



ADCB Asset Management

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October 2017

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Luciano Jannelli, Ph.D., CFA

Head Investment Strategy

+971 (0)2 696 2340

luciano.jannelli@adcb.com

Wietse Nijenhuis

Equity Strategist

+971 (0)2 205 4923

wietse.nijenhuis@adcb.com

Prerana Seth

Fixed Income Strategist

+971 (0)2 696 2878

prerana.seth@adcb.com

Mohammed Al Hemeiri

Analyst

Tel: +971 (0)2 696 2236

mohammed.alhemeiri@adcb.com

Policy opportunities are overstated, but so are political risks

In our July editorial entitled "Positive economic momentum to persist", we argued that global growth would remain solid at least through the first half of 2018. We now see the global expansion remaining robust through end 2018 and have consequently further upgraded our equity stance from neutral to overweight, and reduced our fixed income allocation to underweight.

The key drivers for global growth, in our view, are the rebalancing that has occurred between the US economy and the EU economy on the one hand, and persistently (mysteriously so for Mrs. Yellen) low inflation in developed markets on the other hand. The strong pick-up in Europe has lifted the euro, thereby recycling excess savings from the largest current account surplus holder (the Euro-zone) into the rest of the world. Low US inflation is helpful in that it allows for financial conditions in the US economy to remain accommodating, even now that most US dollar weakness has been priced in by the markets.

Whilst US growth is likely to pick-up, growth in Europe will remain resilient. Such resilience is first and foremost the result of renewed confidence in the European Union's political institutions. It is also being facilitated by the fact that China's import demand for European goods will slow down only moderately. China, in fact, is likely to tighten but thanks to its increasingly more flexible exchange rate regime (which has seen the Renminbi appreciate substantially against the US dollar, whilst losing terrain against the euro), it is likely to do so

in a gradual and orderly manner. This is good news for emerging economies. Having said so, the prospects of a China slowdown (however well managed) and the end of US dollar weakening will make the global environment more challenging for emerging markets.

As for political risks, we have long argued that they were generally overstated, and particularly so in Europe. We still think that populism is being "caged in" by institutions that have a decades-long track record of guaranteeing economic growth. So for the moment President Trump is unlikely to trigger a full blown global trade war and Brexit is clearly not leading to further EU disintegration. As for North Korea, tensions are likely to linger for years but neither party wants a full blown conflict, which would lead to the destruction of the North Korean state and potentially millions of casualties on both sides of the peninsula.

As for policy opportunities, we expect tax cuts and post-hurricane infrastructure spending in the US to exercise a very positive impact on specific equity sectors, but a minor and transitory impact on general economic growth. But here is the catch. Right now capital markets, and in particular equities, don't need strong growth to continue to perform well. They just need continuing growth. In that regard a US tax policy that provides a moderate uplift to an already favourable growth scenario might be better than a US tax policy that would trigger an overheating of the economy. Markets are aware of that too.

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

Market Performance

October 2017

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest 30 Sep closing	Quarterly Change % (Q3 2017)	YTD Change % (30 Sep)
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Index Snapshot (World Indices)

S&P 500	2,534.6	4.0	12.5
Dow Jones	22,641.7	4.9	13.4
Nasdaq	6,531.7	5.8	20.7
DAX	12,902.7	4.1	11.7
Nikkei 225	20,647.0	1.6	6.5
FTSE 100	7,468.1	0.8	3.2
Sensex	31,651.9	1.2	17.5
Hang Seng	28,376.0	6.9	25.2

Regional Markets (Sunday to Thursday)

ADX	4,441.1	-0.6	-3.3
DFM	3,570.2	5.1	0.9
Tadawul	7,244.4	-1.9	1.0
DSM	8,284.7	-8.0	-20.4
MSM30	5,225.24	0.4	-11.2
BHSE	1,278.1	-2.0	5.2
KWSE	6,664.8	-1.2	16.2

MSCI

MSCI World	2,009.6	4.4	14.2
MSCI EM	1,097.0	7.0	25.5

Commodity	Latest 30 Sep closing	Quarterly Change % (Q3 2017)	YTD Change % (30 Sep)
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Global Commodities

ICE Brent USD/bbl	55.7	20.1	1.3
Nymex WTI USD/bbl	50.09	12.2	-3.8
OPEC Basket USD/bbl	54.6	21.0	3.6
Gold 100 oz USD/t oz	1,276.2	3.1	11.5
Platinum USD/t oz	917.1	-1.5	1.0
Copper USD/MT	6447	9.8	17.9
Aluminum	2,116.25	8.9	22.8

Currencies

EUR	1.1772	3.4	12.3
GBP	1.3267	2.9	8.6
JPY	112.53	0.1	-3.8
CHF	0.9720	1.1	-5.0

Rates

USD Libor 3m	1.3356	2.7	33.7
USD Libor 12m	1.7907	2.5	5.7
UAE Eibor 3m	1.5597	2.8	5.6
UAE Eibor 12m	2.1758	1.8	3.7
US 3m Bills	1.0483	-42.0	109.2
US 10yr Treasury	2.3176	1.3	-4.5

Executive Summary

- ▶ The rise in geopolitical tensions contrasts with the synchronized pick-up in global growth. In our assessment geopolitical tensions are here to stay, in particular in the Far East. However, over the next 12 months it seems unlikely that such tensions will morph into any full blown conflict. Geopolitical tensions might create temporary volatility, but moderate global growth will remain supportive of risk assets. As such geopolitical tensions might well create buying opportunities.
- ▶ The Federal Reserve is likely to err on the side of caution when it comes to raising policy rates. Only a more significant increase in wages would justify four more rate hikes by the end of 2018 (as implied by the Fed's so-called "dot plot"). If that would happen it would be the reflection of stronger growth and we would likely see a more sustained pick-up in bond yields as well as still buoyant equity markets. However, if wages and inflation remain subdued, the Fed will be reluctant to raise rates which will be beneficial to both bonds and equities. What matters is that the Fed will focus on shrinking its balance sheet and will remain very cautious when it comes to hiking rates.
- ▶ The true wild card remains China. China's debt accumulation, with overall private debts well above 250% of GDP is unsustainable and as such we expect the authorities to start tightening after the National Party Congress that will take place this month. We think that a slowdown in China will keep a lid on global growth without causing too many jitters in the markets. We steer clear from markets with a high dependency on China.
- ▶ Some US fiscal stimulus and tax reform is still likely to be introduced before the end of 2018, it makes sense to play the sectors and geographies that are most likely to benefit from this domestic US stimulus.
- ▶ The "reflation" theme is bad for emerging markets, although those with sound external balances could prove more resilient. Energy prices are likely to remain supported by OPEC discipline whilst metal prices are likely to feel downward pressure as a result of China tightening. Precious metals remain a good hedge against market turmoil, even if more Fed rate hikes are unfavorable for them.



Overview

October 2017

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 hikes for the moment. Yet, yields might pick-up somewhat 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. Further upward normalization of the long end is most likely in core and high quality Euro-zone bonds.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive. Volatility in oil prices could prove detrimental, particularly for the US junk bonds.
US Treasuries	Overweight duration	Bond yields will remain contained in the near-term given Fed's gradual tightening pace and lack of clarity on US fiscal policy.
EM hard currency bonds	Selectively overweight but reduce duration	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 USD sovereign and quasi-sovereign bonds. We maintain our neutral stance on Indian local currency sovereign bonds.

Equity Markets

US	Overweight	The market has priced out any fiscal policy boosts by the Trump administration. We think this is a mistake and expect to see changes to the corporate tax rate in the US before the end of the year. This will boost US corporate earnings. We also view the rotation out of tech stocks and into other parts of the market as a healthy development.
Eurozone	Underweight	A stronger euro, as we have witnessed in recent months will at some point undermine the equity market rally in the single market given the large share of revenues which Eurozone corporates derive from overseas (over 50%).
Japan	Overweight (US dollar-hedged)	Japanese equities are cheap compared to US equities, while the BoJ's yield curve targeting is likely to keep the yen under pressure. This is good for Japanese corporate earnings.
Emerging Markets	Underweight	EM equities have been driven by the downshifting in US interest rate expectations, leading to a weaker 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	We cut our hedged overweight call on UK large-cap equities to neutral as political uncertainty is overshadowing the benefit to UK corporate earnings from a weaker pound.

