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Weekly Market Flash

Becoming accustomed to a volatile environment

October 16, 2022

In what seems to be the dominant theme of all of 2022, the market again found itself in the usual selloff on Friday—with inflationary pressures and an increasingly aggressive response from the Federal Reserve (Fed) supporting the selling. The weekly closing was -1.6% for the S&P 500 index, bringing the accumulated loss since the beginning of the year to -24%. The illusion of Thursday's violent reversal, where in the face of a bad inflation figure the indices had recovered all their losses and then closed with conspicuous gains, clashed with the harsh reality on Friday. To give some idea of the volatility and indecipherability of the market movements to which we are becoming accustomed to, S&P 500 futures were up 1.57% before the CPI print, fell -2.40% about an hour later, and then closed 2.60% up, thus putting a spectacular end to a series of six consecutive declines.

Highlights

▪ The US CPI report was very negative—the price increase for the month was 0.4%, twice as much as expected (8.2% year-on-year headline). Even worse was the core component, with a monthly 0.6% increase for the second consecutive month, bringing the year-on-year measure to 6.6%.

▪ The 10-year US Treasury reached a yield of 4.07%, and the 2-year above 4.5%. The Fed Fund strip went on to discount a 15% probability of a 100 basis points (bps) hike at the 2nd November FOMC meeting.

▪ In the US, investment grade corporate bonds are falling, with average prices of around 86 cents on the dollar on 13th October, compared with 90 cents about three weeks ago.

▪ The number of ETH tokens fell by 4,000 over the past week as more ETHs were burned to verify transactions than created for the first time since the merger. This deflationary process should lead to higher prices, assuming demand is steady.

“Even worse was the core component, with a monthly 0.6% increase for the second consecutive month, bringing the year-on-year measure to 6.6%, the highest level since 1982!”

Markets & Macro | Becoming accustomed to a volatile environment

Defensive positioning remains.

A widely shared Bloomberg report suggested that the S&P 500 index had given back 50% of the post-Covid rally, when it touched a low of 3'490, and thus triggered technical buying programs. The extreme positioning of all inflation trades (short equities, short bonds and long US dollars) did the rest, in terms of short covering.

As for the details of the US CPI report, it was very negative, whichever way you look at it. The price increase for the month was 0.4%, twice as much as expected (8.2% year-on-year headline). Even worse was the core component, with a monthly 0.6% increase for the second consecutive month, bringing the year-on-year measure to 6.6%, the highest level since 1982! Supporting the core component is the rise in the cost of services (0.8%) driven by the housing category, but also by transport, while prices of durable goods have started to fall.

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

Equity	Last Value	Ytd
MSCI World	2,376.65	-25.14%
Nasdaq	10,321.39	-33.61%
S&P 500	3,583.07	-23.88%
Nikkei	27,090.76	-4.11%
Eurostoxx	3,381.73	-18.86%
Swiss SMI	10,329.34	-17.49%
FTSE 100	6,858.79	-4.22%
Canada	18,326.35	-11.54%
Shenzen	3,842.47	-20.61%
Hong Kong	16,587.69	-26.79%
MSCI EM	863.33	-27.99%

Commodities	Last Value	Ytd
BBG Commodities	113.67	14.62%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.86	11.63%
Gold	1,644.47	-10.10%
Silver	18.28	-21.59%
BBG Brent Crude TR	1,070.84	42.98%
BBG WTI Crude Oil TR	197.80	29.20%

Bond Indices	Last Value	Ytd
US Inv Grande	100.38	-22.58%
US High Yield	71.51	-14.70%
Euro Corps	222.88	-15.46%
JPM Europe Govies	9,169.54	-13.79%
US Treasuries	2,146.57	-14.14%
China Aggregate	247.64	-8.03%
EMBI Global	704.92	-23.34%
EMBI Local	113.63	-17.49%

FX	Last Value	Ytd
DXY Index	1,349.55	15.01%
Bbg JP ASIA	96.34	-10.84%
Bbg JP LATAM	39.25	-4.00%
EUR Index	117.32	-2.86%
EUR/CHF	0.98	-5.76%
GBP Index	610.92	-10.53%
EM FX Index	1,584.17	-8.66%
JPY/USD	148.67	-22.59%
CNY/USD	7.19	-11.63%
Bitcoin	19,151.59	-58.67%

Source: Bloomberg, as at October 14, 2022. Performance figures in indices' local currencies.

"Today, exactly the opposite is happening, with the housing market collapsing, but the impact on inflation delayed."

