Investment Strategy

Quarterly Investment View | October 2021

ADCB
بنك أبوظبي التجاري
ASSET MANAGEMENT LIMITED

Q4 2021 Outlook: Sequenced, not synchronised

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Global economic activity this year can be described as anything but 'synchronised'. As the global economy moves quickly past the rebound phase searching for a new normal, it faces a range of uncertainties. Against this backdrop, how should investors play this more sequenced and less synchronised transition into a mid-cycle environment?

Investors who believed that most major global economies will rebound in a lockstep, have been disappointed this year. The bounce of manufacturing and services sectors in various economies was influenced by a range of factors including the spread of new variants of COVID-19 virus, reaction function of the governments to rise in infections, rate of vaccinations, conduct of the monetary/fiscal policies, and some idiosyncrasies. On the situation with COVID-19 this year, it looked like the east decoupled from the west. On policy support, emerging markets remained on a slower lane. China's economic position has been markedly different from the rest of the world. All these speak to the asynchronous journey that lies ahead as economies move past the early-cycle phase into a mid-cycle environment. Higher uncertainty and financial market volatility, that are associated with such transitions are likely to fall as clarity emerges on how economies graduate into a new normal. However, this transition – which is sequenced and not synchronised – creates opportunities for investors. On pages 2-3 we discuss our investment strategy centered around such a transition, and on pages 4-5 we present our portfolio positioning.

Fixed income (pages 6-7): We increase our underweight in fixed income. Taper risks could be enhanced by increased duration – we recommend holding a short-duration stance on USTs versus the global bond benchmark index but remain overweight on the 5yr intermediate bonds. Amongst corporate bonds, we remain neutral on investment grade (in US and EU) and underweight on high yield segment (both US and EU); we prefer AA and BB rated bonds. Within EM space, we go underweight on EM local currency (we were neutral earlier), remain neutral on EM USD sovereigns, but overweight on EM Asia credit.

Equities (pages 8-9): Against a neutral allocation to equities, we discuss why staying invested in a reasonably well diversified portfolio is warranted. Whilst fading fiscal and monetary support could lead to a valuation compression at the margin, we think earnings remain a fundamental support for equity prices. Given that episodes that are earnings-driven tend to be slower compared to those that are valuation-driven, returns over the next 18 months should be lower compared to those over the past 18 months. We also reiterate here, recent changes we made to our regional and sector preferences.

Alternatives (pages 10-11): Our neutral position on alternatives is driven by overweight on gold offsetting an underweight on commodities-ex-energy. On the latter, while we think another super cycle is difficult but demand for commodities linked to green economy could sustain. We think oil prices remain supported by improving demand outlook and disciplined supply. In the hedge funds space, we prefer strategies that are less correlated to equities. REITs are likely to outperform commodities if inflation stays well behaved; real estate linked to industrial and data centres looks better placed than that linked to retail and offices.

Currencies (pages 12-13): FX trends will continue to be driven by the divergence in central bank policies. Global risk sentiment will also play an important role. Even without hiking rates, Fed could still remain relatively more aggressive compared to other developed market central banks. Hence, the case for stronger USD remains. Moreover, the 'dollar smile' implies that USD weakness comes through only when there is a synchronous global growth – the prospects of which are not very strong, in our view. We see GBP remaining strong against the EUR but could weaken further against the USD in the near-term.

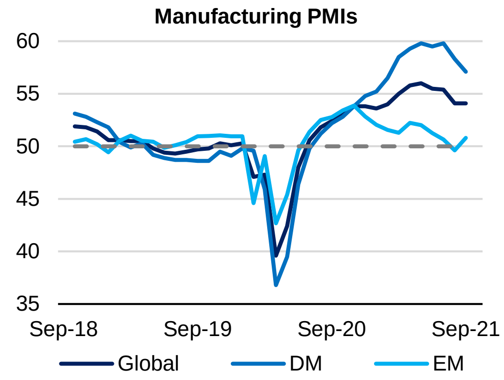
Index

Investment strategy

Not synchronised

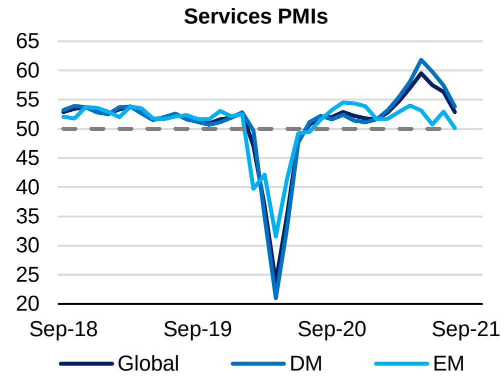
Global economic activity this year can be described as anything but 'synchronised'. Exhibits 1 and 2 show the divergence in the activity of manufacturing and services sectors across major economies. A range of factors including the spread of new variants of COVID-19 virus, reaction function of the governments to rise in infections, rate of vaccinations, and conduct of the monetary/fiscal policies have broadly determined how economies rebounded this year from last year's sharp slump in activity. Adding further to the divergence was the fact that Chinese economy, which managed to contain the virus very well in 2020 and therefore remained the only major economy to have registered economic gains last year, moved well ahead in the cycle. Further, while the US and other major economies maintained ultra-easy monetary/fiscal policies, China's response has been more hawkish – not only in terms of central bank/fiscal policies but also in terms of its zero-tolerance approach to the spread of COVID-19 variants. This, in our view, has pushed Chinese economy farther ahead into the mid-cycle slowdown. We think this divergence in the standing of various economies will influence opportunities and risks in financial markets looking ahead.

