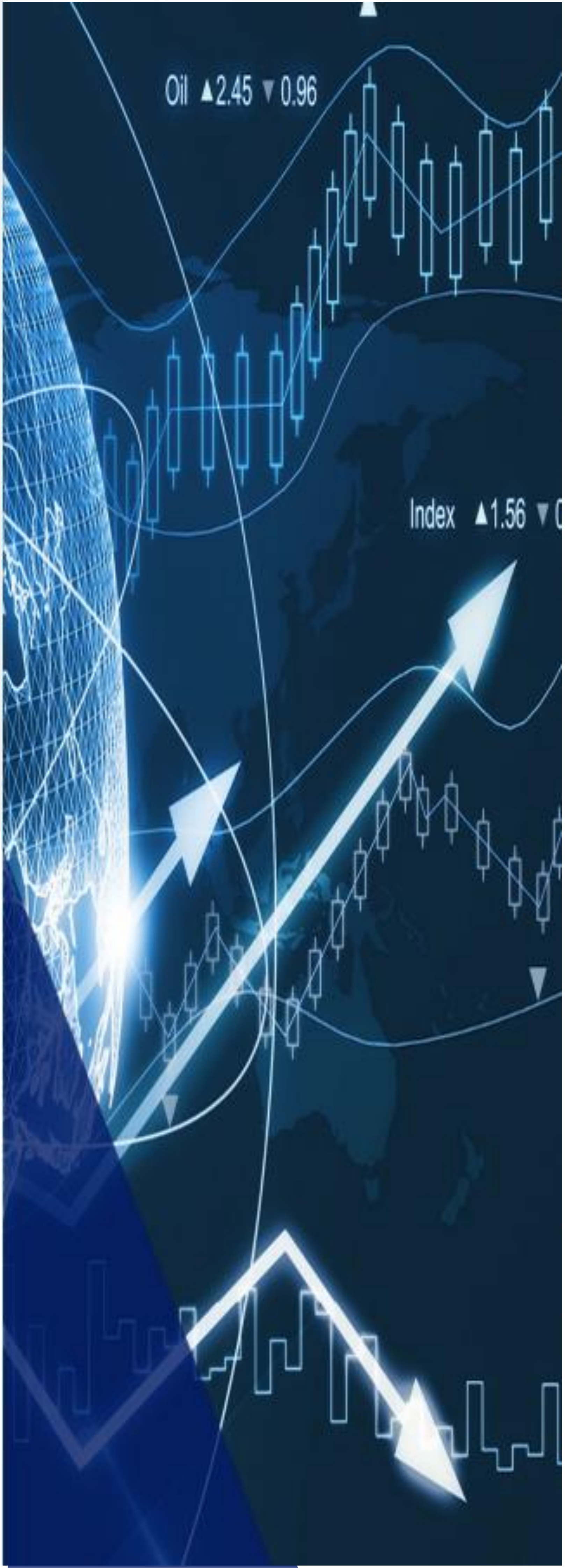
Stay defensive
Stay the course
Sukuk to shine

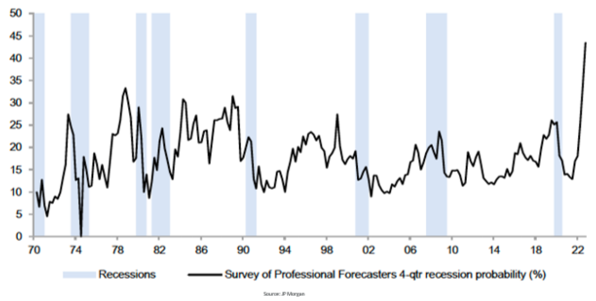
March 9th, 2023



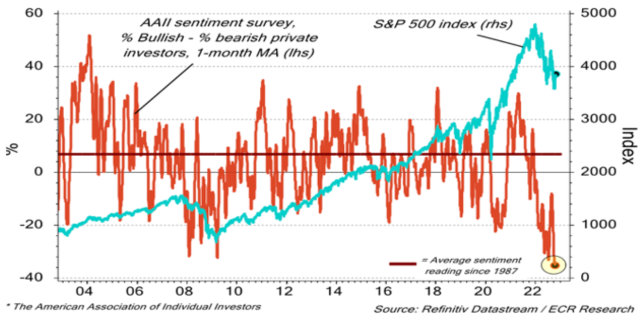
RASAMEEL

What a start to the year it's been. January saw one of the best one month rallies we have seen in a while, driven by the market's expectation that the Fed was going to engineer a soft landing, if not 'no landing' at all. Furthermore, as we noted coming into the year, when the majority on leaning on the side of bearishness, it doesn't take much for the market to shift the other way, as shorts get covered and puts get sold for calls.

