

In the third quarter, both of the leading anglo-liberal democracies lurched towards the political abyss and even potential constitutional crises, while global growth continued to decelerate on the back of trade policy uncertainty and the end of an aberrantly long economic expansion. Against this backdrop, the USD rose, gaining +4.3% against the Euro, +3.2% against the GBP, and even +2.2% against the Swiss Franc. The JPY was broadly flat against the USD and Japanese equities were the leading performer of major economies gaining +3.1% in USD terms. Looking ahead to Q4, we see some niche tactical oppor-

tunities, which we cover in detail in our Q4 country and sector outlook (see TABLE 1 on PAGE 2 and TABLE 2 on PAGE 3), but the longer term direction of the market remains at an apparent crossroads. This has prompted many investors to ask whether we are at the precipice of further risk off events that necessitate a rethink of portfolio allocations or whether monetary or even fiscal policy could keep the long bull market going. We seek to answer these questions and more in our three-part series on derisking. You can access each section below:

BATTENING DOWN THE HATCHES

September 2019

FIS GROUP
BATTENING DOWN THE HATCHES
Part 1: Why Should Investors Derisk & What Should They Consider?

Tina Byles Williams
CIO & CEO

SUMMARY

In the U.S., we see in the late stages of the longest economic expansion in history and the bull market which began in February 2009. We evaluate the current economic environment and its implications for the U.S. economy and the market. We see a number of factors that could lead to a recession, and we see a number of factors that could lead to a soft landing. We see a number of factors that could lead to a hard landing. We see a number of factors that could lead to a double-dip recession. We see a number of factors that could lead to a prolonged recession. We see a number of factors that could lead to a severe recession. We see a number of factors that could lead to a deep recession. We see a number of factors that could lead to a total collapse. We see a number of factors that could lead to a global financial crisis. We see a number of factors that could lead to a global economic crisis. We see a number of factors that could lead to a global environmental crisis. We see a number of factors that could lead to a global health crisis. We see a number of factors that could lead to a global security crisis. We see a number of factors that could lead to a global energy crisis. We see a number of factors that could lead to a global water crisis. We see a number of factors that could lead to a global food crisis. We see a number of factors that could lead to a global population crisis. We see a number of factors that could lead to a global aging crisis. We see a number of factors that could lead to a global migration crisis. We see a number of factors that could lead to a global inequality crisis. We see a number of factors that could lead to a global justice crisis. We see a number of factors that could lead to a global peace crisis. We see a number of factors that could lead to a global stability crisis. We see a number of factors that could lead to a global prosperity crisis. We see a number of factors that could lead to a global happiness crisis. We see a number of factors that could lead to a global well-being crisis. We see a number of factors that could lead to a global quality of life crisis. We see a number of factors that could lead to a global future crisis. We see a number of factors that could lead to a global destiny crisis. We see a number of factors that could lead to a global purpose crisis. We see a number of factors that could lead to a global meaning crisis. We see a number of factors that could lead to a global value crisis. We see a number of factors that could lead to a global truth crisis. We see a number of factors that could lead to a global beauty crisis. We see a number of factors that could lead to a global goodness crisis. We see a number of factors that could lead to a global kindness crisis. We see a number of factors that could lead to a global compassion crisis. We see a number of factors that could lead to a global empathy crisis. We see a number of factors that could lead to a global love crisis. We see a number of factors that could lead to a global hope crisis. We see a number of factors that could lead to a global faith crisis. We see a number of factors that could lead to a global charity crisis. We see a number of factors that could lead to a global generosity crisis. We see a number of factors that could lead to a global giving crisis. We see a number of factors that could lead to a global kindness crisis. We see a number of factors that could lead to a global compassion crisis. We see a number of factors that could lead to a global empathy crisis. We see a number of factors that could lead to a global love crisis. We see a number of factors that could lead to a global hope crisis. We see a number of factors that could lead to a global faith crisis. We see a number of factors that could lead to a global charity crisis. We see a number of factors that could lead to a global generosity crisis. We see a number of factors that could lead to a global giving crisis.

CHART 1 Allocators are Derisking

CHART 2 Economic Outlook

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September 2019

FIS GROUP
BATTENING DOWN THE HATCHES
Part 2: How Should Investors Derisk?

Tina Byles Williams
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SUMMARY

In PART 1 of this series, we posited that the next recession could take two possible forms:

- A traditional cyclical downturn as decelerating industrial production leads the economic recovery.
- Stagnation, caused by a negative supply shock occurring in an environment of either weak or negative economic growth.

An extended famine, we believe that the most likely scenario would be a combination of the two: i.e., decelerating industrial production in the conventional scenario, with the recession precipitated by a bear market in risk assets, catalyzed by either an inflationary or a deflationary shock. In either case, we believe that the real market decline could be accelerated by the unwinding of excessive risk taking and leverage that has resulted from over a decade of ultra low interest rates.

