ADCB Asset Management

The Quarterly Investment View
April 2017

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Don’t annoy the buyer of last resort

The buzzword of the previous two editions of The Quarterly Investment View was “American Miracle”. The “American Miracle”, in my view, is the resilience of the US economy and US asset prices in the face of a global economy that since the 2008 Global Financial Crisis has struggled to gain significant momentum. This resilience is ever so remarkable if one considers that the US dollar has strengthened considerably since 2014. It is the reflection of US companies’ total dominance in today’s new technologies and nascent industries, of the relative strength of the country’s banks, the depth of its capital markets, and the flexibility of its markets for goods and services.

The United States is definitely among the countries that has most benefitted from globalization, a top performer in today’s global economy. As such it might seem paradoxical that the country is now taking the lead in revising the world order of which it has profited so much, and of which it has certainly been the most important advocate. Not only is it paradoxical, it is also very difficult to anticipate what will happen as the current US administration questions free trade and shakes up long-standing geopolitical alliances.

Two expectations seem reasonable. First, the United States is a very large and complex country, the economy and society of which are interwoven with the rest of the world. As such, changes will occur, but it will be a very gradual process. Second, uncertainty regarding the country’s new course is here to stay, for many years to come.

Despite the recent stumble on healthcare reform, it is still reasonable to expect some "successes" for the Trump administration. By the summer we are very likely to see agreements with Congress on meaningful tax reduction for households and corporations. Deregulation and infrastructure spending, at least for 2018-19, are also going to give a boost to domestic confidence. At the same time the Federal Reserve, whilst further hiking rates, will do so in a moderate fashion so as to avoid an excessive appreciation of the US dollar. Longer term yields are unlikely to go much higher. As for trade, the so-called border adjustment tax is unlikely to be too disruptive. For one thing, many economists exaggerate when they say that a 20% tax on imports and a 20% rebate on exports would lead to a 20% appreciation of the US dollar. Things are not that simple and there is no clear correlation between the US trade balance and the US dollar. The US dollar is likely to remain strong as the new administration has a key interest in protecting the buying power of US consumers, but a massive dollar rally that undoes much of the current US recovery is unlikely. It is true that all countries stand to lose from a trade war. The US, however, will lose less than most other countries because we live in a world of excessive capacity and the US – unlike China, Europe or Japan – is a net buyer. In fact, it is the buyer of last resort. China, in particular, will be as pragmatic with Trump as Japan was in the 80s with Reagan (who was officially a free trade advocate but who – like Trump – did not refrain from negotiating special trade arrangements to protect his country’s domestic industries).

Over the longer term, it is more likely that other economies will seek to protect their trade through weaker – and thus more competitive – exchange rates versus the US dollar. They are unlikely to engage in a full blown trade war with the buyer of last resort.

As for the key question for investors, through 2017 the relative strength of the US economy is likely to coincide with a strong (but not super-) dollar and contained yields. As such it is likely to continue to benefit global capital markets. Nobody will want to annoy the buyer of last resort.

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

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest 17 Mar closing	Quarterly Change % (Q1 2017)	YTD Change % (17 Mar)
Index Snapshot (World Indices)			
S&P 500	2,378.3	6.2	6.2
Dow Jones	20,914.6	5.8	5.8
Nasdaq	5,901.0	9.6	9.6
DAX	12,095.2	5.3	5.3
Nikkei 225	19,521.6	2.1	2.1
FTSE 100	7,425.0	3.9	3.9
Sensex	29,649.0	11.4	11.4
Hang Seng	24,309.9	10.5	10.5
Regional Markets (Sunday to Thursday)			
ADX	4,424.9	-2.7	-2.7
DFM	3,521.3	-0.3	-0.3
Tadawul	6,921.6	-4.0	-4.0
DSM	10,361.0	-0.7	-0.7
MSM30	5,668.3	-2.0	-2.0
BHSE	1,374.6	12.6	12.6
KWSE	6,810.7	18.5	18.5
MSCI			
MSCI World	1,863.1	6.4	6.4
MSCI EM	965.6	12.0	12.0

Commodity	Latest 17 Mar closing	Quarterly Change % (Q1 2017)	YTD Change % (17 Mar)
Global Commodities			
ICE Brent USD/bbl	51.8	-8.9	-8.9
Nymex WTI USD/bbl	48.78	-9.2	-9.2
OPEC Basket USD/bbl	49.7	-6.8	-6.8
Gold 100 oz USD/t oz	1,229.3	7.1	7.1
Platinum USD/t oz	965.0	6.9	6.9
Copper USD/MT	5889	7.1	7.1
Aluminium	1,908.5	12.7	12.7
Currencies			
EUR	1.0738	2.1	2.1
GBP	1.2396	0.5	0.5
JPY	112.70	-3.6	-3.6
CHF	0.9982	-2.0	-2.0
Rates			
USD Libor 3m	1.1518	15.4	15.4
USD Libor 12m	1.8132	7.6	7.6
UAE Eibor 3m	1.4620	-0.9	-0.9
UAE Eibor 12m	2.1424	2.3	2.3
US 3m Bills	0.7262	-42.0	46.0
US 10yr Treasury	2.5005	2.3	2.3

Executive Summary

- The prospect of sizeable fiscal stimulus in the US is still there. Most of that stimulus will have to be negotiated with Congress. As such we will not see many concrete measures before the end of the summer and the impact on growth will not materialize before 2018.
- Uncertainty regarding the effective size and composition of fiscal stimulus means that the Federal Reserve will maintain an overall cautious policy stance, also because the US dollar and yields have already spiked in anticipation of a scenario of expansionary fiscal policy combined with more restrictive monetary policy.
- As yields stabilize, there is still some potential for equities, but – rather than moving overweight the asset class – we prefer to play the sectors and geographies that are most likely to benefit from the US "reflation" theme.
- China's structural problems are likely to get worse before they get better, but we do expect stimulus to continue through the fall. As such, major turmoil and downward pressure on the renminbi is unlikely to materialize before the end of 2017.
- The "reflation" theme is bad for emerging markets, although those with sound external balances could prove more resilient.
- Selective emerging markets hard currency bonds offer good value, whereas local currency bonds remain subject to a scenario of continuing exchange rate volatility.
- Energy prices have rallied sharply from multi-year lows in February. They should stabilize with the stronger US dollar. Downside risks cannot be excluded.
- The rally in industrial metals should come to an end, as China will come under pressure again.
- Precious metals could see periods of gain, especially during bouts of strong risk-aversion. As such, they are a good hedge against market turmoil, even if more Fed rate hikes are unfavorable for them.

Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Intermediate to long	It is on yields that the prospect of fiscal stimulus in the United States is having the biggest impact, although most of the upside has by now been priced in.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive. Volatility in oil prices could prove detrimental, particularly for the US junk bonds.
US Treasuries	Neutral	Bond yields will remain contained in the near-term given Fed's gradual tightening pace and lack of clarity on US fiscal policy.
EM hard currency bonds	Selectively overweight but reduce duration	We recommend emerging markets that have better domestic dynamics, less dependency on global trade, positive reform momentum and the potential for credit rating upgrades. We particularly favor Russia USD sovereign and quasi-sovereign bonds. We maintain our neutral stance on Indian local currency sovereign bonds.
Equity Markets		
US	Overweight	We maintain our US equity overweight because we still like the market's low beta characteristics as well as the fact that it is at the epicenter of the Trump "reflation" theme.
Eurozone	Underweight	We maintain our underweight in Eurozone equities as earnings remain subdued and the euro is now likely to stabilize versus the US dollar.
Japan	Overweight (US dollar-hedged)	The "reflation" theme, combined with the BoJ's yield curve targeting is likely to keep the yen under pressure, which is good for Japanese equities.
Emerging Markets	Underweight	The "reflation" theme is bad for emerging markets, as it increases their financing costs more than it increases demand for their goods.
United Kingdom	Overweight (US dollar-hedged)	We have an overweight on large-cap UK equities on a US dollar hedged basis. FTSE 100 companies derive around 70% of their revenues from overseas and are therefore helped by continuing Brexit-induced GBP weakness.
Energy & Commodity Prices		
Energy	Neutral	The recent rally in the oil price by now fully reflects the latest OPEC agreements. With the US dollar at a higher level, we expect the oil price to remain range bound.
Industrial Metals	Underweight	The full implications of China's transformation story will determine a further reduction in the commodity intensity of its economy. It is reasonable to expect that the recent rally is now petering out.
Precious Metals	Overweight	The "reflation" theme is bad for precious metals. Yet, bouts of risk-off jitters are still very likely in 2017. Thus we keep them as a "market insurance" risk hedges in our portfolios.
Currencies		
EUR	Moderate downward pressure	The prospect of more expansionary US fiscal policy combined with further rate hikes, whilst the ECB is still committed to QE, has already determined a depreciation of the euro. Whilst the bulk of the cross-Atlantic policy differential is now priced in, we still expect some, albeit modest, depreciation.
GBP	Further corrections expected	The pound sterling is likely to weaken further as the authorities will pursue more accommodating policies to compensate for the adverse implications of Brexit.
JPY	Further depreciation likely	The combination of US "reflation" and BoJ yield curve targeting is likely to push the yen down further.

