Strong labor market but flaring geopolitical risks

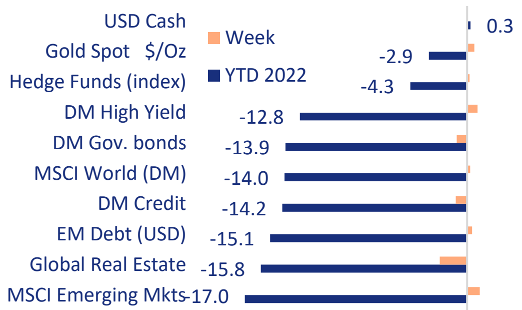
- **Recession concerns crushed by booming US labor market**
- **Geopolitical risks flare up following Taiwan visit of House speaker Pelosi**
- **Chinese recovery sputtering amidst deepening real estate crisis**

US stocks ended the week mixed following a very strong jobs report that rekindled expectations of more tightening to come, with the S&P 500 recording modest gains and the Dow Jones unchanged. Equities continued to be supported by above-consensus earnings, while yields closed higher in the five days through Friday, as the message coming from the labor market and hawkish declarations by Fed officials outweighed the rising US-China tensions sparked by the Taiwan visit of Nancy Pelosi. On the other side of the pond equities in Europe and the UK eked out only modest gains, as economic momentum worsened significantly in the common area and the BOE raised rates by 50 basis points, forecasting that inflation remains "very elevated" and a recession could start in winter. Mainland China equities closed slightly negative for the week with economic woes coming back to the fore. Business surveys were underwhelming and the real estate crisis deepened.

The US labor release hogged the limelight, and rightly so, showing strength across the board, with payrolls numbers, wage growth and employment all above expectations. The economy saw the addition of 528,000 non-farm payrolls in July, while the steady-employment payrolls level is around 100,000 per month. No wonder that San Francisco Fed Mary Daly said that the Fed is 'far from done yet'.

The rift between the two global superpowers is widening as the PLA encircled the island of Taiwan and ran unprecedented live military drills after Nancy Pelosi left Taiwan. There is no visibility as to when tensions could subside, with Western leaders possibly emboldened to fly to Taiwan and the Chinese feeling compelled to escalate. Stay safe.

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



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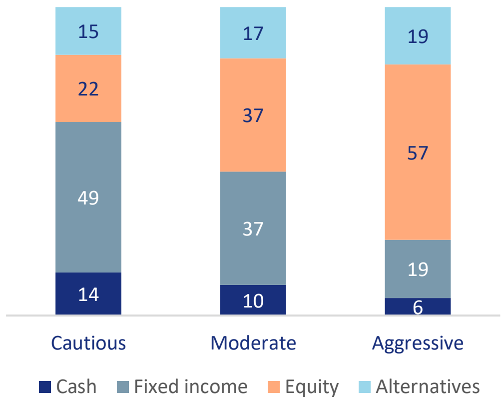
Cross-asset Update

We continue to have little confidence in the fast and furious rally that has followed the July Fed meeting. Both the belief in the Fed pivot, that is in a milder monetary cycle now that a supposedly 'neutral rate' has been reached, as well as concerns about an impending recession, should have been crushed by the Friday's blowout jobs report. Job openings are too plentiful for the economy to be facing a hard landing, and the Fed has a 'whatever it takes' approach to taming inflation at multi-decade highs with a booming labor market, hence the tightening will continue. Investors seem to have cherry-picked from Powell's words what could please animal spirits the most. Yes, the Fed will be 'data-dependent', but the Fed chair in the Q&A session two weeks ago also mentioned that the natural rate of unemployment has moved higher. Outside of the economic jargon this means that there is more need for tightening to curb labor market strength. Indeed, following the payrolls release equities stalled, treasuries pulled back and the pricing of future policy rates changed to signal a high probability of a 75-basis-point hike in September and a peak rate in December at 4%. This seems still too benign, and some analysts are now leaning towards a 5% terminal rate, a far cry from market expectations. The most likely scenario for this year seems to remain that of an ongoing slowdown, with risk assets stuck in a range and the next big risk event being, rather than a recession, the mid-term elections.

High yielding bonds have rebounded hard alongside equities in the past two weeks, yet risks remain round the corner. If history is any guide, buying the weaker credits when a tightening cycle is in full swing, as now indicated by the deep inversion of a treasury yield curve, has rarely been a good idea. The same holds for EM debt, as US rates volatility is still at peak levels, and that volatility in the past abated only when policy rates inflected lower. In summary, with equity and high-yielding credit gains capped, sticking with high-quality bonds still seems a winning strategy, although capital gains may well be behind us and one must be happy with coupon clipping only. As for gold, it is hard to envisage more than a short-lived rally for now, considering the outlook for US policy rates.

