FIS GROUP

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MARKET OUTLOOK

Q2 2018: Whipsaws and Other Tradable Goods

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Q1 REVIEW

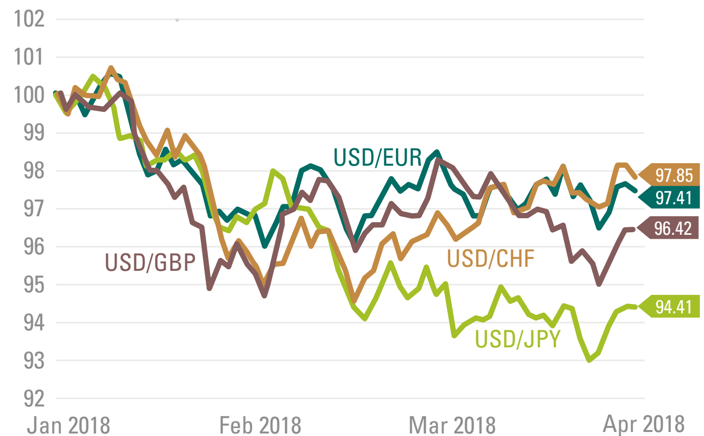
Global risk assets spared no time ringing in the new year, surging 7.3% (10% for emerging markets) in the opening weeks of January. But a cocktail of fears including are pricing of the pace of rate tightening in the U.S. and an unwinding of short vol positions cascaded through global markets, wiping out most of the year's gains in a brief two-week period (see CHART 1). Since then, markets have been contained in a range-bound trend, that many observers are hailing as a return to normalcy in the markets. Part of this boundedness is surely over fears of a trade war as the Trump Administration has finally launched their long promised salvo of trade measures against China. We profile this conflagration in further detail in our recent FIS Foresights piece, The Real Target is "Made In China 2025"; Not the US-China Trade Deficit. Over the past five quarters, Japan has modestly outperformed Europe, which has in turn modestly outperformed the U.S., though all developed markets have been dwarfed by emerging and to a lesser extent frontier markets (see CHART 1).

CHART 1 | Past Five Quarters Performance in Major Markets
Index Price in USD

Source: FactSet

So far our four main themes for 2018 - more aggressive Fed rate hikes, U.S. dollar strengthening, mean reversion of low vol, and geopolitical risks from Trump's foreign and trade policy - appear on track, other than of course the U.S. dollar, which slumped again in Q1 against major global currencies (see CHART 2). Although the US dollar's long-term structural downtrend from a slower underlying pace of U.S. productivity growth relative to the rest of the world and a persistent external deficit, over the 6 to 12 month investment horizon, the US dollar could be buoyed by cyclical factors. For example, U.S. fiscal stimulus is initially bullish for the dollar, despite the fact that this will worsen the current account balance. Additional protectionist measures should also support the dollar as long as retaliation is muted. Already in early Q2 the USD has begun to retrace some of its earlier losses and we think the positioning of the markets in long EUR remains particularly crowded.

CHART 2 | Q1 2018 Saw USD Declines Relative to Major Currencies
Index Price



Source: FactSet

Q2 OUTLOOK

Most of our positioning from Q1 was accretive, as we remained overweight Japan and Emerging Markets (EM) relative to the U.S. and the UK. Within EM, Korea and Poland underperformed, but our favor to Brazil, Russia, Taiwan, Nigeria, Pakistan, Colombia, and Chile relative to EM all proved accretive, as did our tactical underweight to India despite our longer-term bullish outlook on the market. During Q1 we exited our position in Nigeria for a handsome gain and switched into Egypt, which has since also outperformed.

Looking towards Q2, on the surface we have made few changes, remaining constructive on Core Europe and Japan, neutral to the U.S. and UK while eschewing Australia. Within Europe and Japan we have tilted more heavily towards financials in particular, as we believe that rate normalization in both markets will accrue disproportionately towards banks, which remain at depressed valuations, especially in Japan.

For this next quarter, we are neutral overall on emerging markets, as our longer-term constructive view is tempered by some expectation for U.S. dollar strengthening and potential weakness in the Chinese credit cycle in the near term. We have reversed our bullish position in Taiwan and are now underweight the market as it is perhaps the most susceptible to Sino-American trade tensions. We are similarly a little more cautious on Korea, though tactically positioned to benefit from what we believe could be some positive news flow coming out of the summit meetings with North Korea. In Russia we are bucking the market consensus and staying overweight, having even added slightly to the position on price weakness following the most recent round of sanctions over Russia's support for Syria. While Russian geopolitics remain deplorable, (particularly their brazen assassination of a British national on British soil), Russian economics continue to improve. We believe that a stable to positive outlook for oil prices will ultimately prove more important for Russian risk assets than current geopolitics; while we are being paid to ride out the storm with a 5.3% dividend yield on the market (for the ETF). Moreover, Russian equities, which should trade at a discount to their peers, remain too cheap for the improving economic fundamentals and in an environment which remains supportive of oil prices. As noted in the Table outlining our sector positioning, both supply-demand dynamics and geopolitics (particularly with the Trump Administration threatening to withdraw from the Iran Agreement) should continue to support oil prices for at least the next few quarters (if not higher or for longer). This quarter, we added Thailand to our EM portfolio. Despite multiple delays in holding a civilian election, Thailand's military junta has brought relatively competent and stable economic management. Moreover, Thailand's relatively low external debt and foreign funding makes it less vulnerable than many other EMs to global/EM turmoil.

