MAY 2023 | ISSUE # 280510

Habib Investment Limited

Views from the desk

Monthly Global Market Overview and Outlook

Habib Investment Limited
Regulated by the DFSA

For Professional Clients Only

A question of USD 31 Trillion and 25Bps

Will the debt ceiling debate finish the Fed's inflation fight?

Global Market Overview

> *As an investor, constantly remind yourself: always follow the liquidity, never fight the FEDs.*
>
> **— Sandeep Jadwani | ACSI**
> **Head of Investment Advisory**

U.S. stocks hit 2023 highs last week on hopes for a debt ceiling solution. Yields climbed on expectations the Federal Reserve could hike rates again instead of pausing at its next meeting. As we exit the peak period of earnings season, where analysts set the bar lower by aggressively downgrading estimates, we saw a resilient quarter with a strong earnings beat rate and an earnings surprise rate that reached a multi-quarter high. Inflation helped revenue and margins as firms passed on higher prices to a still-strong consumer. We think higher financing costs and dwindling savings could start to bite: Earnings expectations look too rosy. It's just a very uninspiring, low-growth backdrop, with tight monetary policy and earnings that could be down this year versus last.

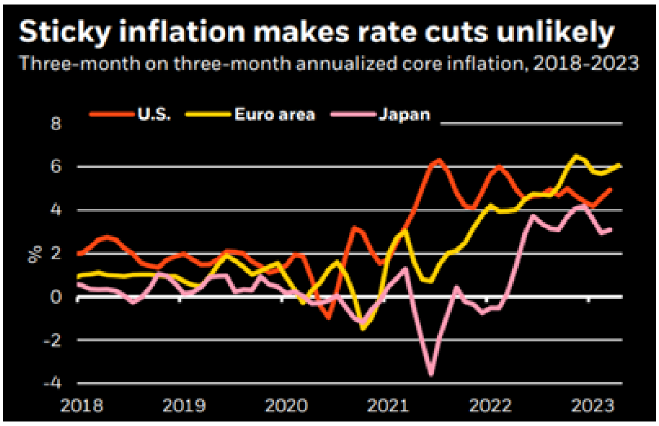
The S&P 500 is up about 9% so far in 2023 after falling 19.4% in 2022 with forward 12-month price-to-earnings ratio is now at 19 compared with 17 at the end of 2022 and a long-term average of about 16, according to Refinitiv data.

Mega-cap stocks have collectively outperformed the S&P 500 by 34% year-to-date following moderating interest rates and an improved earnings outlook. We believe their outperformance can continue if growth remains far enough below the potential to keep rates near current levels. However, they walk a narrow path; in our view, if growth reaccelerates (causing rates to rise) or a recession occurs (driving equity exposure lower), mega-cap names may be vulnerable again.

As investing trends come in and out of fashion, it can be difficult to navigate what is real and power the future, and what is hype and eventually fade. Resolve among bears is weakening after a $3 trillion equity rally this year defied everything from banking turmoil to falling profits and now a potential US default. **"The cost of missing out may be just too high."**

There's this optimism that the Fed is either finished or almost done with its rate-hiking cycle, then there's the notion that the recession could be pushed out.

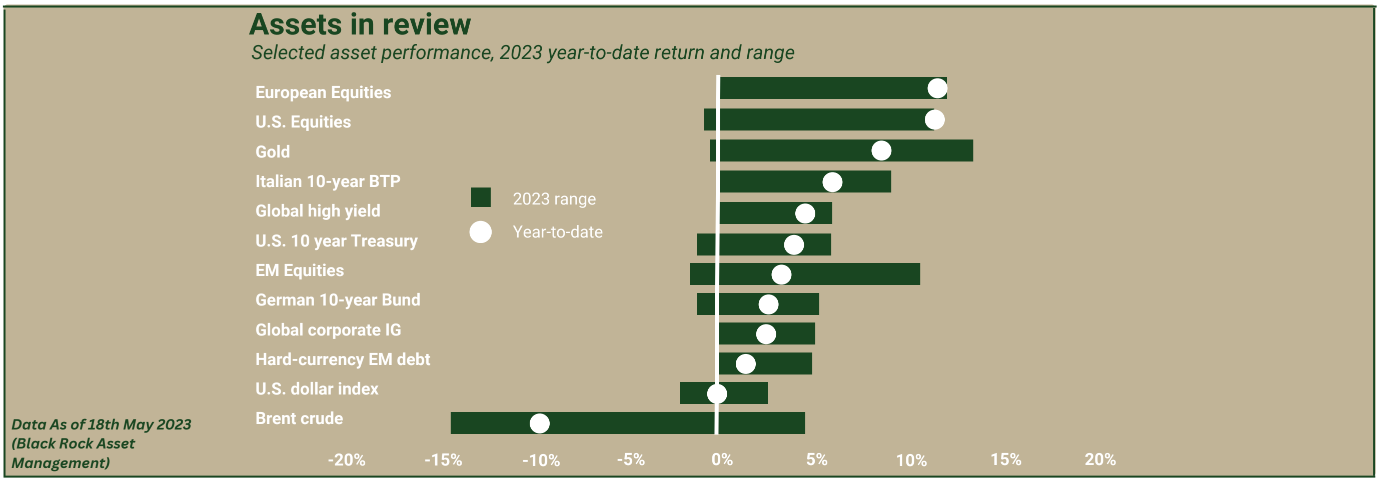
Gulf investors have largely been spared the surging inflation, consequent raises in rates, growth in labor costs, energy price hikes and looming recessions which threaten Western countries. Nations which produce oil have benefited from a tail wind in higher prices, fuelling domestic growth.



