بنك أبوظبي التجاري ADCB

Equity themes: Prefer domestic exposure over exporters

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- **Global growth has repeatedly undershot expectations in recent years, failing to return to pre-financial crisis growth rates in spite of widespread unconventional monetary policies**
- **This has contributed to a plunge in global trade, which in turn has been exacerbated by increasing protectionism**
- **Unless growth reaccelerates, it seems unlikely that politicians will risk removing tariffs, quotas and bans in a meaningful way any time soon. This means that trade could continue to struggle, hindering export dependent sectors**
- **In addition, now that central banks seem unable to push currencies down further, there is increasingly little scope to favour exporters in specific countries (especially in Japan and Europe for example)**
- **Although rising protectionism and currency wars are negative for global growth, certain markets, sectors and stocks will be less impacted, or can even benefit from this trend**
- **In particular those companies which derive the majority of their revenues from their domestic market should outperform**
- **Although there is a case for broader developed market domestic exposure, given our US equity overweight, coupled with the relative strength of the US economy means that for the time being we recommend to implement this idea via US stocks**

Stock and sectors less tied into the global trade cycle to benefit

Despite a raft of global trade deals, including mega ones such as the Trans-Pacific Partnership (TPP), the world is moving in a more, not less protectionist direction. Along with slowing global growth, protectionist measures have contributed to falling trade. Global trade has dropped by 24% during the past two years (see chart on next page), not quite the >40% fall seen during the global financial crisis (GFC), but a very large move nonetheless. Following the GFC it was assumed that the world would return to pre-crisis growth levels and that trade would recover. However, this has not materialised, and in fact this is where the problem lies; growing protectionism has its roots in the lacklustre global economic rebound. In other words, the world's failure to return to pre-crisis growth rates has led to protectionist measures in a bid to safe guard jobs. The ongoing US election is a case in point where all three remaining candidates have expressed concerns over the TPP trade deal. At a general level, this suggests that companies more tied into their domestic economies will face fewer challenges than companies which are more dependent on foreign revenue streams.

The case for domestically focussed equities is further supported by the inability of major central banks to incrementally weaken their currencies beyond what has already taken place. If this is correct, then it makes less sense for analysts and strategists to favour those markets. Japan and the Eurozone are the first that come to mind, where exporters have benefitted from devaluations which made them more competitive.

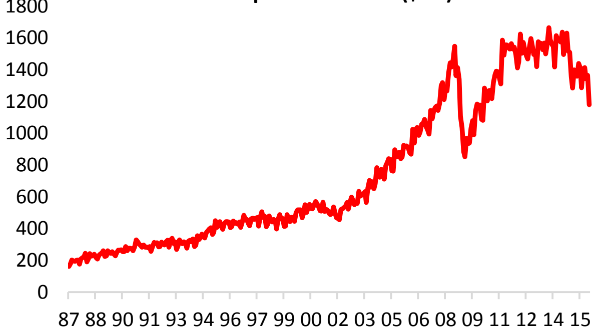
In our equity strategy we have an overweight recommendation on US equities. The relative strength of the US economy means that the domestic sectors in the US are on firmer footing than in many other markets. As such we currently believe the best way to play the domestic exposure theme is via US equities. In this note we have screened the MSCI United States index and offer a list of stocks which derive all of their revenue domestically. We believe that over the next few years these stocks can outperform as they will be driven by internal rather than external drivers.

Why domestically focussed equities can outperform

Trade is slowing - protectionism is growing

With hundreds of new measures every year, the world is moving in a more protectionist direction. According to research by the B20 Trade Taskforce, merely removing measures put in place since the global financial crisis could create 9m jobs and add $423bn to global GDP. This is unlikely to happen given the political trend in Europe and in the US is shifting and politicians increasingly focus on protecting jobs and businesses at home. Companies which do not depend on overseas revenues will be less affected by economic weakness abroad, slowing trade as well as by further trade restrictions.

World exports to world ($bn)



Source: IMF Direction of Trade Statistics, Thomson Reuters

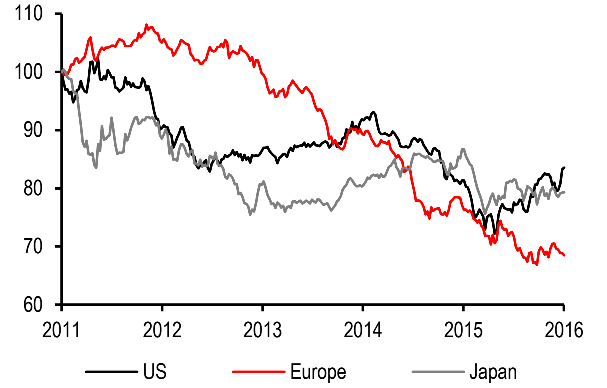
The currency angle

Another reason to focus on domestically orientated companies comes from the fact that currencies have played an increasingly important role in driving corporate revenues. There are many examples of central banks targeting currencies in an attempt to stimulate inflation and growth. So far, these attempts have failed (or wildly undershot expectations) and fewer tools now remain available to policy makers should they want to influence their currencies further. Japan is the prime example of this, Japanese equities have seen some of the strongest earnings growth in the world over the past few years, driven largely by yen weakness. A weaker yen, means cheaper Japanese goods. However, with fewer options to incrementally weaken the currency, there is little reason to remain positive on Japan's export focused companies.

Limiting EM exposure

In the years leading up to the global financial crisis emerging markets (EMs) were booming, supported by the China inspired commodity super-cycle. EM growth was so strong that talk of economic decoupling, between growth in EMs and that in developed markets (DMs) was rife. DM companies aggressively sought more EM exposure as a way of tapping into this strong growth. As a result, companies with a higher proportion of EM revenues generally outperformed those without it (see charts below). These days the story is different, with (large) EM exposure seen as a headwind rather than a tailwind. Given the structural nature of the slowdown in the emerging world we believe EM exposure will remain a hindrance in the medium-term and possibly longer.

