Economy & Market Watch
December 5, 2023

Wrapping up 2023: A year of many surprises

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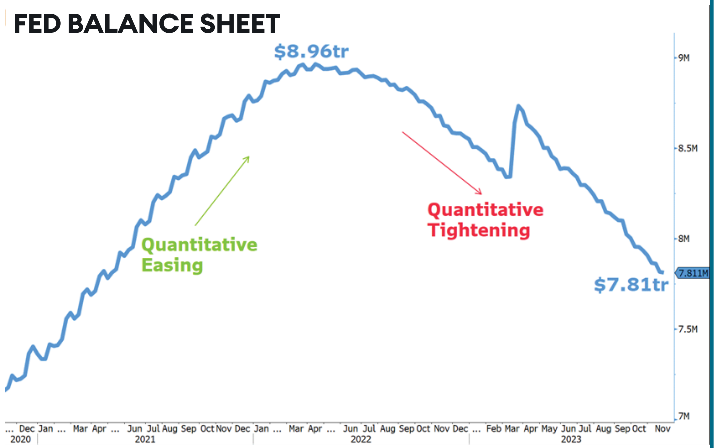
As the year comes to an end, we assess the significant changes in the economic and market outlook from the beginning of the year till now. Outcomes have been quite the opposite of what was expected, whether it was the outlook for the US or Chinese economy, or the prospects for equities and bonds.

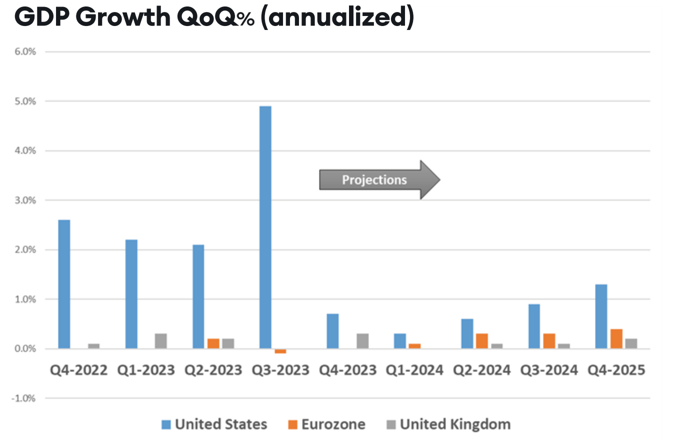
ECONOMIC UPDATE

2023 has been the year of many surprises:

1. The most predicted recession has become the most postponed one: It was widely expected that the sharp increase in interest rates in 2022 would push the US economy into recession in the first half of 2023. However, the economy remained surprisingly resilient and the predictions for a recession kept getting pushed further. The Federal Reserve used multiple weapons in its fight against inflation: a) The Fed Funds Rate were increased to a 20 year high range of 5.25%-5.50%; b) the Fed initiated quantitative tightening (the opposite of quantitative easing), i.e. running off its bloated balance sheet from a peak level of $8.96 trillion to $7.81 trillion, sucking liquidity out of the system and; c) used aggressive forward guidance, i.e. extremely hawkish communication to telegraph its intent of keeping rates high till inflation is brought down to its target level of 2%. The continued strength in the US economy can be attributed to accumulated savings with the consumers and low interest rate sensitivity within household and corporate balance sheets (as they were able to lock in low rates for the long term). There are clear signs of slowdown in certain components of the economy, but it is still not pointing to a recession. A recession next year, if at all, is likely to be short and shallow.

US Fed Fund Rate
5.25-5.50%





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2. The Fed pivot turned to higher-for-longer and has flipped again: The base-case at the start of the year was for the US economy to face recession in the first half of the year and consequently, the Fed was supposed to cut rates by June or July. However, the economy turned out to be stronger than expected and hence the outlook for any rate cuts were pushed forward. The collapse of some regional banks in March re-ignited the expectations of a Fed pivot but the banking crisis was swiftly addressed by the Fed and the focus went back to fighting inflation. Even though the headline inflation continued to cool down rapidly, core inflation (after stripping out volatile food and energy) proved to be stickier and hence the narrative switched from an early pivot to "higher for longer." Right now, there are clear signs that inflationary pressures from rents and wages are easing, leading to a belief that the Fed would be cutting rates as soon as April or May of 2024.

