Higher for Longer...

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Inflation data in the US continues to head in the right direction but economic growth remains surprisingly strong despite the onslaught of sharply higher interest rates. However, this means the Federal Reserve has not finished its job yet and interest rates are likely to stay higher for longer. Only a disorderly market crisis would probably make the Fed reconsider its stance and cut rates earlier.

ECONOMIC UPDATE

A soft-landing scenario: At the beginning of the year, a recession in the US economy was the most likely outcome of the tight monetary policy. However, this recession has ended up being the most-predicted and the most-postponed one. The mixed nature of data does not point to an imminent recession. Headline consumer price index (CPI) came in-line with expectations at +3.2% Y/Y in July compared to 3.0% in June. Core-CPI, which excludes food and energy, was also up 4.7% Y/Y v/s 4.8% in June. As far as the market is concerned, there were no hawkish surprises in the report. Retail sales rose for the 4th consecutive month, boosted in July by Amazon's Prime Day and spending on entertainment and food services. The second estimate of Q2 2023 gross domestic product (GDP) numbers showed the economy grew by 2.1% annually, above the 2% growth rate witnessed in Q1, fitting in with the soft-landing scenario.

US Inflation Rate
3.2% Y/Y

A resilient consumer: It was estimated that consumer spending, and hence economic growth, will slow down rapidly as the accumulated savings during the pandemic-period will run down. Savings have reduced significantly but consumer spending continues to be strong. One of the key factors supporting consumer spending is the reduced sensitivity to interest rates since consumers have been able to lock in low interest rates on their loans (mortgages in particular) for extended periods over the last decade when interest rates were running abnormally low. Interest servicing as part of disposable income for US households is running at multi-year lows despite total debt outstanding reaching all-time highs. The other important reason is wage growth – which has come off the highs of 2022 – but is still running at 4.3% annualized which is higher than the headline inflation rate of 3.2%. As a result, the real income growth has turned positive after a couple of years of pain when inflation was treading higher than wage growth (please see the following charts). Apart from these, within the higher-income cohort, higher interest income on money market and short term fixed income funds are more than offsetting the negative effect of higher inflation rates.

US Wage Growth
4.3% Y/Y

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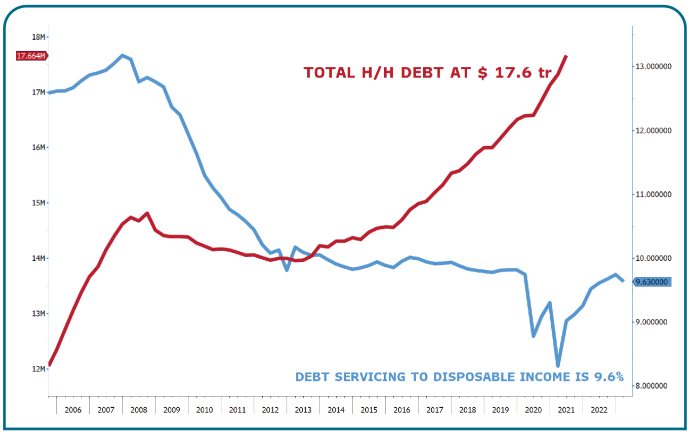
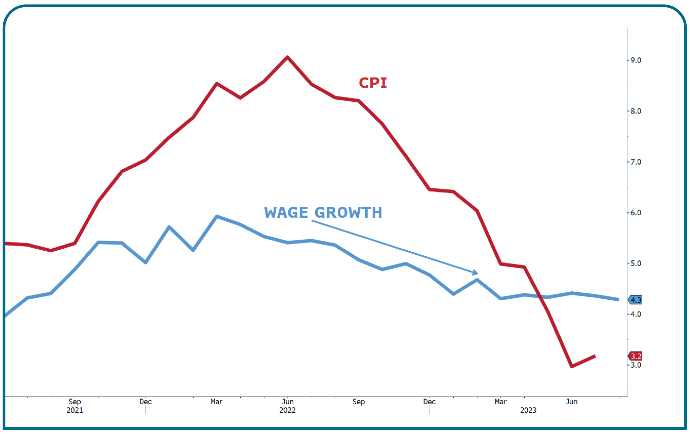
HOUSEHOLD DEBT SERVICING LOW DESPITE ALL-TIME HIGH DEBT LEVELS



US WAGE GROWTH IS HIGHER THAN INFLATION RATE



What could break? Higher interest rates for longer can build stress in the banking and financial services industry as we have seen with Silicon Valley Bank and other smaller banks who were incurring unrealized losses on their bond portfolios and at the same time are unable to retain client deposits. Higher interest rates are already proving a dampener for commercial real estate where transaction volumes have plummeted because the cost of borrowing is much higher than the rental yields investors get. Moreover, as existing loans come up for renewals and new interest rates kick in, investors will start losing money on their commercial real estate holdings. Commercial real estate is already vulnerable after Covid since office occupancies have dropped, probably permanently in many cases. Another risk on the horizon is the growth scare in China, which is reeling under the weakening property market, where 70% of the household wealth is invested in, and very high levels of public debt that limits the flexibility for the government to announce large scale fiscal measures to boost domestic demand. A disorderly unravelling of any of these big risks could make the central banks to reverse their tight monetary policy earlier than anticipated.

