ASAS CAPITAL

أساس كابيتال

www.asascapital.com

Regulated by DFSA

"Speed bumps ahead?"

May 2023

Table of contents

CIO Speaks (1/5)

Another week, another bank in trouble.

We have repeatedly alluded in our newsletters to the lag effect of the rapid interest rate hikes set in motion by the U.S. Federal Reserve in early 2022 and warned that it would take several months before the full effects become clear.

Since March 2023, almost exactly a year since the hikes began, the following banks have collapsed in the U.S. alone:

Silvergate Bank, the 147th largest bank in the country

Silicon Valley Bank, the 16th largest

Signature Bank, the 29th largest

On May 1st, 2023, First Republic Bank – **the nation's 14th largest bank with over $200 Billion in assets and more than 7,000 employees** – entered this "Hall of Shame". Most of its business was sold to JPMorgan Chase after federal regulators seized it as it suffered from a run on its deposits.

First Republic is the second-largest bank to fail in US history, taking over that mantle from Silicon Valley Bank which held the 'record' for about a month.

It should be kept in mind that **these bank failures have been triggered by liquidity issues and not loan losses or adverse credit developments** in some of the other weak spots that we have discussed in the past, e.g., commercial real estate, multifamily housing, auto loans or credit cards.

Those dominoes are yet to fall.

Meanwhile, uncertainty continued to pummel the banking industry, despite assurances from financial regulators and bankers such as Jamie Dimon that the worst of the recent crisis is over, and the health of the banking system remains strong. Shares of smaller regional lender PacWest Bank have struggled after the company confirmed reports that it was considering "strategic options," that may include the possible sale of the company.

There are currently more than 4,100 commercial banks in the U.S., according to the FDIC. In comparison, the number of banks in Canada according to the IMF was 81 as of 2021, while Japan had 112, China had 187, Germany had 251, and the U.K. had 311. As smaller banks struggle to adapt to a period of higher interest rates without as many options as their larger "too-big-to-fail" rivals, the number of banks is likely to keep going down. The implications for the economy bear watching.

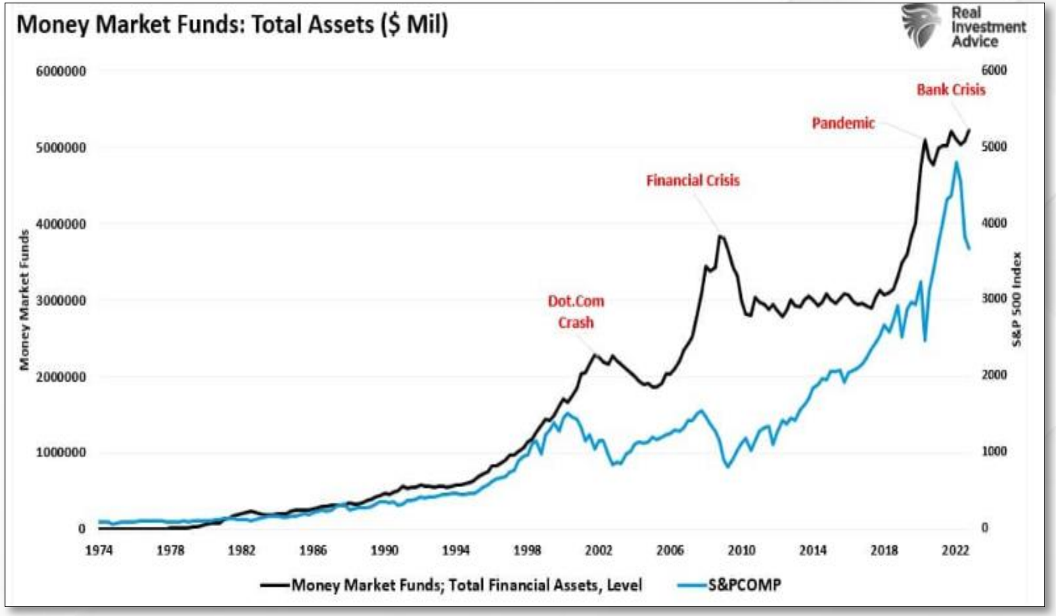
Liquidity crunch

Liquidity and credit are the lifeblood of an economy.

The collapse of First Republic will **amplify the tightness in bank lending standards** that had already started before the failure of Silicon Valley Bank and has accelerated since then.

At the same time, bank depositors are fleeing banks and transferring their funds to Money Market Funds. As of May 3rd, 2023, **total assets with Money Market Funds stood at $ 5.3 Trillion**, near all-time highs.

