FIS GROUP

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MARKET OUTLOOK
Q3 2017

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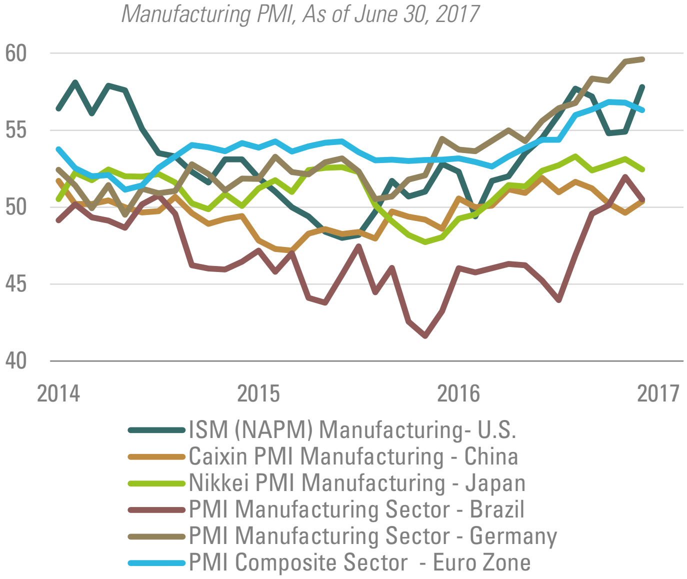
Full Steam Ahead

Global equity markets climbed by 4.3% in Q2 (and 11.5% year to date) despite basically flat performance in June on the back of a further rout in oil prices as well as a surprisingly weak May CPI. Small cap and so called Trump reflation stocks back most of their post-election gains, as investors grow more discouraged about the prospects of lower corporate taxes and regulatory repeal. In the U.S., companies with global operations have broadly outperformed domestically focused firms thus far this year, partly because of a pickup in emerging markets and a weaker dollar. High powered growth stocks, which have thrived in a low economic growth environment, finally stumbled again toward the end of the second quarter as a more hawkish tone amongst the world's major central banks (Fed, ECB, BoE, Bank of Canada…) caused yield curves to steepen and thereby benefit cyclical sectors such as financials and energy/materials. Emerging markets again led developed markets; whilst European stocks outperformed U.S. stocks, largely due to the euro area's strong cyclicality and exposure to global growth. Japan remains a dual-paced economy, with international sectors doing well, but domestic sectors stagnating, as wage growth remains sluggish. On the geopolitical front, the most market-relevant stories in the second quarter emanated from Europe where the underperformance of Eurosceptic parties (as we had forecasted) buoyed European stocks, between the first and second rounds of the French election. In the U.K., the June election outcome increased the probability of a softer Brexit and has all but killed the Tory's plan for fiscal austerity.

Going forward, despite pockets of concern over either elevated valuations or political risk, we believe that equity markets remain in a sweet spot due to moderate economic growth, healthy corporate profit growth, stable margins and low inflation (see CHART 1 and CHART 2). Against a positive macroeconomic backdrop, political risks in Europe have been dissipating. Over the past few weeks we have seen, (i) a deal of sorts cobbled together to keep Greece on the EU road, (ii) Italy's plan to merge its worst performing banks into Intesa, one of its national champions, and (iii) Spain do the same with Banco Popular. So, an impending European crisis does not seem to be a threat. To some extent, the same can be said of China where the engineered slowdown in Chinese growth appears to be modulating, as real-time indicators (railway freight traffic, excavator sales, electricity production and retail sales) are, at a minimum, stabilizing. Finally, Japan is in a stealth bull market (i.e., few investors talk about it), which does not seem to depend on yen depreciation to keep going.

