THE EARNINGS TEST

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Dear Reader

Half of 2024 is already behind us and most investors can look back on fairly robust returns. Even though equity market performance was skewed by a few but very big names – more on this in our Equities section – the overall fundamentals remained solid enough to compensate risk-taking in most markets.

The second half of the year will be dominated by politics and in particular the US presidential elections in November. Concerns about sovereign debt levels in developed economies have once again moved up the list of investor worries, but in all honesty, this may be more of a topic for 2025. Nevertheless, central banks may **wait** before continuing or – in the case of the US Fed – launching their easing campaigns. Excessive fiscal stimulus was at the core of the sudden surge in inflation post-pandemic, and more of it could reverse the otherwise positive dynamics on the price front.

With the post-WWII order dominated by the US continuing to fracture, navigating the world of investments will only become more complicated. We have collected some of our thoughts on this issue in our Special Topic on page 10.

Never a dull day: that's life in financial markets! Since no one (we know) has a crystal ball, we always enjoy sharing our thoughts with you and look forward to being challenged.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP

Limited easing at best

Global growth has been holding up fairly well so far this year and most leading indicators point to continuing expansion. Inflation, meanwhile, is more subdued but far from most central bank targets. This combination is allowing most monetary policymakers to sit back and wait.

Key points

- No need for the Fed to rush
- Politics may yet again derail Europe
- While China struggles, India races ahead

US Fed slightly more confident

Markets have heavily scaled back expectations of US rate cuts. As long as the economy is growing at trend and inflation is above the 2% objective, there is no reason for the Fed to rush. At this stage, only limited easing. One important consideration is the rapid increase in the US fiscal deficit under the Biden administration. Should Trump win a second mandate in November, given the man's preferences for low taxes and generous spending, fiscal risks could increase further. The Fed can do little to rein in government profligacy other than keeping funding costs high. Since fiscal largesse usually also leads to inflationary pressures and possible economic overheating, there are good fundamental reasons to keep policy relatively tight in such a context. Moreover, other than in the weakest sectors of consumer credit markets, few areas of the economy appear to be struggling with the relatively high nominal and real rates.

Politics trumping the economy in Europe?

An economic recovery looked to be well under way across Europe until politics intervened. While the strong showing of populist parties in the EU parliamentary elections was widely anticipated, the reaction in France was not. The snap election has led to new concerns about eurozone stability, as the political center is at risk of yielding to parties at the fringes with less orthodox economic programs. While the ECB has tools to avoid excessive spread widening, it could struggle to rein in the inflationary effects of increased spending without cutting short the easing cycle it started in June.

As China struggles, India races ahead

China's growth target of 5% is modest by the country's ambitious standards, but it may still be hard to meet. Orchestrating a change of growth model is a tall order for any regime, but the Chinese leadership seems particularly reluctant to move from rhetoric to action. This has to do with the investment-led growth theory at the heart of Communist economic thought. But China is not in need of investments; what it needs are consumers who are confident and as a result ready to spend. Unless the government points the way with more fiscal support, this is unlikely to happen. Meanwhile India, after a closer election than many anticipated, can again focus on fundamentals rather than politics, with growth rates of 7% or more beckoning.

Table 1: Real GDP growth (y/y in %)

	2023E	2024F	2025F	Short-term trend
United States	2.5	2.3	1.8	↘
Eurozone	0.5	0.7	1.4	↗
Germany	-0.1	0.2	1.2	↗
United Kingdom	0.3	0.7	1.3	↗
Japan	1.9	0.2	1.2	→
China	5.2	4.9	4.5	↘
India	7.8	7.0	7.0	→
Russia	3.3	3.0	1.6	↘
Brazil	3.0	2.1	2.0	↗

Table 2: Consumer price inflation (y/y in %)

	2023E	2024F	2025F	Short-term trend
United States	4.1	3.1	2.4	↘
Eurozone	5.4	2.4	2.1	↘
Germany	6.0	2.4	2.1	↘
United Kingdom	7.3	2.6	2.2	↘
Japan	3.3	2.4	1.9	↘
China	0.2	0.6	1.5	↗
India	4.8	4.5	4.5	→
Russia	6.0	7.1	5.0	↘
Brazil	4.6	4.0	3.5	→

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

The coming earnings test

Financial markets enjoyed a solid first six months, with only longer-dated US Treasuries failing to deliver positive returns. Can this favorable trend extend into the second half? While politics will contribute its share to volatility, it is earnings that will determine the overall outcome.

