

# INSIGHTS INTO WHAT MAY LIE AHEAD

## Market update

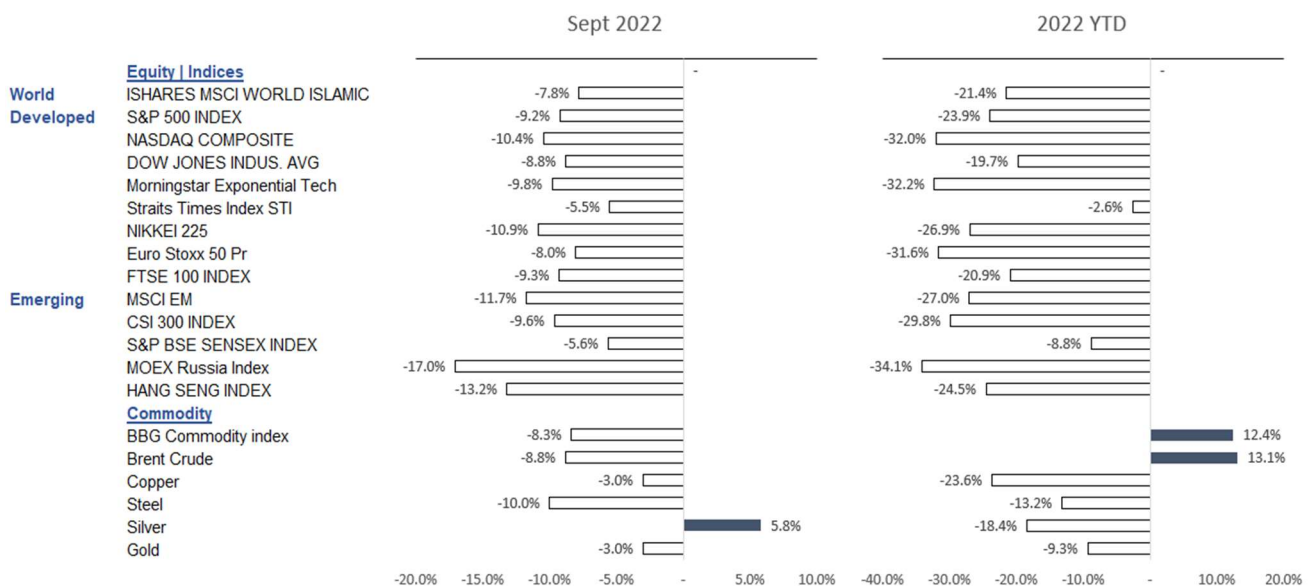
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October 2022



## INSIGHTS INTO WHAT MAY LIE AHEAD

September marked an extremely difficult month for global equity and bond markets. The ongoing pace of monetary tightening and recession fears hit investor sentiment hard with the MSCI World index, the S&P 500 and the Nasdaq falling 9.6%, 9.2% and 10.4% respectively over the month. Chinese equities also fell to their lowest level in almost five months with the Hang Seng index down 13.2%. Extreme moves across developed market currencies, particularly the Euro, Pound and Yen, and the UK government bond turmoil further added to overall market volatility. The long maturity UK government bond has performed almost in line with Bitcoin and is down about 55% YTD. The Euro is now trading well below parity with the USD, while the British pound which posted a flash crash earlier, has recovered slightly since the UK rolled back its proposed tax cuts. The \$/Yen is now trading above 146, a 24 year low. Over in the commodity markets, oil remained volatile and fell 8.8% in September, as the US continued to release more oil out of its strategic reserves. OPEC+ meanwhile agreed to a 2m bpd production cut vs 1m bpd cut discussed previously. A persistently strong dollar and rising real yields continued to weigh down on gold, which ended the month down 2.9%. Elsewhere, sabotage of the Nord stream pipeline mounted further concerns over the vulnerability of Europe’s energy infrastructure as we head into winter months.

