Higher Rates, Slowing Economic Activity

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Persistent inflationary pressures are forcing central banks to stay hawkish even as economic activity continues to slow down. Markets are repricing further rate hikes in the coming months while pushing back any expectations for rate cuts any time soon. Interestingly, equity markets seem to be unfazed by this hawkishness and worsening economic outlook. Meanwhile, bond markets continue to point towards an impending recession.

ECONOMIC UPDATE

Fed is clearly ahead in the game

As expected, the Fed did not increase interest rates during its June meeting after 10 consecutive hikes adding to 500 bps. However, the Fed accompanied the pause with a particularly hawkish message and dot-plot projections that indicates two more hikes in the coming months. The market is now ascribing 85% probability of a 25 bps rate increase in July. The European Central Bank raised its interest rate by 25 bps, taking the deposit rate to 3.50% and clearly indicating that it is 'very likely' to raise rates again in July given the sticky core inflation. The market expects a pause after this. On the other hand, The Bank of England increased rates by 50 bps, bringing its Bank Rate to 5%. The prospects of further hikes by the Bank of England look high given the sharp increase in core inflation to the fastest level in the last three decades.

Total rate hikes by US Fed
500 bps

While the US Federal Reserve has been the most resolute and aggressive in raising rates in this cycle, other central banks are now catching up (please see interest rate and inflation figures in the chart below).

Central Banks	Current Rate	Increase in rate	Headline Inflation	Trend	Core Inflation	Trend
US Federal Reserve	5.25%	500 bps	4.0%	↘↘	5.3%	↘
European Central Bank	3.25%	325 bps	6.1%	↘	5.3%	↘
Bank of England	5.00%	475 bps	8.7%	↘	7.1%	↗↗
Bank of Canada	4.75%	450 bps	4.4%	↗	4.1%	↘
Reserve Bank of Australia	4.10%	400 bps	6.8%	↗	5.5%	↗↗

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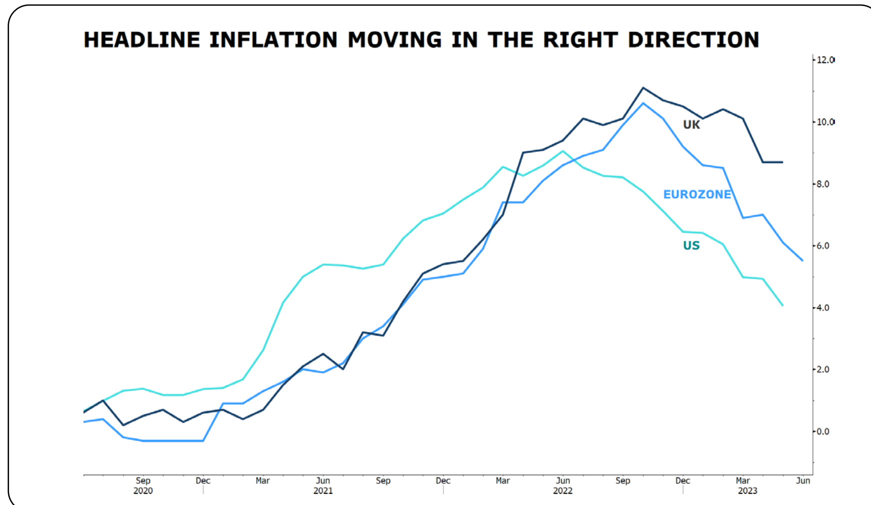
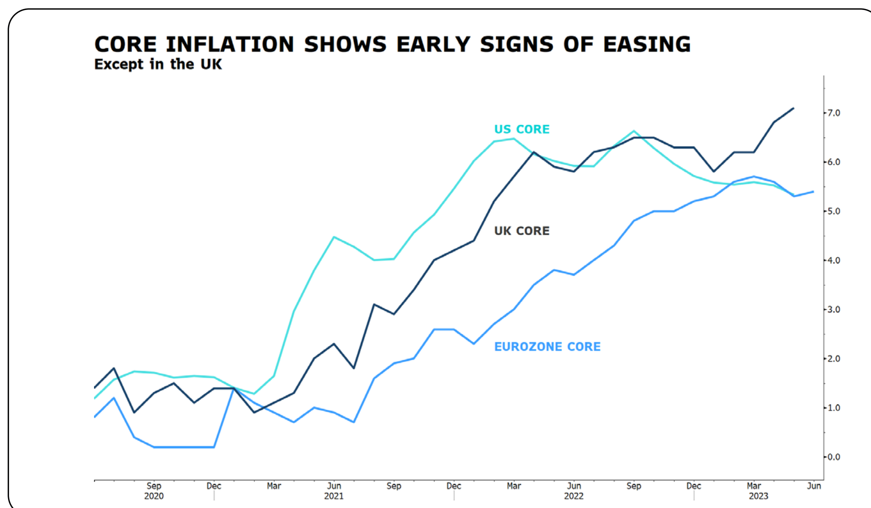
Inflation moving in the right direction – US has made more progress

