Weekly Market Flash
How cheerful can global markets remain?

November 27, 2022

In the decidedly calmest week in several months, due to the US Thanksgiving holiday, equity markets made moderate gains, further reducing losses since the start of this year. Support came from strong consumer gains, increasingly dovish talk from the Federal Reserve (Fed), light positioning, and simply a lack of significant 'bad news', which calmed some of our biggest short-term fears. However, with major events coming up in the next couple of weeks (including economic data in the US and Europe like inflation, labor market and ISM, as well as the two central bank meetings in mid-December), we are approaching quite a busy end of the year. As a result, it remains to be seen how cheerful global equity markets can stay in a mixed scenario.

Highlights

▪ The FOMC minutes revealed a notably more dovish board. The minutes thus hint at a peak in inflation, and as a consequence, a peak in the US dollar and the 10-year Treasury.

▪ The November US flash PMIs were the clearest in the manufacturing slowdown. In particular, the manufacturing PMI fell to 47.6 (versus 50.0 expected). Jobless claims rose to 240,000, while continuing claims also started to rise.

▪ The June Fed Funds rate fell to 5.02% from an intraday high of 5.12%. The rest of the curve also continued its inexorable inversion movement. The US 2-year-10-year has now reached -80 bps, implying a sharp economic slowdown accompanied by a precipitous return of inflation.

▪ Bank of America forecasts a 12.9% total return for US investment grade corporate bonds in 2023, a major rebound from this year's sharp losses. UBS is even more optimistic, forecasting 14% total returns for high grade bonds. Meanwhile, analysts at Deutsche Bank are the most pessimistic, predicting a US recession for the fourth quarter 2023.

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Markets & Macro | How cheerful can global markets remain?

Inflation and labor market data will be key.
In terms of the Fed, this week's FOMC minutes revealed a notably more dovish board than Fed Chair Powell's last performance following the October meeting to which they referred to, which saw the third consecutive 75 basis points (bps) hike. These are interesting dynamics, with an apparent divergence of opinion between the Chairman and the domestic majority. The minutes thus hint at a peak in inflation, and as a consequence, a peak in the US dollar and the 10-year Treasury.

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

Equity	Last Value	Ytd
MSCI World	2,703.67	-14.66%
Nasdaq	11,226.36	-27.68%
S&P 500	4,026.12	-14.30%
DJ Industrial	34,347.03	-3.70%
Nikkei	28,283.03	0.25%
Eurostoxx	3,962.41	-4.75%
Swiss SMI	11,168.03	-10.79%
FTSE 100	7,486.67	4.94%
Canada	20,383.77	-1.30%
Shenzen	3,775.78	-21.94%
Hong Kong	17,573.58	-22.33%
MSCI EM	941.01	-21.33%

Bond Indices	Last Value	Ytd
US Inv Grade	107.77	-16.63%
US High Yield	75.01	-10.18%
Euro Corps	231.14	-12.33%
JPM Europe Govies	9,560.71	-10.11%
US Treasuries	2,192.88	-12.28%
China Aggregate	247.94	-7.92%
EMBI Global	759.78	-17.38%
EMBI Local	120.37	-12.59%

Commodities	Last Value	Ytd
BBG Commodities	114.92	15.88%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.23	10.59%
Gold	1,754.93	-4.06%
Silver	21.75	-6.71%
BBG Brent Crude TR	1,028.31	37.30%
BBG WTI Crude Oil TR	181.44	18.51%

FX	Last Value	Ytd
DXY Index	1,272.85	8.47%
Bbg JP ASIA	98.45	-8.89%
Bbg JP LATAM	39.35	-3.75%
EUR Index	119.57	-0.99%
EUR/CHF	0.98	-5.21%
GBP Index	634.41	-7.09%
EM FX Index	1,625.95	-6.25%
JPY/USD	139.19	-17.32%
CNY/USD	7.17	-11.29%
Bitcoin	16,605.50	-64.16%

Source: Bloomberg, as at November 25, 2022. Performance figures in indices' local currencies.

Our view: The most important part of the minutes is the claim that "it will probably soon be appropriate to slow the pace of interest rate hikes." As a result, it will be even more interesting to listen to Powell on 30 November, which will be the last public release before the blackout period prior to the mid-December meeting. In recent weeks, financial conditions (driven by credit spreads, the rally in the S&P 500 index, and the weakness of the US dollar) have improved significantly. So this will be an important test, after what happened this summer following the stock market rally that was violently rejected at Jackson Hole.

