ADCB Asset Management

The Quarterly Investment View
July 2015

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Growth not Greece remains the issue

Over the last months the yields on US Treasuries and German government bonds have risen, while markets have mainly suffered jitters because of the ongoing Greek debt issue. In spite of the Balkan country now edging closer to exiting Europe's single currency area, one might thus be tempted to conclude that global growth is again set to surge. Equity markets are thus only temporarily halting their rise because of the uncertainty related to an eventual exit of Greece out of Europe's monetary union.

Whilst we agree that the uncertainty relating to the Greek issue is causing a lot of volatility in capital markets that will prove temporary as the Eurozone is resilient even to an eventual Grexit, we are not that sanguine about the robustness of global growth going forward. In the United States corporate earnings are at very high levels whilst labour costs are edging higher too. Moreover, the strong US dollar will continue to be a drag on growth as the US current account deficit – which had been steadily improving since the onset of the Global Financial Crisis – might well deteriorate. China continues to struggle to prevent a more significant growth slowdown as it tries to shift spending from investments to consumption. With the US and China likely to remain under pressure, Europe is likely only to emerge from recession, not to enter into a vigorously expansionary cycle, let alone meaningfully contribute to global growth.

We thus believe that prospective rate hikes by the Federal Reserve will be limited, and they are likely to be so through 2016. The recent hike in bond yields should therefore gradually peter out. In the space of the advanced economies, the Eurozone and Japan equity markets might still do fine as the European Central Bank and the Bank of Japan are likely to continue to inject liquidity and prevent their currencies from appreciating too much. US equities continue to be less attractive as valuations are high, and earnings seem poised to grow more moderately. Emerging market bonds and equities might well surprise to the upside as the recent rise in global yields will come to an end. GCC capital markets should benefit from the combination of stable energy prices and relatively expansionary macro-economic policies.

Major downside risks remain – in our view – the possibility of a nasty growth surprise in the United States, as well as a stronger than expected slowdown in China. Greece, in our view, is right now more noise than anything else.

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

Key indices, Commodities, Currencies and Rates

Index	Latest 30 June closing	Quarterly Change (% Q2 2015)	Change YTD (%)
Index Snapshot (World Indices)			
S&P 500	2,077.4	-0.2	0.2
Dow Jones	17,757.9	-0.9	-1.1
Nasdaq	5,013.1	1.8	5.3
DAX 40	11,203.0	-8.5	11.6
Nikkei 225	20,522.5	5.4	16.0
FTSE 100	6,613.7	-3.7	-0.7
Sensex	28,065.7	-0.6	1.0
Hang Seng	26311.6	5.4	11.2
Regional Markets (Sunday to Thursday)			
ADX	4713.8	5.7	4.3
DFM	4082.2	16.3	8.3
Tadawul	9104.3	3.5	9.0
DSM	12091.7	4.2	-0.7
MSM30	6436.26	3.0	1.3
BHSE	1354.6	-5.7	-4.1
KWSE	6187.6	-1.3	-5.1
MSCI			
MSCI World	1,747.2	-0.3	1.5
MSCI EM	971.9	-0.2	1.7

Index	Latest 30 June closing	Quarterly Change (% Q2 2015)	Change YTD (%)
Global Commodities			
ICE Brent USD/bbl	62.4	15.4	10.9
Nymex WTI USD/bbl	57.15	24.9	11.6
OPEC Baskt USD/bbl	58.8	15.1	13.1
Gold 100 oz USD/t oz	1164.5	-0.9	-1.0
Platimum USD/t oz	1078.3	-5.5	-10.7
Copper USD/MT	264.15	-4.3	-7.1
Aluminium	1695.75	-7.2	-9.6
Currencies			
EUR	1.1058	3.9	-7.9
GBP	1.5589	6.0	0.9
JPY	123.52	2.0	2.3
CHF	0.9482	-3.8	-5.9
Rates			
USD Libor 3m	0.2832	4.6	10.8
USD Libor 12m	0.7715	11.1	22.7
UAE Eibor 3m	0.7529	2.2	10.1
UAE Eibor 12m	1.0857	2.3	6.5
US 3m Bills	0.0153	-42.0	-85.7
US 10yr Treasury	2.4349	22.4	8.4

Executive Summary

- Federal Reserve to pursue only very modest rate hikes, possibly only in 2016. ECB and BoJ to remain increasingly supportive through 2016,
- US growth to remain around 2% YoY. Europe's and Japan's momentum to continue. Non-commodity exporting emerging markets will continue to boost solid growth, unlike commodity exporting emerging and advanced economies.
- Advanced economies' equities have still some upside given accommodative monetary policies and subdued oil prices. We are more cautious on US equities than on European and Japanese equities.
- China's reform and growth problems will remain with us for a longer period. They are now being exacerbated by a very strong US dollar, to which the Renminbi has hardly devalued.
- Emerging markets which are not exposed to commodity prices and where the reform process seems to be more promising, such as India, are more likely to take advantage of the decline in commodity and energy prices
- Selectively emerging markets hard currency bonds offer good value, whereas local currency bonds remain subject to a scenario of continuing exchange rate volatility and US dollar strength
- Energy prices seem to have stabilized at new levels, up from their troughs earlier in the year. The major risk for renewed downward pressure lies in lower demand due to a stronger-than-expected China slowdown.
- Industrial metals have still more downside given the ongoing transformation of China's economy
- Precious metals upside to be capped by continuing global disinflation.

Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Better stay long	The recent spike in yield is likely petering out as the market has already discounted the limited extent to which the Fed will hike rates.
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 exports not only face growth issues but they seem to be prone to currency volatility. In commodity importer country's bonds, we still prefer USD bonds rather than local currency bonds because of continuing US dollar strength.
Equity Markets		
US	Moderately underweight	US equities will underperform their advanced economies' peers because of potentially more disappointing earnings (both because of the USD impact and domestic growth slowdown). Continuing monetary policy uncertainty is also unlikely to help equities.
Eurozone	Moderately overweight	Interest rate compression is now likely to favor more the periphery economies. It might make sense to move some of the DAX profits in the wider European indices as well as some periphery indices.
Japan	Moderately overweight	Very accommodative Japan monetary policy is still supportive to our constructive view on Japanese equities. Prime Minister Abe's recent reform measures (the so-called "Third Arrow") will also play a positive role.
Emerging Markets	Selectively overweight	Emerging equity markets remain a mixed bag. We are overweight those emerging markets that are more reform prone and less dependent on commodities, such as India and some Eastern European and Asian economies, such as Turkey and Indonesia.
Energy and Commodity Prices		
Energy	Neutral	We expect energy prices to continue to trade in their current range. The major risk to the downside would this time not derive from an increase in supply, but rather from a reduction in aggregate demand, specifically as a result of a stronger-than-expected slowdown in China.
Industrial Metals	Underweight	The full implications of the China transformation story will determine a further reduction in the commodity- intensity of its economy. There may be some recurring technical rebounds in specific metal prices, but globally deflationary downward pressures are likely to continue in this commodity space.
Precious Metals	Underweight	The US dollar is likely to remain strong. This is part of a more general story where emerging markets' massive current account surpluses are all but vanished. It is not favorable for precious metals.
Currencies		
EUR	Down	Euro will still weaken as ECB monetary policy will remain significantly more expansionary than Fed monetary policy. A more significant appreciation of the US dollar would be the result of a return to a global risk-off scenario. This could happen if the US and China slowdown would be more nasty than expected.
GBP	Down	GBP should weaken less than the Euro, and might even rise against the US dollar, since the UK business and monetary cycle might be stronger than many expect. What might – at some point in time – constitute a negative factor for the GBP could be the uncertainty regarding a EU in- or out referendum. As this referendum will, however, not take place before 2017, we consider this for the moment too be a very minor risk.
JPY	Down	Japanese yen is expected to remain in a slow depreciating trend as the BoJ will continue to inject large amount of money into the system. But the yen being a carry trade currency, it should see temporary rebounds during global risk aversion phases.

