Investment Strategy

The Equity Strategist | September 17 2019

بنك أبوظبي التجاري
ADCB
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A short-term pain trade

- **Our preferred trades – US by region, defensive/non-cyclical growth sectors, large caps by size, growth as the style and quality as a factor – which have worked well so far this year are likely to underperform in the near-term…**
- **…as fading trade uncertainty and a strong policy support trigger a pro-cyclical bounce led by a rotation into the cyclical and value segments of the market which have underperformed so far.**
- **Any such rotation we believe will be short-lived but should benefit Europe, Japan and EM by region, industrials and consumer cyclicals amongst sectors, small cap stocks and value style (we are already overweight high dividend yielders here).**

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US-China trade stand-off: at the precipice we change

The single most important factor influencing the financial markets globally this year has been the US-China trade stand-off. We had several periods of 'deal-on' and 'deal-off' on trade front leading to 'risk-on' and 'risk-off' respectively in financial markets. The impact of the ongoing trade-war between the two largest economies of the world has been widely researched, discussed and telegraphed. For instance, according to the IMF, US-China tariffs could lower global economic output by 0.8% in 2020 and trigger more losses in future years (see *US, China tariffs could lower global economic output by 0.8% in 2020: IMF*, Business Today, September 13 2019). As a result, global economic policy uncertainty rose (exhibit 1). Recession risks rose too (exhibit 2) as market participants watched the US-China trade-war/tech-war with one eye and the contracting manufacturing sector with another.

In our The Weekly Market View – August 26 2019, we argued "there are reasons to believe that trade concerns will abate in the near-term. Mr. Trump, who is concerned about his re-election in 2020 is unlikely to materially ratchet up trade tensions any further, for now. Worth noting that Trump's approval rating is already similar to that of presidents who fell short of re-election amid recession. Also, University of Michigan consumer sentiment indicator shows that republicans have been losing faith in the economy with the associated reading (for August) falling to its lowest level since Mr. Trump took office. Furthermore, tariffs that are currently announced are capable of more than offsetting the benefits the tax cuts gave to the average US consumer. So looking at the bigger picture, we tend to believe that trade wars should at least stop being an incremental overhang on equities in the near-term; here 'no news is good news' ".

Subsequently, there has been some positive news flow around trade. The US and China have both showed goodwill to each other ahead of the commencement of their talks next month. Mr. Trump last week announced that the tariff increase on USD250bn worth of Chinese goods scheduled for October 1 will be delayed until October 15 out of respect for the People's Republic of China celebrating its 70th anniversary. China reciprocated the goodwill gesture by exempting US soybeans and pork from additional tariffs (see *US-China trade deal would pull economy back from 'tipping point'*, Fox Business, September 13 2019). Later, Mr. Trump said he would consider an interim trade agreement with China (see *Trump Open To Interim China Trade Deal*, Forbes, September 13 2019). Any deal, even if 'interim' should be positive for the financial markets in the near term. Of course, there is (significant) risk that Mr. Trump could change his mind very swiftly. But in our view, at least for the near-term, this is unlikely to happen given that the vicious cycle triggered by an intensifying stand-off between US and China ('deal-off' leading to a 'risk-off' sentiment which in turn tightens financial conditions and leads to a rise in fear of recession) can have a huge implication for the re-election prospects (exhibit 3) of Mr. Trump and we believe he cares about it.

A strong policy support remains in place

Monetary policy support, which has kept this extended late-phase of the cycle alive, continues to remain in place. In fact, the last two weeks have seen key Central banks enhancing their support. Earlier this month, the People's Bank of China (PBOC) said it would cut the reserve requirement ratio (RRR) by 50bps for all banks, with an additional 100bps cut for qualified commercial banks. Whilst the PBOC has slashed its RRR seven times since early 2018, the latest came at the upper end of market expectations and the amount of funds released in this instance will be the largest so far in the current easing cycle. In Europe, the European Central Bank (ECB), in its policy review last week, cut its interest rate for deposits by 10bps taking the rate to a negative 0.5% and also announced a quantitative easing program in which it intends to buy USD22bn worth of bonds and other financial assets per month starting November. The most dovish push came when the ECB declared that it would continue these purchases for "as long as necessary".

The US Fed and Bank of England (BOE) are two other major central banks that will review their rate decisions later this week. In case of the US Fed, markets continue to expect a good chance of a 25bps interest rate cut later this week. Of course, markets are likely to look for guidance on the future rate path.

