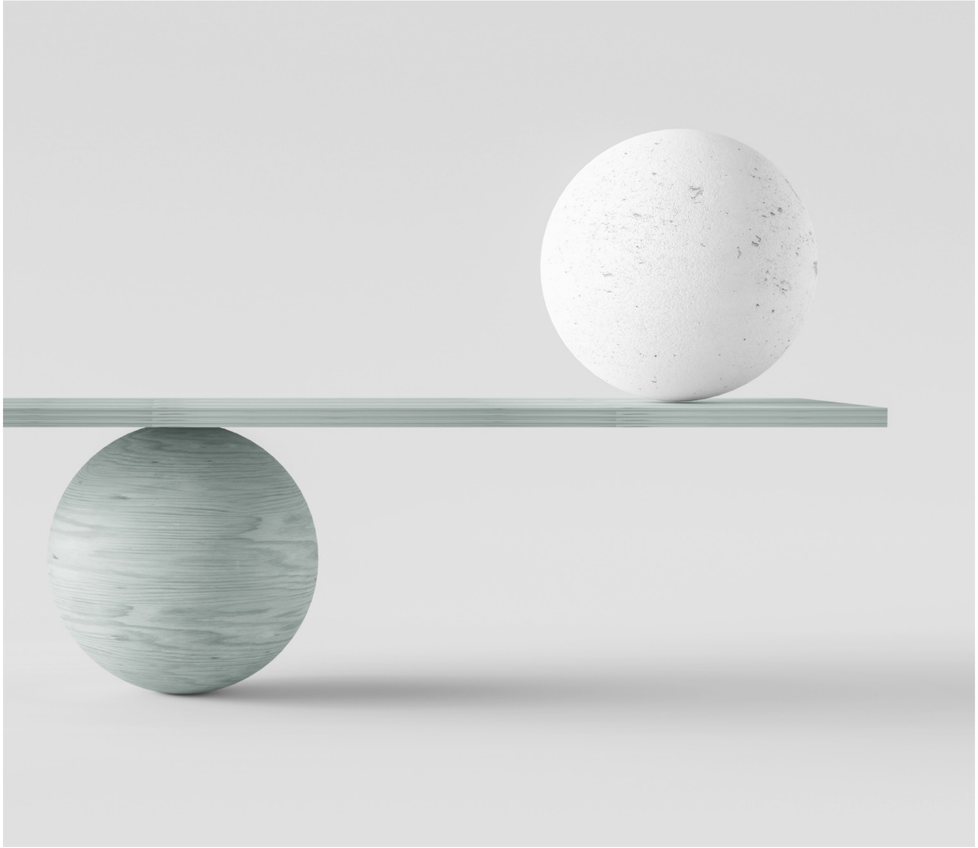
IN LIMBO

Q2 2023



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Dear Reader

The current market situation has many investors scratching their heads. The US economy has suffered the sharpest rate shock since the 1970s, but no recession is in sight and profit margins remain sky-high. Moreover, overall uncertainty is as high as it has been for a long time, not least owing to the recent shocks in the global banking system, and equity markets are booming. Can this be good? And even more importantly, can it end well?

Well, it's complicated. Although many factors are at work that were different fifty years ago, the sheer weight of higher rates will eventually bring down activity. A recession therefore appears unavoidable, but it's far from clear how deep and long such a contraction of US GDP could be. Markets aren't currently worrying too much about it and are continuing to wait for the Fed pivot. We don't think this will come in 2023 and, combined with a high probability of a recession, this argues for staying defensively positioned in our portfolios. After all, at least the nominal returns on most fixed-income assets have become more palpable, making the wait for a market bottom fairly bearable.

The imminent end of the US dollar hegemony has been a frequent recent headline in many media. We provide our contribution to this debate in our Special Topic.