2017 growth to remain moderate, but steady

Fiscal reforms to continue, but spending to pick up a bit

With oil prices having stabilized the GCC economic outlook can be looked at with increased confidence. A key driver of such confidence is the fact that, barring renewed significant downward pressure on oil prices, most GCC governments will pursue further fiscal reforms but at the same time allow for some uptick in spending. As such government-led investments will lead to moderate growth in non-oil activity. As a result private consumption should also strengthen, albeit to a lesser degree.

Fiscal mix encouraging beyond 2017

Whilst the pick-up in fiscal spending is the key factor in our constructive 2017 growth outlook, it is the quality – rather than the net direction – of the fiscal stance that should give hope for medium- and long term growth, and thus the goodness of investments. Whilst GCC governments continue to work on bringing their public finances on a more stable path through subsidy reforms and the introduction of VAT, spending will focus on strategic infrastructure. Critically, the largest regional economy, Saudi Arabia, will set the tone with a close to 40% increase in infrastructure and transport spending after heavy cuts in 2016. Dubai will also be in the lead as the city continues to lay the groundwork for the 2020 Expo event.

Better public finances resulting in easing liquidity in spite of a still challenging international environment

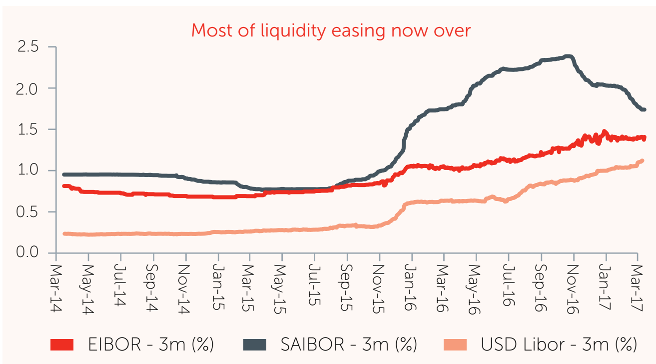
The stabilization of the region's public finances – facilitated not only by the higher oil price but also, in Saudi Arabia, by the issuance of government debt has led to an improvement in general liquidity conditions in spite of the prospect of further Federal Reserve rate hikes. The discrepancies between regional banking rates compared to US banking rates and the decoupling of the oil price from the US dollar are of course encouraging as they tell us that some substantial change has taken place both at the level of public finances management and in the micro-economic fundamentals of the oil market.

We would, however, caution against drawing too optimistic conclusions from such "decoupling". Persistent US dollar strength and an upward shift in the short end of the US dollar yield curve is quite likely given the combination of Trump policies that still have to work out. This will keep emerging market growth, commodity and energy markets in check. The current positive momentum might last through 2017 as China continues to stimulate its economy in the run-up to the 19th Party Congress. Beyond that nothing can be taken for granted. As such the regions governments are right to use the current window to continue to rationalize and consolidate public finances and to prioritize investment- over current spending.

Equities – remain neutral

GCC equities have considerably underperformed both global and emerging market (EM) equities year-to-date. There is quite a bit of difference in performance between the markets, with regional heavyweights Dubai, Abu Dhabi and Saudi Arabia all declining and Bahrain rallying (+13%). This compares with EM and global equities which are up 12% and 7% respectively. We believe that the reason for the region's underperformance has to do with imported monetary policy from the US as well as the stronger US dollar. In the aftermath of the global financial crisis (gfc) the US Federal Reserve slashed interest rates to historical lows. At that time GCC economies (and indeed the global economy) were in need of this monetary support. However, over the past 12 months the US economy has accelerated relative to other countries and regions, meaning that a stricter policy stance in the US is now warranted given the level of US economic activity. Given that GCC economies are still recovering from the drop in oil prices of recent years, (tightening) US monetary policy is now less appropriate for GCC economies. The combination of moderate growth and tighter financial conditions is not ideal for equity markets.

On the positive side, however, ongoing fiscal consolidation in the region means that the macro position of most economies is improving. At the same time GCC equities valuations are undemanding, trading at a discount to both EM and DM equities (on a trailing PE basis). In addition, the GCC offers extremely attractive dividend yields of c4.2% (on a 12-month trailing basis) compared with EM and DM averages of 2.5% and 2.3% respectively. Overall we advocate a neutral position towards regional equities.



Source: Bloomberg

Trump reflation not over yet

Growth pick up continues for the moment

Whilst we do not believe that US growth will sustainably break above the 3% annual pace, we do believe that growth can continue to grow at the 2% plus rate through 2017. In other words, whilst a recession does not seem on the cards, growth might still somewhat disappoint compared to what many seem to expect. Is that important? At this stage probably not. In spite of the recent Republican failure to repeal and replace "Obamacare", the market will continue to put high hopes on the implications of new trade and fiscal policies that will not be finalized before the end of the summer.

Politics is everything, even five months after the election

With the economy running at full employment, it is true that the growth impact – as compared to the potential inflation impact of any new set of economic policies is going to be limited. Both the infrastructure spending and trade relocation policies, for example, are going to run into the constraint of available qualified labor in the US.

Whilst justified, growth concerns (and the rate concerns that come with it) somehow miss the point. What matters is that the current economic cycle, with structurally more subdued growth, might last longer and that at the margin lower taxes and less regulation are going to add to growth and benefit significant sectors of the economy. This is true even if we are not going to see sustained boom levels (here defined as continuing annual growth rates north of 3%). The political precedents are simple and straightforward. Over the last decades, no US president – especially when republican – has failed to push through significant fiscal reform when his party also controlled Congress. As such, the positive economic momentum is likely to last through the summer at least, because that is the minimum time required for Congress and the President to deliver on tax reform.

Fixed income: Advocating a flattening bias on Treasuries

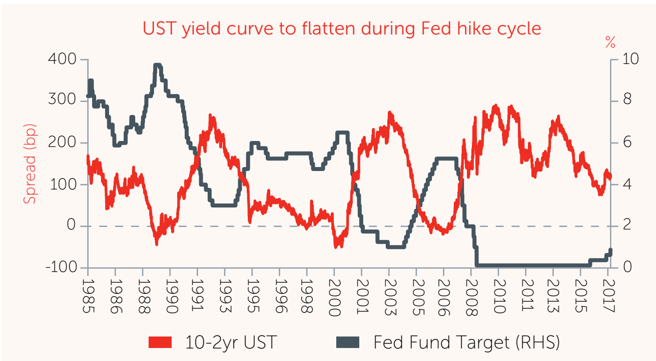
Long-dated Treasury yields are likely to remain capped after the Fed's affirmation of a gradual tightening pace at the last FOMC meeting. We expect the yield curve to flatten i.e. short-dated bonds will underperform the long-dated bonds as typically seen during Fed tightening cycles. Moreover, market expectations of long-term inflation which surged on the Trump reflation trade, have been fairly muted since Trump's inauguration. This implies that uncertainty about fiscal policies lingers with markets still awaiting details on the timeline of these fiscal reforms. The lack of clarity which could last until the end of the summer, along with political uncertainty in Europe should keep 10-year Treasury yields contained within the 2.2-2.5% range.

