The case for a pause in tightening fades

- **Activity and inflation readings were both stronger than expected last week**
- **Recession risk is lowered, but so is the probability of an imminent pause from central banks**
- **Persistent global core inflation blurs visibility, and supports market volatility ahead**

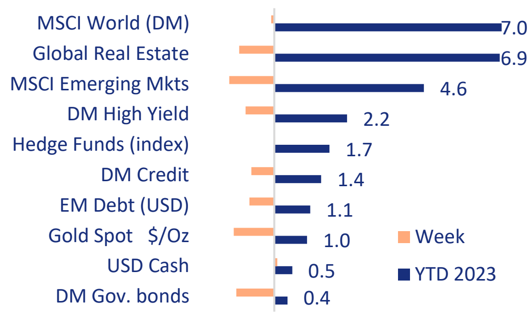
US January CPI data was released last week, and the message was clear: with the current strength in activity, inflation is not plunging. The recent slide in its momentum was simply interrupted in January with monthly gains of +0.5% for headline CPI and +0.41% for core, the strongest m/m in several months. This should lead to a 4.4% level for the Core PCE, far from the Fed's 2% target. Taking a broader view, global core inflation surprised to the upside in January, around +4% y/y.

Markets obviously reacted negatively, with all major asset classes printing negative weekly returns, and a stronger dollar pressuring commodities and emerging markets. There was however no panic: the change in narrative is not just about monetary tightening, but also about stronger US and global growth, with upbeat retail sales and a pickup in factory output. This explains why corporate bonds outperformed govies, and why stocks from developed markets were only marginally negative.

Still, less visibility on inflation and central banks is a recipe for more volatility ahead, especially as we don't see margins of safety from valuations. As we enter the final stages of the earnings season, with 80% of US companies and half of their European peers having already reported, the picture is not particularly exciting. The proportion of companies beating expectations is lower than usual, and so is the percentage of companies raising EPS guidance. Earnings would benefit from stronger growth, but multiples would suffer from higher interest rates – and ultimately discount the potential risk of a postponed, maybe material recession from the delayed impact of longer monetary restriction.

Our positioning is unchanged for the time being but we are ready to act on higher volatility. Stay safe.

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



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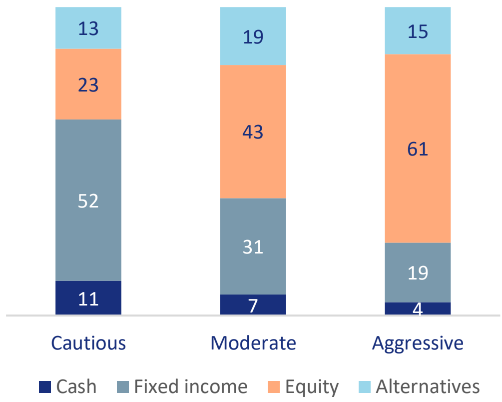
Cross-asset Update

Last week saw quite some disconnect in the performance of equities versus bonds, with the former holding up nicely in the face of more hawkish central bank rhetoric, and the latter selling off badly. Bond investors rightly translated less market friendly commentaries by central bank officials into an outlook for higher yields, representing more downside risk for bonds. On the other hand, equity investors must have embraced a no-landing scenario, whereby the economy is expected to power through the tightening without incurring any slowdown phase. This seems to be too optimistic, as historically higher rates volatility has eventually translated into macro and risk-asset volatility, although with variable lags.

Although the macro-rich week may have provided contradictory signals about the strength of the US economy, the Conference Board US Leading Index of 10 Economic Indicators, that has forecasting power looking ahead from three to six months, continues to hover at the lows of the year after being in negative territory for six straight months. At the same time, Fed rates are now expected to peak at 5.3% in July this year, to ebb only slightly lower and stay above 5% throughout December. Against a backdrop marked by deteriorating growth - as per leading indicators - and higher rates there are some signs of excessive risk taking by investors, as for instance indicated by the difference between the yield on BBB-rated US bonds and the Treasury 3-month yield, at historic lows. Such a yield differential, between a non-risk-free and a risk-free yield, measures the degree of risk aversion or greed, when at very high or low levels versus history.

