Mind the Gap

Gary Dugan
Chief Investment Officer

CIO-WEEKLY | 17th April 2016

- **The gap on the growth outlook between equity and bond investors remains wide**
- **US economic data are still mixed**
- **The US earnings season is off to a good start**
- **Oil investors will focus on the outcome of the Doha meeting**
- **Some profit taking may be appropriate on Indian equities and bonds on further strength**

The gap between equity investors' perceptions of the growth outlook and the bond investors' remains wide. Investors chased returns from both European and Japanese equities last week as they jumped into recently underperforming assets. Japanese equities ended the week up 6.5% and Eurozone equities up 4.9%. Meanwhile bonds are signaling that, whilst the equity markets may be more excited with near-term prospects for growth, they are not. The US 10 year bond yield remains at 1.75% indicating still little anticipation of a marked improvement in the outlook for growth.

The US economic data is still mixed with some components of growth struggling to shine through. US retail sales for March came in below expectations. Headline retail sales growth was -0.3% month-on-month with core retail sales up just 0.1% against expectations of +0.4%. Economists now estimate that real consumer spending looks to be flat quarter-on-quarter. Indeed retail sales have tailed off at the back end of the quarter, suggesting a poor start to the second quarter. The Beige book, a regional survey of economic activity, showed modest to moderate growth in most districts. Almost all districts reported an improvement in wages. The so called "Nowcast" estimate of first quarter US GDP growth based on data releases through the quarter is down to just 0.3%. Lower than expected retail sales in the US don't come as a surprise when you see that a new academic study puts the shortfall of US pension funds at $3.4 trillion. A recent academic study put the gap between what the funds are promising in terms of pension benefits and the valuation of current pension assets as $3.4 trillion. The numbers won't be lost on US householders, who must fear that their pension pots will be far less than they expected when they reach retirement.

Equity markets received a boost from better than expected results from some of the US banks. JPMorgan results were ahead of expectations, spurring further momentum in the equity markets. Adjusted earnings per share were reported at $1.41 versus expectations $1.25. Revenue fell 3%, but expenses were down 7%. ROE declined to 12% from 14%. It is clear that investors are rotating into previous underperforming markets. Chinese equities have continued to make progress and are now up around 20% from their lows. Japanese equities have rebounded 8% from their lows, but the market remains 11% down since the start of the year.

The oil market is waiting with bated breath for the outcome of the meeting of oil producers in Doha. The most likely outcome is commitment to freezing production at January levels until a new meeting potentially scheduled for October this year. Given that the Brent crude price has already rebounded 54% from $28 on the basis of a potential agreement, we would rather expect that the oil price could settle lower in the coming weeks. A significant setback in the price of crude however looks unwarranted. Although the IMF and other have been cutting their global growth forecasts, there is increasing conviction that China's determination to build up strategic reserves of oil through 2016 will make up for any other shortfall in global oil demand. Barclays estimates that China will import 8m barrels per day this year, up sharply from 6.7m barrels per day. Chinese demand should more than match the positive surprise seen in terms of Iran's production, which is calculated to be as high as 600,000. The increase in Iranian production more than offsets the cut in production seen in the United States.

Future price movements in the oil price will naturally be a driver of the performance of local equity markets. Given the Saudi equity market's poor recent performance, it appears to be better placed to weather any sell-off in the region if oil prices settle back after their recent rally. However equally we don't believe that the Saudi equity market is yet cheap enough, nor with sufficient positive newsflow to warrant any significant gains from current levels.

The Saudi Index has fallen 29% year-over-year and is down 5.8% in 2016, trailing other GCC markets. However valuations are not yet below other GCC or emerging markets'. Earnings were forecast to decline sharply in the first quarter, but have been better than expected. Pure petrochemical players had better profitability through managing their costs stringently. However, pure fertilizer plays had a sharp fall in earnings due to lower product prices. Cement companies have suffered due to lower government contracting and a build-up of inventories. They may see some respite if exports are permitted, as this could help improve profitability. Bank earnings have been flat quarter-on-quarter, as lower liquidity is curbing loan growth and deposits are on a downward trend. Banks are trading at or below their book value making them cheap. However, investors are not rushing in as reduced government projects and Ministry expenditure is affecting businesses and increasing non-performing-loans (though these are well covered). In the consumer sector guidance on lower profitability had already been issued, so investors were not taken by surprise by the poor results.