Growth on track as oil price seems stabilizing

Oil price stabilizing at significantly higher levels

The first quarter's gloomy picture of the oil price crashing sharply seems to be behind us. The oil price has now stabilized at a level which is significantly higher than the lowest touched in the first quarter. The Brent has remained above US$60 per barrel since mid-April. This is despite OPEC continuing production above 30mn barrel per day and little sign of supply tightening elsewhere. There was a strong surge in global crude demand in the first quarter, but supply continued to overwhelm demand (3.1mb/d vs 1.7mb/d). According to International Energy Agency, changing market expectations - rather than current conditions (supply outpacing demand) - are supporting crude prices as the looming impact of oil companies' recent spending cuts are being priced in. We remain of the view that the crude price will remain at current levels, with a positive bias as demand improves in the second half of the current year (similar to market consensus view). However, a potential global growth slowdown, thus this time a demand- rather than a supply factor, remains a key risk to the oil price.

Macro-economic impact has been limited until now

Although we have a constructive view on the crude price in the medium term, the average price for this year will be significantly lower than the averages in the recent years. This has already started showing some impact on the fundamental macroeconomic indicators of the GCC members. Most GCC governments' fiscal balances and current accounts have moved into deficit after almost a decade of large surpluses. Bahrain and Oman's credit ratings and Saudi Arabia's credit outlook have been downgraded. Saudi Arabia has burnt its foreign reserves at a high rate in the last few months. So how is it going to have an impact on the growth outlook for the GCC members in the medium term?

Economic fundamentals in Oman and Bahrain – being smaller countries having lower oil production - are different from remaining GCC members. Therefore, their macroeconomic fundamentals are more sensitive to the oil price movement in the short-to-medium term as compared to their peers in the region. The larger members, such as Saudi Arabia and the UAE, on the other hand, can support deficits for longer thanks to their huge international reserves.

Moderations in Producer Manager Indices (the most used leading indicators for the business cycle) in the UAE and Saudi Arabia are not significant enough - as they remain strong in absolute terms - to be considered as signals of an imminent slowdown. Private sector credit growth in the UAE remains close to its one-year average. Credit growth in Saudi Arabia has moderated somewhat, but that can be attributed to slower personal financing needs in recent months, as a result of the cash disbursements by the government and private sector companies to their employees earlier this year. Also, a high base effect is playing its part as credit to private sector has been growing in the double digits since late 2011.

We are in the third quarter of the lower crude price environment, and we have not witnessed any major cut backs in infrastructure projects. Expansions of regional airports, railway projects, metro projects and other infrastructure projects remain on track, thereby confirming the still very solid growth outlook.

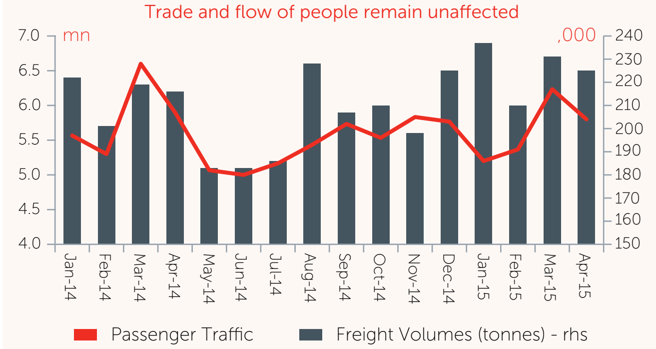
How does Dubai look this time around?

There is little evidence of any impact on the Dubai economy of the lower oil price environment. Hard indicators such as number of air passengers, cargo handled and data from the hospitality sector remain buoyant. Passenger traffic at Dubai and Abu Dhabi airport have grown at an average rate of 6.5% YoY and 20% YoY respectively in the first four months.

Valuation still attractive

Notwithstanding the downgrade in sovereign ratings for Bahrain and Oman earlier this year, as well as the downgrade in credit outlook for Saudi Arabia from stable to negative, we see a limited impact on private sector credit quality in the region especially in the UAE, Kuwait, Qatar and Saudi Arabia. With limited surplus generated during the oil price boom, Bahrain and Oman could face, however, difficulties in maintaining the high government spending.

We continue to be positive on equities as valuations seem to be fairly attractive. Most markets in the region are trading at either high single digit - or low double digit PE multiples, except for Saudi Arabia. However, caution is necessary in view of the volatility in the oil price which systematically affects sentiment in the equity markets. Domestic demand driven sectors are likely to outperform, given the continued momentum in government spending.



Source: DSC, Dubai airport

Growth remains sluggish

Downside risks still warrant holding treasuries

So far our slower-than-consensus growth forecasts have been vindicated by a significant slump in growth in the first months of the year. Over the last months we have seen some pick-up in growth, mainly in housing activity and durable goods orders. Somehow the correction in oil prices, combined with still low interest rates, seems to have facilitated a come-back of consumer credit and spending. Also because of the wealth effect from the lower oil price, there is a reasonable chance that growth will remain resilient. At the same time the strong US dollar will continue to impose a drag on growth through negative trade flows.

Dependent as it is on low interest rates, and with a good chance that corporate profits might run out of steam, we still consider it advisable to keep US Treasuries as a hedge against recurring nasty growth surprises.

Corporate profits can hold up if wages remain in check

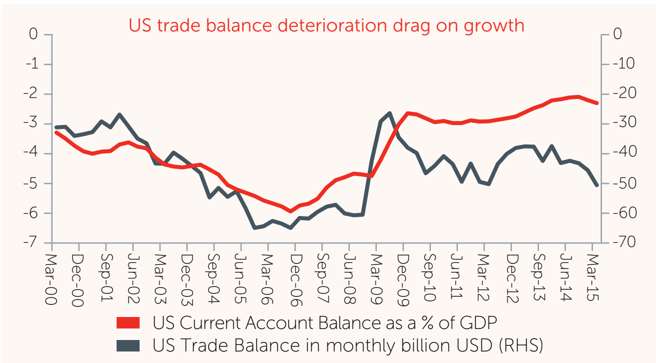
Job creation has moved beyond the winter slump and seems to be back at the 200'000 jobs a month pace. For one thing, monthly job data are subject to error and a poor leading indicator. Additionally, there might be some reasons to be concerned about a potential pick-up in wage growth in the United States, and we would stress the word "potential". Unlike many market observers, we have always had serious doubts about the Federal Reserve significantly hiking rates in the US over the coming years. In other words we do not fear wage increases to translate into an uncontrollable inflationary spiral. Rather wage growth could hamper corporate profitability at a time that corporate profits continue to hover at a record 12% of GDP and losing steam. A fall in corporate profits would at this stage likely put downward pressure on GDP, i.e. economic growth.

