Emirates NBD
WEALTH MANAGEMENT

Is a US default on its debt **unthinkable?**

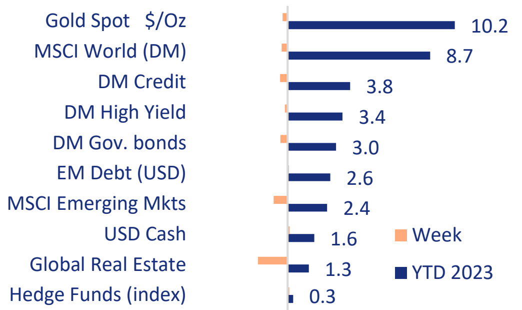
- **Last week was negative for most markets, with recession concerns and uncertainty about the US debt ceiling**
- **We do not think a US default will happen but definitely expect volatility to trend higher**
- **We materially increased our allocations to money market, this time by going underweight on equity**

Last week was eventful, with good economic data from Asia, a confirmation that inflation stopped increasing in the US but remains a clear concern in the West, and importantly the US debt ceiling issue generating increasing anxiety. Overall, we may only have a limited number of rate hikes ahead, but the pressure will continue to be felt on the economy, especially as it combines with tighter credit standards from banks.

Recession risk pushed stock prices lower last week, now that the bulk of the earnings season is behind us. Bonds were no shelter due to the uncertainty surrounding US sovereign debt. Should we think the unthinkable: a debt default from the world's largest economy? Most probably not, but uncertainty is everywhere: on the negotiations, on the funding deadline and even on the details of what would happen in case there's no deal.

Against such a backdrop, our monthly TAA Committee decided to increase our allocation to cash by 2 percentage points, lifting it to a record high +6 percentage points across profiles. We funded this increase by decreasing equities, where we are now underweight for the first time this year. The rationale is simple: we think that volatility should rise, or even potentially spike, given the incredible collection of potential concerns. Cash is King in such a context for its downside protection and flexibility, but in addition, the risk-adjusted yield it provides on a tactical horizon is simply unparalleled with this level of confidence. DM stocks are priced for a perfect scenario that may, or may not, happen. If it does, we believe that stocks from emerging markets would benefit more. If it doesn't, we will have opportunities to put this ample cash reserve to work down the road. The weeks ahead will be dominated by the US debt-ceiling debate. Stay safe.

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



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Cross-asset Update

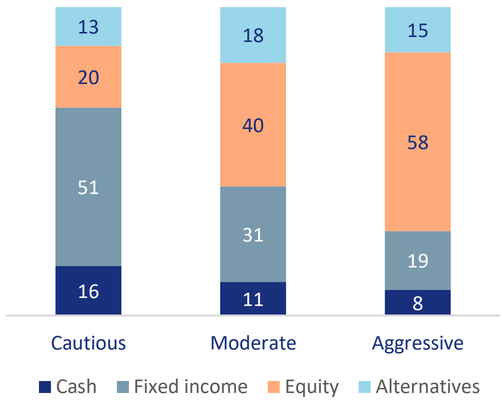
Both stock and money market investors are looking to a time when the Fed will be easing, but for different reasons and highlighting a growing divergence between the two. Fed funds futures indicate cuts in the second part of the year that would be coming to pass only if a shock hits the economy, that is a banking crisis or a recession, while equities remain richly valued buoyed by the hope of the easing of policy. The divergence will have to close at some point, and most likely to the disadvantage of equity investors that will have to take stock of an unfavourable outlook. Indeed, Jay Powell in the post-FOMC press conference mentioned that the Fed will give priority to inflation rather than employment in its dual mandate, that makes the hurdle to easing policy particularly high in order to avoid reviving price pressures with premature cuts. The current equity rally does not seem to be on a solid footing either, driven by few mega-caps and skewed towards high quality stocks, pointing to a defensive stance, hence little conviction amongst equity investors themselves.

The transmission channel of a crisis could be provided by the tightening of bank credit as lenders reduce credit supply and set aside liquidity to tackle business volatility and deposit flights. And according to the Fed's Senior Loan Officer Survey, a quarterly gauge of bank credit conditions, credit data is showing tighter financial conditions, that are already at levels that in the past triggered a recessionary phase. Also, the debt ceiling issue is occurring at an unfortunate time, since as soon as the ceiling is lifted by Congress, significant issuance will be required to replenish the Treasury General Account, that is going to withdraw liquidity from the market. The expectation is for Congress to reach an agreement just before the Treasury runs out of money, projected to occur sometime in early June. The combination of lower liquidity and tighter credit will be a tough test for the still optimistic equity market.

