP growth has underperformed even these downgraded estimates. It is this secular slowdown which has provided grist for the mill for populist politicians and polices (such as immigration unfriendly policies) that if implemented, could actually exacerbate these secular headwinds.

CHART 2 U.S. Real Potential GDP Estimates *$ Trillion*



Source: The Conference Board Budget Outlook 2007-2015; BEA

In Europe, Japan and increasingly, China, these demographic headwinds are even worse.

The poor secular fundamentals discussed above will underpin continued policy accommodation by monetary authorities who have championed the fight against the deflationary fallout from the GFC with little assistance from fiscal policy. Indeed the Fed's arguable success in healing U.S. labor markets has encouraged other developed country monetary authorities that are broadly following the U.S. road-map, albeit with varying lags, by maintaining ultra-expansionary monetary policies for as long as it takes to achieve the desired results. Over the intermediate term, such policies are supportive of risk assets.

2. **The U.S. is experiencing monetary policy exhaustion in that there are diminishing marginal benefits from monetary accommodation for real economic growth. With a fundamentally weak growth backdrop and more vulnerable valuation levels (particularly in the U.S.), the probability of a systemic tail risk event has increased. The most likely sources of tail risk are delineated below.**

   Adding to the poor demographic dynamics the long-term fallout from the debt super-cycle has paradoxically limited the ability of accommodative monetary policy to spur real economic demand and inflation. Even super-accommodative monetary policy has its limits and in the U.S. we are undergoing the results of monetary policy exhaustion. This is because monetary policy has limited ability to spur demand when interest rates are zero bound. Absent fiscal policy support, the other two policy tools available to monetary authorities are to anchor the term premium in order to stoke the prices of financial assets (making investors feel wealthier and theoretically more willing to spend) and currency depreciation to buoy net exports. In the U.S. both have reached their respective limit. At a forward Price/Earnings ratio of 15.8, U.S. equities are well priced (though not in bubble territory) while high

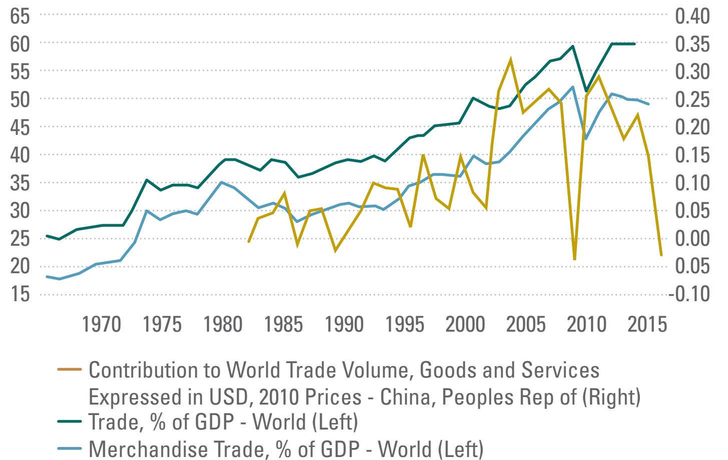
yield debt prices have been crumbling. Currencies are, of course, a relative phenomenon. Even before the Fed raised rates in December by a whopping 0.25%, the dollar appreciated by 23.46% since its July 2014 low because of even more accommodation by other central banks.

3. **Demographics and the increasing service intensity of world economic growth will reorder the economic winners and losers among sectors and regions.**

Another key secular trend is the increased service and IT intensity (as opposed to physical/labor production) of economic growth among the world's developed economies as well as increasingly, China. Growth in the rich economies of the U.S., Europe and Japan is being driven ever less by physical production and ever more by intangible services. This is a long-running theme of post-industrial development, but it is amplified by demographics: as people get older, they buy less stuff, and more services such as entertainment and healthcare. One consequence is that merchandise trade volumes, after several decades of growing much faster than global GDP, have slowed to about the same growth rate as the global economy. This is likely to be a very durable adjustment. Both China's growth slowdown and the changing composition of its growth will exacerbate this trend. (See CHART 3).

On the sector front, service sectors, particularly health and IT service intensive economy will outperform sectors that have been buoyed by mining, manufacturing and merchandise trade volumes. This will present a secular headwind for production and trade dependent components of the EM that have been grown by servicing Chinese and the developed world's demand for capital goods, while providing a bid under technology intensive and service oriented regions. Additionally, the increasing technology intensity of the production/supply chain will further challenge the so-called "Asian" model of growth through low cost labor production.

CHART 3 Slowdown in Global Trade Volumes Excerbated by China



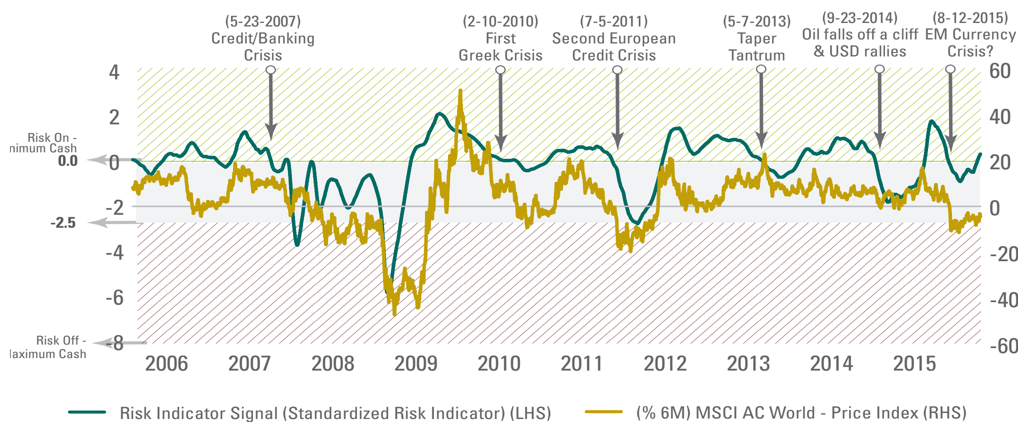
Source: FactSet amd FIS Group professional estimates

SIX CYCLICAL ASSUMPTIONS THAT UNDERPIN OUR STRATEGY FOR 2016

1. **Stocks outperform bonds despite Fed tightening.**

The consensus view for 2016 appears to be quite bearish. Indeed as we survey the vital signs: imploding commodity prices; political and economic fragility in the EM world; growth disappointment and policy uncertainty out of China; an appreciating dollar, which further challenges peaking U.S. profits and exports deflation to the U.S., there is very little to cheer about. Distressingly, the first

