

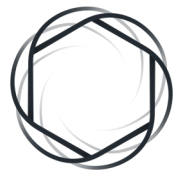


S.P. HINDUJA

BANQUE PRIVÉE

House View

July 2023



Thoughts of the CEO

“Mid-way through 2023: Greater clarity in some areas, remaining uncertainties in others.”

As we enter the second half of 2023, it is helpful to take stock of where we stand in terms of several key economic and financial indicators, and in terms of what has surprised us and what has not.

The US stock market had a stellar first half, with the S&P 500 up 16.4 per cent in total returns (including dividends). That is a surprise. This is despite earnings growth of -2 per cent in Q1 2023, and analysts expecting -6.4 per cent for Q2, and just +0.8 per cent in Q3, according to FactSet. For Q4, the expectations are for +8.2 per cent. The stock market appears to have priced in a very short period of earnings headwinds in 2023, with a nice recovery in Q4.

Equities were helped so far this year by inflation slowing in several key markets. Our regular readers will know that we had pointed out that it would merely take a sideways move in energy prices for the headline year-on-year inflation rate to fall noticeably. And instead of a mere sideways movement in energy prices, we had sharp declines: Crude oil prices fell by almost a third from a year ago, while the European reference gas price was down 75 per cent over the same time. And, as night follows day, the US headline consumer price inflation rate slowed from 9 per cent year-on-year in May last year to 4 per cent this past May — the most recent data point as we write this note.

Similar evidence from another important measure of inflation is producer prices. In the US, it is down from 11 per cent year-on-year last May to just 1.1 per cent this May. And in the euro area, producer price inflation is down from an eye-watering 36.2 per cent year-on-year last May to 1 per cent this May. Since producer price inflation captures what is happening as goods leave the factory, and since factories tend to pass on price changes to end consumers, producer price inflation of just 1 per cent should be a very good signal for consumer price inflation in the second half of the year.

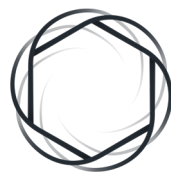
Despite the great progress on headline and producer price inflation, central bank interest rates have not declined this year, but continued to move up. This apparent paradox reflects the fact that central banks tell us that they are not targeting the headline inflation rate nor the producer price inflation rate, but a narrower measure of inflation, namely core inflation, which excludes energy prices and volatile food prices. This measure stood at 5.3 per cent for both the US and the euro area as of May 2023. That is still some way from central banks' target rate of 2 per cent. And as we were writing this note, US Federal Reserve chair Jay Powell, told a conference: “Although policy is restrictive, it may not be restrictive enough, and it has not been restrictive for long enough.” At the same event, the head of the European Central Bank, Christine Lagarde, said that policymakers were “not seeing enough tangible evidence of underlying inflation [...] stabilising and moving down.”

We are, therefore, in unusual times: energy, commodity and goods inflation is declining, yet robust pockets of inflation, especially in services, are still present and supported by a strong labour market. Thus, while we are getting closer to an interest rate ceiling, we will need to see cooling inflation in services, too, before borrowers expect support from interest rates. The portfolio conclusions are discussed in more details on the following pages.

Yours Sincerely,

Karam Hinduja





Investment positioning

Overall, our portfolio positioning remains cautious. We believe equities are still vulnerable to a recession and remain underweight with a focus on quality and defensiveness. With rates close to peak, oversold utilities and telecoms present an opportunity. We show no preference for either US or Europe. We find relative value opportunities in certain markets, such as Japan, China and India. Cash levels in portfolios remain overweight. Please see our detailed recommendations on pages 6, 7 and 8.

Stocks up, but narrow market leadership

On the previous page, we highlighted the great performance of the S&P 500 in the first half of the year. A closer inspection shows that only one sector, technology, and within that sector only a few heavyweights, such as Nvidia, Alphabet and Meta, were the key drivers (Figure 1). But an equal weight index of the S&P 500 shows that the stock market ended the first half of the year up by 6 per cent.

Conceptually, a bull stock market, or even one that just keeps pace with nominal GDP growth, should be reflecting the broad-based growth across an economy. Such a wider basis helps investors assess the likely sustainability of the uptrend. A narrow base implies some struggling sectors, and that more caution and differentiation are required.