Developments around the U.S. Debt ceiling are likely to create further challenges. The Treasury hit the ceiling in January 2023 and has been taking what are known as "extraordinary measures" to keep paying the bills. It was earlier estimated that it will run out of maneuvering room around August 2023 unless the Ceiling is raised. Since then, tax revenues have come in lower than expected and Treasury Secretary Janet L. Yellen has said that the United States could run out of money to pay its bills by June 1.



We share the almost unanimous belief that the path to an agreement on this matter by the Senate and the House may be acrimonious and volatile, but that the Ceiling will eventually be raised and there will be no default. One of the implications of the Ceiling being raised will be a higher supply of fresh U.S. securities which will, at least at the first instance, result in less liquidity with banks and the wider financial community.

In this context, we also note that the U.S Money supply indicator – M2 – has turned lower for the first time in almost 60 years. M2, which measures cash in circulation plus dollars in bank and money-market accounts, swelled by more than 40% during the pandemic as the central bank flooded financial markets with emergency liquidity. It peaked at $21.7 trillion in March 2022 and has declined to $20.8 trillion in March 2023. While this is good news for those concerned with inflation, taken together with the other data suggests that a significant economic slowdown, aka recession, is on the way.

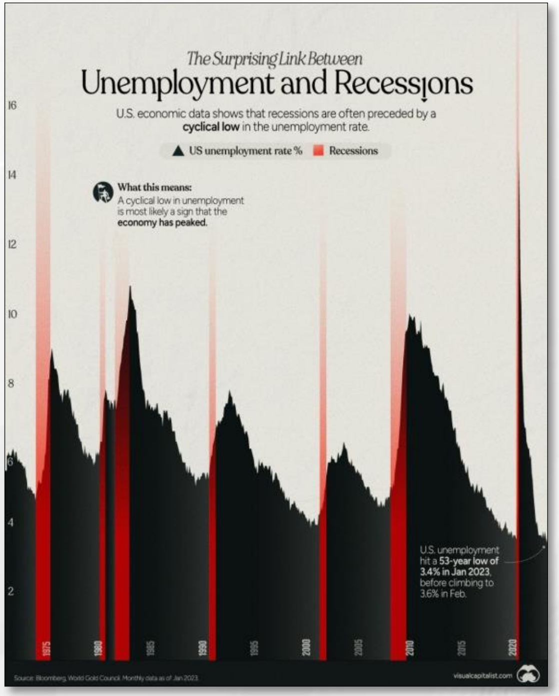
CIO Speaks (3/5)

Speed bumps ahead

Several other indicators are flashing similar signs.

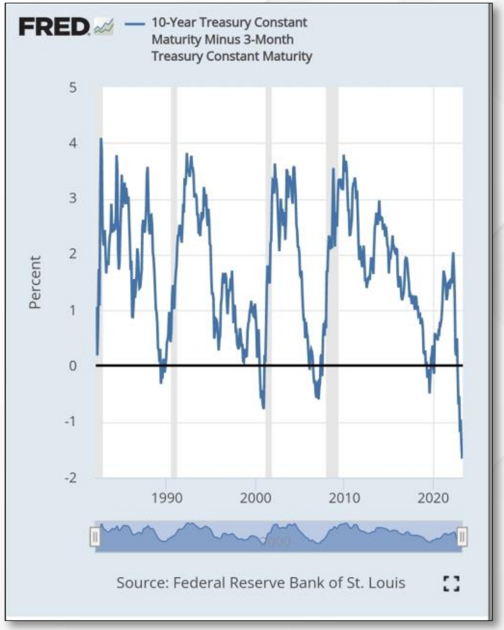
The 3m/10Y yield curve – an accurate predictor of recessions in the past – has been **inverted since October 2022 and currently stands at -1.82%**

The Federal Reserve has repeatedly announced its intent to take the unemployment rate from the current historically low level of ~3.5% to 4.5% by end 2023. The chart below shows that such a rise in unemployment levels is almost always followed by recession.



We are of the view that the US will go into recession somewhere between September 2023 and March 2024.

On the inflation front, latest CPI data shows annual inflation dropped to 5.0% in March and will likely drop below 4% by the end of the year. **The drop in annual inflation was mostly attributable to the energy price spike of March 2022 dropping out of the calculation.** (A further big drop in the energy component of inflation will likely happen in June, but again, only because of similar price jumps of a year ago that will fall out of the year-over-year calculation.)



