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GLOBAL INVESTMENT OUTLOOK 2019
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It gives us great pleasure to present First Abu Dhabi Bank’s (FAB) Global Investment Outlook for 2019.

As FAB approaches its third year, we continue to grow stronger and build on our position as the UAE’s largest bank. We have the strongest combined ratings of any bank in the MENA region, rated Aa3/AA-/AA- by Moody’s, S&P and Fitch respectively. We are also well positioned to capture future opportunities across our entire business spectrum.

With our continued growth, we are emulating the achievements of our home country – the UAE, which has just climbed 10 places to No.11 in the World Bank’s Ease of Doing Business rankings, out of 190 economies, underscoring the foresight of the local and federal governments.

Abu Dhabi and the UAE stand at the longitudinal geographic centre of global economic activity, and FAB continues to take advantage of this. Our offices in our current overseas locations give us access to numerous markets and asset classes globally.

We do not need to travel far, however, to find great opportunities. A number of positive developments have taken place in the Middle East, with GCC bonds being included in the JP Morgan Emerging Markets Bond Indices, and Saudi Arabia’s equities due to enter the MSCI Emerging Markets index early in 2019. The broader MENA investment landscape is in good shape, despite crude oil prices having recently corrected.

As investment challenges grow more complex, our Global Investment Outlook is designed to support investors in making sound decisions, as many opportunities materialise in emerging markets this year.

We wish you a prosperous year ahead.

Yours sincerely,

André Sayegh
Deputy Group CEO & Group Head of Corporate & Investment Banking

Hana Al Rostamani
Group Head of Personal Banking
THE YEAR THAT WAS, AND 2019
ALAIN MARCKUS
THE YEAR THAT WAS, AND 2019
MEAN REVERSION OR JUST RATIONALITY, 2019 PROMISES TO BE GOOD
Alain Marckus

It had been a long time since global markets had seen a year such as 2018. In fact, the last time cash outperformed most major asset classes as it did last year was in 1994. The then US Federal Reserve Chairman Alan Greenspan had gone into an aggressive ‘normalization’ of American interest rates. He hiked them six times that year from 3% to 5.5%. Last year, Jerome Powell’s Fed completed its fourth hike in December, bringing the Fed Funds Target Rate to 2.5% from the 0.25% where it stood three years earlier.

The shift to more normal conditions from the unprecedented monetary stimulus the world’s major central banks established after 2009 saw a healthy correction in global markets. This correction was quite pronounced in equities, both in developed and emerging markets. It also pushed corporate bond yields higher, and simultaneously boosted the dollar while depressing commodity prices. What may lie ahead in 2019, we believe, may be a much better scenario for world markets after a torrid ending to 2018, if history is anything to go by.

In 1994, the S&P 500 ended the year 2% down after a volatile ride. The following year, however, the index rose 33.6%. There is good reason to think that 2019 could offer similar stellar returns for some of the riskier asset classes that we think start with emerging markets and high-yield credit.

US equities are a good example. Part of the reason why the Fed was so aggressive in hiking interest rates was due to the robust health of the US economy, which grew nearly 3% in 2018. That was the fastest pace in 14 years. In 2004, when the US expanded 3.8% in real terms, it added some US$750 billion to its US$11.8 trillion economy in nominal terms. Last year, the country created more than US$1 trillion in additional domestic goods and services, twice Poland’s entire GDP in 2017.
This year, US nominal growth is likely to be similar, with real GDP expected to grow some 2.3%, a slower pace but still far from a recession. At the same time, the Fed is no longer under pressure to normalize interest rates in the way it had done last year, given that US dollar benchmark rates ended 2018 at 2.5%, just shy of the 2.75% that Fed economists themselves see as the so-called neutral level. And yet, US interest rates are still much lower than where they were a couple of decades ago.

This comes at an interesting time, when the other two important central banks in the world, namely the European Central Bank (ECB) and the Bank of Japan (BoJ), are still in the process of rolling back their own monetary stimulus, put in place in similar fashion to the US Fed’s. The BOJ and ECB are still playing ‘catch up’ with the US when it comes to rates. They are however, likely to do so at a much slower pace. This would suggest that some of the monetary tightening pressures that drove losses in markets in 2018 may not be such a big concern this year.

With the world’s largest economy, the US, growing at an above-average rate, and monetary tightening under control, there is little reason to believe the negative performance of 2018 will repeat itself in 2019. On the contrary, some of the most beaten-down assets could very well be outperformers this year.

Emerging markets, which are particularly sensitive to the Fed’s policy are perhaps a very good example. China, the largest economy in the emerging world and the world’s second biggest overall, is still growing at a healthy rate that is well above numbers shown by G7 economies.

The country expanded 6.5% last year, the slowest pace in nearly 30 years but almost twice the speed of the US. China has been grappling with deleveraging its economy, as well as the trade war it now finds itself in with the US. Expansion, however, is likely to accelerate this year as the effects of a round of reserve requirement cuts enacted last year by the Chinese central bank, the PBOC, reverberate positively through the economy.

The trade dispute with the US is likely to simmer down as we get through 2019 too. Both countries have made significant progress in talks that took place at the end of last year. The crux of the issue remains in place, however, at the time of writing. Yet, we believe that the two sides have agreed to be civil and to minimize the pain that both have endured as a result of this spat. As we expect the uncertainty to die down, investment is likely to pick up. We believe this looks like the perfect scenario for investing, after the PBOC injected liquidity into the economy in 2018 that will stimulate growth.

China remains the bellwether for the rest of the developing world, so if it does well in 2019 it could buoy other emerging markets. Indeed, the country was the biggest contributor to the 17% correction we witnessed in the MSCI Emerging Markets Index for last year. The benchmark CSI 300 Index of stocks traded in Shenzhen and Shanghai dropped 26.3% in dollar terms over the same period. Depressed valuations and an accelerating economy are only two reasons to expect Chinese stocks to perform well this year, and most emerging markets are expected to follow.
LEVERAGE AND VOLATILITY – THE REVERSAL ARGUMENT

While we expect this year to be more promising than last year, we believe it may not be smooth sailing either. Throughout most of last year, we witnessed heightened volatility, unlike what investors had become accustomed to throughout the decade of easy money policies. Almost every asset class in the world experienced large swings later in 2018 and we expect that to not only continue, but to remain pronounced.

While the market’s swoons last year at times seemed dizzying, they were, however, in line with historical volatility for most asset classes. The past 10 years, instead, were the exception, and can be largely attributed to the unprecedented monetary stimulus from the Fed, the ECB and the BoJ.

Since the Global Financial Crisis, the adjusted US dollar monetary base increased by more than US$3.2 trillion, or five-fold. Interest rates dropped from 5.25% to near-zero in that period while the Fed bought US Treasuries and mortgage-backed securities at an unprecedented rate. The ECB added a similar amount of liquidity while the BoJ printed nearly US$4 trillion of new money. Altogether, the three central banks have added nearly US$11 trillion of liquidity to the world economy.

As these measures have now started to be rolled back, leverage is becoming more expensive for borrowers. Investors have started to adjust their investment mindset as a result. Near-zero interest rates across the globe allowed outsized returns through leverage over the last 10 years. At its low, Libor was at 0.22%. This allowed investors to borrow money almost for free. The benchmark rate ended 2018 above 2.8%, a sharp rise of 110 basis points in just a year.

The higher cost of funding has also reduced the total returns for leveraged investors. High-yielding assets, attractive up until now, are suddenly starting to look less appealing. This was clear in the way emerging market currencies sold off in the first half and goes some way to explaining why other risky assets also performed poorly last year.

If the formula of borrowing to invest may not work as well anymore, there still are plenty of gains to be made from harnessing the market volatility to generate higher returns. With this volatility, structured products that use options to mitigate risk on certain assets are offering higher returns versus the open-ended risk that may now come with leverage. Investors should keep things simple. Good returns can be made by taking advantage of market anomalies, and this volatility may sometimes be an opportunity to buy.

GEOPOLITICAL UNCERTAINTY – WHERE ARE WE NOW?

The Global Financial Crisis of 2008 created extreme market volatility, comparable to the 1930s. A decade later, in 2018, volatility returned with rising interest rates. However, in 2019 we expect less geopolitical risk in the world – and many of the market fluctuations last year were prompted by geopolitical uncertainty, as Brexit neared its conclusion, nationalist parties rose to power in a number of European economies, and US President Donald Trump, took unexpected measures to push ahead his ‘America First’ agenda. As the saying goes, risk can be hedged, uncertainty cannot.
At least one of the sources of that uncertainty is likely to find a resolution early in 2019: Brexit. This is set to conclude by 29th March, whether it entails a negotiated exit or not. There remains a possibility that Theresa May delays any exit or another referendum is called. We believe these outcomes would face a public backlash and risk triggering early elections in the UK that would create more uncertainty. A second referendum on the issue, for one, risks confirming the previous result again making the UK’s exit from the European Union even messier. However it plays out, by the second quarter we will have more clarity on Brexit.

That uncertainty has supported the strength of the dollar, and helped push riskier global assets into bear market territory last year. The key currencies underpinning the dollar index add to the potential appreciation pressure on the greenback. The euro, which represents 58% of the index, and the British pound, responsible for another 12%, have been reacting to political uncertainty derived from Brexit.

In the first three quarters of 2018, both these currencies appreciated when there were indications that a constructive agreement could be reached and then dropped when the so-called ‘hard Brexit’ looked more likely. Hence 70% of the direction of the dollar last year was determined in part by the outcome of the UK’s exit from the European Union.

As this event moves to the rearview mirror, we expect the euro and the British pound to start showing strength that better reflects these economies. That could mean that the dollar index reverses some of the 4.3% gain from 2018. A weaker dollar would help boost US exports and GDP. It will also reverse some of the falls we have seen in emerging market currencies and commodities.

This would be particularly helpful for crude oil. Energy prices were on a rollercoaster last year. Brent crude reached its highest point since 2014 in the first days of October last year, then rapidly dropped more than 35% in the following three months. At the high, Brent was up 29% for the year-to-date – it ended down nearly 20%.

The stronger dollar was to blame in part, but the main reason for the savage correction was the change in the market perception of supply and demand for crude. Investors began to worry about oil shortfalls early in the year when the US reintroduced sanctions against Iran. This reduced the availability of crude at a time when Venezuela, home to the world’s largest known reserves, had seen its own production drop to a third of what it was in 2014.

OPEC, led by Saudi Arabia, as well as non-OPEC member Russia, responded by boosting production and, along with record oil production in the US, significantly reduced the gap. Then the Trump administration granted Iranian oil waivers to the six biggest importers of the commodity. The damage of higher oil prices, together with the devaluation of the currencies in most of the emerging world (which account for more than half of the world’s oil demand), took a toll on demand too, and ultimately the spectre of oversupply was priced in.

OPEC and Russia came to the rescue as they agreed on a 1.2 million barrel cut to production in December. Once more, though, investors carried their bets too far, pushing crude prices below where fundamentals suggest they should be.

We believe this year will be less frantic. After the first quarter, OPEC members will have fully implemented their supply cuts. Shale producers in the US have also begun to reduce output in response to the price drop, and that effect is likely to become evident in inventory levels around the world.

We believe the likely shift in sentiment for oil should come just as the dollar peaks. This would help the commodity reach higher levels, and achieve the average US$70-US$75 price for a barrel of Brent that FAB forecasts this year, slightly above the US$72 average logged in 2018 and some 35% higher than the US$53.8 at which it traded on 21st December, 2018.
SUNNY SKIES OVER THE UAE

It will not be an airline commercial, but a less hawkish Fed, a weakening dollar, and rising oil all suggest the UAE could have a banner year. Dubai, in particular, could start to feel the economic effects of the impending Expo 2020 exhibition, the largest such event in the Arab World.

The Dubai Financial General Market Index was one of the worst-performing stock gauges in the world last year, down more than 25% for the year to 20th December. One of the Middle East’s most liquid stock markets, it was hit by the impact of rising interest rates (which helped depress property stocks), risk aversion, oil price volatility and recession fears. As a result, Dubai stocks were trading at one of the lowest price-to-earnings multiples since 2011 at the close of last year.

The Emirate is also about to see some benefits from an AED50 billion stimulus package that Abu Dhabi begins to roll out this year, not to mention the potential boost in investor interest ahead of the Expo. US dollar interest rates, which drive their GCC pegged counterparts, are likely to stabilize, which could improve the outlook for property. And oil prices are likely to steady as well.

If valuations and economic fundamentals are not enough to convince investors to return to Dubai stocks, mean reversion will. Statistics have shown that particularly bad outcomes are often followed by good ones. And such a difficult year as 2018 could only be followed by a better one.
GLOBAL RATES OUTLOOK

SIMON BALLARD
The global economy, in terms of growth assumptions, appears to be finely balanced in 2019. Optimism regarding sustained future economic expansion felt at times during 2018 has quietly ceded ground to a picture of less synchronized and perhaps more modest growth over the coming quarters.

This said, the global growth outlook remains healthy overall, which should prove supportive for a tighter bias in rates over the course of 2019. Central banks will remain very data-dependent, though, as they set monetary and fiscal policy this year, and rightly so.

While the IMF, back in October 2018, announced its first downgrade of global growth expectations in over two years, the agency still predicts global growth to have been 3.7% in 2018 and forecasts a similar expansion this year, down just 0.2 percentage point from the prior forecast.

The downgrade was designed to reflect likely impacts of US trade tariffs and monetary tightening stresses in emerging markets, as well as ‘clouds on the horizon’ and the fact that ‘the likelihood of further negative shocks to the growth forecast has risen’.

Meanwhile, growth in MENA, Afghanistan, and Pakistan region is projected to have increased to 2.4% in 2018, from 2.2% in 2017, and to reach 2.7% this year, before stabilizing at about 3% in the medium term. The drag on growth rates in this region will likely stem from US sanctions on Iran. Within this, though, our macro growth outlook for the GCC region remains firm. We see the UAE economy as having expanded 2.4% in 2018 and anticipate 3.7% growth in 2019. Saudi Arabia’s GDP is expected to have increased 2.2% last year and to expand 2.4% this year, and Kuwait by 2.3% and 4.1% respectively.
RAMIFICATIONS OF HIGHER RATES

The immediate and most direct implications of a higher yield structure would seem to fall on the lower end of the risk spectrum. Indeed, we look toward those higher-yielding assets that have outperformed on the back of investors’ hunt for yield, and borrowers that have exploited an access to cheap funding and leverage in recent years.

As interest rates rise, investors will more likely be able to hit a given yield target in a higher-rated asset (perhaps by shifting from emerging market risk to developed market risk, or from sub-investment grade to investment grade). At the same time, debt service costs for borrowers will increase, which for those with weaker balance sheets could become onerous. In the worst case this could put upward pressure on corporate default rates. At the very least, credit quality curves should steepen.

However, while we expect the path of least resistance for rates to remain higher in 2019, we also feel that a measured pace of tightening, with no pre-set course, predicated on firm macro fundamentals, should not prove overly disruptive for risk assets. Indeed, we believe that gradual tightening now remains the sensible longer-term strategy. While the maintenance of monetary accommodation may be a fillip for near-term growth prospects, it will also likely raise future tightening expectations with associated recession risks. It’s time to mend the roof while the sun is shining.

SHIFT TOWARD TIGHTENING

Growth expectations have been adjusted lower to reflect the impact of a shift toward a monetary tightening bias by several central banks – led by the Fed – as well as to incorporate the perceived negative effects on global growth of the trade tariffs imposed by the US on Chinese (and other) imports. As a result, interest rate expectations – especially those for the US Fed Funds Target Rate – are now being adjusted accordingly.

We have long been of the opinion that the global rates environment will continue to tighten and that the underlying yield structure will continue to edge higher as we head into 2019. We maintain this view today. This said, we are cognizant of the myriad obstacles and challenges now facing the global economy – be they macro or geopolitical in nature – which will probably restrain central banks in their tightening efforts. We anticipate, therefore, that the rise in interest rates will remain more of a crawl than a gallop.

Indeed, the Fed has been on a clear tightening crawl, raising rates by 225 basis points in nine subtle 25 basis point moves since December 2015. Our fear is that such a strategy could actually lead to a higher terminal rate than if the Fed were to adopt a more hawkish approach. Future rate concerns might also be fueled by the fact that the tightening done so far has had no meaningful dampening effect on the US economy, which is spearheading G10 growth and a near-50-year low unemployment, buoyed in part by President Donald Trump’s fiscal stimulus.
While US tax cuts, by nature, will tend to have only a short-term positive impact on economic growth and, in the context of myriad macro and geopolitical obstacles facing the markets over the coming year, we would conjecture that global growth may have peaked, or plateaued and this should help anchor the absolute extent of rate hike expectations.

However, from a global perspective, with the European Central Bank having ended its quantitative easing/asset purchase program in December last year and the Bank of England showing a bias to tighten monetary policy were it not for the uncertainties of Brexit, we now appear to be faced with the prospect of tighter financial conditions in many geographies over the course of 2019. From this point onwards, therefore, as the marginal effects of tightening are felt more directly, we would suggest that global markets will be increasingly susceptible to central bank rhetoric and communication policies.

With economic growth – and asset price appreciation – of recent years having been founded on financial market repression and a near-zero interest rate environment, this specter of higher rates raises the fear of a risk asset correction. Central banks’ communication of intended policy changes will hold the key to market reaction. Advocate a data-dependent approach to setting rates and the market should be reassured. Hint at a blinkered desire to ‘normalize’ rates though, focusing on implied inflationary risk, with less regard for short-term growth prospects and macro data, and the market will likely protest.

**WAGE GROWTH IS KEY TO INFLATION, WHICH IS KEY TO GLOBAL RATES**

Until now, inflationary pressures have been relatively well-anchored, allowing central banks the freedom to follow a measured pace of – or timetable toward – tightening, while aiming to achieve a symmetric and sustainable 2% inflation objective. Tightening labour markets could change this.

Wage growth, or relative lack thereof, has generally been the missing link in the global inflation equation up until now. In turn, this has helped to restrain interest rate tightening expectations.

Moderate wage growth trends have helped to keep aggregate inflation low, but in recent data we have begun to see signs that this could be about to change, thereby fueling more hawkish undertones in the market. The prospect of wage growth may figure high in a consumer happiness index, but it could also give central banks the excuse to call an end to the monetary accommodation party and ratchet interest rates higher.

To this end we note that wage growth is beginning to show upward momentum in the US and Europe, although we would caution that all labour cost increases are not necessarily made equal. For example, while average per worker earnings or average hourly earnings have clearly been strengthening over the past two years, unit labour cost growth (wage growth adjusted for productivity growth) has remained broadly flat over the same period.

Nonetheless, in aggregate, the global labour market is showing clear signs of tightening, with wages biased to the upside, which could feed hawks’ rhetoric between now and early/mid 2019. Such a scenario adds weight to our expectation of a higher-than-currently-priced-in interest rate environment as we head into 2019.
DISCREPANCY BETWEEN FED AND FUTURES MARKET PRICING

Another key reason why we believe that risks to the interest rate outlook may still lie to the upside, notwithstanding macro and geopolitical uncertainties, is the difference in pricing between the interest rate futures market and the Fed’s well-publicized ‘dot plot’.

With a 25 basis point Fed funds increase having been widely anticipated by the market at the last FOMC meeting of 2018 (December), the outlook for 2019 has been more mixed. Rate tightening expectations for this year have been scaled back from the more hawkish levels of 2018.

Meanwhile, the Fed’s ‘dot plot’ screen on Bloomberg – and at the end of the day of course it is the Fed that sets rates, not the futures market – has consistently alluded to a more hawkish terminal Fed funds rate, implying a more meaningful selloff in bonds and a higher yield structure for investors to position for. At time of publication, the ‘dots’ implied a Fed funds rate of 2.875% by the end of this year and a terminal rate of 3.125% out to the end of 2021.
EUROPE’S LONG ROAD TO RATE HIKES

While the European Central Bank has also embarked on a journey toward monetary policy and balance sheet normalization, it is on a very different course – and at a slower pace – to the Fed. The ECB, of course, brought its asset purchase program to a conclusion at the end of last year.

That said, ECB president Draghi has clearly stated that the Bank stands ready to open the monetary sluice gates again in the near-term, should macro conditions deteriorate. Therefore, while QE may have officially ended, we do not believe that the Bank will be in a position to raise interest rates in the Eurozone until the latter half of this year at the earliest.

Moreover, the prospect of an increasingly veiled political landscape in Europe during the course of 2019 could be a further impediment to ECB normalization aspirations.

Political uncertainty remains elevated, fueled in recent months by the rise of nationalism in Italy, and Angela Merkel’s stepping down as leader of the CDU party in Germany and her subsequent announcement that she will not stand for Chancellor again at the end of her current term.

The populist Italian coalition government’s casual approach to fiscal responsibility and resistance to adhering to Eurozone deficit targets has also driven a wedge in the yield spread between German bonds and Italian BTPs. The basis of market concern over the second half of 2018 centered on Rome’s plans for a wider budget deficit to allow a continued focus on citizen-targeted spending rather than austerity. This has led to open and succinct criticism from Brussels, which in turn has led to Italian Deputy Prime Minister Matteo Salvini referring to the EU bureaucrats as the ‘enemies of Europe’.

![Italian pressure point](source: FAB, Bloomberg)
CONCLUSIONS

Global markets are still pricing in a benign monetary tightening path by the Fed, and the end of ECB stimulus, even as inflation data and outlooks remain reasonably anchored and as US protectionist trade policies weigh on global growth metrics. Moreover, the market continues to balance expectations for further incremental rate rises by the FOMC, even after the US central bank has steadily raised rates since the end of 2015.

With tighter monetary policy having failed to meaningfully dampen US labour market strength, though – the jobs market continues to tighten with the US unemployment rate at a near-50 year low –, we believe that wage growth inflation could be the key trigger to more hawkish central bank rhetoric over the coming quarters.

Analysis of labour market data across the US, Eurozone and UK suggest that an increase in wage growth inflation could already be underway. With increased momentum, this could provide central banks with a welcome excuse to accelerate their monetary policy and balance sheet normalization strategies, beyond what global markets are currently pricing in.
OIL OUTLOOK
GLENN WEPENER
Despite more volatile price action in 2018, especially in the latter part of the year, crude prices appear to have stabilized again as we start 2019. Geopolitics, improved coordination between OPEC and NOPEC producers, together with ongoing natural demand for oil will be the core drivers on the upside of the equation, although risks to the downside continue to exist and cannot be ignored either, including a potential global economic slowdown if the trade war saga drags on.

GEOPOLITICS

The Trump administration’s decision to withdraw from the Joint Comprehensive Plan of Action (JCPOA) agreement in May 2018 was one of the key geopolitical events that had a direct impact on oil prices last year. At the beginning of 2016 when sanctions against Iran were lifted, the country’s crude exports stood at around 1.3 million barrels/day. This eventually rose to 2.5 million barrels/day in April last year, before beginning to slide ahead of the resumption of US sanctions on Iranian oil in November. The EU has made a concerted effort to find ways around these sanctions and protect any of its firms doing business there. However, most large European and other foreign companies do not want to risk potentially hefty US penalties and this was underlined by the relatively speedy withdrawal by many conglomerates such as Total, Siemens and Hyundai from previously planned projects in Iran. International insurers have also declined to insure Iranian registered tankers, so Tehran will have to rely on its own fleet more heavily again. The actual drop in Iranian supply in world markets will only probably become clearer in the latter part of 2019, although current market estimates suggest a potential gap of 500,000 to 1.5 million barrels/day. We anticipate a fall of around 1 million barrels/day, but the true figure will probably remain somewhat elusive as Iran could adopt new methods to hide the transit of its crude. Asia was Iran’s primary market for oil exports, especially China, India, South Korea and Japan. China will likely continue to purchase Iranian crude paying with yuan or through barter deals, and although India reduced the amount it imported from Iran by 30% last year it, together with seven other countries including South Korea,
Taiwan and Japan, managed to secure a temporary six-month waiver from Washington which will allow it to continue to buy a certain amount of Iran’s oil for the time being, albeit on a reducing scale as it restructures its supply networks. India has also reached an agreement with Saudi Arabia and Iraq to take Indian rupee as part-payment for their crude.

