MSM House View

Outlook 2023: Core Views

Markets will need a strong third quarter earnings seasons to break the risk-off mood! While not unexpected, investors turned more cautious as the US Fed's "higher for longer" mantra gained credibility and the dysfunctionality of the House Republicans left agreement on a fiscal 2024 budget in doubt. That said, w**e continue to run a small overweight in fixed income and hold equity exposure at neutral.**

As we enter the final quarter of 2023, our focus is shifting towards the following signals:

- **US and Global geopolitics are back in focus.**
- **DM central banks are converging to end the rate hike cycle!**
- **Recession risks in 2024 are rising.**
- **The third quarter earnings season will set the tone for market sentiment.**

US and Global geopolitics are back in focus! In the US, dysfunction continues to run the US House of Representatives as we start the fourth quarter. Most analysts are paying scant attention to the House Republican Speaker saga under the assumption that it will have limited impact on markets and the economy.

The likelihood of a US government shutdown in the fourth quarter is now the base case for the November 17 deadline. Approval of the US fiscal 2024 budget hinges on a new and improved Speaker of the House (not guaranteed) and subsequent passage of the twelve necessary full-year spending bills by the deadline. Even as the Goldman Sachs analysts have a shutdown as their base scenario, they do not believe it will last more than two to three weeks "given the political consequences of certain aspects of a shutdown." Thus, worst case for the economy would be a temporary hit to GDP growth on the order of -0.4% to -0.6%. The debacle bears watching in the face of global geopolitics and recession risk for 2024.

Global/Mid-East geopolitics is the bigger issue and could impact markets more directly. The Hamas surprise attacks on Israel of this past week and the Israeli government's response will continue to dominate our and the media's attention.

The extent of the surprise and horror of the attacks will be met by a brutal response from Israel's newly announced unity government. According to analysts, for 16 years, Israeli governments tried to manage the risk from Hamas' leadership.

The aim now, post the weekend's carnage, is to destroy their military capability and leadership. As per Bloomberg reporting, Lt. Colonel Richard Hecht, Israeli military spokesman, told reporters on Thursday, "right now, we are focused on taking out their senior leadership, not only the military but also their government leadership."

Other than the fact that that innocent civilians will bear the brunt of this war, there are no clear answers to several questions that will dominate markets including:

- How long this war will last?
- Will it expand to other fronts (e.g., the West Bank, Lebanon, Iran)?
- Will US-brokered talks between Israel and Saudi Arabia resume? etc.).

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According to Nouriel Roubini's recent interview with Bloomberg's Francine Lacqua, global financial *markets are discounting the risk of a "massive conflict throughout the Middle East for now" with a baseline scenario which assumes "Israel occupies Gaza, it's going to get ugly, but the conflict remains contained."* One week into this war, the initial knee-jerk bounce in oil prices has turned down and, according to some, is focusing on potential destruction to oil demand going forward.

DM central banks are now converging on a pause/end to the rate hike cycle! As of the first week of October, after US Treasury rates drove sovereign debt yields higher, the futures markets for the major developed markets are now indicating no further policy rate hikes from four of the five DM central banks (US Fed, ECB, Bank of England, and Swiss National Bank). Markets are still showing a potential rate hike by the Bank of Japan in the first quarter of 2024.

This is a shift from mid-September when markets were pricing in better-than-even odds that both the Bank of England and the Swiss National Bank would raise their respective policy rates by 25 basis points, while the US Fed and Bank of Japan were expected to pause after their July moves.

The sharp increase in US Treasury yield during the closing weeks of September showed that markets finally recognized that "higher for longer" is real! Curiously, the bear-steepening of the US curve did not have a significant effect on futures pricing of policy rate increases. Rates markets have calmed down since their recent peak. After a brief double-test of the 4.90% 10-year US Treasury yield the past week, yields have now fallen back below 4.70%.

As a result of the rise in rates, US Federal Reserve voting members have turned less hawkish since their September FOMC meeting. Several Federal Reserve members (e.g., Vice Chair Philip Jefferson, Dallas Fed President Lorie Logan, and San Francisco Fed's Mary Daly) have all indicated that the increase in Treasury yields may have done some of the necessary tightening for them and may indicate less need for the central bank to raise rates again.

