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A STROLL AROUND THE GLOBE

Overview

On the global macroeconomic front, US remains the primary growth engine and appears better positioned than its peers in the developed world. The World Economic Outlook, published by the International Monetary Fund (‘IMF’) last October, highlighted the worsening operating conditions in some developed and emerging nations. The IMF revised down its global gross domestic product (GDP) forecast by 0.2 percentage points to 3.8% for 2015. The growth projection for developed economies was lowered by 10 bps to 2.3%, while the forecast for emerging nations stood at 5%, down 0.2 percentage points from the previous estimate. The Eurozone has been reporting disappointing data over the last few months and the ECB (European Central bank) seems committed towards stimulating the economy. The recent Euro 1.2 trillion QE (Quantitative Easing) announced by the ECB bears testimony to that. The divergence in monetary policies within the developed markets is expected to result in a strong dollar, which might hurt US corporate profitability.

On the other hand, the emerging markets story is a mixed bag. While the Chinese central bank and the government remain committed towards supporting the 7% plus GDP growth figure, India seems to be in a bright spot with a stable political environment, improving macro environment and an accommodative monetary policy. Since India is a key beneficiary of low oil prices, the beginning of a rate cut cycle bodes well for its business climate.

Gold seems to depict mixed signals over the near-term. On one hand, the low interest rate regime remains supportive of Gold prices while a strong dollar due to tightening by the FED could affect Gold prices adversely. The holdings in the Gold ETFs and the open interest in Gold futures contracts have both fallen. This indicates lack of interest to own Gold over the last few months. The recent analysis of the technical pattern in Gold prices does not suggest a clear trend; however, the commodity is trading near its crucial support level of the 1,200 mark. We expect support for the yellow metal to come in the form of excess monetary supply in the financial system over the long-term, due to easing by various central banks (like the ECB and BOJ), which could increase the nominal value of Gold in different currencies.

Crude Oil has declined by more than 50% from its recent peak and the pace of slide has surprised many market participants. This is not the first time that oil has reacted downwards sharply. However, we do not expect a sharp rebound in prices like the previous occasions. The issue is more “structural” in nature this time around. Moreover, oil does not appear to be an effective hedge against geopolitical risk anymore. The growing non-OPEC supply (US & Russia in particular) coupled with technological innovation (shale gas revolution) has led to an oversupplied market and a lower cost of production.

FINANCIAL MARKETS DECOUPLING FROM THE REAL ECONOMY AS VALUATION OF EQUITIES RISE

We have seen a clear decoupling of the financial market from the real economy since the beginning of 2012. One would ideally expect the cyclical sectors to outperform during an economic recovery, which would in turn, aid the market performance. This was the case prior to 2012. However, since the beginning of 2012, this trend has reversed and the financial markets have rallied despite the cyclical index underperforming the defensive index. Despite this, a deeper look into the improving profitability and the growth of US corporates reveal that the current financial market rally is not purely driven by liquidity. The profitability and growth of US corporate enterprises have clearly outpaced the remaining segments in the economy. As a result of this, the US corporate profits after tax as a % of GDP has increased from 4.61% in December 2008 to 10.63% in December 2013. (Source: The Bureau of Economic Analysis)

Financial Markets outpace the Real Economy?

Chart1: Market Decoupling from Real Economy (Declining Cyclical/Defensive ratio despite market rally implies decoupling from real business cycle since beginning of 2012 ...)

Source: Bloomberg, Mashreq Private Banking
US EQUITIES ARE RICHLY VALUED BUT NOT EXPENSIVE YET...PREFER ‘VALUE’ BASED STRATEGIES

The price to book multiple for S&P 500 index – a valuation measure for equities – has increased steadily from 2.16x in 2010 to 2.57x currently. Although this seems expensive on the face of it, especially given the marginal increase in the Return on Equity (ROE hereafter), a closer look at the quality of ROE reveals the opposite.

Although the ROE of the S&P 500 Index has virtually remained unchanged since 2007, the total leverage in the system (measured by net debt / operating profits (EBITDA)) has declined sharply from 4.6x to 1.6x. This indicates that the contributors to the ROE have been the core business factors like increase in asset utilisation and profit margins and not the financial leverage, thereby representing a healthy and profitable growth.

Chart 2: S&P 500 Valuations get support on improving fundamentals

HIGH YIELD (HY) SPACE - IN A VULNERABLE SPOT

Although equities are not expensive, the high-yield bond space seems to be highly vulnerable to a ‘Risk-Off’ environment. Any deterioration in risk sentiment could result in a correction of these securities, thereby increasing the credit spreads. In the Fixed Income space, the price sensitivity is subject to two major components: (a) the risk-free interest rate, and (b) the credit spread. Lower the credit rating, the higher the sensitivity to the credit spread. While both the rates and the credit spreads tend to mean reverting, we observe that the credit spread cycle is much shorter as compared to the interest rate cycle. Thus, we expect the rates to remain low while a correction in credit spread seems due. The hunt for yield in the current low interest rate environment is expected to keep creating bubbles in the HY space.

Chart 3: Movement in Rates & Credit Spreads

Under normal market conditions, the two variables tend to move in different directions. i.e. when the rates move higher (a scenario of better economic growth supporting risk sentiment), the credit spreads tend to tighten. However, in scenarios where the rates move down because of economic slowdown and the environment switching to a ‘Risk-off’ mode, the credit spreads tend to widen. The negative correlation results in a natural hedge between interest rates and spreads. However, during certain periods like the current scenario, the two components can move together (similar to the 2013 scenario). The interest rates are expected to increase, while the credit spreads are rebounding from their lowest levels (as can be seen in the chart). In such cases, the high-yield credit becomes more vulnerable to a fall as it gets adversely hit by both the components; i.e. the increase in interest rates & an increase in credit spread.
A STROLL AROUND THE GLOBE

The rate hike in the US could happen sooner than expected following the strong jobs data in the US and other macroeconomic indicators remaining positive. However, with a subdued outlook for inflation, the yield curve is expected to flatten; i.e. in terms of risk, the shorter end of the curve represents higher risk than the longer end.

Chart 4: Fall in oil prices could create some opportunities in the US HY Energy credit space

MEANWHILE, GOLD TRADES NEAR THE CRUCIAL USD 1,200/OUNCE MARK

Any decisive move away from the crucial support could indicate an appropriate entry point in the light of rich valuations in equities and debt markets. There is an absence of a clear trend in Gold prices given the mixed signals from various indicators. However, the open interest position in the Gold contracts would be the key parameter, which would decide the direction in the near-term.

Chart 5: Gold near its crucial support level of 1,200

WHILE GOLD STILL REMAINS AN EFFECTIVE HEDGE AGAINST TAIL RISK, OIL LOSES THAT SPOT!

We prefer Gold to be an integral part of a well-diversified portfolio. Adding a small percentage (5-10%) of Gold to one’s portfolio would increase the quality of the overall portfolio. However, with the recent correction in Oil prices due to a structural shift in the market, Oil no longer acts as an effective hedge against tail risk.

Chart 6: A structural shift in the Oil market, leads to a new normal in Oil prices
MENA Markets

a. United Arab Emirates (UAE) 
7-9
b. Kingdom of Saudi Arabia (KSA) 
10-12
c. Egypt 
13-16
d. Qatar 
17-19
e. Turkey 
20-22
f. Nigeria 
23-25
TABLE 1: UAE ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (AED bn)</td>
<td>1,051</td>
<td>1,276</td>
<td>1,367</td>
<td>1,478</td>
<td>-</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>1.6%</td>
<td>4.9%</td>
<td>4.7%</td>
<td>5.2%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Consumer price index - CPI (% YoY)</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.7%</td>
<td>1.1%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Government gross debt (% of GDP)</td>
<td>22.1%</td>
<td>17.5%</td>
<td>16.6%</td>
<td>12.3%</td>
<td>-</td>
</tr>
<tr>
<td>Current account surplus (% of GDP)</td>
<td>2.5%</td>
<td>14.7%</td>
<td>18.5%</td>
<td>16.1%</td>
<td>11.1%</td>
</tr>
<tr>
<td>Fiscal surplus (% of GDP)</td>
<td>(5.9%)</td>
<td>(5.6%)</td>
<td>(4.9%)</td>
<td>(1.9%)</td>
<td>-</td>
</tr>
<tr>
<td>Net foreign assets (AED bn)</td>
<td>79</td>
<td>92</td>
<td>161</td>
<td>247</td>
<td>-</td>
</tr>
<tr>
<td>Population (in mn)</td>
<td>8.3</td>
<td>8.4</td>
<td>9.2</td>
<td>9.3</td>
<td>-</td>
</tr>
</tbody>
</table>


ECONOMY PICKING PACE; OIL LOSING MOMENTUM

The UAE economy gained momentum in 2013, registering a growth of 5.2% versus 4.4% in 2012. The oil & gas sector’s growth weakened to 4.8% in 2013 as compared to 7.6% in 2012, while on the other hand, the non-oil sector’s growth accelerated from 3.3% in 2012 to 5.4% in 2013. The share of the oil & gas sector in 2013’s nominal GDP stood at 38.9% (39.4% in 2012). Despite being the single largest contributor to GDP, the oil sector’s share in GDP is low as compared to the country’s GCC counterparts. Going forward, the sector’s growth is likely to lose steam further as global crude oil prices continue their free fall. Oil prices fell around 46% in 2014 as the OPEC ruled out cutting oil production and witnessed a continued fall in January 2015 to below USD50 per barrel. Nevertheless, the preliminary IMF estimates indicate that the UAE’s real GDP grew by 4.3% in 2014. Meanwhile, the government forecasts the UAE to grow at around 4.5% in 2015, aided by the expanding non-oil sector, especially tourism, retail sales, trade and real estate. However, the estimates from international institutions peg the 2015 growth rate in the range of 3-3.5%, down from earlier forecasts ranging from 4.5-5%, taking into effect the impact of lower oil prices. The real GDP growth rate of the UAE’s non-oil sector is forecasted to be at 5.6% in 2014 and is expected to remain above 5% in 2015 and 2016 as well, on the back of increased foreign investment inflows, mainly into tourism, real estate and construction sectors, as a result of the favourable market conditions.

LONG TERM VISION FOR BROAD BASED GROWTH

With an ambition to be recognized among the world’s best economies by 2021, the country is implementing its UAE Vision 2021 that envisages the key themes for socio-economic development, specifically calling for a shift to a diversified and knowledge-based economy. Besides this, Dubai is hosting the World Expo in 2020, which is a six-month long exhibition of trade, innovation and products from around the world. The expo will be held on a proposed giant 438-hectare site on the edge of Dubai and is expected to generate a financial return of around AED139bn. In order to meet these objectives, the UAE is investing on several big ticket projects such as the USD10bn national rail project. Dubai plans to invest USD32bn in a desert project to create one of the world’s largest aviation mega hubs. Other major projects include development of the Mall of the World, a mixed-use complex in Dubai, expansion of the Dubai metro network, Khalifa Industrial Zone in Abu Dhabi, and four 1,400 MW nuclear reactors in Abu Dhabi. Thus, powered by a vigorous investment drive and the government’s effort to transform the Emirate into a leading regional hub for numerous economic activities, the country’s growth prospects remain bright in the coming years.
NON OIL COMPANIES BRIMMING WITH ACTIVITIES

The seasonally adjusted headline HSBC/Markit UAE PMI for the non-oil producing private sector achieved the second highest reading of 59.3 in January 2015 since the series began in August 2009, below the record high of 61.2 in October. The January PMI data reflects sustained production growth in the first month of 2015. The rate of output expansion strengthened, supported by stronger sales, good market conditions, start-up of new business and export orders. Subsequently, hiring continued to rise in January. However, input prices also rose, signalling the prevailing cost pressures. Overall, the current scenario suggests encouraging near-term prospects for the economy as demand is holding up fairly well, although lower oil prices and weaker demand from key export markets may weigh on the economy.

Chart 3: HSBC/Markit PMI

Chart 4: Credit outstanding & sectoral share (in AED bn)

BANKS PARTICIPATE IN GROWTH STORY

The total outstanding bank credit stood at AED1,179bn at the end of September 2014, registering a growth of 8.4% YoY and 2.8% QoQ. Overall credit has grown at an average of 2% over the last six quarters, reflecting a growing economic activity. Personal loan for business activities constituted the largest segment of the total outstanding credit at 20.3%, while the construction & real estate sectors accounted for 16.1%, making it the second largest segment. International rating agency Standard and Poor’s expects around 8-9% credit growth in the UAE in 2014-2015, in line with the healthy economic activity driven by strong government spending, and non-oil private sector growth. However, international agencies such as the IMF have advised the UAE to be prudent regarding project financing, as Dubai’s government-related entities have an estimated USD78bn worth of debt maturing in 2014-2017.

REAL ESTATE MARKET STILL APPRECIATING, THOUGH AT A LOWER PACE

The capital value of properties in the UAE is still appreciating; however, the average rate of growth has somewhat stabilised recently with new and more stringent lending restrictions in place (the UAE Central Bank imposed a 75% mortgage cap for expatriates and an 80% cap for Emiratis), a higher transaction fee (transfer rates increased from 2% to 4%) and increased supply of houses. According to real estate firm, Colliers International, home prices in Dubai stayed flat while property transactions were 6% lower QoQ in 3Q2014. Global real estate consultancy firm Jones Lang LaSalle predicts house prices in Dubai to fall by 10% in 2015, after rising almost 60% during the last two years as around 25,000 residential properties will be ready in 2015, equivalent to about 7% of Dubai’s present housing stock. This suggests that the case of excessive high property rate growth is unlikely to happen in future with authorities vowing to remain watchful with regard to property regulation and increasing house supply in the wake of Dubai Expo 2020.

IMPROVING GOVERNMENT FINANCES

The UAE’s fiscal position highlights that its diversification strategy has helped. Fiscal deficit narrowed from AED156bn in 2009 to AED29bn in 2013. Crude oil revenue growth has stabilised in the last two years to around 6.5%, while other revenue grew 26% in 2013 after rising 13.6% in 2012. Share of oil revenues also dipped slightly from 68% in 2012 to 64% in 2013. The fiscal balance is projected to be at 11% of GDP in 2014 and is expected to slightly narrow at around 8-9% of GDP in 2015 and 2016. The current account surplus, which stood at a healthy 16% of GDP in 2013 narrowed to 11.1% of GDP in 2014 due to lower oil export growth and higher import growth. However, the UAE is expected to maintain high level of public spending, helped by a diversified economy, abundant financial reserves amounting to around 260% of GDP, and a relatively low break-even oil price. The UAE has approved a balanced budget for 2015 in October 2014 totalling AED49bn, up 6.5% from 2014 with 49% of the budget earmarked for service projects, social development and social benefits.
MODERATE INFLATION TO AID SPENDING

Consumer price inflation came in at 3.1% in December 2014, maintaining its moderate upward trend. The housing and utility costs, accounting for around 39% of consumer expenses, continued to accelerate as it rose 5.4% YoY. The rising housing costs in Dubai are driving up countrywide house price inflation as more residents move to nearby emirates. The food prices rose 1.3% YoY in December, recording the lowest YoY increase in 2014, helped by lower global food prices. The overall inflation for 2014 stood at 2.33%. Going forward, the IMF and the UAE’s Ministry of Economy predict a manageable inflation rate of 2.5% for 2015, aided by weak oil prices, which will allow the government to focus on investments without worrying about runaway prices.

VALUATION

Dubai was the third-best performing market (+12.0%) in the GCC region in 2014, after Qatar (+18.4%) and Bahrain (14.2%). Abu Dhabi delivered a return of 5.6% over the same period. The country also witnessed substantial foreign investor interest in 2014, after the MSCI upgraded the UAE to Emerging Markets status. The Dubai Financial Market also experienced increased IPO activity in the wake of Emaar Malls IPO, which generated huge interest. The IPO, which was one of the largest in almost 7 years, received orders worth USD43bn for its USD1.6bn sale. Three other companies have also launched their IPOs in 2014, namely, Marka, Amanat Holdings and Dubai Parks. Following the success of its retail unit IPO, Emaar is now planning an IPO for its hotel unit along with several other companies such as DAMAC Properties, Daman Investments and Massar Solutions, which are likely to float their IPOs in 2015. These happenings revived foreign investor interest in the market resulting in enhanced liquidity. FIIs have invested AED7.6bn on a net basis during 2014. Dubai’s DFM Index is currently trading at 11.9x one-year forward consensus earnings, higher than its five-year average one-year forward multiple of 9.8x. Abu Dhabi’s ADX index relatively commands marginally lesser premium as it trades at 11.3x one-year forward consensus earnings, higher than its five-year average one-year forward multiple of 9.9x. Considering the healthy expansion of the UAE’s corporate earnings in 9M2014 (rising approximately 33% YoY), driven by the higher earnings in banking and real estate sectors and expectations of the continuing good performance in 4Q2014, we expect the valuation to remain on the higher side as compared to the historical averages.
### TABLE 1: SAUDI ARABIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
<th>4Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (SAR bn)</td>
<td>702.2</td>
<td>736.5</td>
<td>715.1</td>
<td>712.4</td>
<td>657.8</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>4.89%</td>
<td>6.41%</td>
<td>3.72%</td>
<td>2.41%</td>
<td>1.97%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>2.97%</td>
<td>2.71%</td>
<td>2.69%</td>
<td>2.75%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Repo rate (%)</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
</tr>
<tr>
<td>Current account surplus (% of GDP)</td>
<td>20.4%</td>
<td>14.1%</td>
<td>16.8%</td>
<td>11.8%</td>
<td>-</td>
</tr>
<tr>
<td>Net foreign assets (SAR bn)</td>
<td>2,824.1</td>
<td>2,866.7</td>
<td>2,866.8</td>
<td>2,909.0</td>
<td>2,875.3</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>5.5%</td>
<td>6.0%</td>
<td>5.9%</td>
<td>5.7%</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Saudi Arabian Monetary Agency (SAMA), Central Department of Statistics & Information

### NON-OIL SECTOR IMPROVING ALTHOUGH OIL TO REMAIN A DOMINANT CONTRIBUTOR

The Saudi Arabian real economic growth accelerated to 3.6% YoY (preliminary) in 2014, after it halved to 2.7% YoY in 2013 vs. 2012. The expansion came on the back of healthy growth in the non-oil sector. The Kingdom’s focus on diversifying the economy away from oil continued to yield results as the private, non-oil sector remained the major contributor to the growth at 5.1% YoY. Meanwhile, the oil sector grew modestly by 1.7% YoY, aided by a 0.8% YoY rise in oil production and a new refinery coming online in 2014. Manufacturing (+12.1%), Construction (+6.7%), Transport (+6.1%) and Trade & Hospitality (+6.0%) remained the major drivers of the non-oil sector, since the fundamental demand remained intact. However, the GDP growth in 4Q2014 slowed to 1.97% YoY from 2.41% YoY recorded in 3Q2014, signalling that plunging crude oil prices may be affecting growth. Going forward, the real GDP growth for Saudi Arabia is forecasted to slowdown in the range of 2-2.5% in 2015, as contribution from the oil sector declines on low oil prices whereas the non-oil sector may also witness lower growth since the government is expected to turn more prudent towards fiscal management by curtailing expenditure, while non-oil exports suffer from the global slowdown. However, the non-oil sector’s contribution to the largest Middle Eastern economy is expected to grow over the long-term with the government maintaining its support for industrial activities. Construction will also continue to be one of the key growth sectors due to the Kingdom’s focus on housing and infrastructure. However, crude oil will remain the key revenue generator for the Kingdom in the foreseeable period.

### BALANCED LONG-TERM GROWTH – SAUDI VISION 2024

In the Eighth Development Plan (2004–2009), the Saudi government chalked out strategies to diversify the Kingdom’s economy away from oil. For this, the government laid emphasis on offering world-class education and training systems, building industrial cities, and providing high-quality healthcare facilities, thereby bringing Saudi Arabia on par with the developed nations. The government has planned industrial investments that would boost the non-oil share of exports from 26.8% (2004) to ~60% (2024). For achieving this, it plans to boost investments expenditure from 21.1% (2004) to 49.3% (2014). The service sector too will play a vital role in the economy. The Kingdom is building excellent infrastructure for education, communication, transportation and other facilities. The government has envisaged that the service sector’s export contribution would rise from 7.4% (2004) to 20.7% (2024) of GDP. Through these action plans, the share of oil & gas in the total exports is expected to decrease from 65.8% to 19.5% during the 2004–2024 period.
CREDIT GROWTH CONTINUES TO BE STRONG

Bank lending remained strong with total credit growing at 11.8% CAGR (4Q2012–4Q2014). Out of the total credit of SAR1,251bn (4Q2014), Commerce and Manufacturing were the key sectors, taking a share of 20.4% and 12.7%, respectively. The relatively stable demand scenario in the Kingdom has boosted industrial activities and resulted in higher credit uptake by the Manufacturing sector (12% CAGR) over the same period. Manufacturing is expected to demand a larger lending share, since major investments are on the anvil in the sector.

