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Weekly Market Flash

The risk-reward for risky assets remains favorable

October 30, 2022

It was a second consecutive week of substantial gains for world equity markets. The S&P 500 index rose 3.95%, while the MSCI World index rose 4.01%. However, the technology sector underperformed during the week, paying for the poor earnings results that were reported by Big Tech. Overall, sentiment across the market has changed dramatically over the past 20 days —especially since yet another shocking inflation print. In our view, the real contributors to such a radical change in investors' mood comes down to three factors, which we discuss below.

Highlights

- US home prices recorded their second consecutive monthly decline. Demand is weakening due to rising mortgage rates, while the inventory of homes for sale is rising.
- Amazon, Meta, Google and Microsoft have reported problems on the horizon. Their statements indicate that advertising is slowing, the strong US dollar is having a negative impact, and their ability to pass on rising costs to consumers is diminishing.
- Government bond yields fell during the week, driven by signs that Fed rate hikes are beginning to take a toll on the economy—US Treasury 10-year bond yields sank to 4.02%, the German Bund to 2.09%, and the Italian BTP to 4.15%.
- Bitcoin has been trading sideways for months, bringing uncharacteristically but healthy low volatility. The digital currency's volatility compared with the Nasdaq and Sterling indexes reached a two-year low earlier this week.

"Fortunately, we quickly guessed that the market would give weight to this article regardless of whether it actually paved the way for a pause by the Fed."

Markets & Macro | The risk-reward for risky assets remains favorable

Maintaining neutral stance on equities.

As mentioned, investor sentiment has shifted notably in the last 20 days—since the recent inflation figure sent the S&P 500 index below 3'500, versus 3'900 at Friday's close, or up 11.5% from lows.

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

Equity	Last Value	Ytd
MSCI World	2,561.04	-19.30%
Nasdaq	11,102.45	-28.57%
S&P 500	3,901.06	-17.10%
Nikkei	27,105.20	-4.01%
Eurostoxx	3,613.02	-13.26%
Swiss SMI	10,772.37	-13.95%
FTSE 100	7,047.67	-1.56%
Canada	19,471.19	-5.89%
Shenzen	3,541.33	-26.79%
Hong Kong	14,863.06	-34.40%
MSCI EM	845.58	-29.44%

Bond Indices	Last Value	Ytd
US Inv Grande	101.90	-21.41%
US High Yield	74.55	-11.07%
Euro Corps	225.70	-14.39%
JPM Europe Govies	9,347.59	-12.11%
US Treasuries	2,149.28	-14.03%
China Aggregate	246.01	-8.64%
EMBI Global	718.26	-21.89%
EMBI Local	114.12	-17.13%

Commodities	Last Value	Ytd
BBG Commodities	111.76	12.69%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	66.75	9.81%
Gold	1,644.87	-10.08%
Silver	19.26	-17.37%
BBG Brent Crude TR	1,115.49	48.94%
BBG WTI Crude Oil TR	205.35	34.13%

FX	Last Value	Ytd
DXY Index	1,325.46	12.95%
Bbg JP ASIA	96.28	-10.90%
Bbg JP LATAM	39.38	-3.67%
EUR Index	118.22	-2.11%
EUR/CHF	0.99	-4.32%
GBP Index	626.66	-8.22%
EM FX Index	1,581.36	-8.82%
JPY/USD	147.60	-22.03%
CNY/USD	7.25	-12.36%
Bitcoin	20,916.42	-54.86%

Source: Bloomberg, as at October 28, 2022. Performance figures in indices' local currencies.

Our view: We believe the change in investors' mood has been driven by three factors:

1) The famous Wall Street Journal article we mentioned last week.

Fortunately, we quickly guessed that the market would give weight to this article regardless of whether it actually paved the way for a pause (or slowdown, but not a pivot) by the Federal Reserve (Fed). On the topic of central banks, dovish surprises came in recent weeks, first in Australia, then in Canada, and finally in Europe with the European Central Bank (ECB). In particular, the Bank of Canada (BoC) raised rates by 50 basis points (bps) versus the 75 bps expected by the market, while the ECB had soft language that generated a terminal rate repricing of almost 50 bps (2.50% versus 2.95%), and ruled out any discussion of Quantitative Tightening anytime soon, greatly supporting the peripherals.