Recession risks in 2024 are rising and, unlike the fears for 2023, have a higher probably of occurring. Contrary to the late 2022/early 2023 recession calls which were primarily driven by unfounded fears of runaway inflation, the possibility of a mid- to late-2024 recession has several catalysts. These include the lagged effects of the historically aggressive rate hikes by the US Fed, tighter lending standards in the US banking system, a normalized labor market, and a weaker macro-economic environment.

Timing is everything. In end-2022, only nine months had passed since the Fed reversed its pandemic era zero rate policy (ZIRP) and raised rates by 4.5%. Notoriously known as a blunt monetary policy tool, Rafael Bostic (Atlanta Federal Reserve President) wrote in November 2022 that "it can take 18 months to two years or more for tighter monetary policy to materially affect inflation." We are now into month 20 since the Fed began tightening and the effects of monetary policy are being felt in some sectors.

The March 2023 Silicon Valley Bank failure, shortly followed by Signature Bank and the UBS rescue of Credit Suisse, brought home the mark-to-market valuation risks sitting on bank's balance sheets. The successful efforts by central banks to stave off a funding crisis, triggered tighter lending

standards by US banks. The combination of a reduced availability of loans and higher interest rates means that spending levels (corporate or individual) are less likely to increase at best, or more probably decrease.

While the latest job numbers in the US point to the continued resiliency of the economy, the economic conditions in the US have been shifting over the past months.

The services sector accounted for 78% of the US economy in 2021 (statista.com). It has kept the US economy in expansion mode on the back of consumer spending, offsetting the contraction of the manufacturing (11% of the economy) sector. Since its 2-month recovery to a reading of 56.2 (expansion territory) in February of this year, the Markit Services PMI has trended down to 49.2 (contraction) in September. The ongoing recovery in the manufacturing sector may keep the economy expanding over the near term, but not necessarily in the coming year.

We've long shared the view of the BCA Research team that a US recession was not probable until 2024. Their view is that it could begin in the second half. However, recent events highlight three risks that could pull the start date forward. First, the rise in bond yields could renew the March stress on the banking sector. Second, Mid-East tensions and Russia's policy moves could drive energy prices higher and cut into consumer spending. Lastly, the end of student debt payment deferrals in September will put additional pressure on consumer spending going forward.

The **third quarter earnings season will set the tone for market sentiment.** According to the latest estimates compiled by LSEG I/B/E/S, this reporting season is shaping up as an inflection point for US companies but an "earnings recession" for their European peers.

The S&P500 companies are now expected to post positive earnings growth of 1.3% in the third quarter after dropping 2.9% in the second quarter (7.9% above estimates). Excluding the energy sector, earnings would be up 6.2%. Earnings revision had been trending positive over the past weeks which sets up a positive picture for the season.

More notably, bottom-up earnings forecasts for the following quarters are pointing to low double-digit growth through 2024. On the revenue front, analysts are estimating flattish growth of +0.6% for the quarter, followed by steady recovery of three to six percent through 2024. Seven of the eleven sectors are forecast to post positive earnings growth, led by the Communication Services (+33.8%) and Consumer Discretionary (+23.1%); the laggards are Energy (-34.7%) and Materials (-20.5%) sectors.

Unlike the failed predictions for a US earnings recession in the first quarter of 2023, the Euro Stoxx 600 companies are more likely to meet this definition in the upcoming earnings season. European analysts have been revising earnings and revenue estimates downwards these past weeks.

Earnings are now predicted to drop 11.4% (vs -10.9% the prior week) in the third quarter after falling an estimated 5.6% last quarter. Similarly, revenue estimates have come down to -7.9% growth versus -6.4% the prior week. This negative trend is forecast to continue into the first half of 2024. At a sector level, earnings growth from the energy (-46.9%) and materials (-41.9%) companies are expected to be the major drags, partially offset by the financials (+22.2%) and utilities (+11.0%) sectors.

