**June 20th 2022**

# Help Less Central Banks

- **Central banks are all at sea with reactionary and often poorly signalled rate shifts**
- **The probability of global recession steps up as economic data disappoints**
- **Surveys of US smaller companies show unprecedented stress in the economy**
- **Bank shares look vulnerable after performance that has been in line with the market**
- **China's asset markets continue to show strength**

**The 'Fed put', and central banks that were the drivers of the equity investors' 'buy on the dip' mentality are well gone.** Central banks are now the enemy and not the saviours of the asset markets. Last week's central bank meetings only added to the already prevailing angst, opaqueness and trouble. Fed chair Jerome Powell's assertion that "we are going to react to the incoming data" further unnerved investors. And just one inflation number was enough to force the Fed to hike the Fed funds rate by 75bps – the highest increase in 28 years. The US central bank had clearly signalled earlier that it would increase the rate by 50 basis points. So much for well-considered policy making. Those of us that have been arguing for a meaningful tightening of monetary policy since last some quarters derive no pleasure in being right. Policy mistakes on the part of central banks create economic cycles, and this may yet prove to be a very serious one.

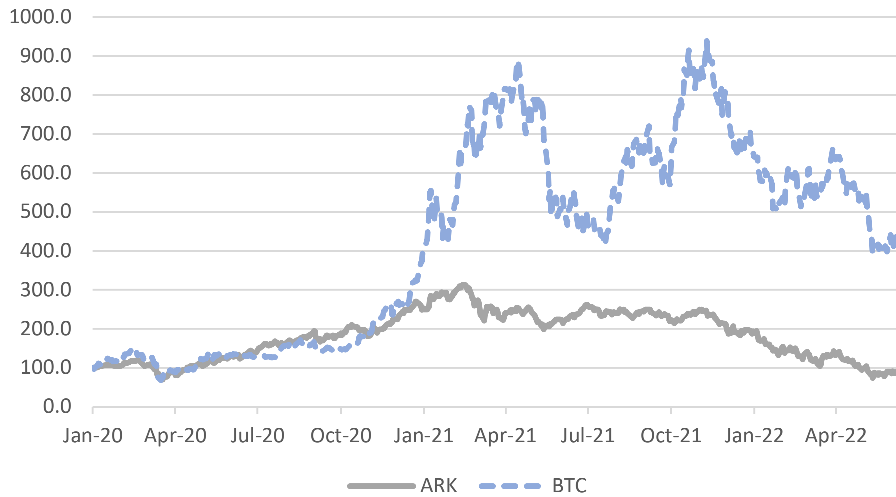
**UK MPC all at sea**

If the Fed looked outright foolish, as one commentator chose to put it, the UK Monetary Policy Committee were a bunch of wimps. We fail to understand how a central bank thinks of maintaining its credibility when it announces an increase in its forecast for inflation to 11% and yet thinks a 25bps rise in rates to 1.50% is adequate.

**The much-delayed reaction of central bankers means we will have to cope with a massive unwinding of years of misallocation of capital, which will be destructive to share prices and wealth.** Some share prices will never recover to their previous peaks. It's as simple as that. Take the unwinding of the share prices in the tech sector. Cisco's share price, for instance, peaked on 31 March 2000. Even at the recent peak of the US equity market at the end of 2021, Cisco's share price was still 20% below the March 2000 high. Today the stock is 44% below its all-time high that was 12 years ago. A more recent example is Netflix whose share price has plunged 79% since November. The misallocation to cryptocurrencies created the mother of bubbles. Such assets that depend on the scale of the network of people engaged in trading these assets have been particularly vulnerable. Bitcoin has fallen 78% since last November.

