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ADCB
ASSET MANAGEMENT LIMITED

Cautious tactically, constructive strategically

- **Following a strong performance of equities since their March-lows, we are cautious on the near-term outlook for the asset class.**
- **However, on a strategic time-frame, we remain constructive and focus on structural growth stories.**
- **In this note, we highlight three high-conviction ideas – one of which is at this stage contrarian idea – with a 12-month view.**

Cyclical position

Equity markets across the globe have bounced back quite strongly from their March lows. Also, some of our preferred structural themes have outperformed and delivered strong positive returns so far this year. In the near-term, we think some caution is warranted. As we move from the 'rebound' phase to the 'recovery' phase, 'levels' should start to matter more than 'changes' and 'magnitude' should matter more than 'direction' (exhibit 1 shows our three-stage model of an economic sudden stop and how various variables behave in these stages). Here, it is worth remembering that we are at best going back to a slow-growth environment, and the pre-crisis level of economic activity is expected to be achieved only by end-2021 or later. Further, it is worth noting that amongst the economic data surprises which have been extremely positive recently (exhibit 2), much of that indeed came from positive surprises on the soft data side. Although the hard surprises too have recovered from their March lows, their rise pales against that of soft data surprises. Inflation outlook remains bleak despite the strong rise in inflation expectations (exhibit 3) which has aided a pro-cyclical environment and helped cyclical assets in recent weeks, as is witnessed by the weakness of the US dollar, the most countercyclical of all currencies (exhibit 4). Realised inflation continues to surprise to the downside (exhibit 5) and remains way below the expectations too (exhibit 6). Continuing low consumer confidence expectations suggest inflation is unlikely to rise significantly in the near term (exhibit 7). Crucially, from an equity valuation perspective, based on the long-term experience, cyclically adjusted equity valuations tend to remain high when the real yield (based on realised inflation) is neither too negative nor too positive, a situation we are currently in (exhibit 8).

Cautious near-term

As such, earnings and macro-economic data surprises are likely to moderate looking ahead, in our view, driven by hard data. Whilst the recent US earnings season was better-than-expected –secular growth stories (big-tech) did well too – European earnings season has been rather more mixed. As such, cyclical themes/segments are likely to get a reality check in the coming months. As we move into the autumn, a potential rise in virus cases and considerations of mitigation strategies should begin to influence market perceptions. Here, whilst we do not think that a full lockdown of major economies is likely, we do think that markets might become jittery on any potential rise in number of COVID-19 infections. Further, political (US elections, Brexit etc.), geo-political (US-China, US-EU and Brexit etc.) and policy (fiscal support and stimulus measures) risks could rise. Technically speaking, August and September are seasonally weak months for global equities; October typically sees a wide range (exhibit 9). Whilst the skew index remains high (exhibit 10) and implied volatility is higher than the pre-crisis levels (exhibit 11), sentiment continues to be bearish (exhibit 12) and fund flows indicate no exuberance (exhibit 13).

Our equity strategy

Overall, we remain constructive on the 12 month outlook for equities but we do think some caution is warranted in the near term with the risk-adjusted-returns likely to deteriorate. Within a 12 month view, we say with conviction to stay overweight 'new economy' themes (page 5), underweight financials sector (page 5) and underweight Europe ex UK (page 6) – the latter being currently a contrarian view.

During turbulent times, cyclical sectors/markets are likely to be disproportionately negatively impacted. Some of our preferred themes – of non-cyclical growth relating to the 'new economy' are likely to outperform in such a scenario. Any correction (in absolute terms) in long-term growth sectors is likely to be used by market participants to increase their allocation. For our equity strategy summary see page 8.

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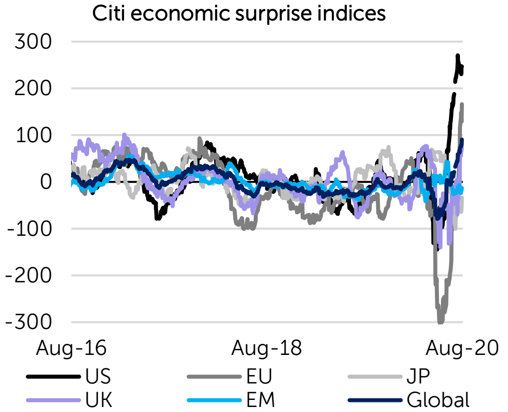
Exhibit 1: The convalescence model of an economic sudden stop: from panic to greed to sanity