Exhibit 1: Divergence in manufacturing sector…



Source: Markit, Bloomberg, and ADCB Asset Management

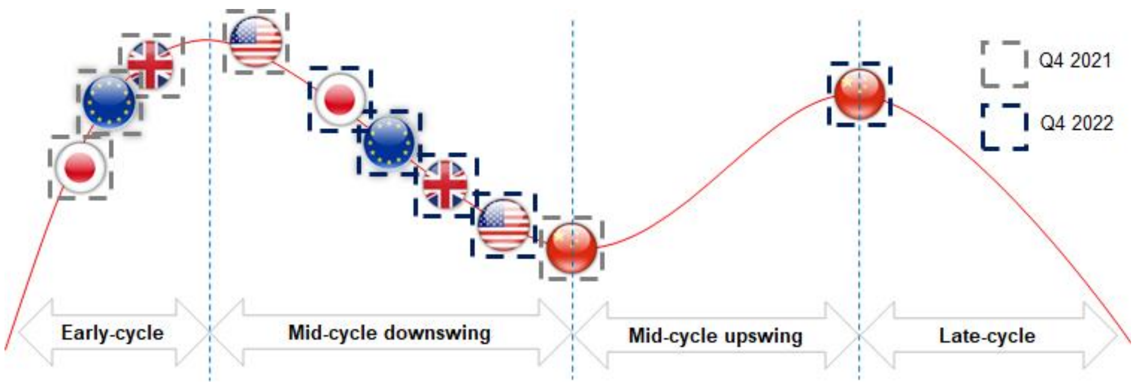
Exhibit 2: …and services sector



Source: Markit, Bloomberg, and ADCB Asset Management

In this context, spotting the current and expected positions of various economies along the cycle could be an essential exercise. We do that in the visualisation below (exhibit 3). Our hypothetical economic cycle (represented by the red curve) comprises of four stages – early-cycle, mid-cycle downswing, mid-cycle upswing, and late-cycle. Against this, using Bloomberg consensus estimates for quarterly GDP growth (y-o-y terms), we identify the position (for Q4 2021 and Q4 2022) of various major economies along the cycle. Also, worth bearing in mind that this cycle is moving faster than normal (for discussion see Q3 2021 Outlook: Three peaks and a fast-moving cycle, July 2021). It can be seen that China is well ahead in the cycle followed by US, UK, Eurozone, and Japan. We discuss the outlook for each of these economies on the following page. For now, it is worth noting that changes in the economic positions between Q4 2021 and Q4 2022 are rather conspicuous and readily help investors in assessing the outlook for financial markets broadly.

Exhibit 3: Visualisation of the cycle*: where major economies are and will be



Source: Bloomberg, and ADCB Asset Management | Notes: *Conceptual visualization not to scale on both horizontal and vertical axes

United States

Strong rebound momentum in the US has been constrained by supply-side issues (including semi-conductor shortages and acute labour shortages) this year. Yet while the economic momentum has likely peak in Q2, growth rates remain still very strong in historical context. Looking ahead, fading fiscal impulse, and incrementally tighter monetary policy are likely to result in slower growth rates. A range of downside risks facing US economy/markets include weaker consumption, tax increases, debt ceiling debate, Fed taper (and potentially higher interest rates), uncertain inflation outlook, and risks associated with mid-term elections.

China

A broad-based and sharper-than-expected slowdown in the property market continues to weigh on the economic momentum in China. Adding to this, was the zero-tolerance approach of Chinese authorities which resulted in severe economic restrictions even for smaller outbreaks of Delta variant of COVID-19 in the country. Carbon emission reduction directives and power shortages are weighing on the industrial production. Crackdown on technology sector has increased uncertainty there. Retail sales growth has slowed markedly. To counter this, we expect policy easing in China and that should revive the economic momentum in 2022.

Eurozone

Eurozone economic activity is expected to scale back its pre-pandemic trend by 2022. Thanks to the EUR750bn Next Generation EU fund, recovery in investment has been rather strong and led to the overall economy emerge stronger from the recession of 2020. However, in the near-term, employment/consumption picture could be clouded by the removal of emergency short-term work compensation schemes. Political risks surround the forming of Government in Germany and French Presidential elections in 2022. These along with strong recovery are likely to start a debate about reform and/or re-imposition of fiscal rules.

United Kingdom

After a strong rebound earlier this year, the UK now faces shortages of goods and labour which are in turn weighing on the activity. While the demand side showed only marginal weakness, most of the drag in the activity seems have emerged from the supply side. Support from fiscal and monetary policies is expected to wane; in fact, tightening could be on cards (in form of interest rate hikes and tax rises). Brexit related trade negotiations have seen little progress over recent months and this could in turn put into doubt, the trade deal agreed with the EU last December.

Japan

Change in leadership is likely to be the most important development in the near-term. With Mr. Fumio Kishida elected the new President of the Liberal Democratic Party and likely to be the 100th Prime Minister of Japan, November general election would come into focus. While this development is unlikely to result in a dramatic change in the policy, Mr. Kishida's proposals on income redistribution, digitalisation, and infrastructure spends are likely to drive the microeconomics. Stabilisation in the fifth wave of COVID-19 along with a strong progress in vaccinations should help the economy counter some risks associated with global supply chains.

Our strategy

Very broadly, we think rising uncertainties (associated with growth, inflation, and policy) warrant investors staying invested in well-diversified portfolios. Our equity positioning (neutral) is more diversified now compared with three months ago (with overweight US, UK, and Asia Pacific; underweight Eurozone and EMs outside Asia). Our positions in the fixed income (underweight) focus on shorter-duration USTs, select EM USD sovereigns, and EM Asia IG corporates. Our overweight in cash works as the dry powder and also as a near-term offset to the underweight in fixed income. Amongst commodities, we keep our overweight on gold as a risk-hedge and prefer oil to industrial commodities. In other alternatives, we prefer hedge funds that are less correlated to risk. In the FX we think USD could stay strong against other DM currencies. We highlight that we are slightly more constructive on the 12-month outlook for Asia now than we were three months ago. See pages 4-5 for our positioning.

Some of the risks facing financial markets include:

- Sustained higher inflation leading to weaker consumption
- Persistent supply-side bottlenecks weighing on the economic activity
- Hard landing of Chinese economy
- Sudden spike in bond yields driven by higher real rates
- Monetary policy mistakes
- Fiscal policy disappointments/higher taxes
- Political and geo-political risks (French and Japanese elections; US-China trade discussions)
- Vaccine hiccups (efficacy challenges with new strains/variants)
- Debt ceiling in the US

