NBAD

From West to East

Weekly Investment View

25th January, 2016

Downside is leading to better values

Given the events in the markets last week, we must ask whether the bounce in the markets last Thursday and Friday mark an important turn. In all probability, "It's too early to say", in the words of former Chinese premier, Zhou Enlai. And in the same way that his questioner was apparently referring to an historical event, whereas Zhou thought it was a reference to more recent events, we could ask the question twice - firstly about the short-term, and secondly about the long-term.

`US data has not been good, but it's not all one-way'

Whatever the right answers to these questions turn out to be, the gap between perception of the global economy as apparently priced by markets and the reality of the economic and fundamental data has narrowed in the last 48 hours of trading. The global economy may not be in the best shape at the moment, but the data does not support the view of a collapse. For example, the US economy has rightly been a source of concern lately, but last week's data suggested that talk of imminent recession could be premature. The Markit manufacturing PMI at 52.7 was stronger than earlier survey data and suggests the need for a more balanced view.

The apparent 'trigger' for the rally in risk assets was the Draghi/ECB indication that further policy easing in March is under consideration. It seems ironic that the eurozone economy appears to be one of the strongest relative to trend at the moment. Still, an increase or extension of QE would be supportive of our view that eurozone equities are one of the asset classes to overweight, at least on a tactical basis. Coming back to the 'trigger' theory, we see it more as a coincidence; after all, the prospect of further QE by the ECB is not a new idea.

`Japan remains a tactical over-weight for the time being'

The Bank of Japan (BoJ) may offer more for the markets to digest in its monetary policy meeting this week. Both the fall in the Japanese equity market (correlated with other developed markets) and the rally in the yen have tightened financial conditions notably, although the BoJ will probably wait to see the impact of these moves as the recent crop of activity and survey data looks fine. In last week's Tankan report, although the reading for large manufacturers was weaker, this was balanced by stronger non-manufacturing, such that the combined number was higher and the PMI remained above 52. As with the ECB, whilst the timing of policy moves is not clear, the biases are, and BoJ policy should remain relatively supportive of Japanese equities - again, at least on a tactical basis. Longer-term, we remain deeply concerned about the headwinds from demographics and government debt off the top of the chart.

However, not all the narrowing of the 'difference' between the data and the markets came from the rally at the end of the week. Notwithstanding the comments above about the US data, there were some negatives last week too. Of the slower moving data (and hence less surprising), the IMF revisions to their global growth forecasts must be mentioned. They cut their global growth forecast to 3.4% from 3.6% for 2016, and to 3.6% from 3.8% for 2017. Of the data that comes early in the monthly cycle of data releases around the world, Taiwan's export orders came in below expectations at -12.3% year-on-year, in line with the weak number released earlier in the month by South Korea.

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

`Beware economic effects from falling markets'

Staying with the 'difference', even if the markets have got ahead of themselves in the cycle (and ignoring the longer-term structural issues for now), it will be important to be alert for evidence of feedback loops from the markets to the economies. The falls in equity markets, the rise in credit spreads, and (depending on which country you look at) the rise in domestic interest rates and currency values have tightened financial conditions, in some cases dramatically.

Like the ECB and BoJ the Chinese authorities are also easing policy to help their economy. Working out which lever they are pulling, and how, and what effect the moves will have on domestic and global asset markets is more difficult to gauge, however. Their fiscal policy is the easy bit; they are easing and the results can be seen in the data. The currency has taken centrestage in the last six months, and in 2016 so far, the unfolding chapter in this particular story relates to how monetary policy dovetails with the currency. Up until now the markets had been expecting further cuts in policy rates and reserve requirement ratios (RRR), but both actions and an allegedly leaked memo indicate that we may get less RRR cuts as the central bank (PBOC) might put more downward pressure on the currency than other measures. For now and ahead of Chinese New Year early next month the PBOC has used a variety of measures to inject liquidity into a system where capital outflows have tightened conditions. Working out what is going on in the Chinese economy and markets is not easy, and the task appears to be getting harder.

`Oil was awaiting short unwinding to rally'

Oil has played a big role in markets so far this year and last week was no different. The oil market could "drown in oversupply" grabbed the headlines as prices plummeted through the 2008 lows, only to find support late in the week. With so much coverage of this market recently, most of the relevant information is in the public domain and where the price goes from here seems to depend on a mixture of perception and known unknowns. Perception has clearly been bad, and Friday might mark a turn in that perception. However, a lasting turn probably requires more information about the known unknowns. Of these, the top of our monitored list are: how quickly US shale production declines, and how much impact the colder weather in the northern hemisphere has and prompted the 240 million barrel short position in the futures markets to be unwound. Expectations about the decline in US shale production seem to be centred on a figure of 500,000 barrels/day this year, with the most extreme forecast around 1 million. A decline at the upper end of the range, cutbacks by one or more of the other major producers (there is some talk of an OPEC meeting in March) and the market could look quite different.

These factors seem important beyond our region too. The fall in energy and commodity prices has not played out according to the standard economic models. They would have suggested that the increases in real incomes due to the commodity price falls would have been spent and hence increased economic growth. In contrast, not only does it appear that much of this windfall has been saved instead (or used by governments to reduce subsidies), but also the drop off in investment in the energy sector and spending by oil producers has been so sharp in terms of scale and time that this has been the dominant driver of growth. And not just growth, it would appear that the selling of assets by sovereign wealth funds and reserve managers, and fears of more selling, have pushed markets down as well. Going back to our earlier comments on Japanese equities, it is quite likely that they have been a victim of their own liquidity, whereby in falling markets investors often sell what they can and not necessarily what they'd like to, as this would be harder to achieve in size.

`Value buying opportunities are appearing on the horizon'

The uber bears have got a lot of airtime so far this year and we have no problem with that. Many of them raise a number of important issues about debt, the dangers of quantitative easing, valuations and China (to name a few). At the same time risk assets have obviously fallen in price dramatically and the price action on Thursday and Friday was obviously different. For the first group, this pause in proceedings might be dubbed the end of the beginning. For those trying to work out if this is a selective buying opportunity it might be dubbed the beginning of the end. We'd be in the latter group and looking for more signs that it is safe to go back into the water, at least in our favoured asset classes.

Implicit in this view is the belief that investors can be patient. The issues highlighted by the uber bears are important and have worried a lot of people, and the falls in the market have been deep and record-breaking. It seems unlikely that risk assets will go straight back up, rather a period of volatility probably lies ahead during which investor confidence will be rebuilt. Working out which assets have gone down more than they should have relative to others will be key to buying profitably in the weeks ahead. Whilst not the worst performing or highest-beta assets out there in recent weeks, we'll be looking closely at MENA bonds and equities for such opportunities. In the bond markets, you'd need to venture into Africa and Latin America to find more beaten up prices, not surprisingly given the oil price. One of the key missing ingredients in the local bond markets is a sign that the primary market is alive and well. It began to open last week and we'd take comfort from one or two more deals being able to come to market and then trade well on a secondary basis. P/E ratios (low) and prospective dividend yields (high) underline that valuations are supportive for the local equity markets. However, signs that growth have bottomed out will be needed to unlock the value and last week's IMF forecast changes signaled that we are still waiting for that to happen. 2016 GDP growth forecasts have been revised down to 2.6% and 1.2% for the UAE and Saudi Arabia respectively, numbers that now seem reasonable but may not be the last word. Overall, we do expect to be able to buy selected risk assets very cheaply this year, starting slowly and 'averaging-up', and various of these do have the considerable advantage that their correlation with the S&P500 is very limited.

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.