SIGMA
PRIVATE OFFICE

Q2 2023 MARKET REVIEW AND OUTLOOK

MARKET REVIEW & OUTLOOK

Global equities continued their positive momentum in the second quarter of 2023, with the MSCI World Index rising 13.99% and finishing up 22.28% from last October's bear market lows. The S&P 500, and most other developed market indices are also up over 20% from their lows, crossing the common threshold for the start of a new bull market. Unfortunately, there is no surefire way to know a bull market is underway in its early life, but as John Templeton says, "bull markets are born on pessimism" and investors typically dwell on macroeconomic woes while stocks march higher as they climb the proverbial wall of worry. Where we are today seems to fit that bill; macroeconomic data is mixed, and volatility likely persists from here, but equity markets are not the economy, and they seem to be looking ahead to a brighter future as the recession that many market participants feared does not seem imminent.

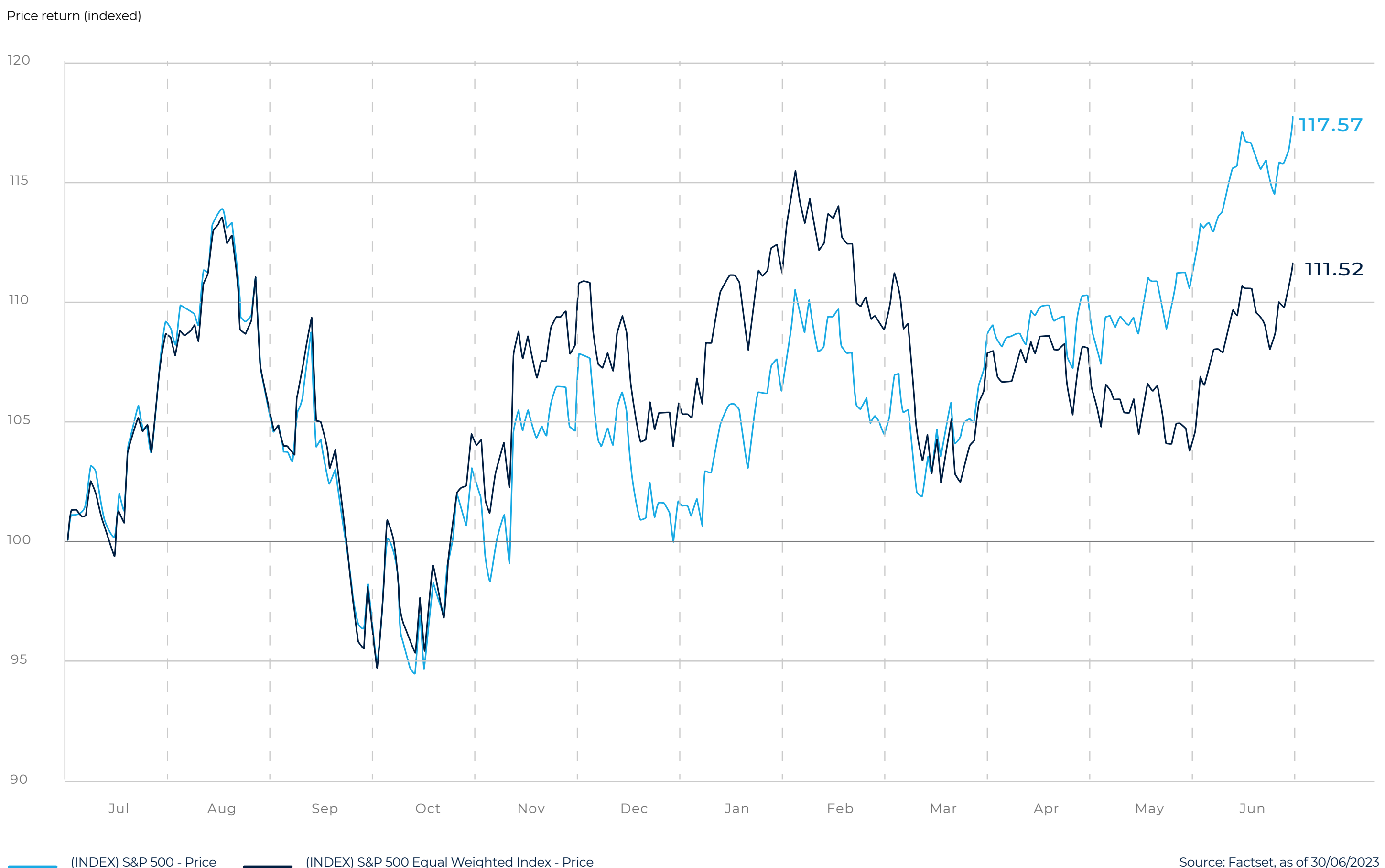
Looking beneath the headline index performance, differences in returns on a stock, sector and market capitalisation level emerged. Artificial Intelligence (AI) driven excitement lifted mega cap tech stocks higher with chipmaker NVIDIA Corporation a notable outperformer, up 189.46% year to date following a blowout Q1 earnings release; they revised up their Q2 revenue guidance to $11bn vs $7.2bn consensus expectations on higher AI related demand. With AI on track to be the biggest boost to economic productivity since the invention of the Internet, we explore the developments, opportunities, and risks later in this document.

