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Weekly Market Flash

A (very) weak inflation-growth-response mix

June 5, 2022

After the previous week's strong rebound, with the S&P 500 index rising by 6.5%, equity markets suffered a retracement this week – albeit with much smaller losses of around a single percentage point for the Nasdaq, S&P 500 and Eurostoxx 50 indexes. At the same time, data and events during the week confirmed and reinforced the macroeconomic themes that we've been witnessing in recent months, including strong inflationary pressures and diverging central bank policies.

Highlights

▪ Oil prices continued their inexorable march, with Brent crude closing at USD121 on Friday evening (and this happened despite the initial weakness that had greeted OPEC's production increase).

▪ The European CPI for May surprised once again, coming out at 8.1% YoY, above expectations of 7.8%.

▪ The Bank of Canada raised rates by 50 bps, and added decidedly hawkish tones to its statement. The Canadian benchmark rate thus rose to 1.5%, and another 150 bps are expected for a year-end rate of 3%.

▪ In May, US Treasuries, which rose by 0.18%, posted their first monthly gain since November. Credit also managed to mark the first positive month since the beginning of the year, with US investment grade closing at 0.93% up, and high yield at 0.25% up.

Markets & Macro | A (very) weak inflation-growth-response mix

Reaffirming our underweight to Europe.

"Increased production by OPEC will ease market conditions in the short term; but lower spare capacity within OPEC makes the oil market vulnerable to future shocks."

Data and events during the week confirmed and reinforced the macroeconomic themes that we've been witnessing more recently: strong inflationary pressures, driven primarily by energy prices, but more recently also by the food component and rising wages; the responses of central banks, with significant divergences starting to emerge between countries and the resulting trends in local financial variables (starting with currencies and rates); and the labor market – especially in the US – still decidedly strong and tight, which together with the savings accumulated during the pandemic and the prolongation of the reopening effect, continues to support the economy, and even more so energy prices.

Our view: Let's take a look at the main events under a lens. Firstly, oil prices continued their inexorable march, with Brent crude closing at USD121 on Friday evening. And this happened despite the initial weakness that had greeted OPEC's production increase. In fact, the cartel decided to increase production more than previously planned, without clarifying Russia's status in OPEC+ following the EU embargo on shipping announced earlier this week (after a difficult internal agreement was reached). On the one hand, increased production by OPEC (even if the group struggles to meet earlier commitments) will ease market conditions in the short term. On the other hand, lower spare capacity within OPEC, and in particular Saudi Arabia, makes the oil market vulnerable to future shocks.

The strength of oil, with limited and controlled supply, is supported by the full boom from the economic reopening, the arrival of the driving season in Europe and the US, and the fact that China is finally giving signs that it wants to end lockdowns on a lasting basis – which is perhaps at the worst possible time given the coincidence with the factors mentioned above.

Secondly, on the inflation front, the pressure seems to be shifting dangerously to Europe and the European Central Bank (ECB). The European CPI for May surprised once again, coming out at 8.1% year-over-year (YoY), above expectations of 7.8%. The fact is that the market and analysts continue to be too complacent about Eurozone inflation. It is striking to look at the Citi Inflation Surprise Index for various countries (Figure 1), with the highlighted green line relating to Europe. While the other countries are slowly coming back in, or have always remained low (Japan and China in particular), the figure for Europe is completely out of range.

“The fact is that the market and analysts continue to be too complacent about Eurozone inflation.”

Moreover, no intervention is planned for next Thursday’s ECB meeting, and only in July should we see the first rate hike, with many doubting whether it will be 25 basis points (bps), which is the more likely probability, or 50 bps. In fact, the market is pricing in only 120 bps of hikes between now and the end of the year, in a context of a weak currency (the Euro has lost 10% against the US dollar since the beginning of the year) and exploding energy prices (oil is 45% higher since the beginning of the year, and energy spending now accounts for 9.5% of GDP in Europe).

Figure 1: Citi Inflation Surprise Index

Source: Citi, as at June 3, 2022.

A completely opposite example (of a central bank's credibility and determination to take the inflation problem seriously) was given by the Bank of Canada this week. In fact, as expected, the central bank raised rates by 50 bps, but added decidedly hawkish tones to its statement. In particular, the central bank warned that it might decide to be 'more forceful' if necessary, updating the statement to note that the economy was 'clearly operating in excess demand', with the risk of high inflation becoming even more entrenched. With this hike, the Canadian benchmark rate thus rose to 1.5%, and another 150 bps are expected for a year-end rate of 3%. All this with an inflation rate of 6.8% YoY, and a currency that is significantly stronger than the euro, thus helping to contain import inflation.