On May 3rd, the Federal Reserve raised its benchmark overnight interest rate by a quarter of a percentage point to the 5.00%-5.25% range and dropped from its policy statement language saying that it "anticipates" further rate increases would be needed.

However, price increases in services remain stubbornly high, as wage gains that drive up businesses' operating costs are proving slow to moderate. Nonfarm payrolls rose by 253,000 in April with the unemployment rate falling to 3.4%, against expectations of added 185,000 and 3.6% respectively.

Given this outlook, **it seems likely that the Federal Reserve will live with the economic slowdown and not go into a rate cutting cycle through 2023.** Unless something breaks.

CIO Speaks (4/5)

According to the National Bureau of Economic Research, the duration of an economic downturn averaged 10 months in the ten U.S. recessions since 1957 (a period of 65 years). Economic downturns create challenges for corporate profits, and S&P 500 earnings growth turned negative in each of the past ten recessions. S&P 500 earnings per share (EPS) declines, from peak to trough, ranged from -4.6% in the 1980 recession, to -91.9% during the Global Financial Crisis (GFC) from 2007 to 2009. **The average earnings decline across all ten recessions was -29.5%.**

Are you scared yet?

Based on FactSet data, **analysts still expect earnings growth for the second half of 2023.** For Q2 2023, analysts are projecting an earnings decline of -4.6%. For Q3 2023 and Q4 2023, analysts are projecting earnings growth of 1.9% and 8.8%, respectively. For all of CY 2023, analysts predict earnings growth of 0.9%. **The forward 12-month P/E ratio is 18.3**, which is below the 5-year average (18.5) but above the 10-year average (17.3). It is also above the forward P/E ratio of 18.1 recorded at the end of the first quarter (March 31), as the price of the index has increased while the forward 12-month EPS estimate has decreased since March 31st.

Peak Month	Trough Month	Months of Contraction	Quarters of EPS Decline	EPS Change
August 1957	April 1958	8	4	-17.0%
April 1960	February 1961	10	7	-11.7%
December 1969	November 1970	11	5	-12.9%
November 1973	March 1975	16	4	-14.8%
January 1980	July 1980	6	4	-4.6%
July 1981	November 1982	16	4	-19.1%
July 1990	March 1991	8	10	-36.7%
March 2001	November 2001	8	5	-54.0%
December 2007	June 2009	18	7	-91.9%
February 2020	April 2020	2	4	-32.5%
Average Contraction Duration (months)		**10.3**		
Average EPS Decline (peak to trough)				**-29.5%**
Average EPS Decline (excluding tech bubble-2001 & financial crisis-2007)				**-18.7%**

Data Source: FactSet, National Bureau of Economic Research (NBER), D.A. Davidson
Peak Month is last month of economic growth before contraction, with Trough Month defining the bottom of the contraction (as per the NBER)
EPS Change uses S&P 500 reported EPS, trailing four quarters, updated quarterly

Also, while institutional investors including hedge funds have reduced equity positions, household ownership of equities is still 31%, which is comparable to levels seen around the dot com bubble. Part of this is probably attributable to flows from the 401k plans, which remain high given low levels of unemployment.

The above reinforces our view that **the risk-reward for US equities is unfavorable in the near term**. Since the implied volatility is trading at relatively low levels (VIX is trading around the 17 handle), investors have the opportunity to hedge their long positions relatively cheaply.

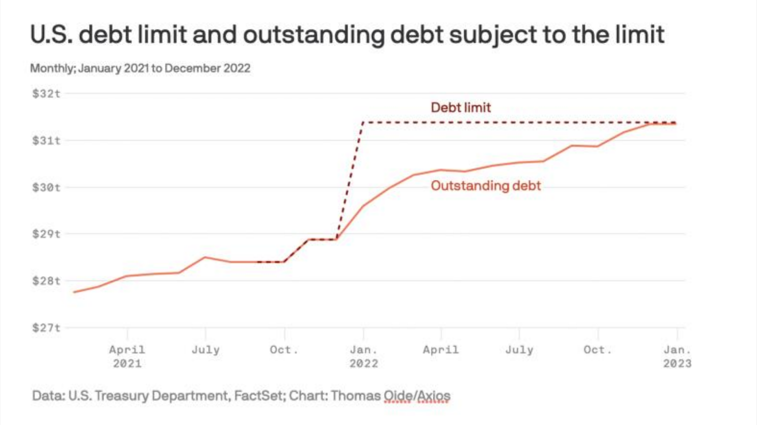
CIO Speaks (5/5)

Moving on to fixed income, OIS yield curves and Federal funds futures suggest that the market expects that the Federal Reserve, once it moves into accommodative mode, will cut interest rates by ~ 250 bps from the terminal rate. However, historically the Fed has cut rates by 400+ bps during recessions. As such, while peak yields for bonds in this cycle are probably behind us, we believe **the risk-reward on high quality bonds including EM sovereigns is still favorable**.