Beyond AI, first quarter earnings were a notable bright spot across the board, even if market reactions were relatively muted in general. Heading into earnings season, consensus estimates for the S&P 500 was a 6.7% y/y decline in Earnings per Share (EPS). Although marking a second consecutive quarter of earnings declines, the actual year-over-year EPS decline came in at a much better than feared -2.1%, with 78% of companies beating expectations, above the 10-year average of 73%. Strong Q1 earnings results and guidance highlights corporates' continued resilience in face of greater macroeconomic uncertainty.

Market breadth, a relative measure of advancing compared to declining stocks, came under increasing scrutiny this quarter. Strong gains were largely concentrated in the mega cap growth space with the "Big 5" US stocks (Apple, Microsoft, Alphabet, Amazon and Nvidia) accounting for over half the S&P 500 realised gains year to date. Many other companies failed to keep up with the broader index, explaining the divergence of returns we see in Chart 1 between the S&P 500 Market Capitalisation vs the Equal Weighted Index. However, unlike early bull markets, which typically feature wide market breadth, historically narrow breadth itself has not been a precursor to equity market weakness. Concerns around weak market breadth also eased towards quarter end as AI excitement moderated, soft-landing expectations picked up and the debt ceiling overhang lifted, helping broaden the market rally to small and mid-cap stocks.