Survey of professional forecasters US recession probability



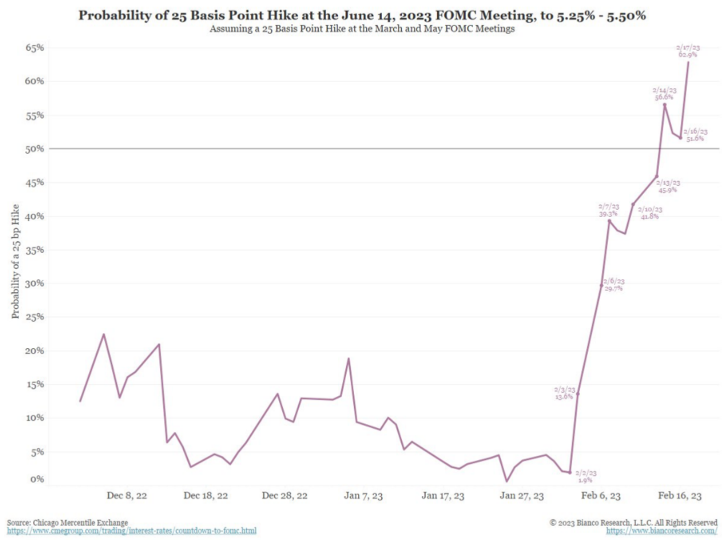
The US AAII* Bull – Bear spread is extremely negative which tend to be a contrarian bullish signal



The market was also factoring in a Fed pivot relatively quickly which was seen as being supportive to the high growth areas of the equity market.

February then saw the markets, both equities and fixed Income in the US, come back under pressure as, while economic data stayed relatively strong, inflation fell by less than expected. While the US jobs data was far stronger than the market anticipated, CPI, PPI and PCE also came out way ahead of expectations and the market started to price in higher rates, with the probability of Fed rate increase of 25bps to 5.25- 5.5% increasing from <5% to over 60%. In the case of Europe inflation rose in several economies. As a result, both the US equity and bond markets turned lower in mid-February as they tried to digest the risk of higher rates.

Probability of higher rates has increased dramatically



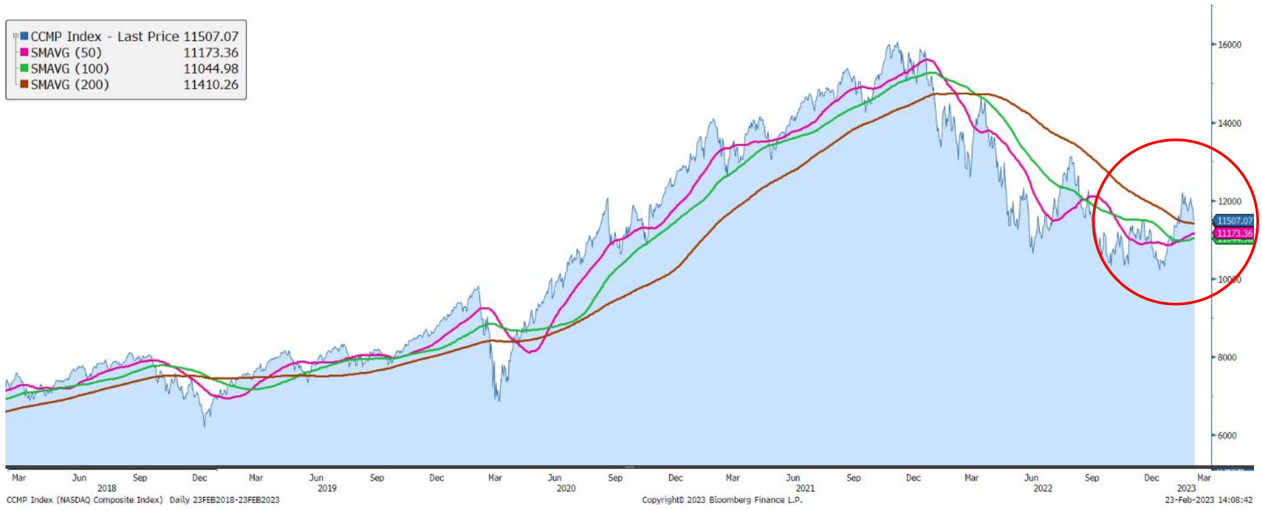
The markets, both fixed income and equity, are confused and grappling with changing data and an environment which has few historical comparisons. Making it that much more difficult to read.