"The US 2-year-10-year has now reached -80 bps, implying a sharp economic slowdown accompanied by a precipitous return of inflation."

The data released in the US this week supported a less aggressive stance by the Fed. The market therefore enthusiastically welcomed all the data that came out below expectations. Since a (mild) recession is fairly embedded in prices, this mood is likely to persist in the coming weeks, again following the mantra that 'a weak economy = less hikes from the Fed'. In terms of specific data, the November US flash PMIs were the clearest in the manufacturing slowdown. In particular, the manufacturing PMI fell to 47.6 (versus 50.0 expected), the lowest level since the pandemic. The composite figure also fell to 46.3 (against 48.0 expected). Further confirmation came in the form of jobless claims, which rose to 240,000 (against 225,000 expected), while continuing claims also started to rise.

"...the performance of the S&P 500 index in recent weeks forces us to make some important choices in the coming days and weeks."

With the data weakening, and the more dovish Fed minutes, investors began to anticipate a less aggressive pace of hikes—the June Fed Funds rate fell to 5.02% from an intraday high of 5.12% to close the session at 5.02%, down 20 bps. The rest of the curve also continued its inexorable inversion movement. The US 2-year-10-year has now reached -80 bps, implying a sharp economic slowdown accompanied by a precipitous return of inflation.

In terms of portfolio strategy, the performance of the S&P 500 index in recent weeks forces us to make some important choices in the coming days and weeks. On the one hand, the temptation to ride out the end-of-year rally is strong, as seasonality and positioning (which is still very unloaded) argue in favor of a further recovery. In this context, data on the labor market and especially inflation in November will be essential. From a fundamental point of view, however, the recent rally has brought the index some distance from our "fair value" level for the index, which is in fact in the 3'300-3'400 area. The most divergent factor between our model and market expectations is corporate margins, which we believe will have to contract during the coming recessionary phase. This divergence creates a potential downside from current levels of over 15% (Figure 2). At the same time, the technical picture does not help. For instance, if, as we believe, the stock market has entered a bear market from which it will only emerge following a recession and the central bank's subsequent change of course (the infamous "Fed pivot"), discipline dictates that we revert to a defensive stance in the short term—at the risk of losing further upside, which would, however, be ephemeral and misleading for investors.

Figure 2: S&P 500 Index

Source: Bloomberg, as at November 25, 2022.

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"With cooling inflation data signaling a slowing in the Fed's rate hiking cycle, yields at the high grade end of credit are now starting to look appealing..."

Fixed Income | Is corporate debt due a comeback in 2023?

BofA and UBS forecast double-digit returns.

Just three months ago, the markets had to find a good reason as to why the Fed shouldn't raise rates by 75 bps at each meeting. Now, everyone is convinced that inflation in the US will magically evaporate next year. Traders are happy in finding evidence that the Fed needs to dial down its tightening pace and only nasty CPI surprises (above 8%) would revive hawkish pricing.

Against this backdrop, yields on the 10-year US Treasury have dipped to 3.66% with the 2-year yield slipping to 4.46%. Yields on 10-year Bunds came down to 1.8% and BTPs to 3.70%. As already mentioned in many of our previous comments, 10-year US Treasuries now offer a yield that is meaningfully lower than the 2-year maturity (75 bps of inversion). This is because still-to-come tightening from the Fed is holding front-end yields higher, while concerns about an economy losing momentum are spurring investors toward longer-dated notes.

With cooling inflation data signaling a slowing in the Fed's rate hiking cycle, yields at the high grade end of credit are now starting to look appealing—and investors and analysts are eyeing the potential for a major comeback in corporate debt next year.

“UBS is even more optimistic and sees a “once-in-a-decade” opportunity in credit next year with the caveat that “timing is everything.” ”

Figure 3: Credit Rallies

Source: Bloomberg, as at November 25, 2022.

Strategists at Bank of America expect both lower rates and tighter spreads to support blue chip credit returns next year. BofA forecasts a 12.9% total return for US investment grade corporate bonds in 2023, a major rebound from this year’s sharp losses. In a more pessimistic case where rates and spreads remain at current levels, BofA sees returns of 5.8%—near the current yield of the index. UBS is even more optimistic and sees a “once-in-a-decade” opportunity in credit next year with the caveat that “timing is everything.” The bank is forecasting a difficult first half of the year as the US falls into recession at the start of April. UBS is forecasting 14% total returns for high grade bonds.

