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Weekly Market Flash

Which central bank could succumb next?

October 2, 2022

It was another extremely volatile week, with a risk-off tone widely spreading across the market. Volatility in the rates market was the main driver of the third consecutive week of loss in equities, with the S&P 500 index falling -2.9%. In the UK, the Bank of England (BoE) had to intervene to preserve the stability of the Pension Fund System, which was resoundingly going into distress after the announcement of the new government's fiscal expansion plans caused interest rates to explode across the curve. But even in the US, the Treasuries market, which is supposedly the most liquid market in the world, is partly dysfunctional, and inter-bank spreads have started to widen this week. The key issue, in our view, is that there is no sign yet of a change of course from the US in the face of events on this side of the Atlantic.

Highlights

- The UK government sent the Gilt market into a tailspin, with rises of between 100 and 200 bps across the curve following the announcement of a fiscal expansion of 4 percentage points of GDP.

- The BoE decided to reopen its QE program by allocating GBP65 billion to buy government bonds “at an urgent pace” in an attempt to revive confidence and boost the pound.

- In the credit market, UK and European high grade corporate bond spreads blew out to their widest levels since the early part of the pandemic, and US investment grade corporate bond spreads reached their widest since July.

- Cryptocurrencies ranged steady during the week. Their short-term correlation to the Nasdaq index became negative, and the medium-term correlation fell below last month’s peak.

“I don't see this really impinging on US inflation or real growth developme-nts.”

Markets & Macro | Which central bank could succumb next?

The UK’s situation is a red flag.

Despite developments in the UK, there have not been any signs of a change of course from the US Federal Reserve (Fed). For example, this week saw Fed Governor James Bullard reiterate hawkish communication, suggesting that the outlook for the US economy won't be materially affected by the drama in the UK: "This is mostly about financial markets needing to price in the volatility that you're seeing in the UK, so we have some movements in the US because of that. I don't see this really impinging on US inflation or real growth developments."

Figure 1: Year-to-Date Performance of Major Indices

Equity	Last Value	Ytd
MSCI World	2,401.32	-24.41%
Nasdaq	10,575.62	-31.99%
S&P 500	3,585.62	-23.88%
Nikkei	25,937.21	-8.19%
Eurostoxx	3,318.20	-20.40%
Swiss SMI	10,267.55	-17.98%
FTSE UK	6,893.81	-3.78%
Canada	18,444.22	-11.07%
Shenzen	3,804.89	-21.40%
Hong Kong	17,222.83	-23.98%
MSCI EM	873.29	-27.20%

Bond Indices	Last Value	Ytd
US Inv Grande	102.45	-21.24%
US High Yield	71.39	-15.25%
Euro Corps	225.20	-14.58%
JPM Europe Govies	9,305.04	-12.51%
US Treasuries	2,179.51	-12.82%
China Aggregate	250.34	-7.03%
EMBI Global	714.12	-22.34%
EMBI Local	114.14	-17.12%

Commodities	Last Value	Ytd
BBG Commodities	111.49	12.42%
BBG Base Metals	221.13	-20.73%
BBG Agriculture	67.89	11.68%
Gold	1,660.62	-9.22%
Silver	19.03	-18.36%
BBG Brent Crude TR	990.79	32.29%
BBG WTI Crude Oil TR	182.39	19.13%

FX	Last Value	Ytd
DXY	1,337.47	13.98%
Bloomberg JP ASIA	96.99	-10.24%
Bloomberg JP LATAM	39.19	-4.13%
EUR Index	117.35	-2.83%
EUR/CHF	0.97	-6.72%
GBP Index	606.93	-11.11%
EM fx	1,581.44	-8.82%
JPY	144.74	-20.49%
CNY	7.12	-10.68%
Bitcoin	19,387.25	-58.16%

Source: Bloomberg, as at September 30, 2022. Performance figures in indices' local currencies.

