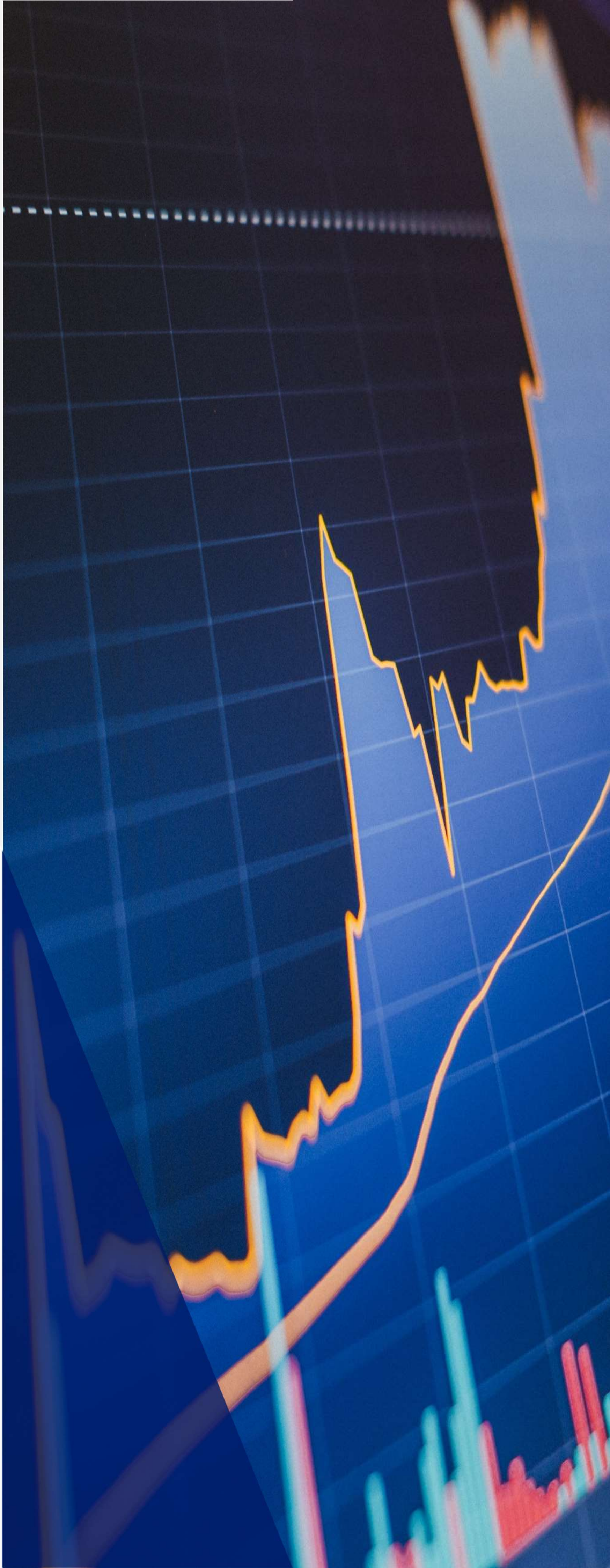
A bear bounce, or something more?

