Blackshield Capital

MARKET OVERVIEW Q3 2023

Projections and outlook

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October 2023

Market Overview Q3 2023 – projections and outlook

Executive Summary

For most of the year, we focused on the macroeconomic component of central banks' global interest rate strategies, and in particular the possible outcomes and scenarios.

Much of what we said centered on the criteria for differences between financial, monetary, and credit policies, and closer to the end of the year, in the third quarter of 2023, these differences converged into a single point in investment terms: **the effects of these policies influence financial markets at different rates.**

For the first time in several decades, high interest rates, high oil product prices, and tight credit conditions have occurred simultaneously. This creates a challenging environment for both the global consumer and the corporate sector and negatively affects savings rates and growth in consumer spending.

After the regional bank crisis, global markets started to grow strongly: in the US on the back of a strong labor market, in Europe based on the growth of certain sectors (luxury, travel), in China the main thesis was the opening up of the economy. However, even more significant than these narratives was the little-noticed fact that all this happened against the backdrop of declining volatility, which allowed large market participants (pension funds, systemic hedge funds) to fix the gains, reduce the inflow of new investments into the stock market and take a defensive position relative to the market until the end of the year.

Against this backdrop, the main question is how strong the fundamentals of the global economy are now, whether de-globalization is playing a major role, and whether US stock indices will regain their growth against the backdrop of a deteriorating labor market.

These questions remain the main ones for the following quarters, but they do not remove from the agenda the question of the probability of recession, its duration, and severity.

In this context, we recommend strategically:

Stocks
- Companies with stable cash flow, high interest rate coverage and dividend payments

Fixed Income
- Corporate bonds with high credit ratings
- US government bonds with short and medium duration
- Mortgage-backed securities

Global Markets
- Europe: tracking the momentum of the global economic recovery
- China: beneficiary companies of regulatory relief

Commodities
- Gold and gold mining companies, industrial metals, oil and petroleum products

Expected in the fourth quarter of 2023:

- Gradual increase in unemployment following the negative trend in business activity in the world's major economies.
- A subsequent slowdown in service inflation due to the weakening labor market.
- Further weakening of purchasing power due to the exhaustion of abnormal levels of savings starting in 2020.
- Sticking to the current course of monetary policy - keeping rates at the current level and, with a possible new round of inflation growth, increasing shrinkage of the economy.
- Possible increase in equity market volatility due to mixed negative long-term and near-positive short-term economic expectations.
- Debt market may become a safe haven for investors due to its own sell-off amid pause in monetary tightening policy and stock market correction.

Market Risks:

- The thesis about the fragility of the global economy - remains unchanged, which, subsequently, may create volatility in the stock markets in the next 2-3 quarters
- Further decrease in market liquidity
- Geopolitical crisis, emergence of new armed conflicts and wars

It's been more than **1.5** years since the Fed initiated the fastest cycle of interest rate hikes to curb inflation in decades.

STRATEGY

Growing interest in generative artificial intelligence, combined with solid household balance sheets and nearly a trillion dollars in savings, has prolonged the life of interest rate policy increases.

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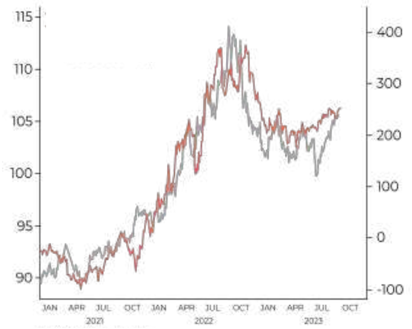
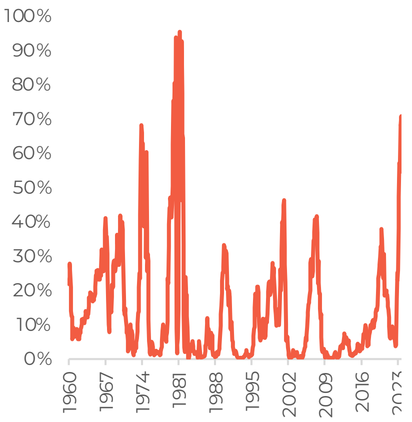
USD and 2-year government bond yield dynamics



