Investment Strategy

Quarterly Investment View | August 2023

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ASSET MANAGEMENT LIMITED

2023 Mid-Year Outlook: Mission Improbable

For most investors, at the start of the year, the US economy achieving a soft-landing was mission improbable. However, the US economy managed to stay resilient through H1'23. This now made the market consensus move to the soft-landing in the US as the base-case. Market performances now seem to be pricing in a relatively optimistic scenario compared to the start of the year. Against this backdrop, how should investors position for H2'23?

We continue to work with a mid-cycle slowdown and not a recession as our base-case for the global economy. To that extent, we think investors should position and navigate a soft landing in the US over the next six months. We admit that the risks and uncertainty around the US macro-outlook remain elevated. Add to that the disappointing growth in China and falling services sector activity in Europe, risks become evident. Yet, in our view a muddle through of the global economy is what investors should consider at this stage. On inflation, in the absence of any major shock, the disinflation process should continue over the remainder of the year. Inflation could prove to be sticky in Europe but in the US, inflation should continue to surprise on the downside. Turning to the central bank policy, we believe that the Fed is close to being done with interest rate hikes for this cycle. However, we continue to see risks tilted towards a more hawkish Fed than to a more dovish Fed. In our investment strategy section of the report (pages 2-4), we discuss these points in detail. In our asset allocation, our strategy is to remain OW equities, and UW fixed income. For equities, we expect positive but lower (compared to H1'23) returns during H2'23. For our detailed portfolio positioning and trade ideas see page 5.

Fixed income (pages 6-7): We remain underweight on fixed income. Markets have repriced a more hawkish Fed. Yet, the uncertainty about the timing of the first rate-cut is likely be a source of volatility in financial markets – especially for bonds. While there is value in bonds over the long-term, near-term trajectory is unclear. We are underweight on DM sovereigns as DM central bank monetary policies will remain tight in the near term. We are neutral on Global IG with a preference for EU IG over US IG. We remain underweight on Global HY. Within EM, we are overweight on EM LCY bonds and stay neutral EM USD sovereigns with preference for high-quality bonds.

Equities (pages 8-9): The first half of the year saw valuation expansion that drove equity prices higher. In the second half of the year, we need corporate earnings to take over as the key driver. We think corporate earnings will not disappoint. However, we acknowledge that earnings-driven equity markets tend to be slower compared to valuation-driven ones. Therefore, we expect lower, but positive equity market returns during H2'23. Yet, investors need to be mindful of the building divergence across regions.

Alternatives (pages 10-11): We use our position in alternatives to diversify away some risks with traditional asset classes. While we do not tactically allocate to this asset class, we provide an update on the outlook for various sub-asset classes. In this note, we discussed how private credit managed to adjust to higher interest rates, why copper has strong cyclical and structural outlook, and also provide an update on the commercial real estate sector.

Currencies (pages 12-13): We expect the USD to remain weak in the near term as the ECB and the BoE are likely to be more aggressive compared to the Fed. However, at the same time, we rule out the possibility of sizeable USD weakness and expect bouts of USD strength given the evidence of US growth outperformance. We expect GBP to remain strong versus the USD with the UK facing more persistent inflation, underscoring a more aggressive BoE. We expect EUR to remain stable with sizeable euro rally looking difficult. We expect JPY to remain weak as the BoJ is likely to further delay policy normalisation.

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Investment strategy

Why the US recession hasn't happened yet

At the start of the year, for many investors a soft landing in the US looked like a mission improbable if not a mission impossible. After all, about six months ago, the market consensus was calling for a global recession led by the US. The argument then was that the Fed was pursuing one of the fastest rate hiking cycles which always pushed the US economy into a recession. At that time, we argued that a US recession was not a foregone conclusion that our base-case was for an asynchronous mid-cycle slowdown of the global economy. Halfway through the year, the Fed has indeed engaged in one of the fastest rate hiking cycles of the modern history, raising interest rates by a full 5ppt this cycle, and yet the US economy has not entered a recession. In fact, more recently the US economic data has started to surprise the market consensus expectations on the upside. What is going on? Well, the explanation lies in how this time is different. Three sectors which were vulnerable to rising interest rates proved to be resilient this time around.

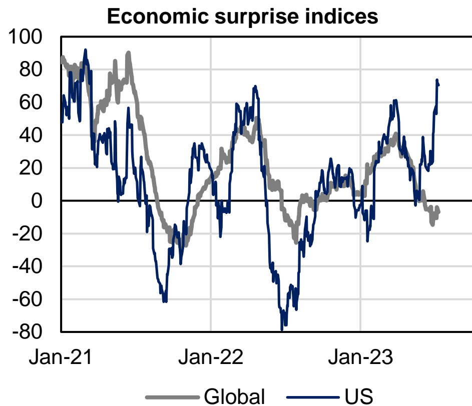
1. Consumption: During the pandemic, government transfers boosted household income while household spending was severely curtailed by social restrictions. This has resulted in huge excess savings for the US household. The US Federal reserve estimated that the US household had accumulated about USD2.3trn in savings in 2020 and through the summer of 2021. However subsequently, as the pandemic restrictions eased allowing consumers to buy, consumer prices rose, and interest rates increased, household savings rates fell, and consumers started to drawdown from their excess savings. Bank of America estimated that as of end-May, US consumers had around USD675bn in excess savings from pandemic-era. Assuming a drawdown rate of USD70bn/month (based on recent evidence), this would cover consumers for another 10 months. All this meant that the consumption trends remained strong even when interest rates went up.
2. Housing sector: Existing low-rate long-term mortgages played a key role in blunting the impact of interest rate surges on the critically important cyclical sector of the US economy. According to the Federal Reserve Bank of Dallas, long-term fixed-rate mortgages account for 96% of the total mortgage stock. This meant that the average mortgage rate remained well below the new mortgage rate through this interest rate cycle. The evolution of the mix of the mortgage was also favourable. Close to 56% of the outstanding mortgages had rates exceeding 4% as of July 2019. This proportion fell to 28% by March 2022. According to the most recent data from Redfin while 92% of homeowners with mortgages have a rate below 6%, 82% have a rate below 5%, 62% enjoy a rate below 4%, and 24% boast a rate below 3%. Effectively, higher interest rates did not translate into higher mortgage costs for consumers.
3. Business sector: Corporations have reduced their leverage following the Global Financial Crisis of 2008/09 (GFC). The net debt-to-equity ratio of US corporates was close to 100% in 2003 but rose to a peak of 131% around the GFC. However, subsequently this leverage fell to 50% in early 2022 but rebounded slightly to 60% as of Q2'23. Not just this, the share of short-term debt and the current component of long-term debt in the total debt stock fell consistently from 55% in 1997 to 20% in 2022. This meant that short-term borrowing costs and refinancing needs of the US corporate were not as acute.