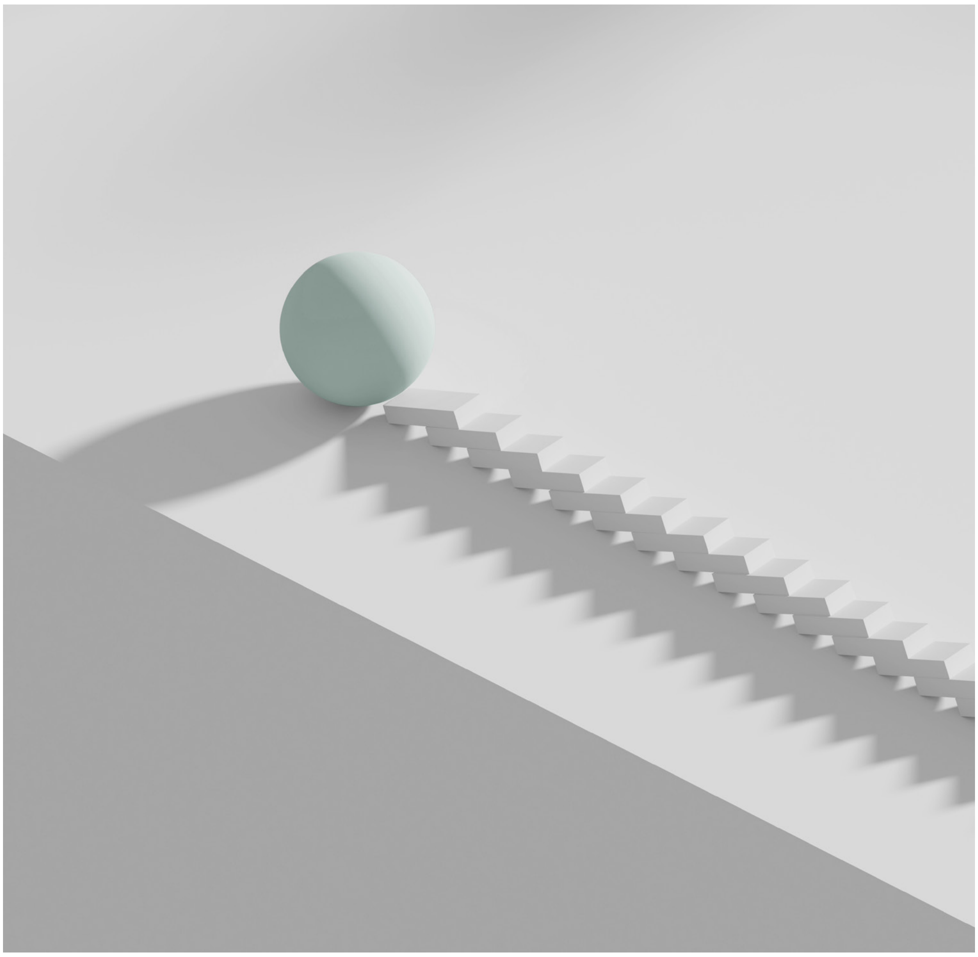
In these unusual times it's important to challenge our convictions, and the best way of doing so is a robust exchange of views. We look forward to your questions and perspectives.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP
Recession and recovery

Conditions for the global economy will remain challenging as the end of the era of easy money exacts its toll on activity and asset prices. Near-term the US is facing material recession risks, while China is emerging from last year's slowdown. Europe could follow, having avoided the worst.



Key points
- Tighter monetary and credit conditions to tip US into recession
- European resilience paves way for modest recovery
- Rebound of Chinese activity to reverberate across the globe

US recession still looming

US economic activity remained surprisingly robust at the start of the year, but lately cracks have started to appear here and there. Manufacturing is contracting and business investment has softened. While employment is still holding up, underlying trends such as new payrolls and job openings have weakened, suggesting that activity in the services sector too will roll over in the nearer future. How could it be otherwise? The economy has been hit by one of the largest and sharpest interest rate shocks in living memory. The Fed has raised its policy rate by a cumulative 475 bps within just one year and is not done yet. While the terminal rate may be in sight, quantitative tightening should continue to proceed at a pace of some USD 95bn per month for the foreseeable future. But it's not just monetary conditions that have deteriorated materially; so have credit conditions, as banks have tightened their credit standards and reduced their appetite to lend. Meanwhile, inflation has peaked but is slow to fall back to target. Under these circumstances, the Fed cannot abandon its mantra of "higher for longer" without jeopardizing its credibility. Recession is the place where all these trends are likely to meet. However, such a recession could be swift and shallow; but it could also be long and deep. At any rate, downside risks to US growth prevail for the time being.

Europe resilient

Only last year, Europe was expected to suffer a deep contraction, as the flow of cheap Russian gas had abruptly ended. However, surprisingly speedy responses from all the actors involved and what turned out to be a clement winter limited the negative fall-out from the energy crisis. As a result, growth should recover, albeit moderately, in most European economies over the course of the year. This should allow the ECB to further normalize monetary conditions and thereby get the better of inflation.

China leads the way once more

China's unexpected abandonment of most policies to contain the Covid-19 pandemic late last year has already borne fruit, with activity indicators across the Chinese economy jumping back to life since the beginning of the year. The official growth target of 5% for 2023 looks comfortably within reach, even in the current uncertain global environment. This is decidedly good news for global growth.