Porftolio positioning

Exhibit 4: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities				A more diversified exposure warranted
Fixed income				Taper talk to dominate – negative for duration
Alternatives				Prefer gold and market hedge strategies
Cash and liquidity				Dry powder looking for deployment opportunities
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US				**“Modest” overweight with focus on quality**
Canada				Stick with the benchmark
Europe ex UK				Light on structural drivers of growth
UK				Prefer global large caps with quality-tilt
Japan				**Near-term tailwinds from improving macro**
Asia Pacific ex Japan				**Prefer ASEAN (Singapore) and EM Asia**
EM LatAm				Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA				
GCC				Stick with the benchmark
Global sectors				
Comm. Services				Diversified telecoms and Media
Consumer Discr.				Hotels, Rest. & Leisure
Consumer Staples				Food, Beverage & Tobacco
Energy				**Capital discipline and makeover plays**
Financials				**Focus on growth opportunities in Asia**
Health Care				Biotechnology and Health care technology
Industrials				**Industrial automation and IoT**
IT				**‘Moderate’ OW with focus on durable growth**
Materials				Structural weakness on a shift to ‘new economy’
Real Estate				Real estate management & development
Utilities				**Gas utilities and Renewable Electricity Prod.**
Factors/styles/sizes				
Large cap				Strong balance sheet, earnings visibility
Mid cap				Likely to be market-performers
Small cap				Strained by leverage and peak-growth
Growth				Prefer non-cyclical growth
Value				Avoid value in sectors facing disruption
Dividend yield				Prefer quality dividends and dividend growth
Quality				Quality in the environment of low risk-tolerance
Momentum				Benefits from ‘new economy’ orientation
Legend	*New*	*Old*	*No change*	

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks. Last changes made in our note The Equity Strategist: Looking to the East, September 13 2021

Exhibit 4: **Recommended portfolio positioning (continued)**

Fixed income**	Underweight	Neutral	Overweight	Comments
Duration	■			Remain overweight on 5yr bonds
US Treasuries			■	Prefer US Treasuries acting as a hedge
US Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		Bottom-up approach is key: AA sector attractive
- HY (off benchmark)	■			Bottom-up approach is key: BB sector attractive
European Bunds		■		ECB to be less aggressive
European Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		QE program in the form of CSPP to support
- HY (off benchmark)	■			Valuations look stretched
UK Gilts			■	BoE unlikely to be aggressive
EM USD Sovereign		■		
- Brazil			■	Less dovish Fed could weigh on various EMs, selectivity is key
- Russia			■	
- High quality GCC			■	
EM LC Sovereign	■ ←	□		**Fed taper to fasten EM policy normalization**
- India Govt. bonds			■	Preference for short-dated government bonds
EM Corporate	■			High leverage is concern, but opportunities in Asia
- EM Asia			■	Preference for Asia IG with spreads attractive
Alternatives	**Underweight**	**Neutral**	**Overweight**	**Comments**
Gold			■	Hedge against political and inflationary risks
Oil		■		Looking for a balanced market
Other commodities	■			Commodity super-cycle is difficult to realize
Hedge funds		■		Strategies that are less correlated to equities
Currencies	**Negative**	**Neutral**	**Positive**	**Comments**
USD			■	Fed's aggressiveness versus DM central banks
EUR	■			Path of short-term rates over long-term
JPY	■			Rising UST yields and opposite BoJ policy
GBP		■		Driven by the aggressiveness of BoE versus Fed
EM currencies		■		Driven by idiosyncratic developments
Legend	*New*	*Old*	*No change*	
	■	□	■	

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: **Positions recommended based on Bloomberg Barclays Global Aggregate (USD unhedged) Index benchmarks

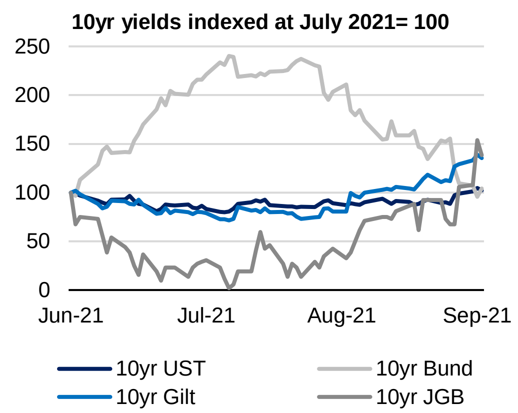
Fixed income

Preparing for policy normalisation

The third quarter of the year was a mixed bag for various fixed income assets. The market participants digested more hawkish messages from the DM central banks with the backdrop of uncertainty over rising Delta virus concerns, inflation fears and growth slowdown concerns. DM central banks began to signal their readiness to exit from the ultra-loose monetary policies on the back of rising price pressures. The Fed, post the hawkish June meeting, was relatively less hawkish until the end of August. But in the September meeting, the Fed's message of possible taper was clear. Across the Atlantic, the ECB surprised with a hawkish signal in August, announcing withdrawal from its pandemic-related stimulus PEPP (Pandemic emergency purchase programme). Finally, the BoE also signalled earlier than anticipated rate hikes, addressing the signs of rising inflation. As a result, DM sovereign bond yields were relatively more volatile in Q3 compared to Q2. This was particularly the case with core Eurozone and UK gilt yields. UST yields were relatively range bound until the September FOMC meeting, post which the 10yr UST yields touched the highest level in three months.

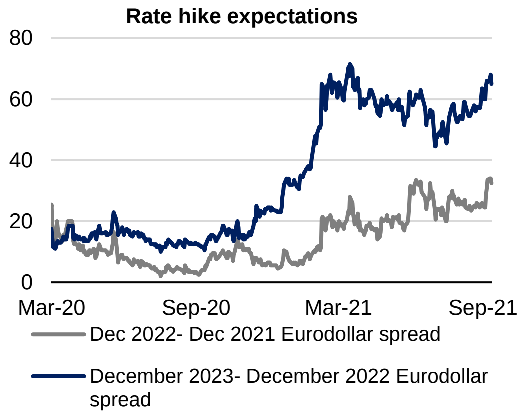
As expected, Fed hints of taper beginning in the fourth quarter, has already spooked the bond markets with the UST yields rising across the curve. The yield curve has fairly steepened as the taper signal coupled with rising inflation concerns led to faster rise in long-term bond yields. Despite the steepening, the front-end bonds were not immune to the sell-off. Talks of early policy normalisation have led to aggressive rate hike pricing again by the markets. Over the quarter, market expectations of Fed rate hikes had eased. But this changed immediately after the recent September FOMC meeting in which the voting members were equally split for a rate hike or status quo in 2022. We believe the market is again getting too aggressive in pricing these rate hikes. Trimming of asset purchases does not necessarily mean that the Fed will be in a hurry to raise rates. The bond taper process in itself, if started in Q4 2021, could take at least six-eight months to complete. Market consensus expects that the Fed could pare US Treasuries by USD10bn/month and mortgages by USD5bn/month, leading to a full exit from the USD120bn/month quantitative easing program within eight months. Given the underlying uncertainties related to COVID-19 (a possible wave during winter) and peak global growth concerns, it is too early to project Fed rate hikes to follow the taper in 2022. Fed taper, on the other hand, would provide some wiggle room for the central bank to address the next downturn, which could be earlier than anticipated given the pace of the current economic cycle. Until there is more clarity regarding the same, we expect the long-term bond yields to remain volatile. The 10yr UST yields have been trading too low versus the Fed's long-term neutral rate, making it vulnerable to taper risk. As a result, we recommend holding a short-duration stance on USTs versus the global bond benchmark index but remain overweight on the 5yr intermediate bonds.

