ADCB Asset Management

The Quarterly Investment View
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ADCB

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Fed policy error and China slowdown the main risks, but not for now

In the October editorial of this quarterly publication, we argued that the global policy opportunities were overstated, but that so were the political risks. As for the policy opportunities, the contours of US tax reform have now emerged and we would still argue that it will at most add 0.3% to US GDP growth, nothing particularly spectacular. As for political risks, they are here to stay of course, but the rhetoric of governments and politicians is always more upsetting than the actions they effectively undertake. This is only natural since politicians usually have as much to lose, if not more, as investors.

Moving into the year 2018 it makes probably sense, therefore, to have once more a closer look at the major *economic*, as opposed to the political risks. We see are two such risks. The first consists of a Federal Reserve that pushes the US economy into recession through unwarranted rate hikes. The second risk scenario is a situation where Chinese authorities depress domestic and thus global growth through excessive deleveraging.

Risks are always also opportunities. The flattening of the US yield curve at this juncture still seems more the result of low inflation expectations and low global bond yields, rather than the sign of an imminent US recession. Throughout this very long hiking cycle the Fed has always preferred prudence over bold action. It is likely to continue to do so under the new Powell Chairmanship. A few more rate hikes this year will occur. If inflation picks up there will be a moderate pick-up also in longer term yields. Critically the US dollar weakness that we have seen in 2017 is over, thereby removing a tailwind from emerging markets. Advanced economy equity markets should, however, be more resilient given the global economic upswing.

The Chinese economy, on the other hand, will almost certainly face a slowdown as President Xi Jinping will tighten stimulus, or at least further reduce spending by the country's inefficient state-owned enterprises. We would like to point out that from the viewpoint of global financial markets China constitutes a risk of economic rather than financial contagion. The distinction might seem semantic but it is not. A major and lasting sell-off in the equity market of any major economy would have an analogous impact on global equity markets. A major sell-off in China – taken in isolation of other global events - would only temporarily affect global markets, since Chinese financial assets, including credit, are mostly held by Chinese entities.

Moving away from the financial dimension to the more important underlying *economic* fundamentals, the real problem is the nature of China's growth. Whilst the economy expands annually at just below 7%, its investments are still growing at a rate above 7%, and state-owned entities still grow their output at double digits. This inherently inefficient growth process whereby the overall economy's value added grows less than investments is the result of politically motivated soft budget constraints combined with the lack of proper accounting standards (essentially the absence of write downs on loss making positions). It is now Mr. Xi Jinping Job's to bring this to an end, thereby recognizing that the country will grow at a much lower rate going forward. This will dampen growth in advanced economies, but on the positive side might well further reign in inflationary expectations. It will create significant headwinds for some, but not all emerging markets.

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Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest (13 Dec closing)	Quarterly Change % (Q4 2017)	YTD Change % (13 Dec)
Index Snapshot (World Indices)			
S&P 500	2,662.9	5.7	18.9
Dow Jones	24,585.4	9.7	24.4
Nasdaq	6,875.8	5.8	27.7
DAX	13,125.6	2.3	14.3
Nikkei 225	22,665.8	11.8	19.1
FTSE 100	7,496.5	1.7	5.0
Sensex	33,089.6	5.7	24.1
Hang Seng	29216.1	6.1	32.8
Regional Markets (Sunday to Thursday)			
ADX	4,384.4	-0.3	-3.6
DFM	3,404.1	-4.5	-3.6
Tadawul	7,094.1	-2.6	-1.6
DSM	8,206.9	-1.3	-21.4
MSM30	5,066.49	-1.4	-12.4
BHSE	1,264.1	-1.5	3.6
KWSE	6237.9	-6.6	8.5
MSCI			
MSCI World	2,084.4	4.2	19.0
MSCI EM	1,118.8	3.4	29.8

Commodity	Latest (13 Dec closing)	Quarterly Change % (Q4 2017)	YTD Change % (13 Dec)
Global Commodities			
ICE Brent USD/bbl	62.8	8.5	9.9
Nymex WTI USD/bbl	56.71	9.5	5.4
OPEC Basket USD/bbl	62.8	13.7	17.7
Gold 100 oz USD/t oz	1,258.1	-2.7	8.6
Platinum USD/t oz	889.1	-4.2	-3.2
Copper USD/MT	6685	3.1	21.5
Aluminium	1,990.75	-4.3	17.5
Currencies			
EUR	1.1832	-0.4	11.8
GBP	1.3437	-0.3	8.2
JPY	112.63	0.6	-3.3
CHF	0.9847	2.1	-3.0
Rates			
USD Libor 3m	1.5735	18.0	57.7
USD Libor 12m	2.0283	13.8	20.3
UAE Eibor 3m	1.7182	10.3	16.4
UAE Eibor 12m	2.4693	13.7	17.9
US 3m Bills	1.3250	-42.0	160.7
US 10yr Treasury	2.3618	0.4	-4.2

Executive Summary

- The rise in geopolitical tensions contrasts with the synchronized pick-up in global growth. In our assessment, geopolitical tensions are here to stay, in particular in the Far East, yet over the next year it seems unlikely that such tensions will morph into full blown conflicts. Geopolitical tensions might create temporary volatility, but moderate global growth will remain supportive of risk assets. As such, geopolitical tensions might well create buying opportunities.

- We are not excessively concerned about a significant inversion of the US yield curve, i.e. a situation whereby the long-term yields end up being lower than the short term rates because the Federal Reserve excessively hikes rates. Either inflation goes up, and the Federal Reserve will hike rates by 75bp, and long-term yields would rise more or less to the same extent, or Jerome Powell and his team will limit themselves to at most two more rate hikes in 2018. Either way financial conditions in the US will remain relatively accommodating.

- The true wild card remains China. China's continuing investments have created an overall accumulated debt well in excess of 250% of GDP. Whilst it is clear that the authorities will continue tightening, it needs to be seen if they manage to do so in a gradual way without disturbing global growth too much, and thus without causing too many jitters in the markets. We steer in any case clear from the markets that are more dependent on China.

- In the US, it makes sense to play the sectors and geographies that are most likely to benefit from tax reform although one should not expect too much.

- The "reflation" theme is bad for emerging markets, although those with sound external balances could prove more resilient. Energy prices are likely to remain supported by OPEC discipline. Metal prices are likely to feel downward pressure with China tightening. Precious metals remain a good hedge against market turmoil, even if more Fed rate hikes are unfavorable for them.

Market Outlook and Portfolio Positioning

Asset Allocation

Equities	Overweight	With global growth still on a solid footing, equity markets are expected to post continuing, albeit diminishing positive returns.
Fixed Income	Underweight	Bond markets are to perform reasonably as we do not expect major policy rate hikes for the moment. Yet, yields might pick-up somewhat as global growth continues to consolidate.
Alternatives	Neutral	We maintain our exposure to hedge fund strategies that are less correlated to the market, as well as gold and treasuries as an insurance against risk-off moods.

Fixed Income

Duration	Intermediate to long	The US rate hikes have for now had their biggest impact on yields. Accommodating monetary policies in Europe and Japan should keep long-term yields lower.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
US Credit	Underweight	Valuations remain expensive. In the event of high volatility, high-quality investment grade bonds will be preferred over junk bonds. US high yield spread compression does not comply with flattening US yield curve.
Euro Credit	Underweight	Valuations are more expensive than US credit. Investment grade and High yield bonds are trading at yield level lower than some of the sovereign global bonds (safe-haven assets).
US Treasuries	Overweight duration	Any rise in long-term bond yields will be limited compared to short-term bond yields as inflation pressures remain subdued and Fed maintains a gradual hiking stance.
EM hard currency bonds	Selectively overweight but reduce duration	Hard-currency bonds preferred over local currency bonds as monetary policy rhetoric will become less dovish and EM currencies remain under pressure due to broad dollar strength. We recommend emerging markets that have better domestic dynamics, less dependency on global trade, positive reform momentum and the potential for credit rating upgrades. We particularly favor Russia and Indonesia USD sovereign and quasi-sovereign bonds.
GCC	Overweight high quality sovereigns	GCC credit spreads yet to fully reflect the recent rise in oil prices. We prefer GCC sovereigns with solid public and external accounts including UAE and Kuwait and with strong reform potential including Saudi Arabia.
India	Neutral	Rising inflation pressures to check the drop in local-currency sovereign bond yield.