We become increasingly cautious and stripe out risks that cannot be handled by investors across the risk spectrum.

In such an uncertain macro economic backdrop, we suggest the below investment strategy:

1. **Putting cash in companies with strong balance sheets and growing dividends.**
2. **Diversify outside of the USA, by including Japan and Europe, which they argued are currently undervalued.**
3. **Since there could be some stock market volatility coming up, make sure your portfolio has a diversified mixture of assets, and think about your time horizon.**
4. **Adding Gold as well as keeping part of monies in deposits could be helpful to hedge the market volatility.**
5. **Most importantly, don't forget to consider bank deposits to get short term cash yields.**



With X-Date staring at US, it's time to DE-risk (not DE-couple): one (25bps hike) for the road?

Though inflation is off its peak, but the CORE is peaking across the developed markets

Global Market Outlook

Q1 saw a 'semi-v' shape pattern when looking at the path of aggregate earnings this quarter, as analysts significantly downgraded expectations which set the bar lower and resulted in companies surprising to the upside.

Looking ahead to next quarter, guidance numbers have started off much more positively compared to last quarter. There have been 31 negative announcements for Q2 compared to 27 positive announcements, resulting in a negative/positive ratio of 1.3. For context, Q1 only saw 26 positive announcements in total.

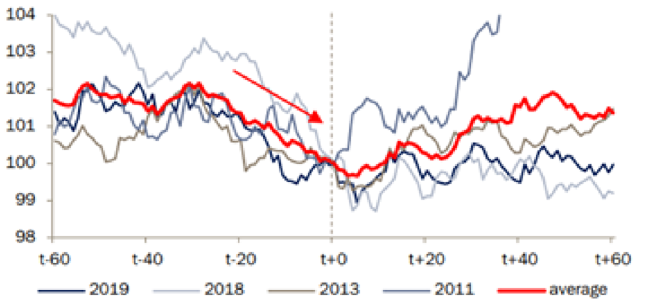
Interestingly, the dramatic improvement in Q1 earnings growth has not translated throughout the rest of the year, as Q2, Q3, and Q4 growth expectations have all declined marginally since April. Perhaps analysts are adopting a 'wait-and-see' approach before revising estimates any further.

As US debt ceiling negotiations are approaching their final innings and the X-date is moving closer, we assess the risks priced in the market and how to hedge for an adverse outcome. While a default (and a downgrade from AAA ratings) on US government debt remains extremely unlikely, the risk of a government shutdown is very real and may have significant repercussions for the US cycle. The White House and House Republicans have an agreement in principle on a deal to raise the debt ceiling for 2 years and cap spending, House Speaker Kevin McCarthy confirmed, moving the nation one step back from the brink of a historic default.

With a highly significant change in market expectations of a rate hike amid continued growth and sticky inflation, Treasury yields have moved up across the curve. The 2Y yield was up by over 26bp last week and almost 53bp higher month-to-date. Meanwhile 10Y yields were up 10bp last week with the month-to-date rise at 37bp.

