Washington reaches a tentative **debt-ceiling agreement**

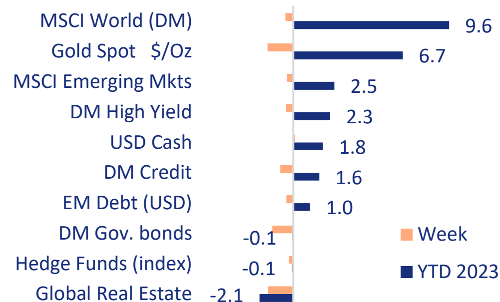
- **A debt-ceiling deal was agreed between President Biden and House Speaker Mc Carthy last week-end**
- **We think it should win US Congressional approval Wednesday, removing a potentially devastating tail-risk**
- **This however doesn't change the big picture, and we stick to our reasonably cautious positioning.**

The focus of the recent weeks reached a key stage late on Saturday, with a debt-limit deal being agreed between the Biden administration and the Republican House Speaker. Both sides made compromises: the debt ceiling will be suspended until January 1st of 2025, in exchange for a cap in non-defense federal spending for two years. The next step is to have a corresponding bill being voted by the US Congress, starting with the House on Wednesday. We are reasonably confident it will pass.

This is good news or, more precisely, this is the potentially catastrophic risk of a US debt default being removed from the investment landscape. We had always put a neglectable probability on such a nightmare scenario anyway, but this means that this doesn't really affect the big picture. While global activity remains on a very solid ground, clouds are accumulating for the quarters ahead: persistent inflation, higher interest rates for longer, constrained credit supply and now some level of fiscal drag are uncertainties at best, clear headwinds at worst, which are not reflected in the valuation of some asset classes. We are, again, not outright bearish but stick to our overweight on money market funds, while being cautious on risky bonds and on stocks from emerging markets.

We start the week with a market holiday in the US but do not expect risk assets to skyrocket in response to the debt-ceiling deal. Their fundamental upside potential is limited, and we will get important economic data, especially Friday's US monthly job report, to gauge whether the Fed may hike again in June or July. The market consequences of the probably deluge of Treasury issuance once the debt-ceiling is suspended are also difficult to predict – and potentially not great. Have a great week.

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



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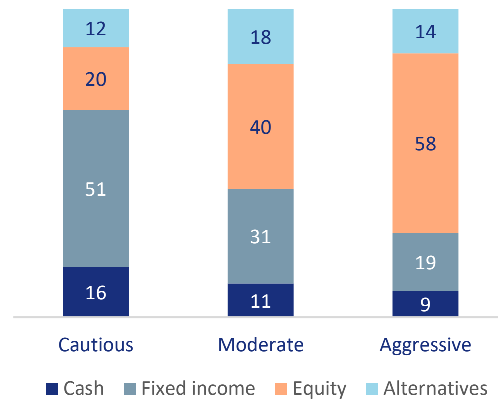
Cross-asset Update

Inflation technology stocks have surprised to the upside on growing enthusiasm about disruptive innovation driven by AI, to an extent that year-to-date the performance gap between the Nasdaq and the more cyclical Dow is over 20%. Market breadth has been very skewed towards growth stock, while cyclical sectors have been left behind. Amidst persistent uncertainty, such gap can be maintained in our view, as the quality factor continues to uphold the sector versus the broader market. Indeed, we hold the view that IT outperformance is not only about ChatGPT, but rather about the quality of the balance sheets of large-cap IT companies that supports them, amidst growing scepticism towards companies more geared to the business cycle. The fact that the MSCI World Information Technology sector against the market has been tracking the relative performance of the MSCI Quality Index is just a confirmation of what observed above. Even in the case of a US recession, the less cyclical segments of IT, from platforms to software, could continue to surprise to the upside amidst falling yields, making the whole sector even more expensive.

As for the broader market rally, we see both lights and shades in the shorter term, while remaining sceptical about the sustainability of the upside in the longer run due to the banking crisis and the lagged negative effects of the Fed's tightening. On the positive side, both positioning and sentiment do not seem to be excessive, as indicated both by net long futures positions across the main US indices and sector risk premia we have worked out to derive proxies for investor sentiment. With positioning at best neutral and sentiment still below neutral levels, there seems to be more room for animal spirits to get further invigorated. At the same time, the lifting of the debt ceiling, contrary to common belief, is not a net positive for markets. The US Treasury will be increasing issuance to replenish its General Account, sucking liquidity out, that alongside the unabated Quantitative Tightening carried out by the Fed should further and significantly tighten financial conditions. Also, one more rate hike cannot be ruled out, either in June or July, as the US economy remains resilient, and inflation still surprises to the upside.