Rising costs and rising inventories to keep growth from spiking

Whilst it is possible that new labor could join the labor force to keep wages low - in which case wages will not further rise and keep inflation at bay - this is not a foregone conclusion, since many of those who left the labor force in the aftermath of the 2008 Global Financial Crisis, might not be inclined to come back again. A less benign outcome could thus be a temporary hike in wages which would however induce companies to reduce output at a time when the inventory over sales ratio has picked up considerably. Thus wages in the US are most likely to remain in check as is, most likely, the case for economic growth.

Federal Reserve will remain very prudent, but US dollar unlikely to depreciate

We remain very cautious as to the Federal Reserve hiking rates soon. Whilst the Federal Reserve will first and foremost look at the domestic economic situation – which in our opinion is anyway more fragile than many observers think - it will not be entirely oblivious to heightened turmoil in the Eurozone, as well as a stronger-than-expected slowdown in China. While our long-standing call for very moderate hikes by the end of the year has by now largely been vindicated, we would not be surprised to see the first hike in December only, or possibly in 2016. Regardless, we expect the US dollar to remain relatively strong as all other major central banks will persevere in their more expansionary stance.



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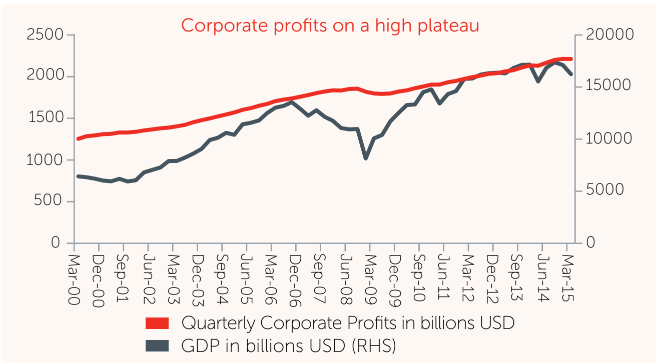

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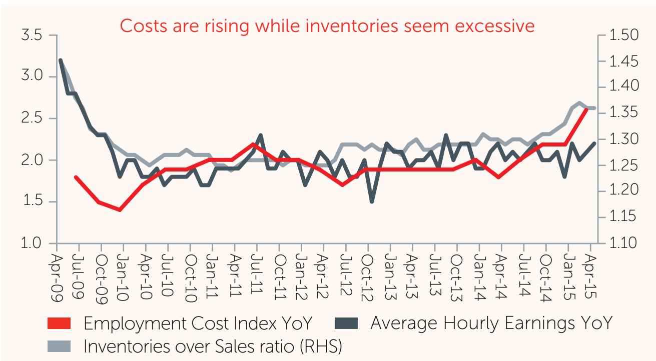


Source: Bloomberg

Recovery stabilizing

QE will last through September 2016

Following a pick-up in inflation rates, some observers have argued that QE might be called off before September 2016. We believe this to be unlikely since major economies such as France and Italy have only recently emerged out of very weak, or negative, growth rates. Moreover, real rates remain at historically very low levels. Absent structural reforms – which take time to play out – and massive fiscal stimulus - politically a non-goer – there is a very straightforward limit to the growth stimulus of QE in the Eurozone. The Eurozone runs the world's largest current account surplus and, as such, QE-induced devaluation of the continent's single currency is likely to be detrimental to growth elsewhere. At some point the reduction of growth abroad – in particular in the United States – will backfire on growth in Europe. To some extent that has already been happening, as can be seem from the comparison between the Citigroup Economic Surprise Index in the United States and the Citigroup Economic Surprise Index in the Eurozone. At some point in time persistently negative surprises in the United States (to a large extent determined by the drag on growth of the stronger US dollar), could not but result in less good economic news in the Eurozone.

Growth seems to be holding up at a sluggish pace

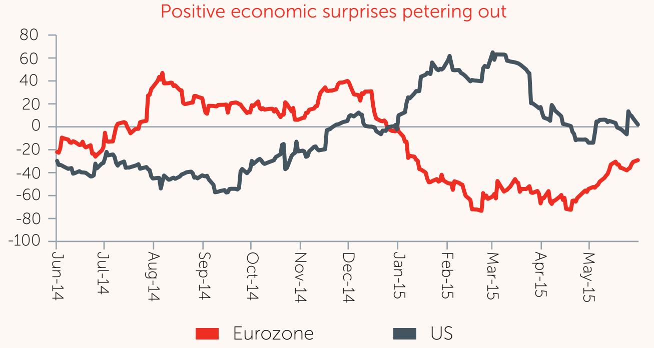
As we mentioned in our earlier quarterly, the litmus test for successful Eurozone QE will be credit growth in all Eurozone countries. This goal seems now increasingly likely as QE is being successful in pushing down yields in all Eurozone countries.

It is true that the month of May has seen a massive pick-up in long-term yields in the Eurozone. This pick-up, however, needs to be qualified. First and foremost, it is a pick-up that regards long-term government bond yields. It is true that those yields are very important as a benchmark for the entire spectrum of capital costs. Yet, it must also be observed that these markets had entered a phase of massive overbuying, such that a correction was inevitable. It should also be pointed out that similar phenomena occurred in the US and Japanese bond markets, in the aftermath of initiation of the Fed and BoJ QE programs. In some sense it confirms that market participants have shifted away from so-called risk-free assets, to riskier assets. More importantly, in the Eurozone spreads have continued to remain benign, and even come further down, as QE is also dampening the risk of contagion from an accidental accident whereby Greece defaults and exits the Eurozone (something we still consider unlikely). This is important since lower yields in the periphery are the key factor for credit growth in those countries where – over the past years - it has mainly disappointed: Portugal, Spain and Italy.

Grexit still unlikely, periphery Eurozone equity markets to catch-up with German equities

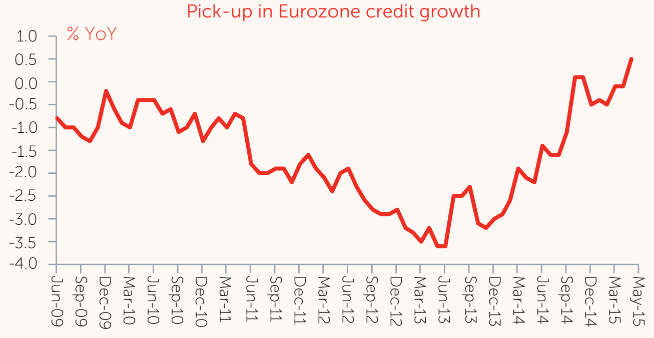
Whilst contagion risks from a Greek exit have largely diminished because there are no longer large holdings of Greek debt by foreign market participants, the political damage of a Grexit would still be very large both in Greece and in the Eurozone creditor countries. The long-term geopolitical implications from the destabilization of a NATO and European Union country on the fringe of Europe would also be very serious. Moreover, most Greeks don't want to leave the Eurozone and are willing to pay some price for staying. We expect a solution to be reached whereby – even while the country is going through a temporary default – Greece will accept continuing austerity in exchange for some reduction of its debt load. It is not clear when that deal exactly will be reached and as a result European (but also global) equities might still see some volatility. Beyond that, however, we expect European equities to continue to catch up with equities of other advanced economies, as QE continues. Eurozone periphery equities should also pick up with German equities, as the recovery spreads from the single currency core to the weaker economies.