In Europe, the biggest economic threat has changed from the energy crisis to the impact of monetary policy. The effects of tighter monetary policy, reflected in the current cycle of interest rate hikes which is the most aggressive since World War II, are being felt in tighter bank lending and weaker demand for credit. On May 4th the ECB raised rates by 25 bp, taking the central deposit rate to 3.25% and reiterated that the “ECB is not pausing” and there is “more ground to cover”. The ability of governments to spend is constrained by persistently high inflation. Some support could come from China’s recovery from the pandemic, but progress on that front as so far been slower than expected.

Debt ceiling and risks of a global financial crisis

- **What is Debt Ceiling** - The debt ceiling is a limit on the total amount of government borrowing (currently around $ 31.4 trillion). Since 1960, Congress has raised the ceiling 78x, 49x under Republicans and 29x under Democrats. Last raised in December 2021 – from $ 28.9 to $ 31.4 trillion ($ 2.5 trillion increase)
- **Why is the debt limit an issue now?** US debt had reached the statutory limit on Jan 18 and currently using “extraordinary measures” to manage the nation’s cash and debt to avert default, expected to run till June 2023.
- **How is Debt Ceiling Raised** : Congress must vote (with 60% majority) to raise the limit in order to allow the government to borrow sufficient funds to meet its ongoing legal obligations.
- **Current Battle Between Democrats & Republicans** : Republicans (49%) agreed to raise the debt ceiling by $1.5tn but mandated $4.8tn in spending cuts over a decade. Given the stakes, Democrats (51%) have refused to negotiate spending cuts over the debt ceiling.
- **What happens if Congress doesn’t increase the debt ceiling?**
  - fail to pay back its debts, including interest payments on Treasury bonds — technically putting the U.S. government in default.
  - lose faith in the dollar,
  - the nation’s credit rating would be downgraded (volatility in CDS)