DM stocks with high EM exposure relative to benchmark



*For each country the 25 stocks with the largest EM exposure were bottom-up aggregated and measured against its respective benchmark
Source: MSCI, Worldscope, Thomson Reuters, HSBC

Developed markets better placed, especially the US

The US is a relatively closed economy, by this we mean not only are exports as a percentage of GDP low (less than 20%), but US companies also generate a lower share of their revenues from abroad than European or Japanese companies. This is one of the reasons why US stocks tend to outperform during broad based sell-offs in financial markets as these are often caused by fears over global growth.

Within our current equity strategy we have an overweight recommendation on US equities for the aforementioned reason. Sector-wise in the US we have a preference for defensives; telecoms, utilities, consumer staples and health care. Looking into the revenue breakdown of US sectors shows that the defensive sectors are also the ones which (generally) have a higher domestic revenue exposure, and thereby sits well with our equity strategy preference for defensive sectors (see table below).

Geographic revenue split for MSCI US sectors

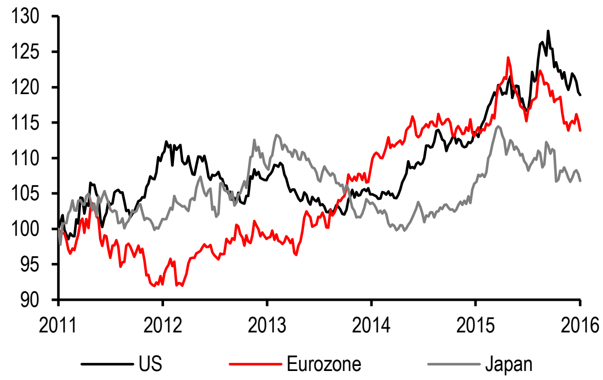
	Americas	US	Americas ex US	Europe	Asia Pacific	Africa & ME	Misc
Telecoms	100	-	-	0	0	0	0
Utilities	97	93	4	1	0	0	2
Financials	85	83	2	5	6	0	4
Health Care	79	79	1	7	2	0	11
Cons Disc	75	72	4	8	4	0	13
Cons Staples	73	64	9	6	2	0	20
Industrials	66	59	7	11	10	3	10
Energy	61	58	4	5	1	1	31
Materials	58	51	7	20	9	0	14
IT	45	39	5	11	8	0	26

Source: MSCI, Worldscope, Thomson Reuters, HSBC

Domestically focused equities have already been outperforming

Whether it be for reasons such as increasing protectionism or slowing global growth, domestically focused equities have been outperforming for some time. The chart below shows the performance of three baskets of stocks with high domestic revenue exposure (in each case the 25 stocks with the highest domestic exposure in the respective index were used). In the US and Eurozone performance has been stronger than in Japan, not unsurprising given the substantial weakening of the yen over the past 3 years. The past 4 months domestic stocks have underperformed the broader market as fears about global growth rapidly receded. However, we expect these issues to resurface, meaning that the long-term trend of outperformance of domestic focused stocks should continue.

Stocks with high domestic exposure relative to benchmark*



*For each country the 25 stocks with the largest domestic exposure were bottom-up aggregated and measured against its respective benchmark
Source: MSCI, Worldscope, Thomson Reuters, HSBC

Risks to our view

The key risk to our view is a significant pick up in global growth or global growth expectations. Were this to materialize, (either because we have underestimated the cycle or by game-changing policy innovations such as the implementation of helicopter money by one of the world's major central banks) global trade would likely be boosted and the cyclical rather than defensive themes would rally.

How to play it

In the below screen we have focused on the geographic composition of MSCI United States index constituents. The data comes from company accounts supplied via the Thomson Financial Worldscope database as well as Bloomberg. The data gets updated once a year. The compilation of the data and the bottom-up aggregation in this note has been done by HSBC Global Research in their annual Who Sells Where report.

These stocks are not our specific recommendations, but have been screened purely on the basis of their high domestic revenue exposure only.

A quantitative screen of our domestic exposure theme

Stock	Industry group	Revenue exposure (%) Domestic	Foreign
Aetna	Health Care Equipment & Services	100	0
Altria Group	Food Beverage & Tobacco	100	0
Anthem	Health Care Equipment & Services	100	0
AT&T	Telecoms	100	0
Berkshire Hathaway 'B'	Diversified Financials	100	0
Charles Schwab	Diversified Financials	100	0
Comcast 'A'	Media	100	0
CVS Health	Food & Staples Retailing	100	0
Dominion Resources	Utilities	100	0
Express Scripts Holding	Health Care Equipment & Services	100	0
Lowe's Companies	Retailing	100	0
Nextera Energy	Utilities	100	0
PNC Financial Services Group	Banks	100	0
Regeneron Pharms.	Pharmaceuticals & Biotechnology	100	0
Reynolds American	Food Beverage & Tobacco	100	0
Simon Property Group	Real Estate	100	0
Southern	Utilities	100	0
Target	Retailing	100	0
Time Warner Cable	Media	100	0
Union Pacific	Transportation	100	0
United Health Group	Health Care Equipment & Services	100	0
US Bancorp	Banks	100	0
Verizon Communications	Telecoms	100	0
Walgreens Boots Alliance	Food & Staples Retailing	100	0
Wells Fargo & Co	Banks	100	0

*25 MSCI United States index constituents with 2014 revenue derived 100% from domestic sources according to Worldscope data

Source: MSCI, Worldscope, Thomson Reuters, HSBC

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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