FIS GROUP

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MARKET OUTLOOK Q3 2019

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CIO & CEO

A Late 2019 Performance Pivot to Non-US Markets?

Q2 2019 IN REVIEW

Despite a rocky mid-point, precipitated by the infamous "tweet heard around the world" on May 5th, when President Trump once again pivoted to a more bellicose stance in the trade war with China, global equities eked out a solid gain of 3.6% during Q2. Coincidentally, Fed Chair Jay Powell indicated that they were open to cutting interest rates (at a conference in Chicago on June 4th), in response to declining inflation expectations and further evidence of slowing global growth.

Among developed markets, European equities were boosted by a more dovish pivot by the ECB whilst Japanese equities continued to face headwinds from declining global trade and a poor fiscal environment. Meanwhile, the overvalued U.S. dollar went nowhere; caught in the crosswinds of unfavorable structural dynamics (growing twin deficits and poor valuation), a favorable cyclical tailwind from superior U.S. growth and a U.S. administration clearly focused on jawboning the dollar down. Oil prices declined by almost 3% during the quarter as markets continued to work through the lingering effects of last year's tightening in financial conditions, which, along with extended angst over Sino-U.S. trade tensions, slowed commodity demand.

The performance of global equites in the first half of the year (+16.23%) is consistent with our commentary in the last two Market Outlook reports, which projected a late cycle rally. The question is whether the strongest period might now be behind us? We think it probably is for U.S. equities, though in the short-term they could still be modestly boosted by "insurance" interest rate cuts by the FOMC. In our Q1 and Q2 Outlooks this year we projected that performance leadership will shift from the U.S. to the rest of the world (RoW) during the second half of the year and we continue to believe that such a pivot will occur, particularly if the dovish pivot by major central banks materializes into actual policy.

STOCK MARKET IS A BETTER NEAR TERM FORECASTER

Much has been written about the contradictory messages being heralded by the bond vs. stock markets. Whilst the stock market continued to climb a wall of many worries, since May the yield curve has inverted, with 10-year yields falling from 2.5% to 2.0%, seemingly heralding a darker near-term outcome (see CHART 1 on the next page). In this instance, we believe that the stock market is a better near-term forecaster. The key change which reconciles the message being sent by the bond market vs. the stock mar-

TABLE 1 | Key Market Returns
Annualized

Description		2Q 2019		YTD 2019		2018 Calendar Year	
		USD	Local	USD	Local	USD	Local
MSCI AC World Index - Net Return	ACWI	3.61	3.23	16.23	15.90	-9.42	-7.69
MSCI AC World Index ex USA - Net Return	ACWI ex US	2.98	2.13	13.60	12.89	-14.20	-10.65
MSCI EAFE - Net Return	EAFE	3.68	2.80	14.03	13.68	-13.79	-10.99
S&P 500 - Total Return	U.S.	4.30		18.54		-4.38	
MSCI Canada - Net Return	Canada	4.88	2.59	21.01	15.77	-17.20	-9.74
MSCI Europe - Net Return	Europe	4.48	4.03	15.80	16.08	-14.86	-10.59
MSCI United Kingdom - Net Return	U.K.	0.91	3.32	12.91	12.98	-14.15	-8.82
MSCI Japan - Net Return	Japan	1.02	-1.67	7.75	5.81	-12.88	-15.15
MSCI China - Net Return	China	-4.02	-4.30	12.97	12.79	-18.88	-18.71
MSCI China A - Net Return	China A	-3.56	-1.44	28.28	28.33	-30.32	-26.48
MSCI India - Net Return	India	0.50	0.14	7.70	6.48	-7.30	1.39
MSCI Russia - Net Return	Russia	16.85	12.78	31.08	20.75	-0.39	17.05
MSCI Brazil - Net Return	Brazil	7.17	5.55	15.90	14.61	-0.49	16.27
MSCI EM (Emerging Markets) - Net Return	Emerging Markets	0.61	0.20	10.58	10.05	-14.57	-10.07
MSCI EM Asia - Net Return	Emerging Asia	-1.25	-1.18	9.72	9.98	-15.45	-13.12
MSCI EM Latin America - Net Return	EM Latin America	4.44	3.17	12.64	10.88	-6.57	3.78
MSCI EM ex China - Net Return	EM ex China	2.89	2.46	9.57	8.96	-12.42	-5.67
S&P GSCI Crude Oil Total Return	Crude Oil	-2.85		26.95		-15.30	
	Trade-Weighted Dollar	-0.19		-0.49		7.91	

Source: FIS Group Professional Estimates & FactSet

ket is that inflation expectations have unhooked from growth and unemployment trends (see CHART 2). Chairman Powell's dovish tilt suggests the Fed has now done the same thing with monetary policy. Consequently, given the bond markets' increasing focus on what the Fed will do with short-term interest rates, yields tell us little about U.S. growth prospects or recession risks.