	Shock	Rebound	Recovery
Attitudes	Pessimism	Optimism	Realism
Macro data	Steep falls	Sharp rises	Stabilization
Data surprises	Deep negative	Strong positive	Moderately positive
Policy	Appears reactive	Supportive	Stimulative
Inflation expectations	Fall	Rise	Stabilize
Investor attitudes	Panic	Greed	Sanity
Equity styles	Defensives	Cyclicals	Secular growth

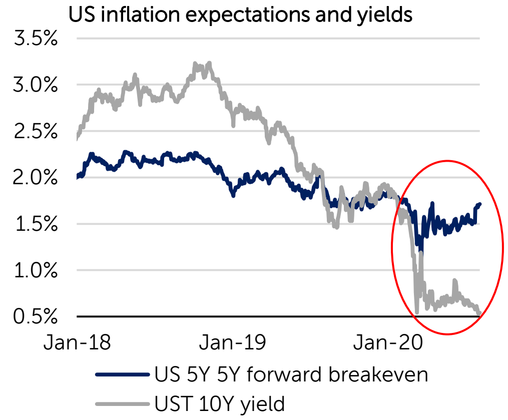
Source: ADCB Asset Management

Exhibit 2: Economic surprises positive



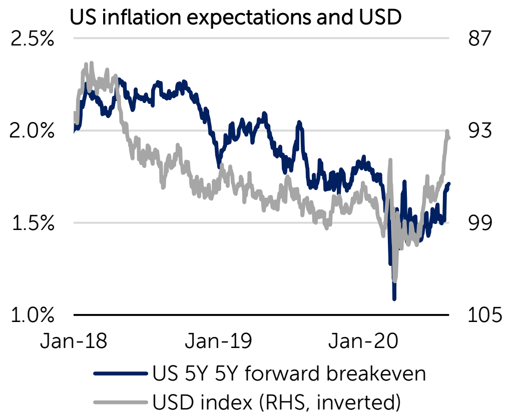
Source: Citi, Bloomberg and ADCB Asset Management

Exhibit 3: Real yields in deep negative zone...



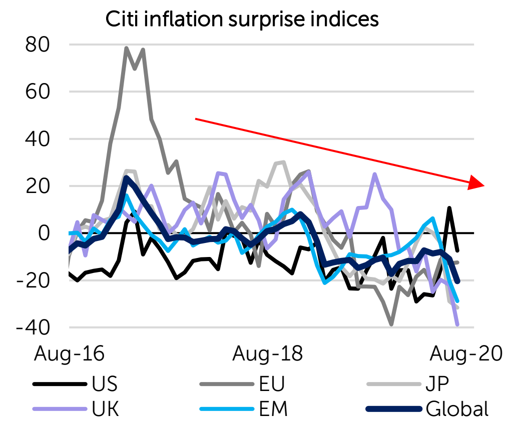
Source: Bloomberg and ADCB Asset Management

Exhibit 4: ...have caused a pro-cyclical rally



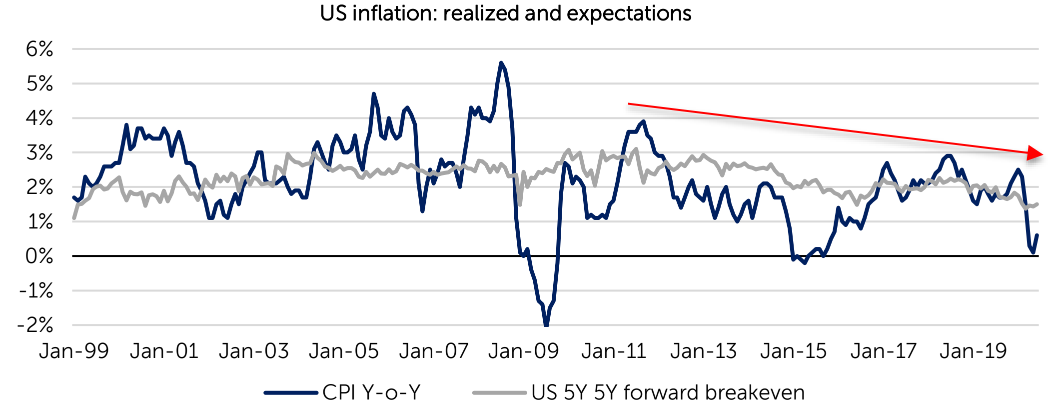
Source: Bloomberg and ADCB Asset Management

