Post-Brexit rally continued last week, but looks unsustainable

Brexit worries were cast aside with some vigour last week as risk assets rallied sharply. The stand-out performer was the Japanese equity market which gained an incredible 9.2% (3.8% in US dollars). Equity investors were betting heavily that the Bank of Japan and the Japanese government are on the verge of introducing major new stimulus measures. Emerging market equities also gained handsomely (+4.7%) while traditional safe haven assets; gold, treasuries and the Japanese yen reversed some of their post-Brexit gains. Economic data during the week was encouraging, Chinese GDP came in a fraction higher than consensus expectations, while new yuan loans in China rose much more strongly than anticipated, underlining the ongoing stimulus efforts by policymakers in China. Elsewhere US retail sales rose a brisk 0.6% suggesting that Q2 growth in the US could be revised higher. The S&P 500 set a new (intraday) record every day last week, the first time that has happened since 1998.

Never a dull moment in Emerging Markets

Emerging markets (EM) have enjoyed a strong revival in recent weeks, boosted by Brexit uncertainty in Europe and the stability in the US dollar. According to EPFR Global data European equity funds saw their largest ever weekly outflows, with redemptions amounting to $5.8bn (week ending July 13). EM equity funds on the other hand witnessed their highest inflows since March ($1.6bn) over the same period. Events in Turkey over the weekend may put a spanner in the works for EM in the very near-term. However, we believe that they are unlikely to derail the overall more positive tone on EM assets which has prevailed in recent weeks. Turkish equities comprise just 1.3% of the EM benchmark, meaning that spill-over should be contained. Having said that, the traditional barometers of EM risk, the Turkish Lira, Mexican Peso, South African Rand and Brazilian Real could well see some volatility as risk is repriced. Overall we maintain our tactical overweight recommendation on EM equities and continue to advocate broad, aggregate EM equity exposure rather than via individual EM equity markets (apart from India on which we have a structural overweight call).

Wietse Nijenhuis
Equity Strategist
Tel: +971 (0)2 205 4923
wietse.nijenhuis@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Rahmatullah Khan
Economist
Tel: +971 (0)2 696 2843
rahmatullah.khan@adcb.com

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Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	2,161.7	1.5	5.8
Dow Jones	18,516.6	2.0	6.3
Nasdaq	5,029.6	1.5	0.4
DAX	10,066.9	4.5	-6.3
Nikkei 225	16,497.9	9.2	-13.3
FTSE 100	6,669.2	1.2	6.8
Sensex	27,836.5	2.6	6.6
Hang Seng	21659.3	5.3	-1.2
Regional Markets (Sunday to Thursday)			
ADX	4576.7	0.0	6.3
DFM	3471.9	3.0	10.2
Tadawul	6661.7	2.5	-3.6
DSM	10428.7	4.7	-0.0
MSM30	5859.96	0.8	8.4
BHSE	1172.8	1.8	-3.5
KWSE	5390.7	0.0	-4.0
MSCI			
MSCI World	1,700.6	2.3	2.3
MSCI EM	867.8	4.7	9.3

Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	47.6	1.8	27.7
Nymex WTI USD/bbl	46.0	1.2	24.1
OPEC Baskt* USD/bbl	42.9	0.7	37.1
Gold 100 oz USD/t oz	1337.5	-2.1	26.0
Platinum USD/t oz	1091.9	-0.5	22.5
Copper USD/MT	4945.5	5.0	5.2
Alluminium	1655	0.0	9.9
Currencies			
EUR	1.1035	-0.1	1.6
GBP	1.3192	1.8	-10.5
JPY	104.88	4.3	14.6
CHF	0.9827	-0.1	2.0
Rates			
USD Libor 3m	0.6879	3.1	12.3
USD Libor 12m	1.3083	4.4	11.1
UAE Eibor 3m	1.1161	-1.4	5.8
UAE Eibor 12m	1.6677	0.8	13.1
US 3m Bills	0.3001	9.6	84.4
US 10yr Treasury	1.5509	14.2	-31.7

