First Abu Dhabi Bank
From West to East
Weekly Investment View
14th October, 2018

Bull markets have corrections, and they are a chance to buy

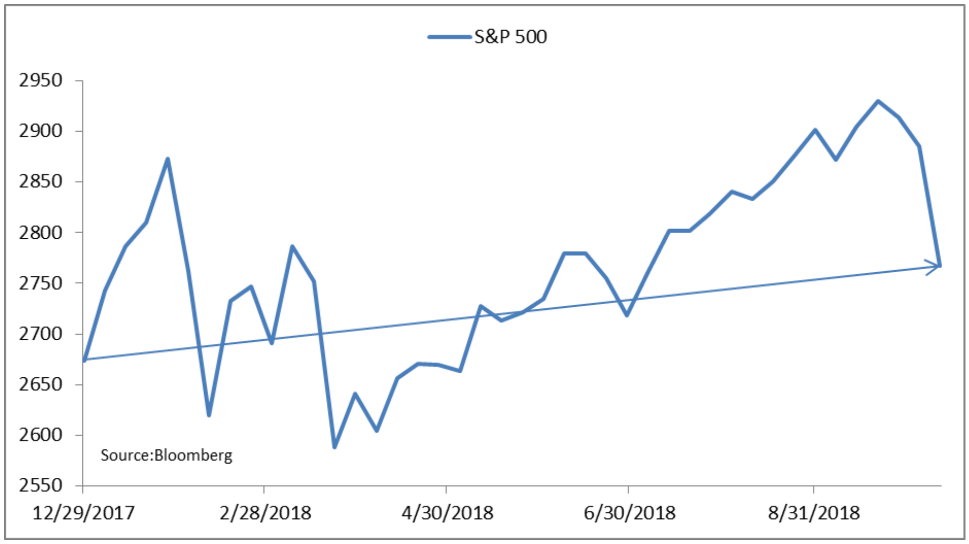
It took a while, but US stock markets have started to reflect the new interest rate environment. However, the very reasons that two weeks ago pushed the yield on 10-year US Treasuries to 3.25%, a key psychological level, support the continuation of the bull market in US stocks. Still, the speed at which rates have adjusted in October seems to have spooked equity investors.

Between 6th and 10th October the yield on the 10-year US Treasury rose more than 17bp, one of the sharpest moves this year. That took US Treasury yields to highs not seen in seven years. It was a response to signs the US economy remains very strong, even after six consecutive rate hikes.

As it becomes clearer that inflation is a real threat in the US, and the Fed as yet has no incentive to stop hiking rates, investors have been revising the value of stocks. Such a wake-up call in the beginning of the last quarter may have prompted profit-taking as some funds lock-in gains made so far this year. That in turn forced some selling from other funds that react to market moves.

Sometimes the market works like dominos, and once one of the pieces gets off-balance it pushes others to fall as well. To make matters worse there was a large short position on the VIX volatility index before the sell-off started. This means that a lot of money was betting that there would be less volatility, and that stocks would continue to climb without hiccups in the near term. As volatility picked up, these bets had to be unwound. If someone is betting that the market will rise and be calm, once it does the opposite the way to stop losses is to bet on further drops and volatility. This only makes the market become shakier and fall further.

The move is very similar to what happened in February and this report had warned readers in early September that market positioning suggested there was a risk of a rapid and temporary correction in US stock markets.



However, as noted then, the move is expected to be temporary. The US economy remains very strong and that could underpin earnings growth going forward, therefore stocks there could resume their bull market run once the correction is completed.

In fact, the sell-off has improved valuations, in particular for some sectors that had already been lagging the market. Since early September investors reduced exposure to some growth sectors (those that sport high price-to-earnings ratios) such as technology, while increasing their holdings of value sectors (which have low price-to-earnings ratios).

This year, such a rotation means buying more stocks of companies that make consumer staples – products that people buy whether or not the economy is doing well – while selling certain technology names. That helps explain the 3.27% drop in the Nasdaq 100 Index last week, its worst weekly loss since March.

Financial stocks also suffered, with the sector sub-index in the S&P 500 down 5.57% last week. That sell-off, however, could make shares of US financial companies start looking attractive again, given they benefit from higher interest rates. Banks that focus on the domestic economy and are less likely to suffer from both the appreciation of the US dollar and any potential backlash from President Donald Trump's nationalistic rhetoric are particularly interesting. The KBW Regional Banking Index, for instance, is trading at less than 12 times next year's expected earnings, near the lowest valuation since 2011.

Regional banks also benefit from a push on the part of the Trump Administration to increase lending in smaller communities, which has led to deregulation and more ability to leverage, both of which should increase their return on equity going forward.

