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Weekly Market Flash

Will the Fed stop fighting inflation "at any cost"?

May 29, 2022

With positioning and sentiment in such extreme conditions, it took very little to trigger a significant recovery (finally) across all risky assets. As a result, stock markets avoided an eighth consecutive week of losses, while emerging markets, credit and cyclical commodities performed extremely well. Evidently, the early warning signal from the US dollar, which we mentioned last week, proved reliable, with weakness continuing this week.

Highlights

▪ Minutes from the Fed meeting confirmed that the next two meetings will bring two more 50 bps hikes, but added that this will put the Fed in a good position to judge the picture and the next steps in the second half of the year.

▪ It seems that the latest developments in Ukraine should lend some support to markets in the near term, in particular Europe, which is already outperforming driven by banks.

▪ Data from JP Morgan projected month-end rebalances to drive ~1-3% of equity outperformance over the past week. JP Morgan estimated the potential equity buying by the end of May due to monthly rebalancing to be between USD34 billion and USD56 billion.

▪ Altcoins like Ether, Solana and Avalanche took a beating this week. Signs of a lack of demand have been building for quite some time, as the demand for block space on the Ethereum network has reduced significantly in the wake of Terra's collapse.

Markets & Macro | Will the Fed stop fighting inflation "at any cost"?

Hopes for a slower pace of tightening build.

This week, against a backdrop of deteriorating economic data – indicating a clear deceleration in activity, which could therefore lead the Federal Reserve (Fed) to reduce the intensity of tightening in the coming months – came the Fed's minutes from the May meeting. The tone of the press conference had been decidedly more hawkish. While there were no big surprises, there was some softening of the tone, which, in an oversold context, was evidently enough to lift the mood (sometimes the absence of bad news is enough to trigger hedging, and it seems that we are in this context).

"...the idea that is spreading is that precisely because of the current aggressiveness, the Fed will be able to relax to see the effect of tightening on the economy..."

Our view: The text confirmed that the next two FOMC meetings will bring two more 50 basis points (bps) hikes (after the 75 bps hike since the beginning of the year), but added that this will put the Fed in a good position to judge the picture and the next steps in the second half of the year. And given that after the second hike we will be in the middle of summer, in the run-up to the important monetary policy meeting at Jackson Hole, the idea that is spreading is that precisely because of the current aggressiveness, the Fed will be able to relax to see the effect of tightening on the economy – and likely announce a slowdown in the pace of tightening there.

Further, the minutes pointed out that financial conditions have tightened considerably in recent weeks, precisely because of the Fed's action. They also noted that the balance sheet reduction (quantitative tightening) could have 'unpredictable effects'. In essence, it would finally appear that the central bank is sending some signals of 'greater sensitivity' to the market, and no longer of wanting to fight the battle against inflation 'at any cost'.

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The market was thus able to continue the repricing of rates that it had already been doing for a couple of weeks, with the terminal Fed rate (June '23) falling from a peak of 3.65% to the current 3.15%. Now, it is possible (or even probable) that the market is just fantasizing, given that in general the Fed's rhetoric has always been clear about its intentions to seriously combat inflation – but as we said recently, we think it is more natural for tightening to take place in stages and in a more gradual manner, allowing time for the economy to settle.

Another form of relief came from the war front, or rather, geopolitics. It seems that the latest developments in Ukraine should lend some support to markets in the near term, in particular Europe, which is already outperforming driven by banks. Overall, a reversal in the tightening of sanctions may have started:

- Russia is clearly winning in Donbass. While it is "their" way, with destroying and advancing, but their strategy is finally working. This should set the basis for negotiations where Putin will sit from a stronger position and potentially obtain some guarantees against some concessions (and potentially reduced sanctions?)
- Mario Draghi had a phone call with Putin, and reportedly obtained reassurance on the supply of wheat and other food commodities, currently interrupted due to the blockade of Black Sea ports. The Kremlin instead stated: "Vladimir Putin emphasizes that the Russian Federation is ready to make a significant contribution to overcoming the food crisis through the export of grain and fertilizer, subject to the lifting of politically motivated restrictions by the West"
- This week, Germany and Italy decided to allow their oil companies to open accounts in Russian rubles with Gazprom Bank to pay for gas and oil
- The EU 'failed' to come to an agreement to block oil imports from Russia (accusing Hungary of obstructionism, but Greece was also against it, because of transport – and the feeling is that it was a perfect excuse to avoid tightening)
- In Davos, President Zelensky urged the West to stop playing around with Russia and impose tougher sanctions

> "...we continue to believe that the long-term trend has changed structurally to the downside for equity markets."

