

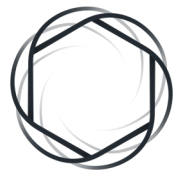


S.P. HINDUJA

BANQUE PRIVÉE

# House View

January 2024



# Thoughts of the CEO

“The value of considering alternative scenarios.”

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By the close of 2023, the forward markets had priced in a high degree of certainty: The probability of lots of rate cuts by the US Federal Reserve for 2024 — a 0.25 percentage point reduction in each of March, May, June, July, September and November (CME as of 31 December 2023). That would take us from the 2023 closing rate of 5.25–5.50% to 3.75–4.00% by the end of this year.

While we, too, expect lower rates in 2024, we are also mindful of why we hold diversified portfolios: History teaches us to be humble about what we can extrapolate into the future. Often, we even struggle to deduce what happened in the past. This is currently the case with several central banks trying to understand how their models failed to predict the post-lockdown inflation surge.

The Bank of England, for example, has invited former US Federal Reserve Governor, Ben Bernanke, to advise them on what they might do better. Everyone is putting on their thinking caps. The former Bank of England economist, Charles Goodhart, has offered an ingenious solution. Instead of pretending to know what the future holds for growth and inflation, he suggests that central banks should become a lot more modest and base their opinions on an even number of scenarios. That way, Goodhart says, the markets will avoid taking the lazy way out and relying on the middle scenario as the base case.

Applying Goodhart's insights to the inflation outlook for 2024 would mean that we should not bet the farm on the market's current pricing for interest rates. It also means that we should consider realistic alternative scenarios for our portfolios not yet priced in by the markets. For example, China currently finds itself in deflation (–0.5% year-on-year, as of November 2023). On top of that, the Chinese currency ended the year 2.9% weaker against the US dollar and 6.6% down on the euro, implying that the US and the

eurozone were importing Chinese deflation. One reasonable alternative scenario, therefore, is that inflation might fall a lot faster than priced in by markets; we might even get a bit of deflation!

We are not forecasting deflation here, merely pointing out the advantage of considering our portfolios in terms of a range of scenarios, rather than just betting on a central case. This brings us to another potential inflation scenario. In this House View, in Figure 1, we show the interplay of economic conditions on inflation. There is a lagged effect of about a year between the output gap and the impact on inflation. So, yes, inflation has come down beautifully until now, but this chart shows why it may become a little tougher in the coming months.

There is also another scenario that is currently being discussed, namely whether the new, costlier supply chains, demographics and labour shortages are now history in terms of their contribution to inflation, or whether they may have merely been temporarily obscured by sharply falling energy prices and the delayed impact of high interest rates. The markets are not priced for these many alternatives, which means the likelihood of positive or negative surprises.

2024 is also a year where important political events are in the calendar, including elections in India and the United States. One way to approach investing therefore, and regular readers will be aware of my mentioning this on several occasions, is to ensure that a core portfolio for wealth preservation is optimally diversified across asset classes, currencies, markets and jurisdictions.

Yours sincerely,

Karam Hinduja





# Investment Positioning

A slowing global economy is set to put pressure on corporate earnings in a market that seems to have recently discounted an ideal soft landing of the economy. We expect that the lagged effects of higher rates will continue to feed through the US economy next year. Only a significant and rapid reduction in interest rates, triggered by falling inflation rather than a deteriorating economy, could spur a new rally in equities, which already trade at demanding multiples. However, the uncertainty surrounding the US economic cycle could also lead to lower equity valuations that are difficult to time.

## Still cautious, therefore...

We are thus very cautious about the performance of risk assets over the next 12 months and see fixed income in a relatively more attractive risk-reward position. We are also aware of continuing geopolitical risks with two major conflicts currently ongoing and the fact that national elections in many countries (the US included) will take place next year. Recession risks remain.

## ...but also aware of the optimistic scenario

As discussed on the previous page, a portfolio aimed at wealth preservation is diversified precisely because of the uncertainty associated with key forward-looking assumptions. We thus outline here the assumptions associated with a so-called soft-landing scenario and a “Goldilocks” economy, i.e. one that is not too hot and not too cold. This appears to be what the market was assuming as of the close of 2023: interest rates

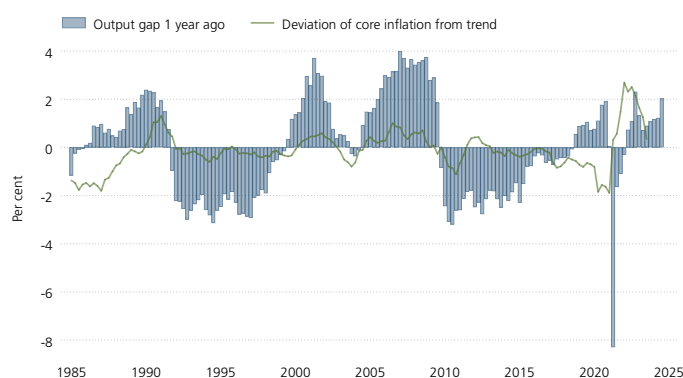
were predicted to come down gradually, no assumption in the pricing of a deep recession requiring massive rate cuts.