Positive economic surprises petering out



Source: Bloomberg

Pick-up in Eurozone credit growth



Source: Bloomberg

Abe fires a "third arrow" amid a moderate recovery

Long term measures will take longer

Prime Minister Abe announced recently a set of reforms considered as "the third arrow of Abenomics", with a view of pushing sluggish economic growth higher. Demographics being at the centre of Japan's economic problems, one of the focus points of the announcement is increasing labor supply and productivity. The strategy is to provide more incentives for women to participate in the labor market through expanding, amongst others, childcare facilities. At the same time it also envisages more use of robots, as well as allowing limited immigration of highly skilled foreign workers in certain economic sectors.

Another important announcement, from the point of view of the equity market, is a plan to reduce corporate taxes from the current level of 36% to less than 30% in the coming years. In order to boost productivity and efficiency, the announced plan includes changes in labor laws, corporate governance and tax policies. It also plans to modify the government pension fund investments which should be more oriented towards equity investment.

The recovery was better than earlier expected

The first quarter real GDP growth has been revised upward from 1.5% to 3.9% QoQ annualized on the back of 1.2% growth in the final quarter of 2014. However, growth could be easing a bit as inventory gains of the first quarter will be a drag on growth in the second quarter.

Domestic demand is expected to pick-up moderately as wage growth continues to improve. Investment indicators also show a pick-up in recent months. External trade is additionally supportive to growth numbers as exports show traction while imports remain in contraction mode.

The currency dynamics continues to be supportive

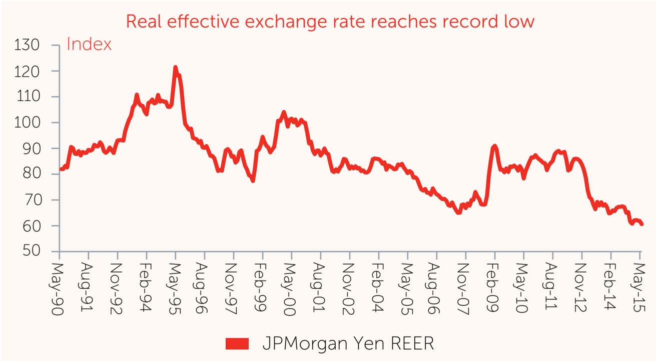
The recent depreciation of the Japanese yen against both the US dollar and the euro pushed the real effective exchange rate (REER) to a record low in June. This is expected to support exports and earnings of firms.

Triggering a higher inflation remains a challenge

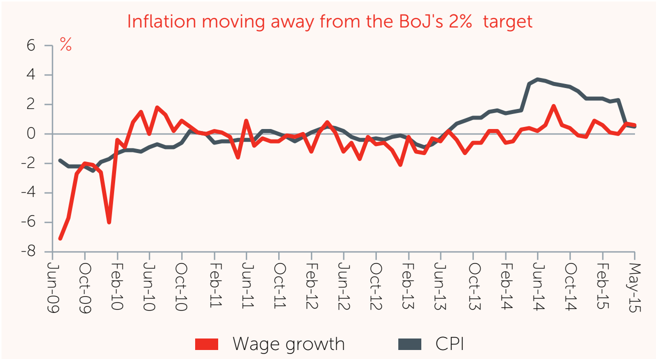
Whilst moderate growth momentum continues, inflation remains a challenge for policy makers. It is clear now - after two months of inflation data in the post VAT period ranging around 0.5% - 0.6% - that the Bank of Japan is unlikely to achieve its inflation target in 2015. Markets expect the 2% inflation target is likely to be achieved not before 2017. With slower inflation, the risk to the economic revival is higher, as the entire strategy of Abenomics rests on creating inflation to push wage growth and thus consumption. This is also important for the sustainability of the high public debt-to-GDP ratio.

Equity still has some potential for upside

As the moderate economic recovery is on track and the Bank of Japan remains committed to a large injection of liquidity into the financial system, we continue to see more upside potential in the equity market. From the valuation point of view as well, the 12-month forward PE for Nikkei 225 is slightly below its ten-year average, unlike its global peers where most of them are trading at significantly higher multiples than their respective ten-year averages. We also believe that the recent depreciation of the yen should further support earnings of the many listed export-oriented companies. The planned reduction in corporate taxes in coming years, is also positive for equity prices.



Source: Bloomberg



Source: Bloomberg

The limits to stimulus in the context of an ongoing investment bubble

China suffering most of US dollar strength

China's slowdown is set to continue as the country is still largely dependent on exporting manufactured goods, and China's virtual peg with a strengthening greenback is making it less competitive versus almost all its trading partners.

Consuming instead of investing, yes, but how?

For a country that has overly invested in manufacturing, the appreciation of the exchange rate is a true disaster since it cannot but further exacerbate the downward pressure of the return on domestic investments, not only in the export industry but in all industries that somehow support China's export industry. On the other hand a too rapid reduction in investment spending cannot but lead to reduced consumption since close to 70% of national income is still derived from investments.

This is exactly where the dilemma lies for the Chinese government: it must stimulate the economy to prevent an implosion of investment spending. By doing so it must buy time to grow consumption spending. The fact is that the ongoing economic transition in China from investment led growth, which heavily relied on infrastructure spending and exports, to domestic consumption driven growth is likely to continue to weigh on the economic outlook. The sluggish global economic conditions have weighed on exports while the curtailment of investments has slowed down manufacturing, and inevitably also consumption.

The limits of stimulus

Unlike advanced economies, where investments constitute less than 20% of GDP and no sector rebalancing is required, there is a clear limit to what stimulus can do to the economy. The fact of the matter is that China has a problem of overinvestments and that stimulus will inevitably lead to even more investments, rather than consumption. The Chinese government is well aware of this and has over the last years been very reluctant to introduce stimulus. Thus, whenever it restarts a new wave of stimulus measures, it does so with a temporary perspective. In fact, the gradual decline in Chinese growth rates is perfectly in line with a gradual reduction in the country's monetary base.

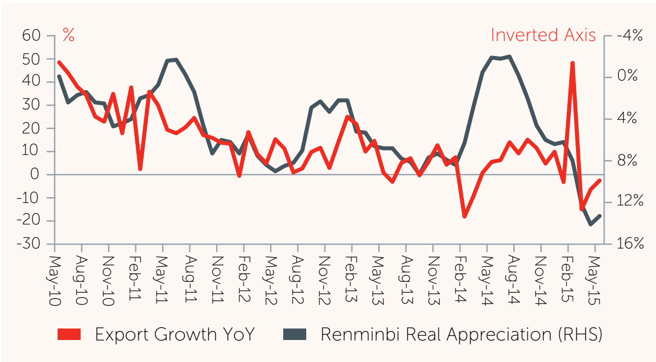
Currency depreciation might make sense to alleviate the burden of the export sector, as recent stimulus seems mainly to have benefitted housing and equities

By bringing the Lending Rate down from 6% to 4.85% and the banks' Reserve Requirement Ratio from 20% to 18.5% the People's Bank of China (PBoC) has been successful in boosting house sales, as well as domestic equity prices. We are still of the opinion that the PBoC could take some more action to promote currency depreciation, as that might be the easiest way to boost industrial output.