Inflation expectations are in turn highly correlated with oil prices (see CHART 3). Much of the current oil-price volatility is being driven by worries over damage to aggregate global demand, growth expectations in the wake of the Sino-U.S. trade war, and by what now appears to be a too-aggressive posture by central banks attempting to begin normalizing rates last year. In 2H19, we believe that accommodative global monetary policy and fiscal stimulus will revive demand for oil, particularly in EM economies. On the supply side, this week's extension of OPEC 2.0's production cuts into 1Q20 means supply growth will remain constrained. Prices should rise, and forward curves, particularly for Brent, should steepen as refiners are forced to draw inventories to meet product demand. This is a key reason why we believe that U.S. equity investors are too optimistic on the path of interest rate cuts by the FOMC. Bond markets are pricing in 75 bps of interest rate cuts by the end of 2019 and 25 bps in 2020. We expect a much more modest 50 bps insurance interest cut in 2019, akin to what the FOMC did in the mid-1990s.

RoW PERFORMANCE LEADERSHIP HANGS ON CHINA

Our expectation that performance leadership will shift to the rest of the world in the second half of 2019, is based on our belief that China's growth slide is bottoming and that, at least in the short term, the policy uncertainty from the U.S.-Sino trade imbroglio will be diminished because both sides need an apparent "win", even if it does not substantively address their underlying strategic fissures.

That said, the volatile Caixin Manufacturing PMI dipped below 50 and both the manufacturing and service indices weakened in June (see CHART 4 on the next page). As mentioned in our 2Q 2019 Outlook, historically it has taken 6 to 12 months before the effect showed through *via* a rebound in global trade, commodity prices, and other China-related indicators.

While the authorities are once again boosting infrastructure spending by allowing local governments to issue special bonds (as exhibited by the material increase in social financing in CHART 5 on the next page), their clampdown on shadow banking also remains important. Notably, "Entrusted Loans," which typically are off-balance sheet, have declined, suggesting that despite the policy pivot towards reflation, balance sheet repair and deleveraging remains an important. The net effect of this is that non-state owned private companies remain starved for credit as well as a more nuanced reflation approach. We expect a more muted policy impetus to global trade and commodities than in 2016.

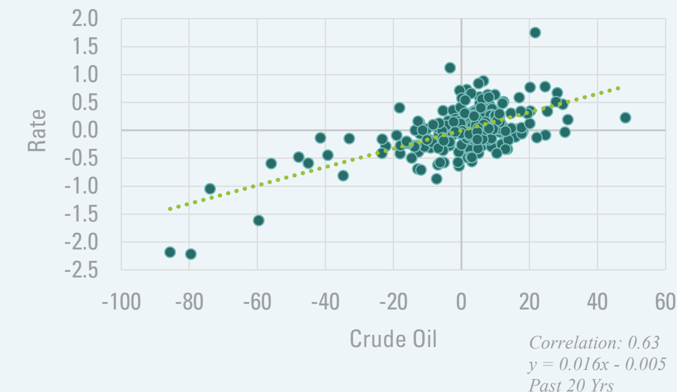
CHART 1 | Bond market more ominous
10-Year Bond minus Fed Funds Yield, BPs

Source: FIS Group Professional Estimates & FactSet

CHART 2 | Inflation expectations have unhooked from growth and unemployment trends
Interest Rate, Inflation Compensation, Break Even, 5-10 Years Forward, Coupon-Equivalent, R^2 Correlation

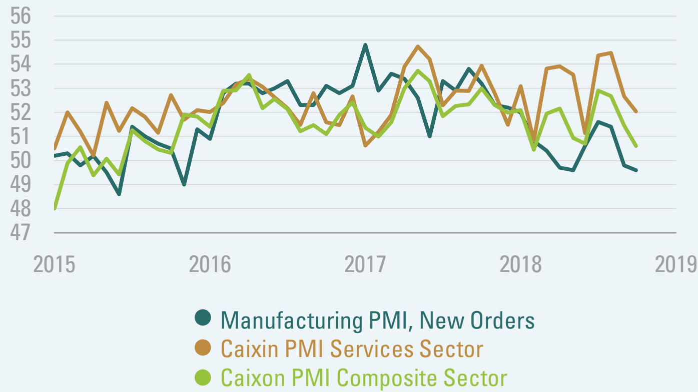
Source: FIS Group Professional Estimates & FactSet

