Macro and Market Outlook UPDATE

Stay defensive……
sukuk preferred

May 2023

RASAMEEL

SUMMARY

In the current market environment, one of high rates and slowing growth, we are less optimistic on equities and other risk assets and more optimistic on fixed income.

With the high levels of inflation, we have seen in recent years, the various central banks around the world have been raising rates aggressively. The Fed rate, for example, is now over 5%. This, and the stresses now being caused by deposit flight in the US and soon elsewhere, is putting the brakes on the economy and GDP growth for 2024 is expected to be only around half the levels of 2022.

A high rate, slowing growth environment, is usually not positive for equity valuations, which are already stretched. It is though, a good environment for fixed income. Falling yields are positive for fixed income instruments, especially those of mid to long duration, if longer dated yields also decline.

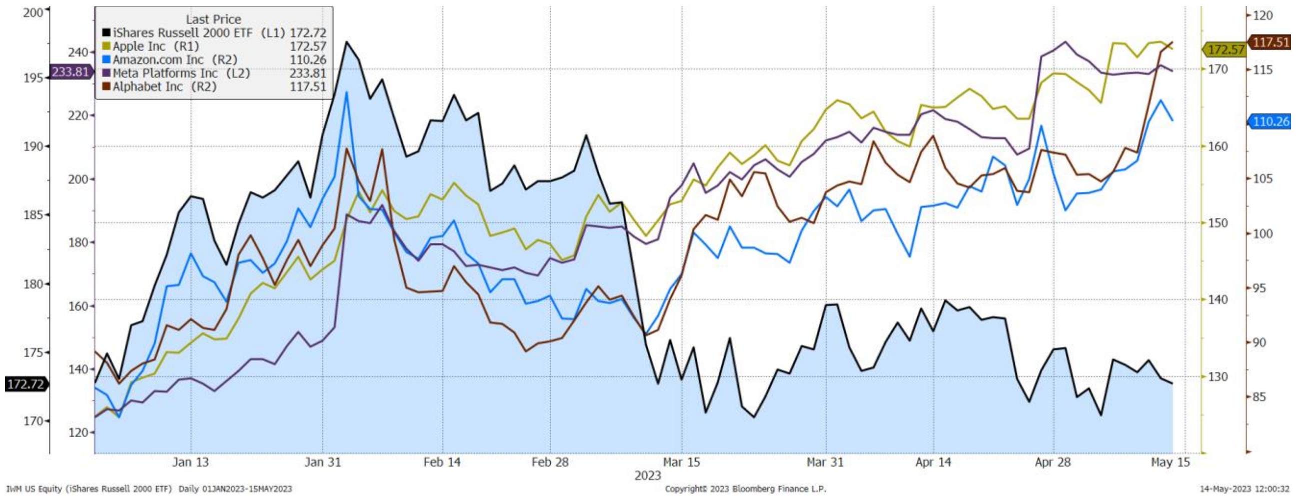
Our sukuk opportunity strategy offers direct access to some of the highest quality diversified sukuks in the market and we expect will deliver excellent risk adjusted returns over the next 6-12 months. In our opinion, the window of opportunity in sukuk is relatively short. Once yields have fallen back to reflect the economic reality, we would be looking to switch back into the more high-risk areas of the market. Equities, and especially Disruptive Technologies, should catch a bid when the Fed and Treasury and others step back from tightening and pivot towards aggressively providing liquidity to support waning economic growth.

OUTLOOK 2023: AN UPDATE ON THE MACRO AND THE MARKETS

We came into the year expecting the second half of 2023 to ‘likely be an opportune time to add to risk assets’, preferring to remain underweight Equities and overweight Fixed Income and Precious metals. Our view has not changed.

While the main Equity indices have rallied strongly since the start of 2023, this hasn’t been broad-based. Rather it has been driven by a handful of mega cap tech stocks. Market breadth is extremely low. The Russell 2000, for example, is actually down for the year.

