

# Macro and Market Outlook

2023 OUTLOOK  
2H REVIEW

August 2023



## MACRO OUTLOOK

### Economic data: To weaken further.

- Data indicates that the USA economy is weakening and may enter a mild recession in late 2023, early 2024. Other Western economies similar or worse.

### Inflation: Path is for lower inflation in 2H 2023

- Driven by slower economy.

### Company Earnings

- Continue to expect them to come in below current consensus.

## MARKET OUTLOOK

### Equities: Remain Defensive

**2H:** Still expect equities to price in weaker macro and earnings.

- Defensive positioning; Overweight Cash and Healthcare.
- Underweight highly indebted companies and those sensitive to economic slowdown.

**Late 2H23-1H24:** Likely a good time to be positioned for recovery and a boom in gov spending.

- Look to rotate out of cash and defensive areas into higher beta areas.

### Sukuk: Overweight in 1H23 and into 2H23

- Yields to decline into late 2023 as slowdown priced in.
- Yields at 10yr+ highs.
- A 6-12 month trade.

### FX & Precious Metals: USD may make another leg up.

- USD 'flight to safety' currency.
- Cautious on PM for moment, but expect outperformance on eventual USD weakness, likely 2H23 or '24.
- BRIC+ currency is a longer term but real threat to the USD.

### Venture Capital and Private Equity: 2H23 and 1H24 may offer excellent distressed opportunities.

- Investors need to ensure that deals are attractively priced for the current environment.

### Real Estate: Still needs to correct further for impact of higher rates/yields and weaker economy.

- May offer good entry point in 2H23, as economic slowdown gets priced in.

## KEY THEMES

### Fiscal repression will in time keep inflation higher for longer, driven by:

- Climate Change Policies.
- 'Build Back Better at Home' capex programs.
- Universal basic Income programs.

## EXECUTIVE SUMMARY

Our outlook coming into the year was largely spot on. We got the direction of inflation and rates right. We got the general direction of economic growth right. We got the direction of earnings right. The list goes on.

So, what didn't work? Well, at least at the time of writing, we had not anticipated that equities would rally as they have. Coming into '23, we had expected equities to be flat to lower by 2H23, driven by slowing economic data and weaker earnings being priced in. This, unfortunately for us given our defensive positioning, did not play out, with many equity markets up strongly YTD.

While earnings have decelerated massively, liquidity from Japan and China and from prior stimulus programs, such as the Inflation Reduction Act, as well as the hype around AI, drove a small group of large cap tech stocks to rally, dragging the rest of the market with them.

META, NVIDIA, Apple and Tesla have all rallied c.100%+ off their October lows of last year. Strip these names out though and returns are more mediocre. The Dow Jones for example is only up c.6% YTD (as of 9 Aug), dividend yielders such as S&P Global Dividends index is flat to down and the defensive US Consumer Staples sector is up only low single digit on a total return basis. So hardly anything to shout about.

**The equity market is increasingly pricing in a soft landing or 'no landing' at all**, with the expectation that the Fed and other central banks will pivot rapidly, before any real damage to the economy occurs. Similarly, many economies have also proven to be less interest rate sensitive than expected.

**We expect this favourable outlook will change as we move closer to '24.** Indeed, the less sensitive economies appear to be to high short-term rates, the higher these rates are likely to be pushed, eventually causing a far greater negative impact on the economy.

**We continue to expect the 2H23 to be a period of 'risk off'.** Eventually market fundamentals and valuations do matter, as they always have, and the period of dislocation will close. By late '23 analysts will have gone through revising their earnings expectations for the 1H'24, which we expect will be much lower than current consensus.

**The real estate market, both commercial and residential, is likely to come under pressure towards year end in many of the key economies including the US, UK and EU.** Commercial real estate is suffering from high vacancy rates, with many businesses cutting their space requirements. While residential has held up well to-date, a significant percentage of mortgages in the UK will be reset at higher levels over the next 12 months. Overlay an increase in unemployment and it could be a perfect storm in parts of the real estate market.

**Fixed income has struggled in the rising rate environment.** The Fed is already at 5.5% and the probability of the Fed raising further to 5.75% has increased. The BOE is at 5% and is expected to also raise to 5.75-6%, given inflation in the UK is still c.8%. The ECB is expected to also raise rates further. As noted above, the higher rates move the greater is the risk of them, namely the central banks, 'breaking' something in the economy. We already saw the start of this with the small/mid-sized banks coming under pressure in March, which narrowly escaped a fully-fledged bank run.

**Our base expectation is for a slowdown ahead and to use it as a time to ADD to risk assets, such as equities, real estate and the like.**

## Review of the 1H23 and expectations for 2H23 and 2024

Looking back at the first half, we got a lot of calls right:

- **Economic data has indeed worsened** further and, while some commentators think we have exited the 'slowdown', we don't think we are there yet.
- **Inflation has, as expected, started coming off** across most economies and we expect will fall further. PPI across the US and EU, for example, has fallen significantly. The rental component of US CPI has only just started to fall off, so we expect this will be a major factor to drive US inflation lower.
- **Company earnings have been revised down** with earnings for the first two quarters being down c.6.7% and c.7% in Q1 and Q2 respectively, in the USA. We expect more downward revisions particularly for the fourth quarter and for 2024. Analyst consensus still points to a significant recovery in '24 with US corporate earnings growing by 10%. We expect this will need to be halved, driving up forward looking valuations.

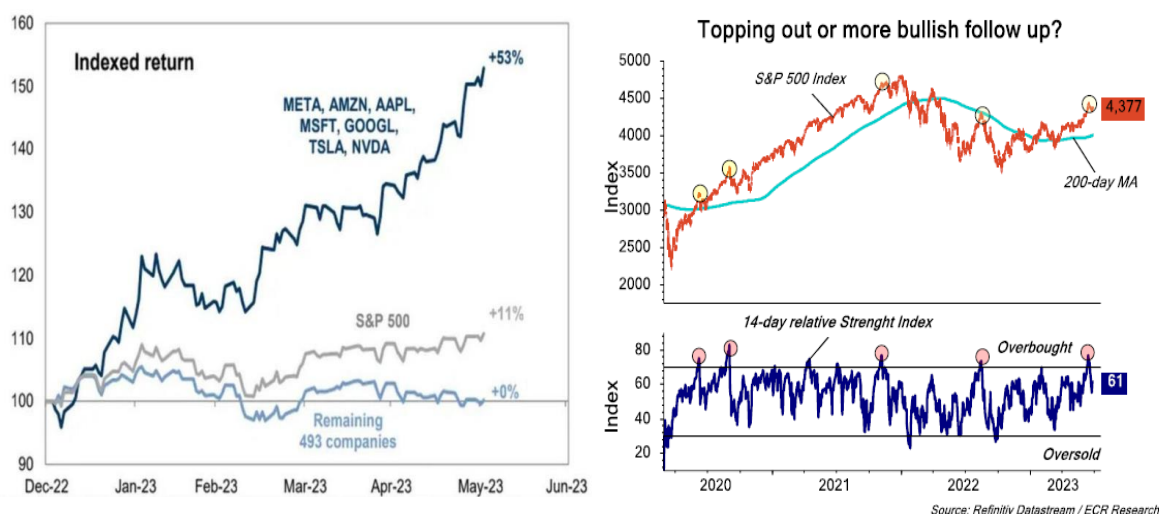
As we highlight in the summary above, what we didn't expect was a substantial rally, in what are largely already expensive stocks. The AI rally.

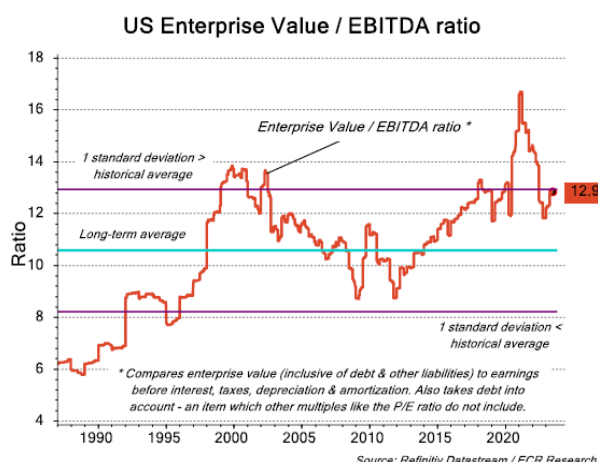
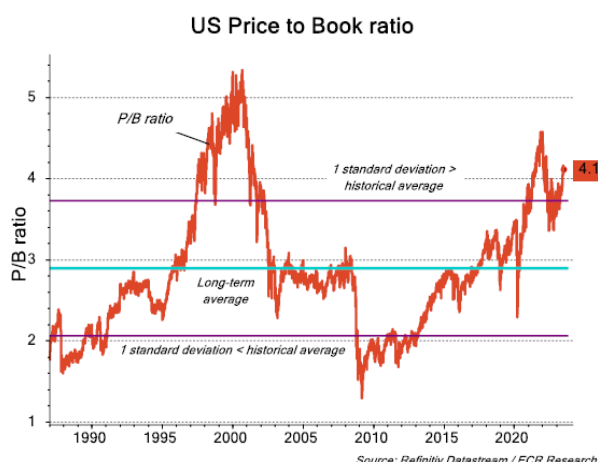
The rally though, was driven purely by multiple expansion and the expectation that AI will have dramatic impact on forward earnings for these companies.

Nvidia, for example, is now trading at some 40x sales. Tesla is trading at 9x. It's a similar story for all of the large capitalisation technology names that have rallied up – they are all expensive and on most metrics. Microsoft trades at 11x trailing sales. This compares with the S&P as whole which trades closer to 2.5x sales.

While many of these companies have a great business model the US Technology sector is expensive compared to history and earnings continue to come off, hardly something to chase.

The US Technology Sector and market overall is looking overbought and expensive:





**Economic Data:** is expected to remain weak with US growth declining to just 1% in 2024.

Compared to prior expectations from the IMF, GDP growth for the World and for Advanced economies for 2023 is slightly higher than prior forecasts (those of IMF, October '22), at 3% and 1.4% respectively, compared to 2.7% and 1.1% in their earlier forecasts.

Of note though, is that 2024 projections are lower than '23, with US GDP forecasted to fall to only 1%. There are some bright sparks though - China's growth is expected by the IMF to be 5.2% for 2023, compared to 3.2% in their prior forecast. But falling back to 4.5% in 2024.