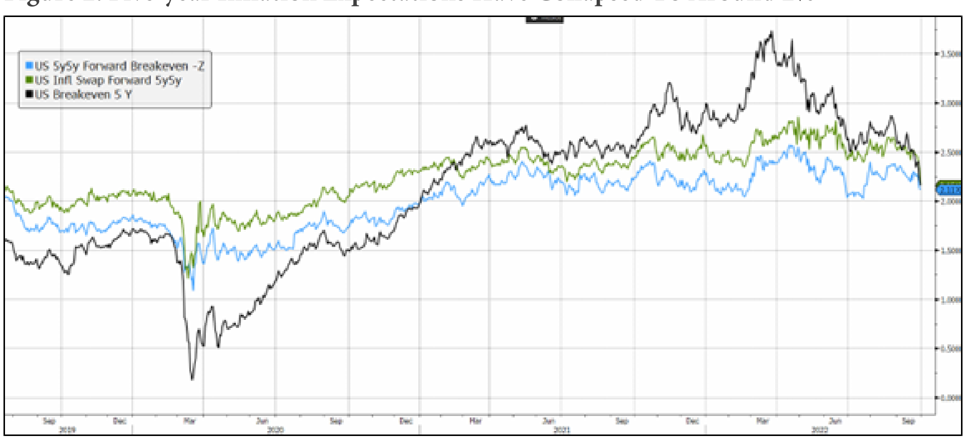
"In our view, it seems almost normal to expect a crash in the US as well, sooner or later."

Our view: Judging from past episodes of liquidity tightening, it seems that we are only at the beginning of rolling VaR shocks. At the end of the day, one must remember that markets are under attack on three fronts: interest rates are rising (at an unprecedented pace, and across all countries in the developed world), and the Fed is removing liquidity through reverse repos, as well as the balance sheet. In our view, it seems almost normal to expect a crash in the US as well, sooner or later. Indeed, traders now seem almost to wish for it, believing that an episode—such as a credit event, or anything equivalent to what happened with pension funds in the UK—would end the Fed's tightening cycle. Without this, it is hard to imagine a break in the downtrend, which is proceeding slowly and inexorably, in the absence of a strong catalyst.

What is increasingly surprising is that the Fed's attitude does not change in the face of market distress, but neither does it change in the face of the collapse of all indicators of consumer and inflation expectations. In Figure 2, we see three indicators of five-year inflation expectations, all of which have collapsed to around 2%—a sign that investors expect the ongoing tightening to have the desired effects on price growth, and that the Fed's credibility is no longer in question. It is therefore striking that this is not enough for Fed speakers to moderate their tones. We can only hope that the fall of these indicators below the 2% threshold will placate Fed members.

"The situation in the UK should be a red flag for Japan and the EU."

Figure 2: Five-year Inflation Expectations Have Collapsed To Around 2%



Source: Bloomberg, as at September 30, 2022.

This dynamic is even more destabilizing for the rest of the world, since the Fed is exporting inflation (since all commodities are expressed in US dollars, therefore making them increasingly expensive to import). The situation in the UK should be a red flag for Japan and the EU. When push comes to shove, everything but the US dollar is vulnerable to runs. Only a tiny number of countries can hope for a safer journey, such as Switzerland or commodity-rich countries with stable governments, or generally those with large trade surpluses and not overly-large fiscal deficits.

Turning to the UK, it is important to analyze what happened, as it is symbolic in value. We believe that the BoE's actions can act as a harbinger of what might happen in Europe and the US should rate pressures, in a high debt system, continue. Thus, the new government has sent the Gilt market into a tailspin, with rises of between 100 and 200 basis points (bps) across the curve following the announcement of a fiscal expansion of 4 percentage points of GDP (without hedging), against a backdrop of galloping inflation. This development comes after the International Monetary Fund issued an unusual rebuke to UK fiscal policy this week, warning that tax cuts would exacerbate social inequality.

"We believe that the BoE's actions can act as a harbinger of what might happen in Europe and the US should rate pressures, in a high debt system, continue."