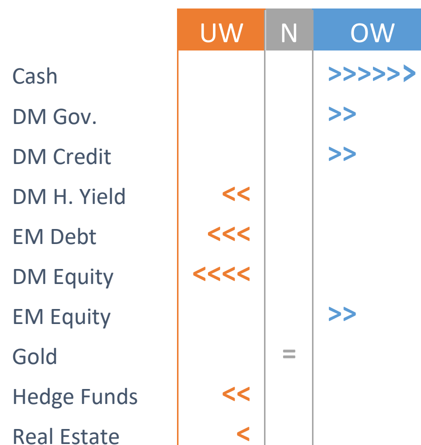
Overall, we believe the rally will continue to be skewed and marked by poor breadth, and that further upside at some point will be capped either by tighter financial conditions or a sharp slowdown in the US economy. Our best advice is still for clients to be very selective when adding to risk. Gold is a precious edge in the current environment, though still has to work through some of the excessive speculative positioning driven by heightened expectations of the Fed's tightening cycle drawing to an end.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING



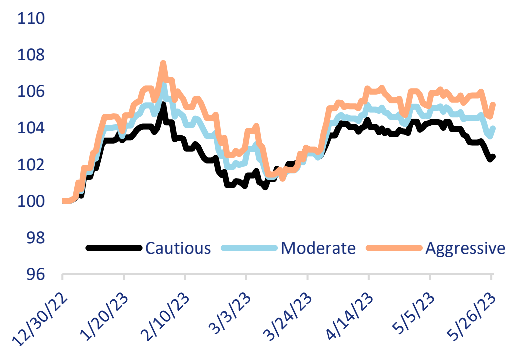
TAA – RELATIVE POSITIONING – MODERATE PROFILE

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

It was a sense of Déjà vu last week. The US debt ceiling impasse went down to the wire as a rating agency placed the AAA rating of the country on rating watch Negative. But finally, as expected, both sides reached an agreement just in the nick of time to avoid this. Although the UST yield curve bear-flattened, expect it to re-steepen this week. Debt ceiling agreements should provide relief to the front-end treasuries. However, more notably, the liquidity will come under pressure. The TLTRO repayments and the ECB's QT are added to the liquidity contraction forces in the US, i.e., the impending Treasury General Account balance build-up, the Fed's QT, and the continued shift from US bank deposits to MMFs, are the main culprits for draining liquidity.

Regarding bond positioning, the record net shorts in the CFTC data are being distorted by basis trades – with leveraged investors short futures & long cash. So while there's no doubt that there is some buying by hedge funds and long-only institutions this year, there's plenty of room for longs to build ahead of any Fed easing cycle.

Over the past few weeks, markets have forcefully repriced Fed cuts on the back of fading external risks and fairly upbeat macro data. As per the latest data, there are no rate cuts priced in this year from three rate cuts barely a month ago. But this repricing may be done now. Based on past easing cycles, we may need to see the trend of NFP falling below +100k for the Fed to consider lowering rates. So all we could say is that bond yields are poised on a knife's edge with a sharp tilt to yields coming down in the future.

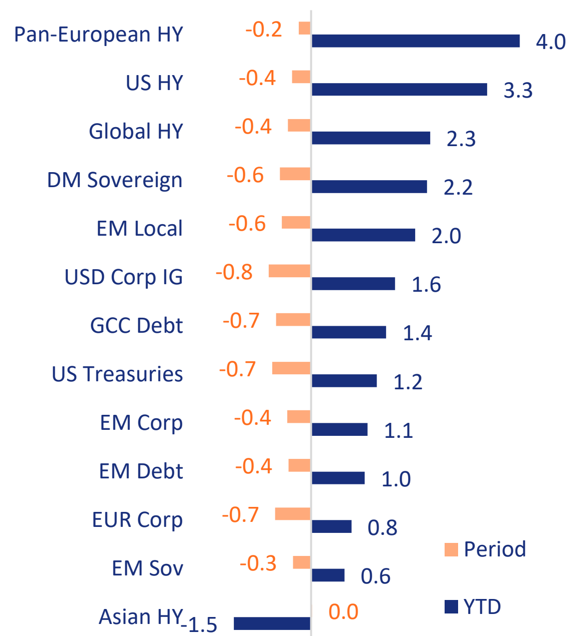
Yield premiums on dollar bonds in Asia tightened on Monday after the debt-ceiling deal. This should be replicated across various segments of the fixed income. All the segment OAS spreads currently trend near the median YTD level and hence not wide enough to enter risky HY trades.

Coming to the region, S&P confirmed Bahrain's sovereign rating to B+, with a positive outlook. The positive outlook reflects the wider current account surpluses and continued financial sector stability in the near term. In addition, S&P estimates the government to continue implementing reforms to reduce the budget deficit. Bahrain posted a record current account surplus of 15.4% of GDP in 2022. Last week, S&P also highlighted the strength of the Dubai government balance sheet by reducing debt forecasted at about 51% of the GDP ($66 billion) in 2023. Also, S&P highlighted that the robust recovery of the real estate and tourism sectors, measures taken for social and economic reforms, and GREs monetization are helping in economic growth.

