بنك أبوظبي التجاري
ADCB

ASSET
MANAGEMENT
LIMITED

QUARTERLY INVESTMENT VIEW

APRIL 2019

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ADCB
ASSET MANAGEMENT LIMITED

Contents

April 2019

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US expansions do not die of old age, they are always murdered by the Fed

For the savviest investors, however, such "murder" has never been a source of grief!

On the contrary, over the last 40 years, each recession provoked by the Fed has been a great buying opportunity. In fact, for the equity market the Fed was always like a "purger", rather than a murderer, cleansing it from all sorts of intoxicating illusions about the future. Of course, cathartic medication is by nature excessive. The market, rather than reverting to economic reality, undershoots. Hence the buying opportunity.

Our readers will forgive us for the gastric description of US (and global) equity market cycles since 1980. In reality the 40 years of Great Moderation have been very beautiful, rather than ugly. Over this period fiscal policy and labor market regulation have largely given way to the Fed as the sole steward of the economy. The latter's monetary policy has been extraordinarily successful. Interest rates have come down with inflation. Expansions' life expectancy has risen, whilst recessions have become shorter and shallower, allowing the Fed to stay close to its full employment target.

Today it is the Great Moderation that is being murdered

Unfortunately something has changed. Since the beginning of this century full employment alone has become increasingly ineffective in preventing the continuous erosion of US wages. The successful economic model is now broken. Monetary policy is no longer being relied on as the key driver of economic policy. Trade policy is being experimented as the new panacea. But it will not be enough. Increasingly, US voters are demanding redistribution. The "Tea Party" slogans are gone and whoever wins the US elections in November 2020, it is time to reckon with higher taxes, and potentially more labor market regulation. This is a very serious concern for investors since it is the continuous and persistent increase of the capital income shares at the expense of the labor income share that explains much of the stock market performance since 1980 . Recessions might still remain short-lived, but higher taxes and increased regulation will lead to less growth and more inflation. The 20s will see lower equity returns than we have grown accustomed to during the beautiful four decades of the Great Moderation. On the argument of long-term equity returns we also refer our readers to our recently published Equity Thematician.

For 2019, however, we advise to enjoy the (tea) party as long as it lasts. We see no recession, rather a pick-up in global growth in the second half of the year. As a result the current volatility in global equity markets will give way to a more sustained upward movement later in spring. Troubles will re-emerge sometime in 2020 when the Fed will raise rates, instead of cutting them as the market is currently expecting. Higher rates and a stronger US dollar are likely to cause a recession in 2021. Based on the belief that the Fed has no monetary policy ammunition left, many observers argue that the next recession will be big and long. We disagree. It will be a short and shallow recession. As such it will again be a buying opportunity. The real question is another one. Will it be the last big buying opportunity of the Great Moderation? Or will it be the first small buying opportunity of the new era of lower equity returns?

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

Key indices, Commodities, Currencies and Rates

Past quarter global markets' performance

Index	Latest (29 Mar closing)	Quarterly Change % (Q1 2019)	YTD Change % (29 Mar)
Index Snapshot (World Indices)			
S&P 500	2,834.4	13.1	13.1
Dow Jones	25,928.7	11.2	11.2
Nasdaq	7,729.3	16.5	16.5
DAX	11,526.0	9.2	9.2
Nikkei 225	21,205.8	6.0	6.0
FTSE 100	7,279.2	8.2	8.2
Sensex	38,672.9	7.2	7.2
Hang Seng	29051.4	12.4	12.4
Regional Markets (Sunday to Thursday)			
ADX	5101.0	3.8	3.8
DFM	2631.3	4.0	4.0
Tadawul	8788.8	12.3	12.3
DSM	10145.7	-1.5	-1.5
MSM30	4005.56	-7.4	-7.4
BHSE	1413.6	5.7	5.7
KWSE	5583.8	9.9	9.9
MSCI			
MSCI World	2,107.7	11.9	11.9
MSCI EM	1,058.1	9.6	9.6

Commodity	Latest (29 Mar closing)	Quarterly Change % (Q1 2019)	YTD Change % (29 Mar)
Global Commodities			
ICE Brent USD/bbl	67.6	27.1	27.1
Nymex WTI USD/bbl	60.14	32.4	32.4
OPEC Baskt USD/bbl	66.4	28.8	28.8
Gold 100 oz USD/t oz	1292.4	0.8	0.8
Platinum USD/t oz	849.5	6.8	6.8
Copper USD/MT	6485	8.7	8.7
Alluminium	1900.25	4.3	4.3
Currencies			
EUR	1.1218	-2.0	-2.0
GBP	1.3035	2.3	2.3
JPY	110.86	1.1	1.1
CHF	0.9952	1.3	1.3
Rates			
USD Libor 3m	2.5998	-7.4	-7.4
USD Libor 12m	2.7106	-9.8	-9.8
UAE Eibor 3m	2.8479	0.4	0.4
UAE Eibor 12m	3.2063	-10.3	-10.3
US 3m Bills	2.3809	-42.0	1.1
US 10yr Treasury	2.4050	-10.4	-10.4

Executive Summary

- With the Federal Reserve pausing, and China gradually injecting more credit stimulus, we should see a pick-up in global growth in the second half of this year. Even if the ECB is now in fact once more increasing accommodation, the pick-up in global growth is likely to determine a peaking of the US dollar versus the euro. This will provide some temporary relief to emerging markets, but we remain overall cautious on emerging markets since emerging bond and currency valuations are still rather rich.

- Even if China and the US manage to clinch a deal on trade, we doubt that global trade concerns are likely to go away over the next years. In fact, the so-called trade war is just the cover of a global tech war. In the short term trade concerns are to weigh on financial markets, simply because investors are still wary about global growth. In the long run, trade issues will be a drag on markets, rather than a cause of volatility and major sudden drawdowns.

- Trade concerns, but above all the structural slowdown in China, are behind our bearish view on emerging markets. Having said so, 2019 might see some upside for emerging markets. This is so because we are likely to see some incremental credit stimulus in China. In addition, stronger global growth in the second half of 2019 should somewhat weaken the US dollar which should also help emerging markets. Having said so, this is likely to end by 2020 when US inflation, and therefore higher Fed fund rates, will push up the US dollar. We might still move temporarily overweight emerging equities, especially if China credit stimulus picks up. But for the moment we remain cautious and play the asset class through tactical calls on Brazil and South Africa, whilst we stick to our long-standing core India call.

- China will remain dedicated to deleveraging as its credit-driven growth model is no longer sustainable. We have been surprised by the rise in credit stimulus in January. Whilst the government seems now to have decided to add some more credit, we still do not believe that it will be as significant as in 2015-16. The implications are that any surge in credit markets will be short lived.

Market Outlook and Portfolio Positioning

Asset Allocation

Equities	Neutral	Equities continue to do well in this late phase of the cycle, thanks to the policy put from central banks and from governments. We remain cautiously optimistic about the outlook for the asset class and remain overweight US equities; underweight Europe and EM.
Fixed Income	Underweight	Whilst high quality government paper might continue doing well, we see risks for further spread widening and higher yields on the short end of the curve.
Alternatives	Neutral	We maintain our exposure to hedge fund strategies that are less correlated to the market, as well as gold and treasuries as an insurance against risk-off moods.
Cash and liquidity	Overweight	

Fixed Income

Duration	Barbell approach	A barbell approach combining long-term Treasuries and short-term money market paper seems most sensitive.
Advanced economy corporate bonds	Underweight	Spreads remain unattractive.
US Credit	Underweight	US credit to remain volatile in the late phase of the business cycle.
Euro Credit	Underweight	The backdrop of weak economic growth in Europe, ECB's limited policy ammunition and possibility of primary issuance supply rising over next few months underscore our underweight stance on Europe credit.
US Treasuries	Overweight duration	Any rise in long-term bond yields will be limited compared to short-term bond yields as Fed pause to raise concerns on growth.
EM hard currency bonds	Tactical overweight	Fed pause and China stimulus are positives. However, we stress on a tactical stance as risks remain. We also selectively prefer Russia, Brazil, Indonesia and high-quality GCC sovereign dollar bonds.
GCC	Overweight	Increased preference for high-quality sovereign bonds due to their low correlation characteristics and inclusion in the EM bond index. Reduced preference for Oman bonds on rising fiscal uncertainty.
India	Tactical overweight on short-duration LCY bonds	The central bank will maintain a dovish bias with easing price pressures and slowing growth outlook. A short-duration stance on India GSecs looks appealing.

Market Outlook and Portfolio Positioning

Equity Markets

US	Overweight	US equities remain attractive given the quality of the corporates and transparency in earnings. US equities continue to offer the best spread of return on equity over cost of equity globally. Within US, we prefer consumer related themes; prefer services over manufacturing.
Eurozone	Underweight	Subdued economic activity, political risks, Brexit uncertainty and potential auto tariffs make us cautious about the outlook for Eurozone. However, we remain watchful of a potential inflection point. Within the region, we remain focussed on defensive quality.
Japan	Neutral	Cheaper valuations, under-ownership and potential for a cyclical bounce within the market make a glass half-full case. Weaker economic momentum, impact of the increase in domestic sales tax, lower earnings growth make the glass half-empty case.
Emerging Markets	Underweight	EMs recorded a strong performance this year but continue to underperform DMs, especially the US. We find selective opportunities in India (structural), Brazil (tactical) and South Africa (tactical). We remain underweight China.
United Kingdom	Neutral	Global orientation of the UK equity market indices makes them rather immune to Brexit uncertainties. However, equity investors will be impacted through the currency channel. Due to the prevalent uncertainty, we keep our neutral stance.

