Investment Strategy

Equity Strategy | September 13 2021

ADCB ASSET MANAGEMENT LIMITED

The Equity Strategist: Looking to the East

- **Over the next 12-16 months, uncertainties could rise as we move towards a post-pandemic 'normal'. Staying invested in a more diversified portfolio is key.**
- **From a broader asset allocation perspective, we stay neutral equities and alternatives, underweight fixed income, and overweight cash.**
- **Within equities, we raise our allocations to Asia to a "moderate" overweight and trim our US overweight to a more "modest" position. We also make changes to our sector allocation.**

Investment outlook

As we argued in our Q3 outlook report (see Quarterly Investment View, July 2021), markets are facing three peaks – peak growth, peak inflation, and peak policy support – at the time when the economic cycle is moving faster than normal. Also, a range of uncertainties persist. These include the emergence of new variants of the COVID-19 virus, behaviour of the labour market as we move from the post-pandemic 'rebound' to 'recovery', central bank dilemma (whether to keep the monetary policy accommodative to aid the nascent recovery or to start tightening so that they begin to accumulate some ammunition to fight the next downturn), emergence of supply-side bottlenecks impacting inflation outlook, and weakening consumer confidence as fiscal policy support fades. While the level of economic growth remained strong, peak growth concerns weighed on the performance of risk assets intermittently during recent months. Citi Global economic surprises index – which measures the extent to which the actual economic activity across the globe surprised versus the estimates – peaked mid-June, fell consistently subsequently, and turned distinctly negative in mid-August. All this is reflected in the elevated level of uncertainty regarding unemployment, core PCE, and GDP growth at the US FOMC. This uncertainty is also feeding into a wide range of strategists' year-end target levels for S&P 500 and 10Y UST yields. Looking ahead, for the next 12-16 months, we think investors are best served by maintaining a well-diversified portfolio to counter this broad range of uncertainties. Of course, staying invested in a well-diversified portfolio was always prudent, it is just now a bit more important too.

Regions

- Upgrade Asia Pacific (APac ex Japan + Japan) to a "moderate" overweight from neutral. Within Asia, the following is our order of conviction:
    - Japan
    - ASEAN (Singapore)
    - China and Hong Kong
    - India
    - Taiwan and South Korea
    - Australia and New Zealand
- Trim US overweight to a "modest" position
- Elsewhere, our unchanged active positions include overweight UK, underweight Eurozone and underweight EM outside Asia

Sectors

- Trim overweight on IT
- Upgrade financials to neutral from underweight
- Upgrade industrials to overweight from neutral
- Downgrade energy to neutral from overweight
- Downgrade utilities to underweight from neutral
- Elsewhere, our unchanged active positions include overweight communication services and underweight materials

Factors/styles/sizes.

We make no changes to our factor, style and size preferences. We continue to prefer large cap, quality, and non-cyclical growth.

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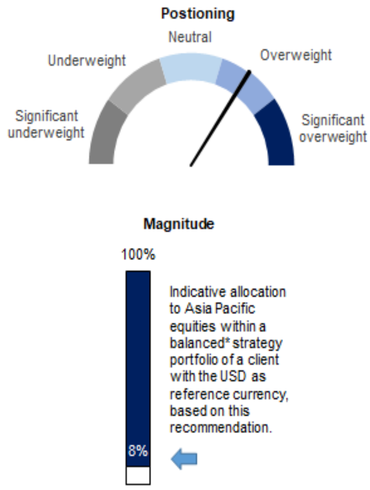
Understanding our recommendation on Asia pacific equities



Source: ADCB Asset Management | Notes: *Investors should consider their own risk preferences and, where necessary, consult with their financial advisor before implementing this strategy

Porftolio positioning

Exhibit 1: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities				Year of two halves – with quality favored in H2
Fixed income				Taper talk to dominate – negative for duration
Alternatives				Prefer gold and market hedge strategies
Cash and liquidity				Dry powder looking for deployment opportunities
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US				**"Modest" overweight with focus on quality**
Canada				Stick with the benchmark
Europe ex UK				Light on structural drivers of growth
UK				Prefer global large caps with quality-tilt
Japan				**Near-term tailwinds from improving macro**
Asia Pacific ex Japan				**Prefer ASEAN (Singapore) and EM Asia**
EM LatAm				Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA				
GCC				Stick with the benchmark
Global sectors				
Comm. Services				Diversified telecoms and Media
Consumer Discr.				Hotels, Rest. & Leisure
Consumer Staples				Food, Beverage & Tobacco
Energy				**Capital discipline and makeover plays**
Financials				**Focus on growth opportunities in Asia**
Health Care				Biotechnology and Health care technology
Industrials				**Industrial automation and IoT**
IT				**'Moderate' OW with focus on durable growth**
Materials				Structural weakness on a shift to 'new economy'
Real Estate				Real estate management & development
Utilities				**Gas utilities and Renewable Electricity Prod.**
Factors/styles/sizes				
Large cap				Strong balance sheet, earnings visibility
Mid cap				Likely to be market-performers
Small cap				Strained by leverage and peak-growth
Growth				Prefer non-cyclical growth
Value				Avoid value in sectors facing disruption
Dividend yield				Prefer quality dividends and dividend growth
Quality				Quality in the environment of low risk-tolerance
Momentum				Benefits from 'new economy' orientation
Legend	*New*	*Old*	*No change*	

