CITÉ GESTION

Newsletter : From Fed to ECB | June 2022

Key Take-Aways

- May was another extremely volatile month, with equities posting new year lows in the middle of the month, but managing to recover most of the losses by the end of the month. After seven consecutive weekly declines, the S&P posted its biggest weekly gain since November 2020 appreciating 6.6%.

- On the inflation front, the US CPI growth decelerated from 8.5% YoY in March to 8.3% YoY in April, easing some concerns that the Fed needs to be even more aggressive than what the market is expecting.

- Despite a deceleration in inflation, it is still at elevated levels. Thus, after a 50 bps rate hike in the Fed funds rate in May, it is forecasted another 50 bps hike at its next June meeting and that the rate ends the year somewhere between 2.75% and 3%.

- With inflation decelerating, the bond market also witnessed some stabilization with the US 10 year Treasury yield trading around 3% and credit spreads contracting, leading to a positive month for US bonds.

- We think that higher inflation will be with us for a while, but that the Fed's hiking is mostly priced-in which is why we believe it's time to reconsider fixed-income and USD duration in general.

- However, we recommend to stay short duration in EUR fixed income, as only now is the ECB starting its rate hike process and has to recognize that it is behind the curve.

- After briefly touching a 20 years high during May, the dollar index, had its biggest weekly drop in nearly four months stabilizing at level 102.

- Oil prices rose 9.5% in May and reached their highest level in more than two months by beginning of June, supported by the prospect of a ban on seaborne Russian oil imports by the European Union, and also a reopening of activity in China.

May Review : Jerome, the hawk(ish)

May was another volatile month for the markets, with most of the major indices hitting their year-to-date lows in the middle of the month, to finally strongly recover at the end of the month.

The month was marked by another Fed meeting where Jerome Powell maintained a hawkish tone, stressing that inflation remained high and that the US economy continued to perform well. As expected, the Fed raised the Fed Funds by 50bps to 100bps.

US indices finished mixed, with the S&P500 and Russell 2000 finishing at +0.18% and +0.14% respectively, while the Nasdaq fell -1.93%.

In Europe, the indices ended the month positively, led by the PSI 20 (+8.02%), IBEX (+3.24%) and FTSE Mib (+2.49%) as well as the EuroStoxx50 at +1.34%, only the SMI (-4.05%) and Stoxx600 (-0.61%) ended in the red, dragged down by the fall of Nestlé and Roche.

In the rest of the world, the main indices finished in the green, with the Nikkei closing at +1.61%, the CSI300 at +2.08% and the Ibovespa at +3.22%. The MSCI ACWI finished in line with the S&P, at +0.18%.

Unsurprisingly, the energy sector was the strongest performer, up +5.98%, followed by Industrials (+2.68%) and Materials (+2.34%).

The dollar index eased slightly (-1.17%) to establish at 101.752. The EUR/USD rose by 1.79%, the CHF/USD by 1.27% and the GBP/USD by 0.22%. The yen recovered slightly against the dollar, ending the month at 128.67 (+0.79%)

The US 10-year yield ended the month at 2.84%, a slight contraction of 9bps. The bund yield rose by 18bps to reach 1.12%. Bond indices stabilized somewhat, with the Bloomberg Global Aggregate Index and the JPMorgan EMBI rising by 0.27% and 0.19% respectively, while the Bloomberg Global High Yield Index fell by -0.09% and the Bloomberg Core Developed Government Index by -0.50%.

The Bloomberg Commodity Index was up +1.44%, setting its annual increase at 32.44% and the WTI closed May at $114.70 (+9.53%).

The VIX index closed the month at 26.40 after oscillating between 15.01 and 36.45

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,132	-0.62	-3.08	0.18	-8.55	-12.76	17
Nasdaq	12,081	-0.41	-5.78	-1.93	-14.91	-22.52	22
Russell 2000	1,864	-1.25	-3.81	0.14	-9.79	-16.58	17
Euro Stoxx 50	3,789	-1.36	0.69	1.34	-0.67	-9.47	12
Stoxx 600 EUR	443	-0.72	-1.03	-0.61	-1.18	-6.98	12
FTSE 100	7,608	0.10	1.54	1.13	1.83	4.78	10
SMI	11,611	-1.06	-5.00	-4.05	-3.23	-7.37	15
NIKKEI 225	27,280	-0.33	0.64	1.61	-1.95	-4.32	15
CSI 300 China	4,092	1.56	2.19	2.08	-2.84	-16.95	12
MSCI EM Index	1,078	1.23	0.55	0.46	-5.11	-11.72	11

