Waking up to reality

Investment Outlook 2016

From the CIO Office
WAKING UP TO REALITY

2016 looks like it will be a very tough year for investors. Policy makers are still actively involved in supporting economies six years after the asset markets started their recovery, yet global growth continues to disappoint. Our advice is to remain defensively invested and wait for true value to appear in the valuation of risk asset markets, before committing to any further significant purchases.

The problem for the world is that it is still adjusting to the reality of weaker global growth and extraordinarily high levels of government and corporate debt. We are struck by the ongoing struggle for consistent global growth to emerge. The last six months has seen another phase of disappointing global economic data releases. Already economists at the World Bank have cut their global growth forecast for 2016 to below 3.0%

Inflation has (worryingly) yet to pick up anywhere close to normal levels. Indeed the world continues to worry about the deflation threat. The recent further fall in the oil price only adds to the disinflationary pressures into the global economy. It is instructive to note that, despite all the quantitative easing and the Fed trying to instil confidence through increasing interest rates, market inflation expectations have fallen back yet again in recent months.

2016 will be different to 2015 even if for only one reason, that the Federal Reserve is already on a path of increasing interest rates. Whilst other central banks are still running easy money conditions, higher US interest rates will undoubtedly detract from global growth. The consequent rise in the dollar coupled with higher rates will add incrementally more risk in the markets.

If there are positives it is that some asset markets have already moved rapidly to discount problems. Amongst bond markets, emerging market debt and global high yield have had serious price drops, bringing them closer to a level that will offer genuine good long-term value to investors. Many commodity markets are at multi year lows. An oil price below $30 must bring a correction in the supply demand equation. It is not if the oil price will ever recover, but when.

In a world that lacks growth we still worry about the performance of global equities. Analysts continue to downgrade corporate profit forecasts undermining what at times seems like relatively low valuations. We continue to be attracted to markets where policy makers continue to be heavily involved in supporting their economies. In both the eurozone and Japan we expect policy makers to come with further waves of quantitative easing. Japan also benefits from having a corporate sector that is much more focused on reform and substantially lifting their returns on capital.

In the emerging world, India is still a standout. Whilst 2015 was a year of disappointment in respect of reform the country is still slated to achieve medium term growth of 7% per annum. It is also one of the few countries that has still the ability to cut interest rates consistently over time. We expect China to remain a perennial problem for the markets, although we don’t believe the very negative views that are expressed by some commentators.

In MENA markets, equities have fallen a long way but remain on valuations that are well above previous distress levels. It doesn’t mean that we necessarily see valuations back to previous floor levels, but that is the kind of value we seek given that the region is facing tremendous challenges from low oil prices, elevated fiscal deficits and weak growth. The good news is that necessary reform programmes have been accelerated, which can only be good news for the region over the long term.

The key to this year is the ability for policymakers to keep the confidence of the markets. If investors believe that actions of governments and central bankers will encourage an acceleration of growth, investor returns should be solid. If investors lose confidence in policy makers risk markets will be in trouble.

Gary Dugan
Chief Investment Officer
Emirates NBD Private Banking

If there are positives, it is that some asset markets have already moved rapidly to discount problems.
More importantly, the overall oil market balance will be tighter in 2016 than it was last year.

Global Economy
We believe the global outlook is not as bad as some make out.

Global Equities
In 2016, we encourage investors to invest with reference to sectors or stock specifics and less to the countries.

Global Economy
Higher domestic interest rates and increased public sector borrowing likely to slow private sector borrowing.

Bonds
Our approach on portfolio investing for 2016 is purely income generation as we see limited opportunity for capital gains in this current macro environment.

Oil Prices
More importantly, the overall oil market balance will be tighter in 2016 than it was last year.
UAE REAL ESTATE
2016 outlook for local real estate remains cautiously optimistic, with buying opportunities coming to market after recent weakness.

INDIA
A combination of better corporate earnings and expectations of government measures to boost growth in the next fiscal year’s budget would typically lead to some good absolute returns.

CURRENCY
With the US economy likely to remain the positive standout, the dollar is likely to benefit and risk currencies are expected to remain subdued should geopolitical unrest increase.

CHINA
We believe the risks are overblown and expect that international investors will prefer to take on China exposure through international stocks that have a large relationship with China rather than through domestic equities.

GOLD
We see upside risks to the gold price in 2016.
We think that the macroeconomic picture at the start of 2016 is less negative than that suggested by the way markets have started the New Year.

Although 2016 has begun with more than the usual degree of volatility, there is a little more certainty about some of the key issues facing the world. This should provide some reassurance that 2016 could actually be a year of progress despite the volatility experienced in the first weeks of January. In particular with the path of US interest rates in 2016 looking more certain, with ‘lift-off’ now behind us, the question becomes how much the Fed will raise rates instead of whether they will at all. And in Europe the impending sense of crisis and doom that characterised the start of previous years is no longer with us.

However, financial market volatility early in the New Year does suggest that there is a significant disconnect between broadly positive macro developments and the financial markets response.

The fact that the era of zero rates is behind it should actually create confidence in the US economy. Markets are now likely to find an anchor in accommodative monetary policy outside of the US and from recovering US-led global economic growth.

Divergent monetary policies need not be destabilising so long as the communication of policymakers is effective. We are also inclined to think of ongoing oil price softness as carrying the potential to boost demand, rather than seeing deflationary risks in it.

The Fed tightened monetary policy by 25 bps in December, increasing the Fed funds target range 0.25% – 0.50% and the discount rate to 1.0%, with the vote being unanimous. The FOMC said that labour market slack had diminished ‘appreciably’ and said that it is ‘reasonably confident’ inflation will rise to 2% in the medium term. The Fed maintained that future adjustments will be ‘gradual’ although notably the dot-plot was little changed, still suggesting four quarter point hikes this year, while the median long run funds rate is still seen at 3.5%. The minutes of that meeting, however, released in January suggest that the decision to tighten was a closer call than many at the time realised.

Although US non-farm payroll data was much stronger than expected in December, the absence of earnings growth in that month has arguably reduced the prospects for the FOMC following up on the first rate hike quickly this year. However, in reality it will probably take a few weeks for the significance of this data to be properly understood, such is the amount of uncertainty in other parts of the world. US Q4 economic growth is admittedly looking at risk of falling back towards 1.0%, but the momentum in the labour market growth around the turn of the year suggests that Q1 growth could be quite strong. For choice therefore we prefer to stick with our core
assumption to expect four rate hikes over the course of this year, starting in March and consistent with the Fed’s dot plot.

Furthermore, we suspect that with the US closing in on full-employment an inflationary jolt could surprise and be quite sudden, especially once oil prices begin to find a base. The Presidential election in November might also be an argument for front-loading rate hikes into the early part of the year.

To some extent we feel there is a disconnect between macroeconomic developments and financial markets which continues to confuse investors. A large part of this is to do with China, whose economy has been slowing for some time but whose markets are struggling to come to terms with it, and with authorities that are finding it difficult to manage.

In relation to oil as well, while weakness should be a positive for growth overall, the markets are viewing it as deflationary. The repercussions for US financial markets are often negative in the first instance which has the effect of hurting broader sentiment as well. Hence, while the data flow paints a relatively convincing story of US recovery, the market reaction appears unconvincing. Ultimately we suspect the conundrum will resolve itself positively, but it might take a while.

