Weekly Market Flash

Will the market recovery last?

October 23, 2022

This week, global equity indices, and risky assets in general, finally managed to post a week of substantial gains—the S&P 500 index rose over 4.7% and the MSCI World index 3.6%. Credit spreads and more cyclical commodity prices moved in sympathy. But the recovery did not come without a hitch, with a brisk start to the week and a retracement during the middle of the week, once again caused by pressure from the interest rate market and expectations on central bank tightening.

Highlights

- The yield on the 10-year US Treasury reached 4.25%, its highest level since 2008. Meanwhile, the real yield on the 10-year reached a post-2009 high at 1.74%.
- A Wall Street Journal article reported that some Fed officials have begun signaling their desire to soon slowdown the pace of rate hikes, leading to a pause in early 2023.
- So far in the Q3 earnings season, 99 out of 500 S&P 500 index constituents have reported their earnings, with sales surprises averaging 1.2% and earnings surprises averaging 4.5%.
- In the hedge funds space, amid our expectations for generally higher volatility, we believe that many areas within both the relative value and macro strategy will remain attractive.

"…it cannot be said that the stronger-than-expected inflation data of the past two months did not have a strong response from the Fed, driving forward rates remarkably higher."

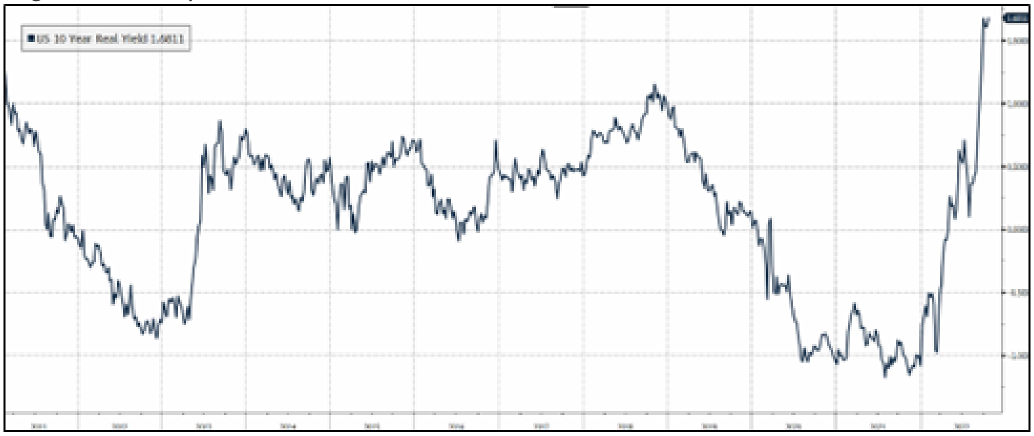
Markets & Macro | Will the market recovery last?

A Fed pause, in the near term, is on the cards.

During the week, sovereign bonds yields hit new multi-year highs. There was also a notable milestone for Fed Funds futures—before retracing on Friday, the market had come to price the terminal rate above 5% for the first time this cycle. To put this into context, when Federal Reserve (Fed) Chair Powell shocked the market at Jackson Hole in late August (only two months ago), futures had closed at 3.78% for the March 2023 meeting. Therefore, it cannot be said that the stronger-than-expected inflation data of the past two months did not have a strong response from the Fed, driving forward rates remarkably higher.

As for US Treasuries, there was a further acceleration in the rise of yields, with the yield on the 10-year reaching 4.25%, its highest level since 2008. Meanwhile, the real yield on the 10-year reached a post-2009 high at 1.74%. This last measure is perhaps the most significant, and the one that has driven the repricing of multiples all these months, as real rates are the starting point for quantifying the cost of capital in any asset valuation model. To provide some reference, as shown in Figure 2, at the end of 2021 the 10-year real rate was at -1.15%, so the increase is remarkable and unprecedented in such a short period. A swing of almost 300 basis points (bps) in less than one year represents a huge tightening in financial conditions.

Figure 2: US 10-year Real Yield



Source: Bloomberg, as at October 21, 2022.

"...the risk of repeating what happened this summer, with the market over-interpreting the Fed's opening signals, is still considered very high..."

Our view: In the midst of all this tension, a story circulated on Friday that, with all due caution, could prove to be important in the coming weeks. A Wall Street Journal article reported that some Fed officials have begun signaling their desire to soon slowdown the pace of rate hikes, leading to a pause in early 2023. The intention would be to pause the cycle in order to assess the impact of the hikes on the economy, reducing the risk of causing an unnecessarily abrupt slowdown.

Within the story it was also made clear that this issue is a matter of debate, and that there is no consensus at all within the central bank. Clearly, the risk of repeating what happened this summer, with the market over-interpreting the Fed's opening signals, and posting an extraordinary rally in stock markets (and an equivalent tightening of credit spreads), is still considered very high among committee members. The Fed is quite explicitly using the level of the S&P 500 index as a target for tightening financial conditions, which in its intentions must remain tight in order to help slow the economy.

"...we think it would be savvy, sooner or later, to start signaling a willingness to pause in order to assess the impact of the accumulated tightening."