US credit spreads have come under pressure recently, reversing from near all-time lows with junk bonds being the worst hit. Energy company debt which constitutes a significant portion of junk debt, has underperformed in reaction to the recent slump in oil prices. Room for further spread widening remains as current levels are still near record lows with volatility in oil adding pressure. We wait to take advantage of any spread widening once there is more clarity on tax proposals and any banking sector reforms.

Equities – remain overweight

US equities have had an incredible run since the February 2016 lows in global equity markets, returning 34% vs. 27% for global ex US equities. Inevitably such a run has left the market looking vulnerable to a correction. Not only that, but investors are currently pricing in a goldilocks environment in which economic growth and inflation are picking up, but not so much to prompt the Federal Reserve to tighten monetary conditions more than another 50bps this year. Risks associated with a stronger dollar, earnings growth, fiscal policy disappointment, European politics and Chinese growth have equally been pushed to one side for the time being.

Despite considerable scope for disappointment to any of the above assumptions, we maintain our US equity overweight position. We like the market's safe haven characteristics, which means that should global equities stumble, the US is likely to hold up better than other regions. The US is also the market where the global "Trump-flation" optimism emanates from, so were president Trump able to deliver meaningful deregulation or tax cuts, US corporates would be the ones to benefit. Stay overweight US equities.



Source: Bloomberg

Changes ahead, but not too many

Inflation potential is as much overstated as political risk

The Euro-zone's economy continues to grow at a steady yearly pace of around 1.5% and growth momentum indicators are improving. The surge in production and consumption confidence indicators, in particular, have given hope that there could be a significant acceleration in growth. In other words, just as many observers are now arguing that US growth will sustainably grow at a 3% plus rate, speculation is likewise - and arguably consistently rife that the Euro-zone can sustainably grow at a rate superior to 2% a year. We continue to have our doubts, on both accounts.

The problem with Euro-zone growth remains that it is too export-led, and too little domestically driven. This is bound to remain so, as austerity is likely here to stay (and possibly somewhat increase in 2017) and credit growth will still be sluggish, especially in the so-called periphery economies. This also implies that monetary policy will normalize, but at a very slow pace. The sluggish pick-up in demand is clearly reflected in a weaker inflationary pick-up in the Euro-zone compared to the US. Whilst in the latter both headline- and core inflation (excluding food and energy items) have consistently picked up, in the Euro-zone core inflation has continued to stall. Such divergence between headline and core inflation unfortunately not only tells us something about the past, it is also a bad omen for the future. The increase of prices in necessary goods only (energy and food) inevitably reduces demand for other goods by lower income households. The conclusion is clear, a significant pick-up in demand is not imminent.

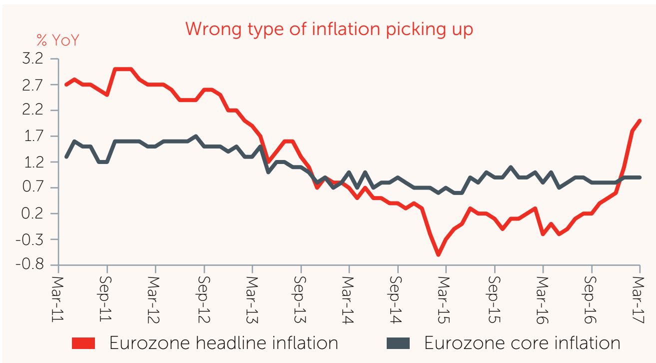
Importantly, however, whilst we see growth expectations overdone, we do not expect monetary policy normalization to be pushed back by major political shocks. As we have stated before, the risks associated to the French and German elections are overstated. As such, continuing US growth momentum with a still strong US dollar is likely to allow Europe to stick to its current growth trajectory through 2017, with ECB accommodation being removed only very gradually.

Fixed Income: Political risk to drive yields in the short term

In spite of positive economic surprises, safe-haven assets like German bunds will continue to attract demand thanks to political uncertainty in the region. In contrast, French OATs-Bund spreads which have widened significantly on election risks, will remain under pressure as we inch closer to French elections. Beyond the election risks, we expect German bund yields, supported by ECB buying, to move higher. Particularly if economic data in Europe continues to positively surprise. Government bonds are yet to price in the likelihood of the ECB retreating from its accommodative stance later this year either through lifting the negative deposit rate or deciding to taper asset purchases further. In such a scenario, we could see German bunds underperforming US Treasuries towards the end of this year if the hawkish bias shifts from the Fed to the ECB.

Equities – remain underweight

Eurozone equities typically perform well when US treasury yields rise, the US dollar strengthens, commodity prices are low and global PMIs are strong. This is more or less the environment we have inhabited over the past two quarters. Despite this favourable backdrop, Eurozone equities have continued to underperform global equities. The reason is down to earnings and political uncertainty, neither of which are likely to go away completely in the coming quarters. On the earnings side, Eurozone corporates have sequentially disappointed expectations over the past 6 years. This, despite the fact that the euro has depreciated significantly against the dollar. The consensus is forecasting c13% earnings growth for 2017, this seems difficult to achieve considering average annual earnings growth since 2011 has been -4%. Political risks, although ultimately likely to be overstated are not going away either. This is restraining investment in the region which in turn also weighs on earnings growth (and economic growth). Besides the French and German elections later this year, we have the Greece debt saga, Brexit negotiations and the prospect of Italian elections in the next 12 months or so. Historically high levels of political uncertainty have corresponded with falling valuations. Overall, high levels of uncertainty and elevated earnings growth expectations lead us to maintain our underweight recommendation on Eurozone equities.



Source: Bloomberg

Hard Brexit full steam ahead

Theresa moves on: it will be no deal

So far our expectation of a so-called "hard Brexit" keeps on panning out. This has less to do with what the governments involved would prefer than with the reality of the June 2016 referendum and the negotiation process that is now finally being kicked off. There was no way Theresa May could have given in to the requests of the opposition and the House of Lords for certain "Brexit guarantees" without diluting her negotiating power and being in denial of the will expressed by the people last summer. At the same time, it seems highly unlikely that she will win major concessions from (the unanimity of) the other 27 EU member governments. She said that "no deal" would be better than "any deal". She might have to settle for just that.

Inflationary pressure building, currency to remain weak

At this stage UK PMI indicators continue to stall whilst PMI indicators in the US and the Euro-zone remain on an upward trend. For sure, such discrepancy is not that meaningful and might be short-lived, especially if one considers that the UK PMI is still comfortably in expansionary territory. The real risk for the UK is persistent inflationary pressures resulting in more currency depreciation. Indeed with public debt close to 100% of GDP and a fiscal deficit running around 4% of annual output, there is little margin for the government to provide additional fiscal stimulus. As such, the BoE would be reluctant to engage in rate hikes since the combination of restrictive fiscal and monetary policies would depress the economy too much. Continuing monetary policy accommodation – the true divergence with the UK's main trading partners – will thus lead to further currency depreciation.

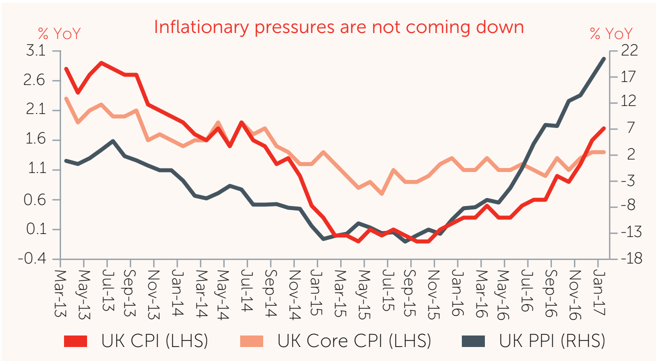
Gilts: Inflation pressure could trump safe-haven flows

The sell-off in the gilt market has been limited relative to German bunds recently as indicated by the sizeable narrowing of the 10yr Gilt-Bund spread (lowest level in six months). This indicates that the likelihood of monetary normalisation is more probable in Europe than in the UK even though both central banks have advocated a slightly hawkish tone recently. We believe that the two-year long negotiation process of "Brexit" will be very complicated after the formal trigger of Article 50 and hence should support safe-haven appetite for bonds. However, we are wary of the rising inflation which could put pressure on the bond market. 10-year gilts currently offer a negative yield of 1.76%, not attractive when compared to developed market peers where real yields are trading in positive territory.