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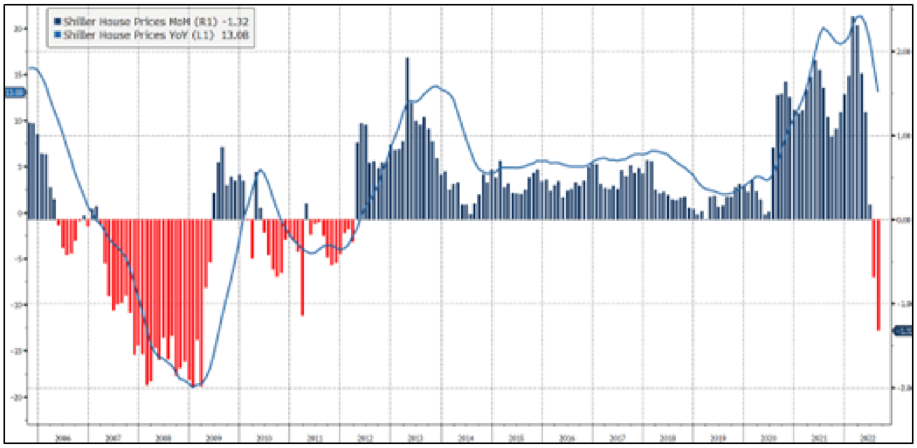
2) Macro data has (finally) started to deteriorate in recent weeks.

The US real estate market is near collapse, with activity semi-paralyzed and house prices in heavy contraction (Figure 2). US home prices have recorded their second consecutive monthly decline, which hasn't been seen since 2012. Demand is weakening due to rising mortgage rates, while the inventory of homes for sale is rising—meaning that further sharp price declines are likely in the coming months. We also note that house prices in the US have increased by more than 40% since the start of the pandemic.

Mortgage rates, now at 7%, have more than doubled since the beginning of the year, and mortgage payments are difficult to afford: an average monthly payment on a 30-year fixed-rate mortgage is now more than USD2,600 according to Redfin, while the rising cost of living and falling stock markets are also making it more difficult to save to accumulate the equity needed to purchase a home. This explains the paralysis of activity in the sector.

"...the rising cost of living and falling stock markets are also making it more difficult to save to accumulate the equity needed to purchase a home."

Figure 2: US House Prices



Source: Bloomberg, as at October 28, 2022.

“The paradox is that investors may read these updates as a confirmation that the cycle is slowing, and with it inflationary pressures diminishing.”

PMIs in both the service and manufacturing sectors have also shown signs of contraction in both Europe and the US. It is needless to explain that the inflation-obsessed market eagerly welcomes any signs of economic slowdown in the hope that this will appease inflation as well as central banks.

3) The paradox that is precisely the poor performance of Big Tech.

To varying degrees, Amazon, Meta, Google and Microsoft have reported problems on the horizon, being noticeably affected by the market. Their statements indicate that advertising is slowing, the strong US dollar is having a negative impact, and their ability to pass on rising costs to consumers is diminishing—so both hiring and capex plans will be scaled back soon, if not immediately. The paradox, then, is that investors may read these updates as a confirmation that the cycle is slowing, and with it inflationary pressures diminishing.

It is interesting that in this very context comes the Fed meeting next week. We would definitely be surprised if Fed Chair Powell, after the recent market rally, was to endorse the market's hopes without pushback. Rather, we expect some somersaults to be able to confirm that the intensity of the upturns will diminish after the discounted 75 bps hike on Wednesday (with the Fed Funds at 3.75%-4.0%), but that this does not at all mean that the cycle is terminated and the fight against inflation won.

“We believe that it is premature to relax too much on the central bank front, or at least for the Fed, which has now embarked on a struggle to regain anti-inflation credibility...”

Unfortunately, the picture is still complex. In fact, compared to August, on the one hand, rates are definitely higher today (200 bps or so), but it is also true that inflation has risen considerably, against all odds. We therefore believe that it is premature to relax too much on the central bank front, or at least for the Fed, which has now embarked on a struggle to regain anti-inflation credibility—and is unlikely to give up before it sees concrete signs of an economic slowdown (particularly in the labor market) and inflation itself.

In terms of asset allocation, we’re happy with our neutral stance, having increased our equity exposure two weeks ago in anticipation of a year-end rally, which seems to be taking place. The next two important hurdles will be the Fed meeting next week, where we do not expect to see a market-friendly message, but more importantly the next inflation print for the month of October, which is due November 10th. Base effects and lower energy prices should finally lend some help to the series, which makes the risk-reward for risky assets still favorable in the short term.