Generally, growth forecasts are still very much below historical growth:

(Real GDP, annual percent change)	PROJECTIONS		
	2022	2023	2024
<b>World Output</b>	3.5	3.0	3.0
<b>Advanced Economies</b>	2.7	1.5	1.4
United States	2.1	1.8	1.0
Euro Area	3.5	0.9	1.5
Germany	1.8	-0.3	1.3
France	2.5	0.8	1.3
Italy	3.7	1.1	0.9
Spain	5.5	2.5	2.0
Japan	1.0	1.4	1.0
United Kingdom	4.1	0.4	1.0
Canada	3.4	1.7	1.4
Other Advanced Economies	2.7	2.0	2.3

Source: IMF

While economic data did weaken over 1H23, it surprised us and many other market followers that it wasn't worse given that rates in the US have reached 5.5%. A few factors can explain this:

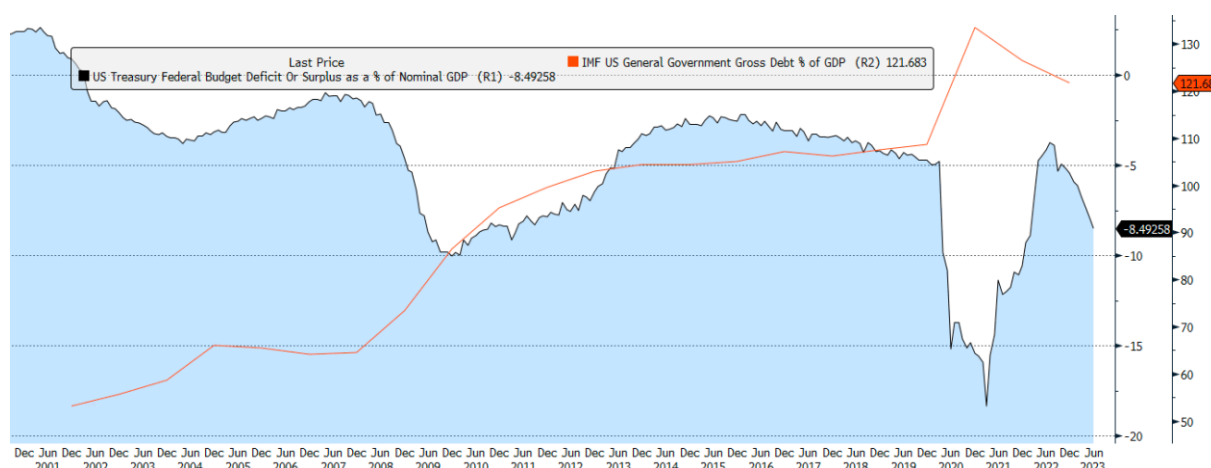
- There has been significant fiscal stimulus.
- Limited Quantitative tightening (QT)
- Many debtors, both residential and corporate, were able to refinance at lower rates just a few years earlier.
- Excess savings built up following the covid stimulus.

### Fiscal stimulus has remained incredibly supportive.

The US government increased its fiscal stimulus, with Acts such as the “Inflation Reduction Act”, which pushed hundreds of billion into the economy. They also took significant measures to protect the banking sector in March.

As the charts above highlight, the US Government spending is still way above pre-covid levels – hence mitigating some of the impact of higher rates and making the Fed’s job of reducing inflation that much harder.

US Government debt increased massively during '20 (now over 120%) and the budget deficit continues to expand at -8%:

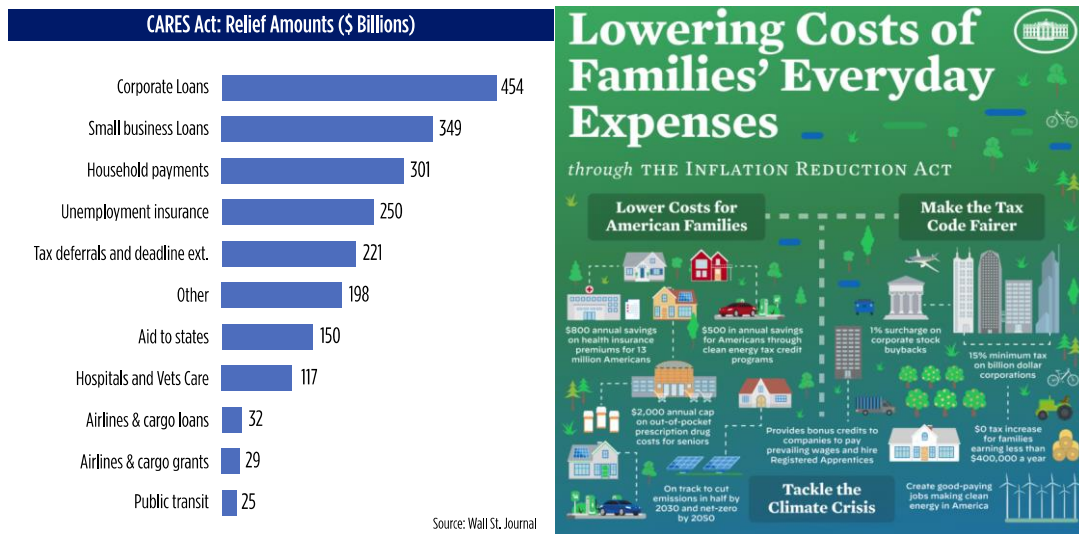


In our Outlook '23 at the start of the year, we did raise the view that the government would take matters into their own hands and drive 'inflation higher for longer' via policies related to climate change and build back better at home policies.

We had expected though, for these policies to be implemented during the next slowdown, NOT as a measure to fight inflation. The Inflation Reduction Act put close to a trillion into the economy, in part to assist consumers with higher prices.



It started with CARES (2Trl+), then Inflation Protection (c1Trl). Next up will be 'Build Back Better at Home' and Climate Change Mitigation policies?:

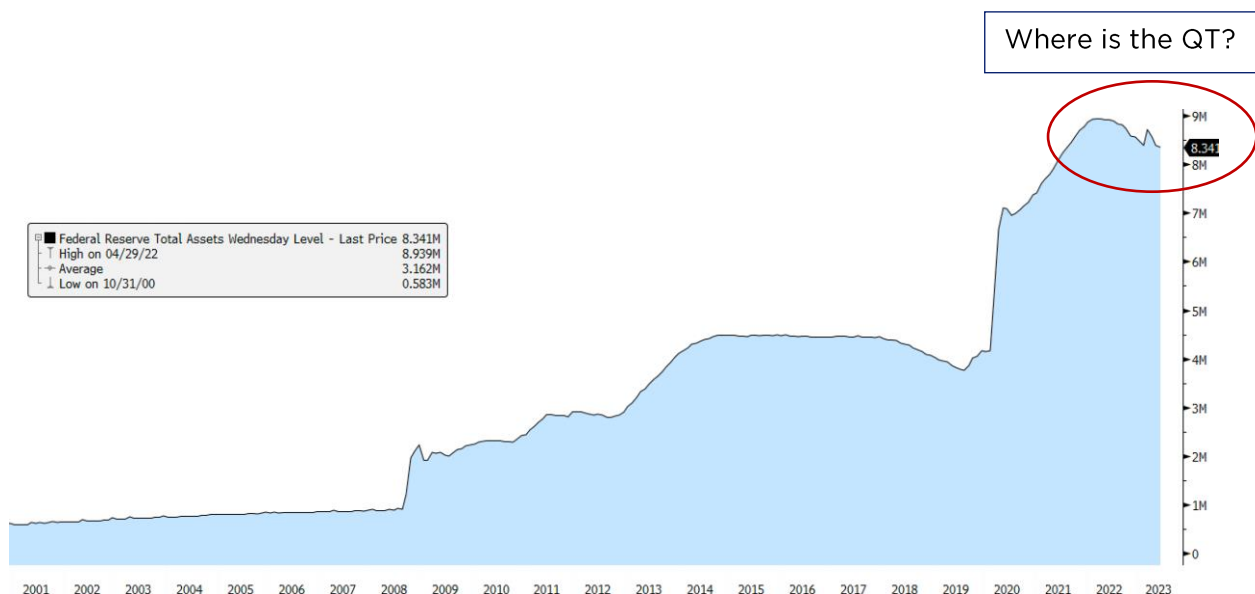


### Quantitative Tightening has been limited.

Not only has there been significant fiscal stimulus, which has made the job of the Fed that much harder to reduce inflation, but the amount of quantitative tightening has been extremely limited. Furthermore, much of the 'tightening' was reversed during the recent banking crisis in March '23.

Had the Fed or the US Government been serious about cutting inflation they would have done a lot more Quantitative Tightening (QT) and been more fiscally prudent.

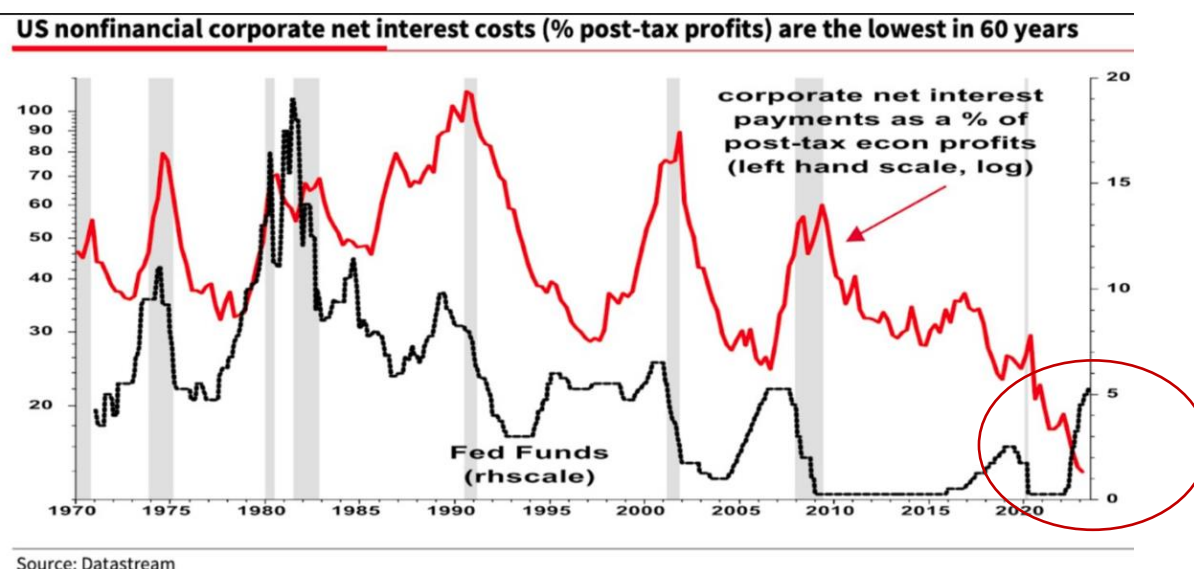
So far, the Fed's Quantitative Tightening (QT) has been limited and the total assets held by the Fed are close to usd9trl:



**Borrowers have been able to refinance at much lower rates just a few years earlier, limiting the impact of higher rates....at least for the moment.**

Debtors, whether corporates or mortgage bond holders, were able to refinance at much lower rates just a few years back. If the maturity of this debt is a few years out, they are insulated from rising rates, at least until the debt/loan matures and needs to be refinanced at potentially much higher rates.

Only a few years back companies such as Microsoft and Apple were able to issue 50yr paper at yields far below current levels. Not only have these corporates been able to 'lock in' low yield, but the cash they have is often held in deposit and thus benefits from current high rates.



The chart above is a perfect example of this phenomena as it shows that the net interest cost for US companies has declined, even while rates are reaching decade highs.

But this is perhaps just a short to medium-term phenomenon as over time an increasing number of borrowers will need to roll their debt over at higher rates. Furthermore, the higher rates reduce the desirability of raising new capital to finance capex or acquisitions, so will slow potential growth.

In the case of mortgage holders, they have also been able to refinance at much lower rates than current, just a few years ago. As such, they are also insulated from higher rates, at least until the mortgages roll over. Mortgages in the US are relatively long maturity, often based on the 30yr.

Indeed, the strength is the US residential market has surprised us, with prices moving higher in the last few months being driven by what is described as a structural housing deficit of some 1.5 million units due to the underbuilding in the prior decade (NAHB Jan '23). The strength of the US housing market though, will be overly sensitive to any drop off in employment as, should unemployment pick up, mortgage holders may get forced to sell, putting further pressure on the economy.

An area that has been very weak, is the commercial real estate market in the US. Some USD 1.5trillion in mortgages will come due in the next two years, a potential 'time bomb' as higher interest rates and spiraling office vacancies push down property values. Some 70% of commercial mortgages sit on the balance sheet of regional and smaller banks, so any write



downs may put pressure on the financial system. Certainly, it will tighten credit conditions, impeding growth towards year end and into early 2024.

