Slowing, tightening, falling

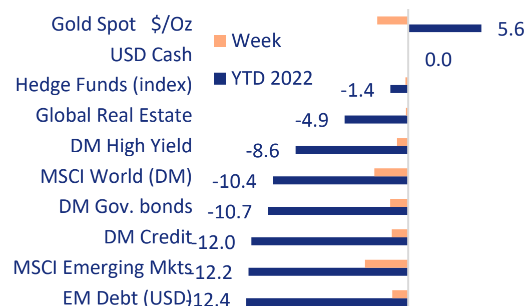
- **Markets are under pressure from hawkish central banks' rhetoric, war uncertainty and slowing growth**
- **On growth, the IMF downgraded their 2022 projections and China's COVID situation is not improving**
- **The good news is that Q1 earnings are good and contribute to make equity valuations now reasonable**

All major asset classes were in the red last week, pushed lower by a combination of well known concerns. The hawkish tone from the Fed escalated every day, with a 75 basis-point hike now being openly discussed, with a tightening labor market as a backdrop. While the probability of such a move remains very low, this confirms that at least one half-point increase is imminent. With regards to growth, the IMF materially downgraded their 2022 forecasts and marginally for 2023. The institution is not known to be optimistic and absolute levels are not that low, but this added to global concerns, especially as China's zero-COVID policy takes an increasing toll on activity, with no end in sight. This shakes currency markets and raises questions on demand for commodities, including oil.

Meanwhile, Emmanuel Macron secured a second presidential term yesterday, with an agenda which is undoubtedly more market friendly than his contender's. The earnings season continues, with, importantly, US tech names publishing this week. So far, Q1 numbers are beating expectations by a significant margin. This doesn't go a long way in comforting investors for the future, but at least, with a rising denominator and a falling numerator, equity multiples are now looking very decent. The same happens in fixed income where yields from government bonds now provide some value to investors. It will take time for markets to consider the positives, especially as the war in Ukraine starts its third month with little hope of a resolution, and as any good news on the - so far resilient- economy is primarily seen as a sign of more and more tightening ahead.

We reduced both our bonds underweight and stocks overweight last month. We have to be patient and stomach volatility. Stay safe.

ASSET CLASSES USD % TOT.RETURN, YTD 2022 & LAST WEEK



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Cross-asset Update

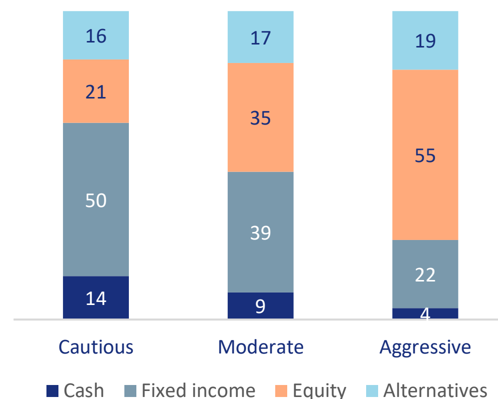
It is making headlines that US long-dated real rates are back to basically zero after being in negative territory since 2020. Real rates do matter, as they measure the degree of tightening of financial conditions, which have been ultra-loose in the last couple of years. The inverse correlation between the price-to-earnings ratio of the equity market and the 10-year real treasury yield has historically been pretty tight, and the burden on the private sector tends to increase as real rates shift higher. So, the obvious question now is how much upside we would still be expecting. And this question should be asked Fed officials, as they are the ones who are now determined to tighten policy in order to fight inflation. So, in a nutshell, we must gauge what lies ahead in terms of Fed policy and then we can go back to answering that question.

By and large, when long-dated real yields trade in line with the real growth rate of the economy, for the United States currently estimated at 1.7%, they exert neither restrictive nor expansionary effects. Going from the current 0% to 1.7% would be a huge leap, considering that the 10-year real yield this year has already surged by 110 basis points. Also, when it reached 1% in late 2018 the equity market cracked and the Fed had to sweeten the pill by reverting to looser policy in order to stem the crash. If it is not unreasonable to expect that the Fed will want to see at some point the 10-year real yield trade at least at 1%, this does not necessarily imply that the nominal yield must go up by 100 basis point straight. The same result can be also achieved with market implied inflation shifting half a percentage lower, for instance because the economy slows down, and the nominal yield half a percentage higher from current levels. So, if we are lucky, that is if inflation rolls over, we could get away with the 10-year nominal yield 50 basis points higher from here. And not necessarily this year, as financial conditions have already tightened to quite a degree just on the effect of pure Fedspeak.

Yes, the scenario is quite uncertain. Real yields are too low, but the degree of tightening could still be manageable provided inflation peaks soon. That is not much of comfort, though, and meantime investors must be wondering how they should manage their portfolios with so many unknowns. One option would be to lay emphasis on income generation, as the outlook for returns remains clouded. With the US 10y2y yield curve close to inverted and little visibility about future inflation, it is obvious that one is not paid for longer-duration bets. So, income generation could be achieved by allocating capital to high-yielding short-duration bonds. Fatter coupons offer somewhat of a buffer against inflation and shorter duration in this case equates with higher yields. Investors should be targeting income generation within equities as well. High dividend-yielding stocks have historically offered less downside risk during volatile market conditions, as well as high-cash-flow companies have. Both are skewed towards the value investment style, which is not hurting at all considering the still large growth-value valuations gap in favor of the latter.