Energy and Commodity Prices

Energy	Neutral	Saudi Arabia and other major oil producers (OPEC 2.0) are likely to stick to supply discipline. A pick-up of global demand in the second half of the year will also be helpful. Over the longer term, we see more pressure on the oil price as US shale production is likely to continue to rise.
Industrial Metals	Underweight	China tightening will put downward pressure on industrial metals.
Precious Metals	Overweight	Bouts of risk-off jitters are very likely over the years to come. Thus we keep gold as a "market insurance" risk hedges in our portfolios.

Currencies

EUR	Moderate downward pressure	The pick-up in global growth in the second half of the year is likely to put a bottom to the euro, in spite of the increasingly dovish stance of the ECB. Things are likely to change in 2020, as the Federal Reserve is likely to turn more hawkish than many are now expecting.
GBP	Some further corrections expected	The Pound Sterling is to follow the euro rather than the US dollar. But downside risks persist with the Brexit uncertainty
JPY	Moderate downward pressure	BoJ yield curve targeting will continue putting downward pressure on the yen. Temporary emerging market strength would also weaken the yen, which is the quintessential funding currency for carry trades.

What's trending: Robotics and Automation

April 2019

Robotics and Automation

In today's modern industrial world, automation serves as a significant means of achieving efficient growth. Robots have the potential to optimally produce goods at cheaper costs, with lesser errors and downtime, with a higher quality compared to human operation. Robotic systems caters to the ongoing, rising demand for productivity, efficiency and quality by automating the manual operations in both industrial and non-industrial sectors. Increasingly sophisticated robotic systems can help in meeting stricter quality and safety standards and regulations. Besides operational benefits, robotic automation provides an array of financial benefits including better pricing for superior products and cost optimization accruing higher profit margins.

The developed economies are becoming highly imbalanced with increasing pensioners and declining working population. Robots boost productivity and make up for the shortfall resulting from an ageing population. As of end-2018, the worldwide operational stock of industrial robots is estimated at 2.4 million.

Growth opportunity

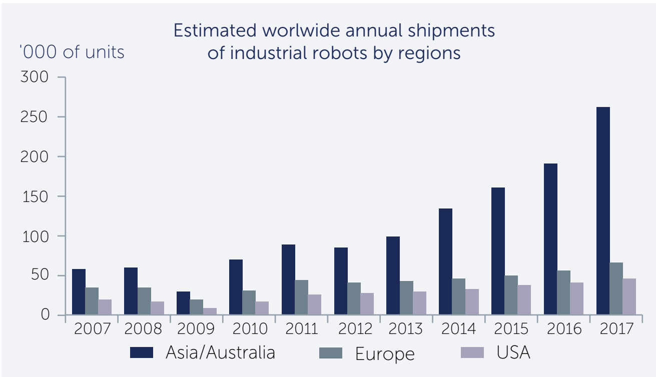
Rapidly evolving industry: The global robotics and automation industry has the potential to act as a multi-decade growth opportunity for investors to capitalize on the present and future growth of the global economy. Presently, the industry is at an inflection point. During 2016, M&A activity in the robotics and automation space hit an all-time high with over 50 acquisitions, 11 of which were for more than USD 500 million. This trend will likely accelerate in years ahead.

Robotics will play a critical role in changing the industrial dynamics: A new generation of industrial robots will pave the way for ever more flexible automation in near future, according to the 2018 World Robotics report. In figures, more than 1.7 million new industrial robots will be installed in factories around the world by 2020. The estimated global stock of industrial robots will increase from about 1.8 million units at the end of 2016 to 3.1 million units by 2020. This represents an average annual growth rate of 14% between 2018 and 2020. Region wise, in 2019 the operational stock of robots is estimated to increase by 16% in Australasia, 9% in the Americas, and 7% in Europe.

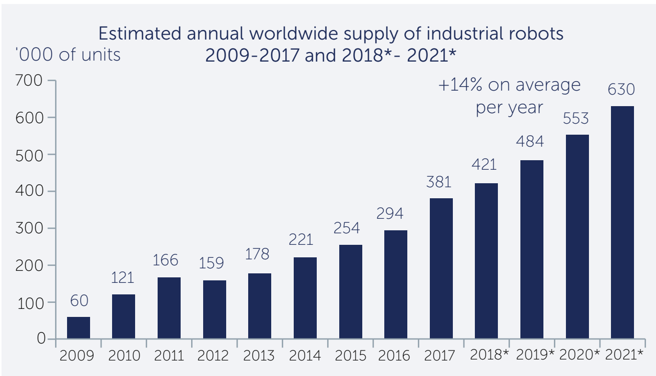
Increasing participation in adopting automation by technology giants: Interestingly, technology giants such as Amazon and Google have been increasing their involvement in developing automation technology. Amazon bought a robotic warehouse system maker Kiva to adopt automation technology into their delivery business. Google also purchased a portfolio of robotics-related businesses with the goal of creating a consumer robot technology by 2020, including Schaft, a Japanese start-up which developed a two-legged robot.

Strong government support for robotics development:

The developed economies have started allocating significant budgets for further development of robotics technologies. In November 2017, the UK pledged to invest GBP 2 billion to back the development of robotics and biotechnology with the vision to improve the country's competitiveness in the global arena. Emerging markets are also heavily reliant on robotic technology eyeing massive potential for future growth. South Korea holds a 35-year history of designing and building robots. The country had manufactured robots at an annual growth rate of 21% since 2008, according to a BlackRock report. China has the largest number of industrial robots in operation since 2016. In 2020, this will amount to about 950,300 units, considerably more than in Europe (611,700 units). China is looking to robotics in order to meet its ambitious productivity goals, aiming to double per capita income by 2020 from its 2016 levels. Furthermore, China is the world's largest importer of robots, however, the country lags in the usage of industrial robots when compared to other countries, suggesting more growth ahead.



Source: IFR World Robotics 2018



Source: IFR World Robotics 2018
* forecast

How to go for it

Our Investment Advisory team has identified number of products. If this is of interest to you, please reach out to your relationship manager.

Amid improving fundamentals equity markets poised to get foreign flows

OPEC+'s action supports oil price

Amidst the softness in global growth and rising US crude production, OPEC along with Russia decided to reduce crude production progressively by 1.2mn barrel per day during a meeting held in January. According to International Energy Agency, the compliance of the cut decision was 94% in February, thereby reducing the global supply by 340 kb/d during the month. The agency further estimates that agreed cuts by OPEC+ and additional reduction in supply from Iran and Venezuela due to sanction will result into global demand outpacing supply in the second quarter this year. Moreover, our view on global growth remains constructive for 2019 which should support the global crude demand. Therefore, we believe that the downside risk to the oil price is contained and the average price is likely to be similar to the average price of last year. However, any negative surprise on global growth and/or non-compliance of production cuts from OPEC+ members could result into sharper swings in the prices as we have witnessed over the last few years.

Real economic indicators show green shoots

In a relatively stable average price environment as we expect on a yearly basis, UAE banking sector data provides a cue about how the real economic activity has been shaping up in the recent past. Domestic credit growth has been hovering just under 4% mark, largely led by credit to non-GREs business and industrial sector which has been growing in excess of 6% yoy over the last few months. This suggests confidence has been building up in the sector. Similarly, private sector credit growth in Saudi Arabia, though remains low, has also improved over the last few months. Consumer spending indicators such as Point of Sales data have rebounded strongly in the last months of 2018. The momentum continued in January this year. Our discussions with top management of more than 30 regional large and mid-cap companies from different sectors also provide us positive feedback on the regional economic outlook. Most companies expect 2019 to be better than last year. Companies from Saudi Arabia believe that worst for the economy is behind us as impact from structural reforms that on one side helped the government to consolidate its finance but on the other side created transient headwinds for private sector as government retrenched spending, optimized subsidies and imposed taxes. The expansionary budget for 2019 supported by recovery in oil and non-oil revenues, stabilization in population and adjustment of business for new tax regime are positive factors.

UAE based companies put forward optimistic outlook as ADNOC announced a five-year plan of spending AED400bn, 60% of which will be directed towards upstream projects while remaining will be spent on downstream refining and petrochemical industry. Various media reports suggest that process of awarding projects has already started. Companies also expressed confidence that EXPO2020 related spending will accelerate in coming months that should support the broader economy in Dubai for the next two years.

Increased preference for high-quality sovereigns; reduce Oman

In line with the emerging market bond rally, GCC sovereign bonds have performed well since the beginning of the year. Higher oil prices, change in Fed's stance and search for yield are some of the factors driving spreads lower in GCC. In addition, the inclusion of the GCC bonds in the JP Morgan Bond Index has started from January 2019, which implies we will see more index-related flows into GCC bonds in the coming months.

Overall, we retain our preference for GCC bonds due to their low correlation characteristics. However, in our recent emerging market report, we reduced our preference for Oman bonds and increased preference for high-quality sovereign bonds. After being downgraded to junk by the rating agencies, In case of Oman, bonds may look attractive in terms of cheap valuations. However, the risk-reward profile does not look convincing on mounting fiscal risks. Oman, unlike Bahrain, prospects of any financial aid from its GCC peers look dim given the country's political orientation. In addition, Oman bonds were already included in the JP Morgan bond index and inclusion of other GCC bonds this year will ultimately reduce its overall weighting in the index.

On the other hand, high-quality sovereign bonds in GCC are looking still attractive, as indicated in our Emerging market Credit Ranking model. Inclusion of the GCC bonds in the JP Morgan bond index is likely to attract index-related inflows and hence should prove supportive for the bond spreads. In the primary market as well, Saudi's first sovereign bond issuance received strong interest from investors. With the decent demand available, most of the GCC countries should be able to borrow and meet their financing needs easily.

