TROUBLED TIMES IN A TROUBLED WORLD

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Dear Reader
Financial markets have just suffered the worst first half year in recent memory, and still the outlook has not improved. On the contrary, with the US Federal Reserve and other central banks committed to subduing inflation, financial market conditions will become even more challenging. Global growth can only slow from here, and recession is a clear and present danger for many economies. Even China's improving fortunes will not alter this gloomy picture.

However, financial markets would not be financial markets if they were not to find opportunity in the face of adversity. And indeed, the global shake-out has created value where there was little or none six months ago. While equity markets could suffer another down-leg, the normalization of interest rates is well advanced. Risk-free rates and quality credit once again offer decent returns as well as some downside protection if and when markets take another turn for the worse. In this context, broad-based diversification remains the key to long-term investment success. Investors should therefore look through their current drawdowns, adjust their risk exposure if needed, keep their eyes open for attractive entry points, but overall stick with their strategy.

The momentous events which have unfolded since 2020 have challenged many received wisdoms, none more so than the idea of globalization. In our Special Topic, we will explore the prospects for what has been a key driver of global growth and integration over the past decades.

We hope you will find our quarterly commentary informative and thought-provoking, and look forward to our ongoing exchange.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP
The cost of fighting inflation

With inflation at a 40-year high in many advanced economies, central banks have finally responded more forcefully. The corresponding higher rates, together with high commodity prices and the inflation-induced loss of purchasing power, have started to impact growth. The risk of recession is now real.

Key points
- Fed and ECB committed to tackling inflation
- Recession risk high for the US and even higher for Europe
- Largest EM economies to stay on the expansion path

US: landing, soft or hard?

Earlier in the year, the US Federal Reserve changed its view on inflation, and is now firmly committed to bringing it back to target even at the cost of a recession. This year, a US recession is still an unlikely outcome, but as monetary policy continues to tighten — by way of higher Fed Funds rates, which may reach 3.5% in 2023, and a shrinking balance sheet — activity could eventually slow to the point of contraction during the course of 2023. While a recession need not be as deep as in 2009 or 2020, any policy response is likely to be much more muted, not least because inflation should remain above target into 2024, restricting the Fed's ability to ease monetary conditions. As a result, a recovery could also be more sluggish than during the more recent recessionary periods. Uncertainty around this outlook is high, and the risks are skewed to the downside if the incipient consumer retrenchment due to the inflation-induced loss of real purchasing power were to be prolonged by substantial weakness in house prices and the housing market in general.

Europe: the end of the recovery

Before the outbreak of the war in Ukraine, Europe was poised to experience one of the strongest years of growth on recent record. Not any longer. Soaring energy prices and sky-high inflation, combined with arguably only moderately tighter ECB policy, are bound to slow activity from Q4 onward, with a recession around the turn of the year a realistic outcome. Since the energy situation is unlikely to improve anytime soon, the outlook for 2023 as a whole has also deteriorated and, as a result, stagnation could return to the continent.

Recovery in China, robust growth in India

China might as well be on another planet, with restrictive measures to fight Covid-19 and easier policy to lift growth. However, as the lockdowns have ended for now, monetary and fiscal actions will reverse the negative trends in activity observed during Q1 and should give rise to a moderate recovery during the second half of the year. India, meanwhile, has navigated the challenges posed by the pandemic, higher commodity prices, and inflation remarkably well so far and, despite tighter monetary policy, is poised to enjoy another year of robust growth.

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

	2021E	2022F	2023F	Short-term trend
United States	5.7	2.5	1.9	↘
Eurozone	5.2	2.8	1.9	→
Germany	2.8	1.8	2.1	→
United Kingdom	7.2	3.6	1.1	↗
Japan	1.7	1.7	1.8	↗
China	8.1	4.1	5.2	↗
India	8.7	7.1	6.3	→
Russia	4.2	-9.7	-1.5	↘
Brazil	4.7	1.0	1.1	↘

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

	2021E	2022F	2023F	Short-term trend
United States	4.7	7.5	3.4	↘
Eurozone	2.6	7.2	3.0	↗
Germany	3.2	7.2	3.4	↗
United Kingdom	2.6	8.3	4.8	→
Japan	-0.2	1.9	1.1	→
China	0.9	2.2	2.3	↗
India	5.4	6.7	5.0	↗
Russia	6.7	15.8	9.2	→
Brazil	8.3	9.9	5.3	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

Deflating bubbles, tightening central banks

Investors just suffered the worst half year in recent financial history. Not even during the dark days of stagflation in the 1970s did all major asset classes (save commodities) post material negative returns. If the experience of the dot-com bust in 2000 is anything to go by, we are not out of the woods yet.