CHART 3 | 10 year TIPS breakeven inflation & crude oil
DIFF 6M



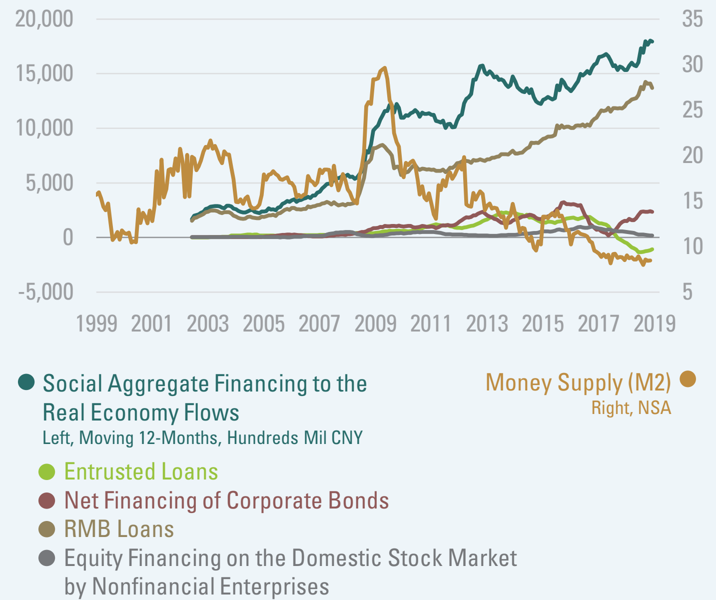
Source: FIS Group Professional Estimates & FactSet

CHART 4 | China: Volatile Caixin Manufacturing PMI dipped below 50 and both the manufacturing and service indices weakened in June
Index



Source: FIS Group Professional Estimates & FactSet

CHART 5 | China credit: acceleration with restraint



Source: FIS Group Professional Estimates & FactSet

MIXED MESSAGES ON THE EM EARNINGS FRONT

Across the emerging world, earnings and valuations are yielding mixed messages (see CHART 6 and CHART 7). Korea's forward earnings outlook appears dismal and insufficiently punished by the market, despite underperforming the rest of EM by -10% in the past twelve months. Yet in June, Korea was among the best performing markets worldwide gaining 8.8% vs 6.5% for the rest of the world). Meanwhile, China's -8% underperformance vs EM over the past year has coincided with a modest multiple contraction amid an earnings outlook that was not nearly as bearish as Korea's. Latin America's recent performance appears broadly in line with earnings expectations, thus showing signs of recent market efficiency. India shines as a lone bright spot among the major emerging markets where forward expectations are ahead of trailing performance, yet Indian equities have nonetheless lagged EM and the rest of the world YTD.

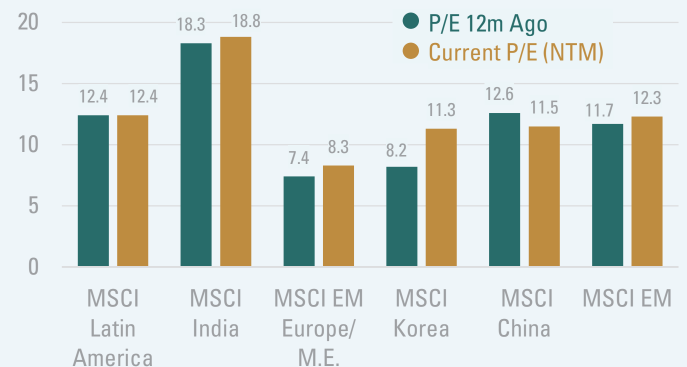
GEOPOLITICAL TAIL RISKS

Finally, despite our expectation of a continued late cycle rally which will pivot to non-US markets, geopolitical tensions remain a wild card that could abruptly disrupt this late cycle rally.

