



CIO OFFICE MORNING MARKET WRAP – 28th June, 2022.

The rally in Asian stocks is fizzling out this morning amidst growing concerns about high inflation and slowing growth. Treasuries are rising, though the 10-year yield is still holding above 3%, and crude oil advancing as worsening political crises threaten Libyan and Ecuadorian supplies. The US dollar and gold are little changed. Chinese and tech shares have so far been the weaker performers and Hong Kong is in the red. US and European futures are dipping following minor losses yesterday. Bitcoin is weaker but trading above the 20,000 support level.

Recession thoughts are at the forefront of investor minds, as S&P Global is forecasting a downturn in the US in 2023, with the Fed front-loading rate increases this year. A first rate cut should come in the third quarter of 2024. For Goldman Sachs the odds of a hard landing are very high in 2024, leading to a shift in Fed policy. And while consensus is focused on rising price pressures, Michael Burry, made famous by the movie 'The Big Short', tweeted that he sees deflationary effects from excess inventories in the retail sector leading to the Fed reversing policy. At a minimum, we would think that the Fed will pause in its tightening path by year end in order to assess the impact of the firming of financial conditions. That should be enough to drive a significant market rally, irrespective of how events will subsequently unfold. The copper-to-gold ratio, usually anticipating the direction of longer-dated yields, is taking a plunge, suggesting the Fed's current hawkish turn will sooner rather than later cause at least a sharp slowdown.

Amidst the doom and gloom of US recession calls, it must not go unnoticed that the longer-term expected return of the 60-40 US equity-bond portfolio has considerably improved since December last year. The portfolio should return on average about 5% yearly at current market pricing, still below the historic average return of 8%, but competitive enough to allow for wealth creation in the long run. Our back-of-the-envelope calculations are in line with the forecasts of some major investment houses, giving reason for comfort. Buying at more reasonable valuations makes all the difference at longer time horizons, especially under the expectation of a more challenging growth-inflation mix which could see markets less prone to long-lasting multi-year rallies.

ECB policymakers met in the Portuguese resort of Sintra to tackle the inflation shock they failed to forecast. It will be impossible for them to quell the fastest consumer price growth in history without causing a recession, considering the weaker links in the euro area and the spill-over effects of the next-door conflict. Fragmentation risks due to rising pressure on the yields of one of the most indebted developed nations in the world, Italy, is alive and kicking, though still manageable one day with debt mutualisation measures at the common area level, and possibly internal reforms in the country. But sooner rather than later the ECB will have to shelve plans to tackle inflation aggressively the way the Fed did. A 'whatever it takes' approach requires a stronger economic fabric, rather than the vulnerabilities related to the entrenched Ukraine conflict.

The leaders of the G7 nations meeting in Germany are discussing imposing a ceiling for the price paid for Russian oil. The White House is trying to find some magic bullet that would limit Russian gains while at the same time avoiding restricting supply with implications on already high prices. Yet, since this has never been tried with Iran or Venezuela, it must not be easy to achieve. Devising new sanctions is on the other hand straightforward, and further restrictive steps were promptly announced. It was about a ban on new imports of Russian gold, preventing Moscow from importing technology for its arms industry and tightening measures around oligarchs. But Europe's resolve to commit to ever-increasing sanctions could soon be put to a serious test, given its high dependence on energy imports. A gas crisis could be looming, with gas storage units on track to be 90% full by 1 November as per the European Commission's estimates, but stock rates quickly receding to below 75% in the case of a cut-off of flows. And Russia's Nord Stream pipeline to Germany, already at only 40% of capacity, will shut for maintenance for 10 days next month. Some investors consider the energy cost for Europe ultimately untenable with odds of a possible ceasefire rising on these grounds.

In a sign that de facto a new cold war is crystallizing, NATO is set to label China a 'systemic challenge' in new policy guidelines this week, while Russia will be called a 'direct threat', rather than a 'partner' as in the 2010 version. In March, Chinese Foreign Minister Wang Yi warned Washington against building a version of NATO in the Indo-Pacific. With superpowers colliding, economic friction, inefficiencies and inflation are only set to rise.

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Chief Investment Office
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