Macroeconomic Outlook

We continue to work with 'a mid-cycle slowdown and not a recession' as our base-case for the global economy. To that extent, we think investors should position and navigate a soft landing in the US over the next six months. We admit that the risks and uncertainty around the US macro-outlook remain elevated. Add to that the disappointing growth in China and falling services sector activity in Europe, risks become evident. Yet, in our view a muddle through of the global economy is what investors should consider at this stage. Across regions, US exceptionalism has re-emerged thanks to the improvement in growth-inflation mix there (exhibit 1). Led by domestic activity, Japanese economic momentum remains strong. It is in Europe that the economic momentum is fading at a time when both the European Central Bank and the Bank of England are strongly focused on fighting inflation (exhibit 2). Turning to emerging markets, despite the disappointing China recovery, emerging market activity remains strong. In China, we do expect the policy support to arrive sooner rather than later helping the broader Emerging markets bloc.

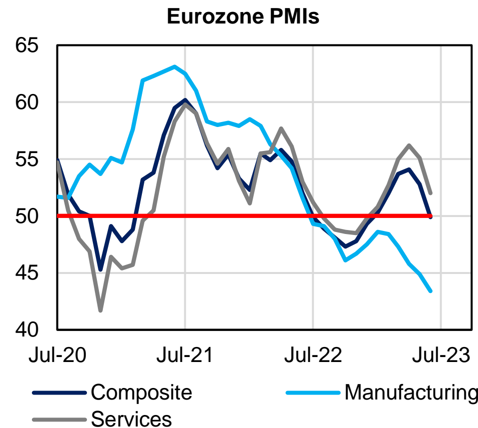
On inflation, in the absence of any major shock, the disinflation process should continue over the remainder of the year. Inflation could prove to be sticky in Europe but in the US, inflation should continue to surprise on the downside. Admittedly, year-over-year comparisons are becoming less favourable for the US CPI. Despite concerns, we do not yet see tangible signs of a wage-price spiral. Long-term inflation expectations remain well-anchored too.

Exhibit 1: US exceptionalism has re-emerged



Source: Citi, Bloomberg, Datastream, Refinitiv, and ADCB Asset Management

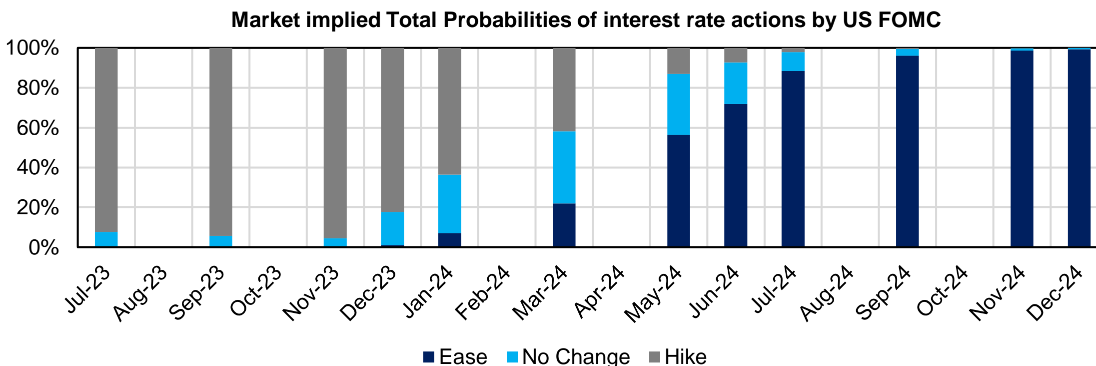
Exhibit 2: Economic momentum fading in Europe



Source: S&P Global, Bloomberg, Datastream, Refinitiv, and ADCB Asset Management

Turning to the central bank policy, we believe that the Fed is close to being done with interest rate hikes for this cycle. However, we continue to see risks tilted towards a more hawkish Fed than to a more dovish Fed. To that extent, we do not rule out further hikes from the Fed. We do not see rate cuts till H2'24 (exhibit 3). The European Central Bank and Bank of England have further tightening to do. Bank of Japan should turn hawkish later this year.

Exhibit 3. First rate cut from the US Fed to arrive in H2'24



Source: Institute of Supply Management (ISM), Bureau of Labor Statistics - US, Refinitiv, and ADCB Asset Management | Notes:*simple average of manufacturing and services ISM PMIs

Asset allocation

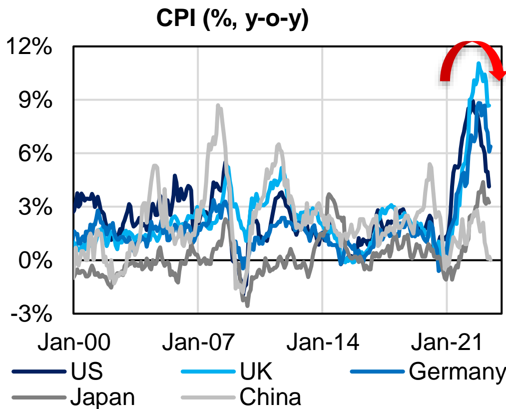
Tying all this into our asset allocation, our strategy is to remain OW equities, and UW fixed income. Equity sentiment has improved sharply but positioning is still light. A further upside in equities is conditional on a revival in manufacturing activity and a strong earnings season – we expect both. After the recent move higher in yields, fixed income markets are now pricing in a better economic outlook and as a result, a more hawkish Fed. Yet, the uncertainty about the timing of the first rate-cut is likely to be a source of volatility in financial markets – especially for bonds. We use our exposure to alternatives to diversify some of the risks.

Risks

A sharp deterioration in the global growth outlook owing to an escalation in unforeseen systemic risks, much stickier inflation needing central banks to turn even more hawkish, and investor sentiment deteriorating rapidly are key risks to our positioning. Consumer health risks are also worth watching.

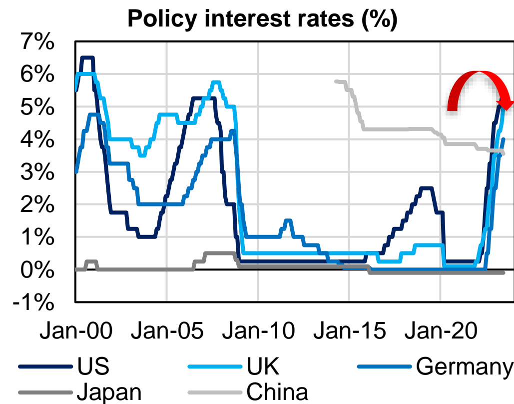
Also, in our 2023 Outlook: Peaks and valleys, January 2023 we argued that peaks in inflation, interest rates, and the USD along with the valleys (troughs) in global growth, corporate earnings growth, and investor sentiment are all likely to influence market performances during 2023. We also pointed out that risks to these trends should be monitored. In exhibits 4-9 on the following page we provide an update on the trajectory of these six trends.

