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Equities technically on the verge of a bear market, Fed likely to pause

Last week's massive corrections have pushed most equity markets below their 200 day moving averages. We do not often employ technical analysis because, on a day-by-day basis, it is more useful for traders than for asset managers. However, when long-term price patterns of major markets are being affected (such as the S&P 500 breaking below its 200 day moving average) it is necessary to pay close attention. In fact, at such junctures many asset managers do just that, such that a further correction might well become a self-fulfilling prophecy. The true underlying reasons of any correction are, of course, fundamental rather than technical. They are behind our long-standing equity underweight call, as well as our preference for US Treasuries and – within the emerging bond universe – hard currency over local currency bonds. The essence of our fundamental call is unchanged: markets fear a global growth slowdown, rather than rate hikes which the Fed is anyway unlikely to implement. In addition, ***as we explain in our lead article on pages 2 and 3 of this publication****, global economic growth risks are being increasingly compounded by political risks.*

Temporary rallies possible, but longer term prospects remain bearish

Next week we start without the "guiding hand" of US markets, as Monday will be a Bank Holiday in the United States. As a result global markets are expected to remain in a state of uncertainty and volatility well into Tuesday trading (whilst our local, as well as Asian markets, are likely to remain in this condition until they reopen on Wednesday). Key data to watch will be US housing data, Manufacturing PMIs for almost all major economies, as well as important growth data from China. As far as the latter are concerned, it will be particularly important to watch Chinese industrial production data, as they might tell us more on Chinese ongoing prospects. Temporary equity rallies are of course possible, but at this stage we do not believe in a major and lasting rebound. And we strongly caution into buying in a commodity prices rebound, be it in the energy or metals space.

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Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	1,880.3	-2.2	-8.0
Dow Jones	15,988.1	-2.2	-8.2
Nasdaq	4,488.4	-3.3	-10.4
DAX	9,545.3	-3.1	-11.1
Nikkei 225	17,147.1	-3.1	-9.9
FTSE 100	5,804.1	-1.8	-7.0
Sensex	24,455.0	-1.9	-6.4
Hang Seng	19520.8	-4.6	-10.9
Regional Markets (Sunday to Thursday)			
ADX	3955.1	-4.3	-8.2
DFM	2815.5	-5.1	-10.6
Tadawul	5838.1	-6.2	-15.5
DSM	9185.1	-6.0	-11.9
MSM30	5112.52	-4.7	-5.4
BHSE	1200.9	-0.1	-1.2
KWSE	5265.9	-3.8	-6.2
MSCI			
MSCI World	1,521.0	-2.6	-8.5
MSCI EM	709.2	-4.2	-10.7

Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	28.9	-13.7	-22.4
Nymex WTI USD/bbl	29.4	-11.3	-20.6
OPEC Baskt USD/bbl	25.0	-12.2	-20.1
Gold 100 oz USD/t oz	1088.9	-1.4	2.6
Platinum USD/t oz	829.4	-5.7	-7.0
Copper USD/MT	4310.5	-3.9	-8.3
Alluminium	1476	-1.0	-2.0
Currencies			
EUR	1.0916	-0.1	0.5
GBP	1.4258	-1.8	-3.2
JPY	116.98	-0.2	2.8
CHF	1.0012	0.6	0.1
Rates			
USD Libor 3m	0.6196	-0.2	1.1
USD Libor 12m	1.1451	-0.9	-2.8
UAE Eibor 3m	1.0579	0.8	0.3
UAE Eibor 12m	1.5340	0.7	4.0
US 3m Bills	0.2289	18.4	40.7
US 10yr Treasury	2.0347	-3.8	-10.3

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China's crisis is not over, Europe facing a new one, US recession cannot be ruled out

