

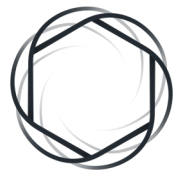


S.P. HINDUJA

BANQUE PRIVÉE

House View

May 2023



Thoughts of the CEO

“Central banks are now playing for time.”

The primary reason central banks increase interest rates rapidly is to have an impact on the economy. But, just like any medicine, there can be unintended consequences. While hiking short-term interest rates is the classical way to tackle inflation, the side-effects might include tremors in the financial system. This is what we saw recently and we are already in the second month of those unintended consequences. This raises the question how central banks might now calibrate their two objectives: Tackling inflation and supporting the financial system. (The Fed even has a third objective: Maximum sustainable employment).

A softer approach on the inflation lever could mean not being willing to bring inflation back to the 2 per cent target too quickly. The odds, therefore, are that negative real interest rates, and thus inflation, may be with us for longer, which is not good news.

The world economy and financial markets are plagued by a fundamental disequilibrium between inflation and interest rates. A long period of low interest rates contains the seed for valuation bubbles and financial crises. Central banks will sooner or later have to bring measures back to old-style parameters. Either inflation comes down below the level of interest rates, or interest rates will have to continue to remain elevated.

The chances of the former happening quickly have not improved last month. The best current measure of inflation trends, the so-called core rate of inflation, which excludes volatile components such as energy and food prices, has risen by around 5.6 per cent in the euro area and in the US. Judging by ten-year government bond yields of 2.4 per cent for German Bunds and 3.5 per cent for US Treasuries, we are indeed far away from the desired equilibrium.

At the same time, economic indicators have deteriorated further, which could help central banks in their fight against inflation. Sentiment among manufacturers in the more advanced economies is clearly in recessionary territory and consumer sentiment has remained at historically low levels. The hard economic data released over recent weeks seems to point in the same direction. Retail sales numbers, industrial production and international trade data have disappointed. A recession is still the most likely scenario.

The combination of a clear necessity to aim for a higher interest rate level and the threat of a major recession is an obvious policy dilemma for central banks. The bank failures in the US have attested to that threat. For the time being, we seem to be stuck with monetary policy that can only fight inflation by risking further turmoil in the banking sector. That is unusual.

As a consequence, we believe that central banks are now playing for time. On the one hand, they are likely to keep up the threat of higher money market rates. On the other hand, they certainly hope that inflation will come down fast in the run-up to a recession, which would allow them to pivot to lower rates. The data is not currently showing this. It is therefore more likely that inflation will remain above interest rates for some time to come, and the root cause for the current disorder will remain inadequately resolved.

Given this context, we maintain our defensive stance. On the following pages, we provide more details and charts to support our view.

Yours Sincerely,

Karam Hinduja





Investment positioning

The geopolitical backdrop remains challenging and core prices continue to be elevated. In this context, markets appear too complacent when overlooking the growing risks of recession and tighter credit conditions. We maintain a very cautious stance on risk assets and believe that investors should maintain a well-diversified allocation in their portfolios focusing on quality in both equities and bonds, and that they should hold more cash than usual. Please see our detailed recommendations on pages 6, 7 and 8.

Classical portfolio diversification paying off

After the death of the so-called 60/40 portfolio was proclaimed last year, recent stresses in financial markets have revived this classical diversification pattern. While riskier investments such as equities declined, bonds significantly increased in value. The 10-year US treasury yield was just above 4 per cent at the beginning of March, but by end of April had fallen below 3.5 per cent. What is interesting here is that we had not seen much of this pattern since the announcement of tighter monetary policy in spring last year. As Figure 1 shows, the rolling correlation between global equities and bonds, as measured by the MSCI World Index and the Bloomberg Global Aggregate Index, increased steadily last year. This means that the performance of equities and bonds behaved very similarly. Both asset classes increased or decreased in value in lockstep. This contributed to the classical 60/40 portfolio producing some of the worst results for a long time. As a result, even