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.
Industrial Metals	Underweight	China tightening will put downward pressure on industrial metals.
Precious Metals	Overweight	The "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	The pound sterling is likely to remain under pressure as the prospective rate hikes have by now been discounted in the price.
JPY	Further depreciation likely	The combination of moderate Fed tightening and BoJ yield curve targeting is likely to push the yen down further.

Steady growth amid continuing fiscal consolidation

Fiscal consolidation laying groundwork for growth sustainability

Fiscal sustainability is by now largely reflected in a significant reduction of the GCC countries' oil break-even prices. It needs to be said that not all countries are on an equal footing in that regard. Whilst serious concerns remain with regard to the fiscal positions and debt levels of Bahrain and Oman, the UAE and Kuwait shine in that regard given their public finances are perfectly under control. Saudi Arabia is a special case where more reforms must happen both in terms of liberalization of its economy and fiscal consolidation. Yet, the country seems to have the right political momentum with the government committed to an agenda of gradual, but continuous reforms. However, in the short term the region is struggling to gain significant cyclical momentum as the lagging impact of fiscal consolidation still has to play out. This was inevitable: It is better to have lower growth now so as to make growth more resilient in the future, which is only possible with sound public finances. The VAT introduction should also be helpful in that regard.

Oil price to help

With prospective domestic growth gradually picking up – Saudi Arabia is committed to a significant jump in infrastructure spending and Dubai is continuing to spend for the upcoming Expo 2020 – the stronger oil price is also likely to help. Global crude inventories have been coming down, as shale production is less resilient. We expect OPEC, together with Russia, to maintain production controls. The upside potential for the oil price might be limited, but neither do we see the risk of a major correction. This is particularly important for the fiscally more fragile countries such as Bahrain, Oman and Saudi Arabia, allowing them to set their spending and taxing targets with more certainty as to the break-even levels. Gradually this will give local capital markets more confidence, which is critical at a time when the US interest rates, to which the GCC countries are pegged, are on the rise.

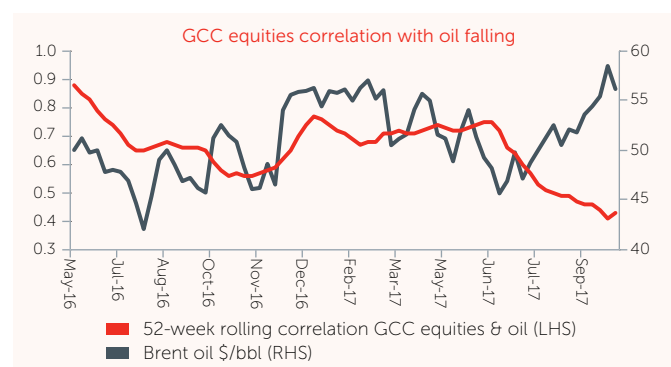
Fixed Income: Improved appetite supporting demand

GCC credit default spreads have tightened recently on the back of rising oil prices and an improving fiscal outlook thanks to lower government budget deficits. Saudi Arabia recorded the largest drop in the CDS level ahead of its first global conventional dollar bond issuance this year and also on the back of an improving fiscal balance. Overall the appetite for dollar bonds has been quite strong in the region mainly driven by better interbank liquidity conditions, low interest rates and investors' search for yield. This has allowed GCC countries to successfully tap international markets in the first half of the year with Abu Dhabi raising USD10bn worth of dollar bonds, Saudi Arabia issuing USD12bn of dollar bonds and USD9bn of global sukuk, Kuwait raising USD8bn while Oman and Bahrain issuing USD5bn and USD3bn worth of bonds recently. More dollar sovereign issuance is expected before year end and is likely to continue to be well received by investors.

However, we remain biased towards high quality sovereigns such as the UAE and Kuwait given the backdrop of geopolitical tensions. Saudi Arabia remains attractive taking into account the country's commitment to fiscal consolidation and economic diversification. In contrast, Bahrain and Oman are comparatively less attractive even though their bond issuances have attracted strong demand. This is mainly due to their weak fiscal position and rising public debt levels.

Equities –remain neutral

Regional markets have decoupled from oil prices. The 52-week rolling correlation between oil prices and regional equities has fallen to its lowest in 15 months at the time when oil prices have rallied sharply from June lows. Typically reduced expectations of US monetary tightening, a weakening US dollar and strengthening oil prices would propel regional equities higher. However, GCC equities have been unable to benefit from this favourable backdrop due to rising geopolitical uncertainty in the region as well as still ongoing fiscal consolidation. As a result GCC equities have underperformed emerging and developed equities by 23% and 12% respectively year-to-date. Looking ahead we expect the broader backdrop for regional equities to slightly deteriorate, meaning (somewhat) tighter US monetary policy and a more stable to stronger US dollar. In this environment it is difficult to envisage regional equities strongly outperforming. However, valuations are reasonable with dividend yields standing out as among the highest in the EM space. Furthermore, reforms continue to take place in the region, in particular in Saudi Arabia. The Kingdom's addition to the MSCI watch list for potential inclusion into the MSCI emerging markets equity index should act as a catalyst for further reforms. We hold a tactical overweight recommendation on Saudi equities.



Source: Bloomberg

United States

October 2017

Growth remains steady, risk assets still to benefit

How important is the inflation mystery for risk assets?

Since markets are doubtful about the Federal Reserve's ability to carry out their intended 100bps in rate hikes through 2018, the clearest risk is that markets are underestimating the inflation potential, and are therefore too complacent with the current level of interest rates. In reality, inflation is likely to remain contained and any hikes over and on top of say 50bps would be conditional on growth also substantially picking up. In such a case bond markets would suffer, but equity markets might should fare well. In our base case scenario of fewer rate hikes we expect bond markets to trade sideways and still see upside potential for equity markets. In other words, we believe that inflation is structurally lower than it used to be. As a result the economic cycle can last longer and so too the financial cycle.

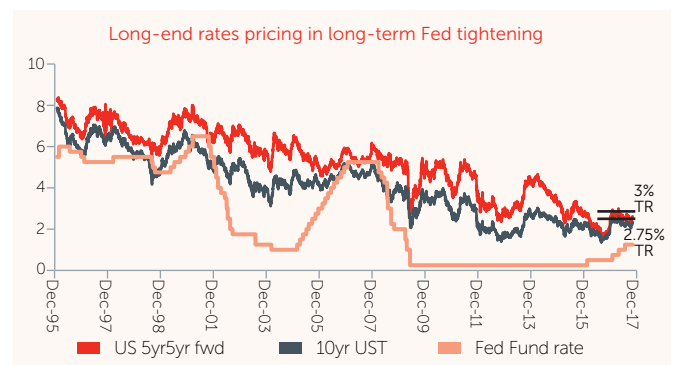
US growth to prove resilient, but expect no miracles

US growth has been firming after it disappointed in the first quarter of 2017. Whilst growth is likely to pick up further through 2017, and also do reasonably well in 2018, we do not expect it to steadily return significantly above the 3% annual rate which we were used before the 2008 crisis. This is because wages are growing modestly despite employment peaking. The depreciation of the US dollar, fiscal stimulus and some infrastructure spending that will repair the damage of the hurricanes are factors that will trigger an uptick in growth, but their impact will be mostly temporary. Modest growth and contained inflation are ideal for capital markets. Over time they could of course trigger imbalances through asset bubbles. As explained in the bond and equity sections below, we believe that we are not there yet.

