Growth concerns?

- **Last week saw lower interest rates and an outperformance of defensive segments**
- **Rising covid cases and falling consumer confidence seem to raise questions on growth**
- **We remain reasonably constructive but expect volatility ahead**

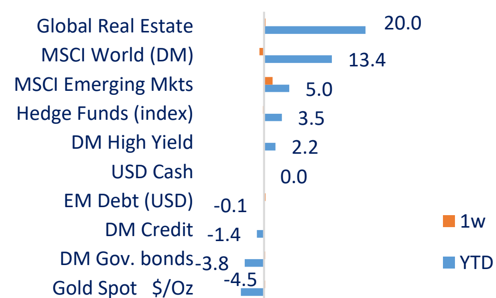
Global markets last week seemed to signal a change in narrative. Not that long ago, the only question was about how and when central banks would react to a booming economy and rising price pressures.

Last week was different. No doubt, growth was solid in June and all inflation measures were up. But with a strong increase in global covid cases, and with interest rates continuing to fall for a third consecutive week, markets are starting to question the scenario itself, and especially the future trajectory of the economy. Stocks were down in developed markets, with an unambiguous sector hierarchy: energy, financials, industrials underperformed, utilities and staples did well.

Let's say it clearly. We think that the resurgence of the virus should not derail the recovery. The link between infections and hospitalisations has weakened materially for vaccinated populations, and vaccination rates are progressing. We also believe that the global economy is not firing on all cylinders yet: Europe and services still have room to catch-up. We still find some modest but positive fundamental upside on stocks. We however acknowledge that markets hate uncertainty, and that elevated valuations and unanimously positive sentiment create vulnerability. This is why our positioning has evolved from bullish to constructive. We remain overweight risk, but less than in H1, with our latest change being to downgrade high yield from overweight to neutral. Volatility will remain elevated, and a correction is not to be excluded in the summer. This could be a good news for long-term investors: an opportunity to increase exposure.

We wish you and your family Eid Al Adha Mubarak, good health and prosperity. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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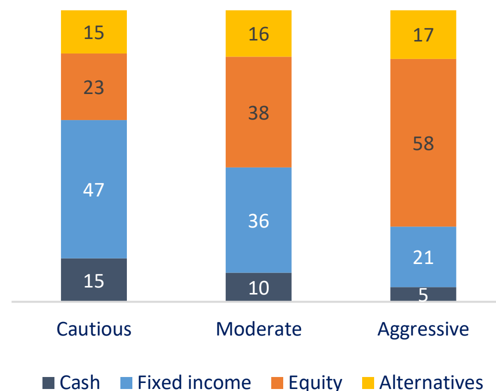
Cross-asset Update

The growth outlook seems to be pretty uncertain judging from the relentless fall in long-dated US yields since March. Never mind that the Fed upgraded GDP forecasts as recently as in June and that the US economy is expected to expand as per consensus projections at a rate well above trend for most of 2022, yields are sending a different message. There are different ways of getting in the details of that message. One way is to consider that business confidence is correlated with the yearly returns of risk assets and that one can, with statistical techniques, back out the confidence level implied by today's yearly returns. Proceeding along those lines, it seems for instance that the US ISM Index should be at 55, rather than at its current value of 60. So, the economy would still be expanding, but at smaller rate. Another way would be to back out directly the GDP growth implied by risk assets, since their returns are mainly driven by the economy, and this technique would be yielding a GDP rate for 2022 well below 1%, not in line with above-trend consensus projections. Although there are not many short-term catalysts at hand to push yields higher in the direction of fair value, future growth is underestimated to such an extent that further downside risk should be very limited.

Concerns about the outlook have indeed started to mount of late. The reflation trade has stalled and actually partially reversed some of its previous gains, and pessimism on China is growing. We hold the view that it is a matter of investors digesting peak earnings, peak growth and peak stimulus happening more or less at the same time before markets can progress further. Excess savings accumulated because of fiscal support in the US, Canada and the UK are estimated to be north of 10% of 2019 GDP and should be spent as the economies reopen, exerting their maximum effect in early to mid-2022. Well before that happens, the Chinese government should step in to stimulate the economy via infrastructure investments in the second half of this year to counterbalance the negative effects of the previous prolonged tightening.

