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MACRO & MARKETS: GLOBAL & GCC

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Dealing with lifetime highs!

After a disappointing April, May turned out to be a great month for global markets, especially S&P500 that went up by 4.8% to clock a YTD of 10.6%. Japan is up 17% for the year. Like they say, "Lift all boats", all markets and asset classes (equities, gold, bitcoins, etc.) got lifted but the macro backdrop continues to be confused. Index is a misnomer as only a handful of stocks shape the index these days. From Magnificent 7 to Magnificent 5 and now to Magnificent 1 (Nvidia), the stock market stands on just one leg (stock)!

The volatility index (VIX) hovers in a tight band between 12-14 indicating no nervousness in the market. When things are this calm, it should be really worrying! Bond spreads are at their tightest with no premium for extra risk. The flat yield curve is already denying higher return for higher tenor, and spreads also exhibit a similar trajectory. Such tight spreads can result in only one outcome- spread expansion. For e.g., the EM sovereign Bond index is enjoying the same YTM as that of UST 10-year with a spread of 0! We have seen this picture before.

Higher rates should technically result in lower valuation (theory). But higher for longer rates seem to enthuse stock markets across the world so much so that we can count several big markets that are now experiencing lifetime highs. I have never seen such stock market lifetime highs when interest rates remain elevated. There are no precedents to "higher rates and higher valuation" in any of the past Fed hikes going back to 1950's. Something should give in. The question is: How do you deal with lifetime highs of stock markets? Should we play the momentum game, or should we look at asset reallocation, say to fixed income where Aggregate bond index of Bloomberg offers a yield of 5.1%, a far cry from 10-year average of 2.7%. Even if one is inclined to play the equities game (since the party is going strong), should we succumb to the AI, EV's and Quantum computing frenzy that seem to propel the market or we would be better off looking at consumption boom in Asia and Latam?

While the USD strength continues, the fall of Yen is noteworthy. The Yen is now at 157, the lowest in the last 34 years. This is a classic study in macro economics where a developed market currency behaves more like an emerging market currency, thanks to years of experiment to keep rates near zero to spur demand, inflation, and bank lending. Not sure if those outcomes were achieved, but most of the Japanese investors were certainly keeping their cash outside Japan to earn higher yield. Structurally, the Yen has equilibrium effect with respect to exports and imports. The economy relies heavily on imports for consumption, while Japanese companies are major exporters worldwide. In this backdrop, it is surprising to see the currency fall from 100 a few years back to nearly 160 now. Where is the equilibrium?

The role of gold is also intriguing. It has reached $2400/oz and is up by 13% for the year. Normally, good performance of gold should happen only during distress times. Right now, many are looking to gold as an inflation hedge as bonds have abandoned that role a long time back. If it is a great inflation hedge, and is also performing well as an asset class, then what should be a fair allocation to gold. Should it be 35% as against 5% now? It is not uncommon to get the allocations wrong. Another example would be MSCI China where negative assessments resulted in active managers reducing their weights from 15% after Covid to about 5% now, but MSCI China rose 30% between January 2024 and May, proving managers wrong.

On the same question of portfolio allocation, the recent study by Schroders on capital market assumptions for the period 2023-2034 (which basically tells one how much to expect going forward from asset classes) is interesting. The amount of additional risk one should take in US equities is disproportionate to the incremental return say with High Yield.

US Asset class	Expected annualized return	Standard Deviation
Cash	2.6%	0%
Government Bonds	3.9%	6.3%
Tips	4.2%	6.2%
IG bonds	4.8%	7.3%
High Yield	5.7%	8.8%
Equities	6.9%	15.4%

Source: Schroders

While a lot of praise has been sung about S&P 500 and Nvidia, a silent unsung performance is that of FTSE 100 which clocked 34% total return during the last three years as against 31% for S&P500. Analysts see FTSE as more balanced with representation from several sectors including consumer staples, healthcare, mining, and energy. The rebound in REITs during May 2024 is also good with FTSE global NAREIT index up by 5% during the month, though negative for the year.