Market Outlook and Portfolio Positioning (continued)

Equity Markets

US	Overweight	The market has priced out any fiscal policy boosts by the Trump administration. We think this is a mistake and expect to see changes to the corporate tax rate in the US before the end of the year. This will boost US corporate earnings. We also view the rotation out of tech stocks and into other parts of the market as a healthy development.
Eurozone	Neutral	A stronger euro, as we have witnessed in recent months will at some point undermine the equity market rally in the single market given the large share of revenues which Eurozone corporates derive from overseas (over 50%).
Japan	Overweight (US dollar-hedged)	Japanese equities are still cheap compared to US equities, while the BoJ's yield curve targeting is likely to keep the yen under pressure, and the Japanese economy keeps improving. This is good for Japanese corporate earnings.
Emerging Markets	Underweight	EM equities have been driven by the downshifting in US interest rate expectations, leading to a weaker dollar. This has more than offset weakness in commodity prices. We expect this tailwind to subside and EM equities to underperform, although we do like Indian equities.
United Kingdom	Neutral	For the moment the odds of a deal between the UK and the EU have risen compared to a no deal outcome. Whilst this is likely to reduce uncertainty for corporates, it will also stabilize the exchange rate. A stable pound implies that UK equities are unlikely to do much better than EU equities.

Energy and Commodity Prices

Energy	Neutral	The combination of OPEC supply controls and the synchronized global growth pick-up will prevent a significant oil price correction.
Industrial Metals	Underweight	China tightening will put downward pressure on industrial metals.
Precious Metals	Overweight	The "reflation" theme is bad for precious metals. Yet, bouts of risk-off jitters are still very likely over the years to come. Thus we keep them as a "market insurance" risk hedges in our portfolios.

Currencies

EUR	Moderate downward pressure	After the euro's strong rally, the ECB is now more likely to disappoint in terms of significantly unwinding its stimulus. At the same time, uncertainty about Fed policy combined with talk of fiscal tightening is likely to keep upward pressure on the US dollar. As such we would expect the euro now to move sideways with a downward bias.
GBP	Further corrections expected	Although the currency has stabilized after the recent preliminary agreement between the UK and the EU, it will still have some uncertainty-induced downward pressure.
JPY	Further depreciation likely	The combination of moderate Fed tightening and BoJ yield curve targeting is likely to keep some downward pressure on the yen.

Short-term growth prospects remain subdued amidst major reform efforts

Short-term pain not all over yet

With the exception perhaps of Dubai, most GCC economies are still feeling the fallout of lower oil prices and the fiscal adjustments that has come with it. Within the region, it is important to distinguish between countries. The UAE and Kuwait, in particular, have no long run issues of fiscal sustainability and should gradually be able to resume more constructive stimulus spending. Perhaps more clarity as to these policies will emerge after the start of 2018 with the introduction of the Value-Added Tax which is expected to yield the governments at least 1% in terms of additional revenues. The outlook is however significantly different for Oman and Bahrain where deficits remain substantial in spite of austerity measures, and where the debt trajectory is still going upward. Both countries will have to do much more to make their public finances sustainable.

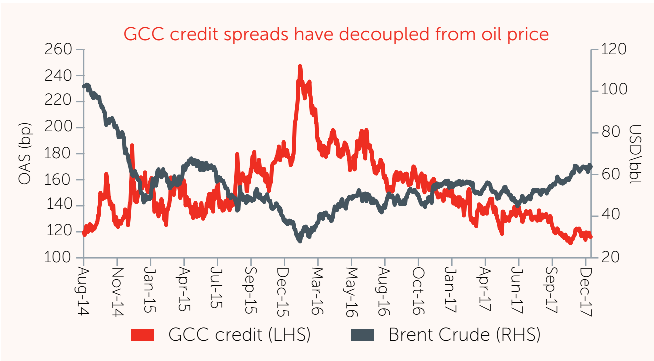
Saudi Arabia remains a special case where in the face of the necessity of significantly more reforms, the country's leadership is undertaking major and unprecedented steps with a view of radically reshaping the country's social, economic and even cultural structure. It is extremely important to stress that global capital markets are placing a lot of confidence in the country's capacity to set a new course, as is witnessed by the recent issuance of 12.5 billion USD. The country's fiscal position continues to improve modestly with the deficit now below 10% of Gross Domestic Product. The stable oil price, which is likely to continue to benefit from joint OPEC and Russia market stabilization measures will also help.

For those who were still doubting, we would like to add that the major reform efforts, such as the anti-corruption drive and societal liberalization measures, such as for instance increased integration of women into the work force, will give tremendous additional returns to each dollar invested by the government, whether it be in infrastructure or in other projects. These additional returns may take time to work out, but they will be huge and they are likely to raise confidence already now, not only domestically but also on the side of foreign investors (see the equity section below).

Fixed Income: Preference for high-quality sovereigns

GCC credit default spreads tightened in 2017, yet recently they have come under pressure on account of rise in regional tensions. Even the increase in oil prices has failed to have much of an impact on the investor sentiment yet. Having said that, we expect that investors' concerns on recent regional tensions will fade away and the focus will eventually shift towards the macro-economic reform implementation taking place in the region. In UAE, the introduction of value-added tax in the beginning of 2018 will provide some fiscal clarity and could reduce the country's reliance on debt borrowing. Kuwait also remains better placed given its strong public and external balance sheets. While Saudi Arabia is expected to raise debt in 2018, the country's improving fiscal balances and reform potential indicates that any increase in supply will be easily absorbed by the market. Higher oil prices in 2018 will also boost offshore investor confidence and GCC credit spreads are likely to price in the upward correction in oil prices.

Overall, we continue to favour high quality sovereigns such as the UAE and Kuwait and also prefer Saudi Arabia given the country's commitment to fiscal consolidation and economic diversification. Bahrain and Oman remain less attractive due to their weak fiscal position and rising public debt levels.



Source: Bloomberg

Equities – neutral overall, but tactically overweight Saudi

GCC equities have considerably underperformed both global and emerging market (EM) equities year-to-date, disregarding the upswing in the oil price and in the other emerging markets. In our view, a lot of this has to do with the fact that there are not too many domestic institutional investors, nor foreign investors in GCC markets. Thus investors have remained cautious as they wait for the momentous change going on in these markets – in particular fiscal consolidation and huge economic reforms in Saudi Arabia – still have to play out. This is unfortunate because the international environment might become less favourable as it was throughout 2017, with the oil price rally steaming out, the US dollar bottoming and US rates rising. However, we believe that Saudi Arabia's addition to the MSCI watch list for potential inclusion into the MSCI emerging markets equity index, will be a catalyst for the Saudi index but also for some other GCC markets. A critical test bank will be the ARAMCO floating. Were it to occur on an international market, it would add to the transparency of the overall Saudi reform efforts, and greatly inject confidence in Saudi assets in particular. The recent success of the ADNOC IPO might have given us a pre-taste of that.

Growth outlook brightens, inflation expectations still in check

US growth strong and steady, but expect no miracles

It might be tempting to expect an acceleration in US growth now that the second and third quarter of 2017 have done very well – growing at a more than 3% annualized growth rate – and the US Congress should be able to produce some tax stimulus latest by January 2018. Besides, confidence indicators remain very high and the economy keeps on creating jobs at a rate that is just below 200'000 per month, not a bad performance if one considers that unemployment is already at a historically extremely low level, i.e. 4.1% of the total workforce. Both financial conditions and confidence indicators are back at the relatively benign levels at which they have already been since the end of the 2008 crisis. Now, like then, those levels have not led to an acceleration of the growth rate to tune of what we were used to before 2008. Obviously, the growth we are having now is the new normal, given a smaller workforce and higher debt levels.

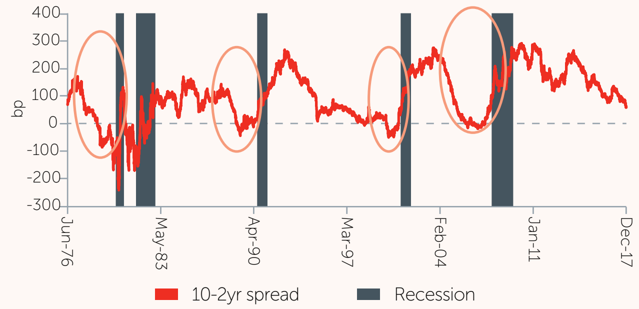
Tax reform is going to have a limited impact

Whilst we do not believe in a temporary acceleration of the growth rate, a temporary acceleration – say of one or two quarters – is still possible. Tax reform could be a temporary driver not so much of increased consumption spending, given that most of the beneficiaries will be in the higher income brackets who will to a large extent increase savings, but possibly in terms of investment spending. Here too, however, one should not expect too much. The reduction of corporate taxes is unlikely to trigger more investments in a low capital cost environment where companies have typically used cash to purchase their own stock. A temporary boost in investments could however be triggered if – as it seems – lawmakers will introduce a short term window whereby they can immediately fully deduct investments from the income that will still be taxed at the higher old corporate tax rate.

