INVESTMENT STRATEGY

Investment Management

Servicing beyond solutions

Investment Strategy Q1

Geneva - Headquarters
Place de Longemalle 10-12
1211 Genève 3, Switzerland
Tel: +41 22 715 1211

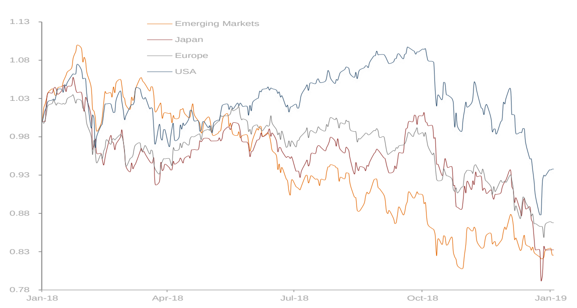
Zurich Branch
Nüschelerstrasse 1
8001 Zurich, Switzerland
Phone: +41 44 265 71 11

Beirut Branch
Allenby Street, Beirut Souks,
Block 25, 4th Floor, Beirut, Lebanon
Phone: +961 1999 366

Global stock markets

Following a period of very low market volatility; 2018 saw some notable regime changes. It was to become quite a year for global equity markets. In particular the fourth quarter will stand out and be one to remember. After the Dow Jones reached a new all-time high on October 3rd, things had started to unravel in a fashion most investors were not prepared for. By the end of the quarter US equities had fallen 20%. Oversold markets usually rebound from the middle of December to the end of the year. This time, however, a rally was missing. A sign that the structural changes will continue to affect markets in the new year. US stocks closed the year lower for the first time since 2008, yet still outperformed by only dropping 6%. Europe was down 14%, Emerging Markets -17% and Chinese equities lost 20%. Few indices were up on the year, such as Brazil, Russia and India. These markets, however, all benefit from a weak currency.

MSCI World Equity Indices *(Bloomberg L.P.)*

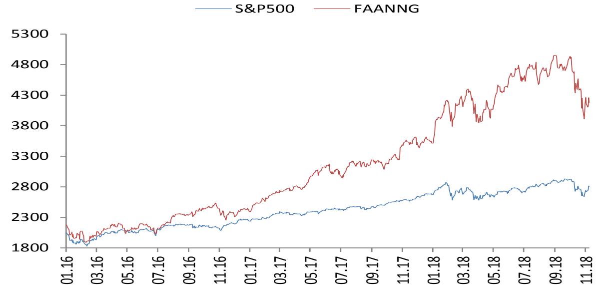


Many investors list the tighter monetary policy by the FED and the repeatedly flaring trade war between the US and China as main reasons for the bad year. But, as usual there's more than meets the eye and ultimately things are much more complex.

FacebookAmazonAppleNetlixNvidiaGoogle

The big tech companies continued to be among the dominant drivers, although starting in the Summer months to give back some of the relative

FacebookAmazonAppleNetflixNVIDIAGoogle*(BloombergL.P.)*

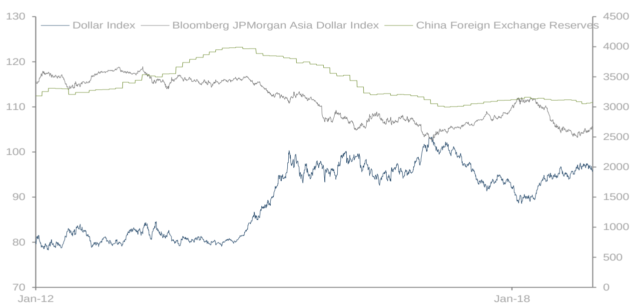


strength versus the broader market. Whereby these overcrowded trades have become themselves a source of volatility. Worries emerged when Facebook and Google faced a privacy backlash while growth concerns have been steadily mounting. The stark sales warning by Apple after the turn of the year, when it cited unforseen slowdown in China, had ripple effects on the financial world. Also, the events in the past months show that market liquidity in times of need is absent. At any rate 2018 has ushered in an adjustment phase. Much will depend on how FAANNG will continue to develop. This cohort's combined expected earnings per share of USD 110 compares to USD 170 for all 500 companies in the S&P500 together!