As against this positive performance across the world comes the cautiously negative performance of GCC markets where the S&P GCC composite index is now down 6.4% thanks to a dismal May 2024. While oil prices held steady within a band of &80-85/bbl, the geopolitical uncertainly mainly triggered by Israel-Hamas war is keeping the GCC markets on edge. Also, the higher for longer interest rates is biting the earnings especially for Saudi Arabia. But this is not deterring the pace of reforms and launch of new institutions with the latest being Blackrock that launched a $5 billion multi asset investment firm in Riyadh supported by PIF. The idea is to increase the inflow of

capital into Saudi Arabian capital markets, a welcome step for a region that is mostly seen as providers of capital to the outside world. This will be a good boost to the $30 billion GCC Asset management industry dominated by handful of asset managers. A recent report published by Marmore provides some comprehensive aspects of this growth industry dominated by money market and equity funds.

Among the GCC stock markets, the only bright spot seems to be Kuwait that is enjoying positive performance while Qatar has been under performing with index down by 14% for the year. The under performance of Qatar can be attributed to the sharp fall in natural gas prices. The correlation between natural gas prices and Qatar stock index is close to 0.5. Also, many GCC banks have exposure to Egypt and Turkey, economies that is suffering from sharp currency depreciation due to hyperinflation and macro-economic shocks.

Energy markets are in tight goldilocks with OPEC+ firmly keeping the production cuts in place to defend the price while US shale acts as the swing producer to make sure that oil prices do not go above. While the chatter about energy transition on the back of climate change narrative is still very active, the actual transition away from fossil fuels is still some time away given the slow pace of capex happening in the renewables area. As against the need for $1 trillion of investments annually, the actual spending is close to just $350 billion. Analysts estimate that at this rate of investment, the transition could take at least 50 years! A closer look at this problem resulted in an article that I recently published.

Finally, the fabulous performance of the global stock market must have certainly increased the wealth of many family offices who are now dealing with the question of succession and wealth transfer to the next generation. Studies show that when such transfers happen, money is normally destroyed than preserved and this takes one to the aspect of wealth management with a focus on wealth preservation. An interesting study sort of answered the tricky question of how much money can be transferred from one generation to another. The simplicity and elegance of the formula is really appealing.

- Amount of heritage received (H)
- Number of heirs to split the wealth (Q)
- Return on Investments (i)
- Number of years of accumulation (N)
- Annual affluent's expenditure, as a % of his family income (G)
- Divorce rate among affluents and, therefore, wealth split in the process (D)
- Wealth tax (T)

Considering these variables, the future value that a patriarch will transmit to the second generation of their family will be:

