بنك أبوظبي التجاري
ADCB

ASSET
MANAGEMENT
LIMITED

QUARTERLY INVESTMENT VIEW

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Contents

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Radical policy rethink pre-empts Central Banks' puts

On June 4 we reduced our equity weight, reiterating in particular our bearish outlook on emerging equity markets. It looks increasingly likely that 2018 will be remembered as the year that policy makers made a decisive turnaround from supporting financial markets towards a more neutral, if not market negative, attitude. Remember the 2008 Global Financial Crisis, and all that followed? Since the first enactment of emergency fiscal measures in almost all major Western economies and the extraordinary credit stimulus undertaken by the Chinese authorities, we have gone through extraordinary monetary policy measures – ranging from quantitative easing to negative interest rates – by all the major central banks. Indeed, over the last decade we have seen a long list of policy initiatives, all aiming at stabilizing financial markets at a time of subdued global growth.

In truth, the European Central Bank and the Bank of Japan are still pursuing extraordinarily accommodative policies, whilst the Federal Reserve has only recently started to move decisively away from it. At the same time markets had been expecting the withdrawal of the emergency measures for some time now.

They had not been expecting, however, that such withdrawal would take place in the context of a radical global policy rethink that, in fact, would start questioning some of the basic tenets behind the "Great Moderation" of the last 40 years, namely prudent fiscal policies and free trade. Take the decision of the US Administration to engage in deficit spending well into 2019, and likely through 2020. With unemployment at a historical minimum and growth relatively resilient, it is forcing the Federal Reserve to increase rates more rather than less so as to keep inflation at bay. Higher US debt levels will at some point compromise the country's long term outlook. For now, higher US dollar yields, and the resulting upside pressure on the US dollar, are making life significantly more difficult for emerging markets, forced to follow in the footsteps of the Federal Reserve so as to avoid massive capital outflows that would destabilize their domestic economies. Looking beyond emerging economies, a stronger US dollar is in general not a good thing for the global economy, since it discourages the recycling of excess savings from the world's largest surplus holders Japan and the European Union.

It is important to highlight that a more profligate US fiscal policy is finding support across the country's political spectrum, including significant parts of the Democratic Party. As for trade, even if the US President has broad powers to take measures without the support of the US Congress, here too Mr. Trump has more support than many like to admit. Short, the radical policy rethink is here to stay. It is also global, as can be seen from the Brexit vote in the UK and strength of populist parties in Europe.

An important consequence of the current policy rethink is that it will make it less easy for central banks to stabilize financial markets in case of global turmoil. Yes, the rate hikes enacted by the Federal Reserve should keep inflation, and thus long term yields, at bay. But fiscal profligacy and trade tariffs are potentially inflationary and might push Chairman Powell to do more, raising lending costs excessively and forcing domestic consumers to retrench. On the other side of the Atlantic, it is difficult to see how President Draghi can protract Quantitative Easing, let alone take extra-ordinary measures to keep Italian government yields under control, as long as there is a populist government unwilling to engage in more prudent budgetary policies. Indeed, such extra-ordinary measures would have to be enacted under the so-called Outright Monetary Transactions (OTM) procedure by which the beneficiary government would underwrite a memorandum committing itself to austerity. It is obvious that the whole design of OTM, the essential idea of the mechanism, was for it never to be used. In other words, policy coordination between the ECB and the European governments was such that markets would not dare betting up yields, since that would trigger the OTM procedure. That coordination, that policy credibility, is now much less obvious. As for China, the authorities are bent on reducing leverage. They know all too well that the country has to break away from debt-financed investment spending, if it wants to graduate its economy from middle-income to high income status. The trade war that Mr. Trump is unleashing on the country allows the leadership to put the blame of continued deleveraging on the United States.

The radical policy rethink is thus making it harder for central banks to come to the rescue. Volatility is here to stay, and emerging markets are likely to suffer the most.

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest (27 Jun closing)	Quarterly Change % (Q2 2018)	YTD Change % (27 Jun)
Index Snapshot (World Indices)			
S&P 500	2,699.6	2.2	1.0
Dow Jones	24,117.6	0.1	-2.4
Nasdaq	7,445.1	5.4	7.8
DAX	12,318.9	2.1	-4.4
Nikkei 225	22,270.4	3.8	-2.2
FTSE 100	7,593.2	8.0	-0.9
Sensex	35,104.4	6.8	3.4
Hang Seng	28234.4	-5.8	-5.2
Regional Markets (Sunday to Thursday)			
ADX	4545.3	-0.9	3.3
DFM	2809.5	-9.4	-16.5
Tadawul	8322.5	5.7	15.0
DSM	8954.6	4.1	4.7
MSM30	4570.41	-4.1	-9.3
BHSE	1309.0	-0.9	0.0
KWSE	4895.3	-1.1	-1.1
MSCI			
MSCI World	2,076.3	0.5	-1.3
MSCI EM	1,052.1	-10.1	-9.2

Commodity	Latest (27 Jun closing)	Quarterly Change % (Q2 2018)	YTD Change % (27 Jun)
Global Commodities			
ICE Brent USD/bbl	77.5	10.5	16.1
Nymex WTI USD/bbl	72.46	12.0	20.4
OPEC Baskt USD/bbl	74.3	12.8	15.3
Gold 100 oz USD/t oz	1249.8	-5.4	-3.7
Platinum USD/t oz	852.9	-7.9	-7.5
Copper USD/MT	6688	0.0	-6.6
Alluminium	2199	10.5	-2.6
Currencies			
EUR	1.1552	-6.0	-3.5
GBP	1.3085	-6.2	-2.8
JPY	110.39	3.8	-2.1
CHF	0.9980	4.4	2.3
Rates			
USD Libor 3m	2.3356	1.0	37.9
USD Libor 12m	2.7709	4.1	31.5
UAE Eibor 3m	2.4350	4.4	35.4
UAE Eibor 12m	3.2307	15.7	25.2
US 3m Bills	1.9151	-42.0	39.4
US 10yr Treasury	2.8383	3.2	17.5

Executive Summary

- The radical global policy rethink is jeopardizing free trade across the world, and fiscal prudence in developed markets. We reiterate our stance that these tensions are very unlikely to go away in 2018. Even if a full blown global trade war seems still unlikely, the fear alone of it – combined with cooling global growth – is likely to keep markets volatile, with recurring downward pressure. It will take a while, before they will feel confident to climb once more the proverbial "wall of fear".

- We had been long surprised by the resilience of emerging markets. The end of the US dollar weakness, which had characterized most of 2017, together with the trade war concerns are now finally exercising their toll on emerging markets. The renewed strength in the US dollar, in fact, implicates – together with rising US interest rates – a significant deterioration in the financial conditions of emerging markets, in particular those with high US dollar debt levels. The stronger greenback is also not favorable for commodities, of which some emerging markets are major exporters. Finally, global trade concerns impact emerging markets more than developed economies.

- Federal Reserve tightening combined with some signs of growth cooling have determined a further flattening of the curve. Whilst continued flattening is on the cards, we would exclude a significant inversion of the US yield curve, as it seems more likely that the Federal Reserve would pause hiking towards the end of the year, especially if the US dollar further strengthens. On the upside, we would not exclude a temporary break-out of 10 year yields towards 3.5%. Either way, financial conditions are likely to remain tight, especially when compared to previous years.

- 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 destabilizing the domestic situation too much, and thus without causing too many jitters in the markets. In any case, we steer clear from the markets that are more dependent on China.

Market Outlook and Portfolio Positioning

Asset Allocation

Equities	Neutral	With global growth cooling and policy measures becoming less market friendly, equity markets will remain under pressure.
Fixed Income	Underweight	Whilst high quality government paper might continuing doing well, we see risks for further spread widening and higher yields on the short end of the curve. The underweight in fixed income serves to finance additional cash holdings.
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	Barbell approach	A barbell approach combining long-term Treasuries and short-term money market paper seems most sensitive.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
US Credit	Underweight	Valuations remain expensive. High yield spread compression is not likely 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 with increasing signs of global slowdown and Fed pressing on more rate hikes this year.
EM hard currency bonds	Underweight	Hard-currency bonds preferred over local currency bonds as monetary policy rhetoric will become more hawkish and emerging currencies remain under pressure due to broad US dollar strength and tightening US financial conditions. We only prefer Russia USD sovereign and quasi-sovereign bonds.
GCC	Overweight high quality sovereigns	GCC credit spreads yet to fully reflect the recent rise in oil prices. Valuations appear attractive. 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 and front-loaded RBI rate hikes to check the drop in local-currency sovereign bond yield.

Market Outlook and Portfolio Positioning

Equity Markets

US	Overweight	Deficit spending combined with rate hikes has usually led to an increase in equity prices. Growth is likely to persist through 2019, as is the boost in US corporate earnings. It will be a volatile ride though.
Eurozone	Neutral	A stronger euro and trade growth fears are undermining the equity market rally in the single market given the large share of revenues which Eurozone corporates derive from overseas (over 50%). Exposure to China and Asia is also not helpful.
Japan	Neutral	Japanese equities have suffered recently with the strength of the Japanese yen depressing prospective corporate earnings. In spite of rather solid domestic fundamentals, Japanese markets are therefore likely to remain under pressure.
Emerging Markets	Underweight	As expected the tailwind provided by a weaker US dollar, has now subsided. The underperformance of emerging equities is likely to persist, although we still like Indian equities.
United Kingdom	Neutral	A soft Brexit outcome would likely push up the Pound Sterling, which would be bad for UK equities. On the other hand, a no Brexit deal would unlikely further depress the Pound Sterling which has already fallen considerably. As a result the payoff outlook is asymmetric and UK equities are unlikely to do better than other equity markets.

