The Changing Face of Globalisation

CIO Office
Investment Outlook Q3 2018
Introduction – The Changing Face of Globalisation

The first half of 2018 witnessed the return of volatility and hasn’t rewarded investors with great returns so far. It started well with a strong rally in January around the narrative of a vigorous, synchronised and non-inflationary global economy; it did not last. Fears of higher inflation and higher rates quickly annihilated gains in Q1 and the wall of worries only grew in Q2: divergences in the macro picture, a stronger dollar hurting EM assets, and escalating trade tensions.

Volatility in 2018 didn’t come as a surprise (see our previous quarterly publications “Eyes Wide Open” and “When Markets Move”). It should indeed remain elevated, not only for months, but probably for years: the cycle is maturing, central banks are tightening, technology keeps on disrupting, political parties are rising and falling, and global powers are being redistributed.

However, volatility doesn’t necessarily mean negative returns, it simply requires discipline: agility, discernment and careful calibration. To that extent, we are happy to say that our cautious asset allocation proved appropriate in H1 and that a majority of our convictions did well in relative terms.

Having said that, absolute performances remain unexciting. Looking forward, we are positive for the second half of 2018 and have started to increase our allocation to equities. It could be another bumpy ride, between the trade war rhetoric and US mid-term elections in November, but we believe that the positives outweigh the negatives.

On the positive side, the global economy is robust and should remain so. The US is DM’s bright spot, with the long awaited increase in wages starting to materialise, an important driver for a consumption-dominated economy. Other regions have moderated but their trajectory remains positive, above trend in Europe, and with strong domestic demand in the major emerging countries. The second key positive for risky assets is the combination of double digit earnings growth with the stagnation of stock markets. Valuations have retreated and these lower multiples are not justified given the supportive medium term outlook.

Finally, investor’s positioning is much less optimistic, which means that any good news should trigger flows.

We are however not in an extreme situation of distressed value and outright panic, which wouldn’t even

![Exhibit 1: USD % returns for major asset classes – more volatility than performance in H1](source: Bloomberg as of 29 June 2018)

![Exhibit 2: Valuation – evolution of MSCI All Country fwd PE](source: Bloomberg as of 29 June 2018)
require a catalyst to normalise; indeed, much of the recent movement in markets had more to do with rhetoric rather than fundamentals. Unlocking this fundamental upside potential will require some good news.

There are a number of uncertainties. Inflation and rates were the dominant fear in Q1, but the US 10 year rate is now back below 3%. If the US curve is flattening, it has not yet inverted (an historically relevant early-indicator of recession, at least before quantitative easing was invented), and short-term real rates remain negative within developed economies. Monetary policies are still accommodative and central banks are proactive with their intentions and timing to prevent any negative surprises.

The key concern is political risk, the most prominent one being the current trade tensions. Political risk is not anecdotal; the lower and middle classes represent the majority of voters of any democracy. When they are unanimously unsatisfied, political change happens – Brexit, Donald Trump, Italy, Austria, Mexico, as examples. This dissatisfaction of the masses leads some politicians to cater to the unsubstantiated hype, thus designating an external cause as something to be feared and proposing a simple solution to address it. For example, globalisation and immigration are the external causes and closing borders and imposing tariffs are the solutions, irrespective of rationale or truth.

It is a wonder why President Trump cut corporate taxes when the economy is booming and when the share of corporate profits in the economy is as high as ever. Equally, one could also be surprised why he would attack globalisation symbols like China or German car manufacturers to “bring jobs back to America” when the unemployment rate is one of the lowest in modern history. He could similarly move forward.

It is probable that the announced measures (levies on steel and aluminium from Europe, Mexico and Canada, and tariffs on USD 50bn of Chinese imports) will be implemented, but we believe that markets have already priced them in. From now on, some degree of confidence that there won’t be further escalation could be enough to trigger a relief for global equities, EM assets, and non USD currencies.

It is not impossible, especially when American manufacturing icons like General Motors or Harley Davidson are explicitly stating that tariffs could reduce US jobs. The very people who elected Mr Trump would arguably pay the price of a full out trade war and its consequences to the US economy and inflation. It could eventually help China replace the US as the leading force of global trade. While the author of “The Art of the Deal” (1987) is building walls, the inheritors of the 2500 years old “Art of War” are deploying the new Silk Road. However, this is not our central scenario and we recall that in Davos earlier this year, President Trump also stated that “America first does not mean America alone”.

Finally, but importantly, our region shows some very encouraging signs as GCC governments wisely use the opportunity of higher oil prices to stimulate their respective economies. The Kingdom of Saudi Arabia’s confirmation as a new member of the leading MSCI Emerging Market index will be positive for the country and wider region. Globalisation is not only a negative. And the same applies to volatility.

Our key investment recommendations are detailed in the following pages. As regards equities, we favour the US and the Energy sector for their formidable medium-term earnings prospects, and will accumulate on weakness our long term-convictions Emerging Asia and the Technology sector. On fixed income, current levels are compelling for GCC and EM debt in both hard and local currency, and we see value for the long-term in US government bonds.
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Q3 Equity Strategy – A lookback at Q2 2018

- Trade tensions and their consequences kept performance subdued
- Volatility is higher, in line with our expectations
- Being selective has paid off, with pockets of outperformance
- The KSA market had a stellar first half, fuelled by regional banks
- Technology and Energy sectors are leading global equity market performance

We began 2018 with a moderately positive stance: markets were expensive, however a strong economic backdrop and earnings growth warrant positive returns. Markets have been more volatile in 2018 than in 2017, with the CBOE Volatility "Vix" Index averaging 15.6 in 1H 2018 but well below the 10 year average of 20. What stands out in 2018 is the performance of the more cyclical sectors and the continued lead of growth over value as a factor. The MSCI World Growth Index (Net Return) is up 4 percent this year, a lead of 8 points over its Value equivalent index. Developed markets have led in the first half of 2018 (H1), with the S&P 500 ending up for a third straight month, and the MSCI EM Index posting a fifth monthly loss.