Exhibit 4: A natural fall in inflation…



Source: Statistical Offices, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 5: …should allow policy rates to peak

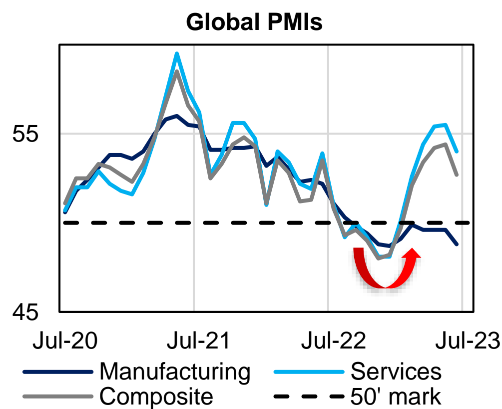


Source: Central Banks, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 6: USD should weaken further…

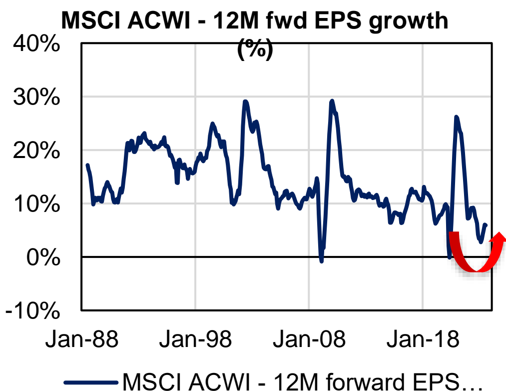
Source: Datastream, Refinitiv, and ADCB Asset Management

Exhibit 7: …as global growth remains resilient



Source: S&P Global, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 8: Bottoming out in earnings expectations…



Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 9: …should result in the revival of global investor sentiment

Source: Sentix, Datastream, Refinitiv, and ADCB Asset Management

Tactical Asset Allocation and Trade Ideas

Exhibit 10: Tactical Asset Allocation with a 3-month view

Asset Class	Positioning*					Balanced**		
	SUW	UW	N	OW	SOW	SAA	TAA	Active
Equities				■		**35.0**	**38.2**	**3.2**
North America				■		22.0	24.0	2.0
Europe	■					6.0	4.0	-2.0
Japan			■			1.9	1.9	0.0
APac ex Japan				■		4.3	5.3	1.0
EM ex Asia		■				0.8	0.5	-0.3
Japan (JPY) off BM				■		0.0	2.5	2.5
Fixed Income		■				**50.0**	**46.8**	**-3.2**
DM Treasuries IG		■				27.2	25.2	-2.0
DM Corporate IG			■			10.4	10.4	0.0
EM USD Sov. IG			■			0.7	0.7	0.0
EM LCY IG				■		4.3	5.3	1.0
EM Corporate IG		■				0.5	0.2	-0.3
Global HY		■				5.0	4.0	-1.0
Cash		■				2.0	1.0	-1.0
Alternatives						**15.0**	**15.0**	**0.0**

Colour legend ■ Current ■ Previous

Source: Bloomberg, Bloomberg BGN, Bloomberg Indices, Hedge Fund Research, MSCI, Standard & Poor's, DataStream, Refinitiv, and ADCB Asset Management | Notes: *Positioning recommendations: SUW = Significant Underweight; UW = Underweight; N = Neutral; OW = Overweight; SOW = Significant Overweight. **Based on balanced risk profile. SAA = Strategic Asset Allocation; TAA = Tactical Asset Allocation; Active weight = TAA weight – SAA weight. Weights may not sum to 100% due to rounding.

Exhibit 11: Our high conviction tactical investment themes/trade ideas

Open positions	Asset class	RV?	BBG ticker		Date opened	Current date	Open price	Current price	Performance
Prefer UST (7Y-10Y) over other DM Sov.	Fixed income	Yes	LT09TRUU Index	LGTRTRUU Index	5-Jul-22	4-Aug-23	477.0	453.3	-1.8%
EU IG Corp over US IG Corp	Fixed income	Yes	LECPTRUH Index	LUACTRUU Index	9-Jan-23	4-Aug-23	281.8	290.2	2.5%
HK equities	Equities		HSI Index		14-Nov-22	4-Aug-23	2248.3	2501.7	11.3%
Chinese hotels & leisure	Equities		CSIH3204 Index		14-Nov-22	4-Aug-23	1301.3	1340.1	3.0%
Cybersecurity	Equities		HXRTR Index		22-Mar-23	4-Aug-23	516.6	568.1	10.0%
Chinese semiconductors	Equities		FDSSMNTR Index		22-Mar-23	4-Aug-23	24.6	22.6	-8.1%
Indian equities	Equities		M1IN Index		22-May-23	4-Aug-23	916.4	988.4	7.9%
GBPUSD higher	FX		GBPUSD Curncy		15-Jun-23	4-Aug-23	1.3	1.3	0.8%
Copper	Commodities		LOCADY Comdty		15-Jun-23	4-Aug-23	8457.0	8450.5	-0.1%
Average									**2.5%**

Closed positions	Asset class	RV?	BBG ticker		Date opened	Closed date	Open price	Closed price	Performance
US Div. banks over US Reg. banks	Equities	Yes	S5DBNKTR Index	S5RBNK Index	13-Mar-23	13-Jun-23	1223.6	1244.6	24.8%
Asia investment grade credit	Fixed income		I10550US Index		9-Jan-23	14-Jun-23	386.6	393.6	1.8%
USDJPY lower	FX		USDJPY Curncy		9-Jan-23	14-Jun-23	132.1	140.1	-6.1%
GBPEUR lower	FX		GBPEUR Curncy		9-Jan-23	14-Jun-23	1.14	1.17	-2.9%
Gold	Commodities		XAU Curncy		14-Nov-22	14-Jun-23	1771.4	1942.5	9.7%
Gold miner equities	Equities		M1WDS1MI Index		14-Nov-22	14-Jun-23	437.2	494.4	13.1%
Average									**6.7%**

Source: ADCB Asset Management

Fixed income

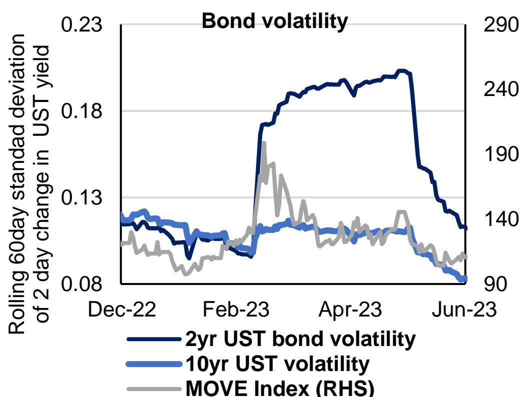
Waiting for the peak

The first half of the year was volatile for the global bond markets. Inflation softened but at a slower pace while growth has mostly surprised on the upside. The Fed remained aggressive with its rate hikes, pausing at the June meeting but later again raising rates at the recent July meeting. Banking instability and debt ceiling concerns added to the overall bond volatility. The MOVE index which measures the volatility in the treasury market- overall jumped in the first half of the year. Increased volatility in short-term yields mainly contributed to the overall bond market volatility due to uncertainty over monetary policy (exhibit 12). Despite the rise in volatility, fixed income assets have managed to score marginal positive returns in the first half of the year. Global aggregate bond indices posted small gains but significantly underperformed equities. Global Treasuries underperformed peers with the underperformance more pronounced over last three months. Long-dated USTs were the best performers as yields on 10Y UST declined. Short-term UST yields jumped with the Fed tightening policy. In Europe, yield on 10Y German bunds fell while yields on 10Y UK Gilts rose sharply in the first half of 2023 as the Bank of England remained aggressive with rate hikes.

