Investment Strategy

Quarterly Investment View | October 2022

بنك أبوظبي التجاري
ADCB
ASSET MANAGEMENT LIMITED

Q4 2022 Outlook: ‘Pivot’al patience

A range of macro, micro, policy, political, and geopolitical headwinds have cause acute weakness in financial markets so far this year. Uncertainty around macro outcomes caused concerns of systemic risks which in turn increased cross-asset correlations causing most assets to fall together. While other risks are likely to simmer in the background, financial market fortunes are largely linked to a central bank ‘pivot’ – which we think is coming, but investors need to be patient.

Given the recent hawkish tone of the central banks, especially the US Fed, markets have worried that central banks might tread the rate-hiking path without acknowledging downside risks to global growth. Indeed, some of the comments from the central bank officials have increasingly sounded that way over the past few months. Looking ahead, as growth slows in the US, and a possible recession hits Eurozone and the UK, markets are hoping that central banks will eventually ‘pivot’. A pivot could mean different things for different people. For us it is a notion that monetary policy will eventually react symmetrically to growth and inflation risks – not doing so accounts for a policy error. We discuss these in the investment strategy section on pages 2-3. Until there is a confirmation that policy error will be avoided, financial markets are likely to remain volatile. Other risks ranging from ongoing COVID to geopolitical hot spots are likely to keep markets on the edge. For now, investors should have ‘pivot’-al patience and wait for an appropriate time to re-risk. We remain overweight cash (awaiting opportunities), neutral equities and alternatives, and underweight fixed income. For our detailed portfolio positioning see pages 4-5.

Fixed income (pages 6-7): With inflation turning out to be more persistent, Q3 2022 saw a shift in narrative from “lower for longer” to “higher for longer” rates. Policy related uncertainty is likely to be the key risk for the fixed income assets looking ahead. We remain overweight US treasuries as recession hedge and prefer 7Y-10Y segment as we believe that upside in long-term rates will be limited. In DM corporate, we stay neutral US and EU IG, and underweight US and EU HY. In the EM space, we are neutral EM USD sovereigns, underweight EM LCY bonds, but overweight EM Asia credit.

Equities (pages 8-9): As at end of September, equity valuation multiples have contracted significantly solely contributing to the decline in equity prices this year. I/B/E/S consensus earnings growth expectations for MSCI ACWI during 2022 moved higher to 8.5% now from under 7.0% at the start of the year. Based on various macro outcomes, we detail three scenarios – base-case, bear-case, and bull-case for global equities. In the near-term, against a backdrop of elevated uncertainty, equity investors are better served by remaining defensive and by focusing more on quality and non-cyclical growth.

Alternatives (pages 10-11): Alternatives continue to offer diversification opportunities. We continue to prefer gold, and macro and market defensive hedge fund strategies. In this note, we discuss why food prices could stay elevated over the medium-term to long-term, what the essential conditions for gold prices to rise are, and why carbon-rich energy commodities have further upside in the near-term but how clean energy is likely to overtake in the medium-term to long-term. We also discuss the outlook for commercial real estate and sector outlook for apartments, industrial, retail, healthcare, and proptech.

Currencies (pages 12-13): Q3 2022 saw some notable moves in currencies across the DM space. USD hit a 20-year high, JPY hit the weakest level against the USD since 1990s, EUR and GBP both hit a multi-decade low against the USD. While the USD strength could continue, further sharp gains for the greenback are not only difficult but also detrimental to the global economy. Perhaps worth thinking about USD as USD/Europe and USD/Asia with the former continuing to rise but the latter stabilizing. Worth keeping an eye on central bank interventions in the FX markets.

Kishore Muktinutalapati
Head - Investment Strategy
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

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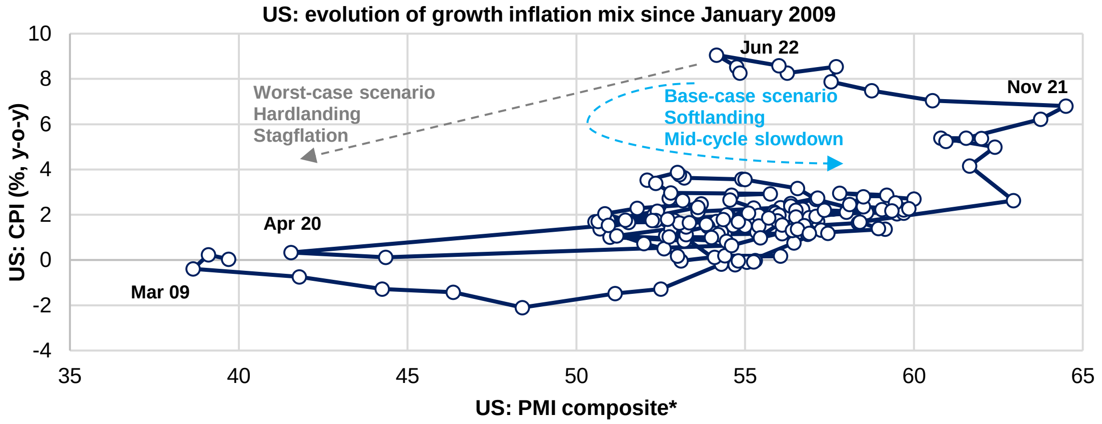
Investment strategy

A range of macro, micro, policy, political, and geopolitical headwinds have caused acute weakness in financial markets so far this year. Also, uncertainty around macro-outcomes have fed into the concerns of systemic risks which in turn increased cross-asset correlations causing most assets to fall together. For instance, so far in 2022, the portfolio of 60% equities, and 40% bonds lost c16% of its value – the worst performance in 50 years. This even surpasses the worst performance of the early 1970s and the 2008 global financial crisis. While the both bonds and equities have contributed significantly to this weak performance of the 60:40 portfolios, the contribution of bonds this time around has been abysmal compared to previous episodes of heavy drawdown of the overall portfolios.

Looking ahead, while some of the micro, political, and geopolitical headwinds are likely to simmer in the background, macro and policy drivers are likely to take over as the most important drivers of financial markets. Here, as we have been arguing (for instance in our report 2022 Outlook: Catch'22, January 2022), it is the appropriateness of the monetary policy response to the evolution of the growth-inflation mix that matters most (also see exhibit 1). Given the recent hawkish tone of the central banks, especially the US Fed, markets have worried that central banks might tread the rate-hiking path without acknowledging downside risks to global growth. Indeed, some of the comments from the central bank officials have sounded that way over the past few months. Looking ahead, as growth slows in the US, and a possible recession hits Eurozone and the UK, markets are hoping that central banks will eventually 'pivot'. A pivot could mean different things for different people. For us it is a notion that monetary policy will eventually react symmetrically to growth and inflation risks. Now for investors three questions come up. What is the outlook for inflation? What is the outlook for growth? How should investors position?