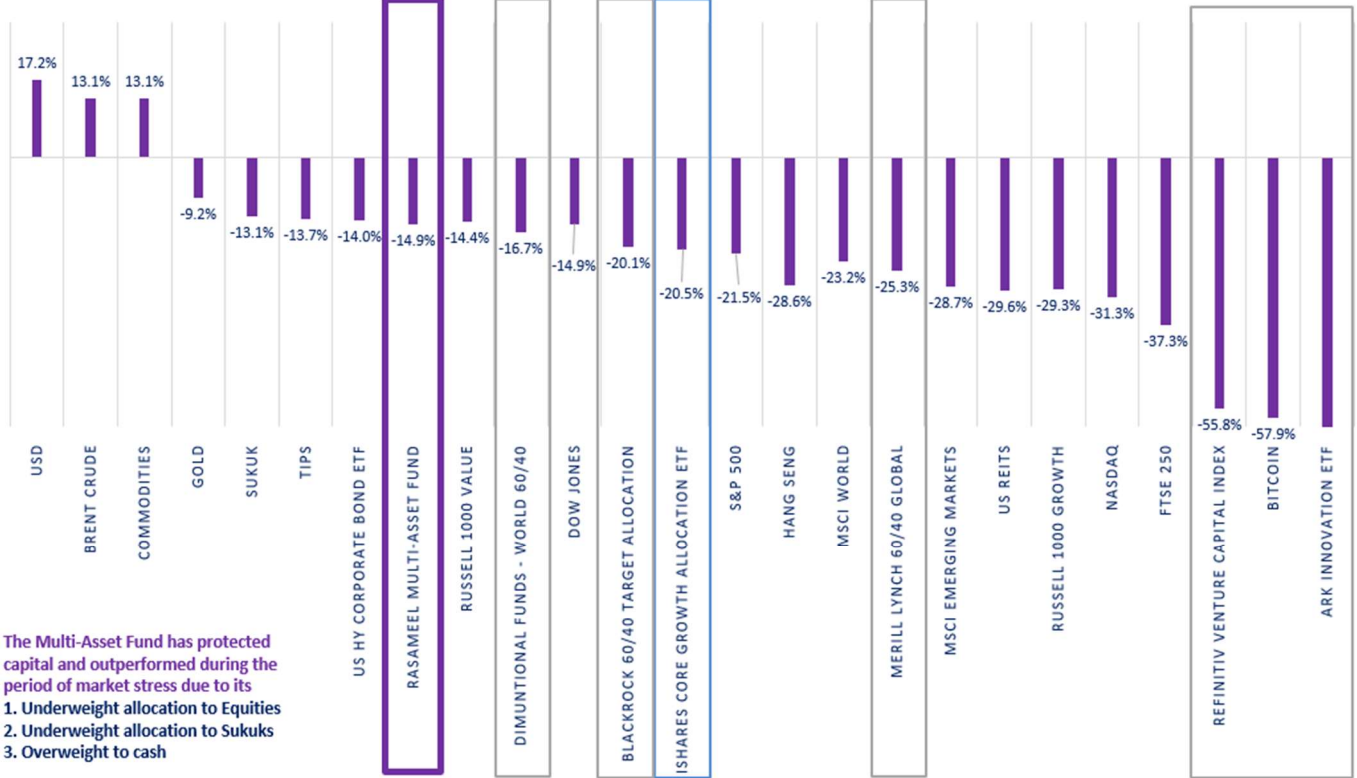


### Rasameel Performance:

In terms of our performance, it was a rather disappointing month given our relatively defensive positioning being overweight cash. The Disruptive Technologies Strategy (-8.9%) marginally outperformed its benchmark (-9.8%), the Morningstar Exponential Technologies index. The Global Equities Strategy (-8.1% vs -7.8%) and the Multi-Asset Fund (-6.3% vs -5.4%) marginally underperformed their benchmarks, the MSCI World Islamic index and the Core Growth Allocation index over the month. Within the Multi-Asset Fund, the sukuk tranche fell 1.2% but significantly outperformed US treasuries. The iShares 20+ Year Treasury Bond ETF (TLT US) fell 8.8% for the month alone. Within equities, performance was largely hurt by exposure to China and the technology and energy sectors.

Year to date though all our strategies are outperforming their respective benchmarks.

**MULTI-ASSET FUND - YTD PERFORMANCE VS SIMILAR BALANCED STRATEGIES**



The Multi-Asset Fund has protected capital and outperformed during the period of market stress due to its

