Passing storms bring opportunities

Quarterly Q4 2015
From the CIO Office
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Macro uncertainty delays recovery in risk assets

- Global growth at trend level is supportive of equities, although risks still remain
- Balance of risks are still unfavourable for emerging markets and commodities in particular
- Fed language and China slowdown will continue to stoke market volatility
- US treasuries are range-bound until clarity is provided on the timing of the next hike
- Fed dovishness to cap dollar gains and boost investment grade credit

Rising volatility narrows choice of investments

In examining the returns of different asset classes to 30 September, investors could be tempted to consider 2015 a year with few places to hide. Positive returns have been achieved by local-currency Eurozone equities as well as Developed Market (‘DM’) government bonds (dollar-hedged), with Japanese equities remaining flat, whilst US corporate credit and USD Emerging Market (‘EM’) high-grade bonds have shown mildly negative returns. Faring worst in the ranking are global equities in USD (including US equities), European fixed income, EM bonds in local currency, EM currencies and commodities, all displaying higher negative returns.

Contrary to our expectations three months ago, the picture of improving global growth providing a more sustainable rally in risk assets has been obscured by China devaluing the yuan, and the US Federal Reserve (‘Fed’) expressing concern over recent developments in global economic growth and inflation expectations at their September policy meeting. Both events for different reasons cast doubts on the ability of central banks to steer the economy and caused investors to sell risk assets. We have not lost hope in global equities and corporate credit in particular, which we keep at overweight, as we believe that the Fed and China induced market volatility will only delay their ultimate recovery. Risks, though, have materially risen, and investors are therefore advised to be very selective in their portfolio approach, allocating capital to the ‘few places’ where they should ‘hide’ (unless economic conditions improve materially): namely DM equities, DM credit and specific pockets of opportunities within EM (India).

World growth suffers under Emerging Market strain

The heightened volatility in financial markets has been triggered by the protracted slowdown in China, coupled with the uncertainty expressed by the Fed on the strength of the global economy at the September policy meeting. Policy officials made the start of the tightening cycle conditional on improving global conditions, in order to avoid a possible negative fallout from higher rates due to EM weakness. This increased focus on the global economy, and in particular on China, has hindered investor confidence the Fed may have on the US economic recovery, while at the same time it has clouded the visibility on the timing of the next rate hike, particularly as other central banks continue with their easing programmes. At the same time, the slowdown in China has significantly impacted commodities as well as commodity based markets (notably Emerging) that are driven by Chinese demand.

It is a close call whether US policy rates will see lift-off by year-end, although by then the US labour market should have reached levels of employment below 5% and inflation should have picked up (the effect of the oil slump will have dropped out of annual comparisons). The US economy seems to be on a stable path of slightly above-trend growth for the next few quarters, supported by positive consumption trends and a recovering housing market. Janet Yellen, the Fed’s chief, in a recent speech toned down her previous dovishness, downplaying the risks to the domestic economy from international developments and stating that, unless data surprise negatively, a rate rise by the end of this year should be expected.

The Chinese economic environment remains subdued, although its slowdown is not as steep as currently depicted by the consensus. Activity continues to cool, by way of a multi-year process whereby excess growth in the real estate and industrial sectors are to be gradually absorbed by consumer consumption and the service sector gaining more share. Given China’s real and significant contribution to global GDP, a slowdown is a net negative for risk assets. However, the road to recovery will continue to be bumpy, and after the sharp deterioration during the summer, we are now witnessing some stabilisation in real estate prices, as well as an acceleration in infrastructure projects, which should temporarily support construction activity and help manufacturing recover. This, alongside more policy easing expected during Q4 2015, should see a short-lived recovery by the end of 2015, or early 2016.

The current consensus forecast of 3% for global growth in 2015, with minor downward revisions from the previous quarter, is predicated on the resilience of EM economies offsetting widespread weakness in EM economies. So far consumption in the US and in Europe, though to a lesser extent in Japan, has held up strongly (benefiting from lower financing costs and low input costs resulting in low inflation and boosting real income levels), while capital investment has lagged expectations. Overall we still think phase of this moderate recovery will continue to be led by the consumer, with capital expenditure picking up only modestly as emerging countries economies continue to contract.

Being selective within DM equities and US credit still offers the best risk-return trade-off

Our continued overweight to DM risk assets is based on a combination of moderate global growth led by the US and Europe, low commodity prices and investor-friendly central banks (with the exception of the Fed). A key risk to this view however, as well as risk assets generally, is further weakness in EM countries which would trigger a deterioration in global activity to below-trend levels, which in turn would be detrimental to the DM economies.

The negative economic trends which started to unfold in emerging markets in 2010 have now come to a head and manifested in falling growth rates, excessive private leverage and subsequent plunging asset prices. Commodity producers like Brazil and Russia have been structurally impacted by the persistently low prices of natural resources, while China is experiencing a structural, long-term...
slowdown. India remains one of the few exceptions in this uninspiring environment, supported by low oil prices and strong domestic growth, although the drive for reform has recently somewhat lost momentum. Overall, however, we maintain an underweight stance to EM equities, awaiting evidence of improving fundamentals to change our views.

In global equity markets we see the best combination of favourable macroeconomic conditions, liquidity and valuation multiples in the Eurozone. The latest economic data suggest the area is on track to grow above trend in the next couple of quarters, in spite of the EM shocks to which it is itself exposed via trade links. Valuation levels are not excessive compared to historic levels, and earnings should grow in the high-single digits at a minimum, given the positive macro outlook and focus on the domestic recovery – benefiting from a weaker euro and lower input costs.

Japan has recently been a source of disappointment, with downward revisions to the macro outlook for H2 2015 driven by anaemic investment and consumer expenditure, causing the economy to be at risk of falling into recession for the second time in twelve months. Companies are simply not investing despite record profits mainly due to a weak yen, while wage inflation is too subdued given the tight labour market. However, the expectation is growing that the Japanese authorities will soon have to resort to more stimulus to spur growth, as well as focusing on economic growth rather than constitutional reform, which has been the focus over the last few months. We will watch events closely, keeping for now the equity overweight to the area.

Stronger economic conditions in the US on the other hand, are currently not sufficient to warrant an overweight allocation to US equities, given above-average valuations, peaking profit margins, a probable trend of rising wage inflation, and the adverse impact of the stronger US dollar on earnings. Yet, given the breadth and depth of the US market, investors can attempt to achieve above-market returns by gaining exposure to specific themes or sectors undervalued versus their potential. We hold the view that investors should hold a blend of growth and value sectors and be biased towards domestically-oriented and higher-quality stocks.

We maintain a cautious view on GCC equity markets, driven in the long-term by the trend of crude-oil prices, which still has a negative bias. Additionally, the drop in commodity-driven developing markets contributes to making local equities more expensive and is a hurdle to their potential rerating. Although investors may well see a year-end rally in local equities, most likely driven by the favourable seasonality in crude oil, we would rather wait for commodities to stabilize before committing capital to regional equities for the long-term.

Within fixed income, during these periods of heightened market volatility, we prefer corporate credit to government bonds, with a defensive bias towards Investment-Grade (‘IG’) securities. Overall US long-term yields are expected to remain range-bound until the start of the tightening cycle. We see the portfolio allocation to government bonds not as a source of return, but rather as a volatility-dampening factor when macro uncertainty rises. Government bonds are priced for stagnation and only offer refuge in a deflationary scenario, which currently is not our base case.

We continue to see value in US IG credit, in particular following the recent widening of spreads, the asset class is appealing both versus non-US IG and US high-yielding securities. IG credit also provides a more favorable risk profile during bouts of market volatility. Although US High-Yield (‘HY’) is attractively valued, with spreads running above their 10-year average, instability in financial and commodity markets remains a drag to its performance. We remain overweight for aggressive investors, in GCC bond markets spreads have widened in line with the fall in oil prices. As long as Brent crude stabilizes in the USD40-50 per barrel range, the bulk of the derating should be behind us, and we continue to maintain an overweight tilt.

In foreign exchange (‘FX’) markets we retain a long-term bullish view on the US dollar mainly based on monetary policy divergence between the US, in tightening mode, and other countries. However, in the short-term repeated bouts of volatility are likely to see the outperformance of the yen and the Swiss franc (both safe-haven currencies) and of the euro, due to the unwinding of carry trades.

**Key risks: recession in the emerging economies, US interest rate policy, USD strength**

The legacy of the Financial Crisis of 2008 has been the sluggish level of global growth with which investors have been confronted, particularly following unprecedented levels of Quantitative Easing at different stages by different central banks. Since 2010 EM countries have been slowing down and the slack has to an extent been taken up by DM economies, themselves growing at subdued rates when compared to previous recoveries before the Financial Crisis. Should this divergence become extreme, EM weakness could well extend to Japan, Europe and to the US, with investors reducing allocations to risk assets. Within EM, the main risk currently lies with Chinese growth. If the effect of the recent policy stimulus fails to materialize in the Chinese economy and eventually in corporate earnings, the deterioration in the business cycle will continue, most likely resulting in a hard-landing. This scenario would without doubt warrant a defensive allocation, biased towards government bonds and investment grade credit, with an overweight to global equities.

US interest rate policy is key as well, and markets will take it badly if the Fed tightens either too early or too late, compared with what markets consider to be the ideal timing. The shift of the first hike to March 2016, the most likely consensus date for liftoff, was not welcomed by investors, which took it to mean that the US economy is still under watch due to lingering doubts on its performance. The failure to hike in December may well expose the Fed to the risk of a belated tightening, forcing Fed officials into steeper and faster tightening in order to avoid stoking inflationary concerns. Under this scenario equities would suffer a greater level of volatility, with multiples contracting more than under a milder tightening cycle. The main victims of fast rising yields are government bonds, and investors would not find many places to find shelter.

Excessive US dollar strength also remains a risk to US growth. The US dollar is able strengthen over the long-term, all else being equal, if growth in the US accelerates faster than in the rest of the world, which has been the case so far and remains our base case. Under this scenario the appreciation of the dollar will depend on the speed of rate hikes. A steep tightening cycle would be most dollar bullish, leading to tighter monetary conditions, which eventually would be detrimental to US growth and therefore to US and to global equities.
Our current conviction trades:

a. Overweight Developed Markets (DM)
b. Within DM equities, overweight the Eurozone and slight overweight Japan
c. In the US, focus on specific market sectors and themes
d. Within DM equities, preference for the financial, technology, pharma and consumer sectors
e. Within EM equities, overweight India
f. Within GCC equities, preference for the UAE banking sector and large-cap, high-dividend-yielding stocks
g. Within fixed income, overweight investment-grade bonds (US) and US high-yielding bonds (for aggressive profiles)
h. Overweight investment-grade GCC bonds
i. Long JPY and EUR against the USD in the short term

Our medium-term views:

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<th>Equities, geographical areas</th>
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<td>Underweight</td>
<td>Overweight</td>
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<th>Equities, sectors</th>
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<td>Consumer</td>
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<td>EM Bonds</td>
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<td>Inv-Grade Credit (US)</td>
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<td>High Yield Credit (US)</td>
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<td>GCC Bonds</td>
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<td>Underweight</td>
<td>Overweight</td>
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Source: PB-CIO Office. Data as at 30 September 2015.

Richard Jablonowski
Chief Investment Officer – London

Giorgio Borelli
Senior Manager, Quantitative Analysis – Dubai
Economics
Global Economy

Fed’s blink creates more uncertainty

> Elsewhere pressure remains for more stimulus
> Except in the UK where tightening talk continues

The Fed blinked in September at the opportunity to tighten monetary policy for the first time in nine years. Although the markets were technically not pricing in much chance of a rise in US interest rates last month, there was still a great deal of surprise and no small amount of confusion when the FOMC’s unchanged decision was finally announced. This was because the analyst community was split more or less fifty-fifty over the outcome, and in the last few days in the run-up to the decision the momentum appeared to be with those looking for a hike, if only for the Fed to get the first interest rate hike behind it.

The crux of the Fed’s decision to stay put appears to come down to the new statement that appeared in the statement saying that “Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.”

So despite the ongoing improvement of domestic fundamentals, the Fed is now more concerned about the slowing global economy, by which it means developments in China and other emerging markets, the downturn in commodity prices and perhaps the strength of the dollar. These were the issues that tipped the balance in favour of waiting for more information about the labour market and probably about prices.

Although Yellen was short on specifics about what might actually cause the Fed to tighten policy, subsequent comments from Federal Reserve officials have sought to reassure financial markets by signaling that an interest rate rise is still likely before the end of the year. Our own working assumption is that December is now the next likeliest time for a Fed move, given that 13 out of 17 FOMC members still saw a rate hike by the end of the year. US Q2 GDP was revised firmer to 3.9%, up from 3.7% previously, and although this is now quitehistoric it adds to the available evidence about the building momentum in the US economy.