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,132	-0.62	-3.08	0.18	-8.55	-12.76	17
UTILITIES	376	0.58	0.09	1.03	-0.11	4.65	20
ENERGY	658	3.14	14.35	5.98	13.99	58.43	12
TELECOM	202	0.51	-2.38	0.94	-14.10	-24.35	14
CONS STAPLES	772	0.42	-6.57	-0.53	-2.17	-3.16	20
REAL ESTATE	276	1.15	-10.38	-0.05	-8.40	-14.19	38
CONS DISCRET	1,210	-0.37	-12.35	-0.11	-17.22	-24.69	20
MATERIALS	539	0.72	0.32	2.34	-2.39	-4.72	15
HEALTH CARE	1,538	1.30	-1.10	-0.51	-3.34	-5.83	16
INFO TECH	2,453	1.22	-2.10	0.82	-12.04	-19.39	20
FINANCIALS	588	0.69	-1.92	-0.76	-7.41	-8.78	12
INDUSTRIALS	798	1.36	-3.78	2.68	-7.97	-10.15	16

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	101.752	0.08	0.53	-1.17	3.50	6.36
EUR-USD	1.0734	-0.42	-0.52	1.79	-3.01	-5.59
USD-JPY	128.67	0.85	0.13	-0.79	5.73	11.81
USD-CHF	0.9595	0.23	0.21	-1.27	4.01	5.10
EUR-CHF	1.0297	-0.23	-0.39	0.34	0.82	-0.76
GBP-USD	1.2602	-0.40	-1.85	0.22	-4.08	-6.87
EUR-GBP	0.8518	-0.02	1.27	1.55	1.12	1.24
JP EM FX Index	52.78	-0.12	0.57	1.38	-1.33	0.41

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	2.84	11	-5	-9	133	133
Germany	1.12	7	15	18	130	130
UK	2.10	11	14	20	113	113
SWITZERLAND	0.89	7	-2	1	102	102
Japan	0.24	1	-1	1	17	17
US IG Spread	140	-4	-5	-8	40	40
US High Yield spread	423	0	39	18	153	153
EUR High Yield spread	503	-6	71	20	157	157

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	131.3	-1.89	1.79	1.44	5.57	32.44
Gold Spot $/OZ	1837.4	-0.96	-4.88	-3.14	-5.17	0.45
Crude Oil WTI	114.7	-0.35	11.25	9.53	14.35	48.94

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	26.2	-0.35	-2.02	-7.21	27.38	8.97

Source: Bloomberg 05/31/2022

Macro and Rates : Looking for a slowdown

The global economy is slowing down, but still resilient, and strong in particular in the United States. And this is a problem for financial markets if it persists

Inflation, higher rates, war in Ukraine, Covid in China: They are each taking their part on the global economic slowdown, and investor's nerves. Russia's attack on Ukraine continues to squeeze the commodity complex, adding to the inflationary pressure, forcing central bankers across the world to hike rates and reduce their balance sheet, taking liquidity off from the global financial system.

And Covid itself, has not disapeared, at least in China where the authorithies tries to fight a new infection wave with lockdowns in several cities.

The big picture remains full of uncertainty and risks. Inflation and response against it will be key in the coming month.

The US Federal Reserve has shown a clear path of its monetary policy normalization. Fed fund rates are now expected to end the year somewhere between 2.75% and 3% and we start to see early signs that inflation may have peaked in the country. The US Personal Consumption Expenditures Deflator (PCE Deflator), one the Fed's preferred inflation gauge, slowed in April. Of course, a month is not a trend and we might need another 2 or 3 months of inflation slowdown for the confirmation that a peak has been reached. But we remain confident. Inflation in the US remains close to its highest level in 40 years but market expectations of longer-term inflation have begun to ease.

At the opposite of Europe, inflation pressure in the US has not only been driven by the Covid pandemic and the war in Ukraine but also a robust economy post-Covid supported by a strong internal demand. The Fed will likely make a pause in its normalization process when signs of soft-landing in the economic activity and so internal demand will emerge. If and when the case, rates, stock markets and volatility will stabilise. In a way, we should expect to switch now into a «bad news, good news» mode for financial markets.

Europe is another story. Inflation pressure has been driven recently by the offer instead of the demand and the energy and soft commodity problematic generated by the war in Ukraine.

Inflation is clearly installed in Europe. The Euro area flash CPI increased 8.1% year-on-year, and the price of Brent crude oil is above USD 120 again, despite the OPEC+ approving a higher hike in production. The combination carries a clear message for the ECB: they can and have to tighten financial conditions by hiking interest rates and curb inflation pressure, their unique mandate.

