"Navigating by the stars under **cloudy skies**"

- **Flash PMIs indicated economic weakness in August, adding to the current uncertainty**
- **Perplexity dominated central bankers' Jackson Hole gathering, with no actionable hint**
- **Nvidia stellar numbers and the BRICS extension are however clear good news**

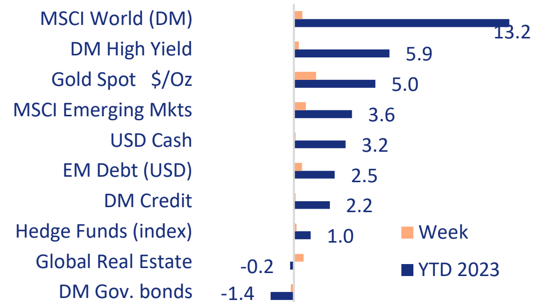
Our title, verbatim from Fed's Chairman Powell speech at the annual Jackson Hole symposium last week, is a perfect illustration of the current perplexity. Elevated inflation remains, forcing central banks to remain restrictive, including potential more hikes from the Fed. But this happens at a time when flash PMI indicate economic weakness. Adding extreme levels of debt to the equation explains investors anxiety: it is not difficult to see the glass as half-empty, and to question the Goldilocks scenario that prevailed in the previous months, when central bankers themselves can't say much more than "2% target" and "data dependency".

Having said that, if we take a step back, slowing the economy is not a bug of monetary policy: it is a feature, in their battle against inflation. It is arguably working, while the worst-case scenario of an "anti-Goldilocks", combining recession and inflation, seems very unlikely. It should be either recession and declining inflation, which would support quality bonds, or growth and resilient inflation, which would help equities.

Last week also provided sources of hopes with two important drivers. First, Nvidia's fantastic earnings report, which lifted all tech stocks last week, demonstrates that artificial intelligence is not a distant dream: it is happening. The second great news of the week was the BRICS summit which agreed on an extension to 6 countries, including the UAE and KSA, and potentially more in the future. This is about re-globalization, in a more inclusive, balanced, and thus sustainable way: multilateralism is always great news.

Unpredictability ahead drives our positioning, which remains balanced and slightly defensive, with a quality bias. Stay diversified and ready for anything.

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



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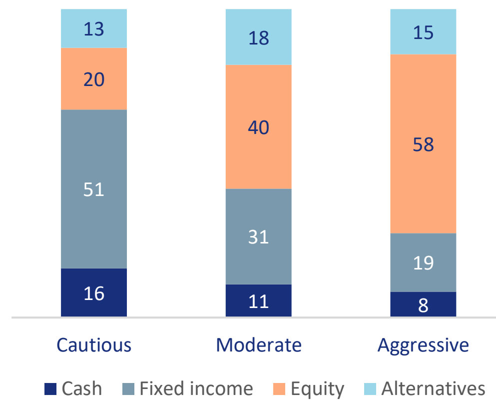
Cross-asset Update

A no-landing scenario in the United States implying the reacceleration in activity down the road has gained traction and seems to have been priced in, with DM stocks off the highs of the year by a few percentage points, credit spreads still close to their tightest levels and yields soaring to decade highs. Positioning is no longer reflecting caution on risk-assets, and sentiment, though not outright euphoric, is skewed positive. Yet, the outlook still remains split between a mild recession occurring once the lagged effects of the Fed's repeated hikes make themselves felt, and improvements in the economy the higher rates notwithstanding that would ultimately warrant Fed funds above 6%, in turn precipitating a plunge in growth anyway. The former scenario still seems slightly more likely than the latter, though it is now quite a close whether to pick one over the other with some confidence. New highs in real treasury yields over both sides of the pond is a sign that US activity remains strong, but also that there may be growing unease with ever-rising debt levels in the developed world alongside no hints of government restraint on the fiscal front.

And while unrestrained public spending may have averted a US recession in spite of the Fed's record tightening, it could also be creating the conditions for resurgent inflation sometime in the near future if activity reaccelerates. Usually, sharp losses in the US dollar, like the ones seen since its late-2022 highs, portend higher inflation with a lag, as swings in the global reserve currency tend to lead swings in China's Producer Price Index. This in simpler terms overall means that dollar weakness, when significant, loosens global financial conditions enough for price pressures to be rekindled. And should China decide to go for some really big stimulus by year end, something Beijing has so far wanted to avoid in order to avert financial instability via excess credit creation, then commodity demand would be stoked as well, compounding the pro-growth dollar effects. Also, some investment houses do not see US core inflation go sustainably below 3% if a recession is avoided, that in turn would be setting the stage for higher headline inflation as activity remains sustained.

