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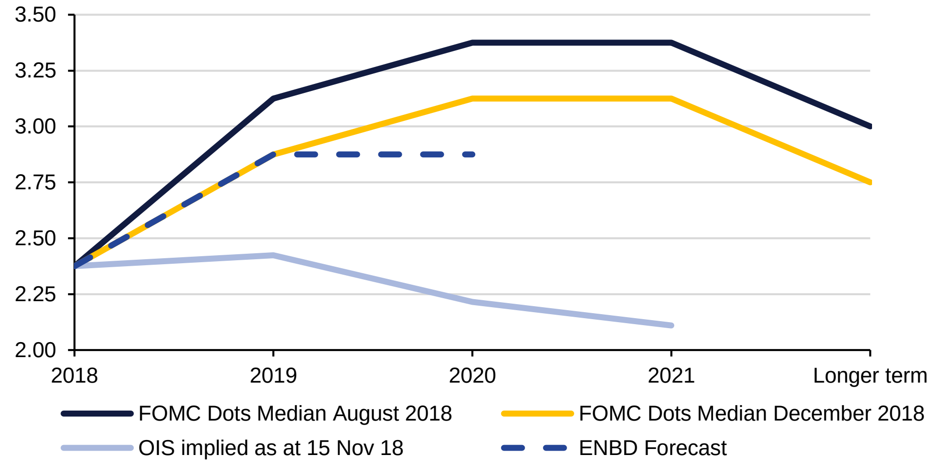
Monthly Insights

Despite downgraded global growth outlooks, financial markets have performed relatively well so far this year. However, this should probably be seen in the context of the sharp losses seen in December, as well as being due to the reassurance being offered by policymakers about monetary policy.

- **Global macro:** While markets have started the year in relatively good spirits, with equities and oil prices rising, growth forecasts have been pared already including by the World Bank which warned of 'Storm Clouds' this year.
- **GCC macro:** GCC growth rebounded in 2018, following a recession in 2017. We are cautiously optimistic on 2019, with oil production likely to be higher on average for most GCC producers, and non-oil growth underpinned by government spending.
- **MENA macro:** As some of the .global pressures on non-GCC MENA countries have eased over the past several months, locally driven political risk has returned to the fore in terms of negative drivers on the regional economies.
- **Sub-Saharan Africa macro:** China is investing in East Africa as part of its Belt and Road Initiative, with potential windfalls for China, Africa, and the UAE.
- **Interest Rates:** After increasing for much of the first three quarters in 2018, UST yields declined sharply in 4Q18 in response to evolving expectations of slower global economic growth.
- **Credit Markets:** GCC bonds outperformed their EM peers in 2018 mainly as a result of increased bid on the back of inclusion in the JP Morgan's EMBI index.
- **Currencies:** The dollar has fallen since the start of the year, adding to December's losses, and could be headed for a third consecutive January of declines.
- **Equities:** Global equities have started 2019 on a stronger footing following some progress on issues weighing on investor sentiment at the end of last year. Notwithstanding the positive start to the year, there are enough reasons to be cautious looking ahead.
- **Commodities:** We have revised our oil price forecasts for 2019 lower as global demand conditions look set to worsen amid still persistent supply growth. We now expect Brent futures to record an average of around USD 65/b and WTI futures close to USD 57/b.

Markets' progressively pricing out the Fed



Source: Bloomberg, Emirates NBD Research.

Content

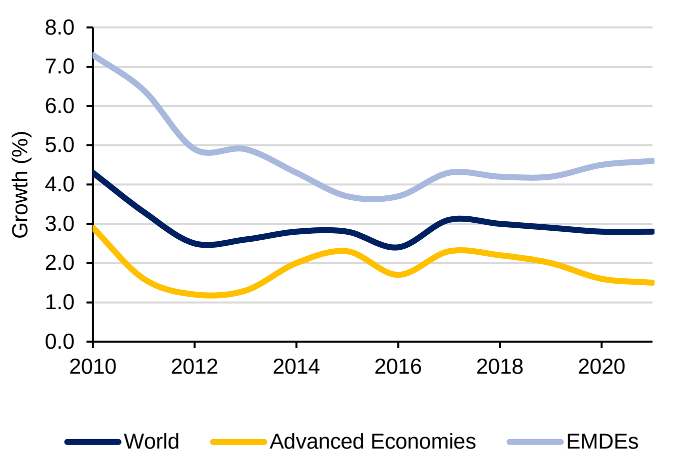
Global Macro

While markets have started the year in relatively good spirits, with equities and oil prices rising, growth forecasts have been pared already including by the World Bank which warned of 'Storm Clouds' this year. This follows from similar warnings from the IMF and OECD late last year.

Storm clouds gather

The World Bank cut its forecast for global economic growth as slowing growth in trade and investment and rising interest rates hurt momentum. It now expects global expansion of 2.9% this year, down from 3% in 2018, a reduction of 0.1 percentage points from its June forecast. Growth in China was revised downwards by 0.1% to 6.2% while that in the US was left unchanged at 2.5% and Japan was revised up by 0.1% to 0.9%.

Global growth flattens



Source: World Bank, Bloomberg, Emirates NBD Research

China stimulates on two fronts

China's economy will be key to how global growth pans out this year. January has already seen news that Chinese exports and imports fell sharply at the end of last year, down -4.4% y/y and 7.6% y/y respectively in December. The export pull-back was the largest since a 6.2% decline in December of 2016 and presumably reflects the impact of tariffs. This report is consistent with ongoing slowing in China's domestic economy (falling imports) and the impact of the trade war with the U.S. (drop in exports).

China had already moved to stimulate growth in the first few days of the year with the People's Bank of China (PBOC) announcing a 100bps cut in Required Reserve Ratio (RRR) for banks, including 50bps effective 15 January and another 50bps effective 25th January. The move is expected to free up estimated liquidity of around RM800bn and is in response to increasing downside risks for China's economic growth from external trade conflict, slowing housing market and softening consumption. Fiscal policy has also been loosened with China said to be mulling more tax cuts. Both steps shows that the Chinese government is committed to maintaining stable economic growth and containing systemic risks. However, so far there is little sign that the economy is responding to stimulus measures, and some analysts have warned that China's real rate of growth is less than 2%.

US growth does not dispel doubts about rates

Elsewhere the year has begun with relatively mixed news. Nonfarm payrolls (NFP) data in the US showed that 312k new jobs were added in December, far above market estimates and the second largest increase in 2018 as a whole. The growth was broad based, average hourly earnings rose by 3.2% y/y while the unemployment rate rose to 3.9% mainly due to increased labour force participation. The report showed that while manufacturing and housing data may be showing some signs of slowing, the labour market in the US remains buoyant.

Despite the strong NFP report, Fed Chair Jerome Powell gave a more cautious assessment following it, perhaps in an effort to calm financial markets. Powell indicated that the Fed would be 'patient' in assessing economic conditions and that the central bank was prepared to shift policy 'significantly' if warranted. Equity markets soared on the back of Powell's comments on the implication that the trajectory for rates in 2019 may not be as steep as initially feared.

The minutes of the FOMC's last meeting in December also showed a dovish tone. Future rate hikes are not on a preset trajectory but going to be very much data dependent. The minutes also noted that the FOMC could afford to be patient about further policy firming and hinted that a relatively limited amount of additional tightening would be appropriate. FOMC members also took note of the contrast between the strength of the incoming data on economic activity and concerns about downside risks evident in financial markets.

Government shutdown adds to uncertainty

However, with a government shutdown underway in the U.S. and with speculation that it could take time for it to be resolved, the timing of future rate hikes is likely to remain clouded by the absence of published frontline data, at least this month or so. If the Fed does become more data dependent the first inflation reading seen this year at least provides some reassurance that it will not have to move hastily. U.S. CPI inflation eased in December to 1.9% y/y while core inflation remained at 2.2% y/y, further lowering market expectations for further rate hikes in 2019. Currently the markets are relatively evenly balanced as to whether there will be a hike or a cut in U.S. interest rates by the end of the year, although looking at the strength of the US economy at the moment, we continue to expect two more rate hikes in 2019, probably starting around the middle of the year.

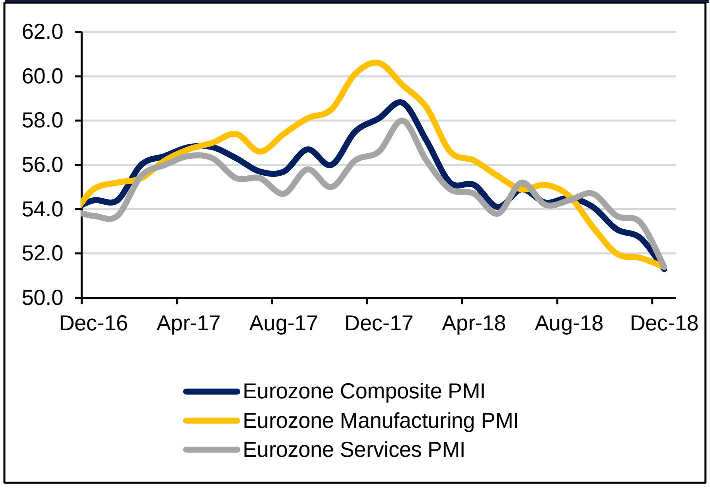
Trade talks promising but details awaited

On a more positive note the US and China completed trade talks after three days of discussions earlier this month with apparently substantial agreements having been reached. The US said that they will decide on the next steps after the official report has been discussed back in Washington and that they want any deal to include 'ongoing verification and effective enforcement' mechanisms. Both the U.S. and China probably have an interest in resolving the dispute, which is why the markets appear relatively hopeful about the outcome. China would like to remove a key headwind to economic growth, while President Trump is clearly sensitive to equity market falls and would also like to distract from unpopular domestic issues. However, there remains considerable uncertainty about the kind of agreement the US is actually willing to accept. U.S. trade hawks would like changes that go beyond traded goods and vague promises on market access and Intellectual Property rights. It seems unlikely that China's concessions on these issues will be comprehensive and fast enough so the outcome may not be as clear cut as the markets hope, with a low level of tension likely to remain.

Eurozone outlook darkens

Elsewhere, the signs are that these trade tensions along with other idiosynchratic issues are already weighing on activity in other parts of the world. Eurozone industrial production fell by -1.7% m/m in November, while October data were revised down to 0.1% m/m from 0.2% m/m. French consumer confidence slumped to the lowest in four years in December – falling to 87 versus 92 in November, partly reflecting the impact of Yellow Vests protests there. The European Commission's economic sentiment index - which covers the mood among both households and companies - dropped to 107.3, and down from 109.5 in the previous month. The decline was broad-based with consumer confidence also dropping -6.2%. The slide in the index is the worst in the last two years and is reflective of trade headwinds and the risk of a German recession casting a cloud over the region's outlook. On that note Germany's economy only narrowly avoided a recession in the second half of the year, expanding only 1.5% y/y in the whole of 2018 according to preliminary estimates. The weak numbers will raise fresh concerns over the Eurozone outlook and the ECB's projections. For now the ECB is likely to stick to the central message at the upcoming council meeting, with rates seen on hold at least through the summer. However, President Draghi appears to be preparing the groundwork for a change in the outlook acknowledging that 'recent economic developments are weaker than expected', and we no longer see the ECB hiking interest rates later this year.

Eurozone growth stagnates in 2018



Source: Bloomberg, Emirates NBD Research

Japan activity subdued

In Japan as well growth in Japan's services and manufacturing sectors also slowed in December. The Markit/Nikkei Japan Services PMI came in at 51 in December versus 52.3 in November and the Composite PMI reduced to 52 from 52.4 in November. That said, the readings are not too far from the 51.1 and 52.2 respectively recorded an year ago. Sales tax in Japan is set to increase from 8% to 10% in October this year which is making policy makers worry about a fall in consumer spending. However, wage growth in Japan came in at 1.1% y/y– more than double f the expected 0.4% gain.

Markets too sanguine about Brexit

The latest developments in the UK regarding Brexit only seem likely to extend the uncertainty evident in recent economic data. UK production falling again in November, with industrial production showing a 0.4% m/m decline, following October's 0.5% fall and manufacturing production falling 0.3% m/m following October's 0.6% contraction. UK PM Theresa May lost the vote in Parliament on her Brexit deal by a landslide 230 votes, the largest government defeat in history. She now faces a motion of no confidence brought by the opposition Labour party. Most likely she will win that vote but what will follow after is uncertain. May now has to go back to the drawing board to try to salvage the situation, most likely by engaging in cross party talks and perhaps talking with the EU again. That might mean that parliament could have a bigger say in any solution, but that solution still has to be found.

The pound has recovered a little as markets are assuming that the probability of no deal has diminished, while chances of a delay to article 50, a second referendum, or even no Brexit at all have all increased. We think it is too optimistic to think that order will be able to suddenly emerge out of chaos, and there may actually be no majority in parliament for any deal. In that case the UK could still end up with a disorderly Brexit on the 29th March by default. We have revised our forecasts to reflect the more uncertain outlook, with the Bank of England no longer expected to raise interest rates this year.

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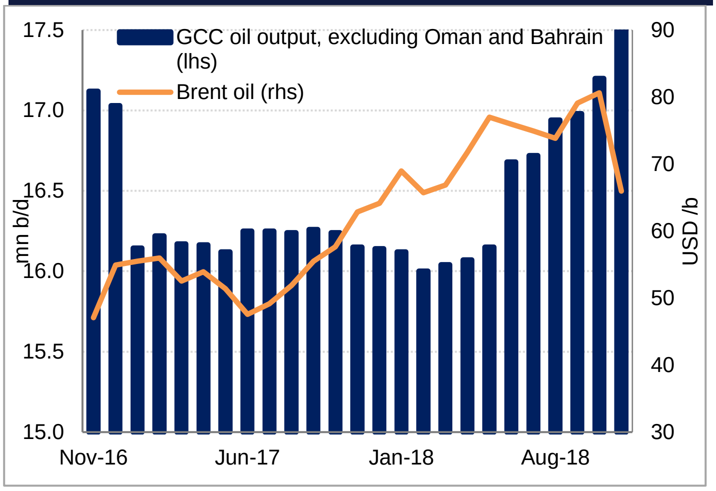
GCC Macro

GCC growth rebounded in 2018, following a recession in 2017, both of which were driven by oil production. We are cautiously optimistic on 2019, with oil production likely to be higher on average for most GCC producers, and non-oil growth underpinned by government spending. As always, risks abound.

Regional growth accelerated in 2018

GCC growth rebounded in 2018, following a recession in 2017. Both the recession and subsequent recovery last year were driven by oil production: in 2017, GCC oil exporters reduced oil output in a bid to reduce the excess supply of oil in global markets, but from June 2018, production was increased as oil prices recovered. Production in Q4 2018 was much higher than we had expected and as a result, the hydrocarbons sector contributed positively to overall GDP growth in the GCC last year.

