The Week Ahead: UK PM's speech and China GDP data in focus

Economics Team

Monica Malik, Ph.D.
Chief Economist
+971 (0)2 696 8458
Monica.Malik@adcb.com

Shailesh Jha
Economist
+971 (0)2 696 2704
Shailesh.Jha@adcb.com

Contents

I. Recent Events and Data Releases 2
II. Economic Calendar 9

US: December inflation data to show price pressure building

The key US economic release this week will be the December inflation data (due 18 January), which we expect to show a build up in price pressure. Consensus estimates that headline inflation strengthened to 2.1% y-o-y (0.3% m-o-m), up from 1.7% y-o-y (0.2% m-o-m) in November, largely on the back of higher energy prices. An acceleration in food prices is also forecast to support the rise in headline inflation. Core inflation is expected to rise in December to 2.2% y-o-y (November: 2.1%), despite the monthly increase remaining steady at 0.2% m-o-m. Rental price increases have been a key driver of core inflation in 2016. A further strengthening in core inflation dynamics in 2017 is behind our expectation of two rate hikes by the Fed in 2017. We believe that the critical factor will be the ongoing tightening in the labour market and its impact on core inflation. The UK and Eurozone (final print) are also anticipated to see an acceleration in headline inflation in December. On the political front, Donald Trump will be inaugurated as the 45th president of the US on 20 January.

Europe: ECB to remain on hold, British PM May in focus

Markets will closely monitor any potential comments by the British PM Theresa May on a possible Brexit trade deal between the EU and UK, in her address to the nation (17 January). Recent comments have suggested that the ruling Conservative party is unlikely to accept free movement of labour from the EU, which increases the likelihood of the UK pulling out of the Single Market completely (hard Brexit). May is also looking to secure the ability to negotiate trade deals with third parties independently, rather than jointly with the EU. Any strengthening in market expectations of a hard Brexit could imply further depreciation in the GBP and a sell-off in gilts (see page 4). Meanwhile, we expect the ECB meeting (19 January) to be comparatively uneventful, after an extension of the QE programme was announced in December. The ECB will likely emphasise an accommodative stance this year, despite acceleration in inflation in December.

China: GDP data to remain resilient despite market volatility

We expect Chinese GDP growth to print at 6.7% y-o-y in 4Q2016, broadly in line with the consensus and steady at its 3Q level. Growth is likely to remain well supported by fiscal spending, outweighing the impact of the recent volatility in the CNY and a surge in interbank rates (see page 5). Credit data released last week showed that aggregate lending in the economy accelerated in December, including a modest pick-up in corporate borrowing. We expect lending by development banks and off-budget fiscal spending to have supported corporate investment in 4Q2016. We also expect the industrial production and fixed investment data for December to surprise on the upside, boosted by a sharper-than-expected upturn in infrastructure investment.

I. Recent Events and Data Releases

A. MENA Economies

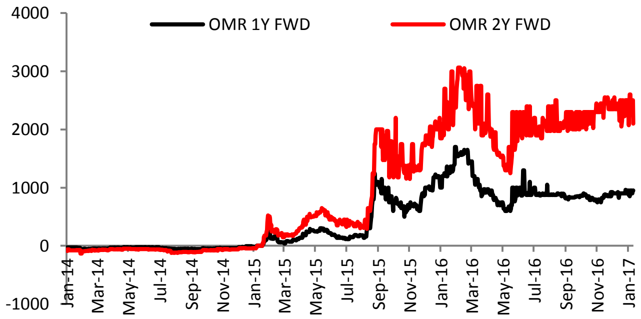
Oman: No change in OMR's peg to USD expected

