Investment Strategy

Quarterly Investment View | July 2022

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Q3 2022 Outlook: Delayed, not derailed

Financial markets have experienced extraordinary volatility during H1 2022 as inflation hit a multi-decade high. Both bonds and equities lost value in tandem – challenging even multi-asset portfolios. Elevated inflation and sharp rise in interest rates have also started to feed the stagflationary fears amongst investors. We think a recession over the next 12 months is not inevitable, and that our base-case scenario of falling inflation and slowing growth has been delayed, but not derailed.

Financial markets have had a turbulent H1 2022. Driving the turbulence in financial markets were a range of factors including persistently high inflation, slowing growth, lingering virus, rising geopolitical risks, and the central bank tightening – all at the same time. Going into the second half of the year, we continue to see macro uncertainty persist. While the recession probabilities have certainly risen, they are still not at levels which indicate an imminent recession. A mid-cycle slowdown remains our base-case and we think Fed tightening could play out like in 1990s (soft-landing) and not like the 1980s (hard-landing). However, our worst-case scenario takes into account the rise in recession probabilities. We discuss this in the investment strategy section on pages 2-3. We remain neutral equities and alternatives, underweight fixed income (but with increased overweight in USTs, and adding duration), and still keeping cash at an overweight to deploy when the opportunity arrives. For our detailed portfolio positioning see pages 4-5.

Fixed income (pages 6-7): While most fixed income assets posted losses during H1 2022, a short-duration stance (vs the benchmark) worked. However, after the dismal first half, we believe the second half could look better for fixed income assets. Rising recession risks/slowdown fears could favour US Treasuries. We add duration on USTs. Elsewhere, we stay neutral on US and EU IG, underweight on US and EU HY. We emphasise our preference for high-quality bonds. Within EM, we are neutral USD sovereigns, underweight local currency bonds. We remain overweight EM Asia credit.

Equities (pages 8-9): Equities entered a bear market and capped the worst H1 on record. Most of the equity market losses this year were driven by a fall in valuations while earnings held up well. History suggests that returns are generally strong after such a bleak first half – this is in line with our base-case. However, should the worst-case scenario materialize, there is further downside for equities. Against this backdrop of elevated uncertainty, equity investors are better served by focusing more on quality, non-cyclical growth, and relative (rather than directional) calls. Our conviction is in Asia and global healthcare.

Alternatives (pages 10-11): Alternatives continue to provide the diversification benefits. We remain overweight on gold, and macro/market-defensive hedge fund strategies. Elsewhere, we think we are unlikely to see another super-cycle in commodities. Should global economic slowdown concerns persist, industrial metal prices look more vulnerable. Prices of food commodities have risen sharply over the past two years, but more recent data points to a moderation. In this note, we also discuss the outlook for industrial real estate – which could be challenging in the near-term but remains constructive long-term.

Currencies (pages 12-13): After a stellar rise in H1, we think it is difficult for the USD to rise further in H2. But we do acknowledge that there are macro forces which could stop the USD from falling sharply. While we remain negative on the outlook of EUR/USD, we are slightly less negative now than 3-months ago. ECB tightening and improving China outlook should help the EUR. We expect that the pound sterling to remain weak versus the USD and flat versus the EUR. Given the BoJ is the most dovish of all major DM central banks, the wide interest rate differential will keep the JPY weak versus the USD.

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Investment strategy

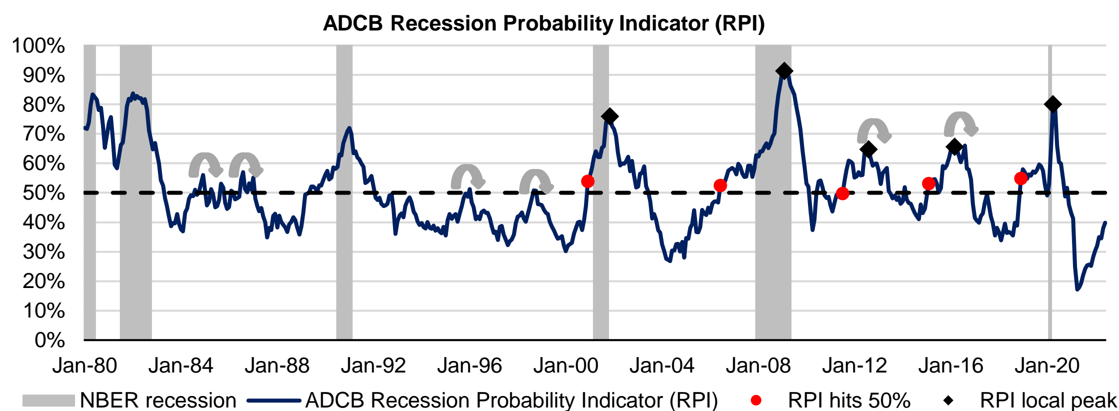
Financial markets have had a turbulent H1 2022. What was more stressful to investors was the fact that bonds and equities experienced volatility and drawdowns at the same time. Global equities entered a bear market while global bonds recorded their worst performance ever. Driving the turbulence in financial markets were a range of factors including persistently high inflation, slowing growth, lingering virus, rising geopolitical risks, and the central bank tightening – all at the same time. Financial markets are notoriously famous for their inability to focus on more than one risk at a time. Therefore, when confounded by a range of risks, financial markets tend to become volatile purely reflecting the uncertainty. During such periods, the bearish sentiment dominates even the relatively strong fundamental picture; and it is easy to be bearish at a time when asset prices are falling. This further exacerbates the weakness in financial markets. This has been the story so far this year. However, the narrative seems to have changed more recently – while markets were fixated on the persistent and elevated inflation for most part of H1 2022, recent weeks saw more focus on rising recession risks. No wonder, "recession" is one of the most searched keywords on Google of late.

Is a recession inevitable?

Well, it is inevitable at "some point" but does not mean that we are most likely to see one in the next 12 months. Going by the history, recessions do happen regularly. Between 1929 and 2008, the US had 14 recessions – that averages one recession every 5.6 years. The economic expansions that precede recessions come in various lengths – some could last just a couple of years while some could last over a decade. For instance, after the recession linked to the Global Financial Crisis of 2008/2009, the US economy enjoyed its longest ever (albeit also the weakest) economic expansion which lasted for about 10.5 years before ending in the COVID-19 related economic shock. Even the expansion in the 1990s lasted for about 10 years before ending in the early 2000s recession. Admittedly, recessions were more frequent in 1970s and early 1980s.