Key points

- Earnings to determine future course of financial markets
- Focus on quality both for equities and bonds
- Sovereign debt dynamics a key risk factor

Earnings at the core

The next few earnings seasons will represent a major test for markets and investors. With elevated valuations in some (but not all) major equity markets, continued robust earnings growth remains the key ingredient for sustained investor confidence and, in the end, higher index levels. Corporate results are a timely gauge of the state of economic activity, the source of revenue growth, and the ability of companies to maintain their margins – a key factor determining profitability and the bottom line. As evidenced by the past few quarters, solid earnings can lift markets even if they are already trading at all-time highs. In fact, investors are willing to pay a premium for such companies. However, they have much less tolerance for businesses that miss their targets. Usually, these are ruthlessly sold off. The lesson is to favor quality stocks: companies that can maintain margins and market share and have a record of sustained earnings growth over the cycle. Even in adverse scenarios, such stocks tend to be able to hold their own and emerge largely unscathed once conditions improve again. Quality is also the watchword for fixed-income investors. While governments may be tempted to soften their budget constraints via the printing press, corporates don't have this option. Quite literally, their balance sheets and earnings reports are their bond.

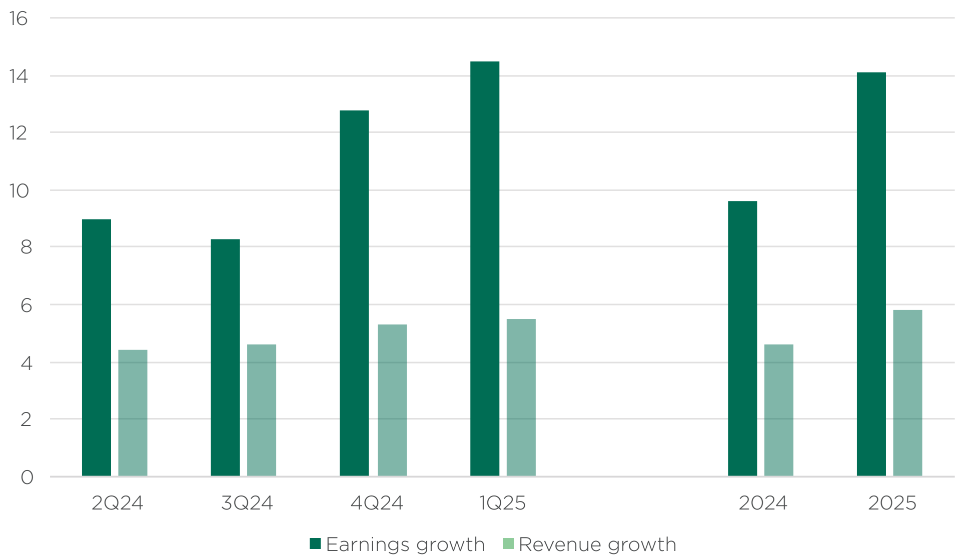
Our positioning

In global multi-asset portfolios, we recommend maintaining a neutral allocation to equities given the underlying economic resilience and their nature as a real asset. In turn, we remain underweight in fixed income, albeit with a somewhat longer duration. The balance is allocated to gold, another real asset and hedge against USD weakness, as well as risk-managed strategies.

What we are watching

Beyond the all-important earnings cycle, going forward we will focus on politics and, among other things, on how it may impact the debt dynamics in major developed economies such as the US and France. Inflation will remain a topic, especially as price levels have fallen to a point where future progress will be harder to come by. The combination of these two factors – debt and inflation – may materially reduce the room for central banks to ease policy in the coming quarters. This is the third focus of our attention.