Our call on the KSA worked well, as the expected MSCI EM Index inclusion came to fruition. KSA banks fared even better, and the sector is up 32% year to date, aided by rising rates and improved liquidity as government revenues benefited from rising oil prices. Other EMs however, bore the brunt of trade friction, a strong Dollar and geopolitical tension.

Asia’s consumer economies had mixed results in 2018: Indian equities (large caps) had gains in local currency terms but not so in Dollars. The mid and small cap India sectors fared worse and fell over 10% in 1H. There were large outflows from equity markets by foreign institutions, however large domestic inflows more than filled the gap. China markets suffered (the domestic Shanghai Comp. Index fell 14%), as trade tariff rhetoric escalated. However, our overall preference to EM Asia did well relative to broader EM.

Amongst DMs, the US with a 3 percent return for the S&P 500 and 9 percent for the Nasdaq Index stands out. European markets bore the brunt of regional political turmoil.

Globally, the technology (the FANG stocks are up 29% in 1H), genomics and energy sectors have outperformed the MSCI World Index which is close to flat for the year. The cyber security sector (+17%) profited from the growing threat of global cyber warfare. Whilst we cannot quantify returns in the electric vehicles industry, we see an exponential growth in the infrastructure i.e. charging stations, electric batteries, rollout of EV models by the big auto makers and regulations to ensure countries move on a large scale to more environmentally friendly transport.

What stands out in 2018 is the performance of the more cyclical sectors.
Equity Strategy for 2H 2018

- Strong near-term earnings growth is a tailwind for US stocks and the global energy sector
- Global Tech sector benefits from steady long-term earnings potential
- Valuations are not outrageous and close to long term averages on some metrics
- Volatility will generate opportunities for the long term investor
- This might already be the case in Emerging Markets (compelling entry points for the long-run)

Strong revisions to earnings growth in 1H 2018 creates a gap with equity valuations now close to long term averages; no longer near the mid-January highs. This provides a favourable backdrop for equity market performance in 2H 2018. However active management has a key role to play in volatile markets with the added caveat to be selective and focus on quality. We define a quality company as one with sustainable profit growth and a strong balance sheet, able to buffer any rise in interest rates and reduced liquidity as Central Banks tighten monetary policy.

Exhibit 4: Global sector Returns and Valuations compared to the World, DM and EMs

Source: Bloomberg, MSCI Net Return Indices as of 30 June 2018

We define a quality company as one with sustainable profit growth and a strong balance sheet
Equity Strategy for 2H 2018

While global growth may moderate into 2H 2018, it is still above trend. Geopolitical anxiety and risks to global trade have risen, but the macro environment remains supportive of taking risk. The growth outlook is strong, and we see scope for reasonable returns in the second half of 2018.

The effects of trade tariffs: US companies drive 73% of their revenue domestically but source a large amount of raw material from overseas, particularly auto components and electrical goods. Europe generates 52% of revenue from overseas whilst Chinese companies are domestically focused with 88% revenue internally generated. Therefore, trade tariffs may not hurt all EMs as much as expected. Potential trade tariffs have led to lower guidance so far only from the global auto industry. GDP growth is estimated to be affected by just 0.1% for China if tariffs are limited to USD 50bn rather than the on the overall USD 502bn of exports to the US. The ripple effect however, should not be underestimated with a possible impact on the US itself and its trading partners i.e. Europe, Korea, Japan, Taiwan, Canada and Mexico.

Earnings growth remains the top differentiator for returns. We are seeing sustained upward revisions to earnings growth led by the US and Asia. The US and China together constitute more than two thirds of the world’s market cap and India is estimated in the next decade to become the 3rd largest country globally by market cap. Hence, these markets remain our focus in 2018 and for the longer run. In the US, strong economic growth and the benefit of tax cut are helping the bottom line of companies, which should continue until the end of 2018.

In Asia, the young demographics and increasing spending power of the middle class will ensure the growth of the economy and the consumer sector. India’s per capita GDP is estimated to rise from USD 1700 to USD 4000 in the next 10 years and its consumer industry to grow from USD 500bn to USD 2tn. EMs are expected to lead DMs in economic growth and corporate profitability over the next few years.

The KSA’s upgrade to Emerging Market status, its economic reform program, Vision 2030 and higher oil prices supporting government revenue could lead to further upside. Historically, newly included countries in the MSCI EM have delivered an average 55% return over the year preceding implementation (although the index inclusion is obviously not the only factor behind this number).

We like the technology and energy sectors as leaders of earnings growth estimated at 16% for tech and 27% for energy, though the latter is coming off lows. The tech sector has been an outperformer over the last decade and should continue to do so on account of the large spend on innovation and penetration power. We continue to focus on select technology sectors with exponential growth – cloud services, data analytics, robotics, cyber security and connectivity (the Internet of Things). Energy is a near term defensive play with a growing and sustainable dividend yield and we elaborate on this later.

Exhibit 5: Long term earning growth estimates by sector & region

<table>
<thead>
<tr>
<th>Sector</th>
<th>LT EPS Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>27%</td>
</tr>
<tr>
<td>Tech</td>
<td>16%</td>
</tr>
<tr>
<td>Cons. Disc</td>
<td>15%</td>
</tr>
<tr>
<td>EM</td>
<td>14%</td>
</tr>
<tr>
<td>World</td>
<td>13%</td>
</tr>
<tr>
<td>Industrial</td>
<td>13%</td>
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<tr>
<td>DM</td>
<td>12%</td>
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<tr>
<td>Healthcare</td>
<td>10%</td>
</tr>
<tr>
<td>Real Est</td>
<td>10%</td>
</tr>
<tr>
<td>Material</td>
<td>10%</td>
</tr>
<tr>
<td>Cons. Stpl</td>
<td>9%</td>
</tr>
<tr>
<td>Telecom</td>
<td>9%</td>
</tr>
<tr>
<td>Utility</td>
<td>6%</td>
</tr>
<tr>
<td>World</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, MSCI LT EPS CAGR (3-5 years) as of 30 June 2018
Globalisation vs Protectionism

How do we ensure consistency of returns?

- **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 they keep pace with demographic preferences.

