Starting to adjust asset allocation

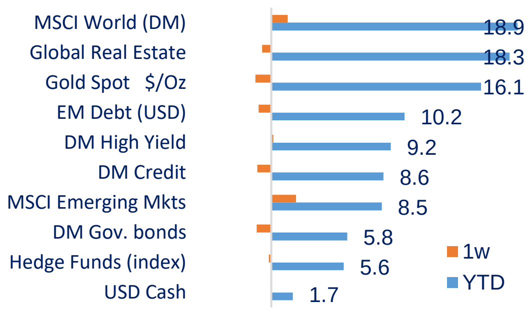
- **Wednesday, we reduced Emerging Market debt to Neutral and added to Emerging Market equities**
- **Last week was better for cyclical assets than for defensive ones – some normalization of extreme positioning**
- **The week ahead will focus on the Fed monthly meeting on Wednesday, where a rate cut is expected**

Tactical Asset Allocation aims at identifying and seizing near-term opportunities, based on an analysis of the backdrop, valuations, and behavioural factors. We held our September committee last week. Our central scenario acknowledges a slowing global economy, but the combined impact of monetary easing and fiscal stimulus should avoid a recession in the near-term. Under this assumption, defensive assets look expensive while some cyclical assets, particularly EM Equities, show a reasonable valuation. This difference also mirrors the current investor positioning, driven by pessimism.

We were overweight in EM Debt through all the year, and it has been the best performing fixed income segment of our coverage. When the trade war suddenly re-escalated in early May, we immediately reduced Emerging Market equities, which are now cheaper. We just decided to reverse this positioning: reducing EM Debt to neutral, and buying back EM Equities to overweight. Given the current rates environment, the risk/reward within Emerging Markets have switched: it's better to be an owner than a lender, to say it in short.

We still don't expect an imminent deal on trade between the US and China but see the long-term investment case for EM Equities as compelling, especially in the UAE and in India. Our overall positioning remains rich in cash for resilience and flexibility. As we write, Oil prices jumped 11% after attacks disrupted Saudi supply. We will closely monitor the situation and its implications for investment.

ASSET CLASSES USD % TOTAL RETURN, YTD 2019 AND WEEK



MAURICE GRAVIER
Chief Investment Officer
MauriceG@EmiratesNBD.com

ANITA GUPTA
Head of Equity Strategy
AnitaG@EmiratesNBD.com

YAHYA SULTAN
Head of Fixed Income Strategy
YahyaS@EmiratesNBD.com

GIORGIO BORELLI
Head of Asset Allocation
GiorgioB@EmitatesNBD.com

Cross-asset considerations

What a difference two weeks make. At the end of August investors witnessed spectacular rallies across defensive assets, with US 10-year yields rallying almost 120bps, gold up more than 18% since the start of the year and the Japanese yen touching a two-year high against the US dollar. US Treasury markets were clearly flashing warning deflationary signals even as yields below zero in most European countries were pointing to a depression. Equities, apparently unscathed and mostly range bound, told a similar story at a sector level as the gap between pricey defensive sectors and value stocks was growing ever larger. Something had to give, either equities would have in the end tumbled or government bonds retreated.

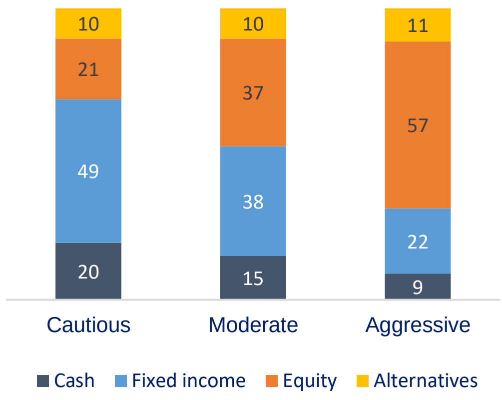
Although doubtful about a quick resolution of the trade conflict, we have steadily been in the non-recession camp, hence held the conviction that yields would have to rise ultimately alongside risk assets. The first two weeks of September have marked a dramatic turnaround, with value outperforming growth and defensive assets pulling back at lightning speed. Investors took notice of steadily climbing global economic surprises throughout August and were cheered by the announcement of a US-China meeting to be held in Washington early in October.