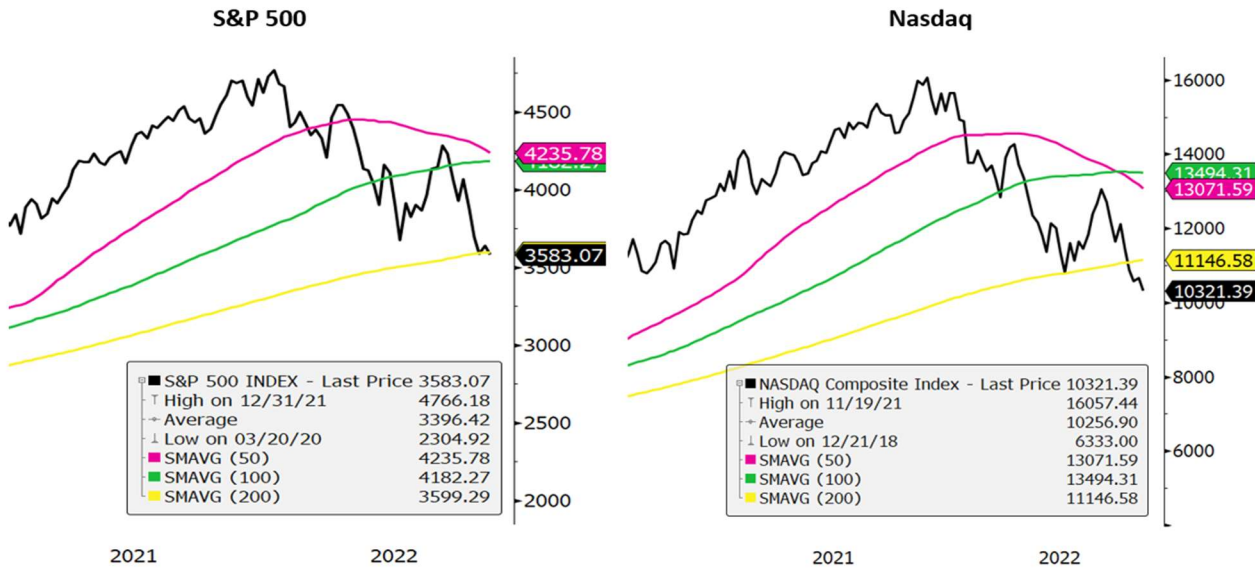
1. Underweight allocation to Equities
2. Underweight allocation to Sukuks
3. Overweight to cash

Reported numbers as of 30st September 2022

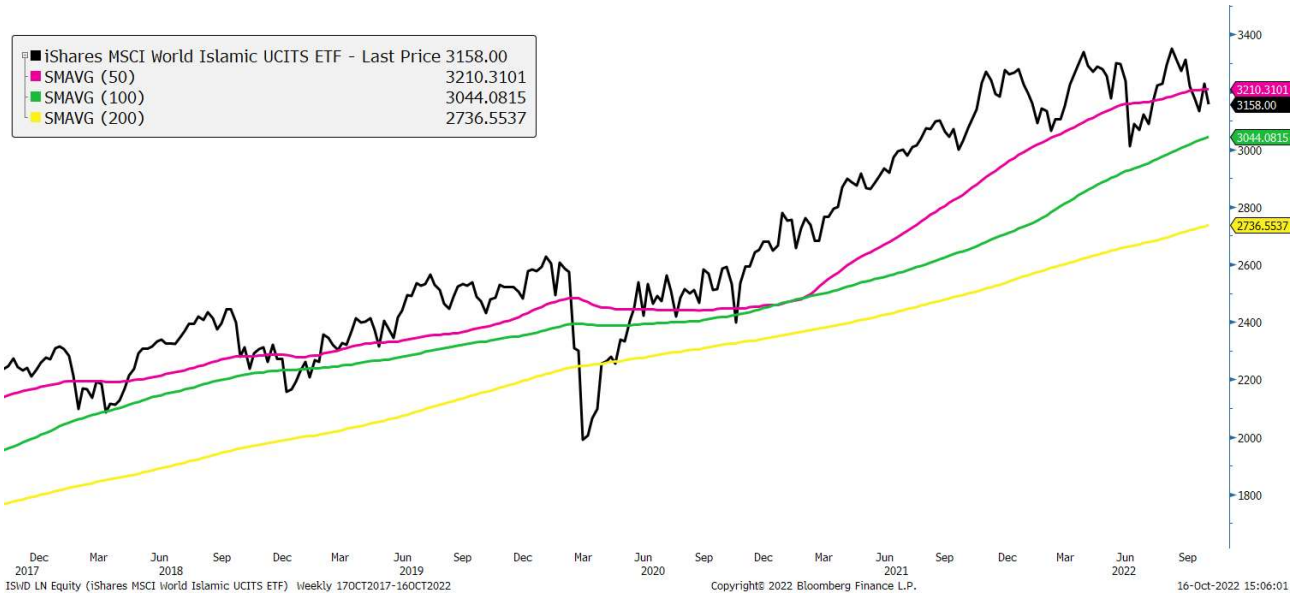
**MARKET REVIEW**

Risk assets took a real dive in September with the S&P falling to its 200-week moving average (wma). This was in line with our cautious outlook. As we had expected, there was a rebound off the 200 wma support level, but so far, as at the time of writing in October, this has been less than we had anticipated.

