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Newsletter : Fed job not over | December 2022

Key Take-Aways

- The S&P500 started November in the red, with participants concerned about the Fed meeting. However, lower than expected inflation, more dovish tone from the Fed supported risk assets, as well as a USD depreciation.

- The lower than expected October US inflation report released on November 14th propelled all asset classes from equities to fixed income. Core inflation, at 6.3% YoY, remains very elevated on an absolute basis. Due to the type of inflation cycle, it is far too early for central banks to ease their monetary policy.

- The deeply inverted US curve, with the 2s10s at -80bps, reflects increased perception of recession risk. While Manufacturing PMIs indicate contraction, the Services ISM surprised to the upside This hardly suggests that the US economy is slowing as much as the Fed might like.

- On the employment front, the US job report delivered above-expected payroll growth. For the Fed to pivot it is required both a softening job market and structural inflation pressure easing which have not happened yet.

- Investment grade bonds offer a decent spread-pickup in maturities above 1 year. We continue to recommend taking on new positions at the short-end of the curve.

- After a positive month of November, the Dow Jones Industrial Average Index entered in bull market territory and closed more than 20% above the low hit in September 2022. Technically, the equity market seems to be overbought. We now believe that the short-term risk/reward of equities is less attractive and we suggest to put in place hedging solutions

- The EUR had the greatest monthly appreciation against the USD (+5.3%) since September 2010. The Yuan gained against the Dollar, after eight consecutive months of depreciation, on the back of prospects of easing on Covid restrictions.

- In regards to commodities, the EU and G7 agreed to a price cap of $60/bbl on Russian crude oil purchases, this came in lower than the $65 - $70 price that was initially suggested.

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Review: The bounce goes on

In the US, the S&P500 started November in the red, with participants concerned about the Fed meeting, which once again raised interest rates by 75bps, the fourth consecutive 0.75% hike, bringing its key rate to 3.75%. Two days later, the Nonfarm Payrolls figures confirmed the good health of the US labour market, raising fears of a longer than expected restrictive monetary policy. We had to wait for the inflation figures on 10 November, which were better than expected (headline +7.7%/core +6.3% YoY vs. consensus +7.9%/+6.5%), for the market to change direction and move sharply higher.

In Europe, the Eurostoxx50 started the month on a high note, continuing the rebound that began the previous month.

In China, we saw protests against the Zero-Covid policy which led the government to ease restrictions. The government also put in place a massive rescue package to help the housing sector. This news reassured investors who began to reconsider China as "investable".

The major equity indices posted a second consecutive month of gains, the most notable being the Hang Seng China Enterprises Index (HSCEI) which ended the month at +29.11%.

In the US, the Dow Jones was the biggest riser, gaining 6.04%, followed by the S&P500 at +5.59%, the Nasdaq at +4.51% and finally the Russell at +2.31%.

Europe once again outperformed the US, finishing at +9.73%.

On the fixed income side, the BBG Global Aggregate index ended the month up 4.71%, the EMBI index up 6.61% and the Global High Yield up 5.61%.

The DXY index contracted by 5.28% to settle at 105.95.

The US 10-years yield ended the month down 44bps, the bund down 21bps and the UK Gilt also down 36bps.

The Bloomberg Commodity Index rose 2.38% to end the month at 116.1.

The VIX continues to fall, ending just above 20.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,080	3.12	1.35	5.59	8.56	-13.12	17
Nasdaq	11,468	4.42	1.63	4.51	4.38	-26.12	22
Russell 2000	1,887	2.74	1.28	2.31	11.10	-14.94	20
Euro Stoxx 50	3,965	0.77	0.48	9.73	15.36	-4.70	12
Stoxx 600 EUR	440	0.63	0.31	6.92	8.90	-6.80	12
FTSE 100	7,573	0.81	1.57	7.12	7.23	6.15	10
SMI	11,128	0.45	0.30	2.77	3.74	-11.11	16
NIKKEI 225	27,969	-0.21	-0.52	1.38	6.97	-0.86	15
CSI 300 China	3,853	0.12	2.11	9.83	-13.13	-20.34	11
MSCI EM Index	972	2.03	4.32	14.85	-1.43	-18.71	11