In PART 2, we will evaluate the macro background, asset return sensitivities and market responses during economic downturns over the last 30 years. For stagnation, we will evaluate the 1970s and 1980s as well as periods of heightened changes in inflation expectations and bottom-quarter growth from 1970 to the present.

TABLE 1 Key Statistics of Downturns Over Last 30 Years

	2018 (Q1-Q2)	2008 (Q1-Q2)	2001 (Q1-Q2)	1980 (Q1-Q2)	1981 (Q1-Q2)
Inflation	Rate	5.1%	3.8%	3.0%	1.8%
Real GDP	% Change	-0.2%	-1.8%	-1.8%	-1.8%
Unemployment	Rate	5.8%	5.2%	5.2%	5.2%
Stocks	% Change	-1.8%	-3.5%	-3.5%	-3.5%
10 Year	Rate	4.8%	4.8%	4.8%	4.8%
30 Year	Rate	4.8%	4.8%	4.8%	4.8%
Stocks	% Change	-1.8%	-3.5%	-3.5%	-3.5%
10 Year	Rate	4.8%	4.8%	4.8%	4.8%
30 Year	Rate	4.8%	4.8%	4.8%	4.8%

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October 2019

FIS GROUP
BATTENING DOWN THE HATCHES
Part 3: Evaluating Rebalancing Techniques for Portfolio Derisking

Tina Byles Williams
CIO & CEO

SUMMARY

In this, the third of a three-part series, "Battening Down the Hatches," we evaluate the rebalancing techniques that most effectively derisk portfolios to reduce the probability of a recession. We see a number of factors that could lead to a recession, and we see a number of factors that could lead to a soft landing. We see a number of factors that could lead to a hard landing. We see a number of factors that could lead to a double-dip recession. We see a number of factors that could lead to a prolonged recession. We see a number of factors that could lead to a severe recession. We see a number of factors that could lead to a deep recession. We see a number of factors that could lead to a total collapse. We see a number of factors that could lead to a global financial crisis. We see a number of factors that could lead to a global economic crisis. We see a number of factors that could lead to a global environmental crisis. We see a number of factors that could lead to a global health crisis. We see a number of factors that could lead to a global security crisis. We see a number of factors that could lead to a global energy crisis. We see a number of factors that could lead to a global water crisis. We see a number of factors that could lead to a global food crisis. We see a number of factors that could lead to a global population crisis. We see a number of factors that could lead to a global aging crisis. We see a number of factors that could lead to a global migration crisis. We see a number of factors that could lead to a global inequality crisis. We see a number of factors that could lead to a global justice crisis. We see a number of factors that could lead to a global peace crisis. We see a number of factors that could lead to a global stability crisis. We see a number of factors that could lead to a global prosperity crisis. We see a number of factors that could lead to a global happiness crisis. We see a number of factors that could lead to a global well-being crisis. We see a number of factors that could lead to a global quality of life crisis. We see a number of factors that could lead to a global future crisis. We see a number of factors that could lead to a global destiny crisis. We see a number of factors that could lead to a global purpose crisis. We see a number of factors that could lead to a global meaning crisis. We see a number of factors that could lead to a global value crisis. We see a number of factors that could lead to a global truth crisis. We see a number of factors that could lead to a global beauty crisis. We see a number of factors that could lead to a global goodness crisis. We see a number of factors that could lead to a global kindness crisis. We see a number of factors that could lead to a global compassion crisis. We see a number of factors that could lead to a global empathy crisis. We see a number of factors that could lead to a global love crisis. We see a number of factors that could lead to a global hope crisis. We see a number of factors that could lead to a global faith crisis. We see a number of factors that could lead to a global charity crisis. We see a number of factors that could lead to a global generosity crisis. We see a number of factors that could lead to a global giving crisis.

CHART 1 Asset Allocation Weights

CHART 2 Economic Outlook

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Part 1: Why Should Investors Derisk & What Should They Consider?

Part 2: How Should Investors Derisk?

