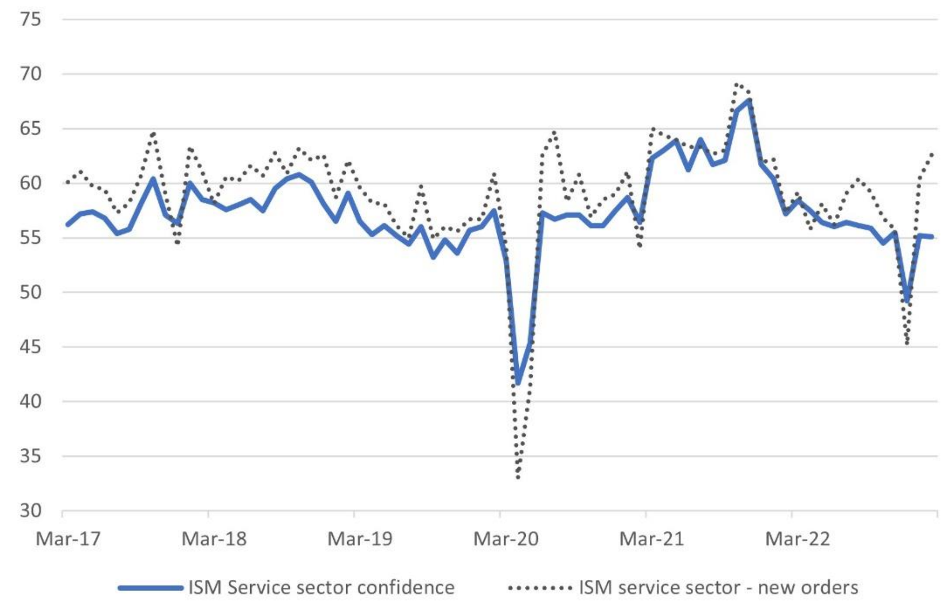
Central Bankers' Job is Far from Done

- **US wage growth surprises to the upside, and growth data better than expected.**
- **European inflation forecasts on the rise**
- **US 10-year bond yield consolidates at around 4%, as investor complacency still evident**
- **China's economic growth forecasts disappoint; we remain constructive on the equity market**
- **ADNOC shatters records with $124bn subscribed – a 50x oversubscription.**

The US 10-year bond yield drifted briefly above 4.0% last week before retreating to remain virtually unchanged on the week at 3.95%. **However, the economic news flow remains emphatically negative for the bond market.** Still, the fact that yields have not moved higher has perhaps to do with hope among investors that the economic data flow for February, to be published through March, will be weaker.

Last week's US wage data was worryingly well above expectations. There was a significant upward revision to Q4 2022 unit labour costs to a seasonally annualised rate of 3.2% from 1.1%, at leaving the year-on-year run rate at 6.3%. US Industrial confidence data showed marked strength in the service sector, which continues to surprise with higher-than-expected inflation.

Chart 1: US service sector activity and new orders remain strong



Source: Bloomberg

In Europe, where energy prices have eased significantly, the latest inflation reports show core inflation running at 5.6%, leading economists to increase their forecasts yet again for the balance of the year. There are expectations that the ECB will raise rates by 50bps at its meeting in May.

The focus of the markets this week is the US non-farm payroll data. The consensus amongst economists is that 212,000 jobs were added to the economy in February after last month's surprising addition of 517,000. Compared with the January, this more benign data point leads some commentators to believe that we may have seen the near-term peak in 10-year yields. However, bond yields are higher because the Fed, in all likelihood, will raise rates by 50bps. Although an increase of that magnitude would only match broader market expectations, it may just shake investors out of their slumber that the Fed's job is anywhere near complete. The risk to further rate increases remains on the upside.

In our view, complacency abounds in the bond markets. As government bond yields shot up and consolidated, spreads on corporate debt, high yield, and emerging market debt have remained relatively stable. This reek of complacency and reflects the view that when growth is good, why worry about defaults! However, while that may be where we are today, our future looks far less certain. The more inflation persists at these higher levels, the greater the risk that central banks will have to raise rates aggressively—and eventually force their respective economies into recession. The many rate increases effected thus far have not materially slowed global growth.

Corporations are obviously worried about the prospect of higher rates and long-term interest rates. February saw high-grade issuances of $151bn, about 40% higher than any previous February.

The other risk to the bond market comes from reduced buying by central banks and a general tightening in credit conditions. The Fed is on a path to decreasing the size of its balance sheet, with balances down $160bn. The US has seen a collective drop of $100bn in deposits since the start of the year, which will only crimp available credit in the economy. The mix of the bond holdings of banks has trended towards shorter duration, again putting pressure on longer-dated bonds.

China's aspirations are modest but consistent.
The Chinese government budget, presented on Sunday, may initially disappoint the market, but we still see good momentum in the equity market. The Chinese authorities somewhat disappointed the market with their new 2023 GDP target of 5.0%. The government also sounded relatively constrained on the scale of the planned fiscal boost to the economy. Rather than pushing too hard, the government is happy to let the end of the lockdown provide that much needed year-on-year stimulus to the economy. It highlighted consumption as the key driver to growth in 2023 and something that the government will be keen to underwrite. The focus will likely be on ensuring that consumer confidence is maintained through targeted housing market support.

But, as a sign of the times we are in, Bloomberg characterised the budget as "Li's report underlined a shift in Beijing's outlook toward emphasising national security, technological self-reliance and financial stability over the pace of growth". The nationalistic dogma serves no one well.

In any case, we retain our constructive view of the Chinese equities, focusing on domestic plays, mainly consumer related. This argues for concentrating on the Chinese A-share market, which is domestically focused and remains substantially undervalued. We continue to avoid anything with a global technology angle for fear of potential US sanctions.

The UAE's new IPO, ADNOC Gas – Investor demand unsatiated
As we anticipated, ADNOC Gas responded to the overwhelming demand for its IPO by increasing the number of shares available for subscription. However, it disappointed many in the market by only taking

the float size up to 5% from 4%. Retail investors are expected to only receive a 2% allocation. The book-building process saw $124 bn in demand for the IPO, which implies a 50x oversubscription. The significance of the IPO to us is that it likely paves the way for ADX and DFM IPOs in 2023 with a high watermark. The company set the final price of the IPO at AED2.37, near the top end of the initially indicated range of AED 2.25 to AED 2.43. The final price implies a market value of AED182bn ($50bn) and an indicative dividend yield of 6.5%. The company is clearly competing well with cash deposit rates of around 5%. UAE investors are typically yield-seeking; hence, this IPO will provide a benchmark for future IPOs.
