Asas Capital

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Everything Everywhere All at Once!

April 2023

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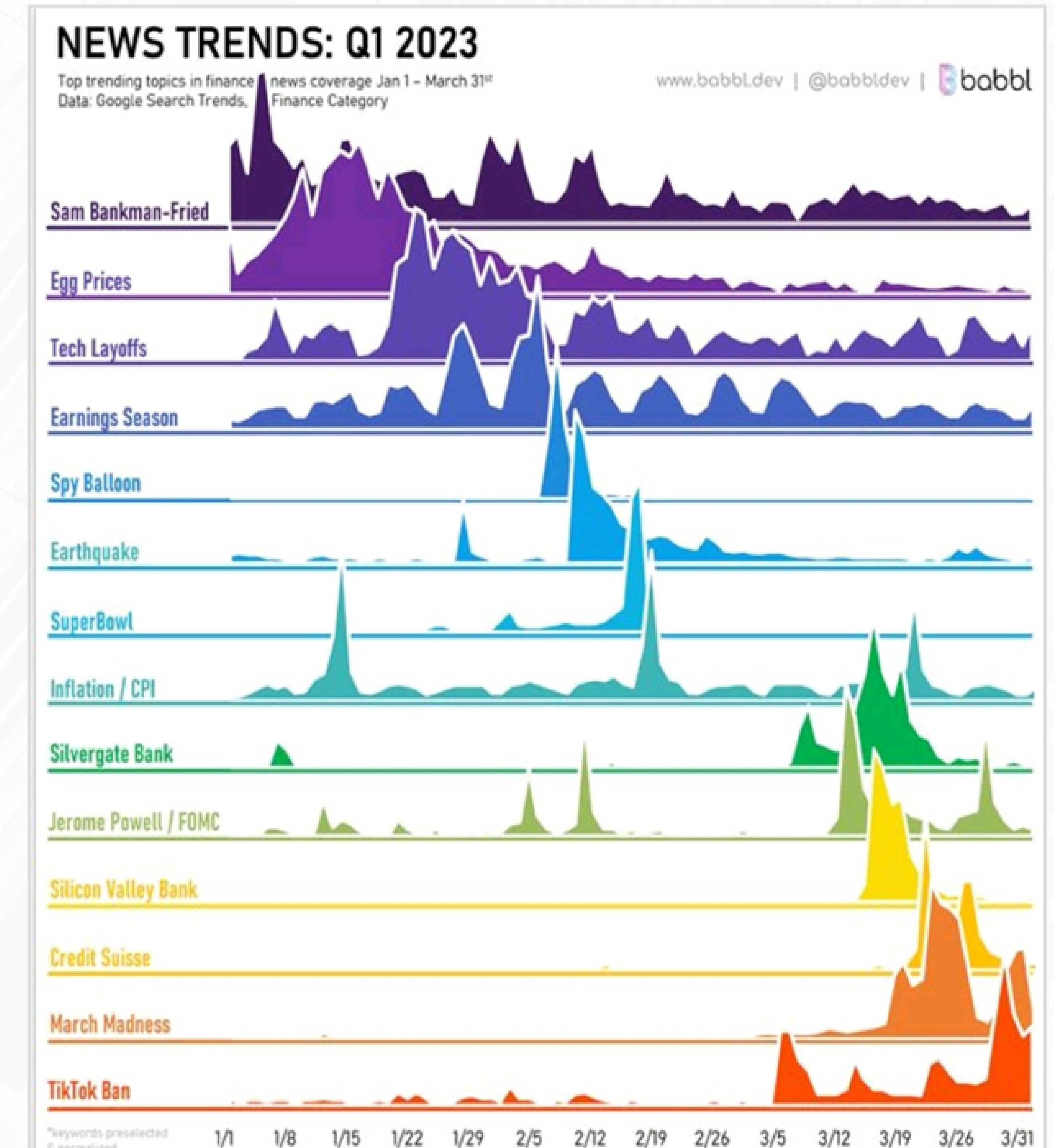
CIO Speaks

There could hardly be a more appropriate description for the first quarter of 2023 than the title of the movie that won this year's Academy Award for Best Picture. It felt like some significant economic shift was happening every time you blinked – **a rate hike, a collapsing bank, or a surge in the crypto sphere.**

Rather than take you through a long list of economically important events, attached is the picture showing the top trending topics in financial markets through the quarter.

Interestingly, some other potentially significant developments – **such as the reopening of China, the initiatives from various countries to move away from the US Dollar, the geopolitical realignments in West Asia** – don't seem to have caught the popular imagination so far.

In our 2023 Outlook, we had expressed the view that the consensus expectation of a weak first half and a robust second half is unlikely to play out. The market's performance so far has validated our assessment.



CIO Speaks

On March 31st, stocks capped a first-quarter rally that saw the **Nasdaq gain more than 16% while the S&P 500 rose 7% as investors shook off a bank crisis and more interest rate hikes** from the Fed. All 11 sectors in the S&P 500 were higher amid the broad-based rally to cap the week, month, and quarter. Markets seemed to have entered a time warp — where last year's losers were this year's winners, and vice versa. Tech stocks brought the FAANG vibes from 2021 and before, while Energy was a loser.

Bonds have also performed well after a disastrous 2022, albeit with a volatility that is unprecedented in recent memory. **The S&P 500 Bond Index is up 3.48% through the quarter**. A look at the underlying data shows some interesting nuances. The margin by which the Nasdaq 100 outperformed the S&P 500 was at its highest level in the last 20 years, except for the post-pandemic period.

The dispersion in performance, both within the S&P 500 and the Nasdaq 100, was huge.

CIO Speaks

Most of the performance of the Nasdaq-100 – as much as 88% - came from only 10 stocks

S&P 500: Market Cap Change YTD

USD Billions

2,000
1,500
1,000
500
-
(500)

+1.8T
-21B

Top 15 Largest Stocks
The Remaining Part of the Index

Source: Tavi Costa
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THE TOP 10 NASDAQ 100 STOCKS IN 2023 ACCOUNT FOR 88% OF GAINS

AAPL MSFT META AMZN GOOGL AMD NVDA TSLA ASML AVGO ABNB BKNG INTC ADI SGEN FTNT WBD CDNS INTU LRCX REGN GFS MU CMCSA SNPS ADBE MELI QCOM TXN WDAY ALGN NXPI TMUS TEAM FISV ANSS ODFL AZN MAR COST IDXX CRWD ADSK AMAT NFLX PANW ATVI VRTX KLAC CSCO MCHP CPRT