Energy and Commodity Prices

Energy	Neutral	The recent decision to increase output taken by OPEC and Russia is likely to have a limited impact on the oil price, given the reduction in output by Venezuela and Iran. If anything we would expect the market share of the GCC suppliers to rise. Also, the recent increase in tensions between the US and Iran, might well lead to more turmoil in the more troubled parts of the region, specifically Iraq, and thus put actually upward pressure on the price.
Industrial Metals	Underweight	China tightening will put downward pressure on industrial metals.
Precious Metals	Overweight	The US "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

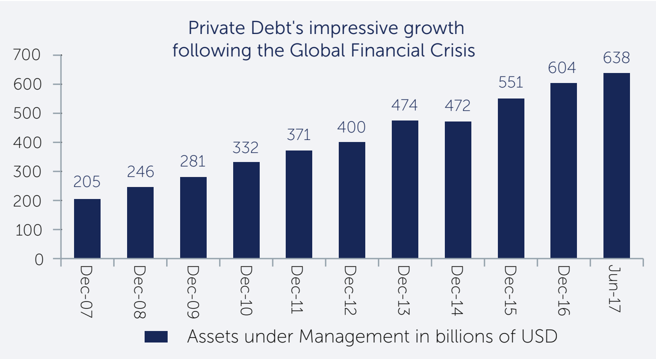
EUR	Moderate downward pressure	Political uncertainty is likely to weigh more than Quantitative Tightening, which anyway has been largely priced in. Trade war concerns and emerging market woes are also more likely to benefit the US dollar, the Japanese yen, and the Swiss franc, rather than the euro. As such we would expect the euro to continue to move sideways with a downward bias.
GBP	Some further corrections expected	The Pound Sterling is to follow the euro rather than the US dollar. Some more uncertainty-induced downward pressure on the euro cannot be excluded, in the run-up to the October deadline for a Brexit deal with the EU.
JPY	Moderate downward pressure	The combination of moderate Fed tightening and BoJ yield curve targeting would normally put continuing downward pressure on the yen. The risk is that further global risk-on concerns would undo that outlook.

What's trending: Private debt

July 2018

Low yield environment delivers "new" asset class

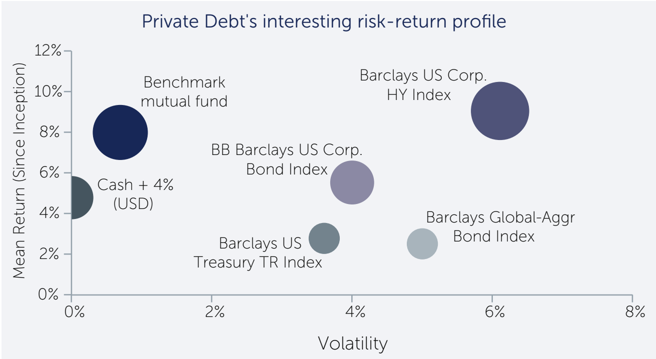
Over the last years, private debt has become increasingly mainstream for the general public, as investment houses have pooled the relative investments in accessible vehicles. Private debt is nothing less than lending by institutional investors to small, medium sized companies in the form of senior secured debt or subordinated debt. The asset class is not traded on public exchanges and as a consequence is less liquid than publically listed securities. Historically accessibility to the asset class has been restricted to commercial banks. However, following the financial crisis increased regulation, such as e.g. the Basel capital adequacy rules, forced banks to reduce lending to the mid-market segment leading to the rise in non-bank institutional lending via pooled investment vehicles. Demand for private debt further increased over the last decade (Figure 1) due to its attractive yield characteristics in a backdrop where global bond yields have been suppressed. Whilst unconventional monetary stimulus (quantitative easing) is perhaps a cyclical reason underpinning low yields, low productivity and deteriorating population growth coupled with high household debt are structural drivers which suggest that there might be an enduring ceiling to global bond yields. As a result Prequin, a company specializing in data and information gathering on alternative assets, projects that the private debt market can grow to USD 2.5 trillion within the next ten years given the attractive yield dynamics and the fact it is still relatively an unpenetrated sector.



Source: Prequin

The yield and liquidity profile have often been compared with private equity. However, unlike private equity and other private investments, private debt investors start receiving positive cash flow immediately and are charged management fees only on invested capital reducing the so called "J Curve effect". In addition, private debt funds do not have imposed lock up periods resulting in an improved liquidity profile. It is true of course that private debt is less liquid than public debt, as is in fact reflected in the monthly liquidity of most private debt investment funds. IIt is, however, worthwhile to note that since the introduction of the Volcker rule post the financial crisis the distinction is less clear. Effective liquidity, i.e. the capacity to sell rapidly at an assumed fair price has become much more difficult. For example, ICG, a specialist asset manager, estimated that it took seven times as long for investors to liquidate bond portfolios in 2015 as it did in 2008.

Another important aspect of private debt is its ability to provide uncorrelated returns. Cross asset correlations have been rising since the introduction of loose monetary policy post the financial crisis. The core risk exposure in private debt investment comes from idiosyncratic firm specific sources, which is not the case with publicly traded corporate fixed income. From 1999 to 2015, it has been noted that middle market loans (a popular private debt instrument) offered a volatility as measured by standard deviation of 7.42, compared to syndicated leverage loans of 9.06 and high yield bonds of 10.65. Moreover, the default rate for middle market loans was 3.42%, compared to syndicated leverage loans of 4.93% and high yield bonds 4.45%. This is because publicly traded bonds are mostly unsecured obligations with standard indentures, opposed to private debt where investors have more control over terms and conditions such as covenants and collateral structures.



Source: Prequin

No such thing as a free lunch

Whilst our base case does not forecast a recession in the next 12 months it is important to note that we are currently in the advanced stages of the business cycle. As such asset classes without daily liquidity can experience large drawdowns in periods of risk aversion as investors seek to exit positions on concerns of a deteriating credit outlook.

How to go for it

Our Investment Advisory team has identified the appropriate route to to gain access to this opportunity. In general this is through a pooled investment vehicle. If this is of interest to you, please reach out to your relationship manager.

UAE finally coming out of the shadows of austerity

Whilst Dubai had throughout the last four years maintained a relatively anti-cyclical fiscal policy, Abu Dhabi had focused on budgetary prudence, thus determining a significant retrenchment in growth rates. This is now behind us, with the emirate announcing 50 billion AED in spending over the next three years. The detailed execution plan is expected by early September, however the objectives include job creation, increasing tourism and improving private sector development. Importantly, fiscal spending is to be accompanied by measures aiming to make the economy more competitive, decreasing the cost of operation for companies, boosting tourism and creating jobs. The government's measures must be seen in conjunction with ADNOC's decision to invest over the next five years 45 billion USD in the expansion of its downstream capabilities. Whilst the overall impact is still difficult to assess some forecasters argue that the combined impact of the two spending loans, which according to the government should lead to 25,000 new jobs, could over the next 3-5 years be in the order of 2% extra annual GDP growth and lead to annual increase in loan growth in the order of 4%.

Key structural reforms pursued by the government

The UAE is to ease restrictions on foreign business ownership and residency rights in a move to increase investments, attract fresh talent, and make the population stickier, thereby promoting more stable life-cycle investment and consumption patterns.

New measures are also taken to support SMEs by facilitating government contracts for SMEs, reducing red tape and taxation, as well as ensuring speed payment. The support for the SMEs comes together with the de facto lifting of the free-zone system, by allowing free-zone companies to operate across the national territory.

With a view of enhancing the country's profile as a tourist and transit hub, the government has also announced a further liberalization of transit and tourist visas. Both Abu Dhabi and Dubai have reduced fees on hotels and restaurants to make the hospitality industry more competitive.

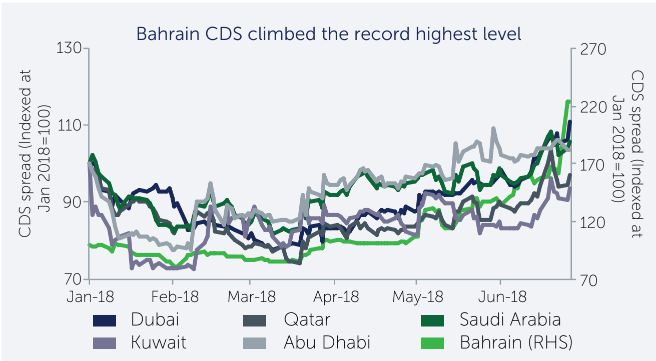
Housing loans worth 7.5 billion AED will be distributed among Emiratis in Abu Dhabi as part of government efforts to provide its citizens with decent living standards.