Other geopolitical stories to keep in mind going forward include the approach of elections in Nigeria, which may see a resurgence of militant activity within the country’s oil rich Niger Delta region, while Venezuela’s severe social and economic decline continues apace with its once impressive oil industry on the precipice of a total collapse. This dire situation in a country with the world’s largest reserves of crude is highlighted by the fact that production is now around 1.2 million barrels/day, a level not seen since the 1940s, and even the little of this that is still exported is not raising much in terms of revenue because the bulk of it is being used to repay debt owed to countries such as Russia and China.

DEMAND AND SUPPLY

A high level of compliance by signatories to the original output cut agreement helped to reduce inventories and push the oil market closer to a more balanced status in the first half of last year. It also partially countered the sharp recovery in US shale production. Indeed, shale has made a significant comeback over the past two years, driving total US production to average 10.8 million barrels/day in 2018. However, this fast-paced growth now appears to be slowing, while a lack of spare pipeline capacity, and the fact that most US refiners were originally built to handle a heavier grade of crude, have led to some difficulties for fracking firms in getting their output to market quickly.

On top of this, the financial performance of many shale firms has been less than exciting. Debt levels remain high, costs are rising despite the improvement in technology, the heavy use of water by fracking rigs is putting pressure on this relatively scarce resource, and as shale fields have a limited lifespan the number of ‘sweet spots’ within the various basins is declining. This latter issue was raised recently by Paal Kibsgaard, the CEO of the world’s largest oil services company, Schlumberger, during a speech he made about the sector late last year and in which he stated: “The well-established market consensus that the Permian can continue to provide 1.5 million barrels per day of annual production growth for the foreseeable future is starting to be called into question. Pipeline woes are indeed causing a slowdown in the Permian, but this isn’t the only problem. Instead, we believe the main challenge in the Permian going forward is more likely to be reservoir and well performance as the rate of infield drilling continues to accelerate.”

Meanwhile OPEC produces 40% of the world’s output and its exports still represent 60% of the total volume of petroleum traded internationally, according to the EIA. The amount of global spare production capacity is an issue which could well grow in importance in the coming years, especially as the only real swing producer is still Saudi Arabia. OPEC’s second largest producer is now Iraq, which pumped over 4.7 million barrels/day last year, but, as is the case in Libya, political and security risks remain high and output disruption there is a real risk. In October last year, an IEA report estimated that global spare capacity is already down to just 2% of global demand. (Spare capacity is traditionally defined as the amount of oil that can be brought online within 30 days and sustained for a minimum of 90 days, according to the EIA).
On the demand front it is true to say that this side of the equation weakened and inventories began rising again towards the tail-end of 2018, due primarily to fresh concerns over the outlook for global economic growth, especially while the US/China trade dispute remains unresolved. These worries, combined with calls by President Donald Trump for lower prices, helped push Brent below US$55/barrel at one stage, but the market has stabilized since, boosted in part by a decision at the December OPEC+ meeting to cut production by 1.2 million barrels/day for a six-month period beginning in January this year.

Meanwhile, the natural demand growth for oil continues, with the IEA predicting annual demand for this commodity to rise by 1.4 million barrels/day in 2019 from 1.3 million barrels/day last year. Other factors to bear in mind are the expansion of the chemical and aviation industries, both of which require crude as a key input for their products, as well as the implementation of a proposal by the International Maritime Organization for shipping companies to reduce the permitted amount of sulphur in the bunker fuel they use to 0.5% from 3.5% by 2020. Any vessels failing to comply will face fines and/or the withdrawal of their insurance cover and may even be declared “unseaworthy”, which would bar them from sailing. This, in turn, means the demand for the more expensive but cleaner fuel from lighter crude grades could increase. Admittedly, though, some of the less environmentally-minded shippers will probably find a way to skirt this rule for the time being.

THE CAPEX CONUNDRUM

In September last year, energy research firm Wood Mackenzie issued a report in which they warned about a building supply risk over the longer term, driven by the ongoing lack of appropriate expenditure on the discovery of fresh reserves of conventional crude, an issue which we too raised in our 2018 annual outlook.

“The warning signs are there, the industry isn’t finding enough oil. Guyana is one of the very few giant oil discoveries made during the downturn. Fact is, we need more Guyanas, a lot more, and we need them soon. Without them, the oil market is in danger of tightening in the not too distant future,” was the WM report’s introductory paragraph adding, “Invariably, the opportunity to develop known sources diminishes. A supply gap opens up in the mid-2020s, reaching 3 million b/d by 2030, 9 million b/d by 2035 and a formidable 15 million b/d by 2040. Barring technology breakthrough beyond what we already assume, we’ll need new oil discoveries.”

This risk was also highlighted by the IEA back in 2017 when it reported that fresh oil discoveries had dropped to just 2.4 billion barrels in 2016 compared to a yearly average of 9 billion barrels between 2000-2015, and that the number of projects greenlighted to proceed had fallen to their lowest level in 70 years. “To meet rising demand and offset underlying declines, the industry needs to approve production of around 18 billion barrels of new resources each year between now and 2025,” the IEA stated. Meanwhile, proven reserves controlled by most of the world’s primary oil firms have shrunken by over 30% since 2000 with only two companies, namely BP and Exxon, reporting a rise. Admittedly some firms have begun to loosen their purse strings and allocate cash towards exploration over the past two years, but such amounts are still moderate at best as most continue to prioritize profits, especially as the pain of the 2014/15 price crash remains fresh in their minds.

RENEWABLE ENERGY

‘Green’ energy has come a long way in the past 20 years and remains a much debated hot topic. From our point of view and as we have stressed before, renewables will no doubt be the long-term primary disruptor of the fossil fuel industry, however we also believe that this outcome lies further out than most people currently believe. In a study undertaken by BP in 2016, crude oil was still the largest source of global energy demand at 34%, this was followed by coal at 28%, natural gas at 23.5%, hydropower at 6%, nuclear at 5% and renewables a lowly 3.5%. Now, the numbers have changed slightly since then but fossil fuels still account for the majority of our energy needs. Electric vehicles account for only 2% of the global car market, remain relatively expensive compared to their combustion engine driven rivals, and the wider infrastructure to support this sort of transport is still lacking. Battery life is improving but its inputs such as lithium and cobalt are relatively difficult to source in reliable concentrations – in fact more than 50% of the world’s supply of cobalt comes from the Democratic Republic of the Congo – and so alternative options may need to be found. Even the EIA predicts that fossil fuels will account for around 77% of global energy demand in 2040 from just over 80% today.
CONCLUSION AND FORECASTS

Considering all of the above, and barring any serious black swan event, we anticipate the price of Brent could record a US$70-US$75 average in 2019, while WTI should be in the region of US$60-US$65. Our reasoning for this is that global producers are still able to pump enough extra crude to prevent the market from breaking sharply higher in the near term, despite the impending drop in Iranian exports and tight spare capacity. Equally, better coordinated action by OPEC/NOPEC countries and the formalization of an ‘OPEC+’ structure, should ensure that a further drop in prices will also be avoided. At the same time we also acknowledge the potential headwinds facing the global economy in 2019, but when looking further out we remain concerned that the ongoing lack of sizeable CAPEX into conventional exploration could create a supply shock event within the next few years, unless this specific issue is adequately dealt with.
US-CHINA TRADE
SIMON BALLARD
Donald Trump’s campaign for the White House during the course of 2016 was centered on the slogan of ‘Make America Great Again’. One of the key targets that he promised to prioritize on becoming president, in order to indeed make America great again, was the US trade-deficit, particularly that with China.

In 2017, the US bilateral trade imbalance with China stood in deficit to the extent of US$376 billion, an increase of US$29 billion over the prior year. Note that the deficit has grown exponentially in recent years, having been just over US$100 billion back in 2002. Over the years China has exploited its cheap manufacturing base and weak (some would say manipulated) currency to its clear advantage, to accumulate significant surpluses. Over the course of this year we expect the US to continue to push for a reduction in China’s bilateral trade surpluses as well as for Beijing to drop its ‘Made in China 2025’ technology initiative.
WE SHOULD NOT BE SURPRISED
That Trump’s actions since entering the Oval Office have fueled a so-called trade war with China should therefore come as no surprise. He is doing exactly what he promised to do, although the extent to which protectionist policies can directly benefit the US economy in the near-term remains debatable.

We would suggest that the underlying macroeconomic basis for the US wanting to renegotiate its trading relationship with China comes down to a desire to contain the future role and weight of China in the global trade equation. According to data from the IMF, China’s share of global gross domestic product on a purchasing power parity basis continues to creep higher. From a level of 15.28% in 2012, China is expected to have accounted for 18.7% of global GDP last year, a figure that is then forecast to rise to 20.82% by the end of 2023.

The crux of the US-China trade polemic, though, comes down to one simple factor: Trump’s aim to build robust and sustainable economic foundations for the US. A central pillar of this strategy over the coming years will be the repatriation of former US industrial production activity from China and other regions where currency weakness has created a competitive production advantage over recent decades.

One thing should therefore be perfectly clear: Trump did not set out on a quest to trigger an actual trade war, but rather to simply reduce the US economy’s reliance on imports, bolster the US labour market, and promote greater consumption of domestically-produced goods, while at the same time checking the economic ascendancy of China on the global GDP ladder.

The regeneration of the US industrial base will be a multi-year process at best, though. We therefore believe that Trump’s protectionist initiatives will carry more costs than benefits during the course of 2019. Yes, global markets are right to be concerned.

THE TRADE WAR, SO FAR
US tariffs on Chinese imports have developed rapidly. Indeed, it could be argued that the escalation of the trade war in 2018 had no precedent in recent history. While the US began with tariffs on solar panels and washing machines, the breadth of penal pricing grew to cover some US$250 billion of imports from China. China, in turn, imposed tariffs on most of its US imports.

Overall, therefore, we would suggest that trade tariffs are likely to prove counterproductive over time. This could be the case on this occasion if they end up thwarting the negotiations that the US is seeking in the first instance, and hardening the stance of both parties involved.

The simple bottom line is that tariffs end up being indirect taxes, the cost of which ultimately fall on consumers.

So, we would suggest the net effect of these actions has been to create dislocations, raise costs, and increase macroeconomic uncertainty. The standoff between the two sovereigns now requires one or both sides to concede. If not, the polemic will become more costly.

We are cognizant that US/China trade tensions could deteriorate further during the course of this year. For this reason, markets should remain vigilant of future risks. While tariffs may be seen as having a limited absolute impact on the two economies in isolation – the value of China’s exports to the US is estimated at around just 2% of China’s GDP, down significantly over the past decade or so, and US exports to China only represent around 1% of US GDP – over a longer-term horizon the costs become more onerous. The longer the two sides refuse to concede, the more the engrained risks will be accentuated.
GLOBAL GROWTH

As the IMF reminded us last October, the imposition of tariffs can have a direct impact on US inflation over the coming quarters. Industrial production will not shift from China to the US in the near-term, and so US consumers and producers will simply be faced with a higher price to pay for imported goods.

We are already seeing some signs of inflationary creep in recent data releases, with US PPI and CPI having showed an upward bias in late 2018. Further extension of the tariff actions over the course of this year would likely only exacerbate such inflationary pressures, in turn potentially reigniting a more hawkish outlook for US interest rates.

If Trump were to cast the tariff net further, thereby catching a greater number of consumer goods, then the implications for inflation could become even more significant. This, in turn, may lead the Federal Reserve to adopt a more hawkish stance towards interest rates – and just at the time when Mr. Trump is already critical of monetary tightening for the offsetting effects that it has on his economic expansion plans.

INFLATION/INTEREST RATES

First and foremost we expect the imposition of tariffs on Chinese imports to have a direct impact on US inflation over the coming quarters. Industrial production will not shift from China to the US in the near-term, and so US consumers and producers will simply be faced with a higher price to pay for imported goods.

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CURRENCY IMPLICATIONS

The outlook for 2019 in terms of the consequences of the trade dispute between the US and China does look set to remain disproportionately more onerous for the latter’s currency. Coupled with continued deleveraging, the overhang of weakening domestic demand, a cooling property market and potentially rising credit defaults, the US-China interest rate differential should edge wider, which in turn will support a continued move higher in the USD/CNY rate.
The last quarter of 2018 saw many investors looking forward to the New Year and a clean slate, as the tumultuous moves which began in October showed no signs of abating in late December. The rout began in US Treasuries and closed the year driven by oil price weakness, just as the US Federal Reserve faced unprecedented criticism from President Donald Trump. While President Trump’s attacks had no bearing on it, the Fed delivered a dovish hike in the December meeting of its rate-setting committee, moving the target range to 2.25%-2.50% (up from 0%-0.25% at the end of 2015). Members of the Federal Open Market Committee kept a fairly dovish outlook for this year, although they still expressed optimism about the economy.

The underlying data in the US was supportive of the four hikes executed during 2018 and we believe there will be an additional one or two this year. Any moves, however, will be data-dependent. At the time of writing, Fed Fund Futures implied one 25 basis point hike in 2019. This should give the Fed enough ammunition to face any economic downturn with more normal policy tools. It may well be the only central bank which has this luxury, as the rest of the developed market continues to struggle under the tightening already undertaken.

It seems clear that Fed Chairman Jerome Powell and his colleagues underestimated the impact quantitative tightening would have outside the US, and the clear reallocation of assets and ensuing pressure on funding has shone a spotlight on the weak link economies that have yet to get their houses in order.

The global ‘cross currents’ have, in part, forced the Fed to reassess its hiking path, especially after markets repriced risk assets in late 2018, with the 10-year US Treasury hitting a yield of 2.755% after the December FOMC announcement, back to where it was at the beginning of the second quarter of 2018.

We expect volatility to continue early in 2019, now related to the trade wars, as there is no clear path to resolution, despite positive gestures by the Chinese to reduce automobile tariffs and various soundbites from US officials. The consequences for Europe and other developed markets have been more obvious with both the Reserve Bank of Australia and the European Central Bank hitting a more dovish note late last year, as underlying growth and inflation data began to disappoint. Our base case is that the Fed will be the only central bank still in a position to tighten policy further this year, with even ECB Governor Mario Draghi acknowledging that risks have turned to the downside.
The European Union, in fact, faced battles on many fronts in 2018. Aside from Brexit, we look to the German economic and political situation to continue to deteriorate, for social unrest in France to escalate and, as Jean-Claude Juncker steps down from his current role as EU President, for the May elections to also be of interest. We anticipate further moves towards fiscal integration in Europe this year, with the common budget proposals to gain some headlines, although with French President Emmanuel Macron’s clear failure to reform the French labour market and budget, he may have to sacrifice his ambition in Europe for the sake of his job at home. The agreement reached between Italy and the EU in December over its budget will only serve to further irritate German savers, who need their leadership to focus on the resolution of domestic issues. The reduction of the proposed budget deficit to 2.04% from 2.40% has given Italian debt some respite but we believe the weaker sentiment will continue during the first half of 2019 as there is no real reform in place. Other headwinds to growth during this year will be the UK’s exit from the group, which could have a dire impact on the Netherlands (the UK is their second largest export destination), Ireland and Germany.

There is some positive news in Europe, though, as wage growth looks set to continue. Germany is expected to increase minimum wages and the repeal of the fuel tax in France has dissipated one expected drag. Greece is showing positive growth and may be moving towards a credit upgrade, although this would not be likely before the second half, if not 2020. Although Spain’s economy is beginning to show signs of a slowdown, it has stopped piling up excessive deficits, as its fiscal shortfall moves below 3% of GDP. The political turmoil faced by the Spanish late in 2017 has calmed and there are high hopes that the new fiscal plans can pass Parliament. If not, there may be a new election on the cards.

We remain cautious in our approach to Europe and do not see much opportunity for an increased pace of quantitative tightening or rate hikes. Inflationary pressures are few and even though oil is expected to have seen its lows last December, it looks unlikely that it will move back into a range leading to broad based inflationary pressure (our 2019 price average projection is US$60-US$65 for WTI).

The outlook for the UK in 2019 will be predicated around the type of Brexit transition, the timeframe of negotiations and consequent parliamentary support. Despite Brexit negotiations, the UK economy has performed relatively well. While investment has stalled, unemployment has fallen and wage inflation has appeared after years of negative real wage growth. Inflation remains above the Bank of England’s target of 2% and there remains very little spare capacity left in the economy. In 2018, the British currency was driven almost entirely by the continuously unfolding Brexit saga. Bleak headlines drove the currency 19 big figures lower since the start of the year and we expect uncertainty to be replaced with concrete agreements as we move closer to this year’s deadlines.

Leadership challenges and the lack of cohesion in the British government will prove damaging, even post-Brexit, whether a favourable deal is reached or not. Therefore, other currencies could outperform the pound especially in the first quarter and any gains past that will be contingent on the Bank of England’s decisions, although we do think that cable now looks undervalued (by over 20% compared to the US dollar, according to The Economist’s Big Mac Index). A closer look at the current trend in the yield curve shows that, although inversion remains far away, markets are speculating that rates will not exceed 3% over the next economic cycle.
CONCLUSIONS

The US remains apart from most of the rest of the developed world, although it cannot remain completely immune to global headwinds, and we believe the American economy will feel them more keenly in the second half of this year. That said the shorter end of the curve offers some good opportunities for steepeners even as inversions in the belly become more pronounced.

We expect some space to fade these movements in the first quarter but look for more exaggerated moves first. Thin liquidity and risk-reduction played their part in the market at various points of 2018, but key levels remained mostly in place and we should see further US dollar strength in the first half of 2019.

Europe is caught between a rock and a hard place with pressures from Brexit, trade wars and many ongoing political and social battles. There has been some reform but we find it difficult to see much room for positive growth across the board and see no hikes for 2019. Indeed, we expect the euro will continue to weaken to a low of 1.085 in the first half, with a slightly more positive story into the second half, supporting a year-end target of 1.105.

While the outcome of the UK’s exit from Europe is still uncertain, from a technical level we see cable on a short path lower, with 1.2150 a reasonable expectation in the first half, as a lot of downside has already been built into the price. Brexit, coupled with the US/UK rate differential, suggests the upside in the first half is limited to around 1.3500-1.3800. Of course, any positive news on Brexit will see somewhat of a binary reaction.

We expect an increase in volatility to keep markets interesting and throw up many opportunities to capitalize on the moves ahead.
FOCUS ON BREXIT
SIMON BALLARD
The closer we get to 29th March 2019, the day the UK is scheduled to leave the European Union, the further the UK seems to be from agreeing the terms on which the divorce will be struck. However, more than just the pure economic arguments for and against Brexit that have driven the narrative over the past two years, it is now political uncertainty that is weighing most heavily on UK risk asset, and currency, sentiment.

Admittedly, Prime Minister Theresa May won a confidence vote in early December, but that ‘win’ came at a cost and left her politically marooned. She only held on to Downing Street by promising Brexiteer backbenchers that she would not lead the Conservative party into the next general election (to be held by May 5 2022 at the latest, but possibly much sooner!). With 37% of Conservative MPs having voted to evict her in December, hers is anything but a position of strength in early 2019. One might feel sorry for her; as a ‘Remainer’ in the 2016 referendum she hasn’t asked for any of this.

The UK government now faces at least three possible outcomes in terms of Brexit itself, regardless of who is prime minister.

1. Brexit based on an agreed, but now necessarily significantly re-negotiated ‘Withdrawal Agreement’ after which a transition period will follow for all the necessary trade and financial arrangements to be ironed out and agreed. According to the wording of Article 50, which stipulates how a member state should leave the EU, the transition period will be set at 2 years. To main Brexiteers, such an ‘agreed’ divorce would be an unacceptable ‘soft’ Brexit.

2. Brexit, but with no ‘Withdrawal Agreement’ in place by 29th March 2019. A so-called ‘no deal’ scenario would mean the UK leaving the EU with no agreements in place with its trade partners and needing to adopt World Trade Organization rules as it negotiates individual trade treaties. This is the ‘hard’ Brexit that many Brexiteers are calling for and that Remainers fear so deeply.

3. No Brexit. A second referendum results in the electorate now rejecting the idea of leaving the EU and the project is cancelled.
STRIVING FOR THE IMPOSSIBLE

Mrs. May says she is committed to delivering the Brexit that the British electorate voted for, but therein seems to lay the overarching problem of the process.

The result of the June, 2016, plebiscite being 51.89% in favor of leaving the EU and 48.11% in favor of remaining a member of the Union means that, on average, the UK electorate actually voted for something bang in between ‘in’ and ‘out’. The ‘majority’ in favour of leaving the EU was just 3.78%.

Mrs. May seems to be on a hiding to nothing, trying to please all factions. There seems to be zero possibility of finding a ‘one-size-fits-all’ solution and this has been clear in terms of political buffeting over recent months.

Indeed, delivering what the public voted for is impossible and it is this futility that has resulted in ministerial resignations, renewed Conservative party infighting and continued talk of the desire for a general election from opposition political parties.

Mrs. May survived the December vote of confidence in her premiership, but we would conjecture that the path of least resistance for British pound investor sentiment over the coming months should remain resolutely lower. The threat of a future mutiny against Mrs. May remains a clear and present danger for UK risk assets, with investor sentiment highly susceptible to headlines concerning her position in 10, Downing Street.

ECONOMIC CONSEQUENCES

The economic consequences of scenarios 1 and 2 above (‘soft’ and ‘hard’ Brexit) may be near-impossible to quantify accurately at this stage given the uncharted nature of this journey. Anyone telling you otherwise is simply guessing. By definition, the in and out campaigns will see very different outcomes.

The bottom line though is that leaving the EU under either guise will have a degree of negative impact on the UK economy. The London School of Economics has predicted that Brexit will cost the UK economy between 1% and 10% of GDP in the long run, with the more severe impact coming from a hard Brexit or ‘no deal, crash out of the EU’ Brexit.

Indeed, the UK economy is expected to take a (short-term) hit from a hard Brexit outcome as trade flows stall and economic activity shifts capacity and investment into the EU. The Bank of England has warned of ‘big economic consequences’ and has forecasted a drop in London property prices of as much as 30% in the case of a disorderly, hard Brexit. Governor Mark Carney has said emergency interest rate cuts may be needed under such a scenario.

Scenario 3 would likely trigger a relief rally in British pound-denominated assets as the macro outlook reverts to the status quo, but even then, this would perhaps only emerge after a sharp spike in volatility and investor uncertainty assuming it is only the result of a second referendum.

WHEN IS A DEAL NOT A DEAL?

The Withdrawal Agreement signed between Mrs. May and the EU late last year was deeply criticized by all political factions and led to the December vote of confidence. With neither side able to cede significant ground in the negotiations, we see no meaningful chance of the Withdrawal Agreement being successfully voted through parliament, which it must be in order to take effect.

The most controversial element of the agreement has been the so-called Irish backstop, the clause in the agreement that addresses plans for how to treat the Northern Ireland/Republic of Ireland border. This will be the only physical border between the UK and the EU post Brexit.
SO WHAT IS THE ‘BACKSTOP’ AND WHY IS IT SO CONTENTIOUS?