Our view: The problem is that inflation in services is usually more resilient. And it is especially so in the rents category (32% of the index), which update when the contract expires and not before, making them quite lagging. This aspect fits in perfectly with what we have been saying recently about the Fed's hyper-aggressive policy, which, however, is based on a variable (inflation) that has little correlation with the current (or future) performance of the economy. Indeed, last year real estate activity (and house prices) were exploding, but the shelter component of the CPI was subdued (so pushing the Fed to the mistake of not hiking rates in due time). Today, exactly the opposite is happening, with the housing market collapsing (mortgage rates are almost 7% in the US), but the impact on inflation delayed. We will have to wait at least six months for it to calm down.

The interest rate market took little time to adjust to the scenario: the 10-year US Treasury reached a yield of 4.07%, and the 2-year above 4.5%. The Fed Fund strip went on to discount a 15% probability of a 100 basis points (bps) hike at the 2nd November FOMC meeting, while 75 bps is now guaranteed. The question remains whether the December hike will be 50 bps or 75 bps, while the terminal rate is flirting with 5%.

"The market's attention will shift from the macro to the micro over the next two weeks, with the bulk of US companies expected to report guidance..."

Internationally, the climate is anything but relaxed. To give just two examples, relations between the US and Saudi Arabia are very tense following the Opec+ decision to cut crude oil production two weeks ago. In recent days, many details have emerged about the background, in which the US administration (with the mid-term elections approaching and the race wide open) has done everything to avoid the cut, which is having the effect of supporting prices, in a context of high inflation and decelerating growth. The US administration also accused Saudi Arabia of siding with Russia, while it seems that the other producer countries were willing to listen to demands from the US. We also note that on Thursday, the market had tried to find a foothold to prolong the recovery rally in the prospect of a Biden-Putin meeting to start negotiations, but this is unlikely to happen any time soon, or at least not before the elections.

In England, on the other hand, there was great instability on the domestic political front, resulting in a loss of credibility with international investors. UK Prime Minister Liz Truss, in trouble because of the revolt within her own party and the pressure on interest rates caused by her tax cut policy, tried to save herself by stepping back and sacking her Finance Minister. After the news of Kwarteng's departure, in favor of Jeremy Hunt, and the blocking of the corporate tax hike, on Friday the market began to focus on the fact that the Bank of England (BoE) support for the long end of the Gilt curve ends, while Liz Truss is still Premier.

In this climate, the earnings season opened, with banks reporting between lights and shadows. JP Morgan and Citigroup beat estimates, while Morgan Stanley, which is much more associated with investment banking and thus more cyclical financial activity, reported poorly. The market's attention will therefore shift from the macro to the micro over the next two weeks, with the bulk of US companies expected to report guidance rather than quarterly numbers—which should not struggle to beat expectations, as they have been visibly lowered over the past few weeks. Needless to say, from an asset allocation perspective, we remain defensive in this environment, waiting for at least one of the most critical fronts to show some sign of improvement.

"The USI CPI report makes it difficult for the Fed to slow down to a 50 bps hike at its last meeting in December, as they indicated they intended to do."

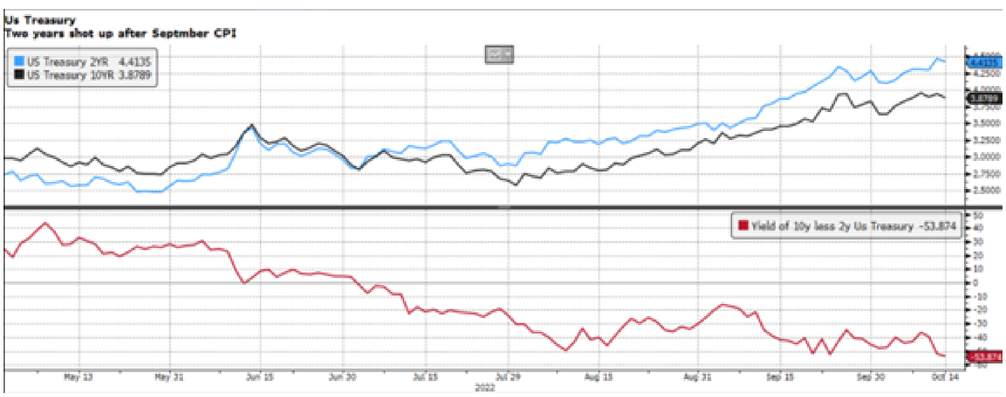
Fixed Income | Up in Quality and Seniority

Challenging environment drives spreads wider.