Probability of recession in the next 12 months in the New York Fed survey



Strategy

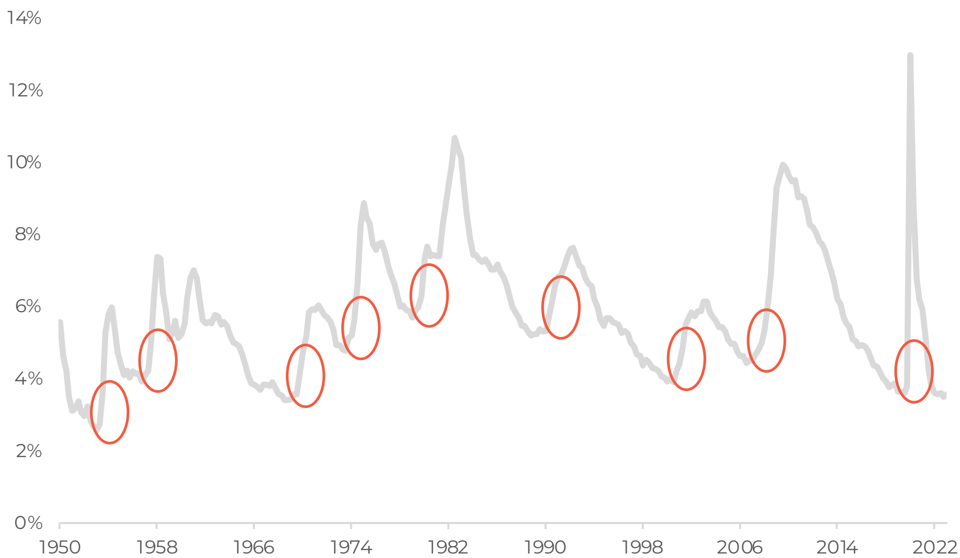
It's been more than 1.5 years since the Fed initiated the fastest cycle of interest rate hikes to curb inflation in decades. And while signals of recession have been evident one way or another for quite some time, the economy has continued to show signs of resilience. Growing interest in generative artificial intelligence, combined with solid household balance sheets and nearly a trillion dollars in savings, has prolonged the life of interest rate policy increases.

The U.S. dollar has experienced several ups and downs over the past few years. After a strong rally from mid-2021 through October 2022, the dollar lost ground and has been strengthening since July of this year. Most of the dollar's momentum can be explained by two factors: interest rates and economic growth dynamics. As for the future outlook, we believe the dollar's meteoric rise is overrated, and it is not due to some sort of de-dollarization trend that may be exaggerated in the short term. In fact, the dollar is trading 21% above purchasing power parity, which typically acts as a strong return driver. In addition, rising securities yields could worsen the balance of payments and worsen the budget deficit.

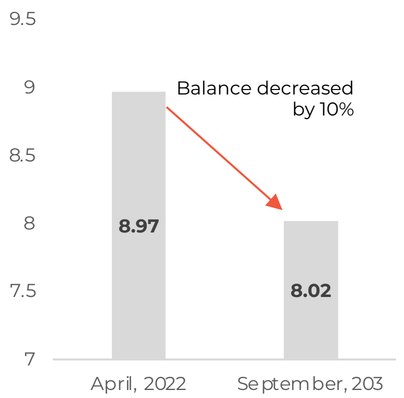
The other equally important strategic indicator is the labor market. Its structural nature leads to the fact that after reaching low levels, unemployment starts to rise, and it does not stay there for long. This is one of the manifestations of the cyclical nature of the economy and the limit to output growth. Full employment is not an equilibrium state for the economy. If unemployment is high enough, the central bank can maintain a loose monetary policy and worry less about inflation. But in the case of higher employment, economic growth has a significant impact on inflation. The only sensible way to manage this is to keep interest rates near the so-called "neutral rate," which provides the optimal amount of GDP growth, employment, and inflation. But in practice, this is a rather delicate balance, and a number of assumptions are formed in keeping it in check.

One thing is important from an applied perspective: the U.S. has never before in history avoided a recession when the 3-month average unemployment rate rose by a third of a percentage point or more. From current levels, this brings us to the coming recessionary scenario.