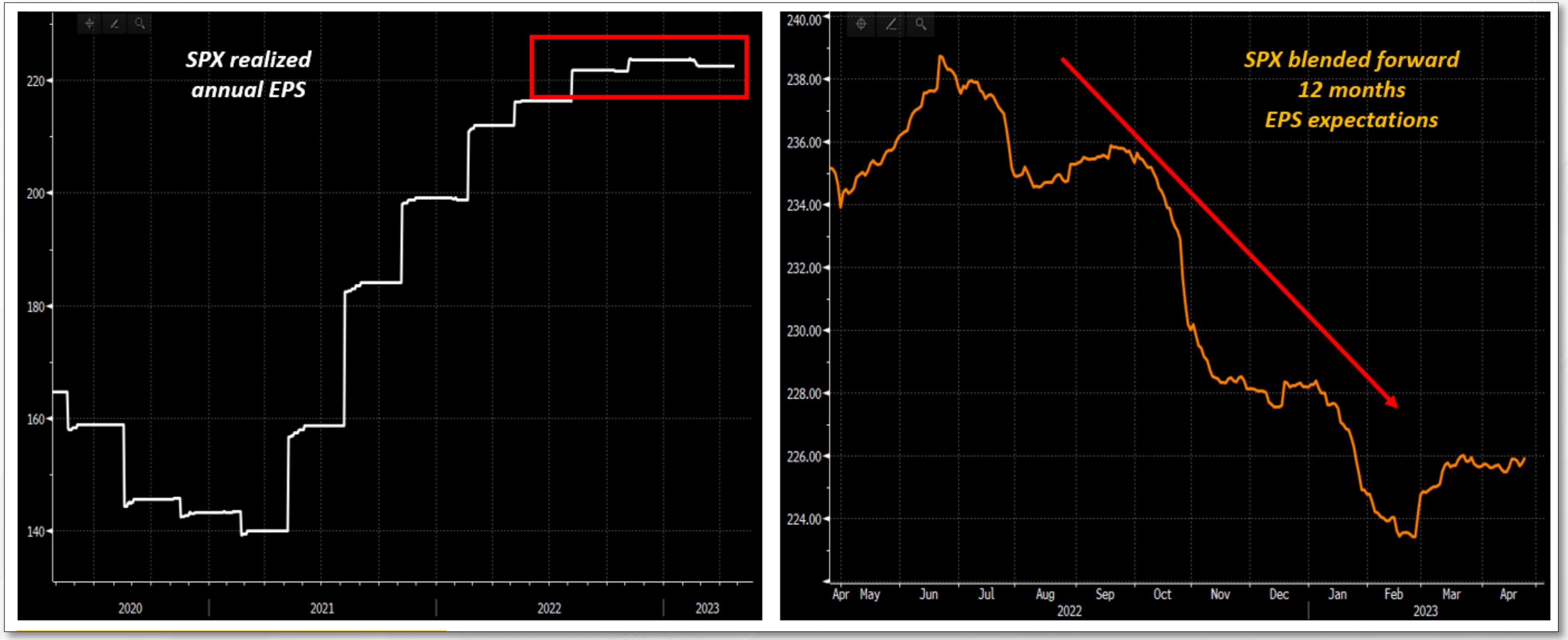


US Government CDSs during the 2011 US debt ceiling crisis
(**Red (green) - increasing (decreasing) US Federal default risk)**

Does the spike in CDS provides an attractive investment opportunity ?

Asas Capital
أساس كابيتال

Earnings growth expectations slashed and expected to stay flat



Source: TheMacroCompass.com

Expectations for future 12-month EPS growth has collapsed from the $240 to the $225 area

Asas Capital
أساس كابيتال

P/E expansion driving S&P 500 rally since late 2022

S&P 500 target of 3,555 at 15.8x 2023e EPS of $225 – downside of 15% from current levels

VIX has fallen to levels last seen in 2021

Take advantage of low VIX to protect portfolio cheaply

S&P 500 2023Q1 Earnings

- S&P 500 on course to have 2nd consecutive quarter of earnings decline
  - Ex-Energy, it will be 4th consecutive quarter (seen twice before – GFC & COVID)
- Analysts set the bar lower by aggressively downgrading estimates heading into earnings season; paving the way for a resilient quarter with a strong earnings beat rate
  - 77% of the reported results beat analyst expectations
  - On 01-Jan, S&P 500 Earnings growth expected for Q1 was +1.4%, revised to -5.1% on 01-Apr
- 6 consecutive quarters of declining net profit margin
- 264 companies have given EPS guidance for 2023
  - 111 (42%) have issue negative EPS guidance

Sector	Total	Reported	Remaining	% Reported	Above	Match	Below	Blended Growth
S&P 500	**500**	**419**	**81**	**84%**	**77%**	**5%**	**18%**	**-0.7%**
Consumer Discretionary	53	41	12	77%	73%	7%	20%	55.0%
Consumer Staples	37	26	11	70%	88%	4%	8%	-0.3%
Energy	23	21	2	91%	86%	0%	14%	19.6%
Financials	72	68	4	94%	65%	3%	32%	7.3%
Health Care	65	53	12	82%	83%	6%	11%	-14.8%
Industrials	76	70	6	92%	84%	3%	13%	25.5%
Materials	29	26	3	90%	85%	0%	15%	-22.6%
Real Estate	30	28	2	93%	57%	18%	25%	-7.8%
Technology	64	45	19	70%	91%	2%	7%	-9.9%
Comm. Services	21	14	7	67%	71%	7%	21%	-9.4%
Utilities	30	27	3	90%	59%	4%	37%	-22.2%

Earnings Growth	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2E
S&P 500	11.4%	8.4%	4.4%	-3.2%	-0.7%	-4.7%
S&P 500 Ex-Energy	5.2%	-2.1%	-3.3%	-7.4%	-2.4%	0.5%

Net Profit Margin	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1E
S&P 500	12.5%	12.9%	12.7%	12.1%	12.0%	11.9%	11.6%	10.7%	11.1%

Source: I/B/E/S data from Refinitiv – Data as of 05-May-23

Earnings beating estimates but are they growing or the quality improving?

