Strangely quiet

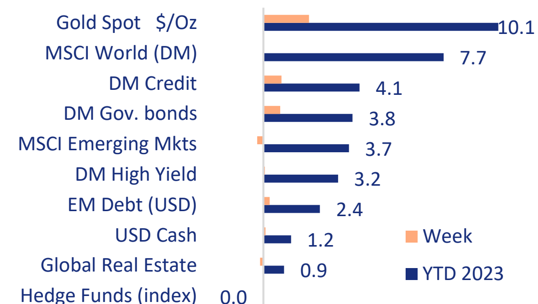
- **Last week was mildly positive and overall quiet on global financial markets**
- **March PMI releases were overall soft, especially weak for manufacturing in the West**
- **US inflation and retail sales will be the key data of the week ahead**

Last week was a bit shorter for global financial markets, with holidays in the West. Still, they were surprisingly quiet, despite an avalanche of economic data. Leading indicators were overall negative on manufacturing activity, with the US ISM falling to 46.3, missing expectations and firmly in contraction territory. The same gauge was at just 50 in China and 47.3 in Europe. PMI Services were however much better, remaining in expansion territory everywhere, and it’s worth noting that the UAE and KSA continued to outperform. The week ended with the US monthly job report, which confirmed a downtrend. The 236k job creations were in line with expectations, and materially below February’s revised number of 326k.

The key market drivers remain monetary policy and the banking system, which are to some extent interlinked: some level of banks’ stress is probably not an issue for monetary authorities, as it pressures growth, but only as long as the headwind doesn’t become a hurricane. Inflation data to be released this week will matter for the Fed’s decision in May. We will also see the beginning of the Q1 earnings season which, according to consensus expectations, should display a sharp drop compared to Q1 last year.

This is not an easy backdrop for investments, and turning outright defensive looks tempting. But it’s also dangerous: it would have been damaging to miss the recent rebound in markets, which didn’t have a clear fundamental catalyst. We will consider all options in our tactical asset allocation committee this week. So far, our positioning is not aggressive at the asset class level but we express a clear quality bias within both the equity and fixed income asset classes.

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



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Cross-asset Update

As we write today, the year-to-date returns of our three tactical asset allocation profiles have shown a spectacular recovery from their lows. Our Cautious, Moderate and Aggressive profiles are now up by respectively 4%, 4.5% and 5.2% this year, which compares to a low point of +1% just a few weeks ago. This happened despite the combination of persistent inflation, hawkish central banks, major stress in the banking sector and arguably worsening geopolitical tensions.

We are obviously not unhappy with such numbers, especially as they fare well against our global competitors, but it's important to understand the logic behind.

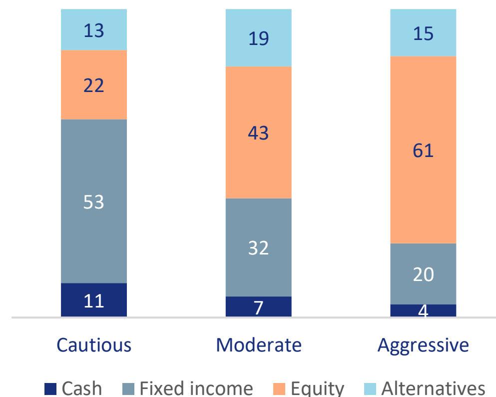
So, why are markets so resilient? The first reason is fundamental: there is no evidence of an imminent recession starting in the developed world. The weakness in manufacturing activity is clear, but it is at least offset by strength in services, which represent a prominent part of developed economies. This doesn't sound like good news when it comes to monetary tightening from central banks. However, this is where the current banking stress comes at play. Central banks made it clear that the fight against inflation was more important than growth. To that extent, they may not be totally unhappy with the fact that banks are not in a position to inundate the economy with more loans. However, the limit of central banks is clearly the risk of a full-fledged credit crunch which could create a financial crisis and a deep recession. Central bankers have to be measured.

Bottom-line, markets are increasingly comfortable with the idea that we won't see a material increase in monetary tightening ahead. Indeed, Canada, Australia and even India have already paused interest rates hikes. Western central banks should keep interest rates at current levels, or marginally higher, until the economy starts to materially deteriorate. Importantly, central bank's toolbox is not just interest rates. In their efforts to provide liquidity to banks, their balance sheet is currently expanding again. This is not a nightmare scenario for most markets.

The following question is about timing. Change in economic conditions can be sudden, yet it seems that the coming months should be relatively benign. When data starts to deteriorate, markets will have to make a call: is it bad, as it pressures earnings and solvency, or is it good, as it also means more support ahead from monetary authorities?