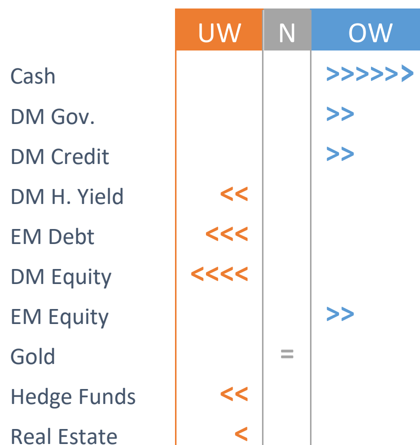
In summary, dollar weakness, fiscal largesse, and decisive Chinese stimulus make for higher inflation risks, the ones of the kind mentioned by Jay Powell at Jackson Hole that would warrant higher rates. While markets can still recover from the pullback underway to rally further, at some point something will have to break. As the scenario remains highly uncertain, what we think we now know with some confidence is that a recession should not be imminent. It seems late to go overboard on risk assets, and too soon to be heavily underweight. Looking for quality, hence lower risk, within each asset class could be the answer: cash in risk-free assets, IG bonds in credit, and selective US exposure in equities on America's exceptionalism. Accumulating gold on weakness seems appropriate as a bet on easier policy down the road.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING



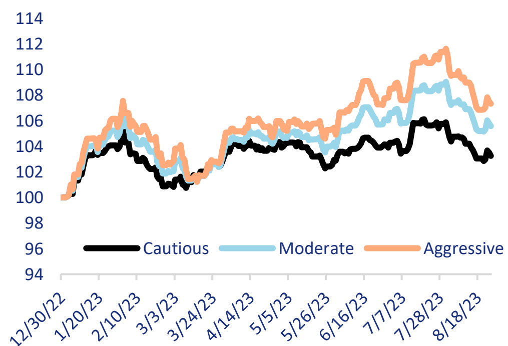
TAA – RELATIVE POSITIONING – MODERATE PROFILE

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

Last week US Treasury yields retraced some of the previous gains after the sell-off in bonds had seen the yield on the 10y note exceed its October 2022 peak of around 4.25%, and the real yield approach 2%. The 30-year treasuries also touched a high of 4.44% before coming down. We are officially in unchartered territory. The following 20 bps move could be either way; hence, we advise not to enter long-duration trades. Moreover, as mentioned in the past weeklies, September and October historically have not been great months for adding duration to portfolios.

Markets unanimously gave a hawkish verdict to Chairman Powell's Jackson Hole address last week. Powell avoided discussing long-term topics such as r* or higher inflation targets, as some had anticipated. However, he did state that "two percent is and will remain our inflation target." Most of the speech repeated many themes he discussed after the FOMC statement: the Fed is data dependent, "will proceed carefully," and is prepared to tighten further if the labour market is no longer easing. The peak rate expectations have not moved much higher, increasing by only 3 bps to 5.49%. The "Higher-for-longer" theme gained traction with rate cut expectations trimmed in 2024.

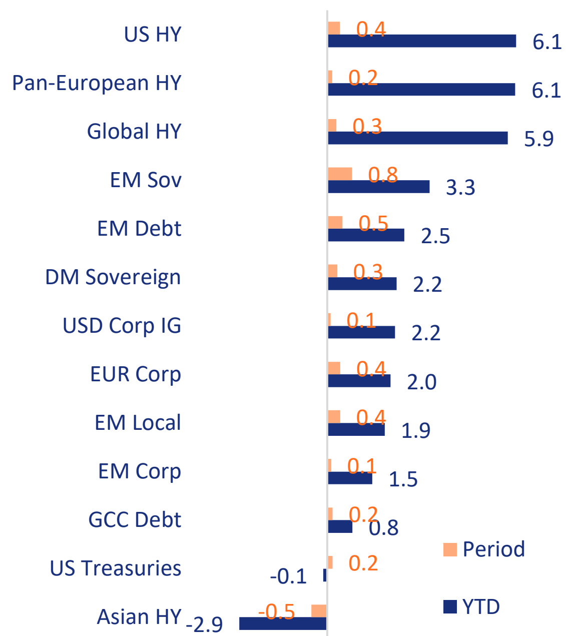
As brutal as the past two years have been for US bond investors, yields are now high enough to offer a strong safeguard against further losses. The return profile is asymmetric, and the rewards for a rally are much larger than any hit from the fresh rout. The 5-year treasuries provide a sweet spot. If yields go up 50 bps, the potential return from a long 5-year position will be +2.27% in the next twelve months, and if yields go down by 50 bps, the potential return could be as high as +6.65% in the same duration. The figures for the 10-year are +0.22% and +8.37% respectively. But we advise investors not to get too excited with these numbers as there's probably limited room for yields to decline in the coming months, compared to prior Fed on-hold episodes, especially as several factors suggest core inflation should prove sticky near 3% through the fourth quarter.

With equity volatility creeping up in August, attention is shifting to credit markets, given that equity volatility is a critical component of credit spread valuation models. Credit spreads are little-changed and have yet to respond to the rise in equity volatility. Hence, we still do not like high-yield bonds in terms of positioning. The credit cycle in the US could take more time to collapse, but current HY valuations are stretched. According to JP Morgan, IG spreads have become tighter on the backdrop of the lowest August supply since 2015. However, the incentive for spreads to remain tight is on weaker footing as historically September has been the second busiest month of supply. The current IG yields of 5.3% are near historical medians during recessionary times and provide attractive entry opportunities.