Exhibit 1: A mid-cycle slowdown in the US rather than an outright recession is still our base-case scenario



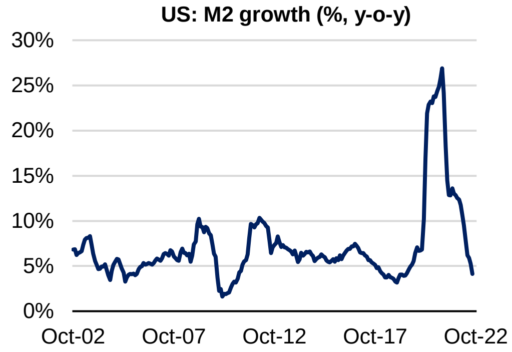
Source: Institute of Supply Management (ISM), Bureau of Labor Statistics - US, Refinitiv, and ADCB Asset Management | Notes:*simple average of manufacturing and services ISM PMIs

What is the outlook for inflation?

Inflation across developed markets has recently hit a multi-decade high. But the money growth which leads inflation has started to moderate sharply not only in the US (exhibit 2) but also across major developed markets. However, one should acknowledge that the nature of inflation is different across economies. For instance, in the US, inflation is as much a "core" problem as it is "headline". But in Eurozone and the UK, inflation is largely a headline problem with higher energy prices contributing more to the overall inflation.

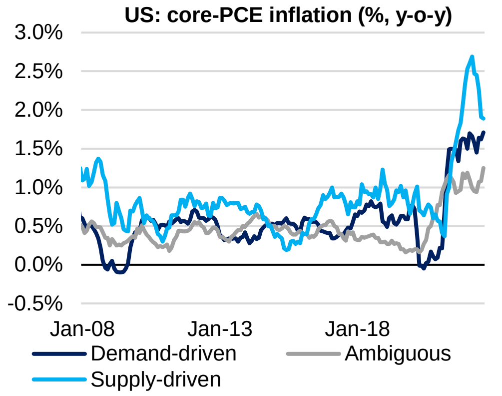
In the US, supply-driven inflation is still dominant even after moderating in recent months (exhibit 3). Fed's policy has the potency to reduce the demand-driven inflation which of course is still elevated. But the supply-driven inflation is something that needs to be addressed with tools outside the central bank tool kit. Therefore, the share of supply-driven inflation remains important in determining the appropriateness of the monetary policy. Now let us consider the parts of inflation the central bank can influence. Starting with commodity prices, the actions of the US Fed so far this year have resulted in the USD squeezing higher (see page 12). This has caused the deflation in commodity prices which have fallen rather sharply from their June peak (see page 10). Retail consumption trends remain strong but inflation expectations of the consumers have remained well anchored and in some cases have even fallen recently. Housing and rents contribution to the overall consumer price inflation in the US has been high in recent months but we know that this component responds to the monetary policy tightening (which has occurred to a large extent already) with a lag. Moreover, some of the alternative high-frequency data for rents in the US has started to point to a strong moderation. For businesses, some of the recent surveys point to lessening cost pressures. Relationship between wages and inflation is more complex, and hawkish comments tend to ignore the importance of potential improvement in productivity. Market expectations of inflation, as measured by breakeven rates, have fallen sharply so far this year. All in all, we expect inflation to moderate rather strongly in the year ahead. In fact, strong disinflation (and even outright deflation in certain sectors) is the key risk for financial markets in 2023. This should make the Fed pausing or slowing its rate hikes a more likely scenario.

Exhibit 2: Money supply growth has slowed quite sharply in the US



Source: Datastream, Refinitiv, and ADCB Asset Management

Exhibit 3: Supply-driven inflation has not fully normalised

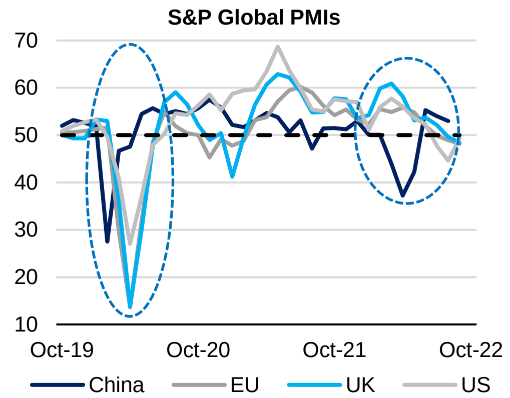


Source: Federal Reserve Bank of San Francisco, and ADCB Asset Management

What is the outlook for growth?

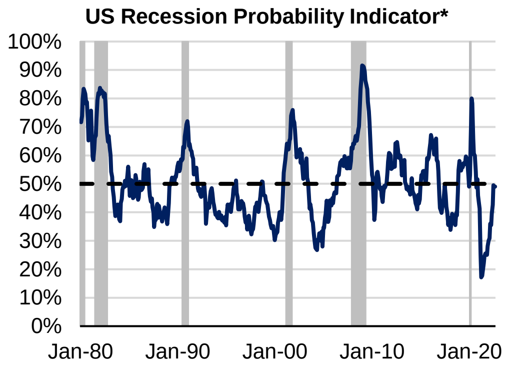
Growth is undoubtedly slowing across the world as expected (see Q3 2022 Outlook: Delayed, not derailed) and this should support a central bank pivot as inflation expectations remain anchored. For the global economy in aggregate, we stick with our view of an asynchronous mid-cycle slowdown (exhibit 4, and exhibit 1). In Europe, a recession looks more likely in the next 12 months. In Asia, recession probabilities are the lowest with China and Japan yet to realise the operational leverage gains from the post-pandemic reopening. In the US, recession probabilities have certainly risen (exhibit 5) yet an outright recession looks less likely.

Exhibit 4: PMIs have softened across the board



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

Exhibit 5: Probabilities have risen but a US recession is still not a given



Source: National Bureau of Economic Research (NBER), Refinitiv, and ADCB Asset Management | Notes: *For details, see Q2 2022 Outlook: Watchful, not worried

How should investors position?