Key points

- Remain underweight in equities
- More limited headwinds from rates favor quality credit
- High-yield bonds and some private-market assets at risk

No time to be brave

The combination of rapidly slowing growth, even possibly recession, and rising policy rates represents a toxic mix for financial markets. While the prices of many overvalued assets may have adjusted to the point of looking attractive, the time has not yet come to call for a bottom. The sheer magnitude of the correction since the beginning of the year is no guarantee of a near-term trend reversal. Markets are often mean-reverting, but they also tend to overshoot. As long as the financial system is deleveraging and monetary policy tightening, risk assets will struggle to rebound beyond the inevitable bear-market rallies. Equities and low-quality fixed-income sectors are most at risk, as deteriorating fundamentals will weigh on earnings and could compromise the ability of weaker borrowers to stay on top of their liabilities. But all assets are not created equal, and the sharp rise in rates has lifted yields to levels not seen since the short-lived sell-off at the beginning of the pandemic. Moreover, the headwinds from rates have already largely dissipated, and quality bonds in particular are once again attractive for investors looking for decent current yield. At the same time, the poor macro outlook will keep equity volatility high and, combined with materially higher rates, even capital-protected structures have become feasible again. This means that provided they remain risk-aware, investors again have more attractive alternatives to parking their cash in still low-yielding deposits.

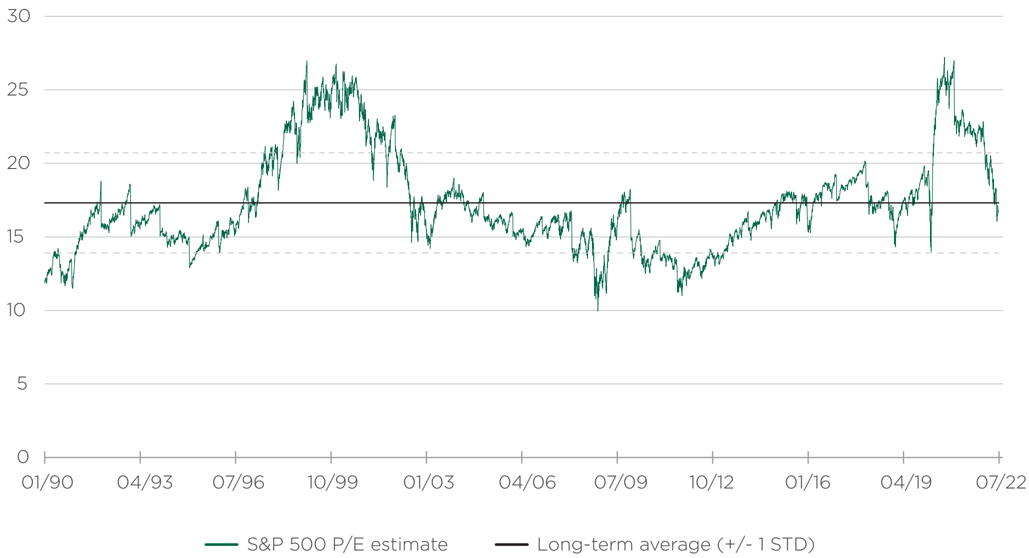
Our positioning

As risk assets have more downside on deteriorating fundamentals, we have accentuated our underweight in equities and also trimmed some credit exposure. At the same time, we have added US Treasuries to improve the risk properties of our portfolios, but we are still waiting before substantially lengthening the overall duration.

What to watch

Market corrections following periods of exuberance tend to be drawn-out affairs, and we are looking for the proverbial next shoe to drop. High on the list of vulnerable asset classes are corporate high-yield bonds, but also some private-market assets, where limited mark-to-market has so far shielded investors from having to recognize loss in value or outright impairments.

