Asian stocks and US equity futures are declining this morning amidst rising geopolitical tensions, following yesterday’s wild swings. US troops stand now ready to aid NATO in Ukraine. US Defense Department spokesman John Kirby said that “it’s very clear that the Russian have no intentions right now of de-escalating”.

Global markets continued to fall on Monday, following three back-to-back negative weeks, although US equities managed to close slightly in the green after a very volatile session. The S&P 500 entered correction territory, nosediving at the fastest pace ever this early in a year, with investors seeking safety in treasuries, and geopolitical risks and the prospect for rate hikes adding to the risk-off mode. The US dollar gained, bitcoin rebounded from new monthly lows, and Brent crude fell after rallying almost non-stop since late December last year.
There is a growing chorus remarking that stocks have usually rallied in past hiking cycles on the back of the strength of the economy more than offsetting the initial tightening. Should we extrapolate past events even under the current circumstances that see the winding down of asset purchases preceding higher policy rates? Tapering and hiking is different than simply hiking. And the bond market has already signalled it, with yields skyrocketing this year as investors demand a higher term premium, since the management of the Fed’s balance sheet is set to add pressure to the longer-end of the curve. More to the point would be to remark that every major inflection point in equities since the Great Financial Crisis has seen some form of Fed intervention. To highlight just a few, the post-Lehman lows saw the first round of Quantitative Easing, the December-2018 low occurred as the Fed backed off from further tightening, and the Covid low in March 2020 was engineered on the back of unprecedented stimulus. This year’s high is so far in place under the expectation that three layers of tightening come together at the same time: tapering, rate hikes and shrinking of Fed’s balance sheet. If, after the fact, it is no wonder then that the S&P 500 has fallen at record pace, it is maybe contradictory that one should expect a rapid recovery extrapolating from a very different past. We can only reiterate that the market, though now technically oversold, is still far from having discounted the full effect of tightening. A rebound could be in the cards, with the VIX futures curve inverted, pointing to widespread risk aversion, and different measures of market breadth hinting to short-term capitulation. The possibility of a not-so-hawkish Powell speech on Wednesday could be the catalyst for that rebound.

Investors holding safe bonds should still be concerned in spite of the rally in yields. The duration of IG corporate bonds is close to the highest in decades and yesterday the US IG CDS Index compiled by Markit rose to the highest level since November 2020, as investors brace for a tightening cycle. With treasury volatility stubbornly high, it should be a matter of time before further widening follows.

Ultimately, any constructive outlook hinges on a stronger economy, especially if developed-market central banks are more inclined to tighten and fiscal policy in the United States becomes more of a drag this year. It is not helping at all that the Citigroup US Economic Surprise index is back in negative territory, and even less that a composite measure of business confidence has been sinking in January, with activity almost stalling. Market-implied measures of growth have also been falling, alongside inflation breakevens, suggesting not only a Fed-fighting inflation, but also a possible hit to growth. In sum, it seems that the inflation-growth outlook is now a bit less favourable, with price pressures hard to quash, but growth not as steady as expected.
EM equities have so far been an exception to generally falling markets and remain supported by China’s easing policies. The PBoC cut its policy rate last week for the first time in two years and more of the same could be coming as growth rates moderate towards 5% or even below. The problem is that, according to some studies, China needs to growth by at least 5% on average till 2030 to be able to surpass the US by early in the next decade. In order to avoid being off to a bad start, Beijing may be ready to do more on all fronts, although the hoped-for results rest far from assured. At least in the short-term, EM assets should continue to outperform as policy and growth divergence with United States shifts in favor of China. Stay safe.

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