November 2022

CQS Asian Macro Fund
The Big Picture

Outlook for the Global Economy and Markets

Die Another Day

Last month we surmised that financial markets were on the cusp of a rout that would finally mark the end of the end of the current "inflationary bust" phase of the cycle – characterized by rising interest rates and a strong US dollar – and the start of a more typical disinflationary downturn. Perhaps unsurprisingly, we have been proven wrong on timing. The MSCI World Index of stock markets rallied off its mid-October low, led by the much-hated European bourses that outperformed in US dollar terms.

Investors have had a lot of bad news flung at them and yet – except in some emerging markets and, notably, the recently troubled Hong Kong and China indices – the bear market has been quite orderly and still lacks any clear-cut "capitulation". The VIX index of US equity market volatility has stayed firmly below the 40 level over the last two years, well below the 50-80 spikes commonly recorded during serious "risk-off" moments in recent decades.

What explains such resiliency? Does it imply recession might be averted?

First off, we must remind ourselves that Wall Street can diverge from Main Street. It's possible to have a significant sell-off in financial markets without recession, although not the other way around. The inflationary crash of 1987 was one such event that did not coincide with recession… although higher interest rates surely set in motion the "savings and loans" crisis that ended in the 1990 downturn.

The current cycle has several unique features that make timing quite difficult:

- In response to the pandemic, most industrial countries made large fiscal transfers to households and companies to keep them going in lockdown. Private sector cash balances remain high and act as a buffer against declining real incomes.

- While interest rates in the US have risen sharply as inflation returned, monetary policy is easier in many other countries, including Japan and Europe whose central banks are still adding liquidity.

- Partly thanks to macro-prudential measures imposed in the aftermath of the global financial crisis (GFC), major financial institutions remain well-capitalized. More conservative lending standards – notably in real estate – mean that property prices can fall significantly before creating distress.

- Since the GFC, low interest rates have encouraged a wave of corporate financing that has doubled the global stock of corporate bonds. The US has some US$10tr outstanding, or about half of the total. Of this, some 40% are BBB – just above junk. In 2022, only US$100bn of US "IG" bonds matured, so companies did not immediately feel the cost pinch… but this will step up to US$700bn in 2023 and rise gradually thereafter.

In summary, it is fair to say that private sector balance sheets, buffered by fiscal transfers and supported by strong banks, have lent some resiliency to financial markets. Credit spreads, China excepted, have widened but not blown out.

Outside the US, the main threats to growth have been the jump in energy costs, sluggish demand from China and the rising cost of US dollar financing. Domestic interest rates have been slower to rise.

This explains why European markets have managed to recover lately as a build-up of natural gas reserves, aided by mild weather, has offered hope that the Continent might "muddle through" the winter. With the ECB slow to withdraw liquidity and investor sentiment negative, there was ample scope for a relief rally.

Yet the fact remains that monetary policy acts with a lag. Banks are indeed tightening their lending standards; housing prices around the World are falling, so destroying wealth; corporate margins are under pressure and debt rollovers will be costly. Global money supply is already in outright contraction… and consumers will become less willing to draw down savings as rates rise and if job security ebbs.

For financial markets, there is a silver lining: inflation is dropping, and weaker growth means bond yields peak.

So, contrary to our earlier projection, a respite on inflation and US interest rate expectations is now happening without a cathartic purge of equities. As discussed in last month's Big Picture, weaker money and credit growth are important inflation indicators and there is indeed a transitory element to cost inflation that washes out as supply chains are restored, post-pandemic.

Moreover, in all the hyper-ventilating about the US economy and Fed policy, commentators have paid scant attention to China. The World's second-largest economy has been flat on its masked face. This has been a deflationary wave for the rest of the World: China's imports have been declining on a volume basis and the dollar price of manufactured exports has been flat.

China's malaise is both acute and chronic. The acute part has obviously been caused by an unrealistic "zero-COVID" strategy that is starting to unravel. We will not dwell on the details here but, suffice to say, policy is shifting towards a gradual opening over the coming 6-12 months. The chronic part is the housing market that has been the lynchpin of domestic growth and is now in a Japan-style deflation.

What matters for international investors is that feeble demand from China has helped to contain the prices of many commodities, beyond those directly affected by the Russia-Ukraine conflict, despite serious supply shortages in many areas.

