ADCB Asset Management

The Quarterly Investment View
July 2016

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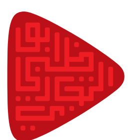

بنك أبوظبي التجاري
ADCB

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Global risks on the rise, while growth remains elusive

As we pointed out in the immediate aftermath of the referendum whereby the people of the UK decided that they want to leave the European Union, such decision should not be seen as an isolated event but rather as a country-specific political manifestation of an economic development that is affecting all advanced economies: secular wage stagnation. Secular wage stagnation, it should be noted, is independent of whether we are in an expansionary, or a recessionary phase of the business cycle. Indeed, secular wage stagnation is not new. Whilst all advanced economies have massively grown for many decades, it is already since the 90s that wages have stagnated for most people in these countries. What is now truly new is that these people are looking for an alternative political solution to their economic problems. And by alternative we mean something that is not necessarily market friendly, such as increased trade barriers, higher taxes to finance less fiscal discipline, less deregulation and privatization, and more political discord amongst Western democracies.

Of course, all might not be as bleak as I just described in the above paragraph. It likely won't. But that is not the point. What matters is that the Brexit vote has - arguably for the first time - potently crystalized these concerns in the mind of investors, at the same moment that advanced economies on both sides of the Atlantic are going to face a series of very serious political tests. In Europe we will have in October a constitutional referendum in Italy, whilst The Netherlands and France will have elections respectively in March and April. As we discuss in our page on the Eurozone, we do not believe that in these three important founding Member-States of the European Union, an anti-establishment party will ultimately carry the day (although their support is growing). It is the uncertainty regarding such a concrete possibility, not its effective outcome, which is now going to create continuing market anxiety. As for the United States, the November presidential election is arguably the most important political test for global capital markets. Here too, whilst in the past such an election could have had an impact on different sectors, for instance the healthcare sector would typically profit from a republican victory, its outcome is now more likely to have a major impact on the entirety of global capital markets. Unprecedented as that may be, here too – in the run-up to the election - it is the uncertainty that matters, not the outcome itself.

Whilst political risks are on the rise, central banks are doing their best to stabilize the global economic and financial system. The most important change in that regard is a more dovish Federal Reserve, and the ensuing assurance (unless we would see a huge spike in the risk-off mood) that the US dollar will no further significantly appreciate. This is good news for emerging markets in particular, which might well temporarily benefit. In the longer run, however, the lack of US dollar strength might well trigger further debt accumulation in those markets, and in particular in China, whose economic growth remains under significant pressure. The world's leading equity market – the US equity market – is in the meanwhile still at the peak of a seven year long bull run, and anything but cheap. We see no good reason, therefore, to alter our global underweight equity stance.

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Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest 30 Jun closing	Quarterly Change % (Q2 2016)	YTD Change % (30 Jun)
Index Snapshot (World Indices)			
S&P 500	2,098.9	1.9	2.7
Dow Jones	17,930.0	1.4	2.9
Nasdaq	4,842.7	-0.6	-3.3
DAX	9,680.1	-2.9	-9.9
Nikkei 225	15,575.9	-7.1	-18.2
FTSE 100	6,504.3	5.3	4.2
Sensex	26,999.7	6.5	3.4
Hang Seng	20794.4	0.1	-5.1
Regional Markets (Sunday to Thursday)			
ADX	4497.6	1.9	4.4
DFM	3311.1	6.5	5.1
Tadawul	6499.9	-10.0	-6.0
DSM	9885.2	-0.5	-5.2
MSM30	5777.31	1.1	6.9
BHSE	1118.4	-7.0	-8.0
KWSE	5364.6	-6.9	-4.5
MSCI			
MSCI World	1,653.2	-0.9	-0.6
MSCI EM	834.1	5.4	5.0

Commodity	Latest 30 Jun closing	Quarterly Change % (Q2 2016)	YTD Change % (30 Jun)
Global Commodities			
ICE Brent USD/bbl	49.7	6.2	33.3
Nymex WTI USD/bbl	48.33	3.5	30.5
OPEC Baskt USD/bbl	46.3	9.8	48.0
Gold 100 oz USD/t oz	1321.9	16.2	24.6
Platinum USD/t oz	1024.4	9.4	14.9
Copper USD/MT	4827	3.3	2.7
Aluminium	1645.75	0.2	9.3
Currencies			
EUR	1.1106	4.8	2.2
GBP	1.3311	-2.6	-9.7
JPY	103.20	-6.4	-14.2
CHF	0.9760	-4.0	-2.6
Rates			
USD Libor 3m	0.6541	2.6	6.8
USD Libor 12m	1.2303	2.8	4.4
UAE Eibor 3m	1.1310	-2.8	7.2
UAE Eibor 12m	1.6379	7.1	11.1
US 3m Bills	0.2587	-42.0	59.0
US 10yr Treasury	1.4697	-22.1	-35.2

Executive Summary

- Federal Reserve now reversing from hawkish to dovish.
- US growth to remain sluggish at best. Europe's growth expectations are adjusting lower. Japan at bigger risk. We might see some positive surprises amongst non-commodity exporting emerging markets. Commodity exporting emerging and advanced economies to remain under pressure.
- Equities to remain under pressure as global growth to remain sluggish and Europe and Japan have run out of significant monetary policy options (barring dramatic changes such as helicopter money, something we don't see on the immediate horizon). After the Brexit vote our equity concerns are being compounded by a permanent rise in global political risk. In such an environment US equities are likely to provide better downside protection than other major markets, such as the Eurozone and Japan. Emerging markets might fare better in the present context of relative US dollar weakness, but only temporarily so.
- China's reform and growth problems will remain with us for a longer period.
- Some emerging markets which are not exposed to commodity prices and where the reform process seems to be more promising, such as India, should still be able to take advantage of the decline in commodity and energy prices.
- Selectively emerging markets hard currency bonds offer value, whereas local currency bonds remain subject to a scenario of continuing exchange rate volatility and would only temporarily benefit from a halt in further US dollar appreciation.
- Energy prices have rallied sharply from multi-year lows in February. However, we see upside potential capped due to little change in demand-supply dynamics.
- Industrial metals have still more downside given the ongoing transformation of China's economy.
- Precious metals are likely to consolidate gains as risk-aversion is here to stay.

Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Better stay long	A dovish Fed and largely deflationary tendency globally will keep yields lower.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
EM bonds	Selectively overweight	Among Emerging Markets we differentiate between commodity exporters and importers, favoring the latter. Commodity exporters not only face growth issues but they seem to be more prone to currency volatility. In commodity importer country's bonds, we still prefer USD bonds rather than local currency bonds because of possible currency volatility.
Equity Markets		
US	Overweight	We changed our stance on the US equities to overweight primarily because we see greater downside risk on global equities and in such an environment the former is likely to decline less than its global peers.
Eurozone	Underweight	We stick to our underweight on Eurozone equities as global growth concerns and European political risks have not come down.
Japan	Underweight	We stick to our Japan underweight as growth continues to suffer and the BoJ appears unable to do anything to prevent a strong yen.
Emerging Markets	Temporary overweight, some selective long term calls	Emerging equity markets might profit temporarily from the halt in the US dollar appreciation. Beyond the short term we remain bearish as the China slowdown story has still years to play out. Long term we selectively see value in those emerging markets that are more reform prone and less dependent on commodities, such as India and Mexico.
Energy and Commodity Prices		
Energy	Neutral	US dollar stability should provide some stability to the oil price too. Global growth concerns remain a risk, however. Any secular uptrend is still far away in the future.
Industrial Metals	Underweight	The full implications of the China transformation story will determine a further reduction in the commodity intensity of its economy. There may be some recurring technical rebounds in specific metal prices, but globally deflationary pressures are likely to continue in the commodity space.
Precious Metals	Overweight	The increase in risk aversion is likely to allow precious metals to further consolidate their gains.
Currencies		
EUR	Range bound	For the remainder of 2016 the euro will remain largely stable versus the US dollar, as the Federal Reserve will not allow for further strengthening of the greenback. A significant appreciation of the US dollar would only be the result of a massive return to a global risk-off scenario. At this stage central banks should be able to avoid just that.
GBP	Downward pressure not over	The pound sterling might well weaken further against the euro and the US dollar, as negative growth data and the UK's current account deficit forces the BoE to provide more stimulus, while the government loosens fiscal austerity.
JPY	Range bound with an upward bias	The Japanese yen is expected to remain relatively stable against the US dollar as the BoJ is facing increased obstacles against a renewed depreciation of the yen. On the contrary. We could see further rebounds as soon as global risk aversion phases re-emerge.

Fiscal constraints remain binding on growth

Sentiment seems to have stabilized in the oil market...

Following a deep correction, oil prices have recovered impressively from their February lows. Rebalancing has come from both sides with stronger demand growth, in particular from India, the US and China; as well as disruptions on the supply side. Both these factors helped generate a smaller surplus in the first half of 2016. Despite the recovery in prices, the average Brent oil price in H1-2016 is only $40.7/bbl, significantly lower than the average price of $53/bbl for 2015. We do not see any further significant uptick in oil prices from current levels over the next few months due to a range of risks to global growth and the temporary nature of some of the supply disruptions as well as a potential turnaround in US shale production. As a result, we expect the average oil price in 2016 to remain below that of 2015.

...but governments will still have lower revenues

Notwithstanding the efforts by GCC governments to raise non-oil revenue, (what is likely to be) the lowest average oil price in more than a decade will result in lower revenues. This remains a binding factor on regional growth prospects as governments, in response to lower revenues, have reduced spending while increasing fees and utility charges and reducing energy and water subsidies. The main channel through which the reduced government spending is feeding into the slower non-oil sector growth is the construction sector which has seen many large projects either stalled or scrapped. A large number of construction workers, especially in Saudi Arabia, have become redundant. Another channel is rationalization in public sector wage growth which will feed into the slower consumption growth.

Corporates' streamlining also affecting consumption

Aside from the impact on the construction sector of lower government spending, there has been a rationalization in the cost structure in the oil and gas sector. The main impact of which is reducing wage costs either via reduced head count or benefits. We expect this trend to continue over the next couple of quarters before stabilizing. Anecdotal evidence also suggests hiring in the services industry, especially in the Food & Beverages and Hotels segments have softened in recent months. Therefore, we expect to see softer economic activity in the coming quarters.

Medium term growth potential for the region intact

Notwithstanding the expected softer economic environment over the coming few quarters, we believe that potential growth for the region remains intact in the medium term. The current reforms which focus on the consolidation of government finances as well as a push for broader long-lasting reforms such as the trimming of subsidies and likely introduction of VAT are going to put government finances on a more sustainable path. This, along with still large financial safety nets for regional governments (especially the UAE, Qatar, Kuwait and Saudi Arabia with large foreign asset reserves), provide support for growth.

Equities; headwinds and tailwinds evenly balanced - remain neutral

In aggregate regional equities have underperformed broader emerging market equities year-to-date, but outperformed developed markets. In terms of the broad drivers for the region, oil prices, the US dollar and Brexit related risk, these appear evenly balanced for the time being. Firstly oil, the impetus behind the sharp price rebound has now faded. This removes an important source of support, although this does not mean that we expect oil prices to revisit their February lows any time soon. Secondly, the uncertainty generated by the Brexit referendum creates an additional headwind, not so much (at this stage) from a read-across to lower global growth and thereby lower oil prices, but more from GBP (and potentially euro) weakness. This will likely dampen property demand from UK investors as well as tourist arrivals. After Indian nationals, British nationals were the largest demographic of non-GCC investor in the Dubai property market in 2015 according to the Dubai Land Department. Given the share of real estate developers in the UAE indices this could weigh on share prices. Third and more positively, the US dollar has resisted appreciating sharply (besides vs. GBP) in the wake of the Brexit referendum while the Brexit vote has also delayed further US rate hikes. This means that liquidity conditions in the GCC are also unlikely to drastically tighten which will help the banks, as will the potential for further M&A activity in the sector (following the announced NBAD and FGB deal). Finally, potential reclassification to EM of Saudi Arabia by MSCI remains long-term option value for Saudi as well as for the region (indeed as does the Kingdom's Vision 2030).

In terms of valuations for the region, these are not expensive, the MSCI GCC ex Saudi index is trading on a 2016e PE of 11.10x, less than its 5-year average. However, dividend yields for the region at 4.5% are substantially higher than EM and DM averages. Overall we recommend a neutral weighting on GCC equities.

Federal Reserve policy reversal panning out

Rate hikes gone, and yields tumbling to record lows

In our April Quarterly Investment View we pointed out that the US economy was not in a position to withstand the Federal Reserve rate hikes expected by the consensus of mainstream economists. As we write the more reliable indicator for Federal Reserve, the Federal Funds Futures, expects no further hike this year. Not surprisingly US Treasury yields have tumbled. Clearly, the fall in US Treasury yields has much to do with so-called "overseas" developments, with Europe's political crisis recently overshadowing China's debt problems. Having said so, the flattening US yield curve inevitably begs the question as to how resilient the US economy really is. All in all, we would be inclined to say that a US recession is still not on the immediate horizon, although we have never belonged to the (consensus) view that the probability of a US recession is very small. Thus, whilst the recent drop in long-term yields is most likely the combined result of a more dovish Federal Reserve policy and negative yielding "overseas" government bonds, they do confirm our view that growth will remain sluggish in the United States.

The job market is cooling

We would argue that it is better not to get carried away by the more than 280'000 new jobs that seem to have been created in June, and not only because the monthly data delivered by the US Bureau of Labor Statistics are frequently revised. The fact remains that job creation is naturally slowing in the US as the unemployment rate is now below 5% and new entries in the labor force are not necessarily qualified to take on the fewer qualified jobs that companies are still trying to fill (as can be seen in the recent tick-up of the unemployment rate from 4.8% to 4.9%).

