ADCB Asset Management

The Quarterly Investment View
April 2016

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بنك أبوظبي التجاري
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Contents

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Little scope for climbing the proverbial “wall of fear”

Whilst we were timely in calling the 2015 peak of global equity markets, we have been surprised by the recent recovery rally. And although that rally has left most markets still well below their earlier highs – the grand exception being of course the US equity market – it was strong enough to induce us to some proper rethink as to whether – maybe – we had turned too bearish. More specifically, when so much news is bad, might it be that markets are willing to climb the wall of fear, betting that the global economy – and thus companies’ revenues – might well survive the upcoming headwinds? After all, by now we know those headwinds all too well: a significant reduction of growth in China spilling over to the rest of the world, and increasingly ineffective monetary policies in developed markets. Are these headwinds – these major potential risks - already priced in, or simply overstated?

The likelihood of a significant China slowdown remains in our opinion very high. Leaving aside all the hype of transforming China from an investment- to a consumption oriented economy, it is worthwhile to restate that investments – not consumption – still constitute the bulk of aggregate demand in China. Reducing investments massively, would be incompatible with the stated goal of more than 6% yearly GDP growth for the coming years. So in order to avoid a too rapid pace of redundancies, China’s state owned enterprises continue to make inefficient investments and grow their debt burden. Market participants are of course fully aware of this, such that at least some part of the additional stimulus the authorities are currently providing will tend to flow out of the country. Given the country’s quasi-fixed exchange rate regime, the People’s Bank of China (PBoC) is then forced to intervene by buying back renminbi against foreign reserves, thus effectively withdrawing stimulus from the system. It is therefore clear that the returns of stimulus are quickly decreasing in China. Unless meaningful reforms are implemented the ever-increasing debt burden will at some point hit back with a vengeance. A significant devaluation of the renminbi is in our opinion still in the cards. That would trigger more devaluations across Asia, and rock many emerging markets that have high US dollar-denominated debt levels.

It must be said that the strong stance of the PBoC in favour of a stable currency – together with more stringent capital controls - has lately contributed to the renminbi regaining ground against the US dollar. It is less clear, however, precisely to what extent this can be attributed to action by the Chinese, rather than to global US dollar weakening. The latter being the result both of the abandonment by the European Central Bank (ECB) of a too aggressive negative interest rate policy and an increasingly dovish Federal Reserve (Fed). The fact, then, that the Fed is increasingly reluctant to allow for a stronger greenback unfortunately confirms our biggest concern: growth will remain sluggish in developed markets, and central banks are running out of ammunition to do anything about that.

Over the longer horizon we expect the US dollar to strengthen as central banks’ action will not be able to counter the persistent trend of US household deleveraging. Over the shorter term, a weaker US dollar might well be successful in clearing the United States out of the recessionary zone and preventing emerging market debt problems turning into solvency crises. So should we just bet on that and climb the wall of fear by overweighting equities in our portfolios? Unfortunately US equities are at the end of a seven year old bull-run, and valuations are – from most perspectives – at record highs: not exactly the right moment to be heroic on US equities. And if US equities will struggle, global equities are bound to remain under pressure too. It is better, thus, to maintain our equity underweight combined with an appropriate hedging position of US Treasuries.

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

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest 31 Mar closing	Quarterly Change (% Q1 2016)	Change 2015 (%)
Index Snapshot (World Indices)			
S&P 500	2,059.7	0.8	-0.7
Dow Jones	17,685.1	1.5	-2.2
Nasdaq	4,869.8	-2.7	5.7
DAX	9,965.5	-7.2	9.6
Nikkei 225	16,758.7	-12.0	9.1
FTSE 100	6,174.9	-1.1	-4.9
Sensex	25,341.9	-3.0	-5.0
Hang Seng	20,776.7	-5.2	-7.2
Regional Markets (Sunday to Thursday)			
ADX	4,390.4	1.9	-4.9
DFM	3,355.5	6.5	-16.5
Tadawul	6,223.1	-10.0	-17.1
DSM	10,376.2	-0.5	-15.1
MSM30	5,467.42	1.1	-14.8
BHSE	1,131.1	-7.0	-14.8
KWSE	5,228.8	-6.9	-14.1
MSCI			
MSCI World	1,648.1	-0.9	-2.7
MSCI EM	836.8	5.4	-17.0

Commodity	Latest 31 Mar closing	Quarterly Change (% Q1 2016)	Change 2015 (%)
Global Commodities			
ICE Brent USD/bbl	39.6	6.2	-35.0
Nymex WTI USD/bbl	38.34	3.5	-30.5
OPEC Baskt USD/bbl	34.3	9.8	-39.9
Gold 100 oz USD/t oz	1,232.8	16.2	-10.4
Platinum USD/t oz	975.7	9.4	-26.2
Copper USD/MT	4,855.5	3.3	-26.1
Aluminium	1,508.75	0.2	-17.9
Currencies			
EUR	1.1380	4.8	-10.2
GBP	1.4360	-2.6	-5.4
JPY	112.57	-6.4	0.4
CHF	0.9618	-4.0	0.8
Rates			
USD Libor 3m	0.6286	2.6	139.7
USD Libor 12m	1.2104	2.8	87.3
UAE Eibor 3m	1.0251	-2.8	55.8
UAE Eibor 12m	1.5793	7.1	45.2
US 3m Bills	0.1983	-42.0	358.5
US 10yr Treasury	1.7687	-22.1	4.5

Executive Summary

- Whilst the Federal Reserve is likely to pursue only very modest rate hikes in 2016, the European Central Bank (ECB) and the Bank of Japan (BoJ) seem to be reaching a stage where their unconventional policies are becoming increasingly ineffective.
- US growth will remain sluggish at best. Europe's growth momentum is likely to suffer. Japan seems to be heading in recession. We might see some positive surprises amongst non-commodity exporting emerging markets. Commodity exporting- emerging and advanced economies to remain under pressure.
- The sluggish global growth environment and potentially limited monetary policy remedies will keep a cap on equities. During risk-off episodes US equities are likely to provide better downside protection than other equity markets.
- China's reform and growth problems will remain with us for a longer period.
- Some emerging markets which are not exposed to commodity prices and where the reform process seems to be more promising, such as India, should be able 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.
- Energy prices have rallied sharply from multi-year lows in February. However, we see upside potential capped due to little change in the overall demand-supply dynamics.
- Industrial metals have still more downside given the ongoing transformation of China's economy.
- Precious metals could see periods of gain, especially during phases of strong risk-aversion. However, we believe that secular deflationary trends will keep gains transient.

Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Better stay long	A dovish Fed and global secular deflationary trends will keep yields lower.
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 exporters not only face growth issues but they seem to be more prone to currency volatility. Among commodity importer countries' bonds, we still prefer USD bonds rather than local currency bonds because of possible currency volatility.
Equity Markets	Underweight	
US	Overweight	We overweight US equities primarily because we see greater downside risk on global equities and in such an environment the former are likely to decline less than their global peers.
Eurozone	Underweight	We are underweight Eurozone equities as we see higher downside risk to global equities, and in such a scenario the relatively high beta Eurozone equities are likely to decline more than US equities.
Japan	Underweight	"Abenomics" seems to have yielded little results in terms of improving fundamentals of the economy. Now that the currency focused BoJ's QQE is touching its limit, Japan equities are unlikely to get any support.
Emerging Markets	Generally underweight some selectively overweights	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 Mexico.
Energy and Commodity Prices		
Energy	Neutral	Notwithstanding the recent rally in the oil price, we see little changes in demand-supply dynamics which gives reasons to believe that the oil price could continue to see volatility.
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 pressures are likely to continue in the commodity space.
Precious Metals	Neutral	Global deflationary trends and the vanishing of emerging markets' current account surpluses are unfavorable for precious metals.
Currencies		
EUR	Range bound with a downward bias	In 2016 the euro will weaken only marginally against the US dollar since the limited prospective rate hikes by the Federal Reserve are now to a large extent priced in. We could see some minor downward pressure especially if the ECB takes more decisive QE action. A more significant appreciation of the US dollar would only 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	Range bound with an upward bias	The pound sterling should weaken even less than the euro, and might even rise against the US dollar, since the UK business and monetary cycle is ahead of that of the Euro-zone. The Brexit referendum, however, will keep the currency pair quite volatile.
JPY	Range bound with a downward bias	The Japanese yen is expected to remain relatively stable especially after the recent gains against the US dollar as long as the BoJ will for the moment not increase QE. But the yen being a carry trade currency, it should see temporary rebounds during global risk aversion phases.

Valuations a plus, but oil price likely to cap upside potential

The recent oil price rally has not significantly altered market sentiment

After having touched a multi-year low in January oil staged an impressive recovery rally in the months of February and March. Whilst this recovery provides a sense of relief for the Gulf Cooperation Council economies, it has not significantly altered the markets' sentiment. Key factors that keep on worrying the market are persistently rising inventory levels and surprising resilience in the high cost production. Some have interpreted the Doha talks between Saudi Arabia and Russia as the start of some freezing of production, eventually to be extended to other oil producing countries. Whilst these talks might have taken some selling pressure off the market, they have done little to provide comfort to potential buyers. The oil price is likely to remain volatile in the near term. We might see some upside pressure as supply disruptions occur in some countries like Nigeria, Venezuela and Iraq. In addition, shale output will finally – at least to some extent - fade. The futures market seems also overstretched on the short side. However, while the oil price might see some further rebound, we will not see significant rises through 2016.

Fiscal constraints to continue...

The persistence of an oil price that remains well below the level we were used to as short ago as 2014, implicates that fiscal constraints will continue to bite into the GCC countries' growth prospects, for sure throughout 2016. And whilst it is reasonable to expect average quarterly prices to be somewhat higher than the first quarter number (at 35.2 US dollar a barrel), it is much less likely to bounce back to the average of last year, which is at 53.6 US dollar a barrel. Moreover, GCC countries are now firmly in a mood of revising their spending patterns with the prospect of permanently lower oil prices. As such, even if a significant recovery in the oil price might well take away some of the fiscal constraints, it is likely to be viewed as temporary anyway. Thus it will not alter the basic fact of more restrictive fiscal policy stances, ultimately dampening growth independently of the oil price gyrations.

Governments' revenues are expected to decline from 41.2% of GDP in 2014 to 31.2% in 2016, according to IMF estimates. Note that nominal GDP is also expected to decline by almost 10% during the same period, suggesting that the actual government revenue decline would be even more pronounced. However, the degree of the fiscal constraint will vary across the member countries – Saudi Arabia, Oman and Bahrain facing the highest cuts in spending while the UAE, Qatar and Kuwait can manage with much smaller reductions.

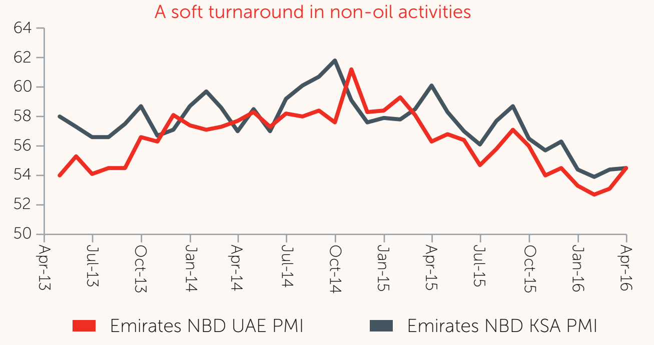
...but signs of stabilization also visible

Notwithstanding the fact that the structurally lower oil prices have depressed regional non-oil sector growth, some high frequency indicators now suggest stabilization. Credit growth in the UAE, Saudi Arabia, and Qatar has held up, non-oil sector PMIs turned around and the liquidity in the banking system, especially in the UAE, seems to have stabilized.

Equities: remain neutral

Having sold off sharply, regional equities have rebounded sharply with the obvious inflection points for the region being US dollar weakness, as well as bottoming oil prices. Looking ahead we believe regional equities continue to be in decent relative shape, but are unlikely to meaningfully outperform as recent tailwinds fade. Prospects for the UAE and Qatari equity markets are supported by strong balance sheets, limited need for fiscal adjustment relative to regional peers and inexpensive valuations. However, looking ahead it is difficult to see what will extend the recent rebound from lows in the event that oil prices consolidate around the $40/bbl level. Saudi equities are even more challenged as we are likely to see further fiscal adjustment and subsidy reform. However, although economic growth may weaken further a lot of negativity is baked into the equity prices as exemplified by low valuations, therefore downside risk in Saudi equities is also limited. Overall we recommend a neutral weighting on regional equities.

A soft turnaround in non-oil activities



Source: Bloomberg

Growth to remain sluggish as the economy can ill afford rate hikes

Growth is picking up at the margin

We think that the US economy might well continue to grow at today's sluggish rate but that there are many fragilities, such that a relapse of real growth close to the zero percent bound cannot be excluded. We don't think that GDP growth, or inflation, can return to the levels we witnessed before the Global Financial Crisis. As such we anticipate that the Federal Reserve will raise rates only marginally, if at all. Thus yields in general will remain contained.