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,080	3.12	1.35	5.59	8.56	-13.12	17
UTILITIES	361	2.56	1.36	7.02	2.68	2.10	19
ENERGY	694	0.55	-1.18	1.26	29.27	70.17	9
TELECOM	173	4.92	2.23	6.85	-6.60	-34.77	14
CONS STAPLES	804	1.91	1.29	6.37	8.31	2.26	21
REAL ESTATE	246	2.35	1.84	6.90	-2.94	-22.47	34
CONS DISCRET	1,134	3.58	2.56	0.99	5.63	-29.04	21
MATERIALS	520	2.44	0.47	11.76	13.14	-7.11	17
HEALTH CARE	1,619	2.45	2.08	4.82	9.04	-0.04	18
INFO TECH	2,372	5.05	1.13	6.03	7.22	-21.63	20
FINANCIALS	602	1.68	0.97	7.04	16.16	-5.59	12
INDUSTRIALS	858	1.62	0.80	7.85	17.07	-2.59	18

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	105.95	-0.82	-0.12	-5.00	1.21	10.75
EUR-USD	1.0406	0.74	0.09	5.30	-0.74	-8.48
USD-JPY	138.07	-0.40	-1.10	-7.15	1.73	19.98
USD-CHF	0.9457	-0.84	0.32	-5.55	-0.98	3.59
EUR-CHF	0.9841	-0.12	0.44	-0.58	-1.70	-5.15
GBP-USD	1.2058	0.89	0.02	5.14	-0.99	-10.89
EUR-GBP	0.8630	-0.15	0.07	0.11	0.24	2.58
JP EM FX Index	50.28	0.44	0.83	3.00	-2.64	-4.35

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	3.61	-14	-9	-44	210	210
Germany	1.93	1	0	-21	211	211
UK	3.16	6	15	-36	219	219
SWITZERLAND	1.11	5	11	-5	125	125
Japan	0.25	0	0	1	18	18
US IG Spread	145	0	4	-26	45	45
US High Yield spread	501	-2	8	-9	231	231
EUR High Yield spread	511	-4	-11	-86	165	165

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	116.1	0.75	-0.39	2.38	-0.85	17.02
Gold Spot $/OZ	1768.5	1.07	1.08	8.26	-2.14	-3.32
Crude Oil WTI	80.6	3.01	3.48	-6.91	-23.84	4.62

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	20.6	-1.31	0.23	-5.30	-28.32	3.36

Source: Bloomberg 11/30/2022

Macro & Rates: Good news remains a good news but...

November proved that macro and therefore monetary policy is the unique driver in financial markets for the moment.

The lower than expected October US inflation report released on November 14th propelled all asset classes from equities to fixed income higher, giving the US dollar another leg down.

No doubt this was a good news this time and more importantly that financials markets were ready for it.

And also no doubt that the inflation reading was positive. Indeed, Core goods prices had their largest monthly decline since March this year and confirmed therefore that the supply shock effects, which was the starting point of this inflation chapter, are fading. This is clearly encouraging and a first step towards the right direction.

As a consequence, the Federal reserve is expected to slow the pace of rate hikes and this has been welcomed by financial markets.

Having said that, one may wonder whether markets have got a little bit ahead of themselves and maybe misinterpreted the message of the Fed. Indeed, a 50bps rate hike in December is an improvement relative to the last meetings where 75 bps were delivered. But it is still a significant half percent increase which by no way indicates the end of the cycle.

Core inflation, at 6.3% year-on-year, remains on absolute levels, very elevated. Given the nature of this inflation cycle, we believe it is far too early for central banks to declare victory and mission-accomplished .

Central banks will require further evidence that inflation pressure has passed. Lagged effect of aggressive rates hikes earlier this year, is about to provide lower inflation rate (disinflation). But we consider the coming disinflation will likely be cyclical and that inflation can only become structurally more entrenched and stronger.