The backstop is intended to be a safety net, a way of avoiding a hard border to separate Northern Ireland from Eire, if appropriate customs arrangements cannot be agreed between the EU and UK by the end of the transition period in December, 2020. But for there to be a transition period of course there has to be a withdrawal agreement in the first place.

Brexiters argue that the backstop will keep the UK tied to EU rules indefinitely and curb its ability to strike trade deals with third countries. The EU believes the backstop should mean Northern Ireland staying in the single market and the customs union until the UK comes up with a permanent solution to the border issue. Mrs. May wants a backstop that would see the whole of the UK staying in the customs union for a limited time after the transition period (so as to avoid any threat to the structure of the United Kingdom itself), but this is something the EU has said is unacceptable and has no room to move on.

The most contentious part of this arrangement though would be that, in the case that a solution to the Irish border polemic cannot be reached during the transition period, the UK will not be able to unilaterally end the backstop.

As such, we feel that there is little prospect of Mrs. May’s ‘deal’ getting Brexiteers’ support since it is based on the principle of the UK remaining closely aligned to the EU through the EU customs unions. The pro-Brexit camp wants a much clearer-cut divorce in order for the UK to then be able to sign new trade deals with other (EU and non-EU) countries.

The Democratic Unionist Party (DUP), which is keeping the Conservatives in Downing Street through their support arrangement for now, will also not support this ‘deal’ if it implies even the slightest differences in the trade treatment of Northern Ireland (via a customs arrangement) compared to that of the rest of the UK.

Meanwhile, the ‘Remainers’ are unlikely to support the Agreement if/when it comes to Parliament. They won’t support any proposal that results in the UK leaving the EU. The clue is in that group’s name.

With the issue at apparent deadlock therefore in early 2019, market uncertainty seems set to remain elevated as we head toward the Brexit deadline of 29th March. In turn, uncertainty breeds contempt and will likely weigh on sterling as the chances of a no-deal Brexit rise.
EMERGING MARKETS FX OUTLOOK
DANAY SARYPBEKOV, PINRATH WONGTRANGAN AND RASHID RASUL
Last year proved to be a difficult one for emerging markets as investors fled certain countries. It started with the Indonesian rupiah in January/February then spread to Argentine peso in the spring before hitting the Turkish lira in August.

Each of these stories is idiosyncratic and connected at the same time. Yet, there was no real contagion in a broader sense, in which investors flee all EM-related assets regardless of valuations or fundamentals. However, there was a connection between the countries that were affected and some of the common factors were high current-account and budget deficits – which often mean a dependence on external dollar funding –, significant oil import needs as energy prices were rising and political meddling in economic policy-making.

Now that the storm has passed, it has left assets denominated in Argentine peso, Turkish lira and other EM currencies at attractive levels. For instance, on a Real Effective Exchange Rate (REER) basis, the Turkish lira weakened in 2018 to its lowest level since 1994 while in US dollar terms Argentina’s Merval equity index traded at some of the lowest levels in five years. As a result, there could be interesting EM opportunities in 2019.

The US dollar outperformed Asian currencies, and US rates (in yield terms) outperformed their Asian counterparts last year. Overall, in 2019, there may be some good risk-reward in Asia, especially in high-yielding currencies such as the Indian and Pakistani rupees and the Indonesian rupiah, as these countries still have positive long-term growth stories. China will continue to be a tricky place to invest in as the US dollar-Chinese yuan rates differential could continue to widen, while the ongoing trade war with the US could also lead to slower growth. At the time of writing, the tariff dispute dominated headlines, but it could ease this year, and the market will likely begin to focus on real growth in the US, as the boost from tax cuts and an increase in fiscal spending wears off.
Historically, the Indian rupee has depreciated 20%-30% every three to five years, and 2018 proved to be one of these, with the currency weakening from the 63.00 handle towards 74.50 against the US dollar, before retreating in December. In 2019, the rupee could move away from last year’s tight correlation to the oil price (higher oil = weaker rupee) and domestic news could become a key driver for the currency. Thus, the focus should shift to GDP growth, inflation and the upcoming elections.

India could experience weaker consumption demand in 2019, and quarterly economic expansion north of 8%, as was the case in 2018, is unlikely. Furthermore, lower fiscal stimulus in the latter half of the year should also help keep growth subdued. At the same time, the election could be a silver lining which could provide some policy surprises, especially with regards to government spending, which in turn would support consumption.

These somewhat contradictory factors in the India story make the Indian rupee a difficult one to forecast over the longer term. However, the rupee is unlikely to depreciate to the same extent it did last year for at least another two years, and thus there may be better opportunities in betting on the appreciation of the currency in 2019, while looking for some weakness in the US dollar towards the second half of the year.

China will be a more straightforward story this year, even if bearish. The interest rate differential between dollars and the yuan could widen, which would lead to further depreciation for the Chinese currency. In the medium term, the worst may be yet to come as China pursues its deleveraging process combined with the overhang from weak domestic demand, a cooling property market, rising credit defaults, and increasing trade protectionism. All this will also weigh on China’s GDP growth, which could slip below 6.5%. China-US trade tensions, however, are unlikely to continue weighing heavily on USD/CNY. But as the Fed continues to hike through at least the first half of 2019, US assets will become more attractive compared to their Chinese counterparts. And, finally, the PBOC is likely to continue easing, but the pace may slow down compared to 2018.

Overall, we are more bullish Asia now than we were in our 2018 outlook. The US Fed governors shifted their stances from ‘hawkish’ to more ‘neutral’ in the fourth quarter of 2018 as they talked of ‘data dependency’ for further hikes. They have also acknowledged the impact of slower growth abroad in their decision-making process as they effectively exported their monetary policy a little early to most EM countries (and indeed some developed markets). The late-2018 changes in the Fed’s rhetoric could result in a key market shift given how far the US dollar and Treasuries moved last year. Most Asian countries, with the exception of India, Indonesia, and Philippines, have current account surpluses so the natural flow from a balance of payments perspective would be to sell dollars against an Asian basket into 2019.

Since March 2017 the Egyptian pound traded within a tight range of 17.50-18.00 and this allowed foreign investors to take full advantage of high yields on government debt. In the second quarter of 2018, that trade showed signs of being crowded as foreign portfolio inflows reached a peak of around US$21 billion in April. However, the sharp depreciation of EM currencies such as the Argentine peso in April/May and the Turkish lira in August had a limited spillover effect on the Egyptian currency and on investor sentiment. Higher oil prices combined with rising US interest rates created some serious headwinds for the Egyptian economy, but Egypt’s GDP growth remained solid at 5%-6% and the government remained on track with its key fiscal reforms.

Even though the Egyptian pound is nominally stable, it is appreciating on an inflation-adjusted basis (REER) and thus sooner or later the central bank will have to allow the local currency to depreciate. To retain its competitiveness, the Egyptian pound should weaken towards at least the 19.00-20.00 range over the next 12 months. Meanwhile in terms of monetary policy, there is little room for the central bank to cut interest rates as inflation will still likely be in the mid-to-high teens in 2019 due to a weakening currency and subsidy cuts for energy and other commodities. Therefore, from an investor perspective, Egypt should still be an attractive carry-trade destination although the dollar returns could be lower this year than in 2018.

In February, Nigeria will vote to select its next President. Although there is likely to be some short-term volatility around the event, major changes in economic policy-making are unlikely, regardless of whether the incumbent President Muhammadu Buhari or the challenger Alhaji Atiku Abubakar wins. Elevated oil prices would be beneficial for the Nigerian central bank’s policy of keeping the Nigerian naira dollar conversion rate stable around 360.00-365.00. Any changes to this regime would take at least three to six months to implement and would be gradual. Therefore, Nigerian government securities should offer one of the best carry trades for 2019, with yields ranging between 12%-16% and a stable exchange rate. Since international institutional investors did not favour Nigeria in 2018, there is room for significant inflows into the country this year, especially after the presidential elections.
TRY, EGP and ARS on the REER basis

Source: FAB, Bloomberg

DEEP DIVE INTO PAKISTAN

After years of political, economic and security unrest, Pakistan is experiencing strong economic growth accelerated by the China-Pakistan Economic Corridor (CPEC), a collection of infrastructure projects worth approximately US$62 billion.
The political situation in Pakistan has improved following the successful transition to a new majority government elected on an anti-corruption agenda. The likelihood of a more stable government, although a positive step, is not enough to deal with the economic challenges Pakistan faces. The new government, under the leadership of Imran Khan, has done well to leverage its relationships with key allies to secure funding, including US$6bn from Saudi Arabia (in the form of a US$3bn deposit and US$3bn in deferred oil payments), US$2bn from China, which has also committed to triple imports, and a potential US$6bn investment from Abu Dhabi’s Mubadala for an oil refinery.

While Beijing has been supporting Pakistan’s external funding needs for the past few years, CPEC-related imports from China have also been a significant driver of the widening current account deficit. In addition to the bilateral support from its allies, Pakistan may require a comprehensive reform package in the form of an IMF program to normalize its twin deficits and set the country on a sustainable path of progress. The finance minister, Asad Umar, formally requested financial assistance from the IMF in October. An IMF program may entail further structural reforms, however the government has been proactive in laying the groundwork for such an event this year, including incremental exchange rate adjustments and a monetary policy tightening. The rupee has devalued 27% between December 2017 and November 2018 and is now fairly valued in terms of real effective exchange rates, which takes into consideration accumulated inflation, and on the basis of which the currency was overvalued.
The State Bank of Pakistan has already raised rates by 175 basis points since November 2017 to 8.5%, however, we expect this to rise to 10% by 30th June, the end of fiscal 2019, on the back of inflation pass-through from higher oil prices, a weaker currency and higher indirect taxes from tighter fiscal policy. The government’s ‘mini-budget’ presented in September targets GDP growth at 5.1% for fiscal 2019, which is in line with IMF estimates and the long-run annual real GDP growth of 5% since 1980. With the bulk of the currency adjustment in place and higher rates, we believe short-term Pakistani T-bills offer an attractive currency-hedged carry return. Pakistan has a mechanism known as the Special Convertible Rupee Account (SCRA) which allows non-resident investors to invest, freely-convert, forward-hedge and freely-repatriate investments in local currency bonds, bills and equities. With three-month T-bills yielding 9.20% in the secondary market, and three-month forwards trading at 3.30% implied, there is a potential pick-up of approximately 600 basis points annualized net of taxes and related fees.

Pakistan is a positive growth story. The new government is taking the necessary steps to close the funding gap and build a more conducive environment for foreign investment, while also engaging the large diaspora of expatriate Pakistanis.
EMERGING MARKETS BONDS OUTLOOK
CHRIS LANGNER
Emerging markets bond investors had little to celebrate as New Year’s Eve approached in 2018. By December of this year, however, they could be cheering loudly. In fact, there are many reasons to consider adding emerging market debt to portfolios.

The risk reward ratio is one of them. The Bloomberg Barclays Emerging Markets Sovereign Index, which comprises dollar-denominated bonds of developing nations, ended the year yielding more than 6.5%, almost 170 basis points more than where it started 2018. That means investors are now being much better compensated for the risk of holding the hard currency debt of the world’s fastest growing nations.

Moreover, the dynamics for the two main drivers of returns in bond markets have now changed. Last year, the prospect that the US Federal Reserve would increase dollar benchmark interest rates suggested bond prices would inevitably drop. In December, however, the US central bank was forecasting only two hikes this year, though market measures suggest it may end up doing only one, or even pause outright.

That would significantly reduce or even remove one of the main drivers for the 4.4% loss that the Bloomberg Barclays Emerging Markets Sovereign Index registered in 2018. In fact, as the Fed takes an expected dovish tilt, it could prompt a rally in US Treasuries that would cause emerging market sovereign bond prices to rise as well.

The hawkish Fed of 2018, however, had another effect on EM that a dovish tone would reverse. The average premium EM sovereign bonds pay over US Treasuries increased to some of the highest levels in history (excluding the Global Financial Crisis in 2008-2009). By December, that premium was some 385 basis points for the Bloomberg Barclays Emerging Markets Sovereign Index, up 130 basis points for the year.

That is also some 90 basis points higher than the average yield premium for the index between 2010 and 2017 and nearly double the 209 basis points low hit in February 2010. This yield premium will likely narrow in 2019, which alone could lead to positive performance for emerging market dollar-denominated bonds.
A more dovish Fed has other side-effects that would benefit emerging market bonds. Last year, the dollar index rallied some 5% as rising US interest rates drew money out of other investments into US Treasuries and bonds. The prospect of fewer rate hikes this year would dampen that movement and likely translate into a weaker US dollar by the end of 2019.

The currency could still find some external support in the beginning of the year because of the Brexit process. The euro and the British pound together comprise about 70% of the dollar index and both currencies have been pressured by the UK’s exit from the European Union. Once the process is completed, on 29th March barring any change of plans, the two currencies are likely to gravitate towards reflecting economic fundamentals. And both Germany, the biggest EU economy, and the UK, have experienced strong labor markets and growth. A stronger euro and British pound later this year would further weigh on the US dollar, helping support the case for more investment in emerging market debt.

A weaker dollar is also likely to translate into gains for local currency bonds in select countries. That sort of investment, however, has to be pursued with more caution and preferably with hedges in place. While there is a possibility that some of the more beaten-up local currencies will rally this year, market volatility has increased significantly and investors risk losing any positive returns from higher local interest rates simply from the currency swings.

The average volatility of the eight most traded emerging market currencies (Brazil, Turkey, South Africa, Mexico, Indonesia, India, Hungary and Poland) hit the highest in half a decade in 2018, as the chart below shows. That is likely to subside, but not significantly, hence investors should pick their local currency bets carefully.

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**Bloomberg Barclays Emerging Markets Sovereign Index Yield Premium (%)**

Source: FAB, Bloomberg

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**One-year realized volatility for the most liquid eight Emerging Market currencies**

Source: FAB, Bloomberg
Finally, on the sovereign side, a better relationship between China and the US is promising too. After engaging in a bitter trade war for most of 2018, the world’s two largest economies declared a truce in December, with both sides starting to make concessions as they seek a resolution to their differences. The civilized tone that emerged suggests progress is likely this year and tensions could simmer down.

Final resolution is unlikely given that the differences between the two countries may be irreconcilable. However, they are likely to inch closer to a middle ground this year. Since China is one of the main components of emerging markets indices and is the biggest consumer for many of the commodities of heavily indebted developing countries, the prospect of stronger growth and renewed investment in the country is positive for emerging market bonds in general.

**CORPORATE CREDIT: DEFAULTS PICK UP**

The outlook for emerging market corporate credit is slightly different. A potential rally in sovereign hard currency bonds and a weakening US dollar are likely to translate into gains for corporate bonds in emerging markets too. However, the effects of last year’s EM currency devaluations is yet to fully be reflected in corporate balance sheets.

Developing nation dollar bond issuers (with the exception of commodities exporters) often face the issue of currency mismatch. In simple terms, the money they earn at home is different from the one used to pay their debt. That can reduce profits or even topple some of these companies into bankruptcy. The result is that when EM currencies devalue, as they did in 2018, it often translates into higher default rates for corporate debt.

Furthermore, benchmark interest rates in most emerging markets have also increased in response to the Fed’s tightening and weakening local currencies, which means even if these companies attempt to refinance foreign debt locally they will pay more.

Paying offshore debt with loans will be more costly too, given that LIBOR, the benchmark rate often used to measure the cost of bank funding for companies, nearly tripled in the past two years to 2.8% as at December 2018. Still, there are signs that many of the developing nation companies have started to go down that avenue. Syndicated loan volumes in Asia excluding Japan and in Latin America increased about 4% last year while in Eastern Europe they rose 3.2% in 2018 compared to the previous year, according to Bloomberg data.

More defaults, higher interest rates, more loan supply and less demand for emerging market corporate bonds suggest these securities could endure a rocky road this year. There will be good deals to be found, but investors will have to be selective.
EMEA

Perhaps the best risk-reward equation of all emerging markets is to be found in GCC bonds. The fact that oil prices were depressed in the end of 2018 but are likely to recover, the high ratings of most GCC issuers and the announcement that the region will be included into the JP Morgan Emerging Markets Bond Index are all strongly supportive of a rally for these bonds.

Eastern Europe, meanwhile, is likely to face very different dynamics. The victory of the Democratic Party in the US midterm elections last year, when they retook control of the House of Representatives, suggests further probes into President Donald Trump’s dealings with Russia and, potentially, further sanctions against the country. That could have a wide-ranging impact on the region.

Other major issuers in Eastern Europe could be shaken by more nationalist rhetoric across the European Union, given their dependence on the economic bloc, suggesting these bonds could suffer more volatility than usual.

REGIONAL FOCUS:
LATIN AMERICA

In Latin America, investors are likely to focus heavily on Brazil, given the rise of a right-wing, market-friendly new president. Former Army Captain Jair Bolsonaro took office on 1st January amid a wave of optimism and a host of promises which, if fulfilled, could boost Brazil’s economy.

The question will be how fast he is able to navigate the local Congress to enact some of the more pressing and politically sensitive changes he plans, such as pension reform and privatization. It is likely that markets would react negatively to delays in the implementation of these campaign pledges pushing Brazilian bonds down in the first half of 2019.

However, Mr. Bolsonaro has made every indication that he is committed to his reform agenda. Once it is implemented, the reforms are likely to significantly reduce the country’s indebtedness and could prompt a couple of upgrades from credit rating agencies. Brazil was held at investment grade by all three major agencies as recently as 2015. A wide-reaching investigation that culminated with a former president being sent to jail and the worst recession in the country’s history, which started in 2014, prompted multiple downgrades from both Moody’s Investors Service and S&P Global Ratings.

The reverse path could lay ahead, which would result in a strong rally in Brazilian bond prices. That process, however, is likely to play out over the next four years, hence owning Brazilian bonds should be seen as a long-term investment for those able to stomach some volatility along the way.

Mexico also saw elections last year, but the outcome was the opposite of what Brazil experienced. Even before he took the president’s office, leftist Andres Manuel Lopez Obrador began to rock global investors. Shortly after being elected, he ran a controversial mini-referendum on the construction of a new airport in Mexico City and, based on the outcome, said he would scrap the project. That decision amounted to a technical default on the dollar project finance bonds that had been issued internationally to fund the airport’s construction. At the time of writing, holders of those bonds were in restructuring talks with the issuer.

The move, however, caused Mexican bonds to sell off so much that some analysts were saying they were cheap at the end of December. At the time of writing, these bonds were recovering some ground as Mr. Lopez Obrador began to show a more pragmatic and less populist-Marxist approach to government. Investors, however, are still urged to approach Mexican assets with care given the possibility of political surprises.
EMERGING ASIA

Asian bonds could enjoy a significant rally given expectations that Chinese economic growth could accelerate later in 2019 and the trade war may subside. Chinese bonds, some of the worst performers in 2018, are likely to benefit the most. The exception may be the dollar debt issued by the central government, given that it trades at such tight premiums that it is unlikely to rally much further. State-owned company bonds, however, were battered in 2018 and could outperform this year as the economic and geopolitical situation of the country improves.

If China does well, most other countries in Asia will too. Investors need to be mindful of local issues, however. Three of the biggest economies in the region face political uncertainty this year, with two of them set for increasingly unclear general elections.

In Malaysia, former Prime-Minister Mahathir bin Mohammad won a surprise election – this time running for the opposition party – last year. Mr. Mohammad (or simply Mahathir, as he is normally called) will celebrate his 94th birthday in July, and, while he remains as sharp as ever, he is expected to hand over control of the government to another politician as early as this year. The move is widely expected to bring Anwar Ibrahim, a longtime opposition leader, into power. It is, however, not entirely clear that such a playbook will be followed, and Mahathir is well-known for following his own agenda. Uncertainties about the transition could swing Malaysian bonds around.

Political uncertainty is likely to provide some volatility across the Malacca Strait, in Indonesia, as well. The world’s most populous Muslim country faces general elections this year. While incumbent President Joko Widodo is still expected to win, the outcome has become less clear, especially after the rupiah depreciated nearly 7% last year, pushing inflation higher. Mr. Widodo lost a proxy election for the governorship of Jakarta, the country’s largest province, a couple of years ago. Until the election outcome is confirmed, investors may want to approach Indonesian bonds cautiously.

India faces a similar issue as a series of local election defeats by the ruling Bharatiya Janata Party (BJP) called into question its ability to hold the Parliament majority it had in 2018 after general elections, expected in May. In December, the Indian National Congress Party, led By Rahul Gandhi, got the majority in Chhattisgarh, Madhya Pradesh and Rajasthan, three states where Narendra Modi’s ruling BJP had taken 70% of the 519 seats in the previous elections. The outcome signaled that Mr. Modi’s hold on the position of prime minister may be more tenuous than markets expect. Even considering the fact that his BJP retains a lead in the polls, and probably will continue to hold the majority in Parliament, Mr. Modi may have to make way for another leader if the party’s representation drops too much. Markets do not like change, and that could be an unforeseen one.

Hence Indian bonds are likely to face additional volatility until the general elections. After that event, however, they could do well, given that India remains one of the fastest growing large economies in the world.
MENA BONDS AND SUKUK
ZEHAN MOHAMED SALEH,
CHAVAN BHOGAITA
AND RAKESH SAHU
Bonds from the Middle East and North Africa are likely to deliver positive returns in 2019, given the repricing of the dollar yield curve which happened in 2018 and supportive technical factors. The cyclical and structural challenges for emerging market economies, slowing Chinese and global growth, protectionist trade policies and tighter global liquidity conditions are all likely to extend into 2019. The issues, however, should simmer down instead of flaring up.

Hence the outlook for EM and MENA credits next year is less bearish than it was in 2018 – unless oil prices drop further. From that perspective, the prospects remain positive, despite the 39% correction in Brent crude prices in the last quarter of the year. The fundamental picture is therefore constructive. More importantly, bets on EM have been reduced, so now the market positioning is cleaner, making way for fundamentals to play a bigger role in investors’ considerations.

The IMF expects developing economies to grow 4.7% next year, the same pace as it projected for 2018, driven by an expected slowdown in China early in the year and increased external risks. The US-China trade war is the wild card. The bar to improving dynamics in the trade negotiations remains high, and the tensions could get worse, although they seemed to improve in December. Additional trade tariffs could lower overall EM GDP by as much as 1 percentage point, according to IMF projections. Policy response from Beijing may mitigate that, however.

**MENA: EMERGING MARKET’S HIGH-YIELDING SAFE HAVEN**

Amid the EM turmoil, many MENA bonds have acted as havens. In fact, MENA bonds outperformed the broader emerging markets and remained calm over the summer of 2018, when vulnerable developing economies saw the deterioration of their currencies and interest rates. However, MENA bonds were not immune. The two major drivers of returns, yield premiums and benchmark bond prices, were a double blow to the MENA bond market, despite positive catalysts throughout the year.
Brent crude, which averaged US$71.7 per barrel last year, rose to the highest level since 2014 on 3rd October, supporting hydrocarbon-exporting economies in the region. We expected the GCC to have generated some US$500 billion in exports of hydrocarbons in 2018 – 50% more than average annual receipts for the last three years. With oil dominating the public finances and trade accounts, higher oil prices meant an improvement of internal and external balances last year and the lowest funding requirements since 2014. Still, total debt issuance of US$78 billion almost matched 2017’s figure of US$85 billion, according to Bloomberg data. In fact, higher oil prices were a mixed blessing – fiscal deficits fell but expenditures rose, increasing the price of oil required for government accounts in the region to break even.