Elsewhere pressure remains for more stimulus

Rather than reassuring financial markets the Fed’s decision arguably contributed to more uncertainty and more volatility in the days following the September decision. Certainly it reinforced the markets’ focus on Chinese economic data, and by extension maintained the pressure on commodity markets and commodity based economies that depend on China for growth. The USD benefited from the perception that other central banks may be forced to ease their monetary policies further, including Australia, New Zealand and Canada. The Norges Bank has already taken markets by surprise by cutting interest rates by 0.25bps to 0.75%, perhaps hinting that policy risks in other parts of Europe remain towards further easing as well. India also cut interest rates by more than expected taking the repo rate down by 50bps to 6.75%. While ECB President Draghi has downplayed the near term prospect of further QE, there are a number of clouds that could darken the Eurozone’s horizon including those from the widening Volkswagen scandal in Germany as well as from the ongoing immigration crisis.

The Bank of Japan left policy steady last month, maintaining the JPY 80tn annual increase in the monetary base in place since October 2014. The Bank seems to be betting that the weakness in growth and inflation during Q2 will be temporary, with an improvement seen in the second half of the year. However with Q2’s contraction being revised positively to -1.2% (q/q seasonally adjusted rate) from -1.6% before, most estimates are now that H2 growth will also still be weak. And as we suspect that inflation will still undershoot the Bank’s time frame for a return to 2% inflation, we find it hard to believe that the BOJ will not increase QE further. Indeed Japan’s August CPI data showed a -0.1% y/y slump in the BOJ’s favoured headline CPI-excluding food measure, which was the first negative print since April 2013. The late October BOJ meeting probably presents the first opportunity as this is when updated economic projections will be released.

Except in the UK where tightening talk continues

Finally, the UK has also seen alternating expectations but this has been about the timing of the first Bank of England rate hike. Despite hawky remarks from some Bank of England officials recently we think it is dangerous to get sucked into the view that a rate rise might be just around the corner. With UK inflation falling back to 0.0% in August, and other data pointing to a moderation in economic activity, UK rate rise prospects are more realistically an issue for mid-2016.
MENA Economy

Regional economies facing headwinds

> GCC economies are fairly resilient in the face of lower oil prices
> Non-GCC exporters will likely see growth slow
> MENA oil importers also under pressure

Over the last several months, global markets have seen a renewed bout of volatility. Oil prices have declined around 20% on concerns about oversupply and slower growth in China, while a sharp sell-off in Chinese equity markets combined with a devaluation in the renminbi led to declines in global equities and emerging market currency depreciation. Uncertainty about when the Fed will begin to normalize monetary policy has not helped.

In the GCC too, equity markets declined as concerns about the global economy and oil were exacerbated by regional geopolitical tensions, not least the conflict in Yemen. GCC FX forwards surged on concerns about the sustainability of currency pegs in the face of widening fiscal deficits and shrinking current account surpluses.

Interbank rates in the UAE and Saudi Arabia have increased, while deposit growth has slowed, indicating tighter liquidity conditions in the domestic banking systems. Anecdotal evidence in the UAE suggests that corporates are feeling the strain as payments from customers are being delayed, with firms in some sectors missing loan payments to banks.

However, economic and survey data suggests that the situation is not as dire as some might think. The Emirates NBD Purchasing Managers’ Indices for Saudi Arabia and the UAE show robust expansion in economic activity in the non-oil private sectors, even if the pace of growth has slowed since 2014. While the relatively strong PMI readings may appear counter-intuitive given the sharply lower oil prices year-to-date, it is important to recognize that ‘manufacturing’ accounts for a significant share of the non-oil sectors in the UAE and Saudi Arabia, and that refining and petchem sector activities are included in ‘manufacturing’ from a national accounts/PMI perspective. Higher crude oil production this year has underpinned growth in these oil-related industries and thus contributed to the robust PMI readings and overall non-oil sector growth.

Nevertheless, for the UAE, lower average PMI readings year-to-date, and softer data in the services sectors in particular, have led us to revise down our 2015 GDP growth forecast to 4.0% from 4.3% previously. In Saudi Arabia however, the nearly 6% rise in oil production year-to-date suggests growth is likely to be higher than we had forecast in January. We have revised up our 2015 growth forecast for the Kingdom to 3.0% from 2.5% previously.

For non-GCC oil exporters – Iraq, Iran, Algeria and Libya – ongoing weakness in global oil prices is resulting in significant macro and market strains, and will likely force economic growth onto a lower trajectory over the coming quarters. The Algerian government announced in August that it would seek to cut spending by 9% in 2016, on top of the lower expenditure they had already announced for 2015, while Iraq also looks set to reduce public spending, with estimates from MEED suggesting the value of major capital expenditure projects in process now stands at only USD 10bn, compared to USD 24bn a year earlier. As growth in the non-oil sectors of this region is driven predominantly by government spending, these cutbacks will undoubtedly result in a slower pace of economic expansion in the near term, while such large reductions to CAPEX can also threaten the long-term outlook by reducing potential GDP growth.

For some of MENA’s net oil importers – Morocco, Tunisia, Egypt, Jordan and Lebanon – the past several months have proven difficult, with economic momentum appearing to slow over the summer, disappointing hopes that 2015 would be a year of recovery.

Tunisia is a case in point, with data showing real GDP in Q2 expanding only 0.7% y/y (-0.2% q/q), which was the slowest pace of expansion since the second quarter of 2011, and which brought growth in the first half of the year to 1.2%. Unsurprisingly, one of the worst performing sectors was Hotels and Restaurants, which declined 8.5% y/y in Q2 2015. Two separate attacks since April targeting foreign tourists will likely result in even steeper declines for the hospitality sector in the second half of 2015, and should offset the boost from this year’s better than expected agricultural harvest. As a result, we have revised our 2015 real GDP growth forecast lower, and are now projecting the economy to expand only 0.6%, compared to 2.7% in 2014.

Lebanon’s already weak economic outlook has also deteriorated in recent months, as large-scale protests have broken out over the government’s failure to address the ongoing crisis over a lack of garbage collection. Policy paralysis is nothing new in the country, however a spike in public demonstrations may threaten to undermine consumer and business confidence even further in the near term. The central bank has stated it is planning to undertake a USD 1bn stimulus program in the hopes of stimulating credit growth, however their forecast is for growth of only 0-1% this year.

More positive news has come out of Egypt, where Italian energy group Eni has discovered what it calls a ‘supergiant’ underwater gasfield, which might turn out to be one of the largest in the world. The field – known as Zohr and containing the equivalent of 5.5bn barrels of oil – sits near existing infrastructure in the Mediterranean Sea, meaning that it can be relatively easy to develop. Tapping into such resources would have a positive impact on the domestic economy, reducing Egypt’s recent reliance on energy imports to meet local demand. The prospects of an increase in foreign direct investment in the near term, and an improved goods trade balance over the long term, would also help ease balance of payments pressures, and mitigate downside risks to the Egyptian pound.
MENA Economy

Khatija Haque
Head of MENA Research

**Oil dependency**

- Iran: 95
- Oman: 80
- Bahrain: 64
- Qatar: 64
- Kuwait: 60
- Saudi: 75
- UAE: 79
- Algeria: 82
- Iraq: 90


**PMIs point to robust non-oil growth**

Source: Market, Emirates NBD Research. Data as at 15 August 2015.
Asset Class Outlook
# Asset Class Outlook

## Strategic Asset Allocation Table

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Sub Asset Class</th>
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<td>7.2%</td>
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Source: PB-CIO Office. Data as at 30 September 2015.
Global Equities

Back to basics

> Volatility to persist until US rates policy clear
> Focus on fundamentals - value and earnings
> Remain pro-cyclical in a moderate growth environment
> In Developed Markets (DM) we see value in Europe and domestic US
> In Emerging Markets (EM) may see a short term rally

Expect equity returns in the low single digits
At times of heightened market volatility, investors should ignore the background noise - monetary policy indecisiveness in the US, Grexit, the slowdown in China, deflationary pressures and geopolitical imbalances - and focus on fundamentals. Under current market conditions, the quality factor becomes important in equity selection. It is advisable to buy companies with solid balance sheets, strong cash flows and robust business models and companies that are leaders in their areas of expertise.

What has been the worst quarter for equity markets since 2011, could turn into the first yearly drawdown, unless equities stage a comeback towards the end of the year. Our base case is that markets will eventually recover, against a backdrop of moderate growth in developed countries, offsetting weakness in the emerging economies. We expect equity returns to be at the lower end of their historical range in the low single digits. Double-digit returns would require above-trend growth across the major countries, a most unlikely scenario given the uneven growth pattern between developed and emerging economies. This is reflected in the diverging performance of DM and EM equities, the latter lagging throughout the year. Global equity returns are ailing under the strain of the slowdown in EM, with Europe and Japan basically flat as of September 30, after giving up gains of up to +22% and +18% respectively, while US equities remain underwater.

Volatility should continue, until investors see a catalyst for improving global growth, possibly a rebound in the Chinese economy towards the end of the year, or the Federal Open Market Committee (FOMC) affirming its confidence in the strength of the global economy. We continue to hold the view that market dips should be seen as opportunities to select quality and value for the longer term.

Major Global Equity Markets – 3yr Performance

Source: Bloomberg. Data as at 30 September 2015.

US - Companies with domestic focus boast better prospects
The US equity market (S&P500), after recording new highs in 2015 and trading in an unusually tight range, went through a double-digit plunge, reacting negatively to the indecisiveness of the US Federal Reserve (Fed) on the timing of the first rate hike. US equities at 14.6X forward price to earnings are still slightly expensive, since they are trading above their 10-year historical average of 14.1X, hence we would maintain a selective approach and avoid buying passive benchmark exposure. For the current quarter, earnings at US companies are estimated to fall by 4.4%. However, for companies more domestically focused, consensus expects earnings to rise by 3.1%, and for those same companies ex-energy earnings are estimated to grow by 8.8%.

The main takeaway is that the energy sector remains the main contributor to the downgrades for the third quarter reporting season, and that overseas weakness and the US recovery will benefit the more domestically-focused companies. Though fears of slowing growth in China have been cited as a major reason for the equity market sell-off, it is worth mentioning that 70% of the sales of S&P 500 companies comes from the US, 12% from Europe and only 10% from the Asia Pacific region (China and Japan).

Investors should shift to a more defensive approach, with a bias towards companies with a larger share of sales in the US, while gaining exposure to a blend of growth and value sectors. We see value in consumer staples (high-quality), technology (high quality and growth, in spite of increasing EM exposure), financials (value, domestically focused) and pharmaceuticals (defensive and growth). In particular, financials should benefit from the outlook for higher policy rates. We remain overweight the energy sector, on expected cuts to oil production and industrials, due to EM exposure and sluggish business spending. We would avoid material stocks, most exposed to the slowdown in China.

European equities supported by firming growth
Although European equities underperformed their US counterparts during the market rout, we see Europe well-supported by above-trend growth in the next few quarters, as well as by continued credit expansion. The structural reforms carried out by Spain and Italy, alongside low oil prices, should help the periphery catch up with core Europe. We remain overweight the common area for the medium term, on a combination of favourable earnings growth (circa 10% for 2015), attractive valuations and a very dovish European Central Bank (ECB). More Quantitative Easing (QE) could be expected by the end of this year, if external shocks threaten the nascent recovery in the eurozone, or deflationary trends persist. Overall we see low double-digit returns in 6 months, in local currency, for the European indices.
Global Equities

We have a bias towards companies benefitting from the accelerating domestic growth, such as consumers and financials. The low euro should continue to help exporters, although EM weakness is becoming a drag on global trade. For the auto sector, hit by the double whammy of the slowdown in China and of increasing regulatory pressure, we see no immediate catalysts in spite of its tame valuations.

More easing expected by the BoJ
The Japanese equity market has recently given up all of its yearly gains, given the global rout and poor economic data. In spite of record profits, companies are not investing or hiring at the expected pace. The recent weak industrial production numbers have prompted downward revisions to Q3 growth, now forecast to be negative. Against this worsening backdrop and considering that the current inflation rate is undershooting the Central Bank's official target, we expect the Bank of Japan (BOJ) to announce more Quantitative Easing (QE) measures at the end of October. As the BOJ will intensify bond and equity purchases, we think it is still worth keeping an overweight stance, which we may well review after a possible year-end rally. However, we advise investors to book some profits and gradually reduce exposure to Japanese equities when market sentiment improves. The slowdown in China, Japan’s main trading partner, further complicates the picture. The additional monetary easing should be a catalyst for domestic demand, partially offsetting the loss in trading activity. PM Abe has reiterated his focus on growth, advocating 3 further ‘policy arrows’, which should help lift business confidence.

EM – Stay with the oil importers, India remains favoured
We see India’s equities well supported by multiple macroeconomic factors. Although the drive for reforms has recently lost momentum, we hold the view that the overall backdrop remains favorable to take more risk at current levels. We expect loose monetary policy in India to boost economic growth. India, as an oil-importing country with twin deficits, has benefitted from the protracted weakness in the commodity markets, hence its currency, in spite of the recent market turmoil and large losses suffered by EM currencies, has outperformed in relative terms. The political environment remains stable and with time we think the pending reforms will eventually be approved and implemented. Earnings have been lagging and next quarter remains critical to bring evidence that corporate sales and profits are back to double digit growth.

