Investment Strategy

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بنك أبوظبي التجاري
ADCB
ASSET MANAGEMENT LIMITED

The Equity Strategist: In search of an ambiguous inflection point

- **We remain cautiously optimistic about the 12 month outlook for global equities. However, as the summer approaches, strong gains recorded year-to-date, depressed volatility and seasonality effects point to subdued returns from equity markets in the near-term.**
- **Especially as markets become 'fundamentally-focussed' from being 'liquidity-driven', differentiation and selectivity become key for the remainder of the year.**
- **A gradual shift away from US equities might make sense looking ahead; we recommend buying into the weakness in Europe (through Switzerland and Spain) and Asia ex Japan (through Australia and HK) equities and trimming US exposure on strength; we downgrade healthcare sector to neutral.**

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

Noor Alameri
Analyst
Tel: +971 (0)2 696 2340
noor.alameri@adcb.com

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Clarity, as if a rare flower found only in the depths of remote jungles, eludes me (anonymous)

We were able to relate to the free verse above as we continued to search for an inflection point in the equity market. An inflection point that prompts a leadership change from equities in the US to those elsewhere. As we have been arguing, such a turning point is likely to be a muddle. Think about the massive outperformance of the US equity market over the past decade and the momentum US stocks have set for themselves over these years. A shift away from such a situation, as any rational investor would expect, is highly unlikely to be a sharp and well-defined one. Further, differentiation of time-frames – tactical, strategic and longer-term – has never been more important than at present. In this note we discuss all the three but let's start with the strategic outlook.

Strategic outlook: optimistic with an eye on risks

We remain positive about the strategic outlook for the asset class. Looking at the broader equity market cycle, we remain in a late-phase which has been extended by the policy-put from the central banks and governments across the world but underwritten by the policy support from the US (and to some extent China). In fact, the current equity cycle has been so protracted that mini-cycles are forming within this late phase. What shaped these so called 'cycles-within-cycle' are the concerns around global growth, associated policy response (or the lack of it) and the market's assessment of the appropriateness of such a policy. Thinking about growth, we believe that global growth concerns are likely to fade away in the second half of the year. Especially as the ongoing strength in the US economy coincides with a growth revival in China and in Europe. This is likely to be positive for equity assets.

Tactical outlook: exercise caution

However, in the near-term we think caution is warranted given the strong rise in equities already this year. Depressed volatility and seasonality effects also indicate more subdued returns from equity markets in the near-term. As it stands, equity market performance since December lows was liquidity-driven (observed from multiple expansion) but we think markets are likely to focus more on fundamentals looking ahead. Markets could even pause for validation – which is likely to come from the earnings season which is currently underway. Over this time frame the focus could also be on risks. Elevated debt levels in China, political risks across the Atlantic, trade disputes (US-China and US-EU) and scope for central bank policy errors can easily become talking points on risks.

Long-term outlook: brace for lower equity returns

In a recent note, we shed some light on the currently generous equity valuations, which are unlikely so see a further expansion in this late phase of what might soon become the longest business cycle expansion in US history. During this expansion US equities have delivered around 12% geometric returns, 40% more than their long-term average! A reversal to that average would imply significantly lower returns for the 2020s, compared to those we have seen in the 2010s, as is recognized by many professional asset managers.