Renewed government spending has helped economic activity pick up, and regional PMIs ran above 50 throughout 2018 and credit growth turned positive. Policy reforms such as the introduction of VAT in the UAE and Saudi Arabia, the region’s two largest economies, and subsidy cuts have not impacted the economy, perhaps thanks to higher oil prices. Saudi Arabia recorded 1.6% GDP growth in the first half, a much welcome end to recession, but is still growing below the medium-term average of 3%. Unemployment for the 33 million-population economy remained high, at 6% of the labour force at the end of 2017, according to the IMF. Saudi GDP takes some time to react to oil prices, though, hence it could grow 2% this year and faster in 2020.

**MENA PREMIUMS: ROOM TO TIGHTEN**

The yield premium most MENA borrowers pay over US Treasuries increased with the rest of EM in 2017. That, however, has opened an opportunity as the move erases concerns about spreads being too tight in the region. While geopolitical risks saw an increase last year, higher yields for individual borrowers are likely to be more driven by technical factors instead.

Still, the MENA region is expected to continue with the same pace of dollar bond issuance seen in 2018. Saudi Arabia is likely to remain one of the largest issuers in the region, particularly after the recent fall in oil prices, and is expected to borrow at least US$32 billion this year. Oman, which saw its fiscal deficit significantly reduced by higher oil prices last year, remains the most sensitive to moves in the commodity price and, therefore, can be expected to return to capital markets in 2019 too. While this could temporarily increase yield premiums for these issuers, it could also be partly offset by the inclusion of several bonds from the GCC into the JP Morgan EMBI index, which translates into additional demand for these securities.
Outside of the oil-producing countries, Egypt has been in focus as it weathered last year’s risk-aversion well. Investors were reassured that the country stuck to the IMF reform program, now in its third year. Egypt has made significant progress, with tax hikes and subsidy cuts, building credibility in its willingness to reform since the 2011 revolution. The monetary policies have also diminished currency volatility, but the question remains the willingness and ability of the Central Bank to cut rates next year. High interest rates have supported remittances so far but weaker growth in the GCC and regulatory change allowing foreign investors to withdraw money more easily could undermine the foreign currency flow and impact domestic consumption. Investors may also be concerned whether the country will continue with its IMF program, since the existing agreement expires in 2019.

Lebanon, meanwhile, has seen increased fiscal vulnerabilities as the country continued to be run by a government which does not have a legitimate cabinet. The political gridlock has now brought the country to a perilous economic and fiscal position. The economy is now contingent on some commitment of financial support from a regional power or a reduction in regional geopolitical risks, particularly the conflict in Syria. Government funding needs are currently being met by stable deposit flows, which have grown at about 3%, a rate that is not enough to compensate for its fiscal and commercial deficits. The existing hard currency liquidity in the banking system can at most plug the external funding gap in the medium term. The rapid build-up in public debt has caused the country’s dollar bonds to be among the region’s worst performers in 2018.

Lebanon needs alternative financing sources in the near future or it could face repayment problems. The formation of a legitimate government is a pre-requisite to the reform agenda and the release of the US$11 billion Cedre monetary commitments to develop infrastructure in the war-torn economy. Investor appetite remains limited in the absence of progress on this front.
To say that 2018 was a tough year for credit markets globally would be an understatement, but Gulf Cooperation Council bonds weathered the storm to deliver a small return of 0.06%, outperforming most comparable emerging market credits.
GCC yield premiums widened around 24 basis points in 2018, as measured by the Bloomberg Barclays USD Credit Index. Bonds in the region, however, endured their fair share of volatility. After rising about 35 basis points in the first half of 2018, spreads tightened by a similar magnitude in the third quarter, as investors adjusted their estimates for US dollar interest rates to a higher range. However, spreads shot up by some 22 basis points in the fourth quarter, as risk aversion, combined with a nearly 39% drop in Brent crude oil prices, resulted in another bout of spread-widening for GCC bonds.

INDEX INCLUSION: EXPECTED TECHNICAL SUPPORT

US dollar bonds from five GCC states – Saudi Arabia, the UAE, Qatar, Bahrain and Kuwait – are due for inclusion in JP Morgan’s Emerging Markets Bond Index from the beginning of 2019. Around US$300 billion of assets under management are benchmarked to this index. The five GCC states together should have a collective weight of 11.3% in the EMBI index. We conservatively estimate that translates into US$25 billion-US$30 billion of fund inflows, which could mean tighter GCC spreads in 2019.

Since 2016, GCC sovereigns, particularly the Kingdom of Saudi Arabia (KSA), have become regular issuers. We expect the issuance of new bonds from the region to remain in the range of US$60 billion-US$70 billion in 2019. That may be slightly lower than the level seen in the past three years thanks to lower funding requirements of GCC sovereigns in 2019, resulting from fiscal consolidation since 2014.

Saudi Arabia has also become a regular issuer in the local market and it lists its bonds on the local exchange. The UAE, in its turn, enacted a new debt law in October, 2018, which allows the federal government to issue sovereign bonds and establish a dirham yield curve.

We expect to see increased issuance from corporates in the region in 2019, given that the IMF forecasts GCC economic growth will pick up to 3% in 2019 from 2.4% in 2018, demanding more capital investment, particularly from government-related entities. GCC corporate treasurers are also likely to perform liability management exercises to take advantage of growing investor interest in the market and as US$20 billion in corporate bonds come due this year. Issuers such as Mubadala, National Bank of Oman, Aldar and DP World already engaged in such exercises last year.

The following risks, however, could negatively impact investor sentiment regarding GCC credits:

(1) A deterioration in regional geopolitics;
(2) An escalation in global risk-off sentiment;
(3) Excessive new issue supply from the region, which pushes credit spreads wider.

CONCLUSION

We are cautiously optimistic for GCC credits in 2019 based on the following rationale:

(1) Our base case assumption is for Brent crude oil to average US$70-US$75 in 2019, even though the commodity retraced to nearly US$50/barrel in December from the US$86.29 level seen in early October;

(2) Economic recovery for GCC countries remains on track, supported by government stimulus and fiscal consolidation – the IMF continues to see growth picking up in 2019;

(3) Most GCC sovereigns now have a stable outlook from all three international rating agencies. While Oman runs the risk of losing its last investment grade rating (from Moody’s Investors Service), we would argue that its yield spreads suggest the market has already priced in the downgrade. For example, Oman’s 5.625% bonds due in 2028 were trading at a z-spread of 420 basis points in December, 15 basis points wider than Bahrain’s 7% bonds due the same year. S&P Global Ratings rates Bahrain B+, while Fitch has it at BB-.\n
(4) The inclusion of GCC nations in JP Morgan’s Emerging Markets Bond Index could act as an additional catalyst for higher flows into GCC credits and thus tighten spreads over time.

(5) The wider spreads on offer at the end of 2018 provided a good entry point and laid the ground for positive returns in 2019.
DEVELOPED MARKETS EQUITIES OUTLOOK
CLINT DOVE, HAYATH BEN BABA AND KEH CHUN WEI
The next leg of the US equity bull market should soon be upon us. As a guide, in 2019 we expect the S&P 500 to trade at between 15x-16x prospective 2020 earnings of $204.82 (i.e. between 3,072-3,277), equivalent to upside of 23%-31% from where the index closed the year. Good stock and sector selection can of course improve this.

**SETTING THE SCENE**

It was, however, a difficult 2018. The S&P 500 lost 6.24% last year, or a loss of about 4% after dividends were included. The index now stands 14.4% below its September high of 2,930.75.

The S&P 500 index stands on a P/E ratio of 14.6X for 2018, and just 13.2x for 2019, and 12.2x for 2020. Those numbers assume consensus earnings of US$190.32 for 2019, or growth of 10.7%, with earnings growth of 7.6% penciled-in for 2020. So the valuation in these simple terms has returned to earth, although it is difficult these days to determine what is ‘normal’. Going back many years, a realistic mid-point of earnings growth and P/E were typically 8%-9% and 14x-16x respectively, depending on the prevailing level of interest rates.

The FANG+ index of technology stocks led the market for much of the year, but, with its extended valuations, this was a correction accident waiting to happen – and the group was down 26.5% at year-end from its June closing high. In reality this development has been positive for the market, which is now much healthier. Earlier in the year, it seemed like market participants knew the valuation dangers, but could not resist staying with the momentum. The FAB Asset Allocation Committee (AAC) has been overweight in ‘genuine’ technology stocks and has not favoured social media stocks.

After a late ‘risk-off’ run, the (usually unexciting) utilities sector was ahead by 1.3% for the year to 24th December. Healthcare was down 0.7%, still one of the best performers, consumer discretionary was down 6.7%, and information technology lost 7.4%, with the worst performances coming in energy (-23%), materials (-20.2%), industrials (-18.9%), financials (-18.7%), and telecommunications (-17.6%).

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**S&P 500 sector returns in 2018 to 24th December**

Source: FAB, Bloomberg
In the final months of 2018, market commentaries trumpeted the US/China trade negotiations, rising interest rates as the Fed normalizes monetary policy, the political stalemate in Washington after the mid-term elections, the people turnover in the White House, and even the possibility that a recession might arrive sooner rather than later. All of these factors continue to reverberate, yet the market exists to discount the future.

FACTORS THAT WILL DRIVE US EQUITIES IN 2019

• During the period after the Great Recession, quantitative easing was all about engineering survival, and the patient is only now able to survive away from the ventilator. During the last ten years or so, much of the world economy has been in suspended animation in a period of (until now) low growth – we believe the global economic cycle has in many ways been ‘on hold’, so this current cycle could be a very long one (i.e. the shorter business cycles of history could be bunk).

• President Donald Trump may at times be controversial – but his policies have been and are market-friendly. Most sensible investors can see that the US economy is doing very well, especially for one of its size. The government shutdown his administration faced early in 2019 should be short-lived and its resolution could prompt a rally.

• Year-end portfolio window-dressing (and tax-loss selling) have been real factors in the market – although they are transitory. Similarly, market commentators have almost ensured that expectations for the worst regarding the US/China trade situation win out – seemingly with no possibility of improvement – yet this, too, should be transitory.

• Perhaps most significantly, we have not seen the excesses usually associated with the end of a bull market (e.g. at the end of 1999). As Fisher Investments is fond of reminding us, half of the returns in a US equity bull market come in the final third of it. We believe this period lies ahead, rather than behind us. So investors have to be involved in that final phase – although few actually are, with many investors underweighting stocks too soon.

• Investors know that S&P 500 company earnings were boosted by the reduction in the corporate tax rate early in 2018, and that it was a ‘one-off’. Accordingly, they and strategists know to expect a quarter or two of annualized earnings drops in the second and third quarters of 2019, purely due to this tough statistical comparison.

• Commentators have talked ad nauseam about how a recession follows after the US yield curve inverts (the US two-year Treasury yield stood 20 basis points below the 10-year at year-end, this being the most popular definition). What they fail to point out is that (a) usually when this happens it is due to the Federal Reserve acting in a heavy-handed way to curbing an expansion, and (b) history suggests that the S&P 500 typically does not peak until 12-18 months after the inversion.

• Having said all this, we are not saying the business cycle has been abolished. Most bear markets are temporary, result in falls of 20-25%, and last on average about 15 months – with excellent trading opportunities for the nimble. In any case, we believe a ‘growth recession’ could be more likely than a recession, and by the time a downturn ends a new bull market has already begun to discount the next upturn.
OTHER FACTORS TO HAVE IN MIND

- The services sector represents about 80% of US GDP, and the provisional reading for the Services PMI for December was 53.4, showing reasonable business activity, helping to underwrite growth in the region of 2.3% for 2019. There was a 0.2% increase in retail sales for November, after a 0.8% increase for October, suggesting good underlying consumption.
- The recent fall in the oil price is in a sense equivalent to a tax cut, lowering manufacturer’s and distributors’ costs.
- We expect the US corporate investment cycle to gradually accelerate; while buying back stock has been a priority, at least with a lower tax rate US corporations can more easily afford to invest.
- Recent sentiment from the Fed has been more dovish, with the 10-year Treasury yield. Further than this, though, what happens when global investment managers reduce their bond weightings? Part of the answer is that if economic growth is good, and stock valuations not too stretched, they buy equities.
- The VIX (volatility) index has begun to trend upwards, having broken out of the 9-20 range prevalent for much of the year. We expect higher volatility in stock prices, although this may be a good thing, signifying greater interest in stocks, rather than too much risk. An increase in the VIX should be consistent with more alpha-generating opportunities for good stock-pickers.
- US rates, led by three-month LIBOR (at 2.81%), are continuing to edge upwards as liquidity tightens. Equity investors appreciate that small- and mid-cap companies are proportionately more reliant on floating rate (rather than fixed-rate) debt – and on debt, they buy equities.
- Perhaps most significantly, we expect the US dollar to weaken later in 2019, boosting the global competitiveness of goods and services, with a favourable translation effect of foreign earnings. At this stage investors with portfolios in base currencies other than dollars may wish to hedge the currency risk.

MARKET FACTORS

- History and academic studies suggest that only a US 10-year Treasury yield in excess of about 3.5% begins to hurt equities.
- After the multi-decade bull market in bonds, investors have been expecting its end – but many have now been ‘faked out’ a number of times, including some prominent players. So what happens to equities if or when bonds fall further? The answer is not clear-cut, and is determined by exactly why bonds fall – and the speed and panic with which they do so.
- There is a large US budget deficit to be funded, and investors may demand higher redemption yields before they enter into long-term bond purchases, especially at a time when the Fed is shrinking its balance sheet by not reinvesting when issues mature. However, steady economic growth in the absence of too many internal or external shocks should cap the 10-year yield at 3.25-3.5% – and that should not damage equities, provided earnings estimates continue to make progress, perhaps helped by a lower dollar. Strategists compare the earnings yield on stocks (the reciprocal of the P/E ratio as a percentage) to the 10-year Treasury yield. Further than this, though, what happens when global investment managers reduce their bond weightings? Part of the answer is that if economic growth is good, and stock valuations not too stretched, they buy equities.
- The VIX (volatility) index has begun to trend upwards, having broken out of the 9-20 range prevalent for much of the year. We expect higher volatility in stock prices, although this may be a good thing, signifying greater interest in stocks, rather than too much risk. An increase in the VIX should be consistent with more alpha-generating opportunities for good stock-pickers.
- US rates, led by three-month LIBOR (at 2.81%), are continuing to edge upwards as liquidity tightens. Equity investors appreciate that small- and mid-cap companies are proportionately more reliant on floating rate (rather than fixed-rate) debt – and on debt, per se. Also, such companies are not significant exporters, so they do not benefit much from dollar weakness, while they suffer from higher non-dollar import costs upon translation. Accordingly, we would not favour an overweight position in US small/mid-cap equities at this time, and much prefer large-cap stocks.

SECTORS

- We still favour the technology sector, and are fans of quality hardware and software companies – though not social media. Ongoing technological disruption should lead to lower costs and better margins in many areas of American business – i.e. the continuation of the so-called ‘Amazon’ effect. Also, the technology sector has a high foreign earnings quotient, so any weakening in the dollar is a benefit. Furthermore, tech is the only sector with a ‘net cash’ surplus in the US equity market. It also looks quite cheap on a ‘PE-to-growth’ basis on 2019 metrics (estimated earnings growth of 10.3%, and a prospective P/E of only 14x), so investors are not paying too much for that growth.
- In addition to the IT sector, we most favour healthcare and energy. The former should benefit from advances in med-tech and the aging population, while quality heavyweights in energy offer good value, especially with crude oil relatively depressed in the short-term.
- Looking ahead a few months, we expect to be adding materials to the overweight list, once short-term uncertainties – essentially regarding China – have played out, and for the reasons discussed in the separate commodities article in this book.
- We systematically avoid utilities and real estate equity sectors, as we want consistent growth, and to avoid companies with excessive debt.
STOCK SELECTION GUIDELINES, APPROACH TO THE MARKET

Even if short-term interest rates are still close to historically low levels, the continued upward march in LIBOR as liquidity tightens is putting pressure on those corporates without pristine balance sheets, and this should continue into 2019. Accordingly in our stock selection we are increasingly emphasizing quality, especially good free cashflow generators. These are the attributes to which equity investors should gravitate as US equities recover going into 2019, at the expense of cash-consuming, lower-quality companies.

Our idealized template for US equity portfolios is currently as follows: a ‘barbell’ approach, with technology at one end (growth), energy at the other end (value) – and a collection of high-quality large and mid-caps in the middle, which provide growth at a reasonable price.

As overall earnings growth in the market falls, mainly due to the statistical comparison with last year’s strength, investors are likely to pay more for growth. Forward earnings multiples have settled back to historic averages, with Bank of America Merrill Lynch recently having observed that stocks generally look inexpensive in terms of growth, free cashflow, and compared to bonds.

Investors in US equities are advised to be prepared to operate opportunistically during 2019, driven by stock selection criteria designed to keep their portfolios safe. We recommend that clients never speculate, that they try to take a medium-to-long term view of the market, and apply a ‘trailing stop-loss’ of 19% from the entry point, to preserve capital.
European stocks had a rough 2018 amid the political uncertainty of Brexit and the rise of nationalism in the Eurozone. That, however, may have created an opportunity for investors seeking value in depressed but good quality stocks.

The STOXX Europe 600 index lost 18.3% in 2018 as at 24th December, with its price to expected earnings ratio touching 12x at year-end, close to a five-year low and well below its long term average of 14.5x. Meanwhile, earnings are still expected to grow nearly 10% in 2019, judging by consensus estimates.

Much of that has been driven by political uncertainty, which also has fueled a widening discount of European stocks to their American counterparts. As of late December 2018, the average price to expected earnings of S&P 500 stocks was 13.35x, compared to 12x for the STOXX 600. Part of that difference reflects lower profitability for European companies and is a result of the STOXX 600’s high exposure to banking and basic resources stocks, which are more sensitive to the political environment.

The sell-off, however, had pushed the dividend yield of European stocks to 4.1% by the end of 2018 with consensus expectations forecasting 4.3% in 2019, well above the yield offered by investment-grade bonds in Europe or inflation. Meanwhile, the S&P 500 had a 2.3% dividend yield in late December, with a modest rise to 2.5% expected in 2019.

Investors may still need to be careful about where to invest when going into Europe. Trade tensions, one of the biggest issues last year, could continue to be a problem this year. If that is the case, it could drag down the performance of some European stocks, as more than 50% of the revenues of STOXX 600 companies are generated outside of the Eurozone, and more than half that portion comes from emerging markets. Stocks from countries such as France, Germany and the Netherlands, which are heavily exposed to foreign income, are particularly sensitive to trade issues. In particular, 70% of the revenues of German companies are generated outside the country. One way to navigate that could be to favour domestic economy-exposed sectors such as telecommunications and utilities. However, if trade tensions do ease beyond the signs of negotiations made by President Donald Trump and Chinese Premier Xi Jinping in December, European equities could rally.

The Eurozone has been growing faster than usual too. Euro-Area real GDP was expanding at a 1.6% rate by the third quarter of 2018, and the ECB expected it would be around 1.8% in 2019 and 2020. Those levels are well above the long-term trend growth of 1%. Unemployment is expected to decrease from 8.3% to 7.4%, reaching pre-crisis lows but still far from full employment. Core inflation for the area is also expected to be 1.7% in 2019.

The fairly positive economic backdrop does not, however, erase the multiple uncertainties the Eurozone faces this year: the potential for a hard Brexit, continued global trade tensions, populism, the defiance of Italy’s nationalist governing coalition and a slowing Chinese economy, just to name a few. All of these probably have been contributing to the money exodus that has hit European equity markets since the beginning of last year. They may also have helped leave the ECB behind the curve, which might force it to tighten monetary policy faster than anticipated if the European economy recovers, strengthening the currency and weighing on European stocks.
These factors favour defensive sectors such as utilities. Furthermore, late cycle sectors such as energy, materials and industrials could perform well given the potential increase in costs, from wages to materials, which favour these more inflation-sensitive sectors. These sectors also performed poorly in 2018, which could translate into a better outcome in 2019.

One of the main challenges in Europe, however, is the different stages at which the various countries in the bloc are at in their respective economic cycles. In Germany, for example, unemployment was at 5.2% at the third quarter of 2018, a historically low level, while headline inflation reached 2.2% last year. Meanwhile, the Italian PMI was below 50, indicating economic contraction, and the country’s unemployment rate, at 10.3%, is well above the region’s. That has added fuel to the nationalist rhetoric in the country, which was in part to blame for the underperformance of EU bank stocks last year.

Any sort of breakthrough in Italy’s relations with the EU could boost bank stocks – though the opposite is also true. Banks could also catch a tailwind, though, from monetary tightening in the EU, as the ECB stopped increasing its balance sheet last year and could even start to wind it down later this year, if the political backdrop helps.

**BANKS**

The banking sector is the most important one in terms of market capitalization within the STOXX 600, making the European equity market heavily sensitive to the political and economic environment. Banks are the most important contributors in terms of dividend yield too, (paying 5.7% on a trailing basis by December), though the high return is partly explained by the fact the sector was the second worst performer last year, having dropped some 33% by 24th December 2018, when it was trading at 7.9x expected earnings, below its long-term average of 9.5x.

There are various factors impacting the sector: poor return on equity, slower-than-expected GDP growth, bad debt provisioning, negative real interest rates and political uncertainty to name a few. European banks also have a global bias as almost two thirds of their revenues are generated outside the euro area.

**ENERGY**

The energy sector was the third best performer in 2018 and is expected to be one of the main contributors to earnings growth within the index in 2019. The sector outperformed in 2018 thanks to rising oil prices and it would have ended the year in the black, had the commodity not turned south in the fourth quarter. However, as long as Brent crude prices stay above US$50/barrel, European companies will generate enough free cash flow to cover capital expenditures and dividends, currently above the long term average of 4.25%.
CONSUMER DISCRETIONARY
In Europe, luxury goods and automakers dominate the consumer discretionary sector. That has been a drag, given that automaker stocks lost on average more than 20% in value in the first 11 months of 2018, pushing their value to an average 6x expected earnings, a historical low and well below its long-term average of 12.6x. That underperformance is partly due to trade tensions which dominated headlines in 2018, since the sector is strongly exposed to EM, and particularly China. Furthermore, new emission testing regimes put in place in the third quarter of last year also took a toll on sales and earnings. Despite slowing global growth, the sector was looking oversold at the end of 2018 while its fundamentals remain strong. Luxury goods are also very sensitive to the political situation in emerging markets, particularly China. That could undermine this sector's performance if the Chinese economy continues to slow.

UTILITIES
Utility companies have benefitted from an increase in prices across the EU as inflation accelerates. The sector pays above-average dividends, at a yield of around 5%-5.5%. It was the best-performing sector in 2018, having lost only 6.2% in the year to 24th December, when it traded at 13.3x expected earnings, a premium to the market and above its long term average ratio of 12.5x.

INDUSTRIALS
Industrials have underperformed the market because of trade tensions, slowing emerging economies and negative investor sentiment. That, however, has made valuation more attractive. If trade tensions ease, that could support the sector. Given the order backlog, the aerospace and defense industry looks promising too, particularly if oil prices remain contained.

MATERIALS
The sector is highly cyclical. Much of its performance will depend on infrastructure investment in large economies. Another potential boost could come from the Chinese support for the manufacturing of electric vehicles, which could increase demand for chemicals and certain minerals.
TELECOMMUNICATION SERVICES

The telecoms sector underperformed last year, but that has made its dividend yield the highest among European equities. The key risks to the sector are rising wages, increased capital expenditure requirements from the adoption of new technologies such as 5G, and the cost of writing off obsolete networks.
Last year, the Global Investment Outlook called Japanese equities the ‘Investment Conundrum of Our Time’. The conundrum lingers on, and a mixed outlook suggests investors should be cautious about the asset class. To be sure, there are still reasons for optimism in some areas.