Equity markets poised to get foreign flows

Given the backdrop of improving outlook, the actual flow of foreign funds in Saudi Arabia's equity market, the largest equity market in the region, has started in March with the first tranche of FTSE EM index tracker funds invested an estimated SAR2.0bn. This is just 10% of the total passive flows for FTSE EM index alone. The major flows for MSCI EM fund will start in May this year. The flows related to these two major indexes related investments are schedule to come over the next one year as shown in the table below. Kuwait equity market is also likely to be included in MSCI EM index this year. In this case, flows will happen next year. Improving fundamentals and expected flows have supported these equity markets in recent months, and are likely to do well, in our view.

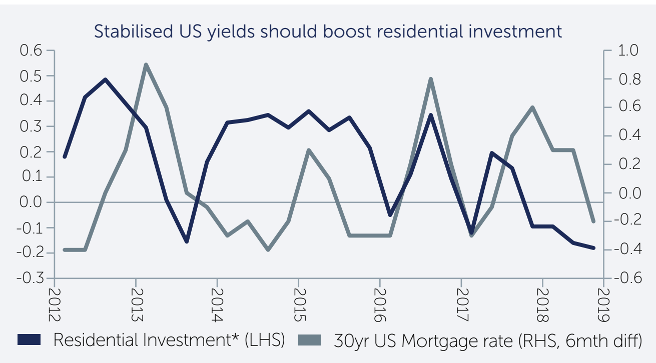
Dates	MSCI Saudi Passive Inflows
30 May 2019	50%
29 August 2019	50%
	FTSE Index Passive Flows
18 March 2019	10%
22 April 2019	15%
24 June 2019	25%
23 September 2019	25%
23 March 2020	25%

Source: MSCI, FTSE

Economy still resilient

Most of the slowdown is likely behind us

In spite of continuing global sluggishness, the US economy is still showing remarkable resilience. We do not think that the US economy is heading into a recession and we think that most of the soft patch is now behind us. In fact, a closer look at the macro-economic fundamentals tells us that the economy still has room to go. To start with, credit conditions have remained relatively accommodating across the economy even with Fed tightening, so we should be confident of further improvement now that the Fed has called off further 2019 hikes. In addition, consumer spending is likely to remain robust with higher wages and lower oil prices. Critically the fact that the labor market is now very tight, means that also lower wages are also going up. This tells us that the savings rate has some more margin to come down. The recent correction of long-term yields, finally, is likely to support the housing market, the traditional driver of the US business cycle. As for US corporations, given still relatively easy lending standards, there is still likely some upside in investment spending in a context of high capacity utilization and rising labor costs.



Note: * 2-quarter moving average qoq%. Source: Bloomberg

Political risks might temporarily fade in 2019

Against an economic backdrop which still seems favorable, i.e. we expect that 2019 will not see a US recession, political risks seem to be also retreating. We do not believe that the global trade concerns are gone forever, but some temporary truce.

Having said that, we suspect that the Trump administration will stress that any deal will remain subject to verification, leaving the door open for additional further measures. At the same time, it seems less likely that a repeat of the government shutdown will occur. As for further turmoil and destabilization related to the Mueller investigation, this is very difficult to predict, but one would think that the existence of a "smoking gun" would by now have been revealed.

Fixed income: 10-year US Treasury stuck in a range

The 10-year US treasuries have been trading in a tight range since the beginning of the year, mainly on account of the change in Fed's dovish stance. The Fed has reversed its rate outlook and is now advocating a "patient" approach in raising rates. A more dovish message has been in the form of the central bank putting an end to the quantitative tightening program this year. Given the Fed's removal of rate hike projections for this year, markets are now pricing in rate cuts from end-2019 and also for 2020. However, we believe that the economic data has to weaken significantly and consistently to coerce the Fed in reducing rates in 2020. Further, before reducing rates, the central bank will assess the impact of its rate pause and impact of the quantitative tightening on the financial conditions. In addition, the Fed is paying close attention to the inflation and with the Fed pause, we could potentially see inflation pressures coming through. This may be enough for the Fed to consider hiking policy rates again, possibly in 2020. Overall, the Fed fund rate should act a floor to the 10-year US treasury yields for now until economic data surprises downwards and hence the 10-year US yields are expected to trade in a range, albeit at a lower range of 2.5-2.8%.

US credit has been one of the best performers within the fixed income space and has managed to partially reverse the losses recorded in Q418. The main driver was the unexpected change in Fed's stance to a more "patient" approach in raising rates. Valuations may be looking attractive, but volatility is likely to remain high in this late stage of business cycle. While US growth will remain strong, it may not be as strong as last year with impact of tax cuts fading away, to provide any catalyst for credit outperformance. In addition, rebuilding of Fed tightening expectations in the latter half of the year will add to increased volatility. As such, we remain underweight on US credit.

US equities: remain overweight

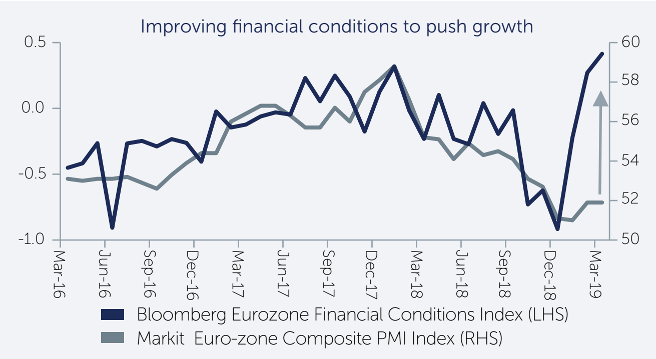
As we have been arguing for a while now, the late cycle environment points to caution for equity investors. It makes sense for investors to focus on quality and defensive themes. In US equities, we find both. For context, the share of US in MSCI All Country World Index (ACWI) Quality index (which aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (RoE), stable year-over-year earnings growth and low financial leverage) is 67% compared with the share of c55% in mainstream MSCI ACWI. Also, within the equity risk spectrum, US is always considered low beta (defensive) while Europe and EM are more at the cyclical risk end. Furthermore, US equities continue to offer the best spread of Return on equity (RoE) over Cost of equity (CoE). At more than 18% (as estimated by I/B/E/S consensus for this year and the next), RoE for US is the highest across the world.

However, we are mindful of downside risks building for the asset class. As argued previously, we do expect the equity returns to slow down structurally (here, we are talking about a decade of lower returns from global equities) and US is likely to play a major role in this. In the near term however, the risk arises from a sharp slowdown in domestic economic growth and/or the earnings recession in the US. Whilst this is to a large extent, due to the base effect, markets will still worry about the growth prospects. In our view, Q1 2019 reporting season which is expected to go full swing only by end of April, is likely to provide a more positive picture. Till then at least, the earnings concerns are likely to weigh on investor sentiment.

Some pick-up likely, later in the year

Europe gradually emerging from the Asia slowdown and trade concerns

Europe, much more than the United States, has suffered from the trade concerns and the Asia slowdown caused by China tightening. The gradual rise in China credit, some sense of a solution in the China-US trade deal, and critically an increasingly dovish ECB is now triggering hope that some rebound will occur in the second half of the year. It is important to also point out that the euro is competitive from an historical perspective, such that some euro strengthening, likely later this year, should not derail growth. The recent improvement in the credit conditions in the Euro-zone confirm the likelihood of a pick-up in growth.



Source: Bloomberg

Political risks are here to stay

Whilst political risks will not fade soon, we believe it is more a long-term concern, rather than a concern for 2019. The May elections of the European Parliament will definitely see an increase in the populist parties, but the mainstream establishment parties will maintain country. Also, whilst in the US and the UK the traditional parties, both on the left side and on the right side of the political spectrum are gradually being "subverted" by grassroots populist, On the European continent mainly right-wing anti-establishment parties are gradually converging to more mainstream positions. This is so because the welfare systems in these countries are stronger, such that the median voter will think twice before pushing the political system to the brink. At least not until a major global recession determines a significant pick-up in unemployment in the core Euro-zone economies.

Bunds yields to remain suppressed

The ECB has surprised more on the dovish side relative to the Fed and this has pushed European bond yields (both core and non-core) lower. In addition to the downward revisions in growth and inflation projections, the ECB has wiped out uncertainty in terms of its monetary policy by indicating that it will not raise rates until 2020, will continue to reinvest their bond purchases and introduced another round of TLTRO funding (targeted longer-term refinancing operations). We expect that the ECB will remain dovish for the entire year and this should keep the bund yields lower. However, scope for the bund yields to fall significantly and to remain below 0% appears difficult as most of the recent ECB actions including the downward growth projections were priced in by the bund market. For the bund yields to sustain in negative territory, there has to be a further sharp deterioration in the global growth outlook.

European credit also had a bright start to the year. While growth concerns have further aggravated in Europe, they have been followed by dovish surprises by the ECB. Valuations look attractive, particularly in the EUR high yield sector. However, the backdrop of weak economic growth in Europe, ECB's limited policy ammunition and possibility of primary issuance supply rising over next few months underscore our underweight stance on Europe credit.

Eurozone equities: retain underweight

European equities performed quite strongly so far this year but marginally underperformed ACWI. Whilst this positive performance could continue, we believe that the European block will underperform world equities.