- **Innovative Sectors with Strong Growth**: Technology & Digital Health

- **Economies with Domestic led Growth**: Asia

- **Economies Benefiting from Policy Revision**: The US and the KSA

- **Escalating Geopolitical and Cyber Risk**: The defence and cyber security sectors

- **Defensive Strategies**: Oil majors have become defensive, as the combination of reduced capex, deleveraging, and higher oil prices are ensuring strong cash flows and growing dividends

Underweight sectors: We are underweight the telecom sector (except for companies that are leaders in 5G networks) and bond proxy sectors such as utilities. We remain wary of the fallout of privacy concerns on social media companies.

Exhibit 6: Our positioning across sectors – themes we like

<table>
<thead>
<tr>
<th>Theme</th>
<th>Region</th>
<th>Tactical</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improving economy &amp; EPS growth</td>
<td>US</td>
<td>🔄</td>
<td>🔄</td>
</tr>
<tr>
<td>Consumer spend, e-commerce &amp; digitisation, growing middle-class &amp; millennials</td>
<td>EM (Asia) – India and China</td>
<td>🔄</td>
<td>🔄</td>
</tr>
<tr>
<td>Higher oil prices: Oil E&amp;P</td>
<td>European oil majors</td>
<td>🔄</td>
<td>🔄</td>
</tr>
<tr>
<td>MSCI EM inclusion</td>
<td>GCC – KSA banks, petchems &amp; healthcare</td>
<td>🔄</td>
<td>🔄</td>
</tr>
<tr>
<td>Geopolitical concerns</td>
<td>Defence</td>
<td>🔄</td>
<td>🔄</td>
</tr>
</tbody>
</table>

**Top Innovation Sectors**

- **Technology in industry**: Cloud Services, Robotics, AI, E-commerce, Blockchain, Semiconductors

- **Healthcare**: Genomics, Digital, Wearables, Life Sciences

- **Financial services**: Digital Payments, Cybersecurity

“The gap between strong earnings growth and valuations is increasing and this should lead to equity market gains. However we remain selective, with a continued bias towards growth and innovation industries.

In 10 years, the Netflix stock is up 10,400% as the company spent on content, built up a sustainable consumer base and expanded to new markets.”

Source: Emirates NBD CIO Office. as of Jul 2018
**Equity Investment Idea: The US**

- Strong gains could continue on robust earnings growth
- Valuations are at 5 year averages
- Tax cut gains not yet fully realised
- The renewed capex cycle should stimulate corporate profitability
- Concerns remain regarding the strong Dollar, impact of trade tariffs and rising rates

Take advantage of the growing gap between earnings growth and valuations: Investors are wondering if US stocks’ cycle of gains for all but one quarter since 2015 still has legs, as trade tensions sap risk appetite and Fed rates rise further. There’s reason to be optimistic, even though the S&P 500’s yield advantage over Treasuries is at risk with 10-year Treasuries at c. 2.83%. In favour of US equity markets, is strong shareholders’ return boosted by strong cash flows.

Better relative earnings prospects and reasonable relative valuations are supported by very high operating margins in the US (15.7%). Estimates for US EPS growth continue to move higher and faster than for most developed peers, while emerging-market forecasts have recently fallen. Tax cuts have added 14% to upgrades in US earnings growth.

Buybacks are expected to reach an astonishing USD 650bn in 2018 and c. USD 400bn of the USD 2tn overseas funds have already been repatriated. The tax cuts, easy credit conditions and improved cash flows provide the liquidity for increase in capital expenditure for US companies.

Relative to DM peers, US companies’ have higher earnings growth forecast for the next two years. FactSet estimates are for S&P500 EPS growth at 20% for Q2 and 21% for the year (2018) vs. 14.2% for DMs. Cyclical sectors in the US are on pace to outperform peers on earnings growth in the next 12 months. The only sectors expected to fall short in the US on earnings growth are consumer staples, real estate and utilities.

US growth prospects are led by more than just lower corporate taxes. Sales growth is expected to surpass developed-market averages for the next two years.

Considering much higher operating margins, strong sales and EPS growth, US stocks’ forward earnings PE premium to the rest of the world at 8 percent looks reasonable (its 5 years average is 15%). US equity-market valuations are back to the five-year forward average at 16.1X earnings.

US tech and healthcare sectors look undervalued. Based on forward P/E, US technology stocks trade at a 7 percent discount to global counterparts, despite median operating margins that are 50% higher. Meanwhile, median US healthcare sector forward P/E is just 16.6x vs. 21.1x for developed-world peers, with margin expectations that are 23% higher.

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*Exhibit 7: US equities see the strongest upward earning revisions in 2018 in the last 5 years*

![Graph showing earnings revisions in US equities](source: Bloomberg, as of 30 June 2018)
Equity Investment Idea: The US

Doubts about the tech sector arose in early 2018 after the strong gains in 2017. Gains have continued into 2018 and the FANG stocks are up 29% in 1H. Amazon, Microsoft, Apple and Netflix are responsible for 84% of the S&P 500 upside in 2018. Amazon alone has contributed 36% to the S&P 500’s YTD return. The top 10 performing stocks in the S&P 500 (largely tech) have contributed to 122% of its YTD return.

The growth outlook should be the focus for equity performance in the US rather than rising bond yields. The strong dollar is detrimental to exporters revenues and remains a risk, as do escalating trade tariffs. Whilst Q2 earning season is an important barometer for estimating if top line growth meets expectations, mid-term elections in November are another important catalyst as markets like certainty.

The US is home to the world’s top innovative global technology and healthcare companies. Their growth is even more certain as they expand into new markets like India.

The US is home to the world’s top innovative global technology and healthcare companies

**Exhibit 8: S&P 500 – Rising EPS, Dividends and Free Cash Flows**

Source: FactSet, Data in USD, as of 2 Jul 2018

The US is home to the world’s top innovative global technology and healthcare companies
Equity Investment Idea: Attractive Backdrop for Oil Equities to Perform

- The late stages of the cycle are historically favourable to oil stocks
- Energy is now a dividend-paying defensive sector at the current oil prices
- A positive view on oil prices is constructive for earnings
- Relative valuation is accessible and investors positioning is currently low

Global GDP, industrial production, PMI, trade, transportation and overall economic growth in 2018/19 indicate that demand for oil should continue to grow. Our inhouse view is constructive on oil prices in 2018 as you will read in the following pages. Business models that were built for USD 50/bbl should enjoy the windfall gain through buybacks and deleveraging.

