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Weekly Market Flash

Are we heading toward a policy error?

September 25, 2022

The past week was quite an unbelievable one, with a mix of macro and geopolitical events—from the war to inflation to the monetary and fiscal response—sowing growing panic across the markets. The S&P 500 index lost more than 4.5% for the second week in a row, with a weekly close near to the June lows. Central banks around the world raised rates by more than 500 basis points (bps) following their meetings. However, in Japan, the central bank persisted in not changing rates, but on the other hand the Treasury finally intervened in the foreign exchange market to stabilize the Japanese yen. There was also a lot of tension in the UK with a very aggressive fiscal package from the government, which plans to finance tax cuts and subsidies with a considerable increase in debt issues on the market. Here, too, the market did not go quietly, punishing both Gilts and the Pound sterling!

Highlights

- The Fed raised its benchmark rate by 75 bps for the third consecutive meeting. On the growth front, forecasts were lowered, but actually by very little. The unemployment rate is expected to rise to 4.4% from the current 3.6%.
- A hawkish message from Powell drove stocks lower for the second week in a row. In his opening statement and his remarks during the FOMC press conference, he left no room for doubt regarding the Fed's attitude toward inflation.
- On the geopolitical front, Putin proclaimed the referendum for the annexation of the occupied territories of the Donbas to Russia, and immediately afterwards the call to arms of 300,000 reservists.
- Among hedge funds, year-to-date, CTAs are the top performing strategy, with the Société Générale CTA Index up 23.41% on the year till September 21.

"The median of the Dot Plots has risen 125 bps this year, which implies that another 75 bps is likely in November and another 50 bps before Christmas."

Markets & Macro | Are we heading toward a policy error?

The negative wealth effect is emerging.

This week, the Federal Reserve (Fed), as widely expected, raised its benchmark rate by 75 bps for the third consecutive meeting—but the Dot Plots forecast (where Fed members see rates for the next few years) and Fed Chair Powell's language in the press conference had a less than reassuring effect. The median of the Dot Plots has risen 125 bps this year, which implies that another 75 bps is likely in November (but the market does not rule out 100 bps in one shot) and another 50 bps before Christmas. The June 2023 reference rate was also revised upward from 3.75% to 4.625%.

On the growth front, by contrast, the forecasts were lowered, but actually by very little. The unemployment rate is expected to rise to 4.4% from the current 3.6%.

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

"...the growing risk is that the Fed's impatience in wanting to achieve a rapid effect on inflation will generate a recession far more severe than necessary..."

Equity	Last Value	Ytd
MSCI World	2,438.50	-23.30%
Nasdaq	10,867.93	-30.11%
S&P 500	3,693.23	-21.62%
Nikkei	27,153.83	-4.58%
Eurostoxx	3,348.60	-19.67%
Swiss SMI	10,137.78	-19.02%
FTSE UK	7,018.60	-2.14%
Canada	18,480.98	-11.01%
Shenzen	3,856.02	-20.35%
Hong Kong	17,933.27	-20.85%
MSCI EM	905.84	-24.50%

Bond Indices	Last Value	Ytd
US Inv Grande	104.81	-19.43%
US High Yield	72.13	-14.37%
Euro Corps	227.31	-13.78%
JPM Europe Govies	9,305.11	-12.51%
US Treasuries	2,188.31	-12.47%
China Aggregate	250.38	-7.02%
EMBI Global	735.05	-20.07%
EMBI Local	116.59	-15.34%

Commodities	Last Value	Ytd
BBG Commodities	112.40	13.34%
BBG Base Metals	219.31	-21.38%
BBG Agriculture	68.69	13.00%
Gold	1,643.94	-10.13%
Silver	18.87	-19.04%
BBG Brent Crude TR	991.22	32.35%
BBG WTI Crude Oil TR	180.55	17.93%

FX	Last Value	Ytd
DXY	1,339.64	14.16%
Bloomberg JP ASIA	97.36	-9.90%
Bloomberg JP LATAM	39.73	-2.81%
EUR Index	117.08	-3.05%
EUR/CHF	0.95	-8.24%
GBP Index	591.95	-13.31%
EM fx	1,597.77	-7.88%
JPY	143.31	-19.70%
CNY	7.13	-10.83%
Bitcoin	19,071.50	-58.84%

Source: Bloomberg, as at September 23, 2022. Performance figures in indices' local currencies.

Our view: The only notable difference in Powell's speech, compared to the already very aggressive tones at the end of August in Jackson Hole, lies in the multiple references to the concept of the "pain" that will be necessary to bear in order to bring inflation under control. In essence, the Fed is preparing the public for a classic demand-strangling economic recession. However, the key point is the inconsistency between the allusions to a moderate slowdown in spite of a monetary tightening of proportions never before seen in terms of speed and intensity. This is without taking into account the addition of the reduction in the Fed's balance sheet, which increases in September to around USD95 billion per month, an experiment never before seen in the Fed's history. As we have already expressed in recent weeks, the growing risk is that the Fed's impatience in wanting to achieve a rapid effect on inflation will generate a recession far more severe than necessary, with the unemployment rate barely 1% above current levels.

