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Weekly Market Flash

A reassuring stance on inflation, for the long term

July 17, 2022

It's been another volatile week for the markets, with negative closures for the main equity indices – but all in all, the decline was limited and between 1%-2%. It was a bad week in particular for the Italian market, due to the resignation announced by Prime Minister Draghi (FseMib was down -3.86%), although the final outcome of the government crisis is still unclear. And with two weeks to go before the Federal Reserve (Fed) meeting, there was also a lot of volatility in the expectations for interest rates – in fact, inflation expectations from both the market and consumers (beyond the current year) remain largely under control, and even falling. Meanwhile, economic data came out in line with the trend of recent weeks, namely that of an overall contained economic slowdown. Overall, while we are forced to remain defensive in our asset allocation, we believe the dynamic is healthy for the long term.

Highlights

▪ With tech earnings picking up next week, investors will be searching for signals on whether the Nasdaq index will be able to recoup its inflation-fueled historic wipeout in the first half of the year. If the second quarter earnings season turns out to be worse than expected, we could see additional forecasts downgrades.

▪ Credit remains under pressure as investors have withdrawn cash from funds that invest in US corporate investment grade bonds for the sixteenth straight week, further extending the record losing streak.

▪ Despite the strong US dollar and the risk off tone across risky assets, Bitcoin held very well above the 20,000 mark, but skepticism remains.

"...despite the inflationary flare-up, inflation expectations from both the market and consumers remain largely under control..."

Markets & Macro | A reassuring stance on inflation, for the long term

Remaining defensive for now.

As mentioned, there was a lot of volatility in interest rate expectations, while economic data released this week was in line with the contained economic slowdown. But we believe that the most important factor is that despite the inflationary flare-up we are currently experiencing, inflation expectations from both the market and consumers (beyond the current year) remain largely under control – and even falling. After the June inflation figure (9.1% year-on-year), the market almost fully incorporated a 100 basis points (bps) rise (which was also due to the Bank of Canada's surprise 100 bps hike during the week), but in the last few days expectations have been around 75 bps. After this second 75 bps hike, the market still expects two more 50 bps hikes in September and November, plus a final 25 bps hike in December, for a terminal value of Fed Funds between 3.50% and 3.75%.

Our view: The Fed's rate pricing leads us to some important strategic reflections on the outlook for the US equity market versus the European one. We read the downgrading of long-term inflation expectations very constructively (various market measures predict CPI between 2%-2.5% over the next five to 10 years). It seems to us that the Fed, after the late 2021/early 2022 slide, has regained full control of the curve. Initially it was the market that drove the repricing on rates (to the upside), while more recently it has been the strong and consistent message – not only from Powell, but also from all the governors who intervene verbally during the months – that has driven investors. If in the short term the impact on risky assets has been negative, in the long term the new stance is reassuring and constructive. In such a difficult phase for economies (and let's not forget the war and related sanctions on Russia), having a credible central bank is crucial for the economy, the currency (strong US dollar) and indirectly for equity markets.

"If in the short term the impact on risky assets has been negative, in the long term the new stance is reassuring and constructive."

Consequently, while we are forced to remain defensive in our asset allocation due to the last missing piece in the macro picture (i.e. a repricing of corporate earnings as a consequence of the likely coming recession, as well as a decline in corporate margins due to pressure from commodity costs, cost of capital and labor), we believe this dynamic is healthy for the long term. As a result, our message is clear: as soon as earnings expectations normalize (in our view, a 10%-15% discount should be sufficient), we will be comfortable returning to buy the dip, even aggressively, at every opportunity – but only in the US market, and technology in particular.

It's a completely different story for Europe, where we find it hard to understand the central bank's (in our opinion) overcautious attitude. We assume that inflation levels are similar in Europe than in the US, but with the disadvantage that due to the weakness of the Euro in recent months, the effect will be more negative in Europe in the coming months. Hiding behind the excuse that inflation in Europe comes from costs (hence supply side), the European Central Bank (ECB) plans to raise rates by only 170 bps over the next 12 months, but starting from a level of -0.50%! Therefore, unlike the Fed, the ECB does not seem willing to accept that to cope with inflation, it is necessary to attack and partially destroy demand; while in the short term the effect on the economy might be less traumatic, the consequences on the exchange rate, economies, and equity markets (via the equity risk premium for example) could be devastating.

