When Markets Move

CIO Office
Investment Outlook Q2 2018
Volatility is back. With vigour and veracity.

Riding the wave of one-way positive markets in 2017 and continued synchronised positive fundamental growth for most asset classes in Q1 2018, investors were rattled by sudden volatility. Political bombast and acts of protectionism, particularly from the US, drove much of this distress among investors faced with volatile, albeit relatively flat markets YTD.

As we anticipated, instability notwithstanding, fundamentals across corporates and economies remains robustly positive. Long-term, however, this political rhetoric is likely to lead to a more strained global political environment and a weaker USD.

Equity markets continue to fall prey to an unorthodox White House, unpredictable behaviour of the world’s super powers, and the threat of a potential trade war between the Commanding Bald Eagle and the Mighty Red Dragon.

We continue to maintain our view that US equity markets should deliver high single digit returns in 2018, with Emerging Markets also expected to deliver positive returns. Volatility can be managed through investing in quality stocks and dividend strategies.

Bond markets, as we expected, saw the end in Q1 2018 to a multi-decade raging bull. The mix of inflation target maintenance, policy normalisation and quantitative easing made for rates volatility. The Fed maintains that rate hikes are warranted against a backdrop of increased positive activity; the cynics, however, would contend that this position is merely a tactic to provide the Fed with tools to stave off a future recession. Whatever the tactics, support is strong for US 10-year rates at levels of about 2.90%.

Bond markets offer varying degrees of risk/reward returns: we are neutral US high yield and – even in the face of a more turbulent experience than developed markets – we are overweight GCC and Emerging Markets. In fact, we maintain our view that the GCC continues to offer attractive yields on both equities and bonds across sovereigns and select corporates.

The GCC is ripe for positive growth. The announcement from MSCI of the KSA upgrade from “frontier” to “emerging” is expected to occur in Q2 2018, which should spur positive equity market activity across the GCC. Bahrain’s recent discovery of its enormous shale gas reserve – the largest in the world – will put Bahrain back in the driving seat, engage favourable sentiment and encourage growth for the Kingdom and its neighbours. The UAE and the KSA remain the strongest players, hosting the most robust and resilient economies in the GCC.

On the commodities front, gold remains our choice for an attractive hedging instrument, particularly so in this volatile environment. Oil is expected to remain resilient and, subject to political stability and production levels increasing, we expect crude to average USD 60/b in 2018.

Volatility is both a gift and a curse. Managed properly, volatility can reap rewards. Caught unawares, volatility is a vulture’s paradise. It is incredibly important to face the markets with “eyes wide open”.

Volatility can be managed through investing in quality stocks and dividend strategies.

Tariq Bin Hendi, PhD
Acting Chief Investment Officer
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Q2 Equity Strategy

- Markets end Q1 lower on concerns about trade tariffs
- Maintain conviction on gains in 2018
- Strong earnings growth remains the backbone of equity performance
- Valuations reasonable and at long term averages
- Volatility will continue at normal levels; AI driven trades adding to sharp swings
- Differentiate the tech sectors: Avoid social media, buy cloud services and security

A lookback at Q1 2018

We maintain our view that in 2018, equity markets will deliver high single digit returns in developed markets and low teen returns in Asian markets, interspersed with bouts of higher volatility, typical of economic late cycles. The first quarter began well for equity markets, yet ended with most indices and sectors in the red due to a number of factors, including terse political rhetoric and threats of trade wars.

As we enter the second quarter of 2018, we should not consider the first quarter as an aberration, but rather a return to normalcy. We think this is a healthy resetting of markets with forces pulling markets in two directions. 2017 was unusually calm with a strong global economy, which remains a strong support.

Some of the outsized gains we saw in 2017 have not been repeated in 2018. Technology which was the main contributor to equity gains in 2017, is flat for the year. The lithium sector which was the best performer in 2018 is amongst the worst performers in 2018. The shift to electric vehicles is getting more prevalent with most large automakers abandoning the internal combustion engine prototype. Demand for lithium or cobalt is not decreasing, it’s just that the demand supply dynamics are reaching a more stable equilibrium. AI maintains centre stage in industry and financial services, hence the demand for high end semi processors and the underlying materials remains resilient.

The GCC equity markets, which were a laggard in 2017 have returned almost 10% in Q1 2018, led by the KSA. Saudi equities performance was boosted by higher oil prices and inclusion in global EM indices.

Exhibit 1: Asset Classes Returns: CY 2017 vs Q1 2018

Source: Bloomberg, as of 2 Apr 2018

Some of the outsized gains we saw in 2017 have not been repeated in 2018
Global growth remains on target, with Asia the front-runner. GDP growth for India and China is in the +6% quantum. US economic growth has been aided by accommodative fiscal and monetary policy which Europe needs to follow. High earnings growth leading to valuations trending to long-term averages are helping investors remain confident about achieving reasonable returns from the equity markets.