Fixed income: US Treasury yield to rise marginally

Subdued inflation pressures, safe-haven demand and hunt for higher yield (outside Europe and Japan) have kept long-term US treasury yields supported and tight ranged for most of 2017. However, short-end bond yields were extremely vulnerable to continuous repricing of Fed rate hike expectations. As a result, US yield curve flattened to the lowest level in almost 10 years. Raised as an economic concern by many in markets, we do not believe that recent flattening is a harbinger of an economic recession in the near term at least. In fact, historical precedents indicate that curve flattening is quite normal especially during the middle of Fed tightening cycle. We believe that this trend is likely to continue as we move further into the tightening cycle. If inflation pressures do rise in 2018, then the Fed could become more aggressive, leading to further flattening. However, Fed may become dovish towards the end-2018 or beginning of 2019 which could bull steepen the curve in the late second half of 2018. We do not see curve inversion risks yet as taking lessons from past policy mistakes, the Fed will be very cautious not to err by tightening too aggressively.

Yield curve flattening not flagging any signs of recession



Source: Bloomberg

US credit spreads have significantly tightened over the past two years, more than halved in case of junk rated US corporate bonds. While strong economic growth argues for lower default rate and better corporate financing conditions, we believe that scope for further compression is very low. Valuations, both in high-yield and investment grade bonds have become very expensive. With the combination of solid economic growth, low volatility has particularly proved supportive for the low-rated segment of the junk bonds. Investors' search for yield could benefit the junk bonds in the near term, but the spread compression trend does not correspond with the flattening bond yield curve. As such, we prefer investment grade bonds over high yield bonds. In case of spike in volatility, investors will prefer increasing exposure to safe-haven assets like US Treasuries or even higher-rated IG bonds rather than junk bonds.

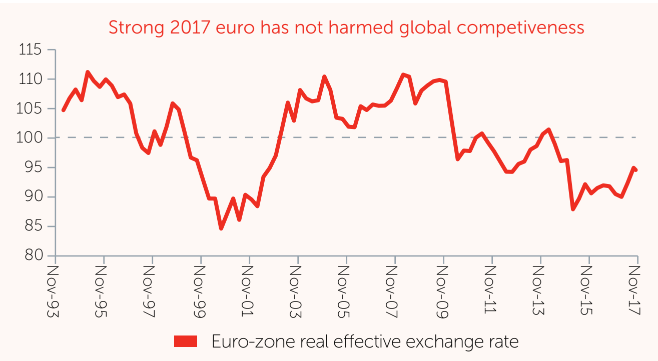
Equities – remain overweight

US equities have again pulled off a phenomenal year, with the S&P 500 up close to 20% year-to-date as we write. Even if one also takes into account the gradual depreciation of the US dollar against the euro, i.e. when looking at the real as opposed to the local currency performance, US equities have done almost as good as European equities. Going forward, we believe that in the advanced economies equity space, it continues to make sense to overweight US equities. It is true that markets should by now have priced in the depreciation of the greenback into the earnings of US companies. It is also true that European companies should profit more than US companies in the later phase of the cyclical upswing. Yet, we suspect that the Federal Reserve will be very cautious in hiking rates, and that US technology companies will again lead the pack, whilst emerging markets will come under pressure regardless (or better because of China tightening). In such an environment, we simply feel that the risk profile of US equities is more rewarding. US equities are to perform well, but offer more downside protection if global market concerns increase.

Growth to roll over moderately in 2018

Growth to roll over with strong euro and China tightening

We still expect growth to somewhat slowdown following the 2017 appreciation of the euro and given the prospect of tightening in China. Europe's growth engine Germany, in fact, has always been particularly sensitive to the Chinese cycle because of its significant exports to that country. On the other hand, we would not want to overplay the trade argument and for more than one reason. First, as the chart below shows, the region's real effective exchange rate is still below the average of its last 23 years. Second, the region exports high quality consumer goods as well as the technologically most advanced capital goods. If China succeeds in managing its slowdown, demand for these items should persist. Also, the European Union has just concluded free trade agreements with Canada and Japan (the latter now the biggest free trade agreement in the world). Finally, the "first phase" Brexit agreement with the UK seems to implicate that trade relations between the UK and the EU will not change at least until 2021. The Euro-zone thus seems well positioned to profit from global growth through 2018.



Source: Bloomberg

Italy is the major political risk

Needless to say the political situation will remain fluid in Europe for years to come, like in almost all advanced economies. With growth picking up, the Catalan crisis still likely controllable, and Germany probably ending up with a government which at the margin will spend more (thus favour rebalancing in the euro area) and be a bit more willing to rethink the European institutions towards a more federal (solidarity-based) approach, in 2018 one would likely see an ebbing down of political tensions. Italy remains the key risk with votes being equally split in three between three groups, the establishment Democratic Party, the anti-establishment Five Star Movement, and the Right of Centre coalition which is partly establishment and party anti-establishment. In our assessment, the latter and the former are likely to compromise and create a government that would still be very cautious in its policy towards the single currency. On the other hand, the same Five Star Movement has watered down its anti-euro stance.

Fixed Income: Bunds to benefit from gradual ECB taper

While German bund yields have risen on a year-to-date basis, the gradual ECB taper announcement in October has pushed yields lower recently. Safe-haven demand and US yield curve flattening has also spilled over to bund yield curve. Inflation outlook remains benign in Europe as indicated by the recent disappointment in core and headline inflation numbers. In addition, stronger euro in 2017 and upcoming China tightening risks implies that pick-up in growth will be moderate in Europe. This should give enough reasons for the ECB to maintain its dovish QE taper plans. As such, bund yields will remain stable (more than the US Treasury yields) with upward risk only likely to occur in the second half of 2018. As such, we expect the 10yr Treasury-Bund yield spread to widen in the near term given relatively dimmer growth/inflation outlook in Europe.

European credit spreads have tightened significantly and relatively been less volatile compared to the US counterpart. ECB's corporate borrowing has contributed to this sizeable credit spread compression. While ongoing ECB policy, improving growth prospects and low default risk could argue for further spread compression, valuations are extremely expensive and unattractive even compared to US IG and HY. Euro IG (<1 %) and HY (<3%) are trading at yield levels even lower than other global bonds (including US Treasuries). As such, we recommend staying underweight on European credit.

Equities – Remain neutral

Eurozone equities should outperform in the context of synchronized global growth and a stronger US dollar. Whilst we are still quite bullish on the growth outlook both in Europe and globally, we think that the US dollar will remain stable and appreciate only marginally against the euro, i.e. not enough to make a material impact on the conversion of European companies' foreign earnings in to euros. Moreover, growth in Europe is likely to roll over at this point, which should then also reflect in minor increases in revenues. Perhaps the most important reason for our current neutral position in European equities – as opposed to the continuing overweight in US equities – is probably the fact that European equities have a high beta. It would be naïve to deny that the current upward cycle in global equities will soon enter its tenth year, and that a significant growth slowdown in the US or China are concrete risks. If a global market correction occurs, European equities will do worse than US equities (they have a so-called higher beta). On the other hand, US equities are for the moment still likely to benefit from tax reform optimism and from the strength of the technology sector. For risk-adjustment reasons, therefore, we prefer to overweight US equities and stay neutral on European equities.

Uncertainty is the only certainty

First battle won yet more battles to come

The UK was successful in striking a Brexit divorce deal, with potential agreement made on the Northern Ireland border, UK and EU citizen rights and financial settlement between the UK and EU. The agreement has not strengthened the domestic position of Mrs May's government. Those conservatives in favour of Brexit consider it to accommodating to the EU. Those who are more in favour of the EU have won a parliamentary vote forcing the government to submit any final agreement to Parliament before the government can start implementing it.

Nevertheless, the commitment on the Brexit divorce principles has opened room for the second round of Brexit discussions which will contemplate future relations, and thus also the trade deal between the UK and European Union. From an economic point of view, the trade deal is more crucial to the UK which is most likely to pitch for a free trade deal. The probability of an advantageous free trade deal getting passed is not that high. In our view, this has created a binary probability structure as far as the final outcome is concerned. Either the UK gets a not so good deal, and accepts it, or it will opt out of a final deal, a good deal being increasingly unlikely (there is of course always the chance that faced with such dilemma a new referendum would determine that the country decides to "withdraw" from Brexit and stay in the EU, but we consider that for now less likely). Critically, we expect uncertainty to persist through 2018, something that will continue to dampen economic activity.