Higher oil output boosts GDP growth

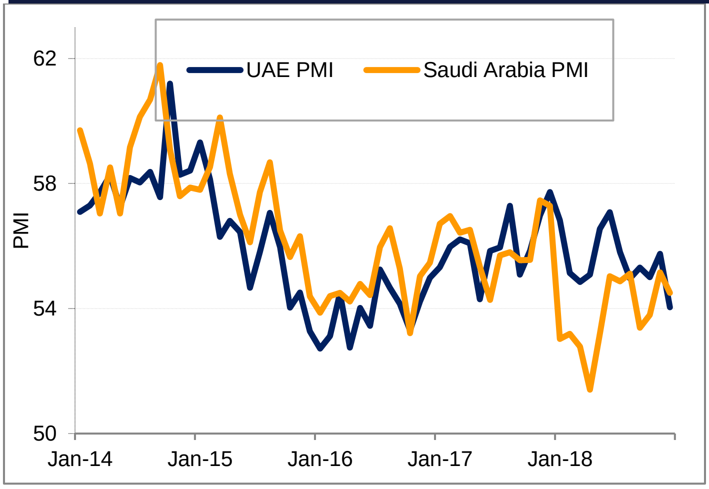


Source: Bloomberg, Emirates NBD Research

Activity in the non-oil sectors last year was surprisingly slow to benefit from both higher oil production and oil prices, as well as increased government spending across the region. PMI survey data for Saudi Arabia and the UAE pointed to non-oil GDP growth at a similar or slightly slower rate to 2017. Importantly, the survey data also indicated very little job or wage growth in the private sectors of the UAE and Saudi Arabia, which likely weighed on private consumption. The introduction of VAT, higher domestic fuel prices, rising interest rates and, in Saudi Arabia's case, taxes on expatriates would have further constrained household spending.

While government spending did rise across the GCC last year, research by the IMF suggests that the multiplier effect of government spending in the region is weaker than it was a decade ago. In Saudi Arabia's case, a significant portion of the increase in spending last year was on defence, where there is a large imported component. We now estimate GDP growth in the GCC averaged 2.4% on a GDP-weighted basis, up from -0.3% in 2017.

PMI surveys point to slower non-oil sector growth in 2018



Source: IHS Markit, Bloomberg, Emirates NBD Research

Qatar, UAE to see faster growth this year

The outlook for 2019 in cautiously optimistic, against a backdrop of slowing global growth and heightened geo-political risks globally. We expect average growth of 2.5% in the GCC this year, with the UAE and Qatar likely to see faster growth than in 2018. We expect Saudi Arabia's economy to expand 2.0% this year, slower than the government's estimate of 2.3% growth in 2018.

Despite OPEC's agreed curbs to production coming into effect in January, we still anticipate that average oil production in the GCC will be higher this year than last year. We expect non-oil sector growth to be underpinned by government spending and continued execution of multi-year infrastructure plans across the region.

Pressure on GCC budgets eased in 2018 as oil prices rose to an average of USD 71/b. However, we expect budget deficits to widen modestly this year, based on our assumption of an average Brent oil price of USD 65/b and increased government spending. The introduction of VAT in Bahrain and potentially Oman (the latter expected in September 2019) should help these countries address their sizable budget deficits, although other fiscal reforms will need to be undertaken to sustain any improvement over time.

Risks remain significant

Despite the improvement in the near-term outlook for oil exporters in the GCC, significant risks remain. The recovery in growth is due entirely to a cyclical recovery in oil production and an oil price in the mid-60s. It does not reflect structural changes to the drivers of economic growth in the GCC or meaningful diversification of budget revenues away from oil. A sustained downward shock to oil prices would likely trigger another round of government spending and/or oil production cuts, with direct consequences for GDP growth..

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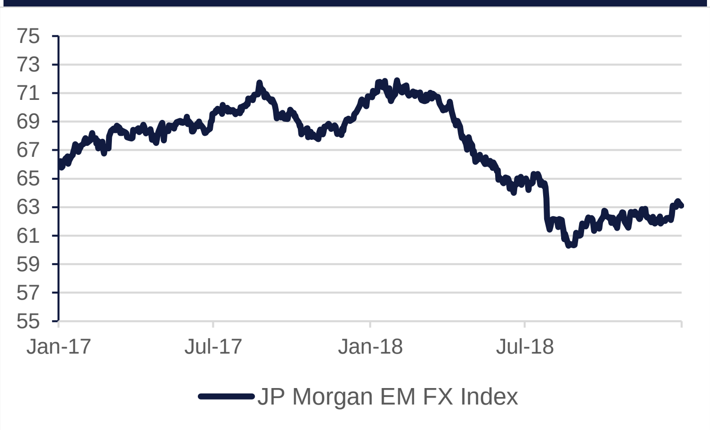
MENA Macro: Domestic political risk to the fore

As some of the global pressures on non-GCC MENA countries have eased over the past several months, locally driven political risk has returned to the fore in terms of negative drivers on the regional economies. Whether it be elections held in 2018 which have yet to result in a fully functioning government (Iraq, Lebanon), elections coming up in 2019 which could disrupt policy making (Algeria, Tunisia), or newly elected governments struggling to implement their essential reform agendas (Jordan), states across the region are struggling to maintain stability. That is not to mention Libya and Syria, which despite some relative progress remain starkly insecure and divided, and Iran which is facing renewed pressures relating to the reimposition of US-led sanctions.

Global pressures have eased

Around mid-2018, the most salient pressures facing non-GCC MENA states appeared to be external; the prospect of monetary tightening in developed markets was raising the risk of unsustainable growth in borrowing costs, and as global oil prices climbed to levels not seen since 2014, near-term pressures on oil importers' current and fiscal accounts mounted. These factors, alongside some idiosyncratic factors relating to Turkey and Argentina, contributed to growing investor aversion to EM worldwide, including the Middle East. Egypt in particular bore the brunt of these global forces, as much of the hot money that had piled in to its local debt left the market over H2 2018.

EM FX pressures easing



Source: Bloomberg, Emirates NBD Research

In the intervening months, many of these external pressures have diminished. The oil rally which saw Brent futures peak at USD 86.3/bl in October collapsed through the close of the year, as Brent fell to just above USD 50.0/bl on Christmas Eve. There has been some muted recovery in prices since, but owing to a range of factors we have revised down our average Brent crude price forecast for 2019 from USD 73.0/bl to USD 65.0/bl, which will alleviate some pressure on most of the non-GCC MENA states. At the same time, as global growth looks increasingly less certain on the back of a host of indicators, the prospect of sharp monetary tightening appears equally less likely. While the chance of a renewed taper tantrum in EM did not stay Jerome Powell's hand in raising rates, the market meltdown seen in December has led to a softening in language from the Fed chair, meaning less pressure on borrowing costs for EM and MENA states.

Inconclusive elections impede policy-making

In a nominally more positive external environment at the start of 2019 than appeared likely in mid-2018, the more notable impediment to economic growth this year will be domestic political risk. Despite the easing pressures on EM generally, Lebanon has seen its CDS rise to record highs of 880 at the of writing on January 14, as the country remains without a government eight months since elections were held in May 2018. Aside from general policy uncertainty, this is also holding up the dispersal of USD 11bn in loans and grants promised in Paris in April last year. Iraq also held elections in May last year, and despite a little more progress than seen in Lebanon, it too remains without a fully formed cabinet, which also has implications for reconstruction aid and investment in the wake of the ISIS takeover.

Lebanon Eurobond 2028 % yield

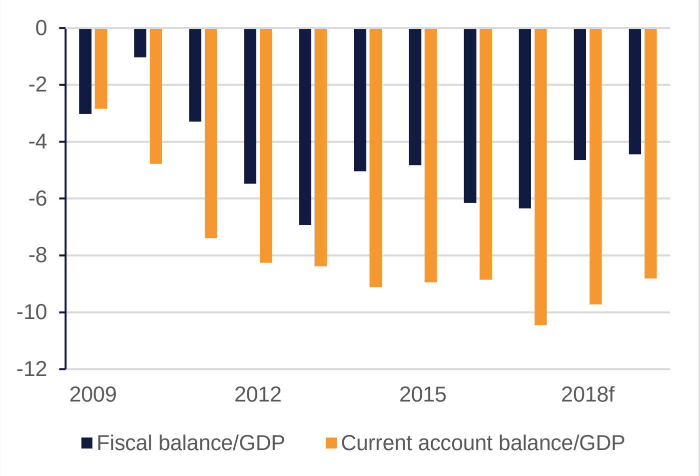
Source: Bloomberg, Emirates NBD Research

In Algeria and Tunisia, it is upcoming elections which will shape economic progress in 2019. In April, presidential elections are scheduled to be held in Algeria, with the probability being that Abdelaziz Bouteflika will stand and win once more, despite health concerns – although there is a chance that the ruling coalition will seek to install Prime Minister Ahmed Ouyahia in his place. In any case, the government is apparently shoring up support in the run-up to the vote, with previously announced plans to cut subsid payments cuts seemingly rolled back on in the 2019 budget.

Tunisia is set to hold parliamentary and presidential elections between October and December 2019, having ended 2018 in a febrile political environment both within government and on the streets. In government, an apparent rift between PM Youssef Chahed and President Beji Caid Essebi resulted in a major cabinet reshuffle in November, which was initially blocked by the president.

Chahed is among politicians behind the launch of a new political party reportedly due to be announced in January, and such an environment will make effective policy making more difficult as varying factions jockey for position in the run-up to the vote. On the streets meanwhile, Tunisia had to contend with numerous protests throughout 2018. These culminated in the self-immolation of a journalist in December, which in an echo of 2010 was the spark for renewed unrest nationwide. This political risk is one of the factors behind ratings agency Fitch confirming its negative rating for Tunisia in December.

Tunisia twin deficits, % GDP



Source: Haver Analytics, Emirates NBD Research

Jordan has faced similar political pressures to Tunisia, whereby its governments have struggled to implement essential economic reforms in recent years owing to popular pushback. In 2018, this resulted in the popular dismissal of the government under PM Hani Mulki, and the new government under Omar al-Razzaz is facing similar difficulties as it seeks to cut its fiscal deficit. We expect ongoing protests will increase pressure to channel greater social spending to the less fortunate.

Egypt and Morocco regional bright spots

The relative bright spots in the region are Egypt and Morocco, where we expect political risk to be fairly minimal over the course of 2019. Since Egypt began its IMF-sponsored reform programme in late 2016, it has seen remarkably little popular push-back despite increasing hardship, and elections held in 2018 passed largely peacefully. As the end of President Sisi's constitutionally limited second term nears we could see greater chances of instability, but for the time being we expect the status quo to be maintain and political risk to be minimal.

As for Morocco, the North African country has been a bastion of stability throughout the past eight years of turmoil in the MENA region, and we expect this to continue this year. While protests in the Rif have brought issues of social inequality to the fore, government commitments to counter this through policies such a 2.5% 'solidarity tax' on firms with annual net profits in excess of MAD 40mn in 2019 should ensure they do not escalate to a dangerous degree, while still remaining fiscally stable. Morocco has a more favourable risk profile than most of its North African neighbours, with a five-year CDS of 113, compared to Egypt's 383 and Tunisia's 384, and this will be supported by a new two-year Precautionary and Liquidity Line agreement struck with the IMF in December.

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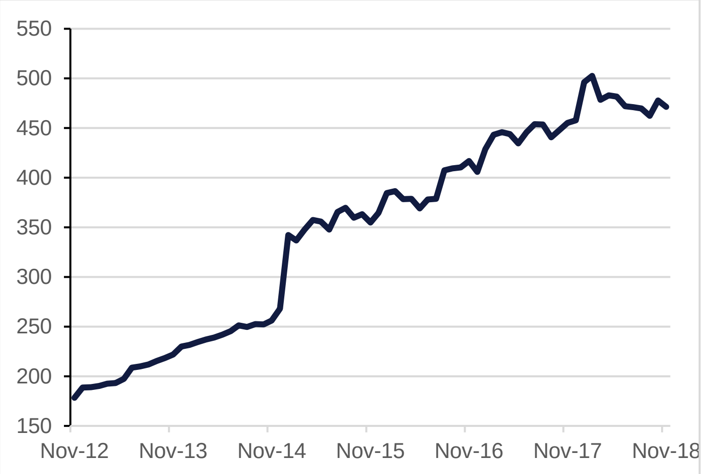
Sub-Saharan Africa Macro: Chinese BRI investments in East Africa broadly positive

Much of the press focus on China's massive Belt and Road Initiative (BRI) overseas infrastructure development strategy has been on the historically significant aim of recreating the ancient Silk Road routes which linked China and the West in ancient times. However, the East Asian giant is also heavily involved in East Africa under the BRI's auspices.

China's involvement in developing ports and railways in countries such as Kenya and Tanzania brings potential windfalls both for China – which stands to benefit from acess to new export markets and cheap labour – and for Africa, which gains access to Chinese expertise, relatively cheap infrastructure funding and improved connectivity. Additionally, the GCC could also benefit, from increased trade volumes passing through its transshipment hubs as East African markets open up.

Nonetheless, the initiative is not without potential hazards for East African governments, as speculation – not least by US Vice President Mike Pence – mounts that China is engaging in debt-trap diplomacy in a bid to secure strategic assets for itself. Equally, the crowding out of local firms in major projects holds back African self-sufficiency and is a potential source of domestic grievance.

China overseas FX loans, USDbn



Source: Bloomberg, Emirates NBD Research

BRI's scope continues to expand

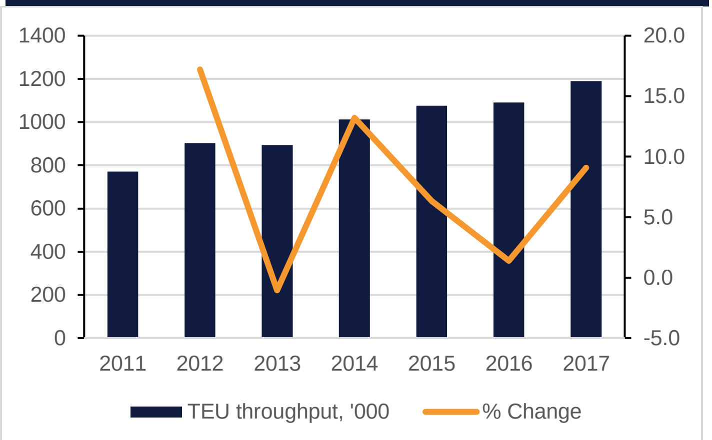
The BRI (formerly One Belt, One Road, or OBOR) is the overarching term for the policies initially set out by Chinese President Xi in 2013 and subsequently fleshed out by the Chinese government over the intervening years, which seek to 'enhance regional connectivity' through the development primarily of new infrastructure projects. While the press focus has mostly been on rail, roads and ports, power projects actually garner the most investment, and there are also ventures aimed at soft power projection such as education initiatives. These infrastructure projects are for the most part located along the ancient Silk Roads, envisaging new rail and road connections between China and Europe, passing through Central Asia and the Middle East – the 'Belt'. Alongside these are projects related to the maritime 'Road' between East and West, for example investments in the port of Gwadar in Pakistan (and its related trade corridor), and in the Turkish facility of Kumport, situated on the outskirts of Istanbul. The BRI is said to encompass 65 countries in total and could total investments worth more than USD 1tn.

