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Weekly Market Flash

No shortage of surprises, or volatility, ahead

July 10, 2022

After last week's setback, markets continued their recovery from the lows reached in mid-June, led by the major stock markets – 4.55% for the Nasdaq index, 1.95% for the S&P 500 index, and 1.56% for the Eurostox index. At the same time, there was once again no shortage of tension and volatility (it now seems clear that the new regime for the Vix is between 20-30, versus the 10-20 range of the previous decade), with a very heavy selloff among commodities from oil to industrial materials to food commodities. This pushed the entire equity-value segment to correct heavily. In fact, the value sector of the S&P 500 index corrected 15.5% from the highs of the end of April to the lows of these days. The key reason for the correction is related to the explosion of recessionary fears in the US, which would be triggered by excessive tightening by the Federal Reserve (Fed). Consequently, between the end of last week and the start of the one just ended, we saw a series of movements in this direction – and some of them have significant implications for markets.

Highlights

- Inflation expectations in the US have plummeted. With the exception of this year, markets expect average inflation for the next five years to be below 2.50%.

- In the US, 372,000 jobs were created in June (above expectations of 265k and in line with the average of the last 12 months). The ISM service sector came out at 52.2, above expectations and in full expansion territory.

- Ahead of the Q2 earnings season, consensus expects Q2 S&P 500 EPS growth of just 6% YoY. While firms will likely clear this low bar, we expect cautious commentary, which could prompt cuts to forward estimates.

- Bitcoin is on course for its best weekly gain since March, helped by a return of risk appetite. Other tokens like Ether, Avalanche and Solana have also had a strong run in recent days.

- In credit market, spreads were still at levels that suggest market distress, with 157 bps in the US and 210 bps in EUR.

"This definitely seems like extreme pricing to us, in contrast to the now daily obsession with inflation."

Markets & Macro | No shortage of surprises, or volatility, ahead

Solid labor market amid a 'technical' recession.

Inflation expectations in the US have plummeted. With the exception of this year, markets expect average inflation for the next five years to be below 2.50%. This should then allow the Fed to cut rates as early as 2023, once the Fed Funds peak at 3.55% in the first half of the year, to then cut rates twice in the second half of the year for a total of 50 basis points (bps).

Our view: This definitely seems like extreme pricing to us, in contrast to the now daily obsession with inflation. We have to recognize that with a very aggressive Fed (in their rhetoric and their actions), it is respectable that investors start to believe in their restored anti-inflation credibility. However, the same cannot be said in Europe where the situation is much worse due to the energy dependency, and the multiple constraints on tightening from the European Central Bank, largely due to the fragility of the system.

The publication of two important data points for the economy (ISM services and labor market report), both of which came out solid, gives us food for thought on the state of the US economy. In the US, 372,000 jobs were created in June (above expectations of 265k and in line with the average of the last 12 months). The ISM service sector (which is much more important than manufacturing) came out at 52.2, above expectations and in full expansion territory.

“The strength of this data exposes us to a paradox: on the one hand, it is possible that the US economy is already "technically" in recession...”

The strength of this data exposes us to a paradox: on the one hand, it is possible that the US economy is already "technically" in recession (according to the definition that a recession occurs when two consecutive quarters see GDP contract). Already having the GDP figures for Q1 (-1.6%), and knowing that (the reliable) Atlanta Fed GDP nowcast indicator points to a 2.1% contraction for the just ended Q1, the math is soon done.

But on the other hand, we have to take two factors into account. First, the economy's most important indicator by definition, the labor market, is still very solid, although some early signs (such as jobless claims) have started to show weakness recently. But above all, we have to take into account the current high level of inflation. It is indeed more difficult for spending and nominal growth to exceed inflation when inflation is at 8.5% (since when we talk about GDP, we refer to real growth).

For the past 20 years, we were used to much more ordinary numbers, i.e. 2% growth and 2% average inflation over the business cycle, for 4% nominal growth, and ideal conditions for financial markets. With inflation at 9%, nominal growth at 8% (which is good for reducing the infamous debt excesses) automatically sends the economy into recession. But this does not mean, in our opinion, that the economy is collapsing and that the central bank should immediately stop raising rates, if not start cutting them soon.