There may be some profits to take on Indian equities and bonds into any further strength. The Indian equity market finally rallied in recent months after a period of disappointing malaise. The Sensex index has now recovered 11.4% from its low and performed particularly well in recent trading sessions. The positive sentiment is likely to be maintain in the near term, with the governor of the central bank suggesting last week that the Reserve Bank of India (RBI) stands ready to cut interest rates still further (probably in August), if the monsoon season leads to well behaved inflation.

Indian bond markets, both in domestic and hard currency, have performed relatively well year-to-date. The scarcity of Eurobond issuance ($-denominated) has supported prices and caused extensive spread-tightening, to the point of overvaluation versus emerging market peers. The domestic bond markets have in particular been buoyed by the RBI's loosening stance. The Bloomberg Indian Local Sovereign Bond Index is up +3.89% year-to-date.

We are considering pairing down our domestic INR bond allocation exposure, as yields look fairly priced. Masala bonds, although in good supply, continue to witness strong interest from overseas investors searching for yield. The RBI has also set a maximum cap of INR 50B in a given financial year on the amount that issuers / entities can borrow.
On the primary issuance front, British Columbia, the Canada's third largest province, is making arrangements to be the first foreign government to issue bonds denominated in Indian rupee (Masala bonds).

In India cuts in interest rates whilst good news for investor sentiment, they have yet to translate into a powerful tailwind for the economy The RBI met market expectations with a recent 25 bps cut in the repo rate, however only half the total cuts in interest rates since April 2015, equivalent to 150 bps, have been passed onto borrowers by the banks. The cuts have not translated into improved profitability for the corporate sector or cheaper borrowing for retail customers. Indian equity markets will now be focused on the fourth quarter of the fiscal year earnings results. India, though largely a closed domestic economy, has not escaped the global malaise. Hence the market has had to absorb significant earnings downgrades over the past few months. Earnings will need to recover to keep the market momentum going and take the Sensex back to its dizzy heights of 29,500 seen early last year. The Sensex index trades at 19.4 times trailing price to earnings, quite expensive relative to most global markets and its own longer-term valuations.

There are some challenges in the UK property market at present. The latest survey from the Royal Institute of Chartered Surveyors showed a marked decline in activity and buyer interest. It is clear that recent tax hikes and other issues related to property ownership, together with fear of the impact of the Brexit vote have damaged sentiment. London in particular is seeing weakness. New buyer interest fell to the lowest level since 2008. The index has fallen from +33 in January to -58 in March. The national market is being impacted by the damage to the buy-to-let boom, which has been rather crushed by government policies to slow house price inflation.

Gary Dugan

Chief Investment Officer

garydugan@emiratesnbd.com

+971 (0)4 609 3739

Disclaimer

Reliance

Emirates NBD Bank PJSC ("Emirates NBD") uses reasonable efforts to obtain information from sources which it believes to be reliable, however, Emirates NBD makes no representation that the information or opinions contained in this publication are accurate, reliable or complete and should not be relied on as such or acted upon without further verification. Opinions, estimates and expressions of judgment are those of the writer and are subject to change without notice. Emirates NBD accepts no responsibility whatsoever for any loss or damage caused by any act or omission taken as a result of the information contained in this publication. Data/information provided herein are intended to serve for illustrative purposes and are not designed to initiate or conclude any transaction. In addition this publication is prepared as of a particular date and time and will not reflect subsequent changes in the market or changes in any other factors relevant to the determination of whether a particular investment activity is advisable. This publication may include data/information taken from stock exchanges and other sources from around the world and Emirates NBD does not guarantee the sequence, accuracy, completeness, or timeliness provided thereto by unaffiliated third parties. Moreover, the provision of certain data/information in this publication is subject to the terms and conditions of other agreements to which Emirates NBD is a party. Anyone proposing to rely on or use the information contained in this publication should independently verify and check the accuracy, completeness, reliability and suitability of the information and should obtain independent and specific advice from appropriate professionals or experts. Further, references to any financial instrument or investment product are not intended to imply that an actual trading market exists for such instrument or product. The information and opinions contained in Emirates NBD publications are provided for personal use and informational purposes only and are subject to change without notice. The material and information found in this publication are for general circulation only and have not been prepared with any regard to the objectives, financial situation and particular needs of any specific person, wherever situated

