The Equity Strategist: Which market will pick up the leadership baton from the US?

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- Perhaps the single most important aspect of the now almost ten year old bull market is the systematic outperformance of the US equities
- With global equity returns likely to slow looking ahead, we ask "is leadership changing in the stock market?"
- We look at Europe and China closely to see if the equity markets there are ready to pick up the leadership baton from the US

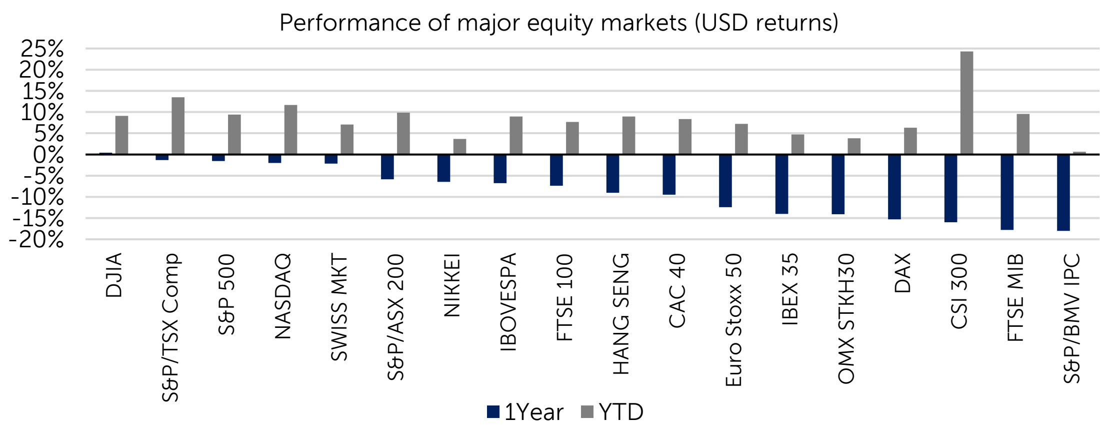
US equity markets have had a strong performance over the past decade – returning 12% on an annualised basis. But as we argued in our report The Equity Thematician: Bracing for lower long-term equity returns, 19 February 2019, those juicy double digit returns of the past decade are unlikely to repeat in the next ten years. Of course, this is a very long-term view but even on a medium term basis, we think there are reasons to believe that we could potentially be approaching an inflection point – where the stock market leadership shifts from the US to elsewhere. Moreover, the divergence in performance trends between past one year and 2019-YTD has already started to feed the market with some thoughts on the leadership change.

It is reasonable, in our view, to consider European and Chinese equity markets, in view of respectively their size and their economic importance, while thinking about the future equity market leadership. China, in particular, is of capital importance since it is a good barometer for the fortunes of many other emerging markets. In the note we also provide our equity strategy views by regions (page 3), by global sectors (page 10) and by factors/styles/sizes (page 11). A quick summary of our equity strategy can also be found on page 2. Page 11 also lists key risks to our calls.

While the performance of both Chinese and European equities has been strong so far this year compared with that in the past year, we think it is still early to call for a rotation out of US into either of these markets. Especially thinking about the risk-return trade-off, we still find equities in the US more attractive compared to their counterparts in both China and Europe. However, we do believe that there will be an inflection point later this year when moving out of US equities makes sense – but it is not now, in our view. We stay overweight the US.

We suggest prudence to investors eyeing opportunities outside the US. A late cycle environment warrants a focus on quality. By region, outside the US, we are neutral UK and Japan. We are underweight Europe ex UK and EM. Within EM, we are overweight India (structural), Brazil (tactical) and South Africa (tactical). We remain neutral GCC equities. By sector, Communication Services, Consumer Staples, Energy and Healthcare are our overweights. We remain underweight IT (especially Tech hardware and Semiconductor sub-sectors) and Materials. Within financials (neutral), we have preference for banks with diversified business models. By size we prefer large caps. Prefer non-cyclical growth and quality dividends.

Exhibit 1: A rotation out of US underway?