What is more, wage growth remains extremely subdued suggesting that the disinflationary forces of globalization, outsourcing and weaker commodity prices continue to have the upper hand.

US dollar stabilization is floor under manufacturing slowdown

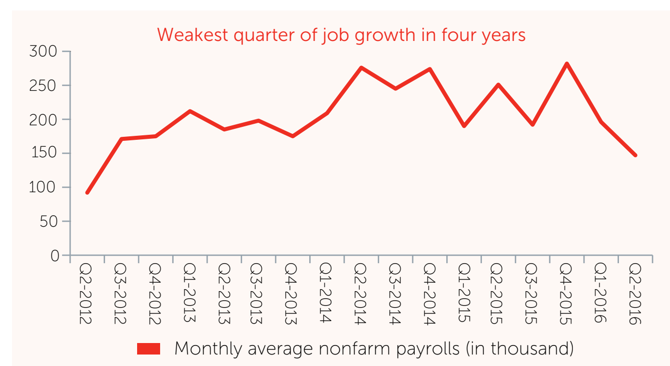
The end of the 2014-15 US dollar appreciation has put an end to the slowdown in US manufacturing that occurred over the same period. This – we believe – has prevented the cyclical slowdown to morph into a recession. With growth in Europe and China is bound to come down further, we see – however – little reason to forecast a surge in growth. Lower for longer clearly remains the key message when it comes to US, and thus global, growth.

Equities; defensive qualities continue to outweigh all else – remain overweight

A common thread in our previously published notes since January is the fact that we find plenty of fundamental reasons to be negative on US equities (margin compression from peak levels, expensive valuations, slow growth and potential Fed tightening) but nevertheless we are overweight. The rationale is simple, during periods of global market turbulence, US equities outperform due to their relative insulation from many global risks. Market performance backs this up, since April 2015 US equities are flat, currently hovering near their record highs, the Euro Stoxx 50 on the other hand is down 26% in euro terms. This does mask a rollercoaster 12-months during which times the S&P 500 experienced a number of sharp corrections, including two in excess of 10% (August 2015 and January 2016). However, unlike European equities, the market bounced back each time.

Bottom-up this resilience stems from the fact that US companies derive a large share of their revenues domestically. For example, in aggregate US equities derive 42% of their revenues from the domestic consumer, and only 22% from the global consumer. By comparison, German companies derive 54% of their revenue from the global consumer and under 2% from domestic consumers. Worries over global growth therefore, will impact German and European equities much more than US equities.

Having said so, we still see value in being selective in the US, in particular we favour defensive sectors such as consumer staples, telecoms, utilities and health care, these sectors have steady earnings and high dividend yields (except health care). We expect these sectors to once again outperform in the upcoming earnings season.



Source: Bloomberg

Political uncertainty unlikely to fade soon

Is all risk now priced in?

At the beginning of this year we went underweight on European equities. Since then only Japanese markets have done worse (although in real terms they have actually done better because of the appreciation of the Japanese yen). With the US economy still growing, albeit at a sluggish speed, with Europe's leading manufacturing indicators still pointing North and Brexit now an accomplished fact, one is tempted to ask if the worst is now priced in. In fact, as we write it is hard to say that the uncertainty with regard to Europe's political future has come down, if anything it might well have gone up following the referendum whereby the people of the UK opted to leave the EU. Moreover, all leading indicators still refer to pre-referendum surveys. We will have to wait until the end of July to get a full picture into how the referendum has impacted the sentiment businesses and households. As for the hard facts, i.e. economic output, we will only have some sense by September.

Uncertainty is everything

Stressing political uncertainty is key since our negative outlook for European risk assets has been – and still is - predominantly based on the negative implications of such uncertainty, rather than an economic growth outlook that would be particularly bad for Europe. As things stand now, lower (Brexit-induced) growth might well spill over from the UK to the EU, for which the UK is an important export market. At the same time, with a constitutional referendum vote coming up in Italy in October, and elections in March and April 2017 respectively in the Netherlands and France, markets will have an opportunity to test the increasingly anxious electorates of three very important founding members of the European Union. And, yes, there are also the Italian banks' bad loans. If the Italian government is allowed to recapitalize the country's banks by using only public money, that could dent the credibility of the recently established European Banking Union. If, on the other hand, the government is forced to partly bail in the banks' (mainly domestic) creditors, it is more likely to lose the constitutional referendum paving potentially the way for the anti-establishment party "Movimento Cinque Stelle" to grab power, arguably an even worse outcome.

It is the permanent rise in the risk premium that matters

Of course, things are likely not to turn out that bad. Italy, France and The Netherlands are – unlike the UK – founding members of the European Union and they have much more to lose than the UK from exiting it. Besides, even if we will only learn in September who will be the next British Prime Minister, there is a likely chance that he or she will not initiate a formal exit procedure until 2017. Other European countries are likely to prefer seeing how the UK fares under its new post-referendum scenario, before trying it out for themselves.

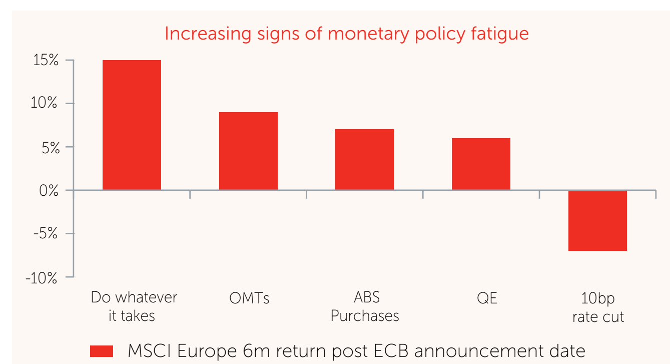
This is not the point, however. Just as our January underweight was not based on the assumption that the UK would leave the EU, but on the uncertainty regarding such a concrete possibility, we would now argue that markets will require an even higher European risk premium not because they now expect Italy - or any other European country - to leave the EU, but rather because the uncertainty of further EU unravelling has objectively gone up.

In other words, nobody knows if Brexit is really going to have a negative impact on the European economy or on the European political project. But with global growth sluggish, and little upside in global equities, an even higher European risk premium, warrants to remain specifically underweight in European assets.

Equities; don't chase the rallies – remain underweight

Having peaked in April 2015 most European equity indices have been stuck in bear market territory for some time, unable to build sustainable rallies. The Euro Stoxx 50 for example, is down 26% during this time in euro terms. The region has been beset by one crisis after the other; Grexit risks in June 2015, China fears in August 2015, worries over global growth in December 2015/January 2016 and now Brexit. There have been, and will continue to be sharp rallies following deep sell-offs, however there is little fundamental to become positive about in our view. The nature of European equities is such that they are much more sensitive to global risks than US equities.