Confidentiality

This publication is provided to you upon request on a confidential basis for informational purposes only and is not intended for trading purposes or to be passed on or disclosed to any other person and/or to any jurisdiction that would render the distribution illegal. The investor may not offer any part of this publication for sale or distribute it over any medium including but not limited to over-the-air television or radio broadcast, a computer network or hyperlink framing on the internet without the prior written consent of Emirates NBD or construct a database of any kind.

Solicitation

None of the content in this publication constitutes a solicitation, offer, opinion, or recommendation by Emirates NBD to buy or sell any security, or to provide legal, tax, accounting, or investment advice or services regarding the profitability or suitability of any security or investment and further does not provide any fiduciary or financial advice.

Third party

The security or investment described in this publication may not be eligible for sale or subscription to certain categories of investors. This publication is not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law or regulation. It is the responsibility of any person in possession of this publication to investigate and observe all applicable laws and regulations of the relevant jurisdiction. This publication may not be conveyed to or used by a third party without the express consent of Emirates NBD. The investor may not use the data in this publication in any way to improve the quality of any data sold or contributed to by the investor to any third party.

Liability

Anything to the contrary herein set forth notwithstanding, Emirates NBD, its suppliers, agents, directors, officers, employees, representatives, successors, assigns, affiliates or subsidiaries shall not, directly or indirectly, be liable, in any way, to you or any other person for any: (a) inaccuracies or errors in or omissions from the this publication including, but not limited to, quotes and financial data; or (b) loss or damage arising from the use of this publication, including, but not limited to any investment decision occasioned thereby. Under no circumstances, including but not limited to negligence, shall Emirates NBD, its suppliers, agents, directors, officers, employees, representatives, successors, assigns, affiliates or subsidiaries be liable to you for direct, indirect, incidental, consequential, special, punitive, or exemplary damages even if Emirates NBD has been advised specifically of the possibility of such damages, arising from the use of this publication, including but not limited to, loss of revenue, opportunity, or anticipated profits or lost business.

This publication does not provide individually tailored investment advice and is prepared without regard to the individual financial circumstances and objectives of person who receive it. The appropriateness of an investment activity or strategy will depend on the person's individual circumstances and objectives and these activities may not be suitable for all persons. In addition, before entering into any transaction, the risks should be fully understood and a determination made as to whether a transaction is appropriate given the person's investment objectives, financial and operational resources, experiences and other relevant circumstances. The obligations relating to a particular transaction (and contractual relationship) including, without limitation, the nature and extent of their exposure to risk should be known as well as any regulatory requirements and restrictions applicable thereto.

Forward looking

Past performance is not necessarily a guide to future performance and should not be seen as an indication of future performance of any investment activity. The information contained in this publication does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. Certain matters in this publication about the future performance of Emirates NBD or members of its group (the Group), including without limitation, future revenues, earnings, strategies, prospects and all other statements that are not purely historical, constitute "forward-looking statements". Such forward-looking statements are based on current expectations or beliefs, as well as assumptions about future events, made from information currently available. Forward-looking statements often use words such as "anticipate", "target", "expect", "estimate", "intend", "plan", "goal", "seek", "believe", "will", "may", "should", "would", "could" or other words of similar meaning. Undue reliance should not be placed on any such statements in making an investment decision, as forward-looking statements, by their nature, are subject to known and unknown risks and uncertainties that could cause actual results, as well as the Group's plans and objectives, to differ materially from those expressed or implied in the forward-looking statements. Estimates of future performance are based on assumptions that may not be realized

Risk

Data included in this publication may rely on models that do not reflect or take into account all potentially significant factors such as market risk, liquidity risk, and credit risk. Emirates NBD may use different models, make valuation adjustments, or use different methodologies when determining prices at which Emirates NBD is willing to trade financial instruments and/or when valuing its own inventory positions for its books and records.