Fixed income: Overweight duration on US Treasuries

US Treasuries have been in a sweet spot thanks to the rise in safe-haven demand amidst the resurgence in geopolitical risks. Even the "less dovish" Fed statement failed to have much of an impact on treasuries, particularly at the long-end of the curve. Only recently have 10-year treasuries come under pressure on account of the rising prospects of tax reform in the US. However, the daily trading range has been moving lower, from 2.3-2.6% in the first quarter to 2.2-2.4% in the second quarter and 2.0-2.3% in the third quarter. We expect 10yr yields to remain range-bound (2.2-2.5%) in the near term in the absence of any significant rise in inflation pressures or wage growth. Even though the Fed maintained its dot plot with four more hikes until 2018, the central bank still appears confounded by the stubbornly low inflation. The Fed also lowered its long-term terminal rate to 2.75% from 3% previously and downgraded its inflation forecasts. With the 5yr5yr forward rate already trading near 2.75%, back-end rates are almost pricing in the Fed's tightening plans. As such, any upward movement in long-end yields is likely to be limited. We remain overweight US treasuries which stand to benefit from

safe-haven flows in a risk off environment. However, in a risk-on world, 10yr yields are likely to move to the higher end of the range given the stable growth outlook in the US.



After coming under pressure in August owing to geopolitical tensions, US credit spreads have tightened again helped by the returning risk-on environment and less dovish Fed stance. In fact, the recent movement in spreads coincides with the strengthening dollar, highlighting investor optimism about the US economy. Most of the spread tightening has been recorded in the low quality high-yield bonds, particularly the energy sector which received a boost from the rise in oil prices. In contrast, investment grade bonds have been under pressure. With valuations looking stretched, we remain underweight on US junk bonds.

Equities – remain overweight

We maintain a modest overweight on US equities. Although on some metrics US equity valuations appear stretched, in the context of low inflation, still low interest rates and ample liquidity the market can sustain such valuations for some time. We still expect tax reform to happen, although this is now a 2018 story. Failure on health care should not be the yardstick to measure the likelihood of tax reform with. The market has priced out the possibility of tax reform based on the underperformance of high effective tax paying stocks relative to the market. This means that any progress on tax reform (in particular corporate tax reform) will likely be an upside surprise and can lead to a jump in corporate earnings expectations. US equities will behave most resiliently in the event of an eventual market pull-back, something we have not seen since the June 2016 Brexit referendum. As such, we believe that it makes sense to keep lower beta US equities overweight.

Growth to roll over

Growth to roll over with strong euro and China tightening

It is reasonable to expect growth to slow down somewhat after the 5% appreciation of the Euro-zone's real effective exchange rate in 2017. The same rate is now up almost 10% since it bottomed in 2015. More importantly, growth in China is going to slowdown and Europe, in particularly Germany, has always been particularly sensitive to the Chinese cycle because of its significant exports to that country. Nonetheless, continuing accommodating monetary policy – ECB tapering is unlikely to significantly alter overall financial conditions – and some fiscal leeway (see next section) are likely to keep growth rates around current levels along with continuing but gradual reduction in unemployment.

Post-election to favor economic resilience

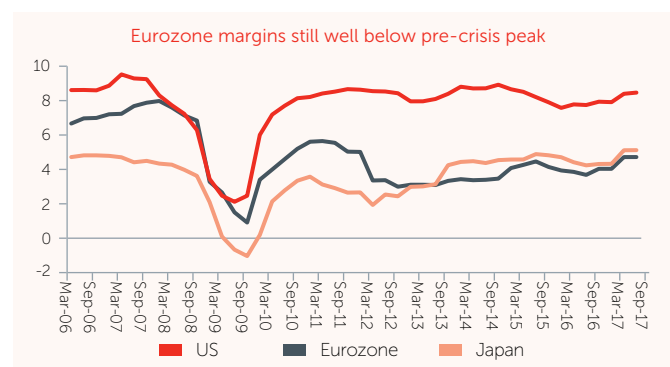
In our assessment the situation in Catalonia (Spain) and the spring elections in Italy are not likely to increase political risk in the European Monetary Union. In other words, now that the Dutch, French and German elections are behind us there clearly is scope for reforming the institutions of the single currency area and to some extent promote more growth. We expect more political integration but, at the same time, we expect the core countries (mainly Germany) to make only a piecemeal fiscal transfer concession. Critically, we expect this concession to come over a longer horizon and be conditional on France and the periphery economies implementing micro-economic and labour market reforms. Such a scenario of "increased" cooperation may not necessarily boost growth in the immediate term but will at least make it more resilient over the years to come. In addition, it is worthwhile to mention that Germany might well provide significant fiscal stimulus in 2018 in the form of lower income taxes and spending on education and infrastructure. Some of this spending will spill over to the area's weaker economies, thus contributing to some extent to some rebalancing between the core and the periphery.

Fixed Income: Bund yield curve to steepen

Similar to US treasuries, bund yields have remained fairly range-bound, benefitting from safe-haven demand due to the rise in global geopolitical tensions and more recently political tensions within the region. With the most recent bout of political risk expected to subside, market participants will focus on the October ECB meeting where Central Bank Governor Mario Draghi is expected to announce his QE tapering plans. The limited rise in German bund yields indicates the market's expectation of a more gradual tapering. However, some form of tapering is priced in as indicated by the German bund yield curve which has bear-steepened in the same way as the US Treasury curve did before the Fed's 2013 tapering announcement. With the opposite flattening trend taking place in the US treasury curve, we continue to expect 10 year US Treasuries to tighten versus their German bund equivalent.

Equities – Upgrade to Neutral

We upgrade Eurozone equities from underweight to neutral. Any tapering of the ECB's bond buying program is by now mostly discounted by the market and is unlikely to lead to further euro strength. Monetary policy will remain very loose in the Eurozone given that the ECB ultimately sets policy for the periphery and not the core, with the periphery not yet able to handle significantly tighter monetary policy. Given the resilient global macro backdrop European equities' higher beta and greater cyclicality of earnings will keep them well bid. Although economic momentum in the Eurozone is likely to slow, growth will remain steady. Still robust growth in the Emerging World (Eurozone corporates derive c50% of their revenues from overseas, a large chunk of which comes from EM) means that European corporates' top-line can continue to expand, albeit at a slower pace given surge in the euro this year. At the same time real wage growth remains close to zero meaning that cost pressures are subdued. Eurozone margins can therefore continue their upward trend, having bottomed in mid-2016 (chart below). Valuations continue to trade at a discount to US equities while dividend yields stand comfortably above that of the US as well (3% vs. 2%). We upgrade to neutral rather than overweight because Eurozone equities are likely to underperform during an equity market correction which will become inevitable at some point.



Pound sterling unlikely to surge

The moment of truth is still far away

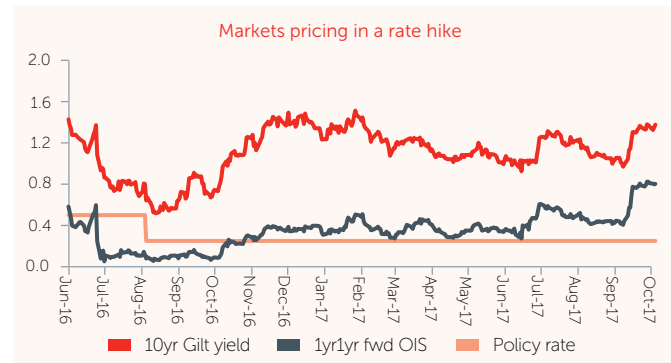
After Mrs. May's speech in Florence, where she argued for a Brexit transition period after March 2019 when the two year negotiation deadline expires, hopes have emerged that some deal on the divorce bill, the UK-Ireland border and citizens' rights is in sight. Such a deal would pave the way for negotiations to start on an agreement governing the future relations between the UK and the EU. Such an agreement would essentially be a trade agreement. Whilst the UK is most concerned for clarity in its future trade and economic relations with the EU, the latter insists more progress must be made on clarifying the effective parameters of the divorce itself. We would not expect to see a breakthrough on these issues before the end of this year given that Mrs. May's position remains weak within the UK parliament and her own party, and the EU is likely to continue playing hardball at least until the new government is formed (i.e. for some months to come).

