Emirates NBD
WEALTH MANAGEMENT

Have markets decided to **fight the Fed**?

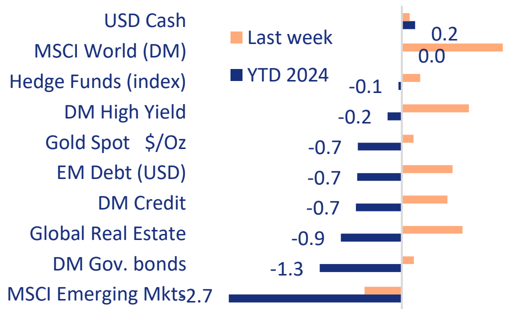
- **The most awaited December US CPI inflation report was a bit worse than expectations…**
- **… Which didn't bother markets, with falling yields and rising DM stocks, led by a rally in tech.**
- **Future markets price twice as much rate cuts as the Fed itself. Volatility in 2024 is just beginning.**

There was one key economic data from the year's second week of trading: the US December inflation report that hit the tape on Thursday. It was not great: headline CPI, the one that matters for consumers, came in at +3.4% year-on-year, 0.2% more than the median expectations. The core CPI, which matters for the Fed, was also 0.1% higher than forecast at +3.9% year on year. This could have rationally questioned the trajectory of rate cuts in 2024, especially after a confirmed tightness in the labour market. But it didn't. US Treasury yields closed lower that day, and expanded their downward trend when the PPI, inflation from the perspective of producers, came in on Friday, this time below expectations and in negative territory. Gold, REITS, and DM rose in sympathy, with a significant rally in tech/ AI related names. Stocks from emerging markets were the only negative asset class.

We are a bit perplex. We see no reason for the Fed to cut rates 6 times, as implied by Fed funds future markets, given the slowdown in the slide of inflation and an overall resilient economy. It looks like market participants see the glass as half-full, probably thinking that the Fed has no reason to stay restrictive either, with, maybe, the idea that they could avoid troubles in an electoral year. This is not the first time that expectations are far away from the central bank's projections. Usually, the latter wins. Several Fed officials are scheduled to speak this week, which will mostly be dominated by the acceleration of Q4 earnings releases.

Our positioning remains favourable to money market funds and bonds, including high yield. We carry a modest underweight in DM stocks and a more pronounced one on hedge funds and global REITS, but an overweight in gold. Have a great week.

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



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Cross-asset Update

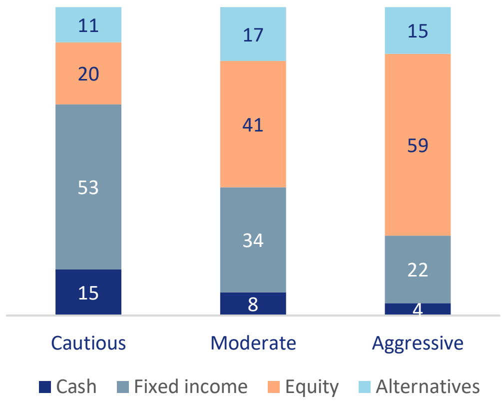
The year is off to a defensive start judging from equity returns, with few major indices globally in the green year-to-date, and the most countercyclical sectors like healthcare and staples topping the list. This is most likely a temporary consolidation following the everything rally that was sparked by the Fed's pivot late last year. The skewing of massive auctions towards T-bills by the Treasury in 4Q23 also helped ease financial conditions, being T-bills a cash equivalent, while relieving pressure at the longer end of the curve with the reduced need for longer-maturity debt.

It seems that in America there is always a way to inject cash in the system. At the end of January, a new Quarterly Refinancing Announcement will be made, whereby the Treasury communicates the amount of issuance and its composition along the curve. Skewing new debt towards T-bills would represent a second attempt to accommodate market liquidity. We will have to wait and see to know what Janet Yellen's decision will be in this regard. More importantly, recent remarks by NY Fed governor Williams and Dallas Fed Logan on the necessity to taper Quantitative Tightening, that is the amount by which the Fed's balance sheet will contract each month as Treasuries held by the Fed are reduced, points once again to a Fed's concern about liquidity. Logan said that "We should slow the pace of run-off as ON RRP balances approach low levels". The RRP facility is that sleeve of the Fed's balance sheet where banks and money market funds can park excess cash. In plain English, the above means that Fed liquidity, that is bank reserves, so far have not been impacted by QT as banks have been withdrawing cash from the Reverse Repo facility. But assuming withdrawals continue at the recent pace, and they will as banks now prefer to invest part of the RRP cash in Treasuries on the expectation of forthcoming cuts, then there is the risk that suddenly bank reserves will feel the brunt of QT having meanwhile RRP cash run almost dry. To avert this the governor, whose past experience as top official on the NY Fed market desk counts, urges QT is slowed down. All of this matters, and beyond technicals, as it suggests that the Fed is not only looking at macro variables to manage policy, and rightly so, as liquidity leads macro variables and affects them. JPMorgan is now expecting the Fed to outline a deadline of the tapering at the January meeting.