Aside from these two primary foci, China has also become increasingly involved in projects in the East Africa region, which have fallen under the wider BRI (while outside the scope of this piece, the fact that West Africa's Senegal has also signed cooperation agreements with China related to BRI demonstrates how all-encompassing, or nebulous, the term is becoming). While China's investment in Sub-Saharan Africa has been on the rise for decades, this has been ramped up under the BRI; in September last year, President Xi pledged USD 60bn in project financing across the continent, which followed an earlier pledge for USD 60bn made in 2015. Major East African projects in which China has become involved include the development of the Bagamayo and Mtwara port projects in Tanzania, a railway between Djibouti and Ethiopia, a free trade zone in Djibouti and a new railway line between the Kenyan port of Mombasa and the capital, Nairobi.

Potential benefits for all concerned

Improved infrastructure has the potential to significantly boost trade in East Africa, which has for decades been held back by capacity constraints; the ports of Dar es Salaam and Mombasa, the two largest in the region, have been plagued by congestion for years. Through investing in expanding the maritime facilities, and building new ones, turnaround times for vessels will be improved, and the ports will also be able to handle larger ships, thereby providing efficiencies of scale. By extension, investing in the connecting land infrastructure opens up the East African hinterland, with the millions of potential consumers and all the resources of Ethiopia, Uganda, South Sudan, Rwanda, Burundi and eastern DRC. As such, the Chinese investment comes with tangible economic benefits both for Sub-Saharan Africa and for China.

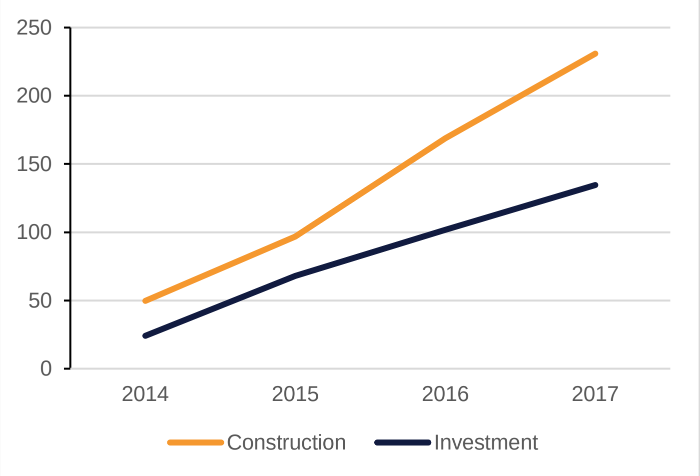
Port of Mombasa container throughput



Source: Kenya Ports Authority, Emirates NBD Research

We also maintain that the GCC, and the UAE in particular, stands to benefit from Chinese investment in East Africa. The Dubai maritime facility of Jebel Ali, the largest container port between Singapore and Rotterdam, already serves as a major transhipment facility for Chinese overseas trade. In the midst of persistent risks of a trade war which would negatively impact GCC throughput volumes, new markets in East Africa could be a (minor) mitigating factor. When President Xi visited the UAE in mid-2018, the two countries signed a number of agreements under the umbrella of the BRI, facilitating Chinese investment into a number of sectors. Not least of these was a pledge of an initial USD 300mn investment in expanding the CSP Abu Dhabi Terminal to an annual throughput capacity of 9.1mn TEU by 2023.

Chinese BRI construction and investment, USD bn



**Values are cumulative. Source: American Enterprise Institute, Emirates NBD Research*

Loans are not without risk

While the potential benefits of China's BRI investment are clear, it is not without its controversy. There has long been speculation that these manifold projects are not only aimed at projecting economic power, but also political and even military might; China has after all also invested in a military base in Djibouti. Speculation has also mounted recently that many of the projects are instances of 'debt-trap diplomacy', whereby China offers ostensibly good terms for project financing, but will seize the associated asset when the beneficiary country fails to pay on time for what transpires to be an overpriced loan for a project that cannot sustain itself. This has most notably played out in Sri Lanka, where massive borrowing for a new maritime port at Hambantota – a vanity project for China-aligned President Mahinda Rajapaska – ultimately led to Sri Lanka having to hand the facility over to China for the next century.

In East Africa, President Uhuru Kenyatta and China's Ministry of Foreign Affairs were in December forced to deny rumours that Kenya Ports Authority assets including the Mombasa Kilindini Harbour were at risk of being seized by China as collateral for loans taken from China to fund the new Mombasa-Nairobi railway. Staying in the region, the Tanzanian Bagamayo project is reportedly only moving forward now as the Tanzanian government, unable to stump up compensation for landowners itself, ceded its equity in the project to the Chinese, who could. Whether well-founded or not, such rumours will serve to foster increased popular opposition to Chinese BRI investment in Africa, part of a wider global pushback which has already taken hold in Southeast Asian countries such as Malaysia.

That being said, data from the American Enterprise Institute (a US think tank) suggests that the bulk of Chinese BRI activity is in construction contracts awarded rather than actual investment of Chinese funds. A a total of USD 148bn was invested from 2014 to the end of H1 2018, according to their research, compared to USD 255.5bn in construction contracts. This serves the purpose of opening up new markets for overexpanded Chinese firms as opportunity dries up at home, but crowds out local firms, in another potential source of contention.

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Interest Rates

After rising for much of the first three quarters in 2018, UST yields declined sharply in 4Q18 in response to evolving expectations of slower global economic growth.

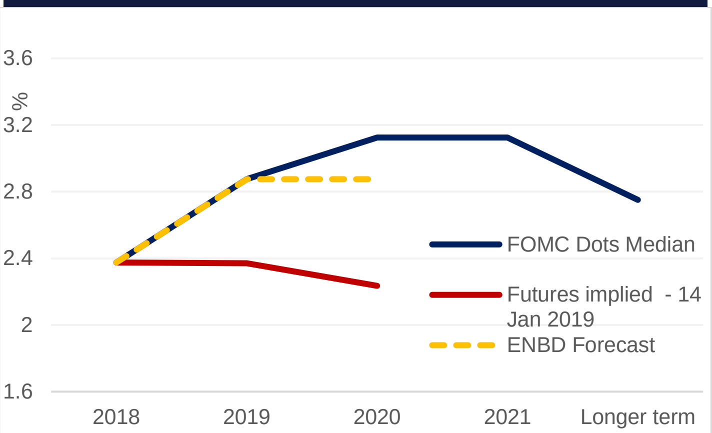
US Rates

The US Federal Reserve raised interest rates four times by a total of 1% in 2018 to take the final Fed rate target to between 2.25% - 2.50%. As expected, yield on 2yr, 5yr, 10yr and 30yr treasuries increased substantially, closing the year 2018 at 2.49% (+61bps y/y), 2.51% (+30 bps y/y), 2.68% (+27 bps y/y) and 3.01% (+27bps y/y) respectively.

Though the current strength of the US economy could easily justify the Fed continuing to raise rates at least two more times in 2019, the ongoing turmoil in financial markets, in reaction to the rising cost of debt and slowing economic growth, can not be ignored. That said, we think the recent shrinkage in UST yields may have over compensated for this risk.

The Fed expects to raise rates twice in 2019, once in 2020 and stay unchanged in 2021. However, much like in 2016, the futures implied probability of rate hikes in the next twelve months is much lower than the Fed's projections. In fact the market is expecting the next change in rates to be a rate cut towards the end of 2019. We don't think the US economic fundamentals justify any rate cut in 2019.

Rate hikes - dot plot vs mkt expectations



Source: Bloomberg

Beside the performance of the US economy, the UST yield curve also tends to reflect changes in volatility and the state of the geopolitical risks. In the quarter ahead, financials markets are facing several macro events such as a) the US-China trade talks, b) ongoing partial government shutdown of the US administration, c) Brexit , d) slowing economic growth in the EM etc which are partially responsible for the current depression in the UST yield curve.

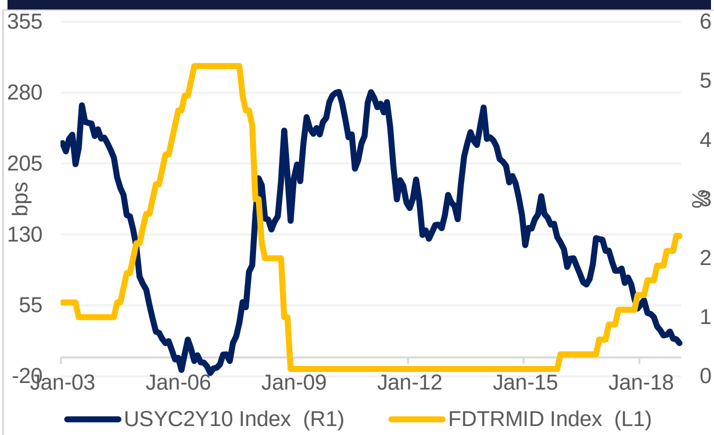
Although the US-China trade ta have become more constructive, the UST yield curve has not recovered the ground it lost in the last quarter. Yields on 2yr, 5yr and 10yr UST are currently well below their peaks of 2.87%, 2.97% and 3.14% respectively reached in October 2018. Since we do not expect material negative outcome of the trade talks, we think there is room for the UST yields to rise from here.

The ongoing partial government shutdown in the US is likely to create lot of noise in the economic data in the first quarter. However, previous experience suggests that much of the weakness in economic growth due to government shut downs eventually gets reversed in the following months and on an annualized basis the impact is minimal. Consequently we think there is scope for yields to rise from here once the government shut down issue is resolved.

Events in the UK and Euro area, if negative, tend to create a flight-to-safety and increase the bid for USTs, thereby driving UST yields lower. The current stand-off on the Brexit deal in the UK, if resolved constructively, could provide a case for increased global appetite for risk assets and reduced appetite for USTs, causing UST yields to rise.

As was expected, the US 2yr10yr spread reduced to circa 19 bps as at 2018 end – its lowest in this decade and only a fraction of 291bps that it touched in February 2010.

UST 2s10s spread vs Fed Target Rate



Source: Bloomberg

Most rate hike cycles include a period of yield curve inversion towards the tail end. Looking at the current cycle, we expect the 2yr10yr spread to invert sometime mid-2019.

Global Rates

The ECB ended its asset purchase program in December despite indications of slowing economic growth in the region. Original fears that removal of the ECB bid would cause yields on Eurozone sovereign bonds to rise were unfounded. The yield on 10yr Bunds is currently 5bps lower over the month to 0.20% and less than half where it was a year ago as investors price in expectations of lower growth and lower inflation in the near future and consequent delay in ECB's rate hikes.

Yields on UK Gilts were amongstf the most volatile last year, fluctuating in line with the tone of Brexit discussions. While economic data is surprisingly holding up, yields on 10yr Gilts have fallen over the year in response to the increasing risk of a no-deal Brexit.

10Yr Government Bond Yields

	Yield %	1M chg	3M chg	12M chg
US	2.71	-18	-46	+17
UK	1.25	+2	-35	-5
Germany	0.20	-5	-29	-35
Japan	0.00	-2	-14	-7
Brazil	5.52	+41	+6	+102
Russia	4.71	-32	-30	+74
Turkey	7.30	-14	-23	--

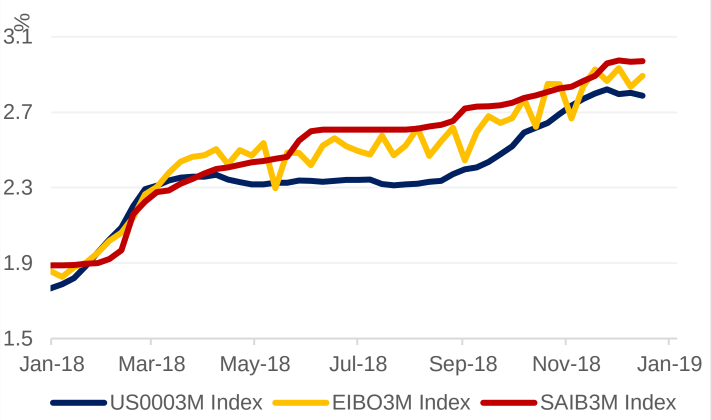
Source: Bloomberg

GCC Local Rates

GCC central banks followed suit with the Fed in raising policy rates last month by 25bps.

- Saudi Arabia Monetary Authority raised its repo rate to 3.0% and its reverse repo rate to 2.50%.
- Bahrain raised its benchmark one-week deposit facility rate to 2.75% from 2.50%. It also increases the overnight deposit rate from 2.25% to 2.50%, the lending rate from 4.25% to 4.50% while the one-month deposit rate will remain the same at 3.25%.
- The UAE central bank raised its Repo rate by 25 basis points to 2.75%.

3m interbank rates



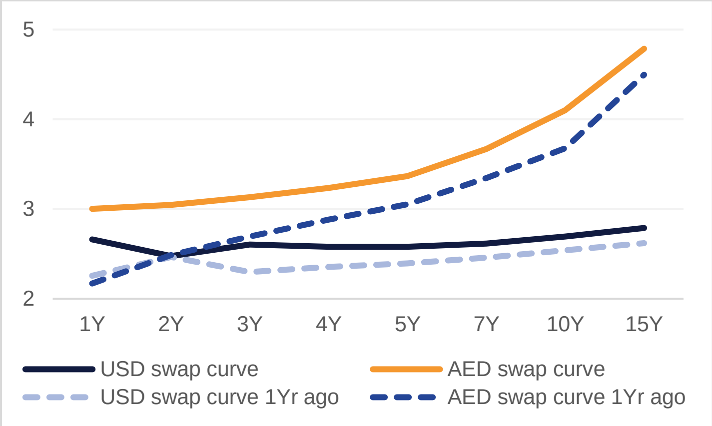
Source: Bloomberg

- Oman Central Bank's repo rate increased to 3.0%.
- Kuwait held its key discount rate steady at 3% but raised its overnight repo rate to 2.50%.

Interbank rates in the GCC also moved in sync with the US Libor rates albeit with higher month-on-month volatility. 3m LIBOR for USD increased 110bps during 2018 from 1.70% to 2.80%, followed by 106bps increase in 3m EIBOR rates from 1.77% to 2.83% and 108bps increase in 3m SAIBOR from 1.80% to 2.97% in the similar period.

The swap curves have also largely followed the movement in the USD swap curve with continuation of steepness in the Dirham curve over the USD curve in the longer end.

AED and USD swap curves



Source: Bloomberg

Looking ahead, we think the spread between LIBOR and local rates may incease as lower oil prices this year may reduce liquidity in local banking systems.

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Credit Markets

GCC bonds outperformed their emerging market peers in 2018 mainly as a result of increased bid on the back of inclusion in the JP Morgan's EMBI index.

Global Bonds

Last year was a tough year for financial markets with total return on most investable assets, particularly in USD terms, being negative as the dollar strengthened, cheap liquidity receded and financial conditions tightened in most developed markets.

As expected, on the back of rising policy rates in the US, yield on 2yr, 5yr, 10yr and 30yr treasuries increased substantially, closing the year 2018 at 2.49% (+61bps y/y), 2.51% (+30 bps y/y), 2.68% (+27 bps y/y) and 3.01% (+27bps y/y) respectively. Rising benchmark yields provided a challenging platform for USD denominated bonds and sukuk portfolios. In addition widening credit spreads exacerbated the negative impact.

