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FAB
First Abu Dhabi Bank

From West to East

Weekly Investment View
15th January, 2018

We remain bullish on equities for 2018, expecting increased volatility

This edition of our report is a prelude to the exclusive FAB event taking place in Abu Dhabi this evening marking ten years in Private Banking, and also to introduce FAB's 'Global Investment Outlook 2018'.

THE POLITICAL BACKGROUND: Although global geopolitical concerns remain, world growth continues to overshadow these, and in the relative absence of inflation. In the US, tax reform is a major success for the Republicans to build upon, but healthcare reform will continue to be challenging. Last year's passing of a 'watered down' budget of $1.1 trillion sets the stage for more Trump-led policy initiatives in 2018, although we should be mindful that the Republican majority in the Senate remains slim, and could be reversed if the mid-term elections in November go badly. In China, following the 15th Party Congress, President Xi Jinping now has more leeway to clean up its political and economic systems – all of which is positive. The Eurozone faces Italian elections in April, and since we went to print Angela Merkel has succeeded in building a coalition in Germany. Brexit negotiations remain tough, as Europe continues to take a hard line; it is not clear what kind of trade deal can be reached. In the Middle East we expect adverse geopolitics to abate, leading to renewed interest in the region's capital markets, helped by oil prices that have recently risen.

THE ECONOMIC BACKGROUND: The current global economic cycle was elongated by QE, which was originally needed to avert a major slump. Reforms, for instance in the US, the Eurozone, Japan and China, should now help lengthen this cycle further. We expect world growth forecasts to be revised upwards again, to 4.0% for 2018 (from the IMF's 3.7%), led initially by the developed nations. The IMF had recently assumed US growth at 2.3% for 2018 (vs. a current run-rate of 3%+); corporate tax reform – in addition to the existing momentum - will see this revised upwards, perhaps to above 3%. Also including some extra infrastructure spending, US growth now has the potential to move towards 3.5% (or even a bit more) into 2019. The ECB recently revised its Eurozone growth forecast up, to 2.3% for 2018 from 1.8% (vindicating our positive European equities stance). Japan's monetary policy should continue to remain more accommodative than its central bank 'competitors', to keep the yen down. Growth is even improving in Japan, however, and in reality the BoJ has already begun to 'taper', largely unannounced. China's forecast GDP growth (at 6.5% for 2018) looks a bit too high; 6.0-6.2% looks more realistic, although that would still be very good. Asia-Pacific (ex-Japan) should see the best regional growth for the medium-to-long term; the IMF expects 5.2% growth for its 'Asean-5' for 2018. World trade should move to a more bi-lateral basis, inspired by Trump. China will appease Trump with more FDI, as Japan already has done.

The 'normalization' of interest rates will continue to be US-led; rates there should go to 1% above inflation (not 2% as historically). Central banks as a group will move towards shrinking their balance sheets, although it must be emphasized this is still likely to be very gradual, as they don't want to impede global growth. Central bank tightening should not affect emerging market (EM) economies, and EM growth should continue to exceed that in developed countries. The ECB is likely to be very wary of increasing its rates - if at all – to keep the euro low, thus sustaining export-led growth. Digitization, and increased productivity through sustained innovation should continue to keep global inflation in check. Essentially, we are very optimistic about world growth overall, despite demographic and other entrenched problems (e.g. inequality in many countries), and don't subscribe to the thesis of secular stagnation put forward by Larry Summers, believing that the world is on a far more solid growth path than it was a few years ago. At this time last year we said that global growth forecasts would improve during the year – breaking a pattern of normal downward revisions – and that is what happened. Investors should expect more of the same this year. After a major crisis, such as in 2008/09, investors should accept the possibility of a much longer economic cycle (notwithstanding a new shock); so seven years could become 14 years - and we are only nine years in. Despite whatever the Trump negatives may be, purely economically we expect the current US cycle to be further extended into 2019, with its momentum continuing into 2020 – the longest for generations.

THE INVESTMENT BACKGROUND: We continue to favour equities for 2018, but expect more volatility; sharp corrections should be bought into. A positive effect on US corporate earnings from lower taxes will follow as the actual realized average rate of 26% falls towards 21%. We expect US corporate capital expenditures to jump this year, as companies were clearly holding back until they saw whether tax reform would pass, and to see the new measures. In global equities, 'value' sectors such as Banks and Energy should do well; US financial regulation will be greatly eased; a more simplified tax system along with rising interest rates will benefit the financial sector. Accordingly, banks will lend more freely; the slackening of Dodd-Frank will be bullish for the sector – and for the whole market.