- **We stick to our global equity underweight call**
- **We stick to our call on US Treasuries as the most effective risk hedge**
- **Within equities we bring our Euro-zone equity overweight to underweight, and shift the proceeds into US equities which are likely to suffer less in a global risk off environment. We had introduced our Euro-zone equity overweight in October 2015. Since then European equities have been moving in line with US equities and global benchmarks.**
- **Within emerging market equities, we stick our preference for India equities as they are the best positioned to take advantage of (or to be not negatively affected by) the global macro-economic environment.**
- **In October we had also introduced a small temporary tactical call on China H- share equities. This call was not based on China's fundamentals, but rather on the assumption that – at least through the winter – the Chinese authorities would have been able to stabilize the exchange rate and thus equity markets. In fact, events have unfolded faster than we expected and the government's attempts of stimulating the economy, without introducing more stringent capital controls, appear incompatible with defending the exchange rate. We therefore close this call with an underperformance of 5% versus the global emerging markets index.**
- **Independently of our geographic allocation, we will pursue more low-beta equity calls, such as high dividend yielders, and shortly issue a note on that.**

China crisis not over

Almost a year ago, we were among the first to highlight the risks associated to a significant growth slowdown in China, and adjusted our asset allocation accordingly. Many more bullish commentators have argued that the Chinese government would do anything to stabilize growth, be it through monetary or fiscal stimulus. The problem with this view, we think, is that stimulus itself will be ineffective as long as capital continues to flow massively out of the country. Capital outflows could be stopped of course, either through a significant further devaluation of the renminbi, or through the introduction of draconian capital controls. Both moves (or a combination of them) would seriously undermine the credibility of China's reform and growth prospects. They would thus have serious implications for emerging markets, and the broader global economy.

If China does manage to further stabilize its exchange rate, that would not necessarily improve its fundamentals, rather worsen them as time progresses. Further stimulus combined with an increase in capital controls would only further inflate China's domestic economic distortions. Indeed, over the last seven years stimulus has been the driving force behind risky assets across the globe. It has become less effective practically everywhere, and China epitomizes the current impotence of stimulus more than any country.

Political risks on the rise in Europe

So far we had – within the equity underweight allocation in our global portfolio – a preference for European equities. This preference was based on the fact that – mainly from a cyclical point of view – the relatively cheaper European companies have more chances to improve their margins and beat expectations than their US peers. In a global environment where the risk-off mood is likely to persist and where also ECB monetary policy effectiveness is petering out, however, European equities would underperform their more "safe-haven" US peers independently of fundamental factors.

This time the underperformance might even increase in light of the significant recent rise in political risk on the European continent. Poland, the biggest Eastern European EU member, has now also a right-wing populist government, just as Hungary. France, Italy and the Netherlands (three important founding members of the EU, together with Germany, Belgium and Luxembourg) have today a significant presence of right-wing populist parties too, albeit at the opposition level. Next spring we are likely to see a resurgence of the refugee crisis that has the potential of enflaming German public opinion and undermining Mrs. Merckel's leadership.

Brexit is a serious matter

But perhaps the most immediate and concrete risk is the upcoming British referendum on EU membership, probably in June or July. Unfortunately this vote is no longer going to be a driver for much-needed EU reform. Indeed the important goal of reducing the power of the EU bureaucracy, by reaffirming the sacrosanct principle of subsidiarity which states that everything should be done first locally, and only centrally as a second choice, appears no longer to be a major stumbling block between the UK and the EU. Likewise, nobody talks anymore about increasing free competition, for example by dismantling the protection that national telecom companies still enjoy. Rather, it is all about restricting the movement of persons from the UK into the EU, and reducing social benefits for non-UK workers from the EU (independently from the fact that they might have paid the same contribution as their UK peers).

Markets are thus going to witness a vote that will do nothing to improve the competitiveness of either the UK or the EU, but that might either result in a dilution of the UK's participation to the EU, or its outright exit. The former case would trigger similar requests for exemptions to the EU rules by other member-countries. The latter might well trigger a new independence vote in Scotland, eventually leading to an intensification of Catalunia's efforts to separate from Spain. Such an intensification of political instability would provide an ideal

backdrop for renewed Grexit risks, as the Greek government struggles to implement extremely unpopular fiscal measures.