When it comes to the ECB (European Central Bank) and the Eurozone, what happens in the US could prove very important this year. We suspect the ECB was hoping that in 2016 the Fed and the Bank of England (BoE) would do much of the work for it, by raising rates and thereby engineering a weaker euro. However, if this scenario does not play out quickly then the ECB will be under pressure to ease policy further probably in March. When it comes to the BoE it is a different story, with the Brexit referendum perhaps the most important event on the horizon. Latest developments increase the odds of the poll being taken in the summer. The associated uncertainties of this vote could put lots of decisions on hold, with more focus on the UK’s twin deficits, especially the size of its current account deficit.

This comes on top of the fact that the pace of UK activity has slowed in recent quarters raising questions about how quickly the Bank of England will begin normalising interest rates.

As far as the Bank of Japan is concerned we view the tightening in monetary policy as a result of the strong JPY since December as undoing a lot of the stimulus that is already in the system. That being the case, and with GDP flat, production declining and inflation showing few signs of meeting the 2.0% target, we suspect that pressure will soon be on the BOJ to further expand its balance sheet, possibly as early as the end of this month.

Divergent monetary policies need not be destabilising so long as the communication of policymakers is effective.
Oil consumption growth should return more to trend like levels of 1.2m b/d (compared with the 1.8m b/d estimated in 2015) with the fastest gains coming from Asia, the Middle East and Africa. There is still substantial room for expansion in Indian and Chinese oil demand, not to mention some of the smaller Asian emerging markets.

Non-OPEC supply should also show signs of weakness. US oil output surprised on the upside in 2015 as producers were able to maintain volumes thanks to profitable hedges entered prior to the sharp decline in prices. In 2016, there are likely to be fewer of these hedges in place and existing ones will be expiring, meaning producers will be exposed to a far less accommodative futures curve than they saw last year. Expenditure cutbacks will impact across the industry as there is prioritisation on the most profitable fields.

By contrast, we expect oil supplies from OPEC to expand in 2016 as the producers' bloc captures more of the global market. Major producers in our region will maintain production at elevated levels and have committed to keeping capital expenditure intact.

Iran should also re-emerge onto global oil markets as a major exporter as some point in 2016. We maintain our outlook for an additional 500k b/d of oil from Iran on average this year, with most of the new supply likely to come in the second half. Even with these increases from OPEC, we still anticipate a tightening in the overall market balance, helping to support prices.

Most importantly, the overall oil market balance will be tighter in 2016 than it was last year.

Oil prices

In the near term, commodity markets are likely to remain under considerable pressure with little prospect of any meaningful rallies. We do think that there is eventual upside to commodities markets in 2016 but that it won't start to make itself felt until the second half of the year. Central to this story is our outlook for oil.

In short, we expect oil to recover from the levels where it ended 2015 as fundamentals begin to act as a supportive factor, rather than the drag they have been for the last 18 months. We expect Brent futures to end the year above USD 60/b, bringing the total year average to USD 55.25/b. NYMEX WTI, the US benchmark, should follow a similar pattern and average just over USD 50/b for the year.

Considering how depressed the market started 2016, these forecasts may appear ambitious. However, USD 55/b for Brent on average in 2016 is only a 3% increase on where prices averaged 2015. Markets will be characterised by strong volatility, which is actually a return to normal conditions for oil compared with the pattern we experienced in 2010-14.

Tighter market should mean higher prices

There are several dynamics that we feel will shape the trajectory of prices in 2016. Most importantly, the overall oil market balance will be tighter in 2016 than it was last year. We expect the global surplus to move from an average of over 1.5m b/d in 2015 to 0.6m b/d this year, a considerable drop in excess supplies. There is little consistency in past performance when assessing the effect on prices from a 1m b/d tightening of global supplies but keeping in mind the market's current focus on stockpiles, a sustained draw in global stocks should help to generate a switch to a more positive sentiment in oil.
Only way is up for sentiment in medium term

Market sentiment toward oil deteriorated throughout 2015. Net long managed money positions for WTI ended the year at their lowest level since 2008 while shorts moved to record highs. With a market so one-sided, it raises the question of who is there left to sell to? Prices for physical oil may have limited downside in the near to medium-term as for many regions are already producing well below breakeven prices, which should prompt the shut-ins we discussed above. When this process starts, which we acknowledge still is a big if at this point, the market may need to quickly shift and cover its shorts, sparking a rapid and intense rally. But in light of the current surplus conditions, we expect the recovery to be grinding and gradual, rather than short and sharp.

There are some risks that could derail our projection for oil prices. First, and perhaps most obvious, is whether China’s slowdown disappoints markets. To start the year, weak PMI numbers out of China set a somber tone to markets, in turn impacting oil prices. But as we have argued several times in the past, looking at actual China oil data presents a far better picture. Apparent oil consumption growth in China (measured by net imports and refinery throughput) averaged 9.9% up to the end of October, an enormous gain on year earlier levels. Chinese consumers are driving more and buying bigger cars, sales of SUVs were up 50.9% year-to-date as of the end of November.

A second major risk is if supply surprises on the upside as it did this year. Oil production in the US continued to increase until the middle of 2015 even as prices continued to grind downward. The reaction of shale oil producers to any rally from current levels is unknown but if they did resume output then we would expect a relatively sudden rise in US oil production given the dynamics of producing shale oil. In 2015, several major producers beyond the US also raised output significantly, namely Russia and Oman more locally.
In 2016, we encourage investors to invest with reference to sectors or stock specifics and less to the countries.

Recent years have shown the folly of investing in equities solely with reference to countries rather than sectors or individual companies. In 2015, the gap between the best performing sector consumer staples and the worst performing sector- energy was 29 percentage points. When you buy an investment in a country or regions’ equity market, you often buy investments in all sectors irrespective of their fundamentals or trading prospects. You would hope that the portfolio manager of a mutual fund invested in just one country will switch out of what are likely to be poorly performing sectors. However, managers tend to hug the benchmark, which means they often invest in sectors even with poor prospects because they don’t want their portfolios to look too different from the underlying index.

European Banking stocks have underperformed in 2015 and are trading at a 30% discount on 12 month forward Price to Earnings ratio to the broader market. The sector remains one of the cheapest in Europe. European banks should benefit from an acceleration in eurozone economic growth and loan growth. We believe the Bank’s capital raising seen in 2014/15 should come to a conclusion, and many of the regulatory pressures seem priced into share prices.

We expect the global healthcare sector to see double-digit returns in the coming years. The sector benefits from the positive newsflow of continued innovation through the commitment of companies to Research and development spending, leading to new drug launches. Developed market governments are allocating more to healthcare, and emerging market consumers have a higher disposable income, which is increasing their willingness to spend on higher cost drugs.

The healthcare sector has experienced depressed valuations over the backlash from the US Democrat Party’s crusade against higher drug prices and Valeant pharmaceutical’s accounting scandal. Consequently, the sector trades at 16.2X 2015E earnings (vs. the five-year peak of 20x in July 2015). Exposure to quality companies with strong drug pipelines will provide a defensive earnings stream since consumers aspire for quality medical care regardless of the economic cycle.

The global technology sector should continue to perform though trading on high valuations, as the expected exponential earnings growth, should justify the value premium. With the shift to digital marketing, social media and home entertainment will benefit and with the shift to online retail (the best performing sector in 2015 +83%), online retailing companies are expected to continue their positive trajectory.
Japan a country standout

For those investors still looking for a country investment Japan probably remains the standout with some very specific country factors. Despite the good performance of Japanese equity markets in 2015, there should be more return in store for investors. Amongst developed markets Japan has the highest estimated corporate earnings for 2016 and valuations are below other developed markets and the ten-year trend averages (14.2X 2015E Earnings).

