



CIO OFFICE MORNING MARKET WRAP – 18th July, 2022.

Inflation and central bank policy were in the driver's seat last week. Although the June CPI printed at a 41-year high, suggesting that the Fed has more work to do to achieve price stability, market reaction was relatively muted as investors looked through high inflation. Equities closed in negative territory, but well off the lows touched in the five days through Friday. The S&P 500 lost 0.9% and the Nasdaq 1.6%. Growth concerns gained the upper hand, as the 10-year treasury yield was down by more than 15 basis points, crude oil shed 5.6% and the US dollar closed at a 20-year high.

All eyes were on the CPI release, above expectations and pointing to broadening price pressures, thus related to the day-to-day functioning of the economy, rather than to reopening categories. The reading was at 9.1% YoY for the headline index, a multi-decade record, while the core printed at 5.9%, a whiff below the May figure and indicating that the core CPI may have peaked in March, at 6.5%. Medical services and rent recorded new monthly highs, quite a headache for the Fed determined to bring the inflation genie back in the bottle. Hence, markets briefly priced in increased odds of a 100-basis-point hike in July, of which Atlanta Fed's Bostic voiced wariness on Friday. But judging future inflation just by its current reading is like looking into the rearview mirror, and with a delay. Treasury yields, both nominals and reals, closed the session below where they were trading pre-CPI. On Friday longer-term inflation expectations as per the University of Michigan survey printed at 2.8%, a one-year low. Equities failed to make new lows for the year and the S&P 500 Information Technology Index was down only 0.3% for the week, not exactly a sign of panic for the inflation outlook. The Bloomberg Commodity Index closed down as well and more than 15% below its June high. Overall, investors are looking through current inflation and must be taking the view that the Fed's tightening will be impacting growth and

ultimately taming price pressures as well. The big unanswered questions are how fast will inflation recede and how deeply growth be curtailed.

One of those questions was answered unequivocally by Bill Dudley, ex NY Fed governor, assessing the consequences of the monetary tightening in his timely Bloomberg column. In his view unemployment will necessarily have to rise “significantly”, and “even an 0.5-percentage-point increase would probably mean a recession, because that’s what has always happened in the past” when it breached that threshold. Also, the Fed will have to be confident enough that inflation has been tamed before stopping tightening, let alone reversing policy. And this is completely at odds with the market view that the Fed will be easing sooner rather than later, with Eurodollar contracts now implying rate cuts already after February 2023. Overall, the treasury yield curve is in agreement with this analysis. The 10y2y term spread, the difference between 10- and 2-year treasury yields, is currently deeper in negative territory than it was in 2006, a warning signal about a future hard landing.

The week was rich in macroeconomic releases, with retail sales, the Fed’s Beige Book, industrial production, as well as the previous week’s employment report and the Institute for Supply Management’s activity indices highlighting the slowdown phase. But the NFIB Small Business Outlook Index released on Tuesday, with a good track record as a forward-looking measure of economic conditions, recorded an all-time low.

JPMorgan and Morgan Stanley kicked off the much-awaited earnings season, followed by Citigroup and Wells Fargo. Overall, bank earnings were underwhelming, with weakness driven by investment banking, mortgages and loan-loss provisions, while positive momentum was maintained in loan portfolios and net interest margins, with trade business remaining strong. JPMorgan and Morgan Stanley showed bigger than expected declines in Q2 profits, with net income down in the order of 30%, the first earnings miss since the start of 2020. Although Citigroup beat both on bottom- and top-line estimates, while JPMorgan disappointed on both, still its net income dropped by 27% versus a year ago. Citigroup stock jumped 13% on Friday. Mortgages were down across the board on rising interest rates, and this impacted Wells Fargo the most, being the largest mortgage lender. Overall, bank results highlighted that consumers and businesses remain healthy, though the outlook highly uncertain.

China GDP grew by 0.4% in Q2, the slowest pace since the country was first hit two years ago by the pandemic. Beijing’s zero-tolerance approach to the virus must have played a significant role and the country now is on track to miss its 5.5% growth target for 2022 by a wide margin, also contributing to deflationary pressures globally at a time of heightened recession concerns. Making matters worse, fixed asset investments continued to slump, pointing to no improvement in the beleaguered property sector accounting for 20% of GDP. The economic outlook will hinge on the ability of the authorities to contain outbreaks and the amount of stimulus they are willing to inject in the economy.

Joe Biden travelled to the Middle East and told local leaders on Saturday that “America is not going anywhere”, meaning that the US would not leave a power vacuum benefitting China, Russia and Iran. The visit was also meant to urge the oil-exporting countries to boost crude production in the attempt to reduce global inflationary pressures. One must wonder why the United States cannot produce more as one of the very few spare suppliers, rather than seeking the help of other countries.

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