The U.S. Dollar Index, China Fx Reserves

That the US Dollar is the name of the game can be witnessed time and again in one form or another. Sometimes it acts as leading indicator and sometimes it is serving as coincident indicator. At the end of the day

The U.S. Dollar Index, China FX Reserves *(Bloomberg L.P.)*

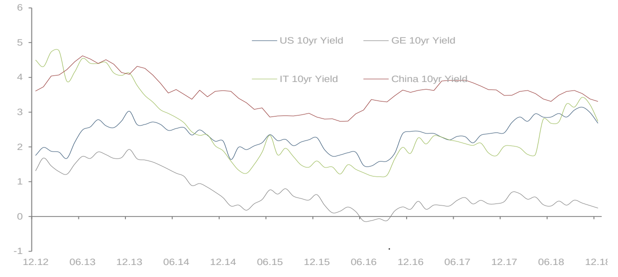


it all boils down to flow. Generally, the US Dollar has been in consolidation mode for the better part of Q4. An indication that money flow into US equities had abated. This current consolidation of the US Dollar can last a while longer. However, our view from the beginning of the year that the globally synchronized growth was gone had become evident to everyone. The economic weakness has become particularly pronounced in Europe. It is therefore vital to have the bigger picture in mind. Also because a rising US Dollar is per se a monetary problem. Whenever the global reserve currency is going up, leading indicator, it is at the same time retrenching global liquidity, resulting in trade disruptions and tighter interbank lending. We still see the US Dollar substantially higher over the medium to longer term.

Global Fixed Income Markets

The FED delivered another widely anticipated rate hike at its December meeting, while forecasting then another three for 2019. However the market turbulences have forced the FED to adapt a market friendly posture, by indicating it can be patient with further rate hikes and that it can respond to changing dynamics. Overall the yield curves have stayed flat. However the three-month USD money market curve has now turned fully inverted.

US, GE, IT, CN 10yr yield *(Bloomberg L.P.)*

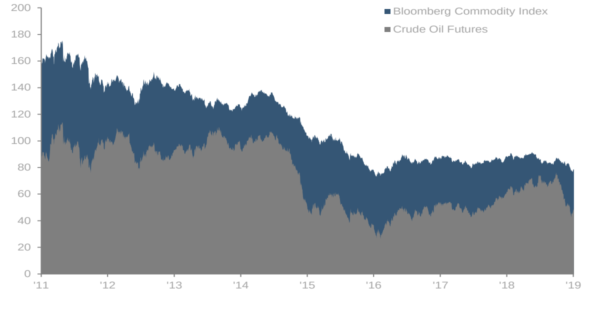


On the back of the expected safe-haven bid the US Treasury 10yr yield has fallen from the yearly high at 3.26% in early October to 2.54% at start of this year. Credit markets on the other hand have not been left untroubled by the risk-off in equities. Both, investment grade and high yield spreads have seen accelerated widening in the fourth quarter. The debate is on whether the yield curves are a harbinger of recession. The risks certainly have increased.

Commodities

It was probably no coincidence that the Dow Jones and Crude Oil had peaked on the same day, on October 3rd. We have warned in our Q4 report that the subsequent drop from that high had been sharp, thus warranting a more cautious stance. In fact the International Energy Agency as well as the OPEC have both since revised down their global oil demand estimates. But maybe more detrimental to the price of oil was that market speculation had reached levels unseen before based on the data from NYMEX. Fast money was stopped and an epic run to the exits followed. As markets will need to adjust to lower growth

Bloomberg Commodity Index, Crude Oil *(Bloomberg L.P.)*

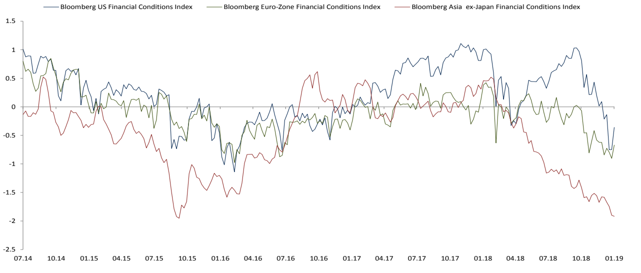


expectations, so too have central banks to take into account falling headline inflation data from the lower oil price. However, that is not the only challenge they face. Markets make clear statements that central banks do not appreciate the difference between economics and real economies. But then again, as we have elaborated on these pages before, for the FED it has been all about normalization of rates. The statements that low inflation readings were just transitory and things will be bright down the line had been nothing but statements.