Underlying economic conditions are reacting to aggressive rate hikes and slowing down fast; exactly in line with what central banks set out to achieve. Headline inflation readings have cooled off significantly from the highs made in the middle of last year, due to lower energy and food prices and the higher base effect. Core inflation in the US and Eurozone are showing early signs of easing though the UK continues to struggle due to structural factors linked to Brexit. Please see the graphs below. It is clear that the US has made more progress in the fight against inflation.

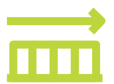
Probability of rate hike by Fed in July

85%





Central banks have a clearly stated goal of bringing inflation down to 2%, which is still some distance away; and hence tight monetary policy is likely to continue. The Fed and the ECB have been vocal about the need for 'a period of sub-standard growth' to tame the malice of inflation. This indicates that they would not necessarily change course due to an economic recession.

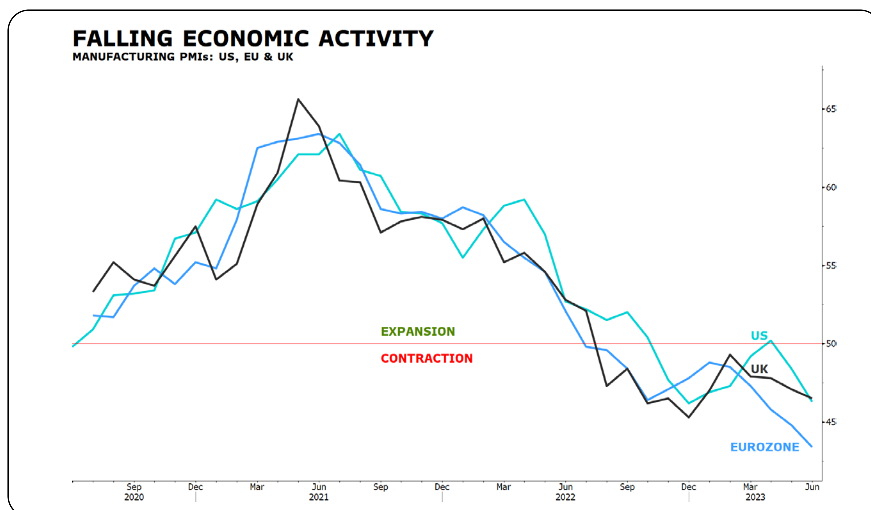


2%

Central Bank Target for Inflation

The Eurozone is already in a technical recession (two consecutive quarters of GDP contraction in Q4, 2022, and Q1, 2023) while the ECB continues to raise rates. The US economy has proven to be far more resilient and the likelihood of a recession, if at all, has now been pushed forward to the end of this year. However, the slowdown is quite marked in many spheres of the US economy and various indicators are now flashing impending recessionary conditions. The manufacturing PMI (purchasing managers

index), which is a leading indicator of business activity and outlook, has dipped well below the level of 50, indicating a sharp contraction (please see the graph below). The latest release of Senior Loans Officer Opinion Survey indicates that lending standards for medium and large corporates have tightened to levels that correspond to an imminent recession while at the same time also showed credit demand has slowed down to a level last seen during the financial crisis in 2008. These data points have direct implications on corporate earnings and overall economic growth.



