FIS GROUP

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MARKET OUTLOOK

Q3 2018: A Final Melt-Up

Looking Beyond Geopolitical Headwinds and the Removal of the Central Bank Put on Market Declines

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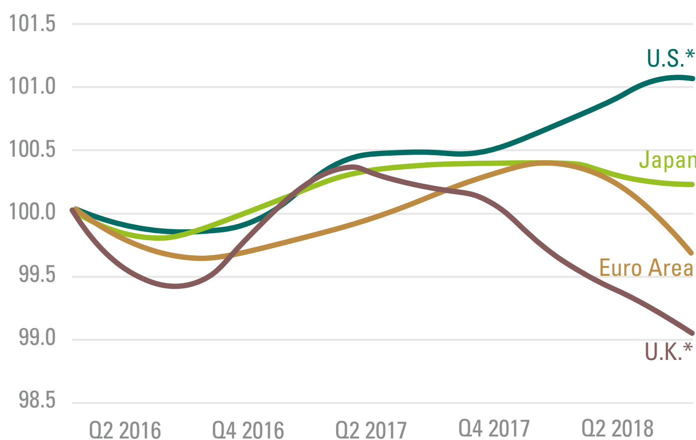
At its half-way mark, 2018 has been a tough year to make money. Investors have lost money on US investment grade bonds, on emerging debt, on US Treasuries, on European bonds, and on pretty much every major global equity market. Towards the end of the second quarter, only US small caps, US tech stocks, US junk bonds, and oil have made new highs. Despite the clear indication that global growth is peaking outside of the U.S. and heightened geopolitical risks occurring at a time when key policymakers seem less inclined to cushion the markets against adverse developments, both our Systematic Market Risk and Sentiment Risk Indicators point to a snap-back in risk assets. Our market risk indicators appear to be indicating that we may be entering the final more volatile "melt-up" of this market cycle, (which in the U.S. was catalyzed by the Trump tax cuts) before the gathering headwinds of peaking global growth, rising wages, escalating trade fissures as well as less accommodative central banks come to a head.

From a macro perspective, outside of the U.S. global growth appears to be peaking (see CHART 1). Real **U.S.** growth is on pace to reach 4% in the second quarter and the current 3.75% unemployment rate marks a 48-year low and for the first time in over 20 years, there are now more job openings than there are job seekers (see CHART 2).

Consequently, the most significant risk for the intermediate to long term, is the consequences of the U.S. economy overheating, particularly in light of the Trump Administration's tax cut and spending policies which is projected to grow the budget deficit to 4.6% of GDP next year. For investors, a tightening labor market will weigh on earnings and increased inflation expectations could expedite the Fed's hiking campaign. Perhaps Jay Powell's announcement that he will hold a press conference after every FOMC meeting may open the door for the Fed to move back to its historic pattern of hiking every six weeks.

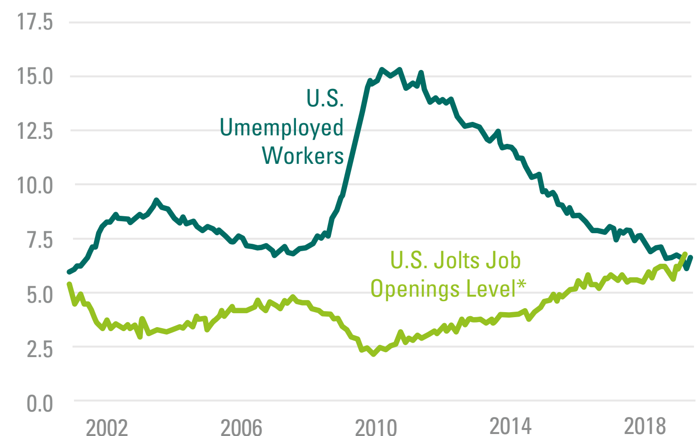
This backdrop has buoyed the U.S. Dollar, which appreciated by over 5% against most major currencies last quarter and is now up nearly 2% year to date. The U.S. Dollar is a counter-cyclical currency, in that it tends to outperform when the global economy is decelerating and if the Chinese economy continues to weaken, global growth will remain under pressure (see CHART 3 on next page). Since Treasury yields bottomed last September, U.S. real rates have risen across the entire yield curve and real rate differentials between the U.S. and other major economies have increased. Therefore, although the U.S. Dollar is not cheap on a purchasing power parity basis, long-term interest rate differentials suggest room for appreciation from current levels, even when one accounts for the difference in inflation expectations.