It's no different for us. Being defensively positioned in a 'bull' market, which equities have been in since October last year, is not ideal and makes us constantly question our thesis.

In the case of the US, the major indices broke through what we would see as resistance (200 day moving average or dma) and are yet to fall below that. In Europe the markets are close to 2021 highs. Hardly indicative of a slowdown, or the fact that a war is going on their borders.

The Nasdaq has broken through key technical resistance –

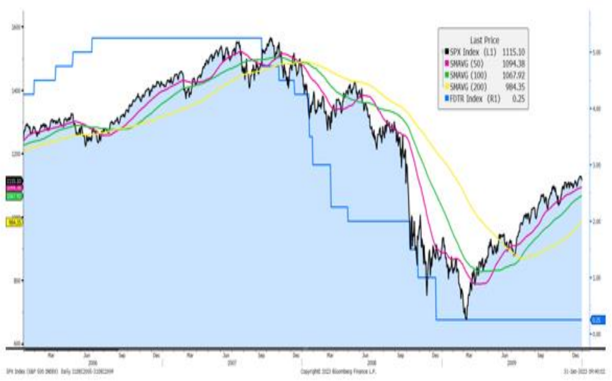
a positive signal and one we should not ignore



By comparison, it was far easier to invest during the 2008 or 2000 market crashes. During that time, most equity markets all crashed in parallel and they all remained in a technical bear trend, with the index not breaking above the 200dma, other than very briefly, all the way to the bottom. So had one gone to cash, one did not need to constantly reassess whether the thesis was right or wrong. You simply stayed underweight risk assets all the way to the bottom and waited for the technical indicators, the 50wma crossing the 100wma or the market breaking above its 200dma.

2000 to 2004 Daily Moving Averages

2006 to 2009 Daily Moving Averages



The worst environment, if one is bearishly positioned, is one where the market continues to move higher against all the odds and rational thought. An underweight and underperforming manager may be forced to capitulate, just as the markets are about to turn. Tiger Management is a perfect example of this, with its founder Julian Robertson struggling with his Technology shorts in 1999, only to close them just before the market broke down. Timing is everything. But so is reading the market. The right view, but at the wrong time is a recipe for disaster. As we know, the market can stay irrational for longer than one can stay solvent.

So, what do we make of it all?

The strategies we run are done so with a longer-term outlook, focused on fundamentals such as earnings and valuations.

While the strength in the economic data may be seen as a positive by many, we take the view that, rather generating a 'no landing' scenario, it will rather worsen any eventual slowdown.

The pressure is on the Fed to continue to raise rates. Strong data and higher inflation will push them to likely raise right into a slowdown. Underlying economic data often lags forward indicators and most forward indictors are downward.

