

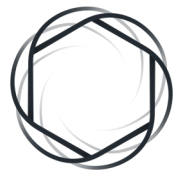


S.P. HINDUJA

BANQUE PRIVÉE

House View

MARCH 2023



Thoughts of the CEO

“Financial markets are struggling to find the narrative.”

Over the past month, bond markets reversed January’s dovish narrative that central banks had done most of their work fighting inflation and that we would see interest rate cuts in the second half of the year. Equity markets also had a supportive narrative in January, namely, that while there would be some weakness in earnings in the short term, earnings would grow again later in the year. As regular readers of our House View may recall, this narrative seemed inconsistent to us then, and even more so now.

As we have pointed out, inflation may prove to be a stickier problem than these scenarios were implying. While headline inflation has been falling as a result of lower energy prices, central banks tell us that they are not, and cannot, target headline inflation. Central banks say that they are targeting a narrow basket of items that excludes energy and food. This they define as “core” inflation. And here lies the problem. Core rates in the US are receding only slowly. In fact, the version that the US Federal Reserve says is its preferred gauge (the PCE or Personal Consumption Expenditure) accelerated by 0.6 per cent month-on-month in the most recent print, which equates to an annualised rate of over 7 per cent. And in Europe, core inflation is also accelerating.

Why might this be happening? One reason is that last year’s spike in energy prices is finding its way into the core numbers with a lag as producers are simply passing along their higher costs. This would be a relatively benign reason because one could argue that this might represent a one-off uptick. Other reasons may be less benign and more like red flags for monetary policymakers, namely, that demand for goods is still too strong and that wage growth (7.9 per cent year-on-year in the US in January) are too high to allow inflation to return close to central banks’ target levels of around 2 per cent anytime soon.

While markets have started to revise their rates expectations and no longer expect a Fed rate cut this year, we do not yet see any evidence of pessimism for the earnings cycle in the consensus numbers. The issue here remains an inconsistent narrative: How could inflation return to significantly lower levels if equity markets expect the economy to pick up steam and for earnings to start growing again?

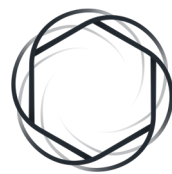
The bottom line, therefore, is that as long as inflation is not on a clear glidepath to central banks’ target levels, we will continue to find ourselves in a more volatile investment environment. If growth is strong, earnings might improve, but rates will be higher. If growth is weak, inflation and interest rates will come down, but earnings will deteriorate.

Against this backdrop, we believe our portfolios are well-designed to weather a wide range of outcomes as the market struggles to find the narrative.

Yours Sincerely,

Karam Hinduja





Investment positioning

After the strong performance of January, financial markets re-examined their assumptions over the past month. Stickier inflation prints and clearer statements by central bankers have driven home the point that the fight against inflation is not yet over. Markets are now pricing in higher rates for longer, which also weighed on equity markets. We maintain our cautions stance. Please see our asset class and sector preferences on pages 6, 7 and 8.

Equity markets seemingly trading off interest rate assumptions

The flip in equity performance from positive in January to negative in February appears to have more to do with interest rate assumptions than with earnings estimates. When we compare the performance of a very broad US equity market index (the Wilshire 5000) with the development of corporate bond yields in the mid-quality space (Baa), we find that over the past year or so the equity market has closely followed changes in bond yields (Fig. 1). This implies that rising rates would threaten current valuation levels.

At the beginning of the year, it appeared that markets were basing their valuations on the best of all scenarios: Corporate profits that start to rise again significantly as early as the second half of the year combined with key interest rates starting to fall again. This optimistic scenario, which was not our base case, was revised in February.

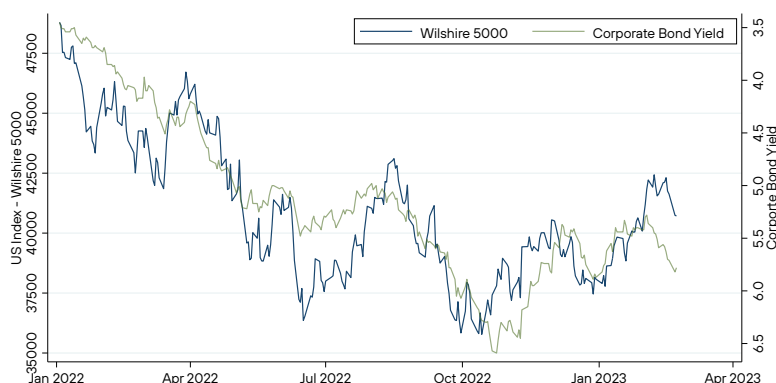
In terms of economic growth prospects, it is worth noting the current absence of the usual fiscal and monetary stimulus programmes. In fact, the opposite is happening, in that governments need to reign in their Covid largesse and central banks are withdrawing their stimulus. Standard economic theory tells us that such a policy approach is associated with economic slowdowns and even recessions.