Fixed Income | Is the recession risk priced in enough?

Credit sentiment remains weak.

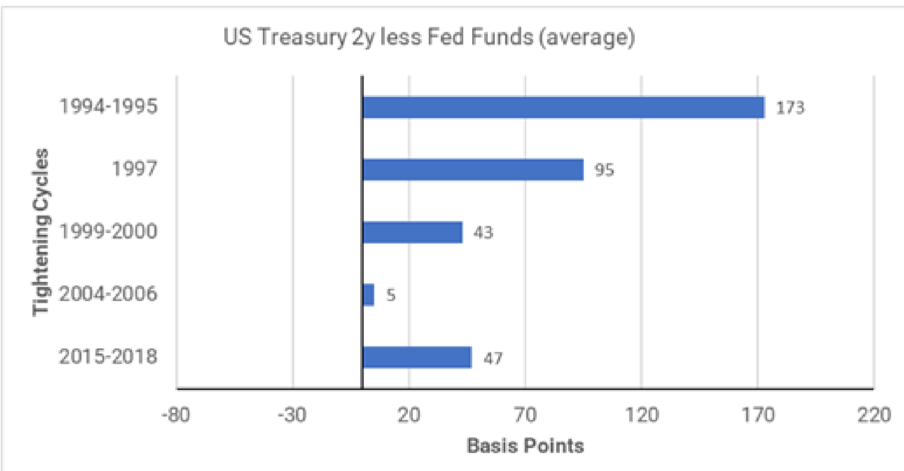
"In the name of pragmatism and to increase its chances of getting inflation back down to 2%, the Fed must be willing to push short-term interest rates higher..."

Government bond yields fell during the week, driven by signs that Fed rate hikes are beginning to take a toll on the economy—as suggested by housing sector and consumer confidence data. US Treasury 10-year bond yields sank to 4.02% (from 4.3%), the German Bund to 2.09% (from 2.5%), and the Italian BTP to 4.15% (from 4.88%).

Our view: These tentative signs of economic weakness, combined with a smaller-than-expected hike from the BoC and the less hawkish attitude of the ECB, have prompted markets to price a less steep path of rate hikes in 2023. The Fed is still expected to deliver a 75 bps increase next week but the hope is that the next phase will be a stepdown in tightening to 50 bps hike in December.

However, to date, the Fed's monetary tightening hasn't done much to reduce inflationary pressures or loosen the labor market. In the name of pragmatism and to increase its chances of getting inflation back down to 2%, the Fed must be willing to push short-term interest rates higher—regardless if it increases the likelihood of recession. Expectations in the swap market for where the Fed's policy rate is likely to peak next year (May 2023), after breaching 5%, have ebbed to around 4.8%. The differential between US Treasury two-year yields and the Fed's benchmark rate has always been positive before the conclusion of monetary tightening. The median has been about 47 bps, suggesting that if the swap market is correct, two-year yields may climb as high as around 5.20%. While such a projection may sound distant, it is in line with inflationary pressures in the US, which, contrary to expectations, have yet not diminished at all.

Figure 3: Differential Between US Treasury 2-year Yield and Fed Funds



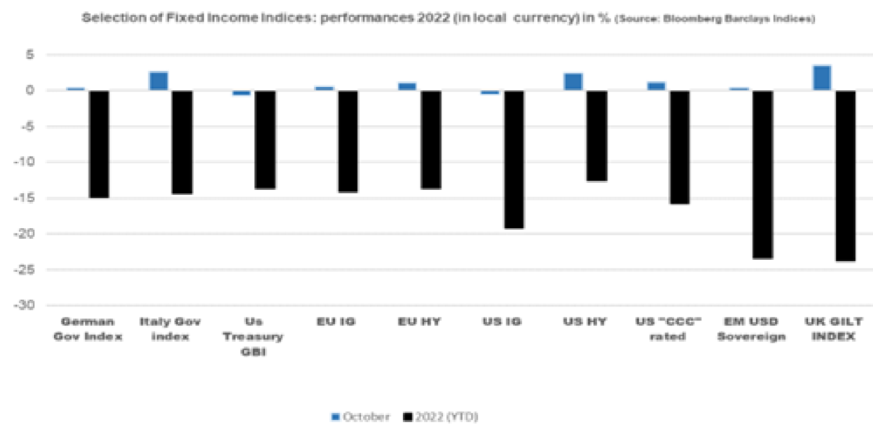
Source: Bloomberg, as at October 28, 2022.