Is there more room for the value trade across asset classes, which would see global equities break out of their trading range and yields rise further? We think it is possible, unless the US and China's confrontation worsens further. Current intermarket relationships are quite constructive in this sense as well. Since trade conflicts have deescalated in very late August the US yield curve has steepened substantially and gold has been stopped in its bullish trajectory. The recent climbing of future economic expectations versus current assessments, both in the US and Europe, portends further steepening on both sides of the pond, which in turn would imply a turn in business activity, necessary to avoid that manufacturing confidence plumbs depths historically associated with recessionary periods.

Hence, we would expect that cyclical assets return in favor, in particular EM stocks within equities and credit relative to government bonds in fixed income. The rotation out of expensive equity sectors should continue and gold is expected to lose further ground against industrial metals. For any rotation into value to be sustainable the outlook outside of the US must improve substantially. For now we must be happy with barely more than anecdotal evidence of that, and investors will be looking to the hard data released out of China this week to be reassured on this front.

Usually, sentiment and liquidity lead hard data, hence positive economic surprises, the Fed's mid-cycle adjustment and Draghi's restart of Quantitative Easing in Europe provide comfort to our view. Any stumbling block on the way to a trade deal, still long and winding, will prove to be a setback to markets, but also to the deal Mr Trump will be under pressure to close by mid-year in 2020 in order to clinch the possibility of a reelection.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

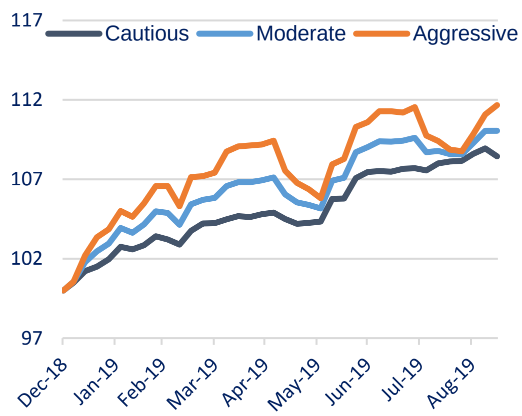


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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 – YTD INDICATIVE PERFORMANCE



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

Fixed Income Update

It was an eventful week with macro-data and progress in trade-talks pushing risk assets higher, while pressuring bond prices lower across the board. To add, the postponing and relaxation of some tariffs by the US and China helped nurture sentiment. The benchmark US Treasuries saw a sharp sell-off across the curve. The 10-year Treasury yield climbed above 34bp over the week to close at 1.89% while individual segments of the US yield curve remains inverted.

The US has agreed to postpone the imposition of an additional 5% in tariffs by two weeks to 15 October as a sign of goodwill. Tariffs on $250bn worth of Chinese goods were previously set to increase from 25% to 30% on October 1st, which happens to be the 70th anniversary of the People's Republic of China. Furthermore, the Chinese have also reprieved additional tariffs on certain US goods it imports.

Inflation and retail spending in the US picked up, providing a boost for investor sentiment, and risk appetite. As the recent core inflation readings show some consistency, it could revive the hawks at the Federal Reserve to debate over the next rate cut. August core inflation was a bit stronger than expected, up 0.3% MoM, and accelerated to 2.4% YoY.

The US budget deficit widened to $1.067 trillion for the first 11 months of the fiscal year, a 19% increase versus last year. The White House's Office of Management and Budget expects the deficit to exceed $1 trillion for the fiscal year, which ends on September 30. The deficit is expected to bloat to $960 billion in F2019, according to the Congressional Budget Office (CBO) latest report, and average $1.2 trillion in each of the next ten years.