Exhibit 5: Mixed bag for DM yields



Source: Bloomberg, and ADCB Asset Management

Exhibit 6: Increased rate hike expectations



Source: Bloomberg, and ADCB Asset Management

Neutral on US and EU IG, Underweight on US and EU HY, Preference for AA and BB rated bonds

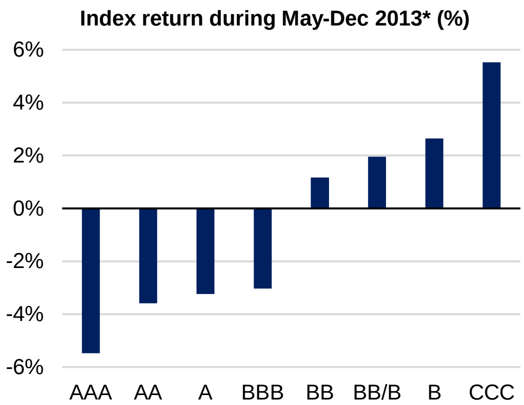
Developed market corporate bonds kick-started the third quarter on a positive note, but came under pressure in September. Central bank signalling earlier policy normalisation impacted the appetite especially for the investment grade bonds. Fed's taper signal and more hawkish tone by other DM central banks has put pressure on long-duration fixed income assets including IG bonds while HY bonds, due to their short-duration characteristics, suffered less comparatively. In fact, HY bonds have relatively done better than equities with oil prices providing support to the sector. The looming taper announcement may not necessarily result in the taper tantrum scenario of 2013. However, our analysis of 2013 taper tantrum period shows that the long-duration fixed income assets were most impacted during the taper tantrum sell-off. In the event of taper-related volatility, along with long-dated USTs, US IG could come under pressure given the relative duration extension seen compared to 2013 taper tantrum period. US HY bonds were immune to the 2013 taper tantrum but could become vulnerable due the current tight spread levels. In terms of sector, financials and basic industries had recorded the largest spread widening during 2013 taper tantrum period. As such, we remain neutral on US and EU IG bonds while remain underweight on US and EU HY bonds. Our neutral stance on US IG and underweight stance on US HY acts as a hedge against our short-duration call on USTs.

Going underweight on EM local currency, Stay Neutral on EM USD sovereigns, Overweight on EM Asia credit

The third quarter of 2021 also proved to be a mixed bag for EM bonds amidst the rise in UST yields and stronger dollar weighing on the sentiment. DM policy normalisation pose risks for EM bonds. EM local currency bonds could be the most vulnerable as the taper talk could fast track the policy normalization process of various EM central banks. On the other hand, EM USD sovereign bonds could also come under pressure, due to stronger USD prospects. But the pain could be less given the recent decline in their correlation with the UST volatility. Also, while we agree that valuations have tightened in EM USD sovereign, they are relatively cheap versus EM local currency bonds. As a result, we recommend going underweight on EM local currency bonds while remaining neutral on EM USD sovereigns. Within EM local currency bonds region-wise, EM LatAM local currency bonds could be the most susceptible to taper-related risk, despite the central banks there taking a proactive approach in policy normalization. On the other hand, EM Asia local currency bonds could be less impacted as China will remain accommodative, addressing the growth concerns. Even with our neutral stance on EM USD sovereigns, there are selective opportunities in the BBB and BB rated space and we remain positioned through our selective overweight on Russia and Brazil respectively. In addition, we prefer higher-quality EM sovereigns and the GCC region stands out the most. We express caution in adding new positions in the low-rated EM sovereigns as these could be come under pressure with the potential taper risk.

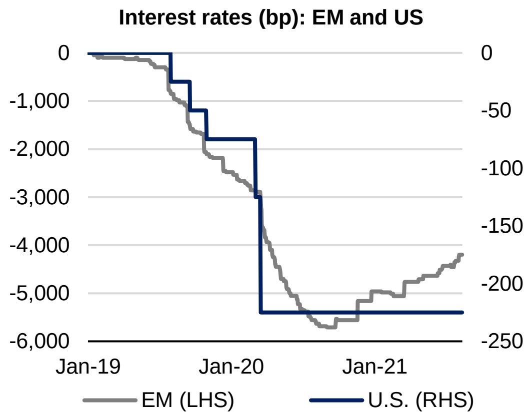
In EM corporate, we retain our preference for Asia credit through our overweight stance on Asia IG bonds, despite the recent China regulatory concerns. The third quarter has been challenging for Asia credit with the default concerns of China property developer Evergrande pushing spreads wider. While Evergrande falls in the Asia HY segment where we do not hold a position, market fears have led to the widening of Asia IG spreads as well. Asia HY remains vulnerable given that China contributes almost 50% and real estate sector holding the largest weight in the index. Asia IG will be relatively less susceptible with government-related agencies holding the largest weight but not completely immune as the agencies could have exposure to bad debt in real estate market. Nevertheless, it is crucial to look past the recent volatility as the regulatory crackdown is a credit positive move. Also, credit impulse has started to bottom out with the authorities taking an accommodative stance to prevent a liquidity crunch. Growth slowdown concerns have been excessively priced by the market with valuations looking cheap in Asia IG. Beyond China, it is also important to look at the growth outlook for the region as a whole which is set to improve with better control of COVID-19 situation.