Overall, we continue to believe that the policy support will remain in place in the near-term. This should under-write a more pro-cyclical move in the markets.

At the time of writing this report, oil prices moved sharply higher (c10% up on Monday September 16 2019) due to the supply disruptions resulting from drone attacks on two oil facilities of Saudi Arabia. Whilst the extent of damage (which will determine the time to restoration of supplies) remains highly uncertain, we see reasons why a sharp rise further in oil prices is not very likely. Firstly, c200m barrels of Saudi oil stockpiles (distributed across KSA, Japan, Egypt and The Netherlands) could cover the lost production (estimated at c5.7m barrels a day) for about a month. The prospects of US using its reserves (which at the time of writing the report has been put forward/approved by Mr. Trump) and other Gulf players boosting their production are being underappreciated by the market in our view. Also, further sharp rise in oil prices (say beyond USD75/bbl) is likely to bring large shale supply back into the market. Therefore, we believe that a runaway oil price is less likely in the near-term. Of course, this event does result in the rise of the geopolitical risk premium but we think improvements elsewhere (US-China trade front and policy support) are likely to be more influential and are likely to play a major role in containing sharp rises in risk premia.

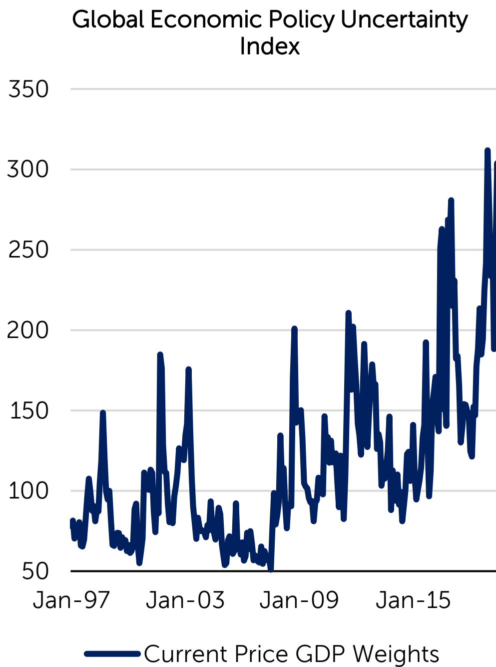
We are not changing our winning team

In our strategic allocation, we retain our preference for US by region, defensive/non-cyclical growth sectors, large caps by size, growth as the style and quality as a factor. Indeed, our preferences have worked in our favour so far this year (exhibits 4-6). After having performed strongly, all these segments now sit on rich valuations – especially in relation to the rest of the market. Against this backdrop, in the near-term a more pro-cyclical bounce could be in store. A bounce led by moderating trade uncertainty and confirmation of policy support should provide a lift to those segments that have lagged so far.

This would prompt the market leadership to move away from leaders to laggards:

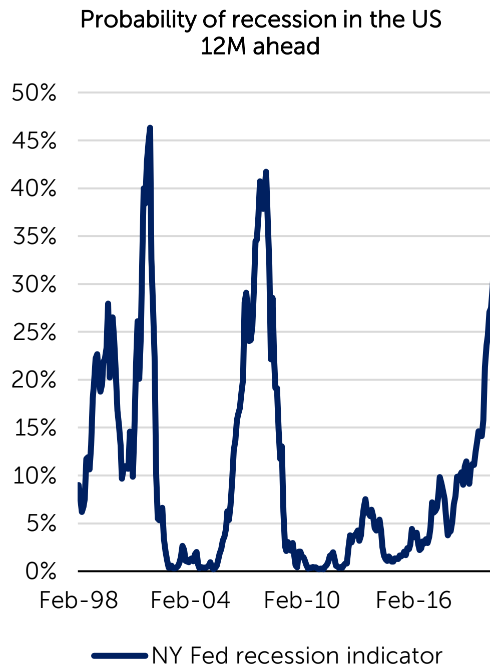
- from US to Europe, Japan and EM (we would emphasise Taiwan and South Korea here)
- from defensive sectors into cyclical sectors (industrials and consumer discretionary stand out, in our view)
- from quality/growth into value. In our recent note The Equity Strategist: Ahoy there, dividend yields are here, September 4 2019, we highlighted the attractions of dividend yields.
- from large caps into small caps.

Exhibit 1: Global economic policy uncertainty rose sharply...



