



CIO OFFICE MORNING MARKET WRAP – 19th May, 2022.

US markets close -4% lower on Wednesday, their worse intraday performance in almost 2 years. Every sector was affected as risk aversion is about growth concerns. Developed market stocks were down -1.4% on average yesterday and emerging markets -0.4%. Consistently with recession fears, safe bonds were sought after. The 10-year treasury yield lost -10 basis points to 2.88%. Logically, shorter maturities were less buoyant with the 2-year losing only -3 basis points to 2.67% and the 5-year -7 basis points to 2.89%. This bull flattening illustrates both a hawkish Fed and its longer-term potential damage on growth. The price of Brent crude oil moved down -2.5% to \$109. Meanwhile the trade-weighted dollar was 0.1% firmer, mostly against cyclical currencies – the yen and the Swiss franc were up due to their safe haven status. No such thing however for major cryptocurrencies, which were sharply down.

We have been consistently saying that volatility should not come as a surprise in 2022, the year of low visibility. Still, the magnitude and apparent randomness of daily variations is stunning, and so is the fact that despite this very palpable real volatility, implied measures from options markets are still not at panic level. Between Tuesday's hawkish comments from the Fed, and a strong intraday rally in stocks, and yesterday's epic sell-off, one of the triggers is certainly the highly disappointing results from Walmart and Target, two icons of mass consumption in the US. This is the material consequence of a deteriorating outlook in terms of purchasing power and corporate margins. No doubt, economic activity was strong in the US in Q1, including retail sales, and the job market is buoyant. However, lower income segments have started to feel the pain of higher prices, especially on basic, non-discretionary expenses, such as food and gasoline. Both Walmart and Target share prices lost -25% in 2 days – this is not usual for such theoretically defensive stocks. If this happens on numbers from the first quarter of the year, with a much more benign backdrop, markets become increasingly concerned about what's in store for

the coming quarters, with the Fed being much more aggressive, prioritizing the fight against inflation over anything else, the war in Ukraine still ongoing, and China still affected by lockdowns? This is where seeing implied volatility -the fear index- at 30 rather than 40 is a concern: we cannot say that capitulation is necessarily over.

We have to face it, the risk of an economic downturn is significant. This is not our base case, but the probability is rising, especially because slowing growth is the only way for central banks to fight inflation, and it is, obviously, a dangerous game. Having said that, a severe recession seems very unlikely, and seeing a mild one would not necessarily be a nightmare for markets in the medium term. Inflation would normalize, the cycle would be reset, and policy responses would be very different. After all, recessions are part of the normal economic life, not the end of the world. In the meantime, markets should remain extremely volatile. In such a context, we reiterate two advices: first, it is impossible to tactically time the market, positions should be taken opportunistically but always with a medium term horizon. Second, leverage is very dangerous in such a context, as it can tie your hands at the worse possible moment. Meanwhile we remain invested with only minor active positions: should a recession be avoided, which is our central case, then equities would recover but long-term interest rates are probably capped. Should a recession happen, safe bonds would benefit, and stocks would anyway recover in a later phase. The current difficulty is that the fears of stagflation can affect both asset classes negatively: interest rates, earnings, and equity multiples. Pricing-in now a growth scare supports short-term volatility but is not bad news for future returns. Patience is paramount.

In the news today, Turkey, a NATO member, blocked the applications of Sweden and Finland to the security alliance. This certainly pleases Moscow but upsets Washington, where Joe Biden said he will work to have the Scandinavian countries in. Meanwhile, Janet Yellen confirmed that the Treasury considers blocking bond payments from Russia to US investors. The US reopened their embassy in Kyiv and the Pentagon said that Russian forces are scaling back their operations. Finally, the New York Fed released their Global Supply Chain Pressure index, which was on the rise for the first time this year, adding to inflation concerns and reflecting the impact of Covid lockdowns in China.

This is the transition to Asian markets, which are in the red, but not in outright panic. Stocks are down -2% in Japan, as the yen rises, but interestingly core machine orders for March were way above expectations, which is good news for the global economy. Hong-Kong is also down -2%, with tech stocks under pressure after Tencent published poor numbers, and a cautious guidance, warning that the regulatory crackdown won't end quickly. China's domestic markets are however only down -0.3% and Korea -1%, despite concerns over another possibly imminent missile test from their northern neighbour. Interest rates are marginally firmer, and so are oil prices. Gold and its digital crypto competitors are stable. Bottom-line, it's not a global panic.

There is no major economic data release today, but we'll have a look at weekly jobless claims and April home sales in the US.

Stay safe.

Chief Investment Office
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