Strong US Equity market driven by mega cap technology stocks

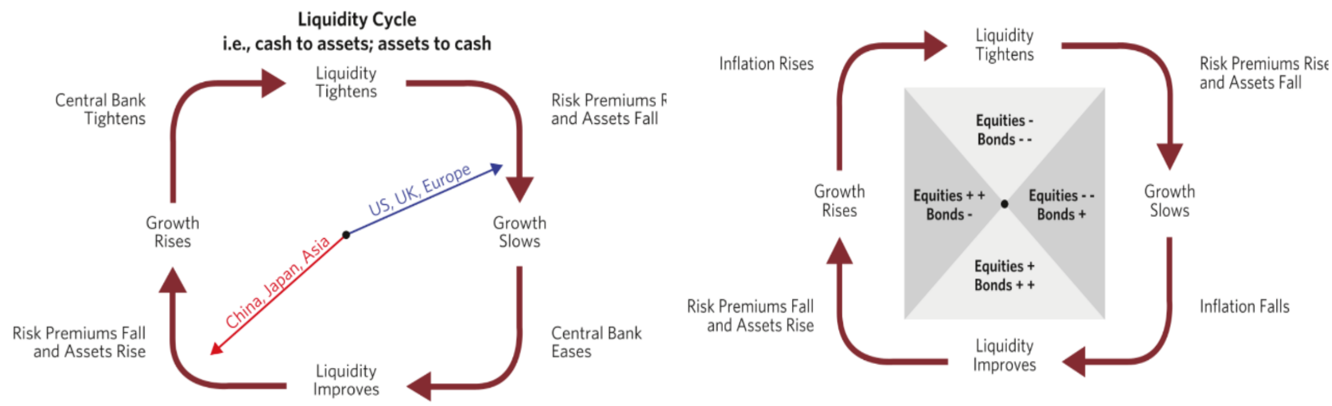


While many market commentators have been highlighting that Q1 earnings results have generally been better than market consensus, the reality is that they still reflect a contraction. Earnings growth for the S&P500 was -2.5% for Q1, up from the -6.7% expected in March, and it is the second straight month of contraction. The market appears to be pinning its hopes on stronger earnings in the 2H23 and for full year earnings to grow by 1% in '23 and 5% in '24. **We expect both will need to be revised down as we move through the rest of 2023.**

Expectations for economic growth for 2024 are already declining, with the IMF expecting the US GDP to grow by just over 1% relative to 2% in 2022.

	2022	2023	2024
World Output	3.4	2.8	3.0
Advanced Economies	2.7	1.3	1.4
United States	2.1	1.6	1.1
Euro Area	3.5	0.8	1.4
Germany	1.8	-0.1	1.1
France	2.6	0.7	1.3
Italy	3.7	0.7	0.8
Spain	5.5	1.5	2.0
Japan	1.1	1.3	1.0
United Kingdom	4.0	-0.3	1.0
Canada	3.4	1.5	1.5
Other Advanced Economies	2.6	1.8	2.2

The simple graphic below, gives an indication of where we are in the business/economic cycle. Generally, bonds do better in a late stage tightening cycle, which is where we are currently for much of the developed world.