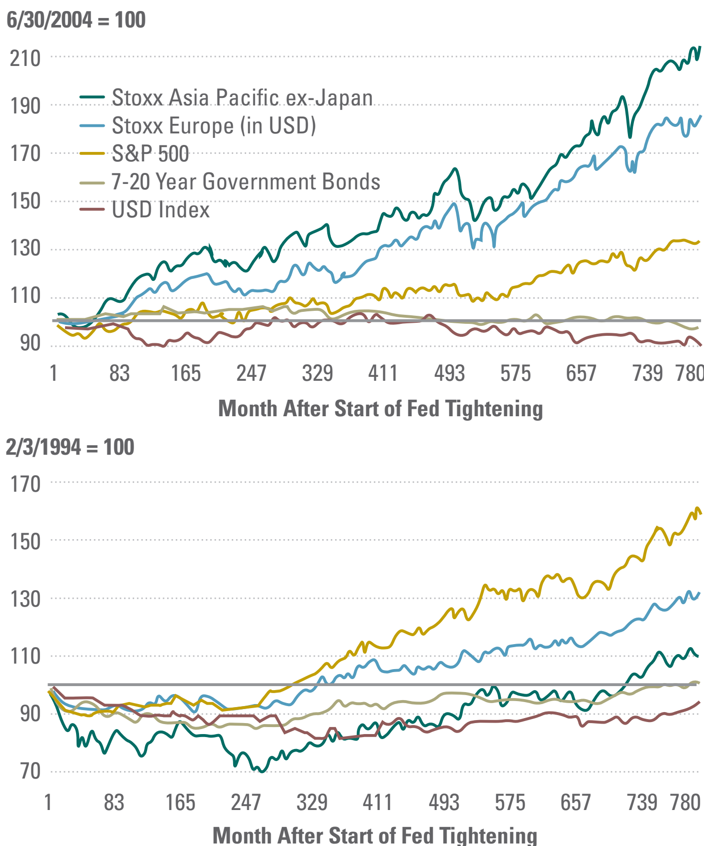
CHART 4 Global Equity Risk Indicator



Source: FIS Group professional estimates

trading week of 2016 seems to confirm the gloomiest of scenarios. Yet our risk indicator, depicted above, appears to tell a different story. (See CHART 4). On December 22nd it actually crossed into "risk-on" territory after languishing in the "risk-neutral" zone since August 12th. As we have written about before, this indicator has been remarkably accurate in forecasting systemic (as opposed to temporary sentiment or event driven) changes in equity risk performance. This result forced us to revisit again asset price returns after prior Fed tightening cycles.

CHART 5 Asset Prices After the Start of Previous Fed Tightening Cycles



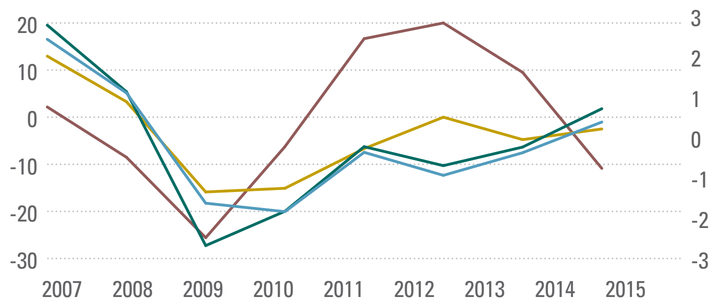
Source: Gavekal Data/Macrobond

CHART 5 shows how key asset prices performed in the three years after June 2004 and February 1994, the beginning of the last two significant tightening cycles. As we have written about before, for both tightening periods, the Fed was well ahead of its counterparts in Japan and Europe. Additionally, as with this cycle, the 1994 tightening cycle was preceded by a banking crisis (the savings and loan crisis) and was the turning point for another melt-down in commodity prices. However, in both cases the U.S. dollar remained relatively tame in the first three years after the Fed first hiked rates. Additionally, equity markets traded sideways in the first six to twelve months but after that, U.S. equities outperformed significantly in 1995 through 1997 while Europe and Asia outperformed in 2005 through 2007.

We certainly appreciate that prior patterns are not prologue for the future. However, despite widely held negative sentiment based on the belief that the dollar will continue to appreciate against all other currencies; we believe that most of the dollar's appreciation will be confined to the EM world; and that the next two to three years will look more like the 2005 though 2007 period.

2. **Peaking U.S. earnings that have already been challenged by the U.S. dollar's strength will be further strained by increasing wages and interest costs. Japanese equities are our highest conviction overweight followed by European equities.**

CHART 6 Corporate Profits Under Pressure from Rising U.S. Dollar and Inputs Costs *% 1YR*



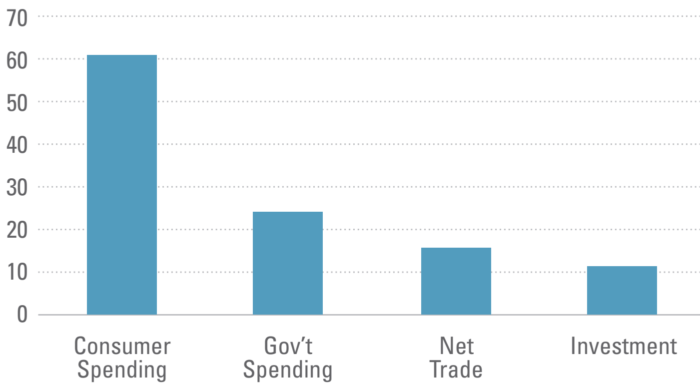
Source: FactSet amd FIS Group professional estimates

This is a major premise for our continued overweight to developed non-U.S. equities. As shown in CHART 6, after the GFC, corporate profits comprised an increasing share of Gross Domestic Income on the back of lower wage and income costs. The first assault on corporate profits came from the rising U.S. dollar in 2014. A firming U.S. dollar eats into U.S. corporate sector profitability via negative translation effects and by importing of global deflation. The second assault is likely to come from increasing wage and interest costs. Real wage growth, which is now running at over 2%, could further squeeze profit margins. Additionally, while U.S. markets have largely priced in a moderate expansion, other markets whose economic and

monetary cycles are lagging several years behind the U.S. have not fully done so.

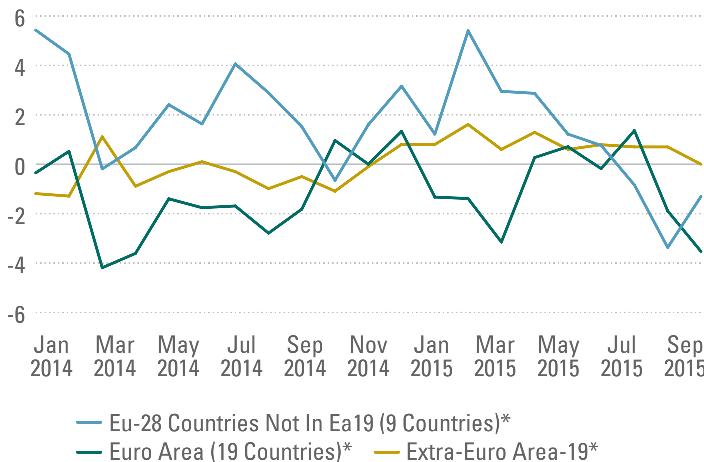
For the Eurozone, survey data and narrow money growth continue to tell a story of a firm and stable cyclical recovery. In addition, the ECB likely will err on the side of caution in adding further support if inflation or growth falters, and looser fiscal policy in Germany will also help. In recent quarters, real GDP growth for the common currency zone has stabilized at 1.6%. As shown in CHART 7, Household consumption has accounted for two-thirds of Eurozone GDP growth in the past two years, particularly as global headwinds have intensified. Indeed in 2015, trade within the European area has been the primary bulwark against diminishing trade outside of the area. (See CHART 8); suggesting that while the QE policy behind the euro's depreciation did indeed boost asset prices and helped unclog moribund credit channels,

CHART 7 Contribution to Eurozone GDP Growth
% Share in Last 8 Quarters



Source: Capital Economics

CHART 8 Despite Euro's Depreciation EU Trade Balances Supported by intra European Trade
Volume Index, 2000=100



