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Weekly Market Flash

A necessary but dangerous choice

December 18, 2022

After equity markets started to turn around last week, resistance levels were confirmed by this week's negative performance, with the major central banks—in particular, the European Central Bank (ECB)—adding to the dose of hawkishness against a backdrop of fragile economies, which have now clearly entered a slowdown phase. The performances of markets were negative but not shocking: the MSCI World index lost 2.15%, the S&P 500 index 2.08%, and the Eurostox 50 index 3.50%. Since the hawkish surprise came from the ECB, the most troublesome losses occurred in the space of European rates, with yields rising 30-40 basis points (bps) on all curves, the Bund-BTP spread widening 25 bps to 215 bps, and the Bund-US Treasury differential collapsing from 170 bps to 130 bps.

Highlights

- The Fed and the ECB both raised rates by 50 bps this week. While the Fed reduced its rate hikes from 75 bps to 50 bps, it has not yet finished hiking—and in its projections, the Fed made it clear that it is leaning toward further rate hikes in the coming months.

- The ECB sent a clear signal to the markets to expect more aggressive rate hikes. In addition to raising the refi rate to 2.50%, the central bank outlined their plans for quantitative tightening, by EUR15 billion per month, starting in March, and significantly updated their inflation forecasts.

- In Europe, macro data are holding up. In the US, data were still decidedly ugly, in particular retail sales (contracting in both real and nominal terms), and PMIs.

- Commodities have been one of the rare bright spots this year with the S&P GSCI Index and the Bloomberg Commodity Index respectively up 4.82% and up 13.85%.

Markets & Macro | A necessary but dangerous choice

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The ECB takes the focus off the Fed.

The move in the Bund-US Treasury differential this week is particularly significant since, although the Federal Reserve (Fed) has certainly not been soft in its tone, the ECB's aggressiveness marks a change of pace. It is decidedly belated, but it should be read as an alignment and a desire to regain credibility on the inflation front, at any cost. To provide some context to highlight the exceptional nature of this movement, German 2-year bond yields (which rose 22.1 bps in one day) recorded the largest daily increase since September 2008.

The mighty rally in October-November thus came up against the double wall offered by the hardness of central banks, which persists (or even starts) as macro data deteriorate, especially in the US. In Europe, in fact, data are holding up, at least compared to extremely negative expectations due to the energy crisis that is proving to be less severe than expected. In the US, on the other hand, data this week were still decidedly ugly, in particular retail sales (contracting in both real and nominal terms), and PMIs, which came out in the 45 area, i.e. well below the contraction level of 50.

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

Equity	Last Value	Ytd
MSCI World	2,636.91	-16.68%
Nasdaq	10,665.44	-31.26%
S&P 500	3,830.94	-18.36%
DJ Industrial	32,708.42	-8.10%
SPX Value ETF	143.07	-6.71%
SPX Growth ETF	216.92	-28.42%
Nikkei	27,527.12	-2.43%
Eurostoxx	3,804.02	-8.42%
Swiss SMI	10,770.38	-13.96%
FTSE 100	7,332.12	2.81%
Canada	19,389.22	-5.88%
Shenzen	3,954.23	-18.19%
Hong Kong	19,450.67	-14.02%
MSCI EM	960.22	-19.65%

Bond Indices	Last Value	Ytd
US Inv Grade	109.09	-15.08%
US High Yield	74.43	-10.03%
Euro Corps	231.76	-12.09%
JPM Europe Govies	9,565.84	-10.06%
US Treasuries	2,236.25	-10.55%
China Aggregate	253.52	-5.85%
EMBI Global	782.26	-14.93%
EMBI Local	122.81	-10.83%

Commodities	Last Value	Ytd
BBG Commodities	112.90	13.85%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	66.93	10.11%
Gold	1,791.21	-2.08%
Silver	23.17	-0.60%
BBG Brent Crude TR	983.26	31.28%
BBG WTI Crude Oil TR	177.44	15.89%

FX	Last Value	Ytd
DXY Index	1,262.78	7.61%
Bbg JP ASIA	100.21	-7.26%
Bbg JP LATAM	39.43	-3.56%
EUR Index	121.11	0.29%
EUR/CHF	0.99	-4.69%
GBP Index	632.57	-7.36%
EM FX Index	1,646.55	-5.06%
JPY/USD	136.34	-15.59%
CNY/USD	6.97	-8.86%
Bitcoin	16,826.92	-63.68%

