ADCB Asset Management

The Quarterly Investment View
April 2018

بنك أبوظبي التجاري
ADCB

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Introduction

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Volatility is here to stay, but markets will try to climb the wall of fear

Exactly a year ago we wrote in the editorial of this quarterly publication that on trade issues most countries would try to accommodate with the United States and that, as such, a trade war was unlikely to unfold. We argued that the United States can be seen as "the buyer of last resort" in a world where supply is in excess of demand. Over the last few months the Trump administration has decided to test the effective weight of its bargaining power as "the buyer of last resort". The mere threat of a trade war has been sufficient to rock markets for the simple reason that free global trade has effectively been one of the main bedrocks of a period of a prolonged period of sustained global growth.

Markets have also shown signs of nervousness at the risk of increasing inflation in the United States, forcing the Federal Reserve to expedite the pace of rate hikes, thereby potentially triggering a recession, or at least an increase in the cost of capital and, all other things equal, the current valuation of equities versus fixed income.

At the same time, however, the US tax reform *combined with* the recent agreement between democrats and republicans to raise caps on defense and nondefense expenditures, *as well as* the 45 billion US dollars in hurricane relief are giving a serious boost to US growth through 2018 and 2019. Whilst we suspect that over the next two years rate hikes might be a bit more moderate than many market participants are currently expecting, we would also like to stress that the current policy framework, i.e. a tightening monetary policy together with an expansionary fiscal policy, has normally coincided with an upward move in equity markets. Add to that a scenario of relatively stable global growth and one can see that markets will attempt to climb the wall of fear and try to ignore threats of trade wars, as well as other geopolitical risks.

Will it be an easy ride? Most likely not. The US-China trade discussions in particular are going to continue to trigger a lot of market volatility. Yes, we believe that a solution will be negotiated whereby China will to some extent give in to the United States. The US Administration however will try to extract as much as possible from China in terms of access to its domestic markets. In the process Mr. Trump might be tempted to upper the ante each time a deal seems in reach. Why would he do that? First, in the run-up to the November Midterm election he will want to show his constituencies that he is really tough on China. Second, he wants to make it very clear to the Chinese that he can live with equity market corrections. Of course, the latter point is true only up to a certain degree, since a more severe and permanent correction of the equity market would bite into the US economy, and thus Mr. Trump's electoral fortunes. But this is precisely our argument. Whilst there are still strong reasons for equity markets to move up, the politics of trade negotiations are very likely to induce continuing volatility.

Continuing volatility combined with the prospect of China tightening does not bode well for emerging markets. At the same time we are seeing a roll-over in growth in Europe and Japan. Thus, whilst we remain constructive on the global equity outlook, we stick to our overweight in US equities given that they are least sensitive to global growth. At the same time we stick to long-term US Treasuries and gold as risk hedges in the persistently volatile global environment.

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Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest (20 Apr closing)	Quarterly Change % (Q1 2018)	YTD Change % (20 Apr)
Index Snapshot (World Indices)			
S&P 500	2,670.3	-1.7	-1.7
Dow Jones	24,448.7	-3.0	-3.0
Nasdaq	7,128.6	1.6	1.6
DAX	12,572.4	-6.8	-6.8
Nikkei 225	22,262.3	-5.8	-5.8
FTSE 100	7,398.9	-7.4	-7.4
Sensex	34,571.6	-2.6	-2.6
Hang Seng	30,578.8	0.8	0.8
Regional Markets (Sunday to Thursday)			
ADX	4,693.5	4.3	4.3
DFM	3,062.0	-7.8	-7.8
Tadawul	8,335.4	8.9	8.9
DSM	9,157.6	0.6	0.6
MSM30	4,756.03	-5.4	-5.4
BHSE	1,298.6	0.9	0.9
KWSE	6,633.4	3.5	3.5
MSCI			
MSCI World	2,097.2	-1.9	-1.9
MSCI EM	1,158.3	1.5	1.5

Commodity	Latest (20 Apr closing)	Quarterly Change % (Q1 2018)	YTD Change % (20 Apr)
Global Commodities			
ICE Brent USD/bbl	74.9	5.3	5.3
Nymex WTI USD/bbl	68.92	8.5	8.5
OPEC Basket USD/bbl	70.4	2.6	2.6
Gold 100 oz USD/t oz	1,326.4	2.4	2.4
Platinum USD/t oz	921.5	0.4	0.4
Copper USD/MT	6,923	-7.4	-7.4
Alluminium	2,296	-12.5	-12.5
Currencies			
EUR	1.2210	3.2	3.2
GBP	1.3945	4.3	4.3
JPY	108.79	-5.8	-5.8
CHF	0.9781	-2.5	-2.5
Rates			
USD Libor 3m	2.3592	36.4	36.4
USD Libor 12m	2.7603	26.4	26.4
UAE Eibor 3m	2.4642	29.7	29.7
UAE Eibor 12m	3.0887	8.2	8.2
US 3m Bills	1.8335	-42.0	23.6
US 10yr Treasury	2.9621	12.7	12.7

Executive Summary

- The rise in geopolitical tensions contrasts with the synchronized pick-up in global growth. Trade concerns, in particular, have taken center stage. We reiterate our stance that these tensions are very unlikely to go away in 2018. However, we still think that these tensions will not morph into major conflicts, in particular a full blown trade war, even if the likelihood of the latter has now objectively risen. As such, one can argue that the recent bout in volatility reflects the fact that markets are correctly pricing the higher risk scenario. 2018 will likely see continuing volatility, but equity markets at the same time climbing the proverbial "wall of fear".

- The resilience of emerging markets has probably been the most surprising development, since one would expect many emerging markets to be particularly vulnerable to the threat of a fall in global trade. What has probably helped emerging markets, as well as energy and commodity markets, is the continuing weakness of the US dollar. Weakness of the US dollar could of course persist, as China in particular might try to accommodate the US trade requests by allowing a stronger renminbi. At a global level, however, it is difficult to imagine significant additional US dollar weakness. Thus we advise selectivity when it comes to emerging markets.

- We are not excessively concerned about a significant inversion of the US yield curve, i.e. a situation whereby the long-term yields end up being lower than the short term rates because the Federal Reserve excessively hikes rates. Either inflation goes up a bit more than expected, and the Federal Reserve will hike rates by 75bp more in 2018, repressing long-term yields by acting pro-actively, or Jerome Powell and his team will limit themselves to at most two more rate hikes in 2018. Either way financial conditions in the US will remain relatively accommodating.

- The true wild card remains China. China's continuing investments have created an overall accumulated debt well in excess of 250% of GDP. Whilst it is clear that the authorities will continue tightening, it needs to be seen if they manage to do so in a gradual way without disturbing global growth too much, and thus without causing too many jitters in the markets. We steer in any case clear from the markets that are more dependent on China.

Market Outlook and Portfolio Positioning

Asset Allocation

Equities	Overweight	With global growth still on a solid footing, equity markets are expected to post continuing, albeit diminishing positive returns.
Fixed Income	Underweight	Bond markets are to perform reasonably as we do not expect major policy rate hike surprises for the moment. Yet, yields might continue to pick-up gradually as global growth continues to consolidate.
Alternatives	Neutral	We maintain our exposure to hedge fund strategies that are less correlated to the market, as well as gold and treasuries as an insurance against risk-off moods.

Fixed Income

Duration	Intermediate to long	The US rate hikes have for now had their biggest impact on yields. Accommodating monetary policies in Europe and Japan should keep long-term yields lower.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
US Credit	Underweight	Valuations remain expensive. In the event of high volatility, high-quality investment grade bonds will be preferred over junk bonds. High yield spread compression is not likely with flattening US yield curve.
Euro Credit	Underweight	Valuations are more expensive than US credit. Investment grade and High yield bonds are trading at yield level lower than some of the sovereign global bonds (safe-haven assets).
US Treasuries	Overweight duration	Any rise in long-term bond yields will be limited compared to short-term bond yields as inflation pressures remain subdued and Fed maintains a gradual hiking stance.
EM hard currency bonds	Selectively overweight but reduce duration	Hard-currency bonds preferred over local currency bonds as monetary policy rhetoric will become less dovish and emerging currencies remain under pressure due to less US dollar weakness. 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 and Indonesia USD sovereign and quasi-sovereign bonds.
GCC	Overweight high quality sovereigns	GCC credit spreads yet to fully reflect the recent rise in oil prices. Valuations appear attractive. We prefer GCC sovereigns with solid public and external accounts including UAE and Kuwait and with strong reform potential including Saudi Arabia.
India	Neutral	Rising inflation pressures to check the drop in local-currency sovereign bond yield.

