NBAD

From West to East

Weekly Investment View

8th February, 2016

Starting with US jobs…and ending with the NBAD Outlook 2016

US data released last Friday showed the all-important US Non-Farm payrolls suggested 151,000 jobs were created last month, below expectations of 190,000. The data for December was revised down, from 292,000, to 262,000. The market took it as good news that average hourly earnings rose by 2.5% year-on-year, up from 2.2% the previous month. As we have commented in the past, the 'real' level of unemployment is much higher.

US Treasury yields continued to fall last week, with the 10-year currently down to 1.84%, as the US recession thesis is gradually gaining credence. US interest rate futures are now pricing in just one 25 basis point increase in the Fed Funds rate at the most during this year. Indeed the 2-year Treasury note has seen its yield fall to 0.73%, so in the eyes of the market, inflation expectations remain low. Investors increasingly don't believe the Fed will have the leeway to 'normalize' in the way it wanted to. Normalization (i.e. keeping rates positive, usually 1-2% above prevailing inflation, and also facilitating the 'price of money' to be determined more by market forces) could see this pushed out to 2017.

The US dollar saw a period of surprising weakness during the week, although closed off its lows. US ISM data suggesting weakness in the services sector came as a disappointment (adding to the continuation of recent months' weakness in manufacturing data). The US dollar may keep a firm tone, however, in particular versus the euro and the yen, which have negative rate differentials.

`The investment world remains in a fragile state'

Last week saw the publication of the electronic version of the 'NBAD Global Investment Outlook 2016', so we are taking the opportunity to walk our readers through a summary of what they will find. The introductory letter suggests the investment world continues to be in a somewhat fragile state, and that investors are not convinced by the 'quick fixes' served up by policy-makers (e.g. Greece). Indeed investors will need to continue to pay close attention to central bankers' policies. Meanwhile, many asset prices are already very depressed, across equities, bonds, and commodities; as such, we are laying out a road-map of our approach to 2016. The overall tone of what we are saying is probably best encapsulated in the following: "In 2016, investors will need to exercise patience, and then have the requisite courage to decisively deploy funds when opportunities present themselves".

Risk Factors, Global Economics, and the case for Bonds': The latest IMF estimate for global real GDP growth in 2016 (3.4%) is expected to be revised further downwards. The reigning-in of US QE occurred with the belief business confidence has been built during the last very difficult five years. Instead the resulting asset bubbles only benefitted the holders of those assets. As QE was withdrawn by the US (and given the often China-related consequences on commodities), large falls in emerging market asset prices produced a 'reverse QE' effect, driving further outflows in risk assets. Economic data in the US is continuing to weaken of late, after steady improvement over recent years. Fears of a US recession are also on the minds of market participants. We think Janet Yellen may pull back from December's 'dots'. The Fed has not always got its timing right in the past, while globally central banks have been accused of not reacting quickly enough (e.g. the ECB and Greece). Lastly, on rates, we think the Fed could find it very difficult to raise rates this year, especially in the light of the Japanese joining the ECB in monetary stimulus.

Policy-makers are in a quandry. The aim has been to create inflation, after anaemic growth. Inflation could result from rising commodity prices and is welcome in a disinflationary environment as long as it's kept in check. This would be warranted if backed-up by productivity improvements. The Europeans have been grappling with this for some time with the periphery of the Mediterranean countries showing improvements over Northern European countries. In Japan, the reflation of that

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

economy has proven to be somewhat elusive.

In China, the authorities remain interventionalist, with monetary and fiscal policy tools at its disposal to bolster growth. The renminbi will be adjusted further downwards, prior to a low before full SDR (and also eventual MSCI index) entries. China's sustainable 'real' GDP growth rate is probably in the 4-4.5% range, once the savings rate falls slightly. Chinese equities fortunately only have an MSCI weight of about 2.7%, and are small vs. GDP.

`At least there are visible Black Swans'

What are the 'known' Black Swans we most worry about? The answer is probably Japan, as negative rates don't cancel debt, and the 'unknowns' resulting from Abenomics and all that preceded it are of great concern. The other known Black Swan that really bothers us is increasing illiquidity, driven by more regulations, and the way lenders are demanding more and more collateral. Taking this down to markets, we see fewer and fewer market makers, and lower capacity - all of which means even more volatile markets, everywhere.