The Nasdaq by comparison fell through its 200wma 'support' level, with both indices making new lows for the year.

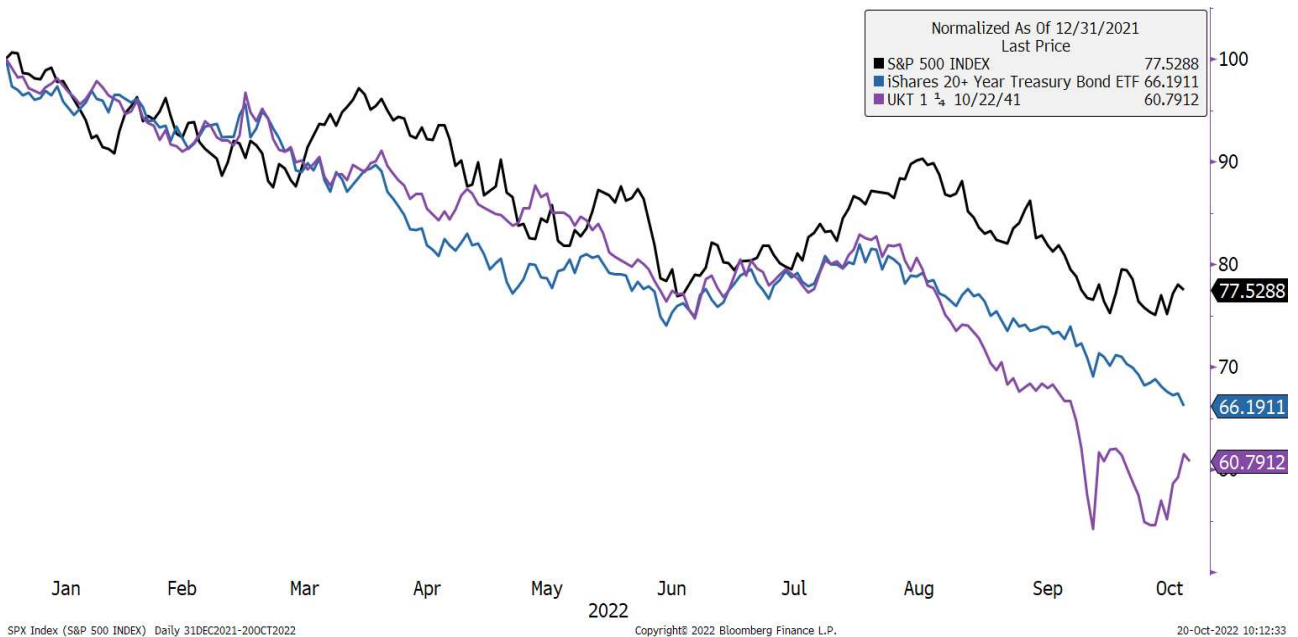


The MSCI World Islamic index, by comparison has fared far better, given its far higher exposure to Energy (c.17%) which has performed extremely well this year on the back of demand picking up and supply disruption caused by the continuing conflict in Ukraine.



More critically though, the historically defensive, low risk areas of the market, namely bonds have fared just as badly, if not worse, than equities. The gilt market in the UK has literally collapsed and the 20yr US Treasury bond has fallen dramatically.