As central bankers go on a tightening mode, they need to keep an eye on the evolution of growth and inflation data to determine the appropriate interest rate level. Given the pace of policy tightening, it is easy for the Central banks to miss obvious signals that they have done enough. This would account for a policy error. Until there is a confirmation that policy error will be avoided, financial markets are likely to remain volatile. However, the case for a central bank "pivot" is strengthening and this is a positive for risk assets. Yet, we believe it is a bit early to position for this. **For now, investors should have 'pivot'-al patience and wait for an appropriate time to re-risk. We remain overweight cash (awaiting opportunities), neutral equities and alternatives, and underweight fixed income (on unfavourable risk-return).**

Porftolio positioning

Exhibit 6: 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, and Consumer services
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 sector
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 6: Recommended portfolio positioning (continued)

Fixed income**	Underweight	Neutral	Overweight	Comments
Duration			■	Preference for UST 7-10yr segment
US Treasuries			■	Prefer US Treasuries acting as a hedge
US Credit				Preference for HQ corporates over HY corporates
Investment Grade		■		Short-intermediate bonds, High-quality preference
HY (off benchmark)	■			Short-dated, high-quality preference
European Bunds		■		ECB to be less aggressive
European Credit				Preference for HQ corporates over HY corporates
Investment Grade		■		End of ECB's bond buying
HY (off benchmark)	■			Weak growth and tight financial conditions
EM USD Sovereign		■		Tight financial conditions, hawkish Fed and strong USD to weigh on EM HY and EM importers, selectivity is key
Brazil			■	
HQ*** GCC + Oman			■	
EM LC Sovereign	■			EM policy normalization
EM Corporate	■			High leverage is concern, but opportunities in Asia
- EM Asia			■	Preference for Asia IG

Alternatives	Underweight	Neutral	Overweight	Comments
Gold			■	Hedge against geopolitical and inflationary risks
Oil		■		Looking for a balanced market
Other commodities	■			Prefer green commodities for long-term
Hedge funds		■		Macro and market defensive strategies

Currencies	Negative	Neutral	Positive	Comments
USD			■	Hawkish Fed, US resilience, safe-haven demand
EUR	■			ECB unlikely to match Fed's hawkishness
JPY	■			BoJ policy remains odd-one out
GBP	■			Slowing growth and monetary policy uncertainty
EM currencies		■		Driven by idiosyncratic developments

Legend	*New*	*Old*	*No change*
	■	□	■

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

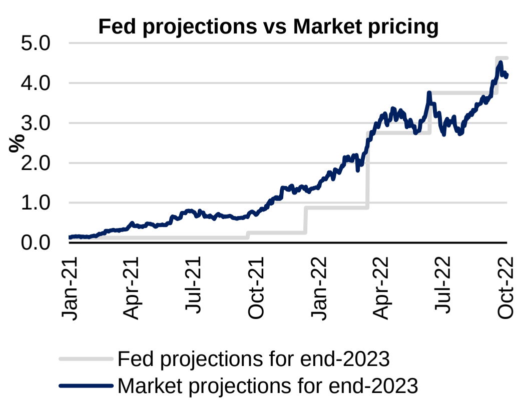
Faster rise= steeper fall

Fixed income assets continued to remain under pressure in the third quarter of 2022. After a brief rally in July, sell-off in fixed income assets again aggravated in August and September with global central banks intensifying their fight against inflation. Jackson Hole symposium was the key driver where the Fed along with other central banks stressed on the need of tighter monetary policy. Bloomberg Global Aggregate bond index declined by c7% in the July-September period, taking the YTD losses to c20%. This has been the worst performance of the index to date. The decline was led by Global inflation-linked bonds and Global Treasuries.

As we had outlined in our 2022 outlook, the interplay between growth, inflation and central bank policy reaction function will be key driver for the fixed income assets. With inflation turning out to be more persistent, the third quarter saw a shift in narrative from "lower for longer" to "higher for longer" rates. Market expectation of the peak Fed fund rate jumped to c4.5% (before the September Fed meeting) from c3.2% as of beginning of August. However, the Fed also responded with a more aggressive action at the September meeting, triggering a sell-off in the bond market. With the Fed projecting a slightly higher terminal rate than the market, we believe that bond markets will continue to face volatility. However, this volatility is less likely to do with inflation volatility in our view given the evidence of softening market-implied inflation-based expectations and also normalisation seen in the household and consumer-based surveys. Policy-related uncertainty is likely to be the key risk for the fixed income assets. A more hawkish Fed completely ignoring downside risks to growth has further raised the risks of policy error (an aggressive Fed completely ignoring downside risks to growth). Data-dependent Fed may not be able to perfectly time the dovish pivot given its reliance on inflation data which tends to lag current price pressures. Higher policy uncertainty also means more pain and volatility in the short-term rates. We believe that upside in long-term rates will be limited as they are likely to remain anchored to the long-term neutral policy rate. Despite an aggressive Fed stance (and its willingness to go beyond the long-run neutral rate), the Fed has not made any upward revisions to the long-term neutral rate. In fact, pre-pandemic factors influencing the long-run neutral rate (inequality, demographics, higher savings rate) could come back in force once the pandemic-related disruptions start to fade. A faster and aggressive Fed action will only accelerate the pace of return to the long-term neutral rate. We continue to advocate a long-duration stance (7-10yr US Treasury segment).

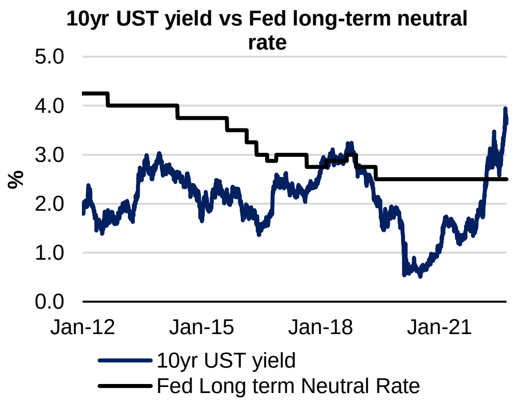
As interest rate risk is likely to be the key driver for the fixed income markets, inflation-linked bonds are not a good hedge in such a scenario. Global inflation-linked bonds have been the worst performers YTD. Similar to nominal bonds, inflation –linked bonds are susceptible to the shifts in the central bank monetary policy and interest rates. The performance of inflation-linked bonds is dependent on inflation expectations, which have eased this year with the Fed turning hawkish. On the other hand, fixed income assets like floating rate notes (FRNs) whose performance is positively linked to the Fed's hiking cycle are likely to benefit the most. We believe that FRNs could be a good tactical bet to consider in the short-term. Bloomberg US FRN Index have been the best performer, recording marginal positive gains on YTD basis. FRNs tend to perform well during a concentrated Fed-rate hike cycle (aggressive Fed) compared to a more-spread out Fed rate hike cycle (patient Fed). However, FRNs only act as an interest-rate risk hedge and are susceptible to credit risk and could come under pressure in the event of a sudden Fed dovish shift.