Japanese equities have been the best performing major developed market since 2013. Margin expansion and top line growth should drive corporate earnings growth and stock market returns. Crucially the market is seeing a strong improvement in returns on capital. The return on equity (ROE) has improved for the TOPIX from 6% in 2012 to 8% in 2015. Corporate reform is showing signs of success with the challenge lying in converting the cash in balance sheets to capital expenditure. The Bank Of Japan’s purchase of ETF’s tracking the JPX-Nikkei 400; (the JPX-Nikkei only invests in companies that have high ROEs) reinforced the pressure on companies to improve their ROEs.

MScI Total Returns 2015 (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>2015 (%)</th>
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<tbody>
<tr>
<td>US</td>
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</tr>
<tr>
<td>CHINA</td>
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</tr>
<tr>
<td>EUROPE</td>
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<tr>
<td>EMERGING</td>
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Source: Bloomberg

The weakness of the euro will improve the competitiveness of European companies in global markets.
It is too easy to be dismissive of bond markets as offering little value in the face of a rise in US interest rates. Rises in interest rates at least in the early stage of rate tightening are typically something to be feared by bond markets. However this time could be different. There is no strong conviction in the market about how high US interest rates will be increased; indeed with recent problems in China and general nervousness in markets that may percolate into the global economy, there is still a small risk that the Fed may do nothing more or indeed be forced to cut rates.

Bond market returns in 2016 will largely be driven by the success or otherwise of central banks to deliver the inflation that their mandates require. To date the markets have been much more skeptical than the policy makers about the success of the massive waves of quantitative easing to create inflation. The recent fall in oil prices will only make the gap between current inflation rates and central banks’ targets even harder. The major difference between this year and any of the previous seven years is that the Federal Reserve has already started to raise rates because they are more convinced than ever before that US inflation is on the right path to the Fed’s target. The financial markets remain skeptical but it has to be recognised that there has never been such a significant risk that (for a change) the central bankers could be right.

The good news for investors looking for opportunities in the bond markets, as 2015 came to a close some sub sectors of the global bond markets sold off aggressively. We believe this has created some selective opportunities.

European High Yield Debt
While US companies continued to actively re-leverage their balance sheets, European companies have carefully managed their balance sheets in recent years to the benefit of bond-holders. The profitability of European companies shows some tangible signs of consistent improvement. Given the steady improvement in the Euro area GDP growth, we expect European corporate profit margins to continue to improve. And while European managements might eventually take advantage of low yields to issue more debt and start actively re-leveraging their balance sheets like their US counterparts, we continue to expect such a shift to occur only gradually. The ECB should provide support for the market by maintaining generally very loose monetary conditions for much of 2016.

Emerging Markets
Investors will have to be patient investing in the emerging market bonds in 2016. Valuations are low and offer opportunity but a number of major countries still face significant challenges. In Brazil proceedings continue to impeach the current President, which combined with ongoing poor economic news doesn’t help the market. In China it seems everyone is waiting for an impending disaster in the bond market. However it should be borne in mind that the authorities have many tools to support the bond market such as a further easing of monetary conditions. Of the major emerging countries India has probably the best backdrop with a possible further easing of monetary conditions as the fall in oil prices feeds through to low inflation. For more immediate investment opportunities we see value in Mexico, Chile, India and Indonesia.
Middle Eastern debt markets
Concerns over country fiscal imbalances and deficits are likely to continue to put downward pressure on bond and sukuk prices. Tighter liquidity conditions stemming from the retrenchment of government spending and weaker growth have contributed to the widening of bond spreads. A further challenge for the markets is that we expect to see deluge of supply on the primary market as well as potentially some downgrades by the rating agencies, which could weigh on sentiment and increase the cost of refinancing for corporates. We do expect to see governments in the region such as the Kingdom of Saudi Arabia, issue debt in the international markets to bridge their funding needs. GCC Banks are also likely to opportunistically use any strength in the markets to issue debt to reinforce their balance sheets.

Europe
European companies have carefully managed their balance sheets in recent years to the benefit of bond-holders.

China
Authorities have many tools to support the bond market such as a further easing of monetary conditions.

Emerging Markets
Investors will have to be patient investing in emerging market bonds in 2016.

The good news for investors looking for opportunities in the bond markets is that as 2015 came to a close some sub sectors of the global bond markets sold off aggressively.
Despite the nearly 50% decline in oil prices in 2015, we estimate growth in the GCC remained relatively robust, averaging 3.4% on a nominal GDP weighted basis, as slower non-oil sector growth was offset by a substantial 4% rise in GCC oil production (excluding Bahrain and Oman).

As OPEC is expected to maintain its strategy of protecting market share in the face of lower oil prices, we expect oil production to remain around current levels in Saudi Arabia and rise further in the UAE, Oman, Qatar and Kuwait. This should continue to underpin GDP growth in the GCC in 2016.

However, non-oil growth is likely to slow this year for several reasons. Although governments in the region are not expected to cut spending aggressively in 2016, the fiscal policy stance has become much more prudent across the region. Non-oil income will be raised through higher fees and taxes (including new land taxes in Saudi Arabia and higher corporate income taxes in Oman), while households will face higher utilities and energy costs as subsidies are reduced across the GCC.

Low oil prices and increased geopolitical and economic uncertainty have also had a negative impact on both consumer and business confidence, and this has been reflected in declining regional stock markets.

- Growth is likely to slow this year, as governments are more prudent with fiscal policy.
- Banking sector liquidity remains challenging as government deposits under pressure and Fed hikes rates this year.
- Higher domestic interest rates and increased public sector borrowing likely to slow private sector borrowing.
With increased uncertainty about the global economic outlook reflected in volatile global markets at the start of this year, households and corporates are likely to remain cautious about spending and investment decisions in the near-term at least.

Interbank rates in Saudi Arabia and the UAE rose sharply last year, as liquidity in the banking sector tightened on lower government deposits and increased public sector borrowing to finance budget deficits. We expect liquidity conditions to remain challenging this year, as although oil prices are forecast to recover from current lows, the average oil price is expected to be similar to 2015 (USD 55/b for Brent).

Furthermore, we expect the Fed to hike at least another 75bp, and possibly another 100bp, this year which will keep GCC interbank rates on an upward trajectory. In 2015, most banks absorbed the higher cost of deposits to a large extent, but these are likely to feed through to increased borrowing costs for consumers and corporates in 2016. Private sector credit growth may also be constrained by increased government borrowing as authorities seek to partially finance budget deficits from debt issuance.

Nevertheless, we still expect non-oil sectors in the region to expand in 2016. Manufacturing will be supported by increased oil production, as was the case in 2015, while government spending on key infrastructure will continue, particularly in the UAE and Qatar. Even in Saudi Arabia, where the government announced a -13.8% cut in budget spending for 2016, the authorities have indicated that housing, public transport and infrastructure projects that have already had funds set aside in previous years will continue as planned, in addition to the funds allocated in the 2016 budget.

In the UAE and Qatar, projects related to transport and tourism infrastructure ahead of Expo 2020 and the 2022 FIFA World Cup are also expected to go ahead. Indeed the Emirates NBD Dubai Economy Tracker surveys showed the construction sector outperforming travel & tourism and wholesale & retail trade in terms of activity and order growth for most of last year.

