AUGUST 2023 | ISSUE # 250813

Habib Investment Limited

Views from the desk

Monthly Global Market Overview and Outlook

Habib Investment Limited
Regulated by the DFSA

For Professional Clients Only

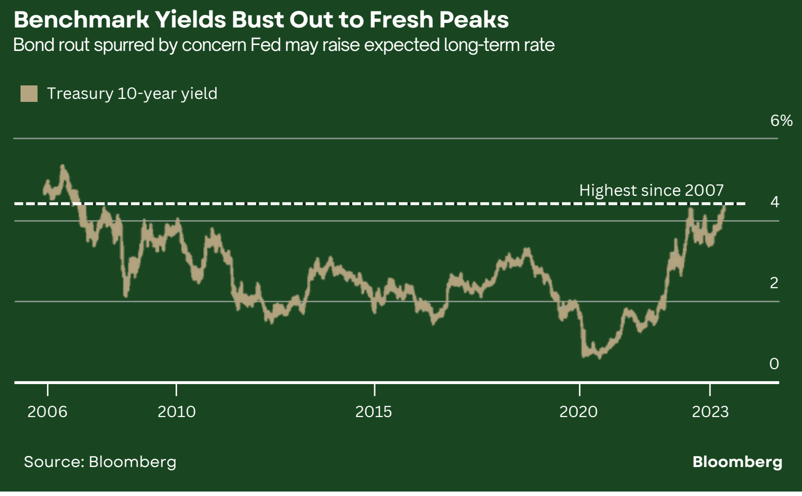
Everything is Reaching the Moon

Whether it's yields, interest rates, risk, or the Chandrayaan 3...

Macro Overview

'Doom and gloom' and 'stocks only go up' predictions are a dime a dozen in the market, and while it is important to be aware of volatility, it is more important to revisit portfolios at regular intervals."

— Sandeep Jadwani | ACSI
Head of Investment Advisory



Most of the things we speak about in the financial markets have reached to moon. Be it the 30 year mortgage rates in the USA, the global credit card debt, equity valuations or be it the yields. Notably, the Chandrayan-3, India's 3rd Lunar mission, successfully landed on the moons south pole making it the first on the south pole and 4th country on Moon.

Contrary to expectations at the start of the year, US stock markets have delivered strong returns in 2023. Market pullbacks are common, especially when equities have been advancing at a rapid pace for months, but many are now assessing some new dynamics that could influence their investing strategies. There's a fresh realization that rates could stay higher for longer despite some initial forecasts and hopes of cuts starting in 2024.

While the Fed's aggressive hiking cycle weighed on the performance of the stock market last year, stocks have been in rebound mode for most of 2023. The S&P 500 Index is still up 14% YTD, but it has pulled back nearly 5% over the first three weeks of August, as the yield on the 10-year Treasury broke out of the 3.25%–4% band it had been trading in for much of the year.

The Bank of Japan recently lifted the band on its long-term yields, giving the country (which is the largest foreign holder of U.S. Treasurys pegged at $1.1T) less of a reason to buy U.S. debt.

Hedge funds, including Bill Ackmans Perishing Square have also been shorting Treasuries after the Treasury increased the size of longer-term debt sales to address mounting borrowing needs.

Inflation has obviously cooled down since its peak in 2022. But there are concerns it could pick up again, with persistent labour market tightness, and nominal wage growth that's above historical trends. So, the question is still then about trade-offs.

How much of a price is the Fed willing to pay now, in terms of higher unemployment, in order to get inflation back to 2% and keep it there? Is there some wiggle room on the inflation front? Can the Fed let it hover higher than 2%? Would it ever formally accept that above-2% inflation is tolerable? These seem like the big questions in the months ahead, or maybe just in the days ahead. Below are some facts to consider before riding the wave of euphoria:

1. Moody's downgraded the credit ratings of several banks, due to ongoing challenges in the banking sector.
2. Industrial data continues to show deterioration.
3. Valuations look expensive from a historical perspective by most metrics.
4. Corporate earnings beat expectations, but mainly because the latter were steadily guided downwards.
5. The 10-year Treasury yield is the only fly in the ointment right now as it hovers very close to a multi-year breakout above 4.33% – 4.35%.

China: The Center of Deflation & Global Uncertainty

Determinants of Oil

China's macro issues, along with a growing expectation that maybe the U.S. Fed is not done with its tightening cycle have weighed on oil more recently.

Global Outlook

Economic indicators are signalling a higher likelihood of a recession particularly in the United States. Inflation rates much higher than the target of 2%, decreasing consumer spending, and geopolitical tensions have been putting pressure on the Federal Reserve to tighten monetary policy. Historically, such tightening has often been a precursor to economic downturns. The rising debt levels, both public and private, exacerbate the risk, as higher interest rates could lead to widespread defaults.

Other factors prompting the "higher for longer" outlook is that economic growth still seems to be running well above Fed estimates even under the current market forces. Fears of higher government deficits, which resulted in a downgrade by Fitch, as well as sticky inflation, could also extend the cautious tone of the U.S. central bank.

