Divergences

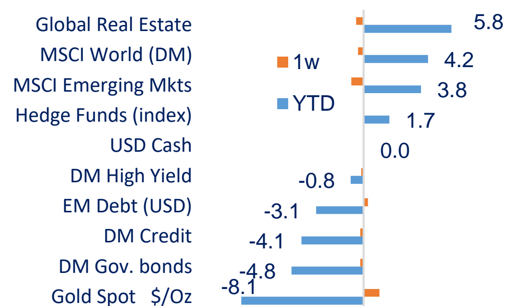
- **Central Banks around the world have different views and responses to inflation**
- **Global markets were overall slightly negative but divergent across asset classes and segments**
- **Our positioning reflects our confidence in a reasonably constructive outlook for risk assets**

Last week didn't teach us a lot on global activity, with an imminent acceleration from consumption in the Western world, but we learn on central banks' take on inflation and policy. On Wednesday, the Fed reiterated a firmly patient position. They rose their economic outlook for the year, but the update of their rates projections, the "dot-plot", clearly indicates that they see no reason to hike interest rates before 2023. The line is similar from the large developed markets, with only some fine tuning from the Bank of Japan with regards to their target on the 10-year rate. On the other hand, central banks in Brazil, Turkey, Russia and Norway have issued a different guidance: rate hikes could be coming there sooner to contain inflationary pressures, to control credit extension or limit the risk of housing bubbles. China is a particular case: with their recovery in a more mature phase than anywhere else, they are not using monetary policy to stimulate and highlight a "neutral" stance, which has rocked their stock indices.

Global stocks were slightly down, less than a percent, and so was the fixed income market with the US 10-year Treasury yield closing at 1.73%. Growth sectors were looked after, while a drop in oil prices affected the cyclical complex. Oil prices lost around 7% with the combination of a stronger dollar and weaker demand in Asia triggering profit-taking. Divergences were also apparent in the first discussions between US and Chinese officials under the Biden administration.

We still hold the view that inflationary pressures will be material but temporary, and that investors are better off in cyclical assets such as stocks and real estate. If anything, divergences are an opportunity for the fundamental investor to make a difference and we are ready to seize opportunities. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2020, LAST WEEK



MAURICE GRAVIER
Chief Investment Officer
MauriceG@EmiratesNBD.com

ANITA GUPTA
Head of Equity Strategy
AnitaG@EmiratesNBD.com

GIORGIO BORELLI
Head of Asset Allocation
GiorgioB@EmitatesNBD.com

SATYAJIT SINGH
Head of Fixed Income Strategy
SatyajitSI@EmiratesNBD.com

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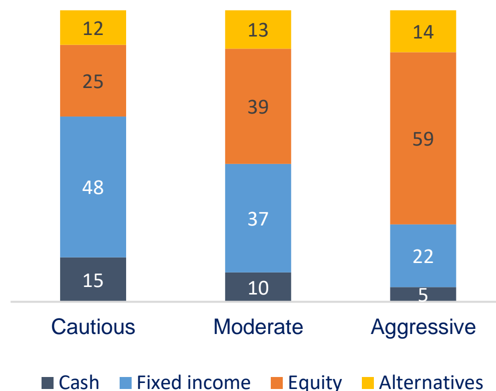
Cross-asset Update

The FOMC meeting concluded on Thursday with a very dovish note struck by Jerome Powell. If the Fed's accommodative stance makes for no new news, there was still an element of surprise in the message to markets, which was the extreme degree of dovishness even as against those investor expectations already leaning in that direction. It is now obvious that the Fed wants to run a high-pressure economy, no matter what. The Summary of Economic Projections, released quarterly, sees unemployment drop to 3.5% and inflation at, or slightly above target and no rate hikes throughout 2023. The most important point of the whole Q&A session is the clear break with the past, that "we are not going to react pre-emptively on forecasts". This has implications across asset classes, as a new policy stance should translate in a different market regime, hence a new asset trajectory.

With the old Fed, a stronger economy leading other countries would have signified a structurally stronger dollar, while with the new stance it doesn't, as the currency yield differential would not move in favour of the dollar due to lower for longer rates. It would have meant also a bearish gold market, with rising real rates. But the new Fed will ultimately cap long-dated yields by anchoring short-term rates for a very long time, in spite of rising inflation. And, even assuming that markets keep on challenging the Fed's judgement and push long-dated yields far above current levels anticipating higher inflation, the Federal Reserve would most likely intervene. It would have to, as excessively higher yields would tighten financial conditions and run counter the basic tenet of running the high pressure economy. In the end, Powell's ultra-accommodative message ties in with our longer term view on the US dollar and gold, of fading cyclical strength in the former and weakness in the latter.