Option Adjusted Credit Spreads OAS (bps)

	OAS	1M chg	3M chg	12M chg
US IG Corp	147	+6	+37	+58
US HY Corp	444	+8	+103	+123
EUR IG Agg	93	+3	+5	+43
USD EM Agg	321	-2	+37	+104

Source: Bloomberg

The widening of credit spreads mainly stemed from investors expectations that global growth will decelerate from here. The health of corporates' cashflows is also liklely to be dented as cost of borrowings inceases.

Total return on the US IG corporate bond index in 2018 was a loss of 2.51% mainly as a result of 60bps widening in average credit spreads while that on the European aggregate bond index was a gain of 0.41% mainly as credit spread widening was limited to 34bps. CDS levels on US IG and Euro Main widened to 88bps (+39bps y/y) and 88bps (+37bps) respectively.

Global bonds bounced back sharply last month on signs of Fed forbearance and positive US-China trade talk commentary. The rally was also boosted by stability in oil prices.

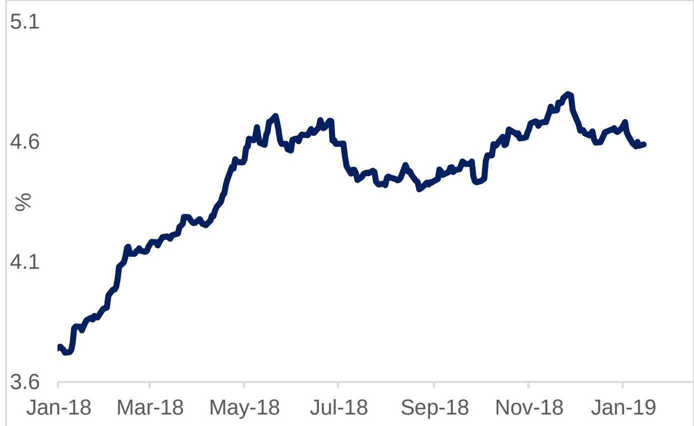
GCC Bonds – Secondary Market

While GCC bonds did not remain unscathed amid a general sell off in EM assets last year, they did noticeably outperform their emerging markets peers. Total return on the Bloomberg Barclays GCC bonds index was a small gain of +0.18% in 2018 compared with a loss of -2.5% on EM bond index.

GCC bonds are benefiting from higher bids as the region is less exposed to trade risks, credit ratings are still relatively high and currency fluctuation risks are negligible.

Also the increased bid ensuing from inclusion in the JP Morgan's EMBI index still continues to cement the performance of GCC markets.

Bbg Barclays GCC Credit Index – YTW %



Source: Bloomberg

In the secondary market, in 2018, the best performers were mostly the securities issued by the Bahrain and Qatar sovereigns which in effect recovered from their previously oversold positions. In contrast, Oman and Oman government-owned entities faced reasonable pressure on their bonds with yield widening 200 – 300 bps during the year.

Late last year, Fitch cut Oman's rating from BBB- to BB+, citing large continuing fiscal deficits which are leading to a sharp deterioration in government's balance sheet. With S&P's rating on Oman at BB, Moody's is the only rating agency that rates Oman investment grade at Baa3 albeit with a negative outlook.

In contrast, the rating outlook on Bahrain was revised to stable by Moody's on the back of materially reduced liquidty risk after the $10 billion financial support package from its neighbors. Bahrain recently announced cabinet approval for the signing of partnerships with key international oil companies to help develop the major oil & gas discovery made last year. Production from the new discovery could potentially reach 200k barrels a day though development will potentially be expensive.

Several GCC governments have recently announced their 2019 budgets. Dubai government expects a budget deficit of $1.6 billion (AED 5.6 billion) and Saudi Arabia sees a budget deficit of $35 billion (SAR 131 billion). Qatar expects a small surprlus which is not surprising given that most of its revenue comes mainly from sale of natural gas instead of oil. Oman's 2019 budget deficit is likely to be around $7 billion which it expects to fund 86% via new debt and 14% via reserve liquidation.

Continuing the trend of consolidation in the banking sector in the recent past, National Commercial Bank (NCB) and Riyad Bank in Saudi Arabia are believed to be seeking advisers for a potential merger that would create an entity with $182 billion in assets. As per the media reports, the proposed combination has the backing of the Public Investment Fund, the sovereign wealth fund that owns about 44% of NCB and 22% of Riyad Bank. Currently there are minimal international bonds issued by the Saudi banks. Consolidation and the creation of larger banks may see an increased approach from them to tap capital markets this year.

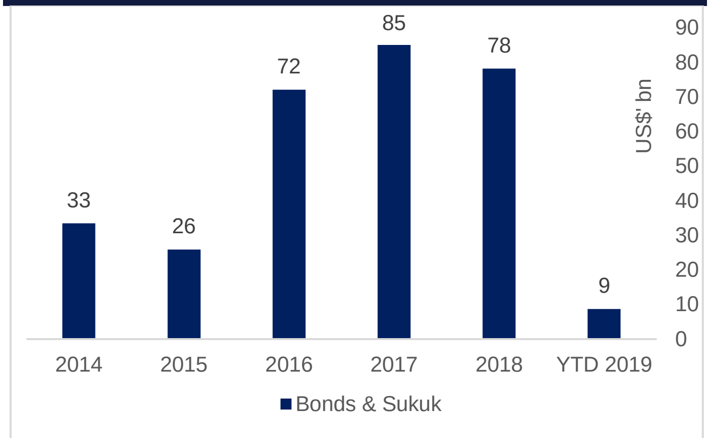
GCC Bonds - Primary Market

Much in line with our forecast, total new issues from GCC issuers crossed $78 billion last year. With oil price likely to average around $65/b this year, GCC sovereigns will see budget deficits of around $50 - $60 billion, the bulk of which is planned to be funded by debt. Adding the refinancing need of circa $26 billion, our forecast for new issues in the current year is of around $70 - $80 billion.

In the last two weeks we have already seen Saudi Arabia raise $7.5 billion via two tranches with the 10yr tranch ($4 billion) pricing at T+175bps and the 31 yr tranche ($3.5bn) pricing at T+230bps.

The Aa3 rated First Abu Dhabi Bank priced $850 million sukuk at T + 130ps and Dubai Islamic Bank is likely to price its Tier 1 NC6 Reg S sukuk within this week.

GCC USD New issues



Source: Bloomberg

Looking ahead, Saudi Arabia's oil giant, Aramco, plans to issue dollar bonds in the first half of this year. Aramco's IPO is now scheduled to be offered in 2021 and the company needs over $70 billion to fund its purchase of SABIC. Aramco is likely to have enough room to borrow money as it is believed to be virtually debt free. Aramco has so far largely avoided bond markets, relying almost exclusively on its own cash or bank loans. The closest it has come to issuing debt was when it raised 11.25 billion riyals ($3 billion) in a debut local currency Islamic bond sale last year.

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Currencies

USD - another soft start to the year

The start of 2019 has seen the dollar add to the declines realized in December 2018 with the currency presently on target to fall in January for a third consecutive year. There have been two main fundamental drivers behind the weaker USD. Firstly, investors are mindful that the current cycle of tightening of monetary policy is coming to an end. This sentiment started to materialize following a shift to a more dovish tone from Fed Chairman Powell in December 2018 and became more pronounced following the central bank's December meeting. Although the Fed increased interest rates by 25bps, it lowered the median forecast to two rate hikes in 2019 from the three previously. Furthermore, the minutes from the meeting show that some members were against the rate hike. As a result of this, the market is not expecting any additional rate hikes in 2019. While this is a view that we do not share, the OIS and Fed Funds Futures imply little probability of a hike and an equal chance of a rate cut. This prospect may weigh on the dollar in the short term, although other central banks may also begin to dial back on the their own tightening plans, providing something of an offset.

DXY breaks below 100-day MA

Source: Bloomberg

The second driver behind the dollar sell-off has been the unwinding of safe haven bids. Despite concerns over slowing global growth, markets have been positive for the first two weeks of the year. Equities are in the green, with the MSCI World Index rising 3.41%., while commodities are faring even better, shown by the 6.76% climb in the S&P GSCI Index.

Currently, the Dollar Index is trading at 95.599, having broken below the 50 and 100-day moving averages since the year began (96.643 and 96.018 respectively). Should the index break below the 200-day average (94.943), there is a risk of a further decline towards the 61.8% one-year Fibonacci retracement (94.098). The chances of this are further exaggerated by analysis of the weekly candle chart which shows that for the first time since Q3 2018, the index has broken and closed below the 200-week moving average (95.891).

EUR fails to capitalize on USD softness

As expected the ECB ended the Asset Purchase Program in December, however recent data indicates that the central bank may have to take a longer than expected pause before considering to begin a tightening cycle. In December, inflation fell back from 2.0% to 1.6%, while economic confidence fell, PMIs retreated and industrial production declined by the most since March 2016. These developments have raised questions over whether the bloc can regain the growth momentum witnessed during the start of 2018. As a result EURUSD has failed to gain much ground this month, rising a negligible 0.09% since January 1st.

EURUSD supported by 200-week MA

Source: Bloomberg

Technical analysis of the daily candle chart shows that EURUSD has spent January testing moving averages. Having found support at the 50-day moving average (1.1384), the cross has been hovering about the 100-day moving average (1.1471) for the last week. In order for the price to gain further ground, there has to be a firm break of the 100-day moving average and a successful break of the 23.6% one year Fibonacci retracement (1.1532). While the price remains above the 200-week moving average (1.1325) this seems like the most probably outcome as this level has succeeded in halting losses and prompting rebounds on every occasion since August 2018.

As Brexit edges closer, pound inches

Sterling has been dominated by Brexit over the last month and is likely to continue to be in the coming one. In the second week of December 2018, GBPUSD fell below the 1.25 handle to hit a 20-month lows following a decision by PM May to delay the Parliament vote on her Brexit deal until after the new year. Since then, the pound has recovered amid short covering and as investors speculate about more positive outcomes such as a possible postponement of article 50, a second referendum, a soft Brexit or the UK remaining in the European Union. Such outcomes may prove to be wishful thinking, however, and we think the market may still be underestimating the probability of no-deal (see Global Macro). Should this happen, or the odds of this occurrence increase, the pound is at risk of falling sharply again, and we retain our forecast for it to revisit 1.25 again this quarter. We have also removed our expectation for the Bank of England to raise interest rates this year canceling out one potential GBP positive.

GBPUSD tests 100-day MA

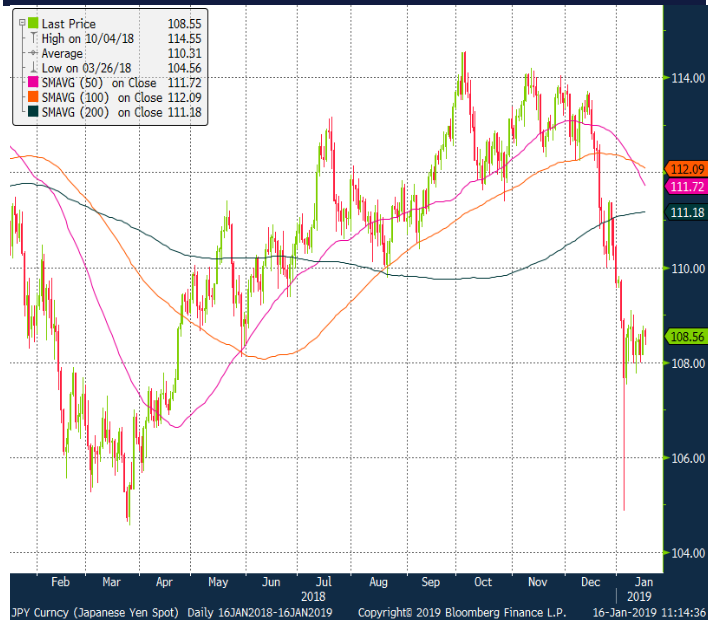
Source: Bloomberg

Currently trading at 1.2847, GBPUSD has been testing the 100-day moving average (1.2891) and the capping trend line of the daily downtrend that has been in effect since October 12th 2018. In order to generate further gains, the price needs a firm daily close above this level.

USDJPY recovers from 10-month lows

Despite trading at a 10-month low of 104.87 on January 3rd 2019 due to a 'flash-crash', improving risk appetite has seen USDJPY rebound to its present level of 108.56. The initial declines were principally driven by safe haven bids triggered by investor concerns over slowing global growth following disappointing production and survey data from the U.S., China and the Eurozone. However the strong performance of equity and commodity markets caused most of this drop to unwind. With the Bank of Japan almost certain to maintain monetary policy as it is, the main drivers for JPY this year will be risk appetite and yield differentials. From a technical viewpoint, however, the break and consistant closes below the 200-day moving average (111.17) and 50-week moving average(110.22) since the turn of the year leave USDJPY looking vulnerable.

USDJPY recovers from 10-month lows



Source: Bloomberg

CAD outperforms as oil soars

The Canadian dollar has been the strongest performing G-10 currency in 2019. At their January meeting, the Bank of Canada held interest rates at 1.75% and signaled to the market that there may be no more normalization of monetary policy in 2019. As a result of this, the OIS now shows a reduction in the implied probability of a rate hike by May 2019 to 26.8% compared with 56.4% one month ago. However, a year to date increase of 12.20% in WTI Crude prices have been constructive to the CAD and helped USDCAD fall from 1.3631 to 1.3257.

From a technical viewpoint, USDCAD has had a colorful start to the year. Having broken out of the daily uptrend that had been in effect since 2nd October 2018, the price proceeded to collapse through the 50-day moving average (1.3350) and the 76.4% one year Fibonacci retracement (1.3331). Additional losses were only halted when the 100-day moving average (1.3189) provided support on two different occasions. As things currently stand, there is a significant risk that this level is re-tested. Should it fail to provide support, a break and close below this threshold has the potential to trigger a larger and more significant loss, first towards the 38.2% one year Fibonacci retracement (1.3120) and then towards the 50 and 200-week moving averages (1.3041 and 1.3035).

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Equities

Global equities have started 2019 on a stronger footing following some progress on issues weighing on investor sentiment at the end of last year.

Not only did the first round of talks between the US and China end on an optimistic note, Federal Reserve officials have made a concerted attempt to calm financial markets by hinting at a slower pace of monetary policy tightening. These developments along with signs of an economic stimulus from China has helped offset the ongoing Brexit chaos and seemingly unending US government shutdown.

Since the start of the year, the MSCI All Country index has rallied +4.2%. The strength has been broad based with all major sub-indices clocking positive performance. The MSCI Emerging Markets index, the MSCI G7 index and the MSCI Frontier Markets index have gained +4.1% ytd, +4.2% ytd and +3.2% ytd respectively. Having said that, these gains need to be seen in the context of the sharp sell-off in equities at the end of last year. For the record, the MSCI All Country index lost -7.2% in December 2018. One notable trend has been the rebound in technology and commodity stocks. The MSCI All Country Commodity Producers Index and the MSCI All Country IT index has rallied +5.6% ytd and +3.2% ytd respectively. The move in oil prices has helped as both Brent and WTI oil contracts have rallied in excess of 10% since the start of 2019.