SOURCE: YAHOO FINANCE

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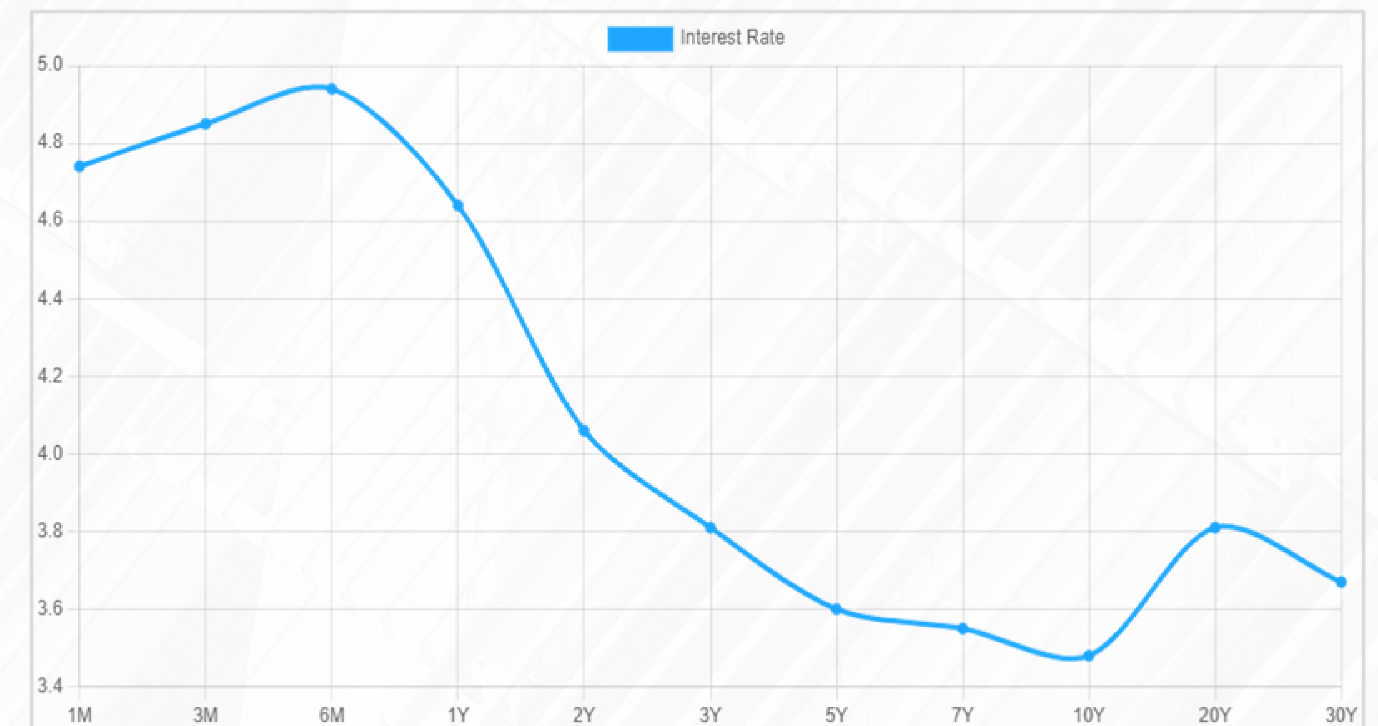
Ok, so what now?

In the short term, there are a few tailwinds that could boost the major indices further. Investor sentiment is skewing bearish, which is usually complementary to bulls in a contrarian fashion. **And even with recent gains, the best-performing index, the Nasdaq 100, isn't yet overbought according to market technical.** The increase in liquidity accompanying the rescue efforts for the collapsed banks is also being seen as a factor.

We had projected the possibility of a short-term rally in our previous newsletters towards 4150 on the S&P 500. We believe that this momentum is still in place and a further move towards 4250 or so is likely.



At its meeting on March 22nd the Federal Reserve took the benchmark rate a quarter percentage point higher to a range between 4.75%-5%. The so-called dot plot, which the Fed uses to signal its outlook for the path of interest rates, indicates that most officials expect only one more rate hike by the end of this year with the terminal rate at 5.1%. In his Press Conference, Powell categorically stated that a rate cut in 2023 is not part of his 'baseline scenario'. **For 2024, the rate-setting Federal Open Market Committee projected that rates would fall to 4.3%.**

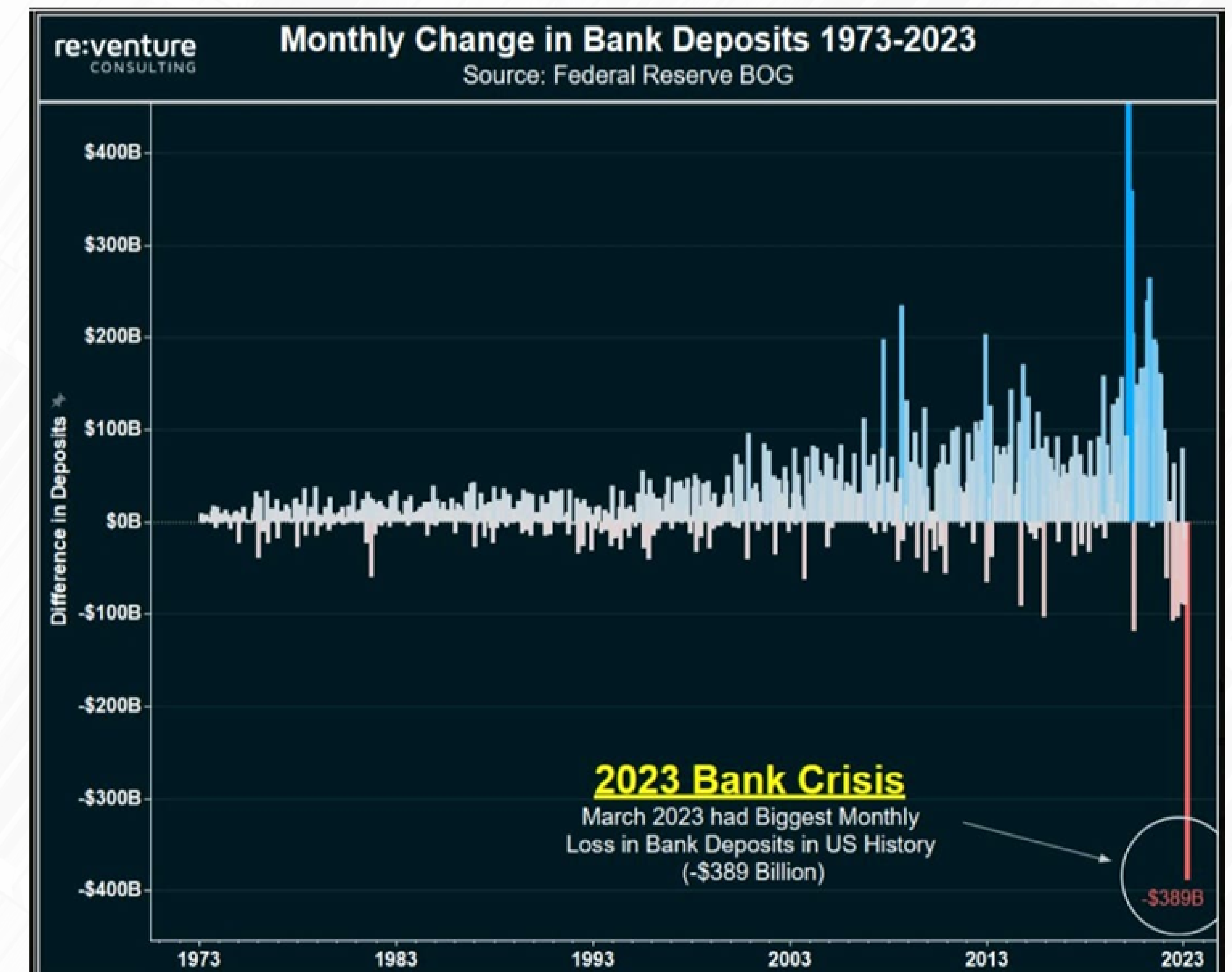
The market has a different view. As of March 31st, the US Dollar yield curve was as in the chart, signaling that the fixed income market expects rates to peak around May or June and then start declining relatively sharply

CIO Speaks

What's causing this divergence in expectations?
We are of the view that the bond market believes that the Fed will be forced to revise its tightening bias due to a significant weakness in the economy. Possible triggers for this weakness include continued problems in the banking sector, tightening of credit conditions and an increase in unemployment beyond current expectations.

