ADCB Asset Management

The Quarterly Investment View
January 2017

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Contents

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No end to the American miracle?

In the introduction to our last Quarterly Investment View, I discussed the outperformance of US equities versus all other major equity markets. This outperformance has by now lasted almost 4 years. It is ever so remarkable because over the same period the US dollar has also significantly appreciated. Whilst one should not be in denial about the multiple problems affecting the global economy, it would likewise be senseless to deny that the outperformance of US equities is a reflection of the country's better fundamentals. As I wrote in October, it has not only to do with the timely clean-up of the US banking system, and the massive easing by the Federal Reserve in the aftermath of the September 2008 events. It also has to do with the fact that US companies have dominated the marketplace for technological innovation over the last 10 years or so. And amongst advanced economies, only the US enjoys favourable demographics, a more flexible labour market, as well as a financial system that is less reliant on banking, facilitates debt write-offs and is less prone to stigmatize bankruptcy.

The question thus is obvious: will the US equity market continue to consolidate its record highs, and pull other equity markets up, or will the more expensive US equity market finally capitulate? Any major correction in the US equity market would, in our view, trigger corrections elsewhere. Only a side- or upward moving US equity market is compatible with further gains for global equities. We believe that the Trump presidency is a real game changer and for that reason we removed our global equity underweight shortly after the election. Within equities we have also kept our US equity overweight. More important, arguably, we have changed our overall equity allocation by shifting into those sectors that are more likely to benefit from an expansionary fiscal policy and, at the same time, we continue to favour currency-hedged equity bets in the UK and Japan, whose currencies are likely to depreciate further.

The main question on everyone's mind is, of course, how long the American miracle can last? Let me try to answer. Trump's fiscal policy would, under conservative estimates (i.e. taking into account that there is also a Congress, in addition to the President) over the next 10 years add close to 1% of GDP in yearly spending. The limits of fiscal stimulus in the context of full employment, and doubts about the composition of the stimulus (how much will be in less effective tax cuts, rather than infrastructure spending) are likely to lead to some disappointment. Higher yields and the stronger greenback are not helpful either.

Here is the catch, however. Perhaps Mr. Trump's greatest talent is expectations management, and his honeymoon period will only really start on January 20. Given all the uncertainties related to his fiscal policy (and those uncertainties are a key ingredient of his way of managing expectations), the Fed will be cautious to hike rates, allowing the US dollar and yields to stabilize. This will also allow the People's Bank of China to prevent a too sharp devaluation of the renminbi, at least until the Communist Party of China 19th National Congress this fall (see our China page). Meanwhile, US consumers and corporations might well give Mr. Trump the benefit of the doubt and keep up spending, such that markets might continue to "overshoot" for the months to come.

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

Key indices, Commodities, Currencies and Rates

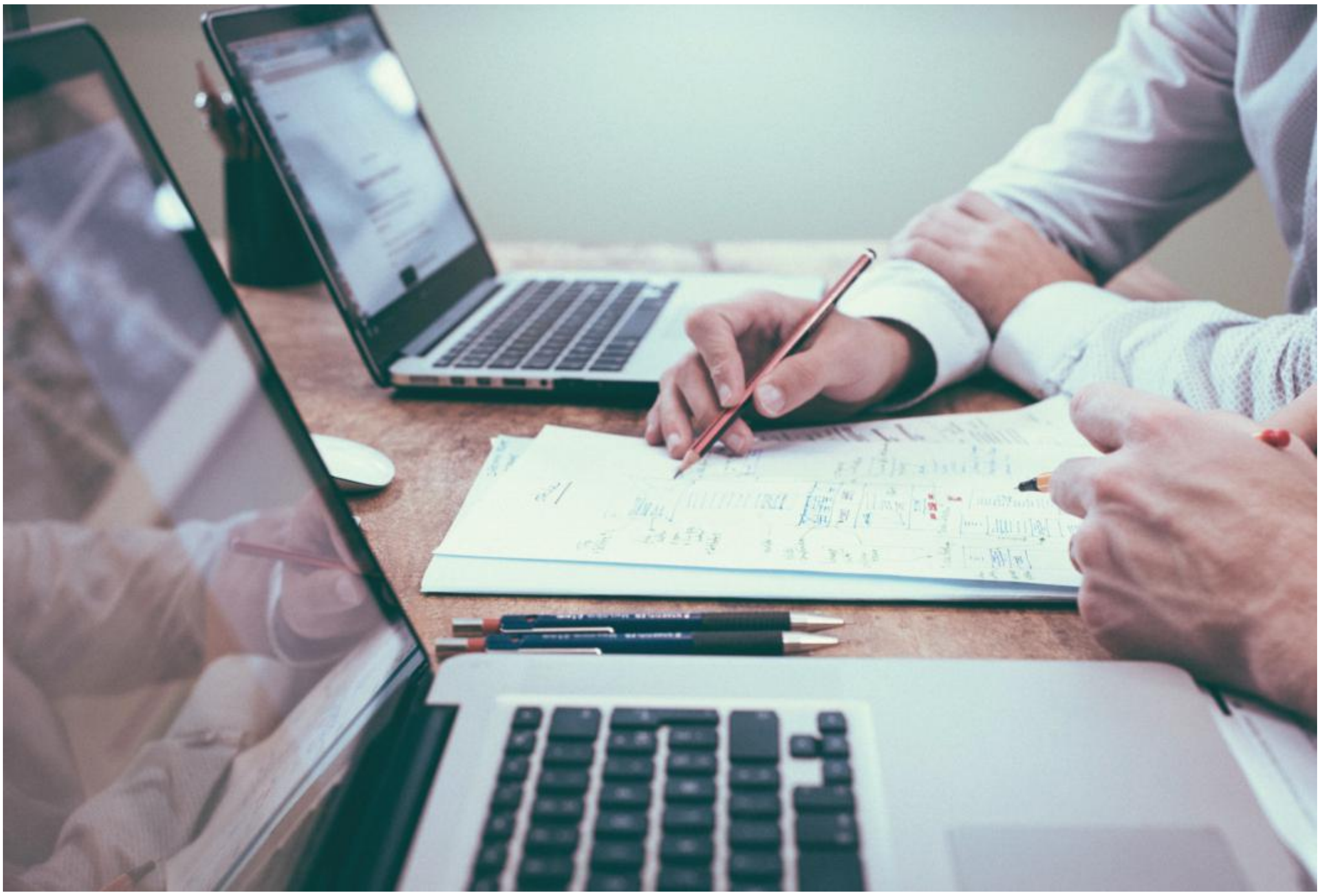
Past quarter global markets' performance

Index	Latest 14 Dec closing	Quarterly Change % (Q4 2016)	YTD Change % (14 Dec)
Index Snapshot (World Indices)			
S&P 500	2,253.3	3.9	10.2
Dow Jones	19,792.5	8.1	13.6
Nasdaq	5,436.7	2.3	8.6
DAX	11,303.0	7.0	4.7
Nikkei 225	19,273.8	17.0	1.2
FTSE 100	6,945.7	0.7	11.3
Sensex	26,613.7	-4.5	1.9
Hang Seng	22,059.4	-3.6	2.5
Regional Markets (Sunday to Thursday)			
ADX	4,474.0	0.5	4.4
DFM	3,572.3	3.1	13.7
Tadawul	7,066.0	25.7	2.2
DSM	10,304.3	-0.7	-0.7
MSM30	5,727.69	0.2	6.1
BHSE	1,189.4	3.3	-2.3
KWSE	5,661.8	5.1	1.0
MSCI			
MSCI World	1,763.7	2.2	6.1
MSCI EM	872.8	-3.4	9.9

Commodity	Latest 14 Dec closing	Quarterly Change % (Q4 2016)	YTD Change % (14 Dec)
Global Commodities			
ICE Brent USD/bbl	54.4	9.9	44.6
Nymex WTI USD/bbl	51.26	5.8	37.8
OPEC Basket USD/bbl	51.8	16.1	65.7
Gold 100 oz USD/t oz	1,137.8	-13.1	7.7
Platinum USD/t oz	923.8	-10.0	3.7
Copper USD/MT	5735	18.7	22.0
Aluminium	1,753.75	5.3	16.5
Currencies			
EUR	1.0498	-6.2	-3.0
GBP	1.2534	-3.1	-14.7
JPY	117.74	15.5	-2.6
CHF	1.0238	5.0	1.8
Rates			
USD Libor 3m	0.9634	12.9	57.2
USD Libor 12m	1.6540	6.6	40.4
UAE Eibor 3m	1.3336	10.4	33.0
UAE Eibor 12m	2.1903	19.4	46.4
US 3m Bills	0.5381	-42.0	227.5
US 10yr Treasury	2.5930	61.2	13.3

Executive Summary

- The election of Donald Trump is a real game changer because the Republican Party has also won the US Congress, thus setting the stage – after years of gridlock – for sizeable fiscal stimulus.
- Uncertainty regarding the effective size and composition of fiscal stimulus means that the Federal Reserve will maintain an overall cautious policy stance, also because the US dollar and yields have already spiked in anticipation of a scenario of expansionary fiscal policy combined with more restrictive monetary policy.
- As yields stabilize, there is still some potential for equities, but – rather than moving overweight the asset class – we prefer to play the sectors and geographies that are most likely to benefit from the US "reflation" theme.
- China's structural problems are likely to get worse before they get better, downward pressure on the renminbi will not go away.
- The "reflation" theme is bad for emerging markets, although those with sound external balances could prove more resilient.
- Selective 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. They should stabilize with the stronger US dollar.
- The rally in industrial metals should come to an end, as China will come under pressure again
- Precious metals could see periods of gain, especially during bouts of strong risk-aversion. As such, they are a good hedge against market turmoil, even if more Fed rate hikes are now not favoring them.