As the loans mature, they will need to be refinanced at much higher rates. The higher interest cost will crowd out other expenditure and investment.

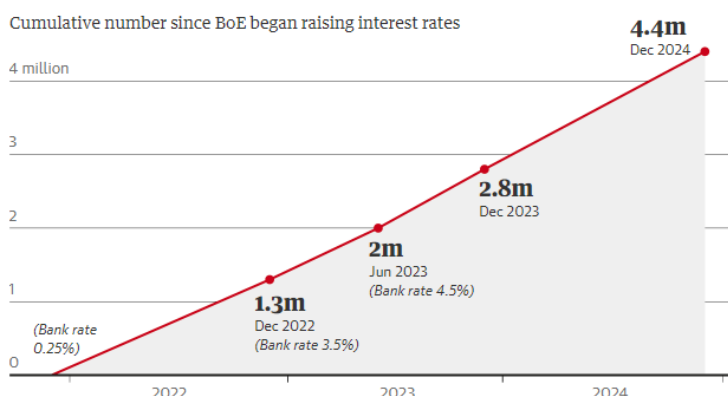
While the US residential mortgage market may be somewhat insulated from higher rates, this is not the case in the UK or Australia, where mortgages tend to be shorter term.

In the UK, for example, the bulk of mortgages are variable or fixed with a term of less than 2 years. Many of these mortgages will be renewed at vastly higher rates over the next 12 months or so.

According to the figures from UK Finance, about 800,000 fixed mortgages will expire before the end of this year, with a further 1.6m coming to an end in 2024.

The figures do not include variable rate and tracker mortgages, which will already have risen sharply, or buy-to-let mortgages.

### Mortgage timebomb: Millions will have exited fixed-rate deals before the next election

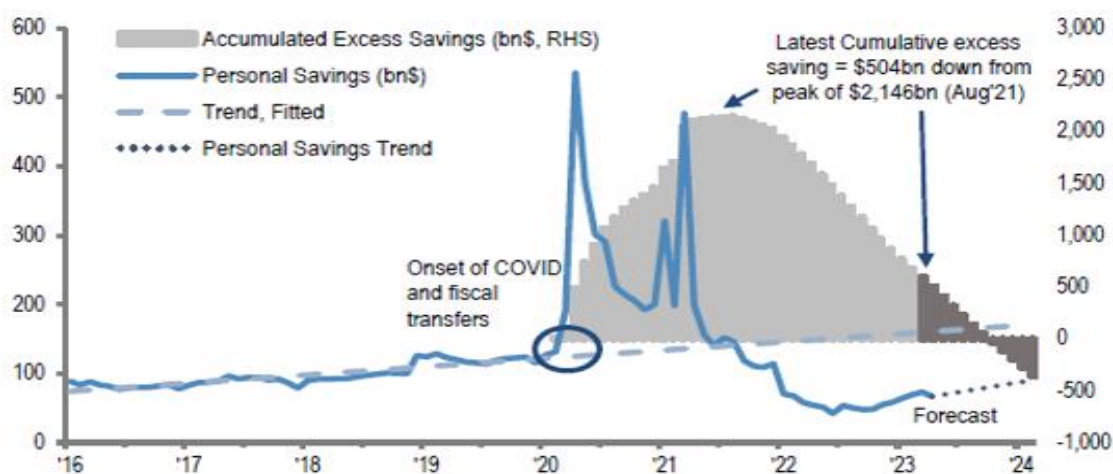


Source: Bank of England, UK Finance. Note: number of fixed-rate homeowner mortgages expiring by year, cumulative since January 2022

In the UK a total of up to 4.4 million homeowners are expected to exit fixed deals between the start of the Bank's rate-hiking cycle and the end of 2024. Renters are also being squeezed, as landlords pass on higher costs by pushing up rents at some of the fastest rates on record.

### Excess savings built up following the covid stimulus...but these are now running down.

As the chart below depicts, there was a massive ramp up in savings due to the covid stimulus. These have given support to the economy and the housing market, but these are likely, according to JP Morgan and others, to run out towards the end of '23.



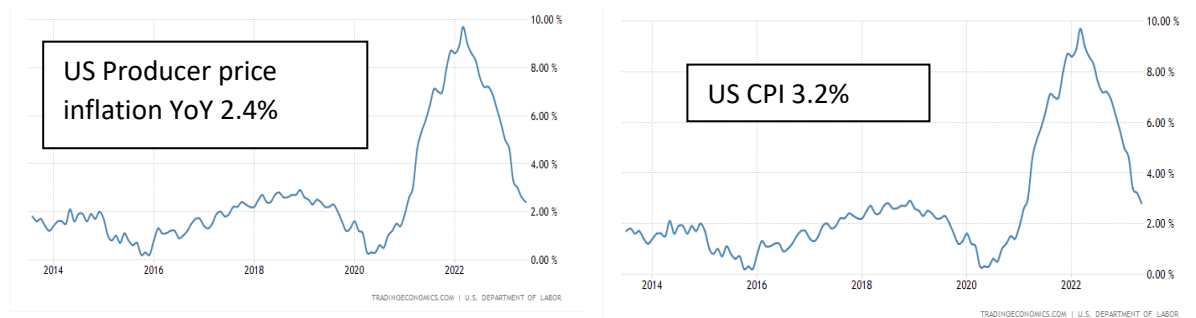
Source: J.P. Morgan Equity Macro Research.

## Inflation: Inflation is on the retreat.

Regardless of the limited measures we consider have been taken to slow economic growth in many countries, inflation is now very much on the decline. US CPI is already down to 3% and we expect will further decline as we move towards year end.

Indeed, PPI has fallen dramatically and is now negative in several markets. We see this as a precursor of lower inflation.

**US PPI and Inflation has fallen off significantly:**



Not only has the YoY inflation rate fallen off in the US, but so have longer term expectations.

The 10yr breakeven inflation (the difference between the 10yr Treasury Bond and the Treasury Inflation Protected Securities or TIPS) has been trending down, an indication that inflation is expected to decline over the longer term.

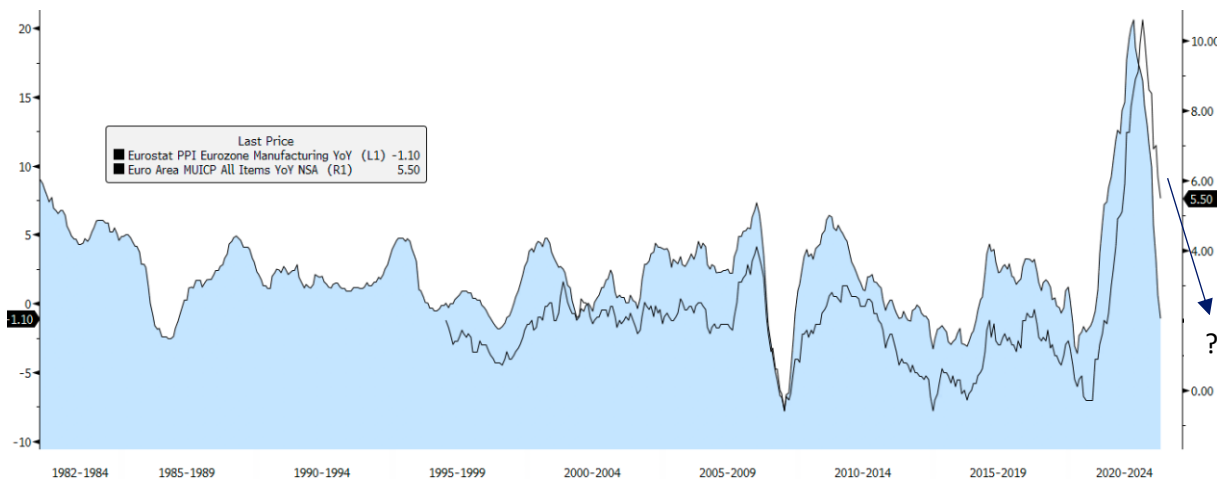
**10yr breakeven inflation down to 2.4% and we expect will fall further:**



While the direction is down, there may be some near-term volatility in the inflation data due to base effects and also higher energy prices. We see these as shorter-term influences, and, while the market may start to price in higher inflation and hence higher rates for longer, we expect economic growth is likely to continue to weaken, resulting in inflation falling further.

It's a similar story in the EU, where inflation has also been trading lower. In fact, PPI for Europe has now fallen into negative territory, so CPI is likely to fall rapidly. This will put less pressure on the ECB to continue raising rates.

In Europe PPI has fallen to -1.1% and is expected to drag CPI lower into 2H23:



The ECB has been slow to raise rates and we expect they have further to go. The Fed may do one more 25bps raise to 5.75%, should the next inflation read showing an increase. But we anticipate there is little need for them to do further, especially if the economy weakens more than the market currently anticipates.

## MACRO OUTLOOK

**USA:** With inflation falling off, and stronger equity markets, there is increasing support of the view that we have already exited a slowdown that there won't be 'any landing'. The Goldilocks scenario.

Under this scenario, inflation could cool to central bank targets, allowing them to pivot aggressively without triggering a recession. This certainly would be a best-case scenario.

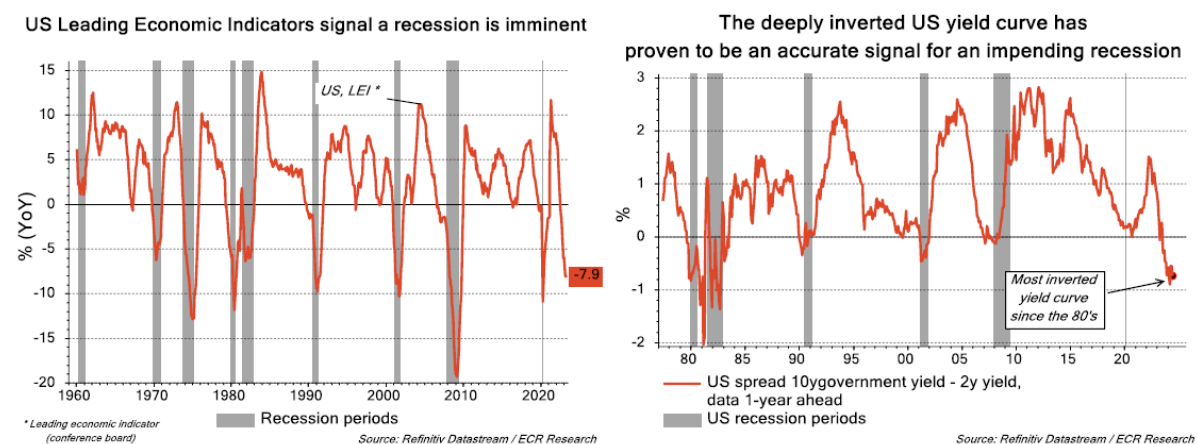
Under this 'goldilocks' scenario, risk assets would be well supported.

We assign a modest probability of this, <30%, being more cautiously disposed and expecting it more likely that, while the Fed will pivot, it will be done because of something 'breaking' in the economy.

**The yield curve inversion supports the thesis of a slowdown ahead.**

Yield curve inversion is historically an excellent indicator of slowdown ahead. It has close to a 100% success rate of forecasting recession ahead. It refers to when the short end of the curve, which central banks control with rate policy, is higher than longer dated paper. This is a reflection that the bond market expects inflation, and thus rates, to fall off.

