



## **CIO OFFICE MORNING MARKET WRAP – 21st February, 2022. ALSO AVAILABLE ON ALEXA.**

The minutes of the January FMO meeting, and the unfolding of the Russia-US standoff must have been top of mind for investors, with the hope that the economy remains resilient enough to tide markets over very stormy waters. In a week marked by risk aversion, US and European stocks lost slightly less than 2% across the major indices, emerging markets outperformed but still lost ground, treasuries gained and gold surged on a safe-haven bid. Brent crude saw some profit taking and the US dollar was little changed. Investors will have to find their way in the quagmire of the substantial tightening planned by the Fed and rising geopolitical risks, and playing offence and defence at the same time could be a sensible strategy. We implemented our TAA Committee decision to proceed to a reduction of our large treasury underweight, triggered by the yield on the 10-year note closing above the 2% threshold. Treasuries subsequently rallied and the current episode of risk aversion could have more to go. We expect further drops in equities, which at some point would be conducive to gradual risk taking in our portfolios. Gold is acting as a safe haven and could easily rise above \$2,000 in case of a Russian invasion, whereas hedge funds in our model portfolios are fulfilling the purpose of reducing portfolio volatility while remaining invested.

The Ukraine crisis is the worst in a decade, and should it have to do more with NATO's continued expansion, as Putin complains, rather than simply with "Russia bullying Ukraine", it would be much more complex to solve than initially thought. Although it seems that the West would avoid a direct intervention, an invasion would still cause a spike in energy prices sharply affecting markets and the economies. As long as uncertainty persists, negative sentiment is going to weigh on risk assets, compounding the effects of the withdrawal of central bank stimulus. So far equities have been the clear losers, alongside Ukraine, while gold the winner, alongside both Biden and Putin. A meeting between US Secretary of State Blinken and Russian Foreign Minister Lavrov is scheduled this week in Europe, although Biden continues to prognosticate an invasion almost daily, Vice President Harris said that "Putin has made his decision. Period", and Russia and Belarus have decided to extend joint drills near the Ukrainian border.

The minutes of the latest Fed meeting suggest so far little inclination towards a shock and awe approach to contain the highest inflationary pressures in four decades, implying that Fed officials remain cognizant of the ongoing slowdown phase and still expect price gains to be eventually contained. A reactive, rather than proactive approach still prevailed, as 'most' on the committee are ready to remove accommodation more quickly in case inflation is stickier than expected. Consensus within the Fed seems to gravitate around the view that economic data warrants four or five 25-basis-point rate hikes this year, to be started soon in March, but well short of hiking at every meeting. For the time being markets may then have reached peak hawkishness, with more than six hikes discounted in the next twelve months. The inflation and retail sales figures since January have been stronger than expected, so a 50-basis-point hike at the March meeting cannot be ruled out. Investors should also be mindful that the winding down of asset purchases, only to be completed in March, has yet to make itself fully felt, and no past episode of the end of a round of Quantitative Easing has so far failed to cause significant bursts of volatility. Since the Fed has set itself the task of taming inflation, but not at the cost of causing a recession, we think that there will be in the end a pain threshold in terms of negative market performance it will be sensitive to.

Macroeconomic and policy divergence could not be more pronounced between the US and China, the former with a red-hot labor market and a central bank in full tightening mode, the latter dealing with the fallout from an unravelling real estate sector and the PBoC shoring up the economy via a newly-started easing cycle. The released inflation figures confirm the growing dichotomy. In the United States the Producer Price Index jumped 9.7% in January, pointing to unresolved supply-chain bottlenecks and following a CPI release the previous week at a four-decade high. Should US inflation recede as expected, it would most likely be settling at levels well above both pre-pandemic trends and the Fed's target. On the other hand, the governor of the PBoC said that inflation in China is "generally mild". PPI inflation dropped to 9.1% in January, while CPI eased to 0.9% YoY on food deflation, hence the dovish stance of the Chinese central bank. Policy divergence should trigger substantial Renminbi weakening, which in turn would be a net negative globally as China would be exporting the deflation that the Western central banks have been fighting with no respite. US retail sales were well above expectations, pointing to a solid labour market and no growth scare in sight, helping risk assets avoid a deeper plunge. Yet, the US Leading Index unexpectedly fell by 0.3% in January, weighed down by higher jobless claims, lower consumer expectations and stock prices.

Growing geopolitical risks overshadowed the two-day G20 finance-minister meeting held in Indonesia at the end of the week, where the ministers recommitted to a global corporate tax deal going live next year. More echo had the G7 foreign minister meeting on Saturday, where they called on Russia “to choose the path of diplomacy” and de-escalate.

Week ahead. Monday - Covid restrictions are lifted, with Australia reopening its borders and UK Boris Johnson set to announce end of covid restrictions. PMI surveys will be released for the euro area, the UK and Australia. Tuesday - release of Germany IFO business survey and US Conference Board Consumer Confidence. Wednesday - CPI released in the euro area. Thursday - GDP release in the US. Friday - Personal Consumption Expenditure report, Durable Goods and University of Michigan Consumer Sentiment in the US.

Stay safe.

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