Speculation against OMR's peg to USD has gradually risen from end-2016

Oman's Ministry of Finance has denied media claims that Oman is looking to secure deposits from other GCC countries, aimed at raising its FX reserves. Oman noted that it has "sufficient reserves and there is no risk to the value of the Omani rial". Speculation of a weakening of the OMR against the USD has gradually increased since end-2016 (as reflected in the forward markets), albeit it remains below the levels seen in 1Q2016. There is greater speculation in the two-year space, and the OMR is now seeing greater selling pressure than the SAR. Within the GCC countries, Oman's peg to the USD is seen as being the most vulnerable given the country's relatively lower FX reserve position compared to its regional peers. Fiscal consolidation in Oman was weaker than in some other GCC countries in 2016, especially in terms of retrenchment of government spending, and we expect a fiscal deficit of -16.5% of GDP for 2016. Speculation against the SAR has moderated with the rise in oil price and reforms to lower the fiscal deficit.

Fig. 1. Oman: Weaker FX reserves position than other GCC countries, supporting speculation against OMR

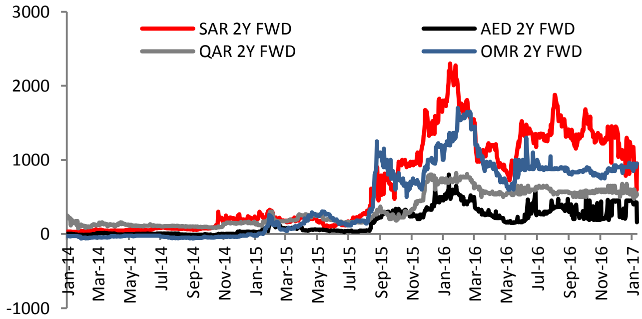
Swap points



Source: Bloomberg

Fig. 2. GCC: OMR seeing greater selling pressure than SAR in 2017

Swap points



Source: Bloomberg

Fiscal buffers still supportive of OMR peg, though fiscal consolidation required

We do not expect a change in the OMR's peg to the USD in the short to medium term, as the benefits (including anchoring FX and inflation expectations) outweigh the negatives. Any potential benefit to government finances from higher oil revenues in OMR terms would be more than outweighed by the associated surge in import costs, in our view. Meanwhile, a move to a more flexible exchange rate would require use of FX reserves to support the OMR at times of lower oil prices or heightened speculation, which would require greater FX intervention to maintain OMR stability. Official comments indicate a strong commitment to the peg. Oman's FX reserve position remains comfortable, with total FX reserves at some 45% of GDP (including NFAs in the banking system and holdings of SWFs). Government debt levels also remain low, estimated at around 20% of GDP in 2016. Nevertheless, it is critical that Oman lowers its fiscal deficit so as not to erode its fiscal and macroeconomic buffers.

External borrowing likely important for financing 2017 fiscal deficit

We forecast that Oman's fiscal deficit will narrow to around -13.8% of GDP in 2017 with the rise in oil revenues. We believe that the government will rely heavily on external debt issuance to help finance the 2017 deficit. This would reduce the pace of FX reserve drawdowns and liquidity tightening in the domestic banking sector. We expect Oman to issue further international debt in 2017, possibly around USD2-3 billion. Oman has already invited banks in early January 2017 to submit proposals for an international bond issue. The country raised some USD3.5 billion in international bonds and syndicated loans in 2016 to help cover its fiscal deficit.

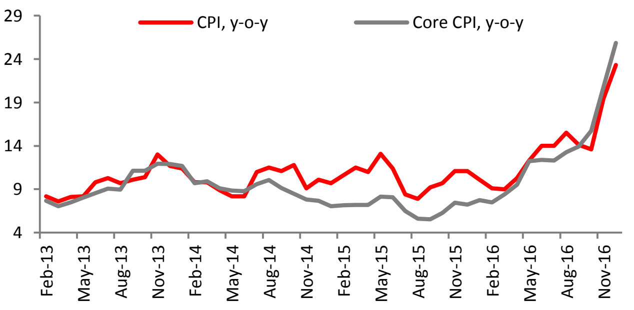
Egypt: Inflation accelerates to 23.3% y-o-y in December