We remain overweight in IT, which should outperform further over the year as a whole, driven by a multitude of growth possibilities. The majority of US mutual funds are underweight in IT, thinking they will be able to buy the sector cheaply – they will likely be mistaken. The 'FAANGs' (including Apple and Microsoft) look highly-valued, but deservedly so (excluding Netflix) as they produce significant free cashflow. This is not a 'dot-com' bubble when looking at current valuations – Big Data and serious, genuine innovation in the broader sector is driving prices – as is AI (artificial intelligence). The original understanding of 'convergence' is taking on a massively different and exciting meaning. Industry giant, Microsoft, has reinvented itself (via cloud computing), and semiconductors are in a structural growth phase, and likely to be much less cyclical than in the past.

We believe that markets are nowhere near the euphoria necessary to bring about a lasting reversal; the last third of gains usually arrives in the final phase of bull markets. We don't expect Fed funds to go above about 3% (vs. 1.42%, within its current range of 1.25-1.50%), and therefore don't see the risk of equities being adversely impacted. Incoming Fed Chair Powell should continue the normalization path in 2018, although rate rises should be kept under control given that government debt in the US remains high. As interest rates rise there will be an increasing rotation to higher-quality investments – and we would expect hedge funds to begin to increase short positions in lower-quality ones.

EQUITIES: We expect earnings estimate revisions to generally be very positive during 2018 (they already look good), helping to moderate many valuations. The S&P500 (at 2,786.24) is on a P/E ratio of 16.9x for 2018, on consensus earnings growth of 10.4% - but this should improve further. The P/E for 2019 is only 15.1x, based on healthy earnings growth of 11.5% - although still with analysts behind the earnings curve. The cycle should be sustained by US and non-US growth, and we think the S&P could trade at 17.0x 2019 earnings (currently at 184.01 points) later this year, i.e. 3,128 - just over 12% above current levels. Last year we posited a correction of 5-8% within a bullish scenario, but it didn't arrive. This year there should be a greater chance of one occurring, probably later in the current half as investors who have been long take some profits, enabling others to enter. It shouldn't be until very late this year (or early 2019) that investors begin to worry about flatter earnings progression in 2020. Meanwhile, strategists are busily revising upwards their top-down earnings forecasts, and sector analysts will follow. We still like European (ex-UK) equities, which is more of a 'value' play, and a hedge against the IT/Growth overweight that we have in US equities. The STOXX Europe 600 index is on a P/E of 14.2x for 2018 and 13.1x for 2019; the latter looks inexpensive, and is based on earnings growth of 8.8% which we expect to see revised upwards. As in 2016 after the Brexit vote, foreign earnings-heavy UK equities could perform if sterling falls, or if a 'soft' Brexit begins to look more likely. In the end, Brexit concessions should be made by both sides, and the sense of its conclusion could trigger renewed interest in UK assets.

Our largest proportionate overweight position vs. the benchmark remains 'Asia-Pacific (ex-Japan) equities – 'APEJ' for short. APEJ is (in weight order): China, Australia, South Korea, Hong Kong, Taiwan, Singapore, Thailand, Indonesia & the Philippines. The index is on a P/E of 13.0x for 2018, and only 12.2x for 2019, based on earnings growth of 9.6% and 6.5% respectively (but 6.5% looks far too low). There is more detail in the Outlook regarding why this is our favourite region by some way. A good selection of mainland Chinese stocks should work well this year, ignoring uninformed comment that China is about to crash. We also think it helpful that Asia-Pacific (ex-Japan) includes Australia, a classic 'late-cycle' commodity play; Australia is only now looking as though it will challenge the all-time index highs of 2007. In Emerging Markets we are looking for opportunities in commodity producers, while still favouring commodity-consuming economies. Since 2013's 'taper tantrum' the current account deficits of India and Indonesia are much-improved; the EM world is less risky than before, and EMs are less hostage to commodity prices than historically, with stronger growth expected to underpin valuations. India remains a core holding for the longer term in our models, to take advantage of its demographics and reforms.

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We studied Japan, with our key finding regarding equities being that the Tokyo 'second section' (over 2,000 small & mid-caps) is a real haven for good stock-pickers, with stocks under the radar of the large institutions. Elsewhere, in MENA equities we are currently 'neutral' vs. the benchmark, and will remain so until investment sentiment settles.

FIXED INCOME: Fixed income will always be a large proportion of a conservative client's mandate, and rather less of a growth mandate. We are still underweight in Developed Market Government bonds, expecting three Fed rate hikes in 2018, and two in 2019. As mentioned earlier, we are bullish on US growth, and don't expect a recession there for a while yet. Last year saw a US 10-year Treasury yield range of 2.04-2.60%, quite close to what we predicted; in 2018 we expect a range of 2.40-3.00%. With Fed funds at a maximum of 3% (i.e. 2% inflation plus a normalization/cushion of 1%), the US 10-year Treasury yield could rise to 3.50% by year-end 2019. With no recession in sight we don't expect yield curve inversion.

