ADCB Asset Management

The Quarterly Investment View
October 2016

بنك أبوظبي التجاري
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An American miracle and the paradox of monetary policy limits

Negative headlines have abounded over the last months, as Brexit has highlighted the apparently unstoppable rise of political risk in advanced economies, and most data confirm that global growth will remain below what we were used to prior to the 2008 Global Financial Crisis. The three major central banks appear to be paralysed, either unable to pursue an effective expansionary stance (the case of the European Central Bank and the Bank of Japan), or unable to normalize their stance through higher reference rates (the Federal Reserve). Yet, in spite of these negative headlines, equity markets have climbed the wall of fear and managed to muster some significant gains over the summer.

One should put this into perspective, of course. With the exception of the United States, most equity markets are still well below their record highs. And whilst US equity markets as well as most emerging markets, amongst which also the UAE markets, have gained so far this year, European and Japanese equity markets remain in negative territory.

The resilience of the US equity market is remarkable. A lot of it has to do, for sure, with the timely clean-up of the US banking system as well as massive easing by the Federal Reserve in the aftermath of the September 2008 near collapse of the global financial system.

The fact, however, that US equity markets have kept outperforming in recent years, in spite of a significant appreciation of the US dollar, tells us that there are more factors at play. It is big US companies like Google and Amazon, to name just a few, that have dominated the marketplace for technological innovation, whereas companies from other countries have simply failed to keep up. Compared to Europe and Japan, the US enjoys favourable demographics, a more flexible labour market, as well as a financial system that is less reliant on banking, facilitates debt write-offs and is less prone to stigmatize bankruptcy. But the US has also seen a significant rise in income inequality, probably more than Europe, and certainly more than Japan. This explains, amongst others, the very high level of the cyclically adjusted price–earnings multiple of the US equity market relative to a lower current price-earnings multiple. Indeed, if earnings are extremely high compared to their ten year average at a time that global demand, and thus company revenues, are subdued, it must be that significant cost reductions have over the past years been the main driver of earnings growth. In other words, value has continuously been transferred from workers to shareholders.

But just like Brexit is Brexit, low growth is low growth. Economically, this American miracle will come to an end when cost cutting becomes so significant that they lead to a widespread reduction in aggregate demand. Politically, it can only last as long as the electorate doesn't rebel, and starts jeopardizing longstanding market-friendly trade, fiscal and monetary policies. In the US, or elsewhere.

Over a shorter horizon, however, we see a paradox. The fact that central banks are now hitting their limits, might well temporarily favour the global economy and stabilize financial markets. More specifically, the likelihood of a weaker US dollar, because of a less (than expected) accommodating stance by the ECB and the BoJ, and less (than expected) tightening by the Fed, is good for the global economy. It allows a partial recycling of Europe's and Japan's excess savings. A weaker US dollar also puts a halt to further capital outflows from China and emerging markets. But here is the catch: it induces China's provinces and state enterprises to engage in more, rather than less, inefficient debt-fuelled investments. At some point in time those debts will become unsustainable, trigger across-the-board emerging currency devaluations, and further deflate the global economy.

We stick to our global equity underweight and our US equity overweight. We have called off our emerging equity overweight and replaced it with a currency-hedged call on UK equities.

I hope you will find the relevant readings both enjoyable and instructive.

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

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest 30 Sep closing	Quarterly Change % (Q3 2016)	YTD Change % (30 Sep)
Index Snapshot (World Indices)			
S&P 500	2,168.3	3.3	6.1
Dow Jones	18,308.2	2.1	5.1
Nasdaq	5,312.0	9.7	6.1
DAX	10,511.0	8.6	-2.2
Nikkei 225	16,449.8	5.6	-13.6
FTSE 100	6,899.3	6.1	10.5
Sensex	27,866.0	3.2	6.7
Hang Seng	23,297.2	12.0	6.3
Regional Markets (Sunday to Thursday)			
ADX	4,476.3	-0.5	3.9
DFM	3,474.4	4.9	10.3
Tadawul	5,623.3	-13.5	-18.6
DSM	10,435.5	5.6	0.1
MSM30	5,726.2	-0.9	5.9
BHSE	1,150.0	2.8	-5.4
KWSE	5,398.4	0.6	-3.9
MSCI			
MSCI World	1,725.7	4.4	3.8
MSCI EM	903.5	8.3	13.8

Commodity	Latest 30 Sep closing	Quarterly Change % (Q3 2016)	YTD Change % (30 Sep)
Global Commodities			
ICE Brent USD/bbl	49.1	-1.2	31.6
Nymex WTI USD/bbl	48.24	-0.2	30.2
OPEC Baskt USD/bbl	44.6	-3.5	42.7
Gold 100 oz USD/t oz	1,315.9	-0.5	24.0
Platinum USD/t oz	1,027.4	0.3	15.2
Copper USD/MT	4,832	0.1	2.8
Aluminium	1,664.75	1.2	10.6
Currencies			
EUR	1.1235	1.2	3.4
GBP	1.2972	-2.5	-12.0
JPY	101.35	-1.8	-15.7
CHF	0.9714	-0.5	-3.1
Rates			
USD Libor 3m	0.8537	30.5	39.3
USD Libor 12m	1.5518	26.1	31.7
UAE Eibor 3m	1.2711	12.4	20.5
UAE Eibor 12m	1.8070	10.3	22.5
US 3m Bills	0.2739	-42.0	68.3
US 10yr Treasury	1.5944	8.5	-29.7

Executive Summary

- We place a big question mark behind the Fed's hiking intentions through 2017. The ECB and BoJ seem to be reaching the limit of QE.
- US growth to remain sluggish at best. Europe's growth expectations are adjusting lower. Japan at bigger risk. The pressure is likely to return on commodity exporting emerging economies, although US dollar weakness might prolong their favorable environment for some time.
- We see significant risks for equities because of the sluggish global growth environment and potentially limited monetary policy support. In such an environment US equities are likely to provide better downside protection than other major markets.
- China's structural problems are likely to get worse before they get better.
- Some emerging markets which are not exposed to commodity prices and where the reform process seems to be more promising, such as India, should fare better.
- 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 might still have some upside as a weaker dollar goes hand in hand with stronger aggregate demand.
- Industrial metals have further downside given the ongoing transformation of China's economy
- 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 the global deflationary environment does not favor their fundamentals.

Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Better stay long	A relatively dovish Fed and globally deflationary trends are likely to keep yields at bay. Temporary spikes are however possible as the ECB and the BoJ adjust their easing policies.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
EM bonds	Selectively overweight	Among Emerging Markets we differentiate between commodity exporters and importers, favoring the latter. Commodity exporters not only face growth issues but they seem to be more prone to currency volatility. Among commodity importer country bonds, we still prefer USD bonds rather than local currency bonds because of possible currency volatility.
Equity Markets		
US	Overweight	We maintain our US equity overweight primarily because we still see greater downside risk on global equities and in such an environment US equities are likely to decline less than their global peers.
Eurozone	Underweight	We maintain our underweight in Eurozone equities as we see higher downside risk to global equities and in such a scenario relatively high beta Eurozone equities are likely to decline more.
Japan	Moderate underweight	"Abenomics" is in a serious crisis. The BoJ's capacity to trigger inflation looks increasingly incredible, as the yen is bound to remain strong. Equities are therefore likely to remain under pressure.
Emerging Markets	Neutral	We have now taken our general emerging equity overweight off the table. Some markets, that are more reform prone and less dependent on commodities, such as India, remain interesting however.
United Kingdom	Overweight (US dollar-hedged)	We have an overweight on large-cap UK equities on a currency-hedged basis. FTSE 100 companies derive around 70% of their revenues from overseas and are therefore helped by continuing Brexit-induced GBP weakness.
Energy and Commodity Prices		
Energy	Neutral	Notwithstanding the recent rally in the oil price, we see little changes in demand-supply dynamics. We might see some further upside, but ultimately we expect the oil price to remain range bound.
Industrial Metals	Underweight	The full implications of the China transformation story will determine a further reduction in the commodity intensity of its economy. There may be some recurring technical rebounds in specific metal prices, specifically when the US dollar will be under pressure, but global deflationary pressures are likely to continue in the commodity space.
Precious Metals	Overweight	The US dollar is likely to remain under pressure. This should put a floor under precious metals. They are likely to do better when global financial markets come under pressure. Thus we keep them as a "market insurance" risk hedge in our portfolios.
Currencies		
EUR	Range bound with an upward bias	The incipient limits of central banking, i.e. a less accommodating ECB and a less hawkish Fed are likely to put some mild upward pressure on the euro. An appreciation of the US dollar would only be the result of a return to a global risk-off scenario. This could happen if the US and China slowdown becomes more nasty than expected.
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	Range bound with an upward bias	The incipient limits of central banking, i.e. a less accommodating BoJ and a less hawkish Fed are likely to put some mild upward pressure on the yen. But the yen being a carry trade currency, it could see stronger rebounds during global risk aversion phases.