Most components of inflation basket seeing double-digit yearly price increases

Consumer price inflation in Egypt strengthened to 23.3% y-o-y in December 2016, up from 19.4% in November. We had expected to see inflation accelerate above the 20% level with the floating of the EGP in November and its subsequent weakening, alongside fiscal reforms (subsidy reductions and the introduction of VAT). This was the highest yearly increase in over seven years. The monthly rise moderated to 3.1% m-o-m in December, from 4.8% the previous month, albeit still showing a solid build-up in inflationary pressures. The December price inflation also reflects the second-round impact from the fiscal reforms and strengthening commodity prices. Most areas are seeing a double-digit yearly increase in prices, with food inflation up 28.3% y-o-y (the food category accounts for nearly 40% of the inflation basket). The acceleration in food prices was driven by the effect of the EGP devaluation on imports, whilst fuel price increases pushed up distribution costs. Moreover, health inflation accelerated to 32.9% y-o-y and transportation to 23.2%. Core inflation increased to 25.8% y-o-y, up from 20.7% in November.

Fig. 3. Egypt: Inflation sees further strengthening in December and will remain elevated in 2017

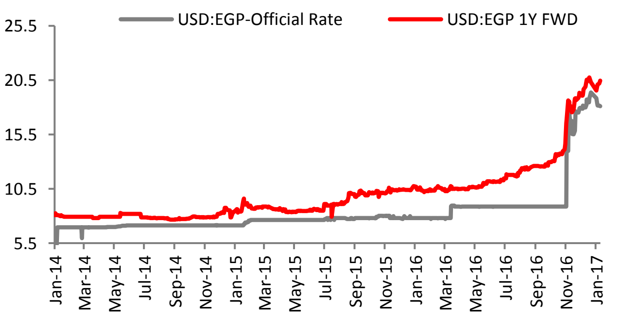
% change y-o-y



Source: CAPMAS

Fig. 4. Egypt: Weakening in EGP since November and fiscal reforms have increased inflationary pressure

USD:EGP



Source: Bloomberg

Economic reforms vital but rise in inflation will dampen private consumption

Inflation is expected to remain elevated over the next year at an annual average of c.20.5% as the devaluation continues to feed into the annual prices. Moreover, we expect further fiscal reforms in 2017, including further reductions to fuel subsidies and a 1pp increase in VAT to 14%. The pick-up in inflation will place downside pressure on private consumption. We only expect to see a meaningful deceleration in inflation at end-2017, though any appreciation of the EGP (on increased capital inflows) would be positive. We expect a further 75-125 bps of rate hikes by the CBE to reduce secondary inflationary pressure. Nevertheless, the EGP liberalisation and fiscal reforms have been vital for improving the medium-term structure of the Egyptian economy, securing the IMF deal and accessing wider capital inflows, as well as reducing FX shortages. Official indications suggest that Egypt will start a roadshow for an international bond issuance from 17 January, with the size expected at USD2-2.5 billion.

GCC: Countries start reducing oil production in line with OPEC agreement

Production cuts expected to take some time to be fully implemented

GCC countries have started reducing their oil output, in line with the joint OPEC and non-OPEC production agreement secured at the end of 2016. The magnitude of the cuts by individual countries has not been disclosed, though Kuwait has indicated that the OPEC cuts announced so far amount to c.60 to 70% of the promised curbs. Overall, the process of lowering production will be staggered, and the full output reduction will take time to implement given existing commercial and logistical commitments. The output targets agreed are aimed as an average for 1H2017, though we continue to highlight our concerns regarding compliance. Market indications suggest that of all the countries involved in the deal, the GCC states have been among the most proactive in lowering their output. Both Saudi Arabia and Kuwait have indicated that they have reduced production by more than the committed amount, with Saudi output lower than 10 million bpd. GCC output cuts have generally targeted US and Europe, whilst trying to maintain market share in Asia. A number of GCC countries have brought forward maintenance works, scheduled for 2H2017 or 2018, to take advantage of the lower production levels.