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We remain overweight in High Yield bonds, consistent with an overweight in US stocks, however we will review this in the weeks to come. We would caution against taking duration risk above 10 years as normalization along with more inflation will likely impact bonds this year. Investment Grade bonds will become more appealing relative to High Yield bonds, likely from mid-2018 onwards. Longer duration Investment Grade bonds, along with perpetual bonds, should be the domain of traders, not investors. Turning to EM and MENA bonds, we are neutrally weighted, with the yield pickup vs. developed market bonds still looking attractive. Volatility in Investment Grade should moderate, and we expect good quality EM bonds to outperform developed market bonds as a consequence.

FOREIGN EXCHANGE: US interest rate increases should finally lead to some firmness in the dollar relative to other major currencies – interrupted from time to time by US politics. We expect a trading range of approximately 91 -100 in the dollar index, given likely interest rate differentials and the expected repatriation of funds in dollars back to the US. In sterling, the outlook for Brexit, and Mrs. May's political tenure will dominate the outlook; a $1.25-1.40 range is expected, with a spike below $1.25 possible if developments take a turn for the worst. The euro/dollar pair is expected to trade in a $1.12-1.22 range during 2018; we expect the ECB to talk the single currency lower, indeed they will have to do this to keep Eurozone exports competitive. Mrs. Merkel reached the kind of coalition deal with Germany's Social Democrats that she was looking for, causing euro strength last week. Looking at emerging markets, these should continue to grow well overall in 2018, so EM FX weakness should be limited in the face of a firmer dollar against the other major currencies. Lastly, we would note that the share of renminbi global transactions is still at a very low level, and that it could take another 2-5 years to begin to see its internationalization in the way the Chinese authorities would like to see.

COMMODITIES; ALTERNATIVES; REAL ESTATE: We suggested in last year's Outlook that base metals should be bought into any dip (which occurred); the same applies at these higher levels. Chinese demand (and supply) will continue to affect copper, aluminium and other metals, as will supply disruptions in countries like Indonesia and Chile. Overall, the late-cycle behaviour that we expect (linked to increased infrastructure spending) should benefit base metals prices. China's credit squeeze has caused intermittent base metal price volatility, although the uptrend in the LME Metals index looks intact. In oil, the overall market continues to rebalance; we currently expect Brent to be capped at about $70/barrel in 2018, with $50 the expected low – however like everyone else we have our screens on, and note that supply-side issues (e.g. regarding Venezuela and certain Middle East producers) and/or excess demand could see $70 exceeded. Turning to gold, this should still be held as a hedge against possible unexpected risks; any dollar strength - which we accept goes against current conventional wisdom - would hurt gold and restrain other commodity prices. The last asset class in this section is real estate, which we argue should definitely have a role in diversified global investment portfolios - for reliable rental income, as a hard asset, and as a volatility dampener – always excluding one's main residence.

INVESTMENT SUMMARY: New all-time highs in the major equity indices (led by the US) is what we have been positioned for, and this is the backbone of our 'risk-on' call, driven by world growth that we firmly expect to be revised upwards during the year, and reforms – and with a distinct tilt to Asia-Pacific. In last week's Asset Allocation Committee a decision was taken to move to overweight (from neutral) in Japanese equities, at the expense of cash, and with the currency hedged as we continue to expect a weaker yen vs. the dollar.

We accept that the US mid-term elections are a risk for the Republicans – but by then a return to a growth mentality will be firmly entrenched, augmented by US regulatory changes that don't require Congress to vote on. In the equity markets we expect technology to outperform over the year as a whole, with higher expected volatility; fundamentally our enthusiasm is undiminished in this very important sector – underpinned by the numerous growth opportunities, and backed up by excellent free cashflow (and very large cash balances) at the major companies.

This year's Outlook book is rather longer than last year's, and covers many investment topics in detail, including; the Macro Economic Outlook; the oil market; the MENA region; global fixed income markets, including developed, MENA and Asia; G4 and Asian FX; European, Japanese and MENA equities; the UAE banking sector; real estate as an asset class; risk control in portfolio management and how it can enhance the quality of returns; an essay on 'Universal Basic Income' – and an introduction to bitcoin and Blockchain – plus a short explanation of VAT! **FAB's experts across its international offices (such as Singapore, Hong Kong and Geneva) have worked together to produce the inaugural FAB Global Investment Outlook 2018, which we sincerely hope you will enjoy. Outlook updates will follow in the weeks and months to follow.**

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