CHART 1

S&P 500 MARKET CAP WEIGHTED INDEX OUTPERFORMING EQUAL WEIGHTED INDEX YTD



Source: Factset, as of 30/06/2023

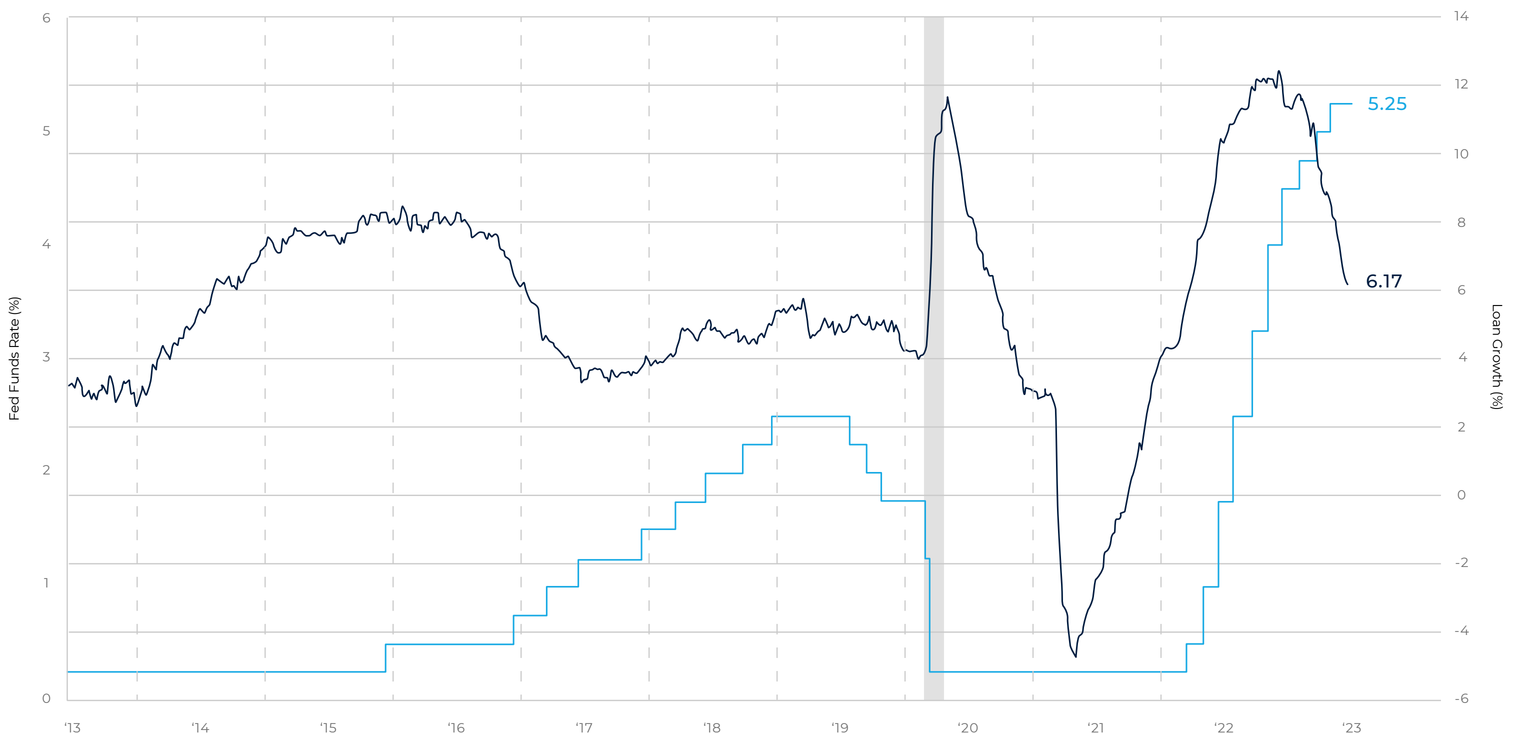
Fixed income markets have had a choppier first half year than equities, with the Bloomberg Global Aggregate Bond Index up 2.71%, as they continue to digest changing expectations for inflation and interest rates. Across the developed world, short term yields are being pushed up by ongoing monetary policy tightening while longer-dated yields are being pulled down by slower growth and cooling inflation expectations. Volatility in fixed income will likely persist until it becomes more evident that the inflation battle is behind us and policymakers are done raising rates. However, with 5 Year Treasury rates at 4.13% investors have flocked into bonds to lock in attractive yields and bullish bond sentiment is becoming a strong consensus trade. In fact, JP Morgan's Treasury Investor Sentiment Survey shows the largest net long positioning among all clients since 2010. Just like overly bullish sentiment in equities is a contrarian indicator, we should be mindful if similar dynamics develop in the bond market.

The quarter wasn't without its headwinds, and we couldn't review it without touching on the US debt ceiling debacle and the banking sector turmoil. For those unfamiliar with the matter, the debt ceiling is the maximum amount the US government can borrow by issuing bonds and once reached the US Treasury Department must resort to other means to meet its obligations, or otherwise risk defaulting on its debt. The debt limit was hit back in early January, with the Treasury expecting to run out of cash by a 5th June X date.

The mere thought of a potential US government default, with its coveted AAA rating, is of course worrying to investors and typically comes with the "necessary" market volatility. This year was no different. Uncertainty around whether Congress would agree to lift the debt ceiling prior to the X date brought into question the sustainability of the equity market rally, with many investors fearing a repeat of 2011, during which equities sank, the dollar sold off and bonds rallied. However, the debt ceiling drama perhaps isn't as uncommon as some might think; since WWII the debt ceiling has been raised or suspended 102 times and this year proved to be just like all other recent past instances whereby policymakers eventually found a compromise, suspending the debt limit through January 2025, and market volatility was ultimately short-lived.

As for an update on the banking sector, our last quarterly market review covered the topic in detail and concluded that the most likely outcome would be a containment of contagion risks as confidence was restored but tighter lending conditions would prevail presenting a downside risk to global economic growth as loan growth slowed. Three months on from the collapse of Silicon Valley Bank and it seems just that has transpired. Following significant deposit outflows, especially at regional banks in the immediate aftermath, bank deposit balances are back to their March 22nd levels following weeks of net inflows. Furthermore, the KBW Nasdaq Regional Bank Index has rebounded 12.60% off its early May lows, signalling confidence has improved as of late. However, recent loan officer surveys point to tightening lending standards and weaker demand across all loan categories as year-over-year loan growth in the US slowed from close to 12% at the end of 2022 to 6.17% at the end of June as seen in Chart 2. Nonetheless, the impact was still better than feared.

