FACING CROSSWINDS AND HEADWINDS

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HABIB BANK AG ZURICH
PRIVATE BANK
SWITZERLAND

Authors

Dr. David Wartenweiler, Chief Investment Officer
(d.wartenweiler@habibbank.com)

Stefan Wüthrich, Senior Portfolio Manager, Fixed Income
(s.wuethrich@habibbank.com)

Karim Sebti, Senior Investment Advisor, Equities, FX and Commodities
(k.sebti@habibbank.com)

Ahmed Ali Raza, Investment Analyst, Special Topic
(ahmedali.raza@habibbank.com)

Group Wealth Management

Salman Haider, Chief Executive Officer
(salman.haider@habibbank.com)

Contact for Switzerland

Leonardo Castillo, Head of Private Bank Switzerland
(l.castillo@habibbank.com)

Editing

Michael Craig Communications
(communications@active.ch)

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Dear Reader
Already at the start of the year we knew that we would be facing challenging market conditions. Now we're not just confronted with high inflation, rising rates and elevated commodity prices. We're also having to contend with the fall-out from the largest war on European soil since World War II, which has reverberated across the globe.

This new market context has two major implications: an inevitable slowdown in global growth and the repricing of asset-class specific risks to account for this, as well as higher discount rates and increased uncertainty about the medium-term outlook. For portfolios this means lower expected returns until the economic and market environment stabilizes over and above the drawdowns already suffered. There is a silver lining, though: rising interest rates allow reinvestment at more attractive levels, and equity market weakness is an opportunity to buy compelling businesses at lower prices. Provided they are well diversified, portfolios will weather this latest storm as well.

Rising yields and high commodity prices represent a particular challenge for highly indebted emerging-market (EM) nations. In our Special Topic, we examine the current risks for EM bonds and discuss how investors should approach this asset class.

We hope you will enjoy reading the latest issue of our Investment Quarterly, and look forward to hearing your thoughts and questions.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP
Growth risks on the increase

The Russian attack on Ukraine has delivered a powerful blow to a world economy which has still not fully emerged from the pandemic. Will the monetary tightening to fight surging prices only slow growth or lead some economies into recession?

Key points

- US Fed to fight inflation but not necessarily push economy into recession
- European growth to slow materially on energy price surge
- China to take measures to end current soft patch

US fights to keep inflation at bay

When the Fed recognized in late 2021 that post-pandemic price pressures could be more sustained, it prepared for a measured removal of monetary stimulus. The war in Ukraine and the ensuing surge in energy and other commodity prices forced it to move its timetable for countering inflation forward. A tight employment market and initial steps in a partial de-globalization, both inflationary in nature, are further complicating the fight for price stability. So far, however, underlying activity has remained solid, and leading indicators point to a sustained expansion into the second half of the year, albeit at a moderate pace. A recession remains highly unlikely for 2022, and is not a foregone conclusion for 2023. If rate increases stay within current market expectations of a terminal rate of around 3.0%, a soft landing remains a possibility. But the final outcome will depend on many factors outside the Fed's control. The current inflationary episode is supply-driven, after all, the result of pandemic-related dislocations and a war which has upended commodity markets. No amount of Fed tightening will fix global supply chains or deliver more crude oil to the market.

Europe shocked by Russia's war

The war in Ukraine laid bare the continent's excessive dependence on energy supplies from Russia. Even though the EU and other European countries responded with unusual speed and unity to the aggression, measures to cut this link will materially slow the incipient recovery and could push some economies to the brink of recession and beyond. In addition, the ECB may well have to tighten policy already this summer to maintain its inflation-fighting credentials, further adding to the economic headwinds.

China's elusive quest for stability

While most of the world has learned to live with Covid-19 and its variants, China is still trying to eradicate the virus, with dramatic effects on its economy. Business activity was already under pressure going into the year owing to actions taken to deleverage the property sector. Some measures to support growth were introduced, but so far they have been no match for waves of rolling lockdowns to contain the virus. Eventually more stimulus will be forthcoming, providing uplift to Chinese growth, and in the process generating some welcome tailwinds for neighboring Asia and the rest of the world.

