NBAD

From West to East

Weekly Investment View

16th of January, 2017

A fore-runner for the NBAD Investment Outlook 2017

Last week in the markets was notable for the good results reported for the fourth quarter by JPMorgan and Bank of America - driven by market movements following the 8th November elections - and even more so for President-elect Trump's press conference delivered on Wednesday. Investors will clearly have to wait longer to receive further information related to his policies mentioned during the election campaign. Pharmaceuticals and other healthcare stocks were hit quite hard by Trump's remarks on drug pricing. Elsewhere, US retail sales for December came in below expectations, although the general mood surrounding consumer confidence remains quite good. Elsewhere, oil prices came off by 3% pending receipt of confirmation of OPEC oil production compliance following its recent agreement to reduce output. **Trump's inauguration this Friday and the events surrounding it will drive the markets in the next week or so. Investors especially want details on the new Administration's trade policies, within the context of a more complete manifesto. In the meantime Treasury yields remain elevated, mainly due to concerns that inflationary expectations could increase.**

'The Asset Allocation Committee has over-weighted Indian equities'

The NBAD Asset Allocation Committee met last week. It was decided to close the recent successful bond duration trade taken to lengthen duration when the US 10-Year Treasury yield touched 2.60%, upon the same yield falling to the 2.31% a few weeks later. Additionally, the tilt in favour of Indian equities within the Global Emerging Market Equity segments of the models was confirmed.

This week will see the publication of NBAD's Global Investment Outlook for 2017, and we are summarizing the main recommendations below. Looking at the Economic and Political background:

'The fact that investors stood their ground through the market shocks of 2016 bodes well for this year'

Firstly, despite the serious shocks of the downside move in many markets in January/February, Brexit (and the resulting significant fall in sterling), and then Donald Trump and the Republicans' surprise win in the US election, we above all note that investors refused to reach ultimately bearish conclusions regarding risk assets. This broad tone has continued into 2017. Cash allocations were already high prior to the US elections, and the rapid turnaround in markets led by US stocks was especially impressive, and a shock to the majority of investors. **Sure enough there are currently some annoying distractions for the incoming US Administration, while at the same time they are learning how to communicate effectively with the media.**

While being aware of many of the 'big picture' and Trump-related risks in the investment environment for this year, we are more optimistic about markets in 2017 than most, and expect what we would characterize as 'satisfactory -to-good' returns in 2017. It will be necessary to be tactical at times - to sell extremely overbought markets, and to buy the dips in one's favourite asset classes – while continuing to have sufficient levels of diversification across asset classes. We think that things

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going more right than wrong - for instance with the new Administration's policies - is simply not priced in. It wouldn't take much of an improvement in business confidence to bring more cash off the sidelines. In the markets we have already seen a rotation out of safe -haven assets, into equities (and into certain sectors) and this should gather pace during 2017. In terms of economics, the world looks good to us. Fiscal policy should now come to the aid of monetary policy, to the delight of the world's central bankers. In the US, having the Republicans in charge of both Houses of Congress was the real win in the General Election, which will facilitate the conduct of policy. We know that President-elect Trump wants to reduce corporate taxes from 35% to 15%, and to spend $1 trillion over a period of years to upgrade and extend the US's crumbling infrastructure. In truth it will inevitably take longer than some expect to get these initiatives underway, and its full rollout could take

two Presidential terms (which we assume, by the way). **Even so, infrastructure spending is known to generate amongst the best 'multiplier' effects.**

'This year economists will probably have to revise growth forecasts up, rather than down'

We expect the majority of economists to be left behind the curve in their global GDP forecasts this year and next. This is in contrast to recent years when they began with forecasts that then tended to be revised downwards throughout the year. Donald Trump believes that US business has been impeded by unduly high levels of regulation. We don't expect the Trump Administration to accept the Eurozone/ Basel restrictions on banking supervision, and in the US, financial regulation amendments don't (unlike tax or trade), require legislation by Congress. Trump is serious about easing the regulatory burden on corporations, and especially to enable banks to lend more freely. Investors will need to sense the mood changes, a classic example of which could be this quote from Mr Scaramucci, the hedge fund manager and now senior Trump advisor: **"Business people like Mr Trump understand you can grow yourself out of excessive debt".**

Crucially, although the expansion part of the current US business cycle has lasted about 32 months longer than the average since the 1930s, we believe Trump Administration policies should extend it at least another 18 months. Meanwhile, global central bank QE is now finally being tapered, but in a veiled way. This should, however, be more than offset by increasing levels of business confidence, spreading outwards from the US. Since 2013's taper tantrum, the current account deficits of India and Indonesia, for instance, have improved, and generally speaking the emerging world is less risky than previously. However the dangers of emerging nation corporates and sovereigns living through periods of US dollar strength have not completely disappeared. China is likely to do much better than 'muddle-through' in 2017, although growth is in reality probably about 5%, not the officially-stated 6.5%. **Overall, IMF global growth forecasts stand at 3.4% for 2017, vs. 3.1% for 2016; we expect estimates for 2017 (and beyond) to be revised upwards.**