Market Outlook and Portfolio Positioning (continued)

Equity Markets

US	Overweight	Deficit spending *combined with* rate hikes has usually led to an increase equity prices. Growth is likely to persist through 2019, as is the boost in US corporate earnings.
Eurozone	Neutral	A stronger euro and trade growth fears are somewhat undermining the equity market rally in the single market given the large share of revenues which Eurozone corporates derive from overseas (over 50%).
Japan	Overweight (currency-hedged)	Japanese equities have suffered recently with the strength of the Japanese yen depressing prospective corporate earnings. It is important to point out that this underperformance has been driven by international developments, not domestic fundamentals.
Emerging Markets	Underweight	EM equities have been extremely resilient, in particular thanks to the weaker US dollar. This has more than offset weakness in commodity prices. We expect this tailwind to subside and EM equities to underperform, although we do like Indian equities.
United Kingdom	Neutral	For the moment the odds of a deal between the UK and the EU have risen compared to a no deal outcome. Whilst this is likely to reduce uncertainty for corporates, it will also stabilize the exchange rate. A stable pound implies that UK equities are unlikely to do much better than EU equities.

Energy and Commodity Prices

Energy	Neutral	The combination of OPEC supply controls and the synchronized global growth pick-up will prevent a significant oil price correction, but further upside is now petering out.
Industrial Metals	Underweight	China tightening will put downward pressure on industrial metals.
Precious Metals	Overweight	The US "reflation" theme is bad for precious metals. Yet, bouts of risk-off jitters are still very likely over the years to come. Thus we keep them as a "market insurance" risk hedges in our portfolios.

Currencies

EUR	Moderate downward pressure	After the euro's strong rally, the ECB is now more likely to disappoint in terms of significantly unwinding its stimulus. At the same time, uncertainty about Fed policy combined with talk of fiscal tightening is likely to keep upward pressure on the US dollar. As such we would expect the euro now to move sideways with a downward bias.
GBP	Further corrections expected	Although the currency has stabilized after the recent preliminary agreement between the UK and the EU, it will still have some uncertainty-induced downward pressure.
JPY	Further depreciation likely	The combination of moderate Fed tightening and BoJ yield curve targeting is likely to trigger some downward pressure on the yen.

Reaping the benefits from fiscal consolidation and the higher oil price

It's getting better

With the oil price on a more sustained footing, most GCC economies are now in a position to benefit from both the improvement in fiscal and external balances. This is of course above all true for the UAE and Kuwait, but also Saudi Arabia has seen a significant reduction both in its fiscal and external break-even price.

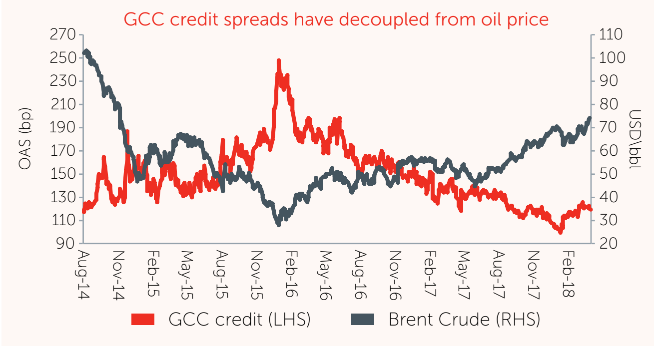
In the UAE, where last year's deceleration in headline growth was by and large due to the reduction in oil production, we are expecting now a more gradual pace of fiscal adjustment and still a widening of the current account surplus. In addition, the UAE banking sector is likely to benefit from solid growth in deposits and loans. More exciting, over a longer horizon, is the government's intention to encourage foreign direct investment also outside the free zones and the energy sector as well as to reform the finance sector with a view of boosting non-bank financing. These reforms will take time, of course, and as such the biggest short-term risk to the current environment remains a correction in the oil price.

In Saudi Arabia we have seen likewise a significant improvement in the fiscal and current accounts. Bank credit and deposit growth is however still very weak. High frequency indicators such as the PMI and cement sales tell us that the growth rebound in the Kingdom is still modest as the government has still been prudent in expanding fiscal spending. In fact, what matters is not that much the size of the fiscal deficit, which by all standards remains considerable, but its *change*, and the fiscal deficit remains in shrinking mode. Also, while the government is bent of deep reforms, such reform inevitably take time, as can be confirmed by the fact that foreign investments are not growing at a rapid pace. The capital market reforms in general, and the prospective partial sale of Aramco in particular, are certainly going to provide a positive boost to foreign investments and growth. Liberalization in the real estate sector and in tourism will also play an important role.

Fixed Income: Attractive valuations

GCC dollar sovereign and credit markets, similar to other emerging markets, came under pressure in the first quarter. The dollar sovereign bond yield curves have cheapened across the maturities and across the GCC countries with a flood of bond issuances conducted this year. However, compared to the GCC credit space, the sell-off in the GCC dollar sovereigns appears limited. In fact, sovereign CDS spreads have tightened versus GCC credit spreads. This clearly signals that prospects of growing fiscal strength on account of the jump in oil prices is getting priced in by the bond market. In addition, the global risk-off sentiment (even though the region remains largely insulated) and rise in middle-east tensions will ultimately drive more appetite for the less risky sovereign-backed assets.

Overall, we believe that given the backdrop of rising oil prices this year, we could see a further improvement in the bond market sentiment. In addition, the recent cheapening appears excessive and valuations have become attractive, particularly for markets like Saudi Arabia where economic reforms have made progress. Even valuations in relatively weak countries like Bahrain and Oman look cheaper than lower-rated African countries, and also Turkey.



Source: Bloomberg

Equities – we stick to our Saudi overweight

GCC equities seem finally to have turned a corner after their considerable 2017 underperformance both versus global and emerging market (EM) equities year-to-date. The improved performance certainly has to do with global factors, such as the higher oil price and also the increased volatility in global markets, which highlights the benefit of relatively uncorrelated markets such as the GCC markets. The impression of a positive domestic reform momentum in some countries, and in particular in Saudi Arabia, is however also finally playing out. We have been favouring the latter's equity market for a while now since we believed that its potential inclusion into the MSCI Emerging Markets Index was inevitably going to promote global portfolios into that market.

Also, whilst it is true that other GCC markets will profit from the improved macro-economic outlook *and* for the upward movement in the Saudi market, we think that the latter maintains the highest upside potential, but as a result also a higher risk for disappointment. Risk-adverse investors might therefore consider to opt for a more diversified GCC portfolio.

Growth outlook strengthens with more deficit spending

From tax reform to extra spending

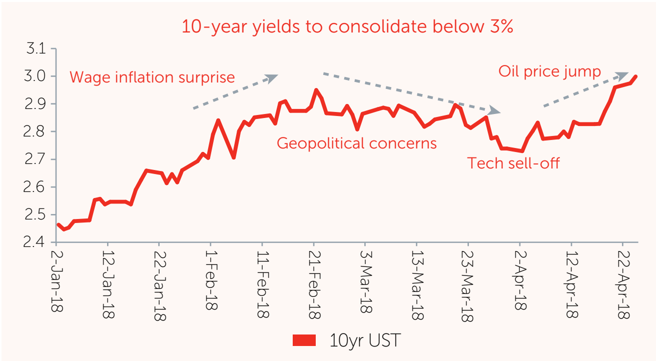
Whilst there has been some talk about a slowdown, following the recently weaker job market figures, the US economy is in fact steaming on. We have always been wary about statements arguing that the US economy should regain the rate of growth (north of 3% in real terms) we were accustomed to before the implosion of the credit bubble in 2008. Having said so, the decision of the US Congress to lift spending on defense and non-defense items, *in addition to* the Trump tax reform, is likely to trigger some positive growth surprises. We would think that the unemployment level, already at a historically low level, might well end up below 3.5% of the total workforce. Financial conditions have improved notwithstanding the uptick in policy rates and some spread widening. Confidence indicators also remain at very benign levels.