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

	2021E	2022F	2023F	Short-term trend
United States	5.7	3.2	2.1	↗
Eurozone	5.2	2.8	2.4	→
Germany	2.8	2.2	2.8	→
United Kingdom	7.2	3.8	1.7	↘
Japan	1.7	2.2	1.8	↗
China	8.1	5.0	5.2	→
India	8.9	7.5	6.1	↗
Russia	4.2	-10.0	-1.5	↘
Brazil	4.6	0.5	1.6	↘

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

	2021E	2022F	2023F	Short-term trend
United States	4.7	6.9	3.0	→
Eurozone	2.6	6.5	2.3	↗
Germany	3.2	6.1	2.6	↗
United Kingdom	2.6	7.0	3.3	↗
Japan	-0.2	1.5	0.8	↗
China	0.9	2.2	2.2	↗
India	5.4	5.6	4.8	→
Russia	6.7	20.0	11.5	↗
Brazil	8.3	8.4	4.6	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

And now for the hard part

Investors are currently faced with a toxic mix of high inflation, accelerated monetary tightening, and slowing growth. In these conditions the traditional asset mix has fared poorly. Nevertheless, diversification remains central to dealing with these multiple crosswinds.

Key points

- Diversification still matters
- Underweight equities as growth is slowing
- Watch the Fed and China

Inflation, stagflation, recession?

Since the beginning of the year, a rare confluence of events has given rise to material drawdowns across most asset classes. In particular, the long-overdue normalization of market and policy rates has robbed quality fixed-income assets such as Treasuries and investment-grade bonds of their more defensive characteristics that would enable them to counterbalance the widespread weakness of equity markets. There have been (and still are) few places to hide, but some of these developments will invariably abate. Eventually yields will peak and government bonds will again be able to play an important role in the management of portfolio risks. To some extent, commodities — be it precious metals, energy or industrial raw materials — have played this role since late 2021, but their impressive surge has already capped the upside. At any rate, the inherent volatility of this asset class will always limit its usefulness in a long-term allocation. Stagflation due to a commodity price shock is unlikely to last, as demand destruction will eventually set in. Other real assets, especially equities, have significantly longer cycles and are therefore better suited to portfolio construction. In times of high inflation and rates, high-dividend stocks offer a cash-yielding alternative, while value stocks provide some cover in markets worried about excessive valuations. More generally, equities continue to provide an appreciable hedge against inflation. Should the current slowdown give way to a recession after all, equities and commodities will suffer, but quality bonds should once again be able to play their diversifying role.

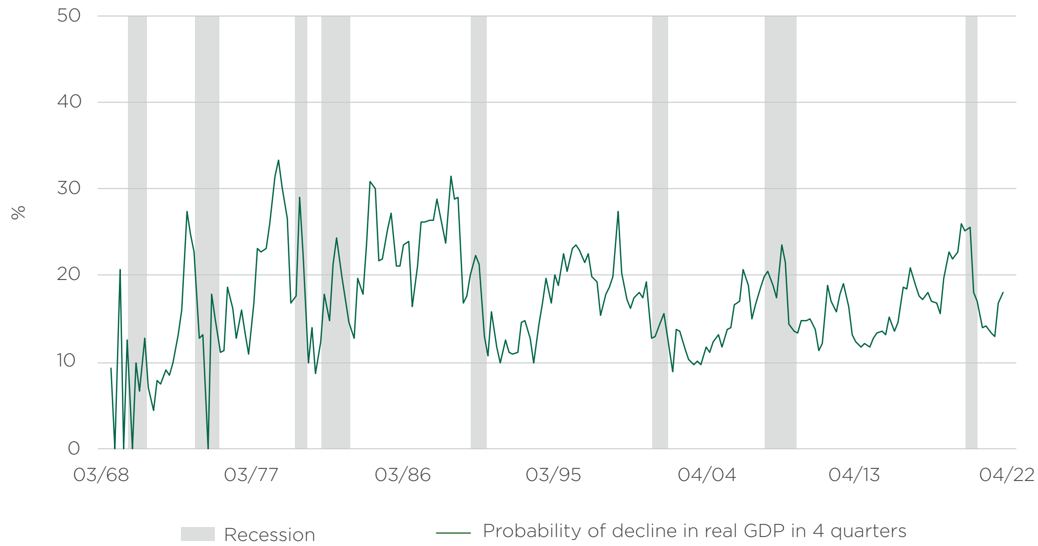
Our positioning

Faced with slowing growth and persistently high valuations, we have moved our equity allocation to moderately underweight. Cash is of limited use in times of high inflation, and we favor equity-linked income strategies to reduce the loss of purchasing power. In fixed income we are keeping duration short, but intend to extend it once rates have peaked.