Hopes for an opening-up of China's economy may now trigger a rebound in cyclical metals and, to a lesser extent, in the energy complex, but the chronic demand issue will not easily be solved.

In short, the global economy is indeed at an inflection point on inflation and this will be critical for expectations for Fed policy and the direction of financial markets. How should investors be positioned?

Our tactical view on risk assets is bullish into year-end. There is a window of opportunity created by a combination of factors:

1. The US Federal Reserve has driven interest rate expectations to an extreme that is unlikely to be met. Collapsing money supply and a sharply inverted yield curve are already making their impact felt. Lower inflation is the catalyst for longer-dated yields to fall.

2. As discussed above, Europe is enjoying relief from the spike in natural gas prices and is hoping to muddle through the winter months. For now, subsidies offer some protection to consumers.

3. China is finally discussing a relaxation of COVID policies. Hope springs eternal, even though the exit will be fraught with difficulties, but Chinese and Hong Kong equities *did* see real capitulation so the current rebound may have further to go.

4. The US dollar's bull run since mid-2021 has been powerful and investor positioning is heavy. There is considerable potential for an unwinding of positions as the narrative of "endless Fed tightening" juxtaposed with "crises in Europe and Asia" has become too extreme.

A decline in the US dollar should trigger rallies in most emerging equity markets and it is critical to the tactical bull story.

The problem, however, is that stubborn, core inflation in developed economies will not fully drop out without "demand destruction" and a rise in unemployment rates. There is no prospect of an actual easing by the Fed until then… and rates in Europe and elsewhere are still lagging. The US dollar typically acts as a haven during recessions.

The US equity market remains expensive and is surely not pricing the type of earnings decline inevitable in recession. Other equity markets will succumb if Wall Street collapses. And, to the extent that any near-term tactical rally lifts equity and commodity markets, then central banks may feel obliged to step up their hawkish rhetoric.

The Bank of Japan will be particularly interesting to watch on this score since it has been grimly determined to resist monetary tightening despite core inflation, under its own definition, now breaching the 2% target. The Japanese labour market is already tight, and a likely flood of overseas tourists will lift employment in the hospitality and transport sectors as we head into the "spring wage round."

Removal of "yield curve control" would be an unpleasant shock for global bonds – hence other risk assets – yet it can only be avoided if the rest of the World goes into recession… which would also be negative.

We are strategically bullish on Japanese equities at these levels, but a short JGB position is a necessary hedge… and we now see the risks to the yen as skewed to the upside with US bond yields dipping.

We were too early in calling for a capitulation in global equity markets but doubt that bullet can be avoided.

Geoffrey Barker

11th November 2022

OTHER IMPORTANT INFORMATION:

This document has been issued by CQS (UK) LLP (FRN 400496) which is authorised and regulated by the UK Financial Conduct Authority and/or (as the case may be) CQS (US), LLC which is a registered investment adviser with the SEC. The information is intended solely for sophisticated investors who are (a) professional investors as defined in Article 4 of the European Directive 2011/61/EU or (b) accredited investors (within the meaning given to such term in Regulation D under the U.S. Securities Act of 1933, as amended) and qualified purchasers (within the meaning given to such term in Section 2(a)(51) of the U.S Investment Company Act 1940, as amended).

CQS is a founder of the Standards Board for Alternative Investments ("SBAI") (formerly, the Hedge Fund Standards Board) which was formed to act as custodian of the alternative investment managers' industry best practice standards (the "Standards") published by the Hedge Fund Working Group ("HFWG") in 2008 and to promote conformity to the Standards. SBAI is also responsible for ensuring that they are updated and refined as appropriate. The Standards were drawn up by HFWG which comprised the leading hedge funds (based mainly in London) in 2007 in response to concerns about the industry, including financial stability and systematic risk. The HFWG completed its work in January 2008 and published its report outlining the Standards. By applying the Standards, managers commit to adopt the "comply or explain" approach described in the Standards.

The term "CQS" as used herein may include one or more of any CQS branded entities including CQS (UK) LLP, CQS Cayman Limited Partnership which is registered with the Cayman Islands Monetary Authority, CQS (Hong Kong) Limited which is regulated by the Hong Kong Securities and Futures Commission, CQS (US), LLC which is registered with the US Securities and Exchange Commission, and CQS Investment Management (Australia) Pty Limited which is registered with the Australian Securities & Investments Commission, Australian Financial Services Licence No. 386047.