Exhibit 5: Inflation surprises trending down



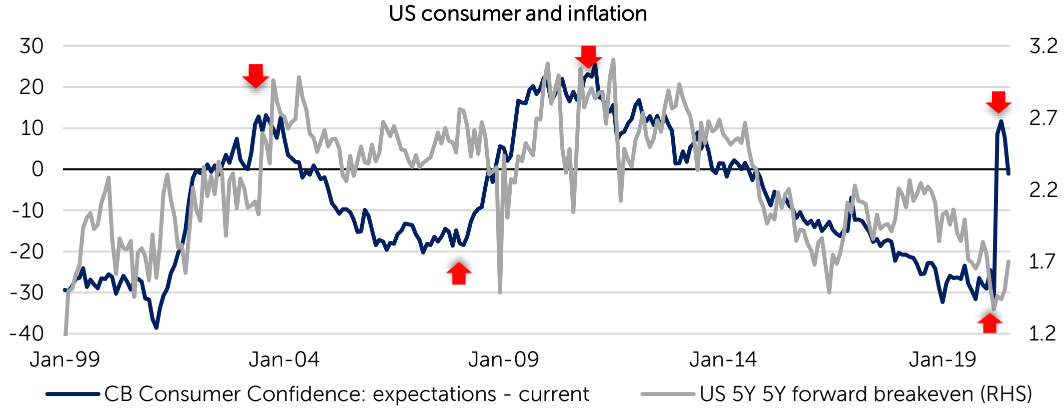
Source: Citi, Bloomberg and ADCB Asset Management

Exhibit 6: Both realised inflation and expected inflation remain in a downward trajectory



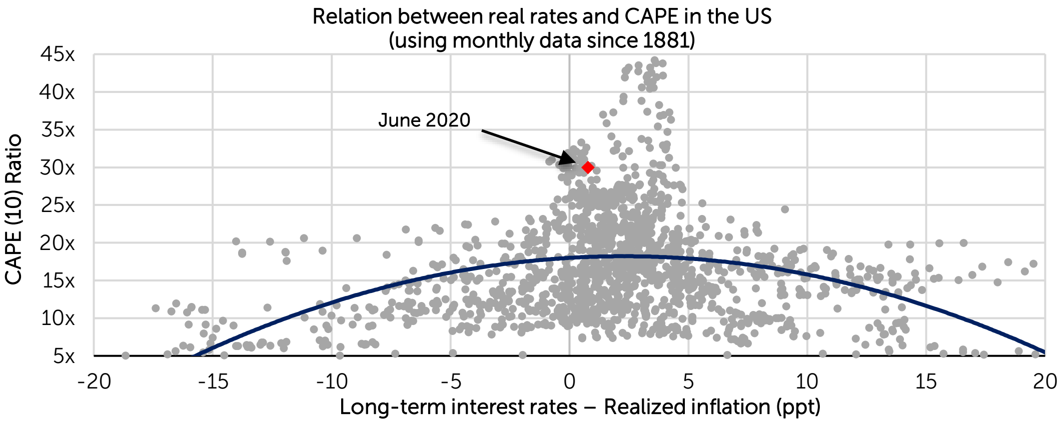
Source: Bloomberg and ADCB Asset Management