Pound sterling to remain volatile

Even with the finalization of the Brexit divorce deal, there is still lack of clarity on the course of the Brexit. This implies that the pound sterling will remain volatile amidst the backdrop of trade deal negotiations. At the same time, we do not expect the pound to depreciate in the same degree as it did immediately post Brexit now that the UK has managed to clear the first milestone. In fact, if real progress is made on the Brexit deal, then pound could even strengthen from current levels. However if we reach a scenario where both the UK and EU fail to strike a deal ("no deal" scenario), then we expect the pound sterling to come immensely under pressure.

Gilts: Safe-haven demand to prove beneficial

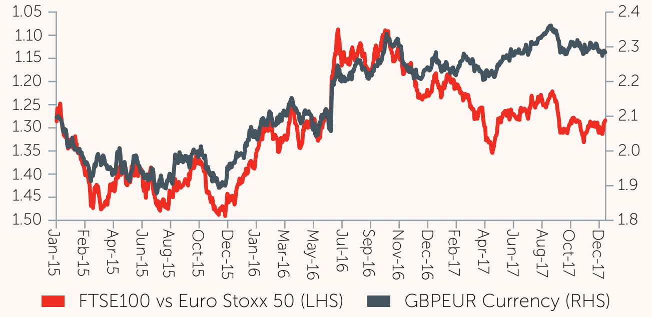
Post the BoE policy rate hike in November, gilt yields and rates have significantly corrected. Even though inflation pressures remain prevalent and well above the central bank's target due to weaker pound sterling, the Bank of England will be very prudent in raising policy rates again. This is mainly due to the lingering Brexit uncertainty even after the successful first phase of Brexit negotiations. In fact, it is quite possible that the central bank may hold a "wait and watch" approach until there is more clarity on the second round of talks focused on the trade negotiations which will be more crucial from an economic point of view.

The GBP overnight indexed swap curve is still pricing in one rate hike until end 2018. These rate hike expectations could recede especially if the second round of talks do not fall in favor of the UK and lead to more Brexit-related uncertainty. As such, dovish BoE and ongoing Brexit uncertainty will continue to spur safe-haven demand for the UK gilts.

Equity – remain neutral

UK equities have underperformed Eurozone equities in both local currency terms and US dollar terms on a year-to-date basis. Most of this underperformance could be attributed to the regain of pound strength versus the dollar ahead of the BoE rate hike expectations. Post the rate hike, the pound has strengthened on the back of successful breakthrough of the first phase of Brexit divorce deal. Brexit-related risks are expected to linger with the focus now shifted to the second round of talks involving the more complex trade deal. While we expect the pound sterling to remain volatile, significant downward pressure on the pound sterling appears unlikely. As such, limited pound weakness will not add much gains to the UK equities. FTSE 100 companies derive almost 70% of their revenues from overseas and thus pound sterling needs to weaken significantly for the FTSE 100 to outperform other global market peers.

FTSE 100 tends to outperform with a weaker GBP



Source: Bloomberg

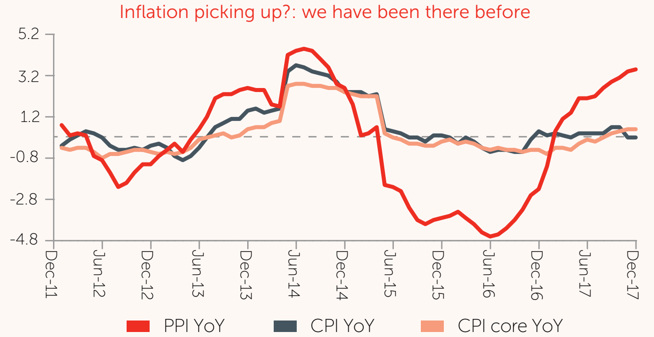
Economy doing very well, time for BoJ to join monetary policy normalization?

Doing better is not enough

Economic growth and, critically, wage growth and consumer price inflation have been doing exceptionally well, that is for Japanese standards of course. It is important to point out that if these domestic indicators are doing so well, the current improvement might well last through the end of 2018 for a simple reason: Japan should profit disproportionally from the global economic upturn given that it is the quintessential export country. In addition, the country signed very recently a free trade agreement with the European Union, the largest free trade agreement in the world. Japan can only profit from more export opportunities to such a huge market as the European Union. Given the rather rosy scenario, plus the consideration that Mr. Abe has won the election and will further proceed with fiscal policies – such as amongst others also increased defence spending - that are stimulating the economy, it comes only natural to ask when the BoJ will start with normalizing monetary policy, just as has already been done by the Fed, the BoE and the ECB. Such action – in particular the tapering of (the growth rate of) the central bank's balance sheet - would likely strengthen the yen which, in turn, would have adverse effects on Japanese equities.

There are two strong arguments -against a massive policy reversal, as well as against a massive appreciation of the Japanese yen. First, whilst inflation is picking up nicely, it is still very low and, critically, it is not the first time that we have seen a similar pick-up which was then later undone. In other words, deflationary expectations are still deeply entrenched. The Bank of Japan is still not in a position to declare victory over those deeply entrenched expectations. Secondly, in fact the Bank of Japan is already pursuing a monetary policy that continues to increase the balance sheet but not at a continuous pace. More specifically it is buying paper with a view of pursuing a zero yield on long-term bonds, and negative yields on other paper. This policy maybe more sustainable than simply acquiring monthly fixed instalments of outstanding paper. What really matters is that it will prevent the Japanese yen from significantly appreciating so that inflation does not come down.

Inflation picking up?: we have been there before

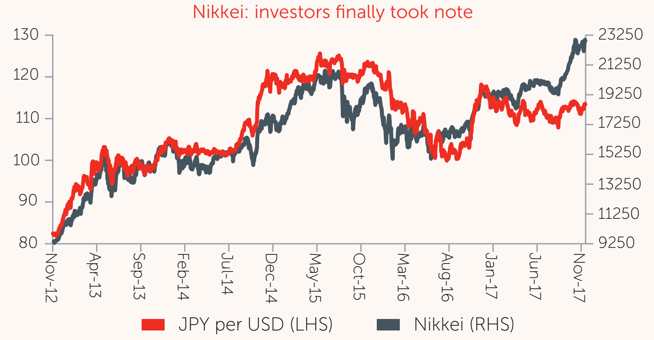


Source: Bloomberg

Equity – remain overweight

We have had a currency-hedged overweight on Japanese equities since October 2016 now. In relative terms we had been a bit disappointed about our call's performance, since we expected that Japanese equities were to outperform in an environment where the BoJ policy is relatively accommodating and thus the yen is not particularly strong. The pick-up that we have seen over the last three months has finally vindicated our stance.

Nikkei: investors finally took note



Source: Bloomberg

It is perhaps notable too that the last three months pick-up, while largely driven by monetary and foreign exchange rate policy, did not coincide with a continuing depreciation of the yen. This tells us that there are more things at play. Japanese companies definitely profit disproportionally from global growth. The recent Free Trade Agreement between Japan and the EU is also helpful since the EU is the economic area that is mostly recovering from previously anaemic growth. And as mentioned earlier in this page, Japan seems to have a stable government that is pursuing reforms and spending, not something obvious amongst today's advanced economies. However, whilst we would argue that the environment is generally positive for Japanese equities, we would insist that the prospect of massive yen strengthening would alter our view. As such the key risk to our call is not only in change in the Bank of Japan's monetary policy, but also an increase in global risk perception. Whenever the markets switch to a risk-off mood, the yen appreciates. This would be bad for our currency-hedged call on Japanese equities.

The new "Great Helmsman" will act

Xi Jinping reaches almost Mao status

Xi Jinping Thought has been enshrined in the Communist Party's constitution, an honour before only bestowed on Mao Zedong, the "Great Helmsman" and founder of the PRC. Deng Xiaoping, who opened the country to global markets, did not receive the same authority (the constitution only refers to Deng Xiaoping Theory, considered a notch lower than Thought).