Trade jitters can impact growth through asset prices

Whilst politics in the US is inherently volatile, policy is more stable. Whatever happens in the upcoming November Midterm elections, the current profligate fiscal policy, based on tax cuts for the rich and increased spending across the board, is unlikely going to be undone. Together with relatively accommodating financial conditions, a weak US dollar and historically low rates, the policy framework remains therefore overwhelmingly conducive to continuing growth. Concerns about trade policy now seem however capable of undoing this otherwise supportive growth environment. We would argue that a concrete threat of serious trade barriers being erected between the United States and China, would likely trigger a big and lasting equity market correction. Such correction would then impact consumer confidence and deter investment growth. The most likely scenario, however, remains that China will makes some concessions to the United States and that a serious trade conflict will be avoided. Talks about trade wars, in other words, are likely to cause market volatility. To the extent that such conflict ultimately does not materialize, they are less likely to impact economic growth.

Fixed income: US Treasury yield to rise marginally

The upward jump in US treasury yields was a crucial driver of the equity market sell-off in February as markets started to worry about inflation pressures after the unexpected spike in wage growth. A "hawkish" Fed which many investors feared, didn't materialize with the Fed sticking to three rate hikes this year. On the other hand, concerns about a potential trade war and a rise in protectionism spurred demand for US treasuries. In fact, US Treasuries were seen as the markets' preferred safe-haven (even over gold and yen) during periods of high volatility (the recent tech sell-off). More recently, the 10-year US yields touched again 3% as a surge in oil prices pushed inflation expectations higher. We believe that the recent sharp rise in 10-year yields driven by oil prices is temporary in nature. Any rise beyond 3% will only signal a more aggressive Fed given that the Fed's long-term median rate is targeted at less than 3%. The yield curve will continue to flatten with the ongoing Fed hikes and higher short-dated bond supply due to the increase in fiscal spending. Further, Fed chair Jay Powell comments suggest that the Fed doesn't not really fear yield curve flattening as a sign of recession. As such, we expect the 10-year yield to remain below 3% this year.



Source: Bloomberg

US credit was also impacted from the sell-off in risk assets in the first quarter. Junk bonds recorded a loss of 0.86% in 1Q, the first quarterly decline since 2015. This is in line with the equity market performance, however lower than the 2.3% loss posted by investment grade bonds (most likely due the fact that most high yield paper has a shorter duration). The less volatile environment, which had proved beneficial for the high yield credit space over past two years, is unlikely to continue for long given the increased trade war uncertainty. Also, despite the recent sell-off, valuations still remain near historical lows, particularly for high yield bonds. A flattening yield curve does not bode well for high yield debt performance. We favor investment grade bonds over high yield bonds, as during periods of sustained volatility investors will prefer safe-haven assets like US Treasuries or at least better quality credit rather than junk bonds.

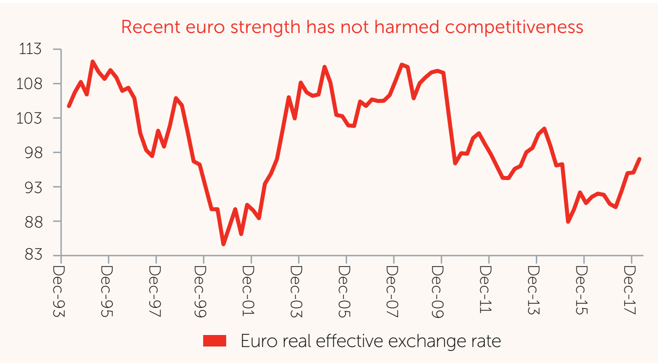
Equities – remain overweight

Strong earnings are likely to have the better over an uptick in the short end of the yield curve. The major headwind for US equities are indisputably concerns about a US-China trade war. These concerns are likely not to fade before year end and, as a result, we are likely going to see a rather volatile equity market. On the other hand, the upside for US companies is that successful negotiations might eventually lead to more market access in China. With economic growth in the US again doing better than in most other countries, and with overall financial conditions beneficial in spite of the Federal Reserve hiking rates, US equities still make sense.

Growth to roll over moderately in 2018

Growth roll over with strong euro and China tightening

As we wrote a couple of months ago, growth in Europe was bound to slow down following the 2017 appreciation of the euro and tightening in China. The bad news is that Europe's growth engine Germany has always been particularly sensitive to the Chinese cycle because of its significant exports to that country. The good news is that overall the euro is strong compared to where it was about a year ago, but historically still quite competitive. As the chart below shows, the region's real effective exchange rate is today below the average of its last 23 years.



Source: Bloomberg

The prospect of a global trade war would, however, be particularly frightening for Europe which has a domestic economy that is less dynamic than the US and, more important, the world's largest trade surplus. It must be said that Europe for now seems on course to avoid being trapped in a trade conflict. For one thing, the United States might at times threaten Europe too, but it has an inherent interest in keeping Europe on its side as it renegotiates its relationship with China. The European Union has also just concluded free trade agreements with Canada and Japan. Finally, the "first phase" Brexit agreement with the UK seems to implicate that trade relations between the UK and the EU will not change at least until 2021. Perhaps Europe should be more concerned about a slowdown in China, even if a managed China slowdown would still be consistent with the country buying Europe's high quality consumer goods as well as technologically advanced capital goods.

Political risk for now not on the rise

In spite of the populists winning the elections in Italy and a relatively weak German government that will be unwilling to engage in major Euro-zone reform with France, we would argue that political risk in Europe is not rising. Our assessment is that piecemeal reform, in particular, continuing reform in the banking sector, will be enough to avert a new debt crisis. Whilst major reforms, in particular a fiscal union with a shared budget, is highly unlikely, continuing modest progress in reforms will be enough to prevent a new crisis. Italy's populists, in fact, are likely to compromise and not push for the country exiting the euro. In these circumstances, political risks will remain in check.

Fixed Income: Bunds to benefit from dovish ECB

Whilst US government bonds were sold in the first quarter with many fearing the end of the bond-bull market, appetite for European government bonds remained strong. As a result, the spread between the 10-year US Treasury and German bund counterpart widened to a record high. In addition to the safe-haven demand, bunds have benefitted from the ECB's stance to remain accommodative for longer. Recent softness in PMI indicators along with the benign inflation outlook indicates that the ECB will be in no hurry to advocate rate hikes this year. However, given the 10-year Treasury-Bund yield spread is already at record wide-levels, we could see some reversal in the near term, especially during periods of heightened volatility when the decline in treasury yields could be more compared to bund yields.

European credit spreads have widened in response to the global market sell-off and now are at their widest level in six months. However, unlike the US, the junk bonds have been worst hit (as expected during times of volatility) compared to investment grade bonds. This indicates that investors have turned more risk averse in Europe. While strong economic growth and corporate balances argue for better credit, volatility is likely to remain high and hence European credit, particularly high yield, will remain vulnerable. In addition, soft PMI indicators confirm our expectation of some slowdown in growth in Europe. We maintain our cautious stance on European credit.

Equities – Remain neutral

With growth in the Euro-zone rolling over, European companies' earnings are less likely to live up to expectations. In addition, whilst global equities in general are likely to suffer from continuing talk about trade wars, European equities could suffer more since in particular the leading German index (Dax) is more sensitive to such concerns. In this regard it is not even necessary to talk about trade wars. European equities are simply more sensitive to the likely growth slowdown in China and this is even more the case now that the euro is relatively strong compared to about a year ago. Finally, talks about trade wars might in the short term keep the US dollar weaker for longer, as countries seek for ways to accommodate the US Administration's quest for increased competitiveness.