Market update

August 2022

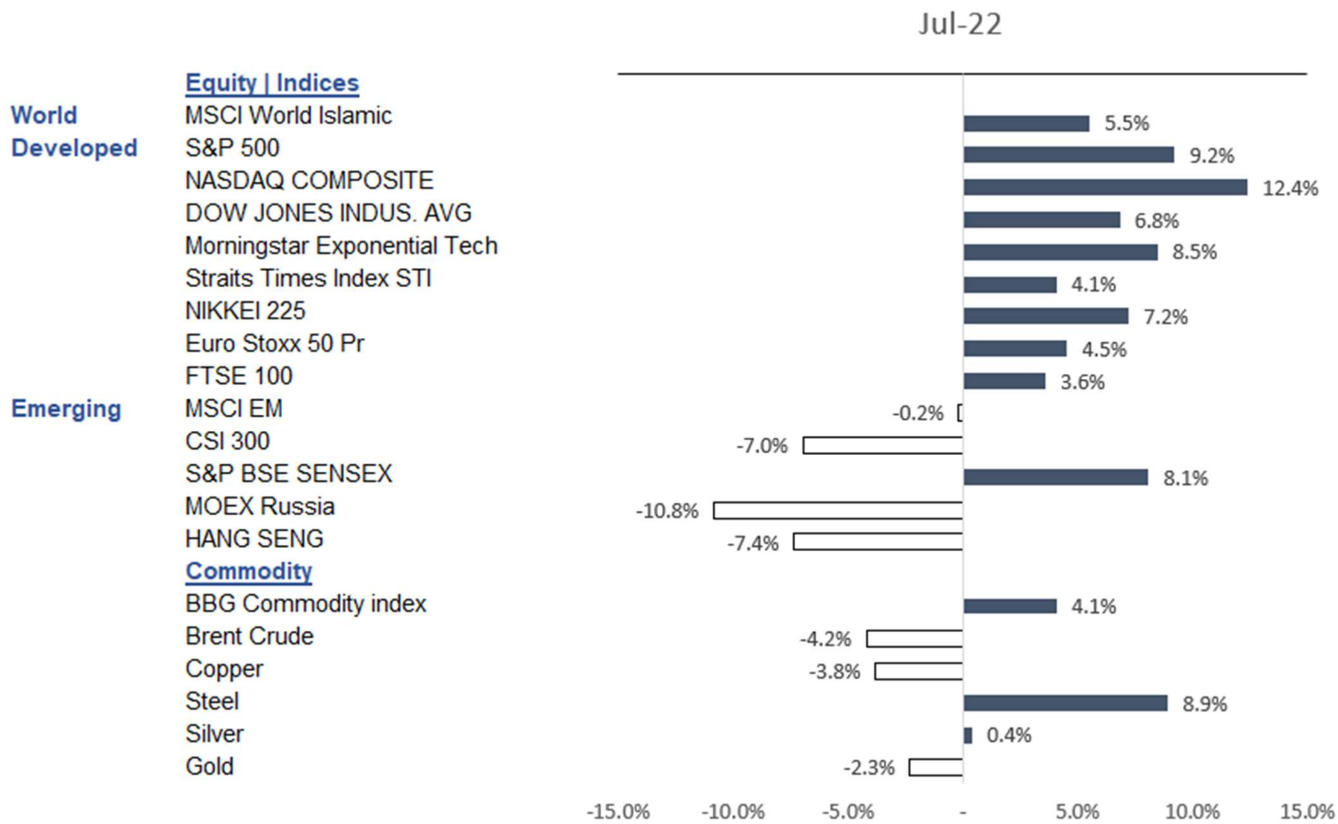


RASAMEEL

MARKET UPDATE

The rally in July took many investors by surprise as equity markets rebounded sharply despite aggressive central bank rate hikes, soaring inflation, energy disruption in Europe, a fresh property crisis in China and few signs of an end to the war in Ukraine. In July, the S&P 500 climbed 9.1% to erase June's losses, while the Nasdaq rallied 12.4%. Improved risk appetite was largely built on the view that the Fed may back down on rapid rate hikes amid signs of softer US economic data. Better-than-feared 2Q S&P 500 earnings also lifted sentiment in the last two weeks of July. In terms of our performance, given our defensive sector positioning, underweight technology and overweight cash, we underperformed in July. Performance was also hurt by our exposure to China, the materials sector and precious metals, gold and silver in particular. July saw US-China geopolitical risks escalate, hurting China related stocks, but we are now seeing a recovery post Pelosi's Taiwan visit. The Global Equities strategy rose 2.2% (gross) vs its benchmark's rise of 5.5%. The Disruptive Technologies Strategy rose 4.6% (gross) vs its benchmark's rise of 8.4%. Our Multi-Asset balanced product delivered a 1.2% return (net) vs 5.1% return for the benchmark. We are though still outperforming on a YTD basis.

While July was a difficult month due to our defensive positioning, our strategies are doing well in the month-to-date through Aug 9th, with all strategies posting returns ahead of their benchmarks.



Our view is that this is a bear market rally. A painful one, when one is defensively positioned. We continue to take the view that we need to see earnings being revised downwards before we can start to call a bottom. We would also argue that it is far too early for the market to rally on the back of the expected Fed pivot. The Fed will only pivot when the economic data is very weak, unlikely before. At which point earnings should be coming off.

Chart - S&P 500's rally since recent June 16 low has been driven entirely by forward P/E (blue) as forward EPS (orange) continue to roll over (at slow pace)

Lastly, whilst we take the view that the recent bounce is a bear-market rally and that we are likely to see lower lows ahead, for investors with little to no exposure to the equity markets or to the disruptive technology theme, we would advocate that they use current weakness as an opportunity to average down or establish equity exposure over the next 6-12 months.

Our market view in summary

Below, we go through our views on what we expect will unfold in the next few months. Base case view is that the Fed will turn less hawkish in terms of messaging in Sept, with rates at around 3%. This will be on the back of all the weak economic data that we expect to flow in over the next few months. At that point, we expect the Fed to either pause or to reduce the increments to 0.25% and raise to a max of 3.5% (our consensus house view). Our team views ranged from 3% up to 5%.

Taking a call on global macro is an incredibly difficult call to make at the moment, and we fully agree with Stanley Drunkenmiller's views here.

06/09 18:16 ET
Druckenmiller said this is his 45th consecutive year as a chief investment officer and he has never before seen an economy where there's **no historical analogue**. He says that's given him more humility than ever.
Jenny Surane Finance Reporter

Our base expectation is for stocks to weaken into September, and potentially beyond, as worse economic data comes through into 2023. We also think there is a need for consensus earnings expectations to fall off. As a result, we are underweight risk exposure across all strategies and are overweight cash.

With that said, however, we do anticipate that some parts of the market - those less economically sensitive areas like exponential technology and potentially gold – could catch a bid on the back of the Fed changing its tone and becoming less hawkish. This would be in-line with what we saw in 2018. Indeed, it is these areas of the market that have fallen off significantly with the recent rate rises.

Chart – Gold, Bitcoin and ARKK YTD vs Fed Funds rate.

The major risk to our currently bearish view is that stocks extend the rally we have had in July, through to the Fed pause. This is a real risk for our view.

Optimists would point out that stocks usually rally in parallel with rate increases. But this is due to the fact that rates rise to slow a 'boom' cycle.

This time round it is very different as rates are rising into a weaker environment. The risk is we could be too defensively positioned into the bear rally. That is a risk that we feel is worth taking in order not to get whipsawed by the market. But we are trying to be nimble around it and will constantly challenge ourselves to ensure we don't get too stuck in our view.

On an optimistic note, though, we don't expect this to be a severe slowdown. Rather, we see a couple of tough quarters and then a continuation of the negative real rate Fed induced market rally.

A few factors that do bring us comfort in our view are:

a) we made the right calls coming into 2022 – that economic data was going to be weaker than consensus and that there was going to be a market sell off and we were positioned for it;

b) that the predicted slowdown, caused by higher rates/yields and tight financial conditions, will play out in late 2022 and into 2023. This is looking increasingly likely given the weak forward-looking economic data that is coming through. The inverted yield curve also firms up this expectation; and

c) that the Fed – unless they want to wreck the financial system – will do the same as they did in 2018, namely eventually pivot and lower rates and do more QE. So, some parts of the market may rally on the back of this whilst others, those that are more economically sensitive, will remain weak due to the weaker economic data. **Historically, stocks in general are weak in a rate cutting environment as they are driven more by earnings, rather than purely Fed action.**

We would also point out that this current rally should be starting to tire and that there have been a number of bear market rallies over the past 8 months.

Outlook

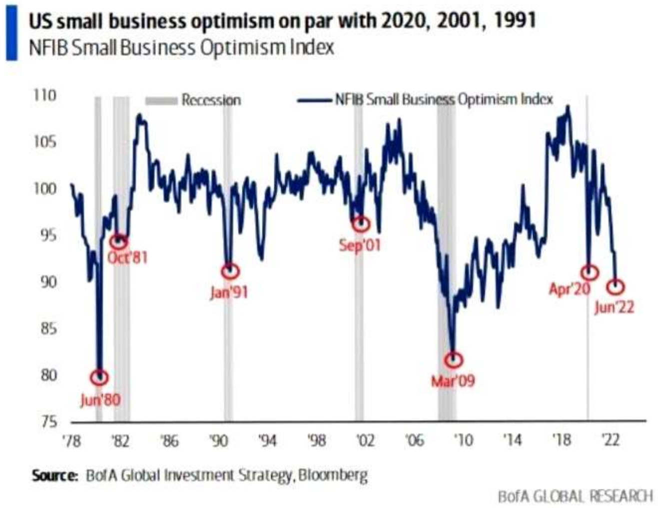
In the past updates, we have provided an assessment of what is happening in terms of macro data. Overall, it's a pretty bleak picture and readers can find our prior reports here.

