Global Consumer Sentiment Index May 2016

Surge in Global Political Uncertainty Distracts From Dominant Drivers of Global Economy

May 16th, 2016

Executive Summary

Over the past few months the focus among investors has shifted from a stabilizing China, weakening USD and stabilizing commodity prices to the rising degree of political uncertainty across the globe.

At the core of the recent surge in political uncertainty is turmoil over the recent rise of Trump in US polls, the potential for a Brexit and ongoing turmoil surrounding debt negotiations in Greece.

The recent surge in political uncertainty has shocked the global economy as it has worked to delay investment and spending decisions and caused a surge in risk aversion. Reflecting the effects of this political uncertainty our Global Consumer Sentiment Index (GCSI) has dropped to a level of .25 since peaking at a level of .5 in December 2015.

Although political uncertainty is currently at the front of investors minds we view the recent surge in political uncertainty as a side show, distracting investors from the larger dynamics at play.

These larger dynamics include the ongoing trend of de-polarization currently being observed across the health of the global economy and the continuation of the global process of runaway exuberance.

While the recent surge in political uncertainty has shocked the global economy it has not derailed the global process of runaway exuberance. As indicated by the GCSI, large pockets of 'exuberance' in the global economy remain in place. As policies across advanced economies remain overly accommodative these pockets of exuberance can be expected to expand.

As the global process of runaway exuberance remains intact we continue to observe developments coinciding with a 'good de-polarization' in the health of the global economy. China's economy continues to show signs of stabilizing, US dollar remains in a downward trend as expectations for policy divergence continue to dissipate and commodity prices continue to stabilize (on Monday oil prices reached 6 month highs).

As we continue to observe a good de-polarization play out we recommend taking advantage of the recent correction in global equity markets to further increase exposure to emerging markets most exposed to our 'key risk factors' (Russia, Brazil, Chile, Malaysia, Peru and Poland).

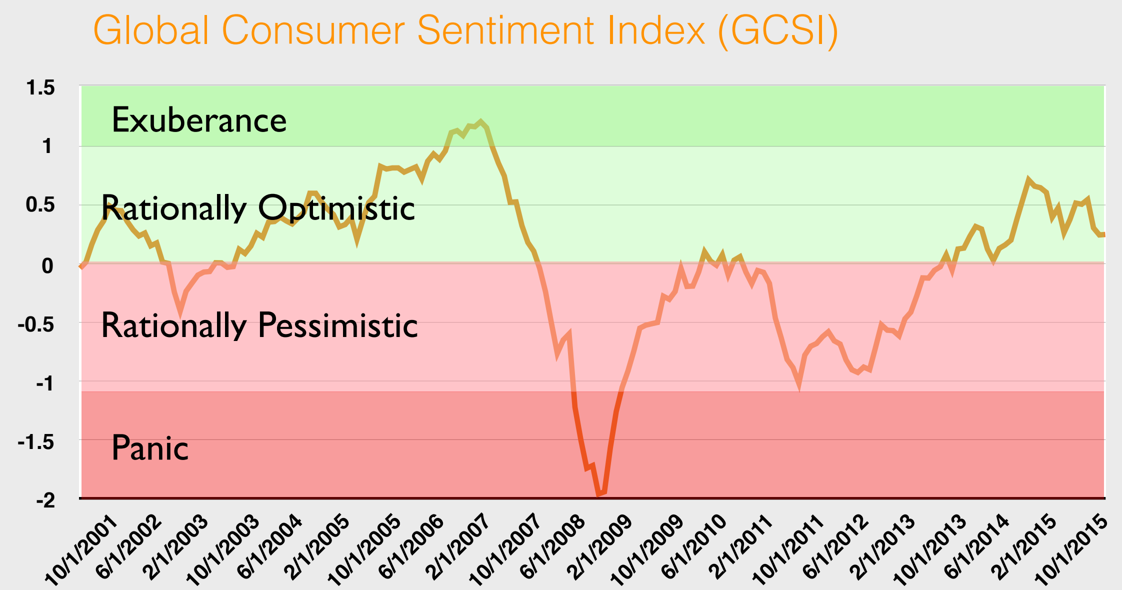
The current degree of political uncertainty displayed across the global economy is unsustainable, going forward the political landscape can be expected to become increasingly clear.

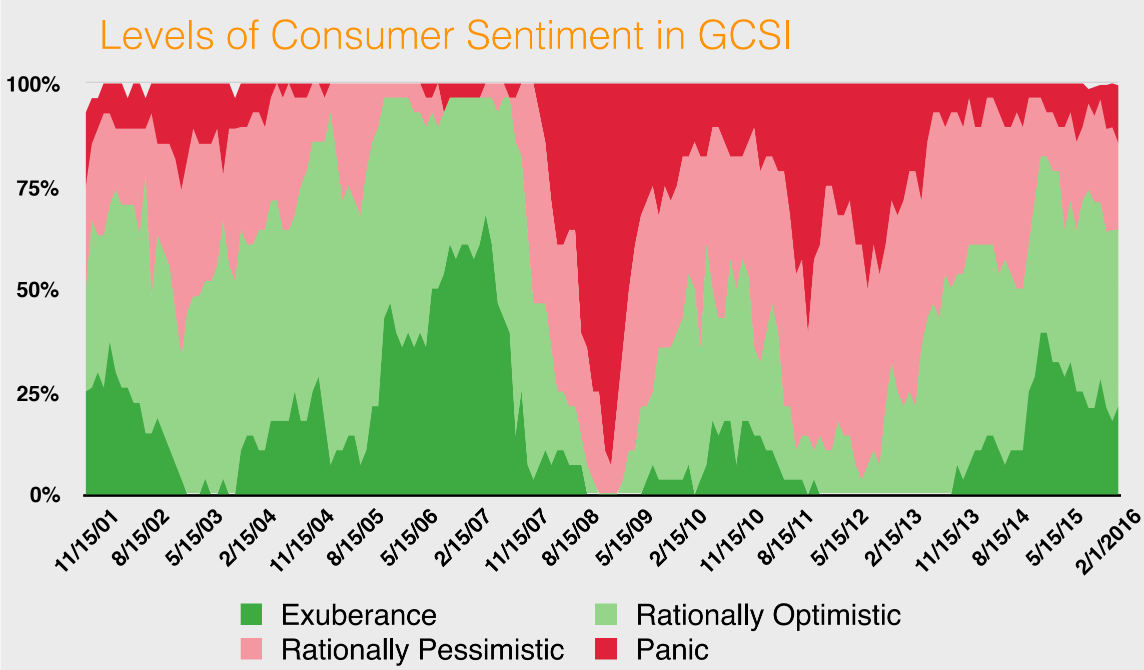
As political uncertainty across the globe begins to settle down the focus among investors can be expected to shift to further and ongoing improvement across our set of key risk factors. As a good de-polarization continues to play out global equity markets can be expected to reach new highs through late 2016/early 2017.