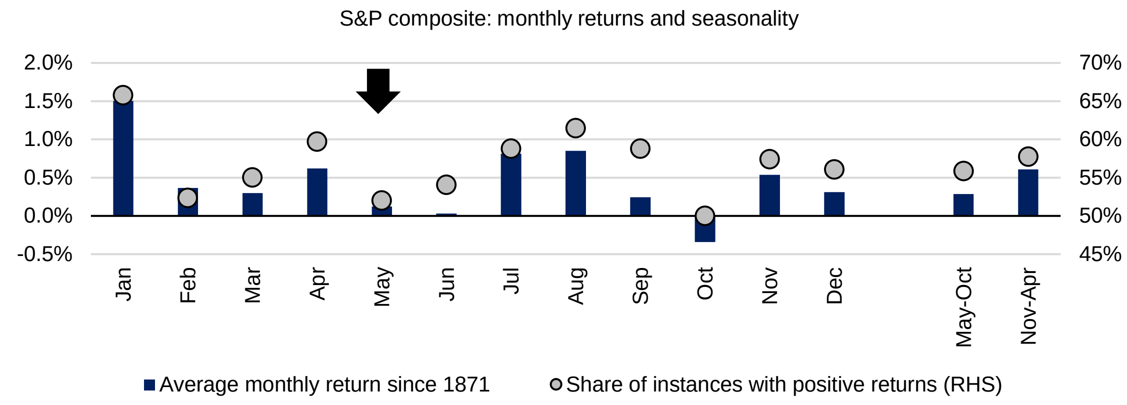
At the cross-roads

This puts us at cross-roads where the tactical outlook warrants caution, strategic outlook is positive and long-term outlook is more sobering. Considering the current situation, we think a gradual shift away from US equities might make sense looking ahead; we recommend 'buying the dip' (of about 3%-5%) in Europe and Asian equities and trimming US exposure on rallies (indicatively 3%-5%). *We remain overweight the US and underweight Europe and Asia ex Japan but selectively increase exposure to those markets that have lagged so far this year – Switzerland, Spain, Australia and Hong Kong.* We also stick to our strong focus on quality, continue to prefer large caps and our inclination for service-oriented sectors remains. By sector, we downgrade global healthcare to neutral and allocate the proceeds equally to communication services, consumer staples and energy.

Seasonality at play

We are approaching a seasonally weak period for equity returns. Historically, summer months of the year have seen significant dip in the returns. Exhibit 1 shows the average monthly return on US equities since 1871. As can be seen, returns during May and June were significantly lower compared with those during the seasonally strong months of January through to April. Very broadly, the average returns during months between May and October were sizably lower compared to returns between November and the following April.

Exhibit 1: We are about to enter a seasonally weak period for equity returns

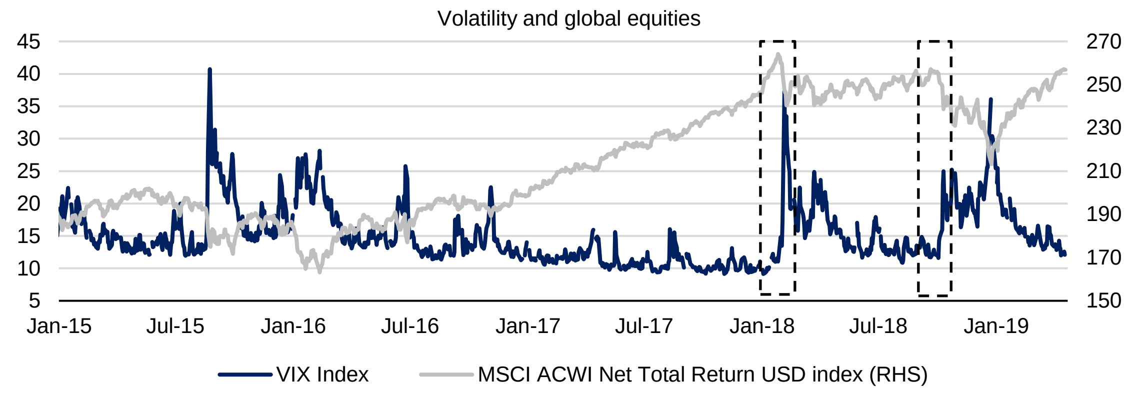


Source: Robert Shiller, S&P and ADCB Asset Management

Depressed level of volatility also points to subdued returns

Volatility in equities (as measured by VIX in exhibit 2) has been falling since the start of this year. It currently stands very depressed against its history since start of 2018. Worth pointing out that two instances of sizable pull back in global equities since start of 2018 were preceded by VIX levels as low as the one that we currently have.

Exhibit 2: Last two instances of equity market pull back were preceded by low levels of volatility which we are currently experiencing



Source: MSCI, CBOE and ADCB Asset Management

Trim exposure to the US – sell into strength, gradually

Returns from the US equity market have sizably outrun those elsewhere in the world over the past ten years. This outperformance can be attributed to a range of factors – relative strength in the economy, expansion in the corporate profit margins and share buybacks etc. Whilst we don't see a sharp and an outright reversal in these conditions, we think that there are reasons (discussed in our recent note) to believe that strength in some of these factors might be fading. At least in the near-term, the efficacy of these drivers is likely to come down resulting in slower returns from US equities. Further, as growth elsewhere (especially in China and in the EU) picks up, the growth premium of US – which has helped in outperformance of US equities in 2018 – should also fade. Of course, for the global growth to hold up, US growth still needs to be strong; but we think coming of a depressed base, growth in EU and China has scope to rebound more strongly here.

