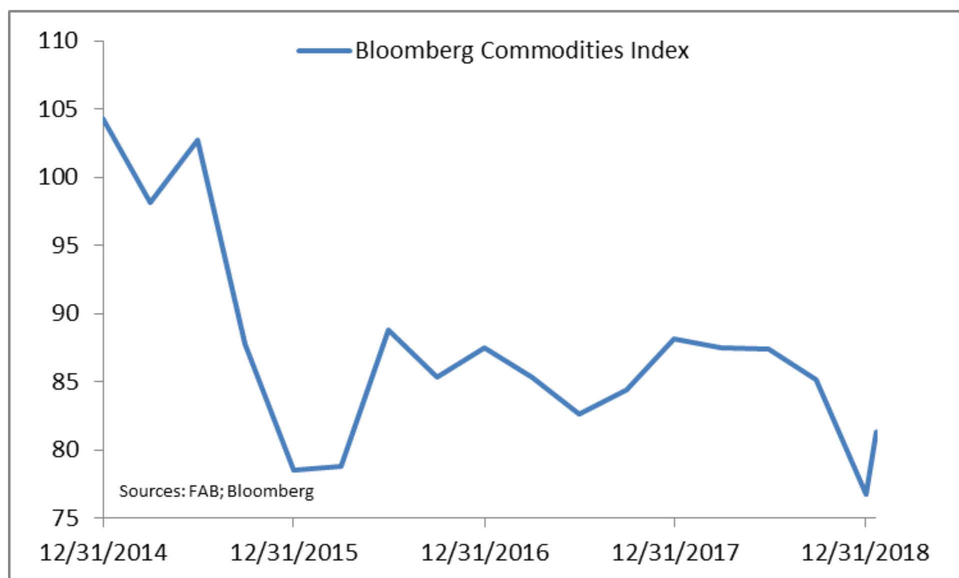
From West to East

Weekly Investment View
20th January, 2019

Leaving the bearish feelings of 2018 behind

Anyone who is still suspicious of the rally only needs to look at investment behavior. The fear of getting caught in an unexpected sell-off has given way to fear of missing out. On Friday, ahead of a long weekend in the US, the S&P 500 rallied 1.3%, ending the week 2.9% ahead. The NASDAQ Composite gained 2.7% for the week and was up by 1% on Friday. A stock rally before a holiday is exactly the opposite of what was happening in the fourth quarter. Trading the day before Christmas or right before the sudden holiday that was called after former President George H. Bush died are perfect examples. In both cases, equity markets saw significant sell-offs.



The current rally has also been hinging on very little, if financial newscasters are to be believed. On Friday, the enabler was talk that China had signaled it would buy sufficient American products in the next six years to erase the current US trade deficit with the country. Earlier in the week, markets had gained on rumors that President Donald Trump was considering rolling back tariffs as a gesture of goodwill, talk that was quickly dismissed by the Department of Commerce. US investors continued to pile into stocks, oblivious to the denial. This fear of missing the next leg of a rally has been widely studied and is a strong driver of gains. However the dynamic can be dangerous when it is fueling a market that no longer makes sense. In the current situation, though, it is a healthy reversal of the unwarranted bearish sentiment that prevailed in the fourth quarter. There are continuing signs that the US economy remains strong – though the Federal Reserve's nine interest rate hikes since 2015 have started to take their toll. Inflation continues to be very benign in the US, too, as Fed Chairman Jerome Powell and other governors of the Central Bank acknowledged in the past couple of weeks. Still, investors got overly concerned in the fourth quarter with rising leverage costs and the prospect of a relentless Fed. While the pendulum may have started to swing back, there still is room for further gains.

"Investors have woken up to the fact that US equities have fundamental strength."