Yes, putting cash to work is possible, but with an eye to minimizing risk and generating income.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

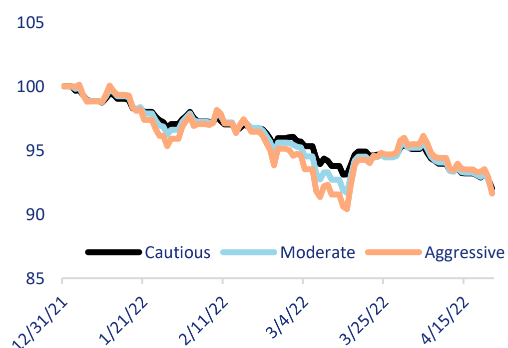


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight

	UW	N	OW
Cash	<<		
DM Gov.	<		
EM Debt		=	
DM Credit		=	
DM H. Yield			>
DM Equity			>
EM Equity		=	
Gold		=	
Real Estate			>
Hedge Funds		=	

TAA – 2022 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Emirates NBD
PRIVATE BANKING

Fixed Income Update

The central banks' hawkish rhetoric has constantly increased over the last week. This has had a dramatic effect on the developed market government bonds. US 10-year treasury yields have increased by 67 bps WoW while the 1-year has increased sharply by 78 bps. This bear flattening of the curve is seen across European yield curves as market participants priced in the early termination of ECB's QE and gradual progress to policy normalization, albeit at a slower pace than the US. This morning as we write, the yields have come down across the region due to an expectation of slower global growth driven by Chinese localized lockdowns.

In addition to the above increasing yields, credit spreads across different segments widened, leading to a double whammy. All the segments were in red as of closing last Friday. Last week's returns ranged from -0.4% in US Treasuries to -1.3% in Emerging Market Sovereign debt. Even segments that had been robust such as China IG, performed poorly due to a combination of worsening growth factors as well as the depreciating currency. Developed Market Govt bonds, IG and HY outperformed Emerging Market last week.

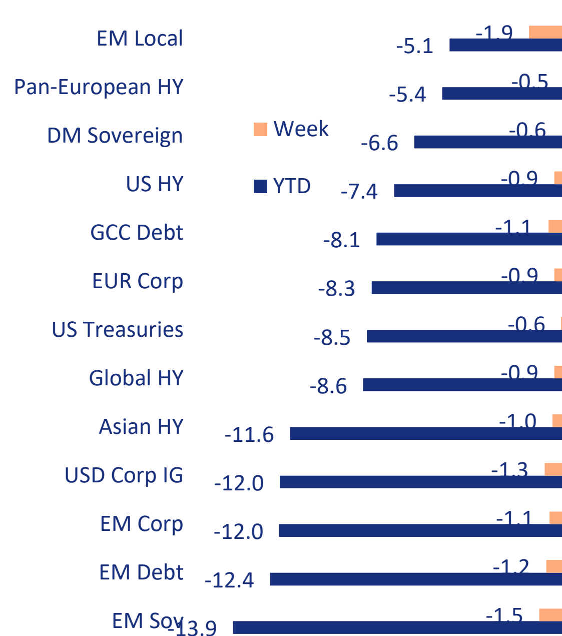
Looking east, the PBOC held a meeting with about 20 major banks and asset-management firms last week to improve cashflows to the much-maligned Real Estate sector. The steps discussed include looser acquisition financing requirements for off-plan projects and extending borrowings to companies where loans are overdue if the developers provide additional credit support, such as pledging more assets. According to the Bloomberg report, around 12 companies, including Sunac, Shimao, and Evergrande, will be supported through these routes. However, according to some estimates, possible bond exchanges and extensions by Sunac, Shimao, and Logan may drive the default rate of China's high-yield developers to above 50% in 2022, leading to negative TRs from the asset class this year.

In a historic announcement last week, the Ministry of Finance announced in the UAE that the first auction of AED-denominated T-Bonds is to happen in May. The tenures in the first auction would be 2, 3, and 5 years. Subsequently, a 10-year note will also be issued. There is a plan to hold eight auctions this year with a total issuance size of AED 9bn. We see a multitude of benefits that follow such a move. In conjunction with taking blue-chip companies public, this announcement will firmly push our local capital markets and create a new attractive segment within the broader Emerging Market fixed income for both local and foreign investors. Building a local mid-term yield curve provides a reference point to price both debt and equities. It will diversify the source of funding for the sovereign. Moreover, as the yield curve matures, we will see an influx of corporates that will be able to tap the public debt market in the local currency, thereby benefitting from multiple funding channels.