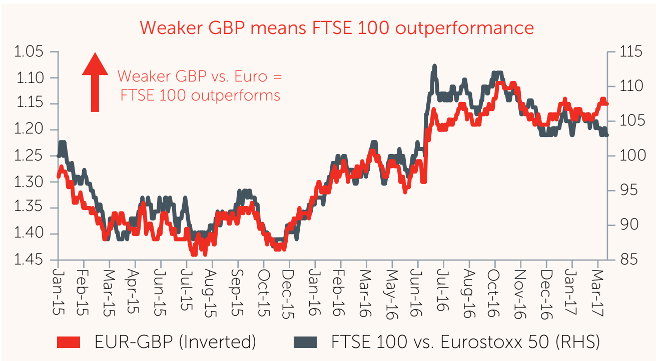
Equity – remain overweight on currency hedged basis

Last September we initiated a currency-hedged call on UK large cap stocks (see link) with the view that continued political uncertainty surrounding Brexit as well our belief that (at some point) UK economic data will begin to deteriorate will weigh on sterling. This in turn would boost earnings for the UK-listed companies deriving (in aggregate) 70% of their revenues from outside of the UK. Although the pace of GBP depreciation has slowed in recent months with the currency stuck between $1.20 and $1.26, we expect that the reality of triggering Brexit will resume the downward pressure on sterling, supporting UK corporate earnings.

Admittedly UK macro data has held up better than we (or the consensus) expected post-Brexit, it still seems likely to us that economic data will at some point deteriorate. Valuations for the market remain attractive and it is worth noting that global funds are still heavily underweight UK equities. Indeed the UK is the second most underweight major market/region after emerging markets. This suggests that downside risks in UK equities are more limited than markets or regions which are more heavily owned. Overall, we maintain our currency-hedged overweight recommendation on UK large cap stocks.



Source: Bloomberg



Source: Thomson Reuters

Weaker yen still on the cards

Stronger dollar still necessary for Japan

The election of Mr. Trump has been a critical factor for undoing most of the 2016 strength of the Japanese yen. It is important to note, however, that the extent to which the yen has devalued – going a significant way in re-approaching its post-QQE minimum of 125 against the US dollar – would not have been possible without the BoJ enacting a significantly revamped version of its Qualitative and Quantitative Easing Program (QQE) in September 2016. It is this strong and explicit commitment to continuing monetary stimulus (currently unique amongst major central banks) combined with continuing reflation in the US that makes further yen weakness still very likely.

The targeting of the entire yield curve, over and above negative interest rates and close to zero long term yields will continue to constitute the core of BoJ policy, as long as and until the authorities can confidently state that deflationary expectations have been firmly removed from the mind set of Japanese households and corporations. As the below chart shows, inflation is now back in positive territory and with producer prices continuing to pick-up there is reason for optimism for the more important consumer prices too. Recent years' history shows, however, that positive price dynamics can be easily undone, especially as long as the overall growth rate remains (as it currently is) close to zero. Critically, the fact that energy prices are unlikely to significantly rally further will be an additional factor for keeping inflation at bay (in line with global price dynamics).

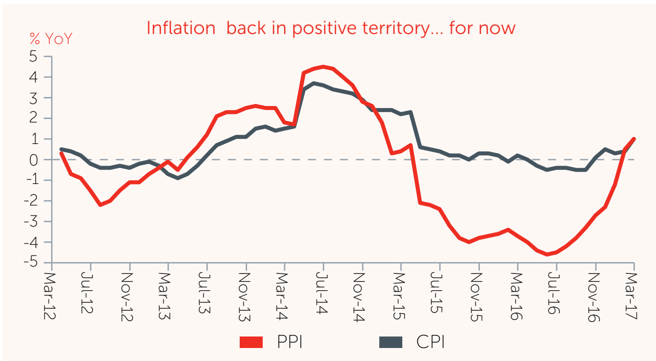
Global boost to Japan's economy for now intact

Japan's trade balance is clearly benefitting from the pick-up in growth in the United States and will keep on doing so as long as the yen remains weak. Clearly any relapse in global growth, perhaps through a dollar strength induced stimulus reduction in China that could trigger a risk-off bout on global financial markets, would be enough to put upward – instead of downward - pressure on the yen. In this sense it is the still fragile global environment that constitutes the greatest risk to Japan's QQE policy, and the country's enduring recovery.

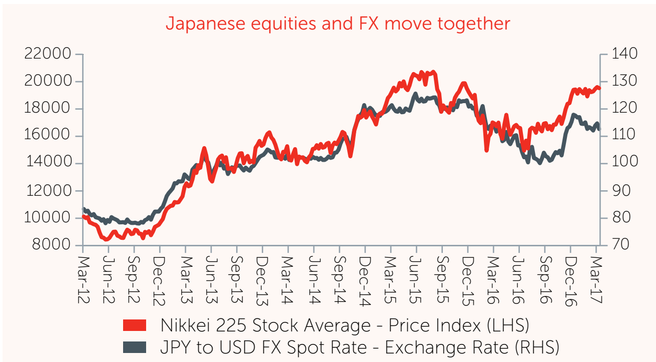
Equity – remain overweight

Since the Bank of Japan implemented its yield curve control policy on 20 September 2016, Japanese equities have returned 19%, outperforming global equities by 9%. We expect strong Japanese equity performance to continue given the divergence in major central bank policies, with the BoJ's stance more accommodative than both the ECB and Federal Reserve. This is important given that Japanese corporate earnings are closely linked to the value of the yen. It should also be noted, however, that volatility in Japanese equities is likely to remain high. This is because by pegging the 10-year bond yield around the 0% level, volatility from the bond market is effectively channelled to the FX and equity markets.

The more the currency depreciates, the stronger corporate earnings momentum becomes which typically drives equity market performance. Our positive view on Japanese equities is therefore dependent on continued yen weakness. To the extent this materialises, the tentative stabilisation in the economy coupled with undemanding valuations and close to neutral positioning by global funds can act as additional supports. However, the main impetus behind the market undoubtedly has to come from the currency. Within the market, given our weaker yen view it goes without saying that we favour the export oriented sectors over domestically driven ones. Overall we continue to recommend a currency-hedged overweight position on Japanese equities.



Source: Bloomberg



Source: MSCI, Thomson Reuters

Growth slowdown a matter of "when", not "if"

Activity to remain relatively resilient through the fall

As is the case elsewhere, in China politics also remains the key driver of economic and financial developments. In its own way, the country also has "elections" which will take place this fall with the celebration of the 19th National Congress of the Communist Party of China. As with all "true" elections, there will be some uncertainty with regards to the outcome. More specifically, whilst there is little doubt that Mr. Xi Jinping will be confirmed as the party's General Secretary and as the President of the People's Republic, the final composition of the Party's Politburo and its Standing Committee are not yet clear. This year the political stakes are particularly high since that composition will indicate whether Mr. Xi Jinping will have to stand down at the 20th National Congress in 2022, in line with recent tradition, or whether he will be anointed as "paramount leader" acquiring a life time claim to the presidency and putting him on a standing comparable to the greatest leaders of China's modern state, Mao Zedong and Deng Xiaoping.

Recent history tells us that a big slowdown in stimulus spending is very unlikely during the gathering of the ruling class where the core leadership team is renewed and the country's policy course is set, for that is exactly what the party's National Congress is. And even if preciously little is revealed about the internal power struggle that is shaping up in the run-up to the event, it is hard to imagine that this time things will be different. The authorities could of course be "forced" to precipitate a slowdown in spending if global dollar strength requires a massive reduction in the monetary base with a view of protecting the external value of the Renminbi. In 2017 we consider this unlikely. For one thing, persistent US dollar strength is unlikely to morph into a massive and full blown dollar rally like in 2014: the Federal Reserve would reverse its hiking intentions. With the dollar appreciating only gradually the PBoC is likely to continue to steer a modest devaluation of the national currency and / or increase (the already significant) capital controls. This should allow them to stick to a gradual reduction in stimulus spending at least until the end of the 19th National Congress.