Attractive valuations underpin GCC bond markets

GCC dollar sovereign and credit markets came under pressure amidst the widespread sell-off in EM bond markets, but GCC bonds have exhibited some resilience over past month. Dollar sovereign bond yields have been stable in better-quality sovereigns like Dubai and Abu Dhabi bonds. This could be on account of limited new supply activity due to Ramadan and higher oil prices finally feeding into some of the credit valuations. In addition, above mentioned reform and spending plans of the government of Abu Dhabi should give a boost to economic activity, whilst not necessarily leading to new debt raising given the sovereign's robust balance sheet and prospect of higher oil revenues. Elsewhere, Dubai also has unveiled a slew of measures to attract foreign investment.

At the same time, lower-rated sovereigns with weaker fundamentals, like Bahrain and Oman, have severely suffered. Bahrain's credit default spreads rose to the highest level since the data started in 2008 and also the highest within emerging markets. The recent announcement of support by the KSA, the UAE and Kuwait, is likely to reduce the spread widening which was probably exaggerated. As was clear also from the case of Jordan, the richer GCC countries will continue to support the weaker economies with a view of stabilizing the region.

Overall, we believe that higher oil prices should help improve the region's fiscal situation and should reduce the need for additional borrowing. Revival of any regional tensions is the only risk that could impact the bond market sentiment. With the recent sell-off, valuations have become at any rate more attractive.



Source: Bloomberg

A closer look at the UAE equity sectors

The banks are expected to benefit the most from the stimulus package and other reforms, through significant loan growth and improvement of the quality of fiscally supported loans to SMEs.

Contractors will also benefit with the revitalization of the real estate sector, housing loans to Emiratis and more speedy payments on contracts. However, investors should be careful about the existing legacy issues with contractors.

The real estate sector itself will however need more time to turn around as oversupply and rising interest rate will have an offsetting impact.

The introduction of free transit visas and the significant cut in hotel and restaurant taxes should boost the UAE tourism industry, and enhance its standing as a leading travel and transit hub. These moves should somehow compensate for the negative impact from the VAT implementation and the stronger US dollar, to which the AED is pegged.

Solid growth outlook cools moderately

Moderate cooling is inevitable

Whilst the US economy is by and large steaming on, some cooling seems to be evident from the business confidence leading indicator, and the flattening of the yield curve. We have always been wary about statements arguing that the US economy should regain the rate of growth (north of 3% in real terms) we were accustomed to before the implosion of the credit bubble in 2008. Some cooling in spending is also now in our opinion inevitable as the US dollar has strengthened as lending costs have risen. In addition to that, whilst the US economy is relatively immune from the global cycle, the slowdown in China and the European Union are also bound to exercise some impact on the US economy. Having said so, the general backdrop of increased deficit spending is and the tax reductions are likely to keep the overall economy in expansionary territory and the unemployment level, already at a historically low level, might well end up below 3.5% of the total workforce.

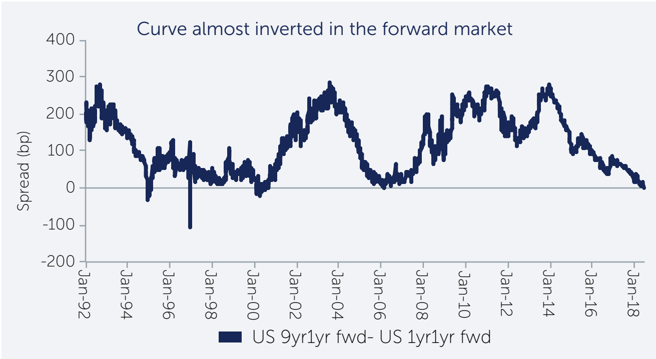
Policies are more stable than you think

In spite of the increased polarization and the judiciary in the Trump 2016 campaign, policy are rather stable. Whatever happens in the upcoming November Midterm elections, the current profligate fiscal policy, based on tax cuts for the rich and increased spending across the board, is unlikely going to be undone. As long as the US dollar does not massively strengthen, and based on our assumption, that the Federal Reserve should also moderate tightening in 2019, the policy framework remains therefore overwhelmingly conducive to continuing growth.

The key policy concern remains the country's trade policy. We would argue that a concrete threat of serious trade barriers being erected between the United States and China, would likely trigger a big and lasting equity market correction. Such correction would then impact consumer confidence and deter investment growth. The most likely scenario, however, remains that China will makes some concessions to the United States and that a serious trade conflict will be avoided. Talks about trade wars, in other words, are however likely to continue and cause persistent market volatility. The US equity market is, however, likely to withstand trade-related downward pressure, better than other markets.

Fixed income: Curve to flatten

US treasuries had a volatile ride in the second quarter with 10-year yields touching new highs of 3.12% on higher inflation and oil price concerns, only latter settling below 3% on trade worries. As we had highlighted in the previously quarterly, the back-up in yields due to the jump in oil prices was temporary in nature. There has been some pick-up in inflation with the Fed's preferred gauge of inflation – Core PCE growing at the fastest pace in a year. Yet, core PCE still remains below the central bank's target of 2% and would need to consistently rise at more than 2% to reach the central bank's long-term target. Strong growth and tight labor market conditions, along with the revival in inflation has compelled the Federal Reserve to press on with two more rate hikes this year (after hiking twice already). In addition, it also revised its dot projections higher, pushing forward the rate hikes into 2018 and 2019. In spite of the hawkish Fed tone, long-term bond yields have remained stable, while the curve has flattened further. This is because the Fed did not make any changes to its dot projections for 2020 and the long-term median rate. In addition, safe-haven appetite has continued to benefit long-term US treasuries amidst the trade war concerns. We believe that the recent curve flattening trend is likely to continue towards the year end as the Fed will stick to its rate hike plans. At the same time, activity in the US is showing some signs of softness which is inevitable given the economy is running at near full employment levels. It will not be very long before the US catches up with the cooling global growth trend. The US forward swap curve is already pricing risks of yield curve inversion and we expect the treasury yield curve to follow suit in the coming months.



Source: Bloomberg

US credit spreads have been quite volatile amidst the geopolitical tensions. Investment grade (IG) bonds have underperformed the most with IG spreads widening to the highest level in almost 2 years. The recent underperformance of the IG sector has been mainly due to rising dollar hedging costs, volatility in US rates and longer duration of the index. On the other hand, US high yield bonds have been resilient and spreads have remained mostly unchanged since the beginning of the year. While corporate sector profitability, strong US growth and declining defaults could support the credit sector, we still believe that the credit spreads, particularly in case of junk bonds, are too low. Given the negative relationship between junk bond performance and the US treasury yield curve, we believe that the high yield sector will remain vulnerable. The volatility in credit spreads is likely to increase, especially if more signs of US joining the "slow growth camp" become apparent. We remain underweight in US credit.

Equities – remain overweight

We have turned more bearish on global equities. At the same time the earning outlook for US equities remains relatively solid, as the economy is less exposed to the global economy and thus better equipped to withstand the China slowdown and global trade concerns. In other words, we prefer to hold relatively more US equities in view of their traditional safe haven role, i.e., the fact that their "global beta" is relatively low.

Growth to remain moderate

Growth slowdown in China is bad news for Europe

We stick to the narrative of weaker growth in Asia having a significantly negative impact on Europe. The European Union has in fact the largest current account surplus in the world, and its economies and companies are among the most exposed to China and Asia. Whilst our call for weaker growth in Europe was originally mainly driven by China stimulus tightening and the 2017 strengthening of the euro, it is now being additionally supported by concerns about global trade. The bad news is that Europe's growth engine Germany has always been particularly sensitive to the Chinese cycle because of its significant exports to that country. The good news is that overall the euro is strong compared to where it was about a year ago, but historically still quite competitive.

Source: Bloomberg

Whilst Europe's growth context has deteriorated since 2018, and we think that growth will remain moderate, a full blown recession seems unlikely. For one thing the real effective exchange rate is from an historical perspective not overvalued, and the recent appreciation of the US dollar is further helping. The ECB, furthermore, is, yes, going to normalize its policy but will do so in a gradual manner. Finally, whilst the risks of trade confrontation have risen substantially, it would be still most realistic to bet on a positive solution for Europe. For one thing, the United States might at times threaten Europe too, but it has an inherent interest in keeping Europe on its side as it renegotiates its relationship with China, its main antagonist. The European Union has also just concluded free trade agreements with Canada and Japan. Nonetheless, the risks have been rising recently and might remain high until later this year, as Trump is likely to maintain an aggressive stance until the November US Midterm elections. Critically, there is also the risk that by October there might be no deal with the UK on Brexit.

Political risk is here to stay

Italy's populist government is unlikely to engage in actions that would defy EU fiscal budget rules. It is likely to obtain some concessions, but they will not significantly alter the country's fiscal stance. Nonetheless, going forward political risks are on the rise in Europe. Italy's electorate feels, rightly or wrongly, that Europe is not helping the country enough on handling immigration. At the same time, Italy's northern neighbours are increasingly unwilling to take on more immigrants.

