Preparing Middle East portfolios for a challenging 2017

A turbulent 12 months beckons given the uncertainty over Trump's policies, elections in key European countries and potentially slower growth in China. Investors in the Middle East should factor in these risks and seek more portfolio diversity, according to speakers at the annual Hubbis Middle East Wealth Management Forum 2017 in Dubai.

Perhaps the biggest risk in 2017 for Middle East investors will be the concept of not being invested.

The foreseeable clouds on the horizon are manageable, according to some investment specialists.

In fact, some of the biggest perceived risk events of 2016 – such as Trump's win and European elections – turned into the most rewarding trades of the whole year.

Where there is cause for uncertainty, however, stems from the unknowns around some of Trump's policies, says Oliver Kettlewell, portfolio manager at Mashreq Bank.

"His pro-growth policies which should be good for growth, and therefore equities, are hard for him to get through Congress," he explains. "On the other hand, trade tariffs are worse for growth but he can enact these more easily."

The risk of trade wars is a concern to many practitioners. "Russia, China, North African and Middle Eastern countries are all impacted by a potentially very-much-changed world order," explains Gerhard Schubert, founder of Schubert Commodities Consultancy. "All of this will greatly increase uncertainties and therefore volatility in all financial markets."

For Gary Dugan, chief investment officer at Emirates NBD, there is reason to be concerned about Trump being antagonistic on the global scene. "We have to look out for this," he adds.

Yet it is unrealistic to expect anybody to be able to turn around the US economy given its structural problems, adds Mohieddine Kronfol, chief

meaning people will want to get paid more to off-set this. "As a result, some of the valuations we see today have got to correct."

Yet regardless of the risks, identifying and getting paid for them drives the Franklin Templeton philosophy, rather than trying to avoid them.

"The research and process is paramount," explains Kronfol, "and must be consistent with the investment universe and product objectives."

investment officer, global sukuk and MENA fixed income, at Franklin Templeton Investments.

"So I wouldn't anticipate radical changes with regards to asset allocation," he adds.

In Europe, meanwhile, the uncertainty of the French elections might undermine the EU and the Euro.

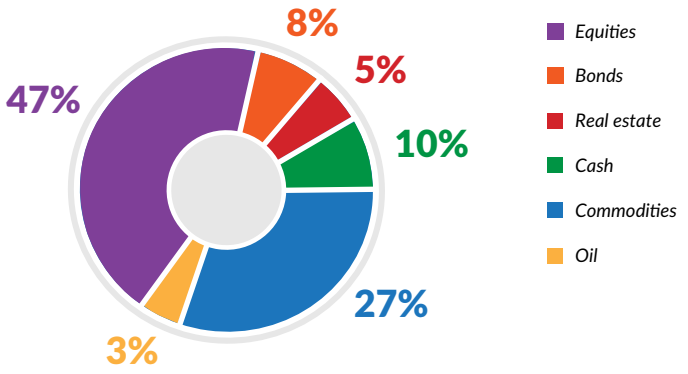
At the same time, the protectionist policies across Europe which are gaining traction could impact global growth.

Further, although one of the biggest problems around the world is the redistribution of wealth, Trump's income-tax policies go in the wrong direction on this, says Dugan.

"The 'noise' [around his policies] at the moment is good for equities, but the latter part of the year will be more of a struggle," he explains.

A combination of the various uncertainties seems to be sending investors in a direction of travel that suggests there is more risk around, he adds,

WHICH OF THE FOLLOWING WILL PERFORM BEST IN 2017?



Source: Hubbis Middle East Wealth Management Forum 2017

"The Middle East investment community will be, in my opinion, a cautious spectator in 2017."

GERHARD SCHUBERT
Schubert Commodities

PLACING YOUR BETS

There are mixed views about which asset classes investors should expect to perform best in 2017.

From some perspectives, equities are likely to do well initially. This was reflected in a sentiment poll among delegate at the Forum.

But some speakers pointed to the fact that corporate profit growth might not come through as strongly as predicted, Plus, some black swans will affect market pricing.

As a result, fixed income might be a better bet. "I am looking for a buying opportunity in bonds, and they could end up, as an asset class, outperforming equities overall," says Dugan.

Indeed, adds Deepak Mehra, head of asset management, general management, for Commercial Bank of Dubai, the worst thing for equity markets is uncertainty of policy. And this exists from the US to Europe to China.

He believes that the right approach is to take risk off the table. "Over the past few years, investors have been buying equities for income and bonds for capital appreciation. This is not sustainable."

In line with this, Schubert, predicts much higher levels of volatility in 2017 than there was in the previous months.

