NBAD

From West to East

Weekly Investment View

11th April, 2016

It's not May yet

The large rally in US oil prices at the end of last week, with WTI back up to $39.72, caused energy stocks to rally, and helped limit the falls in US and other global equity markets over the week as a whole. The S&P500 fell 1.2% over the week, the Euro Stoxx 50 was 1.4% lower, and Japanese stocks (-2.1%) managed to avoid a further full blood-bath which might have been expected following the continued strength in the yen. The latter was certainly a notable feature as the yen has moved contra to poor and deteriorating relative economic fundamentals - but fund flows confounded rationality (see below). Otherwise, the emerging market (EM) currencies as a group have been strong, as part of the generally positive EM asset environment that we envisaged, and helped by dollar weakness. In quality sovereign bonds, the path of least resistance for the yield on the 10-year US Treasury (1.72%) still looks to be firmly downwards. We note that the 10-year German Bund yield fell by 5bp over the weak, to a lowly 0.09%, a new low.

"So why isn't the yen falling, as one would have expected?"

We have received a number of questions along the lines of, "if the outlook for Japan is so difficult, why is the yen strengthening?". When Japanese investors get nervous they (quite reasonably) bring capital home, and this appears to be the case at the moment, resulting in yen purchases irrespective of poor Japanese fundamentals. Given the latter, the old carry trade mentality looked to be back on, that is until the BoJ spectacularly failed to weaken the yen a few months ago - when it strengthened after the move to negative rates on deposits. So despite the sensible view being 'yen weak', the reverse is happening as forex traders bet against a BoJ that has lost a great deal of credibility and has run out of options to get their currency down. One would expect that, going back a number of months, yen short positions had been established in size, and these are now being squeezed to breaking point, with ongoing bouts of yen strength the result - and at a time when the dollar has in any case been weak, partly because of the Fed's dovishness. The dollar currently buys 1.0807 yen, and despite the threat of intervention by the BoJ, the mood still looks short-term bearish for the yen. Although none of the developed world's central banks have been enjoying glory lately, the BoJ looks the least credible, and the Japanese are 'losing' the currency war. The strength of the yen is likely to continue to have a very negative effect on Japanese stocks in yen terms, with knock-on effects in other markets.

We are mindful that the continuation of very low interest rates could continue to keep P/E ratios inflated, and in the face of continuing deterioration in revenues and net earnings, with the latter fanned by authorities around the world cracking down on corporation tax avoidance (e.g. Pfizer/Allergan last week). We expect a poor US earnings season, during which investors will increasingly look past the cosmetic effects of corporate buy-backs, for instance. We accept that the latter are real, and a genuine source of demand for (especially US) equities. All this is translating into a somewhat tantalizing situation being played out in the markets, with the battle between the bears on the one hand, and bullish technical influences on the other, resulting in an almost historic stand-off, a 'knife-edge' scenario. We still expect a bear market in US stocks, although in this strange world of continuing zero (or near zero) interest rate policies, with central banks engaged in massive monetary experiments, it is possible we might be proven wrong. The 15% decline in GAAP earnings during the last three quarters has made the market expensive on this basis, while a high proportion of companies issued earnings warnings in the first quarter, and that excludes energy producers. Analysts' US real GDP forecasts are coming down, and it seems convenient for the Fed to blame worries about international economic influences for its scaling-back of rate rise expectations in the markets (note the FOMC Minutes for the most recent meeting, published last week).

Claude-Henri Chavanon

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The Fed seems unlikely to raise interest rates before June, and only one - or maximum two - rate increases are now generally expected by investors this year.

"It looks as though oil prices are bottoming, but it could be protracted"

A reduction in US crude inventories generated upside volatility in WTI (followed by Brent) oil prices late last week; WTI closed at $39.72, with Brent just below $42. US crude stockpiles fell by almost 5 million barrels, vs. a consensus forecast for a stock build of 3.2 million barrels. On the supply side, US oil production continues to fall - if not off a cliff - while on the demand side, gasoline demand has been quite healthy in the US, and heating oil (i.e. very low-sulphur diesel) was firm last week on the back of unseasonably cold US weather forecast for the rest of this month. The number of oil rigs operating in US oil fields fell by 8, to a total of 354 in the latest reported week, according to Baker Hughes; a year ago 760 rigs were drilling, so many of the unprofitable wells have been shut-in. Oil production in the Middle East is growing, however, and in Russia. For instance, Iraqi exports from its southern ports had risen to almost 3.5 million bpd early this month, up from an average of 3.29 million bpd in March. Lastly, Iran has said it would only be willing to participate in production curtailment discussions once its pre-sanctions levels of 4 million bpd is regained. In last week's report we opined that oil's trading range has probably moved up, but is likely still capped on the upside for the time being. We expect trading (now in an approximate $28-45 range on WTI in our view) to gradually define a bottoming process in global oil prices.