'We still expect a Hard Brexit to be avoided'

The rise of nationalism is a theme that will likely continue to grow this year, especially in Europe, with Dutch, French and German elections taking place. We don't expect Marine Le Pen to become the next President of France, and outside of her widely-publicized social views she has no economic solutions to France's woes. The Netherlands will elect their new leader on the 15th March, and it is very possible that Geert Wilders and his Freedom Party will win. **Turning to Brexit, we expect the negotiations to be slow and difficult, eventually leading to a 'special deal' (e.g. like Norway or Switzerland), with concessions on both sides and irrespective of a degree of 'Hard Brexit' posturing by British Prime Minister, Theresa May.**

In the Middle East, we expect geopolitical risk to continue to gradually abate.

Turning to Investment Strategy Themes for 2017:

'The US dollar should rise in line with rate differentials during 2017'

In the currency markets the US dollar will once again be favoured within G4. With the Fed 'normalizing' rates the dollar is expected to resume its uptrend, yet the trajectory should be steady, given the gradual nature of economic acceleration anticipated in the US. On interest rates, the Fed expects its Fed funds rate to be in the 1.25-1.50% range at the end of this year (i.e. after a further three rate hikes), and we agree. Certainly rate 'normalization' can proceed if economic growth is reasonable - and recent good US consumer confidence data says it will be, with upwards of 2.4% US GDP growth looking quite assured for the current year. Given the background of dollar strength, a high degree of selectivity will be required when going long in Emerging Market currencies. **Specifically in G4 currencies, we expect the Euro/Dollar to reach parity** sometime this year, not just because of dollar strength, but also due to worries regarding the European political timetable and the longer-term structural problems of the Eurozone. **Lastly, we expect sterling to recover vs. the dollar, gradually improving towards the $1.35-1.40 range once markets get more clarity on how the Brexit negotiations are proceeding, and given that the UK economy has been doing better than expected under the circumstances.**

'Equities are favoured over bonds, and developed over EM in both'

We broadly favour Equities over Fixed Income; led by the US, and based on the anticipated economic background described above, we believe equities are in the process of enjoying a new lease of life. The recent rotation to sectors most likely to benefit most from Trump reflation and his business-friendly policies is likely to persist.

Also, let's consider that corporate investment in the US has in many ways been on hold for many months, pending the arrival of more policy certainty, so capex should recover strongly during 2017 once Trump's policies become clearer – and also because of some catching-up. So we firmly believe business investment will be good, and that productivity will improve, in line with Janet Yellen's wishes. In addition to the general benefit to the EPS growth from reduced corporate taxes, it should be noted that any proposed corporate tax reform should particularly benefit US financials, as they currently pay high tax rates. **Lastly, as well as late-cycle stocks, let's not forget technology, which we also expect to continue to do well. Healthcare and utilities should continue to lag.**

Other helpful factors relating to US equities are as follows: (1) Looking at history, only Fed funds above about 4% significantly hurts equities, and we don't envisage interest rates exceeding the Fed's current expectations for the next few years; (2) The prospect of lower capital gains tax for US assets is likely to encourage investors to delay taking profits, keeping stocks underpinned; (3) We expect positive estimate revisions to drive equity prices until the final phase of the equity bull market, which is not expected for some months yet, and (4) if the dollar behaves as we expect i.e. only moderately bullishly, then corporate earnings will be better placed to ride this out. **The above are some of the reasons why we prefer equities above all other asset classes - and with the US in the vanguard.**

'US equities should do quite well this year – buy into the expected inauguration dip'

We expect US equities to do better than the 4-5% performance generally expected for 2017, with perhaps 12+% upside for the year .i.e. with an S&P500 target of about 2,500. The S&P500 is currently on a P/E of 17.5x for 2017, falling to 15.6x for 2018, conservatively based on consensus earnings growth of 11.1% for 2018. With estimates likely to rise, and provided interest rates aren't surprisingly firmer than we expect, valuations are ***not*** stretched. By comparison, the EuroStoxx 50 is on a P/E of 14.3x for 2017, falling to 13.0x for 2018, with EPS growth at 10.5% in 2018. The Nikkei 225 is on a P/E of 19.2x for this year, and 17.3x for next year, based on earnings growth of 10.7% in 2018. We are 'neutral' on Japanese equities. For both European and Japanese equities, strategic currency hedges should remain in place. **European equities come in second place behind the US, partly because they are still relatively cheap, but also because earnings expectations are low and many global portfolio managers are believed to be underweight.**