Despite Surge in Political Uncertainty Across the Globe GCSI Remains Stable in April

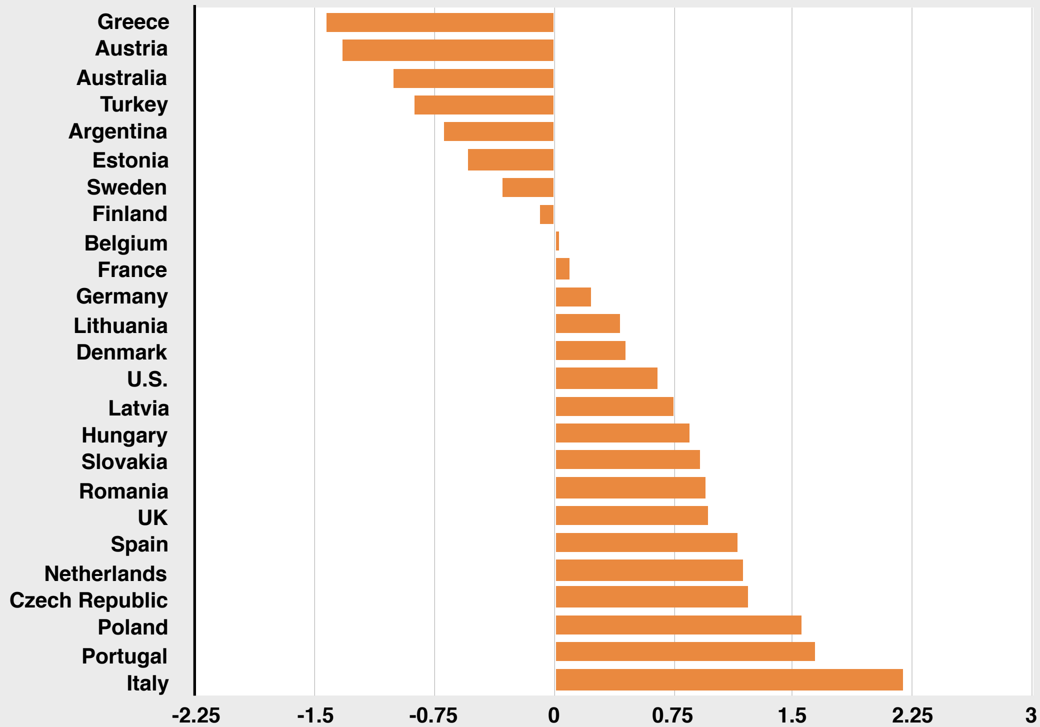
Despite the recent surge in political uncertainty across the globe the RRG Global Consumer Sentiment Index (GCSI) remained at a level of .24 in April, unchanged from March.

Since peaking in December 2015 at a level of .5 the GCSI has deteriorated slightly but remains above a level of 0.

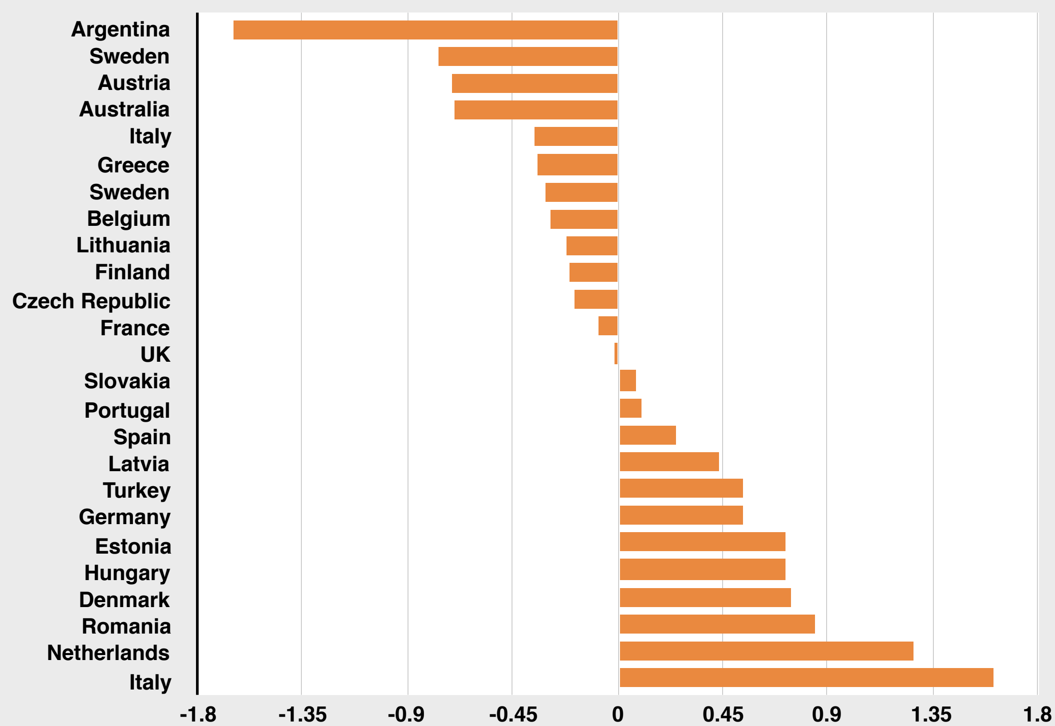




Level of Standardized Consumer Sentiment (April 2016)



Standardized Change in Consumer Sentiment Since March 2016



High Degree of Political Uncertainty Does Not Change Our Outlook

The global economy is suffering from extremely high levels of political uncertainty. Key drivers behind this uncertainty include the recent rise of Trump in the polls, a pending Brexit and ongoing debt negotiations in Greece.

While a surge in political uncertainty is working to depress the GCSI and has acted as a key driver behind the recent correction in global equity markets it has not changed current dynamics at work in the global economy or our outlook or recommendations related to asset allocation. We continue to recommend investors maintain exposure to risk while overweighting emerging markets most exposed to our set of 'key risk factors'.

To understand why the recent surge in political uncertainty has not changed our outlook we must first review the two dominant factors currency driving the GCSI:

Factor 1: Global Process of Runaway Exuberance
In January 2015 what we define as the 'global process of runaway exuberance' was triggered by overly accommodative monetary policies across advanced economies.

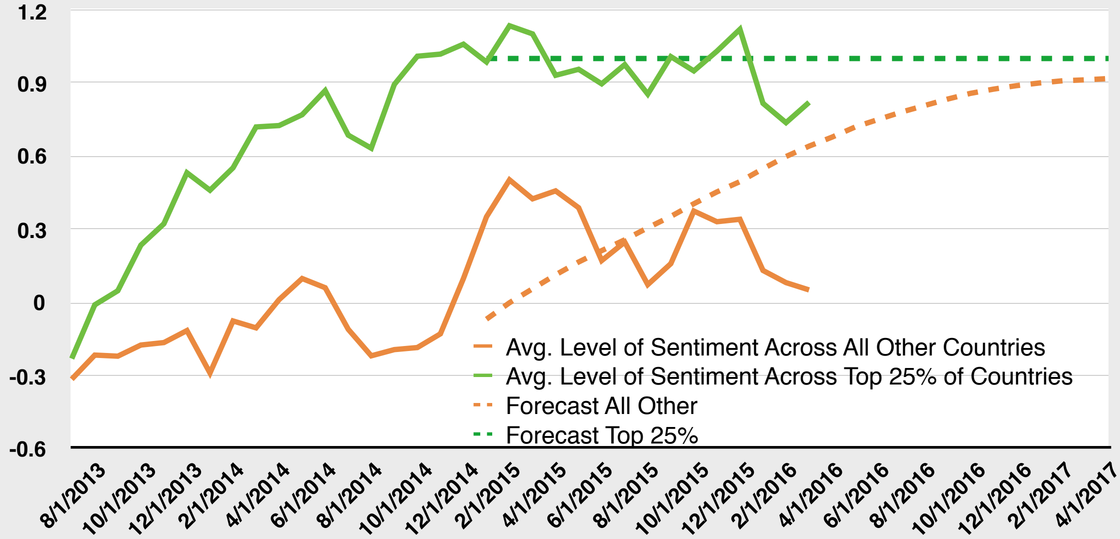
- ➡ Monetary policies across a number of advanced economies become overly stimulative. Generally this occurs as policy makers across the globe become fixated on some key risk.
- ➡ Consumer sentiment across a significant group of countries (not necessarily the ones implementing accommodative policies) rise to levels associated with exuberant consumers due to the spillover effects of easy monetary policies.
- ➡ This creates a reinforcing cycle that leads to "runaway exuberance" - demand and investment from countries with exuberant consumers increases strongly leading to increased demand for goods and increased investment in countries where consumers are not yet in a state of exuberance.
- ➡ Increased demand for goods and increased investment in countries where consumers are not yet in a state of exuberance results in rising levels of consumer sentiment in these countries. This process continues until the global economy is saturated with exuberance and large financial and economic imbalances have built up.