Higher oil price provides some space to reduce pace of fiscal tightening

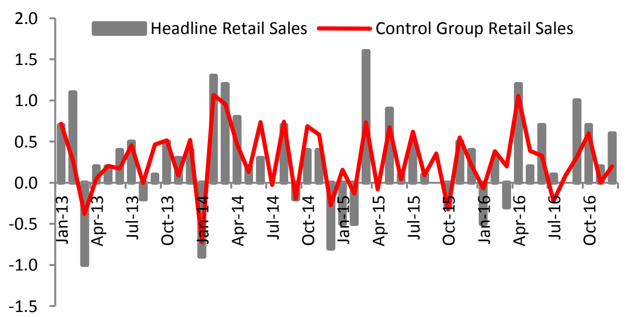
The agreements came into effect on 1 January, with a combined targeted reduction of 1.8 million bpd from OPEC and 11 other producers (including Russia and Oman). There were already some indications that the OPEC countries had started to reduce production in December, albeit from record levels. Data releases in early February will indicate the magnitude of the GCC production cuts in early 2017. The oil sector is expected to be a drag on GCC growth in 2017 in real terms (output changes are included but not price changes in real GDP calculations) after seeing strong growth in 2016. However, the price gains will be positive for narrowing fiscal and current account deficits, resulting in a weaker pace of fiscal austerity in 2017.

B. G4 Economies

US: Retail spending solid, showing ongoing consumption momentum

Fig. 5. US: Retail sales grew by solid 0.6% m-o-m in December, supported by auto and gasoline sales

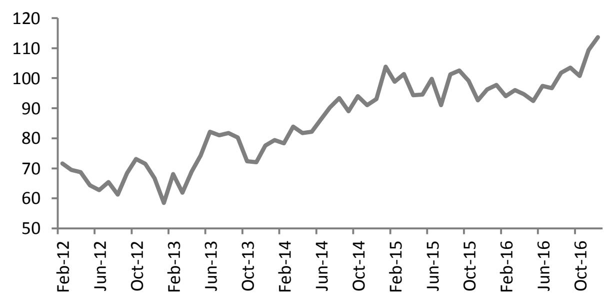
% change m-o-m



Source: US Census Bureau

Fig. 6. US: Consumer confidence rose in 2H2016, with strong readings in November and December 2016

Index



Source: Conference Board

Gasoline and autos behind strong retail spending growth in December

Retail sales accelerated to 0.6% m-o-m in December (consensus: 0.7%), up from 0.2% in November. The strengthening was largely driven by increased spending on gasoline and autos. Gas station sales rose 2% m-o-m (due to higher prices), whilst auto sales jumped

2.4%. Excluding the volatile categories, control retail sales (which feeds into GDP data) rose by a more measured 0.2% m-o-m (November: 0%, consensus: 0.4%). One factor in the softer outturn versus consensus was the -0.8% m-o-m fall in restaurant sales, likely due to colder weather. Other areas of consumption saw solid growth, including online sales which increased by 1.3%. The data continues to point to healthy household spending at end-2016, which we expect to continue into 2017 with consumer confidence remaining elevated. The rise in wages (as reflected in the December payroll data) should also underpin consumer expenditure, though the acceleration should be limited by the rise in gasoline prices. Average hourly earnings rose 2.9% y-o-y in December, the largest gain since June 2009.

No tangible details of new administration's economic policy

Expectations of tax cuts under the new administration are likely supporting private confidence since the presidential election in November. However, there has so far been little detail on actual economic policy, including in Donald Trump's first official press conference as president-elect on 11 January. The focus in the speech was on bringing investment and jobs back to the US. Trump reiterated plans for a large border tax for companies that move their manufacturing offshore.