We must also add to the equation the infamous anti-fragmentation instrument (which is due to be announced next Thursday) and the government crisis in Italy. On the instrument, we believe that if it contains heavy access conditionalities, it could be completely useless because no country will apply for it. If, on the other hand, it will contain light conditionalities, it could be used right away, but that would mean starting to print money again (to buy bonds), just when all the other central banks in the world are doing the opposite. Also, another important detail is that we will have to see what reference will be made to the spread levels between peripherals and Germany. If (as we believe) a definite number will not be provided, it is highly likely that the market will test the levels to see when the central bank's intervention arrives. And with Draghi set to return to the parliament on Wednesday (the day before the ECB meeting), what better time to go look at the cards? Finally, since there is an ongoing political crisis, it will be more difficult for the ECB to call Italy's spread widening 'unwarranted', and thus justify monetary support to the country.

"Unlike the Fed, the ECB does not seem willing to accept that to cope with inflation, it is necessary to attack and partially destroy demand..."

A final comment on Draghi's choice and the Italian drama. We were surprised by the President's sudden decision to resign, which was then rejected for the time being by the President of the Republic. To feel compelled to make such a strong choice at such a delicate moment for the country, Draghi's level of exasperation and despondency must have been very strong. At this point, we would go so far as to say that his reconsideration seems difficult, precisely because of the esteem in which we hold the Prime Minister, and we do not believe that he's playing around with his political counterparts, but that this is a definitive and resigned choice. The only possibility of a step back from his decision could come from international pressures from other European (or US) leaders.

In case of no permanence of Draghi, two alternative paths would open up: 1) the dissolution of the chambers and a vote in the autumn (which has never happened in the history of the Republic), or 2) a neutral government of an institutional nature, with the aim of approving the 2023 budget bill and then going to the polls next Spring. Of the two scenarios, which are both negative, the second would be more favorable for markets and spread stability. In conclusion, in terms of asset allocation, with the aim to further reduce the equity component, we have lightened Europe given the obvious more unfavorable risk/reward in the medium term.

Equities | Will the forecasts downgrades continue?

Earnings reports remain in focus.

"If the second quarter earnings season turns out to be worse than expected, we could see additional forecasts downgrades..."

Equities finished the week down after the first earnings reports from some Wall Street banks disappointed, while mixed data release (notably US CPI) surprised to the upside, suggesting underlying pressures remain firm amid a looming global recession and hawkish central banks.

Of the major equity markets, only the Japanese market and the CAC40 index were slightly positive and flattish respectively, while the Nasdaq and S&P 500 indexes finished the week lower, partly erasing gains from the week prior. European equities followed suit notably and the Italian market was also dampened by the current political turmoil. The recent selloff in Chinese equities is attributed to Covid shutdown concerns and the latest regulatory directives against the tech sector. Overall, communication services, energy, and materials sectors were the worst performers, while utilities and consumer staples were among the best performing sectors, the latter being the only sector in positive territories.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,288.26	-0.16%	1.71%	-12.97%
S&P 500	3,863.16	-0.91%	2.12%	-18.27%
Nasdaq	11,452.42	-1.57%	3.86%	-26.49%
Euro Stoxx 50	3,477.20	-0.84%	0.72%	-16.79%
Swiss Market	10,982.09	-0.30%	2.24%	-12.39%
FTSE 100	7,159.01	-0.51%	-0.06%	-1.08%
CAC 40	6,036.00	0.05%	2.00%	-13.30%
DAX	12,864.72	-1.16%	0.63%	-19.01%
FTSE MIB	20,933.26	-3.86%	-1.69%	-20.98%
Nikkei 225	26,788.47	1.02%	1.50%	-5.93%
Hang Seng	20,297.72	-6.57%	-4.73%	-11.17%
CSI 300	4,248.53	-3.63%	-3.53%	-12.62%

Source: Bloomberg, as at July 15, 2022. Performance figures in indices' local currencies.

Our view: On top of European central banks' decisions and data releases, next week's busy line up of earning reports will be at the forefront of market attention. With tech earnings picking up next week, investors will be searching for signals on whether the Nasdaq index will be able to recoup its inflation-fueled historic wipeout in the first half of the year. If the second quarter earnings season turns out to be worse than expected, we could see additional forecasts downgrades, as to reflect continued deterioration in the macro/operating environment.

"The near-term outlook is still a concern given the broader risk environment and reports of bankruptcies in the industry."

Crypto & Blockchain | Bitcoin holds on, but skepticism remains

Bitcoin holds above 20,000.