Pound sterling to remain under pressure

The lack of a clear endgame – which crucially leaves open the possibility of no deal at all by March 2019 – is likely to keep the pound sterling under pressure. We do not believe that the Bank of England will push through major rate hikes over the coming year. By now the inflationary impact of the devaluation has fed through into domestic prices, whilst the rebound of the pound and long term yields fully discounts one imminent hike. Both prices and economic growth are likely to move sideways. In the short to medium term, the global economic expansion will benefit the UK economic cycle, quite independently of its future relation with the European Union, and by implication with the rest of the world. In other words, the uncertainty will keep a lid on the currency, but for the moment has fewer implications for the broader economy.

Gilts: Gilt market pricing in a rate hike

Gilts have come under pressure on the rising possibility of a rate hike after the BoE raised concerns over the jump in inflation pressures. The 10yr gilt yield has climbed almost 40bp partly in reaction to the hawkish tilt by the central bank. Markets are now pricing in almost 87% probability of rate hike in November. However, any upward movement in gilt yields is likely to be limited now given a rate hike is fully priced in. In addition, given the weak economic outlook, the central bank is unlikely to remain in a hiking mode as this could prove detrimental to the economy. Inflation pressures could also fall due to the pass-through effects of the sharp pound appreciation observed recently. Further, Brexit complications are likely to linger in the near term, supporting safe-haven demand for gilts. However, any downside in gilt yields is unlikely to be massive given real yields remain in negative territory.



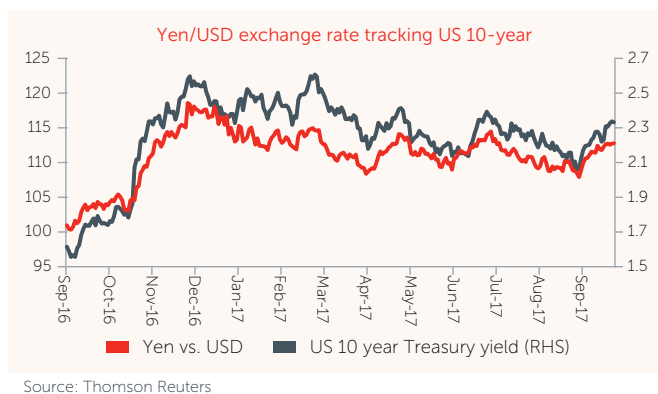
Equity – remain neutral

In our last quarterly we cut UK equities (hedged) to neutral from overweight. Since then UK equities have underperformed Eurozone equities by 3% in both local currency terms as well as in US dollars. The main rationale for our downgrade was that the relationship between a weakening pound and UK large cap outperformance broke down. Not only that but the pound has strengthened significantly in recent months as the Bank of England have signalled rates are likely to go up in the near-term. With inflation running well above target, the BOE feel compelled to act. However, hiking rates to rein in inflation in the context of weak growth may end up being counter-productive. This will weigh on the domestic side of the equity market (retailers, utilities, etc) whilst a stronger pound will impact corporate earnings for the (vast) export oriented part of the market. Ultimately, we do not expect the BOE to embark on a rate tightening cycle, meaning that downward pressure on the currency will return, but it may not be sufficient to generate sufficient investor enthusiasm for UK equities given overhanging Brexit related risks.

Will the BoJ join monetary policy normalization?

Doing better is not enough

There have been encouraging signs both in terms of economic growth and, critically, wage growth and consumer price inflation. With global growth expanding and given that an export-oriented country such as Japan should profit from that, it comes natural to ask oneself if the Bank of Japan will soon join the Federal Reserve and the European Central Bank and commence tapering its asset purchase programme. Such action would likely strengthen the yen which in turn would have an adverse impact on Japanese equities.



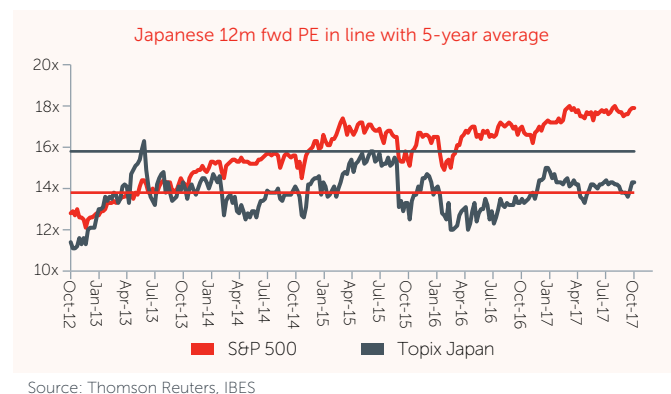
We suspect that a massive policy reversal is not yet on the cards. Inflation has picked up nicely, but the more reliable core consumer prices are registering growth that is barely in positive territory. A stronger yen would likely push it back into negative territory. In fact, whilst a strong export industry constitutes the key strength of the Japanese economy, anaemic domestic consumption demand because of an ageing population has kept the economy growing slowly for decades. As such, whilst the BoJ would want to limit the acquisition of more paper, it is unlikely to deviate from its zero target for 10-year government bond yields. At any rate, a strong showing for Mr. Abe in the upcoming election (something not unlikely given the recent tensions with North Korea) will allow the monetary authorities to stay their course for a little while longer. Finally, sideways moving US yields are likely to prevent an appreciation of the yen.

Equity – remain overweight

We maintain an overweight call on Japanese equities (currency hedged). Prime Minister Shinzo Abe's decision to call snap elections for later in October in the hope of shoring up his political support also has the potential to prolong the extraordinary monetary easing measures introduced by the Bank of Japan. This is positive for Japanese equities. Indeed, the signs are that all aspects of Abe's three arrows (monetary easing, fiscal stimulus and structural reforms) are now bearing

fruit. Unemployment has fallen sharply and companies are improving their return on equity, corporate governance and dividend pay-out ratios. Going into elections in Japan the market typically rallies before investors book gains on the outcome (buy the rumour sell the fact). This may be the case again, however, we believe the positive backdrop will continue post the October 22 elections, especially if US Treasury yields pick up and the yen depreciates.

From a valuation standpoint, at 14x forward PE Japanese equity valuations remain cheap, trading in-line with their 5-year average. US valuations in comparison are trading considerably higher. Overall our base case for the global economy is for the positive backdrop to continue. This is consistent with a weakening yen which will then feed directly into stronger corporate earnings expectations.



Gradual slowdown ahead amidst some improvement in macro-management

China the wild card over the next year, again

China's total debt as a proportion to GDP continues to grow as investments in the less efficient state enterprises are still expanding at a growth rate that is higher than economic growth. Average property price growth rates (measured over the country's 70 largest cities) have slowed down but in many areas real estate prices are by now at worrying levels. It is clear that the authorities will at least reduce the growth rate of real estate assets as credit will be reined in once the 19th National Party Congress draws to an end by the end of October. The balancing act will be to reign in credit growth for state owned enterprises while at the same time compensating for that with social security fiscal spending in favour of households. Still, we expect total stimulus (so-called total social spending) to move sideways at best (see below chart) but more likely begin to roll-over.



Source: Bloomberg

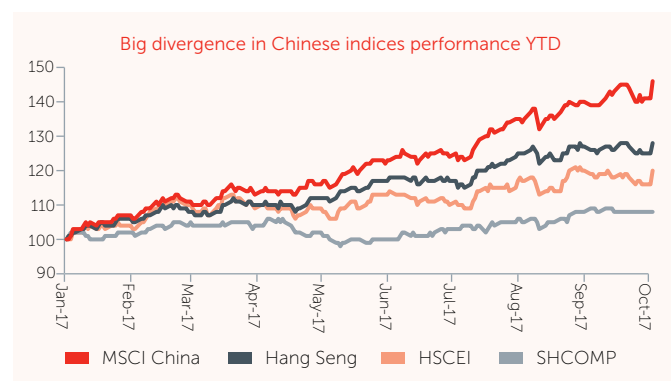
Macro-management has improved

There are reasons to believe that in 2018 China might succeed in muddling through again. A favourable global growth scenario combined with an improved management of the external exchange rate are less likely to lead to capital outflows which would put pressure on the country's forex reserves and thus its capacity to reduce stimulus in a gradual manner.