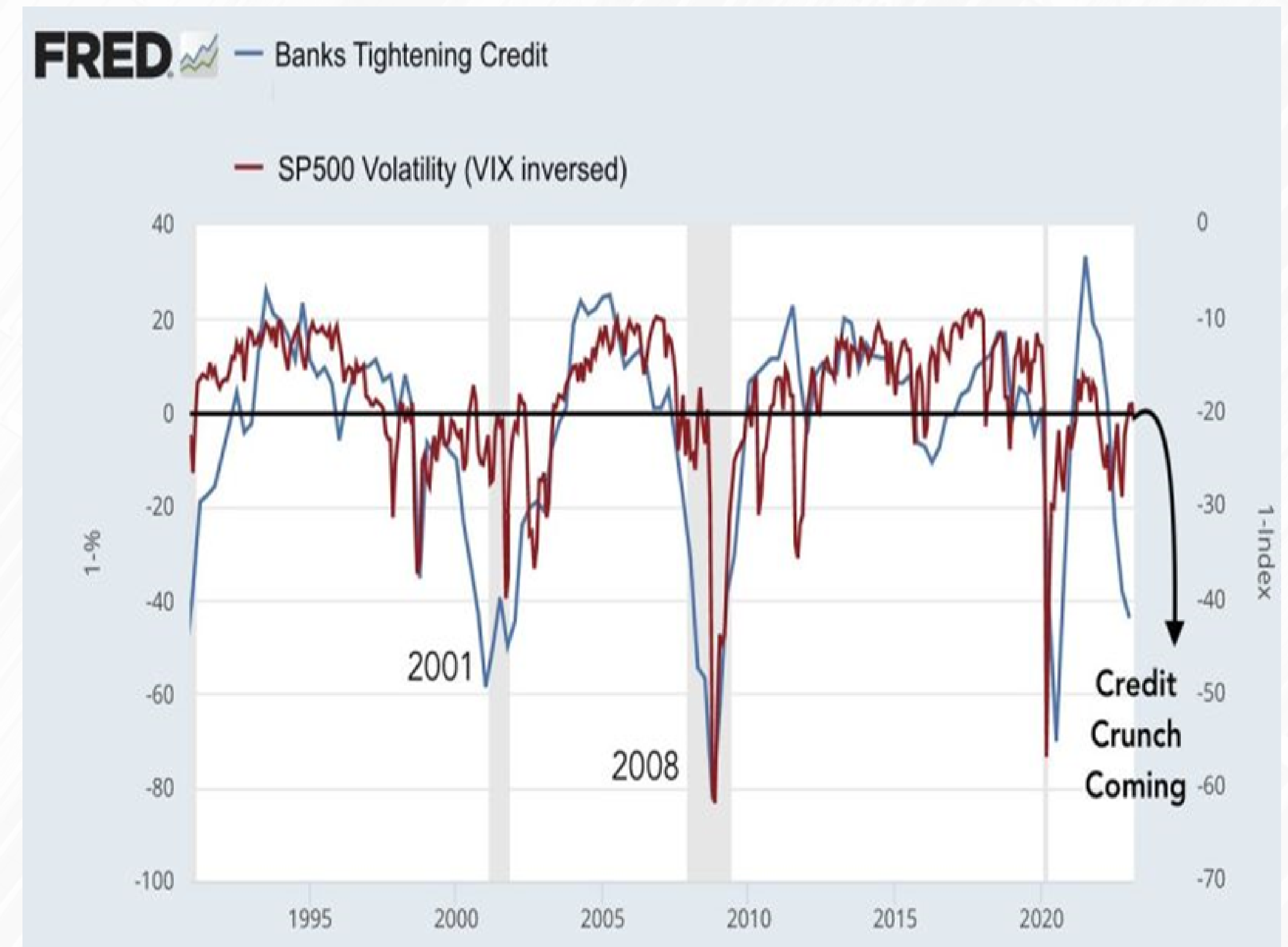
Small regional banks are a potential weak spot. The abrupt closure of three banks in quick succession is forcing them to further tighten their lending standards in order to minimize risks. At the same time, customers are moving their deposits to larger and safer banks and more lucrative avenues such as money market funds. The chart shows the sharp uptick in investments in that space over the last few weeks.

At the very least, this will compel smaller banks to offer higher deposit pricing, thus eating into their profitability. This twin pressure on liquidity and profits, combined with the requirement of higher investments in technology, is likely to force these banks into M&A activity in a meaningful way.



CIO Speaks

A consequence of this reduction in credit appetite is likely to be pressure on the broader economy as weaker players are likely to be denied access to credit – a factor that does not seem to have been priced into the equity markets. The Commercial Real Estate sector seems particularly vulnerable. **Small regional banks account for almost 70% of lending to this sector, and more than a trillion USD of loans are due for refinancing this year.**