Exhibit 7: Fed is more aggressive than markets



Source: Bloomberg, and ADCB Asset Management

Exhibit 8: Fed's LT Neutral rate is unchanged



Source: Bloomberg, and ADCB Asset Management

Neutral on US and EU IG, Underweight on US and EU HY, Preference for high-quality bonds

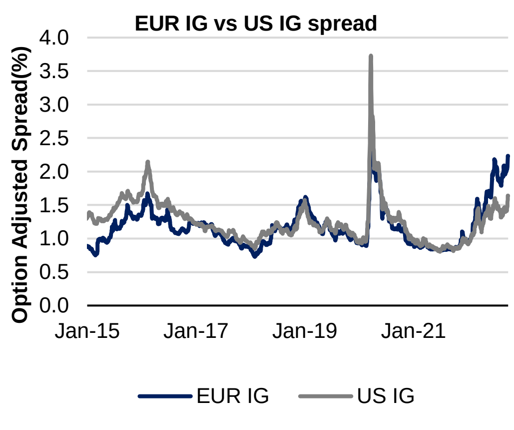
More aggressive central bank response and jump in bond market volatility has negatively impacted DM corporate credit performance. DM corporate IG bonds suffered the most on account of their long-duration characteristics. Bloomberg US IG bond index declined by c5% in the July-September period. Bloomberg European IG Index recorded losses of c3% during the same period. However, European IG spreads have widened more than US IG spreads, highlighting the rise in recession concerns and tightening of financial conditions in Europe. Bloomberg US HY bond index recorded flat performance in third quarter, despite coming under pressure in September. However, US HY index has suffered its worst performance YTD since 2008. With the rising global recession probabilities and tightening financial conditions, headwinds for the DM corporate credit are likely to remain. Despite the recent underperformance, the US credit spreads have not widened as much compared to European spreads and also compared to the COVID-19 sell-off. The sell-off looks excessive with US IG index having declined to 2018 levels. Valuations are also 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 short-intermediate US IG is looking good in terms of valuations vs long-dated US IG. We maintain our underweight (off-benchmark) on US HY given its strong correlation with the movement in equity markets. The CCC rated bonds are under pressure with spreads having widened to the highest level since the onset of the pandemic.

Stay Neutral on EM USD sovereigns, Underweight on EM LCY bonds; Overweight on EM Asia credit

EM USD bonds remain the worst performers in January-September period with accumulated losses of c24%. However, the magnitude of loss has reduced compared to the 1H22. As a result, EM USD bonds outperformed the global bond benchmark as well as US IG bonds in 3Q22. This outperformance has been mainly led by EM HY sovereign bonds which reflects investors' search for yield. While EM USD sovereign bonds are still trading at attractive levels, we still anticipate more pain for the asset class. Global slowdown concerns, strong USD bias and tightening financial conditions does not bode well for EM USD sovereign assets. Continued strength in USD could add further stress on low-rated EMs in particular. In addition, EM USD sovereigns have strong correlation with the UST volatility. As we have highlighted before, EMs with weak external positioning, grappling with high external debt, high short-term debt (% of reserves) and low FX reserve adequacy ratios will continue to remain the most vulnerable to the external volatility. Egypt ranks poor amongst the EMs in terms of its external positioning. Any possible improvement in these weak markets is now conditional of an IMF bailout. In short, while we hold a neutral stance on EM USD sovereign debt, focus here again should be on EM sovereigns with high credit quality (GCC HQ+ Oman and Brazil)

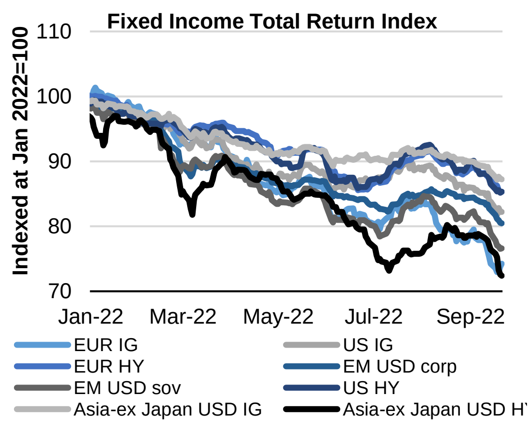
In EM corporate, we retain our preference for Asia credit through our overweight stance on Asia IG bonds. Asia IG bonds have also outperformed US IG and EUR IG bonds in the first nine months of the year, despite declining by 12% during the same period. As a result, valuations have become expensive compared to US IG and EUR IG. Positive turnaround in China's credit impulse is likely to prove supportive for the sector. Asia HY - though trading at attractive levels - continues to remain vulnerable amidst the defaults of key Chinese real estate companies.

Exhibit 9: EUR IG spreads widened more than US IG I



Source: Bloomberg, and ADCB Asset Management

Exhibit 10: Asia IG outperformed peers



Source: Bloomberg, and ADCB Asset Management

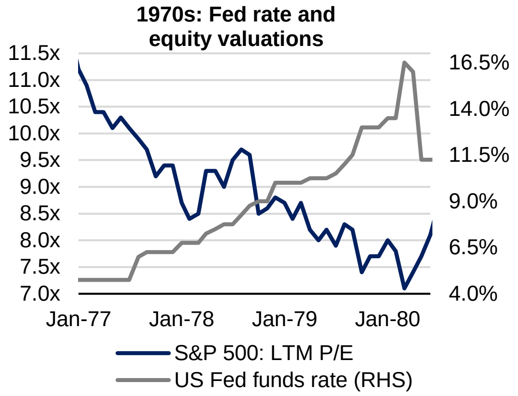
Equities

Implications of tighter monetary policy

In our note 2022 Outlook: Catch'22, January 2022, we pointed out that "*in 2022, we estimate valuation multiples to fall further but earnings growth to remain strong. …. I/B/E/S consensus estimates for 2022 earnings growth stood at c7% (compared with estimated c53% earnings growth during 2021). We believe there is a significant upside for earnings growth estimates for this year. However, valuation changes are likely to induce volatility and influence the returns during the year. The key driver of equity valuations will be the conduct of monetary policy in the US. In relation to equity valuations, it is worth noting that while on an absolute basis they remain elevated, in relation to bonds, they look cheaper*".