In determining if the process of runaway exuberance has been triggered we rely on 2 main criteria:

- ➡ Monetary policies in at least 1 advanced economy must be overly stimulative as indicated by the RRG Modified Tayler Rule
- ➡ An initial 25% of countries must display exuberant levels of consumer sentiment.
- ➡ Once these 2 criteria have been met the process of runaway exuberance is deemed to be underway.

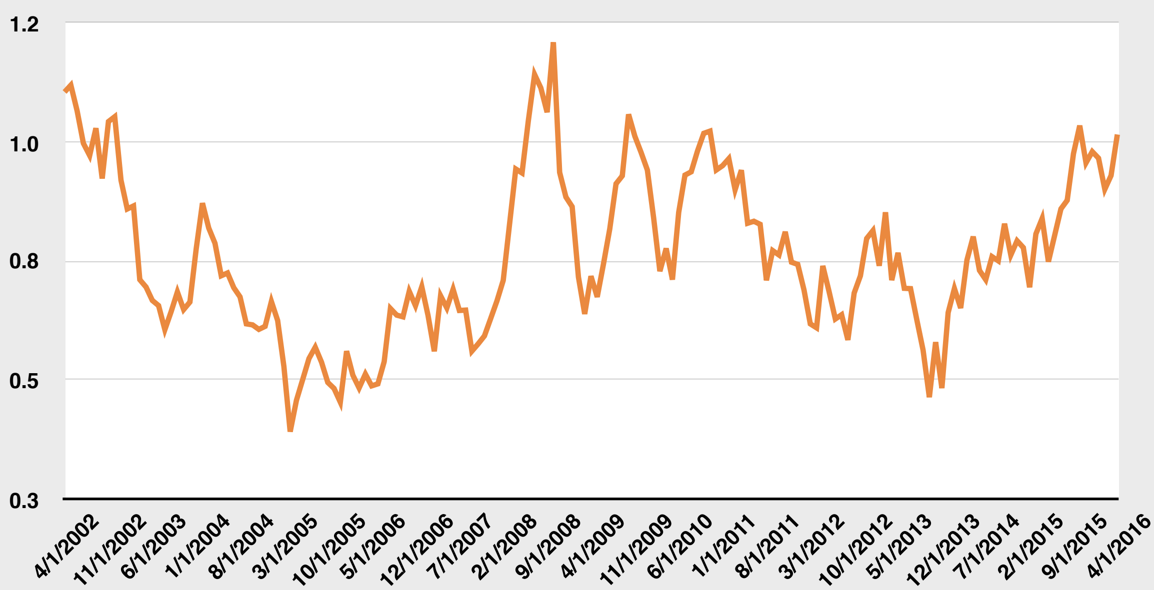
Since January 2015 monetary policies across advanced economies have remained overly accommodative enabling the 'global process of runaway exuberance' to continue. If this process is not derailed the GCSI will be driven to elevated levels near 1 by late 2016/early 2017.

Process of Runaway Exuberance



Factor 2: Extreme Degree of Polarization in Health of Global Economy
In late 2015 the health of the global economy became extremely polarized (the discrepancy between the health of the worlds weakest economies and strongest economies became very stretched). This high degree of polarization is displayed by the elevated standard deviation observed across standardized levels of consumer sentiment included in the GCSI.

Standard Deviation Across Levels of Consumer Sentiment of Countries Included in the GCSI



This high degree of polarization in the GCSI stems from two major developments:

➡ **Prolonged period of overly accommodative policies across advanced economies:**

As previously noted, due to spillover effects of overly accommodative policies the process of runaway exuberance was triggered in early 2015. This was indicated as the percentage of countries in the GCSI displaying standardized levels of consumer sentiment above 1 (indicating consumers are in a state of exuberance) surged from just 11% in December 2015 to 25% in January 2015.

Since January the percentage of countries in the GCSI in a state of exuberance has fluctuated around 25%.

➡ **String of Negative Developments**

While significant pockets of exuberance developed across the global economy in early 2015 a string of negative developments (our 'key risk factors' - slowing China, surge in US dollar, weakening commodity prices, political turmoil, negative spillovers of the Russia/Ukraine conflict and the panic these developments caused in the most effected economies) worked to greatly destabilize a number of emerging markets.

Resulting from these opposing forces the health of the global economy became extremely polarized in late 2015.

This elevated degree of polarization was unsustainable, one of two scenario's was set to play out:

Scenario 1 (Good De-polarization): Something gives, triggering an easing across the 'key risk factors' enabling economies hardest hit by the 'key risk factors' to stabilize. Process of runaway exuberance continues, GCSI rises to levels near 1. Global economy overheats as process of runaway exuberance progresses into late stages.

Scenario 2 (Bad De-polarization): Deterioration continues across 'key risk factors' triggering a crisis' across economies most exposed to key risks. Contagion derails global process of runaway exuberance, GCSI plunges to depressed levels. Global economy falls into recession.

An extreme degree of polarization can be expected to be met with an extreme de-polarization with the global economy either overheating or falling into recession.

Which scenario plays out holds the key to the outlook for the global economy and global equity markets.

In a play out of scenario 1 global equity markets can be expected to rally. In the initial stages of de-polarization the rally will be driven by easing concerns over the stability of the weakest parts of the global economy (this has already started to occur). As the global economy fully depolarizes the global process of runaway exuberance can be expected to continue, awakening 'animal spirits' among investors, further driving global equity markets higher.

In a play out of scenario 2 global equity markets can be expected to plunge due to contagion stemming from crisis' across the group of fragile EMs.

It is important to note that in either scenario EMs most exposed to the full set of 'key risk factors' can be expected to outperform EMs least exposed to the full set of key risks.