The Mr Clean of British politics, Prime Minster David Cameron, was last week one of the many high-profile people to become embroiled in the fallout from the Panama Papers. It was not because he actually did anything wrong (that has not been suggested, at least not yet), but in the hard and unforgiving world of politics, he totally mishandled the ultimate disclosure that he and his wife profited from a trust set up by his late father through Mossack Fonseca. Last week must count as one of the most difficult Mr Cameron has had during his years in politics. Without going into detail here, his opponents have labelled him a hypocrite, and there have been calls for his resignation, as well as public demonstrations against him. During the previous week, he had to deal with claims that the UK referendum had split his government, and after a Cabinet minister said that increasing the minimum wage would drive up immigration - unless the UK leaves the EU. The point is of course that if Mr Cameron is now regarded as less than 'squeeky-clean' by the rather fickle British electorate, this could at the margin but in reality affect the outcome of the vote itself. Five members of the Cabinet, as well as the ultra-popular London Mayor, Boris Johnson, are opposing Mr Cameron and campaigning for the UK to leave the EU. There is a selection of poles, with some saying the vote is now too close to call, especially bearing in mind 'undecided' voters. In these circumstances book-makers have usually been more accurate, and they seem to be leaning more towards staying in the EU. Sterling is of course bearing the brunt of the uncertainty (at $1.4128, despite a weak dollar) so has been doing badly on the crosses. We still believe the UK will vote to remain in, although with last week's developments the outcome is more in doubt than it was.

"Much of the longer-term attraction of UAE equities is derived from non-oil sectors"

For the year-to-date, UAE equities have been doing well, with the DFM up by 7.5% (to last Thursday's close), with the ADX up by 1.0%. While growth has inevitably slowed across the UAE, evident in the usual metrics during periods of oil price weakness, we remain very optimistic regarding the country for the medium-to-long term. In this we are not simply talking our own book. During the last year or so we have become accustomed to hearing about the financial buffers that the UAE has in place, which are to an extent replicated elsewhere in the GCC. In the latest such report, Fitch (via a subsidiary, Business Monitor International) last week added to the positive views, and they can be summarized as follows: (1) The UAE's fiscal position remains strong given huge reserves and the political and economic flexibility to reduce spending; (2) The economy will prove to be resilient to lower oil prices, and its growth outlook is positive and well-balanced; (3) The outlook for Dubai appears especially bullish, helped by its real estate; (4) The non-oil economy will be the main growth driver; (5) Non-oil sector expansion in Abu Dhabi will remain robust, although the hydrocarbon sector will weigh on growth as BMI assumes OPEC oil prices will average $55 and $54/barrel in 2016 and 2017 respectively; (6) Although the UAE's growth will slow, given lower oil prices, it will still be impressive, with over 40% of GDP coming from the services sector; (7) BMI forecasts real GDP growth of 3.4% and 3% in 2016 and 2017 respectively, compared to an estimated 4% last year; (8) Their analysts said that even with the decline in oil revenues, the UAE's model of government-driven development plans is expected to broadly continue; (9) Reductions in fuel subsidies and the possibility of the introduction of a Value Added Tax bode well for further improvements on the fiscal front; (10) While the government will see fiscal deficits, the UAE has the financial arsenal and the political necessity to continue spending; and (11) Foreign ownership in UAE real estate has grown, compared to when domestic players dominated the market.

Lastly, although we at GAM always recommend full portfolio diversification across geographies and asset classes, our work suggests that carefully chosen UAE equities can be bought on prospective P/E ratios at attractive discounts to their possible compound EPS growth rates (i.e. the PE/Growth - or 'PEG' - ratio is less than one). Seasoned equity portfolio managers are usually excited when they can buy stocks at discounts to their growth rates. Certainly in the case of the UAE, if and when oil prices recover, that would be a bonus, rather than a pre-requisite for earnings growth. ***Selected UAE and other MENA assets remain excellent diversifiers within globally diversified portfolios.***

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