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Update on our focus themes

Our investments in the **Energy and Energy Transition process** remain a key focus. **However, we are looking to reduce our overweight to the energy sector to neutral**. The Hamas attacks may temporarily drive oil prices higher but rising recession risks may cut demand, driving prices back down.

Our bullish base case for the energy sector had been driven by the ongoing war in Ukraine, the consistent messaging from OPEC+ that they would cut supplies as needed to keep oil prices stable to higher, and the probability that a China recovery would result in an increment demand for oil.

The first two assumptions have been proven out. The Ukrainian counter-offensive and the latest comments from Putin give no sign that an off-ramp to a negotiated peace is possible over the coming year. OPEC+ messaging has been followed by concrete actions, most recently last week when both Saudi Arabia and Russia extended the voluntary supply cuts (1.3 million bpd) to year end.

As per JP Morgan's equity team, "the cuts reinforce a strong message of OPEC+ unity and the cartel's efforts at maintaining oil prices at a steady and potentially higher level to incentivize more conventional oil production which requires longer investment lead times." More notably, the latest monthly report from the International Energy Agency (IEA) estimates that the cut to supplies means the market is now likely to see a deficit of about 1.1 million barrels a day through the fourth quarter.

China's recovery remains a question mark. After an initial burst of activity, China's post-Zero COVID recovery waned under the weight of a lack of broad stimulus and renewed signs of stress in the real estate sector. While concern over China's sluggish recovery builds, there's been only limited measures to reignite growth, prompting forecasters such as JPMorgan Chase & Co., Barclays Plc and Morgan Stanley to downgrade their projections for China's economic growth this year to below the government's 5% target.

We believe that **the Energy Transition process will continue to drive investment flows,** particularly as the drive to increase electrical vehicle (EV) usage creates a super-cycle for critical minerals. The transition from internal combustion engine (ICE) vehicles to EVs is a long-term structural driver of demand for materials like lithium, manganese, graphite, copper, nickel and cobalt. EV requires between 3x and 14x more of these materials than a traditional ICE. As of May 2021, the IEA estimates that EV vehicles use over 200 kg/vehicle versus ICE vehicles' 30-35 kg/vehicle.

Other clean technologies such as solar panels or wind turbines require rare earth minerals to manufacture the products. Assuming the evolution to EVs continues to gather pace, that will drive an increased demand for the industrial metals that are necessary for the storage and distribution of renewable energies.

The International Energy Agency's (IEA) Sustainable Development Scenario estimates that to reach Net Zero by 2050, the demand for Critical Minerals would need to grow six times larger compared to today's levels. Ixios further points out that the war in Ukraine has increased awareness of the strategic importance of energy independence, creating additional demand for renewables. They believe that China's huge push on renewables is driven primarily by this geopolitical consideration.

Outlook 2023: Core Views

Artificial Intelligence became the topic of the day since the November 30, 2022, launch of ChatGPT (a.k.a., Chat Generative Pre-trained Transformer) using GPT-3.5. It is - like its competitive brethren - a large language model-based chatbot developed by OpenAI to enable users "to refine and steer a conversation with the application towards a desired length, format, style, level of detail, and language used".

Since its launch as a free research project, the chatbot has captured the imagination of millions (over one million in its first five days in the open) and redefined the standards of artificial intelligence. According to a May 19 Forbes article, OpenAI was valued at $29 billion, and the company has raised a total of $11.3B in funding over seven rounds so far. In January, Microsoft expanded its long-term partnership with Open AI and announced a multibillion-dollar investment to accelerate AI breakthroughs worldwide.

The growing interest in AI is reflected in flood of media and research articles on the transformational impact of AI on the global economy. The markets are still in the early stages of understanding the potential implications for markets and society. Like other transformational moments in history, the early stages lead to bursts of enthusiasm, hyperbole, and speculation in markets. Recent strategy papers from NDR and Goldman Sachs, look at the historical parallels (e.g., the California Gold Rush of 1848 and the Internet Bubble of the 1990s) and leave us with a preference for well-capitalized companies that provide the "picks and shovels" to this nascent technology with cross-industry applications. More to follow in the future on this topic.