Table 1: Real GDP growth (y/y in %)

	2022E	2023F	2024F	Short-term trend
United States	2.1	1.0	1.0	↘
Eurozone	3.5	0.5	1.2	↗
Germany	1.9	0.0	1.1	↗
United Kingdom	4.0	-0.4	0.8	↘
Japan	1.1	1.1	1.1	→
China	3.0	5.3	5.0	↗
India	6.9	6.0	6.3	↗
Russia	-3.0	-1.7	1.5	→
Brazil	3.0	0.9	1.7	→

Table 2: Consumer price inflation (y/y in %)

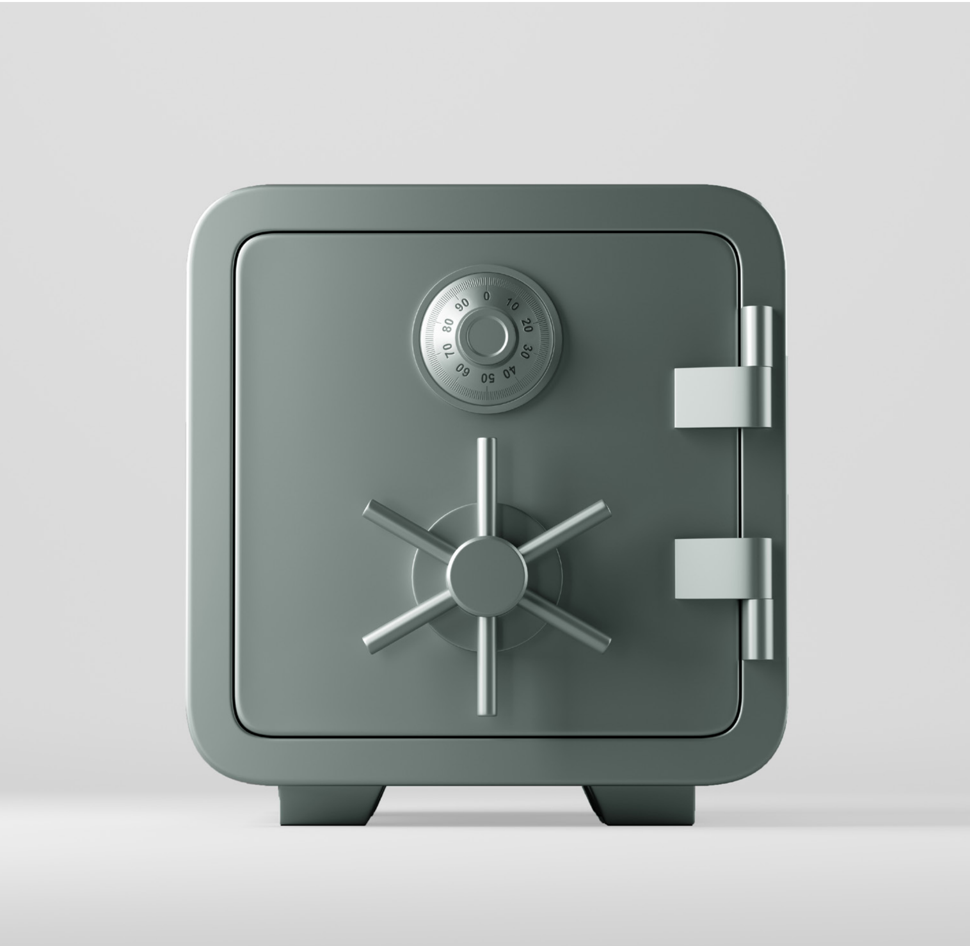
	2022E	2023F	2024F	Short-term trend
United States	8.0	4.3	2.6	↘
Eurozone	8.4	5.6	2.4	↘
Germany	8.6	6.2	2.6	↘
United Kingdom	9.1	6.5	2.4	↘
Japan	2.5	2.3	1.2	↘
China	2.0	2.3	2.3	↗
India	6.7	5.2	4.8	→
Russia	13.8	5.8	4.9	→
Brazil	9.3	5.3	4.2	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

In limbo

More than a decade of ultra-easy monetary policy will continue to cast its shadow on financial markets for a considerable time. While investors can finally park money in low-risk assets and earn a decent return, prices for many assets remain high, probably unsustainably so.