MENA – and especially UAE – equities are favoured for 2017'

Developed country equities as a group are favoured over emerging market equities; in EM equities selectivity will be the key theme next year, and here we especially favour India. Generally, we prefer the net commodity consumers (India, Indonesia, and Korea), over the net commodity producers. Our liking for Indian stocks is perhaps a contrarian call, given the practical problems that have resulted in the practical rollout of what has been called 'demonetization'. This is very much with a medium-term view in mind. **Despite the probability of two (or even three) quarters of sub-3% Indian GDP growth, we regard the demonetization initiative and its short-term problems as a buying opportunity.**

In MENA, we prefer equities over bonds, and recommend overweight positions in MENA equities, emphasizing the UAE, and Saudi National Transformation Plan (NTP) beneficiaries. The UAE economy is still likely to see growth of above 2% in the current year, helped by its already well-diversified economy. UAE equities should do well as oil prices gradually recover, as should select Saudi equities linked to NTP initiatives.

Turning to Fixed Income, regarding the asset class overall we don't have a definitive 'bull or bear' view - rather, a trading mindset looks most appropriate. Although US inflation expectations have risen, they still remain below 2%. We don't foresee an inflationary take-off, so believe recent worries at the long-end to have been overdone. Talk of a 'Great Rotation' out of bonds into equities has begun, but we don't think it's the 'end' for bond markets, and in any case portfolio diversification still demands bond exposure. Duration and credit quality will continue to be important considerations for next year. From here on we expect volatility in bonds to abate relative to the very recent past. **As in equities, we favour developed country bonds over EM, although in the latter concern about tapering is beginning to be priced in, with some value appearing. We expect High Yield, especially in developed markets, to outperform investment grade and sovereigns, linked to a further improvement in business confidence, driven by the US.**

'Buying opportunities in base metals should occur in time'

In commodities, many hard commodity prices over-shot a few months ago, running ahead of 'intensity of use' logic. Copper, which had lagged the other base metals, played catch-up as Chinese traders re-entered the markets. Base metals as a group need to correct, and should be bought if and when this occurs as Trump factors should ultimately be supportive. As mentioned earlier, while we expect the US dollar to rise against most currencies, this shouldn't be too pronounced, therefore shouldn't damage commodity prices too much. **Gold will have its positive moments, as a hedge against unpredictable events, but it does face some regulatory hurdles which have made the outlook unclear. Silver should do better than gold, reflecting its industrial uses.**

'Oil looks to be in a higher, $45-60 trading range'

In the 're-balancing' crude oil markets we expect an average of $57-60 for WTI in 2017, with a return to the upper $60s in early 2018; following the recent production limitation agreement OPEC compliance won't be perfect, but even so we think the trading range has shifted upwards, to $45-60 for WTI. Admittedly this slow but steady rise in prices will continue to breathe life back into the US fracking industry. **By the second half of the year, however, the cumulative underinvestment in capacity by 'Big Oil' during recent years, together with underlying global oil demand growth should help tighten crude oil markets, and $65 per barrel looks possible by year-end (WTI).**

Hedge funds should do better in 2017. Increased performance dispersion across the asset classes should help, but old trend-following strategies probably won't work. A carefully selected and well-diversified portfolio of 'Alternatives' will be able to produce stable risk-adjusted returns in difficult markets. Overall, we expect 'relative value' strategies to do well, directly benefiting from the greater performance dispersion.

'Real estate is a great diversifier – and provides quality risk-adjusted returns'

Real estate remains an essential part of, and should be at the 'base' of all diversified investment portfolios. Good risk-adjusted returns have been possible over time, while the underlying choices within underlying sub-classes is considerable. The emphasis can be on steady income generation, or in less risk-averse classes, to suit a range of investor requirements.

CONCLUDING COMMENTS: We reiterate that starting in mid-to-late January (from Trump's inauguration), and continuing into February, a correction is likely in US equities (of 5% or so), although this should represent an excellent buying opportunity. We expect the Trump Administration to be inventive, and to make fewer mistakes than many skeptics expect. While some Trump execution risk exists, the chance that they get it more right than wrong is not being priced in.

At the same time, a degree of caution is appropriate regarding how the 2008 crisis came about, as it is becoming more of a distant memory; investors and agencies should be watchful to make sure that bad systemic and investment habits don't return.

Especially from the second half of 2017 onwards (as the oil price gradually recovers) we expect the world's largest sovereign wealth funds to be supportive of equities in preference to bonds.

In an article on Asset Allocation in the Outlook we have reminded clients that up to 80% or more of annualized investment returns in diversified portfolios are driven by asset class performance (i.e. markets or sectors), rather than by individual security selection. In another article, we provide details of our Wealth Solutions service, which provides a high level of in-house expertise relating to the safeguarding of family wealth, and its orderly transfer from one generation to the next.

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