S&P 500 2023Q1 Earnings

- 4 out of 11 sectors are expected to report y/y earning growth
  - Consumer Discretionary (+55%) driven by broadline retail (+225%) and hotels, resorts & cruise lines (+120%). Excluding these, growth is +4.0%. Amazon contributing to nearly 70% of this growth
  - Industrials (+26%) driven by airlines (+94%) & construction machinery & heavy transport equipment (+75%). Excluding these, growth is +3.9%
- Amazon.com is also the largest contributor to earnings growth for the entire S&P 500 for Q1 and 2023
- Companies / Sectors with higher international business reporting lower revenues & earning – Healthcare & Information

Company	EPS 23Q1	EPS gth
Apple	1.52	*0.0%*
Microsoft	2.45	*10.4%*
Google	1.17	*-4.9%*
Amazon	0.31	*182.0%*
Meta	2.20	*-19.1%*
Tesla	0.85	*-20.6%*

Name	GICS Sector	Earnings Gth
Marathon Petroleum Corp	Energy	308.7%
Valero Energy Corp	Energy	258.0%
Phillips 66	Energy	218.9%
Amazon.com Inc	Consumer Discretionary	182.0%
American Airlines Group Inc	Industrials	102.2%
United Airlines Holdings Inc	Industrials	85.1%
JPMorgan Chase & Co	Financials	55.9%
Wells Fargo & Co	Financials	39.8%
Exxon Mobil Corp	Energy	36.7%
Microsoft Corp	Information Technology	10.4%
Abbvle Inc	Heath Care	-22.2%
Pfizer Inc	Heath Care	-24.1%
Merck & Co Inc	Heath Care	-34.6%
Abbott Laboratories	Heath Care	-40.5%
Capital One Financial Corp	Financials	-58.9%
Dow Inc	Materials	-75.2%
Moderna Inc	Heath Care	-97.8%
Intel Corp	Information Technology	-104.6%
NRG Energy Inc	Utilities	-181.2%
Micron Technology Inc	Information Technology	-189.3%

Source: I/B/E/S data from Refinitiv – Data as of 05-May-23

Time to move into selective portfolio construction instead of index-based investing

China - Covid reopening faded as geopolitical concern raises

- **<u>China: Strong Economy</u>** : Recovery continuing to gather strength over the coming months.
  - Quarterly GDP rose by 4.5% against expectation of 4%
  - Private-sector credit growth accelerated further in March
  - Real growth in nationwide per-capita income accelerated to 3.8%
  - Job market may continue to lift wages and drive further improvement in household income growth

- **<u>Tensions hit stocks :</u>** Geopolitical tensions appear to weigh on China's stocks. China's stock market fell 14% after the spy balloon controversy erupted in early February.

- While China's economic growth is likely to remain strong, U.S.-China tensions are unlikely to significantly lower in the near-term.

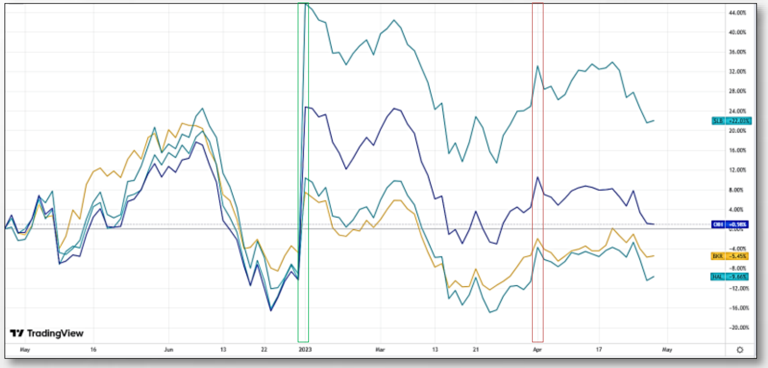
Slump disrupted a 60% three month rebound from the end of October until this year's peak on January 27.

Measured optimism subject to geopolitics !

The OPEC Cuts Bolster The Case For Oilfield Services

- **Shale Wells Shrinking** : U.S. Shale Boom Shows Signs of Peaking as Big Oil Wells Disappear there will be greater demand for services to maintain production levels
- **OPEC intention to have stable oil prices** : Oil price that incentivizes investment in production it's time to drill again, and offshore drilling rates have rebounded.
- **Digital Solutions:** With the introduction of a digital platform strategy, companies belonging to the industry are not only accelerating returns but also reducing cycle time. Starting from increasing productivity and efficiency, oilfield service players are also reducing costs and carbon emissions, thereby optimizing cashflows.