As we are writing, the ECB is about to announce a defined path of rate hikes as well as the end of the asset purchase program. But the European Central Bank faces another challenge. How to normalise monetary policy without penalizing peripheral countries like Italy, Greece, Portugal and Spain? Those countries are running larger Debt to GDP ratio and are already facing wider spreads to German debt. A an exemple, Italy BTP-Germnan Bund 10 year spread has widened by more than 1% since September last year to stand at 2%, seen as the bearable treshold. The rate hike compain the ECB is about to start could weight considerably on those countries as spreads could widen further. Hopefully we trust the ingenuity of the ECB members to set up mechanism like an OMT program (outright Monetary Transactions) in order to limit further spread widening.

Governments in Europe are also expected to play their part to face the economic challenge of the less dynamic Euro-area. Like the UK, with the fresh new fiscal package to help mitigate the purchasing power squeeze for low-income households, European governments will likely have to launch stimulus package to ensure a soft landing rather than a hard landing of the Euro-zone.

Fixed Income : After the US, Europe?

«Prediction is difficult, especially if its about the future» (Niels Bohr). It seems to be similar regarding inflation – at least recently. While wall street analysts, in their forecasts since September 2020, expected US inflation to rise up to 4% in 2021, it is today more than double that number. It is therefore no surprise that (underestimated) inflation is currently the «hot topic». It is also the main driver behind sharply negative returns in fixed income and rather disappointing portfolio performances YTD: a diversified basket of 11 types of assets has returned -8% YTD, the worst year for such a basket since at least 1978.

It seems, however, that rates in the US stabilize: the US 10-year Treasury yield, after touching 3.2%, is now fluctuating around the 3% level. Yields have stabilized across the US yield curve. And this has helped bonds over the last weeks. Especially given that credit spreads have also come down from their highs: US investment grade spreads fell from 1.6% to 1.4% and US high-yield spreads are down more than 80bps from their recent high at 5%.

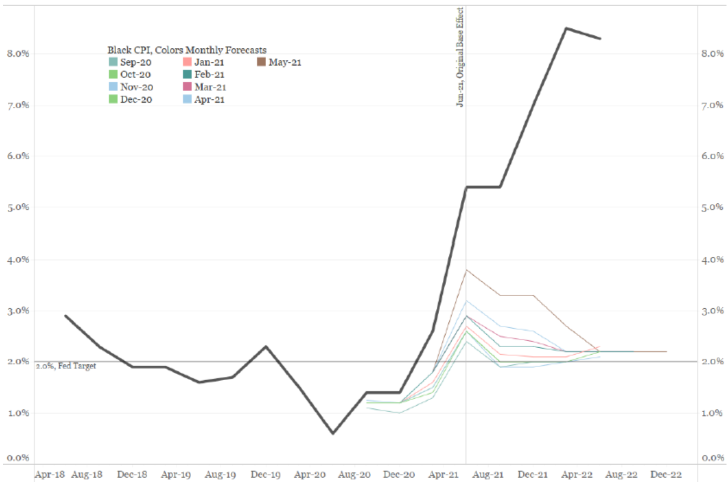
And there are signs that inflation in the US may be stabilizing. The last reading of YoY CPI at 8.3% was lower than the previous 8.5%. While overall macro data continues to be robust in the US, the Citi Economic Surprise Index points to a weakening in the readings. All else being equal, this should be positive for yields and high quality bonds.

While we think that higher inflation will be with us for longer, we do not think that it will continue to rise. The base-effect will therefore be positive in future inflation readings and we believe that its not a bad moment to reconsider fixed-income and USD duration in general. The Fed's hiking is mostly priced-in as witnessed by the short-end of the Treasury curve trading at 2.6%.

Now, the action moves to Europe. There, short-term rates are still negative while inflation readings have shot up massively. Now its the ECB which has to recognize that its behind the curve, and the euro fixed-income market will go through a re-rating in anticipation of a hawkish ECB. The market is now pricing a 50bps hike by September.

We therefore recommend to stay short duration in EUR fixed income. In the US, however, a more diversified approach to fixed income is warranted and taking some duration risk doesn't seem unreasonable any longer.