Global earnings growth estimates for 2018 are in the low teens. The stand out is the US which we focus on as the largest contributor to global equity performance. US Q1 earnings growth is estimated at 17% and the forward Price to Earnings ratio is at 16.6X which is close to the long term average. Though the economic cycle is late stage, the probability of a recession remains low. Overall financial conditions have remained loose, in part due to dollar weakness. But heading into the second quarter, rising wages and consequently rising inflation pose potential headwinds to US equities should they come in stronger than market expectations. The February equity sell-down was triggered by investors’ concerns over wage pressure in the US after the January jobs report. Rising wages negatively impact equity prices, as they affect margins and tighten the pace of rate increases.

Asia, which is in mid economic cycle, provides the consumer base for companies to grow exponentially. Undemanding valuations and accommodative monetary policies, abundant liquidity and stable currencies with controlled inflation remain a recipe for continued performance. Asian equities now trade at 13.3X forward earnings, well below developed markets. Whilst a risk premium has always been assigned to emerging markets, it is time to recognise the growing share of these economies and their stock markets in the world.
Monetary policy in developed markets is normalising as expected. Higher interest rates were always on the anvil in the US as inflation approached the 2% target and economic growth was strong. Europe should follow with some tightening but is still awaiting growth and inflation to reach desired levels. Asian countries follow the opposite path and whilst controlling inflation, have maintained stable rates.

What had slipped from investor minds was the undertaking of trade tariffs by President Trump. This has led to tension between China and the US escalating and the possibility of lower global growth. In a highly globalised world countries are entwined and interdependent on each other. 60% of Eurostoxx companies’ revenue comes from overseas. Whilst only 31% for the S&P 500 companies, it is still a significant number.

The tech sector remains in the limelight albeit for some of the wrong reasons at times. Media coverage on: an accident in a Tesla auto piloted car; the Cambridge Analytica scandal around the Facebook users’ data; President Trump singling out Amazon as deleterious to retail and real estate, are but a few examples of what kept tech companies in headline news. Social media companies are facing increased legislation and control of data around privacy fears. After the recent sell-off from lofty levels, tech companies valuations are very reasonable with the sector trading at 18.0X forward earnings and promising twice the revenue growth of the S&P 500 at 14% and an earnings growth in the high double digits in Q1 2018.

We expect volatility to trade around long term averages i.e. 20 for the VIX Index. The spike of the VIX index to 50 in February, earlier this year caused by the unwinding of short volatility strategies may not recur. However, 2017’s unnatural calm looks like an era of the past.
Q2 Equity Strategy

Q2 2018: How do we position ourselves in a high volatility regime?

- **Quality**: Companies with strong balance sheets and cash flows, lower leverage and high ROE’s. Many of these companies have high ESG (Environmental, Social & Governance) scores, as their management keeps apace with global trends

- **Economies with strong growth**: i.e. Asia, with a focus on India and Hong Kong

- **Sectors with strong growth**: Technology companies that are focused on robotics, AI, internet retail, blockchain and cloud services

- **Defence**: Both physical and cyber, remains at the forefront with escalating geopolitical concerns and cyber attacks

- **Dividend strategies**: Oil majors have reduced debt and higher oil prices are ensuring strong cash flows

- **US Banks**: Beneficiaries of higher yields

**Underweight sectors**: Social media. We are also tactically underweight industrials and aerospace till trade negotiations fall into place.

**Exhibit 4: Our positioning across sectors- themes we like**

<table>
<thead>
<tr>
<th>Theme</th>
<th>Tactical</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer, Tech</td>
<td>Emerging Markets (Asia)</td>
<td>🚭</td>
</tr>
<tr>
<td>Food, Auto, Industrials</td>
<td>Europe ex UK</td>
<td>🚭</td>
</tr>
<tr>
<td>KSA Banks, Petchems &amp; Healthcare</td>
<td>GCC</td>
<td>🚭</td>
</tr>
<tr>
<td>Financials, Tech, Defence</td>
<td>United States</td>
<td>🚭</td>
</tr>
<tr>
<td>Robotics</td>
<td>Japan</td>
<td>🚭</td>
</tr>
<tr>
<td>Oil E&amp;P</td>
<td>Europe</td>
<td>🚭</td>
</tr>
</tbody>
</table>

**Top Innovation Sectors**

- **Technology in Industry**: Cloud Services, Robotics, AI, Ecommerce, Blockchain, Semiconductors
- **Healthcare**: Genomics, Digital, Wearables, Life Sciences
- **Financial Services**: Digital Payments, Cybersecurity

Source: Emirates NBD CIO Office, as of Apr 2018
Investment Idea: Cyber Security

The prospect of a crippling cyber-attack is real – be it via the destruction of infrastructure or through an attack on a leading corporation, bank, or marketplace. Cyber risk is currently viewed as the greatest risk to the financial system by the Basel Committee. This highlights the need for the development of software and hardware which help detect fraud and provide systems and solutions for the protection of data from cyber risks.

According to a Gartner Survey, 17% of the Government CIOs expect to boost spending in Cyber Security in 2018. Gartner forecasts worldwide security spending will reach USD 96.3bn in 2018, up 8% from 2017. Organisations are spending more on security as a result of regulations, shifting buyer mind-set, awareness of emerging threats and the evolution to a digital business strategy.