As for the global growth scenario, synchronized growth – specifically between the US and the Euro-zone is likely to prevent major currency oscillations, i.e. a strong US dollar rally is unlikely such that investors will have fewer doubts about the need to safeguard the country's exchange rate. At the same time the PBoC has allowed for increased exchange rate volatility, stepping back from excessive utilisation of foreign reserves. To the extent that President Xi Jinping intends to reinforce party control he will pursue only a gradual reduction of investments in state owned enterprises. He might be able to do just that in 2018, allowing the country to muddle through and postponing the solution of the country's debt accumulation further into the future.

Equities – remain underweight

Chinese macro data has been very stable in the backdrop of accommodative policy in the run up to October's National Party Congress. This has helped Chinese equities rally 13% and 15% year-to-date in US dollar for A-shares and H-shares respectively compared to 15% for global equities. Q3 however saw an outperformance of A-shares relative to H-shares, likely on the back of the former's (very gradual) inclusion into the MSCI Emerging Markets index from May 2018 onwards. MSCI's decision to begin including A-shares into its main EM benchmark will see inflows into Chinese equities of up to \$500bn over the next 5-10 years. Foreign ownership of Chinese equities is extremely low compared to other markets. However, near-term the key concern is how the market responds to a US dollar which will at the margin likely strengthen and Chinese monetary stimulus which will slow post the leadership gathering later this month. We believe that the risks to the Chinese equity market are growing and maintain an underweight position on the market.



Source: Thomson Reuters

A blip in the road

Double policy whammy on growth

The economic outlook appears to have deteriorated with indicators pointing to a deceleration in growth. GDP came in lower than expected for the third quarter in a row, expanding at the slowest pace since 2014 or since the new government took office. The lingering impact of last years' demonetization on growth, aggravated by the preparations for the July Goods and Services Tax (GST) have hurt manufacturing and investment activity. Most businesses had reportedly put off new manufacturing activity, focusing instead on offloading inventories in light of uncertainty pertaining to the GST processes ahead of its official implementation. With businesses still adjusting to the new tax structure, we expect to see a further slowdown in growth in near-term indicators.

With GST collection disappointing so far and slowing economic growth, the government is in a tough position. In a bid to avoid any political criticism ahead of state elections due in the next few months and the national election in almost two years, the government is likely to push through reforms to help revive growth momentum. However, any form of stimulus will make the government run the risk of fiscal slippage. The announcement of stimulus measures is likely to be cheered by market participants, but not at the cost of significant relaxation of fiscal discipline. As such, we remain wary of fiscal slippage risks and its potential impact on inflation.

Bonds: RBI is supportive but be wary of inflation and fiscal slippage risks

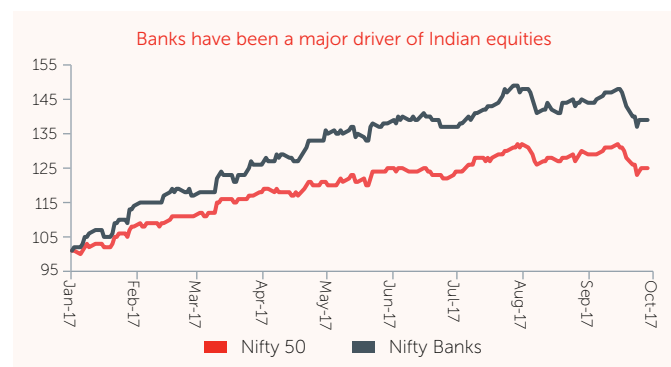
Despite the RBI reducing policy rates in August, Indian government bonds have been under pressure and yields have continued to rise. Even with growth showing signs of weakness, the market is currently not pricing in another rate cut this year. The RBI is expected to remain on hold until the end of this year with the onus of reviving growth momentum remaining on the government. In fact, the RBI will be more focused on managing price pressures which rose to a five month high in August. Inflation likely bottomed in July and is now expected to increase further, mainly on account of higher food and fuel inflation. The 7th Pay Commission Housing Rent Allowance and farm loan waivers are also likely to add to the inflationary pressures in the economy. However, if recent rupee strength and good monsoons are able to limit the price pressures within the target, then the RBI could be open to easing policy rates in order to boost growth. Overall, we expect the central bank to stay accommodative.

Fiscal slippage risk is likely to be a major concern for bond investors after the government indicated that they are considering measures to boost growth. If the government significantly overshoots the fiscal deficit target market participants will find it difficult to digest the already high bond supply, pushing bond yields up. As such, we maintain our neutral stance on government bonds.

Equities: remain overweight

Indian equities have outperformed global equities handsomely year-to-date, rising 24% vs 15% for global equities (in US dollars). However, in Q3 the market stalled, underperforming by 3%. A deterioration in some of the macro data in recent months is responsible for the pull-back, nevertheless, we maintain our long-standing overweight recommendation on the market. The implementation of the GST at the beginning of July is the likely culprit for softer macro data, however, we expect the economy to bounce back in the coming quarters. India is one of the few markets globally undertaking necessary structural reforms in order to boost long-term growth. The GST should be viewed as part and parcel of this process. A pickup in economic growth should also translate into better corporate earnings given the strong correlation between corporate earnings and nominal GDP in India. Valuations have become somewhat cheaper after the recent pull-back and deservedly trade at a premium to other emerging markets. Within the market we continue to prefer those sectors which are more highly geared to the strong domestic demand story in India. Banks in particular have performed well, recent pull-back aside.

Another reason to maintain a structural overweight on Indian equities is the fact that the market is more insulated (than other emerging markets) from global shocks, such as rising protectionism or commodity price sell-offs.

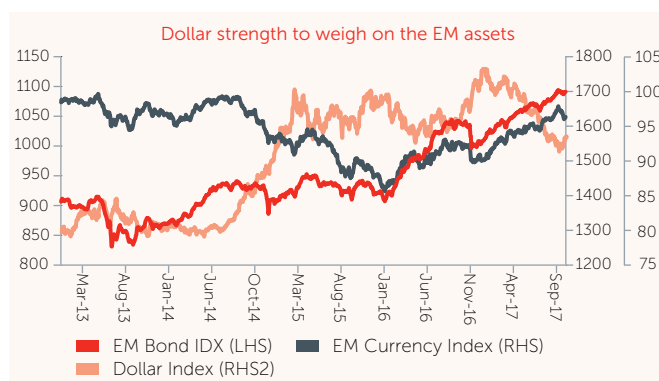


Source: MSCI, IBES, Thomson Reuters

Selectivity key in a dollar strengthening environment

Dollar strength and China tightening are major risks

Emerging economies have been unaffected by the plethora of risks since the beginning of the year, ranging from US President Trump's protectionist rhetoric to the rise in geopolitical tensions. Clearly, an improving growth outlook in developed markets, a weaker dollar and continued stability in Chinese growth have contributed to the performance of these markets. Even a more hawkish ECB during the summer failed to put a dent in the EM rally. While such macro risks have been dismissed by investors in recent times, we continue to have doubts over the sustainability of EM's outperformance, especially given the nascent pick-up in the US dollar and China tightening risks post October's National Party Congress.