The new Great Helmsman's plans are growth dampening

Markets are fascinated by Xi Jinping's rise to absolute power and wonder about his motives. Since it always "takes two to tango", it might be worthwhile to have some thoughts about why the party went along with it, breaking with a tradition of collective leadership that had lasted for almost three decades. The reality is that over those three decades growth was spectacular but now the Communist Party will need something else that justifies their hold on power, i.e. no longer strong growth but a strong man with a great vision. That vision has therefore been enshrined into the Party's constitution as the Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era. In other words, the implementation of Mr. Xi's Thought starts with the recognition that China can no longer grow at the current almost 7% per year rate, and that it will gradually curtail inefficient investments. As a result the economy's growth will become much closer not only to the average of emerging markets, but indeed to the growth rate of the fastest advanced economies, i.e. something in the order of 3%.Mr. Xi is popular because he is seen as a fighter against corruption. Thus the reigning of credit in the overheated real estate sector as well as to the inefficient state owned enterprises, indeed the unwinding of some of those enterprises, is bound to reduce economic growth and create hardship. Yet, to the extent that Mr. Xi's anti-corruption campaign will continue to clean the party at the highest levels he should be able to reduce inefficient investments, "normalize" growth and maintain political stability.

Macro-management has improved

There are reasons to believe that in 2018 China might succeed in muddling through again. A favourable global growth scenario combined with an improved management of the external exchange rate are less likely to lead to capital outflows, which would put pressure on the country's forex reserves, and thus its capacity to reduce stimulus in a gradual manner. As for the global growth scenario, synchronized growth – specifically between the US and the Euro-zone – is likely to prevent major currency oscillations, i.e. a strong US dollar rally is unlikely such that investors will have less doubts about the need to safeguard the country's exchange rate. At the same time, the PBoC has allowed for increased exchange rate volatility, stepping back from excessive utilisation of foreign reserves. To the extent that President XI Jinping intends to reinforce party control he will pursue only gradual reduction of investments in state owned enterprises. He might be able to do just that in 2018, allowing the country to muddle through and postponing the solution of the country's debt accumulation once more into the future.

Equities – remain underweight

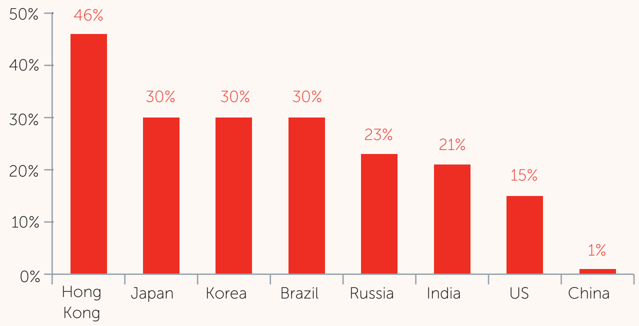
So far the underperformance of both A and H-shares versus emerging markets has continued. Whilst the underperformance versus emerging markets (especially that of A-shares) might somewhat moderate with the decision by index provider MSCI to begin including A-shares into the main emerging markets index from May 2018, many emerging markets will overall remain under pressure as long as the Fed continues to tighten and as long China continues to deleverage.

Thus while one can well make a long-term call on Chinese equities because of them being under-owned by foreign investors, 2018 seems just not to start on a right note neither for emerging equities in general, nor for China equities in particular.

Investments to pull further growth slowdown

Source: Bloomberg

Percentage of market cap owned by foreign investors



Source: HSBC, CSRC, SZSE, JPX
Note: China data May 2017, Japan data end of 2015 and other data March 2015

Growth to pick-up gradually

Growth to rebound but wary of fiscal slippage risks

Domestic growth has shown some signs of recovery post the GST roll-out in July, indicating that the economy is slowly adjusting to the new tax implementation. GDP grew at 6.3% in 3Q 2017, putting an end to the five consecutive quarters of growth slowdown. Strong recovery in manufactory activity which contributed the most to the 3Q growth, also signals that the initial negative impact of the GST has slowly begun to fade as more and more businesses are getting familiar with new GST rules. However, activity in services sector, which contributes more than 50% to the overall growth has decelerated in the 3Q. Recent high-frequency indicators suggest a mixed picture for overall economic activity. While manufacturing PMI recorded the highest number in 6 months in November, services PMI fell into the contraction territory. Overall, we expect economic activity to pick up slowly in the near term and long-term growth potential looks promising on the back of government's structural reform agenda.

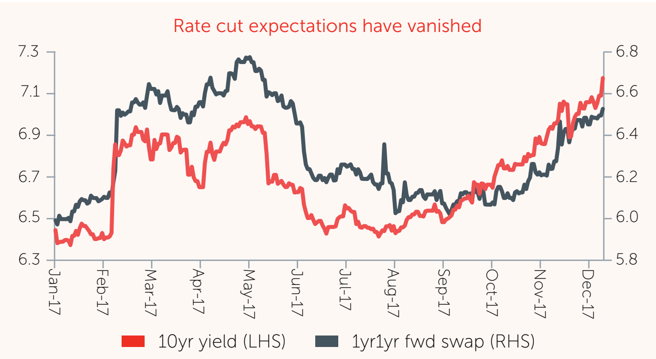
In spite of concerns on growth outlook, investor interest has been strong and received an added boost by the surprise rating upgrade. Moody's raised the country's sovereign rating to Baa2 from Baa3, for the first time since 2004, citing "continued progress on economic and institutional reforms will, over time, enhance India's high growth potential". However, this was not followed by a similar upgrade by the S&P ratings given the rating agency remains concerned about the country's low per capita income, sizeable fiscal deficit and high government debt relative to similar-rated peers. We do share S&P's concerns on fiscal outlook. GST tax receipts have not been as significant as expected and with lower government revenues, the fiscal deficit during April-October period has already reached INR5.25trn or 96% of the financial year target. While the government has expressed its commitment to the fiscal deficit target, continuous weakness in tax receipts and overall revenue could make this goal difficult to achieve. As such, we remain wary of any fiscal slippage risks.

Bonds: Stay neutral

Indian government bonds have been under selling pressure since the last central bank rate cut in August. Even the surprise Moody's rating upgrade failed to have much of an impact on the bond market sentiment. The 10yr government bond yields have risen on the back of market concerns of inflationary pressures, fiscal slippage risks and RBI's OMO sales. However, the RBI's less hawkish stance at the latest MPC meeting has ruled out the possibility of a rate hike. At the same time, any chance of monetary easing are dim on account of inflation risks and fiscal uncertainty. Inflation pressures are expected to rise in the near term, driven by higher food prices, rise in global oil prices and increase in house rent allowances. In addition, fiscal uncertainty is also likely to weigh on the sentiment with market already feeling the pinch of high bond supply and OMO sales (drainage of interbank liquidity). On the demand side, injection of capital into public sector banks will also reduce banks appetite for long-duration government bonds. As such, we maintain our neutral stance on government bonds.

Equities: remain overweight

Indian equities have been one of the best performers so far this year, aggregating a year-to-date return of 32% in dollar terms versus 19% for global equities. Though, foreign interest in Indian equities has waned over past two months as investors booked profits with valuations soaring above average amidst renewed fiscal concerns. Nevertheless, local demand has sustained and has largely substituted for sales from overseas investors. Long-term growth outlook appears positive with short-term disruptions triggered by demonetization and GST implementation slowly fading away. Growth already appears to have bottomed out as indicated by the pick-up in GDP growth recently. As such, steady pick-up in economic activity should boost corporate earnings which have been disappointing. A turnaround in rural consumption, MSP hikes, farm loan waivers along with government initiatives of targeted infrastructure spending and recapitalization of PSU banks should improve the investment outlook. While improving growth and RBI's neutral strategy should prove supportive for equity markets, a repeat of two consecutive years of bull-run looks challenging as valuations have turned expensive. Nevertheless, markets' relative insularity to external factors and long-term growth prospects explain our overweight stance on the equity markets.