CHART 1 | U.S. is outshining its peers
Leading Economic Indicator by Country/Region



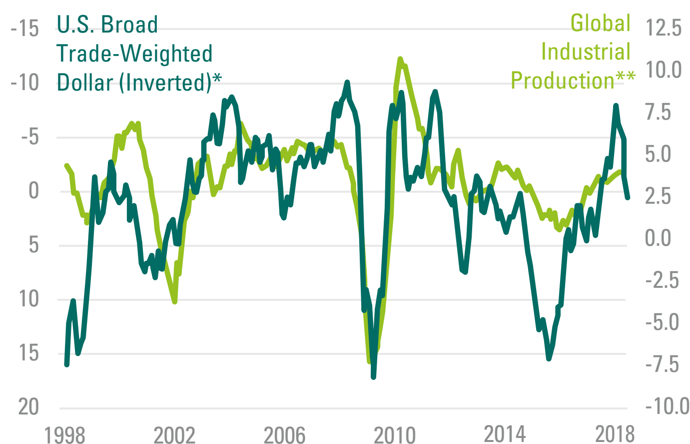
**Amplitude adjusted rebased to January 2016 = 100*
Source: OECD, BCA Research

CHART 2 | There are more vacancies than jobseekers
In Millions



**Job openings and labor statistics*
Source: Bureau of Labor Statistics, BCA Research

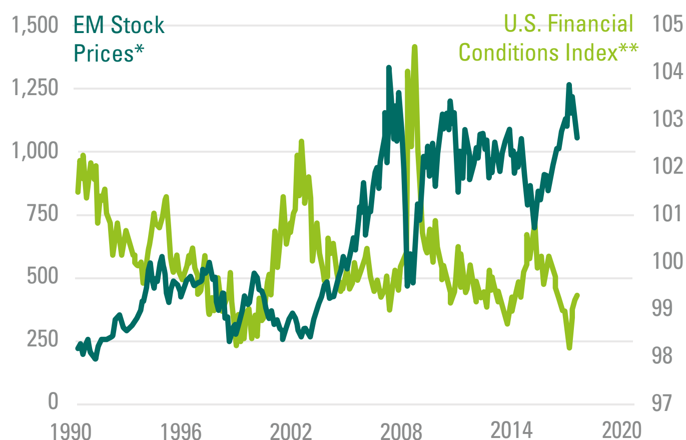
CHART 3 | Decelerating global growth tends to be bullish for the Dollar
Annual % Change



**Source: Federal Reserve*
***Based on BCA calculations*
Source: BCA Research

Emerging markets have been at the tip of the spear in a tightening dollar liquidity environment. (See CHART 4). While the first currencies to falter were from heavily indebted economies such as Turkey and Argentina, the contagion subsequently spread across the EM landscape.