The performance of the oil sector has lagged oil prices. Free cash flow yield at 8%, lower leverage and a lower breakeven price for oil (USD 50/bbl) on account of technology and capital allocation discipline, make the large integrated oil companies an attractive investment. High payout and increased dividends should appeal to income seeking investors.

Oil markets are balanced and the key message from OPEC is of continued cooperation and compromise. Both OPEC and non OPEC nations are happy to live in a USD 70/bbl world. Higher oil prices matter for energy equities as they allow for higher earnings, higher cash flow, and higher returns to shareholders.

At current oil prices (with Brent at USD 78) free cash flow growth and net debt reduction would accelerate significantly for the oil majors. Between them: Shell, BP, Chevron, Total and Exxon will generate FCF of USD 84bn in 2019 and dividend cover would increase to 200%. Leverage is expected to fall by 30 to 40% over the next 3 years. The additional cash would not go entirely to dividend or buybacks but to capex for new fields and new technology for more efficient production.

Oil companies are now reinvigorating their capex cycle hence oil service providers should benefit. US E&Ps are projected to spend for the first time since 2005 and have pledged ongoing capital discipline. Greater capital discipline supports both oil prices and equity valuations. Shell has a budget of USD 25bn annually, BP USD 16bn and Total USD 15bn.

Not only is earnings growth estimated at 27% for the energy sector globally but uncertainty around these earnings has diminished with oil majors getting the highest upward revisions from analysts.

Oil markets are balanced and the key message from OPEC is of continued cooperation and compromise.
**Equity Investment Idea: Attractive Backdrop for Oil Equities to Perform**

We see the potential for oil E&Ps to rally further into the end of 2018. E&Ps will likely be positioned to return cash to shareholders as they generate higher free cash flow and balance sheet concerns diminish.

**Significant value potential from digitalisation is yet to emerge:**
Digitalisation is transforming the oil industry as it is transforming other industries globally. The use of sensors to record data and its analysis to improve productivity is now commonplace in the oil industry. The oil price downturn increased pressure on oil companies to reduce costs and drive efficiency improvements. Drilling costs are being reduced by 10-20% through automated activities. Future projects could have up to 50% less capex due to unmanned platforms, remote operation centers and automated data collection. Digitally enhanced predictive maintenance has significant potential to reduce unplanned downtime and costs. Big data analytics can improve targeted drilling and optimise well locations. The resulting FCF could sustain rising distributions and stronger balance sheets which may herald multi-year outperformance.

Since energy equities are a long duration play on oil prices, concerns around the demise of the internal combustion engine and on the outlook on the longer term demand for oil remain a concern. However, for the next decade at least oil, as a source of energy, will remain dominant.

**Exhibit 10: Integrated oil companies are seeing a rise in net profits**

![Exhibit 10: Integrated oil companies are seeing a rise in net profits](Image)
Equity Investment Idea: The Video Gaming Industry

- A fast growing industry
- Digital distribution is dominating traditional distribution
- Driven by technological evolution and continuous investment
- Multiple game segments: Multiple segments, dominated by mobile

Video Gaming is a fast growing multi-billion industry which is expected to reach USD 128.5bn by 2020 from the current USD 108.9bn. It is estimated that there are 2.2bn gamers worldwide, and could grow to 2.7bn by 2021. China generates over one-quarter of game revenues worldwide and is home to Tencent, the world’s largest gaming company. Half of the entire gaming population comes from the Asia-Pacific region, with nearly 1 billion gamers.

Despite gaming being often associated with younger age groups, approximately 15% of the gamers worldwide are aged between 51 and 65. Men spend more time playing video games than women, however numbers vary based on the genres. For example, women prefer arcade, simulation and puzzle games whereas men are often into athletic, shooter, strategy and adventure games.

A notable shift in the industry has been witnessed as digital distribution is dominating traditional distribution. The industry may be headed to almost 99% digital media, eliminating physical media with the remaining group being the niche collector segment.

Today, billions are spent on video game development costs, which is comparable to the production of a Hollywood movie. Companies like Facebook, Microsoft, Softbank are purchasing game studios along with large companies such as Take-Two Interactive, Nintendo and Activision Blizzard. An example of a high development cost game would be Grand Theft Auto 5, which reached USD 1bn in sales within the first three days of launch. Iron Man’s 3 box office debut, considered a blockbuster, brought in only USD 372mn in its first weekend. Amongst the most popular gaming developers today are Electronic Arts, Activision lizzard, Take-Two Interactive and Nintendo.

The industry can be split into multiple game segments: Console, PC, Mobile – Tablet and Smartphone.

The mobile segment is the largest, with 42% of the total industry revenue. With the adoption of smartphones, mobile gaming has exceeded traditional console gaming numbers. Technological innovation continues to expand the possibilities in the video gaming industry. Today, Nvidia, AMD and Asus compete in developing cutting edge graphic cards which support the upgrade of video game console and PC iterations.
**Equity Investment Idea: The Video Gaming Industry**

In 2017, mobile gaming apps accounted for more than 80% of all app revenue on the Apple Store and Google Play Stores. The availability of smartphones is giving access to a whole new class of gamers. Mobile games are split into multiple categories, such as ad-driven (revenue realised from advertisements) and freemium (a business model in which the game offers free and premium services). Most profitable mobile games today follow the freemium model, such as Candy Crush Saga with over USD 800mn in revenues.

**eSports is continually growing** supported by the increased availability of online streaming platforms such as YouTube and Twitch.tv. The eSports market once popular only in core Asia has now expanded globally.

**VR technology, had existed historically**, however, it is only recently that technological advances have given way for its use in applications. Today, companies are racing towards developing a better VR headset. Companies such as Oculus, Samsung, HTC are amongst the popular VR headset providers.

According to Statista, the global VR market size worldwide is expected to grow to USD 21.5bn by 2020.