Last year, the US-China trade tensions and threats of a slowing global economy weighed on the Japanese stock market, with the Nikkei 225 down 10.4% through 24th December. That, however, was a better outcome than for the rest of the Asian countries, with Shanghai, for instance, having fallen 28.3% in the same period.

Many of the challenges Japan stock markets faced in 2018 remain in place and they remain prone to sell-offs, as major central banks unwind monetary easing introduced after the Global Financial Crisis.

The Bank of Japan has been purchasing ETFs and J-REITS since 2010 as part of its own monetary easing program. The central bank now owns about three of every four shares of Japanese ETFs. The BoJ has also amassed more than JPY476 trillion (US$4.22 trillion) in government and corporate bonds.

The effects of unwinding this program are unclear. The BoJ, however, is expected to do that over a long period of time, and only when the market can stand it, to minimize negative effects. In the meantime, investors need to be aware of bouts of yen strengthening in periods of global tensions, since investors see the yen as a safe haven.

Yet, there are tailwinds for the Japanese economy. The country recorded eight consecutive quarters of growth until the end of the 2017 fiscal year, the longest expansion in nearly 30 years, amid near record-low unemployment and rising consumption. Women are participating more in the workforce and the country is also opening up to foreigners, which supports future growth.

Amid this backdrop, companies have been reporting record profits and continue to invest for future growth. Improvements in governance, as well as continued stock buybacks and dividend hikes could also help lift investor sentiment.
The Japanese economy was flat in the third quarter of 2018, compared to a 1.4% expansion in the previous quarter. The slowdown was driven mostly by a 1.3% decrease in exports, the biggest fall in nearly two years. That was somewhat expected after a string of natural disasters. Typhoons in western Japan and a massive earthquake in Hokkaido shut down factories, affected supply chains, reduced exports and stifled personal consumption in 2018. Japan is still mostly an export-led economy, hence global trade tensions have also impacted the country. Evidence of that is in the fact that shipping stocks mostly underperformed the wider Nikkei in 2018.

In its October 2018 Outlook Report, the BoJ projected the country will continue its moderate expansion, growing 1.4% in fiscal 2018 (which ends on 31st March 2019) and 0.8% in the subsequent year. The reduced pace of expansion is partly due to a cyclical slowdown in business fixed investment and a scheduled consumption tax hike. The deceleration, however, seems natural given that Japan has grown an annualized 1.2% in real terms since Shinzo Abe took office in 2012.

Prime Minister Shinzo Abe won a ruling party leadership vote in September 2018, setting the stage to become Japan's longest serving prime minister in the modern era. Abe might not be wildly popular but his ratings have recovered from the lows of about 30% early in 2018, when his government faced accusations of cronyism. The re-election means he has three more years to build his economic and political legacy.

This also brings the spotlight back to his economic report card. Five years on, have the three arrows of Abenomics – monetary policy, fiscal policy, structural reform – hit their marks?

Haruhiko Kuroda was appointed as BoJ Governor for a new five-year term in February 2018, signaling that monetary conditions will be kept ultra-loose. The bank has been using the framework of 'Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control' to conduct monetary easing to hit the inflation target of 2%. The bank has amassed Japanese government bonds (JGB) over the past 5.5 years, a move that is aimed at eradicating deflationary pressures and boosting prices. The BoJ now owns about 45% of JGBs, or JPY553.6 trillion (US$4.87 trillion). Japan’s inflation target, however, remains elusive.

Such large scale purchases have dried up market liquidity, and ultra-low rates have pressured bank profits. The BoJ has been gradually slowing its bond buying since late 2016, when it set a policy target of zero percent for the 10-year JGB yield.

The bank also introduced forward guidance for policy rates in July 2018. The BoJ made clear it will “maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019.”
Japanese companies’ capital expenditure has seen an upswing. The Development Bank of Japan reports that domestic investment is expected to increase 21.6% to JPY19.75 trillion (US$177 billion) for fiscal 2018. This is the strongest spending growth since 1980, largely spurred by research and development in the chemical and machinery industries as well as in electric vehicles. This also comes when corporate profits are at a record high.

REFORMS AND CORPORATE GOVERNANCE: POSITIVE CATALYST

A key lynchpin of Abenomics is the improvement of corporate governance. This could improve Japanese shareholder returns, resulting in higher investor confidence and better equity performance.

Cross-shareholdings are gradually being unwound, in a sign that companies are changing. This reduces concerns that owners may benefit from favourable deals that do not benefit other shareholders.

The Japan Stewardship Code, enacted in 2014, and the Corporate Governance Code, from 2015, were introduced to encourage transparency and fiduciary duties and to enhance shareholder returns. As of November 2018, 237 companies including asset managers, pension funds and proxy advisors had accepted and signed the revised Stewardship Code. These measures suggest corporate governance in the country is evolving and could be a positive catalyst for investors.

EMPLOYMENT & LABOUR MARKET

Meanwhile, Japan continues to run very close to full employment, with the unemployment rate dropping to 2.4% in the third quarter of 2018, near the lowest in 25 years. The jobs-to-applicants ratio rose to 1.64 last year.

This prompted the Diet to approve draft legislation in November 2018 opening the door to more overseas blue collar workers in sectors facing severe labour shortages. Faced with a shrinking population and aging demographics, the taboo topic of immigration has been showing signs of moderating.

‘Womenomics,’ a term used to describe the reduction of barriers to full-time female employment after childbearing, has also been a core part of the Abenomics growth strategy. To date, the initiative has led to 2.38 million women joining the workforce. Japan has seen the activation of an infrastructure plan to create more than 500,000 new job openings in childcare facilities, to provide free pre-school education, and support employment through recurring education for women who took time off work to have children. Yet there still remains room for improvement.

VALUATION

While Japan is not a story of strong growth in the near future, the Japanese market has some stocks that trade at bargain valuations. Their forward price-to-earnings ratios are below global peers and their historical average.
**POSITIVE CATALYST: TOKYO 2020**

Tokyo’s 2020 Olympics could be a positive catalyst for Japan’s economy, as the country increases infrastructure spending, and inbound tourism grows further. Infrastructure projects related to the Olympics are well underway, and are expected to add up to JPY8 trillion-10 trillion (US$70 billion– US$88 billion). Multiple initiatives to improve the experience for foreign tourists are also in progress, such as nearly ubiquitous wireless internet connection, an improved transport network and English signs. Sectors such as food & beverages, tourism, and transport are likely to be the biggest beneficiaries.

**REGIONAL FINANCIALS UNDER STRESS**

Japan’s banks, especially regional banks, have found themselves in an increasingly challenging business environment. Low interest rates have kept profits under pressure, just as the population shrinks outside the big cities. Smaller lenders are struggling to survive against this backdrop. This has added to scandals at some of the largest regional banks, setting the stage for potential consolidation in the industry.
EMERGING MARKETS EQUITIES OUTLOOK
CHRIS LANGNER AND CLINT DOVE
It is an accepted fact among academics that stock markets tend to overreact to bad news. When that happens, it usually provides an opportunity to make excess returns over a period of time. A good measure of whether something is oversold is to compare historical average valuation metrics to current ones. By every measure, emerging market stocks have become cheap and they are likely to perform well given the recovery in the investment environment we expect this year.

The pace at which the Federal Reserve increased its benchmark interest rates, the strength of the US dollar derived from that, geopolitical uncertainty due to the trade war between the US and China and the UK’s exit from the European Union formed a destructive cocktail for emerging markets last year. The MSCI Emerging Markets Index lost more than 17% in 2018, by 27th December, mostly led by a 21.2% drop in Chinese equities.

Perhaps more importantly, the losses opened a valuation gap between emerging market equities and stocks in the developed world. Investors have already started to close that, as emerging market equities outperformed US stocks in the last quarter of 2018. Between 28th September and 27th December, the MSCI EM dropped 9.3%, while the S&P 500 was down 15.3%. In the previous three quarters, however, the S&P 500 logged gains of 8.6% while the MSCI EM lost 8.4%. There is room for more gains even after this ‘outperformance’, considering how depressed US and EM equities are.

There is also theoretical support for that idea. In 1985, the Journal of Finance carried what was then a revolutionary (and, to some, egregious) article by professors Werner F. M. DeBondt and Richard Thaler. In it, the academics asked the question: “Do stock markets overreact?” Their conclusion was, yes, they do. Because they do, stocks sometimes become undervalued and those ‘oversold’ securities tend to vastly outperform others in the years following the overreaction. The article was one of many that led Thaler to the Nobel Prize in Economics many years later, and is seen as one of the basic readings for behavioral finance studies.

Stock markets overreacted throughout last year to news about the trade war between China and the US and to concerns about reduced dollar liquidity because of rising rates in the US. This year, many of these issues will be much less important. A truce had already been called on the trade war in December, the Fed has turned significantly more dovish and Brexit will likely be resolved by the end of the first quarter.

That means there is a chance that the move down in 2018 could be reversed. Consider the following: over the past five years, the average price of the MSCI EM was about 14x the realized earnings of the companies in the index. At the end of 2018, that measure was at 11.5x. Just to return to its average, the MSCI EM would have to gain more than 20%.
That average, however, already represents a significant discount to developed market stocks. If the index were to return to its better days, it could gain more than 40%. To be sure, none of that is guaranteed, but as Mr. Thaler’s research has shown, beaten down securities one year are often stars for a period thereafter.

If investor behavior and a clear discount were not enough, there is additional reason to be invested in emerging markets. In their October, 2018, World Economic Outlook, the IMF said it expected ‘Emerging Market and Developing Economies’ to grow 4.7% in 2018 and the same in 2019. That compares to an expectation that ‘Advanced Economies’ would expand 2.4% in 2018, and by 2.1% in 2019.

So-called ‘developing economies’ are already a bigger part of the world economy than their advanced counterparts, comprising about 60% of world GDP in purchasing power parity terms, according to the IMF. Yet, only some 10% of global equity fund holdings are allocated to emerging market economies, according to a study from the Bank for International Settlements. The allocation is even smaller for bonds, with only about 6.5% of global assets invested in EM securities.

Part of that could be explained by the lack of transparency and liquidity in many emerging markets. However, the underallocation is clear and fund flow data last year suggests the allocation has probably decreased further. Before the Global Financial Crisis, when emerging markets were more in vogue, more than 12% of global funds under management were allocated to developing economy stocks. It may be too soon to see emerging market equities take up their fair share of global portfolios, but eventually they will get there and the pioneers stand to gain more than the latecomers.

SECTOR BREAKDOWN

The MSCI EM Index is well diversified but it still has a slight sector skew (as most equity indices do). Understanding the industry distribution of an index can help investors avoid pitfalls and increase their returns.

Banks, for instance, dominate the MSCI EM, comprising about 15% of the index. However, internet stocks have taken an increased share of it, now accounting for some 13% of the gauge, followed by semiconductors at around 9%. Today, the largest four stocks in MSCI EM are: Tencent Holdings, Alibaba Group, Taiwan Semiconductor, Samsung Electronics and Naspers.

That also helps explain why EM stocks had such a bad year. Some of the worst-affected sectors globally were information technology and financial services, which underperformed even within the S&P 500. In EM, however, stocks in these sectors have the potential to generate higher returns than their advanced economy counterparts.

Banks, for instance, often have higher net interest margins in emerging markets, given that interest rates are usually higher there. They do, however, also have higher delinquency rates and do not always report them in the same way. In India, since the central bank began to enforce proper reporting, non-performing loan ratios have gone from 2%-3% to 10%-11% and sometimes higher for certain banks. Vietnam experienced something similar five or six years ago and is yet to fully address the issue. Analysts say that financial institutions in China and Indonesia also underreport delinquency and that actual numbers, if relayed under Western standards, could jump four or five-fold.

As for the internet, that is perhaps where the biggest opportunity sits in emerging markets. Some of the companies that operate in these places see even faster growth than their peers in the US or Europe. Looser regulation in some countries has also paved the way for new forms of technology companies, which are far more profitable and are taking the place of traditional players.
COUNTRY FOCUS:
BRAZIL

Last year, Brazil elected right-wing politician Jair Bolsonaro, a former Army Captain, ending more than 13 years of left-leaning governments. Markets have given the conservative candidate a resounding endorsement, with the Brazilian stock market outperforming most other markets in the fourth quarter, having rallied nearly 10% in dollar terms in the three months ended 28th December.

The excitement is warranted, though it could also mean a short period of underperformance in 2019. Mr. Bolsonaro has espoused a liberal agenda which has pleased global investors. However, navigating the local political environment to implement it may be more difficult. He has named a cabinet that accurately reflects a commitment to making Brazil a more efficient, market-driven economy. That may not be enough.

Markets have high stakes on two key pillars of Mr. Bolsonaro’s campaign pledges: pension reform and privatization. The two issues are highly sensitive and will face strong opposition in the Brazilian parliament. As these changes hit roadbumps, investors may be underwhelmed and Brazilian stocks could face some volatility.

CHINA

China is at a political and social crossroads and, perhaps because of that, the country’s stocks and bonds have not been performing at their full potential. Some of the key events that will shape the country’s future, and which were partly to blame for the economic slowdown and stock market rout last year, were defined last year.

In 2018, Xi Jinping, the President of the Communist Party, was able to ensure that he does not have to step down from his post when his term finishes, in 2022. It was the first time since Mao Zedong, the founder of the modern Chinese state, that a person has been allowed to remain in power indefinitely.

It may have been well-timed, as Mr. Xi had big issues to tackle which would probably require more power concentration than the previous political structure afforded. He began, for instance, to clean up what was becoming one of the biggest issues in the Chinese economy: excessive corporate and local government leverage. The deleveraging campaign has taken a toll on the economy, which grew ’only’ 6.5% last year, one of the slowest paces in 30 years.

Mr. Xi has also been at the forefront of pushing China up the value chain and making its society more focused on services than on manufacturing. The efforts have started to bear fruit. Factories now account for 29.3% of China gross domestic product, down from 32.3% 10 years ago, according to the World Bank.

However, assuming Mr. Bolsonaro sticks to his agenda and delivers on these two pledges, the benefits to the Brazil’s assets and its economy are hard to overstate. Since 2014, when the country entered one of the worst recessions in its history amid a wide-ranging corruption crackdown, Brazil has been downgraded four times and now sits deep into junk territory according to Moody’s Investors Service and S&P Global Ratings, whereas in 2013 it was an investment-grade credit. Along with the downgrades came a nearly 40% devaluation in the local currency, which helped depress the dollar returns for a stock market that was in free-fall.

Privatizing some of the inefficient state-owned companies would line the country’s coffers – which would help it reduce its relative indebtedness – and remove a drag on public finances. It could also improve investor sentiment and liquidity in the local market, providing a catalyst for global investors to increase their allocation to Brazil further. Pension reform would also mitigate what is now the biggest expense for the federal government.

The much improved fiscal situation that could derive from these two actions could prompt rating agencies to reverse course and, as progress is made, perhaps even return Brazil to investment grade in a few years. That would translate into large gains in Brazilian bonds and stocks in the longer term.
That was one of the main reasons for the trade war that President Donald Trump’s administration began with China last year. While both countries exchanged tariffs on mostly low-value-added products such as commodities and some manufactured goods, the US’s main demand was that China change its intellectual property policies. The Chinese have begun to abide, partly, by implementing, and enforcing, much more stringent intellectual property theft laws late last year.

For all their differences, however, President Trump and Mr. Xi have a lot in common. Both are pursuing far-reaching reforms and laying the groundwork for their economies to grow faster and more healthily in the next generation or so. The way Americans and Chinese operate, however, is different, and Mr. Xi is likely to continue making reforms one step at a time. As the country moves forward, it is likely to hit roadbumps, as it did last year, but investors cannot afford to ignore the world’s second largest economy, which is set to become the world’s biggest not too far in the future.
This year, India will see general elections, and as the date closes in there are increased signs that the ruling party could have a slimmer majority than analysts predicted early in 2018. The brewing political uncertainty could be a drag on Indian stocks until the polls close. However, once that hurdle is cleared, around the middle of the year, Indian markets could be poised to reverse the losses they incurred in 2018.

That is because many of the issues that caused the Indian currency and stocks to sell-off last year may no longer be such a hindrance in 2019. Dollar strengthening could taper off after Brexit is resolved and as the Fed approaches neutral interest rates, and oil prices are likely to remain range-bound, both of which are likely to offer some respite from the heavy depreciation the rupee suffered last year.

Amid a still strong economy, earnings growth is likely to pick up in 2019 and drive market performance, even if valuations for Indian stocks remain relatively high.

**INDIA REVISITED: ARE THE CHALLENGES BEING MET?**

India has remained a favourite destination for global investors as it remains the fastest growing major country in the world, on course to surpass Japan as the third largest economy by 2030, according to the IMF. However, a nagging current account deficit, dollar strength and a general aversion to emerging markets pushed the rupee down more than 9% in 2018, translating into losses in the equity markets as well.

The underlying reasons to invest in India, however, remain unchanged. The country is the largest democracy in the world, and could soon surpass China as home to the largest and youngest workforce on the planet. The country has grown 7.7% on average over the past decade, too, helping fuel the growth of the middle class to more than 270 million people, according to the National Council of Applied Economic Research. That rate is likely to continue.

Recent reforms have improved transparency and efficiency. India has moved up 53 positions over the past two years in the World Bank’s Ease of Doing Business ranking, sitting at 77 among 190 countries in 2018. Unlike other developing nations, India’s economy is well-diversified, with services, particularly software, accounting for 36% of exports. Growth, therefore, is not dependent on a particular product or commodity.

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**India’s GDP growth rate has been accelerating**

*Source: Ministry of Statistics and Programme Implementation*
INDIAN STOCKS: STILL PROMISING

A falling rupee and inflationary pressures, which forced the hand of the central bank to increase interest rates, weighed on Indian stock markets in 2018. The flagship BSE Sensex index, for instance, was 5.7% up by 27th December in local currency terms, but down 3.9% when expressed in US dollars. The sell-off was much deeper in the midcap and small-cap indices, which are more sensitive to interest rates, as they dropped 31.2% and 22.2% respectively in hard currency terms.

The currency move was mostly due to a sharp deterioration in India’s current account deficit in 2018. We expect the shortfall to close the fiscal year, in March, 2019, at around 2.5%-3% of GDP, compared to 1% in the previous fiscal year. Oil and gold were the biggest culprits of the deficit, as the two commodities account for 30% of total imports.

Rupee depreciation often translates into inflation in India, which helps explain why the Reserve Bank of India increased interest rates even as the economy showed signs of slowing down from a record pace of growth.

The source of the problem, however, bodes well for India in 2019. The currency depreciation has already forced a reduction of other imports and should help balance the current account better next year. Oil is expected to remain stable and the Fed is likely to be less hawkish about raising interest rates, curbing the strength of the dollar. That suggests the rupee could be more stable in 2019 and the RBI, under a new, more dovish governor, is unlikely to be so aggressive about raising interest rates. These dynamics could translate into gains for stock investors in India in 2019.

Investors will have to tussle, however, with the high valuations at which Indian equities still trade. Even after last year’s correction, the Sensex was trading at nearly 24x its previous 12 months earnings at the end of 2018. The country’s equity markets, however, are seen as high-growth plays, with profits expected to be growing at double-digit rates.

GENERAL ELECTION IN 2019

While the stage is set for Indian stocks to recover in 2019, first the country needs to clear the general elections, expected by May. There is a risk that no single party will get an absolute majority and the ensuing coalition government finds it difficult to continue driving reforms. The markets were ill-prepared for this potential outcome at the end of 2018.

However, that does not necessarily mean that, once the elections are out of the picture, equity markets will lose ground in India. Three out of the past four general elections resulted in coalition governments and in two of these three cases stocks were up a year after the polls. In fact, India’s history suggests that having a clear majority has little impact on markets.

LARGE AMOUNTS OF NON-PERFORMING LOANS ON BANK BALANCE SHEETS

Tight liquidity has been weighing on Indian markets, as bank lending growth has been constrained by the RBI's efforts to clean up the financial system. The implementation of the new Indian Bankruptcy Code and its enforcement by regulators have boosted gross non-performing loans at Indian banks to more than 10% of total advances.

As banks contend with these bad loans, they have been unable to expand their assets at the same rate as they used to. The worst of that process, however, is probably over and banks are likely to start lending more freely again in 2019, which would further boost the economy.
India’s valuation multiple remains high relative to its history.

Source: National Stock Exchange
MENA EQUITIES OUTLOOK
MUSA S M HADDAD
After a period of lackluster growth, Middle Eastern economies are set to gather pace in 2019 as governments spend more, buoyed by higher average oil prices and better fiscal positions. Even oil importers such as Egypt could perform well, supported by robust investment and private consumption. The IMF projects the region will grow 2.7% in 2019 after expanding a forecast 2.4% in 2018. We expect that to accelerate further to 2.9% in 2020. Countries in the Gulf Cooperation Council should have some fiscal freedom as FAB forecasts Brent crude prices to average US$70-US$75 this year. Aside from the positive economic backdrop, stock markets in Kuwait and Saudi Arabia could still benefit from index inclusion related inflows in 2019.

SAUDI ARABIA – INDEX INCLUSION CONTINUES TO BOOST THE MARKET

Higher oil prices and the consequent higher government spending are likely to translate into stable earnings growth in Saudi Arabia in 2019. This was already evident in the government’s expenditures in 2018. The IMF expects the country’s fiscal deficit to end the year below 6% of GDP, giving the government breathing room to spend more. That should compensate for a potential stabilization in private capital expenditures, which are being hampered by higher costs of doing business.

Still, earnings growth of about 15%, as seen in 2018, is unlikely to be repeated in the short-term, given that the increase was partly a reflection of weak earnings in 2017. However, a sell-off in the fourth quarter of 2018 improved valuations, setting the stage for strong returns in 2019. Banking, consumer discretionary and health insurance probably offer the best stock-picking opportunities, while the petrochemical space remains difficult.
UNITED ARAB EMIRATES – COMPELLING VALUATION AND ECONOMIC TAILWINDS

Dubai hosts the World Expo 2020 next year, the largest such event in the Arab world. The UAE government estimates more than 25 million people are likely to visit the country because of the event and boost local growth. The UAE economy has already started to recover, and the IMF forecasts real non-oil GDP growth to accelerate to 3.5% in 2019. A host of reforms including a reduction of licensing fees and 10-year visas for investors and professionals, as well as an AED50 billion stimulus package, will help boost non-oil GDP. This already helped the Abu Dhabi Securities Market General Index to be the second best performer in the world, up 10.6% in 2018.

Despite the relatively rosy prospect, Dubai’s Financial Market General Index lost nearly 27% in 2018. The drop pushed valuations to multi-year lows, with Dubai’s index closing the year at less than 7x expected earnings, driven down by real estate stocks. This supports the possibility of a strong rally in 2019. Banks are particularly well-positioned amid a round of consolidation, higher interest rates and an increase in the foreign ownership limit.
KUWAIT – DECLINING PROVISIONING AND INDEX INCLUSION PROVIDE A BOOST

A stable economic environment, a low geo-political risk premium relative to regional peers, the expected inclusion in major emerging market indices and low foreign ownership mean Kuwait is poised for a rally in 2019. Economic growth is likely to remain stable regardless of oil price volatility, thanks to the country's solid fiscal position. Kuwait's budgeted breakeven oil price is expected to remain below US$48/barrel, allowing the government to continue its investment program, expected to increase by 10% this year. The Central Bank of Kuwait has also held interest rates to support lending growth, which is likely to help non-oil GDP grow by 3% in 2019. The fiscal and monetary stimulus, together with expected modest inflation, are likely to foster a pick-up in private sector consumption, especially with VAT and subsidy cuts having been pushed further into the future. Large-cap banks are set to benefit from the adaptation of IFRS 9 slated for 2019, which will reduce their provision requirements and increase profitability. The regulatory tailwind, together with a stable economy, is expected to push earnings growth to about 13% this year.