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

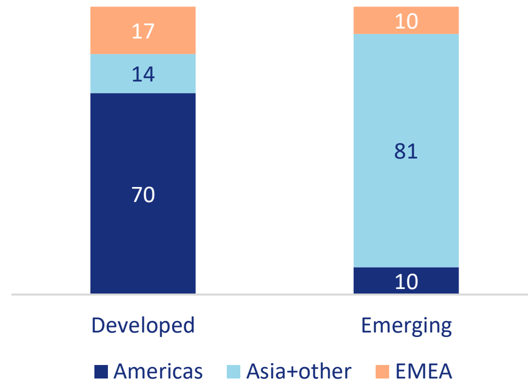
At the end of July, global equities were +18% YTD, with June and July performance aided by an outsized tech rally, the global tech sector was up +41%. A multiples-driven rally in DM, while for EM China stimulus measures boosted equities. All major regions and all sectors were positive, with a shift to more positive positioning by investors with hopes of interest rates peaking in H2 across DM, the tail risk of the US debt ceiling removed, fears of regional banks causing a systemic financial meltdown fading and hopes of AI boosting productivity and growth igniting the longer duration (tech) equity sector performance.

August has seen global equities lose -5%, with China -11%, the worst and the GCC and India the better performers. Both DM and EM equities negative this month, but EM worse at -7%. The selloff is attributed to rising yields, the earnings season being almost over, higher interest rates now seen for longer, rating downgrades in the financial sector, concerning China growth signals and a stronger USD. With inflation, especially services inflation a worry and a tight labour market, rate cut expectations are being shifted out. US treasury yields at cyclical highs are pressuring US equities; the S&P index is 4% off its recent highs, but earnings are a key factor, and strong economic data and 2Q earnings season beats are supportive. The tech sector has had a weak August, even though Nvidia and other big tech companies had strong earnings.

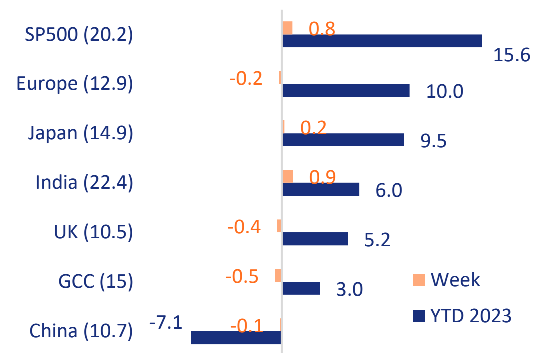
Our positioning is close to neutral on equities (small underweight) with a preference for Emerging markets. Close to neutral on the US, on Japan and the UK and underweight the Eurozone. In EM we overweight the UAE and India and are neutral EM Asia (China). The surprising resilience of the U.S. economy even with higher rates and the narrative around AI, has led the S&P 500 to 16% total returns YTD and the Nasdaq +31%. AI-driven big tech 7 performance is largely behind the gains. Valuations 20X forward P/E for S&P500 is at our year end estimate (4,500 for the S&P 500 with a 0% earnings growth and 20.2X price/earnings). U.S. consumers, "resilience" has been the buzzword for the S&P 500, earnings decline of 5% for Q2 could represent a bottom, with consensus calling for flat earnings growth next quarter and then high-single-digit growth by 4Q, and an optimistic return to double-digit growth next year. On China, we are seeing some green shoots with trading fees reduced, a focus on stabilizing markets is good for sentiment but maybe more for domestic trading. The PBOC recently surprised markets by cutting rates, but is not seen as enough and no cuts to the five-year prime loan rates (used for mortgages). The unravelling of debt at major property developers continues to hang over the economic outlook, with China's EverGrande filing for bankruptcy.

With higher rates for longer in developed markets, we reiterate quality (strong balance sheets) and profitable companies. There are rising risks around credit tightening and liquidity. More and more listed companies are unprofitable. Moody's recent rating downgrades of 10 US banks highlight the headwinds of increasing capital requirements, higher cost of funding, and rising loan losses that continue to challenge the business models of the US regional banking sector.

EQUITY RECOMMENDED REGIONAL POSITIONING

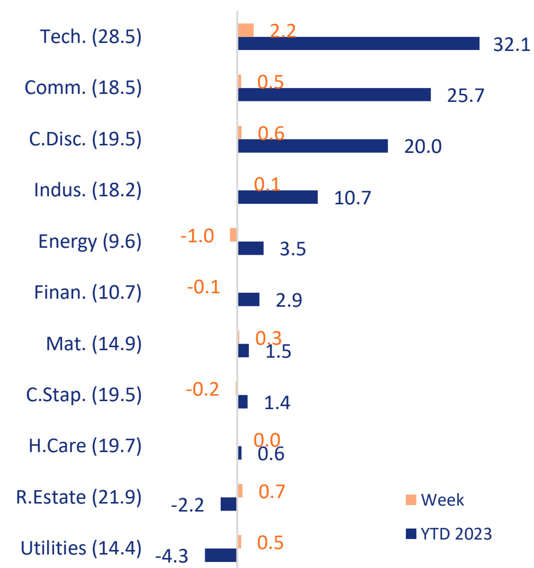


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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