Source: Local stock markets, Bloomberg, ADCB Investment Strategy | Note: Data as at close of 8 March 2019

Our equity strategy in two minutes

Exhibit 2: Equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Prefer consumption and services themes
Canada		■		
Europe ex UK	■			Focus on defensive quality
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			Structurally OW India
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			■	Prefer Pharma, biotech & life sciences
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 Investment strategy

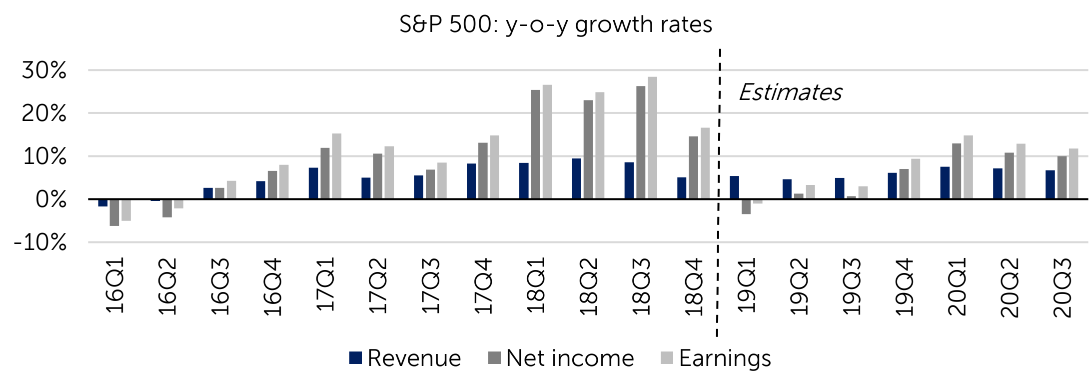
Regions

US (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. Exhibit 3 points to a contraction in earnings in Q1 2019. 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.

Exhibit 3: US earnings recession in sight?



Source: I/B/E/S, Refinitiv, ADCB Investment Strategy

However, US equity markets continued to perform positively thus far this year thanks to the optimism around a potential US-China trade deal. Trade optimism along with the Powell-put have resulted in a strong cyclical rally outperforming defensives (see exhibit 10 under the sectors section). This is likely to change in our view. Defensive sectors – Healthcare, Consumer staples and Energy – are likely to outperform looking ahead. Consumption and services sectors are likely to stay resilient and we would highlight Communication services (sector), Consumer services (industry group within Consumer discretionary) and Commercial & professional services (industry group within Industrials) as potential ways to play this in the US.

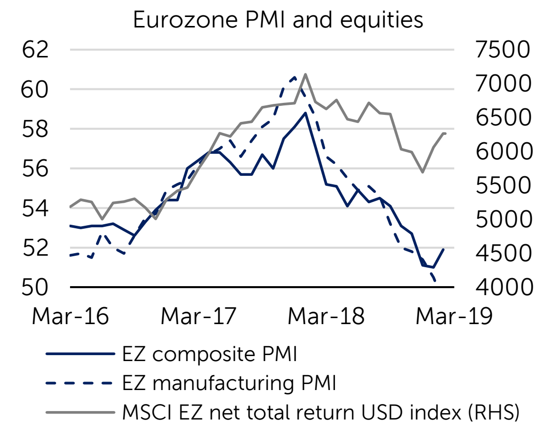
A point of rotation out of the US into elsewhere will come but in our view, it is not yet in sight. As the key underlying theme of this report, we question if Europe and China are ready to take the leadership baton from the US and we do not find any convincing evidence for the same. So for now, we remain overweight US but would only own quality and defensives; within growth segment our focus will be on structural growth stories rather than on those closely tied to the cycle. Further, within the US market, we are more constructive on segments that are exposed to China (very broadly consumer sectors for example) than those that are exposed to Europe (largely industrials and materials). Whilst the China-exposed US stocks have priced in Chinese economic weakness, Europe-exposed stocks have not yet corrected to reflect the weakness in European economic cycle, in our view.

Europe ex UK (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; here are eight reasons why:

