Investment Strategy Note

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بنك أبوظبي التجاري ADCB

Global growth cooling, political risks not gone

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Going neutral on equities by removing our currency-hedged overweights on Japanese and Swiss equities

Increasing signs of a cooling of the global economy are likely to put downward pressure on emerging markets. Global equity markets have still upside potential but the risk-return trade-off is become less and less appealing. Political concerns, such as the US-China trade tensions and Italian doubts about the single currency, have to be seen in the context of this global growth cooling. They induce recurring bouts of volatility, at a time that markets are already fretting about less growth and more stringent global financial conditions (i.e. a stronger US dollar and increasing short-term US dollar rates). Markets will try to continue to climb the wall of fear for a while, but for the year to come it makes sense to adopt a more defensive position.

Concerns about emerging markets and a permanently higher risk premium on Italian debt are likely to keep the Japanese yen and the Swiss franc at elevated levels, and thus jeopardize the local currency performance of Japanese and Swiss equities. We thus close our two currency hedged calls on Japanese and Swiss equities. Our Japan call registered a gain of 28% since inception, with a relative performance of 2% versus the MSCI World Index, and a year-to-date loss of 3%. Our Swiss call registered a loss of 6% since inception, with a relative performance of -10% versus the MSCI World Index, and a year-to-date loss of 7%.

The combination of cooling global growth and rising political risks justifies our continuing overweight in US equities and underweight in Emerging Markets (with the exception of India which remains a long-term core holding across our portfolios, and Saudi Arabia which is benefitting from both the higher oil price and structural reforms).

The prospect of worsening global financial conditions also warrants a continuing underweight in bonds. Within the bonds space we confirm our overweight in US Treasury bonds as their safe haven role will remain crucial and the Federal Reserve is likely to keep inflation under control. We remove our call on Indonesian bonds, with flat gain since inception and a relative performance of -4% against the Bloomberg Barclays Global Aggregate Index. Year-to-date the position has lost 5%. Fundamentally we still believe that Indonesia stands a relatively good chance to weather the current phase of US dollar strengthening and global risk-off sentiment, yet continuing downward pressure on global emerging bond markets, are likely to pull all emerging bond markets further down before they go up. With the sole exception of Russia where we believe that the sanctions by now have been priced in and the macro-economic conditions to be relatively favorable, we stick are underweight in all other emerging bond markets as well as high yield markets.

By reducing our currency hedged-calls on Japanese and Swiss equities we move our global equity position from overweight to neutral. We allocate the proceeds of the above overweight reductions – currency-hedged Japan and Swiss equity markets, and Indonesian hard currency bonds markets – to cash and short-term money market instruments.

US-China trade war risk and Italy troubles must be seen against a global background of cooling growth.

We had placed our hope for some stabilization of global financial markets on the postponement of US trade tariffs against China. Mr. Trump, however, managed to contradict his Secretary of the Treasury within a week, and is now moving on with tariffs on 50 billion US worth of imports from China. Political paralysis in Italy on the other hand is creating doubts about the country's willingness to stick to its commitments to EU fiscal deficit. The resulting sell-off in the Italian bond markets has created jitters in Europe, and beyond.

US-China trade war tensions not fading

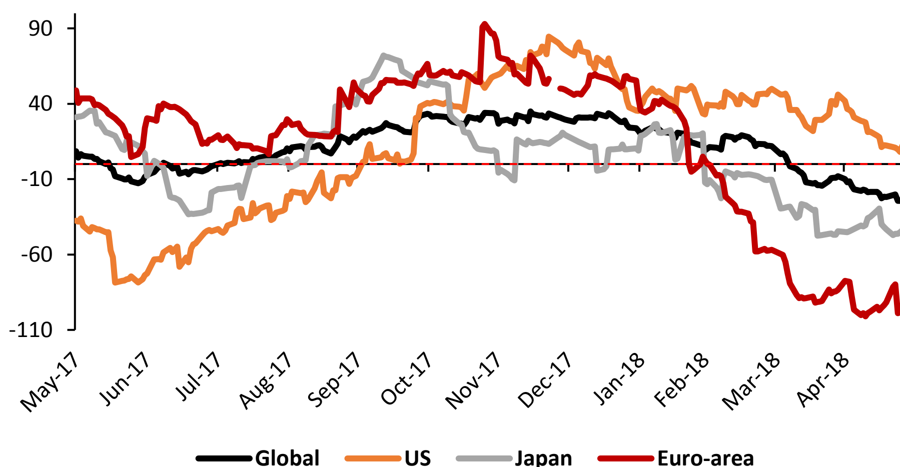
Both events should be placed in the proper perspective. Mr. Trump playing hard ball seems by now a constant of his negotiating tactic. Although he is imposing tariffs on China goods, his Secretary of Commerce is flying to China with a view of negotiating a comprehensive deal with China. As we said earlier, the US was unlikely to be content with China opening up on cars, agriculture and energy. Whilst the timing of the most recent announcement came somewhat as a surprise, this administration will not rest until it reaches its real prize. i.e. China opening its market for US tech companies and banks. A major and irreversible confrontation with China remains perhaps unlikely, at least until the US is still working on a diplomatic solution with North Korea. Chances are big however that tensions will increase before they come down.