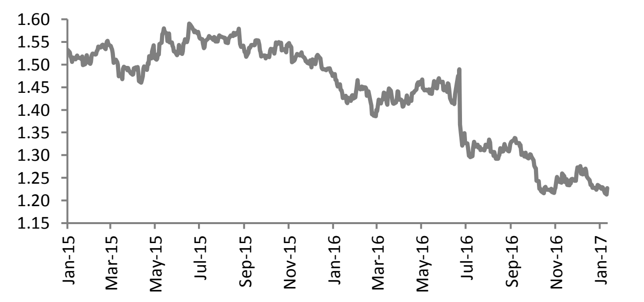
UK: GBP plunges on Brexit concerns, despite resilient economic data

GBP weakness indicative of market concerns regarding hard Brexit

The GBP remains on a choppy downwards path so far this year, falling to a three-month low of 1.21 against the USD on 10 January. We see the GBP moves (up or down) as a gauge of market expectations on the severity of the Brexit deal. The recent slide in sterling came after comments by Prime Minister Theresa May suggested that the UK would prioritise exercising full control over its immigration policy over seeking any trade concessions with the EU. The next key event for the GBP and UK assets in the coming weeks will be when a formal proposal to trigger Brexit by invoking Article 50 goes to a vote in parliament (expected by mid-February). In our view, given the political and public support for immigration controls in the UK, the possibility of a "hard Brexit" has increased. Media analysis from the UK suggests that PM Theresa May is likely to declare her preference for a full break from the EU Single Market, if the EU continues to demand free movement of people as a prerequisite for a free trade deal. Despite a significant depreciation in the GBP since July 2016, we still believe that the implications of a "hard Brexit" are not yet factored in. We believe the GBP could break below 1.15 against the USD by end-2017, potentially stabilising at a level of 1.05-1.07 ("hard Brexit" scenario).

Fig. 7. UK: GBP saw fresh round of sell-offs as markets factored in probability of hard Brexit

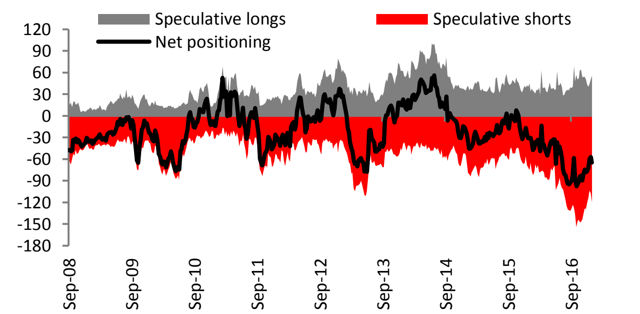
GBP: USD



Source: Bloomberg

Fig. 8. UK: Build-up in speculative short positions in GBP indicates more depreciation this year

GBP: USD futures contracts ('000)



Source: Bloomberg, US Commodities Futures Trading Commission

Meanwhile, economic data for 4Q2016 remained resilient, with IP sharply rebounding by 2.1% m-o-m in November (consensus: 1%; October: -1.1%). So far, UK economic growth has been supported by robust consumption, as consumers have remained somewhat complacent about the realities of Brexit, and a pick-up in exports. However, we expect a steady deterioration in GDP growth from 2Q2017 onwards, particularly in capex, as investment spending is likely to be held back until the contours of a Brexit deal become clearer.

We expect growth momentum to deteriorate from 2Q2017 onwards

C. Emerging Market Economies

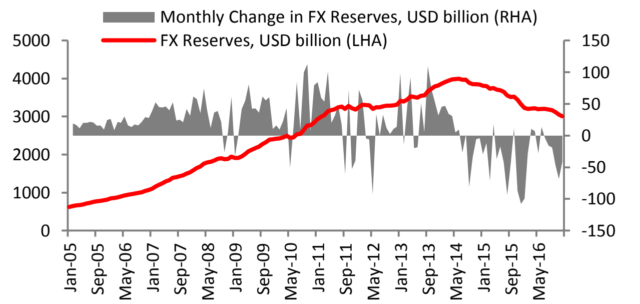
China: FX reserves continue to decline; offshore liquidity tightening