CHART 4 | Tightening U.S. financial conditions do not bode well for EM stocks

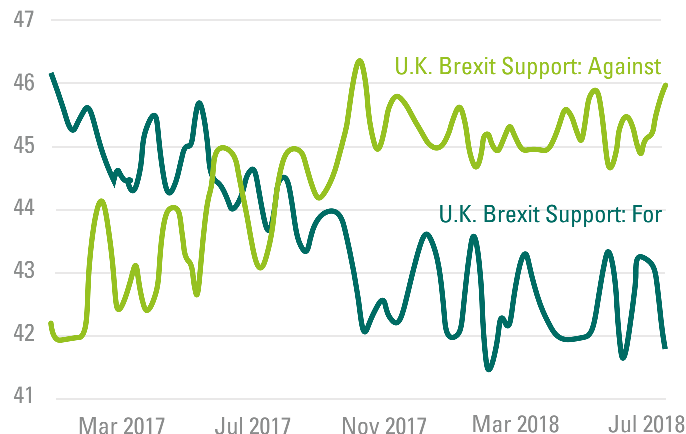


**In U.S. Dollars. Source: MSCI Inc.*
***Source: Goldman Sachs (via Bloomberg L.P.)*
Source: BCA Research

According to the Bank for International Settlements, 80 percent of EM foreign-currency debt is denominated in U.S. Dollars. While BIS numbers do not account for intra-company liabilities between affiliated entities, (therefore, particularly for some countries such as Chile, overstate the risk of foreign currency debt), it is noteworthy that EM dollar debt is now back to late-1990's levels; both as a share of GDP and export levels. Local currency EM issuers could also be vulnerable to tightening U.S. financial conditions. If EM central banks raise rates to defend their currencies (which is what occurred in Mexico, Indonesia, Turkey and Argentina), higher domestic rates could eventually impair local currency borrowers. This is why, as discussed below, we have been under-weight emerging markets as a whole with selective focus on bourses whose countries have stronger economic fundamentals (such as Thailand, Russia, China, South Korea, Egypt and India) or which have become oversold (Brazil).

Growth in the **Euro area** peaked last year with real GDP slowing from 0.8% in Q4 2017 to 0.2% in Q1 2018. Some of the slowdown resulted from slower credit growth. Moreover, the inevitable tightening of financial conditions prompted by the Italian imbroglio will further weigh on Euro area growth. However, Euro area growth is also being hampered by slower growth in China and other emerging markets. Therefore, going forward, disappointing growth and rising trade related tensions will likely weigh on the Euro. In contrast, the pound sterling, which continues to trade well below purchasing power parity, could be buoyed by the marked shift towards a soft Brexit stance with the resignation of hard-line Brexiters from the May government. Underscoring the changing political winds, most polls suggest that if a referendum were held again, "Bremain" would prevail (see CHART 5). Furthermore, on the economic front, the BOE's Monetary Policy Committee voted for an immediate 25 basis point increase in the bank rate in June on the back of strengthening consumer confidence and a pick-up in real wages and the CBI retail survey.

CHART 5 | The "Bremorse" sets in*
%



**Both series shown as 15-day moving averages. Source: What UK Thinks*
Source: BCA Research

Thus far in **China**, recent data on industrial production, retail sales and property prices in tier one cities are down year-over-year. While the Chinese government has cut reserve requirements and loosened some administrative controls, the combined credit and fiscal impulse remain on a downtrend. Even if China does stimulate its economy, it may try to do so by allowing the RMB to weaken, prompting further U.S. Dollar strength.

AN ESCALATING TRADE WAR?

The obvious Damocles Sword hanging over the markets is that one of the greatest drivers of productivity gains over the past two decades—the integration of global supply chains—is now in grave danger of stalling. The big uncertainty remains the extent to which the age of globalization will unravel. Is President Trump playing hard-ball to get the best possible "deal", after which the world will get back more or less to "business as usual"? Or is policy now being directed by trade warriors like Peter Navarro or, worse still, neo-conservatives like John Bolton, whose ultimate goal is the containment of China and the capping of Chinese growth rates? Unfortunately for financial markets, these questions are unlikely to be answered before the end of the summer at the earliest. The best possible outcome is that the current posturing by the US President is the prelude to a "deal" that will get announced a few weeks before the midterm elections. But under this scenario, the US electoral calendar dictates that there will almost certainly be more cage-rattling on trade over the course of the summer.