Long duration bond yields usually peak towards the end of a rate hike cycle and can go very inverted, if the bond market expects the central bank has tightened excessively and that rates and yields will fall lower in the future.



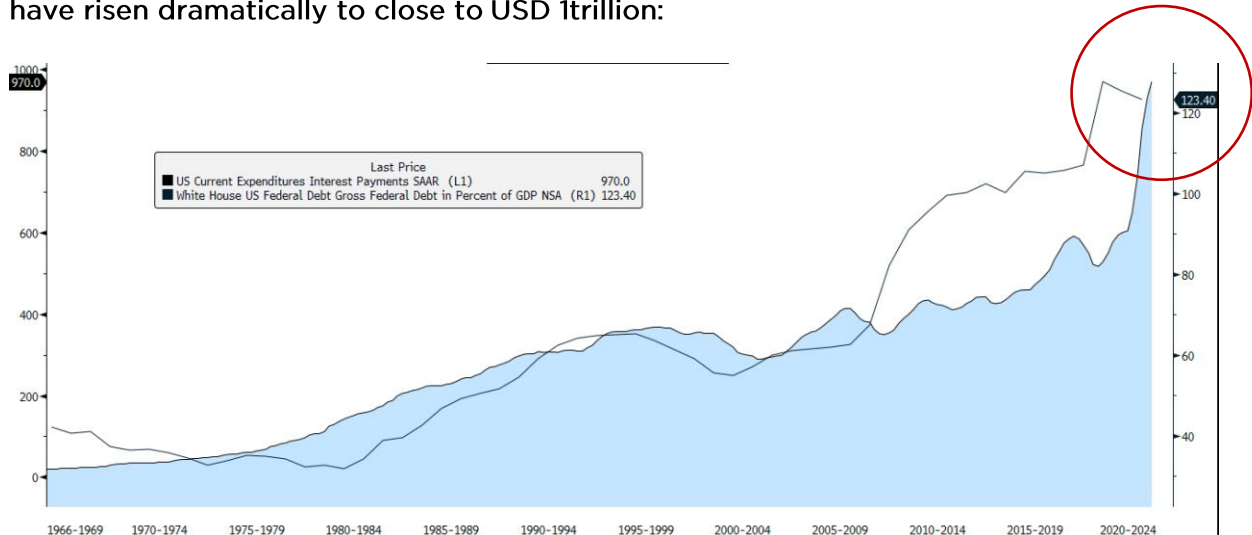
As we note above, the corporate sector has to date been relatively well insulated from the higher rates as they had refinanced at much lower rates. So, the full impact of the higher rates may only be felt further out, as and when they need to roll them over or raise new capital.

The level of government debt though is extremely high, and the impact of higher rates is being seen here very clearly, with interest costs rising precipitously. We use the US as a good example of this, but it is a similar story in many other Western markets.

The growth in government debt we have seen over the past few years has been enormous and it has resulted in a few issues:

- a) it has facilitated the growth of the government rather than the private sector,
- b) resulting in the inefficient allocation of capital and for
- c) interest costs to have risen dramatically.

**US Government debt is over 120% and, with rates/yields higher debt, servicing costs have risen dramatically to close to USD 1trillion:**



The higher interest burden is a headwind to growth.

For starters, it makes saving more appealing. Especially the case when there is uncertainty around the economic outlook. So, capital shifts towards holding cash or short-term fixed income instruments.

Also, high or excessive levels of debt can be highly deflationary.

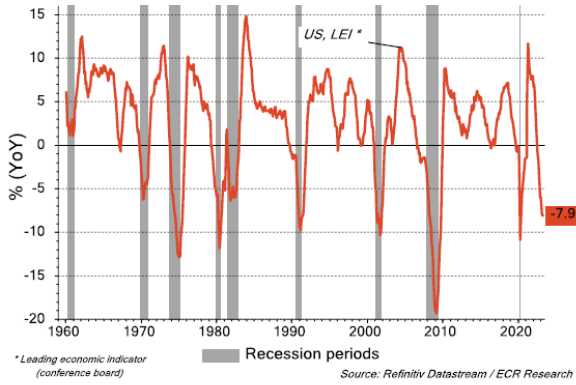
While debt can be used to supercharge an economy, there is a point where it becomes a headwind to the economy as its impact wanes and interest payments need to be made. Higher interest payments are a significant headwind for economic growth as they eat into the capital that could otherwise be used for investment and to stimulate growth. Worst case is when an economy runs a deficit simply to fund the interest, and we are not too far from that already in the US. Hence, why economies like Japan use fiscal repression.... more of that later in the piece.

## Other leading indicators suggest a slowdown is imminent in the USA.

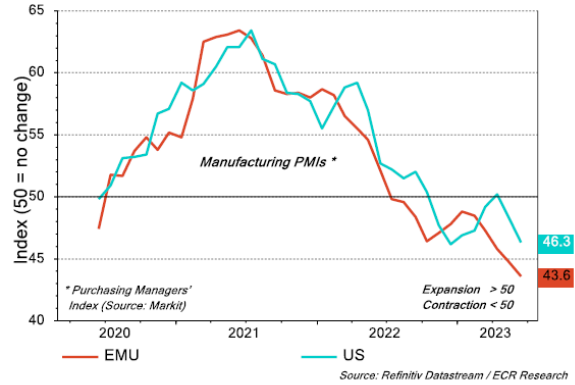
Leading indicators in the US have collapsed, as they have in many other markets, and bank's have increased lending standards, slowing the supply of credit to the market.



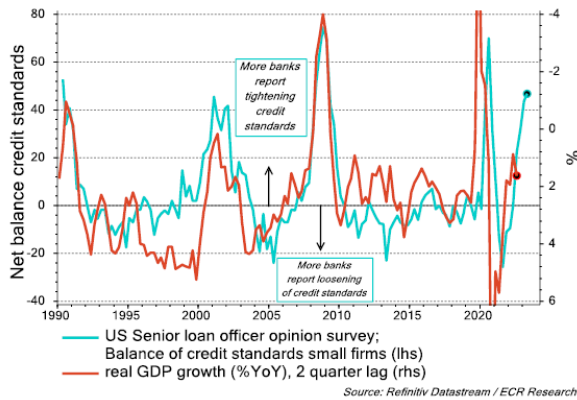
US Leading Economic Indicators signal a recession is imminent



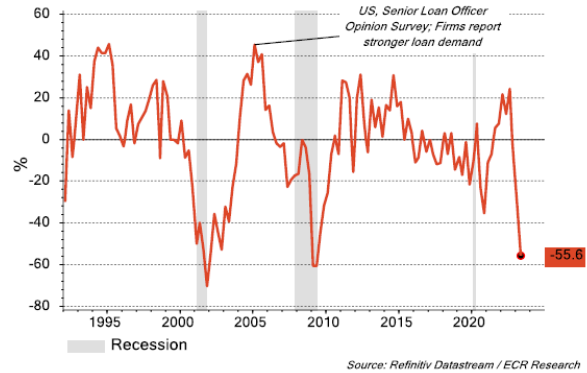
Manufacturing sector in the US & EMU is still struggling



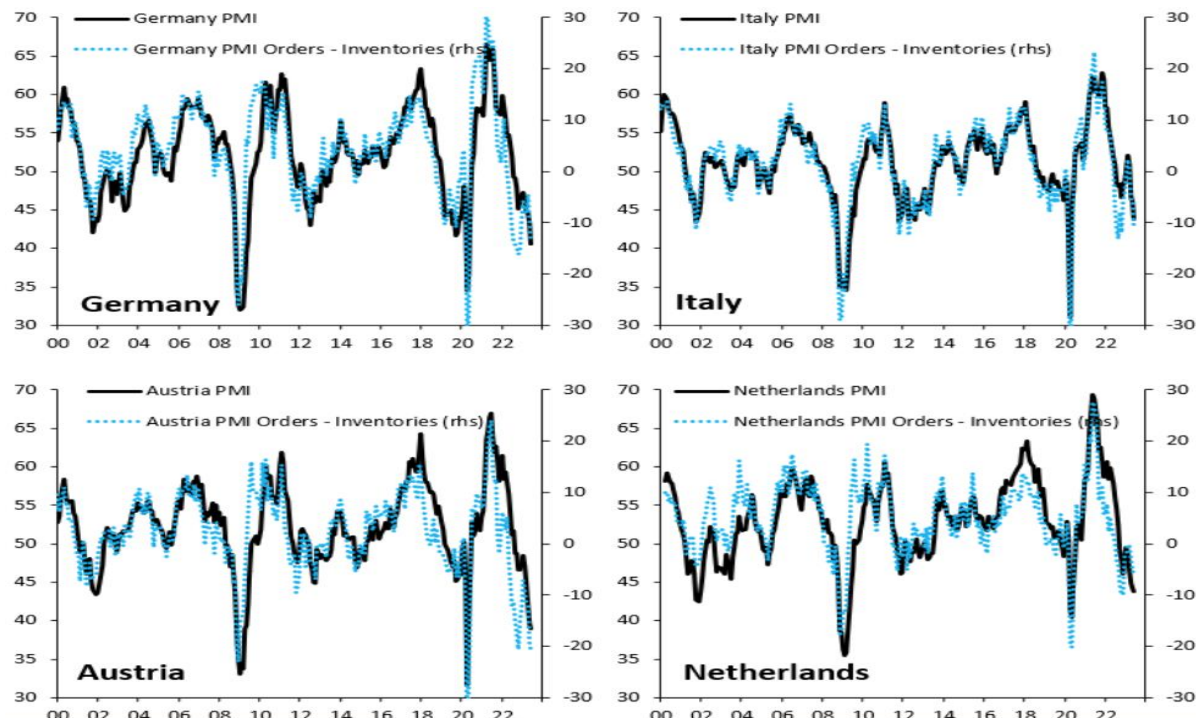
As are tighter lending standards by banks ..



.. and the drop in demand for loan, which could push western economies into recession



It's a similar story in Europe where many of the leading indicators such as PMI are still very weak:



The US, UK and the EU are in late cycle tightening mode. Rates are peaking, growth is slowing, inflation is falling.

**Japan and China though are in a different part of the cycle.**

Japan and China are slowly exiting a period of slow growth and do not have the same inflationary pressures as seen across much of the West.

They are not without their issues though, but are at least in the process of recovery, particularly in the case of China.

**China** has been an amazing success story over the past few decades.

With a per capita GDP of c.USD12,000, up from only c.USD1,000 back in 2000, it is now the world's second largest economy. GDP is c.18trl, behind the USA with c.USD25trl. To get there though, an enormous amount of debt has been used.

China's total debt has already reached the levels seen in the West. **Total debt, government debt as well as corporate and Household, is now close to 300% of GDP.**

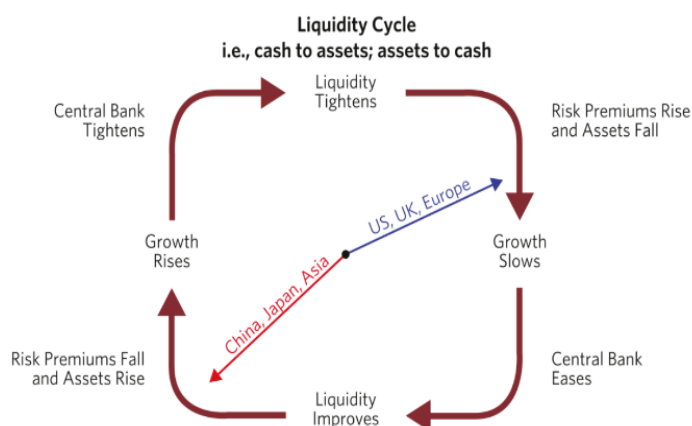
In China, the bulk of government debt is held in state Owned Enterprises (SOEs).