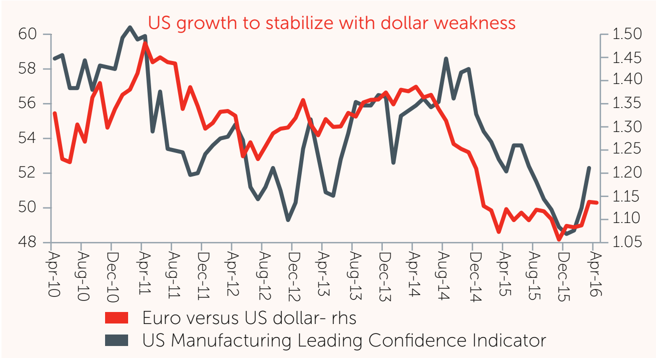
The exchange rate as the key factor of monetary policy

Mrs. Yellen is as much fearful of weak US growth as she is of weak overseas growth (if the two were unrelated she would not care about the latter, as it is not part of her mandate to promote employment beyond the US borders). International growth interdependence has emerged more clearly as unconventional monetary policies have lingered on. In the initial phase of Federal Reserve (Fed) Quantitative Easing (QE), the repression of yields went a long way stimulating risky asset prices, and with it stabilizing credit conditions, as well as preventing the economy form relapsing into recession. With the onset of QE by the Bank of Japan (BoJ) and European Central Bank (ECB), the game has increasingly moved away from interest rates to exchange rates, with the Japanese yen and euro devaluations respectively lifting Japan's and Europe's equity markets. Whilst, however, lower interest rate levels reduce the global cost of capital, lower exchange rate levels by definition do not benefit all countries. In 2015 US growth suffered from the weaker euro. Going forward we expect some rebalancing, but again less overall global stimulus. Monetary policy is becoming more risky.

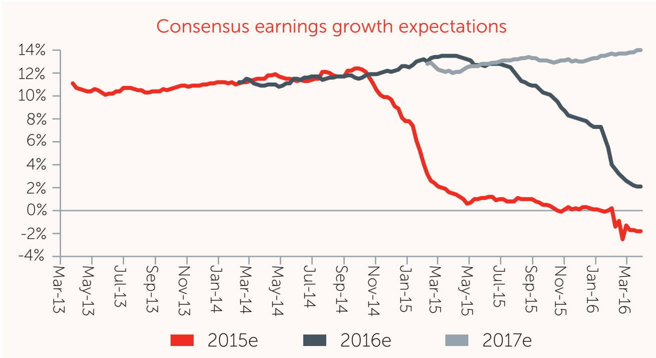
Equities: overweight despite weak fundamentals

Our overweight position on US equities is somewhat misleading and needs to be understood in the context of our overall asset allocation. It does not reflect a positive outlook for the market in absolute terms, but rather encompasses the view that equities as a whole will likely underperform. In such an environment US equities will likely perform relatively better due to their perceived safe haven status.

Having fallen considerably, US earnings expectations for 2016 have now become more realistic, but further downside remains still in our view. Not least because earnings remain close to all-time highs, and margins are at 30-year highs. This looks unsustainable given that the largest driver of costs, labour, is seeing upward pressure in the context of a slowing top line. Other significant risks to the market include falling margin financing and a slowdown in corporates' share buybacks. Risks also exist to key sectors, most notably banks which continue to struggle in the low interest rate environment along with concerns over exposure to non-performing loans in the energy sector. Healthcare stocks are vulnerable as the debate around drug pricing continues while the technology sector could potentially see rising effective tax rates. This would amount to a major drag on the market given that both the healthcare and technology sectors have been among the most profitable segments of the market for years. Overall, and recent rally aside, we continue to expect equities to remain in a broadly downward trajectory. This means that, within an equity only portfolio, US equities will likely outperform.



Source: Bloomberg



Source: IBES, Thomson Reuters

Growth momentum will inevitably fade

Mr. Draghi played it smart, once more

As it became evident that negative interest rates were actually destabilizing markets through the banking sector, Mario Draghi played once more a smart trick, and temporarily managed to overwhelm the markets. In addition to a substantial, and larger-than-expected, increase in the European Central Bank's (ECB) monthly asset purchases, he re-modelled the Targeted Long Term Refinancing Operations for banks in such a way that -by granting negative loan rates for them to increase lending to the private corporate sector – they can compensate for the loss they incur on the negative rates they receive for depositing funds at the ECB. And, indeed, markets were temporarily overwhelmed only to gradually come to the realization – as has happened too many times over the last months – that central banks are slowly but certainly hitting a wall with their current set of non-conventional monetary policy tools.

We would like to stress once more that the effectiveness of Quantitative Easing (QE) by the Bank of Japan (BoJ) and the ECB has been from the onset critically driven by the devaluation of the yen and the euro. As such their QE differed markedly from the QE enacted by the Federal Reserve, where yield repression contributed in a much more significant manner. As can be seen from the below chart, the weaker euro has been critical in reigniting growth in the periphery of the Euro-zone. A stable euro-dollar will, as such, be detrimental to continuing growth in Europe's periphery and the Euro-zone as a whole.

But central bank stimulus is becoming more and more problematic

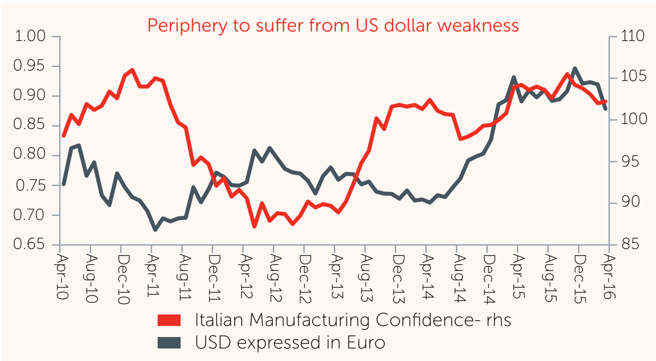
Critically Mr. Draghi seems to have abandoned – also by apparently giving up on ever more negative interest rates – a policy that would allow for further devaluation of the euro. As we have stressed in our page on the state of the US economy, there are limits to the extent that the US dollar can appreciate whilst allowing the US to remain the engine of global growth. To the extent that there is by now some agreement on that at the G-20 level, the ECB – as the central bank of the world's largest current account surplus holder – must somehow follow suit.

Bye-bye to "conventional" non-conventional policy?

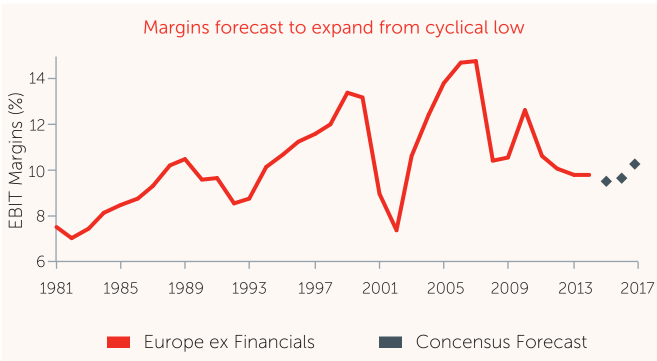
As negative interest rates and massive asset purchases by central banks have by now become, sort of, "conventional" forms of non-conventional policies, speculation is rife about the imminent introduction of newer, truly "non-conventional" non-conventional policies, such as forms of debt monetization (so-called helicopter drops) and taxation on cash. The recognition, however, that any new policy must not result in significant currency depreciation seems for the moment to limit such outcomes. Both helicopter drops and cash taxation – even leaving aside the domestic political objections – would in fact result in renewed downward pressure on exchange rates (unless, of course, they would be implemented simultaneously and in a concerted action by more central banks).