In our view, the question "is a recession inevitable?" is vague, incomplete, and to some extent rhetorical. Instead, the question to be asking is "how likely is a recession over the 12 months?". To answer that we turn to our data-driven proprietary recession probability indicator (RPI). For details on how we constructed this indicator, see Q2 2022 Outlook: Watchful, not worried. After rising 12ppt over the past six months, our RPI now indicates a 40% probability of a recession over the next 12 months in the US. While this sharp rise in recession probabilities has caused investor concern, history suggests that the current levels still do not indicate an imminent recession in the US (exhibit 1). Key levels to watch on this indicator are 50-60-70-and 80%. Major driver of recession fears in recent months has been the elevated inflation – feeding into the economic outlook through weakening consumer sentiment and higher interest rates. Should inflation start to normalize from the current elevated levels, recession fears could start to abate too, in our view. Equity market performances are already reflecting a high probability of a recession. Any evidence that points to fall in recession chances should bring immediate relief to risk assets.

Exhibit 1: Recession probabilities have risen, but a recession is not a given



Source: National Bureau of Economic Research (NBER), Refinitiv, and ADCB Asset Management

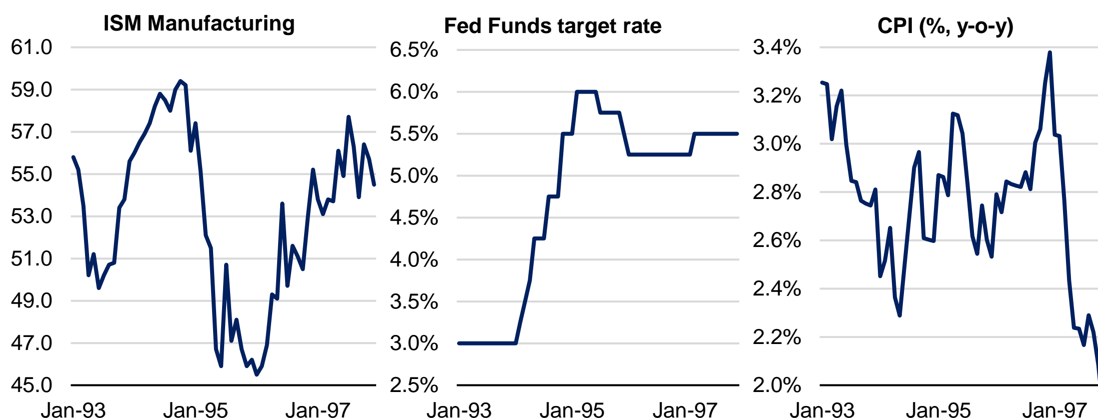
Segments of the bond market yield curve have moved rapidly as they quickly discounted various different aspects of inflation, interest rate hikes, and the subsequent economic slowdown. Taken in aggregate, bond market yield curve dynamics tell us that inflation is elevated but likely peaking, central bank policy is turning hawkish, and likely tipping the economy into a recession.

Hard-landing of the 1980s or the soft-landing of 1990s?

Market participants have often drawn parallels between the current situation and that in early 1980s when the US policy makers had to engineer a recession to bring down inflation which remained elevated through much of 1970s. Whilst there are similarities between now and the 1980s, there are also differences. The most importance difference is at that time inflation expectations became entrenched and unanchored creating a real inflation spiral. However, at present, while inflation is at elevated levels, inflation expectations remain well anchored. In fact, recent months have seen a fall in inflation expectations and market pricing has adjusted accordingly (exhibit 5 in the Fixed income section on pages 6-7).

In this context, we find 1990s template as more relevant (exhibit 2). Following the 1991 recession, the economy rebounded quite strongly and Fed appeared to be behind the curve. However, quick front-loaded rate hikes helped the US Fed to bring down inflation without actually causing a recession. Whilst there are differences between now and the 1990s, there are also similarities. Like 2022, 1994 was also a mid-term election year under a first-term Democratic President whose approval rating was falling and political risks were elevated. Equities wobbled all through the year in 1994 before ending mildly negative. With capacity utilisation remaining elevated, the Fed delivered rate hikes to cool down demand as supply and labour shortages remained. After all, 1994 was when Fed last delivered a 75bps rate hike before repeating the act recently. Recession fears rose sharply as a result in 1994. However, political fears subsided after the midterms delivered a gridlock. GDP growth slowed in 1995 before accelerating in 1996. Inflation stayed in a range before decelerating in 1997 and 1998. Equities rose every year between 1995 and 1999. Going by the 1990s experience, a soft landing is possible and a recession is not inevitable when Fed normalises its policy. Yet it takes Mark Twain to remind us that 'history doesn't repeat itself, but it often rhymes'.

Exhibit 2: Behaviour of growth and inflation when Fed raised rates in 1994



Source: ISM, Bureau of Labor Statistics, US Federal Reserve, Refinitiv, and ADCB Asset Management

How should investors position?

We think it is always prudent for investors to think about macro uncertainties using scenario-based approach. As such, we define three scenarios here: base-case, worst-case, and best-case. **Base-case scenario:** with a probability of more than 50% is a benign scenario under which inflation starts to cool from extremely elevated levels (thanks to easing supply bottlenecks and slowing demand growth), Fed does not pursue an overly restrictive policy, and the economy manages to soft-land. This is similar to our "mid-cycle slowdown" thesis which we discussed in our Q2 2022 Outlook: Watchful, not worried. Under this scenario, risk assets are likely to recover while bond yields are likely to fall. **Worst-case scenario:** with a probability of c40%, the US economy falls into a mild recession as the Fed focuses on fighting inflation. Under this scenario, risk assets are likely to have further downside. Safe-havens including sovereigns, gold, and USD are likely to do well. **Best-case scenario:** has a very low probability (of less than 10%) where inflation falls precipitously giving Fed the scope to not pursue an overly hawkish monetary policy. This should in turn help economy avoid a significant slowdown. In this scenario risk assets are likely to recover above their previous peak. Safe havens are likely to underperform.