Economic activity remains subdued. Whilst the recent PMI data did show some signs of hope, we think downside risks remain. Especially with Chinese growth projections lowered and the activity in the US softening, the economic recovery prospects for Europe will be put to question too. Indeed, OECD cut its growth outlook for Euro area for this year to 1.0% percent from 1.8% citing a range of headwinds the bloc faces. Growth estimate cuts were most acute for Germany (down to 0.7% from 1.6% earlier).

Very broadly political risks remain for the bloc as a whole, especially with the European parliamentary elections scheduled for later this year. Other notable developments that could impact the political landscape include the recent decision by Italy to endorse China's Belt and Road initiative. US has already cautioned Italy against this.

US autos tariffs are akin to the Sword of Damocles hanging above the European Union. President Trump had made it clear that he is prepared to impose auto tariffs on EU in case both parties do not reach a deal (see Trump Continues to Weigh EU Auto Tariffs: International-Wall Street Journal, 20 February 2019). This is likely to worsen the situation across the bloc that is already struggling with industrial recession. Adding to this are structural shifts taking place in the car industry including electrification and autonomous vehicles.

Earnings estimates have stayed surprisingly resilient; especially when those in the US and UK were marked down quite aggressively. We see downside risks to earnings estimates here. Of course the earnings are well below the trend but we think they could stay there for longer.

The ECB has announced a new series of TLTROs (third episode of such easing) at the ECB meeting on March 7. We doubt if this is going to be positive for risk sentiment. Of course long duration sectors are likely to outperform and EUR weakness could boost exporters; but in our view the focus is likely to shift very quickly to flat yield curve which is not very constructive for banks' profitability. For those investors who would still like to build exposure to Europe, we would stress to remain focussed on defensive quality names (heath care and consumer staples) which also yield dividends.

Brexit bleakness

Tick-tock, tick-tock the Brexit Clock

Brexit risks continue to dominate the economic sentiment in the UK. The UK parliament remains undecided, after rejecting Mrs. May's deal for the third time and also simultaneously voting against a "no-deal" Brexit and also against a second referendum. The EU has agreed to postpone the Article 50 deadline until 22 May on the condition that the government's approved Withdrawal Agreement (PM May's deal) is passed through the House of Commons else the UK is set to depart on 12th April. In the latter case, the UK MPs will have the choice between a "no-deal" Brexit and longer extension of Article 50 which requires participation in the EU elections. With Mrs. May losing control over the Brexit decision to the UK parliament, the withdrawal agreement could now be behind us. Having taken charge of Brexit, the UK Parliament held indicative votes on eight options in last few weeks, but none received the majority approval needed to lock a formal vote. The eight options included softer versions of Mrs. May's deal, revoking Article 50 and cancelling Brexit, a second referendum and no-deal Brexit. At the time of writing, PM May has announced her intension to ask the EU for a longer extension to the Brexit deadline of 12th April. Overall, Brexit uncertainty remains binary in nature i.e. soft Brexit or a "no-deal" Brexit and financial indicators signal that the markets are not yet fully pricing the possibility of the latter i.e. a "no-deal" Brexit. An agreement on the deal or a longer extension may reduce the risk of "no-deal" Brexit, but it would only bring in more uncertainty. As such, lack of clarity on the Brexit options and political upheaval will continue to weigh on the markets and the business sentiment. Overall, we believe that, irrespective of the path the UK parliament decides on, the ongoing uncertainty will already have consequences on economic activity. Risks of "no-deal" Brexit will amplify the economic and business uncertainty.

Economic backdrop is bleak

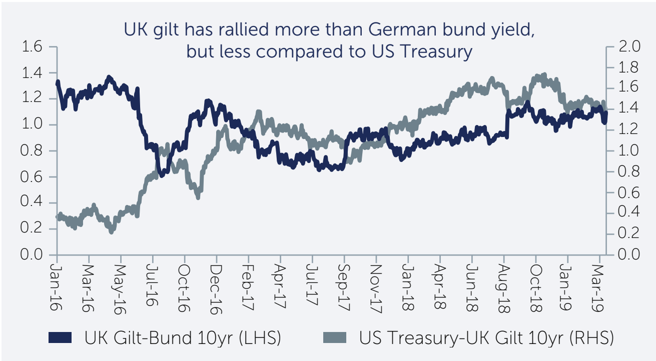
Economic indicators do not score great either. While unemployment may have declined, the UK growth remains subdued with the economy expanding by 0.2% in 4Q18. One of the main reasons is Brexit uncertainty which continues to hold back business investment. In addition, global growth slowdown, particularly in Europe and China, is impacting trade. On the other hand, inflation remains contained and has been hovering near the central bank's target level. The backdrop of weak economic data along with Brexit uncertainly should refrain the Bank of England from tightening monetary policy for now.

Pound to remain volatile

The pound sterling had a decent start to the year. The currency has appreciated almost 4% versus the dollar since the beginning of the year. However, the pound has remained mostly volatile as markets remain perplexed with the possible Brexit outcomes. The recent strengthening of the pound, yet indicates that the markets may be less worried about the "no-deal" Brexit outcome, particularly after the UK MPs have voted against it twice. Brexit uncertainty is likely to increase, especially in the event of a longer extension of Article 50 deadline leading to fresh new general elections in the UK. As such, lack of clarity will keep the pound sterling volatile in the coming months. In the event of a "no-deal" Brexit, currently underpriced by the market, the pound is expected to come under immense pressure.

Gilts: remain bullish

Unlike previous quarters when Brexit uncertainty pushed gilt yields lower, the 10-year gilt yields in the first quarter have mostly traded in a tight range compared to their German and US counterparts. This signals that markets remain directionless ahead of the extended Article 50 deadline. The bond market is also not fully pricing in the possibility of a no-deal Brexit, which is still not off the table. Overall, we believe that Brexit uncertainty is likely to sustain as markets remain clueless about the possibility of various options. Apart from Brexit, recent data has been signaling weakness in UK economic activity, in line with the trend seen globally. The sluggish 4Q GDP print was completely overshadowed by Brexit while PMI surveys also point to softness in manufacturing activity. In addition to Brexit risks, the impact of growth slowdown in Europe and China will also have spill-over effects to the domestic economy



Source: Bloomberg

As such, irrespective of how things pan out, we believe that the gilt yields will remain low as economic outlook is unlikely to undergo a massive expansion. We hold a positive stance on the gilt market.

UK equities: remain neutral

Our neutral stance is purely due to the uncertainty the Brexit event presents and not because of any subjective assessment of the situation. The equity market composition of UK is such that what happens outside the UK is more important than what happens domestically. For the context, c55% of MSCI UK index are stocks that are linked to global consumer and global commodities. Other 20% of the index is Financials which is loaded with international banks. Global industrials make another 9%. However, Brexit does impact UK equity investors through the strength/weakness in the currency – this could swing either way. Therefore we remain neutral UK equities. Thanks to the global orientation of the UK equity index, its aggregate earnings growth estimates came under pressure in line with that in the US. I/B/E/S consensus estimates are for MSCI UK index earnings to grow by c3% this year and by 8% next year.

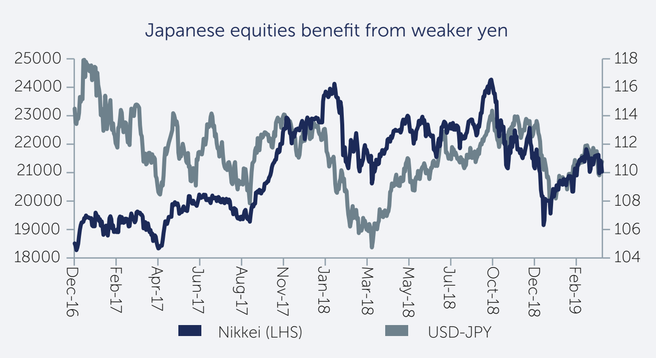
Positive domestic backdrop in a difficult international context

No Abe, no problem

Whilst Prime Minster Abe has very effectively strengthening his hold on power, 2019 might be the beginning of the end of his political career. Ideally, he will manage to win his referendum on constitutional reforms and make Japan a "normal" country. Regardless, he is likely to exit the political scene after the 2020 Tokyo Olympics. Is that a problem? Likely not. Abenomics, in fact, will survive Abe, and both monetary and fiscal policy are likely to remain accommodative, with or without Mr. Abe.

What is more, the uncertainty created by the slowdown in China, as well as some prospective solution to the US-China trade dispute, should lead to some respite for emerging markets. Such developments always trigger downward pressure on the Japanese yen, and thus have the potential of rewarding the accommodating stance of the Bank of Japan. Thin in turn might then lead to upward pressure on wages and consumer prices.

In this sense, the Japanese economy, in spite of – or perhaps precisely because of – its global position as a net creditor – is more likely to benefit from a global downturn than most other advanced economies. In this regard it is interesting to known that the yen has actually hardly strengthened during the 2018 emerging markets' weakness, making us confident that it can further weaken if emerging markets have a temporarily boost. Critically, as the chart below shows, Yen weakness is always a boon for equity prices.



Source: Bloomberg

Monetary policy to remain accommodating

The Bank of Japan will remain much more reluctant than the Federal Reserve, or even the European Central Bank, to unwind its massive balance. Unfortunately it is not at all clear how meaningful its impact will be on domestic inflation expectations going forward. The current policy of yield curve targeting – specifically intervening in the market such that interest rates are negative and long-term yields are zero – can no longer be perceived as shocking the markets. It has become part of the landscape and, as such, inflation expectations might become entrenched, and thus indifferent to additional measures of monetary policy.