The recent rebound in the US dollar suggests investors may be starting to hedge their bets, as the global reserve currency tends to rise either when US growth beats that of peers, or during times of financial strain. We see more upside on the US dollar also on account of extremely bearish positioning, at least until there is high uncertainty about the odds and extension of a US recession.

Overall, tighter credit conditions, lower market liquidity, a narrow equity rally and a rising dollar bode ill for risk assets in the next few months. Investors are advised to be high in quality across asset classes and keep some cash on the side, along the guidelines provided by our Tactical Asset Allocation Committee.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

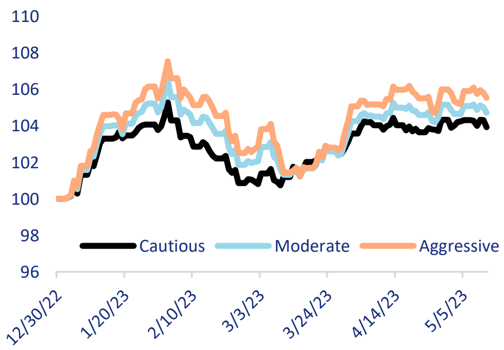


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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 US debt ceiling issues has dominated almost every investor discussion we had in the past couple of weeks. The last time it attracted such interest was way back in 2011. Contrary to expectations, the long-duration treasuries rallied as we approached the X-Date then, with the rally continuing a month after the agreement was reached. JPM recently concluded an institutional investor survey on the topic. No wonder expectations mimic last time's price action. Two-thirds of the correspondents estimate the 10-year to move down by more than 20 bps with a moderately flatter 2s10s curve. An overwhelming 99% and 97% of respondents expect wider IG CDX and JULI spreads, by an average of 44bp and 66bp, respectively.

Dissonance remains between the bond market that expects rate cuts this year and the Fed's rhetoric of not seeing any rate cuts. The 2-month T-Bills dropped by 36 bps last week. We find the 3 to 5-year treasuries very rich and expect yields to back up by 25-30 bps. 67 bps of rate cuts priced in by the end of this year, which seems a bit excessive, and yields could move up slightly from current levels as the market reprices its expectations. Current credit spreads have been relatively stable and range bound. However, we are wary of the optimism of credit spreads. The HY default rate jumped in April and is expected to continue rising over the coming months due to base effects.

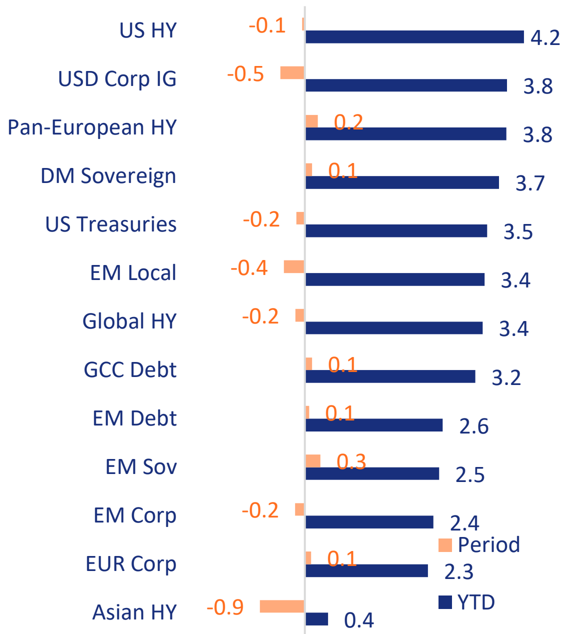
GCC Primary issuance gathers steam this week. After last week's strong Mubadala issuance, KSA is in the market today for a dual-tranche 6 and 10-year sukuk issuance. The IPTs are wider to the underlying sukuk curve by 40 and 70 bps, respectively, but we expect the final pricing to align with the sukuk curve. The 10-year looks interesting as it extends the sukuk curve by 2 years and may leave some premium for the investors. Nogaholding has issued a tender for its 2024 notes and may issue either a 7 or 10-year sukuk, according to the announcement. Some D-SIBs from the UAE and Real Estate players could also tap the markets this week.

We recommend clients stay within 10% of their Fixed Income AUM on both names combined. Egypt has made a list of 32 issuers for IPO on its local markets. Egypt sold a 9.5% stake in state-run Telecom Egypt Co., raising more than 3.7 billion Egyptian pounds ($121 million) in a signal to investors that the country is serious about implementing a comprehensive economic reform program. Turkey's close elections have affected the markets as an opposition win was priced in. As a result, the 5-year CDS has widened by 90 bps, and the market will remain volatile.