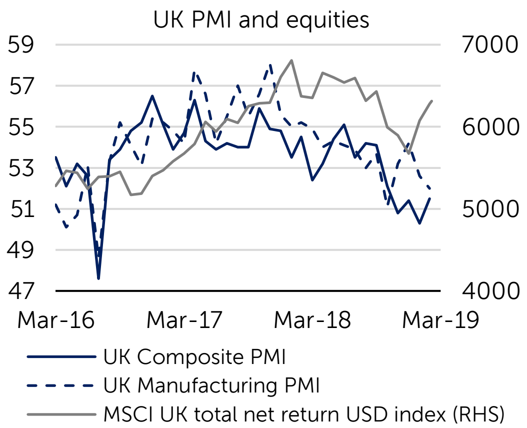
1. Economic activity remains subdued. Whilst the recent PMI data did show some signs of hope, we think downside risks remain. Especially with Chinese growth projections lowered and the activity in the US softening, the economic recovery prospects for Europe will be put to question too. Indeed, OECD cut 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).
2. In Italy, a range of headwinds confront investors. From political risks to banking sector weakness, Italy is likely to set the risk-tone for the region.
3. 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.
4. Brexit remains a potential focal point not just for UK but for pan-Europe. We are simply stuck by the uncertainty the event presents and that is one of the reasons behind our neutral stance on the UK.
5. 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.
6. Outflows from the European equity funds have been persistent since March 2018; although not as sharp as in 2016. Whilst some of the outflows could be linked to the weaker economic momentum of the region, Markets in Financial Instruments Directive II (MiFID II) implementation has also started to have an impact as investors fled pricier options of non-ETF instruments which still make up a good share of equity fund industry size.
7. 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.
8. 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.

Exhibit 4: Eurozone equities might not be discounting economic weakness completely



Source: Markit, MSCI, Bloomberg, ADCB Investment Strategy

Exhibit 5: For UK equities, domestic weakness will not be a major issue



Source: Markit, MSCI, Bloomberg, ADCB Investment Strategy

Of course, Europe, being the region most open to trade globally, continues to benefit from trade optimism. Also positivity around China could help further. As we have argued earlier in this report, there will be an inflection point later this year when moving out of US equities makes sense. European equities could then benefit from being the second largest block on the benchmark index. But for now, we refrain from whole-heartedly positioning for such a rotation. However, 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.

UK (neutral)

Our neutral stance is purely due to the uncertainty the Brexit event presents and not because of over 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.

Japan (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. Yen strength, which we expect, is likely to be an impediment for equity market performance. The corporate sector is strained by the ongoing governance issues; especially in relation to cross-holdings and assets with returns below the hurdle rate.

Asia Pacific ex Japan (underweight)

Our underweight stance on the region is primarily centred around China (which we discuss on page 6). 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. Therefore we retain our underweight on Asia Pacific ex Japan.

China (underweight)

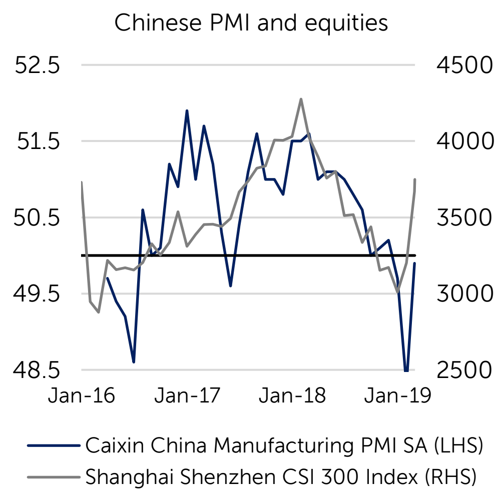
When thinking about China taking the equity market leadership, the first point of dilemma is that 'What the world needs from China is different from what China needs for itself". As can be seen from exhibit 6, what the world needs from China is more imports. Historically, global equities have tracked the Chinese imports data. This shows how deeply Chinese trade (especially imports) influenced global equities. Notably, these imports were relating to commodities and industrial equipment. But with China keen on rebalancing its economy away from investment- and trade-led growth model to a more consumption-led growth model, we wonder if Chinese imports will be able to provide the same impetus to global equities in the future as they did in the past. On trade, the US and China were still negotiating a trade deal at the time of writing this report. However, the markets seem to have priced in a deal. Further, Chinese trade data disappointed in February and this has clearly not helped the equity markets.

The other part of the story is about what China needs for itself. Exhibit 7 highlights the point that Chinese equities are strongly correlated to domestic economic conditions. Here again, the point to consider is that if the consumption-led economic model that China is keen to adopt will provide the same levels of growth as its exports and investments sectors did in the past. Of course, a consumption led model is a more stable model of growth in the long-run but the near-term prospects seem to be dimmed due to the rebalancing. Looking at domestic conditions, we find no concrete evidence of a bottom in economic activity in sight. In February, both official (National Bureau of Statistics) and Caixin indices of purchasing managers activity showed a contraction in the manufacturing sector. Some underlying dynamics pointed to more caution. During February, export orders fell at the fastest pace since the global financial crisis. Manufacturing output contracted in February for the first time since January 2009. Whilst the services sector remained resilient, the expansion slowed. In the service sector which is about half the current size of the Chinese economy, cooling property prices and slowing demand for cars and mobile phones resulted in subdued activity.