Equity valuations have further room to correct



Source: Bloomberg, HBZ

FIXED INCOME

Rate normalization creates opportunities

Yields on US Treasuries have normalized to a large extent, and any additional upside will be capped by deteriorating economic conditions. Credit spreads may widen further, but opportunities have emerged, especially with shorted-date investment-grade bonds, but also with subordinated bonds from quality issuers.

Key points

- Risk/reward favors investment-grade
- Subordinated bonds as a satellite investment
- EM corporates offer yield with moderate duration

Risk/reward favors investment-grade bonds

At this juncture, investment-grade-rated bonds with shorter duration offer what is probably the most attractive risk/reward in fixed income. Shorter-dated financials in particular stand out given their additional yield pick-up relative to corporates. As the upside pressure on US Treasury yields should subside over the remainder of the year, investors should start considering lengthening the duration for quality bonds. For the same reason, US Treasuries have also become attractive again. Following the normalization of yields, they once again offer decent risk-free yield together with valuable hedging properties in a turbulent world.

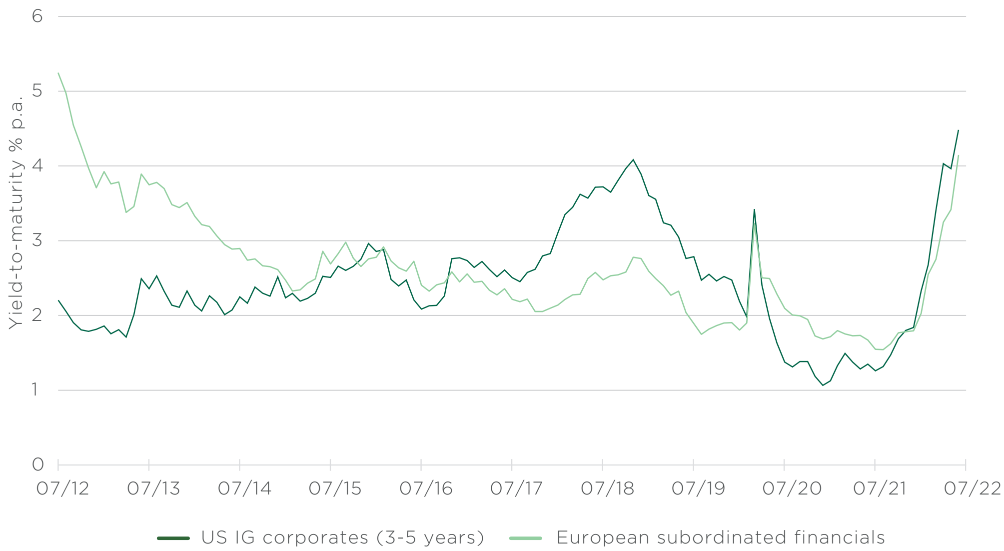
Subordinates with attractive spreads

Spreads of subordinated bonds have more than doubled so far this year, pricing in a lot of bad news. Much of this widening has been driven by risk aversion rather than by any meaningful deterioration in the fundamentals. The so-called extension risk, in other words the risk that issuers refrain from exercising embedded call options, may also have played a role, but is certainly exaggerated. In fact, the sell-off offers a good entry point to start building exposure to subordinated bonds as a satellite in diversified portfolios, which should include corporate hybrids and subordinated financials of national champions. These issuers tend to have an investment-grade rating, but investors still receive a significant yield pick-up for only moderate incremental risk. That said, this sub-asset class will stay volatile in the current market environment. Comparatively speaking though, corporate high-yield bonds are more exposed, as they usually do poorly in an environment of slowing or even negative growth.

Favor corporates in EM

Emerging-market credit — both sovereign and corporate — has fared the worst among fixed-income assets this year so far, and weak issuers continue to be at risk in the current economic context. However, spreads have widened so far that opportunities have clearly emerged. As always, selection remains key, and investors need to pay attention to properly sized allocation and robust diversification. Currently, with their lower rate sensitivity, EM corporates look more attractive than many sovereigns, where the default risk for the lowest-rated issuers remains high. As this market will stay volatile, well-diversified collective instruments remain the best way to invest.