Key points

- Tighter liquidity and higher funding costs are yet to reveal their full impact
- Defensive positioning remains warranted
- US recession as a major risk

It’s complicated

While investors welcome the opportunity to finally be able to place their money again in the relative safety of bank deposits and Treasury bills at attractive rates – at least in nominal terms – the overall impact of higher interest rates on financial assets is more complicated. The repricing required by a change in rates can have serious consequences, as the recent woes of a number of US regional banks have demonstrated. In the worst case, this can lead to insolvency, the point where the value of a bank’s assets no longer matches the value of its liabilities. While most traded financial assets have largely repriced, painfully so for all investors in 2022, there are many less liquid asset classes where the day of reckoning has yet to come. It is these second- and third-round effects of higher rates and lower liquidity which keep us up at night. In particular, businesses which operate with high leverage are at risk, as is, more generally, any asset that requires substantial refinancing at a time of higher funding costs and lower risk appetite. These concerns are also one of the main reasons why we continue to advocate a defensive positioning despite relatively strong equity markets year-to-date. As we highlighted in our previous report, quality fixed income offers the best value at this juncture. Periods of stress, such as the recent banking system turmoil, can create attractive entry points.

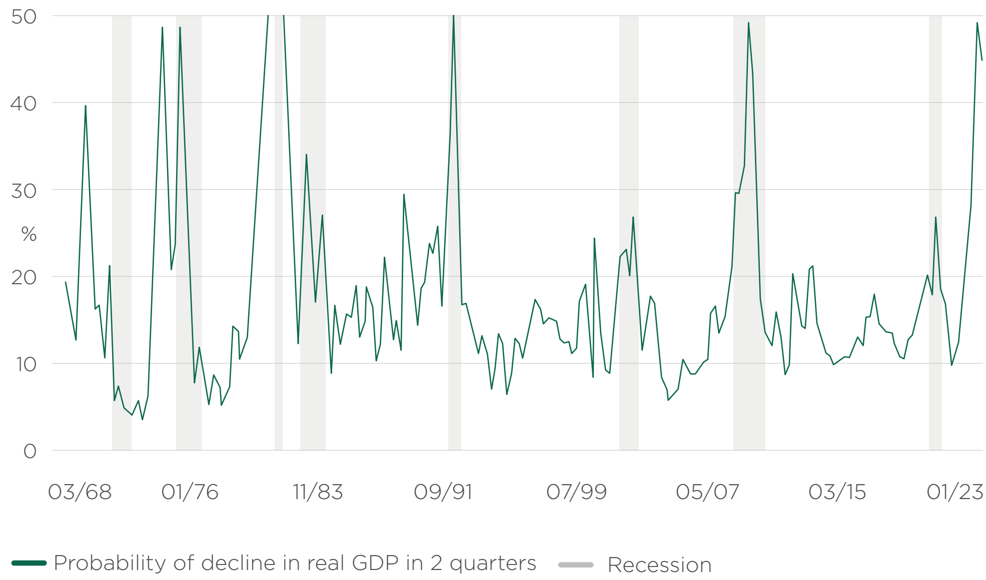
Our positioning

In terms of our tactical allocation, we maintain a fairly pronounced underweight in equities, in view of the still rich valuations, in particular in the US. We are broadly neutral in fixed income, although some of the allocation is currently invested in the money market, thanks to the attractive risk/return of this asset class, as well as in alternative fixed income. We also hold gold as a hedge against more pronounced USD weakness.

What to watch

Top of our watch list is a US recession, as we don’t think the US equity markets have fully priced in the earnings impact of several quarters of negative growth. Central bank policy is another area to follow closely for signs that policymakers may waiver in their commitment to stay firm on inflation. Finally, counterparty risk is a topic which has again become more salient as shorthand for increased fragility in the global financial system, as central banks continue to withdraw and raise the price of liquidity.

US recession risk elevated by historical standards



Source: Philadelphia Fed Survey of Forecasters, HBZ

FIXED INCOME

Stick with quality

Yield is back and investors need not take undue risks to lock in decent returns. We therefore prefer investment grade over high yield, and the same principle applies in emerging markets. Subordinated financials offer an interesting entry point after the setback in March.

Key points

- Investment-grade bonds with best risk-return profile
- Subordinated financials offer good entry point
- Stay with quality in EM space

Investment grade

Investment-grade bonds continue to offer an advantageous risk-return profile. While the short end currently provides the highest yields, extending duration makes sense to lock in attractive yields for longer, as we see only limited upside risk to rates. This makes sense for high-quality bonds in particular, since downgrade risks are more limited and default risks even lower. The lowest-rated investment-grade bonds (BBB-) are much less attractive, as a downgrade to junk would widen spreads significantly. At this point in the credit cycle and given the tight spreads, high-yield bonds are our least favorite. Despite better fundamentals than during previous downturns, higher refinancing costs and lower earnings will expose many issuers to higher default risks in due course.

