Blackshield Capital

MARKET OVERVIEW Q2 2023

Projections and outlook

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Market Outlook Q2 2023 - projections and outlook

Executive Summary

The first half of 2023 and the second quarter are largely characterized by the artificial intelligence boom, which created unprecedented demand for technology stocks and risk assets, which in turn drove global equity indices higher.

The U.S. is approaching its first true boom and bust cycle in four decades, driven by a large increase in the money supply in 2020-2021, which subsequently triggers inflation and central bank interest rate policy responses. It is difficult to overstate the extent to which the normalization of the economy will lead to a recovery in future economic growth. In turn, as the economy grows organically, the stock market can enter into a long-term multi-year growth trend rather than short sprints of a few quarters. At the same time, normalization requires a recessionary "reset" and redistribution of monetary assets and liquidity.

This also applies to the global economy: 10-15 years of negative or zero interest rates and almost continuous quantitative easing programs pumping liquidity into economies to fight deflation have had a variety of unpredictable consequences. By and large, consumers, businesses and investors alike were not prepared to fully adjust to the recent rise in interest rates.

The fallout began to snowball everywhere: the problems of regional banks in the US, the Credit Suisse story in Switzerland, the inflation spike and pension crisis in the UK, and even cryptocurrency regulation. Core inflation has proven to be not only high but also persistent, and a truly stable normalization of these processes requires a natural slowdown in economic growth and the end of interest rate cycles.

In this context, we recommend strategically:

Stocks
- non-cyclical sectors of the economy
- companies with a low debt burden and stable cash flow

Fixed Income
- corporate bonds with high credit ratings
- US Treasuries with short duration

Global Markets
- Europe: non-cyclical economic sectors, energy sector
- China: the sagging IT sector

Commodities
- metals: gold, copper

Second Quarter 2023 Highlights:

- Despite all the fears, the U.S. economy is showing resilience
- Markets assess the situation as favorable: low volatility, positive sentiment
- Fed takes pause as it raises interest rates in most aggressive hike cycle in decades
- U.S. credit default swaps reached crisis levels of 2009 amid fears of credit rating downgrades related to the government debt ceiling
- The balance of short-term debt asset funds (money market funds) reached a record $5.4 trillion in the first half of the year
- Equity yields, investment-grade bond yields, and 3-month debt yields all reached the same 5% level
- The VIX index reached its lowest level since the beginning of 2020
- Shares of Apple, Nvidia and Microsoft hit all-time highs

Market Risks:

- Resilient labor market adds additional inflationary pressure
- A small number of large-cap stocks have driven the strong rally in U.S. equity indices this year
- Rising interest rates in a fragile economic environment amplify the impact of each successive hike

In the third quarter of 2023, it is expected:

- China remains one of the few developed economies that still has potential for GDP growth
- The probability of continued recession developments in the U.S. and Europe remains high
- The first signs of labor weakness are possible, given the rising jobless claims numbers

Market positioning:

- Look for assets with the best ratio of potential upside to downside, currently it is high quality bonds
- In the equity market, select companies with the best fundamental positioning for the current economic situation
- Hedging risk with unpopular but liquid assets, especially commodities and precious metals

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STRATEGY

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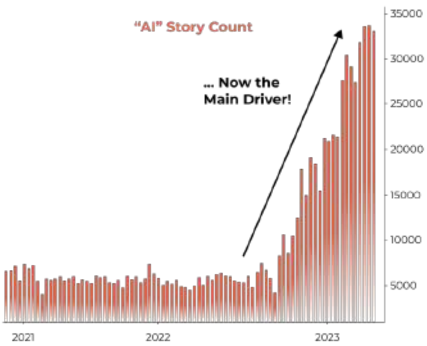
Strategy

The start of a new half-year is a good time to assess the state of markets and economies for new decisions. This quarter has seen many headline-grabbing events - rising political tensions between the U.S. and China, the debt ceiling, and artificial intelligence making its way into various areas of business and private life.