EGYPT – MONETARY STIMULUS BOOSTS POTENTIAL

Egypt looks well-positioned to maintain its economic recovery as it sticks to the IMF program but begins to roll out more pro-growth measures. The country's immense potential remains intact, especially given its favourable demographics, with more than 50% of the 95 million Egyptians below the age of 24. Egyptian equities are undervalued, especially after the 30% correction since the country's benchmark index peaked, in April, 2018. The rally could be particularly strong if an expected interest rate cut materializes.

SECTOR OUTLOOK 2019:
MENA FINANCIAL SECTOR - HIGHER RATES TO BOOST MARGINS

Net interest for banks in the middle East are on the rise as central banks across the region have increased interest rate several times recently. Loan growth is also expected to pick up in 2019 as regional governments boost spending rates.
SAUDI INSURANCE AND HEALTHCARE – REGULATION SUPPORTS GROWTH

Saudi regulation requiring private sector employees to get health insurance is likely to push as many as 1.5 million people to get coverage, adding to the nearly 11 million currently insured. The requirement is likely to help health insurers increase gross written premiums by 24%, to SAR24 billion in 2019. The move is also positive for Saudi hospitals, as more insurance-related business could improve cash flows.

SAUDI RETAIL – DEMOGRAPHIC SHIFT FAVOURS DISCRETIONARY

The rising cost of living and government initiatives that favour employing locals have reduced the expatriate population in Saudi Arabia. This shift has impacted retailers that focus on consumer staples. Meanwhile, large electronics retailers showed solid results in 2018 and are likely to perform well in 2019 as a requirement that locals own 70% of many retail activities should prompt consolidation. The biggest, listed retailers have also been taking market share from smaller players.

PETROCHEMICALS – DEMAND GROWTH IS A CONCERN

The petrochemical sector outperformed broader Middle Eastern markets in 2018, supported by higher oil prices earlier in the year and strong demand from Asia. However, the reverse trend is kicking-in, now that oil prices have corrected. Furthermore, US chemical giants continue to add new plants, weighing on the prices and supply of chemicals, particularly in the polyethylene chain. Meanwhile, 2019 is unlikely to exhibit the Asia-led demand growth seen in 2018. Finally, last year’s rally pushed valuations above average historical multiples, reducing upside potential.

REAL ESTATE – OVERSUPPLY AND RISING RATES SUGGEST CAUTION

UAE property markets saw rental yields and property sales drop in both Dubai and Abu Dhabi as rising interest rates and excess supply took a toll. The softness came amid a slow growth backdrop that prompted the government to increase foreign ownership for UAE-based enterprises and to offer 10-year residency visas for investors. These initiatives are promising, but may not be sufficient to boost property prices significantly in the short-run. Industry players with strong cash flows are best positioned to ride out the downturn.
Egyptian real estate companies benefited from a booming market last year. While investors should expect growth rates to normalize, listed developers (which target mostly high-end buyers) have been able to increase prices while addressing affordability by changing unit sizes and offering easier payment plans. Development costs, however, are rising as non-listed developers bid up land auction prices.

**TELECOMMUNICATIONS – COMPETITION AND SLOWER GROWTH**

The telecoms sector in the Middle East continues to face headwinds, after a tough 2018. Slower growth, higher taxation and saturated markets are likely to continue weighing on profitability. Viva (Kuwait) and Ooredoo (Oman) are perhaps the notable exceptions as they offer attractive dividend yields and have outperformed in the local markets.
‘If the US dollar goes up, commodity prices fall’ is a common statement. While there is truth in that, it is an over-simplification. US dollar strengthening in 2018 increased the local currency cost of raw material imports in non-dollar terms, and therefore impacted demand for them. Of a list of 45 basic resources recently reviewed by Bloomberg, 42 are mainly traded in US dollars - so the broad outlook for the greenback will continue to be a key determinant of many commodity prices. As the IMF has pointed out, however, when supply factors rise above about 60% of causation, the direction of the dollar becomes less important. While supply responses to changes in commodity demand can be cumbersome, when supply tightens prices can really move.

However, demand issues should be kept in perspective. As economies grow, proportionately less is spent on commodity-intensive goods, and more on services – Bloomberg has noted that the services component of Chinese GDP rose from 34% in 1995 to 52% in 2017. Renewed US-China tariff and trade negotiations are also taking a bite off global growth and demand, with corporate capital expenditure curtailed or frozen and supply chains interrupted. It was logical that the IMF recently downgraded its estimates for global economic growth for 2018 and 2019, while an increasing number of commentators are factoring-in the next recession.

We believe, however, that today's lower commodity prices have already discounted most aspects of lower global growth assumptions, and that the US and the world should still see a long growth cycle. Also, any de-escalation of the US/China trade war could positively affect commodity prices, as overall sentiment determines the extent of 'risk-on' (or 'off') in markets. This determines how 'long' commodity traders are prepared to go (they usually show less propensity to go short, given the disproportionate risks of doing so).

While the US dollar does not always dictate the path of commodity prices, the current phase of dollar strength is unlikely to persist far into 2019. If such a view is proven correct, positive sentiment and higher prices will return to the commodity space, accentuated by net long positioning.
Commodities as a class had a lackluster year in 2018. The Bloomberg Commodity Index of 22 raw materials was down nearly 13% in 2018, and ended the year 16.2% below its May closing high. Brent crude was 19% lower in the period (at US$53.8/barrel), and 37.7% below October’s high of US$86.3. Base metals (as per the LME Metals Index) fell 18.1% last year, with bellwether copper (at US$2.63/lb) down nearly 20.3% from its June high of US$3.30/lb. Iron ore futures traded in Dalian (in dollars) were strong during the last month of 2018 (up almost 10% in the first two weeks of December), reflecting perceptions that the trade war with the US would subside. Iron ore, the key raw material used in steelmaking, has reflected the imposition of US tariffs on steel imports, Chinese steelmakers’ substitution for scrap, and China’s environmentally-based production curbs on major steel mills. Steel prices in the New York Mercantile Exchange were 8% higher in 2018, but 22% below the early-June highs; yuan-denominated steel rebar spot prices in Shanghai were down heavily (by 18%) from their October high at year-end. Coal prices were quite strong for much of last year, due to tight supply.

Gold was more than 2.6% lower in 2018, at US$1,282.5/oz, with some recovery logged in December, commensurate with a dollar index that was 4.4% firmer last year, with a closing high and low of US$1,358 and US$1,174. The yellow metal remains without a substantial immediate trigger, and against the background of higher investor tolerance for macro risks, as well as jewelry demand being weak at times when seasoned observers would have expected better demand (festivals). More speculatively-driven silver, at US$15.5/oz, was down 8.5% on the year, with the gold/silver ratio (at 81.9 at the time of writing). Platinum was down 14.3%, but palladium was 19% ahead (at US$1,261), while rhodium, another platinum group metal, was up about 43% in what are very small markets seeing limited supply.

Agricultural product prices were 2.5% lower over the period, according to the Bloomberg Agriculture Index. Weather-related supply shortfalls in wheat, cotton and cocoa were smaller than expected, capping price upside, while the trade war also held prices down. Bad weather is once again expected to reduce the harvests of many grains and oilseeds this year, while livestock diseases appear to be a growing problem. The IMF recently said agricultural product prices are reflecting “diminishing excess supply”.

China deserves a special mention, given its position as consumer of 40-50% of global raw materials. In last year’s Outlook we suggested Chinese growth could fall towards 6.5% annualized, and that has occurred, with that slowdown hurting commodity prices, especially base metals. There had been a deleveraging campaign in China, born out of prudence, but which was becoming too painful – and again, that was before the trade war. So the authorities have moderated or reversed various earlier measures out of sheer necessity. The ‘economic rebalancing’ away from an industrial-based economy hit the construction and engineering sectors, which historically underpinned consumption.

A few months ago, however, the central bank directed banks to lend more to industrial entities, and planning authorities have reemphasized infrastructure spending. In addition, exporters were helped by the yuan being allowed to depreciate by almost 10% against the US dollar since April. At the end of 2018, the Caixin Manufacturing PMI had bounced slightly to 50.2 in November, just above the 50 reading separating expansion from contraction.
**BASE METALS:** Copper, the bellwether of base metals used in numerous manufactured products, will benefit from usage in renewable energy and electric vehicles, and continuing Chinese infrastructure spending. The world (especially emerging markets in Asia) will need increasing amounts of it. The fundamentals have begun to improve markedly, even if overshadowed by negative Chinese and trade sentiment. Global copper inventories have seen a sharp decline since last March, despite the slowdown in Chinese demand and fewer mine disruptions.

Supply deficits are likely to emerge in copper, as the two largest mines in the world will produce less in 2019 (BHP Billiton’s Escondida mine in Chile, and the Freeport-McMoRan-operated Grasberg mine in Indonesia). Average ore grades are also falling, yielding fewer ounces of copper concentrate per ton mined. In 2019, there is the chance of breakdowns in labour negotiations at Codelco’s Chuquicamata and other mines in Chile, including Escondida. Costs have risen, and copper prices have been depressed.

Prices should recover if or when (a) China’s growth slowdown moderates, (b) trade concerns recede, (c) the dollar weakens, and (d) China’s urban rail network and other infrastructure initiatives continue to be rolled-out. The World Bureau of Metal Statistics also sees the likelihood of a wider demand-supply gap for all base metals, and especially for aluminium. The fact that it is a light and versatile metal used in the transportation, packaging and construction sectors stands it in good stead.

**GOLD AND OTHER PRECIOUS METALS:** Gold’s returns have been remarkably varied, and it has been crucial to get the timing right. The all-time closing high (US$1,772/oz) was in 2012, against US$1,282.2 at 27th December 2018, with investors caring less about gold as a hedge, and having displayed a higher tolerance to the world’s macro risks.

Gold production plus scrap recovery is still exceeding total demand. According to the World Gold Council, mined supply of gold was at a record quarterly high in the third quarter (at 875.3 tons), and recycled gold was 306.3 tons, making for total supply of 1,181.6 tons. Total demand of 964.3 tons was just six tons higher year-on-year. Global jewelry off-take was 535.7 tons, up 6%, as lower gold prices attracted some buyers. In India, third quarter jewelry demand grew by 10%, to 148.8 tons, although this compared to a very weak third quarter of 2017. Chinese jewelry demand exceeds that of India, and was 174.2 tons in the third quarter, 10% better than the same period a year earlier. Indian jewelry demand has disappointed as rural demand failed to meet market expectations; Chinese jewelry demand would have been better had citizens not prioritized more world travel over shopping.
Net central bank reserve demand rose 22% year-on-year in the third quarter of 2018, to 148.4 tons, with the highest quarterly net purchases since 2015, and with more central banks buying. The buying was led by Russia (which has replaced most of its US Treasury holdings for gold), followed by Turkey, Kazakhstan, India, and Poland. Physical bar and coin demand jumped 28%, to 298.1 tons in the third quarter of 2018, driven by Chinese retail investors who bought into price weakness towards US$1,200 and as their equity markets corrected.

Diversification remains a key driver for central bank gold purchases, especially for hedging against any future US dollar weakness. Portfolio investors have historically bought gold as an inflation hedge, but the view of US inflation expectations (via 2, 5 and 10-year ‘break-evens’) has recently plummeted. Money manager gold positioning statistics suggest they are only slightly net-long, having recently been net-short. Having said this, gold has little or no counterparty or credit risk, and remains an excellent portfolio diversifier. The gold market has some built-in stabilizers – low prices (i.e. maybe below US$1,200) bring out improved jewelry and long-term hoarding demand, while high prices (perhaps above US$1,400) encourage increased scrap recovery/dishoarding. Between these two extremes institutional investor and speculative demand drives prices.

For the time being we would not be overweight in gold, as we perceive a ‘risk-on’ investment environment in 2019. Dollar gold prices will take their cue from the dollar itself, and as discussed elsewhere in this book we believe the overall trend in the greenback will reverse to the downside later this year, which could help gold.

Turning to silver, the latest Silver Institute market review suggests there was a larger market surplus for 2018, with analysts expecting another surplus in 2019. Mine supply has risen, and industrial demand has come under pressure globally, with a decline in solar demand offsetting growth in the electrical sector. Silver has also not been favoured by investors.

In platinum group metals (PGMs), platinum is currently in surplus, but we believe this could easily move into deficit. Platinum prices have suffered because diesel cars (whose catalytic converters account for about a third of demand) are going out of fashion. However, from last year, new automobiles in the US were required to follow more stringent emission standards, and much of the rest of the world should follow, while from January, 2020, world shipping will also be subject to tighter emission standards to emit less sulphur and carbon. At the same time, South Africa has continued to reduce production in the face of low prices. Within the platinum group metals, although platinum has the best overall catalytic qualities, palladium improves thermal conductivity, justifying its role, and presumably its price, with experts assuming another deficit for 2018 (the sixth in a row), and another in 2019.
SOFT COMMODITIES: Increasingly unpredictable world weather and trade tariffs are making life difficult for the world’s farmers. For instance, drought in northern Europe last year disrupted wheat, barley and other crops, while soybeans and grains were hit as China started implementing retaliatory tariffs on US goods. The disruptions in trade and supply chains inherent in such a complex environment could be large, and must be bullish for prices once bearish trade sentiment factors subside. Complicating the outlook for many soft commodities is the risk of the El Niño weather pattern, which could cause below-average rainfall. As of 3rd December, the National Oceanic and Atmospheric Administration said El Niño was expected to form and continue through the Northern Hemisphere winter with an 80% probability (up from 70% in August), and to continue into spring (55%-60% probability). Selected opportunities are taking shape; for instance, expectations for declining global output in wheat are driving optimism (with prices ahead 17.8% in 2018). Percentage moves in individual markets can be substantial (e.g. 25%-40% price changes over a few months are common), and trading is only for pros. In terms of an investment approach we would advocate a ‘sectoral basket’ in the first instance.

CONCLUSIONS

The FAB Asset Allocation Committee (AAC) has for some time had a very underweight position in commodities, although it could become much more optimistic early in 2019. The combination of a continuing ‘long’ global economic cycle, a reversal in US dollar strength, the power of Chinese infrastructure investment, and/or a perceived de-escalation in trade risks could result in commodity price upside being triggered. Supply-side tightness is uppermost in our thinking – demand factors alone do not hold the key. Any eventual strengthening in the yuan should facilitate renewed Chinese demand for natural resources – and be the icing on the cake – with overall demand being shaped by still-bullish prospects for Asian economic growth.
Global commercial real estate (CRE) investments have continued to rise on the back of steady economic and employment growth in key global markets. This is despite concerns regarding various country tax reforms, the unknown impact of trade tariffs, Brexit, and the flattening of the benchmark yield curve. Long term interest rates have fallen to very low levels in recent years, which has led to a substantial increase in property values. We estimate that global commercial real estate prices have risen by 85% since 2009.

The concern is now what a rising interest rate environment could do to global property prices as quantitative easing is no longer needed to support growth amid a global economic recovery. The good news is that while long term rates are expected to increase they are expected to do so only moderately over time and while that may put some upward pressure on property capitalization rates and rental yields the potential impact is small.

According to JLL, investment in global commercial real estate for the nine months ending September 2018 stood at US$507 billion, a 7% increase from a year earlier. JLL forecasted total investment volumes for the year would hit US$730 billion, with a slightly lower number of US$700 billion expected for 2019. In short, the prospects for the global CRE market in 2019 remain positive, though some moderation in activity levels and volumes should be expected.

While the consolidated global picture and outlook for 2019 is relatively rosy, not all markets behave the same and supply-demand fundamentals can vary significantly from more mature investment markets to emerging economies. Here are some key trends to consider when investing in real estate this year.

**UAE – NEAR THE BOTTOM**

Many adjectives have been used to describe the UAE real estate market in 2018, with ‘soft’ and ‘subdued’ the most prevalent. None of the traditional sub-sectors of retail, residential, office or hospitality have enjoyed much growth, with most recording declines, most notably the mall and residential spaces. While the Dubai market remains in the late downturn stage, with some further declines expected, Abu Dhabi (which traditionally lags Dubai) may see further softening before growth returns.

However, the UAE government continues to breathe new life into the sector. A significant portion of the recently approved record federal budget of AED60 billion is being allocated to education and social spending and coupled with the recently launched ‘Ghadan 21’ project (a three-year AED50 billion Abu Dhabi government program) are expected to positively impact the real estate sector. While these stimuli may take time to move the dial, more immediate initiatives such as relaxing tourist visa requirements, creating 10-year residency visas for certain retirees, relaxing mortgage limits for banks, and creating more freehold investment opportunities for non-UAE residents are all expected to help drive a recovery in our home market.
UK – THE BREXIT FACTOR

From an economic perspective, commercial property has two key components: the investment market (owners) and the occupational market (tenants). The performance of the UK occupier market in 2018 suggests that the Brexit factor has had little impact on the real economy. UK investment market data has suggested, so far, that the initial response to the ‘Leave Vote’ has faded, though that may not be exclusively down to the vote but also due to positive market drivers.

Colliers International and Knight Frank projections suggest that office take-up in 2018 in London was better than the prior three years and that the big six central business districts outside London probably had their strongest year in the last 10 in 2018. Retail, on the other hand, has faced a difficult period, as the EU vote compounded with changes in consumption patterns and technology disruption. The subsequent weakening in the British pound has also squeezed margins further.

While investment volumes dropped in 2018, they did so only marginally. The side effects of the Brexit vote appear to have helped support investment activity – the weakening of the British pound has provided an attractive relative discount, and added uncertainty, which typically leads to capital flowing to liquid, mature, safe haven markets such as the UK. Despite Brexit, demand for UK commercial property is generally stable and prices are holding up.

US

For all his polarizing rhetoric, President Donald Trump’s administration has seen a strong macro-economic backdrop in the United States. The US economy is in the second-longest growth cycle on record. This has supported strong investment volumes into US commercial real estate in 2018 and this trend is expected to continue into 2019 despite a rising interest rate environment. Investment volumes in the US were up 11% in the first half of 2018, at US$122 billion, according to Deloitte. Interestingly this was despite a modest easing in inbound capital flows, compensated by increased activity levels from domestic investors. The composition of cross-border investors has shifted quite noticeably, with buyers from Canada representing a one-third higher share of overall foreign purchase volume in the first three quarters of 2018.

All the traditional sub-sectors of office, industrial, multifamily, retail and hotels have seen strong investment sales growth in 2018, with multifamily in particular seeing a significant surge in transaction activity. Investors have recognized the sector’s outperformance in this cycle, pushing it past even office as the most actively traded sector.

So what’s driving the performance in this sector? Very simply, it is a combination of lower vacancy rates, rental growth and strong fundamental improvement, particularly in markets in the so-called ‘Sunbelt’. Private buyers accounted for almost two thirds of multifamily acquisitions in the first three quarters of the year, with institutional investors and REITs struggling to keep up and deploy capital.
In the office market, new supply has led to a flight to quality and growing vacancy among secondary properties. Thematically the continued rise of co-working spaces does not appear to be slowing yet, a trend many considered temporary.

Growth is expected to moderate in 2019, however. Trade policy and higher short-term rates could add volatility and impact investor sentiment.

However, some sectors, such as industrial real estate, which was boosted by exceptional demand from e-commerce and other logistics requirements, could benefit from disrupters. Finally, debt markets remain strong, with competition in the space driving higher leverage and lower margins. This, coupled with investor ‘dry powder’ at an all-time high of US$180 billion, suggests 2019 looks exciting for the savvy buyer.

EUROPE

Although GDP growth rates vary greatly from one country to the next, the economic backdrop as it relates to the property markets is expected to remain healthy in 2019. The search for secure, stable income has continued to underpin Europe’s real estate. While the industry is generally upbeat about 2019, the short term outlook is more sober in most markets compared to this time last year.

Interest rates have come to the fore as the European Central Bank decided to curb quantitative easing at the end of 2018. However, the prospect of modest rate rises is unlikely to be a threat to activity levels in 2019.

PwC’s Emerging Trends in Real Estate Europe 2019 survey cites German cities among the top 10 picks despite already high volumes of transactions there. That should not be a surprise, given that the industry prizes safety of scale, liquidity and growing economies.

In general, European real estate remains highly liquid overall and with an expected increase in international capital from Asia, and Japan in particular, the biggest challenge will remain how to deploy capital effectively and achieve the sustained cash flows investors cherish. To this end many are looking to alternative real estate and residential, including student housing, retirement homes and assisted living, serviced apartments, social housing and even co-living.

Another emerging trend for 2019 in Europe is the expected increase in investment from high-net-worth individuals, who see an opportunity to buy a trophy asset and take a long-term view. This increase is expected to also focus on funds and property across the board. Furthermore, with a deep pool of equity and a strong debt market featuring a growing presence of alternative lenders, it is not difficult to see why the best assets in the best locations will continue to trade at tight yields.
RETAIL... STILL ALIVE?

The issues facing retail have been widely acknowledged for some time, but this year the concerns over the sector appear to have risen to a new level. In the US in particular over 2,500 retail locations closed during the first half of 2018, with high profile and household names such as Sears and Toys ‘R’ Us having shut down. Out-of-town shopping centres and retail parks are hurting the most. The US retail market is not alone in feeling the pain of online shopping. The UK market, which has more retail space per capita than continental Europe, is facing similar challenges. So much so that investors are contemplating acquiring cheap secondary shopping centres for their alternative use value if redeveloped into logistics or residential units, for example. As is the case with other out-of-favour assets, debt markets have followed suit with muted credit appetite compounding the problem.

It is not all doom and gloom, however. Evidence of a wage growth revival should lead to a boost in consumer spending. How much of that will happen in physical shops is yet to be fully seen. What is evident across the globe, is that the continuing emphasis on the customer experience means that the mix of non-retail tenants, including F&B outlets, fitness and leisure centres, is expanding and the market is becoming more fluid and more adaptable to the changing tastes of its consumers.
FOCUS ON SAUDI ARABIA

GLENN WEPENER
SAUDI ARABIA’S SHIFTING SANDS
Various media headlines, combined with investors and analysts’ preoccupation with the Aramco IPO, has to some extent over the past two years obscured the actual progress made in the Kingdom’s drive towards diversification. Of course, this process has a long way to go and significant hurdles still need to be overcome, but there should be no doubt that it has begun. In this article, we will try to highlight some of the key achievements made so far within Saudi Arabia’s ‘National Transformation Plan.

SUPPORT FOR CHANGE
Almost 70% of Saudi Arabia’s population is under the age of 30 and this underscores the necessity for the country to transform its heavy reliance on oil into an economy which is more diverse and sustainable. Both King Salman and his son, Crown Prince Mohammed bin Salman, are the primary drivers of the ‘Vision 2030’ diversification program, an initiative which is keenly supported by the majority of the Kingdom’s citizens, especially the young. An example of the level of this support was revealed in the 2018 Arab Youth Survey, which suggested that 94% of women and 91% of men aged between 18-24 years old in Saudi Arabia believed that the transformation plan will work. It also showed that nine out of 10 young Saudis held a positive view of the Crown Prince.