Chart - S&P 500, US and UK 20-year bond performance YTD



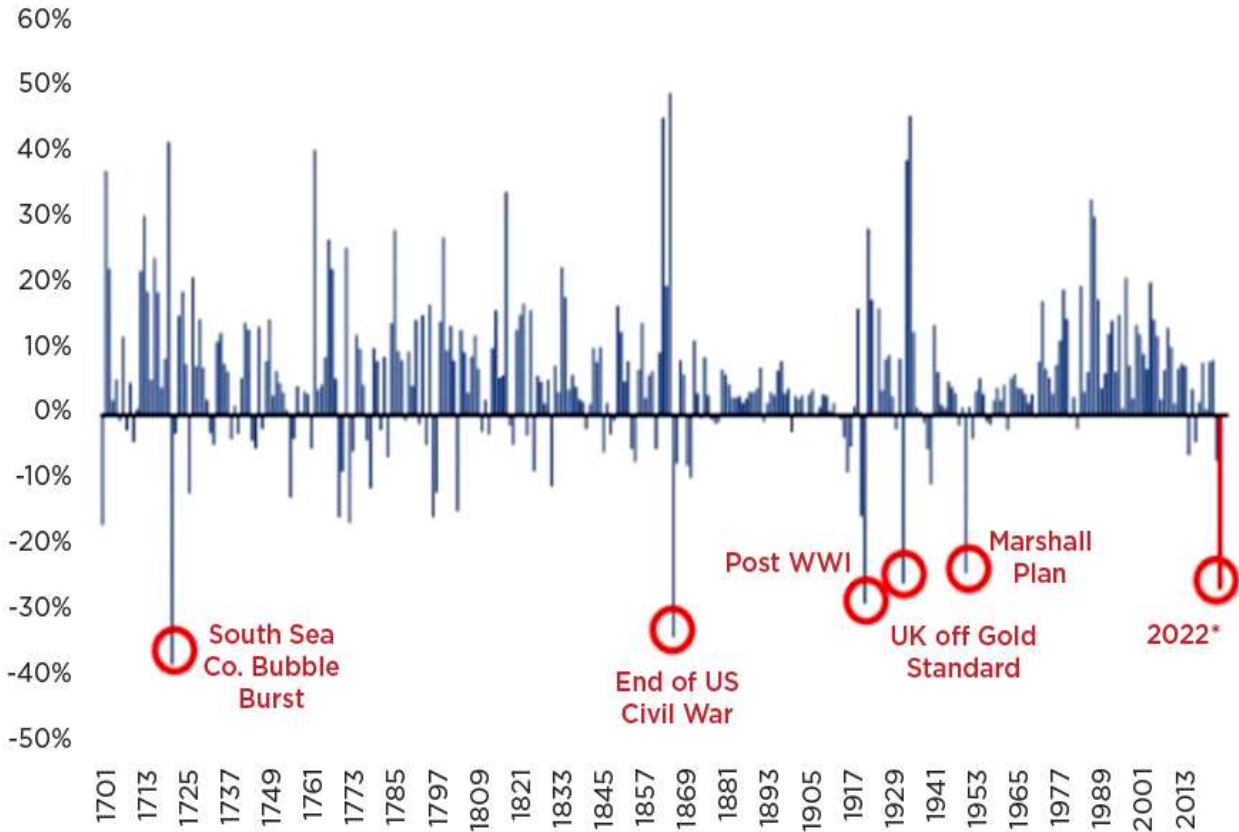
This is something not seen in prior cycles, with bonds being the weakest they have been in decades.



**Chart - Weakness in government bonds compared to prior cycles**

Govt bonds ann. 4<sup>th</sup> worst year after 1721, 1865, 1920

World government bond index annual return (% , GDP-weighted)



Source: BofA Global Investment Strategy, GFD Finaeon. 2022 annualized as of end of September.

Bond yields globally spiked higher in September and early October to reflect due concern for inflation, but also as a result of quantitative tightening, with most large central banks globally stepping away from their bond purchasing programs.

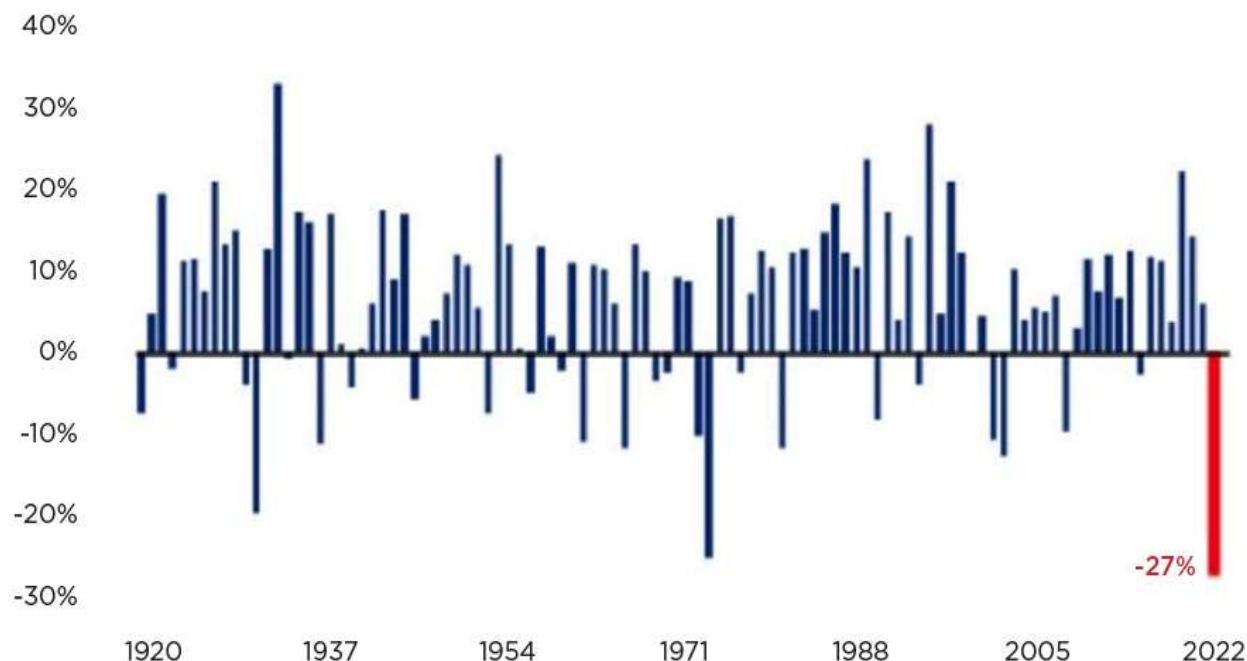
**The scale of the collapse in bond prices is a reflection of two things: how manipulated the bond market has been for the last decade, with the central banks being the buyer of last resort. Which, by doing so, prevented the market from finding a market price. It also reflects how broken the market currently is, with traders struggling to price bonds to take into account current and future growth, inflation and the actions of central banks.**