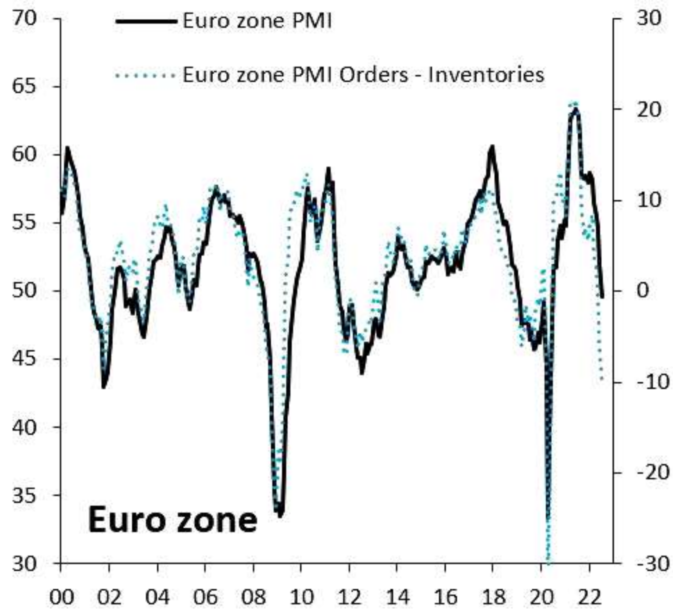
In this update, we review the latest macro data as well as the business cycle in terms of where we currently are, to get a better sense of why we are positioned the way we are.

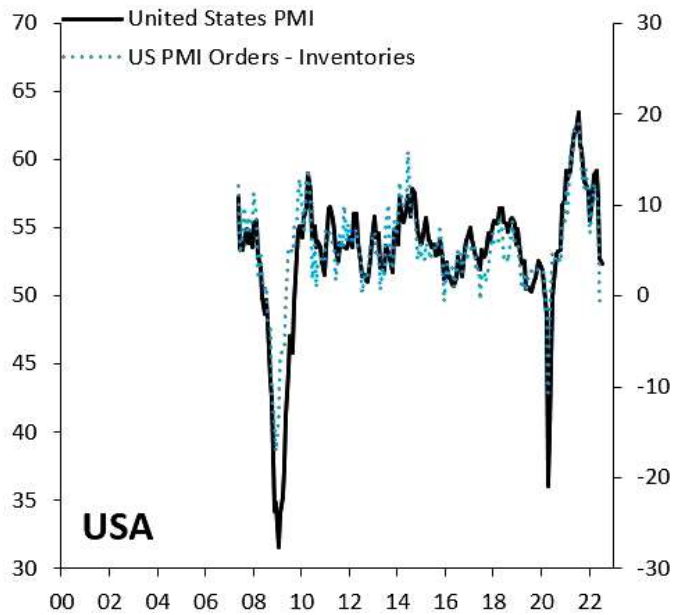
We will then give our expectations on which asset classes and sectors will do best as and when the Fed goes more dovish and the increase in rates goes on hold or at least slows.

So, let's start off with our base case. As reflected on in the last update – found here – we anticipate that both economic data and inflation will start to weaken dramatically as we move through H22022.

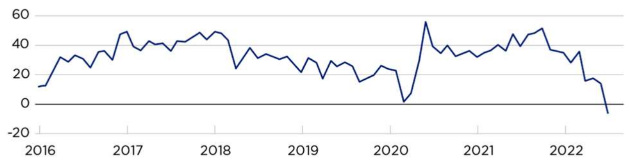
Chart – ISM, PMIs and Small Business Optimism index