Continue to prefer quality and DM equities

Although China remains in slowdown mode for the medium to long term, a rebound in economic activity possibly by the end of the year should be expected, as the slowly improving liquidity conditions due to policy stimulus work their way through. First signs are stabilising property transactions and accelerating infrastructure projects.

As a muted growth environment persists, focusing on DM equities and high-dividend-yielding stocks should provide a safety buffer to portfolios, along with the potential for capital gains as investors rebuild their confidence with the slowly improving macro trends in Q4 2015.

Europe in particular should perform better than other markets being in the earlier stages of the recovery phase. In the US, where profit margins may have peaked, valuations are richer and the business cycle is in a more advanced stage, selective exposure to specific sectors or themes should be followed.
Fixed Income

Cat with nine lives: safe haven assets boosted by rising uncertainty

> Government yields capped by global easing policies
> Further widening of EM risk premiums expected
> Current DM credit spreads offer potential entry point
> GCC bond markets should have seen bulk of derating

The global fixed income market has sailed rough waters in 2015, as macro uncertainty increased, following the surprise devaluation of the Chinese yuan in August, the delay of the first rate hike by the US Federal Reserve (Fed) in September and the resurfacing of deflationary worries in Europe and in Japan, stoked by persistently declining crude prices. The year started on a weak note, as crude oversupply and the slowdown in China contributed to a bearish commodity outlook and triggered concerns over global growth. Risk aversion and market volatility rose dramatically with the devaluation of the Chinese currency, which investors read as the inability of the Chinese authorities to cope with the slowdown in the domestic economy. Financial stress was more pronounced in Emerging Markets (EM), hit by intensifying capital outflows and widespread currency weakness, although it seized developed countries as well, where investors feared the current recovery phase could be derailed by the overseas gloom.

US 10-year treasuries range-bound

Although markets have been increasingly focusing on the timing of liftoff in the US, what really matters for financial assets is the path followed by interest rates after the first rate hike. The decision taken in September to delay the start of tightening caused apprehension that US growth was not solid enough. So much so, that Janet Yellen, the Fed’s chief, reassuringly clarified in a recent press conference that the majority of Federal Open Market Committee (FOMC) members expect tightening to begin by the end of 2015. We hold the view that rates will be normalized starting this year, with one token hike in December. Given the extreme uncertainty as to how the US economy will react, after years of a zero-interest-rate-policy, the expectation is for a very gradual approach by the Fed, with a few, data-dependent, rate increases per year. In a word, we don’t see a steep tightening cycle, hence the US yield curve should remain pretty flat. Steep hikes would cause excessive dollar strength, at a time when the other major central banks remain quite accommodative, which in turn could derail the current recovery.

EM fundamentals remain under pressure, amidst a slowing China and dropping commodity prices. We see risk premiums across emerging countries rising, with continuing capital outflows and weakening currencies. EM spreads have widened throughout the year, wiping out all the returns year-to-date. The EM space has witnessed stressful events, like the downgrade of the sovereign rate of Russia (beginning of the year), of Brazil to junk by S&P and Turkey put under negative watch due to its political instability as a single-party government cannot be formed.

In the Eurozone, the latest reading on inflation for the month of September unexpectedly turned negative, adding pressure for the ECB to add further stimulus in a move to sustain the nascent recovery. The president of the European Central Bank (ECB), Mario Drahi, did not fail to reassure investors on this front, standing ready to expand the existing Quantitative Easing (QE) programme if required, beyond the official September 2016 deadline, to avert deflationary pressures and threats to the economic expansion. On an absolute return basis we do not see appealing investment opportunities for fixed-income investors in the euro area, as QE has crushed both sovereign and corporate yields.

Portfolio positioning and strategy

Under the current conditions of subdued inflationary pressures and moderate economic growth rates, investors should remain constructive on the fixed income asset class. We see no value in DM government bonds, discounting economic stagnation and offering no protection against negative inflation surprises. Within government bonds, which from a pure asset allocation perspective find their space in portfolios to offer a cushion against rising volatility, we prefer US treasuries for their higher carry. We remain overweight corporate credit, more specifically in the US, where the economic recovery, the currently wide spreads and the low expected default rates offer a
Fixed Income

supportive environment. US Investment grade (IG) bonds trade at levels last seen at the start of recessionary periods and at valuations relatively attractive versus US High Yield (HY). Although US HY offers value, spreads trade above their 10-year average, investors are advised to select only higher-quality names, outside of the commodity space, given protracted oil weakness. The asset class remains interesting for the more aggressive risk profiles.

We hold the view that the delay in the normalisation of US policy rates will offer only a short-lived respite to EM bonds. A negative macro newsflow, combined with the outlook for higher US rates should keep spreads under pressure. We see further weakness in Brazil, Turkey, South Africa and Malaysia. Valuations seem to be more in line with the economic reality in India and in the GCC countries. In particular we think that the UAE currently offers compelling opportunities in the corporate credit space.

Our recommendations by country
As already mentioned, in the developed countries US corporate credit remains our favorite choice. The recent spread widening has occurred against the backdrop of rising market volatility, yet with unchanged fundamentals for the asset class. Although EM IG trades at relatively wide spreads versus the US, risk-adjusted we prefer to stick within developed countries.

In emerging countries investors should remain very selective and take advantage of the few existing pockets of opportunities. Although valuations are in most cases attractive, further weakness should be expected, hence the focus on stable sectors and within countries where the bulk of the slowdown has happened. Ideally investors should look into corporates with a strong ownership structure and solid business models, alongside low net leverage and preferably low exposure to currency depreciation. As for EM sovereign nations, countries with high external debt would also be under scrutiny, as markets would factor in the future supply of debt, with consequent pressure on their refinancing obligations.

In Asia we see selective opportunities in Chinese IG corporate credit. It is supported by the plentiful liquidity made available by the Central Bank, and in particular investors should focus on state-owned entities. Indonesia sovereign debt should outperform on the expectation of its rerating, on improved government stability after the government reshuffle.

Our conviction call from last year on Indian local-currency debt, predicated on the outlook for looser monetary policy, panned out well with a cumulative 125 bps of rate cuts so far this year by the Reserve Bank of India (RBI). The US-dollar-denominated debt also offers an appealing carry. Foreign capital should continue to flow into the country, given its stronger economic outlook against other EM economies.

In the GCC countries crude oil weakness remains the key risk factor, with current account balances under pressure leading to tighter liquidity conditions. Some governments are already in the process of adjusting their public expenditure and further steps in this direction must be expected, with budgets shrinking as crude prices should stay low for longer due to oversupply. The Kingdom of Saudi Arabia will increase its debt levels and focus only on the most relevant welfare and infrastructure projects. Credit spreads should bear the brunt of the lower available liquidity. Technical factors related to poor supply and plentiful demand still support the prices of Islamic debt.

Against this backdrop the fundamentals of UAE corporates remain relatively strong, given the relevance of the UAE non-oil sector. After the recent spread-widening valuations seem to be fair. In particular, we see value in the companies which are of strategic importance, or the major contributors to economic growth. For instance the defensive utility and telecom sectors offer compelling investment opportunities. In the transportation segment, the UAE-based airlines and port/container operators trade at appealing valuations and held up relatively well in the bouts of volatility that markets witnessed in the recent months.

UAE Bonds resilient throughout the global rout

Source: Bloomberg. Data as at 30 September 2015.
Be defensive

- Expect high oil volatility to drive GCC equity volatility
- GCC valuations at a slight premium to EM
- Subdued trading volumes are a concern
- Preferred positioning in consumer staples, banking, logistics and stocks with sustainable high dividend yields
- GCC equities should see uplift alongside crude oil rebound

Performance of the major GCC Indices

<table>
<thead>
<tr>
<th>Index</th>
<th>Country</th>
<th>Level</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>Market cap USD bn</th>
<th>2016E P/E</th>
<th>2016E P/B</th>
<th>Dividend Yield</th>
<th>2016 Earnings Growth Est</th>
</tr>
</thead>
<tbody>
<tr>
<td>DFMGI</td>
<td>UAE</td>
<td>3,626</td>
<td>-4%</td>
<td>-28%</td>
<td>125%</td>
<td>115%</td>
<td>85</td>
<td>10.0</td>
<td>1.4</td>
<td>3.5%</td>
<td>23%</td>
</tr>
<tr>
<td>ADSMII</td>
<td>UAE</td>
<td>4,515</td>
<td>0%</td>
<td>-12%</td>
<td>71%</td>
<td>69%</td>
<td>122</td>
<td>9.7</td>
<td>1.4</td>
<td>5.2%</td>
<td>11%</td>
</tr>
<tr>
<td>SASEIDX</td>
<td>Saudi Arabia</td>
<td>7,404</td>
<td>-11%</td>
<td>-32%</td>
<td>8%</td>
<td>16%</td>
<td>451</td>
<td>11.8</td>
<td>1.6</td>
<td>3.5%</td>
<td>18%</td>
</tr>
<tr>
<td>DSM</td>
<td>Qatar</td>
<td>11,475</td>
<td>-7%</td>
<td>-17%</td>
<td>35%</td>
<td>49%</td>
<td>138</td>
<td>11.7</td>
<td>1.7</td>
<td>4.7%</td>
<td>10%</td>
</tr>
<tr>
<td>BGCC 200</td>
<td>GCC</td>
<td>67</td>
<td>-8%</td>
<td>-24%</td>
<td>16%</td>
<td>16%</td>
<td>817</td>
<td>11.2</td>
<td>1.5</td>
<td>4.4%</td>
<td>12%</td>
</tr>
<tr>
<td>MSCI EM</td>
<td>EM</td>
<td>792</td>
<td>-17%</td>
<td>-21%</td>
<td>-21%</td>
<td>-27%</td>
<td>6,545</td>
<td>10.2</td>
<td>1.2</td>
<td>3.1%</td>
<td>12%</td>
</tr>
<tr>
<td>MSCI All country</td>
<td>World</td>
<td>382</td>
<td>-9%</td>
<td>-7%</td>
<td>15%</td>
<td>24%</td>
<td>41,446</td>
<td>13.8</td>
<td>1.8</td>
<td>2.8%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Bloomberg. Data as at 1 October 2015.

In the third quarter, equities in the emerging markets and in particular in the commodity-producing nations dropped sharply, hit by the slowdown in the Chinese economy and by the devaluation of the yuan. Contagion effects spread to GCC equities, which gave up all of the gains made in the first quarter and fell 24% in one year, as oil lost 50% over the same period. In the long run the GCC indices remain strongly correlated with oil price movements, since the regional economies are largely dependent on oil production, while for the short term market sentiment and liquidity are the dominating factors. Although the majority shareholding of some banks and petrochemical companies is sovereign-backed, trading is still retail-driven, with GCC markets currently trading at volumes 30 to 40% below last years’ levels.

For GCC equities, large-cap and high-dividend seem to be successful factors for outperformance, across different market phases, as shown in chart 2. Hence we remain with our conviction of holding large-cap, high-dividend-yielding stocks with sustainable payouts. The top performing sectors in the GCC this year have been utilities, followed by telecoms and consumer non-cyclicals, suggestive of a rather defensive investor positioning. Equity valuations are not yet compelling versus local bonds: equities offer a yield of 4.5%, just slightly above the current GCC bond yield of 4.3%. However, some companies and sectors on a selective basis boast yields in excess of 6%.

Large-cap and high-dividend are outperformance factors for GCC equity portfolios

Source: Bloomberg. Data as at 30 September 2015.
GCC Equities

In the UAE higher-quality stocks, including the large-cap real estate and banking shares, seem to have found a base. Trading in real estate companies and banks makes up the bulk of the volumes, with the banking sector looking attractive in the long term due to its above-market dividend yield. UAE-listed companies reported a -15.9% decline in Q2 2015 net profit over last year. However, revenue numbers were more positive, declining only -1.6%. Earnings from the banking sector were the outlier. On an aggregate basis, net profit at Dubai-based banks grew +23.2% over last year. Revenues at these banks also grew significantly. Abu Dhabi based banks exhibited similar trends, with net profit growing +12% over last year, along with revenues at +5.1%. However, early signs of tight liquidity were evident with loan to deposit ratios for the sector declining. The lifting of the sanctions against Iran should prove positive for regional trade, yet it increases at the same time the downside risk to crude prices.

Most of the large GCC banks have a strong capital base and are sovereign-backed. Economic indicators for the region remain positive and large sovereign-wealth buffers will ensure government spending continues. Due to persistently low oil prices, public spending will be mainly directed towards essential projects and the contracting industry would be the most affected.