What kind of inflation expectations might become entrenched? That is the bug question of course, but what matters is that it may be out of the hands of the Bank of Japan. Nonetheless, a pick-up in emerging markets correction is likely to weaken the Japanese yen, which is the most important funding currency for emerging market investments. Thus the Bank of Japan can avoid politically contentious direct intervention. Perhaps that is not enough, but it is a positive development for Japanese equities.

Japanese equities: remain neutral

Japanese equity markets have performed poorly over the past year (MSCI Japan total return index lost 10% in USD terms compared with a flat performance on MSCI ACWI). Whilst the Japanese equity performance has revived in the recent months in absolute terms, the underperformance relative to ACWI continued. Mapping our top-down and bottom-up views, we believe that the investment case for Japanese equities is well balanced now. We stay neutral Japan.

On the positive side of the balance, valuations have improved quite substantially after the correction over the past year. Japan continues to remain the biggest underweight amongst major DMs in global equity portfolios. The market could get an uplift from improving trade sentiment in Asia (Japanese trade numbers have disappointed quite significantly in the recent months). Within the market, cyclical sectors are very depressed and could be in for a bounce, thereby lifting the entire market.

On the negative side however, GDP growth remains anaemic. Domestic sales tax increase is likely to weigh in the near-term. Earnings and return on equity (RoE) trends are weak too; for the context Japanese corporate sector earnings growth for this year is expected to be close to zero and I/B/E/S Consensus expected RoE for Japan is 430bps below that for ACWI. The corporate sector is strained by the ongoing governance issues; especially in relation to cross-holdings and assets with returns below the hurdle rate. As mentioned, however, yen weakness is expected to be a catalyst though for better equity market performance.

Some stabilization to the slowdown

Sticking to policy

With industrial output and investments continuing to contract, the Chinese authorities are now trying to give some moderate stimulus to the economy, breathing some life into the State-owned enterprises which have in the past been the main beneficiaries of lending. Yet, we still believe that the overall stimulus will be a far cry from the 2015 measures, let alone the 2008 story. Critically stimulus will be much more centred on fiscal support to households, rather than credit to corporations. The former is less interesting for the rest of the world as it is less likely to translate into imports of commodities from emerging markets, or capital goods from developed markets. And, to make matters worse, China will remain tempted to sustain its economy through a weakening exchange rate, which is bad for the rest of the world. We expect however that some strengthening of the euro will temporarily put a floor under the renminbi.

The appointment of Liu He as China's Vice Premier of Economics is a clear signal. President Xi Jinping has been give wide powers. The ultimate goal of such powers is to pursue deleveraging even in the presence of significant market turmoil. This more hawkish policy stance had been in the making through 2016 and 2017 as Xi was preparing for the November 2017 Congress to appoint a Standing Committee of the Politburo of the Party pretty much in his own image. That very policy is also inevitable in view of the massive debt accumulation that has been accruing since 2009 as the country financed domestic investment spending with a view of compensating for slower global demand growth for its products.

The hawkish policy stance of reigning in excessive credit spending, of which Mr. Liu He is the personification, is absolutely necessary if the country is put itself on a sustainable growth path, capable of lifting it from a middle income- to a high income country. Also, now that the population growth has stabilized, there is less need to create each year millions of new jobs. Thus, from the government's perspective, it is better to allow some financial unrest, and compensate that with social spending aimed at alleviating the pain for the weaker parts of the population, rather than increasing debt levels again and kicking the can down the road once more.

Trade conflict might make the policy choice even easier.

China is suddenly immediately exposed to the risks inherent of an economy that is too much tilted towards manufacturing exports. Whilst a slowdown of the Chinese economy was already in the cards with the government trying to reduce bank credits, deflate the real estate bubble and bring down excess capacity in key manufacturing sectors, it certainly would have preferred doing so in a gradual fashion, not as a result of (the imposition of reduced) export revenues.

Then again, the Chinese authorities have now an external scapegoat to whom – if necessary – blame the hardship of deleveraging, and in reality rally support for the policy of deleveraging. Again, one should not take China's commitment to deleveraging as a non-pragmatic rejection of any form of support to the domestic economy. This is ever so true because manufacturing in China is still more than 20% of gross domestic product and employs also more than 20% of the labour force. In other words, China is much more vulnerable to a potential trade war than the United States which employs only 10% of the work force in manufacturing and which exports to China less than half the value of what China exports to the United States. But China will maintain steadfast to a process that ultimately will reduce debts, and slowdown the economy. And the hardship that will inevitably follow from that will be conveniently blamed to the trade war initiated by the US.

Source: Bloomberg

Chinese equities: maintain underweight

Most notable development was the divergence between the performance of mainland-listed and offshore-listed Chinese stocks. So far this year, mainland stocks significantly outperformed the offshore listed names. This divergence can be explained by liquidity flows into mainland shares, pertaining to the MSCI decision to include China A shares into their mainstream equity indices. Just for the context, China A shares have a weighting of 0.8% in MSCI EM index which is expected to grow to 3.8% by November this year. This would mean, based on our back-of-the-envelope calculations, an inflow of USD12bn into Chinese A shares this year. What is worth noting is the potential for the Chinese A share representation to rise in MSCI EM index to eventually have a weight of 16%; however this is more a hypothetical scenario.

Earnings trends remain weak with I/B/E/S consensus expectations on MSCI China EPS growth over the next twelve months at zero. Indeed, these estimates have fallen from c30% to zero in just 12 months. Long-term EPS growth is expected to be weak too. However, we think the earnings will start to grow on a year-over-year basis some time in Q2 2019 due to base effect. Whilst MSCI China index has historically traded on lower multiples compared with rest of Asia, the current 12M forward PE multiple is close to the long-run historical average.

All in all, thinking about the potential leadership rotation out of US into China, we think it is too early to call for an inflection. However, it is prudent, in our view to stay vigilant for rotation opportunities in the near future.

Prepare for a slight "Modi"-fication

Focus on election

After a volatile 2018, stability has returned in most of the Indian assets. Inflation pressures have subsided and settled within the central bank's inflation target. However, economic activity has been decelerating with the 4Q18 GDP print surprising on the downside and the economy growing at the slowest pace in almost two years. As expected, non-banking financial corporations' (NBFCs) financial stress was the key driver for the slowing down the economic activity. Many NBFCs facing liquidity challenges have dragged credit growth lower. Several sectors, including real estate sector and small and medium size enterprises, most dependent on the NBFCs financing, have been the worst hit. Growth is expected to slow down further in the first quarter of the year, as typically seen in the quarter before the elections. Private sector will delay increasing investments due to the political uncertainty ahead of the election. At the same time, the government has pooled in all resources to focus more on the agrarian stress and unveiled new cash packages to support farmers. Ahead of the elections, the government will remain under pressure in election-related spending and this will postpone government spending into infrastructure.

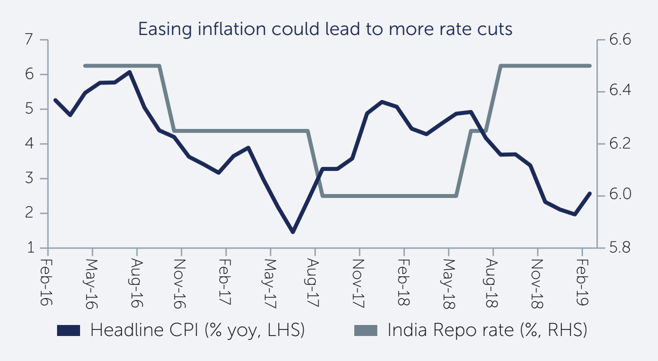
In the coming weeks, the focus will be on the general elections which are scheduled to take place in the April-May period. Recent opinion polls are pointing to the possibility of the incumbent Modi's government retaining power at the center. However, with economic concerns of slowing growth and rising unemployment, the incumbent government may face challenges in securing a similar majority like it did in the 2014 elections. Irrespective of the final result, we do not expect that a change in the political picture will put a break on the reform momentum. Irrespective of which party wins the election, the policy direction is likely to remain the same. The only election risk is a weak coalition formation which could then slowdown the reform progress. But overall, we believe that India's economic fundamentals still score strong and any deceleration in activity will only prove to be a temporary hitch.

More RBI easing on the plate

With the government spending set to slow and private investments likely to be postponed ahead of the elections, we could see growth indicators pointing to further deceleration in the first half of the year. Global growth slowdown could also hurt the manufacturing activity. The backdrop of subdued inflation pressures, election uncertainty and slowing growth concerns provide enough reasons for the RBI to remain dovish in the near term. In addition, the central bank will also focus on ensuring there is adequate liquidity in the banking system and the policy rate reductions pushes the banks to cut rates. As a result, in addition to reducing policy rates, the RBI also boosted rupee liquidity by introducing USD5bn worth of 3-year rupee-dollar swaps. We believe that the RBI will concentrate on these measures for effective transmission of its policy rates cuts into the economy and remain dovish in the near-term.

Bonds: Short-duration on India government bonds

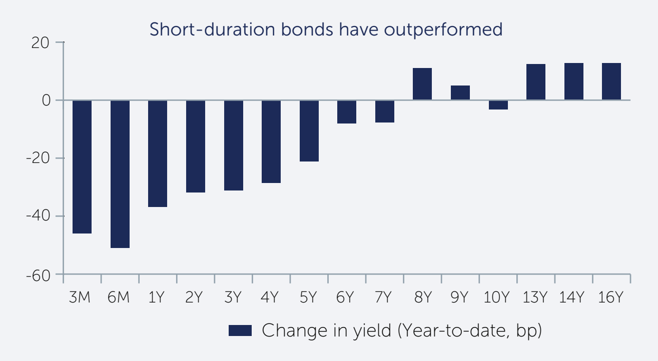
Indian government bonds have been volatile, particularly long-dated bonds, on increased geopolitical tensions and higher bond supply pressures due to expansionary fiscal budget. However, short-dated government bonds have rallied this year, especially after the RBI surprised with a policy rate cut. The rally has also been supported by the recent injection of liquidity conducted by the FX swap auctions. With growth disappointing, increased political uncertainty ahead of the elections and inflation pressures remaining subdued, we expect that the Indian central bank will maintain a dovish stance in the coming months. The February meeting minutes also indicated a benign inflation outlook advocated by most of the MPC members. As such, we recommend an overweight stance on short-dated Indian government securities.