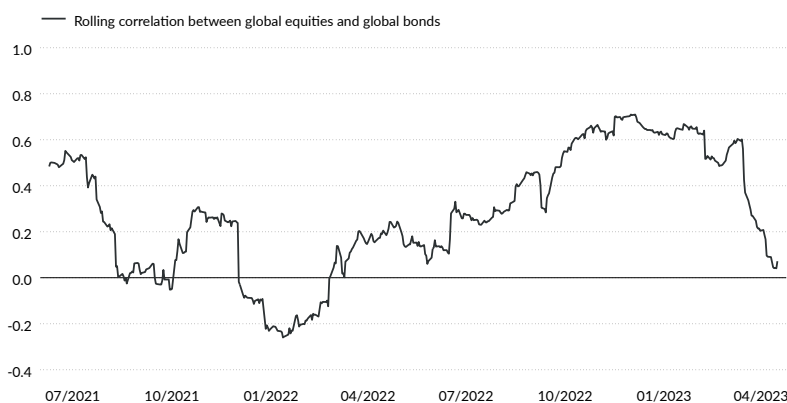
conservative portfolios performed about as poorly as more aggressive portfolios. There was no trace of diversification. This year, at least so far, the correlation has become less positive.

With rates likely close to peak, utilities oversold

Utility stocks have disappointed this year in the US, losing 1.5 per cent on average, compared with a gain of 8 per cent for the S&P 500 index. In a deteriorating economy, utilities should typically offer defensiveness and attractive income. These are sufficient characteristics to be part of a diversified portfolio these days, at least until the uncertainty about the banking crisis further diminishes and the Fed goes on hold. The sector is not cheap, at least in the US, where the S&P 500 Utilities is trading at 18x 2023 earnings, slightly below the 5-year average of 19.2x, and in line with the market average. However, the sector yields 3.1 per cent on average, nearly double the S&P index's yield. The utility

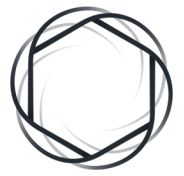
Fig. 1: Portfolio diversification effects

Three-month rolling correlation between global equities and global bonds



SOURCE: BLOOMBERG, WELLERSHOFF & PARTNERS

The chart shows the three-month rolling correlation between global equities and global bonds as measured by the MSCI World Index and Bloomberg Global Aggregate Index. A high positive correlation means that global equities and bonds behave very similarly. A negative correlation means a greater diversification effect of a portfolio of these two asset classes. Recently, the correlation has become less positive (the more negative the correlation, the greater the diversification effect).



sector in Europe looks cheaper. As measured by the EuroStoxx Utilities Index, it trades at 13.8x 2023 earnings (compared to the 5-year average of 17.1x) after having appreciated by around 10 per cent YTD. In addition, the sector yields 4.3 per cent.

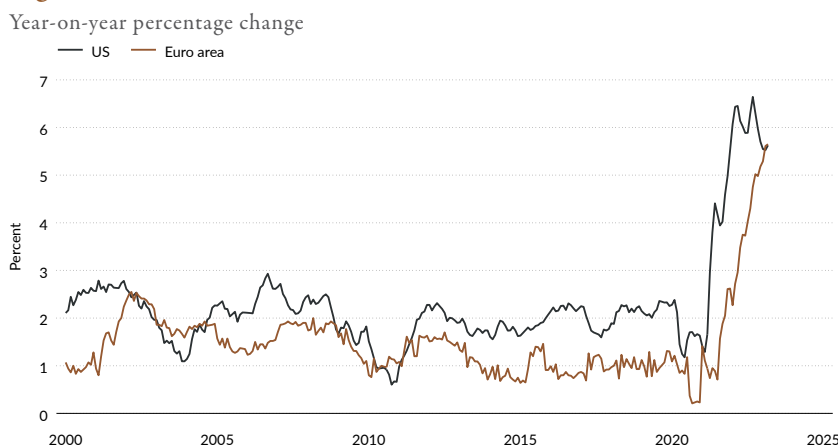
Most of the utility companies operate under monopoly situations with little or no competition under a regulated asset base model that caps returns but instead offers a great degree of visibility and cash flow predictability. This in turn allows them to grow their annual dividend compared to bonds, which pay a fixed income. In fact, market consensus points to 5 per cent annual dividend growth in the US electricity utility segment. Electricity utilities have strong tailwinds such as the growing focus on energy transition and seem better positioned to generate sustained cash flow. This is in line with our capital protection approach. Should the economy go through a rough patch, we believe the sector will again show its protection features like in 2022 (0.2 per cent gain vs. S&P 500's -17 per cent drop). Besides, this time round, the tightening cycle is in a different phase (Figure 2) and the sector is not expected to have to face the same headwinds from the rapid rate hikes in 2022.

need to see short-term interest rates exceeding core inflation if central banks are serious about getting inflation back to 2 per cent. If central banks were now to be distracted by financial stability considerations, then the fight against inflation could take longer.