The Saudi banking sector too has demonstrated strong earnings, with median growth of +6% in Q2, compared to the same period last year. National Commercial Bank has been holding relatively steady and is partially insulated from crude-related volatility. Samba is attractive too, with a strong corporate focus and has the highest return on assets amongst Saudi banks. The Saudi banking sector remains highly underpenetrated, although it boasts the best asset quality in the GCC, with a large capital base and strong growth in credit and deposits. KSA banks have a low loan-to-deposit ratio of circa 80%, compared with an average of 86% for the GCC countries. These factors point to a significant growth potential for banking services in Saudi Arabia.

The real estate sector in the GCC saw mixed results, with median earnings up strongly over last year (+27%) and the blue chip Emaar (UAE) earnings (+36%) also growing strongly over last year. Contracting companies in contrast saw a drop in earnings and have been amongst the worst performers this year.

Oil prices are expected to remain volatile, with the International Energy Agency (IEA) expecting a sharper decline in US shale production than anticipated earlier, due to the threat of increased Iranian oil production in 2016. If oil prices were to decline further the risks for Saudi equities, and in particular for the petrochemical sector, would be skewed to the downside, although the latest Saudi Arabia PMI reading remains firmly in positive territory. Petrochemical companies in line with lower product prices had a decline in earnings growth and revenue over last year.

The GCC telecom sector saw net income drop sharply, -30% (median) over last year on flat revenue, as foreign exchange losses impacted the emerging markets operations of the former incumbents, with results otherwise overall solid. Etisalat (+42% YTD) from the UAE remains the best performer in the telecom sector in the GCC, with most telecom stocks in negative territory for the year. Etisalat garnered international interest as it opened up trading (20% of its shares) to foreigners for the first time. Saudi Telecom (-6% YTD) is reasonably valued and we expect it to perform on the back of improving demographics and increased spending on data.

The worst performing sectors in Saudi Arabia remain cement and telecom (the latter largely driven by ‘Mobily’ underperformance), both currently offering high dividend yields. We expect the Saudi Arabia government to continue to focus only on essential infrastructure projects, at least until crude oil strengthens on a sustainable basis. The earnings growth of cement companies remains tied to improving trends in crude oil.

The performance of the food and retail sector remains resilient, reflecting the defensive nature of the underlying business, with median net income growing 10% over last year. The Savola Group is one of the largest food companies in the MENA region with leading positions in vegetable oils, sugar, retail and investments in dairy, baked goods and poultry (Almarai), as well as in fast foods (Herfy). Savola is considered to be the region’s pioneer in grocery retail. Savola has underperformed the market on lowered guidance. However, it should benefit longer term from its strategic plans to maintain its position of regional leader, both via mergers and acquisitions and organic growth. Saudi consumer stocks may come under pressure, with the possibility that the sector opens up to 100% foreign ownership.

The UAE markets have limited inclusion of retail companies (Agthia and Marka being the exceptions and with the Emaar Malls Group a proxy for retail space). According to recent research, UAE retail sales have been forecast to grow strongly in 2015, and the GCC retail industry continues to maintain positive momentum, driven by a robust economic growth, rising purchasing power, a growing proportion of expatriates, changing consumption patterns and an increasing penetration of international retail players.

US investors can now, for the first time, easily access the Saudi Arabian stock market. The iShares MSCI Saudi Arabia Capped ETF (KSA) began trading on 17 September. The ETF tracks 99% of the market’s capitalization. As Saudi Arabia takes steps to bolster the economy by opening its stock market to foreign investment, the country’s fundamentals remain mixed. Despite plunging oil prices the country enjoys the lowest public debt levels in the region, with the cost to insure its bonds against default falling in recent weeks by the most since 2009, after suddenly hitting a three-year high last month. Yet economic growth forecasts, once ranking the highest in the region, continue to be lowered. Although there has been some speculation of possible devaluation of GCC currencies, devaluations remain unlikely, given the substantial reserves and the low debt levels that most GCC countries enjoy. Nonetheless, Saudi Arabia is being prudent, by looking at ways to cut budget spending to offset the falling revenue from lower crude prices.

FTSE announced in September that Qatar would be promoted from Frontier to Secondary Emerging Market, with a two-phased implementation on liquidity concerns (50% in September 2016 and 50% in March 2017). We expect Qatar equities to consolidate in the short term on a lack of catalysts. The Qatar Index is well diversified, with financials having the largest weighting. Industries Qatar, in line with the fundamentals of the sector, has been amongst the worst performers this year, while banking and utilities have fared much better.
GCC Equities

The direction of GCC equities will be affected by the prevailing trends in crude prices, with geopolitical risks posing a further catalyst.

In terms of price to earnings (PE) ratio versus the MSCI Emerging Markets index, Saudi Arabia and Qatar continue to trade at premiums, whilst the DFM and ADX indices, trade at a discount. We reiterate our preference for the UAE markets over Saudi Arabia, with their lack of exposure to petrochemical stocks and where the underlying economy is driven by the non-oil sector. The UAE indices have outperformed the overall GCC markets so far this year, with the Dubai Index -4% and the Abu Dhabi Index flat. Over a 3-year period the outperformance has been more substantial.

Given the growing uncertainty related to the macro backdrop, GCC-focused investors should have a bias towards blue-chip, defensive names and avoid the more volatile small-cap stocks. We maintain a preference for high-dividend-yielding, high-quality companies, for the logistics sector, as well as for consumer staples and for banking stocks. Consumer staples and banks will benefit, over the longer term, from the favorable regional demographics of a young and growing population and from the growing demand for their goods and services. Lower oil prices remain a supportive factor for the transport and the logistics sector, as well as for the hospitality industry, with lower flight costs benefitting companies exposed to tourism flows.

Top and bottom performers in the main GCC Indices

<table>
<thead>
<tr>
<th>Top Performers YTD</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dubai (DFM)</td>
<td>86.25</td>
</tr>
<tr>
<td>TAMKAFUL EMIRAT INSURANCE</td>
<td>65.75</td>
</tr>
<tr>
<td>DUBAI PARKS &amp; RESORTS PSC</td>
<td>23.46</td>
</tr>
<tr>
<td>COMMERCIAL BANK OF DUBAI</td>
<td>15.30</td>
</tr>
<tr>
<td>EMAAR MALLS GROUP PSC</td>
<td>9.17</td>
</tr>
<tr>
<td>MARKI PSC</td>
<td>8.33</td>
</tr>
<tr>
<td>DUBAI INVESTMENTS PSC</td>
<td>5.55</td>
</tr>
<tr>
<td>EMIRATES INTEGRATED TELECOMM</td>
<td>3.15</td>
</tr>
<tr>
<td>ARAMEX PSC</td>
<td>1.29</td>
</tr>
<tr>
<td>EMIRATES NBD PSC</td>
<td>-1.91</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bottom Performers YTD</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dubai (DFM)</td>
<td>-13.88</td>
</tr>
<tr>
<td>SHUAA CAPITAL</td>
<td>-14.09</td>
</tr>
<tr>
<td>ISLAMIC ARAB INSURANCE</td>
<td>-16.26</td>
</tr>
<tr>
<td>DUBAI FINANCIAL MARKET PSC</td>
<td>-16.42</td>
</tr>
<tr>
<td>UNION PROPERTIES PSC</td>
<td>-18.08</td>
</tr>
<tr>
<td>NATIONAL CEMENT CO</td>
<td>-22.22</td>
</tr>
<tr>
<td>DEAAR DEVELOPMENT PSC</td>
<td>-23.06</td>
</tr>
<tr>
<td>DRAKE &amp; SCULL INTERNATIONAL</td>
<td>-30.39</td>
</tr>
<tr>
<td>ARABTEC HOLDING CO PSC</td>
<td>-34.06</td>
</tr>
<tr>
<td>AJMAN BANK PSC</td>
<td>-34.38</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Saudi Arabia (SASEIDX)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>CO FOR COOPERATIVE INSURANCE</td>
<td>73.27</td>
</tr>
<tr>
<td>SAUDI TRANSPORT AND INVESTMENT</td>
<td>61.44</td>
</tr>
<tr>
<td>BUPA ARABA FOR COOPERATIVE</td>
<td>47.96</td>
</tr>
<tr>
<td>SABB TAMKAFUL</td>
<td>29.21</td>
</tr>
<tr>
<td>AL BABTAIN POWER &amp; TELECOMM</td>
<td>27.16</td>
</tr>
<tr>
<td>JABAL OMAR DEVELOPMENT CO</td>
<td>22.19</td>
</tr>
<tr>
<td>ALHAJI TAMKAFUL</td>
<td>19.36</td>
</tr>
<tr>
<td>ABDUL MOHSEN AL-HOKAIR TURIS</td>
<td>16.75</td>
</tr>
<tr>
<td>NATIONAL SHIPING CO OF THE</td>
<td>14.78</td>
</tr>
<tr>
<td>SAUDIA DAIRY &amp; FOODSTUFF CO</td>
<td>13.92</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Qatar (DSM)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>trzan holding group</td>
<td>25.34</td>
</tr>
<tr>
<td>AL MEERA CONSUMER GOODS CO</td>
<td>24.90</td>
</tr>
<tr>
<td>QATAR INSURANCE CO</td>
<td>18.17</td>
</tr>
<tr>
<td>QATAR ISLAMIC BANK</td>
<td>11.84</td>
</tr>
<tr>
<td>QATAR ELECTRICITY &amp; WATER CO</td>
<td>11.68</td>
</tr>
</tbody>
</table>

Source: Bloomberg. Data as at 30 September 2015.
Growing concerns on the slowdown in China, the unexpected decision by the People’s Bank of China (PBOC) to devalue the Yuan and lingering commodity weakness sent tremors across global financial markets earlier this summer. The disappointment and uncertainty caused by the inaction of the US Federal Reserve (Fed) on policy rates and its focus on non-US economic developments, led to increased nervousness and heightened volatility in FX and related markets. Hence, we see the first rate hike by the Fed, the risk-off sentiment driven by the slowdown in China and its impact on emerging markets to be the dominant themes and drivers for this quarter.

**Euro & JPY to benefit in the near term from market turbulence**

Euro and Japanese yen have been the main beneficiaries of recent market turbulence and of the related risk-off sentiment amongst investors. We expect these currencies to remain well bid in the near term, amidst numerous macroeconomic concerns and until clarity emerges on the normalization of US policy rates.

This however, does not imply a change of stance from our medium to long-term bullish dollar view, as fundamentals still point to a resumption of strength in the US currency. As for the Euro, we see a number of factors clouding the horizon, amongst others the spreading Volkswagen scandal in Germany, signs of sluggish economic momentum in the Eurozone and subdued inflationary trends. Against this backdrop, we see an increasing risk of the European Central Bank (ECB) nudging towards further policy stimulus in the near future, leading to renewed selling pressure on Euro.

The Bank of Japan (BoJ) has an even tougher task to achieve than the ECB, as Japan’s economic performance has remained subdued. Real GDP contracted by 0.4% q/q in the second quarter, following a 1.1% q/q expansion in Q1. At the same time the BoJ faces a challenging inflation outlook. Japan’s strong trade linkages with China and the recent Yuan devaluation have added pressure on the Central Bank to step up monetary easing. We therefore retain our long term bearish outlook on JPY.

In conclusion, we expect both the Euro and JPY to remain well bid in the near term, amidst a backdrop of prevailing risk aversion. However, in the medium-term, we see US dollar strength resuming on accelerating US growth and widening interest rate differentials.

**GBP better placed to withstand a stronger dollar**

The Bank of England (BoE) remains the only other Central Bank, apart from the Fed, to consider a monetary policy tightening in the near future. Economic data shows growth is picking up at a moderate pace. The main engine of growth continues to be the consumer, supported by wage increases and solid employment trends. With inflation near zero, real wages are running at a pretty decent rate. We are confident that the BoE will take steps in the direction of a rate hike in the first half of 2016. Accordingly, we expect potential GBP/USD weakness to be less severe than for EUR or JPY, with the net result that GBP should also benefit on many crosses.

**Expect Emerging Market & Commodity FX weakness to persist**

China continues to be at centre stage and a major influence on global investor sentiment and financial market dynamics. The Chinese economy is facing a slowdown and is in the midst of a major structural adjustment. Repeated interventions by the government to stabilize local equity markets, the steps taken in the direction of freely floating rates and reform on the exchange rate mechanism were intended to revive economic activity and to progress with structural reforms. In this context, we see risks tilted towards further CNY weakness throughout 2016. This puts emerging markets into a predicament, as many of those markets face competitive headwinds. We therefore expect that the EM currencies have more weakness to go from here on account of competitive adjustments of their respective currencies.