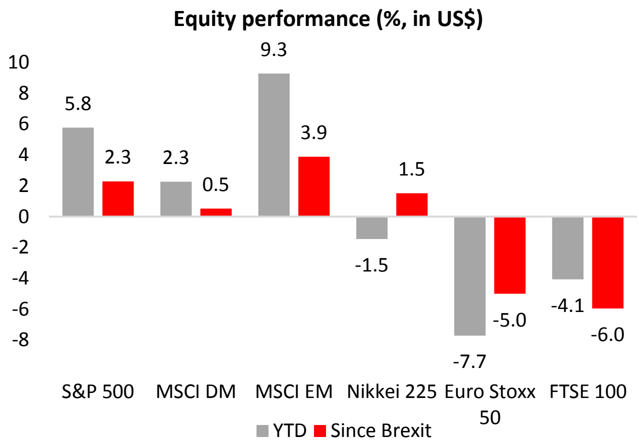
Please refer to the disclaimer at the end of this publication

Up, down, up, down; large swings in markets likely to remain

Equity rally déjà vu

Equities are the most optimistic of all asset classes. Their natural state is to rise, unless there is a good reason not to. They try to anticipate an outcome and then adjust to the reality later, there is no better example than the pre-Brexit referendum rally in the week leading up to the vote which was then corrected in a matter of minutes following the outcome. This optimistic approach to investing will a lot the time result in gradually upward sloping markets, which then every so often correct. Currently however, the environment is different and the range of risks far greater than usual. However, this has not prevented equity investors from adopting a less optimistic approach. As a result the swings witnessed in equity markets this year have been greater and more frequent than might ordinarily have been the case. Plenty of risks remain, these will periodically intensify leading to more volatility in financial markets. This is one of the main reasons we urge investors not to chase the rally in European equities in particular, as the risks related to the Brexit referendum, as well as those surrounding Italian banks are likely to return.

In this context we cannot help but be impressed by the magnitude of the moves in equities last week, especially given the number of risk factors. However, the equity rally should be taken in the context of the overall performance both year-to-date and post-Brexit, the chart below sums up these moves.

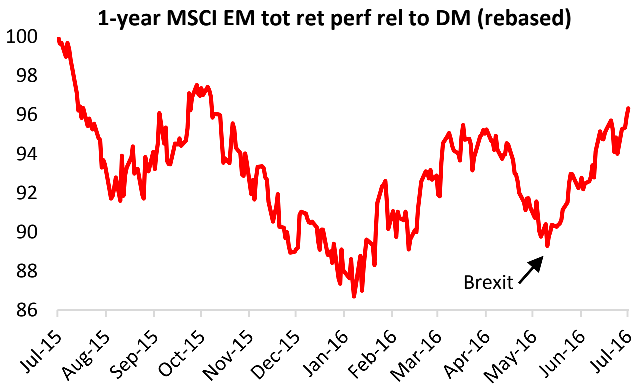


Source: Thomson Reuters

EM equities have been the strongest performers (we discuss this in more detail later) followed by US equities. Japanese equities despite their huge rally last week are still down 1.5% year-to-date (-13% in local currency) while European equities have unsurprisingly performed the worst and remain substantially lower for the year, this too in spite of the 4.6% rally last week.

Maintaining our EM equity overweight recommendation

EM equities are up 9.3% since the Brexit referendum vote, outperforming DM equities by 3.4%, reaching their highest level since November 2015. We have captured most of this upside by going overweight EM equities on a tactical basis less than one week after the surprise decision by the British people to leave the EU. EM investors, however, know the ride is rarely smooth and events in Turkey over the weekend underscore this. Although Turkish equities make up just 1.3% of the overall EM equity universe, sentiment surrounding the asset class could be weighed down by these events for a short period. The main transmissions mechanism for this to happen would likely come via the currency, which in EM often act as the main shock absorber. Having said so, we do not expect the situation in Turkey to mark a permanent inflection point in EMs recent outperformance over DM.