Italy risk premium to stay higher, but contagion to be limited

As for Italy, it is still likely that a domestic political solution will be found that will stabilize its markets, but not remove the substantial spread not only over German and other core bonds, but also over other periphery bonds, namely Spanish and Portuguese paper. This, in our view, is a critical point. The ECB backstop is working, and will continue to work for all countries willing to adapt their economic policies to the EU Growth and Stability Pact. This is the key difference with the crises before 2012, and this should at a minimum keep contagion at bay (also because the ECB 2011 TLTR operations have ensured that most member-government paper is in the national banks of each single country, such that Italian banks own 45% of outstanding Italian debt, and an eventual Italy default would be much more painful for Italy itself than for any other European country).

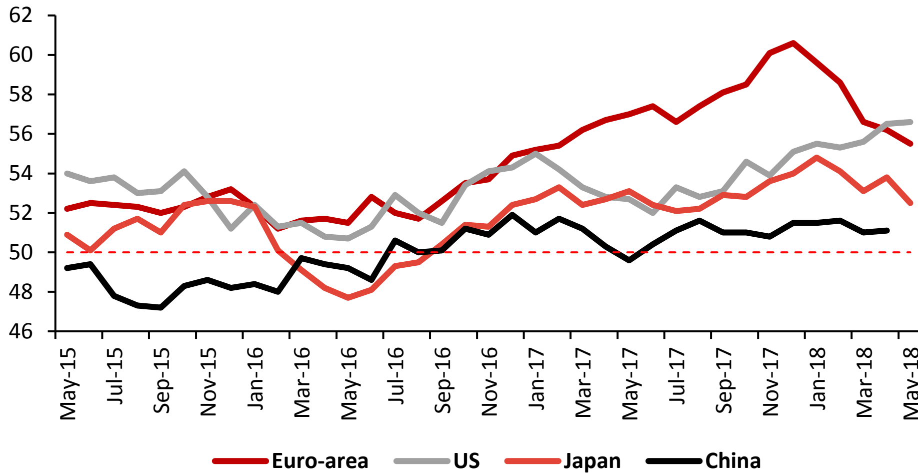
Global growth cooling warrants a more prudent approach for the year to come, whilst temporary risk-off bouts give momentum to US dollar strengthening

The key concern, in our view, is that political troubles such as Italexit talks and a potential trade war between China and the US are emerging at a time that global growth is cooling everywhere, in particular in Europe and China.



Source: Bloomberg, ADCB

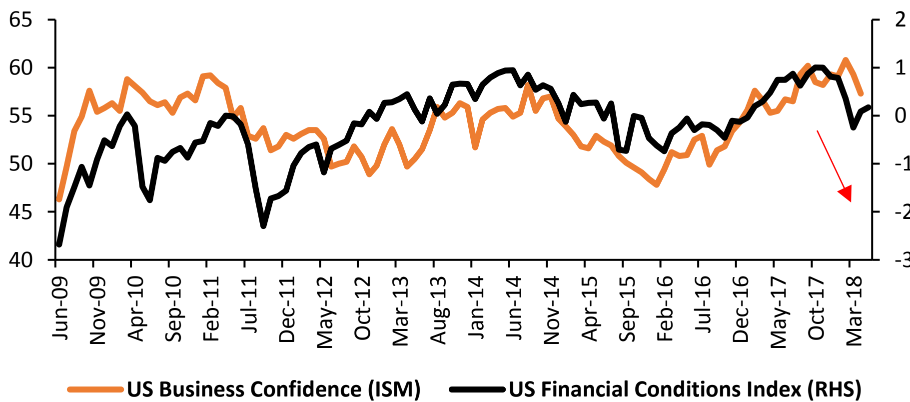
Only US industrial confidence still rising



Source: Bloomberg, ADCB

Global political risks at a time that global growth is underperforming US growth creates an undesirable further upward momentum on a US dollar which is already strengthening by itself. This is particularly bad for emerging and commodity and energy markets. The stronger US dollar is making live of course easier for Europe and Japan. However, these two economic areas are holders of large trade surpluses and, unlike the US, China and Emerging Markets they anyway are less important in terms of contributing to *additional* economic growth. The stronger US dollar, and some further rate hikes, will now also bite into the US economy, and at the margin induce some cooling of US growth.

Deteriorating US Financial Conditions put cap on growth



Source: Bloomberg, ADCB

It is true that these developments carry in them the seeds for a stabilization at some point in time. A cooling of US growth should at some point determine a stabilization of the US dollar. Yet, even if some cooling is likely, it is unlikely to happen before the end of this year, and with US fiscal stimulus firing on all cylinders, US Financial Conditions are likely to deteriorate either through a further appreciation of the US dollar or through continuing rate hikes.

Deteriorating US Financial Conditions and China tightening not good for emerging markets, or major developed market exporters

A deterioration of US Financial Conditions is harmful for Emerging Markets, in particular those with high debt levels and a considerable presence of foreign investors in their domestic markets. Critically, concerns about emerging markets do not only stem from US dollar strengthening. China tightening also plays a role and, as can be seen from below chart, China is now serious about reigning in leverage.