Jackson Hole Symposium: The Jackson Hole symposium is an annual gathering of central bankers and finance ministers that is held in Jackson Hole, Wyoming in the US, to discuss important issues facing the world economies. Speaking at the symposium on 26th August, the Fed Chair Powell was cautiously optimistic about inflation moving in the right direction. However, he laced his speech with a number of threats to raise rates further if required. Interestingly, his hawkish stance was balanced by several caveats that gives the impression that the Fed is done increasing rates, barring some unforeseen circumstances. On the subject of whether 2% inflation target set by central banks is too low, the president of the European Central Bank said “We don't change the rules of the game halfway through,” meaning that central banks want to clearly see inflation reach a level of 2% before they cut interest rates. However, one of the statements that captures the current situation facing central banks most aptly was J. Powell’s comment, “we are navigating by the stars under cloudy skies.”

Central Bank Inflation Target
2%

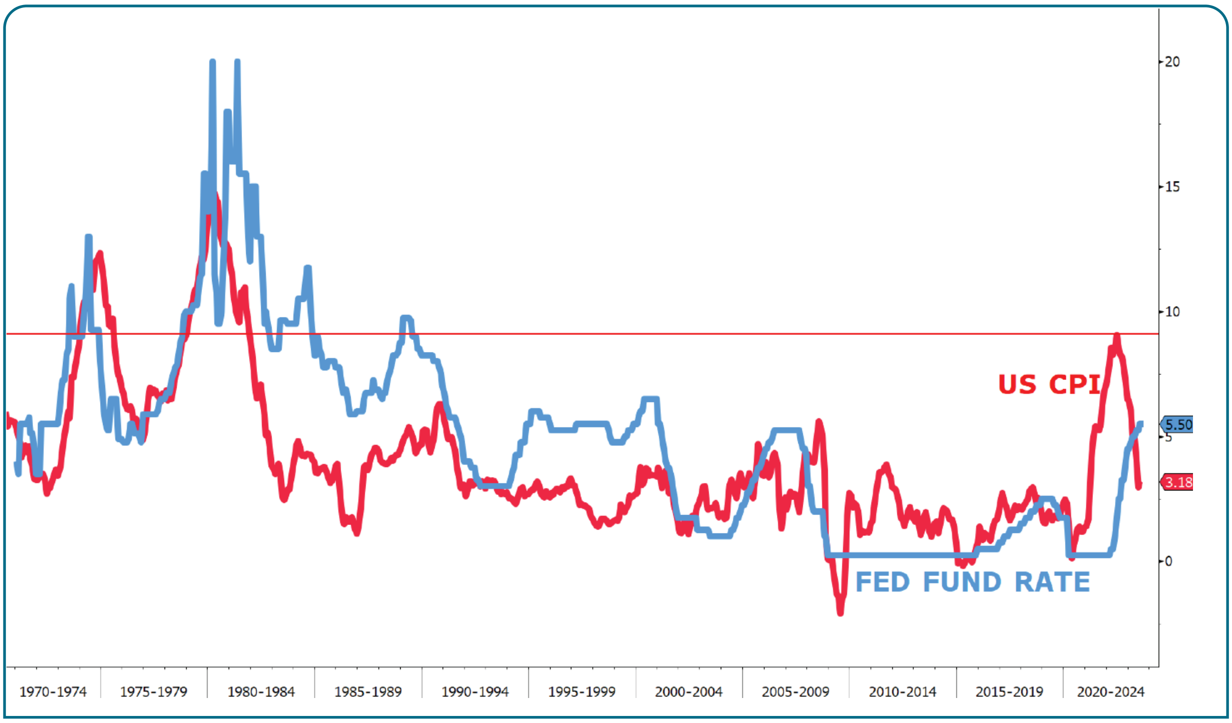
Other notable events during the month: At the start of August, the credit rating agency Fitch downgraded the US government’s credit rating from AAA to AA+, citing unsustainable debt and deficit trajectories and increased political dysfunction. This had little impact on 10-year US Treasury yields or the US dollar. However, US Treasury yields spiked up later in the month, to almost 16-year highs, due to supply-demand equation: over $1 trillion of Treasury bills have been issued since the resolution of debt-ceiling in June when the Fed is no longer a buyer (Quantitative Easing has been stopped) and reduced demand from China, Japan and Saudi Arabia.

