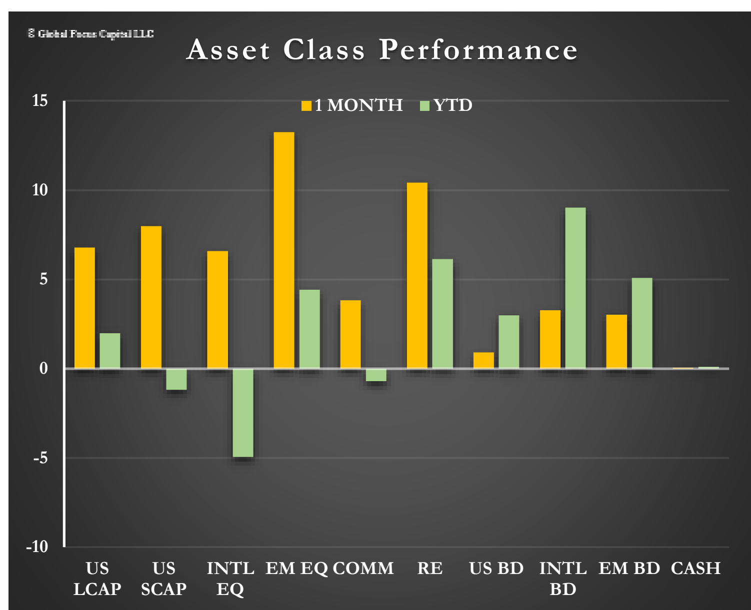
GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

More Rocky than a Bunny Market!



The first quarter of 2016 came to an end last Thursday and if you were hibernating this year you would have missed the huge peak and valleys that investors have had to already endure this year.

The start of the year felt like a Rocky Balboa fight. Risky assets were absolutely pummeled during the first 6 weeks of the year and were down for the count.

Most investors were taken by surprise by the strength of the first punch and the retail section started emptying out early. White towels were being thrown about but out of nowhere equity markets started gathering strength.

Just like a fighter on the ropes biding time equity markets started little by little chipping away. By the end of February stocks had stabilized and the first real signs of a competitive fight emerged during the first week of March. The point count had evened out and by the end of the month the count had swung around in many categories. At the end of Q1 world equity markets were essentially flat but there were surprises galore.

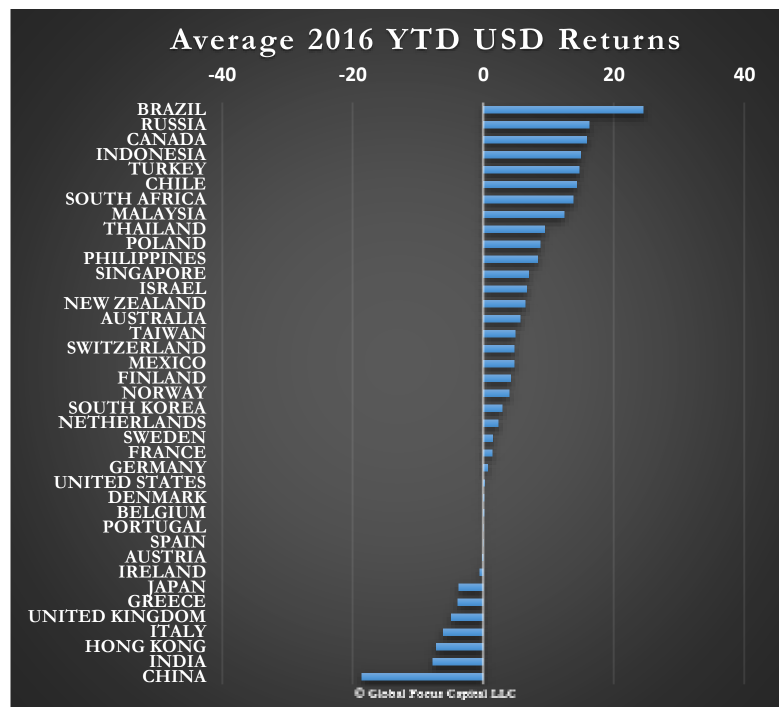
The biggest surprise by far this year has been the re-emergence of Emerging Market Equities.