Equities: headwinds to outweigh positive margin story

On the surface European equities look better placed than their US counterparts. Working in their favour are margins which remain near cyclically depressed levels, providing plenty of scope for expansion in the event top line growth improves given the subdued wage and interest cost environment. This – as outlined in the above paragraphs – is exactly the problem! On top of this political uncertainty is arguably higher now than for a very long time (think Brexit, Spanish elections, immigration). Valuations for most European indices are not particularly cheap following the recent market rebound while earnings expectations continue to deteriorate, **overall we remain underweight European equities.** Looking ahead, in order for us to turn more optimistic on the region we would want to see; 1) the passing of the Brexit referendum in June; 2) ECB easing measures begin to bear fruit and; 3) earnings expectations to rebound.



Source: Bloomberg



Source: IBES, Thomson Reuters

Abenomics seriously running out of ammunition

Benefits of weaker yen tapering off

A weaker yen, which was the main channel of monetary policy in Japan and ultimately the underpinning of "Abenomics", seems to have run its course as the US dollar refuses to strengthen any further. A bout of global risk aversion in the early weeks of the current year, in fact, strengthened the currency. The US Fed turning increasingly dovish is also not helping the BoJ in its efforts to devalue the yen.

Hardly anything domestically to rely on

The quarterly comprehensive surveys conducted by the BoJ, known as Tankan surveys, do not provide any signal of the improvement in the domestic economic activities. Although large manufacturing companies do expect some growth, it is expected at a much slower pace. On the other hand small manufacturing companies expect contraction in their activities.

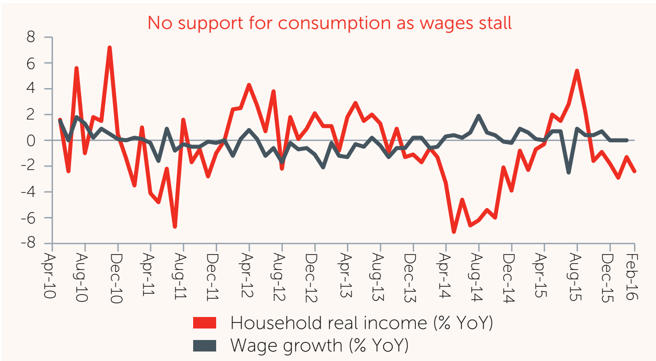
	Period	Survey	Actual	Prior
Tankan Large Mfg Index	1Q	8	6	12
Tankan Large Mfg Outlook	1Q	7	3	7
Tankan Large Non-Mfg Index	1Q	24	22	25
Tankan Large Non-Mfg Outlook	1Q	20	17	18
Tankan Large All Ind Capex	1Q	-0.7%	-0.9%	10.8%
Tankan Small Mfg Index	1Q	-2	-4	0
Tankan Small Mfg Outlook	1Q	-5	-6	-4
Tankan Small Non-Mfg Index	1Q	4	4	5
Tankan Small Non-Mfg Outlook	1Q	1	-3	0

Source: Bloomberg

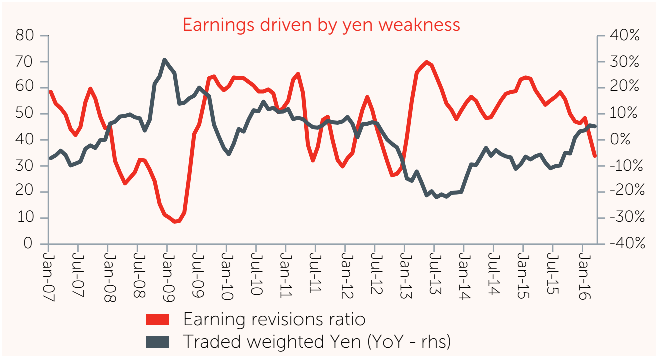
With not so positive expectations on production growth, private investment is expected to have declined in the first quarter of 2016. Note that a significant contribution from private investment had improved the GDP figure in the final quarter of 2015 which nevertheless contracted by 1.1% due to large declines in consumption and net external trade. Looking ahead, consumption is unlikely to have rebounded from the fourth quarter contraction as suggested by the negative print on retail sales for January and February. At the same time, nominal wage growth has not seen any growth since November (up until February) while real household income declined by 2.4% YoY in February. Although Bloomberg consensus expects 0.6% QoQ SAAR growth in the first quarter, we suspect that the country could face a technical recession if private investment contracts as suggested by the Tankan surveys, and consumption does not rebound as suggested by the high frequency monthly economic data. The government has announced to front load its fiscal measures in the first two quarters of the year which could support growth a bit but then it will have a drag on subsequent quarters' growth.

Equities to underperform in absence of yen weakness

The Bank of Japan is the first major central bank which appears closest to reaching the limits of what monetary policy can achieve. The market is now clearly questioning the BoJ's ability to meaningfully weaken the currency and boost either economic growth or inflation. This is a major headwind for equities given that yen weakness has been the key driver of Japanese earnings growth for some time now (see chart below). Considering as well that Japanese earnings and margins are close to all-time highs and the macro outlook is challenging (meaning top line growth is unlikely to come to the rescue), it is difficult to see what can propel the market higher. Having said that, potential downside is capped somewhat by 1) low aggregate valuations, the Nikkei 225 is trading on a 12-month forward PE of 17.7x compared to a 10-year average of 21.5x and 2) global mutual funds have already sharply cut their exposure to Japanese equities and are now underweight the market (having been heavily overweight 12 months ago). Some market commentators also point to a positive corporate reform story off of very low levels. However, this appears to only be happening at a glacial pace and in our view is unlikely to offset the more powerful negative influences mentioned above, especially in the near-term. We therefore maintain our underweight recommendation on the market.



Source: Bloomberg



Source: Bloomberg

Near term confidence belies continuing fundamental problems

The storm has abated, for now

Following China's "mini-devaluation" in August last year, and its "creeping" continuation through the remainder of the year 2015, the situation seems now to have stabilized following clear remarks by the authorities that they desire a stable currency. In fact, the currency has strengthened since. When the market opened after the Chinese New Year holidays, the PBoC set the reference price of Renminbi more than one percent higher against the US dollar. Critically - courtesy also more stringent capital controls and an easing of US dollar strength as global risk aversion abated – the heavy erosion in forex reserves appears to have been halted quite successfully.

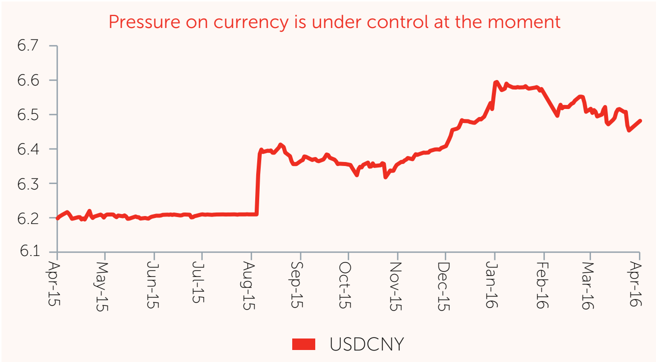
The more determined stance by the PBoC on the exchange rate has probably also allowed the government to once more prioritize growth over consolidation in the short to medium term, and thus reiterate the target of 6.5% annual growth over the next five years. A targeted fiscal stimulus initiated last year seems to have started giving some results as we see a turnaround in the leading manufacturing PMI surveys. This could temporarily improve the high frequency economic data, which could further improve sentiment in the near term.

