An unpleasant "déjà vu"

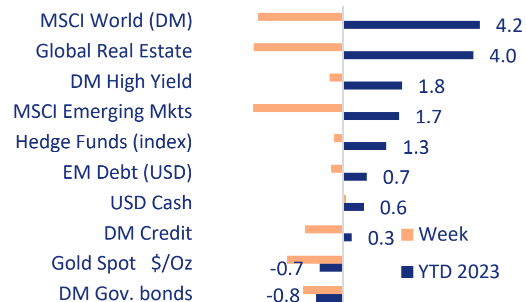
- **A higher than expected US Core PCE inflation added to the risk of more central bank tightening ahead**
- **All asset classes, except cash, were in the red last week, in a "2022-like" pattern**
- **Shifting scenarios on inflation and growth support volatility, but the worst is never certain**

Last week was tough for all asset classes, with one main explanation: the recent series of data showing healthy growth and persistent price pressures culminated with the Fed's preferred measure of inflation - the US core PCE - printing 4.7%, much higher than the forecast of 4.3%, and a reverse in its recent moderating trend.

This year is all about the relative trajectories of growth and inflation, with central bank reaction functions in the middle. As long as inflation was moderating, central banks had reasons to slow the pace of tightening and wait for the impact to percolate into demand, growth, and prices. The major risk for markets is that they could change their mind and reaccelerate: more pressure for markets, and more risk of a delayed but potentially severe downturn ahead. All markets are obviously extremely sensitive to any shift in scenario, especially after the traumatizing correlation shock of 2022.

We will get more color on the state of the economy with all the monthly leading indicators and inflation measures being released in the coming days and weeks. A clear difference with 2022 should however not be dismissed: market participants are not in denial anymore. Indeed, the level of Fed funds priced-in by futures markets is now higher than the one predicted by the Fed's dot-plot itself. Seeing resilient growth everywhere (it's not just a US exception) is not a fundamental bad news, even if it supports volatility. And in the meantime, yields from the safest assets are certainly not unpleasant for investors. Equity valuations have corrected in February the excessive optimism of January, and may even go further, which is also not that bad for the medium term. Our positioning is unchanged for the time being. Stay safe.

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



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Cross-asset Update

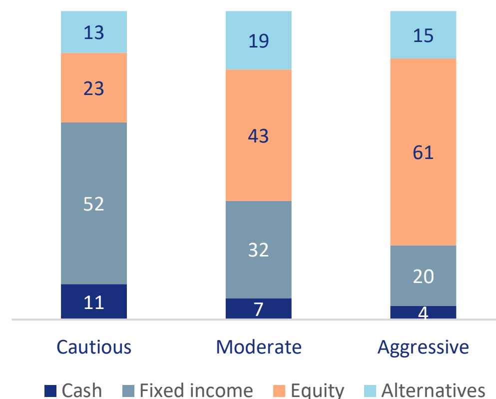
The release of hawkish-leaning FOMC minutes last Wednesday alongside higher inflation readings reinforces our conviction on the underweight tactical call on developed-market risk assets - equities and high-yielding credit - hence the need for investors to be selective when taking risk in DM equities and HY bonds. Our preference for DM higher-quality bonds allows investors to allocate to an asset class with best risk-adjusted returns against the backdrop of rising yields and an uncertain growth outlook, while that for EM equities provides exposure to cheaper assets linked to the Chinese recovery and expansive policies.

The impact of higher Fed rates for longer is negative across asset classes, with the exception of the US dollar, that has started to rise again, and eventually Treasuries if a recession indeed takes place. Equities are capped by rising real rates, or they crash if real yields rise too fast. The same holds for high-yielding credit, that has a strong equity component, in the sense that it is sensitive to the growth outlook. Treasury volatility bottomed at the end of January and has been rising ever since as investors started to understand that the Fed means business when it says inflation must be curbed. Under the so-called Taylor rule, a quantitative framework devised by the Fed to set benchmark rates depending on the state of the economy, Fed funds should be as high as 8%.

The issue is whether the economy is indeed going to buckle, given the recent contradictory releases. The gap between hard and soft data, the former suggesting strength while the latter weakness, is at its widest historically. The jobs report released two weeks ago was strong, but marred by statistical oddities. Some business confidence indicators suggested resilience, while the latest reading of the Conference Board Leading Index was in line with recessionary levels. The point is that we are in a sort of nobody's land, in the latter stages of the tightening, but not yet at the point when its effects are making themselves felt across the economy and markets. We would tend to give more weight to the Conference Board Leading Index, a composite of ten leading indicators built to get insights into the outlook three to six months ahead. Also, we take into account that the latest Senior Loan Officer Survey, as of January end, saw the percentage of tightening loan officers rise to almost 45%, when historically levels around 50% or above coincided with recessions. Last but not least, the re-steepening of yield curves, that has been taking place since mid-January, usually precedes recessions by some months, setting us up for one possibly starting from this summer.