The weak performance of both bonds and equities has resulted in balanced funds, typically 60% equities and 40% bonds, having their weakest performance for many years. The S&P Core Growth Allocation index (AOR US) is down 21.3% to end of September while the highly regarded Bridgewater’s All Weather fund is down 27%.

## Chart – showing balanced fund return

### Worst first 3 quarters ever for 60/40

Performance of 60/40 portfolio through first 3 quarters of the year



**Source:** BofA Research Investment Committee, Global Finance Data. Note: 60/40 constructed using an index of 60% S&P 500 total return and 40% US 30-year government bond.

While we are outperforming our equity and balanced strategy benchmarks YTD, we continue to see these markets as extremely difficult to navigate. By way of example, we started the year very underweight bonds. This was based on them not offering any value, particularly in a rising inflation environment. With the 10yr US now offering over 4%, the SECO '44 sukuk around 6%, yields are starting to look attractive, especially if the economy and inflation slow dramatically. But we are increasingly less confident, as we highlight later in this piece, that inflation is going to return to its prior lows.

In terms of equities, even with the sell off to date, we expect they may make lower lows.

**Indeed, our view on the markets has changed over the last few months, becoming more bearish in outlook for both the global economy and for equities as a whole.** As we highlighted in our prior market update - [here](#) - the Fed has painted themselves into a corner between a rock and a hard place. Raise too far and too fast and the Fed kills the economy. Don't raise enough and inflation will come back with a vengeance, like it did in the 1975-1980 period.

**Our current base case is that a recession now looks increasingly unavoidable. The real unquantifiable at this stage is how deep the recession will be and to what extent the markets, whether bonds or equities, will reflect it.**

To aid us in understanding the potential downside in the market, we have reviewed the prior recessionary busts to help provide us with a range of where the market may go. While this is helpful, however, it is only there to provide an indication of the potential worst-case scenario.

In terms of timeline, if equity markets do follow prior cycle lows, the average peak to trough is 30% and takes approximately 12 months. The bear market of 2000 and 2008 took substantially longer to unfold.

### S&P 500 Bear Markets Since 1950

Peak	Trough	%Decline	# of Days	Breakeven	# of Days	Years
7/15/1957	10/22/1957	-20.7%	99	9/16/1958	329	0.9
12/12/1961	6/26/1962	-28.0%	196	9/3/1963	434	1.2
2/9/1966	10/7/1966	-22.2%	240	5/4/1967	209	0.6
11/29/1968	5/26/1970	-36.1%	543	3/6/1972	650	1.8
1/11/1973	10/3/1974	-48.2%	630	7/17/1980	2114	5.8
9/21/1976	3/6/1978	-19.4%	531	8/15/1979	527	1.4
11/28/1980	8/12/1982	-27.1%	622	11/3/1982	83	0.2
8/25/1987	12/4/1987	-33.5%	101	7/26/1989	600	1.6
7/16/1990	10/11/1990	-19.9%	87	2/13/1991	125	0.3
7/17/1998	8/31/1998	-19.3%	45	11/23/1998	84	0.2
3/24/2000	10/9/2002	-49.1%	929	5/30/2007	1694	4.6
10/9/2007	3/9/2009	-56.8%	517	3/28/2013	1480	4.1
4/29/2011	10/3/2011	-19.4%	157	2/24/2012	144	0.4
9/20/2018	12/24/2018	-19.8%	95	4/23/2019	120	0.3
2/19/2020	3/23/2020	-33.9%	33	8/18/2020	181	0.5
<b>Averages</b>		<b>-30.2%</b>	<b>338</b>		<b>603</b>	<b>1.7</b>