Market Outlook and Portfolio Positioning

Fixed Income		
Duration	Intermediate to long	It is on yields that the prospect of fiscal stimulus in the United States is having the biggest impact, although most of the upside has by now been priced in.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
EM bonds	Selectively overweight but reduce duration	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 country bonds, we still prefer USD bonds rather than local currency bonds because of possible currency volatility.
Equity Markets		
US	Overweight	We maintain our US equity overweight because we still like the market's low beta characteristics as well as the fact that it is at the epicenter of the Trump "reflation" theme.
Eurozone	Underweight	We maintain our underweight in Eurozone equities as earnings remain subdued, and the euro is now likely to stabilize versus the US dollar.
Japan	Overweight (US dollar-hedged)	The "reflation" theme, combined with the BoJ "yield curve targeting" is likely to keep the yen under pressure, which is good for Japanese equities.
Emerging Markets	Underweight	The "reflation" theme is bad for emerging markets, as it increases their financing costs more than it increases demand for their goods.
United Kingdom	Overweight (US dollar-hedged)	We have an overweight on large-cap UK equities on a US dollar hedged basis. FTSE 100 companies derive around 70% of their revenues from overseas and are therefore helped by continuing Brexit-induced GBP weakness.
Energy & Commodity Prices		
Energy	Neutral	The recent rally in the oil price by now fully reflects the latest OPEC agreements. With the US dollar at a higher level, we expect the oil price to remain range bound.
Industrial Metals	Underweight	The full implications of China's transformation story will determine a further reduction in the commodity intensity of its economy. Also because of the rise in the US dollar, it is reasonable to expect that the recent rally is now petering out.
Precious Metals	Overweight	The "reflation" theme is bad for precious metals. Yet, bouts of risk-off jitters are still very likely in 2017. Thus we keep them as a "market insurance" risk hedge in our portfolios.
Currencies		
EUR	Moderate downward pressure	The prospect of more expansionary fiscal US policy combined with further rate hikes, whilst the ECB is still committed to QE, has already determined a depreciation of the euro. Whilst the bulk of the cross-Atlantic policy differential is now priced in, we still expect some, albeit modest, depreciation.
GBP	Further corrections expected	The pound sterling is likely to weaken further as the authorities will pursue more accommodating policies to compensate for the adverse implications of Brexit.
JPY	Further depreciation likely	The combination of US "reflation" and BoJ "yield curve" targeting is likely to push the yen down further.

Oil deal a sentiment booster, economic activity to pick-up slowly

Light at the end of the tunnel

The GCC economic outlook at the beginning of the year 2016 was mired with falling oil prices that touched decade lows in January. As the year progressed, sentiment started improving as oil prices rebounded handsomely. Having said that, the average price at less than USD45 per barrel for 2016 is still the lowest since 2004, pressuring regional government finances. However, large reserve cushions and successful issuances of sovereign bonds along with fiscal reforms have helped governments to sail through large deficits. The oil production deal among OPEC members, and joined by large non-OPEC oil producing countries, will result in cuts in global oil supply by almost 2 million barrel per day. Starting in January 2017, it is potentially a game changer for regional economies. We believe that the deal will surely help the average oil price in 2017 to be higher compared to 2016.

Fiscal reforms likely to continue

Despite an expected higher average oil price in 2017, we believe that the fiscal reforms initiated by GCC governments will continue. Further subsidy rationalization, especially in the fuel and energy sectors will garner higher receipts for governments. We believe that progress on VAT implementation in 2018 will remain on track, bringing a landmark change to a region with almost no tax. Moreover, we believe that the rationalization and prioritization of infrastructure projects will also continue in order to further solidify government finances.

Easing liquidity, but Fed rate hikes would still push regional monetary policy towards tightening

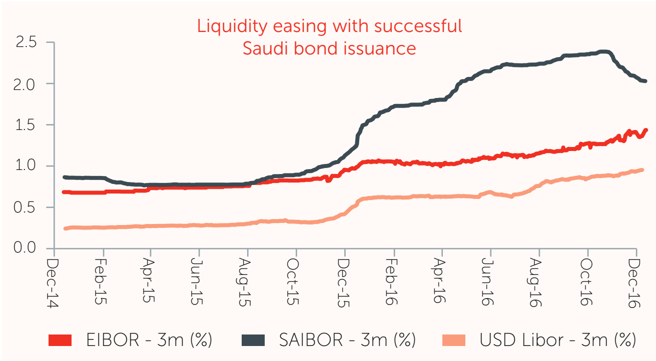
Lower average oil prices and the consequent fiscal deficits in the region had one unintended consequence; a tightening of monetary conditions, especially in Saudi Arabia. With the issuance of large government bonds in October, tight local liquidity conditions have eased. However, we believe that monetary conditions in the region will remain tight in 2017 as regional central banks follow the Fed in hiking interest rates.

Economic activity to pick-up slowly

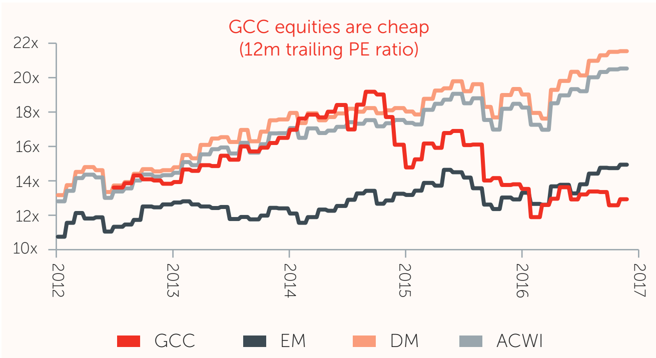
A stabilization in oil prices at higher levels will boost sentiment, however, it will take some time to boost growth in the non-oil sector. Even though we expect slightly better growth prospects in the region this year compared to last year, persistent fiscal consolidation and tighter monetary conditions will stymie any sharp rebound in non-oil sector growth.

Equities: remain neutral

On the whole GCC equities (+8%) have underperformed both global (+9%) and EM (+13%) equities year-to-date on a total return basis. Within the region there have also been significant divergences in performance, for example UAE equities rising 15% vs. 2% in Qatar (total return). Although oil prices have enjoyed a significant rebound during the year, the region has been impacted by the strength of the dollar. While US monetary policy, which gets imported into the region, has for many years been helpfully loose given slower economic growth in the GCC, it is likely that tighter Fed policy will be less appropriate looking ahead. Although pressure on GCC interbank rates has eased somewhat from domestic factors (lower government deposits), pressure to the upside will likely remain from tighter Fed policy. The UAE continues to be the best placed regional economy. UAE equities depend heavily on the property market cycle, which appears to be stabilizing while consolidation in the banking sector should also be viewed positively given tighter funding conditions. Valuations for the region are attractive relative to their own history and also relative to emerging and developed markets.



Source: Bloomberg



Source: MSCI, Thomson Reuters Datastream

Recent pick-up in growth unlikely to push Fed to accelerate hikes

Growth picks up in latter half of 2016

Growth in the United States has picked up in the latter half of 2016, although – at this stage – it is still far from clear whether it will sustainably break above the annual 3% pace. Consumption, in particular, held up steadily whilst investments continued to disappoint. Part of the sustained growth in consumption is of course due to the continuing creation of jobs with the unemployment rate now at 4.6%, although this result is somewhat mitigated by the fact that labor participation has come down again. The build-up in manufacturing confidence, after a softening patch during the summer months, combined with the most recent spike in consumer sentiment, suggests continuing momentum in the first months of 2017.