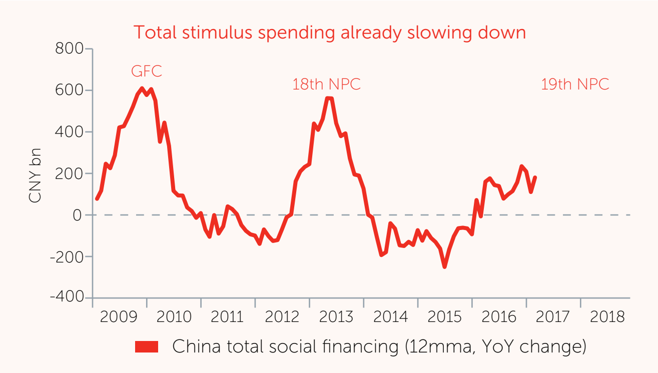
Stimulus-driven growth is not a long-term solution

The problem remains, however, that continuous stimulus of the like we have seen over the last nine years is not only failing to solve the country's problems, but also creating more problems down the road. In 2008 the country's total debt stood at 160% of GDP. In 2016 it rose from 240% to 260% of GDP. Not only is the current debt trajectory unsustainable from a quantitative point of view, it is also driving perverse qualitative incentives as most of the stimulus benefits state owned enterprises rather than Chinese households and private corporations.

Having said so, and for the reasons discussed above, at this stage we would expect the slowdown in total accommodation to be gradual, anticipating a greater reduction in stimulus in 2018. The timing is, however, less important than the "if". A slowdown in Chinese stimulus and aggregate activity is on the cards. The global ramifications will be significant, especially for emerging markets.

Equities – remain underweight

The first three months of this year have seen a divergence in performance between Chinese A-share and H-share equities. A-shares (traded on Shanghai exchange) have risen 5% compared to H-shares (traded in Hong Kong) which are up 12%. This is somewhat surprising in the run up to a major political event which typically sees A-shares performing better. It is estimated that retail investors comprise roughly two-thirds of China's A-share market, and these investors tend to be quite sensitive to signals from Beijing. Given that we are in the run-up to the National Party Congress later in the year signals should remain favourable, allowing Chinese equities to perform reasonable well. Nevertheless, risks to the downside appear considerably higher than to the upside in our opinion. The most obvious immediate risk is rising geopolitical tension between the new US administration and the Chinese leadership at a time when (for political reasons) China is unlikely to back-down, especially with regards to trade. Of course many of these concerns are discounted in valuations which are more or less in line with EM aggregates. The parts of the market we would be more inclined to be positive on, the so-called "new economy" sectors such as IT are already extremely expensive. Whereas "old economy" stocks such as materials, industrials and financials are trading at a discount. Overall we remain underweight Chinese equities because we feel that risks to growth and trade are more likely to materialise than any potential catalysts (such as accelerating reforms).



Source: Bloomberg

Demonetization not as bad as feared

Growth story intact as remonitization kicks in

Recent GDP data indicates that the government introduced cash ban in November led to some slowdown in economic growth, but not as much as initially feared by the market. With the remonetisation process now kicking in faster than originally anticipated, we expect growth to bounce back in the coming quarters. Signs of recovery are already evident in the recent uptick in manufacturing and services activity.

In addition, investor sentiment and economic confidence is expected to improve after the victory of the ruling Bhartiya Janata party in recent state elections. The BJP win has not only improved the majority for the ruling party in the upper house, but also paved the way for a second term for Mr. Modi's government. Increased political stability means that the government will be in a better position to push much needed reforms like labour laws and privatisation of loss-making PSUs, ensuring a continuation of growth momentum.

In contrast, inflation concerns have resurfaced as wholesale and consumer price inflation have been on the rise. The recent uptick is primarily on account of higher food prices and low base effects of commodities which are coming in to play. The stickiness in core inflation during the demonetization period is much more of a worry and was the main rationale for the RBI to shift from its accommodative to neutral stance at its last monetary policy meeting. With domestic demand recovering from the cash ban, core inflation could further surprise to the upside. As such, we expect the central bank to stick to its current neutral stance in the near term given its aim to keep inflation within its medium-term target of 4%.

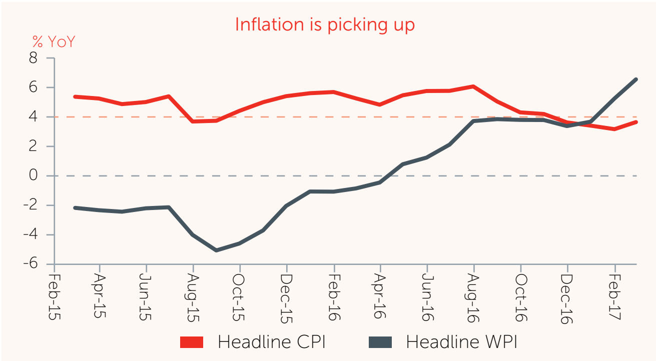
RBI's neutral stance and inflation risks to weigh on bonds

Government bond yields have moved up sharply as the likelihood of monetary easing has been reduced with the central banks' shift to a neutral stance. The sell-off in long-dated bonds was more pronounced due to rising inflation concerns. In the absence of monetary easing prospects and given rising inflationary pressures, downward pressure on government bond yields is likely to be limited. At the same time, bank liquidity remains in surplus in spite of the RBI's liquidity absorption through reverse repo auctions while credit growth will take some time to pick up with the supply of new currency notes accelerating. This should support local demand for government bonds in the near-term, also putting a cap on bond yields. As such, we maintain our neutral stance on the government bond market.

The Indian rupee has been one of the best performing currencies in the emerging market space, driven by a more hawkish central bank stance and fiscal prudence. Even though the rupee is overvalued in real terms, investor sentiment should stay positive amidst the assurance of reform continuity after the recent state election results.

Equities: maintaining our structural overweight

Indian equities have performed very strongly year-to-date, rising 16% in dollar terms compared with +12% for EM and +7% for global equities. The period of weak performance post the demonetisation has been quickly caught up. Concerns that the demonetisation would negatively impact corporate earnings proved to be overdone, but it did allow valuations to come down, creating an attractive entry point. We have been structurally positive on Indian equities since 2014 and remain so; the market is one of the few strong structural stories globally. Recently the market has received a new injection of reform-based optimism following Prime Minister Modi's comprehensive victory in state elections. We expect that this will keep Indian equities well supported in the near-term. Valuations for the market are at a premium to EM (as they always are), but this premium is currently roughly in-line with its own 5-year average (see chart) and should therefore not be an impediment to further performance in our view. Overall we remain structurally positive on Indian equities.



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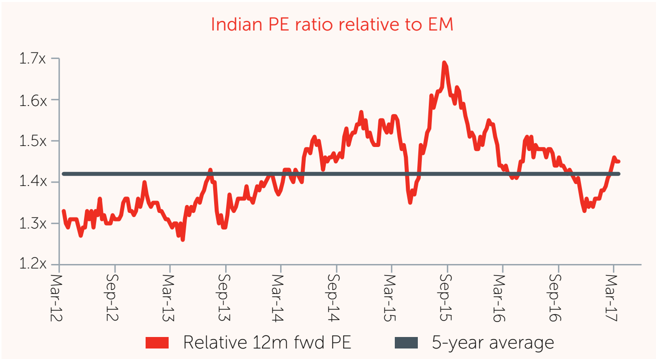


Source: MSCI, IBES, Thomson Reuters

Strong start to the year

Not as bad as anticipated

Emerging markets started the year on a strong note after coming under immense pressure post Mr Trump's election victory. Strong inflows into EM assets have helped currencies to strengthen versus the dollar, several even recovering the losses aggregated from last year. Relative stabilization in US rates and the dollar along with the Mr. Trump's softening view towards US protectionism have helped improve sentiment. At the same time, macro data coming out of EM has been stronger than expected. In fact, upward surprises in economic data from emerging markets have been greater than those of developed economies.

It is reasonable to expect that ongoing growth momentum in the developed world may have trickled down to emerging economies. However, we have our doubts that EM economies will sustainably benefit from the growth recovery in DM given the rise in populist and protectionist policies in developed markets. Separately, higher US rates and dollar strength have reduced the scope for monetary and fiscal expansion in EM. As such, we do not expect that EM economies will receive any major boost to growth in the near term.

