The First Gold Medal Goes to Brazil!

With all the bad news coming out of Brazil investors must be perplexed by the strength of the Brazilian equity market this year. After a strong jump up last week in both equity prices and the Real, the MSCI Brazil index is up 20% for 2016.

The news last week was not good. It was reported that GDP growth clocked in at -3.8% with little hope for a rebound this year. The Zika virus keeps wreaking havoc on the local population, Olympic Game preparations are over-budget and behind schedule, and lastly Ex-President Lula De Silva was detained in a corruption scandal involving the country's largest company Petrobras.

Capital markets are unforgiving to those foolhardy enough to believe that short-term predictions can be made with any accuracy and the example of Brazil hammers home the point. Just when you think that certain investments are basket cases with no hope things turn around. A great example of this happened last week in global capital markets.

ASSET CLASS	LAST WEEK	FRI	THU	WED	TUE	MON	YTD 2016	2015
US LCAP	2.7%	0.3%	0.4%	0.4%	2.4%	-0.8%	-1.7%	1.4%
US SCAP	4.3%	0.6%	1.0%	1.1%	2.0%	-0.3%	-4.5%	-4.4%
INTL EQ	4.7%	1.1%	1.1%	1.5%	0.9%	0.0%	-4.7%	-0.4%
EM EQ	6.9%	1.4%	1.4%	2.2%	1.7%	0.0%	-0.2%	-14.6%
COMMODITIES	3.9%	2.0%	0.5%	0.5%	0.2%	0.6%	-0.2%	-24.7%
REAL ESTATE	3.7%	0.0%	0.5%	0.8%	2.8%	-0.3%	0.2%	2.5%
US BONDS	-0.2%	-0.2%	0.2%	0.0%	-0.4%	0.1%	1.7%	0.5%
INTL BONDS	0.9%	0.3%	0.8%	-0.3%	-0.2%	0.3%	4.6%	-6.0%
EM BONDS	1.4%	0.2%	0.2%	0.3%	0.3%	0.3%	3.0%	1.3%
CASH	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%

Now, I am not all that confident that Brazil is out of the woods yet and in fact our country allocation model rates Brazilian equities toward the bottom of the pack.

The point is that capital markets are always full of surprises.

When do we get the biggest surprises? Usually when the consensus view is at an extreme.

After the walloping that commodities and emerging market investments have been taking in the last few years, it is not too surprising to find investor sentiment heavily skewed against these beaten up sectors.

So what happened last week? The heat map of key asset class performance tells an interesting story. After a rough start to 2016, equity markets recovered last week. The S&P 500 was up 2.7% but still lagged higher perceived risk international equity and US small caps.

Emerging market equities clocked in with the highest performance at 6.9%. Year to date, EM equities while still in the red are significantly out-performing developed market indices. There is a long way to go, but maybe we are seeing an inflection point for EM equities.

Another asset class that re-emerged last week was commodities – up 3.9% for the week. All major sectors exhibited gains except for a small drop in the Livestock complex. Not bad for a sector where investors have been flocking away at high speed.

Without a resurgence of higher inflation it is hard to see how commodities compete effectively against equity-oriented investments but maybe after a decade of extremely poor investment performance (see our note "Beyond the Fog of Daily Capital Markets") we are in store for some unexpected mean reversion.

Again just when a lot of market participants have given up on commodities we may be seeing a turnaround. It would not be the first time that this has happened! Capital markets have sometimes cruel ways to remind us about our limited predictive capabilities.

Along with the positive surprise in Equities and Commodities came along a (related) big move in EM Currencies.

USD PER CURR	LAST WEEK	FRI	THU	WED	TUE	MON	YTD 2016	2015
YEN	0.1%	-0.2%	0.3%	-0.3%	-0.6%	0.9%	5.7%	-0.3%
EURO	0.7%	0.7%	1.0%	-0.3%	-0.1%	-0.6%	1.3%	-10.2%
SWISS FRANC	0.5%	-0.1%	0.8%	-0.2%	-0.2%	0.3%	0.8%	-0.7%
POUND	2.5%	0.4%	0.7%	1.0%	-0.1%	0.5%	-3.6%	-5.5%
CA DOLLAR	1.3%	0.1%	0.5%	0.0%	0.8%	0.0%	3.9%	-16.6%
AU DOLLAR	3.5%	0.5%	1.5%	1.5%	0.1%	-0.3%	1.8%	-11.1%
RENMINBI	0.2%	0.3%	0.1%	-0.1%	0.0%	-0.2%	-0.4%	-4.5%
BRA REAL	6.7%	2.9%	1.4%	2.0%	0.1%	0.1%	5.9%	-32.8%
RUBLE	4.7%	1.4%	0.4%	0.7%	1.4%	0.7%	1.2%	-17.8%
RUPEE	2.3%	0.3%	0.4%	0.5%	0.7%	0.4%	-1.5%	-4.6%

The Brazilian Real that had depreciated close to 33% last year had a big up move relative to the US dollar of 6.7% last week.

The Russian Ruble also had a big recovery last week after many years of depreciation versus the USD.

Just when most market observers expected further US dollar strength in 2016 we have seen a bit of a change with the Yen and Euro actually appreciating.

We have even seen the Canadian Dollar appreciate 3.9% year to date.

Currencies are clearly tied to the big picture of capital markets and all three big surprise moves last week were in a sense related. A weaker US dollar benefits commodity prices which in turn are positively correlated to the financial health of resource dependent economies such as Brazil and Russia.

Is this a fundamental turnaround in the fortunes of beaten up asset classes such as EM equities and commodities? Hard to tell and one week of good performance does not make a trend.

Our views based on our allocation models suggest some reservation about fully embracing a turnaround.

- We prefer developed equity markets to EM by a slight margin
- The valuation advantages of EM Markets are offset by poor growth and negative investor sentiment
- Within EM equities we rate some markets quite highly (Korea, Hungary, Czech Republic for example) but most of the larger cap country indices rank in the middle of the pack
- Commodities as a whole are viewed as unattractive especially industrial metal and energy sub-segments
- Without a resurgence of inflationary pressures we do not see a sustained recovery in commodity prices

So what lessons can investors learn from last week's capital market surprises? Expect the "unexpected" is a good way to think about the ever changing global capital markets.
When investors find themselves with too much company (the one way trade) it is probably a good time to question the wisdom of crowds.
An approach that recognizes the limits of our predictive abilities and gradually balances changing fundamental circumstances in relation to investor sentiment is our preferred way of operating. Relying too much on the "slam dunk" trade is fraught with peril. Expect the "unexpected" and stay tuned to large skews in investor consensus.

Sincerely,

Eric J. Weigel

Managing Partner and Founder of Global Focus Capital LLC

Feel free to contact us at Global Focus Capital LLC (mailto:eweigel@gf-cap.com or visit our website at http://gf-cap.com to find out more about our asset management strategies, consulting solutions and research subscriptions.

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