Entry point for subordinated financials

In March, subordinated financial bonds came under huge pressure, as investors feared a banking crisis following the collapse of several smaller US banks and the forced takeover of Credit Suisse. However, swift action by regulators has limited the contagion risk, and the sell-off offers a good entry point to gain exposure to this segment with a clear focus on quality issues, namely those of the largest national champions. Bank fundamentals are much improved as a result of the measures taken in the wake of the Great Financial Crisis to shore up the capital base. Following the shocking bail-in of additional tier-1 bonds as part of the CS takeover, regulators across the globe were quick to assert that they would not follow the Swiss example and would respect the capital structure in similar circumstances. This sub-asset class now offers great return prospects, but is best accessed through a fund vehicle to assure sufficient diversification.

EM: quality trumps yield

Despite a robust start to the year, growth will remain subpar for many emerging market (EM) economies, and the ongoing recovery in China may not be enough for many to offset slower global growth. Fundamentals remain strong for corporates, but earnings will be tested, with all sectors impacted by tighter liquidity and higher funding costs. Investment-grade paper in both the corporate and sovereign segments offers decent yields at risk much lower than EM high yield, where spreads appear mispriced, and which we are therefore underweighting for the time being.

Yield on USD investment-grade bonds: best in years!

Source: Bloomberg, HBZ

EQUITIES

Not out of the woods yet

Global equities continued to rally in the first quarter on the back of declining long-term interest rates. European equities outperformed their US counterparts, as the energy crisis failed to materialize and the region has avoided a recession so far. But it's too early to sound the all-clear.

Key points

- Slowing growth to challenge earnings in Q2
- Financials likely to remain under pressure
- Favor Europe and quality companies

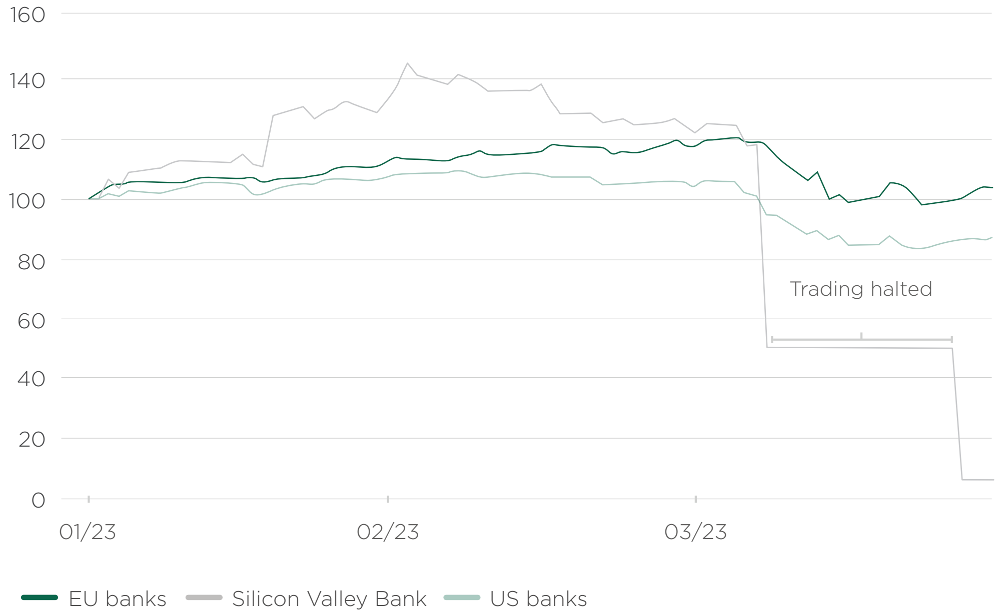
Lower long-term yields boost most equities...

Sectors sensitive to interest rates, such as technology and consumer discretionary, benefited from lower discount rates and investors anticipating the start of a new business cycle in six to twelve months from now. The communications sector also profited strongly in the first quarter as many constituents, such as Alphabet and Meta, recovered much of their previous year's losses. These sectors exhibit significant positive correlations to the styles of growth, quality, and large cap. Consequently, growth stocks outperformed value names, companies with strong balance sheets outperformed weaker ones, and larger caps outperformed smaller caps. The next test is already looming, though, in the form of the second-quarter earnings season, for which analysts expect a material contraction (–4.5% for the S&P 500).