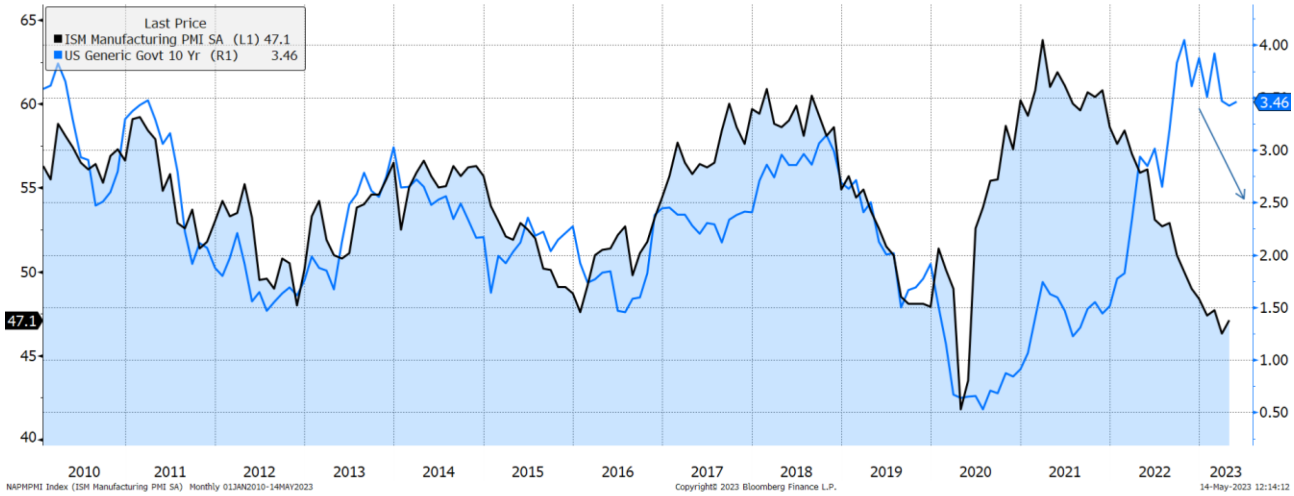


Source: Bridgewater

A high rate and slowing growth (and slowing earnings) environment, is generally not positive for equities. It is though a good time to have exposure to fixed income, especially as the economy slows and rates/yields start to fall on slower growth and inflation.

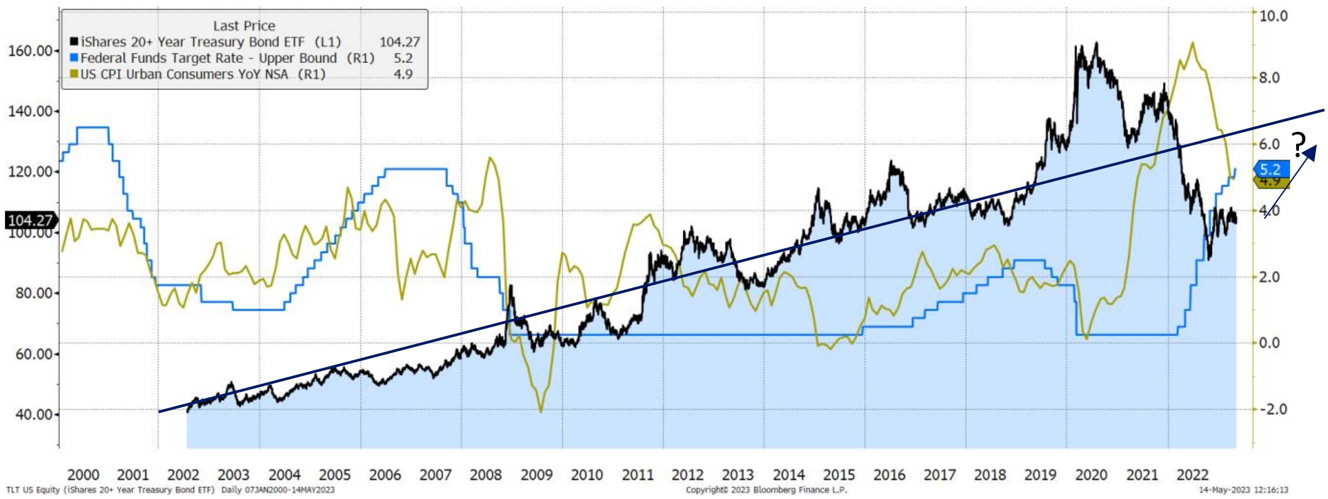
As growth slows and inflation comes off, rates will decline across the short end of the yield curve. This dynamic is shown clearly below, showing the correlation between US Manufacturing and the US government 10Yr bond. Historically as the ISM (manufacturing or services) weakens, so too does the 10yr yield.