Source: Bloomberg

In the past, an appreciating dollar and US hiking cycle has proved detrimental to most emerging economies. Whilst the fundamentals of many EMs have improved over past three years, a halt or reversal in the recent US dollar (weakening) trend poses a risk for the more fragile EM economies that have benefitted the most from dollar weakness. These are countries such as Brazil, South Africa and Turkey where fundamentals look weak in comparison with other emerging economies. These countries are also susceptible to a revival in domestic political risks. In addition, China tightening is one of the major possible risks not being fully accounted for by investors. Chinese growth is likely to slow down with the withdrawal of stimulus post the Party Congress in October. This slowdown could spill over particularly to the export-oriented emerging economies with strong trade linkages to China. By and large, these include most Asian economies including; Malaysia, Thailand and Vietnam but also countries further afield such as Brazil, Chile and South Africa.

As such, economies like Russia, Indonesia and India which have favorable domestic drivers, reform appetite and relatively lower dependence on Chinese growth are likely to outperform and will also remain more resilient to a potential appreciation of the US dollar.

EM Bonds- Selective opportunity in Russia and Indonesia

Sustained dollar weakness since the beginning of the year has provided a tailwind for the emerging markets sovereign bonds rally. Even bond markets with relatively weak fundamentals have performed well, supported by stable US rates. However, given our expectation that dollar weakness has likely peaked, a reversal in the recent rally cannot be ruled out and countries with fragile fiscal and external balances could be vulnerable.

We recommend taking profit on our tactical overweight stance on Turkish US dollar bonds. Post the April referendum, Turkish bonds continued to rally, supported by dollar weakness and an improvement in the domestic growth outlook. While the economy will remain supported by the government's fiscal spending, macro-economic fundamentals are not robust enough to withstand much external volatility. Separately, political uncertainty can resurface and could undermine business sentiment.











In contrast, we maintain our overweight stance on Russian and Indonesian USD sovereign bonds. Strengthening fiscal balances, strong external balances and declining inflation coupled with loosening monetary policy in these countries should help bring down the risk premium embedded in the sovereign dollar bonds.

Equities – remain underweight











We stick with our underweight on Emerging equities which has admittedly been the wrong call so far this year. Emerging equities have outperformed global equities by 13% year-to-date in total return terms. Almost half of the outperformance is down to US dollar weakness, something we do not expect to persist. Emerging equities' dependence on China continues to make the asset class vulnerable to a change in sentiment on China, especially with the National Party Congress due to take place in the coming months. Having said so, valuations trade at a considerable discount, earnings growth is strong and the external environment will remain supportive outside of any China-related shocks. A small underweight on the asset class is warranted in our view, although we continue to favor Indian equities within the EM space and maintain our long-standing structural overweight on India.

Appendix

October 2017

GDP Forecast	2017		2018	
	Consensus	ADCB	Consensus	ADCB
US	2.2%		2.3%	
Eurozone	2.1%		1.8%	
Japan	1.5%		1.1%	
China	6.7%		6.4%	
India	6.8%		7.5%	

Source: Bloomberg

CPI Forecast YoY	2017		2018	
	Consensus	ADCB	Consensus	ADCB
US	2.0%		2.0%	
Eurozone	1.5%		1.4%	
Japan	0.5%		0.7%	
China	1.7%		2.2%	
India	3.6%		4.5%	

Source: Bloomberg



In agreement



Expect significantly less



Expect moderately less

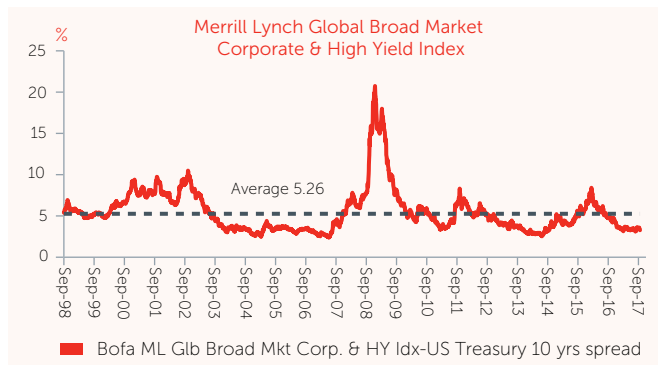


Expect significantly more

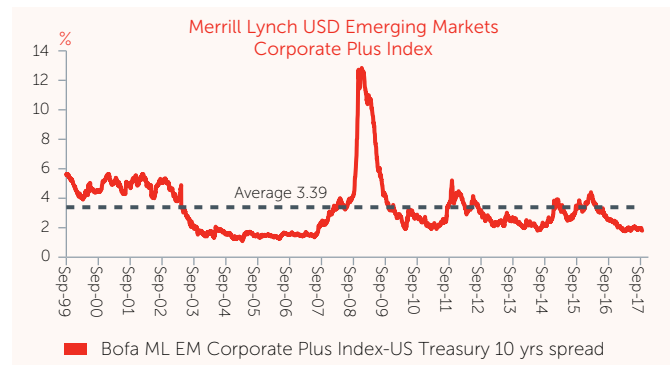


Expect moderately more

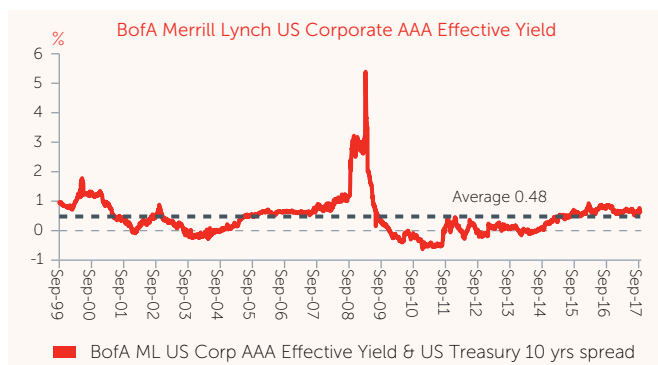
Bond Market Spreads



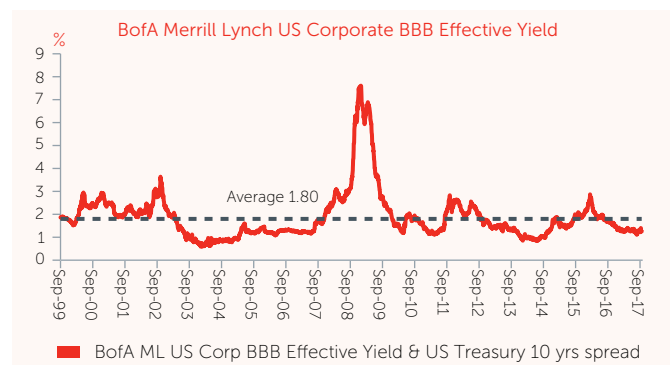
Source: Factset, Federal Reserve Bank of St. Louis