Notwithstanding the positive start to the year, there are enough reasons to be cautious looking ahead. It appears that markets are too sanguine about multiple issues currently at play and still optimistic over earnings estimates. While there has been some progress on trade talks, it is important to note that there are limited indications at this point that a long-lasting outcome can be reached. Similarly, a pause in monetary policy tightening by central banks is not expected to last. Additionally, there is a prolonged partial government shutdown in the US and increasing probability that the Brexit negotiation will result in more chaos than clarity.

On the earnings front, the start of 2019 was marked by a cut in guidance by market heavyweights across sectors. This puts at risk what has been strongest pillar of support for equity prices over the last couple of years. It is becoming evident that developments over the last six months are starting to bite corporate earnings. It is no surprise then to see analysts as per Citigroup's global earnings revision index at the start of 2019 lowering the profit estimates by the most since 2009. The early indications from the earnings season in the US corroborate those revisions. With 4% of companies in the S&P 500 index having reported earnings, 90% of companies have reported a positive EPS surprise and 65% have reported a positive revenue surprise. However, according to FactSet, the blended earnings growth is 10.6% compared to estimates of 12.3% at the end of 2018.

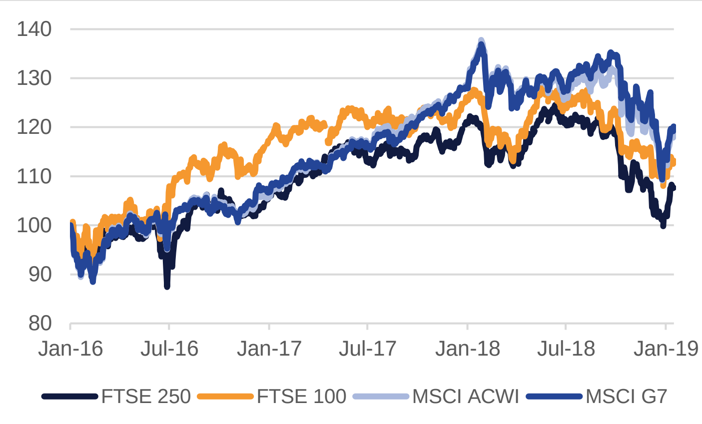
Key Moments to wach in H1 2019

Brexit

The January 15 defeat of the government's Brexit deal in the House of Commons by more than 200 votes has thrown more questions on the way forward than providing any answers. It is ironic that what was supposed to be the last step in multi-year long Brexit saga has rather become the first step into the unknown. Obviously many scenarios are being debated but none looks plausible at the moment. The current strength in broader European equities and UK equities in particular appears to reflect higher probability assigned to a new referendum or a long extension to the transition period. However, with so many paths in the Brexit process at the moment they are akin to clutching onto straws than anything else. The Euro Stoxx 600 index and the FTSE 100 index have gained +3.3% ytd and +2.5% ytd respectively. Importantly, the FTSE 250 index which is mostly dominated by companies which derive revenue from the UK has rallied +5.3% ytd.

Looking ahead, it does appear that the current risk-on rally in UK equities seems premature even after taking into account the selloff in Q4 2018. However, technical parameters such as higher short interest position, significant underperformance relative to global peers over the past 18 months and low base of earnings forecasts could provide some floor in case the Brexit negotiations continue to dribble on and manage to avoid the worst case scenario of no-deal exit. Needless to say should a no-deal scenario materialize, these factor would matter little. The FTSE 250 index is currently trading at 12.5x 12 month forward earnings compared to the MSCI G7 index which is trading at 14.5x 12 month forward earnings.

UK equities have underperformed since 2016



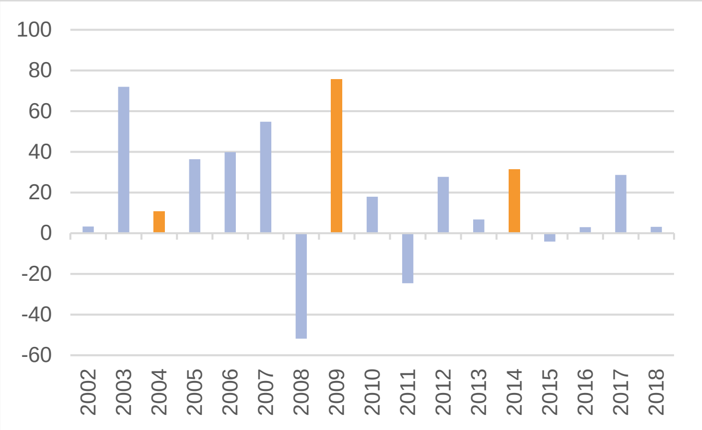
Source: Bloomberg, Emirates NBD Research

Indian General Elections

Indian general elections are scheduled to be held in April–May 2019. The elections which are held every five years remain a pivotal moment for the country's economy given the influence of political stability on the ability of the government to move ahead with key economic policies. While we concede that there are other important factors which could have an impact on Indian assets, an analysis of the past market movements following the last three elections shows the importance investors attach to the same.

In 2004, the Nifty index fell 17% in the month of May when the results were announced as it showed that a coalition of parties had come to power. In 2009 and 2014, the Nifty index gained +18.7% and +20.0% respectively in the month of May as the results showed majority for a major political party. Similarly, annual changes in election years show a similar pattern with returns of 10.7% in 2004 (versus 72.0% in 2003), +76.0% in 2009 (versus -52.0% in 2008) and +32.0% in 2014 (versus +6.7% in 2013). Put together, these numbers suggest that Indian financial markets experience outsized moves in election years and we expect 2019 to be no different.

Nifty returns (%)



Source: Bloomberg, Emirates NBD Research

For 2019, the consensus base scenario, including ours, is that the incumbent Prime Minister Narendra Modi will return to power with a smaller majority. Any result contrary to the consensus view could result in significant moves in Indian financial markets as the current incumbent won with the largest majority in India since 1984. Also, the current ruling party is considered to lean right of center and is perceived as capital markets and industry friendly.

China-US trade talks

At the start of December 2018, China and the US agreed to a 90-day ceasefire on its trade confrontation with no new tariffs to be imposed. The end of 90 day period (the start of March 2019) also became the deadline to reach an agreement to end the simmering trade war. The first round of talks between both sides ended this week on a positive note.

At the start of the trade skirmish there was a lot of conjecture about the actual impact on both economies. The latest economic data from China has given first indications of the potential impact should this last beyond the deadline. The trade data for December showed that Chinese imports and exports dropped -7.6% y/y and -4.4% y/y in USD terms compared to gains of 2.9% and 3.9% in November and 20.3% and 14.3% in October. This needs to be seen in context that the full 2018 export growth was 9.9% y/y. The data clearly shows that the front-loading impact is over and from here on the negative impact kicks in. Also worth noting that the Chinese manufacturing PMI moved into contraction territory in December 2018. This is the first reading below 50.0 since July 2016.

High correlation between Chinese PMI data and equity market performance

Source: Bloomberg, Emirates NBD Research

The impact on equity prices was fairly visible. Since the start of July 2018 to the end of November 2018 when the trade war was at its peak, the Shanghai Composite Index lost -13.5% in USD terms compared to a loss of 7.0% in the MSCI EM index during the same time. Also, since the initial verbal rapprochement between the US and Chinese Presidents in December 2018, the Shanghai Composite index has gained +2.5% in USD terms compared to 1.0% gain in the MSCI EM index during the same period. From an US equity perspective, an increasing number of companies are talking about the impact on their earnings going forward.

The above numbers clearly indicate the importance market participants are attaching to the US-China trade negotiations and this makes March 2019 as important for equity market momentum in 2019. The base case priced in the markets at the moment suggests some sort of agreement will be reached which will avoid a flare-up. However, the key will be how long-lasting the agreement remains given the rather impetuous nature of US President Donald Trump's decision making process.

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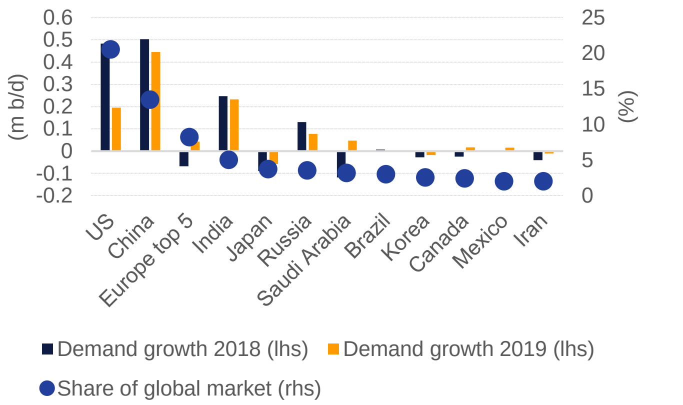
Commodities

We are revising lower our forecast for average Brent prices in 2019 to USD 65/b (compared with USD 73/b previously) and for WTI to USD 57/b (USD 66/b previously). Softening demand conditions, the US-China trade war and a relentless non-OPEC supply outlook are all weighing on oil, and commodity, prices. OPEC countries have responded by cutting production but the scale of the cuts as announced are unlikely to be enough to help push the market back into deficit.

Broad slowdown in EMs will weigh on commodity demand

Oil demand growth is projected to underperform its long-term trend in 2019, expanding by 1.41m b/d compared with a five-year average of 1.53m b/d (IEA projections). While demand growth will be positive in most markets this year it will be at a slower pace in critical markets. The US, representing more than 20% of global oil consumption, will see demand growth slow to around 200k b/d compared with closer to 500k b/d estimated for 2018. Consumption in China, which accounts for 13.5% of global oil demand, will remain positive but also a slower pace than in 2018. Where an acceleration is expected, the impact on global oil markets is relatively muted. Saudi Arabia, Canada, South Korea, Mexico and Iran will all report faster demand growth (or slower declines) but collectively they still represent less than China's total share of demand.

Oil demand in 2019



Source: IEA, EIA, Emirates NBD Research.

Casting a shadow over demand for oil, and commodities more generally, is the US-China trade dispute. Without a deal, the US will raise tariffs on USD 200bn of Chinese imports to 25% and impose tariffs on another USD 267bn from the start of March. Both countries have an interest in a positive resolution to talks but the risk of miscalculation is high, particularly in light of the personalities involved. US president Donald Trump will need to resist the urge to portray achieving a deal as a 'win' over China to prevent a return to retaliatory tariffs.

Measuring the impact of protracted US-China trade war on oil prices is admittedly a woolly endeavor but it will have undoubtedly been a major part of the more than 40% drop from Brent's 2018 peak of USD 86.29/b to USD 50.47/b. So long as the trade dispute remains unresolved it will act as a weight on prices. But a positive resolution on trade only gets markets back to focusing on the decelerating trend of global growth: both the IMF and World Bank have lowered their growth projections for 2019 based on factors beyond the US-China trade war. The upside quantum of a trade deal is consequently more muted in our view than the scale of decline if negotiations fail.

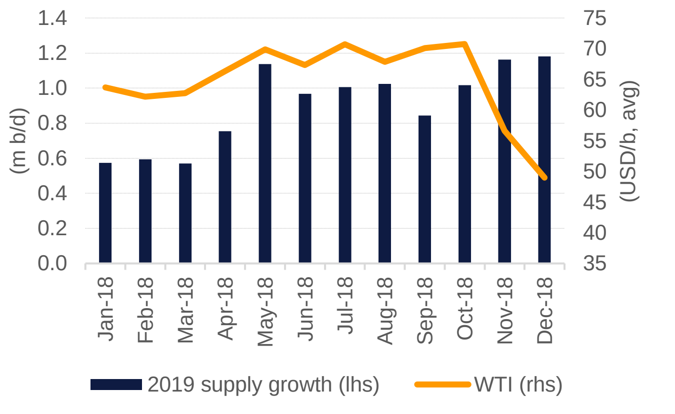
Supply remains battle between OPEC and non-OPEC

Oil supply in 2019 will again be a battle for influence between OPEC efforts to get prices close to fiscal breakeven levels and rapid, flexible growth from alternative producers, notably in the US. Non-OPEC supply growth will ease to 1.49m b/d in 2019 from almost 2.5m b/d recorded last year but is still well above its long-run average (we are excluding Qatar which has left OPEC from the calculation for now to ensure a consistent base for comparison).

Most of the non-OPEC supply growth will again be concentrated in the United States. Shale oil producers continue to surprise on the upside in terms of supply and the EIA has steadily revised its outlook for growth in 2019 higher. Even as prices plummeted in December oil and gas companies in Texas, which has provided the bulk of US supply growth, remained aggressive in their capital plans for 2019. Nearly half of companies surveyed by the Dallas Fed planned to focus on increasing production, even as WTI prices grind against breakeven costs. Most of the firms surveyed by the Dallas Fed were basing their capital spending plans on WTI prices around USD 50-55/b, not far off levels in early January.

As we have outlined in the past, logistics constraints to getting crude out from producing regions to export terminals remains a challenge for the US oil industry to surmount this year. So far it has not prevented supply from growing but has meant that physical prices at the wellhead remain discounted and inventories have become a 'buyer of last resort' for producers. This trend will remain intact for at least H1 2019 after which some pipeline relief will come online. These exact same dynamics have contributed to the unprecedented steps taken in the Canadian province of Alberta where the government has enforced a production cut to try and run down inventories and narrow the discount for domestic crude prices.

EIA growth projections



Source: EIA, EIKON, Emirates NBD Research.

The drilling rig count in the US has levelled off around 875 active oil-focused rigs since around May 2018, around half its peak level in Q4 2014. However, the number of drilled uncompleted wells has broken to over 6,000 and drilling productivity has continued to creep upwards. The short-cycle and capital flexibility of producers in US shale basins will allow them to take advantage of much shorter moves in crude pricing and curve structures; even as average WTI prices fell the EIA continued to revise higher its production growth forecasts.

OPEC forced into cutting supply

With an unremitting supply picture beyond their control, OPEC countries have started 2019 with another round of production cuts. Some producers got an early start to the cuts with market surveys of production showing that already in December collective OPEC production fell by 630k b/d. In order to achieve the targeted cut from October 2018 levels OPEC production should decline another 800k b/d from the obligated members (Libya, Venezuela and Iran are exempt from the cuts).

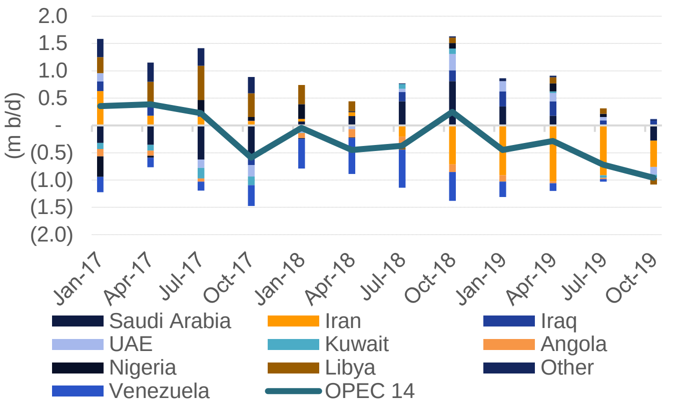
OPEC ministers, particularly from Saudi Arabia and other large producers, have stressed that they are prepared to do 'whatever it takes' to restore oil market balances to neutral. We interpret this as a pledge to cut production even further than the semi-official target of 3% cuts from October 2018 levels. OPEC producers will then return to 'over delivery' on production targets despite this having a mixed result when they tried it in 2017-18. Limiting volumes to such a degree should help to stabilize oil prices; Brent prices appear to have found a floor around USD 50/b as the year has begun. But even with compliance to the cuts in H1 coming in close to the same degree of compliance seen in 2017 and the first half of 2018, oil market balances will still keep accruing inventories.

