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Habib Investment Limited

Views from the desk

Monthly Global Market Overview and Outlook

Habib Investment Limited
Regulated by the DFSA

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Market Overview

> *Investing requires qualities of temperament more than it requires the qualities of intellect".*
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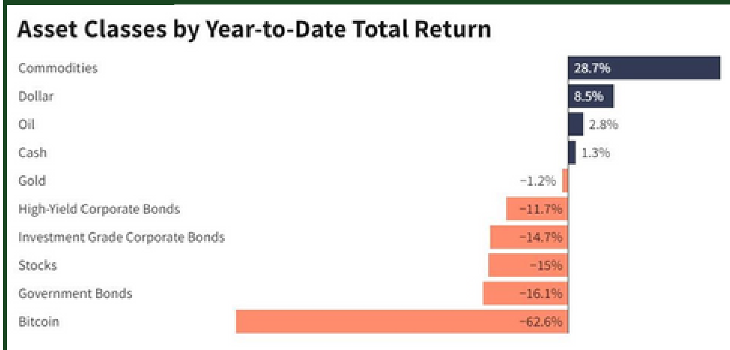
> **- Sandeep.S.Jadwani (ASCI,CIB)**
> **Head Of Investment Advisory**

Don't fight the Fed! The hawkish tone is not only prevalent in the U.S., but ECB and BOE as well, who hiked rates by a similar 50bps, opening up a new chapter for the world economy. Whispers of a recession have turned into screams, while the last big batch of economic data for 2022 is worrying traders as they begin to leave the office for the holidays. This year's been a brutal one for stocks. Despite slowing inflation and a smaller Federal Reserve interest-rate hike, the S&P 500 is slumping toward a rare large December drop. The index is down 5.6%(MTD) & 17% (YTD), which would be the third-largest year-end decline this century and just the sixth slide out of 22.

Graph 1



Source : Bank Of America Research (as on 16th December 2022)

What's even rarer is that the rout is coming at the end of a dreadful year. Only 2002 looks worse on that basis, and back then the Fed was already cutting rates rather than promising to hike further and hold them higher for longer. Little wonder then if Wall Street is starting to wonder if the night is going to get darker still before there's any chance of a new dawn.

November's report indicated consumers are feeling the double-punch of sky-high inflation and painful interest rate hikes from the central bank. This retail sales data adds to recessionary concerns, as it suggests that consumers may be becoming more cautious with their spending.

Fed Chair Jerome Powell could not have been clearer about the long fight ahead to get back to price stability and that the central bank "will stay the course, until the job is done."

Graph 2: S&P 500 Year end and Dec performance

***Dejavu 2008** : The classic Year end vs Dec performance of S&P 500 is a reliable sentimental indicator. However, retail sales and higher for longer rates dampen the sentiment for a long-haul bull run.*

Infection • Injection • Inflation • Inflection

Slew of events that have impacted the financial markets and all have been interlinked

Inflation has undoubtedly been the key economic theme of 2022, with price growth breaching decades-long records in several major economies.

December has tended to be a good month for risk assets, inspiring the term "Santa Claus Rally" to describe late December surges. It's been the third-best month for both the S&P 500 Index (since 1950) and the NASDAQ Composite (since 1971), and the second-best month for the Russell 2000 Index since 1979. International stocks also have historically participated in Santa Claus Rallies. For example, the FTSE 100 Index's average monthly return for December is 2.55%, the MSCI Emerging Markets Index's average return is 3.18%, the MSCI EAFE's average return is 2.34%, and the Hang Seng's average return is 1.79%. But 2022 has been contrarian to most of the trends with MSCI World down by more than 2 % for the month (YTD -17%)

The US Treasury curve saw yields jump across tenors in December. The peak Fed funds rate moved higher to 4.89% for the May 2023 meeting. The move reversed the slight rally from the previous day after the composite PMI fell to 44.6, a sixth straight month below the 50 mark, indicating a contraction in the private sector. With the shift higher in benchmark rates, probabilities of a 50bp hike at the Fed's February meeting have risen to 38% from 25% ; probability of a 25bp hike stands at 62%, down from 75% a day earlier.