Source: Factset, Federal Reserve Bank of St. Louis

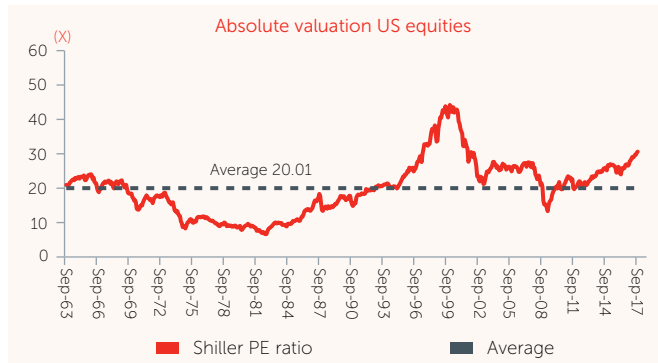


Source: Factset, Federal Reserve Bank of St. Louis

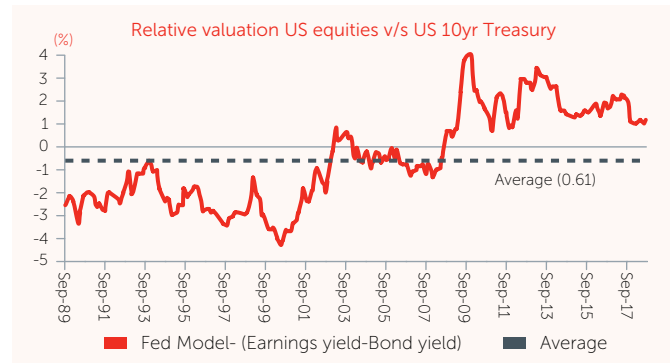


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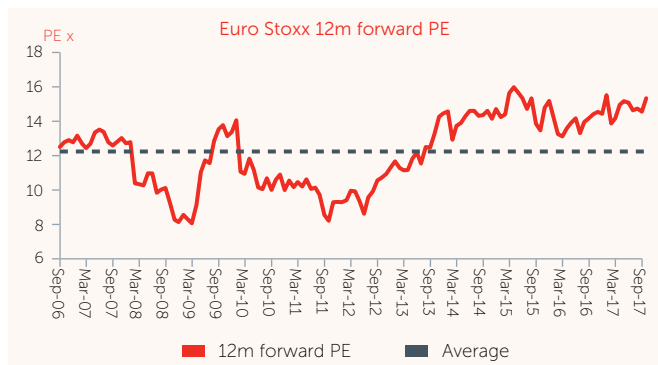
Equity Market Valuations



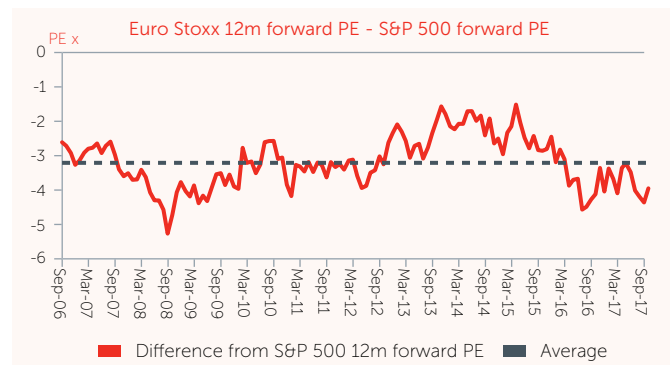
Source: Thomson Reuters, multpl.com



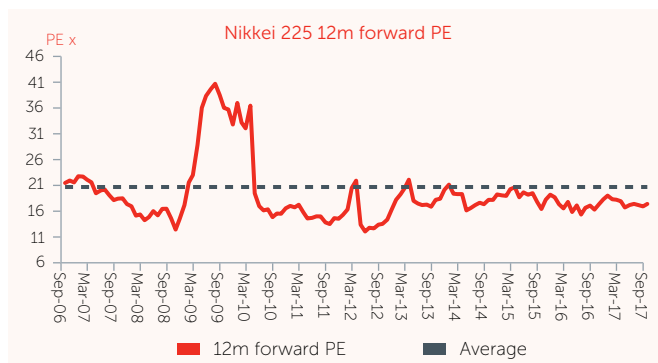
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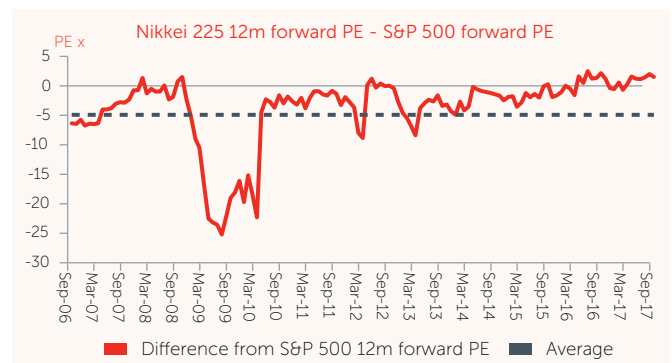
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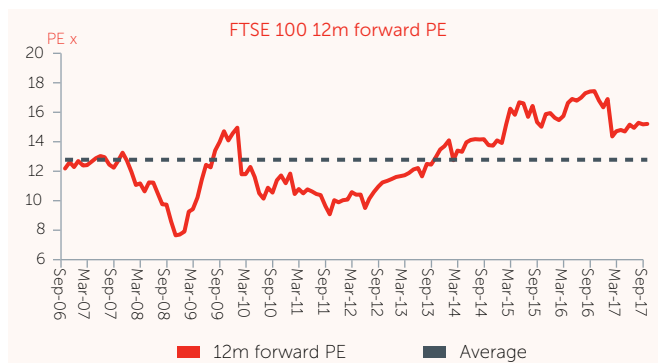
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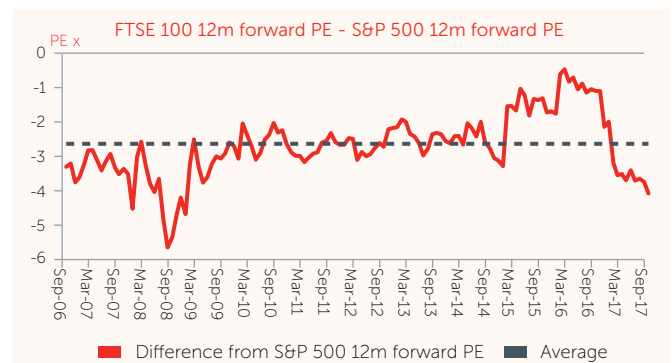
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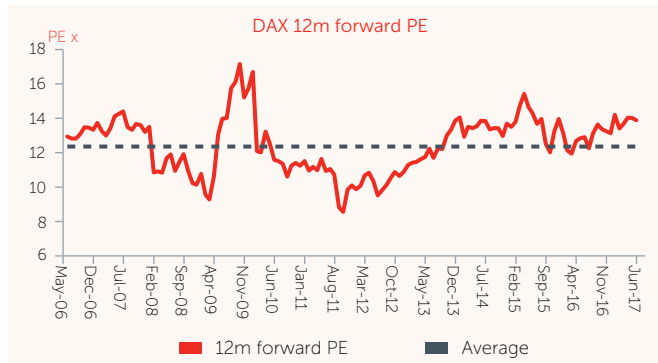


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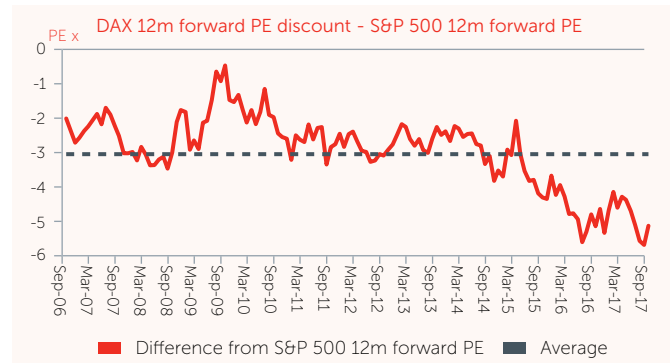
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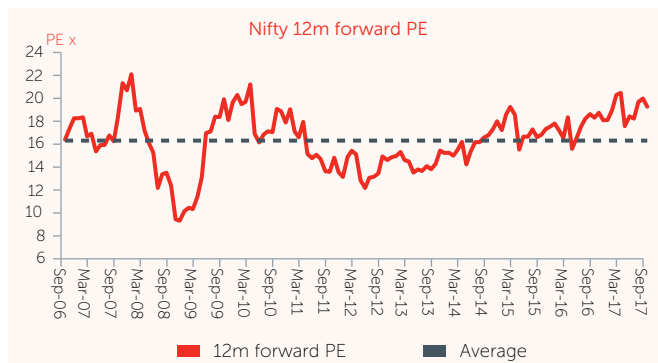
Equity Market Valuations