For our full, detailed list of country and sector positioning, see TABLE 1 on PAGES 3-6.

FRONTIER OUTLOOK AND INDEX UPGRADES

Q1 was also a busy time on the frontier, with Vietnamese equities approaching parabolic heights by the end of the quarter. After seeing the markets crest mid-April, we moved Vietnam back to neutral relative to frontier. The long-term fundamentals of the market remain solid and reasonably priced given a growth outlook (0.7x forward PEG); but we expect a cooling off period for at least a few months as fundamentals catch-up to prices. Romania also surged ahead 19% during Q1, fulfilling our forecast for some further outperformance of the market. We are cautious going into the end of the year as inflation is cresting up and the government's fiscal impulse continues unfettered. This could herald upside surprises for interest rates and a potential for a swift reversal of market sentiment. But the market there remains reasonably priced at about 10x trailing earnings and 1.1x P/B and so we will remain constructive a little longer, but are becoming more cautious.

In Argentina, the markets corrected 5.6% during Q1 and now seem to be waiting for the next sign. We are monitoring the inflation numbers closely, which are coming in right at our rule-of-thumb threshold of about 2% monthly CPI to stay neutral on the market. Over the coming months we are looking for a lack of bad news or more price weakness to re-enter the market. Kuwait also outperformed during the quarter (+8.1%), reaffirming our call for an overweight in our annual outlook. We think the positioning relative to other GCC markets remains very positive for Kuwait, but after some solid early year performance we are a little less sanguine on Kuwait's outperformance for the rest of the year. We still think Kuwait has a chance to get flagged by MSCI for watch-list inclusion for an upgrade to emerging markets, but for now it appears that an ultimate upgrade is not likely without a significant uptick in liquidity.

Remaining in the Gulf, markets are aflurry over the prospect of Saudi Arabia's potential to upgrade to emerging markets status. On March 28, FTSE announced that Saudi Arabia would be elevated to secondary emerging market status within their global equity indices. Local brokers and some investors are beginning to hype the potential for MSCI to follow suit this June. We are not so sanguine and see an MSCI announcement of an upgrade as coming late 2018, at the earliest, with mid-2019 still more likely. We also are not excited by Saudi equities, which remain at or slightly above their historical valuations and roughly on par with the rest of their would be emerging market peers. While the reforms occurring within Saudi Arabia are very interesting, and definitely should yield some exciting individual stock opportunities, we are not convinced that this market represents either a growth or value opportunity, and thus remain dissuaded to follow any beta play in the market. For our views on other potential reclassification candidates, as well as a review of recent research suggesting a trading strategy for such index changes, please refer to our recent FIS Foresights piece, Profiting from MSCI Reclassifications.

TABLE 1 | Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment		●				**Slight Underweight.** Both our Systematic Market Risk and Sentiment Rick Indicators call for a slight pull back in global equity risk assets.
US Dollar			●			**Neutral.** The dollar's long-term structural downtrend reflects both a slower underlying pace of U.S. productivity growth relative to the rest of the world and a persistent external deficit. The U.S. shortfall on its net international investment position, now at about 40% of GDP, is likely to continue growing in the coming decades. However, over the 6 to 12 month investment horizon, the US dollar could be buoyed by cyclical factors. For example, U.S. fiscal stimulus is bullish the dollar, despite the fact that this will worsen the current account balance. Additional protectionist measures should also support the dollar as long as retaliation is muted.
Region / Countries	**-**		**N**		**+**	
Developed Markets				●		
United States			●			**Neutral.** Stretched valuations and growing threats to earnings from rising wage pressures and a potential trade war are offset by a strong fiscal impulse, reasonable earnings, and most of all, a safe haven status globally.
Core Europe				●		**Overweight.** European growth may be moderating and a slowdown in China would likely weigh on Euro area earnings; but we still see more upside in the market. We are especially keen on financials and other cyclicals as they emerge from multiple years in the doldrums.
Japan				●		**Strategic Overweight.** Japan continues its multi-year course to arrest decades of languid growth and bad policy impulses. Valuations are still very attractive while ROEs, dividend yields, and other metrics continue to close the gap with European and American equities. Within Japan, we have moved into Japanese financials as we expect them to benefit disproportionately from eventual BOJ tapering with valuations at near 20-year lows.
U.K.			●			**Neutral.** Uninviting economic fundamentals and an overhang on sentiment from Brexit negotiations are offset by the FTSE's exposure to non-UK revenue sources, which remains modestly attractive.
Australia	●					**Underweight.** Australian equities remain uniquely unattractive with a forward PEG ratio of nearly 2x, or about 50-150% higher than global indices. Book valuations also at 10-40% premiums, with strong headwinds coming from a slowdown in China.