Exhibit 7: Consumer confidence expectations lead the inflation expectations



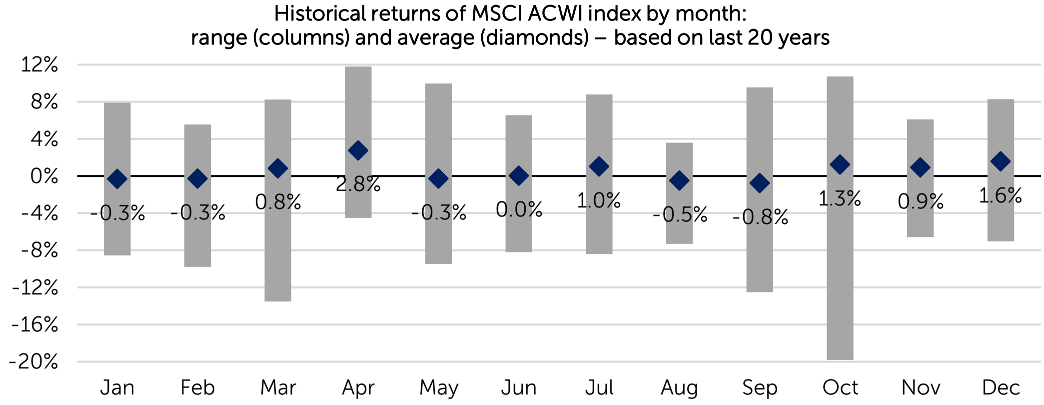
Source: Conference Board, Bloomberg and ADCB Asset Management

Exhibit 8: Equity investors like it not too hot, not too cold



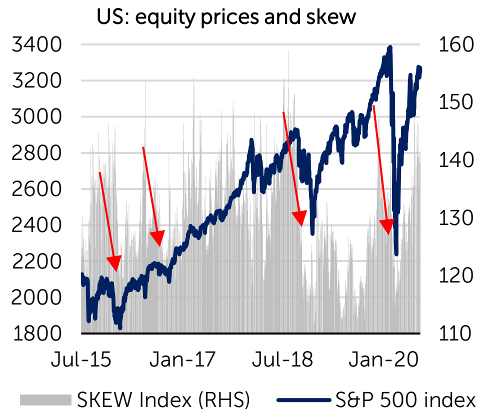
Source: Robert J. Shiller "Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated" and ADCB Asset Management

Exhibit 9: August and September are seasonally weak months for equities; October typically sees a wide range



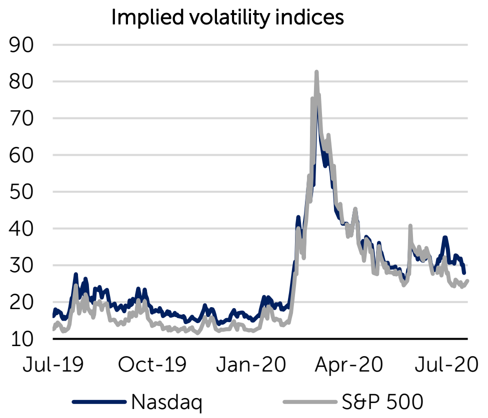
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 10: High skew index warrants some caution



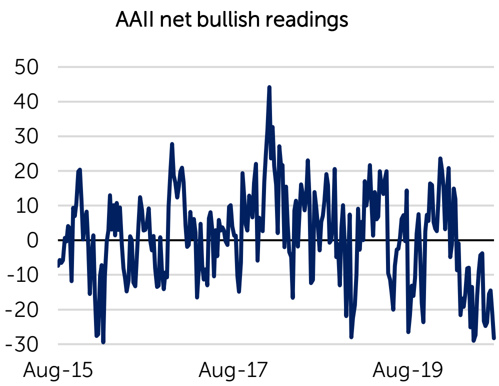
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 11: Implied volatility remains elevated compared to pre-pandemic levels



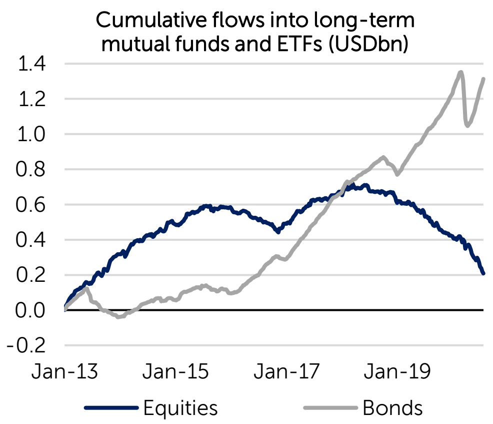
Source: Chicago Board Options Exchange, Bloomberg and ADCB Asset Management

Exhibit 12: Investors are net bearish...