Something will have to give. Either the economy continues to improve apace and the no-landing scenario comes to pass vindicating equity investors, or at some point it takes a decisive turn for the worse under the weight of higher rates and the caution of bond investors is vindicated. We would tend to think that the second scenario is more likely, with real yields eventually positive across the curve in the United States starting to make themselves felt. Indeed, subtracting the market-implied inflation of 1.8% from the Fed funds peak rate, expected to reach 5.3% in Summer, one gets a real rate that sits above the US long-term potential growth level of 1.8%, restrictive enough to see the economy buckle in the end. Neither equities nor high-yielding bonds in the developed markets are taking this into account valuations-wise, hence we would rather continue to be selective across both asset classes, rather than embrace full market exposure.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

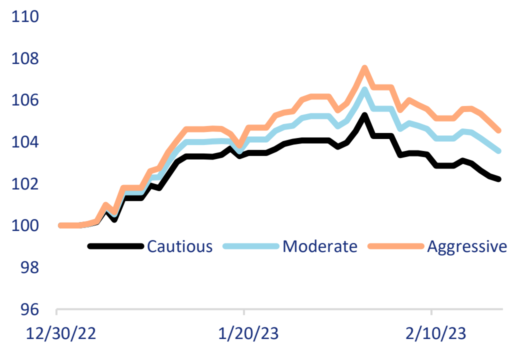


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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 "Higher-for-longer" narrative gains steam as strong macro data sows doubts on the immediate Fed pause and rate cuts for the year. Inflation is expected to come down slower than anticipated earlier. But this means that we are kicking the proverbial can down the road. A higher rate for a longer period increases the chances of a severe crash-landing. Markets now price a 5.3% peak rate for this cycle and rates above 5% till the end of 2023. The 1-year US treasury yields touched 5% for the first time since 2001. The 2-year and 10-year rates moved up by 10bps during the week. The 2s10s inversion at 80bps remains high.

Even within Fixed Income, there is a dispersion in what rates and credit currently predict. While rates markets are essentially pricing a high probability of recession, as indicated by the inverted yield curve, credit markets remain sanguine and are priced for perfection despite the current widening. HY and EM Debt spreads widened significantly as the "Higher for longer" narrative is ominous for risky assets. Currently, both segment spreads trade around their median for the year. Alternatively, IG levels remain tighter. It is better to target carry this year and go for high coupon issuers instead of lower-priced ones. A recent FT report announced that Blackrock's bond ETFs had received $146bn net inflows in the last ten months. We recommend careful exposure to ETFs at this point when the dispersion in credit is very high and selectivity remains key.

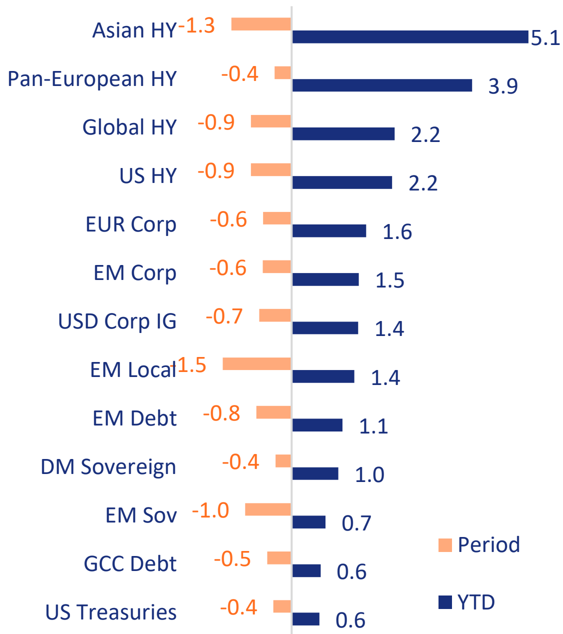
S&P revised its default rate base expectations higher. The rating agency anticipates the US HY default rate to increase to 4% by the end-2023 just shy of the 4.1% long-term average. Revenue from weaker issuers will feel the strain as growth slows, even barring a recession, and an expected rising unemployment rate will negatively affect consumer-reliant sectors, which make up about half of the issuers rated in the 'CCC' to 'C' categories. According to the rating agency, the distressed ratio and current HY spreads are very complacent, predicting only a 2.6% rate of default by this year-end.

Egypt has issued a mandate for its inaugural three-year Dollar Sukuk. There will be a lot of local demand from the region for the issue. We expect the issue price of around 11.5%, considering the country's sovereign conventional curve. Inflation in the country remains high, with January urban CPI jumping to 25.8% YoY, levels seen in 2017, and economists anticipating another surprise rate hike this month. Net government debt-to-GDP remains high at 74% of GDP in fiscal 2023. If it goes through, the current issuance will probably provide 20%-25% of the country's short-term funding needs excluding promised FDI deals from the GCC.

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

Global equities very slightly negative for the week with developed markets in line and Europe outperforming. Emerging markets have not done well in February so far, losing some of the January gains, +4.5% YTD, lagging Developed markets +7% YTD. In Asia, Indian equities had a slightly negative week, China equities were -2% and in the GCC the KSA performed better. Not surprising to see the S&P 500 almost flat for the week, with the Nasdaq performance a bit better and still leading YTD globally.