CHART 2
US LOAN GROWTH IS SLOWING BUT REMAINS HEALTHY



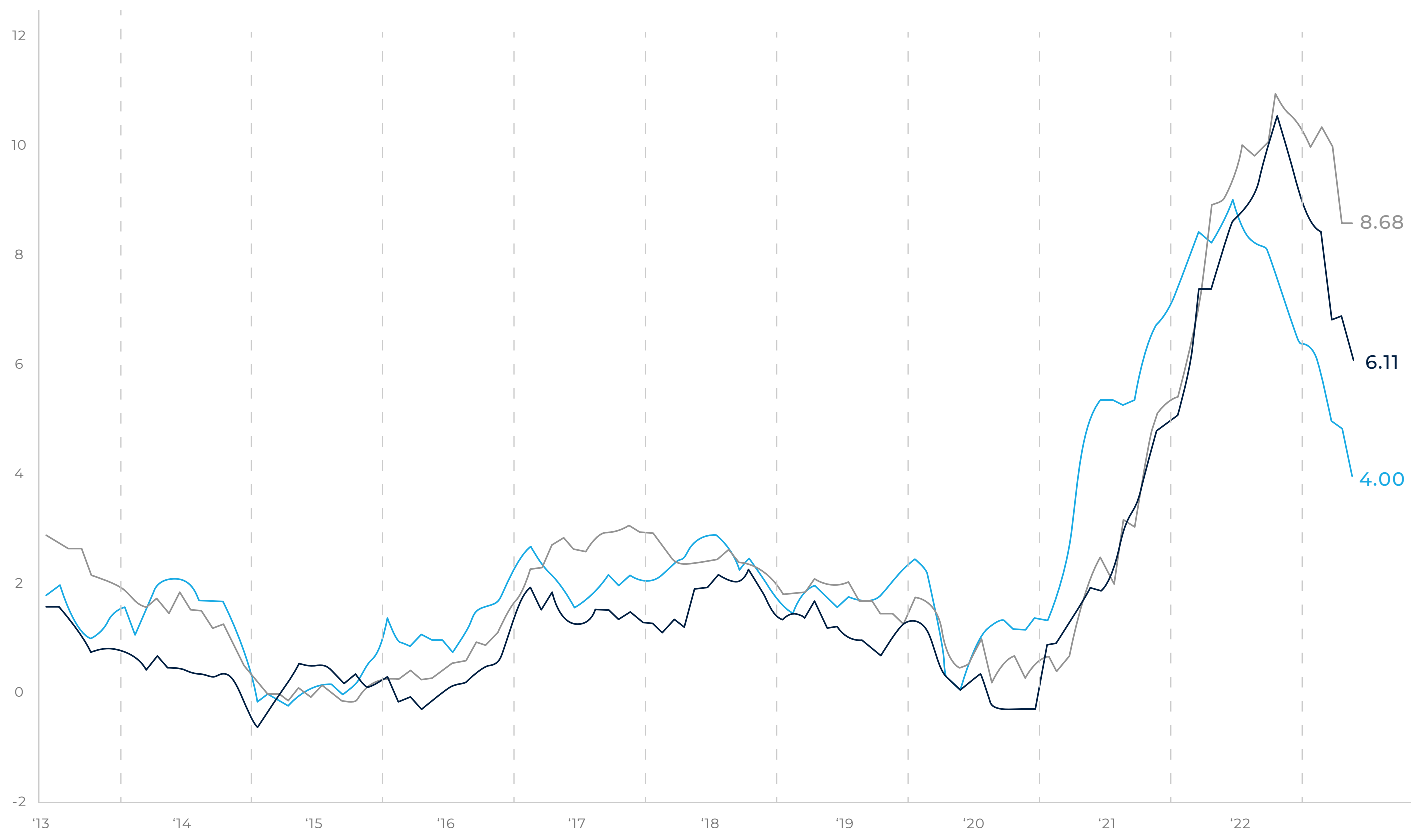
Source: Factset, as of 30/06/2023

The additional tightening of credit conditions following the banking sector turmoil somewhat complicates the Federal Reserve's (the Fed) task of determining the appropriately restrictive level of monetary policy. To add to the complexity, monetary policy works with "long and variable lags" increasing the risk that by the time the policy action shows up in the economic data, economies are already irreversibly sliding into recession. As such the Fed are faced with leading the US economy down a narrow path of slow, but mostly non-recessionary, economic growth and gradually normalising inflation to orchestrate a "soft landing." So far, they seem to be on track and the decision to hold interest rates at current levels for the first time in 11 meetings, at the June 14th FOMC Meeting, suggests the Fed are nearing the end of their rate hiking cycle. They did continue to stress data dependency and the path of policy rates from here will largely depend on incoming inflation and employment data.