We can observe lots of factors working in this direction: deglobalisation, climate policies that induce massive investments in the green economy, government stimulus to avoid social unrest due to the energy crisis. Add the fact that supply chains have been re-designed from low-cost to friendlier countries and the idea that the US and Europe will keep sanctions against Russia even after the war has ended and you obtain a perfect cocktail for structural inflation pressures.

The US yield curve inversion is calling for recession, Macro data suggests mixed-pictures for now.

The shape of the US curve, deeply inverted with the 2s10s at -80bps reflects increased perception of recession risk. While Manufacturing PMIs already indicate contraction in the activity, with evidence of weakness in demand with inflation curbing purchasing power, the Services ISM surprised to the upside delivering a 56.5 reading versus an expected 53.5, with business Activity component rising from 55.7 to 64.7 the highest of the year. This hardly suggests that the US economy is slowing as much as the Fed might like.

On the employment front, the recent US job report delivered above-expected payroll growth (263k versus 200k expected) and more importantly a much higher than expected wage growth (0.6% versus 0.3% expected). The participation rate slumped to 62.1%, underlining the tightness of labor supply.

All in all, the recent data suggest a slowdown in activity is in place but also that there are some strong factors both in inflation and the US job market that still suggest that Fed's job is not done yet. A fed pivot requires both softening in job market and structural inflation pressure easing which have not happened yet.

In the meantime, markets will continue to call and time in an early manner this pivot, switching from euphoria to disillusion until it gets it right. This should leave us for the months to come with financial markets stuck in well-known ranges with the sentiment that equites are flirting with the top of the range and US 10 year yields testing the lows.

Fixed Income: It's all about inflation

The Fed has two key inflation targets: firstly, a trailing PCE inflation that averages 2% over time, and secondly, long-term inflation expectations well-anchored around 2%. With long-term inflation expectations now very close to 2%, at least one precondition for a Fed pause is in place.

Trailing inflation, however, while trending down, is not yet close to the 2% level. The last reading of CPI was 7.7% YoY and the PCE was 6% YoY. Hence, the second precondition for a Fed pause is not in place, although we are moving in the right direction. Given this intermediate situation, the Fed is likely to adopt a slower pace and do smaller hikes in the coming months.

Bond markets have already reacted and posted positive returns in November: The Bloomberg Global Aggregate Treasuries TR index in USD rose 4.9%, the Bloomberg Global Aggregate Corporate TR in USD added 5% and the JPM EMBI Global Diversified Composite jumped 6.7%.

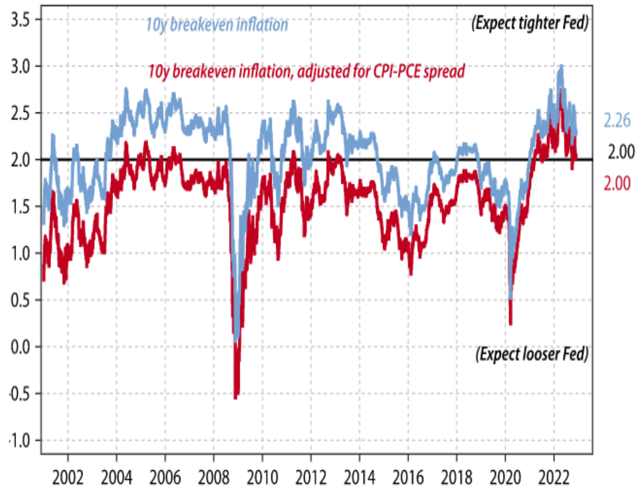
The unexpected fall in YoY CPI from 8.2% to 7.7% (vs. 7.9% expected) published on 10 November led to a sharp decline in Treasury yields. On that day alone, the 10-year Treasury yield dropped by 28bps. Since then the slide in core yields has continued and the 10-year yield fell from its recent high of 4.33% to as low as 3.5% at the beginning of December. The US curve inversion is now even stronger with the 3-month to 10-year spread falling to as low as 85bps. Recession fears are in the air, and that has helped bonds. The highest yield on the Treasury curve is now the 1-year maturity with approx. 4.75%.

