GDP behind, Central Banks ahead: **the resilience question.**

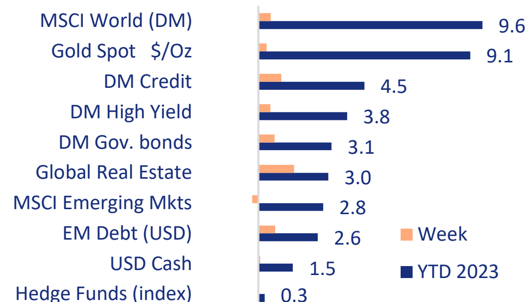
- **US Q1 GDP grew less than forecast, with persistent inflation, but markets were not derailed**
- **It is a big week ahead for Central Banks with both the Fed and the ECB expected to hike**
- **The short-term outlook still looks reasonably benign, but some valuations remain a bit optimistic.**

Last week was rich in terms of data, be they corporate earnings or important top-down numbers. Among the latter, first-quarter GDP growth for the US came in at +1.1% annualized, clearly below the median forecast for +1.9%. By contrast, the Fed's preferred measure of inflation, the core PCE, didn't show any sign of weakness at +4.6% year-on-year. No matter how optimistic one can be, there's no way this can be seen as good news. Markets, however, didn't blink. Almost all major asset classes delivered positive weekly returns, led by listed real estate and safe bonds, but closely followed by stocks from developed markets.

Are we witnessing dangerous complacency? The answer is certainly not binary. First, bottom-up factors were not bad, with impressive quarterly results from some big tech names in particular. Second, the top-down picture deserves more details. Global growth is on track for a very robust +3.6% gain in Q1, which is way better than many had feared. Third, the disappointment from US Q1 didn't come from the almighty consumer but from weakness in corporate spending and inventories. This doesn't look like the beginning of the end. Resilience persisted in Q1 and was not derailed in April, but the question remains open looking forward. A key component of the outlook is of course the level of tightening from central banks, and to that extent, the week ahead will provide some answers: rate hikes from the Fed and the ECB, but most importantly, comments and hopefully some guidance. We will also look at the US monthly job report Friday.

We stick to our large overweight in cash and safe bonds, against an underweight in hedge funds, riskiest bonds and DM equities, whose valuations discount an ideal scenario that, while possible, is certainly not a given.

ASSET CLASSES USD % TOT.RETURN, YTD 2023 & LAST WEEK



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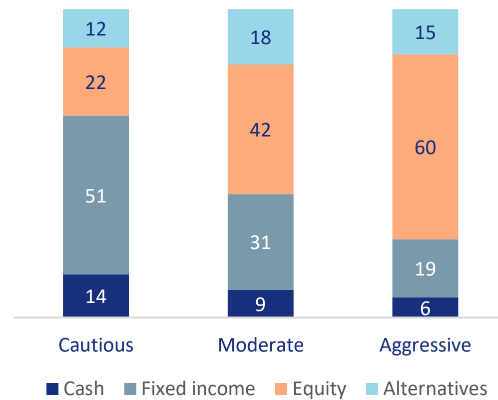
Cross-asset Update

The banking crisis is again making headlines, following evidence of more deposit flights from regional banks and First Republic's failure. We hold the view that liquidity leaving the smaller lenders is the consequence of the Fed's very tight policy that the banking system as a whole cannot sustain for long. A deeply inverted yield curve limits lenders' profitability and in the end their balance sheets deteriorate and credit availability must shrink. Yet, another major liquidity-draining factor, the debt ceiling issue, is at work and we suspect it will compound the negative effects of the banking sector's woes, soon making for a hostile environment of tighter financial conditions for risk assets.

