CIO OFFICE MORNING MARKET WRAP – 4th April, 2022. ALSO AVAILABLE ON ALEXA.

Asian stocks are up this morning boosted by a rally in Hong Kong following the easing of a dispute between China and the US over audits, while US futures are little-changed and Treasuries are falling on the outlook for accelerated rate hikes by the Fed.

Markets barely eked out gains, bonds rebounded and commodities pulled back in a week revolving around the ongoing Russia-Ukraine conflict and marked by macroeconomic releases pointing to US economic strength, Chinese protracted weakness and a less resilient Europe.

Investors continue to be concerned about the stagflationary effects of the war in Ukraine, translating into higher prices of basic resources and shocks to growth. Indeed, the two countries combined lead in commodity exports across energy, industrial metal and agricultural commodities; and the unintended consequences of war on the business cycle should not be underestimated, as "contagion works in mysterious ways", according to World Bank's chief economist Carmen Reinhart. And alarm bells were also sounded by the OECD chief economist, as "uncertainty deters consumer purchases and business investments". Yet, it is worth highlighting that upheavals can derive as well from the excessive use of sanctions, as justified as they may seem to be according to their proponents. The IMF First Deputy Managing Director said that the sweeping measures adopted by the West against Russia could “cause fragmentation at a smaller level” of the international monetary system, which in less nuanced language would point to a potential loss of dominance of the dollar-based system. The conflict continues to cause disruptions in all directions, but none of the parties want to step an inch back. So, let’s watch out for unintended consequences down the road.

The jobs report confirmed once more that the US labor market is booming. While commentators may highlight that payrolls came just shy of expectations, at 431,000 in March, a slowdown would actually imply a release of about 100,000 per month, a far cry from the currently red-hot levels. And unemployment dropped further, to 3.6%, where marginal improvements could be ever harder to come by. So, the Fed will be enticed to tighten sharply, as neither the war nor higher inflation have so far dented the labor market, which in turn will support strong retail sales, the opposite of what the Fed wants to see. It will be a matter of real rates having to rise to cool demand, and that will be managed by Powell via the shrinking of the balance sheet, likely to be started in May. Futures paired gains after the jobs report, while treasuries extended losses. As for other economic reports, PCE inflation failed to make headlines being in keeping with estimates both at the headline and core level. Personal income increased as expected but less than inflation, while spending dropped more than projected in the month of February, according to the Personal Income & Spending report. With real purchasing power being dented by rising price pressures, there is the risk that unemployment at some point will get affected, in spite of evidence to the contrary from the March payrolls numbers. Renowned investor Mohamed El-Erian talked of a “cost-of-living crisis” in the next two-to-three quarters, whereby lower purchasing power should impair sentiment further. The bottom line is that, either inflation will hit consumers, or the Fed will have to hit consumers if price pressures don’t do the job. New York Fed chief said that inflation risk in US is “particularly acute”.

The US ISM manufacturing index, at 57.1, declined to below-consensus levels in March, marking the lowest reading since September 2020. New orders and production were weaker, compounded by signs of persistent supply-chain issues. Overall, we would be tempted to say that conditions in the manufacturing sector weakened to quite an extent, had it not been for other manufacturing surveys which provided more favorable signals. The euro area composite PMI, at 54.5, was weak in the details, with a large fall in the future output index, pointing to the Ukraine conflict already impacting sentiment significantly. More concerning is the steep increase in inflation, to 7.5% yoy, a new EMU-era record high. This should be no surprise, being Europe very sensitive to energy prices, hence most exposed to the negative impact of the ongoing war. China is still dealing with a prolonged soft patch, partly due to the extremely severe covid policy which saw renewed lockdowns. Business confidence as measured by the PMI report fell below 50, in contraction territory, in the month of March. Manufacturing bucked the trend of positive March seasonality, while services significantly undershot expectations. The authorities are expected to adopt further offsetting stimulus measures in the months ahead.

At the OPEC meeting on output no hikes in production on top of the pre-planned ones were decided. Saudi Arabia and the UAE underscored that politics should be kept out of discussions and that Russia is a key member of the group. The meeting took place before Joe Biden's announcement of the significant release of strategic reserves for a maximum of 6 months to cap gasoline prices. Strategic reserves constitute spare capacity which must in the end be rebuilt, and reducing that spared capacity for policies which have doubtful effects can only reinforce the conviction about a tight market. Biden's decision is likely to eventually boost rather depress prices.

European and Chinese leaders met virtually about the war in Ukraine, a summit which can be said to have been frosty at best. Xi called on the EU to act more independently of the US, while van der Leyen said that China supporting Russia would do "reputational damage" to the country. Von der Leyen acknowledged that the two sides exchanged "clearly opposing views". Nothing done, the conflict will drag on.

Week ahead: Monday, Eurogroup meets in Luxembourg to discuss impact of Ukraine war on Europe; Tuesday, United States, ISM Services Index; Wednesday, United States, Federal Reserve meeting minutes; Thursday, German Industrial Production, ECB monetary policy accounts.

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