As a result, the BoE decided to reopen its QE program, which is the opposite of what it was about to do, by allocating GBP65 billion to buy government bonds "at an urgent pace" in an attempt to revive investor confidence and boost the pound, which has recently fallen to an all-time low against the US dollar. However, this move from the BoE presents several problems. It is in fact temporary QE, carried out during a rate hike, and therefore contradicts the current monetary policy. As an asset purchase, it is negative for the currency, and this tends to increase the inflationary effect of the program. As a result, the QE announced, to some extent, nullifies the effort to fight inflation and the effort to support the currency with a policy of rate hikes.

But clearly, there was no choice, hence the symbolic value of the intervention for other countries: for the BoE, as for other central banks, the fight against inflation takes second place if the need to avoid a financial catastrophe emerges. After the Bank of Japan's recent intervention to stabilize the Japanese yen, we witnessed the second capitulation of a central bank with respect to its attempt to realize its monetary policy plans. In all of this, it has to be said that between Thursday and Friday, rates and the pound began to recover, partly due to short covering, and partly due to the first signs of a possible scaling back of the expansion program by the government.

The next suspect is clearly the European Central Bank (ECB), which would probably come before the Fed, given the fragility of the EU system with peripherals always struggling when liquidity is lacking. It will therefore be important to monitor spread trends (particularly Italy's, given that the new government has just been elected and the team of ministers is being built), to see which central bank might be the next to capitulate.

Finally, on the Ukrainian front, things are not improving. Due to the prevalence of financial instability issues, there was little talk of both the sabotage of the Nord Stream pipeline (with responsibility still to be clarified), and Putin's declaration of annexation of the four Donbass republics (the act will have to be ratified by parliament—a formality). This was followed by a rather aggressive speech, in which he did not clarify whether he is ready for peace talks. We are therefore approaching the earnings season with a decidedly oversold market, sentiment and positioning at all-time lows, extremely hawkish monetary policy expectations, and corporate earnings forecasts falling in recent weeks. Let's say that should we see a decent earnings season, and rates stabilize, the conditions for a year-end mini-rally could be aligned.

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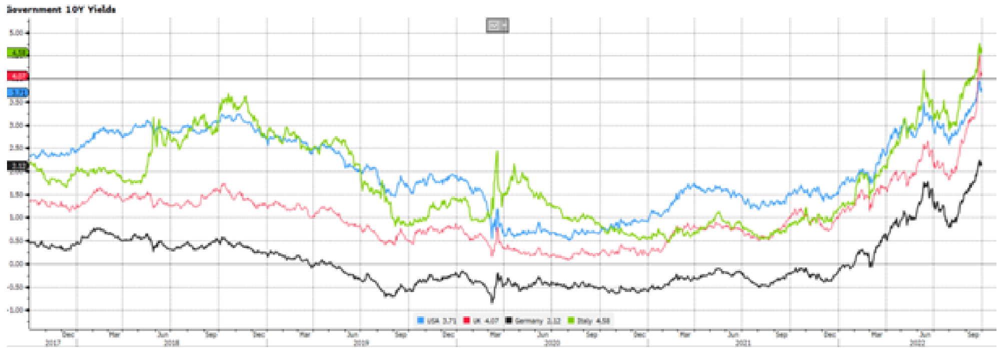
Fixed Income | Going higher quality, shorter maturity

UST 10-year briefly breaks above 4%.

This week, the bond crash in the UK was a general warning to remain watchful on the state of public finances. Trying to pass off a massive fiscal easing, while inflation remains a huge problem and while the central bank is tightening policy, was heavily punished by investors. Gilts plunged and the US Treasury 10-year yield briefly broke above its key 4% level.