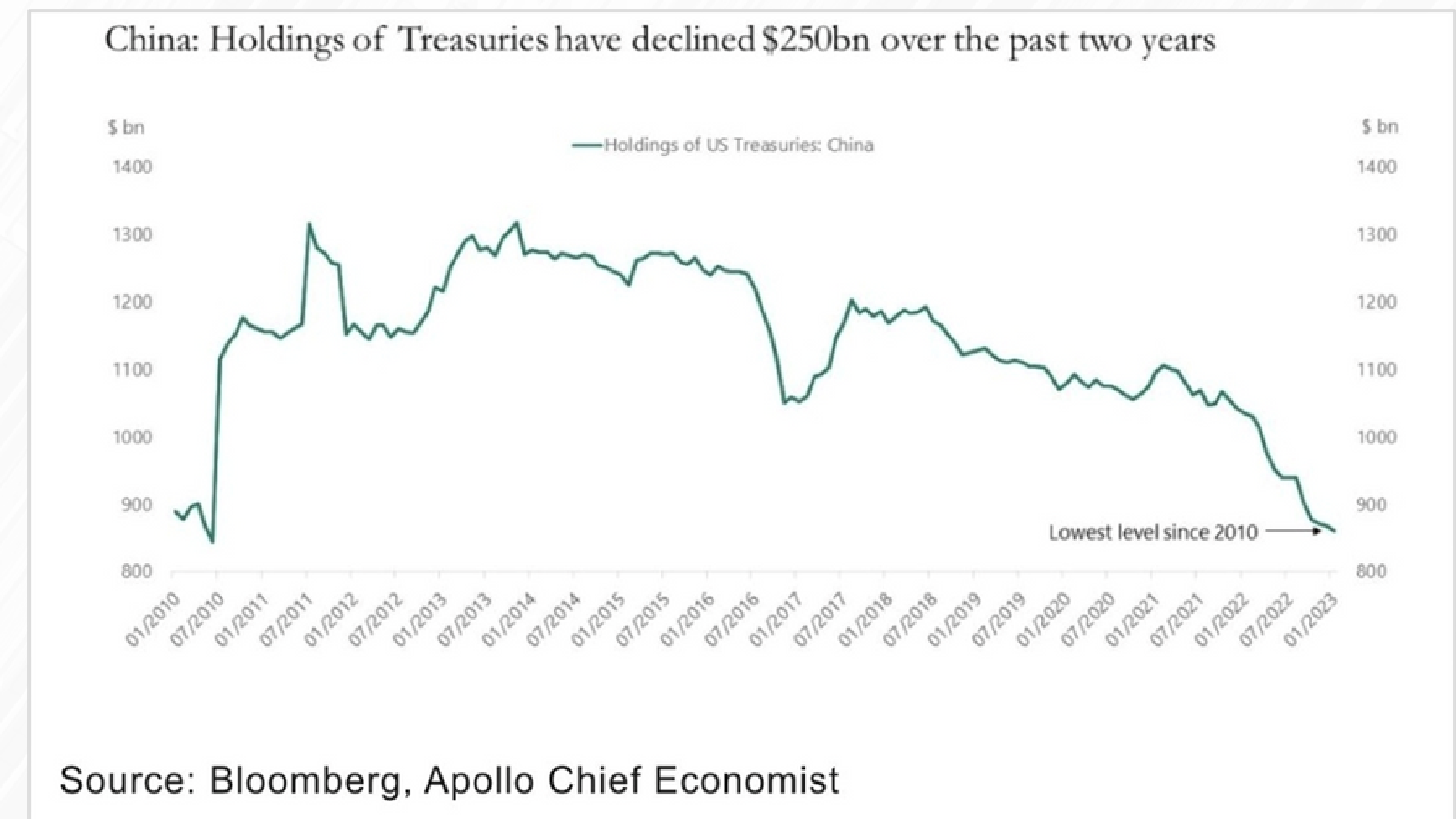


On balance, we believe that the economy will slow meaningfully in the latter part of the year. **On equities, we continue with our call to be overweight defensive sectors like Healthcare, Staples and Utilities and underweight Consumer Discretionary and Technology Hardware.** The ongoing rally should provide an opportunity to underweight high-growth names. **On fixed income also, we continue to favor high-quality investment grade bonds of intermediate duration.** The GCC can provide some good diversifiers in this context.

The current weakness in energy stocks is also a buying opportunity in our view for medium term investors. **The announcement over the weekend from OPEC to cut production by 1.16 barrels per day lends further support to this assessment.**

CIO Speaks

Outside the US, we had expressed the view several months ago that forces to reduce global dependence on the US Dollar are gathering momentum. **Russia, Brazil, India, China and South Africa have now confirmed that they are developing a new currency to rival the U.S. Dollar.** These countries, along with members of the Shanghai Cooperation Organization ("SCO"), have expressed plans for a 'roadmap for the gradual increase in the share of national currencies in mutual settlements' and 'ramp up coordination on energy exploration and policy'.
Perhaps unsurprisingly given the above, China has been steadily reducing the holding of US Treasuries in its reserves. Current levels are the lowest since 2010.

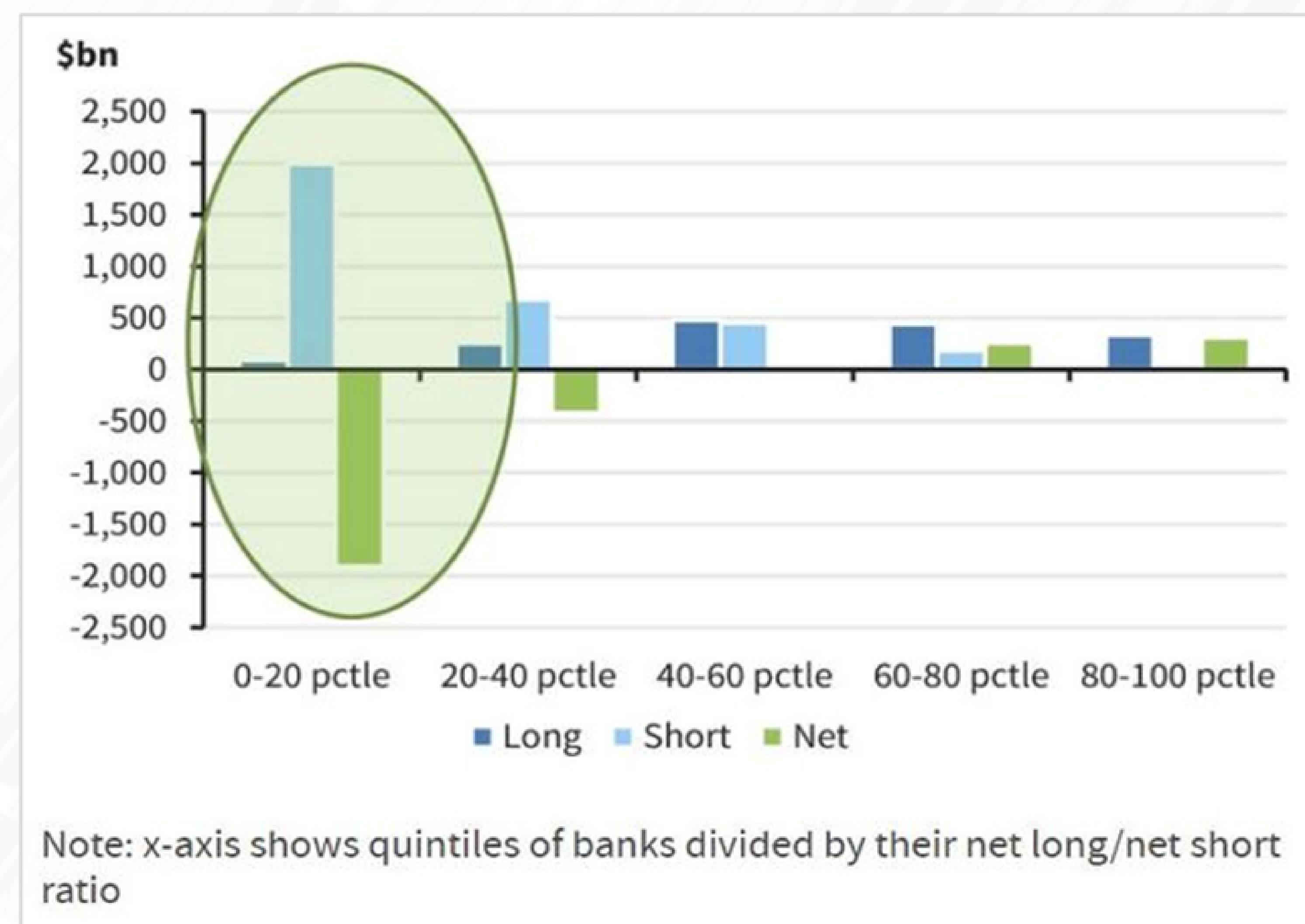


We do not expect the transition to be an overnight success, but the direction seems clear. Investors would be well advised to pay close attention to diversification in their portfolios

U.S. banks imperiled with high real estate lending & unhedged rising rates

- There is a stark divide among US regional banks when it comes to hedging of Treasury portfolios, one-fifth (0-20 percentile) of banks accounted for the large short duration exposure across the industry.
- US regional Small/medium banks accounts for
  - 50% of US commercial and industrial lending,
  - 60% of residential real estate lending,
  - 80% of commercial real estate lending, and
  - 45% of consumer lending
- Outsized exposure to office loans could become the next group to face strains after bank failures roiled financial markets this month
- Deposits at US banks fell sharply, and lending declined by the most in nearly two years amid financial turmoil triggered by the collapse of several banks due to not hedging the rising rates

