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Weekly Market Flash

Will the ECB's hawkishness turn out to be premature?

June 12, 2022

This week was one that seemed to be continuing the rebound of equity markets – but it turned into a nightmare for equity indices, and more generally for all risky assets. The trend started with European peripherals, led by the Italian BTP, which reached precocious yield levels as well as spreads to the Bund. Obviously, the dominant theme was once again inflation, and the delayed, and therefore disruptive, response that central banks are adopting to cope with the massive rise in prices. Europe and the US recorded losses of around 5% across all indices, while among the world's major markets China (3.5%) and Japan (flat) were saved, for a number of specific reasons.

Highlights

- The Italian 10-year yield reached 3.67% – the level prevailing when the QE programme began in 2014 – while the spread to Bunds widened to 224 bps.

- The ECB confirmed that net asset purchases will end on 1 July, and that rates will rise by 25 bps in July. It also kept the door to a 50 bps rate hike in September wide open.

- The May US CPI was very bad, with a 1% rise month-on-month, and the YoY figure at a new 41-year high. The University of Michigan consumer sentiment preliminary print for June came in at 50.2, far below the 58.1 expected.

- In contrast to US and European indexes, Chinese stocks rallied, driven by signs of easing the multi-year crackdown on the technology sector, the easing of lockdowns, and rising hopes for further monetary easing given the mild inflation print.

- Bitcoin dipped below USD30,000 after the inflation release. On the positive side, the token has been trading within a narrow range since the beginning of May.

"...unlike in the past, with the current inflationary dynamic, central banks cannot intervene with extraordinary measures in the event of shocks..."

Markets & Macro | Will the ECB's hawkishness turn out to be premature?

Dealing with the new post-COVID and post-Ukraine war world.

This week, in our view, the most worrying performance concerns the Italian BTP, where the 10-year yield reached 3.67% – the level prevailing when the QE programme began in 2014, and not far from the levels prevailing in 2012, when Draghi pronounced the famous "whatever it takes". The spread, at 224 basis points (bps), is still (relatively) under control (although that too is starting to concern us).

But our thinking is that the absolute level of the 10-year is dominating, as this represents the cost of debt with which a country's government has to finance its deficit (with estimates for 2022/23/24 for -5.8%, -4.6% and -4.8% on GDP, respectively). The spread has widened less at this stage because the upward trend in interest rates is an (almost) global phenomenon, so that even in Germany the 10-year has risen, thus limiting the difference compared to Italy.

Our view: The reason for our concern is that, unlike in the past, with the current inflationary dynamic, central banks cannot intervene with extraordinary measures in the event of shocks, or at least to a limited extent. We don't want to go so far as to say that Draghi's 'whatever it takes' would have no effect today, but it would be much riskier and exposed to the risk of counter-evidence. In fact, in the pre-Covid and pre-Ukraine war world (and sanctions on Russia of course), the infinite elasticity of supply ensured a regime of low inflation all over the world. And in Europe inflation was also too low, and that a higher inflation regime would have helped governments to ease the debt burden (relative to GDP).

> "It is obvious to all that if there is a risk on these [ECB] projections, it is that growth will disappoint significantly downward..."

Today, however, we find ourselves in the opposite situation, in which inflation has the only positive effect of helping the governments of southern European countries to lighten the burden of their debt heavily, but imposing an enormous cost on consumers (inflation being a real tax on consumers), and a form of soft debt restructuring. Adding to this problem is the discontent of the Northern European countries, savers par excellence, who are further harmed by financial repression, real negative returns being a further tax on those who save, who see their savings (and the insurance industries for example) irreparably damaged.

Consequently, it is clear that the European Central Bank (ECB) is coming under enormous pressure from the northern hawks, and has kept the door open to a series of rate hikes. Specifically:

- Net asset purchases will end on 1 July.
- Reinvestments from the emergency pandemic purchase programme will continue at least until the end of 2024 and will remain the main (and only) tool against widening yield spreads.
- Rates will rise by 25 bps in July, while the door to a 50 bps rate hike in September is wide open. The statement says: the cycle of hikes could also tighten as the ECB stated that 'a gradual but sustained path of further interest rate hikes will be appropriate' beyond September.
- Growth and inflation projections imply a high risk of stagflation. Inflation will be 6.8% in 2022, 3.5% in 2023, and 2.1% in 2024. GDP growth is expected to be 2.8% in 2022, 2.1% in 2023, and 2.1% in 2024

Moreover, it is obvious to all that if there is a risk on these projections, it is that growth will disappoint significantly downward, as signaled by the recent economic indicators that continue to come out below expectations, and the rise in energy and commodity prices. Hence, there is the risk that all this hawkishness will turn out to be premature and dangerous, to the detriment of weaker countries such as Italy, and that a reversal will be necessary in the future, when the country's assets will by then be at a bargain price for foreign investors. While this is nothing new, it must also be said that the country has had many years to put its accounts in order, with the support of the central bank (which has now accumulated 30% of Italian debt on its balance sheet). But it must be acknowledged that this time the pandemic got in the way, especially given that it struck Italy unprepared as the first country in the western world, thus amplifying the disruptive effect on the economy and public health.