It is currently projected that the US Treasury would be running out of available funds to pay its debt as soon as early June, unless the debt ceiling is raised by Congress and the Treasury is then allowed to again issue bonds to finance it. Under these conditions the Treasury redirects funds as much as possible towards debt repayment, while limiting new issuance. This injects net liquidity in the system, as the Treasury expenditure is not offset by new debt securities that must be paid for. Once Congress has agreed on a new limit, issuance will increase dramatically to replenish the Treasury Generally Account, and liquidity will be drained from markets accordingly. And this should start from June, if forecasts about when the Treasury's available funds will run dry are correct. Also, banks must meantime decide where to invest the liquidity they will set aside to tackle ongoing deposit withdrawals. T-bills 3 months from now are exposed to the debt ceiling issue, that is to the allegedly negligible probability of a US default, and at other maturities it is more convenient for lenders to park money in reverse repurchase agreements, than to buy short-dated US debt securities. Once money is absorbed by RRPs, whereby banks swap funds for shorter-dated securities yielding the so called RRP rate, the money leaves the banking system and is not available for lending. This will be compounded by the fact that depositors, withdrawing money from low-yielding current accounts, will be placing it in more competitive money-market funds, also investing in reverse-repurchase agreements.

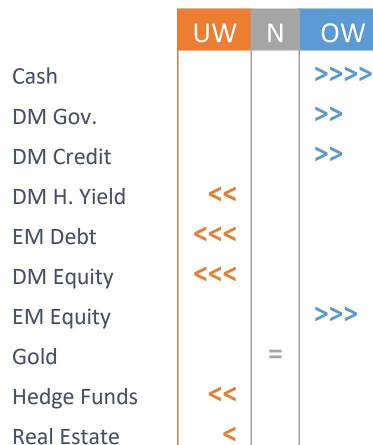
In summary, the intersection of the banking crisis and the debt ceiling is going to cause significant liquidity to leave markets, either due to new treasury issuance from June, or to the swelling of RRPs as the crisis progresses. This is going to affect risk assets, and the US dollar in different ways. Equities are likely to pull back, credit spreads to widen, and the dollar to start bottoming out in anticipation of a deteriorating outlook. We continue to advise clients to lean defensive and remain overweight cash, mirroring our current tactical asset allocation.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING



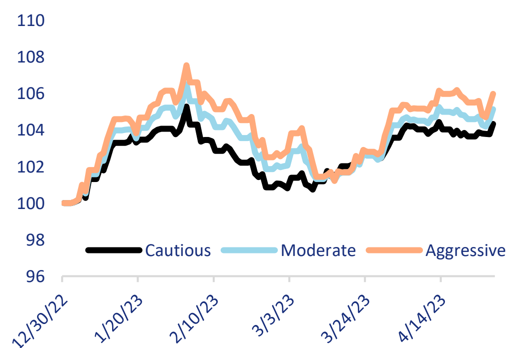
TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight



	UW	N	OW
Cash			>>>>
DM Gov.			>>
DM Credit			>>
DM H. Yield	<<		
EM Debt	<<<		
DM Equity	<<<		
EM Equity			>>>
Gold		=	
Hedge Funds	<<		
Real Estate	<		

TAA – 2023 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

The calm that we spoke about last week is nerve-racking. The macro data that came out last week were the worst of everything, with slower than anticipated GDP growth (US Q1 GDP 1.1% Vs. 1.9% cons.) and higher than expected inflation (Core PCE QoQ 4.9% Vs. 4.7% Cons.). Given the background, the FOMC meeting due to start on 2nd May gets great importance. Our base case is for a 25 bps hike and then a pause. However, investors will be equally anxious to listen to Chairman Powell's presser and Q&A statement that will be parsed minutely for implicit messages. In the last four instances of pauses, we have seen the 10-year yield go down, and there have been zero instances where 10-year yields have gone up within 180 days after the pause. The credit spreads have compressed in the six months following the pause in two cases but have blown up after that in 100% of the instances, making us very wary of the riskier segments. We are not sure that this time it will be different.