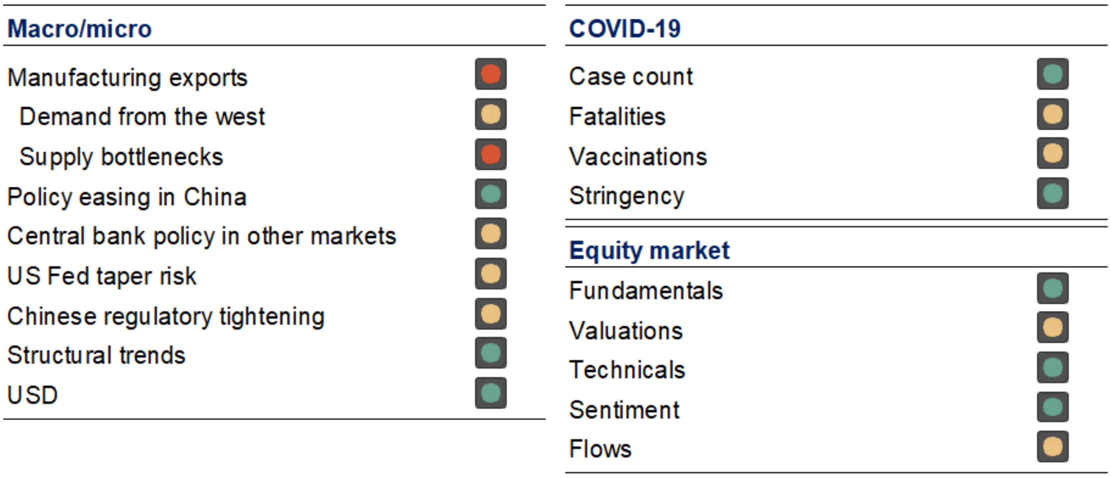
Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks

Changes to geographical allocation

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

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

Exhibit 2: Traffic signal card points to potential opportunities in Asian equities



Source: ADCB Asset Management

- **Japanese** equity market tends to benefit from hopes for more stimulus from a potential new Prime Minister, and lower rates compared to other developed markets. Japanese equity market presents relative value after recent underperformance and could be helped by the strength in the industrial cycle over the next 12 months. COVID-19 cases seem to have peaked and vaccinations have picked-up pace. Over the long-term, improvements in corporate governance and other reforms could provide further support to Japanese equities.
- **ASEAN markets** (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) could get a boost from a revival in sentiment driven by a fall in COVID-19 case counts and increasing vaccination rates. Domestically oriented consumer-related companies present great investment opportunities. We think Singapore deserves a special focus given the recent control of COVID-19 cases and favourable policy risk backdrop.
- **Chinese/ Hong Kong** equity markets are likely to be helped by bottoming credit impulse and rebound in its internet sector equities. Further, as we argued in our report China-US tech decoupling – implications for global portfolios, July 28 2021, recent meltdown in Chinese tech equities points to a potential decoupling of the sector from that in the US. China appears to be charting its own course for this strategically important sector of innovation. For long-term global investors, China is too big to ignore – even after adjusting for a 'different' investing climate. Paradoxically, having a well-defined exposure to China is more important now than ever. While regulatory risks have clouded the near-term outlook, market reaction has been extreme too. We remain constructive on the broader theme for the long-term. We think investors with no China exposure risk missing opportunities there.
- **Indian** equity market has benefitted from two developments. 1) An improvement in the profitability after a multi-year slump. This is as we expected and will likely last for many more years. 2) Acute weakness in Chinese equities - which has triggered a rotation of EM-focussed money into Indian equities as an alternative. Given the recent run up, Indian equities look technically overbought. Fund positioning is neutral relative to history, but valuations (based on 2021e and 2022e) look slightly

stretched. Against this backdrop, should Chinese equities do well, Indian equities could underperform in the next 12 months as rotation back to Chinese equities takes hold. If one takes a longer-term view on India, many structural trends are supportive (better demographics, rising exports, and expanding digital economy), and valuations look attractive. Indian equities, like other EM equities, are under-represented in global benchmarks/portfolios.

- **Taiwan and South Korea** should be helped by the strong demand for tech hardware. Further, South Korean consumer discretionary space should find support from stable (or stronger) Chinese economy and consumers there. However, it is worth noting that Taiwanese stocks have performed well already and incremental outperformance might be difficult to attain.
- We are not taking any high conviction active stance on **Australia and New Zealand**. These markets represent less than 2% of MSCI ACWI and c10% of MSCI AC Asia Pacific.
- On **Pakistan**, MSCI announced recently[1] that it will reclassify the MSCI Pakistan Indexes from EM to FM in one step, coinciding with the November 2021 Semi-Annual Index Review. This removes the market from our benchmark of MSCI ACWI.

Trim overweight on US equities

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

Changes to global sector allocation

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

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

Risks to our overweight on Asia Pacific equities

- Softer demand for Asian exports or persistent supply-side bottlenecks
- Weaker than expected demand for technology hardware
- A sharp rise in long-term UST yields causing a 'taper tantrum'
- Excessive USD strength (should make Asian exports more competitive though)
- Geo-political risk-off event in the region
- Emergence of new virus variants in the region
- Slower vaccinations hampering removal of restrictions

[1] MSCI Downgrades Pakistan to Frontier Market After Four Years, Bloomberg, September 8, 2021, 12:45 AM GMT+4

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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