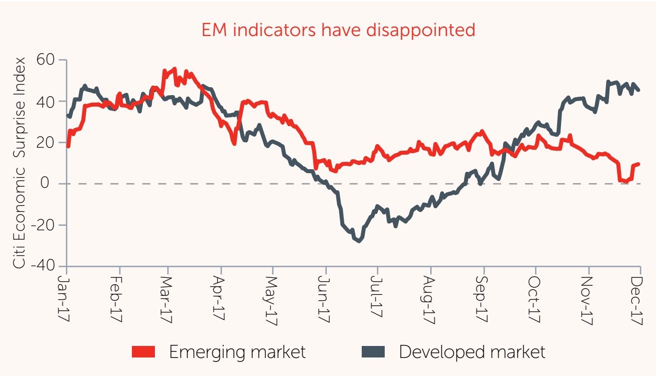


Source: Bloomberg

Optimism to wane in 2018

Dollar strength and China tightening are major risks

There are no doubts that synchronized global growth has spilled over to the emerging economies in 2017. Improving economic activity outlook managed to bring out weak economies like Brazil and Russia out of recession. Sustained weakness in dollar, improvement in corporate earnings and China's expansionary policies encouraged investments into these economies. However, this optimism is unlikely to continue going into 2018. In fact, market participants have been way too optimistic about economic activity in the EM given most of the economic indicators have surprised on the downside. We have raised our concerns on dollar strength being a potential threat for the emerging market as these economies are highly dollar leveraged. Pressure on EM currencies has already been evident since the beginning of September. Given our expectation of further dollar appreciation, we expect EM economies to remain under pressure, particularly with weaker fundamentals like Turkey and South Africa. In addition, China deleveraging could pose risks for economies which are heavily reliant and have strong trade linkages with China, including Asian economies.



Source: Bloomberg

Less dovish EM central banks means growth not to surprise on the upside

The benign inflation environment which most of the emerging markets took benefit from, is unlikely to be seen in 2018. Price pressures are biased to move upwards, mainly fueling from the rise in energy prices. This implies that the EM central banks, particularly in countries where growth is still at low levels, will not have enough room to ease policy rates. As such, with potential for monetary easing likely to be tapering out, the possibility of any upward surprises in growth is likely to be limited.

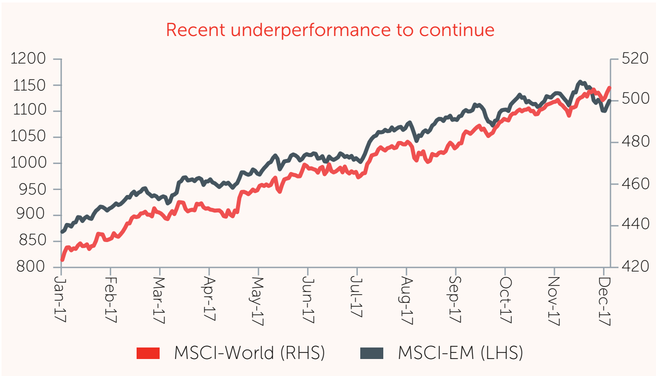
EM Bonds- Remain selective

Emerging market bonds have been one of the best performers in the global fixed income space in 2017. However, appetite has eased since September on the back of increased Fed rate hike expectations as indicated by the rise in 2yr US Treasury yield and strength in dollar. Compared to EM equities and currencies, the sell-off in the dollar bond markets has been resilient. This could be on account of relative improvement in EM fundamentals, particularly in their external buffer indicators. However, economies with weak fundamentals and dominant local risk factors like Turkey and South Africa remain under pressure.

Potential dollar strength and relative rise in US yields will impact appetite for emerging market dollar sovereign bonds. Having said that, we still selectively prefer economies with strong external balances, improving fiscal certainty and reform potential. In addition, rise in energy prices in 2018 is likely to prove favorable for commodity exporting countries with scope of strengthening their fiscal balances. We maintain our preference for Russia and Indonesia bonds. Dollar bonds in Latin America were the favorites of bond investors in 2017, led by Brazil and Mexico. However, political uncertainty is expected to rise in both the countries with elections scheduled in 2018.

Equities – remain underweight

While emerging market equities have outperformed the global equities on a year-to-date basis, the level of outperformance has reduced since September. This corresponds to the same time when the dollar strength started to regain ground after bottoming out in end-August. Emerging market equities had benefitted most out of the die down of "reflation trade" and weakness in dollar. However, with the US most likely to succeed with corporate tax cut reform and dollar strength to stay its course into next year, investor rotation out of emerging market stocks is likely to take place. In addition, China tightening risks have now increased post the completion of National Party Congress and emerging markets' overall vulnerability to China could add further weakness to the emerging equities asset class next year. As such, we maintain our underweight stance on the emerging market equities.



Source: Bloomberg

Appendix

GDP Forecast	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.5%	In agreement	2.1%	Expect moderately less
Eurozone	2.0%	In agreement	1.7%	Expect moderately less
Japan	1.2%	In agreement	1.0%	Expect moderately less
China	6.4%	Expect moderately less	6.2%	Expect significantly less
India	6.7%	In agreement	7.4%	Expect moderately less

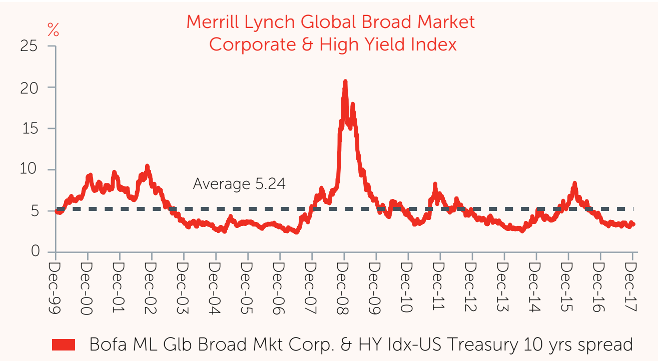
Source: Bloomberg

CPI Forecast YoY	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.1%	Expect moderately less	2.2%	In agreement
Eurozone	1.5%	In agreement	1.6%	In agreement
Japan	0.8%	In agreement	1.0%	In agreement
China	2.3%	In agreement	2.2%	Expect moderately less
India	3.5%	Expect moderately more	4.5%	In agreement

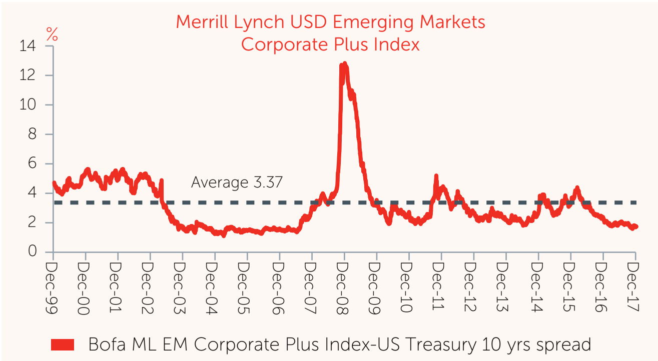
Source: Bloomberg

In agreement | Expect significantly less | Expect moderately less | Expect significantly more | Expect moderately more

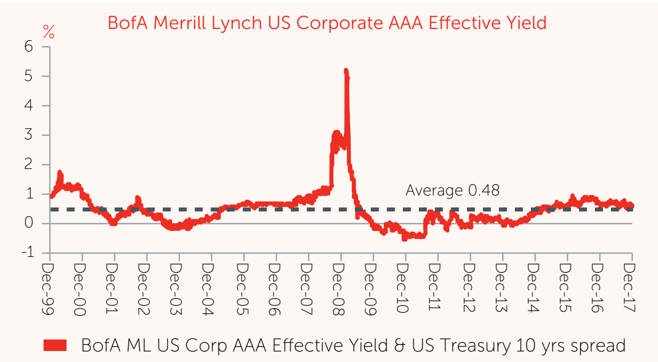
Bond Market Spreads



Source: Factset, Federal Reserve Bank of St. Louis



Source: Factset, Federal Reserve Bank of St. Louis



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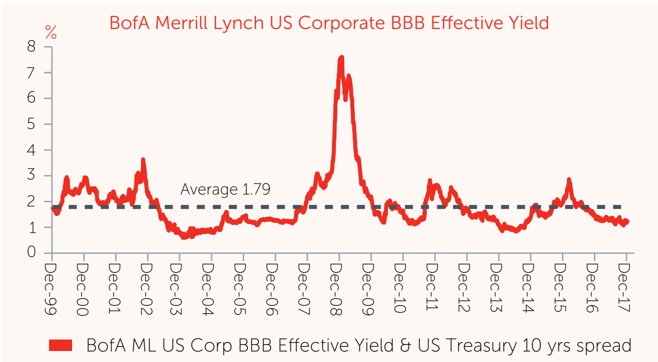
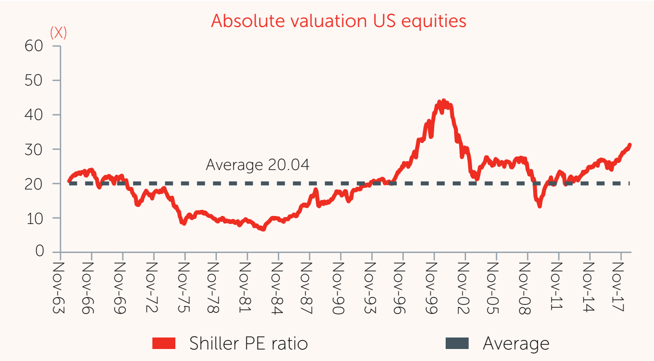
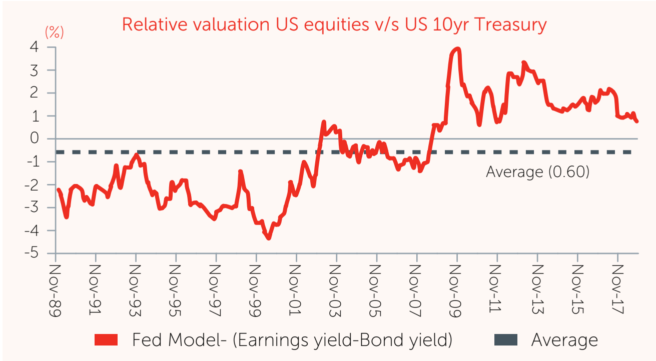