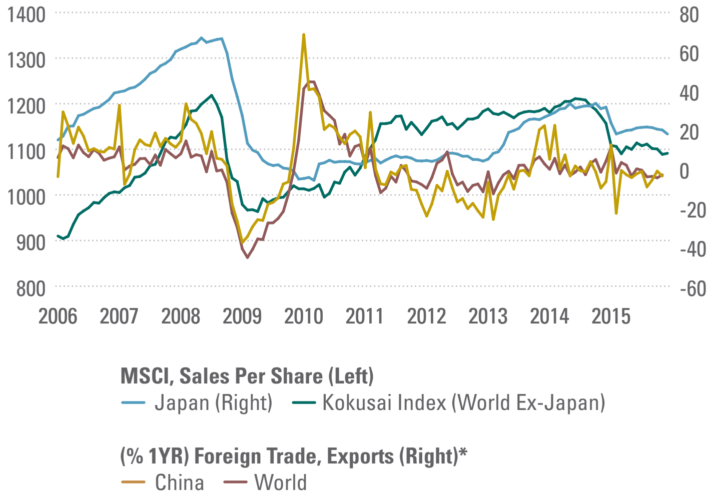
**Volume index, 2000=100, Sa. Wda-Euro Area (19 Counties)*
Source: FactSet and FIS Group professional estimates

deflationary commodity prices provided an even more important boost to purchasing power for households and firms that rely on imported raw materials. Therefore, unless we see signs of a slowdown in domestic demand, we are optimistic that the euro area economy can weather global headwinds from higher U.S. rates, fiscal tightening in the U.K., and slow growth in emerging markets.

Among non-U.S. equities, Japanese equities are the most under-appreciated opportunity; but they remain as our highest conviction market. As we speak with various investors, the focus seems to be on the mixed results of Prime Minister Abe's three arrow policy. We believe that such investors miss the larger achievement of restoring confidence in a nation that for the last 30 years has suffered from a series of psychological setbacks from a long period of financial stagnation as well as some of the worst natural disasters in living memory. This is why business surveys, particularly among non-manufacturing firms (such as the Tankan survey) are at levels last seen in the early 1990s. Investors also under-appreciate the fact that the primary bogeyman, deflation, bottomed last year (particularly when the impact of energy prices is removed). In nominal terms, the economy grew by 3.1% in 3Q 2015, its third fastest pace of expansion in the last two decades. As a result, corporate profit margins have made record highs every quarter since Q1 2013. In fact, in contrast to the moribund revenue growth in the U.S., Japanese companies are growing revenue at around 2% per annum whilst pre-tax profits are growing at 7% to 8% per annum. Although Japanese exports are exposed to the slowdown in China, on a sales per share basis, Japanese companies are still outperforming their global peers. (See CHART 9). In summary, Japanese equities remain our highest conviction call because of the combination of attractive valuations (see CHART 10); gradually improving economic fundamentals (end of deflationary slide and improving output); a robust corporate earnings profile (see CHART 11 and CHART 12) and healthy balance sheets that will fuel further M&A activity (see CHART 13).

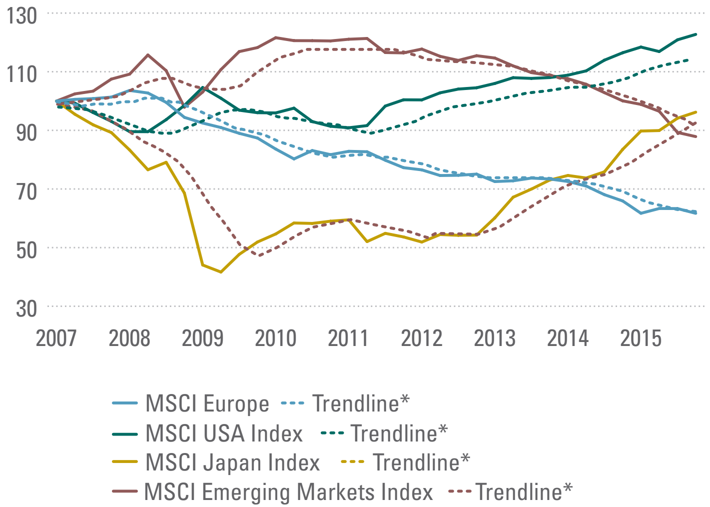
Finally, the policy backdrop for Japanese companies remains supportive with an accommodative BOJ, corporate tax reform, corporate governance reform as well as positive macro effects from the TPP. For example, the proposed changes by the ruling LDP for the next round of Japanese corporate tax reform would further reduce the effective corporate tax to 29.7% (30.62% in Tokyo), putting Japanese corporate tax rates effectively on par with Germany, and significantly lower than the U.S. This comes on the heels of the spring 2015 reduction in the effective corporate tax rate from about 35% to 32%. Obviously this is positive for Japan and the market rallied about 5% in mid-December when this came out. Additionally, the proposed reduction of NOL write-downs from 65% to 50%, will continue to foster a more competitive environment for profitable companies and likely reduce the incentive for manipulating earnings.

CHART 9 Japanese Company Sales Growth Exceeds ROW Despite China Slowdown



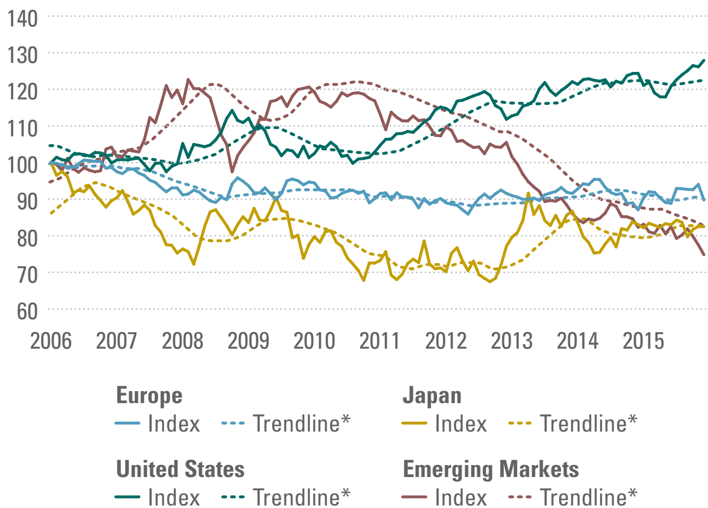
Source: FactSet and FIS Group professional estimates

CHART 11 Regional Earnings Per Share Relative to the World Index



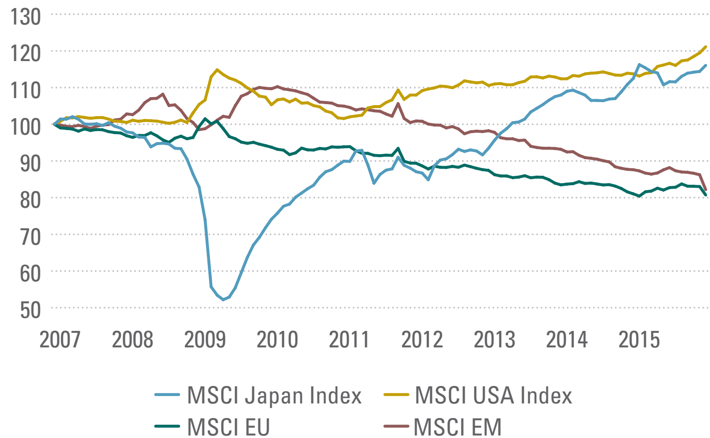
**1-Yr Moving Average*
Source: FactSet and FIS Group professional estimates