The country though, has a closed capital account and residents can only transfer a limited amount to foreign bank accounts. Hence, local investors have invested locally and are massively exposed to the local property sector.

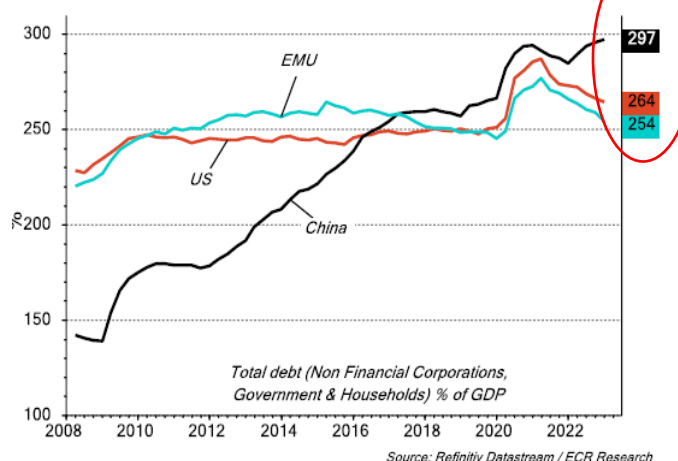
The property market has been a major driver of growth – both in terms of direct employment and demand, but also in terms of driving the wealth effect. As prices moved higher, owners felt richer and spent an increasing amount of earnings, with less requirement to save.

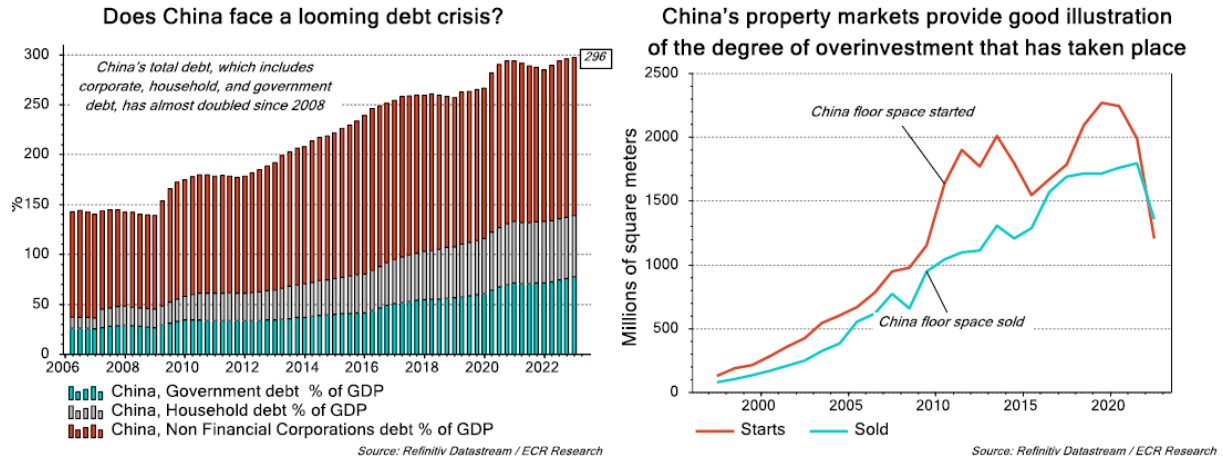
As a result of cheap financing and the closed economy, there has been massive overinvestment in real estate. However, with overbuilding and the fragility in the economy, prices have come under pressure and with this there is the **potential of a debt crisis.**

**The potential is certainly there but we expect the government will continue to 'kick the can down the road' and manage this issue through support measures.**



**Chinese debt has risen to 'western' levels, limiting the Chinese ability to stimulate growth effectively**

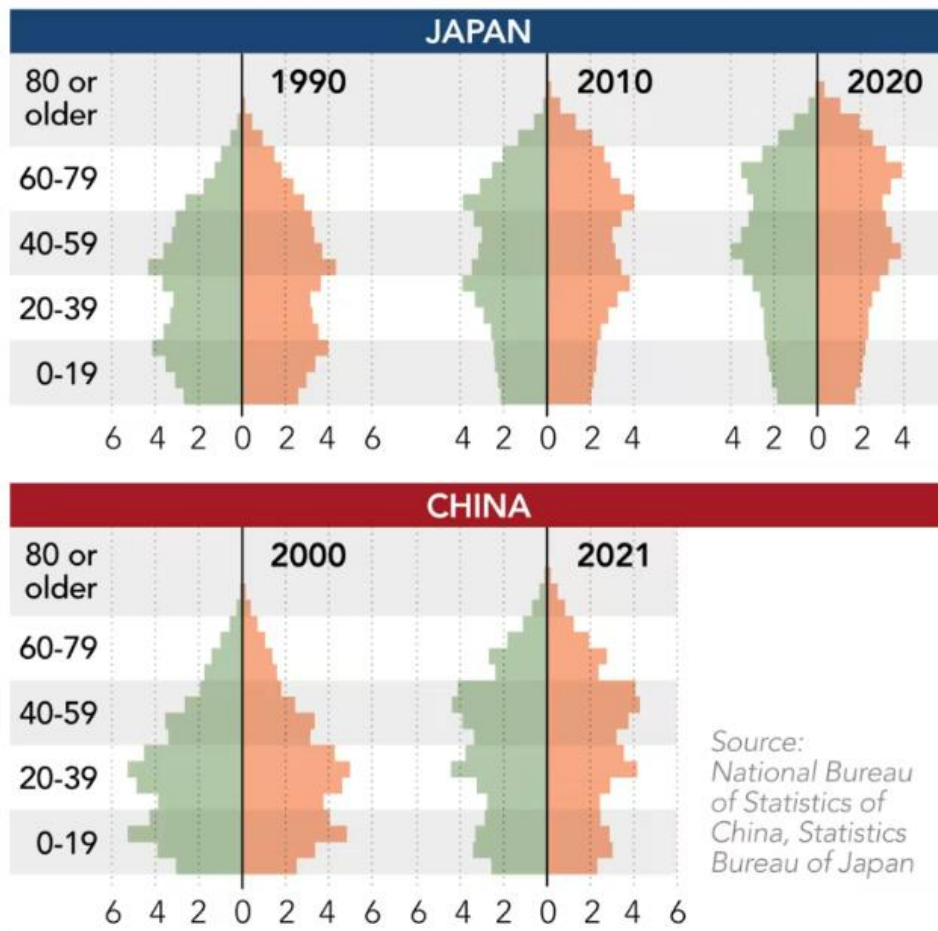




Not only is the working population over-exposed to real estate, but it is aging rapidly and is quickly following Japan's demographics, that of a shrinking workforce.

This is deflationary and impacts fiscal spending through a smaller base to fund social security and taxes.

To some extent the use of robotics can mediate the smaller workforce, but it creates stresses on covering items such as social security or national healthcare, as the size of the working population decreases, whilst the older population expands.

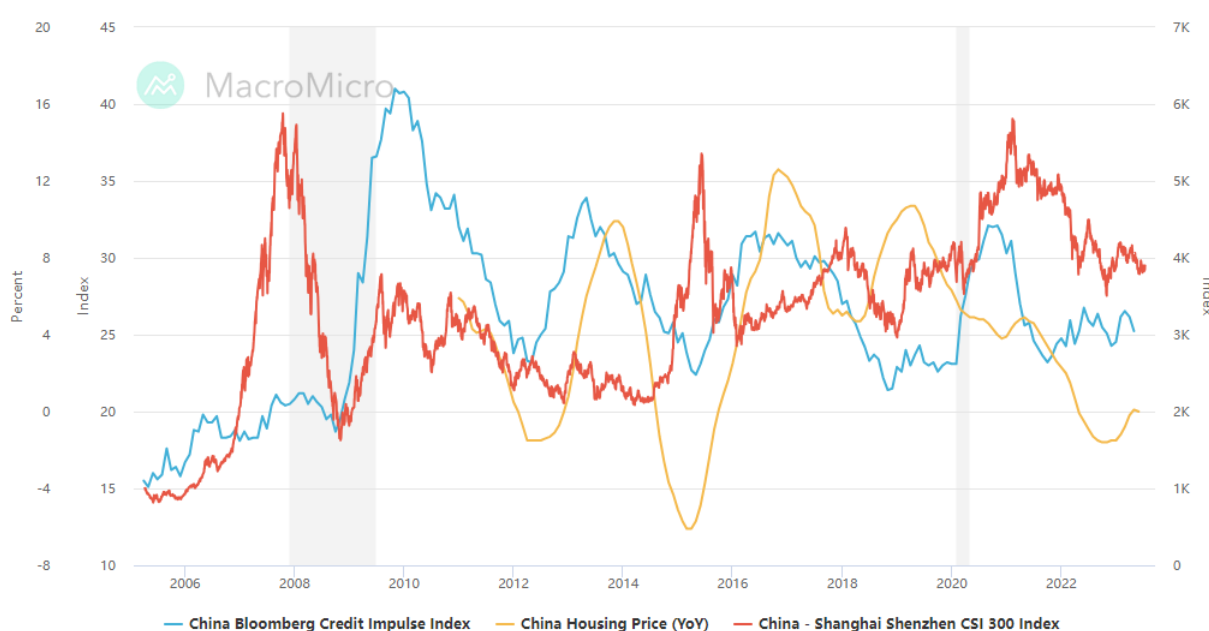


On the longer term, the government needs to implement structural reforms to increase domestic consumption, through the promotion of privately owned business and a shift away from state control. They will also need to do away with FX controls and open the economy more.

Current weakness in China's economy is reflected in their low inflation print of 0% (zero), so the government and People's Bank of China (PBOC) are on the other side of the tightening cycle and are able to provide stimulus. Indeed, they must in order to avoid a deepening bust.

The government has implemented measures to stimulate the economy, but these have been relatively targeted as they wish to avoid reinflating the property market bubble which they have successfully deflated.

**China's Credit Impulse has weakened, and more stimulus is likely required:**



So far though, the results to date have been less than spectacular. Indeed, the credit impulse has already declined, and the housing index is still extremely weak, though showing signs of stabilizing and improving.

We would expect them to come in with more stimulus, especially if the West suffers from a slowdown.

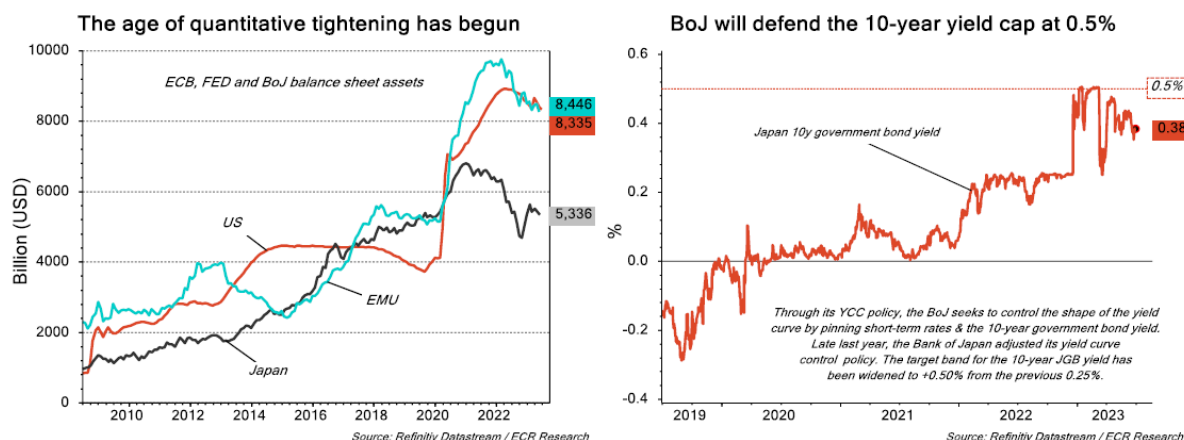
**With Chinese authorities easing monetary policy to stimulate the local economy, there will be some leakage of stimulus into other markets.**

### Japan – another driver of global liquidity

Japan, like China, is another market that is able, through financial repression, to be in stimulative mode rather than tightening.