Export-oriented sectors, including tourism & travel services, will continue to face the headwind of a strong USD through 2016, as US interest rates rise. Surveys indicated that margins were under pressure last year as firms cut prices to remain competitive, and this is likely to remain the case in the coming months. On a more positive note however, the inflation outlook remains benign, with import costs contained and transport costs easing as fuel prices are liberalised. Lower housing costs are also starting to feed through to the official inflation index in the UAE, and we expect inflation to average 3.5% this year from an estimated 4.0% in 2015.

**GCC REAL GDP (%YoY)**

- 2012: 6.0%
- 2013: 3.2%
- 2014: 3.4%
- 2015E: 3.4%
- 2016F: 3.2%

*Nominal GDP-weighted average. Source: Bloomberg*
Sovereign bonds is the largest segment in the GCC bond universe, accounting for one third of the total outstanding amount. In addition, the GCC market includes a significant number of government related issuers that have their credit quality directly linked to the government’s rating.

Going into 2016, we are optimistic about the performance of sovereign bonds albeit not without material downside risk in the immediate quarter or two. Our confidence in the medium term performance stems from increasing budgetary discipline and pace of reforms in the region. In the interim, performance of the GCC sovereign bonds will equally be affected by fundamental (rating downgrades) and technical (increasing supply, falling local demand) factors.

High budget deficits to drive substantial new supply

As per the latest budget announcements, total budget deficit of GCC sovereigns is likely to be around USD140bn in 2016, highest on record in absolute numbers. This may increase further if oil prices linger around USD 30/b for longer. In addition the budget deficit could also be higher if actual expenditure exceeds the planned budget as has generally been the case with Saudi Arabia recently.

Beyond 2016, budget deficits may reduce via introduction of taxes and cutting down of expenditures, including subsidies. As of now, budget deficits are likely to be funded by liquidating foreign reserves, privatisation of government assets and by raising new government debt.

GCC government’s public debt is projected to increase by circa USD112bn in the current year. We expect at least half of this to be funded by bonds as governments would endeavour to reduce the strain on liquidity in the local banking system.

Assuming a 60:40 split between hard currency and local currency, we expect new USD denominated bond supply of circa USD36bn this year. However, there is some downside risk to our projection from the possibility of the governments tapping deeper into the overseas syndicated loan market or using private placements with international investors instead of fronting the capital markets’ volatility. For example, Qatar is currently in the process of signing a USD5.5bn syndicated loan deal, possibly with several Japanese banks.

Declining GCC sovereigns credit quality albeit still high by the global standards

GCC sovereign creditworthiness has declined since the onset of oil price rout and sovereign ratings have been downgraded to an average of ‘A+’. That said this should be seen in light of the fact that only circa 53% of global sovereign ratings are in investment grade and ‘B’ category rated sovereigns

Tighter liquidity in the GCC banking system

Liquidity in the GCC banking systems has reduced as oil revenue related deposits decline and borrowings from the governments and related entities increase. Loan-to-deposit ratios have crept up higher in all GCC countries. In KSA it is close to 88% (vs guidance of 85%) while in UAE it is close to 103% vs the central bank guidance of 100%. This has reduced availability of access liquidity to deploy in public bond investments. The reduction in local demand for the GCC bonds is likely to add to the pressure on bond prices.
have generally made up the single-largest cohort in the global sovereign bond market.

Four out of the six GCC countries still remaining in the ‘Aa’ category, should retain international investors interest.

**GCC credit spreads getting cheap on relative value**

GCC sovereign bonds have begun to look cheap on relative value after an average 68bps widening in credit spreads over the last year. BBB- rated Bahrain bonds are cheaper than even BB+ rated Brazilian or Russian bonds of the same tenure. CDS spreads on GCC sovereigns have increased over 300% in the last one year when, in-fact, the actual debt at the sovereign level remains minimal.

**CONCLUSION**

We expect GCC sovereign spreads to widen further predicated on the basis of high new supply, continued rout in the oil prices, increasing budget deficits, rising USD rates, falling liquidity in the GCC banking sector and the generally prevalent risk aversion. We expect total returns for the full year to remain positive.

Our confidence in spread tightening in the second half of the year is based on an expectation of oil prices moving towards USD50, increasing pace of fiscal reforms, inflow of cheap capital from Eurozone and Japan and finally the relative value of the GCC bonds in view of their high credit ratings.

Budget deficit could be higher if actual expenditure exceeds the planned budget as has generally been the case with Saudi Arabia recently.

**BAHRAIN**

Already raised USD1.5bn in November last year and could likely approach the market again this year.

**UAE**

UAE has no material need to raise debt for funding deficits, however the government plans to tap the market to support economic growth and fund infrastructure assets in preparation for the Expo 2020. Emirate of Sharjah is already in the market this month with a benchmark sized dollar denominated offering. Abu Dhabi and Dubai will likely visit investors during the year.
MACRO HEADWINDS STALLING GCC MARKETS, WHEN WILL FAIR WINDS BLOW?

In the MENA equity markets, 2015 felt far worse than the market return data shows.

Up until July 2015 the markets held up relatively well as the oil price held in close to $60. However as investors start to recognise that $60 marked the top for the year and that $30 was beckoning, equities fell precipitously.

We find ourselves pulled between two scenarios for equities in 2016. One that sees persistent oil price weakness dragging down the equity market still further, a second more positive view that sees a building recovery in the second half of the year based on a stronger oil price and the benefit of ongoing structural reform.

The bull case

The Bank’s commodity analyst envisages that some order will be brought to the oil market as we approach the end of the year leading to some strength of the oil price. Certainly if oil hit the $60 level the market would be encouraged and equities would rise materially higher. However whilst all the focus is on the oil price, to us the structural changes underway in response to the challenges of a low oil may be an even more positive factor for the major GCC economies and markets in the medium term.

Structural change brings potentially two positive factors to bear on the markets an economic one, and a financial markets change. The lowering of subsidies and a more determined effort to encourage the non-oil private sector are changes that should accelerate the reform of GCC economies. $100 oil had led to too many countries not pushing hard enough to make the shift away from the dependence on oil, $30 oil has focused the minds in a positive way. The development of the non-oil private sector opens the door to much greater depth to the financial markets. Less public ownership of the economic base of the economy allows for more IPOs and debt issuance from a variety of issuers. A greater scale of financial markets will increase the weighting of MENA markets in financial sector indices encouraging more foreign investment in the region and potentially higher valuations.

The bear case

If we are wrong on a recovery in oil prices then the GCC equity markets face a very difficult 2016. It is already well recognised that liquidity is tight in the region which tends to lead to weaker economic growth. Should the oil price remain anchored around $30 liquidity conditions would be tough with an inevitable rise in market interest rates. The dollar’s strength will undermine the region’s competitiveness leading to the risk of price deflation and a further fall in corporate profits. One of the current key supports of the market is the dividend yield. However investors will be mindful that in the stress of the Dubai crisis in 2012 dividends were cut or passed.

Whether you take a bear or bull view of equities, it should be recognised that GCC equity prices have had a significant correction and valuations are becoming more compelling. Given the very low oil prices and difficult fiscal situation with government spending in many countries still not matched by revenues the risk is that markets trade at a very low valuation relative to history before they rebound. Price to book valuations and price to earnings are all low by historical standards.

GCC markets have to be evaluated in light of oil prices remaining low for longer. The GCC indices remain strongly correlated with oil price movements, since the economies are largely dependent on oil production. Sentiment and liquidity remain dominant factors. Although the majority shareholding of some banks and petrochemical companies is sovereign-backed, trading remains retail-driven.