CHART 10 Regional Price-to-Book Relative to World Index Comparisons



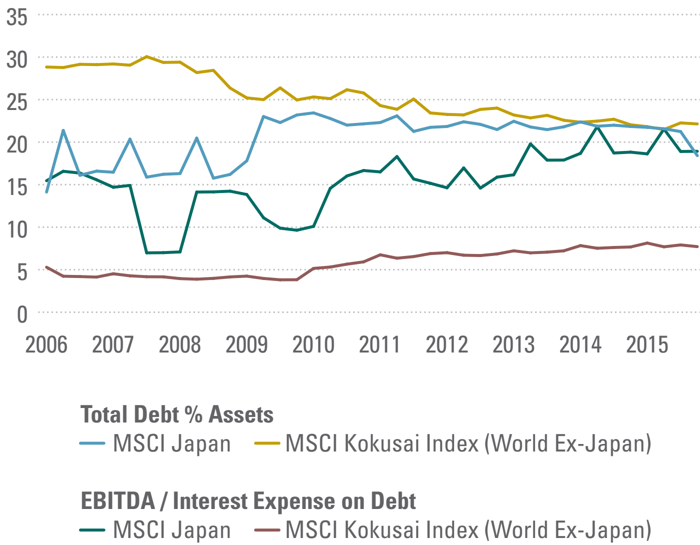
**1-Yr Moving Average*
Source: FactSet and FIS Group professional estimates

CHART 12 Regional Return on Equity Comparison Relative to the World Index



Source: FactSet and FIS Group professional estimates

CHART 13 Debt Coverage for Japanese Companies vs. ROW



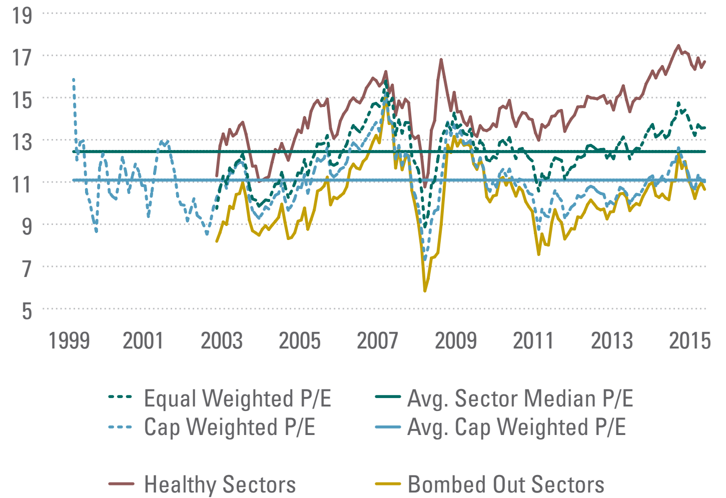
Source: FactSet and FIS Group professional estimates

3. **EM not a screaming buy and faces more earnings and performance disappointment in 2016**

On the face of it, the valuation of emerging markets looks compelling. After declining 40.06% from its 2011 high, the MSCI Emerging Markets index is now at a forward P/E ratio of 11, a third cheaper than the S&P 500 Index. As a result, the valuation premium of developed over emerging equity markets is close to its highest in more than ten years. What's more on average, emerging-market currencies are now below fair value against the U.S. dollar, following a depreciation which has boosted competitiveness, helping formerly vulnerable emerging economies to narrow their current account deficits. So is it time for investors to take a dip in the emerging market pool once again? In our humble opinion, one should proceed with extreme caution and selectivity. It is true that emerging market benchmarks are trading at a deep discount to developed markets, but the apparent divergence is explained almost entirely by the difference in sector weightings between emerging and developed indexes. The emerging market equity universe has a much higher preponderance of financial and commodity stocks, sectors which are undergoing structural de-rating adjustments around the world. If we adjust for this sectoral discrepancy, the emerging market discount is much smaller. On an equally-weighted sector basis the emerging markets are on a P/E ratio of 13.6, which is on par with its long term average. (See CHART 14).

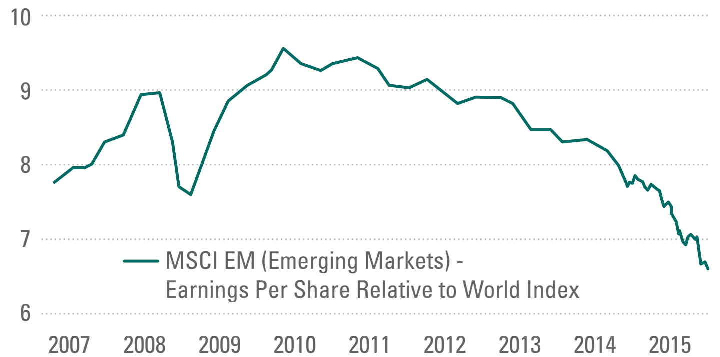
Additionally, deteriorating growth and earnings suggest that we are still not at an attractive entry point. (See CHARTS 15).

CHART 14 Attractive EM Valuations Primarily Influenced by Bombed-Out Sectors



Source: FactSet and FIS Group professional estimates

CHART 15 Lackluster Fundamentals - MSCI EM Earnings Per Share Relative to the World Index



Source: FactSet and FIS Group professional estimates

Unfortunately, the investment rationale for underweighting EM cited in our Q1 2015 Outlook have not materially changed, with the notable exception of India:

"EM economies that are reliant on capital inflows and are net commodity exporters have been the hardest hit, including Indonesia, Turkey, South Africa and Brazil, but even those with stronger balance sheets (and which are net commodity importers), like China and India, saw currency depreciation against the U.S. dollar. One source of concern is that earnings in the EM are currently stagnant and several key countries are either slowing or at risk of outright recession. The end of the commodity super-cycle as well as U.S. dollar strength, which boosted many EM countries, will also be a headwind for commodity producer countries. Additionally, current account deficit countries facing inflationary pressures will be constrained in their ability to revive growth through accommodative

fiscal or monetary policies, because doing so would further undercut their currencies. These policy constraints currently plague commodity producer countries such as Brazil, Indonesia and South Africa, as well commodity consumers Turkey and India."

EM, therefore remains our lowest conviction investment. Within our EM portfolio, we will continue to maintain overweights to China H share consumer services and to a lesser extent, IT stocks, as well as India small cap (which are now trading at more reasonable valuations). Additionally, we believe that EM Europe outside of Russia (specifically Czech Republic, Romanian and Hungarian stocks) warrants at least a benchmark-weight, as they will benefit from increasingly strong intra-European investment and trade.

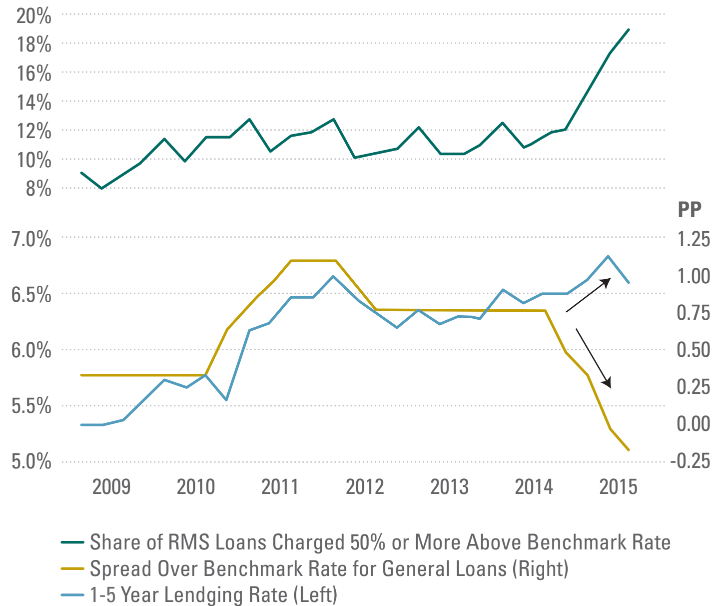
4. **China's growth reduction (to around 6.5%) and restructuring, as well as the gradual depreciation of the RMB as it decouples from the dollar peg will be fraught with policy missteps and continue to place pressure on other EM countries; but it will not pose a systemic risk to the developed world.**

As we have written about in the past, the challenges facing China are that:

- Its policy makers face the difficult challenge of having to pirouette between two different Chinas: the booming consumer-oriented services sectors/regions and the capital goods and industrial sectors that are facing a "debt-deflation" cycle of falling cash flows and tumbling asset prices.
- It is caught in an "Impossible Trinity." As Beijing lowers rates to combat slowing growth, it is hard pressed to resist downward market pressure on its currency. So it must either allow the RMB to decline further (spooking global markets) or regain its ability to control both the currency and interest rates by slowing the pace of capital-account opening.