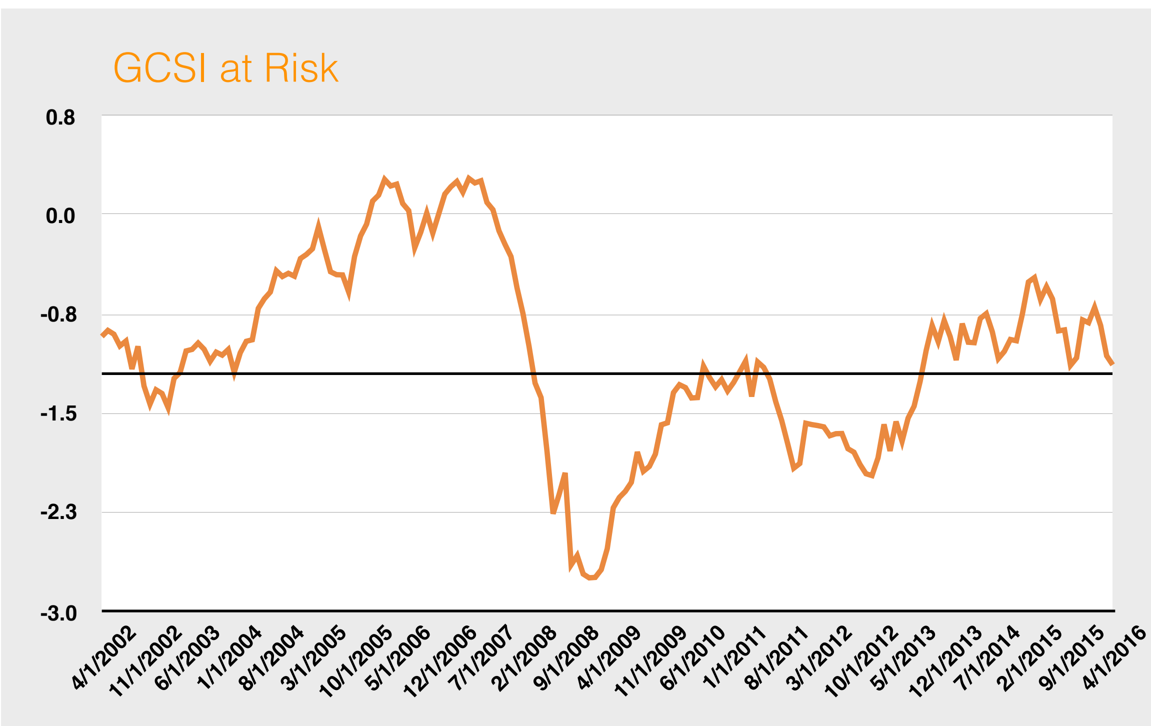
In a play out of scenario 1 EMs most exposed to the 'key risk factors' have much more upside potential given a sudden and unexpected improvement across the key risk factors.

In a play out of scenario 2 EMs most exposed to the key risk factors have much less downside compared to EMs least exposed to the key risk factors. While a potential crisis has largely been priced into EMs most exposed to the set of key risk factors it has not been fully priced into EMs least exposed to the set of key risk factors.

Gauging the Potential For a Bad-Depolarization

Gauging the ability of the global economy to withstand an economic shock (which in this case would most likely come as a further deterioration across the set of key risk factors) is key to determining which scenario is most likely to play out.

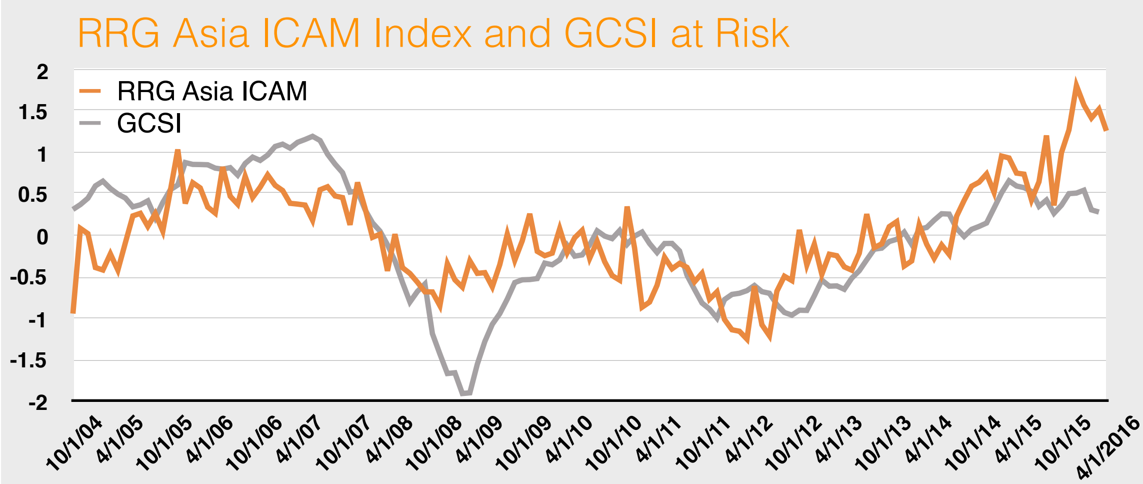
Levels of consumer sentiment across the most depressed countries in the GCSI can be used to gauge the stability of the most fragile parts of the global economy. In the below chart GCSI at Risk is displayed. GCSI at Risk is simply the average level of consumer sentiment across the bottom 20% of countries in the GCSI in terms of consumer sentiment.

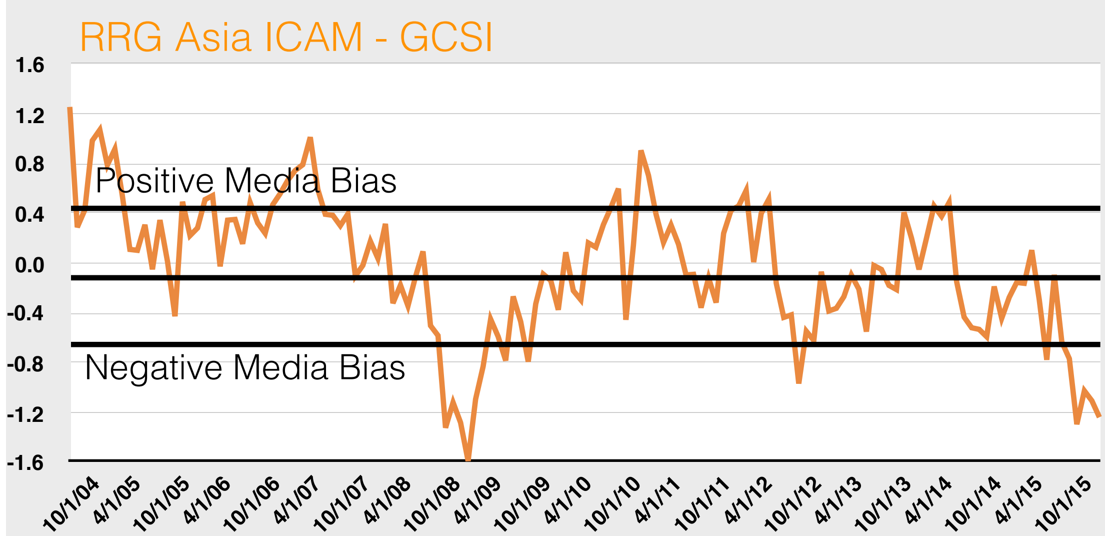


As detailed last November, see **here**, levels near -1.2 in the GCSI at Risk provide an indication that the global economy has become highly vulnerable to a potential shock. That is, a shock is likely to trigger crisis' across the weakest parts of the global economy. In April GCSI at Risk dropped to a level of -1.13, indicating that it is unlikely fragile EMs would be able to withstand further deterioration across the set of key risk factors.