All this leads us to reaffirm a strategic principle that has guided our asset allocation for years: a strong underweight of European equity markets and the single currency. We realize that certain ‘compromise’ policies are necessary for the political stability and sustainability of the European system, but capital markets need more decisive, farsighted and courageous actions, especially in difficult circumstances such as the ones we are currently experiencing.

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Unfortunately, the (very) weak inflation-growth-response mix of the ECB leads us to reaffirm our position. And if we seek diversification both in the currency and in the stock market, we do so in solid or commodity-rich countries, like Canada, Norway, Australia, Switzerland and, as we have done recently for more opportunistic export-related issues and the Chinese reopening, Japan.

Equities | Will the equity risk premium widen further?

A “super bad feeling” about the economy.

“Warnings from JP Morgan’s CEO Jamie Dimon and Tesla’s CEO Elon Musk regarding the economy soured investor sentiment.”

As mentioned earlier, this week US equities pared some of the previous week’s gains. Within the S&P 500 index, energy stocks markedly outperformed. The industrials and consumer discretionary sectors were flattish, with the latter aided by Amazon (6.3% up on the week) ahead of its stock split on Monday. At the same time, warnings from JP Morgan’s CEO Jamie Dimon and Tesla’s CEO Elon Musk regarding the economy soured investor sentiment. Microsoft’s downgrade of its quarterly guidance, while marginal, highlighted the forecasting difficulties facing companies due to the high volatility of FX rates.

The week’s macro data provided little support, with no signs that inflation is receding – and next week, the US CPI print will also be critical for the direction of markets. European equities also fell during the week as uncertainty on the ECB’s tightening pace and slow economic growth prevailed. And both China and Japan’s stock markets gained on the back of the countries relaxing their COVID safety measures, as well as continued stimulus measures announced by the Chinese government.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	32,899.70	-0.83%	-0.20%	-8.62%
S&P 500	4,108.54	-1.15%	-0.54%	-13.23%
Nasdaq	12,012.73	-0.95%	-0.55%	-22.94%
Euro Stoxx 50	3,783.66	-0.61%	-0.13%	-9.58%
Swiss Market	11,529.16	-0.95%	-0.71%	-8.02%
FTSE 100	7,532.95	-0.57%	-0.86%	3.88%
CAC 40	6,485.30	-0.26%	0.28%	-7.16%
DAX	14,460.09	-0.01%	0.50%	-8.97%
FTSE MIB	24,166.66	-1.91%	-1.38%	-9.04%
Nikkei 225	27,761.57	3.66%	1.77%	-2.63%
Hang Seng	21,082.13	2.07%	-0.47%	-8.92%
CSI 300	4,089.57	2.38%	1.19%	-16.90%

Source: Bloomberg, as at June 3, 2022. Performance figures in indices' local currencies.

“Revenue uncertainty is not the only “known unknown” that investors have to contend with.”

Our view: As one of the most vertically integrated automotive companies, Tesla has a unique insight into the state of the economy. Thus, Mr. Musk’s “super bad feeling” about the economy should probably not be taken lightly. Inflation has made it very difficult for companies to manage their daily operations, from handling logistics and inventories, to addressing labor shortages, to managing treasury operations and FX exposure. This is likely to be reflected in Q2 earnings and forward guidance. In other words, revenue uncertainty is not the only “known unknown” that investors have to contend with. As such, we expect the equity risk premium to potentially widen further.

Separately, we are closely monitoring China’s stimulus measures and their impact on the economy. We believe that there has been a pivot in the government’s stance toward the property sector. For now the market remains skeptical about the announced policies’ ability to change the tide of economic slowdown, especially with lockdowns largely still in place. Nonetheless, we are encouraged by the government’s willingness to directly support the property market, something that was not contemplated since the sector’s troubles began.