Near term growth outlook remains subdued amid volatile oil market

A floor under the oil price

Over the last two quarters, the oil price has largely traded in a range of USD40-50 per barrel, albeit with high volatility. This provides a sense that the oil market has discovered a floor, at least in the near term. Although positive, it is not clear that the recent OPEC decision to cut production will be able to push prices significantly higher. For one thing, the exact details of the agreement are yet to be finalized. At the same time the inventory overhang is likely to remain a factor in the near-to-medium term. On the demand side the softening global growth outlook will likely keep oil prices volatile in the coming months. However, on a longer term basis, we feel more confident that average oil prices will creep up slowly as demand continues to increase at a pace of around one million barrel a year while cuts in investment (estimated to be somewhere between USD750bn and USD1trn) will curtail future production capacity.

Tightening in monetary conditions continues

Lower average oil prices and the consequent fiscal deficits in the region have one unintended consequence in terms of tightening monetary conditions; rising interbank rates. These rates have been trending up mainly due to the decline in deposits by GCC governments and public sector enterprises in their respective banking system. Saudi Arabia has faced the biggest impact of such a tightening given the Kingdom's large fiscal deficit. A sharp adjustment in government spending and large borrowings have dried up liquidity in the country's banking system, leading to tighter monetary conditions. Elsewhere, monetary conditions have tightened relatively less, for example in the UAE and Qatar - mainly on account of the comparatively smaller cuts to government spending in those countries. Nevertheless, we believe that tighter monetary conditions will continue across the GCC in the next few quarters.

Growth to remain subdued in the final quarter of this year before seeing a slight pick-up in 2017

The impact of tighter monetary conditions as well as adjustments in government spending will continue to weigh on the region's economic growth for the remainder of the year. Kuwait is likely to be an exception as the country has focused on countercyclical fiscal policy despite having a large fiscal deficit.

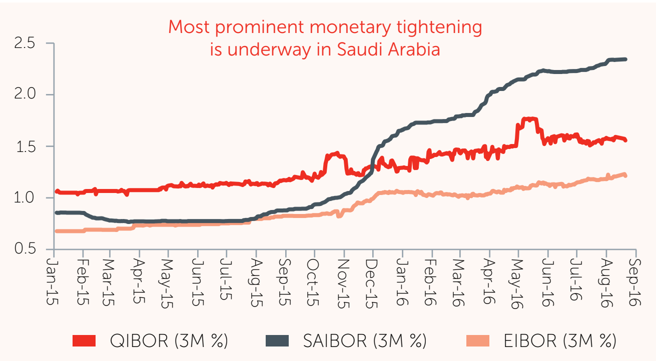
Next year's budgets could see smaller cuts

Looking ahead, our baseline expectation is that the oil price is likely to remain in its current range (USD40-50 per barrel), we expect smaller cuts in government spending, especially in Saudi Arabia. Although this is unlikely to revive growth very strongly, it could arrest the downtrend in economic activity.

Notwithstanding the soft economic environment for the next few quarters, we believe that the region's growth potential remains intact in the medium term. The current reforms which focus on the consolidation of government finances as well as a push for broader and longer-lasting reforms such as rationalization of subsidies and the likely introduction of VAT are going to put regional government finances on a more sustainable path. This, along with still very large financial back-ups in the UAE, Qatar and Kuwait, and reasonable reserve levels in Saudi Arabia, suggests macro stability in the long run.

Equities: remain neutral

All regional equities have underperformed global markets. If we look specifically at the GCC benchmark (which does not include Saudi Arabia) it has underperformed both developed (DM) and emerging market (EM) equities year-to-date, rising 2% vs. a c14% and c4% rally in the broader EM and DM indices respectively. This does not tell the full story as local equities' superior dividend yield means that the underperformance vs. EM narrows to c10% while marginally outperforming DM on that basis (by +0.3%). High dividend yield is one of the main attractions for the region, in what is otherwise a very low yield world. This, coupled with stability in the oil price and fiscal consolidation in many countries, means that local equities can continue to deliver decent, if unspectacular, total returns in the coming 12 months. UAE and Qatari equities are among the lowest beta markets in the EM benchmark, meaning that while they are unlikely to be strong outperformers (even when oil rallies sharply as investors will likely buy cheaper, more cyclical plays such as Russia and Brazil), so too are they unlikely to be the worst performers. Valuations for the region are in-line with their longer-term averages. We recommend a neutral position in local equities with an intra-region preference for UAE equities.



Source: Bloomberg

Growth remains subdued

Weak and uneven growth so far in 2016

Growth in the United States has disappointed, slowing down significantly as the economy moved from 2015 into 2016. Growth has also remained uneven as consumption has significantly picked up, whilst investments as well as government expenditures have not. It has been pointed out that growth in consumption has been driven by the significant reduction in unemployment in the United States. Better labor market conditions are of course a necessary pillar for growth, but they do not explain why growth has stalled in 2016. Moreover, the fact that consumption has fared relatively well compared to other components of GDP can be explained by the combination of a very low oil price and a strong US dollar, which have benefitted US consumers enormously. These are, however, one-off improvements which in the meanwhile have partially reversed with oil prices almost doubling from their lows and the greenback now clearly off its peak.

Wages not really picking up

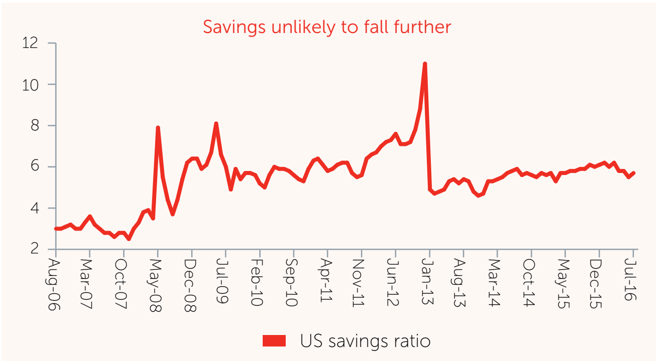
Job creation has kept up well in the United States, but will likely moderate as the business cycle matures. Therefore, for consumption to remain resilient, wage increases are required, lest consumers would scale back their savings, which seems unlikely with an ageing population. Importantly, however, while the labor market inches closer and closer to full employment, wage growth seems to have peaked around an annual rate of 2.5%, significantly below the level seen during previous cycles. Thus, with the benefits of the lower oil price and stronger US dollar petering out, and income growth refusing to meaningfully accelerate, it is more prudent not to bet on a significant pick-up in growth. To change this outlook, one would like to see signs of an improvement in investments, something that is still not there.

Political risks here to stay, Federal Reserve to hike little

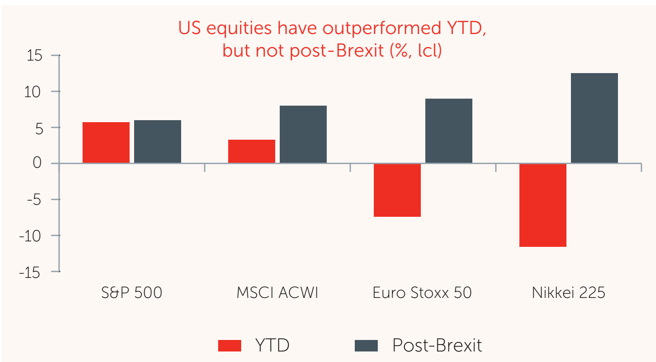
Markets tend to look at a potential Trump presidency as a major shock to the US economy and the financial system. As such the November 8 election is largely considered to be a one-off event. We do not believe that this is the correct way pf viewing the US presidential election. For sure, a Clinton victory is much less likely to trigger volatility than a Trump victory. However, as we have already highlighted with regards to the Brexit vote, political pressure to change "conventional" trade and fiscal policies that have been in place over the past decades are unlikely to abate, regardless of who wins the race to the white house. As such, increased political risks are here to stay. Another reason – together with low growth – for the Fed to be careful to hike.