Source: Thomson Reuters

Bond prices pushing investors into stocks

A large part of the US equity market rally as well as EM's recent outperformance is down to the fact that bond yields have been compressed to record levels in most part of the world. This has then forced investors to seek other, riskier assets. US equities in particular have benefited, but looking at the detail behind the US rally, it has been the defensive stocks, those companies which are most resilient to an economic recession which have outperformed. The same can be said of high dividend yielding stocks and sectors which trade more like bonds, utilities and telecoms companies for example. The worry now is that these names are beginning to look expensive. With Q2 earnings season now under way, we expect that the US will be able to continue to perform reasonably well as earnings could surprise on the upside somewhat (consensus expectations are for earnings to contract 5% y-o-y. Further out however, earnings growth expectations are probably too high (14% for 2017), especially considering very high US margins, rising wage costs and economic growth which may yet be impacted by Brexit and other major global risks.

Summary market outlook

Bonds	
Global Yields	Decent economic releases, in particular a positive surprise in US core inflation led to a reversal in the US Treasury 10-yr yield from its record lows. We don't expect yields to back up much further as global growth concerns and political events will continue to benefit safe haven assets such Treasuries.
Stress and Risk Indicators	Risk indicators such as the VIX index fell as equities rose and safe havens fell. The VIX is currently close to its lower limit will likely limit a further slide. However, dollar strength and political developments in Turkey could temporarily push EM CDS spread a bit higher.

Equity Markets	
Local Equity Markets	GCC equity markets have tried to keep pace with global peers in the recent weeks. Now, markets will be increasingly influenced by the quarterly earnings reported by companies which we expect could see some pressure in light of governments' fiscal consolidation in the last few quarters.
Global Equity Markets	Global equity markets, with its recent rally, surprised most market participants as they brushed aside Brexit fears. The downward adjustments in the Fed rate trajectory also helped equity market sentiment. The rally could go a little further, however, we remain cautious as fundamentals have not changed.

Commodities	
Precious Metals	More risk seeking behaviour by investors weighed on precious metals during the week. However, we believe that the gold price will benefit when the markets' attention refocuses on European political risk.
Energy	The oil price seems to have found a range which is under the recent high of around USD51/bl. We believe that the price will continue to trade under that ceiling in the near term.
Industrial Metals	Industrials metals were mixed last week. Long term prospects remain negative with China pushing in the direction of less rather than more consumption of industrial metals.

Currencies								
EURUSD	Euro remained largely flat through the last week except briefly spiking upside on Thursday.							
Critical levels	R2	1.1221	R1	1.1128	S1	1.0979	S2	1.0923
GBPUSD	Cable regained some of its loses last week as the Bank of England avoided cutting interest rates and also passed up the opportunity to inject further stimulus. We suspect that this could be a temporary rebound as the evolution of Brexit negotiations and the impact of Brexit on the domestic economy will create downward pressure on the currency.							
Critical levels	R2	1.3805	R1	1.3498	S1	1.2868	S2	1.2545
USDJPY	The Japanese yen depreciated massively thanks to expectations of fiscal stimulus potentially combined with further monetary stimulus. The easing risk-off environment also helped the currency to move lower.							
Critical levels	R2	109.85	R1	107.36	S1	101.35	S2	97.83

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
7/18/2016	NAHB Housing Market Index	Jul	60	60	Housing related data will be looked at by markets.
7/19/2016	Housing Starts	Jun	1165k	1164k	
7/21/2016	Existing Home Sales	Jun	5.48m	5.53m	
7/21/2016	Leading Index	Jun	0.2%	-0.2%	
7/22/2016	Markit Manufacturing PMI	Jul P	51.5	51.3	

Japan

	Indicator	Period	Expected	Prior	Comments
7/21/2016	All Industry Activity Index MoM	May	-1.1%	1.3%	Industry activity index and PMI will be looked at by markets.
7/21/2016	Machine Tool Orders YoY	Jun F	--	-19.9%	
7/22/2016	Nikkei PMI Mfg	Jul P	--	48.1	

Eurozone

	Indicator	Period	Expected	Prior	Comments
7/19/2016	ZEW Survey Expectations	Jul	--	20.2	PMIs are to be the main focus of the market.
7/21/2016	ECB Rate decision	Jun	No change		
7/22/2016	Markit Mfg PMI	Jul P	52.0	52.8	
7/22/2016	Markit Mfg PMI (GE)	Jul P	53.4	54.5	

China and India

Indicator	Period	Expected	Prior	Comments
				No important economic data from China and India

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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