The asset class had been left for dead after many years of disappointing returns, but this year the asset class is punching above its weight - already up 4.4% (MSCI EM).

EM equities have vastly out-performed developed markets especially those in Asia and Europe. A 9% gap has developed between developed and emerging international stocks (MSCI EAFE).

Let's take a closer look at what is happening within global equity markets. We gather insights from the bottom-up by examining the performance of 13,000 stocks domiciled in 48 countries. The market capitalization profile of most popular equity market indices is highly skewed toward the largest

companies thus potentially obfuscating developments that might be happening outside of the view of the mega cap stocks that increasingly dominate index performance. We therefore equally weight all stocks in our global sample. We denominate returns in US dollars.



Averaging the bottom-up individual stock returns by country yields some interesting results.

Who's under-performed?

- China, the largest equity market by weight in the MSCI EM Index (about 24%), ranks at the bottom with an average stock loss of nearly 20%. Chinese stocks are clearly not contributing to the EM rally!
- India another key EM market also ranks at the bottom with an average per stock loss of close to 8%.
- Japan, the largest weight in MSCI EAFE, also ranks close to the bottom with an average stock return of -4%. This is in spite of currency gains.
- The average UK stock, the second largest weight in EAFE, is down nearly 5%. Part of this is due to the depreciation of sterling relative to the US Dollar, but in local terms UK stocks have lost money this year.
- The average US stock in our sample shows a Q1 return of 0.2% ranking in the bottom half of our country aggregates.

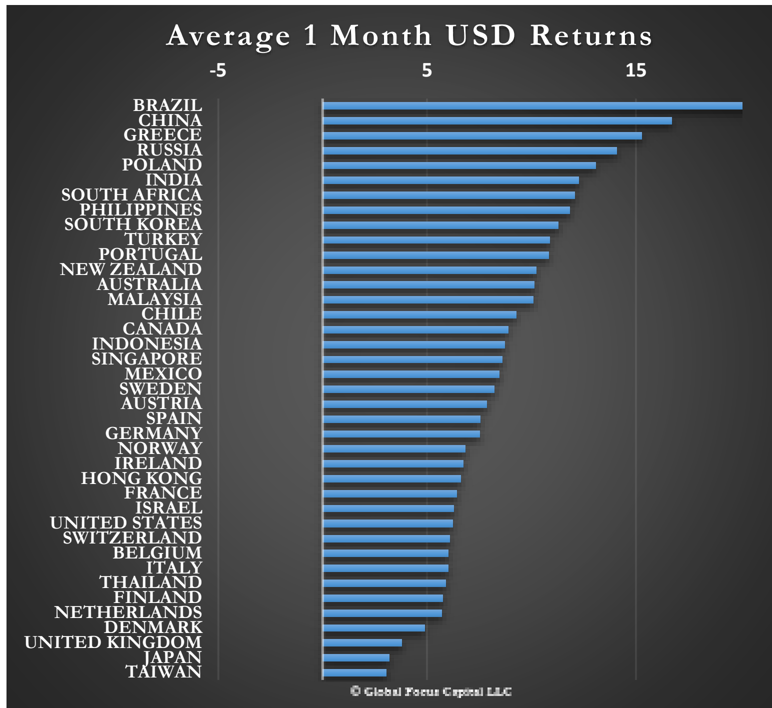
Despite the poor showing of the average Chinese stock how is it possible that EM equities as a whole are up for the year? No doubt investors are somewhat stunned by the YTD eye-popping returns to resource-oriented markets such as Brazil and Russia.

In our sample of global equities the average Brazilian stock is up over 24% while the average Russian equity is up about 16%. South Africa, another major EM market, punches in at an average stock return of close to 14%. Other emerging markets with average YTD returns exceeding 10% include Indonesia, Turkey, Chile and Malaysia.

