PATIENCE IS A VIRTUE

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Dear Reader

Where do we stand after one of the most dismal years for financial markets in recent memory? Is the proverbial glass half-full or half-empty or worse? To us the glass appears half-full when looking at the combined monetary tightening effectuated by central banks across the globe, and half-empty when we consider the risks of recession in many economies, especially developed ones.

It's a similar story for the major asset classes. For fixed income, the outlook is much improved, with yield levels not seen in years and only a limited risk of even higher rates. Quality can be an issue, but investment grade is bound to deliver decent returns. For equities, though, much remains in the eye of the beholder: valuations have corrected but are not really compelling, with the exception of value stocks and some European and emerging markets. Earnings expectations, on the other hand, have remained unrealistically high for most scenarios other than a soft landing. So there's no rush to load up on equities yet.

One key risk for markets is that only too many investors expect this correction and contraction to play out like similar previous episodes, with the Fed cutting rates and governments spending. We fear that this time things may well be different; we spell out the reasons for our concerns in our Special Topic.

In markets it tends to pay to remain invested, and in relationships it pays to stay engaged. So we will continue to reach out to you, and hope that you will continue to reach out to us. We look forward to our ongoing dialog.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP

Lower inflation and lower growth

Central banks the world over tightened monetary policy at record pace in 2022 after having misread the inflation risks. By year-end, the effects of higher rates had started to depress activity, and more will follow. After the sudden end to its zero-Covid policy, China should be the outlier.

Key points

- Fed policy likely to lead to a recession in the US
- Lower energy consumption and prices will not prevent recession in Europe
- Chinese growth to rebound following end of zero-Covid policy

US Fed still leaning against the wind

After more than 400 bps of rate increases in 2022, the pace of Fed tightening is inevitably going to slow in the months ahead: Economic momentum has weakened and inflation has crested. However, nothing suggests that monetary policy will go into reverse anytime soon. Inflation remains well above the Fed's long-term target of 2%, sustained by solid wage growth and broad-based price rises in the service sector. Moreover, the Fed is acutely aware of the risk of easing too early, which could lead to a renewed surge of inflation similar to what happened in the early 1980s. Record-low unemployment and slowing but still robust job growth are complicating matters further, with both cyclical and structural forces at work: lingering effects of the post-lockdown recovery and the retirement of baby boomers respectively. Monetary policy will therefore continue to turn more restrictive for some time, mainly through a combination of still higher rates and a shrinking balance sheet. Under such conditions, a recession appears almost inevitable and, if both credit growth and business investment contract in tandem, it could be a fairly deep and protracted one. While more benign scenarios are possible, both the Fed and markets will have to contend with unusual degrees of uncertainty following more than a decade of unsustainable monetary – and fiscal – largesse.

Europe: no energy crisis for now

A clement start to the winter and significantly lower consumption have so far prevented a full-blown energy crisis in Europe. Nevertheless, inflation rates remain uncomfortably high in most EU and non-EU countries, and monetary policy will tighten further across the continent. Lower energy prices could limit the negative impact on growth, but neither the EU nor the UK will avoid a period of recession.

China: bucking the global trend

A dramatic slowdown of activity eventually forced China to abandon its zero-Covid policy late in 2022, but not before Xi Jinping had been appointed for a third and possibly open-ended term as undisputed leader of the country. More pragmatic economic policy should allow a material rebound in Chinese growth once the country returns from the traditional Lunar New Year holidays. This could also provide much-needed economic oxygen to many economies closely linked with the Chinese cycle.

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

	2022E	2023F	2024F	Short-term trend
United States	2.0	0.5	1.2	↘
Eurozone	3.3	0.0	1.3	↘
Germany	1.8	-0.5	1.3	↘
United Kingdom	4.2	-0.9	0.9	↘
Japan	1.3	1.3	1.1	→
China	2.8	5.1	5.0	↗
India	6.9	6.0	6.4	↘
Russia	-3.0	-2.9	1.6	↘
Brazil	3.0	0.8	1.8	↘

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

	2022E	2023F	2024F	Short-term trend
United States	8.0	3.8	2.5	↘
Eurozone	8.4	5.9	2.3	↘
Germany	8.7	6.7	2.9	↘
United Kingdom	9.1	7.1	2.5	→
Japan	2.5	1.9	1.1	→
China	2.0	2.3	2.2	↗
India	6.7	5.1	4.7	↘
Russia	13.8	5.8	4.4	↘
Brazil	9.3	4.9	4.4	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

Patience is a virtue

With inflation having peaked for now, many market participants are already avidly anticipating an end to the Fed's tightening campaign. Not so fast, we would caution. Investors are well advised to take the Fed seriously and remain patient.