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

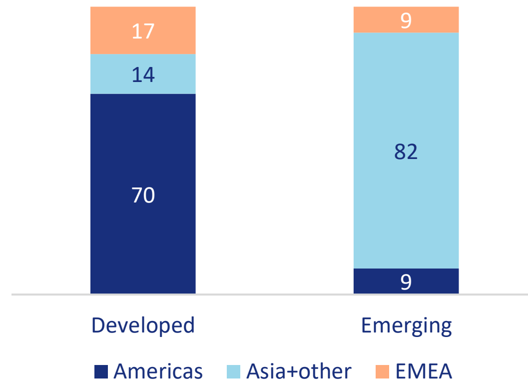
A sigh of relief for markets, with a deal to raise the US debt ceiling, in a bid to avert a US debt default. Market reaction to the issue is less significant than the evolution of market liquidity post the debt-ceiling resolution, and the T-Bill issuance that follows. US debt ceiling worries did not overly impact markets last week, with global equities down just half a percent. Whilst global equities are + 9%, global equity flows are flat YTD, in contrast to inflows of $175bn in 2022, $949bn in 2021 and $182bn in 2020. (Bank of America data). On the other hand, inflows to cash/money market funds YTD are at a record, and now even depleting deposits of the big banks.

Last week, saw small gains in US equities, the S&P 500 crossed the key level of 4200 on Friday. It was a good week for India, with all other major global markets in the red. China equities fell-3% and the MSCI China is -6% YTD as worries about China's economic recovery are surfacing. We are overweight EM Asia and Japan and whilst India and Japan have shown recent gains, China has back tracked. We still have confidence in its recovery based on domestic demand resurgence. UAE markets were little changed last week, and continue to see strong interest in IPO's with ADNOC Logistics increasing its offering to 19% of the company's total issued share capital with the gross demand surpassing $125 bn, a 163 times oversubscription rate, marking the highest-ever for a UAE book-build IPO.

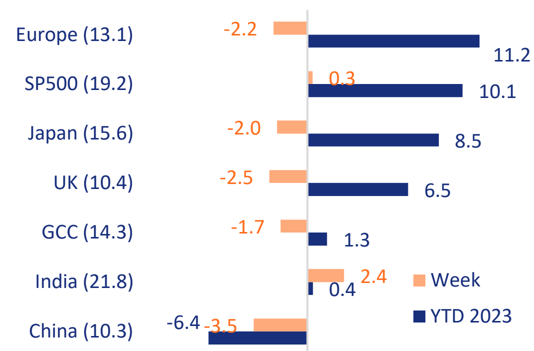
Japan equities are outperforming with the Nikkei +18.5% YTD. Japan's recovery lagged that of the US and Europe the last 3 years, as Covid-related restraints on mobility lasted longer. This is expected to change with growth set to accelerate, driven by stronger domestic demand and supported by the reopening. There is not yet runaway inflation and real rates should remain accommodative, helping to catalyse a revival in capex. Also, no tightening in sight. Besides macro factors supporting Japanese equities which are at a 33-year high are margins, consumption, and investment indicators rebounding.

Also standing out is the Nasdaq up +24.5% YTD, (last week +2.5%), with AI fueled gains for mega cap tech and semi stocks. Even with anxiety around the debt ceiling, the last couple of weeks have been dominated by the growing AI-fervour leading to a chase for upside with low equity positioning as, for many, there's been a lack of participation in equity performance year-to-date. MAGMA or MAGMNA, the new acronym more AI centric, is taking over from FAANG. Nvidia could become the first chipmaker to be valued at more than $1tn, as demand for its AI processors has led to large revenue and profit gains. Nvidia appears within reach of joining Apple, Microsoft, Alphabet, Amazon and Saudi Aramco, companies valued at more than $1tn. The SOXX semiconductor ETF of 30 US companies, is up 18% in two days, seen as an AI play. The narrowness of the equity market leadership (7 stocks account for the majority of YTD S&P500 gains), has made this a very difficult market to navigate as large-cap tech performance has dominated all else. Info tech was the only global sector positive last week.

EQUITY RECOMMENDED REGIONAL POSITIONING

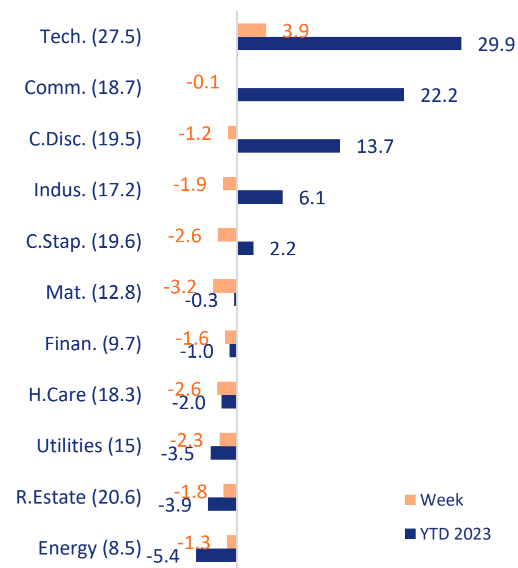


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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