China's FX reserves declined to USD3.01 trillion in December, after falling by USD41 billion over the month. They have now dropped steadily since 2Q2014, with a cumulative USD320 billion erosion in 2016 alone. We believe that the depletion of the country's FX reserves since November 2016 (USD110 billion) largely suggests intervention in FX markets by the PBoC. However, such measures are not intended to target any specific level of USD:CNY but rather to limit a disorderly movement in the currency, as market concerns about US trade policies towards China have risen. We expect a bigger decline in FX reserves in January as the PBoC likely increased its sale of USD (spot and forward) in the Hong Kong market in order to tighten the liquidity in the offshore yuan (CNH). This has led to a surge in Hong Kong Interbank Rates (HIBOR), has increased the funding costs for short positions by traders, and has temporarily stemmed the capital outflows.

FX reserves fall by USD320bn in 2016; PBoC steps up intervention in offshore FX markets

Fig. 9. China: FX reserves have continued to fall steadily since 2Q2014

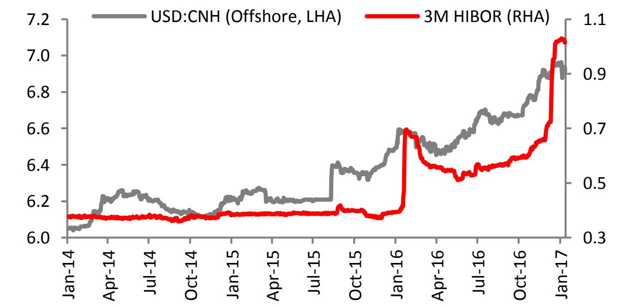
USD billion



Source: State Administration of Foreign Exchange, China

Fig. 10. China: PBoC likely intervened in FX markets, soaking up yuan liquidity and pushing up interbank rates

USD:CNH (LHA), % (RHA)



Source: Bloomberg

Despite these developments, we maintain our USD:CNY forecast of 7.30 by end-2017. We consider the recent interventions by the PBoC in FX markets as transitory for two reasons. First, the central bank is only likely to use its FX reserves to stabilise the currency in periods of extreme financial-market risk aversion against China. We expect the PBoC to limit its role in the FX markets from 2Q2017 onwards, when there is more clarity regarding US trade policies towards China, which are likely to be less extreme than those proposed by President Trump during his election campaign. Second, the policy preference for the government remains towards pegging the CNY against a diversified basket of currencies. In late December, the government announced a newly weighted FX basket (CFETS) against which the CNY will be managed, which includes currencies of 11 new major trading partners (including the AED and SAR). This marginally reduces the

We continue to see trend of weakness in CNY throughout 2017; we expect USD:CNY at 7.30 by year-end weight of the USD in the basket (to 26.3% including USD pegged currencies, from 26.4%). Since non-USD currencies in the basket are on a depreciating trend, the government's policy preference is likely to be towards a weaker USD:CNY, barring any risk-aversion episode.

Growth momentum remains more resilient than previous episode of FX volatility in 1Q2016

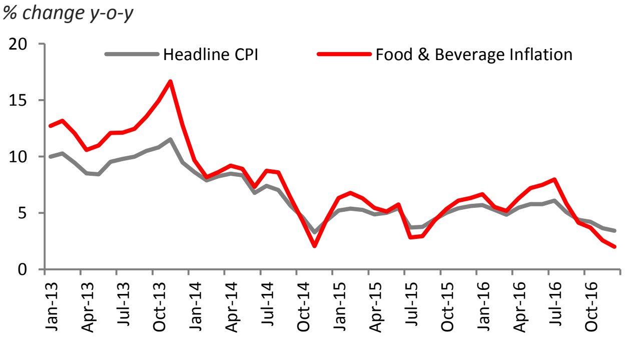
Despite the FX volatility seen over the past week, we remain sanguine about the prospects of the Chinese economy this year. We emphasise that the measures taken by the PBoC this year are not motivated by rising concerns about the strength of the underlying economic momentum, as they were in January 2016. Fiscal spending, both direct and off-budget, has remained generous over the past few quarters, and economic data continue to positively surprise the markets.