While we acknowledge that the Fed's stance is having the desired effect of keeping inflation expectations well anchored for the long term—which is a prerequisite for a well-functioning economy, particularly on the investment front—the tightening is acting not only on demand but also on asset prices, including stocks, bonds and houses. We must therefore add the negative wealth effect that is being unleashed, which will increase the impact on consumption. Now in terms of the S&P 500 index, we are back at levels very close to the June lows (3'650). If in June the market seemed to anticipate a soft landing, it seems inevitable that a hard landing will have to correspond to a lower level. It will therefore be important to see if and when the Fed will intervene, at least verbally, once the June lows have been broken, with the risk of quickly reaching the area around 3'300. Moreover, as shown in Figure 2, two important indicators of the real estate market (Existing Home Sales and Builders Confidence), which are the most sensitive to the change in rates, suggest this sector has already been in recession for a few months—well before rates exploded to their current levels. This week, in particular, the 30-year mortgage rate reached 6.60%.

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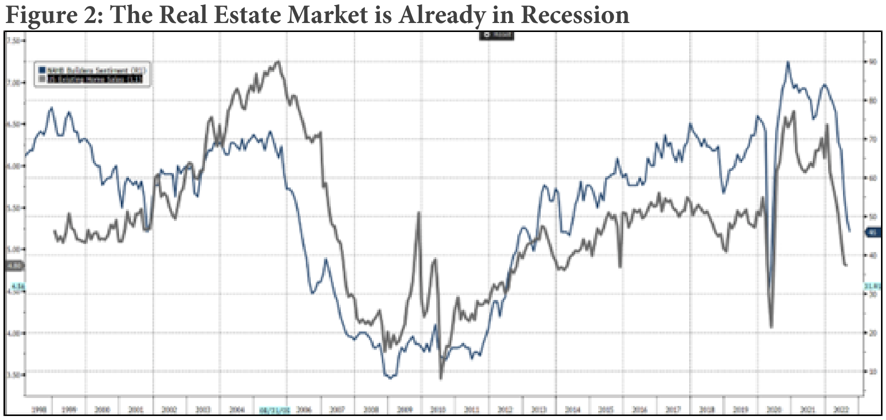
Figure 2: The Real Estate Market is Already in Recession



Source: Bloomberg, as at September 23, 2022.

As mentioned earlier, in the hyperactivity of the central banks, the Bank of Japan (BoJ) stood out for its obstinacy and inconsistency. For the first time since 1998, the Treasury intervened in the foreign exchange market to support the currency. The BoJ prints and sells Japanese yen to control the yield curve (by buying bonds from the market), while the Treasury buys them instead, squandering foreign exchange reserves. This recipe leads to financial instability, as well as further inflation and Japanese yen weakness. We also note that the market positioning was (and probably remains) so short of the Japanese yen that after the intervention, the currency recovered marginally.

"...the impact of the war on military spending, energy prices, food and raw materials is confronting the West with its own demons..."

On the geopolitical front, the news was certainly no better. As is well known, Putin proclaimed the referendum for the annexation of the occupied territories of the Donbas to Russia, and immediately afterwards the call to arms of 300,000 reservists. In his address to the nation, there was no lack of not too veiled threats to use nuclear weapons. Although the West is rightly treating Putin's move as a bluff prompted by the desperation of an isolated man (India and China also seem to have distanced themselves according to the latest statements), the implicit consideration of the territories to be annexed as Russian soil leaves the question open: how will Putin react to attacks by the Ukrainians? Will there be an official declaration of a state of war? Will gas flows via Ukraine be further reduced?

The intersection between monetary policy and the military front in Ukraine lies in the price dynamics, fiscal and monetary policies in the Western world. On the one hand, Putin is resoundingly losing the bet on an easy military victory, and all the weaknesses of the Russian system are now established. On the other hand, the impact of the war on military spending, energy prices, food and raw materials in general is confronting the West with its own demons, and the responses of different countries will have consequences for the long term. The British case this week is the most blatant: rising public deficit, galloping inflation, exploding interest rates, and collapsing assets. In short, a typical situation for an emerging market crisis.

Equities | Are we there yet?

Earnings forecasts to continue adjusting lower.

A hawkish message from Powell drove stocks lower for the second week in a row. In his opening statement and his remarks during the FOMC press conference, he left no room for doubt regarding the Fed's attitude toward inflation. One statement from Powell stood out to us, highlighting the extent of the Fed's hawkishness:

"The reasons for why this sell-off has been a panic-less one so far is not as important as the fact that retail investors are still left with high equity allocations..."

"…we believe that we need to raise our policy stance overall to a level that is restrictive. And by that I mean is… putting meaningful downward pressure on inflation. That's what we need to see in the stance of policy. We also know that there are long variable lags, particularly as they relate to inflation. So it's a challenging assessment. So what do you look at? You look at broader financial conditions, as you know, you look at where rates are, real and nominal in some cases, you look at credit spreads, you look at financial conditions indexes... And you see this I think in the Committee forecast, **you want to be at a place where real rates are positive across the entire yield curve**" (emphasis added).