Our expectation is that both Saudi Arabia and the UAE cut more than the apparent 3% target and will start 2019 with output 4.6% and 5.3% lower than October levels respectively. There will be an immediate near term hit on economic performance but prices still remain far below fiscal breakevens in both countries (USD 82.7/b for Saudi Arabia and USD 68.8/b for the UAE). We doubt that Iraq will participate in cutting production and that few other OPEC members will slash output as aggressively. Commitment to this round of cuts appears far less assured than the 2016 Declaration of Cooperation between OPEC countries and partners like Russia, risking that OPEC+ diplomacy will be far more fractious this year (note Qatar's decision to leave the club with effect from January 2019).

Production cuts need to be seen in context

Production from OPEC will end up lower on average in 2019 but most of the decrease will be from declining Iranian and Venezuelan production, rather than countries that have committed to cutting output. In Saudi Arabia, Iraq, the UAE and Kuwait output targets (assuming the new lower targets are held) still represents levels well above historic averages and close to 2016 record average output.

OPEC production growth y/y



Source: IEA, Emirates NBD Research.

President Trump has been an unreliable ally of OPEC countries in another sense. Part of the reason Saudi Arabia, the UAE, Iraq and others raised production from May onward was to compensate for the impending drop in supplies from Iran as US sanctions on the country tightened. By granting importers of Iranian crude waivers for six months from November the US administration helped to remove one of the sources of anxiety over supply heading into this year. The waivers will expire in Q2 2019 just as the year/year decline in Iranian volumes accelerates. Other OPEC members will need to resist the urge to swamp markets with additional output in order to take advantage of the decline in Iranian volumes. Our forecasts, however, assume that production will increase in H2 and that gains in Saudi Arabia and the UAE among others will offset the declines in Iran.

Price outlook downgraded

Taken together, these supply and demand factors result in a market balance still in surplus for 2019, moving from around 500k b /d in Q1 to flat over the middle quarters the year before widening again in the final quarter. Measured against OECD consumption, stocks will average out at around 61 days of demand, compared with 59.7 in 2018.

We are revising our forecast for oil prices this year as fundamentals and sentiment have shifted considerably since we last laid out our forecast (September 2018). We now expect Brent futures to record an average of around USD 65/b in 2019, moving from USD 61/b in Q1 to USD 67.50/b over the middle months of the year before slipping again in Q4. We expect WTI prices to record an average of around USD 57/b, characterized by a wide Brent/WTI spread in H1 as pipeline shortfalls dislocate US pricing from global moves. We stress that markets should be prepared to endure substantial volatility in 2019 with considerable swings above and below our forecast. We wouldn't rule out Brent moving back below USD 50/b or touching USD 80/b.

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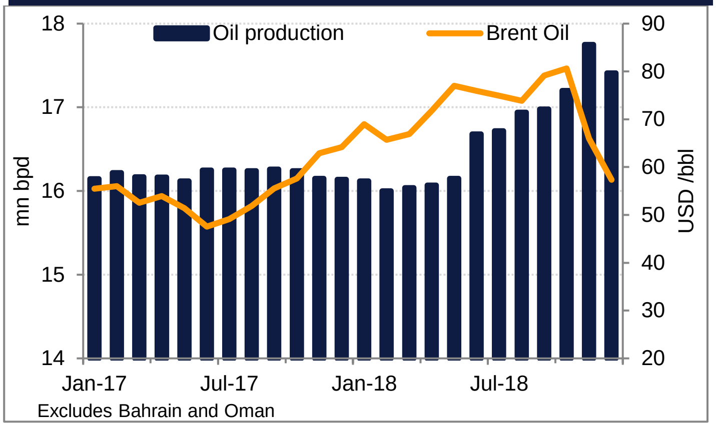
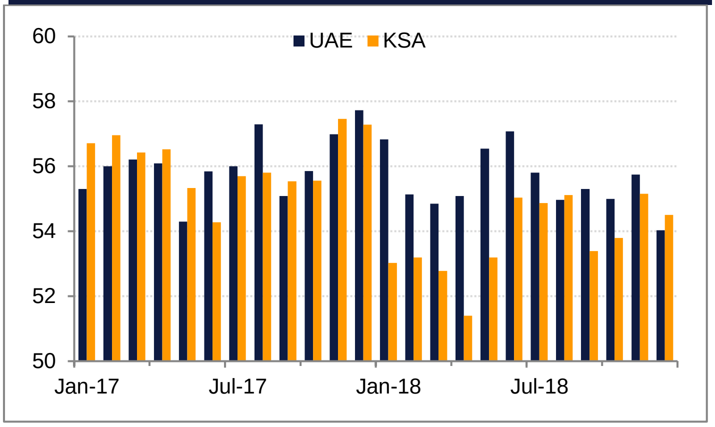
GCC in Pictures

GCC Oil Production and Oil Price



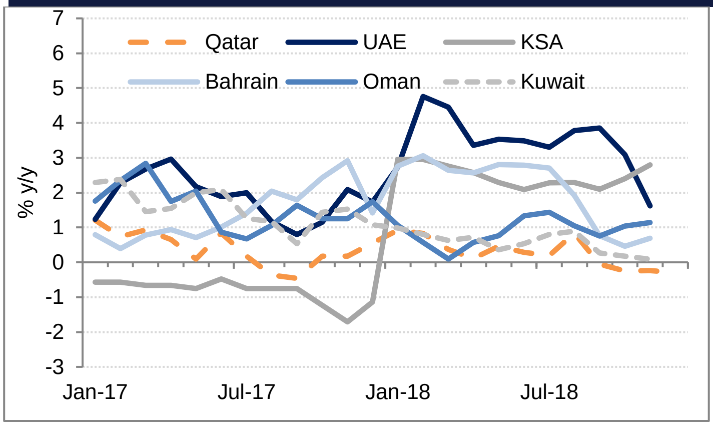
Source: Bloomberg, Emirates NBD Research

Purchasing Managers' Index



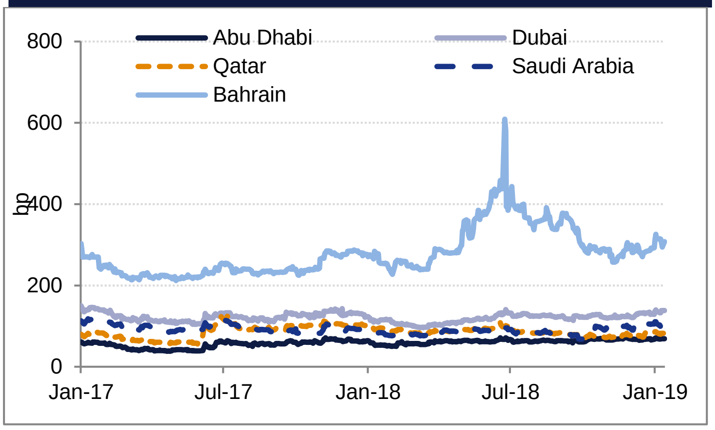
Source: IHS Markit, Emirates NBD Research

Inflation



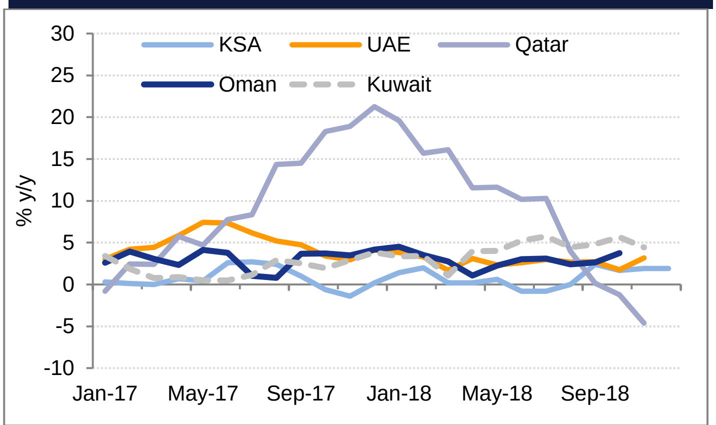
Source: Haver Analytics, Emirates NBD Research

CDS Spreads



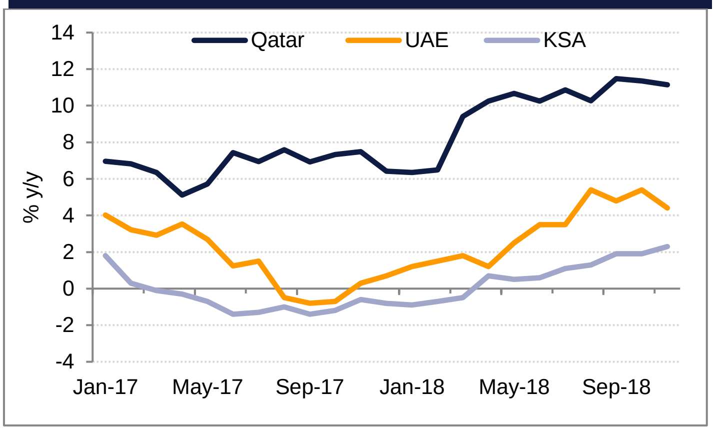
Source: Bloomberg

Money supply (ex Government. deposits)



Source: Haver Analytics, Emirates NBD Research

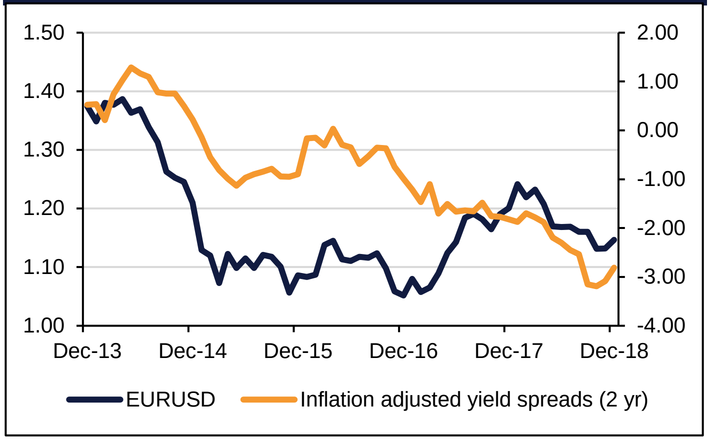
Private sector credit*



**Qatar data is bank loan growth to private sector, not total private sector credit. Source: Haver Analytics, Emirates NBD Research*

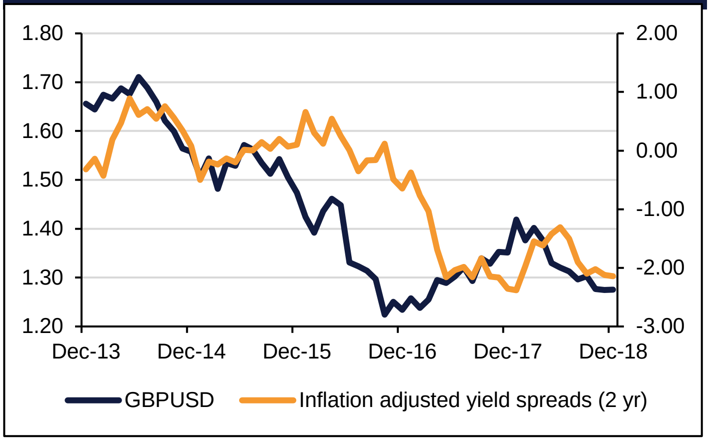
FX–Major Currency Pairs & Real Interest Rates

Interest Rate Differentials–EUR



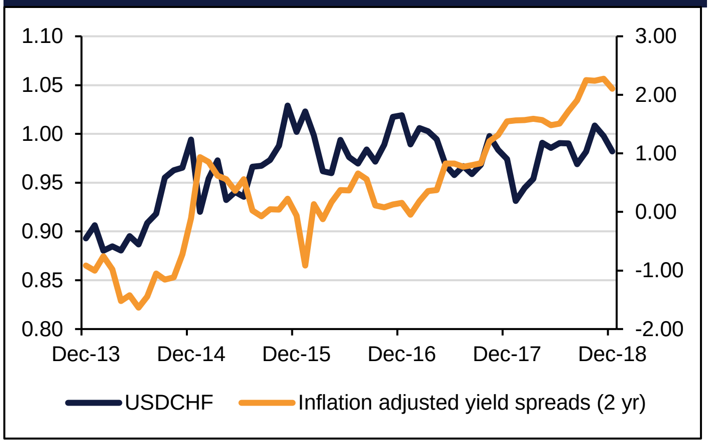
Source: Bloomberg, Emirates NBD Research

Interest Rate Differentials-GBP



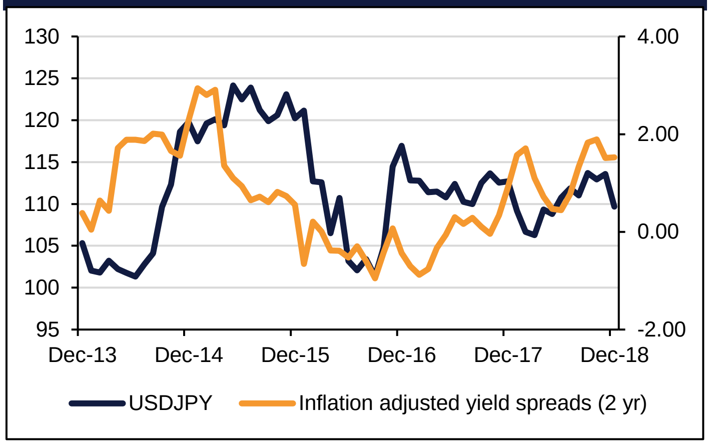
Source: Bloomberg, Emirates NBD Research

Interest Rate Differentials-CHF



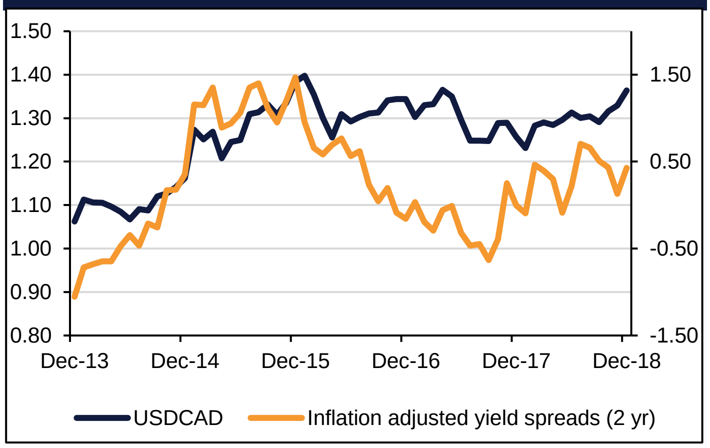
Source: Bloomberg, Emirates NBD Research