This is not to say that we necessarily expect the EU to accept major changes to the UK's treaty commitments, nor that the British people will indeed vote in favour of Brexit. Rather, until next summer markets will "only" speculate about such eventualities. That is enough for us to raise the political risk premium on European equities, and consequently reduce our holdings thereof.

US recession cannot be ruled out

We still think that a US recession can be avoided in 2016. Yet, the fall of the ISM leading manufacturing indicator below 50, the drop in the ISM leading services indicator, the spike in junk yields, combined with relatively high manufacturing inventories makes us puzzle about the consensus view that the occurrence of a recession can virtually be ruled out. At the very least it seems clear to us that the Federal Reserve made a mistake by hiking last December. A year ago we had forecasted for 2015 no rate hike, at most one. For 2016 we are making the same forecast, with only one change: the direction of the rate change might be down.

Policy paralysis and political risk

There is a common thread linking the three largest economies of the world. We would call it political risk. The Chinese leadership wants to move from an export led to a domestically driven economy, but fear the loss of (government) control that comes with such a project. The European elite no longer has a vision as to what the common European project should lead to. The US establishment struggles to find a "respectable" candidate on the Republican side, and has only one on the Democratic side. With the non-elected elite (i.e. the Central Banks) unwilling or unable to provide further support, markets are noting that the elected (the case for the US and Europe) and supreme (the case for China) elites are starting to run out a clear vision as to where they want to go to.

ADCB equity strategy allocation by country/region

	MSCI ACWI Weight	ADCB View	Level of Conviction	Rationale
USA	53%	OW	Very Strong	In an environment where fundamentals stop mattering because risk-off sentiment prevails, US equities will outperform. We still expect downside for the US market, but less than other markets on a relative basis
Japan	8%	UW	Fading	A weak Japanese yen has been the driving force for stronger earnings revisions in recent years. However, the currency acts as a "safe haven" during market turbulence. As such, the stronger currency will act as a drag on earnings
United Kingdom	7%	UW	Strong	Strong macro cycle but high weight of miners in the index a handicap. Low inflation, interest rates and peaking margins suggest business cycle is maturing. EU-referendum a long-term overhang.
Switzerland	3%	UW	Strong	Like Japan, the Swiss franc tends to attract buying when broader markets are under pressure. This will not be helpful for exporters. However, the country should be more insulated from political risk inside Europe.
Canada	3%	UW	Very Strong	Not the right time for commodity-related themes to outperform.
Australia	2%	UW	Very Strong	Same as Canada, commodity exporting markets will remain under pressure in our view.
Eurozone	10%	UW	Very Strong	Greater China exposure now more of a risk than a source of support. The Brexit referendum will give investors a new focal point for political risk in Europe, acting as a long-term overhang.
Emerging Markets	10%	UW	Very Strong	Valuations cheap but no identifiable catalyst on the horizon. Many markets forced to hike rates to protect the currency despite weak growth. This lack of independent monetary policy a major risk, as is the continuing weak commodity cycle. Within EM we prefer Indian equities.
Other	3%			
Sum	**100%**			

