mashreq
Asset Management

mashreq المشرق

Portfolio Managers Outlook

Portfolio Managers Outlook Quarter II 2013

Fixed Income Outlook

The first quarter has seen a variety of market themes that kept market participants busy and constantly on their toes. The year started almost as expected with higher yields in US Treasuries and it appeared to have caught some investors in Emerging Markets off-guard. When the 10 year yield moved above the 2% level for the first time in almost a year, a short sell-off in high grade and high yield bonds was triggered. Since, then the yield started fluctuating between the 2% and 1.8% levels which was taken with more comfort as positions had been adjusted.

While the US experienced a positive momentum with generally more risk appetite the FED has capped the upside for yields with its outright market purchases of Treasury bonds and Mortgage Backed Securities which the FED is expected to continue for the foreseeable future.

Economic data coming out of China is promising and hints at higher quality growth. Looking at other Emerging Markets and the European market though, bond did not perform well especially in the periphery where investors were uncomfortable about the recurring market disturbances caused by Italian elections as well as the Cyprus bailout.

Globally new issuance was active and met high demand throughout the period. New issue premiums could not always be realized by investors due to the pricing power of the syndicates. Books still tend to be highly oversubscribed.

Looking forward to the second quarter, it will start off while the Cyprus bailout and its implications still have to be digested and a reassessment of the European situation takes place. It is likely that the markets will stay volatile. On the positive side, the situation offers more attractive entry points into assets than at the beginning of the year, e.g. the JP Morgan Emerging Market Bond Index is 60 basis points wider than at its low.

Economic data will become the most important driver for market's performance as the big market events of the first quarter are slowly fading away. It remains to be seen though, how the sequester in the US ultimately impacts their economic recovery and if Europe can reinstate confidence after the Cyprus bailout was not handled in the best way possible, especially since some officials made inconsiderate statements that were not to the benefit of risk perception. Many debt issues still need to be solved. Nevertheless in our base case scenario the outlook is constructive but it will certainly not be a journey on a straight line.

Equity

When we last updated our view in December, the world economy was at risk of stumbling over a fiscal cliff. The picture has improved since then thanks to a temporary resolution of the US fiscal mess and a redoubling of balance-sheet based stimulus measures by major central banks.

Stock markets remain buoyant and bond yields restrained thanks to the commitment to existing open-ended balance sheet expansion programs by the major central banks. Quantitative easing has fostered substantial improvements in financial conditions in the US, Europe, and elsewhere, and is in the process of being employed again more forcefully in Japan.

US outperformance is the most obvious feature of global equities. This has largely been due to the superior earnings growth reported by domestically-focused US corporates. The US has avoided the sharp macro setbacks seen elsewhere, while firms have expanded margins, in large part by driving unit labor costs to multi-decade lows.

MENA markets

MENA markets have showed strength to start the year. While last year was more about a couple of star performing markets, we are presently seeing breadth in YTD performance across MENA markets. All MENA markets have ended the quarter in the positive territory with exception of Egypt which we highlighted in our last update will be a special case due to political instability.

Index	Price Return
S&P Pan Arab Composite Large Mid Cap	3.68%
Dubai	15.01%
Abu Dhabi	14.59%
Saudi Arabia	5.54%
Qatar	2.57%
Oman	7.18%
Kuwait	13.73%
Egypt	-5.11%

As we expected sectors that depend on domestic demand have outperformed, a clear example of that is Saudi Arabia where retail stocks continued to outperform, however petrochemicals and banks lagged. Concerns over a hike in feedstock and gas prices caused petrochemicals to underperform, and the pressure on net interest margin for banks shied the investors away from the sector.

The star of the quarter was Dubai Financial market which returned 15% YTD, as investors were optimistic about the recovery in real estate sector in the emirate. Emaar the bellwether stock returned 40% YTD on the back of flow of good news regarding new launches and increasing real estate prices. Also, strong momentum and above expected dividends from the banking sector has pushed bank stocks up. Kuwait has performed well being the second top performing MENA market year to date, however the return mostly came from small caps leaving large and mid caps underperforming. Meanwhile, Qatar equities are struggling despite a weak 2012 performance. We expect this to change as fund flows into the Doha market will be increasing. Lastly, Egypt is being plagued by a lack of leadership, ongoing conflicts between sects and consequently, a balance of payments crisis.

We are expecting a consolidation in equity prices in the second quarter especially in UAE where the rally was so sharp and so quick. Also, valuations in UAE have stretched, so it is the time of profit taking to do its part, and despite return on equity has recovered from its lows, it needs to trend towards its mid- cycle levels (10-15%) to justify the current valuations.

While a short-term period of consolidation now looks likely for many of the markets in the region, we broadly expect equities as an asset class to outperform fixed income over the coming quarters. In our view, a combination of rising consumer and business confidence, loose credit conditions, and strong expansion within the non-oil private sectors of the GCC economies are set to boost corporate earnings and keep stocks buoyed throughout the year. We remain most bullish over the medium term on Saudi and UAE equities, which are able to rely on solid fundamentals - and surging sentiment in the case of Dubai and Abu Dhabi.

Contact Us: Tel: +9714 207 8811, **Email:** assetmanagement@mashreqbank.com, **Web:** www.mashreqassetmanagement.com

April 2013