Exhibit 6: Rising Chinese imports have helped world equities...

Source: NBS, MSCI, Bloomberg, ADCB Investment Strategy

Exhibit 7: ...but Chinese equities are tied to domestic cycle



Source: Caixin, Shenzhen Stock Exchange, Bloomberg, ADCB Investment Strategy

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.

India (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.

Also, issues around non-banking financial corporations (NBFCs) which have been a drag on the equity market performance since mid-2018 are discounted into the prices, in our view. At least, issues around NBFCs are unlikely to be a deterrent to the market performance going forward.

One other concern around the Indian financials space was the rise of non-performing loans (NPLs) for domestic banks. There are reasons to believe that the worst is behind us. The recent earnings season has already provided some evidence. For instance State Bank of India, the largest Indian bank already reported a moderation in NPLs and pick up in domestic loan growth. Stable CASA ratios (ratio of deposits in current and saving accounts to total deposits) and improvement in loan yields are likely to drive net interest margin expansions. Against this backdrop, valuations for banks in general might start to look attractive. Consolidation in the banking sector, something the finance ministry has been advocating, is likely to provide an upside catalyst.

Economic activity remains strong. PMIs continue to point to a robust growth in both manufacturing and services sectors. Strength in India's economic activity comes as a deep contrast to the weakness elsewhere in the region. Central Bank monetary policy has turned a lot more growth-friendly – at least we can say so following the surprise rate cut in February.

Global fund managers have cut their exposure to market quite significantly in the recent period. However, this could very quickly change once the elections are out of the way. Earnings growth and return on equity remain strong too. I/B/E/S consensus expected earnings growth of c25% this year for MSCI India stands tall against the world earnings growth of c5%. Worth noting that the earnings estimates remain strong despite the correction in the stock prices. This hints at the potential for the valuations to expand from the current levels.

All in all, as we have argued before, capital flows into the market are likely to slow further ahead of the elections but should resume strongly after that. The risks on the horizon include an escalating geo-political tension between India and Pakistan and also the potential for a trade skirmish between India and the US.

EM LatAm (underweight; tactically overweight Brazil)

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.

Despite the recent weakness, Brazilian equity performance year-to-date stands at 12.5% in USD terms outperforming global equities. Behind the underperformance were a few investor concerns.

- To start with, markets started to doubt the growth revival in Brazil. Whilst Q4 2018 fell short of expectations, the underlying trends do not indicate further weakness. Drag on the GDP growth came as the strength in consumption was offset by weakness in investment growth and imports. As the consumption continues to grow, a large fall in inventories should result in stronger investment growth in the quarters to come – thereby reviving the headline growth numbers.
- Markets turned more sceptical about the pension reforms in Brazil. However, the recent weeks saw Bolsonaro administration reveal more terms about the proposed reforms. As per the official estimate, the total savings arising from this reform are likely to be around BRL1.2trn. This proposal is now submitted to the congress and needs to be run past the Constitution and Justice Committee, a Special Committee and a Plenary to complete the process in the lower house. It is reasonable to expect a resolution in early July. However, going into the event there are likely to be episodes of hope and despair – creating volatility. We think that is normal in any reform implementation (think about reform momentum in India, Indonesia and also Saudi Arabia). We advocate patience for investors and to refrain from trading based on news flow.
- Markets, which were expecting a rate cut, were disappointed by the Central Bank staying on hold in its recent monetary policy meeting. However, the point that investors miss is that the benchmark interest rates and inflation rates are well below the historical averages. This should start to feed into lower cost of equity and thereby resulting in valuation expansions.
- The idiosyncratic issue with the index heavy weight Vale (c10% of MSCI Brazil) did not help too. Vale stock prices fell as investors estimated the environmental and/or socioeconomic remediation expenses due to the collapse of dams (including the recent one in the Brazilian town of Brumadinho). News around several government entities recommending dismissal of some executives and the subsequent resignation of the several top executives including the CEO and head of a key department were treated quite negatively. Whilst this is indeed a negative development for Brazil investors, we think it should be looked at as an idiosyncratic corporate issue.