Chart 3: Loan uptake by two major sectors

Source: Saudi Arabian Monetary Agency

AFFORDABLE HOUSING, NEW MORTGAGE LAW TO DRIVE CONSTRUCTION SECTOR

Affordability remains a key constraint as housing is still a distant dream for the majority of Saudi population. In the Ninth Development Plan (2010-2014), the Saudi government estimated that around 1.25mn housing units will be required at the current demand levels. Understanding this need, the Saudi government has focused on providing affordable housing for low and middle income groups by earmarking SAR250bn to build 500,000 homes across various regions. In order to address the affordability need and offer a comprehensive legal framework for real estate finance, the Kingdom began the implementation of Shariah-compliant mortgage regulations last year. This will boost liquidity in the real estate market and enable citizens to leverage for a house purchase. The value of retail real estate loans disbursed has risen (30.3% YoY for 2014), indicating Saudi citizens’ willingness to invest in the property market. Further, the government has allocated SAR63bn for transportation and infrastructure projects in its 2015 budget.

Chart 4: Real estate loans disbursed by banks to individuals

Source: Saudi Arabian Monetary Agency

NITAQAT LAW TO BOOST EMPLOYMENT AMONG SAUDI CITIZENS

Saudi private companies employ a large number of expatriates. In order to counter it and increase employment among Saudi citizens, the government introduced the Nitaqat programme, which requires private companies in most industries to ensure that at least 30% of their employees are Saudi nationals. Through this programme, the government plans to boost employment among Saudi citizens. Further, the government is mulling raising minimum wages for both Saudi nationals and expatriates. These factors will lead to higher disposable income and in turn expand the economy.

PMI NUMBERS DEPICT EXPANDING MANUFACTURING

Saudi Arabia’s Purchasing Managers’ Index (PMI) dipped marginally to 57.8 in January 2015 after touching a three-year high of 61.8 in October 2014. Despite the drop, the PMI remains among the strongest in the world. The Kingdom’s non-oil producing private sector has been witnessing a strong growth on the back of a continuous rise in output, new orders and employment. These factors point towards a growing business and healthy capacity utilisation over the near-term. Although the global economic conditions remain uneven, strong domestic demand is expected to boost the Manufacturing sector’s growth in the near-term.
KINGDOM OF SAUDI ARABIA

NCB IPO – THE BIGGEST IN THE GCC REGION

Saudi Arabia’s largest bank in terms of assets – National Commercial Bank (NCB) – raised SAR22.5bn (USD5.6bn) through an IPO in November 2014 by selling 500mn shares. This was the world’s second largest IPO in 2014, after Alibaba Holding (USD25bn) and the largest ever in the GCC region. This is the Kingdom’s first bank IPO since 2008, which indicates the upbeat sentiment among the Middle East stock markets, as IPOs generally happen in a vibrant economy. Recently, NCB was included in the Tadawul All Share Index, the Kingdom’s benchmark index.

DIP IN FOOD PRICES EASES INFLATION

Inflation in Saudi Arabia continued its downward trend and moved further down to 2.4% YoY in December 2014 as compared to 2.5% in November (2.9% in January), as inflation in ‘Food & Beverages’ (highest weight in the basket) dipped to 2.6% YoY (5% in January). A drop in food inflation will help reduce inflationary pressures coming from the ‘Housing & Utilities’ segment. Despite a growing young population and rising disposable incomes, the Saudi government has been able to contain prices at moderate levels, keeping inflation under check. The SAMA expects a stable inflation rate in 1Q2015 as a result of the global decrease in commodity prices, although some commodities may witness price increases due to increased consumption demand consequent to a royal decree issued on January 2015, providing for the payment of a two-month bonus salary to all Saudi state employees to mark the accession of Kingdom’s newly-crowned King Salman, following the death of his brother King Abdullah.

KINGDOM ANNOUNCES RECORD SPENDING FOR 2015

The Brent crude price has declined by over 50% from the peak it touched eight months ago to around USD57 a barrel. This created panic among investors that the Kingdom might cut its spending in 2015. However, Saudi Arabia surprised the world by announcing a counter-cyclical budget with a record spending of SAR860bn. Out of this, the government has earmarked SAR217bn (~25%) for education and SAR160bn for health and social welfare. The government marginally reduced the allocation for infrastructure & transportation, and kept it at SAR63bn.

OPENING UP OF TADAWUL – A POSITIVE SIGN

The Capital Market Authority (CMA) has been enforcing various regulations over the past couple of years to make the Saudi stock market more efficient and transparent in order to make it ready for foreign investments. On 22 July 2014, the CMA announced its plans to open up Tadawul, the MENA region’s largest stock market (market cap ~USD53bn, as of 12 February 2015) to foreign investors in 1H2015. The news of the opening up of Tadawul has attracted attention from foreign investors, since they hunt for quality investment avenues. Investors will gain diverse benefits from their potential investments in Saudi stocks. Although declining oil prices will hurt Saudi Arabia’s revenues, strong forex reserves will help the Kingdom maintain its growth initiatives. Moreover, the Saudi riyal being pegged to the US dollar takes away the currency risk.

VALUATION

TASI had surged during the first nine months last year on the back of high oil prices and optimism among investors after the announcement of the opening up of the market. TASI had gained 30.6% from the beginning of 2014 till 9 September 2014. However, a sharp decline in oil prices, especially in Q2Q3, created panic among investors, who pulled out their investments. Consequently, TASI posted a loss of 2.4% during 2014. The annual returns were lower than the DFM (12%) and QE (18.4%) indices, as theses indices surged on the back of their MSCI Emerging Market Index upgrade. Currently, TASI is trading at 15.2x (as of 12 February 2015 close) one-year forward consensus earnings, higher than its five-year average one-year multiple of 12.3x. With the exception of the petrochemical sector, Saudi companies are expected to post a healthy earnings growth over the medium-term on the back of favourable demography and evolving consumption habits. Further, TASI’s reasonably good dividend yield of 2.9% also remains a major attraction among investors. Based on these factors, TASI may continue to trade at elevated multiples in comparison to its historic average, although the strong decline in the crude prices can weigh on investor sentiments.

Chart 5: TASI (SASEIDX Index) and 1-yr forward P/E trends

Source: Bloomberg

Mashreq Private Banking
TABLE 1: EGYPTIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>4QFY13</th>
<th>1QFY14</th>
<th>2QFY14</th>
<th>3QFY14</th>
<th>4QFY14</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices (EGP mn)</td>
<td>446,200</td>
<td>518,000</td>
<td>499,300</td>
<td>480,400</td>
<td>499,900</td>
</tr>
<tr>
<td>GDP Per Capita (EGP)</td>
<td>21,334</td>
<td>24,154</td>
<td>23,282</td>
<td>22,401</td>
<td>23,310</td>
</tr>
<tr>
<td>GDP Quarterly growth rates (%) (YoY)</td>
<td>1.5</td>
<td>1.0</td>
<td>1.4</td>
<td>2.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Domestic Savings nominal growth rate (%) (YoY)</td>
<td>(13.2)</td>
<td>(45.8)</td>
<td>5.3</td>
<td>(39.5)</td>
<td>(11.8)</td>
</tr>
<tr>
<td>Domestic Investments nominal growth (%) (YoY)</td>
<td>(8.1)</td>
<td>10.8</td>
<td>(0.1)</td>
<td>17.7</td>
<td>22.6</td>
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<td>CPI in urban areas</td>
<td>8.7</td>
<td>10.1</td>
<td>11.7</td>
<td>10.3</td>
<td>10.5</td>
</tr>
<tr>
<td>T-bills rate (91 days) (%)</td>
<td>13.9</td>
<td>12.0</td>
<td>10.7</td>
<td>10.3</td>
<td>10.5</td>
</tr>
<tr>
<td>Total Population (in mn)</td>
<td>84.7</td>
<td>85.2</td>
<td>85.7</td>
<td>86.2</td>
<td>86.7</td>
</tr>
</tbody>
</table>

Source: Central Bank of Egypt, Ministry of Finance Egypt (*Egypt’s fiscal year ends in June)

SIGNS OF INITIAL ECONOMIC GROWTH RECOVERY

The Egyptian economy faced adverse domestic and global shocks in the recent past, severely impacting its growth. Following a period of turmoil, the government is implementing a series of structural economic reforms in several fields that are aimed at achieving economic and financial stability, restoring investor confidence, and increasing employment opportunities. The GDP registered a 3.7% YoY growth in Q4-FY14 (1.5% YoY in Q4-FY13), resulting in an annual growth rate of 2.2% for the full fiscal year. This growth was spurred by both public and household consumption and investments. On the demand side, private consumption grew 4.1% YoY in FY14, after having grown by 3.2% YoY in 9M-FY14, while public consumption grew at a rate of 5.8% in FY14 as compared to 6.1% during 9M-FY14. Final consumption contributed 4% to GDP growth during in FY14, compared to 2.5% a year earlier. On the supply side, non-oil manufacturing and construction were the key sectors driving the growth in FY14. In FY14, the non-oil manufacturing sector grew 9%, while the construction sector recorded a real growth rate of 5.6%. General government and agricultural sectors witnessed a growth of 4.1% and 3.0%, respectively, while wholesale and retail trade grew at 3.4% during FY14. These five key sectors represented around 57% of the total real GDP.

The government continues to initiate significant reforms such as tax reforms, the reduction of energy subsidies, addressing the shortfall in electricity, arrears to foreign oil companies, and encouraging new investments, production and exploration. With regard to optimum utilization of resources, the government has recently issued the Mines & Quarries Act. Through this act, the government intends to launch various industrial projects based on the available resources, thus effectively maximizing their value addition and also enhance employment opportunities. Based on the reforms initiated by the government, Fitch upgraded Egypt’s credit ratings from B to B stable in December 2014, which will boost investor confidence in the Egyptian economy.

STABLE POLITICAL ENVIRONMENT TO OPEN UP INVESTMENT OPPORTUNITIES

The election of the former army chief, Abdel Fattah el-Sisi as the President in May 2014 has resulted in a political transition. However, the rift between the Muslim brotherhood and the government authorities continues. The Parliamentary elections are likely to be held in March 2015 and in this regard, the government has also approved a draft law on electoral districts. The new regime is expected to create a stable political environment, which would contribute towards improving business confidence and triggering an uptick in consumer demand.
MONETARY POLICY TIGHTENING TO CURB INFLATION

The Central Bank of Egypt (CBE) had decided to raise the overnight deposit rate, overnight lending rate and the rate of its main operation by 100 basis points to 9.2%, 10.2% and 9.7%, respectively in July 2014. This decision was taken in light of the expected inflationary pressures due to the government’s decision to cut subsidies as part of its fiscal consolidation plan. Consumer prices rose sharply after the government cut energy subsidies in July 2014, reaching an eleven-month high 11.8% in October. Since then, inflation has been on a downward trend due to a slowdown in food cost. The decline in annual inflation is mainly fuelled by the sharp decline in the annual inflation rate of the Food & Beverage group, which reached 7.1% during November 2014 from 11.5% in October 2014 and 19.1% in November 2013. Monthly inflation, on the other hand, declined significantly to -1.5% during November 2014 as compared to 1.7% in October 2014 and 0.9% during November 2013. The annual core inflation also decreased to reach 7.8% (the lowest rate since 2013) as compared to 8.5% in October 2014 and 11.9% in November 2013. It further declined to 7.7% in December 2014. In January 2015, annual inflation eased to 9.7% from 10.1% in the previous month. As a result, the Central Bank of Egypt cut its benchmark overnight deposit rate by 50bps to 8.75% on 15 January. Additionally, in an attempt to absorb excess liquidity and to protect the domestic currency, the central bank held deposit auctions on 23 December 2014 worth EGP70bn with a six-day maturity at a fixed annual interest of 9.75%.

EFFORTS BEING MADE TO REIGN IN FISCAL DEFICIT

The loose fiscal policy had pushed the budget deficit to 13.7% of GDP in FY2013. According to the FY14 actual budget outcomes, the overall budget deficit stood at 12.8% of GDP. Meanwhile, for the period between July-November 2014, the budget deficit came in at 4.6% of GDP as compared to 3.3% for July-November 2013. In order to reign in budget deficit, the government is working towards introducing a number of reforms. On the revenue side, the government is restructuring the tax system to pave the way for a fair distribution of the tax burden. In addition, the government is also pursuing other strategies that include countering tax evasion, widening the tax base through a set of amendments related to the income tax law, and transferring into the value added tax. Earlier this year, the government increased the tax rate on people earning more than EGP1mn a year from 25% to 30% for a three-year period starting tax year 2014. Taxes on cigarettes and alcohol have also been raised. Taxes on wine and spirits were increased by 150%, while taxes on domestic and imported beer were hiked 200%. Through these tax hikes, the government expects to raise tax revenues of EGP364bn in FY2015 as compared to EGP358bn in FY2014. The measures undertaken by the government to increase revenues paid off with a marked improvement in the country’s economic performance during 1H2014/2015. Tax revenue increased by 9.9% during the period to EGP 114bn primarily attributed to EGP 14bn hike in the revenues of products and services taxes. The budget deficit’s declined in the first half of the current fiscal year to register EGP 89.4bn, equivalent to 4.5% of GDP as compared to EGP 132bn, equivalent to EGP 5.7% of GDP in the last fiscal year.

On the expenditure side, the government is e-prioritizing public spending. In June 2014, President Abdel Fattah al-Sisi’s government raised the prices of heavily subsidized energy products by up to 78% and slapped new taxes on dividends, capital gains and high-income earners. The government plans to spend the savings on higher public sector wages, education, healthcare and pensions. Without these reforms, the government estimates the deficit for FY2015 would have been close to 14%.

NATURAL GAS OUTPUT TO BE RAISED

Egypt’s dry natural gas production has declined by an annual average of 3% from 2009 to 2013. The substantial gas discoveries in the deep offshore Mediterranean Sea and in other areas in Egypt remain undeveloped because the price that the Egyptian government is willing to pay foreign operators for the
gas is too low, rendering some investment projects commercially unviable. However, the government is now working on attracting investments for the development of offshore fields. In June, the country revised upwards the price it pays to buy natural gas from RWE Dea. The agreement, which will apply only to newly-discovered gas, was the first step towards fulfilling a pledge to provide more attractive terms to foreign firms to boost production. The government is also working on paying back USD6bn it owes to energy companies.

In addition, Egypt is set to resume its major gas development, the ‘BP West Nile Delta’ gas scheme, which has been on hold for more than three years. The project is a USD10bn investment by BP (UK), which was signed with the government in July 2010. Its production was originally scheduled to start in late 2014 at a rate of 1bn cu ft/day (equivalent to about 20% of Egypt’s total current production), but work was held up, owing to a slew of issues, including a dispute over the proposed site for the onshore gas treatment plant. The government’s agreement on the West Nile Delta project could positively impact Egypt’s natural gas output. The production from this project should help boost the country’s declining exports of natural gas and generate additional revenues for the government, helping it to bring down its budget deficit further, going forward.

EXPANSION OF THE SUEZ CANAL TO BOOST ANNUAL REVENUE

The Suez Canal has transformed Egypt into a passageway for one tenth of world trade, providing continuous revenues (around USD5bn annually) to the country. The government is now in the process of expanding the Suez Canal. The project includes widening and deepening the original channel, adding a 45-mile long additional lane to accommodate two-way traffic and building tunnels underneath to speed up travel to the Sinai Peninsula. This will allow the number of ships that can be handled everyday to almost double to 97. The long pending plans to develop a 76,000-sq-km area around the canal into a global industrial and logistics centre, are also moving forward. The country raised USD8.5bn by issuing investment certificates, carrying a 12% interest rate. The funding goal was reached in just eight days as Egyptians lined up to invest in the project. According to the central bank, 82% of money came from individuals. The new development is expected to boost annual revenues from the Suez Canal to USD13.5bn by 2023.

EGYPT TO BENEFIT FROM LOW OIL PRICES

Egypt’s main challenge in 2015 is to bring down the public debt level (climbed to 95.5% of GDP by the end of FY13 from 79% in FY10). Domestic public debt rose up to 85% of GDP from 67%, while debt service costs, mainly on domestic debt, rose to 14.1% of GDP from 8%. The high debt service costs are severely restricting the government’s ability to spend on the much-needed growth and welfare enhancing measures. However, on a brighter note, the fall in the crude oil prices is expected to bring down Egypt’s subsidy bill, support fiscal consolidation and also help in reducing the government’s budget deficit.

EXCHANGE RATE STABILITY

Support from countries such as Saudi Arabia, Kuwait and the United Arab Emirates in the form of grants, concessional loans and oil shipments has been a key factor behind the stabilization of Egypt’s economy since mid-2013. Considering the GCC’s large fiscal buffers and the geostrategic importance of Egypt, the support is expected to continue, although the level of support is anticipated to change due to the fall in oil prices. Additionally, Egypt is gearing for an economic summit in March 2015 and also a possible deal with the International Monetary Fund (IMF), which could help the country unlock new sources of capital. Successfully securing external commitments particularly during the forthcoming economic summit is expected to help stabilise the Egyptian Pound.

VALUATION

The Egyptian Exchange (EGX) has been extremely volatile in the recent years in response to the country’s unstable political environment. In 2011, the EGX 30 index fell by around 50%, following the public unrest and the change in the government. However, the market recovered partly in the following year and continued to deliver positive returns in 2013 (up 24%). With the removal of President Mohamed Morsi and the installation of a new government, the market continued its uptrend, ending 2014 with a return of over 31%. It is currently trading at 13.4x one-year forward earnings, well above its five-year average of 5.9x. The economy is expected to continue on the recovery path on the back of tough reforms such as cut in energy subsidies, while the earnings of Egyptian companies is also expected to grow at a strong rate. Based on these factors, we believe the high forward PE valuation is justified.
Chart 4: Yearly index performance

Source: Bloomberg
**TABLE 1: QATARI ECONOMY AT A GLANCE**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (QAR bn)</td>
<td>185.4</td>
<td>189.9</td>
<td>193.9</td>
<td>189.7</td>
<td>193.1</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>6.8%</td>
<td>5.9%</td>
<td>6.2%</td>
<td>5.7%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>2.9%</td>
<td>2.8%</td>
<td>2.6%</td>
<td>3.0%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Repo rate (% year-end)</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Budget surplus (% of GDP)</td>
<td>26.8%</td>
<td>52.2%</td>
<td>(4.9%)</td>
<td>41.7%</td>
<td>(4.6%)</td>
</tr>
<tr>
<td>Current account surplus (% of GDP)</td>
<td>28.4%</td>
<td>27.0%</td>
<td>32.3%</td>
<td>28.5%</td>
<td>24.0%</td>
</tr>
<tr>
<td>Net foreign assets (QAR bn)</td>
<td>89.3</td>
<td>106.7</td>
<td>117.6</td>
<td>133.2</td>
<td>138.3</td>
</tr>
<tr>
<td>Population (in '000s)</td>
<td>–</td>
<td>2,004</td>
<td>2,144</td>
<td>2,152</td>
<td>2,187</td>
</tr>
</tbody>
</table>

Source: Ministry of Development, Planning and Statistics, Qatar Central Bank

**NON-HYDROCARBON SECTOR TAKES CENTERSTAGE, DIVERSIFICATION PICKING PACE**

Qatar’s economy expanded at 6.0% YoY in 3Q2014 after achieving 5.7% YoY growth in 2Q2014, on the back of the growing non-hydrocarbon sector amidst the slowing growth of the hydrocarbon sector. The hydrocarbon sector witnessed a 2.8% YoY decline in 3Q2014 with stagnating production and cooling global oil prices, while its share of nominal GDP fell below 50% for the first time in 3Q2014 and stood at 49.3%. The hydrocarbon production has stabilized with Qatar imposing a moratorium on additional natural-gas development projects in the North Field until 2015. As per the latest estimate from the Ministry of Development, Planning and Statistics (MDPS), Qatar’s hydrocarbon output is expected to contract 1.8% in 2014, but may grow 0.3% in 2015 as gas production from the Barzan facility offsets the declining oil output. However, the country’s conscious efforts on diversifying and establishing itself as a knowledge-based economy have started leaving an imprint on its Non-hydrocarbon sector expansion. The non-hydrocarbon sector grew 12.0% YoY in 3Q2014, on the back of majority of its segments reporting double-digit growth, primarily driven by investment spending in the sector and growing population bolstering overall demand. The MDPS is hopeful about the non-hydrocarbon sector and expects it to outpace the hydrocarbon sector in terms of GDP contribution in 2015. Accordingly, the MDPS expects Qatar to expand at 7.7% in 2015 and 7.5% in 2016 as compared to the expected growth of 6.3% in 2014. Meanwhile, the MDPS has warned that falling oil prices could become a key risk to the outlook if they persist for longer or become steeper. Oil prices have retracted by around 50% since June 2014 when they were trading in the range of USD108-110/barrel, amid supply glut due to OPEC’s refusal to cut down supply (as it tries to protect market share), increasing shale gas supply in the market and dwindling demand especially from China and emerging economies.