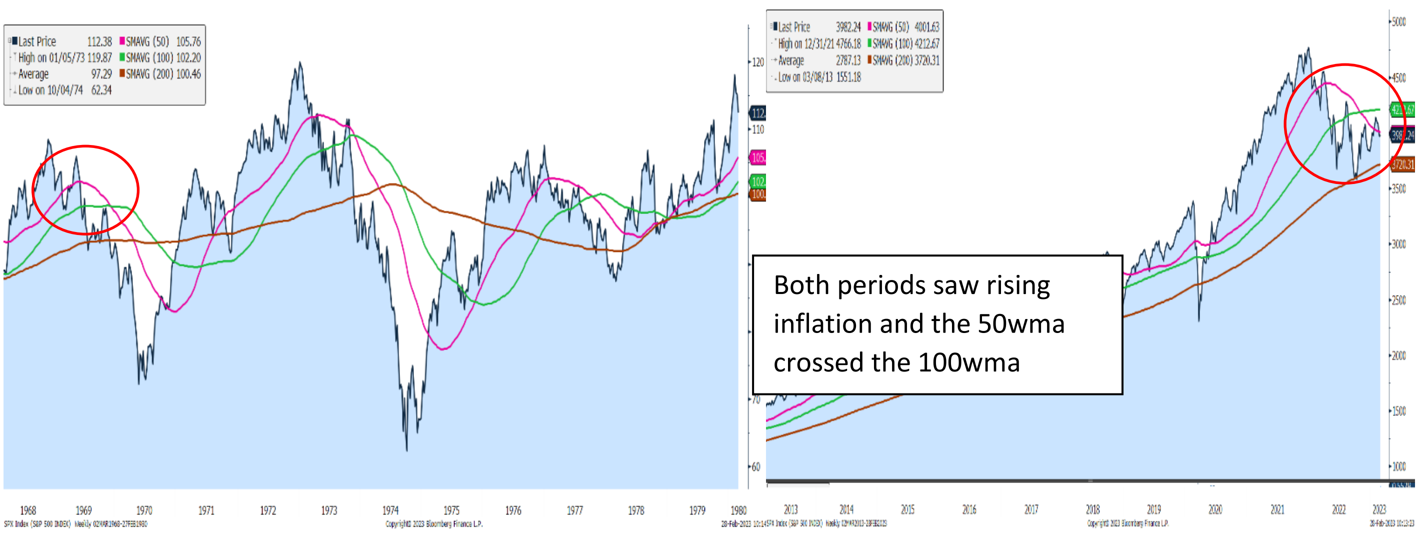
The Fed has done this a number of times, namely tightening until something breaks. And we think this will be the case this time round as well. Indeed, we hope it will be, as we are well positioned to take advantage of any major down moves, having plenty of dry powder and in the Navigator Fund having a slight overweight to mid-long duration high quality sukuk.

From a fundamental point of view, nothing has changed for us over the last few months. Forward data continues to weaken. Earnings and margin expectations are still too elevated and need to be adjusted lower and the US equity market remains expensive.

From a technical standpoint, while technicals are an excellent confirmation tool, and we should be cautious to ignore them, we will not be driven by them alone. Often there is far too much noise in the present moment for the technicals to overrule the fundamentals.

Indeed, if we look back at the 1970s, when markets were struggling with high inflation and uncertainty, the S&P was extremely volatile but eventually, broke through 200wma support which, when it did, it did with gusto. From a purely technical point of view there are similarities between the two periods.

<u>**S&P 1970s with weakly moving average (wma) compared to today**</u>



So, on the back of weakening fundamentals and relatively high valuations, we remain comfortable with our underweighting to US equities.

In the case of Europe, we came into the year highlighting the value in the market relative to the US. We are marginally overweight Europe and there is decent relative value here, but this does not explain the massive run up in the European equity markets. With economically sensitive sectors such as Apparel, IT and Materials up c.18% YTD at the time of writing in late February. In part this will be driven by the China re-opening trade and what appears to be a lot of speculation. While China is the largest consumer of copper and growth there is picking up, we are not sure copper should be trading 50% above the levels of 2019. Dr Copper has rallied over the last few quarters and is not, in our opinion, reflecting a general slower global economy.

So, our base case remains one of following the data and being cautious on the near term and more optimistic further out where we expect good opportunities to present themselves.

In terms of allocations, in the case of the equity strategies, they remain very overweight cash, c.25% in the case of global and 30% for DT. So, the Strategies still have c.70-75% exposure to the equity markets. **If we are wrong and markets move higher, the strategies will generate absolute performance. If we are right and markets move lower and there is plenty of cash/dry powder to take advantage of lower prices.**

In essence, the positioning feels right.

In the case of the Navigator Fund, the fund is now slightly overweight fixed income/sukuk and very underweight equities. This also feels to be reasonable positioning given the uncertainties in the market.

The one area we continue to really favor, as a 6-18m trade, is fixed income/sukuk.

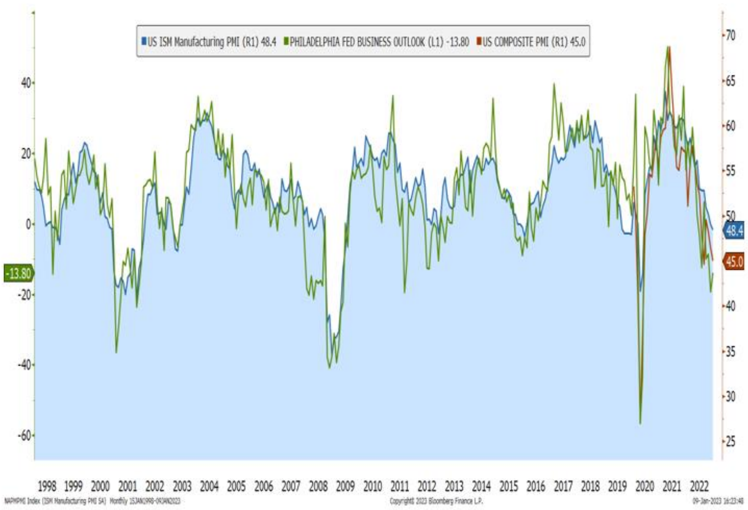
US bond yields have been moving higher with the strength in the current economic data as well as the higher inflation print. The US Treasury bonds now (as at 5/03/23) give a yield of c.4.8% of 2y maturity and c.4% for the 10yr maturity.