Looking at the market action to date from the peak, the S&P is down some 25% and has been in a downdraft for approximately 9 months. So, if the current market plays out like the average cycle as above, we are almost there. Should we, however, expect markets to trend in a similar fashion to 2000 or 2008, we are about halfway there and could expect some sort of bottom in the 1Q or 2Q. That would have to reflect the worst-case scenario.

To assess the potential of worst-case scenario we have provided a simple sensitivity table that incorporates EPS and market multiple into the equation. The tables below reflect the sensitivity of the index to weaker earnings and then a falloff in the multiple being applied by the market.

**Equity risk/reward should negative earnings revisions accelerate**

Severity of 2023 recession	Upside/Downside		2022 EPS Cut- Consensus \$223 EPS as on 10/10/2022					
	Spot SPX - 3588	Spot Fwd PE - 15x	-15%	-10%	-5%	0%	5%	10%
			189.6	200.7	211.9	223.0	234.2	245.3
Mild	2023 EPS Cut	10%	-18.1%	-13.3%	-8.5%	-3.7%	1.2%	6.0%
		5%	-20.8%	-16.1%	-11.4%	-6.8%	-2.1%	2.6%
		0%	-23.4%	-18.9%	-14.4%	-9.9%	-5.4%	-0.9%
Severe		-5%	-26.0%	-21.7%	-17.3%	-13.0%	-8.6%	-4.3%
		-10%	-28.7%	-24.5%	-20.3%	-16.1%	-11.9%	-7.7%
Like '02 & '08		-15%	-31.3%	-27.3%	-23.2%	-19.2%	-15.2%	-11.1%

		S&P 500 2022 Target (Spot - 3588 on 10/10/2022)					
2023 EPS Growth		-15%	-10%	-5%	0%	5%	10%
2023 EPS		189.6	200.7	211.85	223	234.15	245.3
Fwd PE Ratio	15.5	2938	3111	3284	3457	3629	3802
	15.0	2843	3011	3178	3345	3512	3680
	14.5	2748	2910	3072	3234	3395	3557
	14.0	2654	2810	2966	3122	3278	3434
	13.5	2559	2709	2860	3011	3161	3312
	13.0	2464	2609	2754	2899	3044	3189
	12.5	2369	2509	2648	2788	2927	3066

Note - The above analysis is based on the assumption of 2022 EPS meeting the current consensus of \$223

In terms of using the table above, if the S&P multiple falls to 15x and earnings growth falls by 5% for 2023 this would equate to an S&P of 3178 (11% downside from its current level). Similarly, if we have a 10% fall off in earnings for 2023 and the market multiple falls to 13, this would equate to an S&P of 2609 (27% downside from its current level). This is not a forecast, just a reflection of where the S&P could go based on its sensitivities to valuation multiple and earnings. Currently, consensus is for 240 EPS for 2023, so this is far from current expectations.

Based on above, albeit very simple, sensitivity analysis, a fall in the S&P to around 2600 would simply bring us back to the lows of 2020. This would be in line with prior major cycle lows, such as 2000 and 2008, with the S&P declining by c.45% peak to trough and still being just above its 200-month moving average trend line.

This is the potential worst-case scenario. The truth is we have, as Stanley Druckenmiller highlights, very little in the way of prior cycles to use to get a better sense of what to expect. As highlighted above we are already close to the typical average sell off and valuations have corrected somewhat. So, while markets may move lower, it is important to bear in mind that they have already sold off substantially and we should not fall into the trap of becoming too bearish.



### S&P 500 valuation measures

S&P 500 Index: Forward P/E ratio



It's of note here to also highlight that while we remain bearish, we are far less bearish than many others. We don't expect a long drawn-out recession. Rather we expect the Central Banks and governments to step back in at their earliest opportunity to support the markets. We are simply not there yet, for them to do so without losing all credibility.