What to watch

The Fed may still be the only game in town. However, markets have been notoriously poor predictors of Fed policy, and the current aggressive forecasts could be tested once inflation starts to roll over. China's struggle with Covid-19 and growth is another important flash point to watch, as are events in and around Russia's war in Ukraine.

The Anxious Index: Recession risk rising



Source: Federal Reserve Bank of Philadelphia, HBZ

FIXED INCOME

Approaching peak interest rates

Treasury yields moved higher as the Fed started to tighten policy, but given the new uncertainties beyond 2022 the upside has become more limited. Short duration remains appropriate for the time being, but the next move should be to lengthen duration again.

Key points

- The time will come to increase investment-grade bond exposure
- Longer-dated US Treasuries have good hedging properties
- Corporates favored in the EM space

Time to add Treasuries?

Investment-grade bonds — both government and corporates — have a long duration as an asset class, and their performance has suffered accordingly since the beginning of the year. Short term they are likely to continue performing poorly amid expectations of higher US policy rates. However, upside pressures on US yields should soon subside, presenting a good opportunity to lengthen the duration again, with investment grade corporate bonds offering an appealing risk-return profile. Shorter-dated US Treasury notes are already providing reasonable yield for a highly liquid and risk-free asset. In the meantime, floating-rate notes represent an alternative, although their supply is limited. Once interest rates have peaked, investors should consider adding longer-dated US Treasuries to their portfolios. They will receive a decent return, and additionally will benefit from the instrument's inherent hedging qualities in an environment of slowing economic growth.

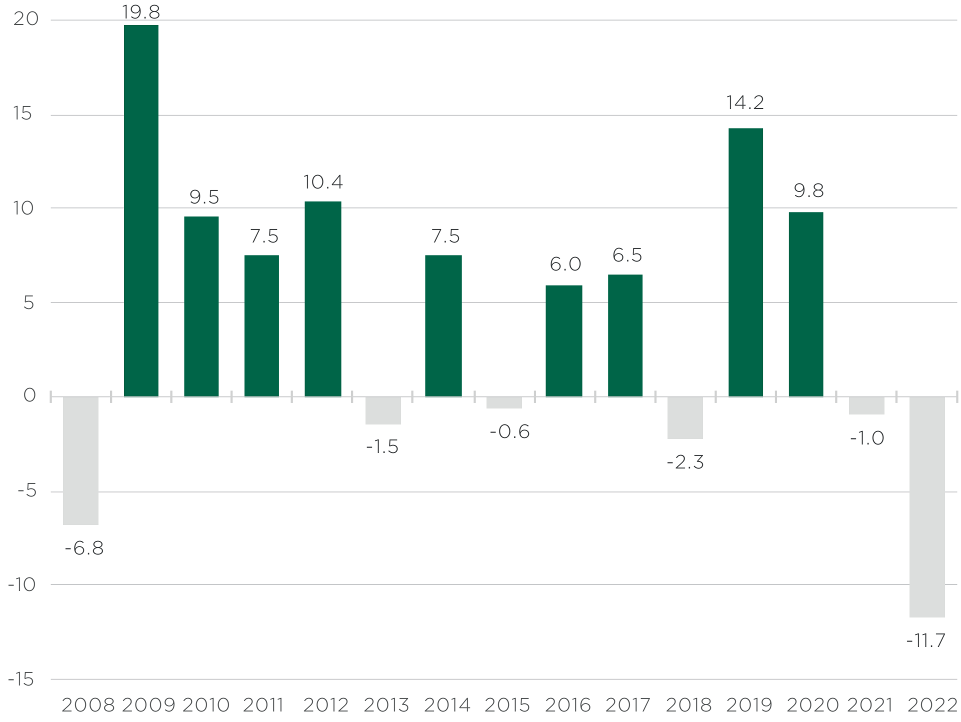
Cautious on EM sovereign bonds…

Emerging-market (EM) bonds sold off massively at the start of Russia's war against Ukraine. Since then the asset class has recovered somewhat from the drawdown, but with its high duration remains under pressure owing to higher yields and wider credit spreads. Selectivity is the name of the game in this space. Many issuers, especially lower quality ones, will remain under pressure because of higher commodity prices and rampant inflation. Sri Lanka's payment moratorium may well be just the beginning of worse to come for weak EM sovereigns. Investors should focus on solid names and invest in a well-diversified portfolio, which is always of paramount importance, but even more so in the current market context.

