Fear, Uncertainty and Doubt

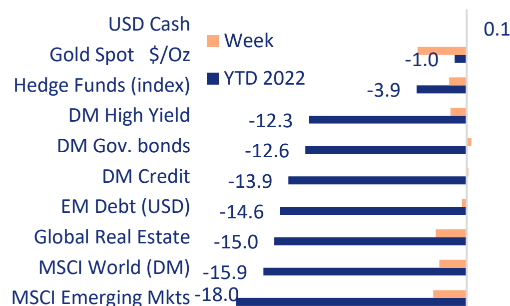
- **Last week was extremely volatile -again- and overall negative for most markets…**
- **… With market participants now acknowledging a perfect storm on inflation, policy, and growth**
- **The short-term remains totally unpredictable, but we remain reasonably confident for the medium-term**

Last week was another negative one for most markets, as participants are finally taking into account the harsh reality of a backdrop combining high inflation, radical monetary tightening and inevitably, risks to economic growth. Cyclical assets lost another -2 to -3% across regions, and defensive assets did not shine, with gold correcting by almost -4%, now negative year-to-date. The fixed income universe was to some extent supported by risk aversion, with the safest segments being close to flat over the week. Crypto assets tumbled, which probably had some contagion effect on US stock markets. Fear, Uncertainty and Doubt dominate.

Let's start with the bad news. Even after a -20% correction on major risk markets, behavioral indicators are not in full panic territory, and if valuation metrics are reasonable, they are not a "no brainer" bargain. There is an unanswered multi-trillion dollar question: will the Fed be able to effectively fight inflation, without ruining the economic recovery? Adding the war in Ukraine and China's concerns to the picture, the jury is out and will remain so for months. It means that the short-term is absolutely unpredictable.

There are however reasons to be confident in the medium-term. First, a -mild- recession in the world's largest economies is possible, but it wouldn't necessarily be a nightmare for markets. It would calm down inflation for sure and reverse policy responses, and it is arguably at least partially priced-in by some markets. Second, the behavior of interest rates and inflation expectations interestingly suggest that we may approach the perception of "peak hawkishness" from central banks. This is not a catalyst in itself, but it's better than the opposite. We thus have kept our positioning unchanged. Stay safe.

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



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Cross-asset Update

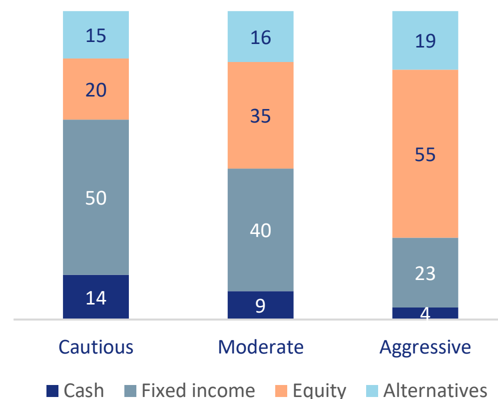
Psychology has always been a key factor affecting investment decisions. At the January market top sentiment was very bullish in spite of sky-high valuations and of some seasoned investors, like GMO's founder Jeremy Grantham and hedge fund manager Ray Dalio, having made calls of market bubbles for some time. Who could, after all, have suspected that all that could go wrong would indeed go wrong in the subsequent few months? After a five-month fall, investor mood has finally turned and commentaries of more downside are rife. Indeed, in the good old times at current levels, with equity valuations back at the historical averages and a fall of at least 20% on the major indices, one would have bought the large dip trusting that some form of stimulus measure or the other would have saved the day. And, isn't it true that such a drop without a recession in sight is a great buying opportunity?

A major bottom is in place not only when there is complete capitulation, for now still absent, but also when all of the bad news is out. As for capitulation, we should maybe expect US equity volatility to reach above 40%, which it did for instance both in early 2018 and in August 2015, even as central banks had investors' back. But now they don't, so shouldn't we be trusting to buy the market only when sentiment sours further, as a safety net is no longer there? As for future bad news still lurking somewhere and waiting to spring to the fore, there is plenty of choice. Inflation is squeezing US consumer confidence, now at recessionary levels, hence neither retail sales nor unemployment should be able to hold at current levels. The Fed's tightening process still represents a question mark as to the effects of the run-off of the Fed's balance sheet on markets, considering that the past two episodes of Quantitative Tightening did not end well. China slowdown is developing harsher contours and will affect the global cycle. In summary, we would not sound the all-clear for a major bottom to be in place.

Yet, conditions for a forceful rebound seem to be in place. Market breadth, measuring the degree of investor participation in a market movement, has fallen to levels that in the past saw risk assets react positively. US inflation seems to have peaked, so treasury yields should be capped from here. Although China yesterday reported terrible data, Shanghai is aiming for return to normal life as per official statements by the central authorities. Oversold technical market conditions, US yields and the Chinese outlook should provide the triggers for a rally, still be a bear market one until we get more reassured on the above-mentioned fronts.