Uncertainty is the only certainty

Brexit uncertainty isnt over yet

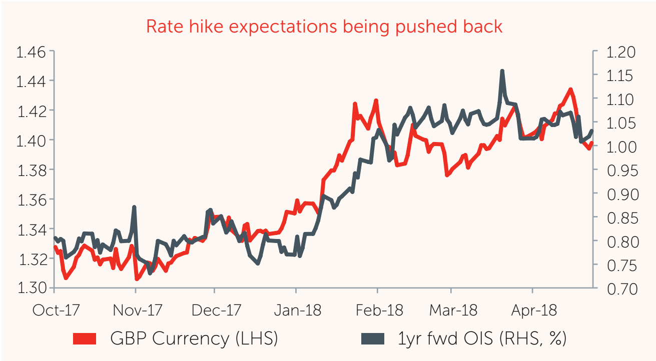
After last December's progress in the first phase of Brexit talks, another breakthrough came in the form of the two sides coming to an agreement on a twenty-one month transition period post March 2019 (when the UK formally leaves the EU). This has reduced market concerns, especially from businesses and corporates who feared a chaotic Brexit to materialize. The ease in concerns has been evident in the pound which has been on a strengthening mode since the beginning of the year. Nevertheless, we still believe that Brexit uncertainty is likely to remain for a while, particularly in regards to what kind of deal the UK is transitioning to. In March, PM Theresa May suggested two possible alternatives for the future relationship. That was to be either a "customs partnership" in which the UK would copy EU requirements on imports or a "highly streamlined customs arrangement" which would use technology to minimize any frictions. Both these suggestions have however been regarded as "unrealistic" by the EU, which is more inclined towards either an "off-the-shelf" soft Brexit or a deal which maintains tariff-free goods trade. Overall, the likelihood of the UK staying in a customs union has now increased with the House of Lords supporting it. A Withdrawal Bill contemplating anything close to a customs union, however, would still have a hard time passing through the House of Commons. Short, uncertainty on the final Brexit outcome has still not gone away.

Economic activity remains weak

While there has been some positive momentum on the Brexit front, the economic outlook appears to have deteriorated. So far, it has been a subdued start of the year with a sizeable drop recorded in both the manufacturing and services PMI. The slowdown in activity, mainly caused by the impact of "Beast from the east" storm, was also reflected in the first quarter GDP numbers. We believe that investment activity is unlikely to pick up until there is absolute clarity on Brexit. The ongoing Brexit negotiations will continue to add uncertainty to the market. This also means that the pound -which has strengthened significantly this year- will remain volatile. At the same time, we do not expect the pound to depreciate to the same extent as it did immediately after the Brexit referendum (unless we reach a scenario where both the UK and EU fail to strike a deal i.e. "no deal" scenario", which to us seems rather unlikely)

Gilts: remain bullish

Like other sovereign bonds, gilts have also benefitted from the safe-haven appetite. In addition, domestic factors have helped in driving bond yields lower. A recent string of economic releases have disappointed with 1Q GDP being the weakest in five years and the CPI posting a larger than expected drop, signaling that inflation may be finally slowing with the lagged effects of pound weakness receding. Given the recent softness in data and the Brexit uncertainty which is still likely to linger, the Bank of England may push back further monetary tightening for the moment, with market expectations of a May rate hike now almost vanished. Separately, improving public finances have allowed the Debt Management office to reduce the gilt supply this year. As such, receding inflation pressures, a subdued growth outlook, persisting Brexit uncertainty and a positive supply dynamics should prove favorable for the gilt market.



Source: Bloomberg

Equity – remain neutral

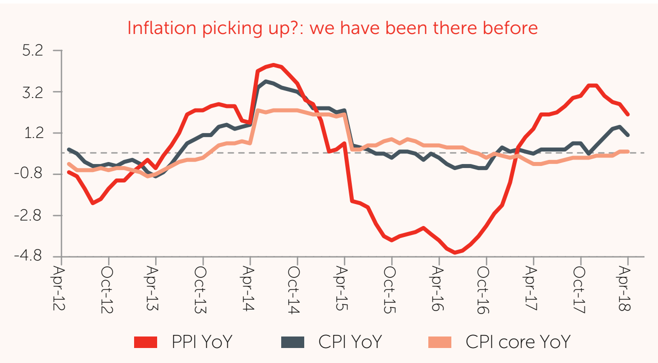
In the first three months of the year, UK equities recorded their worst quarterly loss since 2009, when the UK was in recession. In fact, UK equities have been the worst performers, underperforming other major equity markets. In addition to the global market sell-off, continuous strength in the pound amidst weak dollar appetite has also contributed to this underperformance. Pound strength is quite harmful for the FTSE companies as 70% of their revenues are dollar-denominated. Whist recent pound strength appears excessive, we do not foresee any major reversal. Economic activity still remains weak and if the recent disappointment in economic data persists for a longer period, which is not unlikely in our view unless there is an increase in clarity on Brexit, should weigh on the equity market.

Economy still doing very well, Mr. Abe's problems notwithstanding

Abe's political problems manageable, BoJ still cautious

Concerns about Prime Minster Abe illegally supporting cronies in real estate deals, have led to his lowest approval ratings in a long time. Whilst such development are likely to bite in his capacity to push through constitutional reforms, they are not likely to seriously imperil his government, led alone lead to the ruling LDP losing power.

If anything the concerns that the government's position might be weakening, is going to make it even more difficult for the BoJ to abandon its still very accommodative policy stance. Yes, economic growth and, critically, wage growth and consumer price inflation have been doing exceptionally well, that is for Japanese standards of course. The fact remains, however, that the Japanese economy is more vulnerable to any global downturn than most other advanced economies. In addition, we have seen pick-ups in inflation and wages before, only to be undone relatively soon, as can be seen from the below chart.



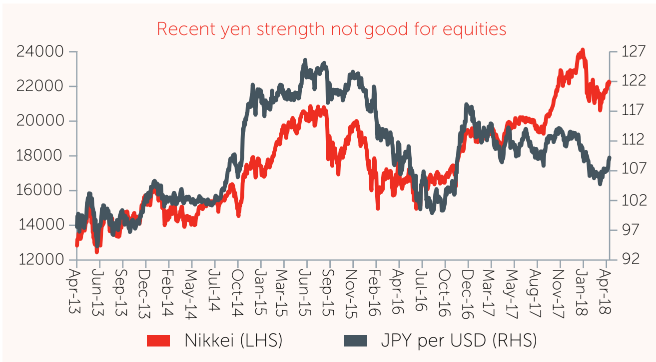
Source: Bloomberg

Thus whilst the are many reasons for optimism, such as amongst others the recently negotiated free trade agreement with the European Union, the BoJ will prefer to err on the side of caution, before undoing its massive balance sheet as is being done by the Fed and prospectively by the ECB. In this regard it is worthwhile to observe that the BoJ is already pursuing a monetary policy that continues to increase the balance sheet but not at a continuous pace. More specifically it is buying paper with a view of pursuing a zero yield on long-term bonds, and negative yields on other paper. This policy may be more sustainable than simply acquiring monthly fixed instalments of outstanding paper.

Equity – time to reduce overweight?

Our assessment that the BoJ would stick to a monetary policy that is relatively accommodating, has led us to believe that the Japanese yen would remain relatively weak against the euro and the US dollar, which in turn would favour Japan's earnings and thus equities. Hence the currency-hedged overweight on Japanese equities which since October 2016 has done well, but is now suffering with the recent global market turmoil triggering an appreciation of the yen. Japanese equities have as a result suffered more than most other equities markets.

It is important to point out that the recent strength of the yen is more related to global trade and growth concerns, than it is to any change in the country's domestic monetary policy. In fact, the key driver of yen strength is safe haven flight as investors undo their emerging market carry trades that are often financed by yen borrowing. As such one might see renewed downward pressure on the Yen, associated with a pick-up in Japanese equities. In fact, 2017 also saw an initial underperformance of our Japanese call, which later recovered towards the end of the year.