Former Treasury Secretary Lawrence Summers mentioned worrying signals of a drop-off in activity and people "reading a bit too much in the moment in terms of economic strength, relative to the way things could look very differently in a quarter or two". JPMorgan's Jamie Dimon said that "out in front of us there's some scary stuff". Both implicitly gave little relevance to the no-landing scenario quite a few investors still seem to be so fond of.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

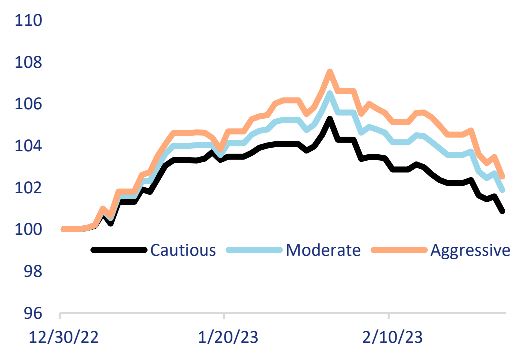


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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

2023 has lived up to its reputation of being an unpredictable year. January saw a rally in both yields and credits, resulting in significant returns for the riskier segments for Fixed Income, such as High Yield. Investors became complacent as an ill-timed hope for a quick Fed pause drove markets. February came as a rude awakening. The yields started inching up, and spreads widened from their tightest levels for the year. The catalysts were a hawkish Fed, strong macro data, and inflation coming down slower than anticipated. As a result, long-duration and yield-sensitive segments bore the brunt. Year-To-Date, the safest segments have been the worst affected, while the high carry in High Yield and EM Debt has helped them outperform.

The question before the investor is if the current trend would hold. We are skeptical. The Higher-For-Longer paradigm will eventually result in a credit squeeze which would impact the High Yield and low-rated Emerging market economies. With mid-5 yields available in solid credits, there is no need for fixed-income investors to take undue risk. It could be a toss between the return of versus return on capital once we enter the end of the cycle.

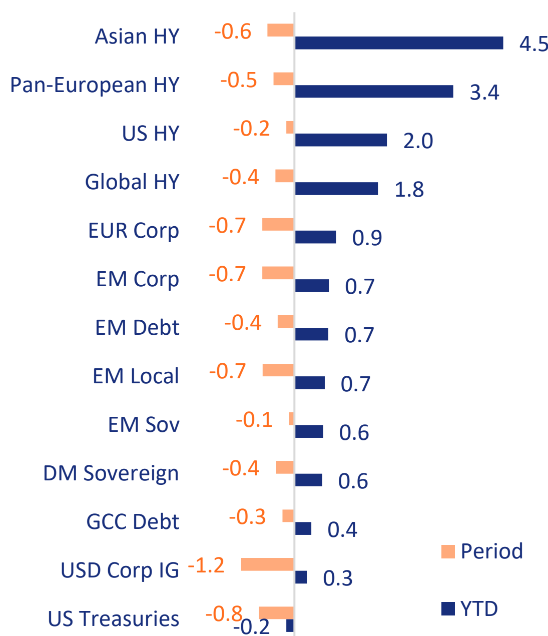
Last week, the 10-year treasury yields increased by 13 bps, while the curve flattened. The 2s10s is just within shy of 90 bps inversion. Credit spreads behaved well across segments. US HY spreads tightened by 21 bps as strong macro data is a backstop for high-yield defaults. According to the latest S&P report, defaults in 2023 are nearly two-thirds higher than in 2022. Even so, year-to-date global defaults hover just above the long-term average of 7.4. S&P expects defaults to continue to rise, given increased rating transitions into the 'CCC' category--notably from the 'B' rating category--which tend to prelude more meaningful increases in defaults

Primary markets from the region and Asia have been very active. Egypt issued its first sukuk last week with solid demand from the MENA investors, leading to final spreads tightening by more than 60 bps from the IPTs. HDFC, India's largest private-owned bank, issued a $750mn three-year senior USD Note with books covered 4x times. The Yield on this three-year note was an attractive 5.68% when issued. This week we may see a 5-year green issuance from a Govt related Entity, REC of India. Lastly, Air Lease Company, one of the largest Aircraft leasing companies, has issued a mandate for selling an inaugural Sukuk this week.