Going by the weighted average of our scenarios, we remain neutral equities and alternatives, underweight fixed income (but with increased overweight in USTs, and adding duration), and still keep cash at an overweight to deploy when the opportunity arrives. Within equities, we have higher conviction now in our overweight in Asia (by region), and global healthcare (by sector). Within alternatives, our preference remains for gold and macro/market-defensive hedge fund strategies. Amongst currencies while we are not negative on the USD, we think much of the greenback appreciation is behind us.

Porftolio positioning

Exhibit 3: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities		■		Diversified exposure to quality and non-cyclicality
Fixed income	■			Prefer USTs and DM sov. that cushion the risk-off
Alternatives		■		Prefer gold; macro/market-defensive strategies
Cash and liquidity			■	To deploy when the opportunity arrives
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US			■	Prefer equal weighted indices; focus on quality
Canada		■		Stick with the benchmark
Europe ex UK	■			Focus on quality and China-exposure
UK			■	Prefer global large caps with quality-tilt
Japan			■	Improving governance, and cheap valuations
Asia Pacific ex Japan			■	Prefer China and ASEAN
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows, and weak currencies
EM EMEA	■			
GCC		■		Stick with the benchmark
Global sectors				
Comm. Services			■	Diversified telecoms and Media
Consumer Discr.		■		Hotels, Rest. & Leisure
Consumer Staples		■		Food, Beverage & Tobacco
Energy		■		Capital discipline and makeover plays
Financials	■			Focus on growth opportunities in Asia; fintech
Health Care			■	Prefer defensively-oriented inexpensive segments
Industrials			■	Industrial automation and IoT; likely GICS change
IT		■		Cautious on tech hardware and semiconductors
Materials	■			Structural weakness on a shift to ‘new economy’
Real Estate		■		Real estate management & development
Utilities	■			Gas utilities and Renewable Electricity Prod.
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage and peak-growth
Growth			■	Strong preference for non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from ‘new economy’ orientation
Legend	*New*	*Old*	*No change*	

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks.

Exhibit 3: Recommended portfolio positioning (continued)

Fixed income**	Underweight	Neutral	Overweight	Comments
Duration	Old		New	Add duration (on USTs) vs benchmark
US Treasuries			No change	Prefer US Treasuries acting as a hedge
US Credit				Preference for HQ corporates over HY corporates
Investment Grade		No change		AA; short-duration sectors- financials
HY (off benchmark)	No change			Short-dated, BB; financials and communications
European Bunds		No change		ECB to be less aggressive
European Credit				Preference for HQ corporates over HY corporates
Investment Grade		No change		End of ECB's bond buying
HY (off benchmark)	No change			Weak growth; end of ECB's bond buying to weigh
EM USD Sovereign		No change		
Brazil			No change	Tight financial conditions, hawkish Fed, higher commodity prices to weigh on EM HY and EM importers, selectivity is key
HQ*** GCC + Oman			No change	(Brazil and HQ GCC + Oman)
EM LC Sovereign	No change			EM policy normalization
EM Corporate	No change			High leverage is concern, but opportunities in Asia
- EM Asia			No change	Preference for Asia IG with spreads attractive
Alternatives	**Underweight**	**Neutral**	**Overweight**	**Comments**
Gold			No change	Hedge against political and inflationary risks
Oil		No change		Looking for a balanced market
Other commodities	No change			Commodity super-cycle is difficult to realize
Hedge funds		No change		Prefer macro and market defensive strategies
Currencies	**Negative**	**Neutral**	**Positive**	**Comments**
USD			No change	Fed's aggressiveness versus DM central banks
EUR	No change			Path of short-term rates over long-term
JPY	No change			BoJ policy remains odd-one out
GBP	No change			BoE likely to be less aggressive
EM currencies		No change		Driven by idiosyncratic developments

Legend *New* (shaded box) | *Old* (outlined box) | *No change* (shaded outlined box)

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: **Positions recommended based on Bloomberg Barclays Global Aggregate (USD unhedged) Index benchmarks. ***HQ = High Quality

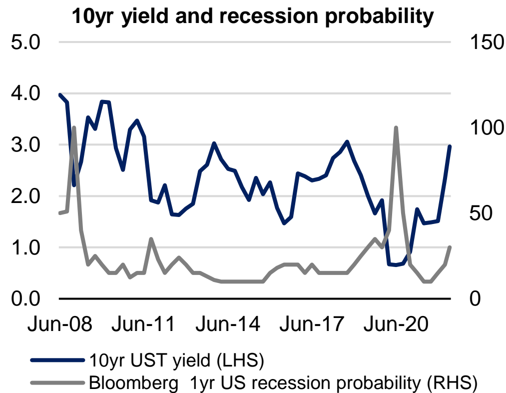
Fixed income

We add duration on USTs (7-10yr segment)

Fixed income assets had a challenging first half of the year with aggressive central bank policy response to the persistent inflation pressures weighing on the sentiment. Bloomberg Global Aggregate bond index declined by c14% in the first half of 2022, marking its worst performance to date. Global central banks further intensified their response to stem 40yr record high inflation pressures in the second quarter of this year. Starting with US, the Fed delivered a 50bp rate hike in May, followed by a 75bp rate hike in June- the largest one-time policy rate hike since 1994. The ECB signalled its willingness to raise policy rates in the second half of this year and announced an end to its asset purchase programmes. However, reacting to the rise in periphery spreads and to avoid a repeat of the Eurozone debt crisis, the ECB in an emergency meeting softened its hawkish rhetoric and indicated it was looking into tools to avoid fragmentation of the bond markets. The Bank of England raised policy rates for the fifth time in a row with the backdrop of weakening growth outlook. In contrast to the DM peers, the BoJ stuck to its accommodative monetary policy stance.