We believe that large-cap and high-dividend yields are factors that will be successful in 2016.
How would we position GCC equity portfolios?

We believe that large-cap and high-dividend yields factors will be successful in 2016. Equity valuations are becoming more compelling versus local bonds as yields creep above bond yields: Some sectors and select companies (cement, petrochemical, telecom) yield in excess of 8%. However, we would caution investors to ensure that they are not investing in value traps. High dividends have to be sustainable based on a strong business model with good cash flows.

We reiterate our preference for the UAE markets over Saudi Arabia and Qatar, with their lack of exposure to petrochemical stocks and where the underlying economy has a larger exposure to the non-oil sector. The opening of the Etisalat shareholder base to foreign ownership and inclusion in the MSCI Emerging market indices has been a large contributor to the Index.

We would initiate or add to GCC equity positions as soon as we see clear bottoming of the oil price and also when geopolitical tensions in the region recede. We maintain a preference for high-quality companies with sustainable cash flows, such as the logistics sector, as well as for telecom and consumer stocks. Consumer staples and telecom will benefit over the longer term from the favorable regional demographics of a young and growing population. For the moment 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.
NO MAJOR SURPRISES

The final quarter of 2015 showed no major surprises in terms of movement in sentiment across the UAE real estate sectors, with the market largely continuing trends witnessed in the previous quarters.

The residential market has continued to show a gradual softening across the United Arab Emirates, albeit in line with the majority of commentator expectations, a trend which is likely to continue into the early part of 2016. There is a general consensus from market monitors that the decline in residential values and transactional volumes is attributed to a combination of increased supply and reduced sentiment. The sustained delivery of apartment and villa developments since the market’s recovery, post 2008-09 financial crisis, has now seen a large number of residential developments and master-planned projects completed and delivered to market. This has placed pressure on residential prices. Official supply has started to slow in 2015 Y-o-Y.

As a general comment, the interest rate upward movement in the US is unlikely to have a significant impact on institutional investment into local real estate as the spread between real estate yields and debt remains healthy. Tightening availability of debt in local markets is having more of a negative effect on UAE real estate than the increase in interest rates.

Dubai

Apartments and villas continue to show signs that the correction in the residential market is still taking place, and looking likely to move into the 2016. Market commentators have suggested that the market-wide dip in residential values tends to fall in the region between 10-15%, depending on data catchment. Further evidence from Dubai’s Land Department also supports this view, reporting a decline in total transactional volumes and values by 33% and 28% as of November 2015 in comparison to the same time period in 2014. This clearly evidences a drop in demand for residential units across Dubai in 2015 which links back to negative key macroeconomic indicators over the same period.

Rents across Dubai slightly down but remain less affected than prices over the 12 month period in 2015. There are still a few areas showing signs of growth including...
Jumeirah Village Circle (JVC) and Jumeirah Village Triangle (JVT) which have both benefited from infrastructure improvements and the addition of community retail. This has drawn tenants into these previously less-established areas who are looking for a combination of affordability and lifestyle.

Dubai’s office sector showed signs of a moderately subdued Q4 in 2015 in comparison to 2013 and 2014, however, demand remains positive for good quality office space in the right location, driven often by business’ expansion requirements or consolidation of satellite offices. The most active market segment continues to flow from the start-up and SME business, whose office footprint tends to fall in the range of 2,500 to 5,000 sq ft units, with expansion from these offices leading the number of enquiries across the market. Larger occupiers, typically linked to the legal and engineering sectors have accounted for larger deals across Dubai (40,000 sq ft+) within 2015. However, as suitable options for value and quality space across Dubai are limited, a number of occupiers have engaged themselves directly with developers to build out customised solutions. Deals such as these can take up to 36 months to meet the market, and perhaps an explanation for the split in activity.

The recently reported transaction of GRDI’s Standard Chartered Building in Downtown, Dubai to Kuwait Investment Authority for a reported AED 650mil (c.USD 180mil) is proof that Dubai remains one of the preferred regional cities for GCC real estate investment.

**Abu Dhabi**

The real estate market in the capital has been slightly more resilient to market pressures in 2015, when compared to other Emirates, notably at a much lesser extent than the equivalent Dubai market, with apartment prices in the down -3% YTD, and villa prices stable with around 1% growth YTD. The rental market has also remained stable although some agents are claiming large increases of +5% for sought after developments. This stabilised 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 seen modest increases in rental rates in 2015 up to 7% for quality stock which remains in limited supply. Landlords holding some of less desirable buildings in Abu Dhabi are lowering rental to lease empty space. On the whole demand has been flat with the lower oil price raising concerns about future government spending, stalling expansion plans for many private companies’ reliant on government contracts.

Similar to the other real estate sectors in Abu Dhabi, the hospitality sector has held its ground in 2015, with RevPARs up 2 % YoY and occupancy levels up 2% YoY at 74% on average over the last 12 months. A decision by the Abu Dhabi Tourism and Culture Authority (ADTCA) to limit the number of new hotel licenses should keep the market buoyant in 2016 by controlling supply.

**Other Emirates**

In previous years, the real estate markets in other Emirates’ surrounding Dubai and Abu Dhabi tend to track these two larger, more established areas, typically with a lag of 6-12 months. Sharjah and Ajman, with their close proximity to Dubai, are also starting to experience negative pressures, especially on their residential markets, as competing, affordable options are delivered in secondary locations within Dubai.

The UAE’s office market in contrast has proved to be more resilient over 2015, with the economy being buoyed by the growth of entrepreneurial business start-ups and SMEs.
FX markets in 2015 have mainly been dominated by three themes:

A. Policy divergence amongst major central banks.
B. Extended slump in Oil prices and commodities.
C. China growth worries, Surprised Yuan devaluation and impact on china trading partner currencies.

It is unsurprising that amongst the major currencies the Canadian dollar was the biggest loser in 2015, followed by Norwegian Krone, which is also increasingly used as proxy to oil market. Note that the JPY and CHF managed to hold ground against a broadly stronger US dollar. This could be attributed to heightened market volatility and risk aversion in third quarter of 2015 as well as markets disappointment on lack of action from Bank of Japan and the Swiss National Bank.

Safe havens such as JPY and gold should benefit and risk currencies are expected to remain subdued should geopolitical unrest increase.
For 2016, we expect the FX markets to be driven by following themes:

A. Policy divergence amongst the central banks but to a lesser extent compared to 2015.

B. China growth deceleration, market volatility & gradual Yuan devaluation.

C. Further weakness in Oil prices and commodities in H1.

D. Escalation in Geopolitical tensions. Not to mention the impact of FED tightening on US and global growth.

Following successful lift off in December, our central view is that we expect the US Federal Reserve to hike the Fed funds rate by 25 basis points in each quarter of first half as labor market improves further and on signs of inflation finally beginning to nudge higher. At the same time European Central Bank’s continued easy policy stance to counter low inflation is likely to be a driver of a weaker euro towards parity in first half of 2016. Even if ECB leaves policy unchanged, the ECB policy rate at -30 bps under Fed hikes will likely weigh heavily on Euro. However, the cyclical economic recovery in the Eurozone should accelerate and pave the way for a EUR rebound in late 2016.

Likewise we see downside risks for AUD and NZD. Both would typically be viewed as some of the most vulnerable currencies to rising US interest rates. Both currencies have wide and positive interest rate differentials which are at most risk of being eroded.