Exhibit 7: Long-duration sell-off meant high-rated bonds underperformed



Source: Bloomberg, and ADCB Asset Management | Note:*Taper tantrum period from May 2013-December 2013

Exhibit 8: EM leading policy normalisation



Source: Bloomberg, and ADCB Asset Management

Equities

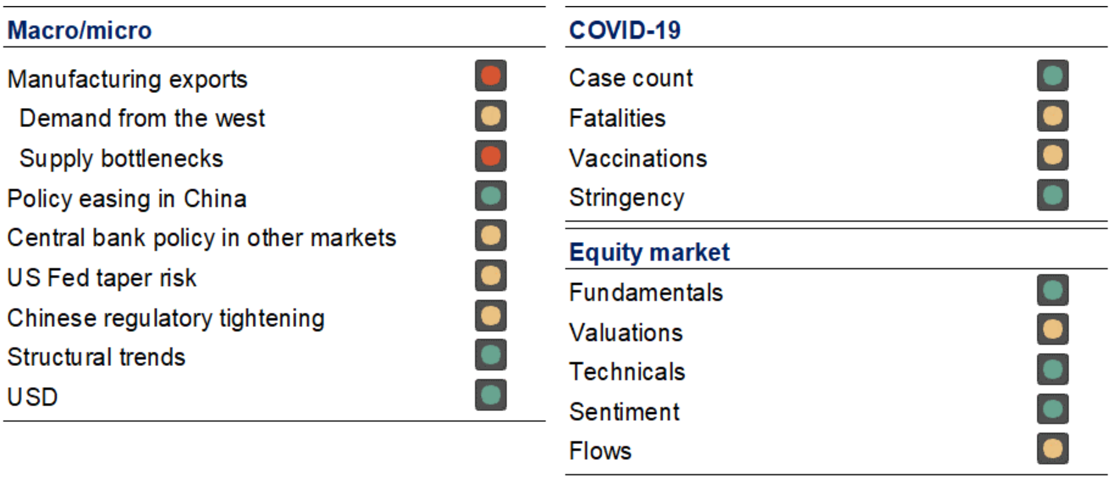
This section is an extract (with necessary updates) from our recent note The Equity Strategist: Looking to the East, September 13 2021 where we made some changes – by both country and sectors, but not factors and styles – to our equity allocation. These changes are also highlighted in the portfolio table on pages 4-5.

As discussed in the investment strategy section of this report (on pages 2-3), global growth is sequenced not synchronised. Further, as we argued in our Q3 outlook report (see Quarterly Investment View, July 2021), this economic cycle is moving faster than normal. Also, a range of uncertainties persist as the broader cycle moves from an early-cycle to mid-cycle environment, albeit with its constituents at varying speeds and positions in the cycle. Looking ahead, for the next 12-15 months, we think investors are best served by maintaining a well-diversified portfolio to counter this broad range of uncertainties. Of course, staying invested in a well-diversified portfolio was always prudent, it is just now a bit more important too. In an attempt to diversify more, we made some portfolio adjustments recently (see The Equity Strategist: Looking to the East, September 13 2021); we reiterate the same here.

Upgrade Asia Pacific (APac ex Japan + Japan) to a 'moderate' overweight from neutral

Asia has lagged broader equities so far this year due to a range of headwinds including – rising COVID-19 cases, unfavourable macro backdrop, and equity market-related issues (originating from China). However, our traffic signal scorecard (exhibit 9) points to trends turning more positive for equity markets there.

Exhibit 9: Traffic signal card points to potential opportunities in Asian equities



Source: ADCB Asset Management

- **Japanese** equity market tends to benefit from hopes for more stimulus from a potential new Prime Minister *(Mr. Fumio Kishida now elected as the leader of LDP)*, and lower rates compared to other developed markets. Japanese equity market presents relative value after recent underperformance and could be helped by the strength in the industrial cycle over the next 12 months. COVID-19 cases seem to have peaked and vaccinations have picked-up pace. Over the long-term, improvements in corporate governance and other reforms could provide further support to Japanese equities.
- **ASEAN markets** (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) could get a boost from a revival in sentiment driven by a fall in COVID-19 case counts and increasing vaccination rates. Domestically oriented consumer-related companies present great investment opportunities. We think Singapore deserves a special focus given the recent control of COVID-19 cases and favourable policy risk backdrop.
- **Chinese/Hong Kong** equity markets are likely to be helped by bottoming credit impulse and rebound in its internet sector equities. Further, as we argued in our report China-US tech decoupling – implications for global portfolios, July 28 2021, recent meltdown in Chinese tech equities points to a potential decoupling of the sector from that in the US. China appears to be charting its own course for this strategically important sector of innovation. For long-term global investors, China is

too big to ignore – even after adjusting for a 'different' investing climate. Paradoxically, having a well-defined exposure to China is more important now than ever. While regulatory risks have clouded the near-term outlook, market reaction has been extreme too. We remain constructive on the broader theme for the long-term. We think investors with no China exposure risk missing opportunities there.

- **Indian** equity market has benefitted from two developments. 1) An improvement in the profitability after a multi-year slump. This is as we expected and will likely last for many more years. 2) Acute weakness in Chinese equities – which has triggered a rotation of EM-focussed money into Indian equities as an alternative. Given the recent run up, Indian equities look technically overbought. Fund positioning is neutral relative to history, but valuations (based on 2021e and 2022e) look slightly stretched. Against this backdrop, should Chinese equities do well, Indian equities could underperform in the next 12 months as rotation back to Chinese equities takes hold. If one takes a longer-term view on India, many structural trends are supportive (better demographics, increasing export activity, and expanding footprint of the digital economy), and valuations look attractive. Indian equities, like other EM equities, are under-represented in global benchmarks/portfolios.
- **Taiwan and South Korea** should be helped by the strong demand for tech hardware. Further, South Korean consumer discretionary space should find support from stable (or stronger) Chinese economy and consumers there. However, it is worth noting that Taiwanese stocks have performed well already and incremental outperformance might be difficult to attain.
- We are not taking any high conviction active stance on **Australia and New Zealand**. These markets represent less than 2% of MSCI ACWI and c10% of MSCI AC Asia Pacific.
- On **Pakistan**, MSCI announced recently (see "MSCI Downgrades Pakistan to Frontier Market After Four Years, Bloomberg, September 8, 2021, 12:45 AM GMT+4") that it will reclassify the MSCI Pakistan Indexes from EM to FM in one step, coinciding with the November 2021 Semi-Annual Index Review. This removes the market from our benchmark of MSCI ACWI.

Trim overweight on US equities

We fund our Asia upgrade by just trimming our overweight in the US to a "modest" overweight position. This is possible because US is 60% of the benchmark and Asia Pacific is just 18%. US equities have outperformed quite significantly over the recent years and market valuations stated to look full. Over the next 12 months or so, US equities could face headwinds from weaker consumption, tax increases, debt ceiling debate, Fed taper (and potentially higher interest rates), uncertain inflation outlook, and risks of mid-term elections. Yet, the equity market in the US is underwritten by quality-rich corporates and innovation themes – which is where our structural preference is.