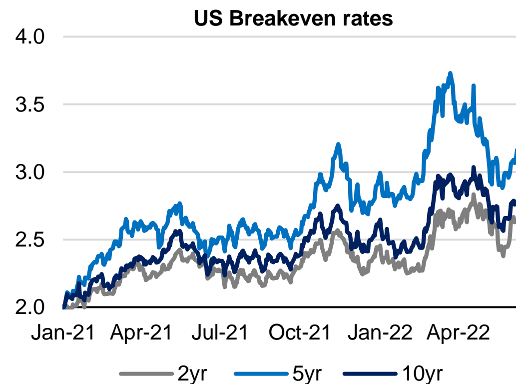
The first half of the year for fixed income assets pretty much played out as we had expected during the start of the year. Inflation uncertainty and central bank policy path were the dominant drivers for the fixed income assets with yields rising across the curve and bond market volatility reaching new highs. A short-duration stance (vs the benchmark) worked in favour (3-5yr UST segment posting loss of c6% in 1H22 vs 10-20yr UST segment recording loss of c19% in 1H22 and vs Bloomberg Global Aggregate loss of c14% in 1H22). However, after the dismal first half, we believe the second half could relatively look better for fixed income assets. Whist volatility is likely to remain, focus has now moved towards the Fed's possible policy path and whether the central bank's aggressive stance could hurt the growth outlook. Rising recession risks could favour US Treasuries given their safe-haven characteristics. This underscores our recent increase in allocation to US Treasuries (Q2 2022 Outlook: Watchful, not worried)

Exhibit 4: Rising UST yields and recession probabilities not a past trend



Note: The recession probability indicator above is not ADCB's RPI. Source: Bloomberg, and ADCB Asset Management

Exhibit 5: Inflation has peaked?



Source: Bloomberg, and ADCB Asset Management

At the same time, we believe now is the time to add duration exposure. The UST yield curve has flattened recently with certain parts of the yield curve inverting. The yield curve could flatten further with the Fed remaining aggressive in its resolve to contain inflation pressures while the market anticipates the Fed policy to trigger an economic downturn. Our case for adding duration is backed by firstly the disconnect seen between the rising recession probabilities and the upward trend in long-term UST yields. Historical precedents indicate that the recent positive correlation between the movement in UST yields and recession probabilities has been rare. Economic data has started to point to increased slowdown risks with the Citi US economic surprise index moving deep into the negative zone after turning negative in mid-May. Secondly, market-based inflation expectations, key driver for long-term bond yields, have softened and may already have peaked. We believe these expectations could eventually start feeding into easing of consumer-survey based inflation expectations (sudden surge being one of the reasons for the bumper 75bp Fed rate hike in June). Finally, the market expectation of peak Fed fund rate stands at around 3.5% with pricing of a rate cut in 2023 (Eurodollar pricing). Long-term bond yields have declined after touching this market implied peak rate. The long-term rates are also fully pricing in the expectation of the Fed moving past the Fed's projected long-term neutral rate of 2.5% (restrictive monetary policy). Furthermore, increased rate cut expectations

should lead to a decline in bond yields across the curve, but would benefit the long-dated bonds due to their interest rate sensitivity.

Neutral on US and EU IG, Underweight on US and EU HY, Preference for high-quality bonds
Aggressive DM central bank policy stance and increased bond market volatility have been significant headwinds for the DM corporate credit. Bloomberg US IG bond index has declined by 14% in 1H 22, while Bloomberg US HY bond index dropped by 14% in 1H 22. Long-duration characteristics and narrow spread buffer were responsible for the US IG underperformance while US HY tracked the stock market volatility. While the headwinds for USD credit are unlikely to recede in the near term, we do not anticipate a repeat of the 1H 22 sell-off, particularly in case of US IG. The sell-off looks excessive with US IG index having declined to levels last seen during the Covid-19 sell-off. Valuations are now looking cheap with the current yield-to-worst on the US IG index trading near the highest levels since 2009. However, amidst rising recession risks quality is key. We remain neutral on US IG but intermediate US IG is looking good in terms of valuations vs long-dated US IG. In terms of ratings, AA rated bonds look attractive, having underperformed the BBB rated segment. US HY slightly outperformed US IG. But we maintain our underweight (off-benchmark) on US HY given its strong correlation with the movement in equity markets. In addition, signs of rising liquidity risks in US HY are emerging with the decline in new issuances, posing risks for the refinancing needs of lower-quality corporates. In fact, the underperformance of CCC bonds vs BB bonds is already underway, in a reversal to the trend seen in 1Q22.

Stay Neutral on EM USD sovereigns, Underweight on EM LCY bonds; Overweight on EM Asia credit
EM USD bonds were the worst performers in 1H 22 with losses exceeding 20%. Tightening of US financial conditions, rising UST yields, stronger dollar and finally China debt-sell-off have been significant headwinds for the EM debt. The sell-off has raised the attractiveness of the EM USD sovereign bonds, particularly versus the US HY and the EM LCY peers. However, it is still early to increase allocation to EM USD sovereign bonds. EM USD sovereign bonds are vulnerable to further tightening of financial conditions, meaning more funding stress for EM sovereigns, particularly the EM HY sovereigns. Default risks have aggravated in countries with sizeable public debt (Argentina and Sri Lanka). Broad dollar strength is a threat for the emerging markets given most of the EMs hold huge dollar-denominated debt, making them susceptible to increased external volatility. Economic fallout from the Russia-Ukraine crisis has further exacerbated the financial distress of weaker EM economies (Sri-Lanka, Pakistan, Argentina, Egypt). Meanwhile, China debt troubles are also unlikely to vanish anytime soon, but signs of turn-around in China credit impulse and pick-up in economic activity is positive for the sentiment of the asset class. However, given the rise in external risks at a time when EM debt levels have reached record high, we maintain our neutral stance on the EM USD sovereign debt. Based on our credit score model, we continue to prefer EM commodity exporters on the back of their strong fundamentals. In addition to our selective preference for high-quality GCC and Brazil, we now also add Oman to the list which is trading attractive due to its improved economic outlook. Fiscal positioning of Oman has improved on the back of government's diversification efforts coupled with rise in oil prices. The country's oil breakeven levels have dropped from 101USD/bbl in 2016 to 60USD/bbl in 2022.