As highlighted **here,** we believe fragile EMs are in a much better position to withstand a shock than the GCSI at Risk currently indicates.

Our view is based on the RRG Asia Internet Consumer Activity Monitor (ICAM) which indicates that a global negative media bias set in during late 2015 and remains present. Survey based consumer sentiment indexes (which the GCSI at Risk) is derived from are very sensitive to media bias. In line with this the current negative media bias is working to substantially depress survey based consumer sentiment indexes, indicating that economic conditions across the most fragile parts of the global economy are much more stable than GCSI at Risk would imply.





Surge in Global Political Uncertainty Tests Stability of Fragile Economies

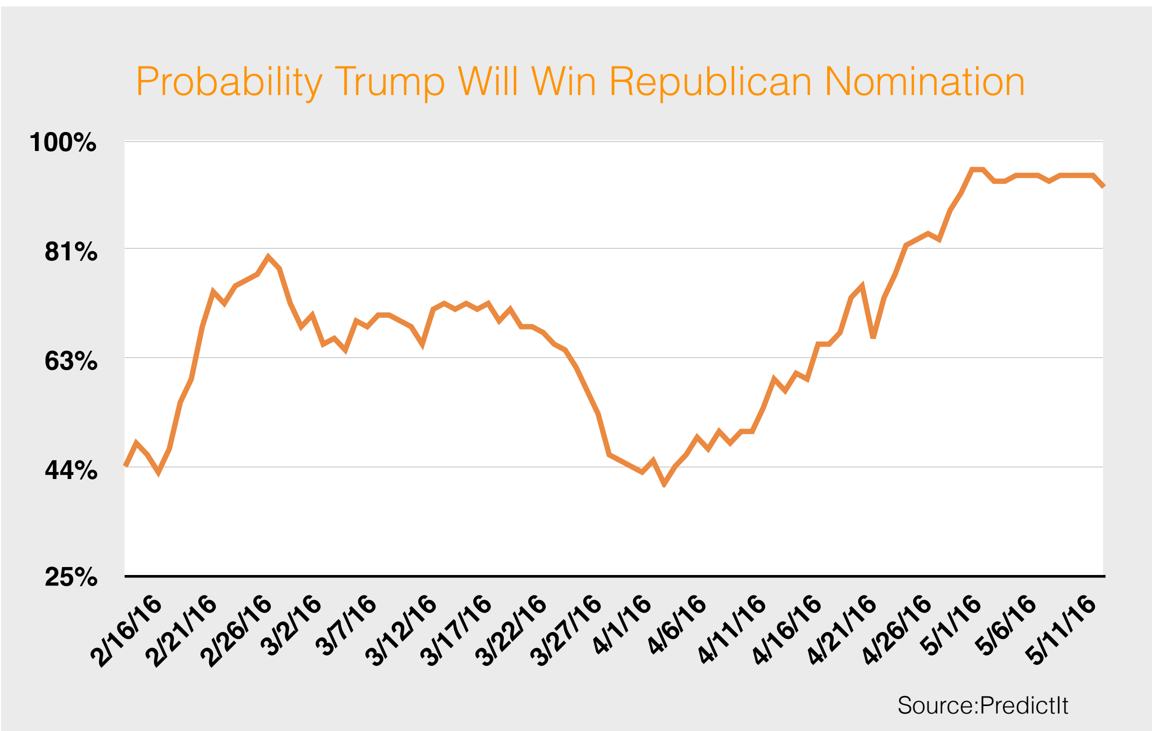
The recent surge in political uncertainty across the globe has caused a spike in risk aversion and caused firms across the world to put a pause on hiring and investment decision. This has caused global equity markets to undergo a slight correction, (since peaking on April 19th the MSCI Emerging Markets Index has dropped by 8%).

We believe it is fair to say that the recent surge in political uncertainty has 'shocked' the global economy and financial markets to a certain degree. This has tested the stability of the weakest parts of the global economy, putting our theory (that the most fragile parts of the global economy are more stable than the GCSI at Risk would imply) to the test.

Highlighting Political Uncertainty Across the Globe
At the core of the recent surge in political uncertainty is turmoil over the coming presidential election in the US, the potential for the UK to exit the EU and ongoing turmoil surrounding debt negotiations in Greece

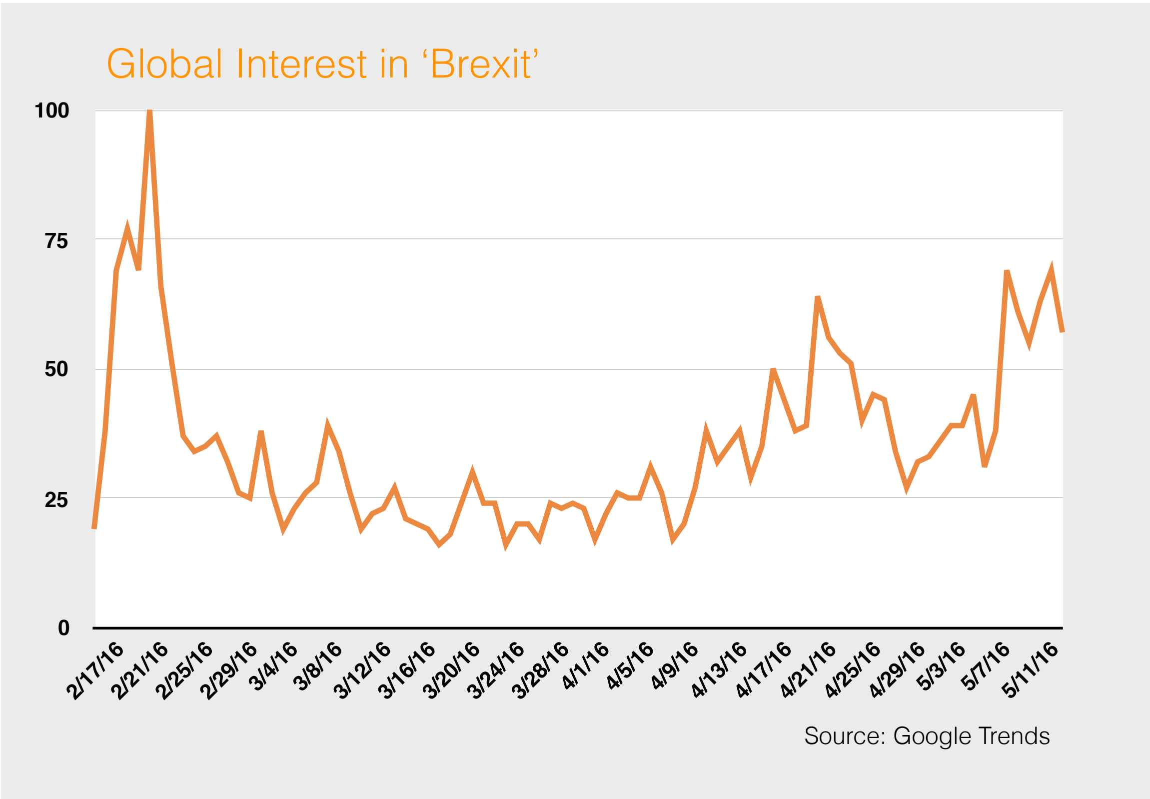
Rise of Trump and Uncertainty
Since early April the probability that Trump will win the Republican nomination has increased substantially. According to PredictIt (an online predictions market where users place money on who they think will win the election) this probability has increased from just 40% in early April to just over 90% as of May 12th. Driving the increase in a potential Trump nomination was both Ted Cruz's and John Kasich's departure from the race in early May.