Security has traditionally been a labour-intensive industry. This has changed with effective technologies such as facial recognition software, criminal behaviour detection algorithms, criteria-based search of recorded video, and robots. The integration of technology will complement existing manned guarding.

Robots can check vehicles and visitors, smart cameras can monitor activity wirelessly such as at construction sites. However, the more we use technology the more we expose ourselves to the risk of cyber-attacks. Privacy concerns around data misuse is also considered a cyber security threat.

Exhibit 5: Spend on Cyber Security in 2018 as a % of IT Budgets – Government CIO’s

Source: Gartner, as of Oct 2017

Exhibit 6: Global Cyber Security Market Size (USDbn) & Growth (%)

Source: Markets and Markets Research, as of Jul 2017
Investment Idea: Cyber Security

Cyber-attacks leave their mark on companies and individuals. The Petya malware affected shipping routes, ATM machines and transport systems; the WannaCry virus infected hospital systems particularly the UK’s NHS; the Dyn attack brought down Netflix, Twitter, The New York Times and PayPal, among dozens of other internet services.

Experian, the world’s biggest credit monitoring service, faces greater regulatory pressures and information security risks after the data breach at Equifax, when hackers stole personal information including social security numbers, birth dates and addresses of over 145mn US consumers i.e. nearly half the US population.

Cisco’s latest security software claims to be more predictive in preventing threats, by recognising traffic patterns that could signal an attempted breach. Cisco has partnered with Apple to develop a tool that offers enterprise cyber security teams’ greater control over iOS devices.

Palo Alto Networks has created a firewall that controls how data flows within and around a company’s core corporate infrastructure, allowing a customer’s security team to control which applications connect and regulate traffic from other devices.

FireEye provides vector-specific appliance and cloud-based solutions.

Gigamon provides visibility and control of data-in-motion traversing enterprise, federal, and service provider networks (network test equipment).

The opportunities for investing in listed securities or instruments that focus on cyber security are on the increase. A number of Index Linked Products focus solely on this sector. Cyber security ETF’s have returned over 12% in Q1 outperforming the broader markets by a wide margin.

Exhibit 7: Estimated Daily Cybercrime Activity

<table>
<thead>
<tr>
<th>Event</th>
<th>Estimated Daily Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malicious scans</td>
<td>80bn</td>
</tr>
<tr>
<td>Records lost to hacking</td>
<td>780,000</td>
</tr>
<tr>
<td>New malware</td>
<td>300,000</td>
</tr>
<tr>
<td>Phishing</td>
<td>33,000</td>
</tr>
<tr>
<td>Ransomware</td>
<td>4,000</td>
</tr>
</tbody>
</table>

Source: McAfee - Economic Impact of Cybercrime, as of Feb 2018

Exhibit 8: Reasons for Cyber Attacks

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyber Crime</td>
<td>82%</td>
</tr>
<tr>
<td>Cyber Espionage</td>
<td>12%</td>
</tr>
<tr>
<td>Cyber Warfare</td>
<td>4%</td>
</tr>
<tr>
<td>Hacktivism</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Hackmageddon, as of Jan 2018

Exhibit 9: Target Distribution - Cyber Attacks

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>40%</td>
</tr>
<tr>
<td>Human health &amp; social work activities</td>
<td>10%</td>
</tr>
<tr>
<td>Financial &amp; insurance activities</td>
<td>8%</td>
</tr>
<tr>
<td>Multiple industries</td>
<td>7%</td>
</tr>
<tr>
<td>Public admin &amp; defense, comp social security</td>
<td>7%</td>
</tr>
<tr>
<td>Fintech</td>
<td>6%</td>
</tr>
<tr>
<td>Information &amp; Coms</td>
<td>6%</td>
</tr>
<tr>
<td>Others</td>
<td>17%</td>
</tr>
</tbody>
</table>

Source: Hackmageddon, as of Jan 2018
The KSA Equity Markets: Conviction will Pay Off

- Inclusion in the FTSE EM Index received well by investors
- Foreign Institutional Investors showing interest in the KSA markets
- Socio economic reforms will pave the way for diversification away from oil
- See further upside supported by MSCI EM Index inclusion and stable oil prices

The FTSE included the KSA in its Secondary Emerging Market Index in its March review. The MSCI announcement is expected in June. The KSA would have a weight of c. 2.7% in the FTSE EM index and a similar weight in the MSCI EM Index, which would result in inflows into the KSA equity markets of USD 4bn for FTSE and USD 40bn for the MSCI.

According to FTSE Russell, Saudi is under-invested by foreign active managers and the inclusion will help change this especially in the context of Vision 2030. There are currently c. USD 175bn of passive assets tracking the FTSE EM index series.

To facilitate inclusion in the EM Indices, Saudi regulators announced reforms including easing rules for foreign institutions to invest. This remains the biggest catalyst for the KSA market as its c. 2.5% share of the EM Indices would lead to the corresponding passive inflows boosting its equity market.