Fixed Income | A run-for-cover rebound

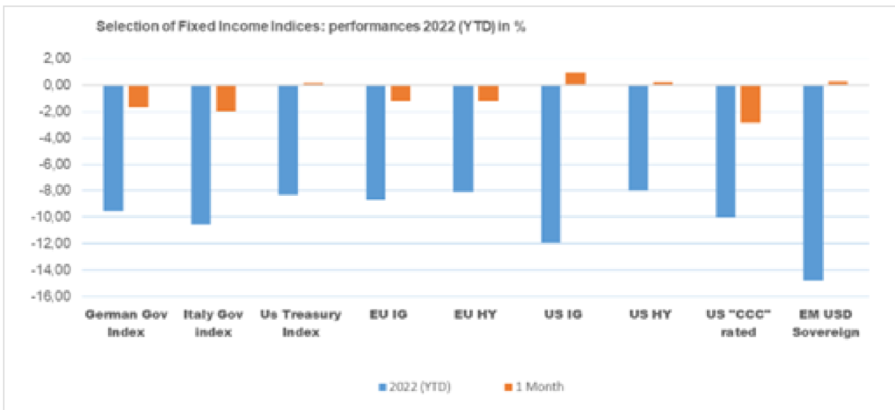
Distress spreads through debt markets.

> "European fixed income suffered another difficult month, after inflation accelerated to a fresh all-time high and investors brace themselves for a more aggressive ECB rate hike..."

In May, the US fixed income complex found some relief following the prospect of a less aggressive hiking cycle from the Federal Reserve. Treasuries, which rose by 0.18%, posted their first monthly gain since November. Credit also managed to mark the first positive month since the beginning of the year, with US investment grade closing at 0.93% up, and high yield at 0.25% up.

Unlike the US, European fixed income suffered another difficult month, after Eurozone inflation accelerated to a fresh all-time high and investors brace themselves for a more aggressive ECB rate hike by the end of the year. Meanwhile, government bonds continued their series of negative monthly performances, with Bunds (-1.68%) and BTPs (-2.0%). EUR credit also struggled, with EUR investment grade and EUR high yield losing ground too (both dropped -1.23%).

Figure 3: Fixed Income Performance

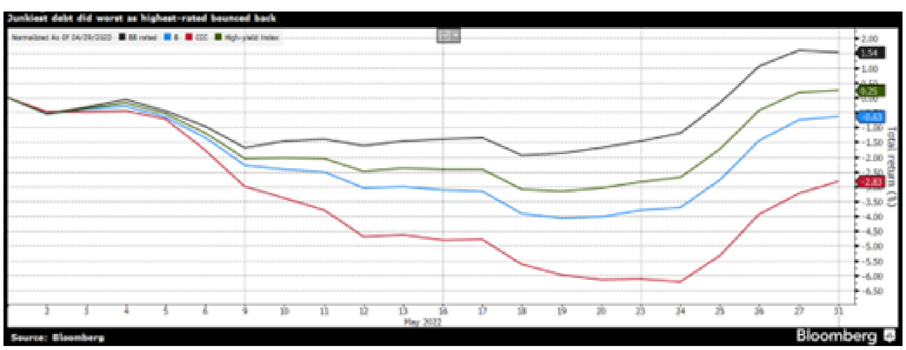


Source: Bloomberg, as at June 3, 2022.

> "...distress is spreading through debt markets, as financial conditions tighten and the economy slows, pushing credit spreads wider."

US credit's recovery was led by blue-chip bonds. Junk debt rated BB (the black line in Figure 4), which accounts for half of the high yield market, is propelling the rally – with utilities and energy leading by sector. The same is true of high grade, where investors are fleeing to the safety of higher-rated bonds as the economic slowdown reduces appetite for credit risk. Bonds rated CCC (the red line) are meanwhile down more than 3% this month, the fifth straight decline marking the longest streak of losses for that part of credit since 2015.

Figure 4: High Yield Bond Performance



Source: Bloomberg, as at June 3, 2022.

Our view: Outperformance by the safest debt suggests more of a run-for-cover rebound than an all-clear signal, leaving the 'junkiest' issuers free to continue their descent into distress. According to Bloomberg, distress is spreading through debt markets, as financial conditions tighten and the economy slows, pushing credit spreads wider. The USD155 billion pile of distressed bonds and loans in the US is the highest since December 2020.

For context, the fourth quarter of 2020 saw the most US bankruptcy filings since 2009 and included the worst last month of the year since 2011. On the one hand, major banks, sitting on an estimated USD50 billion of buyout loans they need to sell to investors, are testing the waters to see if they can start offloading the debt. But, as inflation fears have turned into recession worries in 2022, loan prices have broadly dropped, making the debt harder to sell. The average loan was worth 9.83 cents on the US dollar at the end of May, about 5 cents below the level at the end of last year.

Week Ahead | Key events to watch for

- **All the week's action will focus on Thursday: the US CPI will be released and the ECB conference will take place**. Fireworks are therefore expected, with the hope that the US CPI will not surprise to the upside once again, but rather that the infamous base effects will finally start to ease current price pressures.

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