Key points

- The Fed is not done yet
- No need to rush into (equity) markets
- Stay tuned to monetary policy and political events

Don’t fight the Fed

The Fed got its inflation call horribly wrong in 2021, but since then has scrambled to re-establish its inflation-fighting credentials. This, and ample references to the 1970s and early 1980s, a traumatic period in the Fed’s annals, suggest to us that the US central bank is determined to drive out inflation even at the risk of a serious recession. Economic data will therefore need to worsen further before the Fed halts its tightening campaign. And it will take even longer for it to go into reverse. In turn, corporate earnings will come under pressure and weigh on asset valuations. For this reason alone, we recommend that investors bide their time and limit their exposure to equities, favoring dividend strategies and value plays. At the same time, the normalization of interest rates is by now well advanced, and this has created value across many fixed-income sectors and thus opportunities to deploy capital elsewhere. After a dismal year, at least the fixed-income bucket of global multi-asset portfolios is poised for better returns, with a running yield of 4% or more. Volatility has moderated as the worst signs of panic have abated, but it still provides a sound basis for building structures with asymmetrical pay-offs, a key feature when it comes to protecting capital.

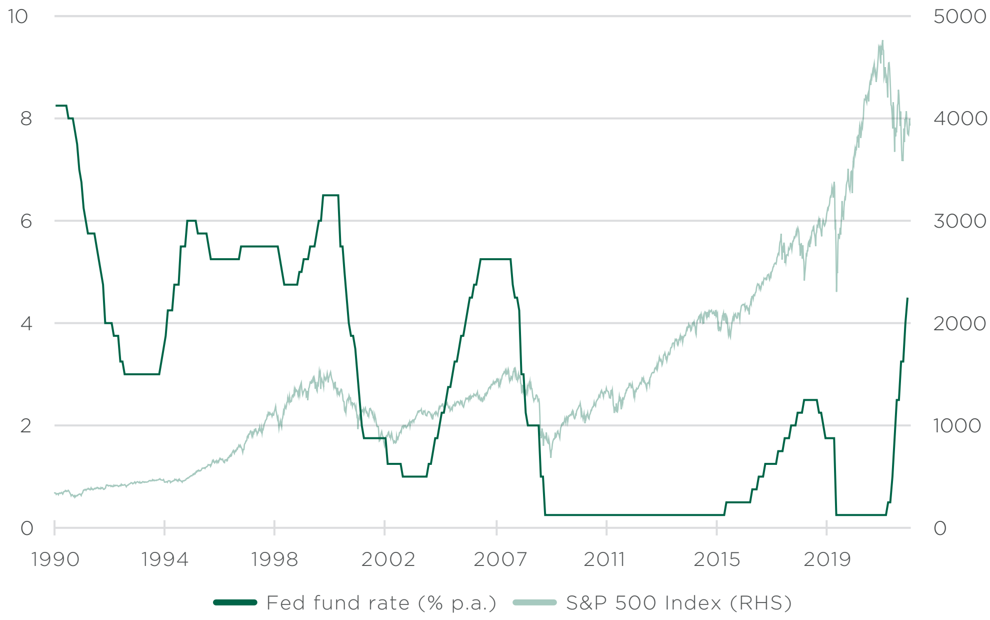
Our positioning

In light of the above, we remain underweight in equities, with a bias to diversifying further away from the US. Fixed income looks decidedly more attractive than in a very long time. We have largely eliminated our underweight and have also lengthened the duration, as the upside to yields appears limited. We also maintain our alternative allocation, at the moment focused on income generation and gold as a USD hedge.

What to watch

Whether markets like it or not, central banks, and in particular the US Fed, will continue to set the tone for the foreseeable future. Any material change in their rhetoric would, of course, catch our attention and warrant a thorough review of our current stance. In addition, China’s economic development may surprise positively and improve the overall macro backdrop. Finally, with the deadline for lifting the US debt ceiling approaching fast, for example, political events could again upend financial markets. Accidents have happened before, and markets would not take such a development kindly.