On the first challenge, policymakers' attempts at avoiding a disruptive debt deflation spiral through "old economy sectors" has led to increased infrastructure spending and preferential borrowing rates targeted at the (mostly state-owned) capital goods sector. As a result of sliding growth, steadily rising bad debts and the need to earmark capital for "helping" big state firms, banks have also become cautious in their lending, particularly as full liberalization of interest rates has increased competition for deposits and raised funding costs. In response, banks appear to be favoring too-big-to-fail state-linked enterprises, whilst private sector borrowers are paying a hefty premium, and required to commit collateral and secure third party guarantees. As a result, China's credit market has become even more bifurcated; with the share of borrowers who pay 50% or more above the benchmark interest rate rising to 18% by mid-2015, compared to 12% in 2014. In essence, despite central bank easing measures, this group is unlikely to benefit and will instead see a rising cost of debt finance. (See CHART 16).

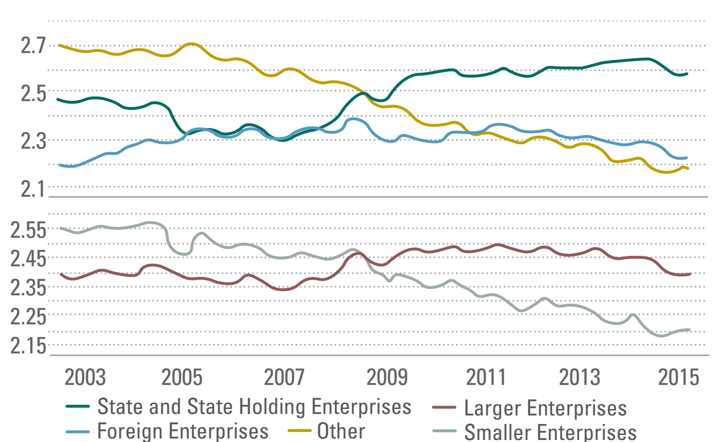
CHART 16 Fewer Companies are Benefiting from Monetary Easing *Rising Credit Premium Charged on Lending*



Source: Gavekal Data/Macrobond

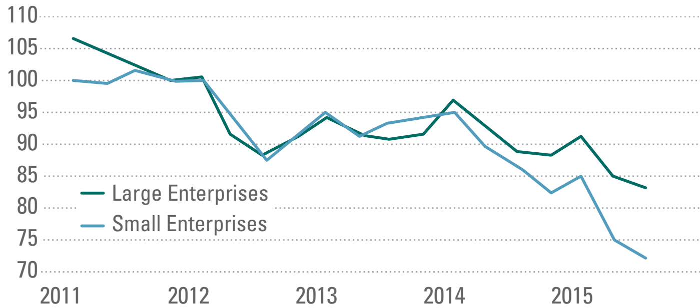
Therefore, the risk in China is that private firms, especially small enterprises, bear the burden of the clean-up via much higher borrowing costs which reduces their appetite to invest. (See CHART 17 and CHART 18). Already, the bad-debt ratio in sectors with heavy private sector participation—manufacturing, wholesale and retail—has started to rise especially fast. Weaker growth is likely to drive more bankruptcies and higher non-performing loan ratios. This will leave the state with no option but to ease more aggressively in order to meet its GDP growth target of 6.5%.

CHART 17 Private Sector Deleveraging; Less So for the State
Assets/Equity Ratio by Corporate Type and 6-Month Moving Average



Source: Gavekal Data/Macrobond

CHART 18 Demand for Loans in China Deteriorated Faster for Small Companies *PBOC Index of Loan Demand, Rebased to 12/2011*



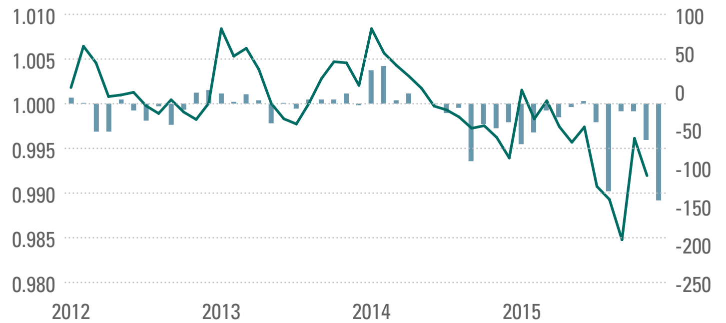
Source: CEIC, Gavekal Data/Macrobond

Debt deflation can either be absorbed through increasing write-offs and deleveraging or it can be partially exported to the rest of the world via currency depreciation. This leads to the second challenge referenced above; i.e., the difficulty of trying to reduce interest rates whilst also attempting to stabilize the RMB.

The Renminbi's December 1 inclusion as the 5th currency among the IMF's reserve basket was a major diplomatic and geopolitical accomplishment for Beijing. While the long term impact will be bullish for the RMB, the market's reaction was negative, particularly after the PBOC introduced the trade-weighted renminbi index against a basket of currencies. From a policy perspective, tracking a basket is justified since the RMB's de facto peg against the dollar meant that it had appreciated rapidly in trade-weighted terms when the dollar started to strengthen in mid-2014. For example, although the renminbi fell by 4.7% against the dollar in 2015, its nominal effective exchange rate actually rose. But, as happened in August when the PBOC introduced a new fixing mechanism for the currency, this policy change was poorly communicated and fed speculation that the PBOC intends to devalue the currency. As shown in CHART 19, market speculation has driven the spread between the two exchange rates to a record high.

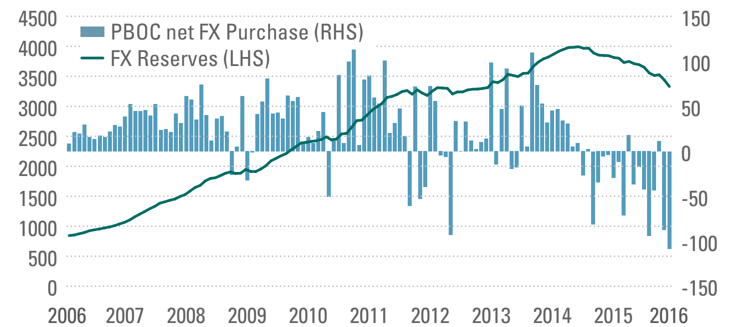
In order to stabilize the currency, the PBOC again had to buy over $100bn (twice the previous peak in foreign exchange reserve purchases last August) and, in the short term, will likely have to continue to intervene on a large scale in order to shift market perceptions that the renminbi is a one-way bet. (See CHART 20). With reserves estimated over $3 trillion, the PBOC does indeed have the fire power to defend the onshore rate should it choose to. The risk for the PBOC is that intervention into the currency market to support the yuan requires absorbing local currency from circulation in order to sell U.S. dollars. Without offsetting liquidity injection, narrow money growth will shrink and interest rates will tend to rise. If this occurs, it will be detrimental to China's growth as higher interest rates will suffocate the overleveraged economic system. To prevent interest rates from rising, the PBOC has to inject as much