Source: Factset, Federal Reserve Bank of St. Louis

Equity Market Valuations



Source: Thomson Reuters, multpl.com



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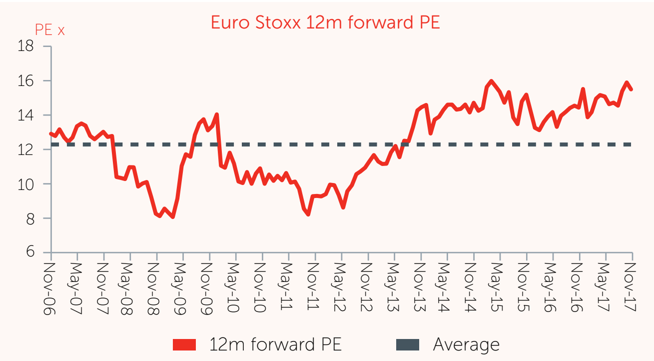

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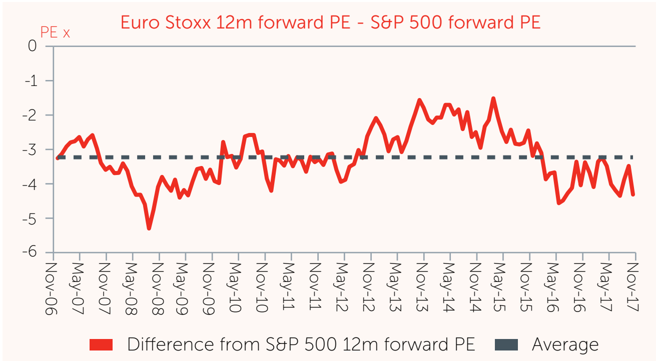

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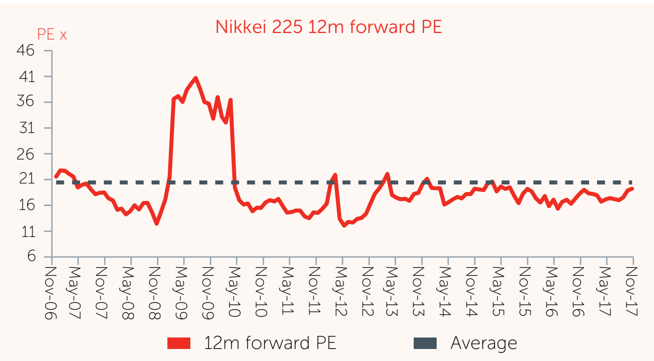

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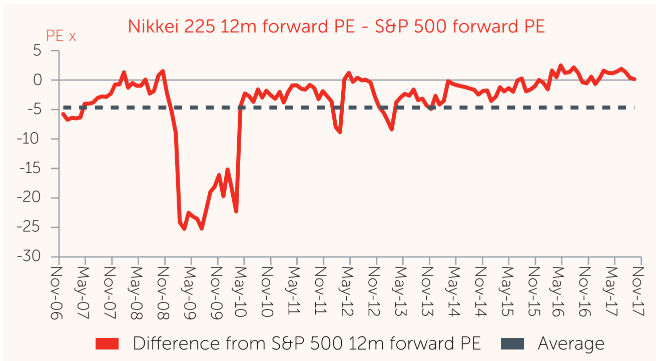

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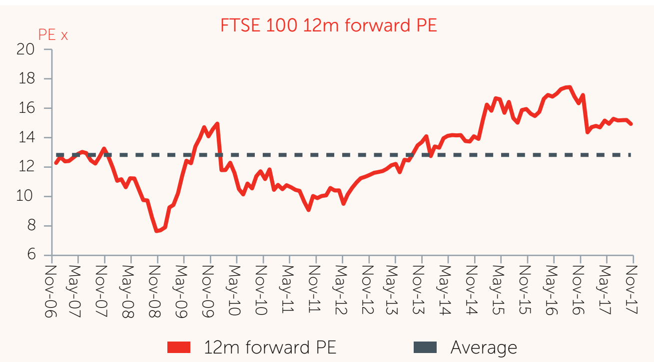

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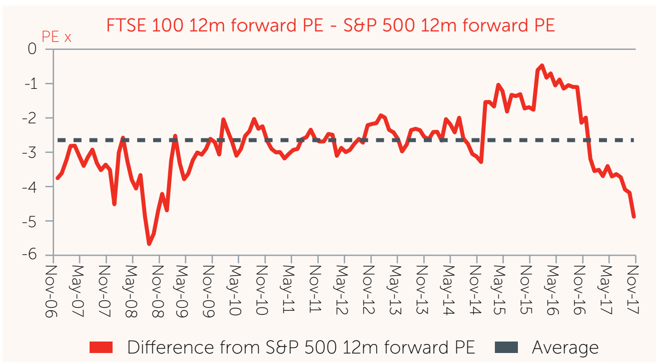

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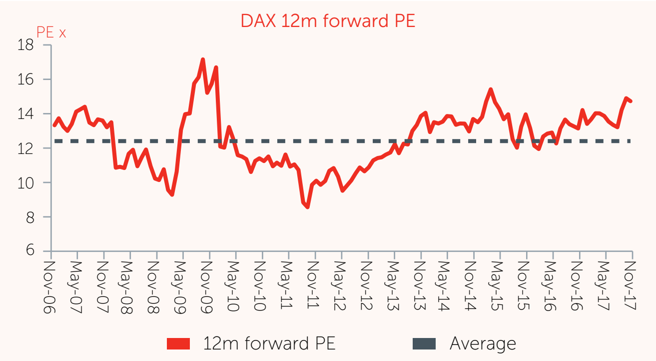
Equity Market Valuations



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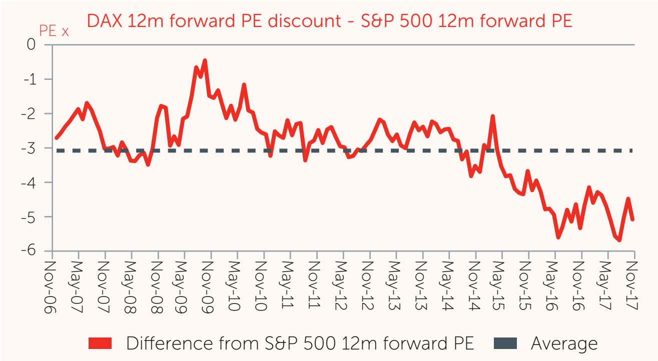

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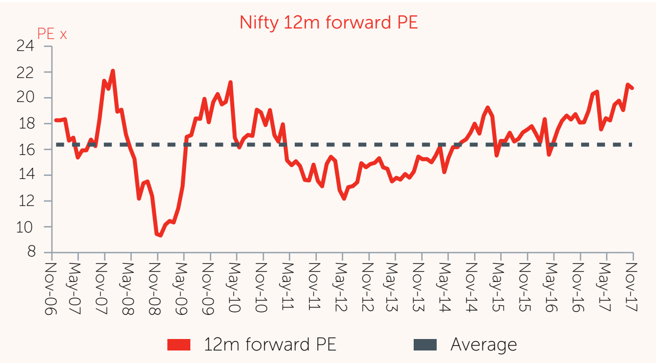

