Hawkish Fed versus improving macros

- **Chair Powell and Fed speakers reiterated the need for higher rates for longer**
- **Markets saw some profit taking caught between restrictive policy and improving macros**
- **China-US tensions back to the fore with more suspect objects downed in US skies**

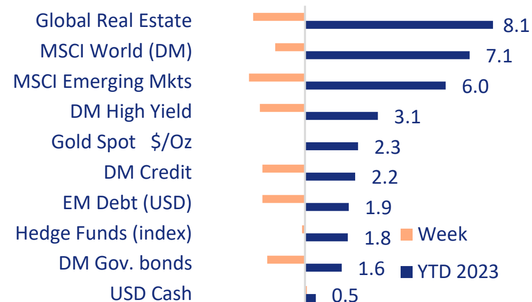
Risk assets closed the five days through Friday in negative territory across the board, even as treasuries lost ground amidst a stronger US economy and more hawkish messages from central bankers. Hedge funds and gold closed little-changed, not offering much relief alongside cash in a week that saw resurfacing concerns about the impact of tighter policy.

Fed chair Powell warned on Tuesday that rates will have to be raised more than investors expect, since it will take "a significant period of time" to curb inflation due to a stronger labor market. The message is starting to sink in, with futures now discounting rates to peak slightly above 5% in July and expectations for cuts pushed into 1Q24 from 2023-end. A series of senior US policymakers also reinforced the message, dashing hopes for a Fed pivot this year. The US, and in general the Western economies, continue to be stronger than anticipated, keeping both the Fed and the ECB in tightening mode, in turn capping the returns of risk assets. Investors will be closely watching for a deterioration in the earnings outlook, as in past cycles earnings recessions started when the Fed paused tightening.

Given the future uncertainty in terms of growth and inflation trade-off, as well as the current valuations, we continue to see value in higher quality bonds, while equities in the developed markets look priced for perfection. Investors seeking growth are advised to prefer emerging to developed market stocks, supported by the Chinese recovery as well as moderate multiples.

The week was also marked by resurfacing geopolitical tensions, that markets took in their stride, as the US shot down more allegedly Chinese objects flying over its skies. Stay safe.

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



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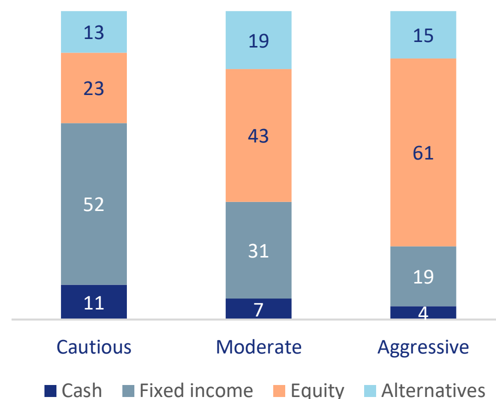
Cross-asset Update

Developing-country equities have seen an impressive rally since October-end, rising more than 19% in dollar terms as of last Friday, as compared to more subdued gains of 9.3% for their DM peers. And January actually saw the best three months in a decade of cumulative returns across all of the EM asset classes, equity, local bonds and currencies. But year-to-date US and European stocks have accelerated higher and more than closed the gap. We have advocated for an EM equity overweight since the start of the year, predicated on the reopening of the Chinese economy, and we still hold the view that that trade has more to go.

The recovery in China is driven by the pent up demand of consumers that had to accept exceptionally long lockdowns in 2022, during which they accumulated savings. The real estate sector, structurally impaired due to excessive leverage and supply and expected to be in stagnation for years, will not be the natural destination for the bulk of those savings, that should then end up being spent on consumer goods and services. The process should be gradual, and as personal expenditure increases, and is reflected in improved macroeconomic releases, local equities should continue to rise. Business confidence is picking up, with the January services PMI now well into expansion territory from deeply recessionary levels and the manufacturing sector also starting to expand. The Chinese expansion will have positive spillover effects to all of EM Asia, and Taiwan and Korea are the markets that have so far benefitted the most from the Chinese change of fortunes. To be sure, the EM rally has not been broad-based, with Mexico participating as well, but Indonesia unchanged, and Brazil and India in negative territory in the last three months. Yet, in the short term the global growth environment remains favorable for EM equities, with the harsh slowdown from overtightening that was expected both in the United States and in Europe now delayed, possibly until the second half of the year. The Chinese credit impulse, that began to inflect higher in November 2021, has historically been leading both Chinese equities and global business confidence by about 12 months. This may also be why Western markets bottomed in the last quarter of 2022, and more importantly why Chinese equities should still have room to rally into the first half of this year.