CHART 1 | Global Economic Activity Full Steam While China Lands Softly
Manufacturing PMI, As of June 30, 2017



Source: FIS Group Professional Estimates and Factset

CHART 2 | Global Earnings Recovering
Net Earnings Revision Ratio, MOV 1Q
As of July 12, 2017

Source: FIS Group Professional Estimates and Factset

On the commodity front, growth indicators have not confirmed weakness in commodity markets and for the second half of the year, we expect oil prices to rebound as inventories continue to be drawn down. Specifically, while consumption is projected to rise by 1.5 MMB/D, the Saudi-Russia led coalition is expected to remove 1.4 MMB/D by the end of March 2018, with insufficient offsets from U.S. and Libyan production increases (estimated at 0.7 MMB/D).

The key threats to the ongoing sweet spot for global equities are monetary policy tightening; demanding equity valuations (particularly in the U.S.); and policy uncertainty, as well as under-appreciated geopolitical risks. On valuations, U.S. equities are indeed stretched on commonly used measures such as price/earnings ratios and CAPE; but less stretched when compared to bond yields. Therefore, we do not see any clear and immediate danger of a bear market this year.

On the monetary policy front, we see gathering risks as major central bankers seem to be changing their tune and keen to replenish their respective cupboards with monetary ammunition for potential future use. For example, on June 27, 6 six senior central bank officials from the ECB, the BOE and the Fed came out with hawkish statements. By far, the FOMC is most advanced in its tightening regime and is expected to stick with its game plan of shrinking its balance sheet in September with another modest hike in December despite soft May CPI data, which it believes reflected either randomness or lagged effects from the growth scare in early 2016. This trajectory will maintain the current "sweet spot" for equities until interest rates climb above the equilibrium rate. Yields around 4% on the 10-year Treasury, particularly when accompanied by rising inflation (in the 3 to 4% range), have typically represented an important threshold for more restrictive Fed action.

On the geopolitical risk front, as previously observed, political risk has subsided in Europe. We have always believed that the hype and associated political risk premiums engendered by populist movements were a red-herring in continental Europe. (See our assessment of key geopolitical risks for 2017). Even in Italy, the continental country that was a consensus favorite for the next Eurozone exit vote, the Eurosceptic 5 Star party is losing ground amidst improving economic growth and more accommodating ECB policy relative to Italy's troubled banks. In Asia, however, even beyond the obvious threat from North Korea, the apparent bromance between Chinese President Xi and President Trump appears to be (quite predictably) fraying. China now faces a structural challenge that puts it in direct competition with advanced countries; it has grown to become the world's second largest economy and cannot continue to export deflation and maintain relatively unbalanced trade relationships with the rest of the world, particularly as it seeks to climb the production value chain. As we wrote in our 2017 outlook, unlike Europe, we see the risk of growing America and Chinese tensions as the real underappreciated risk. In the Middle East, the kerfuffle between Qatar and Saudi is less market relevant but symptomatic of a reshuffling of the political order in which America retreats from being the global policing presence that it has held since the early 20th century. Our recent ForeSights issue, *A World Without America* which discusses the evolving geopolitical order, along with a note providing our perspective on the Saudi/Qatari conflict, is provided in the special report section of this outlook.

Our *Q3 Outlook* is summarized in TABLE 1 on PAGES 3-4. In addition to our model forecasts, our **sector positioning** has been heavily influenced by the more hawkish turn among major central bankers leading us to conclude that at the very least, central banks want yields to move higher. As such, a rotation is under way from growth stocks (tech, consumer discretionary…) and stable earners (utilities, staples, telecoms…) towards financials and perhaps even the beaten-up cyclicals (materials, industrials…), particularly in Europe and in Japan. In that respect, the trend that re-emerged during the closing days of June may have legs. For if bond yields continue to rise, we could yet witness many more trading days where every single sector is down, while financials rise.