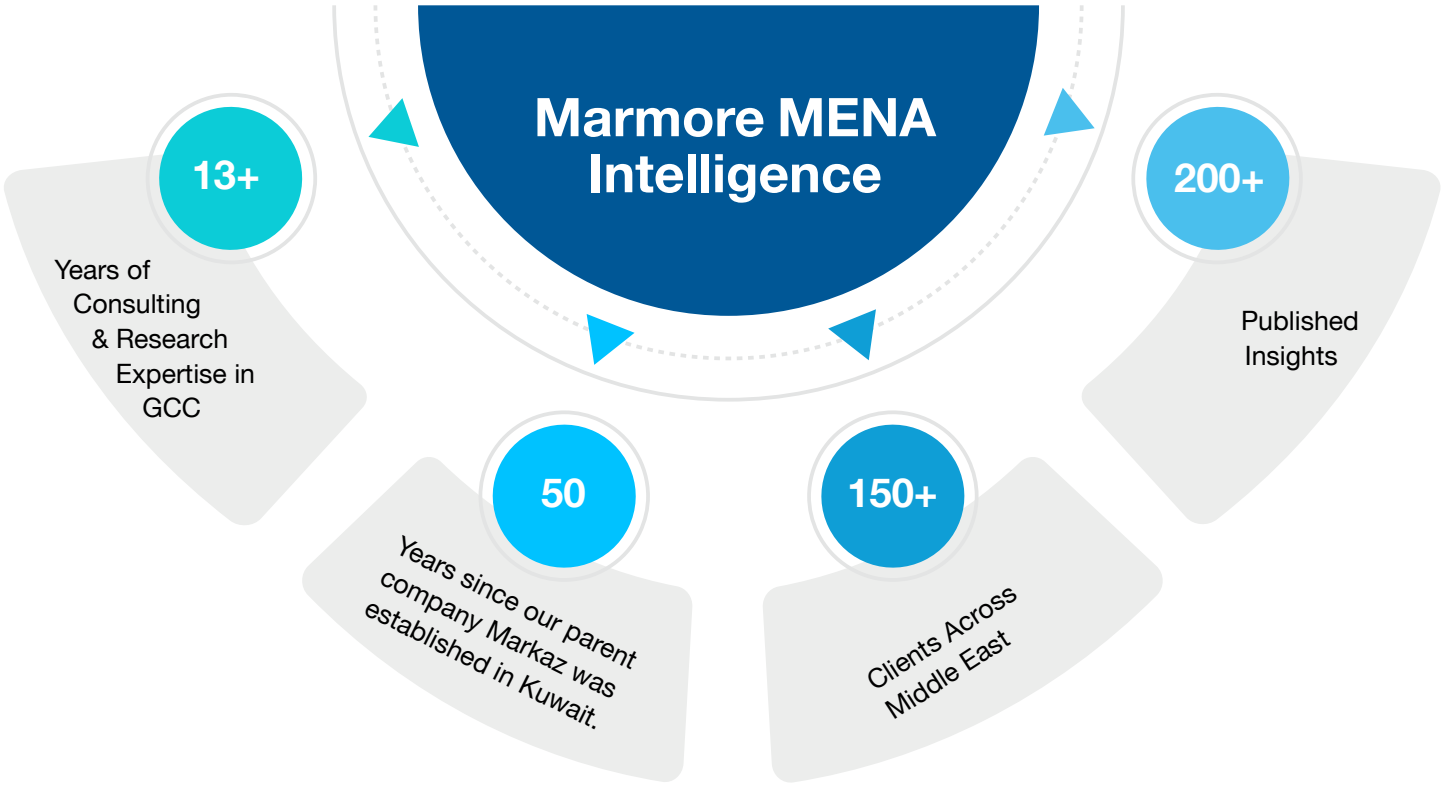
$$FV= [Hx(1+i)N)+((H \times i)x (1-G)/Q)x((1+ i)N-1)/i)]x(1 - T)$$

Equity & Commodities	Close	Returns	
		YTD-24	2023
Global Equities			
Global (MSCI World)	3,445	8.7%	21.8%
USA (S&P 500)	5,278	10.6%	24.2%
Japan (TOPIX)	2,772	17.2%	25.1%
GCC Equities			
GCC (S&P GCC Composite)	138	-6.4%	6.2%
Saudi Arabia (TASI)	11,503	-3.9%	14.2%
Abu Dhabi (FTSE ADX General Index)	8,863	-5.3%	-6.2%
Dubai (DFM General Index)	3,978	-2.0%	21.7%
Kuwait (Boursa Kuwait All Share PR)	7,052	3.4%	-3.1%
Commodities			
Oil (Brent Crude in USD/bbl.)	81.6	5.9%	-10.3%
Gold (in USD/oz.)	2,327	12.8%	13.1%

Fixed Income	Yields	
	May-24	2023-end
U.S. Treasury 10Y Sov.	4.49%	3.87%
Saudi Arabia 10Y Sov.	5.20%	4.39%
Abu Dhabi 10Y Sov.	5.01%	4.32%
Kuwait 10Y Sov.	5.19%	4.34%

Source: Refinitiv, YTD and Yields as of May 31, 2024

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