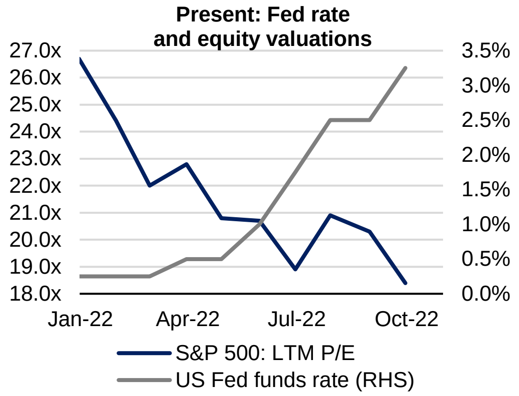
As at end of September, equity valuation multiples have contracted significantly solely contributing to the decline in equity prices this year. I/B/E/S consensus earnings growth expectations for MSCI ACWI during 2022 moved higher to 8.5% now from under 7.0% at the start of the year. While we were expecting a contraction in valuation multiples, we did not see a contraction of this magnitude. As inflation proved persistent, Fed indicted its strong resolve to fight inflation with tighter monetary policy. No surprise, Fed officials invoked the memories of the Volcker-era Fed and equity markets responded equally aggressively. To put things into context, during the late 1970s, Fed reserve raised interest sharply from 4.75% in 1977 to 16.00% in 1980. Equity market valuations (as measured by the 12-month price-earnings multiple) of S&P 500 shrunk by 37% over the same period (exhibit 11). Fast forward to the present, equity valuations corrected by c33% already this year as US policy interest rate (upper bound of Fed funds target range) moved from 0.25% at the start of the year to 3.25% in September (exhibit 12). This give us a sense of what equity market is pricing in in terms of the monetary policy tightening in the US.

Exhibit 11: During the 1970s tightening episode, equity valuations contracted c37%



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

Exhibit 12: Equity valuations have fallen c33% already this year as Fed funds rate rose



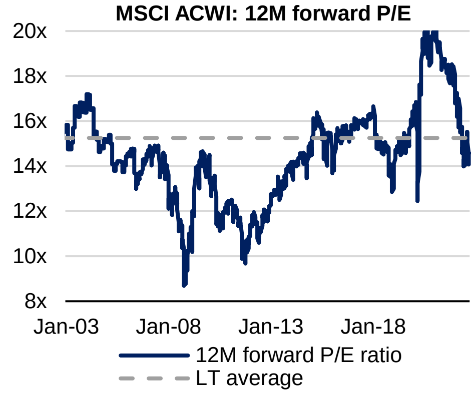
Source: S&P, Federal Reserve, Datastream, Refinitiv, and ADCB Asset Management

Valuations

Looking ahead, given the extent of de-rating that happened already, valuation compression might not have much further to go. As such, the 12M forward PE has fallen sharply already, and is now below the 20-year average of 15.3x (exhibit 13). Yet, much of this compression in valuations (i.e. rise in earnings yield) was driven by the rise in risk-free rate while the equity risk premium (ERP, i.e. the premium demanded by investors to hold equity risk) has not changed much (exhibit 14).

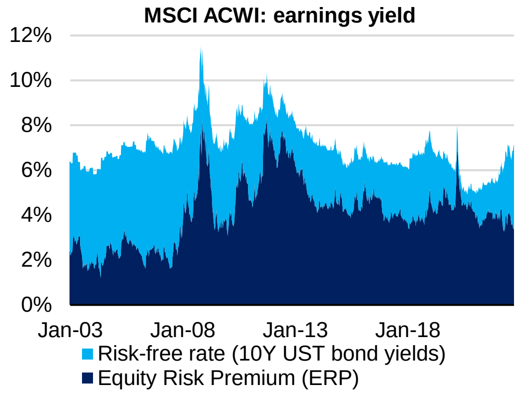
With the risk-free rates already pricing in the rise in policy rates, we believe they are closer to the peak of this cycle. If anything, risk-free rates should fall in case a global recession materialises. However, in that scenario the ERP is likely to rise (making it our bear-case). The extent of rise in ERP will depend on how deep and prolonged the recession is likely to be. In case of a mild recession, ERP rise is likely to just offset a fall in risk-free rate allowing the valuation multiples to largely remain unchanged at the current below-average levels. In case of a deeper recession (which is still unlikely in our view), ERP could rise rather sharply more than offsetting the favourable movement in risk-free rates. Our base-case still sees a soft landing where risk-free rates and ERP remain stable. Yet, our bull-case scenario sees a sharp fall in risk-free rates as central banks pivot, and ERP remains stable providing scope for valuations to expand at least marginally from the current levels.

Exhibit 13: Valuations have fallen below their long-term averages…



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

Exhibit 14: …as risk-free rate increased but equity risk premium remained stable…