Part 3: Evaluating Rebalancing Techniques for Portfolio Derisking

TABLE 1 | Global / Country Positioning

Region / Countries	-	N	+	
Developed Markets		●		We continue to remain neutral to developed market equities vis a vis emerging markets, lacking clearer directions in the near-term for major markets. Within developed markets we continue to focus on long-term strategic themes favoring the defense sector and healthcare while expressing short-term tactical views in Australia and with gold miners while retaining modest defensive exposure in Switzerland.
United States		●		Neutral. Overvaluations in the U.S. are tempered by short-term imbalances in dollar liquidity that are bullish USD assets. Further USD liquidity and the specter of slowing growth are bearish U.S. risk assets in the medium-term.
Core Europe		●		Neutral. Within Europe we remain overweight in Swiss stocks, albeit at a lower conviction than earlier in 2019. We flipped our Spanish overweight to underweight amid diminished market dispersion and cut our Italian overweight initiated last quarter.
Japan	●			Underweight. Our tactical models pointed to overweight Japan in Q3 and were right, but we ignored those in favor of higher conviction calls in Australia which modestly disappointed. But we continue to believe the near-term outlook in Japan appears weak and are not inclined to believe the effects of the impending sales tax hike are quite fully priced in.
U.K.		●		Neutral. With no direction on UK at the macro level, we remain neutral and hopeful that policy missteps from London do not cause contagion in financial markets.
Australia			●	Tactical Overweight. Our tactical models continue to point to high confidence near-term outperformance based on a high degree of valuation dispersion among Australian stocks and we will stay in this trade for now. We have shifted part of this Australian exposure into gold mining mid and large cap stocks as a hedge on global market tail risk.
Canada		●		Neutral. Our tactical models cite low quality at reasonable valuations so we see no clear view in Q4. We have shifted part of this exposure into gold mining mid and large caps as a hedge on global market tail risk.
Emerging Markets		●		We remain neutral to emerging markets because of the countervailing trend of weak exports and a sideways U.S. dollar versus some early signs of recovering global LEIs and economic stabilization in China.
Emerging Markets Asia				
China		●		Neutral. China is clearly implementing gradual financial market reforms that should yield positive results in the medium to long-term, but the current environment remains one of decelerating growth and uncertainty.
Korea		●		Neutral. Long-time market reform has taken a back seat to a deteriorating earnings outlook for now. We are mindful of historically depressed valuations and looking for a new entry point, but do not see it yet.
India	●			Underweight. Our long-term positive view on India was strengthened by the unexpectedly large win for Modi in the May elections, but we expect this to take a few more months, at least, to reignite investor appetite for one of the more expensive emerging markets.
Thailand			●	Overweight. Thailand remains buoyed by inflows of foreign investment, a stable domestic capital base, and is a defensive safe haven amid uncertainty across emerging markets.
Emerging Markets Europe				
Russia			●	Overweight. Russia continues to outperform based on defensively cheap valuations, radically high dividends, and steady improvements in corporate governance (albeit from a low base).
Emerging Markets Africa				
South Africa		●		Neutral. While we have low expectations for South Africa, we also are cognizant of the coiled spring in local positioning within the market as "SA Inc." remains deeply underowned.
Emerging Markets Latin America				
Brazil			●	Overweight. Low inflation, positive economic reforms, and signals from our tactical model citing positive momentum and attractive valuations keep us overweight Brazilian equities.
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. Our tactical models also cite poor quality and low momentum.

TABLE 2 | Sector Positioning

Sector / Style / Capitalization	-		N		+	
Early Cyclical Consumer Discretionary, Financials						We neutralized our Q2 underweight to DM financials as our tactical models' leading indicator turned positive (though yield curve and momentum signals remain negative), but we remain underweight consumer discretionary within DM to fund higher conviction calls elsewhere. Within EM, our country calls have led us to a broadly neutral position in both sectors.
Late Cyclical Energy, Industrials, Materials, Technology, Communication Services						We have trimmed our energy overweight back to neutral as our tactical models are flashing negative across nearly all relevant factors, conflicting with our macro view that geopolitical and growth surprises both skew to the upside. We also remain underweight IT and communications to fund thematic overweights within industrials and materials. In industrials we remain in our long-held (and highly accretive) theme of European defense stocks while in materials we have taken a position in international (mostly Canadian and Australian) gold miners as a hedge on market tail risk and also to exploit attractive valuations and sentiment.
Counter Cyclical Consumer Staples, Health Care, Utilities						We remain tactically positioned in DM consumer staples, partially as a by-product of our Swiss overweight. We remain overweight our long-term strategic theme in healthcare stocks and neutral to utilities.
Large vs. Small Cap						We are underwhelmed by high valuations in U.S. small cap stocks, but large cap stocks are not so much more attractive and with signs of wobbles in some of the U.S. tech giants we remain neutral. In Europe and Japan, we are no longer overweight small caps, having recently ended our long-term strategic overweight. In EM, we believe a trade slowdown and rising protectionism could hit large cap EM stocks worse than small caps, but are simultaneously cognizant that a rebound in EM risk assets will likely accrue to the more liquid segment of the market first.
Value vs. Growth						The long running outperformance of growth over value will end at some point, perhaps even soon, but we are not quite so sanguine yet to express this as a factor overweight.

● Developed ● Emerging Markets

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