CHART 19 Capital Flows to China & Offshore/Onshore Exchange Rate Spread



Source: Bloomberg & FIS Group professional estimates

CHART 20 FX Reserves & Net Purchases of FX by PBOC *$ Billions*



Source: Bloomberg & FIS Group professional estimates

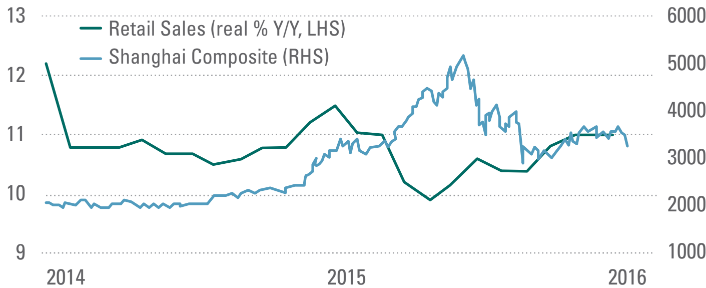
liquidity into the system as it has withdrawn during its currency intervention operations, i.e., it has to "print" a lot of money. Such money printing could heighten expectations for further currency depreciation and lead to even more capital outflows. Hence, the real test for the PBOC is not the lack of foreign reserves - it has more than enough. The true challenge is whether it can continue to "print" RMBs and while halting capital outflows. Faced with such a challenge, the odds are that the RMB will be allowed to depreciate by another 5% or so in the next six months. Such non-trivial yuan depreciation could trigger another down leg in Asian currencies versus the U.S. dollar.

INVESTMENT IMPLICATIONS

The most likely way for China to disrupt the global economy is therefore through financial contagion. With a deteriorating growth/earnings outlook, A-shares remain overvalued, so we expect domestic stocks will hit further air pockets. But most global investors have already written off the A share market after last year's bubble, so lasting spillover effects should be limited. Domestic bond defaults also have limited relevance outside China. Additionally, A share volatility should not be extrapolated to be a barometer of the Chinese economy. Prices are driven

by speculative forces rather than fundamental factors. Conversely, equity price moves don't drive developments in the economy. Relatively few in China own equities and those that do are much wealthier than average with high rates of saving. This is why retail spending in China actually strengthened in the second half of last year in the aftermath of the equity market implosion. (See CHART 21).

CHART 21 Retail Sales Growth & Equity Prices



Source: Bloomberg & FIS Group professional estimates

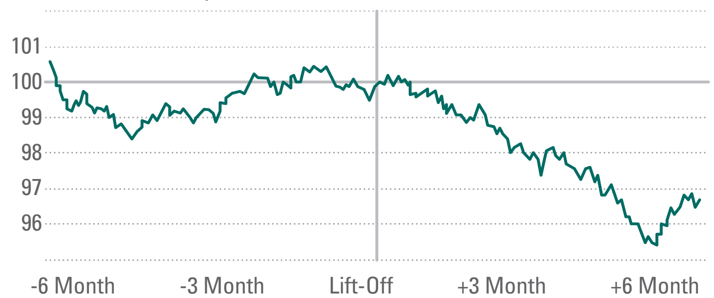
The RMB could be another source of market disruption. We believe that it is likely that the market will force Beijing to sacrifice its long-standing goal of currency stability relative to the U.S. in order to enable monetary easing to be effective. As the Fed keeps hiking rates, narrowing the spread between U.S. and Chinese rates, a strong CNY will be ever-harder to sustain. However, since the Chinese financial system remains fenced off from the rest of the world by capital controls and is highly liquid, the risk of systemic financial crisis remains low. If the renminbi does decline by another several percent, the main losers will be other emerging markets, especially Asian exporters that compete with China. With CNY/USD in steady decline, other EM countries will find it very hard to stabilize their own currencies. This in turn reduces their ability to deleverage and return to strong growth. That is not great news, but presents a lesser risk to global growth than the rising probability of a U.S. recession.

Finally, policy mistakes and conflicting growth data will continue to (mistakenly) stir fears of a China hard landing. As we have written in the past, tap dancing between the disparate policy needs that arise from heavy industry sectors/regions that are in recession vs. robust service sectors; between ample room for both monetary and fiscal policy reflation while still trying to tamp down on credit excesses; between ambitions of liberalizing the financial and capital markets while trying to control speculative excesses and/or stem substantial capital outflows; is likely to generate conflicting growth data as well as policy missteps that will intermittently stirs fears of a China hard landing. We do not however subscribe to a hard landing worst case scenario because of Beijing's determination and ability to support growth with bigger fiscal deficits and further monetary easing.

5. **The U.S. dollar will have limited upside relative to the yen, euro and sterling but will meaningfully appreciate relative to most EM currencies.**

While the U.S. dollar is in the midst of a multi-year appreciation trend, we believe that its upside will be limited relative to the Euro and Yen. With growth in Europe and Japan likely to accelerate from very low recent levels, widening trade imbalances widening and dollar valuations that already reflect Fed tightening, the euro looks range-bound between US$1.05 and US$1.15 and the yen between 115 and 125. Additionally, the consensus belief that the start of a Fed tightening cycle necessarily implies a strong dollar has scant historical precedent. As shown in CHART 22 below, the U.S. dollar typically appreciates in anticipation of Fed tightening but not necessarily after; a classic case for buying the rumor and selling the fact!

CHART 22 U.S. Trade-Weighted Dollar Average After Start of Fed Rate Hike Cycles*



**Dates for start of Fed Rate Hike Cycles: 7/1/1977, 10/21/1980, 12/4/1986, 2/4/1994, 6/30/1999, and 6/30/20014*

Source: BCA Research

6. **Defensive sectors in the U.S. (and early cyclicals in Europe and Japan) will outperform deep cyclical sectors.**

We believe that the main drivers of relative sector performance will be a. the U.S. dollar, b. commodity intensity and c. pricing power. As shown in TABLE 4 below, the dollar is negatively correlated both with the MSCI All-Country World Index (ACWI) and deep cyclical sectors.

Drilling into sector performance, the tables show that resource dependent sectors loathe U.S. dollar strength, as most commodities are priced in U.S. dollars. Moreover, supply is hitting the market at the most inopportune time, given that emerging markets (EM) and Chinese-related demand is decelerating, on the margin. This paints a bearish picture for commodity related sector earnings prospects. A strong dollar is not surprisingly, more deleterious to U.S. sectors (where only earnings of Financials and Utilities are positively correlation with the dollar) than the global sector landscape (of which over 50% is comprised of U.S. companies). (See TABLE 5 and TABLE 6).