**INTERNATIONAL EVENTS TO BOLSTER INFRA ACTIVITY**

Qatar hosted the 2015 World Handball Championship recently and will stage another major international event in 2022, the FIFA World Cup. Also, with its infra spending push, the country is expected to spend nearly USD180-USD200bn on various infrastructure related projects over 2013-2018 with the aim of developing transport infrastructure including railways, creating modern residential and hospitality environment along with world class sporting venues. In line with this, the country will award infrastructure projects worth USD30bn including the Doha metro in 2015. Additionally, with the increased project spending, the Building & Construction sector is witnessing an increasing growth trend since the last few quarters and achieved the highest growth of 18.5% YoY in 3Q2014 among all the sectors.
QATAR NATIONAL VISION 2030

With an eye on long term inclusive growth, the implementation of the Qatar National Vision 2030 (QNV) is expected to increase the economy’s competitiveness while stimulating growth over the coming years. QNV not only focuses on economic development but also lays emphasis on human, social and environmental development. Qatar has been implementing various large scale projects in order to achieve Vision 2030. Some of the big ticket investments include the Lusail real estate development project with an estimated budget of USD45bn and Doha metro and Qatar rail worth USD40bn along with others for developing expressways, airports, a new port and an education city.

INCREASE IN BANK FUNDING SUGGESTING GROWING BUSINESS ACTIVITY

Bank lending continued to remain healthy in recent months backed by the public and private funding demand with implementation of major projects. Total domestic credit disbursed by banks stood at QAR6,089bn for the eleven months ended November 2014, up approximately 10.8% YoY. The Public sector enjoyed the largest share of credit disbursements at 42.8%. The consumption and real estate sectors were neck-and-neck, with a share of 15.8% and 15.7%, respectively, in total domestic credit, making them the next biggest bank funding recipient after the public sector. Consumption sector lending grew 15.3% YoY while the Real estate sector recorded a loan growth of 4.6% YoY during the first eleven months of 2014.

BUSINESS COMPETITIVENESS REMAINED STRONG

According to the World Economic Forum’s ‘The Global Competitiveness Report 2014-15’ published in September 2014, Qatar is ranked 16th among 144 countries, despite slipping three places in global rankings. The country is the second most competitive economy in the Middle East, behind the UAE (ranked 12th). The country continues to benefit from the high levels of macroeconomic stability, efficient goods and financial markets. Separately, Qatar ranked 48th in World Bank’s 2014 Ease of Doing Business rankings, down slightly from the 45th place it secured in 2013.

FISCAL SURPLUS TO SUPPORT GROWTH

Qatar has been building significant wealth over the years generating strong fiscal as well as current account surplus on the back of strong hydrocarbon revenues. The current account surplus stood at 24.0% of GDP in 3Q2014 as compared to 28.5% of GDP in 2Q2014. However, the fiscal balance remained volatile as the country recorded a deficit of 4.6% of GDP in 3Q2014 after registering a surplus of 41.7% in 2Q2014 and a deficit of 4.9% in 1Q2014. Qatar’s current account and fiscal surplus are projected to narrow going forward, led by a combination of factors such as plateauing LNG and crude oil exports, softer energy prices and rising imports. The fiscal surplus is expected to hover around 13% of GDP in 2014, down to 21.2% and 16.6% of GDP in 2015 and 2016, respectively, as per the industry estimates. However, the Qatar National Bank forecasts that despite the decline, the surplus will be adequate enough to cover the government’s spending plans, without resorting to large-scale debt funding, required for achieving Vision 2030 as well as prepare for the 2022 FIFA World Cup. Qatar approved the highest ever general budget for 2014-15 at QAR225.7bn. The budgeted spending was also up 3.7% YoY at QAR225.7bn. The increased spending is majorly dedicated to the completion and implementation of key development projects that have been allocated QAR87.5bn, up 16% from 2013-14. However, Qatar’s MDPS highlighted that steep decline in oil prices will affect fiscal revenues in future. Also, the break even oil price, assumed at USD65/barrel for 2014-15 budget, will rise in 2015 and 2016, further narrowing the buffer and impacting the government
spending power. Accordingly, Qatar is likely to put a ceiling on total expenditure in the 2016 budget (January-December) at around QAR140bn to check the fiscal deficit, while priority will be accorded to development projects whereas the budget is expected to be based on an assumed oil price of USD55 per barrel.

DECREASE IN FOOD PRICES NEGATING HIGHER RENTALS

Qatar continues to experience moderate inflation despite consumer price inflation (CPI) inching up from 2.3% in January 2014 to 2.7% in December 2014. The rise in inflation is led by the Rentals, Fuel & Energy group, which rose to 7.3% in December 2014 on account of continued upward rental pressure for residential buildings amidst rising housing demand from growing population (including expatriates). However, low Food & Beverages group inflation, due to declining global food prices, has partially offset the rise in Rental inflation while moderating the overall inflation. Prices of the Food & Beverages group fell by 0.4% in December 2014 while being way below the 1.6% and 1.8% inflation recorded in January & February 2014. With global food prices expected to remain low, Qatar’s headline inflation is forecasted to accelerate moderately from 3% in 2014 to 3.5% and 4.4% in 2015 and 2016, respectively.

RISING FOREIGN INTEREST ON LOWER RESTRICTIONS

Qatar relaxed foreign ownership norms in Qatari listed companies in May 2014, allowing foreign investors to own up to 49% in the listed companies versus the previous cap of 25%, as part of reforms to improve stock market liquidity and further develop the financial industry. Also, the non-Qatari GCC nationals who were previously treated as foreigners for the purpose of trading in Qatari stocks are to be treated as Qatari citizens. This has revived FII's interest in the stock markets which invested QAR7,742.1mn in 2014 on a net basis.

VALUATION

Led by the euphoria of upgrading Qatar from the Frontier Market to the Emerging Market (EM) status by the MSCI and S&P in May 2014 and September 2014 respectively, the Qatar Stock Exchange (QSE) index scaled new heights in 2014 (touched a year high of 14,350). In August 2014, the MSCI lifted the weights of three Qatari stocks in its EM index on foreign ownership reforms. Consequently, the QSE gained 18.4% in 2014, delivering the best returns among the GCC countries. The QSE Index is currently trading at 13.4x one-year forward consensus earnings, higher than its 5-year average one-year forward multiple of 11.1x. However, given the robust earnings growth expectations and the healthy current dividend yield of 3.8%, the multiples may remain at an elevated level versus the historical average.
TABLE 1: TURKISH ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (TRY bn)</td>
<td>417.22</td>
<td>405.89</td>
<td>408.42</td>
<td>423.92</td>
<td>461.65</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>4.2%</td>
<td>4.5%</td>
<td>4.8%</td>
<td>2.2%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Consumer price index - CPI (% YoY)</td>
<td>7.88%</td>
<td>7.40%</td>
<td>8.39%</td>
<td>9.16%</td>
<td>8.86%</td>
</tr>
<tr>
<td>Repo rate</td>
<td>4.50%</td>
<td>4.50%</td>
<td>10.00%</td>
<td>8.75%</td>
<td>8.25%</td>
</tr>
<tr>
<td>Current account deficit (USD bn)</td>
<td>12.11</td>
<td>15.88</td>
<td>11.62</td>
<td>12.51</td>
<td>6.82</td>
</tr>
<tr>
<td>Government debt (TRY bn)</td>
<td>407.94</td>
<td>403.00</td>
<td>408.99</td>
<td>408.41</td>
<td>408.21</td>
</tr>
<tr>
<td>Foreign currency reserves (USD bn)</td>
<td>108.12</td>
<td>109.28</td>
<td>104.28</td>
<td>110.19</td>
<td>109.81</td>
</tr>
</tbody>
</table>

Source: Turkish Statistical Institute, Central Bank of Republic of Turkey

GDP CONTINUED TO DECELERATE IN 3Q2014

In 3Q2014, Turkey’s GDP (at constant prices) increased by a modest 1.7%, representing the lowest growth rate since 4Q2012. Inclement weather which impacted agricultural production and weak growth in Turkey’s key export markets impacted GDP growth. Agricultural sector continued to perform dismally due to adverse weather conditions and lowered the GDP growth by 0.7%. Services sector made the highest contributor to 3Q2014 growth at 1.7%, while industrial and construction sector accounted for 0.6% and 0.1% respectively to the growth. Net exports were up 2.5% YoY in 3Q2014. Despite the ongoing problems in Turkey’s main export markets such as Russia and Iraq, the momentum in total exports was sustained due to the increase in exports to the European Union and the US. Following the weak 3Q2014 GDP numbers, the World Bank cut Turkey’s 2014 growth forecast to 3.1%; however, retained its 2015 forecast at 3.5%. World Bank expects Turkey to benefit from the sharp decline in oil prices which has resulted in the outlooks for inflation and the current account improving substantially.

Table 2: Sources of GDP Growth

<table>
<thead>
<tr>
<th>SOURCES OF GROWTH</th>
<th>2012</th>
<th>2013</th>
<th>1Q14</th>
<th>2Q14</th>
<th>3Q14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Consumption</td>
<td>(0.30%)</td>
<td>3.40%</td>
<td>2.30%</td>
<td>0.30%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Public Consumption</td>
<td>0.60%</td>
<td>0.70%</td>
<td>0.90%</td>
<td>0.30%</td>
<td>0.60%</td>
</tr>
<tr>
<td>Private Investment</td>
<td>(1.10%)</td>
<td>0.10%</td>
<td>(0.20%)</td>
<td>(0.80%)</td>
<td>0.00%</td>
</tr>
<tr>
<td>Public Investment</td>
<td>0.40%</td>
<td>0.90%</td>
<td>0.20%</td>
<td>(0.20%)</td>
<td>(0.10%)</td>
</tr>
<tr>
<td>Net Exports</td>
<td>4.00%</td>
<td>(2.60%)</td>
<td>2.60%</td>
<td>2.90%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Change in Stocks</td>
<td>(1.50%)</td>
<td>1.60%</td>
<td>(1.00%)</td>
<td>(0.40%)</td>
<td>(1.50%)</td>
</tr>
<tr>
<td>GDP</td>
<td>2.10%</td>
<td>4.10%</td>
<td>4.80%</td>
<td>2.20%</td>
<td>1.70%</td>
</tr>
</tbody>
</table>

Source: Turkish Statistical Institute

UNEMPLOYMENT RATE MARGINALLY DOWN, STILL AT ELEVATED LEVELS

Turkey’s seasonally-adjusted unemployment rate decreased marginally to 10.4% in October 2014 from 10.5% in September 2014, as the slowing economy continues to take its toll on the country’s labour market. This was primarily on account of the slowdown in job creation mainly in the agriculture and construction sectors.
INFLATION RATE SLOWS IN JANUARY

Inflation rate eased to 7.24% in January 2015, down from 8.17% in December 2014 and 9.15% in November 2014. This is the lowest figure since November 2013 and was primarily on account of slowdown in prices of services, food, clothing and footwear as well as decline in cost of transportation. With the inflation showing signs of easing, the Turkish Central Bank cut its benchmark one-week repo rate by 50 bps to 7.75% in its January 20th meeting. With Turkey heavily dependent on oil imports to meet its energy requirements, the plummeting oil prices could offer relief on the inflation front. This coupled with the decline in food inflation could result in further reduction in inflationary pressures in 1H2015.

TURKISH LIRA SINKS TO AN ALL TIME LOW AGAINST THE DOLLAR

The Turkish lira which has been under pressure in recent times, dropped to an all-time low against the dollar on Feb 10. This was primarily due to concerns over political pressure on the country’s central bank to lower interest rates which continues to discourage investors on the currency. An aggresive rate cut policy could encourage inflation which continues to be over the official target in Turkey.

JANUARY PMI FALLS BELOW THE CRITICAL 50 MARK

The Purchasing Managers Index (PMI) for Turkey fell below the 50 mark which separates growth from contraction. PMI for January 2015 fell to 49.8 from 51.4 in December and marked a six-month low. The fall in PMI mostly reflected fall in output and new orders.

CURRENT ACCOUNT DEFICIT DROPS TO 4-YEAR LOW

Turkey’s 2014 current account deficit stood at USD45.84 bn (down 30% YoY), the lowest in four years. The fall in current account deficit was primarily on account of the declining oil prices which cut the value of imports sharply. According to the Turkish Statistical Institute, Turkey’s energy imports declined by almost 2% YoY in 2014 which aided the decline in current account deficit. Trade deficit narrowed to USD8.51 bn in December 2014, down 14.6% YoY primarily due to a decline in imports (down 5.6% YoY to USD21.83 in December 2014). Exports rose 1.2% YoY to USD13.33 bn in December 2014. Exports face downside risks from tensions in Iraq (which is Turkey’s second largest export destination) as well as renewed signs of weakness in the euro area (which is Turkey’s top export destination).

ERDOGAN BECOMES FIRST EVER PUBLICLY ELECTED PRESIDENT IN AUGUST

Former Prime Minister Recep Tayyip Erdogan, who was Turkey’s Prime Minister for over a decade, won the first-ever direct presidential elections in August. The vote has been seen as a milestone in Turkish politics as Turks elected their president by a popular vote for the first time in the country’s history. The victory will extend Erdogan’s more than 10-year rule for another five years. In late August, Erdogan handpicked former Foreign Minister Ahmet Davutoglu to succeed him as the ruling AKP leader and premier. The new government, which would be in power until the elections in mid-2015, would strive to maintain its strong record on growth before the parliamentary election and accordingly, put pressure on the central bank to cut rates to spur growth.
TURKISH GOVERNMENT ANNOUNCES MAJOR ECONOMIC GOALS

The Turkish government recently announced the first 9 programs out of the 25 transformational programs aimed at boosting the economy. The government aims to increase the GDP from USD800bn to USD1.3tn by 2018, decrease the rate of the GDP’s current account deficit from 6% to 5.2% and reduce the unemployment rate to 7% from around 10%. The plans include reducing Turkey’s dependence on imports, development of more efficient agricultural policies, developing domestic energy production etc.

VALUATION

The XU100 Index posted an impressive 26% gain in 2014 and was one of the best performing indices in the world. The index was under pressure in 1Q2014 due to high tensions in the political arena as well as the FED’s decision to end the bond purchasing program in 2014. However, the index accelerated in 2Q2014 due to the local elections in March and also did well towards the end of the year. Currently, the index trades at 10.4x one-year forward consensus earnings, which is at a premium to the 5-year average one-year forward multiple of 9.7x. The recent rally could be attributed to the inflation rate coming down due to fall in crude prices as well as expectations of improvement in GDP growth from 4Q2014. Although private consumption is expected to return to being the main growth driver, the weakness in the currency, political uncertainty and volatility in global markets will weigh on investor sentiment. Accordingly, we expect gains to be muted in 2015.

Chart 4: XU100 Index and 1 year Forward P/E Trends

Source: Bloomberg
TABLE 1: NIGERIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
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<tbody>
<tr>
<td>Nominal GDP (NGN bn)</td>
<td>20,464.4</td>
<td>21,401.5</td>
<td>20,169.8</td>
<td>21,734.8</td>
<td>22,933.1</td>
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<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>5.2%</td>
<td>6.8%</td>
<td>6.2%</td>
<td>6.5%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Consumer price index - CPI (% YoY)</td>
<td>8.0%</td>
<td>8.0%</td>
<td>7.8%</td>
<td>8.2%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Overnight borrowing (% year-end)</td>
<td>12.1%</td>
<td>10.5%</td>
<td>10.5%</td>
<td>10.3%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Current account surplus (USD bn)</td>
<td>3.7</td>
<td>5.4</td>
<td>4.6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Gross government debt (USD bn)*</td>
<td>53.4</td>
<td>64.5</td>
<td>65.3</td>
<td>57.0</td>
<td>-</td>
</tr>
<tr>
<td>Gross forex reserves (USD bn)</td>
<td>45.5</td>
<td>43.6</td>
<td>37.8</td>
<td>37.5</td>
<td>39.5</td>
</tr>
</tbody>
</table>


3Q2014 GROWTH STABLE; FALLING OIL PRICES LEAD TO A CUT IN 2015 GDP GROWTH ESTIMATES

In early 2014 Nigeria announced that it would change its base year for GDP calculations from 1990 to 2010, in an effort to provide an improved understanding of the drivers of the economy. The rebasing resulted in an 89% increase in the 2013 nominal GDP to USD510bn, enabling Nigeria to surpass South Africa’s 2013 GDP of USD352bn and catapulting it to the status of the Africa’s largest economy and 26th largest globally. Subsequent to the rebasing, the sector composition of GDP changed dramatically and underpinned Nigerian governments’ efforts to showcase its economy as one not dependent entirely on the Oil & Gas sector. Post revision, the share of industry declined to 25.8% from 46.1% while Oil & Gas declined to 14.4% from 32.4%. Notably, the share of services jumped to 50.2% from 23.6% earlier. In 3Q2014 real GDP grew by 6.2% YoY (+106bps vs. 3Q2013), continuing to clock more than 6.0% growth since 4Q2013. The GDP growth was primarily driven by non-oil sector, which grew by 7.5% YoY, offsetting the 3.6% YoY decline in the Oil & Gas sector. The non-oil sector was driven by growth in Agriculture, Textile, Apparel and Footwear, Telecommunications and Real Estate sectors. Nominal GDP of Agriculture sector grew by 9.2% YoY in 3Q2014 (+272bps vs. 3Q2013, +252bps vs. 2Q2014), the contribution of agriculture to real GDP stood at 26.6% in 3Q2014 vs. 20.9% in 2Q2014, with crop production forming the largest chunk of the contribution. In 2015, the Central Bank of Nigeria (CBN) expects non-oil revenue to reach NGN150bn from NGN75bn in 2014 as the government seeks to diversify its revenues away from the oil sector revenues.

Despite the rebasing, oil still accounts for more than 75% of government revenues and around 90% of the country’s exports. In January 2015, Nigeria cut its 2015 GDP growth estimate to 5.5% from an estimated 6.23% in 2014, following slashing of government expenditure and a sharp dip of close to 60% in the global crude oil prices in the past six months. The country’s 2015 budget of USD23bn was based on a benchmark oil price of USD65 per barrel (revised downwards from USD77.50 in 2014). We think with crude oil prices hovering around USD50 per barrel, a prolonged period of suppressed oil prices may make even the trimmed GDP forecast appear optimistic. Nigeria being a developing nation has significant growth potential, although factors such as recent slump in oil prices and the currency, political tensions and terrorist insurgencies by militant outfit Boko Haram could hinder investments and affect growth.