Ignore fundamentals, OW US equities on relative basis

US equities have been the outperformers in the developed world this year, rising 6% year-to-date and +18% from its February lows. We remain of the view that despite all the obvious headwinds for US equities (presidential elections, high valuations, compressing margins, etc.), the market will outperform other major countries and regions such as Europe and Japan over the next 12 months. Our overweight recommendation speaks much more to the challenging overall environment for global equities than it does for US equity market fundamentals, which are admittedly unattractive. Assuming that the global equity market backdrop does not improve in the coming year, it becomes difficult to picture how European or Japanese equities could decouple and outperform US equities. In fact, at the margin further US equity decoupling may be more likely given the potential for euro strength (resulting from ECB constraints). This would hamper Eurozone earnings while boosting those in the US. Overall, the low beta nature of US equities makes it too risky to bet against this market in the challenging environment we currently find ourselves in, we therefore maintain our overweight on US equities.



Source: Bloomberg



Source: Thomson Reuters, MSCI

Growth at risk with monetary policy limits in sight

Economic growth remains very sluggish

The Eurozone's economy is soldiering on even as growth disappointed in the second quarter of this year. Importantly, the third quarter should be better than the second quarter as confirmed by a decent pick-up in manufacturing confidence. It seems to us that most of the optimism in the Eurozone derives from continuing solid export demand given that domestic consumption remains weak. In an environment where the euro is unlikely to devalue further, and where global growth still seems to be cooling, such export-driven support appears fragile.

Limits of monetary policy are close by, while doubts linger about fiscal action

The recent pick-up in headline inflation should not lead to too much enthusiasm. Whilst the price dynamics of the Euro-zone have now moved out of negative territory where it found itself at the beginning of 2015, at 0.4% it is still a far cry from the ECB's target of "lower than, but close to 2%". Moreover, market expectations, which have been consistently correct in forecasting inflation, do not expect a substantial pick-up in the coming next years. One might ask how impactful the ECB's unconventional monetary policies have been if growth remains lacklustre and inflation well below its target. Not surprisingly, even if the ECB has throughout indicated that its QE program should not be seen as bound by the March 2017 deadline, leaving it almost "open-ended", doubts are rising as to the longevity of the current unconventional policy. The ECB is already loading on too much negatively yielding paper. To avoid doing that, and plausibly better stimulate the economy, it would have to buy proportionally more so called periphery country - than core country bonds. This would meet fierce opposition as it could easily be interpreted as the core economies directly subsidizing the periphery.

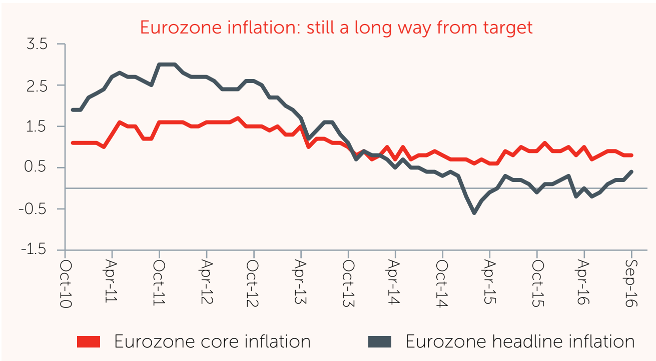
Political risks reflect policy paralysis

The ECB has set up a task force to study the reforms the Euro-zone requires. These reforms are not monetary but fiscal and structural in nature and, as such, are to be undertaken by national governments. Unless pressed by a major event, they are unlikely to do that. For the moment, on the contrary, too many electoral hurdles have to be cleared – from the Italian referendum in December 2016 to elections in Germany in September 2017 and in between elections in the Netherlands and France - for politicians to be willing to take any reform initiative in the presence of mounting social disenchantment.

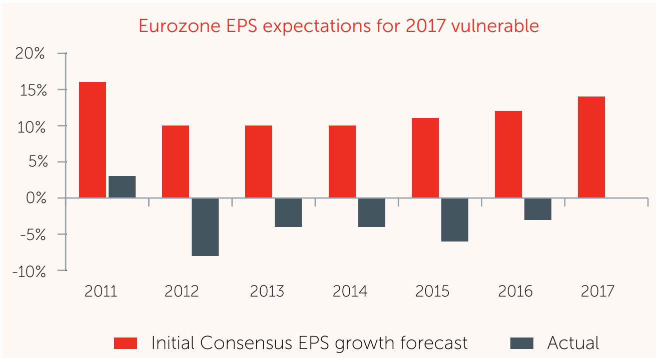
Underweight equities –a volatile downtrend

On the surface it might appear that Eurozone equities are performing reasonably well. The fact that they are 9% higher since June 24th (the day after the Brexit referendum) would support this view. However, taking a small step back shows that they are in fact down 7% year-to-date and -21% from their April 2015 highs. Despite this sizeable underperformance (especially vs. US equities) valuations are expensive. The Euro Stoxx 50 currently trades at 19.8x trailing PE, relative to a long-run trailing PE of 15x. Typically it makes sense to assign greater importance to forward looking valuations rather than trailing ones. However, given the elevated levels of economic and political uncertainty (not least thanks to Brexit) in the Eurozone, it seems very probably that earnings growth expectations (currently +12% for 2017) are woefully overestimated for a seventh consecutive year (chart below).

US elections, European politics, Brexit issues, growth concerns, ECB ineffectiveness, overly-optimistic earnings expectations, high valuations and potential for euro strength support our underweight call on Eurozone equities.



Source: Bloomberg



Source: IBES, Thomson Reuters, HSBC

Brexit impact yet to be felt

Economic indicators rebound after initial slump

The divorce between the UK and the European Union is expected to restrict labour migration from the latter to the former. At the same time the separation will restrict UK producers' access to European product markets. Therefore, most market analysts feared that a Brexit would have a severe impact on the UK's economic activity. This fear led to a slump in survey-based indicators in July, the month immediately after the Brexit vote. However, political developments suggest that the exact separation process will take longer than previously expected. The UK's new government has decided to only invoke article 50 of the EU treaty (which then kicks off a formal two-year exit process) by the end of March next year. Realizing that the divorce process was not going to be rushed has allowed sentiment indicators to rebound.

At the same time, activity indicators have remained resilient in the two months following the Brexit vote. Industrial production accelerated in July, while retail sales were strong in both July and August. There was hardly any visible impact on the labour market as the unemployment rate remained steady at 4.9%, with wages growing around 2.3% YoY.

Notwithstanding the rebound, the Brexit process will weigh on economic activity

Despite the fact that economic indicators have rebounded, the reality of Brexit has not changed. The possibility of UK producers losing access to the single market and cheap labour, especially from Eastern Europe has not gone away. Note that half of the UK's total exports go to EU countries. Therefore, we expect the initial respite from the fact that the Brexit process will take some time before it starts affecting businesses and ultimately consumers will fade and economic reality will set in. Once the process of separation begins it is likely to create uncertainty. We expect that uncertainty to feed through to a deterioration in the investment environment which ultimately will affect consumption as well.

On a medium term basis, the Brexit vote has also jeopardized the UK's fiscal consolidation path as the government has deferred tax reforms which could have enhanced revenue. With public debt close to 100% of GDP and a fiscal deficit running around 4% of annual output, the government will not be in a position to provide a meaningful fiscal stimulus during a downturn.

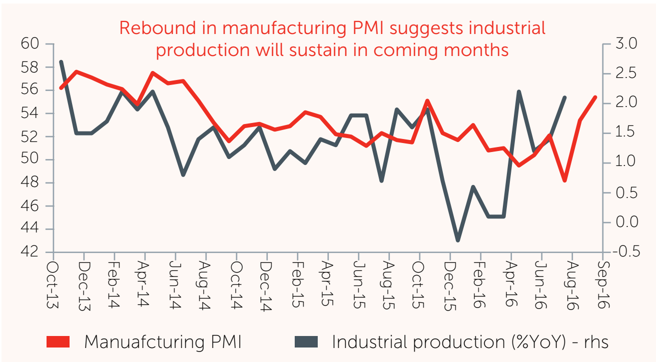
Bank of England acknowledges the near-term improvement but sticks to its medium-term outlook

The rebound in economic sentiment surprised even the Bank of England which was expecting almost no growth in the second half of the year following the Brexit vote. Although the central bank acknowledged the sharp rebound it reiterated its downbeat economic outlook over the medium-term. That suggests that it will maintain its easing bias, which could include a further rate cut later this year. A lower interest rate, possibly more QE in the context of the UK's large current account deficit (c6% of GDP) will continue to weigh on the currency.