More downside for S&P as Fed continues to tighten



Source: Bloomberg, HBZ

FIXED INCOME

Quality to outperform

Many fixed-income sectors offer yields not seen in years. We continue to prefer investment-grade bonds while being very selective on high-beta exposure. On the emerging markets (EM) side we remain cautious, favoring EM corporates with strong fundamentals over sovereigns.

Key points

- Investment grade the place to be
- Stay clear of corporate high yield
- Basket of EM oil exporters and selective on HY

Investment grade is the place to be

High-quality bonds currently offer yields that have not been available in a very long time. We see the best value in the short-dated segment, but are cognizant of the opportunity to start extending duration, as we see only limited upside to rates. We prefer corporates that are systemically important to a country. The fundamentals of these bonds are solid, and we only expect a limited spread widening in a slowdown or recession. Among the current wave of new issues, many bonds offer a pick-up in yield versus the existing curve.

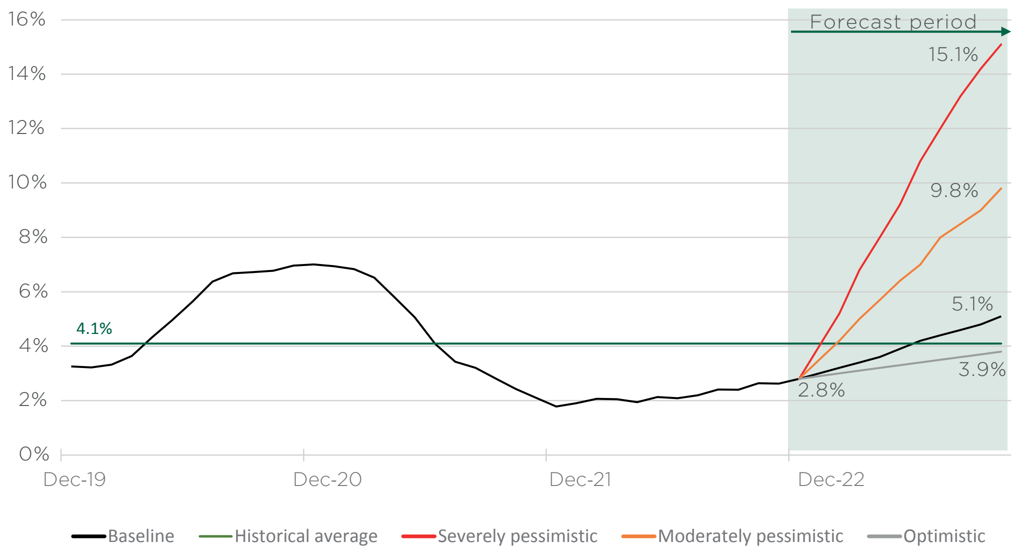
Not yet time for corporate high yield

According to the rating agency Moody's, the default rate for speculative-grade corporates increased to 2.8% in December from 2.6% in November 2022. Amid deteriorating macro and financial conditions, we expect the default rates to rise more significantly in 2023. Moody's predicts that the default rate could rise to 5.1% in 2023 in its baseline scenario, and much more under a pessimistic scenario. We believe spreads on high-yield bonds (at 475 bps for the Bloomberg global high yield index) do not reflect the true global risk picture. In a recessionary environment, spreads could widen significantly – historically they reached 800–1000 bps – and therefore we maintain our underweight in high yield.

EM: the quest for quality yields

Entering 2023, EM spreads have been range-bound, with the main new market driver being China's faster-than-expected re-opening from pandemic restrictions, which is a net positive for risk markets. While this does not impact our view of material US recession risks, stronger China growth expectations are supportive of EM valuations in the near term. Sovereign spreads have not moved in line with the significant relative changes in commodities prices. At current oil levels, the potential upside for net oil exporters seems limited, while several net importers seem cheap. Having said that, we prefer high-grade MENA countries given the solid fundamentals and fiscal strength (we expect several rating upgrades). With many global uncertainties remaining and fragile macro dynamics, we favor quality, which we believe should outperform. Within EM investment-grade and high-yield, we continue to expect fundamentals to drive the relative spread performance.

Global high-yield default rates expected to rise



Source: Moody's, HBZ

EQUITIES
Valuations not compelling yet

Despite an impressive rally in Q4, equities will continue to face an uphill struggle. While valuations have adjusted, not all bad news has been fully discounted yet, with earnings being the main risk. We therefore prefer value stocks and Europe and emerging markets over the US.