Inflation will remain at the heart of everything in the coming months. This is why so far our positioning is relatively neutral on both fixed income and equity. We however have clear preferences: the safest issuers within fixed income, and the best growth/valuation balance within equities. We also overweight cash over alternatives: money market and fixed deposits are without a doubt the very best uncorrelated return one can find, especially adjusted for their ultra low risk.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

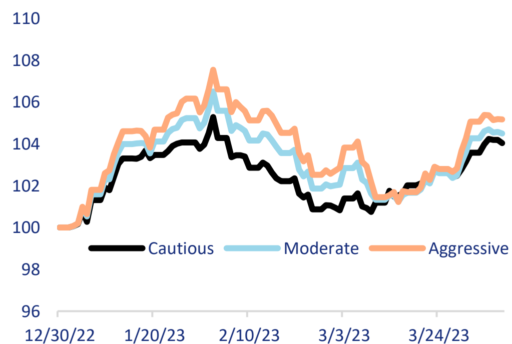


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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

Bull-flattening of the US Treasury yield curve continued last week as weaker-than-expected macro data points led a rally in long-dated treasuries. The 10-year treasury yield touched a YTD low of 3.29% before moving up slightly to 3.36% post the release of the US Jobs data last Friday. Spreads have been range bound and behaved well, with HY spreads widening slightly.

After the banking crisis, the negative correlation between stocks and bonds is back, offering solace to diversified portfolios. The 40-day correlation between US stock and bond futures turned negative last month, severing a year-long positive streak. According to a Bloomberg analysis, Fixed-income ETFs' inflows exceeded those of equity peers in the US in March. Investors' appetite for longer-duration maturities signalled widespread anticipation of a policy pivot by the Federal Reserve. Six of the month's top 10 bond ETFs in terms of flows target intermediate or long-term durations.

At the same time, the bankruptcies keep on ticking up. US corporate bankruptcy filings spiked in March, pushing the first-quarter tally to the highest level for the first three months of the year since 2010. S&P Global Market Intelligence recorded 71 corporate bankruptcy petitions in March, the fourth straight month of increases and the highest monthly total since July 2020. The recent filings brought the year-to-date total to 183 as of March 31, more than any comparable period in the past 12 years.

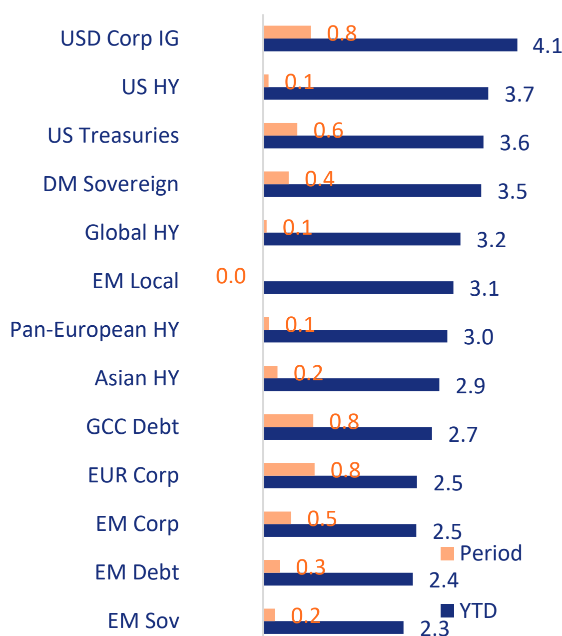
Closer home, however, there is more good news as Saudi Arabia's long-term foreign currency rating has been upgraded to A+ from A by Fitch on Kingdom's strong fiscal and external balance sheets. According to the release, Government deposits at the Saudi Central Bank, comprising the government's current account and the fiscal reserve, increased to SAR 463bn, or 11.1% of the country's GDP in 2022. In addition, net government debt stood at 12.7% of GDP.

Looking back at the primary issuance performance in the first quarter, we had added 60 securities to our list with an overwhelming tilt towards Investment Grade in line with our views of being overweight in Investment Grade long duration bonds. The Bloomberg Barclays IG index yields peaked at 5.18% in early March and since then have dropped to 4.68% as of Friday. On average, we have seen longer-duration IG bonds outperform everything else, generating a median return of 4.82% YTD from our list. Regarding sectoral splits, EM Govt bonds in our list have outperformed every other asset class with a median return of 4.31%. On the other hand, emerging Market High Yield bonds ranked the lowest in terms of median performance. This illustrates that the "Going Up in Quality" strategy would have worked for fixed-income investors this year. This would be the ongoing theme for the year.