Figure 3: 10-year Government Bond Yields

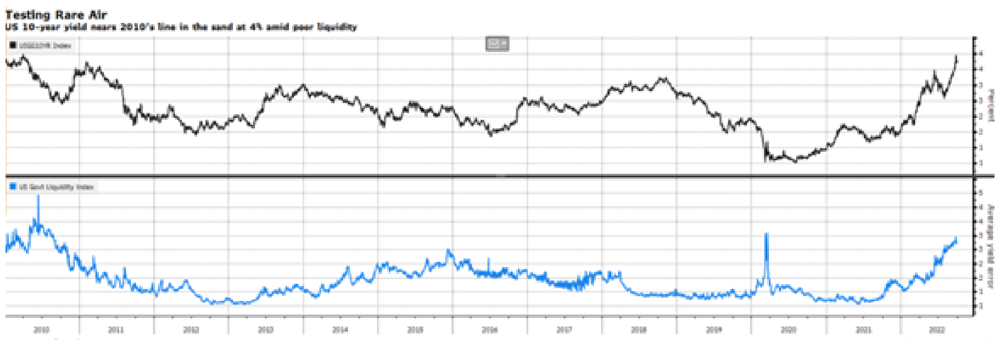


Source: Bloomberg, as at September 30, 2022.

"In a sign that surging bond yields aren't enough to lure buyers, bonds at the two-year auction were sold at yields above the prevailing market rate at the time bidding closed."

Our view: Even though prices quickly rebounded on Wednesday when the BoE stepped in to stabilize the market, the hawkish signals still coming out of the Fed, which now expects to push policy rates to at least 4.6% in 2023, are what matters. In a sign that surging bond yields aren't enough to lure buyers, bonds at the two-year auction were sold at yields above the prevailing market rate at the time bidding closed. The fact is all this has the perverse effect of further reducing the liquidity and exacerbating moves: the Bloomberg index of prevailing liquidity conditions in the US Treasury market (the blue line) has climbed steadily in recent weeks—and is just shy of its peak seen in March 2020.

Figure 4: UST 10-year Yields Rises Amid Poor Liquidity



Source: Bloomberg, as at September 30, 2022.

The diminishing liquidity has not helped credit. UK and European high grade corporate bond spreads blew out to their widest levels since the early part of the pandemic, and even US investment grade corporate bonds weakened, with spreads reaching their widest since July. Meanwhile, US junk bonds fell to their weakest levels since mid-2020.

"Our view is to maintain a cautious stance across corporate credit and invest in short maturities of IG corporates."

Our view is to maintain a cautious stance across corporate credit and invest in short maturities of investment grade corporates that have gradually become more interesting. In particular, we like bonds denominated in US dollars, with maturities ranging between 2023-2025 and with A+ to BBB ratings—which are now offering yields in the 4.3%-5.10% region.

Crypto & Blockchain | Cryptocurrencies are forming a long-term bottom

Crypto remains steady despite risk-off tone.

Despite riskier assets continuing their downward trend this week, crypto ranged steady. The short-term correlation of crypto to the Nasdaq index became negative, and the medium-term correlation fell below last month's peak. Volumes against the pound increased this week, led by a stronger bid and narrative for cryptocurrencies, which we haven't seen since the start of the conflict in Ukraine when Russians were

“Our view is to maintain a cautious stance across corporate credit and invest in short maturities of IG corporates.”

selling Russian rubles to buy crypto.

Elsewhere, a report from CoinShares indicates that inflows into Ethereum-based investment funds (European ETP) revived during the week following the Merge. The influx of money also coincides with a modest but steady increase of assets on chain. On the supply side, we recall that the supply from previous staking is still in lock up period, while the new supply issued is far less than when Ethereum was a PoW blockchain.

Our view: Cryptocurrencies are in the middle of the process to form a long-term bottom. At this stage, the price action and the number of active wallets suggest that most of the crypto ‘tourists’ have already liquidated most of their positions, leaving long-term investors accumulating positions. We can wait for another leg down, which could be triggered by the forced liquidation from Miners due to the unsustainability of the cost of their debt. After this correction, funds can speed to deploy the exceptional amount of money raised last year. For this, we see a considerable optionality in the crypto trade if other central banks follow the BoE and abruptly stop their quantitative tightening, or release fresh rounds of quantitative easing. This will likely trigger foreseeable multi-digit returns with a relative limited drawdown.

Week Ahead | Key events to watch for

- **US macro data will be in focus** next week, where it is hoped that the first signs of an economic slowdown will emerge to appease the Fed. The two ISMs (services and manufacturing) and the labor market report (Friday) will be published.

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