As mentioned earlier, the US CPI print for September was not good, and this report has all but confirmed a 75 bps rate hike by the Fed in its November meeting. Moreover, this report makes it difficult for the Fed to slow down to a 50 bps hike at its last meeting in December, as they indicated they intended to do. With gasoline prices rising again and prices of core services still strong, there won't be much good news on inflation for the rest of the year.

Against that backdrop, the expectations of future tightening from the Fed increased to a total of 143 bps of hikes by next December. For the next year, the peak will be reached in March to a new high of 4.92%, and the rate priced for end-2023 rose to 4.57%. Short-end US Treasury yields shot higher with the 2-year up 14 bps to 4.45%.

Figure 2: US Treasury Yields Shoot Up

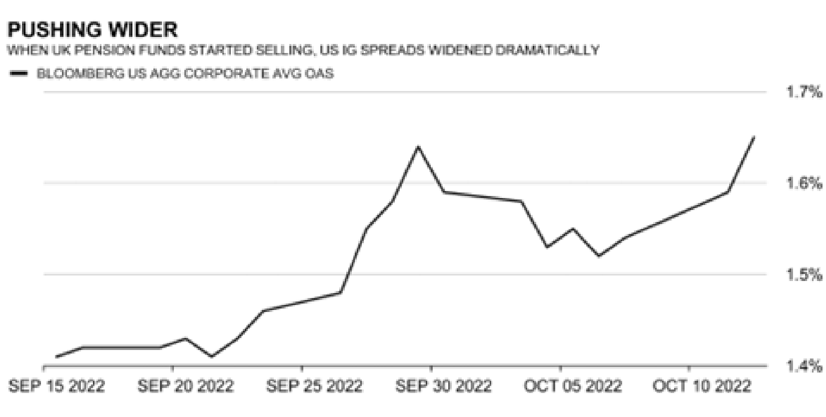


Source: Bloomberg, as at October 14, 2022.

"UK pension funds are dumping assets to meet margin calls as the BoE confirmed it will end its emergency bond buying program, with reverberations being felt everywhere."

More bad news for fixed income came from England during the week. UK pension funds are dumping assets to meet margin calls as the BoE confirmed it will end its emergency bond buying program, with reverberations being felt everywhere. Meanwhile, in the US, investment grade corporate bonds are falling, with average prices of around 86 cents on the dollar on 13th October, compared with 90 cents about three weeks ago. Spreads widened by around 30 bps as a result.

Figure 3: US Investment Grade Spreads Widen



Source: Bloomberg, as at October 14, 2022.

Our view: Some expressed concerns about the potential reverberations from the stress in the UK to other markets, such as the US market for collateralized loan obligations (CLOs). This may prove to be not true. Yet, as the panic that gripped the UK market illustrates, there are still dark corners in global finance. Liability-Driven-Investment, or LDI strategies, helped to solve a problem that faced pension managers during the years when central banks embarked on massive quantitative easing. This sent yields on long dated gilts to historic lows. Pension funds that guarantee retirees a fixed, regular payout rely on the income from those bonds to meet their future commitments. As yields fell, their liabilities rose because of the accounting conventions used in pension reporting. To help cover the shortfall, they turned to LDI strategies. These strategies involved using derivatives or repurchase agreements, effectively lending bonds out in return for cash, which they could then reinvest into more bonds, as well as riskier assets.

"Some expressed concerns about the potential reverberations from the stress in the UK to other markets, such as the US market for CLOs."

The arrangement worked smoothly as long as gilt yields were falling as it brought the pension funds a profit on those trades. But when yields spiked, acutely and quickly, they were hit with sudden demands for funds to cover their losses (a margin call). According to the UK's Investment Association, the total assets in LDI strategies almost quadrupled to GBP1.6 trillion (USD1.8 trillion) in the 10 years through 2021. That compares with a UK government debt market worth about GBP2.3 trillion. No wonder that the BoE had to step in and bail the pension funds out with unlimited purchases of long-dated government debt to prevent a massive bond selloff, which could have led to cascading margin calls.

Our conclusion is that, although unrelated, with all these events and rumours, this is a time to maintain a cautious stance across fixed income. In credit, staying up in quality and up in seniority, and investing in short maturities of investment grade corporates that have gradually become more interesting—such as USD 2023-2025 maturities for A+ to BBB ratings, which are now offering yields between 4.5% to 5%.