As China exits a zero-COVID regime, the Chinese economy is facing the same headwinds that every major economy has faced when reopening. It's feasible to expect a sizable wave of new infections, hospitalizations and mortalities over the coming months, which could test the resolve of the central government's commitment to reopening the country. Easing restrictions is good news in the short-term, but a **vaccination** strategy is essential for a long-term strategy. Otherwise, **infections** may rise rapidly. Employees have to stay at home.

China reported November monthly economic data that broadly missed market expectations, as COVID disruptions continue to hamper growth despite loosening pandemic restrictions. Industrial production decelerated to 2.2% year-on-year (vs. 5.0% in October) due to supply chain disruptions.

India is now the poster-child for EM investors. Government's policies have increasingly been tailored towards supporting and expanding the economy's manufacturing footprint, as a source of improving trend growth and employment

Globally, trade conflicts and protectionist policies have highlighted fragilities of existing global value chains, magnified by the pandemic. This has provided a good opportunity for India to capitalise on the window to attract part of these capacities. We maintain our FY23 growth projection at 7% yoy and are mindful of a passage of pent-up demand domestically besides, a more challenging external environment next year.

The risk of over-tightening is particularly high for the ECB. Wage growth is not a big risk in Europe. The ECB could act more cautiously. The ECB worries about energy prices and second round effects on inflation. We don't expect companies to pass on higher cost due to weak demand. Markets are not convinced either, they are sceptical that the ECB adds two more hikes than expected. Watch the IT-GER sovereign spread as a key risk measure. We expect the ECB to turn less hawkish when frictions increase, and some EUR economies face a severe economic downturn.

BoJ Governor Haruhiko Kuroda shocked markets by adjusting the central bank's yield curve control program, sparking a jump in the yen and yields just months before he is due to step down. The BOJ will now allow Japan's 10-year bond yields to rise to around 0.5%, up from the previous upper limit of 0.25% on its movement range.

Tight financial conditions and China's biggest COVID outbreak yet mean global economic growth will slow further in the first quarter of next year, dragging most commodity prices lower. The slowdown will be accompanied by investor risk aversion, which will further undermine commodity prices The raft of inflation data and central bank policy decisions were key drivers of prices, but to some extent China stole the show. We now think that a dismantling of the zero-COVID policy is well underway. On paper, the removal of restrictions should give a boost to commodity demand, and particularly transport-related demand for fuels. But in reality, we think the consequent surge in infections (and fear of infection) will weigh heavily on activity in the coming months. This is the **inflection point** underpinning our forecast that commodity prices will fall in the first quarter of 2023.

Market Definitions 101

Alpha (α)

Alpha (α) is a term used in investing to describe an investment strategy's ability to beat the market. Alpha is thus also often referred to as “excess return” which refers to the idea that markets are efficient, and so there is no way to systematically earn returns that exceed the broad market as a whole

Beta (β)

Beta (β) is a measure of the volatility—or systematic risk—of a security or portfolio compared to the market as a whole (usually the S&P 500). Stocks with betas higher than 1.0 can be interpreted as more volatile than the S&P 500.

Delta (Δ)

Delta (Δ) is a risk metric that estimates the change in price of a derivative, such as an options contract, given a $1 change in its underlying security. The delta also tells options traders the hedging ratio to become delta neutral.