Although the US credit cycle has turned, US Treasuries will likely see yields fall. Reduced growth with high levels of debt equates to sustained lower yields on Government bonds. Buyers of shorter-dated eurozone or Japanese government paper will face higher negative yields, as that trend probably has further to go. High Yield spreads moving out have historically been lead indicators of equity downside.

Of the risks we see, the most 'expected' is a bear market in US stocks; a good time to reassess this would clearly be closer to the US Presidential election. Historically, US expansions have lasted an average of 59 months, versus 79 months for the current elongated one. Recessions have lasted an average of ten months. Meanwhile, all the corporate earnings 'tricks' have been exhausted. Any rallies in the S&P500 almost certainly provide a pre-recession selling opportunity in this over-valued asset class. It is too early to try to quantify S&P500 downside, as reductions in estimates haven't yet slowed. Developed market equity assets are highly correlated - and this increases during market stress. Eurozone equities should outperform the US by 5-10% (due to low P/E ratios), but are correlated to the S&P500. In Japanese equities, corporate re-structuring is a positive, but these are also correlated to the US markets.

In major Emerging & Frontier equities, the estimated earnings growth rates all look too high. Having said this, emerging market earnings should stabilize this year, especially once commodities stabilize. On the shortlist of markets we like are South Korea, Argentina, India, and Mexico. In Chinese equities transparency issues keep us sidelined along with institutional 'blocked sales' stock that will come out. Our article, 'India Revisited', takes a measured view of the country's investment prospects; essentially the political logjam must ease, and there needs to be confidence that corporate earnings will recover.

We believe oil is trading in a range of $25-45, capped by forward sales and OPEC/US shale production on the upside, and with most of the bear factors reflected towards the lower end. We would look to establish longs close to $25 (basis WTI), for potential upside to $40, placing a stop at $20. Short oil positions approximate 9 days' consumption, and periodic covering of a portion of these will drive more 8-12% up-moves.

`Oil is in a low trading range - not continually falling'

The Outlook discusses most of the MENA countries in some detail. The re-pricing of oil has provoked reforms and fiscal effectiveness by GCC oil producers. Here in the UAE, Governments had already begun tightening fiscally more than a few years before oil prices fell. Existing MENA currency pegs should remain although 'basket' currency pricing is more likely in the future. Looking at MENA equities, market valuations have become more compelling after the steep falls of last year. More balanced crude oil price sentiment going forward may present some opportunities. We are positive on Egypt; it is an important country in the region, with almost 90 million people, and a large economy. It wouldn't take much to go right for investors to do well, provided policy measures include a currency devaluation.

On major G7 currencies, we are still looking for signs of an end to the dollar bull market. This has been made more complicated by a new round of competitive currency devaluations around the world. Unless the Fed also goes to negative deposit rates we expect the US dollar to continue to strengthen. Regarding sterling, we believe talk of the 'Brexit' has been more than factored in, and that the currency could do well in the second half of the year after the vote.

Below is a summary of our recommended 'Investment Approach' for the immediate weeks and months ahead. Holding above-average cash is advisable for the moment, and being overweight in quality bonds. We have only just begun to see meaningful money coming out of equities. It was very difficult to make money in 2015, and this year will also be challenging. Volatility remains generally elevated. The bearish tone in equities is being exacerbated by the fact that sovereign wealth funds are only retaining their very best external managers, and many are trimming equity positions where liquidity still allows. Investors are no longer assuming much growth and are becoming far more fund manager-selective. 2016 should see good, nimble 'active' managers' win; performance dispersion and greater volatility helps them. Where mandates allow, excellent 'market-neutral' funds will be a good place to be.