CURRENCY DEVALUATION AND AN INCREASE IN INTEREST RATES TO PROTECT DEPLETING FOREX RESERVES

In 2014, Nigeria was unable to execute its plan of shoring up forex reserves to USD50bn through various fiscal measures as the country’s forex reserves declined by USD9.0bn to USD34.5bn, mirroring the...
decline in oil earnings and the central bank’s efforts of supporting the Naira. In addition to the drawdown from its forex reserves, the central bank announced devaluation of Naira by about 8% and a simultaneous increase in its benchmark lending rate by 100bps to 13% to protect its currency against speculation, amidst falling oil prices. However, these moves give Nigeria a narrower leeway to contain a potential growth in inflation. We note that inflation has moderated to 8.0% YoY in December 2014 after remaining above 8.0% YoY in the recent months and though high, it is still within the central bank’s targeted range of 6%-9%. The current forex reserves cover around 6-7 months of imports, though the weak outlook for oil prices may force the country to further dip into its forex reserves to support its currency from further decline. In 3Q2014, Nigeria’s external debt grew by 31.4% YoY, although we note that the proportion of debt to GDP too is within limits despite the economy battling the decline in oil prices/oil production. The Nigerian government continues to face the challenge of assuring inclusive growth through investments in infrastructure, agriculture and services sectors by boosting medium and small-scale enterprises (MSMEs) and gradually minimising the dependence on external funds. Looking into the current scenario Nigeria might need additional external aid in order to meet its budgeted and non-budgeted expenses.

PRESIDENTIAL ELECTION POSTPONEMENT SENDS THE NAIRA IN A DOWNWARD SPIRAL

Nigeria’s election commissioner recently postponed the presidential elections to March from February 2015. The postponement was largely attributed to Nigeria’s security forces not being in a position to guarantee voters’ safety, considering that they were already overstretched in containing advances from Boko Haram. We note that the Naira has been constantly depreciating even after its devaluation in November 2014, falling by more than 25% since November 2014 and piercing the crucial 200 per dollar mark recently. This erosion in the currency’s value reflects not just the prolonged weakness in oil prices, but also concerns over Nigeria’s security forces likely siding with ex-military man and presidential candidate Muhammadu Buhari, thereby potentially influencing results. The Nigerian army has assured of its neutral stance in the presidential battle, which is expected to be closely contested. Despite the currency rout and the Naira currently trading well above CBN’s targeted range of 160-176 per dollar, the central bank has stated that the currency’s peg is still appropriate in an apparent move to avoid further speculative attack on the Naira. CBN’s moves so far in curtailting the currency route seem to have borne little fruit with the country’s forex reserves declining by USD1bn to USD33.4bn as of February 10, 2015 from January 28, 2015. In fact the failure to stall the Naira’s crash may require the CBN to devalue the currency for a second time, in our view. Notably, the CBN has ruled out the possibility of freely floating the currency, citing the dangers of high volatility associated with an import-dependent country.

TRADE AND FOREIGN INVESTMENTS TO LEND SUPPORT

Nigeria’s trade and foreign investments into key sectors such as agriculture, telecom, manufacturing and finance have been the key factors that have ensured the Naira’s stability in recent years. The exchange rate does not show much fluctuation as of September 2014 despite various internal and global headwinds, but has recently deteriorated to close to 180 NGN/USD in the backdrop of devaluation of the currency. Nigeria is able to maintain a cushion to absorb global economic shocks by holding adequate foreign exchange reserves, but it witnessed a 13.2% YoY decline in the reserve level in 3Q2014. At the end of 3Q2014, Nigeria held foreign exchange reserves of USD39.5bn, which was approximately 7.1% of its GDP.
SUPPORT FOR SERVICES SECTOR INVESTMENTS A STEP IN THE RIGHT DIRECTION

Nigeria’s services sector remains a key component of GDP, accounting for about half of the GDP in 3Q2014. In September 2014, the World Bank announced an injection of USD500mn into the Nigerian government’s Development Finance Project (DFP), in order to aid the government’s efforts to encourage economic growth and generate jobs. The funding is expected to facilitate increased access and availability of financing for micro, MSME covering diverse areas such as agriculture, trade, light-manufacturing etc. In order to lower Nigeria’s dependency on oil production and attain sustainable development, the move to encourage investments in other sectors is a prudent one.

VALUATION

The Nigerian Stock Exchange All Share Index registered a sharp 16% decline in 2014 and has already declined by close to 20% in the first few weeks of 2015. The index had been on an upward rising trend since mid-2012, although it weakened in the second half of 2014 and into 2015 owing to the fall in global oil prices and currency and the related economic impact, concerns over the uprising of violent insurgency in the country and the presidential election delay. Despite its rise as the largest economy in Africa, the key equities market in Nigeria still lags the South African market by a wide margin with respect to market capitalisation. The Nigerian Stock Exchange All Share Index currently trades at 7.3x one-year forward EPS, which is well below its five-year historical average of 8.5x. The index is expected to continue being pressured by the weak oil price trends, especially given OPEC’s assertion that it would not boost oil production and the oversupply situation pertaining to shale gas reserves in the US. The postponement of Nigerian presidential elections could be seen as a major risk to the country’s democratic government rule, in our view.

Chart 7: NGSE Index and 1-yr forward P/E trends

Source: Bloomberg
Emerging Markets

a. China 27-29
b. Brazil 30-32
c. India 33-35
d. Russia 36-39
e. South Africa 40-41
f. South Korea 42-44
g. Indonesia 45-47
TABLE 1: CHINESE ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
<th>4Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (CNY bn)</td>
<td>13,908</td>
<td>18,175</td>
<td>12,821</td>
<td>14,083</td>
<td>15,086</td>
<td>20,144</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>7.70%</td>
<td>7.40%</td>
<td>7.50%</td>
<td>7.40%</td>
<td>7.30%</td>
<td>7.30%</td>
</tr>
<tr>
<td>CPI (% YoY)</td>
<td>2.50%</td>
<td>2.40%</td>
<td>2.30%</td>
<td>2.40%</td>
<td>1.60%</td>
<td>1.50%</td>
</tr>
<tr>
<td>Foreign direct investment (USD bn)</td>
<td>32.18</td>
<td>25.74</td>
<td>19.31</td>
<td>29.60</td>
<td>29.43</td>
<td>32.21</td>
</tr>
<tr>
<td>Gross forex reserves (USD bn)</td>
<td>3,587.5</td>
<td>3,748.2</td>
<td>3,909.5</td>
<td>3,985.3</td>
<td>3,940.9</td>
<td>3,840.0</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>4.00%</td>
<td>4.05%</td>
<td>4.08%</td>
<td>4.08%</td>
<td>4.07%</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Bloomberg, National Bureau of Statistics of China

ECONOMIC GROWTH TO REMAIN IN HIGHER SINGLE DIGITS

China’s economy grew at a robust 10.5% (average) over the past decade on the back of strong foreign capital inflows that supported industrial and infrastructure investments, and improved productivity. A favourable demography of young working population attracted investment into the manufacturing sector, leading to a healthy industrial growth. Further, the government’s pro-export policies have helped China to become an export powerhouse. However, after posting a GDP growth of 9.3% YoY in 2011, growth moderated to 7.7% YoY in 2012 and 2013 – the lowest since 1999 – on account of a sluggish economic climate among the developed nations. Real GDP grew 7.4% in 2014, the slowest rate of Chinese economic growth since 1990. With growth slowing, China is trying to strike a balance between providing a steady stream of credit to struggling businesses and bringing the country’s heavy debt load under control. Further, the government is mulling various measures to bolster domestic consumption and this could be a major driver for the economy, going forward.

FDI INFLOWS EASING WITH SHIFT IN COMPOSITION

China’s FDI inflows have risen steadily to reach a record high of USD117.6bn in 2013, since it entered the World Trade Organization in 2001. However, during the first six months of 2014, FDI grew at a meagre 2.8% YoY to USD48.9bn. Moreover, FDI decreased by 0.57% QoQ to USD29.43bn during 3Q14 and by 5.20% QoQ to USD27.9bn in 4Q14, indicating flagging investor optimism on China’s economic prospects. Notably, the country’s stand-off with Japan seems to have taken a toll on the latter’s FDI contribution.

PBoC REINS IN CREDIT GROWTH AS DEBTS SWELL

Considering the flagging economic growth, the People’s Bank of China (PBoC) has opted for controlled and targeted efforts rather than broader moves to stimulate the economy. These include allowing some lenders to have lower reserve requirements. The PBoC relaxed the amount the amount of reserves that commercial banks are required to hold by cutting the CRR by 50 basis points; a move that frees up about 500 Billion Yuan in additional funds that bank can lend. China is trying to strike a balance in order to prevent a ‘hard landing’ and ‘rein in credit growth’, as it battles the build-up of excessive debt and industrial over-capacity that followed the global financial crisis in 2008. Consequently in November, PBoC reduced its benchmark lending rates by 40 basis points to 5.6% and the benchmark deposit rate by 0.25 percentage points to 2.75%, its first rate cut since 2012.
APPRECIATION OF YUAN TO HIT EXPORTS

Over the past few years, the Chinese Yuan has been appreciating (vs. USD) and touched 6.0407 (mid-point) in January 2014. Later in the year, the Yuan touched a high point of 6.2598 in the second quarter. Moreover, since the high, Yuan has maintained a level above 6.21 during most part of the 2014. The appreciation has offered an incentive for foreign investors; however, it is proving detrimental for domestic exporters, since it makes their goods expensive in the world market. The PBoC intervened to buy dollars and allowed the Yuan to depreciate (by ~3.5%) to make Chinese exporters more competitive. However, the PBoC may not be able to resort to this for a longer period, as China has amassed forex reserves of over USD3.84tn. Consequently, the Chinese currency is bound to appreciate from time to time and this will negatively impact China’s exporters.

Chart 2: Yuan spot price movement (mid-point; vs. USD)

Source: Bloomberg

RISING COSTS AND FALLING DEMAND IMPACTS MANUFACTURING

China’s manufacturing continued to slow down with its Purchasing Managers’ Index for Manufacturing (PMI published by HSBC) decreased to 50.0 in November as compared to its 16-month high of 51.7 in July. Further, PMI stood at 49.7 in January 2015, (below the 50-mark signifies contraction) reflecting persistent sluggishness in manufacturing. After a brief spurt in purchasing activity during September, China’s factory activity slowed by more than expected in November, highlighting how a cooling economy is impacting its vast manufacturing sector. Manufacturing growth will continue to support economic growth, although the rapid expansion seen during the boom years may not happen anytime soon.

LOW INFLATION PROVIDES SCOPE FOR EXPANSIONARY MONETARY ACTION

China’s inflation has been moderating over the past three years. The country’s inflation rate remained near a five-year low in December, edging up to 1.5% from 1.4% the month before. Thus, inflationary pressure has largely subsided and remains well below the government’s 2014 target of 3.5%. However, the data pointed to persistent weakness in the world’s second largest economy. Accordingly, if economic growth remains below expectations in the near-term, the government will have sufficient room to frame a consumption-oriented monetary policy.

Chart 3: Inflation trend (CPI, YoY)

Source: Bloomberg
CONSUMER SPENDING HOLDS KEY FOR ECONOMIC GROWTH

The Chinese economy grew 7.4% in 2014, barely missing the official 7.5% target. It was the slowest pace in 24 years as property prices cooled and companies and local governments struggled under heavy debt burdens. Moreover, the on-going sluggishness in most of the developed markets is taking a toll on the export-oriented Chinese economy. The government may further introduce monetary policies over the near-term to boost consumer spending, which will hold the key for economic growth. However, the IMF has suggested that China should set its GDP growth target for 2015 in the range of 6.5-7% and avoid unnecessary stimulus measures.

WEAK PROPERTY MARKETS POSE RISK TO GROWTH

The scenario in China’s property sector continues to be grim. Home sales declined 10% YoY during the first ten months of 2014 due to credit tightening and slower economic growth. China’s housing growth rate was meagre 2.16% and 2.21% during the 3Q14 and 4Q14, respectively, as against 8.81% during the second quarter of 2014. The average price for new homes fell for the fifth consecutive month in September, wiping off the gains recorded over the last year. However, in late September, the central bank eased mortgage lending standards to shore up the housing market. Over 30 local authorities have relaxed their earlier restrictions to support the sluggish market. China’s urban home ownership rate is already 87%, suggesting a further reduction in demand in the country’s housing market. The slowdown in the construction and infrastructure sectors, which account for over 20% of the country’s GDP when ancillary industries such as cement, steel, chemicals, etc. are factored in, pose a great threat to China’s economic growth.

STOCK MARKETS UNEASY OVER UNCERTAIN ECONOMIC OUTLOOK

After remaining range bound for the first six months of the year, China’s benchmark Shanghai Composite Index posted a gain of 58% in 2H2014, as investors believed the improving economic scenario in the US and monetary stimulus in the Eurozone will offer a boost to domestic industries. Further, the announcement of opening up of China’s stock market has boosted investor optimism, pushing the benchmark index upward. Beginning October 2014, the connected markets in Shanghai and Hong Kong offered international investors an access to mainland China stocks. Despite the gains made during the entire 2014, the index is still ~5% down as compared to its five-year high. Consequently, the index is trading at 11.9x, one-year forward consensus earnings, which has surpassed its five-year average one-year forward multiple of 10.9x. An expansion in multiples in the future appears likely over the medium–term, as developed economies come out of the wood and China’s domestic consumption picks up.

Chart 4: Shanghai Composite Index and 1-yr forward P/E

Source: Bloomberg
TABLE 1: BRAZIL ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
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<th>1Q2014</th>
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<th>3Q2014</th>
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<tr>
<td>Nominal GDP (BRL bn)</td>
<td>1,215</td>
<td>1,293</td>
<td>1,204</td>
<td>1,271</td>
<td>1,289</td>
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<tr>
<td>Real GDP (BRL bn)</td>
<td>167.8</td>
<td>168.6</td>
<td>168.3</td>
<td>167.3</td>
<td>167.4</td>
</tr>
<tr>
<td>Real GDP growth rate (% QoQ)</td>
<td>(0.6%)</td>
<td>0.5%</td>
<td>(0.2%)</td>
<td>(0.6%)</td>
<td>0.04%</td>
</tr>
<tr>
<td>Broad National CPI (% Yoy)</td>
<td>5.9%</td>
<td>5.9%</td>
<td>6.1%</td>
<td>6.5%</td>
<td>6.75%</td>
</tr>
<tr>
<td>Benchmark Selic rate (%)</td>
<td>8.9%</td>
<td>9.9%</td>
<td>10.7%</td>
<td>10.9%</td>
<td>10.9%</td>
</tr>
<tr>
<td>Government gross debt (% of GDP)</td>
<td>58.2%</td>
<td>56.7%</td>
<td>57.5%</td>
<td>58.5%</td>
<td>61.9%</td>
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<tr>
<td>Fiscal surplus (% of GDP)</td>
<td>(5.8%)</td>
<td>(3.2%)</td>
<td>(3.3%)</td>
<td>(4.7%)</td>
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</tr>
<tr>
<td>International reserves (USD bn)</td>
<td>376</td>
<td>376</td>
<td>377</td>
<td>381</td>
<td>376</td>
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</table>

Source: IBGE, BCB

DOMESTIC DEMAND AIDS EXIT FROM A TECHNICAL RECESSION

After contracting for the first two quarters in 2014, the Brazilian economy witnessed its first expansion in 3Q2014, thereby crawling out of a recession in technical terms. GDP expanded a meagre 0.04% over the previous quarter, though it fell short of market expectations of an increase by 0.2%. The country had technically slipped into a recession in 2Q2014 after its GDP shrank consecutively for the first two quarters of 2014 (1Q2014: -0.2% & 2Q2014: -0.6%). Expansion in 3Q2014 was aided by an increase in the domestic market. On the demand side, fixed investment witnessed a turnaround from a decline of 5.2% in 2Q2014 to an increase by 1.3% in 3Q2014. Increase in government consumption (+1.3%) was partly offset by a decrease in private consumption (0.3% QoQ). On the supply side, exports of goods and services rose by 1% in 3Q2014, but it was below the 3.0% rise recorded in 2Q2014. However, the contribution of supply side to the economy registered a decrease of 2.6% due to overall increase of 2.4% in the country’s imports.

Once a major contributor among the emerging markets, Brazil’s economy has slowed from 7.5% growth in 2010 to around 0.1% this year. The gloomy conditions have prompted Brazilian economists to reduce 2014 and 2015 GDP estimates from an earlier forecast of 0.48% and 1.1% to 0.33% and 1.04%, respectively. Further, financial markets reacted negatively after the re-election of Dilma Rousseff (by an immediate fall in the Brazilian stock markets and Brazilian real coming under pressure). Moreover, the country is at risk of losing its investment grade rating, unless the new government implements major economic reforms.

ROUGH WEATHER AWAITS IN SECOND TERM FOR DILMA ROUSSEFF

Brazil’s President Dilma Rousseff starts off her second term with a gloomy outlook and a daunting to-do list. Rising deforestation in the Amazon region and a worst drought might require an introduction of rationing of energy and water to the industrial south-east. Further, the risk of overshooting of the budget is looming over the preparations of 2016 Olympics. However, the situation with the Brazilian economy is the worst. The country is trapped in stagflation equilibrium with high inflation and negative growth for three of the last four quarters. Moreover, any fiscal measures to boost public finances might result in aggravating the jobless rate.
NEW TERM STARTS OFF WITH MARKET FRIENDLY MEASURES

Policies intended to boost growth during Dilma Rousseff’s first term did not yield their desired results. GDP rose by just 6.7% during her first four years. However, her new government started off with market friendly measures such as recruiting Joaquim Levy as the Finance Minister who is targeting a fiscal surplus of 1.2% in 2015 and 2% in 2016 in order to prevent Brazil losing its investment-grade credit rating. However, combined with stubborn budget inefficiencies like ballooning inefficient subsidies to energy, transport and credit, the finance minister needs to find a savings of 2% from other sources. Meanwhile, the president has announced a cut of BRL18bn (USD6.7bn) a year in pension and unemployment benefits to win back the trust of investors. Since her victory in October, the benchmark interest rate has been raised from 11% to 11.75%, the highest level since 2011. In order to support the weakening real, Brazil’s central bank also announced that it would halve its vast currency intervention programme. The bank declared that it would sell only USD100m of currency swaps in daily auctions until at least the end of March 2015, down from the USD200m it currently offers. Growth is expected to remain modest due to tighter monetary and fiscal policies, weak external demand, low levels of investment and persistent infrastructure bottlenecks. The central bank expects GDP to grow 0.7% in 2014 and accelerate to a 1.2% expansion in 2015. Analysts have duly slashed growth forecasts for 2015 from 2.5% a year ago to 0.8% or less.

Chart 3: PMI & Economic Activity Index

Source: BCB, HSBC

STUBBORNLY HIGH INFLATION DESPITE RATE HIKES

Brazil’s 12-month inflation rate came in at 6.56% in November, showing no signs of cooling down or converging with the central bank’s target rate of 4.5%. Annual inflation has been on a rising trend since January 2014, when it stood at 5.59%, despite the central bank raising the benchmark Selic rate by 100 bps from 10% in January to 11.75% currently. On a MoM basis, inflation of food & beverages and transportation in November 2014 rose from 7.60% to 7.83% and 4.17% to 4.24%, respectively. All the other components registered either a fall or remained steady in November as compared to October. Inflation is expected to come down slowly, as overdue increases in administered prices are likely to push up inflation temporarily.