Under this soft-landing scenario, slowing economic growth, falling inflation, and lower interest rate expectations should mean lower yields, supporting bonds and equity valuations, while the absence of a deep recession should enable companies to continue to grow earnings.

Essentially, there should be a “normalisation” of inflation and central bank interest rates towards their long-term trend. Lower central bank rates should also be positive for fixed income investors: quality bonds could deliver good results in 2024.

Under such a scenario, risk assets could profit from “healthier” earnings in the second half of the year. Furthermore, the AI theme should continue to be a source of surprises, both positive and negative, on specific company revenues and valuations.

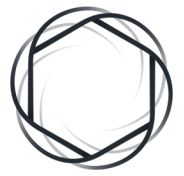
**Fig. 1: How economic conditions impact inflation**



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, WELLERSHOFF & PARTNERS

The chart shows the extent to which the US economy is operating above or below potential growth (the output gap), with a lag of four quarters, and the deviation of core inflation from trend. The trend in US inflation is currently just under three per cent, only slightly above consumers' inflation expectations. As can be clearly seen, the economic trend has an effect on inflation when taking the one-year lag into account. The latest US economic data suggests that the decline in inflation will become more difficult from now on.





### Revisiting out-of-favour Chinese equities

Given the weaker yuan and cheap valuations, Chinese equities should be an interesting place to be for longer-term investors, in our view. China's structural transition, away from the housing market and towards clean energy, export diversification as well as domestic consumption, presents opportunities. The current depressed market sentiment means we can capture these opportunities at attractive valuations.

### Update on EPS for 2024

We see 2024 as a year with challenging fundamentals:

1. Sluggish global growth. US growing sub-trend, the Eurozone in recession, and China struggling to grow above 5 per cent on a new growth path, that would probably lead to lower potential growth.
2. With inflation moderating, corporates' pricing power will lose a lot of momentum as a driver of top-line growth
3. Scope for additional margin improvement is very limited.
4. Higher financial expenses during 2024 will put additional pressure on earnings. Corporates will need to face significantly higher rates in refinancing deals.

5. Therefore, we view a strong case of earnings downward revisions throughout 2024 from current 12 per cent year-over-year towards mid-single digits.

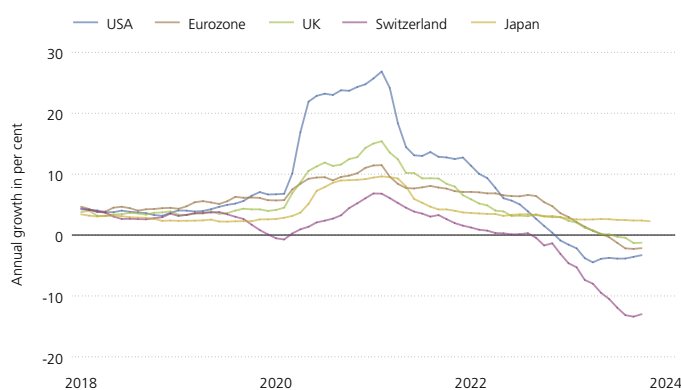
6. Finally, high valuations, especially after the strong re-rating from November to December 2023 offers very little support.

### Countervailing inflationary streams

Our readers should be aware that there is a discussion under way as to whether or not "team transitory" has won or not. This was the label applied to those academics who had argued that inflation was merely "transitory" and that it should be ignored (i.e. central banks should not raise rates by much or at all). How central banks responded ranged from those that hiked before the Fed and by more than the Fed (e.g. many emerging markets), those that hiked after the Fed and by less than the Fed (e.g. the European Central Bank), and those that did not hike at all (e.g. the Bank of Japan). The data of what those policy responses delivered is still coming in.