"In credit markets, sentiment remains weak, with a feeling that corporate debt markets need to do more to price in recession risks."

In credit markets, sentiment remains weak, with a feeling that corporate debt markets need to do more to price in recession risks. As Goldman Sachs' strategists put it: "while the last four decades have seen credit spreads justifiably shrug off rising recessionary fears, we think the current episode is different. Higher policy rates and real yields will continue to bolster the value proposition of cash, pushing the credit risk premium higher." Moreover, corporate default rates, currently about 1.5%, will slowly uptick and could rise to the 3% range within the next year.

Against this background, the growing volume of troubled debt (defined as bonds trading at yields at least 10 percentage points above US Treasuries, or loans changing hands at less than 80 cents on the US dollar) shows investors are already demanding a higher return for holding on to the debt of risky enterprises. A case in point is Carnival Corp, with more than USD8 billion of debt obligations trading at distressed levels, according to data compiled by Bloomberg. The cruise company managed to sell USD2 billion of bonds earlier this month to refinance some of its debt, but paid a yield of 10.75%. This compares to yields as low as 6% for Carnival's bonds last year.

Figure 4: October Fixed Income Performance



Source: Bloomberg, as at October 28, 2022.

"The growing volume of troubled debt shows investors are already demanding a higher return for holding on to the debt of risky enterprises..."

Crypto & Blockchain | Which way will Bitcoin go?

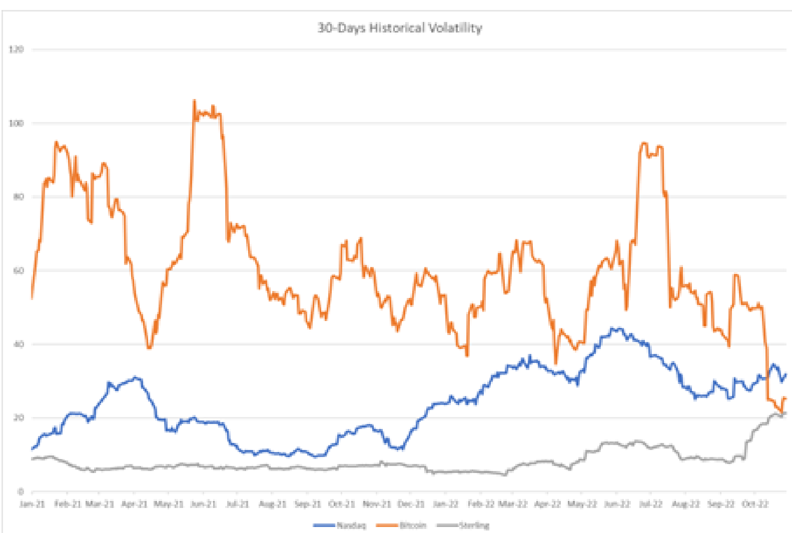
Volatility likely to rise.

Bitcoin has been trading sideways for months, bringing uncharacteristically but healthy low volatility. The digital currency's volatility compared with the Nasdaq and Sterling indexes reached a two-year low earlier this week (Figure 5).

"Crypto may benefit if there is any "pivot language" at the next Fed meeting..."

Our view: In this situation, any news can explode volatility in either direction. Crypto may benefit if there is any "pivot language" at the next Fed meeting—or if the Fed sounds too hawkish, it can bring a new test of this year's lows at 18k. As a reminder, in the September meeting, Bitcoin suddenly plummet from 22.7k to 20k in a matter of hours. This shows how the convexity of the asset around the event can be used to leverage a bullish bet or to build a "cheap" hedge, exploiting the relatively low realized volatility of this period.

Figure 5: Bitcoin, Nasdaq Index and Sterling Volatility



Source: Bloomberg, as at October 28, 2022.

Week Ahead | Key events to watch for

- **On the central bank front**, on Wednesday will see the Fed announcement and press conference. In the UK on Thursday we are more likely to see a less hawkish message from the BoE.

- **In terms of macro data,** the US we will see both the ISM Services and Manufacturing indices, and the labor market report (Friday). In China we will see the PMIs.

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