On top of this, Congress negotiators are working on the renewal of tax breaks for families and businesses that recently expired. If a deal is approved, USD70bn of additional liquidity would be available to beneficiaries. The outcome though remains uncertain.

Overall, despite valuations and sentiment being on the rich side for risk assets, downside should be limited in Q1 on the expected liquidity flows.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

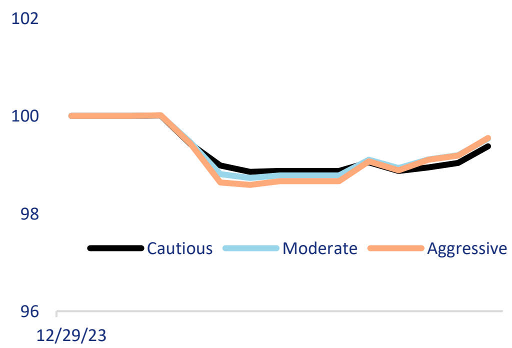


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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, we had a heavy data dossier with US CPI numbers at the forefront of investor minds. The inflation release was slightly stronger than anticipated, while the PPI figures came in below expectations. The focus has now shifted to QT after conflicting statements from the Fed officials. First, Dallas Fed president Lorie Logan said cross-sectional distributional issues could arise much earlier for individual banks that bear watching. She also added that the Fed should slow the pace of runoff as ON RRP balances approach low levels. This raised the market perception of an earlier start to QT taper. Subsequently, NY Fed President Williams questioned the need for such a move. Most analysts believe that in Jan FOMC, there will be some discussion about the pace of QT, and in Feb, we may have a roadmap for the taper. An earlier QT would be supportive of spread products. This will also remove the pressure on the US Treasury yields to move higher as a response to higher Treasury issuance since we would have a non-price-sensitive buyer in the market.

The market is pricing in 30 bps more rate cut by Dec 2024 as of last week compared to the week before, with the year-end Fed rate according to OIS swaps at 3.68%. We have seen a massive flattening of the UST yield curve as 2-year dropped by 23 bps to 4.14%, the lowest level since May 2022. The 10-year pulled back to 3.92% after reaching 4.09% on Thursday after the stronger-than-expected CPI release. The US Treasury benchmark was up 0.34% last week due to the bull-flattening.

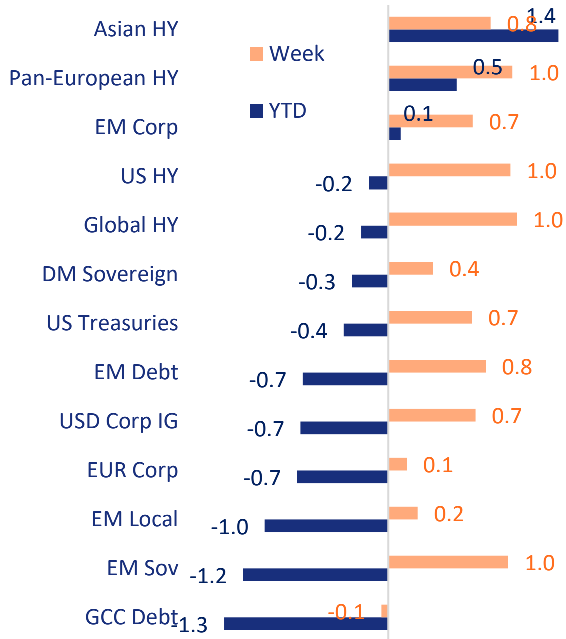
Credit spreads have also compressed slightly, with High Yield being the top beneficiary. HY spread compressed by 12 bps. Both EM and IG spreads compressed by 4 bps. The spread compression in IG comes even though we have achieved record issuance volumes. Total Investment Grade bond issuance for the year reached $99bn. Seventy-one borrowers have tapped the high-grade primary market over the first eight sessions of the year, a massive 31% increase over the 3y moving average. Thematically, there's been a drastic shift out the curve early on, with tenors 10 years and longer comprising 43% of the $99bn+ in new issue volume, up from just 28% over the same period last year.

Emerging Market bond issuance is also off to a scorching start, with a total of $53bn. GCC issuance has already crossed $13.8bn thanks to a massive $12.5bn bond sale by the KSA. The pipeline remains strong as more than $33bn bonds are set to mature this year. QIIB has announced a mandate to issue 5-year senior $ sukuk. India's largest commercial Vehicle finance NBFC, Shriram, has also issued a mandate for selling 3.5 year $ bonds this week.