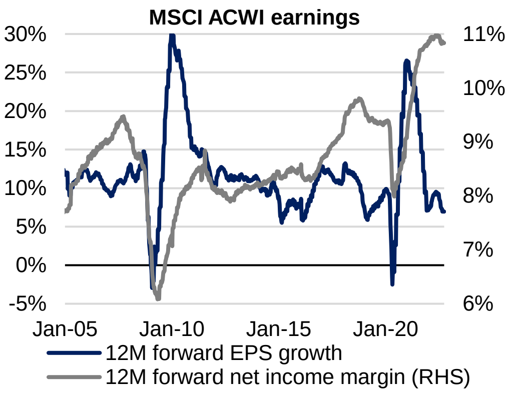


Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Earnings

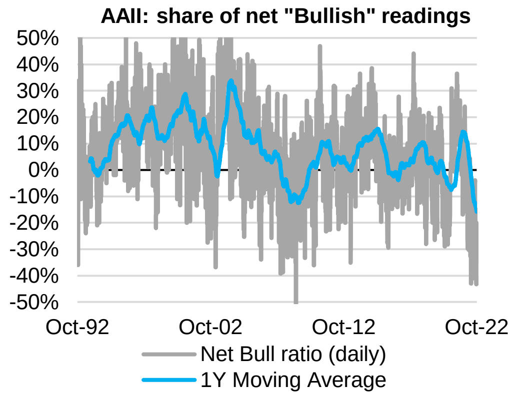
Remarkably stable ERP was underpinned by strong earnings growth for the corporate sector. Despite the calls for earnings to fall off the cliff in Q2, corporates reported better than expected earnings. While we see earnings growth normalising from elevated levels, we don't see an earnings recession in our base-case. Of course, should a recession materialise, earnings are likely to fall sharply adding to the downside described in our bear-case scenario above. However, in case our thesis of a mid-cycle slowdown and not a recession materialises, earnings growth can accelerate in H2 2023 as economic momentum strengthens. Current I/B/E/S expectations for earnings growth of MSCI ACWI aggregate is c6% for next year – we see upside risks to this number in absence of an outright global recession. Net profit margins for the corporate sector remain close to their record highs of c11% and are helping earnings growth hold up (exhibit 15). While further expansion is indeed difficult, we see limited risks of a sharp contraction of margins over the next 12 months.

Exhibit 15: … bringing resilience of earnings growth estimates under scrutiny…



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

Exhibit 16: …while the equity sentiment remains very bearish



Source: American Association of Individual Investors, Datastream, Refinitiv, and ADCB Asset Management

Our allocation and trade ideas

Equity sentiment is already weak (exhibit 16), positioning is cautious, valuations are now more normal, and the recent performance is already reflecting a tighter monetary policy. In case the inflation cools rapidly (which we expect) and central banks pivot (which we also expect) – both paving a way for soft landing of the economy, equity market returns could be strong over the next 12 months. Yet in the near-term, against a backdrop of elevated uncertainty, equity investors are better served by remaining defensive and by focusing more on quality and non-cyclical growth. By geography, we are overweight Asia, US, and UK and underweight Europe-ex-UK and EMs outside Asia. By sector, our preference is for Healthcare, industrials, and defensive segments of communication services. Thematically, we continue to see better prospects in services vs. manufacturing, re-opening trades in Asia, clean energy, biotechnology, and de-globalisation plays. For a detailed portfolio positioning by regions, sectors, and styles, see pages 4-5.

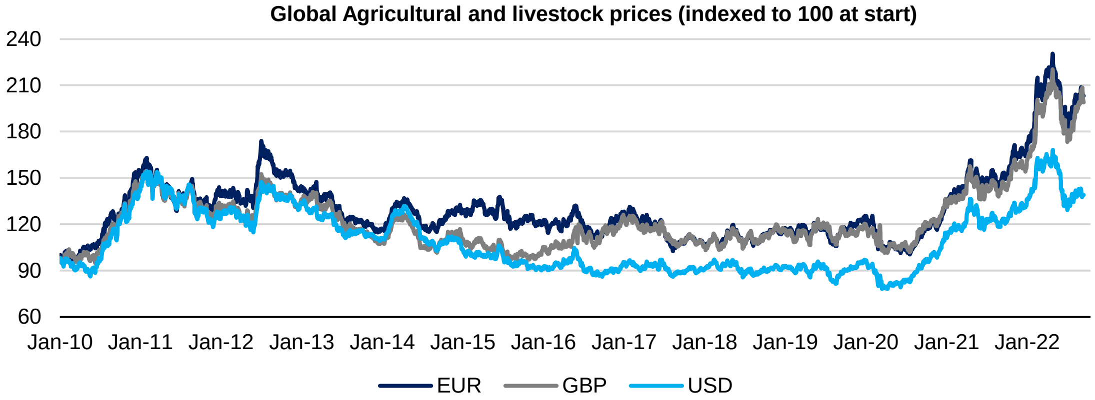
Alternatives

Food commodities

Food prices (as measured by FAO Food Price Index) dropped for the sixth consecutive month in September. In nominal terms, UN FAO Food price index has fallen c15% since peaking in March this year. A range of factors including slowing global demand, lower oil prices feeding into lower input costs, improving weather outlook, and removal of exports constraints linked to re-opening of Ukraine's Black sea ports have all helped in the fall of the price of food commodities. Yet, it is worth remembering that food prices are still up c6% from a year ago and a whopping 50% since hitting the low in May 2020. Falling food prices were a welcome development for the global economy facing persistent inflation. While food inflation remains a major concern for emerging/developing market economies, it is also becoming increasingly important for developed markets as concerns of price stability take hold. Here, not all developed markets are made equal. As shown in exhibit 17, food prices in USD terms have been more contained than those in EUR and GBP. With European economies already facing slower economic growth, higher food prices along with higher and rising energy prices might put them on a path to stagflation.

Over the medium-term to long-term food prices could stay elevated as worsening geopolitics challenge global supply, climate change makes the crop produce unpredictable, and higher energy and fertiliser prices keep cost pressures elevated. Food security remains our preferred long-term theme for this reason.

Exhibit 17: Food prices have fallen, but more sharply in USD terms



Source: UN FAO, Refinitiv, Datastream, and ADCB Asset Management

Gold

Gold prices fell so far this year. While gold has certainly performed better than other cyclical commodities, the yellow metal could not stand up to investor expectations as a haven asset. Monetary tightening (that led to a rise in real rates from extremely depressed levels) and a stronger USD have both been headwinds for gold prices this year. Given gold's failure as an inflation-hedge this time around, institutional investors are exiting gold with heavy liquidation in the ETFs. Also given rising concerns of a recession, jewellery demand has been soft. At the same time, mine output is up creating unfavourable demand-supply dynamic. Looking ahead, as US Fed hits a peak rate, and as USD starts to stabilise, gold could see some price appreciation. Recycling rates which have risen recently may ease in the near-term due to lower prices. Central bank buying could return as a strong source of demand as geopolitical risks intensify. In that context, we continue to view gold as a long-term hedge against slowing global growth, hegemonic instability and potential USD debasement.

