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First Abu Dhabi Bank

From West to East *Weekly Investment View, 13th May, 2018*

Markets take a relaxed view of developments

The exit of the US from the nuclear deal was largely discounted

US dollar upside capped by tame US inflation, and Treasury auctions

Fed moving four times this year not looking credible (three only)

Technology, our favourite sector, leads global equities, +10.4% YTD

We remain overweight in Indian equities, and…

Populism is very much alive - now in Malaysia

INVESTMENT SUMMARY: Two US Fed officials who spoke last week underlined the FOMC message that rate normalization needn't be steepened (i.e. that three hikes should be sufficient). The Fed's preferred PCE 'core' inflation series has been running about 0.3% below data from the Labor Department, so the latter's 2.1% year-on-year for April is not a problem. More analysts are saying that inflation is being kept under control by structural factors such as the influence of Amazon and other E-Commerce companies, in line with comments in our 'Outlook 2018'. Equities last week were in the mood to bounce back, yet the even better view we have of first quarter US results (as good as +26%, year-on-year) has left the market unimpressed - and with a moderate summer correction possible. EM equities rallied as US rate increase expectations came off the top, and we are confident that much of the EM world can live with a stronger dollar. Intense diplomatic activity is underway on a number of fronts in trade and geopolitics. The US action to exit the Iran deal has put some distance between the US and Europe, although the world's leaders are surely becoming accustomed to the ways of President Trump.

In the markets last week: Last Tuesday President Donald Trump kept his promise to take the US out of the Iranian nuclear deal brokered by former US president, Barack Obama, in 2015. Spot crude prices initially sold off, but ended the week at $77.12/barrel for Brent, up just over 3%. The European signatories to the deal decided to continue to back it. Global equities as per the MSCI World index closed 2.09% higher over the week; developed markets rose 2.03%, and emerging rose 2.49%. **Global bonds were almost static overall.**

The S&P 500 closed up 2.41% last week, at 2,727.72, led by energy stocks, and also late in the week by healthcare as the market reacted to Trump's efforts to cap drug price increases. The NASDAQ Composite (driven by tech, and biotech) closed up 2.68%. Apple ended just below a new all-time high. Holders of equities should be heartened by the VIX ('fear index') falling last week to 12.65, down from the 14.77 of the previous week. Elsewhere in equities, the STOXX Europe 600 index rose 1.39% over the week, helped by energy stocks, but held back by continued political uncertainty in Italy while populists parties are engaged in marathon talks to see if a governing coalition can be formed. In Japan, the TOPIX closed ahead 1.32%, helped by energy stocks, while Asia-Pacific (ex-Japan) equities closed 2.35% higher, helped by Chinese equities (the CSI 300 closed up 2.60%), on the back of Chinese exports having beaten expectations for April, at a year-on-year rate of 12.9% in dollars, well above the 6.8% expected. Imports also beat, suggesting a healthy economy. Lastly, regarding Chinese equities, note MSCI's inclusion of some onshore-listed Chinese shares from next month. **Looking at global sectors, our favourite Information Technology (within MSCI World) leads the pack, up 10.4% for the year-to-date.**

The bell-weather US 10-year Treasury yield closed at 2.9695%, up two basis points on the week, thus continuing to frustrate the bond bears looking for a decisive break above 3.00-3.02%, mainly due to US year-on-year Department of Labor 'core' inflation only being unchanged (at 2.1%), plus well-received US Treasury auctions of $73 billion of 3-, 10-, and 30-year securities last week, $7 billion more than in the previous quarter. The $25 billion auction of the 10-year came just below a 3% coupon, and the 30-year also saw strong demand at a yield of 3.12%. By the end of the week the 10- minus 2-year spread in US Treasury yields had narrowed to 0.435, a ten-year low, mainly reflecting action at the short end, where the policy-sensitive two-year yield firmed by four basis points, to 2.5349%. **The German 10-year Bund yield settled 1½ basis points higher over the week (at 0.559%), probably reflecting concerns about Italian politics, offsetting weaker-than-expected German factory output.**

The US dollar was down fractionally on its index against the major currencies last week, at 92.537, while the MSCI Emerging Market Currency Index delivered a much steadier performance, being 0.32% firmer, despite continuing weakness in the Argentinian peso and the