This week, Celsius revealed in it's bankrupt filling that it has a USD1.2 billion hole in its balance sheet. The bright news, if any, comes from Tim Beiko, member of the Ethereum Foundation, who indicated in a tweet that Ethereum's long-anticipated transition to PoS might take place during the week of September 19.

Market action: Despite the strong US dollar and the risk off tone across risky assets, Bitcoin held very well above the 20,000 mark, but skepticism remains. The near-term outlook is still a concern given the broader risk environment and reports of bankruptcies in the industry.

Fixed Income & Commodities | Credit remains under pressure

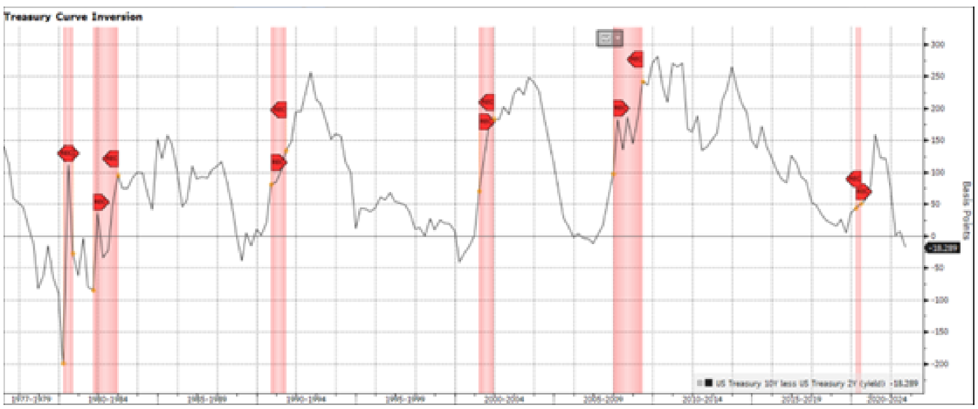
Yield curve inverts after inflation data.

The jump in consumer prices in June to another four-decade high reinforced the near-certainty that the Fed will keep tightening monetary policy aggressively. The draconian measures that the central bank might take to crush inflation have favored longer-term US Treasuries, predicting that these bonds will outperform if the economy falls into a recession.

> "Markets have since repriced, seeing the overnight rate peaking at 3.7% in December..."

Our view: Before the inflation data, the bond market was already pricing in more than 60 bps of rate cuts by the end of 2023 after a peak in short-term rates at around 3.30%. Markets have since repriced, seeing the overnight rate peaking at 3.7% in December, followed by more than 70 bps of cuts next year. The same message is conveyed by the divergent paths of the 10-year yield, which fell as much as 28 bps below the 2-year yield (black line), almost to the levels of late 2000 during the collapse of the dot-com bubble.

Figure 2: US Treasury Curve Inverts



Source: Bloomberg, as at July 15, 2022.

The key question is whether the degree of the yield curve's inversion will mirror 2000 or the much larger moves in the early 1980s, when the Fed's efforts to rein in an inflationary surge set off back-to-back recessions. In 2000, 10-year yields dipped as much as 56 bps below those on 2-year notes. In 1980, the gap widened to as much as -2.4%.

> "In June, there was an almost 80% drop in the number of junk rated companies' borrowings compared to the same month last year."

Credit remains under pressure as investors have withdrawn cash from funds that invest in US corporate investment grade bonds for the sixteenth straight week, further extending the record losing streak. The primary market faced resistance again. Pepsico (A+, A+) braved the hostile market conditions and sold USD2.5 billion in three tranches, with the 5-years offering a yield of 3.625% (0.55% above the 5-yearTtreasury). On the other hand, investors' concerns also touch traditionally illiquid corners of the market, such as leveraged loans in Europe where prices have fallen by almost 10% this year (the worst since 2003). In June, there was an almost 80% drop in the number of junk rated companies' borrowings compared to the same month last year (according to Bloomberg calculations). Indeed, this is a warning of how difficult it has become for companies to raise liquidity.

Chart of the week

After it failed to break the resistance at 1850 and the break of the 200 daily moving average, gold is fighting again around the long-term support in area USD1700.

Figure 3: Price of Gold

Source: Bloomberg, as at July 15, 2022.

Week Ahead | Key events to watch for

- **Europe and US corporate results** will be in the spotlight. Earnings season will feature the results of IBM, Goldman Sachs, Tesla and Twitter, among others.
- **The ECB will raise rates** (the market is split between a 25 bps and 50 bps increase), and it will announce anti-fragmentation measures (which could be tested immediately).
- **In Italy, the fate of the Draghi government will be known**, but not before Wednesday.

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