In summary, we believe that our moderate but clear pro-cyclical positioning makes sense, and even more so that we recently downgraded our outlook from optimistic to constructive. In this mid-cycle slowdown phase investors should be more mindful of security and fund selection than beta exposures and leave some powder dry to take advantage of possible market setbacks.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

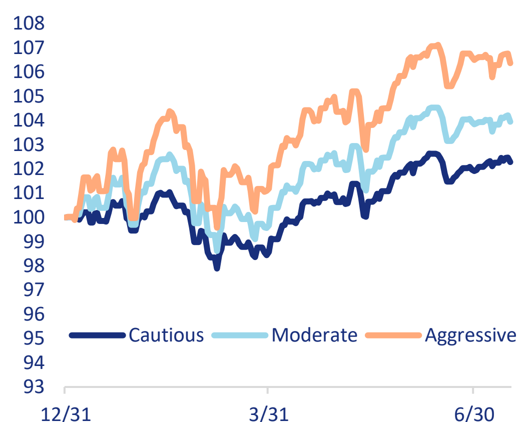


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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

UW/N/OW:Underweight/Neutral/Overweight

TAA – 2021 INDICATIVE PERFORMANCE



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

Fixed Income Update

What do the bond markets know that we have missed seems to be the real conundrum for most of us. It feels more and more like a mid-cycle play than an early cycle. The last couple of business cycles were very extended due to policy support, although cycles used to be shorter and subject to sharper swings before that. There are also quite several indicators pointing to this being a mid-cycle phase. Chief among them are expectations of corporate earnings, and economic growth has peaked.

Moreover, central banks worldwide seem to be questioned more on their stance on tackling inflation than supporting growth. The yields at least are behaving the same way discounting a slowdown in future growth. Last week culminated what we call in cricket parlance a hat-trick with three consecutive weeks of yields coming down.

Investors should be careful during such times with at least 10%-15% of their fixed income allocation to defensive assets to protect against large drawdowns. There could be a false sense of diversification due to holding multiple highly correlated securities, such as emerging market debt and high yield. Both these asset classes tend to perform poorly during turbulence. We typically advise a core and satellite approach to Fixed Income investing. The core should be a mix of defensive assets and aggregate-type funds that adapt quickly to changing backdrops. In contrast, the satellite allocation to high yield and emerging market debt would generate the additional yield.

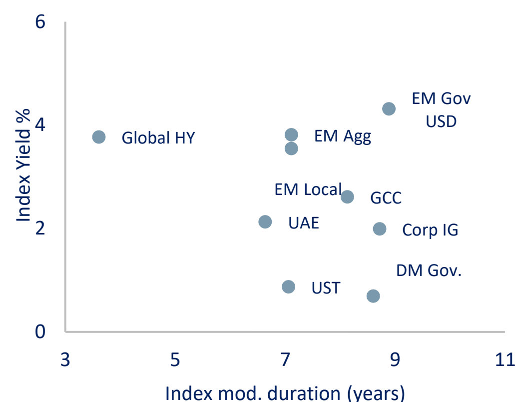
Markets tend to get nervous as yields move below 1.4%, with spreads widening in the riskier asset classes. High yield spreads increased by nine bps and is now 350+ for the first time this month. US High yield was the worst asset class in terms of weekly performance with -0.2% returns. We had recently booked profits in our overweight allocation to High yield and turned neutral. Long duration and defensive assets outperformed due to the yields going down.

MENA primary markets have taken a break after a superb first half where $59 Bn bonds were issued. There were more than 5 new issuers while sovereigns took a backseat due to improving fiscal balances. Qatar Petroleum issued the largest Emerging Market bond tranche of the year selling $12.5 Bn last month. Most of the capital appreciation from the region is out of the picture, with yields at the front-end moving down significantly for the high yield sovereigns. Carry would generate most of the return for the asset class going ahead.

FIXED INCOME KEY CONVICTIONS

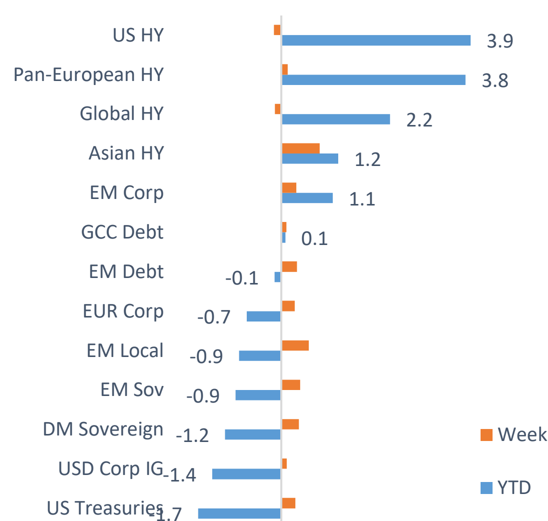
DEVELOPED MARKETS
UW Government bonds
Selective on Credit
Now NEUTRAL High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

Q2 earnings growth for the S&P 500 is estimated by consensus at 62% y/y, and 100% for MSCI Europe. Of course, base effects are huge: the focus should be less on the growth rate and more on what companies say in their forward guidance with respect to consumer sentiment, profit margins, rise in input costs, supply chain constraints, growing commodity prices and wage pressure. While Fed Chair Powell continues to see inflation as transitionary, with continued accommodative monetary policy, firms such as Blackrock which raised wages by 8% across the board have warned of inflation, along with others.