The risk of further potential downside remains for commodity currencies (AUD, NZD, CAD), considering policy divergence, China’s ongoing turmoil, reduced commodity demand and lingering price weakness. Within commodity FX, the Australian and New Zealand dollars are most sensitive to turbulence in China, their vulnerability being most similar to emerging market peers given their direct dependence on trade with China. The Canadian dollar (CAD) on the other hand is closely interlinked to oil. With prices likely to remain under pressure on the supply-demand outlook, we expect CAD to weaken further. October federal elections in Canada also add to the near term uncertainty for CAD.
Commodities face dual risk from China & Fed, expect low prices for longer

- The summer months have not been kind to commodities
- Swift price declines since August have pushed commodity indices to the levels seen near the start of early 2000s super-cycle
- We expect prices, especially for industrial metals, to stay low for longer on sluggish demand from China and Fed rate hike risk

Precious Metals

For most of the year, gold prices have been dragged lower on expectation that rates would start to rise at some point in H2. Underperforming physical demand, a strong US dollar and deflationary conditions have also had a major bearing on keeping the prices soft. However, dynamics in the near term appear to have changed for us to believe that risks are moderately skewed to the upside for the rest of the year. Physical demand from China and India has started to pick up. During August, China imported 84.9 tonnes of gold from Hong Kong & Switzerland, up 12% m/m and 107% y/y from these two primary sources. The upcoming festival season in India should also boost local demand. Bullion ETF redemptions have started reversing the modest inflows since early August. The surge in market volatility over the summer, possible weakness in equities and the uncertainty on the timing of the first rate hike in the US would likely buttress gold markets for the rest of the year.

However, we continue to see modest downside risk for the yellow metal next year on re-emergence of dollar strength.

For the rest of the year, we expect platinum to be the worst performer amongst precious metals. 40% of platinum demand comes from the making of auto catalysts for diesel cars. Fears that demand from the auto sector could fall, following the Volkswagen emissions scandal and potentially large inventories, should keep the metal under pressure. On the other hand, palladium, used more heavily in gasoline auto catalysts, is expected to benefit from the switch to gasoline engines. However, the upside potential of palladium might be limited by the general negative sentiment around commodities.

Oil and gold hit by widespread weakness in commodity markets

Industrial metals prices hit five-year lows in August as the slump in Chinese equity markets and underwhelming industrial data cast doubt on the prospect for further metal demand. With concerns about the health of the Chinese economy and its negative impact on global growth, it is difficult for us to expect a trend reversal in the prices of industrial metals. Indeed, we have become more bearish in this respect and now expect aluminum to average less than USD 1,800/tonne next year and have cut our copper outlook modestly.

Oil

Oil markets will remain highly volatile as we come into the end of 2015 and move into next year, but we expect prices will eventually begin to grind upwards. That said, any gains are unlikely to be exciting and there may be several downward lurches on our way higher.

Oil has been unusually volatile in 2015 when compared against its historical performance. Brent futures have experienced a larger number of wide moves (either positive or negative) than would be expected, when looking back to when the contract began trading. Indeed, the degree of volatility picked up over the last few months: in 21 trading days in August a third showed movements greater than 4%, far above their historical average frequency. Part of the reason for this year’s enhanced volatility has been the market’s overemphasis on weekly data looking at stock-levels, production or drilling rig numbers. Uncertainty in other financial markets - particularly as a result of unclear policy direction from the Fed - will also have meant funds lurching in and out of commodity markets.

To support our view of gradually rising prices, we look to a substantial slowdown in non-OPEC production in 2016. In particular, the double-digit increases in US production growth from 2012-14 will slow markedly and could reverse, as smaller producers are unable to hedge forward production at commercial levels and see credit lines dry up. Doubts are now also emerging about the sustainability of Russia’s production growth, as the government looks to raise taxes on oil producers, meaning investment budgets could be slashed for next year.

Oil demand is also showing some signs of vigour, as low prices spur consumption. Gasoline product supplied in the US, a measure of demand, has expanded by an average of over 4% in the year up to mid-September, its fastest pace in data looking back to 1995. The US economy, still the world’s largest consumer of oil products, continues to display strength and rising job numbers and consumer sentiment will help to put more cars on the road and burn through historically high stock levels. Demand in emerging markets should also accelerate going into 2016.
Headwinds persist
While we anticipate that these macro-level trends will be hard to ignore and will help to draw down the global surplus, there are still several major headwinds in the way of oil moving into a sustained and meaningful rally. The global surplus remains substantial. We estimate the market oversupply at 2.6mn b/d in Q2 2015 before falling to 0.6mn b/d on average in 2016. While sharply lower than this year’s levels, the oversupply in 2016 is nevertheless well above historic levels.

There is still the potential for major new supplies to enter into the market from the start of 2016. If the nuclear deal reached between Iran and the P5+1 is implemented, we cautiously estimate that as much as 500k b/d of Iranian oil will return to global markets, helping keep OPEC producing well above its 30mn b/d target.

Diverging trajectories in monetary policy – the Fed tightening while the ECB and BOJ maintain accommodative tones – will be USD-supportive into 2016. A stronger US dollar, all else being equal, should weigh down on oil and commodity prices in general.

A note on OPEC
Market attention will also fixate on whether OPEC will blink in the face of low prices and cut its production target of 30mn b/d. We think this is unlikely. OPEC’s share of global oil production will expand in 2016 to over 40% from 39.3%. While this may appear a minimal change in percentage terms, it represents around 830k b/d of oil production, not far off the total production of the UK. The gains could be even larger if the expected slowdown in non-OPEC oil production is faster than currently expected.

OPEC’s spare capacity buffer is also growing tighter as member nations produce at full tilt to maximize market share. As Iraq produces over 4mn b/d and Iran, the UAE and Kuwait all close in on 3mn b/d each, OPEC’s production as a share of its total capacity rose to 88.9% in August. We expect OPEC members will attempt to keep production at current levels or raise it if possible which means this gap will narrow even further. Should demand pan out as planned or better in 2016, OPEC members will be well positioned to benefit from any upward price shock, which we believe has been OPEC’s objective in maintaining production at elevated levels all along.
Global Real Estate

Weight of money continues to drive the market forward

- UK commercial property performing strongly. Market momentum to continue into 2015/2016 driven by strong fundamentals and weight of money. Better value and higher yields available ex-London and in alternative property;
- European commercial property attractive at present due to comparatively cheap valuations, QE from the ECB and Euro weakness. Some further volatility anticipated for EU listed property companies but upward trend to continue;
- US commercial property performing strongly due to abundant liquidity and improving fundamentals and will continue to do so for the remainder of the year. US REITs have struggled YTD and short-term performance will be volatile with interest rate lift off;
- Asian property continuing to labour under China-led economic headwinds but money continuing to target core Japanese & Australian assets;
- Investment via REITs and mutual funds are the easiest way to gain immediate, diversified exposure to these markets.

Overview

Global real estate continues to perform well, driven by improving fundamentals, recovering credit availability, low rates, accommodative monetary policy and heavy demand from investors seeking yield and fleeing volatility in other asset classes. The resultant peak pricing in many gateway cities in the US and the UK is a cause for concern but the timing, or perceived timing, of any rate rises will be the key to the peak of this market cycle.

Europe is the now the main growth region as the recovery was delayed here due to persistent economic turbulence from Greece et al, but the market is now firmly on the front foot driven by investor demand and benefiting from the ECB’s QE programme. Meanwhile, China’s slowdown continues to hinder Asian markets with only consistent activity for core assets in Japan.

Source: Morningstar, 2015. Data from 01.01.2015 to 30.09.2015.
* YTD figure includes estimate of September 2015 total return.
UK
The UK commercial property market continues to perform well due to ongoing improvements in underlying property fundamentals, strong domestic and international capital inflows and attractive yields relative to equities and bonds. Supported by these tailwinds, UK commercial property, both listed and unlisted, has outperformed other UK asset classes over the last 12-months.

A prominent sign of the UK market’s continuing attraction has been the GBP 45bn of commercial property transactions that have taken place in the UK so far this year. London in particular has consistently been a popular destination for overseas monies as investors consider it a safe haven for their money due to better liquidity; consistently strong supply/demand fundamentals; abundance of ‘big ticket’ investments and superior returns. A weak GBP has also aided USD or USD-related buyers and North American and Far Eastern investors have been particularly active in 2015. As a result, rents and prices in many areas of London are now well in excess of their pre-financial crisis peaks, particularly for offices and shops in the severely supply-constrained West End and Mid-Town sub-markets with little headroom for further growth in either. This has led domestic buyers and an increasing amount of international capital into the UK regions where competition is lower and property yields remain at an attractive level relative to London and to those from equities and bonds. This search for yield has led to strong interest this year in non-mainstream/alternative property such as student accommodation and leisure assets. Not only are income yields here currently superior to other property sectors, but returns are often driven by elements with a low or even negative correlation with other economic factors. Indeed, the top 10 property deals in 2015 have been dominated by alternative real estate with purchases of large student living, hotel and leisure portfolios by North American investors. The continuing weight of money across all sectors and further improvements in UK property conditions will continue to drive the market forwards into the remainder of 2015.

However, many overseas investors find acquiring property directly in unfamiliar jurisdictions challenging. A more efficient solution would be an investment in a REIT, listed property company or mutual fund. These offer immediate market exposure to an existing diversified portfolio of property assets with greater liquidity and, in some cases, lower transactional costs compared against owning directly. Diversification ensures a more stable income stream for investors as individual lease expiries or the failure of any one tenant or property would have a negligible impact on overall distribution levels or portfolio value.

1 Total Returns in GBP for period 01.10.2014 to 30.09.2015. September 2015 total return for IPD All Property is estimated at time of writing. Source IPD, ENBD, MSCI RE, 2015
2 Data as at 01.10.2015 Source: PropertyData, 2015
3 Standard purchaser’s costs for UK commercial property are 5.80%. Bid/offer spreads on more liquid REITs and listed companies are generally lower. Mutual fund bid/offer spreads tend to reflect purchaser’s costs. Source: Emirates NBD, 2015; MSCI RE, 2015
Global Real Estate

Top 10 UK Property Deals YTD 2015

<table>
<thead>
<tr>
<th>Building</th>
<th>Location</th>
<th>Sector</th>
<th>Price GBPm</th>
<th>Vendor (nationality)</th>
<th>Purchaser (nationality)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centre Parcs Portfolio</td>
<td>UK-wide portfolio of leisure parks</td>
<td>Alternative</td>
<td>2,400.0</td>
<td>Blackstone (US)</td>
<td>Brookfield Office Properties (Canada)</td>
</tr>
<tr>
<td>HSBC, 8 – 16 Canada Square, E14</td>
<td>Central London</td>
<td>Office</td>
<td>1,175.0</td>
<td>NPSK (S Korea)</td>
<td>QIA (Qatar)</td>
</tr>
<tr>
<td>Liberty Living Portfolio</td>
<td>UK-wide student accommodation portfolio</td>
<td>Alternative</td>
<td>1,100.0</td>
<td>Brandeaux Student Accommodation Fund (UK)</td>
<td>CPPIB (Canada)</td>
</tr>
<tr>
<td>Moorfield REF I &amp; II</td>
<td>UK-wide portfolio</td>
<td>Mixed Use</td>
<td>1,000.0</td>
<td>Moorfield Group (UK)</td>
<td>Lone Star (US)</td>
</tr>
<tr>
<td>30 St Mary Axe, EC3</td>
<td>City of London</td>
<td>Office</td>
<td>726.0</td>
<td>Evans Randall (UK)</td>
<td>Safra Group (Brazil)</td>
</tr>
<tr>
<td>Jurys Inn Portfolio</td>
<td>UK-wide hotel portfolio</td>
<td>Hotel</td>
<td>676.0</td>
<td>JV: Mount Kellett Capital (US) /Oman Investment Fund (Oman)</td>
<td>Lone Star (US)</td>
</tr>
<tr>
<td>Project Warwick</td>
<td>UK-wide portfolio</td>
<td>Mixed Use</td>
<td>635.0</td>
<td>Highcross Fund (UK)</td>
<td>Northwood Investors (US)</td>
</tr>
<tr>
<td>Nido Portfolio</td>
<td>Student accommodation portfolio – 3 x London assets</td>
<td>Alternative</td>
<td>600.0</td>
<td>JV: Coral Student Portfolio (UK) /Curzon Land Ltd (UK) /Round Hill Capital LLC (US)</td>
<td>Greystar Student Living (US)</td>
</tr>
<tr>
<td>2 King Edward Street, EC1</td>
<td>City of London</td>
<td>Office</td>
<td>582.5</td>
<td>GIC Real Estate (Singapore)</td>
<td>Norges Bank Investment Management (Norway)</td>
</tr>
<tr>
<td>Walbrook Building, EC4</td>
<td>City of London</td>
<td>Office</td>
<td>575.0</td>
<td>JV: Ares Management (US) /Delancey (UK)</td>
<td>Cathay Life (Taiwan)</td>
</tr>
</tbody>
</table>

Global Real Estate

Europe

European property has recovered strongly over the last 12-months as investors finally overcame their economic fears to pursue the attractive yields and valuations available there despite only tentative improvements in underlying fundamentals. The upward movement in property values has accelerated since the start of 2015, aided by the announcement of the ECB's QE programme.