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Summary market outlook

Global Yields	Growth concerns supported risk free assets last week, pushing the yield on the 10yr US Treasury temporarily below 2%. Most European sovereign yields also moved lower. The risk-off environment will continue in the near term, keeping sovereign yields lower.
Stress and Risk Indicators	The VIX index touched the highest level since September last year. Sovereign CDS spreads, particularly emerging, trended higher in the past weeks. Whilst short-term rallies cannot be ruled out, the risk-off environment will continue to push them higher in the foreseeable future.
Precious Metals	Gold prices gains were much more muted than one would have expected in such a serious risk-off environment. The reasons are global deflation and slower growth in emerging markets, which is why we remain cautious on the precious metal.
Local Equity Markets	GCC equity markets are facing a double whammy as the impact of the global equity sell-off is being compounded by a further sharp correction in the oil price. We remain cautious for the moment.
Global Equity Markets	Growth concerns are being compounded by increasing political risks – see this Weekly's lead article - keeping investors generally anxious about equity prospects. We do not rule out temporary rebound rallies, but we stick to our equity underweight.
Energy	It might be tempting to buy into rebound rallies, but oil – unlike equities or bonds, and like metals – is a commodity. As such it is much more difficult to buy into a rebound. Bearish sentiment on demand growth, and the lack of a clear indication of less supply, is likely to keep a cap on the price.
Industrial Metals	Industrial metals prices were relatively stable during the week but continue to lack an identifiable catalyst in our view.

Currencies	**Commentary**	**Critical levels**
EURUSD	In spite of the sharp risk-off environment, the euro held its ground against the US dollar. We expect the euro to trade with slight upward bias as US rate expectations adjust lower, and as long as the risk-off environment does not deteriorate further.	R2 - 1.1082 R1 - 1.0999 S1 - 1.0819 S2 - 1.0722
GBPUSD	Despite no fundamental reasons for a sharp depreciation, political uncertainty (EU in-or-out referendum) weighed heavily on the pound. This could push the currency further lower in the near term as politics will continue to dominate economics.	R2 - 1.4723 R1 - 1.4491 S1 - 1.4139 S2 - 1.4019
USDJPY	The yen benefitted from the risk-off environment over the last weeks. It could go a little higher if the current extreme caution against risky assets continues. However, it seems to be not very far from the level where BoJ starts feeling uncomfortable.	R2 – 119.16 R1 – 118.07 S1 – 116.20 S2 – 115.42

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
01/19/2016	NAHB Housing Market index	Jan	61	61	
01/20/2016	Housing Starts	Dec	1200k	1173k	
01/20/2016	Building Permits	Dec	1200k	1282k	It is too early see any impact of higher rates on the housing sector in the US, but market will look for any early sings.
01/20/2016	CPI Ex Food & Energy YoY	Dec	2.1%	2.0%	
01/22/2016	Markit Mfg PMI	Jan P	51.0	51.2	
01/22/2016	Existing Home Sales	Dec	5.2m	4.76m	

Japan

	Indicator	Period	Expected	Prior	Comments
01/18/2016	Industrial Production MoM	Nov F	NA	-1.0%	
01/18/2016	Tertiary Industry Index MoM	Nov	-0.7%	0.9%	Indicators for the final quarter growth are not expected to be good.
01/21/2016	All Industry Activity Index MoM	Nov	-0.8%	1.0%	
01/22/2016	Nikkei Mfg PMI	Jan P	52.8	52.6	

Eurozone

	Indicator	Period	Expected	Prior	Comments
01/19/2016	CPI Core YoY	Dec F	0.9%	0.9%	
01/21/2016	ECB Policy Meeting	Jan 21	No change		Not many economic indicators are scheduled to be released this week.
01/22/2016	Markit Mfg PMI	Jan P	53.0	53.2	

China and India

	Indicators	Period	Expected	Prior	Comments
01/19/2016	Industrial Production YTD YoY (CH)	Dec	6.1%	6.1%	
01/19/2016	Retail Sales YTD YoY (CH)	Dec	10.7%	10.6%	
01/19/2016	Fixed Assets Investment YTD YoY	Dec	10.2%	10.2%	Real indicators from China for the final month of the last year and economic growth data for the final quarter would attract interest. However, no surprises are expected.
01/19/2016	GDP YoY (CH)	4Q	6.9%	6.9%	
01/18/2016	Exports YoY (IN)	Dec	NA	-24.4%	
01/18/2016	Imports YoY (IN)	Dec	NA	-30.3%	
01/18/2016	Trade Balance (IN)	Dec	-$9.54bn	-$9.78bn	

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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