MAPM: Markets Weekly

12th August 2022

Summary

- US CPI inflation comes in below estimates and down from June at 8.5% year-on-year, resulting in an equity and bond market rally as the probability of yet another 75bp Fed hike falls
- Earnings season continues, with energy profits making overall index performance appear better than expected
- Geopolitical uncertainty continues following Nancy Pelosi's visit to Taiwan, with the ramifications for US-China relations yet to be determined

Market and Economic review

As the market grasps for indications of monetary policy and the likely direction of economic growth, investors continue to chase data releases, resulting in a series of positive and negative surprises which have added noise to a slow-changing macroeconomic outlook. This week was no different, starting with low trading volumes in anticipation of Wednesday's US CPI print after the release of unexpectedly strong jobs data last Friday afternoon, showing that non-farm payrolls increased by more than double the amount expected and unemployment had crept down to 3.5%.

On the announcement that US consumer prices rose 8.5% on the year, coming in below the 8.7% increase expected and slowing significantly from the 9.1% rise in June, markets rallied; taking this as a signal that inflationary pressures are beginning to ease and the case for yet another 75bps rate hike weakened. Month-on-month data was consistent with this hypothesis, with prices unchanged from June due to falling gasoline prices. However, in order to control expectations, various Fed speakers responded that further evidence of cooling prices will be required before they are prepared to relax their hawkish stance, suggesting decisions will continue to be data-led until such a turning point is reached. As a result, the outlook remains uncertain despite hopes being at least temporarily buoyed.

In Europe, stocks also rose, albeit less significantly, as investors took confidence from the better-than-feared Q2 earnings season. This was despite warnings from Norway that they plan to prioritise filling their own power reserves over exports this winter whilst Russia continues to weaponise energy exports, temporarily suspending oil flows to Hungary, the Czech Republic, and Slovakia this week until a payment issue was resolved. In Germany, water levels of the Rhine, a key transportation corridor for fuel trading, have dropped to 40cm, making it harder for barges to traverse the route and putting pressure on rail and road transport for the movement of goods. In the UK, the Bank of England plans to begin selling government bonds as soon as next month. This is despite preliminary estimates suggesting UK GDP contracted 0.1% in Q2 this year, falling 0.6% in the month to June.

While market focus has wandered elsewhere, 75% and 52% of companies who have announced earnings from the S&P 500 and Euro Stoxx 600 respectively beat expectations. This has, however, been largely driven by energy names whose strong performance has distorted the performance of the remaining constituents.

Despite a fresh lockdown in tourist hotspot Sanya, China also experienced positive movements this week, in line with other markets. This comes as military drills simulating attacks on Taiwan were announced as "complete" with ongoing monitoring and training set to continue. While the value of exports surged in July, the volume of these actually fell due to weakening external demand and import growth missed expectations. After a CPI reading of 2.7% (year-on-year), the highest level in two years, the PBoC committed to protect the economy from inflation risks by avoiding excessive stimulus. Despite these concerns, soaring inflation in the US and Europe has made this figure appear relatively modest, with some suggesting China's slower price growth may help tame inflation elsewhere.

In rates markets, change has largely been focused at the front-end of the curve. After rising with the positive jobs data, the 10-year US Treasury yield lulled before picking up again later in the week. This was despite a small drop immediately following the announcement of flat month-on-month inflation. Credit markets have been quiet, with spreads tightening alongside moves in interest rate expectations.

Last Sunday, Senate Democrats celebrated passing their $700bn climate, healthcare and taxation package, known as the Inflation Reduction Act. Although the Act's ability to tame inflationary pressures has been questioned, it should bring the US much closer to Biden's goal of halving CO_2 emission from 2005 levels by 2030, if passed by Congress. With $369bn for climate and clean energy programmes, the package includes a methane penalty from

2024, a carbon capture and storage credit of $85 per tonne, $30bn for renewables and batteries, $27bn for clean energy projects in disadvantaged communities, and a tax credit of up to $7,500 for new clean vehicles.

Next week, key data releases include US retail sales and housing starts, UK unemployment and CPI inflation, eurozone HICP inflation and Chinese retail sales.

Movers

Equity	Current Level	WoW	YTD	YoY
MSCI DM	651	1.75%	-13.79%	-11.35%
MSCI EM	1,014	1.14%	-17.67%	-21.83%
S&P500	4,207	1.50%	-11.73%	-5.41%
FTSE 100	7,481	0.56%	1.31%	3.62%
Eurostox	3,763	1.01%	-12.46%	-10.54%
US Value vs Growth	--	0.99%	6.85%	8.43%
Government bond				
US 10 year Yield	2.88%	5.7	137.4	155.4
US 2 / 10 Spread	-0.34%	6.8	-110.9	-144.3
Germany 10 Year Yield	1.01%	5.1	118.3	147.0
UK 10 Year Yield	2.12%	7.2	115.0	155.0
Italy / Germany 10 Year Yield	2.07%	-0.1	71.8	103.6
Credit Spreads				
Barclays £ Corp TR Index	1.89%	-0.9	75.4	83.1
Eur High Yield Spread (XOVER)	4.72%	-47.1	229.8	235.1
US High Yield Spread (CDX HY)	4.41%	-22.8	148.2	151.1
EM $ Spread (CDX EM)	2.84%	-32.8	97.3	119.2
Currency				
USD Index	105.18	-1.35%	9.94%	13.19%
GBPUSD	1.2191	0.98%	-9.91%	-12.09%
GBPEUR	1.18	-0.21%	-0.52%	0.14%
EM FX Spot (JPM Index)	50.94	1.07%	-3.09%	-9.71%
Other				
Crude (1st Future)	99.85	5.19%	28.37%	39.77%
Vix index	20.34	-0.8	3.1	4.3
Treasury Vol index (SMOVE)	115.96	-8.9	37.5	50.2

Source: Bloomberg as at 08:30am on 12/08/2022

Outlook

Central banks continue to focus on bringing down the rate of inflation, attempting to navigate a slowdown in economic growth and avoid a recession. Medium term market pricing continues to suggest an expectation that inflation will eventually fall back, though markets are pricing in an increasing risk that this is at the cost of a contraction in output. The economic side effects of the war in Ukraine, and the supply chains scars caused by COVID-19, provide additional complexity and uncertainty in the calibration of monetary policy. The price of oil and industrial metals, although still elevated, have fallen back of late and we believe this reflects an increased probability of recession.

We continue to run a moderate equity overweight, with two thirds of it allocated to China. As noted in prior reports, increased optimism of a pullback in social restrictions, more positive macro data, and ongoing easing from the authorities leave us favouring this region. This is complemented by smaller overweight positions to US and UK equities. We retain a moderate overweight in Alternatives and Property, which can act as good diversifiers and offer inflation protection characteristics over the longer term. Where funds do not hold Alternatives or Property, we maintain a beta-adjusted exposure to equities instead. The overweight positions are funded by a Fixed Income underweight and, where possible, this is implemented using a diversified mix of UK/US/European Fixed Income.