Interest Rate Differentials-JPY



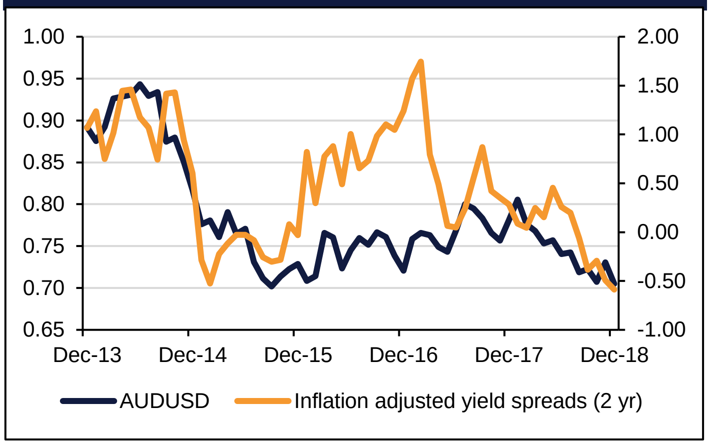
Source: Bloomberg, Emirates NBD Research

Interest Rate Differentials-CAD



Source: Bloomberg, Emirates NBD Research

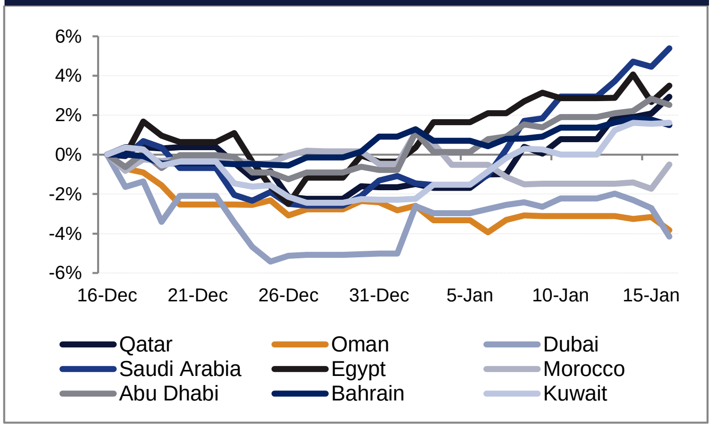
Interest Rate Differentials-AUD



Source: Bloomberg, Emirates NBD Research

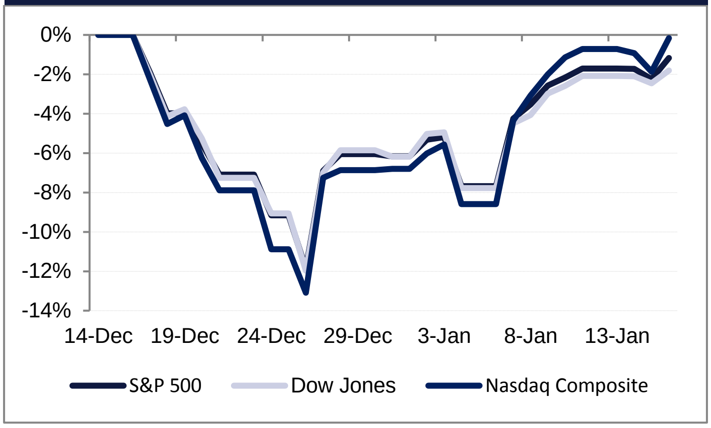
Major Equity Markets

MENA Equity Markets



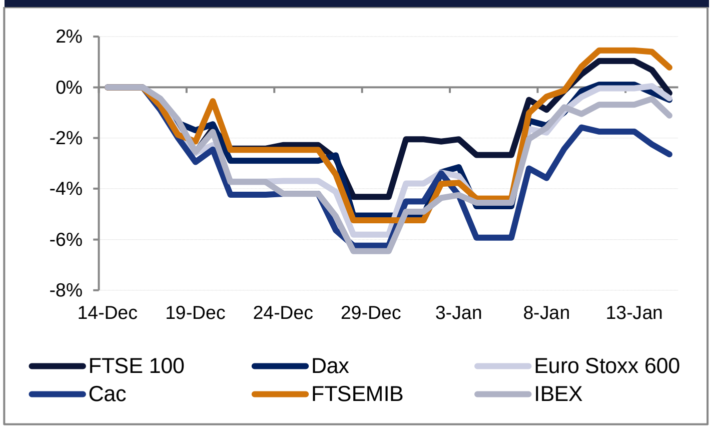
Source: Bloomberg, Emirates NBD Research

US Equity Markets



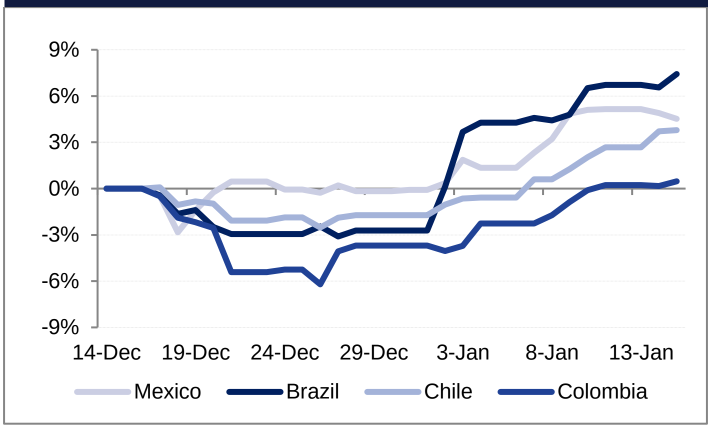
Source: Bloomberg, Emirates NBD Research

European Equity Markets



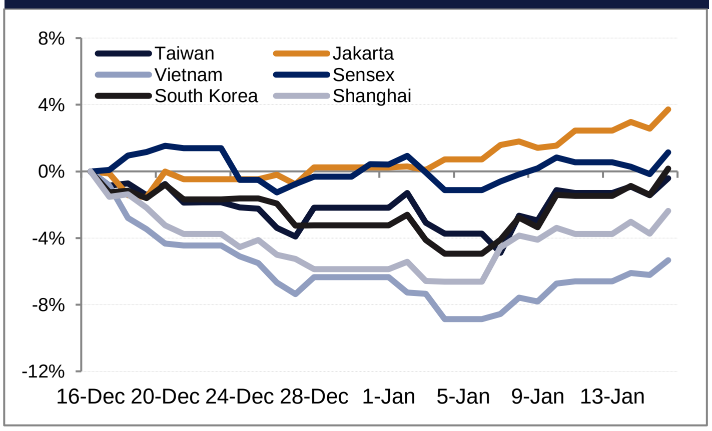
Source: Bloomberg, Emirates NBD Research

Latin American Equity Markets



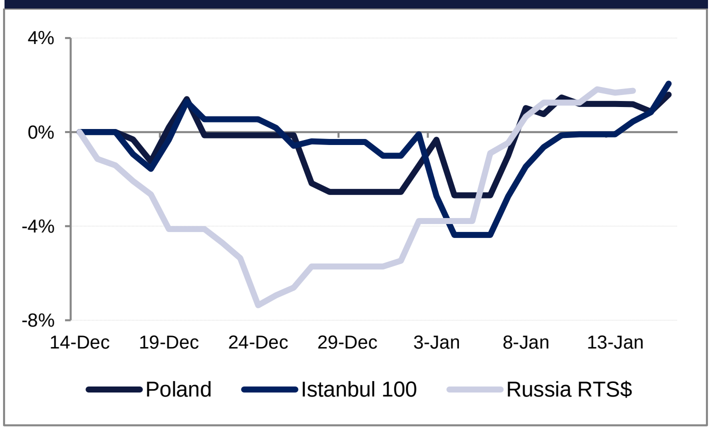
Source: Bloomberg, Emirates NBD Research

