



## CIO OFFICE MORNING MARKET WRAP – 30<sup>th</sup> June, 2022.

The S&P 500 swung between gains and losses yesterday, with US equities on track for their fourth negative month. Central bank chiefs talked, adding nothing new to the macro debate. Small caps underperformed, a sign of lingering concerns about the health of the economy. Healthcare and IT companies gained ground, while energy and retailers fell. Long-dated treasuries fell, but real yields did rise, and market-implied inflation took a plunge, as investors upped the odds of a recession. The dollar advanced, gold slipped and crude lost ground, although an EIA report showed crude supplies down more than 3 million barrels in two weeks.

Yesterday some of the world's most important central bankers spoke in Sintra and struck a hawkish tone. Investors focused on ECB's Lagarde, Fed's Powell and BOE's Bailey. Powell laid emphasis on the importance of fighting inflation, and from his words it was clear that risks to the economy would be taking a backseat as compared to pushing against rising price pressures. Rates will move into "into restrictive territory fairly quickly", he said. In his view the labor market remains "tremendously strong", and markets have largely discounted the rates trajectory of the dot plot. But the main concern of economists remains the stickiness of inflation, forcing Fed officials to shift Fed funds to the 4% level already in H1 2023. Lagarde failed to push against the market pricing of policy rates, which implies hikes to the level of 2% by year-end, well above the neutral rate. That seems somewhat out of touch with the reality of spillover effects from the Russia-Ukraine conflict and the solvency of the most indebted countries in the euro area. Baileys said that tightening will match pay developments, which

were in the spotlight following clashes between unions and the government in the UK. Overall, more tightening across the board and rising risks to growth.

The frontloading of the Fed's hikes saw the bond market yesterday shifting to pricing a half-point rate cut sometime in 2023, implying that traders upped the odds of a recession forcing Powell to change course. Market-implied inflation also plunged alongside gasoline prices, while treasury yields across the curve shifted lower. Swap contracts related to policy rates pointed to a level of 3.1% by December, significantly lower than the market-implied peak of 3.6% seen in March. The shifts in market activity intensified following the sharp deterioration in US consumer sentiment, the lack of leniency in the latest Powell's message being no reason for comfort either. The 5-year yield led the way down to as low as 3.15% and 5-year breakeven inflation fell to 2.6%.

Although inflation surprised to the downside in Germany – 8.2% versus 8.8% expected in June, owing to government measures reducing pressure on households and business – it was notably higher than projections in Spain and Belgium. This suggests that the euro area figures should run at 8.5% in the Friday flash release according to some projections, the highest reading since before the euro was introduced. While consumer sentiment has deteriorated significantly this year both in the US and the euro area, business confidence has not been impacted as much by inflation. This is not expected to last, though. For instance, the Conference Board US Leading Index 6-Month Annual Change, an activity gauge strongly correlated to US corporate confidence and usually leading it, already plunged slightly in negative territory in May.

If markets see recession risks growing even in the short term, what is being discounted across asset classes? According to JPMorgan calculations, equities, industrial metals & Euro HG credit are already pricing a 75%-80% probability of a recession, while government bonds only an 18% risk, US HY credit a 34% probability and Euro HY/US HG credit around 47%. If the pricing of a hard landing is so uneven across asset classes, in a pure mechanical fashion one would have to be overweight the risk assets more heavily discounting the risk, like equities and industrial metals, versus being underweight credit, also be overweight IG versus HY and anyway be overweight government bonds given their historical records during economic downturns.

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