Source: Bloomberg

Indian equities: remain overweight

Our overweight position on India is more structural. Indian equities recorded a sizable underperformance year-to-date as the focus was largely on the potential outcome of the general elections scheduled for April/May this year. As we held for a long time, whilst capital inflows are likely to be hesitant this side of the elections, they are likely to pick up soon after the election results are announced. In our view, the outcome of the elections is unlikely to have a strong bearing on the equity market performance for too long. Reform momentum is likely to continue irrespective of the party in power – this has been the case ever since the economic liberalisation in India in early 1990s.



Source: Bloomberg

Economic momentum is strong, earnings growth remains stellar, valuations are now attractive after the recent underperformance and the market is not well owned.

It's not "goldilocks" again

Fed pause and China stimulus are only temporary positives

After a tough 2018, emerging markets have had a good start to the year. The Fed's dovish shift in reaction to the tightening US financial conditions towards the end of last year has been the catalyst for the rotation into emerging market assets. In addition, the recent progress on US-China trade talks has de-escalated the previous trade tensions. Separately, concerns on China slowdown have also softened with the Chinese government announcing new round of fresh stimulus to support the economy. Increased inflows into EM assets may remind of the 2015-2016 "goldilocks" environment with low inflation pressures and accommodative developed market central bank policies. We believe that the Fed pause should allow majority of the EM central banks to support pro-growth policies and cut rates. While this should have positive impact in the short-term, the rate cuts may not be as shallow as seen in 2016 given that markets will start pricing in a more hawkish 2020 Fed stance towards the end of the year.

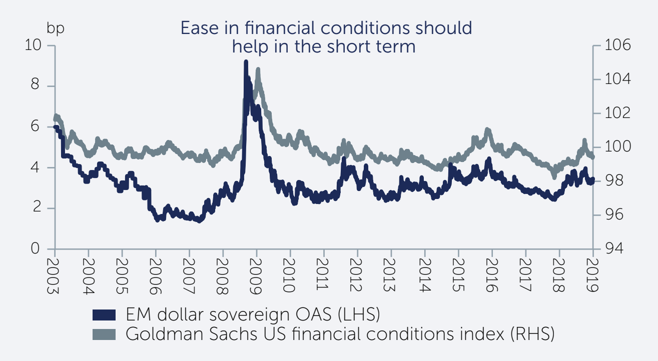
The current economic situation in China also looks quite similar to what we witnessed in 2015-2016. In the beginning of 2016, slowdown in China's growth had become a major worry for the global markets and triggered increased volatility in the emerging markets. Chinese economy escaped a hard landing and growth bounced back in 2016 as the Chinese government unleashed a massive stimulus. Fast forwarding to today, similar to what markets witnessed in the beginning of 2016, 2019 started with reports of slowest growth recorded in 2018 in almost 28-years. While the Chinese government has again responded with a stimulus program, the size of the stimulus is not as aggressive as seen in previous years. So far, economic indicators have shown mixed impact from the recent stimulus. Separately, the size of the stimulus being modest from before means that its impact may not be felt across all emerging markets.

EM Bonds- Tactical overweight on sovereign dollar bonds

Emerging markets bonds have been rallying since the beginning of the year since the Fed's policy "pivot" in January 2019. We had been maintaining a cautious stance on emerging market bonds, in spite of the recent rally and advocated a more selective approach. One of the reasons behind our selective approach was that we were not yet fully convinced of the Fed freezing rates fully for the remainder of 2019, nor of the degree to which China would provide significant additional stimulus. It is the combination of more China stimulus and Fed dovishness that puts downward pressure on global yields and the US dollar, thereby ultimately supporting emerging market bonds. As a result, we recommend a tactical overweight on emerging market dollar sovereign bonds.

The search for higher yield naturally boost demand for emerging market bonds. With the US treasury yields remaining range-bound for the year and European bond yields moving in the negative territory, emerging market bonds offer attractive yields. We would like to stress though that there is a continuing likelihood of the Fed hiking rates in 2020. At the same time we don't believe China stimulus will be of the same scope and size as its 2015-16 stimulus. Hence, there is a good chance that emerging markets will again come under pressure towards the end of 2019. This then explains the tactical nature of our call. In addition, there are emerging economies that have been facing increased fiscal uncertainty and deterioration in the credit outlook.

Thus, we insist on selectivity and stress that the countries with the most solid fiscal fundamentals are Brazil, Russia, most of the GCC countries (high-quality sovereigns), Indonesia (reduced external risks) and – as fare as local bonds are concerned – India.



Source: Bloomberg

EM equities: underweight with selective overweights

Our underweight stance on the region is primarily centred around China. Elsewhere within the region, we are overweight India on a structural basis (see the discussion below). Very broadly, the region as a whole remains closely tied to the trade cycle which is not supportive. Recent high frequency indicators of economic activity have not provided any evidence that the strong performance of the regional equities can be sustained. In fact the exports from the region remain weak. Earnings growth is weak too – despite a strong earnings growth expected from India, earnings in the region are expected to grow only by 4% this year – well below the global average. Acute weakness in the earnings picture of Korea and to some extent Taiwan is feeding onto broader weakness. Return on equity remains weak too. This makes us believe that the recent strong performance of Asian equities is largely down to improvement in Chinese situation which we doubt can be sustained.

Strong gains from EM LatAm indices during January were partly reversed during February. Brazil and Mexico came under pressure pulling down the regional aggregates. We remain tactically overweight Brazil and strategically underweight the rest of the region.

In EM EMEA, where we are underweight, we are selectively overweight South Africa due to the scope for earnings revival and potential for valuation expansion. Recent announcement of Eskom funding and restructuring, in our view, gives some hope about taking out the bottlenecks for industrial growth in the economy.

Appendix

GDP Forecast	2019 Consensus	2019 ADCB	2020 Consensus	2020 ADCB
US	2.4%	In agreement	1.9%	In agreement
Eurozone	1.2%	Expect moderately more	1.4%	In agreement
Japan	0.7%	In agreement	0.5%	In agreement
China	6.2%	Expect moderately less	6.0%	Expect significantly less
India	7.2%	In agreement	7.3%	Expect moderately less

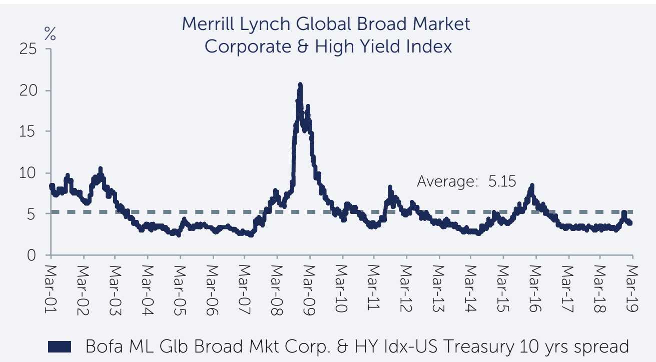
Source: Bloomberg

CPI Forecast YoY	2019 Consensus	2019 ADCB	2020 Consensus	2020 ADCB
US	1.8%	In agreement	2.2%	Expect moderately more
Eurozone	1.3%	In agreement	1.5%	In agreement
Japan	0.9%	In agreement	1.2%	In agreement
China	2.1%	In agreement	2.3%	Expect moderately less
India	3.5%	In agreement	4.1%	In agreement

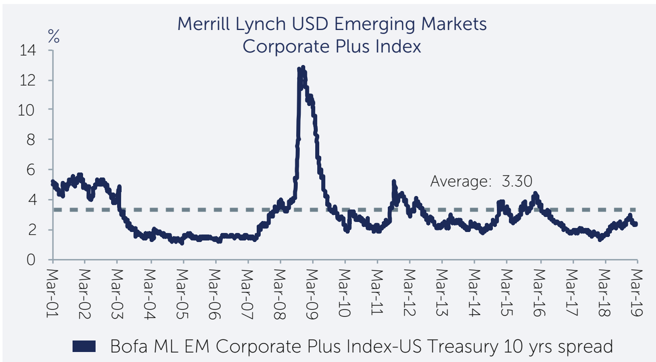
Source: Bloomberg

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

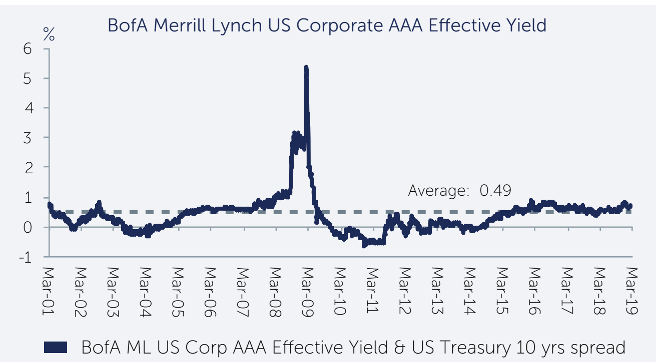
Bond Market Spreads



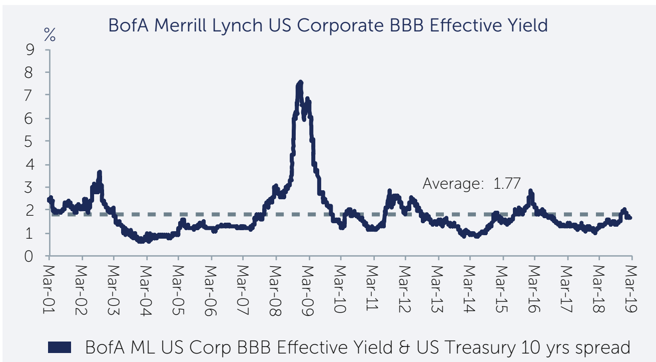
Source: Factset, Federal Reserve Bank of St. Louis