Equity – overweight UK large caps

Large cap UK equities (FTSE100) have been among the best performing stocks globally since the June 23rd Brexit referendum, rising 14% in local currency. The reasons for this relate mostly to pound sterling weakness as well as Bank of England policy reaction to the Brexit vote. To a large extent these two factors are intertwined given that easier monetary policy leads to currency weakness. However, the UK's slowing economic growth and sizeable external vulnerabilities also call for a weaker currency. Despite the 14% depreciation in sterling against the US dollar already, we expect further pressure on the currency, not least because a cheaper pound is required to maintain capital inflows in order to fund the c6% current account deficit. This will continue to boost earnings for UK large cap stocks. 70% of FTSE 100 companies' revenues are derived overseas; UK listed global heavyweights such as Burberry, Randgold, BHP Billiton, Rio Tinto, BP, British American Tobacco, GlaxoSmithKline, to name a few, generate only a small share of their profits in the UK.

The FTSE100's sector composition also gives it defensive qualities which will help in what we expect will remain a challenging environment for global equities. The market is under-loved by investors, making a sudden large exodus from UK equities unlikely. We recommend a dollar-hedged overweight on both the FTSE100 and MSCI UK (see link).



Source: Bloomberg

BoJ loses effectiveness amid sagging growth and inflation outlook

BoJ's ability to influence currency has diminished

Since the beginning of the year, the impact of the Bank of Japan's policy action on financial markets, including the currency has diminished. The introduction of negative short-term interest rates earlier this year and continued JGB purchases (which pushed a large part of the sovereign yield curve into negative territory) failed to lead to further yen weakness, nor did these policies incentivise domestic investment. That forced the BoJ to reassess its strategy last month. The central bank is now focusing on the yield curve as it targets the 10yr yield to be around zero with some steepness in the long part of the curve. Initial reaction from the currency market does not look very encouraging.

End of deflation is nowhere in sight while growth remains uneven as well as anemic

The effectiveness of the central bank's policy is diminishing at a time when there is no sign of inflation. Headline inflation became negative in March, while core inflation has also been inching down. On top of that pipeline inflation is running deep into negative territory which does not suggest a revival in inflation any time soon. The sharp appreciation of the yen this year is also expected to put downward pressure on prices in the coming months.

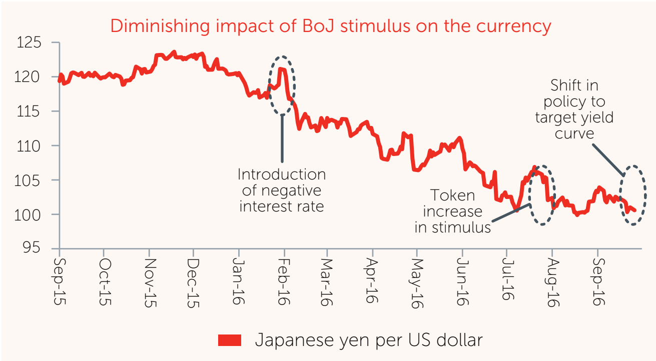
Not only has inflation failed to pick-up, economic growth has been uneven and anemic since the start of "Abenomics". During the last thirteen quarters since the central bank started its QQE policy, GDP growth has been negative in five quarters. With the deflationary tendency remaining well entrenched and wage growth not picking up sustainably, the current economic environment creates doubts over consumption growth. At the same time global trade headwinds, as reflected by a continuous decline in exports since September 2015, are another risk to growth. A sharp currency appreciation this year further aggravates the risk from the trade channel. Tankan surveys conducted by the BoJ for the third quarter also point to a subdued economic environment in the coming quarter.

Despite the fact that results of the BoJ's monetary policy have thus far been mixed (at best), we believe that the central bank will not give up, and it will continue experimenting with different tools to weaken the currency and revive inflation.

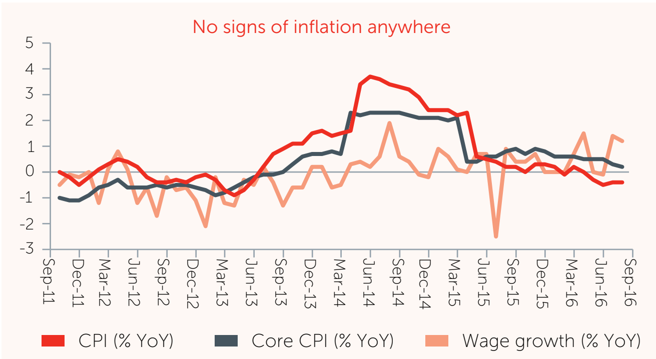
Remain underweight unless the BoJ *really* delivers

Yen strength has severely impaired the outlook for Japanese corporate earnings in 2016. Consensus EPS growth for 2016 has plummeted from c12% only a few months ago to below 3% at the time of writing, making the market's earnings revisions the most negative of any major market globally in recent months. There is potential for this downgrading process to extend a little further, in particular for 2017 earnings which are currently expected (by consensus) to grow c9%. Further yen strength towards the ¥95/$ level would be the most obvious catalyst for this, along with continued Bank of Japan (BoJ) disappointment. Having said so, a further 5% appreciation of the currency (spot is around ¥101/$) is unlikely to have the same detrimental impact on the earnings outlook nor on equity market performance as the 19% y-t-d appreciation already witnessed.

At the same time there remains a chance that the BoJ surprises the market and delivers a major policy shift, for example by implementing outright helicopter money. Whether or not this will end up being successful is beside the point, like all major central bank interventions post 2009, investors are likely to give the BoJ the benefit of the doubt. We would expect the market to rally on the back of such an event. This, coupled with much lower global fund holdings of Japanese equities (compared with 12 months ago) and reasonable valuations argue for a moderate underweight until (if at all) the BoJ implements a major policy shift, at which point we would re-assess the situation.



Source: Bloomberg



Source: Bloomberg

Still hiding behind a weak US dollar

China activity slowdown stabilizing

Summer appears to have been good for China. A rapid decline in industrial production and GDP growth have been averted, and – reading from the healthy increase in retail sales growth – consumption appears to be holding up as well. Positivity has also been reflected in an upward move in equity markets, and a new surge in house prices. More importantly, both the official and private (Caixin) leading indicator for manufacturing confidence have reversed their downward trend, confirming that growth could remain steady over the coming months.

But is this gradual slowdown going in the right direction?

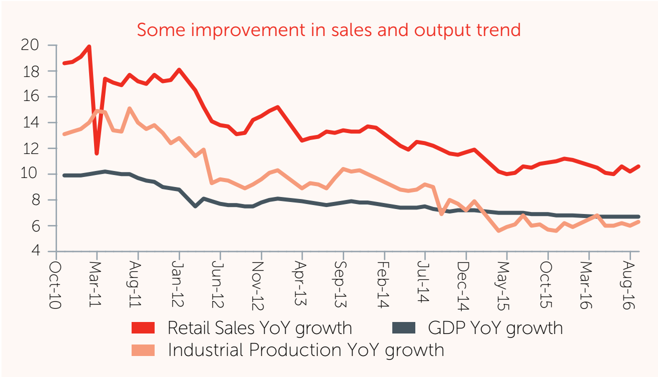
The good news is, of course, that the Chinese authorities are perfectly aware of the desired direction: a gradual slowdown of the country's growth rate and a change in the composition of such growth, with less investments and more consumption. As such, the fact that retail sales are holding up nicely is, in and by itself, encouraging. It is important, however, to ascertain why retail sales are holding up. If consumption is robust because income growth is strong, then we have a positive story. If, on the other hand, consumption is being induced by asset bubbles that do not correct for the economy's underlying imbalances, then the story is less comforting. Unfortunately, it seems that China's growth is still too reliant on rising debt levels that finance the wrong investments by State-owned enterprises, rather than a sustainable pick-up in income driven by productivity-enhancing investments.

