

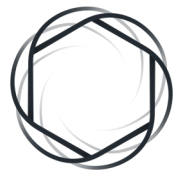


S.P. HINDUJA

BANQUE PRIVÉE

House View

FEBRUARY 2023



Thoughts of the CEO

“January has brought a bit more optimism on global growth, inflation and regional differentiation.”

The year has started on a more optimistic note with regard to growth and inflation in key regions. In Europe, an extended period of unseasonably warm weather has resulted in still relatively full natural gas storage facilities and dramatic declines in gas prices. The recent worst-case scenario of a Europe that would have to close factories to prevent power outages has not materialised. Now the talk is about Europe perhaps even avoiding a recession.

There is also more optimism around China's reopening and the accompanying official speeches that have focussed on growth and recovery and the role of the private sector.

And in the US, while we have not yet received much positive data to change the consensus view that a slowdown is underway there, good news has come from the inflation side: both the headline and core numbers have trended lower. The markets took that to mean that peak inflation may be behind us and that rates might not need to rise by as much as previously thought, which simultaneously boosted equities and bonds.

As we have pointed out in our previous letters, we too had expected evidence of an inflation ceiling around now — on the assumption of energy prices not increasing. We have also made the point that fighting inflation that is so far above target is unlikely to be a quick thing. We showed in charts that in the past it took a few years to complete the mission. And we pointed out that every major episode of bringing inflation back to target in industrialised economies over the last century was preceded by substantial positive real interest rates. In other words, central banks' interest rates were pushed much higher than core inflation. And core is the bit that excludes volatile energy and food prices.

Historically, what we have just experienced — negative real interest rates, that is — were merely brief exceptions, and not the norm. If we are again going back to the norm,

then we should expect something similar this time too: cash that pays an interest rate higher than the inflation rate.

Markets are impatient, though. We should, therefore, expect bouts of optimism as we saw in January to be offset from time to time with bouts of, not pessimism, but let's call it realism. To help us navigate this path, we take a look in this House View at the predictive power of earnings expectations and labour markets. We show that the former is a leading indicator of growth (and recessions), and the latter a lagging indicator. The data shown there suggest that this may not yet be the time to make a significant pivot to equities. At the same time, the diverse expectations for growth in the world's three large economic engines — Europe, China and the US — provide an opportunity to consider the regional exposure in our portfolios. The world is big and the opportunities plentiful.

Yours Sincerely,

Karam Hinduja





Investment positioning

The pace of the current slowdown in the US is in line with what we have previously seen before a recession. Europe may avoid a recession it currently appears, while China has received a boost from reopening. Hence, the investment environment remains challenging. We, therefore, continue to recommend our clients to maintain a defensive portfolio positioning, focusing on fixed income and continuing to hold more cash than in normal circumstances.

Earnings as a leading indicator

The question of when to increase the allocation to equities in any significant way needs to consider earnings trends. As can be seen from Fig. 1, declines in earnings growth tend to precede recessions. The chart shows the growth rates of the profits of the 500 largest US companies in the months before and after the start of a recession. The data shows that profits would typically shrink before the officially defined start of a recession. The low point of the decline in profits tended to be recorded about half a year into the recession. Earnings developments can, therefore, be seen as a potential leading indicator into and out of a recession – long before a recession is officially identified and labelled as such by the government's statistical office.

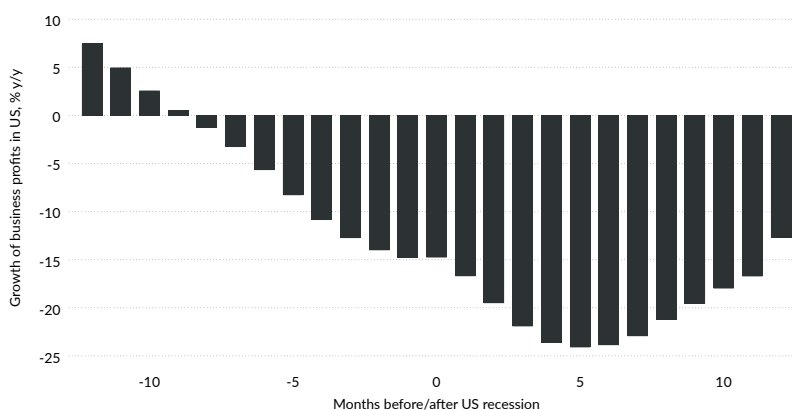
Where do we currently stand with earnings trends? Negative profit growth is expected when the S&P 500 data comes in for the fourth quarter of 2022. That would then be the first negative profit growth in the current economic