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

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Our view: The paradox is that the market fell in a week that seemed to take a very different, extremely positive direction after the release of a soft CPI (7.1% year-over-year versus 7.3% consensus and 0.1% month-over-month versus 0.3% consensus). Our analysis is that we are actually entering the most problematic phase of this bear market. Specifically, one in which the economy starts to slow markedly, inflation is finally starting to normalize, but from levels too high for the Fed to reverse the tightening—and markets come into conflict with the central bank, resulting in equity losses and credit spread widening. The point is that unfortunately this phase could be a long one, as the core CPI is still at 6%, and the target level for the Fed is 2%.

But let's come, in chronological order, to the message from the two major central banks, the Fed and the ECB, who raised rates by 50 bps this week. The Fed reduced its rate hikes, from 75 bps to 50 bps, but it has not yet finished hiking. However, in its projections and during the press conference, the Fed made it clear that it is leaning toward further rate hikes in the coming months and more hikes than the market expects.

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The economic projections released at the same time brought much more to digest. Growth in 2023 was reduced from the 1.2% forecast by the Fed in September to 0.5%. At the same time, PCE inflation expectations for 2023 were raised to 3.1% from 2.8%, and the unemployment rate rose to 4.6% from 4.4%. But the most relevant figure is the dot plot projection for Fed Funds in the coming months. Despite the weakening growth and employment outlook, the median for the end of 2023 rose to 5.125% from the September forecast of 4.875%. In essence, having to choose between growth and inflation, the Fed decidedly chose to lower inflation, whatever the cost. And at the press conference, Powell was urged to provide more details on the path forward. When asked 'whether a recession in 2023 would prompt the Fed to start easing early', Powell replied that his job is to promote maximum employment and price stability. The labor market is booming, while inflation is well above the Fed's target.

The ECB succeeded in taking the focus off the Fed, sending a clear signal to the markets to expect more aggressive rate hikes. In addition to raising the refi rate to 2.50%, the central bank outlined their plans for quantitative tightening, by EUR15 billion per month, starting in March, and significantly updated their inflation forecasts. Meanwhile, Bloomberg even reported that more than a third of the Governing Council wanted a 75% increase.

Our view is that the ECB's alignment with the Fed's hawkishness is a necessary but dangerous choice. On the one hand, we can only appreciate the decision to regain credibility by imposing short-term impairments in favor of long-term system sustainability. At the same time, to intervene so late with respect to the inflation explosion (practically a year) is to deny the central bank's previous implicit line, i.e. to have interpreted inflation in Europe as the consequence of a supply shock, mainly from energy, against which the ECB could do little. So instead it added tightening just when the direction of inflation had reversed, with the economy already in near-contraction. A risky choice, in short, that will surely lead to a further economic slowdown, while it is not certain that it will bring down inflation (if it were indeed supply-side).

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Finally, we note that as far as the US is concerned, the market for the moment seems not to believe the Fed. Indeed, there is still some divergence between Wednesday's Fed guidance and market prices, with the Fed targeting end-2023 rates at 5.1%, while futures are still only at 4.40%. Obviously, sooner or later the two measures will have to converge, perhaps right down the middle, with the Fed having to raise less than expected, and at the same time rates adjusting upward.

Certainly, and this is true for both economic areas, the coming months will be delicate and with many tensions between economic data, central banks' verbal interventions, and movements in rates, stocks and currencies. There will be a lot to volatility, but needless to say, we are happy with our remarkably defensive stance on the markets, after repeatedly reducing equities in our asset allocation in recent weeks. While we don't expect any more big moves between now and year-end, it will be important to see how sentiment develops as we open 2023.

Equities | Between a rock and a hard place

We're entering the trickiest phase of the correction.

During the Q&A session post his press conference on Wednesday, Fed Chair Powell stated: "Housing services, as I mentioned, there's good news in the pipeline. As long as housing, new housing leases show declining inflation, that will show up in the measure around the middle of next year. So that should help. And the big piece, again, is core services, ex-housing, which is very important. And we have a ways to go there. You do see some beginning signs there. But, ultimately, that's the big—the more than half, as I mentioned, of the PCE core index. And it's very fundamentally about the labor market and wages. If you look at wages, look at the average hourly earnings number we got with the last payrolls report, you don't really see much progress in terms of average hourly earnings coming down."