This document has been prepared for general information purposes only and has not been delivered for registration in any jurisdiction nor has its content been reviewed by any regulatory authority in any jurisdiction. The information contained herein does not constitute: (i) a binding legal agreement; (ii) legal, regulatory, tax, accounting or other advice; (iii) an offer, recommendation or solicitation to buy or sell shares or interests in any fund or any security, commodity, financial instrument or derivative linked to, or otherwise included in, a portfolio managed or advised by CQS; or (iv) an offer to enter into any other transaction whatsoever (each a "Transaction").

Any decision to enter into a Transaction should be based on your own independent investigation of the Transaction and appraisal of the risks, benefits and suitability of such Transaction in light of your individual circumstances. Any decision to enter into any Transaction should be based on the terms described in the relevant prospectus, supplement, offering memorandum, private placement memorandum, subscription documents, trading strategy, constitutional document and/or any other relevant document as appropriate (each an "Offering Document"). Any Transaction will be subject to the terms set out in its Offering Document and all applicable laws and regulations. The Offering Document supersedes this document and any information contained herein.

Nothing contained herein shall constitute or give rise to the relationship of partnership nor shall it constitute a joint venture or give rise to any fiduciary or equitable duties. Any information contained herein relating to any third party not affiliated with CQS is the sole responsibility of such third party and has not been independently verified by CQS or any other independent third party. The information contained herein is not warranted as to completeness or accuracy and no representations are made in such respect, nor should it be deemed exhaustive information or advice on the subjects covered; as such, the information contained herein is not intended to be used or relied upon by any counterparty, investor or any other party. The information contained herein, as well as the views expressed herein by CQS professionals made as of the date of this document, is subject to change at any time without notice.

CQS uses information sourced from third-party vendors, such as statistical and other data, that are believed to be reliable. However, the accuracy of this data, which may also be used to calculate results or otherwise compile data that finds its way over time into CQS research data stored on its systems, is not guaranteed. If such information is not accurate, some of the conclusions reached or statements made may be adversely affected. CQS bears no responsibility for your investment research and/or investment decisions and you should consult your own lawyer, accountant, tax adviser or other professional adviser before entering into any Transaction. CQS is not liable for any decisions made or action taken by you or others based on the contents of this document and neither CQS nor any of its directors, officers, employees or representatives (including affiliates) accept any liability whatsoever for any errors and/or omissions or for any direct, indirect, special, incidental or consequential loss, damages or expenses of any kind howsoever arising from the use of, or reliance on, any information contained herein.

Information contained in this document should not be viewed as indicative of future results as past performance of any Transaction is not indicative of future results. Any investment in any fund or other vehicle managed by CQS (a "CQS Fund") or any of its affiliates involves a high degree of risk, including the risk of loss of the entire amount invested. The value of investments can go down as well as up. An investment in any CQS Fund will involve a number of material risks which include, without limitation, risks associated with adverse market developments, volatility of markets invested in, currency and exchange rate risks, risk of counterparty or issuer default and risk of illiquidity. Any assumptions, assessments, intended targets, statements or other such views expressed herein (collectively "Statements") regarding future events and circumstances or that are forward looking in nature constitute only subjective views, outlooks or estimates and are based on CQS's expectations, intentions or beliefs. The Statements should not in any way be relied upon, and involve inherent risk and uncertainties beyond CQS's control. The Statements should not be assumed to be accurate or complete, now or in the future (including with respect to the composition and investment characteristics of any CQS Fund), and may be subject to change. CQS undertakes no responsibility or obligation to revise or update such Statements. Target returns and volatility targets discussed in this document are high-level, may change with market conditions and are generally used only as guidelines. Target returns reflect subjective determinations by CQS. Performance may fluctuate, particularly over short periods of time. Targeted returns should be evaluated over the time periods indicated and not over shorter periods. Target returns are not intended to be actual performance and should not be relied upon as any indication of actual or future performance. Some of the information contained in this document may be aggregated data of transactions executed by CQS that has been compiled so as not to identify the underlying transactions of any particular CQS Fund.

Any indices included in this document are included to simply show the general market trends relative to the types of investments CQS tends to select for certain CQS Funds for the periods indicated within this document. The indices are not representative of CQS Funds in terms of either composition or risk (including volatility and other risk related factors). CQS Funds are not managed to a specific index.