Pricing in the best of all worlds

Financial markets appear not to be pricing in much of a slowdown or even a recession. There is no sign currently of any expectation of the kind of lower corporate profits in the second half of the year that would be the case in a recession. Bond markets also do not appear to be expecting a recession. Risk premiums for corporate bonds have actually been declining in recent months despite a notable drop in economic indicators. These inconsistencies with the fundamental data reinforce our cautious stance.

Fig. 1: Stock markets reflecting changes in bond yields

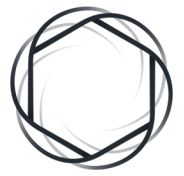
US Wilshire 5000 equity index and Baa-rated corporate bond yields (inverted)



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

The chart shows the development of a very broad US equity market index (Wilshire 5000) and the development of corporate bond yields (Baa) since the start of 2022. The equity market has closely followed changes in bond yields to an extent that is quite spectacular. Rising rates would threaten current valuation levels.





US in slowdown phase, negative real rates and high wage growth supportive

The US recession indicator in figure 2 still implies the probability of an economic downturn.

The first effects of tighter monetary policy can already be seen in money supply growth rates. If we look at the M2 money supply indicator in the economy as a yardstick, it is already falling in the US, even in nominal terms. The reason why the economy is not reacting more strongly to this is probably due to the fact that real interest rates are still deeply negative almost everywhere, which acts as a powerful stimulator. It means that anyone who borrows money today will pay back less in real terms in the future. Central banks know that if they want to get inflation under control, they will have to keep raising interest rates, at least until this is no longer the case.

On balance, therefore, this suggests the risk of slower growth than is currently priced in.

Only minor adjustments so far to earnings expectations

Where do we currently stand with regard to earnings trends? Based on data as of 24 February 2023, negative earnings growth is expected when the full S&P 500 data becomes available for the fourth quarter of 2022. That would then be the first negative earnings growth in the current economic downturn since the pandemic year of 2020.

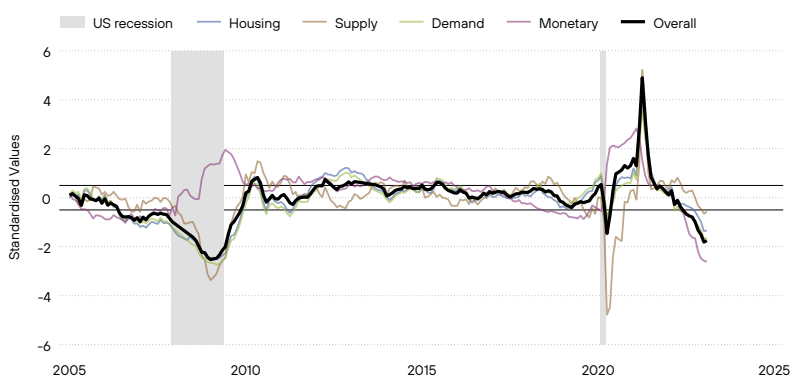
The expected Q4 2022 decline of -3.2 per cent in year-on-year earnings according to Refinitiv, would place us in the modest or early stage of the typical shrinkage compared to the average for other slowdowns over the past fifty years or so.

The situation is volatile, though. The earnings expectations for the first quarter and the second quarter of 2023 flipped, in January, from still hopeful year-on-year growth to modestly negative year-on-year declines of -0.6 per cent for Q1 2023, then deteriorated further in February to the current -4.3 per cent, i.e., more pessimism has crept in within the space of a month. The same trend is reflected in the earnings expectations for Q2 2023: initially -0.7 per cent was expected, but now the forecast is -3.5 per cent, also according to Refinitiv. Yet, the surveyed analysts appear to believe that all will soon be well because they expect a nice recovery in Q3 2023 of +3.2 per cent (only a slight trimming of their January forecast of +5.2 per cent) and for Q4 2023 they expect +10.3 per cent, almost unchanged from what they thought in January.

If that recovery were to materialise, the earnings profile would look very different from the average historical trends associated with growth slowdowns. It would also be one of the shortest and mildest recessions ever. We find these market assumptions too optimistic. The likelihood, therefore, is for earnings disappointments in the coming quarters.

Fig. 2: US recession indicator

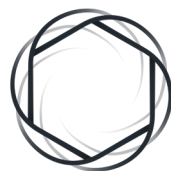
Components of the recession indicator



SOURCE: WELLERSHOFF & PARTNERS

This chart tracks data that has historically been relevant as a recession indicator for the US. The supply and demand side indicators have improved slightly recently. Despite this, all components, and thus the overall indicator, still signal a high probability of a recession.