Analysts continue to forecast robust S&P earnings growth (y/y in %)



Source: Bloomberg, HBZ

FIXED INCOME

More of the same

At the half-year point, the credit market landscape remains familiar: thin credit spreads are balanced by high yields, offering decent returns. Bad credits are few and far between while good ones are easily refinanced amid high capital market activity. The bottom line? Stay with quality.

Key points

- Attractive absolute yields driving the market
- Idiosyncratic EM risks lead high-yield outperformance
- Keep duration flexible in H2

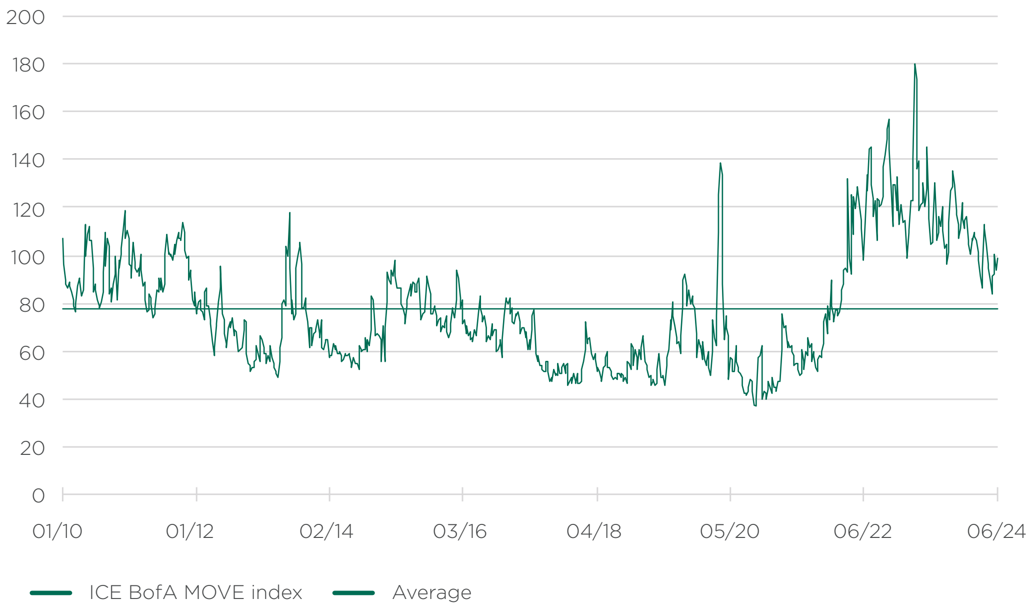
Investment grade: between politics and monetary policy

A notable development in developed credit markets is the interplay between politics, budget deficits, and bond market volatility, highlighted by France's snap parliamentary elections, the current situation in the UK, and the situation in the US ahead of the presidential elections in November. This dynamic is positively correlated with credit and rates, as was the case in France. The first half of the year saw strong economic growth and high yields, boosting demand. In the second half, we anticipate slower GDP growth, potentially leading to lower yields and negative impacts on spreads. Elections and monetary policy uncertainties could easily increase volatility. Potential scenarios include tighter credit spreads if the Fed cuts rates and corporate earnings remain strong, or wider spreads owing to declining demand as a result of lower yields or political instability. Credit metrics show relatively high leverage and low interest coverage, though rating trends are positive. We foresee a modest steepening of the curve if yields decline. We recommend overweighting financials, consumer sectors, basic materials, telecoms as well as media and entertainment, and underweighting technology and retail.

EM exceptionalism

Emerging markets (EMs) defied expectations of a slowdown during the first half of the year, supported by strong domestic demand. Initially, growth was expected to slow owing to China's deceleration and global rate hikes, but overall, the EM complex maintained steady growth. The anticipated moderation in China is likely to reduce overall EM growth in the second half, but this will be seen as a normalization rather than weakness. Growth in Latin America will balance cooling in Mexico following elections and a re-accelerating economy in Brazil. Central and Eastern Europe should maintain growth despite Türkiye's recession. Full-year growth forecasts for EMs remain healthy. Meanwhile, progress on disinflation has been mixed. The persistence of high services inflation and currency weakness have been limiting factors. Some easing is expected, but remains contingent on Fed policy and the dollar. So far this year, EM credit, driven by high yields, has outperformed local markets. We continue to recommend cautious positioning with a focus on carry strategies while being prudent on duration and considering relative value trades.