According to FactSet, the expected 8.2 per cent year-on-year earnings growth anticipated in Q4 will reflect this sector earnings performance: Communication Services (+36.3 per cent), Utilities (+26.2 per cent), Consumer

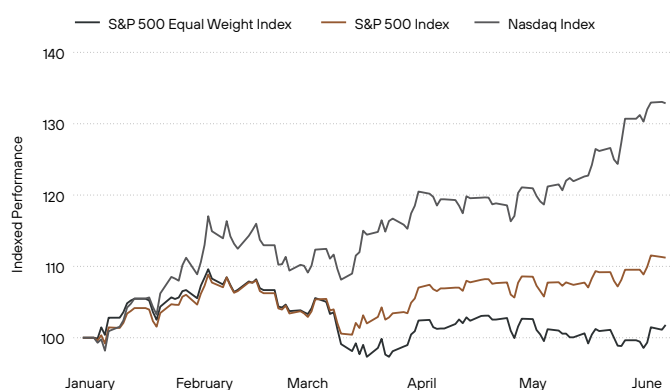
Discretionary (+21.3 per cent), Information Technology (+12.4 per cent), Financials (+11.2 per cent), Industrials (+8 per cent), Consumer Staples (+5.6 per cent), Real Estate (+14.8 per cent) and Health Care (+1.9 per cent). Two sectors are expected to show falling earnings growth: Materials (−1.7 per cent) and Energy (−24.1 per cent). Note that the forecast declines in the latter two would be consistent with the expectation of moderating headline and producer price inflation.

Tighter credit conditions

While the stock market suggests that the outlook is positive, the effects of tighter monetary policy and lending conditions are working their way through the economy, which suggests the need for caution.

As can be seen from Figure 2, the broad money supply is contracting in the United States, the euro area, the UK and Switzerland, but not in Japan.

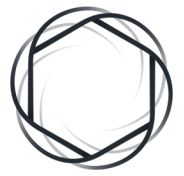
Fig. 1: Performance of selected US stock market indices, January 2023 = 100



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

This chart shows the equally weighted S&P 500 index, the market-capitalization-weighted S&P 500 index and the technology-based Nasdaq index. The indices have started to diverge since mid-March, and this development has recently been accentuated again. Drivers behind this development are technology stocks such as Nvidia, Alphabet or Meta, which are heavily weighted in the S&P 500 index and Nasdaq index. But in terms of market breadth, the picture is different and much weaker.





Contractions in the broad money supply are associated with slowing inflation down the road, but they are also associated with economic headwinds and stresses and strains. These pressures can be sector-specific or regional, as we saw in the smaller US banks earlier this year, or even country-specific (e.g. Sweden is struggling with a housing market in trouble). Actually, the latter is a good reflection of the fact that the inflation of the collateral that has contributed to credit generation has vanished. On top of that, we are already seeing some segments of credit stress (autos and credit card delinquency rates in the US) and growing evidence of significantly higher bankruptcy rates around the world. The point is that when interest rates rise, things break. Sometimes unexpectedly.

No two business cycles are perfectly alike. In the current cycle, the role of non-banking financial institutions providing private credit might be hiding the real impact of the policy tightening in the financial system. These institutions are not obliged to mark their loans to market, and they usually grant longer maturities. All this could be delaying and adding complexity to the impact of monetary tightening.

Whoever needs to refinance now is typically exposed to the combination of higher rates and may need to shop around more to get a positive response. In some cases, there can be the added weight of disruptive structural factors, e.g. in the stories of shopping mall owners handing back the keys, or reports of investment grade companies turning to

private debt markets for financing because of the tighter lending conditions elsewhere.

There can also be supportive structural factors, such as demographic trends underpinning the US housing market despite higher rates. There are also the many helpful lags in the economy, such as borrowers who have locked in low rates. It is this diversity that can delay a recession or mitigate its strength. From a portfolio perspective, the uncertainty of the current economic environment in a tightening cycle keeps us cautious.