Unemployment rate in the USA, %



Fed balance sheet: decrease from a year earlier



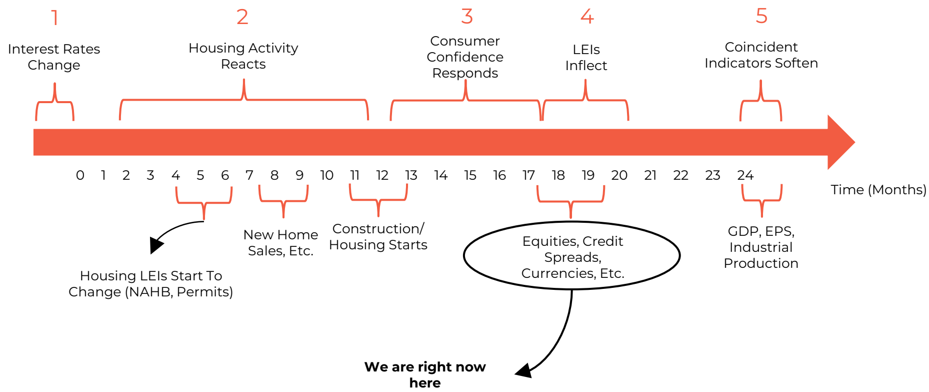
Despite the deterioration, current financial conditions are better than at the end of 2022

Strategy

On the horizon of a few months, we expect a non-inflationary sentiment with high employment, but as we approach and enter 2024, the likelihood of a second wave of inflation increases, especially against the backdrop of rising oil and energy prices.

Milton Friedman, Nobel Prize-winning economist, made popular the term "long and variable lags in the economy." The term itself means that central bank monetary policy decisions gradually penetrate the economy, with a certain lag, and this lag is highly variable. Most interestingly, in a speech in June 2023, Fed Chairman Jerome Powell referred to this term when explaining the current macro context and what is happening in the economy.

Impact of changes in interest rates on the economy



Even setting aside the residual effects and public savings from the COVID programs, throughout the entire interest rate hike cycle, the U.S. has periodically implemented stimulus and support programs: the Inflation Reduction Act, the program to support regional banks and the banking system, and the student loan relief program.

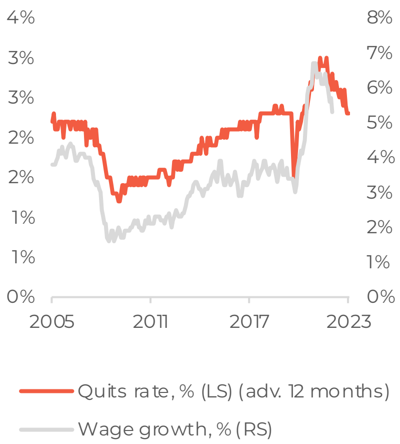
Although QT (Quantitative Tightening, or quantitative easing program) continues to operate, each of the above programs and a number of other political-economic decisions actually served as compensation for the relatively shrinking liquidity.

On the one hand, patterns in interest rate policy are gradually becoming patterns in the economy, in particular rising borrowing costs, debt loads, and shrinking corporate profits; on the consumer side, it is rising borrowing costs, rising mortgage rates, and more. More and more loans will gradually move to higher interest rates, which means households and businesses will be forced to cut back on non-priority consumption goods/services. In turn, tighter bank lending leads to less effective credit and less economic impact of borrowed funds.

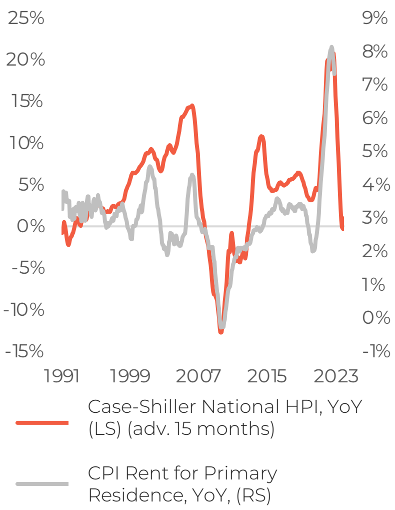
Paradoxically, higher interest rates can support the housing sector (especially construction): higher costs of owning free land stimulate landowners to sell building plots; a high and still liquid labor market is an opportunity to involve relatively inexpensive labor in the construction of new projects.

Several leading indicators point to a further contraction in wage growth and a decline in rent inflation:

Leading indicators point to a decline in wage growth



Declining house prices are affecting lower rents

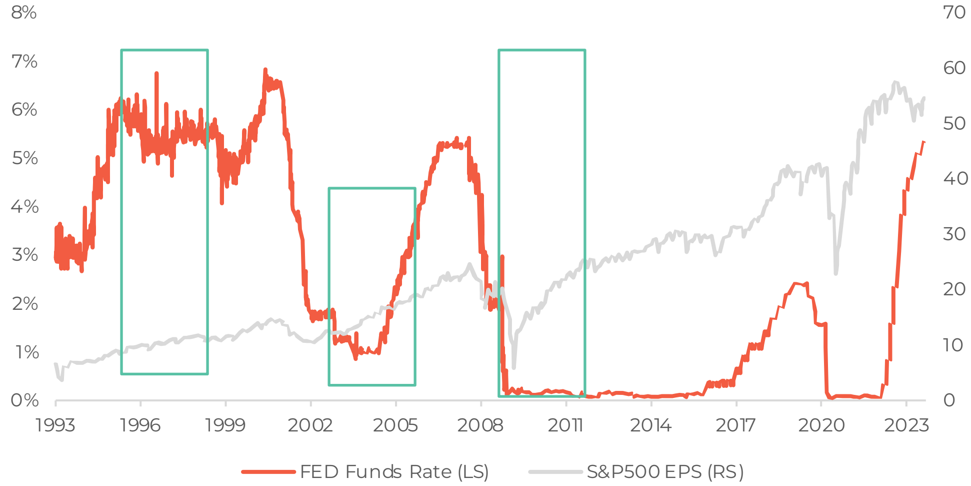


Strategy

Despite media pressure about the strength of the economy and the potential for nominal GDP growth, it is safe to assume that the Fed will avoid a situation in which a peak interest rate hike is followed by a sharp cut. In a historical context, the pause between these events is important, and a sharp cut after a hike has usually been followed by a shock to the stock market.

Last quarter, corporate earnings (EPS) of companies in the S&P500 Index posted nominal gains relative to expectations, but a detailed analysis of similar situations in the past shows that a sustained trend increase in EPS only fully occurs once the Fed begins to cut interest rates:

Fed Funds Rate and S&P500 EPS Growth



From a strategic point of view, we are less optimistic about stock indices than bonds. Despite the rather confident rhetoric, the Fed is quite close to actually recognizing the deterioration of the economy, and thus to changing the vector of interest rate policy. Therefore, our baseline scenario assumes the following:

Current economic development scenarios

What Type Of Landing?	No Landing (Uncertainty persists; No Recession/Recovery)	Soft Landing (Recovery w/o Recession)		Hard Landing (Recession Then Broad Recovery)
What It Means For The Macro Outlook?	Macro Purgatory... Data Remain Volatile, No Clear Sign Of Recession Or Recovery	Reflationary Macro Recovery	Goldilocks Macro Recovery	Rising Unemployment Broadly Weights On Macro
What Happens To Interest Rates?	Rates remain Higher For Longer Fed Pauses; No Hikes Or Cuts In '24	Rates Drift Higher Additional Hikes Likely	Interest Rates Drift Lower Fed Pauses In 23; Cuts Rates In 24 Amidst Macro Recovery w/o Rising CPI	Interest Rates Decline Alongside Rising Unemployment & Fed Cuts

Our current view

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Strategy

High levels of corporate refinancing at low interest rates, restrained issuance of corporate debt and multiple implicit fiscal and regulatory stimuli acted as a counterbalance to the aggressive interest rate policy of the US central bank. ***This allowed the stock market to continue to grow against the backdrop of the actively developing theme of recession. At the same time, stock indices started to decline from the middle of the third quarter.***

Stock market

We recommend a greater focus on quality fundamentals and interest rate risk coverage in our model equity portfolio. As positive factors in the form of lower oil prices, excess savings and fiscal policy start to fade from the second half of 2023, we expect that this could be a period of mixed dynamics for the stock market, in which it is prudent to adopt a more balanced positioning.

Debt market

High interest rates and the Fed's continued thesis of a strong economy have created a challenging environment for the bond market. However, a number of headwinds in the corporate sector and a correction in the stock market are making less volatile debt instruments with higher risk premiums, increasingly attractive. ***Given the smooth dynamics and market specifics, tactical rebalancing and focus on the underlying economic scenario make debt market instruments attractive on the horizon of the coming quarters.***

Commodity markets

Rising energy prices and growing demand for industrial metals are attracting the attention of investors looking for alternative sources of yield. A strong dollar in Q3 2023 did not help commodity indices, but the future outlook for the greenback allows for an even more enthusiastic return to commodity markets. ***Among the most attractive assets are oil and petroleum products, copper, and gold.***

Europe

A weak recovery and reduced global trading activity amid geopolitical tensions amid aggressive ECB policy led to conservative gains in European equity markets. ***The moderately negative economic backdrop leaves room for short-term growth.***

China

China's mixed political and economic situation prevents the fastest growing technology sector from developing fully. Deflationary effects in the economy and government regulation, despite a number of easing measures, are combined with an attractive stock market valuation, which will require a positive momentum for the inflow of foreign investment capital.

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