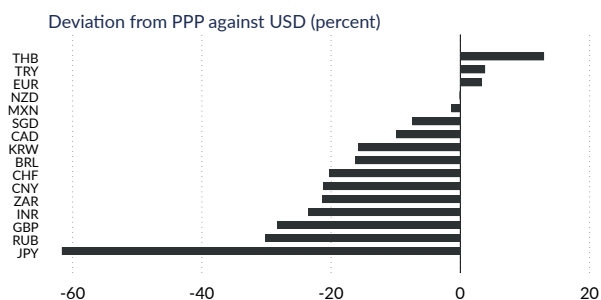
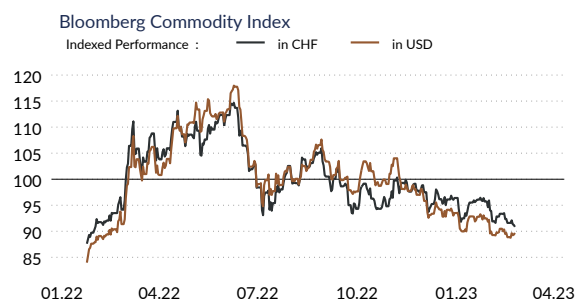
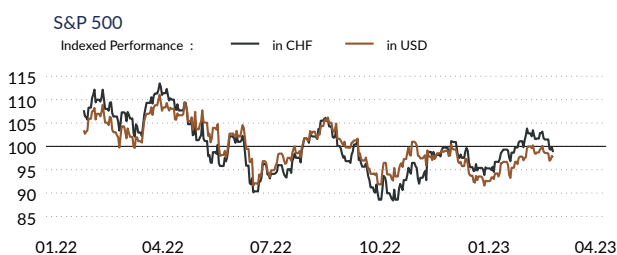
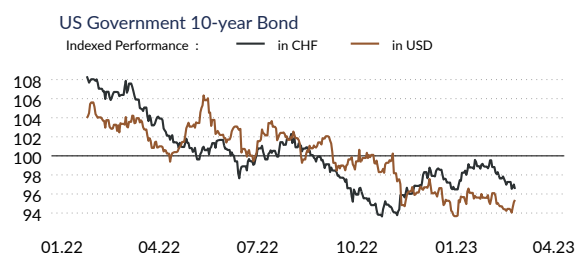


Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2023E	2024E	2023E	2024E	Q1 2023	y/y 12/2022
USA	1.6	1.0	1.2	4.5	4.0	4.75	-3.7
Eurozone	1.0	0.4	1.4	5.0	4.0	2.5	-0.2
UK	1.7	0.0	1.0	5.5	5.5	4.0	0.6
Switzerland	1.4	0.6	1.2	3.0	2.5	1.0	-5.2
Japan	1.1	1.4	1.0	3.0	2.0	-0.1	4.6
China	4.5	4.0	4.0	2.2	2.2	4.35	6.7
Brazil	1.2	1.2	1.4	4.2	4.0	13.75	-1.5
India	5.0	6.0	6.5	5.0	5.0	6.5	7.6
Russia	1.0	0.0	1.0	10.0	4.0	7.5	22.2
World	2.9	2.5	3.0	5.5	4.0	-	-

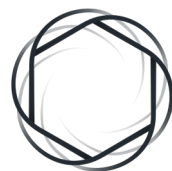
SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

Financial Markets



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS



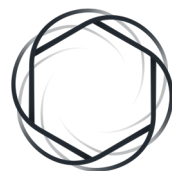


Global Asset Allocation Preferences – March 2023

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.
Fixed Income	++	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 but might stay at high levels for longer than expected. While the Fed is unlikely to reverse its hiking cycle as fast as the market expects, 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.
		Duration	Short- to medium-term.		Recent shifts in the prospects for growth and inflation have renewed the uncertainty about global monetary policy cycles, pointing to the possibility of more monetary tightening than previously expected. This reinforces our preference for short-to-medium duration to avoid the impact of likely extra doses of tightening.

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



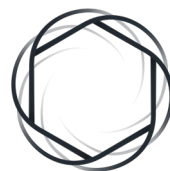


Global Asset Allocation Preferences – continued

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% levels is facing headwinds in the form of resilient growth and stubborn inflation. Earnings declines and margin contraction across sectors are far from being complete and 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 as we see the region more sensitive to growing risk aversion. We see Europe more attractive on valuation ground but seek for quality stocks too. As far as Emerging Markets concern, we continue to have a long-term preference for faster-growing India and more cautiously China as a tactical move to play the reopening.

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





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>

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



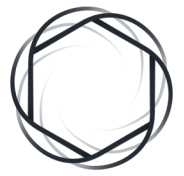


Figure of the Month

6.6

This is the average real GDP growth rate for India projected for the next few years, according to estimates from the World Bank, the OECD and the IMF. This will make India the fastest growing major economy in the world over the medium term. The expectation is for the economy to be driven by a boom in discretionary consumption, underpinned by a young and growing population, as well as other global and domestic secular trends, such as digitisation, the energy transition, investment in manufacturing and the setting up of alternative supply chains and hubs.

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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.

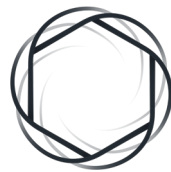
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