Japan's inflation is over 3%. And yet the BoJ's interest rate and the yield across JGBs is well below that, with the 10yr capped at c.50-75bps.

This is a very good example of financial repression, whereby the central bank and government are either the buyers of last resort, if not the only buyers, or use their influence to force local institutions to buy government bonds.



By keeping yields so low though, capital will exit the market and look for higher returns elsewhere.

This is in part positive for liquidity supply in the West and, we believe, is one of the reasons why asset prices have, on balance, performed well over the 1H23, despite the Fed and other central banks tightening.

## Macro Summary

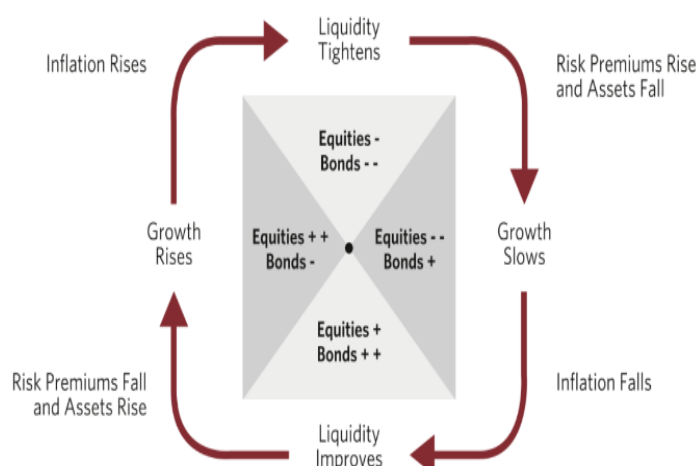
- The economies of US, UK and Europe continue to slow, and all leading indicators show a slowdown ahead.
- Inflation remains high but is falling rapidly. The central banks remain in tightening mode, but the Fed is closer to end of cycle than the UK or ECB.
- In Japan and China, inflation is less of an issue and the central banks and governments here are in the early stages of easing.
  - Macro-outlook is slightly better in economies such as China, which is coming out of a slowdown, with GDP growth there forecast by the IMF to be 4.5% in 2024.
  - Both the major economies of China and Japan are still relatively weak so we should expect that liquidity from these large economies will be increased.
  - This liquidity is likely to continue finding its way into Western markets.



## MARKET VALUATION AND VIEW

As we highlight in the prior sections, we believe that:

- **The West** (US, UK and EU) are entering a period of slower growth and, for a short period at least, tighter liquidity. **Generally bad for equities and good for bonds.**
- **Parts of Asia**, including Japan and China, on the other hand are coming out of a period of slower growth and are able to stimulate their economies. **Generally, good for equities and bad for bonds.**



We have though noted in this update that liquidity in one part of the world, can spill over into others. For this reason and given the expectation that Western central banks and governments will provide significant support to markets, we are not overly cautious on equities over the medium term.

We do though, take the view that consensus earnings – particularly in the US - need to be ratcheted down over the next few quarters.

### Company Earnings and valuations:

**US company results have been coming in ahead of consensus, but expectations for earnings in 2H23 and 2H24 may still need to be ratcheted down.**

So far, some 84% of S&P500 companies have reported Q2'23 results. **The blended year over year earnings decline is 5.2%.** 49 companies have issued negative earnings guidance for Q3 '23, while only 30 have issued positive guidance.

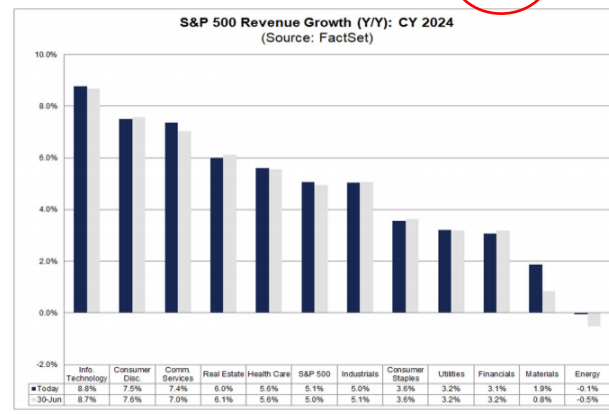
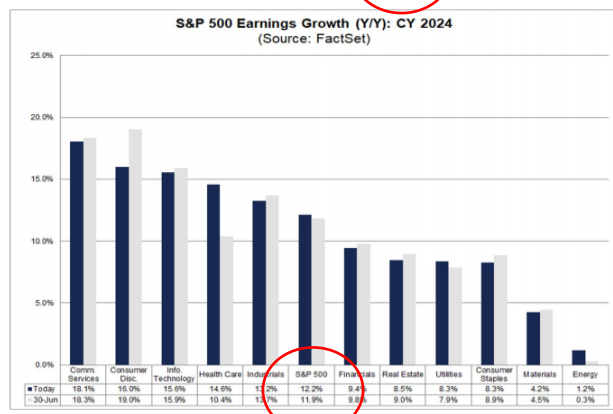
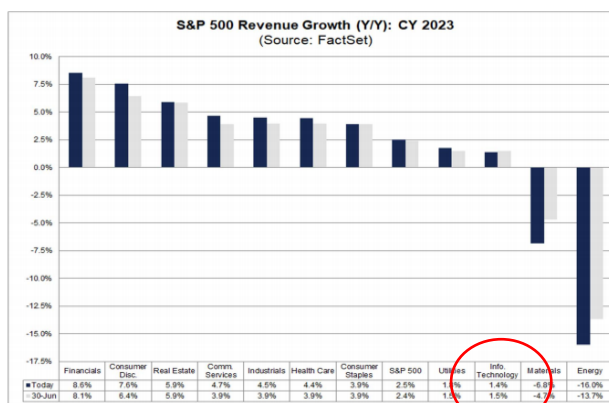
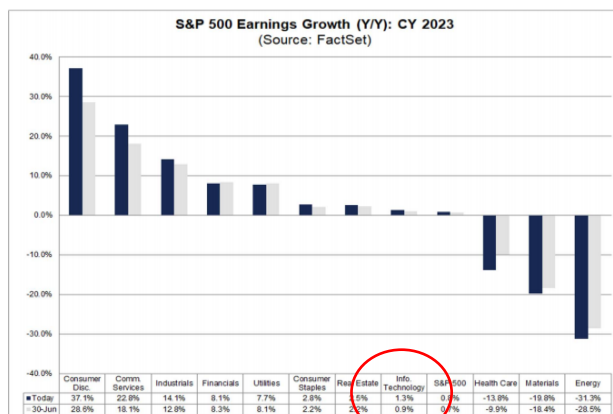
So, while market commentators highlight that earnings are ahead of expectations, they are still contracting and well down on earlier expectations at the start of the year.

Looking forward, analysts are expecting earnings growth for S&P 500 companies to pick up:

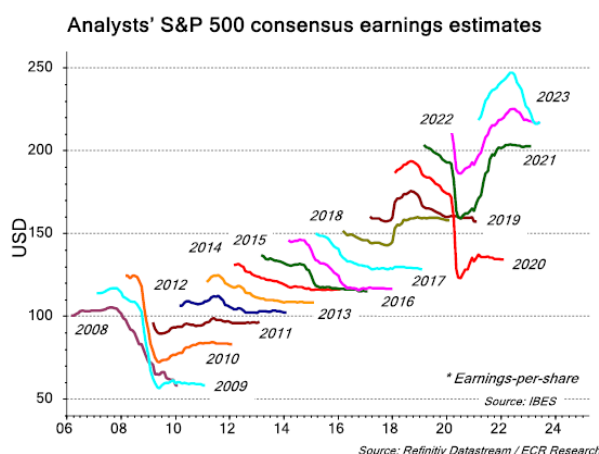
- For Q3'23 analysts are projecting earnings growth of 0.2%
- For Q4'23 analysts are projecting earnings growth of 7.6% and revenue growth of 3.4%.
- For CY 2024 analysts are expecting earnings growth of 12.2% and revenue growth of 5.1%

Of note in the tables below is that the best performing sector - Technology - had one of the slowest growth rates in 2023, with consensus earnings of 1.3% for the full year 2023. So, the performance we have seen in the YTD, with the NASDAQ up some 30%, has largely been multiple expansion.

We are of the opinion that the expectations for Q4 and for the 1H24 need to be reduced, on the basis of slower economic growth, weaker margins and higher cost of capital.



Consensus expectations have fallen significantly for 2023 already, but much of this was in the Q1 and Q2 periods and we expect Q3 and Q4 will also be weaker as the impact of higher rates starts to bite.



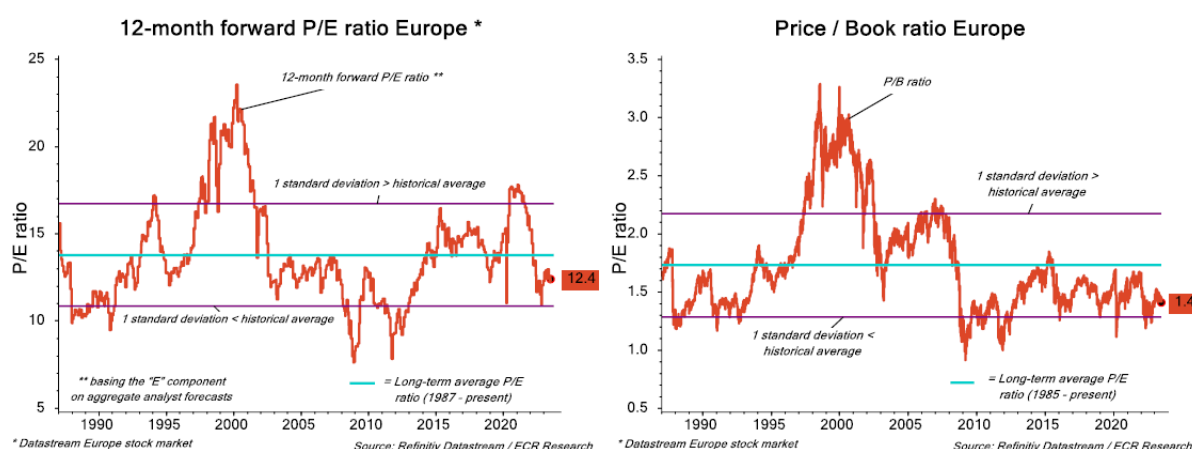
The forward 12-month P/E ratio for the S&P500 is now 19.2x. This is above the 5-year average of 18.6 and the 10yr average of 17.4. If we adjust the forward EPS numbers down the market looks increasingly expensive. Especially, if one takes into consideration that the risk-free rate, which is used to calculate the Net Present Value of a company's cash flows in a DCF analysis is now above 4%, well above the average for the last 5 or 10years.

In our Outlook '23 report at the start of the year we took the view that if the market – the S&P500 – was priced at c.14x earnings and earnings growth was flat, the S&P500 could trade at 3100-3200. Well below current levels.