While we believe that we are now in the final leg of the central bank tightening cycle and the Fed may be largely done with rate hikes, but monetary policy is still likely to remain tight in the near term. Growth prospects have been better than expected based on strong services activity and resilient labor market. As such we believe that risk of rate hike cannot be completely ruled out. Even if the Fed remains on pause mode in the second half of the year, the policy is likely to remain restrictive. Continuing evidence of strong growth resilience, particularly out of US, should push back the possibility of rate cut. The uncertainty about the timing of a rate cut could continue to remain a source of volatility for the bond markets. As a result, we remain underweight on fixed income. We maintain our underweight stance on DM treasuries. Along with the Fed, the ECB and especially the BoE are likely to remain in tight mode in the next three months which implies monetary policy uncertainty will remain. Risks to our negative view on DM treasuries is a dovish surprise by the key DM central banks.

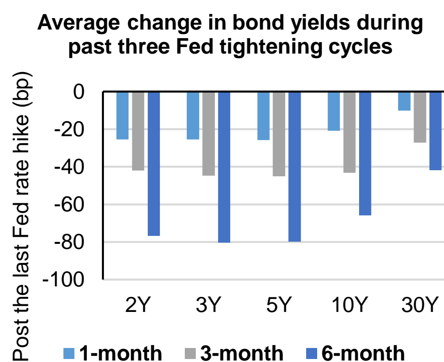
However, we still maintain our preference for 7-10yr USTs. Long-dated USTs have underperformed recently with recent incoming data pointing to US growth outperformance. However, we believe there is limited upside for long-term UST yields taking into account the current end phase of the Fed tightening cycle. Historical precedents show that the UST yields decline across the curve post the last Fed rate hike (3months and 6 months after the last Fed rate hike) with the 3yr and the 5yr UST declining the most. As the entire curve tends to start moving lower post the last Fed rate hike, long-dated USTs are likely to outperform due to duration effects (exhibit 13). However, given the uncertainty regarding the timing of last Fed rate hike- long-dated USTs could still face near-term volatility.

Exhibit 12: Short-term rates caused higher bond volatility



Note: 2yr and 10yr UST volatility calculated as the rolling 60 day standard deviation of 2-day change in yields | Source: Bloomberg, and ADCB Asset Management

Exhibit 13: Long-dated yields should drop after the last Fed rate hike



Source: Bloomberg, and ADCB Asset Management

Neutral on Global IG, Underweight on Global HY, Preference for EU IG

Global corporate and Global HY were the best performers in the first half of 2023, outperforming Global sovereign bonds. Short-duration assets- EU HY and US HY were the winners. Spreads in the US HY and EU HY in fact tightened in 1H 2023. The rating-wise performance showed wide divergence with CCC-rated and AAA-rated both being the top performers.

We believe that short-duration assets could perform well in the near term with the prospects of increased monetary policy uncertainty. Global HY should benefit given their short-duration characteristics and hence we recently trimmed our underweight on Global HY. European HY could still outperform US HY as the former is reasonably pricing in the slowdown risks. US HY (which forms a significant portion of the Global HY index) valuations are not attractive taking into account the late phase of Fed tightening cycle. Hence we still maintain underweight stance on Global HY.

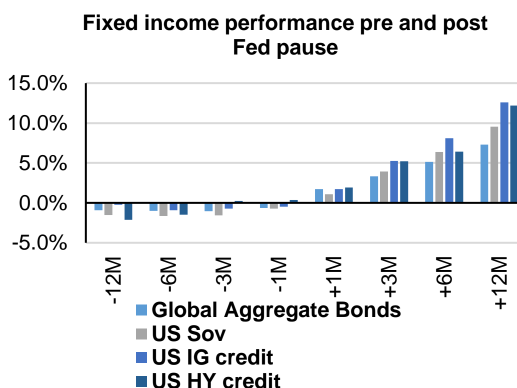
In addition, we wait to add exposure to other long-duration fixed income assets once there is clarity over the last Fed rate hike of the cycle and whether the Fed has entered a pause mode. Our historical analysis of the previous five Fed tightening cycles shows that the Global corporate IG and US IG were the best performers in the periods 1-month to 12-months post the last Fed rate hike (exhibit 14). However, given the risks of another rate hike tilted higher than the pause, we maintain our neutral stance on DM IG corporate.

Stay Neutral on EM USD sovereigns, Overweight on EM LCY bonds; Took profit on Asia IG

In EM, we are overweight on EM LCY. Similar to EM USD sovereigns, EM LCY performance is also dependent on the trajectory of UST yields and the USD (in terms of FX performance influencing the total return performance). But overall vulnerability is lower in case of EM LCY compared to EM USD sovereigns. In addition, the sensitivity of EM LCY index to UST yields tends to jump during periods of sharp decline in UST yields- (positive beta). The influence of external drivers in impacting EM LCY performance has reduced in line with the decline in foreign holdings of EM LCY debt. As a result, EM LCY sovereigns are more insular to offshore bond redemptions during periods of elevated global market volatility. The inclusion of China LCY bonds in the Global bond benchmark index has also increased EM LCY sensitivity to China's growth outlook (exhibit 15). This correlation is rising again with key EM central bank monetary policy divergence reducing against China's more accommodative policy stance. Many EMs started to tighten rates earlier (some also aggressive) than the DM central banks. Hence the EM central banks have the advantage of switching to a more accommodative stance earlier than the DM central banks. This is particularly in case of EM countries where there is evidence of slowing price pressures (EM EMEA is an exception here). Lower external vulnerability, influence of domestic factors, increased correlation to China growth outlook (which is softening now) act as supporting forces and make the EM LCY a good diversification play. Risks to our positive view on EM LCY bonds is unexpected jump in EM inflation (particularly Asia) and resilient economic growth resulting in a less dovish/hawkish EM central bank surprise.

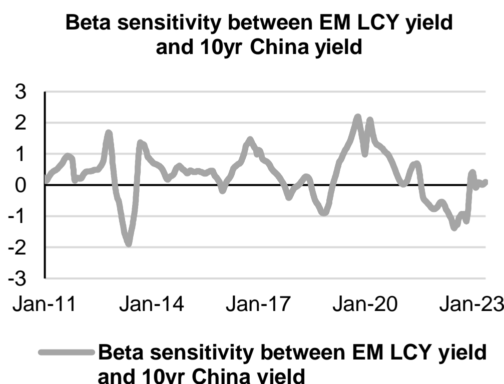
EM USD sovereigns performed well in 2Q23, mainly due to rally in EM sovereign HY bonds. We believe this strong performance is not sustainable as EMs with weak fundamentals are likely to remain vulnerable and exposed to external bond volatility. Given their high correlation and vulnerability to US financial conditions, we remain neutral on EM USD sovereigns and maintain our quality selective preference on GCC high-quality, Oman and Brazil. In EM corporate, we maintain our underweight stance. We took profit on Asia IG on the back of rise in China growth concerns and expensive valuations against peers (exhibit 11).