However, major economies continue to show signs of resilience to the scale of monetary tightening taken by central banks. GDP data for both the US and UK has surprised on the upside for Q2 while labour market conditions in the US still look strong this far into the rates cycle. Inflation too is cooling but we expect the Federal Reserve will want to see more entrenched signs of disinflation before it is prepared to shift to an accommodative stance in 2024.

Economies across the GCC are being weighed down by lower oil production as OPEC+ has extended and deepened its production cuts. That will put more of the burden on the non-oil sectors to support growth in the region.

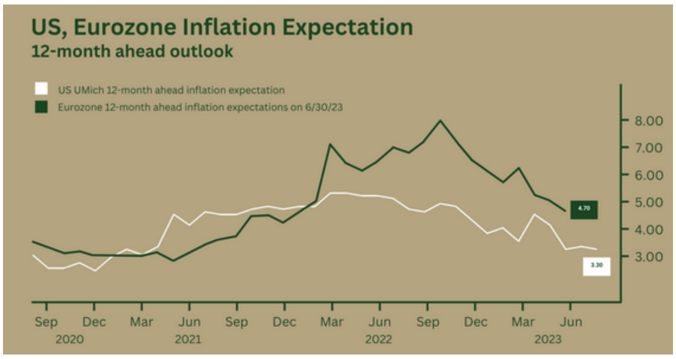
Powells Jackson Hole speech could deliver the final blow to the markets. The tone of the speech will likely focus on how long the rates will stay high rather than how far they may rise. The bond market is now pricing in a higher for longer policy path. The futures markets are now forecasting a rate cut sometime in H2 2024. Usually, the FED starts to ease ahead of economic weakness. But this isn't necessarily bad news for financial markets. Historically, when taking S&P500 into consideration, the returns from current monetary cycle until the start of easing has been positive.

Credit agencies have also added fuel to the spark. These agencies echoed concerns over higher for longer interest rates and asset quality risks, especially for lenders with material exposures to office loans. However, their outlooks were revised to stable, reflecting improved stability and relatively good funding metrics. A Fitch analyst recently warned that U.S. banks could see more downgrades if the operating environment weakens further.

U.S. crude oil futures have hit a 4 weeks low as troubles in China's property sector add to concerns about lackluster economic data from the world's second-largest oil consumer. A bigger-than-expected drop in U.S. crude supplies still helped to ease the price decline, though implied gasoline demand in the U.S. revealed a weakening in demand for the summer driving season.

The world's second-largest economy is in a predicament and the property market stands at the heart of its troubles.

Construction accounts for as much as a quarter of China's gross domestic product, but real estate reverberations are shaking up confidence and many are afraid about knock-on effects on the overall economy. Housing sales, prices and investment are down, while a deflationary spiral threatens to fuel an even bigger disaster for a country that just experienced three years of strict Zero Covid controls. China's central bank has stepped up to defend its currency following the latest series of weak economic data releases. The midpoint on the onshore yuan was set at 7.2006



S&P Global's latest preliminary Purchasing Manager Indices (PMI) report for August across Europe carries some disappointing news once again. Both manufacturing and services activities have shown contraction this month, casting a shadow on growth prospects for the eurozone and the UK in Q3. However, amidst the challenging figures, there's a glimmer of hope, at least in the eurozone, some economists are pointing towards.

In a potentially positive turn, some experts suggest that eurozone manufacturing might have bounced off the lows, as the headline index has risen slightly to 43.7 points. While still well below the 50-point threshold for expansion, this figure surpasses both consensus expectations of 42.6 and July's value of 42.7 points. Analysts attribute this improvement to a slightly better order situation and a slower destocking, Conversely, the eurozone's services PM has dipped to 48.3 points from July's 50.9, potentially reflecting the impact of tighter monetary conditions and persistent inflation on consumers' spending power.

The data for the UK are similar but with a tilt to an accelerating downtrend. Manufacturing activity has come in below expectations, at 42.5 points versus the expected 45; and Services is now in contraction mode too, at 48.7 points versus the expected 51.

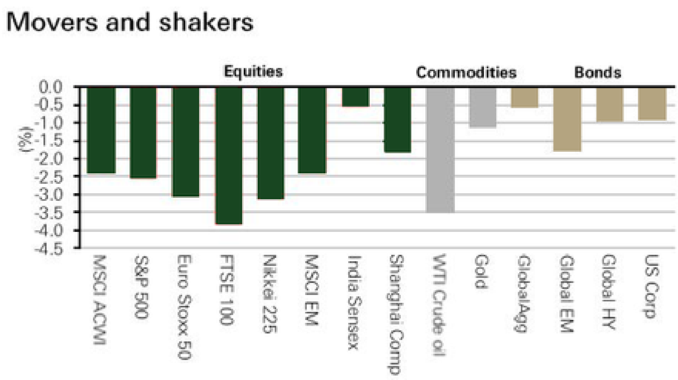
In response to these findings, both the euro and the British pound have come under pressure, and government bond yields are sharply lower. While a slim majority of traders now anticipate that the European Central Bank will hold off on further interest rate hikes in September, the belief is that the central banks rate hike trajectory has not concluded yet.