Oilfield services sector is the VanEck Oil Services ETF (NYSEARCA:OIH), which responded sharply to the OPEC announcement:



Company Name	Currency	Market Cap	P/E	Book Val	Price/Book	Div Yield	Last Price	52W High	52W Low	1yr Target Est	EPS Est Next Year	EPS Current Year	PEG Ratio (5yr expected)
VanEck Oil Services ETF	USD	2.41B (Net Assets)	16.48	-	-	1.04%	268.80	336.30	195.77	-	-	-	-
Halliburton Company	USD	28.892B	8.82	8.81	3.63	2.02%	$ 32.00	$ 43.99	$ 23.30	43.9	3.63	3.09	0.31
Baker Hughes Company	USD	29.398B	14.42	14.54	1.98	2.56%	$ 28.84	$ 38.66	$ 20.42	36.91	2	1.5	0.44
Schlumberger Limited	USD	68.343B	12.82	12.9	3.72	2.09%	$ 47.96	$ 59.45	$ 30.65	64.68	3.74	3.01	0.49

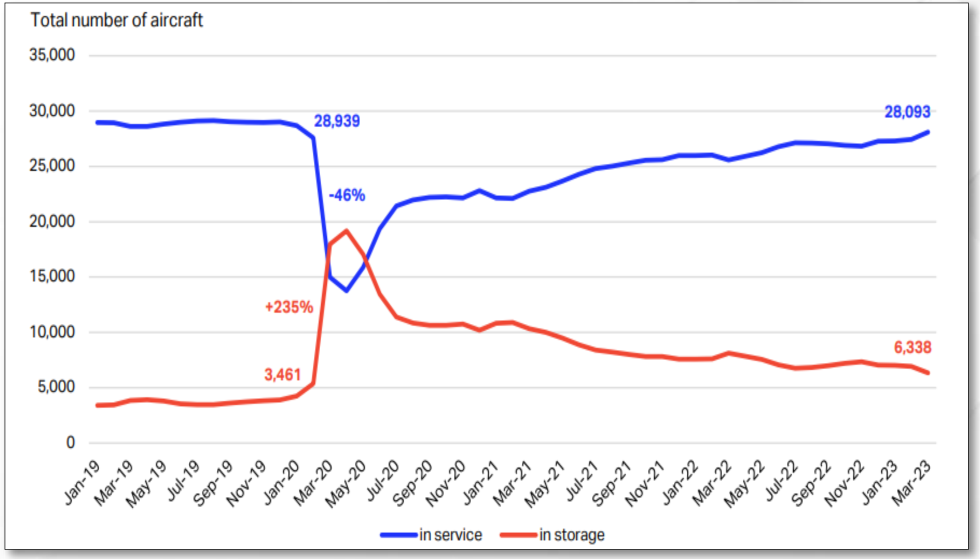
Is Now the Time to Buy Oil Equipment and Services Stocks?

ASAS CAPITAL
أساس كابيتال

Is economy re-opening a turning point for global airlines?

- Global passenger demand **continued to grow in March.** Industry-wide revenue passenger-kilometers (RPKs) increased 52.5% YoY and **88% of pre-pandemic level**
- International RPKs grew 68.9% annually and **18.4% below pre-pandemic level**
- Domestic RPKs were almost fully recovered, **only 1.1% below pre-pandemic** levels after growing 34.1% YoY
- Industry-wide passenger **load factors continued to trend at 80.7%** vs pre-pandemic average of 84%