Entry points: yields surge for quality bonds



Source: Bloomberg, HBZ

EQUITIES

More pain to come

During the first half of the year, central banks globally turned much more hawkish in order to tackle inflation. As interest rates moved materially higher, global equities suffered a deep correction and entered a bear market. By now, concerns about runaway inflation have given way to recession worries.

Key points

- Rising recession risks
- Valuations still not low enough
- Corporate profit margins unsustainable

Recession fears to the fore

Fears about runaway inflation dominated the first half of 2022, which in turn forced central banks to adopt an increasingly hawkish stance. As monetary policy started to normalize, global equity markets suffered one of the steepest declines in recent years. By now, though, recession fears have replaced inflation worries, and could have an equally devastating effect. Recession risks are currently the highest for Europe, which is particularly hard hit by surging energy prices. However, the US is similarly exposed to the adverse effects of rising prices, higher funding costs, and slowing demand. Valuations are not yet sufficiently low to represent a major argument against additional downside. At any rate, they will provide little protection if liquidity and leverage in financial markets fall further. The outlook is somewhat better for emerging markets, at least in Asia, where China is set to return to moderate growth, thanks among other things to more accommodative monetary and fiscal policy. The local equity markets have already started to anticipate the better prospects. That said, in a globalized world, any outperformance may be limited.

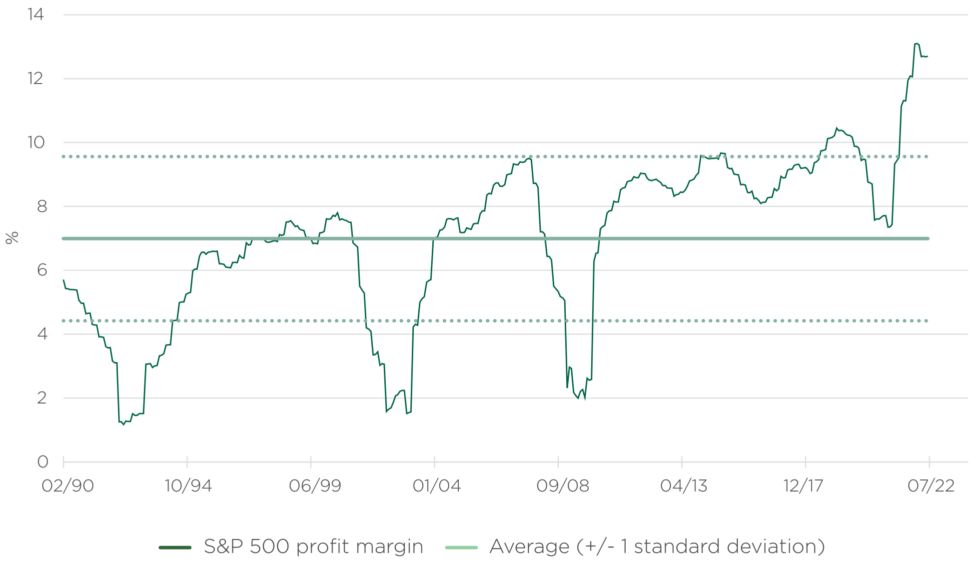
Profit margins unsustainable

The most important reality check for equity markets will be the coming earnings seasons. For the US, current profit margins remain at record highs, and forward earnings are expected to stay well above the post-global-financial-crisis trend. Earnings growth is expected to be above 10% this year and to remain in the high single digits next year. With growth momentum slowing — and potentially a recession within the next twelve months — such earnings forecasts appear far too optimistic and are thus bound to suffer considerable downward revisions at some point. Substantially lower earnings — either projected or realized — would certainly set up markets for another major down-leg.

How to weather the storm

Markets should continue to reward earnings stability and hence business models with strong pricing power and sectors enjoying stable demand. This points to tilting allocations more towards defensive industries such as health care, which historically have managed to grow earnings even through recessionary periods. Value stocks are relatively cheap from a historical valuation perspective, but they do expose investors to cyclical sectors that are at risk in a context of lower growth.

S&P 500 profit margins unsustainable



Source: Bloomberg, HBZ

COMMODITIES AND FX

Rolling over?

Commodity prices have started to reflect growth concerns and have moved away from their recent highs. The pace of normalization will, however, depend on many factors, including supply conditions and geopolitics. The USD meanwhile remains well supported, despite clear signs of overvaluation.