Consequently, in our view, the heavy profit-taking movements on the commodity-related trade, with the related vertical falls in inflation expectations and the extraordinary recovery in bonds (the US 10-year fell from a high of 3.50% to a low of 2.80%), are technical and not structural in nature. We find it hard to believe that inflation can fall rapidly to levels acceptable to the Fed.

We refer in particular to the labor market issue (very strong, and with the usual theme of labor shortages), and to the fact that inflation is moving from the headline to the core, which by definition is more sticky, and difficult to eradicate. So, it will take time, but this is not necessarily a conspiracy for the market. We believe that the main variable that will drive markets in the coming weeks will be corporate earnings expectations, rather than macro variables. And with the earnings season just around the corner, there will be no shortage of surprises (and of course, volatility).

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Equities | Focus shifts to Q2 earnings season

Will cautious commentary prompt cuts?

The main equity indices finished higher this week. The Nasdaq index was up for five consecutive sessions, while the S&P 500 index was also up after closing its worst first half of the year since 1970 last week.

Overall, growth sectors outperformed value, with information technology, consumer discretionary and consumer services among the better groups, reversing the trend from the past week, while energy, materials and utilities were some of the laggards. Asian equities finished the week on a negative territory given downbeat Covid headlines.

“While firms will likely clear this low bar, we expect cautious commentary which could prompt cuts to forward estimates.”

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,338.15	0.82%	1.87%	-12.84%
S&P 500	3,899.38	1.98%	3.05%	-17.52%
Nasdaq	11,635.31	4.58%	5.52%	-25.31%
Euro Stoxx 50	3,506.55	1.76%	1.57%	-16.09%
Swiss Market	11,015.03	2.27%	2.55%	-12.13%
FTSE 100	7,196.24	0.46%	0.45%	-0.56%
CAC 40	6,033.13	1.84%	1.99%	-13.32%
DAX	13,015.23	1.58%	1.81%	-18.07%
FTSE MIB	21,774.18	1.96%	2.26%	-17.81%
Nikkei 225	26,517.19	2.24%	0.47%	-6.89%
Hang Seng	21,725.78	-0.11%	0.24%	-4.92%
CSI 300	4,428.78	-0.73%	-0.70%	-9.33%

Source: Bloomberg, as at July 8, 2022. Performance figures in indices' local currencies.

Our view: The focus has now shifted to the second quarter earnings season, as investors grapple with whether or not the US economy is headed into recession. Large banks will kick off half year results next week, providing key signals on consumer health in the specter of a slowing global economy. Overall, consensus expects Q2 S&P 500 EPS growth of just 6% year-on-year (YoY). While firms will likely clear this low bar, we expect cautious commentary which could prompt cuts to forward estimates.

Crypto & Blockchain | Crypto market inches back to USD1 trillion

Return of risk appetite supports currencies.

“Bitcoin is on course for its best weekly gain since March, helped by a return of risk appetite in global markets more broadly.”

As bankruptcy proceedings begin for Three Arrows, the non-fungible token (NFT) world has been awakened by the news flow on his NFT collection. At the height of last summer’s NFT mania, the hedge fund launched a fund dedicated to NFTs, called Starry Night Capital, that aimed to raise USD100 million – and that deployed USD21 million in blockbuster purchases.

The wallet is now estimated to be around USD4.2 million. The average value of an NFT is down 68% in the last three months to USD628. To underscore the data point, former Twitter CEO Jack Dorsey’s USD2.9 million first tweet is now worth just USD280.

Market action: Bitcoin is on course for its best weekly gain since March, helped by a return of risk appetite in global markets more broadly. Other tokens like Ether, Avalanche and Solana have also had a strong run in recent days, helping to take the overall market value of cryptocurrencies back close to USD1 trillion.

Fixed Income & Currencies | Spreads remain at distressed levels

Funding costs jump almost 12 bps.