The **upcoming month may prove trendless but volatile** as the mix of economic data, politics, and earnings set the tone for the final quarter of 2023. Our base case scenario now assumes a US recession in 2024, DM central banks holding policy rates near current levels for the foreseeable future (i.e., approximately six months), and major EM central banks (including China) easing monetary policy ahead of DM peers.

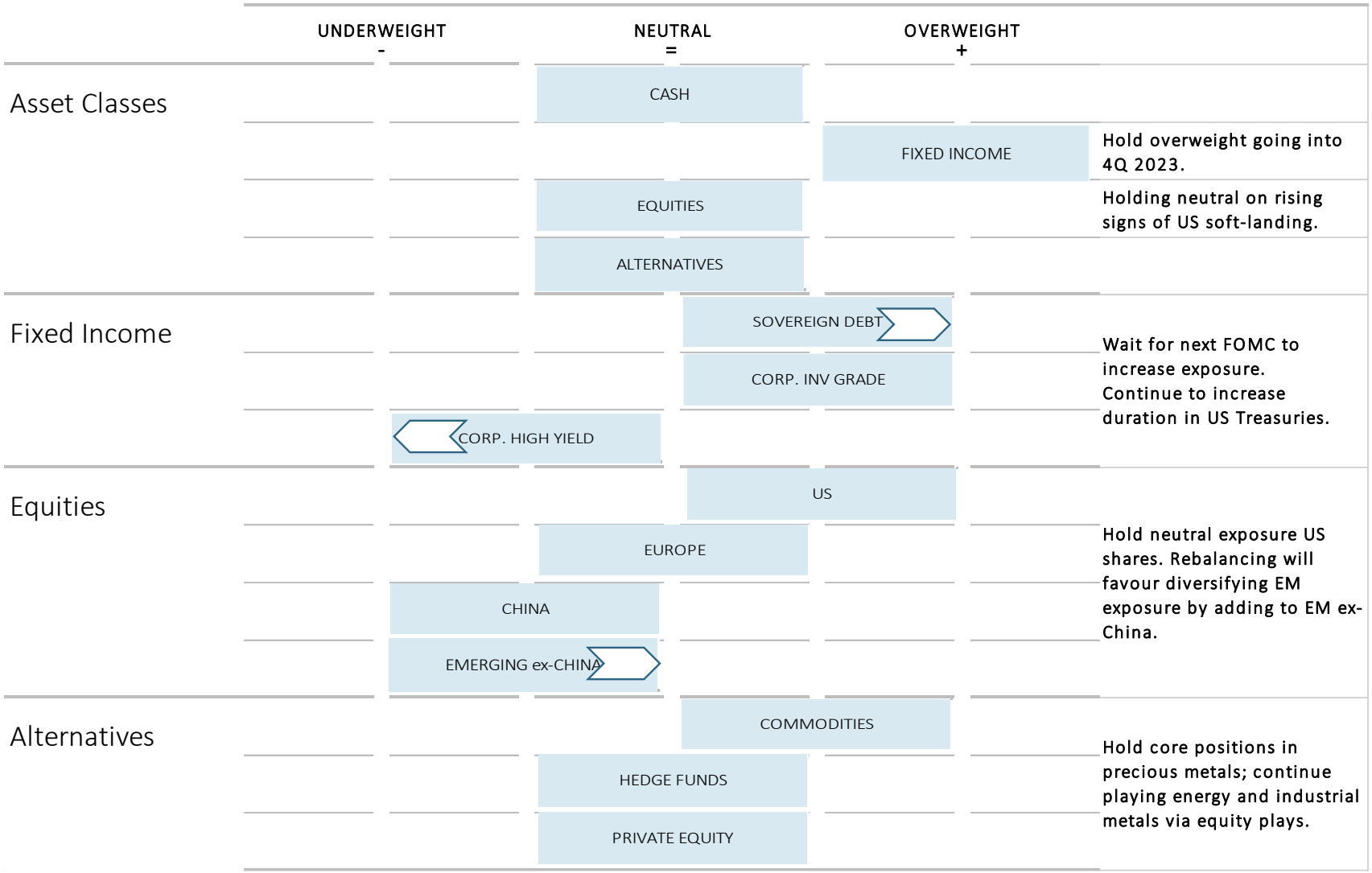
As such, we are **holding our neutral exposure in cash** as it offers attractive returns. We believe US and European central banks are at the end of the rate hike cycle unless growth rebounds. Cash returns may grind a touch higher going into the fourth quarter.