RISING DEFICIT PORTRAYS A GRIM PICTURE

Brazil faces its first annual primary deficit in almost two decades. The public sector posted a deficit of BRL25.5bn in September, a much wider deficit than expected. Over a period of 12 months ending September, the consolidated public sector’s primary fiscal surplus slipped to 0.61% of GDP, which is substantially below the government’s target of 1.9% of GDP. The combined fiscal and current-account deficits sum up to 8.6% of GDP, painting the worst picture in almost 15 years. Joaquim Levy has committed that the budget surplus before interest payments would be gradually returned to the equivalent of at least 2% of GDP per year. However, the finance minister is expected to face resistance in his attempts to roll back costly stimulus measures from within the left-wing governing coalition, which is sworn to protect social spending. The finance minister is further planning to work with the private sector to expand investment and increase the supply of goods produced in Brazil, a change of focus from the credit-and-consumption policies of the past decade.
VALUATION

The re-election of the president has failed to cheer the financial markets. Brazil’s IBOVESPA Index declined and shed 13.2% from 6 October till 12 February 2015, while it was down 2.91% during the entire 2014. The index is currently trading at 10.8x one-year forward consensus earnings, below at its 5-year average one-year forward multiple of 11.0x as well as MSCI’s Emerging Market Index (10.8x one-year forward consensus earnings). Henceforth, the new government’s ability to restore confidence and facilitate investment-led growth will be the major drivers that will determine the future market performance.
TABLE 1: INDIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (USD bn)</td>
<td>424.3</td>
<td>485.4</td>
<td>525.4</td>
<td>473.4</td>
<td>472.8</td>
</tr>
<tr>
<td>Growth rate (% YoY)</td>
<td>7.5%</td>
<td>6.4%</td>
<td>6.5%</td>
<td>8.2%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>5.2%</td>
<td>4.6%</td>
<td>4.6%</td>
<td>5.7%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Consumer Price Index (% YoY)</td>
<td>9.8%</td>
<td>9.9%</td>
<td>8.3%</td>
<td>7.5%</td>
<td>6.46%</td>
</tr>
<tr>
<td>Repo rate (% quarter-end)</td>
<td>7.5%</td>
<td>7.8%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Current account deficit (% of GDP)</td>
<td>(1.2%)</td>
<td>(0.9%)</td>
<td>(0.2%)</td>
<td>(1.7%)</td>
<td>(1.3%)</td>
</tr>
<tr>
<td>Gross external debt (% of GDP)</td>
<td>21.9%</td>
<td>23.1%</td>
<td>23.7%</td>
<td>25.5%</td>
<td>25.3%</td>
</tr>
<tr>
<td>Gross forex reserves (USD bn)</td>
<td>276.3</td>
<td>295.7</td>
<td>303.7</td>
<td>315.8</td>
<td>314.2</td>
</tr>
<tr>
<td>IIP growth rate (% YoY)</td>
<td>10.8%</td>
<td>18.4%</td>
<td>7.4%</td>
<td>10.8%</td>
<td>18.4%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, **Revised figures based on change of base year

GDP – SLOWLY TURNING AROUND

India’s economic growth slowed down in 3Q2014 to 5.3% YoY (2Q2014: 5.7%), but it was a better performance than 3Q2013. The slowdown in GDP is mainly due to the decline in agriculture and manufacturing sectors, offset by a large improvement in the services sector. It is interesting to note that the services sector (63% of GDP) has continued to grow at a healthy rate of 7% in 3Q2014, as against 6.3% in 3Q2013, primarily driven by a robust financial sector and government spending. While the manufacturing sector (~18% of GDP) recorded the biggest fall to reach 1.2% in 3Q2014 as compared to 4% in 2Q2014. The slowdown in manufacturing, especially the contraction in both consumer durable goods and capital goods production, has added further uncertainty to its prospects. The Agriculture sector (~10% of GDP) was down to 3.2% in 3Q2014 as compared to 3.8% in 2Q2014. The skewed and deficient monsoon situation dragged down agriculture growth, specifically impacted by the El Nino effect on the south-west monsoon, which set in late. However, based on a new calculation method (base year changed to 2011-12 from 2004-05), the statistics department said the Indian economy grew 7.5% YoY in 3Q2014 and is on track to expand 7.4% in the year through March 31.

GOVERNEMENT TO MEET FISCAL DEFICIT GOAL

The government had set difficult targets for reducing the fiscal deficit from 4.5% in FY2014 to 4.1% in FY2015, 3.6% in FY2016 and 3.0% in FY2017. For the current financial year, the government appears to be confident of meeting its fiscal deficit target, despite a challenging revenue situation. The Indian cabinet recently approved the telecom spectrum auction for various bands. Revenues worth INR648.4bn are expected from this auction, of which INR160bn are expected to be realized in the current financial year. On the other side, the spending by ministries has also been slow, which is expected to help the government work out its fiscal arithmetic. The delayed rollout of the Food Security Act is also expected to help paint a better fiscal picture. The government also enforced austerity measures, cutting down on foreign travel and conferences in five-star hotels, and higher dividends from state companies.

FALL IN CRUDE OIL PRICES – WELCOME NEWS FOR GROWTH

Crude oil has always been the vulnerable point for the Indian economy. India imports 70% of its crude oil, which accounts for close to 40% of its total imports. Over the past few months, crude oil prices fell drastically to reach a five-year low, which has been positive for an economy like India that runs a trade deficit of almost 8% of GDP. Lower oil prices imply lower inflationary pressures, and thus higher real
Disposable incomes and higher consumer demand. Businesses also benefit from their falling input costs. The improvement in the current account and fiscal deficits offers greater monetary and fiscal policy space to support growth. It is estimated that every USD10 fall in oil prices can potentially boost India’s GDP growth by 0.1%.

**REFORMS, A NEW KICK START FOR ECONOMY & MARKETS**

The new government led by Prime Minister Mr. Narendra Modi announced several reforms in the first six months such as labour reforms, diesel price de-control, the ‘Make in India’ movement along with progress in the proposed Goods and Service Tax. Not just that, the government also extended diplomatic ties to attract foreign funding. With these efforts, India can now expect nearly USD55bn worth of investments pouring over the next five years from countries like Japan and China.

The government has promised to liberalise the coal mining sector and challenge the monopoly in block allotments, after the recent decision by the Indian Supreme Court to cancel over 200 coal block licences from 1993 to 2011. Presently, the other players allowed owning mines are steel, power and cementing companies. Despite having one of the world’s largest coal reserves, India still imports sizeable amount of coal to meet its energy demand. Further, Indian finance minister outlined the government’s priorities in reforming land acquisition and labour laws, and continuing the disinvestment agenda. All these factors have contributed to the renewed optimism in the Indian markets, which have outperformed both their Asian and global peers in 3Q2014. This growth is expected to continue well into 2015, since cyclical, rate-sensitive and investment-oriented stocks find flavour among investors.

**LENDING RATES START TO EASE WITH INFLATION SEEMINGLY IN CONTROL**

Indian consumer price inflation increased for the first time in the past five months to 5% in December 2014 from a record-low of 4.4% in November 2014 primarily driven by higher food prices. Food, beverages & tobacco group prices increased 5.1% in December 2014 from 3.6% in November 2014. Inflation for fuel and light was flat at 3.4%, while inflation for housing eased to 7.8%. Further, inflation for clothing, bedding and footwear eased to 6.5%. Inflation for miscellaneous items also declined 4.0%. However, the overall inflation is still significantly below its all-time high of 11.2% in November 2013.

In its recent monetary policy review, the Reserve Bank of India (RBI) cut its policy rate by 25 basis points, a first reduction in 20 months, to 7.75% with a view to boost growth. The broad-based decline in inflation coupled with commodity tailwinds has clearly opened space for a growth-driven monetary policy. Barring pulses, the agricultural output seems to be on par with the last year’s levels. The collapse in oil prices gives comfort to the RBI on imported inflation, which is the real driving force. Based on these factors, the RBI can be expected to cut 50-75 basis points in its lending rate during the first quarter of 2015 and make a cumulative cut of 100 basis points by FY2016, taking repo to ~7% or below by 2016.

**DEFICIT WIDENS MARGINALLY IN 3Q2014, BUT REASONABLY COMFORTABLE**

India’s current account deficit (CAD) widened to USD10.1bn (2.1% of GDP) in 3Q2014 from USD7.8bn (1.7% of GDP) in 2Q2014. CAD widened to five-quarter high since exports growth slowed, while imports increased because of a rise in demand for gold. Merchandise export growth during 3Q2014 slowed to 4.9% from 11.9% during 3Q2013 a year ago, while merchandise imports increased by 8.1% against a...
decline of 4.8% in 2Q2013, largely due to a sharp rise in gold imports. Both gold prices and inflation had declined during the quarter, which reflected higher disposable income among people, who were likely to buy more gold. Evidently, net gold imports increased to USD70bn in 3Q2014 from USD70bn in 2Q2014. However, the RBI said that current account deficit is reasonably comfortable because of the lower oil prices. The CAD from April to September 2014 stood at USD17.9bn (1.9% of GDP) as against USD26.9bn (3.1% of GDP) for April–September 2013. The balance of payments (BoP) was also in the positive territory. The accretion to foreign exchange reserves was at USD6.9bn in 2Q2014 as against a drawdown of USD10.4bn in 2Q2013. The RBI expects CAD to remain slightly elevated in the range of 2-2.4% of GDP for the next two quarters. GDP growth will be pressurised by both lower farm growth and subdued government expenditure. Further, low inflation will reduce the nominal value of GDP. In 3Q2014, the trade deficit rose by 16% to USD38.6bn from USD33.3bn in 3Q2013. Net services receipt improved marginally in 3Q2014, growing by 3.2% to 19% on account of higher exports of services. Buoyed by the surge in portfolio inflows of USD9.8bn in 3Q2014, while foreign direct investment inflows remained stable at USD8bn, the capital account recorded a surplus of USD5.6bn in 3Q2014.

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Chart 5: Current account surplus and forex reserves (USD bn)

Source: RBI, Bloomberg

Chart 6: Exchange rate trends (INR/USD)

Source: Bloomberg

VALUATION

Driven by ‘Modi euphoria’, strong global liquidity and stable macros, S&P BSE Sensex outperformed its emerging market peers with a return of ~30% and is continuing its momentum into 2015. The index is currently trading at 16.2x one-year forward consensus earnings, which is higher than its ten-year average one-year forward multiple of 14.9x. Businesses should focus more on earnings growth, which will take markets higher as the economy continues to bounce back. However, falling oil prices and decline in inflation along with the recent reforms initiatives taken by the government support strong growth in corporate earnings. Thus, the current valuations appear justified while earnings growth is likely to push the market higher.

Chart 7: Sensex Index and 1-yr forward P/E trends

Source: Bloomberg
TABLE 1: RUSSIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
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<tbody>
<tr>
<td>Nominal GDP (RUB bn)</td>
<td>17,538</td>
<td>18,592</td>
<td>15,992</td>
<td>17,267</td>
<td>18,985</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>1.3%</td>
<td>2.0%</td>
<td>0.9%</td>
<td>0.8%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Consumer Price Index (% YoY)</td>
<td>6.1%</td>
<td>6.5%</td>
<td>6.9%</td>
<td>7.8%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Bank of Russia key rate (%)</td>
<td>5.5%</td>
<td>5.5%</td>
<td>7.0%</td>
<td>7.5%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Total external debt (USD bn)</td>
<td>716</td>
<td>729</td>
<td>716</td>
<td>732</td>
<td>679</td>
</tr>
<tr>
<td>Current a/c balance (USD bn)</td>
<td>(0.7)</td>
<td>8.0</td>
<td>26.8</td>
<td>12.9</td>
<td>6.4</td>
</tr>
<tr>
<td>International reserves (USD bn)</td>
<td>523</td>
<td>510</td>
<td>486</td>
<td>478</td>
<td>454</td>
</tr>
</tbody>
</table>

Source: Russia Central Bank

ECONOMIC GROWTH STAGNATES

The Russian economy continued its deceleration in 3Q2014 as its GDP grew 0.7% YoY, marking the slowest quarterly growth in 2014 as compared to a 0.8% growth in 2Q2014 and a 0.9% increase in 1Q2014. However, the GDP growth surpassed the forecasts of a 0.3% increase, aided mainly by net exports and an improvement in agricultural harvest, which rose 11% in 3Q2014. The economy is still far from being out of the woods as GDP shrank 0.5% in November, recording the first drop since October 2009. The declining economic growth reflected the continued internal structural limitations and a waning consumer & business sentiment amidst heightened market volatility and policy uncertainty due to the geopolitical tensions. The country witnessed several rounds of international sanctions, counter-sanctions, with heavy currency depreciation and elevated inflation levels resulting in weak demand components, which were responsible for a low level of economic activity in 3Q2014. The saturation in the retail lending market, a slower wage increase and falling consumer confidence impacted consumption, which was reflected in the retail trade turnover as its growth slowed to 1.4% in 3Q2014 from 1.9% in 2Q2014. The fixed capital investment shrank by 2.4% YoY in 3Q2014. It is estimated to contract by around 3% in 4Q2014 due to a reduction in corporate capital expenditure amidst a deteriorating economic situation, higher borrowing costs as well as a limited nature of borrowing avenues and reduction in own capital.

Russia’s economic outlook continues to remain gloomy as growth succumbs to the imposition of stricter international sanctions, thereby compounding the underlying weakness, while the plummeting Rouble stokes inflation and plunging oil prices erode export revenue. Consequently, the Russia’s Economic Ministry forecasted GDP to shrink by 3% in 2015, as the benefits of Rouble depreciation is exhausted and assuming that average annual oil price remains at USD50 per barrel. Meanwhile, the World Bank in its latest update has predicted a contraction of 2.9% of GDP in 2015 versus an earlier estimate of 1.5% contraction, on the premise that domestic demand will be negatively impacted by high borrowing cost and inflation.

STRICTER SANCTIONS COMPOUNDING PROBLEMS

The US and the EU in response to Russia’s annexation of Ukraine’s Crimean region, initially imposed sanctions on specific individuals, groups and companies in Russia, prohibiting their entry, freezing their assets and slapped a ban on business operations with sanctioned entities. Later, as the conflict between Ukraine and Russia escalated, more countries joined in to impose sanctions, which became stricter in nature. The scope of sanctions also widened to Russia’s military, petrochemical and financial sectors, limiting access on long-term foreign capital to Russian banks and energy producers. In response, Russia imposed counter sanctions banning the import of food & food products from a number of Western economies. These developments have severely hampered the economic environment in Russia as it
RUSSIA

witnessed increased foreign exchange market volatility and a significant depreciation in its currency. A weaker currency made imports costlier, thereby reducing the demand on one hand and fuelling inflation on the other, particularly affecting food inflation. In order to tame the runaway inflation, the CBR raised its key rate significantly and restricted the domestic credit access both for investors and consumers. This coupled with a limited access on foreign capital dampened the domestic business and consumer demand. The country’s economy is unlikely to get any respite in the near future as the effect of the sanctions introduced in 2H2014 will be felt in 2015 as well.

ROUBLE’s FREE-FALL HALTS ON CBR INTERVENTION

The Russian currency experienced a steady weakening since the start of 2014, but the downfall became severe in 4Q2014. This was prompted by a number of factors, foremost being the falling oil prices and limited access to external capital markets in the backdrop of international sanctions. In 4Q2014, Ruble depreciated around 53% against the US dollar, while registering a fall of around 85% in the whole of 2014. Moreover, it lost 25% against the US dollar since the OPEC decision on 27 November 2014 to maintain its production level of 30mn barrels per day, despite the crude prices falling almost 50%. The hoarding of foreign exchange by Russian banks and large exporters and declining demand of Ruble-denominated financial assets owing to the strengthening US economy also accentuated the fall. To stem Ruble’s free fall, the CBR adopted a set of measures including switching to a free float regime in November and also intervened several times in the forex market, spending around USD88bn in 2014, resulting in shrinking of CBR’s international reserves by around a fifth in 2014 to around USD386bn in the first week of January 2015. This helped Ruble in recovering from its all-time low of around 80 per dollar it touched on an intraday basis in mid-December 2014. However, rising fiscal pressures, high interest rates, loss of CBR’s reserves and limited debt rollover capacity of the Russian banking and corporate sector took a toll on the country’s sovereign rating. Fitch downgraded Russia to lowest investment grade, whereas S&P cut Russia’s rating to junk, i.e. below investment grade in January 2015.

INFLATION REMAINS ELEVATED DESPITE REPEATED RATE HIKES

Inflation in Russia further soared in January 2015 at 15% YoY (preliminary) after recording a double-digit increase of 11.4% YoY in December 2014, the highest rate since the 2008 financial crisis. Consumer inflation has been trending above the CBR’s target of 7.5%, set in September 2014. The elevated inflation is primarily on account of strong Ruble depreciation and rising food prices amidst external trade restrictions imposed in August 2014. Food prices rose 15.4% in December as compared to 12.6% in November. Russia’s import ban on various food items from the West in August 2014 in retaliation against Western sanctions has primarily led a surge in food prices. The prices of non-food items also grew by 8.1% YoY in December after increasing by 5.9% in November. Going forward, inflation is likely to remain elevated given the expected high growth in consumer prices, as trade restrictions and Ruble depreciation will continue to aggravate pricing sentiments. Accordingly, Russia’s Economic Minister forecasts an inflation rate of 12% in 2015, up from the previous estimate of 7.5%.

On the other hand, the CBR responded by tightening its monetary policy to tame inflation and bring it near its medium-term target of 4%. The Russian central bank has increased its key rate six times since February 2014, to take it from 5.5% to 10.5% and further by a steep 650 basis points to 17.0% on 16 December 2014. However, it reduced the key rate in February 2015 from 17% to 15%, shifting its focus to shore up the Ruble as it expects a slump in economic activity to contain further inflation.

TRADE BALANCE IMPROVES AS ECONOMY SLOWS DOWN

Russia’s current account situation improved in 3Q2014, since it recorded a surplus of USD6.4bn as compared to a deficit of USD0.7bn in 3Q2013, aided by the increase in trade balance. However, this
improvement came from a faster decrease in imports as compared to exports in the backdrop of the slowdown of the Russian economy, currency depreciation and the impact of the food embargo introduced by Russia. In contrast, trade surplus recorded in the first two quarters was a result of increasing exports. Situation of financial account slightly improved in 3Q2014 as it recorded an inflow of USD57bn versus an outflow recorded in previous quarters. Still, direct and portfolio investments recorded a higher outflow on a cumulative basis in 3Q2014 in comparison to 1Q2014 and 2Q2014, as capital inflow dries up due to the stricter international sanctions and uncertain economic situation while outflows rose triggered by the Ukraine-Russia conflict. According to industry estimates, more than USD100bn has flown out of Russia in 2014 while the government expects another USD115bn capital outflow in 2015. The CBR estimates that current account balance will reduce from an estimated USD64bn in 2014 to USD56bn in 2015, as exports will fall 6-8% in dollar terms in 2015, led by lower oil prices, while the Finance Ministry estimates a budget deficit of 0.7% of GDP in 2014, revising down an earlier forecast of 0.7% surplus.

**Chart 4: CPI trends (% YoY) & Bank of Russia key rate (%)**

**Chart 5: Balance of Payment dynamics (USD bn)**

Source: Federal State Statistics Service, Bank of Russia

Source: Bank of Russia

**IIP GROWTH DEFIES SIGNS OF SLOWING ECONOMY**

Russia’s industrial output recovered in December, rising 3.9% YoY after it shrank 0.4% YoY in November. The industrial output rose by 1.7% in 2014 as a whole, faster than the overall expected economic growth of 0.5% in 2014. IIP was boosted by the manufacturing sector, which grew 4.1% YoY versus a decline of 3.0% recorded in November. However, the manufacturing appears to have received a one-off boost from temporary factors such as buying spree for consumer durables to beat impending price hikes. Further, the utilities sector also registered a growth of 3.4% YoY, albeit lower than the 7% growth achieved in November 2014.

**Chart 6: IIP and its components (% YoY growth)**

**Chart 7: PMI**

Source: Federal State Statistics Service

Source: HSBC

**PMI SUGGESTS CHALLENGING FUTURE AHEAD**

The uncertain economic environment amidst international sanctions has taken a toll on the business environment. The HSBC Russia Composite Output Index fell to a 68-month low of 45.6 in January 2015 as compared to 47.2 in December indicating the prevailing contraction in the Russian private sector output amidst increasing inflationary pressure. The major highlights of the survey was the decline in the total business activity at the fastest rate since May 2009 and broad-based contraction in both the manufacturing and services sector output, leading to a decline in the overall private sector employment at the fastest rate since July 2009. The decline in the composite index was led by the services sector as the HSBC Russia Services Business Activity Index fell to 43.9 in January. The manufacturing sector PMI further moved below the 50 mark to 47.6, after it remained in expansionary mode for five months till November 2014.
Russia’s MICEX Index lost around 45% on a currency adjusted basis in 2014 as compared to a decline of 4.7% registered by the MSCI Emerging Market Index. The poor economic growth along with capital outflows resulting from western sanctions heavily impacted the market performance. According to CBR’s data, net outflows from Russian assets increased almost 150% to USD303bn in 2014 as compared to an outflow of USD122bn in 2013. The sell-off pushed down the index valuation, which is currently trading at 6.1x one-year forward consensus earnings, almost at par its 5-year average one-year forward multiple of 6.0x and at a 50% discount to MSCI’s Emerging Market Index (~11.9x one-year forward consensus earnings). Although the markets are trading at an attractive P/E multiple and a healthy dividend yield of 4.1%, given the forecast of further deterioration in the economic situation, investors will remain cautious before betting on Russia.

