

## Central banks move into 'pain mode'

Weekly Market Monitor, week 38, 2022



### Stories

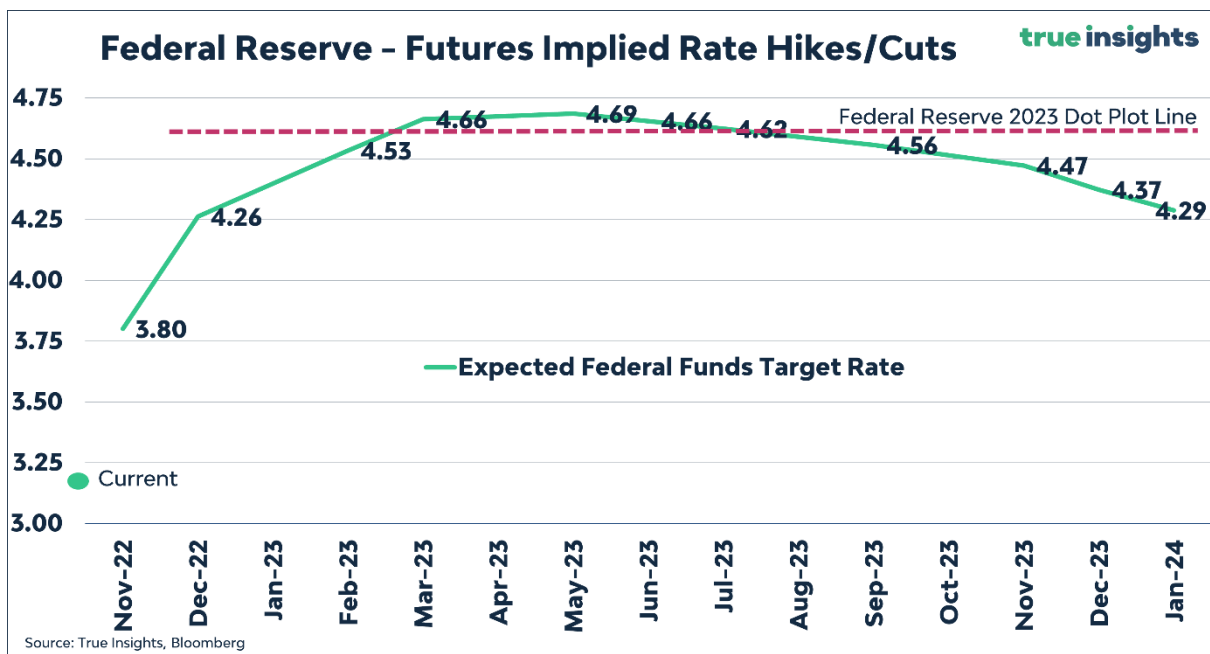
#### Macro

##### Boosting the dots

The Federal Reserve delivered on the dots, confirming it is very committed to getting inflation back to target. FOMC members expect the Fed Funds Target Rate to peak at 4.625% in 2023, up almost 100 basis points compared to the June Dot Plot. This means the Fed anticipates six more 0.25% rate hikes.



As the Fed aims to tighten even more aggressively, it also manages to restore credibility. Markets have fully embraced the new Dot Plot, with the Fed Futures suggesting the peak will be reached in February – March next year. The path to get there would be another 75 basis point hike in November, 50 basis points in December, and a final 25 basis points in February.



## Sacrificing the economy

The Federal Reserve's updated economic projections show just 0.2% GDP growth for 2022, a downward revision of 1.5% percentage points compared to the June projections. The 2023 GDP growth forecast was lowered by 0.5 percentage points to 1.2%.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2022