Exhibit 14: Waiting to add to long-duration assets



Source: Bloomberg, and ADCB Asset Management

Exhibit 15: EM LCY- more sensitive to China bond



Source: Bloomberg, and ADCB Asset Management

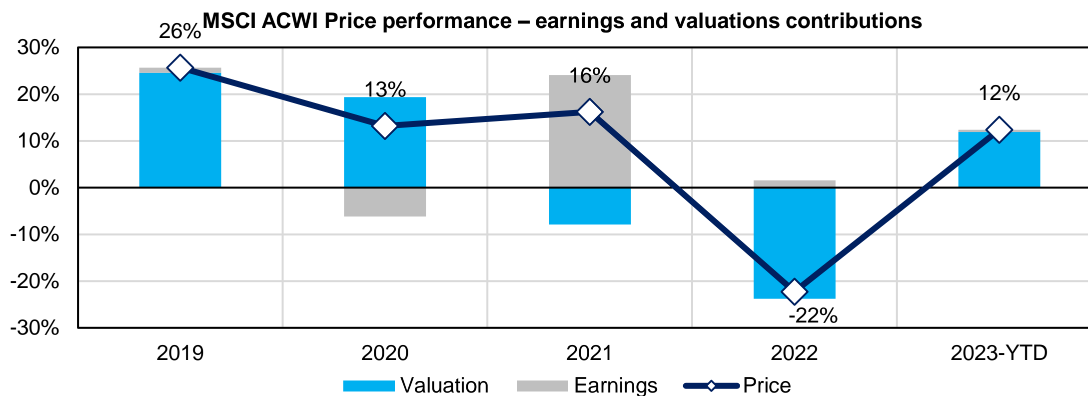
Equities

Strong H1 performance

Global equities, as measured by the MSCI All Country World index (ACWI) delivered gains of c14% in the first half of the year. This was the second best first-half performance for equities in almost 25 years. By region, US outperformed by 3ppt while Canada and UK underperformed. While Asian equities delivered gains, they underperformed global benchmarks. By global sectors, gains were concentrated in Information technology, communication services, and consumer discretionary. Energy and utilities sectors not only underperformed but also posted losses in absolute terms.

Equity market performance so far this year has been primarily driven by the valuation expansion while earnings contribution has been limited (exhibit 16). In 2022, compression of valuation multiples was entirely responsible for the bear market in global equities. However, so far in 2023, valuation multiples expanded as some of the extreme left tail risks associated with the hard landing of the US economy faded. After their year-to-date move higher, valuations now look to be fully discounting the potential for the US soft-landing. Accordingly, there is little upside left in valuations.

Exhibit 16: Price gains were driven by valuation expansion thus far. Earnings need to deliver from here on



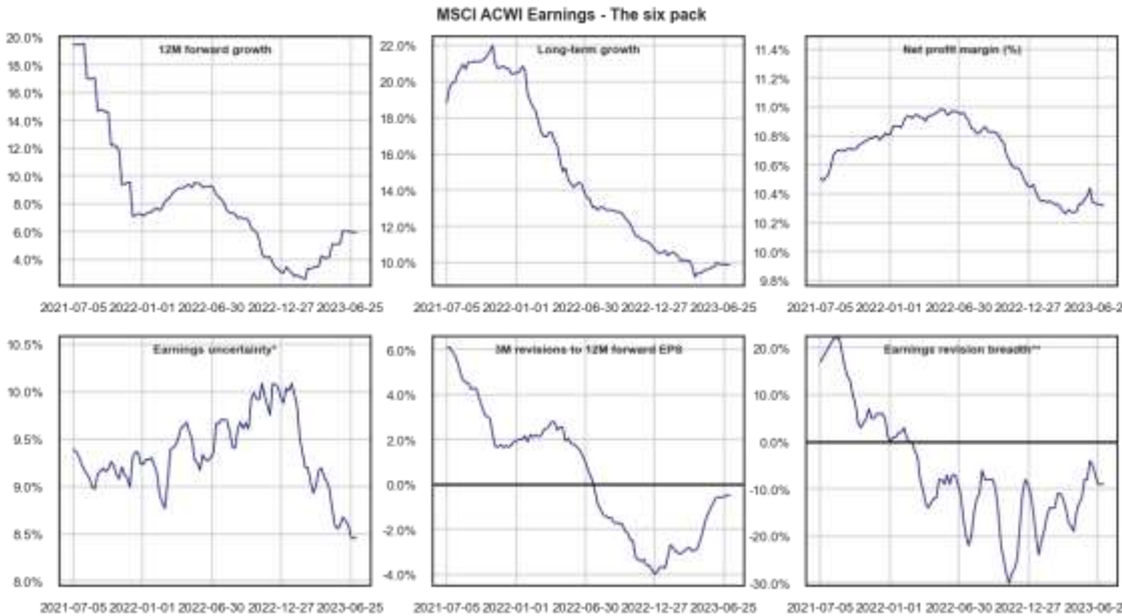
Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Looking ahead, earnings growth needs to take over as the primary driver of equity returns. Absent the earnings revival, equity markets may just move sideways with macro forces inducing volatility. However, we do believe that earnings growth is set to improve over the coming months – just in time to contribute positively to the returns. Yet, one should be mindful that earnings-driven equity returns tend to be much slower than valuation-driven ones. Therefore, while we still expect positive returns from equities, it is reasonable to assume that the fast gains that we have seen over the first half of the year are unlikely to be repeated in the second half.

Focusing on earnings, at the MSCI ACWI level we are seeing an improvement in earnings outlook (exhibit 17). For instance, the 12-month rolling EPS growth estimate has risen over the past five months after falling consistently since mid-2021. As it stands, as per I/B/E/S consensus, expectation for earnings growth over the next 12 months is +6% – we see upside to this number. Expectations for long-term growth in earnings have stabilized at c10% level after falling from the 22% level reached in late 2021. Net profit margins have stabilized too after contracting from the record-high levels reached in mid-2022. Earnings revision momentum has certainly improved during recent months. At the same time, revision breadth – which is a leading indicator for earnings – has turned less negative.

Previewing the Q2'23 earnings season which has just started, we believe that corporate earnings will deliver results above expectations triggering earnings upgrades. For the S&P 500, I/B/E/S consensus expects the aggregate earnings to have contracted by 8.1% (y-o-y) during Q2'23. If the energy sector is excluded, the contraction is expected to be 2.6% (y-o-y). Revenue growth estimate currently stands at -0.9% (y-o-y) for the overall index and it is +2.8% (y-o-y) when the energy sector is excluded. We think US corporates have done better than market expectations. As such, according to Refinitiv, as of 4th August, out of 84% of the companies in the S&P 500 that have reported earnings for Q2'23, 79% reported above analyst expectations. This compares positively to a long-term average of 66%.