Chinese equity rally starts showing signs of fatigue

The local equity market is now finally showings signs of fatigue after a very long rally. We have worried throughout about the wisdom of investing in an equity market that is entirely out of sync with the country's economic fundamentals.

Further upside potential for this – largely still very opaque equity market – is now also being questioned by an increasing number of market participants, as the limits of the stimulus policy become more obvious, and the one-off consequences of the market liberalization measures peter out.



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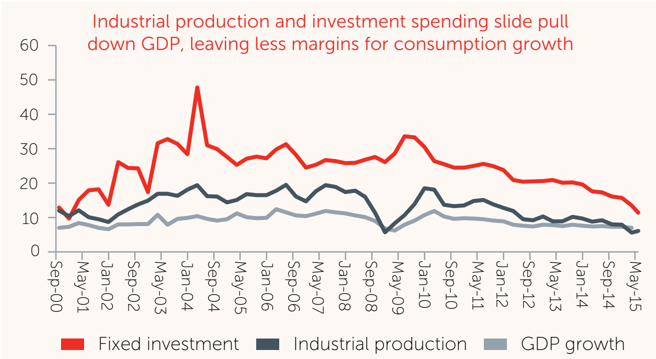

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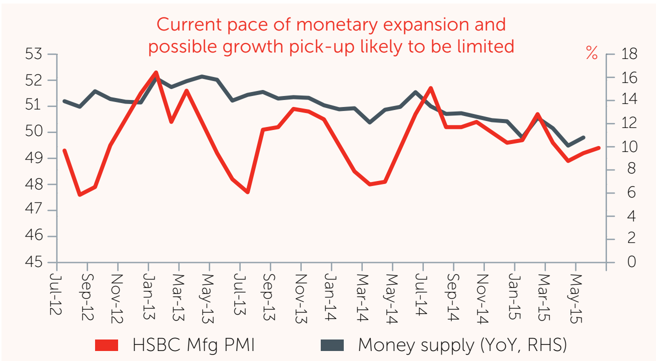


Source: Bloomberg

The long term story still holds

Markets suffer from growth disappointments, and ignore the inflation success story

The recent Indian equity market volatility is a reflection of doubts creeping into the market about the pace of growth and the government's ability to push through critical economic reforms, even as the inflation dynamics has improved remarkably. Corporate revenues and earnings were affected by the sluggish economic recovery and the less favorable external environment - exports declined in the first five months of this year. Moreover, the Indian Meteorological Department's recent forecast for a less than average monsoon outcome (rain fall for the country's main crop season) also acted as a sentiment dampener for the equity market.

Fundamental improvement key for the future growth

Although the pace of economic recovery and reform process has been slow, fundamental improvements such as fiscal stability, external stability and price stability are key for future growth prospects. The government's fiscal improvement resulted into the sovereign credit rating outlook being upgraded by Moody's from "Stable" to "Positive", creating a possibility of rating upgrade later (the current credit rating is Baa3). The current account deficit has narrowed significantly, providing relative stability to the Indian Rupee, as has been evident from its recent resilience while many emerging market currencies declined against the US dollar. Finally, the factors that were behind recent years' high inflation – namely, double digit rural wage growth, minimum support price for farm produces and high fiscal deficits - are now satisfactorily under control. A benign energy price environment remains broadly an important supporting factor for the country's macroeconomic stability.

What will drive growth in coming quarters?

In light of the above fundamental macroeconomic improvement, the most important factor for growth to gather pace would be the capital spending cycle revival (this we highlighted in our January quarterly). So, do we see any signs of picking-up in capital spending? The answer - in our view - is yes. The pick-up in capital goods imports (16% YoY on a three-month trailing basis), the spike in foreign direct investments (up 24.5% YoY in mar-15) and anecdotal evidence of an improvement in projects under implementation, suggest that a slow revival is underway. However, we must concede that the pace is less than satisfactory, and a negative factor will remain the overstretched balance sheets of companies, especially in the infrastructure sector, as well as the hangover of high non-performing loans in banks' books.

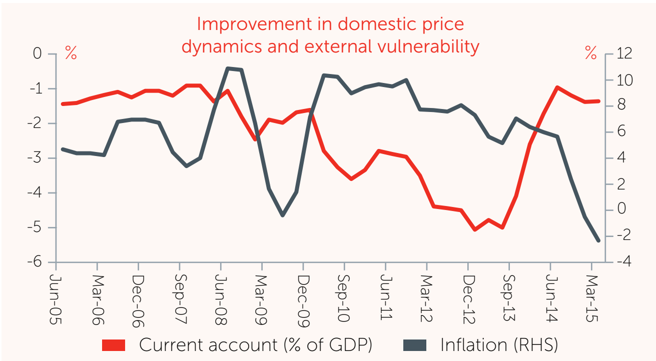
Where will the pick-up in capital spending come from?

We believe that the capital spending push will come mainly from the public sector that accounts for almost two-fifth of total non-household investments. Public sector companies are sitting on huge cash piles (according to a Business Standard report in Dec-14, aggregate cash balances of 54 listed PSUs was more than US$300bn) which could be directly invested by companies in their own expansion, or could be paid as dividend to the government for use in infrastructure spending. The government rationalizing the spending by shifting more resources towards building infrastructure will also help.

We maintain a positive view on equities and bonds

Therefore, India is in a spot where downside risk to growth is limited. However, risks to the equity market come from the elevated earnings expectations, even after the significant downgrades in recent months. High current valuations make the equity market vulnerable.. Having said that, we continue with our moderately positive bias for Indian equities, primarily in view of the positive factors related to the growth dynamics mentioned above.

On the fixed income side too, like equities, we are positive as the government's fiscal performance has further improved. The credit rating outlook upgrade is also positive for the asset class. A benign inflationary environment (wholesale price inflation remaining in the negative territory) should provide more room for the central bank to cut interest rates, even though Governor Rajan sounded hawkish after the June rate cut. A below normal monsoon, affecting farm production and thus food prices, is a major risk in our view.