While an economic slowdown will pull inflation lower, we are increasingly of the view that central banks and governments are going to steer towards maintaining higher levels of inflation than the current target of around 2%. Furthermore, we don't, for example, expect the Fed to do a Volker and raise rates dramatically to a level that kills inflation altogether. Certainly not at this time.

As mentioned in prior reports they are just so indebted that they need to use inflation to reduce the real value of their debt. US government Debt/GDP is currently 127%, while in Europe and Japan it stands at 88% and 231% respectively. Commentators have for years been expecting both governments and central banks to favor inflation as a way to reduce these to more manageable levels. Central banks have tried to raise inflation in the past, but it is only now that the impact of easy monetary policy, mixed with supply chain disruptions, that we are seeing inflation move so significantly higher.

Covid and the massive government response to that event drove the inflation we see today. Next up, we believe very likely, will be Climate Change and the 'Build Back Better at Home' policies that are very likely going to be launched in the next economic slowdown, which is forecast to be in 2023.

It can be anticipated that billions if not trillions of dollars could be spent in the 'war against climate change'.

We also expect there will be an increased drive to 'Build Back Better at Home'. It will start with semi-conductors and go from there. It will drive GDP and job growth in the US and Europe but will also result in higher prices. 'A price worth paying for local manufacturing and local jobs' may be the buzzword of the next few years? The days and benefits of globalization will be dissipated in favor of supporting local markets and jobs.

These themes around climate change and local production are not something new. We raised them some time ago and our investments in Lam Research, a semi-equipment manufacturer, Canada Nickel and Hudbay, copper and nickel miners, are in part reflective of this theme.

**Both themes, 'fighting' climate change and oil dependence and favoring local production, will be inflationary by their very nature.**

So, while inflation may drop off mid recession, we are now increasingly of the view it is likely to be higher than current central bank targets of c.2%.

This impacts the outlook for bonds, as bond yields may not revert to their historical lows. Something the market is likely trying to price in currently. We have also spoken in the past about financial repression, but again it hasn't been clear as to how this could be implemented.

One way would be through public-private partnerships with local institutions being required/encouraged to hold government bonds, such as Green Bonds. Another would be through quantitative easing with significant bond buying programs to keep yields artificially low, such as those we have seen over the years and we currently see in Japan with the 10yr JGBs yield being held at 0%.

Financial repression would initially be a positive for bonds as yields would fall, but would be a disaster for them longer term in terms of real performance.

**Furthermore, if we do see these two themes and others being driven by the government, it does shift the power over the market away from the central banks and more towards the government and its think tanks. Thus, one should anticipate even larger amounts of fiscal stimulus and largesse. Something one needs to get on the right side of in terms of allocations and sector selection.**

So, as we move closer to year end and towards 2023, we should not lose sight of the fact that markets are already down significantly. All we need is one large break in the markets to facilitate both government and Fed action to reverse market course. We are not there yet, but are likely to see such an event in the next 6 months.

## Outlook for asset classes over next few months

**Equities:** Potential is there for a bounce off support in the near term. Outlook for the next few months into year end, is for equity markets to make lower lows.

We continue to prefer defense to offence and are overweight cash in all strategies. We are also overweight Healthcare. We continue to be underweight economically sensitive areas of the market such as technology and parts of the materials and industrials sectors.

In terms of country allocation, we are underweight the US and European markets. While we wait for China exposure to benefit from M2 money supply growth, it hasn't happened yet.

**Bonds:** Yields are approaching interesting levels, but given our outlook above we are holding back on adding aggressively.

**USD:** We expect the dollar to rally into any slowdown and to continue to do so until something breaks and the Fed needs to revert back to quantitative easing to reduce bond yields and/or some form of bail out.

**Final comment:** Once we come to an end of this 'everything down' environment, we would expect bonds, gold and then equities to perform well, in that order. First bonds will reflect the weaker economic environment. Then gold will start to price in the return of QE. Following that, equities will start to price in an improved outlook. We expect, in that order.

We would advocate that staying invested is also key. There is a lot of negativity already priced into the market and, as we know from prior cycles, markets can flip on a dime and rally on a comment from the ECB or Fed. Trying to time the market has been shown to be extremely difficult. Likewise, preserving capital is also critical, to ensure we are well positioned to use dry powder should lower lows materialize.

While the next few quarters are likely to be difficult, we are actually very optimistic, as any break lower will provide an excellent entry point to add to risk exposure. Longer term, we expect assets such as equities and gold will provide strong returns and, while holding cash works for now, we expect it will be a terrible investment in a few years' time.

## Asset Management Department

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