Turkish lira (in the case of Argentina, traders smelled blood with the country approaching the IMF for support; in Turkey, president Erdogan said interest rates needed to go down, rather than up). In the major currencies, the Bank of England left interest rates unchanged, and reduced its growth expectations quite sharply, from 1.8% to 1.4% for the current year. It's probably worth remembering that the great Eurozone experiment is still under pressure: broadly, President Macron of France (bolstered by the ECB's Mario Draghi, for instance) wants greater European integration and a greater willingness of its strong members to fund the weak. **However Chancellor Merkel of Germany (and the Bundesbank) disagree with that view.**

Before discussing oil, we should within the space we have discuss the Iran nuclear deal. The US State Department revoked the existing statutory waivers on previous sanctions, and issued new temporary waivers to facilitate a winding-down period, during which businesses must make preparations to comply. The deadline ending on 6th August, 2018, includes (but is not limited to) dollar bill sales to the Government of Iran, trade in gold and precious metals, trade in Iran's automotive sector, and the purchase of Iranian sovereign debt. This will be followed by the deadline for oil-related sanctions on 4th November. The imposition of secondary compliance sanctions upon all non-US parties interacting with Iranian entities means that such parties will have to think extremely carefully about any links they may have, and if possible also those of their counterparties. 'Enhanced Due Diligence' will be necessary at all levels, to counter the risk of sanctions violations. Financial entities will surely avoid, rather than attempt to mitigate, risks. Those sovereign signatories who have stated their intent to adhere to the deal are likely to find this will be extremely difficult to do in practice. However, recently-hired US National Security adviser, John Bolton, has been quoted as saying the Trump Administration will try to pursue a broader deal with Iran that would satisfy the president's concerns. **The winding-down periods provide time for diplomatic efforts.**

Turning to the crude oil market itself, the news about the impending US sanctions comes at a time of supply tightness, exacerbated by speculative interest. It looks as though Venezuelan output will continue to plummet, with market concern growing about more frequent outages in Iraq. Iran produces around 4% of global crude output in normal times, and was recently at about 3.8 million b/day (mbd), being the third-largest oil producer in OPEC after Saudi Arabia and Iraq. Iranian crude oil exports can be expected to fall, with a reduction centering in a range of 300-500,000 barrels/day. In the short-term, the US API estimated that crude stocks fell by a larger-than-expected 1.85 million barrels last week. Looking to the medium-term, the US EIA raised its projection of US crude production to 12 mbd by the end of 2019 (from about 10.7 mbd now). Saudi Arabia and other OPEC members could step in to fill any growing production gap. OPEC meets next month, and clearly at an interesting time. Brent crude trading at current prices is significantly good news for oil exporters - including US tight oil producers (especially once they get the extra pipeline capacity they need). **In summary, there is a case for expecting a moderately higher trading range (perhaps $60-85 to the year-end), with expectations of a supply-side response in the months to come.**

Lastly: (1) Dr. Mahathir Mohamad has won a 'shock' victory in Malaysia's election, ending the six-decade rule of Prime Minister Najib Razak's party in a landmark result. Already Malaysia's longest-serving premier, he will return to power at the ripe age of 92, and this time on the other side of the established political divide, after his four-party Pakatan Harapan (Alliance of Hope) alliance won more than half the seats. The four parties have differing aims, yet hopefully Dr. Mohamed can be a unifying force in a country that still has lots of potential, despite some economic hurdles. He said he wanted to lead a business-friendly administration, and would seek ways to boost Malaysia's stock market, and reduce debt levels. Malaysia is a small weighting in our favoured overweight Asia-Pacific (ex-Japan) equity grouping. **We will follow events closely as they unfold.**

(2) Our colleagues in Global Markets have a short-term expectation that the USD/INR will trade around the 67.5 level, vs. Friday's close of 67.3337. Their 3- to 12-month expectation is for the pair to trade around 68.0. Certainly higher crude oil prices are unhelpful to India, for obvious reasons, although the recent move does seem to factor in too much bad news. Also in the short-term investors may be nervous about the state elections in Karnataka state, counting for which is underway after voting earlier this weekend. The result of the vote (in this state the BJP is pitted against the Congress Party) is apparently too close to call. About 34-35% of the popular vote is needed to win. **We remain overweight in Indian equities in our asset allocation, while - short-term politics notwithstanding - EM bond investors may find the 7.727% yield on Indian 10-year Government bonds rather tempting.**

Alain.Marckus.bankfab.com
Clint.Dove@bankfab.com

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