When listed, Saudi Aramco would add another 2.2% to the KSA’s weight in the EM Index. Other IPOs in the pipeline would add to the weight – Saudi Airlines, Saudi Exchange, and Saudi Airports.

The KSA Index trades at 14.2X forward earnings with a yield of 3.5%. This is a slight premium to the MSCI EM Index which trades at 12.7X forward earnings. The KSA was the exception to the global rally of 2017 and the
Investment Idea - The KSA

Tadawul index ended 2017 flat, hence provides upside as valuations are not stretched.

The KSA has 21% of global oil reserves and 10% of global oil production along with the 4th largest natural gas reserves. Its population of 30mn, two thirds below the age of 30, provide the demographics for increasing consumption a strong workforce to grow the economy. Social reforms to empower Saudi nationals, particularly youth and women will pay off with increased workforce participation.

“Saudi Arabia’s Vision 2030” was adopted as an approach and a roadmap for economic and developmental action in the KSA. The vision encompasses—in a number of domains—strategic objectives, targets, outcome-oriented indicators, and commitments that are to be achieved by the public, private, and non-profit sectors.

The goal is to spur multiple different new industries within the country and diversify the economy and dependence of the KSA away from oil exports. Business and industrial zones are in progress, such as the NEOM project, which will focus on industries including energy and water, biotechnology, food, advanced manufacturing and entertainment.

We are overweight the banking sector in the KSA on a higher rates outlook and the petrochemical sector on stable and improving oil prices. These sectors also have larger trading volumes and potential inclusion of a number of stocks. We highlight Al Rajhi Bank, NCB, Samba, Bank Saudi Fransi, SABIC, Yansab and APPC as potential entrants to the EM indices.

**Overweight sectors**
- **Banking:** Liquidity issues are improving. Loan to deposit ratios have now stabilised. Dividend payout is being maintained. Higher rates are positive for Net Interest Margins. Saudi banks have c.60% low cost CASA deposits hence higher local rates are positive for NIMs
- **Petrochemicals:** The rally could continue as with oil above USD 60, product prices will move in line. Companies like SABIC which is a global chemical leader is growing both organically and inorganically and diversifying out of the KSA
- **Healthcare:** Greater use of private sector healthcare is strongly supported by the government

**Neutral sectors**
- **Consumer:** The rally in oil prices is finally flowing through to spending
- **Telecom:** Dividend payout has been maintained, though earnings growth is muted. Increasing use of data and young demographics will drive cash flows

**Underweight sectors**
- **Contractors:** Facing receivable issues with margins contracting
Investing in a Higher Volatility Regime

- Higher asset volatility a late-cycle feature
- Growth scares hit risk assets harder with fading policy support
- Active portfolio management important amidst rising uncertainty
- EM bonds and low-volatility stocks resilient under turbulent market regimes

The Goldilocks backdrop of accelerating growth and tame inflation which persisted throughout 2017 drove a strong bull market in risk assets, with volatility tumbling across asset classes. In particular, the market-implied volatility for US equities and US Treasuries recorded all-time lows (Exhibit 12), lulling investors into a complacent view of the world of investments. It is human nature to extrapolate past tendencies into the future, hence why not think that one could replicate this performance on the S&P500 and high-quality US Bonds? At the end of 2017 volatility was lingering below historical norms and the macroeconomic environment seemed to be indeed supportive.

Reality dawned on investors in early February this year, with a brutal sell-off in equities preceded by relentlessly rising long-dated US government yields: the awakening of volatility in the Treasury market in late 2017 driven by inflation fears was a harbinger of harsher times to come for equities.

One may wonder what caused the change in the volatility regime. The volatility of asset returns can be loosely defined as the variability of their returns; the higher their variability, the more uncertain the expected returns. During 2017 global equities did not incur a fall greater than 2.5% on any day, reflecting supportive growth and inflation dynamics, and low variability in macroeconomic forecasts. Investors have to accept that 2018 would see economic growth and plentiful liquidity peak, due to the maturing cycle and inflation rearing its head again.

Higher volatility in risk assets tends to be a late-cycle feature, and to come about more frequently when the economy is in a downturn (Exhibit 13). Exhibit 13 depicts a proxy for the US business cycle (the Goldman Sachs Bull Bear Index), and the instances of when US equity volatility has spiked. Equity volatility started to rise significantly a couple of years before the end of the cycle, both in the late ‘80s and late ‘90s, as well as in early 2008, after the end of the cycle a year earlier. Repeated bouts of volatility continued as the US economy plunged into recession. The early-cycle volatility after the Great Financial Crisis reflects the aftershocks of the crisis and occurs less frequently.
Investing in a Higher Volatility Regime

Since the US cycle is quite mature, it is not unreasonable to think that markets are currently shifting to a higher volatility regime. The US yield curve is a good indicator of the future trend to be expected in equity volatility. A flattening of the yield curve, when longer-dated government yields drop faster or rise slower than shorter-dated yields, points to a future slowdown in the economy. The protracted flattening of the curve eventually translates in equity volatility spiking. Exhibit 14 highlights that volatility is going to be persistently higher in the following two years (rising blue line).