We do not know if the resurrection of these EM markets is sustainable but at least these markets are off the mat and putting up a good fight. Clearly the pickup in commodity markets has had a major role in providing much needed relief to EM investors. The MSCI EM Index is up 4.4% for the year without any real help from its largest index constituents.

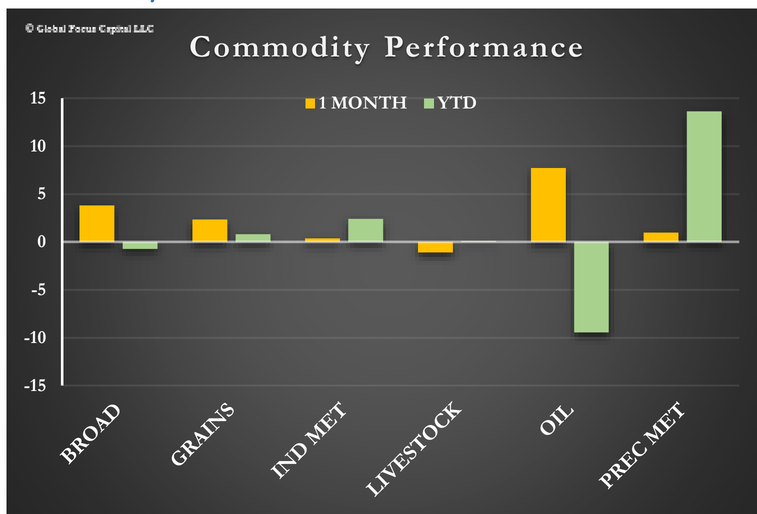
Imagine what would happen if Chinese equities started performing. In the last month Chinese equities have also picked themselves up off the mat with returns averaging close to 16.7%. This is right

behind the continued out-performance of Brazilian stocks. Indian stocks have also started recovering while Russia and South Africa have continued their strong showing.



- Even much maligned Greek stocks have started showing signs of life again.
- As a group, most EM markets out-performed last month with the MSCI EM index up over 13% in March.
- By contrast the strong March rally in US stocks seems a bit over-hyped ranking toward the bottom of our country aggregates.
- The US is by far the largest market in the world, but this year at least smaller markets are out-punching big brother.
- The gap between international Developed and Emerging markets grew as UK and Japanese stocks continued to relatively disappoint.

Given the strong start to the year for Emerging Markets is this all simply due to rising commodity markets?



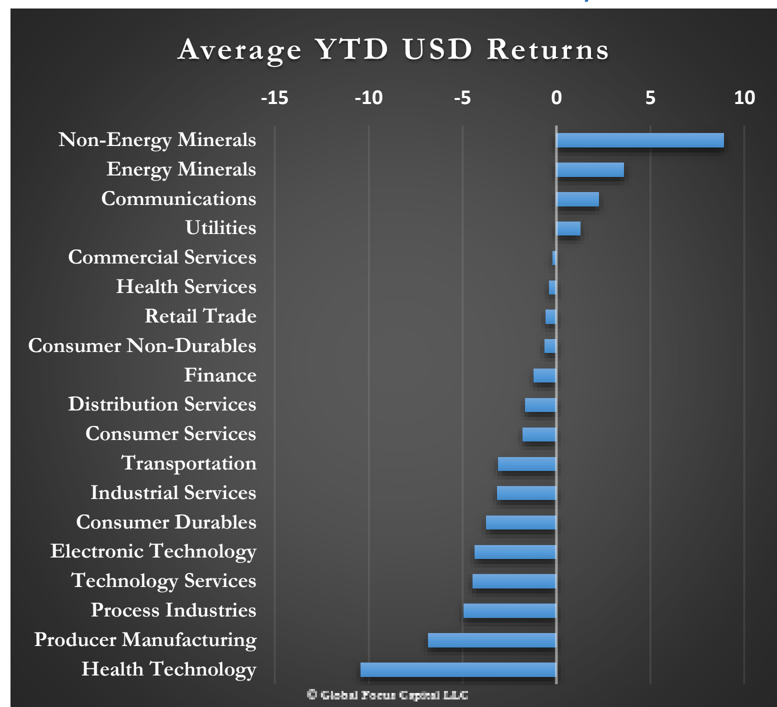
Commodity markets have no doubt recovered from the depths of despair. In fact for most of 2016 equity and especially energy markets seem to have moved in lockstep with each other.