Whilst we believe that the situation is for now manageable, in the sense that Italy is likely not to push for a major crisis, at some point this situation might change if and when a recession would hit Europe and the country would not be willing to undertake fiscal policies compatible with the European Central Bank framework. We don't see this happening for now, but we would stress that, unlike the situation in 2012, with the current Italian government it would be much more difficult for Mr. Draghi to enact policies that would support Italy. Prospective ECB policy normalization towards the end of this year, will already give us a taste of this.

Bunds to benefit from dovish ECB

Even though the ECB indicated a target end date of this year for its bond buying programme, core European bonds have staged a rally. This has been due to a combination of factors. Firstly, the growth climate in Europe has started to look dim with economic indicators pointing to a growth slowdown. Secondly, in addition to growth concerns in Europe, political uncertainty within the region has not completely disappeared. Rising political-led volatility in Italy had pushed investors to safe-haven bunds in May. Thirdly, trade tensions between the US and Europe continue to escalate, after the US did not exempt Europe from steel and aluminium tariffs. Lastly, the ECB remains concerned about the above-mentioned factors, particularly the threat of trade woes on the growth outlook and hence has pledged not to make any changes to its policy rate setting at least through the summer of 2019. We believe that the ECB will continue to remain accommodative and this should prove beneficial for German bunds. While safe-haven appetite during times of increased volatility will benefit both bunds and US treasuries, the latter could see more inflows, especially if the volatility is on account of increased trade tensions.

European credit came under selling pressure, particularly in May when increased political uncertainty in Italy and the rise in geopolitical tensions spurred risk-off sentiment in the markets. Unlike the US and similar to the trend seen in the first quarter, junk bonds have underperformed more than investment grade credit in Europe. This underperformance appears justified with the recent backdrop of weakness in economic data. In addition, ECB's policy normalisation could have an impact on credit as the ECB - the main buyer - withdraws its bond buying program by end of this year. As such, we remain underweight on European credit.

Equities – Remain neutral

With growth in the Euro-zone rolling over, European companies' earnings are less likely to live up to expectations. In addition, whilst global equities in general are likely to suffer from continuing talk about trade wars, European equities could suffer more since in particular the leading German index (Dax) is more sensitive to such concerns. In this regard it is not even necessary to talk about trade wars. European equities are simply more sensitive to the likely growth slowdown in China, and this is only being exacerbated by the US contemplating tariffs on cars.

The clouds are not clear yet

Brexit uncertainty to remain

Prime Minister Theresa May was victorious in getting her EU withdrawal bill passed through both the upper and lower houses without the amendment of "meaningful vote" which was advocated by pro-Europeans rebels to allow for parliamentary control in case of a no-deal scenario with the EU. While Mrs. May's government may have passed one of the key milestones, the passage of the EU withdrawal bill has not changed the Brexit situation much. There is still lot of uncertainty lingering over the possible negotiations to take place between the UK and the EU and also another domestic legislation i.e. the trade bill and customs bill are due to be presented in the Parliament later in July. The debate on the two bills will prove to be a hurdle for Mrs. May's government. Many of the pro-European rebels who may have backed off from the "meaningful vote" amendment on the withdrawal bill, will not be willing to compromise on the amendments to the trade bill. One of the main amendments, which already has the backing of many Tory MPs is the "cross-party" amendment to the trade bill which would allow the government to "take all the necessary steps to implement an international trade agreement which enables the UK to participate after exit day in a customs union with the EU on the same terms as existed before exit day". In addition to this, Mrs. May's cabinet is still on an impasse on the possible route for the future customs arrangement and remains undecided between their preferred choice of a customs partnership with the EU or the technological solution ("max fac"). As such, we believe that the Brexit uncertainty is likely to persist in the coming few months, particularly as we edge closer to the March 2019 deadline with no real progress in Brexit negotiations likely to be made until October.

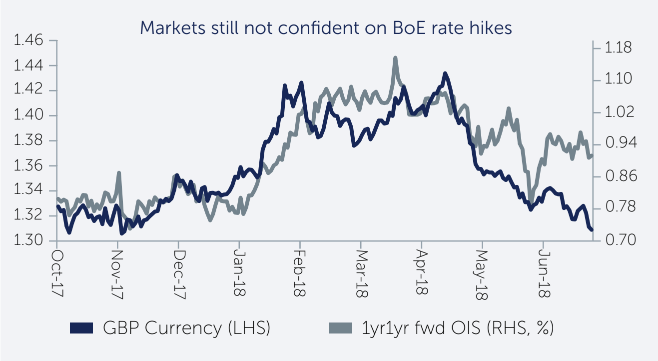
BoE to delay rate hikes

The economy had a weak start to the year with growth dropping in the 1st quarter to the lowest level in six years, thus compelling the Bank of England to delay the tightening process in May. Since then, economic data has still been mixed even though the central bank remains confident that the slump in 1Q GDP was just a blip on weather-related factors. Industrial production growth has been disappointing while the manufacturing PMI has been mostly flat. However, there has been some improvement in retail sales and consumer confidence. The Bank of England keeping rates unchanged, struck a hawkish tone at the recent meeting, pushing the market rate hike expectations in August above 50%. But the central banks' decisions are highly data dependent and considering the ongoing softening of global growth, one cannot rule out the possibility of growth remaining subdued in the UK. Moreover, Brexit-related risks have not vanished yet and as long as there is lack of clarity on the Brexit scenarios, we find it difficult to believe that investment activity will pick up. This also means that the pound will continue to be volatile, though we don't expect any massive depreciation.

Gilts: remain bullish

Gilts yields have been well anchored, largely benefitting from the safe-have demand amidst the Italian political uncertainty in May, as investors flocked to core European bonds to reduce risks. In addition, domestic factors have also supported demand for the bond market. The economic backdrop of the country remains weak with not major improvement seen in economic indicators. Growth in the first quarter declined to lowest level since 2012 which was largely expected by the market. More-frequent economic indicators reported in April and May have been fairly mixed. The cooling trend of growth seen in other parts of the world also does not bode well for the UK economy.

The backdrop of the mixed economic outlook and Brexit uncertainty still adding risks should provide enough reasons for the Bank of England to adopt a "wait and watch" approach for a while. Even though, the possibility of rate hike may arise, we still believe that long-end Gilt yields will remain anchored. This is because the economic outlook is unlikely to undergo a massive expansion, taking into account the mixed global picture and Brexit-related uncertainty. As such, we hold a positive stance on the gilt market.



Source: Bloomberg

Equity – remain neutral

After having a difficult first quarter, UK equities managed to recoup some of their losses in the second quarter in spite of the global market volatility. In dollar terms, UK equities have performed better than their European counterparts on a year-to-date basis. Much of this recovery could be attributed to the pound weakness. Revival of dollar strength along with a "wait and watch" BoE stance has pushed the pound lower. This may have spurred demand for the UK equities which largely benefit from a weaker pound given that 70% of FTSE 500 companies have their revenues denominated in dollar. However, the economic picture is still not clear as data remains mixed and recent cooling of global growth, along with the trade tensions, will only add to the macro-economic uncertainty. In addition, lack of clarity on Brexit front will continue to impact sentiment while the pound will remain volatile between the BoE meetings. As such, we maintain a neutral stance on UK equities.

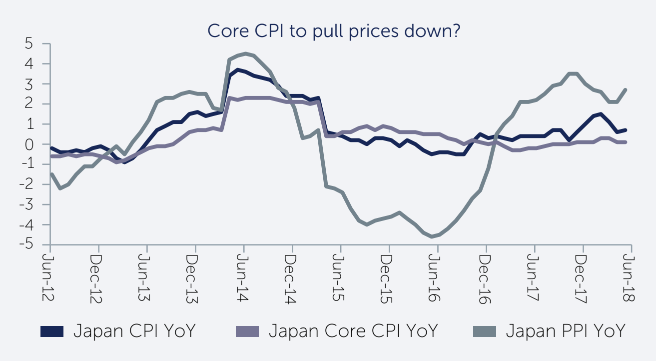
Emerging market turmoil is not good for Japan

Bank of Japan has suddenly more reasons to remain cautious

Concerns about Prime Minster Abe illegally supporting cronies in real estate deals, have taken a backstage. They were never likely to seriously imperil his government, led alone lead to the ruling LDP losing power, but they could dent into his capacity to push through constitutional reforms.

At any rate, the key concerns for Japan regard much more what is happening in Asia at large, than what is happening in Japan itself. The US seems much more willing to strike a trade deal with Japan than with any other of its allies. But the uncertainty created by the slowdown in China, potentially to be aggravated by US trade tariffs, is now being compounded by additional turmoil in emerging markets. Such developments always trigger upward pressure on the Japanese yen, and thus have the potential of compromising the accommodating stance of the Bank of Japan. Thin turn might then lead to less wage growth, and less consumer price inflation.

In this sense, the Japanese economy, in spite of – or perhaps precisely because of – its global position as a net creditor – is more vulnerable to any global downturn than most other advanced economies. Critically, as the chart below shows, the recent improvement in headline inflation is not being matched by a similar increase in producer prices or core prices. In other words, the Bank of Japan's "success" in promoting inflation appears to be the result of higher oil prices, rather than increased domestic discretionary spending. As such, the risk of yet another disappointment in inflation numbers remains high.