Yields expected to be capped either via policy rates or more directly by means of market interventions - against the backdrop of abundant liquidity, stronger growth and inflation in line with that economic growth rate - are an open invitation to taking more risk, especially in equities. The ultimate implication would be sinking real rates, ballooning market valuations, a renewed gold bull market and a lasting bearish one for the dollar. Yet, pushing consistently in one direction creates the conditions for being unable to reverse course when need be. This year should see a nice ride in financial markets. It remains to be seen how the Fed will tread that fine line when confronted with the necessity of reining in asset purchases, or simply just when the current liquidity impulse fades.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

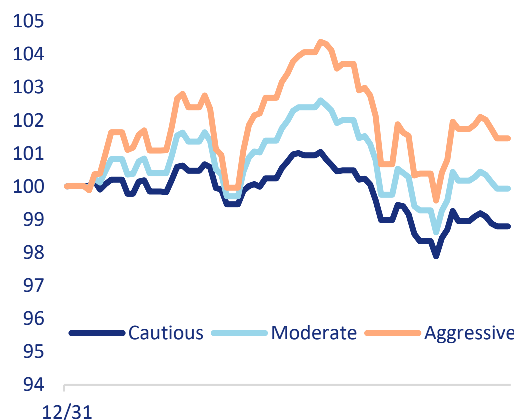


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	UW	N	OW
Cash		=	
DM Gov.	<<<<<		
EM Debt			>
DM Credit			>
DM H. Yield			>
DM Equity			>>
EM Equity			>
Gold			>
Real Estate		=	
Hedge Funds	<<<		

UW/N/OW:Underweight/Neutral/Overweight

TAA – 2021 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

We are watching history being made in the US Treasury market. The long duration US Treasury index officially entered bear market territory last week with a correction of 21% from the peak of March 2020. The bull market in treasuries had started in 1981 and lasted 40 years without a single 20% correction ever. The 10-year Treasury yields also reached a one year high of 1.72% and is the worst-performing compared to other developed market benchmark 10-year bonds. The Fed maintained a stoic stance without budging to the demand of the markets. They reiterated their stance to look through intermittent inflation, and the updated dot plots show no rate hikes till the end of 2023. However, the treasury yields' movement indicates that the market doesn't seem to trust the Fed's guidance. The updated inflation numbers for 2021 and 2023 are above 2%, the Fed's long-term target. If the 10-year yields move up to 2%, we will not hesitate to reverse our current underweight position.

The sub-sectors were a sea of red last week. The OAS spreads across Bloomberg Barclays indices traded in a tight range. The only exception was Emerging Market Debt, where spreads compressed by 8 bps last week. Our preferred asset class Asia High Yield gave the highest return of +0.6% last week. Emerging Market central banks have started increasing rates to fight inflation, with Brazil, Russia, and Turkey leading the bandwagon. The Emerging Market central banks might not be as patient as FED with inflation. This would be negative for local currency bonds as rates increase across the board.

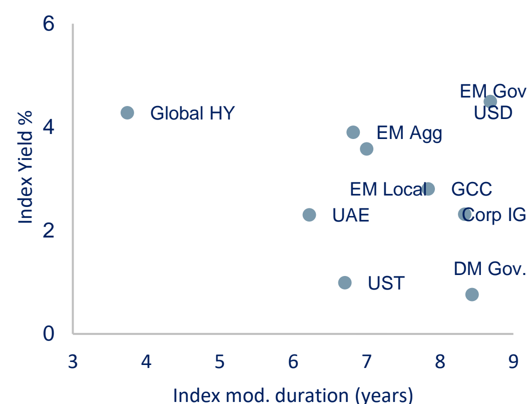
The primary issuance numbers remain strong across both Investment Grade and High Yield as companies continue to take advantage of the very attractive funding environment. Analysts have upsized their expectations of yearly issuance levels by 25% in the High Yield sector. The High Yield sector issued $125 Bn, which is 58% higher than the previous first-quarter high achieved in 2015. 73% of the year-to-date USD HY gross issuance has been earmarked for either debt repayment or refinancing, which is bond investor-friendly, according to Goldman Sachs. Weekly fund flows to Fixed Income returned to green last week. Short-duration bond funds and Agg-type funds cornered 65% of the total inflow. Emerging Market fund inflows remained muted at only 96 Mn.

In MENA, the sovereign curves continued to trade down. The bonds were down by 0.25% to 0.5% in the belly of the curve, while the long-duration bonds were down by approximately 1pt. The local primary market was muted as issuers waited for clarity on the Fed's stance. There are rumors about Arabian Centre coming to the market with a new offering. The existing 2024 maturity bonds currently trade around 4.7% yield. Doha Bank has issued a mandate for the issuance of 5-year senior notes last Friday. We expect the primary issuance volumes to increase before the Holy month of Ramadan, where bond sales remain muted.