FIXED INCOME KEY CONVICTIONS (2023)

DEVELOPED MARKETS
Overall overweight DM FI
OW Government Bonds
Neutral corporate (IG & HY)
EMERGING MARKETS
Overall UW EM Debt
Favor quality and selectivity

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



Source: Bloomberg

Equity Update

Last week saw developed market equities reverse first week 2024 losses. Japan equities outperformed, as did the tech sector. Brent crude futures are trading higher in escalating geopolitical conflict, following Houthi attacks in the Red Sea disrupting shipping channels. Any inflationary impact is too early to specify but transit volumes through Red Sea/Suez Canal are down, and global freight rates are up. We are seeing the impact on companies like Tesla, who have paused production in Germany because of disrupted supplies.

In Asia, China equities continue their downtrend and India its uptrend. YTD China's CSI 300 Index is -4.3% and Hong Kong's Hang Seng Index is -4.7%. China's consumer prices have marked their longest streak of declines since 2009, extending the deflationary streak that may require more government support. Also, export shipments fell 4.6% in 2023, their first decline since 2016. We are neutral China equities. India is our only overweight position in the EM space, and it continues its 2023 uptrend with small gains of a percent last week. UAE markets which we also favor are on a similar uptrend with Q4 earnings expected to announce growing dividend pay-outs, especially the banks.

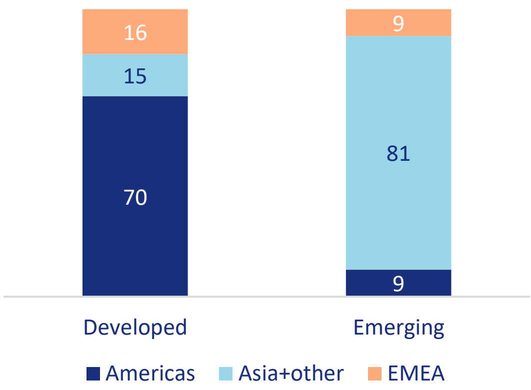
Japanese equities are at three-decade highs (we have started the year overweight, despite last year's rally). The Nikkei 225 index has gained 6.3 % YTD, with the broad market Topix +5.4%. The likelihood of an interest rate increase by the Bank of Japan in the near term is receding as inflation ticks down.

Developed market equities have so far continued the 2023 pattern and leading returns. The S&P 500 index closed Friday at 4,783 up 1.8% for the week and the Nasdaq was up 3.1%. Inflation data was viewed favorable while bank earnings got a mixed response. Thursday's CPI release did not point for a clear path to a dovish Fed, but Friday's PPI miss has gone some way to making up for that. Fedspeak continued to push back against the more aggressive rate cut expectations priced in by markets.

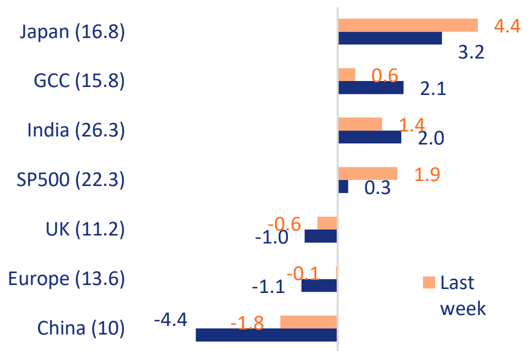
Friday saw the start of quarterly earnings season in the US. Consensus looking for S&P 500 earnings to increase 1.3% in Q4, the second straight quarter of growth following a three-quarter-long earnings recession that began late in 2022. Friday had Blackrock reporting that assets have crossed $10 trillion. 4 major banks also reported. Net interest income strong but peaking, and one-time charges related to the FDIC deposit insurance fund to recover losses associated with protecting uninsured depositors after the closures of two U.S. banks early last year, were not unexpected.

Outside of earnings, Tesla was in the headlines on Model 3, Model Y price cuts in China and components shortages in Germany. Delta Air Lines and United Airlines shares fell almost 10% as planes stay grounded on an ongoing FAA Boeing 737 max9 investigation. AI proliferation a high-profile takeaway from the CES, with Nvidia shares up over 10% last week.

EQUITY RECOMMENDED REGIONAL POSITIONING

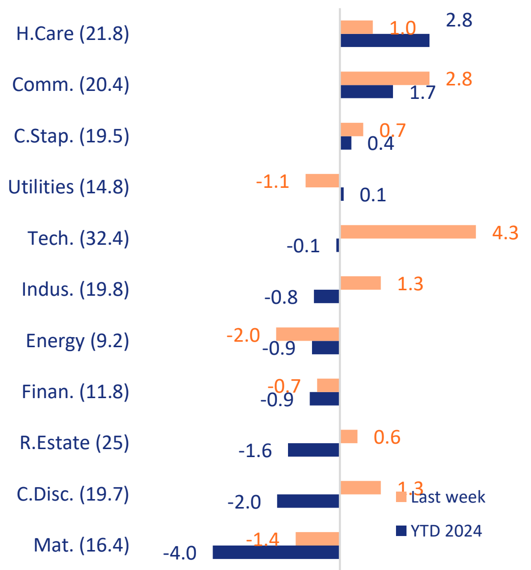


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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