So, let's look at the data. In the US, the May CPI (Consumer Price Inflation) print came in at 4% y/y, its lowest annual increase in over 2 years. Inflationary forces have clearly moderated substantially since peaking a year ago as shown in Chart 3; goods supply constraints are largely back to pre-pandemic levels, input prices are declining in both manufacturing and services sectors, and leading indicators point to a further slowdown in rent prices. The labour market is the trickier part of the equation with continued wage gains keeping core inflation sticky. Nonetheless, there are signs the US labour market is slowly rebalancing and wage measures are trending lower which should feed through to a more pronounced decline in core inflation going forward. Goldman Sachs are forecasting an inflation rate closer to 3% by year end with 1.6% GDP (Gross Domestic Product) growth. While still too soon for the Fed to declare victory and another one or two rate hikes may still be on the cards, historically equity markets haven't waited for an all-clear sign, staging strong rallies post peak inflation and Fed hawkishness.

Unlike the Fed, the European Central Bank (ECB) proceeded with another 25bps hike at their June meeting, bringing the benchmark rate in the Euro Area to 3.5%. With the annual inflation rate running at 6.1% in May, the ECB likely still has a few more hikes left before they have sufficient ammunition to pause. However, with the Euro Area already in a technical recession (Q4 '22 and Q1 '23 both saw GDP contract by 0.1%) the ECB will need to tread carefully.

CHART 3
INFLATION IN THE DEVELOPED WORLD CONTINUES TO TREND LOWER



Turning to the UK, the May CPI print read 8.7% y/y, unchanged from April and seemingly failing to gain any real disinflationary traction. Like in the US, the tight labour market and subsequently strong wage growth has been a significant headwind for the UK but there are some promising takeaways from the US's progress so far and the UK should also benefit from the same disinflationary trends going forward. With that said, the Bank of England surprised markets with a 50bps interest rate hike on June 22nd, accelerating the pace from previous meetings and acknowledging they are lagging the curve in their inflationary battle. Market pricing for higher rates in the UK was the driving force behind Sterling's push higher peaking at 1.28 GBP/USD this quarter.

Whilst most developed world Central Banks are tightening monetary policy and fiscal stimulus, China is a different story. Without an inflation problem and with economic growth slowing, the People's Bank of China are cutting rates to ease credit conditions and proposing fiscal stimulus plans to bolster the Chinese economy. The post-covid recovery, although strong initially, has lost some of its steam recently with economic data releases missing expectations and sparking some concern.

Ultimately, the above-mentioned fears are all good examples of bricks in the wall of worry. Whether it is concerns about slowing global growth leading to Saudi oil production cuts, liquidity fears as the US Treasury issues bonds to build back their cash reserve or the AAII (American Association of Individual Investors) Bull-Bear spread signalling the highest levels of bullish sentiment since November 2021, the fact remains that economic data and earnings continue to surprise to the upside and the most anticipated global recession in history keeps getting pushed back. Furthermore, there are early signs economic data is starting to bottom out, but investor sentiment remains overly pessimistic suggesting a new bull market increasingly seems underway. Of course, downside risks remain and further fallout from the banking turmoil or upside shocks to inflation and interest rates could raise recession odds, but neither seems likely now and both lack surprise power.

Regardless of where markets move from here in the short term, they are efficient, forward looking and cannot be timed. As such, long term investors should remain invested at their strategic asset allocation to avoid any disappointments; in the last 11 bear markets, after stocks rallied back 20%, the S&P 500 was up on average another 22% over the next year. After a year of painful declines across equities and bonds in 2022, capturing the upside that ensues remains vital to achieving your long-term investment goals.

> "The fact remains that economic data and earnings continue to surprise to the upside and the most anticipated global recession in history keeps getting pushed back."

