OCTOBER 2023 | ISSUE # 271015

Views from the desk

Monthly Global Market Overview and Outlook

Habib Investment Limited
Regulated by the DFSA

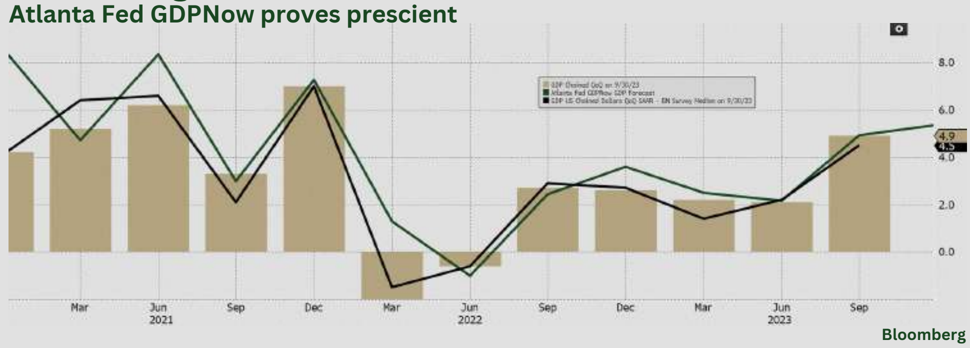
For Professional Clients Only

Navigating Global Monetary Trends and Economic Outlook: Insights for 2024

2023 is almost in the rear view, however downside risk remains while investors remain reactive.

US GDP Higher than Economist Estimates

Atlanta Fed GDPNow proves prescient



Bloomberg

Macro Overview

> *The stock market is a device for transferring money from impatient to the patient"*
>
> **- Warren Buffet**

In today's complex financial landscape, the foresight to anticipate impending challenges is critical. The Federal Reserve, European Central Bank, and Bank of England are currently nearing the culmination of their most assertive hiking cycles since the 1980s, with their peak impact anticipated in the coming months. Meanwhile, the real estate sector in China, previously a primary growth driver, is currently embroiled in a severe crisis, contributing to the projection of a global GDP growth slump to 2.7% for 2024, down from 3% in 2023, with mild recessions in the US and UK accentuating the deceleration.

As the global central bank rates approach their zenith, the Fed's impending decision on a potential final hike remains a close call. Looking ahead to 2024, the Bank of Japan is poised to shift away from extreme stimulus settings under the guidance of Governor Ueda, while the Turkish central bank continues to play catch-up on their own series of rate hikes.

In the final quarter, the credit market confronts a stern test as the Federal Reserve's shift toward higher interest rates challenges the concept of a gentle economic landing. This shift has caused credit spreads, both in the high-yield and investment-grade sectors, to widen notably, prompting corporate executives to grow increasingly anxious about the economic trajectory. Notably, corporate defaults are on the rise, with projections indicating a potential 4% default rate for 2023, with little relief expected in 2024.

A broader perspective reveals that global monetary policy has maintained a restrictive stance over an extended period, coinciding with a downward trend in inflation. Projections for 2024 indicate that most central banks will be making cuts, with the global GDP-weighted central bank rate expected to peak at 7% in 4Q23, nearly double the 3.4% level observed on the eve of the Covid pandemic, and gradually descend to 5.8% by end-2024 and 4.7% by end-2025.

In the United States, a series of imminent catalysts, including strikes, a government shutdown, and student loan repayment, are poised to contribute to a slowdown in economic activity. Observations of dwindling excess savings, coupled with the cumulative impacts of monetary policy tightening, are increasingly manifesting in consumption patterns and a notable surge in consumer loan defaults. With deteriorating financial conditions, the specter of a recession looms prominently.

Despite expectations for a decline in headline and core CPI inflation to 2.8% and 3.0%, respectively, by the end of 2024, the escalation of energy prices presents an additional factor that could potentially fuel upside inflation risks. The anticipated trajectory suggests that the Fed will maintain higher rates for an extended period, with nearly even odds of a 25-basis-point rate increase towards the conclusion of 2023. Moreover, the projected unemployment rate may rise to 4.7% in 2024, prompting an anticipation of 75 basis points in rate cuts.