Source: Bloomberg

Decreasing returns to unconventional monetary policy amidst a continuing emerging markets' correction

The key issue for Japan's continuing extra-ordinary monetary accommodation is not whether it is sustainable, it probably is, but whether it is still effective. Even if the Bank of Japan seems much more reluctant than the Federal Reserve, or even the European Central Bank, to unwind its massive balance, it is not at all clear how meaningful its impact will be on domestic inflation expectations going forward. The current policy of yield curve targeting – specifically intervening in the market such that interest rates are negative and long-term yields are zero – can no longer be perceived as shocking the markets. It has become part of the landscape and, as such, inflation expectations might become entrenched, and thus indifferent to additional measures of monetary policy.

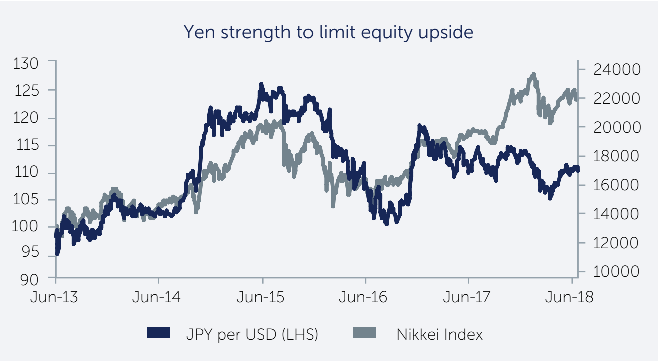
What kind of inflation expectations might become entrenched? That is the bug question of course, but what matters is that it may be out of the hands of the Bank of Japan. If emerging markets continue to correct, the Japanese yen – which is perhaps the most important funding currency for emerging market investments – is likely to appreciate. Unless the Bank of Japan would directly intervene in the foreign exchange market, something politically less obvious, there would be little left to be done to stem such a rise. A stronger yen would immediately bring down inflation expectations, and deteriorate the country's growth outlook.

Equity markets no longer well positioned

Global growth cooling and less market friendly policies in the United States, China and the European Union are already making the outlook for global equities less attractive. The fact that the global market concerns are now specifically spilling over to emerging markets is particularly harmful for Japanese equities since – as explained above – it makes it less easy for the Bank of Japan to ensure that the yen remains weak.

That is also why we recently undid our currency-hedged overweight on Japanese equities which since October 2016 had done well, precisely because the yen had depreciated for an extended period since the end of 2016.

It is also important to stress that geopolitical shifts are globally shifting from the Middle East to the Far East, as the US and China confront and tensions surrounding North Korea might well come back, in spite of the recent summit between Trump and Kim Jong-un. Again, the yen being the regional safe haven currency, all political uncertainty is likely to benefit it, and to compromise Japanese local equity performance.



Source: Bloomberg

Deleverage at any cost, almost

Sticking to policy

With the appointment of Liu He as China's Vice Premier of Economics, Xi Jinping has given a clear sign that he intends to pursue deleveraging even in the presence of significant market turmoil. This more hawkish policy stance had been in the making through 2016 and 2017 as Xi was preparing for the November 2017 Congress to appoint a Standing Committee of the Politburo of the Party pretty much in his own image. That very policy is also inevitable in view of the massive debt accumulation that has been accruing since 2009 as the country financed domestic investment spending with a view of compensating for slower global demand growth for its products.

We are now assisting to a significant correction of the country's equity market combined with a depreciation of the renminbi, the country's still non-convertible currency. Again speculations are rife for the government to do something, perhaps release some addition credit spending to prop up equity and property prices. Whilst we believe that the government will do all that is in its power to prevent domestic stabilization, it is likely to do so without injecting further credit into the system. The reason is simple. The hawkish policy stance of reigning excessive credit spending, of which Mr. Liu He is the personification, is absolutely necessary if the country is put itself on a sustainable growth path, capable of lifting it from a middle income- to a high income country. Also, now that the population growth has stabilized, there is less need to create each year millions of new jobs. Thus, from the government's perspective, it is better to allow some financial unrest, and compensate that with social spending aimed at alleviating the pain for the weaker parts of the population, rather than increasing debt levels again and kicking the can down the road once more.

Trade conflict might make the policy choice even easier.

China is suddenly immediately exposed to the risks inherent to an economy that is too much tilted towards manufacturing exports. Whilst a slowdown of the Chinese economy was already in the cards with the government trying to reduce bank credits, deflate the real estate bubble and bring down excess capacity in key manufacturing sectors, it certainly would have preferred doing so in a gradual fashion, not as a result of (the imposition of reduced) export revenues.

Source: Bloomberg

Then again, the Chinese authorities have now an external scapegoat to whom – if necessary – blame the hardship of deleveraging, and in reality rally support for the policy of deleveraging. Again, one should not take China's commitment to deleveraging as a non-pragmatic rejection of any form of support to the domestic economy. This is ever so true because manufacturing in China is still more than 20% of gross domestic product and employs also more than 20% of the labour force. In other words, China is much more vulnerable to a potential trade war than the United States which employs only 10% of the work force in manufacturing and which exports to China less than half the value of what China exports to the United States.

China will try to play ball

For the same reason the Chinese authorities will keep their heads cool as they discuss future trade (and not only trade) relations with the US. In other words, they will maintain officially an aggressive stance, but behind doors they will try to accommodate US requests. In the end, the US is mostly concerned about having more access to certain domestic sectors of the Chinese economy, than to put tariffs on Chinese imports. Critically, the US wants relaxation on US investments in China, but on the other hand wants to put a halt to Chinese companies buying US companies. It also wants more Chinese cooperation in cracking down on cyber-attacks and intellectual property rights. China will accommodate as much as possible, provided it can do so without giving the impression of a total and humiliating surrender.

What China will not be able to offer will be a total liberalization of the capital account since such a move would risk triggering massive capital outflows and thus domestic instability. Rather, whilst the country might well further open the finance sector to foreign operators, it will keep the capital account largely controlled also with a view of avoiding excessive fluctuations of the renminbi.

Equities – remain underweight

Whilst H shares have held up well, the underperformance of both A shares versus emerging markets has taken an additional hit. Whilst we believe that overall emerging markets are likely to remain under pressure as the US and China continue to quarrel about trade, it is clear that China domestic shares remain the most vulnerable. The reduction of the country's credit bubble and excess capacity will also not be helpful. These factors, in our view, will outweigh the inclusion of the A-shares into the MSCI Emerging Markets Index. The arguments for the long-term potential of Chinese equities are of course still there, but 2018 continues to look rather bad.

Growth to pick up, but risks have risen

Growth picks up but external threats pose risk

Growth is clearly showings signs of recovery with the 1Q GDP rising by 7.7% on yoy basis. Government spending was the main driver for the pick-up in growth with a double-digit expansion recorded in the construction sector. The Government-led push in construction activity is typical in a pre-election year. Going forward, we expect that growth will continue to pick-up further due to last year's low base effect and on account of increased public spending ahead of next year's elections. However, given the recent backdrop of cooling global growth and emerging market sell-off, external challenges remain and could weigh on the growth prospects. Export growth in India has been showing signs of weakness even without the impact of global trade tensions being accounted for. More importantly, the jump in oil prices, the stronger dollar and higher US rates are external headwinds likely to negatively impact the macro-economic fundamentals in the coming months. As such, we believe that the impact of reforms such as GST implementation, which are structural in nature will take more time to be fully reflected in the GDP numbers.

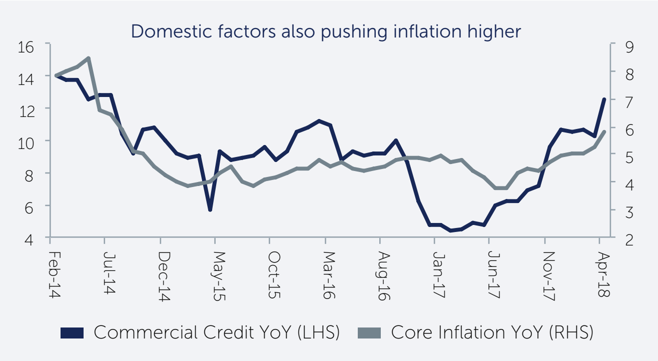
Weaker trend in rupee calls for front-loaded RBI rate hikes

Similar to other EM currencies, the Indian rupee has weakened significantly on account of broad dollar strength and more importantly, the impact of higher oil prices on the current account deficits and price pressures. Given India's high oil import bill and still uncertainty about the global oil supply outlook, volatility in the Indian currency is expected to remain. This is in spite of the central bank making a surprise preemptive move in raising policy rates in June. Even with more rate hikes likely from the central bank, the scope for any reversal in rupee trend remains limited. This is because the portfolio inflows are not likely to be buoyant to finance the current account deficit.