In EM corporate, we retain our preference for Asia credit through our overweight stance on Asia IG bonds. Asia IG bonds have outperformed US IG and EUR IG bonds in the first half of the year. As a result, Asia IG is trading slightly expensive compared to US IG but still trading cheap versus the EUR IG. China's credit impulse is showing signs of improvement, inching closer to the positive growth rate on yoy basis. Latest economic activity indicator also points to improving growth outlook in China compared to weakening growth outlook in the US. Asia HY - though trading at attractive levels - continues to remain vulnerable amidst the defaults of key Chinese real estate companies.

Equities

What comes after a bear?
On June 13 2022, S&P 500 index entered its bear market which is defined as at least a 20% drop in the price of the index from its recent peak. To start with, getting the context is important. During February and March of 2020, S&P 500 lost c34% in what was the sharpest decline in its prices ever. Subsequent to hitting a trough on March 23, 2020, S&P 500 index has risen a whopping 114% by January 03, 2022. However subsequently, the market recently corrected by 23% leaving the S&P 500 index currently just 64% higher compared to the March 2020 lows. So far this year the price action has been driven by shrinking valuation multiples in turn driven by the normalizing monetary policy while earnings growth remained intact. The first question that comes to mind is “where do we stand in terms of the scope of the current market drawdown?”

To get a sense of this, we looked at previous episodes of S&P 500 index falling by more than 20%. We found eight such episodes since mid-1960s (exhibit 6). In these episodes the maximum drawdowns varied quite significantly. For instance, the smallest bear market drawdown was 22% in 1966 and the largest was 57% during the Global Financial Crisis of 2008/09. Still, looking at the average of eight instances, the drawdown was c38%. Bear markets in equities which are not accompanied by a recession tend to be rare but when they occur, they tend to be light in terms of the drawdowns. Since mid-1960s we had two instances of S&P 500 getting into a bear market territory, but the US economy did not enter a recession. Here, on an average, the maximum drawdown was 28%. However, when the bear-market in equities coincides with a recession, the drawdowns tend to be larger. We have had six such instances over the past 55 years where the S&P 500 index experienced an average drawdown of 42%. So, when we put the current 23% drawdown into historical context, we are led to believe that the US equities might be close to a bottom if a recession can be avoided and that there is further downside from here if a recession eventually arrives.

Exhibit 6: S&P 500 bear markets since 1960s

Peak	Trough	Peak-to-trough drawdown	Recession	After the trough 3M	6M	12M	3Y
9/2/1966	7/10/1966	-22.2%	No	11%	23%	32%	30%
28/11/1980	12/8/1982	-27.1%	Yes	38%	42%	58%	88%
25/8/1987	4/12/1987	-33.5%	No	20%	19%	20%	42%
19/2/2020	23/3/2020	-33.9%	Yes	38%	48%	75%	64%
29/11/1968	26/5/1970	-36.1%	Yes	17%	21%	46%	58%
11/1/1973	3/10/1974	-48.2%	Yes	10%	33%	38%	55%
24/3/2000	9/10/2002	-49.1%	Yes	19%	13%	33%	56%
9/10/2007	9/3/2009	-56.8%	Yes	39%	50%	66%	101%
Average		**-38.4%**		**24.0%**	**31.2%**	**45.9%**	**61.7%**
Average (recession)		**-41.9%**		**26.8%**	**34.6%**	**52.6%**	**70.4%**
Average (no recession)		**-27.8%**		**15.6%**	**20.9%**	**25.8%**	**35.8%**

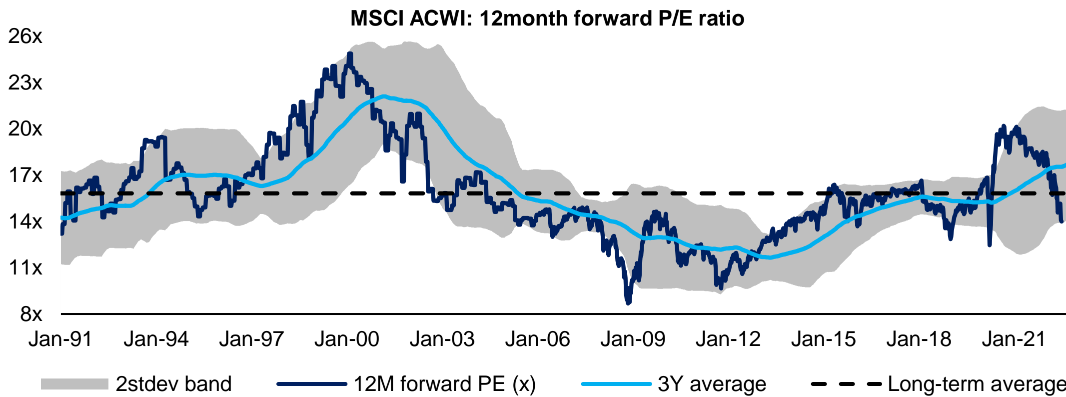
Source: S&P, Refinitiv, and ADCB Asset Management

Now the question that follows is “what comes after a bear market and how should long-term investors react?” We once again revert to the history where in all the eight instances discussed earlier, markets bounced quite strongly subsequent to finding to a bottom. For the context, after market troughs, S&P 500 index rose by 24% and 46% over the 3-month period and the 12-month period, respectively. On an average, markets reached three-fourths of the peak price 3-months after hitting a bottom and recovered completely within three years. Of course, there are variations within the sample. According to an analysis by Schroders, if you had stuck with stocks after the first 25 per cent fall in markets during the recession years of 1970, 1974, 2001 and 2008 you would have been even after somewhere between 2 and 4.8 years. However, if you had dashed for cash after a 25% fall instead, that number rises very substantially. So, the key takeaway from the bear-market history is that staying invested beats cashing out.

Valuations
Most of the equity market losses this year were driven by a fall in valuations while earnings held up well. Rising long-term bond yields have exerted acute pressure on valuations given the quite extended duration of equity benchmarks. For the context, 12M forward PE ratio of MSCI ACWI fell from c18x at the start of the year to just under 14x by end of June. That is compression of c23% in valuation multiples – driving almost all of the equity losses year-to-date.

As can be seen from exhibit 7, equity valuations have moved from being expensive to inexpensive over the past 16 months. In a three-year rolling window, equity valuations have fallen to two-standard deviations below the mean. When compared to long-term history (since 1990), equity valuations look cheaper. In our view, equity market valuations have discounted most of the headwinds. In absence of a recession, equity valuations may not have downside from the current levels. Of course, in case a recession materialises (which is not our base-case), valuations could de-rate further.