The storm – sooner or later – is bound to return

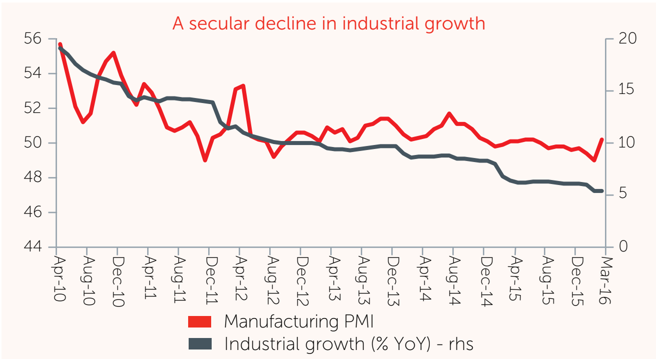
Whilst the easing of the storm seems critically dependent on an external – and thus uncontrollable – factor, i.e. a more dovish Federal Reserve, the contradiction of stimulating an inefficient economic system in the presence of a (still largely) fixed exchange rate regime will at some point inevitably lead to a further erosion of the country's reserves. When that will happen, it will occur with a vengeance because the issuance in the first two months of the year of record loans by the banks is aggravating, rather than curing the country's underlying fundamental problems. Debt to GDP in China continues to rise as the authorities – understandably – fear a politically dangerous too sharp slowdown in activity.

Short term rally possible, but long term prospects remain very poor

Chinese equities have rebounded from February lows, nevertheless performance continues to lag behind most international markets. The improved Sentiment on Chinese macro has seemingly been of greater benefit to other markets, especially commodity exporters in the emerging world. The formidable economic headwinds facing the country are likely to resurface periodically, capping the upside for equities and creating a poor risk reward trade off in our opinion. A key issue facing the country is that further monetary easing, which is required to cushion the economic downturn also risks exacerbating capital outflows, placing pressure on the currency. Easing has as a result been too sporadic too meaningfully support equity performance. The property market has been the main beneficiary of the easing which has taken place with property sales at their strongest level for some time. Nevertheless, large imbalances remain in the sector, in particular outside of the tier one cities. As such we expect property related worries to resurface. Property stocks have recently rolled over around their 200-day moving averages, perhaps signally weakness ahead. We retain our underweight on the market.



Source: Bloomberg



Source: Bloomberg

Consumption to support growth

Consumption is leading the way

In a difficult global environment where international trade has been shrinking for most emerging economies, India's large domestic consumer base provides critical support to the country's economic growth. The moderation in domestic inflation has supported households' real income while the government's fiscal policy aims at putting more money in the people's hands. The focus on generating rural demand with higher budgetary allocation to social schemes, whilst balancing urban demand with a proposed wage increase for government employees this year is expected to support consumption in the coming quarters.

On the other hand, the government's efforts to kick-start private investment has yielded less than satisfactory results, for reasons that are both global and local. First, the substantial decline in exports over the last one year has resulted into idle capacity in many export oriented sectors. Second, the sharp decline in commodity prices has reduced the attractiveness of investments in the mining sector which was the largest contributor in the previous business cycle. Finally, large non-performing assets, largely in the infrastructure sector (power, telecom and real estate) and the mining sector have made banks risk averse.

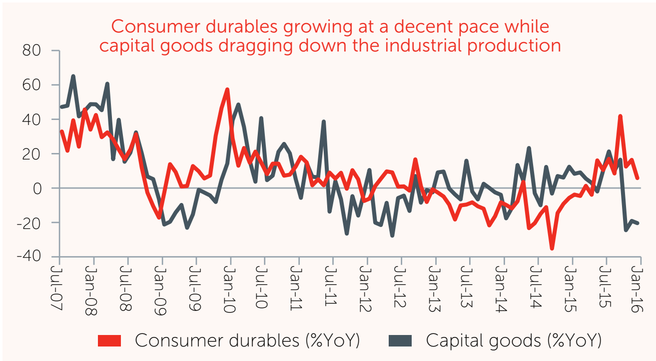
The decline in demand for capital goods has not been compensated by a sufficiently strong demand for consumer goods, resulting into declining industrial production over the last few months. However, everything is not bleak on the investment side as government spending on the transport infrastructure, in particular road and railways has been supportive and will likely result in a second round of industrial investments. At the same time, we expect consumer demand to provide continuous support to the consumer industries.

Fiscal consolidation underpins financial stability

We have been highlighting for some time that the country is largely done with structural adjustments in terms of controlling external and fiscal deficits, as well as inflation. Concerns on fiscal consolidation had arisen earlier this year due to sluggish revenue growth and pressure on the government to spend more heavily on capital items. However, the government reiterated its commitment to fiscal consolidation by sticking to a lower fiscal deficit which provides financial stability with a stable currency and lower interest rates. In fact, the currency has gained almost 2.5% (granted, some of the gains are due to more dovish Fed stance), and sovereign bond 10yr yield have come down by 30bps.

Equity: Still attractive on a relative basis

Indian equities have underperformed of late as risk appetite has returned to global markets, primarily boosting higher beta markets such as Brazil and Russia. Should global conditions deteriorate again, Indian equities will behave defensively. Indeed this is what we expect to happen in the medium-term, and therefore we maintain our overweight recommendation. Having been heavily over-owned for some time, enthusiasm for the market has waned somewhat as weak business sentiment, overcapacity, stressed assets in the banking system and the slow pace of implementation of the government infrastructure projects have taken investors' attention. This has helped to moderate earnings growth expectations somewhat, falling by over 7% on a 12-month forward basis. Nevertheless, expectations of 18% still remain high. Risks clearly remain for the market, but on a relative basis we believe Indian equities are well positioned and continue to benefit from the combination of strong domestic growth and accommodative monetary policy. Within the market we would focus on domestic consumption plays which are better insulated from external weakness.