What is also concerning is that the ECB seems to have increasingly limited firepower to reassure investors it can support the economy and the markets. The chart below shows that the 6 month return following each major ECB policy announcement has fallen, even turning negative. Overall we remain underweight European equities believing that political risk is too high to try and speculate on an inflection point.



Source: MSCI, Thomson Reuters, HSBC

Economic outlook going from bad to worse

Support becomes headwind as the yen turns around...

Reduced expectations for Fed rate hikes in the coming quarters and years as well as further signs of monetary policy ineffectiveness have reversed the trajectory of the Japanese yen. The currency has appreciated 20% this year, creating a major headwind for the economy. Such a sharp appreciation is not only likely to affect exports, but also corporate earnings. Whilst many other countries are seeing signs of stabilization in their exports, Japan's export decline has accelerated over the last few months. In addition to adversely affecting external trade and corporate earnings, a rising currency will make it more difficult for the central bank to generate inflation. Note that so-called "Abenomics" is based on the expectation that through currency devaluation the country will be able to escape from the already well-entrenched deflationary forces, thereby pushing up wage growth and thus domestic demand.

...amid weak domestic fundamentals

Despite the country avoiding a technical recession thanks to positive Q1 16 GDP growth, the recovery from the Q4 15 contraction has not been very convincing. Most high frequency monthly data do not bode well for Q2 16 growth with both production and consumption disappointing. Industrial production declined an average 1% (m-o-m) while retail sales declined 1.4% (m-o-m) on average for the first two months of Q2 16. Tankan surveys, which have been a good indicator for quarterly economic growth and which are conducted by the central bank, also indicate disappointing economic activity. Both manufacturing and non-manufacturing companies, in particular medium and small ones, have reported slower activity. Large companies, on aggregate, maintained their level of activity in the second quarter primarily due to a rebound in the petroleum sector, while many sectors, most notably the auto sector, reported slower activity.

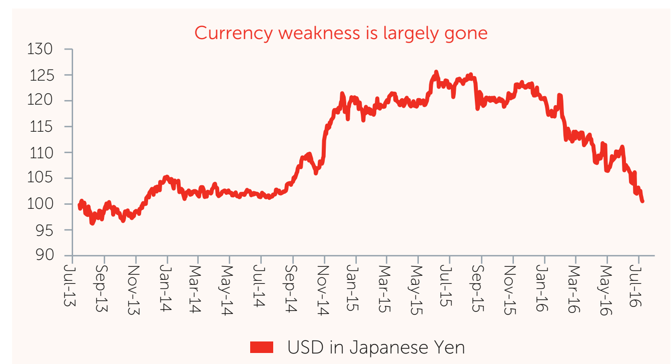
Market losing hope on inflation revival

Stalled wage growth and headline inflation running into negative territory for the last three months strongly suggest the Bank of Japan's efforts to generate inflation in the economy have failed. Looking ahead, weaker economic growth is also unlikely to support an increase in prices. On top of that, the strong currency has created further headwinds for inflation.

Equities; still hostage to the BoJ and the yen – remain underweight

The major tailwind supporting Japanese equities over the past few years, a weakening yen, faded in late 2015. Not only that but given the yen's appreciation this year it has become a major headwind. The correlation between earnings and the yen has been very high. As such the major driving force behind Japanese earnings growth has been removed. Given the potential for global risk aversion to remain elevated following the Brexit referendum, there seems a decent chance the yen could still strengthen further to below the ¥100/$ mark. In the context of earnings growth expectations (of 12.2% on a 12-month forward basis) which remain comfortably above the global average (8.5%) further cuts to earnings growth expectations are a real possibility (having already been cut by 9.3% in the past 6 months). Other risks to the market stem from near record high margins and limited scope for further (successful) BoJ intervention.

Downside risk from current levels is of course more limited than it was at the start of the year. The Nikkei 225 has already fallen 20% year-to-date and 28% from its high in August last year (both in yen terms). Global fund holdings of Japanese equities are significantly lower now meaning that a huge sudden withdrawal is unlikely. At the same time the BoJ will likely continue to scale up its purchases of equity ETFs, although as a share of free float market cap this is likely to remain small and insufficient to compensate for the high degree of currency risk (from a foreign investor point of view). Overall we remain underweight Japanese equities.



Source: Bloomberg

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Slowdown continues with gradual currency devaluation

Stealth currency devaluation

The authorities seem to have learned their lessons from the August 2015 official "mini" currency devaluation. After having announced a new reference exchange against a basket of major currencies – and having conveniently ignored it in the first months of the year when the US dollar weakened against the euro – since April the renminbi is now down almost 3% against the greenback. Thus the authorities have been able to halt continuing capital outflows whilst at the same time putting an end to the continuous deterioration in the country's real exchange rate, i.e. international competitiveness. When comparing the renminbi devaluation with other Asian emerging currencies, it seems however excessive, telling us that the Chinese government remains extremely concerned about the country's growth prospects, and that the recent resurgence in the global risk-on mood is likely overdone.

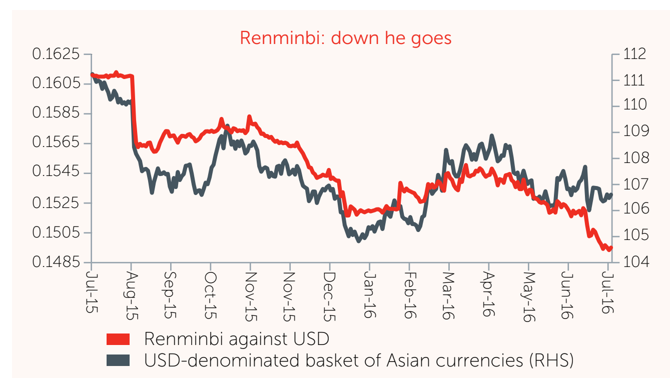
Growth down again

China's growth concerns are warranted, in our view. Whilst the stabilization of international capital flows gives the authorities more leeway to stimulate the economy (without such stimulus immediately fleeing out of the country), they have been rightly prudent to overplay their hand. The problem with stimulus programs of China's recent past, in fact, is that they have all led, yes, to some tick-up in the country's growth rate, but at the cost of even higher increases in total accumulated debt. On the other hand, enacting bold reforms by dismantling inefficient state-owned enterprises and preventing banks from making inefficient loans, is not as easy as it looks, since it can easily spark into social unrest. Also, state-owned enterprises are key constituents of the country's power structure and closely associated with the country's elite. Thus, whilst that elite is aware of what needs to be done in the long run, it has obvious reasons to act slowly in the short run. Chances are, therefore, that stimulus will remain in place to prevent a sharp slowdown in economic growth, but nothing more than that. As such, we will continue to see more sluggish growth in China too, as can be seen from the Caixin leading manufacturing indicator.

