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Weekly Market Flash
Have we entered a bear market?

September 18, 2022

Wall Street's rebound after the post-Jackson Hole losses was short-lived. This week's monstrous inflation figure triggered a new violent reaction in markets—headline CPI rose 8.3% YoY, while the worst surprise came from Core CPI, which was up 6.3% YoY against expectations of +8.1% and +6.1% YoY. The situation was made more difficult by the fact that the bearish pressure on the inflation data came from energy, but all the less volatile components showed robust rises. The components that have surprised to the upside, such as shelter, are also typically the most lagging and clash with the fact that the housing market is slowing sharply. Patience will be needed to see the series go down, yet relief should be forthcoming—as all indicators that tend to anticipate inflation are pointing toward a normalization to historical levels.

Highlights

- Amid the higher-than-expected inflation print, the S&P 500 index lost 4.77% this week.
- Hotter-than-expected inflation means traders are now betting that the Fed will lift its benchmark rate as high as 4.4% early next year.
- In the primary bond market, borrowers are paying on average 12.5 bps in new issues concession versus only 2 bps in 2021. Sentiment has also soured in the junk bond market.
- This week saw a major milestone for the cryptocurrency world after seven years of planning—the Ethereum protocol successfully merged to go from a Proof of Work consensus mechanism to Proof of Stake.

Markets & Macro | Have we entered a bear market?

FedEx earnings represent state of world economy.

"...relief should be forthcoming—as all indicators that tend to anticipate inflation are pointing toward a normalization to historical levels."

Amid the higher-than-expected inflation print, the S&P 500 index lost 4.77% this week, and avoided closing on the lows thanks to some short covering at the close of the session on Friday.

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

Equity	Last Value	Ytd
MSCI World	2,569.29	-19.21%
Nasdaq	11,448.40	-26.39%
S&P 500	3,873.33	-17.81%
Nikkei	27,567.65	-3.13%
Eurostoxx	3,500.41	-16.09%
Swiss SMI	10,610.65	-15.35%
FTSE UK	7,236.68	0.90%
Canada	19,385.88	-6.68%
Shenzen	3,932.68	-18.78%
Hong Kong	18,761.69	-17.25%
MSCI EM	944.12	-21.34%

Bond Indices	Last Value	Ytd
US Inv Grande	107.10	-17.67%
US High Yield	74.20	-11.92%
Euro Corps	230.70	-12.49%
JPM Europe Govies	9,448.02	-11.17%
US Treasuries	2,214.03	-11.44%
China Aggregate	253.41	-5.89%
EMBI Global	749.73	-18.47%
EMBI Local	118.89	-13.67%

Commodities	Last Value	Ytd
BBG Commodities	116.74	17.72%
BBG Base Metals	227.34	-18.50%
BBG Agriculture	68.93	13.40%
Gold	1,675.06	-8.43%
Silver	19.59	-15.95%
BBG Brent Crude TR	1,048.66	40.01%
BBG WTI Crude Oil TR	194.23	26.86%

FX	Last Value	Ytd
DXY	1,308.67	11.52%
Bloomberg JP ASIA	99.11	-8.28%
Bloomberg JP LATAM	40.10	-1.92%
EUR Index	117.93	-2.35%
EUR/CHF	0.97	-6.82%
GBP Index	612.51	-10.30%
EM fx	1,615.68	-6.84%
JPY	142.92	-19.48%
CNY	6.99	-9.03%
Bitcoin	19,820.79	-57.22%

Source: Bloomberg, as at September 16, 2022. Performance figures in indices' local currencies.

Our view: On the macro side, the dynamic is now clear, and investors seem resigned. Last year, despite the fact that the light at the end of the tunnel (of the pandemic) was clearly visible, the US and European economies continued to see massive doses of fiscal support. For their part, the central banks hesitated, continuing to inject liquidity and keeping rates low— if not in negative territory. And now we are paying the price with inflation showing no signs of abating for the time being, despite the early signs on the supply side of normalization in the near future.

"…there is the risk of ending up in another excess: killing the economy with a much heavier recession than necessary."

The problem, as already explained, is that it seems that the Federal Reserve (Fed) has put the autopilot on full throttle in the direction of rates, and it is not stopping to see what effects the tightening produces. As a result, there is the risk of ending up in another excess: killing the economy with a much heavier recession than necessary. In our opinion, this dynamic is typical of our society, which is impatient in wanting immediate results from its actions, and so volatile in its moods that it goes from one excess to another.