US yield volatility with renewed upside?

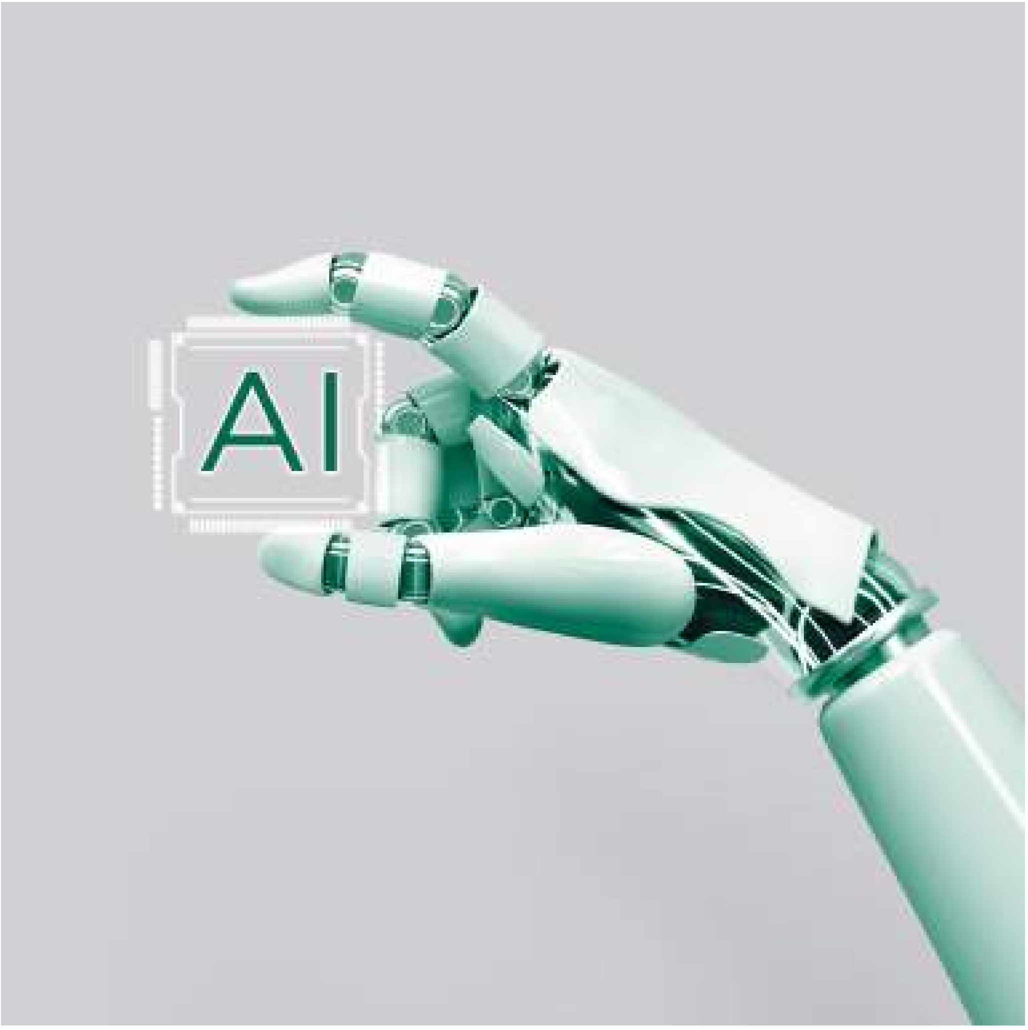


Source: Bloomberg, HBZ

EQUITIES

AI, resilience, and random walks

It's essential for investors to balance short-term risks with long-term potential. A lack of market breadth, a situation where only a few stocks drive gains, poses short-term risks. Nevertheless, the ongoing AI transformation presents exciting investment prospects beyond possible market volatility.