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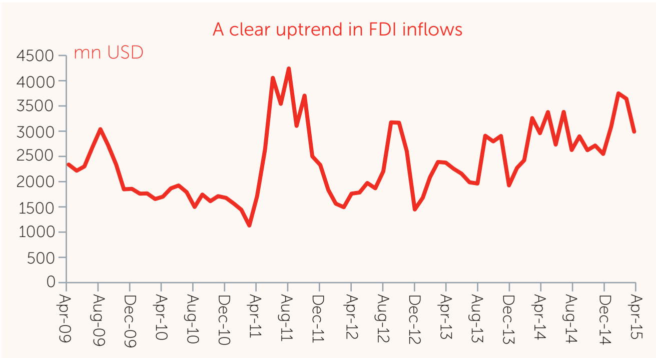


Source: Bloomberg

GDP Forecast	2015 Consensus	2015 ADCB	2016 Consensus	2016 ADCB
US	2.2%	Expect moderately less	2.8%	In agreement
Eurozone	1.5%	Expect moderately less	1.7%	In agreement
Japan	1.0%	In agreement	1.4%	In agreement
China	6.9%	Expect moderately less	6.7%	Expect moderately less
India (FY)	7.6%	Expect moderately more	7.9%	In agreement

Source: Bloomberg

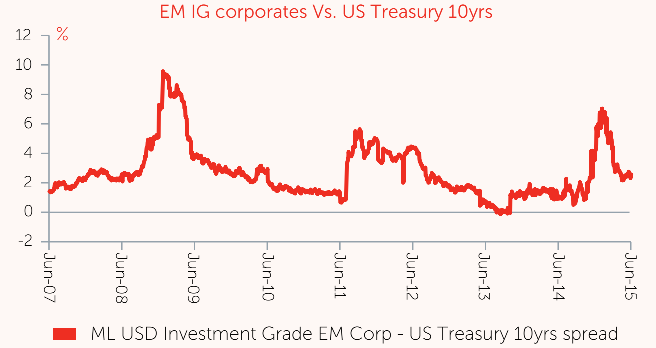
CPI Forecast	2015 Consensus	2015 ADCB	2016 Consensus	2016 ADCB
US	0.3%	In agreement	2.2%	Expect moderately less
Eurozone	0.2%	In agreement	1.3%	In agreement
Japan	0.8%	In agreement	1.2%	Expect moderately more
China	1.5%	In agreement	2.0%	In agreement
India (FY)	5.4%	Expect moderately less	6.1%	Expect moderately less

Source: Bloomberg

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

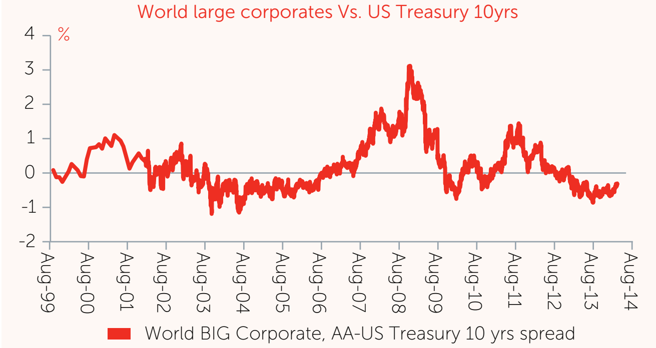
Bond Market Spreads

EM IG corporates Vs. US Treasury 10yrs



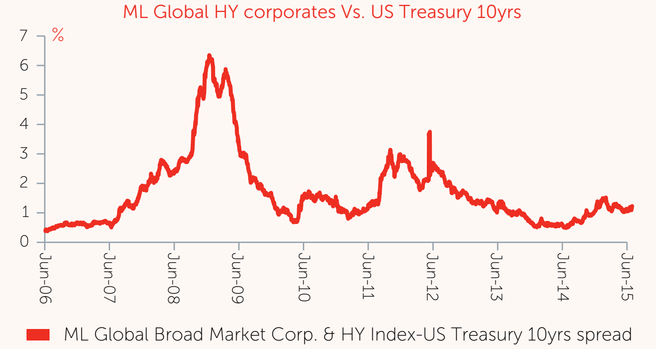
Source: Thomson Reuters

World large corporates Vs. US Treasury 10yrs



Source: Thomson Reuters

ML Global HY corporates Vs. US Treasury 10yrs



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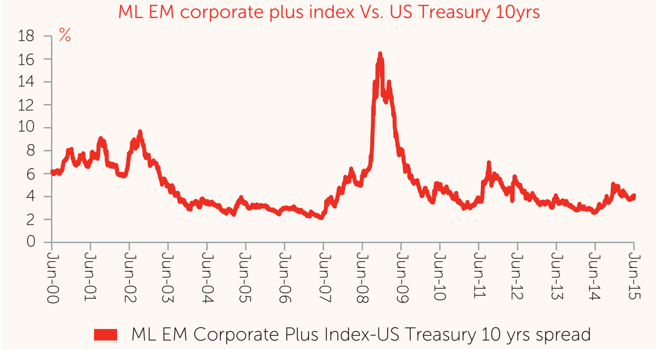
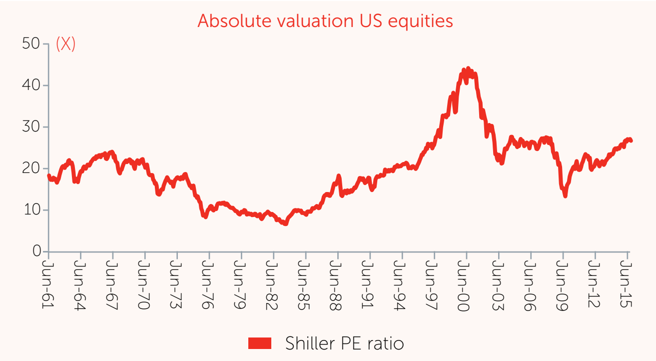
ML EM corporate plus index Vs. US Treasury 10yrs

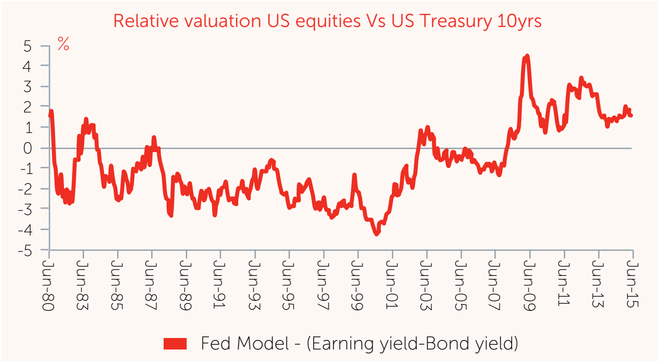


Source: Thomson Reuters

Equity Market Valuations



Source: multpl.com



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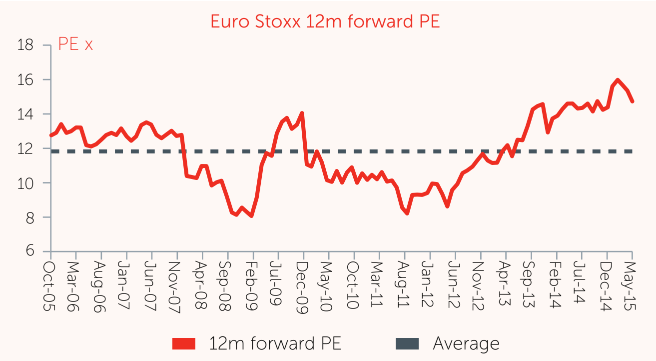

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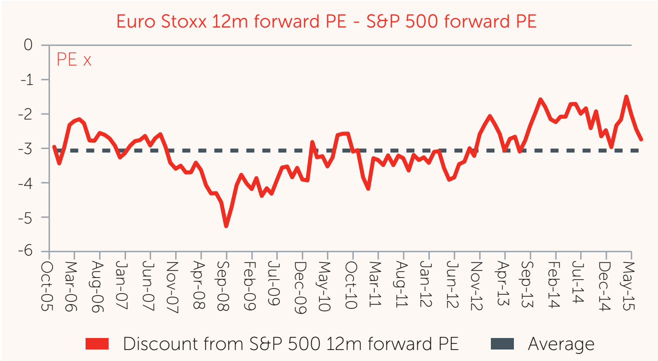