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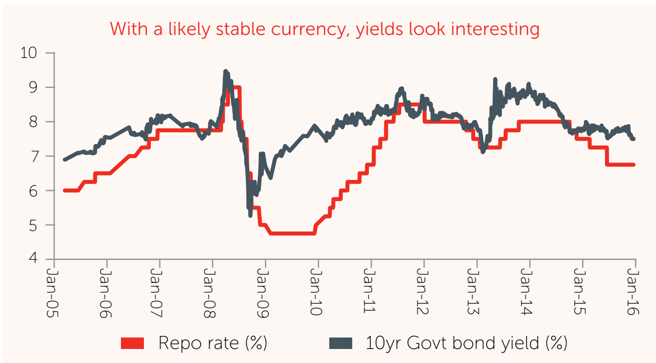


Source: Bloomberg

GDP Forecast	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	2.1%	Expect moderately less	2.3%	Expect moderately less
Eurozone	1.5%	Expect moderately less	1.6%	Expect moderately less
Japan	0.6%	Expect moderately less	0.6%	Expect moderately less
China	6.5%	Expect moderately less	6.3%	Expect significantly less
India	7.7%	Expect moderately less	7.8%	In agreement

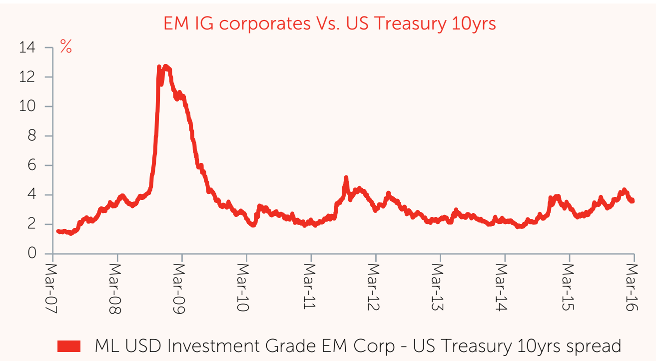
Source: Bloomberg

CPI Forecast YoY	2016 Consensus	2016 ADCB	2017 Consensus	2017 ADCB
US	1.3%	In agreement	2.2%	Expect significantly less
Eurozone	0.3%	In agreement	1.4%	Expect significantly less
Japan	0.3%	In agreement	1.8%	Expect significantly less
China	1.7%	Expect moderately less	1.9%	Expect significantly less
India	5.3%	Expect moderately less	5.3%	Expect moderately less

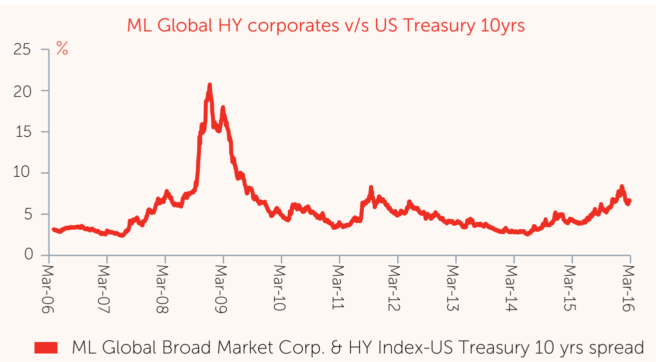
Source: Bloomberg

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

Bond Market Spreads



Source: Thomson Reuters



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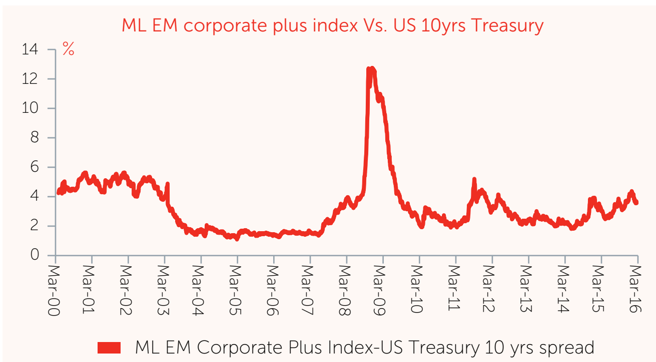
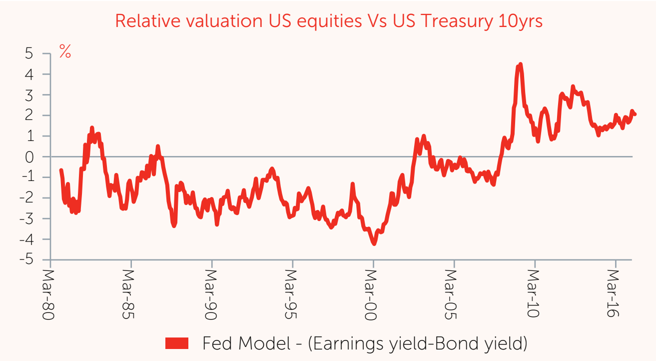
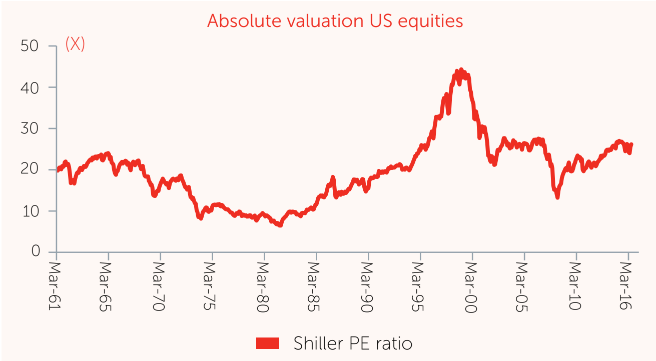


Source: Thomson Reuters

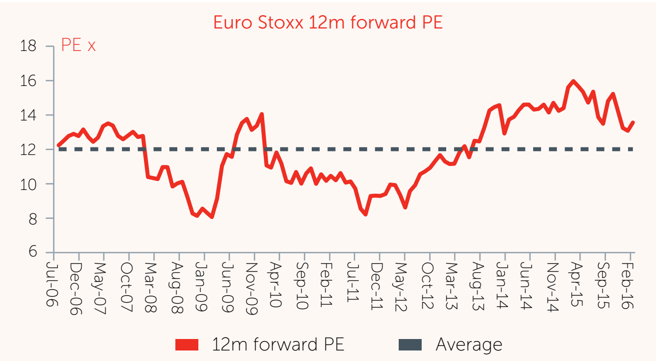
Equity Market Valuations



Source: Thomson Reuters, multpl.com



Source: multpl.com



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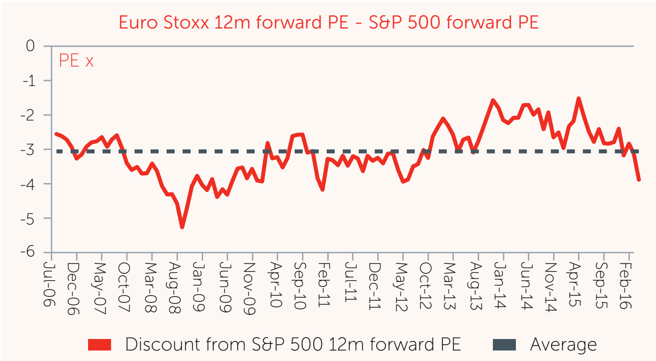

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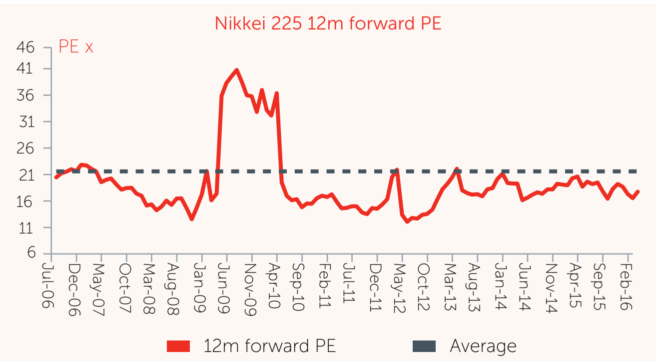