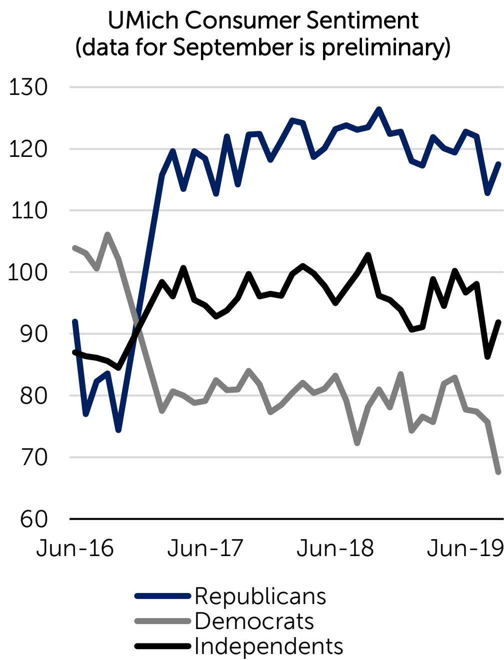
Source: Bloomberg and ADCB Asset Management

Exhibit 2: ...stoking fears of a recession



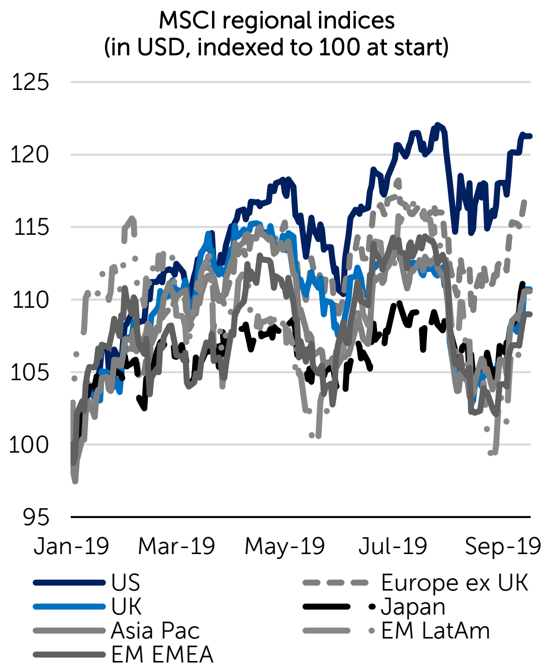
Source: NY Fed, Bloomberg and ADCB Asset Management

Exhibit 3: Republicans are losing faith in the economy



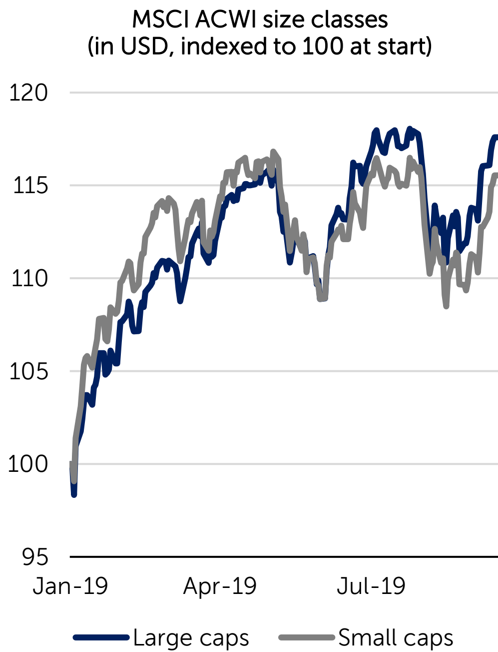
Source: University of Michigan, Bloomberg and ADCB Asset Management

Exhibit 4: So far this year, the US outperformed the rest of the world...



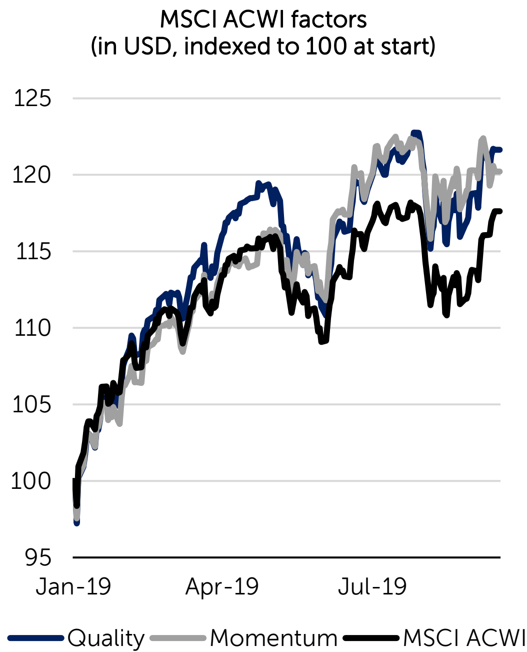
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 5: …large caps outperformed small caps….