Key points

- Material downside risk to earnings
- Valuations not yet compelling
- Preference for value stocks and EM

Late year rally

Monetary tightening continued throughout the final quarter of 2022 as most central banks remained – and remain – committed to fighting inflation. Nevertheless, as headline inflation slowed on the back of lower energy and core goods prices, global equities staged a powerful rally, recouping in the process almost a third of the losses suffered since the beginning of the year. Elevated valuations finally started to adjust once investors realized that interest rates were bound to rise substantially. However, while equity markets suffered the worst drawdown since 2008, earnings expectations fell only modestly. Although only moderate, this level of earnings revisions represents a major market risk in the event that corporate results disappoint. From this perspective, the US market appears more vulnerable, with valuations more attractive in Europe and emerging markets (EM).

Value to trump growth – opportunities in EM

After more than ten years of being dominated by growth stocks, value stocks have finally started to catch up, narrowing what is arguably still a wide performance gap. Value names are expected to continue outperforming, as profit margins will remain under pressure in an environment of high interest rates and wage growth. In terms of sectors, energy should benefit, as tight capacity constraints will support prices for the foreseeable future. However, healthcare, a defensive growth sector, should also outperform in the late cycle, as consumers tend to prioritize medical care over discretionary spending. Regionally, emerging markets offer an entry point following the abrupt end of most pandemic-related restrictions in China – which has also introduced new policies designed to ease some major headwinds (e.g., support for the much-battered real estate sector and fewer restrictions on technology firms). Beyond the local market, exporters and commodity producers with significant exposure to China all stand to benefit from the reopening. China's attempt to transition from an export-oriented to a consumption-led economy will likely also provide a tailwind to ASEAN countries thanks to their geographic proximity. India's annual GDP growth rates have approached those seen in China during the early 2000s, but valuations already reflect the improved growth performance. Latin America offers some opportunities given that some countries (such as Brazil) will be among the first to ease their monetary policies. Risks there remain mainly political.

COMMODITIES AND FX

Whither the US dollar?

Lower market expectations of Fed rates ended the US dollar's rally in late 2022. Nevertheless, the USD remains richly valued, and several factors could translate into more downside. Gold stands to continue to benefit, while lean inventories will support crude oil.

Key points

- USD weakness limited for now
- Gold supported by weaker USD
- Oil price to remain firm

USD: after the peak

The trade-weighted US dollar has declined by more than 10% since its peak in late September last year. The correction, largely driven by reduced expectations of US Federal Reserve rate hikes, had a positive impact on global financial markets. The weaker USD thus contributed to a rally in emerging-market assets, although other developments were also at play, such as the anticipation of a reopening of the Chinese economy following the 20th Party Congress. Whether the sell-off will turn into a rout or will remain limited will depend on many factors beyond the narrow scope of US monetary policy, namely the relative growth performances of major economies, relative monetary trends, and valuations – the USD remains fairly expensive against most majors. From this perspective, more limited downside for eurozone growth combined with a relatively hawkish ECB could provide another push for the euro. Similarly, a more restrictive Bank of Japan could boost the yen further. However, other events may also have reduced the attractiveness of the USD, not least the seizure of Russian foreign reserve assets by the US and many European partners, which has prompted concerns among many central bankers about the safety of their own currency reserves.

Of gold and oil

Such concerns help explain the much-improved fortunes of gold, which has rallied recently. This rally did not immediately follow the peak in the US dollar. Softer US economic data and reduced Fed expectations also played a role, as USD weakness often – but not always – translates into gold strength given the simple fact that gold is priced in the US currency. But the desire for diversification among private and official investors was most certainly another contributing factor. Meanwhile, the global oil market experienced the most remarkable year, with the price for the front month rallying more than 50% until June, only to give up much of its gains by year-end. In the short term, weaker demand is creating some downside risks, but from Q2 onward the market should tighten as Chinese consumption rebounds amid low stockpiles. Reduced Russian output and exports as a result of far-reaching Western sanctions could also impact the market balance. In light of the eroding spare capacity, producers will have to invest more in oil production to avoid potential supply disruptions. As in 2022, Russia and China will again represent the main sources of price volatility.

Reversal of fortunes: weaker USD, soaring gold (indexed as of 23/7/2023)

Source: Bloomberg, HBZ

KEY MARKETS

Cash reigns supreme

Despite signs of improvement and a gradual re-emergence of optimism, Pakistan and the UK have a myriad of challenges to address as they face issues brewed both at home and abroad. The UAE continues to be an enviable exception.