Source: Bloomberg

This time, however, the risks are bigger as they are associated with increased concerns about a US-China trade war that would have particularly disruptive consequence for Asia and Japan. Add to that a Chinese economy that is already in a slowdown phase, and at some point – although not yet now – we will close our currency-hedged call on Japanese equities.

Caught off guard by Trump

China was already bracing for a slowdown

An important reason for Mr. Xi Jinping becoming the most powerful Chinese leader since Mao Zedong has to do with the fact that economic growth in the country is rapidly slowing down compared to the double digit rates of the 90s and the first decade of the current century. There is, of course, nothing dramatic about the country's growth rate slowing down. After all, China is now a middle income country and no longer a low income country. It is impossible for middle income countries to sustainably grow at double digit rates. Having said so, the country's growth model has also been based on massive investments in inefficient state-owned enterprises as well as infrastructure. Curtailing those investments is going to be necessary and at the same time painful for some interest groups. Thus it was felt that the country needed a strong leader to face resistance from these interest groups and more in general eventual social unrest that might follow as the country moves from a manufacturing export-based growth model to a service domestic consumption-based growth model.

Trade conflict disrupting transition to balanced economy

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

Source: Bloomberg

This is ever so true because manufacturing in China is still more than 20% of gross domestic product and employs also more than 20% of the labour force. In other words, China is much more vulnerable to a potential trade war than the United States which employs only 10% of the work force in manufacturing and which exports to China less than half the value of what China exports to the United States.

China will try to play ball

In the end, the US is mostly concerned about having more access to certain domestic sectors of the Chinese economy, than to put tariffs on Chinese imports. Critically, the US wants relaxation on US investments in China, but on the other hand wants to put a halt to Chinese companies buying US companies. It also wants more Chinese cooperation in cracking down on cyber-attacks and intellectual property rights. We believe that China will accommodate as much as possible, provided it can do so without giving the impression of a total and humiliating surrender.

What China will not be able to offer will be a total liberalization of the capital account since such a move would risk triggering massive capital outflows and thus domestic instability. Rather, whilst the country might well further open the finance sector to foreign operators, it will keep the capital account largely controlled also with a view of allowing for some further appreciation of the renminbi, so as to appease the US in that way.

Equities – remain underweight

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

Growth to pick-up gradually

Growth recovery resumes

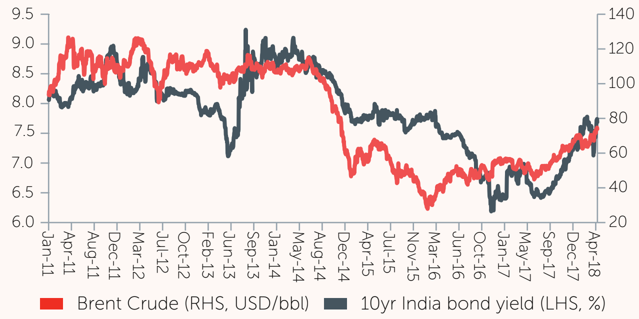
The economy appears to be on the path of recovery- post the demonetization and GST-led slowdown. The fourth quarter GDP marked the best rate of expansion seen in the previous five quarters. Growth was led by a pick-up in manufacturing and construction activity which were the worst hit post demonetisation. But more importantly, the double-digit growth recorded in gross capital formation (the highest since 2Q16) clearly indicates that the investment climate has started to improve. We expect that growth will pick-up further in the coming quarters with the support of increased government spending. Nevertheless, challenges remain. The revelation of the massive banking frauds does not bode well for the banking sector, which continues to struggle with sluggish rise in credit growth. In fact, the unveiling of these frauds could lead to tighter banking sector regulation which might further arrest the pick-up in credit growth.

In addition to the above-highlighted challenges, one cannot completely ignore the political climate which will come to the forefront ahead of state elections this year and the 2019 general elections. As a result, the government will be inclined more towards spending programs than to reform measures. This was already evident in the FY18/19 budget which was less reformist and focused on more popular measures such as the introduction of healthcare reform (known as the ModiCare). Whilst many of these measures make sense long term, they ultimately increase the fiscal spending and put a strain on government finances.

Bonds: Stay neutral

There has been no respite for Indian government debt which has continued to be heavily sold by the markets. The 10-year government bond yield has climbed by almost 40bps since the beginning of the year. Heavy bond supply pressures combined with inflation concerns dented demand for Indian government securities in the first two months of the year. In addition to these factors, the revelation of USD2bn bank fraud by the second-largest state-run bank has brought investors' focus on the health of the public banks in India. True, the government has made efforts in boosting demand by increasing foreign investment quota limits and also relieving supply pressure by targeting a lower issuance target. But these efforts have proved fruitless in light of the recent rise in oil prices. Inflation concerns had softened a bit with the declining trend in CPI and the RBI having lowered its inflation projections. However, with the sharp jump in oil prices, these inflationary risks have resurfaced. Based on the RBI estimates, every USD10/bbl rise in crude oil prices should push CPI inflation by 30bp. The rise in crude oil prices should also prove detrimental for the trade balance and hence the rupee, given the country's oil import bill. Continued weakness in the Indian rupee could reduce the attractiveness of the high-yielding government debt. As such, we recommend to stay neutral on Indian government securities.

Indians bonds face pressure with rising oil prices



Source: Bloomberg

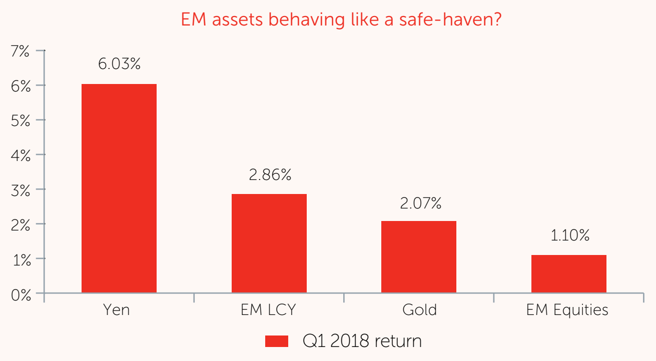
Equities: remain overweight

Similar to other emerging markets, Indian equities have also been vulnerable to the global market sell-off this year in spite of its insular characteristics. In addition to the external headwinds, equity markets are also facing domestic headwinds, particularly post the Indian budget. The introduction of the long-term capital gain tax and the ongoing banking fraud scandal that has shed light on the poor health of the public sector banks' balance sheets, have been the main domestic factors triggering the sell-off. While the former is short-term in nature, banking fraud risks are likely to weigh on the markets in the next few months. In addition, with the close proximity to 2019 elections, one cannot rule out the pricing in of political noise in the coming months. Historical precedents indicate that the year before elections is particularly volatile for the markets. Barring the looming political noise, India still remains an attractive long-term investment given its improving fundamentals and reform potential. In addition, relative insularity to global markets makes India a better bet especially at times of increased global market volatility. We maintain our overweight stance on Indian equities.

Don't ignore the risks

Not so risky anymore?

The first three months of the year have been difficult and volatile for most global risk asset markets. However, this volatility did not compel investors to step completely away from emerging market. In fact, appetite for emerging markets assets has remained robust even amidst the ongoing concerns about trade war and geopolitical tensions. This is in stark contrast to past periods of similar market turmoil when emerging assets, given their higher risk characteristics, were heavily sold-off. Whilst emerging markets' fundamentals have structurally improved, it is still unlikely that they would not figure among the first victims if a major global trade war would unfold. In fact, emerging markets remain, generally speaking, amongst the most trade dependent. In addition to China tightening risks, many central banks in the emerging market are likely to move to a tightening mode (with the backdrop of rising Fed rates and Libor rates). Countries like the Czech Republic, Romania, Malaysia and Korea have started raising policy rates while others have turned neutral (Poland, India) or are likely to end their loosening cycle soon (Brazil). Less dovish monetary policies mean that the economies may not be able to grow as fast as they could earlier with the help of loose monetary policies.