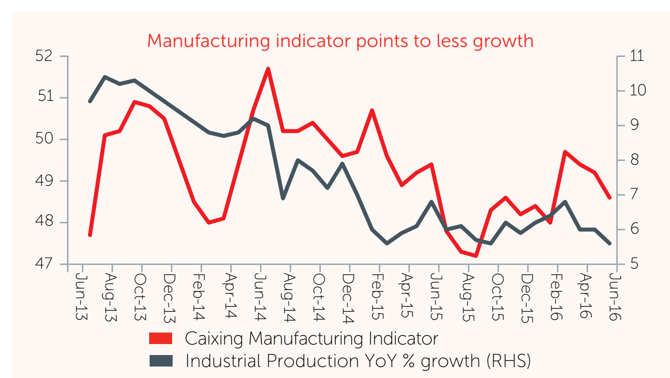
Chinese equities – remain underweight

In the near-term, Chinese equities, and indeed the economy can find support from a stable US dollar. This is also one of the key points in our tactical overweight on emerging market equities. However, we find few additional reasons to turn more positive on the Chinese equity market. The challenge facing the country in terms of reforms is enormous, however, the pace of the reforms has been disappointing, particularly in reducing over-capacity and dealing with bad debts in the system.

Overall, China's broad macro weakness comes in the context of rising equity valuations, not as a result of strong share price performance but thanks to sharp cuts to earnings growth expectations. 12-month forward consensus earnings have been slashed by more in China than in any other emerging or developed market over the past year (-26%). Worryingly, the pace of earnings downgrades has not slowed, having been cut by 2.7% over the past month alone (more than any other market bar Spain). As a result, 2016 expected earnings for China are just 1% currently compared with 6.2% for emerging markets. The forward PE ratio sits at 10.6x, a 10% discount to emerging markets in aggregate, above its 5-year average discount of 13%. The lower than average discount sits uneasily with the weak earnings picture and plethora of macro risks in our opinion, as such we remain underweight Chinese equities.



Source: Bloomberg



Source: Bloomberg

Further boost to consumption with efforts to revive investments

Wage hikes and revival in monsoon rains to boost consumption

The government approved a wage hike for its employees by an average of around 23% which will inject almost INR 1,021bn (equivalent to c$15bn and around 0.75% of GDP) into the economy this financial year. This is going to further boost consumption, already the main driver of the GDP growth in recent quarters. Further good news on the consumption side comes from the pickup in monsoon rains which had lagged at the start of the season. A good monsoon season is expected to support rural income and moderate food inflation.

Efforts being made to boost lagging investment

While consumption has been boosted of late, efforts to revive private investment spending are also taking place. The government continues to focus on infrastructure spending on roads and railways as it liberalizes foreign direct investment policies to remove barriers for investment in many important sectors. It has recently already liberalized the pharma, defence, aviation and single brand retail sectors recently.

At the same time, we see progress on the resolution of banks' non-performing loans as well as a stabilization in exports which have been hampering capacity expansion. We believe that the ongoing clean-up of the banking system will take several quarters before the banks are capable to finance capital investment in the country. A sustainable recovery in exports could also take time given the uncertain global economic environment. These factors suggest that the recovery in capital spending will still take a couple of quarters.

Upside risk to inflation to prevent further rate cuts

Consumption driven growth has a tendency of pushing inflation up, which is exactly what is currently happening in the Indian economy. A large increase in government employees wages, lower base effect for energy prices and broader inflation have increased the upside risk to inflation which has risen closer to the upper limit of the Reserve Bank's target range.

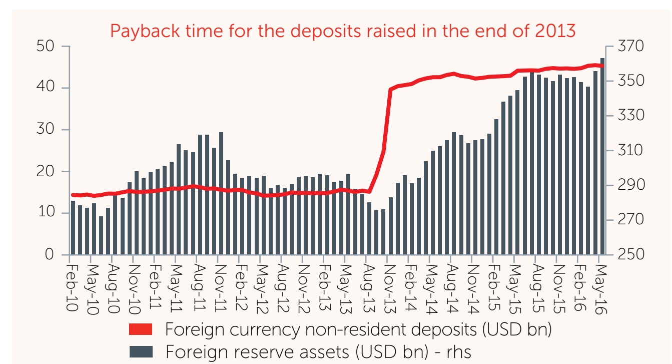
Along with upside risk to inflation, the likely pressure on the fiscal deficit target due to the wage increases (which was only partially accounted for in the budget) and foreign currency non-resident deposits outflows later this year make us believe that the central bank has limited room for further interest rate cut this year.

Macro stability to contain the currency volatility

Over the last two years, the country has witnessed a significant improvement in its external balance along with the containment of the fiscal deficit as well as inflation. This provides a structural support to the Indian rupee. The past months currency movement has been reflective of this fact. However, we some potential for higher currency volatility later this year when a large amount (c$20bn) of maturing Foreign Currency Non-Resident deposits is expected to flow out. However, we believe that the outflows are manageable given the ample foreign reserves (c$365bn) and forward purchases of US dollar by the Reserve Bank of India.

Equities; a bright spot in a challenging environment – remain overweight

Following the strong market rebound from the middle of February this year, Indian equities underperformed as investors sought higher beta plays. Rising oil prices and inflation were viewed as an impediment to the Indian corporate story (more so than the macro story). More recently however, Indian equities have outperformed, boosted further by the uncertainty generated by the outcome of the UK's referendum. Having been over-owned for some time, the market's underperformance earlier in the year meant that EM funds scaled back their Indian equity exposure from record high levels. This is therefore no longer a hurdle for the market. Earnings growth is another source of support. Compared to many other markets (see China section) earnings momentum in India is turning positive, meaning that consensus expectations for earnings growth are rising, rather than falling. Valuations are not cheap, the market trades on a consensus 12-month forward PE ratio of 17.2x, around 15% above its 5-year average. However, there are good reasons for India to trade at a premium, not only the strong macro position, but also the market's relative defensiveness. We therefore maintain our overweight recommendation on Indian equities.



