CIO OFFICE MORNING MARKET WRAP – 25th July, 2022.

Volatility remained material last week, but on its sunny side: weekly returns for all major asset classes were positive. Global stocks gained +3% across regions, and global REITS +4%. The fixed income asset class was all green, following its risk hierarchy: government bonds gained +1.5%, high quality credit and EM debt +1.8% and high yield +2.9%. Gold ended the week +1% higher at $1727 and Brent crude oil added +2% at $103.20.

Such a unanimous behavior is usually associated with good news on liquidity, i.e. support from central banks. There was none last week. Indeed, we had more interest rate hikes, especially from the ECB and its higher than expected +50 basis points increase, ending multiple years of negative interest rates. The Bank of Canada also delivered a jumbo +100 basis points hike. Hawkishness and determination in fighting inflation remain the norm in the West, and it shouldn't be different this week with the Fed. But nuances matter. First, the economy is slowing down, as confirmed by the flash PMIs everywhere, with a particular red flag for the Eurozone. This suggests inflation will follow. Second, central bank show that they also care about collateral damage. To that extent, the ECB gave a masterclass. As we predicted – which was not difficult, they invented a new tool and a new acronym to be able to deal with divergent sovereign debt spreads. Some countries are indeed more indebted and vulnerable than others. The TPI for Transmission Protection Instrument is here to counter “unwarranted and disorderly market dynamics”. There is of course a long list of criteria, but they are not really quantified and bottom-line, most of the decision-making process is discretionary. No size limit has been communicated either. Basically, the ECB has created an additional way to expand its balance sheet to buy government bonds, to its discretion. Interest rates are being normalized, but at the very same time the unconventional magic money toolbox is expanded. The ECB is definitely creative, especially given the fact that according to their status, their only core mission is price stability, and that direct lending to governments is explicitly forbidden. This may explain why details on the TPI were not abundant: what is more deterrent than a secret weapon? Italy was not particularly highlighted by the ECB, despite the resignation, the same week, of PM Mario Draghi, not exactly a stranger to the ECB and the inventor of the ultimate monetary weapon, the famous “whatever it takes”.

Bottom-line, last week’s returns were the result of one scenario gaining traction: a recession may very well happen, and as central banks are not crazy, they will reverse their course sooner than their own forecast, which will benefit every asset class. Behavioral factors were also at play: with such a level of pessimism among the investors’ community, no true positive catalyst is needed to have a good week. Meanwhile, the Q2 earnings season continues and on aggregate it’s not bad at all. With roughly one fifth of US companies having reported, it’s still early but so far, earnings are 4% above forecast and sales marginally better as well. The current valuation multiples do not apply to an illusion, but to robust earnings. However, the message of caution is in every single management guidance, comment, and hiring plans.

Uncertainty is significant for the coming quarters, and the analysis can be kept simple. Inflation is the single most important catalyst for the months to come. Apart from the war in Ukraine, on which we have no clue, its fate is linked to economic activity. There are two reasonably possible outcomes. First possibility, we get a global recession. In this case, inflation collapses and central banks quickly reverse their action. It’s painful for risk assets, from equities to high yield and EM debt, but safe assets do their diversifying job and ultimately, some form of monetary support comes to rescue in the medium term. Second, and this is our current scenario, the global economy is shaken but not derailed. Inflation seriously moderates but stays material, which means that central banks pause, and hesitate. This is reasonably favorable for assets which already price-in material economic risks, mostly equities, especially in EM. This is not bad for the safest bonds and for duration, as growth decelerates. It is more difficult for high yield or EM debt: not enough growth to mitigate default risk, but not enough trouble to reopen the tabs of magic money. It also means high volatility for some time, which is, unfortunately for the time being, our strongest conviction. The level of anxiety may also increase as the World Health Organization just designed monkeypox as a “public health emergency of international concern”. However, there was no consensus within the organization for such an alert, based on scientific facts – we all remember that WHO was blamed for having been too late in calling Covid a pandemic in 2020, this may explain. Monkeypox is not Covid anyway: transmission mechanisms are different, while some vaccines and treatments already exist.

As we write this morning, Asian markets are overall negative. The recession narrative pushes stocks lower in Japan, China and Hong-Kong, between -0.5% and -0.8% as we write. Korea by contrast is slightly in the green. In Tokyo trading, US Treasury yields are marginally higher than Friday. The 2,5 and 10-year gain +3 basis points on average, at respectively 3%, 2.87% and 2.78%. Gold is steady and oil prices are modestly lower with the Brent crude at $102.7. After a positive weekend, major crypto currencies are falling again: -4% for bitcoin at $21,800 and -6% for ether at $1500.

The week ahead will be dominated by the monthly policy meeting of the Fed. The FOMC will communicate its decision on rate, most probably a +75 basis points hike, and hold its press conference this Wednesday 27th. Q2 GDP in the US will be released the following day and then Euro-area consumer price index on Friday. These are probably the macro indicators to look at. We will also have a predictable dose of pessimism from the IMF’s update of their world economic outlook tomorrow. Much more important will be the continuation of the Q2’s corporate earnings season. It’s time for big tech in particular: numbers are due this week for Alphabet, Apple, Amazon, Microsoft, and Meta.

Stay safe.

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