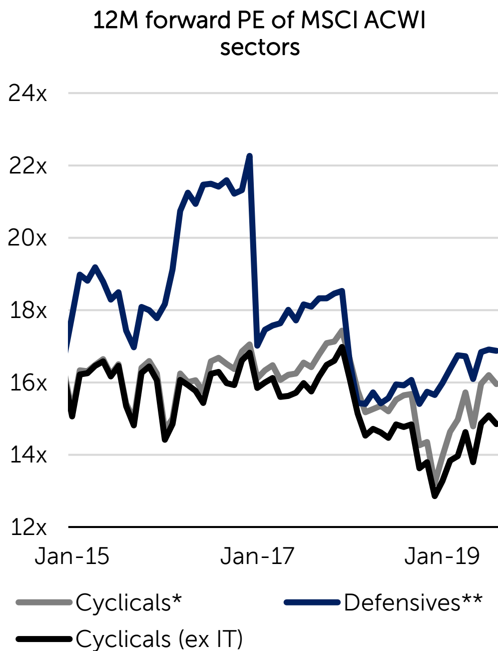
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 6: …quality and momentum outpaced the overall market



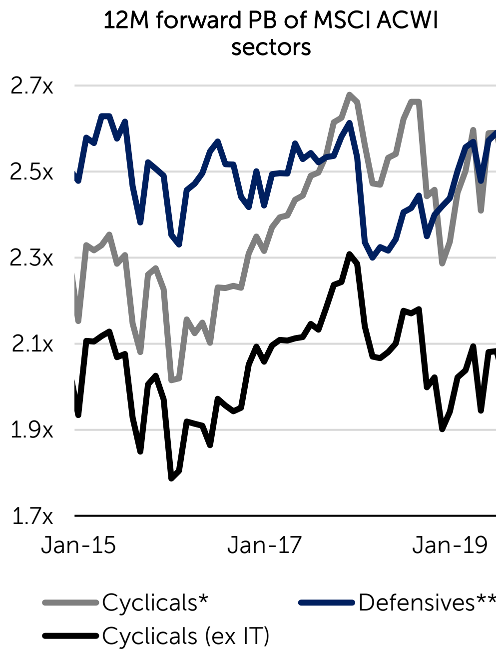
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 7: Defensive sectors trade on rich valuations: on 12M forward PE…



Source: MSCI, Bloomberg and ADCB Asset Management | Notes: *simple average of Consumer Discretionary, Financials, Industrials, IT and Materials. **simple average of Communication Services, Consumer Staples, Energy, Health Care and Utilities

Exhibit 8: …as well as on 12M forward PB basis



Source: MSCI, Bloomberg and ADCB Asset Management | Notes: *simple average of Consumer Discretionary, Financials, Industrials, IT and Materials. **simple average of Communication Services, Consumer Staples, Energy, Health Care and Utilities

Here we list, 9 reasons why we think a pro-cyclical bounce is likely in the near term and 4 (rather strong) reasons why we think it will be only short-lived.

Why we think a pro-cyclical bounce is likely

1. Risk-on mood is positive for cyclicals in general. Helped by a potential improvement on the US-China situation and policy support, there are chances a risk-on mood will prevail in the markets.
2. Valuations of defensives relative to cyclicals and growth relative to value are stretched (exhibits 7-9).
3. Rise in bond yields has in the past coincided with outperformance of value segment within equities (exhibit 10).
4. Quality is an over-crowded trade after a strong performance in the past months (see *Quality Stocks Are an Overcrowded Trade*, Bloomberg, September 6 2019).
5. Big-tech, which has been behind the strong run up in US equities, is coming under regulatory scrutiny (see *Facebook and Google antitrust investigations: all you need to know*, The Guardian, September 7 2019).
6. We are entering seasonally weak months for US equities. Based on the average monthly return data since 1871, October has been the weakest calendar month for S&P composite. Returns in September too have been rather subdued in the past.
7. ETF flows have so far disproportionately benefitted large cap stocks making them more expensive, particularly in relation to small caps. As investors look beyond the blue chips on improved risk appetite, small caps should look attractive.
8. In our view, potential for further US monetary policy accommodation is bigger than anywhere else. Therefore, any potential USD weakness arising thereof, should be good for emerging markets and cyclicals.
9. Value to outperform growth in the near-term. At this point, cyclical value is primed to take over momentum.
   We do not regard 'value' and 'growth' as mutually exclusive segments – (ask us why – write to us at investmentstrategy@adcb.com) – this is a reason why we are overweight growth but only neutral value in our strategic equity allocations.