Source: Bloomberg

Appendix

GDP Forecast	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	1.9%	In agreement	2.3%	Expect moderately less
Eurozone	1.5%	In agreement	1.5%	Expect moderately less
Japan	0.5%	In agreement	0.8%	Expect moderately less
China	6.5%	In agreement	6.3%	Expect significantly less
India	7.7%	In agreement	7.8%	In agreement

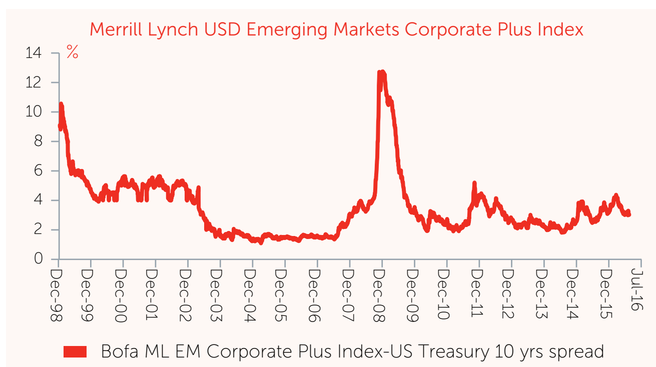
Source: Bloomberg

CPI Forecast YoY	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	1.3%	In agreement	2.3%	Expect significantly less
Eurozone	0.3%	In agreement	1.3%	Expect significantly less
Japan	0.0%	In agreement	0.8%	Expect significantly less
China	2.0%	Expect moderately less	2.0%	Expect significantly less
India	5.3%	Expect moderately more	5.2%	Expect moderately more

Source: Bloomberg

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

Bond Market Spreads



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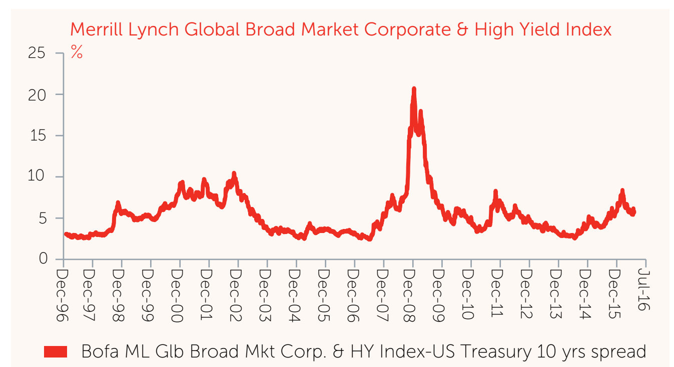

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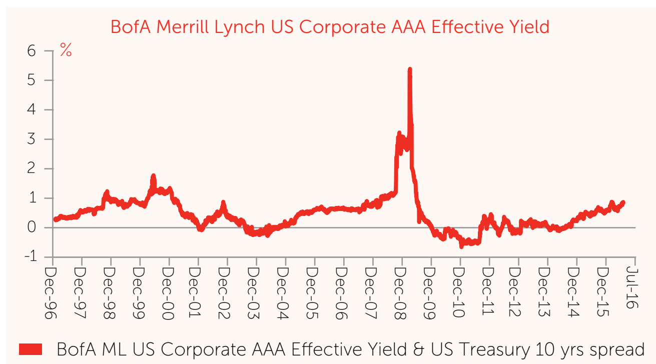

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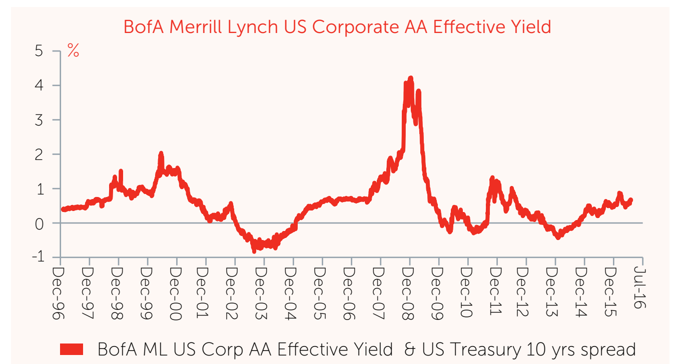
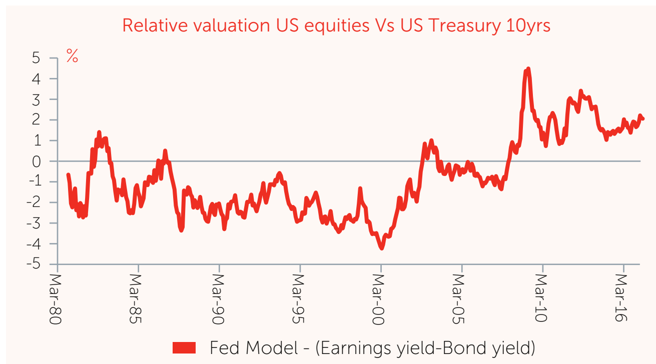


Source: Thomson Reuters

Equity Market Valuations



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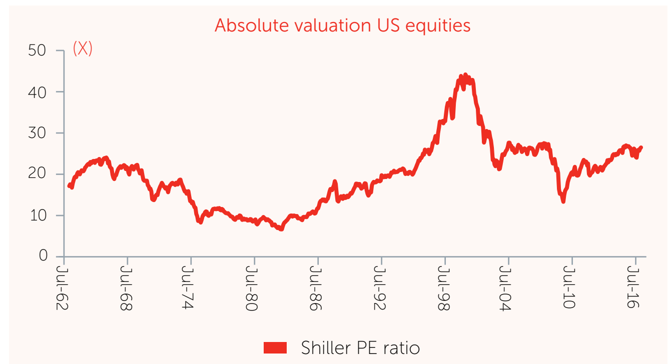

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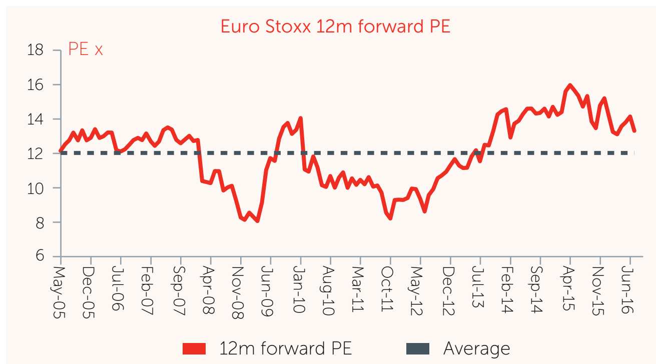

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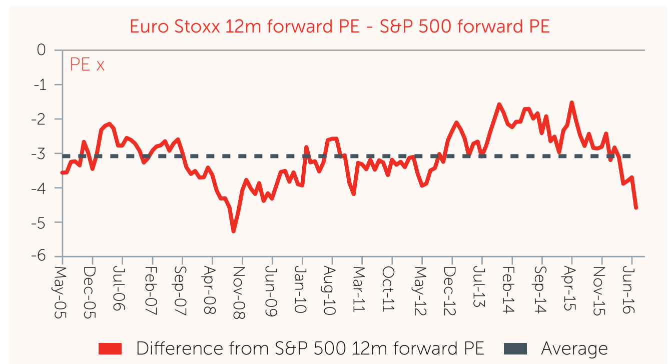

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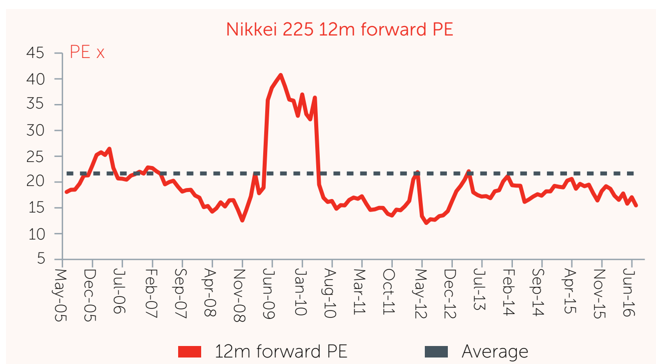