As a result, there has been remarkable investment activity on the Continent over the last 12-months with a total of EUR 162bn of transactions, a 38% year-on-year increase, and are now at a level comparable only to the previous pre-financial crisis market peak in 2007. There was EUR 39bn of transactions in Q2 2015 alone, 20% higher than in Q2 2014. Almost all European countries have experienced large annual increases in transaction volumes particularly in the stronger Northern economies (Germany and the Nordics) and on the periphery (Spain, Italy and Ireland) due, primarily, to opportunistic investors. France, as a major Eurozone economy, has surprised on the downside with weak investment activity whilst investors in Russia and Poland have been affected by sanctions and general EM sentiment respectively.

Domestic pension funds, insurance companies and REITs have been the principal buyers of European property to date and the focus has been on prime, yielding assets in home markets. However, there has been some movement up the risk curve into more 'value-add' assets to capture the market recovery and cross border investment is rising rapidly with Asian and Middle Eastern sovereign wealth and US opportunity funds notably active. The latter has been attracted to the comparatively cheap real estate on offer in peripheral Europe, especially in Spain and Ireland, and they have been the dominant buyers here over the past couple of years, often via acquisition of the underlying debt. With further domestic and international capital inflows (especially given FX considerations for the latter), improving credit conditions and ongoing monetary stimulus, European real estate will make further gains for the remainder of H2 2015 and into early 2016.

Like the UK, REITs and mutual funds offer investors the most convenient way to gain immediate diversified exposure. Eurozone property equities have been the most immediate beneficiary of the market recovery and QE programme, outperforming almost all other European equity sectors year to date despite a sell-off in Q2 when concerns about Greece impacted financial stocks in general. Property conditions and capital flows will prevail but there will be some volatility in listed securities over the short term as in wider European equity markets.

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4 Figures to 30 June 2015. Source: CBRE, 2015
Global Real Estate

USA

The US commercial property market also continues to perform well in 2015 with a year-to-date total return of 6.8%\(^5\). In a volatile, low interest rate environment, income producing commercial property remains an attractive investment due to high relative yields supported by improving property fundamentals, steady income growth and an accommodative financing environment. US CMBS issuance has recovered back to levels last seen in the mid-2000s and transactional activity remains robust with USD 153bn of commercial property year to date, a 19% increase year-on-year\(^6\). This large weight of both domestic and an ever increasing volume of overseas capital chasing too few assets has caused prime real estate prices in many major US metropolitan areas to hit record highs and pushed yields to record lows. This has been particularly acute in NYC/Manhattan where deal volumes are up 45% year-on-year\(^7\). Like the UK, this has frustrated many would be buyers in major US city centres, pushing them into more secondary property assets and/or locations where prices and yields remain attractive and competition is less intense. Abundant liquidity and improving property fundamentals are positive for US commercial property and the direct market will continue to perform strongly into H1 2015.

Despite the ongoing performance of direct property, US REITs have struggled so far this year, underperforming the wider equities market, as measured by the S&P 500, for most of H2 2015 primarily due to concerns that implied pricing of underlying assets had departed too far from risk free rates. Although investors remain confident in the US property market and REITs, any expectation of a near-term interest rate rise will negatively impact performance, as has been shown so far this year. Over the medium term, US REITs’ balance sheets remain healthy and continued access to cheap funding will keep them insulated from any rate rise.

\(^6\) Source: JLL, 2015
\(^7\) Source: JLL, 2015

Source: NCREIF. Data as at 30 September 2015.

Source: Real Capital Analytics / Moody’s. Data as at 30 September 2015.

Source: Morningstar, 2015. Data from 01.01.2015 to 30.09.2015.
Asian real estate continues to be impacted by the economic headwinds emanating from China and from general weakness in emerging markets over fears about the implications of a US rate rise. For these reasons, listed property companies in the region have struggled throughout 2015, underperforming wider equities, which themselves have had a disappointing year, by 1.4% year to date. Investment activity has remained largely insulated from these issues as market volatility tends to lead investors away from other asset classes into the security of bricks and mortar. However, unlike previous periods, investment activity has also now softened with USD 31bn of transactions in Q2 2015, a -3% year-on-year decline. Overall though, there has been USD 56bn of commercial property transactions year-to-date, a 2% increase on H1 2014. Japan continues to dominate investment activity, accounting for 34% of the Asian total. Domestic and international investors have been attracted to core, income-producing assets, predominantly in Tokyo, where spreads between property yields and financing costs continue to be accretive. The Bank of Japan’s monetary policy also remains supportive of property investment. The other two major markets in the region, Australia and China, had disappointing starts to the year but activity recovered to USD 4.4bn and USD 7.9bn respectively in Q2 after a number of large scale deals completed. Slower economic growth in China will likely have a dampening effect on investor demand after Q4 2015 as there are a number further large deals likely to complete in Q3 2015. Hong Kong and Singapore have also experienced limited activity throughout the year, although one or two large deals have glossed over the general lethargy in capital markets.

The remainder of 2015 should see these trends continuing with investment into core properties in gateway cities in Japan whilst volatility affects China and other key regional markets. Again, REITs and mutual funds offer the most efficient entry route as direct acquisitions in faraway markets can be a challenge for all but the largest and most sophisticated investors such as sovereign wealth funds.

Source: Morningstar, 2015. Data from 01.01.2015 to 30.09.2015.

8 Data from 01.01.2015 to 15.06.2015. Source: Morningstar, 2015
9 Source: JLL, 2015
Investment Themes
Portfolio Derisking and Asset Allocation Choices

> Outright position hedging is not the only way to derisk a portfolio
> Derisk MENA portfolios via Sukus or US treasuries
> Derisk global portfolios via Investment Grade (IG) bonds and high-dividend-yielding stocks
> DM assets have a better risk-return profile than EM when global growth is sluggish

Investors usually underestimate the importance of not taking too much risk in a portfolio, only to be eventually reminded by financial markets at times of heightened volatility how painful excessive risk exposure can be. Derisking a portfolio does not necessarily mean that the investor must hedge exposure via derivatives; nowadays enough financial instruments and subasset classes are available for investors to achieve some milder form of portfolio derisking via proper asset allocation or investment choices.

GCC portfolios and market risk
For multi-asset GCC portfolios, built with cash, GCC bonds and GCC equities, the most common question, even among professionals, is how to best hedge risk exposure in case markets turn sour. It goes without saying raising cash is an obvious option, for any type of portfolio.

If a GCC portfolio is purely Sharia compliant, the most straightforward way to reduce risk is to increase sukuk allocations. A Sharia compliant portfolio has the most constraints in terms of derisking possibilities.

If the GCC portfolio is not Sharia compliant, US-dollar, risk-free assets offer the largest derisking potential. The reason being that returns on GCC equities are driven in the long term by oil returns. It is hard to find an asset class more inversely correlated to crude oil (hence to GCC equities) than US risk-free bonds (table 1). Firstly, because the dollar itself tends to move inversely with oil, and secondly because government bonds tend to move inversely with oil.

It is possible to somehow derisk any kind of GCC portfolio by gaining exposure to large-cap, high-dividend-yielding stocks, which tend to fall less than the equity market due to the dividend component, offsetting the rising uncertainty on capital gains as volatility rises (Chart 1). The trade-off is that high-dividend-yielding stocks may rise less than the market, being more defensive.

Table 1.
US Treasuries & GCC equities tend to move in opposite directions

<table>
<thead>
<tr>
<th>US Treasuries and GCC Equities 5 Year Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
</tr>
<tr>
<td>Median</td>
</tr>
<tr>
<td>Maximum</td>
</tr>
</tbody>
</table>

Source: Bloomberg, PB-CIO Office. Data as at 30 September 2015.
US Treasuries – BofA ML US Treasury Index
GCC Equities – MSCI GCC Equity Index

Chart 1.
High dividend and large-cap are outperformance factors in GCC equities

For global portfolios increasing levels of derisking are achieved by raising the allocation to
> Defensive equity sectors (the sectors least sensitive to the business cycle, utilities, telecoms, consumer staples, pharma)
> High-dividend-yielding stocks
> Investment grade bond (best proxies for risk-free assets after cash)
> Government bonds

Investors tend to underestimate the role of government bonds in a portfolio, focusing on the expected paltry returns (large coupons are hard to come by in this space nowadays). Yet, government bonds, from an asset allocation and portfolio construction point of view, rather serve the purpose of reducing the drawdown of a portfolio and its volatility. In other words, in recessionary times capital losses and volatility are cushioned by government bonds, the asset class with the largest positive returns historically, when the economy contracts (table 2).
Portfolio Derisking and Asset Allocation Choices

Table 2.
US Treasuries outperform all asset classes during recessions

<table>
<thead>
<tr>
<th>US Recessions and Asset Class Performance</th>
<th>US Treasuries</th>
<th>Global IG Corp Bonds</th>
<th>Global Equities</th>
<th>Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1990 - March 1991</td>
<td>8.53%</td>
<td>N/A</td>
<td>-2.87%</td>
<td>N/A</td>
</tr>
<tr>
<td>March 2001 - November 2001</td>
<td>5.71%</td>
<td>4.72%</td>
<td>-12.49%</td>
<td>-19.5%</td>
</tr>
<tr>
<td>December 2007 - July 2009</td>
<td>9.46%</td>
<td>3.12%</td>
<td>-34.79%</td>
<td>-22.8%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, PB-CIO Office. Data as at 30 September 2015.
US Treasuries – BofA ML US Treasury Index
Global IG Corp Bond – BofA ML Global Investment Grade Corporate Bond Index
Global Equities – MSCI AC World Index USD
Commodities – CRB Commodities Index

The next best proxy for government bonds, apart from cash, in developed markets is IG corporate credit, given its low default-rate. Aggressive investors who wish to derisk their portfolios and want to avoid large allocations to government bonds, can opt to afford more capital to IG credit.
Stay put

With the Fed on the brink of raising rates (the Fed risk), economic growth slowing down in emerging world (growth risk), the Chinese economy in the doldrums (China risk), commodity prices falling (commodity risk), rising default risk and falling angels (credit risk) there is plenty to worry about for the faint hearted fixed income investor. However we note that none of these risks are an immediate event. In fact these are long term directional risks which have existed for some time and are expected to take a long time to play out. Although the time for exuberance may be behind us, the recent deflation in bond prices has provided some buying opportunities.

**Global IG bonds likely to benefit from low inflation outlook**

With the inflation outlook across the globe becoming sublime, the interest rate hikes, as and when they commence, are unlikely to be too steep or too fast. In an interest rates-lower-for-longer scenario, investment grade bonds are likely to remain supported. Though the price of investment grade bonds has a higher correlation with benchmark rates, the benefits of their stronger credit profiles and mostly higher liquidity make them an attractive place to stay invested. As the investor base becomes more cognisant of the fundamentals, we think high yield bonds will relatively be more volatile than the investment grade bonds in the coming few months.

As at now, the credit spread premium between the global IG bonds and Global HY bonds is at circa 502bps which is more than 75% higher than the 286bps seen last year. Even after recent material widening of spreads on HY bonds, we think they have room to widen further as most factors that contributed to this widening are likely to persist.

Looking deeper, we find that the credit spread differential between the Global IG bonds and the US IG bonds is also at its recent high. With current level of 22bps being almost 275% higher than where it was in mid 2014, US IG looks cheap to enter.

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**GCC Perpetuals**

Anita Yadav
Head of Fixed Income Research

Stay put

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Looking deeper, we find that the credit spread differential between the Global IG bonds and the US IG bonds is also at its recent high. With current level of 22bps being almost 275% higher than where it was in mid 2014, US IG looks cheap to enter.
GCC Perpetual bonds – Should be ‘buy’ not ‘bye’
First half of the year was all about macro issues and the diverging policies of the various central banks. In that environment, high grade bonds were more volatile as they have a limited cushion of credit spreads built into their price. As a result, high yield bonds outperformed high grade bonds in the first half. In contrast the second half is all about the fundamental risks. Decelerating economic growth and increasing default risks has dampened sentiment on high yield bonds. We expect the momentum in negative sentiment to prevail over the next few months.

Credit spreads on US high yield bonds have almost doubled over the last one year from 359bps in July last year to about 685bps now. Although the possibility of them widening further is high, we think the average current yield of circa 8.4% more than sufficiently compensates investors who can endure short term volatility. Similarly the double digit return currently available on several GCC based high yield issuers may be worth a consideration.

Within GCC, there are several issuers offering double digit return. However the most stable ship is the GCC perpetual securities, particularly the ones representing the Tier 1 securities of the GCC banks. After the issuance of first perpetual security in November 2012 by Abu Dhabi Islamic Bank, the perpetual bond market in the GCC has grown four fold. The key characteristics of this universe are:

- Currently there are 13 issues (including two from corporates) with a total of USD 8.3bn outstanding.
- Around 84% of the outstanding is from the banking sector with only two corporates, one from GEMS Education (USD 200mn) and another from Majid Al Futtaim (USD 500mn).
- A little over 44% is in the sukuk format and remaining in conventional bonds.
- With the exception of MAFAU and the recently issued securities from NBAD and NBK, all other perpetual bonds are unrated. However, notching them down from the parent level rating will indicate credit quality in the BB range, on average.