...but financials suffer

After a good start early in the year, financials, on the other hand, suffered massively as US regional banks came under pressure in March. The collapse of Silicon Valley Bank and the troubles at other smaller US deposit-taking institutions were the consequence of a sharp rise in interest rates in 2022, which led to substantial mark-to-market losses. The losses crystallized once assets had to be sold to cover accelerating deposit outflows. In contrast to the Great Financial Crises of 2008, however, this time the turmoil was caused by an asset and liability mismatch and not by delinquent borrowers. Moreover, the forced takeover of Credit Suisse by UBS further added to market jitters and led many customers to shift bank deposits into money market funds and treasuries. As a result, bank lending has tightened considerably, which will eventually impact consumption and thus economic growth. In the short term, the banking sector will continue to face headwinds as the inverted yield curve is constraining net interest income generation, a situation which is more pronounced for US banks than their European peers. Furthermore, loss provisions are likely to increase, and M&A activity is set to decline on the back of slowing growth and higher interest rates. This should reverse once central banks move past peak rates and markets start anticipating the first rate cut. Looking forward, we believe Europe is better positioned than the US given the lower probability of recession and more favorable valuations. Given the near-term headwinds for earnings, we prefer larger companies with solid business models and strong fundamentals.

European banks outperforming US peers
(indexed January 2023)



Source: Bloomberg, HBZ

COMMODITIES AND FX

Weaker dollar set to lift oil and gold

The US dollar peaked last year and the downward trend is likely to gain momentum as the Fed approaches its terminal rate. The lower USD also lifted commodity prices including gold, although supply issues are also behind the latest rally in crude.

Key points

- USD on a downward trend
- Oil prices lifted by supply issues
- Weaker USD, central bank buying to support gold

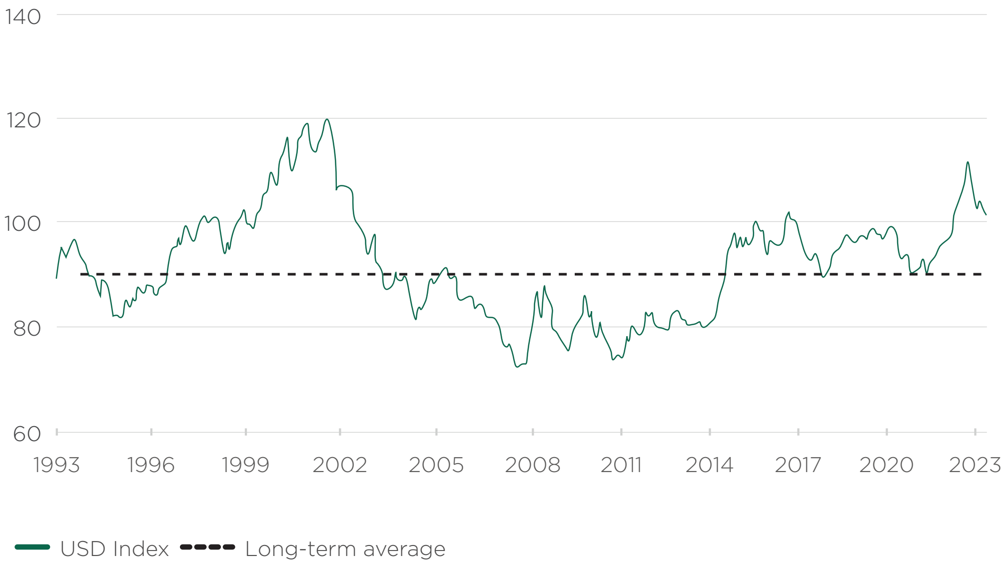
Bearish outlook for the USD

Midway through the past quarter, the USD appreciated as the market anticipated much higher Fed funds rates, but reversed course in March amid the regional banking crisis in the US, which briefly risked turning into a global one. The impact of these events remains uncertain, but the USD appears to have been on a downward trend ever since its cyclical peak in September of last year. Owing to the banking stress and slowing activity, markets lowered their expectations for future Fed rate hikes and the dollar weakened in turn against all majors. Anticipation of a lower peak in rates, combined with the likelihood of a US recession, mild or otherwise, while other central banks keep tightening, is bearish for what is historically still a fairly expensive dollar. A political dimension is also weighing on the dollar: China and many EM countries perceive the USD's dominance as a risk to their sovereignty and independence and are seeking to reduce exposure to the US currency.

Oil and gold on the rise

Oil prices rebounded in March as OPEC+ announced an unexpected production cut. The ensuing supply lifted crude prices well above USD80/bbl. But the oil rally also reflects a weaker US dollar, as Treasury yields retreated from their recent highs following the Silicon Valley Bank collapse. The market now expects a supply deficit in the current quarter as the medium-term demand outlook is bolstered by China's economic reopening. On the other hand, the supply outlook is constrained by lower Russian output due to Western sanctions and a possible US recession. Some of these factors have opposite effects on oil prices and should nurture volatility. Fundamentally, though, the oil price should remain well supported, with the spot price for Brent likely to average around USD70–90/bbl in 2023. Gold also benefited from the turmoil in the global banking system, which may accelerate the end of the US monetary tightening cycle. The drop in US yields reduced gold's handicap as a non-interest-bearing asset. While gold may be vulnerable to short-term profit-taking, the fundamentals remain in favor of holding it for reasons of risk diversification and as a hedge against further USD weakness. Not only are private investors seeking to protect themselves from market volatility and inflation, but central banks have also acquired 125 tons of gold year to date, the strongest start in over a decade.