> "The feeling is that the central bank's hands are tied, with the hawks in full control, and that only in the face of an overt crisis situation will some new measure be announced."

A final point on the subject of central bank support: the part that caused yields (and the Italian stock market, which lost 5.2% on Friday) to accelerate was the absence of an announcement on any anti-fragmentation measures on the cost of debt for peripheral countries. The market was expecting some sign that the central bank was preparing a plan, but this did not come. The feeling, therefore, is that the central bank's hands are tied, with the hawks in full control, and that only in the face of an overt crisis situation will some new measure be announced.

Figure 1: Italian 10-year Yield and Spread

Source: Bloomberg, as at June 10, 2022.

The market had hoped that the week's most important data, the May US CPI, would finally provide some relief, a positive surprise and a clear reversal of the trend, thanks to the definitive disappearance of the base effects that had weighed down in the first months of the year, pushing up prices year-on-year (YoY). Instead, the opposite happened. In particular, headline inflation was very bad, with a 1% rise month-on-month and the YoY figure at a new 41-year high (8.6% YoY, while Core CPI was a little better, but still above expectations at 6.0% YoY). The situation in the US is also worrying, with consumer sentiment very low and galloping inflation leaving no room for the Federal Reserve (Fed) to loosen its grip on rates.

> "It is difficult at this point to imagine that the stock market can easily break the unfavorable price action."

It is difficult at this point to imagine that the stock market can easily break the unfavorable price action. A test of the S&P 500 index's lows at 3,800 cannot be ruled out in the coming weeks, where the only element of support for the market could come from investors' positioning, which is certainly extreme, with mistrustful sentiment and the consensus view already extremely bearish. The only positive note (for our asset allocation and the market as a whole) is that on the one hand, hedges such as the Swiss franc, the US dollar and gold worked to stem losses, and on the other hand the Chinese market (to which we have slight exposure) held up very well thanks to the support and reopening measures that are finally coming, in an inflationary environment that is much more under control (this week's CPI at 2.1% YoY).

Chart of the week

The EUR/CHF currency pair tested May 2020 lows at 1.05008, but closed below the 200 Days Moving Average.

Figure 2: EUR/CHF Performance

Source: Bloomberg, as at June 10, 2022.

> "The ECB's very slow response to the rampant inflation in Europe cemented the view that the central bank is significantly behind the curve on fighting inflation."

Equities | Don't fight the PBOC

Chinese equities decouple from US and European equities.

Despite some strength early in the week, US and European stocks experienced heavy losses. The sell-off, which started Thursday afternoon, accelerated following the release of a higher-than-expected US CPI print. And the ECB's very slow response to the rampant inflation in Europe cemented the view that Europe's central bank is significantly behind the curve on fighting inflation. In this environment, technology stocks were particularly weak given their long duration nature. At the same time, the University of Michigan consumer sentiment preliminary print for June came in at 50.2, far below the 58.1 expected. The June reading marks one of the lowest on record. All index components fell in June. According to the survey director, Joanne Hsu, 46% of consumers attributed their negative views to inflation.

In contrast to US and European indexes, Chinese stocks rallied, driven by signs of easing the multi-year crackdown on the technology sector, the easing of lockdowns, and rising hopes for further monetary easing given the mild inflation print.

“Our calls with China experts suggest that public capex (the weapon of choice for Chinese policymakers) will provide relief starting in the third quarter.”

Figure 3: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,392.79	-4.56%	-4.76%	-12.78%
S&P 500	3,900.86	-5.04%	-5.55%	-17.60%
Nasdaq	11,340.02	-5.59%	-6.11%	-27.25%
Euro Stoxx 50	3,599.20	-4.87%	-5.00%	-13.99%
Swiss Market	11,084.62	-3.86%	-4.54%	-11.57%
FTSE 100	7,317.52	-2.83%	-3.67%	0.94%
CAC 40	6,187.23	-4.48%	-4.21%	-11.32%
DAX	13,761.83	-4.83%	-4.35%	-13.37%
FTSE MIB	22,547.48	-6.70%	-7.99%	-15.14%
Nikkei 225	27,824.29	0.23%	2.00%	-2.41%
Hang Seng	21,806.18	3.70%	6.75%	-5.56%
CSI 300	4,238.99	3.77%	7.88%	-13.77%

Source: Bloomberg, as at June 10, 2022. Performance figures in indices' local currencies.