We are **holding a slight overweight exposure to global bonds** as yields have risen. Political gridlock amongst Republican Representatives remains a reality for now and keeps a government shutdown in play. We continue to run short (2-3.5) duration risk within portfolios with a focus on Investment Grade corporate credits. We look to increase duration risk towards 4.0 should yields increase again in the coming weeks. We still favour issuers in recession-resistant sectors (Consumer Staples, Heath Care). The rising recession risk poses risks for high yield and emerging market bonds.

We **retain our neutral exposure to equities** contingent on a strong third quarter earnings season. As recession risks in 2024 are rising, we are **increasing** Consumer Staples and **reducing** exposure to Consumer Discretionary, Energy, and Real Estate companies. We retain our overweight exposure to Health Care companies (lagging defensive sector with above-market growth potential). We continue to run a moderate overweight in the Industrials and Materials.

Monthly Allocation Grid Across Asset Classes/Market Sectors

October 2023



Outlook 2023: Fixed Income

Forward Guidance 2023:-

In the realm of finance, subtle shifts in economic indicators can trigger substantial consequences. The looming possibility of the US 10-year Treasury yield surpassing 5% has sparked concern and fueled speculation. These developments have led us to revise our target range for the 10-year US Treasury yield from 4.00-4.50% to 4.50%-5.25%. The central question is whether the yield will sustain above 5% for an extended period, potentially leading to an earlier recession or attracting more buyers. The former would result in lower yields as the US Federal Reserve combats a recession, while the latter could prompt a swifter yield drop.

"Fiscal Tightening on the Horizon"

Rising US Treasury yields would drive an escalation in the cost of US debt. This could increase the focus on fiscal tightening, potentially resulting in cuts in government expenditure and reduced corporate investment. Consequently, the likelihood of an imminent recession increases, with its timing possibly sooner than anticipated. Contributing factors include the termination of student debt payment deferrals, which may curtail consumer spending, alongside the persistent high-yield environment.

"Implications for Debt Markets"

Should the US face a recession, the idea of "higher for longer" US Treasury yields comes into question. The Fed's dual mandate of upholding stable prices and fostering economic growth necessitates a shift in UST yields, pushing them downward.

In the short term (1-3 months), 10-year UST yields may break above the current range of 4.75-4.80% to reach 5.00-5.25%. Drawing from historical recessions, US Treasury yields could potentially decrease by 1-2 percentage points over the medium term (6-12 months) following the event.

"Credit spread analysis in the Financial Market "

Economic downturns tend to trigger the widening of credit spreads for high-yield bonds. Historically, this widening trend has been predicted and initiated by pessimistic market participants approximately 2-6 months before the recession begins. Past recession scenarios provide insights into potential widening patterns, such as:

- 2001 Recession: Spreads widened by 2.9-3.5%, with two notable instances.12-13% yield to worst pre-recession.
- 2008-09 Great Recession: A 17% spread widening, including a 2.4% pre-recession widening from May 2007 to September 2007, followed by concerns of a depression, resulting in a 15% spread increase with 8-8.5% YTW pre-recession.
- 2020 Pandemic: A mid-pandemic widening of 7-7.50% and 5.8-6.0% YTW pre-recession, though YTW fell to 5.1-5.3% during the recession due to zero-rate policies.

In the event of a 2024 US recession, we recommend:

Sovereign Debt: Extend duration with 10-year US Treasury bonds at specific yield levels of 4.85% and above.