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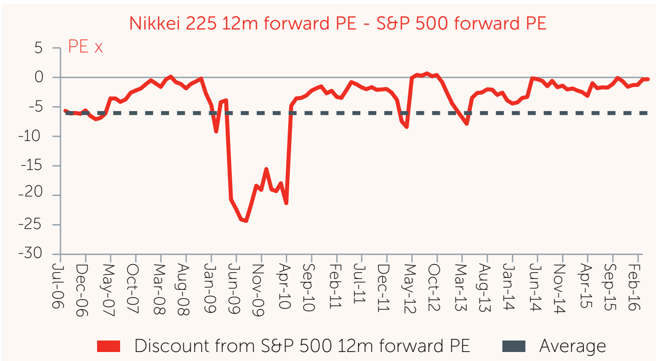

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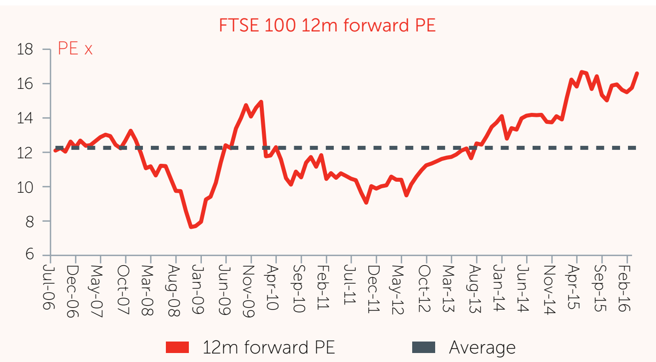

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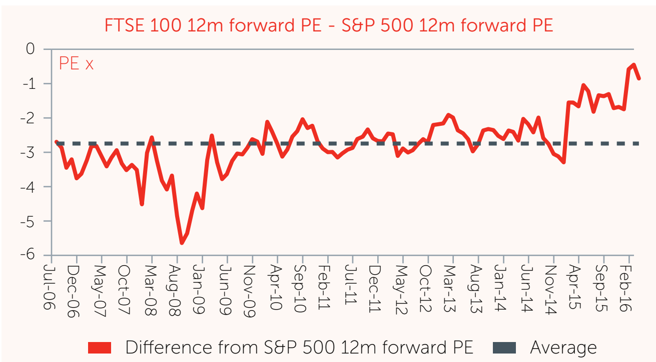
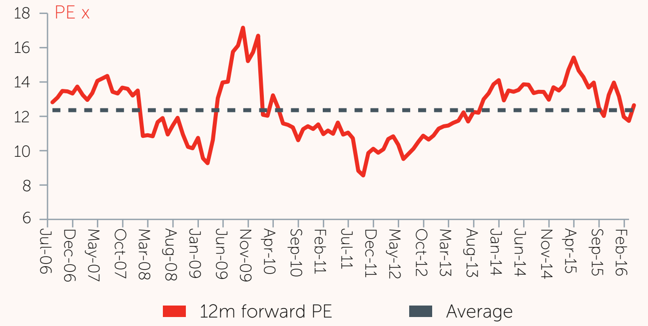