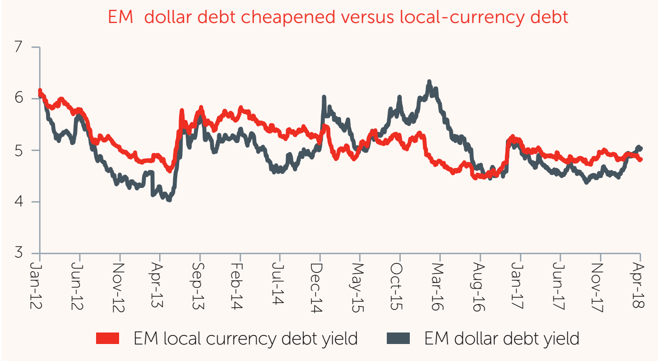


Source: Bloomberg

EM Bonds- remain selective

Emerging market bonds, similar to currencies and equities, have again exhibited resilience during the turbulent first quarter of the year. Local currency sovereign debt has been behaving like a safe-haven lately, recording positive returns in the first quarter. It is the persisting US dollar weakness that has allowed investors to benefit from the addition of the currency component while investing into local currency bond markets. The increased appetite for local currency bonds has suppressed local currency bond yields. In fact, local currency bonds are now trading at a lower yield than the yield on their dollar denominated counterpart. We had seen something similar in 2016 when the US dollar was stronger, global hard currency yields were low, as were oil prices. With dollar weakness likely bottomed out, we should see less interest for emerging markets' local currency bonds. In addition, the monetary easing cycle seems coming to an end with many emerging market central banks now embarking on a more neutral or tighter monetary policy. This should thus limit further declines in local-currency bond yields, which previously benefitted from the anticipation of rate cuts.

Emerging markets' hard currency bonds, on the other hand, have been one of the worst performers in the overall bond space and have not benefitted from the dollar weakness. Looking at the current valuations, dollar debt looks more attractive compared to the local-currency debt. We stick to our selective bias on emerging markets dollar debt with a preference for economies with improving fundamentals like Russia and Indonesia.



Source: Bloomberg

Equities – remain underweight

Amidst the backdrop of the equity market sell-off seen in the first three months of the year, emerging market equities were relatively resilient, ending the first quarter pretty much at the same levels seen at the beginning of the year. The main driver which proved to be in favor of emerging markets is the sustained weakness in the US dollar. This recent resilience looks now vulnerable if one takes into account the trade tensions between the US and China, unless they would lead to a further weakening of the US dollar. On the other hand, the growth slowdown in China is likely to materialize independently of the US-China tensions. As such, we maintain our underweight stance on emerging market equities.

GDP Forecast	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.8%	In agreement	2.5%	In agreement
Eurozone	2.3%	In agreement	2.0%	Expect moderately less
Japan	1.4%	In agreement	1.0%	Expect moderately less
China	6.5%	Expect moderately less	6.3%	Expect significantly less
India	6.7%	In agreement	7.4%	Expect moderately less

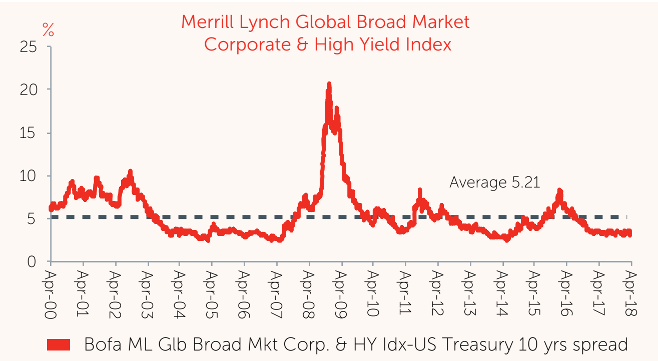
Source: Bloomberg

CPI Forecast YoY	2018 Consensus	2018 ADCB	2019 Consensus	2019 ADCB
US	2.5%	In agreement	2.2%	In agreement
Eurozone	1.5%	Expect moderately less	1.5%	In agreement
Japan	1.0%	In agreement	1.0%	In agreement
China	2.3%	In agreement	2.3%	Expect moderately less
India	3.7%	Expect moderately more	4.7%	In agreement

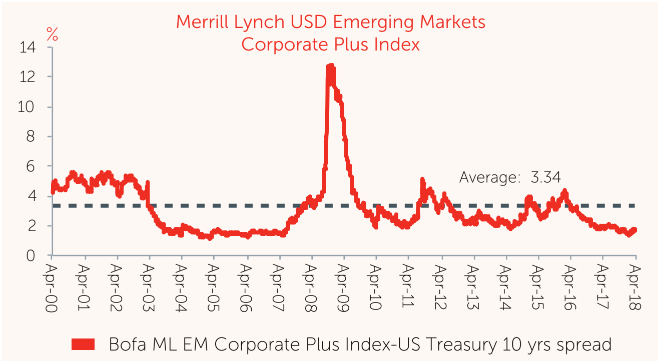
Source: Bloomberg

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

Bond Market Spreads



Source: Factset, Federal Reserve Bank of St. Louis



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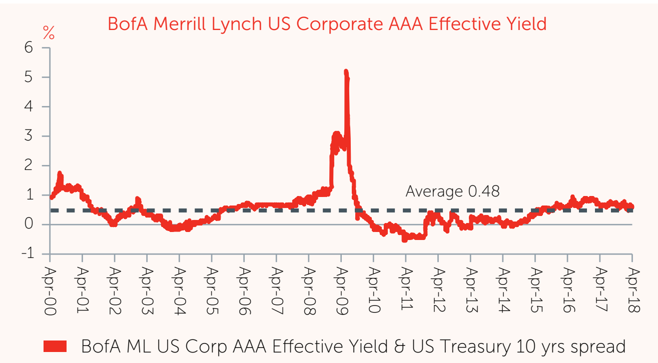

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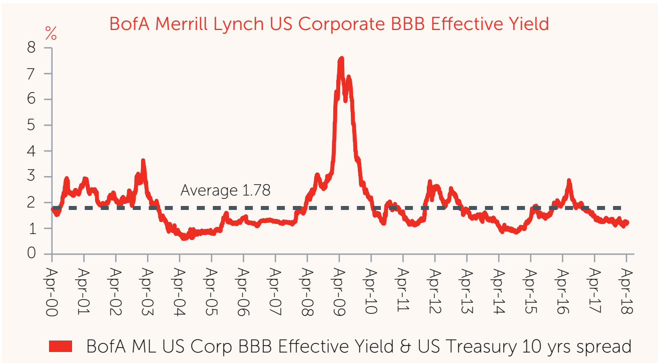
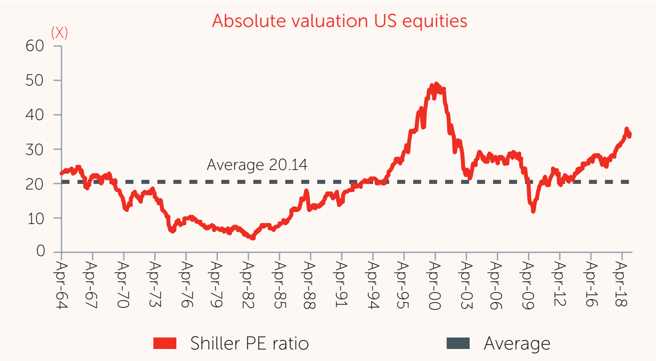


Source: Factset, Federal Reserve Bank of St. Louis

Equity Market Valuations



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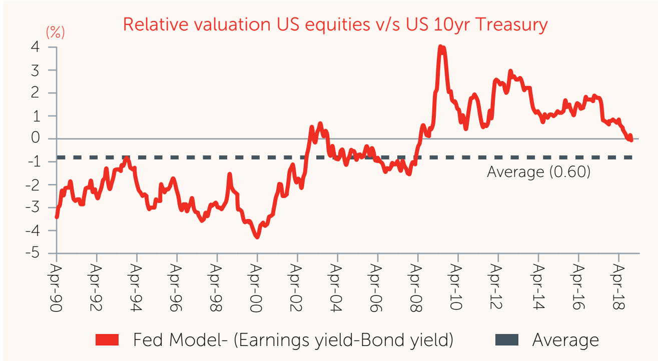