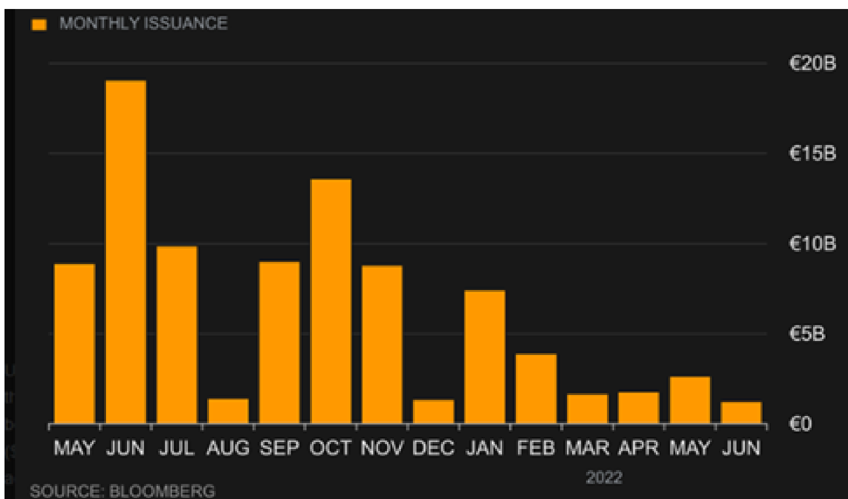
During the week, US and European investment grade corporate bond spreads stabilized somewhat. Recession fears helped soothe investors who were concerned about inflation and raised hopes of more rate cuts next year. Spreads were still at levels that suggest market distress, with 157 bps in the US and 210 bps in EUR, which is above the 150 bps threshold that investors see as a possible warning sign.

"While improving risk sentiment allowed issuers to come into the market, the concessions needed to get deals done were higher than average."

Our view: This small improvement was also confirmed in the primary market, where US investment grade corporate sales rebounded after a week-long hiatus. However, while improving risk sentiment allowed issuers to come into the market, the concessions needed to get deals done were higher than average. According to Bloomberg, funding costs – the premiums paid by companies to get deals done – so far climbed 11.8 bps on average versus 2 bps in 2021.

On the other hand, there was little life into the moribund US junk bond primary market, where June new issue was the slowest for the month since 2010. It was a similar situation for European junk bonds, which have fallen off a cliff since the start of 2022. The struggle to launch high yield deals is such that investment bankers in Europe are seeking anchor orders from private credit in pre-marketing, and then trying to launch a broader deal after.

Figure 2: US Junk Bond New Issuance



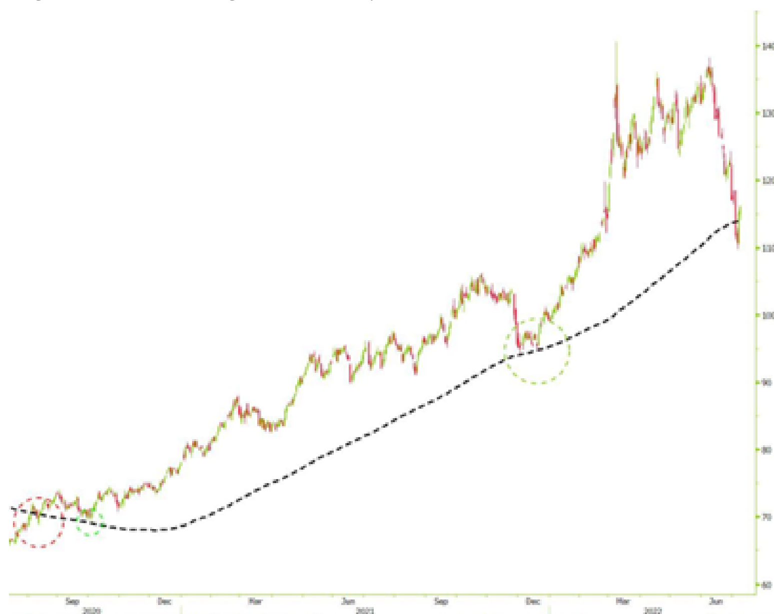
Source: Bloomberg, as at July 8, 2022.

"It was a similar situation for European junk bonds, which have fallen off a cliff since the start of 2022."

Chart of the week

The Bloomberg Commodity Index (BCOM) is testing the 200 Daily Moving Average. Historically, the close above this indicator is an important test for the previous bull trend.

Figure 3: Bloomberg Commodity Index



Source: Bloomberg, as at July 8, 2022.

Week Ahead | Key events to watch for

- **On the macro front, the US CPI for June** will be published (headline is expected at 8.8% YoY and core at 5.7% YoY). But also very important will be US retail sales, and Michigan's consumer confidence, which also contains inflation expectations for consumers.

- **Earnings season begins**, with banks kicking it off: JP Morgan, Morgan Stanley, and Citi, BlackRock, a bit of tech (TSMC) and consumer (PepsiCo and Delta).

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