Asset Class Views - 2023

Asset Class	Sub-Class	View (Sep)	View (Oct)	Rationale
Main Asset Class	Equities	=	=	DM equities are expected to lack support from earnings growth in 2023 as margin compression should eat into the positive effects of continued sales growth and share buybacks. EM equities will have to deal with the same macro challenges as DM equities but should nonetheless benefit in relative terms, starting from a more depressed starting point (both in terms of valuations and earnings).
	Fixed Income	= ▲	= ▲	We expect high-yield (HY) credit spreads to widen significantly later next year as the recession damages companies’ profitability, so we remain underweight on HY bonds in general and favor quality in credit
	Commodities	= ▲	= ▲	Tight financial conditions and China’s biggest COVID outbreak yet mean global economic growth will slow further in the first quarter of next year, dragging most commodity prices lower. The slowdown will be accompanied by investor risk aversion, which will further undermine commodity prices. However, as global activity growth starts to recover from around the second quarter, we expect improved commodity demand growth and investor risk appetite to push prices higher in Q2,2023
	Currencies	= ▲	= ▲	We expect the US dollar to decline in 2023, underperforming most other major currencies. But exchange rates could be volatile again given high global uncertainties

Asset Class	Sub-Class	View (Sep)	View (Oct)	Rationale
Equities	USA	=	=	We are neutral. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare. Earnings downgrades are starting but don't yet reflect the coming recession.
	EU (Ex UK)	▼	▼	We are underweight. The energy price shock and policy tightening raise stagflation risks
	UK	=	=	We are neutral UK equities following their strong performance versus other DM markets thanks to energy sector exposure. The domestic political chaos, uncertainty over fiscal policy and the near-miss of UK LDI systemic risk weighed on recent domestic performance.
	EM (Ex MENA)	=	=	We are underweight EM. Activity is restarting in China, but we see China on a path to lower growth. Tighter state control of the economy makes Chinese assets riskier, in our view. We prefer overweight India and cautious negative South Africa and other indebted EMs and heavy commodity importers
	MENA	= ▲	=	Scaling of capital markets by divesting PSU, Range bound Oil prices, Rising USD IR and key structural reforms make GCC a key low beta, attractive return allocation. In EM space, we lean toward commodity exporters over importers.
Fixed Income	US Treasuries	= ▲	= ▲	We are underweight. We see long-term yields moving up further as investors demand a greater term premium. However, We are neutral & remain invested in the front end due to attractive income potential.
	Euro (Bunds)	▼	▼	We turn underweight. We expect term premium to raise long-term yields and high inflation to persist. Rate hikes are a risk to peripheral spreads.
	UK Gilts	▼	▼	We are underweight UK gilts following the UK government's fiscal splurge. The Bank of England will need to hike rates higher to rein in price pressures, and we believe the move raises serious questions about the UK's fiscal credibility.
	US IG	▲	= ▲	We have a neutral view of IG credit. High-quality IG credit can allow portfolios to generate excess yield through spread premium (also known as carry) that is meant to compensate investors for perceived issuer credit risk. Although credit spreads have widened and the attractiveness of investment grade corporates has increased somewhat, we still believe that the potential for further widening exists as the risks of an upcoming recession increase. We reiterate our bias toward selectivity.
	US HY	=	=	HY has attractive yields and strong fundamentals. However, default rates and rating migration could soon turn less positive and may not be fully compensated by spread levels.

Asset Class	Sub-Class	View (Sep)	View (Oct)	Rationale
Fixed Income	Europe IG	▼	▼	Our UW stance on EU IG remain as we derive alpha from the US or the EM counter parts and avoid a further aggressive draw down participation
	EM	=	=	We remain neutral on EM sovereign debt denominated in dollars, but we believe that the outlook may brighten once inflation is seen to be falling back and once U.S. interest rates have peaked
Commodities	Oil	=	=	Global supply disruption to support Oil whilst a sluggish demand and slowing economic activities put pressure on Oil. Supply reductions & winters to provide some support
	Precious Metals	=	=	Heightened geopolitical risks amidst recessionary fears, US-China tension, Russia-Ukraine and market volatility to drive safe haven demand, however, strengthening USD could pull the metal down.
Currencies	USD	=	=	We expect the US dollar to decline in 2023, underperforming most other major currencies. But exchange rates could be volatile again given high global uncertainties
	EUR	=	=	We see the euro declining from the current rate of around USD1.05 to USD1.00 on a 3month horizon, but expect the single currency to rebound to USD1.10 at the end of 2023
	GBP	=	=	Weak economic outlook, and anticipation of aggressive BOE rate hike until end of 2022;
	EM	=	=	Benign USD, compelling currency valuations, consolidating energy/commodity prices may support EM currencies.