downturn since the Corona lockdowns. The expected Q4 2022 decline (-3.9 per cent in year-on-year earnings according to FactSet) would place us in the modest or early stage of the shrinkage when looking at our chart.

The situation is volatile, though. Over the past few weeks, earnings expectations for the first quarter and the second quarter of 2023 flipped from still hopeful year-on-year growth to modestly negative year-on-year declines of -0.6 per cent for Q1 2023 and -0.7 per cent for Q2 2023, also according to FactSet. The surveyed analysts appear to believe that all will soon be well because they expect a nice recovery in Q3 2023 (+5.2%) and Q4 2023 (+10.7%). If that were to materialise, the earnings profile would look very different from the historical trends in our chart. It would also be one of the shortest recessions ever. We find these market assumptions too optimistic. The likelihood, therefore, is for earnings disappointments in the coming quarters.

Fig. 1: Average development of corporate profits before and after the start of recessions

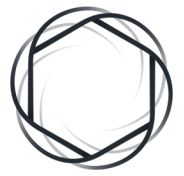
US development of corporate profits indicating the recession



The chart shows the growth rates of the profits of the 500 largest US companies in the months before and after the start of a recession. The data shows that profits would typically shrink before the officially defined start of a recession. The low point of the decline in profits tended to be recorded about half a year into the recession.

SOURCE: REFINITIV, WELLERSHOFF & PARTNERS





Another leading indicator is the PMI (the Manufacturing Purchasing Managers' Index). It is a better gauge to assess business conditions and anticipate changing economic trends that are later validated in other data such as GDP. The PMI measures the activity level of purchasing managers in the manufacturing sector. The last PMI reading in the US (January 2023) came in at 46.8, just beating the forecast of 46.0. A reading above 50 indicates expansionary activity. Therefore, the indicator currently points to contraction in the sector. While the monthly reading exceeding the forecast is good news, it is not enough to visualize a change in the contraction trend initiated five months ago.

Employment as a lagging indicator

Certain indicators are backward-oriented and do not help much in the forecasting exercise when it comes to recessions. Employment is one of these, and we typically see market responses to it. Given how robust the employment numbers have been in the US during the current growth slowdown, we have taken a closer look at the link between employment and recessions in Fig. 2. The chart shows the typical course of newly created job positions in the US across business cycles. If the current downturn were to proceed in line with the average recession since the Second World War, then employment would probably only decline after the onset of the recession. In other words, the labour market is a lagging indicator and does not provide any insight into the likely path of the US slowdown.

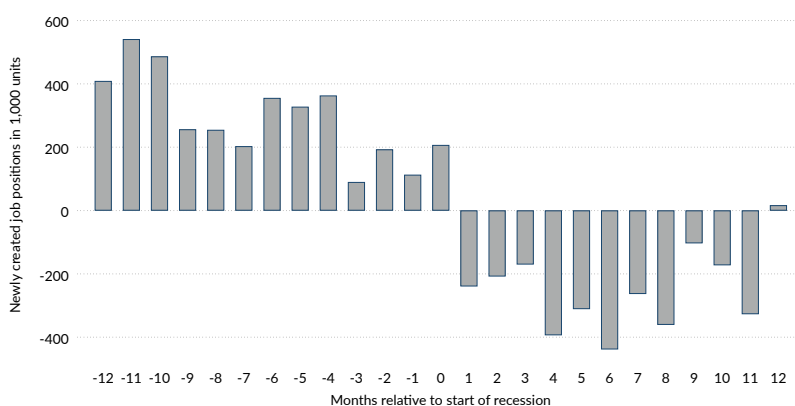
Fixed income outlook

In the opening month of 2023, we saw that high-quality fixed income assets offered the diversification benefits that they failed to deliver in 2022. We expect fixed income assets to be more attractive again to hold, both in absolute terms and relative to risk assets.