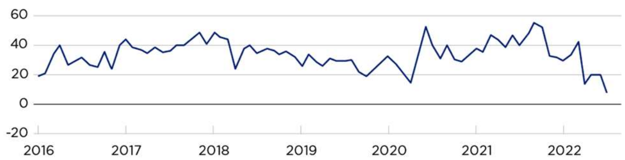




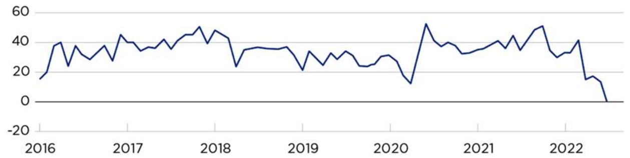
General Business Conditions



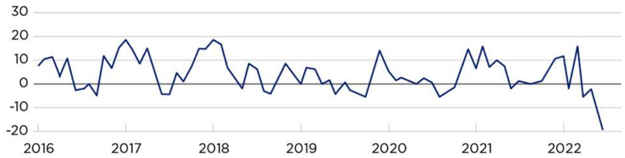
Shipments

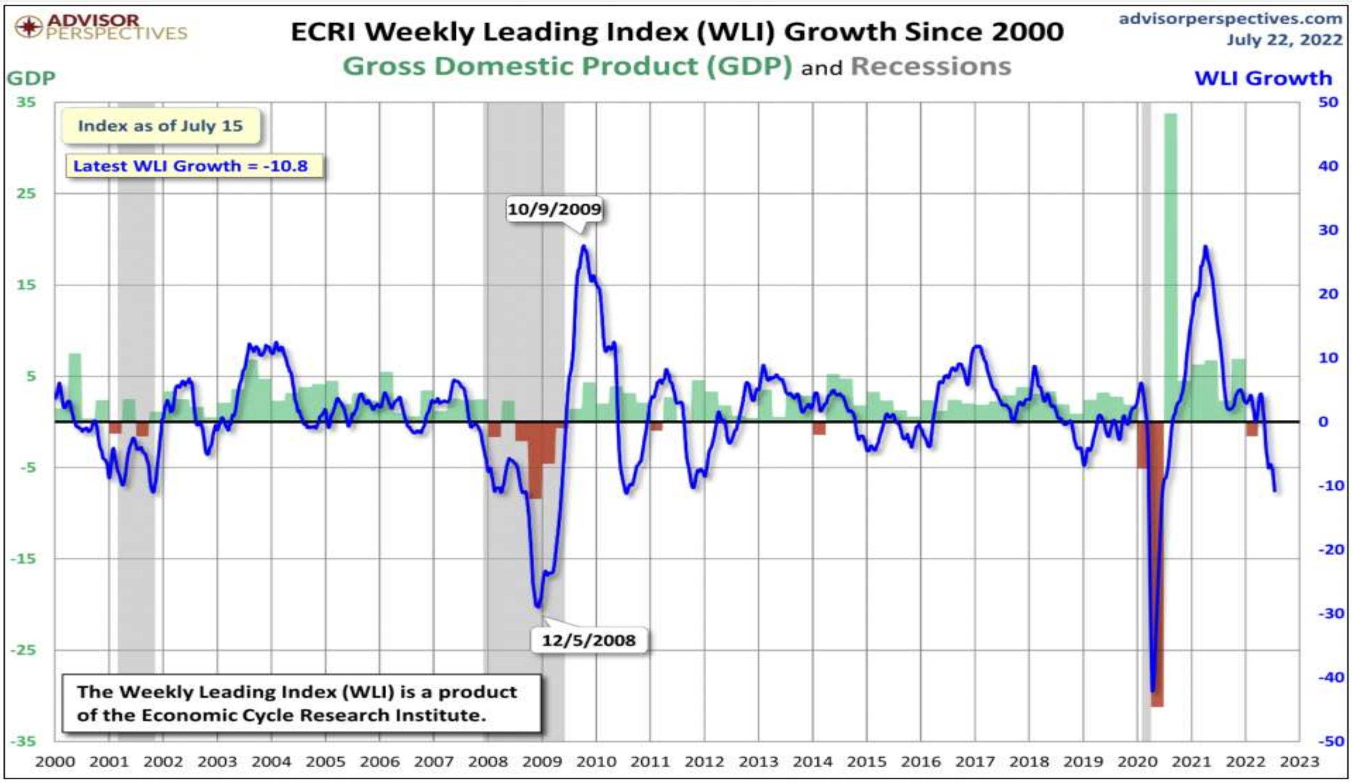


New Orders



Unfilled Orders

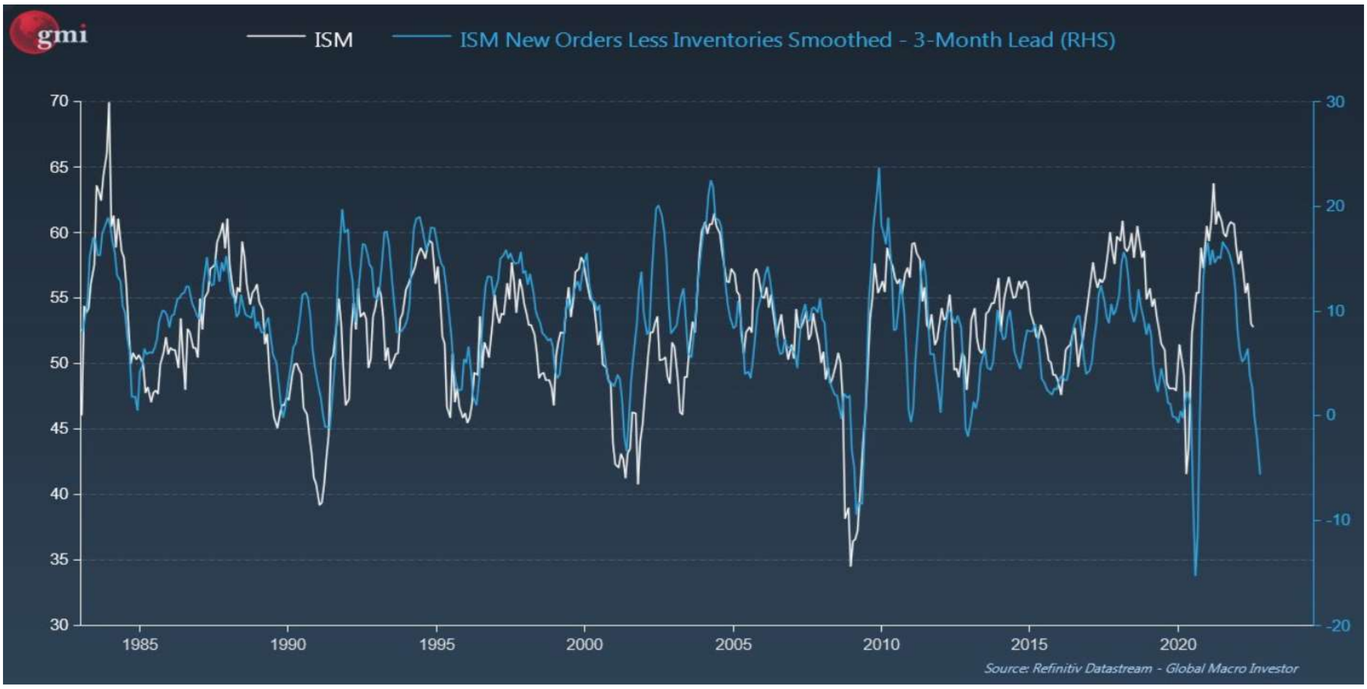




Our analysis of the business cycle

We prefer to look at ISM over GDP to guide us about the business cycle. Markets look forward; not backward and thus we avoid GDP based debates as GDP is a backward-looking data point. ISM on the other hand, when analyzed with inventories is a good leading indicator and can be more useful.

Analysis of the latest ISM and New orders data suggests ISM is expected to weaken further and possibly fall to 40.



Within the confines of the typical business cycle, this would reflect that we are in **late cycle, early contraction phase** – with the Fed raising rates to quell the excesses of the economy.

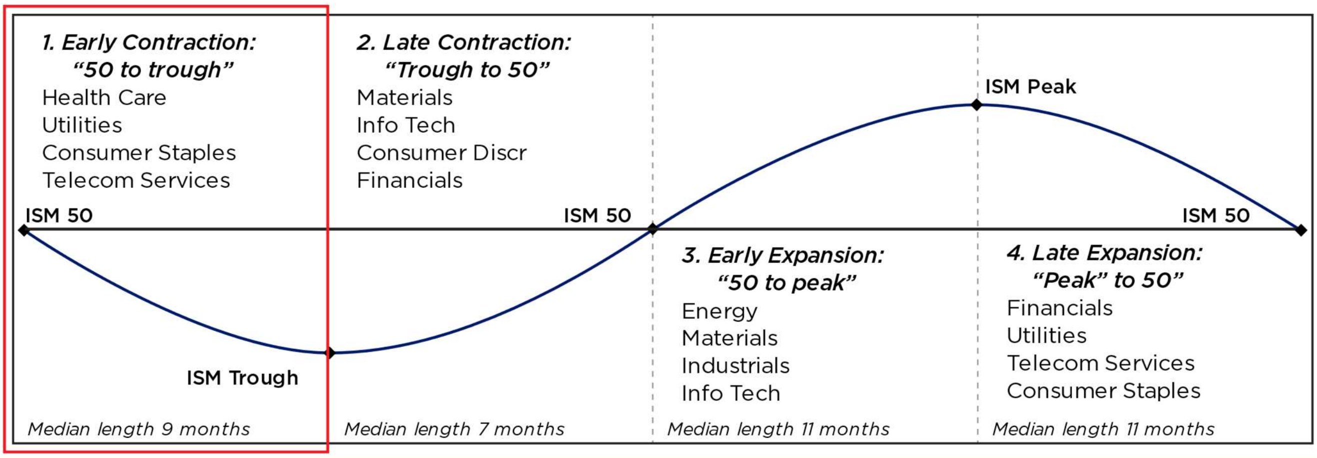
Table - Sectors that work well in a late cycle