Each economy is different, of course, which is why their respective growth and inflation numbers differ. Yet, focusing on the US, Figure 1 shows the extent to which the US economy has been operating above or below its capacity (the output gap). If we lag that by four quarters and superimpose it on the deviation of core inflation from trend, we get an interesting insight. The trend in US

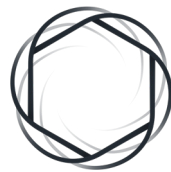
**Fig. 2: Money supply now contracting**



The chart shows the year-on-year broad money supply growth rate in selected advanced economies. The spike during the lockdown, when money increased in bank accounts, and subsequently led to inflation, has been reversed. Now money supply is declining, usually a sign for a weaker economy ahead and lower inflation.

SOURCE: LSEG, WELLERSHOFF & PARTNERS





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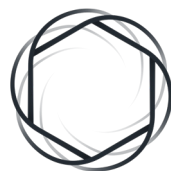
inflation is currently just under three per cent, only slightly above consumers' inflation expectations. As can be seen in that chart, the economic trend clearly has an effect on inflation when taking the one-year lag into account. This means that the latest US economic data suggests that the decline in inflation will become more difficult from now on.

At the same time, there are clearly strong disinflationary forces at work. One of these is the money supply, which is contracting. Figure 2 shows the year-on-year broad money supply growth rate in the US, the UK, Eurozone, Switzerland and Japan. The spike during the lockdown, when money remained unspent in bank accounts, has been reversed. Now, money supply is declining, usually a sign for a weaker economy ahead and lower inflation.

Investors should, therefore, be aware of these countervailing tendencies. Additional complications here for inflation forecasters are the longer-term structural factors which might lead to higher inflation in 2025: costlier supply chains, demographics, labour market shortages and substantial fiscal debt issuance (i.e. fiscal policy working against monetary policy).

We merely wish to highlight that the drivers of post-lockdown inflation is a topic attracting a lot of discussion, meaning that the issue is not settled, and this could impact market pricing positively or negatively in the course of 2024.



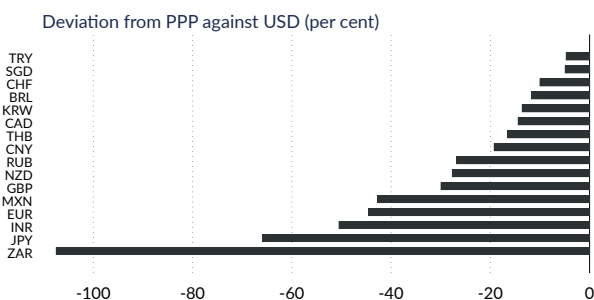
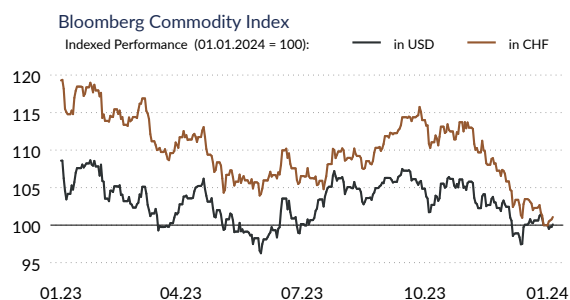
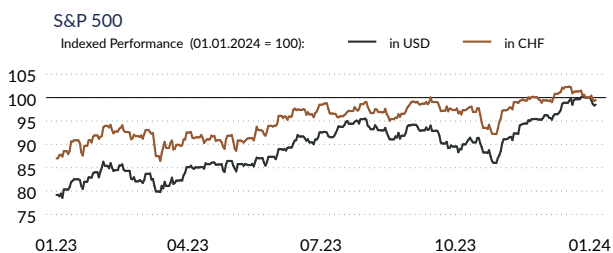
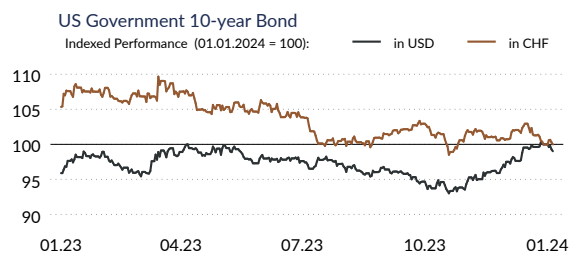


## Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2023E	2024E	2023E	2024E	Q4 2023	y/y 12/2023
<b>USA</b>	1.6	2.4	1.2	3.8	3.4	5.50	-10.1
<b>Eurozone</b>	1.1	0.2	0.8	5.5	3.5	4.00	-9.9
<b>UK</b>	1.7	0.2	0.8	7.0	3.5	5.25	-10.5
<b>Switzerland</b>	1.3	0.5	1.2	1.9	2.0	1.75	-17.7
<b>Japan</b>	1.1	1.8	1.0	3.0	2.0	-0.10	3.9
<b>China</b>	4.5	4.5	4.5	0.5	1.5	4.35	1.3
<b>Brazil</b>	1.4	3.0	1.7	5.0	4.0	11.75	2.2
<b>India</b>	5.0	6.3	6.5	5.3	4.5	6.50	7.4
<b>Russia</b>	1.0	0.8	0.9	5.2	5.0	16.00	17.7
<b>World</b>	3.0	2.9	2.7	6.0	4.8	—	—