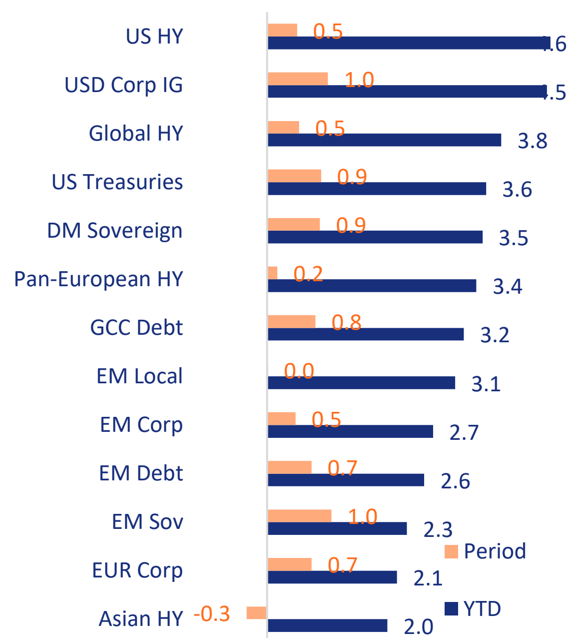
There is a lot more uncertainty brewing in the markets. The US debt ceiling continues to be an overhang. During the last crisis in 2011, the 10-year treasuries dropped sharply as the X-date of 2nd August approached. It continued dropping post-July 31st when the deal was agreed to reach a nadir of 1.75% in early September. Similarly, the spreads rose slightly from May onwards to peak in early October. As we approach the expected X-Date in late June this year, we should see volatility increase. The worst affected security is typically the nearest expiry bill/bond to X-Date. The current steepness in the 1 month-3 month T-Bills is a testament to that, despite the market pricing in a pause after the May FOMC. Similarly, the US CDS curve is inverted, with investors demanding a sharp risk premium in the front end. In addition, indicators such as Senior Loan Officers survey, CBOE LEI, and a 20% increase in YoY Jobless Claims all paint a somewhat volatile picture. Therefore, we would be very cautious of adding risk now.

The uncertainty is reflected in the Emerging Market Debt issuance as well. Global EM primary bond emerging market issuance, having started the year strongly, has precipitously fallen throughout the months since January. April's total of $28.36bn is the lowest figure for April since $23.96bn in 2009. GCC has been leading the issuance bandwagon with more than $30bn bonds priced YTD due to issuance from IG sovereign-related entities and banks. The only spot of bother in MENA is Egypt, where the one-year CDS spreads have reached the highest-ever level of more than 2,000 bps. The $20bn financing requirements for 2024, according to S&P, remain a big challenge. Egypt needs to implement the reforms suggested by the IMF, including divestment of state assets and increasing private sector participation to improve long-term investor confidence and short foreign capital inflow. Without these, Egyptian transactions with the rest of the world would slow significantly, with negative implications for GDP growth, and this could translate into fewer incentives to service external debt.

FIXED INCOME KEY CONVICTIONS

DEVELOPED MARKETS
OW Quality corporates
OW Government Bonds
UW High Yield
EMERGING MARKETS
Overall UW EM Debt
Favor quality and selectivity
OW Selectively Asia, LatAm

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

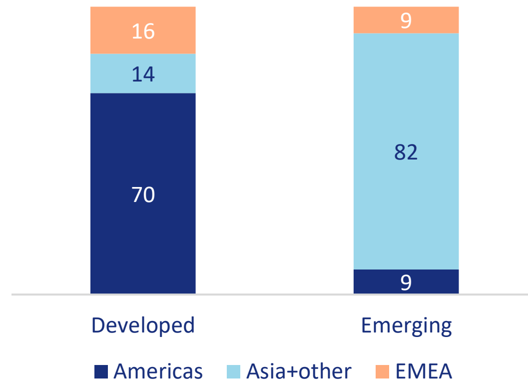
One third of the year is over, with markets supported by the resilience of big banks and big tech and central-bank tightening on the wane. Global equities are up 9% year to date, with developed markets a little better and emerging markets lagging at +2.8%. Europe leads regional performance, with luxury stocks on a tear in a world where global growth is slowing. All global sectors are positive, though with wide variance from +20% for tech to just being in the green for energy and healthcare. UAE and KSA equities had a great performance in April +9.5% and +6.5% respectively as economic data, investment, tech innovation, tourism and real estate are all in an uptrend. Banks which are a major component of UAE listed stocks, announced bumper profits on higher net interest margins. Other emerging markets have seen a rebound with India +4% in April, but a dismal month for China at -5%. The latest eco stats from China were not overly supportive.