S&P 500 sector excess price return relative to the S&P 500 Index

Position of economic cycle (ISN Manufacturing Index)	S&P 500 Materials	S&P 500 Industrials	S&P 500 Consumer discretionary	S&P 500 Financials	S&P 500 Information technology	S&P 500 Energy	S&P 500 Health care	S&P 500 Consumer staples	S&P 500 Utilities	S&P 500 Real estate
Early cycle	0.760%	0.144%	0.964%	0.513%	1.659%	-1.464%	-1.020%	-0.554%	-1.433%	-1.243%
	0.110%	0.142%	0.027%	0.682%	-0.533%	0.516%	0.119%	-0.206%	-0.439%	0.603%
Mid cycle	0.301%	0.131%	0.120%	-0.100%	1.477%	-0.133%	-0.504%	-0.643%	-1.371%	-0.349%
	-0.509%	0.340%	-0.075%	-0.452%	0.692%	-0.213%	-0.184%	-0.285%	1.280%	0.562%
Late cycle	-0.666%	-0.140%	0.249%	-0.014%	0.515%	-0.042%	0.620%	0.314%	0.152%	0.486%
	-0.276%	-0.095%	-0.065%	-0.490%	-0.818%	0.317%	1.524%	1.440%	0.267%	-0.539%

Table - Sectors that work well in an early contraction phase

ISM cycle phases and best-performing sectors



Source: Goldman Sachs ECS Research

The negative data highlighted above, point to a weaker economy ahead and raises the question of whether the Fed will continue raising rates into a weaker economy. If we are watching this data, so is the Fed, and as we highlighted earlier, we expect the Fed to get less hawkish and either pause or reduce the pace to 25bps hikes. The market agrees with our view and is also pricing in rate cuts in 2023.

From the above sector analysis, it is clear that the less economically sensitive areas of the market – such as Healthcare and Consumer Staples - do best as markets go through late cycle and into recession. Folks don't stop using medication because of a slowdown, but they do cut back on large ticket purchases such as new cars and homes. But once the Fed paused its rate hikes, Technology, communication services, real estate and consumer discretionary have historically outperformed over a 6–12-month period after Fed pause.

Given our expectation that we are in late cycle, we are defensively positioned. Like Druckenmiller, one of the top managers, we feel that the risks in the market outweigh the opportunity.

06/09 18:16 ET
Druckenmiller said the other angel on his shoulder is saying he has never seen a market quite like this so he wants to be **cautious.**
Jenny Surane Finance Reporter

06/09 18:17 ET
Druckenmiller:

"This is not a story we've ever seen before."

As such, we are therefore overweight cash and defensive sectors, such as healthcare. It's a sector where we find valuations attractive, and the sector remains well positioned for the business cycle. We are also overweight cash across all strategies.

In terms of underweights, we are underweight materials and industrials. These are typically the sectors that underperform as the economy shifts from late cycle into recession. We are underweight energy in our global strategy relative to the index, given what we see as an excessive weighting of 17% in the index. In the multi- asset portfolio, we maintain more of a neutral position.

We are also underweight technology. This is the one underweight that keeps us up at night.

Technology has been one of the weakest sectors YTD, but it also has the greatest potential to rally back strongly (as we have just witnessed in July and something we spoke to in our June Outlook).

Indeed, we found ourselves getting somewhat whipsawed in July. We added to our technology exposure in June, in what we considered were very sold down names, on the expectation of the space catching a bid from a technical standpoint. But inflation data came out hotter than expected (9.1% vs 8.8%) and the sector tanked, only to now rally in July.

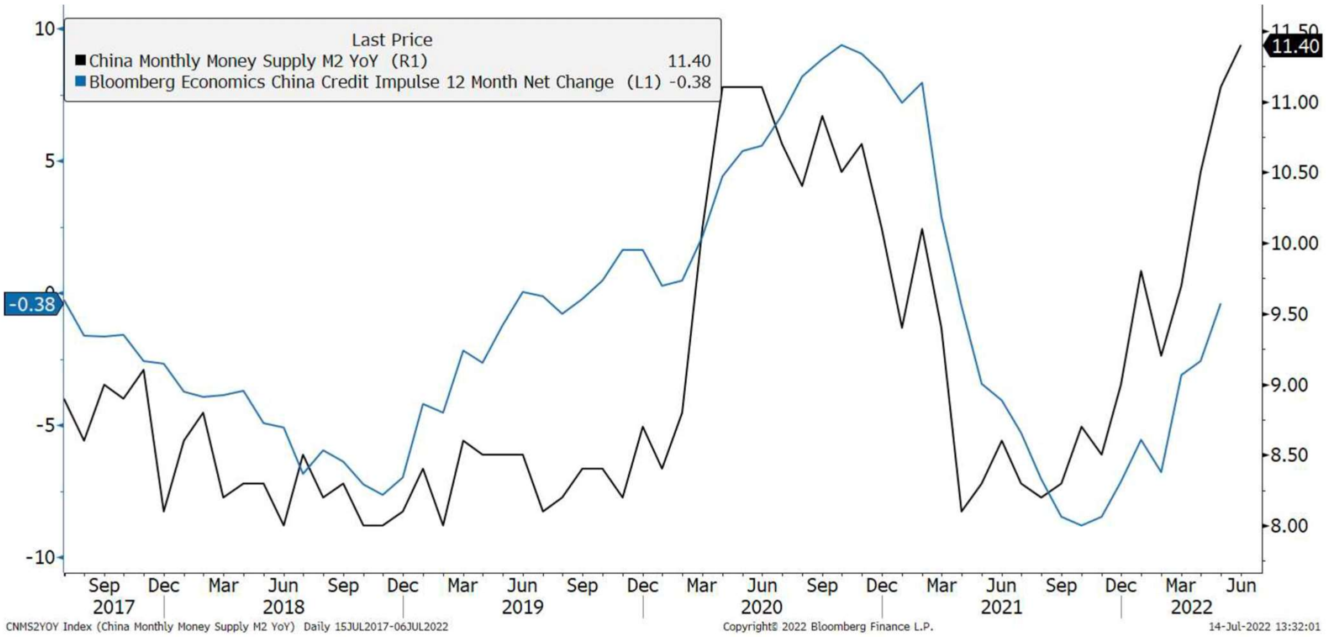
As we highlighted in June, the technology sector as represented by the Nasdaq and the XT US is trading at support levels of their 200w averages. The 50w has not yet crossed the 100w averages, so the sector is really at make-or-break technical levels. We are adding a little to areas in the technology space that we feel are overly sold down. We are very cautious though, given the expectation that consensus earnings expectations are likely to weaken.