The FAB Asset Allocation Committee (AAC) does not have to join the crowd in the recent rush for US equities. The AAC never downgraded its overweight position in the asset class, and actually increased it late in the fourth quarter, when it had become evident that the sell-off lacked fundamental logic. The AAC reiterated that position in a meeting last week which also brought about some key changes to its balanced portfolio. The AAC removed its overweight on Brazilian equities, for one. That position, entered in October, had been very profitable, earning double-digit returns in the very short period since it was implemented. Brazil's story remains constructive, with the newly-elected President Jair Bolsonaro starting to give indications that he is committed to the reformist agenda he touted before the polls. He signed a decree last week, for instance, that could save the country some US$2.7 billion this year by reducing pension fraud. Pension reform is among the most important promises Mr. Bolsonaro has made. He also signaled he will privatize several state-owned companies. These two things could help shore up Brazil's finances and even prompt ratings upgrades in the future.

All of this is reason to remain bullish about Brazil in the long run. However, the AAC's decision to cut the exposure to the country's stock market was tactical. The new Congress is just being seated and Mr. Bolsonaro is likely to face resistance to what are very sensitive reforms. Some of his close aides are facing corruption and nepotism probes, suggesting his administration will be under the microscope. The Bovespa Stock Index has rallied more than 37% since early September, when it became clear that Mr. Bolsonaro could win the election. Given the speed of the move and the challenges the new administration faces in its early days, it makes sense to take profits and wait for a re-entry point.

بنـــك أبـوظبـــي الأول
FAB
First Abu Dhabi Bank

From West to East

Weekly Investment View
20th January, 2019

"Brazil has had such a good run that it is probably time to step back, even if the long-term picture remains good."

In addition, the AAC changed its position on commodities. Throughout most of last year, the AAC was underweight in basic materials, but after the Bloomberg Commodity Index lost 13.2% in 2018 - and given the way world growth is looking - the AAC felt it was time to change that stance. Two factors weighed on the decision: China, and the US dollar. China's economy is likely to accelerate as the effect of interest rate and tax cuts filter into the economy. Its trade war with the US is also now more likely to be resolved in the next couple of months, removing a drag on the world's second largest economy.
In the meantime, however, China could show further signs of slowing down. Last week, the country reported export growth was nearly flat in December. The measure (key for an export-led economy such as China), is likely to slow further, given that many exporters sold more goods early last year as they tried to pre-empt the application of US tariffs. Manufacturing in the country is also contracting, according to purchasing manager surveys. Analysts widely expect the country's fourth quarter GDP, due this week, to show that China slowed down further from the 30-year low growth recorded in the third quarter. The data, however, reflects the impact of last year's trade war and deleveraging campaigns. Later this year, the economy is likely to see the opposite as it re-leverages and the trade overhang is removed.

"The dollar is showing signs of reaching a peak."

The greenback has failed to breach a key technical level and the two currencies that most matter to its level could strengthen this year. The euro and the British pound suffered through 2018 as Brexit uncertainty pushed investors away. Now, the UK's departure from the EU is on the verge of being resolved, for better or worse.
On Wednesday, Prime Minister Theresa May survived a no-confidence vote, simply because the Conservatives and the smaller parties realized that new elections would be called and that Labour's Jeremy Corbyn could rise to power if she fell. That vote came just a day after Parliament voted down her Brexit plan in the biggest defeat a sitting government has ever faced in the UK's modern history. It is unlikely that Mrs. May can reach a consensus and renegotiate terms with Brussels before 29th March, so she now faces three solutions to the problem: crashing out of the EU with no deal in place, delaying the deadline for a deal, or calling a new referendum.
A 'hard Brexit' would at least end the uncertainty and could pave the way for the pound to recover later in the year if the economy continues to do well. According to The Economist's Big Mac Index, the British pound is some 15% to 20% undervalued right now. A hard Brexit, however, could push the pound down in the short-term. Delaying Brexit could have the opposite effect and the pound could rally, as traders price in the higher likelihood of a deal being reached. A similar outcome would ensue if a new referendum is called.
A stronger pound could be bad news for UK stocks, which tend to move in the opposite direction to the currency (due to the extent of foreign currency revenues), and for gilts, which would reflect the lower perceived risk for the country. However, it is unclear that any of the outcomes boosting the pound initially would be positive for the UK in the long run. A delay of Brexit would prolong the uncertainty which has weighed on business sentiment and depressed investment, reducing future growth. It may be good news, naturally, if it leads to a negotiated exit.
Similarly, another referendum could cause popular discontent and lead to new elections which could unseat the Conservatives. There is also a probability that UK citizens confirm their wish to leave the EU a second time, increasing pressure for a hard Brexit. Even if 'Bremain' were to win, it could be by a very narrow margin, so Brexiteers could get a third referendum to be called. Again, uncertainty would drag on and continue to weigh on the economy.
The most likely outcome, at this stage, is Brexit happening by 29th March, with this resolution capping dollar strength for the rest of the year. A receding greenback is positive for commodities, as will be a recovering Chinese economy. With these two factors shifting direction, it makes sense to increase the allocation to commodities.