Exhibit 7: Valuations have recently fallen below the long-term mean

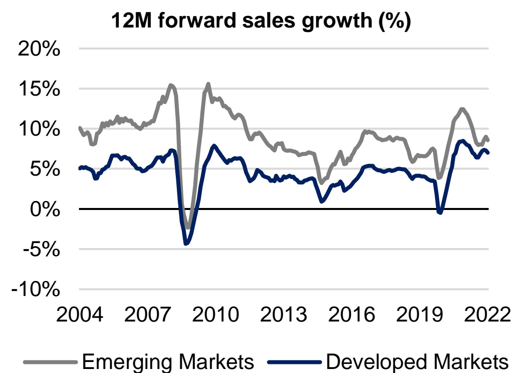


Source: MSCI, I/B/E/S, Refinitiv, and ADCB Asset Management

Earnings

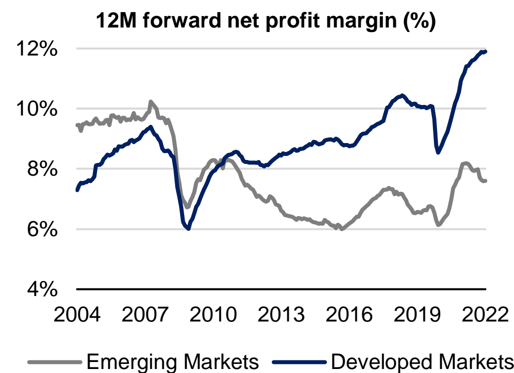
Earnings growth has held up reasonably well over the past six months. Despite the rising cost pressures, Q1 reported corporate earnings came much better than expected. Yet, some corporates have guided to lower earnings for Q2. This puts the emphasis clearly on the Q2 earnings season which is due to begin mid-July. As it stands, expectations for both sales growth (exhibit 8) and margins are relatively stable (exhibit 9). However, estimates of net income margins in emerging markets have fallen sharply over the recent months while those in developed world remained close to peak levels. In our base-case scenario (described in the investment strategy section on pages 2-3 of this document) which does not see a recession, earnings can hold up relatively well. However, in the event our worst-case scenario materialises, sales growth is likely to slow markedly and margins are likely to contract sharply.

Exhibit 8: Expectations for top-line growth have fallen considerably…



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

Exhibit 9: …but margin expectations remain very elevated especially for developed markets



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

Our allocation and trade ideas

Against a backdrop of elevated uncertainty, equity investors are better served by focusing more on quality and non-cyclical growth. As such, the macro environment favours a more selective approach. Also, the macro headwinds call for more relative rather than directional investing. Our high conviction is in Asia (by geography) and global healthcare (by sector). Within technology sector, we prefer software & services to more cyclical technology hardware, and semiconductor segments. For a detailed portfolio positioning by regions, sectors, and styles, see pages 4-5.

Alternatives

Industrial commodities

Commodities, after having outperformed equities only for the second time this decade in 2021, continued their outperformance in H1 2022. As we discussed in our last quarterly note (Q2 2022 Outlook: Watchful, not worried), peculiarities of commodities have helped them outperform financial assets at a time when inflation and rising rates were the primary concerns. However, going forward, as focus shifts away from inflation to growth, commodity prices could come under pressure. Especially, the more cyclical industrial metals could see their price appreciation reverse. In fact, this downdraft of metal prices may have begun already. Bloomberg industrial metals price index has fallen a whopping 33% since its peak in early-March, of course reversing only a portion of gains made over the previous two years (exhibit 10). What was interesting to note was that industrial metal prices decoupled quite significantly from the growth in China – which was a key source of demand over the past couple of decades. That makes us believe that commodity prices were largely influenced by supply concerns and rising inflation. Therefore, while we see Chinese economy picking up momentum over the remainder of the year, we see that offering little support to industrial metal prices.

Overall, we think we are unlikely to see another super-cycle in commodities (especially in industrial metals). Should global economic slowdown concerns persist, industrial metal prices look more vulnerable. Yet, we continue to see opportunities in commodities that feed into the green infrastructure over the medium to long-term.

Exhibit 10: Industrial metal prices have fallen recently in-line with the fall in breakevens

Source: Bloomberg, FRED, Refinitiv, and ADCB Asset Management

Food commodities

The United Nations' Food and Agriculture Organization (UN FAO) food price index rose by 18% in the first five months of the year in nominal terms and by 16% in real terms over the same period. Amongst the constituents, oil and cereal prices rose 28% and 23% respectively in nominal terms so far in 2022. Meat and dairy prices rose 10% each while sugar prices rose by a modest 3%. It is worth noting that the UN FAO food price index rose a whopping 73% in nominal terms and 67% in real terms since hitting a bottom in May 2020 (exhibit 11).

There are several factors that drove food prices higher – some global, some regional, and some specific to individual commodities. The current period of higher and rising food prices can be attributed to a range of reasons including:

- Weather patterns unfavourable to the crop produce
- Labor shortages
- Rising demand for premium grade products
- Global supply chain disruptions
- Higher energy prices
- high feed costs and avian flu outbreaks, and more recently
- the Russia's invasion of Ukraine

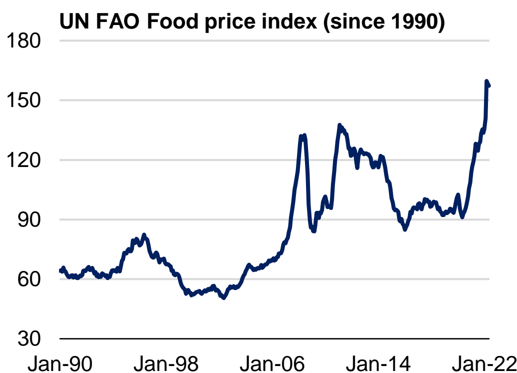
This sharp rise in food prices has now become a regional and global issue and of course also a political and geopolitical one. Governments across developed and emerging economies have started enacting measures to try to contain their domestic prices. In the developed world, these measures include attempts to boost domestic production. In the emerging world, some governments have opted to cut food taxes or put in place

price controls. In addition, some governments have also imposed bans on exports of certain agricultural products. While this could relieve local price pressures, at the global level this could cause more trade disruptions in already tight commodity markets.