Trump election is a game changer, no doubt

We have little doubt that the Trump election will have major implications for growth and inflation in 2017. Our key argument is that fiscal stimulus in the United States will increase significantly. And it will do so because the Republican Party now controls Congress and, in any case, Trump's fiscal policy platform was in fact not that different from Mrs Clinton's, as both candidates favored an increase in infrastructure spending and a freeze in social entitlements. As a result, Mr. Trump should be able to push through a significant part of his spending plans. We estimate that even the realization of only a minor part of his revenue- and spending plans, say about a quarter, would over the coming 10 years lead to an increase in yearly spending of close to 1% of GDP a year. It is true of course that if most of the fiscal stimulus will consist of cutting taxes for the wealthy, rather than investing in infrastructure, the impact on growth would be minimal. It is unlikely, however, that there will not also be a significant boost in infrastructure spending. This, together with further deregulation and corporate tax cuts, might finally ignite some increase in investment spending.

More importantly, Trump is getting the benefit of the doubt

What really matters is that Mr. Trump's honeymoon with the American public (including households, corporations and financial markets) has not even really started, since the presidential inauguration will not take place before the 20th of January. In this regard it is important that Mr. Trump has been a master in managing expectations, first spreading fears by making unconventional policy statements, then soothing them by producing compensating signals. He can keep this game going until early summer, by which time some concrete policy measures, specifically fiscal policy measures, should be on the horizon.

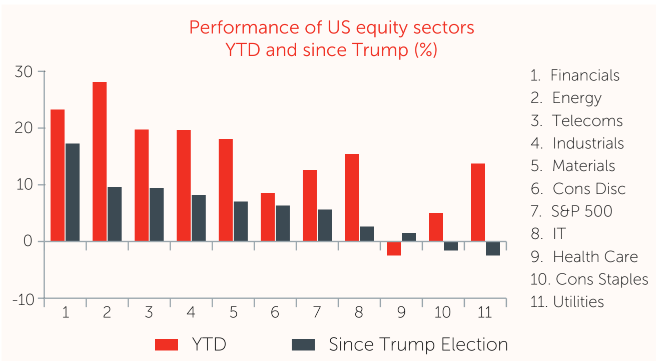
Federal Reserve will move cautiously

Uncertainty about fiscal policy, as well as its implications, will keep the Federal Reserve from moving fast. More importantly, financial conditions have already tightened with the strengthening of the US dollar, and the upward shift of the yield curve. The fact that the Federal Reserve will move slowly means that both yields and the US dollar should stabilize during the first part of the year, facilitating equity performance.

Equities: still overweight US, the low-beta outperformer

Whilst we maintain our overweight recommendation on the market (with +13% the stand-out performers among major equity markets in 2016 year), we do recognize that the risks are rising. For the best part of 2016, we felt that challenges to the global equity outlook meant that the relatively safe-haven characteristics of US equities would serve investors well. This has worked out, US equities even exceeded our expectations. Post November 8 however, while the market's low beta nature remains appealing, the market is now also a way to access the reflation theme in the US as discussed above. The theme is also evident in sector performances, where there has already been a substantial rotation into cyclical sectors. These sectors are more highly geared to a pick-up in economic activity than defensive sectors. Financials have outperformed the most since Mr Trump's election while energy and industrials are among the next best performers, these are also the *sectors we prefer*.

As mentioned, a key risk lies in the composition of fiscal policy, whilst looser fiscal but tighter monetary policy could begin to hinder equities, especially in the context of a strong dollar and valuations near post-crisis highs. President Trump's first steps, the positioning of the Federal Reserve, and the degree to which the People's Bank of China will allow the renminbi to further devalue are political rather than economic developments, and will be key to assess for how much longer the current equity rally can persist.



Source: MSCI, Thomson Reuters Datastream

Political risks by now likely overstated

Sluggish export-driven growth, upside surprises possible

The Euro-zone's economy continues to grow at a steady yearly pace of around 1.5%. The region is an export driven economy which has been a concern for us in recent years, but might now actually turn out to be an advantage through 2017. For all the talk about protectionism and the reduction in global trade, in fact, the Euro-zone should benefit from increased exports as it will profit from the stronger US dollar and reflation in the United States. On the domestic side, monetary policy is likely to remain positive, whilst more fiscal stimulus seems unlikely. The persistence of monetary accommodation combined with a better external environment should, however, be enough to keep the Euro-zone on a positive growth trajectory as also reflected by the main manufacturing confidence indicators. At the same time we believe that political risks, in particular the potential for so-called populists parties to gain power and steer their country out of the European Union, have by now peaked.

Tapering or not, ECB remains very accommodating

At the December press conference Mr. Draghi insisted that the ECB was not tapering its monthly asset purchase program (QE). In fact, he went out of his way to confirm that tapering had not even been discussed. In his view the reduction, as of March, of the monthly purchase quantity from 80 billion to 60 billion euros, does not amount to tapering since it does not involve any gradual reduction to zero purchases. He also pointed out that the ECB was merely reverting to the initial amount of purchases established under its program.

As for us, we would like to point out that the ECB's overall stance remains very accommodating. Purchases will continue until the end of 2017, they will now also include shorter term paper as long as it yields more than minus 40 basis points. Mr. Draghi also pointed out that in case of need the ECB would stand by with more, rather than less, liquidity. Markets interpreted the statement as dovish leading yields to stabilize, the euro to weaken and equity markets to rally. Given this stance, we see little scope for a change in the yield differential between the euro and the US dollar. At the same time there is little scope for the euro to appreciate against the US dollar.

Political risks are overstated

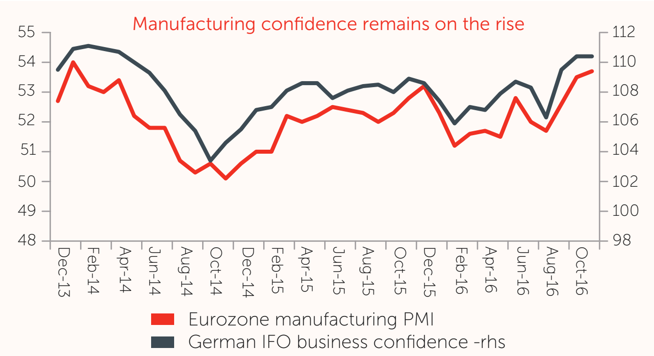
We were early to point out the rise of political risk in Europe. We are now becoming more sanguine on these risks. The single biggest 2017 election event is in our view the second round of the French presidential election to be held in May. This is the only country in Europe where the electoral system has some similarity with the US presidential election in that the electorate will have to choose between one of only two candidates, just as the Brexit vote was about either "yes" or "no". All other upcoming European elections, from the Dutch to the German, and now also likely Italian elections (a date still to be determined), will be based on proportional voting such that no so-called populist party will win a majority enabling it to run the country.

As for France, a Frexit would arguably be enough to put the nail in the EU's coffin. Uncertainty should, therefore, persist. At this stage, however, it seems reasonable to assume that Mrs. Le Pen will not win the presidency.

Equities: elusive earnings growth keeps us underweight

European equities have underperformed significantly year-to-date (-16% relative to US equities in US$ terms). The main problems facing the region is a lack of earnings growth. Just like Japan, the corporate sector in Europe should in theory be enjoying stronger earnings on the back of a weak currency. However, despite a large-scale depreciation in recent years earnings growth has consistently been negative. More worrying perhaps, is that the consensus systematically over-estimates earnings year after year. 2017 earnings growth expectations are currently 13%, significantly up from the 0% in 2016. Next year's expectations seem unrealistic, especially when considering that the last time European earnings growth was positive was in 2011 when they grew 3%. If we cannot believe forward earnings, then forward valuations are of little use. On a 12-month trailing price-earnings basis, European equities are in fact expensive.

Of course, these issues along with the political risks in Europe are well-known, so it is possible that much of this is now in the price. Europe has already become a consensus underweight in global equity portfolios with significant outflows during 2016. At the same time financials comprise around 20% of the index in Europe, a steepening yield curve on a depressed earnings base could therefore be a tailwind for the market. Overall, while we can see a case for ignoring political risks facing the region, we cannot ignore the absence of earnings growth. This is what keeps us underweight for the time being.



Source: Bloomberg

Economic data catching up with the reality of Brexit?