The business cycle ageing and liquidity is being withdrawn by central banks as inflation gradually rises. With fading monetary support, risk assets tend to become more sensitive to negative economic surprises, which in turn occur more frequently as the business cycle ages. On a longer term basis, it should also be taken into account that unconventional monetary support, Quantitative Easing, is being unwound and will eventually drive bond yields higher, exerting further pressure on equities and corporate credit. Overall, it seems that for the medium to long term diverse factors are likely to contribute to the lifting of asset volatility, which should have just entered a new regime.

Yet, on a shorter time frame, the outlook looks brighter. The earnings season, already underway in the US, is going to be a positive catalyst, with bottom line growth forecast to be in the mid-teens. Equities and credit already underperformed earnings in Q1, closing the quarter in the red. Statistically it would be unprecedented if they did it for a second consecutive quarter, unless the economy were headed for a recession, which is unlikely considering that tax cuts have very recently been approved.

Also, US inflation should now rise in line with expectations, rather than surprise positively as it has done since late January. This should in turn help volatility on rates subside and drive a positive correlation between gradually increasing bond yields and equities.

Financial markets are not pointing to further volatility spikes in the short term. EM assets have held up better than in early 2016, when concerns about a hard landing in China put pressure on markets globally. Global high-yielding bonds have remained tight by historical standards, and safe-haven assets, gold and the Japanese yen, have failed to spike higher.

Under the reasonable assumption that volatility will remain structurally higher than in the past, one may wonder if, within risk assets, some sub-asset classes can be more resilient than others. We think this to be the case for high-quality stocks and EM hard-currency bonds.

The earnings season, already underway in the US, is going to be a positive catalyst, with bottom line growth forecast to be in the mid-teens.
Investing in a Higher Volatility Regime

High quality stocks, defined by above-market return on equity and quality of earnings, tend to outperform benchmark indices in high-volatility regimes, as illustrated in Exhibit 15. Investors, under more turbulent times, will have a bias towards stocks with more robust financials and lower leverage.

The case for EM bonds is less straightforward, but equally compelling. Drawdowns of EM bonds have tended to shrink as fundamentals of EM countries have continued to improve since the 1998 Asian crisis (Exhibit 16). Even in 2013-14, when EM equities went through a bear market as commodities collapsed, the drawdown on EM bonds was relatively contained (-10.3%).

We hold the view that, as the EM economies catch up with their DM peers and EM assets gradually lessen their beta to global assets, EM bonds will prove increasingly resilient to higher global volatility.

Exhibit 15: Excess return of US high-quality stocks versus S&P100 volatility

Exhibit 16: Historical drawdown by year of EM hard-currency bonds

Source: Bloomberg, Emirates NBD CIO Office, as of Mar 2018
Q2 Fixed Income Strategy

- Constructive outlook on the fixed income asset class
- Policy normalisation in full force – two more hikes are priced in
- Emerging Markets debt – a bumpy ride ahead, stay invested
- GCC bond markets offer value proposition for the discerning income seekers

So far this year, the fixed income asset class has weathered shifting macro headwinds. The return of volatility has placed tremendous pressure, particularly for credit markets across high yield and emerging markets bonds. That said, the emerging market local-currency bonds have outperformed US high yield bonds. The benchmark “EM local currency bonds” has returned nearly 2.5% year-to-date, while high yield delivered negative returns YTD across the board. Moreover, the yield differential between local-currency and hard-currency bonds in EM debt has converged significantly to the tightest levels versus the long term averages.

Starting the year with a strong payrolls report and a minor uptick in hourly earnings led to the euphoria and reassessment of higher bond yields. Then came the cause for the flight to safety bid with the tech sell-off and global trade concerns and structural issues at the forefront – the fiscal and trade imbalances. We remain constructive on US Treasuries for long-term positioning and see strong support towards the 2.90% level.