India: Macro data post-demonetisation underscores need for comprehensive stimulus

Inflation likely to undershoot RBI's target, 50 bps of rate cuts likely in 1Q2017

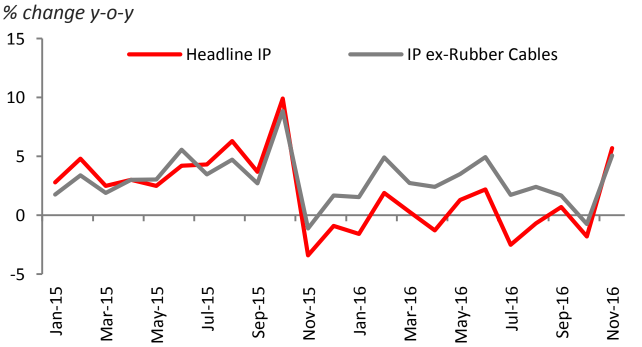
India's economic data released last week confirmed our view that a significant fiscal and monetary stimulus is required to protect the economy from the adverse short-term impacts of demonetisation. CPI inflation moderated to 3.4% y-o-y in December (consensus: 3.5%; November: 3.6%), with food price inflation softening to a five year-low of 2% y-o-y. Furthermore, core inflation also showed some early signs of the impact of demonetisation on consumption demand, slowing to 4.9% y-o-y after having remained stubbornly above the 5% mark since April 2016. We believe that the upside risks to inflation from the external factors (stronger USD and higher oil prices) are unlikely to meaningfully materialise in the near-term as domestic demand remains weak. We forecast CPI inflation at 4.2% y-o-y in March 2017, significantly undershooting the RBI's target of 5% y-o-y. In our view, this should open the room for 50 bps of rate cuts in 1Q2017, likely at the RBI's February meeting. However, from 2Q2017 inflation is expected to increase, driven by a recovery in domestic demand from the demonetisation shock, introduction of the Goods and Services Tax, relatively higher energy prices and rent allowance increases for public servants. Thus, we expect the RBI to keep rates on hold for the remainder of 2017.

Fig. 11. India: Inflation continues to soften; likely to come in below RBI's 5% target for March 2017



Source: Ministry of Statistics and Program Implementation

Fig. 12. India: We see the jump in November IP as a one-off, with contraction likely in 1Q2017



Source: Ministry of Statistics and Program Implementation

Despite pick-up in November IP, we continue to see significant weakness in investment activity

Meanwhile, industrial production registered an unexpected increase to 5.7% y-o-y in November (consensus: 1.5%; October: -1.8%). However, given the statistical quirks in the Indian IP data, we do not see these numbers as evidence of resilience in the industrial sector. In our view, November IP numbers partly showed the impact of a higher number of working days in the month in 2016, compared to last year (Diwali holidays in 2015 fell in November). Looking ahead, we expect investment activity to weaken further in 1H2017, as the demonetisation's impact on investment sentiment lingers. Indeed, new project announcements in 4Q2016 fell to their lowest levels in 10 years. Particularly, the number of investment proposals made in 4Q2016 after demonetisation on 8 November, were 47% below their pre-demonetisation levels in the same quarter. Given these dynamics, we expect the weakness in private investment to continue in 1H2017. This makes it imperative for the government to step in with a significant fiscal stimulus. In the Union Budget for FY18 (April 2017-March 2018), we expect the government to hold back on its fiscal consolidation targets, opting for a deficit of -3.5% of GDP (unchanged over FY17).