US manufacturing and US Gov 10yr bond yields



The potential return in fixed income can be demonstrated by using the iShares 20yr+ Treasury bond ETF, effectively a proxy for the same maturity US Gov bond. Should the Fed Funds and Inflation mean revert to 2% or below, which is easily foreseeable given the damage and leverage in the US financial system, one could foresee the TLT mean reverting back to the 130 range, or a c.20%+ return.

iShares 20+ Year Treasury Bond ETF (TLT US)
a good proxy for Long Duration fixed Income
Massive room for mean reversion



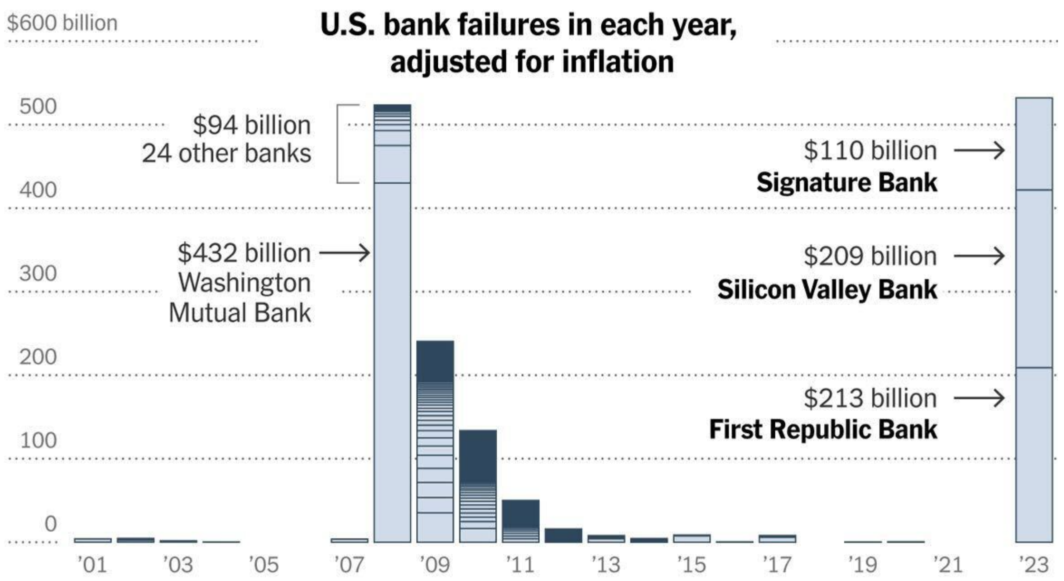
This is obviously subject to the Fed not announcing a higher inflation target for future years. Our view though is that we will have significant disinflation, if not outright deflation, before we see the return of higher inflation levels.

We have often referred to the 'Fed tightening until something breaks'. As we have highlighted in our strategy factsheets, something has now broken and has the potential to be at the epicenter of the expected slowdown we see coming in the next 6 to 12 months.

It may not feel like it, but the US is already in the midst of a banking crisis, brought on by high rates and a deposit run.

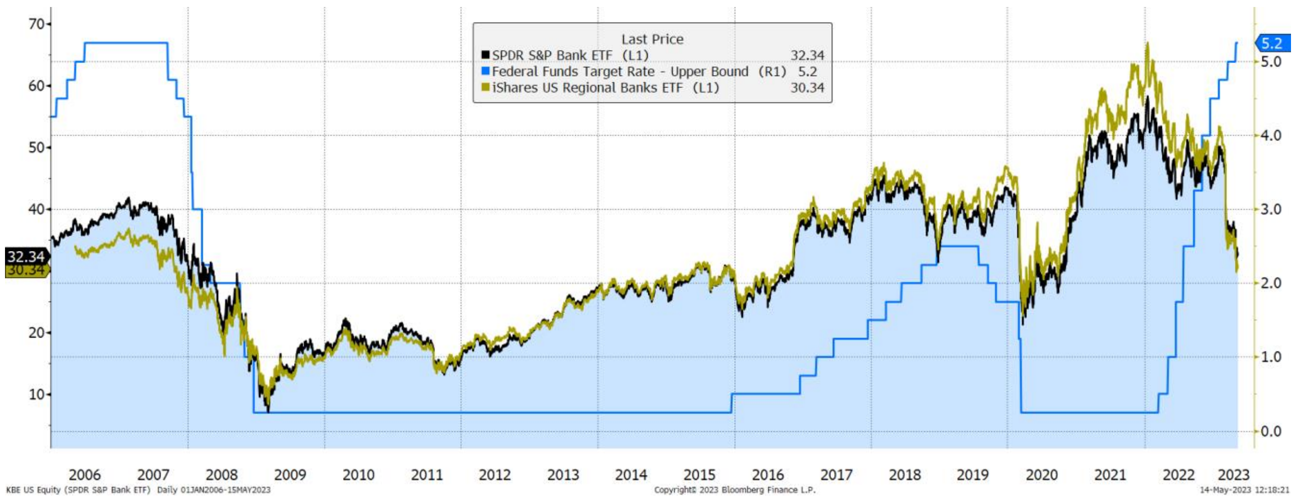
Many banks have large demand deposit bases and are finding themselves unable to pay anything near the current Fed rate. Depositors have thus moved their funds to money market and other institutions paying a higher yield, which has in turn required the banks to sell their longer duration holdings. In a large number of cases, these are very much under water, following the massive ramp up in rates and yields.

