

April 25th, 2022

A Market Without Bounds

- Sharp corrections in corners of the financial markets are an indication of lurking risk
- Yen moves to a two-decade low against the dollar
- US two-year yields have increased five-fold in a few months
- US equities lack technical support as the market level moves into no man's land
- S&P500 at risk of a 20% correction

If there is one very important lesson to learn from recent market movements, it is not to anchor your perception of what the future holds on the smooth market performance of recent years. These markets have had no bounds. Yet, in our discussion with other investors, we find a constant hope that markets will continue to trade within the range they have recently. The reality is staring people in the face, but as has been often the case, they prefer not to believe what they see.

So, what drives our current perception? Let's begin with US short-term rates. The US two-year bond yield has risen to five times the level seen in December, a pretty extraordinary rise in such a short time (Chart 1). Last week, Fed governors seemed to suggest through their speeches that the rise may not be complete. Chairman Jerome Powell appeared to endorse a 50bps rise at the next meeting in May; as restoring price stability gains precedence, other governors have placed on the table an even sharper rise in rates with the potential for a 75bps move. With such a state of flux, investors should be prepared for a broader range of potential outcomes than they had previously contemplated.

As we said last week, investors should not anchor their positionings on the view that the Fed will not force a recession. It will have to do whatever is necessary to bring inflation under control, even if that means a recession.

Chart 1: US two-year government bond yields now five times the level of December

US 2-year government bond yield (%)



Source: Bloomberg

Movements in currencies are shouting trouble ahead. The yen has plunged back to a two-decade low in value versus the dollar (Chart 2). The fall in the value of the Japanese currency is worse than the drop in the Russian rouble or the Turkish lira. Such a scale of move in the yen is creating a problem for the Japanese government and the country's central bank. A fire brake on the fall in the yen's value could come from potential coordinated actions by Japan and the US to halt the slide in the yen. However, the US authorities seem reluctant to act, given that a stronger dollar helps mitigate some of the inflation pressures that the US is so desperately trying to get a grip on. However, the precipitous fall in the yen against the dollar could crimp buying of US Treasuries by Japanese investors as hedging costs are close to substantially offsetting the yield pick of holding Treasuries.

Chart 2: Unprecedented Yen weakness – Yen/Dollar at Two-Decade High

Yen/USD exchange rate



Source: Bloomberg

The next stool to fall in the currency markets has been the Chinese renminbi. In the last four days of the week, the currency has corrected by 2.3%. It was the worst week for the currency since the pandemic began. Nevertheless, to be fair, the current level of 6.52 is substantially stronger than the levels of 7.10 back in 2020.

However, the recent weakness does reflect market concerns about the lack of policy response to the prevailing economic weakness. Also, we are seeing investors selling Chinese local debt as yields on US government bonds surged past those of Chinese paper. Indeed, the selling pressure has resulted from overseas investors offloading positions in both the bond and equity markets in recent months. But here lies a silver lining for the global economy – a weaker renminbi would export some deflation into the global economy through cheaper exports.

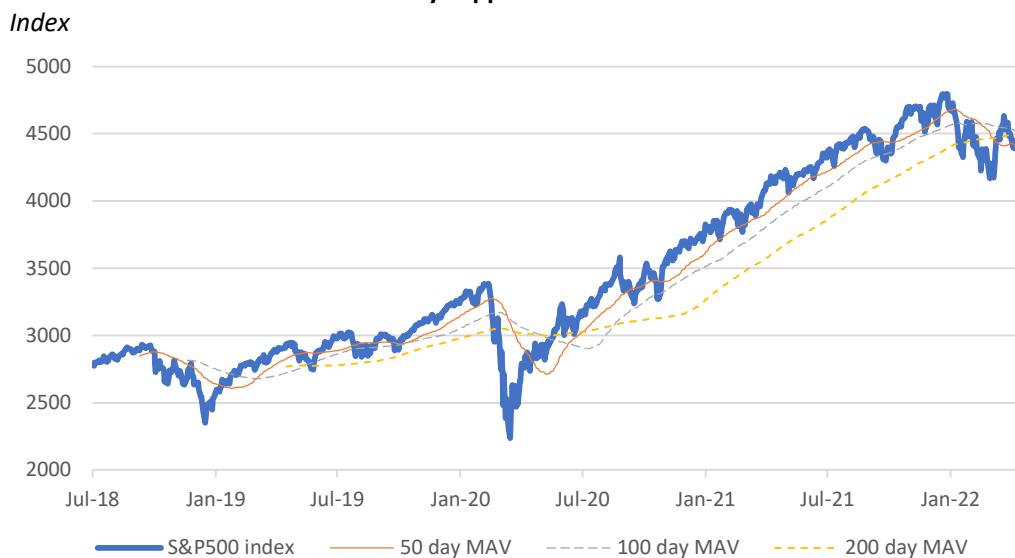
Chart 3: Renminbi/Dollar saw a sharp correction last week