`It's not all bad news'

However, it's not all bad news! During the months to come we expect to see 'capitulation' sales. Right now it's best for most investors to be sidelined, or parked in safe-haven assets. We do expect to recommend putting money to work on a selective basis when the time is right to do so. Investors should look to invest where FDI flows will likely go when negative China sentiment looks to have bottomed. Much of our research is directed to successfully identifying the best commodities to be long of. Copper and iron ore will not go down for ever. In metals and other materials, the 'supply-side' response has begun, even if demand is still weak. When the commodity shorts cover it will mean a classic trading opportunity in all related assets. It will be right to buy various of our favoured Emerging (and Frontier) equity markets. Also, we are thinking outside the box, for instance by seeking great weather forecasters who have an edge in trading 'softs' via their analysis of climatic conditions. In the meantime, investors will be able to find good opportunities in selected 'hard currency' emerging market bonds, many of which offer good value.

Lastly, we finish the Outlook with a few 'behavioural investment' articles that will hopefully be of interest to investors and their advisors: 'Asset Allocation: What it should mean for private investors', and 'Simple Rules of Investing 2.0', a sequel to last year's article. 'How to Invest in Gold' attempts to cover the basics in a market which looks to have finally bottomed. Good luck in your investing endeavours in 2016.

Disclaimer:

This report has been prepared and issued by the Global Asset Management ("GAM") of the National Bank of Abu Dhabi PJSC ("NBAD") outlining particular services provided by GAM and does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to purchase or subscribe for, any shares in NBAD or otherwise or a recommendation for a particular person to enter into any transaction or to adopt any strategy nor shall it or any part of it form the basis of or be relied on in connection with any contract therefore. This report was prepared exclusively for the benefit and internal use of NBAD. This report is incomplete without reference to, and should be viewed solely in conjunction with the associated oral briefing provided by GAM. The report is proprietary to GAM and may not be disclosed to any third party or used for any other purpose without the prior written consent of GAM. The information in this report reflects prevailing conditions and our views as of this date, which are accordingly subject to change. In preparing this report, we have relied upon and assumed, without independent verification, the accuracy and completeness of all the information available from public sources or which was otherwise reviewed by us. In addition, our analysis are not and do not purport to be appraisals of the assets, stock or business of the recipient. Even when this presentation contains a kind of appraisal, it should be considered preliminary, suitable only for the purpose described herein and not be disclosed or otherwise used without the prior written consent of GAM. NBAD clients may already hold positions in the assets subject to this report and may accordingly benefit from the buying or selling of such assets as referred to in this report. This document does not purport to set out any advice, recommendation or representation on the suitability of any investment, transaction or product (as referred to in this document or otherwise), for potential purchasers. Potential purchasers should determine for themselves the relevance of the information contained in this document and the decision to purchase any investment contained herein should be based on such investigation and analysis as they themselves deem necessary. Before entering into any transaction potential purchasers should ensure that they fully understand the potential risks and rewards of that transaction (including, without limitation, all financial, legal, regulatory, tax and accounting consequences of entering into the transaction and an understanding as to how the transaction will perform under changing conditions) and that they independently determine that the transaction is appropriate for them given their objectives, experience, financial and operational resources and other relevant circumstances. Potential purchasers should consider consulting with such advisers and experts as they deem necessary to assist them in making these determinations and should not rely on NBAD for such purposes. NBAD is acting solely in the capacity of a potential arm's-length contractual counterparty and not as a financial adviser or fiduciary in any transaction unless we have otherwise expressly agreed so to act in writing. NBAD does not provide any accounting, tax, regulatory or legal advice. NBAD is licensed by the Central Bank of the UAE.

London

NBAD London Branch is Authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from NBAD London branch on request. Registered in England & Wales: Company No: FC009142: VAT No: GB245 3301 91.

Paris

NBAD Paris Branch is licensed by the French Prudential Control Authority as a credit institution. NBAD Paris is registered in France under the company number: RCS Paris B 314 939 547.

Switzerland

This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness. All information and opinions as well as any prices indicated are currently as of the date of this report, and are subject to change without notice. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. At any time the National Bank of Abu Dhabi PJSC and/or NBAD Private Bank (Suisse) SA may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. National Bank of Abu Dhabi PJSC expressly prohibits the distribution and transfer of this document to third parties for any reason. National Bank of Abu Dhabi PJSC and/or NBAD Private Bank (Suisse) SA will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law. The "Directives on the Independence of Financial Research", issued by the Board of Directors of the Swiss Bankers Association (SBA) do not apply.