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● Strategic (6-12 months+) ● Tactical (3 months)

Region / Countries	-		N		+	
Emerging Markets (Asia)			Strategic			**Neutral. Selective Tactical Overweights to Thailand and a Strategic Overweight to Pakistan. Tactically underweight to Taiwan** which we believe lies at the bulls-eye in potential fallout from increasing Sino-American tensions.
China			Strategic			**Neutral.** Slowdowns in Chinese forward economic indicators and risks emanating from a Sino-American trade war point towards caution in China while top-line and earnings growth in the "New China" economy remains robust. Within China we are heavily overweight healthcare and modestly overweight consumer/consumer tech and thus underweight financials and "Old China".
Korea			Tactical	Strategic		**Strategic Overweight/Tactically Neutral.** Dividend yields and ROEs have quietly nearly converged with their EM peers, while valuations remain at 40-60% discounts to EM, including a forward PEG ratio of merely 0.47x vs 0.74x for EM and 1.2x for DM. We still expect the Korean market to partially close the valuation gap as the world re-discovers the market, but for now we are cautious on the potential blowback to Korean exporters posed by Trump's mercantilist trade policy.
Taiwan		Tactical	Strategic			**Underweight.** The Taiwanese market is uniquely exposed to the potential blowback from a Sino-U.S. trade war, even more so than the Chinese market given the different index composition.
India			Tactical	Strategic		**Strategic Overweight/Tactically Neutral.** Indian corporates still look poised for a long runway of earnings growth on the back of structural reforms and modest interest rates and there are early signs of the capex cycle turning in India. Our models were wise to move us to a tactical underweight in Q1, and now point to a neutral call, but we expect to reinitiate our overweight in the market in the coming months.
Thailand			Strategic	Tactical		**Tactical Overweight.** Thailand is a relatively defensive safe-haven which should better be able to withstand global / EM turmoil. Additionally, despite multiple delays in holding a civilian election, Thailand's military junta brought relatively competent and stable economic management. Consequently, both its external debt and dependence on foreign funding is relatively low.
Pakistan				Strategic		**Strategic Overweight.** We believe the worst of the devaluations are behind us and any more small adjustments are now more than priced in. The market remains at a 30-60% discount to most EM peers with a strongly positive capex impulse from Chinese investments and still much more room to run for local investors to add to risk assets as previous structural reforms take root. This thesis may take longer than expected to play out, but we are being paid to wait with a 5.9% dividend yield (for the ETF) with relatively low correlations to the rest of EM.
Emerging Markets (Europe)						**Neutral with a Tactical Overweight to Russia.** The Central Bank of Russia is likely to cut its main policy rate from a hefty 7.5% after the latest inflation reading fell to 2.2%, which is much lower than its target. Given that real rates will remain high and the oil price is well bid, OFZ domestic bonds should continue to benefit from carry-trade chasing inflows. After a period of industrial consolidation, the outlook for corporate profits has improved, which should support equities.
Russia			Strategic	Tactical		**Tactical Overweight.** Russian economic fundamentals continue to look strong and we have used the recent geopolitical selloff to add to this position, which did outperform in Q1. We believe that a stable to positive outlook for oil prices will ultimately prove more important for these risk assets than the geopolitics, while we are being paid to ride out the storm with a 5.3% dividend yield on the market (for the ETF).

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● Strategic (6-12 months+) ● Tactical (3 months)