**The video gaming industry continues to grow steadily driven by technological evolution and continuous investment.** Game revenues are increasing exponentially as companies explore new and attractive models for consumers to enjoy video games. China is expected to continue to be the largest video game market in the world. The Battle Royale mode is clearly a game-changer and companies such as Activision Blizzard and Electronic Arts who are deeply invested, have a very large opportunity within this gaming mode. Tencent recently announced the launch of the Chinese version of Fortnite, leveraging into the Battle Royale system.

Mobile gaming continues to grow with increased spend per consumer, due to the rising adoption of smartphones and the success of the mobile gaming monetisation models. Mobile gaming’s dominance of the entire global industry is a trend that is very well noted by marketers, brands and advertisers.
Q3 Fixed Income Strategy – A Lookback at Q2 2018

- Macro fundamentals have not derailed from our expectations
- Reiterating Alpha over Beta positioning for the fixed income asset class
- We maintain our positive stance on emerging markets debt, to recover in H2
- GCC valuations offer compelling entry points

During the first half of 2018, financial markets witnessed the return of volatility and idiosyncratic risks, supporting a rise in bond yields and negatively affecting capital flows and returns. Between fundamentals and flight to safety, the 3 percent handle proved a strong support for the benchmark 10 year US Treasury bond. Finally, President Trump’s reflationary rhetoric seems to be back.

Looking back at our strategy and positioning across the fixed income asset class

Exhibit 13: Fixed Income sub-asset class performance YTD

During the first half of 2018, financial markets witnessed the return of volatility and idiosyncratic risks

Exhibit 13: Fixed Income sub-asset class performance YTD

Source: Bloomberg as of 29 Jun 2018
Fixed Income Strategy for 2H 2018

As concerns surrounding global trade have intensified, global investors have sought refuge in US assets. As a percentage of total assets owned through funds, they now represent 58% – the highest level since 2016, prior to the presidential election.

In the past, when the yield curve has flattened and then inverted, it has often been an indicator of a weakening economy and in many cases portended an impending recession. This time around, this signal may not be foreshadowing a near-term recession risk, as it is being heavily influenced by global central bank actions. Current economic activity hasn't shown any indications of slowing down. In fact, as an indication of the current economic strength, the Atlanta Fed's GDP Now model forecast for Q2 2018 real GDP growth has risen to 4.7%, which would be a strong acceleration from the 2.3% GDP growth rate in Q1 and would be the strongest quarterly growth rate since 3Q 2014.

Following a period of heightened volatility and sizeable outflows earlier this year, investors have added some USD 40bn to US equity funds and another USD 8bn to US bond funds since April. Due to the strengthening in US Dollar, we witnessed a shift in capital from DM countries to the US since April, EM has also followed a similar trend of outflow, close to USD 10bn – the fastest pace of outflows since the US presidential election.

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### Exhibit 14: Current valuations across the fixed income asset class

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<thead>
<tr>
<th>Asset Class</th>
<th>Duration</th>
<th>Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE</td>
<td>0.0</td>
<td>8.0</td>
</tr>
<tr>
<td>EM Local</td>
<td>4.6</td>
<td>5.9</td>
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<tr>
<td>EM Corp</td>
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<td>5.9</td>
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<td>EM Sov</td>
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<td>Corp IG</td>
<td>5.9</td>
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<td>UST</td>
<td>7.3</td>
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<td>Global HY</td>
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<td>GCC</td>
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<tr>
<td>DM Sov</td>
<td>7.3</td>
<td>5.9</td>
</tr>
</tbody>
</table>

Source: Bloomberg as of 5 Jul 2018

### Exhibit 15: US stocks and bonds – fund allocations

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<th>Year</th>
<th>Bond (RHS)</th>
<th>Equity</th>
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<tbody>
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<td>2010</td>
<td>47%</td>
<td>53%</td>
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<tr>
<td>2011</td>
<td>48%</td>
<td>52%</td>
</tr>
<tr>
<td>2012</td>
<td>49%</td>
<td>51%</td>
</tr>
<tr>
<td>2013</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>2014</td>
<td>51%</td>
<td>49%</td>
</tr>
<tr>
<td>2015</td>
<td>52%</td>
<td>48%</td>
</tr>
<tr>
<td>2016</td>
<td>53%</td>
<td>47%</td>
</tr>
<tr>
<td>2017</td>
<td>54%</td>
<td>46%</td>
</tr>
<tr>
<td>2018</td>
<td>55%</td>
<td>45%</td>
</tr>
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</table>

Source: EPFR, IIF, as of 20 Jun 2018

### Exhibit 16: New bond issuance for emerging markets have moderated

<table>
<thead>
<tr>
<th>Month</th>
<th>USD bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jun-17</td>
<td>45</td>
</tr>
<tr>
<td>Jul-17</td>
<td>25</td>
</tr>
<tr>
<td>Aug-17</td>
<td>75</td>
</tr>
<tr>
<td>Sep-17</td>
<td>50</td>
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<tr>
<td>Oct-17</td>
<td>30</td>
</tr>
<tr>
<td>Nov-17</td>
<td>40</td>
</tr>
<tr>
<td>Dec-17</td>
<td>50</td>
</tr>
<tr>
<td>Jan-18</td>
<td>60</td>
</tr>
<tr>
<td>Feb-18</td>
<td>40</td>
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<td>Mar-18</td>
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<tr>
<td>Apr-18</td>
<td>60</td>
</tr>
<tr>
<td>May-18</td>
<td>70</td>
</tr>
</tbody>
</table>

Source: Bondradar, CIO Office, as of Jun 2018

### Exhibit 17: China dominates as EM’s largest bond issuer

- China: 45%
- Mexico: 8%
- Qatar: 7%
- Korea: 7%
- Brazil: 6%
- Singapore: 6%
- Argentina: 6%
- Saudi Arabia: 5%
- Indonesia: 5%
- UAE: 5%

Source: Bondradar, CIO Office, as of Jun 2018
Fixed Income Strategy for 2H 2018

Monetary policy setting and normalisation

Although monetary policy normalisation was taken into account, markets neglected the effects of tighter liquidity conditions and of a stronger US dollar on EM assets.

The shift to tightening from DM central banks is also putting pressure on EM central banks to adjust their policy framework to curtail capital outflows and curb currency volatility.

