CIO OFFICE MORNING MARKET WRAP – 12th May, 2022.

Asian stocks are falling this morning following yesterday's Wall Street slide on bad inflation readings spurring bets for more aggressive tightening. We have drops in Hong Kong and Japan and mixed performance in China, while US futures are stabilizing. Hong Kong intervened after its currency fell to the lower-end of the trading band. The treasury curve flattened on concerns of a slowdown and bitcoin fell victim to rising risk aversion and shockwaves in the stablecoin ecosystem. Equity investors remained concerned yesterday, while gold bugs were somewhat relieved following the US CPI release indicating persistently high prices extending to more categories. Stocks accelerated lower led by technology as investors pondered the rising odds of stagflation. The S&P 500 lost 1.7% and the Nasdaq Composite 3.2%, bonds rallied with the 10-year yield trading as low as 2.9%, TIPS inflation rebounded alongside gold, the US dollar was little changed and Brent crude rose.

Price pressures are set to stay elevated, having recorded only a modest slowdown from 8.5% to 8.3% YoY in April, keeping the Fed on an aggressive tightening path. Core CPI saw rapid services inflation, up 6.2% YoY, again just marginally lower versus the previous month. But both the headline and core indices were above projections, a disappointment for investors who had awaited more pronounced declines. The Fed's 2% target is still elusive, and today's issue started when Fed officials failed to withdraw stimulus as goods prices rose significantly in the post-pandemic period, then seeping into stickier service categories. The problem is that services inflation is now pervasive and will barely be offset by the goods sector moderating, as core service prices are growing too fast. Some jumbo hikes are in the offing, a hard pill to swallow.

The control that was lost, must now be regained. Bill Dudley, ex New York Fed governor, in his Bloomberg column suggested that policy rates will basically have to match inflation if one wants to “get real about interest rates”. As already pointed out in this daily note, as much as a terminal policy rate between 2% and 3% holds if inflation is more or less at the target level of 2%, higher inflation simply means interest rates higher than 2 or 3%. So, given where the CPI now is, the neutral rate should be “4 to 5 (percent) or higher”, according to Mr Dudley. We remark that this must not necessarily happen soon, although markets will eventually entertain that possibility and not take it lightly. Likewise, a recession from excessive tightening is not in the cards for now, but investors will somehow have to account for its probability shifting in the wrong direction.

The yield curve flattened, with growth projected to slow under tighter liquidity conditions and longer-dated yields possibly having marked a high for the year. While duration bets can be extended somewhat, investors should not compromise on credit quality, as slowing growth should exert upward pressure on spreads and anyway put the weakest credits under strain.

With the pace of the global slowdown set to accelerate, commodities should take an overdue breather. The Bloomberg Commodity Spot Index has so far failed to record a new high in May, mainly on receding base metal prices. In this case the culprit is China, the major importer of industrial metals globally. There is the possibility that falling business confidence in China will also translate into stalling crude prices. The outlook for more large Fed hikes should not play in gold’s favor eventually. For now yields falling faster than market-implied inflation support the yellow metal, as well as an accident waiting to happen in the more and more convolved Russia-Ukraine conflict.

So much for cryptocurrencies’ once-upon-a-time touted defensive qualities. Negative sentiment is translating into accelerated losses. Truth be told, there is also growing idiosyncratic risks, as yesterday a cryptocurrency supposedly pegged to the US dollar, a stablecoin called TerraUSD or UST, collapsed to briefly trade at less than a quarter of 1 dollar. UST relies on financial engineering to maintain its value to the US currency, but panic spread due to large withdrawals of TerraUSD from the Anchor Protocol. Stablecoins underlie the whole cryptocurrency ecosystem, so their fall indeed caused deep shockwaves across digital assets. Such event reinforce calls for regulation and Treasury Secretary Janet Yellen said that stablecoins need to be regulated by this year, while a comprehensive legislation for the digital sector is pushed to 2025, Cardano founder said. Meanwhile, cryptocurrencies are steading after the TerraUSD woes and bitcoin is climbing back above 29,000, its lowest level since 2020.

PM Mario Draghi said European companies can pay for Russian gas in rubles without breaching sanctions, out of line with European Union guidance to the contrary. It must be that keeping crucial gas flowing is more important than paying lip service to hardly attainable commitments. Europe will wean itself off Russian supplies, but there is a limit to the speed with which this can be achieved and meantime the orderly functioning of society, also based on energy consumption, must be safeguarded. President Putin proved the point that interruption of supplies would be more than a threat in the case of non-ruble payments, after Poland and Bulgaria were indeed cut off for not complying. The Russian ruble is the world's top-performing currency against the US dollar in 2022.

While Russia continues to be under scrutiny for the possibility that it defaults on its bonds, though payments have been made, in China defaults continue to occur amidst policy support aimed at averting systemic events. Sunac China Holdings, the country's fourth largest developer, missed a dollar-bond payment before a Wednesday deadline and is not expected to make payments on other notes.

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