Chart 8: Moscow MICEX index and 1 yr forward P/E trends

Source: Bloomberg
ECONOMIC GROWTH GAINS MODEST MOMENTUM

South Africa’s economic growth accelerated mildly to an annualised pace of 1.4% QoQ in 3Q2014, compared to a feeble 0.5% annualised rate of expansion in 2Q2014. The Agriculture sector grew 8.2%, driven by enhanced crop output, notably maize, as well as improved horticultural and animal production. The Mining sector registered its first quarterly growth of 2014, with the 1.6% expansion in 3Q2014 driven by increased production of iron ore, manganese ore, diamonds etc. and a lower rate of decline in the production of platinum-group metals following an end to the prolonged labour strike. The Manufacturing sector fell 3.4% QoQ due to weak output of wood & wood products, petroleum, chemicals, rubber & plastics, basic iron & steel, non-ferrous metals, electrical machinery etc.

CURRENT ACCOUNT GAP NARROWS MARGINALLY

South Africa’s current-account deficit eased marginally to 6.0% of GDP in 3Q2014, compared to 6.3% in 2Q2014, due to lower fuel costs. Merchandise export volumes grew 3.3% in 3Q2014, led by agricultural goods, which compares favourably against the 5.9% decline in 2Q2014 on weak platinum production and low ferro-manganese & coal exports. The government’s gross national debt rose to ZAR1.72tn (around 46% of GDP) in September 2014, up from ZAR1.56tn at the end of 2013, due to the government’s preference to finance its budget deficit through debt issuance. However, the government’s ability to continue financing the deficit through borrowings may be constrained going forward, given the unfavoured opinion of credit ratings agencies on South Africa. In November 2014, Moody’s downgraded South Africa’s sovereign credit ratings by a notch, noting that power supply issues and labour unrest had hurt the country’s creditworthiness.

INFLATION REMAINS HIGH EVEN AS ECONOMIC GROWTH EXPECTATIONS MODERATE

South Africa’s central bank – the South African Reserve Bank (SARB) – kept the benchmark repurchase rate at 5.75% in November 2014, having raised the rates by 75 basis points earlier during the year. In recent months, the central bank’s interest rate policy has aimed at controlling inflation, even as economic growth projections continue to decline. However, declining oil and food prices have resulted in stabilisation trends in monthly inflation levels, which in November 2014 stood at 5.8% YoY, just below the SARB’s 3.0-6.0% target. Core inflation (excluding costs for food, non-alcoholic beverages, gasoline and fuel) also came in at 5.8% in 3Q2014. However, the South African economy is also affected by feeble growth rates, with the SARB repeatedly lowering the economy’s 2014 growth forecast over the past few months.
SOUTH AFRICA

PERSISTENTLY HIGH UNEMPLOYMENT LEVELS

South Africa’s unemployment rate showed only a slight improvement to settle at 25.4% in 3Q2014, after touching a record high of 25.5% in 2Q2014. Increase in the number of employed persons by 22,000 and a decrease in the number of unemployed persons by 3,000, as compared to 2Q2014, drove the marginal benefit. The construction industry led the improvement by adding 99,000 jobs, which was offset by a 110,000 decline in the number of people employed by private households.

Chart 3: Labour Force & Unemployment Rate

Chart 4: CPI (% YoY) and key components

Source: Statistics South Africa

INVESTMENT GRADE STATUS UNDER A CLOUD

In recent months, South Africa’s credit rating has been downgraded by Standard & Poor’s and Moody’s to BBB- and Baa2, respectively, over multiple concerns such as weak economic growth, prolonged labour unrest, high current account deficit and power supply issues. In December 2014, Fitch Ratings maintained its BBB credit rating and negative outlook on the country. South Africa’s reliance on portfolio investment inflows to fund its deficits is also seen as risky, given the steady stream of unfavourable macroeconomic data and likelihood of interest rate hikes by the US Federal Reserve. The South African government’s borrowing costs may also increase sharply in case of further downgrades by the rating agencies, which would push South Africa’s credit rating to below-investment grade status.

CURRENCY EXPECTED TO REMAIN UNDER PRESSURE

The South African Rand (ZAR) declined over 10% in 2014 due to weak macro-economic data, credit downgrades, feeble global prices of exported mining commodities and lower confidence in emerging market economies. Moreover, concerns over a rate hike by the US Federal Reserve and the political upheaval in Europe have also hurt ZAR, which recently touched a twelve-year low and slid below the 11.8 mark against the US dollar. Unless there are signs of sustained economic recovery and deficit declines, the ZAR is expected to remain weak in the near future.

VALUATION

South Africa’s benchmark equity index – the JSE All Share Index (JALSH) – crossed 50,000 for the first time ever in May 2014. The index has risen strongly over the past few weeks, closing at an all-time record of 52,507 on 12 February, 2015. The index strength is driven by positive earnings data presented by domestic companies, the fresh stimulus programme in Europe, the Russia-Ukraine ceasefire agreement and reassuring US jobs data. The South African benchmark equity index currently trades at 16.2x one-year forward consensus earnings, which is higher than its 5-year average one-year forward multiple of 11.8x. We remain cautious about prospects for further upside in South African stocks, given the substantial valuation premium and the fact that part of the strength is driven by external factors.

Chart 5: JALSH Index and 1 yr forward P/E trends

Source: Bloomberg
SOUTH KOREA

TABLE 1: SOUTH KOREAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
<th>4Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (KRW tn)</td>
<td>360.05</td>
<td>361.46</td>
<td>369.26</td>
<td>367.72</td>
<td>371.80</td>
<td>-</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>3.4%</td>
<td>3.7%</td>
<td>3.9%</td>
<td>3.5%</td>
<td>3.2%</td>
<td>2.70%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>1.4%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>1.6%</td>
<td>1.4%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Repo rate (% quarter-end)</td>
<td>2.50%</td>
<td>2.50%</td>
<td>2.50%</td>
<td>2.25%</td>
<td>2.25%</td>
<td>-</td>
</tr>
<tr>
<td>Current account surplus (USD bn)</td>
<td>23.78</td>
<td>24.84</td>
<td>15.07</td>
<td>24.13</td>
<td>22.66</td>
<td>-</td>
</tr>
<tr>
<td>Gross external debt (USD bn)</td>
<td>412.75</td>
<td>416.11</td>
<td>425.35</td>
<td>442.17</td>
<td>429.05</td>
<td>-</td>
</tr>
<tr>
<td>Gross forex reserves (USD bn)</td>
<td>326.11</td>
<td>335.65</td>
<td>343.61</td>
<td>355.76</td>
<td>353.97</td>
<td>363.59</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>3.10%</td>
<td>3.00%</td>
<td>3.50%</td>
<td>3.70%</td>
<td>3.50%</td>
<td>3.50%</td>
</tr>
</tbody>
</table>

Source: The Bank of Korea

GDP GROWTH SLOWS SHARPLY IN Q4 BUT PRIVATE CONSUMPTION ON RECOVERY PATH POST FERRY SINKING INCIDENT

South Korea’s economy slowed sharply in the final quarter of 2014, with growth hovering around six-year lows, knocked by weak government spending and global demand and heaping pressure on the central bank to cut interest rates. This meant that the economy grew at a seasonally adjusted growth rate of 0.4% in 4Q2014. This is after South Korea’s GDP growth witnessed a brief period of revival from 3Q2013 to 4Q2014, clocking a growth well above +3.0% YoY in each quarter. This growth was primarily driven by strength in the Manufacturing (3Q2013: +3.8% YoY, 4Q2013: +4.5% YoY) and Services (3Q2013: +3.1% YoY, 4Q2013: +3.4% YoY) sectors, which together accounted for more than 80% of GDP, while the Agriculture, Forestry & Fishing sector also aided growth. The growth in the largest sector, Services accelerated to 3.4% YoY (2Q2014: +2.7% YoY) in 3Q2014, while the Manufacturing sector slowed to 3.2% YoY. Exports of goods and services (+2.5% YoY, -2.2% QoQ) were under pressure following a slowing global economy (including China) and a weaker Japanese yen. Private consumption expenditure (>50% of GDP) rose by 1.5% YoY (+1.0% QoQ), driven by spending on durables such as passenger vehicles and services such as healthcare. We note that private consumption has been on a leash (2Q2014: -0.3% QoQ, 1Q2014: +0.2% QoQ) as the country plunged into mourning and citizens cut spending following the sinking of ferry MV Sewol in April 2014, which claimed more than 300 lives. Last year, Korea’s finance ministry had to cut its GDP growth forecast for 2014 multiple times on weaker-than-expected trends in capital expenditure and private consumption. In December 2014, Korea’s finance ministry further cut 2014 GDP growth forecast to 3.4% from 3.7% and also trimmed its 2015 GDP growth estimate to 3.8% from 4.0%.

USD40BN STIMULUS PACKAGE AND INTEREST RATE CUTS

The Korean economy has been plagued by concerns over slowing growth and potential deflation, with the new Finance Minister Choi Kyung-hwan even drawing parallels with its neighbour, Japan, which had to endure a prolonged slump. The Finance Minister’s expansionary policies (dubbed by economists as ‘Choinoisics’) include a USD40bn stimulus package announcement in July 2014. The stimulus envisages easing the limits on mortgage loans by allowing for higher loan-to-value and debt-to-income ratios in a bid to provide an impetus to the stagnant property markets. The stimulus also seeks tax benefits for corporations which offer wage raises or higher taxes on corporations, which hoard cash as policymakers aim to reallocate savings from corporations to households. South Korea’s central bank, The Bank of Korea (BoK) slashed its benchmark interest rate by a quarter percentage point to 2.25% for the first time in 15 months in August 2014, just a month after the stimulus announcement. The rate cut by the BoK, in
conjunction with Finance Minister Choi Kyung-hwan’s stimulus, was seen as a co-ordinated measure by the government to revitalize growth by accelerating consumption and investment. The BoK again cut the benchmark interest rate by another 25 basis points to 2.0% in October 2014, a record four-year low as Korea struggled to achieve its own GDP growth targets. However, the danger of capital flight out of the country following a smaller interest rate gap with other developed countries poses a threat to the economy.

SPENDING BOOSTER IN 2015 TO WIDEN FISCAL DEFICIT

South Korea, Asia’s fourth-largest economy, unveiled its budget plan in September 2014, to boost spending in 2015 to KRW5.7tln or USD536bn (a jump of 5.7% or KRW2.0tn vs. the planned spending in 2014) as the government pulls out all stops to wriggle the economy out of potential stagnation. However, the government expects these expansionary policies to widen the fiscal deficit to KRW3.3tn (2.1% of GDP) in 2015 from KRW2.5tn (1.7% of GDP) expected in 2014. The acceleration in spending could also raise the sovereign debt to 35.7% of GDP in 2015 from 35.1% of GDP in 2014. The expansionary measures such as the stimulus and rate cuts have exacerbated concerns over higher consumer debt levels, which could rise even further on cheaper borrowing costs and easier credit availability.

PRIVATE INDEBTEDNESS REMAINS AT ELEVATED LEVELS; LOW INFLATION REMAINS A WORRY

South Korea’s household debt has more than doubled over the past decade to reach alarming levels of more than USD1tn, which could lead to an increase in the instances of defaults. In fact, the expansionary measures adopted by the Korean government may lead to further indebtedness in the economy, as the government focuses on driving private consumption driven-credit growth rather than export-driven growth to revive the economy. We note that household credit growth has remained strong over the past few quarters, reaching 6.7% YoY in 3Q2014. Although the ferry incident has not curtailed household credit growth, it has not translated into a substantial jump in inflation. South Korea, the fifth-largest crude importer globally, has and should continue to benefit from the recent meltdown in oil prices. In December 2014, the consumer price inflation fell below 1% for the first time in 15 years, reaching 0.8%, continuing its downward trajectory, aided by lower fresh food and industrial goods prices. The prolonged period of low inflation which is well below the central bank’s targeted range of 2.5-3.5%, has stoked fears of a deflationary environment and potential adverse impact on economic growth. However, BoK expects this trend to reverse and inflation to rise to 2.0% in 2015, with 0.6% being contributed by the hike in cigarette prices.

CURRENT ACCOUNT SURPLUS AND FOREX RESERVES LEND FINANCIAL STRENGTH

South Korea’s trade and current account surplus and foreign flows driven by the interest-rate differential have been the key factors in the strengthening of the Won in recent years. Although exports contribute significantly to the country’s GDP, the stronger Won has made Korean exports less competitive as compared to its Japanese rivals. South Korea held significant forex reserves of around USD363bn at the end of 4Q2014. We think these forex reserves and a rising current account surplus provide a comfortable cushion to Korea for possible crisis periods or to counter a potential outflow of funds from the country when the US FED starts its interest rate hike cycle.
South Korea's real estate market demand has remained weak following the 2008 global recession. Although the increase in mortgage loans during the pre-recession period has led to household debt at close to 70% of its GDP, the interest rate cut and the easing of mortgage lending policies has already stoked resurgence in home loan applications. For example, the mortgage loan applications through 22nd August, 2014 jumped around three times as compared to July 2014 for Standard Chartered’s Korean unit. The South Korean government seeks to improve customer sentiment through stabilisation and improvement in the housing prices. The policymakers aim to boost private consumption on higher levels of disposable income as the loan-to-value ratios become favourable.

**VALUATION**

The Korea Composite Stock Price Index (KOSPI) declined by 4.8% in 2014, underperforming some of the other Asian indices. The KOSPI is currently trading at 10.5x one-year forward consensus earnings, which is above its 5-year average one-year forward multiple of 9.4x. During the past year, Korea, which had seen a record level of foreign flows, witnessed a decline in investor enthusiasm in the final few weeks of 2013, following weak corporate earnings, poor domestic liquidity and an appreciating Won. Although the index has witnessed an improvement in multiples, the valuations relative to some other Asian markets remain low, mirroring concerns over growth prospects, an ageing population and political tensions with aggressive neighbour North Korea.

**HOUSING DEMAND RESURREPTION KEY TO GROWTH**

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TABLE 1: INDONESIAN ECONOMY AT A GLANCE

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<tr>
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<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
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<tbody>
<tr>
<td>Nominal GDP (IDR tn)</td>
<td>2,360</td>
<td>2,368</td>
<td>2,404</td>
<td>2,484</td>
<td>2,620</td>
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<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>5.63%</td>
<td>5.72%</td>
<td>5.20%</td>
<td>5.12%</td>
<td>5.01%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>8.40%</td>
<td>8.38%</td>
<td>7.32%</td>
<td>6.70%</td>
<td>4.53%</td>
</tr>
<tr>
<td>Bank rate (% month-end)</td>
<td>7.25%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>Current account deficit (% of GDP)</td>
<td>3.89%</td>
<td>2.12%</td>
<td>2.06%</td>
<td>4.07%</td>
<td>3.07%</td>
</tr>
<tr>
<td>Foreign direct investment (IDR tn)</td>
<td>67.0</td>
<td>71.2</td>
<td>72.0</td>
<td>78.0</td>
<td>78.3</td>
</tr>
<tr>
<td>Foreign exchange reserves (USD bn)</td>
<td>95.7</td>
<td>99.4</td>
<td>102.6</td>
<td>107.7</td>
<td>111.2</td>
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<tr>
<td>Government debt (USD bn)</td>
<td>113.6</td>
<td>114.3</td>
<td>122.4</td>
<td>122.2</td>
<td>125.4</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia, Statistics Indonesia, The Investment Coordinating Board

**ECONOMIC GROWTH HITS FIVE-YEAR LOW**

Indonesia’s economic growth decelerated to 5.01% YoY in 3Q2014 - the slowest pace in five years and also below the lower end of the government’s 2014 target of 5.1-5.5%. The constrained GDP growth was primarily on account of notable moderation in investments, which grew just 4.02% in 3Q2014 compared to 5.21% in 2Q2014, due to lower investments in non-construction equipment. Private consumption, which accounts for over half of Indonesia’s GDP, rose 5.44% in 3Q2014, which was slightly lower compared to 2Q2014 as election-related activities ended and public sentiment towards the economy turned less optimistic. Government expenditure rose 4.4% YoY, primarily due to higher procurement expenditure. Exports fell 0.7% YoY in 3Q2014, with demand for primary commodities declining due to weak global demand. The Indonesian government’s policy of imposing restrictions on raw mineral ore exports, due to its emphasis on promoting value-added exports from mining, has also impacted the contribution of exports to overall economic growth. The government has set an economic growth target of 5.8% for 2015, a 70bps gain vs estimated 2014 numbers.

**MINING EXPORTS LIKELY TO BE BOOSTED BY ENERGY COMMODITIES**

The Indonesian government has stepped up pressure on mining companies by implementing a ban on ore exports and a new 20-25% tax (slated to rise to 60% in 2H2016) on mineral concentrate exports. This move is aimed at forcing companies to invest in building processing smelters and produce value-added exports. However, following negotiations in July 2014, the government allowed two US-based companies to commence exports of iron ore, lead and zinc concentrates after a six-month stand-off over new tax rules. Coal exports may also be impacted by the new licensing and upfront royalty payment rules implemented from October 2014, which are aimed at clamping down on illegal mining. The government expects the mining sector to clock 2.3-2.7% growth in 2015 compared to just 0.3% in 3Q2014, driven by resumption of exports and commencement of production in the Cepu oil & gas block.

**NEWLY INSTALLED GOVERNMENT DELIVERS QUICKLY ON ITS PROMISE OF FUEL SUBSIDY CUTS**

The Indonesian government’s decades-old policy of making cheap fuel available to consumers by offering subsidies has resulted in a financially burdensome annual commitment. However, effective 1 January, 2014, the government, which had been voted into power in October 2014, announced an end
to petrol subsidies and capped the subsidy on diesel at IDR1,000 per litre. Accordingly, aided by the
global fall in oil prices, Joko Widodo, who took charge as president of the newly-elected
government, has delivered on his pre-election promise of fuel subsidy cuts. Due to these measures, the
government expects the fuel subsidies bill to be just IDR81tn, which is a steep reduction from its
prior estimate of IDR276tn. About 50% of the savings are expected to be deployed towards
infrastructure development, and another 37% would be used to provide subsidies for the poorest
sections of the population with an aim to enhance consumer spending. The government anticipates that
the fuel subsidy savings would be reflected in a budget deficit of just 1.9% of GDP in 2015, which would
be a significant improvement over the estimated 2014 figure of 2.5% of GDP.

CURRENT ACCOUNT DEFICIT AND INFLATION SET TO MODERATE IN 2015

Indonesia’s monthly inflation eased to 4.53% YoY at the end of 3Q2014 from 6.70% at the end of
2Q2014, aided by lower commodity prices and lower demand. Further, the current account deficit
narrowed to 3.07% of GDP in 3Q2014 from 4.07% of GDP in the previous quarter, driven by a surplus in
the non-oil/gas trade balance and higher manufacturing exports. Still, the central bank, Bank Indonesia
(BI), raised the benchmark interest rate by 25bps to 7.75% in November 2014 - the first rate increase in
12 months - in anticipation of a rise in inflation following the government’s announcement of the first
round of fuel subsidy cuts. Monthly inflation in December 2014 also rose to 8.36% YoY - the highest level
in six years. In 2015, BI anticipates inflation to ease into the 3.0-5.0% range, led by a sound monetary
policy and improved policy co-ordination at the government level. Further, in 2015, the decline in oil
prices may help the government in its efforts to push down the current account deficit below the legally
permissible upper limit of 3.0% of GDP.

BUSINESS COMPETITIVENESS REMAINS SOLID

September 2014, Indonesia is ranked 34th among 144 countries, a gain of four places over the previous
year’s ranking and a solid improvement over its 89th rank in 2007. The country continues to benefit
from improving infrastructure and public & private governance, although concerns over corruption and
an inefficient labour market remain.

CURRENCY MAY NOT WORSEN MUCH MORE FROM CURRENT LEVELS

The Indonesian Rupiah (IDR) has been trading beyond the 12,000 mark against the USD since the past
few weeks due to several factors such as prevailing concerns over the high current account deficit and
risks to global economic growth from the rapidly falling oil prices. In mid-December 2014, the IDR hit its
lowest level in 16 years, on year-end foreign currency buying by local players to meet their repayment
obligations and also as risk-averse investors exited Indonesian bonds on expectations that the US
Federal Reserve would raise interest rates, following encouraging US economic data. However, BI may
not be required to intervene aggressively to support the IDR if the government is able to effectively
execute its policy initiatives on cost savings.