Wall Street Inflation Forecasts vs. Actual (US)

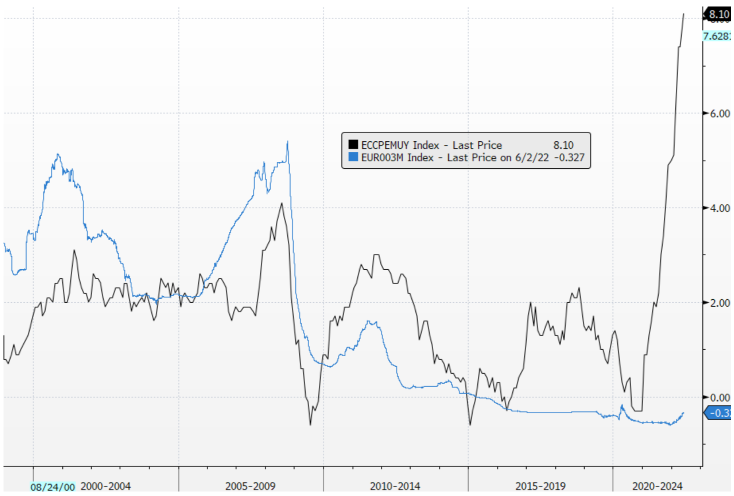


Source: Bianco Research LLC

Citi Economic Surprise Index (USA)

Source: Bloomberg

Eurozone CPI YoY vs. EURIBOR 3m



Source: Bloomberg

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Equity : Are we in a bear market?

The month of May showed us very volatile movements on the markets with a gloomy atmosphere most of the time to end up very positively. The S&P posted its biggest weekly gain since November 2020 after seven consecutive weeks of decline, with performances of 6.6% on the S&P and 7% on the Nasdaq, respectively. Finally, the market finished the month almost flat and seems to have found some stability despite the volatility.

The excess to the upside makes for a period of above average returns, and the swing toward excess on the downside makes for a period of below average returns. We saw a number of excess to the upside in 2020 and 2021 and now we are seeing corrections thereof.

The dramatic performance of the FAAMGs after the pandemic attracted the attention of investors and supported a generalized upward trend. By September 2020 the stocks had nearly doubled from their March lows and were up 60% from the beginning of the year. The 5 stocks are heavily weighted in the S&P 500 and distracted attention from the less impressive performance of the other 495 stocks.

In the tech sector, the positive psychology and the behavior of the investor put the market in the sky with now a painful return to earth. We are probably where we should be. Here are some of the declines form the top and well-known tech/digital and innovation stocks. PayPay – 55%, Coinbase -75%, Netflix -68%, Shopify – 70%, Spotify -55%, Uber -45%, Zoom -50%, Snap -30%, Twilio -60%

Do you really believe that the value of these companies has fallen more than half on average in the last few months?

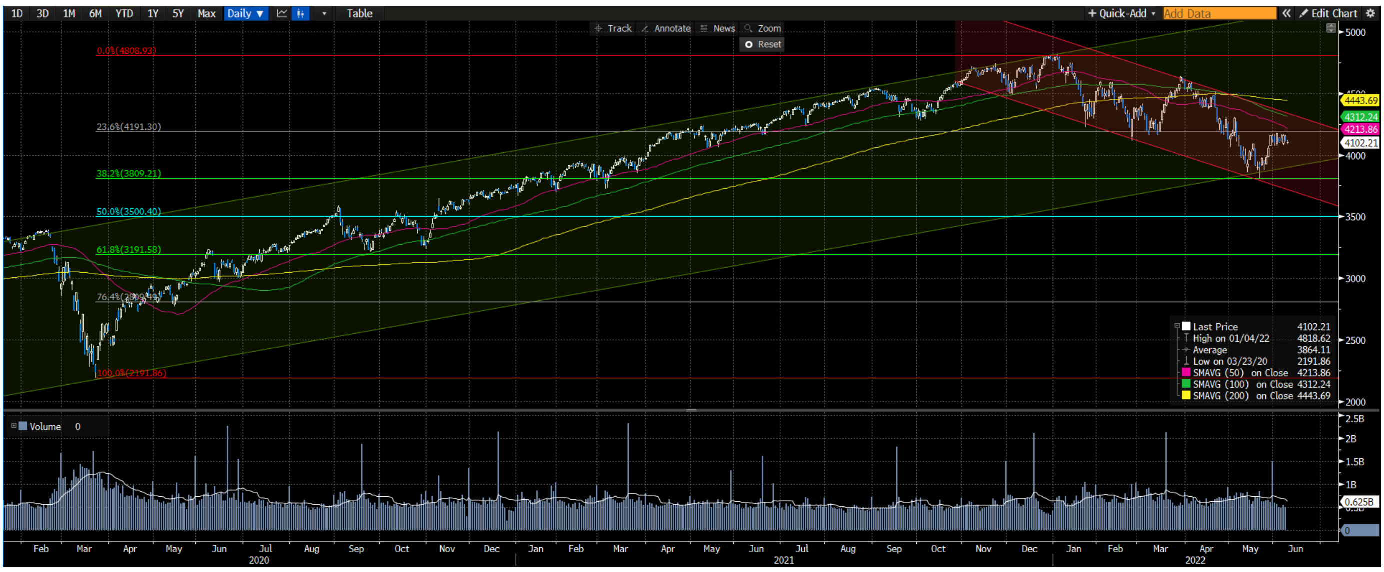
The answer is yours but it should be no.