The global currency environment has changed, not China's fundamentals!

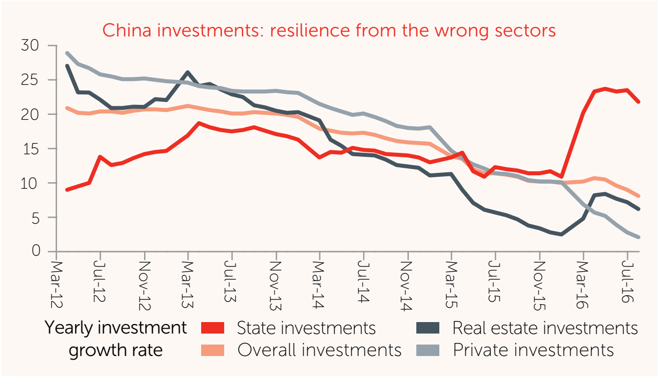
More than a year ago China shocked the world with a "mini-devaluation" that left many wondering if something bigger was on the cards. The reform introduced in August 2015 widened the trading band and also allowed that band to move over time. This is exactly what has happened since with the renminbi down almost 7% against the US dollar during this period. This year the US dollar weakened against the euro and the yen, but the renminbi continued to devalue in spite of China having moved from a dollar-referenced exchange rate to a currency basket including the euro and the yen. The fact that the US dollar rally is now firmly over, is what is really helping China as it allows the country to gradually depreciate its currency without triggering massive capital outflows. The problem, however, is that China remains vulnerable to any global spike in the US dollar, at which point we would return to serious balance of payment problems. At the same time, the weak renminbi actually incentivizes further investment in the wrong sectors, as well more debt accumulation. Thus, when global jitters return, they will likely hit China with a vengeance.

Economic complacency a risk to equities

Chinese equity performance has diverged enormously in Q3. A-shares have risen just 1.3% while H-shares have surged 10.6%, outperforming EM by 2% during the quarter (in US dollars). Year-to-date, however the picture is rather different as both A and H-shares have underperformed EM by 32% and 13.6% respectively. H-share outperformance (over A-shares) was driven mainly by anticipation of the long-awaited Hong Kong-Shenzhen stock market connect (officially approved on August 16 and expected to start in November) along with the large valuation gap between the two indices (H-shares trade at a 20% discount to A-shares). Additionally better than expected earnings numbers are also likely to have played a role; over two-thirds of H-share companies beat expectations in the most recent earnings season. Going forward, however, catalysts are difficult to identify. Expectations around the Chinese macro outlook tend to swing from overly bearish to complacent. We believe that following the trough in sentiment in February that the pendulum has again swung towards complacency, thereby also increasing the likelihood of economic disappointment getting reflected in equity prices. Remain underweight both A and H-shares.



Source: Bloomberg



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Consumption remains the main support

Consumption is likely to remain the main driver of growth

India's strong growth story has largely been driven by consumption amid a decline in investment, particularly in the last few quarters, while a continuous decline in exports over the last six quarters has hardly contributed to growth. We expect consumption to remain the main driver in the coming quarters thanks to government employees' wage increases. In addition, a steady improvement in rural wages along with a better monsoon season this year will provide higher disposable income to rural households. This is important given that rising risks to the global economic outlook lead us to believe that the external sector is unlikely to be a major contributor to growth for the foreseeable future. On the other hand, investment has been taking longer to revive in a sustainable manner. Subdued credit growth confirms this. Despite the government's efforts to revive the investment cycle through spending on roads and railways, high levels of non-performing assets in the banking system and stress in some of the main drivers of investment (such as important infrastructure sectors) will continue to weigh on the investment environment.

The passage of the Goods and Services Tax Bill (popularly known as GST) by Parliament and ratification by more than half of state assemblies pave the way for its implementation from the next fiscal year. This provides a strong momentum to the reform process.

Food inflation moderates but consumption-investment dynamics unlikely to allow sharp disinflation

Inflation has moderated sharply in August from its recent peak in July due to a decline in food price inflation, however, it is unlikely to moderate further in the coming months. If one strips out the food component from headline inflation, it ticked-up slightly from 4.6% to 4.7%. In an environment where consumption is growing at a strong pace but investment is declining, pressure on prices is bound to happen. With consumption driving growth, it calls for caution on the monetary policy side. We believe that the inflation outlook is less benign beyond the next few months. Both headline and core inflation are expected to end the financial year around 5% with an upside risk. This should not provide much room for further monetary easing given that the RBI has cut the rate to 6.25% and stated its desire to maintain real interest rate around 1.25%.

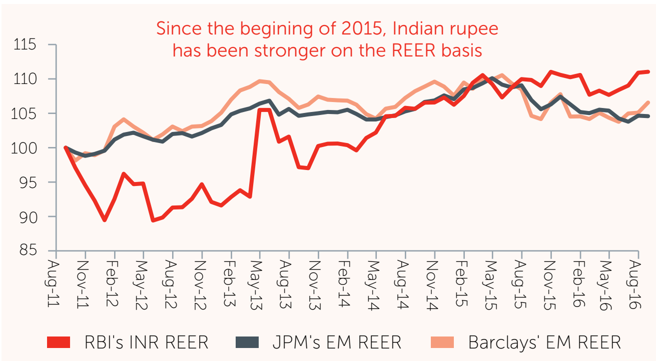
Rupee on a strong footing, expected volatility could be used to guide a small depreciation

A strong improvement in the external balance of the country coupled with a moderation in inflation and containment of the fiscal deficit provide a strong footing for the Indian rupee. Notwithstanding the small depreciation this year, the currency has gained significantly on a real effective exchange basis over the last few years. Since the beginning of 2015, it has clearly diverged from its Emerging Market (EM) peers and has moved to an over-valued zone. This divergence coincides with India's exports underperformance vis-a-vis EM exports. We believe this could push the RBI to use potential volatility in the currency during the Foreign Currency Non Resident (FCNR) deposits related outflows later this year to guide a moderate depreciation. Note that around USD25bn is expected to flow out of the country as FCNR deposits mature in the fourth quarter. We maintain our call for a 3-5% depreciation of the INR against the US dollar annually.

Equities: maintaining our structural overweight

We continue to like Indian equities due to their defensive qualities within EM. As pointed out above, the main driver of the Indian economy has been consumption, making it an internally rather than externally driven story. This matters for equity markets in an environment where global growth and trade are visibly slowing. It is therefore also the consumer sectors where we believe the greatest potential lies within the market. A stable to slightly weaker INR, especially relative to other EM currencies will continue to underpin investor confidence.

Valuations trade at a sizeable premium to the EM aggregate. However, this is nothing new and we believe the market deserves its premium thanks to superior macro fundamentals. The c35% 2017 PE premium can also be justified by a much higher expected EPS growth rate (18.4% vs. 13.3%) and ROE (16% vs. 11.5%). We remain structurally overweight Indian equities.



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Time to withdraw our tactical overweight

Improving growth differential vs. developed economies is somewhat misleading

Economic growth in emerging markets (EM) has been declining since the 2008-09 global financial crisis (GFC). This process now looks to be over as most forecasts for EM growth suggest a stabilization, rather than a further deterioration in the economic outlook. This means that the widening growth differential vs. developed economies, which the EM world enjoyed prior to the GFC could resume. However, we are not very convinced by this argument as the improvement in EM growth is predominantly coming from a smaller contraction in some major EM economies such as Brazil and Russia. On the other hand, growth in other large economies, China for example is only going down. In fact, China's slowdown poses a significant risk not only to broader EM growth, but also to global growth. In addition, growth in India - the fastest growing major EM economy - is also not accelerating.

Slowing global trade unhelpful for EM growth

Strong overall EM growth in the period prior to the GFC was accompanied (if not in large part driven) by robust global trade. Demand from developed world consumers for EM goods as well as commodity demand from China were key underpinnings of the EM story. Average annual growth in global trade over the last two decades has been around 7% which is 1.5 times average global economic growth. This speaks to the importance of trade for sustainable higher growth in EM. This tailwind for EM has become much less powerful in recent years - UN trade figures put average global trade growth at a mere 1.5% per annum over the last two years. In the absence of strong global trade, the much-vaunted growth differential between EM and developed economies looks fragile.