Key points

- Commodity price stabilizing on deteriorating global growth outlook
- Supply disruptions and geopolitics to support prices
- USD overvalued but supported by rates and risk aversion

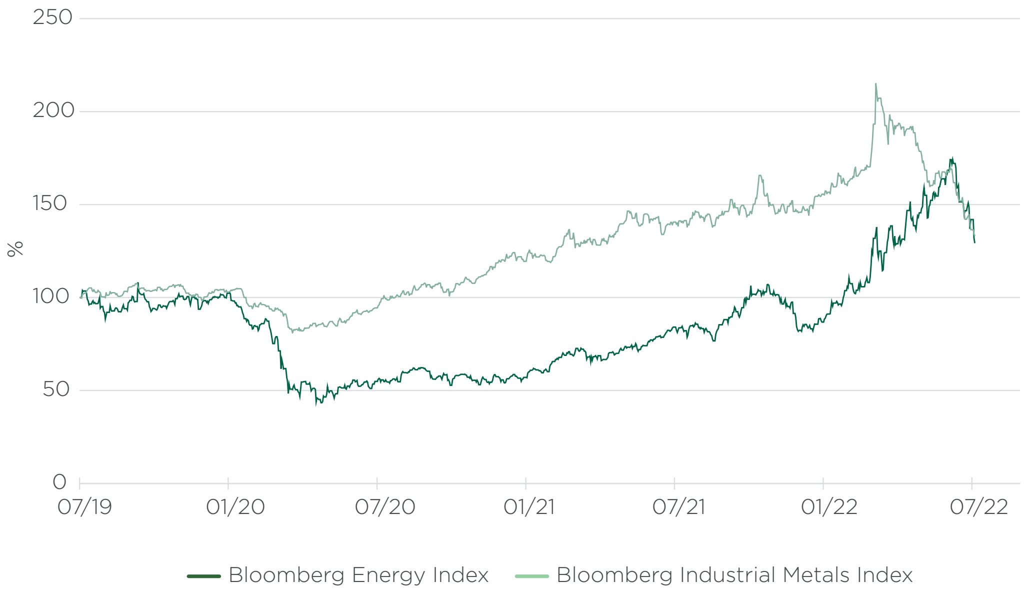
Oil prices to remain firm

Oil prices have been stabilizing amid growing signs of a global slowdown. Nevertheless, they should remain elevated as long as the war in Ukraine is ongoing. So far, energy prices have corrected from their recent highs and are now trading just above their pre-war levels. While the war has amplified upside pressures on crude — and other commodities — much of the rise had already occurred prior to the conflict owing to supply-chain tensions caused, at least in part, by the pandemic. At this stage it seems unlikely that prices will fall significantly below those levels, as years of underinvestment have degraded both up- and downstream capacity. Moreover, OPEC member countries have not really given in to demands for increased output. Prices should therefore remain firm near-term, and only additional supply combined with signs of falling demand could push them significantly lower. The metals complex presents an altogether different picture, with most metals materially down for the year as growth concerns have already impacted prices. One outlier is nickel, of which Russia is a main supplier. Going forward, however, the unfolding energy transition and the search for greater supply security will sustain robust demand in the medium and long term. Here too, geopolitical tensions should support prices, as Russia and China are crucial producers of metal ores and rare earths. On the micro side, capital expenditure will need to be considerable to compensate for years of underinvestment. While rising rates increase financing costs, industry profits have reached record levels, which should encourage capital spending.

The dollar vs. the rest

Precious metals too have come under pressure, with the exception of palladium, which has broad industrial uses. Nevertheless, gold in particular will continue to play an important role as a portfolio diversifier in a world dominated by inflation concerns and geopolitical tensions. For the moment, rising US interest rates and widespread risk aversion favor the USD at the expense of gold and, for that matter, most other currencies. However, gold should bottom out as rates stabilize and the equity markets continue to disappoint. Negative real rates will benefit gold, which can also act as a hedge against any sudden USD weakness. On a trade-weighted basis, the USD is at its highest level in almost twenty years. Strength will persist, though, in an environment where other majors remain severely challenged — including the EUR, which may fall to parity.

