



CIO OFFICE MORNING MARKET WRAP – 15th December, 2021. ALSO AVAILABLE ON ALEXA.

Market volatility has steadily increased since Powell's tones have become more hawkish on prospective policy for 2022, and risk off sentiment yesterday was broad across asset classes as investors awaited the Fed chair's message to be delivered today after the FOMC. US equities at some point lost more than 1%, with the tech-laden Nasdaq underperforming, a heavyweight like Microsoft down in the mid-single digits, and the information technology sector leading declines alongside industrial stocks. The most speculative stocks tumbled, as measured by the Goldman Sachs basket of most-shortaged stocks, which entered bear market for the first time since June. The yield on the 10-year note edged slightly higher, though real rates advanced more significantly, the yield curve barely budged, while the US dollar gained and Brent crude and gold dropped.

Investor concerns heightened when a gauge of wholesale prices in the US was shown to have reached record levels, increasing almost 10% versus a year ago. Also, one year inflation expectations of consumers in the NY Fed survey recorded the highest level ever of 6%, materially higher than the consensus inflation forecast for 2022. The read-across to monetary policy is of course that this could push the Fed to tighten soon after the end of the accelerated tapering, now expected by March 2022. And, actually, recommendations that the Fed gives clear indications that it will be tightening sufficiently

are multiplying, from prominent investor Mohammed El Erian, to ex Treasury Secretary Lawrence Summers, to ex Fed Governor Narayana Kotcherlakota.

What will then constitute a hawkish surprise for markets? We think that we should be looking at the terminal rate, the one achieved, let's say, by 2024-end, which is also the highest in the monetary cycle. The market is now pricing it at 1.5%, significantly below current Fed projections. Investors have so far simply been convinced that Powell will manage to hike barely three times in 2022 and then only a few more times subsequently, and thereafter have brought inflation under control. So, the market thinks the Fed is in control and that more now, in terms of hikes, means less later, hence the benign pricing. If tomorrow, after Powell has spoken, this pricing changes, the market will have shifted view, expecting that the Fed is forced to hike more than it would like to, with more now, in terms of hikes, and more later as well. Bloomberg is now engaging clients with a nice quantitative model of the US economy called SHOK, where one can fiddle with scenarios and play the would-be economist by checking the model output. Let's assume we input three hikes for 2022 and then we get regular hikes until the Fed's terminal rate is hit. What would happen? The model response is a recession by early 2023. This is basically the reason why investors, including ourselves, remain unconvinced that the Fed will shift right from the start to a very hawkish stance. As already remarked, Powell's speech later today will put any view to the test.

Central banks are not the only game in town this week. Who is interested in bottom-fishing in the Chinese markets may want to check tomorrow the important release of fixed asset investments, expected to ease, industrial production, likely to have picked up, and retail sales, possibly decelerating on Covid outbreaks.

Please take notice that this week sees the last Daily Note of the year, which will be then resumed in January 2022.

Stay safe.

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