For Mehra, he is bullish about some specific asset classes which provide an in-built hedge against higher inflation and interest rates. This includes, for example, income-generating commercial real estate in the UK at current levels of sterling, and also income-generating German commercial real estate given the benign interest rate outlook in the Eurozone. Equipment leasing funds in the US are also firmly on his radar.

STRIVING FOR MORE DIVERSITY

Regardless of the investment outlook for 2017, however, there remains a big requirement in the Middle East for diversification. Dubai is arguably winning the diversification battle. Non-oil industries such as tourism, real estate and airlines are more developed, plus there are 'free zones' such as the DIFC help to encourage foreign direct investment and improve diversification.

Many of the other GCC states are less diversified, continuing to be more reliant on state spending and subsidies.

As a result, a greater emphasis is needed on private sector participation. For example, GCC governments own around USD250 billion in local-listed stocks which could be unlocked to kick-start non-oil industries.

At the level of an individual client portfolio, many investors are still too reliant

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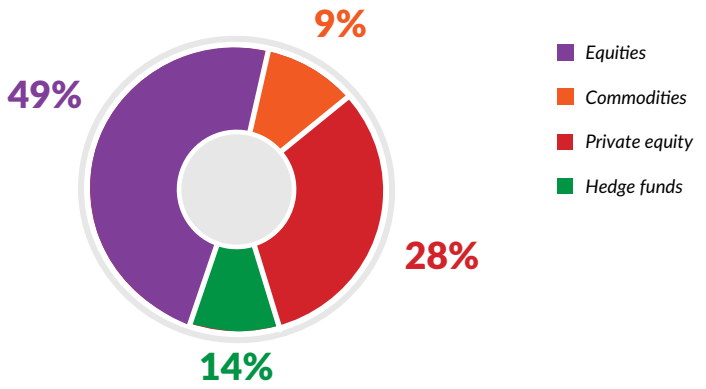
MOHIEDDINE KRONFOL
Franklin Templeton Investments

HOW SHOULD INVESTORS IN THE MIDDLE EAST BEST DIVERSIFY?



Source: Hubbis Middle East Wealth Management Forum 2017

on local-market stocks and bonds. But according to Kronfol, the region must focus more on fixed income to build more efficient portfolios.

There is some take-up of funds, meanwhile, as the quickest and cheapest way to diversify.

This also highlights the increasing role for managed investments. And especially in the current environment, where returns will be harder to come by and volatility is higher, the importance of rebalancing cannot be overlooked.

More specifically, managed portfolios help clients move away from the concentration risk of owning a few local-market securities towards a globally diversified solution.

A lot of advisers and clients are also demanding passive options, such as ETFs and index mutual funds, as the answer to every allocation decision.

While passive funds are most appropriate in some more developed markets, like the US. Yet for emerging markets, Kettlewell says that the current low-return environment potentially makes these instruments less attractive compared with the early years of the current bull market.

Looking wider, there is always a place for alternatives in client portfolios, given their different return-drivers to bonds and stocks. Some investment specialists also believe that alternatives will be even more attractive in 2017.

This is based on bonds and stocks being expensive and open to volatility from geo-political risks.

Separately, the new globally-accepted and binding rules for Shariah-compliant investment products for gold have removed all uncertainties associated with them, says Schubert.

He believes this should be a major boost for investor clarity. And in turn, this should lead to more investments into gold as an asset class diversification tool.

"The Middle East investment community will be, in my opinion, a cautious spectator in 2017 with the new US administration in place, ongoing Brexit talks and elections in Netherlands, France and Germany," adds Schubert.

PREPARING INVESTORS

Some practitioners say 2017 will be about wealth preservation, not necessarily growth.

"It appears to be clear that certain equities should benefit more than others under the new US administration," explains Schubert.

Equities in infrastructure companies, for example, should be a strong benefactor if the new administration is to be believed.

"However," cautions Schubert, "most companies involved in this have already seen their stock prices readjusted and the rest of the world will want to wait what a very clearly stronger domestic US policy means for the rest of the world."

"The US might be in danger to become too closely looking inward and not noticing what damage these policies can have for many other countries," he adds.

More broadly, it is increasing challenging for wealth managers to manage future expectations when past returns have been so good – for example, the 35-year bull market in bonds, or the S&P 500's eight consecutive calendar year of gains, says Kettlewell.

As a result, investors must be prepared for lower returns due to lower growth, lower interest rates and inflation.

One approach is educating clients to stop comparing illiquid, local-market real estate returns with liquid stocks and bonds. ■