Bonds: Stay neutral

The local currency sovereign bond market has also been under selling pressure. The second quarter has in fact recorded a sharp rise in 10-year bond yields which rose by almost 60bp. Most of the underperformance has been on account of increasing inflation pressures due to the rise in oil prices and impact of government house rent allowances. There has been a 12 percent increase in the price of the India crude basket recorded since the beginning of April. Signs of increase in inflation have been evident with consumer prices rising at a higher than expected rate of 4.87% in May. In order to account for the rise in inflation and rupee weakness, markets have increased their bets on more rate hikes by the central bank in the coming few months. The RBI surprised the markets by raising rates by 25bp for the first time since 2014 in order to stabilise the rupee, which sold-off heavily amidst the recent emerging market rout. Even if oil prices stabilise, external headwinds causing rupee volatility would imply a hawkish bias from the central bank. Apart from the oil prices, core inflation has been sticky and the decline in output gap and recent improvement in credit growth means that inflation will be on the rise for the remaining part of the year. There is also an added uncertainty on the domestic factors including minimum support prices.

However, interbank liquidity has been tightening recently after remaining in surplus for majority part of the year so far. If the liquidity conditions continue to tighten, one cannot rule out the possibility of the RBI conducting open market operations to release liquidity into the system, thus limiting the upside in government bond yields. As such, we remain neutral on Indian government securities.



Source: Bloomberg

Equities: remain overweight

Similar to other emerging markets, Indian equities have remained under pressure due to the global market sell-off, yet have still managed to outperform their peers, again highlighting the market's insular characteristics. However since the January peak, the MSCI India has corrected almost 4%. While the triggers in the first quarter were mainly due to domestic factors post the Indian budget, external headwinds including higher oil prices, trade tensions, stronger dollar and the widespread emerging market rout impacted the equity market sentiment in the second quarter. We believe that Indian equities could face some volatility in the near term. Even though the domestic growth story remains intact, the rise in global oil prices has exacerbated investors' concerns on the country's twin deficits. The rupee is likely to remain volatile in spite of central bank's hawkish stance, thus putting pressure on the offshore flows. The political climate will also remain cloudy as we inch closer to the general elections next year. Nevertheless, as a long-term investment, we believe that Indian equities remain an attractive proposition on account of the improving fundamentals, positive growth outlook and reform progress. While we are underweight on the emerging market equities asset class as a whole, we prefer holding Indian equities which should be less vulnerable to external risks relative to other emerging markets.

A difficult road ahead

Dollar, Hawkish Fed and trade conflicts pose risks

Emerging market assets, which proved resilient to the rise in volatility in the first three months of the year, have come under renewed pressure over the past two months. Increased expectation of faster Fed policy normalization, broad dollar strength and rising trade tensions between the US and China are the factors responsible for the rapid sell-off in EM assets. We had expected this given the high risk nature of EM assets and the fact that majority of the EM economies are heavily trade dependent. In addition, risks of a slowdown in global growth are also raising concerns for the growth prospects in EM economies. While the growth story in US remains rosy, the softness in growth in Eurozone and Japan and also China seems to be spilling over to the emerging markets. Latest PMI indicators clearly signal that economic activity in EM economies is not surging ahead like it has been over the past few years and has shown signs of weakness. Even without the impact of tariffs being fully taken into account, exports are already losing momentum as indicated by the sharp decline in new export measures. At the same time, it is only common to see downward surprises in other economic indicators too, in line with Europe and Japan. The jump in oil prices has also proved painful for oil importing economies including India. With fears of faster Fed tightening, stronger dollar combined with trade tensions and China tightening, global risks will remain sizeable to trigger further volatility in EM assets, even though fundamentals for the majority of the economies may have improved since 2013 taper tantrum.

EM growth has surprised on the downside

Source: Bloomberg

Brace for further EM tightening

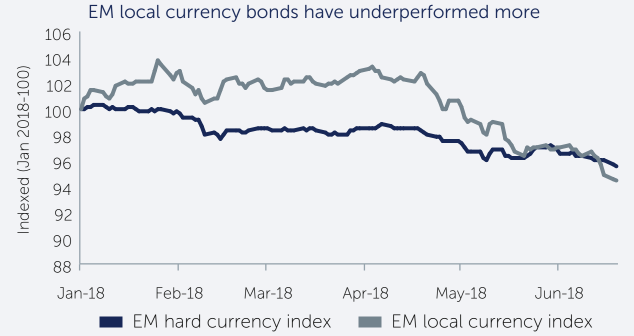
Stronger dollar and higher US rates have proved detrimental for the emerging market currencies. The EM currency index has declined by almost 6% since the beginning of April. Continuous outflows from EM assets leading to currency depreciation has forced many EM central banks to pursue preemptive monetary tightening in order to limit currency weakness. This not only includes weaker economies like Argentina and Turkey which have raised rates by 1258bp and 975bp respectively since April, but central banks of relatively stronger economies like India and Indonesia have surprised the market with policy tightening. Stronger dollar bias and tighter US financial conditions will only make it challenging for the EM central banks to achieve balance between currency outflow and slowing growth (particularly in case of weaker economies). As highlighted in our January Quarterly, we expect that monetary tightness in EM is slated to pick up. A tighter monetary policy will be only prove to be a further drag on EM economic growth.

EM Bonds- Underweight with preference for Russia

Emerging market bonds have been the worst performers within fixed income asset class with the sell-off having aggravated particularly over past two months. The sell-off has been broad-based and even countries with improving fundamentals and a positive growth story have been susceptible to outflows. With US financial conditions tightening (tighter USD libor-OIS spread) and stronger dollar bias, we expect that emerging market bond markets will remain vulnerable to any jump in global market volatility. The fact that even strong economies 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 was already shaky just a few months ago. This made us close our overweight call on Indonesia and in line with our underweight stance on emerging market dollar bonds. We particularly remain wary of countries with higher external debt and wider current account deficits. At the same time, we stick to our Russia call. The country remains well-positioned due to its low public debt levels and current account surplus and we believe that sanctions risks are already priced in.

In addition, as we had highlighted in our previous quarterly, local currency EM sovereign bonds, which exhibited "safe-haven" like features in the beginning of the year, have come under extreme pressure lately. Coupled with dollar strength, the reversal of central bank monetary policy path- switching from neutral/loose to tighter monetary policy-has exacerbated the sell-off in local currency bond markets. In spite of the recent sell-off, hard currency debt looks cheap versus local currency and hence likely to outperform the latter. In absolute terms, however, both asset classes are to remain under pressure.

EM local currency bonds have underperformed more



Source: Bloomberg

Equities – remain underweight

Similar to other EM assets, EM equities have also been susceptible to significant outflows and as a result, have now recorded YTD losses of almost 5%, making them the worst performer so far this year. The resurgence in dollar strength , higher US rates combined with trade tensions between US and China have contributed to the widespread underperformance of EM equities, not only limited to weaker economies. Fed's indication of a faster tightening this year is likely to keep the dollar anchored, which should pose challenges for EM equities. In addition, concerns on global growth receding with the exception of the US, is also likely to weigh on the emerging markets. EM equities have historically tend to outperform during times of better EM PMI performance relative to US. However, this has not been the case lately as EM PMIs have retreated compared to the US counterpart. As such, EM equities are likely to remain under pressure given the backdrop of cooling global growth, stronger dollar bias and recent Fed hawkishness.

Appendix

GDP Forecast	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.9%	In agreement	2.4%	In agreement
Eurozone	2.2%	In agreement	1.9%	Expect moderately less
Japan	1.1%	In agreement	1.0%	Expect moderately less
China	6.5%	Expect moderately less	6.3%	Expect significantly less
India	6.6%	In agreement	7.3%	Expect moderately less

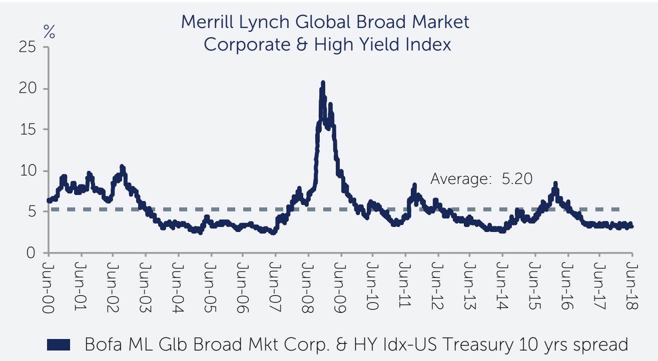
Source: Bloomberg

CPI Forecast YoY	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.6%	In agreement	2.3%	In agreement
Eurozone	1.6%	Expect moderately less	1.6%	In agreement
Japan	1.0%	In agreement	1.0%	In agreement
China	4.0%	In agreement	4.0%	Expect moderately less
India	4.7%	Expect moderately more	4.6%	In agreement

