The Equity Strategist: Taking stock

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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A month since we published our *Quarterly Investment View*, in this note, we take stock of our equity strategy. We also establish our sector, factor, style and size preferences for global equities (see page 2). Despite a range of concerns – weakening global growth, tighter financial conditions, trade disputes, political and geo political risks – equities managed to rise strongly in January. In fact, US equities had their best January gains in more than 30 years and the best monthly gain since 2015. Against the backdrop of a mixed macro picture, earnings season provided some positivity. Of course, going into the earnings season, market expectations were lowered (thanks to pre-release profit warnings) and that provided the context for strong earnings beats. At the time of writing this report, with 22% of the companies in the S&P 500 reporting actual results for Q4 2018, 71% of them have reported a positive EPS surprise and 59% have reported a positive revenue surprise (earnings season in the other parts of the world was still nascent).

Looking ahead, we think that the earnings season is likely to provide more clarity on the standing of the global economy, impact of ongoing trade wars on corporate profitability and corporate guidance and expectations. We hold the view that we are in late stage of the equity cycle with equity markets (especially the US) having posted above-average returns over the past few years. This should leave limited scope for valuation expansion looking ahead. Also, as the economic momentum moderates in the future, earnings growth is also likely to be restrained.

By region, **US** still remains our key overweight. The US equity market benefits from being the one with most earnings transparency and quality. Following the sell-off in Q4 of 2018, US equity valuations have corrected. Analysts have cut their earnings forecasts across sectors. USD weakness is also likely to provide a favourable backdrop for equity performance looking ahead. All this means that US equity market run-up might have a bit further to go. Of course, we do acknowledge the risks in the medium term horizon but for now we remain overweight US. Recent weeks saw some strong performance from **Europe** but we remain underweight. In our view, European markets still face a range of headwinds. Economic momentum remains weak. In Italy, the 'Sick Man of Europe', spreads have narrowed from their October–November peaks but remain high. A protracted period of elevated yields would put further stress on Italian banks, weigh on economic activity, and worsen debt dynamics. Political risk remains high with elections for the European parliament in May. Europe is the region most open to trade and is likely to be the one most impeded by growing trade concerns. Indeed, the ECB in its recent meeting acknowledged the downside risks to the Euroarea economy. Equity valuations are cheap but could remain so for a considerable period in absence of catalysts and prevalence of risks. Banks are heavy weights in the Euroarea index and are likely to be a drag on the index performance. Brexit is Europe's Achilles heel. However, we are neutral the **UK** because of the Brexit uncertainty and also because of the composition of UK equity indexes which have more external orientation. Of course, for Europe very broadly there will be an entry point, but it is not now, we reckon. We stay neutral **Japan** given the absence of performance catalysts. **Emerging markets** (underweight) continue to trade on cheap valuations. We see selective opportunities in India (strategic overweight), *Brazil (tactical overweight) and South Africa (tactical overweight)*. We would wait for signals of stability in China, EUR appreciation against USD (EUR-USD is the key currency axis for EM) and marginal easing of financial market conditions globally before turning more positive on EM overall. On the EUR strength against the USD, our analysis suggests that periods of EUR strength associated with strong Euro economy rather than that associated with mere weakness in USD creates a more favourable environment for EM equities to outperform. Of course, USD weakness is in general positive for EM assets but is likely only to be a temporary driver. Whilst our tactical overweight in Brazil and South Africa continue to do well, we would rather wait for more clarity before moving overweight EM overall.

Equity strategy summary

	Underweight	Neutral	Overweight	Comments
Regions				
US			X	
Canada		X		
Europe ex UK	X			
UK		X		
Japan		X		
Asia Pacific ex Japan	X			Structurally OW India
EM LatAm	X			Tactically OW Brazil
EM EMEA	X			Tactically OW South Africa
Global sectors				
Comm. Services			X	
Cons. Discretionary		X		
Consumer Staples			X	
Energy			X	
Financials		X		Prefer banks with diversified business models
Health Care			X	
Industrials		X		
IT	X			UW tech hardware and semiconductor plays
Materials	X			
Real Estate		X		
Utilities		X		
Factors/styles/sizes				
Large cap			X	
Mid cap		X		
Small cap	X			
Growth			X	Prefer non-cyclical growth
Value		X		
Dividend yield			X	Prefer quality dividends
Quality			X	
Momentum		X		
Legend	*New*	*Old*	*No change*	

By sector, we take a defensive positioning. Relying on strong consumption and resilient services trends, we are overweight **communication services** and **consumer** sectors. **Energy** sector has the potential to yield positive earnings surprises in our view. **Healthcare**, though trading on expensive valuations, benefits from its defensive appeal and high return on equity. **Information technology** sector very broadly, and the tech hardware and semiconductors segments more specifically, look still vulnerable to slowing demand and we are underweight the sector. **Materials** sector though undervalued, is prone to cyclical risk. We are neutral **financials** but we have a preference for banks with diversified business models.

We prefer **large caps** to small caps as we think the former are likely to benefit from earnings transparency and quality. In Europe quality style should outperform the rest. **Growth** should outperform value in the near term. Whilst we do acknowledge that value has significantly outperformed growth historically over long run, for now we would steer away from value traps (currently Europe is one in our view). Within growth, we prefer non-cyclical segments. Falling yields (resulting from low growth environment) might help **high dividend yielders** – but we think it is prudent to remain selective and prefer quality within dividend space.

We are neutral **GCC** equities. 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. Of course, 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. 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. 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.

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. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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