Changes to global sector allocation

Following changes to our sector allocation are in line with the changes to our recommendation/allocations by geography. Further these changes help by increasing the diversification.

- Trim overweight on IT
- Upgrade financials to neutral from underweight
- Upgrade industrials to overweight from neutral
- Downgrade energy to neutral from overweight
- Downgrade utilities to underweight from neutral

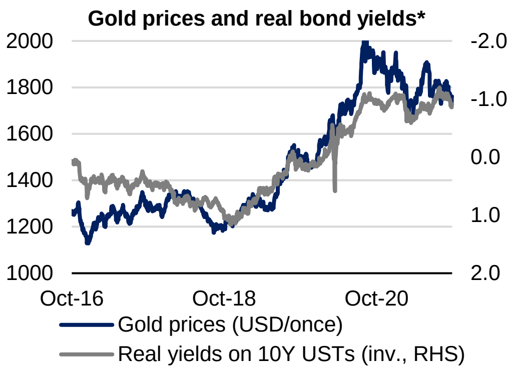
Elsewhere, our unchanged active positions include overweight UK, underweight Eurozone and underweight EM outside Asia by geography. We also retain our overweight in communication services and underweight in materials by sector. We make no changes to our factor, style and size preferences; we continue to prefer large cap, quality, and non-cyclical growth.

Alternatives

Gold

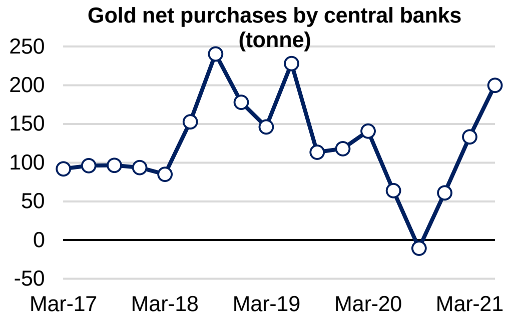
Gold prices have fallen in recent weeks on rising real bond yields (exhibit 10) and strengthening USD. The yellow metal prices have moved between USD1676/ounce and USD1900/ounce this year, after having risen strongly over the previous year. The current level is close to the bottom seen in February this year and well off the highs reached in May. Looking ahead, movement in gold prices is likely to be driven by the Fed policy. Especially tapering plans of the Fed could put a lid on strong rallies in gold prices. In a broader view, the policy backdrop may not be overly restrictive too. Higher demand for coin, bar, and jewellery may be the offset for weakness in demand for ETFs. Central bank demand has revived so far this year. After record-high buying of 657t in 2019, central banks slowed down their purchases of gold in 2020 to 273t. However, H1 2021 saw central banks buying pick up quite dramatically to 333t (exhibit 11). From an investment strategy view point, we continue to see gold as a strong hedge against a range of risks – those that are political, geopolitical, and higher inflation linked. Gold could provide some shield in risk-off environments too.

Exhibit 10: Gold prices share a strong inverse correlation with real rates



Source: Bloomberg, and ADCB Asset Management | Notes: *calculated as yield on 10Y USTs – 10Y breakeven

Exhibit 11: Central bank demand for gold is on rise again after a brief slump in 2020

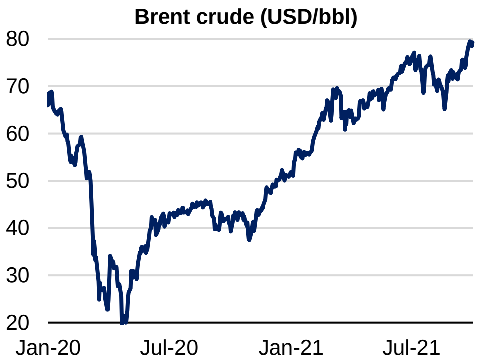


Source: Bloomberg, and ADCB Asset Management

Energy

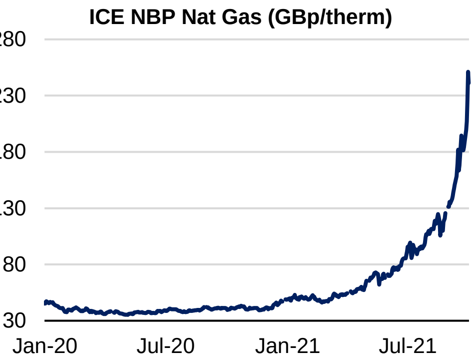
Oil prices over the past 18 months have faced a very uncertain demand environment. Yet since November last year, oil prices rose significantly (exhibit 12). Going forward, as economies around the world reopen following the recent wave of Delta variant-induced restrictions, demand outlook for oil should become less uncertain. This alongside a strong compliance of OPEC+ should lead to stable to higher oil prices in the next year or so. However, the long-term outlook for demand is likely to weaken as climate change policies become popular and the speed of the energy transition picks up pace. Global gas and LNG prices have reached historically high levels in recent months (exhibit 13), backed by a very tight physical market in both Europe and Asia. Thanks to unplanned LNG supply outages, cold weather in Europe and Asia, and lower-than-expected exports from Russia to Europe, market for global gas/LNG was much tighter than expected, and led to a sharp squeeze higher in the prices.