At the moment, we are probably in the peak of inflation in the US and Europe, which may have a slightly less enviable situation with the impact of the geopolitical situation. But as long as the FED does not show any signs of easing on the rate hike, investors will remain cautious and fearful.

The range between 3900 and 4300 on the S&P and the range between 20 and 35 on the volatility index will remain the hot spots that investors will be watching in the near future.

In the current situation, we continue to favor quality stocks but we are less convinced about favoring value stocks versus growth stocks. Indeed, some value stocks are in some cases starting to look a little expensive compared to some growth stocks.

We can see some good opportunities to be considered.



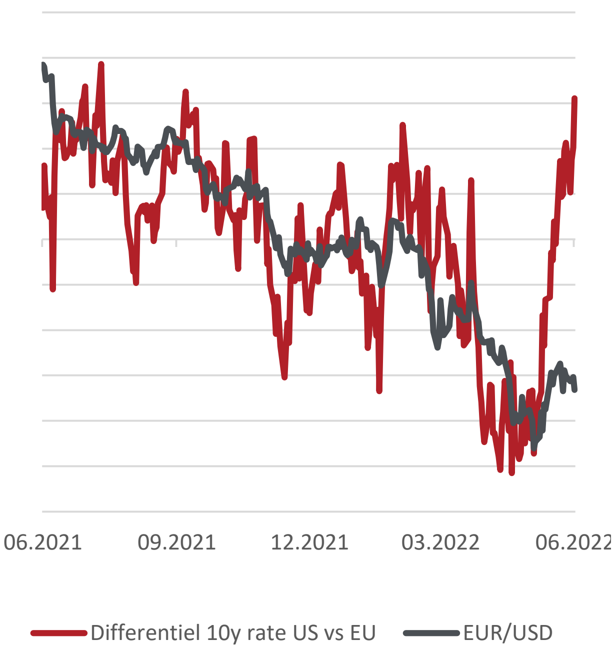
Forex And Commodities : Has The USD Topped-Out ?

After briefly jumping to a 20 years high by mid of May, the dollar index retreated to its biggest weekly drop in nearly four months before stabilizing at 102. The question for forex investors thus is: Has the USD topped out ?

The Greenback is now dragged down by a mixed economic data. In Spite of its safe haven status, the USD is becoming more sensitive to macro economic data in the US.

The USD remains driven by Fed rate hike expectations. Any sign that the US central bank could pause or reduce its tightening policy could affect the Dollar negatively. However, a new variable should now be considered for the greenback's direction: the upcoming response from the ECB to rising inflation. Inflation rose to 8.1% in the Euro area (from 7.5%), confirming the case for the necessity of a tightening ECB policy. While, the question is whether the ECB will go ahead with 25 or 50 bps hikes, the impact of the ECB's tightening policy will most likely affect EURUSD. Given that the ECB has been slower than the Fed to respond to the inflation until now, the first impact of rising interest could be a stronger EUR. Furthermore, the Dollar seems already having priced all the Fed interest rates hikes and could be now stabilizing. However, we should also consider some detractors that could continue to impact the Eurozone negatively, the main example is a further escalation on Russian-Ukraine conflict that disrupt the supply chains in Europe and leads to a lower GDP rate vs the US.

Based on the differential of Interest Rates, potential for EUR to ascent vs USD



Source: Bloomberg

Consequently, with this narrative, it is likely that the EUR/USD pair could take the ascent, and reach the resistance level at 1.08.

The Bank of Japan has still not given an indication of abandoning accommodative settings. This continues to put downward pressure on the Yen (breaking above 132 vs USD – seven years low). The 135 level could be the next major break, in line with a BoJ that continues to defend yield curve over a weaker currency.

Upward pressure on Oil price could continue in the upcoming months.

The oil price already rose to its highest level in more than two months at the beginning of June, accentuated by the prospect of an European Union ban on seaborne Russian oil imports. If this ban find a consensus among European leaders and could be quickly implemented, the momentum on oil prices is likely to continue. More upward pressure on oil price should also be considered due to a return to normal consumptions in China after the Covid-19 shutdown. A new peak at resistance 125-130 is reachable.

Finally, Gold moving in opposite direction of USD, a decline of the latter, could bring some room for a slight increase of the precious metal (range 1870-1920).

Oil continues to reach record ?

Source: Bloomberg

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