Keeping an eye on core inflation

Inflationary pressures remain high (Figure 2). Even though the slowdown in the economy may ease inflationary pressures, it remains unfavourable news for riskier assets. As we have pointed out on the front page of this report, we

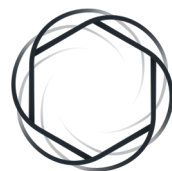
Fig. 2: Core inflation rates in the US and Euro area



This chart shows that the most recent core inflation rates in the US and the eurozone are both around 5.6 per cent. As a result, underlying inflationary pressure (as opposed to headline inflation) remains high in both regions. In the eurozone, price dynamics even appear to be on the rise.

SOURCE: REFINITIV, WELLERSHOFF & PARTNERS



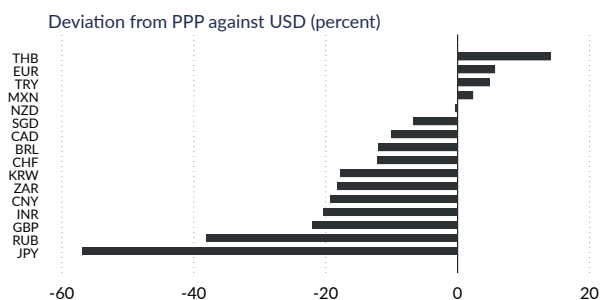
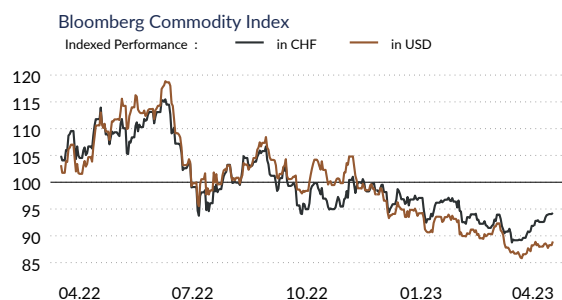
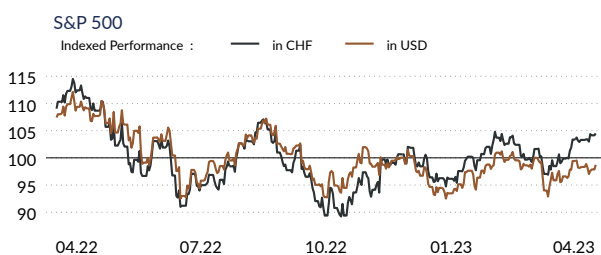
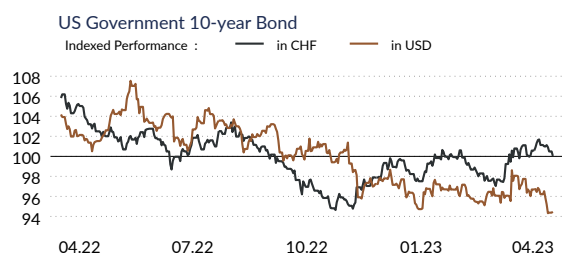


Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2023E	2024E	2023E	2024E	Q1 2023	y/y 04/2022
USA	1.6	1.0	1.2	4.5	4.0	5.00	-8.3
Eurozone	1.1	0.4	1.4	5.0	4.0	3.00	-2.2
UK	1.7	0.0	1.0	5.5	5.5	4.25	0.0
Switzerland	1.3	0.6	1.2	3.0	2.5	1.50	-9.8
Japan	1.1	1.4	1.0	3.0	2.0	-0.10	4.5
China	4.5	5.0	4.0	2.0	2.2	4.35	5.1
Brazil	1.3	1.2	1.4	4.2	4.0	13.75	-6.4
India	5.0	6.0	6.5	5.0	4.5	6.50	8.8
Russia	1.0	0.0	1.0	9.0	4.0	7.50	30.1
World	3.0	2.5	3.0	5.5	4.0	-	-