Exhibit 1: USD weakened during last four US debt ceiling talks

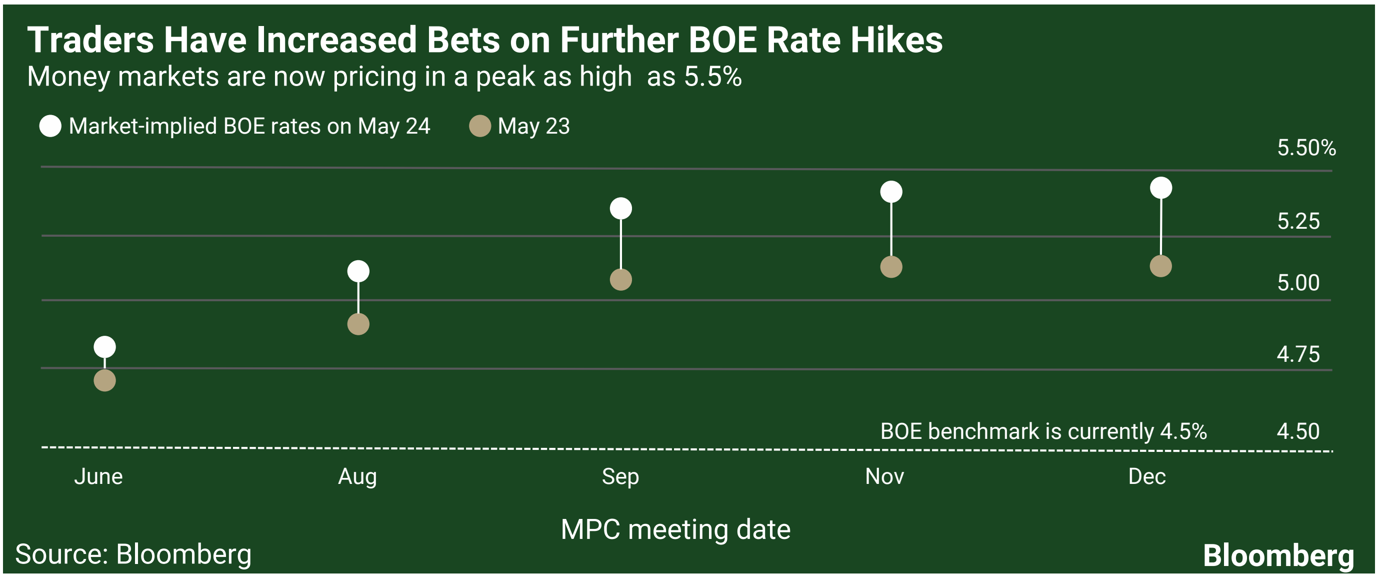
USD trade-weighted index, # of days before/after end of shutdown (=100)



Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

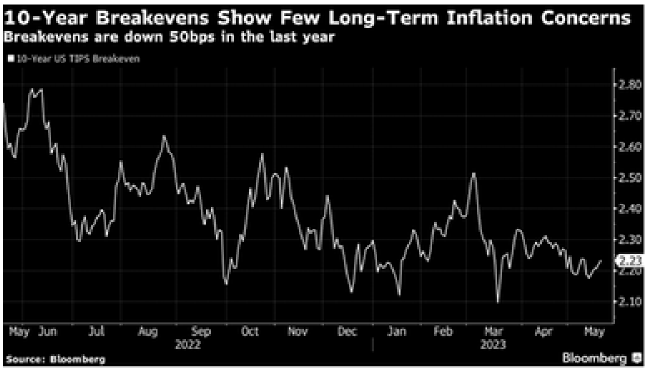
Japanese stocks are becoming equity-market darlings and gaining notable ground over European peers. The Nikkei 225 and Topix are trading at levels not seen in over 30 years and are beating the S&P 500 and Stoxx 600 so far in 2023. Foreign investors are buying Japanese stocks, with renewed interest from Warren Buffett, a weak yen, corporate reforms and supportive BOJ policy all helping drive the market higher. The ratio between the Stoxx 600 and Topix has fallen to the lowest since November.

Strategists have touted Japan's earnings growth, share buybacks and still-low valuations. On a price-to-book, the Topix is cheaper than the Stoxx 600 at 1.3 times versus 1.8, respectively. The Topix's gains this year have been led by electrical appliances, machinery and iron and steel — perhaps giving European stocks' cyclical tilt some competition.