This in turn caused depositors to question the stability of the banks, causing further flight of deposits. To date it is one of the worst banking crises the US has suffered in many decades, similar in scale to 2008.



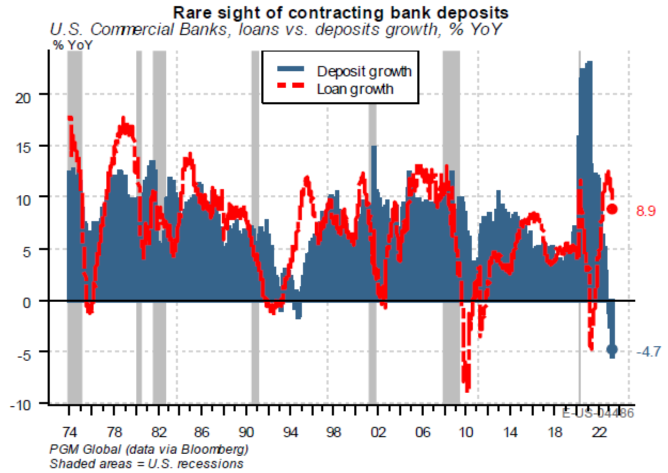
The US regional Bank index is already down some 50% off its highs and may have further to fall.

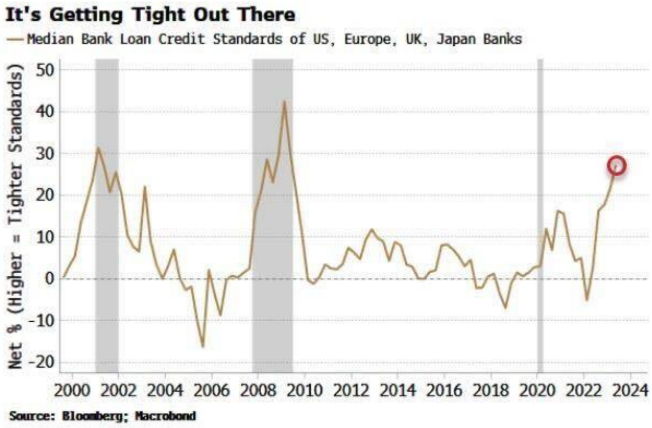
US Regional Bank indices are down significantly



A weak banking sector equates to a tighter credit market as banks look to curtail risk. So, we can expect weaker loan growth, which the chart below highlights relative to the historical trends.

Tighter credit standards, weaker loan growth and a weak banking sector all equate to weaker economic growth, and we expect will bring forward, or worsen, the expected slowdown.





SMEs in the US are very reliant on the smaller/mid-sized banks for loans, and it's the SME's which play a key employment role. Employment data is likely to weaken as we move into the tail end of the year.