…but value in EM corporates

Compared with their sovereign peers, EM corporates look decidedly attractive thanks to their lower duration and often better fundamental qualities. EM corporates also suffered drawdowns, but have since started to recover and will probably continue to do so. EM commodity producers in particular stand to benefit from high commodity prices and the desire of many developed economies to reduce their reliance on Russian supplies.

Investment-grade corporate bonds not immune to drawdowns
(total return in %)



Source: Bloomberg, HBZ

EQUITIES

Regime change

With higher global interest rates, equities face a different market regime. Despite the painful correction since the beginning of the year, the upside is limited and, at least, in the current market context, any outperformance will be driven by factors such as value and yield.

Key points

- Supply chain tensions remain elevated
- Inflation and higher rates weigh on growth
- Earnings to support equities

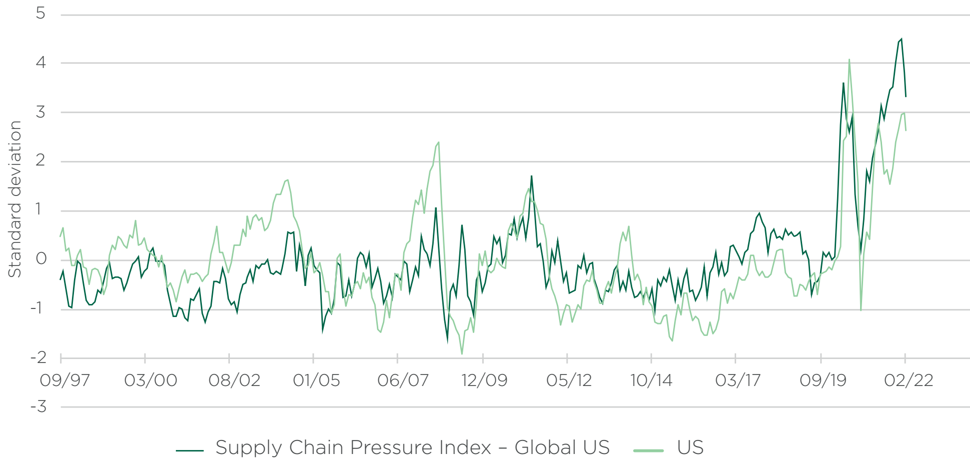
Multiple headwinds

Ever since interest rates started to rise halfway through last year, a more defensive positioning in equities has been warranted. There are no indications that this will change anytime soon. Global equities have lost more than 16% to date this year and could lose even more if a recession were to develop. So far, however, and despite multiple shocks, fundamentals have held up, and make such an outcome unlikely over the coming six to twelve months. Sustained high inflation would no doubt be devastating for equity markets, but for the time being supply factors remain the main drivers behind higher prices and should eventually abate. Some of the current headwinds are originating from China. They are due to the country's "zero-Covid policy," which is depressing economic activity domestically and disrupting supply chains globally. Despite much hawkish talk, central banks will be reluctant to raise rates too sharply in such an environment. Finally, the much feared inversion of the yield curve, historically often the harbinger of recession, has not yet occurred. What could get worse? Additional sanctions on Russian energy would harm global growth further, and European growth in particular, or inflation expectations could become unanchored. Such developments would worsen supply chain problems and increase inflation. Equities would not do well in the ensuing stagflationary environment.

More defensive but still constructive

For the time being, low real yields, less extended valuations, and reasonable earnings growth continue to support equities. Tactically, current conditions favor quality large caps in developed markets with a value tilt and in sectors such as consumer staples, healthcare, and energy. Regionally we continue to favor the US, which is less affected by the war in Ukraine than Europe and largely self-sufficient when it comes to commodities. A slowing global economy and reduced liquidity will also affect the US less than emerging markets, which are a levered play on global growth. Moreover, China has come to dominate the EM equity space, and unless substantial stimulus is forthcoming the local stock market will continue to languish and, with it, most of the EM universe. Some degree of de-globalization is almost inevitable in a world where great power rivalries have resurfaced. Countries will want to regain control over supplies, and in turn companies will start to re-shore production and increase their inventories. Invariably costs will increase, and companies with high profit margins and pricing power will be better positioned to deal with the consequences.