Global data is surprising to the downside and broadly "slowing" again — from China (headline IP 5.6% YoY in April vs 10.9% consensus; retail sales 18.4% YoY in April vs 21.9% consensus; fixed-asset investment 3.9% YoY in April vs 6.7% consensus) to Europe (ZEW Survey Expectations -10.7% vs consensus -5.0%, while GDP QoQ comes in at just 0.1%) to the latest very much "mixed" US Retail Sales story ("missing" on Advance MoM, although higher – ex Auto and Gas and Control).

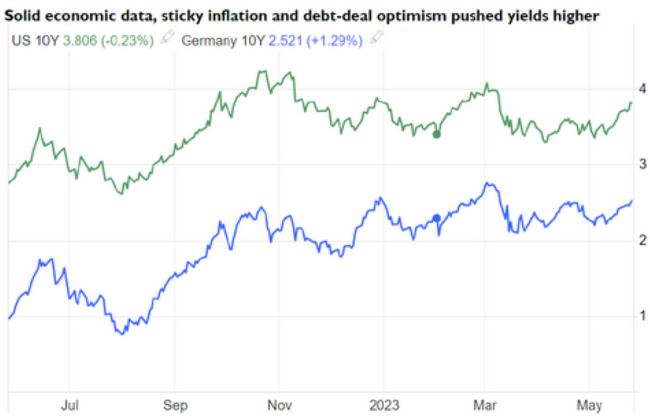
This latest weakness has mainly been with European and China data downside surprises, especially in the hard data for manufacturing and parts of consumer spending. On Bloomberg's measures, European data surprises are lower now than in H1 2022 and to the depths of 2020. In China, growth forecasts have been revised from 5.9% to 5.5%, with a rising risk of slower activity growth, rising unemployment, persistent disinflation, falling market interest rates and a weaker currency.



The biggest news had to be the blow-out inflation data in the UK.

The annual headline inflation rate hit 8.7% for April. That was lower than March, but not as low as expected. And core inflation (that is, inflation without the volatile bits, like energy and food), hit its highest level in more than 30 years, coming in at 6.8%.

The nasty spike in core inflation means that markets now expect rates to go far higher than what they expected earlier. They've gone from pricing in a likely peak rate of 4.75% to pricing in 5.5% now.



Market Definitions 101

Debt Ceiling

The debt ceiling is a limit set by the US Congress on the amount of money that the federal government is allowed to borrow. It prevents the government from incurring excessive debt. Once the debt ceiling is reached, the government is restricted from issuing new debt without raising the ceiling.

IPO

The process in which a private company makes its first offering of its shares to the public by listing on a stock exchange. IPOs are done to raise capital for expansion and/or to enable early investors to realize the returns on their initial investment. They mark a significant point in a company's lifecycle

Credit Ratings

A corporate credit rating is a numerical value or quantified evaluation of a company's creditworthiness, which shows investors the probability of a company defaulting on its debt obligations or outstanding bonds. Credit ratings are given by issuers such as Moody, S&P and Fitch.

Asset Class Views

Asset Class	Sub-Class	View (Apr'23)	View (May'23)
Main Asset Class	Equities	=	=
	Fixed Income	=▲	=▲
	Commodities	=▲	=▲
	Currencies	=▲	=▲
Equities	USA	=	=
	EU (Ex UK)	=	=▲
	Japan	N/A	▲
	UK	=	=
	EM (Ex MENA)	▲	▲
	MENA	=▲	=▲

Asset Class Views

Asset Class	Sub-Class	View (Apr'23)	View (May'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