Exhibit 17: Fixed income asset class performance

<table>
<thead>
<tr>
<th>Bonds</th>
<th>Current Yield</th>
<th>Spread</th>
<th>1mth</th>
<th>3mths</th>
<th>12mths</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Developed Sovereign (Loc)</td>
<td>1.22%</td>
<td>0</td>
<td>0.93%</td>
<td>0.88%</td>
<td>2.26%</td>
<td>0.48%</td>
</tr>
<tr>
<td>Global Aggr Corporate (Loc)</td>
<td>2.81%</td>
<td>99</td>
<td>0.54%</td>
<td>-0.85%</td>
<td>2.47%</td>
<td>-1.21%</td>
</tr>
<tr>
<td>Global High Yield</td>
<td>5.60%</td>
<td>346</td>
<td>-0.07%</td>
<td>-0.87%</td>
<td>4.39%</td>
<td>-0.31%</td>
</tr>
<tr>
<td>USD Emerging Market</td>
<td>5.04%</td>
<td>239</td>
<td>0.30%</td>
<td>-1.35%</td>
<td>2.98%</td>
<td>-1.35%</td>
</tr>
<tr>
<td>US Government</td>
<td>2.58%</td>
<td>–</td>
<td>0.82%</td>
<td>-0.61%</td>
<td>0.04%</td>
<td>-1.35%</td>
</tr>
<tr>
<td>USD Corporate Investment Grade</td>
<td>3.76%</td>
<td>108</td>
<td>0.73%</td>
<td>-1.62%</td>
<td>2.38%</td>
<td>-2.25%</td>
</tr>
<tr>
<td>USD Corporate High Yield</td>
<td>6.22%</td>
<td>350</td>
<td>-0.05%</td>
<td>-1.05%</td>
<td>3.77%</td>
<td>-0.45%</td>
</tr>
<tr>
<td>BBG EUR Aggr Corp (Loc)</td>
<td>1.08%</td>
<td>86</td>
<td>0.22%</td>
<td>-0.53%</td>
<td>0.83%</td>
<td>-0.63%</td>
</tr>
<tr>
<td>Euro Corporate High Yield</td>
<td>1.08%</td>
<td>86</td>
<td>0.20%</td>
<td>-0.50%</td>
<td>0.80%</td>
<td>-0.60%</td>
</tr>
<tr>
<td>USD EM Sovereign</td>
<td>5.52%</td>
<td>279</td>
<td>0.67%</td>
<td>-1.60%</td>
<td>3.20%</td>
<td>-1.64%</td>
</tr>
<tr>
<td>USD EM Corporate</td>
<td>5.12%</td>
<td>255</td>
<td>-0.20%</td>
<td>-1.43%</td>
<td>3.33%</td>
<td>-1.21%</td>
</tr>
<tr>
<td>Local EM Sovereign</td>
<td>4.81%</td>
<td>48</td>
<td>0.13%</td>
<td>1.46%</td>
<td>10.22%</td>
<td>2.31%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, as of 10 Apr 2018
Q2 Fixed Income Strategy

The dilemma on global trade wars sparked by President Trump is weighing on sentiment across the global credit markets. EM credit spreads have had a meaningful correction year to date with spreads widening. We estimate that the US dollar will end the year weaker, as protectionism rhetoric from President Trump should eventually lower its value. EM currencies have held their ground in the recent turmoil. The MSCI International EM Currency Index has barely budged from an all-time high reached early this year, reflecting the strong economic fundamentals of EM nations.

The message delivered by the new Fed Chair at the March policy meeting was to an extent reassuring for 2018. Growth and employment were revised higher, with inflation forecasts little changed. The number of rate hikes planned for this year was unchanged, although the policy outlook for 2019 and 2020 turned more hawkish.

Exhibit 18: Our preferred positioning

<table>
<thead>
<tr>
<th></th>
<th>Tactical</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Investment Grade</td>
<td>Overweight</td>
<td>Neutral</td>
</tr>
<tr>
<td>US High Yield</td>
<td>Neutral</td>
<td>Neutral</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>Overweight</td>
<td>Overweight</td>
</tr>
<tr>
<td>GCC Bond/Sukuk</td>
<td>Overweight</td>
<td>Overweight</td>
</tr>
</tbody>
</table>

Source: Emirates NBD CIO Office as of 10 Apr 2018

Exhibit 19: EM currencies have staged a strong comeback

Source: Bloomberg as of 10 Apr 2018

Exhibit 20: Fed’s preferred inflation gauge is under its target of 2%

Source: Bloomberg as of 10 Apr 2018

EM currencies have held their ground in the recent turmoil
Q2 Fixed Income Strategy

There is evidence that demonstrates the surge in Libor rates to their highest levels seen since 2008; the main reason behind their surge is the steep increase in the supply of Treasuries and expectations for a faster pace of the fed fund rates trajectory. The repatriation of cash following the approval of the US tax reform also played a role in the recent Libor trends. As these technical factors fade in the coming months, Libor should gradually stabilise at lower levels. Higher rates are not necessarily reflective of funding stress.

Macro fundamentals in vogue

Global monetary policies are catching up with global growth. The Fed has embarked on a series of policy rate increases for this year as well as for 2019. The ECB has also highlighted its tapering program and is expected to withdraw the ongoing stimulus completely by September this year; however, we do not expect any rate increases this year. The Bank of England on the other hand will go ahead with their tightening cycle.

Our key risks for our 2018 strategy have now slightly drifted from policy normalisation towards escalating tensions on global trade and protectionism.

The global PMI has also started to show signs of rolling over after nearly two years. The manufacturing activity slowed in 19 of 28 economies tracked by JPMorgan and Markit in March, particularly in the euro area. In February, only 10 countries had sequential slowdowns. The current growth phase is unsustainable long-term and investors need to position accordingly.
Q2 Fixed Income Strategy

Alpha and not Beta
Volatility will remain and is expected to put credit markets under pressure. With the ongoing uncertainties, we recommend investors focus on fundamentals and businesses that have sound business models and strong governance frameworks.