Sukuk offer a similar to slightly higher yield, for the same quality and duration. The AAA rated Islamic Development Banks (ISDB) 7yr maturity (05/29) sukuk offers a yield of 4.4%, which compares with a similar maturity UST of 4.2%. The yield is even better the further out you go in maturities. **The A rated Saudi Electricity sukuk SECO '44, which we consider to be quasi government, gives a YTM of 5.2%.** This is one of our personal favorites as it is long duration, high quality, quasi government.

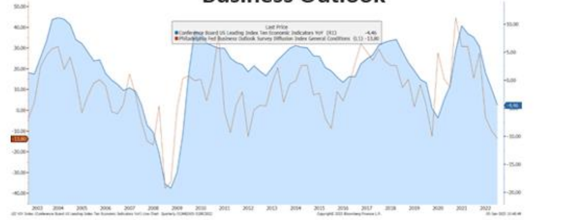
As we highlight earlier, all the signals indicate a slowdown is approaching and that inflation will be falling off.

We don't prescribe to the 'this time is different' mantra. Far from it. We think the rate hike cycle will play out very similar to prior periods such as 2000 or 2007.

Business outlook is bearish



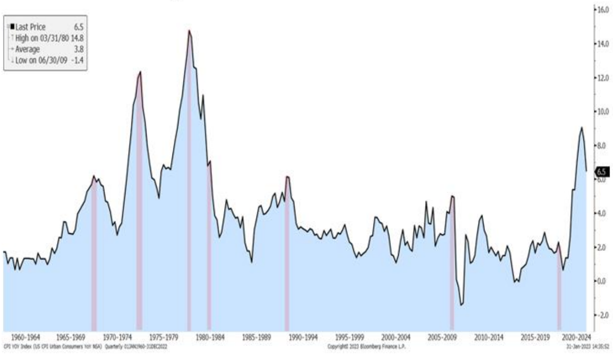
Conference Board US Leading Index vs Philadelphia Fed Business Outlook



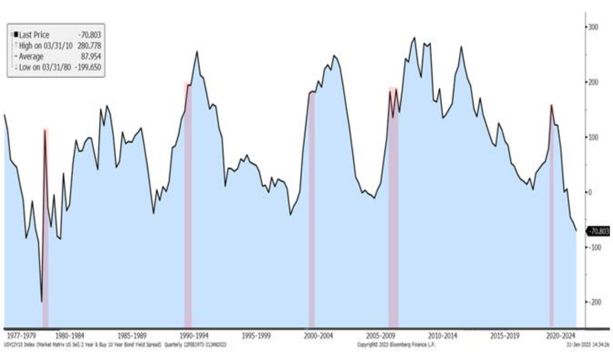
University of Michigan Consumer Sentiment Index