That said, we do see pockets of opportunities within emerging markets that have better domestic dynamics, less dependency on global trade and external financing, improving fundamentals and positive reform momentum. Some examples include India, Indonesia, Brazil and Russia. These markets are less vulnerable to external risks.

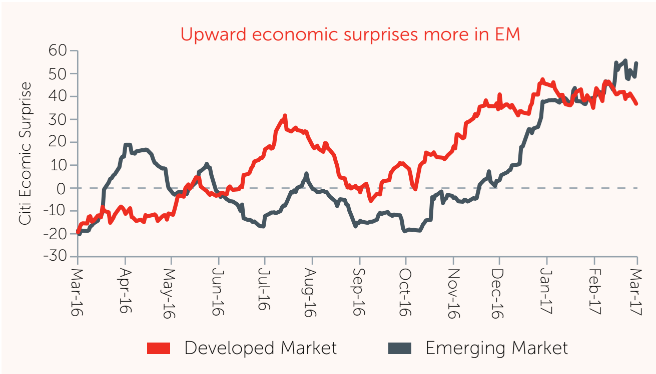
EM Bonds- Positive credit trajectory is the key

Emerging market hard currency bonds have been one of the best performing assets since the beginning of the year. Bond spreads have significantly narrowed down to levels not seen in almost two years. This signals that many investors have unwound their underweight positions post the US election in search of better carry amidst the stabilization in US rates and the dollar. However, we believe that overall valuations may be too stretched compared to growth dynamics in the majority of the markets and maintain our selective bias for EM bonds.

We particularly recommend those emerging markets which have the potential for credit rating upgrades due to their improving macro fundamentals, prudent fiscal stance and reform appetite. This includes markets like Russia, Brazil and Indonesia. Since we recommended our overweight stance on Russian bonds, credit spreads have tightened after Moody's raised its outlook to neutral in February. Similarly, rating agencies have also cheered the reform momentum in Indonesia and Brazil. These three markets which are under the sub-investment grade category have the potential to return to full-investment grade status. Indonesia is at the forefront with S&P likely to upgrade its sovereign rating to investment grade this year.

Equities – remain underweight

EM equities have been very volatile recently, but overall have had a strong start to the year, rising 12%, an outperformance of 5% over developed market equities. Most recently the catalyst for outperformance has come from less hawkish than expected messages from the Federal Reserve. However, this is not something which we expect to continue. Whilst EM equities will always benefit from periods when the US dollar weakens, we expect these periods to be temporary. The policies being proposed by the new US administration are overwhelmingly dollar positive (for example encouraging investment in the US, preventing capital from leaving the US, lowering taxes, spending on infrastructure, creating jobs, etc.). For dollar based investors in EM equities, the currency is a major driver of overall returns. The chart below shows that in 2013, 2014, and 2015 USD movements weighed more on overall returns than the performance of the underlying equities themselves. Overall we do not believe that the benign dollar environment seen so far this year can last, and we remain underweight EM equities.



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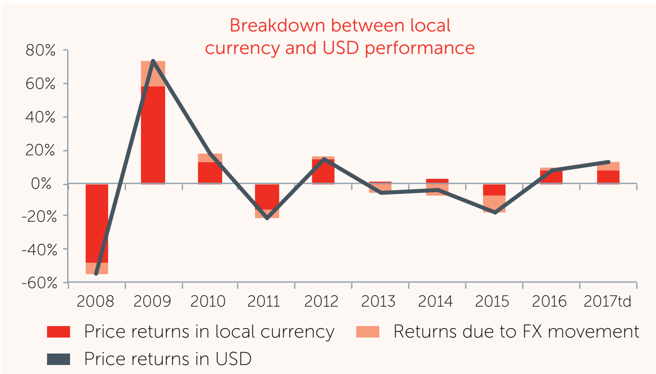


Source: MSCI, Thomson Reuters Datastream, HSBC calculations

GDP Forecast	2017 Consensus	2017 ADCB	2018 Consensus	2018 ADCB
US	2.2%	In agreement	2.3%	In agreement
Eurozone	1.6%	In agreement	1.6%	Expect moderately less
Japan	1.1%	In agreement	1.0%	Expect moderately less
China	6.5%	Expect moderately less	6.2%	Expect significantly less
India	6.8%	In agreement	7.4%	In agreement

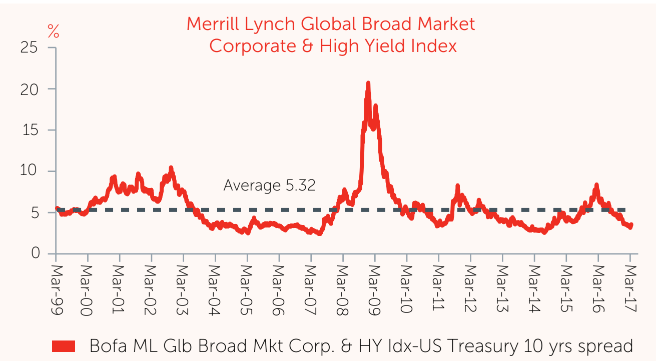
Source: Bloomberg

CPI Forecast YoY	2017 Consensus	2017 ADCB	2018 Consensus	2018 ADCB
US	2.5%	In agreement	2.4%	In agreement
Eurozone	1.7%	In agreement	1.5%	In agreement
Japan	0.6%	In agreement	0.9%	In agreement
China	2.3%	In agreement	2.3%	In agreement
India	4.6%	Expect moderately more	4.9%	In agreement

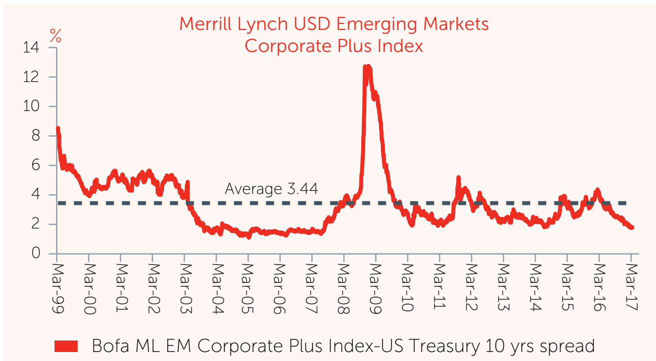
Source: Bloomberg

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

Bond Market Spreads



Source: Thomson Reuters, Federal Reserve Bank of St. Louis



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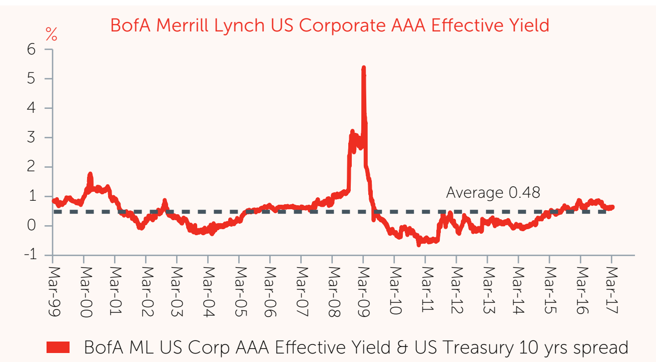