On the positive side though, the earnings continue to remain strong. The expectations are still for MSCI Brazil to deliver an earnings growth of c25% and we think this is possible given the lower base. Brazil could also benefit from a cyclical rally associated with China-rebound. In fact for now, we would like to use Brazil and South Africa as also hedges against our underweight in China.

EM EMEA (underweight; tactically overweight South Africa)

EM EMEA aggregate indices came under pressure thanks to weak performances from Russian and South African equities.

Our tactical overweight on South Africa came under strain in February as investors started to focus on a few negative developments. On the macro economic front, investors waited for further evidence of growth in the domestic economy. In fact the GDP release on 5 March did confirm that the economic recovery from a recession continued in Q4, albeit at a slower rate. Even the high frequency indicators point to growth. IHS Markit's Purchasing Managers' Index (PMI) rose to 50.2 in February from 49.6 in January indicating first economic expansion since June 2018.

Also, foreign investor confidence took a hit as South Africa suffered its worst power cuts in several years in February due to plant-related problems at power utility Eskom, diesel shortages and planned maintenance. Eskom, the public electricity utility company which accounts for 90% of energy supply, had faced operational issues and was strained with debt burden. Lack of proper electricity distribution had proved to be a bottleneck for investment activity in South Africa. However, in the recent budget, South African government provided funds for Eskom and also proposed a restructuring of its business. Whilst this is likely to add to the deficit burden in the near-term (watch for rating agencies acting on this), the restructuring (if implemented as planned) of Eskom is likely to remove a significant structural bottleneck for the economy.

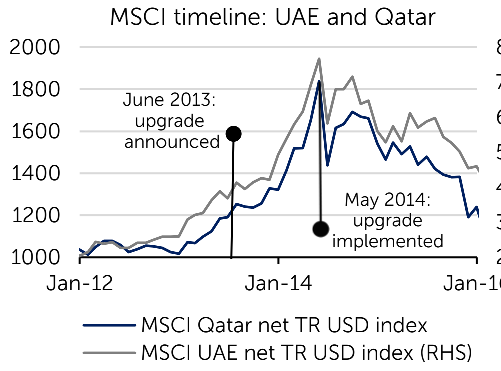
Our long held view is that the reform momentum is likely to pick up following the elections on 8 May. The recent polls – for example from Institute of Race Relations (IRR) – suggests a continued lead for ANC. Betting against a consensus of foreign investors, we do expect some positive developments on the reform side. Of course the chances of strict implementation of structural reforms by Cyril Ramaphosa hinge on the extent of ANC win in our view. The ANC has never scored less than 62% of the vote while the current polls project a vote share of c55% for ANC.

Buffering the downside are cheap valuations. Whilst South African equities have historically traded at a premium (due to higher RoE) to EM aggregate, the current level of forward valuations points to a more subdued premium. Earnings growth expectations are strong –c21% this year and c15% next year. Investor positioning – which we consider as a contrarian indicator – hints at an under-owned market. We remain overweight South Africa with a tactical view point.

GCC (neutral)

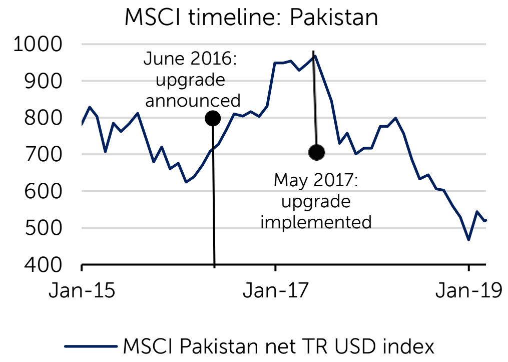
We maintain our overweight on Saudi Arabia primarily as the liquidity event associated with index inclusion (by both MSCI and FTSE) continues to be supportive. Our back-of-the envelope calculations suggest USD18bn in inflows of passive money coming into Saudi Arabia in seven tranches between March 2019 and March 2020. The inflow should be higher when one takes into account, the potential for active money managers to increase their allocations to Saudi. Potential listing of Saudi Aramco could lead to higher weight of Saudi in EM indices and thereby, further inflows. However, our analysis of the previous episodes of MSCI inclusion of UAE, Qatar and Pakistan shows that performance of equity markets undergoing an upgrade is very strong from the point MSCI makes an announcement to the point of actual implementation. In fact after the implementation, performance falters (see exhibits 8 and 9). So we would remain watchful of this trend repeating for Saudi Arabia. But the case for Saudi could be different because the implementation is happening in several tranches while the implementation for UAE, Qatar and Pakistan was in a single tranche. The other difference between Saudi Arabia and UAE, Qatar and Pakistan is that whilst the latter three have been upgraded from Frontier market status to emerging market status, Saudi Arabia is being moved to emerging market indices from a stand-alone status. This means that Saudi Arabia is unlikely to experience any selling from frontier market funds during the rebalancing; but this was the case for UAE, Qatar and Pakistan.