Having said so, US equity market is rather important given its size (US is c55% of MSCI ACWI by market capitalisation), its defensive characteristics and its richness in quality. In this late phase of the cycle, we would rather prefer being defensive and we stick with quality. Therefore, we do not recommend an aggressive rotation out of US equities at this stage, but we favour a more measured reduction of exposure. We recommend cutting US exposure through the healthcare segment which we downgrade to neutral (see the following section).

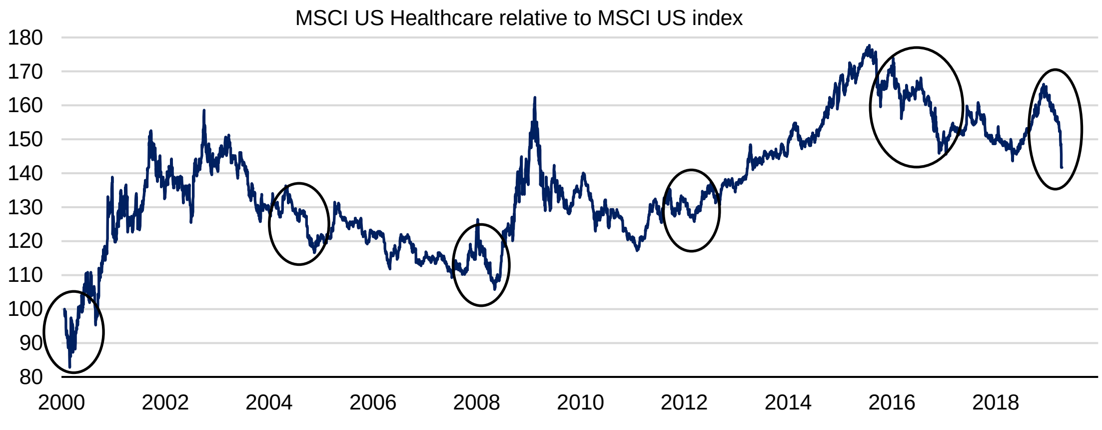
Rx: downgrade health care sector to neutral (from overweight)

Healthcare sector came under severe pressure recently as the political cycle in the US started to impact the sector performance. Medicare-for-all – under which government-sponsored healthcare coverage would expand significantly – not only impacts the profitability of multiple players within the healthcare sector, but also eventually crowds-out the private sector participation in this segment. The Medicare-for-all proposals have been pushed for some time, but may now be beginning to be taken more seriously as initial indications are that this issue may be increasingly more important ahead of the 2020 Presidential election.

Historically, healthcare stocks turned turbulent and eventually underperformed during the years of the US presidential elections (exhibit 3). Healthcare remains strategic/regulated and has repeatedly been the point of political debate especially during the election cycle in the US. Whilst we knew that this was coming for the sector, we were surprised by the recent underperformance – not least because it was much earlier than it usually is in the US election cycle.

US healthcare companies account for more than 68% of the MSCI All Country World Healthcare index. Therefore, it is hard to see how global healthcare sector can do well when the segment in the US comes under severe strain. Having said so, we are reluctant to downgrade the sector to an underweight given the recent underperformance and continued improvement in the fundamentals (notwithstanding the implications of the harsh treatment from the US political cycle). For instance, healthcare is the sector with most positive earnings revisions on a three month basis. Further, healthcare is c38% of Swiss equity benchmarks – which we turn more positive on now (see the following section).

Exhibit 3: US healthcare equities turn more volatile and broadly underperform US equities during the years of Presidential elections. This time the underperformance might have started quite early.



Source: MSCI, Bloomberg and ADCB Asset Management

Increase exposure to Europe and Asia Pacific ex Japan – buy into weakness, gradually