TABLE 4 Correlation of MSCI ACWI Sector Relative Return to U.S. Dollar
January 1996 to January 2016

Sector	Correlation
US Dollar	1.00
Energy/World	-0.59
Materials/World	-0.79
Industrials/World	-0.70
Consumer Staples/World	-0.38
Consumer Disc./World	0.08
Financials/World	0.42
Health Care/World	0.26
IT/World	0.39
Telecomm/World	0.33
Utilities/World	-0.36

TABLE 5 Correlation of MSCI ACWI Sector Earnings Per Share to U.S. Dollar
January 1996 to January 2016

MSCI AWI Sector	Correlation
USD Dollar	1.00
MSCI ACWI World	-0.22
Energy	-0.81
Materials	-0.81
Industrials	-0.17
Consumer Discretionary	0.10
Consumer Staples	-0.09
Financials	-0.24
Health Care	0.10
IT	0.09
Telecomm	-0.41
Utilities	-0.40

TABLE 6 Correlation of S&P 500 Sector Earnings Per Share to U.S. Dollar
January 1996 to January 2016

S&P 500 Sector	Correlation
US Dollar	1.00
S&P 500	-0.67
Energy	-0.86
Materials	-0.74
Industrials	-0.58
Consumer Discretionary	-0.50
Consumer Staples	-0.69
Financials	0.08
Health Care	-0.58
IT	-0.55
Telecomm	-0.03
Utilities	0.04

Source: FactSet and FIS Group professional estimates

Since deflation remains the dominant stock market threat, the absence of pricing power remains a serious profit impediment. According to a BCA Research study, 32 out of 60 industries are having to cut selling prices. Six other industries can't raise prices by more than 0.5% per annum, while another seven are stuck below 2%, which is the rate of overall core consumer price inflation. In other words, 2/3 of the industries cannot keep pace with core inflation rates. The Deep cyclical sector is in the worst shape, with pricing power deflating uniformly.

INVESTMENT IMPLICATIONS

A rising U.S. dollar as well as continued stress in the commodity complex paints a bearish picture for commodity related sector earnings prospects. Therefore, we continue to favor defensive over cyclical sectors for the year ahead. For non-U.S. portfolios, our sector focus is on consumer oriented and early-cyclical sectors. Within the context of a reduced weight to U.S. equities, our sector positioning for U.S. portfolios is more narrowly focused on defensive sectors and Financials.

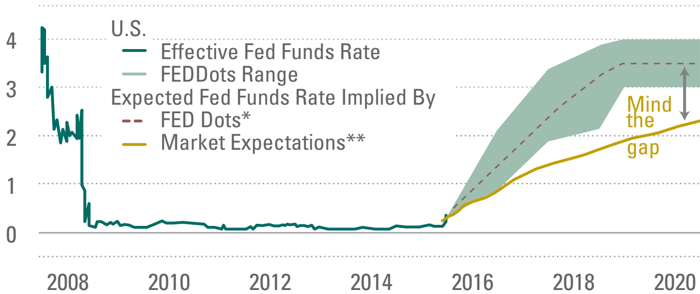
KEY RISKS THAT COULD DISRUPT GLOBAL EQUITIES IN 2016

With a fundamentally weak growth backdrop, more vulnerable valuation levels (particularly in the U.S.) and diminishing marginal benefits from monetary accommodation for real economic growth, the probability of a systemic tail risk event has increased. Possible sources of tail risk could come from:

1. **The Fed raising rates too quickly relative to market expectations which would engender and a rapid/steep appreciation in the U.S. dollar;**

   Going forward, the Fed's primary focus on the labor market in the lead up to the first rate hike will shift to changes in U.S. wages and underlying PCE inflation. If the underlying inflation rate trends up in line with the Fed's projection over the course of next year, then the FOMC will feel justified in lifting rates by 100 basis points in 2016 (assuming that underlying economic growth is stable and there is no financial crisis inside or outside the U.S.) Fed Chair Yellen has emphasized that she will proceed "gradually", as specified by the 'dot plot'. The problem is that investors appear to believe that "gradual" means something much slower. The median 'dots' foresee four quarter-point rate hikes in each of 2016 and 2017, compared to half that amount implied by the bond market. This disparity as well as its attendant impact on the U.S. dollar is one of the key potential disruptors to risk assets in 2016. (See CHART 23).

CHART 23 Effective and Expected Fed Funds Rate *%*



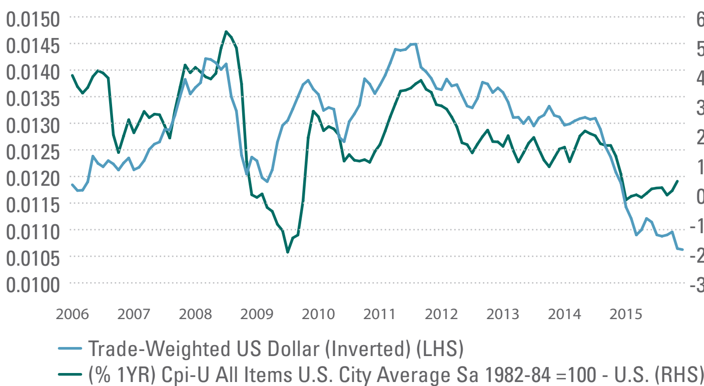
**Median midpoint target from the Fed's summary of economic projections (December 2015)*

***As discounted in the OIS curve as of January 6, 2015.*

Source: BCA Research

Determining the underlying trend will require stripping out the "temporary" effects of shifts in the U.S. dollar and oil prices. Both dragged down inflation in 2015 and we expect both to moderate in 2016. In the case of oil, as long as prices don't drop to well below $30/bbl., the base effect relative to last year's level could conceivably moderate. For example, at $40/bbl., the year on year change in oil prices will moderate from to -10% in January vs. -40% in January 31, 2014. As shown in CHART 24, the greenback's appreciation (shown inverted) has been the other major drag on U.S. inflation. Our base case expectation is that the greenback will be appreciate more modestly relative to both the Euro and Yen for the first half of the year because the disparate central bank policies relative to the ECB and BOJ have largely priced. However, we expect significant appreciation against most EM currencies.

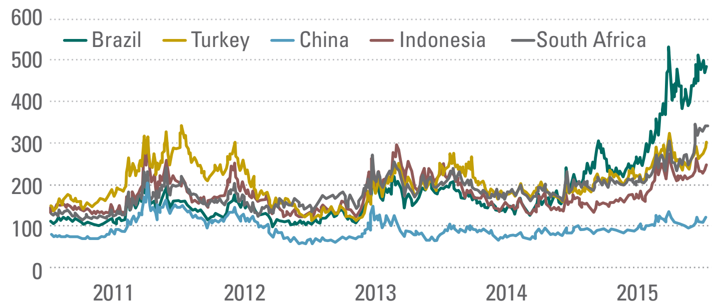
CHART 24 Feedback Loop Between U.S. Dollar and Inflation *%*



Source: FactSet and FIS Group professional estimates

2. **Non-financial credit event.** A rising U.S. dollar and the end of the ZIRP era increase the risk of an EM non-financial corporate sector accident especially in the energy and/or basic materials space, which were the focal point of last decade's capital expenditure excesses. This is because U.S. dollar-denominated debt has to get refinanced and interest has to be repaid at a time when credit quality is rapidly deteriorating for these two sectors in particular. This is why CDS for vulnerable EM countries have risen dramatically. (See CHART 25).