Exhibit 8: 'Buy the announcement, sell the implementation' worked for UAE and Qatar...



Source: MSCI, Bloomberg, ADCB Investment Strategy

Exhibit 9: ...and also for Pakistan



Source: MSCI, Bloomberg, ADCB Investment Strategy

By sector, we prefer banks in the regional context. Gulf banks are likely to be boosted by prospects for stimulus and consolidation in the sector. Also, the drive to increase the foreign ownership could be further positive for regional banks. Regional banks are heavily geared to domestic economic growth and in this context it is worth highlighting that IMF recently indicated that it expects the UAE's economic growth to accelerate in the next few years, thanks to increased investment and private sector credit, improved prospects in trading partners, and a boost to tourism from Expo 2020 (see *IMF Executive Board Concludes 2018 Article IV Consultation with the United Arab Emirates*, February 1, 2019). Against the backdrop of rising non-performing loans in the UAE, resilient business models – those liquid and well capitalised – should perform well. The recent news that Saudi authorities are considering increasing tax on local banks could bring some pressure on the sector.

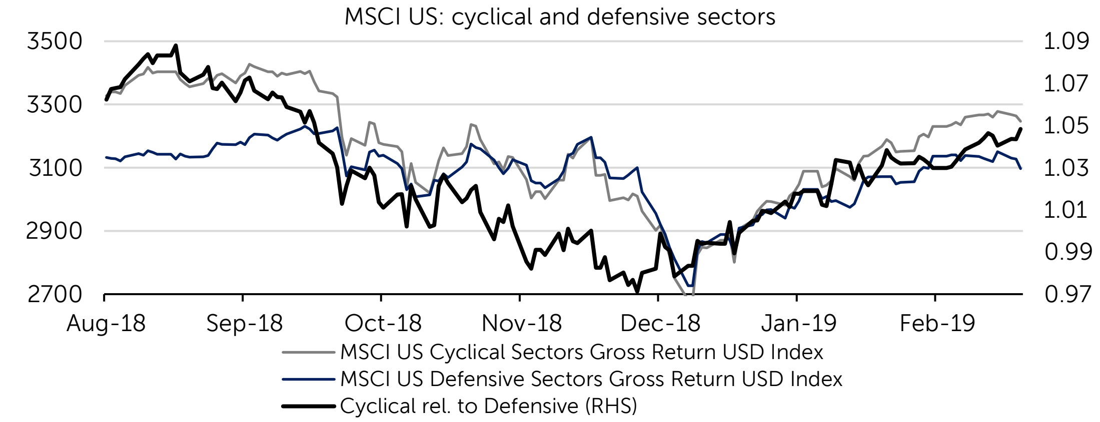
Sectors

By global sector, we retain our defensive tilt. Whilst defensive sectors continued to perform well, the recent upturn in the markets saw cyclicals outperform (exhibit 10). We think this outperformance from cyclicals is likely to falter as the focus shifts to the softness in economic cycle, especially in the US. We are overweight Consumer staples, Energy and Health care owing to their defensive properties. We are also overweight Communication services sector which we think is a structural growth sector. We are underweight information technology and materials.

As we argued in the previous sections of this report, we find the service sector more resilient when compared to the contracting manufacturing sector. Consumption is also holding up steadily across the globe. Rising real wage growth should help the consumer sectors further. Consumer staples and communication services sectors are beneficiaries in this regard. Within consumer staples sector, household and personal products segment stands out with better RoE; but valuations are high too. Communication services sector, with c65% in US also aptly reflects our US overweight. Within the Consumer discretionary space (which we are neutral), we prefer Consumer services to Auto & components. To some extent Commercial & professional services (a sub sector under the industrials sector) could also benefit from the resilient services sector trends.

While overall Healthcare sector should benefit from its defensive appeal, we prefer Pharma, biotech & life sciences segment as a structural growth play. We are also overweight energy; we think the investment case for the sector is based on earnings revival looking ahead. Lower PB valuations for the sector already account for lower RoE. But for now, companies with positive cash flows should outperform. Higher oil prices should provide further impetus.