Percent															
Variable	Median <sup>1</sup>					Central Tendency <sup>2</sup>					Range <sup>3</sup>				
	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run
Change in real GDP	0.2	1.2	1.7	1.8	1.8	0.1-0.3	0.5-1.5	1.4-2.0	1.6-2.0	1.7-2.0	0.0-0.5	-0.3-1.9	1.0-2.6	1.4-2.4	1.6-2.2
June projection	1.7	1.7	1.9		1.8	1.5-1.9	1.3-2.0	1.5-2.0		1.8-2.0	1.0-2.0	0.8-2.5	1.0-2.2		1.6-2.2
Unemployment rate	3.8	4.4	4.4	4.3	4.0	3.8-3.9	4.1-4.5	4.0-4.6	4.0-4.5	3.8-4.3	3.7-4.0	3.7-5.0	3.7-4.7	3.7-4.6	3.5-4.5
June projection	3.7	3.9	4.1		4.0	3.6-3.8	3.8-4.1	3.9-4.1		3.5-4.2	3.2-4.0	3.2-4.5	3.2-4.3		3.5-4.3
PCE inflation	5.4	2.8	2.3	2.0	2.0	5.3-5.7	2.6-3.5	2.1-2.6	2.0-2.2	2.0	5.0-6.2	2.4-4.1	2.0-3.0	2.0-2.5	2.0
June projection	5.2	2.6	2.2		2.0	5.0-5.3	2.4-3.0	2.0-2.5		2.0	4.8-6.2	2.3-4.0	2.0-3.0		2.0
Core PCE inflation <sup>4</sup>	4.5	3.1	2.3	2.1		4.4-4.6	3.0-3.4	2.2-2.5	2.0-2.2		4.3-4.8	2.8-3.5	2.0-2.8	2.0-2.5	
June projection	4.3	2.7	2.3			4.2-4.5	2.5-3.2	2.1-2.5			4.1-5.0	2.5-3.5	2.0-2.8		
Memo: Projected appropriate policy path															
Federal funds rate	4.4	4.6	3.9	2.9	2.5	4.1-4.4	4.4-4.9	3.4-4.4	2.4-3.4	2.3-2.5	3.9-4.6	3.9-4.9	2.6-4.6	2.4-4.6	2.3-3.0
June projection	3.4	3.8	3.4		2.5	3.1-3.6	3.6-4.1	2.9-3.6		2.3-2.5	3.1-3.9	2.9-4.4	2.1-4.1		2.0-3.0

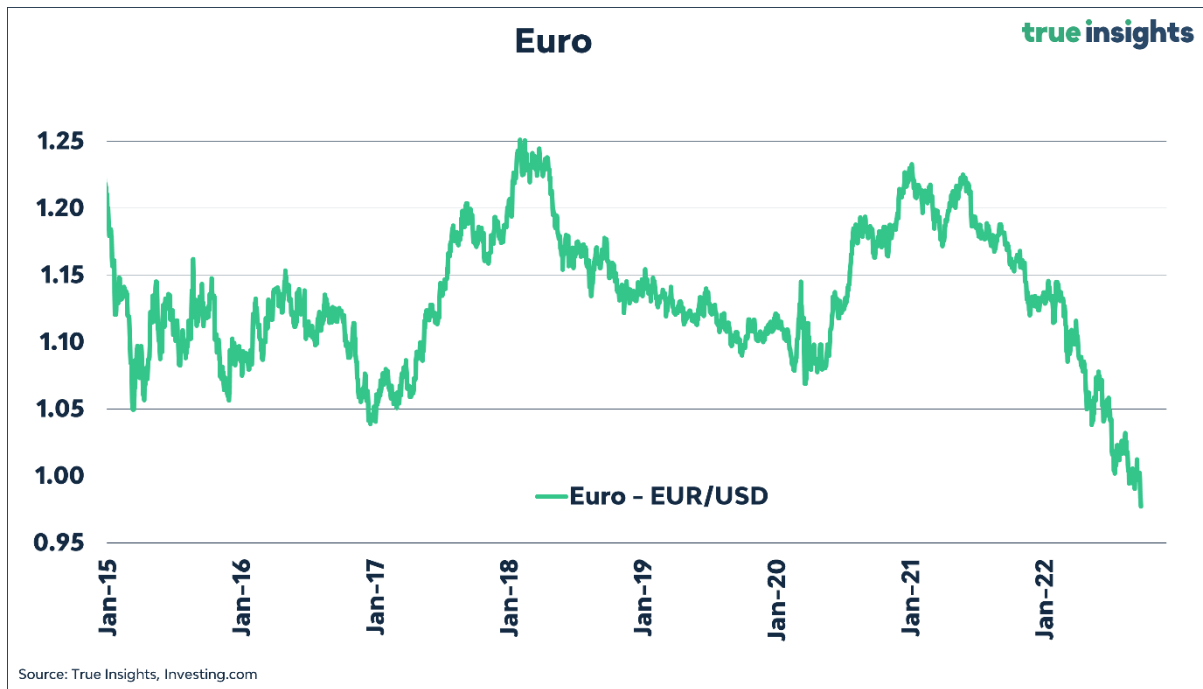
In addition, the Fed expects the unemployment rate to rise to 4.4% in 2023, which is 0.5% higher than the June projection.