Key points

- Dwindling foreign reserves a key challenge for Pakistan
- Continuing tailwinds for the UAE
- UK not out of the woods

Pakistan: cracks in the economy

With no help from the highly polarized political environment or the global context, the Pakistani economy remains in an unenviable state. Policymakers' lack of decisiveness in pursuing unpopular reforms has led to delays in essential fund disbursements from the IMF. With the forex reserves held by the State Bank of Pakistan sliding to a nine-year low, the cracks have begun to appear. The shortage of funds is affecting economic activity, as the banks' ability to open letters of credit for the industrial sector is impaired. This has led to sporadic shutdowns in the manufacturing sector, and has the potential to affect imports of essentials such as food and oil. While the country's leadership has mobilized efforts to secure funding by means of bilateral deposit rollovers, additional deposits from friendly countries, and commitments of as much as USD 10.7 billion for reconstruction from international agencies, delays in disbursements threaten to further exacerbate the current crisis.

UAE: the perfect mix

The past year marked a high for the Gulf state, as it benefited from the oil boom, resurging tourism, and capital inflows in the wake of the Russian war on Ukraine. According to the IMF outlook, the UAE is projected to grow by 4.2% in 2023. The country has built positive momentum on the non-oil trade as well. In addition to this, the property market in Dubai in particular experienced a surge as the region emerged as a haven for Russian capital, with real estate transaction volumes reaching a new all-time high. The country continues to focus on building its non-oil economy. The UAE has also signed trade agreements with India, Indonesia, and Israel to facilitate bilateral trade. Thanks to the surplus from oil prices and a positive ecosystem for the UAE economy, it is on track to achieve the goals of Vision 2031.

UK: challenges continue

The Bank of England has managed to restore much-needed calm to the bond market since last September's Gilt scare. This has helped contain any potential systemic risk as well as rebuild fiscal credibility. Surging mortgage rates have also played their part in slowing house prices. That said, the fact that the economy continues to be impacted by the energy price shock and widespread protests by various labor organizations will weigh on economic activity in the UK.

The UK economy has yet to reach pre-pandemic levels

Source: ONS, HBZ

SPECIAL TOPIC
Why this time is different

Financial markets have just seen the end of one of the worst years in living memory. However, a brisk recovery such as in 2009 may remain elusive, since the tools needed for such an outcome are no longer available. Moreover, priorities, economic or otherwise, are no longer aligned across all key economies.

Key points

- Don’t count on the Fed put anymore
- Governments have little fiscal headroom
- Globalization has uncertain prospects

Monetary policy: from tailwind to headwind

Since the onset of the so-called Great Moderation in the 1990s, monetary policy has not only been used to manage business cycles more actively, but has also played a powerful role in reviving financial markets once the economy has troughed. Obviously the most powerful boosts were delivered following the Great Financial Crisis in 2009 and then again at the peak of the Covid pandemic. However, these massive monetary interventions have also blunted the impact of future actions, and by now have arguably exhausted the ability of central banks to revive markets without undermining their own credibility. That is why the Fed is prioritizing the fight against inflation and why even the Bank of Japan has started thinking about policy normalization. The uncomfortable truth is that markets are wrong to assume that the Fed and its peers will invariably rush to their rescue. In other words, the Fed put is no more.