Large net short duration exposure in swaps is concentrated in a subset of banks



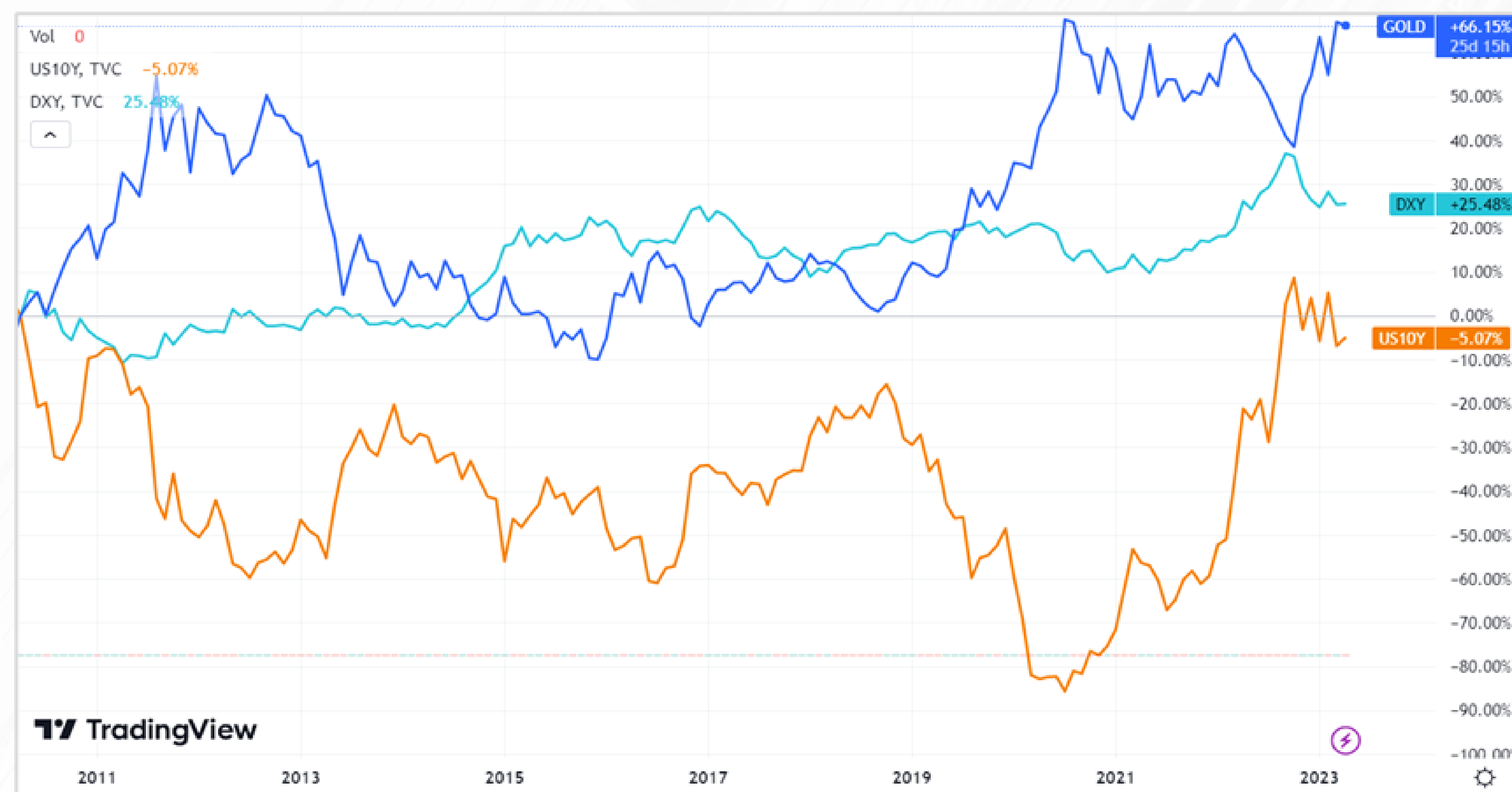
Source : Barclays Research

Is banking meltdown a ‘headwind’ for the economy or recession-causing ‘hurricane’ ?

Gold benefiting from the turmoil in financial markets

- The turmoil in the banking industry has triggered fears of another financial crisis and expectations of a rapid reversal in monetary policy, which is weighing on the US dollar and US bond yields. **Gold and silver prices have rallied as a result**
- Another **driver for an increased interest in gold,** is the expected reduction in prominence of dollar as a store of value

Relationship between Gold, Dollar index and real interest rates



Source : Trading view

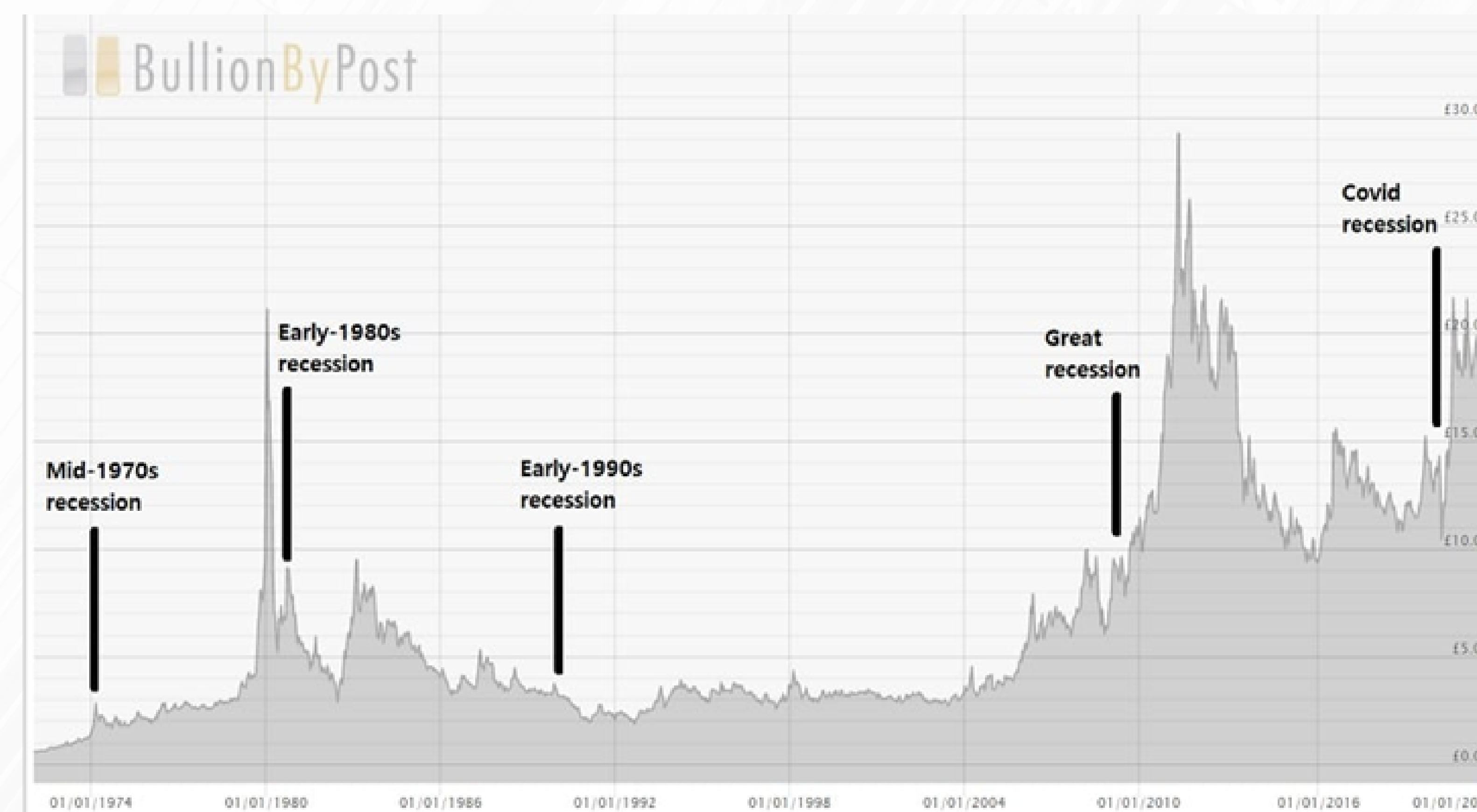
In an environment where real yields are expected to drop, should we not increase the allocation to gold?

