Alkhabeer Capital

GLOBAL OUTLOOK 2016

February 2016

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MARKET INSIGHT

> **Financial markets remained volatile in 2015, though the world economy trudged on its path of slow recovery. We expect more of the same in 2016, with financial markets being largely influenced by monetary policies of central banks**

2015 was a year of high volatility for financial markets. Though the world economy continued on its path of recovery, overall global growth remained fragile. Progress among advanced economies continued to be driven largely by the US, while China, the world's key growth engine in recent years, was faced with a slowing pace of expansion.

One of the key features of the year, in line with trends following the financial crisis, was the increasing influence of central banks on financial markets. Their policy decisions played a crucial role in determining market trends for the most of 2015. The year started with the Swiss National Bank unexpectedly ending its policy of capping the Swiss Franc against the Euro. Soon thereafter, the European Central Bank (ECB) unveiled its much awaited quantitative easing program to spur the ailing Eurozone economy. Later, during the course of the year, the Chinese central bank surprised markets by devaluing the Yuan in a bid to make the currency more market oriented, causing ripples across global markets and fueling a wave of selling in many emerging market currencies. And finally, after dropping hints throughout the year, the US Federal Reserve (Fed), at its last policy meeting of 2015, hiked its key interest rate for the first time in nearly a decade, thereby ending years of near-zero interest rate policy. In addition to central bank policies, mounting concerns of a Grexit in the initial half of the year and fears regarding the health of the Chinese economy weighed considerably on investor sentiment over the course of 2015.

Coming into the new year, we believe that central bank policies would continue to play a crucial role in determining movements in financial markets. The outlook for 2016 will be influenced not only by the actions of the Fed, but also the policies of other central banks. The divergence in monetary policies in advanced economies, mainly the US on one side and Japan and the Eurozone on the other, will largely shape the trends in 2016. The Fed is expected to take a measured approach to raising borrowing costs, while the ECB is likely to expand its aggressive stimulus program. Meanwhile, Japan could ramp up asset purchases too, especially considering the persisting environment of weak growth and subdued inflation. We anticipate trends from monetary policy to continue having a deep influence on the overall performance of key asset classes. We remain bullish on the greenback as the Fed continues to make its monetary policy less accommodative. However, the stronger US Dollar is also expected to weigh on the earnings of US companies, particularly the ones that have a high overseas exposure. Meanwhile, the ECB's easing measures would pressure the single currency, though at the same time buoy European equities. Sovereign bonds in advanced economies are also expected to show a diverging trend, in line with the disparate evolution of monetary policies.

With the Fed expected to continue on its path of a further tightening in monetary policy this year, we remain cautious on the emerging economies that are exposed to high US Dollar denominated debt. We are particularly negative on commodity linked Latin American economies as a stronger greenback will limit a rise in commodity prices. China is expected to grow at a slower pace, while India is likely to be a bright spot and could cement its position as the fastest growing emerging economy, if the government is able to deliver on reforms and improved governance. Meanwhile, oil prices could witness an upside in the latter half of 2016 if OPEC members subscribe to production discipline. For high yield corporate bonds, we remain cautious amid the rising potential for default in the energy and commodity sectors.

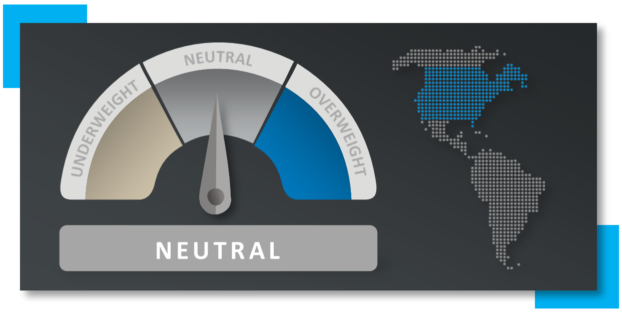
The world remains susceptible to geo-political risks and any adverse unexpected events this year could once again expose the global financial system to fresh economic shocks, in which case investors could seek refuge in the yellow metal and the safe haven Japanese Yen. We remain watchful of the potential headwinds, even as we expect financial markets to continue to be largely influenced by monetary policies.

RECOMMENDED ASSET ALLOCATION FOR 2016

US Equities

3% to 8% Returns

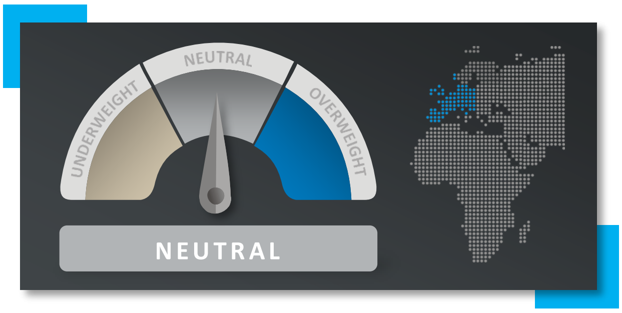
- Growing confidence in the strength of the US economy
- Valuations are higher than the 20-year historical average
- Stronger US Dollar could weigh on corporate earnings



Eurozone Equities

3% to 8% Returns

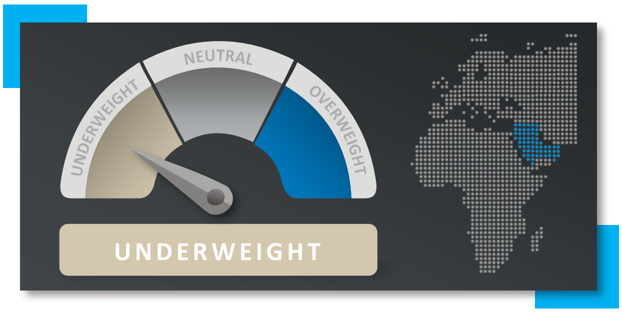
- Weaker Euro likely to benefit exporters despite subdued overseas demand
- Eurozone economy recovering but structural issues still remain
- European stocks are trading at lower valuations than US counterparts



GCC Equities

-5% to 5% Returns

- Volatility in oil prices could impact GCC equites
- Economic growth across the GCC countries is likely to take a hit in 2016
- Valuations are at compelling levels, advise cautious stock picking

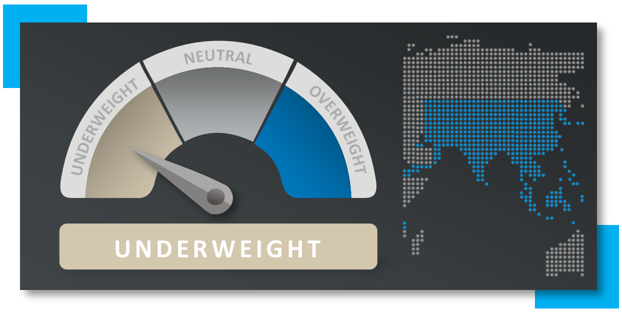


Emerging Equities

Commodity Exporting Economies

-5% to 5% Returns

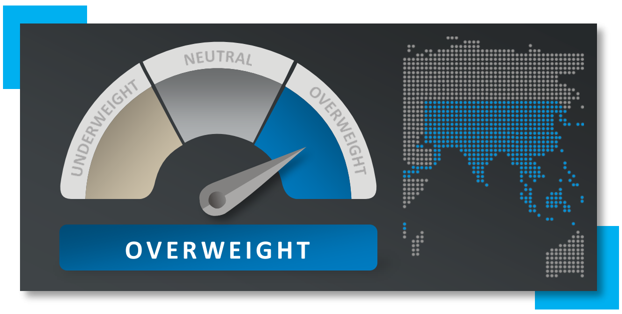
- Commodity weakness will weigh on resource rich nations
- Exporters will be vulnerable to weak global demand



Commodity Importing Economies

5% to 15% Returns

- Commodity importing countries will benefit from low prices
- Countries dependent on domestic economy for growth will benefit

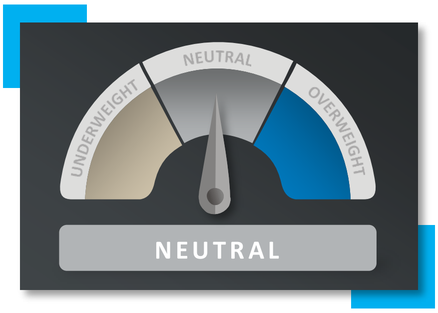


FIXED INCOME

US 10 year Sovereign

+20 bps to +40 bps Returns

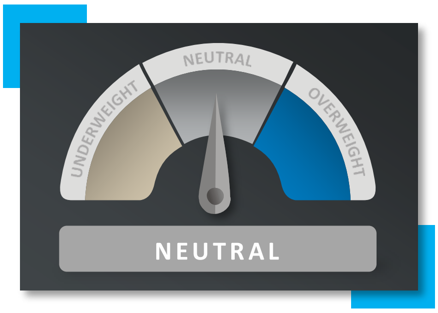
- Pace of rate hikes in the US to be gradual in 2016
- Improving risk appetite to result in low demand for US bonds
- Expect volatility in the bond markets to continue



Euro Area Core (Germany)

-20 bps to -10 bps Returns

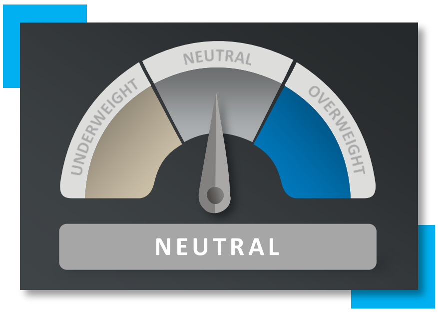
- ECB could expand monthly purchases in 2016 amid subdued inflation
- Scope for further yield compression appears limited



Peripheral (Italy & Spain)

-30 bps to -20 bps Returns

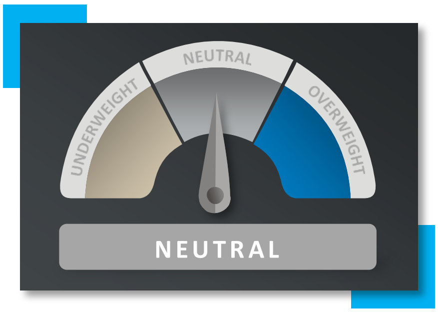
- Expect yields to decline further in the peripheral countries
- Political instability could limit the decline in peripheral bond yields



Corporate Credit

0% to 5% Returns

- IG debt vulnerable to rate hikes in US, but will be supported by institutional demand
- HY bonds face increased prospects of default risk, especially in the commodity sector
- ‘Neutral’ on Investment Grade credit and ‘Underweight’ on High Yield debt



Cash & Cash Equivalents

+25 bps to +300 bps Returns

- Low risk, high liquidity investment preferred amid an uncertain global growth outlook
- Era of rising interest rates in the US to support inflows into money market funds

CURRENCIES

USD ($ Index)

100 to 105

Positive economic data indicates strong US recovery

Diverging monetary policies to support the greenback

Dollar rally not expected to mirror 2015 as pace of subsequent rate hikes will be gradual

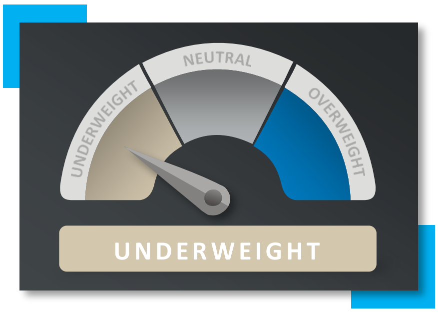
EUR vs. USD

$0.95 to $1.05

Prospects of aggressive stimulus measures by the ECB will continue to pressure Euro

Monetary policy divergence in the US and Eurozone to continue

Structural woes persist in most of the peripheral economies



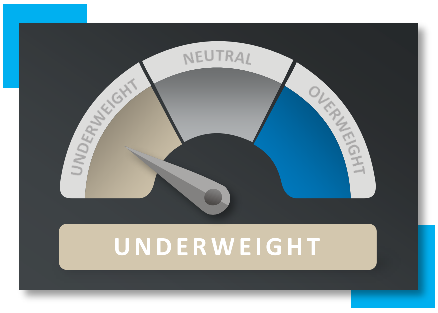
GBP vs. USD

$1.45 to $ 1.50

Interest rates expected to remain lower for a longer period

Growth and inflation forecasts for 2016 have been lowered

Brexit concerns to weigh, though Sterling likely to strengthen against the Euro



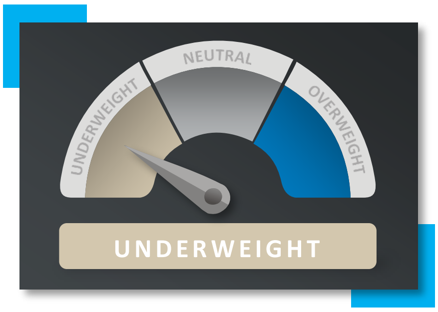
USD vs. JPY

¥125 to ¥130

Subdued growth in Japan despite easing monetary policies

Inflation expectations have been pushed back

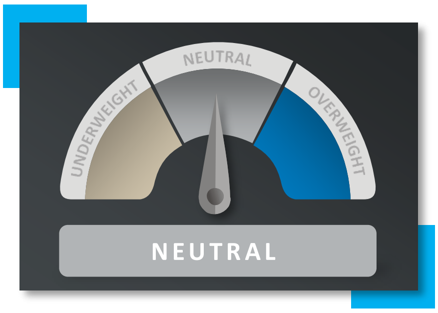
Prospects of further stimulus to weaken Yen



COMMODITIES

Brent

$30 to $45 per barrel



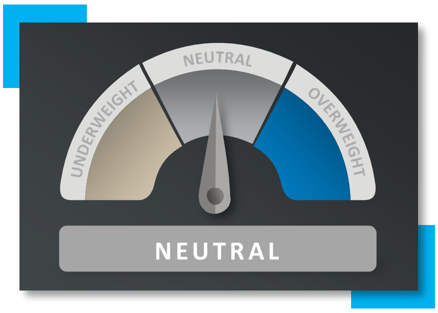
Oil prices to fall in the short run amid supply glut

Expect oil producers to subscribe to production discipline during the year

Geopolitical risks, cut in OPEC production could surprise on the upside

Precious Metals

-5% to 5%



Stronger US Dollar would limit any significant upside

Retains safe haven appeal amid geopolitical tensions

Accommodative policies in few advanced economies will lend support

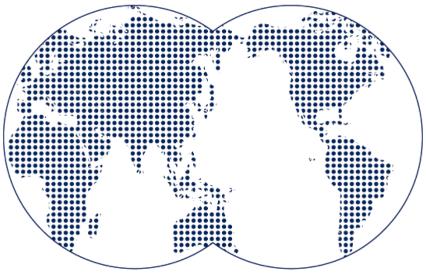
SCORECARD - 2015 PROJECTIONS

Asset Class	2015 Projections	2015 Returns	Alkhabeer's Scorecard	
US Equities** S&P 500 Index	Neutral	-0.7%	✓	
Eurozone Equities Eurofirst 300	Overweight	5.0%		✓
Emerging Equities MSCI Emerging	Mixed Views	-17.0%	✓	
GCC Equities Bloomberg GCC 200	Neutral	-13.8%	✓	
US Treasury US 10yr Sovereign	Underweight	9.8 bps		✓
Europe Core Area German 10yr Bund	Underweight	8.8 bps		✓
Europe Peripheral Area Spain 10yr Sovereign	Underweight	16.8 bps		✓
Corporate Credit Bloomberg High Yield Corporate Bond Index	Neutral	-3.5%	✓	
US Dollar Index*	Overweight	98.63		✓
EUR vs. USD*	Underweight	1.0866		✓
USD vs. JPY*	Underweight	120.20		✓
GBP vs. USD*	Neutral	1.4742		✓
Precious Metals Gold	Neutral	-10.4%	✓	
Oil* Brent Crude	Neutral	$37.28/bbl	✓	
		Total	+2	

**Indicates Level for Asset Classes Instead of Percentage Returns , **Expectations were lowered during the year in Alkhabeer Capital Global Outlook 2015 – Q1 Update*

Overweight: High Degree of Confidence in the Asset Class. Returns Expected to be in Top Quartile of Assets. Neutral: Risk Return Fairly Balanced. Returns Expected to be in Mid Quartile of Assets. Underweight: Expect to Underperform Other Asset Classes. Returns Expected to be in Bottom Quartile of Assets.

EXECUTIVE SUMMARY



Global Economy

The global economy continued to recover in 2015, though the recovery was uneven and slow. Amongst developed economies, the US showed further signs of strength, while growth in the Eurozone and Japan remained sluggish. Divergence in the monetary policies of advanced economies was the mainstay in 2015 and we anticipate this key trend to continue this year as well. We expect the global economy to face headwinds from emerging economies which are anticipated to be vulnerable to higher borrowing costs in the US going forward. The slowdown in China has had a significant impact on the growth of other economies last year and going into 2016, it remains to be seen whether accommodative measures undertaken by the Chinese government will be adequate to sustain high growth in the economy. On the upside, commodity importing economies will benefit from the ongoing slump in commodity markets, while exporters such as Latin American economies are expected to remain pressured. We expect more of the same in 2016 but with slightly better confidence and clarity.

GCC Economy

The prolonged period of low oil prices has led governments in the GCC to resort to precautionary measures. After the UAE removed fuel subsidies, few other GCC countries also implemented similar measures. In 2016, Gulf countries are anticipated to report fiscal deficits and are likely to resort to spending cuts, mostly on discretionary expenditure. The IMF has lowered its 2016 economic growth forecasts for the GCC nations, amidst a slowing hydrocarbon sector. Meanwhile, given the low debt levels in the region, most Gulf countries have turned to borrowings to reduce fiscal pressures. In the banking segment, liquidity concerns have caused regional benchmark rates to spike, weighing on the non-oil sector's performance. The progress of GCC countries in preparing for a value-added tax implementation could garner attention, as this levy could boost government revenues, but also weigh on the regional non-oil sector's performance. Moreover, concerns over the region's construction sector also continues to loom, especially amid prospects that governments might scale back their non-essential infrastructure projects.

EXECUTIVE SUMMARY

Fixed Income

In 2015, fixed income markets were largely driven by central bank policies. We expect more of the same to continue this year. The outlook for further rate hikes in the US is likely to propel the nation's benchmark treasury yields higher. However, the gradual pace of rate increases is likely to cap any substantial rise in treasury yields. Eurozone bonds will remain supported by the accommodative stance of the ECB, though the scope for further yield compression appears limited. Meanwhile, political disruptions in Spain and Portugal could also weigh on the region's fixed income markets and limit the decline in bond yields. We remain cautious on corporate bonds as default risks increase.

Equities

In 2016, we expect European and US equity markets to witness a single digit upside, with a slight positive bias towards the former. The stronger US Dollar is expected to weigh on the earnings of US corporates which have strong overseas exposure, while a weaker Euro will have a positive impact on the export income of European companies. However the fragile nature of the Eurozone recovery and the weakness in overseas demand might continue to dampen domestic corporate performance in the Eurozone. We remain optimistic on consumer discretionary shares in the US as the strengthening labor market and low gasoline prices will support consumer spending. Across the emerging markets, commodity importing countries and countries that do not depend largely on external environment for their growth are likely to outperform this year. However we maintain a cautious stance on emerging markets as higher borrowing costs in the US are likely to result in fund outflows from these economies.

Currencies

Central bank actions fueled increased volatility in currency markets in 2015. We expect divergence in monetary policies in the US on one side and the Eurozone and Japan on the other side to continue. This is likely to drive the trends in currency markets this year. The British Pound could remain pressured against the greenback, as interest rates in the UK are likely to remain lower for a longer time. Moreover, the strong performance of the US economy will aid the greenback in outperforming other G7 currencies. In contrast, subdued economic conditions in the Eurozone, Japan and China are likely to warrant additional monetary and fiscal measures. The absence of essential structural reforms and the unfavorable political environment will continue to push the Euro lower. Meanwhile, China's Yuan which was devalued earlier in 2015 was included by the IMF to its elite currency basket, with the addition taking effect from October, 2016. The Chinese currency has already declined to near-four year lows and could witness further downward pressures as the Fed continues to raise borrowing costs.

Commodities

Crude oil extended its weakness in 2015 as shale production remained resilient to low oil prices and the OPEC maintained its oil production at increased levels. Oil prices hovered close to 11 year low towards the end of 2015. Iran, which reached a historic deal with the West on its nuclear program, has plans to raise production aggressively. However, the scenario could transform if the OPEC nations, pressured by the impact of the low prices on government finances, were to agree on a production cut. Accordingly, prices could experience volatility, but could show signs of recovery ahead of the June OPEC meeting, depending on how market expectations evolve. Furthermore, a decline in shale output and a modest pickup in demand could nudge prices higher, though we expect high volatility in oil markets with upside and downside risks remaining fairly balanced. Gold is expected to remain subdued amid a strong US Dollar, but the yellow metal would retain its safe-haven appeal. Besides, geopolitical flare-ups, especially tensions in the Middle East region, could spark upward surprises in commodity markets.

Cash & Cash Equivalents

In the backdrop of a subdued global growth outlook and challenges to corporate profitability, we recommend a risk averse strategy and advise investors to be overweight on cash and cash equivalents. Cash equivalents such as money market funds, T-Bills, certificates of deposit and corporate commercial paper have traditionally been a low risk and highly liquid investment option and in our opinion would outperform other asset classes. Taking into account that we are 'Neutral' on most of the asset classes, we advise investing into money markets and similar trackers such as trade finance and asset backed leasing, and assign an 'Overweight' rating on this asset class.

GCC OUTLOOK

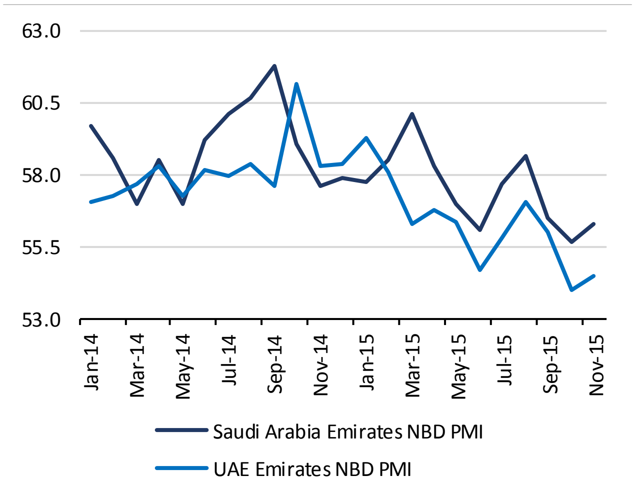
GCC Economies Gear Up to Face the Low Oil Price Environment

A persistent weakness in oil prices has taken a toll on the fiscal health of the GCC nations, as these economies are highly dependent on hydrocarbon revenues for meeting their expenditure needs. The International Monetary Fund (IMF) has projected that the GCC states would lose around $275 billion in revenues in 2015 as a result of the slump in oil prices. Countries in the region have implemented reforms or have indicated their intention to work towards lowering their discretionary spending. The UAE was the first mover in repealing its fuel subsidy in 2015, and after seeing the success of this move, other countries like Kuwait and Bahrain have also hinted about plans to rationalize subsidies. Saudi Arabia has hiked prices of gasoline by up to 50% and also indicated price increases for electricity, water, and diesel.

The recent budget announcements for 2016 in Qatar and Saudi Arabia, highlight that the governments of the region are now cutting down on non-essential expenditure, while continuing to spend on key infrastructure initiatives and social spending. Nevertheless, spending in these two countries has surpassed revenues for the year, resulting in budget deficits. The IMF has lowered its GDP forecast for the GCC nations and expects most of the Gulf economies to end with a budget deficit in 2016.

In the year ahead, we expect the GCC countries to implement a series of additional reforms to help increase government revenues. Saudi Arabia recently announced that it would implement a value based tax on undeveloped lands, in order to boost domestic revenues and discourage locals to unnecessarily hold vacant properties. Real estate experts believe that the move will add up to $13 billion (SAR 50 billion) to government coffers. A recent report showed that Bahrain is planning to implement a series of short and medium term measures to reduce the country's government expenditure by around 30%. Oman also recently approved a set of reforms including a hike in corporate tax rates and removal of fuel subsidies. Kuwait is also planning to raise corporate tax for local firms to 10%, to increase domestic revenue in this tough oil price environment. Reports also suggest that the GCC countries are moving closer towards implementing a Value-Added Tax (VAT) in the region, which could help increase domestic government revenue.

Meanwhile, growth in key GCC countries' non-oil segment has been impacted but only partially by the slump in oil prices. Although the non-oil sector's Purchasing Manager's Index (PMI) readings in Saudi Arabia and the UAE have trended lower in the past few months, they have continued to remain well in the expansive territory, as these countries reap benefits of diversification efforts made in the past. Activity in Saudi Arabia's economic cities along with crucial infrastructure projects in Qatar which are unlikely to get affected ahead of the 2022 FIFA World Cup and the 2020 Dubai Expo, are expected to keep activity in the non-oil sector buoyant moving ahead. Going forward, investors' focus is likely to remain on the GCC region's construction sector, especially amid worries that many projects could get scaled back or get rescheduled over an extended period of time due to fiscal repositioning. Additionally, concerns are building up over prospects of VAT introduction in the GCC, as this tax could increase the cost of doing business and weigh on the non-oil segment's performance in the region.



Non-Oil Sector Activity Remains in Expansive Territory

Source: Bloomberg

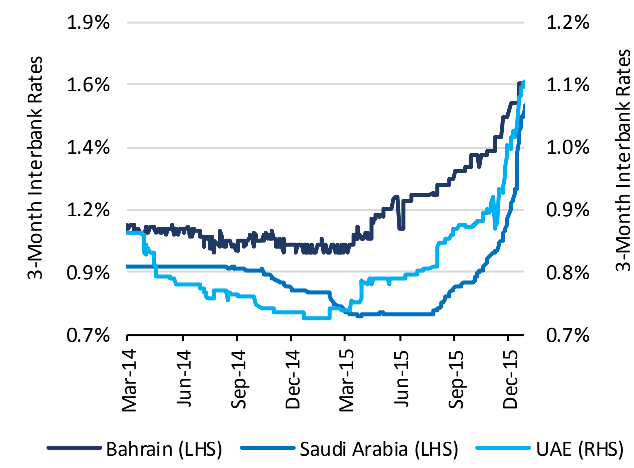
We expect GCC economies to witness a slowdown in economic growth in the year ahead. The IMF expects growth in the GCC region to slow from an estimated 3.25% in 2015 to 2.75% in 2016. The non-oil growth in the GCC is also expected to slow from 5.75% in 2014 to roughly about 4% in 2016 as countries begin to make adjustments to their budget outlays.

Borrowings in the Gulf Countries is Expected to Rise

Fiscal buffers among the GCC countries have eroded in this low oil price environment, as GCC governments have broadly maintained their spending levels despite a higher drop in revenues. Saudi Arabia began tapping its reserves, which caused the Kingdom's net foreign assets to shrink to its lowest level since late 2012. Other Gulf countries, including Bahrain and Oman with low reserves, witnessed a similar situation of asset depletion in 2015. Considering that these countries have low debt levels, they have started issuing bonds to reduce immediate fiscal pressure. Saudi Arabia issued bonds worth SAR 98 billion in 2015, while a few other Gulf countries have also resorted to similar measures or hinted at plans to follow suit. Qatar was the first GCC country to release its budget for 2016, which projects a deficit of QAR 46.5 billion, the country's first forecasted fiscal deficit in the last 15 years. Saudi Arabia also projected a budget deficit of SAR 326.2 billion for 2016, amid subdued hydrocarbon revenues. Both nations, Saudi Arabia and Qatar, have indicated that the shortfall is expected to be covered by domestic and international debt issues.

Meanwhile, recent liquidity concerns in the banking sector have caused a spike in benchmark interest rates across the Gulf countries. Higher borrowing costs in the region could be a net negative for the region's non-oil sector, especially with the GCC economies already pressurized by the developments in the hydrocarbon sector.

Liquidity Concerns have resulted in a Spike in Benchmark Rates



Source: Bloomberg

Forward contracts on GCC currencies, also a proxy to gauge investor sentiment towards the region, have risen to multi-year highs amid speculation that the mounting fiscal pressure might cause the Middle Eastern nations to de-peg their currencies. Most of the concerns on de-pegging have partially eased after central banks in Saudi Arabia, Kuwait, UAE and Bahrain raised borrowing costs to mirror the US Federal Reserve's move to hike interest rates.

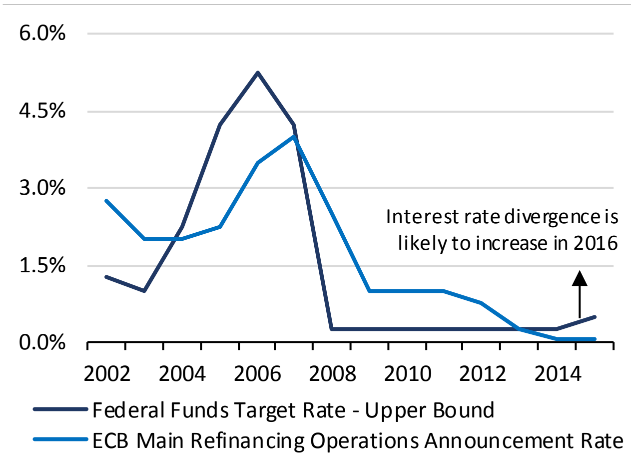
Moving ahead, market participants will keenly eye

THEMES THAT WILL STEER THE COURSE OF 2016

Divergence in Monetary Policies will be at the Center Stage in 2016

After months of speculation and hints given by policymakers, the US central bank finally hiked its key interest rates towards the fag end of 2015, thereby moving away from its near-zero interest rate policy after nearly a decade. The greenback which has surged over the past year amid anticipations of higher rates in the US is expected to continue strengthening in 2016 as the Fed continues to gradually increase borrowing costs. On the contrary, central banks in other advanced economies such as those in the Eurozone and Japan continue to maintain accommodative monetary policies to support their economies. The expected divergence in monetary policies of the Fed on the one hand, and the ECB, BoJ and BoE on the other is likely to be the key underlying factor in financial markets in 2016. The ECB's decision to leave the door open for additional stimulus and the persisting concerns in Japan which have fanned speculation of further asset purchases would be the chief catalyst causing movement in bond yields in these economies to diverge from the US and lead to further Dollar appreciation. Bond yield spreads between the US and German bonds have widened significantly as the two major central bank policies head in opposite directions. We envisage Japan to continue with Abenomics and the Chinese central bank to resort to further accommodative policies. These cross-currents are expected to set the direction for financial markets, especially in the fixed income and currency markets this year.

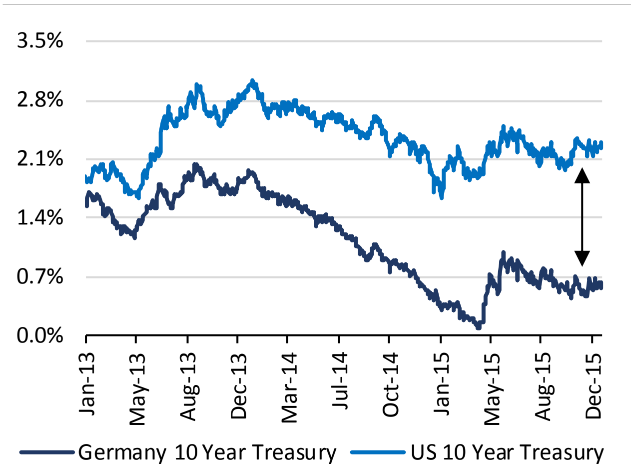
Fed and ECB Benchmark Rates



Source: Bloomberg

One of the notable features that determined trends in financial markets in 2015 was the increased speculation regarding central bank decisions and their monetary policy stance, especially in the US. Financial markets witnessed increased bouts of volatility in anticipation of central bank decisions and the expected divergence in monetary policy increases the likelihood of continuing market volatility. We anticipate markets to witness unpredictability, particularly in the currency and fixed income markets as these would be the most affected by differing policies across advanced economies.

Spreads Between US and German Bonds have Widened

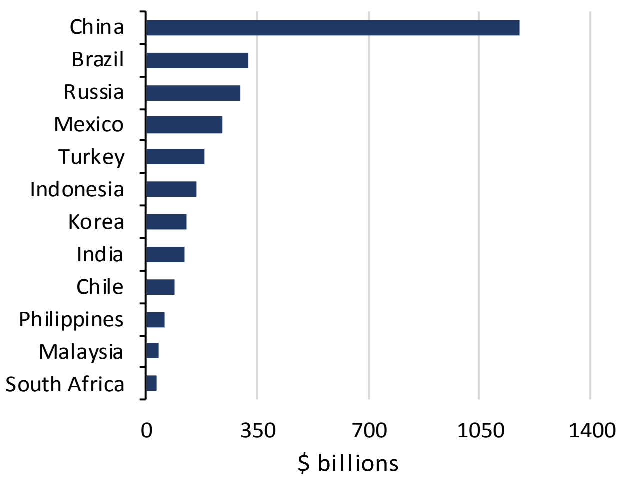


Source: Bloomberg

Tighter US Policy Will Expose EMEs to Financial Vulnerabilities

Foreign currency debt, denominated largely in US Dollars, has increased considerably in recent years in emerging market economies (EME). Under the prolonged period of favorable borrowing costs in the US, many EMEs took on debt denominated in the US currency at low interest rates. According to the Bank for International Settlements (BIS), dollar credit to non-banking firms outside the US increased from $6 trillion during the global financial crisis to $9.8 trillion by the end of the first half of 2015, with EMEs accounting for more than a third of the total borrowings. Changing macroeconomic dynamics, particularly the increased borrowing costs in the US amid a tightening of monetary policy could make EMEs more susceptible to service their foreign liabilities if not hedged effectively. Higher US rates and depreciation of local currencies are expected to put pressure on the debt repayment capability of these economies and combined with increased outflows of funds from EMEs is expected to lead to substantial volatility in emerging market assets. An unexpected turmoil in the emerging markets could have spillover effects on other developed economies as well.

US Dollar Debt Outstanding in EME's

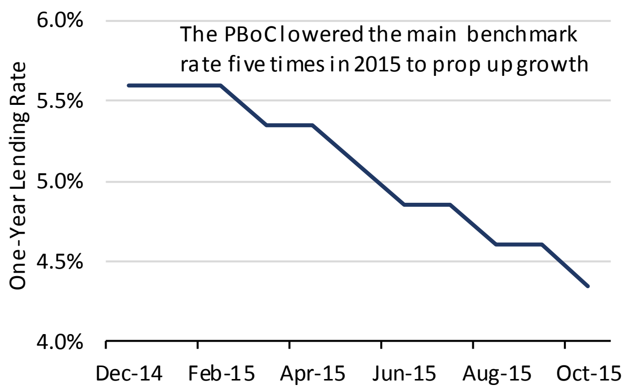


Source: Bank for International Settlements
Note: Figures are for the period ended Q2 2015; indicates debt of non-bank borrowers

China Remains a Black-box; All Eyes on Whether it can Avoid a Hard Landing

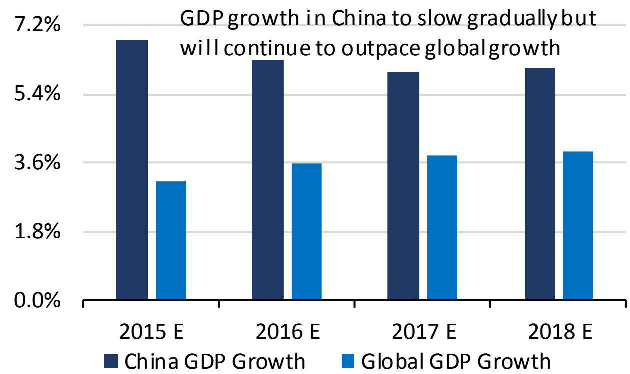
China is a key contributor to the world economy. The current economic slowdown in the nation continues to raise concerns about the possible impact on global growth. China's slowdown has already played a major role in the collapse of energy and metal prices. The surprise devaluation of the Yuan, undertaken in an effort to make it a more market oriented currency, sent ripples across global markets and fueled a wave of selling in many emerging market currencies. The Chinese stock market crash was one of the biggest financial market stories of 2015, causing a steep spike in market volatility and impacting stock markets across the globe. The mid-year slump in China's stock markets and a slew of downbeat economic releases have sparked fears that China would witness a hard landing. However, recent data points to a stabilization in the world's second-largest economy, with industrial production and retail sales numbers coming in above forecasts. Though the nation's trade figures continue to disappoint, the slowdown in Chinese imports has moderated, indicating fresh evidence that the continued policy easing in China and the government support measures are providing a cushion to the decelerating Chinese economy. It remains to be seen whether these measures are able to sustain high growth in the economy for long and whether the economy is able to successfully transform into a consumption oriented one from being primarily focused on investment in the past.

Interest Rates as in China



Source: Bloomberg

Economic Growth Forecasts



Source: IMF

Geopolitical Risks are High; Could Weigh on Investor Sentiment

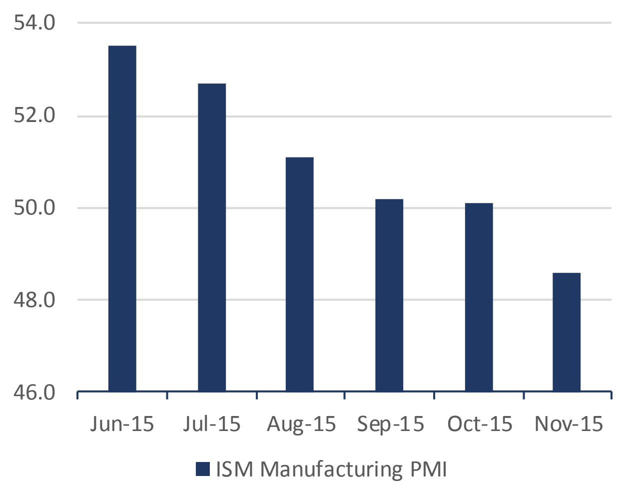
The current high geopolitical risks pose a key risk to financial markets. The previous year witnessed a number of ominous headlines, including the growing influence of ISIS in the Middle East, Russia's entry in the Syrian civil war and tensions between Russia and Turkey. The attacks in Paris, the intensifying refugee crisis in Europe, and tensions in the South China Sea further complicated the situation. Historically, geopolitical tensions have had a considerable influence on financial markets, especially on oil and gold. Going into 2016, the impact of global concerns could rise considerably as tensions between some of the world's leading economic powers escalate and complicate the growing challenges facing the world economy. With Russia alleging Turkey's involvement in ISIS' oil trade and imposing economic sanctions on the nation in retaliation to the downing of a Russian jet, it is likely to hinder the union of the anti-ISIS alliance. Geopolitical worries are anticipated to remain a key factor for market participants in 2016 and we remain cautious about the growing threat of ISIS and the geopolitical tensions in the Middle East region. Any escalation in geopolitical risk could result in investors seeking a refuge in precious metals and the Japanese Yen.

Equities

Neutral On US Equities as Upside and Downside Factors Fairly Balanced

For the year ahead we continue to maintain a 'Neutral' rating on US equities. On the upside, the US economy is anticipated to outperform its peers and the robust performance of the US labor market and wage gains are likely to support domestic spending, a key driver of macro growth. However, on the downside, market participants are likely to remain concerned about the greenback's elevated strength and weakness in overseas markets, which might continue to drag down activity in the US economy. Outlook for the domestic production sector does not seem very promising, especially after the latest ISM survey showed that US manufacturing activity contracted for the first time in November 2015 since May 2013, after continuing to decelerate over the past few months.

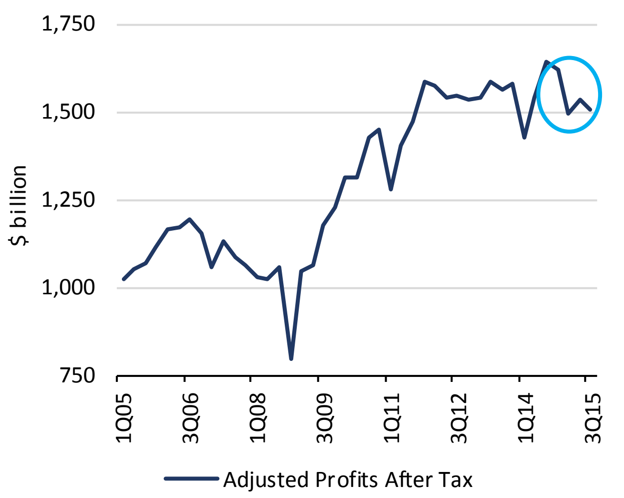
Manufacturing Activity in the US has been Slowing



Source: Bloomberg

Corporate profits in the US registered the largest annual decline in 3Q15 since the recession, underlining the negative impact of a stronger greenback and weakness in markets abroad on local business performance, which could also weigh on the country's economic activity in the near term. A stronger US Dollar will continue to pose headwinds to corporate earnings. According to Factset Research, by the end of 2015, most of the companies had lowered their guidance for 2016 on account of rising borrowing costs and higher wages. Market participants lowered 2016's mean EPS estimates to $17.04 in December 2015 from $19.85 forecasted in November 2015.

A Strong US Dollar Continues to Weigh on Corporate Profits



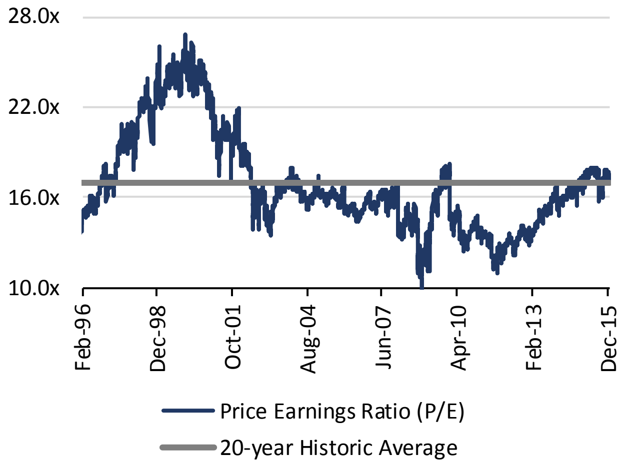
Source: Federal Reserve Bank of St. Louis

On the valuations front, the S&P 500 is trading at a one year forward PE multiple of 17.7x, close to a forward PE of 17.4x a year ago, albeit higher than its 20-year historic average. Meanwhile, earning yields in US equities have been much better than bond yields at home, making US stocks still a better investment alternative than its fixed income counterpart. Moreover, high cash surpluses with corporates continue to strengthen scope for mergers & acquisitions and buybacks among US companies going forward.

We recommend reduction in exposure to stocks of businesses highly dependent on export revenues, amid continued strength expected in the US Dollar. Moreover, we also propose a reduction in exposure to interest rate sensitive stocks, particularly bearing in mind that the Fed is on a trajectory to further raise interest rates in 2016. On the other hand, we are bullish on consumer discretionary sector as a rise in the real income of American workers after years of modest increase, mainly due to low gasoline prices, is likely to support domestic spending.

We expect US stocks to witness a single digit upside during the course of 2016, but markets might continue to witness high volatility next year, amid uncertainty about the timings and pace of future rate hikes in the country. For now, we believe that the upside and downside factors remain fairly balanced and we continue to remain 'Neutral' on this asset class.

Valuations on S&P 500 are Slightly Higher than the Historic Average



Source: Bloomberg

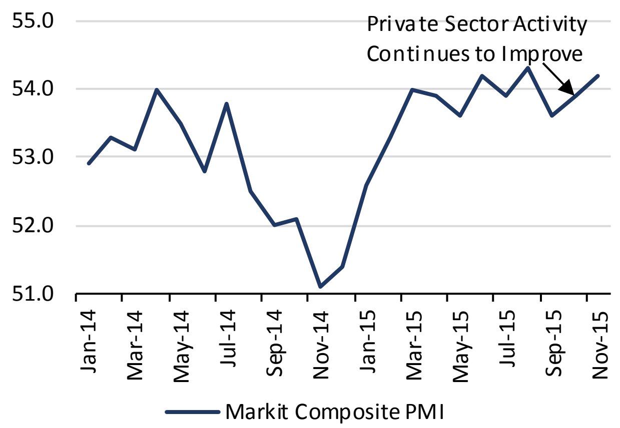
European Indices Likely to Witness a Single Digit Upside, Buoyed by the ECB's Ultra-Loose Policy Stance

During the course of 2015, European indices remained buoyed by the ECB's ultra-loose policy program, despite domestic hurdles and headwinds from abroad. While prospects of a Grexit and the Volkswagen emission scandal weakened sentiment on the local front, the mid-year plunge in Chinese equities coupled with weakness in overseas economies weighed on European stocks in the latter half of 2015. Moreover, before the end of 2015, the ECB announced an extension in the duration of its quantitative easing program, but this news failed to enthuse market participants, who were anticipating that the central bank would also expand the size of its current asset purchase program.

Going forward, we are "Neutral" on Eurozone indices for 2016 despite the ECB continuing to inject liquidity. The Euro has fallen considerably, triggered by the ultra-loose monetary policy of the central bank. This has lent some support to the region's export activity and provided a near term impetus to the European economy, especially amid subdued demand on the domestic front. However, the case for a notable upside in European stocks remains limited as the fragile nature of the Eurozone recovery and the weakness in overseas demand might continue to dampen domestic corporate performance. Profit margins among European companies declined during the third quarter of 2015, despite a weaker Euro continuing to support export earnings amongst companies in the region.

Meanwhile, the Eurozone economy has started showing green shoots of recovery although the pace of economic growth is slow. The unemployment rate has slipped to near four-year low and the Markit composite PMI, a measure of private sector activity, touched a four year high in November 2015, despite the recent attack in Paris weighing on the Euro bloc's business confidence. The ECB's efforts have led to a gradual improvement in the European economy's resilience to global headwinds. Furthermore, the ECB chief has time and again highlighted that the ECB would not hesitate to expand its stimulus program if needed to ward off deflationary pressures and spur growth. We believe that low inflation levels in the Eurozone could result in the ECB expanding its asset purchases in 2016.

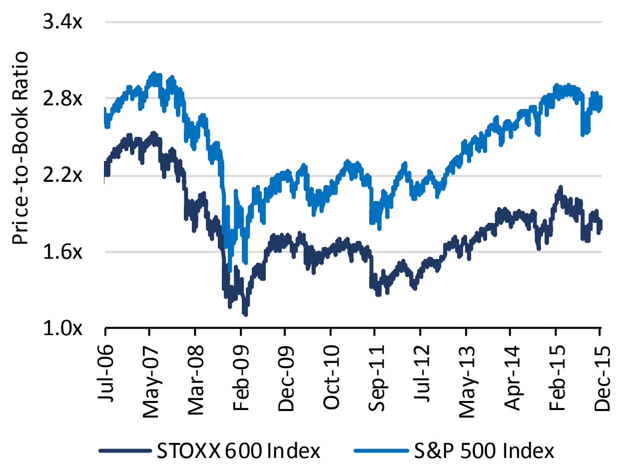
Eurozone's Composite PMI has been Trending Upwards



Source: Bloomberg

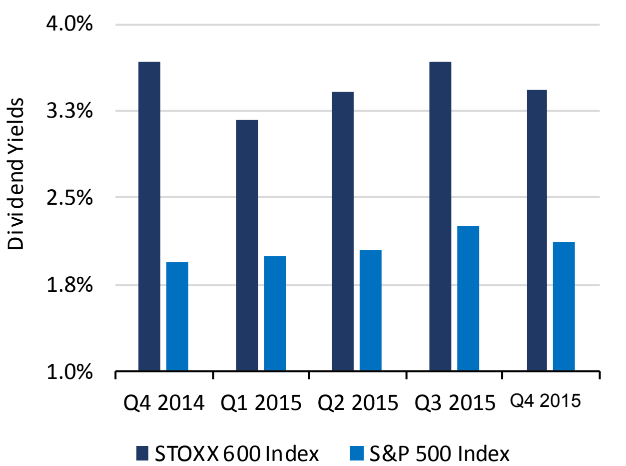
We are slightly positive on European stocks compared to US equities. On the valuation front, the one year forward P/E ratio is well above the 10-year historic average level. However, the price to book ratio of Eurozone equities is considerably lower compared to the US. Also, in terms of pay-outs, dividend yields in Europe are notably higher than yields in the US, making the former a more attractive opportunity. However, even as economic conditions in the region improve and the ECB prints aggressively to fuel inflation, growth in the Eurozone will at best be modest, weighed down by structural issues with most of the economies in the region and broadly uneven and muted growth globally. We expect European indices to give modest returns during 2016 and thereby maintain a 'Neutral' rating with expectations of a single digit upside.

European Stocks are Cheaper than US Stocks, in Terms of the Price-to-Book Ratio



Source: Bloomberg

Dividend Yields for European Equities are Higher than US Stocks

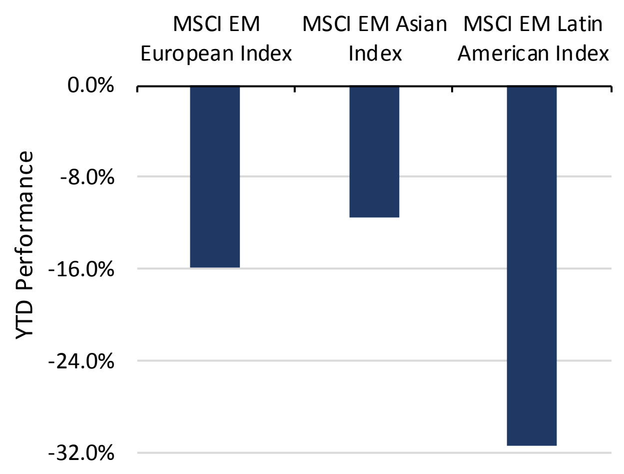


Source: Bloomberg

Selective Exposure to Emerging Markets (EMs) is Recommended for 2016

The MSCI emerging market index witnessed high volatility last year amid uncertainty about the US Federal Reserve's rate hike and slowdown in the Chinese economy. Net capital outflows from the emerging markets in 2015 were the highest since 1988. During 2015, the commodity heavyweight Latin American EMs were the worst performers, as commodity prices plunged. Although emerging Asian markets also ended lower for 2015, they fared better than their Latin American and European counterparts.

Latin American EMs were the Worst Performers for 2015

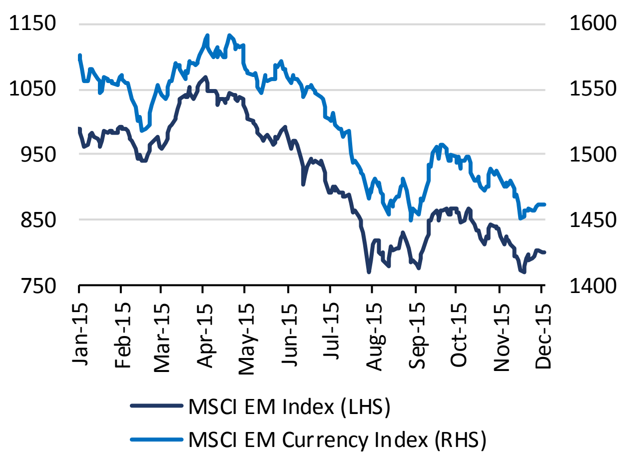


Source: Bloomberg, YTD as on 29th December, 2015

The sell-off in 2015 has resulted in many EM indices trading at attractive valuations. However, we suggest a cautious stance and recommend investors to be selective in their exposure to this asset class. We have a mixed outlook on EMs for 2016. We are 'Overweight' on commodity importing nations and countries that do not depend on external environment for growth, example India and Philippines. Conversely, we are 'Underweight' on commodity exporting countries that largely depend on external environment for growth, such as Brazil and Malaysia.

The Fed has signalled further policy tightening policy in 2016 which is likely to result in further strengthening in the US Dollar compared to EM currencies. Although weaker EM currencies will improve export competitiveness of these nations, a stronger US Dollar would limit any significant upside in commodity prices. We are particularly underweight on resource rich Latin American economies that are largely dependent on exports. Among these EMs, developments in Brazilian markets would gain significant attention, especially as political uncertainty and unfavorable monetary policy in the nation continues to weigh on local equity markets.

Strength of the US Dollar Continues to Weigh on EM Equities



Source: Bloomberg

We are more optimistic on the Asian economies. Among Asian EMs, we expect India to be a better performer than China, considering that the latter is more dependent on overseas demand. Moreover, most forecasting agencies have projected GDP growth in India to be near the 7.5% level in 2016, while China's GDP growth has been downgraded to below the 7% level. Additionally, low commodity prices have helped India to narrow its current account deficit and any progress on policy reforms in India could be a net positive. Moreover, countries such as India and Philippines which are more dependent on their domestic economies for growth will be more resilient to any fluctuations in overseas demand. However, upcoming presidential elections in Philippines could result in increased volatility. We are not very optimistic about export oriented economies in this asset class. Although the Chinese economy also relies largely on exports for its growth, China is slowly changing its growth model to a consumer led economy. A hard landing in China could be avoided, as stronger structural reforms and a loose monetary policy stance in the country might translate into improved consumer spending going forward. The Asian EMs are also major energy importing nations, and will continue to benefit from lower global crude oil prices.

In Europe, the ECB's ultra-loose monetary policy stance might turn out to be a net positive for EMs in the region. These markets are likely to benefit from low oil prices, as most of them are energy importers and stocks in these markets have rich dividend yields. Russia, a major oil exporter, is facing the heat of low commodity prices. Moving ahead, sentiment for

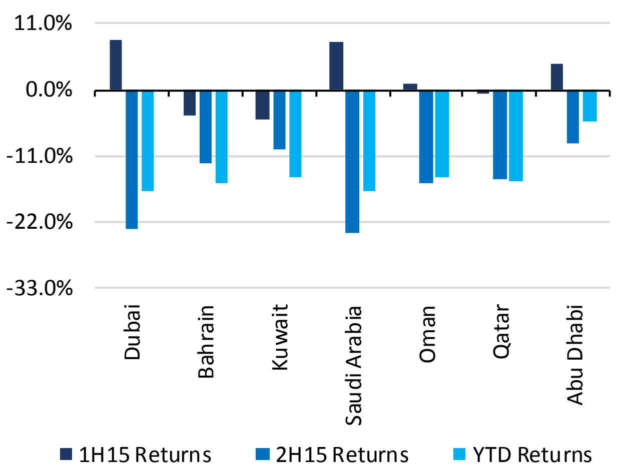
Russian stocks is unlikely to improve in the near term, especially after Europe extended its sanctions on Moscow.

We recommend a cautious stance on EMs that have high US Dollar borrowings and are vulnerable to rising borrowing costs in the US. We anticipate 2016 to be a volatile year for EMs amid diverging monetary policies across the globe. Also, any signs of escalation in geopolitical tensions could have a significant bearing on EMs and spark a sell off across these markets.

Weakness in Oil Prices Likely to Keep GCC Equities Pressurized

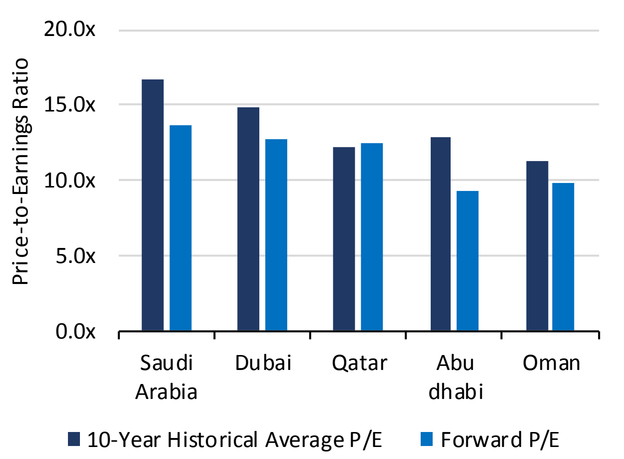
GCC equity markets witnessed high volatility in the year 2015. In the first half of 2015, most benchmark bourses in the GCC region ended in positive territory amid a partial recovery in oil prices. Opening up of the Saudi Arabian markets to foreign investors was one significant reform in early 2015 that supported regional sentiment. However, GCC markets more than offset their first half gains and plunged in 2015 to trade close to multi-year lows, with all key Gulf indices, barring Abu Dhabi's exchange, dropping more than 10%. Mid-year geopolitical tensions in Yemen weighed on regional bourses, while an unfavorable outcome in December's semi-annual OPEC meeting triggered a major drop in crude oil prices and sparked a sell off across these markets.

Sharp Losses in the Second Half of 2015 Weighed on GCC Markets' Performance



Source: Bloomberg, YTD as on 29th December, 2015

Valuations Look Quite Compelling for GCC Equities

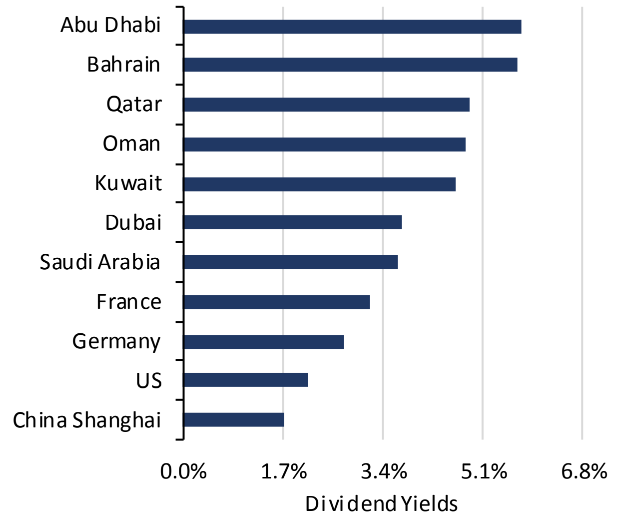


Source: Bloomberg

We believe that the region's markets would continue to face pressures in 2016 as well and have limited upside potential from here on. We recommend investors to selectively invest in Gulf markets, with special focus on companies that are not largely dependent on the hydrocarbon sector. Also, considering that GCC equities are underpinned by relatively high dividend yields, we further recommend investors to focus on companies with good balance sheets and ability to maintain their dividend payouts for a prolonged period.

Meanwhile, we are cognizant of the fact that GDP growth among the Gulf countries is likely to take a hit from low oil prices and as regional governments take measures to scale back expenditures in 2016. Additionally, uncertainty about the future of oil prices is likely to keep Gulf markets volatile during the course of 2016. Any agreement around oil production could result in investor interest returning back to GCC equities. On the valuations front, the one year forward price to earnings ratio on the Bloomberg GCC 200 index is trading at 12 times, much lower than the 10-year historical average of 15 times, suggesting that valuations across these stocks are compelling. However, we do not see any major supporting factors for 2016 that could trigger an upside across the Gulf exchanges. We are 'Underweight' on GCC stocks, albeit the momentum across these markets is highly dependent on oil prices and therefore any major movement in crude prices could have a significant bearing on Gulf bourses.

Dividend Yields in the GCC Countries are Higher than Other Key Markets (As of Mid-December 2015)



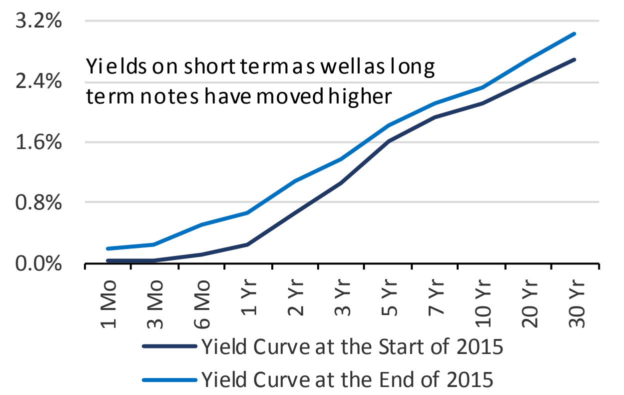
Source: Bloomberg

Fixed Income

US Treasury Yields to Nudge Higher amid Expectations of Higher Borrowing Costs

As projected in our last year's outlook, yields on benchmark US 10 year notes nudged higher in 2015, though the increase in treasury yields was lower than our projections. As expectations of higher rates in the US gained momentum, yields on US notes surged in the initial half of the previous year but eased considerably as the unprecedented slump in Chinese stock markets fueled safe haven demand for US treasuries. Moreover, yields plunged in September after the Fed disappointed markets by not raising interest rates, as widely expected. Renewed expectations of higher borrowing costs in the US and the Fed's subsequent rate hike led to a steady year-end increase in bond yields. The yield curve has shifted considerably higher from the levels seen during the start of 2015, largely an outcome of the changing market dynamics. Treasuries at the short end of the curve have been the most impacted as a result of the Fed's rate hike, with yields on 2-year treasury notes crossing 1% for the first time in more than five years.

US Yield Curve

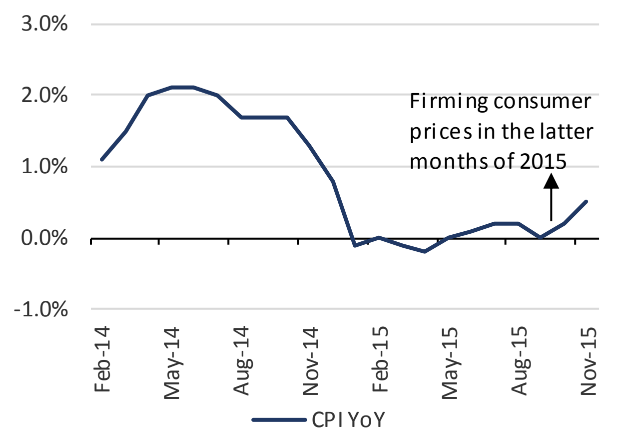


Source: US Department of the Treasury

With the Fed indicating its intention to gradually move away from its accommodative monetary policy, yields on sovereign US notes are expected to rise from current levels but at a restrained pace. As worries regarding the pace of economic growth in some of the overseas economies persist, we share the Fed's view of adopting a gradual path to higher rates. However, any ambiguity on Fed's stance, as witnessed in September 2015, could lead to volatility.

The domestic price environment was fairly encouraging in the closing months of 2015, however, the lingering weakness in commodity prices could prove to be a headwind for US inflation. This could derail the Fed's path and lead to uncertainty about the central bank's actions.

Inflation in the US is Firming



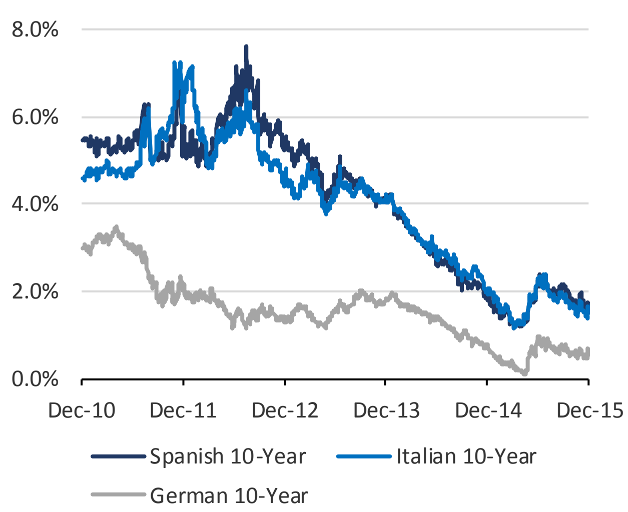
Source: Bloomberg

Currently, the US economy seems to be on a steady recovery path and offers the central bank further room to raise borrowing costs. However, we expect the central bank to be very cautious in raising rates given the fragile nature of the global economic recovery. Additionally, we remain cautious of the possible headwinds to the inflation outlook, led by the persisting slump in commodity markets. Besides, the upcoming Presidential election in the US in the latter half of the year could cause volatility in the nation's fixed income markets. On the whole, we expect bond yields to nudge modestly higher in 2016 and recommend a 'Neutral' rating on US treasuries.

Limited Scope for Further Yield Compression in Eurozone Bonds

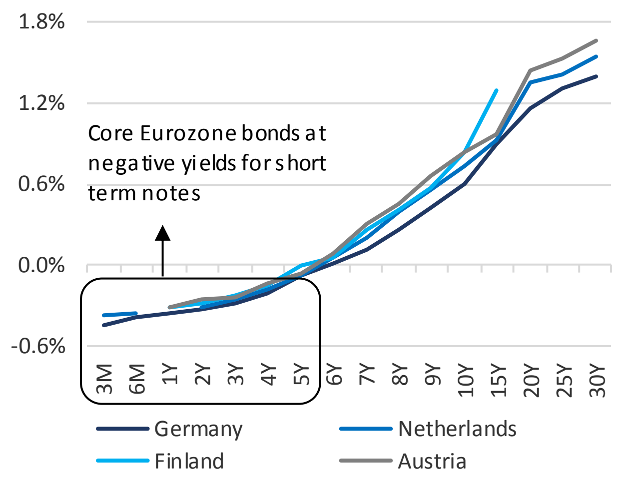
Eurozone bonds surged in the initial months of 2015 in the run-up to the ECB's quantitative easing program. However, bonds turned volatile and the rally was abruptly halted as investors reassessed their positions after the stimulus measures in the Eurozone pushed yields on core and peripheral bonds to multi-year lows. The increased possibility of Grexit also contributed to the sharp reversal. Over the course of 2015, the ECB's ongoing stimulus measures had a profound influence on the region's fixed income markets, with yields on short term German bunds falling below 0%.

Sovereign Bond Yields have Contracted Significantly



Source: Bloomberg

Yield Curve of Euro Area Government Bonds



Source: Bloomberg

The latest ECB action of extending bond purchases until March, 2017 highlights the challenges faced by the region's economy, which has been increasingly plagued by fears of deflation in recent months. Though some of the peripheral economies have pulled out of recession, overall GDP growth in the Eurozone has remained weak and signs of a pickup in economic activity have been slow. Risks to global growth in the latter half of 2015 prompted the ECB Chief to repeatedly indicate a possible expansion of its asset purchases program. It is highly likely that the central bank would implement further accommodative polices in 2016 if risks to its inflation goal persist.

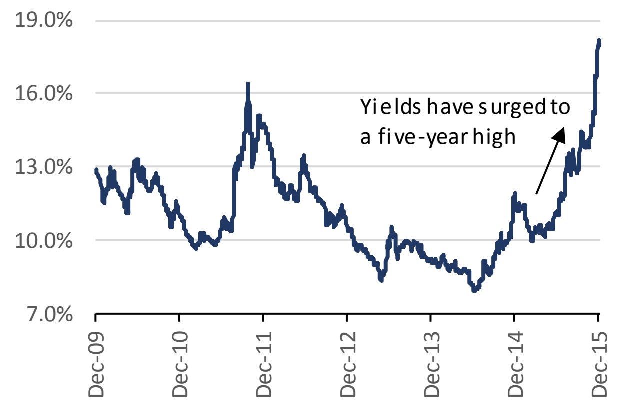
Spreads between core and peripheral bond yields displayed a significant contraction in 2015 and could shrink further this year if the ECB adopts additional measures to loosen monetary policy, though we believe that the scope for additional compression would be limited unless structural reforms are undertaken to reduce the debt load in some of the Eurozone's peripheral economies. Meanwhile, challenges on the political front such as the risks in Spain stemming from Catalonia's push for independence and political concerns in Portugal are likely to weigh on the region's fixed income markets. However, the central bank's purchases should keep peripheral debt assets supported and avert any major selloff. In our view, Eurozone bond yields are expected to decline further from current levels, but given the uncertainty in the political landscape and the limited scope for further yield shrinkage, we recommend a 'Neutral' stance on this asset class.

Expect High Yield Credit to Underperform as Default Risks Increase

The year 2015 witnessed a major meltdown in the US High Yield (HY) bond markets as outflows and yields increased substantially. Yields increased especially in the lower end of the credit spectrum. For instance, the effective yield on BofA

Merrill Lynch 'CCC' HY bonds rose to about 18%. The Bloomberg High Yield Corporate Bond Index posted its first annual loss since 2008 and the overall yield spread between HY Bonds and comparable duration Treasury bonds rose to multi year highs.

BofA Merrill Lynch US High Yield CCC

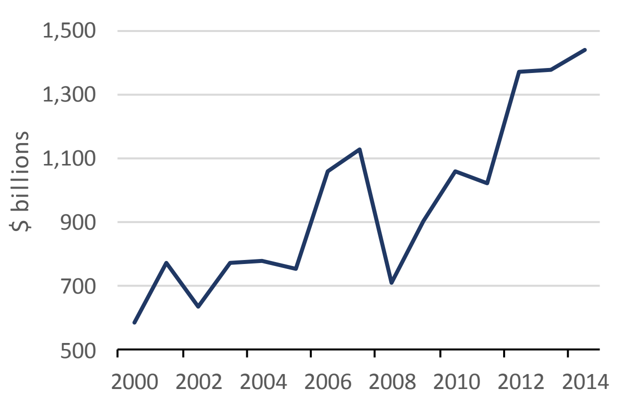


Source: Federal Reserve Bank of St. Louis

Weakness in high yield debt has been mainly due to a plunge in commodity markets, especially in the energy sector which accounts for roughly about one third of the total issuances in 2015. A sharp decline of nearly 36% in oil prices in 2015 has resulted in the proportion of junk bonds trading at distressed levels to climb to post crisis high levels. According to Moody's, the number of companies falling under the "distressed" category (rated B3 or below, with a negative outlook) rose about 37% to 239 in November 2015 from the 2014 levels.

Going forward, we expect the weakness in the HY market to continue into 2016. The weakness is not limited to the commodity sector alone as concerns over the ability of firms to repay funds that were borrowed during the low interest rate period are rising. Years of record low benchmark interest resulted in many US companies amassing high debt levels, which were mostly diverted to fund buy backs and M&A activity. However, with interest costs in the US anticipated to increase and stronger US Dollar impacting corporate earnings, the ability to service debt will become increasingly difficult.

Corporate Bond Issuances in the US have Increased



Source: Securities Industry and Financial Markets Association

According to Standard & Poor's, the default rate on corporate bonds with the lowest credit ratings is expected to increase from 2.5% in September 2015 to about 3.3% by the end of September 2016. Forecast by Fitch Ratings project a higher default rate of 4.5% for US HY bonds by end 2016, with the energy sector default rate estimated to rise to as high as 11%. Although the Investment Grade (IG) credit remains exposed to the risk of rising interest rates in the US, we believe that IG bonds will largely be supported by demand from institutions and pension funds. With economic growth in the US gaining momentum and labor market conditions improving, we believe there will be pockets of strength in certain sectors that investors could consider. Moreover, a selloff in 2015 has made valuations of high quality bonds attractive, hence we remain 'Neutral' on Investment Grade credit and 'Underweight' on High Yield Debt.

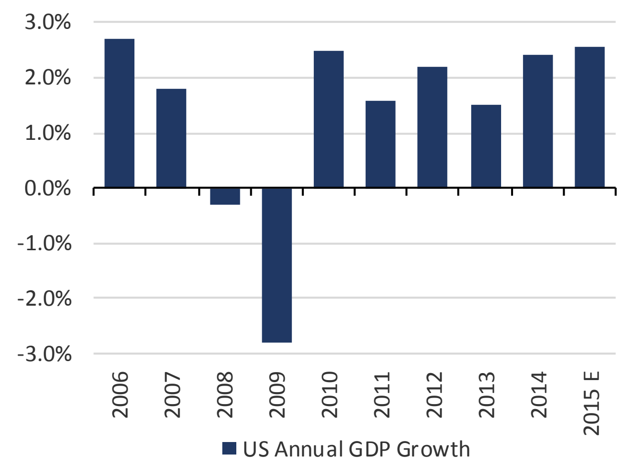
Currencies

Dollar Trajectory to Extend in 2016 amid Further Policy Tightening and Robust Economy

In line with our previous years' forecasts, the US Dollar continued to surge against a basket of six currencies, though the greenback rally overshot our expectations. The American currency rose to multi-year highs, backed by improving economic data from the US and the eventual rate hike by the Fed at its last monetary policy meeting of 2015. The diverging monetary policy trends in the US and other key nations further aided the US Dollar surge.

The recent set of domestic economic reports reflect the increasing strength of the US economy. After contracting in the first quarter of 2015, domestic GDP growth expanded in subsequent quarters. The labor market has continued its strong recovery, with the US economy adding more than 200k jobs on a monthly basis for most of 2015 and the unemployment rate falling to a seven-year low. Retail sales and housing activity have also remained well supported, further suggesting the growing momentum of the nation's recovery. The slew of upbeat releases in the run-up to the Fed's interest rate decision boosted investor confidence regarding the economy's ability to cope with higher borrowing costs.

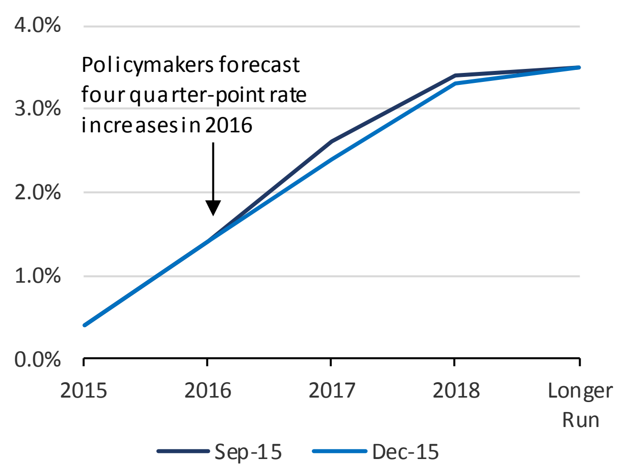
US Economic Growth close to 2006 Levels



Source: Bloomberg, IMF

Expectations of a measured pace of rate hikes in 2016 augurs well for the US economy and also for the greenback. One of the key factors that had hindered the Fed from raising the benchmark rate prior to its decision in December was the economy's low rate of inflation, which has consistently stayed below the central bank's target for a prolonged period. However, consumer prices have firmed steadily in the latter months of 2015 and have increased prospects of gradually moving towards the Fed's target.

Fed's Projected Appropriate Policy Path



Source: Federal Reserve Board
Note: Projections for the federal funds rate are at the end of the specified calendar year.

With the first rate hike relieving a lot of investor uncertainty, the focus now shifts to the pace of policy tightening in the US. The Fed dot plot suggests that policymakers expect four 0.25% rate increases in 2016, though officials have repeatedly stated that future rate hikes would be a gradual process and dependent on the progression of economic data. In our view, the greenback would outperform its major peers in 2016 on account of the continued policy tightening and divergent monetary policies in developed economies. Though the ECB's most recent monetary policy decision of not increasing its monthly asset purchases caused a steep spike in the single currency, we believe that the decline in the greenback was a momentary blip. The US Dollar is expected to advance against its major peers, though the rally is not expected to be as spectacular as witnessed in 2015, considering the Fed's emphasis on the gradual pace of firming. We remain optimistic about the outlook of the US Dollar and expect it to surge to fresh highs by the end of this year.

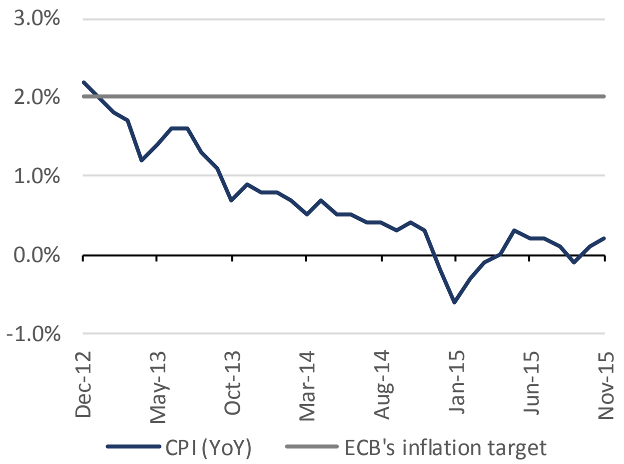
Divergent Policies by the ECB and US Fed Likely to Result in Euro-Dollar Parity

Following increased expectations at the start of 2015, the ECB finally embarked on a large scale €60 billion per month quantitative easing program last year. The common currency remained pressured over the course of 2015, falling to near seven-year lows against the US Dollar and losing ground against other major currencies as well.

The asset purchases which were implemented in an effort to reinvigorate the fragile economic environment in the Eurozone have so far had a modest impact on the region's economy. Though the Eurozone economy showed an improvement in 2015, GDP growth has remained soft, with the 19-nation bloc registering a lower growth rate in the third quarter of the previous year. Economic growth in core and few of the peripheral Eurozone economies has slowed and points to the fragile nature of the recovery across the common currency union.

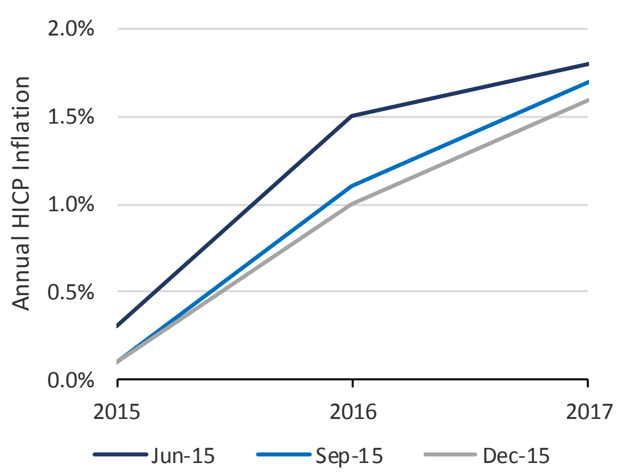
Moreover, the Euro region continues to face challenges in spurring inflation as consumer prices have been stuck near 0% in recent months. The ECB has already reduced its inflation forecasts to 1% in 2016 and 1.6% next year. Besides, the German central bank has also lowered its outlook on inflation, highlighting the challenges faced by the region's largest economy in tackling the sluggish price environment. In addition to the worries faced on the economic front, the Euro region remained vulnerable to other key issues last year. Soaring Grexit concerns in the initial half of 2015, weak growth across emerging markets, the emissions scandal across carmakers in Europe, and the terrorist attacks in Paris, all added to the downbeat sentiment.

Eurozone Inflation Continues to Remain below ECB's Target



Source: Bloomberg

ECB's Changing Inflation Outlook



Source: European Central Bank

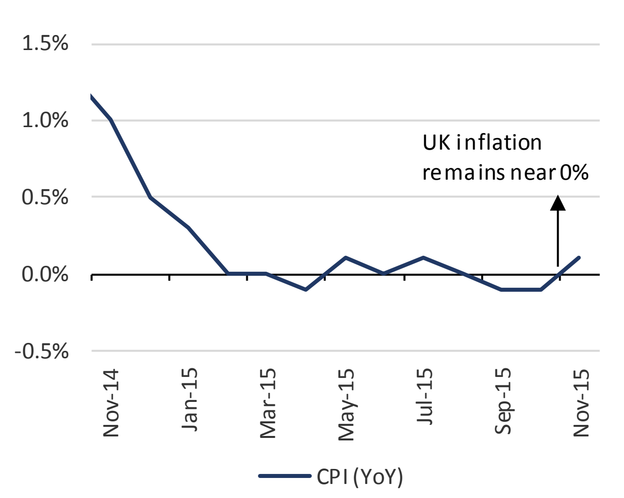
To prop up growth and revive inflation, the ECB extended its asset buying until the first quarter of 2017, without raising the monthly volume of purchases. Though the move initially triggered volatility and fueled a steep spike in the Euro, we believe that the trend will be short lived and that the common currency would extend its downward trend in 2016. The ECB's decision to leave additional room for further liquidity injection is likely to cap any potential rise in the Euro. The ECB Chief has repeatedly announced the prospect of implementing further stimulus if required to boost inflation in the region, which could keep the single currency pressured. In our opinion, the divergence in monetary policies in the US and the Eurozone could result in renewed selling pressure in the common currency. Amid these developments, we hold an 'Underweight' rating on the common currency and have reduced the forecasted target range on the Euro. We believe that the common currency could be pressured in the coming months and the ongoing policy divergence could potentially push the Euro below parity in 2016.

Delay in Rate Hike, Brexit Worries to Weigh on the British Pound

The British Pound nudged slightly lower against the US Dollar in 2015, and displayed signs of volatility. The changing monetary policy dynamics in the US pushed the Sterling to multi-year lows against the greenback in early 2015. However, the Sterling rebounded after the Conservative Party secured a sweeping victory in the parliamentary general elections, which reduced political uncertainty in the nation. The shifting momentum was short lived amid the increasing clamor for higher rates in the US. Though it was earlier expected that the Bank of England (BoE) would raise the benchmark rate from record-low levels before the Fed, the changing economic dynamics and financial market turmoil in the latter half of 2015 have lowered prospects of the BoE moving away soon from its accommodative stance for now.

Expectations of a liftoff have been steadily pushed back in recent months as the global economy deals with concerns over Chinese growth. Furthermore, the UK has been plagued by deflationary pressures like some of the other advanced economies, with inflation in the nation staying below zero for two consecutive months in the latter part of 2015. Low oil prices and modest wage gains will further weigh on inflation and be a major hurdle impacting the central bank's decision. Though domestic growth figures over the course of 2015 have been fairly encouraging, the risks from emerging markets have pressed the BoE to lower its growth and inflation outlook for 2016, potentially suggesting that policymakers would not rush to raise borrowing costs in the nation. Furthermore, the BoE Governor, Mark Carney, has stated that interest rates in the UK were expected to stay low "for some time". Meanwhile, the latest trends from forward contracts based on the Sterling Overnight Interbank Average (SONIA) indicates that traders do not expect a full 25 basis-point hike in the benchmark rate until at least January 2017.

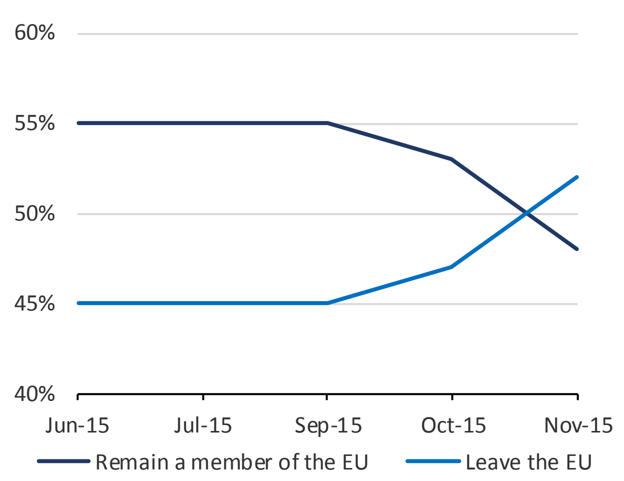
Weak Inflation in the UK



Source: Bloomberg

In addition to the external headwinds, the Pound could also be held hostage to political developments. 2016 could possibly be the year that determines whether the UK remains part of the European Union. Prime Minister David Cameron has already hinted that an 'in or out' referendum on Britain's membership in the EU could be held as early as the middle of 2016. Recent surveys have also shown a marked shift in public opinion. An opinion poll conducted in the aftermath of the Paris attacks in November showed that a majority of the public were in favor of a Brexit, compared to 45% a few months ago.

Shift of Public Opinion in Favor of Brexit



Source: Opinion Research Business International

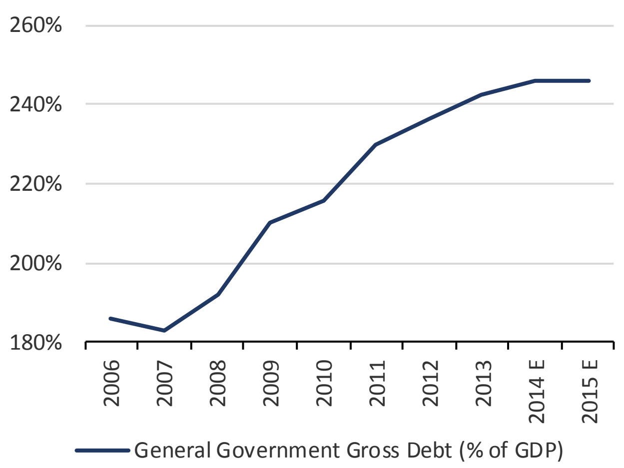
Doubts over Britain's membership in the European Union (EU) could impede corporate investments which could have a profound impact on the Pound. A potential Brexit could also have broader long term implications for the currency. Against this backdrop, we believe that the BoE would not alter monetary policy before the referendum and would hike rates only by the end of 2016 or early 2017. Factoring in the political worries and expectations of a delay in liftoff, we have lowered our stance on the British Pound from 'Neutral' to 'Underweight' against the US Dollar, especially in the backdrop where the Fed is poised to further hike benchmark interest rates. However, we expect the Sterling to outperform the Euro on account of continued monetary easing in the Eurozone.

Yen to Extend Weakness amid Expectations of Further Easing

In line with our forecast for 2015, the Japanese Yen continued to remain pressured and declined to fresh multi-year lows against the US Dollar, though it performed well against the Euro on account of the stimulus program implemented by the ECB. The Bank of Japan's (BoJ) ongoing easing measures have largely influenced the direction of the Japanese Yen, which has fallen more than 25% against the greenback since the BoJ launched its quantitative easing program in April 2013 to revive economic growth in the nation. Despite the unprecedented measures implemented by central bank and the additional stimulus launched in 2014, GDP growth in the nation has remained weak and inflation continues to slide, remaining well below the central bank's 2% target.

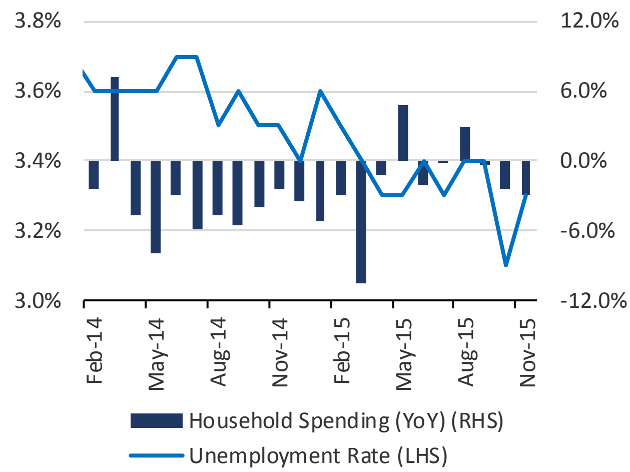
Recent data from the government showed that Japan's economy contracted in the second quarter of 2015, while registering modest growth in the subsequent quarter. The lackluster growth figures underline the challenges faced by the Abe government in dealing with the country's structural issues. Growth has remained frail partially due to the demographics issues such as the dwindling labor force which has impeded purchases and consumption expenditure. The ageing population has also swelled costs related to the expansion of health and social security expenses and pushed the government's debt load to the highest in the developed world. The increasing concerns over the future of the Abenomics program prompted the S&P to downgrade the country's credit rating by one notch, Japan's second major downgrade in 2015 after Fitch lowered its rating on Japanese debt earlier in the year. Further compounding worries, Japan has struggled to spur inflation and faces the risk of slipping back into deflation as the weakness in commodity prices persists.

Japan's Ballooning Debt to GDP Ratio



Source: IMF

Japan's Household Spending is Weak Despite Falling Unemployment



Source: Bloomberg

The challenges faced by Japan reinforce the view that the economic environment in the country remains weak. Though the unemployment rate in Japan has seen a steady decline and recently fell to a 20-year low, its impact on the economy has been muted. Consumer spending is weak and household spending continues to remain sluggish. Moreover, the central bank has already pushed back its timeframe for achieving its inflation goal to early 2017. Its recent easing measures which include a new ETF purchase program and a plan to extend the duration of its bond purchases seems relatively modest, when compared to the size of its ongoing asset-purchase program. In light of these developments and the growing pressures in spurring inflation, we believe that policymakers would ramp up asset purchases in 2016 which could increase downward pressure on the nation's currency. To spur growth, the Japanese government has already planned for an additional supplementary budget, worth more than ¥3 trillion for the fiscal year starting April 2016. We expect the JPY to depreciate further against the US Dollar triggered by weak economic growth, high debt levels, widening interest rate differentials and slow pace of structural reforms and thereby maintain an 'Underweight' rating.

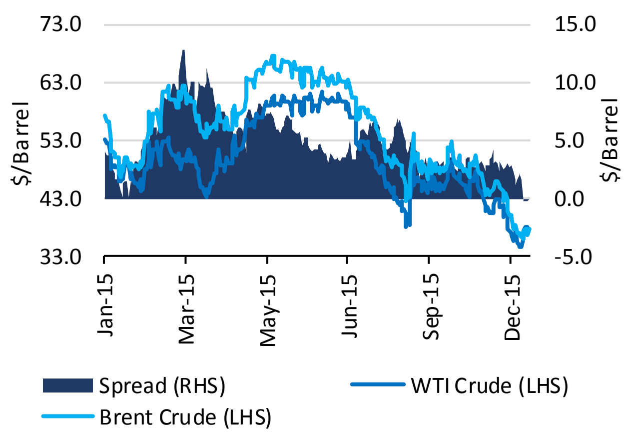
Commodities

Outlook for Oil Prices Remains Challenged by Supply Concerns; However, Prices Bottoming Out

After witnessing a steep slump in the latter half of 2014, oil prices extended their plunge in 2015 as well, falling to near 11-year lows. We expect oil prices to remain subdued for most part of 2016 amid a supply glut. The OPEC's recent decision to abolish its oil output ceiling to defend market share and prospect of additional supply from Iran threatens to worsen the global oil supply glut in 2016.

The low oil price environment has already taken a toll on GCC economies, which have witnessed lower oil revenues and a decline in their forex reserves. These nations have also been forced to curtail expenditure. According to the IMF, hydrocarbon revenues in GCC nations alone are estimated to be almost $275 billion lower in 2015, compared to the previous year. With most of the OPEC nations witnessing a drain on their fiscal buffers amid the widening gap between their break-even oil price and the prevalent market prices, we expect these nations to rethink their stance on output in the forthcoming June 2016 OPEC meeting. Any such move could trigger prices northwards, however, the failure to do so could result in prices dropping to fresh lows.

Despite a Mid-Year Recovery, Oil Prices Tumbled During the Second Half of 2015

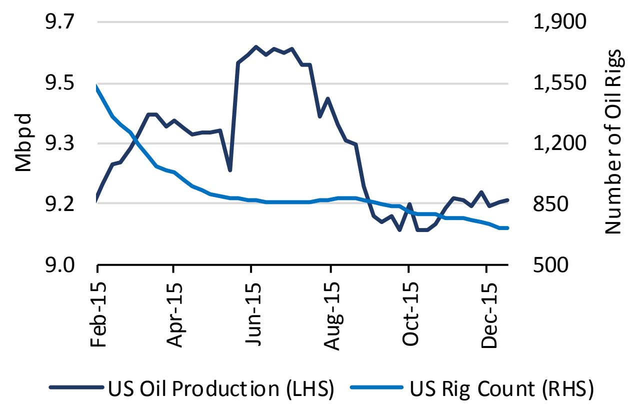


Source: Bloomberg

On the demand side, possibility remains that a potential improvement in global economic growth, amid an ultra-loose policy stance in some of the advanced world economies, would be able to absorb higher crude supplies. According to OPEC's December 2015 report, global oil demand is anticipated to grow by around 1.53 million barrels per day (mbpd) in 2016, amid expectations of a pickup in the global economy. Amongst the major energy importers, weaker GDP growth in China could create a worrisome scenario for oil, however, an improving pace of economic growth in India could partially cover up for the lost demand.

Furthermore, with oil prices flirting near multi-year lows, some of the high cost US shale oil producers are expected to remain relatively more vulnerable to the tough price environment. The recent slump in oil prices has also caused major companies to rollback their spending plans and resort to job cuts. Although these measures are not expected to have an immediate impact on oil markets, prices might find support in the medium term as lower investments translate into expectations of lower output in the future. Meanwhile, the recent move by the US government to lift its four-decade ban on oil exports has largely contributed to US oil trading at a premium to Brent.

Falling Rig Counts might Weigh on US Oil Production



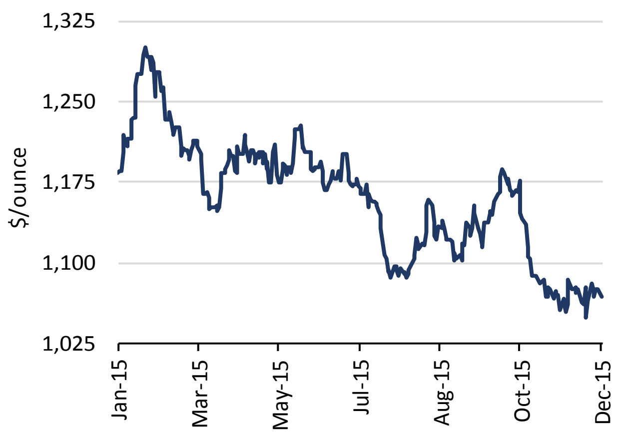
Source: US Energy Information Administration, Baker Hughes

In our view, oil prices would remain subdued at current levels in the short run. Supply side pressures pose a significant challenge to upside expectations. However, the scenario could transform if the OPEC nations, pressured by the impact of the low prices on government finances, were to agree on a production cut. Accordingly, prices could experience volatility ahead of the June OPEC meeting, depending on how market expectations evolve. Furthermore, considering the risk of geopolitical tensions in the Middle East, any escalation in regional conflicts could bolster the case for a sharp upside in oil prices. With oil hovering near multi-year lows, we believe that the decline in oil prices has run its course and the upside and downside risks are fairly balanced at this juncture. We accordingly rate this asset class as 'Neutral'.

Dollar Strength to Weigh on Gold, though Safe-Haven Appeal Retained

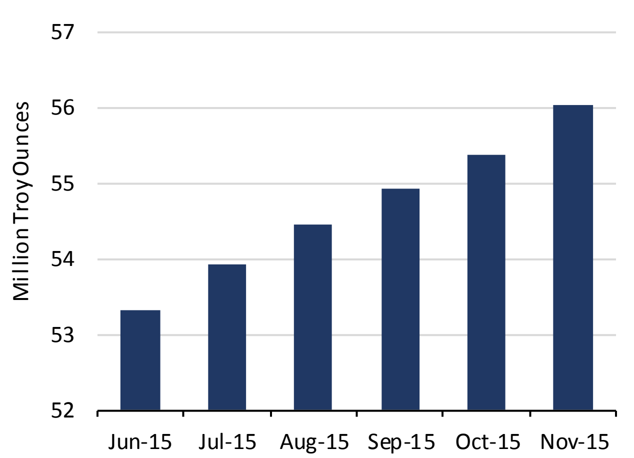
Gold prices ended 2015 with significant losses and breached the psychological $1,100 per ounce level as persistent speculation regarding the timing of higher borrowing costs in the US and a firm US Dollar pushed prices of the precious metal to near six-year lows. The trends in gold prices in 2015 closely resembled the pattern witnessed in the preceding year. Like 2014, gold prices advanced in the initial quarter of 2015 before nudging lower in subsequent quarters. In addition to expectations of higher rates in the US, a general weakness in consumer prices globally also impacted prices last year. With inflation projected to remain subdued in some of the advanced economies in 2016, any substantial price rebound in gold, barring unforeseen geopolitical events, could be limited.

Gold Prices Witnessed Considerable Losses in 2015



Source: Bloomberg

Steady Increase in China's Gold Reserves



Source: Bloomberg

Physical demand for the precious metal also remained sluggish over the course of 2015, rebounding modestly in the latter half of the year after declining in the initial quarters. Purchases in China and India, which make up nearly half of the global gold demand, rose on account of the lower gold prices and the seasonal demand amid the festive season. Separately, China ended years of speculation and began disclosing monthly data on its gold holdings for first time since 2009. Gold reserves in the nation rose steadily since June 2015, indicating the nation's efforts to diversify its foreign-exchange reserves.

Given the current weakness in gold prices, consumer demand could increase in the first half of 2016, especially considering the increased purchases around the Chinese New Year. The accommodative monetary policy stance in the Eurozone and Japan should also keep prices supported. Meanwhile, any escalation of political tensions or geopolitical flare-ups in the Middle East could increase demand for the safe haven yellow metal. However, any marked upside in prices is likely to be capped by the strengthening of the US Dollar and further interest rate hikes in the US. Accordingly, we maintain a 'Neutral' rating on gold.

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Alkhabeer Capital has offices in Jeddah and Riyadh.

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