Investment Grade: Maintaining a short duration position in investment-grade securities.

Outlook 2023: Fixed Income

High Yield: Shift from neutral to underweight, consider profit-taking, and potential rebalancing during a recession.

Inflation-Linked Bonds: Underweight US TIPS due to expectations of declining US inflation during a recession.

Emerging Market: If the US 10-year Treasury yield surpasses 5%, it will exert significant effects on the financing expenses of EM debt:

Higher Global Interest Rates: An uptick in the US 10-year yield often triggers increased global interest rates. This can elevate borrowing costs for EM governments and corporations when issuing bonds in international markets, necessitating more competitive yields to attract investors.

Increased Debt Servicing Costs: EM nations and firms with existing U.S. dollar-denominated debt will face higher interest expenditures. This strain on budgets and financial stability becomes more pronounced when foreign-currency debt is substantial.

Currency Depreciation: Escalating U.S. yields can lead to U.S. dollar appreciation. As EM currencies depreciate against the stronger dollar, servicing U.S. dollar-denominated debt becomes costlier for EM entities.

Reduced Investor Appetite: While higher U.S. yields may lure global investors seeking better returns, they can diminish the attractiveness of EM debt in comparison. This reduced investor appetite can result in higher yields, elevating borrowing costs.

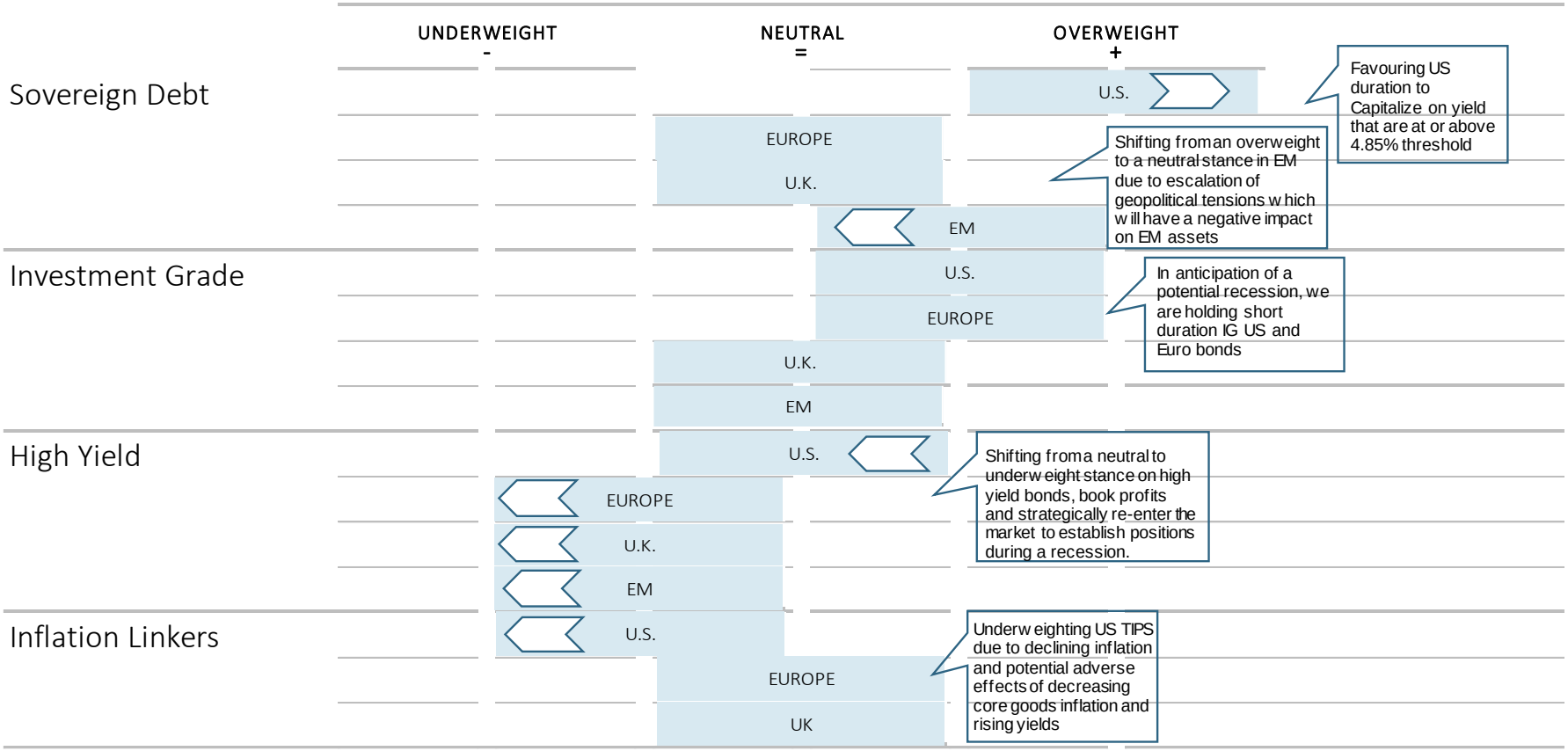
Credit Risk Assessment: Elevated U.S. yields prompt heightened scrutiny of EM countries' creditworthiness. Credit rating agencies may reassess ratings, potentially resulting in downgrades for some EM entities, leading to increased borrowing expenses.