INVESTMENT AUTHORITIES AIM FOR STABLE FOREIGN CAPITAL INFLOWS

Foreign capital inflow into Indonesia has improved substantially over the past few years as ratings
agencies, Fitch and Moody’s, lifted the country to investment grade status in 2011 and 2012,
respectively. Moreover, the country’s nearly 250-million strong population – the world’s fourth largest –
also provides foreign multinationals a strong long-term growth potential due to the extensive customer
base. Indonesia’s Investment Coordinating Board (BKPM) stated that it intends to attract FDI into value-
added processes in order to reduce FDI volatility stemming from the country’s dependence on the
resources sector. Accordingly, BKPM plans to simplify the investment process by allowing a single-
window clearance for proposed investments, which should cut the time taken to obtain an investment
license to four months vs. one year previously. BKPM contends that FDI will rise by 15% YoY in 2015.
INDONESIA

VALUATION

Indonesia’s benchmark equity index, the Jakarta Composite Index (JCI) clocked gains of 22.2% in 2014 on overall confidence in the economy ahead of the installation of the new government. The index registered a record high close of 5,348 points on 9 February, 2015, as the European Central Bank announced a higher-than-anticipated bond-buying programme. JCI closed on 12 February, 2015 at 5,343 points and trades at 15.3x one-year forward consensus earnings, which is higher than its five-year average one-year forward multiple of 13.8x. Index multiples may continue to remain higher than the historical average, as investors reward the new government’s reform measures. The markets may also get a boost if the government effectively deploys savings from fuel subsidies to drive growth and initiates other reform measures to shore up tax revenues.

Source: The Investment Coordinating Board

Source: Bank Indonesia

JCI trades close to its record high

Chart 3: FDI by industry (USD bn)

Chart 4: Exports & Imports (IDR tn)

Chart 5: JCI and 1 yr forward P/E trends

Source: Bloomberg
Developed Markets

a. United States 49-51
b. Eurozone 52-54
c. Japan 55-57
d. United Kingdom 58-60
e. Canada 61-63
US RECOVERY ON FIRMER FOOTING DESPITE WEAK 4Q

The economy grew modestly at 2.6% in 4Q14, after witnessing a solid growth in 3Q14. The weakness in growth was primarily due to a decline in government spending and wider trade surplus. The strong growth in 3Q14 GDP was in part due to military spending, which slowed significantly in 4Q14. Therefore, the weakness in 4Q14 seemed a one-off thing and the positive momentum is likely to continue going forward. The growth will be driven by consumer spending, which remained robust in 4Q14. Consumer spending increased 4.3% (the fastest pace since 2006), as compared to +3.2% in 3Q14. US consumers are now more upbeat about the economy. This is evident from the University of Michigan’s consumer sentiment index, which rose to 98.1 in January (the highest level since January 2004). Additionally, the latest FOMC's statement showed that the economy is expanding at a “solid pace” rather than “modestly” with strong job growth.

The GDP expanded at a 5.0% annual pace (the fastest since 2003) in 3Q14, beating the earlier estimates of 3.9% and 4.6% growth seen in 2Q14. Additionally, the growth in 3Q14 happened across the board with business investment, consumer spending, housing, exports and government spending all showing signs of strength. Real personal consumption expenditures increased 3.2% in the quarter, as compared to an increase of 2.5% in 2Q14. Durable goods increased 9.2%, compared with an increase of 14.1%. Non-durable goods rose 2.5% as compared to a rise of 2.2%. Services grew 2.5% compared with an increase of 0.9%. Further, both the real federal government consumption expenditures and gross investment increased 9.9% in 3Q14, in contrast to a decrease of 0.9% in 2Q14. National defence was also a major driver behind the robust GDP growth – increasing by 16.0% in 3Q14, compared with an increase of 0.9% in 2Q4. The Fed expects the strong growth in the US economy to continue. At its December 2014 FOMC meeting, the central bank stated that the central tendency of the projections for real GDP growth is 2.3% to 2.4% for 2014, up a bit from the September projections. Over the next three years, the projections for real GDP growth run somewhat above the estimates of longer-run normal growth.

LABOUR MARKET ADVANCES – ROOM AVAILABLE FOR FURTHER IMPROVEMENTS

The US labour market continued to progress towards the Fed’s objective of maximum employment. The pace of job growth has been strong recently, with job gains averaging nearly 336,000 per month over
the last three months and exceeding 200,000 on a monthly basis for 11 consecutive months. The broader measures of labour market utilization have shown similar improvement and the labor force participation rate has leveled out. Payroll jobs advanced 257,000 in January (vs. consensus of +230,000), with a significant upward revision in November (+423,000 from earlier revised 353,000) and December (+329,000 from earlier revised 252,000). However, the unemployment rate increased to 5.7% in January from 5.6% in December and expectations of 5.6%. This was due to an increase in the labor participation rate (69.2%). Going back to the payroll report, private payrolls increased 267,000 in January after rising increasing 240,000 in December, while expectations were for 229,000. The Fed expects the sufficient underlying strength in the economy to support the ongoing improvement in the labor market.

**HOUSING DATA SUGGEST SITUATION LIKELY TO IMPROVE IN 2015**

The latest bout of data showed that housing activity may start improving beginning this year. Completed foreclosures declined 9.6% YoY and 12.6% MoM in November. New home sales for December rebounded 11.6% MoM, after declining 6.7% in November, the lowest level since July 2014. Housing starts also rebounded 4.4% MoM, after declining 4.5% in November. Pending home sales increased 8.5% YoY in December, following a small increase of 1.5% in November. Existing home sales also increased 2.4% MoM in December, as compared to a decline of 6.3% in November. As a result, home prices are gradually moving higher, with the FHFA House Price Index increasing 0.8% in December; vs. +0.4% in the previous month and consensus of +0.3%. The National Association of Realtors (NAR) expects the housing market to witness a 7.4% sales rise in 2015, with new home purchases up 30-40%. Further, NAR expects home sales prices to jump +5.0% in 2015.

**MACROECONOMIC DATA OFFERS ENCOURAGING SIGNS**

The US consumer confidence index rose to 102.9 in January from an upwardly revised 93.1 in December. However, December’s retail sales disappointed, with sales declining 0.9% following a 0.7% growth in November. The manufacturing PMI has been consistently hovering above the 50.0 mark ever since the beginning of 2013 thanks to lower unit labour costs, real effective exchange-rate depreciation and cheap energy. However, the ISM Manufacturing Index missed expectations by 1.0 points to 53.5 in January, after a downward revised 55.1 in December. Inflation in the US has been under control for the major part of this year. Measured by the change in CPI (YoY), inflation has declined consistently from 3.17% in 2011 to 0.8% currently, which is well below the Fed’s target of 2%.

**INTEREST RATE HIKE – LIKELY IN MID-JUNE!**

The FOMC’s meeting in January seemed a non-event as there were no major changes in the Fed’s policy. The central bank reiterated its stand to remain “patient” with rate hike, suggesting that the hike is unlikely until the next two meetings (until mid-June). However, the Fed surprised the market by upgrading its economic assessment. The central bank said that the economy is expanding at a solid pace rather than moderately. The central bank also added that the labour market had improved further, with strong job gains and a lower unemployment rate. The FOMC committee continued to see sufficient underlying strength in the economy to support the ongoing improvement in the labour market. As per the December FOMC’s minutes of meeting, the unemployment rate projection stands at 5.2% to 5.3% at the end of 2015, in line with its estimated longer-run normal level. Over the next three years, the committee’s projections for real GDP growth run somewhat above the estimates of longer-run normal growth. Finally, although the FOMC members project inflation to be lower in the near-term on account of the decline in energy prices, they continue to see inflation moving back toward 2% gradually. They expect inflation to be in the range of 1.0-1.6% in 2016 before rising to 1.8% to 2.0% in 2017.

The debate over the timing of the rate hike has actually intensified since the release of January’s non-farm payrolls, which were very impressive. Several Fed officials, including St. Louis Fed President James Bullard, Philadelphia Fed President Charles Plosser, Atlanta Fed President Dennis Lockhart and Richmond Fed President Jeffrey Lacker commented in favour of a rate hike in light of the improving US economy.

**FINANCIAL MARKETS & THE REAL ECONOMY – DECOUPLED?**

Over the last few years, there has been a clear decoupling of the financial markets and the real economy with the former outpacing the latter. One would ideally expect the cyclical sectors to outperform during the economic recovery, which would in turn, support the market performance. This was the case prior
to 2012. However, since the beginning of 2012, this trend has reversed and the financial markets have rallied despite the cyclical index underperforming the defensive index. A deeper look into the improving profitability & growth of US corporations reveals that the current financial market rally is not purely driven by liquidity. Profitability & growth of US corporations have clearly outpaced the remaining segments in the economy. As a result of this, the US corporate profits after tax as a percent of GDP has increased from 4.61% in December 2008 to 10.78% in December 2014.

AND THE EQUITY VALUATIONS SEEM REASONABLE

The return on equity of the S&P 500 Index is another factor that supports the current valuation and adds to the strength in corporate profitability, which has virtually remained unchanged since 2007, despite the total leverage in the corporate sector (measured by net debt / operating profits (EBITDA)) declining sharply from 4.6x to 1.7x. This indicates that the contributors to the ROE have been the core business factors such as the increase in asset utilization and profit margins and not the financial leverage, thereby representing a healthy and profitable growth. The corporate tax environment also continues to support higher than usual margins, since the corporate tax rate has fallen steadily for decades via globalising operations.

VALUATION

The S&P 500 Index has experienced a profound compositional change. The Tech sector now makes up a much larger fraction of the total, since tech firms traditionally enjoy high profit margins. With the ongoing annual earnings season, the Wall Street is expecting another robust set of numbers from US corporations, especially the banking sector. Apart from oil companies, earnings in 4Q14 so far have been good. Excluding oil companies, earnings are expected to grow 7.9% in 4Q14, vs. 8.9% in 4Q13. The index trades at a one year forward P/E of 17.5x, which is above its 5-year average of 13.5x. With a near 2% dividend yield and continued economic strength, any dip provides a good entry point for long-term investors.
TABLE 1: EUROZONE (EU18) ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (EUR bn) Euro area (18 countries)</td>
<td>2,483</td>
<td>2,494</td>
<td>2,509</td>
<td>2,515</td>
<td>2,522</td>
</tr>
<tr>
<td>Nominal GDP (EUR bn) Euro area (19 countries)</td>
<td>2,491</td>
<td>2,503</td>
<td>2,518</td>
<td>2,524</td>
<td>2,531</td>
</tr>
<tr>
<td>Real GDP growth rate (% QoQ)</td>
<td>0.1%</td>
<td>0.3%</td>
<td>0.3%</td>
<td>0.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% QoQ)</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.3%</td>
<td>0.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Key interest rate (% quarter-end)</td>
<td>0.50%</td>
<td>0.25%</td>
<td>0.15%</td>
<td>0.05%</td>
<td>0.05%</td>
</tr>
<tr>
<td>Government Gross Debt (% of GDP)</td>
<td>91.1%</td>
<td>90.9%</td>
<td>91.9%</td>
<td>92.7%</td>
<td>92.1%</td>
</tr>
<tr>
<td>Budget surplus/(deficit) (% of GDP)</td>
<td>NA</td>
<td>NA</td>
<td>(2.80%)</td>
<td>(2.60%)</td>
<td>NA</td>
</tr>
<tr>
<td>Household savings rate (% of disposable income)</td>
<td>12.9%</td>
<td>13.3%</td>
<td>13.2%</td>
<td>13.0%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Unemployment rate (% quarter-end)</td>
<td>11.9%</td>
<td>11.8%</td>
<td>11.7%</td>
<td>11.5%</td>
<td>11.50%</td>
</tr>
</tbody>
</table>

Source: European Central Bank and Eurostat, all figures are for Euro area 18 countries except where specified

ECB EMBARKS ON QUANTITATIVE EASING TO BOOST INFLATION AND GROWTH.............

The protracted period of low inflation that had plagued the Eurozone, deteriorated in December 2014 as the economy witnessed a deflation for the first time since October 2009. In January 2015, the deflationary environment worsened as Consumer prices moved further into negative territory, falling 0.6% compared to ECB’s long-term inflation target of ‘close to, but below 2%’. The low or negative inflation rate in the past few months has mirrored the recent carnage in energy prices. In December
EUROZONE

2014, the ECB lowered its Eurozone inflation expectations for 2015 to 0.7% from 1.1% and for 2016 to 1.3% from 1.4%. The ECB, which had been implementing aggressive rate-cuts over the past few quarters, was left with little leeway to fight the low inflationary environment amidst rock-bottom benchmark rates. Finally, in January 2015, ECB president Mario Draghi unveiled a massive and higher-than-expected Quantitative Easing (QE) program, staving off stiff opposition from Germany to the move. As part of the QE program, the ECB pledged to purchase securities including government debt for a combined amount of up to EUR60bn per month or EUR1.1tn starting from March 2015 until September 2016, a move which would allow the ECB to pull the Eurozone economy out of an extended period of sluggish growth and deflationary pressure. The ECB also signalled that it will conduct the QE programme until it sees a sustained improvement in inflation.

The unemployment rate for the Eurozone has remained steady at close to 11.5% over the past few months, prior to which it has been falling steadily, despite the anaemic economic growth experienced by the region. Although the unemployment rate improved marginally to 11.4% in December 2014, it still remains at elevated levels, with countries including Greece and Spain experiencing unemployment rates well in excess of 20%. We note that Eurozone runs the risk of failing crude prices fanning further deflationary pressures, prompting consumers to delay purchases and rendering the stimulus programmes ineffective, while accentuating the unemployment situation.

The Eurozone economy had got a leg-up in 4Q2013, posting a positive YoY GDP growth after witnessing multiple quarters of negative growth, driven by ECB’s 25 basis points (bps) interest rate cut in November 2013. The GDP growth rate in 2Q2014, was partly supported by a further 10 bps interest rate cut by the ECB in June 2014, which pushed deposit rates into negative territory. However, with the region’s growth rate losing momentum and in a bid to keep deflation at bay, the ECB unexpectedly stepped in with another interest rate cut in September 2014, bringing the benchmark rate to near-zero levels at 0.05%. Along with the rate cut, the ECB also announced stimulus measures in the form of an asset purchase programme to buy debt products from banks starting October 2014, in a bid to boost bank lending, although it excluded government debt from its purview. Under the Targeted Long-Term Refinancing Operations (TLTROs) announced by Mr. Draghi, banks can lock in four years’ worth of zero-level refinance loans at low interest rates. However, the lukewarm response to these measures have resulted in the ECB initiating more aggressive stimulus measures in the form of QE after a slew of measures failed to prop up inflation and growth.

“GREXIT” WOULD BE CATASTROPHIC FOR EUROZONE’S ECONOMY AND THREATEN ITS SURVIVAL

In January 2015, Greece’s anti-austerity Syriza party came to power. Under newly instated Prime Minister Alexis Tsipras, Greece is seeking short-term bridge loan from Eurogroup (the group of Euroarea finance ministers) instead of an extension to the bailout program as the country bids for time to renegotiate bailout terms, including debt reduction. Greece is seeking to avoid default as the deadline of 28 February 2015 for withdrawal of ECB funding looms. In the eventuality of Greece’s exit from the Eurozone, dubbed by the markets as “Grexit”, there could be downward pressure on the Euro currency. Although the Eurozone has emergency reserves to adequately cover the approximately EUR250bn cost of a Grexit, such a scenario could adversely impact the region’s growth and stability. Moreover, if other nations follow suit, the basis on which the idea of Eurozone was mooted could crumble, potentially leading to a dismantling of the currency, in the worst-case scenario. Although the Eurozone members and Greece are still at loggerheads, we believe a Greek default seems unlikely for now, considering the huge repercussions for both, the Eurozone and Greece.
EURO DEPRECIATION FOLLOWS INTEREST RATE CUTS, QE AND SNB SHOCKER

The Euro had been appreciating against the U.S. dollar between mid-2012 to mid-2014 as the Eurozone’s inflation had remained moderate and below the levels of the US economy. However, the spate of interest rate cuts and sluggish economic growth has led to substantial erosion in the value of the Euro since then. The Euro was pummelled in January 2015 against the Swiss franc after the Swiss National Bank (SNB) abandoned its three-year cap of EUR1.20/Swiss franc. The SNB, which had been struggling in recent months to protect this cap, made this move just ahead of the Greek elections and the anticipated QE launch. The Euro further slid in January 2015 to an eleven-year low against the US dollar, exacerbated by expectations of a widening gap in the monetary policies of the two regions (a tighter policy from an impending interest rate hike by the US Fed vs. QE implementation by the ECB) and fears over Grexit following the election victory of the anti-austerity Syriza party in Greece. We see the QE implementation as the last throw of the dice for the ECB. If Eurozone’s economy fails to pick up steam despite these measures, the Euro will continue to move towards parity against the U.S. dollar.

Chart 5: USD/EUR Exchange Rate

Source: Bloomberg

VALUATION

The EURO STOXX 50 Index, an index representing the Blue-chip companies which are sector leaders in Eurozone, grew by a mere 1.2% in 2014. We note that the index has been quite volatile during the last five years, with the valuations reaching low levels in the second half of 2011, reflecting weak investor sentiment following the European credit crisis and weak corporate earnings expectations. However, subsequent to the improvement in global growth and a moderation in the region’s credit environment, the EURO STOXX 50 index valuations have rebounded to the current level of 14.3x one-year forward consensus earnings, which is above its 5-year average one-year forward multiple of 10.8x. The valuations have been propped up on stimulus measures announced by China and Japan, lower crude prices and ECB’s QE announcement. We believe the ongoing weakness in Europe’s GDP growth, concerns over the health of the global economy stemming from plummeting oil prices, deflationary pressures in the Eurozone and speculation surrounding Grexit should remain key considerations for the region’s stock markets. We expect the EURO STOXX 50 Index to inch up from the current levels amidst a potential pickup in consumption expenditure following a significant fall in prices.

Chart 6: EURO STOXX 50 Index and 1-yr forward P/E trends

Source: Bloomberg
TABLE 1: JAPANESE ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3Q2013</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (JPY bn)</td>
<td>117,854</td>
<td>125,529</td>
<td>120,801</td>
<td>121,029</td>
<td>118,681</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>0.4%</td>
<td>(0.4%)</td>
<td>1.4%</td>
<td>(1.7%)</td>
<td>(0.5%)</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>0.9%</td>
<td>1.4%</td>
<td>1.5%</td>
<td>3.6%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Central Government Debt (% of GDP)</td>
<td>214.5%</td>
<td>202.7%</td>
<td>212.1%</td>
<td>214.7%</td>
<td>218.8%</td>
</tr>
<tr>
<td>Export (% GDP)</td>
<td>15.0%</td>
<td>14.4%</td>
<td>14.4%</td>
<td>14.6%</td>
<td>15.4%</td>
</tr>
<tr>
<td>Current account Balance (JPY bn)</td>
<td>1,352</td>
<td>(1,431)</td>
<td>(819)</td>
<td>357</td>
<td>1,667</td>
</tr>
<tr>
<td>Foreign exchange reserves (JPY bn)</td>
<td>127,345</td>
<td>126,682</td>
<td>127,935</td>
<td>128,392</td>
<td>126,441</td>
</tr>
<tr>
<td>Unemployment rate (in %)</td>
<td>4.0%</td>
<td>3.7%</td>
<td>3.7%</td>
<td>3.7%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Source: Bank of Japan, Ministry of Finance, e-Stat

ECONOMY IN RECESSION BUT GOVERNMENT UPBEAT ON GROWTH PROSPECTS

Japan’s economic growth fell 1.9% YoY on an annualised basis in 3Q2014 - the second successive quarter of decline, due to lower capital spending and weak private consumption. Consumer spending, which contributes approximately 60% to Japan’s GDP, rose just 0.4% QoQ in 3Q2014. Earlier, in 2Q2014, the economy shrank at an annualised pace of 6.8% YoY after the government raised the sales tax to 8% from 5% in April 2014 - the first sales tax hike since 1997, aimed at lowering the public debt burden. Due to the prevailing weakness in economic growth, the government delayed a further 2% hike in the sales tax by 18 months, to 2017. Looking ahead, the government expects the economy to expand 1.5% in 2015/16 on the back of improvement in both private spending and capital investment. Capital spending seems poised to benefit from lower import costs following the steep decline in global oil prices and expected improvement in exports, aided by a weaker JPY. During 2014, JPY vs. USD depreciated 14% and touched a 7.5-year low as it fell below the 120 mark, with most of the losses being concentrated in the last quarter of the year.