Investors should also be mindful the EM rally will not proceed in a straight line, with some of the easy money most likely behind us. Both the Fed and the ECB are not done hiking rates, and risks from overtightening seem now skewed to the upside in the United States following the recent strong jobs and consumer confidence reports. Yet, the ongoing easing of policy in China should offer some cushion, while at the same time being a reason to prefer assets underpinned by expansive policies versus markets capped by tightening measures.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

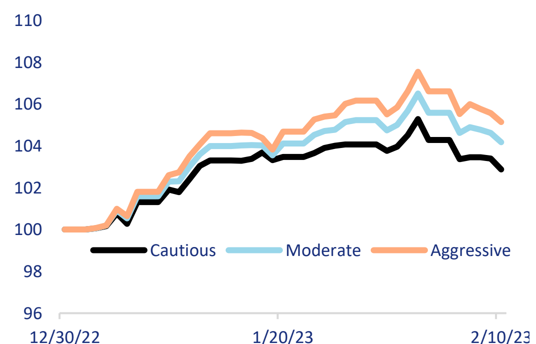


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight

	UW	N	OW
Cash			>>
DM Gov.			>
EM Debt			>>
DM Credit	<		
DM H. Yield	<<		
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 everything rally stopped as abruptly as it had started. Markets finally succumbed to a combination of hawkish Fed, strong US Jobs data and the anticipation of the US CPI due on 14th February. The result was that the bond yields moved up and credit spreads widened. The US Treasury curve bear flattened as at the front-end 1 and 2 year rates moved up by close to 25 bps, while the long end moved up by around 20 bps. The 10-year US Treasury yield crossed 3.7% for the first time since the first week of January. The market now prices a peak rate expectation of 5.2%, up from 4.85% barely a couple of weeks ago. Moreover, the rate cuts priced in for 2023 have significantly come down to 27 bps from the earlier 49 bps. In the last Weekly pubblication we had mentioned about the importance of the 2-year yield, sensitive to Fed policy and that is currently within striking distance of its highest level in the current cycle.

The OAS spreads of the different credit segments widened with High Yield and Emerging Market Debt being the worst affected. The High Yield spreads widened by 25 bps last week and generated -1.09%. At the same time EM Debt spreads widened by 7 bps but the increase in yields hammered the segment which has a long duration at 6.41 years. It was one of the worst performers returning -1.14 last week. As expected this bearish sentiment of investors meant that the safest asset classes were the best places for investors even though all segments were in the red.

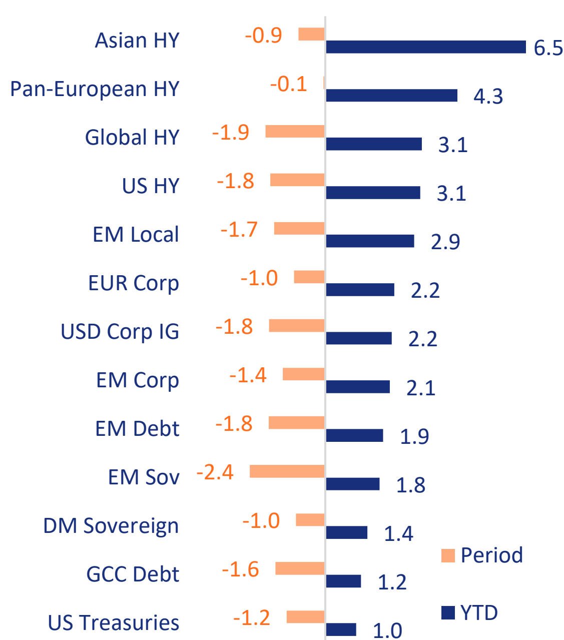
Egypt's sovereign curve saw a widening in spreads across all tenors, with one-year spreads widening the most by 200bps in the last three months. This can be attributed to the higher inflation and Moody's rating downgrade. Goldman expects an unscheduled rate hike before the next meeting scheduled on 30th March.

The primary issuance market from the region revived last week with as many as four deals. Out of $11bn deals, we saw $10bn deals from the Kingdom of Saudi Arabia. The Public Investment Fund tapped the markets for the second issuance after their inaugural $3bn issue in October 2022. PIF, rated A1/A (Moody's/Fitch), sold a $5.5bn multi-tranche bond with maturities of 7, 12, and 30 years at yields of 4.93%, 5.13%, and 5.59%, respectively. Another issuer from the KSA region was GreenSaif pipelines, rated A1/A (Moody's/Fitch) issued its amortized structured sukuk (10-year) and bonds (15 and 19 year) at 5.78%, 6.13%, and 6.51%, respectively. DIB issued $1bn, 5.5-year sukuk at 4.8%. Emirates Islamic Bank issued its inaugural 3-year AED-denominated bond worth AED 1bn at 5.05%. Most of the above securities saw yield compression ranging from 5bps to 35bps.