Source: AAII, Bloomberg and ADCB Asset Management

Exhibit 13: ...and flow trends show no optimism



Source: ICI, Bloomberg and ADCB Asset Management

Our high conviction ideas

New economy themes - stay overweight

Given the strong performance of the new economy indices so far this year, market participants have started to draw parallels to the dot-com bubble. We think such parallels are not justified. Of course, these new economy segments registered strong performances in recent years and the COVID-19 crisis has provided further tailwinds, thus bringing into consideration the Matthew effect (the rich getting richer). It should not be surprising that momentum strategies tend to outperform broader markets over long-run and the new economy themes currently enjoy the momentum.

Investors sceptical about these market segments might be missing a point or two. To start with, the new economy sector, the core of disruption, is becoming strategically important and therefore, equity markets can continue to reward these sectors with higher multiples and higher representation in the overall market for a long time. In this context, it is worth looking at the composition of the US equity market back in 1900 where the rail sector (the 'new economy' then) was c60% of the index while the sector represented less than 10% of the national income and employment. Also, whilst Nasdaq is 'tech-heavy', it is not 'all-tech'. For instance Nasdaq-100 index is 56% tech today, compared with c75% just before the dot-com bubble. Valuations of new economy themes now are nowhere near the valuations of the dot-com bubble era. Further, given the resilience to COVID-19 disruption, these market segments deserve a defensive premium too, in our opinion. Also, fundamentals of Nasdaq aggregate, with higher profitability and stronger balance sheets are much better than the overall market.

As we highlighted in our note Rip Van Winkle wakes up, November 24 2019, it is very hard to argue that the current level of tech-exuberance is as high as it was in the 1990s for three reasons. First, IPO volumes currently are not as high as they were twenty years ago indicating an absence of the very tech-exuberance that eventually resulted in the dot-com bubble. Second, any build-up of exuberance in the new-tech companies has been tamed by the prospects of regulatory tightening. Third, the rise of technology this time around is helped by strong end-user consumption trends, especially aided by millennial and digital native cohorts. Internet, one of the enablers of the new economy saw a strong adoption/penetration across the world over the last twenty years. Number of internet users in the world has grown 1,187% since 2000 bringing the adoption rate to c60%. Notably, internet adoption is the highest in consumer-led developed markets. A few new economy themes could see cyclical pressures but secular trend remains strong. As such, the concept of the new digital economy has much further to run. For instance, based on a PEW survey[1], many Americans are still unfamiliar with the vocabulary of the new digital economy. 61% of Americans have never heard of the term "crowdfunding", 73% are not familiar with the term "sharing economy" and 89% are not familiar with the term "gig economy".

All in all, on a strategic basis, we remain focussed on the new economy themes. Of course, the sector could experience some turbulence near term with increasing prospects of regulatory tightening (especially with US Presidential elections later this year). However, we think long-term investors will be better-off staying focussed. We think investors should align their strategic portfolios to reflect the rising importance of this segment (see Thematic thinking and portfolio tweaking, April 14 2020). Any correction (in absolute terms) in long-term growth sectors is likely to provide investors an opportunity to increase their exposure. For details see our recent report The Equity Strategist: New economy and the Matthew effect, July 19 2020.

Global financials sector – remain underweight

We remain underweight financials (driven by our underweight in banks) in our global equity strategy. To start with, a deeper look at banks' Q2 earnings reports reveals a strong rise in trading volumes offsetting weakness in consumer books and loans. Investment banking fees were also rather high, thanks to the record debt issuance during the quarter. However, we wonder if this support can remain in the medium-term. Further, revenue growth linked to economic activity, is one of the key drivers of banks' performance over medium to long-term. Here, it is worth noting that economic

[1] "Shared, Collaborative and On Demand: The New Digital Economy", PEW research center

growth projections point only to a gradual rebound. For instance, according to IMF's latest World Economic Outlook update, "Global growth is projected at –4.9 percent in 2020. In 2021 global growth is projected at 5.4 percent. Overall, this would leave 2021 GDP some 6½ percentage points lower than in the pre-COVID-19 projections of January 2020." This points out that recovery in the levels of economic activity is long-drawn. This plays into our narrative that during the 'rebound' phase, markets are likely to focus on the 'direction' but as we move to a 'recovery' phase, 'magnitude' should begin to matter a lot more. Further, it is worth noting that this is an unusual recession where incomes grew and house prices rose despite high unemployment. This mismatch could be corrected at some point in the medium-term and that means headwinds for banks. As such, the flat yield curve already dents the sector's profitability. The dividend outlook remains challenging too. We are also watching loan loss provisions and developments on this front especially in smaller banks and banks in emerging markets. Of course, valuations are cheap and investor interest in the sector is weak too – this provides a support on the downside. Long-term outlook for the sector remains clouded by disruption – especially disintermediation facilitated by technology. Further, US-China tensions spell trouble for banks with significant footprint in both countries. Consolidation and cost-cutting are key trends to watch, especially in Europe.