As the potential for a Trump presidency has substantially increased concerns have become very elevated over the potential for a trade war. Trump has stated he would implement steep tariffs on imports from China and Mexico.



Concerns Over Brexit Rise, Compounding Political Uncertainty Across the Globe
Compounding the global political uncertainty caused by the rise of Trump the debate over a Brexit also flared up in late April as US President Obama visited London to voice his disapproval of a Brexit. A vote on continued EU membership that is set to take place on June 23rd. Currently polls show that British voters are evenly split over whether to stay in the EU or exit.

The recent surge in concerns over a 'Brexit' is highlighted in the below chart from Google Trends, displaying the relative popularity of the search term 'Brexit' across the globe. Since early April global concerns over a 'Brexit' have surged.



The IMF has warned that a British vote to leave the EU could have significant and negative effects on the UK economy as it could result in a protracted period of uncertainty, cause a surge in financial market volatility, lead to higher borrowing costs for businesses and households and result in a drop in foreign investment.

On May 12th the Bank of England highlighted its view and stated that a Brexit could result in households delaying spending, cause business to delay investment, and drive the the sharp falls in Britain's Currency which could fuel a surge in inflation.

Due to concerns over a Brexit, risk appetite and investment plans in the UK have dropped sharply. In the 1Q16 investment in central London office buildings dropped by 52% YoY. According to a survey conducted by Deloitte in the 1Q16 international political factors were ranked as the top concern fro CFO's in Germany, Portugal, Turkey and the UK.

Concerns over a Brexit have pulled consumers in the UK out of a state of exuberance. In February standardized levels of consumer sentiment in the UK dropped below the threshold level of 1.

Latest Bailout Negotiations in Greece
Turmoil surrounding Greece's debt negations has recently come close to a climax. In early May turmoil surrounding Greece's debt negations surged as riots over austerity measures erupted following the approval of a controversial set of reforms that will cut pensions and increase taxes. The measures are expected to cover a majority of the $6.15 billion in austerity measures that a being requested by Greece's creditors.

Since peaking at a standardized level of -.62 in October 2015 Consumer Sentiment in Greece has steadily deteriorated and is currently at a very depressed level of -1.4. Recall, consumer sentiment provides a reflection of the underlying health of an economy. At a current level of -1.4 consumer sentiment in Greece is currently at the most depressed levels seen in the GCSI, indicating that Greece's economy is among the most fragile in the world. Recall, when Consumer Sentiment falls below standardized levels of -1 it provides an indication that both consumer and investors have entered into a state of panic.

Recent deterioration in Greece's economy stems from panic over the uncertain economic outlook for Greece caused by the ongoing debt negotiations with EU creditors.

Panic in Greece has worked to decimate both the confidence of consumers and investors in Greece's economy. This has worked to hold back investment and consumer spending and is at the source of the recent deterioration in Greece's economy. In February Greece's retail sales dropped by 7.3% YoY, marking the worst drop seen in 7 months.

While the future outcome of the debt negotiations remains highly uncertain, they have triggered a panic among consumers and investors in Greece which has caused severe instability in Greece's economy and driven a rise in risk aversion across the globe.

Further compounding political uncertainty across the globe is:

➡ Ongoing political deadlock in Spain

➡ Unexpected resignation of Austrian Chancellor Werner Faymann on May 9th

➡ Elections in Japan set to take place in July

➡ A once in a decade replacement of Saudi Arabia's oil minister

➡ Ongoing uncertainty over Europe's migrant crisis

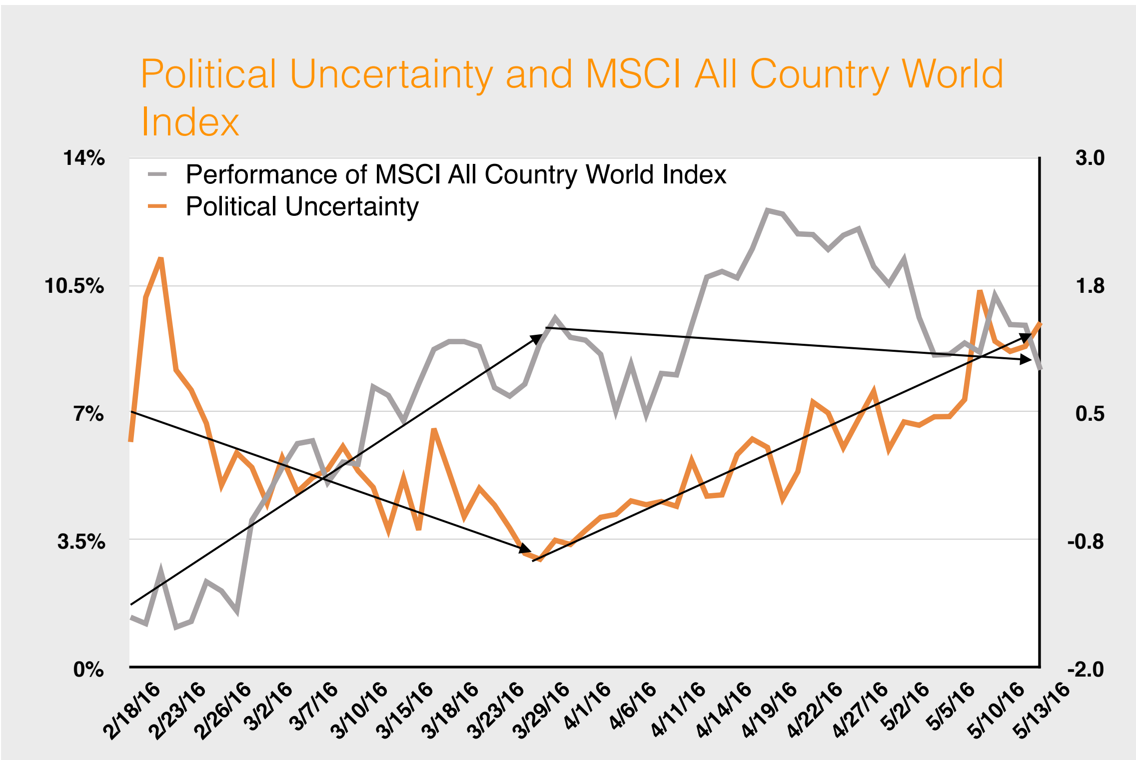
➡ Ongoing impeachment process in Brazil

➡ Unexpected resignation of Turkey's prime minister Ahmet Davutoglu on May 5th

In the below chart we have created a 'Political Uncertainty Index'. This index is driven by the 3 factors currently dominating political uncertainty across the globe (Trump, Brexit and Grexit) and provides an indication as to whether concerns related to these 3 areas are increasing or decreasing. The index is calculated using data from the past 90 days and is based on the probability that Trump will win the Republican nomination as estimated by Predictit and Google Trends data indicating global interest in both Brexit and Grexit.

Since late March the Political Uncertainty Index has trended steadily higher and global equity markets have began to trend sideways.