Capacity restoration is picking up



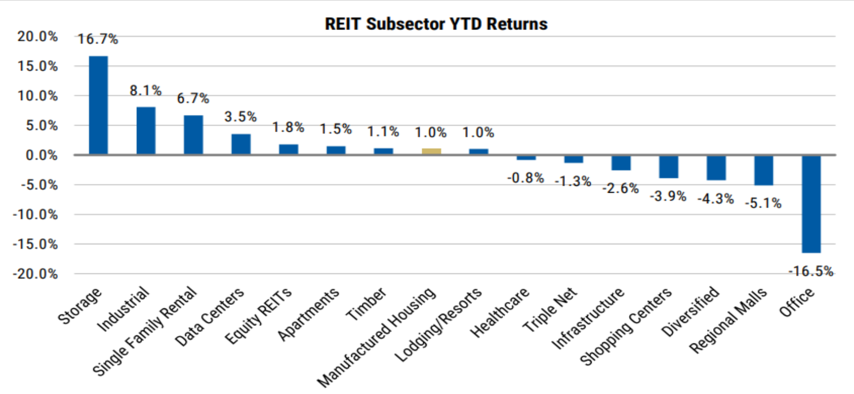
Source : IATA

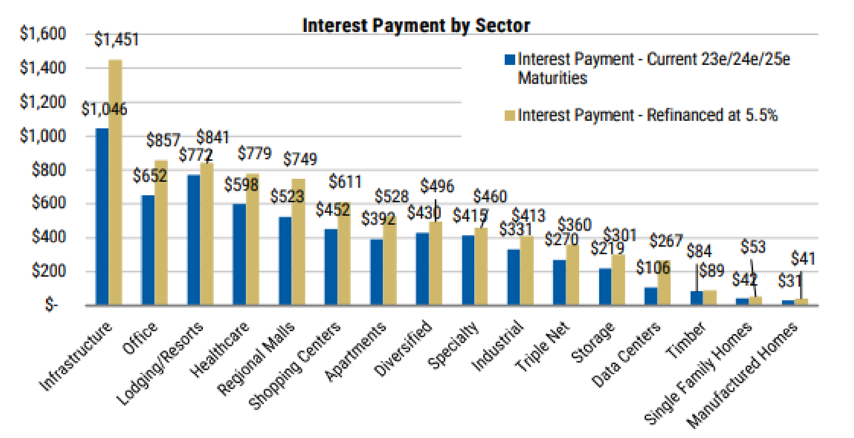
Airline	Jurisdiction	Revenue 22	Rev growth y/y	Rev growth 2019	Yield 22	Yield vs 2019	LF (current)	Price as of Nov 2019	Current	Consensus
Delta air	US	$51Bn	69%	8%	21.69	27%	81%	$57.13	$34.31	$60-70
United air	US	$45Bn	67%	5%	18.14	19%	80%	$92.8	$43.8	$65-70

Is airline industry – both US & EU a part of sector rotation strategy for the next 24 months ?

Will recessionary fears continue to be a headwind for REITS?

- REITs YTD returns at **+2.0% vs S&P +8.2%**
- **Key Catalysts driving REITS :**
  - Potential rise in distress asset sale : Distressed asset sales in **4Q22 totaled 1.2% of $149.8bn of total sales in 4Q22 vs 20.3% in 4Q2010**
  - Tightening lending conditions
  - Debt maturities and refinancing: **potentially at 5.5%**
  - Rising interest rates increasing the spread between cap rates & IR
  - Occupancy requirements
- **REITS to look at in the current scenario:** Industrial, Healthcare, Data center and Apartments





Source : Morgan Stanley

Diversification opportunity but not right now!

DISCLAIMER

This presentation is prepared by Asas Capital Ltd (Asas). Asas is regulated by the Dubai Financial Services Authority (“DFSA”), incorporated in the Dubai International Financial Centre. The information contained in this material does not constitute an offer to sell or the solicitation of an offer to buy, or reco- emendation for investment in any financial product or financial service in any jurisdiction. The information in this document is not intended as financial advice and is only intended for Professional Client and Market Counterparty, as defined by the DFSA, who understand the risks associated with such in- vestments. Investors are not to construe the contents of this document as legal; business or tax advice and each investor should consult its own attorney business adviser and tax adviser as to the associated risks, legal, business, tax, and related matters. All reasonable efforts have been made to ensure accuracy of the information contained in this document, however, it may include certain inaccuracies or typographical errors and Asas reserves the right to modify or update these later. This document has not been reviewed by, approved by, or filed with the DFSA.

Asas does not provide any warranty, express or implied, about the accuracy of the information provided in this presentation. Asas also does not provide warranty, express or implied, on the availability of products and services described in this presentation. But without prejudice to the generality of the foregoing, no representation or warranty is given as to the achievement or reasonableness of any future projections, estimates, returns contained in the document or in such other written or oral information. Past performance is not an indication of future performance. This presentation is confidential and contains proprietary information, neither this document nor any portion hereof may be reprinted, sold, or redistributed without our prior written consent. The distribution of this document and investment in any financial product or financial service may be restricted by law in certain jurisdictions. The investors. should inform themselves as to legal requirements and tax consequences within countries of their citizenship, residence, domicile, and place of business. with respect to holding and disposition of investment and any foreign exchange restrictions that may be relevant thereto. In no event shall Asas be liable for any direct, indirect, punitive, incidental, special, or consequential damages or damages for loss of profits, revenue, data, down time, or use, arising out of or in any way connected with the use of this document or performance of any investments, whether based on contract, tort, negligence, strict liability or otherwise

ASAS CAPITAL

أســـاس كـــابيتـــال

Regulated by DFSA

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

+971 4 3464700

inquiry@asascapital.com

www.asascapital.com