Source: Bloomberg

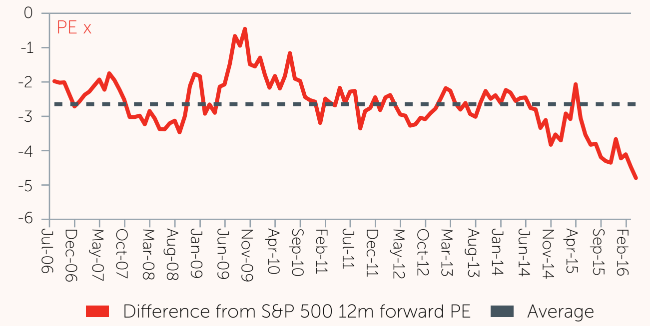
Equity Market Valuations

DAX 12m forward PE reasonable



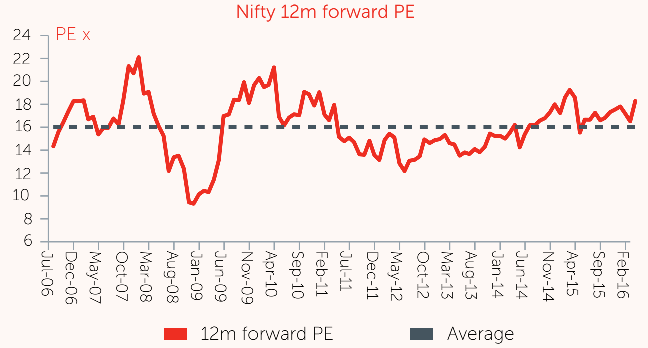
Source: Bloomberg

DAX 12m forward PE discount - S&P 500 12m forward PE



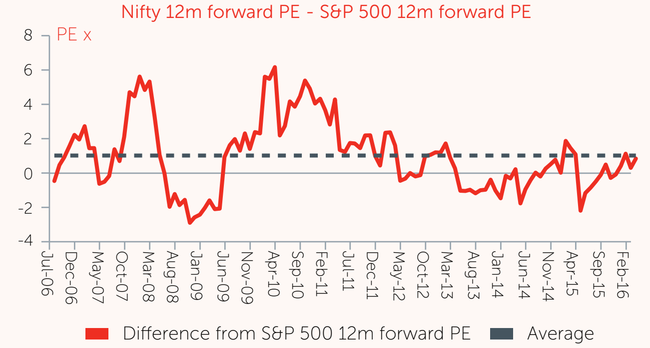
Source: Bloomberg

Nifty 12m forward PE



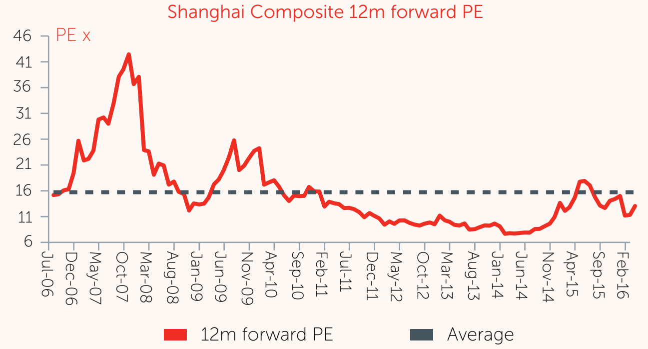
Source: Bloomberg

Nifty 12m forward PE - S&P 500 12m forward PE



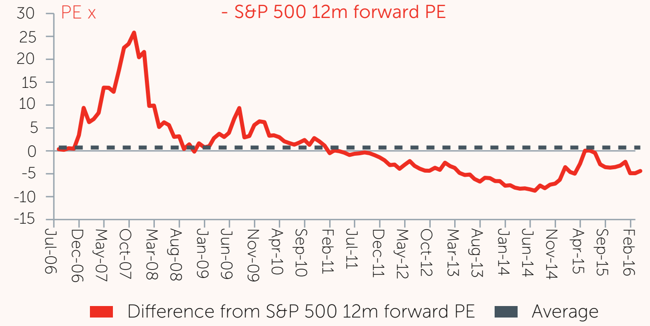
Source: Bloomberg

Shanghai Composite 12m forward PE



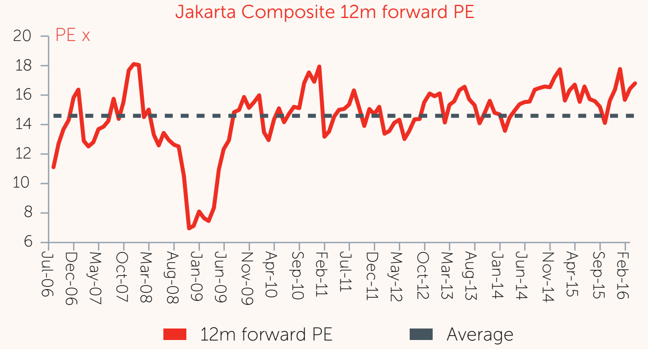
Source: Bloomberg

Shanghai composite 12m forward PE
- S&P 500 12m forward PE



Source: Bloomberg

Jakarta Composite 12m forward PE



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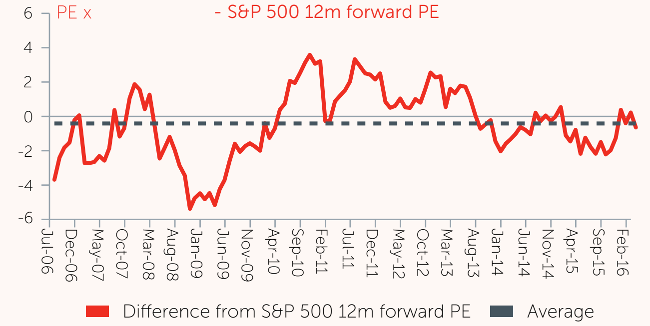
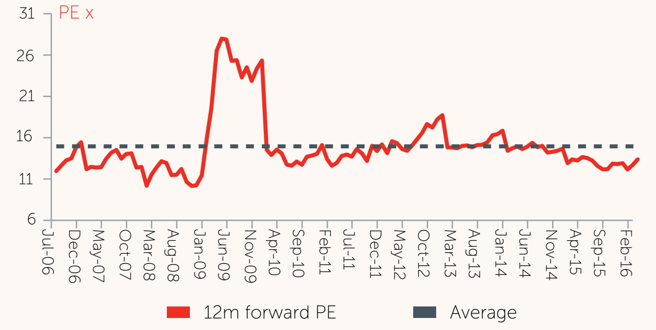
Jakarta composite 12m forward PE
- S&P 500 12m forward PE



Source: Bloomberg

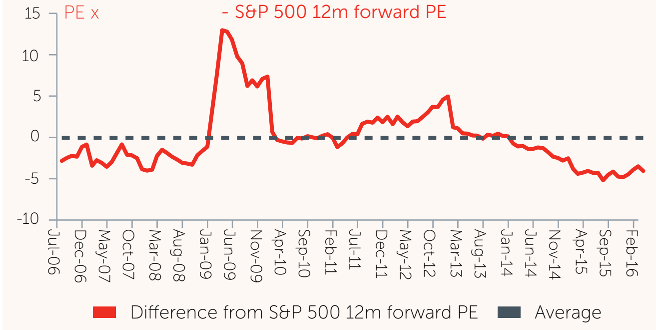
Equity Market Valuations

Taiwan stock exchange 12m forward PE



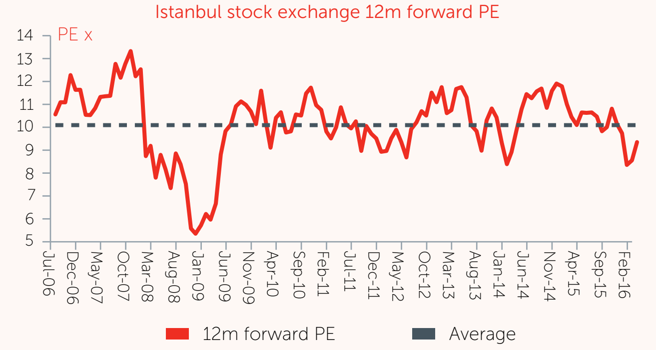
Source: multpl.com

Taiwan stocks 12m forward PE
- S&P 500 12m forward PE



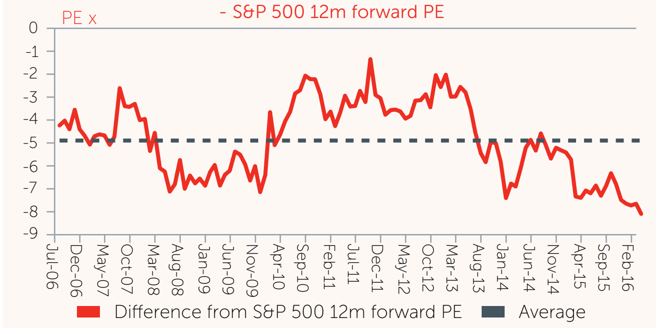
Source: Bloomberg

Istanbul stock exchange 12m forward PE



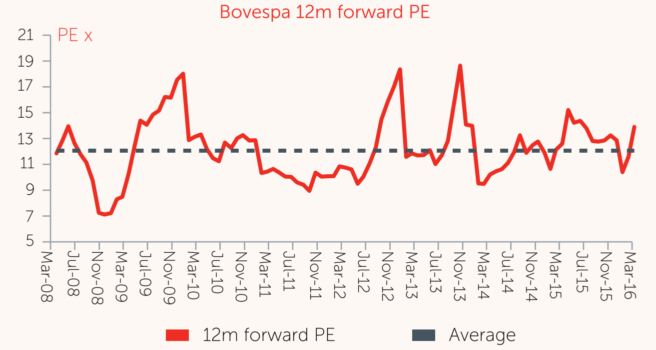
Source: Bloomberg

Istanbul stocks 12m forward PE
- S&P 500 12m forward PE



Source: Bloomberg

Bovespa 12m forward PE



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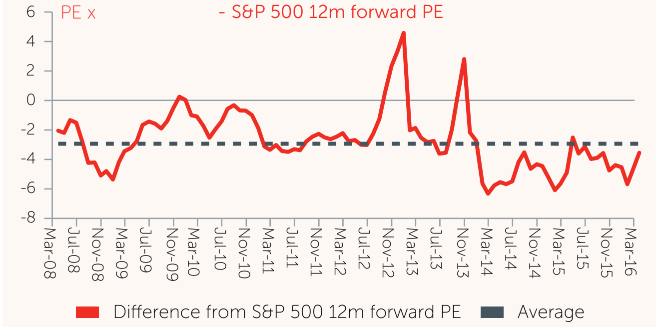
Bovespa 12m forward PE
- S&P 500 12m forward PE



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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