Supply presssure may have peaked



Source: Bloomberg (Federal Reserve Bank of New York), HBZ

COMMODITIES AND FX

Ample support

Commodities markets are unlikely to normalize as long as war is raging in Ukraine. Current supply/demand balances favor firm prices, with the energy transition adding structural upside to many metals. In currencies, there is no end in sight to the strength of the USD.

Key points

- Energy supply disrupted by war in Ukraine
- Fundamental demand for many metals here to stay
- USD and gold safe-haven assets

Suppliers in charge

Commodities have continued to deliver strong performances since the beginning of the year, with energy up 65%, grains up 35%, and metals up 5%. However, the entire complex remains highly volatile, with additional sanctions on Russian fossil fuels only the most obvious upside risk. After all, Russia is the world's second-largest producer of natural gas and the world's third-largest producer of oil. Alternative supplies will take time to source, develop, and deliver, all factors which will sustain high prices. The war in Ukraine has also focused the minds of many Western leaders on the need to reduce dependency on fossil fuels. Efforts in this direction will accelerate the transition to clean energy resources; these, however, are heavily dependent on a number of metals such as copper, nickel, and lithium. Only relatively high and stable prices for these raw materials will sustain the investments in extraction and refining that will be needed to meet the growing demand. Wheat is another commodity directly impacted by the war, as Russia and Ukraine together account for 30% of world exports. The Middle East in particular relies heavily on wheat imports from the two warring nations. Limited supplies and higher prices threaten to have serious social and political consequences if sustained. This dire situation is further exacerbated by persistent problems in global supply and logistics chains, and the ongoing pandemic-related rolling lockdowns in China certainly aren't helping to alleviate these tensions. As a result of multiple production and distribution issues, commodity prices are likely to remain elevated for the foreseeable future.

US dollar and gold as safe haven assets

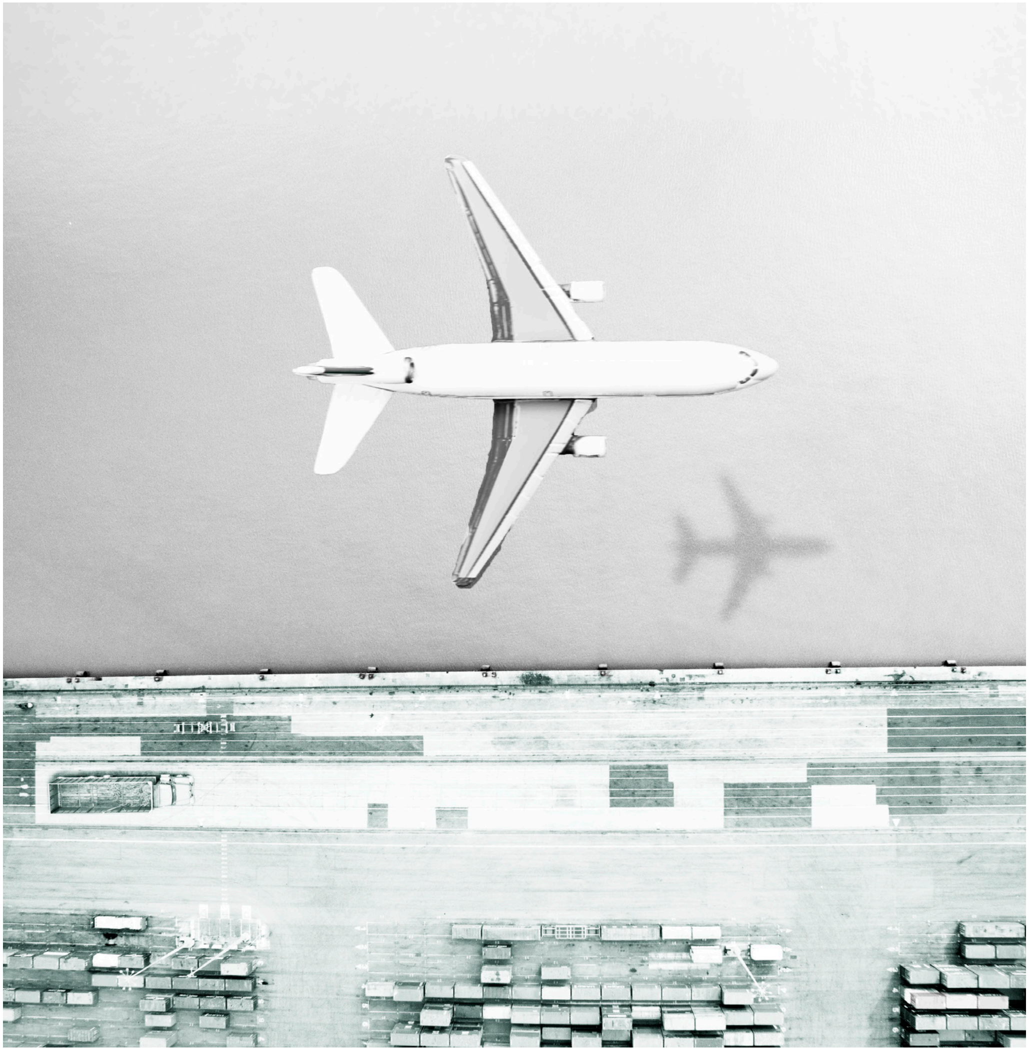
Gold has fallen to the USD 1,800/oz. level range after a high of USD 2,050/oz. in March. The metal still serves as a good diversifier in a multi-asset portfolio, but as real rates approach positive territory, renewed upside is limited. At the same time, the high level of uncertainty will sustain safe-haven flows, while the freezing of Russia's foreign-currency reserve assets will most certainly revive interest among central banks. The USD rally meanwhile looks extended, but amid current geopolitical tensions the currency will maintain its appeal. Other major currencies cannot provide similar qualities: The EUR is too exposed to an escalation of the war in Ukraine, and the JPY is years away from the kind of monetary policy normalization that has done so much to lift the USD.