Yield pick-up
Due to their subordinated payment rank and lower credit ratings the yield on perpetual Tier 1 securities is materially higher than the senior bonds of the banks. The average yield on perpetual bonds is circa 6% while that on senior liquid bonds of the UAE is only 2.78%.

Perpetual bonds vs ordinary equity
With capital ratios well above the required levels, most GCC banks are likely to call their perpetual bonds on the first call date. However it should be noted that payment of coupon/profit and repayment of capital is subject to solvency and capital adequacy tests and regulatory approvals. Coupon/Profit not paid because of whatever reason is non-cumulative. The banks can elect to stop coupon/profit payment or cancel it at its discretion, however it will also trigger a dividend stopper clause and therefore we expect minimal risk of the banks electing not to pay coupon/profit on the perpetual securities on time. Since coupon and capital payments are elective, perpetual securities are not far from the ordinary equity of the banks in its capital structure. It would be logical to expect that investors who are accepting of equity risk will also be comfortable with the risk in perpetual securities. In fact, in the current market scenario, the risk reward profile of perpetuals appears better than equity based securities on the below compelling factors.

- Currently the average dividend yield on GCC banks is about 4.3% while the yield on perpetuals is above 5.65%. It should also be noted that the current dividend yield is likely to be slightly inflated as it is based on current share prices which have fallen in the recent past. The broader DFM index is down 6% for the year.
- Dividend payment is generally annual while the coupon is mostly semi-annual so the investors collects cash more often.
- In the current environment of liquidity tightening, banks may chose to reduce dividend payments, however coupon payments are contractual obligations and will likely continue.
- The volatility in perpetuals securities is generally less than the volatility in the share market.

Bank perpetual bonds are well placed to weather the risk of rate hikes Most of the GCC perpetuals are trading above their par value. Perpetual securities can be called if their capital treatment changes and as such investors should be cognisant of the risk that these get called at par. However most perpetual securities have a five year non-call period. GCC bank perpetuals trade on the basis of yield-to-call and not yield-to-maturity. Since the next call on most GCC perpetuals is less than five years away, the negative impact of a rate rise is lower for perpetuals than the longer-dated bullet bonds.

<table>
<thead>
<tr>
<th>Security</th>
<th>Next Call</th>
<th>Yield</th>
<th>Div Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>DIBUH 6½%01/29/2049</td>
<td>01/20/2021</td>
<td>5.47</td>
<td>5.93%</td>
</tr>
<tr>
<td>EBIUH 5¼%05/29/2049</td>
<td>05/30/2019</td>
<td>6.39</td>
<td>4.01%</td>
</tr>
<tr>
<td>BGBKKK 7¼%09/30/2049</td>
<td>09/30/2019</td>
<td>8.19</td>
<td>3.66%</td>
</tr>
<tr>
<td>ADIBUH 6½%10/29/2049</td>
<td>10/16/2018</td>
<td>4.66</td>
<td>5.18%</td>
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<tr>
<td>NBDUH 5¾%12/29/2049</td>
<td>06/17/2020</td>
<td>4.63</td>
<td>3.83%</td>
</tr>
<tr>
<td>NTKKK 5½%12/29/2049</td>
<td>04/09/2021</td>
<td>5.34</td>
<td>3.62%</td>
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<tr>
<td>BKDBOM 6.85%12/29/2049</td>
<td>05/27/2020</td>
<td>6.77</td>
<td>1.85%</td>
</tr>
<tr>
<td>AUBBI 6½%12/29/2049</td>
<td>04/29/2029</td>
<td>6.25</td>
<td>6.17%</td>
</tr>
</tbody>
</table>

Source: ENBD Research. Data as at 30 September 2015.
India

Patience will pay

> India is in an early recovery phase. The macroeconomic backdrop is stable
> Corporate earnings expected to grow given low input prices
> Capex cycle is yet to start in a meaningful manner
> Low oil prices will stabilize current account deficit and currency
> Food inflation within control, though core inflation remains a concern
> Infrastructure focus on railways (freight), completion of existing projects and power generation
> Confidence in the BJP-led NDA reinforced with the ‘Make in India’ campaign

The structural macro drivers for economic growth seem to be in place for India and equities have rebounded after falling 17% from their peak. India is the top performer amongst emerging markets, benefiting from low commodity prices. A sharp annual decline in the oil and gold prices (which constitute around 40% of India’s import basket) and reduced subsidies have brought the import bill and Current Account Deficit (CAD) down, reducing pressure on the INR.

Last quarter, India’s GDP grew at 7%, amongst the highest globally. This is positive for earnings, which are closely correlated to nominal GDP growth. The International Monetary Fund (IMF) recently lowered India’s GDP forecast for FY16 to 7.3%, but retained its FY17 forecast at 7.5% on the back of reforms, a pickup in investment and continued lower commodity prices.

It is critical that structural reform is visible through the approval of the national Goods and Services Tax bill in the upcoming winter session of Parliament. Approval of the Land Acquisition Act – critical for infrastructure (road, railway and airport) development and industrialization is now an issue to be dealt with at the state level, where support is slowly gaining momentum. The BJP led NDA (the current party in power), needs to win the Bihar state elections to consolidate its position and fast track its reform agenda.

The Reserve Bank of India (RBI) has front loaded its interest rate cuts with a dovish outlook following a benign inflation expectation. The repo rate (now 6.75%) has been reduced by 125 bps this year in an effort to kick-start the investment cycle, which is still lack lustre. The government is providing greater impetus to capex so as to restart pending projects hampered by delayed administrative clearances. Positive real interest rates are also expected to spur discretionary consumer spending.

Currently the Sensex is trading at 17.2x forward earnings, with a flat performance for the year. Earnings are forecast to grow in the high teens over the next few years after disappointing in the last two quarters. Corporate margins are improving and interest rate savings should start kicking in from the next quarter as banks start to cut their base rates. Top line growth indicating a pick up in demand should also follow.

Our top preference in terms of sectors is banking with a bias for large private sector banks and small wholesale banks, as they will benefit the most from interest rate cuts. Cheaper financing will benefit the auto sector and any depreciation of the INR will benefit export-oriented companies, especially IT services. Pharma, in our view, has become expensive although it has hitherto been one of the best performers. We would avoid metals due to a poor global outlook and view it more of a short-term rebound trading call and not yet a fundamental bet.

Infrastructure remains the Achilles’ heel for Indian growth, and increased public investment in infrastructure will boost business confidence. Infrastructure finance is weighing heavily on the Public-Private-Units (PSU) banks, which need to be recapitalized. The National Infrastructure fund has been allocated INR 200 billion as stated in the budget, however the focus is on completing the existing projects before commissioning new ones, with the railway, roads and ports being prioritized. The recent initiative by the government to provide state guarantees to banks for their infrastructure exposure, albeit still pending cabinet approval, would help boost the capital requirements of the banks.

24/7 power generation by 2019 is a focal area and low coal and oil prices are helping this agenda. The urbanization plan is underway with smart cities. Upgrade of India’s ports is planned, as well as the last leg of connectivity to the railways and to major highways. The railway focus is on two freight corridors connecting East to West and North to South, and in passenger logistics the focus is on adding capacity to popular corridors which is being done systematically and sequentially.

Ease of doing business is a focus. The World Bank has published a ready reckoner on the ‘Make in India’ campaign. They see infrastructure as a hurdle, as most projects are stalled on environmental clearance or raw material shortage. Foreign JV’s in progress include Daimler, Alibaba, Foxconn, Honda, Softbank and GE. Whilst India has been rated as the top Foreign Direct Investment (FDI) destination according to an FT survey (USD 30bn beating China) continued bureaucracy and a lack of confidence in the speed of approvals will hamper the acceleration of the investment cycle in the private sector.
India

New issuance (IPO’s) should start as the markets recover and some green shoots are visible as a few small IPO’s are coming to the market.

Fitch feels that the private sector indebtedness is very high and that interest cover is at a 10 year low. One in three large corporates is in distress and EBITDA is insufficient to service the debt. The lack of credit growth also remains a concern and is indicative of insufficient demand as well as a lack of private sector confidence in undertaking new investments. Investors are advised to have a bias towards companies with strong free cash flows and net debt/EBITDA below 3X.

Efforts to attract FDI are being facilitated through Free Trade agreements with many countries which are in their final stages, i.e. Australia, Canada and Peru. Demand from Europe for high value goods is falling and new trade partners and goods need to be explored. There are specific commodity markets where India has an advantage – rubber, cardamom and spices. FDI has been opened for defense, construction, infrastructure, medical devices and insurance already. Globally the use of technology and robotics, while driving efficiency and economic growth, poses a threat to employment in a country with a large working-age population.

Although the start of the tightening cycle in the US may trigger a sell-off in Indian bonds, this should be recovered quickly as FDI and FIIs flows increase.

At a macro level, India is in a sweet spot, with a stable political setup at the national, as well as at the state level. PM Modi’s pro-growth policies, the strong willingness to crackdown on corruption and bureaucracy, low oil and gold prices, low inflation and strong inflows support the Indian macroeconomic story. Crude oil and other commodity prices have fallen to four-year lows and this will positively impact India’s twin deficits while also boosting real income. India’s CAD is likely to remain at ~2% of GDP, while its substantial foreign exchange reserves of around USD 350bn will help tide over volatility in foreign capital flows. The only downside of a strong currency would be its impact on the competitiveness of Indian exporters.

Consensus is for a 16% upside to the Sensex and current market conditions indicate that investors may have a bumpy ride although they will get there in the end.

Performance of MSCI India Index by sector YTD

Source: Bloomberg. Data as at 30 September 2015.
Global Shopping Malls

> Large dominant shopping malls possess sustainable competitive advantages
> These are derived from dominating their catchment area in built up areas with high population densities. Such malls also benefit from network effects
> Traditional retailers expected to grow in absolute terms despite competition from e-commerce
> Malls with the scope to become entertainment centres should outperform

Large dominant shopping malls possess sustainable competitive advantages, which are derived from dominating their catchment area, especially in built up areas with high population densities, which in turn create network effects. Efficient scale is a key competitive advantage with a wide range of shops in one location increasing convenience, together with good transport infrastructure, driving high footfall, which boosts sales and hence tenant demand. The wider the shopping range, the greater the appeal to shoppers. Incremental demand can often be met by expanding the existing mall, which is lower risk than a new development, boosting returns on investment and strengthening the incumbent’s position vis a vis potential competitors. The network effect allows dominant malls to charge a large rental premium compared to high street shops and smaller malls nearby, as well as allowing them to pick high quality tenants and enjoy low vacancy rates.

Virtuous Development Cycle of a Shopping Mall

The benefits of efficient scale is especially true for super regional ‘fortress’ malls which dissuade competitors from entering a certain geographic market, given the high costs of development, difficulty in securing a suitable site, challenges of obtaining development permission, especially in built up areas where land prices are high, as well as higher leasing risk than the incumbent mall operator.

Tenants have switching costs in moving out of a successful mall to a cheaper site, as it is uncertain if lower rents will offset the impact of lower footfall and sales. Additional switching costs include having to make good the premises that are being vacated.

Table of Network Effect Illustration

<table>
<thead>
<tr>
<th>Asset</th>
<th>Mall Floor Area (sqm)</th>
<th>Average Rent Inside Mall per sqm</th>
<th>Speciality Rent Range Immediately Adjacent to the Mall per sqm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankstown Central, Sydney</td>
<td>85,000</td>
<td>1,550</td>
<td>440-800</td>
</tr>
<tr>
<td>Mandurah Forum, WA</td>
<td>40,000</td>
<td>1,530</td>
<td>350-500</td>
</tr>
<tr>
<td>Galleria, Perth, WA</td>
<td>73,000</td>
<td>2,035</td>
<td>300-330</td>
</tr>
</tbody>
</table>

Source: Federation Centres, Retail properties advertised to let (September 2015), Morningstar

Table of Fortress Style Malls

<table>
<thead>
<tr>
<th>Mall Name</th>
<th>Owner</th>
<th>Opened</th>
<th>Gross Floor Area (sqm)</th>
<th>Sales/sqm USD</th>
<th>Total Tenants</th>
<th>Rail Station Within</th>
<th>Land Values</th>
<th>Estimated Valuation USD bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Westfield London</td>
<td>Westfield</td>
<td>2008</td>
<td>164,000</td>
<td>17,000</td>
<td>372</td>
<td>Yes</td>
<td>Very High</td>
<td>3.1</td>
</tr>
<tr>
<td>Times Square, Hong Kong</td>
<td>Wharf</td>
<td>1994</td>
<td>87,000</td>
<td>29,000</td>
<td>230</td>
<td>Yes</td>
<td>Very High</td>
<td>4.8</td>
</tr>
<tr>
<td>Harbour City</td>
<td>Wharf</td>
<td>1966</td>
<td>190,000</td>
<td>43,000</td>
<td>700</td>
<td>Yes</td>
<td>Very High</td>
<td>12.2</td>
</tr>
<tr>
<td>Westfield Bondi Junction, Sydney</td>
<td>Scentre Group</td>
<td>1970</td>
<td>128,000</td>
<td>10,043</td>
<td>508</td>
<td>Yes</td>
<td>Very High</td>
<td>1.8</td>
</tr>
<tr>
<td>Ala Moana, Honolulu</td>
<td>General Growth, Aust Super</td>
<td>1959</td>
<td>195,000</td>
<td>13,000</td>
<td>310</td>
<td>No</td>
<td>High</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: Company data, Morningstar. Data as at 30 September 2015.
Global Shopping Malls

Shopping malls increasingly incorporate entertainment options, which further helps increase footfall and further diversifies the retail offering and experience. This usually includes cinemas, bars and restaurants, although increasingly a wider range of leisure activities such as water parks, aquariums, roller coaster, indoor ski slopes and ice rinks. Larger malls are expected to become entertainment precincts, where consumers visit for the specific entertainment options rather than just the shopping option.