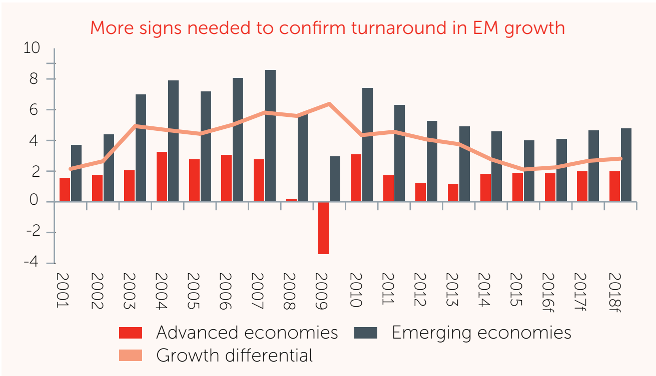
Another indicator which makes us cautious on EM growth prospects is the lagging manufacturing PMI. Notwithstanding the improvement in the indicator over the last few months, it remains very close to the 50 mark which divides growth from contraction. Note that despite consistently slowing during the past two years, manufacturing PMIs in developed economies are still higher than those in EM. We believe that for the EM growth differential (vs. developed economies) to widen sustainably, both global trade and EM manufacturing activity need to pick up substantially.

US dollar leverage remains a major source of risk for EM

According to the Bank of International Settlements, dollar credit to non-bank corporates in EM was close to USD4.5tn at the end of Q2 2015, while the IMF estimates total EM exposure (including banks & governments) to the US dollar was almost USD18tn last year. Therefore, rising interest rates in the US (USD Libor has gained significantly despite only one hike by the Fed) are likely to put stress on EM corporate balance sheets.

Neutral EM equities while global risks rise

In September we removed a 3-month long tactical overweight call on EM equities with an absolute performance of +10% over this period (see link). The tactical nature of the call was meant to reflect our concern over EM macro fundamentals, which remain uninspiring. EM equities generally are much more influenced by global than by local forces, which is why the asset class was able to outperform post-Brexit (thanks to even easier global monetary conditions). However, we expect global forces to turn less supportive over the coming months. Considerations here are US presidential elections (and the associated risk for increasing protectionism), the US Federal Reserve's apparent eagerness to hike interest rates in December as well as resurfacing concerns about China (both debt and growth). Therefore, while acknowledging some of the positive underpinnings for EM equities such as cheap valuations and under-ownership by global equity funds, global risks could dominate the direction for EM in the short-term. On balance we recommend a neutral position in EM equities for the time being.



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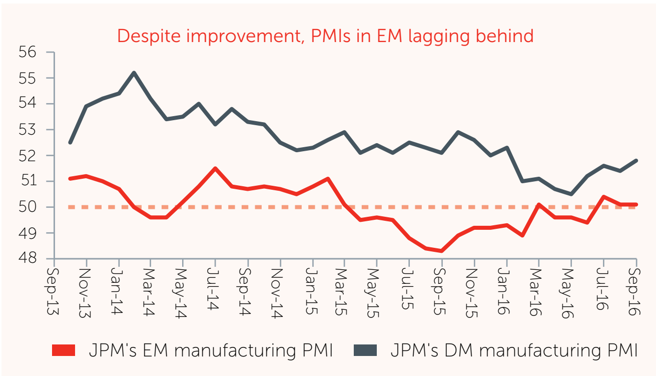


Source: Bloomberg

GDP Forecast	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	1.5%	In agreement	2.2%	Expect significantly less
Eurozone	1.5%	In agreement	1.3%	Expect moderately less
Japan	0.6%	In agreement	0.8%	In agreement
China	6.6%	In agreement	6.3%	Expect significantly less
India	7.7%	In agreement	7.8%	In agreement

Source: Bloomberg

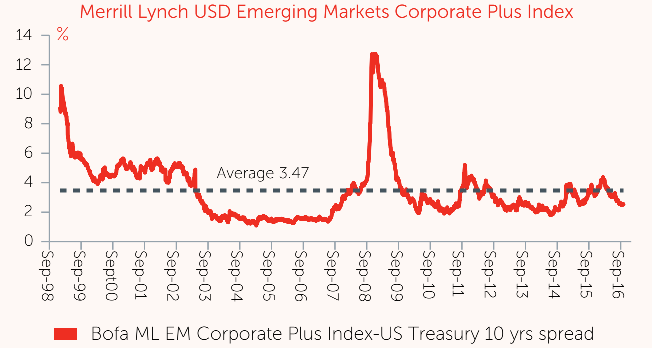
CPI Forecast YoY	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	1.2%	In agreement	2.2%	Expect moderately less
Eurozone	0.2%	In agreement	1.3%	In agreement
Japan	-0.2%	In agreement	0.6%	In agreement
China	2.0%	In agreement	2.0%	In agreement
India	5.3%	In agreement	5.2%	Expect moderately more

Source: Bloomberg

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

Bond Market Spreads

Merrill Lynch USD Emerging Markets Corporate Plus Index



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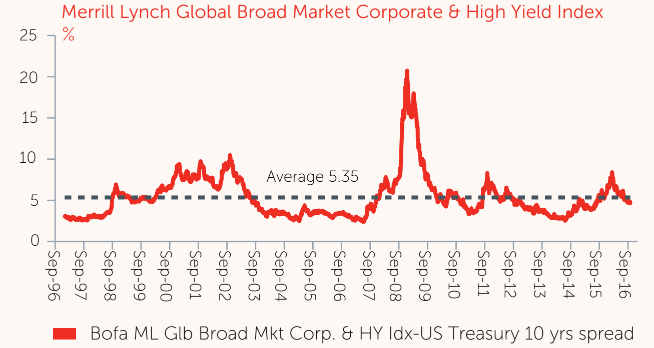
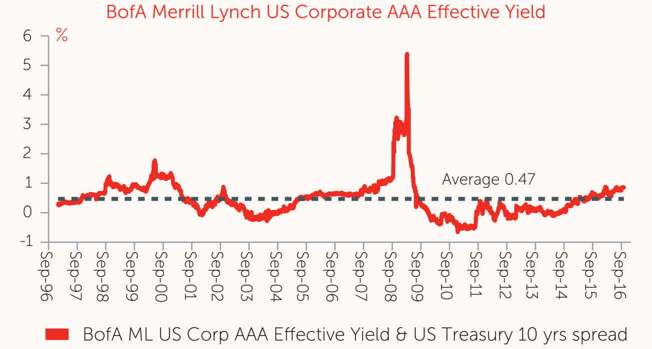
Merrill Lynch Global Broad Market Corporate & High Yield Index



Source: Thomson Reuters

BofA Merrill Lynch US Corporate AAA Effective Yield



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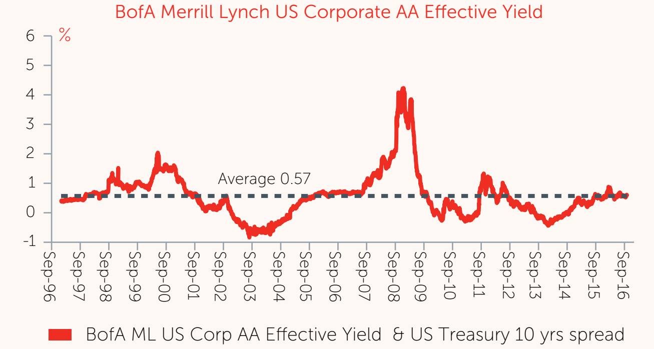
BofA Merrill Lynch US Corporate AA Effective Yield



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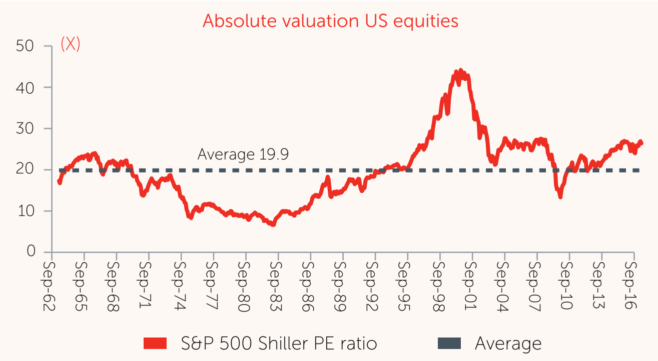
Equity Market Valuations