Commodity prices peaking



Source: Bloomberg, HBZ

KEY MARKETS

Mixed fortunes

Our key markets have experienced mixed fortunes since the beginning of the year and continue to do so, and many challenges are unlikely to disappear anytime soon. A new deal with the IMF would at least buy time for Pakistan before the next election.

Key points

- Pakistan likely to clinch new deal with IMF
- UAE on track for best growth in a decade
- Bank of England bound to lift rates further

Pakistan: waiting for the IMF

Pakistan has one quality in abundance, and that is resilience. It certainly needs it in these trying times, when few things are working in its favor. The recently restarted negotiations with the IMF were finally concluded successfully but the outlook remains challenging. The government has abandoned old policies and taken new measures to stabilize the external accounts, but not enough to remove the daily pressures which have forced the central bank to ration foreign exchange and lift the policy rate to 15%. Nevertheless, and despite a policy rate at record levels, the economy has held up remarkably well, not least thanks to the vibrant and cash-rich informal sector. Once an extended IMF program is in place, Pakistan should be in a position to meet its financing requirements for the next twelve months, including the USD 1 billion payment for an international bond maturing in December. Unfortunately, a return to stability and any respite for the currency may be short-lived, as the inevitable new elections will create new uncertainties and, potentially, new pressures on the economy and markets.

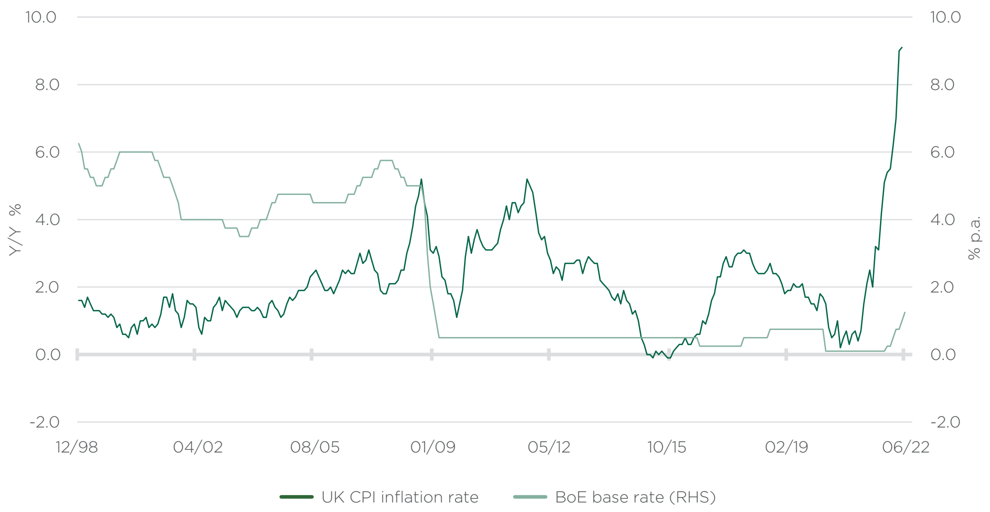
UAE: riding on oil

Sustained high oil prices are likely to lift the UAE's real GDP growth in 2022 to its highest in a decade. Meanwhile the non-oil sector has been experiencing strong positive momentum thanks to the recovery of international travel and tourism. Investment should also pick up as the year progresses, adding another pillar to this broad-based expansion. While inflation has also arrived in the Emirates, impacting consumer spending, the strong US dollar and some easing of supply-chain pressure should limit the overall price increases.

UK: self-inflicted pain

If the UK avoids a recession it will be more down to luck than good management. The country continues to suffer the consequences of its decision to leave the EU and a failure to normalize relations with its natural trading partners. Supply issues linked to the pandemic and the surge of energy prices due to the war in Ukraine have further amplified these effects. Low growth is the best outcome, but only if the Bank of England can control inflation while tightening policy only gradually.

UK: taming inflation at the risk of a recession?



Source: Bloomberg, HBZ

SPECIAL TOPIC
The end of globalization?

Globalization has faced growing criticism from various quarters ever since the Great Financial Crisis. The return of great power rivalries, the pandemic, and, most recently, the war in Ukraine pose a real threat to the functioning of the global economy. Is globalization dead? If so, what does this mean for investors?