Our view: So, with the S&P 500 and the MSCI ACWI indexes down 23% and 24% in USD terms, respectively, from their January highs, why are we not yet ready to buy the market? First, as discussed often with clients lately, we believe that consensus forecasts have not yet been adjusted for margin contractions that normally take place during recessions. Should this adjustment be done, the S&P 500 index would be trading above its current c.17x forward earnings multiple.

Second, this has been a very orderly sell-off across equities and especially across fixed income. Only lately have credit spreads started to widen, signaling panic. The reasons for why this sell-off has been a panic-less one so far is not as important as the fact that retail investors are still left with high equity allocations —in fact, Bank of America private clients' allocation in stocks is at 62.2%! Finally, and most importantly, unlike previous corrections, the "Fed put" is simply not there this time. And while stronger consumer and corporate balance sheets may soften the impact of the tighter monetary policy, we should also keep in mind that balance sheets are not static.

Where do we go from here? Our base case, as mentioned above, is for earnings forecasts to continue to adjust lower, reflecting future margin pressures. This upcoming earnings season is unlikely to reflect that yet, and as a result could trigger another rally like we've seen during the Q2 earnings season back in mid-June, as sentiment and positioning are extremely bearish. What we would like to see is whether the analysts once again disregard the corporates' forward guidance like they did in Q2 and continue to cut estimates. Beyond the earnings season, we would look for other signs of monetary policy effectiveness, whether in unemployment rates rising or housing demand slowing, which is starting to take shape.

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We are constantly self-reminded of the words of Walter Deemer, which say "it is not necessary—nor even wise—to have a strong opinion all the time". So, where could we be wrong in our outlook or what would make us change our opinion? The simple answer is anything that would make the Fed soften its hawkish stance prematurely, including but not limited to a deflationary shock or a credit event.

Hedge Funds | Is now the time to allocate to trend following?

A complementary addition in a diversified portfolio.

Commodity Trading Advisors (CTAs) have historically demonstrated to be a diversifier and hedge against tail market risks. Trend Following, or most simply put, buying winners and selling losers, has long been a hedge fund strategy used by CTAs—sometimes also called managed futures funds. These funds can be described as systematic macro hedge funds that engage in non-sustained directional trades across financial instruments/asset classes and regions with their investment holding periods varying from a couple of weeks to a few months. As a result of their systematic allocation, CTAs' return profile tends to be uncorrelated with equities and bonds, which therefore offers diversification benefits to a traditional equity and fixed income allocation—and complements a diversified hedge fund allocation. CTAs are also well-known for the positive skewness of their returns, i.e. their lower propensity to experience big negative losses.

In brief, CTAs not only offer uncorrelated returns but also, due to their convexity features, positive returns on average in the biggest negative moves for traditional benchmarks. Year-to-date, CTAs are the top performing hedge fund strategy, with the Société Générale CTA Index up 23.41% on the year till September 21. The performance this year, and more generally in the post-COVID reflation trade, highlights the qualities of CTAs as managers have been able to capitalize on strong trending markets. While positioning evolves and will vary from manager to manager, they have commonly made money by being long commodities, long USD versus G10 currencies, short equities, and short fixed income.

"...when analysts called for the "death" of the trend and the commoditizat-ion of the industry, CTA managers had to innovate and, in a way, re-invent themselves."

Our view: In recent years, CTAs had come out of favor for hedge fund investors as the strategy was a victim of its own success during the Global Financial Crisis. Strong CTAs returns in 2008, sometimes called "The Crisis Alpha", highlighted the convexity of the strategy that could help hedge traditional portfolio exposure. Unfortunately, the period post GFC, which was marked by global quantitative easing and generally a low volatility regime, strongly supported traditional asset prices and provided a hard-to-beat benchmark for CTAs strategies.

During that period, when analysts called for the "death" of the trend and the commoditization of the industry, CTA managers had to innovate and, in a way, re-invent themselves. They started to diversify away from pure trend following by including allocation to potentially higher sharpe non-trend strategies (e.g relative value) and/or applying trend following programs focused on markets that CTAs less commonly trade, the so-called "alternative markets" such as credit indexes. The result has been the development of multi-asset or multi-markets quantitative shops that offer an attractive risk-return profile that still mostly benefits from trend following exposure—but is also less exposed to more quiet periods when trend underperforms. This, in our view, justifies a small but stable allocation to CTA managers as part of a diversified hedge fund portfolio.

Week Ahead | Key events to watch for

- **Consumer-related data in the US** will be published next week, as will the inflation figure in Europe.
- **In Italy, political elections are held on Sunday**. With a victory of the right-wing largely foregone, it will be a matter of figuring out the details of the vote and the preconditions for the formation of the new government team.
- **In geopolitics, the referendum on the annexation of the Ukrainian territories** bordering Russia takes place over the weekend.

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