Source: Factset, Federal Reserve Bank of St. Louis

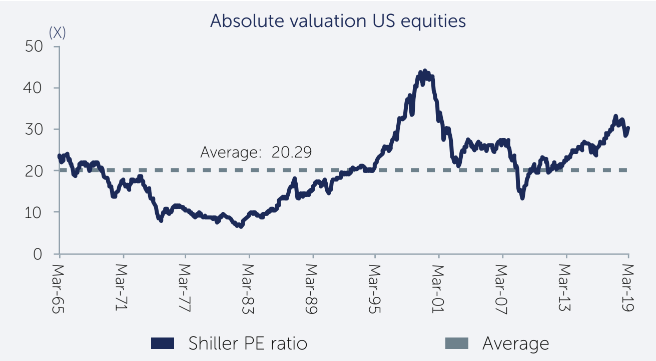


Source: Factset, Federal Reserve Bank of St. Louis

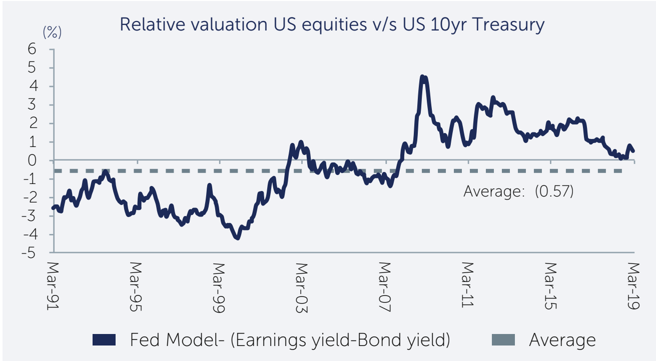


Source: Factset, Federal Reserve Bank of St. Louis

Equity Market Valuations



Source: Thomson Reuters, multpl.com



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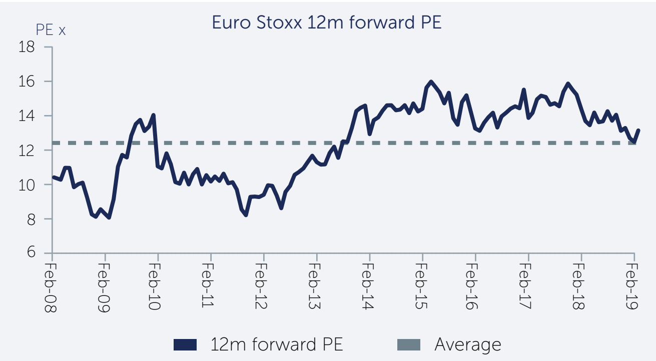

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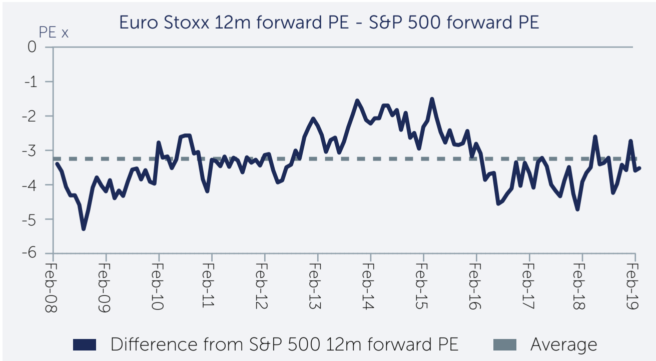

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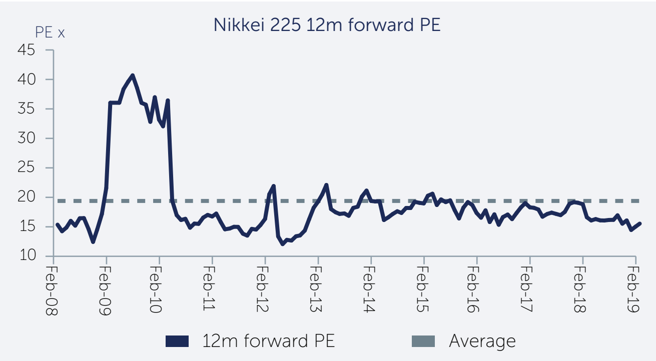

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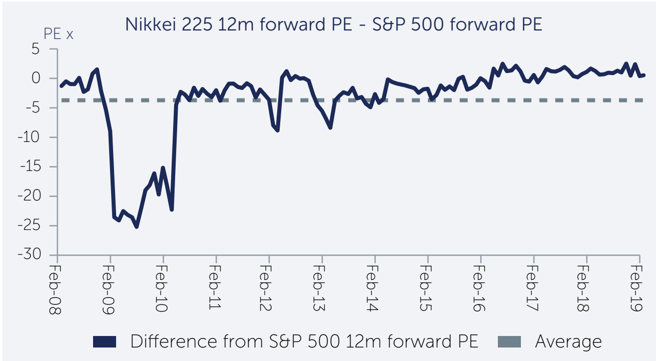

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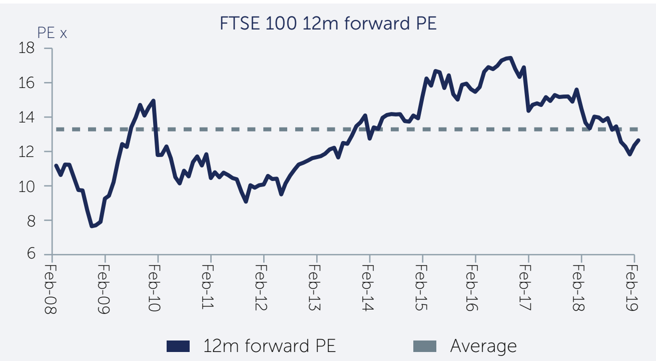

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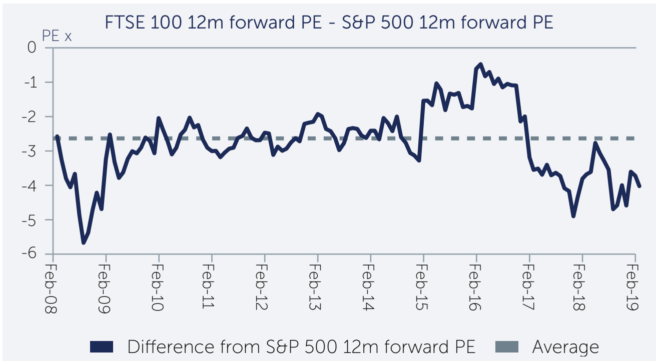
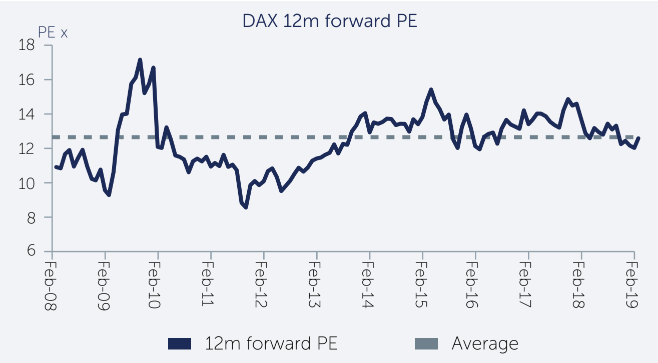


Source: Bloomberg

Equity Market Valuations



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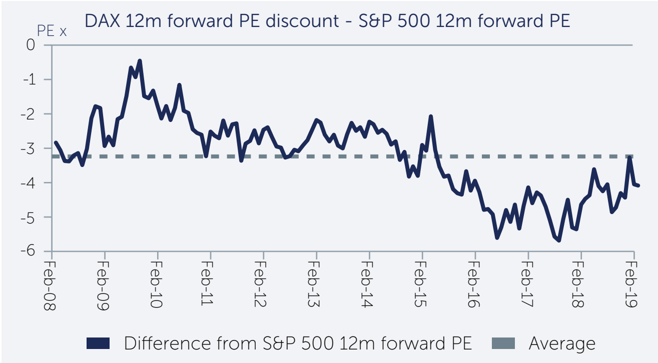

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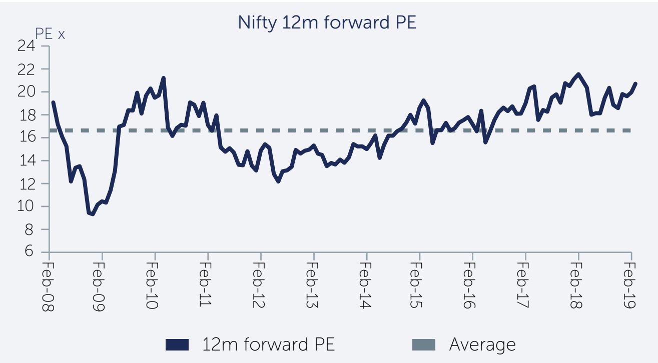