FROM DATA TO DOLLARS: HOW AI AND BIG DATA ARE DRIVING FINANCIAL GROWTH

It is no secret that Artificial Intelligence (AI) is a hot topic these days. Generative AI (GenAI) rides on the back of advanced machine learning algorithms that power AI systems to understand, learn, and generate content in an incredibly human-like fashion. Everyone, from researchers to market analysts, are talking about its potential impacts on the world. As such, AI is not a mere buzzword anymore; it is an engine of growth that is reshaping industries and economies worldwide.

With global GDP surpassing a staggering $95 trillion in 2022, even incremental shifts facilitated by GenAI can have profound effects. According to Goldman Sachs, AI has the potential to contribute up to $15.7 trillion to the global economy by 2030. Studies by PwC & McKinsey echo this view, projecting an almost equal addition to the global economy by 2030 ranging from $13 trillion to $16 trillion. The Goldman Sachs study goes on to suggest that AI technologies could potentially increase global GDP by up to 14% by 2030, with the largest gains expected in China and North America, shown in Chart 4, as countries undergo transformative changes through effective integration and utilisation of GenAI.

CHART 4
THE POTENTIAL IMPACT OF AI ADOPTION ON GDP GROWTH DIFFERS ACROSS REGIONS

Regions	GDP Growth due to AI in %	GDP Growth due to AI in trillion U.S. Dollars
China	26.1	7
North America	14.5	3.7
Northern Europe	9.9	1.8
Southern Europe	11.5	0.7
Developed Asia	10.4	0.9
Latin America	5.4	0.5
Rest of World	5.6	1.2

Source: statisa.com

REVOLUTIONISING KEY SECTORS

The integration of AI and Big Data is set to become a powerful force for economic growth, driving innovation and productivity across various sectors. This contribution is expected to come from two primary sources: productivity gains and consumption-side effects. Productivity would increase as businesses automate processes and augment their labour with AI technologies, leading to cost savings and efficiency gains. On the consumption side, the increased use of AI products and services leads to an enhanced user experience thereby driving demand and consumption. Furthermore, Goldman Sachs emphasizes that AI and Big Data are reshaping various sectors, including healthcare, finance, and transportation. In healthcare, AI can help diagnose diseases more accurately, develop personalised treatment plans, and predict health outcomes. Diagnostic errors in the US alone cost a jaw-dropping $38 billion annually and play a role in about 10% of patient deaths each year; imagine a system where GenAI boosts productivity by freeing up doctors to see more patients but also enhance human intelligence by offering crucial insights that could slip through the cracks with human analysis alone.

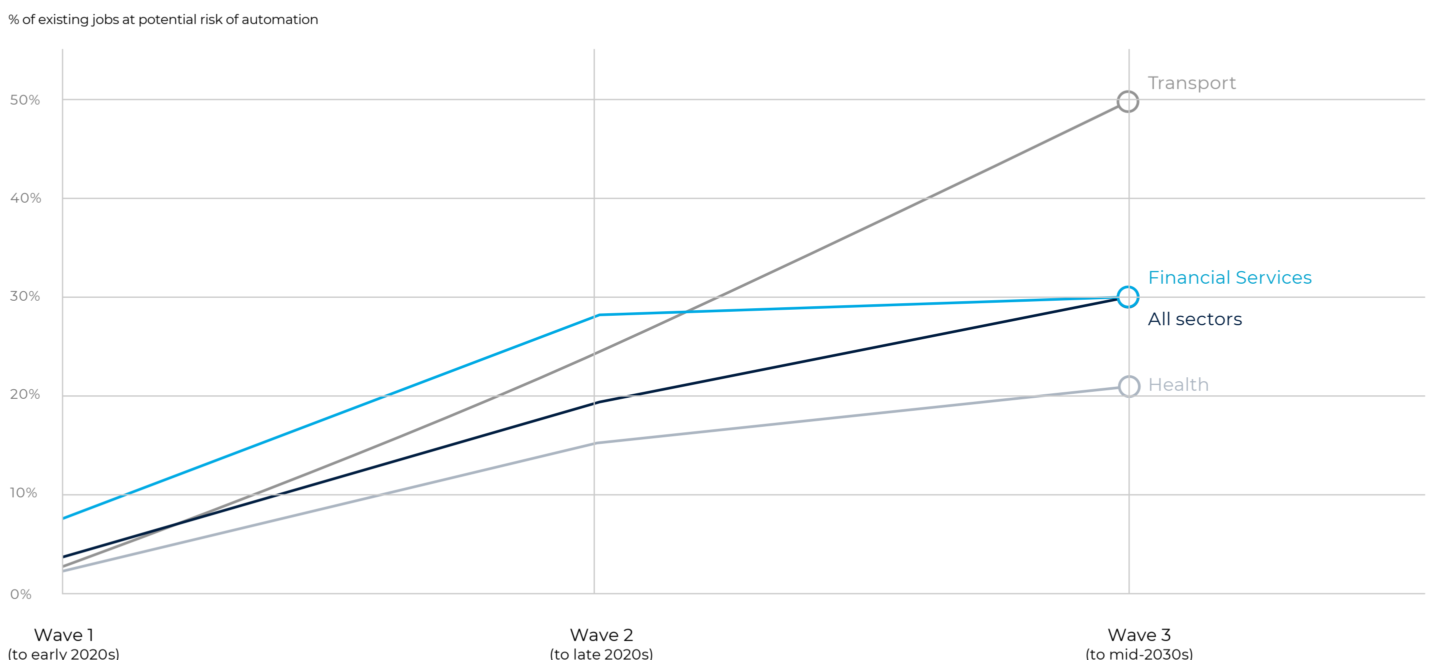
In finance, AI is transforming the way financial institutions manage risk, detect fraud, and serve customers, while in transportation, AI is at the forefront of self-driving technology. Furthermore, AI is proving to be a game-changer in the realm of cybersecurity. It helps in predicting and identifying potential threats and cyber-attacks using machine learning algorithms. It is also used in developing proactive security measures, swiftly identifying vulnerabilities, and responding to breaches in real-time. However, this powerful technology also presents a significant challenge. Sophisticated hackers are leveraging AI to launch more advanced and hard-to-detect attacks. They are using AI to automate their attacks, making them faster, more widespread, and much more effective. This dual-edged sword of AI in cybersecurity highlights the need for robust and intelligent security measures.