Chart – Nasdaq and XT – weekly averages

Another area we are very underweight is US and EU consumer discretionary, focusing rather on China e-commerce names that we think have significant upside potential in a market that we think is closer to a bottom and that various tools will be implemented to bring it out of a recession, while the rest of the world is going into it.

So, in our view, China is ahead of the pack, a little similar to what we saw in 2009 where it was China that provided significant QE to get itself out of recession.

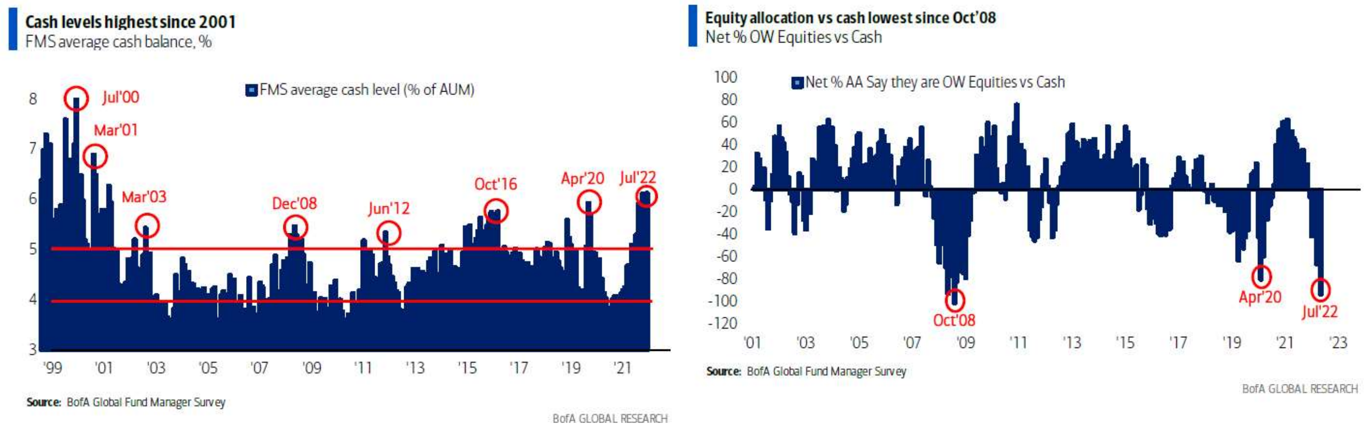
Chart – China M2 money supply and Credit Impulse



Source: Bloomberg

Of note is that we are overweight cash in most strategies. While the defensive sectors do outperform in the end of the cycle or slowdown, they typically still underperform cash. So rather than hide in sectors that are defensive but that we find expensive, we simply take exposure off the table. This positioning is very much in-line with other institutional investors.

Chart - Consensus EPS estimates – US, China and EM

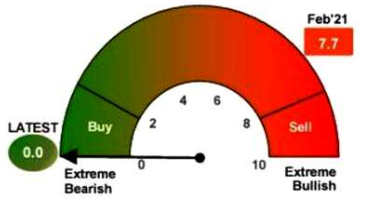


Generally, there is a lot if fear in the market.

BofA Bull & Bear Indicator (B&B)

Our BofA Bull & Bear Indicator is at 0.0, signal is Buy.

BofA Bull & Bear Indicator
Remains at 0.0



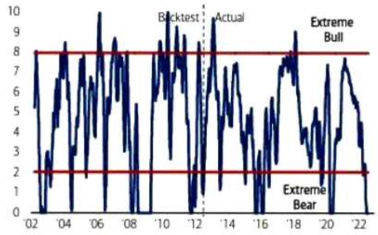
Source: BofA Global Investment Strategy
BofA GLOBAL RESEARCH

BofA Bull & Bear Indicator
BofA Bull & Bear current component readings

Components	Percentile	Sentiment
HF positioning	23%	Neutral
Credit mkt technicals	24%	Neutral
Equity market breadth	3%	V Bearish
Equity flows	37%	Neutral
Bond flows	5%	V Bearish
LO positioning	3%	V Bearish

Source: BofA Global Investment Strategy, Bloomberg, EPFR Global, Lipper FMI, Global FMS, CFTC, MSCI
BofA GLOBAL RESEARCH