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In other words, the Fed is aware that shelter and energy-related inflation will continue to trend lower. What they are unhappy about still is wage inflation, and until that is trending lower, the Fed cannot afford to take its foot off the pedal.

Our view: Unfortunately, that is not good news for equities. Should the Fed succeed in breaking the wage inflation trend, consumption will take a direct hit. In a meeting with a large bank's consumer staples analyst last week, we received confirmation that the consumer is already trading down. But it seems to be a much slower process than the market would like, possibly prolonging this adjustment process.

Despite what we perceived as an uber hawkish Fed stance, markets haven't sufficiently adjusted to the risk of higher rates for longer. Both equity and fixed income markets ended this week lower, but still in an orderly fashion as we've seen throughout this entire sell-off period. This begs the question whether markets are interpreting Powell's (and President Lagarde's) message differently.

Mr. Market is quite aware that total US debt is USD81 trillion, of which the Federal debt is USD32 trillion. At a 5% interest rate, servicing that debt would be USD1.6 trillion, annually—more than the pensions (USD1.4 trillion) and defense (USD1.17 trillion) budget line items. The Fed, and central banks in general, are therefore between a rock and a hard place; the window of opportunity is limited before inflation is no longer containable and debt servicing becomes a bigger problem. Mr. Market will do what Mr. Market does, i.e. test the central banks' resolve to stick to the tightening plan knowing that such a stance is unsustainable over an extended period of time.

This is why we think that we're entering the trickiest phase of the correction with equities unsupported by earnings growth or lower rates. High valuations in the traditionally defensive sectors adds another layer of complexity to this well-telegraphed recession. We would not be surprised if these sectors didn't offer much protection in the near-term. Instead, the market might simply look ahead, favoring cyclicals with reasonable valuations, with the view that under the recession scenario, the fiscal support would benefit these sectors first.

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Hedge Funds | What about commodities?

Attractive opportunities ahead, but volatility is likely.

Earlier this week, were asked to provide our opinion on a multi-commodity hedge fund manager. This analysis highlighted an important topic as commodities have been one of the rare bright spots this year—albeit with high volatility—with the S&P GSCI Index and the Bloomberg Commodity Index respectively up 4.82% and up 13.85% at the time of writing.

Indeed, the persistence of inflation across the world has led to continued interest in commodity markets and the invasion of Ukraine by Russia has acted as an overhang over the entire energy complex. While historically a strong US dollar was bearish for commodity prices, this dynamic didn't play out in 2022 as both the US dollar and commodity markets are up year-to-date. This raises the question: how have hedge funds faired in the commodity asset class this year?

Our view: Before addressing this question, it appears important to layout the landscape of commodity hedge funds and how it has evolved in recent years. Traditionally commodity hedge funds were either linked to commodity trading firms or longstanding independent firms that benefitted from their large internal resources and information to successfully trade across markets. However, the industry started shrinking in a move coinciding with the energy shock of 2015, but that in fact started post-GFC when most commodity markets became more efficient with managers losing some of their "information edge".

Investors also had difficulties withstanding the volatility of such funds in the equity and fixed income bull market and left the space. As funds shut down, traders have gone back to the trading houses, moved to multi-strategy platforms that offer a plug & play structure, and their risk capabilities or macro funds as macro managers have been adding to their commodity bench.

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This evolution of the space therefore explains why we have seen outsized returns in both discretionary macro managers as well as commodity trading advisers in the past year, thanks in part to their commodities exposures. Multi-strategy managers also benefitted from their increased allocation to the asset class, reflecting the strong market backdrop. As we now look to 2023 and beyond, we believe the commodities space can remain attractive in the near-term, though the path forward is expected to be choppy with elevated levels of volatility and dispersion across markets relative to the decade post-GFC. This backdrop should provide a rich opportunity set across both relative value and directional strategies for experienced commodity traders that can shift exposures dynamically.

Week Ahead | Key events to watch for

- **On the macro side, there will be some publications to continue to highlight the state of US consumers**: consumer confidence and personal income data, as well as PCE inflation. Various indicators of the housing market and business activity will also be released.

- **Some companies will also report ahead of earnings season** (Nike, FedEx and Micron). Recall that at the end of August, FedEx shocked investors by portraying the gloomy state of world trade; after Jackson Hole in late August, the S&P 500 index lost 9.3% in September

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