GBP seems to have taken the brunt of selling pressure in recent months due to negative market sentiment related to an early EU referendum and the flip flop by the Bank of England (BOE) on when interest rates could be increased. The UK’s economic growth is expected to remain solid with tight labor market conditions. While the referendum discussion may continue to weigh on sentiment in the first half, we see a high risk of a BOE rate hike sometime in Q2/Q3. Further downside pressure on sterling should therefore be limited beyond 1.45 where we see a long term value in the currency.

The JPY has strengthened after the Bank of Japan’s unexpected and rather disappointing announcement of the policy change to expand the maturity of Japanese Government Bonds (JGBs) it was purchasing. In our view this has greatly reduced the probability of further easing measures over the next few months. Japanese politicians are also wary of a much weaker yen which leads to real wage losses due to imported inflation. We therefore feel that the risks are skewed towards a stronger JPY in 2016 as markets readjust its expectations of substantial policy easing by BOJ. Likely high volatility and flare up in Geopolitical tensions also add weight to our expectations of a stronger JPY towards 1.10 during this year.

China growth deceleration, market volatility & gradual Yuan devaluation – The Chinese economic outlook remains worrisome amidst overcapacity, high leverage and declining exports mainly due to still overvalued Yuan and low global growth. This year we expect the authorities to allow gradual weakening of CNY to 6.75-6.80 (with a high risk of 6.95) to support export growth. This would likely put further pressure on China’s Asian trading partner currencies such as Korean Won, Taiwanese Dollar, and Malaysian Ringgit.

Further weakness in Oil prices and commodities in H1 - Oil prices sold off again during last quarter of 2015 as oversupply continues to mount. So far neither Saudi Arabia and its Gulf partners in OPEC, nor Russia has given any indication of a unilateral production cut for fear of giving up market share. While the market expects a sharp cut in US shale production, it may be balanced out by Iran increasing exports by 500K bpd immediately after sanctions are lifted. We therefore expect Oil prices to remain under pressure in first half of 2016 leading to potential weakness in the Canadian Dollar, Russian Ruble, Brazilian Real and Norwegian Krone.

Similar to oil, most commodity markets continue to face supply glut along with lanquishing demand on account of China slowdown. In our views commodity price weakness coupled with a stronger dollar, and increased volatility in markets would add to renewed selling pressure on Aussie and Kiwi.

An escalation in Geopolitical tensions - Continuation of tensions between Russia and the West, heightened regional conflict in Middle East, Possibility of more Paris-style attacks across Europe, Xenophobia and anger surging across Europe and the United States are some of the geopolitical risks which FX markets could deal with in 2016. Although hard to quantify the likely impact and difficult to forecast, safe havens such as JPY and gold should benefit and risk currencies are expected to remain subdued should geopolitical unrest increase.

Our conviction Ideas this year are:

1. Buy USD Asia
2. Buy USDCNH
3. Short EURUSD, AUDUSD, NZDUSD in first half
4. Long GBPUSD below 1.45
India – further good returns in store if the world can calm down

2015 was a year of hope over delivery for the Indian equity market.

As we look into 2016 the absolute outlook for Indian equities is hampered by global problems particularly in China. The question is whether India’s own fundamentals can overwhelm the headwinds from global problems. A relative judgement is far easier as India’s strong GDP growth, scope for rate cuts and hope for some further meaningful reforms in 2016 should retain investor interest.

Indian equities have been the investment of choice for international investors in Emerging Markets (EM), which has led to India’s outperformance against EM in both dollar and local currency terms. There has also been an increased uptake from domestic investors. The main equity index the Sensex has fallen 7% over one year and trades at 14.3x forward earnings. Earnings growth for the next fiscal year is estimated at 20%. The MSCI EM Index has fallen 19% and trades at 9.5x forward earnings.

There are a number of catalysts for the equity market to at least retain its premium rating in 2016.

There is a hope that the next budget at the end of February will bring further promises of reform and a commitment to greater government spending than previously thought. India has a well known lack of infrastructure. Efforts to improve even basic standards of infrastructure should have a significant payoff of reducing the number of bottlenecks around the country that only add to the medium term inflation.

The recent drop in oil prices that came as a surprise to the markets should provide a further downward surprise to inflation. Lower than expected inflation will give further scope for the Reserve Bank of India to cut interest rates.

The ongoing recapitalisation of state banks should allow for a fall in market interest rates. One of the frustrations for the market has been that although official interest rates have fallen interest rates to the ordinary person in the street have been slower to come down. India really needs to have a stronger credit cycle where consumers, motivated by a stronger economy but also crucially by lower interest rates are prepared to take on more credit. Urban population gross credit growth has been running at just 10% compared to well over 20% in the past.

Structural reform is the perennial hot potato that the government has struggled to meet market expectations on. The introduction of a country wide GST tax which should have been straight forward has been held up in parliament flier busting and the land acquisition bill appears likely to be introduced state by state to get around the political challenges.
Consumption should see a boost from the implementation of the Seventh Pay Commission coming into operation from the 1st January 2016. The pay commission takes place every 10 years and on this occasion covers 4,700,000 central government employees and 5,200,000 pensioners. It has recommended a 23.6% increase in salary, allowances and pension of government staff.

Like 2015 we expect the current year’s GDP growth to be driven by stronger private consumption and Government capital spending. This is positive for infrastructure stocks as well as consumer discretionary.

Auto companies have also been the beneficiaries of low oil and vehicle sales are showing a recovery. Passenger vehicle demand (growth in 2016 estimated >15%) is expected to be strong across product categories, led by new launches. Wheeler companies could witness upgrades on mid market penetration.

Healthcare companies have exhibited strong sales and earnings growth in 2015 and this could continue into 2016 as an increase in per capita income that improves affordability. There are media reports on healthcare companies may be exempt from GST.

We prefer private banks to public sector banks as they do not have the overhang of infrastructure debt and have strong capital bases. The government has already pumped in USD 10 bn to recapitalise state run banks.

If it was just about the Indian economic and market fundamentals alone the equity market would in our view have a positive outlook. A combination of better earnings in the Q3 FY2015 results season and market expectations of measures to boost growth in the next fiscal year’s budget would typically lead to some good absolute returns. However the market is also having to contend with negative sentiment from the problems in China. The INR has been under some downward pressure against the dollar although the currency has performed admirably well versus other emerging market currencies. Given the relatively closed nature of the Indian economy a weaker Chinese yuan is not going to see a significant diminution of India’s GDP growth. Manufacturing sector exports are fractional as a percentage of GDP.

Indian equities have been the investment of choice for international investors in Emerging Markets.
**HOW BAD IS CHINA?**

China is important. Ranking as the second largest economy in the world, China today is crucial to the development of global growth. Between 2007 and 2014 China saved the global economy.

The massive increases in government spending and the tremendous increase in housing activity all contributed to pushing Chinese growth to the 10% level, in support of a global economy that was on its knees. As the FT recently reported, China poured more concrete between 2011 and 2013 than the US did in the whole of the twentieth century.

After the breathtaking economic growth, the Chinese economy is now in need of consolidation. The pace of growth brought problems. Imbalances were built that the authorities now have to unravel. The government is also looking to the future. The economy is on a path to integration in the global financial system which brings its own challenges, particularly with the Chinese currency the renminbi. The government is also trying to reshape the economy turning it away from a high dependence on exports and manufacturing encouraging domestic demand and the service sector.