Moreover, the paradox is that economic growth, at least in the US, is accelerating again. GDP is expected to remain positive in Q3 and Q4 of this year (remember, however, that in the first two quarters of 2022 there was a contraction), thanks to the two main factors of the labor market (which remains robust) and, above all, the reserves accumulated over the last two years by consumers. The second of which compensates for the tightening of rates and the higher cost of energy. And since the Fed has openly stated (and seems very determined to do so) that it intends to destroy demand so as to find a lower equilibrium point at the intersection with the supply curve, we are likely in for a tough few months. Indeed, we know very well that these bearish phases are unlikely to be interrupted before a decisive monetary policy intervention. If that is not enough, fiscal leverage is needed.

The contrast between the still solid present and the decidedly uncertain future impacted by rising rates was highlighted by the announcement of FedEx's disastrous earnings. Quarter adjusted EPS came in at USD3.44 versus USD5.14 expected, and revenues were USD23.2 billion versus USD23.59 billion expected. These statements from the CEO of the company, Raj Subramaniam, clearly reassures the state of the world economy, more than any other analysis or data: "We're seeing volume decline in every segment around the world"; "We've just started our second quarter and the weekly numbers are not looking good, so we just assume at this point that the economic conditions are not really good"; "We are a reflection of everybody else's business", and "The headline really is the macro situation that we're facing". The title lost 21% on Friday!

Unfortunately, from an equity market point of view, although the accumulated losses this year are significant (-19.2% for the MSCI World), the typical panic signals that identified bottoms in the past are not yet visible at all. Without realizing it, we have likely entered a bear market, so rallies quickly fail and defensive positioning only produces temporary rebounds.

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Figure 2: S&P 500 Index

Source: Bloomberg, as at September 16, 2022.

There is also another important aspect. On the one hand, sentiment levels, and institutional investor positioning, have been sitting at extreme levels for several weeks now, as the macroeconomic picture we have described is decidedly in agreement. This probably explains why we have experienced such violent rallies, and why we have not yet broken the June lows. On the other hand, in terms of flows, the retail capitulation has by no means begun yet, as these investors have certainly stopped buying the market, but have not yet exited the market, as typically happens around bottoms. Next week brings the Fed meeting, and let's see if, with the market already suffering from a lot of hawkishness, a slightly less aggressive attitude will bring us some relief.

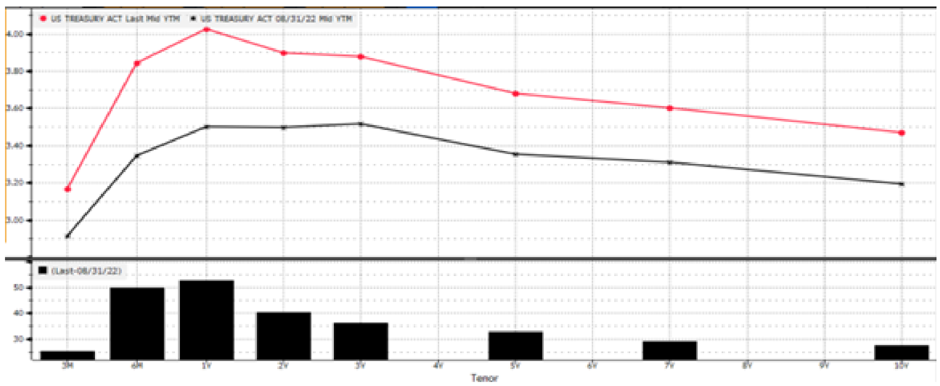
Fixed Income | Will US Treasury yields rise to tempting levels?

Maintaining a cautious stance in fixed income.

This week, after another surprising US inflation figure, global bonds extended their slump on the back of fears of jumbo central bank interest rate hikes. Next week, when the Fed will again increase its benchmark rates, a raise of 75 basis points (bps) is certain—and there are even chances for a 100 bps move.

"How high will rates go before they plateau or fall, and whether bonds will witness increases across the whole curve, are all key questions still to be answered."

Figure 3: US Treasury Yields



Source: Bloomberg, as at September 16, 2022.