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

Emirates NBD PRIVATE BANKING

Equity Update

Yields up and equities down, with the technology sector and China the worst performers. Last week saw global equities fall 2.6% with most regions and all sectors down, reversing partially January's strong performance. Though negative, among the better performers last week was the UAE. In round numbers year to date, Developed Markets are +4% and Emerging Market equities +2%. We seem to be in a cycle different to others, with rates accelerating yet a still buoyant labour market and strong demand (shift from goods to services) and hence inflation slower but not subsiding sufficiently to warrant a rate pause. Core inflation remains key and is still a worry in the US and Europe. However, economies are not yet in recession, indicative of a soft landing and hence we are not worried about major equity downside, but will continue to watch economic and inflation data closely.

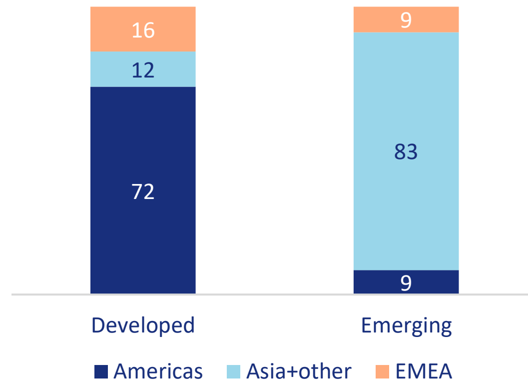
Market reaction in the 2020's is more reactive, hence we expect the volatile intra day, daily and the monthly ups and downs will continue. The impact on equities is double edged. Revenues will grow as long as demand is supportive still being fuelled by excessive savings from the pandemic fiscal stimulus, whilst earnings will stagnate as higher labour and interest rates impact margins. Higher rates have a lagging effect, as most corporates raised money in the low interest rate COVID years. The higher rates will impact consumer lending with a slowdown in auto purchases and mortgages.

The MSCI EM index has retraced around 5% from the recent high at the end of January but is still up 20% from the late October trough. We recommend buying the dip in EM Asia. Tailwinds are earnings estimate revisions for EM inflecting upward, reasonable valuations, China's economy recovering rapidly, India's Adani group making efforts to reassure investors. Funds flows to EM equities look likely to pick up. Headwinds include a steady US dollar that is no longer depreciating against EM currencies and rising geopolitical risk.

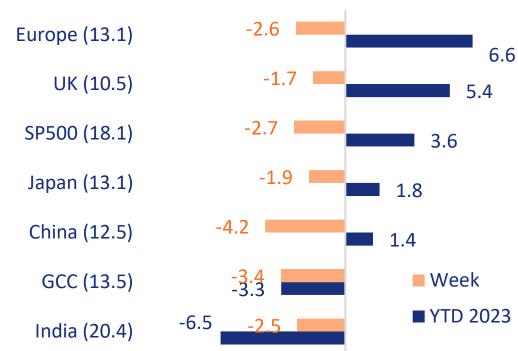
US equities fell last week, with a possible higher rates trajectory weighing on performance. For Q4 2022, the blended earnings decline for the S&P 500 is -4.8% with 94% of companies having reported and calls have provided insight into corporate margin pressures, but labor market commentary signals that some of these headwinds may be abating. The share of management teams citing labor shortages, is less than a third of the peak in 3Q 2021. Continued supply-demand rebalancing is necessary to slow wage growth and headline inflation.

We remain underweight European equities. European companies have cited transport pressure in a large number of earning calls. While global supply chains are improving, they are not as dependable as at pre-COVID times, hence, pricing pressures may persist. China-US shipping rates are back to pre-Covid levels, however Europe-US container costs are double late-2019 levels and 70% of goods transported are on long-term contracts renegotiated at much higher rates in 2021 and 2022. Persistent worker shortages continue to raise labor costs, while diesel, equipment and warehouse storage costs remain elevated, contributing to logistics and distribution challenges and delaying the normalization of domestic supply chains (Bloomberg data).

EQUITY RECOMMENDED REGIONAL POSITIONING

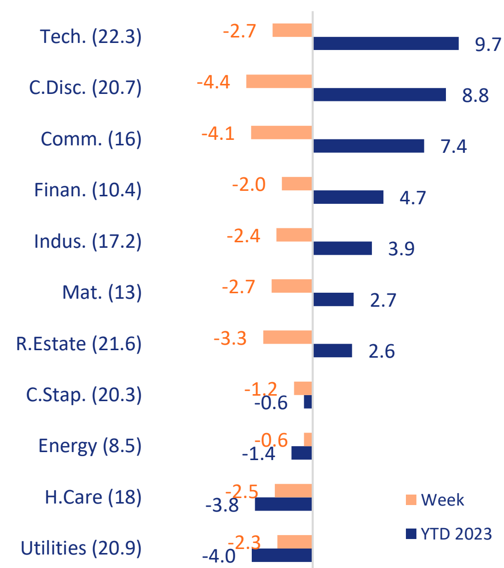


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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