Fed rate cut expectations
Apr-May 2024

3. China reopening fizzled out quickly: After three years of lockdowns, the Chinese authorities suddenly announced a full opening up of the economy in early January. This led to the belief that the reopening of the world's second largest economy will lead to a surge in global growth and inflation pressures. However, at the same time, the crisis in Chinese real estate market was deepening with a number of developers in trouble including large ones like Country Garden. A bubble that had been building for decades started deflating during Covid lockdowns and government crackdown on rampant speculation. Developers had long been selling under-construction properties and routing the cash for buying lands and launching new projects. Real estate transactions and prices that had been falling since the outbreak of Covid failed to revive after reopening. With 70% of the household wealth invested in real estate, the negative wealth effect and balance sheet recession had a direct hit on consumer spending. Three years of lockdowns had also left millions without jobs as many smaller manufacturing units shut and large global importers started diversifying their facilities away from China and exports . Due to a combination of these factors, the economy failed to pick up and all hopes for Chinese growth returning to pre-Covid levels have faded.

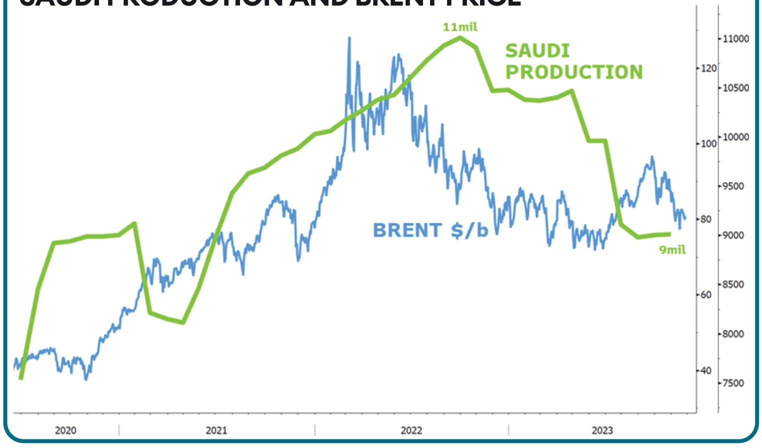
Chinese household wealth in real estate
70%

4. US dollar remained strong despite headwinds: As the Fed was supposed to pivot and cut rates by the middle of this year, the US dollar was expected to weaken. However, due to a variety of reasons the dollar index, that measures the strength of the dollar against its top trading partners, actually ended up strengthening through the year. Factors supporting the dollar include a) The anemic growth, teetering on stagnation, in Europe and the UK; b) The Japanese yen weakening further due to Bank of Japan's hesitancy in addressing rising inflation and; c) Safe haven flows in the dollar at various times during the year including at the time of the US regional banking crisis and US debt ceiling issues. The dollar was able to sustain despite headwinds like a) the regional banking crisis after the collapse of SVB in March; b) US debt ceiling standoff which could have potentially led to a default on US Treasuries in June and c) the downgrade of the US credit rating by Fitch in August.
The US dollar benefited in both the cases: in case of good news such as strong US growth as well as from risk-off sentiments in case of any adverse news.

5. Oil prices remained soft despite production cuts: Oil prices shot up from around $80 to above $120 per barrel after the outbreak of the Ukraine war but then kept slipping all of last year as it became clear that the war was not disrupting oil supplies. This year started with a demand and the price outlook balanced between high expectations from reopening of the Chinese economy versus the risk or recession in the US; US and China being the largest and second-largest consumers of crude oil. The reopening of the Chinese economy was underwhelming while the outlook for a recession in the US kept getting pushed further as the year progressed. At the same time, the economic growth in the Eurozone, the third largest consumer of oil, remained stagnant. OPEC, led by Saudi Arabia, tried to stem the fall in oil prices with a series of steep production cuts it announced in October 2022, April 2023 and June 2023 (please see graph). The first two cuts did not help but the last one led to a sharp rally of 30% in the 3rd quarter of this year. However, with global growth likely to slowdown in 2024, these gains have been given up and brent crude briefly fell into bear market in November.

