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Weekly Market Flash

When will the Fed break its cycle?

May 8, 2022

It was yet another negative week for US and European equity markets – and in fact the fifth in a row. This time it was Europe that suffered the biggest losses (-4.5%), but the US also saw a lot of volatility following the FOMC meeting on Wednesday evening. In our view, what drove the volatility was the divergence in speeches, and especially in forecasts and messages, from the Federal Reserve (Fed) and the Bank of England (BoE) this week.

Highlights

- Fed Chair Powell ruled out the possibility of a 75 bps hike in the coming months, implicitly taking away an element of flexibility should the inflation picture not improve in the short term.
- The BoE announced that growth is expected to turn negative between the end of 2022 and the beginning of 2023, and that inflation should return below 2% as early as the first half of 2024.
- Singapore-based Luna Foundation Guard bought 37,863 more Bitcoin worth USD1.5 billion, which means the reserve now holds roughly USD3.5 billion in BTC. This is the second deal of USD1 billion executed by the LFG so far this year.
- According to Bloomberg, international clearing houses have received and processed payments of USD564.4 million for a Russian sovereign bond due in 2022, and USD84.4 million due in 2042.

Markets & Macro | When will the Fed break its cycle?

Remaining defensive in a traumatic phase.

"It should also be acknowledged that this would not be the first time we could be faced with a central bank turnaround, so we expect to see anything in the coming months."

This week, the Fed was much more hawkish, reiterating the message that the US economy is very solid (as confirmed by Friday's labor market report), inflation is a big problem, and therefore a strong dose of tightening is needed to bring it back to acceptable levels. At the same time, at the press conference, Fed Chair Powell ruled out the possibility of a 75 basis points (bps) hike in the coming months, implicitly taking away an element of flexibility should the inflation picture not improve in the short term. But it should also be acknowledged that this would not be the first time we could be faced with a central bank turnaround, so we expect to see anything in the coming months.

Meanwhile, the BoE has sent out a far more alarming message, which sunk the British pound. The real income shock induced by galloping inflation will have a major impact on growth, which is expected to turn negative between the end of 2022 and the beginning of 2023. Consequently, according to the central bank, the inflation the UK is experiencing is transitory (!) and the lower growth will have the classic function of curbing it – and it should return below 2% as early as the first half of 2024. With this in mind, and markets already racing to price in a stagflationary scenario, price action has been disastrous post the BoE.

There are other factors that are also contributing to stagflationary pressures at the moment. For one, China, which does not seem to want to abandon its zero Covid policy, continues to put pressure on the global supply chain, but also on (downward) growth. It is to be hoped that the

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effects of the lockdowns will quickly run their course and bring about normalization (the infection curves are also fortunately improving in key cities). Secondly, on the war front, there are no signs of détente for the moment. In fact, the fighting has intensified in recent weeks, which is putting pressure for new sanctions, with the European Union seeking an agreement (which has so far failed due to resistance from Eastern European countries and Greece) for a total embargo on Russian oil. As a result, energy prices are not falling, with obvious consequences for inflation and purchasing power.

We are also approaching the infamous date of May 9, the day of the celebration of Russia's victory over Nazism. It is hard to say whether Putin intends to make any announcements on this occasion regarding the evolution of the "special operation" in Ukraine. It is possible that the event is binary, in the sense that Putin could launch a large-scale escalation, calling the reservists to arms to replenish the forces on the ground – or vice versa declare victory by taking the Donbass, laying the foundations for a truce. Between the two, we are leaning toward the latter, but with the double caveat that 1) the Donbass is not yet fully under Russian control, and 2) the 'minimum' victory for Putin should include the capture of Odessa. It should also be added that with the Ruble back to well above the levels it traded at prior to February 24, and energy prices so high, it doesn't seem that Putin has much urgency to end the war quickly.

There are no new operational indications on our portfolio positioning. We find ourselves in a real repricing phase of financial assets in the face of a worsening growth-inflation mix, which is impacting multiples, and we fear corporate earnings prospects in the near term. It is difficult to say when this will end, but the key variable to monitor is the Fed's message: until the Fed sends clear signals that it is breaking the tightening cycle, it will be difficult to see a decisive recovery in equity markets. As a result, we remain defensive in this traumatic phase.

"Fed Chair Powell's well-crafted press conference led to a short-lived relief rally; but the fact still remains: liquidity will tighten at the fastest pace of this century."

Equities | Will we see continued multiple contractions?

Continuing to shorten portfolio duration.

At five weeks, US equities suffered the longest streak of weekly losses in over a decade as both "inflation scares" and "growth scares" weighed on sentiment. Fed Chair Powell's well-crafted press conference led to a short-lived relief rally; but the fact still remains: liquidity will tighten at the fastest pace of this century. European equities also closed sharply lower this week, concerned of a July rate liftoff. Meanwhile, Japanese equities bucked the trend, ending the week modestly up. The weak yen has finally lent support to exporters.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	32,899.37	-0.21%	-0.21%	-8.92%
S&P 500	4,123.34	-0.18%	-0.18%	-13.08%
Nasdaq	12,144.66	-1.50%	-1.50%	-22.18%
Euro Stoxx 50	3,629.17	-3.73%	-3.73%	-14.00%
Swiss Market	11,730.42	-3.28%	-3.28%	-6.62%
FTSE 100	7,387.94	-2.07%	-2.07%	1.46%
CAC 40	6,258.36	-3.69%	-3.69%	-11.27%
DAX	13,674.29	-3.00%	-3.00%	-13.92%
FTSE MIB	23,475.72	-3.20%	-3.20%	-12.89%
Nikkei 225	27,003.56	0.58%	0.58%	-5.37%
Hang Seng	20,001.96	-5.16%	-4.65%	-14.21%
CSI 300	3,908.82	-2.67%	-2.96%	-20.81%

Source: Bloomberg, as at May 6, 2022. Performance figures in indices' local currencies.