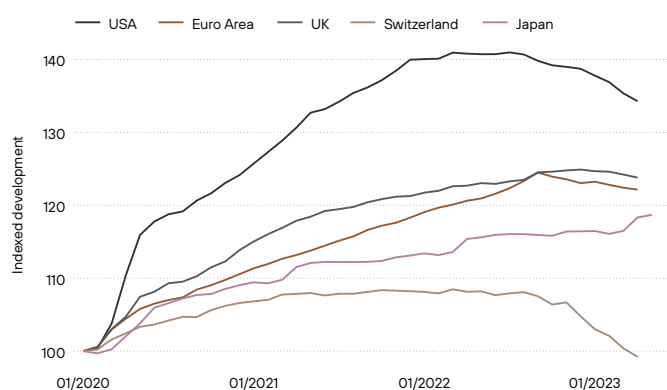
This is especially the case in the context of an inverted yield curve: shorter rates are still higher than long-term rates. As we have pointed out before, an inverted yield curve does not guarantee a recession, but it is unusual to have a recession that has not been flagged by an inverted yield curve.

Revisiting the sovereign debt story

A month ago, markets were focused on that perennial topic of the US debt ceiling. We had assumed that the US would sort it out in time, which is, thankfully, what transpired.

But we want to return to the topic of sovereign debt because it is not over. Please see our comment on page 9 where we highlight our Figure of the Month.

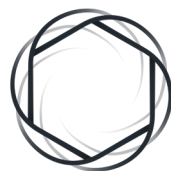
Fig. 2: Broad money supply (M2), January 2020 = 100



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

This chart shows that a measure of broad money supply (M2) in the United States, the euro area, the UK and Switzerland is contracting. In Japan, there was a recent expansion. Contractions tend to be associated with lower inflation and tighter credit conditions.



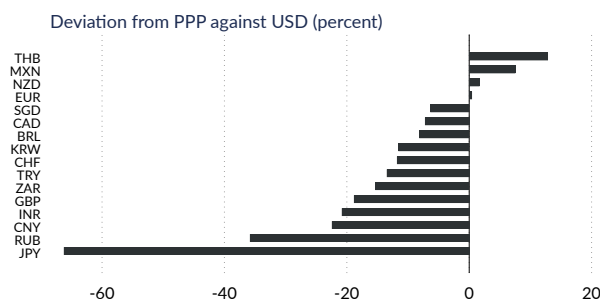
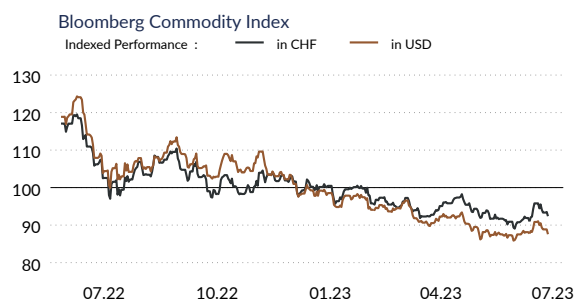
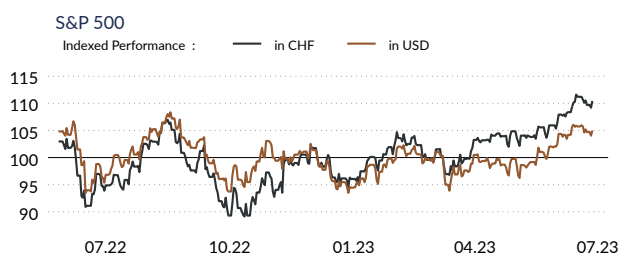
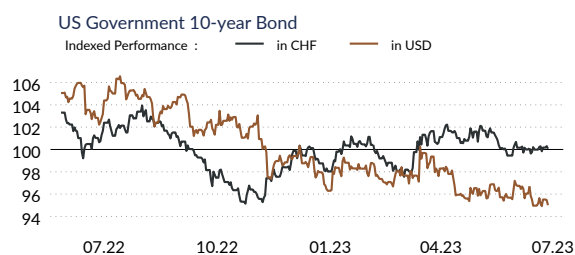


Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2023E	2024E	2023E	2024E	Q2 2023	y/y 06/2023
USA	1.6	1.3	1.2	4.5	4.0	5.25	-9.8
Eurozone	1.1	0.6	1.4	5.0	4.0	3.50	-6.2
UK	1.7	0.2	1.0	6.5	5.0	5.00	-3.5
Switzerland	1.3	0.8	1.2	2.5	2.2	1.75	-12.2
Japan	1.1	1.3	1.0	3.0	2.0	-0.10	4.4
China	4.5	4.5	4.5	1.5	2.0	4.35	4.7
Brazil	1.4	1.5	1.4	5.0	4.0	13.75	-4.4
India	5.0	6.0	6.5	5.0	4.5	6.50	7.8
Russia	1.0	-1.0	0.0	6.0	5.0	7.50	33.5
World	3.0	2.5	2.8	5.0	4.0	-	-