Activity indicators start softening

In the months following the Brexit vote, both manufacturing and consumer confidence kept up well, showing no signs that the event had exercised any impact on the economy. Recent economic releases, however, seem to tell us a different story where the uncertainty generated by the vote slowly starts affecting economic activities. Since August industrial production has been declining on a sequential basis. And whilst November manufacturing indicators improved in most developed markets, the business sentiment index softened in the UK. Also the consumer sentiment indicator fell in November, signalling a possible softening in sales in the coming months.

The possibility of UK producers losing access to the single market and cheap labour, especially from Eastern Europe, will continue to hang over the country's economic outlook. The Brexit vote has also jeopardized the UK's fiscal consolidation path as the government has deferred tax reforms which could have enhanced revenue. With public debt close to 100% of GDP, and a fiscal deficit running around 4% of annual output, it is very doubtful whether the government will be in a position to provide meaningful fiscal stimulus in case the downturn materializes.

Inflationary pressure building up

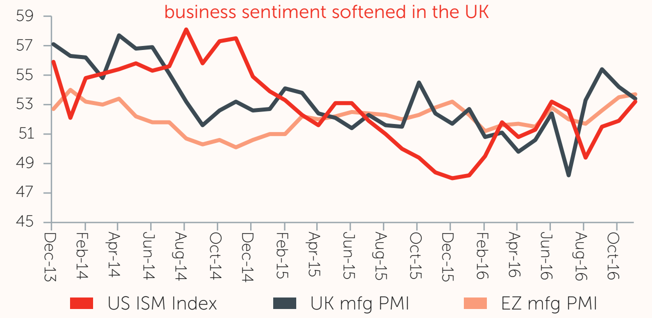
Whilst the currency depreciation and the strong consumer demand of recent months have not yet determined a significant pick-up in headline inflation, the pressure seems to be building. Pipeline inflation, for one thing, has jumped into double digit territory, something that will for sure push up consumer prices in the coming months. The recent rise in energy prices might well persist in the medium term, constituting an additional factor in pushing inflation higher. This is likely to reduce purchasing power of consumers, and thus negatively affect consumption. Despite inflationary pressure which is likely to rise in future, the Bank of England will likely continue to be accommodative as it is fears low growth more than high inflation. This means that the downward pressure on the currency is here to stay.

Equity – overweight UK large caps

In September we initiated a *currency-hedged call on UK large cap stocks* with the view that continued political uncertainty surrounding Brexit as well our belief that (at some point) UK economic data will begin to deteriorate will weigh on sterling. This in turn would boost earnings for the UK-listed companies deriving (in aggregate) 70% of their revenues from outside of the UK. This call was working well until a ruling on November 3rd from the UK's High Court determined that the UK government requires parliamentary approval before triggering article 50 which would kick-start the UK's formal withdrawal from the Union. The sterling strengthened and UK large caps underperformed. Overall since we implemented the call the market is up 2% in sterling terms, in line with global equities. The government has challenged the High Court's ruling meaning that the Supreme Court is now reviewing the case, a decision is expected in early January.

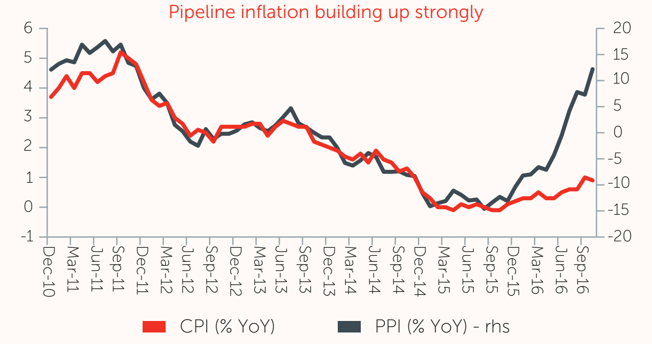
We continue to believe that UK equities can outperform in the current environment, and see no reason given the continued political uncertainty why sterling should be one of the few major currencies to strengthen against the US dollar. Admittedly UK macro data has been much stronger than we (or the consensus) expected post-Brexit, nevertheless, it still seems likely to us that economic data will at some point deteriorate, likely leading to further monetary stimulus from the Bank of England and therefore a weaker currency. Valuations for the market are attractive (14x 2017 PE vs. 15.4x for global equities) but are based on high earnings growth expectations (19.5% in 2017). This seems optimistic and will need to be revised lower (albeit it could materialise with a significantly weaker GBP). In any case, global earnings growth expectations are also elevated at 12.6% for next year.

Unlike PMIs in other major economies, business sentiment softened in the UK



Source: Bloomberg

Pipeline inflation building up strongly



Source: Bloomberg

Policymakers should profit from US fiscal reflation

Stronger dollar most helpful to the BoJ

Whilst the Bank of Japan has throughout the year been trying its best to devalue its currency, success had been meagre. In fact, it was the election victory of Mr. Trump – and the concomitant expectation of a reflationary US fiscal policy combined with continuing rate hikes – that finally pushed the US dollar significantly higher versus the yen. This is not to say that the BoJ has been irrelevant. The complete contrary is true. The introduction of first negative interest rates, then pushing long term yields below zero and, finally, the targeting of the entire yield curve, were and are key ingredients of the weak yen. In fact, the essential backdrop for continuing yen depreciation was set in the BoJ's September meeting, when the central bank adopted "yield targeting" policy, whilst at the same time signalling that it would tolerate inflation above its target level. The US election result acted as the trigger for yen depreciation as expected reflationary fiscal policy in the US confirmed that monetary policies would continue to diverge across the Pacific.

Economic outlook gets boost from across the Pacific

Third quarter growth was boosted by net exports which were largely the result of a smaller contraction in exports as compared to imports. The positive contribution from net exports could continue in the coming quarters, as exports should get a boost from growth prospectively accelerating in the US, which has a one-fifth share in Japan's total exports. A rather sharp depreciation in the domestic currency is likely to be another supportive factor to the country's overall exports.

Critically the BoJ's current policy of keeping the 10yr yield close to zero provides larger fiscal room for manoeuver to the government.

The BoJ hopes that renewed currency weakness, the rebound in the commodity prices, especially energy prices, as well as the marginal improvement in the global economic environment will support a pick-up in price dynamics. It remains to be seen to what extent these cyclical developments can lead to a structural pick-up in price dynamics of Japan's ageing and closed society.

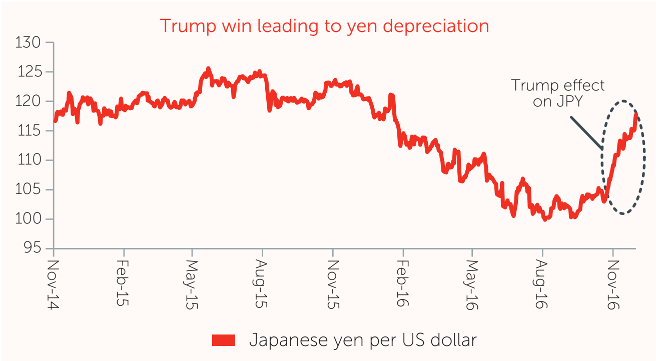
Japan (remain overweight)

In November we upgraded *Japanese equities* to overweight from underweight. The main reason being that the market is one of the prime beneficiaries of the strong US dollar, the flipside of which is a weaker yen. Japanese earnings momentum is strongly correlated with the yen, as the currency weakens, so the consensus revises up its earnings growth projections for the market.

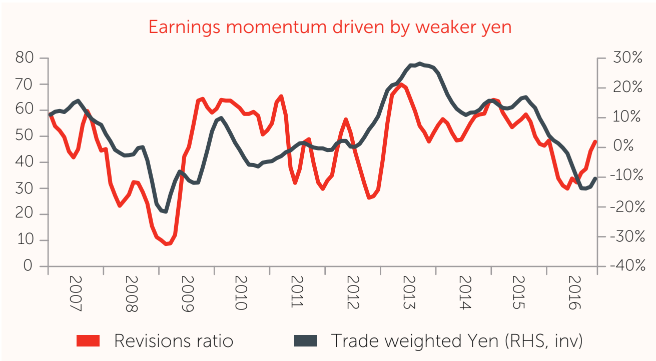
There are good reasons to believe that the yen will remain weak, thereby supporting corporate earnings. Under the BoJ's yield curve control policy, it aims to prevent the 10yr government bond yield from rising above zero. This limits the extent to which a bond sell-off in other parts of the world can impact JGBs, in and by itself positive for Japanese equities, while also keeping the currency under pressure.

In addition, as already described above the case for the market is bolstered by the election of Mr Trump as president, as this will lead to a strong US$ under normal circumstances, i.e. unless there is a major risk-off event.