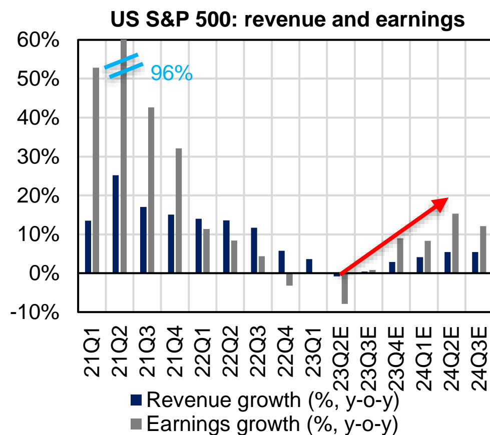
Exhibit 17: Signs of improving earnings trends are emerging



Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management. Notes: *Calculated as the ratio of the standard deviation of estimates for all constituents over mean of estimates for all constituents. **Calculated as the ratio of net number of companies seeing upgrades over the total number of companies.

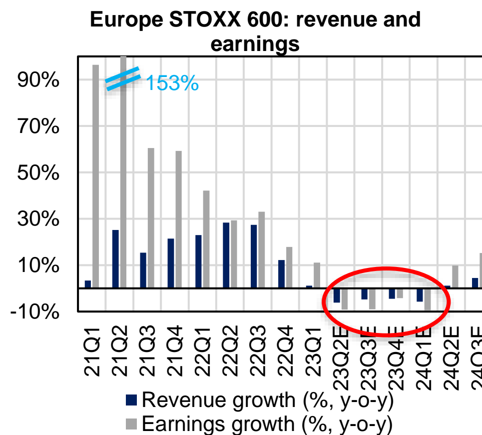
Worth noting that the earnings recovery trends are not uniform across regions and sectors. For instance, we would point the transatlantic divide. While the US earnings growth is expected to have troughed during Q2'23 (exhibit 18), European earnings growth is expected to turn positive only in Q2'24 (exhibit 19). This is in line with the US exceptionalism and weakening European economic momentum discussed in the Investment strategy section of this report (pages 2-4).

Exhibit 18: US corporate earnings are expected to have bottomed…



Source: S&P, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 19: …while in Europe, further drag cannot be ruled out



Source: STOXX, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Country/regional preferences, trade ideas, and thematic ideas

By country, we stay OW US and Asia Pacific-ex-Japan and significantly underweight Europe. We are also underweight on EMs outside Asia. We have an off-benchmark position in Nikkei 225 (Japan) on a FX hedged basis. Sector wise, we continue to see value in global communication services, industrials, and healthcare. Tactically, we also like some China themes (in anticipation of stimulus there) - HK equities, Chinese hotels & leisure, and Chinese semiconductors. For long-term investors, we have identified 13 different themes that are a play on changing trends in the global economy (*should you like to know more about these, please reach out to your ADCB Relationship Manager)*.

Alternatives

Private credit

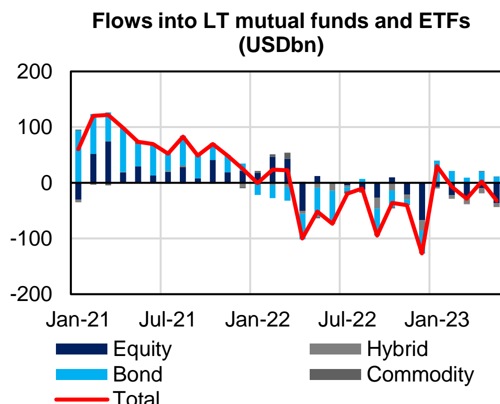
Private credit has attracted a lot of attention over the last several years. Data from Preqin showed that aggregate capital raised in private debt markets (direct lending, mezzanine, and distressed and special situations) has increased from under USD50bn in 2010 to cUSD230bn in 2021 before falling slightly in 2022. The private debt assets under management (dry powder + unrealized value) rose from cUSD300bn in 2010 to USD1,300bn in Q2'22. This rise in activity is primarily due to higher yields, and lower volatility that private credit offers. Following the Global Financial Crisis (2008/09) with the backdrop of lower yields in public fixed income markets, the search for higher yields made some investors venture into private credit space. Also, lower realized volatility of private credit was an attractive proposition given the higher volatility in public markets. For the context, on a volatility-adjusted basis, both the high yield bond and broadly syndicated loan markets consistently underperformed direct lending since 2010.

However, over the past year, a sharp move higher in yields in public debt markets prompted many market participants to anticipate a rotation away from private markets back into the public segments. Yet, the data shows little evidence to support the thesis that activity in private markets is fading. While the interest in public fixed income markets has increased over the past months, it did not come at the expense of private credit markets. Instead, the inflows into public fixed income came as investors rotated out of public equities (exhibit 20). Private credit markets continued to benefit from lower volatility at the time when volatility in public fixed income space rose strongly in 2022 and in 2023. MOVE index – a measure of implied volatility in treasury bonds has risen quite sharply over the past 18 months. At the same time, investors were attracted to higher yields in public fixed income assets. This caused them to rotate out of public equities (where risk premia are low) into public debt. Of course, with MSCI ACWI rising more than 14% during H1'23, avoiding public equities has been a pain trade for investors.

From a macro viewpoint, here are some observations:

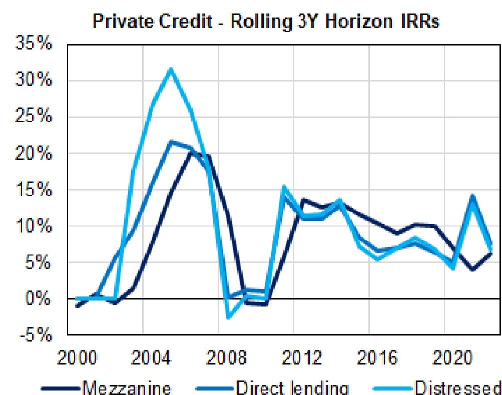
- The trend of continued rise in interest in private credit even at a time when public debt markets are offering attractive yields shows that investors are considering private credit as an asset class, instead of considering it as a mere alternative to public debt.
- Private credit markets appear to be adjusting to higher interest rates. According to an analysis from Goldman Sachs Global Investment Research, borrowers in private credit markets have experienced a significant increase in their coupon payments already.
- Given the floating rate nature of their liabilities, and smaller size of businesses, private debt issuers may be vulnerable to higher-for-longer interest rates and a global recession. However, our macro base-case scenario assumes no global recession and a normalization of interest rates in 2024.
- Further, it is worth remembering that large direct lenders achieve lower risks through reduced issuer concentrations, low loan-to-value ratios, better due diligence, tighter covenants, and controlled structures.
- We expect a higher dispersion of returns at the sub-asset class level and at the fund level. For historical rolling 3Y horizon internal rates of return (IRRs) see exhibit 21.