Key points

- Strong earnings growth with returns driven by mega caps
- Lack of market breadth increasing risk of short-term reversal
- Long-term growth potential intact thanks to ongoing structural shift

Communications and IT dominate quarter

S&P 500 earnings growth once again surprised to the upside in Q1 (8.6% versus the 3.8% y/y initially forecast). The communications and IT sectors were particularly strong, as were a handful of companies more exposed to global revenue streams. As a group, these stocks (e.g., Apple, Nvidia, Microsoft, Alphabet, and Meta) are less dependent on the domestic business cycle, and thanks to high returns on equity (ROE), high profit margins, and cash flow generation they proved resilient to rising interest rates. This was contrary to the conventional wisdom, which expects stocks with elevated price-to-earnings (PE) ratios to suffer disproportionately when discount rates increase. Why this resilience to rising rates? As returns on equity exceeded the cost of debt and equity capital, value was created in excess of the rate of return a rational investor would require. This excess growth, often referred to as “franchise value,” was particularly pronounced for the companies mentioned above. Moreover, ROE was mostly driven by expanding profit margins and faster asset turnover rather than increasing leverage.

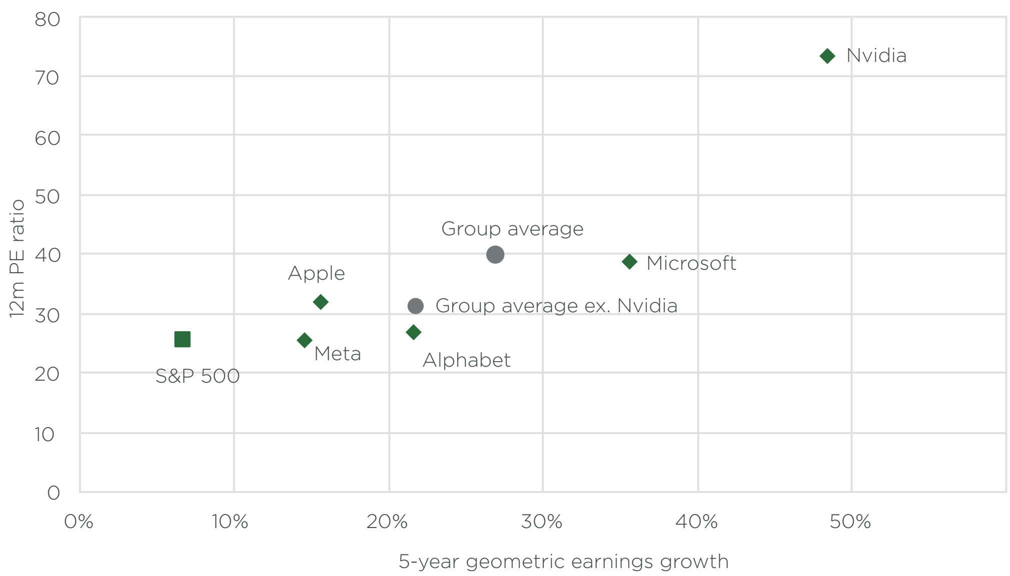
A word on valuations

Relative to the S&P 500, these stocks are trading at an average premium of 54% based on price to earnings (excluding Nvidia, the premium is 21% lower). However, in terms of realized growth rates over the past five years, they have been able to grow their earnings at a much faster pace (27.1%, or 21.8% excluding Nvidia, vs. 6.7% for the S&P 500). Adjusting valuations for realized five-year earnings growth actually reveals a significant discount relative to the index.

Will this continue?

We believe this trend will continue over the next few years, although it will be a random walk with positive drift rather than a straight line. Short-term reversal risk is real, exacerbated by market concentration and by idiosyncratic risks potentially becoming systemic. Another source of randomness is the political context, which will determine the regulatory framework. Nevertheless, we believe that the proliferation of cloud-based computing will continue. Large-scale data centers will need to expand to facilitate AI trainings and AI-related searches, which at the moment use about ten times more energy than a regular web search. This also means that power demand will likely increase, requiring utility companies to scale up capacity. Over the full business cycle, we believe that the IT, communications, and utility sectors will benefit the most from this structural shift.