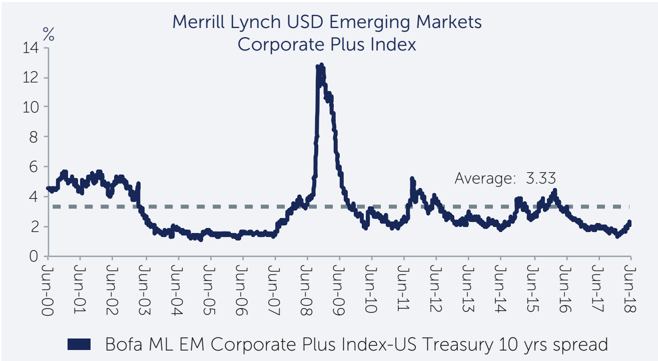
Source: Bloomberg

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

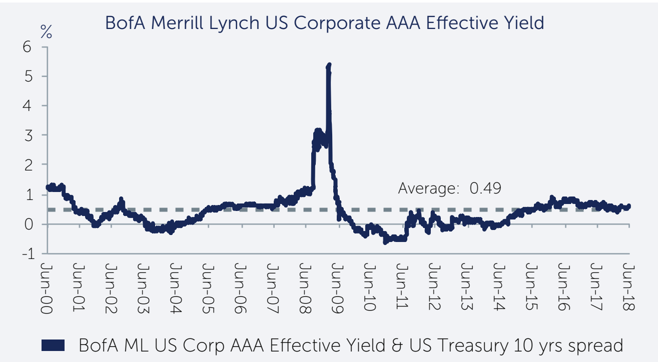
Bond Market Spreads



Source: Factset, Federal Reserve Bank of St. Louis



Source: Factset, Federal Reserve Bank of St. Louis



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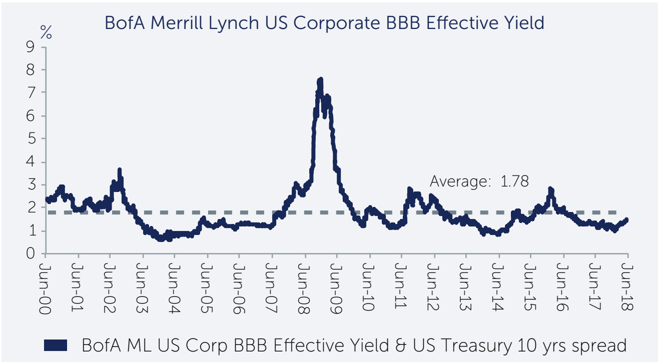
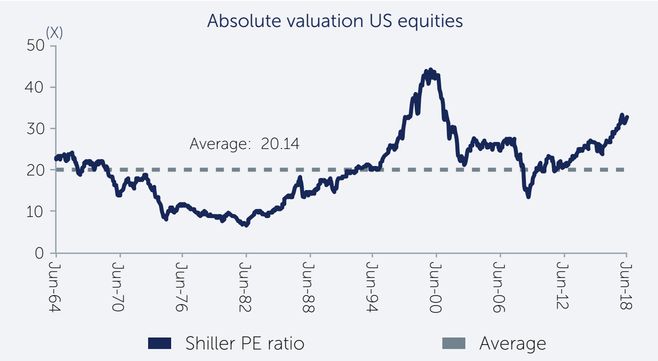
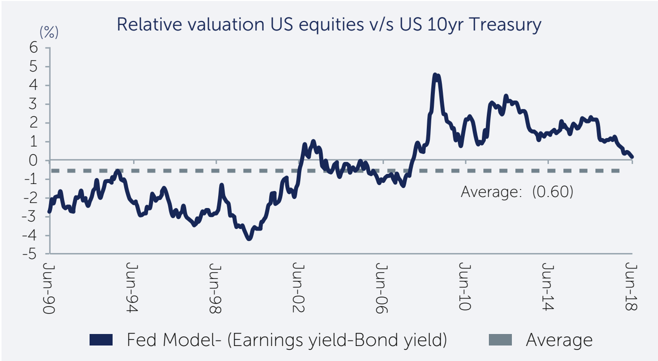


Source: Factset, Federal Reserve Bank of St. Louis

Equity Market Valuations



Source: Thomson Reuters, multpl.com



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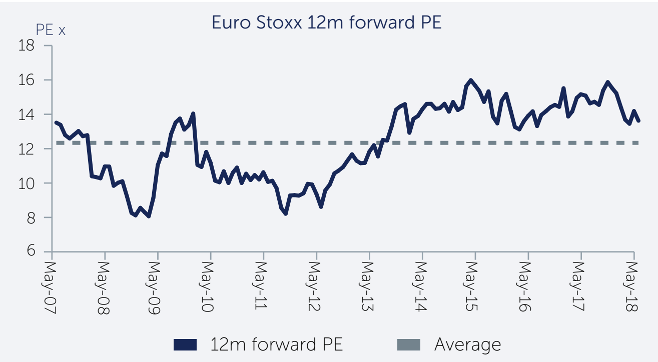

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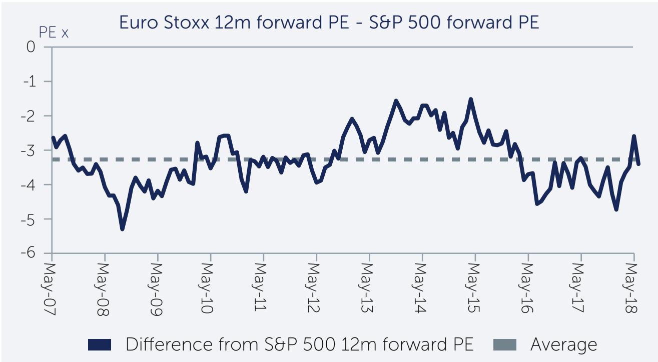

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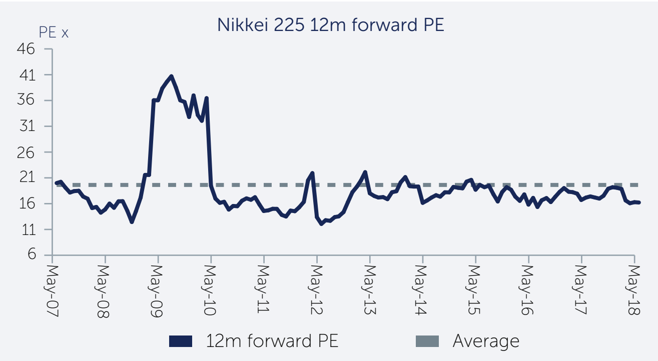

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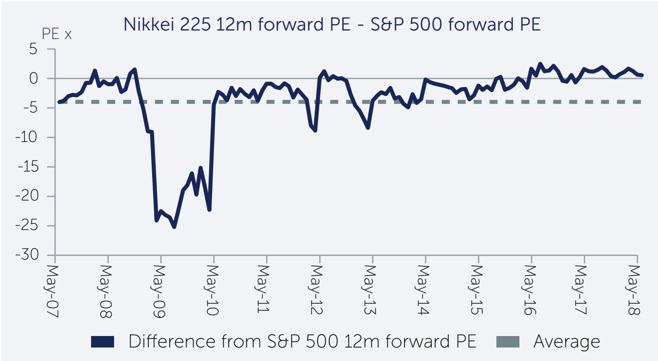

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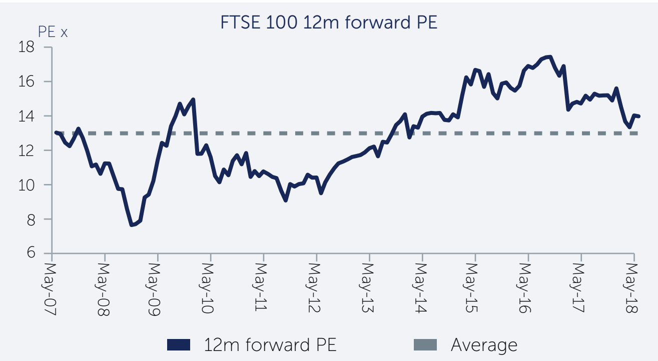

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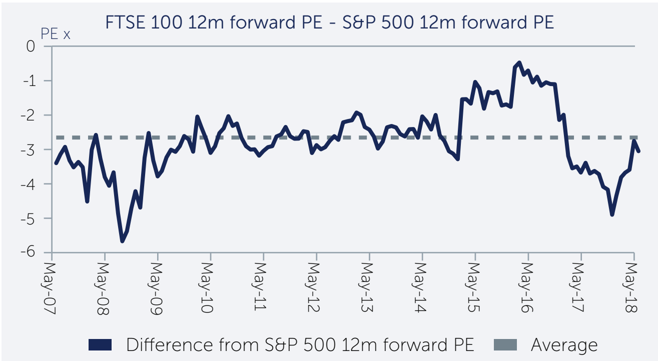

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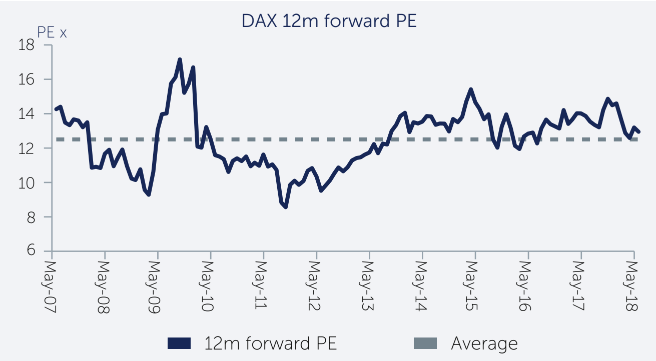
Equity Market Valuations



