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

Volatility in the last 48 hours reached extreme levels across all asset classes, culminating with a severe sell-off this Thursday on US assets.

While global stocks fell by a reasonable -1.2% on average yesterday, US shares tumbled -3.7% with the Nasdaq losing close to -5%, bringing its year-to-date loss to -21%. Interest rates rose sharply with a +10 basis points average increase across maturities. Both the 5 and 10-year Treasury yields closed above the 3% mark at respectively 3.01% and 3.04%, while the 30-year is at 3.12%. The price of Brent crude oil gained 0.9% to $111, the dollar kept on rising, adding +0.3% on average against trade-weighted counterparts, and major crypto assets sold off.

The sharp rise in risk aversion can be read as a global "stagflation" scare. Global growth actually faces a range of shocks, from a longer than expected conflict in Ukraine to a so far out-of-control Omicron outbreak in China. April purchasing managers indices in the West confirmed a clear loss of momentum: the US ISM manufacturing came at 55.4, way below March's 57.1 and the median forecast of 57.6, while the same gauge for services also came short of expectations at 57.4. Comparable measures for Europe painted a comparable picture: while the absolute levels remain in expansion, the trend is down. The situation appears worse in China with the Caixin PMI composite showing a clear contraction at 37.2 – Beijing nevertheless confirmed an inflexible "zero covid policy". The planned embargo on Russian oil from Europe also added to growth concerns. Obviously, the second pillar of investors' anxiety is inflation, and the key event of the week was the Fed meeting this Wednesday. As expected, the US central bank delivered a +50 basis point hike and announced plans to start the balance-sheet runoff in June at an initial monthly pace of $47.5bn, to be doubled after 3 months. Importantly, the Fed indicated flexibility with regards to the pace of rate hikes, with another +50 basis point increase being clearly on the table for the next meeting at least. While the overall tone was reasonably hawkish, with a clear focus on a “much too high” inflation, it was less hawkish than some had expected. The chairman ruled out 75 basis points hikes, typically, and expressed hope that restrictive policies may not be needed. The overall perception was that the Fed would gradually move to neutrality rather than being outright aggressive. This triggered some relief on markets immediately after the news, but yesterday saw a sharp U-turn: many market participants are now concerned that it may not be enough to fight inflation. Bottom-line, markets are now scared of a sinister scenario of stagflation.

No doubt, uncertainty is high and volatility is brutal. Our central scenario is however not as dark as markets suggest. The global economy so far demonstrates resilience, outside of China which should ultimately take control of their Covid situation – like all other countries did. Global growth is undoubtedly dented, and will be hit by additional pressure from higher borrowing costs, spillovers from China’s lockdowns, consequences from the war in Ukraine and even feedback from falling financial markets. But growth should not be annihilated, as reopening dynamics are still at play with, crucially, consumption staying at elevated levels. Under such a scenario, valuations from risk assets now display some upside potential, and interest rates are not far from their fair values. We keep on expecting extreme volatility but taking into account more reasonable valuations and extreme negativity in investors’ sentiment, we reiterate that the big picture is not adverse for the medium term.

As we write this morning, Asian markets are not fully reflecting the sharp sell-off in US assets. Stocks are slightly up in Japan, reopening after a holiday. China and Hong-Kong are down -2% and -3% respectively, with the tech sector underperforming. It is significant, but actually no unusual and certainly not panic. Interest rates continue to rise, with the US 10-year Treasury yield gaining +2 basis points at 3.06%, and so do energy prices with the barrel of Brent trading just below $112. Future contracts on Western stock indices are marginally lower and so are major cryptocurrencies.

Today’s focus will be on the monthly US employment report, which is expected to show 380k net job creations in April and a stable unemployment rate of 3.5%. Any material surprise could send a signal to the Fed, or at least to nervous market participants.

Stay safe.

Chief Investment Office
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Head Office : Baniyas Road, Deira, PO Box 777, Dubai, UAE.