Given the still strong labour market in the US, riskier assets did also well and US corporate spreads continued to tighten but only for the higher quality investment grade segment. High-yield spreads moved sideways in the US. In Europe both investment grade and high yield spreads tightened, but the latter to a lesser extent.

Investment grade bonds offer a decent spread-pickup in maturities above 1 year: a 5-year single-A USD corporate bond yields approx. 70bps more than the Treasury with the same maturity, and a 10-corporate bond about 120bps more than the risk-free rate.

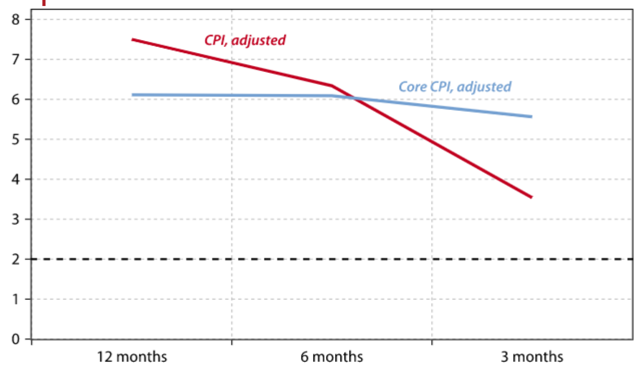
We continue to recommend taking on new positions at the short-end of the curve. The primary market offers many attractive opportunities. Taking on more duration depends on your view of the business cycle in 2023. If we avoid a recession, lower investment-grade and even high-yield could do well. In case of a more difficult environment, stick to Treasuries and upper investment grade corporates. Emerging Market bonds also offer opportunities but there everything will depend on the future direction of the USD.

10y breakeven inflation adjusted by 10y median CPI-PCE spread



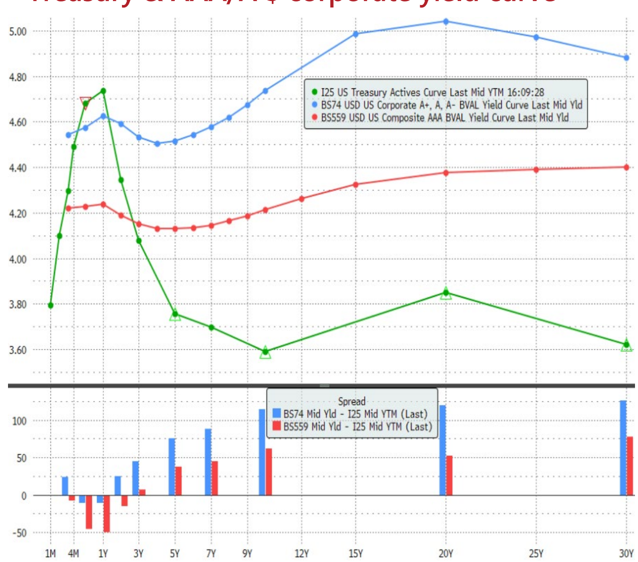
Source: Gavekal Research/Macrobond

Trailing CPI inflation, adjusted for CPI-PCE spread



Source: Gavekal Research/Macrobond

Treasury & AAA/A $ corporate yield curve



Source: Bloomberg

Equity: The market rally that began in October continued in November

Following last month's rally, the Dow is now up more than 20% from its October low and down only about 6% from its all-time high .

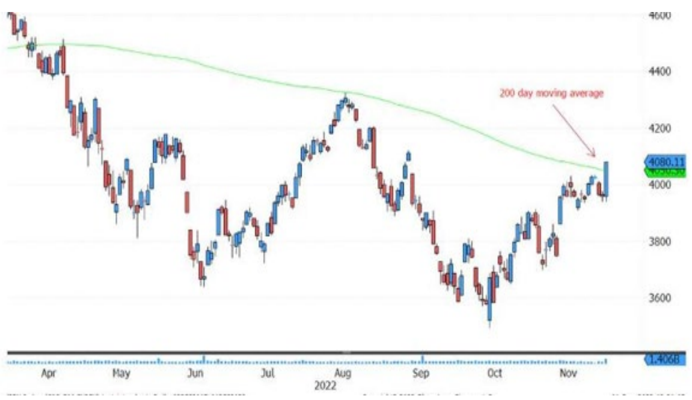
After a positive month of November, the Dow Jones Industrial Average Index entered in bull market territory and closed more than 20% above the low hit in September 2022. The major U.S. equity benchmarks ended higher with growth stocks outperforming their value counterparts. Year-to-date laggards led the November rally.

