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Weekly Market Flash
Sentiment continues to fluctuate

December 11, 2022

This week was decidedly devoid of any major events, but nevertheless, the major equity markets closed in negative territory—the S&P 500 index was down -2.40%, Nasdaq index -2.9%, Eurostox index -0.9%, and the MSCI World index -2.3%. Given the absence of news, it is likely that the retracement of the markets, especially in the US, is largely driven by the technical picture (Figure 2), since the market stopped in perfect tune with the resistance in the 4'100 area for the S&P 500 index. For the moment, we can therefore be satisfied that we lightened our own equity position last week, since, as we have explained, the risk reward looks unfavorable to us above 4'000.

Highlights

▪ The US PPI figure released on Friday does not bode well, with a surprise at 6.2% YoY against expectations at 5.9% YoY. This data shows that by the time the peak for the cycle has been marked (at 10.2%, three months ago), the path to normalization is not linear. However, the direction is downward.

▪ The most surprising dynamic this week was the drop in the price of Brent crude (-11%), which occurred amid the news of the "China reopening."

▪ In the last two weeks, markets have gone from worrying about how far the Fed might raise rates to discounting the alleged narrative of a “just-around-the-corner” recession. This prompted a sharp decline in government bond yields—the US Treasury 10-year yield went down to 3.42%, and in Europe, yields on 10-year Bunds dipped below 1.80%, their lowest level in three months, while 10-year BTP yields fell to 3.75%.

Markets & Macro | Sentiment continues to fluctuate

“...the incoming recession seems so obvious and taken for granted, that you can question whether it is not already fully priced in.”

But concerns for a 2023 recession remain.

Investor sentiment continues to fluctuate at this stage. On the one hand, the incoming recession seems so obvious and taken for granted, that you can question whether it is not already fully priced in. However, what is perhaps underestimated is the potential weakness of the consumer sector. Household indebtedness is on the rise and the six major credit card issuers have shown rising delinquency rates.

Moreover, real earnings have been negative for a year now due to rising inflation, while the excess savings accumulated during the pandemic are slowly eroding. The only pillar that is still solid is the labor market, which has started to show some signs of slowing down (but not yet of shrinking) in recent weeks.

“The same could happen for the CPI in the coming months, and this would be a problem for the market...”

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

Equity	Last Value	Ytd
MSCI World	2,662.86	-15.88%
Nasdaq	11,004.62	-29.09%
S&P 500	3,934.38	-16.18%
DJ Industrial	33,476.46	-5.95%
Nikkei	27,901.01	-1.10%
Eurostoxx	3,942.62	-5.08%
Swiss SMI	11,068.30	-11.58%
FTSE 100	7,476.63	4.82%
Canada	19,947.07	-3.28%
Shenzen	3,998.24	-17.33%
Hong Kong	19,900.87	-12.03%
MSCI EM	978.28	-18.17%

Commodities	Last Value	Ytd
BBG Commodities	111.73	12.67%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	66.00	8.57%
Gold	1,797.33	-1.74%
Silver	23.47	0.71%
BBG Brent Crude TR	944.48	26.10%
BBG WTI Crude Oil TR	169.25	10.55%

Bond Indices	Last Value	Ytd
US Inv Grade	108.86	-15.52%
US High Yield	75.04	-9.77%
Euro Corps	233.09	-11.59%
JPM Europe Govies	9,672.16	-9.06%
US Treasuries	2,217.09	-11.31%
China Aggregate	254.45	-5.50%
EMBI Global	777.39	-15.46%
EMBI Local	122.62	-10.96%

FX	Last Value	Ytd
DXY Index	1,263.79	7.70%
Bbg JP ASIA	100.41	-7.08%
Bbg JP LATAM	39.78	-2.70%
EUR Index	120.10	-0.55%
EUR/CHF	0.98	-5.12%
GBP Index	638.62	-6.47%
EM FX Index	1,650.47	-4.84%
JPY/USD	136.56	-15.73%
CNY/USD	6.96	-8.66%
Bitcoin	17,150.00	-62.99%

Source: Bloomberg, as at December 9, 2022. Performance figures in indices' local currencies.

Figure 2: S&P 500 Index

Source: Bloomberg, as at December 9, 2022.

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Our view: In addition, we are entering an important week of major central bank meetings and likely further interest rate hikes, as well as the release of November inflation data in the US. In terms of inflation, the PPI figure released on Friday does not bode well, with a surprise at 6.2% year-over-year (YoY) against expectations at 5.9% YoY. This data shows that by the time the peak for the cycle has been marked (at 10.2%, three months ago), the path to normalization is not linear. However, the direction is downward. The same could happen for the CPI in the coming months, and this would be a problem for the market that incorporates a Federal Reserve (Fed) rate reversal as early as late 2023.

The most surprising dynamic this week though was the drop in the price of Brent crude (-11%), which occurred amid the news of the "China reopening." The prospects of a complete reopening of the Chinese economy, from an analytical point of view, should imply a marked increase in oil demand. However, Chinese oil demand is estimated to be reduced by at least three million barrels per day due to the lockdowns. In fact, confirmations of the change in direction of the health authorities (albeit extremely gradual) continue to arrive. In fact, it was announced this week that home quarantine will be used for some Covid patients and that they will eliminate mandatory testing for most public places. In total, 10 new measures were introduced immediately. This is the second phase of easing restrictions on Covid in China.