US Treasury yields have been volatile, surprisingly more so than the VIX Index, which is close to 3-year lows at 15.8. The Fed and ECB are both expected to hike by 25 bps (more from the ECB if inflation data disappoints) an outcome already priced in by markets. The Fed's direction on economic growth and inflation remains important as inflation numbers are still above central bank targets. Consumers have, so far, accepted price hikes as results from Nestle, PepsiCo, Coca-Cola and Procter & Gamble indicate. Yet the University of Michigan survey data shows sentiment remains subdued and labour wage hikes could become a drag on the so far robust earnings.

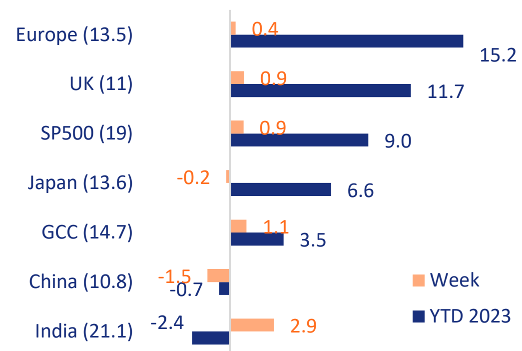
The S&P 500 ended the week almost a percent higher, with April overall +1.6%, as better-than-expected earnings outweighed concerns of rate hikes, persistent inflation and signs of slowing economic growth. The Nasdaq, flat for the month, gained 1.3% last week with tech earnings surprising to the upside. The S&P has been in a range of 3,800 to 4,300 the past few months and we have a neutral outlook as neither valuations or earnings growth is compelling enough to take an overweight stance and expect that with earnings season half way through, the market may take a breather. The reporting season has seen big tech surging on cloud, digital-ad growth and talk of future revenue to be generated from AI. Though Amazon disappointed on April guidance on weakness from its most profitable division Amazon Web Services, it is the largest contributor to earnings growth for the S&P 500 for Q1 and 2023. For Q1 2023 (53% reported), the blended earnings decline is -3.7%, from an estimated -7% at the beginning of April with revenue growing at 2.9%.

Global bank stocks had a positive April but regional banks are not out of the woods as First Republic Bank is in the market for bidders having lost almost 70% of deposits, with no scenario good for current shareholders. It was supported by deposits of $30bn from 11 banks but that wasn't enough. Contagion looks limited, though worries on commercial real estate loans are increasing. Flows to big banks and money market funds continues. JP Morgan has amassed more than 10% of total deposits in the US. It looks like the long-term consequence of these bank implosions may be stricter regulation for smaller banks.

EQUITY RECOMMENDED REGIONAL POSITIONING

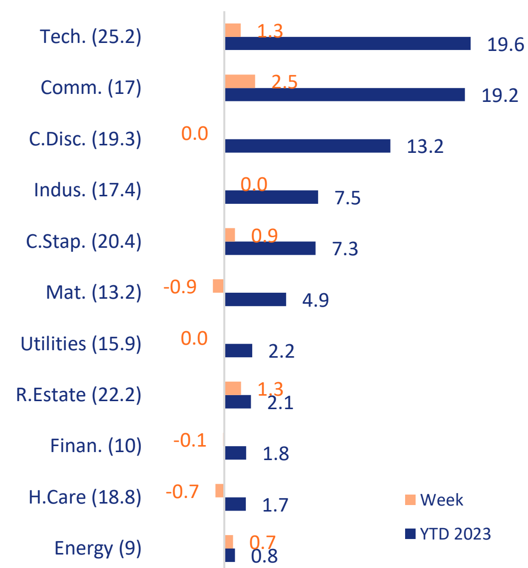


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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