For China, allowing the RMB to depreciate to stimulate its economy has the added benefit of providing a more effective and winnable retaliatory weapon than a tit-for-tat trade war with the Trump Administration. China imports only $188 billion of goods and services to from the U.S., vs. $524 billion in exports to the U.S. This is why the U.S. President and the U.S. Trade Representative Peter Navarro believe that it would be easy for the U.S. to win a trade war. However, a stealth currency war, which the Chinese could initiate by simply stepping up their purchases of U.S. Treasury bonds to drive up the value of the dollar, would level the playing field, even though its effects would further aggravate already tight dollar liquidity. It remains to be seen whether the appreciation of the RMB around the time that President Trump announced the additional tariffs on $200 billion of Chinese exports was simply an attempt to level-set against its broader currency peg or a warning shot, (or perhaps both). While the risks of a currency war, particularly in light of the U.S Congress' equally aggressive stance towards China (as evidenced by their vote to overturn President Trump's concession on ZTE) is obviously non-trivial, we believe that at least in the interim, China is more likely to deploy more surgical measures, such as delaying licenses for U.S. firms, approval of mergers and acquisitions involving U.S. companies and ramping up inspections of American products at the border.

Moreover, it remains to be seen whether the Trump Administration's trade policy will continue to be politically tenable. For example, analysts at the Peterson Institute for International Economics have calculated that 95 percent of the Trump Administration's tariffs are falling on capital goods and intermediate goods, such as steel and aluminum. As previous US administrations have learned from similar policies, companies that use those inputs to make their own products employ more Americans than the steel and aluminum industries themselves. On the other hand, 38 percent of China's retaliatory tariffs target agricultural and food products aimed squarely at red states in the mid-west and 35 percent at intermediate and capital goods.

For investors the ratcheting up of geopolitical risks emanating from the trade imbroglio between the Trump Administration and most of its major trading partners is occurring at a time when key policymakers seem less inclined to cushion the markets against adverse developments. Whereas the Fed had the leeway in 2016 to back away from rate hikes when its initial one seemed to be contributing to global indigestion, the steady reduction of labor-market slack and the specter of unnecessary but sizable fiscal stimulus are likely to keep the Fed from backing off its plan to remove accommodation gradually. It will therefore take a significant drawdown in global risk assets to dissuade the Fed from tightening as the US business cycle matures and inflationary pressure builds via a tight labor market and superfluous fiscal stimulus. In both 2009-10 and 2016, turnarounds in risk assets were triggered by a marked easing of fiscal and monetary policy in China. Could the same happen again? After all, China is already cutting reserve ratio requirements. Our take is less optimistic. We see the cuts in RRRs more as a policy adjustment or correction, than an outright easing. Indeed, it would be very surprising if China embarked on a meaningful easing of policy at a time when oil and food prices, along with inflation, are all creeping higher. In part that's because the policymakers in Beijing were brought up in the Marxist church, and fundamentally believe that the precursor to revolution or regime change is usually inflation. As with the Federal Reserve, we also believe that Chinese policymakers will only deploy fiscal and monetary stimulus to their economy in the face of evidence of a steep slowdown, given the political initiatives to address elevated debt levels, excess industrial capacity, pollution, corruption, and speculative froth in the financial system, all of which call for tighter, not looser monetary settings. Finally, the ECB is committed to winding down asset purchases, including support for Italian bonds, even as the Italian economy continues to need growth-friendly policy to manage debt sustainability. With the largest central banks withdrawing unconditional support for financial asset prices, valuations appear to discount too complacent an outlook for global earnings growth, relative to the myriad potential catalysts for an air pocket.

Q3 2018 POSITIONING

Our Q3 positioning is summarized on PAGES 5-8. In contrast to market consensus as well as the heightened geopolitical risks previously discussed, both our Systematic Market Risk and Sentiment Risk Indicators point to a snap-back in risk assets. Our market risk indicators appear to be indicating that

