



CIO OFFICE MORNING MARKET WRAP – 6th April, 2022.

Sessions remain highly volatile depending on the news flow and the kind of expectations, or hopes, market participants erratically cling to. Yesterday saw stocks completely reverse the previous day's gains, and investors unable to ignore announcements of ever more sanctions on Russia and sharper Fed policy tightening which were anyway in the offing. Losses in the S&P 500 were led by the technology and consumer discretionary sectors, while 10-year real yields shot to a two-year high on comments by a high-ranking Federal Reserve official about the forthcoming shrinking of the Fed's balance-sheet. Following the remarks dollar and gold accelerated in opposite directions, the former to new highs, the latter towards recent session lows. And Asian markets are weak this morning, with Asia-Pacific equities dragged down by Japan and Hong Kong. US and European futures are slipping and treasuries are extending their slump.

Tensions between Russia and the West have been rising by the day. A Russian default, rather than an undesirable occurrence, is now just seen as a way of forcing Putin's hand in the ongoing conflict. That is why dollar-debt payments from Russian government accounts at American financial institutions were halted. The risk of default will be increased not because of the lack of money, but rather due to technical issues related to the settlement of transactions. This is one more unprecedented measure taken alongside the freezing of the CBR's forex reserves overseas soon after the invasion of Ukraine. The EU has now proposed the banning of coal imports from Russia, supplying about half of the continent's thermal coal.

Futures for coal delivered to northwest Europe jumped, and US coal producers rallied. A ban on Russian and Belarusian trucks and ships and a full transaction ban on four banks is being considered by the bloc. All of the efforts notwithstanding, we can only remark that a quick energy transition in Europe is easier said than done, as most contracts are negotiated for the longer-term and re-supplying is also fraught with logistical difficulties to be sorted out in years rather than months. The willingness of the European leaders to take their countries to any kind of self-inflicted pain to stop Putin remains anyway remarkable to say the least.

Treasury markets were spooked by Fed Brainard's declarations that the FOMC will tighten monetary policy "methodically" and shrink the balance sheet "at a rapid pace" starting in May. This is a perfect description of the Fed's printing press moving in reverse gear. She also added that she expects the balance sheet to shrink more rapidly than in 2017-2019. Equity investors should remember that markets crashed when Powell said that quantitative tightening was on "autopilot". Brainard's words count, as it is customary that the Fed vice chair delivers important messages about the direction of policy alongside the chair. As much as the yield curve flattened when the balance sheet did swell, with the Fed's bond portfolio getting smaller the tendency should be towards some steepening. Indeed, the 10 year minus 2 year treasury yield came back slightly into positive territory, so technically the curve now is no longer inverted. The vice chair could have pre-empted much of the hawkishness which might transpire from the March minutes to be published today. The message is not a joyful one for the returns to be expected by the typical 60-40 equity-bond portfolio when the quantitative tightening is in full swing.

Talk of a US recession is now becoming rife, so we will take the opportunity to revisit once more the topic as both Guggenheim Partners' CIO Miner and ex Treasury Secretary Summers have just shed much light on it. Miner published an essay on the company's website where he drew parallels between today's situation and the inflationary era after World War II, which caused a mild recession in 1949. Without going in the details, a war, an epidemic, manufacturing upheavals, supply disruptions, exploding money growth and savings relate to what is happening today, so should the recession which followed, but years later. Lawrence Summers came to similar conclusions in terms of recession odds in a recent paper jointly published with a researcher. Conditional on the current conditions of inflation at multi-year highs and a very tight labor market, the odds of a contraction are quite high in the next two years, in spite of the rosy scenario depicted by the Fed with steady employment levels, according to Summers. The CIO-Office view that a recession usually follows a yield curve inversion by couple of years is in line with the above and would take us to 2024 as a hypothetical candidate year for the dreaded occurrence. Meantime, markets may well rally!

The US ISM services release was quite strong and substantially in line with expectations, showing none of the weakness displayed by manufacturing confidence. Yet, it is the latter which is usually relevant in terms of early signals flashed about a potential economic slowdown and its continuation.

Stay safe.

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