The trade-weighted USD remains strong



Source: Bloomberg, HBZ

KEY MARKETS
Navigating rough waters

As the year unfolds and the array of local and global pressures remains unabated, Pakistan comes out looking for an economic lifeline and the UK fights off a looming recession. The UAE emerges as a beneficiary of the general turmoil.

Key points
- Pakistan scrambles to secure IMF support
- Broad momentum sustained by UAE
- UK still at risk of a recession

Pakistan: in need of friends

Plagued by an unfavorable mix of political and economic developments, the Pakistani economy continues to be frail. The central bank ratcheted the policy rate up to a record 21% in early April after March inflation clocked in at 35.4%. The pressure on foreign exchange reserves remains unabated, although the current account deficit did narrow, thanks primarily to a sharp decline in imports rather than better exports or remittances. The government has made progress on key deliverables to unlock the release of the next tranche under the IMF program, including a mini-budget for improved tax collection. However, the release remains subject to IMF board approval and commitments from friendly nations for additional funding. Against the backdrop of tightening global monetary conditions and a rating downgrade to Caa3, Pakistan has limited access at best to international capital markets. While a restructuring of external debt can probably be avoided, especially through constructive engagement with China, the country's main bilateral creditor, the domestic debt situation may require drastic measures, including extensions and haircuts.

UAE: tailwinds continue

Preliminary data reflects significant GDP growth and a budget surplus of about 10% of GDP in 2022, aided by a sharp increase in tax revenue and virtually unchanged spending. The economy remains supported by strong property and capital markets, with robust increases in home prices and rents and the high-profile ADNOC Gas IPO. In 2023, the UAE will introduce a headline corporate tax rate of 9%, putting the Emirates on a considerably more stable fiscal footing. More recently, a surprise cut in oil production translated into a 6% increase in the price of crude oil and signals a tighter oil market set to benefit the country's oil sector and the economy overall.

UK: resilient... so far

The UK economy proved more resilient than expected and avoided a recession in 2022. For 2023, a contraction in GDP is still possible but could turn out to be quite shallow thanks to the more limited impact of higher energy bills and moderate fiscal loosening announced in the Spring Budget. A recovery thereafter will, however, most likely be fairly weak, with expectations of further rate hikes. The GBP could benefit from a weaker USD, but with limited upside given the challenging macroeconomic setting.

Pakistan in the midst of another crisis

Source: Bloomberg, HBZ

SPECIAL TOPIC

Is the USD's reign coming to an end?

The imminent end of the US dollar hegemony over the world economy and global financial markets is frequently predicted but has yet to occur. History shows that the replacement of a leading global reserve currency is a long-drawn-out process, and this will probably also be the case for the USD.

Key points

- High bar to qualify as global reserve currency
- CNY limited by its lack of full convertibility
- No viable alternative to the USD as yet

Exorbitant privilege

Being the world's major reserve currency bestows on its issuer an exorbitant privilege, as an evidently envious French politician once called it. The issuing country earns so-called seigniorage, the difference between the cost of printing money and its face value, and moreover can under almost any circumstances finance its external deficits. The price for this role comes in the form of a currency that is fully convertible, also for capital account transactions, which can lead to wide currency swings. Moreover, capital markets need to be deep and liquid in order to park foreign reserve assets, requiring a very large economic base. In modern times, only the British pound and the US dollar have been able to assume this role, simply because their nations were at the time the dominant global force, assuring minimum stability in the global trade and financial system enforced, if needed, with their financial or military heft. The euro, a one-time pretender, never even came close.