Our view: This week we saw a rare sign of Chinese equities decoupling from US and European equities. While the People’s Bank of China (PBOC) hasn’t unleashed a policy bazooka, aggregate easing is expected to match 2020, with further RRR cuts, fiscal budget easing and easing of property restrictions by the end of the year. Our calls with China experts suggest that public capex (the weapon of choice for Chinese policymakers) will provide relief starting in the third quarter.

China’s growth outlook is the most challenging part of the equation. A full recovery and earnings inflection are a few quarters away. But the market is always forward looking. We look for signs that the Chinese consumer is emerging from lockdowns confident and looking to catch up on consumption. One of the best signals of consumer confidence is the stock market itself. Our investigations suggest that short covering has played a big role in the recent rally in Chinese equities. Southbound flow (from mainland to Hong Kong) is mixed, to some extent, suggesting that mainland investors have been selling into the rally.

In short, markets stop panicking when policymakers start panicking, and we believe that Chinese policymakers are panicking at this moment. Consumer confidence is the missing piece of the puzzle for a sustained rally that may escape the wrath of the Fed’s quantitative tightening.

“Many investors still believe that the fundamentals of a long-term case [for Bitcoin] are really strong...”

Crypto & Blockchain | Ethereum’s blockchain may be updated sooner

Bitcoin dips below USD30,000.

There have been a few important events happening on Ethereum this week. After several delays, the update of Ethereum’s blockchain could be happening sooner than expected later on this summer, potentially in August. Two more public testnet merges on the Ethereum, Goelri and Sepolia networks, are scheduled to be executed before the mainnet merge.

Mainnet is the term used to describe when a blockchain protocol is fully developed and deployed. In contrast to mainnet networks, the term testnet describes when a blockchain protocol or network is not yet up and running on its full capacity. A testnet is used by programmers and developers to test and troubleshoot all the aspects and features. By moving from proof-of-work to proof-of-stake, Ethereum’s energy consumption is estimated to be reduced by 99.95%.

Market action: Bitcoin dipped below USD30,000 after the inflation release. On the positive side, the token has been trading within a narrow range since the beginning of May. This third crypto winter is different, without a real capitulation at the moment. Many investors still believe that the fundamentals of a long-term case are really strong – and when everyone else is dipping out, this could be the time to double down and go extra hard into it.

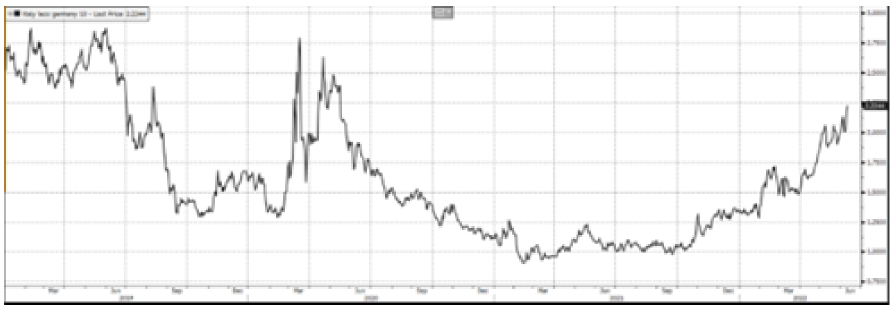
Fixed Income | Will the Euro govvie market avoid a crisis mode?

Yields spike and peripheral spreads widen.

With consumer price inflation in the euro area running at an 8.1% annual pace, and with inflation forecasts revised higher to a level above target in 2024, the ECB confirmed on Thursday that rates would rise in July and in September, and that the inflation outlook will dictate the size of September's change. Money markets are betting on 150 bps of rate hikes from the ECB by year-end, which would entail two half-point and two quarter-point increases in the next four policy meetings. Against this backdrop, both government bond yields and peripheral spreads increased.

"Let's hope that this time the dance between markets and politicians will not mean that the European government bond market must first shift into crisis mode..."

Figure 4: Govvies and Peripheral Spreads Rise



Source: Bloomberg, as at June 10, 2022.

Our view: Investors, who did not forget Lagarde's memorable comment in 2020 that "we are not here to close spreads", were very disconcerted that there was no explicit plan to keep the eurozone together – and only a vague approach toward creating a new tool like another bond buying program, was necessary to keep financial conditions from tightening disproportionately in peripheral economies.

It would not make much sense for the ECB to raise rates aggressively, cause fragmentation, then introduce a new tool to counter it. Let's hope that this time the dance between markets and politicians will not mean that the European government bond market must first shift into crisis mode and unwarranted spread widening, before the ECB acts.

Week Ahead | Key events to watch for

- **Next week will focus on central banks, starting with the Fed**. After Friday's heavy CPI data, the market started to partially price in the possibility of a 75 bps hike on Wednesday, which is keeping tensions elevated.

- **The Bank of Japan meeting will take place on Thursday**, following the Yen depreciation in recent weeks, with the first signs of impatience coming from the Japanese authorities.

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