Meanwhile, analysts at Deutsche Bank are the most pessimistic, predicting a US recession for the fourth quarter 2023. The banks also expects that high grade corporate bonds denominated in euros will be the only corner of the credit market to produce gains next year, with a total return of 1.6% compared with a -0.2% loss for US dollar investment grade, and declines of -4.4% and -3.3% for euro and dollar junk bonds, respectively.

Our view: In our opinion, with high grade corporate bonds with a short to medium maturity handing investors a 5.2% yield in USD (the red line) and 3.8% in EUR (the blue line), we prefer to stay up in quality and up in seniority, and invest in short maturities of investment grade corporates (A+ and BBB).

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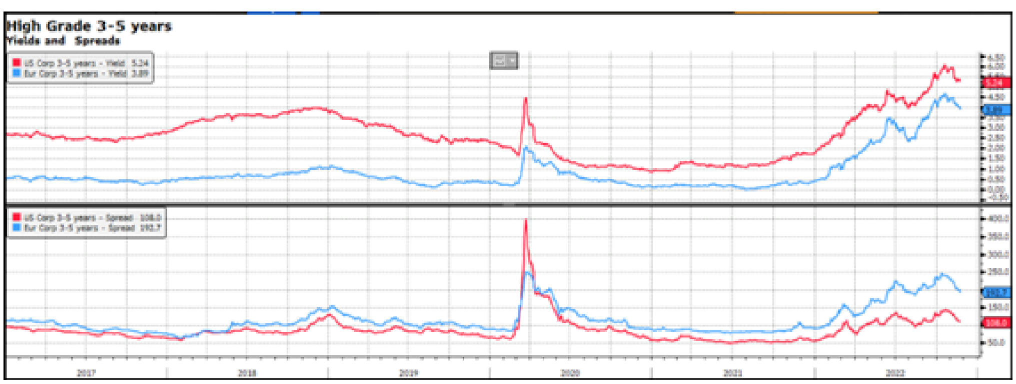
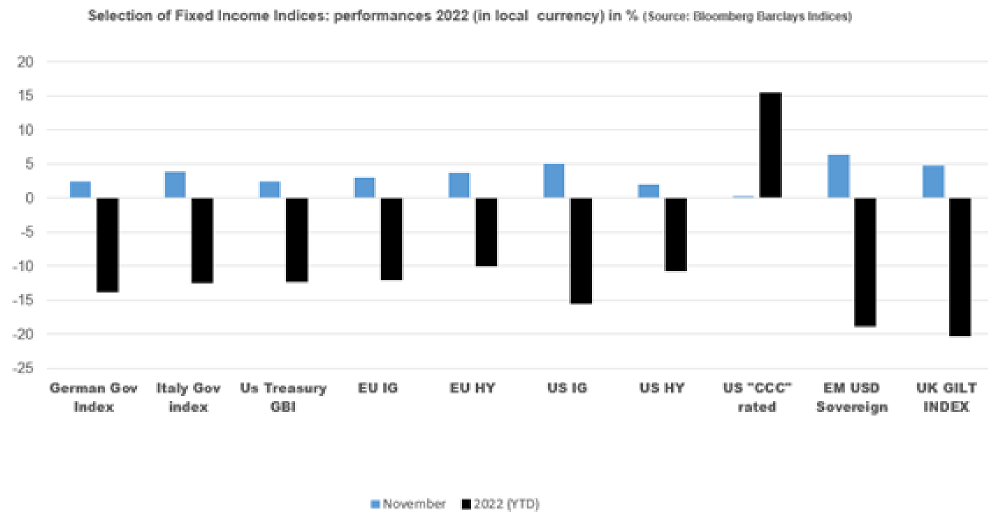
Figure 4: 3-5 years Yields and Spreads



Source: Bloomberg, as at November 25, 2022.

Figure 5: November Fixed Income Performance



Source: Bloomberg, as at November 25, 2022.

Week Ahead | Key events to watch for

- **It's going to be a very busy week for economic data**, both in Europe and the US. In the US we will see the employment report, the PCE inflation reading and the two manufacturing and services ISMs—these will shed light on further rate hikes by the Fed.
- **In Europe there will be the CPI data**, while in China the PMIs will be released.
- **There will be an important speech by Powell**, the last one before the mid-December meeting.

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