Earnings growth justifies valuation premium



Source: Bloomberg, HBZ

COMMODITIES AND FX

Dollar resilience

“Resilience” has become such a fashionable term that it is often used quite randomly. Not so in respect to the US dollar, which once again has defied predictions of its impending demise. Eventually it will fall, but not just yet. Gold will be one of the main beneficiaries, despite already trading at lofty levels.

Key points

- USD strength to persist for the time being
- Gold with upside on structural demand
- Geopolitics and weather to keep oil price volatile

Carry and the USD

The remarkable resilience of the US dollar is largely due to one factor, namely carry. Carry, i.e., the benefit of owning it, has made the dollar the currency of choice ever since the Fed lifted its policy rate to more than 5.25%. Other currencies with lower yields have wilted, most notably the Japanese yen, and have been relegated to humble funding currencies. Even the British pound, which enjoys a similar yield advantage, continues to trade on the weaker side against the USD. A reversal is not in sight until at least the Fed starts easing policy in earnest, which may not happen in 2024. The growing current account deficit could also once again become a problem for the greenback, but not until US fundamentals weaken on a broad basis. This could be the story for 2025, but is unlikely before.

Gold: the USD's alter ego

Gold is the other asset in this space which has shown uncanny strength, rising in May to yet another new all-time high of USD 2,426/oz. before consolidating at moderately lower levels. Its advantage is not yield – on the contrary, gold has so-called negative carry – but its materiality (when owned physically). Gold can be stored outside the financial system and to that extent is sanction-proof, a quality many central banks, but also private investors, value greatly. In addition, being denominated in USD, gold provides a hedge against possible USD weakness, as its price tends to rise in periods when the dollar declines. In that sense, gold can be seen as a quasi-currency. Given this backdrop, fundamental demand is unlikely to fizzle out anytime soon.

What about oil?

Crude oil (Brent) has benefitted from decent global demand and, in particular, relatively tight supply management by the OPEC+ producer countries, with the front contract up more than 12% year to date. Rising demand for refined products during the summer months may create further upside. In addition, geopolitics, most importantly the situation in the Middle East, and the weather – an above-average hurricane season is expected in the Atlantic, which could impact crude production in the Gulf of Mexico – tend to lift prices, though often only in the short term. While producers must be mindful to keep prices within a range in order not to make alternatives competitive, investors should focus on volatility, which makes oil an attractive underlying asset for structured solutions.

US dollar trading well above its long-term average

Source: Bloomberg, HBZ

KEY MARKETS
Looking ahead

As we enter the second half of 2024, our key markets are moving between securing stability and seeking change. Pakistan has adopted a proactive approach to managing its finances, the UAE is reaping the benefits of a diversifying economy, and the UK has opted for a new government.

Key points

- Pakistan preparing for another IMF program
- Improved diversification propelling the UAE economy
- UK chooses Labour and prepares for lower rates

Pakistan: with a plan

In an effort to maintain precarious stability, Pakistan has embarked on the path to greater economic discipline. To this end, the country has engaged on multiple fronts, including initiating talks with the IMF, pushing through a robust albeit unpopular budget, and privatization efforts. Following multiple rounds of negotiations with the IMF, Pakistan is optimistic about securing an Extended Fund Facility of some USD 6 billion. The compatibility of the 2024-25 federal budget with the core IMF tenets is also positive, even though it risks drawing public ire. The budget contains an ambitious tax revenue target of PKR 13.0 trillion, up 38% from the prior year, and is projected to limit the fiscal deficit to 5.9% of GDP. The State Bank has meanwhile reduced the policy rate for the first time in four years to 20.5% following inflation data confirming the moderating trend, an improving current account deficit, and strength in agricultural output. This context is reflected in improved investor confidence, with the local KSE 100 index reaching an all-time high and gains on Pakistan's sovereign bonds.