FIXED INCOME KEY CONVICTIONS

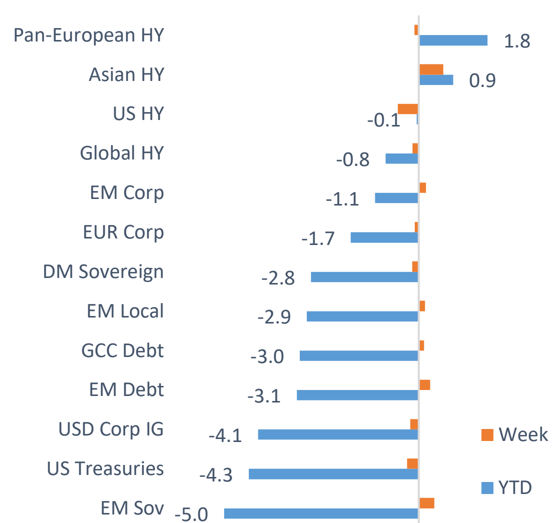
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

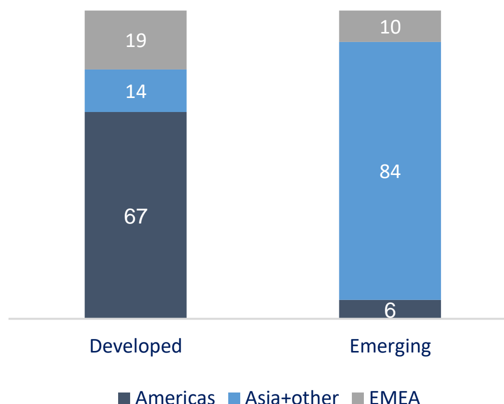
In spite of sharp intraday moves global equities ended the week down just half a percent and with a weekly record inflow at $68bn. During the last 19 weeks global equities received $536bn of inflows, starting during the week of the US election and then further supported by positive vaccine rollouts. This would be an annualized $1.5tn of inflows into equities. The 2017 record is at $0.3tn. The US has received one third of the global equity inflows in 2021 and 80% of last week's inflows and we expect US exceptionalism to continue with the large fiscal stimulus which is supportive of demand and has amongst the best vaccine rollouts globally. Europe had a flat week whilst Japan stood out. EM equities are now trailing DM equities as China continued to lose momentum and India had a down week. Though tech has been underperforming it is flat for the year compared to global equities up 4.2% and the Nasdaq performance for the week was the same as the S&P 500 at -0.77%. The cyclical value rotation has led to outperformance from financials and there is more room for upside for European and Asian banks which are lagging the US financial rally. The 10 year Treasury yield is now 100 bps above its one year low and this is not worrying as long as growth remains the primary driver. The vaccine drive has definitely slowed the spread of the virus and easing lockdowns is having a positive impact on demand especially in the US where domestic air travel is rising. However, whilst US airlines are up in share price, a return to profits is some time away.

UAE equities saw gains of over a percent for Dubai and 1.7% for Abu Dhabi taking year to date gains to 5% for the former and 16% for the latter. Strong dividend payouts seen from the banks, retail (ADNOC) and logistics (Aramex) – stand out in a pandemic year.

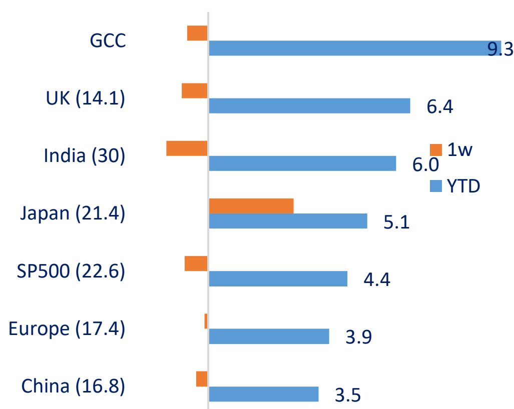
The daily moves specially for the tech sector while sharp, look like the market is finding its equilibrium. The Vix Index is steady at 20. Looking through the noise we would focus on the upward revisions to GDP growth and earnings and the macro data which is supportive of the corporate profit rebound. The cyclical rotation still has some room. Though oil lost some ground the energy sector still leads equity performance in 2021, we are neutral. Financials at a forward PE of 12.3 are both a cyclical and value play. Tech sector is the highest at a 27X forward PE but well supported by high teen revenue and earnings growth. The FAANGS still constitute 33% of global equity market cap. The more defensive sectors staples, utilities and healthcare are bottom of the rung as would be expected in a cyclical rebound.

The auto chip shortage has worsened and the role of semiconductor companies becomes even more important as the traditional auto makers morph into EV leaders. Volkswagen plans to produce a million EVs this year. The switch to clean energy has received more attention after the start of Biden's presidency. A big surge in battery technology and demand for lithium is concurrent with the accelerated global EV rollout. EVs are estimated to be 11% of BEV sales by 2025 with Europe which has tighter emission regulations at 25%.

EQUITY RECOMMENDED REGIONAL POSITIONING

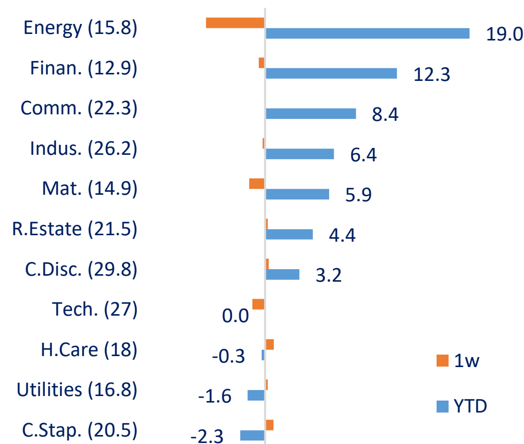


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2021PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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