Silver : Correlation with gold and impact of changing economic conditions

- **Price of silver moves due to two reasons** : silver being a store of value (44%) and silver being used in industrial development (56%)

- Based on history and silver price movement in the last 30 years, we are of the view that silver moves more due to economic and industrial movement vs store of value

- Since, we are in an economic slowdown, we believe that Silver has reached its peak and it will take some time for industrial expansion to pick up



Silver demand by segment

	Tonnes (%)
Investment	16563 (44%)
Electronics	9465 (25%)
Jewellery	4622 (12%)
Photovoltaic	3142 (8%)
Industrial (oth.)	2535 (7%)
Silverware	1014 (3%)

Source : Julius Baer

With economic and industrial slowdown, has silver already touched its peak ?

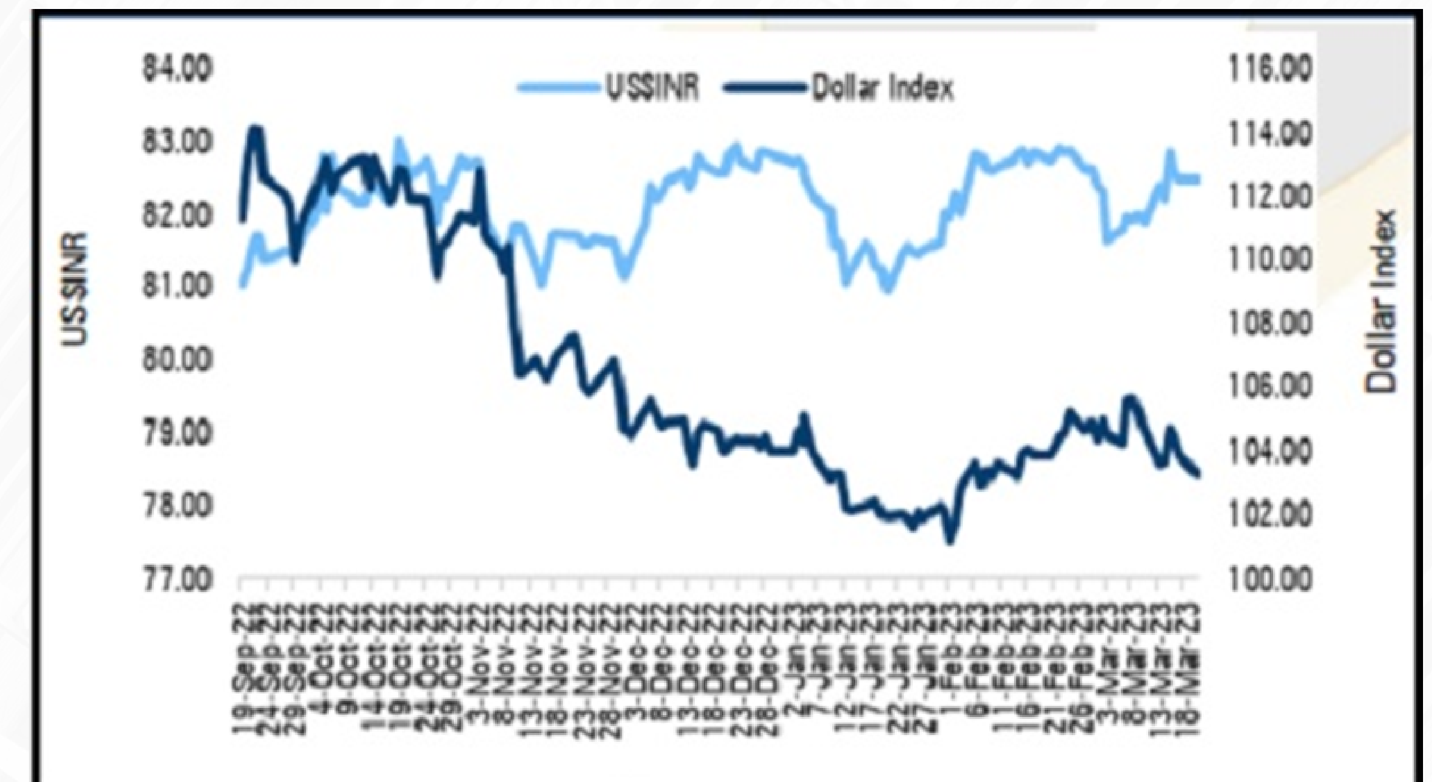
Massive move from RBI to De-Dollarise Trade

Reserve Bank of India (RBI) has authorized both domestic and foreign authorized dealer (AD) banks to open 60 Special Vostro Rupee Accounts (SVRAs) for banks from 18 different nations.

This new mechanism will benefit in multiple ways :

- Increasing interest of the global trading community in INR
- Trade with Sanctioned Countries
- Reduce the risk of forex fluctuation, especially looking at the Euro-Rupee parity.
- Arrest Fall of Rupee result in reducing demand for foreign exchange, by promoting rupee settlement of trade flows.