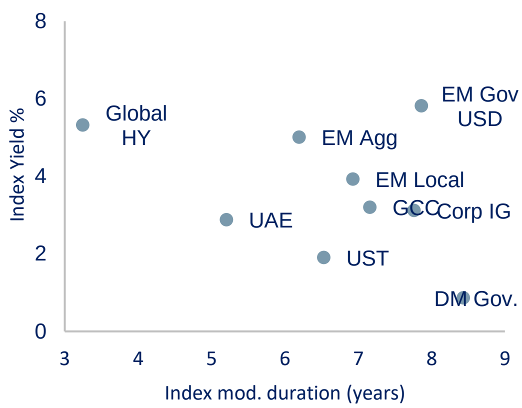
The ECB lowered policy rate (deposit facility rate) by 0.10% to -0.50% while maintaining the interest rate on the main refinancing operations and the rate on the marginal lending facility unchanged at their current levels of 0.00% and 0.25% respectively. The ECB would restart the asset purchase program at a monthly pace of Euro 20Bn from 1st of November 2019.

The finance ministry of India unveils new stimulus measures in a move to stimulate the economy by announcing more than $7bn boost to exporters and housing projects. The package aims to refund taxes and levies for export promotion which will be effective from 1st January. Finance Minister Nirmala Sitharaman told reporters that the government would separately set up a 100 billion-rupee funding window for affordable housing to revive stalled projects. Furthermore, the Finance Minister Nirmala stated that they would make every effort to ensure that the revenue loss from the measures won't affect the fiscal deficit target. In July, she set a goal to narrow the budget gap to 3.3% of gross domestic product in the year ending March 2020. The RBI last month lowered its growth forecast for the economy to 6.9% for the year to March. The measures should provide reprieve to the NBFC sector as they undergo tremendous liquidity stress over the last few quarters. With further rate cuts anticipated, we see upside for benchmark bonds to drift towards the 6% level from current 6.63%. Real yields has further room to compress based on our markets viewpoints.

FIXED INCOME KEY CONVICTIONS

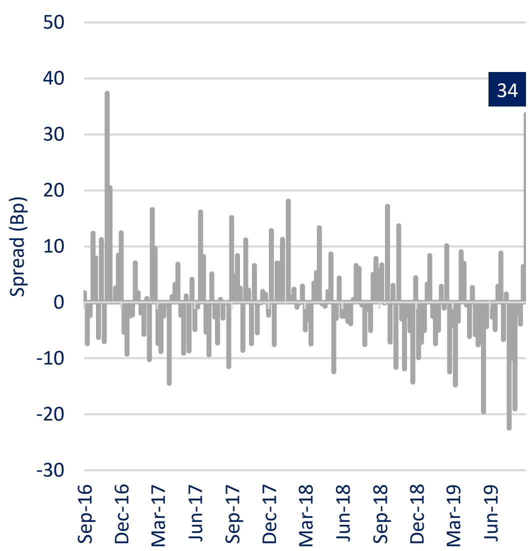
DEVELOPED MARKETS
OW US within Government
OW Corporate Credit
UW High Yield
EMERGING MARKETS
OW GCC
OW Local Currency
UW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

Chart: Biggest weekly change on the UST10Y yield



Source: CIO Office chart

Equity Update

A possible solution to the trade tariff escalation, along with accommodative Central Bank policy, led to global equities rallying (+1.3%). Tech, which is more sensitive to positive sentiment around global growth/ demand, was a major contributor to the S&P 500's weekly 1% return. So were financials, moving higher along with yields. Most developed markets are trading close to record highs, with valuations above the long term median. Index fair values were achieved by mid-2019 and we restate our focus on selectivity for alpha generation. Our slightly defensive sectoral positioning is working and in the cyclical space, we are only overweight Technology and Consumer Discretionary.