These smaller banks face, however, increased competition from non-banking financial institutions and internet startups, which are offering a wider number of loans, including mortgages, and encroaching on the territory that regional banks once dominated. Still, higher interest rates, particularly for longer tenors, means these banks will make more money from each loan.

"The US equity markets sell-off could be seen as an opportunity to buy."

That does not mean the US market sell-off is over yet. The momentum the stock drop has gathered is significant and it may take a couple of positive days for it to reverse. Psychology alone would suggest that. The S&P 500 dropped 3.3% on Wednesday, a rare move that has been matched in less than 2% of the trading sessions of the past 10 years, with two thirds of such falls happening in the Global Financial Crisis years of 2008 and 2009. When investors see such a sharp fall as Wednesday's, it is natural that they get wary and wait before coming back into the market. It is difficult to stay out for long, though.

If a recovery of the uptrend is highly likely in the US, the same cannot be said about European stock markets. The STOXX 600 index fell 0.3% on Friday, when the S&P 500 rose 1.42%. That day, however, the Italian Parliament had also voted in favor of a 2.4% deficit target for 2019, higher than expected and potentially in breach of EU requirements.

"Political tension in Europe could mean stocks there continue to underperform."

Similarly, the problems afflicting emerging markets are likely to remain in place for the time being. And that could mean that developing-nation stocks continue to underperform. After last week's 2.06% drop, the MSCI Emerging Markets Index has lost 15.4% for the year to date, while the S&P 500 is still up 3.5% for the year. Rising interest rates in the US and the resulting strong US dollar only add pressure to developing nations and that has not changed.

However, investors are beginning to see some glimmers of light in the asset class. Turkey, for instance, seems to be on the mend. The country was widely viewed as a weak link and some of the sell-off in EM stocks since July has been attributed to a spillover of issues related to Turkey.

At least one dark cloud has been removed from the country as last week Turkey decided to release US pastor Andrew Brunson, who had been held in custody for two years, accused of aiding an attempt to remove President Recep Tayyip Erdogan from power in 2016. Brunson's release had become a point of contention between Turkey and the US and was part of the reason why the Trump Administration imposed sanctions on a couple of Turkish officials earlier this year. His return to the US could help some investors recover their confidence in Turkey.

The 35.3% year-to-date devaluation of the currency has also reduced imports and is helping correct Turkey's current account deficit, which could also help return some of the country's sheen. It has, however, also had a significant impact on the economy and on Turkey's banks, which have been forced to pay more than twice as much for foreign currency debt than they did only a year ago. That impact could last beyond a potential recovery in Turkish markets following the announcement of Brunson's release and the potential improvement of relations with the US.

Meanwhile, another event in Turkey is having the opposite effect on some Middle-Eastern markets. Events surrounding the disappearance of a prominent Saudi columnist living abroad should soon be clarified. President Trump has refused to allow the relationship with the Middle East's largest economy to sour, but the uncertainty, especially coming amid a US stock market sell-off, has put investors on the back-foot and prompted some profit-taking on the Tadawul, which was down 4.36% on Thursday and another 3.78% on Sunday.

Similar to what Turkey experienced earlier this year, the negative momentum could translate into further losses for that index. However, the fundamentals of Saudi stocks remain solid. The country is reaping the rewards of a period of deep reforms, and the economy is picking up steam. Valuations are also becoming more compelling. After trading at more than 14 times expected 2019 earnings in July, the Tadawul price-to-earnings ratio is now down to 12 times. Meanwhile, higher oil prices and a privatization drive are likely to support further growth.

To be sure, oil prices faltered last week, with the price of Brent crude ending the week 4.43% lower, at US$80.43. The move was partly attributed to the IMF's revision of its world growth forecast to 3.7% this year and next, 0.2 percentage point less than previously expected. As this report has repeatedly highlighted, slowing growth in emerging markets resulting from currency depreciation and trade wars is likely to reduce demand for hydrocarbons in poorer nations. That could offset reduced supply due to turmoil in Venezuela and Libya and sanctions on Iran, suggesting that the US$65-US$90/ barrel band the FAB Asset Allocation Committee has forecast for this year is likely to hold until the end of December at least.

"Slowing demand in EM could keep crude oil prices from rallying much further this year. Limited supply, however, also limits their downside."

Still, at the current level, oil prices are high enough to allow several of the energy-producing countries in the Middle-East to balance or improve their budgets. **That bodes particularly well for investments in GCC bonds, and helps explain why the FAB Asset Allocation Committee remains overweight on GCC bonds.**

The asset class could get a further boost soon too, as the United Arab Emirates enacted a law last weekend that would allow the federal government to issue sovereign bonds. If the country establishes a sovereign bond market, it could reduce the premiums that other state-owned entities pay on their own bonds. **That could further boost the appeal of these bonds to international investors, adding yet another tailwind to the asset class after JP Morgan very recently added debt from five GCC countries to its Global Diversified Index.**

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