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But this news, which supported Chinese assets once again this week (the Shanghai Shenzhen 300 index was up 3.3%), lent no support to crude oil. Evidently, other factors weighed more heavily. For instance, the cap on oil prices recently introduced by the G7 has so far done little to support prices. Russia seems content to sell its oil at a discount to both China and India, and has stated that it is considering introducing a "floor price" or maximum discount to the benchmark at which its oil can be sold. And as for the cuts announced by Opec+ a month ago, the reality is that the actual cuts were less (at one million instead of the two million announced), since some producers such as Angola and Nigeria were already struggling to meet their quotas.

Evidently, concerns of a global recession next year are prevailing in the market—although for now, macro data are still holding, showing signs of a slowdown but still far from indicating an ongoing recession. We also note that the "long energy" trade was a big consensus in the latter part of 2022, and positioning did the rest. The low liquidity in the market during this period has certainly weighed, and rumors of big liquidations by hedge funds chased each other during the week.

Fixed Income | Will the storm clouds turn into a hurricane?

Financial dislocations are starting to appear.

“While this inversion means that a recession is certainly a very real prospect down the line, it’s still not a given...”

In the last two weeks, markets have gone from worrying about how far the Fed might raise rates to discounting the alleged narrative of a “just-around-the-corner” recession. This prompted a sharp decline in government bond yields. The US Treasury 10-year yield went down to 3.42% (which is -0.9% below the high of 4.34% in October), and in Europe, yields on 10-year Bunds dipped below 1.80%, their lowest level in three months, while 10-year BTP yields fell to 3.75% (after touching a minimum of 3.59%).

However, it was a different story on the short end of the yield curve, where markets remained in a holding pattern as investors are looking forward to the calendar of the coming week: US inflation figures for November, and rate decisions from the Fed and the European Central Bank. Expectations of the Fed’s terminal rate remained around the 5% mark, where they’ve been for nearly a couple of months now, giving the 2-year Treasury little room to move away from the 4.3% level and keeping the US curve deeply inverted. While this inversion means that a recession is certainly a very real prospect down the line, it’s still not a given—and, as JP Morgan CEO Jamie Dimon puts it “it’s hard to tell if the storm clouds on the horizon could become a hurricane”.

Our view: Whether it’s a recession or a simple slowdown in 2023 matters little, if the danger comes from the fact that when central banks tighten, something always falls apart. Globally, total public and private debt as a proportion of gross domestic product rose from 200% in 1999 to 350% in 2021, according to the Institute for International Finance. It’s closer to 420% for rich nations. Cheap money is now disappearing and financial dislocations are starting to show up, as the tremors in the UK pension and cryptocurrency markets have demonstrated.

Surely nowadays lenders, especially US banks, are much better capitalized than they were 15 years ago, but that is not true everywhere. In some corner of the market, exposure to property or corporate loans is likely to have seeped into the shadow banking system. An example is Blackstone Inc.’s USD69 billion BREIT, which shares don’t trade on exchanges and has thresholds on how much money investors can take out to avoid forced selling. The fund is essentially a bet on an illiquid strategy—because private credit doesn’t trade in a secondary market—but offers liquidity in the form of redemptions, causing potential for a mismatch when sentiment weakens. To mitigate this, there is a redemption cap at 5%. The fund became a behemoth in the real estate industry since its start in 2017, rapidly snapping up properties in an era as investors chased yield. Now, soaring borrowing costs and a cooling economy are rapidly changing the landscape: redemption requests have exceeded the monthly limit and investors are facing the risk of suspension of their repurchase request.

"Now, soaring borrowing costs and a cooling economy are rapidly changing the landscape..."

Corporates loans are another open wound. Because credit markets deteriorated, banks are saddled with more than USD40 billion of loans disbursed to fund the LBO activity of the last two years. For many lenders, offloading chunks of hung debt—even at a discount—is better than letting it languish on their books, tying up capital that could be deployed elsewhere. Last week Apollo Global Management and Franklin Templeton bought USD750 million of loans backing the buyout of Citrix Systems at 87 cents on the dollar against a secondary market price at around 90.25 cents. Note that of the USD15 billion of debt financing for the Citrix LBO, banks managed to sell just USD8.55 billion of bonds and loans before the buyout closed, and made losses of more than USD600 million on that part of the financing alone after selling at rock-bottom prices.

Against this backdrop, we are maintaining with our cautious stance across fixed income. In credit, this means staying up in quality and up in seniority, and investing in short maturities of investment grade corporates that have gradually became more interesting—especially in USD where you can now achieve an average yield of 4.85% (coupon 4.3%) for maturities around 2.5 years and ratings of A/BBB+.

Week Ahead | Key events to watch for

- **Next week will be a decisive week for market sentiment, given central bank meetings and economic data.** The FOMC meeting will be held Wednesday, (with an expected 50 bps rate rise), the US CPI on Tuesday, and the US Congress faces a December 16 deadline to pass a bill to continue funding the government (if not, a partial shutdown is likely).
- **The ECB and BoE are expected to raise rates** by 50 bps each, while for the Swiss National Bank the market is split between a 25 bps and 50 bps hike.
- **In China, economic data releases** will include industrial production and retail sales.

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