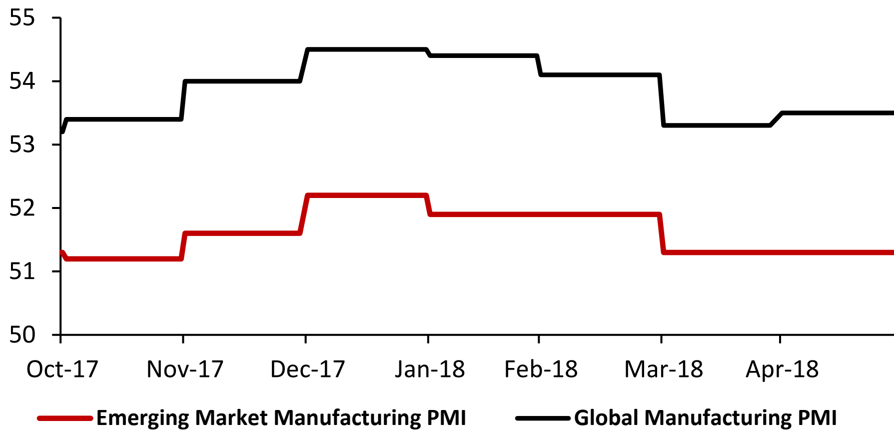
Source: Bloomberg, ADCB

China tightening is never good for major developed market exporters either. As can be seen from the same chart, German business confidence is receding with China stimulus. More importantly, a further rotation away from Europe and Emerging Markets into the US dollar would implicate a further strengthening of the Japanese Yen and the Swiss Franc over and on top of the US dollar. Thus the major developed export markets with the highest risk are the Japanese and Swiss equity market. The equity market best placed to withstand further bouts of volatility is the US equity market. If, on the other hand, our concerns are overdone, the US equity market has still upside as its valuations have come down, and the US is likely to grow more than other advanced economies well into 2019.

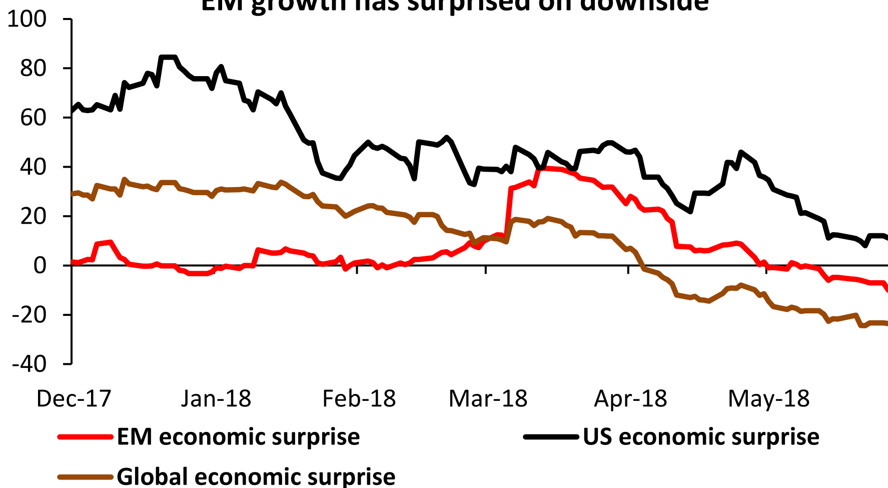
Emerging market bonds sufferings to continue in this context

With US Financial Conditions further deteriorating (either because of a higher US dollar or because of higher US rates, or both) it appears that the bond market sell-off could deepen further in both hard currency and local emerging currency markets. The market is at least to remain under pressure.

Indeed, signs of softening growth in emerging markets (similar to other advanced economies barring the US) have been evident. Since the beginning of the year, purchasing manager’s index data for most of the emerging economies, while still remaining above 50 in most cases, has been surprising on the downside.



Source: Bloomberg, ADCB



Source: Bloomberg, ADCB

As a result, we close our call on Indonesia. The fact that an economies with improving fundamentals and better domestic growth stories such as Indonesia have failed to remain immune to the negative global sentiment clearly signals that the rising dollar environment is compromising a global growth environment that is already more shaky than just a few months ago. While rising oil prices this year should have been a buffer for Indonesia, other factors, such as increased political risk, as well as the high offshore ownership of local bonds, have made Indonesia vulnerable to external shocks. Growth has been disappointing in Indonesia and further rupiah sell-off will only induce more policy rate hikes, hurting future growth prospects. We only stick to our Russia call which, even if the nascent recovery appears to be stalling there too a bit, has a central bank which can still stick to policy rate reduction. In terms of fundamentals too, the country remains well-positioned due to its low public debt levels and current account surplus. However, even if the sanctions seem to be priced in, our Russia call is meant (was always meant) for investors capable to bear the Russia risk. Overall in emerging markets, we do believe that hard currency debt looks cheap versus the local currency counterpart and hence likely to outperform the latter. In absolute terms, however, both asset classes are to remain under pressure.

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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