Asian Emerging Equity Markets



Source: Bloomberg, Emirates NBD Research

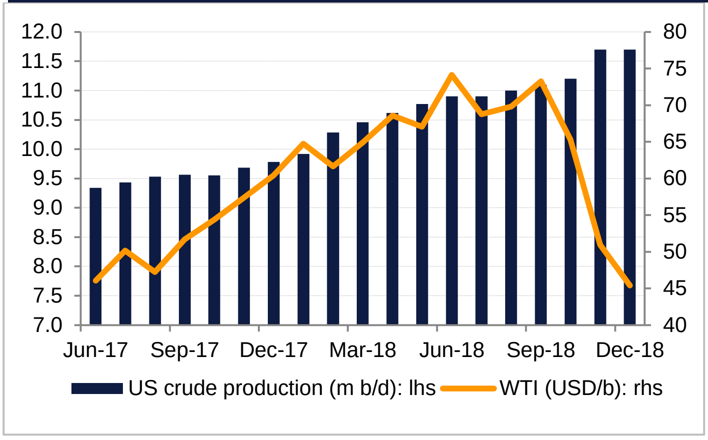
Emerging Europe Equity Markets



Source: Bloomberg, Emirates NBD Research

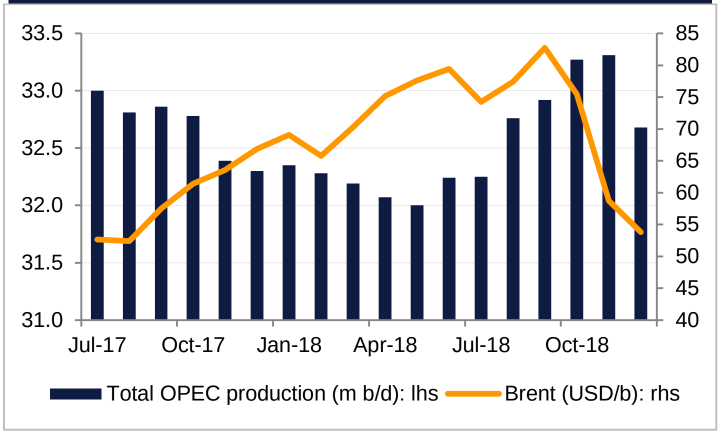
Major Commodities Markets

US oil production and price



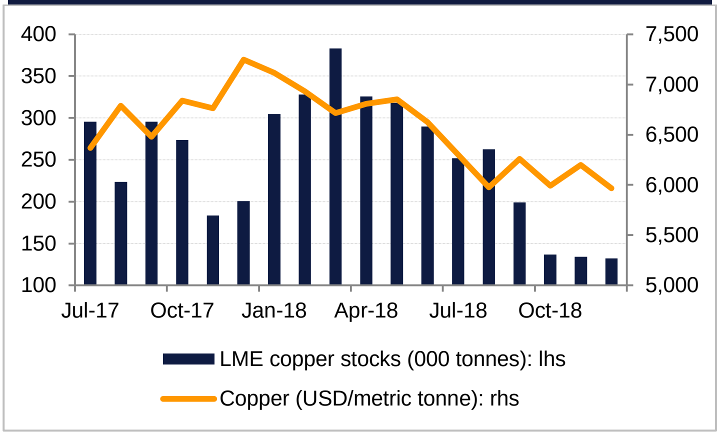
Source: EIKON, Emirates NBD Research

International oil production and price



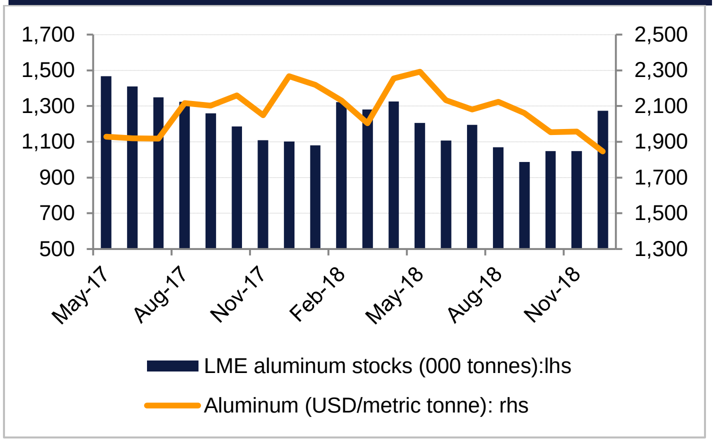
Source: EIKON, Emirates NBD Research

Copper stocks and price



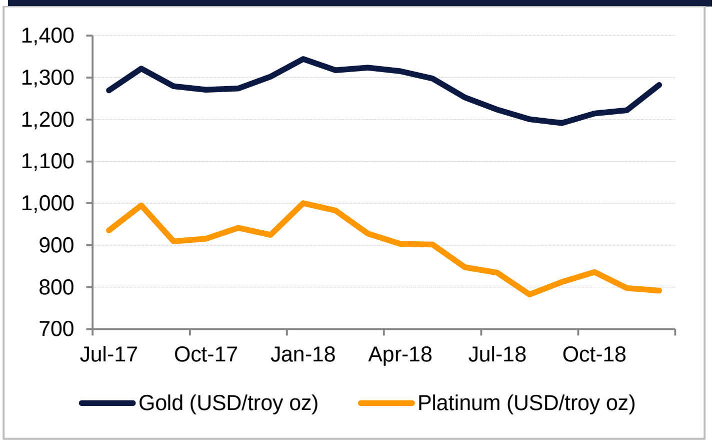
Source: EIKON, Emirates NBD Research

Aluminum stocks and price



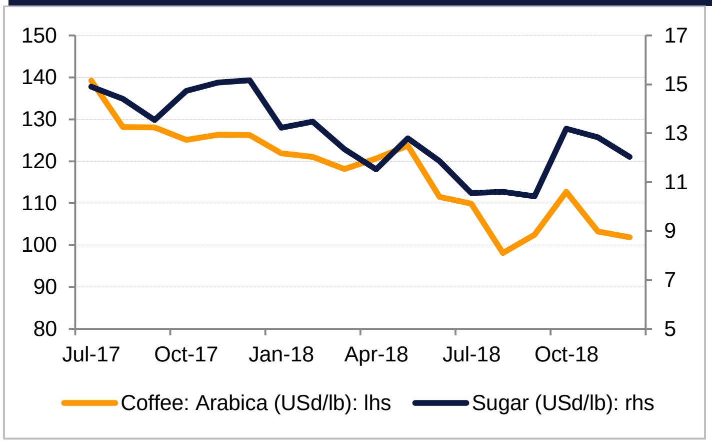
Source: EIKON, Emirates NBD Research

Precious metals prices



Source: EIKON, Emirates NBD Research

Agriculture prices



Source: EIKON, Emirates NBD Research

Key Economic Forecasts - GCC

United Arab Emirates	2016	2017	2018e	2019f	2020f
Nominal GDP $bn	357.3	382.8	427.3	436.6	459.2
Real GDP %	3.0	0.8	2.4	3.1	3.5
Current A/C % GDP	3.7	6.8	7.1	7.9	6.7
Budget Balance % GDP	-3.3	-2.9	0.4	-0.8	0.5
CPI %	1.6	2.0	3.1	1.5	2.0
Saudi Arabia					
Nominal GDP $bn	644.9	683.8	783.5	780.5	813.0
Real GDP %	1.7	-0.9	2.2	2.0	1.6
Current A/C % GDP	-3.7	1.5	9.4	6.7	6.5
Budget Balance % GDP	-12.9	-9.3	-4.6	-5.6	-5.6
CPI %	2.1	-0.8	2.5	2.0	2.0
Qatar					
Nominal GDP $bn	151.7	166.9	191.0	195.4	207.9
Real GDP %	1.8	1.1	3.1	3.6	4.0
Current A/C % GDP	-5.5	3.8	10.2	5.7	4.9
Budget Balance % GDP	-9.2	-5.8	-0.3	1.0	1.0
CPI %	2.7	0.4	0.4	1.5	2.0
Kuwait					
Nominal GDP $bn	109.4	119.5	140.5	141.0	148.0
Real GDP %	2.9	-3.5	2.6	1.6	2.4
Current A/C% GDP	-4.6	6.3	13.0	7.2	12.2
Budget Balance % GDP	-13.9	-9.0	-2.9	-5.5	-5.8
CPI %	3.2	1.6	0.6	1.0	1.5
Oman					
Nominal GDP $bn	65.9	70.7	80.1	80.9	84.3
Real GDP %	5.0	-0.9	2.9	3.1	3.1
Current A/C % GDP	-18.8	-15.2	-5.7	-7.1	-6.2
Budget Balance % GDP	-20.9	-13.8	-6.4	-8.2	-7.1
CPI %	1.1	1.6	1.0	1.5	2.5
Bahrain					
Nominal GDP $bn	32.3	35.4	39.1	40.0	41.7
Real GDP %	3.2	3.9	2.0	2.0	2.4
Current A/C % GDP	-4.6	-3.9	-2.1	-4.2	-7.2
Budget Balance % GDP	-13.5	-10.0	-6.8	-6.4	-6.0
CPI %	2.8	1.4	2.1	3.5	2.5
GCC (Nominal GDP weighted avg)					
Nominal GDP $bn	429	454	518	517	539
Real GDP %	2.3	-0.3	2.4	2.5	2.6
Current A/C % GDP	-2.8	2.6	8.2	6.0	5.9
Budget Balance % GDP	-10.4	-7.4	-2.8	-3.7	-3.3
CPI %	2.1	0.4	2.2	1.7	2.0

Source: Haver Analytics, National sources, Emirates NBD Research

Key Economic Forecasts – Non-GCC Oil Importers

Egypt*	2016	2017	2018e	2019f	2020f
Nominal GDP $bn	332.4	225.8	240.1	283.6	334.8
Real GDP %	4.3	4.1	5.3	5.5	6.1
Current A/C % GDP	-6.0	-6.3	-2.5	-2.3	-2.0
Budget Balance % GDP	-12.05	-10.83	-9.67	-9.37	-8.34
CPI %	13.7	29.6	15.0	12.0	12.0
Jordan					
Nominal GDP $bn	38.7	40.3	41.7	43.2	44.6
Real GDP %	2.0	2.0	2.2	2.6	2.8
Current A/C % GDP	-9.5	-10.7	-9.2	-8.8	-8.3
Budget Balance % GDP	-3.2	-2.7	-3.1	-2.9	-2.6
CPI %	-0.8	3.3	4.6	3.7	2.4
Lebanon					
Nominal GDP $bn	51.1	57.3	62.4	66.3	70.9
Real GDP %	1.0	0.6	0.8	0.9	1.7
Current A/C % GDP	-20.5	-21.2	-19.6	-19.4	-19.9
Budget Balance % GDP	-9.8	-6.9	-9.6	-9.9	-7.9
CPI %	-0.8	4.5	6.3	5.4	4.8
Morocco					
Nominal GDP $bn	103.3	109.6	118.8	121.0	127.5
Real GDP %	1.1	4.1	3.0	2.7	3.0
Current A/C % GDP	-4.2	-3.6	-3.5	-3.4	-3.1
Budget Balance % GDP	-4.2	-3.5	-3.7	-3.4	-3.0
CPI %	1.6	0.8	1.9	2.0	2.1
Tunisia					
Nominal GDP $bn	41.7	36.8	34.5	30.6	30.6
Real GDP %	1.0	1.7	2.5	2.7	3.0
Current A/C % GDP	-8.9	-11.1	-11.1	-9.4	-8.9
Budget Balance % GDP	-6.2	-6.7	-4.8	-4.3	-3.9
CPI %	3.7	5.3	7.4	6.8	5.5
Oil Importers (GDP weighted avg)					
Nominal GDP $bn	223.9	147.4	157.9	187.8	224.0
Real GDP %	3.01	3.32	3.75	3.93	4.55
Current A/C % GDP	-7.4	-8.2	-6.1	-5.6	-5.1
Budget Balance % GDP	-9.4	-7.6	-7.3	-7.3	-6.5
CPI %	8.5	15.7	9.4	8.0	8.1

Source: Haver Analytics, National sources, Emirates NBD Research
**Egypt data refers to fiscal year (July-June)*

Key Economic Forecasts – Non-GCC Oil Exporters

Algeria	2016	2017	2018e	2019f	2020f
Nominal GDP $bn	160.2	165.6	164.1	167.4	172.1
Real GDP %	3.3	1.6	1.8	2.2	2.0
Current A/C % GDP	-12.3	-13.2	-8.9	-7.6	-6.5
Budget Balance % GDP	-13.1	-6.6	-6.9	-6.3	-5.5
CPI %	5.8	6.0	4.0	5.3	6.0
Iran					
Nominal GDP $bn	441.8	433.9	421.2	481.2	570.0
Real GDP %	12.4	3.3	-1.9	-4.0	3.8
Current A/C % GDP	3.7	3.6	3.8	-0.2	-1.4
Budget Balance % GDP	-4.7704	-5.2309	-4.2469	-4.3124	-3.781
CPI %	8.7	10.0	21.0	31.2	17.5
Iraq					
Nominal GDP $bn	165.2	184.6	214.7	242.8	251.2
Real GDP %	11.0	-0.3	3.5	4.3	4.6
Current A/C% GDP	1.3	8.1	24.5	18.9	13.2
Budget Balance % GDP	-14.5	-6.6	-4.4	-4.0	-3.8
CPI %	1.3	0.7	0.4	1.0	1.1
Libya					
Nominal GDP $bn	43.6	63.3	76.1	88.2	96.7
Real GDP %	-6.9	34.8	7.6	5.4	10.4
Current A/C% GDP	-10.2	-9.5	-2.1	-2.6	-2.9
Budget Balance % GDP	-18.1	-10.6	-7.1	-6.3	-5.9
CPI %	9.5	25.0	14.0	10.0	8.5
Oil Exporters (GDP weighted avg)					
Nominal GDP $bn	312.4	299.5	292.3	333.1	392.1
Real GDP %	9.0	5.0	1.2	-0.1	4.3
Current A/C % GDP	0.5	0.4	5.4	2.1	0.7
Budget Balance % GDP	-7.9	-7.9	-6.2	-4.8	-4.4
CPI %	6.1	8.0	12.5	17.5	10.8

Key Economic Forecasts - Global

US	2014	2015	2016	2017	2018f	2019f
Real GDP %	2.6	2.9	1.5	2.2	2.7	2.5
Current A/C % GDP	-2.1	-2.4	-2.4	-2.3	-3.0	-2.5
Budget Balance % GDP	-2.7	-2.6	-3.1	-3.4	-3.5	-4.7
CPI %	1.6	0.1	1.3	2.1	2.5	2.3
Eurozone						
Real GDP %	1.3	2.1	1.8	2.4	1.9	1.5
Current A/C % GDP	2.4	3.2	3.3	3.5	3.2	3.0
Budget Balance % GDP	-2.5	-2.0	-1.5	-0.9	-0.7	-0.9
CPI %	0.4	0.0	0.2	1.5	1.7	1.5
UK						
Real GDP %	3.1	2.3	1.9	1.7	1.3	1.5
Current A/C% GDP	-5.3	-5.2	-5.8	-3.9	-3.5	-3.3
Budget Balance % GDP	-5.3	-4.1	-2.9	-1.8	-1.4	-1.6
CPI %	1.5	0.0	0.7	2.7	2.5	2.1
Japan						
Real GDP %	0.4	1.4	0.9	1.8	0.8	1.0
Current A/C % GDP	0.8	3.1	3.8	4.0	3.6	3.6
Budget Balance % GDP	-7.7	-6.7	-5.7	-3.5	-3.2	-3.5
CPI %	2.7	0.8	-0.1	0.5	1.0	1.0
China						
Real GDP %	7.3	6.9	6.7	6.9	6.6	6.3
Current A/C % GDP	2.3	2.8	1.8	1.3	0.4	0.1
Budget Balance %GDP	-1.8	-3.4	-3.8	-3.7	-3.6	-4.0
CPI%	2.0	1.4	2.0	1.6	2.1	2.3
India*						
Real GDP%	6.4	7.4	8.2	7.1	7.3	7.8
Current A/C% GDP	-1.4	-1.1	-0.6	-1.5	-2.0	-2.8
Budget Balance % GDP	-4.3	-3.5	-3.7	-3.9	-3.5	-3.3
CPI %	6.7	4.9	5.0	3.3	3.9	4.6

Source: Bloomberg, Emirates NBD Research
**For India the data refers to fiscal year (April – March)*

FX Forecasts

	FX Forecasts - Major					Forwards		
	15-Jan	Q1 2019	Q2 2019	Q3 2019	Q4 2019	3m	6m	12m
EUR/USD	1.1430	1.1500	1.1500	1.1800	1.2000	1.1519	1.1609	1.1795
USD/JPY	108.55	114.00	116.00	114.00	112.00	107.75	106.93	105.25
USD/CHF	0.9862	1.0000	1.0000	0.9800	0.9700	0.9777	0.9691	0.9518
GBP/USD	1.2850	1.2500	1.3000	1.3500	1.4000	1.2908	1.2964	1.3071
AUD/USD	0.7203	0.7300	0.7550	0.7700	0.8000	0.7213	0.7222	0.7242
NZD/USD	0.6825	0.6800	0.6900	0.7100	0.7400	0.6836	0.6846	0.6866
USD/CAD	1.3265	1.3250	1.2850	1.2600	1.2500	1.3237	1.3212	1.3169
EUR/GBP	0.8895	0.9200	0.8846	0.8741	0.8571	0.8923	0.8954	0.9023
EUR/JPY	124.07	131.10	133.40	134.52	134.40	124.07	124.07	124.07
EUR/CHF	1.1272	1.1500	1.1500	1.1564	1.1640	1.1261	1.1250	1.1226
	FX Forecasts - Emerging					**Forwards**		
	15-Jan	**Q1 2019**	**Q2 2019**	**Q3 2019**	**Q4 2019**	**3m**	**6m**	**12m**
USD/SAR*	3.7513	3.7500	3.7500	3.7500	3.7500	3.7512	3.7519	3.7578
USD/AED*	3.6730	3.6730	3.6730	3.6730	3.6730	3.6737	3.6745	--
USD/KWD	0.3031	0.3020	0.3020	0.3020	0.3020	0.3027	0.3018	--
USD/OMR*	0.3847	0.3850	0.3850	0.3850	0.3850	0.3856	0.3867	0.3892
USD/BHD*	0.3770	0.3770	0.3770	0.3770	0.3770	0.3761	0.3761	0.3796
USD/QAR*	3.6545	3.6400	3.6400	3.6400	3.6400	3.6541	3.6544	3.6575
USD/EGP	17.9508	18.0000	18.1250	18.2500	18.2500	18.3375	18.8200	19.8100
USD/INR	71.063	71.000	69.000	68.000	68.000	71.9000	72.7200	74.2600
USD/CNY	6.7593	6.9000	7.0000	7.1000	7.2000	6.7802	6.7882	6.7945
USD/SGD	1.3535	1.3500	1.3200	1.3000	1.2900	1.3505	1.3472	1.3405

Data as of 15 January 2019

Source: Bloomberg, Emirates NBD Research

Interest Rate Forecasts

USD Swaps Forecasts					Forwards		
	Current	3M	6M	12M	3M	6M	12M
2y	2.70	2.85	3.05	3.10			
10y	2.74	2.90	3.00	2.90			
2s10s (bp)	4	5	-5	-20			
US Treasuries Forecasts							
2y	2.53	2.67	3.00	3.10			
10y	2.71	2.85	3.05	2.90			
2s10s (bp)	18	18	5	-20			
3M Libor							
3m	2.77	2.80	3.00	3.25			
3M Eibor							
3m	2.93	3.00	3.20	3.50			
Policy Rate Forecasts							
	Current %	3M	6M	12M			
FED (Upper Band)	2.50	2.50	2.75	3.00			
ECB	0.00	0.00	0.00	0.00			
BoE	0.75	0.75	0.75	0.75			
BoJ	-0.10	-0.10	-0.10	-0.10			
SNB	-0.75	-0.75	-0.75	-0.75			
RBA	1.50	1.50	1.50	1.50			
RBI (repo)	6.50	6.25	6.00	6.00			
SAMA (reverse repo)	2.50	2.50	2.75	3.00			
UAE (1W repo)	2.75	2.75	3.00	3.25			
CBK (o/n repo rate)	2.50	2.50	2.75	3.00			
QCB (repo rate)	2.50	2.50	2.75	3.00			
CBB (o/n depo)	2.50	2.50	2.75	3.00			
CBO (o/n repo)	3.00	3.00	3.25	3.50			
CBE (o/n depo)	16.75	15.75	15.75	14.75			

Source: Bloomberg, Emirates NBD Research

Commodity Forecasts

Global commodity prices							
	Last	2019Q1	Q2	Q3	Q4	2018	2019
Energy							
WTI	52.16	50.00	57.50	60.00	60.00	64.76	56.88
Brent	60.71	61.00	67.50	67.50	63.00	71.53	64.75
Precious metals							
Gold	1,292.65	1,300.00	1,350.00	1,350.00	1,380.00	1,268.85	1,345.00
Silver	15.61	15.00	15.25	15.50	15.00	15.69	15.19
Platinum	795.50	850.00	900.00	950.00	950.00	877.68	912.50
Palladium	1,324.00	1,000.00	1,050.00	1,150.00	1,150.00	1,027.51	1,087.50
Base metals							
Aluminum	1,861.00	2,050.00	2,150.00	2,150.00	2,250.00	2,114.59	2,150.00
Copper	5,945.00	6,000.00	6,500.00	6,750.00	7,000.00	6,547.63	6,562.50
Lead	1,972.00	1,936.35	2,078.35	2,148.69	2,218.73	2,249.46	2,095.53
Nickel	11,620.00	12,125.00	12,500.00	12,750.00	13,250.00	13,182.34	12,656.25
Tin	20,700.00	21,000.00	20,750.00	20,750.00	20,500.00	20,081.72	20,750.00
Zinc	2,489.00	2,512.90	2,686.71	2,772.48	2,857.71	2,895.11	2,707.45

Prices as of 16 January 2019. Note: prices are average of time period unless indicated otherwise.
Source: EIKON, Emirates NBD Research

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