Based on FOMC’s June policy statement, the Federal Reserve officials maintained a hawkish stance towards two additional interest rate hikes for 2018. That said, some consider that the dilemma on escalating trade tariffs could result in only one additional rate hike. Due to subdued economic growth and concerns regarding Brexit, the Bank of England will most likely be limited to a single token hike of 25bp during 2018.

Based on our fundamental assessment (comfort on the current global cycle, demographic trends and consumption patterns), we keep a positive conviction on EM debt.

We keep a positive conviction on EM debt
Fixed Income Strategy for 2H 2018

GCC bonds have also taken a hit, due to the broad EM sell-off as well as the significant widening of risk premium in Bahrain. Higher oil prices should improve the fundamental landscape for the GCC region. Weighted average regional GDP growth in the GCC region is expected to increase from 0.1 percent last year to 2.0% this year and then to 3.3 percent in 2019. Moreover, the recent news about the potential index inclusion of GCC countries into the major USD-denominated EM sovereign bond index is another tailwind. Should it be confirmed later this year, Saudi Arabia, Qatar, Kuwait, UAE and Bahrain would have an estimated weight of 12.3% in the EMBI Global Diversified index, taking the Middle East’s total representation in the index to around 18%, from 6.2% currently. The induced flows could be significant, as passive trackers have taken an increasing part of the EM fixed income asset class in recent years.

As regards Investment-Grade bonds, we see value in Sovereign Bonds issued by Abu Dhabi, KSA and Kuwait. Within more risky high yield Sovereigns, Bahrain remains our preferred play. As regards corporate credit, we have a strong preference towards hybrid instruments issued by banks and energy sector. Amortising bonds also offer value for the shrewd investor.

It is worth noting that among the US – China trade war effects on various asset classes, the Chinese domestic bond market has outperformed all major bond indices, both on an absolute and relative basis.

With US inflation gradually increasing, investors look at the Fed’s steadfast tightening with apprehension. The effect of higher policy rates will be partially cushioned by easing lending standards in the US as well as in Europe and Japan. Reports on lending standards released by central banks in these countries show that the percentage of loan officers reporting easier credit conditions is steadily rising. Also, real policy rates in the US are still negative, and an economic slump under these conditions would be unprecedented.
Fixed Income Strategy for 2H 2018

Inflation is showing some signs of pickup in some EM economies. EM local government bonds should remain volatile in the short-term: EM central banks are likely to turn more restrictive, due to a narrowing gap with the US. Rising US inflation has historically spilled over into EM, and central banks are likely to adopt a more hawkish stance to avoid falling behind the curve. We remain convinced that this pickup is transitory.

Duration positioning
The US yield curve has continued to flatten throughout this tightening cycle, following historical norms during times of rising policy rates. The spread between 5-and 30-year yields reached the lowest level in more than ten years. We hold the view that the US yield curve could invert if the Federal Reserve continues with the planned tightening. This phenomenon is exacerbated by the increased supply of short-dated Treasury notes necessary to fund the rising US deficit. Increasing demand by institutional investors for longer-maturity Treasuries, boosted by the appealing yield differential with DM peers and the tame inflation outlook, will keep the curve in flattening mode. The term structure does not compensate for duration making it unattractive to take duration bets.

In our view, the short-to-belly of the curve offer value in the current phase of the extended economic cycle.
Fixed Income Strategy for 2H 2018

Exhibit 28: US Treasury yield breaches the 3 percent handle briefly as flight to safety bid propels yields lower

Inflation report showed sharp price increases
US imposes trade tariffs and the saga begins with retaliation by the Chinese
FED’s Hawkish stance spooks markets in April
Global trade spat moves to a global phenomenon spurring demand for safe haven bonds

The return of volatility – VIX spiked in a disorderly fashion
Italy’s political crisis takes centre stage

Source: Bloomberg as of Jul 2018

The Chinese domestic bond market has outperformed all major bond indices
Fixed Income Investment Idea: Focus on China

> China’s debt level and growth are manageable.
> Monetary policy setting - a robust and credible framework
> Non-financial leverage is a well identified issue, widely dealt with by authorities
> Prefer Chinese banks (The Big 4) and corporate IG issuers

Over the last four decades, China has emerged among the world largest super-powers, due to ambitious political reforms, which have seen the country mastering different phases of globalisation. In October 2016, the IMF added the Chinese Renminbi (RMB) to the basket of currencies that make up the Special Drawing Right. The SDR is an international reserve asset created by the IMF in 1969 to supplement its member countries’ official reserves. The RMB joins the SDR basket in addition to the previously included four currencies — the US dollar, the euro, the Japanese yen, and the British pound.

The Chinese Renminbi has a 10.92% weight on the SDR basket. So far SDR 204.2bn (equivalent to about USD 291bn) have been allocated to members, including SDR 182.6bn allocated in 2009 in the wake of the global financial crisis.

While we see this as an essential milestone in the integration of the Chinese economy into the global financial system and a testimony to its higher standards, the Chinese markets have not significantly benefitted from this inclusion.

With global central bank’s policy transitioning and recent headwinds caused by tighter monetary policies, markets have recently adjusted for the required risk premium on many of the countries faced with idiosyncratic risks and fiscal imbalances. However, China is well placed to deal with such pressures and still has a huge FX reserve base (USD 3.24tn) and a robust external position.

The capital account is still very controlled, and policymakers have demonstrated prudent fiscal and monetary policies, with many tools at their disposal to respond to any economic headwinds.

The successful internationalisation of the RMB is linked to its adoption in cross border trades for actual payments. The common fear of a potential devaluation is certainly one of the reasons why it hasn’t been widely adopted yet.

Regarding listed securities however, foreign holdings of Chinese stocks and bonds have risen exponentially in the last five years with equities accounting for the lion’s share. The Bond connect program, and the surge in panda bond issuance are some of the most recent reforms that the nation implemented to foster and enable broader international participation and capital flows.