Exhibit 12: Oil prices almost doubled over the past year



Source: Bloomberg, and ADCB Asset Management

Exhibit 13: Nat gas prices increased sharply in recent months

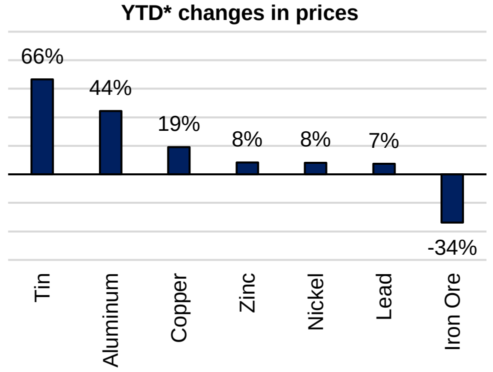


Source: Bloomberg, and ADCB Asset Management

Industrial commodities

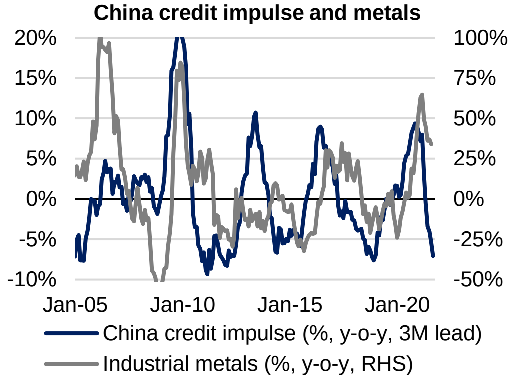
For a while now our view has been that while another commodity super cycle is difficult, demand for commodities linked to clean energy is likely to sustain. We saw this play out in commodity prices to some extent over the recent months. Indeed, the performance of industrial metal prices has been bifurcated (exhibit 14). While the prices of commodities linked to alternative energy, such as copper, nickel and cobalt have risen strongly, other commodities corrected significantly over recent months (iron ore is a classic example of the same). Looking ahead, should China stimulate its economy, it could also improve the demand outlook for industrial commodities. However, it is worth noting that commodity prices have in recent months decoupled quite significantly from the Chinese credit impulse (exhibit 15). This makes us doubtful of a further sharp move higher in broader commodity prices triggered by Chinese stimulus. Further, any such stimulus effects are likely to be offset by a range of restrictions. For instance, for the first time in more than a decade, China held multiple auctions to release state reserves of metals, including copper, aluminium and zinc, to try to boost market supply and help the manufacturing sector that has been impacted by higher metals prices. Furthermore, China will likely improve monitoring and forecasting systems to strengthen price controls.

Exhibit 14: A bifurcation in performance trends: base metals vs. ferrous



Source: Bloomberg, and ADCB Asset Management | Notes: *data as of September 30 2021

Exhibit 15: China credit impulse tends to lead industrial metal prices

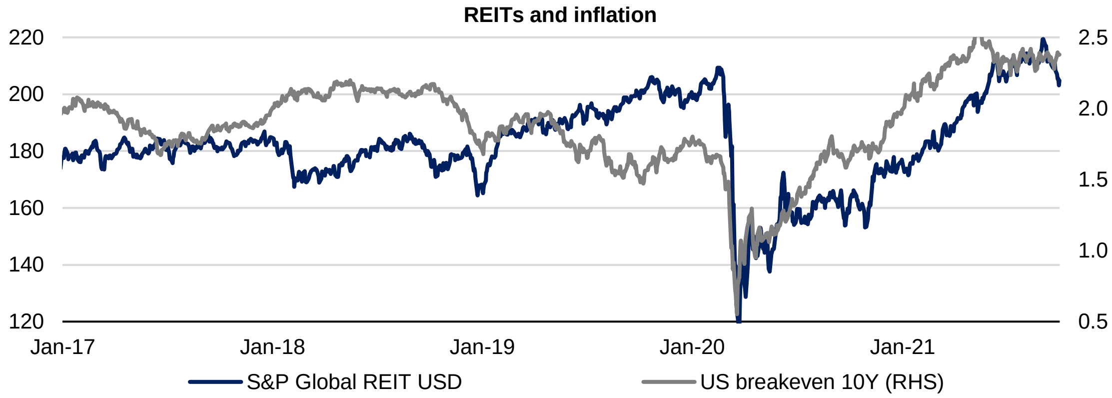


Source: Bloomberg, and ADCB Asset Management

REITs

When inflation risks are rampant, market participants look up to commodities and REITs as potential hedges. This time has been no exception, as can be seen from exhibit 16, since March 2020, inflation expectations have risen considerably and that in turn supported the prices of commodities and REITs. However, should the current higher inflation prove more "transitory" (which we expect it to), some support for REITs could fade. However, worth noting that between commodities and REITs, the latter tends to outperform the former when inflation is not too high (less than 3% as indicated by some empirical studies). Within the real estate, investors need to be selective in our view. In that context, industrial real estate supported by increasing e-commerce, data centres supported by increasing digitalisation, and apartment spaces supported by rental growth look attractive over retail and office spaces. For discussion on house prices see Rising house prices – multi-asset implications, August 16 2021.

Exhibit 16: REITs along with commodities are considered inflation hedges



Source: S&P, Bloomberg, and ADCB Asset Management

Currencies

US Dollar's brilliant summer

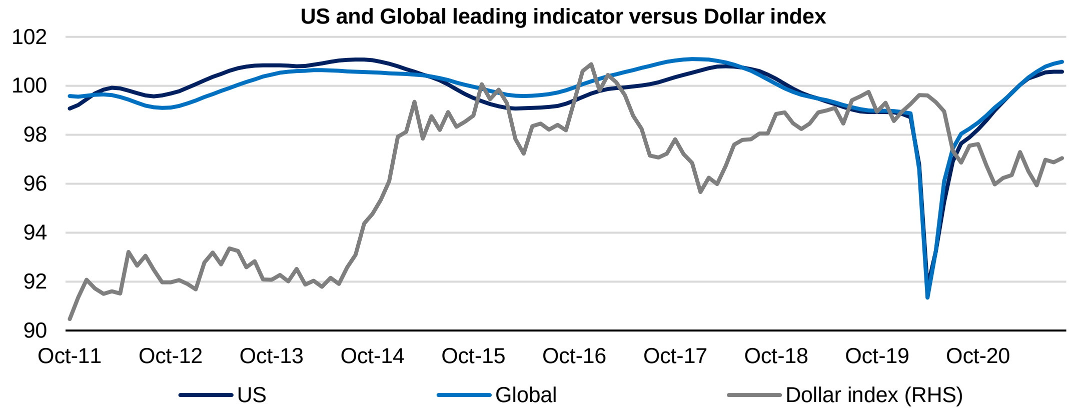
The summer turned out to be strongly in favour of the US dollar. After briefly coming under pressure in the second quarter, the US dollar continued to move upwards in the third quarter. Peak global growth, growth slowdown concerns in China, and rising delta variant cases across the globe despite the higher vaccination rates proved supportive for the greenback. Not to forget, policy normalisation talks led by the US Federal Reserve also helped the dollar. Though it was not a very smooth ride for the greenback. There were couple of pressure points, especially post the disappointing payroll numbers, ECB surprising by withdrawing the pandemic-related stimulus and relatively dovish Fed bias at the Jackson Hole Meeting in August. But the rally strengthened from the beginning of September on the back of the risk-off mood and post the September Fed FOMC meeting which gave a clear signal that the taper could start in the fourth quarter of this year. Going forward, currency trends will continue to be driven by the divergence in central bank policies and also the global risk sentiment will also play an important role.