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

Markets ended lower for the week, with both Emerging, ” EM”, and Developed markets, “DM”, declining but with DM now outperforming and ytd, DM and EM equities are up 7% and 6% respectively. Last week US indices saw the S&P 500 -1.1%, and the Nasdaq -2.4%, with the Eurozone at -2.8%. Asia saw most major markets down with the MSCI China at -3% and India at -0.7%. The India indices were led down largely by FII outflows and a reduction from MSCI EM index of the Adani companies. The global energy sector shone last week with the double whammy of oil E&P companies with record profits and higher oil prices.

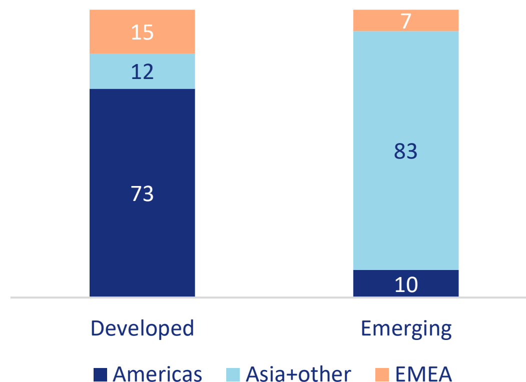
UAE indices were the only notable positive performers with the Dubai Index +2.1%, as earnings were mostly encouraging as were dividend increases. Aldar, DEWA and ADNOC Distribution announced strong profit growth and dividend pay outs. We remain overweight UAE equities for a third year. The Saudi Capital markets forum is currently underway and focused on innovation and capital growth. The UAE and the KSA are expected continue into 2023 with successful new listings.

Last week, US equity markets continued to absorb the implications of monetary policy commentary, resilient economic data, and mixed corporate earnings. US Treasury rates ticked higher, the inversion between yields on the two- and 10-year notes hit the deepest level since 1981 and recession worries increased along with higher rates for longer on the strong labour market. The MSCI China’s strong YTD performance has been supported by China’s reopening, eased regulatory crackdowns on the Technology sector, property market support, and expectations that global central banks may be set to slow down monetary policy tightening. The central bank injected some $150bn into financial markets last week to ease a liquidity squeeze, keeping policy relatively loose. Geopolitical tensions between the U.S. and China remain heightened with tech investment from the US into China discouraged.

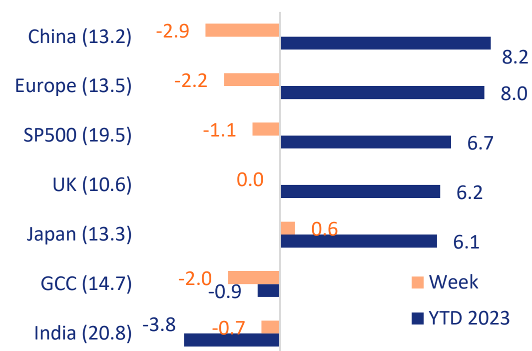
ChatGPT and A.I. chatter has hit a fever pitch. Over the medium term generative A.I. remains one of the more important technology paradigms of this cycle. Nvidia, a critical supplier of high-end chips for computing, has seen a 50% rise in share price since December. Chinese tech companies Baidu, Alibaba and NetEase have also announced plans to expand AI capabilities, fueling gains in their shares. Alphabet’s Google has a 93% market share in search (with $163 bn in search advertising last year) and shares fell 10% last week after concerns surfaced about the competency of Bard, the ChatGPT rival it unveiled on Feb. 6. Microsoft, a significant investor in OpenAi the company behind ChatGPT, launched a new version of its Bing search engine with a chat feature. However, language queries are 5% more expensive and would hit margins.

Earning results have been mixed, but across the US, Japan and Europe Q4 has seen a decline in earnings compared to Q4 2021. Revenue growth has been healthy from +5% in the US to +12% to +15% in Europe and Japan. Guidance is being scrutinized as corporations try to determine the ultimate impact of the aggressive Fed monetary policy tightening on economy earnings.

EQUITY RECOMMENDED REGIONAL POSITIONING

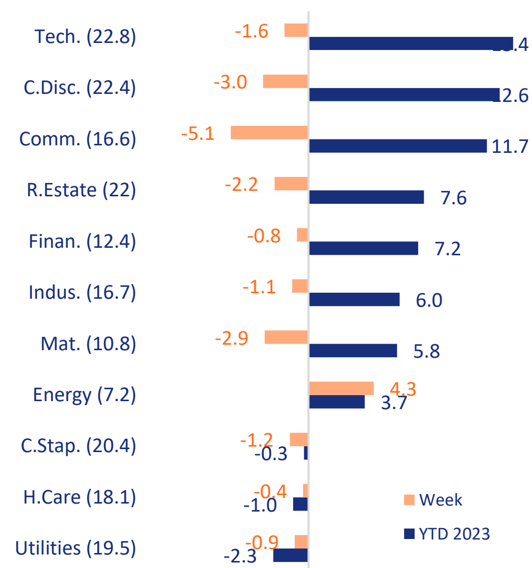


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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