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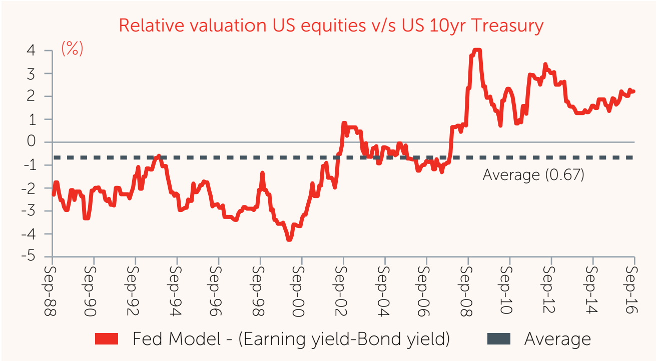

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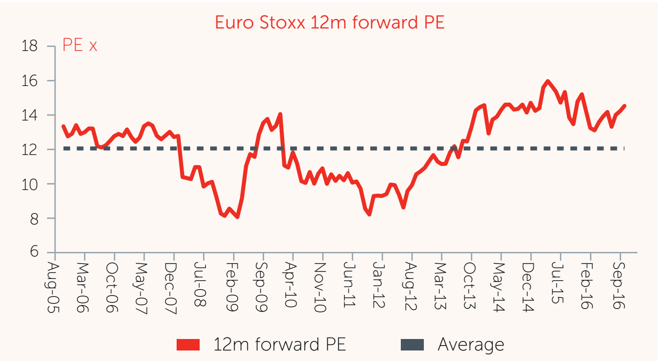

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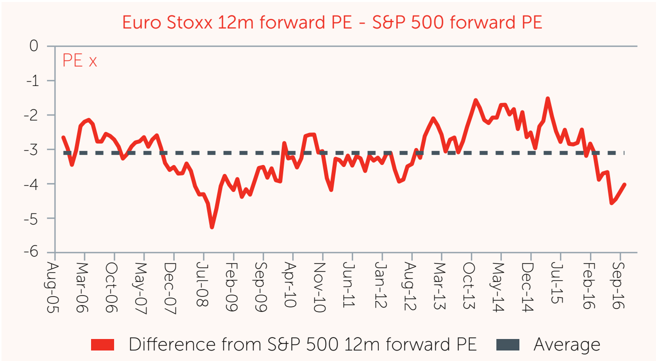

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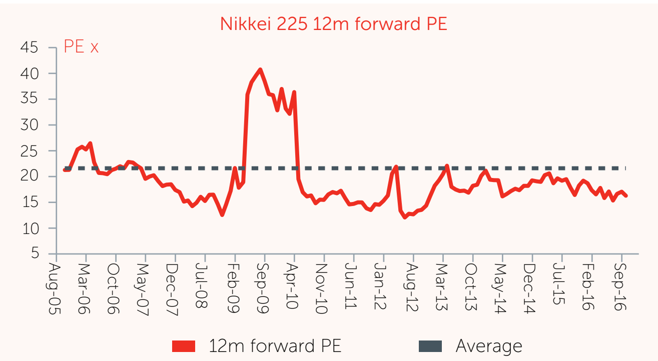

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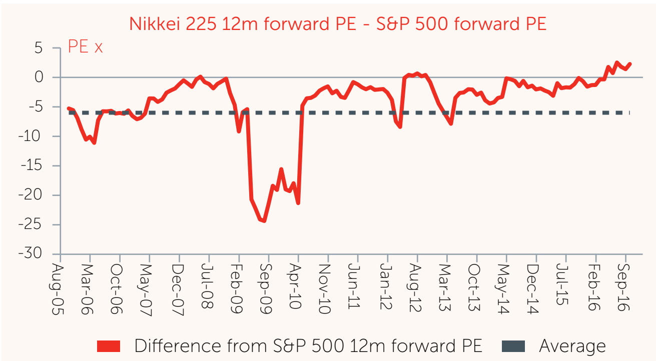

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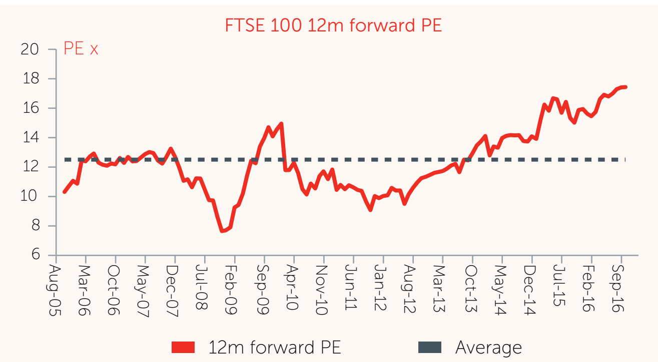

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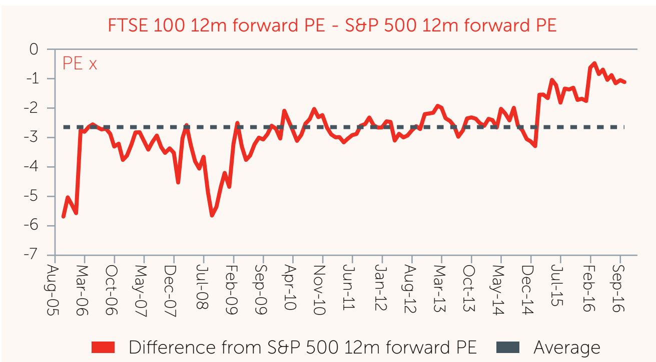

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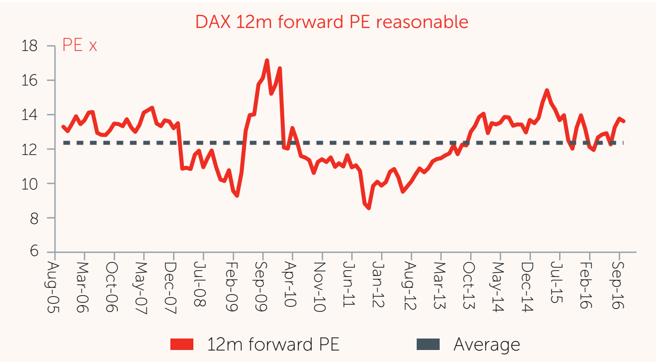
Equity Market Valuations



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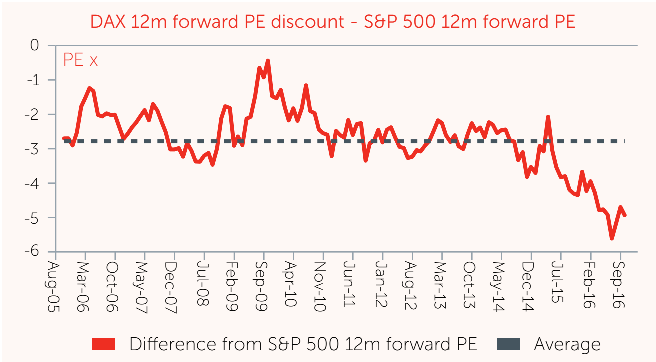

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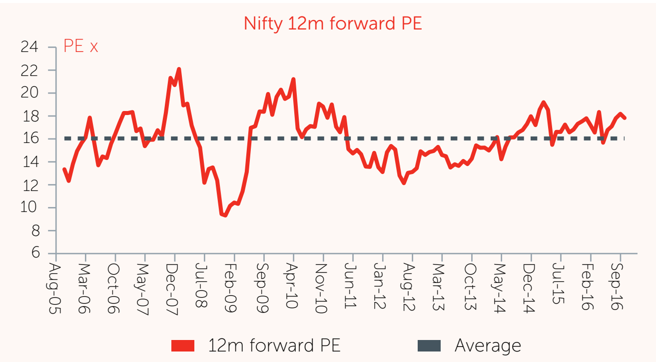