That said, the main risk for fixed income in our opinion, is a higher-than-expected inflation that would trigger the start of a second hiking cycle of interest rates. We, therefore, continue to have a more favourable view on short-to-medium-duration bonds and recommend only going further out in the duration curve selectively while being careful to match maturities with one's expected liquidity needs and liabilities. In addition, we believe we still are in the bear market phase of the credit cycle so quality remains a critical consideration.

Fig. 2: US labour market before and after the recession

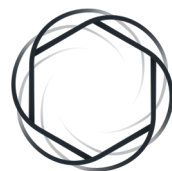
Newly created jobs in the US labour market as a lagging indicator for recession



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

This chart shows the typical course of newly created job positions in the US across business cycles. If the current downturn were to proceed like the average recession since the Second World War, employment would probably only decline after the onset of the recession. In other words, the labour market is a lagging indicator.



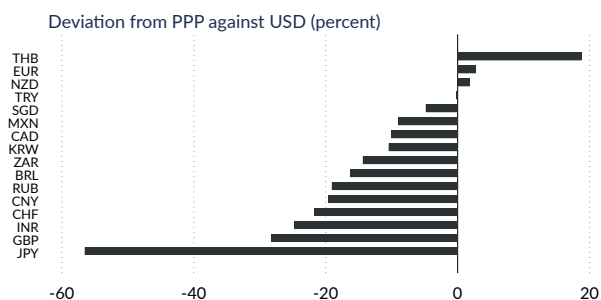
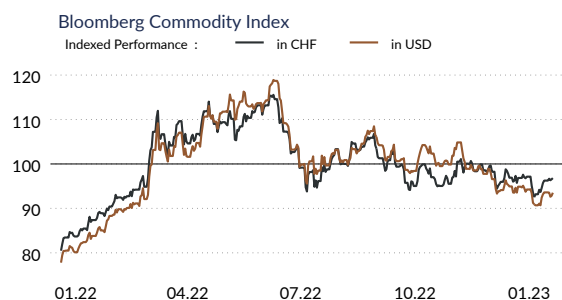
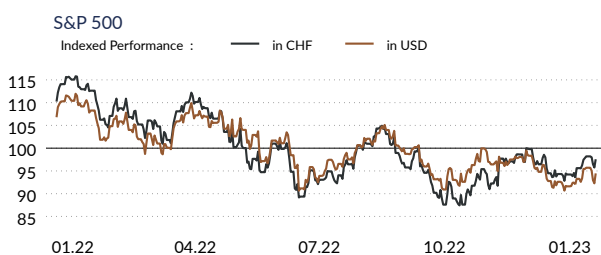
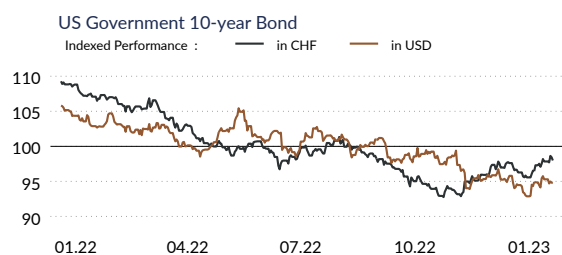


Macroeconomic estimates (in %)

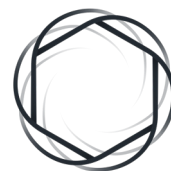
	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2022E	2023E	2022E	2023E	Q1 2023	y/y 12/2022
USA	1.6	1.2	0.4	6.2	4.0	4.5	-1.8
Eurozone	1.0	2.2	0.2	8.3	5.0	2.0	2.6
UK	1.7	2.5	0.4	8.9	5.5	3.5	3.6
Switzerland	1.4	2.1	0.5	2.6	3.6	1.0	-2.3
Japan	1.1	1.5	1.0	2.3	2.0	-0.1	4.7
China	4.5	3.2	3.8	2.0	2.2	4.35	3.7
Brazil	1.2	1.5	1.2	8.9	4.2	13.75	-2.6
India	5.0	6.5	6.0	6.9	5.0	6.25	9.7
Russia	1.0	-4.0	-4.0	14.0	10.0	7.5	20.1
World	2.9	3.0	1.8	7.0	5.0	–	–

SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

Financial Markets



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

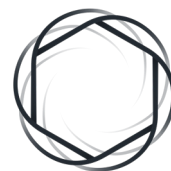


Global Asset Allocation Preferences – February 2023

Asset Class	View	Constituents	We favour	We avoid	Commentary
Cash	++				We continue to hold more cash than in normal circumstances. Money market instruments becoming more attractive to generate yields, particularly in USD.
		Segments	Treasuries, investment grade credit.	Convertibles, High Yield, Emerging Markets.	It is our expectation that rates will reach a peak in the first half of the year. While the Fed is unlikely to reverse its hiking cycle as fast as the market expects (second half of 2023), we expect fixed income assets to again offer the diversification benefits they lost in 2022, making them more attractive to hold, both in absolute terms and relative to risk assets.
Fixed Income	++				We favour US curve “steepeners,” short-to-medium-duration US government bonds, and investment grade credit. Risks for these asset classes include higher-than-expected inflation that would trigger the start of a second hiking cycle of interest rates.
		Duration	Short- / medium-term.		

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE — VERY UNATTRACTIVE



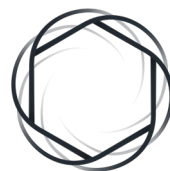


Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Equities	–	Markets	Within regions, we favour an approach of being selective in sectors/stocks, as discussed in Commentary section.	See Commentary section.	The sheer determination of central banks to bring core inflation down to 2 per cent levels, and growing risks of earnings declines and margin contraction across sectors, make us believe that equities are at risk. In a higher rate environment, we favour value over growth and companies with strong earnings resilience featuring pricing power, high margins, and low leverage to fare better. Economic activity surprising to the upside would benefit cyclicals, such as energy and financials.
		Themes	Quality value. Dividends. Consumer staples, healthcare, and agricultural stocks.	Highly levered, long duration, and cyclical equities.	Within US, we continue to favour quality stocks. Within Europe and Emerging Markets, we think the generalised selloffs in 2022 have led to stocks being priced for most of the known macro troubles set to unfold in 2023 and look increasingly attractive. Specifically within Emerging Markets, we continue to have a preference for faster-growing India and China as a tactical move to play the reopening.

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Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Alternatives	+	Selected real estate investments, listed infrastructure, gold.	Distressed debt, Private debt, Consumer lending		<p>High inflation, energy transitions, and growing digitization of the economy keep on being valid arguments to favour infrastructure as an alternative. In real estate, higher rates have significantly diminished capital values. However, the impact is quite dissimilar depending on the market (location), sector, and asset quality. We prefer multifamily in the US and warehouses and residents for students / elderly versus office, hotel, and retail.</p> <p>We expect gold to do well as rates normalise, and risks of recession mount.</p> <p>We remain neutral on carbon credits, but believe that pullbacks in carbon prices could offer opportunities in the medium term.</p>

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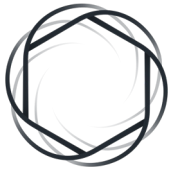


Figure of the Month

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The world population begins this year with 8 billion people, according to the United Nations. We also stand at the fulcrum of change. While it took twelve years to go from 7 billion to 8 billion, it will likely take fifteen to add the next billion by 2037. The impact of this slowdown is already being experienced in China, Japan and Europe. On the other hand, India this year overtakes China as the most popular country, and its younger population is expected to drive faster growth for several decades.

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We are a private bank with an entrepreneurial spirit, embracing collective action and building creative solutions that advance the world, economically and socially.

The future of banking is emerging at the intersection of profit and purpose.

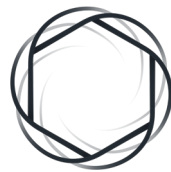
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S.P. HINDUJA
BANQUE PRIVÉE



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