Peaking and then fast receding inflation would be a game changer for risk assets, although for now it seems a rather remote possibility. Unless we hold the view that money supply only has played an outsized role in stoking price pressures. Liquidity momentum has been tumbling following the fiscal drag from dwindling subsidies and the Fed's tightening. Will inflation follow through and tumble as well? Investors will be looking forward to next week's inflation release, as well as the August one, before the next Fed meeting to be held on 20 - 21 September.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

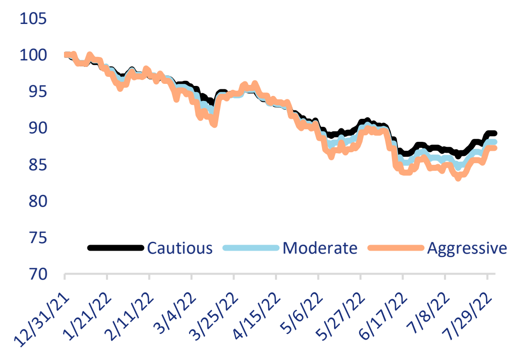


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight

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

TAA – 2022 INDICATIVE PERFORMANCE



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

Fixed Income Update

US treasury yields surged on Friday on a stronger than expected jobs report, as the unemployment rate dropped to 3.5% at a five-decade low. The 2yr yield rose 22 basis points and closed at 3.26%, while the 10yr rose by 18 basis points. The degree of treasury curve inversion remains high with 2s10s hitting 40bps, close to the degree of inversion last seen in 2000 at 47bps. The strong labor market reduces the outlook for Fed funds to decline next year, as weakening gauges of business activity, housing, and consumer confidence could initially suggest. Fed officials also signaled that they don't believe the economy is in recession. Fed Governor Michelle Bowman said she supports the Central bank's recent 75bps rate hike and believes they should continue until inflation is subdued. Hence, the market is predicting a third consecutive 75bps rate hike in September. Next week's inflation data remains crucial, with volatility expected to remain elevated in the treasury market.

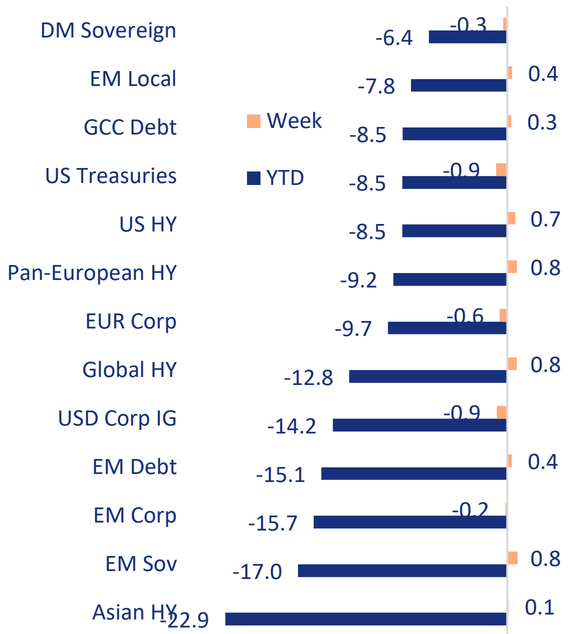
Last week, the BoE also joined the jumbo hike clubs by raising rates by 50 bps, the largest hike in 27 years, with the majority MPC members voted for a 50bps hike. The BoE is now forecasting a recession starting in Q4FY2022 through to 2024. The bank expects its balance sheet to shrink by around GBP80bn in the first year, with GBP35bn of redemptions and GBP10bn per quarter of gilt sales across the curve. Governor Andrew Bailey reiterated his concerns about the tight labor market resulting in higher wages, consequently leading to higher inflation. On the path ahead, the MPC retained both the "scale, pace and timing" and "act forcefully" language. Markets expect one more 50bp hike in September. Separately, on Friday the Reserve Bank of India also raised the repurchase rate by 50bp, taking it to 5.4% with a hawkish tone.

Since mid-July, the HY-IG spread gap has compressed by about 90bp, after trading near historical highs. In the US, the HY rally can be attributed to technical factors, a very low supply in the HY primary market alongside strong inflows (cumulative $7.8 billion net inflows in the past two weeks). In Europe, the HY-IG spread gap is not expected compress further – Firstly, the gap is still at the low end of its post-global financial crisis range, indicating that there is still room for decompression. Secondly, the outlook for tighter monetary policy and a worsening growth-inflation mix would be supportive of high-quality bonds versus HY. Lastly, the end of ECB net purchases should drive risk aversion and continue to attract investments in the safer segments of the credit market. In the MENA region, HY sovereigns like Bahrain and Oman have continued to rally, and offers in both sukuks markets almost completely dried. If the market's focus on recession risk intensifies, then HY could again underperform IG.

