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Weekly Market Flash

Watching, waiting, for a sign of Fed easing

October 9, 2022

This week finally seemed to provide what was a much-needed break for markets, with the S&P 500 index up 1.5% after three weeks of heavy losses. However, Friday's slump certainly dampened optimism for a potential recovery on the horizon. Following a stellar start to the week, with a 5.5% increase between Monday and Tuesday, the main problem this week was that there was no shortage of Federal Reserve (Fed) speakers—who, faced with the first economic data showing signs of weakness, were not soft-hearted.

Highlights

▪ After the release of the US labor market report on Friday, the market rushed to remove all doubt around the Fed's next two hikes between now and the end of the year.

▪ Australia's central bank made a dovish turn, raising rates by 25 bps instead of the expected 50 bps, and announcing a hiking pause soon.

▪ Opec announced its decision to cut crude oil production by two million barrels per day, making the soft landing scenario even more unlikely.

▪ On the war front in Ukraine, the news has not been positive this week. Several rumors have circulated—although unconfirmed for the moment—of a Putin conference where a state of war would be declared.

▪ In the US venture capital industry, preliminary Q3 data points to a continuation of a market slowdown and a swifter activity decline compared to previous quarters.

Markets & Macro | Watching, waiting, for a sign of Fed easing

A 'soft landing' looks increasingly unlikely.

"Fed Funds will still rise, a pause in the increases is still a long way off, and there is no openness to the possibility of cuts in 2023."

As mentioned, there was a number of Fed speakers this week. In summary, the speeches noted:

- Inflation is too high and the Fed will do what is necessary to bring it back to the 2% target.
- There is full awareness of the macro impact of tightening, but the bar for a change in stance is "very high".
- Fed Funds will still rise, a pause in the increases is still a long way off, and there is no openness to the possibility of cuts in 2023. So the dynamics that have been in place throughout this year are continually confirmed, with the market having to move further and further ahead the date when the upward cycle will likely reverse.
- With reference to international dynamics, this is the most important (and worrying) front: the monetary policy horizon is domestic, and international effects do not affect them, nor does the strong US dollar.

“...with this macro picture, and the determination from the Fed so strong, it is very difficult to argue the case for a ‘soft landing’ of economies.”

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

Equity	Last Value	Ytd
MSCI World	2,417.72	-23.86%
Nasdaq	10,652.40	-31.48%
S&P 500	3,639.66	-22.70%
Nikkei	27,116.11	-4.02%
Eurostoxx	3,375.46	-19.01%
Swiss SMI	10,308.57	-17.65%
FTSE 100	6,991.09	-2.41%
Canada	18,583.13	-10.30%
Shenzen	3,804.89	-21.40%
Hong Kong	17,740.05	-21.70%
MSCI EM	897.74	-25.14%

Bond Indices	Last Value	Ytd
US Inv Grande	102.42	-21.01%
US High Yield	72.12	-13.97%
Euro Corps	224.95	-14.68%
JPM Europe Govies	9,250.48	-13.02%
US Treasuries	2,163.28	-13.47%
China Aggregate	250.34	-7.03%
EMBI Global	718.00	-21.92%
EMBI Local	115.31	-16.27%

Commodities	Last Value	Ytd
BBG Commodities	117.14	18.12%
BBG Base Metals	224.27	-19.61%
BBG Agriculture	68.34	12.42%
Gold	1,694.82	-7.35%
Silver	20.13	-13.63%
BBG Brent Crude TR	1,138.25	51.98%
BBG WTI Crude Oil TR	212.69	38.92%

FX	Last Value	Ytd
DXY Index	1,340.74	14.25%
Bbg JP ASIA	97.12	-10.12%
Bbg JP LATAM	39.87	-2.48%
EUR Index	117.21	-2.94%
EUR/CHF	0.97	-6.63%
GBP Index	603.60	-11.60%
EM FX Index	1,596.65	-7.94%
JPY/USD	145.25	-20.77%
CNY/USD	7.12	-10.68%
Bitcoin	19,385.28	-58.16%

Source: Bloomberg, as at October 7, 2022. Performance figures in indices' local currencies.

Our view: We believe the last point, in particular, is very significant. Following the Bank of England’s QE turnaround last week to stabilize rates on Gilts, and the dovish turn from the Bank of Australia, which raised rates by 25 basis points (bps) instead of the expected 50 bps and announced a hiking pause soon, the market had immediately extrapolated the same development from the Fed, with the weakening of the US dollar, and the jump in metals, stock markets and risky assets overall. And following the release of the labor market report on Friday afternoon, the market rushed to remove all doubt around the Fed's next two hikes between now and the end of the year (75 bps in November, 50 bps in December, and rates at 4.35% at year-end).

With regard to payrolls, although the headline number was broadly in line with expectations and with the slowing trend, there is one worrying aspect: the combination of falling unemployment and falling labor force participation, despite the Fed tightening by 300 bps in the span of a few months. As we have already expressed in recent weeks, with this macro picture, and the determination from the Fed so strong (and inexplicable in our view, if not as a strong signal of impatience in wanting to see effects that will only come with time, but which will come nonetheless), it is very difficult to argue the case for a ‘soft landing’ of economies. Unless, suddenly, starting next week (Wednesday will see inflation data for September) inflation starts to fall precipitously.