Global Financial Conditions

The Bloomberg Financial Conditions Indices track the overall level of financial stress in the money, bond and equity markets. The indices show that financial conditions have tightened rather sharply. In Europe and in particular in Asia the conditions have become significantly tight relative to pre-crisis norms.

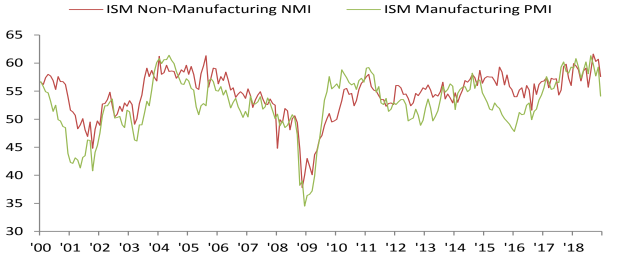
Gobal Financial Conditions *(Bloomberg L.P.)*



Global PMI Data

We warned that the Global Purchasing Managers Indexes, composite and manufacturing, have abandoned the recovery from 2016 and 2017. These leading economic indicators are still cause for worry. In the Euro area PMIs had the weakest reading in more than two years, while in Asia the data continues to show weak growth momentum, with some notable activity weakness. China Caixin Manufacturing PMI even dropped below the crucial 50. It is also worth noting that the PMI data from the US Institute for Supply Management has started to align.

US ISM Non-Manfg & Manfg PMI *(Bloomberg L.P.)*

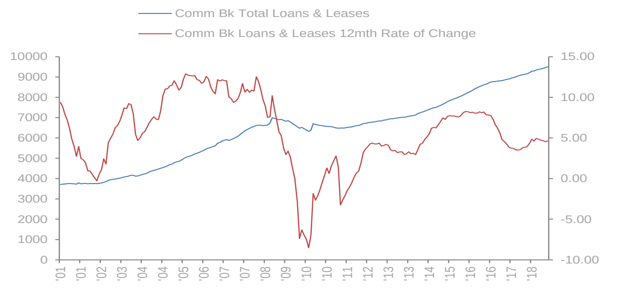


That the business cycle has been long in the tooth is nothing new. Yet, the average year-end forecast for the S&P500 compiled by Bloomberg shows 2975, a 15% increase. Wall street strategists assume that corporates earnings situation remains stable. Maybe they face the same challenge as the central banks regarding economics and real economies.

World Exports, US Credit Growth

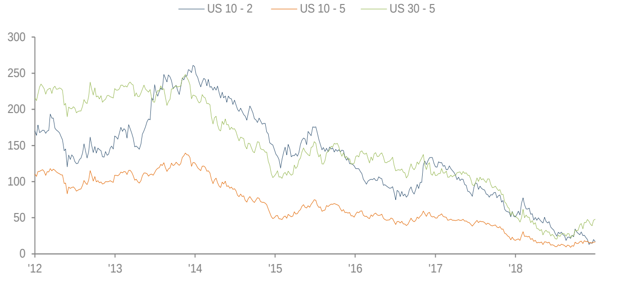
Economists make economic assumptions based on models, where an economy that is expanding must also be growing. Global growth data improved in 2017, but it has lacked momentum. The uptick then in growth data demonstrated positive numbers but not robust growth. In addition to that, without banks and credit growth the economy just isn't growing like it is supposed to. Every time investors have hoped that these reflationary periods were signs that the structural deficiencies had been overcome and a boom was at hand.

US Commercial Banks Loans & Leases *(Bloomberg L.P.)*



However, the persistently flat yield curves have confirmed that this has not been the case. True, the US unemployment rate is down, yet real wage growth is still missing, a factor that would really matter.

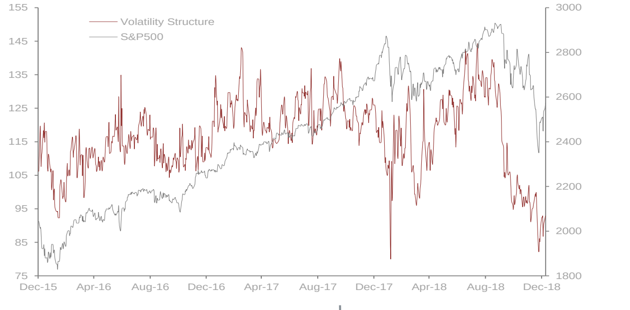
US Yield Curve *(Bloomberg L.P.)*



S&P500 & VOLATILITY

Markets trade on narratives, while valuations and sentiment measures, among others, help investors to master risk. Depending on the narratives, new correlations between assets may develop or long-serving analysis on existing correlations may well be used. From a strategic point of view the name of the game remains the US Dollar. Not because things are truly great in the United States, but simply because things are elsewhere truly not so great! The US will continue to attract liquidity from abroad over the medium to longer-term, one way or the other.

Volatility Measures *(Bloomberg L.P.)*

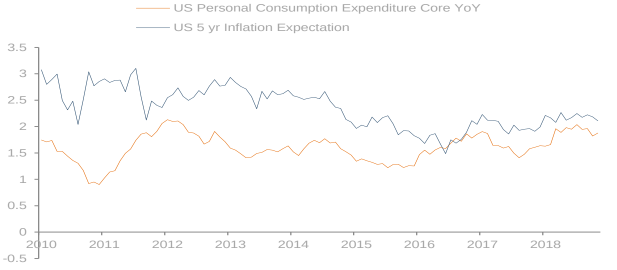


From a tactical point of view the narrative will be spun around the developments in the US-China trade disput and the upcoming earnings season. We remain underweight equities with a target at 2300 for the S&P500. The pivotal levels to the upside to change to neutral are at 2630 and 2730. This changing markets configuration will offer many opportunities.

US10YR YIELD, U.S. PCE & INFLATION EXPECTATION

Ten years after the Great Financial Crisis the global financial and economic landscape has changed. The massive interventions by central banks has not lead to the desired pick up of inflation. The extraordinary monetary policies never really made it into the real economies. Gowth data have not returned to pre crisis levels. Despite of a lot of talk the monetary policies did not result in stimulating the demand side. What's left are too many unintended consequences and most of all too much loss of time.

US PCE & Inflation Expectations *(Bloomberg L.P.)*

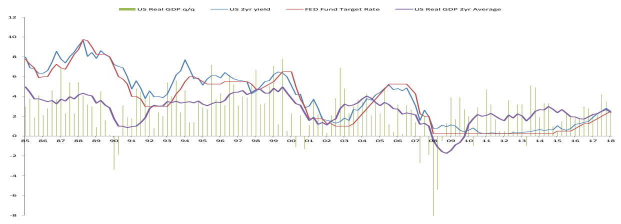


It is crucial to see the big picture. In 2000 when the dotcom bubble burst the ensuing recession caused a crisis at the corporate levels. The policy response then by lowering rates to levels not seen before and particularly the repeal of the Glass-Steagall Act of 1933 had paved the way to the problems starting in 2007. It had scaled up to a crisis at the banking level. Subsequent policy response by bailing out banks and imposing extreme monetary policies when going to negative interest rates and balooning balance sheets of the central banks opened the way to a crisis at the level of sovereigns. Trying to understand the financial markets of today it is important to see it through the lens of this evolution. Interest rates are rising globally because of credit concerns picking up. The FED, now that it has admitted to be also market dependant, will try to sneak in a rate hike whenever possible. It wants to continue the normalization process by raising rates further, despite the criticism of Trump. On the other hand the ECB and the BOJ would love to be in such a position. In China the eyes are on further fiscal stimulus and additional cuts in reserve requirements for banks. The PBOC has been very aware that the Chinese market has been cooling down as well. Overall, markets are coming closer to the end of the debt supercycle. However, the scripts of the previous two crisis cannot be applied!

US 2yr Yield, GDP, FED Fund Target Rate

Global central bankers continue to choose their words wisely by pointing that things will be fine in the future. That the trade war has become the focal point is not only an expression of very weak global growth, but also an indication of a shift away from globalization. The integration of China and the former communist bloc into the world economy has pushed the global economy in the past 40 years like never before. With the structural changes announced at the China's party congress in 2017 things have changed. The US-China trade war could well be seen in the light of an economic cold war. We expect China GDP to decelerate to 6%.