AI'S ANSWER TO A SHRINKING WORKFORCE

In the Western World and China, the potential shortfall in the workforce, caused by reduced birth rates and an ageing population, are a looming economic challenge. However, AI, with its ability to automate tasks and make intelligent decisions, offers a promising solution to global employment markets.

Goldman Sachs economists, Briggs and Kodnani suggest that advancements in new AI systems could expose the equivalent of 300 million full-time jobs to automation while Chart 5 shows PWC's estimation of the percentage of existing jobs at potential risk of automation. But the automation will not necessarily translate into job losses as most jobs are only partially exposed to automation, suggesting that AI will likely complement rather than substitute existing roles.

CHART 5
SOME SECTORS FACE HIGHER RISK OF JOB DISPLACEMENT



Source: PwC estimates based on OECD PIAAC data (median values for 29 countries)

Furthermore, historically the jobs displaced by automation have been balanced out by the creation of new roles. A report by the World Economic Forum suggests that while 85 million jobs may be displaced by the shift towards AI and automation, an estimated 97 million new roles could be born, more attuned to the fresh division of labour between humans, machines, and algorithms. Technological innovations have been the primary drivers for long-term employment growth; think webpage designers, software developers, and digital marketing professionals are all products of information technology innovations. According to a study by economist David Autor, 60% of today's workers are in occupations that didn't exist in 1940. This suggests that over 85% of employment growth in the last 80 years is attributed to the creation of new roles driven by technology.

However, the exponential growth of AI also poses several challenges. Issues such as data privacy, job displacement, and the ethical use of AI are at the forefront of discussions. It is crucial that regulatory frameworks evolve alongside these technological advancements to address these concerns and ensure that the benefits of AI are realized in a sustainable and inclusive manner. Furthermore, businesses and governments must work together to ensure growth is equitable and does not exacerbate existing inequalities.

While the influence of GenAI on the world economy and society may still be largely uncharted territory, there are clear signs the impact could be profound. With its ability to automate, innovate, and enhance, AI, combined with Big Data, holds immense potential for future growth. It is a powerful combination that is set to redefine the world as we know it, reshaping our economies and societies in the process.

Thank you for taking time to read our Market Review.

Sigma Investment Committee

This document is distributed by Sigma Private Office which is a trading name of Sigma Capital Partners MENA Limited who are regulated by the DFSA. The content of this document is for general information purposes only and does not constitute the offering of advice or recommendation to invest. Statements contained in this document may be considered forward looking statements. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described because of various factors. The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance and should not be relied upon as an indication of future results.