But as we have repeatedly expressed, it seems to us that the risk at this point is the opposite—namely, to achieve an excessively violent economic slowdown, resulting in a loss of confidence in the same institution on the part of economic actors, who have already suffered excessively after the pandemic and the consequences of the war on energy and commodities. So, aside from the article, we think it would be savvy, sooner or later, to start signaling a willingness to pause in order to assess the impact of the accumulated tightening. For example, this week the Homebuilders Confidence index collapsed to 38 points, a good 12 points below the expansion/contraction level. Bloomberg's graph (Figure 3), to which we have highlighted recessionary periods for the entire economy, suggests that at even higher levels of this index, the economy has entered recession.

Figure 3: Homebuilders Confidence Index

Source: Bloomberg, as at October 21, 2022.

We avoid getting excited about a single report, and emphasize that the references are to a pause (after the next 75 bps rise in November and another 50 bps rise in December), and not to a pivot, i.e. a reversal as happened in January 2019. But as the hours passed on Friday, the market started to calm down, with rates stabilizing, the US dollar retreating, and equity indices recovering.

“...making some purely tactical considerations, we increased the level of risk on the US equity side in our portfolios.”

We make no secret of the fact that we are slightly biased in our assessments: on Monday morning, making some purely tactical considerations, we increased the level of risk on the US equity side in our portfolios. The oversold conditions, the market's positive response after last week's shocking CPI report, the turnaround in expansionary policies in the UK—which has seen rates stabilize—and the good start to the earnings season, seemed to be a sufficient mix for us to bet on a recovery between now and the end of the year. We therefore hope that the rally will continue, before making fundamental assessments of the economy and corporate earnings in the coming weeks.

Equities | Unlikely to Break the Camel’s Back

Q3 earnings remain strong.

The corporate earnings season, so far, has been fairly resilient, showing little signs of macro deterioration. So far, 99 out of 500 S&P 500 index constituents reported their Q3 earnings, with sales surprises averaging 1.2% and earnings surprises averaging 4.5%. This earnings surprise is higher than the Q2 average earnings surprise. The very low sales surprise magnitude is likely a confirmation that analysts are adjusting their forecasts adequately to reflect the reality of the new macro environment.

This earnings surprise has been strongest in the communications (primarily due to Netflix), health care and financials sectors. The consumer discretionary sector has been so far the only major disappointment with an average negative sales surprise of -1.5% and negative earnings surprise of -4.4%.

“The very low sales surprise magnitude is likely a confirmation that analysts are adjusting their forecasts adequately to reflect the reality of the new macro environment.”

Our view: As we have stated previously, we doubt that this will be the earnings season that breaks the camel’s back. Demand remains fairly robust and corporates are choosing to continue to provide optimistic earnings guidance despite their negative outlook tone. Next week will be important with Big Tech scheduled to report earnings throughout the week. We will be paying careful attention to the guidance of Microsoft in particular, given that the company’s guidance at the Q2 reporting season didn’t seem to be de-risked.

Hedge Funds | What opportunities lay ahead?

RV and macro strategies remain attractive.

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Global markets this year have been roiled by uncertainty—from recession fears, to war in Europe, to hawkish central banks, to persistently higher inflation. These macro factors that continue to dominate markets have driven cross asset volatility to higher levels. And, unlike in the previous cycle when bouts of price swings were short-lived, it seems that elevated volatility could be here to stay.

However, volatility generally results in more opportunities for hedge fund strategies. Amid the market turmoil this year, performance across hedge fund strategies highlights that that they can deliver uncorrelated returns and play an important role in a diversified portfolio by providing alpha with positive, stable returns and less exposure to downside risks.

Our view: With the current market backdrop and our expectations for generally higher volatility, we believe that many areas within both the relative value (RV) and macro strategy will remain attractive. RV strategies, which take advantage of price gaps across related assets, should continue to benefit from this elevated and more persistent market volatility in both equities and fixed income, with the MOVE Index now approaching levels last seen during the COVID crash of March 2020. Inflation and hawkish central banks also mean more uncertainty around global monetary policies, and therefore more opportunity across a broader subset of strategies in RV.

Active central banks may also create attractive opportunities for discretionary macro managers who have a forward-looking perspective on markets and aim to capitalize on a more dynamic policy environment. As central banks continue to react aggressively to persistent inflation, many managers have taken advantage of changing market dynamics—including directional interest rate moves, changing yield curve shapes, and currency trends. With global policymakers having firmly stated their commitment to fighting inflation, managers focused on asymmetric trade structuring or tactical trading may continue to benefit from the resulting elevated market volatility.

That said, and as always with hedge funds, manager selection will remain a key factor given the wide dispersion in returns between top and bottom quartile managers.

Week Ahead | Key events to watch for

- **More inflation and growth data** will be released next week. Later in the week we will see Q3 GDP in the US, as well as flash PMIs in both the US and Europe. Finally, we will see the IFO index for the German economy, as well as CPI across Europe.
- **On the central bank front,** there will be important meetings for the European Central Bank and Bank of Japan.
- **The Q3 earnings season** enters its hottest phase, with the major Big Tech companies reporting next week.

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