EU: Earnings coming in better than expected and analysts are upgrading 2024 EPS expectations. Equity market is attractively priced, but uncertainties remain given rates are still rising.

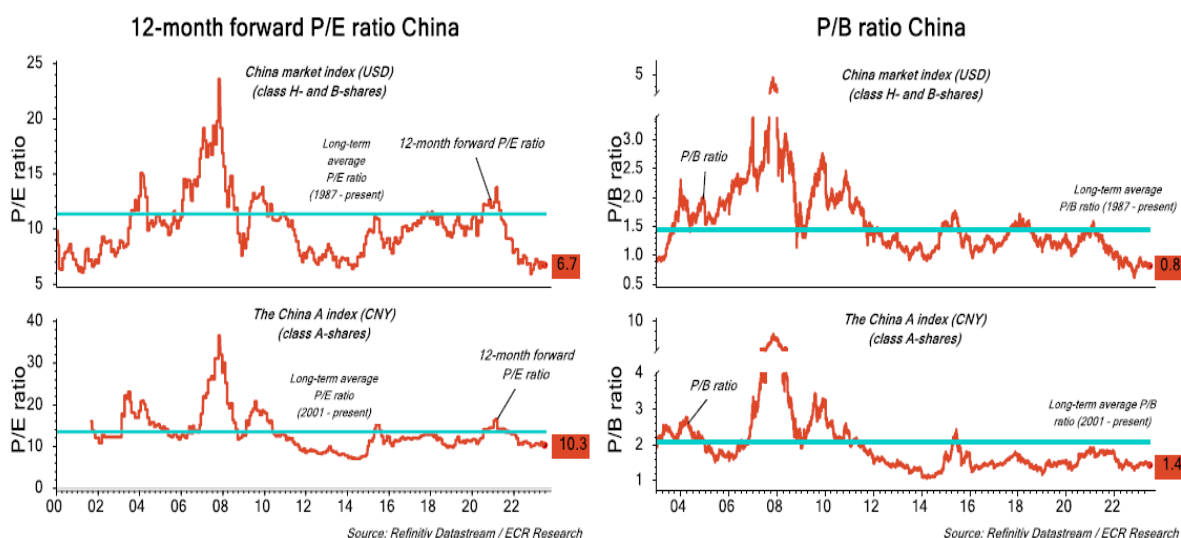
Analysts are still forecasting a 1% contraction in EPS for 2023 and 7% expansion in 2024. Notable though, strategists are less optimistic and are forecasting a 5% contraction in 2023 and 5% in expansion in 2024.

We expect the strategists will be closer to the final result as, just like the US, higher rates still need to be felt by the wider economy. We also see distinct weakness in Germany's manufacturing base, with backlogs keeping the manufacturing base afloat given that new orders are weak. The EU equity market is cheap but perhaps not that cheap, given a risk of widening conflict and economic slowdown.



Asia: China and Japan offer good value. China coming out of slowdown and will – we expect – provide more stimulus and liquidity to the market.

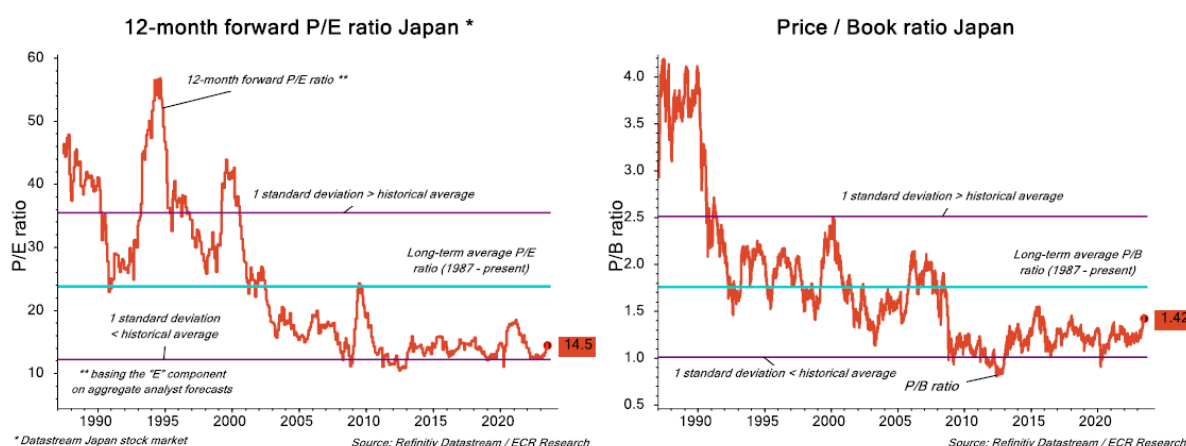
The China equity market has had a dismal few years. It significantly underperformed global markets in 2021 as the government stepped up its regulatory oversight. It had a similarly dismal 2023, being down in dollar terms YTD, while other markets are on average up in the teens.



As we note in this report, China has various issues to deal with economically. There was a time though that the equity market there was becoming non-investable, as the regulatory oversight and governance was also becoming questionable. With the weakness in the economy though, the government there is starting to become more market orientated.

Japan is another market that we find good value. As we note earlier the BoJ is still very expansionary in its policies with rates being held effectively at zero and with yields on JGBs being capped, in the case of the 10yr at 75bps.

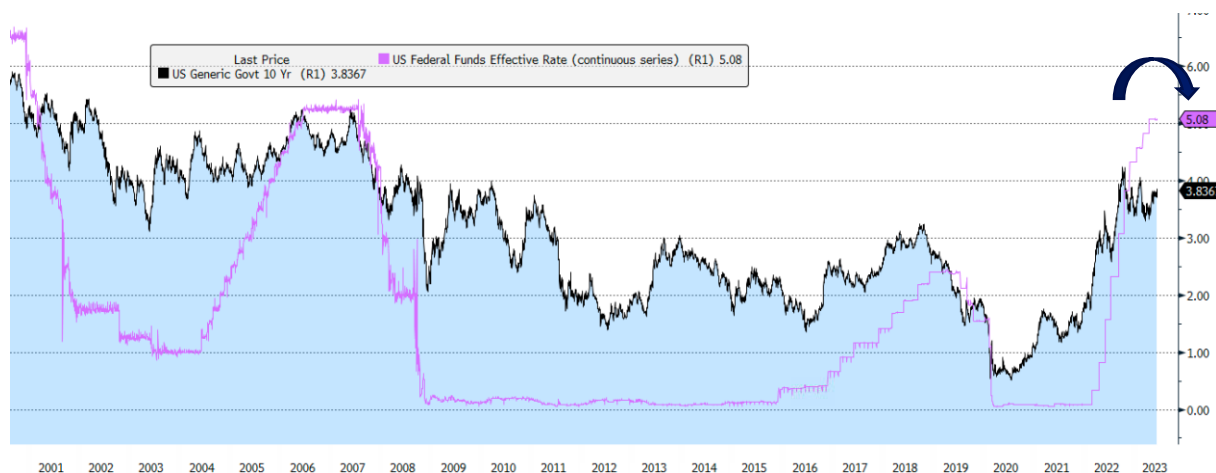
In our Global strategy we are overweight Asia Pacific, which includes China and Japan, with a significant overweighting in China. In our Disruptive Technology Strategy we are underweight relative to the region preferring the Technology exposure we can find in the North American market.



In summary, we find that while the US market is expensive, those in Europe and Asia offer reasonable valuations relative to history.

Our allocations though, are not driven purely by valuations. We still consider the US market to have some of the best blue-chip stocks globally – in terms of quality management, technology, and global scale – and they are the most aggressive in terms of share buy-back programs which have been supportive of share prices.

**Fixed Income:** With rates and yields at close to multi decade highs and offering a real return and with inflation expected to fall lower over time, we are overweight Fixed income in our Multi-Asset Strategy.



The above chart shows the Fed rate and the US Treasury 10yr yield. Fed Rates are now at a 20yr high. Inflation is coming off and indications are that the economy will slow further, with the IMF projecting 1% growth in 2024.

The Fed is using rates as its main policy tool and is keenly aware of the risks of not hiking sufficiently to ensure inflation does not snap higher in future months. With interest costs spiraling as well, we would envisage that the government will limit any new stimulus plans as we move through the 2H23 and 1H24.

Hence, it is our expectation that history will repeat, and the Fed will be cutting rates in 2024 – which will benefit bond prices.

With USD sukuk yields higher than their US counterparts of the same duration, we remain overweight high-quality sovereign and quasi sovereign sukuk in our multi-asset strategy.

## Summary

- **With most leading indicators still suggesting a slowdown ahead and earnings in decline and expected to fall further in 2024, we continue to consider it prudent to be relatively risk adverse in our allocations.**
- **As such we remain underweight US equities, and especially US Technology which is now a very large weighting in most indices.**
- **With our preferred sukuk exposure offering c.5% in yield, we consider this suitable exposure in a time of weaker growth.**

Once we are through this period, and yields are lower than today, we would look to aggressively shift our exposures towards those areas of the market that will benefit from government support programs, improving growth and lower rates.

Most notable would be the green technology space as well as the onshoring area, which would include Technology, Infrastructure and other sectors that will likely benefit from the capex boom.

Our lessons from the past are to stay invested but keep dry powder in these uncertain times, with elevated markets and consensus earnings that still need to be ratcheted down over the next few quarters.

Longer term, we expect equities will be a far better investment than fixed income as we expect some form of financial repression in many parts of the West, similar to what we have seen in Japan over the past few years, with bond yields being held below the rate of inflation.



## KEY THEME

Governments to increasingly control money supply and direct economic development.

**We are at the end of an era. We are, we believe, witness to a critical shift:**

- The control of 'money' is, we expect, going to shift from the central banks to the governments.
- Increasing shift away from globalization to 'Build Back better at Home' (BBBaH) policies, which will be financed through public/private partnerships.
- The end of a 40yr period of ever lower rates, to one of increasing Financial Repression with higher inflation and 'enforced' negative real rates.

We have already seen the first two play out. The third we will certainly see in the next few years. Let us go through them:

The control of money and programs, such as the CARES ACT and Build Back Better at Home (BBBaH), go hand in hand. An increase in government spending or the provision of guaranteed loans will, ceteris paribus, increase the supply of money to an economy.

In 2021, Senate negotiators announced that a \$1.2 trillion agreement for physical infrastructure had been reached. The Inflation Reduction Act increased spending on areas of healthcare and clean energy by 400bn. The CARES Act alone was 2.2trl.

As a result of all the various stimulus programs, the Fed balance sheet expanded by 4trl between 2020 and early 2022 and government debt ballooned.

The current focus is on climate change mitigation. Witness the increasing media focus on the theme, with powerful graphics being used to bring awareness to the issue. During the recent visit to the UK, President Biden and the US Special Envoy for Climate, John Kerry, met with King Charles III to discuss policies to mitigate climate change. Of note, is they had arrived in a 27-vehicle motorcade. The narrative is that no amount is too much to 'save the planet'. This has the potential to draw in trillions of government funding, particularly in the Western nations.

Fighting both 'climate change' and BBBaH policies will potentially require trillions of investments. At least that is what the various governments are likely to declare.

It will likely be facilitated via significant private/public partnerships and the cohesion of 'big business' with government, with the government funding it all with guaranteed loans and the like.