But as the graphic on the left shows many parts of the commodity complex remain under stress. The Bloomberg Commodity index is down 0.7% for the year. The more energy-heavy S&P GSCI is down 4.6%.

Precious metals have done very well this year with gold up 15% and silver up 9%. While $20 oil is still mentioned from time to time, energy markets have had a tenuous recovery but still show losses close to 10% for the year. Smaller components of commodity indices such as grains, livestock and industrial metals are all only slightly above water this year.

Our conclusion is that there is more to the re-emergence of EM equity markets than simply a direct benefit from recovering commodity markets. Commodity markets while off the mat for now are still stumbling about for direction.

Could sectors other than those commodity-related be helping as well?



- An analysis of individual stock performance aggregated to economic sectors shows Non-Energy and Energy sectors with the best YTD performance.
- On average, Non-Energy stocks in our global sample are up over 8% while Energy stocks are up about 4%.
- Two other sectors – Communication Services and Utilities – also exhibit positive average stock YTD performance
- Interestingly, the vast majority of sectors in our equally weighted sample have average negative returns for 2016
- Some of the worst losses are among Health Care and Information Technology companies

While broad based equity indices have gyrated at times like Rocky Balboa behind the scenes we have been witnessing a strong rotation toward out of favor sectors such as Energy, Materials, Utilities and Telecom. Momentum sectors of the past few years such as Health Care and Technology have receded.

The country and sector performance numbers indicate to us that global investors have been quietly changing their stripes. Glamour sectors and equity markets with the best post-Financial Crisis performance are being re-priced. Valuation levels are being examined with a more critical eye and intermediate-term (say 1 year) momentum as a strategy has lost its punch.

Our research shows that price momentum often masquerades as latent growth and in a world where some of the highest growth stocks and sectors appear to be slowing maybe investors have become more concerned about downside protection and the ill effects from high unmet expectations.

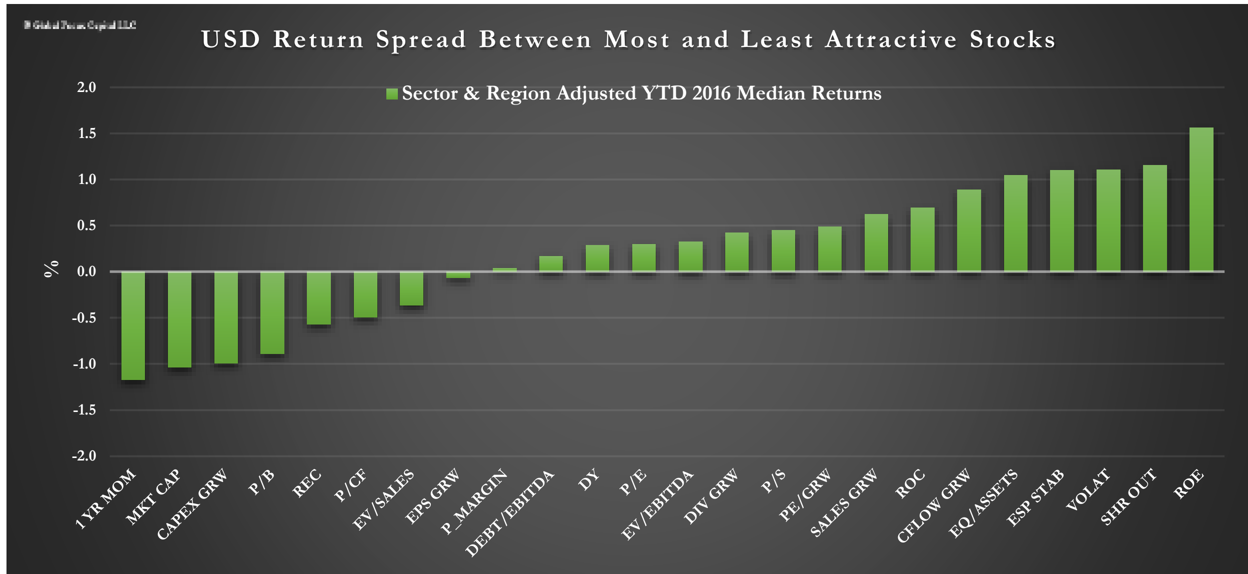
Besides country and sector effects where else do we see a change in investor preferences?