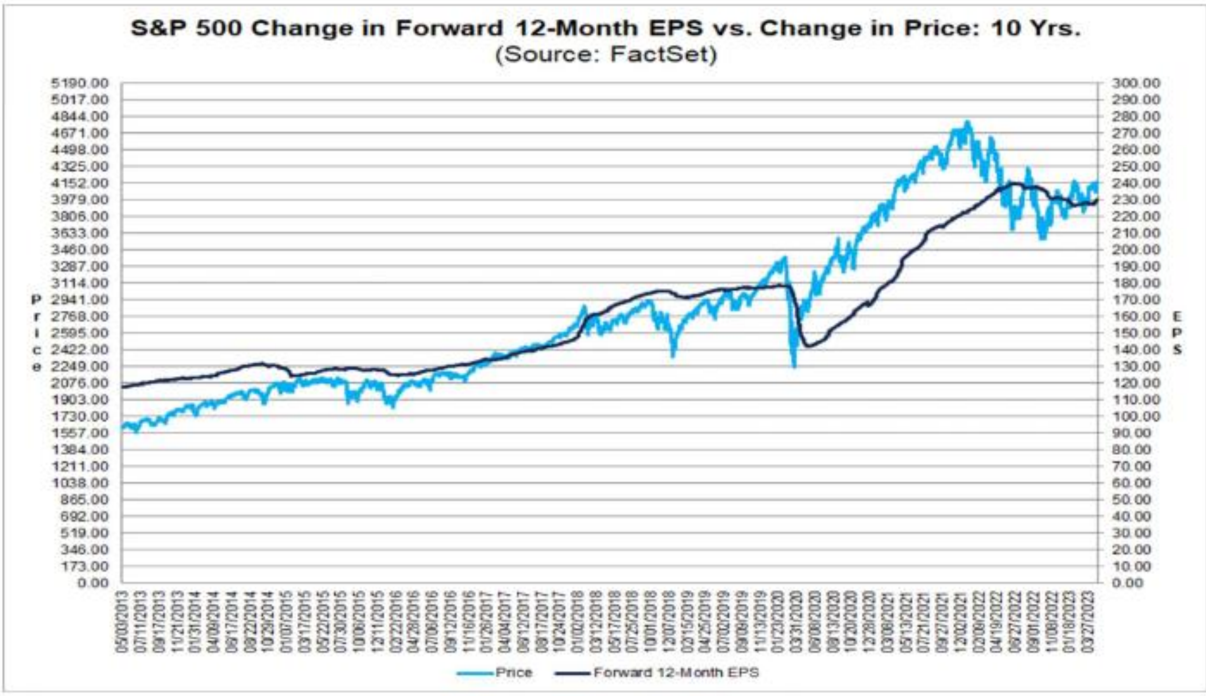
Already even the large profitable companies like Meta have been cutting staff. Meta has cut 25% of its workforce in the last few quarters. Many other tech companies, such Microsoft, IBM, Intel, Twitter and many more, have also been cutting back.

All of which gives us a lot of confidence in our positive outlook for fixed income over the next 6 to 12 months.

Similarly, near term we remain underweight equities across our strategies.

With economic growth declining, we expect earnings will come in a lot weaker than the market is currently anticipating. As we note earlier in this piece, earnings are already contracting. The consensus though is for 5% growth in earnings in 2024, but with all we mentioned above and margins that are likely to come in much lower, we expect consensus will need to come off significantly.

Druckenmiller, a well-known investment guru, is looking for anything up to a 20% contraction in earnings over the next year or two. Anything in that region would result in a much lower equity market in the US. Furthermore, the market is hardly cheap, with companies like Microsoft trading at 32x earnings.



In summary, we would argue that it is still best to remain cautious on global equities. There is still a lot of froth in the market, especially the US. Less so China, a market we like but temper our exposure to, as the regulatory and political outlook is still questionable.

We do though expect any sell-off to be shallower than 2000 or 2008.

Not only is it one of the most flagged slowdowns in recent history, with most commentators being cautious, but in prior slowdowns the Fed had to go through a long-winded process to provide quantitative easing and thus liquidity to the market.

This time round we expect it will be far more aggressive to do so. Particularly due to the banking industry likely being at the epicenter of the slowdown, being impacted by higher rates and the threat of deposit runs.

Holding high quality fixed income, through a period of weaker economic growth and earnings and falling rates, and then shifting into equities once market valuations better reflect the environment, makes a lot of sense to us at this time.

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