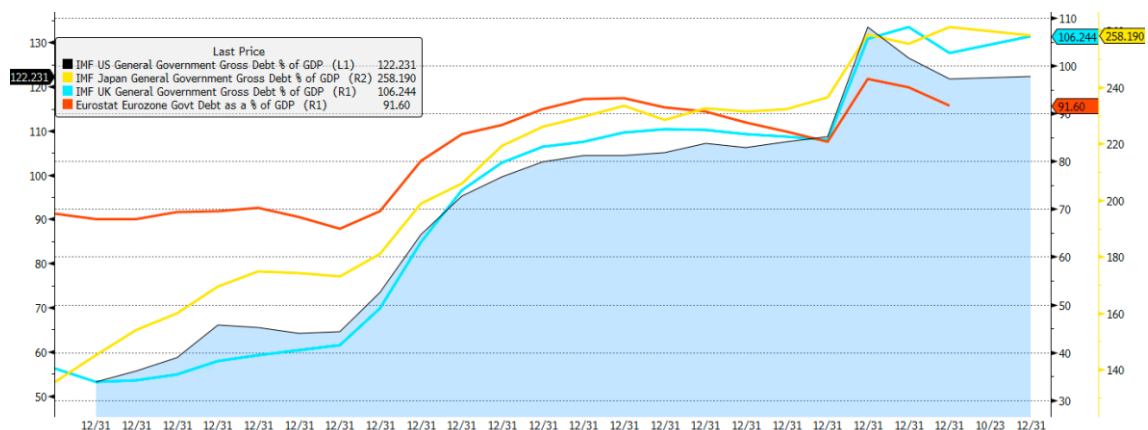
And it's not just the US that is pursuing these policies but the EU and UK. Only recently James Hunt, the Chancellor of the UK, announced a scheme to 'encourage' the large pensions funds to invest in UK VCs, using government funds in private/public partnerships.

And the stimulus is not just in the form of direct allocation. Governments around the world were very active providing guaranteed loans during the covid crisis.

**Of all new loans across Europe made during the crisis, between 40% and 100 % were guaranteed by the state. No wonder the loan market grew dramatically. Many of these**

loans have become due and any losses experienced by the banks, due to default for example, were made whole by the various governments.

Government debt has expanded massively through stimulus programs ...a form of money creation...on a massive scale:



Gov Debt to GDP was already at historically high levels before the Covid19 stimulus packages. US Debt to GDP rose to over 120%. Gov debt to GDP in Japan is already 240% and expected to hit 260% by the end of 2024, so it can be argued the US has some ways to go to catch up.

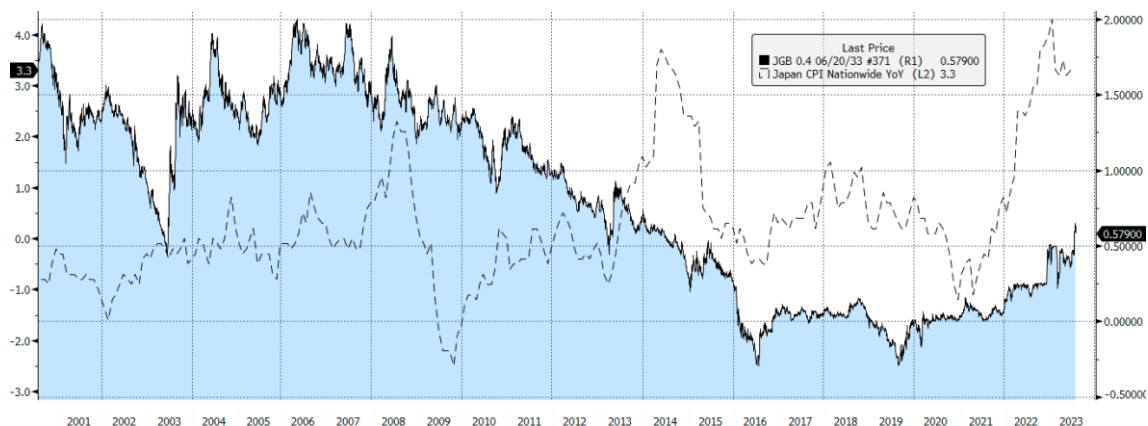
The creation of 'Free money' is ultimately inflationary. Witness the last few years with inflation hitting decade high levels.

One must thus ask how the government will fund all this 'free money' creation through indirect deficit spending and the rising levels of debt. Simple really - Financial Repression.

Just as is the case in Japan, rates and yields can be controlled at levels way below inflation, with the central bank and others that are required to hold 'risk free' government debt, continuing to buy it.

Japan is the example of what is likely to come in the West.

The yield curve is controlled by the BoJ, which sets both the rate and the yield and buys bonds to keep yields at these preset levels, which are well below the inflation level. Financial institutions, such as pension funds and insurance companies, are also 'encouraged' to be buyers of government bonds as a condition to meeting their risk or compliance targets.



The tables below highlight the disparity between global 10yr Sovereign yields and those of Japan. In Japan the BoJ rates are effectively zero and the 10yr is 0.5%. the entire yield curve is manipulated down.

Region	RM	Security	Price	Chg	Yld	Chg	Yld	Low	Range	High	3M Chg
Americas											
10 United States		T 3 1/2 05/33	94.29	+0.03	4.008	-1.4	4.008	3.384	3.384	4.175	+49.0
10 Canada		CAN2 1/2 06/33	93.628	+0.021	3.498	-4.0	3.498	2.827	2.827	3.707	+55.3
13 Brazil (USD)		BRAZIL16 10/33	98.030	+0.022	6.263	-0.3	6.263	6.022	6.022	6.328	+9.4
13 Argentina (USD)		ARGENT18.28 33	37.043	0.000	0.000	1800.8	0.000				
14 Mexico (USD)		MEX3 1/2 02/34	83.571	+0.075	5.589	-1.0	5.589	5.239	5.239	5.716	+25.7
EMEA											
20 United Kingdom		UKT3 1/2 01/33	91.492	+0.156	4.356	-2.1	4.356	3.705	3.705	4.655	+50.8
20 France		FRTR 3 05/33	100.091	+0.049	2.988	-0.6	2.988	2.797	2.797	3.203	+5.3
22 Germany		DBR 2.6 08/33	101.231	+0.025	2.459	-0.3	2.459	2.222	2.222	2.643	+11.5
23 Italy		ITIPS 4.35 33	102.421	+0.155	4.098	-1.9	4.098	3.938	3.938	4.409	+16.4
24 Spain		SPGB 3.55 33	100.552	+0.071	3.486	-0.8	3.486	3.267	3.267	3.707	+5.6
25 Portugal		PGB1.65 07/32	88.402	+0.026	3.161	-0.3	3.161	2.948	2.948	3.361	+1.1
26 Sweden		SGB1 1/2 11/33	92.537	-0.193	2.588	+2.3	2.588	2.173	2.173	2.662	+30.3
26 Netherlands		NETHER2 1/2 33	97.476	+0.007	2.794	-0.1	2.794	2.586	2.586	3.006	+7.7
28 Switzerland		SWISS 3 1/2 33	123.957	+0.081	0.899	-0.8	0.899	1.760	1.760	1.027	-12.5
28 Greece		GGB4 1/2 06/33	103.851	-0.026	3.773	+0.1	3.773	3.501	3.501	4.088	+31.5
Asia/Pacific											
10 Japan		JGB 0.4 06/33	98.462	+0.053	0.564	-0.6	0.564	0.345	0.345	0.639	+15.3
10 Australia		ACGB 3 11/33	91.681	+0.162	3.994	-2.0	3.994	3.320	3.320	4.284	+54.9
13 New Zealand		NZGB 3 1/2 33	90.436	+0.122	4.743	-1.7	4.743	3.989	3.989	4.862	+60.3
13 South Korea		KTB3 1/2 06/33	96.540	-0.230	3.739	+3.0	3.739	3.557	3.557	3.867	
14 China		CGB2.67 05/33	100.155	-0.084	2.652	+1.0	2.652	2.609	2.609	2.734	-8.2

Security	Price	Yld	Chg	Yld	Historical Data Range	Low	Range	High	Avg	+/-	RSI
Benchmarks											
10 JGB 0.005 25	99.999	0.005	-0.3	0.005	-0.1	0.084	0.014	-0.058	+6.3	+2.5	73.3
10 JGB 0.1 06/26	100.232	0.019	-0.3	0.019	-0.1	0.088	0.028	-0.053	+7.2	+2.4	75.5
10 JGB 0.1 06/28	99.653	0.172	-1.1	0.172	-0.3	0.039	0.206	0.096	+7.6	+2.0	68.3
10 JGB 0.1 09/30	98.180	0.362	-2.7	0.362	-0.4	0.136	0.429	0.235	+12.7	+1.8	64.5
10 JGB 0.4 06/33	98.432	0.568	-0.2	0.568	0.0	0.345	0.639	0.433	+13.5	+1.9	68.8
10 JGB 1.1 06/43	97.017	1.220	-4.8	1.220	-0.5	0.940	1.321	1.043	+18.7	+1.9	79.6
10 JGB 1.2 06/53	83.599	1.511	-3.3	1.511	-0.2	1.176	1.600	1.299	+22.1	+3.0	68.4
10 JGB 1.3 03/63	91.289	1.665	-5.3	1.665	-0.5	1.335	1.789	1.459	+20.6	+1.9	67.5
Curves											
10 2yr-5yr	c	18.1	-0.8	13.6	-0.5	13.6	20.4	16.7	+1.4	+0.8	57.3
10 2yr-10yr	c	58.2	-2.2	43.7	-0.4	43.7	63.9	50.6	+7.6	+1.5	64.3
10 5yr-10yr	c	41.2	-1.5	27.9	-0.4	27.9	45.3	35.2	+6.0	+1.5	63.6
Butterflies											
10 2yr-5yr-10yr	c	25.3	+0.9	29.5	0.2	29.5	13.2	21.1	-4.2	-1.1	43.6
10 5yr-10yr-30yr	c	56.4	-0.5	61.5	-0.2	61.5	47.2	55.1	-1.3	-0.4	48.9
Inflation											
10 JP B/E SVR	c	1.074	-2.0	1.011	0.1	1.011	1.476	1.256	-18.2	-1.2	37.4
10 JGB10.1 03/28	104.934	-0.931	-2.9	-1.490	-0.1	-1.490	-0.865	-1.238	+30.7	+1.4	75.4
CDS Spread											
10 CDS USD SR 5Y	c	18.8	+0.8	16.3	0.3	16.3	24.1	18.9	-0.1	-0.1	57.6

Europe did the same in the aftermath of the 2009 Great Financial Crisis, with the yield across the short end of the curve being negative for most EU bonds. Negative! Any buyer of these bonds was guaranteed to make a loss! And yet there were plenty of buyers.

Indeed, what we did see back then was that, when yields were above the target levels set by the ECB, financial institutions would buy these bonds on the expectation that the ECB would step in and take yields lower, back to target.

To reiterate, we are entering a new paradigm. One where governments will play an increasingly significant role in the creation of 'money', using tools such as private/public partnerships and loan guarantees, to support their programs around global issues, such as fighting 'climate change' and 'Build Back Better at Home'.

These policies will be inflationary and so policies of 'financial repression' will be used to ensure that yields and borrowing costs remain low, most likely negative in real terms.

This will have ramifications on both the economy and asset allocation.

This government largess will initially be considered very positive for growth – a boom in capital investment – good for infrastructural roll out, the development of new green technologies and building self-reliance. All themes that would find general support in the populous.

It would be negative though, for savers, depositors, and local bond holders. With return on these assets being below inflation, real returns would be negative, thus driving allocations towards risk assets such as equities.

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

**T.** +965 2247 8800  
**F.** +965 2247 6600  
**E.** [info@rasameel.com](mailto:info@rasameel.com)

[www.rasameel.com](http://www.rasameel.com)

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