18 Countries



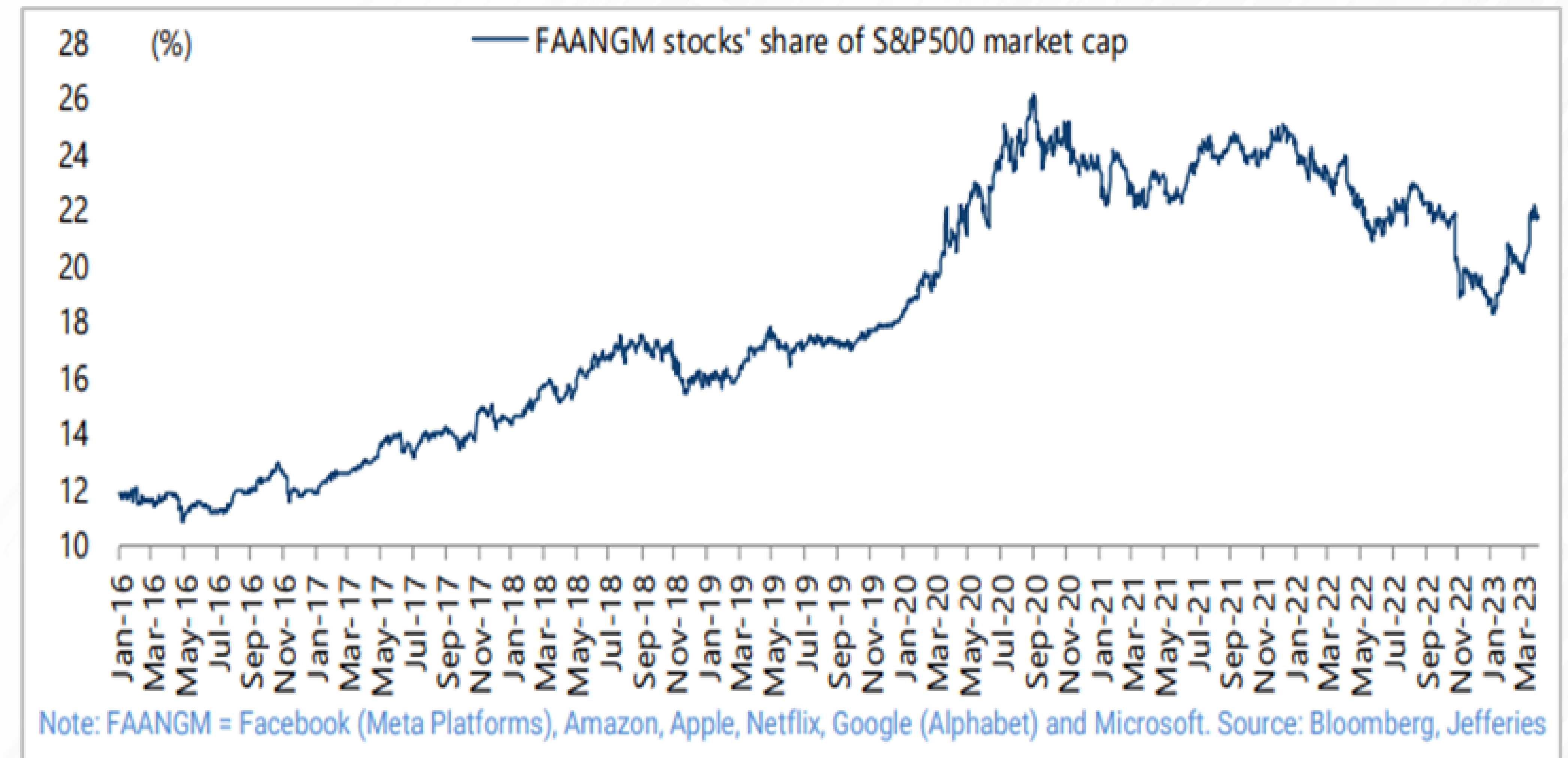
Is the long term USDINR depreciation about to reverse ?

Will value stocks overtake growth stocks again?

- The MSCI World Growth Index has outperformed the **MSCI World Value Index by 13.1% year-to-date, after underperforming by 24.8% in 2022**

- The FAANGM stocks' share of S&P500 market capitalization has risen from a **recent low of 18.3% in early January to 21.8%,** after declining from a peak of 26.2% reached on 1 September 2020

FAANGM stocks' share of S&P500 market capitalization



Source: Jefferies

Will there be a renewed decline in FAANGMs' market capitalization as a percentage of the S&P500 ?.

China : Time to bottom fish ?

- Alibaba's split to unlock value has been the most important so far of the many signals the Chinese Government has given in recent weeks that Beijing wants to pursue more market friendly policies

- MSCI China had been performing in line with the MSCI AC Asia Pacific ex-Japan benchmark prior to Alibaba's rally, with both the MSCI China and the regional benchmark up 1.6% in US dollar terms.

- **Case for China investment :**
  - China reopening beneficiary
  - High local consumer exposure + localization beneficiary
  - Auto Electronics benefit from EV adoption
  - Industry automation to recover along with resurgence in production activity & policy stimulus

MSCI Emerging Markets and MSCI China movement

With US markets going through a turmoil, is this a right time to look at China market?

BABA : Jack's back!

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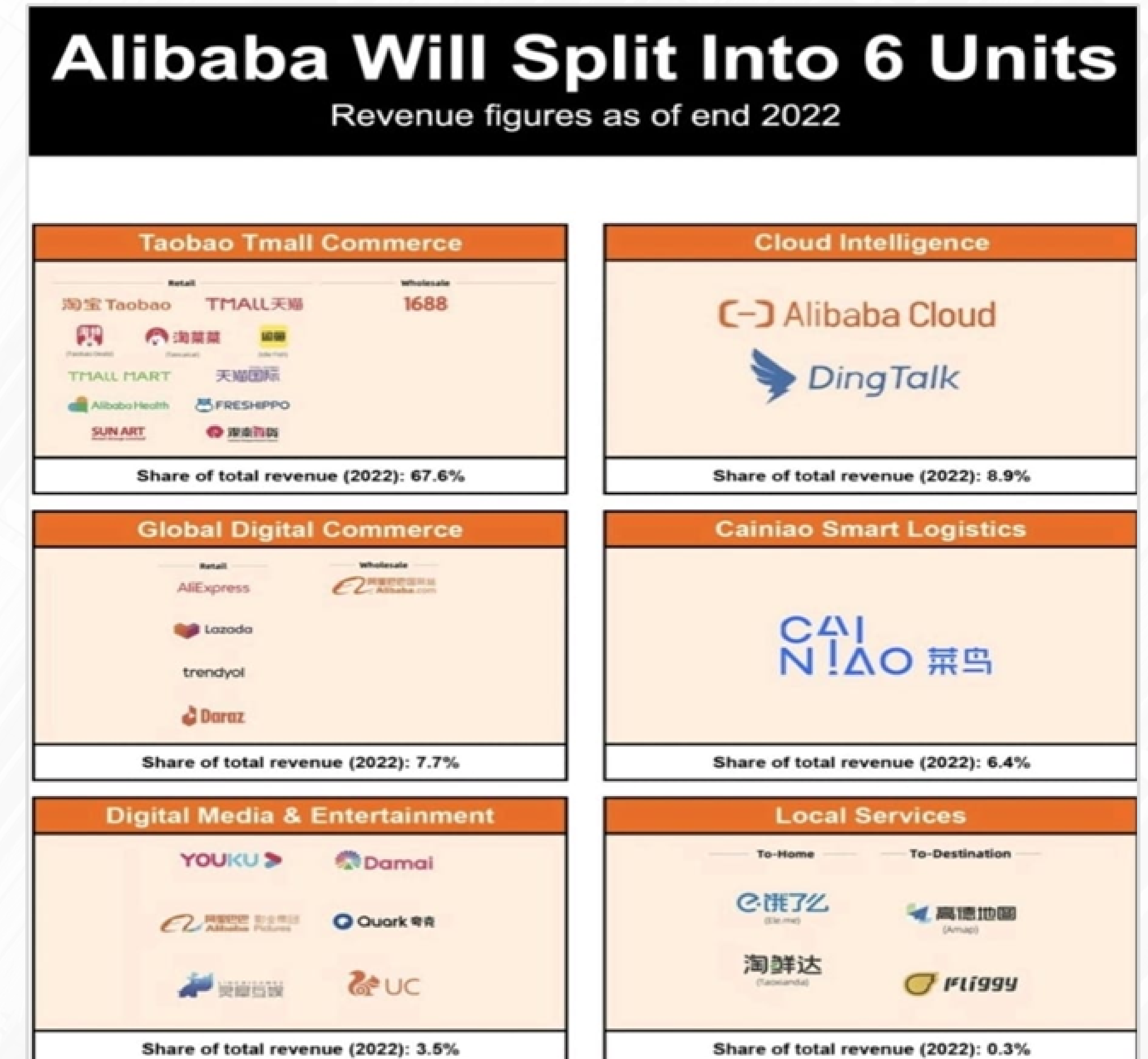
Alibaba's restructuring is a significant positive catalyst as the market generally assigns zero value to ex-core businesses