Exhibit 10: Is this cyclical bounce sustainable? – We think no.



Source: MSCI, Bloomberg, ADCB Investment Strategy

We are underweight Information technology. We think the recent strong performance of the sector is not based on improvement in fundamentals. We have a negative view on the Tech hardware and Semiconductor sub-sectors which continue to be constrained by a weak global tech cycle. For both sub-sectors, earnings growth is likely to remain negative this year.

Materials sector which is our other underweight remains constrained by weak economic momentum especially in Europe and China. Wage costs are rising in the materials sector due to skilled-labour shortages in certain segments of the market. Earnings growth is likely to remain anaemic through this year and the next. Our underweight here is hedged by our tactical overweight on Brazil and South Africa (which have a good share of materials sector representation on their benchmarks).

Elsewhere, we are neutral financials, real estate and utilities. The latter two are likely to be influenced by country-wise idiosyncrasies. Within financials, we prefer banks with diversified business models.

Factors/styles/sizes

We envisage a late cycle environment which is being extended by policy stimuli. With bond yields range-bound to lower, and the economic momentum likely to weaken looking ahead, the risk tolerance is likely to be low. Such an investment environment calls for focus on quality.

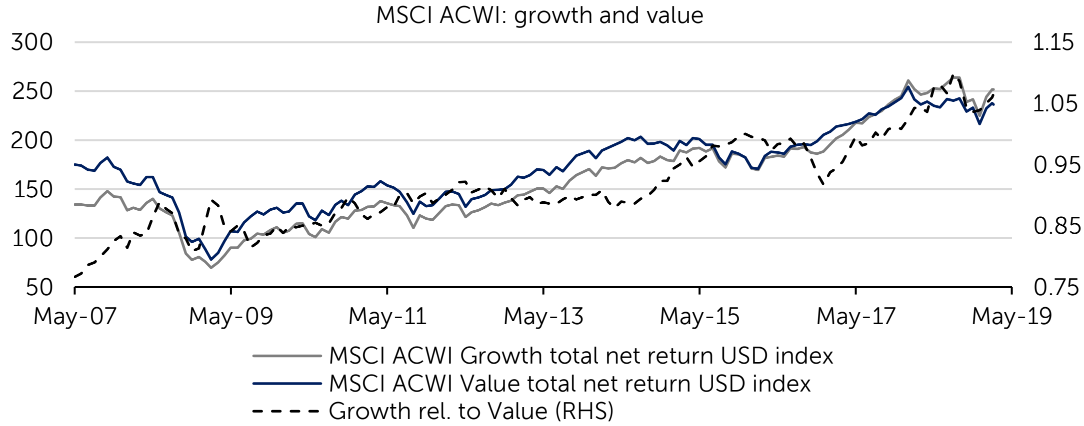
By size, we prefer large caps to small caps. This is directly linked to our preference to stick with quality. Moreover in the US, small caps continue to be strained by heavy debt and deteriorating debt service ratios. Most of this debt is also high-yielding creating vulnerabilities during downturns.

Growth style is likely to be in vogue for a bit longer. We continue to have a strong preference for non-cyclical growth segments. For those seeking value investment styles, we suggest Growth at reasonable price (GARP) as an alternative strategy.

Dividend yielders are likely to outperform in an environment of range-bound to lower bond yields. However, we think investors should focus on counters that offer quality dividends rather than those with higher yields.

Momentum, came back strongly after the January-effect. But we stay neutral momentum strategies as we do expect the leadership to change in equity market at some stage. Rotation out of US into the rest of the world, when it happens, also means a change in focus from growth to value and from defensive to cyclicals. But we are not there yet.

Exhibit 11: Growth continues to outperform value; at least for now



Source: MSCI, Bloomberg, ADCB Investment Strategy

Key risks to our calls

1. Escalation of the US-China trade dispute is a key risk to our US overweight.
2. Biggest risk to our Europe-ex-UK underweight is an aggressive ECB stimulus.
3. Sharp appreciation in the USD and a hard-landing in China are key risks to our tactical overweight on Brazil and South Africa.
4. Sudden supply shocks in commodities (like the iron ore supply disruption from Vale due to the dam collapse in the Brazilian town of Brumadinho) is a risk to our underweight on broader materials sector.
5. A sudden downturn in global economic conditions could strain growth themes. But our preference for non-cyclical growth should support here.

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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