CHART 6 | EM EPS Growth
%

Source: FIS Group Professional Estimates & FactSet

CHART 7 | EM P/E Growth
%



Source: FIS Group Professional Estimates & FactSet

The chief short-term risks emanate from simmering tensions between Iran and the U.S. as well as a no-deal Brexit in the fall. The most important long-term risk remains the strategic rivalry between China and the U.S., despite yet another climb-down by the President at the G20 meeting in Japan. The good news is that actualizing the risks is not in the rational interest of any of the principal actors in all three scenarios. President Trump does not want another unpopular war in the Middle East, particularly against Iran, which would require boots on the ground. While China is a bi-partisan bogeyman that fires up the base, the risks of further escalation would stymie the all-important stock market yardstick, which the President cares deeply about. Finally, neither Iran nor China, despite bellicose nationalist rhetoric for domestic consumption, desires a full-blown armed conflict (in the case of Iran) and trade war (in the case of China). While both the EU and Boris Johnson (the leading candidate for leadership of the UK Conservative Party) are incented to publicly portray a more rigid negotiating stance, neither party benefits from a no-deal Brexit; so, the most likely course may be yet another delay.

Q3 2019 FORECAST

For Q3 2019, we are moving the dial towards cyclical sectors and markets. We maintain our neutral position to **U.S. equities**. We have reduced our overweight to the defensive Swiss market in favor of an increased weight to core European markets, which are more exposed to China reflation. Despite the expected increase in the VAT, we maintain a neutral weight to **Japan** because of a more attractive earnings profile; Japan would also benefit from Chinese reflation. Additionally, we have put on overweight to Australia, which should benefit from both monetary accommodation and China reflation.

As shown in TABLE 2 on PAGE 5, we are neutral to emerging markets. Within emerging Asia, we remain neutral to China. Despite our incrementally constructive view on Chinese economic activity, we prefer to express that through DM equity plays. We have reduced our overweight to Korea amid a bearish earnings outlook and maintain a neutral weight to India from our long-time strategic overweight as the market settles into a post-election trading range and near-term economic data could surprise to the downside. We retain an overweight to Thailand whose financial profile is less exposed to U.S. dollar liquidity and also trimmed further our long-time overweight to Russia. With respect to LatAm, we cut our overweight to Mexico and shifted to an overweight in Brazil as favorable inflation dynamics continue to lower the cost of capital in Brazil that should accrue to corporate earnings. We expect continued progress on pension reform in Brazil, though we could look to exit the trade at signs of overexuberance in the market.

Although there are precious few signs of improvement in global trade and manufacturing, we retain a more balanced allocation between **Defensive Sectors and Cyclical Consumer Discretionary** and other Late Cycle sectors. We continue our overweight to **Energy** and **Industrials**. Our perspective on oil prices was discussed previously. The industrial positions are largely thematic; made up of European Defense companies (a play on increased geopolitical uncertainty) and Chinese environmentally focused companies. Please See TABLE 3 on PAGE 6 for our sector and style positioning).

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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.