Recall, the early 2016 rally was driven by an improvement across the 'key risk factors'. Since late March investors focus has shifted away from the ongoing improvement seen across the key risk factors to rising political uncertainty. As this has occurred global equity markets have began to stagnate.



Fragile EMs Withstand Shock From Global Political Uncertainty

If economic conditions across fragile EMs were in fact as unstable as the GCSI at Risk indicates we would expect a crisis to occur (resulting in a bad de-polarization) given the recent 'shock' stemming from the surge in political turmoil across the globe.

Confirming the fact that economic conditions across fragile EMs are much more stable than the GCSI at Risk would imply we have not observed any crisis'.

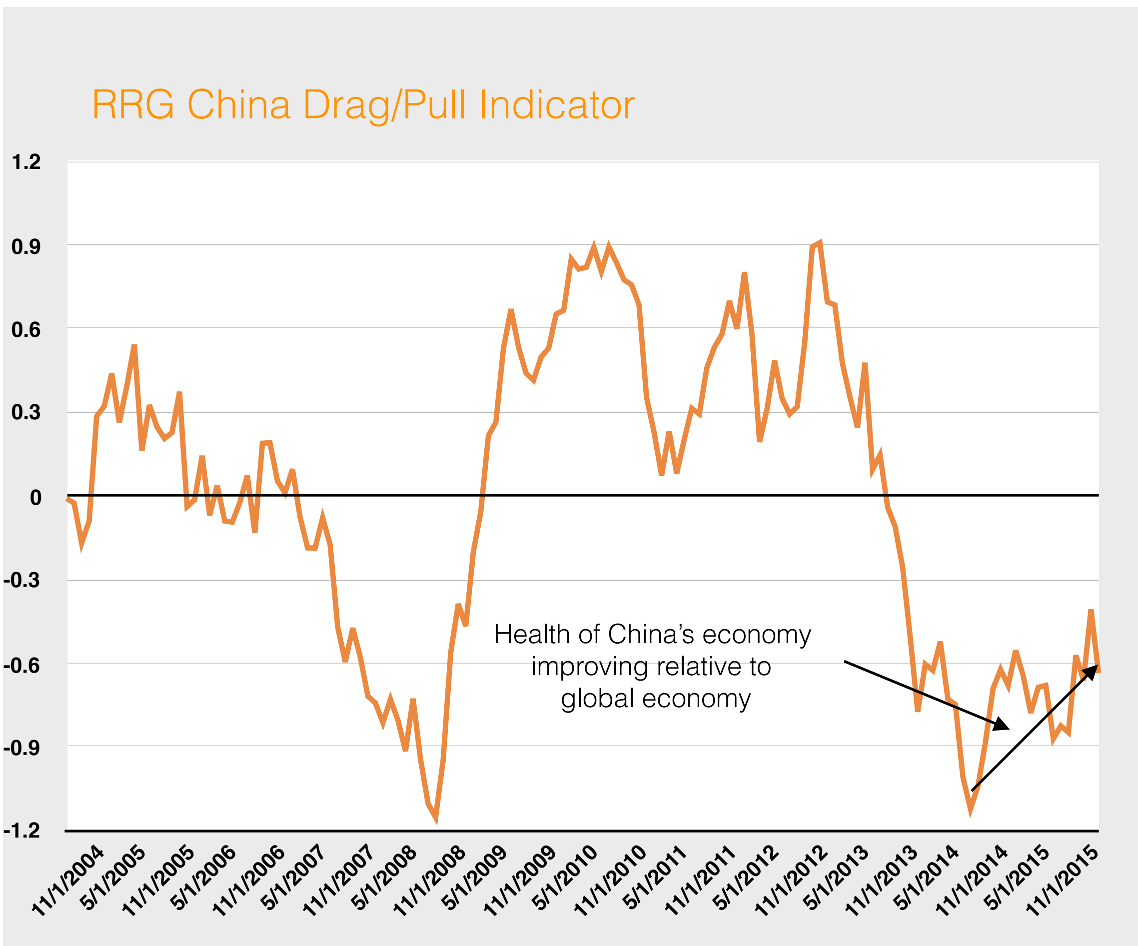
Currently the GCSI at Risk is severely overstating the degree of fragility across the weakest parts of the global economy. We believe GCSI at Risk would be at substantially higher levels if it were not being negatively skewed by the current global negative media bias. In line with this, we believe the risk that a 'shock' results in a bad de-polarization (scenario 2) is currently low.

Global Political Uncertainty a Side Show - Good De-polarization Remains Underway

Although the recent surge in political uncertainty across the globe has resulted in a surge in risk aversion, triggering a correction in global equity markets and testing the stability of fragile EMs it has not changed the 2 dominant drivers currently at work in the global economy. The process of runaway exuberance remains intact and we continue to observe developments in line with a good de-polarization in the global economy.

Highlighting Developments consistent with a good de-polarization:

China - China continues to show signs of stabilizing. Although our China Drag/Pull indicator pulled back slightly in April, see **here**, it remains in an upward trend and can be expected to move higher over the next 6 months, indicating the health of the Chinese economy can be expected to continue improving relative to the health of the global economy.



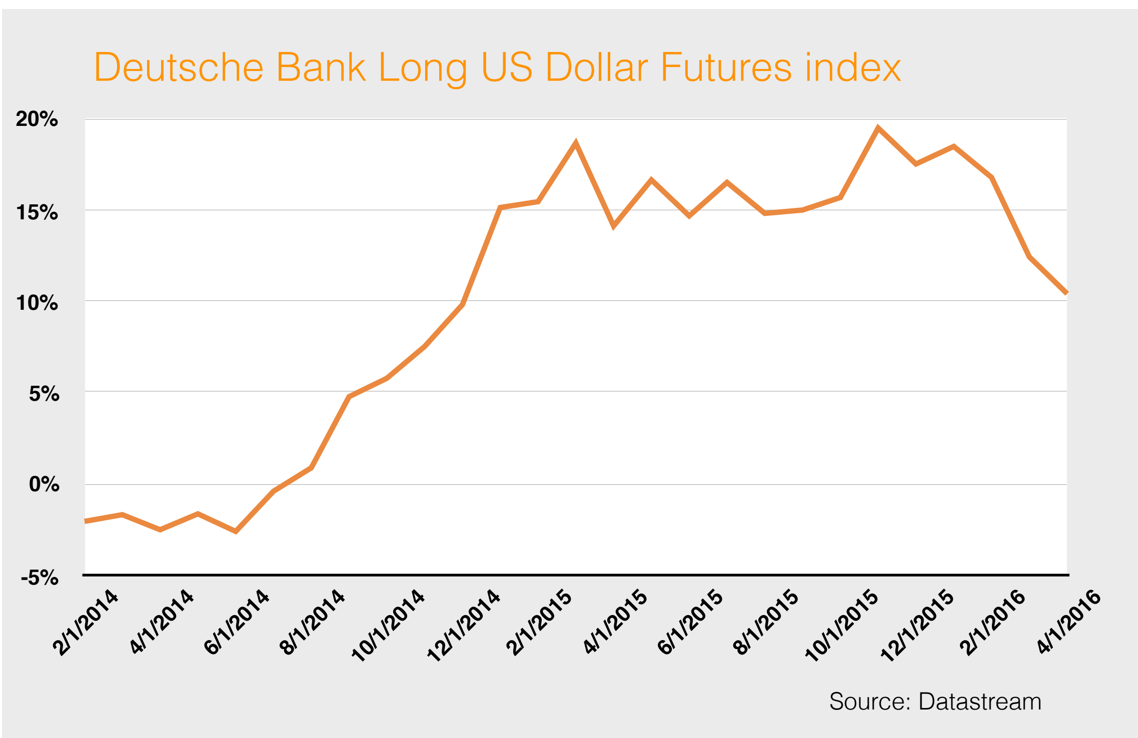
US Dollar - Although the US dollar has strengthened slightly in May it remains in a downward trend. We continue to highlight our view that the US dollar is set to weaken substantially as the global economy continues to de-polarize. A key driver behind a weakening US dollar has been and will continue to be diminishing expectations for 'policy divergence'.