Meantime, investors can put money to work but with an eye to downside risks. The potential for gains in equities should for now be more relative than absolute, and investing in high-dividend yielding stocks would be offering some downside protection. On the other hand, peaking bond yields imply that IG bonds are now more appealing and offer some absolute upside potential as well.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

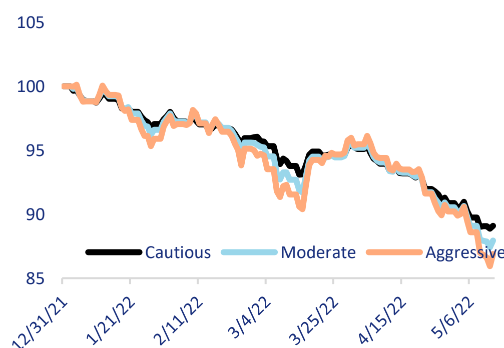


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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.

Fixed Income Update

The latest bout of bond price movements and macro data releases could mean that we are at the cusp of two types of risk. While markets get more convinced about the peaking the US Treasury yields, thus reducing the interest rate risks, the recent fears of slowdown and recession could indicate that we may be moving on to a credit risk scenario. We had mentioned earlier in our publications that increasing rates could make certain sections of the high yield market vulnerable to refinancing risks leading to an increase in defaults. The record bond issuances in 2020 and 2021 and the resultant decrease in short-term liability insulate the high yield issuers to a large extent for 2022 and the first half of 2023. If the Fed is successful in moderating demand, this could hit the toplines of the issuers leading to a double whammy for the lowly rated B and CCC issuers. While high yield spreads in the developed world have widened YTD significantly, this is not the time to go overweight in the segment. We want to give the clarion call to "Go Up in Quality" within fixed income portfolios for the first time since Q2 2020. The recent sell-off comes as a blessing for investors willing to take a plunge. Tons of short-duration BB-rated bonds are available at attractive yields. This is our preferred segment within High Yield. Doing proper due diligence on cash flow versus EBITDA, working capital conversion cycle, and other leverage and coverage indicators will save investors a lot of heartache in the future.

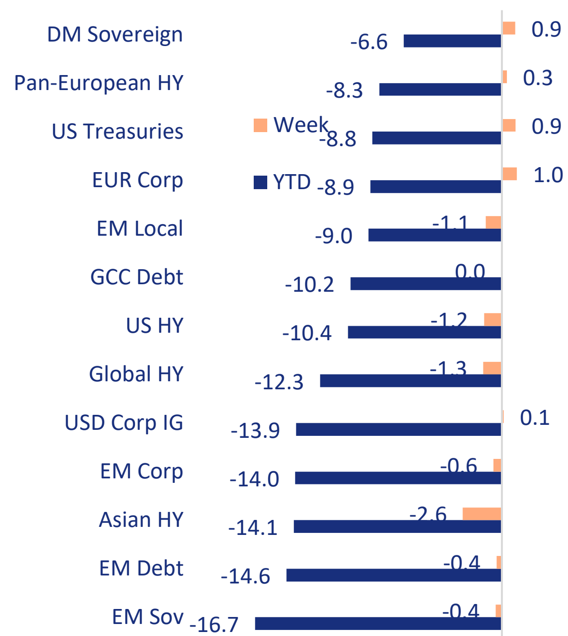
With treasury yields sliding last week, some segments such as the US Treasuries, Euro-denominated Investment Grade corps, EM Sovereign and GCC Debt posted positive returns ranging from +0.4% to +0.8%. On the other hand, emerging Market Corporate and US High Yield had negative weekly returns due to widening spreads as investors get cautious about credit risk. Asia High Yield was the worst-performing segment yet again due to Sunac missing its grace period for payments. Since March, we had turned very cautious in this segment mainly due to two factors. The first one is the non-declaration of audited FY 2021 results by 40% of the players and decreasing quarterly home sales despite the banks' efforts to loosen lending policy. We believe it will be a long road to recovery for the segment unless we see some bi- bang reforms from the govt and monetary authorities in China.

GCC bond returns, especially in the investment-grade space, were positive due to the movement in the yields. The spreads did increase slightly. However, high yield continued to trade weakly, indicating the risk-off nature of the market. Egypt and Turkey continued to trade weak due to worsening macro backdrops. Egypt bonds' fate remains closely tied to the IMF deal, while Turkey needs to stabilize its currency while gaining the upper hand on inflation which is a challenging task for a central bank that is reluctant to increase rates.