Exhibit 20: Investors rotated out of equities into bonds in a pain trade



Source: Investment Company Institute, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 21. Expect higher dispersion of returns across strategies



Source: Preqin, Datastream, Refinitiv, and ADCB Asset Management

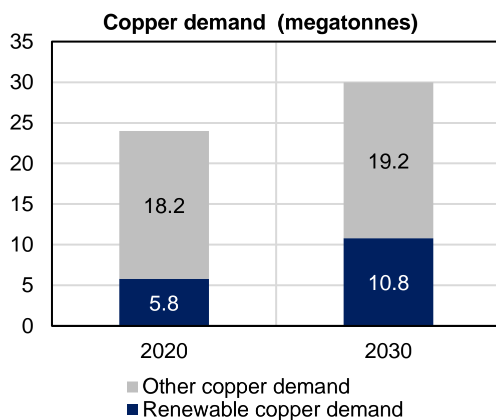
Copper

Cyclical outlook: Copper tends to be a strong play on China growth. Therefore, China growth disappointment in recent months has been a drag on copper prices. Given our expectations for a revival of the growth prospects in China (and its related themes), we do expect copper prices to bounce strongly during H2'23. Weaker USD tends to be supportive of higher copper prices. We think much of the USD strength is already behind us (see FX comments on pages 12-13 for more details) and this should support copper prices broadly. Globally, the manufacturing sector experienced acute weakness over the recent quarters (with PMIs below 50 and falling). However, we expect the activity in the sector to pick-up in H2 rendering support not only for the global economic growth but also for copper in specific.

Structural outlook: While we are not in a camp that sees a commodity super-cycle, we think certain commodities like copper enjoy a strong structural outlook from the green transition. As you can see from exhibit 22, most of the demand growth for copper is likely to come from the renewables segment while the demand from other segments is likely to remain strong. At the same time, the copper supply is expected to fall (for a variety of reasons including water restrictions, declining grades of ore, labour/social unrest and strikes at mines) creating a sizable deficit for the metal starting from this year (exhibit 23). This should squeeze prices higher.

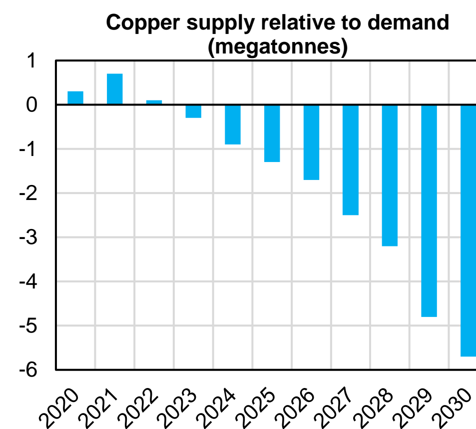
Investment risks: As is the case with most commodities, copper prices could be highly volatile. Therefore, investing into metals (copper included) may not be suitable for all investors. The vehicle of investment matters given costs and risks.

Exhibit 22: Copper is important for green sectors



Source: International Energy Agency, Citi, Evelyn Partners, and ADCB Asset Management.

Exhibit 23: But supply deficit is expected to increase over the coming years



Source: International Energy Agency, Citi, Evelyn Partners, and ADCB Asset Management.

Commercial real estate

During Q2'23 markets' focus has shifted away from the risk of a systemic banking crisis towards the implications for bank lending. Even prior to the banking sector stresses surfaced in the US and Europe, credit tightening was already in place – as indicated by Central bank lending surveys. For instance, the share of ECB banks that made their lending standard stricter rose during Q1 2023 to its highest level since 2011. In the US, the share of domestic respondents in favor of tightening standards rose sharply too but to its post-pandemic high. However, the banking sector stresses have increased the prospects of further credit tightening as both willingness and ability of banks to lend is reduced. A further question is to what degree regulators will move to curtail banks' lending ability. Against this backdrop, the real estate sector has become the new found hotspot. The Commercial Real Estate (CRE) industry could be negatively impacted by the banking sector stress in two different ways – impaired lending, and reduced buying of senior tranches of securitization. Especially in the US, regional banks (which have been the source of crisis) have sizable exposure to CRE. These linkages become more important given the 'non-amortizing' nature of CRE mortgages, which tend to be of 5-10 year terms. CRE also has imminent refinancing needs. For the context, as per Morgan Stanley, USD450bn out of the USD5trn in total CRE debt matures this year and needs refinancing. A total of USD2.5trn CRE debt is set to mature over the next five years – c40% of this came from the banking sector. Retail banks' exposure to CRE lending has grown in recent years with 70% of the core CRE debt coming from regional banks. Banking sector stress came at a time of acute refinancing needs of the CRE sector. This has put additional pressure on CRE prices. Office sector – where vacancy rates are at, or near, all-time highs – is likely to face cash-flow interruptions and a potential fall in property values. Residential mortgages might be the least impacted in this category.

Currencies

US Dollar

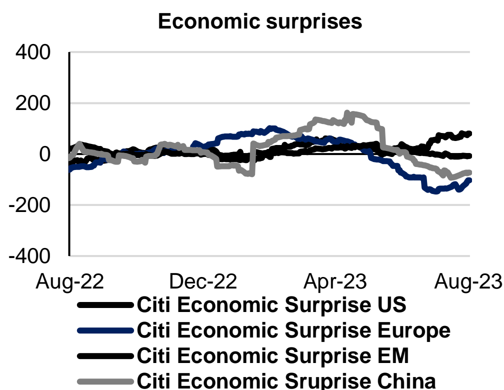
The USD fell, albeit only marginally in the first half of the year despite witnessing two episodes of increased market volatility and deterioration in risk sentiment- first in March due to the banking sector crisis and second in May during the debt ceiling concerns. Interest rate factor and risk sentiment took turns in driving the dollar performance. But it was the interest rate factor which was more dominant especially in the second quarter when markets started to reprice higher expectations of Fed rate hike. This caused the USD to rally putting a pause to the continued weakness post the banking sector crisis. The strong relation with the interest rate differentials was explained by upbeat economic data out of US signalling relative resilience in the US economy. This was particularly evident in June when US economic data started to positively surprise market expectations versus global peers which experienced downward economic surprises (exhibit 24).

In the near term- we believe the interest rate factor could continue to drive the dollar to some extent. Monetary policy uncertainty is likely to persist in the near term with markets going back and forth in terms of pricing the timing of the last Fed rate hike. Overall, from interest rate differentials point of view- the USD is set to weaken as the other DM central banks- the ECB and the BoE are slated to raise interest rates more than the Fed. However, we are unlikely to see sharp weakness in the USD to the same degree or magnitude seen since September 2022 which could only happen in the event of slowing US outperformance versus DM peers and continued slowing inflation prompting a dovish Fed reaction. While the USD is likely to remain weak considering the current end phase of Fed tightening cycle, we could still witness episodes of brief USD strength. This could be the case if US growth continues to outperform DM peers and further delays the timing of a turn-around in the Fed policy. The key risks to our weak USD view are 1) ECB/other DM central banks turn dovish 2) decline in risk appetite or increase in global growth slowdown concerns 3) strong US growth outperformance.