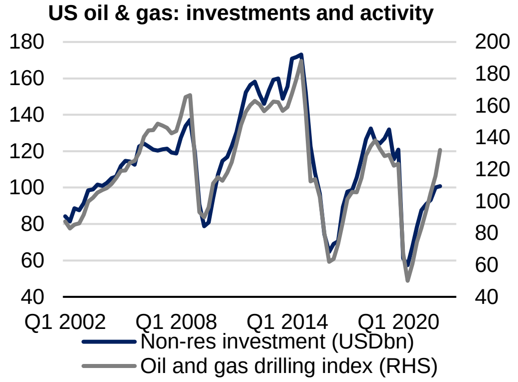
Energy commodities

Brent crude prices have averaged USD102/bbl over the first nine months of this year. Between January and early-march, oil prices rose from USD80/bbl to USD130/bbl. Subsequently remained range-bound till early June. However, between June and September, Brent crude prices fell c32% amid heightened concerns about sluggish global demand, significant increase in supply, and a strong USD. However, as OPEC+ announced its intentions to cut oil production in October, oil prices rallied c13% over the two-week period to early October. Looking ahead, we think it is reasonable to expect energy prices (oil and natural gas) to remain volatile as uncertainties around demand and supply persist. Winter demand out of Europe is likely to be strong exerting further upward pressure on gas prices in Europe. Supply side response from Russia (for gas) and OPEC+ (for oil) appears to be more supportive of prices. In the US, investments into the oil & gas industry have not risen back to the pre-pandemic levels even after rebounding strongly over recent quarters (exhibit

18). However, concerns around a global recession are likely to put a cap on the energy prices over the next months.

Taking a longer-term view, demand outlook for carbon-rich energy sources remains uncertain given the energy transition. Also, mitigation as a climate strategy implies change in global energy mix entailing not only faster phasing out of fossil fuels but also accelerated deployment of renewables. Whilst this development means greater opportunities in the renewables space over the long-term, it also counter-intuitively means higher fossil fuel prices in the near-term. On the fossil fuels, the prices are likely to stay elevated in the near-term as the renewables are not yet widely available to meet the energy demand at the time when additional fossil fuel supplies are likely to remain constrained (exhibit 19). However, higher fossil fuel prices in the near-term should in turn accelerate the migration to renewables over the medium to long-term. Against this backdrop, the outperformance of oil & gas equities relative to clean energy segments during 2021 was noteworthy. For long-term investors, clean energy themes remain an attractive investment proposition.

Exhibit 18: Supply discipline of oil & gas remains price-supportive in the near-term



Source: Datastream, Refinitiv, and ADCB Asset Management

Exhibit 19: Supply constraints of clean energy materials is price-supportive for the long-term

Source: Datastream, Refinitiv, and ADCB Asset Management

Private real estate

In the commercial real estate (CRE) space, transaction activities slowed markedly in H2 2022 after rising sharply in the prior 18 months. Higher funding costs are also contributing to slowness in large transactions and the securitisation market. Looking ahead, being patient for right set of opportunities to arise may be as important in private CRE space as it is in mainstream public markets. It is also worth thinking about how rising interest rates play into the cap rates (operating income/current value) for the market – especially in the US where the interest rate rises have been the fastest in 30 years and also where interest rate rises have far outpaced those in other developed world. In this context, research from Goldman Sachs (*Americas Real Estate: 2022 Private Real Estate Conference Takeaways, October 2022*) points out that when interest rates go up, so do cap rates. However, there are three variables to consider that can break that relationship: 1) rent growth could potentially offset interest rates, and thus when interest rates go up, cap rates can continue to go down; 2) adding value and changing the profile of the specific asset class could break that relationship; and 3) global capital flows.

In terms of the outlook it is always important to keep in mind the divergence between public and private markets of real estate. For instance, after the recent turbulence, public REITs sector is at a significant discount to NAV while private markets have not been as impacted. By sector, the rent growth in apartments was able to offset the inflation. However, looking ahead rent growth is likely to moderate at least in comparison to the previous periods. As we highlighted previously too (see Q3 2022 Outlook: Delayed, not derailed, October 2022), industrial real estate continues to have a strong outlook. Structural drivers such as shift to safety stock, onshoring, growing e-commerce penetration, and the need for tenants to be close to the end customer to facilitate the speed of deliveries, could continue to hold and fuel industrial demand even through macro slowdown. Retail sector could be affected by the near-term pull back in consumption especially going into the year-end holiday season. On the healthcare side, the sector of senior housing seems to be still recovering from the pandemic with occupancy rates continuing to improve but still remaining below the pre-pandemic levels. Labor shortages continue to constrain the growth in the sector. The focus still remains on the use of real estate tech to improve the efficiency. Especially with the return to office in major cities across the US still uncertain (level of occupancy, and number of days employees may be in office), proptech can still be used to improve the workplace experience.

Currencies

US Dollar

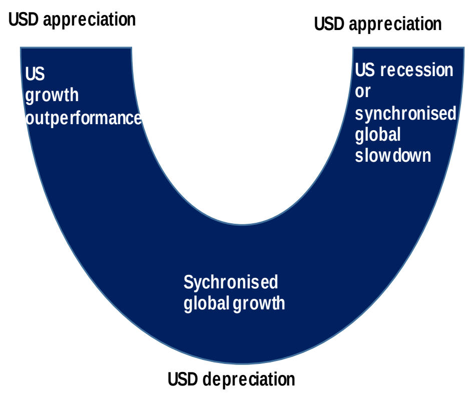
USD strengthened further in 3Q 22 with the dollar index rising to the highest level seen in 20 years. The surge in USD was driven by jump in market expectations of higher Fed fund rate in reaction to hawkish Fed bias and evidence of persistent inflation pressures. Rising global concerns with relative US growth outperformance and risk-off sentiment also drove appetite for the USD.

The famous "dollar" smile is proving to be detrimental for the countries around the globe and has triggered many central banks, both in DM and the EM world, to intervene in the bond and currency markets. Interestingly, this time around, the dollar pain has been more prominent for the DM currencies while EM currencies have been relatively resilient so far. In fact, the trade-weighted dollar index versus the DM currencies has surged at a faster rate compared to the EM equivalent this year. Similarly, JP Morgan G7 FX volatility has also been higher compared to EM FX equivalent. So far, rising interest rates differential between the US and the rest of the world with the Fed leading the race of tightening has been an important support for USD rally. But going forward, with other central banks playing catch-up, interest rate differentials will not be as influential in determining the path of the USD. This does not mean that the end of the USD rally is near. USD will continue to remain strong especially with increased evidence of US growth outperforming peers amidst global slowdown fears. In fact, 1yr recession probabilities indicate that the slowdown risks are the highest in the Eurozone and the UK. USD is also the favourite-safe-haven asset during periods of increased volatility and risk-off sentiment. Meanwhile, strong USD is not Fed's problem as it will eventually aid in bringing down the imported inflation cost pressures. However, sustained USD strength and rising US borrowing rates is ugly for the global economy given it raises the USD funding costs, imposing more funding stress and tighter financial conditions. In fact, financial conditions in the Eurozone and the UK have tightened to the levels seen during the COVID-19 sell-off, thus calling for frequent policy intervention to stabilise the markets.