Number of AI mentions among companies' management



It is safe to say that the AI era has arrived: corporations quickly realized the importance of new technological solutions, their availability and prospects, and began to implement them everywhere: from semiconductor manufacturing to drug production.

By their very nature, market participants tend to overvalue technology in the short term and undervalue it in the long term, which is exactly the effect we saw last quarter. All of the economic and business effects that have been built into the prices of some companies are more a reflection of long-term expectations that cannot be realized so quickly.

Despite mixed investor sentiment regarding the likelihood of a recession in the US and the recent optimism in the technology sector, there are many potential trends for the rest of the year. The psychological effect of FOMO (fear of missing out) may be triggered by the sharp rise in individual assets, but it is in such conditions that it is important not to lose sight of the big picture and big trends.

We realize that the worst is over, but it is extremely likely that the bear market is not over yet: from the standpoint of the economy, a series of events must occur that will fully complete the cycle and allow a major sustained uptrend to form:

Stages from monetary tightening to the transition of the economy to the recession stage

1 Fed hikes rate to 4.75%-5.0%

2 The US dollar begins to depreciate

3 The strong labor market is starting to weaken

4 Fed puts rate hikes on hold

5 Beginning of recession in the USA

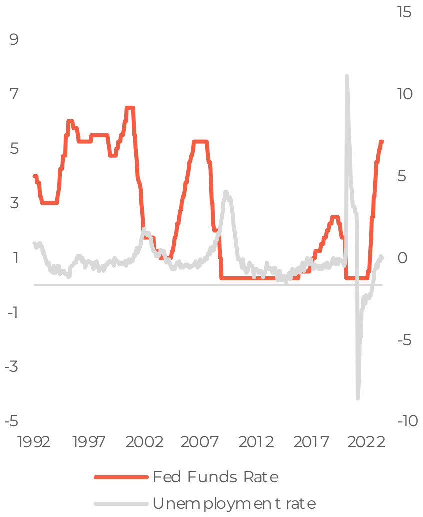
6 The markets are starting to expect a recovery

7 The U.S. economy is hitting bottom

The effects of the gradual interest rate hike by the Fed have not been fully reflected in the economy (first of all, it concerns the debt burden on business and consumer lending). At the same time, the Fed's confidence in maintaining tight monetary policy continues to strengthen, primarily due to the persistently strong labor market (but regarding which there are more and more doubts).

At the same time, the developments in this business cycle suggest a high probability that by the end of 2024 the Fed may cut current interest rates by at least 1/3 on the back of a weakening labor market in the future.

Fed Funds rate and unemployment rate



Strategy

Along with the first quarter, the second quarter confused many investors with a rally in risk assets - the technology, consumer staples and communications sectors outperformed the entire S&P500 index, and the Nasdaq index had its strongest first half since 1983. Many of the risks that predicted economic collapse (government debt ceiling, collapse of major banks) did not actually materialize, which was an additional positive sentiment for market participants.

Nevertheless, as was the case three months ago, there are sufficient reasons to remain cautious over the medium term:

- the yield curve remains deeply inverted, which is a traditional recession indicator
- the one-off injections of money to maintain bank liquidity have taken place and overall M2 liquidity in the US and global liquidity are contracting; the quantitative tightening programme is continuing and the US Treasury General Account (TGA) needs to be replenished
- corporate profits have peaked and continue to decline in many sectors.
- bank lending is becoming increasingly expensive, both to the private and corporate sectors, and this may worsen further as the labor market deteriorates and the cost of servicing debt rises.

Objectively, the economic losses supported by the 2% inflation target are too costly, especially in the run-up to the elections. Despite the lowering of the conservative PCE inflation target (from around 5.4% to 4.6%), Fed members have indicated that sustained monetary easing is still some way off. We believe another rate hike is likely, but the Fed's commitment to labor market metrics requires a separate focus on employment metrics.