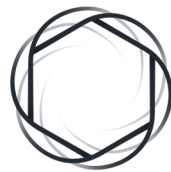
SOURCE: LSEG, WELLERSHOFF & PARTNERS

## Financial Markets



SOURCE: REFINITIV, WELLERSHOFF & PARTNERS



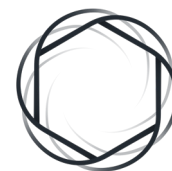


## Global Asset Allocation Preferences – January 2024

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
Fixed Income	++	Segments	US Treasuries and developed market investment-grade credit.	Convertibles, High Yield, Emerging Market debt.	Lower economic growth in 2024, falling inflation, signs of a cooling labour market and a likely pivoting in the Fed and ECB policies, clearly adds attractiveness to core fixed income. We favour US and German sovereigns as we see demand for safe-haven assets rising on lower growth/recession context. Though spreads in both the US and Europe look low, we prefer IG credit in developed markets over high-yield, preferably in non-cyclical sectors. Current IG yields look quite compelling and provide a valuation cushion in a scenario of rising default rates.
		Duration	Medium-term.		

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





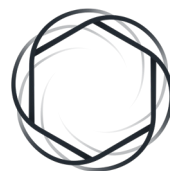
## Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
Equities	–	Markets	US and Japan. Selective in Europe. India long-term	Latin America	<p>The cyclical positioning of the global economy is uncertain. Global growth will slow in 2024 and in particular in the US compared to 2023. Equity multiples are demanding in the US and seem to be pricing a soft landing. The outlook on corporate earnings is pretty unsteady, clearly adding downside risk to the asset class. We see pressure from slowing inflation, higher financial costs and continuing wage growth as drivers for margin compression in 2024. In this context, we prefer less volatile and defensives to cyclicals. Broadly, investors need to reinforce the bottom-up approach and look for high quality companies in a selective exercise.</p> <p>Europe: the macro backdrop is deteriorating and decoupling from the US. Leading indicators are negative and earnings momentum is not attractive. Valuations look cheap but it is probably too soon to play a recovery that will depend much on the global cycle.</p> <p>We have become more sceptical on Chinese stocks benefiting from a sentiment change any time soon. We do not anticipate bold policy responses or macro improvements. We favour India on more visibility in corporate earnings and the economic cycle. We are positive on Japan because of the still attractive valuations and continuing improvement in corporate RoEs.</p>
		Styles/Sectors	High-quality. Value. Dividend growers. Defensive sectors.	Cyclicals, Consumer Discretionary. Small caps	

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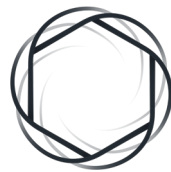


## Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
<b>Alternatives</b>	+		Selected direct real estate, Gold.	REITs	<p>The resumption of the positive correlation between equities and fixed income supports our overweight in Alternatives. Given the strength of the USD and the likely persistence of high rates, we have become less bullish on gold. There are, however, still some good arguments to keep holding gold: hedge against high inflation, currency depreciation, geopolitical risks and central banks' buying activity.</p> <p>High inflation, the energy transition and growing digitisation of the economy remain valid arguments to favour infrastructure as an alternative. Writedowns and defaults are still a threat for real estate. However, a normalisation of rates towards 2H 2024 might start adding some comfort to public REITs.</p>
<b>Cash</b>	+				<p>The direction of the global economy still shows a high degree of uncertainty. With Cash offering &gt; 5.0% yield in USD, we thus maintain an Overweight opinion on the asset class.</p>

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





## Figure of the Month

# –80%

This is the percentage by which the US dollar depreciated against the Swiss franc from 1950 to the end of 2023. At the end of 1950 it cost 4.29 Swiss francs to buy one US dollar. By the end of 2023, it cost just 0.84. While the US dollar is the currency of the world's largest and most liquid capital markets, size did not prevent erosion from inflation. The one investment lesson we can take from history is the value of diversification.

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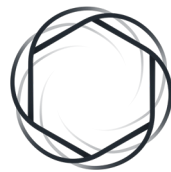
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