Comments from Fed Chair Jerome Powell signaling smaller interest rate hikes going forward, US employment data showed strong hiring and also wage inflation helped the global equity market.

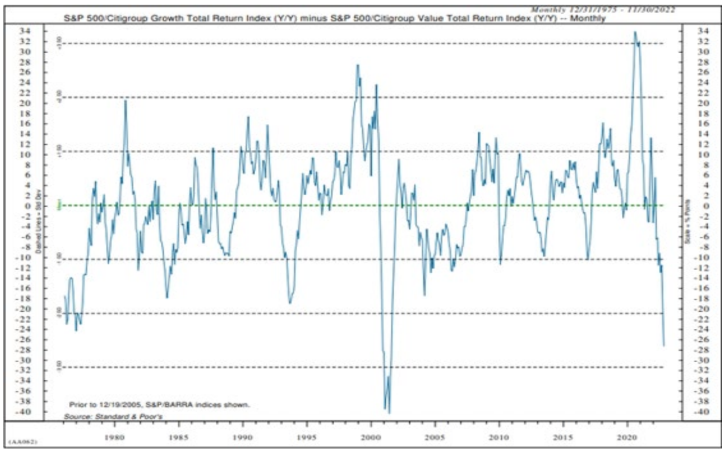
In Europe, stocks rose for a seventh week in a row. We haven't seen this since a long time. Lower inflation spurred hopes that central banks could slow the pace at which they are tightening monetary policy. Also Chinese equities led global markets higher on reopening hopes and after signs of relaxing coronavirus restrictions. Hong Kong's main index rose 27% in November, the most since 1998. Of course all of this doesn't reflect the weakness in equities year-to-date.

Regarding sectors, Cyclical (excluding energy) outperformed defensives, and the average stocks in the S&P 500 did better than the index, which was weighed down by the lagging mega-cap stocks.

The S&P closed above the 200-day MA for the first time in 7 month



The 12-month gap between Value and Growth performance is at its second-widest negative extreme going back to 1976.



Markets technically overbought.

We are heading towards the end of the year. Technically, the equity market seems to be overbought. Investor risk appetite is at a very low level. S&P 500 is bumping up against its 200-day moving average and seems to hesitate, trading in a range since the last two weeks. Apparently, the strong rebounds of October/November mean further decline in December according to historical statistics. The bear market rally was quick and violent, as is often the case when extremes are reached in terms of sentiment and positioning.

Time to hedge ?

We now believe that the short-term risk/reward of equities is less attractive and we suggest to put in place hedging solutions for the clients. The volatility plunged last month, pushing the VIX index back to its historical average, down around 20 from the March peak of 37. We should take advantage of this low volatility to buy protective options for the portfolios or to reduce risky positions. We should not forget that recession risks in the United State remains high and that inflation has not been defeated.

Forex And Commodities: USD declines as yields fall

The EUR had the greatest monthly appreciation against the USD (+5.3%) since September 2010, supported by falling long term USD yields that diminished the relative carry against the EUR. Prospects for a convincing EUR/USD rebound appear unrealistic, as a FED pause is not sufficient for a rebound. Instead, a bearish move is catalyzed by the pressing energy vulnerabilities and highly negatively carrying EUR/USD.

Concerning the GPB/USD, the British Pound has endured G10s worst stagflation case and it is condemned to face additional cyclical challenges. Ranging from Brexit impacts on the labor supply and the consequences of this year's fiscal crisis, the GBP has clearly gained sensitivity to a move on cyclical assets over time, and this is a partial consequence of deterioration of its external balances.

