NBAD

From West to East

Weekly Investment View

14th March, 2016

Making some adjustments

Equities had a good week last week, with the S&P500 enjoying its fourth weekly gain in a row, mainly pulled upwards by higher oil prices. Other developed equity markets did less well, with volatility across many classes as the markets tried to get to grips with the new expansionary monetary measures brought in by the ECB, which were variously described as 'comprehensive'. It was initially taken positively that the rate of monthly asset purchases was increased, and the scope of these widened to include non-banking corporate debt. Mr Draghi added that he didn't envisage cutting interest rates further, and the markets took that particular comment less well, resulting in the 10-year Bund yield increasing to the 0.30% level, from about 0.15%. The euro rallied quite strongly intra-day on this, and closed the week at 1.1156 vs. the dollar. In truth, the markets should be pleased that the ECB, while generally wanting to be more accommodative, appears concerned about not adding a further burden to the European banking sector via higher negative rates. Perhaps the ECB is mindful that it might now need to moderate the impact of broadly higher commodity prices in euro terms, and a slightly stronger euro vs. the dollar than of late could be desirable on this basis to help avoid eurozone growth trending back towards 1% or so. We remain neutral in eurozone equities, but have the sector under review, with a positive leaning. ***Although we are highly skeptical that the ECB's extra quantitative easing will change the underlying economic fabric for the better, we are mindful that this could inflate asset prices, as happened in the US during recent years. Should this turn out to be the case, we would not want our model portfolios to be underweight.***

`Oil is in a bottoming process, but expect it to be very choppy'

With Brent trading back above $40, and WTI above $38, some commentators (for instance the International Energy Agency) are now suggesting at least the beginnings of a fundamental recovery is taking place in the oil markets. While we would of course hope that this is true, and doubtless helped by production problems in Nigeria and elsewhere, the market logic regarding US shale production is almost certainly on shaky ground. The US rig count is indeed well down, yet a large percentage of the extra 4.5-5.0 million b/d of production that came on during the previous four or five years is still in place. We expect (very flexible) shale capacity would now come back on if West Texas traded much above $40 - and definitely towards $45, and that the latter kind of price would be attractive for producers to make hedge/forward sales. This is the definition of the upper part of the trading range we envisage. While we would be very surprised to see $26 (basis WTI) successfully broken, we still expect a very 'choppy' bottoming process during the months to come. The good news, if we are correct, is that it ***is*** a bottoming process. ***We would utilize any correction back towards $30 or below as an excellent opportunity to buy oil-related assets, with a target of $45, with a stop-loss at $25. In addition, any such weakening in the oil price would, we firmly believe, provide an excellent opportunity to buy MENA equities, and especially UAE equities.***

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

'Emerging market assets have better upside potential than developed'

In last week's NBAD Tactical Asset Allocation Committee (TAA), the following changes were made across the model portfolios (not necessarily in order of importance):

'High yield need not mean junk'

Increase the overweight in High Yield, principally through US High Yield: With sovereign and quality corporate debt trading at such low yields, many investors are finding the need for good-yielding securities has become acute. With overall default rates still historically low - and also with the energy segment under less pressure with the rally in the oil price - it was thought appropriate to add. ***This is not a recommendation to buy 'junk' bonds, per se, but rather an***

appreciation that segments of this asset price overly reflect the risks in yield terms.

'Significant short-covering in commodities will precede fundamental improvements'

Increase the overweight in Emerging Market (EM) debt securities: As a 'safety-first' way of increasing EM exposure, and because the yield spreads had looked attractive, the models' weighting had recently been taken overweight. This move is a continuation of that logic, and the further confidence on the part of the Committee regarding commodity prices. We do not expect a new commodities 'Super-Cycle', however, at least not yet. ***Professional management is a 'must' in this asset class, and we maintain a range of model portfolios across it.***

'The US equity rally has been a technical correction in a down-trend'

Reduce the underweight in US equities: While the Committee remains underweight in this asset class, it was thought prudent to moderate this stance from a house-keeping perspective. The analysis provided in our recent reports regarding the deteriorating quality of earnings, the now extended length of the economic expansion cycle, and of course politics remain very much in place. Investors seem to have drawn courage from recovering oil prices, we think incorrectly. ***The market is fundamentally expensive.***

'Emerging and frontier equities markets must be selected very carefully indeed'

Move overweight in Emerging Market equities: As detailed in the recent NBAD Global Investment Outlook, many of these (and frontier) markets were described as very depressed. To reiterate, we had expected some exceptional investment opportunities in commodity-related assets this year, and we like buying EM equity assets when cash outflows look to have dried-up. ***Since the low point in mid-January it is the higher-beta/riskier markets that have risen the most, and this should now broaden-out.***

'The outlook for the Japanese economy continues to deteriorate'

Move underweight in Japanese equities (from neutral): In a real sense, this is a sharing of an underweight position in developed equity markets as a whole. More specifically, it reflects a growing perception that Abenomics hasn't worked, underlined by the latest Japanese 'economic surprise' data showing a marked deterioration since the year-end. ***We have for some time had longer-term reservations about the Japanese economy (demographics, debt) - and the 'longer term' is now arriving. If oil prices are indeed gradually bottoming, this is bearish for Japanese equities.***

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