Other supports are the fact that valuations for the market are not expensive, hovering roughly in-line with their 10yr average. Earnings revisions on the other hand have rebounded and will continue to become more positive if the currency weakens further. Consensus earnings growth for 2017 is in the high single digits, undemanding by global standards (12.6%). At the same time the market was at one point heavily over-owned, but is now less of a crowded trade with global equity funds now broadly neutral Japanese equities.



Source: Bloomberg



Source: MSCI, Thomson Reuters Datastream, HSBC

With the greenback up, risks are on the rise again

China activity remains resilient ...

Following a continuous firming of industrial production and retail sales, also exports and imports are now stabilising. The pick-up in activity has been facilitated by persistent fiscal spending and credit growth. Whilst part of the expansion in fiscal spending now seems to be rolling over, it is unlikely that the government will significantly reduce overall stimulus before the celebration of the 19th National Congress of the Communist Party of China this fall.

...which is the key problem

The problem with the resilience of China's business cycle is that most of the spending is directed in the wrong direction with yearly growth of investments in state-owned enterprises still exceeding 20% after the massive spending spree that started at the beginning of the year. Such growth in the less efficient part of the economy, together with the devaluation of the renminbi (a development that favours producers at the expense of consumers), means two things. First, it is moving the country back in the direction of an export-driven manufacturing economy, rather than towards the desired consumer-driven service economy. Second, it means that the overall debt over GDP ratio of the economy will continue to grow, breeding more rather than fewer problems in the future.

Global currency environment again turns against China

Earlier this year China managed to stop the erosion in its foreign exchange reserves. To some extent the halt in official outflows was facilitated by the willingness of the PBoC to let the renminbi depreciate versus the US dollar. In other words the central bank did not use its dollars to buy back renminbi to the full extent of the capital outflows. It is likely, however, that at least some of the downward speculation on the renminbi had abated as a result of the US dollar weakening against most other major currencies. In the same way, the apparent intensification of outflows in the month of November has likely to do with renewed global strength of the US dollar.

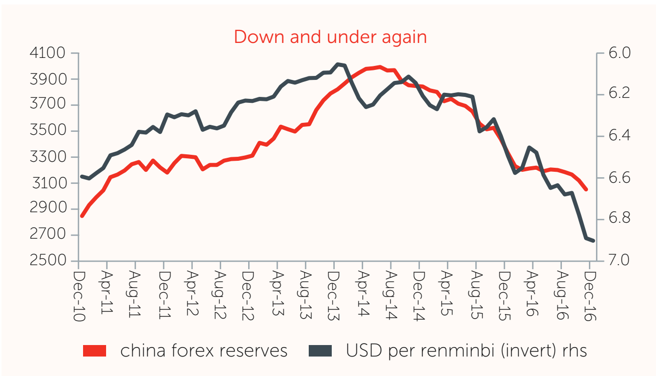
China's predicament a bad omen for emerging markets

Thus the inherent risk for China – as well as for almost all emerging markets – of the Trump "reflation" story is that the stronger US dollar occurs alongside a further lift in global yields. From a global perspective a significant devaluation of the renminbi – and the growth correction that it would entail in China - would have a major deflationary impact, first and foremost on those emerging markets that are highly dependent on China, but also on other major economies. The global risk-off consequences of a renminbi currency shock are significantly further reaching than the new Trump administration imposing tariffs. We believe that a major renminbi currency devaluation will at some point be inevitable.

For such a devaluation to be successful in reigniting the right type of growth in the economy, it would have to coincide with the enactment of bold reforms. It is therefore reasonable to assume that we won't see it until we are beyond 19th National Congress of the CPC. Until then we are likely to continue to see a mild downward slide in the renminbi, as well as in emerging market equities.

Equities: where is the catalyst? Remain underweight

Both Chinese A-shares and H-shares equities have underperformed this year, A-shares falling 16% and H-shares flat, compared to +10% for EM and +6% for global equities (all in US$). Policy-makers in China appear to have stabilized the economy for the time being, however, loose monetary and fiscal policy given the closed capital account breeds market inefficiency. Volatility in Chinese equities is also high. The Hong Kong – Shenzhen stock market connect was launched early December, allowing Hong Kong based investors to trade Shenzhen listed stocks. However, it has made little difference to overall market performance so far, similar to the Shanghai-Hong Kong stock market connect which launched in November 2014. One benefit of the program however could be to reduce volatility in mainland Chinese shares, given retail investors dominate the Chinese market compared to institutional investors in more developed exchanges, such as Hong Kong. Valuations in China are neither cheap nor expensive in aggregate terms; new economy stocks trade at expensive valuations and old economy stocks at large discounts. Our main reason for remaining underweight Chinese equities is that we struggle to identify a catalyst which will push the market higher, while risks to growth and trade relations with the US are firmly to the downside.



Source: Bloomberg

A bump in the road does not derail the long term story

Currency note ban a mere bump in the road

The government's decision to demonetize the higher denomination currency notes (Rs. 500 and Rs. 1000) has negatively impacted economic activity. This short term impact has been confirmed by the November confidence surveys for both manufacturing and services, as the former cooled down (but stayed in expansionary territory), whilst the latter fell sharply and moved into contractionary territory. It is reasonable to assume that this downward move will continue in the next couple of months or so.

It is critical to stress, however, that the impact of the measure is likely to be transitional only, as it is reasonable to expect that once all old currency notes have been handed over, and banks have been supplied with new legal tender, activity will resume normally. There is more, one would typically have a similar acceleration in growth as pent-up demand compensates for delayed spending. There is, in addition, a good chance that the transition will be shorter than expected as after only three weeks since the measures have been enacted, almost two-thirds of the currency in circulation has been deposited with banks. With the supply of new currency notes accelerating, we expect economic activity to soon normalize.

The structural story remains intact

Beyond the short-term negative impact of demonetization, the structural growth story for the country remains intact. The most important positive stimulus will come from the wage hike for central government employees, which this year will be followed by wage hikes for employees of state governments. Add to that the good monsoon season this year, which has enhanced households' income, and one can see that consumption is likely to remain sustained. We think that this solid consumption story, combined with improving financial conditions – specifically a declining interest rate and the resolution of sizeable nonperforming assets in the banking sector - will lead to a revival in private sector investment over the coming quarters.

Although we remain cautious on the potential upside risk to inflation, the broader inflationary path is likely to be well behaved in the medium term. The immediate moderation in inflation due to the recent demonetization is expected to be temporary, whilst we see factors such as a low base effect of commodities, consumption led growth and the lagging investment cycle, contributing to upside inflationary risks in the medium term.

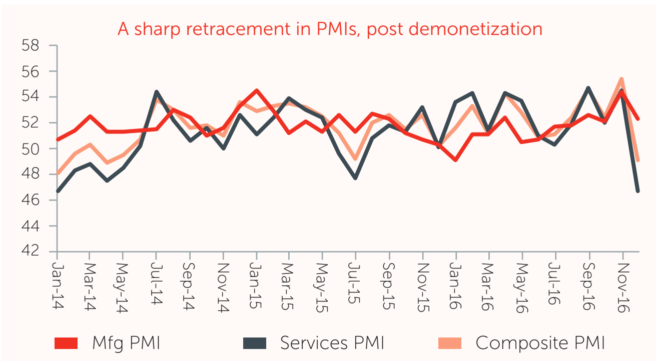
The Indian currency has been one of the best performing major emerging market currencies since the Trump election ignited a US dollar rally. Over the longer term as well, the Indian rupee has outperformed. We believe that the remarkable improvement both in the current account and in the fiscal deficit trajectory, supported by a significant moderation in inflation, will continue to provide a solid base for the currency to withstand external headwinds.

Equities: maintaining our structural overweight

Indian equities were faring relatively well until the demonetization announced on November 8. The market tends to outperform broader emerging markets during periods of risk-off. Ordinarily we would have expected Indian equities to outperform over the past month given that EM equities sold-off following the election of Mr Trump as President of the US. Unfortunately the demonetization announcement prevented the market from behaving in its traditional safe-haven way. In particular the consumer sectors in the market, which had been the engine of economic growth and driver of equity performance have suffered, so too the banks.

Having said so, we remain bullish on the outlook for Indian equities. The reasons are that the positive story for the market remains driven by endogenous rather than exogenous factors, i.e. the main driver of the Indian economy has been consumption. It is also the consumer sectors where we believe the greatest potential lies within the market. A stable INR, especially relative to other EM currencies will continue to underpin investor confidence.