High inflation and Inversion usually precede slowdown

High Inflation forebearer of slowdown



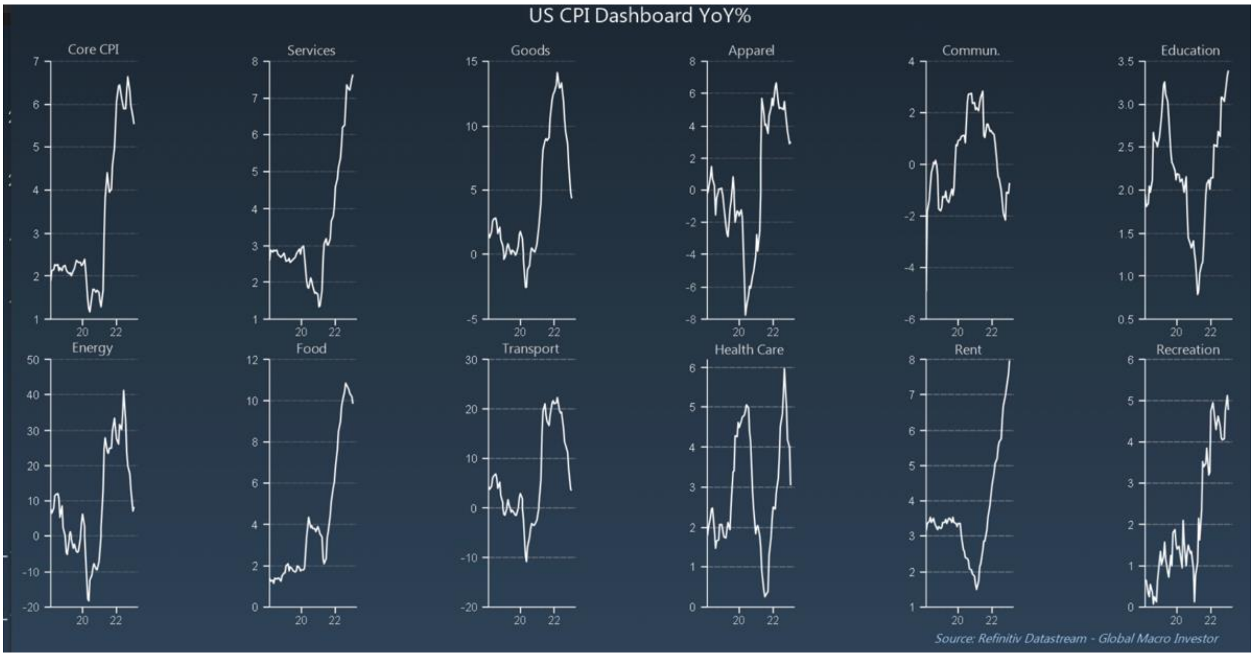
Inverted Yield Curve forebearer of Recession



The charts above highlights very clearly the past rate cycles we have gone through in the recent past. In each case, other than 2019, the Fed continued to tighten and then kept rates elevated to the point that the economy faltered and effectively collapsed ('00-'03 and '08-'09). Otherwise known as a 'hard landing'. The Fed was very aggressive cutting rates, but there is a lag effect between cutting, or for that matter raising, rates on the economy. Lower rates take quarters, if not a year or so, to feed through into economic data.

So, the usual boom bust cycle.

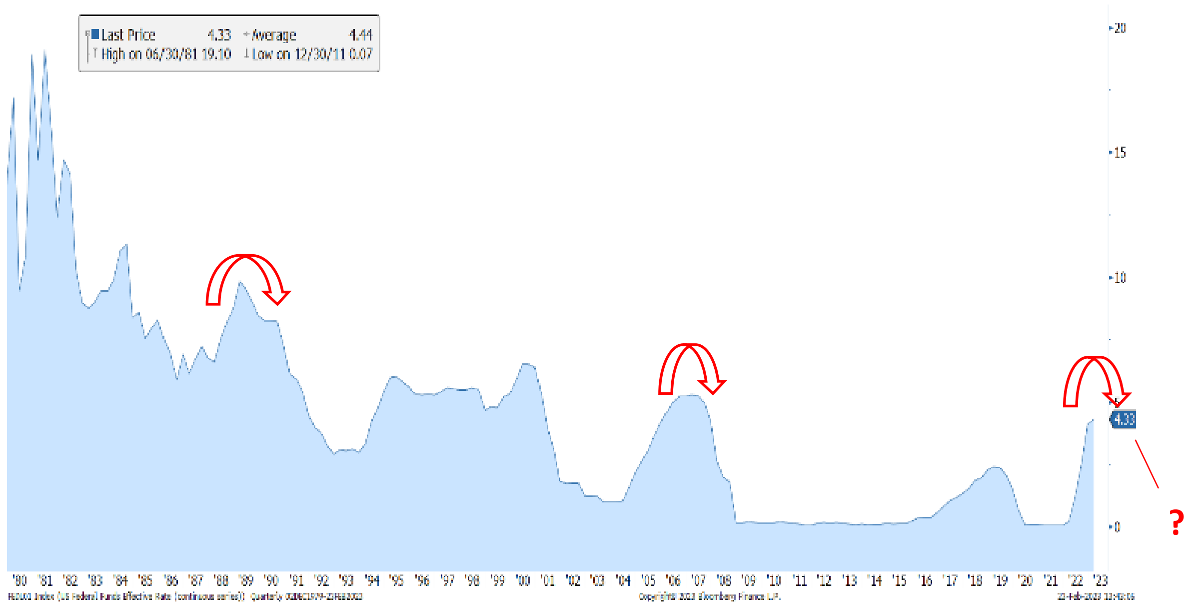
Inflation data is coming off slower than the market expected, primarily due to the shelter/rents component which has continued to move higher. This though is simply due to the lag effect between shelter costs and housing prices. We know residential prices in the US are declining.