Source: Bloomberg

With these three examples of outsized moves, indeed markets have shown that no bound is its worth. It's therefore important to consider where US equities might move in the coming months. Last week was a wake-up call for those who have kept promoting 'buy the dip'. The 'buy the dip' mantra from some strategists was built off the back of two decades of "experience" when there was only a downward trajectory to bond yields, low inflation and supportive policymakers. Last week the S&P500 fell 2.75%, and NASDAQ was off close to 4%, even as the US 10-year bond yield fell on the week. The S&P500 has now slipped below three key moving averages (Chart 4) and is in technical no-man's land. If these technicals are anything to go by, it's tough to make a call on where the markets are headed from here.

Chart 4: S&P500 index falls below key supports



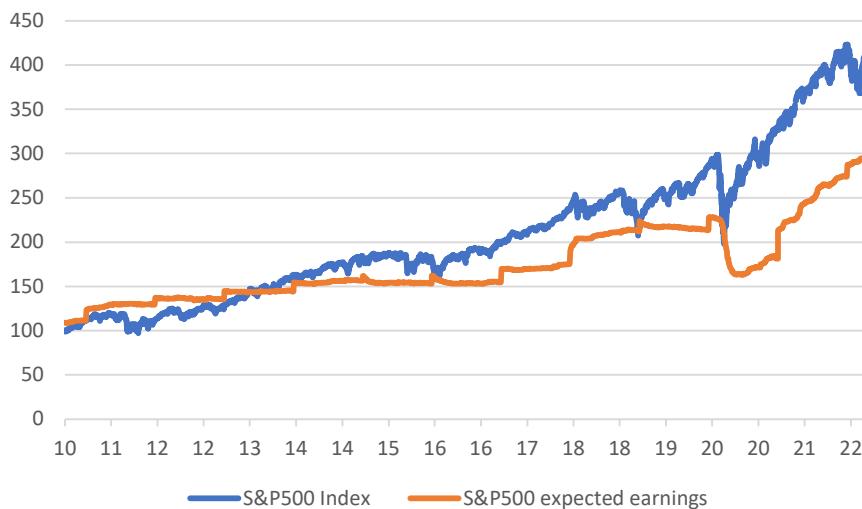
Source: Bloomberg

To better understand the index level relative to fundamentals, we use a chart that we have referred to several times earlier to map the past corporate profits against the index's performance. From 2010 the index is up 277%, whilst the earnings of the index constituents are up 197%. Hence, if it were to revert to the line representing earnings and relinquish all of the revaluation of the equity market over the past 12 years, the index would need to correct by 27%. We would also point out that the earnings outlook is also subject to downgrades as corporates generally absorb the inflation pressure and weaker global growth.

Hence, whether we look at the technicals or the fundamentals, the US equity market appears vulnerable to at least a 20% pullback. Hard to contemplate? All we would ask is that investors take that thought into their decision-making framework. We wouldn't want you to be surprised.

Chart 5: S&P500 index way ahead of corporate profits

S&P500 Index and S&P corporate profits Jan 2010=100



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