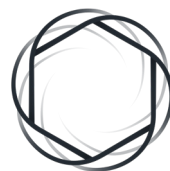
SOURCE: REFINITIV, WELLERSHOFF & PARTNERS

Financial Markets



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS



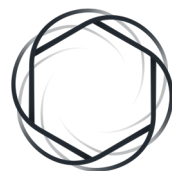


Global Asset Allocation Preferences – July 2023

Asset Class	View	Constituents	We favour	We avoid	Commentary
Fixed Income	++	Segments	US Treasuries and developed market investment grade credit	Convertibles, High Yield, Emerging-Market debt	The Fed's sheer determination to bring inflation down and create spare capacity in the economy suggests downside potential in Treasury yields. The Fed could actually start cutting rates sooner than expected, driving appetite for safe-haven assets. In the event of a global slowdown and a fixed income rally, US Treasuries tend to outperform within the asset class. We favour US Treasuries.
		Duration	Medium-term		We continue to think that, as inflation eases and the economy slows down or enters a recession, adding some duration tends to benefit portfolios. Investment-grade credit offers attractive yields. Most corporate bonds trade at discount to their issuance price which provides valuation cushion. We avoid corporates facing significant debt maturities in the short-term. High-yield spreads do not price an additional earnings decline and higher debt-servicing costs, in our view.

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



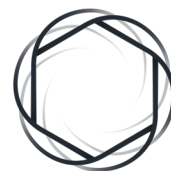


Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Equities	–	Markets	US, selective Asia ex-Japan	Latin America	Analysts expectations underestimate the risks of rapid slowdown in the top-line growth, coinciding with a rise in the cost base. The result could be a sharp squeeze in margins. Trailing EBIT margins in the US have already fallen 150 bps from their peak. In the US, we continue to favour low beta and quality stocks as we see the region as more sensitive to growing risk aversion. We keep the same criteria in Europe, though have become more neutral after recent outperformance in a risk-on market. Remain neutral to positive on Japan where the macro backdrop improves.
		Sectors	Quality, value. Dividend growers. Consumer staples, healthcare, utilities and agricultural stocks.	Construction, Autos, Tech Hardware, Consumer discretionary, Industrials, Commercial REITs	We still believe equities are predisposed to risks, reflecting the shallow recession we expect in developed markets. However, we favour quality names, strong balance sheets and earnings resilience. In a higher rate environment, we favour value (highly selective on financials and energy) over growth and companies with strong earnings profiles featuring pricing power characteristics, high margins, and low refinancing risks to fare better. Defensive US stocks usually outperform during global earnings recessions.

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





Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	We favour	We avoid	Commentary
Alter-natives	+		Selected direct real estate, listed infrastructure, gold	Distressed debt, Private debt, Consumer lending	<p>High inflation, energy transition and growing digitization 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. We thus avoid listed real estate. Industrial real estate, storage and students' residences are preferred segments for direct investments.</p> <p>We continue defending our skew towards gold. The asset should perform well as rates normalise and risks of recession mount. USD weakness and strong purchases from central banks might become additional supports.</p>
Cash	++				<p>Cash remains highly attractive in an environment of high and growing recession risk, demanding valuations of risk assets and underestimated credit risk. Investors can lock attractive risk free real returns in USD for the next 12 months.</p>

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



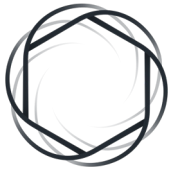


Figure of the Month

121%

This is the estimated size of the US government's "general government gross financial liabilities" for 2023 as a percentage of GDP according to the OECD, which includes all known US government financial liabilities, not just treasury bonds outstanding. This ratio is twice as big as it was in the two decades before the 2008 global financial crisis, demonstrating a significant decline in the US government's creditworthiness in recent decades. The OECD estimates that next year, the US government will spend the equivalent of 11 per cent of its budget to pay the interest on its debt. The US government needs to consider the long-term implications of its deteriorating fiscal position.

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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.

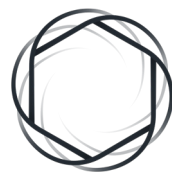
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