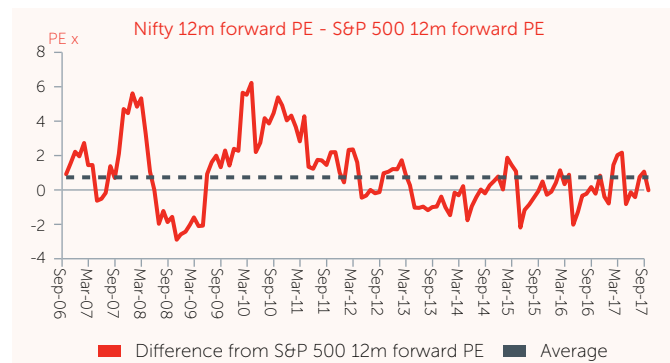
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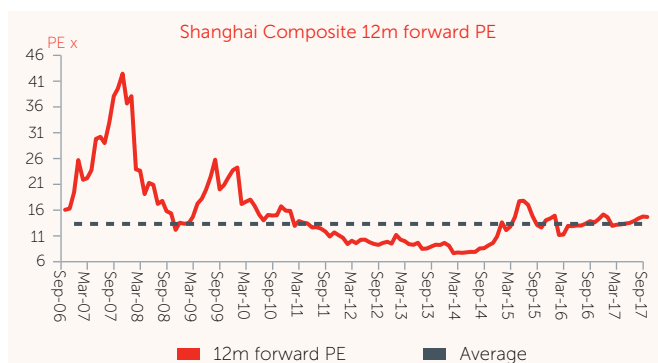
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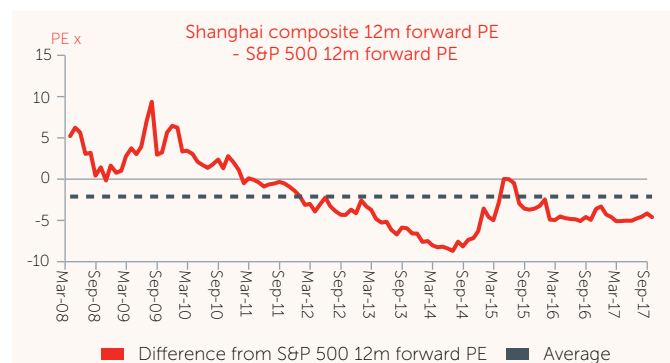
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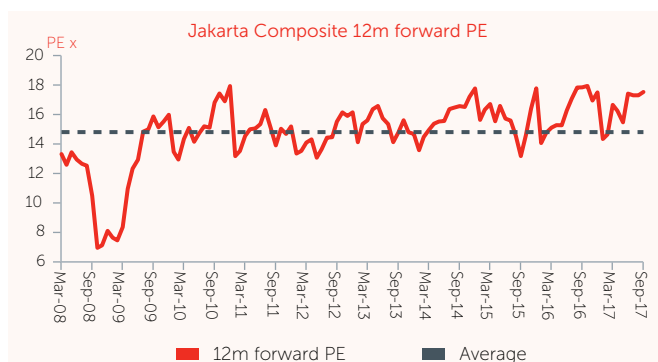
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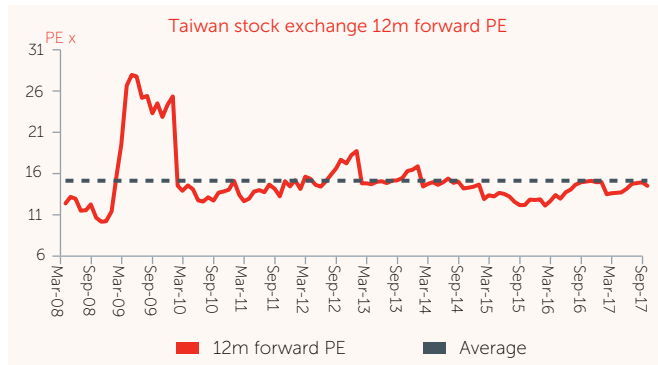


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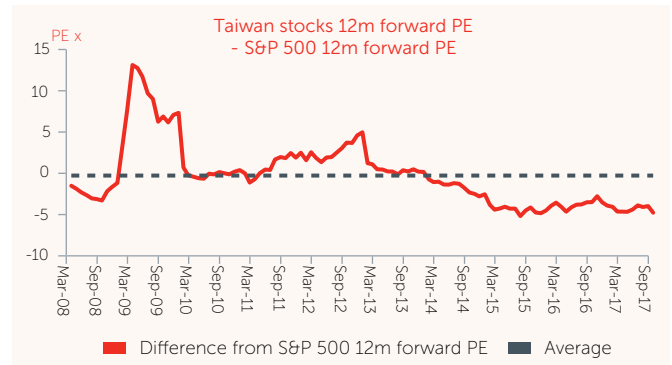
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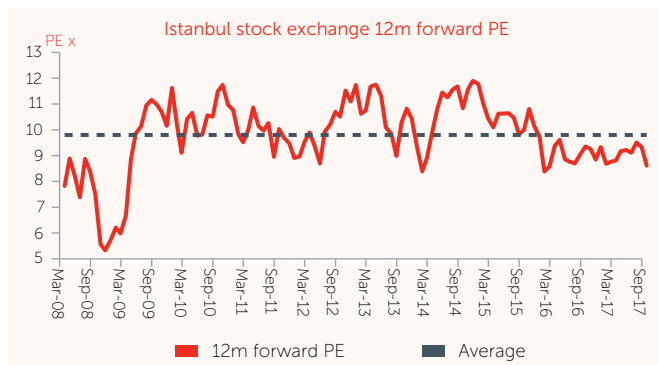
Equity Market Valuations



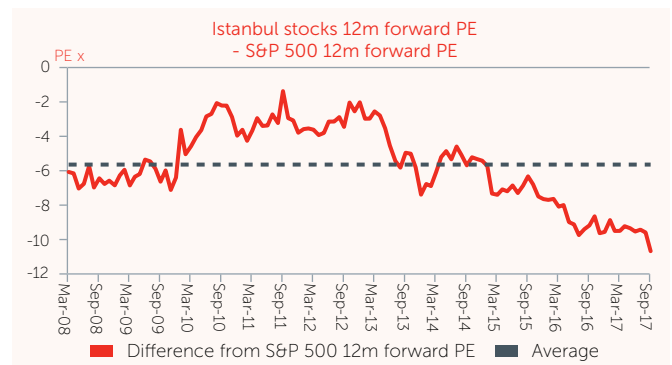
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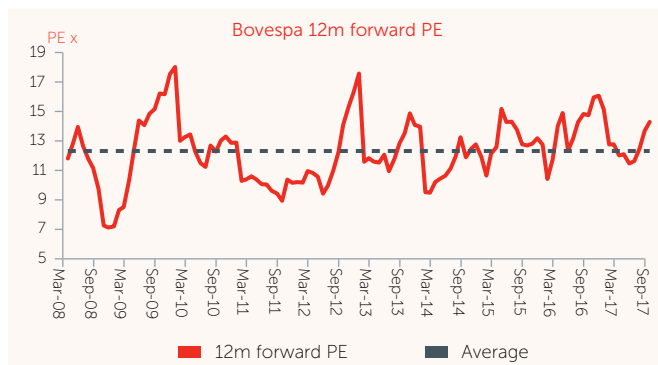
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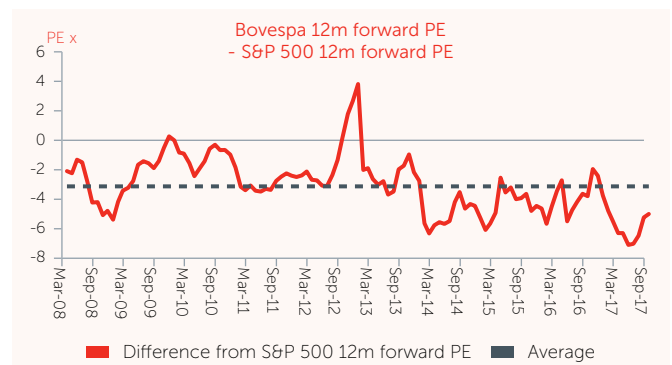
Source: Bloomberg



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Important Information

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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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