Recent market trends indicate

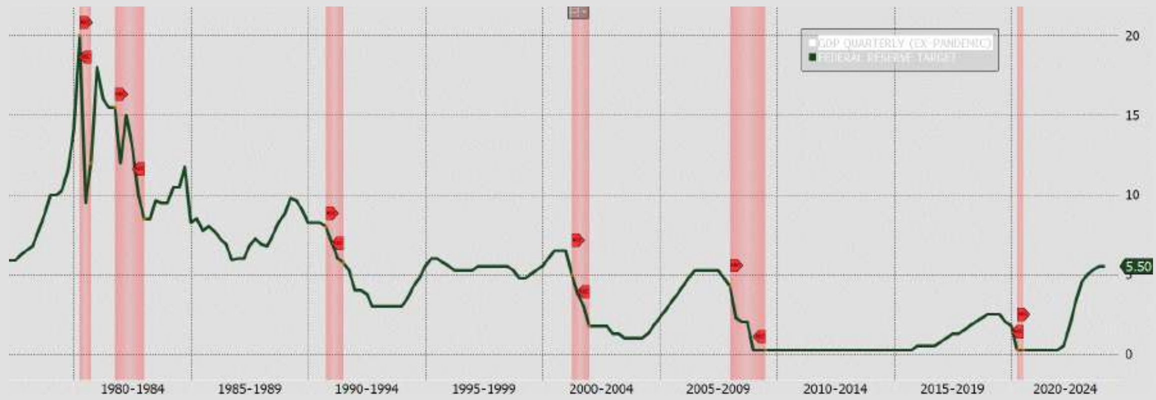
1. A strengthening dollar
2. A slight uptick in treasury yields
3. relative stability in oil prices
4. Recent stimulus measures in China have triggered a rebound in iron ore prices.

Rates, Earnings & now the GDP put the stocks on the backfoot.

Q3 GDP number of 4.9% (above estimate 4.5%) is a big acceleration and could greatly impact rates

This... Doesn't Fit The Models

When the Fed raises rates, GDP falls. Except Now.



Global Outlook

In the ever-evolving financial landscape, it's paramount to look beyond the immediate and consider the plethora of events and fundamental data points that shape the market's trajectory. While the focus often centers on the Federal Reserve's next moves and the ever-watchful S&P 500, we must broaden our perspective. These factors undoubtedly influence market narratives and positioning, but a myopic view may obscure potential risks to the widely anticipated 4Q rally.

As we navigate the early stages of the 3Q earnings season, one cannot help but notice a certain disappointment in the market's response to results. While the aggregate earnings per share (EPS) surprise stands at a robust 7%, exceeding the 4.5% average, forward-looking EPS revisions and corresponding price reactions reveal a broader vulnerability.

Our unwavering focus remains on the breadth of earnings revisions, a metric known for its predictive qualities concerning dollar EPS estimates. In this context, we observe the deceleration of revisions breadth for the S&P 500 into negative territory, marked by a prevalence of downward revisions over upward ones, particularly noticeable in Professional Services, Autos, Real Estate Management, and Consumer Services.

To gain a deeper understanding, we must analyze the rate of change in revisions breadth alongside the performance trends across industries since the start of earnings season. This evaluation highlights the market's efficiency in digesting changes in earnings expectations, with a few intriguing exceptions.

Late-cycle groups like Staples, Healthcare Equipment, Telecom, and Energy have outperformed revisions, while early-cycle cohorts like Autos and Semis have lagged behind. This indicates a recent market penchant for defensive and late cyclical attributes.

Refinitiv reports a 23Q3 Y/Y blended earnings growth estimate of 2.6%. Notably, excluding the energy sector results in a robust 7.4% growth rate for the index. Furthermore, a remarkable 80.1% of the 146 companies in the S&P 500 reporting earnings for 23Q3 have exceeded analyst expectations, surpassing the long-term average of 66%.