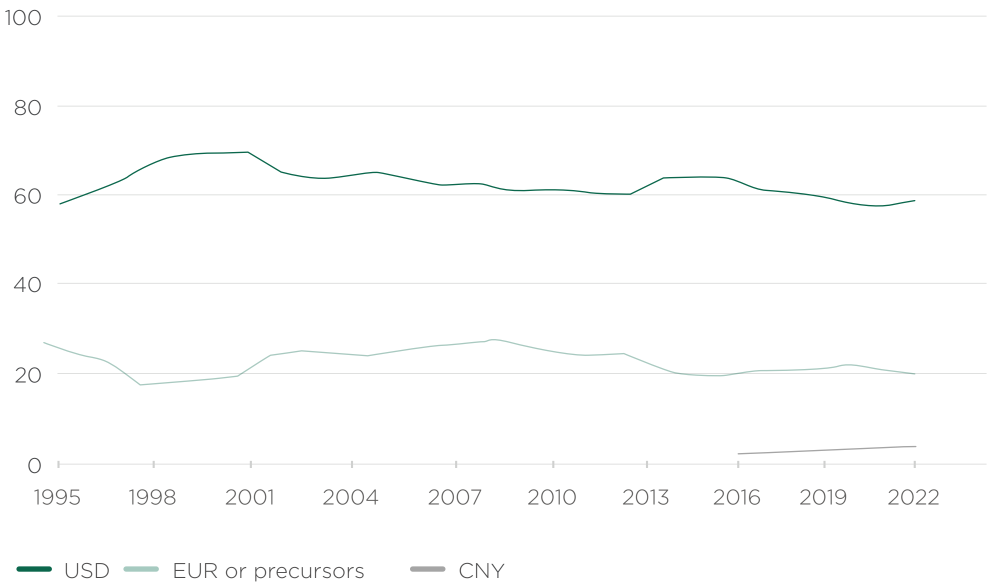
Who else?

Today, the USD's dominant position is being challenged first and foremost by China. Can its currency assume the same role as the USD? In the context of trade, the CNY has already become an important means of exchange, since China has encouraged its trading partners to settle their commercial transactions in their respective currencies, thereby circumventing the USD. The war in Ukraine, the sanctions against Russia, and the antagonistic relations with the US have only accelerated this development. However, within the SWIFT global payment system, only slightly more than 2% of payments are currently settled in CNY, a share which has been fairly constant since 2015. While this is not the complete picture, it highlights the key weakness of the Chinese currency, namely that it is not freely convertible. The likelihood that the control-minded Chinese leadership will end all capital controls any time soon is slim. Within the current global economic system, the USD therefore lacks a real competitor.

The long goodbye

The USD's already long reign is by no means set to last forever. However, most economic agents are practical creatures, and they will not abandon a means of payment unless a viable replacement has proven its mettle. This means that neither the CNY – nor the EUR for that matter – are ready to take over yet, and even less so the ill-named cryptocurrencies.

USD remains on top
(% of global central bank reserves)



Source: IMF, HBZ

As of 17 April 2023

Equity indices	Last	-3M %	YTD %	-3Y %
BBG World USD	1,527.4	3.1	8.6	45.1
S&P 500	4,137.6	3.7	7.8	43.9
EuroStoxx 50	4,379.9	4.9	15.5	51.6
FTSE 100	7,913.1	0.8	6.2	36.7
SMI	11,324.5	-0.7	5.5	17.9
Nikkei	28,514.8	9.1	9.3	43.3
BBG EM USD	1,134.2	-1.9	4.9	25.6
Sensex 30	59,845.5	-0.7	-1.6	95.0
KSE 100	40,255.5	-0.2	-0.4	28.9
Hang Seng	20,782.5	-3.7	5.1	-14.8
Russia RTS	995.7	-0.7	2.6	-7.7
Brazil Bovespa	106,279.4	-4.6	-3.1	34.5

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,513.84	0.8	3.1	-12.1
FTSE US Corp	2,326.24	0.3	3.8	-6.0
FTSE US HY	1,156.54	0.6	4.6	14.1
FTSE Euro gov	207.25	-2.2	1.6	-16.3
FTSE Euro Corp	223.14	-0.8	1.9	-7.2
FTSE EM Sov	784.36	-0.1	2.6	-3.1
DB EM Local USD	155.09	3.1	8.1	-1.5

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	101.55	-0.6	-1.7	2.0
EUR	1.10	2.0	2.7	0.9
CHF	0.89	3.4	3.6	8.0
GBP	1.24	1.3	2.8	-0.9
JPY	133.79	-4.3	-2.1	-19.7
AUD	0.67	-4.1	-1.7	5.2
CAD	1.34	0.2	1.4	4.8
ZAR	18.09	-5.9	-6.2	3.6
INR	81.85	-0.2	1.0	-6.8
PKR	280.89	-18.6	-19.6	-41.9
Gold oz	2,004.17	5.3	10.1	19.4

Interest rates	3M interbank %	10Y government %
USD	5.26	3.51
EUR	3.18	2.43
GBP	4.49	3.64
CHF	1.41	1.12
JPY	-0.03	0.49
AUD	3.63	3.37
CAD	5.05	3.04
ZAR	7.98	11.35

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