Investment Strategy Note

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بنك أبوظبي التجاري ADCB

Defensives to outperform

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- **We remain underweight equities in our global asset allocation and expect bonds, in particular US Treasuries to outperform equities looking ahead.**
- **Within the equity universe we are overweight US equities. In this note we go one step further and outline our sector preferences; we prefer defensive sectors such as consumer staples, utilities, telecoms and health care**
- **The main catalyst for defensive sectors comes from the unpredictable and deteriorating outlook for the global economy, as well as the poor fundamentals of equity markets as a whole. In such an environment companies and sectors with the most stable and predictable earnings will outperform**
- **In addition, defensive sectors generally offer relatively high dividend yields, a theme which we have been advocating this year, given ultra-low global interest rates**

In a challenging environment, remain defensive

2016 is only 5 months old and yet we have seen a rollercoaster in investors' global growth expectations and even bigger swings in equity markets. Stripping out the volatility, we continue to believe that the economic cycle will continue to moderate. To the extent worries over the health of the global economy at the beginning of the year were overly negative, similarly they have now become too complacent in our view, at least when using risk assets performance during February-May as a gauge. In most developed markets, both top-down and bottom-up fundamentals sit very uneasily with the recent strength of equity markets. This can last for a little while. As always, however, fundamentals will determine the medium-to-longer term direction of equity markets.

Given our concerns over the outlook, we maintain an underweight equities position within our broader asset allocation. In our equity-only portfolio, by country, we are overweight US equities, believing that they will prove to be most resilient to what we expect will remain a very difficult environment for risk assets. In this note we go one step further and detail our preference for the defensive sectors within the US equity market. By defensive we mean sectors which are less dependent on the economic cycle. Companies operating in the utilities, health care, consumer staples and telecoms sectors generally fall into this category. They are able to generate stable profits throughout different phases of the economic cycle, including during economic downturns, albeit they will benefit less from periods of strong economic expansion when the cycle turns more positive.

Anyone who wants confirmation that defensive sectors are the best placed sectors to navigate what will likely be a challenging few quarters ahead, needs to only look at the latest earnings season in the US. Consumer staples, telecoms and health care have all managed to generate positive sales and earnings growth at a time when the market in aggregate is experiencing a contraction of -2.3% and -8.9% respectively (see tables on page 3).

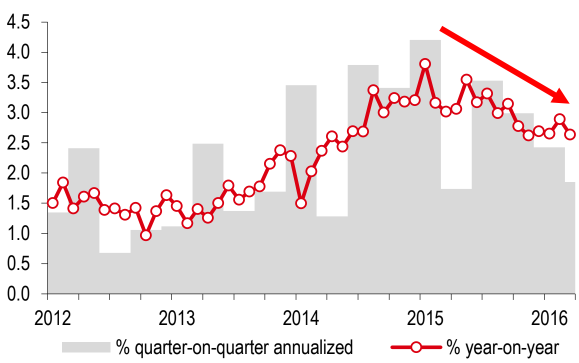
Not only do we expect that the consumer staples, telecoms, health care and utilities sectors will outperform in the current environment, they also offer (with the exception of health care) dividend yields comfortably in excess of the market average. High dividend yield is a key theme which we have been advocating in the ultra-low yield environment of today. It is also something which is likely to stay with us for the foreseeable future.

Defensive sectors

Consumer Staples

Consumer staples are one of the main beneficiaries of the difficult environment. The sector is made up of roughly 60% food and beverage companies and 20% retail and 20% household products, meaning that sector profits are relatively well insulated from a squeeze on consumer discretionary spending. The sector is under-owned by global funds, which can be explained by its high exposure to emerging markets, something which investors have sought to limit in recent years. This in turn has acted as a drag on future earnings expectations. However, in the event that the nascent recovery in emerging markets broadens, higher EM exposure will be a tailwind, rather than headwind. However, even without a turnaround in EM, the case for consumer staples is robust. Companies in the sector have aggressively cut costs, a necessity given consumer staples companies typically have tight margins. However, the recent earnings season suggests that they are managing to defend their margins better than other segments of the market.

US consumer spending growth decelerating, and may continue to do so.

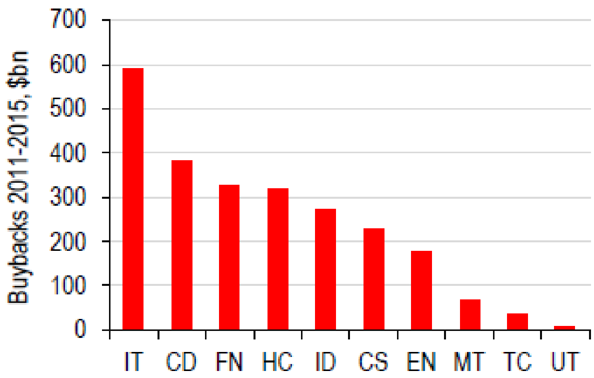


Source: Bureau of Economic Analysis

Health Care

The positive case for the health care sector is the most difficult to outline given that it has gone from being one of the top performing sectors over the past several years, to underperforming the market badly y-t-d. However, we believe that this underperformance should be close to coming to an end. The reason why the sector has struggled of late has to do with the discussions around drug pricing in the US in the lead-up to this year's presidential elections. However, whether this leads to concrete changes in the sector is questionable. Certainly, both buy and sell side are bullish on the sector as shown by fund holdings and analyst recommendations. Longer-term prospects for the sector are supported by an aging population which will require increasing medical care. On top of this balance sheets in the sector are very strong with companies rich in cash, enhancing the possibility of higher dividend payments, although share buybacks and further M&A are more likely, based on recent trends in the sector.