The immediate consequences of this elevated food prices can be two-fold. First, consumption spending on discretionary items could slow as consumers spend more on their essential food items. This could reduce the overall output of the economy. In this context, emerging economies, with a higher share of food consumption in their overall consumption basket, look more vulnerable to these shocks than developed economies. The second impact of rising food prices is its contribution to the overall consumer price inflation. As such, the food price inflation has hit a multi-year high in developed economies and continues to be elevated in emerging economies. Any further rise in food prices could add more to the already elevated consumer prices. So, both these consequences together would mean slower growth and higher inflation adding to the stagflationary winds that are already blowing through the world economy.

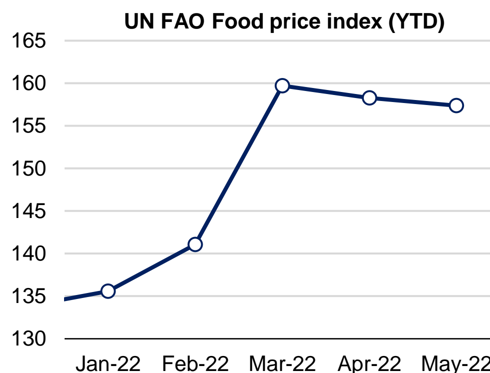
Looking ahead, as some of the pandemic related disturbances like labor shortages and global supply chain disruptions end, food prices could come under control. Weather plays a vital role too. Here according to the Climate Prediction Center at the National Oceanic and Atmospheric Administration of the US, the odds for La Niña decrease over the remainder of the year. Remember, this weather pattern created unfavourable conditions for agriculture over the past several months. The UN FAO food price index may already be reflecting this with the headline food price index falling sequentially for the second consecutive month in May (exhibit 12). This recent moderation was driven by a drop in the vegetable oil and dairy price indices, while the sugar price index also fell to a lesser extent. Meanwhile, cereal and meat price indices continued to rise.

Exhibit 11: Food prices have risen quite sharply over the past two years…



Source: United Nations – Food and Agriculture Organisation, and ADCB Asset Management

Exhibit 12: …but, more recent data points to a moderation



Source: United Nations – Food and Agriculture Organisation, and ADCB Asset Management

Industrial real estate

As we highlighted in our note Q2 2022 Outlook: Watchful, not worried, industrial real estate continued to outperform the other segments as demand and pricing for industrial commercial property got a boost from increased e-commerce adoption since the start of the pandemic. This increase in demand resulted in increased pricing, and this in turn facilitated investments into industrial properties. For the context, according to the data from MSCI, the sector grew from a 15% share of the market before the pandemic to a level consistently above 20%.

However, as COVID-19 pandemic related restrictions eased, e-commerce demand growth decelerated raising some questions for the implications for the industrial real estate. However, we think maintaining a long-term perspective helps here. Looking back at history, between 2013 and 2019, e-commerce sales as a share of total retail sales grew rapidly from c5% to c10%. However, during Q2 2020 that share jumped to as high as 16.4% but subsequently cooled to 14.3% in Q1 2022 still above the expected trend of 13.6% of total retail sales. Going forward, we expect the retail sales to grow in line with the historical trend where growth rates are still very attractive and outpacing the growth in the overall economy.

That means that while the industrial real estate may face some challenges in the near-term, long-term outlook still is attractive. The near-term outlook is also driven by rising rates (10Y USTs and mortgage-financing costs) – which have already impacted the sale of industrial properties in Q2.

Currencies

US Dollar

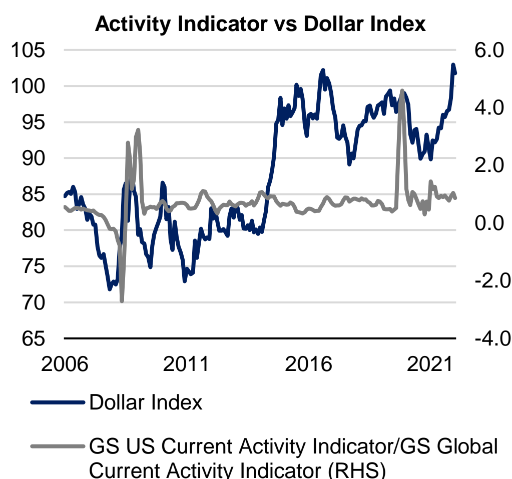
In the currency market, the only thing that has been consistent in the first half of 2022 is the strong dollar rally. USD strengthened further in the 2Q 22, now trading near multi-decade highs, receiving boost from the Fed leading the aggressive tightening camp. Market expectations of higher Fed fund rate continued to build during the quarter with the Fed finally matching market expectations at the latest June meeting. Safe-haven characteristics of the USD also drove demand for the currency as geopolitical risks failed to ebb with the continued escalation of the Russia-Ukraine war.

With signs of peak growth, peak inflation and peak bond yields, there is increasing evidence that the dollar's rally may have also peaked with the currency looking overvalued. However, the US dollar strength has failed to wane, despite brief periods of weakness over past few weeks. A repeat of the US dollar's phenomenal performance in the second half of the year looks, however difficult with the ease in inflation expectations and signs of moderation in supply chain bottlenecks. We believe that the momentum in dollar strength could slow as Fed projections have started to match market's rate hike projections. At the same time, signs of weakness in US economic activity could also give the dollar rally a breather as this could potentially reverse the Fed's current hawkish stance. In fact, market has started to price in the possibility of a rate cut in 2023. Having said that, we do not anticipate significant dollar weakness. The USD, being a counter-cyclical currency, could still benefit from continued supply chain concerns and unyielding geopolitical tensions. Fed is still the most aggressive central bank with its tightening stance. As long as this is the case, wide short-term interest rate differentials mean that the dollar will continue to shine. With recession risks not only building in the US, signs of synchronised global growth slowdown could turn out to be supportive positive for the dollar.