Who wins the policy normalisation game?

The first half of the year for the currency market was mainly driven by the handling of the COVID-19 pandemic through vaccination progress and re-opening plays. More importantly, dollar exceptionalism took a backseat in Q2 with the only slight difference between global growth and US growth trends. However, with more signs of global growth peaking in the third quarter while risks of the COVID-19 pandemic remaining at large through the spread of the delta variant cases, the case for cyclical weakness in dollar now has reduced. In addition, the interplay of DM policy normalisation has also become an important driver for the dollar and the currency market. With the divergence between the DM central bank policies now contracting from before as the Fed, ECB and the BoE move to a more hawkish stance, what will matter in the near term is which central bank will be leading and dominating the policy normalisation.

Clearly, the Fed has been a leader in this regard and will continue to be so. Fed could start the taper in the fourth quarter of this year and based on market consensus estimates even complete the taper process by June-July next year. On the other hand, the ECB has so far announced withdrawal only from its temporary pandemic stimulus support through its PEPP programme. While markets have brought forward the ECB rate hike expectations, market expectation of the Fed rate hikes have also simultaneously become more aggressive, particularly post the latest September FOMC meeting where the Fed members were equally spilt for a rate hike and status quo in 2022. As a result, it is not surprising that the short-term rates differential between US and Europe have widened. While we believe that the Fed taper would not necessarily mean that the Fed could start to hike rates earlier than anticipated, the Fed could still remain relatively more aggressive compared to other developed market central banks. Hence, the case for stronger dollar remains.

Exhibit 17: Soft global growth could be favourable for the US dollar

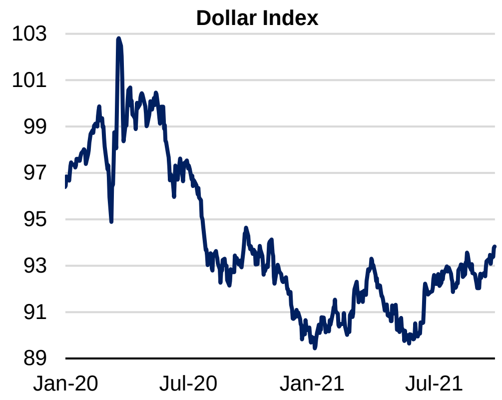


Source: Bloomberg consensus surveys, ADCB Asset Management

Pound sterling: Second after the dollar

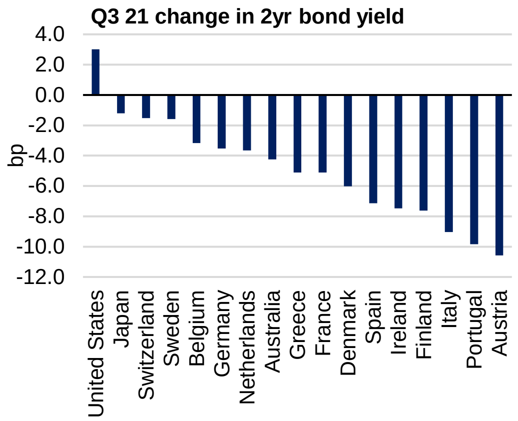
The Pound sterling was fairly steady in the beginning of Q3 but started to lose against the USD in September. This was despite the recent BoE hawkish pivot amidst the rising inflation pressures. The pound sterling recently has depreciated against the dollar due to supply chain disruptions spurring a jump in gas prices in the country. Fuel prices in the UK have reached the highest level in eight years. The pound sterling has also been relatively stable against the euro, but more recently has fluctuated versus the euro too. We expect the pound sterling to remain stronger versus the euro on the back of the BoE's willingness to a modest tightening. The sterling's performance versus the US dollar should again be driven by the degree to which the BoE could normalise monetary policy versus the Fed.

Exhibit 18: Slow and steady dollar rise



Source: Bloomberg, and ADCB Asset Management

Exhibit 19: Short term rates surge in the US

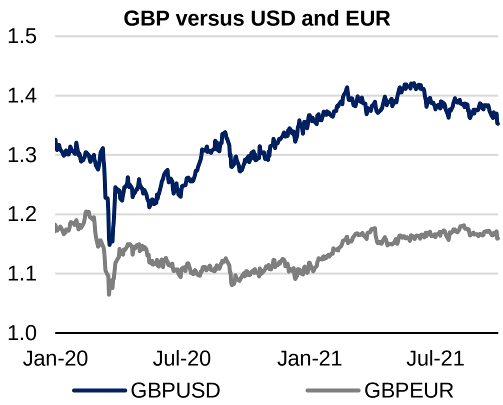


Source: Bloomberg, and ADCB Asset Management

Japanese Yen

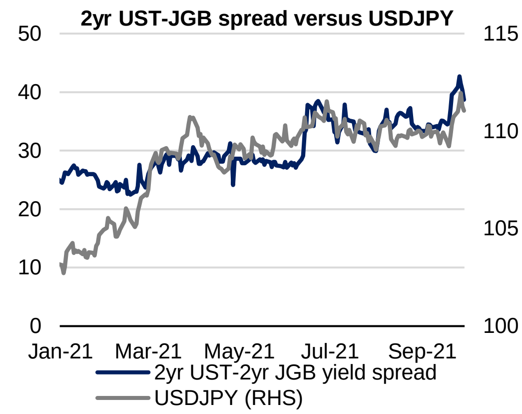
The Japanese yen continue to remain weak versus the dollar amidst the backdrop of broad dollar strength and rising UST yields. The main driver for the yen in the near term will be dependent on how the differential between UST yields and JGB yields plays out. With the Fed leading the policy normalisation in the DM, higher UST yields and more importantly the volatility in the UST rates could keep the yen under pressure. In addition, the BoJ has signalled a more accommodative monetary policy stance and could boost the stimulus as it struggles to reach its inflation goal. The widening policy divergence is not supportive for the performance of the yen versus the dollar, in our view.

Exhibit 20: Supply chain issues cause pound weakness



Source :Bloomberg, and ADCB Asset Management

Exhibit 21: Diverging monetary policy



Source: Bloomberg, and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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