The sizeable valuation premium Indian equities typically enjoy relative to EM has fallen substantially of late. On a 5-year basis Indian equities have traded on average 42% more expensive than EM equities (12-forward basis), currently however, the premium is 36%, the lowest premium over EM since 2013. We remain structurally overweight Indian equities.



Source: Bloomberg

Double whammy with Trump election

EM business cycle yet to catch up with DM one

The expected fiscal reflation in the wake of Mr. Trump's victory in the US has created more headwinds than tailwinds for Emerging Markets (EM). The tailwind could come from stronger consumption led growth in the US, which in turn, could boost EM exports. However, it is likely to be marginal if we look comprehensively at the President elect's policy focus which includes a reduction in the trade deficit. Although we do not consider this our base case scenario, the possibility of restrictive trade policy has become an added risk to the EM growth outlook. Therefore, in spite of EM growth expected to be slightly better in 2017 as compared to last two years, largely due to some major economies such as Brazil and Russia exiting recessions, confidence in EM growth prospects should not be high. Manufacturing PMIs in EMs in recent months have clearly lagged those in Developed Markets (DM). These survey indicators suggest that the improvement in the global economic outlook is largely coming from DMs. While risks out of China remain an overhanging concern. The country is just kicking the can down the road in terms of failing to address economic growth driven by leverage (rising debt to GDP ratio).

Higher new US rate trajectory and dollar strength create headwinds

Headwinds for EMs are easier to identify. The expected fiscal reflation in the US has pushed up interest rates which, in turn, has strengthened the dollar. Rising US interest rates and a stronger dollar are unequivocally negative for EM asset classes. Higher US treasury yields reduces the yield differential between US securities and EM securities, making the latter relatively less attractive. The situation is aggravated by the fact that a stronger dollar creates higher hedging costs for EM assets.

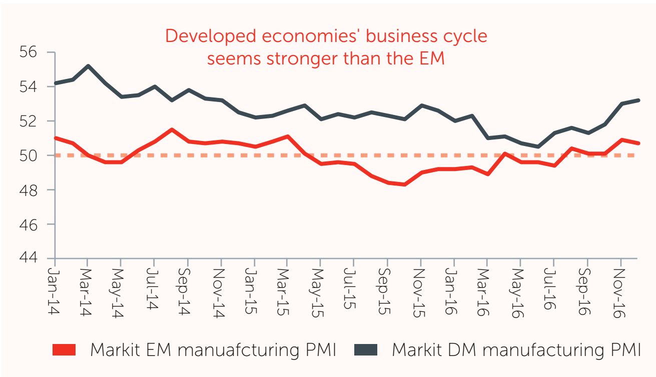
Another headwind comes from the fact that EM leverage in foreign currencies is high, most of which is in dollars. It was attractive for EM governments and corporates to issue dollar-denominated debt for many years post global financial crisis given that interest rates were very low. However, rising rates have forced EM corporates to deleverage. This is confirmed by the Bank of International settlements which shows that US dollar denominated international credit to non-bank borrowers declined in the Q1 2016 (latest data available), the third consecutive quarterly decline. However, the stock still outstanding remains very large at USD 3.2trn at the end of the first quarter of 2016.

Underweight EM equities – The Donald is not good for EM

Since Donald Trump's victory in the US presidential elections, EM equities have underperformed global equities by 6% (in US$ terms), we expect this underperformance to continue into 2017. The reason for this is not to do with the much vaunted increasing protectionism or de-globalization headlines from Mr Trump's election campaign most of which is unlikely to get implemented. Rather it has to do with higher global bond yields and a stronger US dollar. For EM, this will lead to tighter monetary policy, or at the very least, less loose policy given that a stronger US$ means weaker EM currencies. Weaker EM currencies tend to lead to rising inflation expectations which may force EM central banks to tighten policy (or not cut) when the macro conditions warrant a more pro-cyclical stance. This is bad for growth and negative equity markets.

Valuations for EM equities as a whole have risen from 13x at the start of the year to 15x currently (12-month trailing basis), a 5-year high. This is still cheap compared to the 21x for developed markets, however, EM equities always trade at a discount to DM. At the same time earnings revisions in EM have rolled over, meaning that the consensus is now cutting its forecasts for EM earnings growth over the next 12-months.

Although we are underweight the EM equities, we are not forecasting a major sell-off in the asset class any time soon. Much negativity should already be in the price given that global bond yields and currencies have already moved a long way. In addition, a potentially more supportive oil price backdrop (following the deal - if implemented - between OPEC and non-OPEC producers) boosts EM energy exporters. However, we continue to believe that the current global macro environment is not supportive of EM equities outperformance.



Source: Bloomberg

Appendix

GDP Forecast	2017 Consensus	2017 ADCB	2018 Consensus	2018 ADCB
US	2.2%		2.3%	
Eurozone	1.4%		1.5%	
Japan	0.9%		0.7%	
China	6.5%		6.1%	
India	7.3%		7.6%	

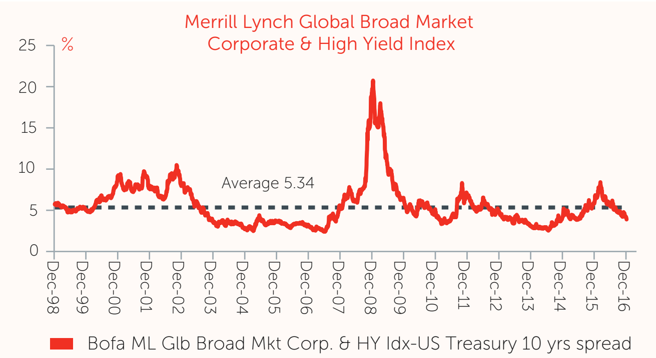
Source: Bloomberg

CPI Forecast YoY	2017 Consensus	2017 ADCB	2018 Consensus	2018 ADCB
US	2.3%		2.4%	
Eurozone	1.3%		1.5%	
Japan	0.5%		1.0%	
China	2.1%		2.1%	
India	4.8%		5.0%	

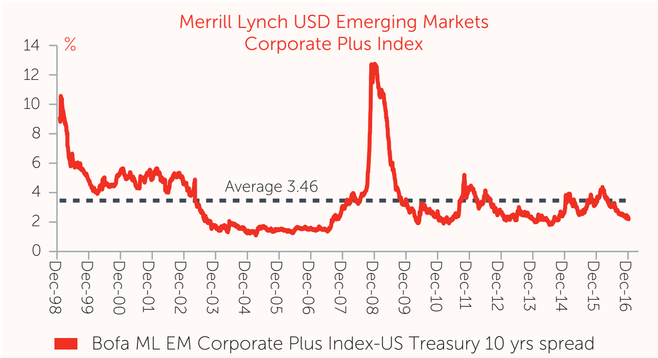
Source: Bloomberg

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

Bond Market Spreads



Source: Thomson Reuters, Federal Reserve Bank of St. Louis



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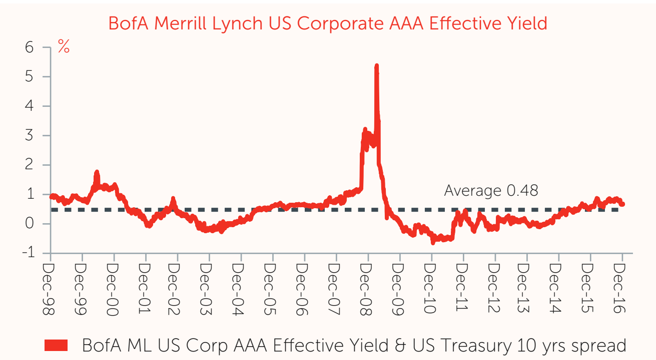