FIXED INCOME KEY CONVICTIONS

DEVELOPED MARKETS
UW Government bonds
Selective on Credit
NEUTRAL High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

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



Source: Bloomberg

Equity Update

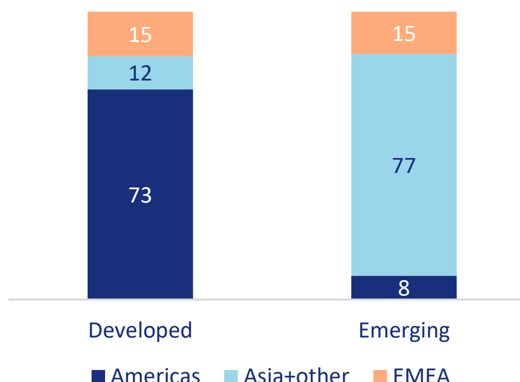
Monetary tightening, inflation and worries on slower demand from China are driving markets down. The world is seeing some of the highest inflation rates since the 1980s as Russia's invasion of Ukraine boosts food and energy prices and China's lockdowns add to supply chain woes. Last week global equities fell 2.7% with YTD losses now at 10.5%. Gainers included only the UAE. While US Q1 earnings have revealed strength and are beating estimates, an accelerated tightening cycle and hawkish central bank commentary had the S&P 500 ending the week -2.74% with the Nasdaq losing more at -3.83%. Global sectors had consumer staples gain slightly as did real estate with all others negative for the week. The Services subsectors did better i.e. airlines and leisure. YTD the only sector in the green is energy and though oil prices are falling this sector could hold up as margins remain robust. The airlines industry is talking of robust demand trends and looking at profitable operations despite fuel cost pressures. The MSCI China Index fell c.7% last week and the Nasdaq Golden Dragon Index that tracks China company shares listed in the US continues to slide and has fallen 30% YTD. Shanghai's stringent lockdowns continue as authorities announced that tough restrictions on mobility will remain in place. Companies are allowed to resume full production however face manpower and logistical challenges. This is increasing global supply chain issues and reducing trade flows and the IMF is concerned about spillovers to the global economy. China growth is seeing downgrades with headwinds from its 'Covid Zero' stance and disappointment over recent PBOC easing measures.

UAE equity markets performance should be further boosted by strong bank earnings, the real estate sector rebound and the planned Treasury issuance. Dividend yields remain attractive and a good hedge against inflation. Building a local mid-term yield curve provides a reference point to price both debt and equities.

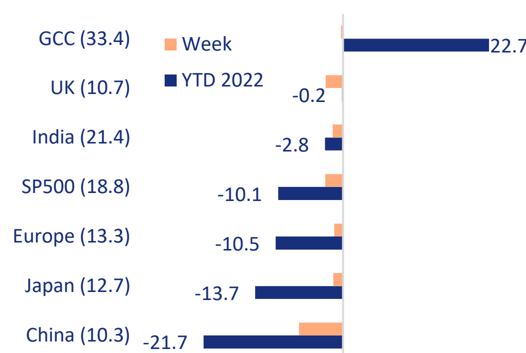
We retain a constructive view on muted equity performance into year end. The economy is improving, at a slower pace than last year, the consumer is still strong, corporate earnings are rising and inflation is likely to decline. According to FactSet, S&P 500 earnings growth rate for Q1 is at 6.6%, up from the 4.7% expected at the end of last year with revenue growth at 11.1%, net profit margin 12.3%, below the year-ago 12.8% but above the 5-year avg 11.2%. 20% companies have reported, beating earnings estimates by 9.1%. Guidance is focused around economic normalization/reopening momentum, inflationary pressures and supply chain constraints, strong corporate and consumer balance sheets, China lockdowns, Covid headwinds on labor availability, higher rates, a pickup in credit provisioning, softer capital markets, plans for price increases/ cost savings.

The streaming subscription economy is showing signs of a downward trend, as rising inflation has consumers rethink discretionary spending. Streaming services such as Netflix, which were the poster child of streaming, are losing subscribers. On the other hand, hardware sales of iphones, EVs remain strong (tangibles vs intangibles) and increased offtake of EVs has been illustrated with Tesla's strong results.

EQUITY RECOMMENDED REGIONAL POSITIONING

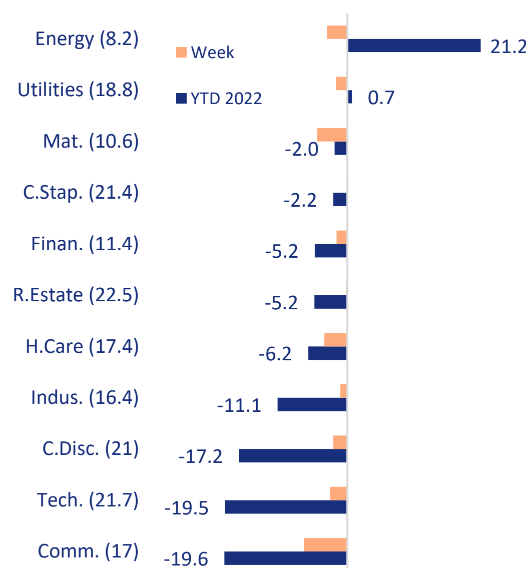


MAJOR INDICES PERFORMANCE (TR, US$) AND 2022PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2022PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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