Change inside emerging markets does not come without some pain. Within a communist political system change occurs by decree which on the surface implies compunction and with pace, however it also assumes that the decrees are well thought out and implementable, which is not always the case. China will need time, when the global community is demanding speed.
Change in China also occurs at a time when the financial system is still nascent. A communist system trying to appear capitalist is at times painful to watch. The last twelve months has witnessed a boom bust in its equity market, but to be fair something not uncommon in the western world. The currency was on a one way path of strength and now seems at times destined for persistent devaluation.

The reality is that China still has the ability to contribute positively to the global economy over the medium term. Whilst there are arguments over the accuracy of economic data releases, there is no denying that China is a large economy, with a population of 1.2 billion people. Even if the GDP growth were in reality half of the level that is reported, it would still represent a level of growth that comfortably surpasses that of the rest of the world.

The reality is that China has a significant challenge in its financial system with large debts of state owned enterprises that will need to be assumed in some way by the government. State enterprises will have to be reformed to free up the invested capital base of the economy. Wasting still more capital on inefficient state owned enterprises would be a step backwards.

Undoubtedly the transformation of the economy from one based on exports and manufacturing to one based on domestic demand and service sector will not be easy. The reform and change in the state controlled enterprises will not be smooth but we suspect that asset markets today are discounting Armageddon rather than the likely muddle through.

Some positive trends are deeply entrenched and will provide the backbone of good news. The oft spoken of rise of the middle classes is now a phenomenon with real momentum. The FT ran a story recently talking about the massive over subscription of entries to marathon runs whereas in the past they struggled to get any runners. Middle classes are in massively increasing numbers consuming the fitness regime of gyms, healthy eating, fitness trainers and marathons.

The Chinese equity market may take some months to stabilise. Having swept from bull market to bear market within a year, the market will need to find time to find a level. We suspect that international investors will prefer to take on China exposure through international stocks that have a large relationship with China rather than through domestic equities.

Chinese debt markets don’t look particularly cheap in a global context but are still well supported by local liquidity. The central bank the PBOC is likely to continue to loosen monetary conditions through modest interest rate cuts, but mainly through further cuts in the reserve requirements of local banks. The latter adds substantially to local investors.

Chinese Consumption – in numbers

- **6.5 US$ TRILLION**
  - The size of China consumer economy by 2020, even if its annual economic growth slows to 5.5 per cent over the next five years It will be second to the United States’ consumer market, which is forecast to expand to US$ 15 trillion.

- **1.3 TIMES**
  - The US$2.3 trillion increase in China’s consumption by 2020 alone will be comparable to adding a consumer market 1.3 times that of Germany or Britain. The spike will come from the rise of the upper-middle-class and affluent households, younger consumers and e-commerce.

- **30 PERCENT**
  - The share of upper-middle-class and affluent households – those with more than US$24,000 in annual disposable income in China by 2020. These households now make up 12 percent of all urban households, up from 7 percent in 2010.

- **17 PERCENT**
  - Yearly consumption growth among upper-middle-class and affluent households, compared to 5 percent among lower-earning households.

- **53 PERCENT**
  - The share of total consumption by China’s youth – those born in the 1980s and later. Consumption by the younger generation is growing at 14 percent annually, twice that of consumer older than age 35.

- **24 PERCENT**
  - The e-commerce market’s share of total private consumption by 2020. Online transactions now account for 15% of domestic consumption, up from 3% in 2010.

Source: The Straits Times

Risk aversion and market volatility rose dramatically with the devaluation of the Chinese currency.
The worst for gold could be over very soon.

We see some of the main factors suppressing the gold price in the recent years beginning to fade. We expect prices to find a floor near USD1,000-1025 an ounce before witnessing a strong recovery towards USD1,250 - USD1,325. A combination of factors discussed below lead us to believe that 2016 will be a turnaround year for the yellow metal.

Physical Supply Demand

We expect global demand to remain stable from India, China and Europe in the form of jewelry, bar and coin investment but mine supply is expected to finally begin to taper off in 2016 after growing steadily since 2009. Low prices in recent years have forced mining companies to cut back on capital expenditures. The long-running build in gold output is therefore expected to start turning lower on relative lack of development going into the industry.

Price of gold at current levels is close to the real all-in sustainable cost of production for a large number of producers. Any substantial drop in prices from here will force companies to stop production of unprofitable ounces; leading to further build up in supply side pressure.

Support for gold will also continue to come from the official sector with buy-side interest from central banks. According to the World Gold Council estimates Central banks collectively have been net buyers for the nineteen consecutive quarters. We expect this trend to strengthen in 2016 as we believe a number of countries will want to build up their gold holdings for reserve diversification purposes against a backdrop of a potentially fully valued US dollar.

Global and US inflation

Gold tends to benefit from rising inflation expectations. During previous US hiking cycles, the Fed has started to raise rates when inflation was already higher than its 2% target. This time, the Fed has embarked upon this cycle ahead of any overshoot. Nevertheless, inflation will head higher in the year ahead. Labor markets have tightened significantly with the overall unemployment rate down to 5%; putting upside pressure on wages which are showing signs of break out after years of tepid gains. These higher wage costs are not showing up yet in overall inflation because of the countervailing impact of energy prices and import costs. But, as these temporary influences fall away during
second half, overall price inflation will begin to increase more rapidly and provide support to Gold prices.

**Market turmoil and Geopolitical Tensions**

Investors’ strategy during this lengthy recovery cycle to pile on the risk assets and equities in search of higher returns have paid off quite well. However, 2016 looks set to be a challenging year macro risks abound. We expect investors to be more circumspect about chasing risk assets higher, indeed even the search for yield may be abeyance. Gold will likely benefit as investors diversify their portfolio and use it as a viable hedge against large exposure to equities.

Growing concerns over China’s faltering economy and its impact on global growth, return of high volatility amidst wider market turmoil, Continuation of tensions between Russia and the West, heightened regional conflict in Middle East would give Yellow metal a huge boost and see it reasserting its role as a safe haven.

<table>
<thead>
<tr>
<th>Year</th>
<th>Gold Mine Production (Tonnes)</th>
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</thead>
<tbody>
<tr>
<td>2014</td>
<td>3,122</td>
</tr>
<tr>
<td>2013</td>
<td>3,064</td>
</tr>
<tr>
<td>2012</td>
<td>2,875</td>
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<td>2,845</td>
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<tr>
<td>2010</td>
<td>2,742</td>
</tr>
<tr>
<td>2009</td>
<td>2,611</td>
</tr>
<tr>
<td>2008</td>
<td>2,428</td>
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</tbody>
</table>

Source: Reuters

Low prices in recent years have forced mining companies to cut back on capital expenditures.
Global real estate, in line with other risk assets, struggled in 2015 although there was mixed performance amongst the different regions. Both the UK and Europe experienced strong relative and absolute performance, the US started brightly before falling back mid-year in anticipation of a rise in interest rates whilst Asia was hampered by China’s woes.