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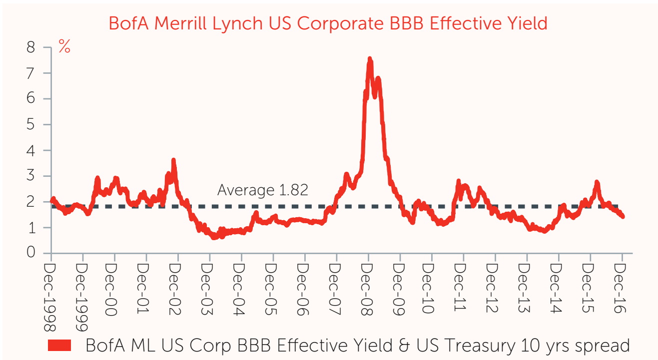
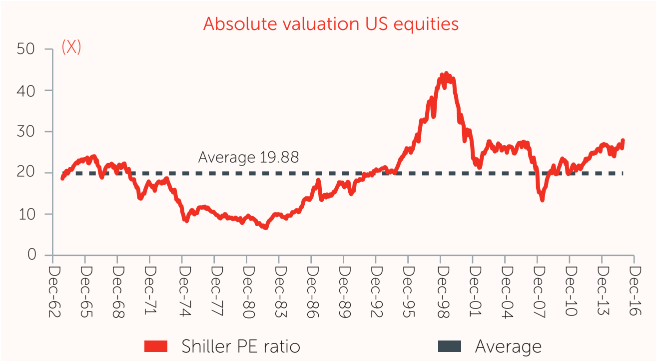
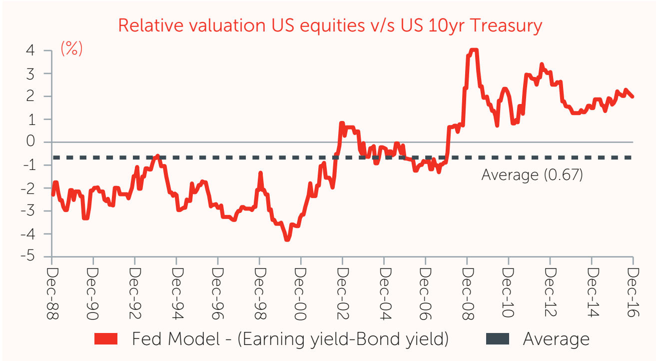


Source: Thomson Reuters, Federal Reserve Bank of St. Louis

Equity Market Valuations



Source: Thomson Reuters, multpl.com



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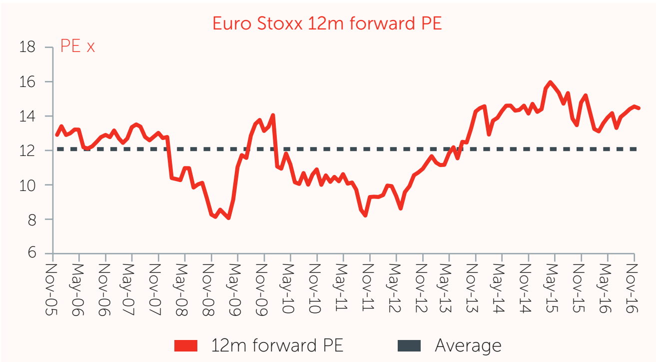

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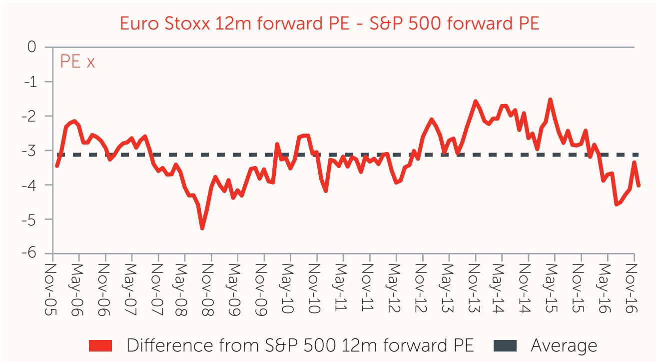

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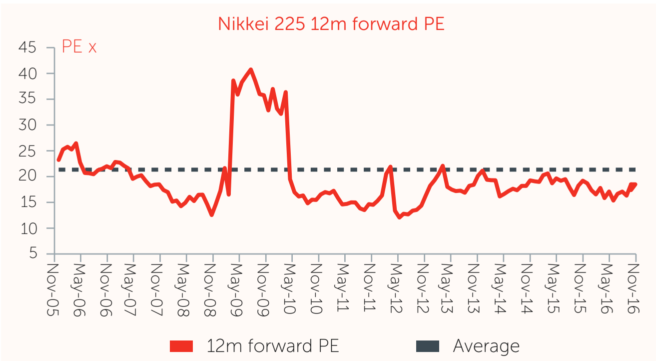

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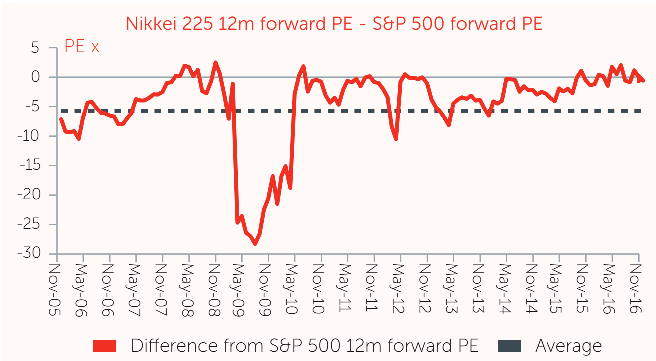

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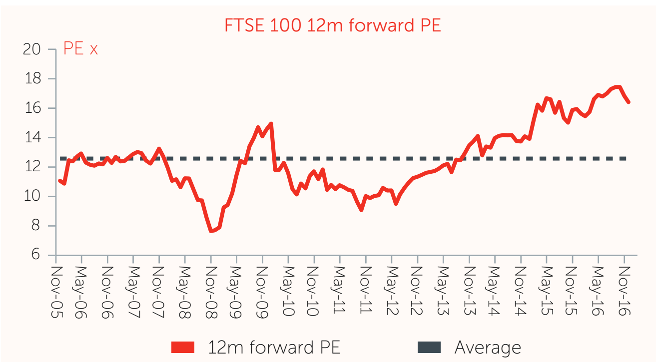

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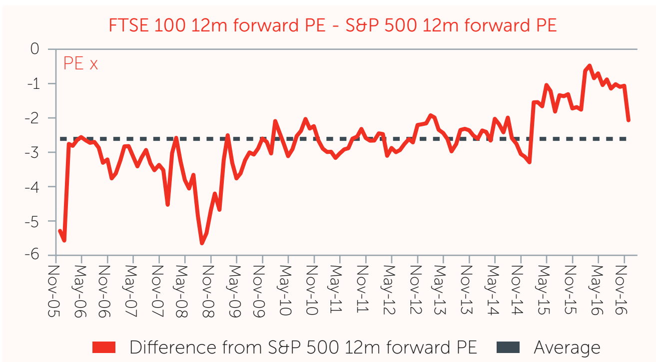

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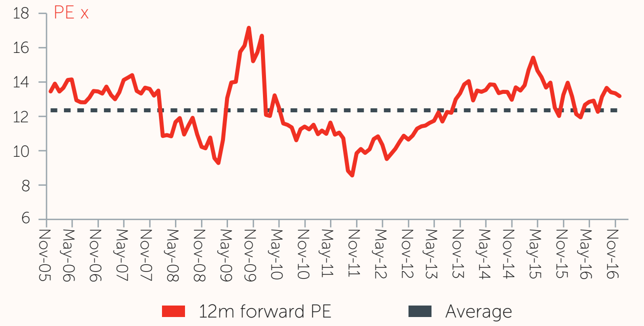
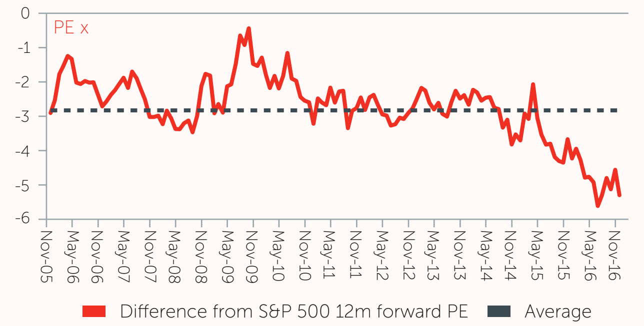
Equity Market Valuations