Key points
- Globalization at the heart of global wealth creation
- A more regional order is emerging
- Investors will still be able to access the global opportunity set

The end of a singular vision

Globalization, the ever-closer integration of economic relations and production chains across nations, lies behind the greatest surge in global wealth ever recorded in human history. While this process started in the post-WWII era, the inclusion of China in the World Trade Organization (WTO) in 2001 was its ultimate achievement. Soon thereafter, however, the first cracks began to appear, most evidently during the Great Financial Crisis of 2008, which revealed the risks of this tight but fragile web connecting economies. Worse was to come with the trade tensions between the US and China. Eventually, the loss of confidence in trade multilateralism trickled into the political ecosystem to give rise to nationalistic and anti-globalist rhetoric and actions.

The road ahead

The disjointed global reaction to the Covid-19 pandemic laid bare deep-rooted distrust as well as dysfunctionalities in what were supposed to be core institutions of global governance. Russia's attack on Ukraine has been the latest blow to these arrangements, with disregard for international norms and the West's comprehensive sanctions further rupturing the global economic tissue. Enduring supply-chain tensions, surging inflation, and rising famine risk are just some of the most visible consequences. Within a matter of years, the world has gone from coordination to desynchronization revolving around two major blocks: the Atlantic world with its Asian outpost and the China-Russia axis, with many emerging economies in between. Growing risks of escalation will only contribute to a further weakening of some of the pillars of globalization. But will this spell its end? Probably not. Rather, a new framework of cooperation will emerge, more regional in nature — think reshoring and near-shoring — but still not devoid of global links. Resilience has become a preferred term for the qualities sought in business processes and economic relations. Diversified distribution networks will be key to protect what will remain in many respects a globalized world.

Investing in the emerging new order

Navigating this emerging new economic world order will no doubt be challenging for investors. However, short of a breakdown of all global norms, investors should continue to be able to access global investment opportunities across most jurisdictions, albeit at the price of more scrutiny and paperwork.

Global trade has peaked for now

Source: Bloomberg, HBZ

MARKET SUMMARY DATA

As of 11 July 2022

Equity indices	Last	-3M %	YTD %	-3Y %
Equity World USD	7,932.7	-12.0	-18.7	23.7
S&P 500	3,899.4	-11.6	-18.2	30.0
EuroStoxx 50	3,461.1	-9.9	-19.5	-1.0
FTSE 100	7,122.2	-6.5	-3.6	-5.2
SMI	10,954.4	-12.6	-14.9	10.9
Nikkei	26,812.3	0.0	-6.9	23.9
Equity EM USD	501.8	-9.0	-17.5	1.6
Sensex 30	54,220.1	-8.0	-6.9	39.7
KSE 100	41,344.0	-7.0	-7.3	22.5
Hang Seng	21,065.4	-0.7	-10.0	-25.9
Russia RTS	1,135.1	11.6	-28.9	-18.9
Brazil Bovespa	100,288.9	-14.2	-4.3	-4.6

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,515.87	-2.1	-9.5	-2.4
FTSE US Corp	2,281.25	-4.3	-14.2	-1.9
FTSE US HY	1,087.05	-6.6	-12.5	1.6
FTSE Euro gov	220.29	-4.7	-11.9	-10.6
FTSE Euro Corp	226.57	-4.9	-11.1	-8.9
FTSE EM Sov	734.00	-9.8	-21.4	-17.3
DB EM Local USD	136.72	-8.7	-15.3	-20.9

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	107.01	7.6	12.4	10.8
EUR	1.02	-7.0	-11.0	-10.1
CHF	0.98	-4.9	-6.8	1.1
GBP	1.20	-8.2	-11.6	-4.5
JPY	136.10	-8.3	-15.9	-20.7
AUD	0.68	-8.2	-6.3	-2.5
CAD	1.29	-2.7	-2.7	0.7
ZAR	16.87	-14.0	-6.1	-17.8
INR	79.25	-4.4	-6.4	-13.8
PKR	207.22	-11.1	-15.0	-24.0
Gold oz	1,742.48	-10.5	-5.0	23.2

Interest rates	3M interbank %	10Y government %
USD	2.42	3.05
EUR	-0.09	1.28
GBP	1.76	2.18
CHF	-0.75	0.88
JPY	-0.02	0.24
AUD	1.94	3.51
CAD	2.96	3.30
ZAR	5.07	11.09

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