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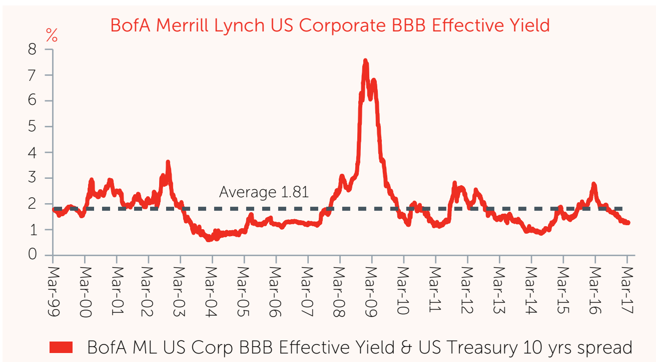
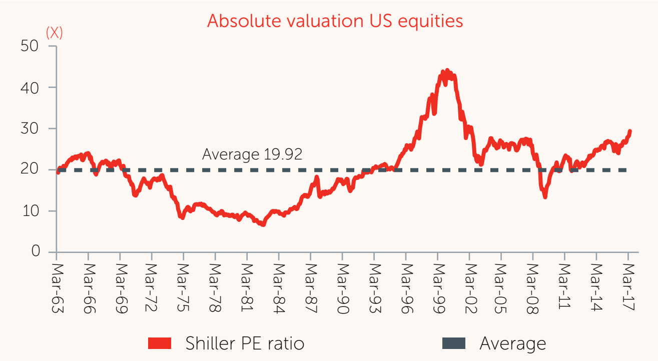
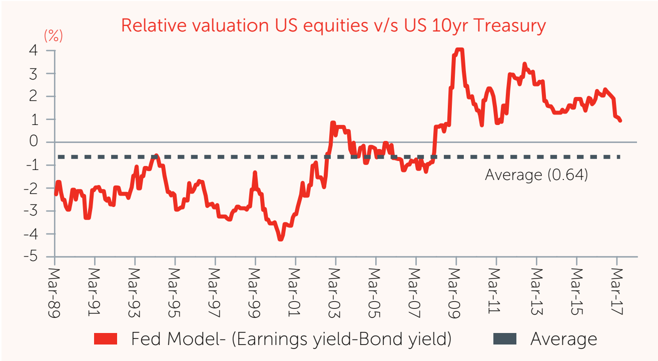


Source: Thomson Reuters, Federal Reserve Bank of St. Louis

Equity Market Valuations



Source: Thomson Reuters, multpl.com



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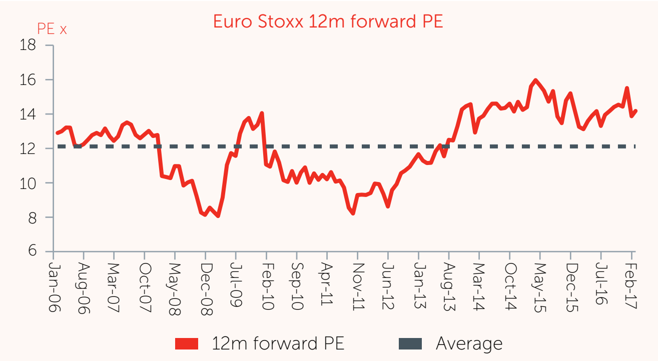

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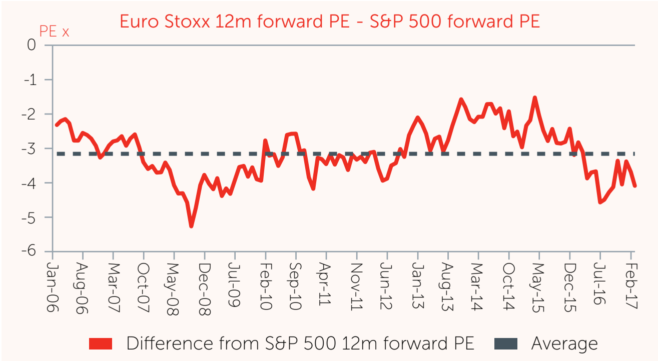

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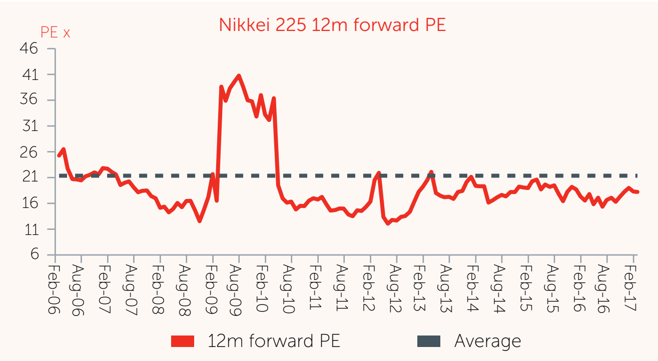

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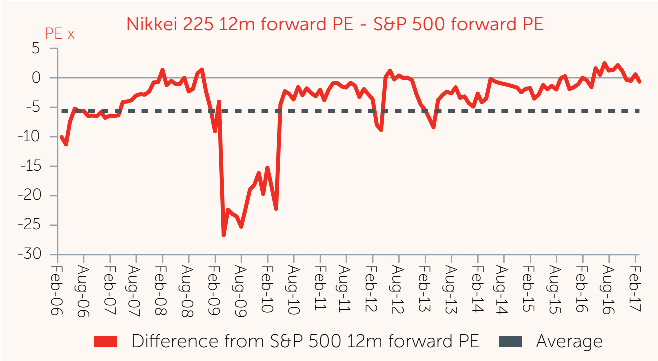

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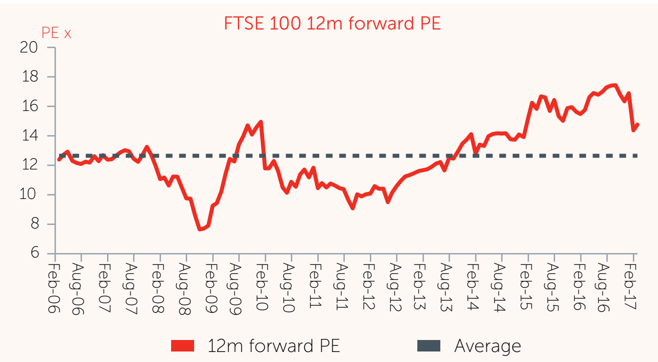

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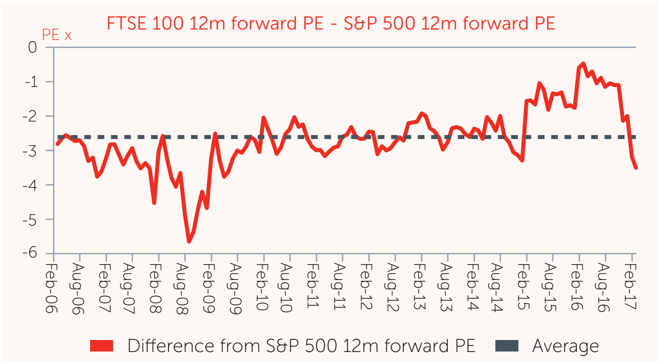

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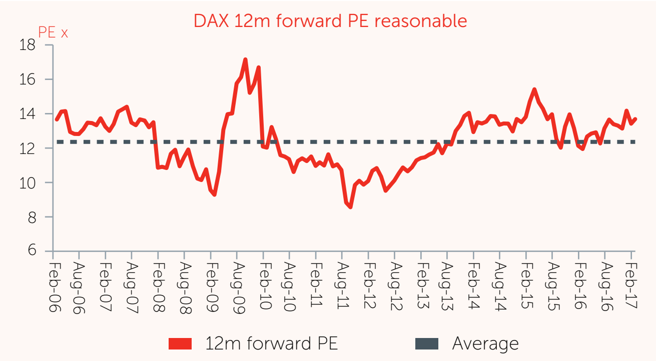
Equity Market Valuations



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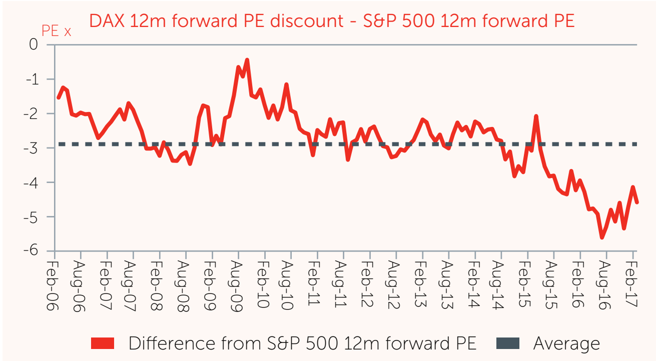

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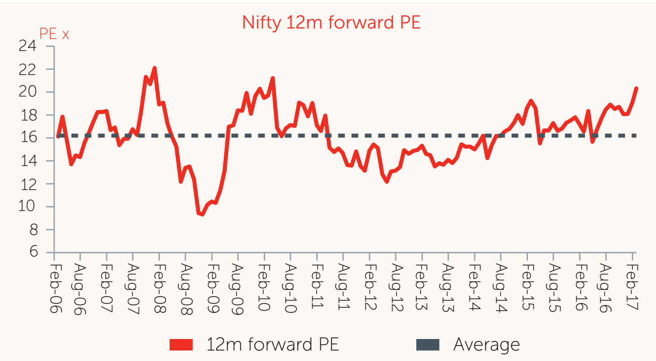