Market Volatility: Rising U.S. yields can contribute to heightened volatility in global financial markets. This may disrupt capital flows and lead to sudden spikes in borrowing costs for EM debt.

We shifted our views from overweight Sovereign local currency to neutral stance and maintain our views of neutral stance in EM , local and hard currency due to the ongoing tensions between Hamas and Israel introduce geopolitical risks that may affect EM assets, potentially driving investors towards safe-haven asset classes. Furthermore, if the U.S. 10-year Treasury yield breaches and sustains above the 5% threshold, it could result in heightened funding costs for EM debt in both U.S. dollar-denominated and local currency markets. EM countries and corporations must prudently manage their debt profiles and consider hedging strategies to mitigate the impact of rising U.S. yields on their borrowing costs.

Monthly Allocation Grid Across Market Sectors

October 2023



Outlook 2023: Global Equity

We maintain our neutral position going into the third quarter earnings season but stand ready to go underweight if CEOs' outlook comments highlight risks. Increased recession risk if Fed's "higher for longer" holds UST rates above 5-5.25%.

As we enter the third quarter, equity investors will again concentrate on the following data flows:

- **3rd quarter earnings season begins mid-October with positive earnings revisions expectations.**
- **Macro-data showing signs of positive reversal in manufacturing spending.**
- **Progress (or lack thereof) in approval of the US 2024 fiscal budget**
- **Geopolitics back in focus as Hamas surprise attacks in Israel raise tensions.**

In this context, we **taking Consumer Staples to a slight overweight** post recent selling pressure. We will use the heightened Hamas-Israel tensions to **cut back our moderate overweight in the Energy** sector to neutral. We continue to run the increased overweight exposure to Health Care companies and the slight overweights to Industrials and Materials. We **move Real Estate back to neutral**.

Regional exposures will see minor shifts away from the United States. Profit-taking will reduce our US overweight as we look to hold European allocations near current levels. While we continue to hold our China exposure as shoots of a recovery appear, we will be diversifying our underweight emerging equity allocation away from China.