On the **regional and country front**, we remain underweight to the **U.S.**, as demanding valuations relative to the rest of the world will become more vulnerable as rates normalize. Additionally, uncertainty over if or when we will see any favorable tax, regulatory and fiscal policy is growing by the day. We are neutral to slightly overweight the **U.K.** because of the higher probability of a soft Brexit as well as increased likelihood that the BOE will remain on hold. We maintain our strategic overweight to **Euro core** stocks based on the sharp decline in political risks coupled with the strongest level of earnings growth in 7 years. Our tactical models forecast continued strong performance from **Japanese** stocks where we have an overweight to higher quality small cap stocks and Financials, which we think will continue to benefit from the BOJ's effort to steepen the yield curve. Corporate governance codes are increasingly taking hold, benefiting equity investors through shareholder friendly practices. This quarter, we introduced a new position in **New Zealand** stocks that historically have been positively correlated with its currency (the Kiwi), which has been rising without equity prices following suit. Additionally, New Zealand's GDP has been rising at 6% and unemployment is 1% below equilibrium; thus, making this country's Central Bank most likely to increase policy rates. On **Emerging Asia** stocks, our overweight to Korea and Pakistan are driven by structural changes in the Pakistani market and continued corporate governance improvements in South Korea. Our neutral view on Chinese equities is focused on the higher growth sectors, such as IT. Despite its recent political turmoil, we are neutral to **Brazil** and focus on small caps in that market. Brazilian stocks have priced in much of the bad political news of late. We remain cautious on the larger ETF driven flows, but believe smaller stocks will benefit from broadening local pension demand for equities.

TABLE 1 | Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment			●			Neutral. Markets continued along the bullish path started in the first quarter. Growth stocks outperformed value stocks across markets, buoyed by gradual growth and falling inflation expectations. Emerging markets again led developed markets, whereas U.S. stocks trailed both Europe and Japan. Our market sentiment indicators have moved back towards "Risk On' territory. Lower than expected inflation has decreased the risk of a sharp reversal of the accommodative monetary policy the richly valued markets have thrived on in recent years. Continued monetary support, strong global earnings growth and declining geopolitical risk in Europe are enough to support equity markets in the near term.
U.S. Dollar				●		Slight overweight through currency hedged equity positions. The US Dollar weakened against almost every major currency (except the Yen) in the 2nd quarter. The move was driven by lower than expected inflation in the US and political risk in Europe continuing to decline. We believe that the extreme weakness in the Euro has now been corrected and anticipate dollar strength against most currencies. We are neutral to slightly hedged (particularly in Japan), but believe the market has overreacted to what is likely a short term fall in US inflation expectations.
Region / Countries	**-**		**N**		**+**	
United States		●				Slight underweight over the next 6 to 12 months. Uncertainty over if or when we will see any favorable tax, regulatory and fiscal policy is growing by the day. US stocks are more expensive than the rest of the world and multiples will be vulnerable if rates normalize. We have increased our exposure to higher growth sectors appropriate for this stage of the cycle. (early tightening).
United Kingdom				●		Slight overweight. Large UK companies generate 70% of their revenue abroad. June's election killed fiscal austerity and will likely force a softer Brexit. Additionally, the cloud of uncertainty will keep the BOE on hold. While growth is below Europe, the market is fairly valued and will likely see continued monetary support, despite higher seeing a 4-year high in inflation. Additionally, the pound sterling is now at bargain basement levels and less likely to see further weakness.
EU (core)				●		Overweight over the next 6 to 12 months. Sharp decline in political risks coupled with the strongest level of earnings growth in 7 years led to continued strong performance of the region. We have added to European financials, small cap and growth sectors as we see the economic and monetary cycle begin to normalize.
EU (periphery)				●		We project outperformance over the next 6 to 12 months. Falling political risks and economic growth should cause relative valuations to return to historic levels.
Japan				●		Outperformance over the next 6 to 12 months. Our tactical models forecast continued strong performance from Japanese stocks. We have an overweight to higher quality small cap stocks and Financials, which we think will continue to benefit from the BOJ's effort to steepen the yield curve. Corporate governance codes are increasingly taking hold, benefiting equity investors through shareholder friendly practices.
New Zealand				●		Outperformance over the next 6 to 12 months. New Zealand equities are positively correlated with its currency (the Kiwi); which has been rising without equity prices following suit. Additionally, New Zealand's GDP has been rising at 6% and unemployment is 1% below equilibrium; thus making this country's Central Bank most likely to increase policy rates.
Emerging Markets (Pacific Rim)			●	●		Neutral on Chinese stocks, tactically overweight Korean equities. High potential for Korean stocks to close their valuation discount to the rest of Emerging market countries as companies improve corporate governance. We have moved to a neutral position on China, but are primarily invested in the higher growth consumer and tech companies.
Emerging Markets (South Asia)				●		Strategic overweight. We like the long term trends in India, but enthusiasm is tempered by rich valuations and potential short-term growth disruptions caused by the GST implementation. We are focused on smaller stocks with higher quality growth characteristics. . We have added a position in Pakistan which we believe will benefit from the fundamental market changes of recent years after index inclusion.
Emerging Markets (Europe)				●		Strategic overweight. Russia has potential to rebound on the back of improved prospects for oil price stabilization, moderating inflation and improving governance. Polish and Czech economies are showing signs of strength with currencies which we expect to strengthen relative to the Euro.

● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

Region / Countries	-		N		+	
Emerging Markets (Africa)			Strategic	Tactical		Neutral with tactical overweight to South Africa. Our tactical models are forecasting a rebound in globally focused and commodity intensive South Africa.
Emerging Markets (LatAm)			Strategic			Neutral with tactical overweight to Brazilian small caps; Brazilian stocks have priced in much of the bad political news of late. We remain cautious on the larger ETF driven flows, but believe smaller stocks will benefit from broadening local pension demand for equities.

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		Strategic		Tactical Variance		Slight strategic underweight in the U.S; Overweight in Europe and Japan. This sector tends to underperform at the beginning of interest rate tightening cycles. That said, a healthy U.S. consumer and a strong labor market should continue to provide solid support to the sector's earnings. Also, other developed markets are far enough behind the Fed's tightening cycle to remain overweight abroad. Globally, we have focused our investment in this sector to the higher growth companies.
Consumer Staples			Strategic			Strategic underweight Globally; Defensive sectors are relatively expensive and tend to underperform at this point in the cycle of all major markets. US Staples in particular will suffer with rebounding inflation, fed tightening and a strong dollar.
Energy			Strategic	Tactical		Tactically overweight but neutral strategic weight. We expect that oil prices will rebound as inventories continue to dwindle. However, we have altered the composition of our tactical overweight to focus on energy companies most leveraged to the stabilization or rebound in the price of oil, while decreasing exposure slightly.
Financials			Variance	Strategic		Slight strategic underweight in the U.S; Overweight in Europe and Japan. We continue to believe in the positive correlation to a steepening yield curve and financial performance. U.S. financial companies may still benefit from promised regulator relief, but the strong quarter has led us to trim our U.S. positions, focusing our investment in Japan and Europe.
REITS		Strategic	Tactical	Variance		Neutral. We are neutral on REITS in the U.S. for now; but they face the crosswinds of an improving wage backdrop and an accommodative but gradually increasing interest rates. We see a bottle neck in the supply of housing within the U.S., which we are expressing through home builder stocks.
Health Care					Strategic	Neutral. Our tactical models have turned Neutral. Valuations are compelling, but the tightening cycle and policy risk are too much to overcome.
Industrials		Tactical	Strategic	Variance		Strategic overweight. This sector should benefit from an acceleration in growth and/or inflation with a free option on any infrastructure related fiscal expansion, which continues to become less certain. We have expressed some of our overweight through European defense companies.
Information Technology			Tactical	Strategic		Strategic overweight. We expect the sector to benefit from strengthening global growth and tame inflation, while we remain at this point in the tightening cycle, we expect our exposure to persist.
Materials			Strategic			Strategic overweight. There is some risk to waning Chinese demands, but this sector which typically outperforms early in the interest rate tightening cycle.
Telecommunications		Strategic		Tactical		Strategic underweight. Defensive sectors are relatively expensive and tend to underperform at this point in the cycle of all major markets. Yield heavy telecom names will suffer with the rise of inflation, fed tightening and a strong dollar.
Utilities		Strategic				Strategic underweight. Defensive sectors are relatively expensive and tend to underperform at this point in the cycle of all major markets. Yield heavy utility names will suffer with the rise of inflation, fed tightening and a strong dollar.
Style (Value at Left / Growth at Right)				Strategic		Strategic overweight to growth. In a slow to moderate growth, low inflation environment we are focusing on companies that have high top line growth, in sectors that perform well late in the economic cycle.
Capitalization (Small at Left / Large at Right)			Strategic	Variance		Neutral in U.S. Small Cap bias abroad. The market has moved passed the pricing in favorable policy outcomes for US small caps. We are left with high valuations and boring fundamentals relative to large cap. Our view on potential dollar strength is a potential tailwind for the group. International small cap stocks are growing at a higher rate and have favorable valuations and balance sheet strength.

● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

The Saudi/Qatar Kerfuffle and its Investment Implications

Mark Twain was indeed right. History may not always repeat itself; but it does rhyme. And so President Donald Trump's expression of seemingly unfettered American support for the new, young, and bellicose Saudi leadership's (or at least what the Saudis seemed to have interpreted as such) rivalry for regional hegemony with Iran is eerily reminiscent of German Kaiser Wilhelm's carte blanche support for Austria-Hungary's conflict with Serbia. The Kaiser's assurances in 1914 marked a decisive moment in the chain of events that, after the assassination of Franz Ferdinand and his wife by Serbian nationalists, accelerated a regional hostility in the Balkan region to a wider European conflagration. While for practical considerations (not the least of which being the U.S.'s conflicted relationship with both countries), we do not believe that the Saudi/Qatar Kerfuffle will lead to another World War, it most definitely will impair regional integration, impose a significant discount on Qatari assets and force the country to liquidate a meaningful share of its sovereign wealth fund's holdings. In this vein, we conclude with a list of foreign assets that would appear to be most vulnerable.

Like their Austro-Hungarian predecessors, the Saudi monarchy is a fading regional power confronting a geo-political and ideological enemy in Iran (in lieu of Russia). The twin pillars of Saudi's demands on Qatar are also echoes of 1914, as Saudi has demanded an end to Qatari support for regional terrorist groups, including those also backed by Qatari neighbor and business partner Iran, and cessation of Qatar-based al-Jazeera news network's unfavorable coverage of Saudi and other regional monarchies (the 21st century equivalent of the Austro-Hungarian demand for sovereign surrender of the internal inquiry into the Franz Ferdinand assassination). Also like 1914, Qatar seems potentially willing to accede to the former demand, but accession to the latter demand would effectively be the equivalent of accepting puppet status within the Saudi orbit.

Fortunately, unlike in 1914, we do not have any equivalent of unfettered military alliances that provides the clear path to a hot war (unless the Turkish support for Qatar were to somehow invoke NATO's Article 5 clause for collective defense). Additionally, despite the renewed warmth in U.S.-Saudi relations, Qatar's Al Udeid military base, the largest U.S. military base in the Middle East, should theoretically encourage the new U.S. administration to dampen any further flare-up among two vital Gulf Cooperation Council (GCC) allies.

Our view is that absent a total public capitulation by Qatar to Saudi's demands (which would likely either follow or be precipitated by a palace coup within the al Thani royal family), the future for the once meaningful GCC is bleak. Qatar will increasingly fall into Iran's orbit out of necessity (first for food, then for security) and will struggle, although not collapse, economically.