Euro

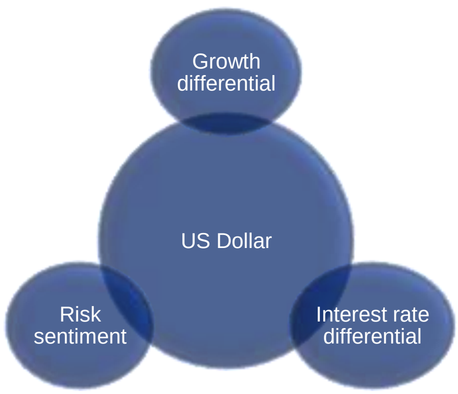
Despite the ECB switching to tightening mode, as expected the central bank still lags behind the Fed and other DM central banks. In addition, the ECB faces a challenging task to tighten monetary policy at a time when the region is undergoing worse energy crisis and rising slowdown risks. As such, it will remain difficult for the ECB to tighten as much as the Fed and we believe that the ECB will be compelled to adopt a more patient strategy. Increased growth concerns and patient ECB mean that the euro could continue to remain weak versus USD. As such, we do not anticipate a complete reversal in the current currency trends unless the Fed surprises with a dovish pivot. In such a scenario, the euro weakness could stabilise. However, given the worsening economic situation in the region, a strong rally in the euro is unlikely. We maintain a negative outlook on the euro.

Exhibit 20: The famous "dollar" smile theory



Source: ADCB Asset Management

Exhibit 21: Rate differentials to take backseat

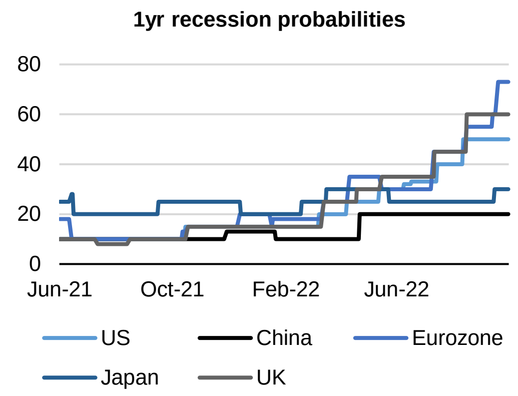


Source: ADCB Asset Management

Pound sterling

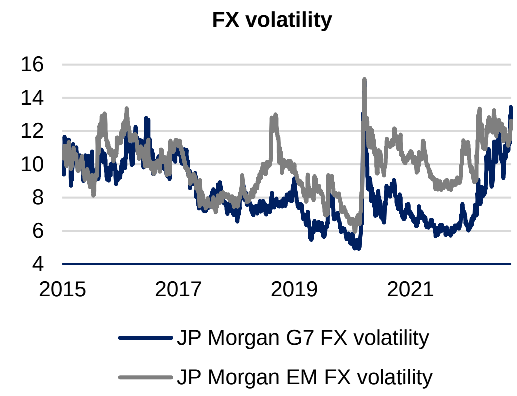
The pound sterling continued to weaken versus the USD and the euro both in 3Q 22. The weakness was again more pronounced against the USD compared to the euro. GBPUSD declined to the record lowest level. Weak economic outlook, persistent inflation coupled with UK's new Prime Minister Liz Truss announcing an expansionary fiscal policy forced the Bank of England to intervene in the bond market. The BoE announced emergency purchases of long-term gilts to stabilize the volatility in the gilt and the currency market. Similar to the ECB, the BoE also faces a challenging task to balance its response to rising inflation and weak growth outlook. 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 USD and flat versus the euro.

Exhibit 22: Eurozone has the highest 1yr probability of recession



Note: The recession probabilities are not ADCBs RPIs |Source: Bloomberg, and ADCB Asset Management

Exhibit 23: Spike in G7 FX volatility

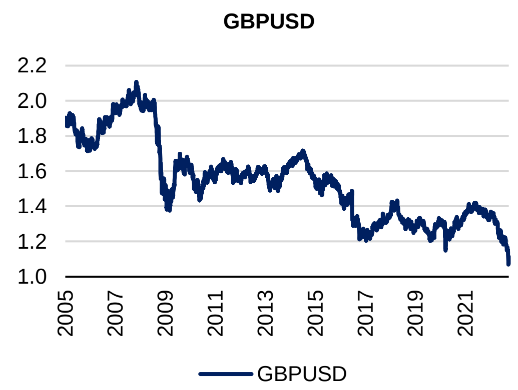


Source: JP Morgan Indices, Bloomberg, and ADCB Asset Management

Japanese Yen

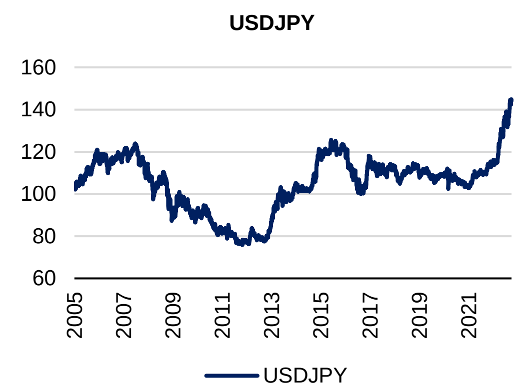
The weakness of Japanese yen against the USD further intensified in 3Q 22 with the yen now trading at the weakest level since the 1990s. Rise in UST yields, broad USD strength and further widening of interest rate differential between US and Japan put downward pressure on the yen. The Bank of Japan was forced to intervene for the first time since 1998 to stabilise the currency market, spending record amount of JPY2.84trn in September alone. We expect the yen to remain weak as long as the BoJ maintains its accommodative stance and or the Fed sticks to its hawkish stance. In the event of dovish Fed pivot, stabilisation in long-term UST yields should provide support to the yen. Meanwhile, central bank interventions in the currency market are likely to be frequent in the near term.

Exhibit 24: Pound sterling weakened versus USD



Source :Bloomberg, and ADCB Asset Management

Exhibit 25: Yen weakened versus USD



Source: Bloomberg, and ADCB Asset Management

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