"Chinese economic activity could reaccelerate later this year, and that, along with a weaker dollar, warranted removing the underweight position on commodities."

However, the AAC has set its sights on oil as the starting point for the move from underweight to neutral on commodities.
Brent Crude rallied 2.5% on Friday, ending the week 3.7% higher. The commodity has risen 24.2% since its recent low of US$50.5/barrel on 24th December. It is already up 16.5% this year alone. Yet, it remains almost 38% below the US$86.3/barrel recent high the contract hit on 3rd October. FAB expects Brent crude prices to average US$70/barrel this year, only a bit lower than the US$71.7/barrel recorded last year. In short, Brent could rise further from here, which helps explain the fairly bullish position the AAC is taking on the commodity. In fact, FAB's Global Investment Outlook, published last week, suggests there is value in energy stocks right now. The S&P 500 Energy Sector sub-index fell 20.5% last year, underperforming oil prices themselves. Higher oil prices would be beneficial for energy-producing GCC economies and could boost their securities. Bonds from these countries are also set to get an extra boost as their inclusion in the JP Morgan Emerging Market Bond Index became official last week. The inclusion will increase demand for these securities, which already pay higher yields than comparable debt from other parts of the world. Hence, the AAC has kept its overweight in GCC bonds, implemented last year.
It will not be a straight line, but many risky assets could see significant upside this year. Even after a heady start, there still are opportunities.

For inquiries related to this article, please contact:

***Alain.Marckus@bankfab.com** or*
Christofer.Langner@bankfab.com

بنك أبوظبي الأول
FAB
First Abu Dhabi Bank

From West to East

Weekly Investment View
20th January, 2019

Disclaimer:

This report has been prepared and issued by Products & Services - Elite & Private Banking ("P&S-EPB") of First Abu Dhabi Bank PJSC ("FAB") outlining particular services provided by P&S-EPB 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 FAB 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 is incomplete without reference to, and should be viewed solely in conjunction with the associated oral briefing provided by P&S-EPB. The report is proprietary to P&S-EPB and may not be disclosed to any third party or used for any other purpose without the prior written consent of P&S-EPB. 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 P&S-EPB. FAB 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 FAB for such purposes. FAB 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. FAB does not provide any accounting, tax, regulatory or legal advice. FAB is licensed by the Central Bank of the UAE.

London: *FAB London Branch is Authorized 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 FAB London branch on request. Registered in England & Wales: Company No: FC009142: VAT No: GB245 3301 91.*

Paris: *FAB Paris Branch is licensed by the French Prudential Control Authority as a credit institution. FAB 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 First Abu Dhabi Bank PJSC and/or FAB 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. First Abu Dhabi Bank PJSC expressly prohibits the distribution and transfer of this document to third parties for any reason. First Abu Dhabi Bank PJSC and/or FAB 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.*

Singapore: *First Abu Dhabi Bank P.J.S.C., Singapore Branch is regulated by the Monetary Authority of Singapore and holds a Wholesale Bank license.*