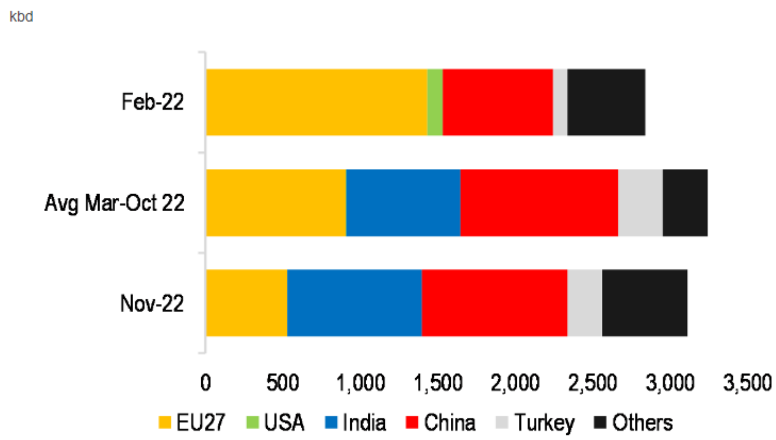
In Asia, bond purchases and the prospects of a more flexible BoJ supported a USD/JPY depreciation by a few percent. Nonetheless, the chances for a significant move in the Yen is constrained by the record trade deficit. The Yuan finally gained against the Dollar, after eight consecutive months of depreciation, as growing protests against Covid restrictions increased hopes of reopening.

In regards to commodities, the EU and G7 agreed to a price cap of $60/bbl on Russian crude oil purchases, this came in lower than the $65 - $70 price that was initially suggested. Nonetheless, the price cap came in slightly higher than the price at which Russia's flagship Urals grade were trading (around $54). This price cap has limited impact, as now the majority of crude oil exports have shifted from Europe to India and China (with a significant increase in Indian imports). OPEC has reduced their forecasts for 2022 global oil demand growth for the 5th time, consequence of mounting economic challenges (including China's zero Covid policy, geopolitical uncertainties, high inflation levels and the monetary tightening by major Central Banks. Base metals, such as Iron Ore, Nickel and Zinc had a nice recovery helped by apparent optimism about relaxation in China's Covid policies, the pledge of at least $162bn in credit by China's biggest commercial banks to property developers, restoring confidence in the housing sector. Aluminum performance was a bit more mannered, as the LME (London Metal Exchange) eventually decided against a ban on new deliveries of Russian origin metal.

EUR/USD year-to-date

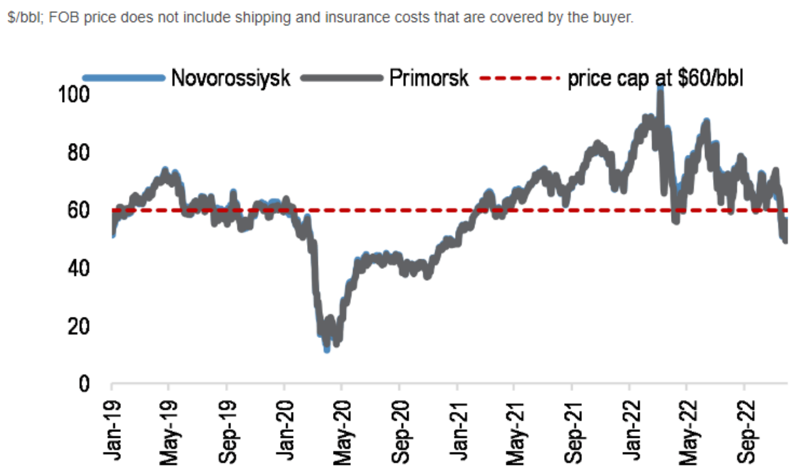
Source: Bloomberg

Russia crude oil exports by countries/regions



Source: JP Morgan, Kpler

Platts Urals crude oil FOB price



Source: JP Morgan, Bloomberg

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