So, lag aside, inflation is and will continue to fall off.

As inflation and economic data fall off as we expect into the 2H23, the FED will cut rates to prevent a slowdown. Just like all previous cycles.

High rates are followed by low rates



So, while in the near term we may see a lot of volatility and the potential for yields to rise a little further, this is excellent time, in our opinion, to add to long duration fixed income exposure. Especially if the market starts to fear deflation once again and yields come off significantly.

The longer the duration, the greater potential return from a fall in rates/yields. As the table below highlights, if rates fell by 1%, bonds with a longer duration would gain more while those with a shorter duration would gain less.

GAUGING INTEREST RATE SENSITIVITY

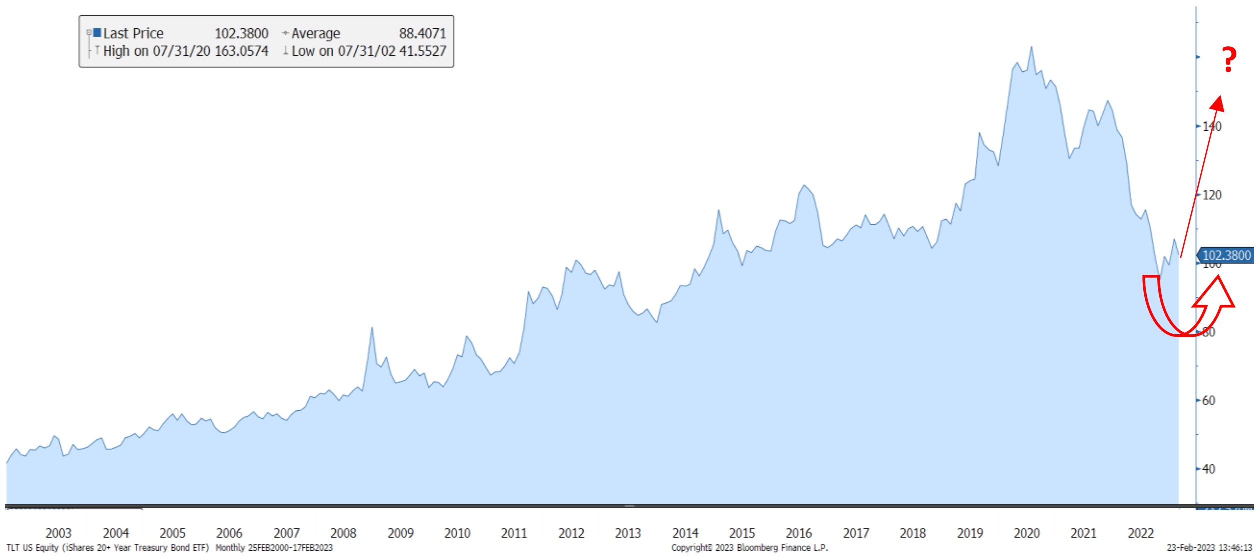
Bonds with longer durations experience greater value fluctuations.

1% rise in rates		
Duration	% NAV change	Resulting value
1 year	−1%	$990
5 years	−5%	$950
10 years	−10%	$900

1% drop in rates		
Duration	% NAV change	Resulting value
1 year	+1%	$1,010
5 years	+5%	$1,050
10 years	+10%	$1,100

Lest we forget the market can very quickly shift from worrying about inflation to being concerned over deflation. This would be extremely positive for long duration bonds and if we do see yields fall back to levels seen in 2020/21, long duration US Gov bonds with c.17 years of duration, such as reflected by the TLT, could provide as much as 30%+ returns.