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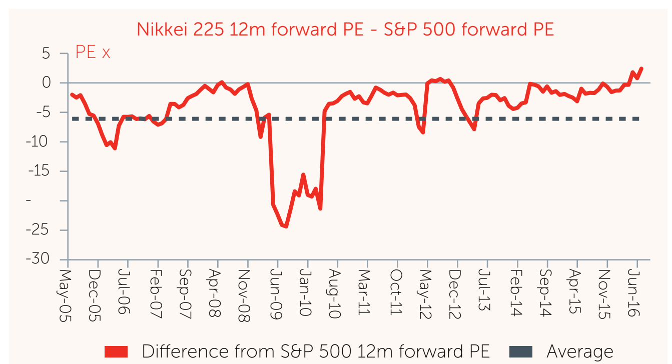

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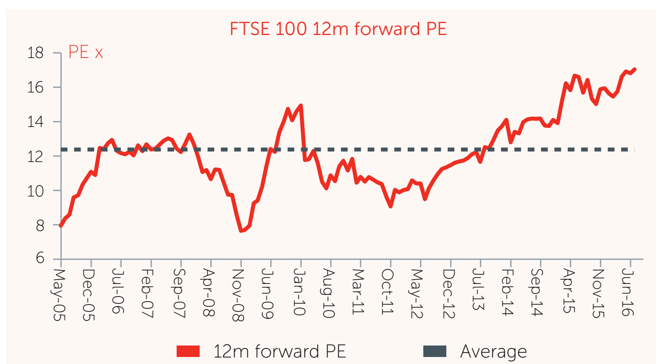

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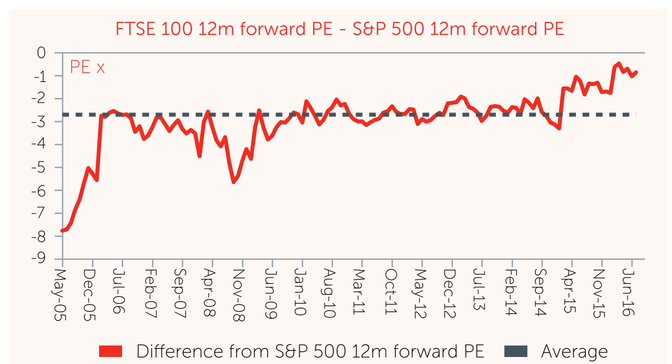

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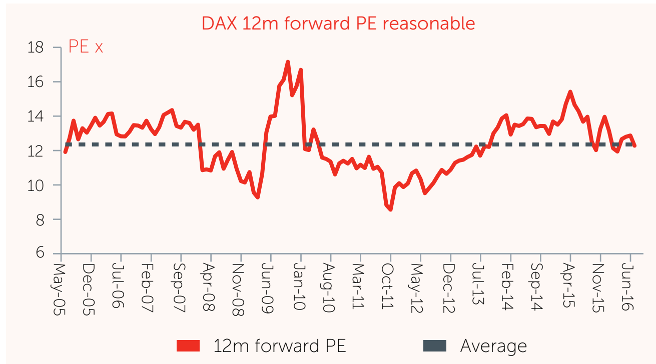
Equity Market Valuations



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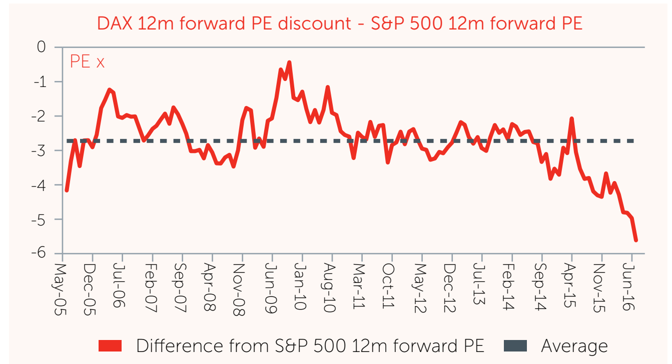

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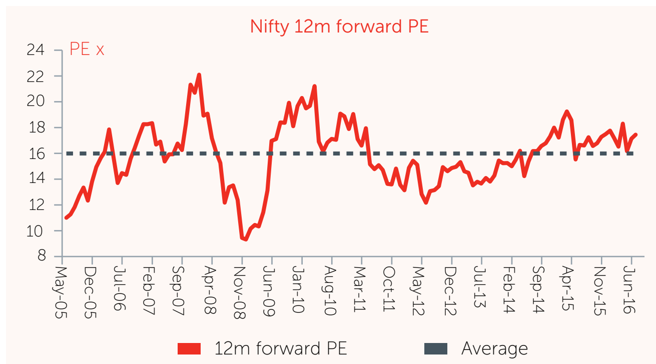

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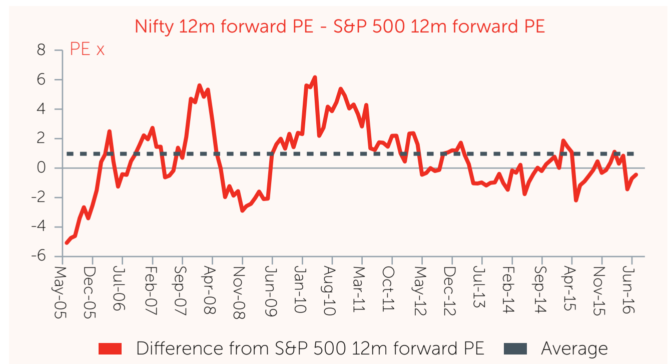

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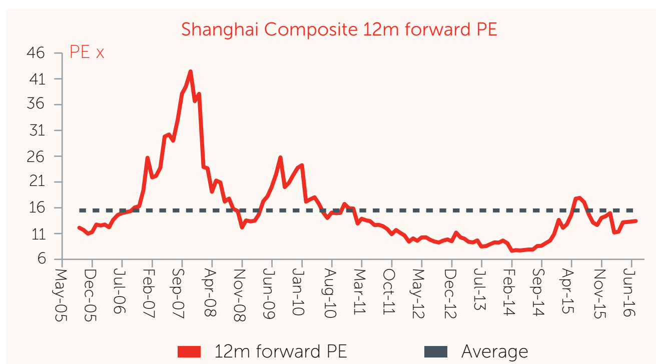