II. Economic Calendar

Fig. 13. Upcoming events and data releases

Time*	Country	Event	Period	Prior	Consensus
GCC Data					
	Kuwait	M2 Money Supply, y-o-y	Nov	5%	--
	Oman	CPI, y-o-y	Dec	1.9%	--
	UAE	CPI, y-o-y	Nov	1.9%	--
	UAE	M2 Money Supply, m-o-m	Dec	0.8%	
	Bahrain	CPI, y-o-y	Dec	1.9%	--
	Saudi Arabia	Non-Oil Exports, y-o-y	Nov	-2.8%	--
Monday, 16 Jan					
3:50	Japan	Machine Orders, m-o-m	Nov	4.1%	-1.4%
3:50	Japan	PPI, y-o-y	Dec	-2.2%	-1.4%
Tuesday, 17 Jan					
8:30	Japan	Industrial Production, y-o-y	Nov F	4.6%	--
13:00	Eurozone	ECB Bank Lending Survey			
13:30	UK	CPI, y-o-y	Dec	1.2%	1.4%
13:30	UK	CPI Core, y-o-y	Dec	1.4%	1.4%
17:30	US	Empire Manufacturing	Jan	9	8.5
17:45	US	Fed's Dudley Speaks in New York			
	UK	Prime Minister Theresa May to speak about Brexit			
Wednesday, 18 Jan					
3:00	US	Fed's Williams Speaks in Sacramento			
13:30	UK	Jobless Claims Change	Dec	2.4K	5K
13:30	UK	Average Weekly Earnings 3m/y	Nov	2.5%	2.6%
13:30	UK	ILO Unemployment Rate 3m	Nov	4.8%	4.8%
14:00	Eurozone	CPI, y-o-y	Dec F	0.6%	1.1%
14:00	Eurozone	CPI Core, y-o-y	Dec F	0.9%	0.9%
16:00	US	MBA Mortgage Applications	13-Jan	5.8%	--
17:30	US	CPI, y-o-y	Dec	1.7%	2.1%
17:30	US	CPI, ex Food and Energy, y-o-y	Dec	2.1%	2.2%
18:15	US	Industrial Production, m-o-m	Dec	-0.4%	0.6%
20:00	US	Fed's Kashkari Speaks on Economy in Minneapolis			
Thursday, 19 Jan					
0:00	US	Fed's Yellen Speaks in San Francisco			
16:45	Eurozone	ECB Main Refinancing Rate	19-Jan	0%	0%
16:45	Eurozone	ECB Marginal Lending Facility	19-Jan	0.25%	0.25%
16:45	Eurozone	ECB Deposit Facility Rate	19-Jan	-0.4%	-0.4%
16:45	Eurozone	ECB Asset Purchase Target	Jan	EU80B	EU80B
17:30	US	Housing Starts	Dec	1090K	1184K
17:30	US	Building Permits	Dec	1212K	1225K
17:30	US	Initial Jobless Claims	14-Jan	251K	247K
Friday, 20 Jan					
5:00	US	Fed's Yellen Speaks at Stanford			
6:00	China	GDP, y-o-y	4Q	6.7%	6.7%
6:00	China	Industrial Production, y-o-y	Dec	6.2%	6.1%
6:00	China	Retail Sales, y-o-y	Dec	10.8%	10.7%
6:00	China	Fixed Assets, ex-Rural, YTD y-o-y	Dec	8.3%	8.3%
13:30	UK	Retail Sales, ex-Auto Fuel, m-o-m	Dec	0.5%	-0.4%
13:30	UK	Retail Sales, ex-Auto Fuel, y-o-y	Dec	6.6%	7.5%
18:00	US	Fed's Harker Speaks in New Jersey on Economic Outlook			
22:00	US	Fed's Williams Speaks at Event at San Francisco Fed			
	US	Inauguration of the 45th President of the US			

* UAE time
Source: Bloomberg

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