SOCIAL REFORMS
The decision to substantially weaken the powers of the ‘Mutawa’ (religious police) over the past few years was welcomed by many Saudi citizens, especially those living in urban areas, and likely formed a part of the Crown Prince’s publicly stated aim to return the country to a more moderate form of Islam.

Another key social reform which was instituted in June last year was the lifting of a ban on women driving, a restriction that had been in place since 1957. The removal of this rule may have seemed to outsiders to be a relatively unimportant initiative, but in Saudi Arabia this was an extremely significant event. It will also have a positive economic impact and not just for driving schools, insurance companies and vehicle retailers, which are all set to benefit directly from the emergence of an estimated three million female road users by 2020. The ability to drive has made it easier for women to seek employment and consider more entrepreneurial opportunities, especially after the authorities also abolished the need for a female to obtain the prior consent of her husband or male guardian with regards to such activities.

The government has already committed to boosting the number of women in the workplace to 30% by 2030 from the current level of around 22%. In 2017, the number of Saudis in fulltime employment increased by 102,000 of which 64,000 were women, and over time a higher rate of participation by female workers should also boost household income and consumer spending. Meanwhile the first woman to head the Saudi stock exchange was appointed in February, 2017, and this was followed in early 2018 by the induction of a female as the first deputy minister of labour.

“What happened in the last 30 years is not Saudi Arabia. What happened in the region in the last 30 years is not the Middle East. After the Iranian revolution in 1979, people wanted to copy this model in different countries; one of them was Saudi Arabia. We didn’t know how to deal with it. And the problem spread all over the world. Now is the time to get rid of it. We are simply reverting to what we followed, a moderate Islam open to the world and all religions. 70% of the Saudis are younger than 30, honestly we won’t waste 30 years of our life combating extremist thoughts, we will destroy them now and immediately,”

ECONOMIC DIVERSIFICATION

REFINING AND CHEMICAL SECTORS: While the long-awaited IPO of Saudi Aramco is on hold for now, this has not stopped the crown jewel of the Kingdom’s economy from pursuing a drive to become not just an oil giant but a global refiner and chemical manufacturing company too. Its planned purchase of SABIC forms a part of this drive, but Aramco also unveiled plans in late 2018 to spend US$500 billion over the next 10 years in doubling its refining capacity, to invest in new natural gas projects and to acquire further relevant assets around the world, especially in Asia and Africa.

ENTERTAINMENT AND TOURISM: In April 2018, commercial cinemas reopened in the Kingdom for the first time in 35 years and more than 300 unsegregated theatres are reportedly set to be constructed over the next ten years. The entertainment sector is one of the focus areas within ‘Vision 2030’ and US$64 billion has been earmarked to develop this part of the economy in the coming years, including the hosting of various sporting events and music festivals, as well as the establishment of a national opera house. Meanwhile although over 18 million people travel to Saudi Arabia every year, the bulk of these visitors come for business, religious pilgrimage and family reasons as tourism visas have not really existed. This situation is changing fast and tourism could eventually consist of various mining-related activities, including a phosphates plant, with the capacity to produce 3 million tons of fertilizer per year. The latter has definite potential as Saudi Arabia holds an estimated 7% of the world’s phosphate reserves.

MINERALS: The mining sector is also undergoing a transformation, with an increased focus on utilizing the country’s reserves of gold, copper, uranium and phosphates. In this regard the King was on hand to inaugurate the ‘Waad Al Shamal’ mining complex in November last year, which once completed, is forecast to boost Saudi Arabia’s non-oil related GDP by three percentage points. This new industrial zone in the north of the country will eventually consist of various mining-related activities, including a phosphates plant, with the capacity to produce 3 million tons of fertilizer per year. The park will also provide a range of complimentary services such as energy exploration and production expertise, supply chain management, liquids treatment and electrical engineering. A number of international firms have already signed agreements to participate in Spark, including Baker Hughes, Halliburton, Schlumberger, Raytheon and Valvospain, while negotiations are reportedly ongoing with a further 120

Jordan, beautiful beaches and islands along the Red Sea coast where international resort operators are already eying opportunities, the famous Camel Festival, which offers a glimpse into Saudi culture, and the port city of Jeddah, believed to have first been inhabited in 115 BC.

MANUFACTURING: On 12th December 2018 Crown Prince Mohammed bin Salman inaugurated a 50 square-kilometre industrial and technology park called ‘Spark’ in an eastern province of the country. Construction began towards the end of 2017 and the first phase is set to become operational by 2021. This megaproject aims to become home to over 300 small and large scale industrial manufacturing and service companies which will be responsible for supplying and exporting locally made equipment to the oil and gas sector including pipes, tanks, valves, pumps and drills. The park will also provide a range of complimentary services such as energy exploration and production expertise, supply chain management, liquids treatment and electrical engineering. A number of international firms have already signed agreements to participate in Spark, including Baker Hughes, Halliburton, Schlumberger, Raytheon and Valvospain, while negotiations are reportedly ongoing with a further 120
industrial investors. Spark is located close to major road and rail networks and will eventually contain a dry port.

**FINANCIAL MARKET REFORMS:** On the financial front and in an effort to attract foreign investors into the Saudi stock market (the largest in the Gulf region), the country’s Capital Markets Authority enacted a series of regulatory changes last year, including a hike in foreign ownership limits, easier registration for qualified foreign investors (QFIs), a more efficient and transparent clearing and settlement process as well as authorizing short-selling and securities lending. These changes were instrumental in getting MSCI and FTSE-Russell to include Saudi Arabia in their Emerging Markets indexes and, by October, 2018, over 300 foreign QFIs had reportedly registered with the exchange. Fintech is another area of focus and the development of this sector was kickstarted in July, 2018, when the CMA approved the first ever issuance of such licenses for local companies.

**EASE OF DOING BUSINESS:** The removal of red tape and other impediments to conducting business in the Kingdom is continuous and has already seen the establishment of a commercial arbitration centre, the introduction of a comprehensive bankruptcy law, and a reduction in customs clearance times for containers to just 24 hours from two weeks. Meanwhile, Saudi Arabia’s General Investment Authority has begun working with the World Bank to identify further areas requiring reform in order to attract greater foreign direct investment and improve the country’s current global ranking of 92 out of 190 countries in the ease of doing business.

**Saudi Arabia Real GDP Growth (% YOY)**

After slowing down in 2016 and 2017, economic growth is expected to rebound this year.
CONCLUSION

The achievements listed above are not exhaustive and do not include other successful diversification steps, such as the implementation of a value-added-tax in January last year, privatizations, a crackdown on corruption and the merging of duplicate ministries. There are admittedly challenges ahead. However, when assessing Saudi Arabia’s progress in weaning itself off its still heavy reliance on oil revenues one should bear in mind that this was never going to be a straightforward or simple project. To help meet its economic goals, the country is currently undergoing necessary societal changes. The international community should continue to support this transformation process, especially given Saudi Arabia’s strategic importance in the world as a whole.
FOCUS ON EMERGING AFRICA

GLENN WEPENER
Since the local currency was floated in 2016 and the country signed up to an IMF-led reform program, Egypt’s economic recovery has been impressive, as has the commitment of Abdel-Fattah El-Sisi’s administration to stick to its austerity program, despite certain domestic social and political risks in doing so. However some clouds have begun to appear on the horizon and these will need to be cleared before the country can achieve its full potential.
POLITICAL STABILITY

The Egyptian government’s strict adherence to its reform agenda these past few years may have surprised some analysts, but its undeniable success was highlighted by the IMF and the World Bank recently, when they congratulated the authorities for their efforts in this regard. “The Egyptian economy has continued to perform well, despite less favorable global conditions, supported by the authorities’ strong implementation of the reform program,” the head of the IMF mission to Egypt, Subir Lall, said in a statement last October. The ratings agencies have also expressed satisfaction with Egypt’s performance thus far, with both Moody’s Investor Services and Fitch Ratings amending their ratings outlook on the country from ‘stable’ to ‘positive’ in 2018.

Such progress would not have been possible without the restoration of political stability and security after almost four years of severe upheaval following the 2011 uprising. In January, 2014, a new draft constitution was approved via referendum and just two months later Mr. Sisi, a former general, was elected as president. In order to transform his country, Mr. Sisi has had to take tough and potentially risky decisions, some of which displeased sections of Egyptian society. However, the country’s economy is in a far healthier state now than it was in 2014, while the overall security situation has also improved significantly. It should also be noted that generous support from some GCC states, including Saudi Arabia, Kuwait and the United Arab Emirates, helped Egypt successfully navigate this difficult transition period.

DEVALUATION AND REFORMS

On 3rd November, 2016, the Egyptian Central Bank devalued the local currency’s exchange rate against the US dollar from 8.88 to 13.00. At the same time, the government signed up to a three-year IMF reform program, which included US$12 billion in financial support via a series of loan tranches, the last of which will be released in 2019.

Spot USD/EGP experienced some initial volatility following the above actions and touched the 20.0000 level at one stage. Since then, however, the market has stabilized and remained within a remarkably stable 17.65-17.95 range for most of last year. A much more transparent currency policy, combined with high-yielding assets and a credible reform program, has reignited foreign investor interest in the country leading to an influx of hard currency, which in turn boosted the Central Bank’s foreign currency reserves to over US$44.51 billion in November 2018 from just US$15.5 billion in July 2016. Remittances by Egyptian expatriates overseas also improved, rising to US$26.4 billion during the 2017-18 fiscal year compared to US$17 billion in 2015-16.

These flows have also helped to clear a significant backlog of outstanding external payments, while the improved liquidity situation encouraged the Central Bank to shut down its foreign exchange repatriation mechanism for foreign investors in December 2018. This mechanism had been established when the country was suffering from a severe shortage of hard currency, but far fewer investors were using it last year, especially as it became cheaper to use the standard interbank market.
TOURISM REBOUNDS

A more competitive currency and a significant improvement in the overall security situation has been key in helping to breathe life back into the tourism sector, which remains a key part of the economy, not just in terms of hard currency revenues, but more importantly because it provides employment to hundreds of thousands of Egyptians both directly and indirectly. Following the revolution in 2011 and a series of terror attacks, annual visitor numbers to Egypt collapsed to just 5.4 million in 2016 from a high of 14.7 million in 2010. This gloomy picture has begun to reverse over the past two years, with 8.3 million foreign tourists travelling to Egypt in 2017, who in turn helped to raise this sector’s revenue by 123% year-on-year to US$7.6 billion. Last year should prove to have been even better, boosted by the resumption of flights by various EU and Russian travel operators. Highlighting this recovery was the news that the World Travel & Tourism Council had ranked Egypt as the fastest growing travel destination in 2018.

Meanwhile, consumer price inflation, which hit a record high of 33% in July 2017, has now absorbed the impact of a weaker currency, the introduction of new taxes (e.g. VAT) as well as a sharp reduction in subsidies. At the time of writing, CPI was last recorded at 15.7% for November, 2018. Inflationary conditions have not been completely subdued, however, especially after Egypt implemented a 50% hike in fuel prices and raised electricity charges by 25% in line with its economic reform program. This situation, as well as some emerging market jitters as the US and Europe have begun to move away from a long period of ‘quantitative easing’, means that Egypt’s monetary policy has been kept relatively tight. Despite this, domestic economic growth has not as yet been impacted, with Egypt seeing a healthy 5.3% GDP expansion in 2018 from 4.2% the previous year. We anticipate this will rise towards 5.5% in 2019, supported by rising exports and better operating conditions for local businesses. The budget deficit picture is also looking healthier after coming in at 9.8% of GDP in the 2017-18 fiscal year – the government has said it is still targeting a level of 8.4% in the 2018-19 fiscal year, though firmer oil prices could make further gains on this front somewhat harder to achieve this year.

The local banking sector has benefited from the better economic environment too, supported by a rise in domestic credit growth and fees, which in turn has boosted profitability. According to a recent Moody’s report, the sector’s non-performing loan ratio should remain broadly unchanged from its current levels of around 4.5%, and the largest Egyptian banks currently all exceed their regulatory minimum capital requirements.
GAS TO THE RESCUE

In 2015 a number of significant gas discoveries were made off Egypt’s Mediterranean coast, including the giant ‘Zohr’ field that holds an estimated 30 trillion cubic feet of natural gas and which became operational in 2018. This field, combined with other gas wells such as ‘Atoll’ and the West Delta’s ‘Taurus’, means that the country became self-sufficient in this energy source late last year and is likely to become a net gas exporter by the end of 2019. In order to maintain such momentum and encourage further foreign investment and exploration in this sector, the government has reworked its cumbersome production contracts. This decision is already bearing fruit and a number of international companies are now bidding on new tenders in the Red Sea region.

At the same time, the government has also realized that it cannot rely on gas alone to meet all of its domestic power needs, especially as the country’s population is set to breach the 100 million mark soon. Therefore it has started to diversify this supply mix by authorizing the construction of various other energy generators, including a nuclear plant, new coal-fired facilities and solar fields. Such diversification will hopefully help to reduce Egypt’s overall energy bill and redirect more of the budget towards other key areas, such as health and education.

HURDLES REMAIN

Despite the achievements listed above, a number of challenges remain and will need to be met in the years ahead. For example, unemployment especially among the young remains high, and, while the IMF’s three-year program comes to an end this year, Egypt will need to continue to implement further structural reforms such as providing more incentives for the private sector and overcoming labour market inefficiencies to create more jobs. The removal of remaining red-tape, including complicated customs tariffs, is also important if Egypt is to become more competitive. This issue was underlined in the World Economic Forum’s latest ‘Global Competitiveness Index’, in which Egypt was ranked 94 out of 140 countries. Meanwhile the country’s national public debt load reached EGP3.695 trillion (US$206.2 billion), or more than 83% of GDP, at the end of June last year, according to data released by the Central Bank, while the government expects external debt to hit US$102.86 billion during the 2018-19 fiscal year. At the same time, Egypt faces around US$24 billion in maturing obligations over the next two years. A large portion of this consists of low-interest loans from GCC states and thus will probably be rolled over relatively easily, but the government will need to keep an eye on its borrowing levels going forward.
CONCLUSION AND FORECASTS

Egypt has made a remarkable turnaround over the last few years and we maintain an optimistic outlook for the economy going forward. The challenges of creating more jobs, reducing debt and keeping the country on a sustainable growth path lies ahead, but Egyptians, supported by their regional and international allies, have the ability and the opportunity to overcome these hurdles while keeping this strategically important country on track towards a brighter future.

EGYPT - KEY INDICATORS 2018*

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<thead>
<tr>
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<th>FX Regime</th>
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<tbody>
<tr>
<td>97 million</td>
<td>5.3%</td>
<td>98%</td>
<td>10%</td>
<td>15.7%</td>
<td>US$44.5 billion</td>
<td>Managed float</td>
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*Estimates: IMF/WB/FAB
Ethiopia’s economy has been expanding rapidly over the past decade and was the best-performing country in the continent for the 2016/17 fiscal year, with GDP growing 10.9%, according to the IMF. This rate is forecast to slow to 8.5% in 2018/19, but will likely keep Ethiopia at the top of Africa’s economic growth table.

Such a performance is pretty remarkable if you consider that Ethiopia is landlocked and, unlike some of its sub-Saharan neighbours, is not endowed with an abundance of natural resources. Much of the recent economic expansion has been driven by government spending, which, while increasing the country’s debt load, has also been directed towards developing Ethiopia’s infrastructure and certain priority sectors. New road and rail networks have been a key recipient of this focus, highlighted by the fact that national road coverage increased to over 113,000km by the end of 2017 from just 19,000km in 1991. Meanwhile, a 32km light rail system in Addis Ababa was opened in 2015, and a 750km electric railway, connecting the Ethiopian capital to Djibouti’s main port, and financed primarily by China, began operating early last year.

A historical lack of power supply has been overcome as a part of the government’s infrastructure program. Since 2010, electricity generation has risen to over 4,000MW from 1,800MW, while the ‘Grand Ethiopian Renaissance Dam’ (GERD) project will add a further 6,450MW to the grid once it is completed in 2020. Ethiopia is also home to Africa’s first waste-to-energy plant, which began operating last year and reportedly incinerates 1,400 tons of garbage per day while supplying as much as 30% of Addis Ababa’s residential household power needs. This has enabled Ethiopia to begin exporting its spare electricity to Djibouti and Sudan.
Although coffee and gold remain key export commodities, the government has identified several areas of the economy outside agriculture and mining, where Ethiopia has an advantage compared to others in the region, and which can be leveraged. For example, Ethiopia has reasonable cotton production and is the 10th largest stockist of hide in the world, so leather is also readily available. This, combined with low labour costs, has helped boost the development of the footwear and garment industry, which, according to official data, has grown by more than 50% over the past five years. Foreign investors have begun taking note and a number of big international brands have already established clothing factories in the country, such as H&M, Armani, PVH, Levi Strauss, Huajian and Tchibo. Chinese and Turkish textile firms in particular have also reportedly increased their sourcing and investment plans in Ethiopia.

Furthermore, such a heady economic growth rate and a population of over 100 million potential consumers has enticed companies such as Coca Cola, which recently announced a US$200 million investment plan for Ethiopia over the next five years. Volkswagen, meanwhile, is reportedly conducting a formal feasibility study for the establishment of a vehicle assembly plant in the country. China’s Lifan automotive Group has already established itself in the Dukem industrial zone, south of Addis Ababa.

On the privatization front, the new administration has announced that it is preparing to sell stakes in some of the country’s state-owned companies such as Ethiopian Airlines and Ethio Telecom, although the profitable domestic banking sector looks set to remain off-limits to foreign competition for the time being at least. Meanwhile, since the historic peace agreement with Eritrea was signed last year, the informal market has also picked up significantly, with trading activity in the towns of Zalambessa and Badme (which lie on either side of the official border crossings between Ethiopia and Eritrea) experiencing a mini-boom for the first time since the borders were closed in the 1990s.

Of course, the economic picture is not all good news. As mentioned earlier, the splurge in public spending has created a debt to GDP ratio of almost 60% and despite an increase in the volume and diversity of exports, Ethiopia still runs a trade deficit and continues to face a chronic shortage of hard currency due to its debt repayments, a rising oil bill and a surge in imports of consumer goods. Another important issue that needs to be overcome is the amount of government red-tape and bureaucracy that hamper investment and the development of the private sector. According to a 2017 World Bank survey, Ethiopia was ranked at 161 out of 190 countries when it came to the ease of doing business. The country is currently hosting over 900,000 refugees fleeing war, famine or extreme poverty from around 24 countries, with the bulk of these migrants coming from South Sudan, Somalia, Eritrea and Yemen. To its credit, Ethiopia has a long history of welcoming refugees and is the 6th largest hosting country in the world, according to a recent UNHCR report. However, such a large influx of people puts further pressure on limited government resources, despite support from various international aid agencies.
POLITICAL BACKGROUND

Ethiopia was ruled by a single dynasty until the 1970s and is one of only two countries in Africa that were never colonized, (although it was occupied by the Italians between 1936 and 1941). Emperor Haile Selassie ruled from 1930 before being deposed in a military coup led by Mengistu Haile Mariam in 1974. Mr. Mariam quickly sealed his grip on power by creating a one-party state and appointing himself both President and head of the armed forces. Then, in 1987, he amended the constitution and renamed the country The People's Democratic Republic of Ethiopia, while running the economy on a Marxist-Leninist ideology. These policies, including the detention and execution of thousands of people, ended up destroying the economy especially the agricultural sector, which in turn worsened the effects of a severe drought in the mid-1980s and triggered mass starvation. Mengistu was eventually overthrown by rebel groups in 1991 and a new constitution was enacted in 1994 converting the country into a federal state. In 1995, the country's first multiparty elections were conducted, and won by Meles Zenawi's Ethiopian People's Revolutionary Democratic Front. In 1998, a border dispute with Eritrea led to a two-year war and years of fraught bilateral relations, a situation which was only resolved recently.

Prime Minister Zenawi led the country until 2012, when he was succeeded by his Foreign Minister, Hailemariam Desalegn. The latter was eventually forced to resign over ongoing anti-government protests in February 2018 and replaced by the young and charismatic Abiy Ahmed, a former intelligence officer. Almost immediately after assuming office, Ahmed introduced a raft of political and economic reforms leading to the lifting of the long-running state of emergency and the release of thousands of political prisoners. On the foreign policy front he has managed to ease growing tensions with Egypt over his country’s controversial GERD project, and then with diplomatic support from Saudi Arabia and the UAE, Ahmed signed a peace agreement with Eritrea which has restored normal relations between Addis Ababa and Asmara for the first time in more than 20 years. This in turn also helped lead to the lifting of UN sanctions on Eritrea in November 2018.

CURRENCY OVERVIEW

The National Bank of Ethiopia currently employs a heavily ‘managed float’ regime on the local currency. It also maintains a series of capital controls in order to preserve its limited reserves, which, at the end of July 2018, reportedly stood at around US$2.8 billion, or less than two months of import cover. Thus, foreign exchange allocations are directed towards strategic import requests first, although it is worth noting that the Abu Dhabi Fund for Development pledged last year to provide Ethiopia with around US$3 billion in financial assistance, while the World Bank approved a US$1.35 billion financing package, which will go towards supporting the country’s economic and political transformation, as well as raising its level of foreign currency reserves.

The Ethiopian birr was devalued sharply in 2017 in the Central Bank's first major exchange rate adjustment since 2010 to boost competitiveness for the country’s exports, and to reduce the gap between the official USD/ETB exchange rate and the black market. The issue has improved significantly since then with both the unofficial and official rates now almost in line with each other, a situation that has probably been helped by the rise in confidence across the country since the beginning of 2018. However, a more flexible currency regime is needed to enhance transparency and attract more foreign investors. The weaker currency had an initial inflationary impact but that has since dissipated slightly with Ethiopia’s annual inflation rate officially reported at 13% in October, 2018, compared to 15.6% at the start of last year.
In October, 2017, Ethiopia’s Central Bank devalued the local currency by 15.5%.
CONCLUSION

Ethiopia’s economic growth continues to be impressive and the initial steps taken by the country’s young and energetic prime minister have already borne fruit both internally and externally. However, as outlined above, serious political and economic challenges remain. The treaty with Eritrea is an important and welcome event but the ink is still wet and thus the accord remains fragile for now. The controversy over Ethiopia’s GERD project, especially around its potential impact on the flow of the Nile, Egypt’s primary source of water, remains a thorny issue between Cairo and Addis Ababa, despite their recent agreement to work together to resolve it. On the economic front, debt consolidation, the removal of unnecessary red tape, more support for the private sector including easier access to bank credit, and a focus on export-led growth is essential for the country to realize its full potential and truly ensure Ethiopia’s ‘renaissance.’

ETHIOPIA - KEY INDICATORS 2018

<table>
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<tr>
<th>Population</th>
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<th>Unemployment</th>
<th>Inflation</th>
<th>FX Reserves</th>
<th>FX Regime</th>
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<tbody>
<tr>
<td>105 million</td>
<td>8.5%</td>
<td>59%</td>
<td>17%</td>
<td>13%</td>
<td>US$2.6 billion</td>
<td>Managed float</td>
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*Estimates: IMF/WB/FAB
Nigeria is one of the world’s top 20 oil producers and, although it is no longer a primary driver of domestic growth, the energy sector still plays the most important role within the overall economy. It accounts for the bulk of the country’s exports and generates over 85% of its foreign exchange revenues. The non-oil sector is led by the services industry, agriculture and construction.

