

Sept 5th, 2022

Worryingly Positive

- There are few places to hide from falling markets
- Equity and bond market returns become more positively correlated
- More inflation lurks within a positive US employment report
- ECB likely to increase rates by 75bps even as Russia turns off a gas tap
- A new prime minister in the UK, amidst a host of challenges
- Asia a region of contrast – Japanese equities rock solid...in local currency

Both equities and bonds disappointed last week. Strikingly though the correlation between bond and equity returns has turned more positive recently (Chart 1), leaving return-chasing investors with few places to hide as both asset classes posted losses. But it could have been worse. Last week, the US 10-year government bond yield hit 3.27% at one stage before settling back at 3.19%. In the process, the global aggregate index lost 78 basis points for the week, with global equities falling 3.3%.

Chart 1: Correlation between Global Equities (MSCI World Hedged to USD) and Global Bonds (Global aggregate Index (Hedged to USD) Turns Strikingly Positive



In the early hours of Friday trading in the US, equity markets appeared sanguine that the economic data releases were a net positive. As the session progressed, though, that view became increasingly sober and the markets retreated, registering their third straight weekly loss.

On the surface, US employment data released Friday looked OK with a slowing pace of hiring. However, the glaringly high number of vacancies mean employers could be under increasing pressure to hire at higher wage rates. Despite more workers returning to the US workforce, there are now two vacancies for every jobseeker.

After the employment report, the market marginally cut the odds of a 75bps increase in policy rates at the next FOMC meeting. We still believe that the Fed should increase rates by 75bps. Irrespective of the somewhat positive noise created by the recent economic data releases, there is a simple mantra of monetary policy: central banks must increase interest rates early and substantially in the face of persisting inflation. The Fed did not raise interest rates early enough, so it must push on with substantial rate increases to keep its credibility. One 'good' employment number should not sway it from keeping to the script.

A big week in the eurozone

It will be a critical week for the European Central Bank (ECB). The market expects the ECB to adopt a hawkish stance and bump up policy rates by 75bps at its meeting on Thursday. Although that's an upgrade from the 50bps increase, which was the consensus until recently, the market still sees the ECB's seemingly aggressive move as less than credible. The central bank, the market feels, is way behind the curve. Eurozone inflation hit 9.1% in August, with nine countries registering double-digit inflation. The rates of inflation in Lithuania and Latvia, for instance, are above 20%. ECB's credibility, therefore, is on the line. So, what should ECB do? In particular, the ECB must attempt to arrest the slide in the euro against the dollar, which has contributed to inflation pressures. The 75bps sharp increase in interest rates that the ECB is likely to announce will come with a promise of more rate increases—against the backdrop of a set of new ECB forecasts predicting a eurozone recession.

The ECB will also announce plans for quantitative tightening—with the likely impact of sending long-term interest rates higher; however, the ECB is also attempting to control the degree to which government bond yields differ across the region. There remains a plan to support the periphery country bond markets such as Italy, Spain and Greece. Italy continues to be the most problematic of the lot, with a 10-year BTP spread of 230bps over German bunds. Investors remain concerned that a new government in Italy will have a far right complexion, probably led by the Brothers of Italy party. Economists expect the likely coalition partners to significantly increase spending but with little hope of balancing the budget.

The inflation challenges facing the ECB have been exacerbated this week by news that Russia may have permanently cut off the gas supply to Europe. On Friday, Russia's state-owned energy giant Gazprom announced an indefinite halt to gas supplies to Europe, citing the need for additional repairs to the Nord Stream 1 gas pipeline. The EU, on its part, believes that there will be no need for rationing if the EU can cut its energy consumption by 15%! In the interim, gas prices are due to rise sharply this week as the market absorbs the new news from Russia.

Chart 2: Natural Gas Prices are due to Rise Sharply Again This Week
\$/Btu



The likely enormous hit to EU GDP from the gas shortages has prompted European governments to react quickly. The European energy ministers will have an emergency meeting on Friday, Sept. 9, to discuss a strategy for filling the energy void. There is the prospect of some mitigation if Germany goes back on its decision to decommission its nuclear reactors and extend coal use. Germany also announced a spending package of USD 65bn of relief, which it believes it can recover partly from the super-normal profits of the energy industry. Such measures against the energy sector may be implemented EU-wide with talks of an EU-wide profit cap on energy companies also gaining momentum.

UK—A new prime minister and new challenges

A new prime minister will be sworn in this week, with Elizabeth Truss looking likely to prevail when the Conservative Party meets to elect a new leader. As in many parts of the developed world, a new cabinet will likely propose relief measures through tax cuts and payments to households and industry. Economists suggest that the measures could cost as much as GBP 30bn—at a time when the Office of Budget Responsibility has already characterised the UK Public Finances as on an unsustainable path.

Europe—currencies still in trouble but offering long-term value – if you are brave

Both sterling and the euro may continue to slide against the dollar. We had hoped that the dollar's prevailing strength would start abating sooner. However, the contrast in fortunes between a slowing US economy with peaking inflation and Europe with rising inflation and a likely recession is not lost on the currency markets. Analysts have targets of 1.12 for sterling and 0.94 for the euro (1.15 and 0.99 currently). The problem with making any forecast for the moment is that the authorities appear some months away from formulating policies that may get ahead of the issues at hand. Remember, UK inflation forecasts hit 22% in the first quarter of 2023. Our only caveat to the traders' view of currencies is that European currencies are at extraordinarily low levels. Sterling has corrected 20% since May 2021, close to the lowest levels versus the dollar since 1985. The euro is down 20% since June 2021.

Asia—a picture of contrasts

Asia remains a picture that is not as solid as the United States but is not as bad as Europe either. Recent industrial production data, for instance, has shown a modest recovery in China and Japan but registered significant declines in the manufacturing hubs of Korea, Taiwan, Thailand and Vietnam. A rally in the auto sector has partially balanced the downdraft in the tech sector. Japan's economic data was relatively upbeat, with industrial production and consumer sentiment being better than expected. The equity market's performance year to date has been strong in local currency terms, down just 4%, but unfortunately let down by the 14% plunge in the value of the yen. The Japanese currency, like other currencies, was under pressure against the dollar last week, and for the moment, there seems to be little improvement in the yen in the absence of some support from the Bank of Japan. If you can bear the yen risk, there's a solid story in favour of Japanese equities in local currency terms.

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