Our view: Central banks are set to drain liquidity at the fastest pace of the century. Whether a 75 bps hike is on the table or not is irrelevant. When faced between taming inflation and causing a recession, we believe the Fed won't hesitate to go for the former. And stronger corporate and household balance sheets and low unemployment rates are only to delay the Fed pivot. We also note that the BoE went ahead with a rate hike despite expecting a recession. The Fed's job isn't to crash markets but to ensure price stability. In the end, Chair Powell said what he said to be able to do what he needs to do.

"We continue to recommend shortening the duration of equity portfolios by reducing exposure to technology and communication services sectors..."

We continue to recommend shortening the duration of equity portfolios by reducing exposure to technology and communication services sectors, especially semiconductor stocks that are particularly recession sensitive. We've also observed that sell side analysts have been cutting target prices for S&P 500 stocks at an accelerated pace since April without material EPS adjustments. Should the earnings outlook deteriorate further (mainly from margin pressures), we would expect continued multiple contractions.

Chart of the week

The Nasdaq Composite index failed to test critical levels at 12500. As we highlighted last week, price action was very weak. Due to volatility, the range of the trend can be wide and we can see multiple sharp rallies, which is typical of a bear trend. The next support is at 11'500 and 10'300 (another -6% and -15% from Spot).

Figure 2: Nasdaq Composite Index

Source: Bloomberg, as at May 6, 2022.

"Bitcoin's extreme price volatility is a major roadblock toward its adoption as a medium of exchange or a store of value."

Crypto & Blockchain | Bitcoin's price volatility remains an issue

LFG adds to BTC holdings.

Singapore-based Luna Foundation Guard (LFG), a non-profit organization dedicated to developing the Terra ecosystem, bought 37,863 more Bitcoin (BTC) worth USD1.5 billion, which means the reserve now holds roughly USD3.5 billion in BTC. This is the second deal of USD1 billion executed by the LFG so far in 2022. LFG has now acquired roughly a third of the USD10 billion goal expressed by Do Kwon, co-founder of Terraforms Labs, earlier this year.

Market comment: Elsewhere in the market, Bitcoin's extreme price volatility is a major roadblock toward its adoption as a medium of exchange or a store of value. Intuitively, nobody wants to pay with a currency that has the potential to double in value in a few days, or wants to be paid in a currency if its value can significantly decline before the transaction is settled. The problems are aggravated when the transaction requires more time. Stablecoins are digital currencies that peg their value to an external reference, typically the US dollar, and are designed to be a peer-to-peer electronic money system. They are backed by overcollateralized cryptocurrency and/or smart contracts that automatically defend the peg by buying or selling the stablecoin instead of relying on the soundness of underlying reserves.

The TERRA's protocol issues Terra currencies pegged to USD, EUR, CNY, JPY, GBP, KRW, and the IMF's SDR. Because they are relatively new, they have not yet stood the test of time because we have not seen how they work during major market stress or shocks. These pegs may experience instability or design flaws that lead to de-pegging, as exemplified by the temporary collapse of Fei, a public algorithmic peg stablecoin that briefly de-pegged after its launch in April 2021.

"Stablecoins have drawn a lot of scrutiny over whether the issuers have enough collateral to back the price and what assets ensure the value of the coins."

Stablecoins have drawn a lot of scrutiny over whether the issuers have enough collateral to back the price and what assets ensure the value of the coins. Algorithmic stablecoins do not have any collateral by design – the collateral is its governance token that can be minted or burned to stabilize the price. If the design turns out to be broken, the value of the coin can drop without a backstop. LFG addressed the worries by adding Bitcoin and Avalanche token as a reserve asset behind the stablecoins.

Fixed Income | Is Russia on track to avoiding a default?

Next payments come due May 27.
Russia's finance ministry abandoned its proposal to use rubles instead of US dollars to make overdue payments on two government bonds. According to Bloomberg, it appears money is getting through, and international clearing houses have received and processed payments of USD564.4 million for a bond due in 2022, and USD84.4 million due in 2042. With days remaining before a 30-day grace period expired on Wednesday, Russia unexpectedly tapped its domestic dollar reserves. The US is allowing the funds to be transferred precisely because Russia is using its domestic reserves. The idea is to force Russia to drain that pool and undermine its capacity to finance its invasion of Ukraine.

"In conclusion, the US may still force Russia to default on its bonds in the coming weeks."

Our view: The next payments are due on May 27 for bonds maturing in 2026 and 2036, after the expiration (27/5/22) of the exemption granted by the US Treasury's Office of Foreign Assets Control to foreign bondholders to receive money from Moscow. However, the contractual terms of the 2026 and the 2036 bonds potentially give Russia other options if it cannot pay using usual routes for reasons beyond its control. For example, the euro-denominated 2036 bond includes the possibility of using rubles as a last resort. In conclusion, the US may still force Russia to default on its bonds in the coming weeks. Therefore, there are no signs yet to profit from distressed levels.

Week Ahead | Key events to watch for

- **The highlight next week will be CPI in the US**, which should (finally) start to decline from 8.5% in March to 8.1%. The Michigan survey on consumer confidence will be released as well, which also contains inflation expectations at one and five years.

- **In Europe, economic sentiment for the EU** and the Zew Economic Sentiment Indicator in Germany will be published.

- **There will also be several Fed speakers speaking at various events**, so we will see how they want to adjust the monetary policy message after the Fed meeting and its impact on markets earlier this week.

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