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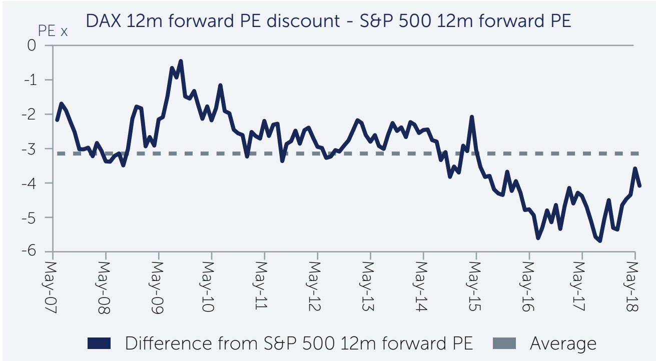

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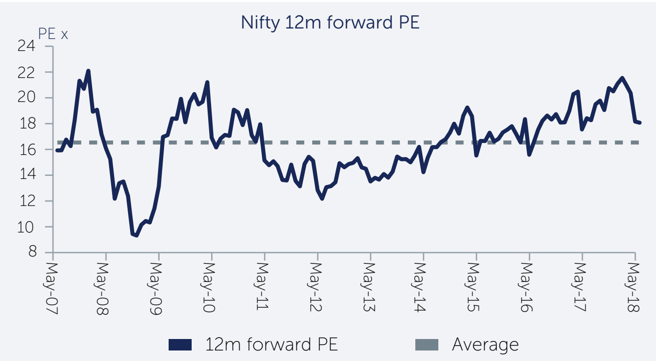

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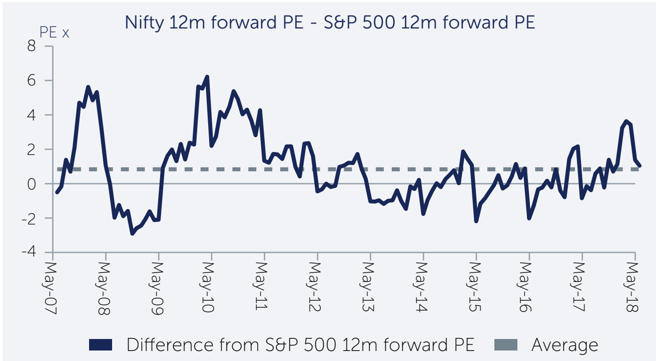

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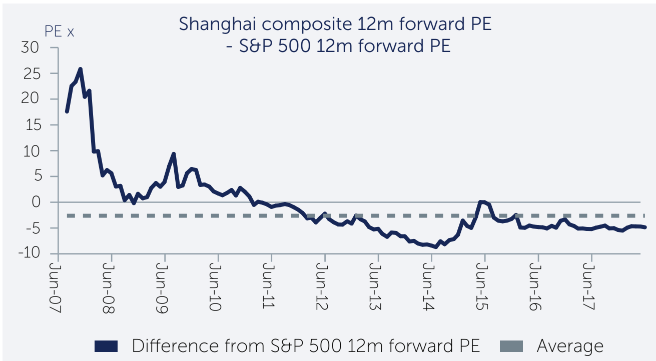

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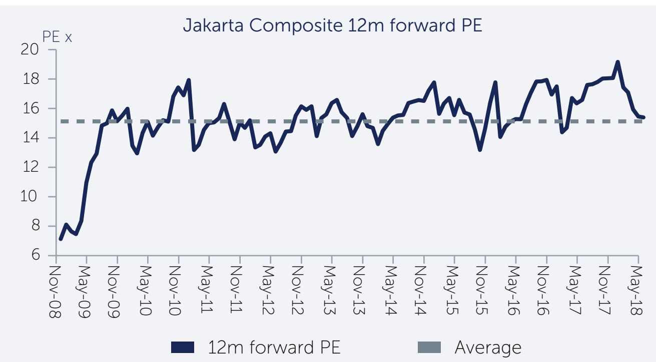

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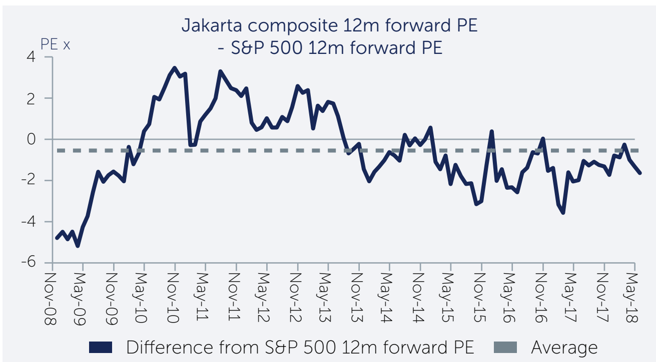

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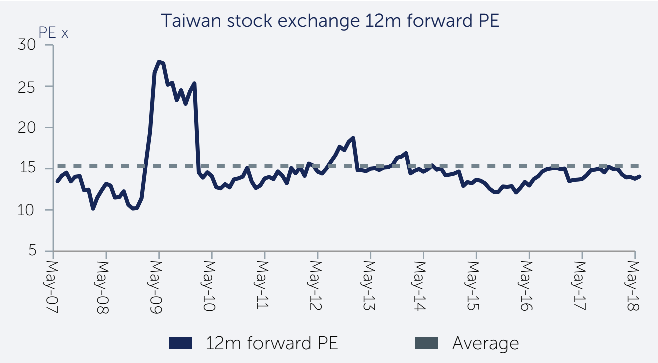
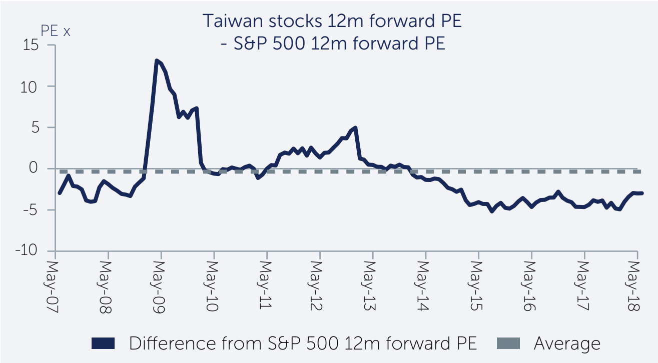
Equity Market Valuations



Source: multpl.com



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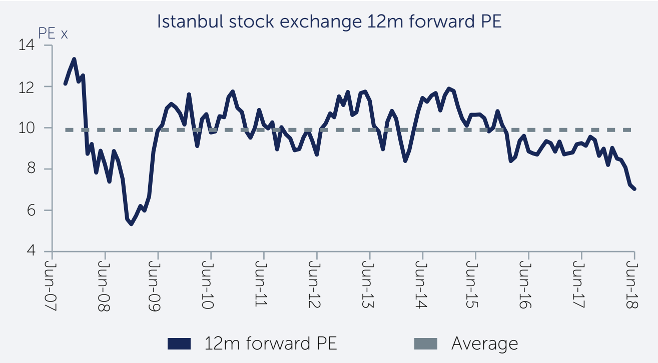

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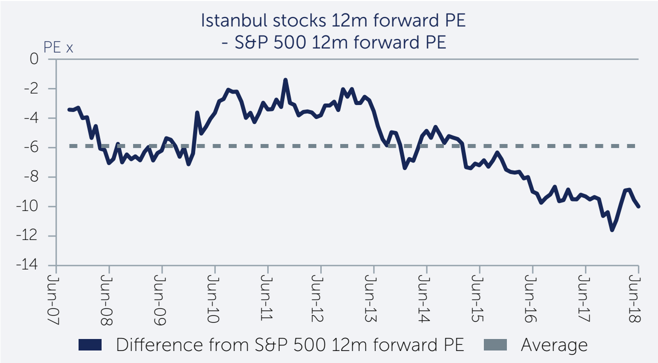

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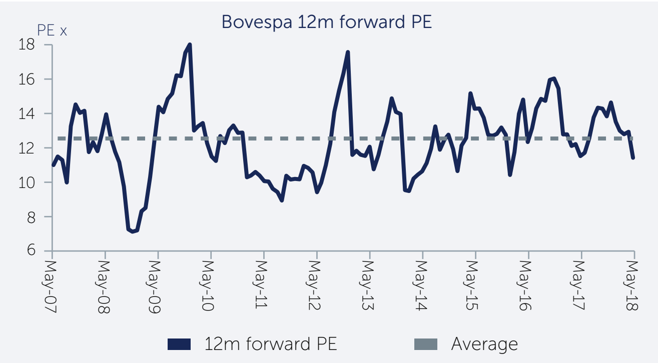

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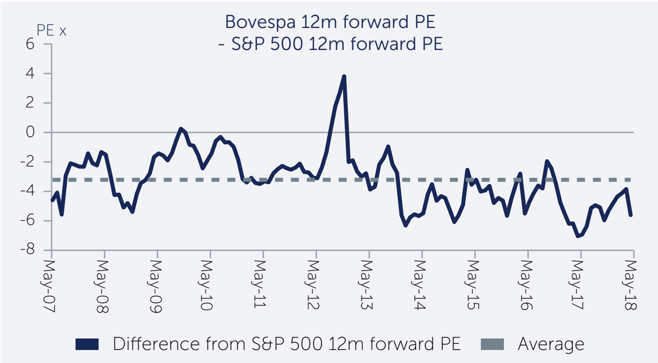

Source: Bloomberg

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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