



**CIO OFFICE MORNING MARKET WRAP – Friday February 11, 2022.
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This morning stocks are under pressure and bonds extending Thursday's losses following the jump in US inflation. US and European equity futures are retreating alongside Asian stocks. Traders are also mulling the latest data from China. Credit growth accelerated after the central bank eased policy to counter the economic slowdown.

Yesterday's session was dominated by inflation across the board, with the US CPI release at a four-decade high and price pressures hitting margins of some European companies in the reporting season. US equities extended declines, led by the technology sector, following a Fed's official comment supporting four rate increases by July 1 - the S&P 500 closed 1.8% in the red, and the Nasdaq more than 2%. The yield on the 10-year treasury note broke the 2% level for the first time since August 2019,

while the yield curve flattened as the 2-year yield hit 1.63%, suggesting investors see tighter policy in the end capping growth. The US dollar fluctuated and gold snapped a four-day winning streak, the latter overall not much affected by rising real rates, as money markets seem to have discounted most of the hawkish outlook and maybe FX investors still hardly believe the Fed will be going for the full range of tightening. Bitcoin, already 35% above the low reached in late January, recorded minor losses, while Brent crude hovered above \$90bbl.

The January consumer price index reached 7.5%, marginally above the median estimate, and core inflation 6%, also the highest level since 1982, further fuelling rate hike expectations. Price gains were broad-based, across energy, food, rents, and even some categories which had not been impacted before, like medical services, which have a large weight in the PCE deflator closely followed by the Fed. Monthly inflation in January ran at 0.6%, well above the 0.2% required for it to remain closer to the Fed's 2% target. Although price pressures are expected to abate, for instance base effects reverse after February, the degree of the drop and the year-end level at which inflation stabilises will be equally important. They will ultimately depend on the price of crude coming back towards \$80bbl, as the futures curve currently implies, and supply-chain issues continuing to ease, both fraught with uncertainty.

Markets are pricing in a 70% chance of a 50bps hike at the March meeting, which last happened in 2000, with an additional 25bps priced for May and June, and about six and a half quarter-point moves discounted in total by year-end. Yes, the Fed must be willing to sacrifice markets and set in motion a negative wealth effect, in order to avoid inflation spiralling higher, but the yield curve has been flattening fast since the January FOMC meeting, and is at such low levels not to leave that much space for as much tightening as expected by the market before it inverts and signals a recession further down the road. The 10-year minus 2-year spread slumped to 45bps, while the 5s-30s to 36bps.

Entrenched equity bulls should not be able to tout the high-equity-margin story for much longer to justify rising markets. Almost record-low unemployment forebodes falling margins to come, if history is any guide, as companies must bow down to rising labor costs, while inflation tends to cause a contraction of stock multiples, which won't allow for any offset in this respect. After all, even resilient margins during the pandemic were a byproduct of policy stimulus, which is why the US has seen them grow more than in other countries. But even assuming all of this won't happen, central banks will be forced to squeeze corporate margins by tackling private demand, as high margins mean pricing power and the ability to pass inflation on to consumers, exactly what tightening is there for. Either way, it is a lose-lose situation.

Yes, Walt Disney released surprisingly positive earnings and closed more than 3% higher yesterday, but a case in point about margin concerns due to rising price pressures is represented by Unilever. The European consumer goods giant reported an 'ugly' 2022 operating margin guidance for 2022 and closed more than 4% in the red. Analysts are starting to question the company's pricing power, after a 'shocking' margin outlook as the company warned that inflation is set to dent profitability for two years.

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