Europe ex UK – keep underweight (contrarian idea)

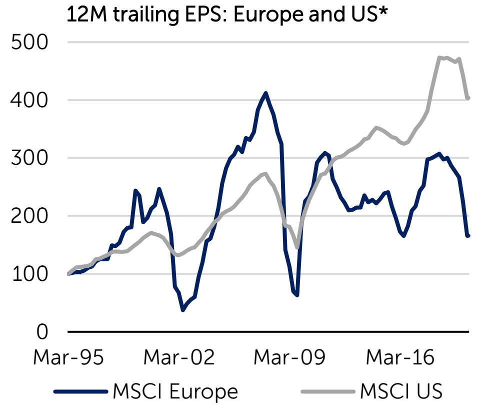
Optimism associated with the recent EU recovery fund is largely in the price. Indeed, in the recent months, prospects of an agreement on the Recovery Fund by the European Union created a sense of positivity and to some extent lowered the risk-premium associated with European equities. We just don't think that the Recovery Fund is the panacea the markets are currently making of it. Looking ahead, markets might begin to challenge the long-term efficacy of the plan. Here, we are of the opinion that for equity investors, the Recovery Fund does not make a huge difference at this stage. Key issues in fact remain with regard to the size of the fund, not particularly overwhelming in relation to the EU's GDP, especially when diluted over the budgetary seven-year horizon. A paramount concern for investors remains the actual allocation of the moneys. What sectors will be beneficiaries? Who will benefit? Will this promote or delay reform in peripheral economies? We don't see the Recovery Fund triggering substantial reform in the EU, capable of significantly boosting the block's potential economic growth. This may be an important incremental step towards a fiscal union, but this will take still a lot of time. It might to some extent halt economic divergence within the EU, but for now it is very unlikely to boost overall growth. As such, given also the composition of European stock indices, we think that European equity prices have benefitted from the news related to the Recovery Fund, and are likely to underperform over the next 12 months.

The region could begin to experience some near-term headwinds too. Resurgence in COVID-19 cases presents a key risk especially as we approach the autumn. Of course, this is not the key reason for our underweight. EUR strength we had noticed in the recent months is likely to prove negative for corporate earnings in the medium-term. Moreover, European corporate earnings are tied to the global cycle (exhibit 14) and we have little clarity on the full recovery prospects. Also, US-China stand-off threatens the global trade and European corporate earnings are likely to be impacted, at least in the medium-term. Brexit risks are likely to resurface in the months ahead, though there have lately been some indications that both sides are willing to make more compromises. Recent rise of the EUR against the USD might be hard to repeat in the near future, therefore the FX is unlikely to drive further returns for USD-investors in European equities. Also, stronger EUR results in weaker equities (exhibit 15). One of the arguments often heard in favour of European equities is the valuation discount to the US. However, as we argued earlier too, the discount at the market level remains an optical illusion and is explained by difference in the composition of equity indices. Looking at some key sectors and comparing the valuation difference Trans-Atlantic, we do not find much discount for European equities (exhibits 16-19).

Europe faces structural impediments like fading demographic support and lower long-term potential growth rate.

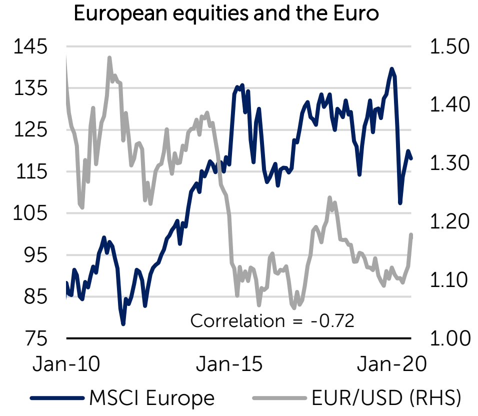
Within Europe, we prefer large cap quality themes and healthcare sector. Europe is rich in ESG but a bottom-up stock selection is more appropriate for this in our view.