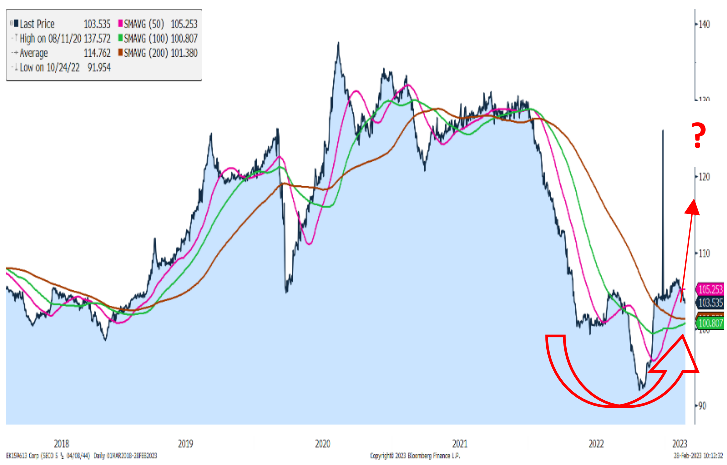
iShares 20yr Treasury Bond ETF (TLT US) since inception



It's a similar story for the Saudi Electricity Company (SECO) long duration sukuk, the SECO'44. If yields fall back to 2021 levels, the sukuk will rally back up to prior levels of around 130, up from c.100.

SECO'44 with a YTM of 5.2%

SECO'44 has plenty upside if yields fall to '21 levels



Deflation further out is still a concern for many. The inflation that we see today was induced by government and central bank action, namely lockdowns and supply chain disruptions and extremely easy monetary policy. And of course, in part the Ukraine/Russia clash, though this is more of a sideline issue.

The easy money policies of 2003-2006 saw one of the biggest bubbles in the property market. Rates were too low for too long and real estate inflated. Similarly, the easy monetary policies of many central banks following 2009 and then again in 2020, have resulted in the widespread inflation of today. Residential housing is at all-time highs in many parts of the world. Equities have been in a 12-year bull market and have become expensive. Bonds also rallied as quantitative easing held bond yields down.

Strip out the easy monetary policies and normalize supply chains, however, and deflation is the larger risk.

There are many deflationary factors that will impact the global economy for the next few decades:

- **An aging population and weaker demographics**: The wealthiest segment of the US, the baby boomers, are retiring. The average age of the richest segment of the US population, the Baby Boomers, is 60+. The average age in the US is 39. It's worse in Europe. Germany, for example, has an average age of 46 years and the working population is diminishing.
- **Indebtedness**: The government Debt /GDP in the US is 140%. It is 95% Europe. Total debt is multiples higher. These are record levels and is deflationary. Debt needs to be serviced and interest costs reduce potential consumption. Similarly, the debt needs to eventually be paid down or at least stabilized. This too is deflationary.
- **Technological advances**: Expect to see millions out of a job due to AI. Anybody who has been laid off and unemployed knows that this is massively deflationary.

Central banks and governments would rather avoid a deflationary bust though and would rather simply keep on providing easy monetary policies. Remember the 'inflation is transitory' mantra. Pretty much reflects how inflation is far preferred over deflation.

But each time we go through these 'bull and bust' cycles, the risk of a major deflationary or inflationary bust increases. Weimar Germany is a perfect of example of this, with the economy swinging from severe deflation to sever inflation, which eventually resulted in Hitler becoming leader. Desperate times, lead to desperate people.

We are not there yet. Japan has government debt to GDP of 260% and climbing, but the US is going in the same direction with a government debt to GDP of over 140%. Japan has taken the financial repression route, to manage these levels of indebtedness, by buying local bonds to keep the 10-year JGBs at 50bps, while inflation runs hot at 3.5%.

The Fed and ECB will want to avoid deflation at all cost, and so will print increasingly more to avoid it. Government debt/GDP will increase rapidly with each cycle. We should also expect talk of Quantitative Tightening (QT) to be exactly that. Talk. There will, in our opinion, never be sufficient QT to reduce the Fed's balance sheet to pre-2020 levels or for that matter pre-2008.

So, plan accordingly. Owning sukuk into the expected downturn and benefitting from their appreciation from a decline in yields and then shifting out into risk assets when the Fed and other central banks are aggressively cutting and re-stimulating makes sense to us. Just as it did in prior cycles. Could rates move higher in the short term? Of course, they could move another 50-75bps. But this cycle is no different we believe from others before it. Stay the course.

For those interested to know more about sukuk and the opportunity we see, pleased reach out to your relationship manager to arrange for a meeting/call.

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