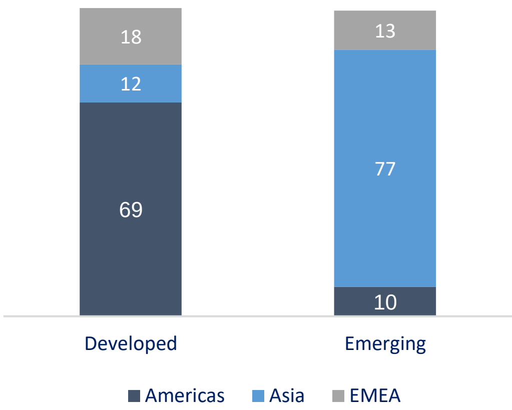
We have made changes in our tactical asset allocation and are back to an overweight in emerging market equities. We can see the shift in investor sentiment, as emerging markets ended the week up 1.9%, with year to date gains in USD now at + 8.5%. Much of the bad news around tariffs looks baked in, and the possibility of the US dollar being weaker would boost EM assets. EM equity valuations are still very reasonable and earnings growth in the high single digits, should meet expectations. Within EM, we are overweight the UAE and India and are neutral other regions in EMEA and Asia. We maintain our underweight position in LATAM.

Our DM equity positioning has also shifted to an Overweight position on US equities. The US maintains its advantage over the rest of the world on macro factors and shareholder return (dividend and buybacks) metrics. Next year's election could keep investor sentiment positive as the main political parties will promise reform and growth. The consumer (70% of the economy) is still strong and whilst lower rates hurt savers, they boost consumption. We expect the market to trade sideways, waiting for the FOMC. We have an Underweight stance on Europe as the growth is not there to justify the rally already seen in the markets this year.

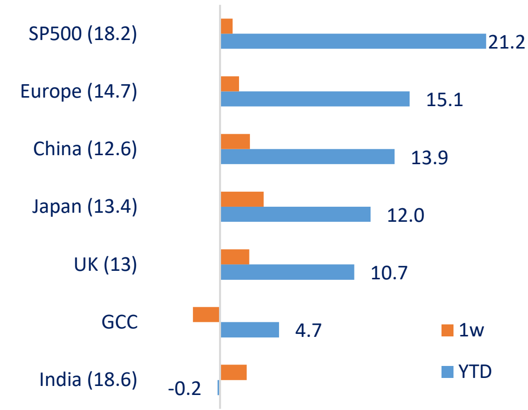
UAE equities were flat last week, whilst the KSA market fell. The KSA Index in price returns is now flat for the year (from a +18% price gain at peak). The largest portion of the MSCI EM upgrade flow is now concluded. The recent news on Aramco's partial and temporary suspension of oil production led to a knee jerk reaction opening, with a quick recovery. We expect KSA equities to trade in line with fundamentals. High yields remain an attraction and any sustainable upswing in oil prices would add to government revenue and economic growth.

We see lots of action in the "newer" technology sectors. Competition continues to ramp up in streaming with Apple offering a monthly package at $4.99, less than half that of Netflix, the current leader in terms of subscribers and content spend. Amazon too, is releasing content at a face pace to keep market share. Apple (+40.4% YTD) hosted its Annual Special Event and in an effort to maintain its margins, the highest in industry for smartphones, outlined a strategy with lower priced models complementing the ultra-high priced new models and a push into services.

EQUITY RECOMMENDED REGIONAL POSITIONING

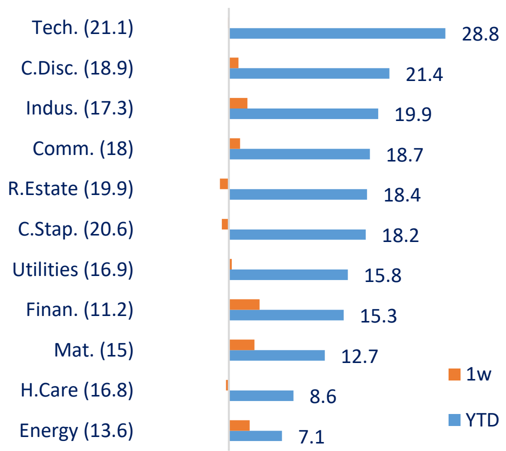


MAJOR INDICES PERFORMANCE (TR, US$) AND 2019PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2019PE



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

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