US buybacks by sector



Note: IT = technology; CD = consumer discretionary; FN = financials; HC = health care; ID = industrials; CS = consumer staples; EN = energy; MT = materials; TC = telecoms; UT = utilities
Source: S&P, HSBC

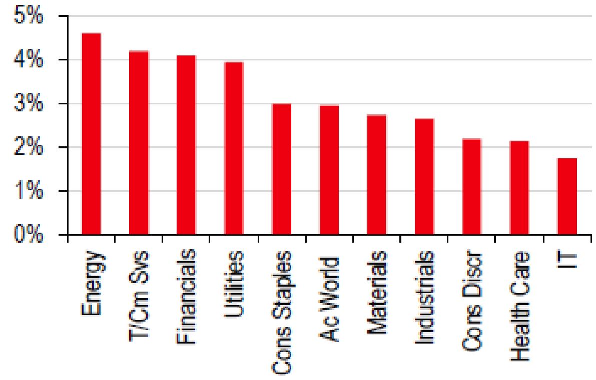
Utilities

The utilities sector is one of the least popular sectors among investors, as such it is heavily under-owned by global equity funds. Valuations for the sector are also particularly cheap, especially when compared to other defensive sectors. On top of this, it is worth noting that utilities offer a dividend yield of around 4%, well in excess of the market average of 2.8%. For some time now we have expressed a positive view on high dividend yield plays given the very low interest rate environment. The sector is currently witnessing strong relative earnings revisions, perhaps boosted by a relatively strong US housing market. In particular housing starts tend to lead to an increase in electricity demand. From a top down perspective, we expect the US housing market to remain well supported by low long term interest rates. Housing has been one of the pillars of economy in the US and although the Fed is determined to hike short rates, it will be very wary of hampering the housing sector in any way.

Telecoms

Telecoms is another sector which is not well owned in the US. Like utilities, it offers an attractive dividend yield of around 4%. Demand for communication and media is still growing fast as network technology as well as devices rapidly develop. A key concern among investors longer term is the fact that barriers to entry are relatively low and therefor competition is likely to increase. This will inevitably erode providers' pricing power over time. We consider this concern to be somewhat overdone, certainly in the near-term and looks especially unjustified if using the sector's exceptional top-line growth in the current earnings season as a guide. With all five telecoms companies now having reported, aggregate top line growth for the sector stands at 11.2% compared with -2.3% for the market as a whole. The sector's earnings growth in Q1 2016 also looks very strong at 16.1% y-o-y vs. -8.9% for the market.

12-month forward dividend yields by sector (All countries world index)



Source: MSCI, IBES, Thomson Reuters, HSBC

Conclusion

The Q1 2016 earnings season provides two very clear signals in our view. Firstly, it highlights the deterioration in the overall health of corporate America. We are on track for the fourth consecutive quarter of earnings contractions and the deepest since 2009. Secondly, a clear picture is emerging as to the resilience of the defensive segments of the market. Three of the four sectors (out of ten) to have shown positive earnings and sales growth are defensive. While the fourth, utilities has experienced a smaller earnings contraction than the market as a whole (-1.2% vs. -8.9%). We do not believe this to be a flash in the pan, but rather part of a longer-term trend. This comes in the context of our view that equity markets globally will struggle to significantly improve upon the violent rally seen between February and the end of April.

Further enhancing the case for the defensive sectors in the market is the fact that they are among the most under-owned sectors by global funds. The reason for this is simply because these sectors are viewed as less exciting in what has been one of the longest US bull markets on record. Under-ownership provides plenty of scope for rotation out of the more cyclical sectors of the market (consumer discretionary, industrials, materials, technology). Finally, the consumer staples, telecoms and utilities sectors offer dividend yields comfortably in excess of the market average, a quality which we expect will be increasingly sought after by investors given the ultra-low yield environment.

Q1 reporting season: earnings growth (9 May 2016)

		Earnings Growth			
	Reported	Positive	Flat	Negative	%
Overall S&P 500	**437 / 500**	**254**	**7**	**175**	**-8.9%**
Oil & Gas	38 / 38	6	0	32	-108.1%
Basic Materials	17 / 19	5	0	12	-16.8%
Industrials	75 / 77	49	1	25	-6.3%
Consumer Goods	53 / 62	38	1	14	8.5%
Health Care	47 / 51	37	0	10	8.6%
Consumer Svs	47 / 74	37	0	9	8.3%
Telecoms	5 / 5	3	0	2	16.1%
Utilities	26 / 30	8	0	18	-1.2%
Financials	92 / 93	51	4	37	-12.9%
Technology	37 / 51	20	1	16	-10.0%

Source: Bloomberg

Q1 reporting season: sales growth (9 May 2016)

		Sales Growth			
	Reported	Positive	Flat	Negative	%
Overall S&P 500	**437 / 500**	**238**	**0**	**199**	**-2.3%**
Oil & Gas	38 / 38	5	0	33	-31.6%
Basic Materials	17 / 19	4	0	13	-11.9%
Industrials	75 / 77	40	0	35	-1.0%
Consumer Goods	53 / 62	29	0	24	-1.3%
Health Care	47 / 51	41	0	6	9.3%
Consumer Svs	47 / 74	34	0	13	8.3%
Telecoms	5 / 5	2	0	3	11.2%
Utilities	26 / 30	4	0	22	-10.2%
Financials	92 / 93	60	0	32	-1.2%
Technology	37 / 51	19	0	18	-3.3%

Source: Bloomberg

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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