Considering revenue growth, the 23Q3 Y/Y blended estimate stands at 1.2%, rising to 3.6% when excluding the energy sector. It's essential to recognize that US Treasury yields are currently in an overshooting phase, geopolitics remains a persistent tail risk, and energy markets have displayed signs of apprehension. Despite these challenges, the three-quarter recession in corporate earnings appears to be ending.

For prudent investors, safe-haven bonds present an attractive avenue to protect against the uncertainties of a protracted economic downturn. Simultaneously, the equity market offers opportunities for bottom fishing,

The investment community stands divided on the optimal trading levels for benchmark bond yields. Hedge funds have positioned themselves with a record short on US Treasuries, anticipating further increases in long-dated yields.

In contrast, retail investors have adopted a contrary stance, securing high rates, seemingly without concern for tomorrow. The outcome of this divergence remains uncertain, yet it's worth noting the advantages held by retail investors, marked by their agility and relatively limited exposure.

Retail investors have primarily experienced MTM book losses, rewarded with a record yield of approximately 5% for ten years. Their holdings also act as a protective shield against significant economic downturns, aligning with the performance of safe-haven bonds in times of crisis. Their resilience and enhanced skills, thanks to the internet, are key strengths, unburdened by the stringent reporting obligations faced by their Wall Street counterparts.

In the backdrop of these factors, it's prudent to acknowledge the ongoing overshooting of bond yields, making it a timely opportunity to consider safe-haven bonds with favorable prospects extending into 2024.

Shifting to the geopolitical arena, the ongoing human tragedy in the Middle East continues to capture our attention. Despite the distressing scenes on the ground, from an investment perspective, there have been no significant developments. The continued risk of the conflict expanding throughout the region remains unchanged. In a different context, the unease in European energy markets appears somewhat perplexing, given the ample gas reserves and the absence of last year's feared shortages.

In summary, it's imperative to lock in the appealing yields of safe-haven bonds and explore opportunities in the equity market.

In **China**, recent policy maneuvers have been initiated to uplift the sentiment in the economy, with President Xi Jinping underscoring a zero-tolerance approach toward a slowdown in growth and persistent deflationary risks. Notable developments include an expansion in the headline deficit and the introduction of a sovereign debt package, reflecting a shift from the conventional growth model. Additionally, President Xi's unprecedented visit to the central bank has underscored the gravity of the challenges faced by the Chinese economy, epitomized by the struggles of developer Country Garden, facing default on a dollar bond for the first time in history.

In another arena, Indian sovereign bonds have emerged as a promising option for emerging market investors, showcasing a 6% outperformance over emerging market debt before their inclusion in an index. The introduction of Fully Accessible Route (FAR) bonds by regulators has provided a pathway for non-residents to invest in specified sovereign securities without any investment restrictions. Furthermore, the forthcoming inclusion of Indian bonds into a JPMorgan emerging market local currency debt index in mid-2024 is expected to stimulate inflows, drawing parallels from the experiences of China. The consequent boost to the rupee may serve to curb inflation, potentially facilitating interest rate reductions by the central bank.

Take Aways

1. Caution remains crucial amidst the market fixation on the Federal Reserve and the S&P 500, with a need for a holistic approach.
2. The third-quarter earnings season has brought forth a mix of disappointments and notable surprises, demanding a thorough evaluation of market reactions.
3. Observations indicate a market preference for defensive and late cyclical attributes, with certain sectors outperforming expectations.
4. The exclusion of the energy sector yields promising growth rates for both earnings and revenues, suggesting potential opportunities for strategic positioning.

Option Definitions 101

Out of the Money

An OTM option is one that has a strike price that the underlying security has yet to reach.

In the Money

An ITM option is one with a strike price that has already been surpassed by the current stock price.

At the Money

An ATM option is when an option's strike price is identical to the current market price of the underlying security.