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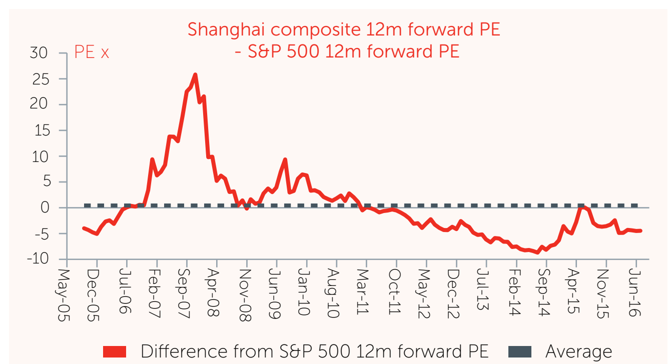

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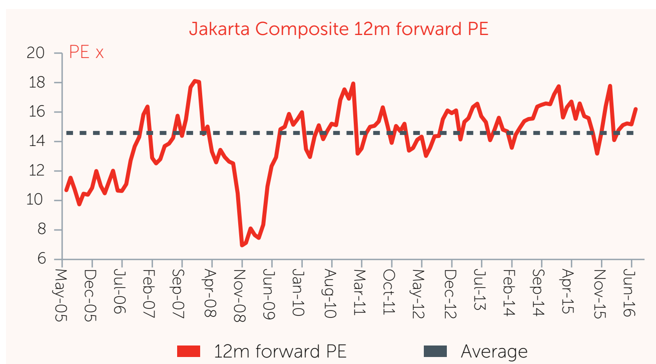

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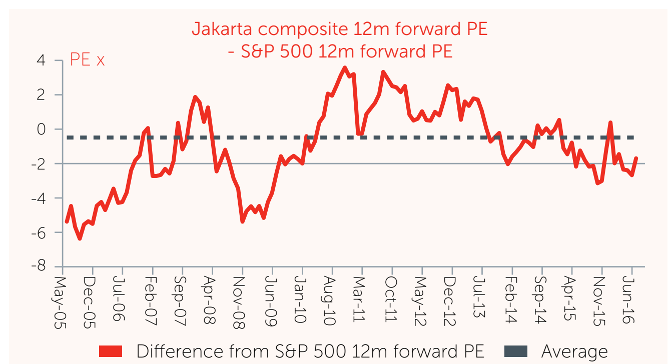

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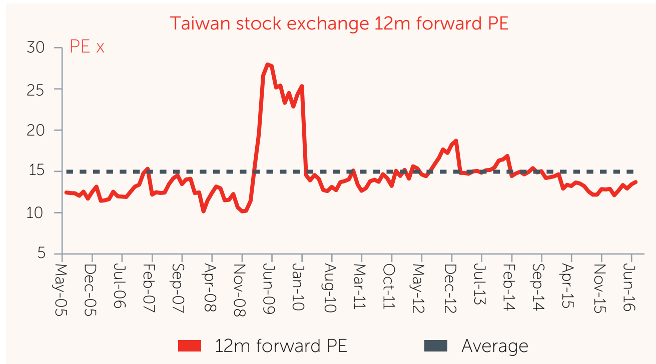
Equity Market Valuations



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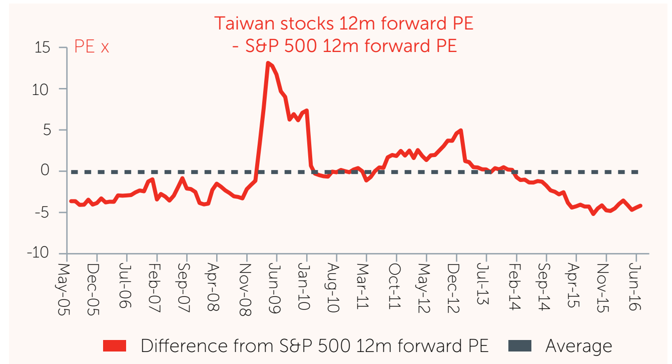

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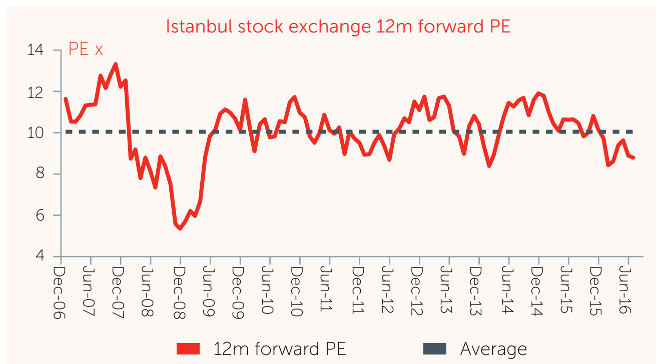

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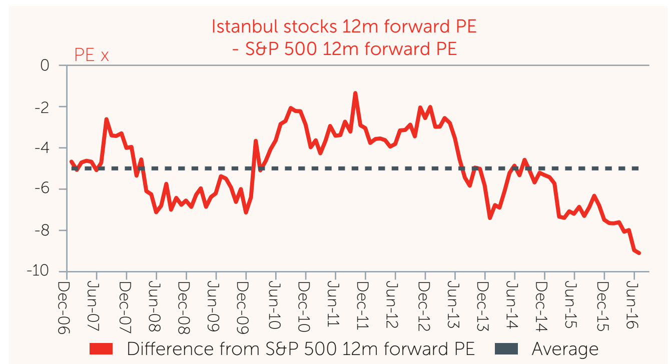

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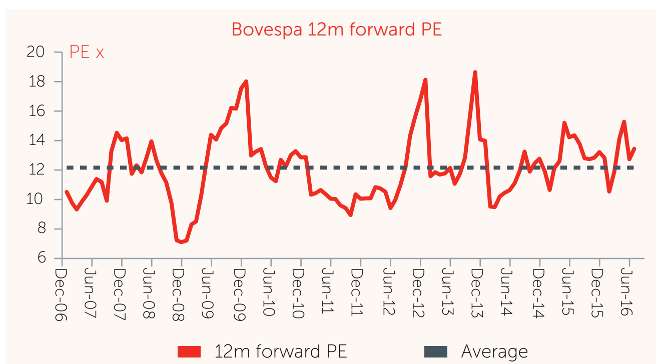

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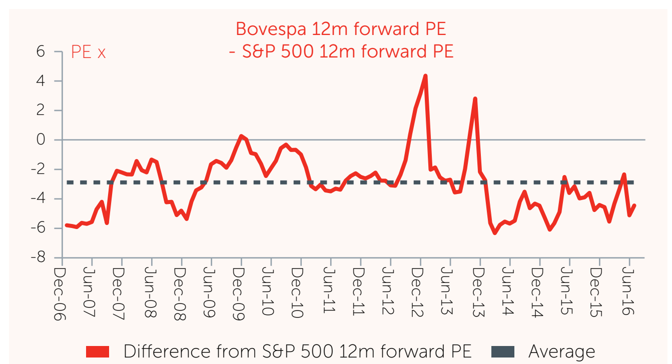

Source: Bloomberg

Sources

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

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