Time to re-iterate the hypothesis of the 60/40 portfolio: Consider 45% Equity 35% Debt 20% Alternatives

Performance for an illustrative traditional 60/40 portfolio has been challenged in 2022 amid surges in interest rates, recession risk, and broader market uncertainty.

Inflation poses a unique challenge to the traditional stock-bond portfolio that we haven't seen since the 1970s. The diversifying nature of the relationship is under increasing pressure, making rethinking portfolios more critical than ever.

Graph 3: 60/40 Portfolio performance for the last 20 years

Feeling Hopeful: **A 60/40 portfolio has bounced back strongly following a negative (positively coorelated) year since 2002**

As we entered 2022 it looked like the historic diversification benefits of the traditional 60/40 portfolio might come unstuck as inflation started to take hold. Few could have quite imagined the extent to which this would materialize – equities at one point were squarely in bear market territory, while bonds experienced the biggest sell-off since 1994. The question now is what happens going forward? Have valuations reset enough and is there enough yield in bonds to make the 60/40 mix appropriate again? Or does the mix have to be iterated with a 45/35/20 Equities-Bonds-Alternatives allocation?

Such a diversified portfolio could offer the same risk profile as the 60/40 portfolio. Importantly, this portfolio's projected returns could be meaningfully better than the 60/40's when inflation runs hot, that is, in the stagflation and reflation scenarios. Alternative investments strategies vary widely. Understanding the characteristics of a strategy is crucial because many in the same category or with similar labels may produce vastly different portfolio outcomes.

2022 has so far been one of the worst years on record for a US 60/40 portfolio. For much of the past 25 years, investors have benefitted from a consistently negative correlation between equities and bonds.

Simply put, when equities sold off, investors could generally rely on bonds to provide ballast and protection in a multi-asset portfolio. Hence, we reiterate our view that a 45/35/20 Equities-Bonds-Alternatives allocation offers more robustness around diversification and inflation protection for the macroeconomic environment ahead. We strongly believe that the persistence of unusually elevated macroeconomic uncertainty increases the appeal of diversifying portfolio exposures beyond traditional stocks and government bonds. In particular, adding a larger suite of assets to the portfolio should help address challenges posed by a prolonged period of elevated inflation.

This time around bonds look like a lot of fun for 2023 with yields sitting pretty just around 4.5% — that's some 2.5 points above the average for the 10 years through 2021. Traders went into the Fed meeting confident rate cuts are coming next year after November CPI sagged and nothing Powell said had much impact on that part of the market. That could be because inflation-linked debt shows signs of being more noise than signal. For one thing, the notes have done a singularly poor job of performing their stated role as an inflation hedge, delivering about as bad losses this year as nominal bonds.

The mantra from central banks — and the IMF — remains policymakers should err on the side of tightening too far and setting off recessions rather than risk slowing down too soon. That was reinforced when the ECB & BOE matched the Fed's half-point hike and more than a third of its policymakers favoured a bigger increase. Most bond investors seem to reckon just about enough has been done to tame inflation.

Finally, when looking for alternative diversifiers, we believe it's best to ask the right questions. Is it diversifying to your current portfolio? Does it offer a durable source or return? Has it been defensive when the rest of your portfolio needed it most? Finding the right alternative may make portfolios more resilient to not only inflation scares, but also many different future market environments. We see benefits to diversifying beyond a broad 60/40 portfolio by incorporating additional building blocks in portfolio construction.

Source and Sighting: Goldman Sachs Asset Management, Bloomberg Research, Blackrock BII, Pimco Outlook, Sys Group


Habib
Investment
Limited
2023
MERRY
christmas
&
HAPPY
new year