US Credit Rating by Fitch
AA+

MARKET UPDATE AND OUTLOOK

Why would rates remain higher for longer? The level of inflation recorded in 2022 was the highest in the last four decades. The US suffered from high inflation from mid-1970s onwards and that could only be controlled in the early 1980s after two attempts by the Fed Chair Paul Volker who raised the interest rates to levels of 20% (please see chart below). The current Fed Chair J .Powell has repeatedly pointed to history and spoken about the risks of loosening policy too soon – clearly referring to the failed attempts in the 1970s and the aggressive action taken by Paul Volker that finally broke the back of high inflation.

HISTORY OF INFLATION AND FED RATES



Equity markets: Volatility induced by higher Treasury yields drove the equities lower in August as the S&P 500 and Nasdaq indices posted their first monthly declines since February. The “Magnificent Seven,” that have driven much of the gains this year released a mixed set of earnings reports this year however, the tech-heavy Nasdaq index is still up 42.7% for the year. Given that the Fed is near peak rates and that economic growth remains robust, any recession down the road is likely to be short and shallow. As a result, investors should use volatility to add positions in indices or high quality stocks for the long term. The following chart shows the extent of losses top stocks like Nvidia, Apple or Microsoft have experienced over the last 15 years and still ended up delivering spectacular returns in the end.

NASDAQ Index
YTD August
42.7%

EQUITY MARKETS ARE HEAVILY PITCHED TOWARDS INVESTORS RATHER THAN TRADERS

Stock	Max. Drawdown (15yrs)	Total Returns (15yrs)
Nvidia	82%	14478%
Netflix	82%	8924%
Apple	58%	3167%
Amazon	56%	3001%
AMD	96%	1752%
Microsoft	69%	1451%
Visa	45%	1294%

Fixed income: Bonds performed well during the first few months of the year but as the interest rate narrative shifted to "higher-for-longer" and long term interest rates started rising, bonds gave up much of their returns. 10-year US Treasury yields dropped to a low of 3.3% in April but since then have risen to a 16-year high of 4.33% in August. Price and yield of the bond are inversely related: higher bond yields reflect lower bond prices.

10-year US Treasury yields rise to 16 year high

High yielding GCC bonds and sukuks have once again proven to be safe havens during the year whereas investment grade international bonds (Bloomberg Global Aggregate Index) and bond funds have delivered negative returns for the year. However, as high quality investment grade bonds and bond funds sell off, they become more attractive to long term investors who would like to lock-in durable income for the long term.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	2986.02	14.81%
Dow Jones Ind.	34721.91	4.78%
S&P 500	4507.66	17.87%
NASDAQ 100	15490.86	42.70%
EUROSTOXX 600	458.19	5.53%
FTSE 100	7439.13	-1.52%
India Nifty50	19253.8	5.60%
Nikkei 225	32619.34	25.00%
Shanghai Comp	3119.876	0.11%

Currencies	Last price	YTD 2023
Dollar Index	103.619	-0.86%
Euro	1.0842	2.81%
GBP	1.2671	5.90%
JPY	145.52	11.08%
CHF	0.8832	-5.59%
AUD	0.6483	-3.56%
CNH	7.2741	5.08%
INR	82.78	-0.12%
SGD	1.3509	0.45%

Regional Equities	Last price	YTD 2023
Dubai DFM	4082.87	22.39%
Abu Dhabi ADX	9810.21	-3.93%
Saudi Tadawul	11,491.20	9.66%

Commodities	Last	YTD 2023
WTI Crude	83.63	8.71%
Brent Crude	81.8	1.11%
Nat Gas	2.768	-30.59%
Gold	180.02	5.24%
Silver	24.426	1.81%
Copper	8422.5	1.21%
Corn	461	-31.25%

Market Data As of 31st August 2023

CBD INVESTMENT SOLUTIONS

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ASSET CLASS	SOLUTIONS
FIXED INCOME	• A large range of regional and international bonds, perpetuals and sukuks • Top-rated global and regional mutual funds investing in bonds and sukuks and distributing regular income • Both Sharia-compliant and conventional fixed income solutions are available
EQUITIES	• International equity and ETF trading on CBD's award-winning mobile app CBD Investr • Trading in UAE equities with CBD Financial Services mobile app or with brokers
MULTI-ASSET	• Income distributing mutual funds, from leading fund managers in the world, investing in equities and fixed income
SYSTEMATIC INVESTMENT PLAN	• Invest regularly in globally diversified and actively managed portfolios on CBD's award-winning mobile app CBD Investr
ALTERNATIVES	• Mutual funds investing in US senior secured loans delivering regular income

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