Rising US real rates may cap upside for gold (% p.a.)

Source: Bloomberg, HBZ

KEY MARKETS
Not all are created equal

Higher commodity prices can be both a curse and a boon, as developments in our key markets show: Pakistan has been pushed to the brink of another balance-of-payments crisis, the UK risks a period of stagflation, while oil-exporting UAE is likely to enjoy another year of robust growth.



Key points
- Pakistan's external accounts at risk
- UAE to benefit from higher oil price and revival of tourism
- Bank of England to tread carefully to protect slowing economy

Pakistan: facing another crisis

At the beginning of the year Pakistan was already facing a perfect storm of surging commodity prices and sustained inflationary pressures. With Russia's invasion of Ukraine the situation deteriorated further amid an escalating crisis between the government and the opposition. In this context, the State Bank of Pakistan was initially reluctant to continue tightening policy, but eventually responded with a whopping 250-bps rate increase in an attempt to reestablish a semblance of stable prices and external accounts. A change of government then allowed a reengagement with the IMF, whose support had been put in jeopardy by measures adopted under the previous prime minister. The period of political instability had also taken its toll on the currency, which at some point had lost some 10% since the beginning of the year against the US dollar. Further action to stabilize the country's fiscal position and limits on nonessential imports will undoubtedly be needed. The crisis is thus far from over, and the sizeable current account deficit remains a major source of concern. However, Pakistan should be able to stay on top of its near-term external liabilities.