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,

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



Source: Bloomberg

Equity Update

Excitement continues around generative AI and which assistant will be the best i.e. Apple's Siri, Amazon's Alexa or Microsoft or Google's and this helped tech stocks to another week of gains with the Nasdaq now +18% year to date. Inflation numbers were not alarming, though way removed from central bank's target and continuing banking sector woes along with the US debt ceiling crunch-time looming had global equities overall lose 0.4% last week with most major markets lower. Exceptions were the KSA, India and Japan.

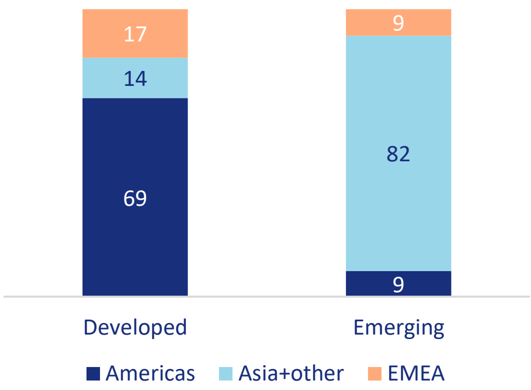
We held our asset allocation meeting and maintained our emerging market overweight, however on a smaller scale and took the developed market underweight a bit lower. DM equities are +9% YTD, with our fair values for the indexes breached that leads us to believe that upside is limited. We maintained our preference for Japan, neutrality to the US and remain underweight the Eurozone (neutral UK). The earnings season, the main catalyst, is now over and the 3-5% beat (US and Europe) has aided market performance, though it was big tech that provided most of the profit and performance for the S&P 500. Also, the prospect of the Fed being done tightening is aiding growth and long-duration sector performance. Any pullback should be viewed as an opportunity to add as low institutional positioning suggests there's money waiting to be put back into equities and that could bias investors to be early rather than late in adding risk, with a decent pullback in equities a buying opportunity even before the first rate cut. The low positioning hasn't aided fund performance as active fund managers have largely underperformed the S&P 500.

Shares of US regional banks continue to fall, deepening underperformance relative to the overall banking sector. The KBW Regional Banking Index fell 6% over the week, year to date -30%. The US has c. 4200 regional banks, many more than most countries and on a percentage basis less than 1% are affected by deposit runs or worries around collapsing due to revaluation of assets. The bigger worry is the consequent credit tightening to smaller businesses and the higher rates (8 to 12%) that commercial real estate cannot afford as those are above the yields (4 to 6%) they generate.

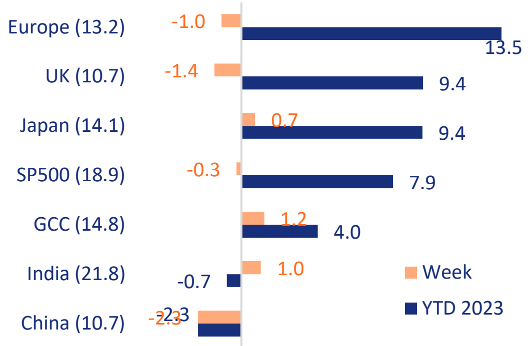
Within the emerging market allocation, we maintain our preference for EM Asia with India as a long-term secular growth story and China expected to rebound in the short term. However, data is yet to show a pick-up in consumption, a lagging effect as China's import volume contracted last month, while exports expanded slower than expected, heightening concerns over its economic recovery since strict zero-Covid measures were discarded in late 2022.

Our UAE overweight continues with more issuance in the pipeline and the current Adnoc Logistics & Services IPO expected to generate interest from income seekers as another quality company with high dividend yield and growth. In the last 3 years of issuance UAE IPO's have gained on an average 55% since listing.

EQUITY RECOMMENDED REGIONAL POSITIONING

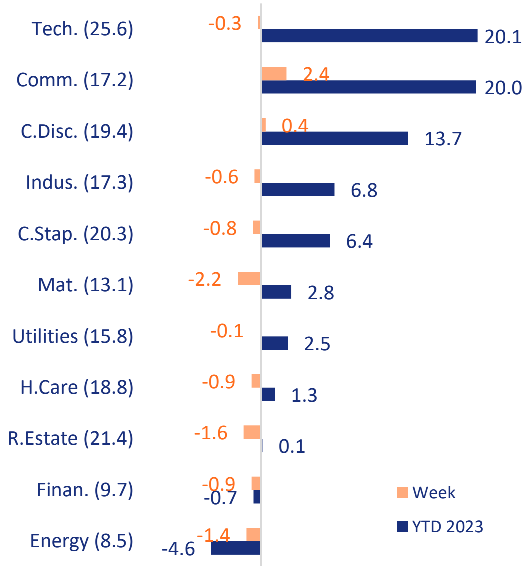


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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