“...our analysis for the past few months remains the same, loud and clear: we are in the midst of a repricing of all assets...”

Complicating the picture is Opec's decision to cut crude oil production by two million barrels per day, making the soft landing scenario even more unlikely. The rise of oil has been conspicuous in the last 10 days, with Brent crude rising from USD85 to USD98; the US administration reacted furiously to the failure of their attempts to avoid a production cut (with the US midterm elections now close), accusing OPEC+ of siding with Russia, and immediately announced a further 10 million barrels of oil on the market, using the strategic reserves (now blunted, given that reserves are at historic lows of around 400 million barrels—so, if anything, the market is discounting that they will have to start rebuilding soon). In the US, there is persistent talk of plans to fragment the OPEC cartel, or even retaliate against the assets of non-cooperating countries, but the operation is politically very difficult to carry out.

On the war front in Ukraine, the news has not been positive this week. Several rumors have circulated —although unconfirmed for the moment—of a Putin conference where a state of war would be declared. The success of the Ukrainian troops in regaining territories (about one third of those originally occupied) is putting pressure on Putin. The fact that he lost some strategic areas (including the Kerson region) that had just been annexed in the referendum exposes Putin to international embarrassment, and also to the first criticism on the domestic front. It is difficult for Putin to accept the success of the Ukrainian counteroffensive without reacting in some way. In this context, it was not reassuring to hear that Biden finds Putin's nuclear threat truly credible. As very well illustrated by the article ‘How does the Russo-Ukrainian War end?’ by Timothy Snyder on substack.com, we do not believe that the use of nuclear weapons is likely. Indeed, it would be completely irrational, but it is clear that with reference to the markets, given the general fragility, the risk must be incorporated.

As Figure 2 highlights, the S&P 500 index quickly returned to supports after a violent rebound attempt in the first two days of this week. Unfortunately, the price action also confirms the weakness of the stock market, which, in spite of such negative sentiment and positioning, is unable to recover. After all, our analysis for the past few months remains the same, loud and clear: we are in the midst of a repricing of all assets (from equities to credit, but also private investments and real estate, which have not yet been impacted only because of the lack of liquidity and therefore the mark-to-market that can be postponed).

"We remain defensive, waiting for some sign of easing from the Fed, or some positive surprise, however difficult that may be to imagine at this time."

The global economy continues to slow, rates continue to rise due to sticky inflation, and central banks cannot come to the rescue of assets and economies until it is probably too late to avoid a hard landing. In particular, with reference to Standard & Poor's (other markets are already much cheaper), while the market was now focused on earnings in the coming quarters (with downside risk, as is typical of recessionary phases), the complicated macro picture and elevated geopolitical tensions make us think that even the contraction of multiples (P/E is down from 23-24 to 17) is not yet complete. As a result, we remain defensive, waiting for some sign of easing from the Fed, or some positive surprise, however difficult that may be to imagine at this time.

Figure 2: S&P 500 Index Returns to Supports

Source: Bloomberg, as at October 7, 2022.

"This is not the first time we've seen the hope trade rear its head only to see it dashed by contrasting factual data."

Equities | Hope is not a strategy

A long and volatile process for the Fed.

As we mentioned earlier, the week started with a two-day "hope rally", driven by the hope of a Fed pivot or pause, that was triggered by a smaller-than-expected rate hike from the Australian central bank and a lower US job openings report (JOLTS Job Openings). However, equities surrendered most of their gains after an aggressive OPEC+ production cut on Thursday and a lower-than-expected US September unemployment figure of 3.5% versus 3.7% expected.

Our view: This is not the first time we've seen the hope trade rear its head only to see it dashed by contrasting factual data. Last week's equity market moves highlighted a few key dynamics worth taking into consideration. First, while some central banks are wavering in their resolve to fight inflation, the Fed isn't. Confusing the two or assuming there is a read-across from one central bank's actions to the Fed's is not just erroneous, but also dangerous.

Second, the Fed is tackling what is primarily a supply-driven inflation problem using tools that affect demand. The decision of OPEC+ to cut oil production by two million barrels per day underscores the complexity of the Fed's approach. The type of "demand destruction" that the Fed has to orchestrate to reach its 2% inflation target will no doubt inflict "pain", as Fed Chair Powell stated. Certain components of inflation will naturally decline, making the reduction from around 8% to around 5% a relatively painless move. However, it's the second phase of a reduction from 5% to 2% that we believe will be more "painful" in size compared to the first phase. The Fed is left with no choice but to follow through on its promise to get inflation to the 2% range. Any premature deviation from this plan risks causing inflation expectations to become unanchored.

"The mismatch between the drivers of inflation and the Fed's tools to tackle them makes us of the view that this will be a long and volatile process..."