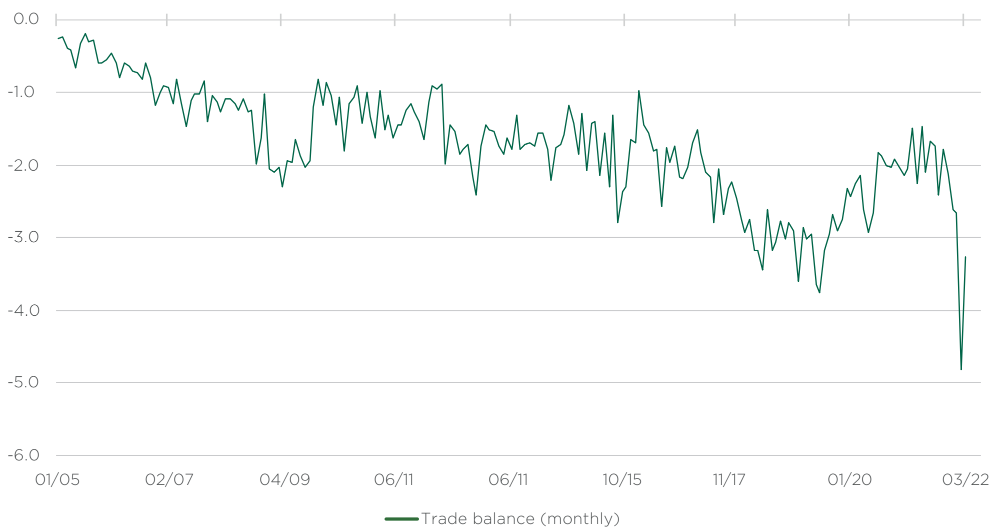
UAE: positive tailwinds

Economic indicators such as the PMI surveys, tourist arrivals, and crude oil output show that the UAE economy has enjoyed a good start to the year. The successful IPO of Dubai Electricity & Water Authority, the world's second largest this year, was another strong endorsement for the local economy and its capital markets. With this backdrop, real growth in 2022 may come close to the solid outcome of 3.8% achieved last year. A limiting factor will be tighter monetary policy, as interest rates will rise in line with those in the US.

UK: higher prices, lower growth

Like all net energy importers, the UK too has had to absorb significantly higher prices since the beginning of the year. This has dented consumer confidence and lifted inflation to the highest level in thirty years. The impact on real disposable income will slow the economy materially. Although inflation will be higher for longer, the Bank of England has already signaled that it will be mindful not to weaken growth unduly when normalizing monetary policy further. In this context, the GBP retains only moderate upside, even after the latest sell-off.

Pakistan: Trade balance with worrying trend (USD bn)



Source: Bloomberg, HBZ

SPECIAL TOPIC
A new EM debt crisis?

The growth prospects of many emerging-market (EM) economies have dimmed significantly against a backdrop of inflationary pressures, supply disruptions, and geopolitical tensions. Highly indebted countries — and thus also investors — face dire times.

Key points

- Weak EM credits vulnerable to challenging macro conditions
- Increased risk of EM debt restructurings
- Diversified fund vehicles best way to access asset class

Genesis of the latest crisis

Since the start of the Covid-19 pandemic more than two years ago, EM economies have faced a plethora of challenges. This period tested their resilience, readiness, and stability. Despite a broad-based recovery during 2021, fragility remained palpable, especially among the most highly indebted countries. Russia's invasion of Ukraine finally tipped the balance as it sparked another sharp increase in commodity prices. Moreover, the surge of food prices on the back of supply-chain issues and rising input costs impacted EM economies disproportionally because of the high weighting of food in the average consumption basket. The outlook is particularly dramatic for countries like Lebanon and Egypt that rely heavily on food imports from Russia and Ukraine.