Economic characteristics under different scenarios

	Soft landing	Slowing growth & inflation	Stagnation & sticky inflation	Hard landing
Inflation	<3%	3%<X<4%	>4%	>4%
2-year rates	<2.5%	3.0%-3.5%	> 4%	> 5%
Real GDP growth	2%	1%	<=0%	<-1%

While the large companies that have benefited from the recent market rally are increasing corporate profits, smaller, unprofitable companies remain vulnerable to rising interest rates: in the Russell 2000 index of small and mid-cap companies, about 40% of companies are at risk in terms of profitability and ability to service expensive debt.

We see the following as the most likely scenarios:

- US inflation peaking, end of the rate hike cycle by the major central banks
- A relatively mild recession in the US, stagnation effects in continental Europe, the inflation problem in the UK, and the erratic multidirectional recovery of the Chinese economy.

Strategy

Risk Factors:
- Deeper imbedding of interest rates and deterioration of credit conditions
- Geopolitical risks, rising cost of commodity assets and logistics
- Interest rate hikes following rebound in inflation amid slowing economy

Optimistic factors:
- Low unemployment and mortgage delinquency rates
- Creation of a soft regulatory environment for rapid growth of the Chinese economy
- Fiscal support that will mitigate stagflationary effects in Europe

	Upside	Base case	Downside
Probability	**20%**	**50%**	**30%**
Assets dynamics	Bond markets show mixed returns amid continued uncertainty over future monetary policy. Equity markets continue to rise as recession expectations are pushed back.	Bonds are up, stocks are at the same level or slightly down. At the same time, global equities are on a downward trend. High quality bonds show positive dynamics as weakening economic forecasts lead to expectations of monetary easing	Bonds are rising, stocks are falling, global equities are suffering double-digit losses, and credit spreads are widening. Safe-haven assets such as high quality bonds, gold, the Swiss franc and the Japanese yen are strengthening
Economic growth	Holds up longer than expected as consumer spending and labor markets continue to generate positive surprises. Recession expectations pushed further into the future	The U.S. economy continues to slow and is likely to move into a mild recession between 3Q 2023 and 1Q 2024. Other Western economies also continue to slow and show little or negative growth. China continues to grow	Sharp decline globally by late 2023/early 2024 due to tight monetary policy
Inflation	Remains well above central bank targets	The slowdown in the US and Europe continues. Economic growth rates will exceed central bank targets at the end of the year and normalize by mid-2024	Falls rapidly when demand for goods and services declines
Financial conditions	Remain tight by historical standards, but do not cause systemic stress in the economy	Remain tight, making the market more vulnerable to negative surprises or external shocks	Abrupt tightening that causes stress in the financial system and increases the risk of systemic events
Geopolitics	De-escalation of the war in Ukraine, e.g. through a ceasefire agreement	Ukraine war drags on and ceasefire talks remain unresolved	More escalation of the war in Ukraine or increased tensions between the U.S. and China

Strategy

The equity market is in transition, with tactically positive sentiment and structurally negative macroeconomic data. The market's strong interest in new technologies and the growth of large-cap companies contrasts with a non-growing mid- and small-cap segment. At the same time, the stock market is not broadly inclined to decline until the labor market deteriorates. The S&P 500 can remain at historically high levels for quite some time and then begin to decline sharply. Against the backdrop of a significant deterioration in the macro environment, we recommend a moderately defensive positioning, as our recommended portfolio fill categories perform well in a volatile market, with companies that offer dividend/coupon yields and are able to show growth in a deteriorating cyclical market.

Commodities

As for commodity assets, we continue to follow the idea of buying gold and silver, which have defensive characteristics and an inverse correlation to the dollar and real interest rates. For the most part, buying silver is being considered, given its cheapness relative to gold.

China

China's economic recovery depends heavily on government support. Despite a sufficient number of favorable factors, a weak property market, the lack of a pronounced trend in credit growth, and uneven production activity are enough to restrain growth. At the same time, the government has erected enough barriers and restrictions for the economy, which are gradually being removed. This trend is beginning to have a positive impact on the Chinese technology market, but with a moderate inflow of new capital.

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