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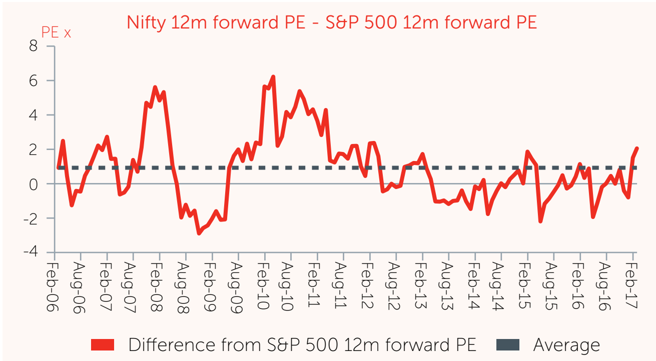

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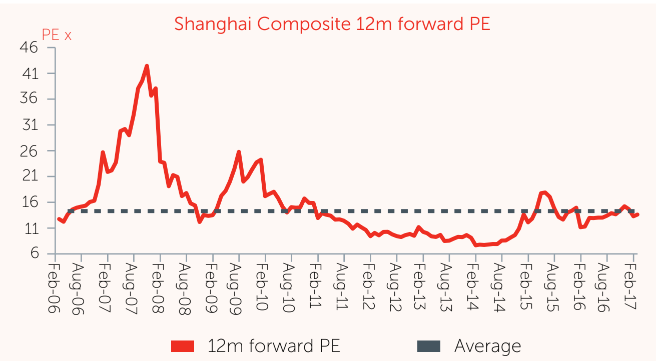

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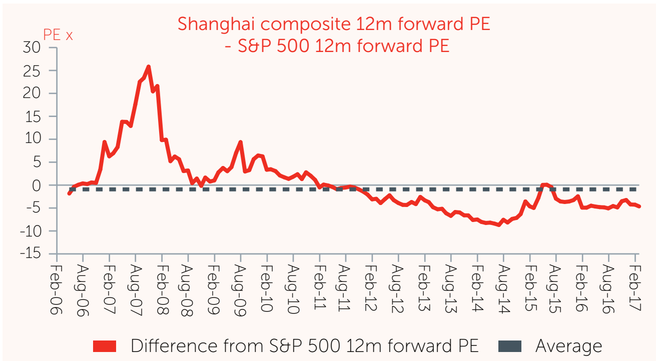

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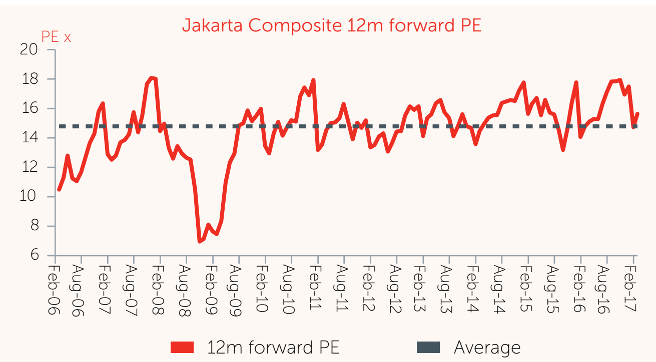

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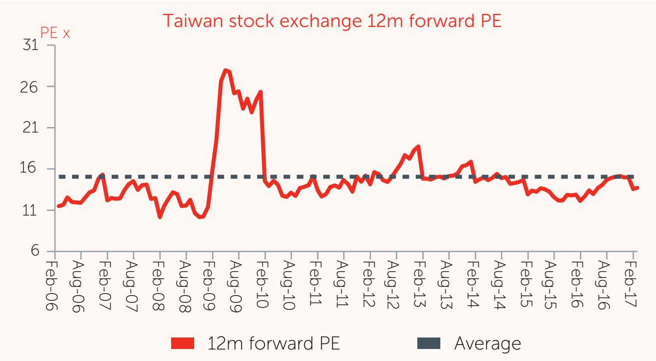
Equity Market Valuations



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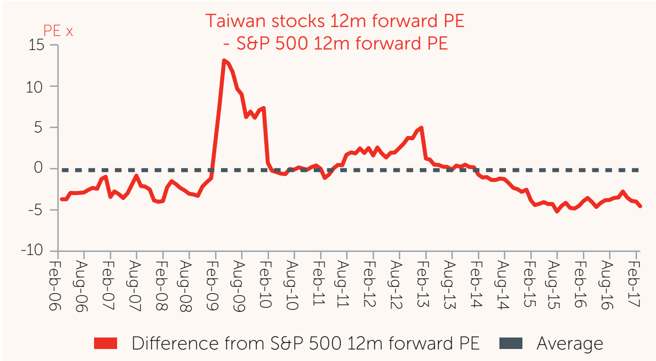

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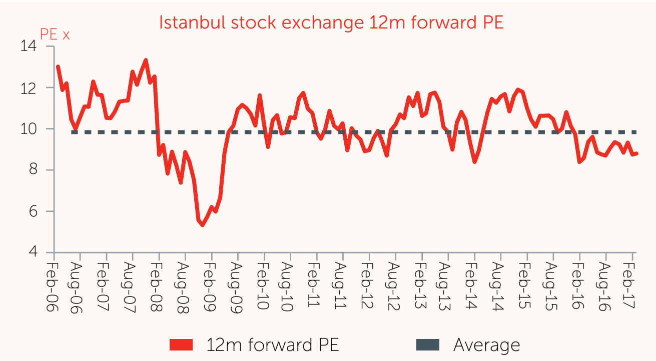

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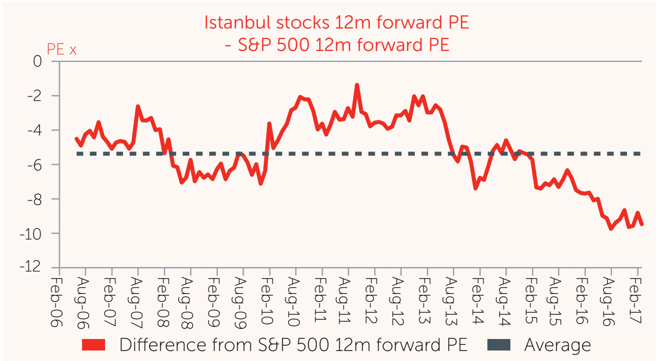

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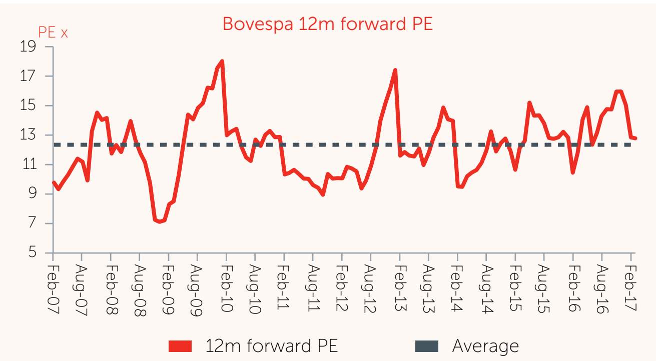

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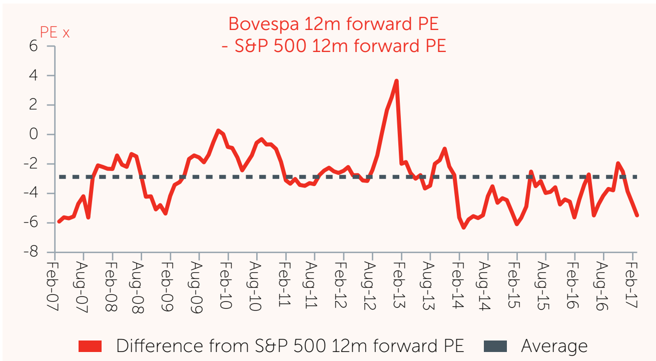

Source: Bloomberg

Sources

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

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