TABLE 2 | Global / Country Positioning

Region / Countries	-		N		+	
Developed Markets			●			We remain neutral for developed market equities vis a vis emerging markets, though we also expect the U.S. market is near the end of its earnings runway and will likely underperform for most of the second half of 2019 after the end of this early summer rally. Within developed markets we have shifted to a more cyclical posture, while retaining modest defensive exposure in Switzerland and certain defensive sectors.
United States			●			Neutral. In the short-term, the market could see further gains as we near a possible rate cut (or at least the expectation of one), but expect to tilt our US exposure to underweight as we move more into the second half of 2019
Core Europe			●			Neutral. Within Europe we have trimmed our Swiss overweight after healthy gains in that position for the past 6 months, and have shifted into German and southern European overweights with underweights in the more expensive Nordics. We remain exposed to our long-time theme in European defense stocks, which has continued to outperform.
Japan		●				Underweight. Earnings and economic outlook in Japan are unattractive and we expect further underperformance as the market could re-rate based on lower earnings. Within Japan we remain biased towards stocks with rising ROEs and improving governance.
U.K.			●			Neutral. With no direction on UK at the macro level, we remain neutral, but have shifted towards expressing our view via the marginally less UK exposed FTSE 100 vs the MSCI UK.
Australia				●		Tactical Overweight. Despite serious concerns from the property market, our tactical models continue to point to high confidence near-term outperformance based on a high degree of valuation dispersion among Australian stocks. This is also our preferred vehicle to capture a possible turn in Chinese economic data.
Canada			●			Neutral. No clear signals on the market, contrary to last quarter.
Emerging Markets			●			The large EM markets continue to offer mixed signals on earnings and valuations (see above) and so we continue to choose to pick our spots on a country by country basis.
Emerging Markets Asia						
China			●			Neutral. We cut our briefly lived A-share venture mid-quarter as the momentum we were trading on appeared to peter out. The position was exited with no gain (relative to MSCI China). We also sold out of our environmental basket theme at a loss. Looking ahead to Q3 we are turning constructive that we could be at a possible inflection point for Chinese economic data, but for now are preferring to express that through DM equity opportunities.
Korea			●			Neutral. Long-time market reform has taken a back seat to a deteriorating earnings outlook for now.
India			●			Neutral. Our long-term positive view on India was strengthened by the unexpectedly large win for Modi in the May elections, but at least for the next few months we expect a tempering of market excitement and a possible downside surprise in economic data.
Thailand				●		Overweight. Thailand delivered a healthy +8.7% excess return over EM in Q2 as we continued our now 12 month strategic overweight in the market. We cashed in part of these gains, but remain overweight.
Emerging Markets Europe						
Russia				●		Slight overweight. Last quarter we erroneously reported that we were closing our Russia overweight, held now for the past 2 years, but in fact we continued to overweight the market, and a good thing we did. Russia was the best performing major EM in Q2, with a smashing 16.3% excess. This was driven in large part by Gazprom's 62% surge as it announced a new dividend policy and an end to certain cash-draining capex projects. We once again trimmed our gains and are now only slightly overweight the market.
Emerging Markets Africa						
South Africa			●			Neutral. South Africa rallied in Q2, but we remain unpersuaded that this is a turn in the market, but also recognize that "SA Inc." remains deeply underowned locally and could see further sudden rallies on only a little news.
Emerging Markets Latin America						
Brazil				●		Overweight. Low inflation prints are good to maintain what for Brazil is a historically low rate environment, which should abet equity demand from Brazil's local investor base, while supporting the ongoing earnings recovery. We also take as a base case continued progress towards pension reform.
Mexico			●			The Mexican market is at a 10-year valuation low based on both P/B and P/E, while the peso is among the cheapest currencies in the world based on Real Effective Exchange Rates, but policy uncertainty surrounding President Obrador ("AMLO") remains a headwind.

TABLE 3 | Sector Positioning

Sector / Style / Capitalization	-		N		+	
Early Cyclicals Consumer Discretionary, Financials		Developed Emerging Markets				We are underweight to early cyclicals as a whole, mainly from Financials which face headwinds from flattening yield curves globally. We pared back our overweight to Japanese financials to a more neutral position but maintain our underweight financials within Europe due to continued geopolitical risk clouding the credit expansion cycle of the banking sector. We also maintained our underweight to financials in EM due to the credit focused reform agenda in China.
Late Cyclicals Energy, Industrials, Materials, Technology, Communication Services				Developed Emerging Markets		We are overweight to late cyclicals as a whole as we believe that the Fed is still below a neutral interest rate level, which has historically supported returns of these sectors globally. We have maintained tactical overweights to energy and industrials throughout Developed and Emerging markets. Energy companies have been beaten down by investors pricing in heightened bankrupcy risk across the sector, but that harsh sentiment has begun to soften as oil prices have come out of a bear market. Our industrial positions are largely thematic; made up of European Defense companies and Chinese Environmentally focused companies. We are neutral to technology in all markets, but are cognizant that companies which have relied on one blockbuster product or M&A activities bolstered by high stock prices are beginning to be repriced.
Counter Cyclicals Consumer Staples, Health Care, Utilities			Emerging Markets	Developed		We are overweight to counter cyclicals within DM but no clear position within EM The market has gone from zero rate increases for this year to one or two rate decreases . Our positioning is in the defensive sectors without clear interest rate sensitivities, staples and healthcare. We are underweight Utiliites, which is most exposed to an interest rate cut.
Large vs. Small Cap			Developed Emerging Markets			Neutral. We are neutral to US small cap stocks due to historically high valuations, despite recent pullbacks. Within Europe, small caps received a big bump during the first quarter, but based on diminished growth expectations and increasing uncertainty we take a more moderate stance on returns going forward.
Value vs. Growth			Developed Emerging Markets			Neutral. Modest overweight to value within the US, where higher Inflation expectations will likely lead to the end of the growth market sooner than it will in other developed markets.

● Developed ● Emerging Markets