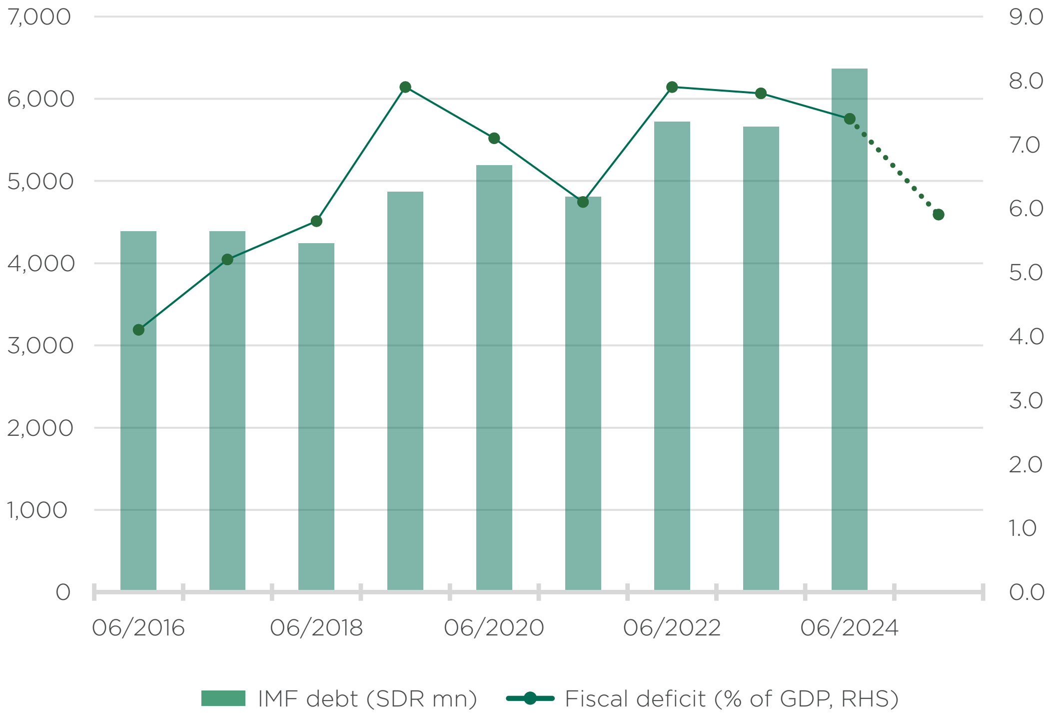
UAE: unbroken strength

With diversification between oil and non-oil sectors and balance in growth, the UAE economy posted 3.6% growth in 2023. The economy is expected to expand a further 3.9% in 2024, supported by public sector investments, foreign trade, tourism, and real estate. The country was exposed to a major risk this year after an unusually excessive spell of rain brought Dubai to a standstill; however, the Emirate was quick to invest over USD 8 billion in its drainage system. Finally, a 10% increase in the crude output target secured by the UAE bodes well for the oil sector as the country continues to expand its production capacity.

UK: new beginnings

Despite a decline in inflation to the 2% target in May, the Bank of England (BoE) left its policy rate unchanged at 5.25%. Nevertheless, lower inflation and a weaker labor market should allow the BoE to start a new easing cycle from August onward. In the general elections on July 4, the Labour Party achieved a landslide victory. However, the new government will only have limited scope for new policies, with its options dramatically constrained by the state of the UK's public finances and Brexit.

Pakistan aims for lower fiscal deficit



Source: IMF, Government of Pakistan, HBZ

SPECIAL TOPIC
New complexity in global markets

The global financial landscape is undergoing a period of significant transformation. Rising geopolitical tensions marked by sanctions, political bloc building, and a stepping away from long-established trading currencies: these developments are introducing new layers of complexity for investors.