DAX 12m forward PE reasonable



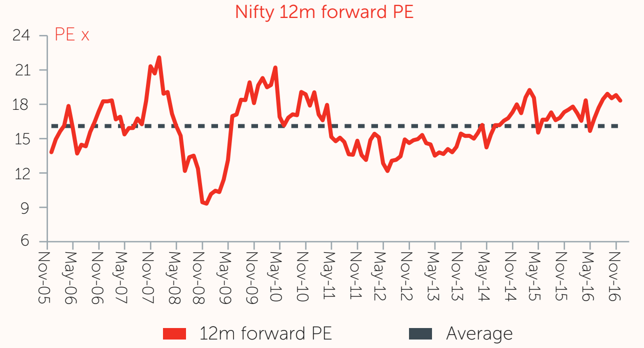
Source: Bloomberg

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



Source: Bloomberg

Nifty 12m forward PE



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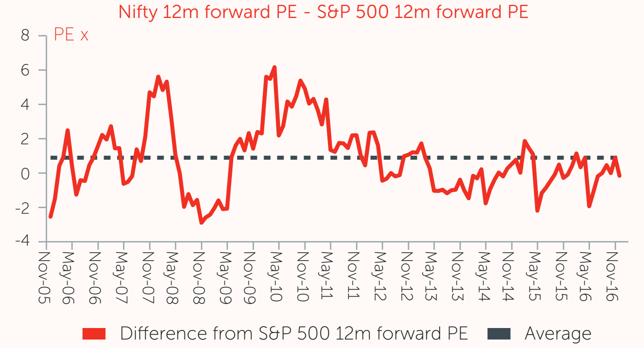
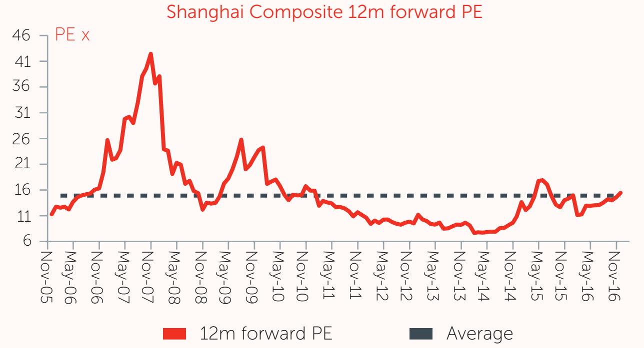
Nifty 12m forward PE - S&P 500 12m forward PE



Source: Bloomberg

Shanghai Composite 12m forward PE



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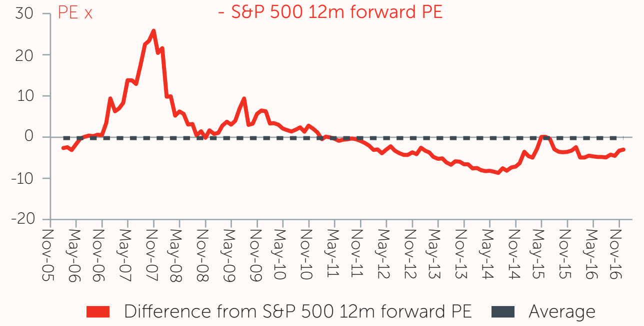
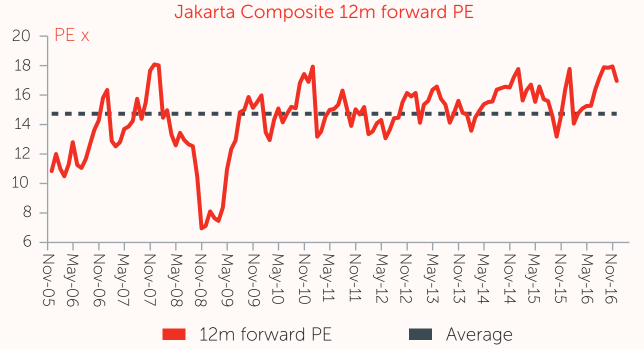
Shanghai composite 12m forward PE
- S&P 500 12m forward PE



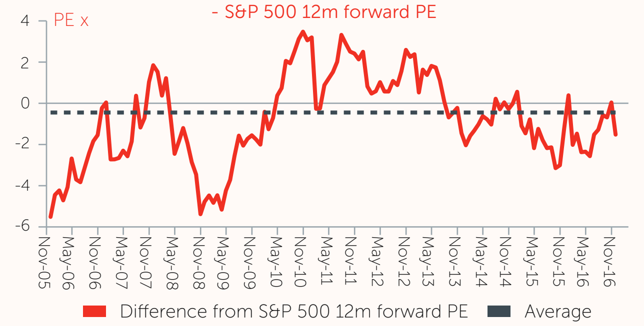
Source: Bloomberg

Jakarta Composite 12m forward PE



Source: Bloomberg

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



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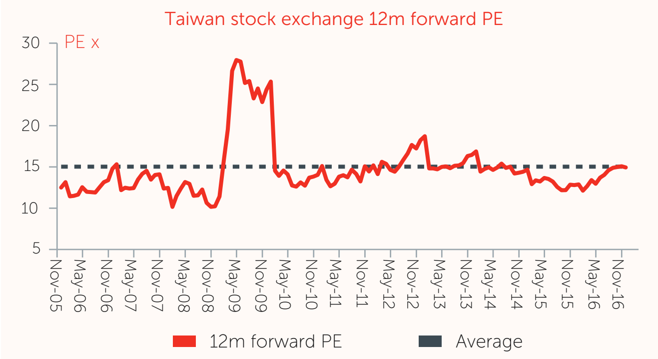
Equity Market Valuations



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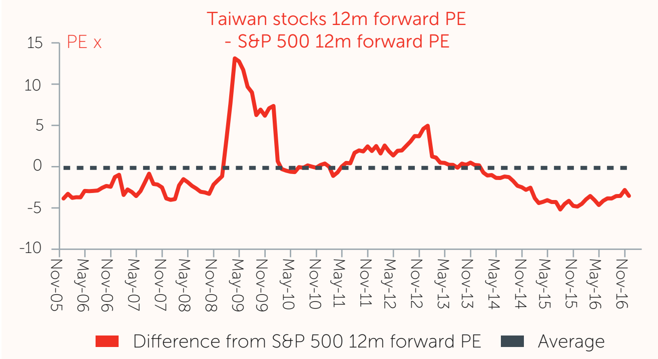

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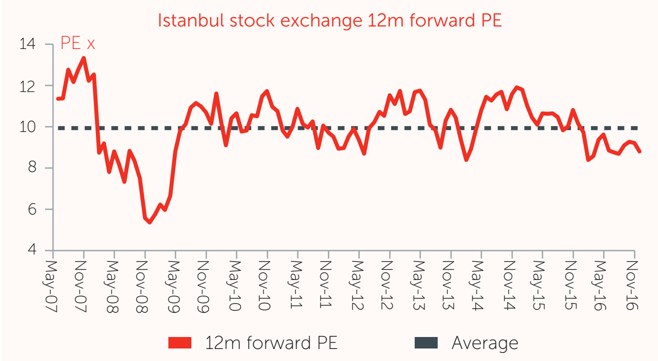

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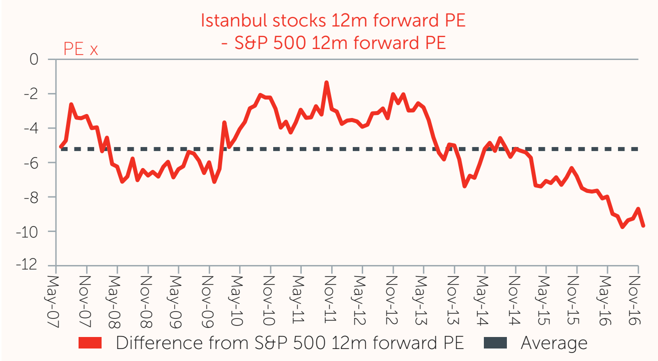

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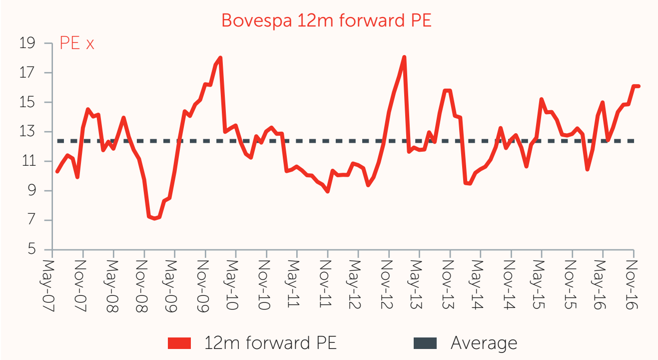

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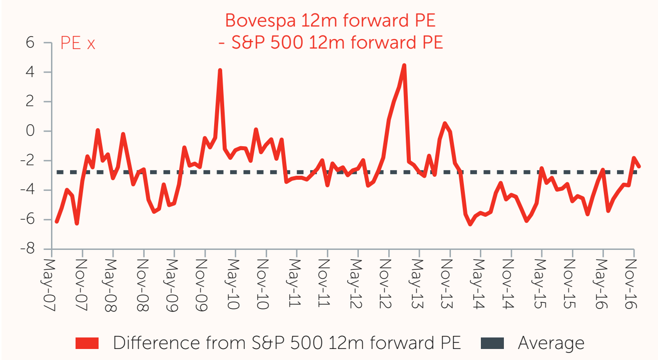

Source: Bloomberg

Sources

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

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