



## CIO OFFICE MORNING MARKET WRAP – 27th January, 2022. ALSO AVAILABLE ON ALEXA.

US equity futures and Asian stocks are retreating this morning, as investors are digesting an unexpectedly more hawkish Powell. Equities are falling in Japan and South Korea, where Samsung missed estimates, while China and Hong Kong are struggling as well. Global bonds are losing ground too, the dollar is at a one-month high, and gold is extending Wednesday's losses in Asia. The treasury yield curve is plumbing new lows for the year and market implied inflation is edging lower. US markets closed mixed yesterday, after wiping out a rally, and treasuries fell as chair Powell reinforced the Fed's determination at quelling persistently high inflation. Global stocks and bonds are off to a negative start in 2022 and volatility does not seem will be abating soon, as investors have to navigate a fast-receding liquidity impulse which last year had lifted all boats.

After letting inflation rise persistently above target as per the new Average-Inflation-Targeting framework, Jay Powell is now chasing it, with a mix of balance-sheet management and interest rate hikes which constitute a U-turn in policy making that make today's world much less predictable for investors. The Fed chair confirmed a first hike in March and did not rule out a string of interest rate rises throughout the year, while at the same time failing to confirm whether that would mean a rise at each meeting, simply saying that the Fed needs to remain 'nimble'. Markets dialled up the number of expected hikes to slightly higher than four in 2022. Powell also confirmed the winding down of asset purchases at such a speed that it would be completed in early March. He also made a comparison with 2015, when the Fed last embarked on a tightening cycle, saying that the economy today is much stronger, with the labor market "consistent with maximum employment", and inflation "well above" the

2% target. It will be now more difficult for the Fed to slow down growth, not driven by credit expansion, but rather fiscal stimulus and rich asset prices. So, one option for them will be to not stop talking up the dollar, while also curbing financial asset prices. At the same time, presumably the Fed will remain sensitive to rates, equities, and their knock-on effects on the economy, as growth slows. In summary, end of tapering and first hike in March with more to follow, and reduction of balance-sheet further down the road.

Warren Buffett once famously quipped that “only when the tide goes do you find out who is not wearing a bathing suit”. And the current market turmoil, driven by the tide of Fed’s liquidity going, is an ultimate test of whom will be taken aback holding the most expensive assets. The repricing since the start of the year has been pretty ruthless. For instance, Cathie Wood’s ARK Innovation ETF, the vehicle focused on innovative and high-growth companies, is down about 55% from the highs touched in February last year; and bitcoin has been cut almost in half since last November. Markets are in a ‘show-me-the-money’ phase, where most speculative assets are dumped, with a tendency to focus rather on earnings or income streams produced in not too distant a future. As much as the liquidity supernova was expanding valuations, and lifting the most exotic investment vehicles offering promises of extraordinary growth in a far-removed time, the dimming of that dazzling light is now shortening the acceptable time horizon for the return on investments, as well as capping the valuations to be paid. One consequence is that growth stocks are being derated in favor of value stocks. Another is that depressed commodities are rerating versus inflated financial assets in an era of growing shortages and future green investments requiring the basic resources of the old economy. If we assume that the decade of the ever-expanding liquidity supernova is behind us, and we throw in the possibility of higher taxes further down the road, and even just somewhat higher inflation, changes in relative pricing could continue well beyond a monetary cycle.

Tesla shares slid 6% and remained volatile in the post-market session yesterday, as its strong results were overshadowed by lingering supply-chain issues potentially limiting production through 2022. Intel disappointed on current-quarter profits, fuelling concerns that the heavy investments planned for the company to regain its technology edge will take their toll on profitability.

The Fed raising rates is not bearish for commodities, in particular for oil as long as the market remains tight. Actually, the implied volatility of crude, as measured by that of a traded oil ETF, is now below that of the VIX Index, which measures the implied volatility of US equities. So, the outlook for crude seems to be brighter in the shorter term. OPEC+ seems likely to increase output by 400,000 barrels in March, a decision to be taken at the meeting to be held next week, confident that demand is going to reach pre-pandemic levels by the end of this year as per forecasts. Brent crude is up 15% year-to-date, and geopolitical risks in Ukraine are only a sideshow to the real driver of still strong demand.

And, yes, the situation in Ukraine is becoming more entangled. Russia threatened to send more weapons to the separatists, saying at the same time that it would respond to any ‘aggressive’ action of the US. President Biden is considering sanctions on President Putin himself, should he decide to invade the country. In a sign that worse could come to worst, the US told its citizens to consider leaving Ukraine, given the deteriorating security situation.

Stay safe.

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