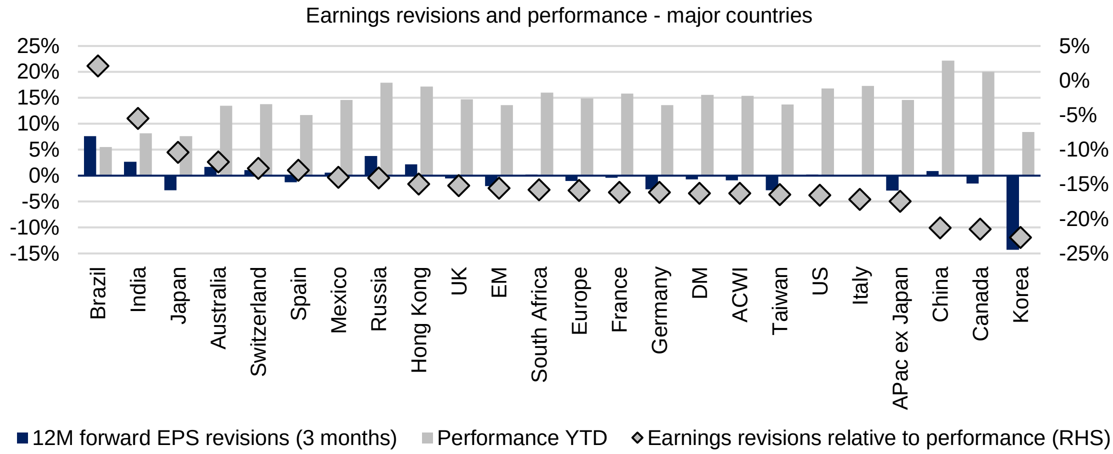
Both European and Asian equities have lagged US equities by a significant distance over the last ten years. European equities have been constrained a great deal by weaker economic growth, elevated political risk climate and clouded outlook for banks which form a significant share of the equity benchmarks. Asian equity markets on the other hand have been impacted by weakening growth prospects for China – which remains the key market-of-influence for the region overall – especially for other markets in Asia ex Japan.

Looking ahead, there are reasons to believe that a gradual improvement is likely to occur in both Europe and Asia. In Europe, especially as European Parliamentary elections pass and there is more clarity regarding future policy direction of the ECB, some of the overhang on the market is likely to be lifted. Growth is likely to return to the manufacturing sector (which has been the pain point for Europe thus far) ahead of a pick-up in global growth which we do expect in the second half of this year.

In Asia, pick up in Chinese activity helped by the stimulus is likely to provide lift to other markets in the region. Whilst we do not expect a full-blown stimulus from Chinese authorities, a gradual and more targeted effort is likely to remain in place. Moreover, by channelling stimulus efforts to the private sector enterprises, China is also – effectively but indirectly – implementing structural reforms. As confidence on Chinese economy returns, investment outlook there should improve and this should in turn lift the outlook in China-dependant markets.

Now thinking about how to increase exposure to both Europe and Asia ex Japan, there are two things to consider. Firstly, markets have run up considerably year-to-date therefore a gradual exposure to these markets is warranted. We prefer buying the dips from here. Secondly, given the broad based run up, we prefer buying laggards first. For this, we try to identify markets where the price performance has underperformed the fundamentals compared to other markets. Exhibit 4 below shows earnings revisions relative to performance for all major countries. We prefer those markets which show positive displacement on this metric – i.e. markets where earnings revisions outperformed price performance on a relative basis across countries. In Asia ex Japan, we find Australia and Hong Kong as relatively attractive and in Europe, Switzerland and Spain stand out. Therefore as a strategy, for now we would recommend buying into dips in these four markets. We would stick with quality counters within these markets.

Exhibit 4: Switzerland and Spain in Europe, Australia and Hong Kong in Asia Pacific ex Japan stand out with positive relative fundamental displacement



Source: MSCI, I/B/E/S and ADCB Asset Management

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Our equity strategy in two minutes

Exhibit 5: Equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	**<u>Trim</u> exposure to US; cut healthcare sector**
Canada		■		Stick with the benchmark
Europe ex UK	■			**Increase exposure through Switzerland and Spain**
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			**Increase exposure through Australia and HK**
EM LatAm	■			Tactically OW Brazil
EM EMEA	■			Tactically OW South Africa
GCC		■		Prefer KSA; regional banks
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Consumer Services to Auto & Components
Consumer Staples			■	Prefer Household & personal products
Energy			■	Companies with positive cash flow to outperform
Financials		■		Prefer Banks with diversified business models
Health Care		■	□	**Risks from US presidential elections are rising**
Industrials		■		Prefer Commercial & Professional Services
IT	■			UW Tech H/W and Semiconductor sub-sectors
Materials	■			UW Materials hedged with OW Brazil and SA
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			US small cap strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Growth at a reasonable price (GARP)
Dividend yield			■	Prefer quality dividends
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Watch momentum for leadership change
Legend	*New* ■	*Old* □	*No change* ■	

Source: ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

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

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