Brent crude oil price YTD
-5.88%

SAUDI PRODUCTION AND BRENT PRICE



MARKET UPDATE AND OUTLOOK

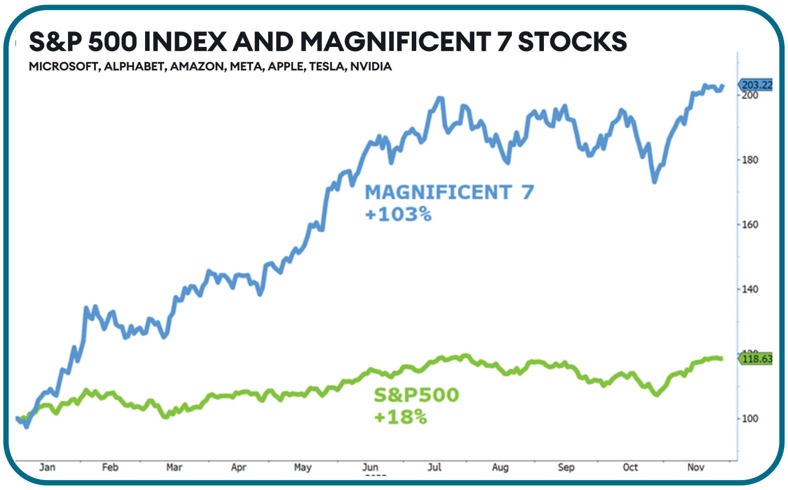
Inflation: Inflation is expected to cool down further towards the Fed's target in 2024 since both the demand and supply side pressures are easing.

1. Demand side: The demand shock post Covid was first experienced in manufactured goods and later, as the economies opened up, in the services sector. Goods prices are already in deflation while services demand has peaked.
2. Supply side: The two most pressing problems remain in the labor market and in house rents. Private data on new leases shows rents growth is below pre-pandemic levels. This will show up in CPI with a lag. The labor market is also healing with the labor participation rate in the 25-54 age bracket at a 20-year high, quit rates at pre-pandemic lows and unemployment rate rising.

Magnificent 7 stocks YTD
+103%

Equities: The outlook for US equities was not very bright at the beginning of the year due to fears of a recession and its impact on corporate earnings. However, the sudden emergence of Artificial Intelligence in mainstream business and in everyday applications electrified the technology sector, with the mega-cap stocks benefiting the most from this new trend. Even though investors remained underweight equities and the hedge funds carried record shorts in the market, the Magnificent 7 stocks carried the Nasdaq and S&P 500 indices to deliver spectacular returns for the year (please see YTD performance of the S&P Index and Magnificent 7). These mega-cap tech stocks are likely to continue their strong run given their earnings visibility, balance sheet power, pricing power and their ability to innovate.

S&P 500 YTD 2023
+18%



Fixed income: After unprecedented losses in 2021 and 2022, the outlook for bonds at the beginning of this year was more promising. However, with the US economy staying strong and the Fed continuing to tighten policy, bonds struggled for much of the year. However, investors who have bought high quality long duration bonds during the year have done well to lock-in durable and predictable income for the long term. It is only after significant improvement in inflation and dovish signals from the Fed by end of October that the sentiments turned dramatically. 10-year US Treasury yields collapsed from above 5% to less than 4.5% in a couple of weeks and bond prices shot up. Going into 2024, we expect the Fed to pause or at some stage cut rates and hence fixed income is likely to perform well.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	3023.63	16.17%
Dow Jones Ind.	35950.89	8.46%
S&P 500	4567.8	18.97%
NASDAQ COMP	14226.22	35.92%
EUROSTOXX 600	461.61	8.64%
FTSE 100	7453.75	0.03%
India Nifty50	20133.15	11.20%
Nikkei 225	33468.54	28.26%
Shanghai Comp	3029.673	-1.93%

Currencies	Last price	YTD 2023
Dollar Index	1103.344	-0.17%
Euro	1.0905	1.87%
GBP	1.2645	4.65%
JPY	147.68	-11.21%
CHF	0.8739	5.79%
AUD	0.6617	-2.88%
CNH	7.1386	-3.03%
INR	83.395	-0.79%
SGD	1.336	0.26%

Regional Equities	Last price	YTD 2023
Dubai DFM	3982.88	19.38%
Abu Dhabi ADX	9540.22	-6.57%
Saudi Tadawul	11,177.48	6.67%

Market Data As of 30 November 2023

Commodities	Last	YTD 2023
WTI Crude	75.84	-5.51%
Brent Crude	80.86	-5.88%
Nat Gas	2.812	-37.16%
Gold	2042.67	11.99%
Silver	25.4059	6.06%
Copper	384	0.77%
Corn	460.5	-31.32%

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ALTERNATIVES	• Mutual funds investing in US senior secured loans delivering regular income

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