GDP growth reached an annualized 1.8% in the third quarter of 2018 and the country posted a current account surplus during the first half of the year. This was a marked improvement on 2015/16 when Nigeria was mired in recession and compared to the anemic 0.83% recorded in 2017. But even if the economy expands to the officially forecasted 2.3% level in 2019 it remains fragile, and is still far below the minimum 5%-6% level required to keep up with the country’s rapidly expanding and youthful population. The last government census was conducted back in 2006, and pleas for enough funding by the National Population Commission to the central government and a change in the law to conduct an updated and more accurate one continue to fall on deaf ears. Politics plays a key part in this particular issue, underlined by the series of major disputes between political parties and various states over census results (including allegations of manipulation) since 1962. The current population of 195 million people is probably underestimated, and Vice President Yemi Osinbajo has acknowledged that Nigeria could become the third most populous country in the world by 2050.

The country’s current debt-to-GDP ratio remains relatively low at around 21%. However, debt servicing continues to eat into government coffers, which means there is less money available for much needed infrastructure projects and the provision and upgrade of other basic services. A report issued by the Central Bank last year showed that the cost of debt-related interest payments had increased by over 37% between June 2017 and June 2018.

The IMF has been calling on the government to speed up the implementation of its ‘Economic Reform & Growth Plan’ to help shift the country away from its exposure to the vagaries of oil prices and create more reliable and sustainable revenue sources.
There is no doubt that Nigeria has the potential to become an economic powerhouse: it has Africa’s largest population and an abundance of natural resources (aside from oil and gas) including large deposits of coal, iron ore, tin and zinc. It also has enormous tourism opportunities as well as enough water and arable land to expand its agricultural sector, which, together with forestry and fishing, employs the largest percentage of the country’s workforce. The removal of red tape, support for the SME and manufacturing sectors, and a more flexible exchange rate regime would further empower Nigeria’s entrepreneurial citizens and create a more vibrant economy.

ELECTIONS AHEAD

Nigerians will head to the polls on 16th February, and active campaigning began in 2018. Presidential incumbent Muhammadu Buhari and his ruling party, the All Progressive Congress (APC), will face off against 31 other candidates for the top job, but only a handful of these look likely to present Buhari with a serious challenge. They include former Vice President Atiku Abubakar, representing the main opposition People’s Democratic Party, previous Central Bank chief Kingsley Moghalu of the Young Progressive Party, former governor of Cross River state Donald Duke, who will represent the Social Democratic Party, and Oby Ezekwesili, a former Minister of Education and World Bank Vice-President, who will stand for the Allied Congress Party.

President Buhari’s APC saw a number of its members defect to other parties last year, including Abubakar, but floor-crossing is relatively common in Nigerian politics. Mr. Buhari does, however, face a stiff uphill challenge to stay in office, and both of these men are currently the presidential race frontrunners, although admittedly this will be Atiku’s fourth attempt to reach the highest office in the land, while concerns and rumours over the state of Buhari’s health continue to emerge. Voters will also be asked to select their choice of governor in 29 of the country’s 36 states, and despite talk of a decline in support for the APC, it is still likely to win most of the key states such as Lagos and Edo.

Meanwhile, regional security analysts will be keeping an eye on the oil-rich Niger Delta region and northern states like Kaduna, Benue and Zamfara, as various militant and separatist groups there may well try to take advantage of the natural tensions created by a general election to advance their own agendas.
ENERGY SECTOR

Nigeria is the continent’s largest crude oil producer, with proven reserves of around 37 billion barrels, as well as over 190 trillion cubic feet of gas. It is also the only OPEC member that has to import petrol to meet domestic demand.

After falling to a 30-year low in 2016, Nigeria’s oil production recovered to around 2.1 million barrels/day last year but it has the capacity to reach 2.5 million barrels/day. The bulk of this output still comes primarily from the Niger Delta region, an area that has in the past experienced regular outbreaks of militant activity, including attacks on production facilities and pipelines. There are proven reserves of crude and gas in the north of the country and the state-owned National Oil Company has announced plans to explore the Lake Chad basin, but here, too, groups such as Boko Haram could hamper a wider development of such resources, at least in the near term. On the positive side the government has opened up its refining sector to greater private sector participation. This has led to the current construction of a 660,000 barrels/day refinery by the Dangote Group, while four refineries are finally being repaired and upgraded. Once all these projects are completed they should help to sharply reduce Nigeria’s heavy imports of fuel and perhaps eventually see the country begin exporting petroleum products.

It is worth noting that Nigerian crude is naturally low in sulphur. This fact could see its popularity increase in 2020 when the International Maritime Organization is set to implement a 0.50% sulphur cap on marine fuel. A key step towards the development of this extremely important sector would be the approval and implementation of the ‘Petroleum Industry Governance Bill’, which has been in the works since 2016 and is aimed at comprehensively reforming the oil and gas sector to make it more efficient and transparent. Towards the end of last year, the current administration promised to work closely with members of the National Assembly to get this bill passed. Hopefully, this will take place before the 2019 general elections.

CURRENCY OVERVIEW

Firmer oil prices in the first quarters of 2018 and some small steps towards reforming the country’s complicated and heavily managed foreign exchange rate regime helped to stabilize the value of the local currency in 2018, and this, combined with the ongoing attractive yields for government securities, has seen the country’s foreign currency reserves recover to more than US$41 billion in 2018 from US$27 billion at the end of 2016.

Nigeria’s current multi-tiered exchange rate policy was introduced in 2016 and some amendments have occurred since then. However, the basic structure looks set to remain in place for the near future, despite continued calls by the IMF and others for the establishment of a more flexible regime to attract more foreign investment and become more competitive. At the time of writing, the system consisted of the following key windows:

• An official USD/NGN exchange rate that has remained fixed at 305.00 since 2016 and is used by fuel importers and the government to service the domestic and external debt.

• The NIFEX (Nigerian Interbank Foreign Exchange Fixing) and NAFEX (Nigerian Autonomous Foreign Exchange Fixing) windows, which have rates driven by demand and supply and are accessible to authorized dealers, foreign investors, local importers/exporters, SMEs and those with approved remittances and capital repatriation requirements. During 2018, the rates on these windows traded closely to those reported within the ‘grey market’, although the central bank does intervene when necessary. NIFEX is soon to come to an end and the NAFEX fixing is now used as a reference rate by the non-deliverable forward market.

Meanwhile the Central Bank continues to enforce a 2017 ban on the use of any of the above windows by local firms which wish to import 41 specific items. Other capital controls remain in place, such as limits on the use of credit cards abroad.
CONCLUSION

Nigeria has managed to successfully battle its way through the recent low oil prices cycle and has finally emerged from recession. However, although it has all the ingredients to become an economic giant, the country is still hamstrung by ongoing and longstanding problems such as the continued heavy reliance on crude revenues, bureaucracy, corruption, weak infrastructure (including a shortage of power) and ongoing security threats. The current government has begun to tackle a number of these issues, but more needs to be done and at a faster pace if this West African nation is to realize its true potential.

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<tbody>
<tr>
<td>195m</td>
<td>1.8%</td>
<td>21%</td>
<td>19%</td>
<td>11.25%</td>
<td>US$42bn</td>
<td>Multi-tiered managed float</td>
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*Nigeria - Key Indicators 2018*  
*Estimates: IMF/WB/FAB*
WHY SHARIAH INVESTMENT MAKES SENSE
RAMESHWAR TIWARY
AND ZEHAN MOHAMED SALEH
While Islamic finance was developed for the Muslim community, there is a genuine socio-economic component that renders its assets equally attractive to investors of all faiths. Islamic financial institutions follow a philosophy of prohibiting transactions considered immoral, while promoting greater social justice by sharing risk and reward. Only a handful of investment options have their structure built on such solid ethical principles. The Shariah philosophy is akin to, and in some respects more stringent than, socially responsible investing (SRI) principles. As the investment landscape evolves, Shariah investment is bound to have an ever greater positive impact on the financial industry.

While outsiders may focus on the religious aspect of Shariah investment, other asset classes could benefit from the adoption of some of its procedures. For instance, Shariah investment screening is a thorough process, from sector selection to looking at underlying company activities and financial ratios.
Islamic investment screening seeks to avoid enterprises engaged in advertising, media and entertainment, alcohol, cloning, pork, pornography, tobacco and speculation, including financial institutions – with the exception of Islamic banks and insurance companies.

The financial screening which follows sector selection aims to ensure that the management of invested companies is prudent, avoiding those which are excessively leveraged or have inefficient cash management. This stage of the screening is in many ways comparable to what major credit rating agencies do in their own evaluations and seeks best practices in balance sheet and working capital management.

This approach could help avoid the kinds of issues which have caused so many financial crises in history: excessive greed, uncontrolled leverage and unscrupulous accounting. Apart from forcing cautious selection of investments, the Shariah approach monitors its parameters on a regular basis.

**EQUITY RETURNS**

Because an investment follows ethical principles, it does not mean that it should not offer comparable or even better returns than those achieved elsewhere. Interestingly, over a longer time period, Shariah investment has shown better returns than traditional asset classes. It has also outperformed during major market meltdowns, such as the Global Financial Crisis in 2008/2009.

Comparing the S&P 500 Index and the S&P 500 Shariah Index since 2005 yields striking results. While the Shariah index may have trailed the traditional S&P 500 at times, it outperformed over the entire period and, in particular, during the financial crisis. That should not come as a surprise. The global financial crisis was triggered by excessive leverage and lack of transparency, the kind of thing that Shariah investing avoids.

**SUUK BONDS**

While the idea of Shariah-compliant debt may sound counterintuitive, the Sukuk market has grown exponentially since its birth in 1990 in Malaysia. Some investors remain afraid that the asset class may be too correlated to energy prices (given the roster of issuers), and illiquid, due to its niche attributes. The market has deepened significantly, however, and now comprises a variety of sovereign, corporate and financial issuers.

Recently, new issuers from the UK, China, Hong Kong, Turkey, Pakistan and various African nations have also tapped the Sukuk pool of liquidity. The traditional issuers, such as Saudi Arabia, have also become more committed to establishing liquid international yield curves.

Aside from now offering similar options and liquidity to traditional investments, Sukuk has exhibited less volatility compared to conventional global bonds and offers an attractive risk-return ratio. Risk-adjusted returns tend to be, in general, higher for Sukuk bonds, perhaps because of the more stable investor base, the shorter duration and the generally solid collateral or covenants inherent to them. Furthermore, global Sukuk exhibits a lower correlation to other asset classes, making it a good diversification tool for traditional investors.
ASSET GROWTH

While still small compared to the overall investable universe, the Shariah-compliant market is now estimated to be around US$1.8 trillion, and has grown at an annual compound rate of 16%-17% since 2000. Global Islamic banking assets have doubled over the past 10 years, and Islamic financial services are now available in more than 48 countries. Such growth has happened even as Shariah products faced multiple challenges, including the interpretation of Islamic law, limited product offerings and lack of investor awareness.

With the surge in global wealth, however, the demand for Shariah products and instruments has picked up, particularly in the Middle East and in some Asian markets. There still is room for those numbers to grow significantly. The Muslim population constitutes more than a quarter of the globe, but Shariah investment is a fraction of total assets allocated to conventional investments.

The rapid growth of Islamic financial markets has seen the development of several new debt, cash and equity market instruments. Such products are important for effective management of investment portfolios and for risk diversification. Moreover, growing awareness of the ethical standards of Shariah ideology has attracted demand from government-controlled institutions and sovereign wealth funds, among others.

The rapid evolution of Islamic investment has been supported by the development of a comprehensive legal structure, such as the one in Malaysia. The legal structure has looked to align the Shariah-compliant corporate, securities and insolvency laws.

The Shariah board plays a key role in interpreting the scope of Shariah law in the context of modern financial structures. Shariah scholars are constantly challenged to have a thorough and sound understanding of other fields of expertise to formulate well-rounded and pragmatic interpretations of Shariah law.

Multiple interpretations of the law, however, have become a hurdle to the development of even more products. In response to that, regulators, institutions and Shariah scholars are working to establish a standard Shariah law that can be applied globally. Such a development would pave the way for wider acceptance of Shariah investments.

The legal framework has been strengthened and is now more aligned with market developments, lending certainty and predictability to Islamic financial transactions and allowing more innovative products. This has further inculcated public confidence in Shariah Investments.
FINTECH OUTLOOK
CHRIS LANGNER
Until very recently payment systems were dominated by card issuers, such as American Express, Mastercard and Visa. Paypal joined the fray about 20 years ago. Then something happened. Well, not in developed markets, where plastic is still king. In Guangzhou, things are quite different, with a whole new generation of players which look nothing like the traditional card companies or even the initial ‘disruptors’. Alipay.com and WeChat Pay, two Chinese smartphone applications, processed more than US$15 trillion in payments in 2017, the equivalent of the entire US gross domestic product. That is also more than twice the US$6.6 trillion in purchase volume that credit, debit and prepaid cards issued in the US generated in the same year, according to the Nilson Report. In fact, while public data is scarce, specialists reckon that Alipay.com has now taken the crown as the largest payments processing company in the world – and most people in the west have never even heard of them. Similarly, the world’s largest money market fund no longer sits in London or in New York, it is housed in Hangzhou, in the heart of China. Tianhong Yue Bao Money Market Fund has CNY1.32 trillion (US$ 191.6 billion) in assets under management, the vast majority of which entered the fund through a mobile application.

A financial revolution is occurring quietly on smartphones in emerging markets. And while China is the poster child that generates striking figures such as those above, financial change is galloping ahead even in old-school feature phones in less affluent corners of Africa or Southeast Asia, in a way people in developed markets could not imagine a decade ago.

Vodafone’s M-Pesa offers many of the services of traditional banking to owners of feature phones (those cellphones in which a person has to use the number keypad to write a text message) in Africa. To use the service, people only need to have a prepaid mobile phone line with Vodafone or one of its subsidiaries in these countries. Users can send a text message that allows them to transfer some of their prepaid credit to someone else or even a merchant.

The service picked up quickly, shortly after being launched in 2007, especially in some of the more remote parts of Africa, where cash is scarce. By the end of 2016, it served some 29.5 million users in Albania, the Democratic Republic of Congo, Egypt, Ghana, India, Kenya, Lesotho, Mozambique, Romania and Tanzania. In December alone that year, M-Pesa processed 614 million transactions. With the data it gathered from usage of the service, Vodafone was soon able to start offering microloans of as little as US$1. The company found that delinquency was lower among its borrowers than among those in the traditional banking system.

The initiative has been emulated elsewhere, with Singapore’s Singtel offering some financial services to the unbanked in Myanmar and rural Thailand since 2013, and bkash having become perhaps the biggest financial company in Bangladesh. Easypaisa in Pakistan, launched in 2009 under a similar model, is now one of the biggest providers of mobile money services in the world.
Pakistan is a perfect example of the potential that the move of financial services from tellers to telephones offers. The nation has about 30 million bank accounts, but boasts some 150 million mobile subscribers (and growing). Similarly, about two thirds of the population in sub-Saharan Africa do not have a bank account. Meanwhile, about 45% of people in the region have a mobile subscription of some form, almost double the number who had it a decade ago.

The pattern is repeated globally. The World Bank estimates that 31% of the world’s population did not have access to banking services of any kind at the end of 2017. Meanwhile, there are more mobile subscriptions in the world than humans and 71.5% of the global population have a mobile broadband subscription, according to network equipment producer Ericsson.

Such is the potential of mobile financial services. However, the trend is picking up much faster in emerging nations than in developed countries for two reasons: banks are more entrenched in developed countries, where people have grown accustomed to having them as financial intermediators, and where regulation is often stricter. Even in the richest countries, though, the trend has started to encroach on traditional lenders. In the US, for instance, startups such as LendingTree and OnDeck have begun to take a bite from brick and mortar banks, forcing them to offer more competitive savings and lending rates.

The means of delivery may be changing, but the multiplier effect of financial services is expected to be the same. Consulting firm McKinsey & Co. estimates that increased access to digital financial services in poorer countries has the potential to increase the overall gross domestic product of emerging markets by US$3.7 trillion by 2025, a six percentage points boost compared to the scenario that does not envision the growth of mobile and online financial services. This revolution could generate some US$2.1 trillion in loans in developing nations and allow governments there to save more than US$110 billion in the reduction of fiscal leakage.

Tax enforcement is perhaps one of the biggest incentives for governments in developing nations to embrace digital financial services. As more people use their phones to do everyday transactions, there is a better record of cash movement, enabling governments to evaluate who are paying their taxes appropriately. That rationale may have been part of the reason why the Narendra Modi administration in India has been pushing for more digital payments, particularly after the 2016 demonetization.

A study by Bank of England economists also suggests that central bank-issued digital currency could boost the economy by reducing transaction costs while improving the transmission of monetary policy. It makes sense: the central bank could simply “turn off” or ‘on’ part of the monetary supply if it is digital, instead of controlling how much banks multiply the issued physical currency through loans by increasing or decreasing interest rates.

Taxes, however, are the ultimate driver behind the studies that central banks in some 15 emerging nations are doing about the viability of government-issued digital currency. News reports suggest that China, for one, is seriously considering rolling out a digital yuan. For the country, it would make perfect sense. Beijing often has to deal with the logistics of transporting cash from one end of the country to another, especially when the occasional regional liquidity squeeze hits. Digital cash would make that process as easy as pressing a few buttons. It would also be easy for the Chinese to convert to a fully digital currency. More than a quarter of all retail transactions in the country are already processed by one of the mobile payments applications. Including the central bank in the mix should not be difficult.

The next revolution in financial services will be technological and this time it is likely to start in the emerging nations before it gets to the developed world. In fact, it has already begun.

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**More phones than people**

![Graph showing the percentage of the world population above 15 with a bank account and the number of mobile subscriptions per total world population. Source: FAB, BIS, World Bank, Ericsson.](image-url)
FOCUS ON
ASSET
MANAGEMENT
ROBERT SUDELL
Investment management traces its roots back to 1774 and the establishment of the world’s first mutual fund called ‘Eendragt Maak Magt’ (‘unity creates strength’), and established by a Dutch merchant looking to pool investor’s money and generate income from plantations in several European countries and American colonies.

In the nearly 250 years since, the fundamental objectives of asset management have not materially changed: to invest in portfolios of securities on behalf of clients and make as high a return as possible for a pre-defined level of risk. A key feature of an asset manager’s business model is the ability to benefit from economies of scale whereby investors will hold fractional ownership of a diverse portfolio of stocks. Having a variety of equities and bonds also protects investors from the idiosyncratic risk of owning a few securities.
Since the early 1990s the evolution of the asset management industry can be separated into two periods. The first one is characterized by extraordinary growth in assets under management (AUM) due to rising levels of household wealth, ease of liquidity and expansionary monetary policy. This period ended around 2008 when the Global Financial Crisis caused a setback to AUM, driven by declining asset prices and tightening liquidity.

In the second period, from 2008 to the present, the industry has reformed itself to the benefit of investors. Most notably, regulators around the world have placed greater emphasis on reducing risk for retail investors and enhancing market integrity, which has led to increased scrutiny of managers and more focus on risk and compliance, cost controls, pricing transparency and governance.

In 2019, it is conceivable that we are leaving the post financial crisis period and entering a new age. In the US, President Donald Trump’s Administration has expressed views that regulation is cumbersome to asset managers and in Europe each piece of new regulation is accompanied by a review clause. This may be the point at which regulatory oversight evolves to reduce the burden on asset managers, allowing them to continue to develop and innovate to the benefit of global investors.

There has never been a more exciting time for asset management companies in the Middle East, given the continuous evolution of technology, social media and the influence of millennials on the way money is invested. Assets held by the industry are forecast to reach over US$100 trillion globally by 2020 from current levels of more than US$81 trillion. Within that, the Middle East is expected to be a key growth area, with AUM likely to more than double to US$110 billion in 2020 from US$45 billion in 2016.

Growing individual wealth and improving interaction between asset managers and wealth owners as technology evolves are two key trends which will help shape the future growth of AUM both globally and in the region. The table on the next page shows that GDP in the GCC countries should be at advanced economy levels by 2023. The DIFC Wealth and Asset Management report 2017 estimated that the AUM in the UAE by 2020 is set to reach US$18.9 billion. Asset managers can help ensure this wealth is invested into their products by using applications on mobile phones, for instance. In China, individuals are already able to invest in mutual funds through their smart phones, it is not unreasonable to envisage this technology being replicated globally giving more people access to real time data on the performance as well as the costs associated with their investments.

Regulation in the Middle East, Africa and South Asia continues to evolve, and the UAE, which is ahead on that front, is the preferred place of doing business for asset managers in the region. With the establishment of the Abu Dhabi Global Market (ADGM), in 2013, to complement the Dubai International Financial Centre (DIFC), the UAE provides investors with hubs of expertise as well as regulatory and legal certainty.
Asset managers in the region continue to adopt global best practices and have started to subscribe, for example, to the CFA Institute’s Global Investment Performance Standards (GIPS), adopted by most large firms in North America and Europe since the turn of the century, which helps give investors a fair representation and full disclosure of investment performance results. Institutional investors, investment consultants and sovereign wealth funds in the region are increasingly asking to see asset managers’ GIPS disclosures when considering whether to appoint them for mandates.

Increased regulatory focus on financial institutions globally should benefit asset managers and their clients. Banks and insurers are being discouraged from engaging in activities that put undue risk on their balance sheets, such as proprietary trading and complex derivative transactions. This gives rise to opportunities for traditional long-only equity and fixed income portfolios which avoid undue risk on capital and provide investors with a reasonable level of capital appreciation for the risk taken in an investment portfolio.

The biggest opportunity for regional asset managers in the coming years could be the development of a defined contribution pension industry for expatriate workers. Today, employers in the region are not legally required to make defined contribution pension payments for expatriate workers. Instead, employers pay a terminal gratuity in line with the labour law of their respective jurisdiction, which is a payment made to an employee based on their contract type, number of years’ service and basic salary. The payment is made on completion of the work relationship and causes trouble for some companies. Typically, the gratuity paid to employees will not be sufficient for individuals to retire on.

Under the envisaged framework, employers will deduct monthly contributions from an employee’s salary and add their own contribution. These monies would then be invested into a managed fund. Employees would also have the option to make additional contributions. Should this materialize, the opportunities for asset managers based in the UAE and within the region will be promising.

Islamic asset management continues to grow and presents an opportunity as well. The industry is currently concentrated in Saudi Arabia and Malaysia, with local asset managers offering products focused on their home markets. In recent years, we have seen Sukuk bonds issued by both the UK and Hong Kong. These steps are necessary for the industry to reach critical mass and global scale. The key to growth in this segment will be the adoption of these strategies by institutional investors as well as the creation of Islamic pension schemes.

As a regional asset manager, FAB has a wide range of Shariah-compliant products and a strong track record of managing such mandates for clients. With its roots going back to the early 2000’s FAB’s award winning investment management franchise offers both conventional and Shariah-compliant mutual funds (Irish-domiciled UCITS funds as well as UAE-regulated funds) and separately managed accounts on a discretionary basis with an investment focus on MENA and emerging markets strategies. With more than US$2 billion of AUM as at the end of September 2018, we manage fixed income, equities and multi-asset portfolios for a wide range of investors, from retail clients to Sovereign Wealth Funds. As active managers our investment philosophy is driven by the conviction that our active or tactical investment strategy will outperform a passive, or ‘buy and hold’, strategy over a full investment cycle.

Many factors, including legislation, demographics and expanding middle class, will present great opportunities for the best asset managers to take a larger share of an expanding market and for them to thrive.
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