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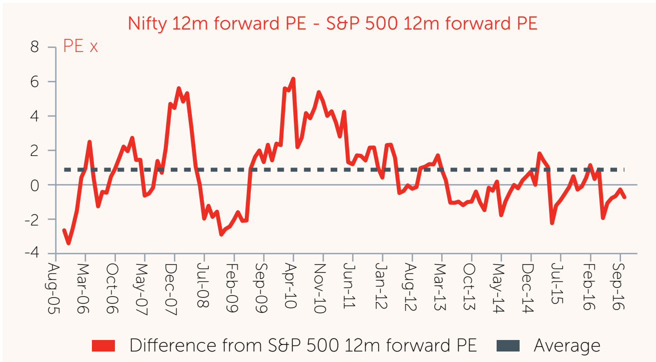

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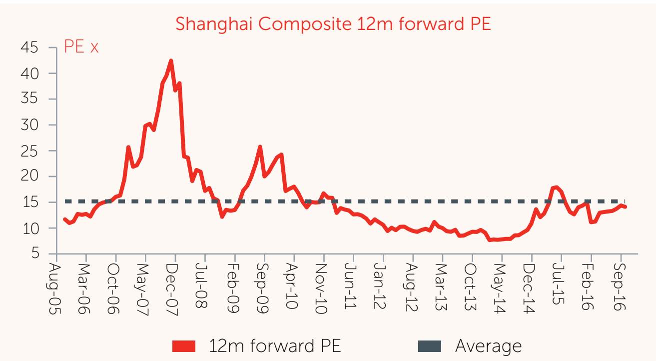

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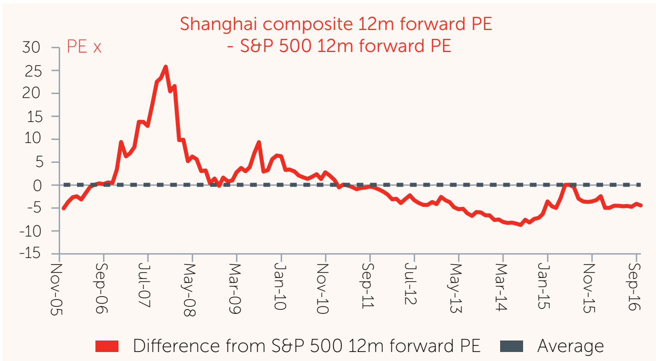

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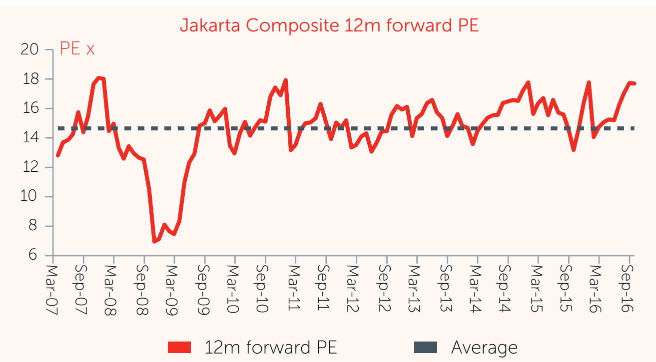

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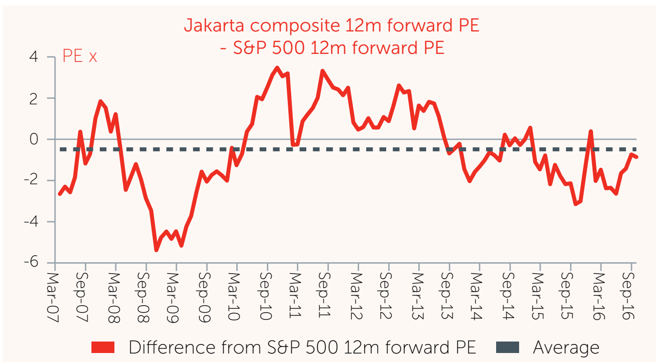

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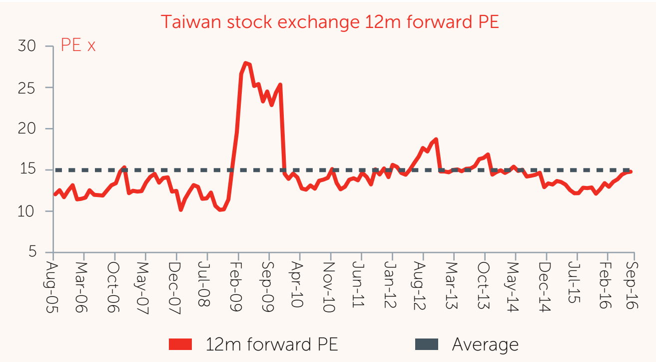
Equity Market Valuations



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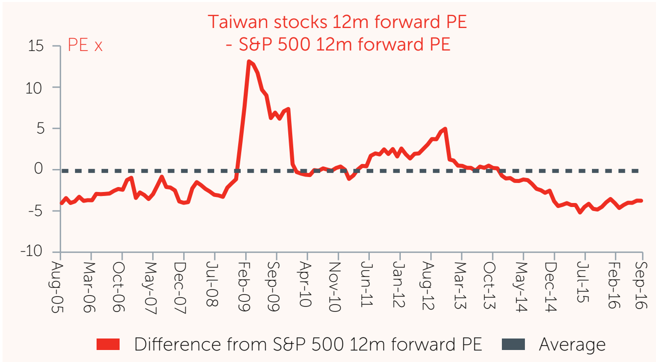

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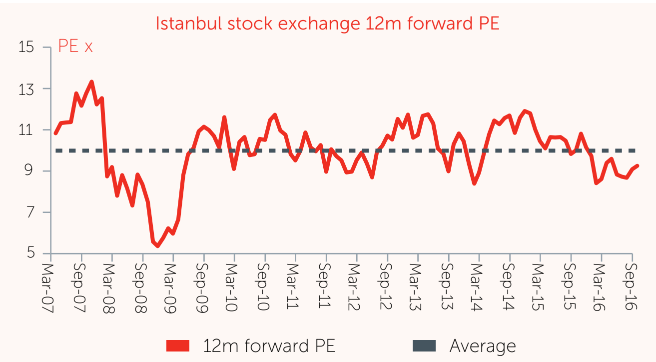

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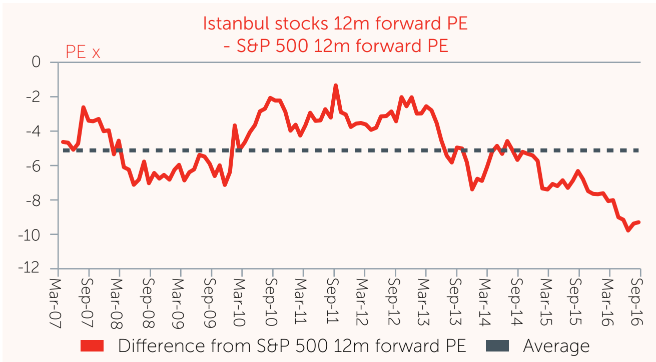

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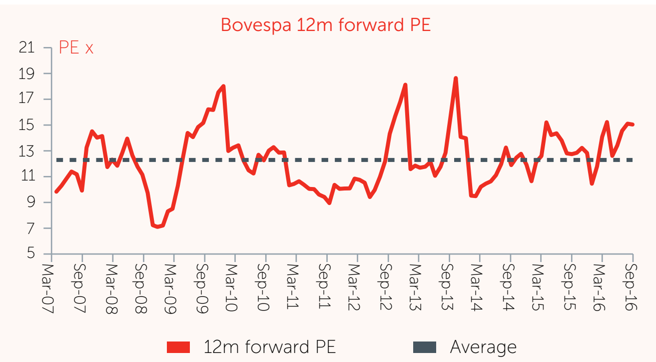

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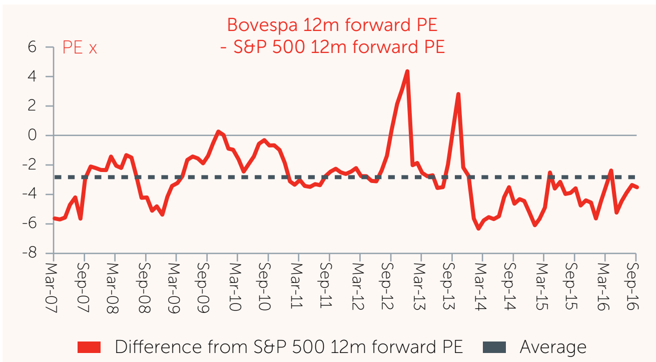

Source: Bloomberg

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

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