Online retail is a key challenge to bricks and mortar retailers, with online retail having grown to 7% of total retail in developed countries and set to grow further. It should be noted that even in the US, the pioneer of e-commerce, it has taken 15 years to reach such levels, according to data from the US Bureau of the Census. Online retailers thrive when the good or service can be sampled online, is relatively homogenous, cheap to deliver and reviews can be leveraged. The categories most impacted include books, music, videos, electronics and online services such as travel and banking. Online sales impact the sales and margins of traditional retailers. However, online market share gains are expected to slow going forward as much of the low hanging fruit has already been picked. Grocery, retail services and food services should largely be unaffected by e-commerce.

Discretionary retailers of apparel, cosmetics, jewellery and homeware could be impacted more but could show a degree of resilience where delivery is expensive or there is a need to try or sample the product in person. This especially applies to high value and luxury goods, where the purchasing experience has greater importance. The internet increasingly empowers consumers to comparative research before they make their purchase and increasingly influences on in-store sales. Whilst on-line sales have impacted market share of bricks and mortar retailers, they have seen sales grow at a modest pace in absolute terms because of the strong growth in total retail sales. According to Morningstar, ongoing economic growth, population growth and increasing disposable income, combined with the ability to replace struggling tenants with stronger categories and the ability to gain market share from high street shops should largely offset the negatives for mail owners.

According to Morningstar research the following retail REITs have strong competitive advantages and are attractively priced:

**Westfield Corporation**
Following a major restructuring in June 2014, all of Westfield’s assets are in the US and UK, (70% and 30% respectively) with the first European asset in Milan currently under development. Westfield owns stakes in large (regional and super regional) shopping malls, but its strategy is to divest more of the regional assets and focus capital on the destination style super regional assets. The bulk of income comes from rent receipts, but the company has very material operations in development and the management of properties for third party investors. In this regard, there is significant value in the firms USD 11.5bn current and future development pipeline, which is not fully reflected in the current share price. Significant value should also be created from the further densification of its major London sites.

**Federation Centres**
Federation Centres (Federation) merged with Novion in June 2015 creating the second largest Australian retail REIT by asset value. Federation’s portfolio covers the full retail spectrum, unlike its peers that focus on a just a part of the retail spectrum. Its assets are split 61% super-regional and regional malls, 27% sub-regional malls, 6% neighbourhood malls and 6% outlet centres. Near term growth will mostly come from underlying rent growth and reduced overhead expenses as merger synergies are captured. Medium term growth should come from development, with the company having a development pipeline of AUD 3.1bn.

**Wharf Holdings**
Wharf Holdings (Wharf) is the leading commercial landlord in Hong Kong, with its flagship retail assets (Harbour City and Times Square) being the most productive retail malls in the world. These substantial assets are destination malls attracting both locals and tourists alike, and account for 9% of Hong Kong’s total retail sales. Growth over the medium term will increasingly come from mainland China, with the new Chengdu International Financial Square (IFS), Chongqing IFS and Changsha IFS. Wharf’s exposure to China residential adds to risk but this has been over played, according to Morningstar, providing and attractive entry opportunity.

**CapitaLand Mall Trust**
CapitaLand Mall Trust (CapitaLand) owns a portfolio of malls around Singapore, located in densely populated areas close to mass transport hubs with high footfall. Non-discretionary products and services such as food and beverage drive repeat customer business and account for 30% of gross income. The attractive locations of its assets underpin the view that rents and high occupancy will be resilient over an economic down-cycle. Unemployment in Singapore remains below historical averages and income growth is steady. Plaza Singapura on Orchard Road, a prominent shopping district, and Raffles City, in the central business district, are well positioned to benefit from rising tourism.
Global Shopping Malls

Table of Global Retail REITs

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Tanger Factory Outlets</td>
<td>US</td>
<td>33.90</td>
<td>-8.7%</td>
<td>41.00</td>
<td>21%</td>
<td>36.57</td>
<td>8%</td>
<td>0.6</td>
<td>40.6</td>
<td>30.3</td>
<td>30.5</td>
<td>6.4</td>
<td>44%</td>
<td>3%</td>
<td>22%</td>
</tr>
<tr>
<td>Westfield Corporation</td>
<td>US</td>
<td>10.16</td>
<td>12.0%</td>
<td>11.00</td>
<td>8%</td>
<td>10.47</td>
<td>3%</td>
<td>0.9</td>
<td>N.A.</td>
<td>19.5</td>
<td>19.2</td>
<td>1.9</td>
<td>63%</td>
<td>2%</td>
<td>10%</td>
</tr>
<tr>
<td>Federation Centres</td>
<td>Australia</td>
<td>2.81</td>
<td>-1.4%</td>
<td>3.10</td>
<td>10%</td>
<td>3.02</td>
<td>7%</td>
<td>0.8</td>
<td>15.1</td>
<td>14.2</td>
<td>14.2</td>
<td>1.1</td>
<td>143%</td>
<td>29%</td>
<td>7%</td>
</tr>
<tr>
<td>Wharf Holding</td>
<td>Hong Kong</td>
<td>44.95</td>
<td>-19.5%</td>
<td>53.00</td>
<td>18%</td>
<td>54.09</td>
<td>20%</td>
<td>1.0</td>
<td>11.9</td>
<td>11.1</td>
<td>11.1</td>
<td>0.4</td>
<td>-61%</td>
<td>9%</td>
<td>4%</td>
</tr>
<tr>
<td>CapitalLand Mall Trust</td>
<td>Singapore</td>
<td>1.94</td>
<td>-3.9%</td>
<td>2.40</td>
<td>24%</td>
<td>2.20</td>
<td>14%</td>
<td>0.9</td>
<td>11.4</td>
<td>17.5</td>
<td>16.6</td>
<td>1.1</td>
<td>-32%</td>
<td>5%</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td><strong>-4.3%</strong></td>
<td><strong>16%</strong></td>
<td><strong>10%</strong></td>
<td><strong>0.8</strong></td>
<td><strong>19.8</strong></td>
<td><strong>18.5</strong></td>
<td><strong>18.3</strong></td>
<td><strong>2.2</strong></td>
<td><strong>31%</strong></td>
<td><strong>10%</strong></td>
<td><strong>9.7%</strong></td>
<td><strong>4.8</strong></td>
<td><strong>10.3%</strong></td>
<td><strong>7%</strong></td>
</tr>
</tbody>
</table>

Source: Bloomberg. Data as at 5 October 2015.
BEst = Bloomberg Estimates
BBG = Bloomberg
MS = Morningstar
UAE Real Estate

> Residential real estate market stabilizing after volatility in H1 2015
> Office market continues to perform – oil price and interest rates potential market movers
> Dubai and Abu Dhabi market leading the trend, with other Emirates following

UAE real estate has continued to display a level of uncertainty in 2015. The sectors experiencing the highest levels of volatility are residential units, villas and apartments, as well as hospitality. Supply in both these sectors has increased while demand has remained static. What has been noticeable from the beginning of the year is that sentiment in the real estate market has shifted. In Q4 2014, there was debate where the market was heading, some predicting another significant correction, as in 2008-09. We are pleased to report that this has not been the case and as confidence is gained in a stabilising market many developers and investors are now starting to actively pursue projects again. The outlook for the rest of 2015 is still not clear and we anticipate further volatility, however there is a growing view from the market that things are set to improve in 2016 and leading up to Expo 2020. Residential leasing has remained stable but growth has been limited mainly due to the increased supply reaching the market in more secondary locations which offer competitive rates. In the commercial sector, sentiment has remained buoyant. Leasing activity has picked up in prime office locations as companies are looking to expand and establish their presence in the region, however we have also witnessed a number of these companies hold off expansion decisions recently as they wait to see whether the oil price will have a significant impact on local real estate. Institutional quality assets are still in limited supply and will continue to hold value. There has been much debate recently over whether the potential threat of interest rate increases on the horizon will have a negative impact on the UAE real estate market. Interest rate movements typically move real estate markets as the cost of debt affects affordability. However, the large amount of cash buyers in the local market suggests that the effect interest rates will have on UAE real estate may be less than in other more developed markets.

Hospitality figures are reflecting pressure on growth, including higher supply and occupancy levels, the strong dirham (fixed to the USD) and significantly the fall in the Russian Ruble at the end of 2014. Despite these factors, there is growing demand for 3* and 4* hospitality and many developers are now focusing on this sector. With the above market forces identified, the rest of 2015 is expected to be relatively flat to negative. Investors into this sector remain cautious with many adopting a ‘wait-and-see’ approach to acquisitions and new developments.

With the market uncertainty, 2015 has seen a large number of investors, previously focusing on speculative development, now focusing on institutional type assets with longer leases which offer income stability over the short-term. Industrial and education properties, with single, 15yr-plus lease terms, are a good example and these assets remain keenly priced versus some of the more speculative opportunities.
Dubai
Apartment and villa prices have softened in 2015. Apartments have been slightly more affected than villas with significant new stock in more secondary locations bringing market averages down. Over the summer period (July and August) prices have come down around 2%. An interesting trend is starting to show that while transaction values are down on previous years, the number of transactions is increasing which suggests more people are entering the affordable end of the residential market. This is reassuring as these buyers are typically end users who are moving out of the rental market into home ownership. This adds further stability to the real estate market as a whole with a greater number of investors across a wider ranges of income brackets.

Dubai hospitality remains soft with occupancy rates down -1% YoY. Interestingly revenue per available room (‘RevPAR’) has improved significantly over the summer months, after a challenging similar period in 2014 although this may be due to religious holidays over this period and will be better assessed at the end of the year.

The office sector, in contrast, has continued to display resilience to any market uncertainty with strong demand and growth. We have started to see some cautious behavior from some of the larger corporate tenants who, where possible, are waiting to see what impact the oil price will have on rentals going forward. Others, with more immediate requirements, have decided to move ahead and the take up in prime locations is positive. Supply is still coming to the market and may reign in growth rates slightly going forward, however, the actual handover dates for many of these development projects nearing completion is uncertain and therefore has not had as significant an impact on pricing with high demand. Quality A-grade offices in desirable locations are expected to perform well over the next year as there is a lack of quality space for larger tenants. New supply is only forecasted to meet current demand over the next 3 years.

There is growing excitement and activity around the build-to-suit model for alternative asset classes such as industrial, education and healthcare, with longer lease terms. These deals, typically at a lower cost to direct acquisitions, offer investors income stability and capital protection during any further short-term uncertainty.

Source: Reidin.com, August 2015
The real estate market in the capital has been more resilient to market pressures in 2015, when compared to other Emirates. The residential market has been largely stable, softening slightly but notably at a much lesser extent than the equivalent Dubai market, with apartment prices down -3% YTD, and villa prices down -1% YTD. The rental market has also remained stable although some agents are claiming increases by as much as 6% and higher for sought after developments. This stabilized rental market has been a reassuring sign following the removal of the rental caps in Abu Dhabi towards the end of 2013.

The office sector has not seen much movement in rental rates in H1 2015, with landlords of less desirable buildings now considering lowering rentals to lease space. Demand has also been flat with the lower oil price raising concerns of future government spending, stalling many companies’ expansion plans in the short term.

The hospitality sector in Abu Dhabi has performed in 2015, with RevPARs up 4% YoY and occupancy levels up 2% YoY at 74% on average over the last 12 months. We anticipate further increases in average daily rates (ADR) with consistent seasonal occupancy levels; as a result, RevPARs should rise at a similar rate. The level of supply expected to the market over the next three years is over 20% but this is expected to be absorbed by the current demand.

Other Emirates
Similar to how the other Emirates real estate markets benefitted from the positive sentiment in Dubai and Abu Dhabi in 2013-2014, they are now starting to see softening and uncertainty in line with the two larger markets. Sharjah and Ajman, with their close proximity to Dubai have enjoyed the ‘spillover effect’ with people working in Dubai and willing to commute looking for larger, more affordable homes. However, secondary locations in Dubai are now starting to compete with some of these lower rates.
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### Introduction

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### Asset Class Outlook

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