MARKET OUTLOOK

US interest rates: As highlighted in this report earlier, the US Federal Reserve has delivered the highest increase in interest rates in the shortest period of time compared to the other developed markets. That is now working its way through the economy, slowing down parts of the economy and bringing inflation down significantly. Core inflation remains more sticky due to the tight labor market and high cost of rents. However, both these factors are showing signs of easing: unemployment levels have risen due to rising labor participation rate while private data shows a plateauing of rental growth (Apartment List Rent Report July 2023). Therefore, we believe the Fed is very near the peak rate, if not already at the peak. However, since the inflation target is still far, rates are likely to stay on hold for the rest of this year even if the US economy faces a technical recession. Further down, we believe the Fed will be the first central bank to cut rates sometime in 2024.

Equities: At the beginning of the year there was a near-consensus among analysts that the equity rally that started in October last year was not warranted and that a steep correction was on the cards. As we had highlighted in our Macroeconomic Outlook Event in February, the S&P 500 index tends to give outsized returns following a 25% drawdown and that consecutive negative years of performance are rare. As it has turned out, after a steep drawdown in 2022, equities have delivered stellar returns so far in 2023. US equities are officially in a bull-market, with gains in excess of 20% from the October 2022 lows. The broad-based S&P500 index is up 15.9% while the tech-heavy Nasdaq 100 index has jumped 31.7% so far in the year. Much of the rally initially was driven by the top-7 stocks, all in the technology sector, but more recently this rally is becoming more broad-based with even the small-caps participating on the upside. As far as the Nasdaq is concerned, this has been the best ever first-half performance for the index. While these returns may not be repeated in the second half of the year, we do not see any serious concern on the horizon. Certain headwinds like a slowdown in company earnings and a technical

recession at some point in time are already baked-in into the prices. Equity markets tend to be forward looking and seem to be drawing comfort from the fact that interest rates have probably peaked and company earnings estimates are being revised higher for 2024.

Long term investors should continue to accumulate stocks either through the indices which can be accessed via low-cost ETFs or through high quality growth stocks which will continue to benefit in a low-growth environment.

Fixed Income: While interest rates have been going higher, the long term expectations for inflation have remained well anchored. This is reflected in the Treasury yields of 2 year bonds versus the 5 year and 10 year paper. The 2 year bonds are more sensitive to short term interest rates and hence the yield has risen during the year. However, the 5-year and 10-year Treasuries are trading at similar levels as at the beginning of the year. This essentially shows that there is massive demand for medium to long-term maturity paper since investors of all types – private clients, institutional investors, pension funds and endowments – are trying to lock-in the currently available attractive yields for as long as possible. Long-dated investment grade bonds will provide maximum capital appreciation at some stage in the next 12 to 18 months when the Fed starts easing interest rates.

Opportunity in Fixed Income

We believe investors should look at investment grade bonds to take the triple advantage of capital preservation, high level of secured income for the long term and potential for capital gains.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	2966.72	13.99%
Dow Jones Ind.	34407.6	3.80%
S&P 500	4450.38	15.91%
NASDAQ COMP	13787.92	31.73%
EUROSTOXX 600	461.93	8.72%
FTSE 100	7531.53	1.07%
India Nifty50	19189.5	5.99%
Nikkei 225	33615.12	28.82%
Shanghai Comp	3202.06	3.65%

Currencies	Last price	2023 Chng
Dollar Index	102.95	-0.55%
Euro	1.0903	1.85%
GBP	1.2691	5.03%
JPY	144.46	-9.23%
CHF	0.8956	3.23%
AUD	0.6657	-2.29%
CNH	7.2702	-4.79%
INR	82.04	0.85%
SGD	1.3531	-1.01%

Regional Equities	Last price	2023 Chng
Dubai DFM	3792	13.67%
Abu Dhabi ADX	9574	-6.47%
Saudi Tadawul	11,459.00	9.36%

Commodities	Last	2023 Chng
WTI Crude	70.42	-12.26%
Brent Crude	75.21	-12.45%
Nat Gas	2.706	-39.53%
Gold	1917.41	5.12%
Silver	22.745	-5.05%
Copper	374.95	-1.60%
Corn	554.5	-15.05%

Market Data As of 30th June 2023

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SYSTEMATIC INVESTMENT PLAN	• Invest regularly in globally diversified and actively managed portfolios on CBD's award-winning mobile app CBD Investr
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