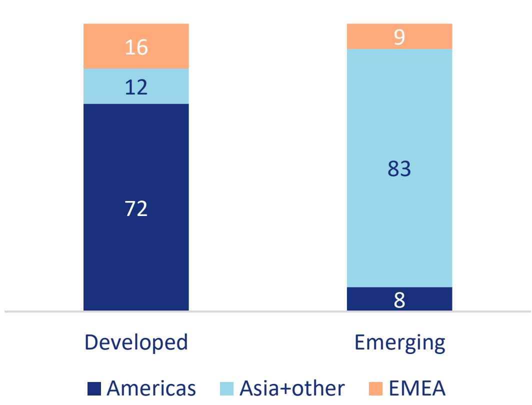
GCC markets saw small gains as earnings continue to be well received – many corporates in the retail, bank and telecom sectors grew earnings by 10 to 30% y/y in Q4 and for CY 2022. Dividends have largely been revised up' both in terms of payouts and percentage-wise. Our conviction on the UAE market outperformance is substantiated by the strong earnings growth. Dubai has established itself as a technology hub, a conference hub, in the top 3 airports globally by traffic, ensuring both tourist traffic growth and an uptick in expat residents. This benefits the banks' consumer businesses and real estate sector's off plan sales, with end-user offtake in focus.

It's been surprising how resilient US equities have been in the face of choppy earnings, inflationary data, and the continued move higher in Treasury yields. The S&P 500 is at 4079, a little above our year end fair value of 4000. To sum up recent eco data: headwinds include January core CPI inflation slightly stronger than expected, reflecting broad start-of-year price increases with housing strong, but offset by falling used car prices and airfares. The services industry continues to benefit from pent up COVID demand and labor market resilience in spite of the Fed's effort to curtail demand. Mixed signals for markets with retail data indicating that demand remains robust, as does the passing on of higher costs to consumers as revenues grow even as earnings are declining in developed markets. At the same time, the policy rate impact of "higher for longer" is yet to materially affect corporates or individuals. Inflation data globally is still worrying, with recent January CPI release from the US, UK and India still indicating high inflation.

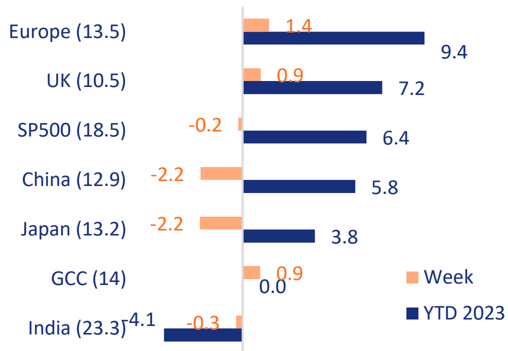
Four fifths of S&P 500 companies have reported Q4 earnings with some mixed read-throughs regarding the strength of the US consumer: a y/y earnings decline of -4.7% but revenues +5.1% y/y as costs are being passed on. For CY 2022, earnings growth is at +4.1% and revenue growth +10.7%. Management commentary: real revenue growth for the S&P 500 has slowed but remains positive. Q4 Earnings takeaways: No recession, labor shortage an issue but improving, however continued wage pressures. Looks like recession risk reduced and potentially hinging on the outlook for wage growth and inflation. Rates a concern. Walmart and Kraft Heinz are saying they are pushing back against suppliers on price increases and not planning on additional price hikes this year.

Seeing continuous downward revision to 2023 consensus earnings expectations. For Q1 2023, analysts are projecting an earnings decline of -5.4% and revenue growth of 1.9%. 2023 consensus estimate is at 2% earning and revenue growth consistent with the below-trend pace of GDP growth required to rebalance the labor market without a recession.

EQUITY RECOMMENDED REGIONAL POSITIONING

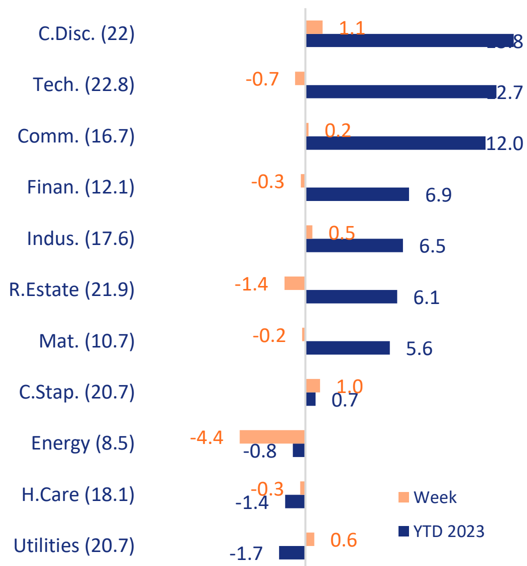


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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