Key points
- The global financial system is becoming more fragmented
- Investors need to follow geopolitical developments closely
- Diversification matters more than ever

The decline of the petrodollar

A notable development is the present erosion of the petrodollar system. The oil trade has traditionally been denominated in US dollars, which has served to reinforce its status as the world's trading currency. However, recent initiatives by Saudi Arabia to explore alternative currencies, e.g., the euro, for oil sales indicate a potential shift in this dynamic. The Chinese government is taking similar steps by aiming to settle the majority of its current account transactions in renminbi. This, coupled with the ongoing trade war between the US and China, suggests that priorities are focused on greater economic independence and more regionalism.

Stepping away from globalization

The fragmentation of the global financial system is also becoming apparent elsewhere as countries seek to assert their economic sovereignty, sometimes prioritizing domestic over foreign investors. Furthermore, sanctions imposed on certain countries or regions can disrupt traditional investment flows and create new risk factors. Fears of sanctions and restrictions on cross-border payments have prompted a number of central banks to increase their gold reserves. A case in point is the Chinese central bank, which has been accelerating its gold purchases while reducing holdings of US treasury securities. This trend towards segregation is characterized by the emergence of regional trading blocs, alternative trading systems, and the settlement of bilateral trades in national currencies rather than the USD – all of which could potentially challenge the established global financial order dominated until now by the US and its currency.

Diversification once again a main focus

As these changes unfold, investors face a more complex and divided global market context where long-established practices may no longer apply. These developments present challenges as well as opportunities for investors. Diversifying assets, including currencies, has always been a cornerstone of sound investment management. However, in today's environment, diversification is equally important across other dimensions. Investing and booking in different jurisdictions will thus invariably help to mitigate the risks associated with specific countries or possible sanctions, which can all have very material consequences for investors.

China's reserves shift away from US Treasuries

Source: Bloomberg, HBZ

MARKET SUMMARY DATA
As of 9 July 2024

Equity indices	**Last**	**-3M %**	**YTD %**	**-3Y %**
BBG World USD	1,898.0	5.4	13.5	20.8
S&P 500	5,572.9	7.0	16.8	27.5
EuroStoxx 50	4,919.2	-1.4	8.8	20.9
FTSE 100	8,157.4	2.8	5.5	14.5
SMI	12,077.5	5.0	8.4	0.7
Nikkei	41,580.2	5.0	24.3	48.8
BBG EM USD	1,220.0	5.1	8.4	-11.9
Sensex 30	80,351.6	7.1	11.2	53.4
KSE 100	80,783.6	14.8	29.5	69.8
Hang Seng	17,523.2	2.2	2.8	-35.9
Russia RTS	1,151.9	2.4	6.3	-29.9
Brazil Bovespa	126,548.3	-2.6	-5.7	0.9

Bond indices	**Last**	**-3M %**	**YTD %**	**-36M %**
FTSE US Gov	1,529.16	1.6	-0.1	-9.1
FTSE US Corp	2,452.67	1.7	0.6	-8.1
FTSE US HY	1,295.67	1.9	3.2	5.7
FTSE Euro gov	215.90	-0.4	-1.2	-14.6
FTSE Euro Corp	239.54	0.5	0.9	-6.9
FTSE EM Sov	883.24	0.8	3.1	-6.8
DB EM Local USD	161.56	-2.0	-2.7	-6.1

Currencies vs. USD	**Last**	**-3M %**	**YTD %**	**-3Y %**
DXY	105.00	0.9	3.7	14.1
EUR	1.08	-0.4	-2.0	-8.9
CHF	0.90	0.6	-6.3	1.9
GBP	1.28	1.0	0.5	-7.9
JPY	160.73	-5.9	-12.5	-31.6
AUD	0.67	1.7	-1.2	-10.1
CAD	1.36	-0.4	-2.9	-8.8
ZAR	18.10	1.6	0.9	-21.9
INR	83.50	-0.2	-0.3	-10.6
PKR	278.50	-0.1	1.2	-42.7
Gold oz.	2,358.77	0.5	14.3	30.4

Interest rates	**3M interbank %**	**10Y government %**
USD	5.57	4.30
EUR	3.70	2.56
GBP	5.30	4.15
CHF	1.26	0.65
JPY	0.15	1.09
AUD	4.47	4.34
CAD	4.97	3.48
ZAR	8.34	11.12

DISCLAIMER

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