The use of this publication is at the sole risk of the investor and this publication and anything contained herein, is provided "as is" and "as available." Emirates NBD makes no warranty of any kind, express or implied, as to this publication, including, but not limited to, merchantability, non-infringement, title, or fitness for a particular purpose or use.

Investment in financial instruments involves risks and returns may vary. The value of and income from your investments may vary because of changes in interest rates, foreign exchange rates, prices and other factors and there is the possibility that you may lose the principle amount invested.. Before making an investment, investors should consult their advisers on the legal, regulatory, tax, business, investment, financial and accounting implications of the investment.

In receiving this publication, the investor acknowledges it is fully aware that there are risks associated with investment activities. Moreover, the responsibility to obtain and carefully read and understand the content of documents relating to any investment activity described in this publication and to seek separate, independent financial advice if required to assess whether a particular investment activity described herein is suitable, lies exclusively with the investor.

Intellectual property

This publication has been developed, compiled, prepared, revised, selected, and arranged by Emirates NBD and others (including certain other information sources) through the application of methods and standards of judgment developed and applied through the expenditure of substantial time, effort, and money and constitutes valuable intellectual property of Emirates NBD and such others.

All present and future rights in and to trade secrets, patents, copyrights, trademarks, service marks, know-how, and other proprietary rights of any type under the laws of any governmental authority, domestic or foreign, shall, as between the investor and Emirates NBD, at all times be and remain the sole and exclusive property of Emirates NBD and/or other lawful parties. Except as specifically permitted in writing, the investor may not copy or make any use of the content of this publication or any portion thereof. Except as specifically permitted in writing, the investor shall not use the intellectual property rights connected with this publication, or the names of any individual participant in, or contributor to, the content of this publication, or any variations or derivatives thereof, for any purpose.

This publication is intended solely for non-commercial use and benefit, and not for resale or other transfer or disposition to, or use by or for the benefit of, any other person or entity. By accepting this publication, the investor agrees not to use, transfer, distribute, copy, reproduce, publish, display, modify, create, or dispose of any information contained in this publication in any manner that could compete with the business interests of Emirates NBD. Furthermore, the investor may not use any of the trademarks, trade names, service marks, copyrights, or logos of Emirates NBD or its subsidiaries in any manner which creates the impression that such items belong to or are associated with the investor or, except as otherwise provided with Emirates NBD, prior written consent. The investor has no ownership rights in and to any of such items.

Emirates NBD is licensed and regulated by the UAE Central Bank.

United Kingdom

This publication was prepared by Emirates NBD Bank PJSC in the United Arab Emirates. It has been issued and approved for distribution to clients by the London branch of Emirates NBD Bank PJSC which is authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority in the UK. Some investments and services are not available to clients of the London Branch. Any services provided by Emirates NBD Bank PJSC outside the UK will not be regulated by the FCA and you will not receive all the protections afforded to retail customers under the FCA regime, such as the Financial Ombudsman Service and the Financial Services Compensation Scheme. Changes in foreign exchange rates may affect any of the returns or income set out within this publication.

Singapore

This publication was prepared by Emirates NBD Bank PJSC in the United Arab Emirates. It has been issued and approved for distribution to clients by the Singapore branch of Emirates NBD Bank PJSC which is licensed by the Monetary Authority of Singapore (MAS) and subject to applicable laws (including the Financial Advisers Act (FAA) and the Securities and Futures Act (SFA). Any services provided by Emirates NBD Bank PJSC outside Singapore will not be regulated by the MAS or subject to the provisions of the FAA and/or SFA, and you will not receive all the protections afforded to retail customers under the FAA and/or SFA. Changes in foreign exchange rates may affect any of the returns or income set out within this publication.

Please contact your Relationship Manager for further details or for clarification of the contents, where appropriate.

For contact information, please visit www.emiratesnbd.com