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

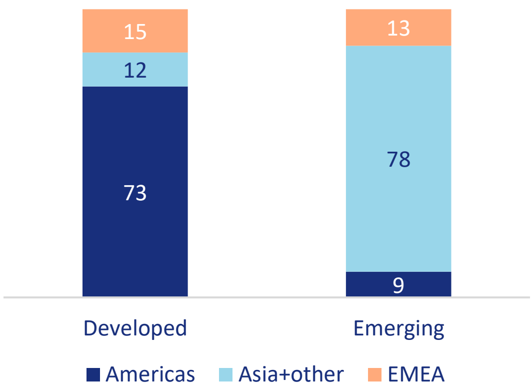
A positive week for global equities, maintaining levels, post the 7% upswing seen in July. The Nasdaq had a good week, as well as the GCC (in spite of falling oil prices), and India. Year to date global equities are down 14% after having seen a trough of 22% on 17th June. Many stocks that had lagged the broader market in H1 have staged a rebound, aided by earnings results and retail buying. Energy however, is the only sector with positive returns YTD and the UK, LATAM and GCC are the only regions in the green. In H2, we have seen a tech rebound as Treasury yields fell, however the strong US jobs report on Friday is causing concerns about the outlook or rising yields. We retain our conviction on select tech sectors which participate in global trends such as the cloud, ecommerce, EV's, the use of big data and AI and semis.

Recent data releases and corporate-earnings reports have flashed mixed signals about the economy's trajectory and whether a recession is on the horizon. The jobs report however removes fears of any imminent recession as the two key features of every US recession, rising unemployment and falling economic output have the first part holding up, though GDP has contracted for two straight quarters. Equity markets continue to be driven by inflation concerns, the war in Ukraine and supply chain constraints. Rising rates, raising debt-servicing costs and leading to demand destruction, are also at the forefront of investor minds.

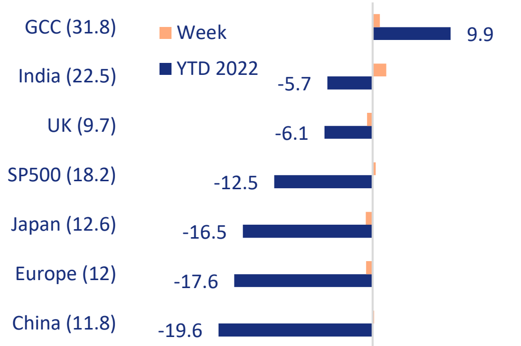
US markets have remained resilient on a strong earnings season and growing belief the Fed can tame inflation. Valuations remain reasonable even after the recent rally and the forward 12-month P/E ratio for the S&P 500 is 17.5X. In spite of a planned 1% buyback tax, S&P 500 buyback announcements are at $541B YTD, well-above the 2021 pace. Q2 Earnings have seen 87% S&P 500 companies reporting, with 63% beating revenue forecasts and 75% profit projections. Y/Y revenue growth is tracking +13.6% and earnings +6.7%. the biggest contributor to the gains has been the energy sector. Looking ahead, analysts expect earnings growth of 5.8% for Q3 2022 and 6.1% for Q4 2022 and for CY 2022, 8.9%. A positive surprise has been the net profit margin for the S&P 500 for Q2 2022 at 12.3%, above the 5-year average of 11.2%, equal to the previous quarter's net profit margin of 12.3%, and just below the year-ago net profit margin of 13.1%.

Asian equities ended the week higher, taking geopolitical tensions between China and the U.S. in their stride following Nancy Pelosi Taiwan visit. On a tactical level we have removed our China OW and added to the India OW. Overall, positioning remains unchanged. We are Neutral Developed Market equities with a preference for the UK and the US and a small OW on Emerging Market equities with a preference for India and the UAE. Economic concerns around China have increased with continuing COVID-induced lockdowns and although an economic rebound in China looks underway according to government and private sector data, the stock market may remain volatile as the US SEC continues to add to China ADR's for their potential delisting.

EQUITY RECOMMENDED REGIONAL POSITIONING

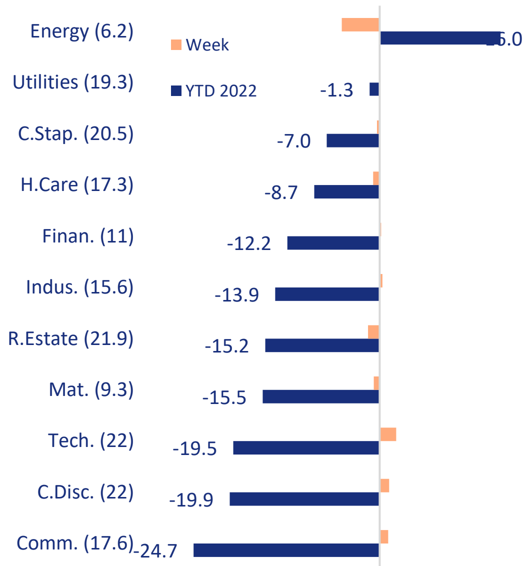


MAJOR INDICES PERFORMANCE (TR, US$) AND 2022PE



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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