Outside of Europe, the GCC is (or was) arguably the most integrated cross-border retail market in the world for listed debt and equity (in a market where trading is driven 80-90% by retail investors). Over the past month, GCC investors have been consistent net sellers of cross-border stocks, representing a great unwind of this regional integration. Given the dominance of Saudi investors in this market, the pain has been and will likely continue to be felt greatest by Qatari stocks, which are down nearly 12% (as of July 5) since the crisis began. Going forward, we predict Qatari stocks and debt will trade at a near permanent discount to their own historical averages and to their UAE peers, and we would advise managers and investors to adjust their valuation models accordingly. The long-stable Qatari Riyal also came under its worst pressure in nearly 20 years (see CHART 3) as speculation abounded about the necessity to unpeg the currency. Across the Gulf in the global financial hub of Dubai, home to tens of thousands of expats from around the world, the hasty ejection of Qatari residents has left doubts in the minds of some about the security of their place in the financial emirate should the newly fortified Saudi-Abu Dhabi political alliance initiate a political spat with their home capital, though there is as of yet no indication of stress on Dubai real estate stocks.

CHART 3 | US Dollar per Qatari Riyal (QARUSD)
As of June 5, 2017

Source: Factset

Looking beyond the local market implications, so far, the markets have shrugged off the diplomatic kerfuffle as a meaningful risk to supply disruptions of either oil or natural gas (prices of both commodities are down over the past month), and thus far we agree with the market consensus. Indeed, we believe this twist in the Saudi-Persian Cold War actually lowers the ceiling for natural gas prices (and is largely moot for oil prices) as Qatar will now find itself with much reduced bargaining power vis a vis its LNG customers as well as Iran, who is not just a neighbor, but also the co-owner of Qatar's largest gas field (but also a competitor as Iran still has more gas reserves than Qatar).

Prior to this crisis, Qatar's budget was already under stress (see TABLE 2) from accelerated spending programs related among other things to the 2022 World Cup, and this stress will increase as Qatar spends more money to find alternate supply routes now that Saudi Arabia has shuttered its sole land crossing. This could result in Qatar tapping its sizeable sovereign wealth fund for additional reserves. Given the political needs to support local asset prices, we would expect demands for additional liquidity to come disproportionately from their foreign holdings, and medium-term needs to come from their liquid portfolios. Of its largest liquid investments, Qatar owns meaningful stakes in Volkswagen, Rosneft, Glencore, Barclays, Royal Dutch Shell, and the Agricultural Bank of China, among others (see TABLE 3). Investors might see some trimming of Qatari stakes in any of these positions over the coming months and/or some search for liquidity out of their private holdings including several high-profile properties in London (Canary Wharf, Savoy Hotel, the Shard, Harrods, etc.) though their holdings in the United States might be closer to peak valuation, including Miramax Films or the Empire State Building (where Qatar has a 10% stake).

TABLE 2 | Qatar Macroeconomic Indicators

Year-end December

	2014a	2015a	2016e	2017e	2018e
Primary Balance (% of GDP)	55.6%	-2.2%	-16.7%	-10.0%	-7.0%
Fiscal Balance (USDbn)	123.5	1.3	(18.8)	(8.1)	(3.6)
Fiscal Balance (% of GDP)	16.1%	0.2%	-3.3%	-1.3%	-0.5%
Budget Breakeven Oil Price (USD/b)	56.0	54.6	72.6	70.9	73.9

Source: Qatar Central Bank, Ministry of Planning and Statistics, IMF and EFG Hermes Estimates

TABLE 3 | Global Portfolio

Some of Qatar Investment Authority's holdings on Jan. 9 , 2017

Company	Stake	Value
Qatar National Bank	51.93%	$19.86 billion
Volkswagen AG	17%	*$11 billion
Rosneft Oil Co.	9.75%	$6.83 billion
Ooredoo QSC	53.49%	$4.99 billion
Glencore Plc	9%	$4.64 billion
Barclays Plc	6.3%	$2.97 billion
Royal Dutch Shell Plc	2.13%	$2.33 billion
Agricultural Bank of China	12.99%	$1.68 billion
Sainsbury Plc	22%	$1.51 billion
Tiffany & Co.	12.99%	$1.25 billion

Source: Bloomberg

Note: Volkswagen includes value of 11.22% bolding in preferred shares

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