**Chart 1: ARK and Bitcoin struggle as global liquidity dries up**

*ARK and Bitcoin prices rebased to January 2020 =100*

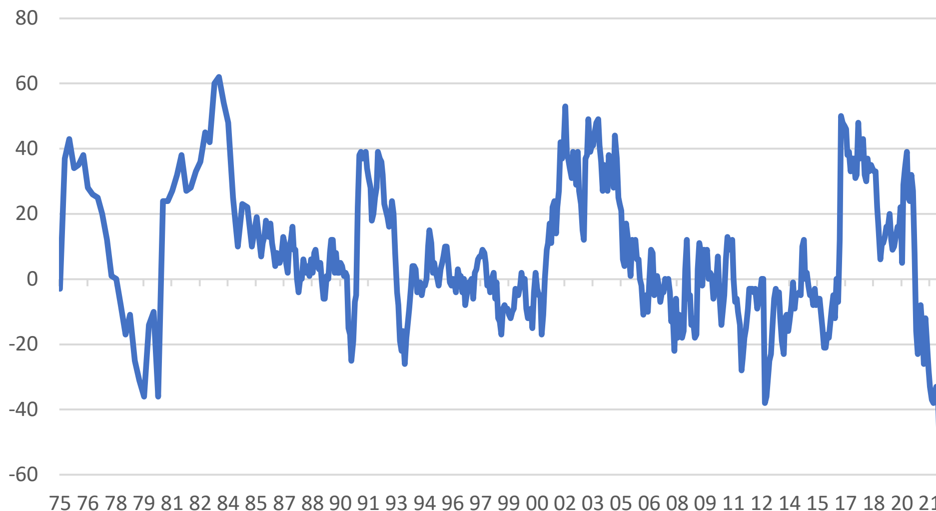



Source: Bloomberg

**Various gauges predicting a US recession in the next 12 months range between a probability of 30% and 70%.** These indicators are, however, increasing on an almost daily basis as market interest rates rise and investor risk appetite wanes. The rise in the cost of borrowing is amply evident, however, what we don't see, until it is upon us, is the reduction in the financial institutions' risk appetite to extend credit. The US loan officers' April survey showed a negligible -1% of loan officers tightening credit conditions. We suspect the survey will show a marked tightening of conditions in the coming months. The last data point is very close to where the survey was in the fourth quarter of 2007. By the end of 2008 the survey was at a net +84% of loan officers tightening lending conditions.

**The US NFIB survey of sentiment amongst small companies is shouting recession** (Chart 2). The latest survey of confidence in the future is at an all-time low with a net 54% of small business leaders being negative about the future. Small companies account for 99.7% of all businesses in the United States. It is difficult to be precise about what a 54% reading means for US GDP for the balance of the year, but it is difficult to see the economy remaining robust with so many companies being negative about the future.

**Chart 2: NFIB Indicator of Small Companies Sentiment at Rock Bottom**



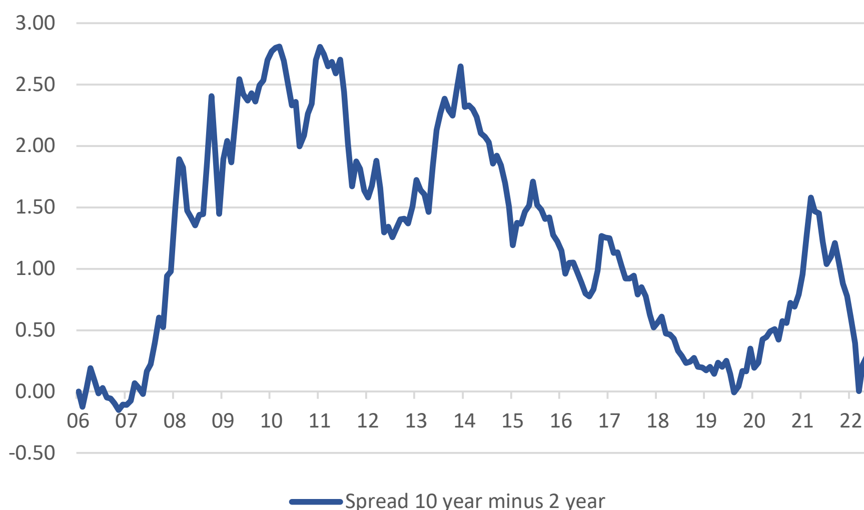

Source: Bloomberg

**The next few months are likely to be tough in financial markets.** Higher government bond yields look inevitable given the persistence of inflation, and the seeming commitment of central bankers to keep raising rates. The markets can only stabilise if we see an unexpected and meaningful pullback in inflation in coming months. Such a scenario doesn't seem likely although there are tentative signs that US retailers are prepared to cut prices to defend market shares.

**Vulnerability amongst the banks?**

In the financial system there must be casualties from the significant increase in global interest rates. The global banks sector is certainly the one that warrants attention. To date the sector has performed largely in line with global equities, maintaining its relative performance over the past 18 months. The conventional wisdom has been that banks will benefit from a steeper yield curve. However, there is no sign of a steep yield curve; indeed, it is quite the opposite. Also, the rise in credit spreads with the US high yield spread over 400bps and absolute yields above 7% is a harbinger of likely write offs for defaulting credits. We will be monitoring bank credit default swaps which are always good measures of the degree to which investors are losing confidence in any one name.

**Chart 3: US flat yield curve – reflects the market's recession concerns**




Source: Bloomberg

**China – in recovery mode**

**The only major market moving in the right direction relative to our expectations is China.** Last week's data releases were strong and are consistent with an economy that is improving fast. Exports increased by 6.8% month-on-month in May, industrial production rose 3.2% month-on-month, and retail sales were just ahead of expectations, up 3.6% month-on-month. There are signs of hope in the beleaguered property sector as well. The pace of house price declines has decelerated, and volumes of property purchases are off rock bottom. Although the global headwinds persist, the equity market continues to trend higher, which is encouraging.

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