After several consecutive years of robust growth, extravagant capital inflows and supportive monetary policy, prime real estate values in major gateway cities in both the US and the UK are now in excess of their pre-financial crisis levels. Limited credit availability for risky activities like property development has generally restricted supply in these markets which has led to strong rental growth as occupational demand has recovered. Appreciating rents are now the main component of property returns in these markets as there is little scope for yields to compress further in a rising rate environment. However, there is still an overabundance of liquidity, particularly for core assets in Central London and Manhattan, so there is little prospect for a precipitous drop in values. Instead, there will be slower growth for property markets in the US and UK in 2016, especially when compared to preceding years, as investors turn their attention to more ‘value-add’ properties, secondary locations or alternative assets. The attraction of alternative real estate is not just in currently superior income yields, but that returns are often driven by factors with a low or even negative correlation with other economic or property market drivers. Indeed, over a third of all property transactions in the UK in 2015 were outside of the core sectors of office, retail and industrial and the top 10 largest property deals of the year were dominated by purchases of large student living and hotel portfolios by North American institutions.

Asian real estate continues to be affected by the twin headwinds of slower economic growth in China and from general weakness in emerging markets sentiment. However, property investment activity has remained largely insulated from these issues as market uncertainty and volatility tends to lead investors away from other asset classes into the security of bricks and mortar. Japan continues to be the focus of this investment activity with both domestic and international investors 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.

This leaves Europe as the main focus for global real estate investors as the recovery here was delayed due to persistent...
economic turbulence from Greece et al, but the property market is now firmly on the front foot driven by strong investor demand and recovering fundamentals with the added benefit of the ECB’s QE programme. The recovery has continued to gather pace over the course of 2015 and almost all European countries have experienced large annual increases in transaction volumes particularly in the stronger Western European economies of Germany, France, Benelux as well as in the Nordics. By contrast, investors in Russia and other Central and Eastern European countries have been affected by sanctions (in the case of Russia) and poor sentiment on emerging markets in general.

Domestic funds, pension funds, insurance companies and listed property companies / REITs have been the principal buyers of European property to date. Their focus has been on prime, yielding assets in gateway cities in home markets. However, there has been steady movement up the risk curve into more ‘value-add’ assets to capture the market recovery and cross border investment is rising rapidly with Asian institutions 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.

2016 should see further improvements in property market conditions and continuing domestic and international capital inflows. Supported by ongoing monetary stimulus, this will drive European real estate values forward throughout the year. Eurozone property equities have been the most immediate beneficiary of the market recovery, outperforming almost all other European equity sectors in 2015 despite a mid-year sell-off, and represent an efficient way to gain immediate exposure.
In theory investors should hold a portfolio well-diversified across asset classes to weather the ups and downs of markets. Maintaining such a disciplined approach has been challenged in recent years, as quantitative easing has at times made risk seemingly riskless 2012-14, while in 2015 it felt like everything would lose you money including cash.

We look at some of the disciplines that we believe investors must hold to, as we move into what may prove to be a very trying 2016.

**Diversification may not work perfectly during times of stress but it still works**

Unfortunately the benefits of diversification can be partially challenged at times of heightened market volatility. Many investors will think back to 2007-009 when it seemed nothing offered protection from the collapse in the world financial crisis, but in fact two assets did. US treasuries and gold.

Since 2009, due to the huge flows of central bank liquidity into global financial markets, correlations between asset classes have risen materially.

The waves of capital entering asset markets has also suppressed market volatility. Between 2013 and early 2015 Federal Reserve easy money policies dampened the riskiness (volatility) of many asset classes to levels well below previous norms.

Equally, if the central banks start to reduce their quantitative easing as the Fed has done in recent quarters, we may see correlated downside to the asset markets and also higher volatility. The good news is that we expect at least the ECB and the Bank of Japan to continue to provide significant injections of capital into the markets in 2016.

However even with these higher correlations there is good evidence that some assets will still provide protection to an investor’s wealth during times of stress. The best performing asset class in this respect is US treasuries, which tend to deliver a positive performance during market downturns. The next best asset based on historical data is investment-grade (IG) bonds. We believe a cautious investor for 2016 should have an allocation skewed towards government and investment grade bonds. Such a portfolio would allow the cautious investor to diversify risk, rather than to maximise returns.

More aggressive investors can diversify return by adding a defensive bias to their strategic asset allocation. This would be achieved being overweight credit versus equities and, within equities, overweight developed versus emerging markets (more volatile than DM). Credit exhibits in general lower volatility versus equities and tends to perform better during times of macroeconomic uncertainty, but stable growth (table 2). Although global growth is expected to be steady for 2016 (3.3%) versus 2015 (3.1%), uncertainty about the outlook remains relatively high.

Investors who wish to diversify their returns can also look to add gold to their portfolios, or to add funds pursuing absolute return strategies.

After DM government bonds, gold tends to have the lowest average correlation to major asset classes. The Asset Class Correlations chart illustrates that, in a portfolio of 9 asset classes, DM government bonds have an average 10-year correlation to other assets which is close to 0%; gold has an average correlation slightly above 40%, while for all other asset classes the average correlation runs significantly higher.

Absolute return investment strategies attempt to deliver positive returns irrespective of market direction. Returns for these strategies tend to be smoother, although lower than the overall market return when this is strongly positive. As a result of rising volatilities and correlations, portfolios have recently tended to exhibit more frequent drawdowns (losses incurred from peak to trough). A partial remedy to this is offered by diversification via hedge funds. The investor is advised to select absolute-return funds with proper track-record to this purpose, as it is not so obvious that a broad-based hedge-fund-tracking index adds significant value.
## Portfolio Positioning for Tough Times

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Sub Asset Class</th>
<th>Cautious Portfolio Positioning</th>
<th>Moderate Portfolio Positioning</th>
<th>Aggressive Portfolio Positioning</th>
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</thead>
<tbody>
<tr>
<td>Cash</td>
<td>USD Cash</td>
<td>14.3%</td>
<td>7.0%</td>
<td>6.8%</td>
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<td>Bond</td>
<td>DM Gvt Bonds</td>
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<td>38.0%</td>
<td>23.2%</td>
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<td>Global IG Bonds</td>
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<td></td>
<td>Global HY</td>
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<td></td>
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<td>EM Bonds</td>
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<td>0.0%</td>
<td>0.0%</td>
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<td>40.0%</td>
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<td>6.3%</td>
<td>7.8%</td>
</tr>
<tr>
<td></td>
<td>MENA Bonds</td>
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<tr>
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<td>1.5%</td>
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<td></td>
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<td>3.4%</td>
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<tr>
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<td>Alternative</td>
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<td>Commodities</td>
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<td>Hedge Funds</td>
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<td>Real Estate</td>
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<td>0.0%</td>
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<tr>
<td>Total</td>
<td>Cash</td>
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<td>6.8%</td>
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<td>23.2%</td>
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<td>Equity</td>
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<td>40.0%</td>
<td>53.0%</td>
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</table>

Cautious’, ‘Moderate’ and ‘Aggressive’ portfolios match the risk profiles for clients.

**GOLD HAS THE SECOND LOWEST CORRELATION TO MAJOR ASSET CLASSES**

![Asset Class Correlations](source: Bloomberg)

The good news is that we expect at least the ECB and the Bank of Japan to continue to provide significant injections of capital into the markets in 2016.
CONTRIBUTORS

Gary Dugan – Chief Investment Officer
Tim Fox – Head of Research & Chief Economist, Global Markets & Treasury
Edward Bell – Commodity Analyst
Giorgio Borelli – Senior Manager Asset Allocation
Nigel Burton – Director Real Estate
Anita Gupta – Head of Equity Strategy
Khatija Haque – Head of MENA Research
Yahya Sultan – Fixed Income Strategy
Anthony Taylor – Fund Manager, Real Estate
Raman Trehan – Head of FX/Commodity Advisory & Strategy
Anita Yadav – Head of Fixed Income Research
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