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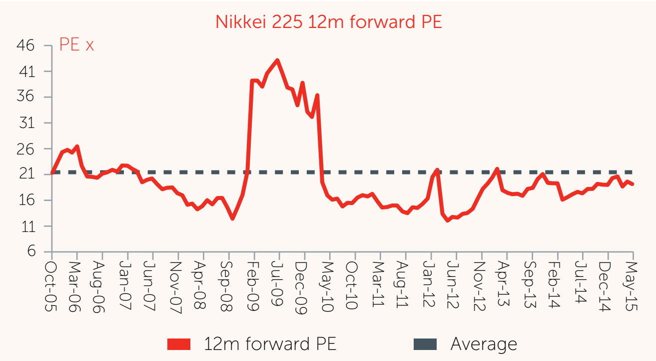

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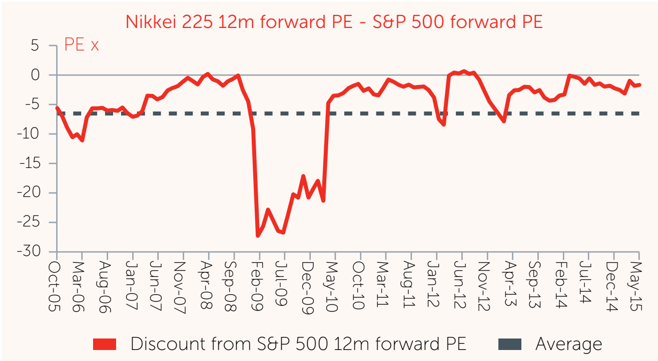

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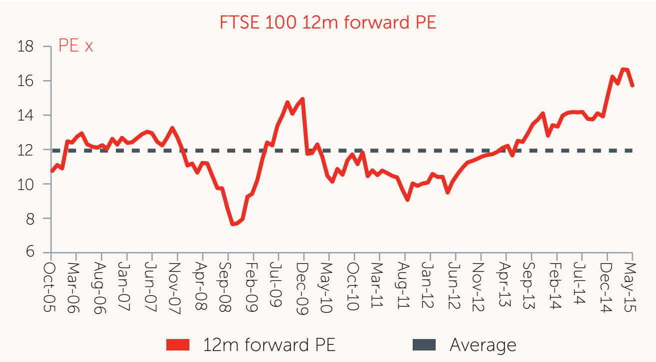

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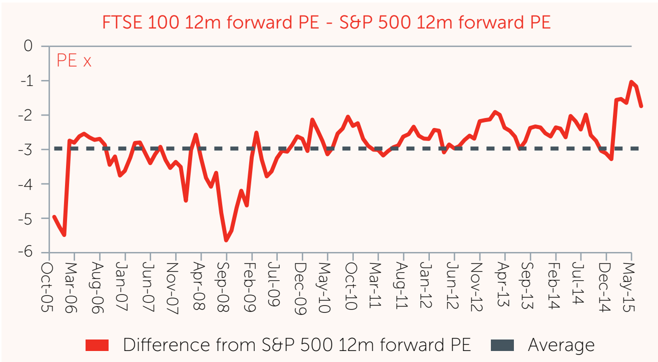

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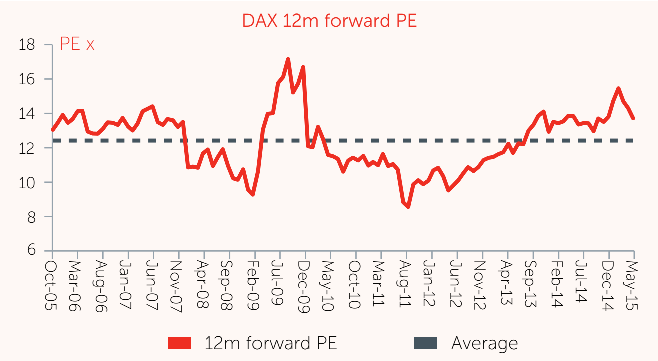
Equity Market Valuations



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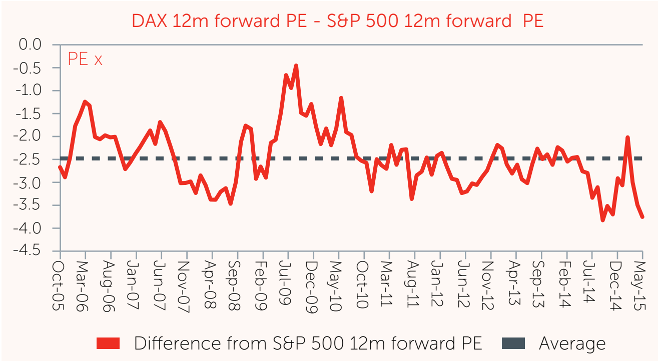

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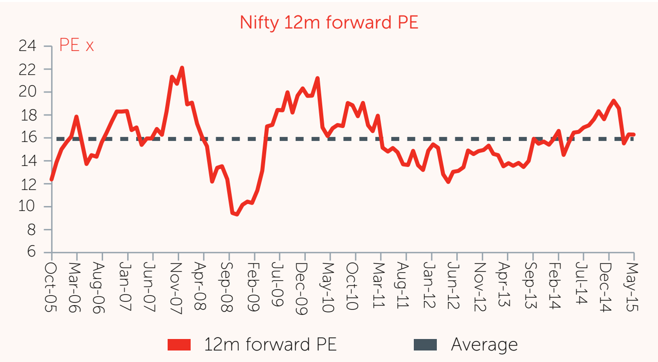

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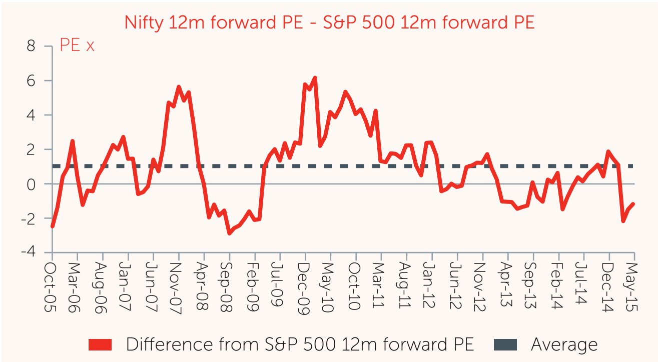

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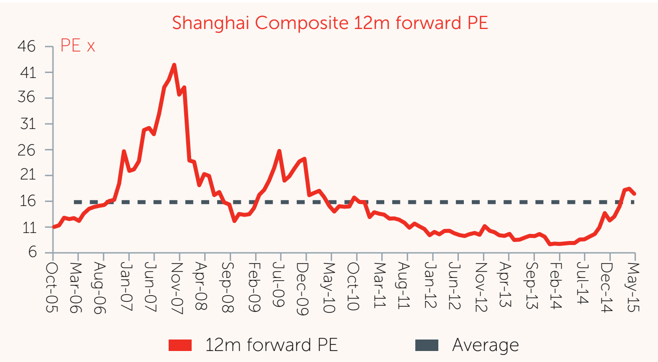