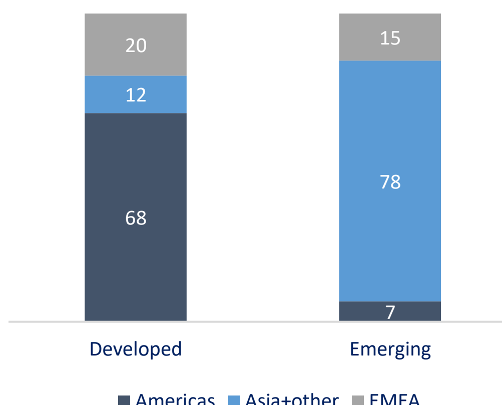
Last week saw most DM equity indices lose momentum. The S&P 500 fell a percent and both technology and financials underperformed. Europe was only slightly down. The resurgence of the virus is taking a toll on reopening and consumer sentiment. It was the reverse for EM indices which have lagged DM performance this year, with China and India markets ending the week positively. UAE markets were mixed though trading volumes are picking up aided by new listings.

Q2 earnings season starts well, with major US banks announcing much higher earnings in Q2, across the board y/y but for some partly due to a write back of provisions taken in Q2 2020. Bank of America said consumer spending has significantly surpassed pre-pandemic levels, deposit growth is strong and loan levels have begun to grow. This is in line with last week's Beige Book report that the U.S. economic recovery continued to strengthen, but pricing pressures were broad-based and grew more acute in the hospitality sector. On the consumer front Pepsi too had stellar results. Domestic traffic is visibly picking up with Delta Air Lines providing a positive outlook. In Europe Richemont, amid a broad rebound in the luxury sector, has doubled revenue in Q 2 y/y and UK's Burberry said sales are back at pre-pandemic levels.

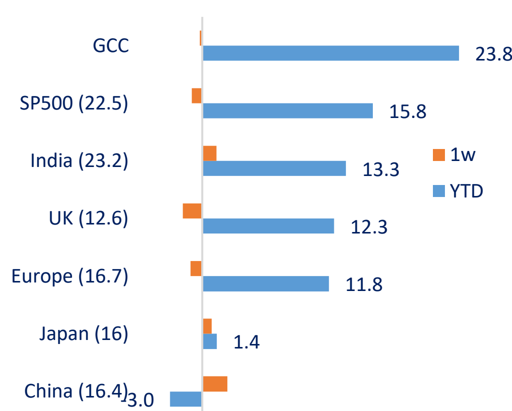
Yahsat, an integrated satellite communications company that offers solutions to over 150 countries had a successful listing in Abu Dhabi as the exchange changes rules to encourage listings. The IPO of Yahsat is a landmark transaction for Mubadala and Abu Dhabi. Tranches were oversubscribed multiple times.

Wall Street has seen record listings this year including China companies such as Didi which are facing regulatory fire from their home base as China discourages listing of firms with large user data bases on foreign bourses. The US has already had over 500 IPO's — with cryptocurrency exchange Coinbase, video game platform Roblox, US job listing site ZipRecruiter, website creator Squarespace and UK fintech Wise following Palantir and Asana from last year. However 40 to 50% of the listings are companies which are yet to turn a profit and many of these are trading below IPO price indicating initial hype which may require years to pay investors for the risk of investing in businesses which still have to prove themselves in terms of profitability.

EQUITY RECOMMENDED REGIONAL POSITIONING

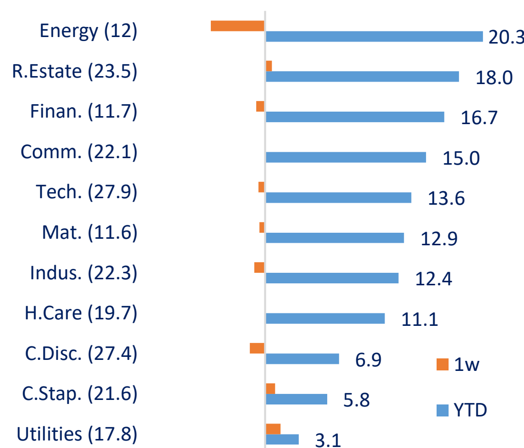


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2021PE



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

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