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

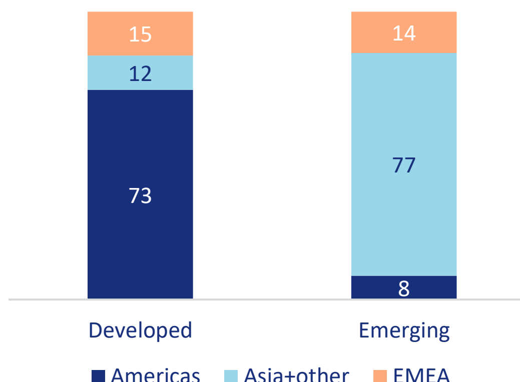
The Fed hiked by 50 bps in May with 2 more on the way, and India and the UK are also in synch on monetary policy. The ECB should follow suit later in the year. Inflation at 40-year highs and economic growth slowing with talks of a recession a year down, has led to global equities falling for a 6th straight week. Last week's 2% fall has YTD equity performance at -16%, with Developed Market equities just slightly better than Emerging Markets. The selloff widened as the outperformers so far, the GCC and Indian equities fell over 5% last week, the latter as inflation over the target range led to an unscheduled rate hike. The unappealing growth-inflation policy mix, probably set to continue till year end, is keeping volatility high across all regions. Europe's economy is worse affected as the war in Ukraine is at a stalemate, while Asia economies are exposed to the ongoing COVID-19 lockdowns in China. Defensive sectors are in favour globally with consumer staples and healthcare outperforming last week. Do equity prices now more or less reflect the worsening macro-outlook and the hawkish Fed? Valuations are lower for most regions and sectors than historical averages.

Markets may see a rally from oversold levels as Q1 corporate earnings have been stellar and margins have held up, reflecting the ability to pass rising costs onto customers. In the US we still see a buoyant jobs market and strong consumer even as concern over inflation and rising mortgage rates builds. However, we remain cognizant of the very high inflation numbers and guidance from corporates around supply chains constraining production, hence expect rallies to be short lived and equities range bound near term. Food and fuel inflation are key but housing rents, 30 – 40% of the core and headline baskets, are rising faster than at any time since 2006 in the US. European car manufacturers have spoken of essential components shortage from Ukraine. Stellantis CEO said its target to sell only EV's in Europe by the end of this decade depends on fixing supply-chain problems and if the EU ensures access to enough clean energy, batteries, raw materials and charging infrastructure.

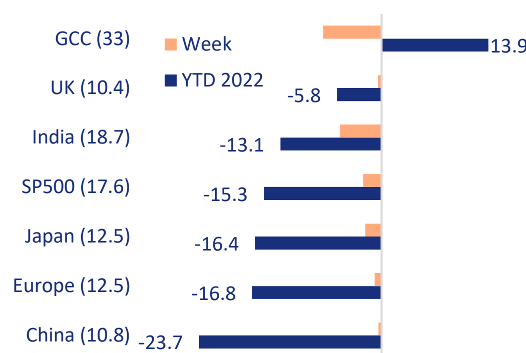
Saudi Aramco, the world's largest oil producer, has overtaken Apple as the world's most valuable company. It showed stellar Q1 results, with net income of $39.5bn, an 82% rise on a year ago and in line with oil price gains. Plenty of cash for capex. The UAE and KSA markets gave up some of their gains last week, but are still very much positive for the year with both the Dubai and Abu Dhabi indexes over +10%YTD. Dubai's residential market sales in April are up 36% y/y propped by off-plan and ready-unit sales reflected in the real estate sector rally.

JP Morgan upgraded the China tech sector as they feel 'significant uncertainties facing the sector should begin to abate on the back of recent regulatory announcements," The Nasdaq Golden Dragon Index whilst it recovered last week is still down 30% YTD, close to the Nasdaq's 25% YTD drop. Growth sectors continue to sell off on the higher Treasury 10-year yield. Twitter shares fell as Elon Musk looks into fake/spam accounts which he estimates at 20%, much higher than the 5% earlier disclosed and this could affect his $44bn takeover bid.

EQUITY RECOMMENDED REGIONAL POSITIONING

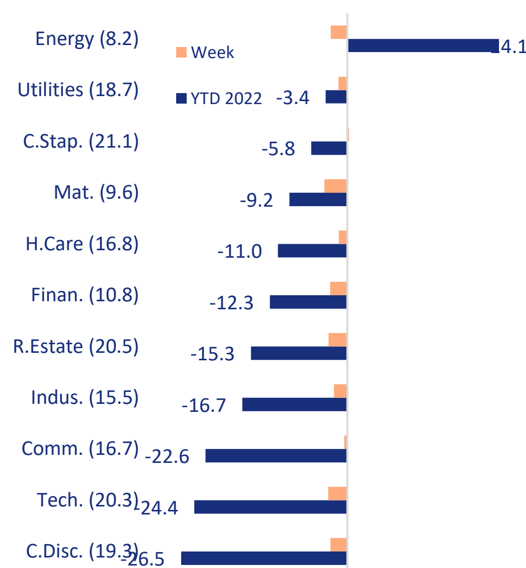


MAJOR INDICES PERFORMANCE (TR, US$) AND 2022PE



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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