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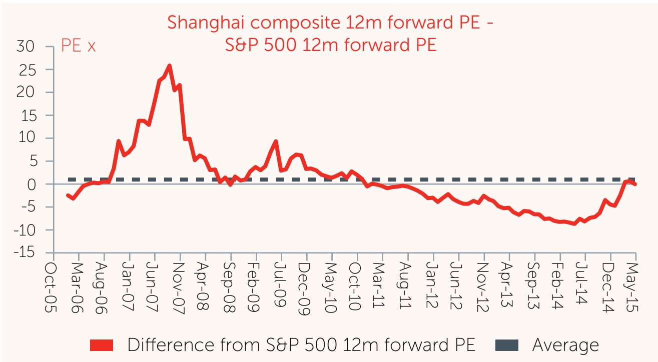

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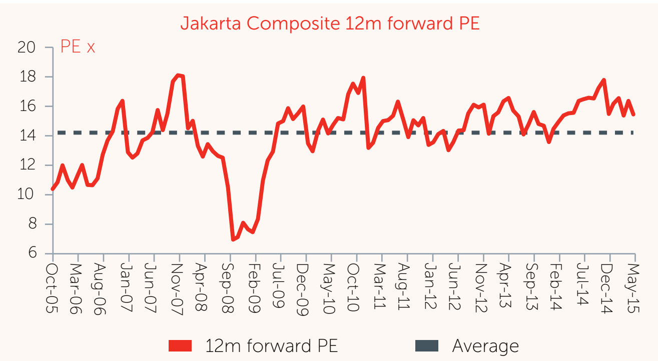

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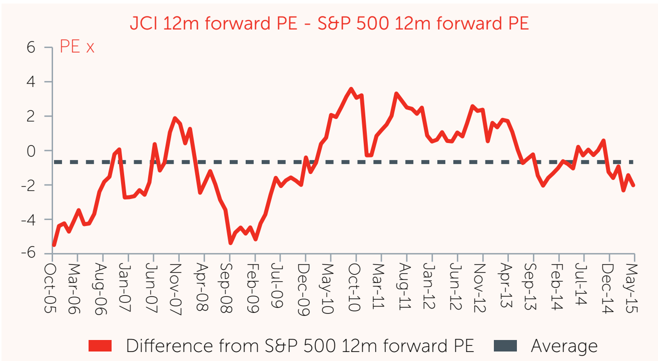

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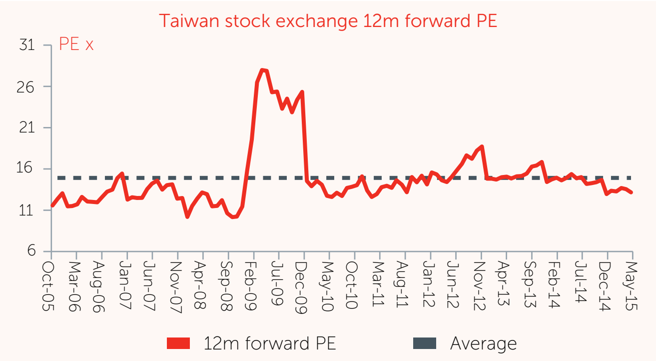
Equity Market Valuations



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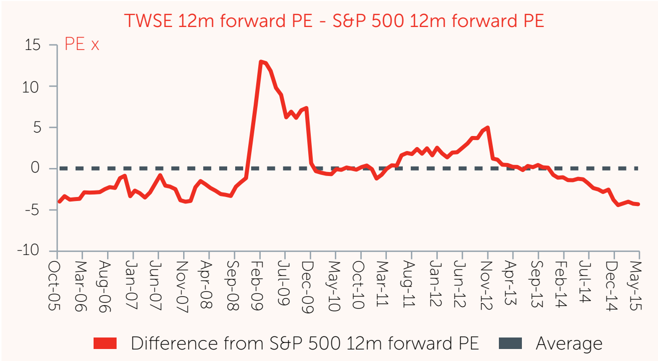

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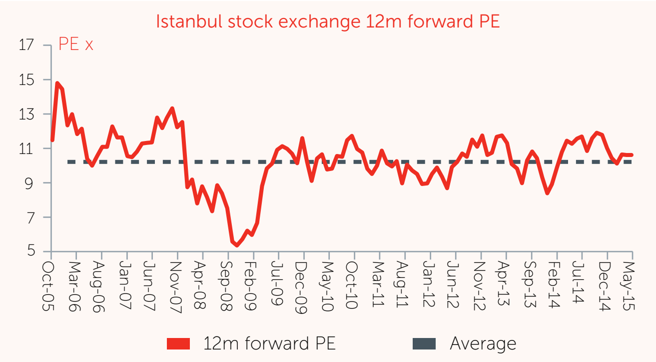

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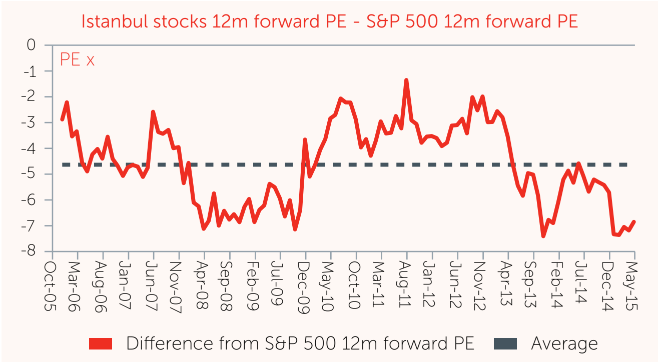

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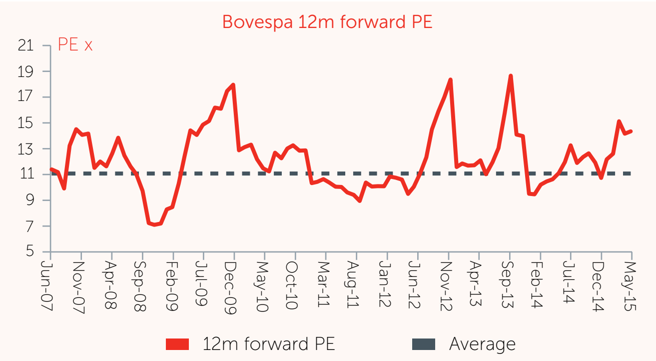

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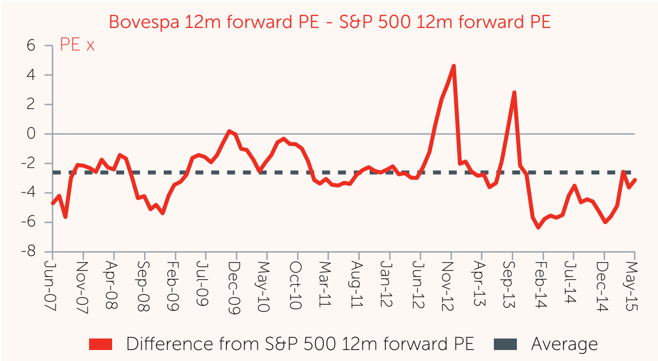

Source: Bloomberg

Important Information

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

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

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