Exhibit 14: European earnings tend to be cyclical



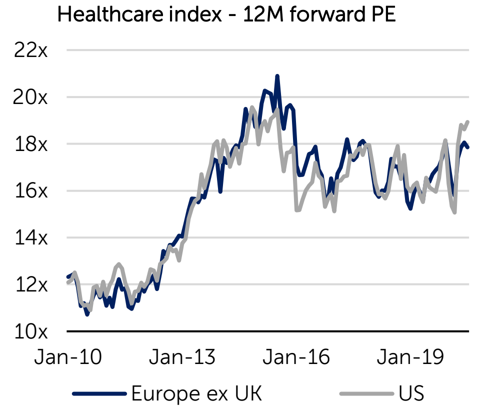
Source: MSCI, Bloomberg and ADCB Asset Management | Notes: *all series indexed to 100 at the start

Exhibit 15: Euro strength and European equities are inversely correlated



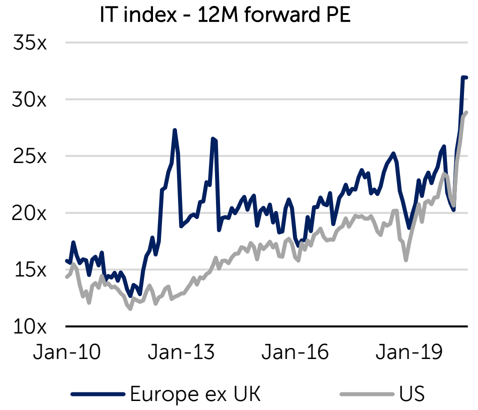
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 16: Comparing valuations of healthcare...



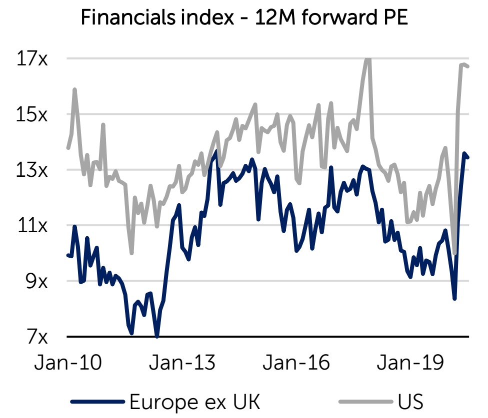
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 17: ...information technology...



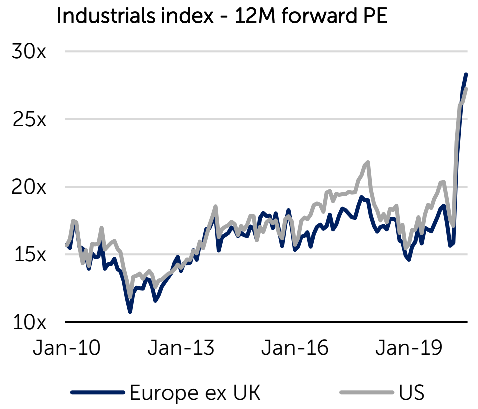
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 18: ...financials...



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 19: ...and industrials sectors reveals no significant transatlantic valuation gaps



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 20: Equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Heavy exposure to financials sector
UK		■		Stick with the benchmark
Japan		■		Prefer 'new economy' enablers
Asia Pacific ex Japan		■		Focus on new China vs. old China; neutral India
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA	■			
GCC		■		Stick with the benchmark
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Internet & direct marketing retail
Consumer Staples		■		Prefer Household & personal products
Energy			■	Focus on capital discipline and makeover stories
Financials	■			Impeded by lower interest rates
Health Care		■		Prefer Biotechnology and Health care technology
Industrials		■		Prefer Commercial & Professional Services
IT			■	New economy enablers
Materials	■			Structural weakness on a shift to 'new economy'
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from 'new economy' orientation
Legend	*New*	*Old*	*No change*	

Themes that we are watching

[Lower returns over the long-term]()

[Services vs. manufacturing]()

[Deglobalising world]()

[Rise of sustainable investing]()

[New economy]()

Source: ADCB Asset Management

Sources

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

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

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