Do not chase yields: There is substantial supply of good credit within the bond markets. Investors should avoid being complacent while positioning and focus on value and income over growth.

Duration positioning
The shape of the yield curve should provide some direction for investing in the bond markets. We foresee further flattening as the short term rates adjust and normalise with the ongoing Fed’s tightening cycle. The diminishing term premium on the yield curve is counter-intuitive. We prefer the 5 to 7 year on duration.

DM Bonds: DM government bond yields YTD have edged up close to key support levels and have been contained with ongoing global macro headwinds. The flight to safety bid has led to capped yields. The US faces structural challenges with a burgeoning fiscal deficit post the recent fiscal stimulus, in a late economic cycle.

Emerging Markets Debt
Our conviction on EM debt remains intact. Buoyant and strong macro fundamentals and prudent monetary and fiscal policies underpin our conviction. Corporate balance sheets demonstrate low default rates and a stable ratings outlook across EM credits; this should counter any near-term volatility or market stress. EM growth rates have been diverging from their DM counterparts and continue to dominate about two-thirds of global growth. EM external balances have also shown signs of consistent improvement.

One of the main investor concerns surrounding EM debt has been the FX volatility; the volatility has subsided substantially and EM currencies have demonstrated robustness.
Q2 Fixed Income Strategy

The insatiable search for yield continues to attract capital flows to emerging markets bonds.

Q1 Primary issuance: Asia
> Asian credit spreads spiked to the highest levels seen in six months during March
> China took 68% of the market issuance, with a strong performance from the Chinese corporate sector that achieved USD 14.02bn volume in March

Q1 Primary issuance: CEEMEA
> The region continues to be pushed along by large sovereign issues
> Q1 2018 managed to beat Q1 2017’s former record of USD 61.84bn

Q1 Primary issuance: LATAM
> LatAm issuance dropped to a low of USD 4.14bn in March
> Both Brazil and Argentina saw spreads over Treasuries widen by roughly 20bps over the month
> Chile’s central bank, meanwhile, revised up its growth forecast range by 0.5% to 3-4% for 2018

Q1 Primary issuance: GCC
> Surge in Sukuk supply during Q1
> GCC bond sales for Q1 lower as compared to the same period in 2017
> GCC sovereigns to take the lead in terms of issue size followed by Banks and corporates for refinancing upcoming debt obligations
Investment Idea – European Subordinated Debt

> European Financials have seen improving fundamentals and recapitalisation of balance sheets
> Strong technicals and stretched valuations will drive spreads tighter in 2018

The Eurozone economy continued its robust performance in Q1 2018, driven by a resilient domestic demand, an accommodative monetary policy, a recovering labour market and healthy external demand. In Western Europe, growth is running at about 2% on average, with some economies seeing appreciably higher rates.

Eurozone’s 2018 economic outlook looks solid on the back of an improving labour market and accommodative financial conditions that should continue to support growth. As per the ECB, annual real GDP growth is expected to average circa 1.8% in 2018 and 2019.

Inflationary pressures are beginning to pick up. In the euro area, core inflation has gradually increased over the years as exhibited below. Greater inflationary pressures are visible mainly in wages in economies where unemployment rates have returned to pre-crisis levels. Inflation is expected to reach 1.5% in 2019.

At the height of the Eurozone financial crisis in 2012, ECB chief Mario Draghi promised to do "whatever it takes" to prevent the bloc’s economy from collapsing. The central bank has since unleashed experimental and extreme measures, which include slashing interest rates below zero and pumping trillions of euros into the economy.
Investment Idea – European Subordinated Debt

The ECB’s significant move to reduce its monetary stimulus won’t have much impact as policy rates were unchanged and are set to remain in place.

After almost a decade, European financials have shown signs of improved fundamentals with well capitalised balance sheets. We find opportunities in the European banks hybrid debt segment within the capital structure.

> Change in investor attitude on the back of significant strengthening of balance sheets, higher capital and liquidity ratios and improving asset quality
> Average non-performing loans ratio has seen a balanced decline over the past few years and is under 4%
> The banking sector’s return on equity has ranged between low to mid-single digits and has considerably improved over the last couple of years as legacy costs, such as misconduct, litigation and restructuring expenses have eased
> The Common Equity Tier 1 (CET1) ratio for major European banks has more than doubled, from just 7% in 2006 to just over 14%
> We prefer AT1 and Tier 2 debt securities where European banks are either approaching or are already at end-point minimum CET1 requirements

Loss Absorption Mechanism is driven by investor choice – some fixed income investors are not able to invest in contingent equity – hence preferring the write-down model – which appears to entail greater loss severity.

Discretionary Triggers such as a regulator’s call of point of non-viability present challenges for investors.
## Oil Outlook

The balance of risks in oil markets is increasingly weighted to the upside as a confluence of fundamental and policy factors have added upward momentum to prices. In mid-April, Brent futures were above USD 70/b, their highest level since the end of 2014, and were more than 25% higher than they were at the same time in April 2017. Over the remainder of 2018 we see several major risks ahead that could keep oil prices in this elevated range but all the while raising the prospect of a slide further out.