There is so much optimism priced into the markets including rate cuts, soft landing, AI etc. The hype around AI has driven bullish sentiments and has pulled up the indices which also increases the risk of overvaluation and speculation hype. An indicator, the rising VIX indicate growing, potentially leading to deeper drawdowns. There is no need to sell and pay taxes when you can use derivatives to hedge

Consequently, Gold prices have come under increased pressure in recent weeks, testing five-month lows this week near USD 1,893 an ounce amid surprisingly resilient US economic data and concerns over the Federal Reserve's likely response. At the time of writing this, Gold was trading at USD 1,902/oz, down over 7% since its peak of USD 2050/oz in May. Ahead of Fed Chair Jerome Powell's Jackson Hole policy speech on Friday, CME fed fund futures suggest money markets are pricing increased chances of another rate hike by November.

The changing backdrop has pushed both nominal and real US yields higher, adding to dollar strength and undermining gold's near-term appeal. But, we don't think short-term headwinds erode the portfolio case for gold.

Asset Class Performance Aug '23



*As of 17th of August

Market Definitions 101

Yield Curve

A line that plots yields, or interest rates, of bonds that have equal credit quality but differing maturity dates.

Yield Curve Inversion

When long-term interest rates drop below short-term rates, indicating that investors are moving money away from short-term bonds.

Flat Yield Curve

A yield curve in which there is little difference between short-term and long-term rates for bonds of the same credit quality.

Asset Class Views

Asset Class	Sub-Class	View (Jul'23)	View (Aug'23)
Main Asset Class	Equities	▲	=
	Fixed Income	=▲	=▲
	Commodities	=▲	=▲
	Currencies	=▲	=▲
Equities	USA	=	=
	EU (Ex UK)	=▲	=▲
	Japan	▲	▲
	UK	=	=
	EM (Ex MENA)	▲	▲
	MENA	=▲	=▲

Asset Class Views

Asset Class	Sub-Class	View (Jul'23)	View (Jun'23)
Fixed Income	US Treasuries	=	=
	Euro (Bunds)	▼	▼
	UK Gilts	▼	▼
	US IG	=▲	=▲
	US HY	=	=
	Europe IG	▼	▼
	EM	=	=
Commodities	Oil	=	=
	Precious Metals	=▲	=▲
Currencies	USD	=	=
	EUR	=	=
	GBP	=	=
	EM	=	=

▲ overweight = neutral weight ▼ underweight ■ negative tilt ■ positive tilt

Critical Future Events

Sep 14: ECB Meeting

Sep 21: BoE Meeting

Sep 20: FOMC Meeting

Sep 21: BoJ Meeting

Real Yields are Climbing, while the USD still has to pick up

This paves the way for USD to strengthen unless it does not.

US real yields keep marching higher as the country's regular sovereign debt sells off even faster than Treasury Inflation Protected Securities. Concern is growing that a resilient economy plus a determinedly hawkish Federal Reserve will lead to a brave, old world where bond yields remain at the levels common before the 2008-09 global financial crisis, now that they have reached such heights.

One peculiar feature of all this is the way currency traders are mostly looking past elevated real yields, something that is normally deemed to be a key fundamental driver for exchange rates. The US dollar slumped late last year as the Fed moved toward a slower pace of hikes. That was also evident when the bond market's key benchmark for real yields — the rate on 10-year TIPS — started retreating. That decline soon stalled, and real yields have pushed higher since early April — around the time that surprising US economic strength overwhelmed the narrative that March's banking crisis meant the Fed would soon stop hiking rates.

The dollar meantime has remained in a holding pattern at best. So, if real yields recapture their sway over currency markets, the greenback could be set for a blistering run.

US 10-year TIPS yields pushed at the 2% level, a psychological barrier not seen since 2009. And it's not alone. In country after country, inflation-linked bond yields are climbing to new highs. They may have further to go in this selloff, but they won't stay this high for long.

Real yields reflect two things: the pace of growth in an economy and inflation expectations. Nominal yields are basically a reflection of interest-rate expectations plus a premium for uncertainty. Real yields are the nominal yield minus expected inflation. But they also represent the true cost of funding in an economy: how strongly traders think the central bank needs to keep the brakes on in order to meet its inflation targets.

Of course, 10-year yields should theoretically look through economic cycles, but in reality they don't. However, there is a school of thought that believes rising borrowing needs will drive up real yields in coming decades, as JP Morgan economists Alexander Wise and Jan Loeys recently argued. That may be true, but in the meantime, economic data will start to deteriorate and the Fed will start lowering rates.

The neutral rate of interest may well be — in fact probably is — higher than during the slowflation, new normal years following the GFC. That doesn't mean the yield on 10-year TIPS can sustainably remain a full percentage point higher than its peak in that period even as the economy slows.

The interplay of factors on global scales. paints a complex market picture. While disappointments and challenges have emerged, there are potential catalysts for positive movement as well. It is paramount for investors to remain nimble and stay attuned to both micro and macro developments as they navigate these complex and uncertain markets.

Source and Sighting: BJSS, Bank of America, Bloomberg, Nomura, JB, Goldman Sachs Asset Management, Barclays, HSBC