BofA Bull & Bear remains at 0
BofA Bull & Bear Indicator since 2002

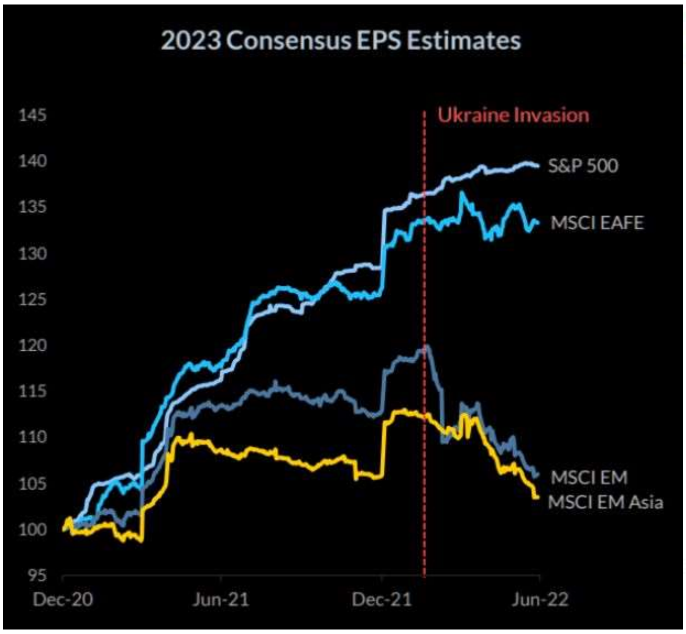


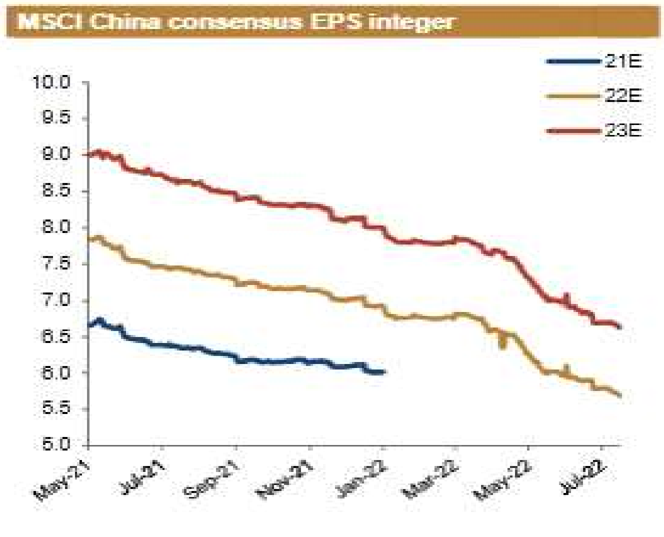
Source: BofA Global Investment Strategy, EPFR Global, FMS, CFTC, MSCI
BofA GLOBAL RESEARCH

While a fearful market could be reflective of a buying opportunity, we would like to see earnings expectations start to come off in the S&P and other wider indices, before we can start to get positive on the wider market. Our base expectation is that earnings guidance will come in weaker than currently expected – this would fit with the data we see. But it's something we will track carefully over the next few weeks/months as, so far, Q2 earnings are coming in relatively strong.

Of note is that guidance in China has already fallen off.

Chart - Consensus EPS estimates – US, China and EM





Sources: Bloomberg, CMS (HK) Research;
Data as of 15 July 2022

In terms of our muti- asset strategy, we came into the year very underweight bonds and are now adding back. We will bring this up to a neutral position at least with around 35-40% exposure.

Chart – SECO 44 yield since launch

The sukuk we allocate to are high quality names, and in the case of the seco'44 above, are offering attractive yields of around 5%. We find this acceptable given where the US 10yr rate is currently at, 2.75%. We do find this a 'tricky' trade given where inflation currently is, but if economic data continues to worsen as expected, we should start to see yields falling off into the latter part of 2022 and into 2023. **If we have a real bad economy, bonds will do especially well.**

While we are basing our asset allocation on our expectation on where the economy, economic data, and thus earnings relative to current consensus are headed, it also necessary to overlay this with the actual timing of the Fed.

So, what are our current base expectations for the Fed and other central banks?

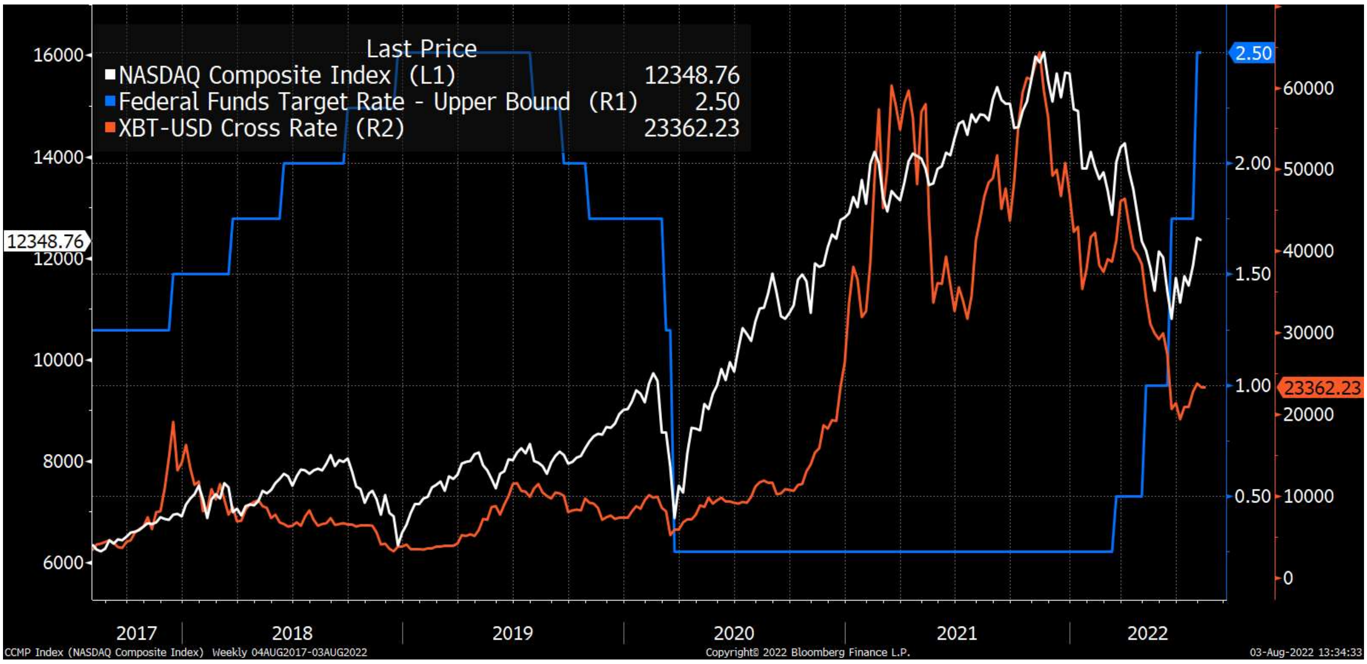
Our base case is that Fed messaging will become less hawkish in the Sept/October period. While we do expect that parts of the market may catch a bid, history is a good guide to highlight that equities and risk assets in general, do not rally on a Fed pause. Nor do they rally in a declining rate environment. **Typically, they find a bottom only once ISM and other leading economic indicators bottom.**

Chart – 2000s – SPX bottomed close to (after) an ISM bottom

Chart – 2009 – SPX bottomed close to an ISM bottom

To be clear, we are not anticipating a 2000 or 2008 type of event. Rather we anticipate that the economic slowdown will be more subdued. So we think that 2018 can also be used as an example of how certain asset groups like sold down high growth technology or for that matter bitcoin – those areas that are not economically sensitive – could start to rally.