Euro

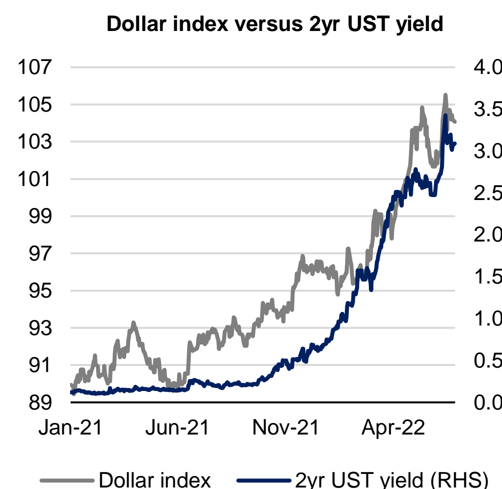
The ECB is set to move to gradual policy normalisation in the second half of this year. However, the ECB is unlikely to match the Fed's aggressiveness. Sudden and fast unwinding of the ECB's loose monetary policies could have repercussions for the region, especially for the periphery countries. ECB is mindful of these risks and hence was quick to send a signal that it was looking into an anti-fragmentation tool in order to backstop the periphery spreads. This implied that the ECB could in fact be more patient and adopt a gradual tightening stance. This has delayed the possibility of the euro to stage a comeback rally. Having said that, euro stands to benefit from a prospective cyclical rebound in China's economy. Recovery in growth may be uneven given China's strict zero COVID-19 policy but growth is likely to have bottomed with the country's re-opening plans. While we do not anticipate a complete shift in the current currency trends, but we acknowledge that the scope for significant weakness in euro is looking increasingly difficult. We are slightly less negative on our outlook for the euro in the second half of this year.

Exhibit 13: Downside risks to US mean downside risks to Dollar



Source: Bloomberg, and ADCB Asset Management

Exhibit 14: Dollar tracking the short-term UST yield

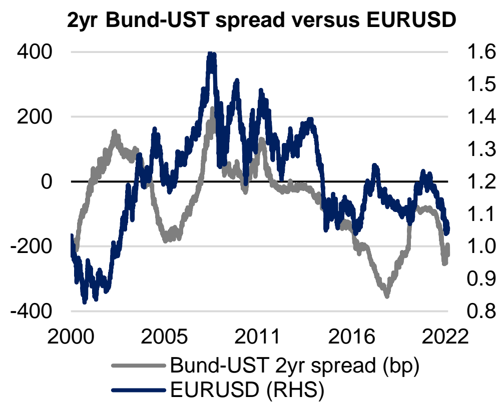


Source: Bloomberg, and ADCB Asset Management

Pound sterling

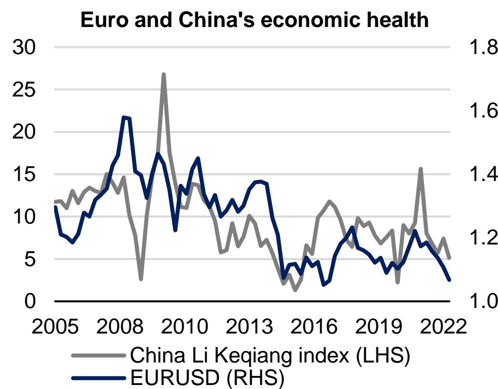
The Pound sterling weakened versus the US dollar and the euro both in the first half of the year. The weakness was pronounced against the US dollar compared to the euro. The pound sterling weakness versus the euro gathered momentum only in 2Q 22 with the ECB's sudden change in stance. The BoE has stuck to its hawkish bias, having raised rate five times in a row. Pound depreciation is adding to the inflation concerns. However, the BoE faces a challenging task with its monetary policy as latest economic indicators point to deceleration in economic activity. Given the high uncertainty around the BoE's monetary policy outlook in 2022, the pound sterling will continue to experience bouts of volatility over the year. We expect that the pound sterling to remain weak versus the US dollar and flat versus the euro.

Exhibit 15: ECB to be more patient in tightening policy



Source: Bloomberg, and ADCB Asset Management

Exhibit 16: China rebound tailwind for the euro

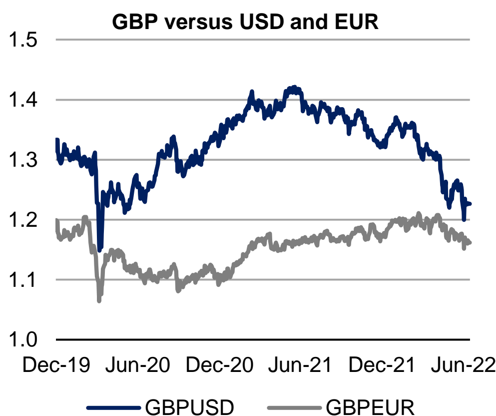


Source: Bloomberg, and ADCB Asset Management

Japanese Yen

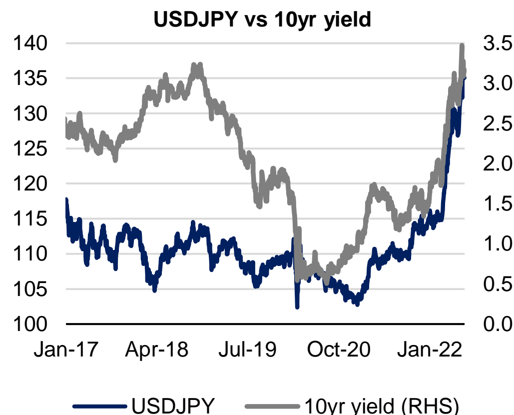
The Japanese yen significantly weakened versus the dollar in 1H 2022. The BoJ remains an odd-one out in camp of hawkish DM central banks, maintaining its accommodative stance and its yield curve control policy. This has further widened the differential versus other DM central bank policies. We believe this divergence will be maintained as the BoJ focuses on the growth outlook. However, rising recession risks in the US and ease in UST yields could reduce the pressure on yen weakness. But given the BoJ is the most dovish of all, the wide interest rate differential will keep the yen weak versus the dollar.

Exhibit 17: Pound sterling weakened versus dollar



Source :Bloomberg, and ADCB Asset Management

Exhibit 18: Yen weakened with the rise in UST yield



Source: Bloomberg, and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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