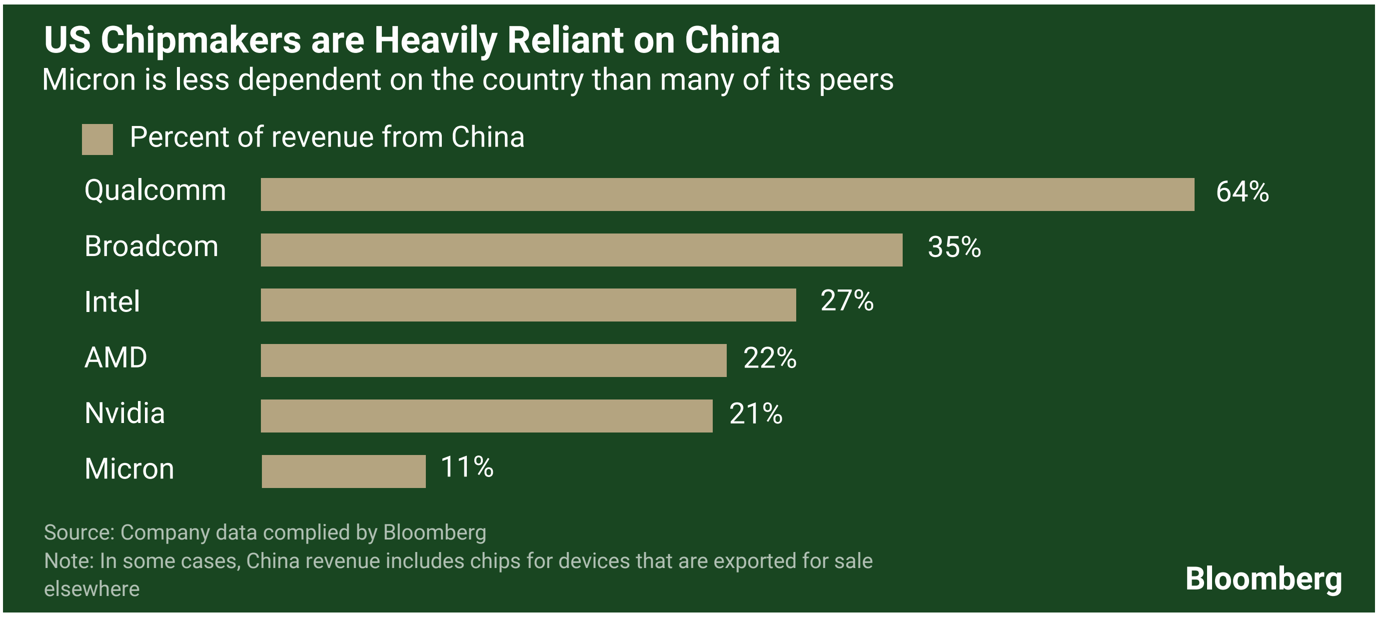
June 14: FOMC Meeting

June 16: BoJ Meeting

June 15: ECB Meeting

June 22: BoE Meeting

Semi - Conductors: IYKYK



Investors have signalled chip makers as one of the big potential winners in AI, following the viral success of ChatGPT and similar tools.

The US keeps sanctioning Chinese companies over a range of alleged abuses, and Beijing had held back — until now.

Micron Technologies, this week became the first casualty of "retaliation for the US's export controls on semiconductors."

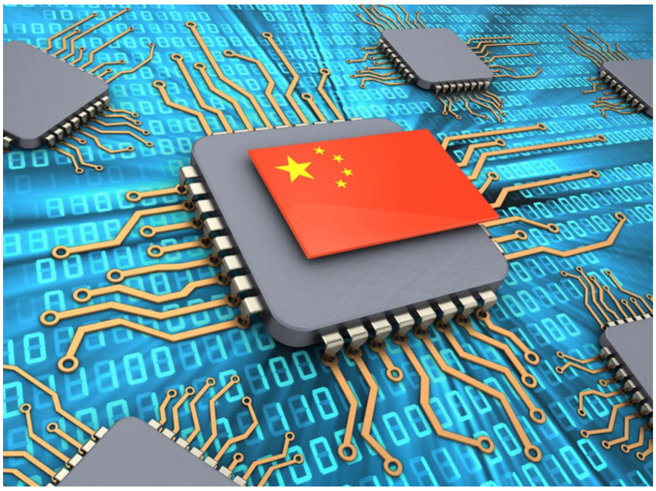


Image: iStock

Beijing didn't say as such. Instead, it claimed Micron's products have "relatively serious" cybersecurity risks at a time when the government operates increasingly through the prism of national security.

A tough loss for Micron, but not so much for China, which can replace the company's memory chips with similar products from local suppliers as well as South Korea's Samsung Electronics. South Korea, a major trade partner with China and security partner with the US, is stuck in the middle of the spat as its memory chipmakers Samsung Electronics Co. and SK Hynix Inc. are poised to potentially gain from Micron's loss of market share in China.

The move brings fresh uncertainty to the other US chipmakers that sell to China, the world's biggest market for semiconductors.

The question is, what else China has on its retaliatory sleeve that wouldn't cause itself harm?

Is this the start of a re-evaluation journey in the semi-conductor space with all US players discounting the possibility of a ban by China?

Author

Sandeep Jadwani | ACSI
Head of Investment Advisory
sandeep.jadwani@habibinvest.com

Source and Sighting: JBSS, Blackrock, Bank of America, Bloomberg, Nomura, JB, HSBC, Goldman Sachs Asset Management, Financial Times