Key highlights of the restructuring :

- Potential IPO's
- Capital returns
- Synergies under new structure
- **Alibaba is 8.4% of the MSCI China**
- **Alibaba's logistics arm Cainiao — currently valued at more than $20 billion — has started preparations with banks for its Hong Kong IPO**



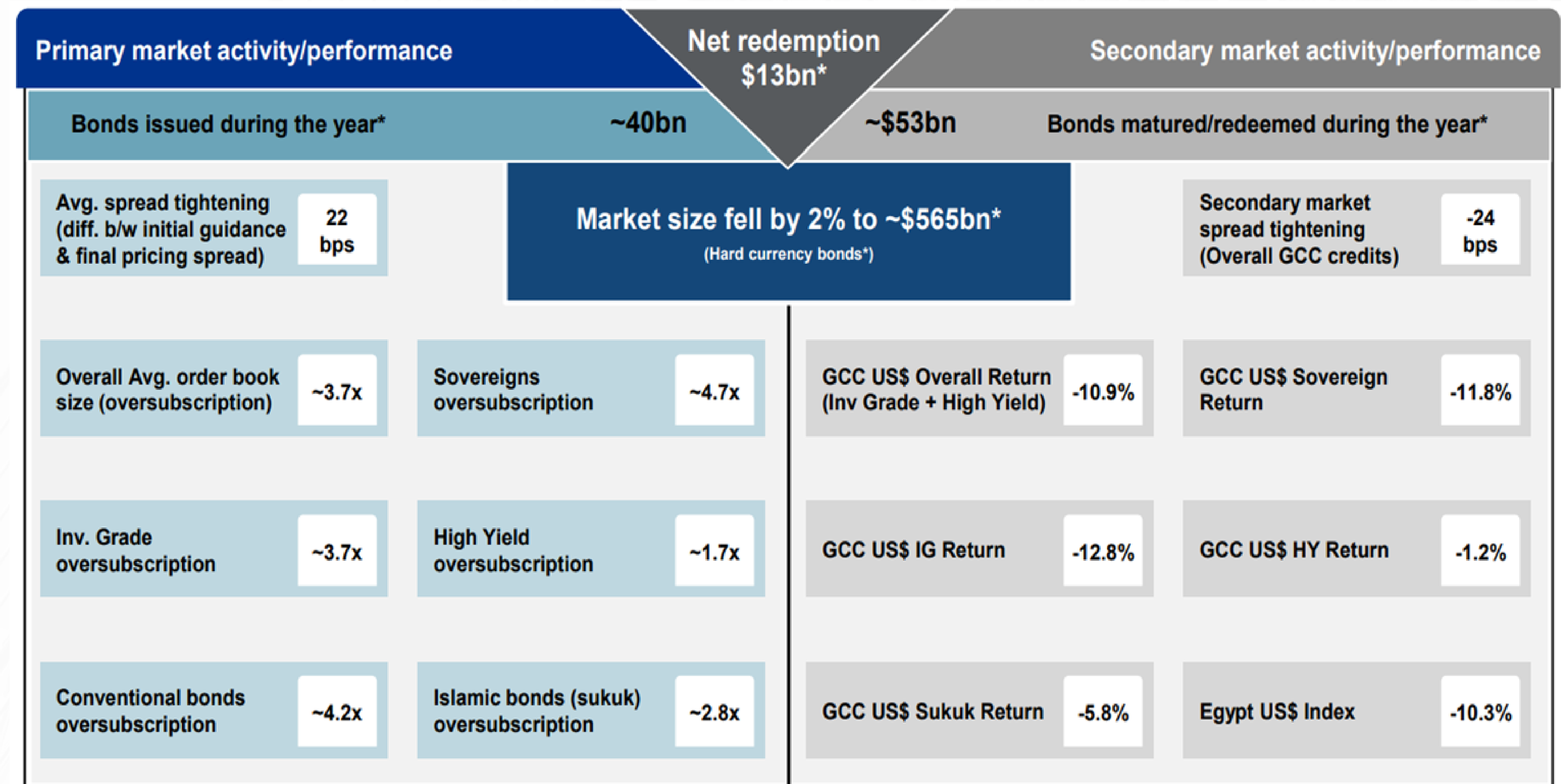
Source : Company data

Is this the perfect time to add exposure to BABA?

GCC : Borrowing needs have come down due to stronger revenues

GCC new issuance was in line with global / emerging markets trend, however, for the GCC the decline was primarily driven by the **improved economic environment, higher oil revenues and a robust rebound in the non-oil activities**

Reception to new issuance remains strong !



Source : First Abu Dhabi Bank

GCC credits offer good combination of yield, carry and credit quality

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- GCC credits – with average credit rating 'A+/A' (the highest in the EM space) – providing coupon carry of ~4% (EM's aggregate coupon carry of circa 4.5% and credit quality of 'BBB')

- Credit rating agencies (Moody's, Fitch) are maintaining a positive outlook on the GCC region. They have indeed taken strings of positive rating actions over the past two years, supporting investor sentiment towards the region.

Bloomberg US$ Bond index & credit quality		Index Credit Quality Rank	Current Index Spread (OAS)	Current Index Yield to Worst	Current Index Price	Refinancing cost (extra basis to pay)	Index Coupon (Current)
GCC Sovereigns	A	2	127	5.08%	93.3	84	4.24%
Asia Sovereigns	BBB+	4	321	7.05%	87.1	251	4.54%
EMEA Sovereigns	BBB-	6	418	8.04%	83.5	263	5.41%
EM Sovereigns	BBB-	6	412	7.92%	78.8	317	4.75%
LatAm Sovereigns	BB+	7	367	7.39%	75.3	307	4.32%
Egypt Sovereigns	B	11	733	11.18%	77.7	394	7.24%
GCC IG	A+	1	110	4.96%	92.0	128	3.68%
ASIA IG	A-	3	148	5.45%	91.3	203	3.42%
EM IG	A-	3	146	5.35%	90.9	150	3.85%
GCC HY	BB-	9	247	6.44%	95.5	82	5.62%
Asia HY	BB-	9	979	13.57%	78.7	819	5.38%
EM HY	BB-	9	691	10.74%	74.2	525	5.49%
GCC Aggregate	A	2	139	5.24%	92.5	126	3.98%
ASIA Agg	A-	3	296	6.87%	88.8	306	3.81%
EMEA Agg	BBB	5	360	7.51%	86.0	243	5.08%
EM Agg	BBB	5	347	7.32%	84.0	279	4.53%
LatAm Agg	BB+	7	430	8.06%	76.7	343	4.63%

Source : FAB, Refinitiv

High quality fixed income assets are poised for benefit from US monetary policy stance.

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Get In Touch

ASAS CAPITAL
أساس كابيتال

702 South Tower PO BOX 506806 Emirates Financial Towers, DIFC Dubai, UAE

+971 4346 4700
+917 4386 7557

inquiry@asascapital.com

www.asascapital.com

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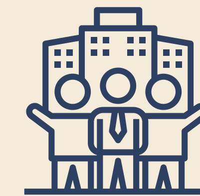
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