OPEC has carried over its strong compliance to the production cuts it agreed with partners at the end of 2016. Average compliance in 2017 was 98.8% but it has jumped to more than 150% in the first three months of 2018 according to Reuters. Saudi Arabia has continued to do much of the heavy lifting in achieving better than expected compliance but in fact all OPEC producers that are party to the deal have achieved a higher level of compliance this year. The UAE has been one of the most improved members, achieving a compliance rate of 124% on average in Q1 compared with around just 41% in 2017 as a whole. Compliance in Iraq is higher than it was in 2017 but has been steadily declining since hitting a peak in November when production was disrupted by civil conflict in the country. Venezuela has actually achieved one of the highest levels of compliance but for involuntary reasons (see Exhibit 35).

We had expected that Middle East producers would actually increase production in 2018 to take advantage of the improvement in oil prices but Q1 suggests the opposite. If MENA producers maintain their current levels of oil production our projections for global oil market balances would push deeper into deficit, implying a bigger draw on inventories and more support for prices around current levels. But there is still most of 2018 to go, leaving plenty of time for changes in regional oil production. The strong start to the year actually gives producers space to ease back on the cuts if the current price levels risk eroding marginal demand or other producers face disruptions.

Outside of the region, the biggest fundamental risk to OPEC production levels stems from Venezuela. Oil output there fell 476k b/d below year ago levels in Q1 according to Reuters, an acceleration of the already precipitous decline seen last year. The IEA estimates that total capacity in the country could fall to as low as 1.38mn b/d by the end of 2018, the lowest level since the 1940s. Deteriorating economic conditions and defaults from state enterprises across economic sectors have left PDVSA, the state oil company, lacking funds to halt the decline in output or pay foreign partners. With the pace of decline accelerating and no viable means to redress it, we expect a decline of around 500k b/d on average this year compared with a 280k b/d drop in 2017.

Sticking to supply side risks production in the US could end up disappointing owing to logistical choke points. The EIA projects growth in US crude oil supply of 1.37mn b/d this year, effectively the fastest growth on record. Drilling productivity has continued to improve during the slump in oil prices, allowing fast levels of growth at a lower overall rig count. But the rest of the oil infrastructure in the US has not caught up. Pipelines linking production centres to export terminals are at already close to capacity and expansions are only expected in 2019. The US also lacks multiple ports at which the largest oil tankers can take on crude, constraining the egress of crude from production regions such as the Permian basin in Texas.

The UAE has been one of the most improved members, achieving a compliance rate of 124%
Oil Outlook

Producers in Texas are currently facing a wide discount for their crude compared with seaborne Brent or WTI as they run up against off-take constraints. While producers could send crude by truck or rail to export terminals, at the margin this discount could prevent producers in the Permian in particular from achieving the scale of growth expected by most of the major forecasting agencies.

One channel that is open to US oil producers is storage. Total crude inventories are holding at their five-year average according to recent EIA data while Cushing stocks are at less than 50% of capacity. The WTI curve remains in backwardation, meaning storage trades won’t work but we would nevertheless expect to see some build in stocks from current low levels as pipeline capacity to the more valuable seaborne market is strained.

There are several political risks that are also adding a bid tone to crude markets. The appointment of Mike Pompeo as US secretary of state and John Bolton as national security adviser has shifted the Trump administration to a more hawkish stance with respect to geopolitical challenges. Neither Pompeo or Bolton support the JCPOA agreement with Iran (the nuclear deal) and their appointments raise the risk of president Trump refusing to renew waivers on Iran sanctions as scheduled in May. After sanctions were imposed in 2012 Iranian oil production dropped off sharply, falling by as much as 1mn b/d from pre-sanctions peak to trough.

Exhibit 36: Market Balance

Source: IEA, Emirates NBD Research, as of Mar 2018
Oil Outlook

If Iranian production fell by a similar amount this year our forecasts for market balances in the second half of 2018 would push into a much deeper deficit that notionally should be supportive for prices. Other OPEC producers could fill the gap created by the decline in Iranian output. But considering the outspoken messaging from Saudi officials in particular to keep the market tight a supply response to lower Iranian production can’t be counted on.

We believe there is also a strong risk of the US placing sanctions on imports of oil from Venezuela. So far the White House has delayed imposing sanctions as refineries in the Gulf of Mexico seek out alternative sources of heavy crude. Imports of crude from Iraq and Canada are already increasing as shipments from Venezuela have declined in line with falling production.

Our core forecast is for Brent futures to average around USD 60/b in 2018 but should any of the above risks materialise in a more concrete manner from Q2 onwards we would expect prices could settle in a much higher range. Looking beyond this year, many of these price supportive risks could end up catalysing a decline as producers race to take advantage of the high prices. The potential return of barrels OPEC is holding off the market along with the timeline of developing shale projects means that a rapid increase in production in 2019 can’t be discounted.
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