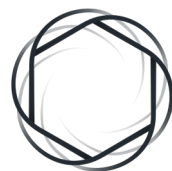
SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

Financial Markets



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS



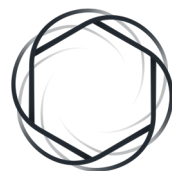


Global Asset Allocation Preferences – May 2023

Asset Class	View	Constituents	We favour	We avoid	Commentary
Cash	++				We continue to hold more cash than in normal circumstances. Cash remains highly attractive in an environment of high and growing recession risk, demanding valuations of risk assets and underestimated credit risk in our view.
Fixed Income	++	Segments Treasuries and developed market investment grade credit	Convertibles, High Yield, Emerging Market debt		The recent turmoil in the banking industry reinforces our positive stance on safer government bonds. Further weakness in money supply and credit data suggest recessions later this year. This could set the stage for the Fed to start cutting rates and will drive appetite for safe-haven assets. Investment grade credit offers attractive yields.
		Duration Medium-term			The investment approach in credit needs to focus on investment-grade holdings, in our view. Balance sheet metrics such as liquidity, short-term debt and refinancing risks are at the centre of our analysis. We avoid investing in bonds from issuers facing significant debt maturities in the short term. We believe intermediate duration provides valuable diversification relative to cash or short-duration bonds in periods of equity selloffs.

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



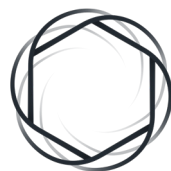


Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Equities	–	Markets	US, selective Asia ex-Japan	Latin America	<p>Within the US, we continue to favour low-beta and quality stocks as we see the region more sensitive to growing risk aversion. Becoming more neutral in Europe after recent outperformance, which has been backed by the relief on the energy front. Remain neutral on Japan. As far as Emerging Markets are concerned, we continue to have a long-term preference for faster-growing India and more cautiously China as a tactical move to play the reopening.</p>
		Sectors	Quality, value. Dividend growers. Consumer staples, healthcare, utilities and agricultural stocks.	Construction, Autos, Tech Hardware, Consumer discretionary, Industrials, Commercial REITs	<p>Regardless of a mild or deep recession ahead in the US and Europe, we favour quality names, strong balance sheets and cash generators. In a higher rate environment, we favour value (highly selective on financials and energy) over growth, and companies with strong earnings resilience featuring pricing-power characteristics, high margins, and low refinancing risks to fare better. Defensive US stocks usually outperform during global earnings recessions. With rates close to peak, we see utilities oversold. Healthcare, staples, food producers and food retail remain favourites.</p>

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Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Alternatives	+	Selected direct real estate, listed infrastructure, gold	Distressed debt, Private debt, Consumer lending		<p>High inflation, energy transitions and growing digitisation of the economy keep on being valid arguments to favour infrastructure as an alternative. In real estate, renewed downside risks exist in the form of writedowns and defaults. The sector is highly exposed to the new headwinds stemming from tightening lending standards. Selected logistics, storage and students residences are preferred segments. Avoid listed real estate in general.</p> <p>We continue defending our skew towards gold. The asset should perform well as rates normalise and risks of recession mount. USD might become an additional support.</p>

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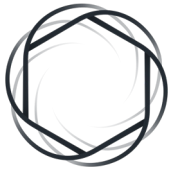


Figure of the Month

-0.5

0.5 is the number of percentage points of negative contribution to the latest US CPI number (March 2023) from energy. The base effect is helping the Fed in its battle against the headline inflation rate. 2023 energy prices are increasingly being favourably compared to the worryingly high 2022 ones. Indeed, energy costs are now 35 per cent below their June 2022 peak and this effect could accelerate. If energy prices remain flat to June, they will drag -1.7 percentage points from the headline CPI for that month. This is a technicality, of course, but sometimes the base effect brings good news too. As we point out in Figure 2 though, keep an eye on the core inflation rate.

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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.

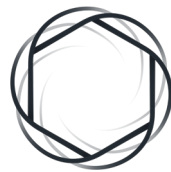
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BANQUE PRIVÉE



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