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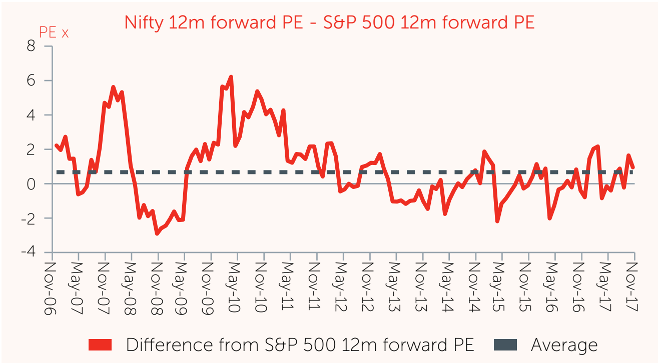

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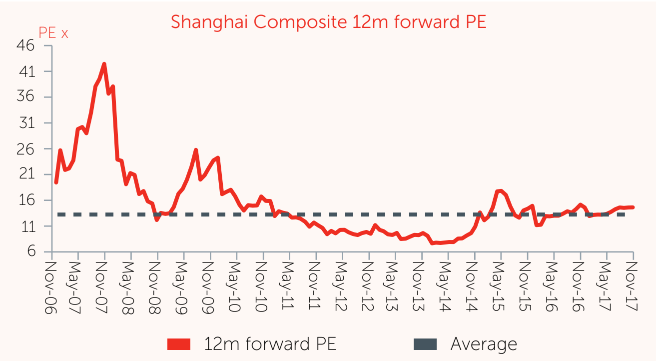

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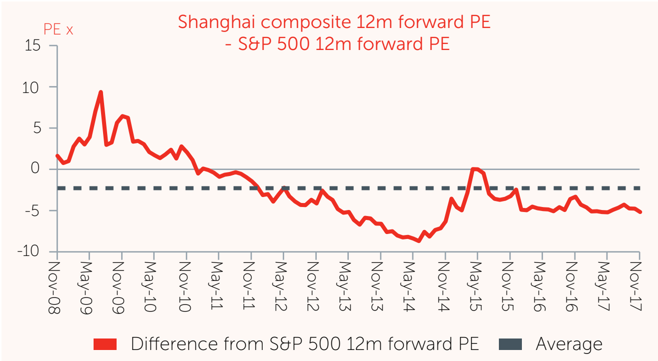

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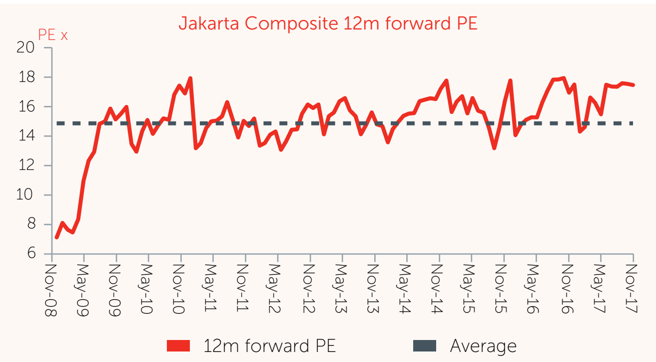

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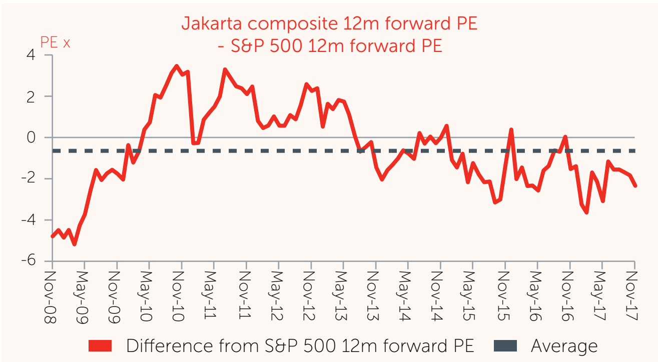

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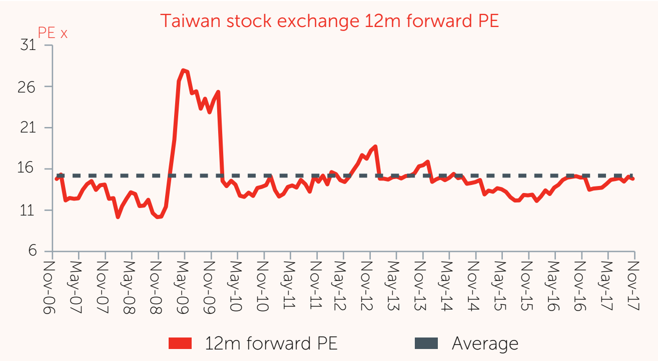
Equity Market Valuations



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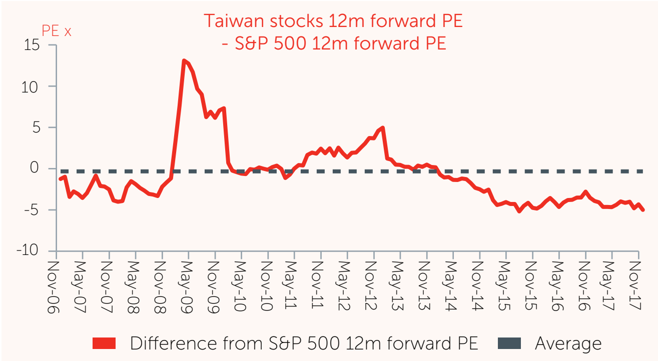

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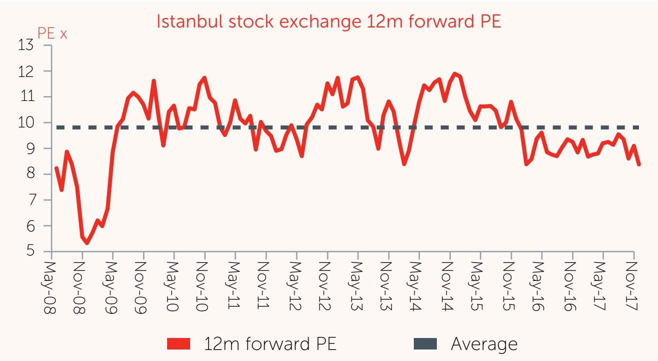

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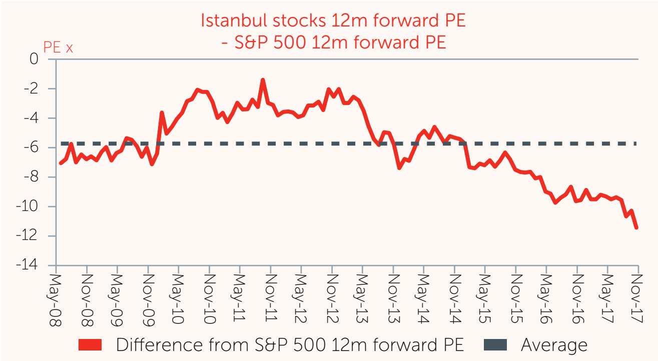

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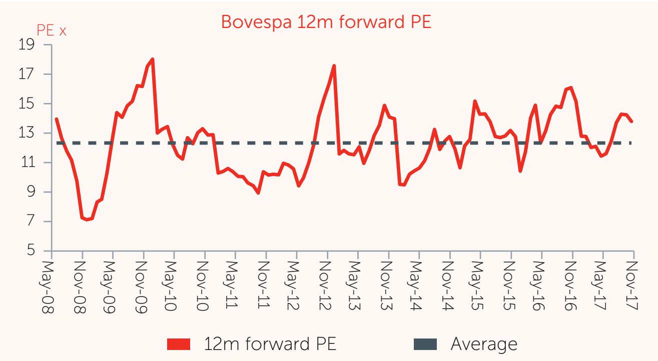

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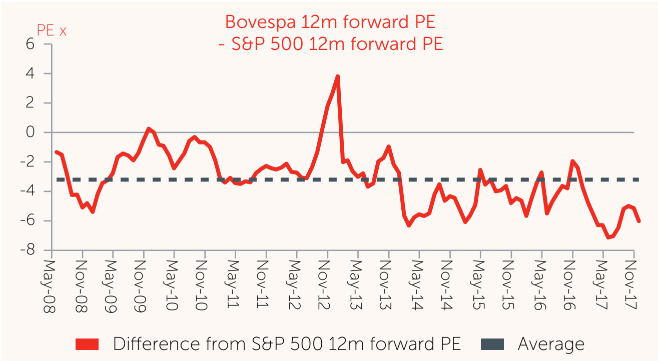

Source: Bloomberg

Notes

Important Information

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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