The yields on the Chinese bonds have remained well insulated and contained under the 4 percent level YTD, despite the various volatility episodes which have affected emerging markets, linked to US dollar and rates. The benchmark ten-year bond yield is currently at 3.6%, a sharp increase after the record low of 2.7% in September 2016. Our preference within Chinese bond issuers would be financials and across the investment-grade corporates. While the deleveraging process continues, corporate balance sheets are sound while valuations on a risk-adjusted basis are compelling.

Foreign holdings of Chinese stocks and bonds have risen exponentially in the last five years.

Exhibit 29: China growth differential to the rest of the major economies cannot be ignored

Source: IMF, as of Jul 2018
Fixed Income Investment Idea: Focus on China

In a period where the US Fed has embarked on tighter monetary policies, hiking rates and shrinking balance sheet, EM outflows have exacerbated, especially in the last six to nine months. However, the Chinese policymakers have remained committed to their agenda and implementation framework, and ensured financial stability to the Chinese economy. This factual resilience is for us a proof that Chinese authorities have a firm grip on the entire financial system and don’t lose control. The constant market intervention, active FX control triggers, rules and flexibility on the reserve requirement ratios (RRR) to name a few tools, assure proper management and abundant liquidity for economic activity. The authorities have also kept monetary policy in a neutral stance as they continue to clamp down on high corporate debt levels and risky lending practices to prevent any damage to the financial system.

Although the nation’s recent official economic data remains upbeat, policymakers are starting to balance concerns about economic conditions alongside their longstanding commitment towards containing credit and curbing excess borrowings. So far, results show that the deleveraging process is in progress without hurting the economy.

The overall Chinese government debt position remains well contained and in our view manageable across both central and local borrowers. The primary concern lingers around the corporate sector leverage and its mounting debt.

The reduction on the corporate debt would inevitably have ramifications to business investments and could be a drag on China’s economic growth. China’s policymakers have been aggressive in their drive to reduce the corporate debt mountain, intensifying their efforts to implement measures to curb borrowing. As a result, outstanding off-balance sheet lending has fallen by 100bn yuan in the first four months of 2018, having grown by 2.2tn yuan in the same period last year.

The Chinese policymakers have remained committed to their agenda and implementation framework.
Cross asset views: Opportunities in Volatile Markets

- Synchronised growth gives way to narrow US-led expansion
- Market volatility rises with US dollar ascendancy and higher US policy rates
- Non-US growth expected to pick up in H2 2018 amidst rising geopolitical risks
- Outlook for EM assets should improve alongside fundamentals

This year’s disappointing market performance across asset classes provides payoff for 2017’s Goldilocks backdrop, when risk assets delivered elevated returns amidst record-low volatility for global equities and bonds. Returns for equities, government bonds, credit and hedge funds are underwhelming for the year, with money managers on average tracking the flattish-to-negative performance of most benchmarks. Investors are increasingly concerned about trade conflicts and geopolitical tensions, in spite of a relatively supportive macroeconomic environment and healthy corporate earnings growth. This marks a sharp departure from the Olympian calm markets sported only some months ago, and reflects peaking liquidity and growth globally.

The degree of synchronisation in world growth has been questioned by markets in Q2. Last year growth was accelerating both in the developed and the emerging nations, and most of the global markets were up. Currently, the world is still expanding at a robust pace but acceleration can really be found only in the US. As Exhibit 32 shows, this has led to a narrower leadership within global equities so far.

Some pockets of the US equity market shone in Q2, in particular US Small Caps and US Technology, the former very sensitive to domestic growth, the latter on a secular up-trend expected to drive a new wave of technological progress across the economy. The Fed signalled on multiple occasions that policy rates would continue to rise in keeping with the expanding business cycle, bringing the US dollar (+5 percent in Q2) on the ascendancy. The improved US outlook has at least partially been priced in for the short-term, especially in the currency, as highlighted by the overbought levels in our US Dollar Risk Appetite Index, and to some extent in the relative performance of US stocks versus rest-of-world equities (Exhibit 33).

**Exhibit 32: MSCI AC World Index and proportion of equity markets above their 200-day moving average**

**Exhibit 33: US Dollar Risk Appetite Index and US equities versus rest-of-world**
Cross asset views: Opportunities in Volatile Markets

The outperformance of US assets is accounted for by the country’s outstanding economic growth rate. The US Purchasing Manager Index, a comprehensive measure of business confidence, is in the upper-end of its historical range, while similar gauges in other countries are trailing visibly behind (Exhibit 34).

We hold the view that US outperformance will ultimately be followed by a broadening of the growth cycle to other countries, which would see the resumption of the equity rally and in general positive returns across risk assets. This could happen through two channels: either spillover effects from the buoyant US consumer will lead a recovery in global retail sales and eventually in manufacturing, or the positive feedback to manufacturing will come from the full-employment levels in the DM countries (Exhibit 35). Either way, tight labour markets should be the propelling force behind a manufacturing revival outside of the US.

The loosening of monetary policy in China should also help stabilise Chinese markets and eventually EM assets. Chinese authorities are lowering the Reserve Requirement Ratio (RRR) for deposits to stabilise the economy, following the curbing of excessive credit creation and the adverse impact of trade tariffs. In the past a lower RRR was followed by an expansion in money supply (Exhibit 36), which in turn ended up boosting domestic equities.
Cross asset views: Opportunities in Volatile Markets

Investors should keep some powder dry on the side to take advantage of volatility spikes in the second half of this year. If the economic scenario plays out according to our script, adding to risk on weakness should prove to be rewarding. We hold the view that a barbell approach would work best, by holding risk assets in the US, where growth is expected to remain resilient, and increasing EM positioning in bonds and equities on oversold levels.

The expected 12-month-forward growth in earnings is highest for US equities (Exhibit 36), supported by a favourable macroeconomic backdrop and monetary policy still far from being restrictive. For bond investors US Treasuries look particularly appealing as well, offering the highest yield amongst DM issuers. This is unusual, since US government debt is regarded as the risk-free asset of choice.

EM FX seems to be already offering value, as shown by our EM FX Risk Appetite Index, currently at levels which in the past often coincided with buying opportunities (Exhibit 37). This holds true for EM sovereign hard-currency bonds as well, whose spread is wider than US high-yield corporate spread for the first time since 2000.