we may be entering the final more volatile "melt-up" of this market cycle, (which in the US was catalyzed by the Trump tax cuts) before the gathering confluence of peaking global growth, rising wages, escalating trade fissures as well as less accommodative central banks come to a head. Consequently, in our tactical accounts, we reduced the allocation to cash to more neutral levels. We continue to overweight developed markets but have increased our weights to more defensive bourses or currencies (e.g., Switzerland and Japan). We also maintain our underweight to Emerging Markets as a result of tightening dollar liquidity, China's continued slowdown and gathering threats of a trade war. Among emerging markets, we eliminated our positions in Colombia and Pakistan for a handsome gain and loss, respectively. We are neutral to China with a focus on health care and environmental themed companies. We are neutral Korean equities on a dollar hedged basis and maintain our overweight to Russian equities as Russian economic fundamentals continue to look strong, while valuations are the cheapest among emerging markets. Russia modestly outperformed in Q2, but merely kept pace with oil prices and is still being unduly discounted from the short-term fears over further sanctions. We increased our neutral position in Brazil to overweight. While Brazil certainly has its challenges, we believe that after losing nearly a third of their value in USD terms, Brazilian equities are tactically oversold and ripe for a positive tactical correction. In Q2 we added to Thailand expecting it to be a relatively defensive safe-haven which should better be able to withstand global / EM turmoil. That proved errant in the short-term, but we now see space for a tactical correction in the market. Beyond that, a fundamental growth story is re-emerging in Thailand which could point to a multi-year period of strong economic and earnings growth.

On the sector front, we are rotating our sector positioning from an overweight to cyclical sectors to a neutral weight and increasing our allocation to the more defensive Consumer Staples sector. Among cyclicals, we maintained our overweight to the oil sector because we do not believe that Saudi Arabia's pledge to increase production over the remainder of the year will sufficiently offset lower crude output from Venezuela, Iran, Libya and Nigeria, as well as potential U.S. pipeline bottlenecks.

TABLE 1 | Global / Country Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment				●		**Tactical Overweight.** Contrary to market consensus, both our Systematic Market Risk and Sentiment Risk Indicators point to a snap-back in risk assets after a decidedly underwhelming first half of the year. We believe that we are entering the more volatile final "melt-up" stage of this market cycle, (which in the U.S. was further catalyzed by the Trump tax cuts) before the gathering headwinds of peaking global growth, rising wages, escalating trade fissures and less accommodative central banks come to a head.
US Dollar				●		**Overweight.** The Dollar has strengthened on the back of robust U.S. growth which has allowed the Fed to maintain its moderately hawkish stance. In contrast, disappointing growth and rising trade related tensions will likely weigh on the Euro while the Yen's traditional safe haven status suggests a more mixed profile. Rising bond yields and tightening dollar liquidity will weigh on EM currencies and we have added to our currency hedged basket relative to the Korean Won.
Region / Countries	**-**		**N**		**+**	
Developed Markets				●		**Overweight.** We are overweight developed markets with greater focus on more defensive bourses or currencies (e.g., Switzerland and Japan) and we are gradually rotating our sector positioning from an overweight to non-energy cyclical sectors to a neutral weight to the more defensive Consumer Staples sector.
United States			●			**Neutral.** US macro and earnings data has been very strong, buoyed in part by the fiscal impulse provided by the Trump tax cuts. Despite relatively stretched US equity valuations and gathering threats to earnings from rising wage pressures and continued dollar strength, USD investors should benefit from favorable currency translation as well as US equities historic outperformance during times of geopolitical uncertainty.
Core Europe		●				**Underweight core EU equities to fund an overweight to Swiss equities.** Peaking global growth, the lagged effect of a strong Euro last year, as well as the slowdown in China would likely weigh on Euro area earnings. Consequently, we have reduced our position in European small cap stocks in favor of a more neutral positioning in previously underweight defensive areas such as consumer staples and Swiss equities. We remain 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 restrictive monetary policy. 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 remain overweight Japanese financials as we expect them to benefit disproportionately from eventual BOJ tapering with valuations at near 20-year lows.
U.K.				●		**Overweight.** This primarily reflects a positive view on the GBP, which appears oversold and ripe for a rebound, particularly in light of increasing probability of a "soft" Brexit or Brexit in name only, with the departure of hardline Brexiters from the May government. We also expect the GBP to be supported by gradual interest rate tightening by the BOE.
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 are also at 10-40% premiums, with strong headwinds coming from a slowdown in China.