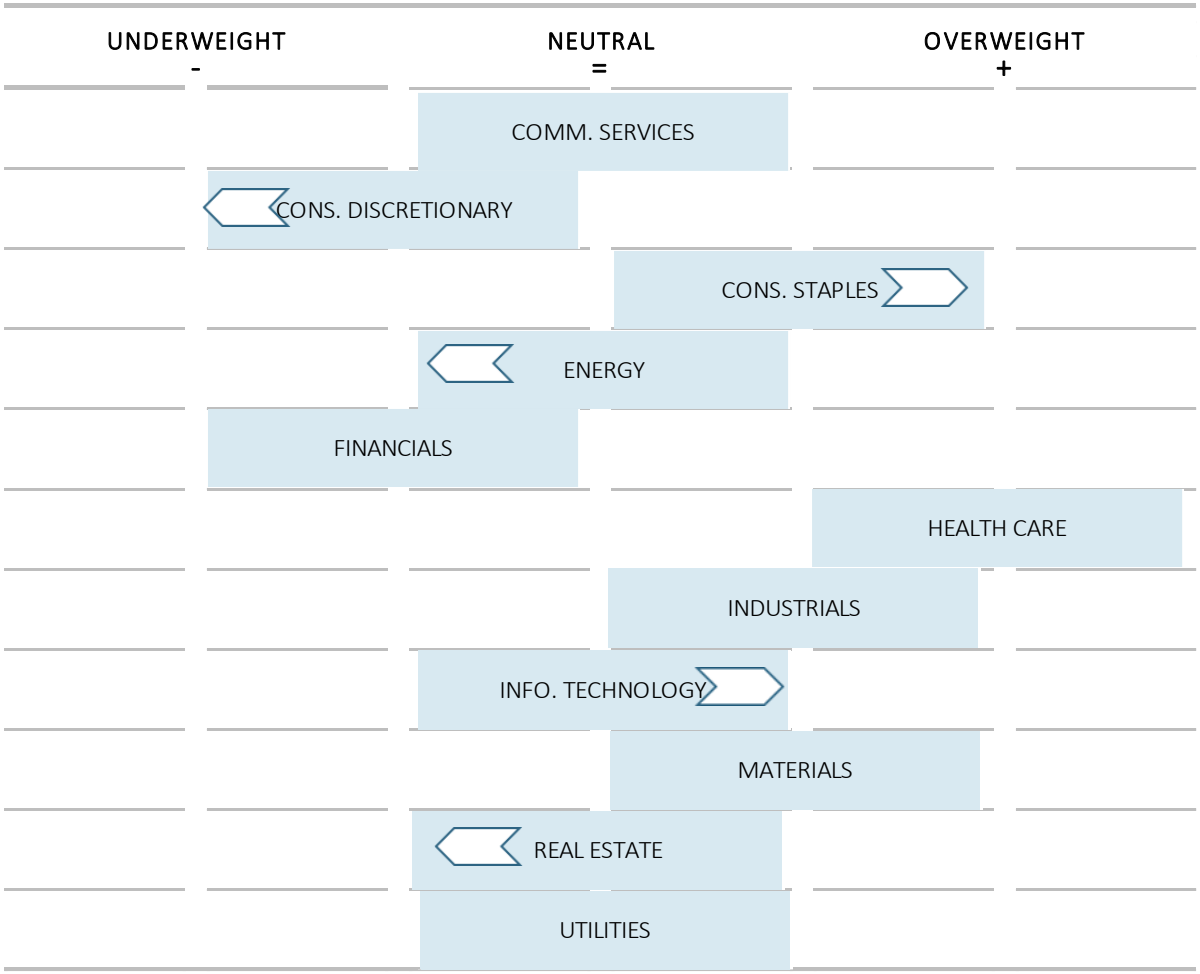
Expectations for the third quarter earnings season are still positive for US companies at +1.3% EPS growth (+6.2% ex-Energy) but revision strength is fading. European company EPS growth estimates are fading and down to -11.4%. Market sentiment is cautious (rising volatility) as renewed fears of higher rates and recession risk raise caution flags. Another pivotal earnings season as investors will react sharply to earnings disappointments.

We continue to see better value in non-US shares as valuation metrics remain relatively high for the broad US index versus European and Asian markets. In addition, select emerging markets' valuation levels, central bank policies, and sentiment are improving.

As usual, our direct investments favour companies with high quality balance sheet strength, strong free cashflow, and with product pricing power.

Monthly Sector Views vs MSCI AC World Equity Index

October 2023



Reduce on rising recession risk.

Increase overweight to defensive sector post revaluation.

Reduce on rising recession risk.

Hold overweight to defensive sector with high earnings growth potential.

Look to increase IF 3Q results/outlook comments confirm valuations

Reduce to neutral on rate risk.

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