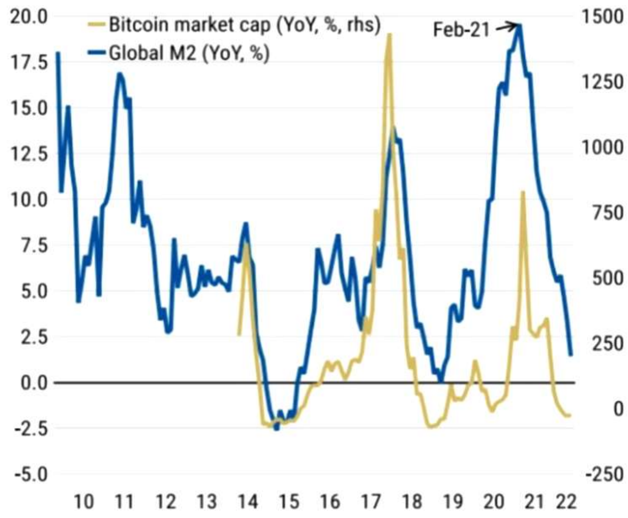
Chart – Nasdaq at 200wma support level, Bitcoin showing signs of stabilization



As we find in the general broad sector analysis, those parts of the market least impacted by an economic slowdown are most defensive. So too we believe are those areas of exponential growth, those parts of the market which are more sensitive to rates and the cost of debt than the underlying strength of the economy. Indeed, in many cases the economic slowdown will drive traffic towards these exponential growth areas as they are often more efficient than the existing offerings.

We are thus confident that when the Fed does shift stance and become more dovish that this should be to the benefit of the exponential names and the Disruptive Technology strategy that we run.

Bitcoin's market capitalisation trajectory - all about money supply growth (so Fed policy)



Source: Macrobond, Morgan Stanley Research

Drunkenmiller's view on Gold and Bitcoin

06/09 17:43 ET

Collison says a lot of people compare Bitcoin to **digital gold.** Druckenmiller says if you believe we'll have **irresponsible monetary policy and high inflation**, then if it's in a bull phase you'll want to own Bitcoin and if it's a bear phase you'll want to own gold.

Jenny Surane Finance Reporter

Astute readers will point to 2000 when this did not play out, but that was because technology had been in a bull market all the way through to the end of 2000, so there were massive valuation disparities etc. This time is very different with the exponential growth names, such as those held by the Ark Innovation fund being extremely weak coming into the hike cycle.

Chart - ARKK

So, our base case is we are likely 3 months away from the Fed stepping off the brake and will likely ease again as we move through 2023 as the data deteriorates. Historically, again we would note that, while markets usually rally when the Fed raises rates to cool a 'hot market' or economy, this time is very different. The fed is hiking into weaker data. **So, we expect that the speed on transmission from hiking to cutting will be rapid.**

A comment on the Fed recent 75bps hike in July

The Fed raised rates by the expected 75bps on the 27th of July. The market rallied on the back of it, but it is worth noting that the market has rallied on the day of the Fed rate increase announcements this year, only to dip off in the period following.

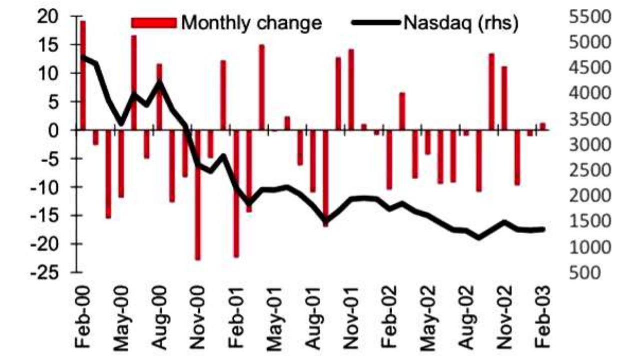
Powell gave some bumbled responses to the many questions that came up but came across as lacking the necessary conviction to really deal with inflation. But this is subject to interpretation as he did indicate he was not concerned with the economy and expected he would be able to raise rates to the 3.25% mark before becoming concerned about the economy. He also indicated he was comfortable with seeing a little weakness in the employment data as this would provide a little slack and ease inflationary pressures.

So, stocks got a bid. This was, given our conservative position, our fear. No doubt it was/is the fear of many institutional managers.

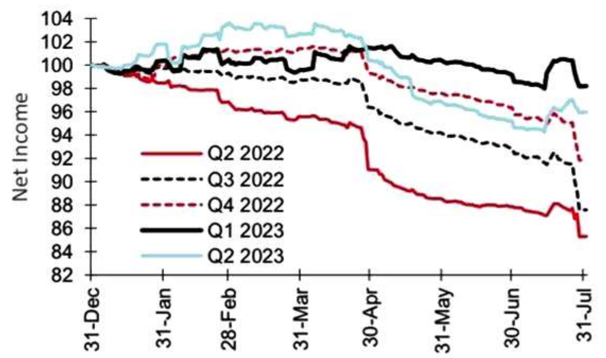
It doesn't though alter our outlook. We expected 75bps. It was market consensus. Powell's comments may have come across as timid on inflation, which can be seen as a positive, but if he doesn't deal with it effectively it will become the economy's wrecking ball. Either tighten now and get inflation to recede, or it will come back higher in the near term. The Fed also needs to build up some dry powder so that they have some flexibility to cut rates into the next recession. And, as we discuss above, earnings and economic growth are what drives markets, not the Fed, and data is coming in very weak following the excesses of 2020/21.

So, we are not chasing this July 'rally' but will rather watch and wait to assess the economic data as well as earnings and start to add to risk exposure when the latter starts to price in the former.

Double-digit rallies were common in the Nasdaq bear market



Despite Nasdaq's rally, profit forecasts continue to be cut



Disclaimer

This document is not directed at or intended for use by any person resident or located in any jurisdiction where the distribution of such information is contrary to the laws of such jurisdiction, or such distribution is prohibited without obtaining the necessary licenses or authorizations. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the content. The information contained in this document is for informational purposes only and should not be regarded by recipients as a substitute for the exercise of their own judgment. This document does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to affect any transactions, or to conclude any legal act of any kind whatsoever. When making a decision about your investments, you should seek the advice of a professional financial advisor. No representation or warranty of any kind, either express or implied, with respect to the content is made. This document is provided on a confidential basis to invited parties and may not be copied or distributed without prior written consent. Subject to contract. This document is prepared for promotional purposes, and it may not be presented or distributed in State of Kuwait except to the "Professional Clients" only according to the definitions contained in the first book of the Executive Bylaws of Kuwait Capital Markets Authority. Rasameel Investment Company hereby undertakes that it does not disguise, diminish, or obscure important items from the investment subject of promotion.

Warning

The past performance of any investment or a product is not a reliable indicator of future results, and it cannot be relied upon for investment decision making.

RASAMEEL

Rasameel Investment Company
Kuwait City, Souq Al Safat, 3rd Floor, Office 6 & 5
P.O. Box 4915 Safat 13050

T. +965 2247 8800
F. +965 2247 6600
E. info@rasameel.com

www.rasameel.com

Rasameel