In line with our expectations there has been much less policy divergence than many had expected since early 2015. Investors have started to question the possibility of policy divergence in the current global economic environment.

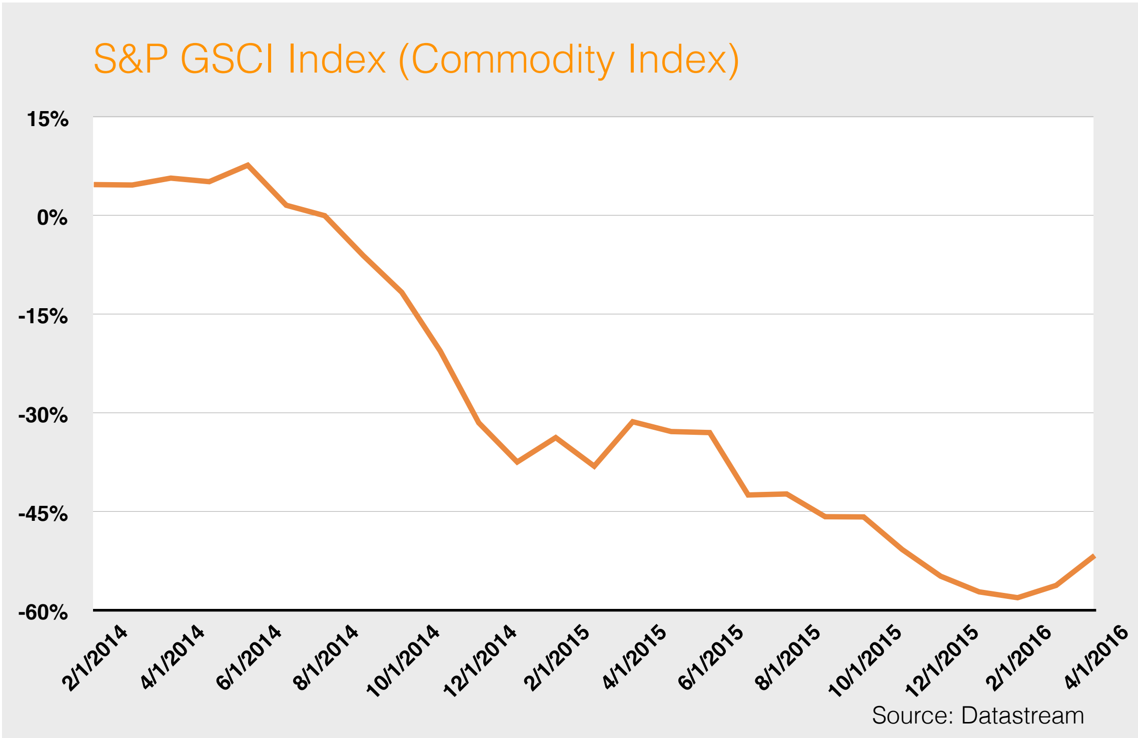
In a speech at the US monetary policy forum in New York in February Governor Lael Brainard highlighted this development by stating, "Beginning in 2014, we saw confident predictions of a coming strong divergence in monetary policy among the major economies. To date, there has been less policy divergence in reality than had been predicted. This observation raises the question of whether there may be limits on policy divergence in current circumstances".

Governor Brainard further highlighted, "to the extent that we are observing limited divergence in inflation outcomes and less divergence in realized policy paths than many anticipated, this could be attributable to common shocks or trends that cause economic conditions to be synchronized across economies".

We believe these 'common shocks or trends' causing economic conditions to be synchronized across economies are our 'key risk factors'. If the key risk factors ease the global process of runaway exuberance will remain, reacting to overheating pressures policies across the globe can be expected to converge towards a tightening stance. If the key risk factors further deteriorate the global economy can be expected to plunge into recession and policies across the globe will converge towards an easing stance. In either scenario (good or bad de-polarization) monetary policies across the globe can be expected to converge, not diverge.



Commodities - Although commodity prices have recently consolidated gains they remain in an upward trend, helped by a weakening US dollar and further fueled by signs that China's economy is stabilizing (improving relative to the global economy).



Political Turmoil in EM Continues to Climax and Ease - Political turmoil across many EMs continues to climax. Equities in Greece have rallied strongly as turmoil surrounding the debt negotiations has reached a climax and progress has been made as an agreement on debt relief has become increasingly probable. euro-area finance ministers presented the first-ever plans for a debt relief on Monday.

Political turmoil in Brazil continues to approach a climax as the Rousseff impeachment process continues.

Conclusion - Overweight EMs Most Exposed to Key Risk Factors

As we continue to observe a good de-polarization play out we recommend taking advantage of the recent correction in global equity markets to further increase exposure to emerging markets most exposed to our key risk factors, see below table.

The current degree of political uncertainty displayed across the global economy is unsustainable, going forward the political landscape can be expected to become increasingly clear. We are already seeing this with the recent approval of austerity measures in Greece (enabling the country to receive the next installment of its bailout loan from the eurozone) and the increasing probability of a Rousseff impeachment in Brazil.

As political uncertainty across the globe begins to settle down the focus among investors can be expected to shift to further and ongoing improvement across our set of key risk factors. As a good de-polarization continues to play out global equity markets can be expected to reach new highs through late 2016/early 2017.

Exposure to Key Risk Factors (1 Being Most Exposed, 18 Being Least Exposed)

	Exp. to Russia/ Ukraine	Exp. To Commodit y Prices	Exposure to Oil Prices	Exp. To Strength in USD	Exposure to China	Political Turmoil	Panic	Exposure to Key Risk Factors
Russia	2	1	1	10	12	1	1	1
Brazil	7	8	7	2	5	1	1	2
Chile	11	2	16	6	3	1	1	3
Malaysia	16	4	4	11	7	1	1	4
Peru	5	3	8	13	5	0	0	5
Poland	1	11	13	1	18	1	0	6
Colombia	10	5	2	8	13	0	0	6
South Africa	6	9	17	3	10	1	0	8
Turkey	4	13	9	5	16	1	0	9
Argentina	12	6	6	9	11	0	0	10
Greece	3	14	12	4	18	1	0	11
China	8	18	11	17	1	0	1	12
Mexico	18	10	3	7	17	0	0	13
Thailand	13	12	19	16	9	1	1	14
Indonesia	17	7	10	15	7	0	0	14
Philippines	15	16	15	14	4	0	1	16
South Korea	14	19	18	12	1	0	1	16
Egypt	19	14	5	19	15	1	0	17
India	9	17	14	18	14	0	0	18