In our monthly publication The Equity Observer we examine the performance associated with commonly used stock selection factors such as valuation, growth, profitability, leverage and momentum. For a list of our equity factors please refer to the monthly publication. All factors are aligned such that one would expect positive return spreads.

Our approach for monitoring stock factor performance is a bit different from that of other research shops. First, our sample is very broad encompassing 13,000 equities in 48 markets. We also equally

weight our sample sometimes leading to non-trivial differences relative to market cap based approaches.

The most important difference, however, is due to stripping out the country and sector effects from security level returns. We adapt a procedure from Heston and Rouwenhorst (Journal of Financial Economics, 1994) to separate the top-down influences (country and sector) from the bottom-up stock level factors. In our opinion, this form of return purification allows us to gain more refined insights into factor performance.



Taking away the effects from geography and sector provides an interesting perspective on how global equity investors may be changing their preferences. Some of our key observations:

- Intermediate-term (say 1 year) momentum as a strategy has under-performed in 2016.
- Higher rated sell-side analyst recommendations have under-performed more lowly rated stocks
- Small cap stocks have also under-performed once sector and region effects are taken into account.
- Lower risk strategies are leading to positive returns. Risk in this context applies to multiple forms – return volatility, financial leverage, earning stability and superior quality/profitability
- Investors are expressing a preference for yield in the form of dividends and share buybacks
- While valuation as a concept is working not all metrics are behaving the same. For example, low P/B is working perversely while low P/E and P/S stocks are out-performing
- Investors have not totally given up on growth but they have maybe become more conservative in the type of metrics they trust. Cash flow growth has been associated with superior YTD performance while EPS growth has had a de Minimis effect.

Putting all the pieces together - Region, Sector and Stock Factors.

Just like the fighter Rocky Balboa who after absorbing multiple heavy blows to the head somehow managed to

stage dramatic comebacks global investors have witnessed this year one of the most remarkable equity market recoveries in recent history.

Among equity markets, emerging markets have re-emerged after a long period of under-performance. Thus far in 2016 EM markets have out distanced developed markets by wide a margin. The MSCI EM Index has outperformed MSCI EAFE by over 9% thus far in 2016.

Most of the EM out-performance does not seem entirely correlated to global commodity market conditions. In fact we observe that apart from Precious Metals most major commodity groups are still languishing. The energy complex is still YTD in the red despite a strong recovery from the depths of despair in mid-February when predictions for $20 oil were common.

What we find in our sample of global stock returns is a shift toward previously out-of-favor sectors such as Energy, Materials, Telecom and Utilities. Conversely, previous high growth winners such as Health Care and Information Technology have ceded ground.

Part of this shift toward more value-sensitive sectors and regions may be driven by a desire to better protect the downside and capture yield in what most strategists would agree is a low capital market return environment.

We perceive that investors are changing their stripes. Valuation levels are being more carefully examined. Investors are also showing a desire for lower risk both from a return as well as financial statement perspective. Momentum strategies have lost their punch as have sell-side analyst recommendations.

Many of the characteristics typically associated with larger capitalization companies such as lower volatility, higher yields, stock buybacks and higher levels of profitability seem to be gaining favor among global equity investors.

Global equity markets are by no means out of the woods yet and adjusting to a low return capital market environment will take time. We see global markets being more similar to Rocky Balboa – at times exhausted and bloodied but despite great hardships triumphant in the end. For the foreseeable future we see ourselves living in a risk on/off world with investor preferences increasingly tilted toward capital preservation strategies.

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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