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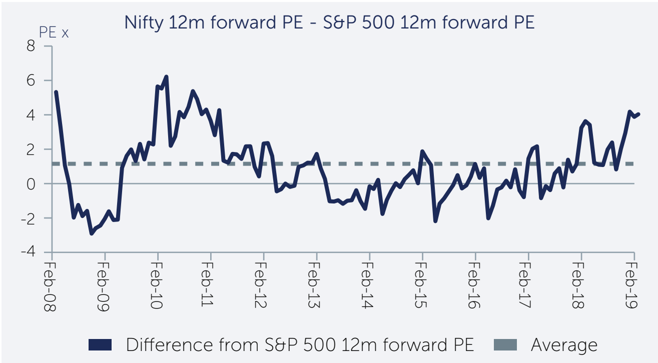

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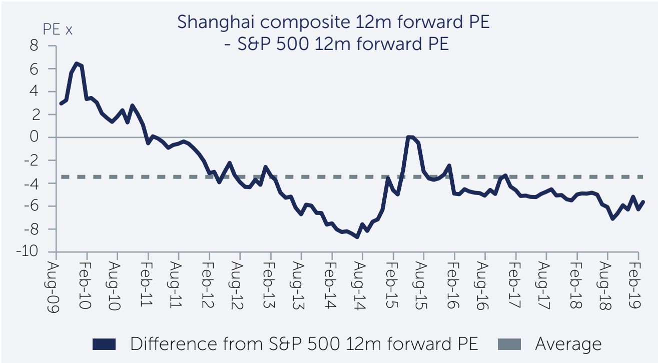

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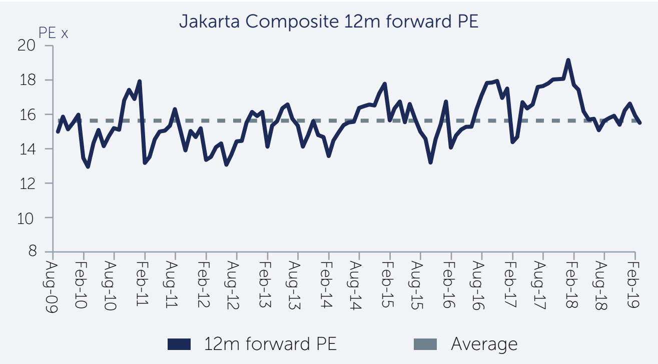

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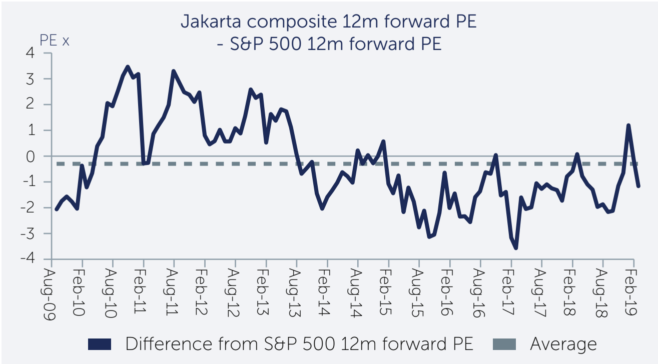

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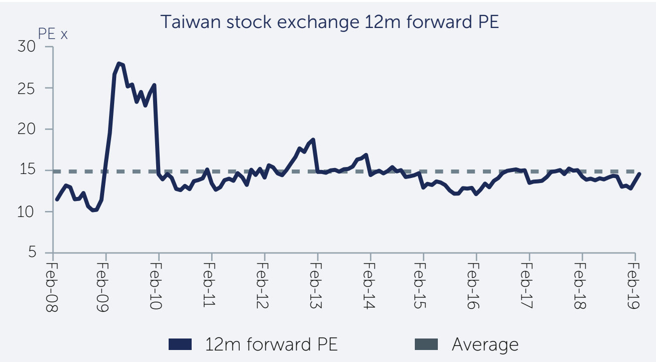
Equity Market Valuations



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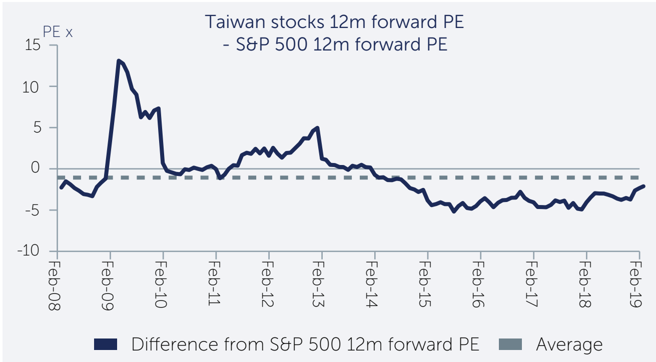

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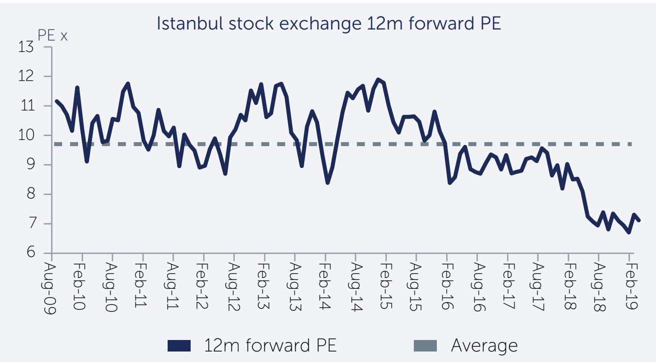

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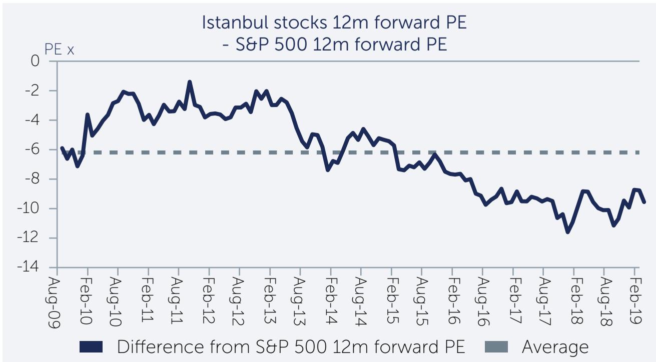

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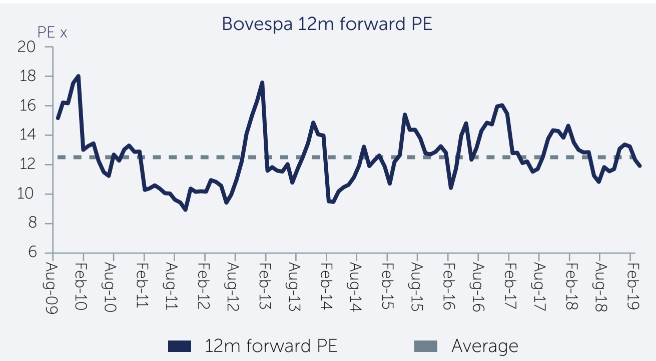

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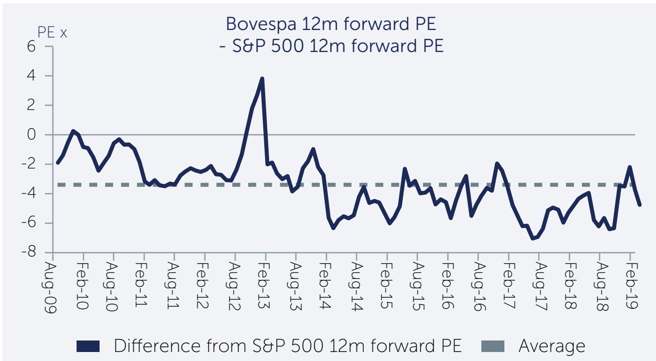

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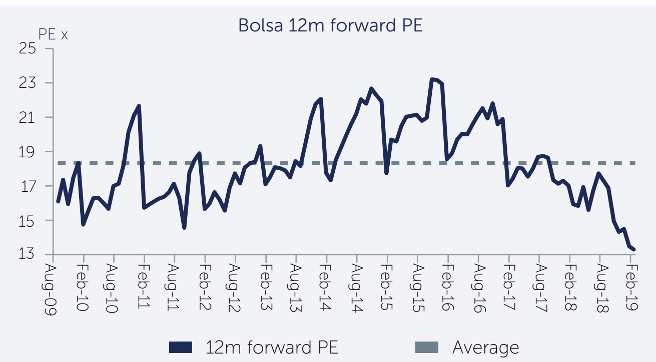

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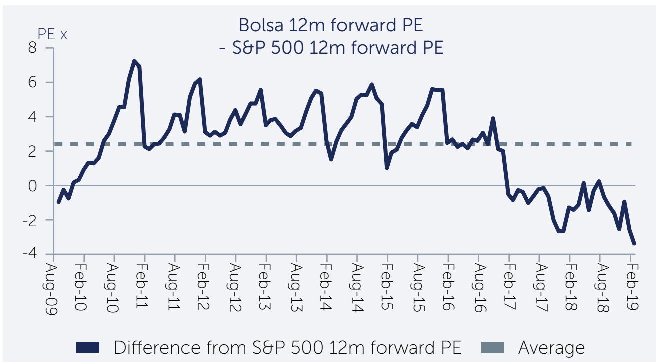

Source: Bloomberg

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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