As the S&P 500 index managed to break through the resistance area around 4'100, the short-term scenario remains moderately constructive. We will therefore try to ride out the recovery rally as much as possible, but with caution – as we continue to believe that the long-term trend has changed structurally to the downside for equity markets.

Chart of the week

The chart of the S&P 500 index suggests that a double bottom could have taken place below 3'900. Friday's break of the 4'100 resistance opens the way to further gains into the 4'250 region.

Figure 1: S&P 500 Index

Source: Bloomberg, as at May 27, 2022.

Equities |Cautious on the bounce back

Month-end rebalancing provides support.

"With investor sentiment remaining at extremely low levels, we would be cautious on this week's equities bounce back as it also coincides with month-end rebalances."

After seven straight weekly declines, US equities bounced back. The end of the week's rally pushed both the S&P 500 and Nasdaq indexes higher for the week, up around 6.6% and 6.8% respectively. The strongest performance came from consumer discretionary stocks on the back of several well-received retailers earning reports, suggesting continuing strength in consumption. Overall, there are not a lot of areas of weakness to be flagged, though the communication services and health care sectors, which were also up on the week, were among the laggards.

Despite the softening in the eurozone's flash PMIs, the positive gains were carried over on European equities, albeit a touch lower than in the US. Meanwhile, Asian equities were slightly up on the week, except for China, which closed down around 1.8%.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	33,212.96	6.28%	0.96%	-7.85%
S&P 500	4,158.24	6.62%	0.81%	-12.22%
Nasdaq	12,131.13	6.85%	-1.53%	-22.20%
Euro Stoxx 50	3,808.86	4.40%	1.84%	-9.03%
Swiss Market	11,647.17	2.99%	-3.82%	-7.14%
FTSE 100	7,585.46	2.67%	0.84%	4.47%
CAC 40	6,515.75	4.06%	1.03%	-6.92%
DAX	14,462.19	3.44%	2.58%	-8.96%
FTSE MIB	24,636.26	3.71%	3.04%	-7.27%
Nikkei 225	26,781.68	0.16%	-0.25%	-6.07%
Hang Seng	20,697.36	0.30%	-3.32%	-10.77%
CSI 300	4,001.30	-1.78%	-3.51%	-18.83%

Source: Bloomberg, as at May 27, 2022. Performance figures in indices' local currencies.

Our view: This week also saw the release of softer than expected consumer sentiment (University of Michigan). And with investor sentiment remaining at extremely low levels, according to Goldman Sachs, we would be cautious on this week's equities bounce back as it also coincides with month-end rebalances – which might have provided some support. In fact, data from JP Morgan projected month-end rebalances to drive ~1-3% of equity outperformance over the past week as pensions shift allocations from bonds to equities. Overall, JP Morgan estimated the potential equity buying by the end of May due to monthly rebalancing to be between USD34 billion and USD56 billion.

"A combination of the wealth effect on crypto investors and a loss in confidence are temporarily affecting the digital asset space."

Crypto & Blockchain | Bitcoin dominance reaches multiple-year highs

Signs of a lack of demand are building.

Altcoins like Ether, Solana and Avalanche took a beating this week. Signs of a lack of demand have been building for quite some time, as the demand for block space (the amount of transactional data that can be included in each block, with users paying network fees for doing so) on the Ethereum network has reduced significantly in the wake of Terra's collapse.

Market action: Network's expensive gas fees have been falling since December and recently reached multi-year lows, which means a fall in user activity. On top of that, rumors are spreading about ETH's upcoming shift to PoS, which may not be as stable as espoused by founder Vitalik Buterin, while Miners hope the transition will take place later. As we discussed last week, a combination of the wealth effect on crypto investors and a loss in confidence are temporarily affecting the digital asset space. Ether derivatives saw liquidations nearly double those of Bitcoin in an unusual move. At the same time, Bitcoin dominance touched a multiple-year high amid crypto's purist escaping from emerging projects to much secure protocols.

Week Ahead | Key events to watch for

- **The focus will be on growth and inflation**, with a lot of data on the agenda between Europe and the US. In the US we will see ISM data (manufacturing and services) and the labor market; in Europe the CPI and PPI in May. More volatility is therefore to be expected, with the paradox that bad data should be welcomed by the market (as it confirms the economic slowdown, which should take pressure off inflation).

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