US 2yr yield, US GDP, FED Fund Rate *(Bloomberg L.P.)*

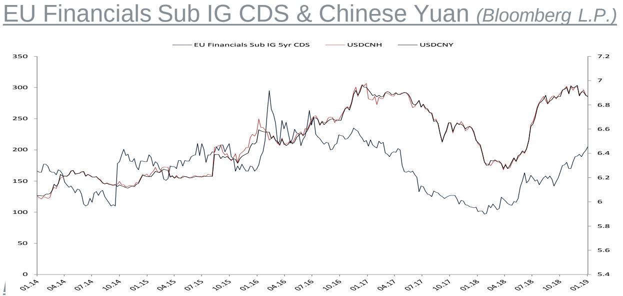


Markets are increasingly indicating that monetary authorities are past the point of control. Investors are well advised to adapt a pragmatic approach. It will be more and more a trader's tape. One man's joy is another man's sorrow.

EU Financials Sub IG CDS & Chinese Yuan

Banking in the Euro Monetary Union is as critically dependent on Dollar liquidity as are the Emerging Markets which are functioning under huge debt, which is mostly Dollar denominated. The symptoms showed renewed signs of distress of Dollar funding in 2018. The name of the game remains the US Dollar and that there's more to it. There are a few questions marks over the European politics. Europe, which finds itself in an ever increasing difficult project. Given the poor state of the economy, the rise of more centrifugal forces will not be a surprise. Then there is Brexit. A lot has been written about it. Maybe there will be a delay of the March 29 deadline. Maybe there will be a cliff edge Brexit. In any case, all the parties involved have not made a good impression. And it is fair to say, that confidence hasn't been built either, on both sides of the channel.

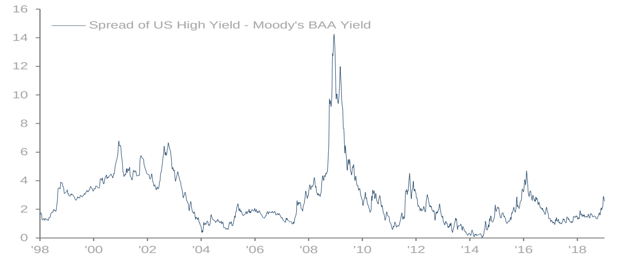
EU Financials Sub IG CDS & Chinese Yuan *(Bloomberg L.P.)*



Yield Spread U.S. High Yield – Moody's BAA

Credit spreads have taken their toll during the risk events in Q4. Yet, the widening has still unfinished business. We expect that the levels of 2011 will eventually be surpassed. We see the risk building of a rise in credit rating downgrades as well increased number of defaults globally.

US High-Yield & Moody's BAA *(Bloomberg L.P.)*



Summary

- Pragmatic approach remains key
- Passive investing is past, it's a traders tape
- Equities remain underweight – S&P500 at 2300
- FED to be market dependant, will hike whenever market conditions allow
- We keep strategic O/W on US equities, although recognise tactical opportunities in EU and EM
- Agricultures at the beginning of a long-term bull
- Synchronized global slowdown to accentuate
- Risk of recessionary tendencies remain high on weak global demand

		Change			
Country Allocation	**Recommendation**	Q1	Q2	Q3	Q4
USA	Overweight	→			
Europe	Neutral	→			
United Kingdom	Neutral	→			
Switzerland	Neutral	→			
Japan	Overweight	→			
Emerging Markets	Underweight	→			
Asset Allocation					
Cash	Overweight	→			
Bonds	Neutral / Overweight	↗			
Fixed Coupon	Neutral	→			
Floating Rate	Neutral	→			
Sovereigns	Underweight	→			
Corporates	Overweight	→			
Equities	Underweight	→			
Discretionary	Underweight	→			
Consumer Staples	Overweight	→			
Energy	Neutral	↘			
Financials	Underweight	→			
Health Care	Overweight	→			
Industrials	Underweight	↘			
IT	Neutral	→			
Materials	Neutral	→			
Telecoms	Overweight	→			
Utilities	Overweight	→			
Alternative Investment	Neutral	→			
Commodities	Overweight	→			

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