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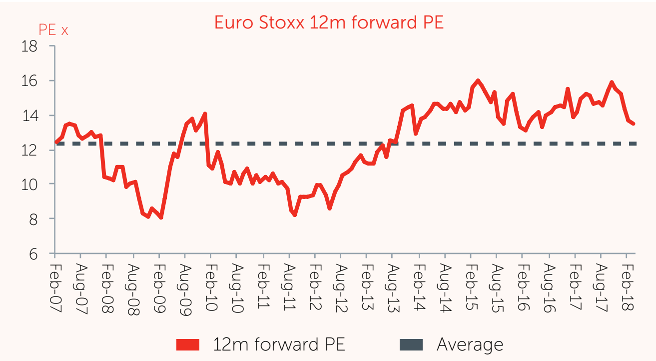

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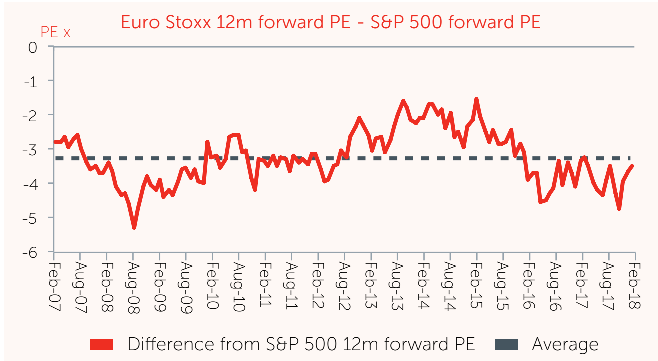

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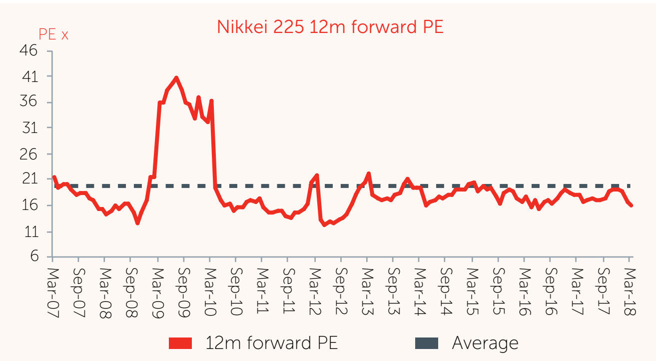

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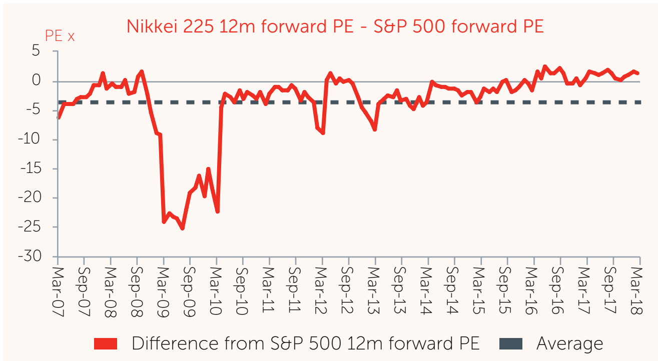

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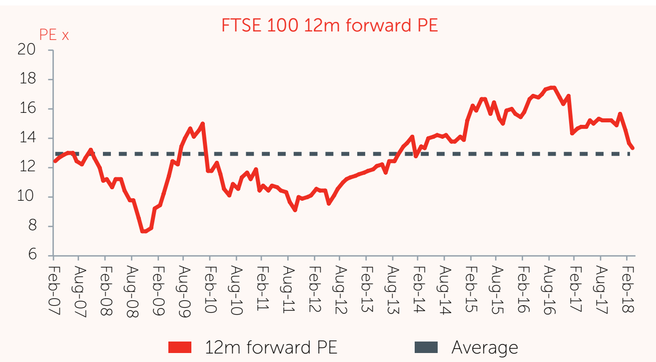

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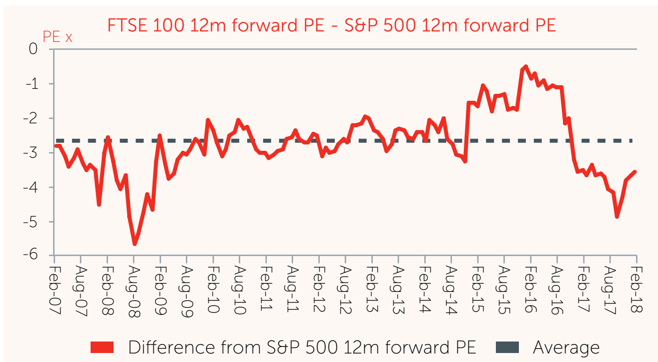

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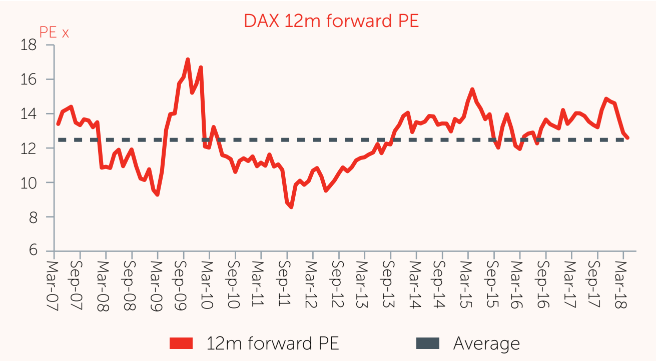
Equity Market Valuations



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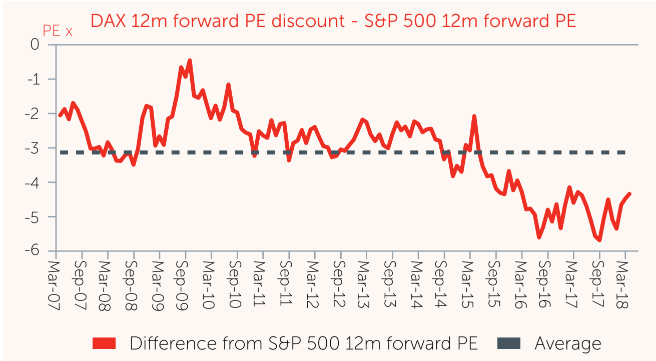

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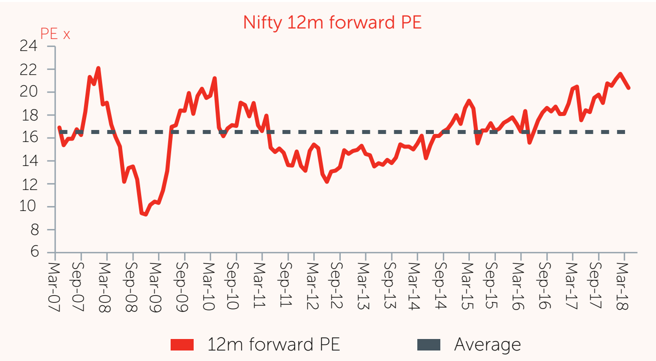

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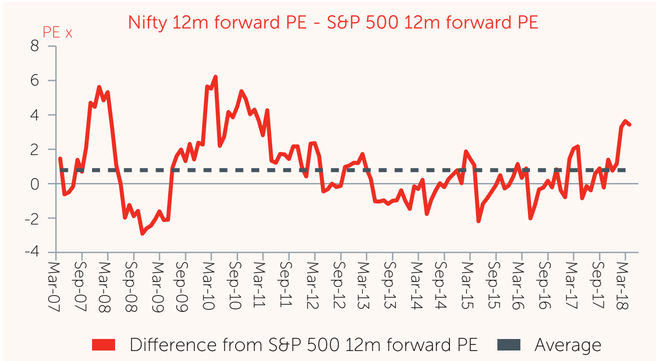