Crypto & Blockchain | Resilience in VC

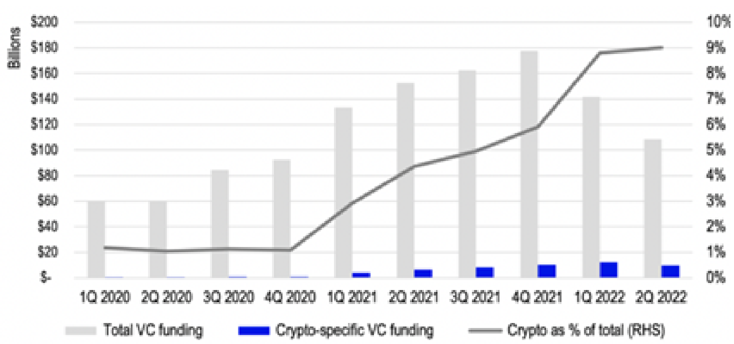
Dry powder is at an all-time high.

"Despite the cryptocurrency L1 token price trends observed during 2022, a notable area of relative resilience within the industry has been VC operations."

The prospect of a hawkish Fed after the higher-than-expected inflation print has been a major headwind for cryptocurrencies, and all risk assets more generally. The number of ETH tokens fell by 4,000 over the past week as more ETHs were burned to verify transactions than created for the first time since the merger. This deflationary process should lead to higher prices, assuming demand is steady. Despite this, ETH/BTC cross has continued to fall, in a clear sign of a defensive switch, as Bitcoin's beta relative to risk assets is lower than Ethereum's.

Despite the cryptocurrency L1 token price trends observed during 2022, a notable area of relative resilience within the industry has been venture capital operations. According to a Coinbase report, the volume of cryptocurrency-specific venture capital financing has increased its market share of total venture capital financing.

Figure 4: Crypto-specific VC Funding Versus Total VC Funding

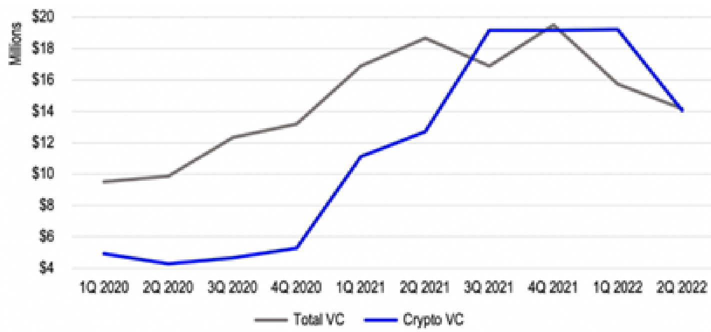


Source: CB Insights, The Block and Coinbase.

“We view the relative strength of cryptocurrency-specific VC funding during this period as a powerful indicator of investor conviction in the asset class.”

The average transaction size has soared 49% in recent years, reaching a peak in Q4 2021 of USD19.5. The average transaction size is now in line with that of other venture capital funds. In terms of cryptocurrency-specific funding, the exponential growth in average deal size is also representative of the increased contribution of venture capital to early-stage companies, as opposed to late-stage deals that naturally attract larger commitments. Indicating how more mature projects that need more conviction in deployment are now being financed.

Figure 5: Average Deal Size (Crypto-specific Funding Versus Total)



Source: CB Insights, The Block and Coinbase.

In addition to the relative strength in capital deployment observed in recent quarters, growth in terms of new fundraising has also shown immense strength despite the apparent ‘cryptocurrency winter’. The dry powder waiting to be distributed is now at an all-time high, as cryptocurrency-specific fundraising totaled some USD35.9 billion in the first half of 2022, compared to only USD18.8 billion raised in the full year 2021. Among the many, the most notable are the USD16 billion raised by A16A in May 2022, the USD2 billion from FTX Ventures in January 2022, the USD1.5 billion from Huan Ventures and USD1 billion from Electric Capital.

Our view: The venture capital space inherently compels investors to take a long-term perspective. We view the relative strength of cryptocurrency-specific VC funding during this period as a powerful indicator of investor conviction in the asset class. These trends and metrics give us confidence that the cryptocurrency sector can emerge from the current bear market in a position of well-funded strength.

Week Ahead | Key events to watch for

- **Next week will see data on the housing market in the US**, inflation data in the UK, and business sentiment in Europe.
- **Corporate results** see Netflix, IBM, Tesla, Bank of America and Johnson & Johnson, plus almost a third of the index constituents.
- **In China, the long-awaited Communist Party congress** will take place, with key leadership roles and priorities for the next five years.

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