CHART 25 Rising EM Credit Default Risk Portends a Potential Source of Systemic Risk *CDS 5Y, Mid, Basis Point - Yield*



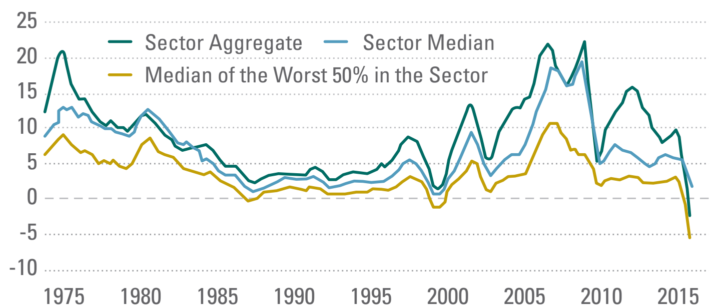
Source: FactSet and FIS Group professional estimates

3. **Disorderly fall in oil prices (below the $25 threshold);**

The primary contagion risk of a disorderly capitulation in oil prices and the commodity complex in general is a corporate default either among high yield issuers or EM debt issuers. Worryingly, the S&P 1500 energy sector in aggregate is now unable to cover its interest costs with operating profits. Unless commodity prices bounce back strongly, the U.S. energy sector will remain in contraction. (See CHART 26). This is also clearly bad news for suppliers of mining and energy equipment.

CHART 26 The Energy Sector in Aggregate Cannot Cover Interest with Current Profits

Coverage Ratio: EBIT / Interest Costs; S&P 500 Energy Sector, Ex-Refining and Marketing Subsector



Source: Compustat/Gavekal Data/Macrobrand

The global energy market has effectively transitioned from a monopoly (controlled by OPEC) into a competitive marketplace in which low cost producers must expand production to maintain their incomes. In this new order, Middle East tensions, that have historically added a geopolitical premium to the price of oil, have actually had the opposite effect; as Saudi Arabia is trying to punish Shia dominated Iran/Iraq (which both have higher fiscal break-even thresholds) by refusing to cut oil production in their fight for regional dominance. Therefore, oil producing economies are having to adapt to survive such pricing, as will the most efficient shale producers. It is these dynamics, coupled with the seasonal effect of a mild winter, as well as speculative flows, that have caused oil price to trade between US$30 and US$40/bbl. Obviously, the longer oil prices remain at the lower end of this range, the greater the risk of a disorderly corporate default event.

Over the course of 2016, world demand for oil is expected to grow at around 1.4 million b/d; even though the oil market is currently being oversupplied to the tune of around 1.5 million b/d at a time when inventories are at record levels. The removal of sanctions on Iran is eventually expected to add another 1 million b/d to this over-supply. In response to lower oil prices, U.S. production has already fallen by around 600,000 b/d from April 2015 and another 400,000 b/d is expected in the coming months. This drop in U.S. production is on top of an expected 1.5 million b/d supply reduction from high cost producers in the North Sea and the Canadian Tar sands, whose break-even price is around $80/bbl. Putting it all together, it is reasonable to expect the global oil market to balance toward the end of the year at around $50/bbl.

Our Q1 2016 Strategy delineated on the table on PAGE 16 attempts to balance these risks with the previously discussed secular and cyclical risks and opportunities. Our secular and cyclical themes are summarized in a table on PAGE 3.

Important Disclosures:

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All performance and other projections are historical and do not guarantee future performance. No assurance can be given that any particular investment objective or strategy will be achieved at a given time and actual investment results may vary over any given time.

Risk / Environment	-		N		+	
Global Equity Risk Environment				→ Strategic		Our systemic risk indicator entered risk on in late December.
U.S. Dollar				Strategic		Central Bank policies and Libor-Ois spreads are dollar supportive. Greatest appreciation expected relative to EM currencies with a trading range relative to the Euro and Yen (as disparate monetary policies largely discounted).

Regions / Countries	-		N		+	
United States		Strategic	Tactical			Peaking profit margins from dollar strength warrant focus on domestically exposed sectors. Margins will be further pressured by increasing wage and interest rate costs. Low beta feature provide some defense relative to offshore macro-economic risks. This is why are only gradually/tactically reducing our weight to U.S. equities.
United Kingdom		Strategic				Energy and Materials intensity warrant an underweight. While do not think a "Brexit" is likely, the political machinations prior to the vote could put pressure on the pound.
EU (core)				Strategic		Stabilizing growth suggest scope for positive earnings surprise. Best played through early cycle sectors, particularly those that benefit from intra-Europe trade. That said, we are changing our exposure to be more consumer sector focused.
EU (periphery)				→ Strategic		Spanish and Italian equities provide decent valuations and improving earnings. Our tactical models are forecasting outperformance.
Japan					Strategic	Our highest conviction overweight. Japanese equity fundamentals (valuation and earnings growth) are among the most attractive. The only areas of caution is the possibility of yen appreciation as a flight to safety currency and exposure to China.
Australia	Strategic					Materials and Financials intensity (70% of market capitalization) will weigh on profits until China's reflation efforts achieves much stronger traction.
Canada		Strategic				Energy and materials intensity will weigh on profits and currency. Substantial Financials weight will also drag because of weakening credit growth.
Emerging Markets (Pacific Rim)			Strategic			China's down-shifting growth; the high probability of a misstep as Beijing pirouettes between the "two China's" and likely depreciation of the RMB relative to the US dollar warrants caution for US investors. Best sectors remain: Services, Health and IT.
Emerging Markets (South Asia)				Strategic		Last year's relative underperformance of Indian equities also provide a more reasonable entry point. India's current and fiscal health render it less vulnerable to Fed normalization. Focus on small to medium cap companies.
Emerging Markets (Europe)		Strategic				The marked pickup in intra-European trade and relative fiscal health of Eastern Europe (ex Russia), places Hungary, Czech Republic and Romanian equities on our radar. We are still bearish on EM Europe heavy-weights Turkey and Russia.
Emerging Markets (Africa)		Strategic				For U.S. investors, significant negative basic balances and the rand's commodity sensitivity lead to a slight underweight.
Emerging Markets (LatAm)	Strategic					Although our tactical model suggests a relief rally, deteriorating macro and currencies as well rising political uncertainty keep us away. Too early to bargain hunt in this market.

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		Strategic ←		Variance		The US Fed rate cycle and moribund pricing power warrant caution in the U.S. The opposite trends however buoy this sector in Europe, China and India.
Consumer Staples			Strategic →	Tactical		Lower energy input costs and the deflationary environment favor this defensive sector. Our tactical models support an overweight.
Energy		Strategic				Supply/demand conditions, the ineffectiveness of OPEC to contain production and the on-stream of oil from Iran makes another down leg a high probability.
Financials			Variance	Strategic		Relative insulation from dollar appreciation. Margin improvement awaits steepening yield curve. Our tactical models project outperformance in selective industries such as REITS. Avoid outside of US particularly in EM where banks are under-provisioned.
Health Care			Tactical	← Strategic		Secular dynamics supportive of this sector but pricey. Our tactical models project some retracement in this sector's outperformance.
Industrials		Strategic				This sector's limited pricing power and dollar exposure warrants an underweight; a view supported by our tactical models.
Information Technology			Tactical	← Strategic		Dollar appreciation represents a mixed bag for US tech. Our tactical models are projecting a retracement in this sector's outperformance.
Materials	Strategic ←					Weakening Chinese demand and end of commodity super cycle do not bode well for this sector. Our tactical models are also signaling poor performance.
Telecommunications			Strategic →	Tactical		Cheap and provides defensive haven while disinflationary undercurrent still underway. Could also be boosted by M&A activity.
Utilities		Strategic →	Variance, Tactical			Will struggle with rate normalization in US. However, our tactical models support an upgrade.
Style (Value at Left / Growth at Right)			Strategic ←			On balance, defensive sector mix and the downgrade of IT is beginning to lead to reduce the Growth orientation.
Capitalization (Small at Left / Large at Right)		Variance, Tactical	← Strategic			Domestic orientation favor small caps; affirmed by our tactical models. Improvement in credit availability will disproportionately help non-US small caps.

← Change from Q4 2015 ● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios