Weekly Economic Review by UAE (DUBAI) Chapter of ICAI

(For internal circulation to members only)

Week ending December 16, 2017

	Current Week	Previous Week	Change		Current Week	Previous Week	Change
DFM	3355.40	3393.46	-1.12%	USD/INR	64.05	64.46	-0.64%
ADSM	4339.22	4276.93	1.46%	EUR/USD	1.1749	1.1773	-0.20%
SENSEX	33462.97	33250.30	0.64%	USD/JPY	112.60	113.48	-0.78%
NIFTY	10333.25	10265.65	0.66%	USD/CNY	6.6094	6.6209	-0.17%
DOW	24651.74	24329.16	1.33%	Gold	1256.44	1248.49	0.64%
NASDAQ	6936.58	6840.08	1.41%	US 10-year	2.35	2.38	-1.26%
S&P 500	2675.81	2651.50	0.92%	Crude - Brent	63.23	63.40	-0.27%

Stock markets in UAE had a relatively subdued year with not much sharp movement higher or lower. Dubai's DFM Index is up 5.23% for the year and given the average dividend yield of about 4% the overall return for the year at just below 10% is quite attractive, given that the fact that the economy continued to face headwinds from the crash in crude oil prices. In the second half of the year a pick up in crude oil prices and higher government spending across the GCC, helped boost sentiment in Dubai which is the key magnet for liquidity in the region. Abu Dhabi's ADSM Index is up 4.77% for the year and with its higher dividend yield also returned just under 10% in return for investors this year. The outlook for next year also seems bright as crude oil prices remain firm and government spending in GCC is expected to remain robust. Dividends in UAE are paid largely annually and this is around the period March to May. This could be an opportune time for investors to accumulate high dividend yielding companies like Dubai Islamic Bank 7.32%, ADCB 5.84%, Air Arabia 5.74%, First Abu Dhabi Bank 4.41% and look to exit post dividend after the first half of the year. The massive success of Adnoc Distribution's IPO in December with over subscription of 22% will prompt other strong government or quasi government companies to tap the IPO market for funding. UAE equity markets in 2018 also could provide higher double digit gains.

In UAE, inspite of economic growth slowing down, interest rates have increased this year. The reason for this is the fixed USD-AED peg which results in defacto US monetary policy adopted in the UAE economy. As the US Fed increased interest rates, interest rates in UAE Dirhams also increased. With the US Fed poised to increase interest rates further in 2018, interest rates will rise further in UAE and this will put pressure on the large SME sector which is very crucial for GDP growth. In the bond market, there have been several large issuances by GCC governments and also by the large banks and with liquidity in global markets continuing to be robust we will witness large issuances in 2018 and this will be a good opportunity for bond investors to accumulate bonds with attractive yields and ratings.

In India, Foreign exchange reserves topped $400 billion for the first time ever in 2018 with reserves increasing by $42 billion. Foreign Institutional Investor's (FII's) poured record funds into the Indian Bond markets with USD 22.83 billion of inflows this year in the debt markets. In the equity markets FII inflows was at a rather subdued USD 8.3 billion. FDI inflows in fiscal year 2016-17 was at a record high $60.08 billion. In the first two quarters of the current fiscal year up to September is at $34 billion and is expected to set another new record.

One reason for the subdued interest of FII's in Indian equities is the high valuations. Sensex has gained 27.5% in 2018 and valuations do seem stretched. It is trading at a P/E ratio of 24.80 which is at the higher end of the spectrum it has traded since the pre-financial crisis times. The upside from there levels seem rather limited, unless there is a big upsurge in earnings in the next few quarters. Economic growth has been rather lukewarm and in this environment an immediate upsurge in earnings may not be a possible scenario. Interest rates in India are among the highest in among the G-20 countries and the fixed income market could offer better value over the next few quarters. There are two factors that could bring some volatility in the equity markets in India. Firstly, the annual budget which is slated to be released in Q1 could contain some populist measures as this will be the last budget before the next general elections in April 2019. Secondly, any volatility in global equity markets could feed through into Indian equity markets.

The Indian Rupee has appreciated by 5.7% in 2017 due to large inflows from FII's & FDI. The Reserve Bank of India (RBI) has been buying US Dollars from the market to prevent the Rupee from appreciating but has been constrained by the large amount of liquidity in the domestic market after massive amounts of cash found its way back into the banking system after demonetization late last year. The Rupee is expected to trade with an appreciating bias in 2018 as inflows from FII's and on account of FDI are expected to continue at a solid pace.

There is pressure on the RBI to cut interest rates to boost economic growth which has been sluggish with inflation being relatively benign. In November inflation at the retail level, CPI hit a 15-month high of 4.88%. The reason for the spike in inflation was due to the food component in the Index. The impact of inflation on the bond markets was visible in the bond markets with the 10-year bond yield jumping higher to 7.17% which is the highest level since July 2016. While the inflation data dashed hopes of another rate cut by the RBI, the probability of RBI hiking rates is rather limited. The move higher in inflation is more due to supply side issue from the food sector which has about 50% weightage in the Index. It is difficult to understand how an interest rate hike would help bring down food prices! In the past RBI has gone purely by the book and hiked interest rates when CPI moved higher, irrespective of the reason for this increase in CPI. It is quite possible that we could witness at least one interest rate cut from the RBI in 2018. At the Monetary Policy Meeting earlier in December, RBI held the REPO rate unchanged at 6% with 5 of the 6 members voting to hold interest rates steady. One member, Ravindra Dholakia, a professor at Indian Institute of Management Ahmedabad voted for a 25-bps cut. The RBI statement also mentions that it expects food inflation to abate in the coming months with overall inflation expected to be in the range of 4.3-4.7% for the rest of Fiscal year 2018. The impact of higher crude oil prices on inflation was also discussed as India imports about 80% of its crude oil requirement. Increased crude oil prices have a cascading effect on the Indian economy, pushing prices higher.

In the US, stock markets have had a fabulous year with the Dow Jones Index up 24.7% for the year till date. The rally in stocks has been due to better than expected earnings, large pools of liquidity and hopes of large corporate tax cut. The Republicans are close to getting one of the biggest tax reforms through the senate and house, though the narrowing of their majority in the Senate to 51-49 after the recent loss in Alabama makes it a bit more difficult. Equities have rallied every single year since the Financial Crisis in 2008 which is 9 long years and in the second half of this year there has hardly been a correction. In terms of fundamental valuations, the Dow Jones Index is trading at a P/E ratio of 21.70. The broader S&P 500 Index is trading even higher with the P/E ratio at 25.1, which is the highest since 2004. The dividend yield on the S&P 500 has fallen below 2%, at 1.90%. A cautious approach to adding to fresh allocations to equities could be advised for 2018.

If stocks seem frothy, the biggest mania since the Tulip Mania in the 17th century is forming in cryptocurrencies. Bitcoin the flag ship for these cryptocurrencies has surged higher from 960 in late December last year to 18,098 as of Friday, a gain of 1785%!! Bitcoin has also gained mainstream acceptance with Bitcoin futures commencing trade in the world's largest futures market in CME earlier this month. There are several other cryptocurrencies which are in the process of getting into the mainstream in the coming months. One major attraction and also possible challenge for regulators is the anomality that can be obtained by moving funds through these cryptocurrencies. At some point of time, regulation could emerge for these cryptocurrencies which could signal a bursting of this emerging bubble.

In the fixed income market, the 10-year US Treasury yield has traded in a rather narrow range this year, inspite of interest rate hikes and expectations of at least three more in 2018, between 2.20 & 2.40%. The feds funds rate is at 1.25-1.50% currently and the spread between the 10-year rate and the overnight rate at about 100 bps in a rising rate environment does seem rather unusual. One reason for this could be the transparency of the US Federal Reserve in reiterating that rate increases will be gradual. Any marginal change in this could tone with a new head at the Fed could rock markets.

The US economy has picked up pace in the second half with the record job addition phase continuing for the 86th consecutive month in November and forecasts are there that this could extend into next year also. Consumer spending has also rebounded strongly in the last three months with September, October and November retail sales data beating economist forecasts and surging higher. Consumer spending accounts for about two-thirds of USD GDP and the Hurricanes in the key states in the US only briefly dented these numbers but more importantly the rebound in reconstruction spending has been strong.

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Source: Bloomberg.com, Investing.com