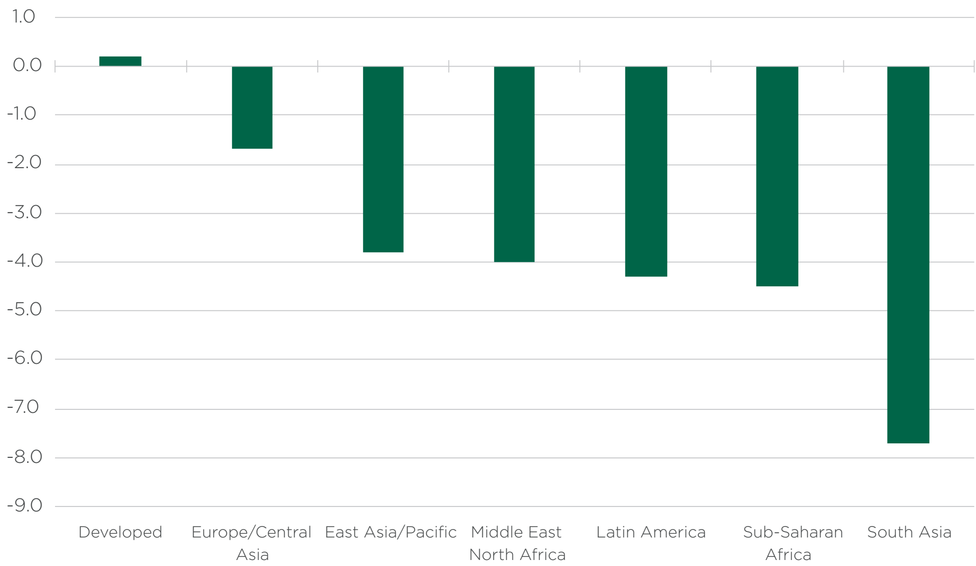
The end of the line

As a new global monetary tightening cycle has started, the cost of servicing debt has become another pressure point. Again, EM borrowers are doubly exposed. Rising G7 central bank rates and, in particular, higher US Fed rates are increasing their external funding costs, while higher local rates to fight domestic inflation risk choking the local economy. In fiscal terms, many borrowers have little to no wiggle room. The level of general government debt in emerging markets increased by some 9% of GDP during the first year of the pandemic alone, and is deemed unsustainable for many. Commodity importers are faring even worse, as currency reserves have been depleted to pay for essential imports. Thanks to a combination of low growth, a lack of fiscal resources, and rising debt servicing costs, many EM economies are facing a socioeconomic crisis. Many of these countries will eventually require international support in the form of both multilateral lending and debt restructuring involving foreign private-sector creditors. The case of Sri Lanka is a warning of what may lie ahead.

Lessons for investors

Yield-seeking investors are often blind to the underlying risks of high-yielding EM debt, taking assurance from the fact that the issuers are sovereign countries. However, when faced with the choice of either feeding the population or paying creditors, most governments will understandably choose the former. The best way to avoid the pain of ending up with a defaulted bond is to invest in this space via diversified fund vehicles. These may also suffer defaults, but they usually offer greater diversification and have the know-how to work through a restructuring process.

Mind the EM gap: expected GDP shortfall in 2023 relative to pre-pandemic levels (%)



Source: World Bank, HBZ

MARKET SUMMARY DATA

As of 5 May 2022

Equity indices	Last	-3M %	YTD %	-3Y %
Equity World USD	8,387.9	-11.1	-14.0	36.7
S&P 500	4,123.3	-10.1	-13.5	43.6
EuroStoxx 50	3,564.6	-15.2	-17.1	6.4
FTSE 100	7,264.3	-5.0	-1.6	0.8
SMI	11,527.1	-6.8	-10.5	22.2
Nikkei	26,319.3	-5.0	-8.6	23.3
Equity EM USD	512.3	-16.3	-15.8	7.5
Sensex 30	54,470.7	-7.6	-6.5	45.4
KSE 100	43,393.1	-5.5	-2.7	25.0
Hang Seng	20,002.0	-19.4	-14.5	-29.3
Russia RTS	1,088.0	-29.1	-31.8	-11.8
Brazil Bovespa	105,234.7	-6.5	0.3	10.9

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,518.32	-6.8	-9.4	-0.1
FTSE US Corp	2,295.39	-9.8	-13.7	1.9
FTSE US HY	1,132.03	-6.2	-8.9	7.6
FTSE Euro gov	224.15	-7.5	-10.4	-6.0
FTSE Euro Corp	231.77	-6.2	-9.1	-5.2
FTSE EM Sov	775.47	-13.6	-17.0	-8.0
DB EM Local USD	143.14	-13.4	-11.3	-11.6

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	103.66	8.4	8.2	6.3
EUR	1.06	-7.7	-7.2	-5.9
CHF	0.99	-6.7	-7.8	2.5
GBP	1.23	-8.6	-8.5	-4.9
JPY	130.56	-11.6	-11.9	-16.0
AUD	0.71	-2.3	-3.4	0.4
CAD	1.29	-2.0	-2.2	4.3
ZAR	16.00	-6.3	-1.7	-11.6
INR	76.92	-3.4	-4.0	-9.7
PKR	186.44	-7.1	-6.2	-24.8
Gold oz.	1,883.82	1.9	2.1	45.5

Interest rates	3M interbank %	10Y government %
USD	1.40	3.13
EUR	-0.43	1.14
GBP	1.23	2.01
CHF	-0.75	1.01
JPY	-0.02	0.25
AUD	0.92	3.56
CAD	1.90	3.12
ZAR	4.45	10.58

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Habib Bank AG Zurich
Private Banking
Weinbergstrasse 59, P.O. Box 225, CH–8042 Zurich.
Tel: +41 44 269 45 00, Fax: +41 44 269 45 18

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SWITZERLAND

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