Region / Countries	-		N		+	
Emerging Markets (Africa)						We exited our Nigeria position, held since early June of last year, for a +47% gain (+26% excess vs EM), on Jan. 19, after which time the market slumped back down 12%. We initiated a call on Egypt shortly thereafter which has since outperformed by nearly 15% vs EM. We remain bearish on South Africa.
South Africa		●				**Underweight**. We can agree that the outlook in South Africa is less bad than it was under Zuma, but we still don't see enough upside relative to other superior opportunities worldwide. The currency remains vulnerable, despite already being cheap, and there is little reform on the horizon that might spur an investment cycle to deliver robust earnings growth, while the market remains more expensive than its EM peers.
Egypt					●	**Strategic Overweight**. Egypt is amid a classic cyclical turnaround. A previously unstable macroeconomic situation has given way to a stable currency, falling inflation and interest rates with a market that is trading at a discount to EM with much higher growth prospects.
Emerging Markets (LatAm)			●			**Neutral with Overweights in Colombia and Chile.**
Brazil			●			**Neutral.** Low inflation and interest rates remain a highly positive catalyst to earnings growth, but as the easing cycle is almost certainly at an end in Brazil, we see most of this as priced in already. Local pension funds are very likely incremental buyers given historically low allocations, but foreigners may also be net sellers as we expect the headlines in Brazil to get worse before they get better as we approach what is an historically uncertain election in Brazil.
Colombia				●		**Strategic Overweight.** Colombia is a late entrant to the LatAm re-rating cycle having been left behind for much of the 2016-17 rally in LatAm. The market is trading at a 30-40% discount to peers and still probably has one more rate cut to come. And while Colombia is also facing an election this year the likely outcome portends substantially less risk than in either Brazil or Mexico.
Mexico		●				**Underweight.** Economically, Mexico remains at risk from NAFTA renegotiations, though these risks may be overpriced at the moment. There is also a substantial internal political risk from left-wing Presidential candidate Andres Manuel Lopez Obrador (AMLO). While we think there is a good chance AMLO will be less bad than the markets are likely to price in, we expect an economic slowdown from any turnover in regime, given the cronyist structure of Mexican government contracting, and thus remain cautious.
Chile			●	● (Tactical)		**Tactical Overweight.** The surprise victory by conservative candidate Sebastian Pinera coincided with a cyclical upswing to yield a virtuous economic cycle. Growth in Q1 was the fastest among the liquid markets in the region. Chilean exporters may also stand to quietly benefit from U.S. protectionism as the country stays under the Trump Administration's radar, while offering an alternative to certain American products for European and Asian markets seeking retaliation against U.S. agricultural products.

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● Strategic (6-12 months+) ● Tactical (3 months)

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		Developed	Emerging Markets			**Strategic Underweight in US, Neutral in Europe and EM**. The EU will continue their tapering program until the end of 2018 while EM is riding the wave of an expanding middle class.
Consumer Staples		Developed, Emerging Markets				**Strategic Underweight.** Defensive sectors tend to underperform at this point in the cycle of all major markets. We have reduced the underweight within the US due to rising risk associated with high valuations.
Energy			Emerging Markets	Developed		**Strategic Overweight.** The sector is fairly valued and with better balance sheets and a small rise in oil prices will be a jolt to earnings. Current supply / demand dynamics and the Trump administration's Iran deal would further support prices.
Financials		Emerging Markets			Developed	**Strategic Overweight in the U.S., Europe and Japan.** We continue to believe in the positive correlation to a steepening yield curve and financial performance; focusing our investment in extremely cheap Japanese and European financials. Fair valuations and regulatory reforms should provide a tailwind in the US and Europe.
Health Care			Developed		Emerging Markets	**Underweight in US and Developed markets** due to fairly high valuations and possible policy risks. We have a tactical overweight to Chinese Health Care stocks to exploit favorable valuations and structural reforms.
Industrials			Emerging Markets		Developed	**Strategic Overweight to Europe and US.** This sector should benefit from an acceleration in growth and/or inflation with a free option on any infrastructure related fiscal expansion, which is unknown. We have maintained our overweight to European defense companies, and added to smaller companies exposed to EU capital spending.
Information Technology			Developed	Emerging Markets		**Neutral.** This sector has been the main leader within the US market and it seems that profits have peaked. EM is a strategic overweight because this industry is still expanding overseas, except for China, which is experiencing a stall and might be hitting a period that this industry trades sideways.
Materials			Developed, Emerging Markets			**Neutral.** There is some risk to waning Chinese demand. The late cycle demand for Materials is largely neutralized by the political risk surrounding this sector globally.
Telecommunications		Developed, Emerging Markets				**Strategic Underweight.** High Yielding defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets.
Utilities		Developed	Emerging Markets			**Strategic Underweight.** High Yielding defensive sectors are overvalued and tend to underperform at this point in the cycle of all major markets.
Small Cap				Developed, Emerging Markets		**Strategic Overweight to Developed and Emerging Markets.** Smaller companies are better positioned to benefit from the self-sustaining economic growth cycle in Europe, improving governance in Japan and local consumer growth in many EM markets.
Value vs. Growth			Developed, Emerging Markets			We have shifted to neutral positioning relative to Value and Growth. Inflation expectations will likely lead to the end of the growth market we have experienced the past few years. As the inflation cycle strengthens we anticipate a value tilt opt the portfolio.

● Developed ● Emerging Markets

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