Why we think any pro-cyclical rotation will only be short-lived

1. We regard this sector rotation healthy, also as a basis for quality consolidation and resurgence.
2. We are in a late phase of economic expansion. Quality and defensive do well in such an environment. As soon as markets price in the possibility of an interim trade deal, the focus will likely shift back to the aging cycle – thus bringing quality back in demand.
3. Global economic uncertainties can rise very quickly. As such we think the US and China are engaged in a prolonged trade/tech-war and the chances of intensification of the stand-off in the future (medium-term) remain rather high. Therefore, we see the conciliation as only temporary.
4. We think it is prudent to wait for an inflection in economic data before adding more cyclical/value exposure to strategic portfolios.

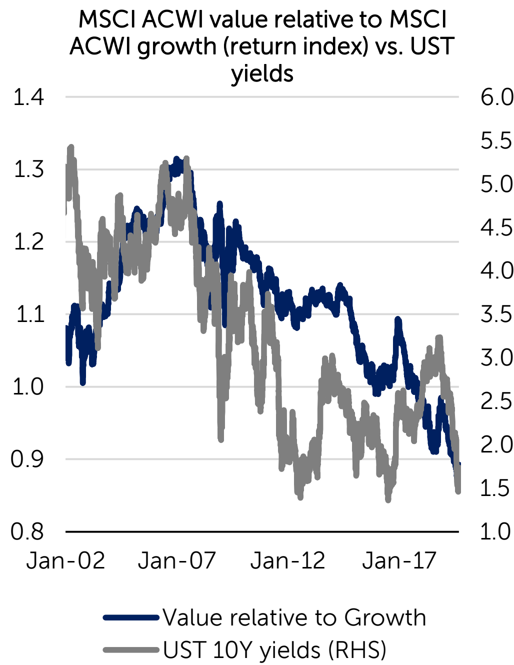
Conclusion

Pro-cyclical rotation only means a change in leadership: from defensives to cyclicals and from growth to value (exhibit 11); it doesn't mean losses in absolute terms for quality investors. In fact, periods of risk-on with cyclicals outperforming have delivered positive returns on overall markets. Moreover, as we highlighted above, there are reasons why we think this rotation will be short lived. Therefore, we stick to our strategic asset allocation (preference for US by region, defensive/non-cyclical growth sectors, large caps by size, growth as the style and quality as a factor), with a 12M view (exhibit 12) but do acknowledge the risks of this becoming a pain trade in the near-term.

Exhibit 9: Value sits at a deep discount to growth

Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 10: Value stocks outperform when bond yields rise



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 11: What works when

	Tactical (3M view) outperformers	Strategic (12M view) outperformers
Region	Europe, Japan and EM	US
Sector	Industrials and Consumer cyclicals	Comm. services and consumer staples
Size	Small caps	Large caps
Style	Value	Non-cyclical growth
Factor	High dividend yield	Quality
Themes		Services oriented sectors

Source: ADCB Asset Management

Exhibit 12: Equity strategy summary of our 12M view

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Selective OW Switzerland and Spain
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			Structurally OW India; OW Australia and HK
EM LatAm	■			Tactically OW Brazil
EM EMEA	■			Tactically OW South Africa
GCC		■		Prefer KSA; regional banks
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Consumer Services to Auto & Components
Consumer Staples			■	Prefer Household & personal products
Energy			■	Companies with positive cash flow to outperform
Financials		■		Prefer Banks with diversified business models
Health Care		■		Risks from US presidential elections
Industrials		■		Prefer Commercial & Professional Services
IT	■			UW Tech H/W and Semiconductor sub-sectors
Materials	■			UW Materials hedged with OW Brazil and SA
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	■			US small cap strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Growth at a reasonable price (GARP)
Dividend yield			■	Prefer quality dividends
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Watch momentum for leadership change
Legend	*New*	*Old*	*No change*	

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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