Asset Class Views

Asset Class	Sub-Class	View (Sept'23)	View (Oct'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 (Sept'23)	View (Oct'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

Oct 26: ECB Meeting

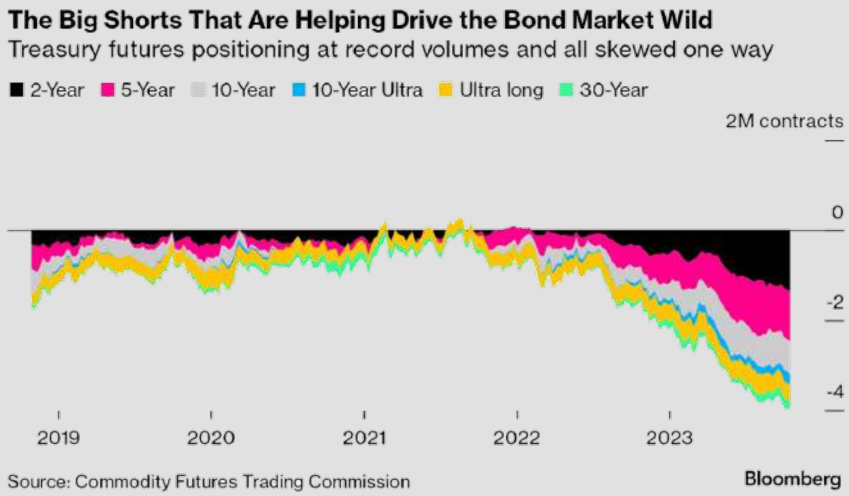
Nov 2: BoE Meeting

Oct 31: BoJ Meeting

Nov 2: FOMC Meeting

Who knew the market for US Treasuries could be so exciting?

> *Widening spreads give banks reason to pause bond sales. Financial bonds are underperforming the broader investment-grade market."*
>
> **- Sandeep Jadwani | ACSI, CIB**
> **Head of Investment Advisory**



The past few weeks in bond markets have been a wild ride for an area most people find boring.

What happened: Lower demand for long-term US Treasuries, a greater-than-expected need to fund the US deficit and hints from the Federal Reserve that interest rates may stay higher for longer have all contributed to dramatic swings in long-dated Treasury prices in recent weeks. Most notably, the 10-year Treasury yield breached the 5% mark for the first time in 16 years.

What it means: A lot of consumer interest rates are tied to the 10-year Treasury bond, and higher long-term yields feed into higher rates on mortgage loans, credit cards and more.

Some money managers think long-term yields could go even higher, even to 6%, particularly if a government shutdown leads Moody's Investors Service to cut the top rating it now assigns to US government debt. So investors may want to steel themselves for more dramatic news about US government debt.

What you can do: Most important, don't panic and don't do anything dramatic. Take the emotion out of it, take a good walk, and don't get obsessed about interest rate movements. For investors with long-term bond funds that may be down 10% or more just be patient. Prices will eventually recover, and higher interest payments will help soften the blow in the meantime

Opportunity: Now could actually be a good time to add more exposure to long-term Treasuries too.

If you invested in long-term bonds a couple years ago, those losses are sunk costs. We expect short-term rates to come down next year, and that will afford some principal appreciation, to recapture some of those losses.

Higher interest rates, meanwhile, will provide a bit of a headwind for stock market sentiment, and some investors who bought high-dividend stocks when rates were low may be looking to move into fixed income.

The volatility in Treasuries weighed on assets across markets. US banks put a planned investment-grade bond-selling spree more or less on ice. Stocks also sank, helping slam the breaks on an expected rebound in equity fundraising.

Others worried that the surge in US mortgage rates toward 8% was crimping demand for housing. Seems like the Fed will be forced to halt rate hikes as the pace of tightening has made it too costly for the government to pay the interest on its debt pile.

Emerging-market bonds outperformed, but they may be pricing themselves out of consideration for a number of investors. Yields on them in their own currencies have fallen below US Treasuries, causing the classic "risk premium" expected in emerging markets to all but vanish.

The spike in US yields also sent the Japanese yen tumbling past the 150 per dollar mark and close to its weakest level since 1990, putting currency traders on intervention watch.

Source and Sighting: BJSS, Bank of America, Bloomberg, Nomura, JB, Goldman Sachs Asset Management, Federal Reserve, Bureau of Economic Analysis, Investopedia