CONTINUES ON NEXT PAGE

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

Region / Countries	-		N		+	
Emerging Markets		●				As a whole, we maintain our underweight to emerging markets as a result of tightening dollar liquidity, China's continued slowdown and gathering threats of a trade war. Among emerging markets, we are neutral to Chinese and Korean equities, overweight Brazilian, Russian, Thai and Egyptian equities and underweight Indian, Taiwanese and South African equities.
Emerging Markets Asia						
China			●			**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 clean tech (non-solar) stocks and modestly overweight consumer/consumer tech and thus underweight financials and "Old China".
Korea			●			**Neutral.** Dividend yields and ROEs have quietly nearly converged with their EM peers, while valuations remain at 40-60% discounts to EM. But while we still expect the Korean market to partially close the valuation gap as the world re-discovers the market, for now we remain tactically cautious on the potential blowback to Korean exporters posed by Trump's mercantilist trade policy.
Taiwan	●					**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. The TWD is also one of the few EM currencies that remains overvalued vs. the USD.
India		●				**Underweight.** 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. But in the short-term, we see some potential for a tactical pullback, at least relative to other clearer opportunities in emerging markets.
Thailand					●	**Strategic Overweight.** In Q2 we added to Thailand expecting it to be a relatively defensive safe-haven which should better be able to withstand global / EM turmoil. That proved errant in the short-term, but we now see space for a tactical correction in the market. Beyond that, a fundamental growth story is re-emerging in Thailand which could point to a multi-year period of strong economic and earnings growth.
Emerging Markets Europe						
Russia				○		**Tactical Overweight.** Russian economic fundamentals continue to look strong, while valuations are the cheapest among emerging markets. Russia modestly outperformed in Q2, but merely kept pace with oil prices and is still being unduly discounted from the short-term fears over further sanctions. Poland, Hungary, Czech, etc. appear modestly attractive economically but the narrow structure of those equity markets and valuations don't offer any particularly attractive opportunities at the present time.
Emerging Markets 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. 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.

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

Region / Countries	-		N		+	
Emerging Markets Latin America						
Brazil				● Strategic		**Overweight.** Brazil certainly has its challenges, but after the market lost nearly a third of its value in USD terms, we see it as tactically oversold and ripe for a positive tactical correction. Within Brazil we remain especially bullish on financials.
Mexico			● Strategic			**Neutral.** We have upgraded Mexico from underweight to neutral. With the victory of Andres Manuel Lopez Obrador (AMLO) having been fully priced in by the market and economic fundamentals are reasonable given the market valuations with the prospect for interest rate cuts on the horizon in 2019. But, Mexico remains at risk from NAFTA renegotiations and so we remain cautious despite a clearly oversold currency.

CONTINUES ON NEXT PAGE

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

TABLE 2 | Sector Positioning

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary			● Developed ● Emerging Markets			**Strategic Underweight in U.S., 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 U.S. due to rising risk associated with high valuations along with style rotations that are occurring this year which should continue into next year.
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. At the current price levels for oil, these companies should see improved profits and margins.
Financials		● Emerging Markets			● Developed	**Strategic Overweight in the U.S., Europe and Japan.** We are focusing our investment in extremely cheap Japanese and European financials which should be recovering from central bank and regulatory headwinds. Fair valuations and regulatory reforms should provide a tailwind in the U.S. and Europe. For US small cap we see this sector turning the corner due to declining regulatory pressures and an increased probability of M&A transactions.
Health Care			● Developed		● Emerging Markets	**Neutral in developed markets although in US small caps we see this as a defensive positioning that could benefit from the increased IPO offerings.** We have a tactical overweight to Chinese health care stocks to exploit favorable valuations and structural reforms.
Industrials			● Emerging Markets		● Developed	**Strategic Overweight in 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.

CONTINUES ON NEXT PAGE

● Developed ● Emerging Markets

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 tech is a strategic overweight because this industry is still expanding overseas.
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. There are changes within this industry for US large caps due to index reclassifications that will change the dynamic/exposures going forward.
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			**Neutral.** Structural tailwinds due to increasingly protectionist trade policies have been widely priced in to US small cap stocks, leaving valuations stretched. We have paired our overweight to European small caps, but still maintain an overweight position in Japanese small caps and select emerging markets.
Value vs. Growth			● Developed ● Emerging Markets			**Neutral.** 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 which are currently trading at a 2 sigma underweight to growth.

● Developed ● Emerging Markets

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