Our view: Hotter-than-expected inflation means traders are now betting that the Fed will lift its benchmark rate as high as 4.4% early next year, pushing the US Treasury curve back up to a tempting yield at a time when riskier assets could be coming under additional pressure. Still, how high will rates go before they plateau or fall, and whether bonds will witness increases across the whole curve, are all key questions still to be answered. Our view is to maintain a cautious stance and focus the exposure across shorter maturities in high quality credit.

In the primary market, even after a strong start with issuers such as McDonald's (MCD 4.6% 09/09/32), Nestle (NESNVX 4.125% 10/01/27), and Walmart (WMT 3.95% 09/09/27) piling into the market, September volume remains low. Borrowers are paying on average 12.5 bps in new issues concession versus only 2 bps in 2021. On the other hand, sentiment soured in the junk bond market, where yields climbed back to this year's high of 8.9%.

"Borrowers are paying on average 12.5 bps in new issues concession versus only 2 bps in 2021."

Figure 4: US Corporate High Yield Bonds

Source: Bloomberg, as at September 16, 2022.

Crypto & Blockchain | Will new Ether issuance be cut?

Bitcoin's dominance reaches record lows.

This week, we witnessed a major milestone for the cryptocurrency world after seven years of planning—the Ethereum protocol successfully merged to go from a Proof of Work consensus mechanism to Proof of Stake. There are two main implications from this. The most important, of course, is the upgraded mechanism of verification. Now, it is less expensive in terms of energy, as validation will not require huge amounts of energy and specialized expensive hardware to run complicated algorithms, while a standard computer is enough to run basic operations to validate a transaction. As a result, the protocol will consume -99.95% less in energy usage.

"Over the long term, the lower supply should support the price of the native token ETH, if demand continues to grow."

The second main feature is a potential cut in the issuance of new ether. This is less certain and depends on how much the market values Ethereum's blockspace. In a nutshell, before the merger, the ETH was issued from two sources: miners rewards with approximately new 13,000 ETH/day and the staking activity of around 1,600 ETH/day. After the mergers, only the ~1,600 ETH per day will remain, dropping total new ETH issuance by ~90%. The new process could make the protocol even deflationary if we consider the tokens destroyed to pay each transaction (base fee), which fluctuates depending on network activity. Over the long term, the lower supply should support the price of the native token ETH, if demand continues to grow. In terms of performance, the protocol has better metrics but without L2s, Ethereum might not be able to compete with alternative L1s. But the strength that has distinguished this blockchain from others is the number of developers in this ecosystem that can provide scalable and fast solutions.

After the merger, other side effects will have to be considered. For example, a changed outlook for the mining industry. This will unleash a wave of mergers and acquisitions and a divestment of equipment that is no longer needed, in contrast to the 2021 buying spree. The new process will attract new ESG-sensitive professional investors focused on reducing the carbon footprint—which is of course a sensitive topic with Europeans worried about heating their homes this winter.

The criticism of the new consensus mechanism is on the direction toward a system more prone to centralization and censorship. For those that buy a large amount of ETH and put it into play, nothing can prevent them from exerting their influence on Ethereum's PoS protocol. In Bitcoin's Proof of Work protocol, the richest and the poorest have the same rights. No one can exercise dominion over the others against their will and users can trust that the rules will not change, given its decentralized nature.

"Perhaps this is the most anticipated event in the crypto world, and we don't expect that the success is a major surprise—while the possible failure was a large tail risk that has dissipated."

Our view: Perhaps this is the most anticipated event in the crypto world, and we don't expect that the success is a major surprise—while the possible failure was a large tail risk that has dissipated. Debates around whether Ethereum could flip Bitcoin will continue in the coming months. For now, that remains to be seen but Bitcoin's dominance has reached record lows. We should not forget that the value propositions of the two crypto currencies are diverging. For example, Bitcoin is a store of value, it is censorship-resistant, and no one can modify it—which if different from Ethereum. The current macro environment dominated by policy tightening remains very challenging for risky assets that captured abundant liquidity in the previous cycle. That said, the merger represents a big step.

Week Ahead | Key events to watch for

- **Next week, the Fed is likely to join the ECB in raising rates** by 75 bps, while the Bank of England and Norges Bank are expected to make moves of 50 bps. It is less clear what the Swiss National Bank might do next.

- **In Europe, we will get a first glimpse of September's economic activity** with PMIs, expected on Friday.

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