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

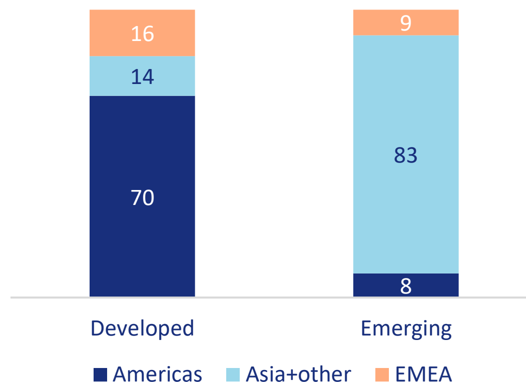
A shorter week for most markets with events and data pulling in both directions and most major equity indices showed little change. Flat is good for global equities, maintaining the Q1 gains of +7%. Outperformers last week were the UK, UAE, KSA, India amongst regions and the energy sector, as OPEC cut oil production taking oil prices up. Regional US banks also gained a percent as worries on deposit runs dissipated. However, analysts have cut US regional bank earnings expectations by 20 to 30% for 2023/ 24 and money market funds continue to see large inflows, in a shift away from bank deposits.

Treasury yields have moved notably lower in March on the back of banking system concerns which has supported a rally in growth and technology stocks. The S&P 500 (+7% in Q1) continues in a tight trading range, though many investment houses expect a breakdown. Mega Tech is responsible for much of Q1 performance with just 20 stocks in the Index responsible for 90% of Q1 gains. The upcoming earnings season will determine direction, though we are supporters of a continued similar trading range near term. The market has already factored in the 7% expected drop in Q1 y/y earnings and lower revenue growth of 2%. However, guidance around the impact of rates on refinancing will be closely watched as will corporate margins. Earning season kicks off with major US banks JPMorgan, Wells Fargo and Citigroup on Friday. We began the year with expectations of a flat earnings growth from the S&P 500 for 2023 and finally consensus is closer to us at 1.5% (they were +5% at the end of Dec) but consensus earnings growth expectations for 2024 at 10%, is optimistic in our view.

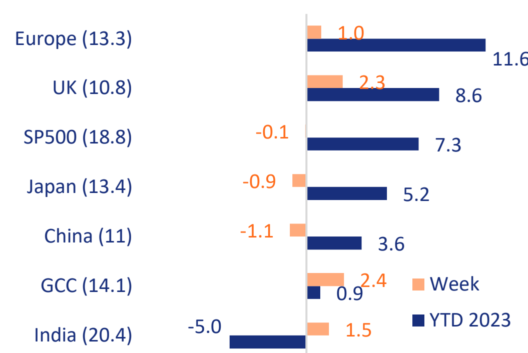
The UAE saw a successful listing of the Al Ansari IPO which rallied on the first day after receiving strong demand. Besides continued increasing market breadth, the recent oil rally reinforces our overweight view on the UAE. We are also overweight EM Asia, recently seen gains with a rally in the China tech sector and India.

Conflicting forces will continue to direct markets: continuing rates volatility, banking stress with funding pressures with a mismatch in assets and liabilities, commercial real estate lending tighter, falling housing prices (a relief), recession fears, inflation not as hot but still heavy, with higher oil prices not helping. Policymakers have maintained that rates must go a bit higher to combat inflation, despite recent stress in the banking sector.US nonfarm payrolls data shows the labor market remains resilient, clearing a hurdle for the Fed to continue with one more rate hike. The tightening cycle for most developed regions Central Banks looks close to peaking and pausing. This was the catalyst awaited for an equity rally but this has already been priced in and hence the earnings direction is now the most important catalyst along with lending conditions to corporates. Commercial real estates is facing a big refinancing risk with nearly $1.5Tn of debt due for repayment before the end of 2025, Some analysts estimate that office, retail property valuations could fall 40%.

EQUITY RECOMMENDED REGIONAL POSITIONING

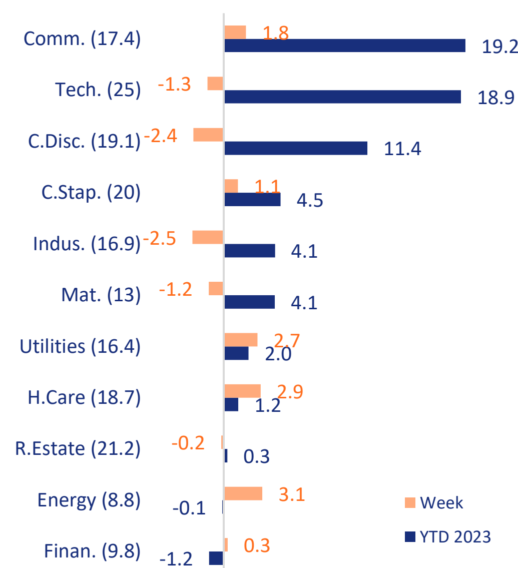


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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