Adding to risk on weakness should prove to be rewarding.
Cross asset views: Opportunities in Volatile Markets

Although EM equities already discount quite some investor anxiety about shrinking global growth due to existing trade conflicts, and incorporate as well a risk premium due to the rising dollar and US policy rates, sentiment could still deteriorate further (Exhibit 39). EM equities are historically sensitive to global growth (Exhibit 40) and it is another factor for volatility. However, we recall that the dynamics of the major EM regions are increasingly domestic and consumer-led, in a word, more autonomous. We advise investors to add opportunistically to EM equities when volatility spikes, to enhance their long-term expected returns.

Investors might wonder whether gold has lost its luster for good, considering that it has delivered negative returns year-to-date in spite of rising geopolitical tensions. Real US rates, global growth and market positioning play in our view a stronger role in gold’s trends than trade conflicts or the scrapping of the Iran deal (Exhibit 41). According to our sentiment model gold is not yet at long-term oversold levels, although a rebound seems to be overdue as US real rates ease back and the US dollar consolidates recent gains. As US monetary policy becomes outright restrictive in 2019 gold should derate further and offer a long-term buy opportunity.

![Exhibit 39: Sentiment on EM equities not yet at deeply oversold levels](image)

Source: Bloomberg, CIO Office as of Jun 2018

![Exhibit 40: EM equities have a high beta to global trade activity](image)

Source: Bloomberg, CIO Office as of Jun 2018

![Exhibit 41: Gold not yet offering a buy opportunity in spite of negative YTD returns](image)

Source: Bloomberg, CIO Office as of Jun 2018

We advise investors to add opportunistically to EM equities when volatility spikes.
Oil markets have moved from feast to famine as OPEC’s production cuts have moved the markets into deficit faster than had been expected.

Unplanned outages in major producers like Venezuela and Iran pose a substantial risk to supply for the rest of 2018 and into next year.

Production increases now will help to balance markets but will leave supplies at very tight levels going into 2019, providing a floor to prices in the medium term.

Oil markets enter the second half of 2018 with great uncertainty over whether there will be enough crude to meet demand, a complete reversal of the past few years when rapid supply growth contributed to massive increases in inventories. OPEC’s production cuts helped to move markets back to balance faster than the producers’ bloc had likely expected and OPEC is now signaling it will raise output over the coming months. However, declining production capacity in several members means that any near term increase in output sets the scene for persistently tight markets to the end of the year and into 2019.

OPEC managed to come to an agreement at its latest meeting which was a more constructive outcome than had been widely expected. The statement given by the producers’ bloc stressed that members will “strive to adhere” to their target of 100% compliance with the production cut agreement that has been in place since January 2017, rather than the over-compliance that has helped oil markets tighten quickly. However, the official statement appears to have been left intentionally vague with no specific country allocations nor is there a timeline for how quickly production will be raised. This has left the market guessing as to how much output will end up coming back online and how quickly.

For OPEC to achieve 100% collective compliance with its production cut, it has space to raise output by around 700k b/d from its production levels in May (according to IEA estimates). Part of OPEC’s over-compliance is down to intentional cuts beyond targeted levels by Saudi Arabia and a few others but most of the ‘extra’ decline this year is due to unplanned outages from Venezuela, Angola and, most recently, Libya. Saudi Arabia has already increased production significantly with market estimates for June output ranging from 10.5m b/d to 10.7m b/d, near record highs.

Meanwhile for OPEC’s partners in the deal, hitting 100% compliance would imply a decrease in output of around 230k b/d from May levels as compliance between the 10 countries has only averaged around 70% during the tenure of the deal. Sharp declines in production from Mexico have been
Oil Outlook

more than offset by increasing output from Kazakhstan and middling compliance by Russia in recent months. Between the 24 countries that are part of the deal, an additional 500k b/d would mean aggregate compliance of 100%.

In practice though the terms of the production cut deal are now likely to fall by the wayside in favour of finding a production level that keeps prices in a band between USD 70/b – USD 80/b. The agreement in June to raise output was likely only made on the understanding that production from Venezuela and Iran will fall significantly by the end of the year. We expect that production from Venezuela and Iran will be around 650k b/d lower in 2018 compared with 2017. However, the deterioration in Venezuela’s production is accelerating and our forecast of a 470k b/d decline may be too conservative.

For Iran the expected decline in output is more uncertain as it depends on how strictly importing nations adhere to US sanctions against taking Iranian barrels. So far signs are that main importers of Iranian crude – eg; South Korea, EU nations, India – are already moving away from Iran and exports, and production, will fall as a result. The US is taking a harder line with respect to sanctions than they did in 2012 with the State Department targeting a complete end to Iranian crude exports once sanctions come into effect. Iran exports roughly 2.2mn b/d, an enormous amount for other producers to have to offset directly.

OPEC did not revise specific country quotas at its meeting to avoid officially sanctioning a transfer of market share between members. But there are few countries with the capacity to raise production and any increase in production would be borne most significantly by Saudi Arabia, the UAE and Kuwait. Between them these three countries have around 2.75mn b/d of spare capacity, accounting for around 85% of OPEC’s total, according to IEA estimates. An increase in output now would further erode OPEC’s spare capacity—which has already been in decline since 2015—and help to set a longer-term floor under prices. Perhaps one of the most bullish statements that emerged out of last week’s meeting was Saudi minister al Falih’s warning that Saudi Arabia’s long-term strategy of maintaining spare capacity of 2mn b/d was “very high” and “very expensive.”

In just 18 months the oil market has moved from feast to famine and prices have moved upward as a result. We expect that prices are likely to hold in a range between USD 70/b-USD 80/b, although temporary upward spikes and downward crashes are to be expected on short-term, idiosyncratic factors. As we move into 2019 the full impact of higher tariffs will begin to drag on broader economic growth and mean oil prices stay closer to the bottom end of the range.

Exhibit 44: OPEC spare capacity held in the GCC

<table>
<thead>
<tr>
<th>Country</th>
<th>Spare capacity (mn b/d)</th>
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</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>2.02</td>
</tr>
<tr>
<td>Total</td>
<td>3.42</td>
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</table>

Source: IEA, Emirates NBD Research.

Spare capacity (mn b/d)
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