This document is not intended for distribution to, or use by, the public or any person or entity in any jurisdiction where such use is prohibited by law or regulation. In accepting receipt of this information, you represent and warrant that you have not been solicited, directly or indirectly, by CQS and are receiving this information at your own request. It is your responsibility to inform yourself of and to observe all applicable laws and regulations of any relevant jurisdiction.

(Continued on next page)

CQS (US), LLC is a member of the National Futures Association (the "NFA") and is subject to the NFA's regulatory oversight and examinations. However, you should be aware that the NFA does not have regulatory oversight authority over underlying or spot virtual currency products or transactions or virtual currency exchanges, custodians or markets.

The information contained herein is confidential and may be legally privileged and is intended for the exclusive use of the intended recipient(s) to which the document has been provided. In accepting receipt of the information transmitted you agree that you and/or your affiliates, partners, directors, officers and employees, as applicable, will keep all information strictly confidential. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information is prohibited. Any distribution or reproduction of this document is not authorized and prohibited without the express written consent of CQS, or any of its affiliates.

AIFMD and Distribution in the European Economic Area: CQS (UK) LLP is an Alternative Investment Fund Manager (an 'AIFM') to certain CQS Funds (each an 'AIF') (as defined in the Alternative Investment Fund Managers Directive (Directive (2011/61/EU) ('AIFMD')). The AIFM is required to make available to investors certain prescribed information prior to investing in an AIF. The majority of the prescribed information is contained in the latest Offering Document of the AIF. The remainder of the prescribed information is contained in the relevant AIF's pre-investment disclosure document, the monthly investor report, and the fund limits document. All of this information is made available in accordance with the AIFMD. In relation to each member state of the EEA (each a "Member State"), this document may only be distributed and shares or interests in a CQS Fund ("Shares") may only be offered or placed in a Member State to the extent that: (1) the CQS Fund is permitted to be marketed to professional investors in the relevant Member State in accordance with the AIFMD (as implemented into the local law/regulation of the relevant Member State); or (2) this document may otherwise be lawfully distributed and the Shares may otherwise be lawfully offered or placed in that Member State (including at the initiative of the investor).

Information required, to the extent applicable, for Distribution of Foreign Collective Investment Schemes to Qualified Investors in Switzerland: The representative in Switzerland is The Fund has appointed ACOLIN Fund Services AG, succursale Genève, 6 Cours de Rive, 1204 Geneva, Switzerland, as its Swiss Representative. Banque Heritage SA, 61 Route de Chêne, CH-1208 Geneva, Switzerland is the Swiss Paying Agent. In Switzerland shares shall be distributed exclusively to qualified investors. The fund offering documents, articles of association and audited financial statements can be obtained free of charge from the Representative. The place of performance with respect to shares distributed in or from Switzerland is the registered office of the Representative.

PRI Note:

PRI is an investor initiative in partnership with UNEP Finance and the UN Global Compact.

About CQS

CQS is a credit-focused multi-strategy asset manager founded by Sir Michael Hintze in 1999. Our deep experience allows us to offer solutions for investors across a range of return objectives and risk appetites. We are an active asset manager with expertise across the credit spectrum, including corporate credit, structured credit, asset backed securities, convertibles and loans. We are committed to delivering performance and high levels of service to our investors. CQS has offices in London, New York, Hong Kong and Sydney.

CQS (UK) LLP
4th Floor, One Strand
London WC2N 5HR
United Kingdom
Tel: +44 (0) 20 7201 6900
Fax: +44 (0) 20 7201 1200

CQS (US), LLC
152 West 57th Street
40th Floor
New York
NY 10019
United States
Tel: +1 212 259 2900
Fax: +1 212 259 2699

CQS (Hong Kong) Limited
16th Floor
8 Queens Road Central
Central, Hong Kong
China
Tel: +852 3920 8600
Fax: +852 2521 3189

CQS Investment Management (Australia) Pty Limited
Level 13
1 Margaret Street
Sydney
NSW 2000
Australia
Tel: +61 2 8294 4180

clientservice@cqsm.com
www.cqs.com

SBai Standards Board for Alternative Investments SIGNATORY Feb '19

Signatory of: PRI Principles for Responsible Investment

G-19-0309 / 12.19