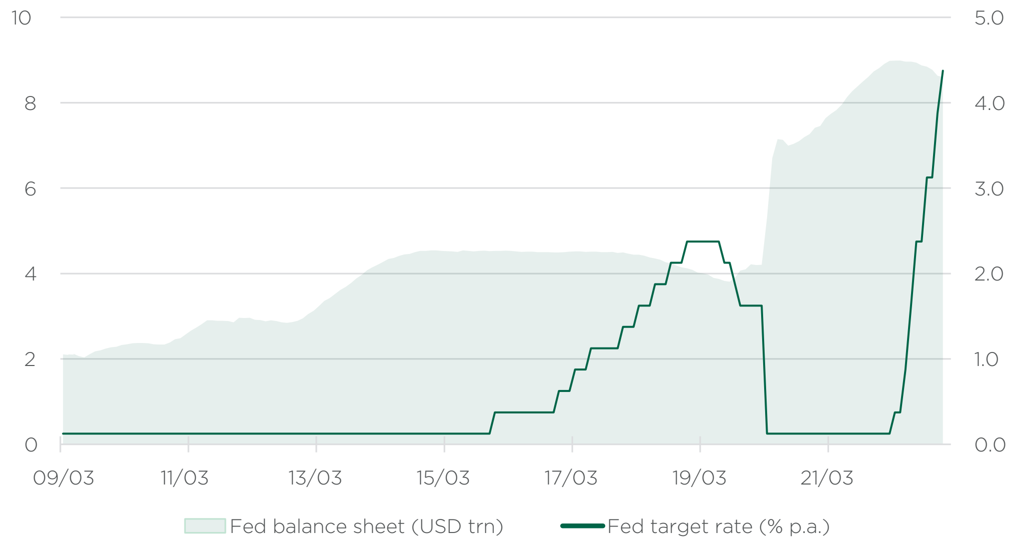
Limited fiscal headroom

Central banks were instrumental in reviving markets and the global economy both in 2009 and 2020. But governments also did much of the heavy lifting, especially during the pandemic, to such an extent that today most governments in the world – with the possible exception of some oil and gas-producing countries – have reached the limits of their ability to stimulate their economies by fiscal means. Bond markets have been eyeing with increasing concern the rising debt-to-GDP ratios of many sovereign borrowers, and made short shrift of the debt-fueled growth strategy promoted by the short-lived Truss government in the UK. Going forward, governments will have to be much more mindful of how they employ their limited fiscal headroom, and blanket solutions such as those adopted during the pandemic will not pass muster with markets anymore.

Globalization in reverse

The by now open rivalry between the US and China, as well as Russia's reckless invasion of Ukraine, have greatly damaged the future prospects of globalization, which had already slowed following the 2009 recession. As supply chains acquire a new strategic dimension, governments will willingly accept higher costs for increased security. Moreover, the economic dividends of integrating hitherto untapped markets have dramatically declined, not least due to rapidly deteriorating demographics in many target countries. All of this will curtail profit margins and ultimately returns on investments.

No room for easier monetary policy after years of accommodation



Source: Bloomberg, HBZ

MARKET SUMMARY DATA

As of 23 January 2023

Equity indices	Last	-3M %	YTD %	-3Y %
Equity World USD	8,366.4	11.0	4.8	18.6
S&P 500	3,972.6	5.9	3.5	19.5
EuroStoxx 50	4,133.4	18.9	9.0	10.6
FTSE 100	7,797.4	11.9	4.6	3.9
SMI	11,341.3	8.9	5.7	4.9
Nikkei	26,906.0	-0.3	3.1	12.9
Equity EM USD	526.8	20.3	8.4	-0.8
Sensex 30	60,941.7	1.9	0.2	46.4
KSE 100	38,443.6	-9.2	-4.9	-9.8
Hang Seng	22,044.7	36.0	11.4	-21.0
Russia RTS	1,002.8	-4.6	3.3	-37.2
Brazil Bovespa	112,040.6	-6.6	2.1	-6.3

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,505.50	5.4	2.6	-6.3
FTSE US Corp	2,323.44	10.2	3.7	-6.2
FTSE US HY	1,145.37	7.0	3.6	2.8
FTSE Euro gov	210.74	3.2	3.3	-15.7
FTSE Euro Corp	224.38	5.0	2.4	-11.0
FTSE EM Sov	793.44	17.0	3.8	-13.9
DB EM Local USD	150.41	13.2	4.9	-16.0

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	102.01	-9.0	-1.5	4.3
EUR	1.09	10.1	1.5	-1.6
CHF	0.92	8.8	0.4	5.2
GBP	1.24	9.7	2.3	-5.7
JPY	129.60	14.4	0.7	-16.0
AUD	0.70	11.0	2.7	2.3
CAD	1.34	2.6	1.4	-1.7
ZAR	17.13	7.4	-0.7	-16.0
INR	81.13	1.6	1.6	-12.4
PKR	229.88	-4.6	-1.9	-33.1
Gold oz	1,926.08	16.2	5.6	22.9

Interest rates	3M interbank %	10Y government %
USD	4.82	3.50
EUR	2.42	2.19
GBP	4.06	3.36
CHF	1.03	1.22
JPY	-0.03	0.39
AUD	3.25	3.45
CAD	5.07	2.86
ZAR	7.33	10.42

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