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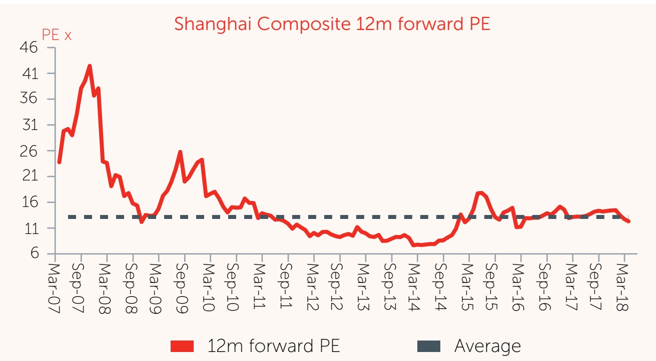

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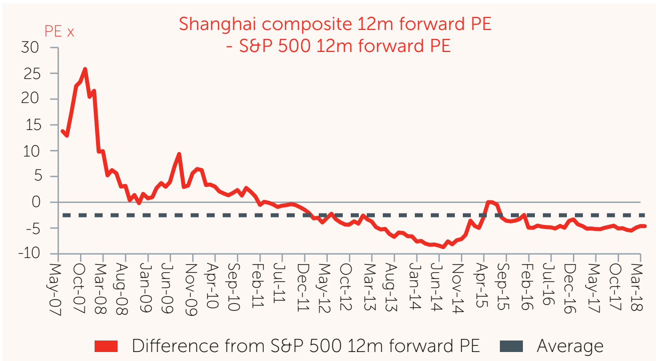

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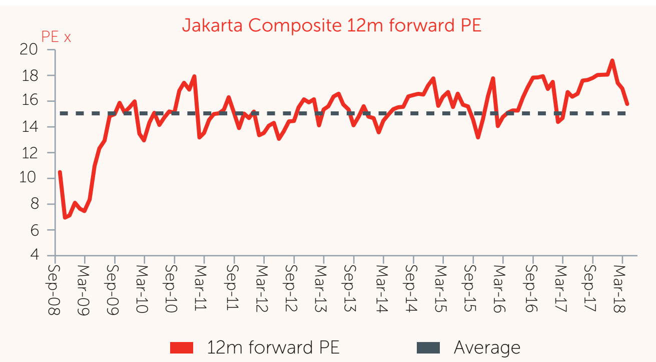

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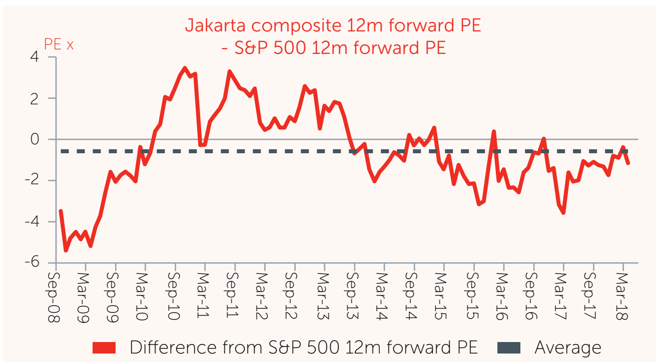

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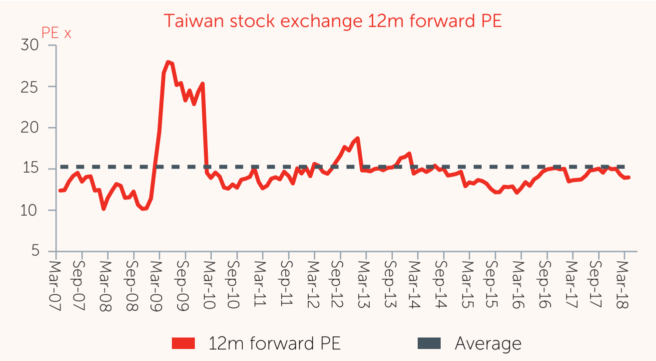

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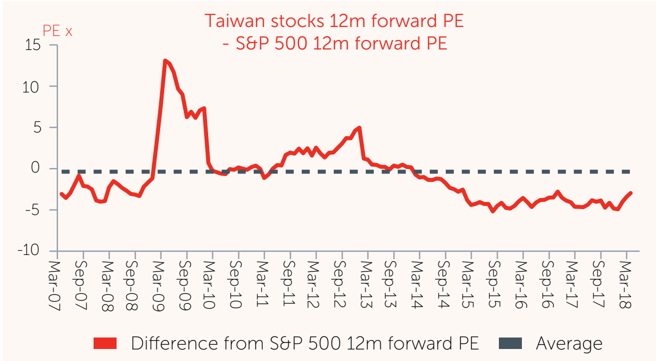

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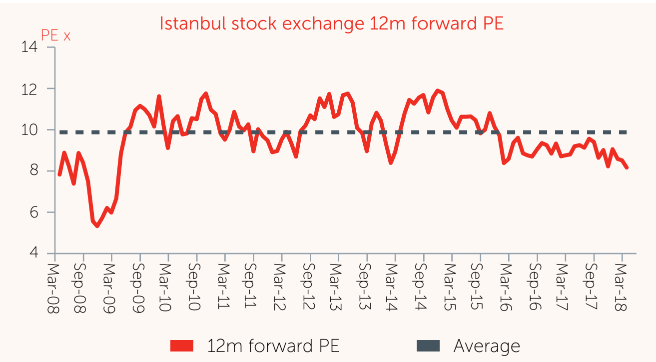

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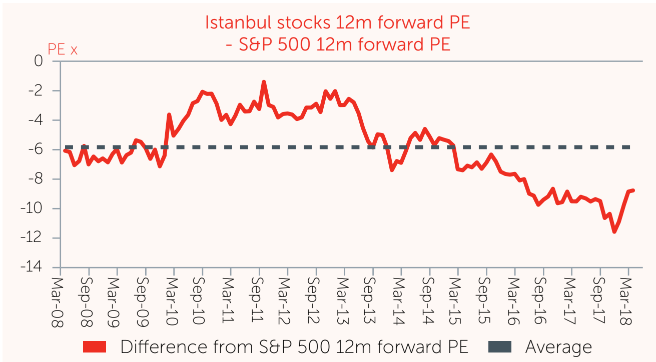

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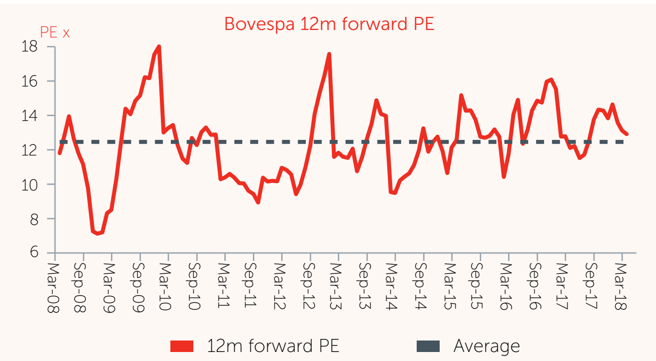

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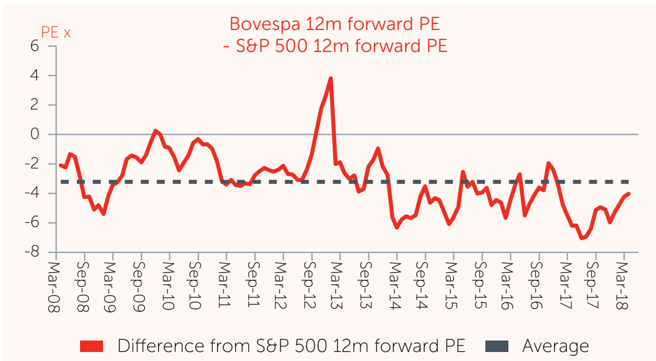

Source: Bloomberg

Sources

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

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