Will there be a year-end rally?

Asset managers are coming into the final quarter of the year (a traditionally strong quarter) in a very vulnerable position, with high cash levels and low equity allocations. With sentiment and positioning still at extremely low levels, we wouldn't be surprised to see a material year-end rally. Potential catalysts include a positive US CPI surprise and/or a better than expected Q3 earnings season with resilient guidance.

What does this all mean for equity portfolios?

For the better part of this year, we have been resisting making single stock calls, largely due to the typical nature of bear markets—where fundamentals are overshadowed by positioning and sentiment. Instead, we opted for calling the shots at the sector, country, and factor level, which has worked reasonably well on a volatility-adjusted basis. We expect this to change as soon as we start to see certain stocks that exhibit interesting risk/reward profiles. We wouldn't be looking to add risk, but would rather replace lower conviction positions instead. The reason is because our base case is still for the Fed to continue on its current path until the job is done. Peak yields, not peak inflation, is what matters here. The mismatch between the drivers of inflation and the Fed's tools to tackle them, as highlighted above, makes us of the view that this will be a long and volatile process—and certainly much longer than the hope crowd is expecting.

We were victims of the hope trade ourselves, when it came to semiconductors. We were slow in reacting to the signs of inventory build in memory and gradually reduced our industry overweight to equal weight, hoping that the consolidated industry would hedge against inventory buildup risk. AMD's sales warning on Thursday points to a worse outlook for the industry and the sector. Separately, Big Tech, especially Apple and Microsoft, stand out as particularly vulnerable relative to the market. These traditional safe havens are experiencing widening valuation gaps vis-à-vis the rest of the market. Should their earnings or guidance disappoint, we would expect them to close part of that valuation gap. We will be going into this earnings season with an underweight exposure to these stocks.

"Activity in new deals across the various strategies is showing signs of drying up, recording its third consecutive drop of total number deals successfully closed."

Private Equity| The dust has yet to settle in VC

Managers' focus returns to fundamentals.

Looking at preliminary Q3 data of top-line venture industry figures in the US, the data points to a continuation of a market slowdown and a swifter activity decline compared to previous quarters. Activity in new deals across the various strategies is showing signs of drying up, recording its third consecutive drop of total number deals successfully closed—20% off from last year's peak. In terms of deal value, USD43 billion were invested in the period, a nine-quarter low pointing to a decrease in the average dollar amount per deal done as the count of deals kept up relatively better and is still higher on a historical basis.

On the exit activity front, just USD14 billion in exit value was generated in the third quarter. To put this in context, this figure is in line with activity seen in 2014 and well below last year's highs—for example, USD266.8 billion was generated in the second quarter of 2021. On the other hand, US VC fundraising continued its upward march for what will be an all-time high year, yet with still one quarter to go. So far, new funds have raised USD150.9 billion, surpassing last year's record, although the pace in the third quarter slowed with just USD29.3 billion.

“Market rationalizatio n is occurring in the midst of record dry powder levels in the VC fund industry as funds keep collecting new money, although at a slower pace.”

Our view: The decline from record levels in new deal activity, and more specifically the accentuated drop in the dollar value of investment per deal, suggests that investment managers are adopting an approach more focused on company fundamentals and valuation awareness amid the economic downturn. Market rationalization is occurring in the midst of record dry powder levels in the VC fund industry as funds keep collecting new money, although at a slower pace.

We identify the high levels of funds’ disposable fresh money to invest as a technical support for valuations, however, a wait-and-see attitude on the part of GPs, despite their “obligation” to deploy capital in time, we deem as a market healthy sign and the likely start of market recovery. On our end, we are closely monitoring the evolution of mega-funds' new vintages fundraising activity at exigent target sizes as we expect them to show weakness in the foreseeable future.

Despite the pressure mounting on the exit side, the industry has yet to see an increase in down rounds. This is not unexpected as down rounds can extend in a down market as companies find creative ways to lengthen runway and stay away from equity new rounds— layoffs, overhead cuts and VC direct lending. One of the highlights of the period was the announcement of Adobe's USD20 billion purchase of Figma, a web-based design platform. The deal poses the largest price for a VC-backed company at the time of the agreement, as well as reportedly the highest revenue multiple ever paid for a late-stage software firm. This information contrasts with the total USD14 billion total exit value generated by the industry in the third quarter (Figma’s deal is not included as it is has not yet closed). With IPO activity muted, the options are shortening for late-stage VC-backed enterprises, and public corporate M&A add-on acquisitions may take representativeness in the future after years of low competitiveness versus public markets / PE firms.

Week Ahead | Key events to watch for

- **On the economic front, the only thing that really matters is the US inflation figure r**eleased on Wednesday. Expectations are for rise of 8.1% and 6.5% year-on-year for headline and core, respectively.
- **We are entering the middle of earnings season, starting with the usual US banks**: Citi, MS, JPM, and Wells Fargo. One of the key focus for the upcoming season is management guidance around the strength of the US dollar and pressures on margins from labor costs and commodities.

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