TRADE DEFICIT NARROWS SHARPLY

In November 2014, Japan recorded a trade deficit for the 29th straight month, although the deficit narrowed sharply by 31.3% YoY to JPY894bn. A weaker JPY boosted exports by 4.9% YoY to JPY6.2tn, led by electronic components, optical equipment and machinery. Exports to the US jumped 6.8% YoY to JPY1.3tn, but exports to China - Japan’s largest trading partner - rose just 0.9% YoY to JPY1.15tn. Further, in November 2014, imports fell for the first time in three months by 1.6% YoY to JPY7.1tn, led by a sharp 21.6% decline in crude oil imports due to weak global prices.

BOJ’s INFLATION BOOSTING MECHANISM BEING TESTED BY PLUMMETING ENERGY PRICES

Shinzo Abe’s re-election as the Prime Minister of Japan following snap elections cleared the path for more aggressive stimulus measures by promoting a weak JPY and boosting inflation. Japan’s economy has been impacted by nearly two decades of deflation, although the recent quarters have seen a series of price hikes. The country’s central bank – Bank of Japan (BOJ) – has pursued a policy of low interest rates and purchase of government bonds to stabilise the consumption and investment cycle in the economy. Accordingly, the BOJ has set an inflation target of 2% by 2015/16. In October 2014, the BOJ...
surprised the markets by stating its intention to boost the economy’s monetary base by JPY80tn per year, up from its previous annual target of JPY60-70tn, primarily through purchase of government bonds. However, monthly core inflation eased to a 14-month low of 0.7% in November 2014 due to only modest price increases for energy and electronic goods. The limited inflation gain underscores the negative impact on consumer demand and industrial output due to the sales tax increase in 2014. BOJ remains optimistic that it will be able to achieve the inflation target by the end of 2015/16, highlighting that a broad-based rise in wages would be critical to achieve that objective.

BUSINESS COMPETITIVENESS REMAINED STRONG

According to the World Economic Forum’s ‘The Global Competitiveness Report 2014-15’ published in September 2014, Japan climbed three places to reach the sixth position overall for the most-competitive economy in the world. Japan’s ranking was driven by continued strength in business sophistication (first position for the sixth year in a row) and innovation (fourth position). However, the country’s overall ranking was impacted by severe macroeconomic challenges (127th rank) due to high levels of public debt & budget deficit and a low labour force participation rate of women (49.4% in 3Q2014).

TAX REVENUES MAY HELP CURTAIL THE PUBLIC DEBT BURDEN

Japan’s national debt rose to JPY1,039tn in 3Q2014, up by JPY21.0tn since December 2013 on rising social security costs incurred for the ageing population. The country’s public debt currently stands well above 200% of GDP, indicating the vulnerable state of public finances in the country. Japan’s 2015/16 budget, expected to be worth JPY96tn and poised for approval by the cabinet by mid-January, 2014, may include a JPY5.5tn contribution from tax revenues - the highest level since 1991. Tax revenues are expected to benefit from the JPY depreciation and improvement in corporate profits, going forward. If tax receipts rise as expected, the government would be in a position to lower its debt issuance next year by JPY3tn to JPY38tn. The government contends that if the economy manages to wriggle out of the deflation trap, it may be able to achieve the targeted primary deficit - the difference between revenues and expenses, excluding debt repayments and bond payments - of 3.2% of GDP in 2015/16, or about half that of 2009/2010 levels. The December 2014 re-election of Shinzo Abe as the Prime Minister, after he had called for snap elections, should provide fresh impetus to growth-oriented economic stimulus policies.

EMPLOYMENT TRENDS CONTINUE TO IMPROVE

Japan’s monthly unemployment rate came in at 3.5% in November 2014, same as in the previous month, as the number of unemployed people fell 2.1% YoY. The healthcare & welfare and information & communication sectors added 350,000 and 140,000 jobs, respectively, which was partially offset by 290,000 job losses in the manufacturing sector. New job offers fell 4.4% YoY, but rose 1.2% QoQ. Notably, the ratio of job offers to job seekers rose for the second consecutive month to 1.12 - the highest level in 25 years. The recent stabilisation in unemployment trends follows a sharp decrease in May 2014, when the unemployment rate touched a 16-year low.

VALUATION

Japan’s benchmark equity index, Nikkei 225 (NKY), hit multiple seven-year highs over the past few months, and closed at 17,980 points on 12 February, 2015, driven by various catalysts such as BOJ’s decision to widen the monetary base, significant depreciation of the JPY vs. USD and encouraging economic data. In another trigger, Japan’s USD1.2tn Government Pension Investment Fund was reportedly seeking a mandate to raise its allocation to domestic equities to 25%, from 12% earlier. The market appears particularly upbeat about the weakness in JPY, which is deemed to be a positive sign for Japanese exports. NKY currently trades at 17.5x one-year forward consensus earnings, which is higher than its 5-year average one-year forward multiple of 15.3x. Although valuations appear high currently,
the premium may be justified, given rising hopes for higher investments and consumption within the economy, which may trigger a growth revival.

Chart 5: NKY and 1 yr forward P/E trends

Source: Bloomberg
TABLE 1: UK ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>4Q2013</th>
<th>1Q2014</th>
<th>2Q2014</th>
<th>3Q2014</th>
<th>4Q2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>2.70%</td>
<td>2.90%</td>
<td>3.20%</td>
<td>2.60%</td>
<td>2.70%</td>
</tr>
<tr>
<td>Consumer Price Index - CPI (% YoY)</td>
<td>2.10%</td>
<td>1.73%</td>
<td>1.73%</td>
<td>1.43%</td>
<td>0.93%</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.23%</td>
<td>6.97%</td>
<td>6.47%</td>
<td>6.07%</td>
<td>5.90%</td>
</tr>
<tr>
<td>External Balance - Curr. Acct. (% of GDP)</td>
<td>(4.23%)</td>
<td>(4.39%)</td>
<td>(5.17%)</td>
<td>(5.55%)</td>
<td>(45.55%)</td>
</tr>
<tr>
<td>Fiscal Balance – Budget (% of GDP)</td>
<td>(5.95%)</td>
<td>(5.73%)</td>
<td>(5.76%)</td>
<td>(5.60)</td>
<td>--</td>
</tr>
<tr>
<td>Central Bank Rate (%)</td>
<td>0.50%</td>
<td>0.50%</td>
<td>0.50%</td>
<td>0.50%</td>
<td>0.50%</td>
</tr>
<tr>
<td>3-Month Rate (%)</td>
<td>0.53%</td>
<td>0.52%</td>
<td>0.55%</td>
<td>0.55%</td>
<td>0.56%</td>
</tr>
<tr>
<td>2-Year Note (%)</td>
<td>0.56%</td>
<td>0.71%</td>
<td>0.86%</td>
<td>0.42%</td>
<td>0.44%</td>
</tr>
</tbody>
</table>

Source: Bloomberg

THE RECOVERY IS BECOMING MORE BALANCED

The UK economy continued to grow strongly at 2.6% YoY in 3Q14. This was the seventh successive quarter of expansion and the longest sustained run of output growth since the economic downturn in 2008. The IMF expects the UK’s real GDP to expand by 2.4% in 2014 and 2.2% in 2015. The Office for National Statistics’ (ONS) analysis of job-to-job flows suggests that employees are increasingly confident about labour market conditions. This has led to this measure rising to its highest level since the economic downturn and its composition suggests that workers are increasingly moving between industries and occupational groups. Just over two-thirds of this recent growth has come from a combination of stronger household spending and investment.

HOUSING SECTOR & THE BUSINESS CYCLE ARE WELL CORRELATED

In contrast to other OECD countries, the housing market cycles in the UK are marked by sharp movements in prices and an inelastic response of residential investment, owing notably to supply constraints. Housing cycles in the UK also tend to have a large impact on the economic activity, with booms generally associated with a worsening of household balance sheets and a rise in relatively high-risk mortgages. A recent analysis by the IMF reveals that house price shocks in the UK have a strong impact on consumption and household debt. In response to a 10% increase in house prices, private consumption responds strongly, increasing up to 2% in five quarters. Furthermore, the high elasticity of household debt to house prices captures the fact that mortgage credit expands rapidly during housing booms, resulting in a higher household debt leverage ratio. Over the past 30 years, real house prices have increased the most in the UK when compared with other OECD economies. Over this period, annual house price increases have averaged 3% in real terms, as compared to 1% for the OECD as a whole.

The UK construction market witnessed the slowest growth in December since July 2013 with the construction PMI standing at 57.6, well below the economists’ forecasts of 59. However, residential home building was buoyant along with growth in commercial building. Civil construction was the only sub-sector that reported contraction with a falling output for the first time since May 2013. According to industry sources, UK construction firms have recorded the strongest growth in 2014 in terms of residential construction since 1997.
UNITED KINGDOM

HOWEVER, PRODUCTIVITY GROWTH RATES REMAIN WEAK

Output per hour fell by 4.4% between 1Q2008 and 4Q2009 in the latest data, before returning to its pre-downturn level in 3Q2011. Output per hour declined again in 2012 and 2013, and remains little changed in 3Q2014. As a result, productivity on this measure remains 1.8% below its pre-downturn level in 3Q2014, and around 15% below the projected path of productivity growth had pre-downturn trends been maintained. While output has now recovered to reach above its pre-downturn level, the recovery of productivity has been the slowest in the UK since the Second World War. As per the recent ONS report, the weakness in productivity growth can be partly attributed to the UK’s industrial mix and in particular to the productivity performance of mining & quarrying. Productivity in this industry, which is dominated by the extraction of oil & gas from the North Sea, has been on a long-term declining trend falling by more than 50% since 2008.

LOW INFLATION & WEAK INDUSTRIAL DATA....

The all-item consumer price index (CPI) declined to a 12-year low in December 2014 at 1%, mainly attributable to the heavy decline in oil prices. Structurally, falling food and transport costs along with certain recreational and cultural goods continued to have a downward impact on inflation. Overall, food prices have declined by 1.7% y-o-y and motor fuels by 5.9% with the average petrol price under GBP1.23 per litre in November. Manufacturing and service sectors also witnessed the slowest growth in the last few years. The UK’s manufacturing PMI declined to 52.5 in December, the lowest in 18 months, while the Services sector grew at its slowest pace since June 2013. The tapered growth across all sectors led to weaker sterling value against the US dollar. The Pound Sterling fell to 1.52 against USD, the lowest in 17 months. Market believes that, deflationary pressures have evidently engulfed the UK economy and this could lead to a further decline in consumer price growth. Moreover, weaker inflationary burden may also push back the much anticipated interest rate hike in the UK.

ACCOMMODATIVE MONETARY POLICIES & PRUDENT FISCAL MEASURES

The Bank of England (BoE) has maintained its accommodative monetary policy stance to support growth. Repairing of bank balance sheets has progressed and the authorities have elaborated on a strategy for the two state-owned banks, aimed at returning them to good health and eventually selling them to private ownership. The BoE has also outlined a framework for stress-testing bank soundness. The bank rate (0.5%) and QE balances (GBP375bn of gilts) have remained unchanged. The BoE formally implemented a policy of forward guidance in August 2013, similar to the one employed by the US Federal Reserve. Moreover, the flow of credit has increased, reflecting both the demand and supply factors. After declining during 2010–12, consumer credit rebounded strongly in 2014 and has touched a level of GBP1.25bn, the highest in the last seven years.

Following the global crisis, the UK’s public finances had deteriorated sharply with the overall deficit widening to 11% of GDP in FY2009/10. In response, the government announced a package of fiscal consolidation measures aimed at reducing the overall deficit to 5¾ percent of GDP by the end of FY2013/14. The overall deficit as percentage of GDP stood at 6% in 3Q14. The government remains fully committed to fiscal consolidation, with the aim of bringing the overall balance to a small surplus by FY2018/19. The 2014 Budget shows a reduction in the overall deficit to 4¾ percent of GDP in FY2014/15 from 5¾ percent in FY2013/14 without creating an undue drag on growth.
LEAD TO IMPROVEMENT IN JOBS DATA...

Unemployment in the UK fell more than forecast to the lowest in six years. According to the ONS, the jobless rate dropped to 6% in the three months through October 2014 from 6.2%, and from 7.4% the year earlier. The data also showed that jobless claims have fallen for 25 consecutive months since November 2012. Unemployment fell 63,000 to reach 1.96mn people, while employment rose 115,000 to a record 30.8mn. Jobless claims also fell 26,900 in November.

With manufacturing and services cooling and a slump in the Eurozone threatening the UK’s growth, these numbers may give ammunition to BoE officials who favour keeping the key interest rate at a record low. The BoE kept the benchmark unchanged in December since the majority of the Monetary Policy Committee agreed that falling unemployment and a sharp decline in oil prices are positive for the UK economy, and wages are expected to increase in 2015.

VALUATION

With the Scotland vote ending with a decisive ‘No’, the next impending political event on the horizon is the UK general election, which is scheduled for May 7, 2015. Charting its course in the run up to this event, the FTSE 100 Index remained just shy of crossing its all-time high level. The index currently trades at a 1-year price-earnings (P/E) multiple of 15.4x with a robust dividend yield of around 4.8%.

Chart 5: FTSE and 1 yr forward P/E trends

Source: Bloomberg
TABLE 1: CANADIAN ECONOMY AT A GLANCE

<table>
<thead>
<tr>
<th>Particulars</th>
<th>3QFY13</th>
<th>4QFY13</th>
<th>1QFY14</th>
<th>2QFY14</th>
<th>3QFY14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (CAD mn.)</td>
<td>1,903,152</td>
<td>1,918,856</td>
<td>1,950,324</td>
<td>1,968,976</td>
<td>1,991,612</td>
</tr>
<tr>
<td>Real GDP growth rate (% YoY)</td>
<td>2.1%</td>
<td>2.7%</td>
<td>2.1%</td>
<td>2.5%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Consumer price index - CPI (% YoY)</td>
<td>1.15%</td>
<td>0.93%</td>
<td>1.39%</td>
<td>2.22%</td>
<td>2.08%</td>
</tr>
<tr>
<td>Business credit growth (YoY)</td>
<td>7.6%</td>
<td>6.7%</td>
<td>6.6%</td>
<td>7.7%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Current account deficit (% of GDP)</td>
<td>(0.69%)</td>
<td>(0.78%)</td>
<td>(0.58%)</td>
<td>(0.50%)</td>
<td>(0.42%)</td>
</tr>
<tr>
<td>Fiscal deficit (% of GDP)</td>
<td>(0.54%)</td>
<td>(0.59%)</td>
<td>(0.85%)</td>
<td>0.01%</td>
<td>(0.36%)</td>
</tr>
<tr>
<td>Gross forex reserves (CAD mn)</td>
<td>73,555</td>
<td>76,512</td>
<td>84,515</td>
<td>80,958</td>
<td>82,529</td>
</tr>
<tr>
<td>Average unemployment rate (%)</td>
<td>7.10%</td>
<td>7.00%</td>
<td>7.00%</td>
<td>7.00%</td>
<td>6.60%</td>
</tr>
</tbody>
</table>

Source: Bank of Canada, Statistics Canada

GDP GROWTH MODERATELY SLOWS IN 3Q14

Canada’s real GDP growth rate expanded 0.7% QoQ in 3Q2014 (2.6% YoY), after touching its highest quarterly gain of 0.9% QoQ in the previous quarter since 3Q2011. The main contributors to this growth were exports of goods (+2.2%) and the household final consumption expenditure (+0.7%). The household final consumption expenditure was up 0.7%, as a result of increased outlays on goods (+3.0%). However, expenditure on services slowed (+0.5%) as compared to +0.7% in 2Q2014. Exports of goods and services increased 1.7%, following 4.4% increase in the previous quarter. Business gross fixed capital formation grew 1.5%, following a gain of 0.8% in the previous quarter. Real GDP remained moderately lower in October (+0.3%), after a 0.4% increase in September. In October, mining, oil & gas extraction and manufacturing sectors were the major contributors to growth. Similarly, construction, public sector (education, health and public administration combined) and professional services also showed expansion. On the other hand, there were declines in utilities, agriculture and forestry sectors. Wholesale trade was also down, while retail trade remained unchanged. For the entire 2014, OECD has increased its estimate of Canada’s economic growth to 2.4% from 2.3% earlier. Canada is expected to remain the second-fastest growing economy among the G7 nations, after the UK (3.0%). Further in 2015, OECD has forecasted the country’s economic growth to pick up to 2.6%, trailing America’s 3.1% and the UK’s 2.7%, but still outpacing the rest.

FOCUS ON EXPANDING TRADE

Canada is focusing on expanding its trade to boost economic growth. The country has signed a free-trade deal with South Korea as well as the European Union (EU). The CETA pact with the EU, which is set to begin in 2016, will overtake the North American Free Trade Agreement as Canada’s biggest cross-border deal. When fully implemented, the agreement is expected to increase two-way trade in goods and services between Canada and the EU by 23% or EUR26bn. With CETA, 99% of the existing tariffs will be removed. Canadian exporters currently remain overwhelmingly dependent on the US, which buys about 75% of Canadian goods and supplies about half of all its imports. Canada’s free-trade deal with South Korea is expected to boost its exports to South Korea by 32% and add USD1.7bn to the economy. Such agreements to facilitate trade will open up new markets for Canadian companies, promote investment and create more jobs for the country, driving economic growth. Free trade agreements also benefit consumers as they lead to increased competition, resulting in lower prices.
BUSINESS OUTLOOK OFFERS ENCOURAGING SIGNS

According to the business outlook survey conducted by the Bank of Canada, there are signs of strengthening demand, especially among export-oriented firms and manufacturers. However, the outlook for businesses that are linked directly or indirectly to the energy sector has deteriorated recently. Overall, following improved past sales activity, businesses expect sales to grow at a slightly faster pace over the next 12 months. Firms anticipating a positive impact from the U.S. economic outlook are more optimistic than others. The balance of opinion on employment in machinery and equipment declined overall, hiring intentions and investment plans are more robust for manufacturers than for firms in other sectors.

Chart 3: Balance of opinion on rate of increase in sales growth (%)
Chart 4: Balance of opinion on increase in investment and employment (%)

BUSINESS CREDIT GROWTH REMAINS ELEVATED

Canada’s business credit growth has been on an upward trend since February 2010, when it had declined by 0.4% YoY. Business credit growth picked up to 8.0% YoY in October 2014, following a 7.1% YoY growth in July. Household credit growth also emerged from cycle-lows, rising 4.5% YoY in October, which represented the quickest pace of growth since February 2013. Residential mortgage growth, though remains low, is showing early signs of recovery as growth maintained its pace in October, rising by 5.1% for the third consecutive month. Despite the slow household credit growth, indebtedness among Canadian households (the ratio of household debt to disposable income) increased to a record high in the third quarter (162.6%), as disposable income grew slower than debt.

Chart 5: Business and household credit growth (%)
Chart 6: Consumer credit growth has slowed down (%)

INFLATION SLOWDOWN

Canadian inflation slowed to 1.5% in December as cheaper gasoline caused the rate to be below the Bank of Canada’s inflation control target of 2%. Gasoline prices helped to ease inflation, partially offset by continued weakness in CAD against USD. Gasoline prices declined 5.9% in November, down to their lowest level since February 2011, which dragged the overall inflation down. The Bank of Canada reduced the bank’s key rate to 0.75% highlighting that the plunge in world oil prices would further lead to a slowdown in the inflation rate.
VALUATION

The Canadian stock market has been on an upward trend since the middle of 2012. After touching a new 5-year high in early September, the Toronto Stock index (TSX) has corrected sharply, falling over 4.2% in September to record its worst monthly loss since May 2012. The correction was in line with the weakness in global markets, as concerns about a slowing global growth hit investor sentiments. Nevertheless, the TSX has started to recover from the sell-off. After falling more than 11% in 2011, the TSX gave a positive return of 3% in 2012, followed by a gain of more than 10% in 2013. Further, the TSX ended 2014 at a level of 14,640, implying a full-year return of around 12%, representing a third consecutive year of positive returns. The TSX is currently trading at 2015 forward PE of 17.4x as compared to a 5-year average of 13.9x. The median forecast of a poll conducted by Reuters indicates that analysts expect the TSX to touch the level of 16,000 by mid-2015, implying a 9% rise from its current level.
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