Euro

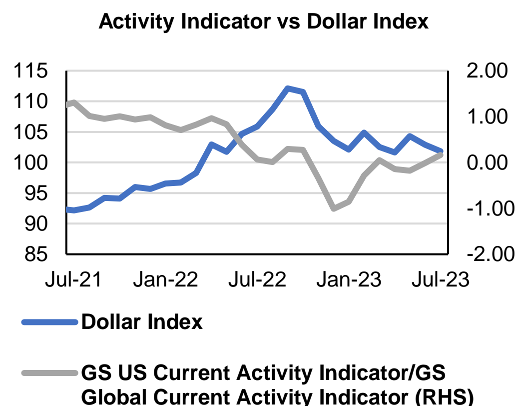
EUR has been one of the top performers in 1H23, but most of the outperformance occurred in 1Q23. During the beginning of the year, markets had turned optimistic about the growth outlook of the region which translated into market paring the recessionary bets on the region. This optimism supported the EUR rally which was even resilient during brief period of global market volatility when the banking sector crisis hit the markets in March 2023. However, investors were later met with disappointment in 2Q when European economic data started to surprise negatively. As a result, the EUR-USD started to trade on the side-lines. Despite the growth underperformance, EUR did not witness significant deterioration as sustained and sticky inflation forced the ECB to remain aggressive. We believe that in the near term- EUR should be stable with a strong rally looking difficult: While the ECB – still lagging behind the Fed and facing a more challenging inflation backdrop- could be forced to remain hawkish than the Fed in the near term. This should support the euro. However, risk of economic slowdown vs continued US growth outperformance could keep the EUR in check. We maintain a neutral stance on the EUR.

Exhibit 24: US positive growth surprises..



Source: Citi economic surprise index, Bloomberg, ADCB Asset Management

Exhibit 25: ..leading to stable USD

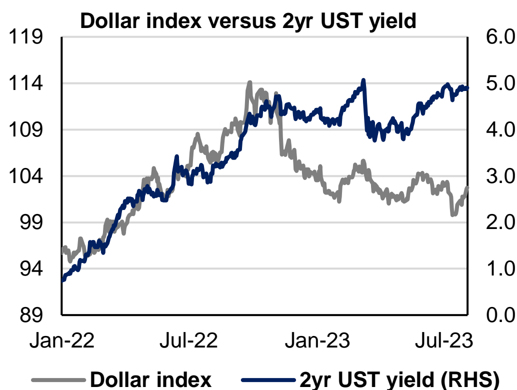


Source: Goldman Sachs, Bloomberg, ADCB Asset Management

Pound sterling

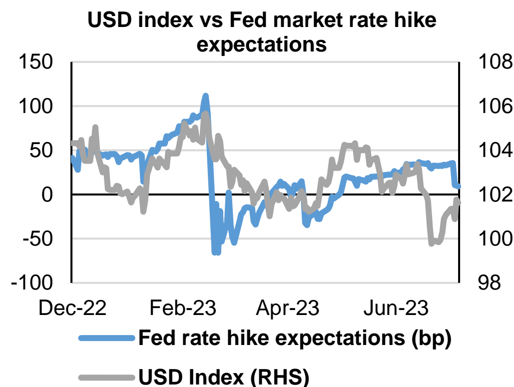
GBP has outperformed other G10 currencies, recording gains of around 5% in 1H23. Better than expected economic data, strong consumer confidence, sticky inflation and continued BoE tightening have proved to be supportive for the currency. While inflationary pressures have subsided in the US and in Eurozone, inflation has proven to be more persistent in the UK. Tight labour market and wage growth, particularly has been quite strong in the UK. While recent PMI surveys point to weakness in economic activity, the BoE could continue to hike policy rates even when the Fed goes into pause mode given the stickiness in inflation. Markets still expect another two rate hikes of 25bp from the BoE. As such, we believe that BoE will be more hawkish than the US Fed and accordingly expect GBP to still strengthen against USD in the near term. However, any material rise in recession probabilities in the UK will be a setback for GBP.

Exhibit 26: Interest rates have been..



Source: Bloomberg and ADCB Asset Management

Exhibit 27: ..an important driver for USD

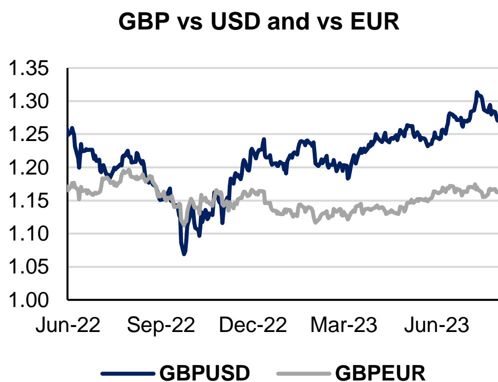


Source: Bloomberg, and ADCB Asset Management

Japanese Yen

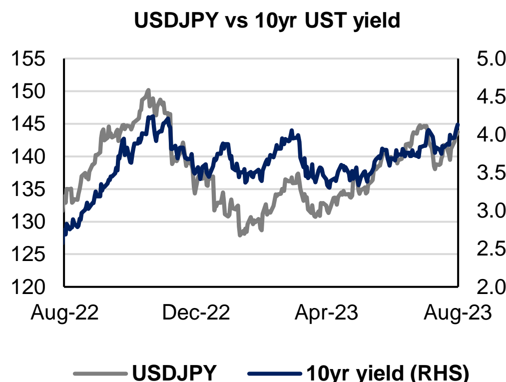
JPY has weakened by 9% (exhibit 29) against the USD in 1H23, despite strengthening in 1Q23. This was on account of rise in UST yields in 2Q23 but more importantly markets met with disappointment over the BoJ not pursuing a change in monetary policy. New BoJ governor Ueda failed to advocate any change in the current policy approach in 2Q23. More recently, the BoJ surprised the markets with slight policy tweak, introducing more flexibility to its yield curve control policy and regard the upper and lower bound of the target range as reference points rather than limits. This new flexibility has failed to have any meaningful impact on the USD-JPY as any sharp rise in JGB yields have been met with BoJ intervening in the market with bond purchases. We turned negative on the JPY in June and maintain our negative outlook. In the near-term, it is unlikely to witness significant strength in the JPY as the BoJ is unlikely to exit from the YCC policy before the year-end. Risks to our negative view on JPY is BOJ announcing an exit from its loosening monetary policy stance and the Fed turning dovish causing UST-JGB interest rate differentials to tighten.

Exhibit 28: Pound sterling- leading the pack



Source :Bloomberg, and ADCB Asset Management

Exhibit 29: JPY weakened against the USD



Source: Bloomberg, and ADCB Asset Management

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