Any hike from the current level of 3.25% brings the Fed further into restrictive territory. And since long-term yields also – somewhat disturbingly – continue to rise, the economic impact of this Fed hiking cycle gets more pronounced. The Fed has gone into 'pain mode.'

We don't think equity markets and high yield bonds are priced for this and remain underweight.

## The Euro has further to go

Since we initiated our short position, the Euro has depreciated a whopping 14% against the US dollar. Yet, markets expect the ECB to hike by more than 220 basis points between now and June next year. This means the ECB must continue hiking through a recession – and lower inflation that comes with it – which seems unlikely.

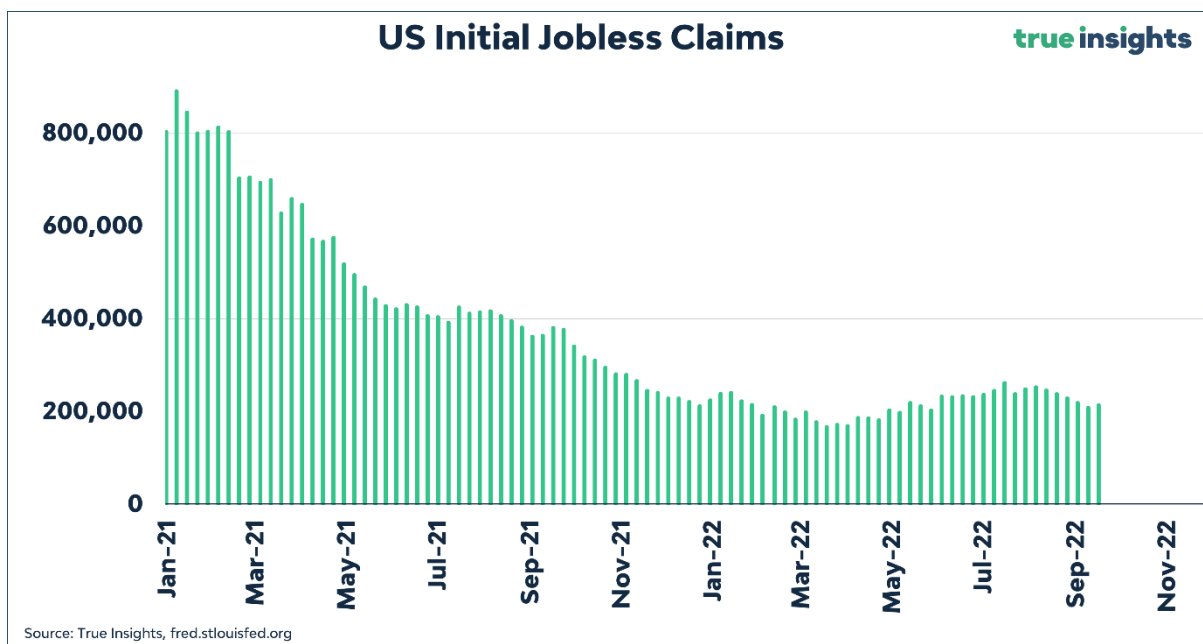


We think the Euro has further to fall against the US dollar.

### US labor market – zero signs of weakness

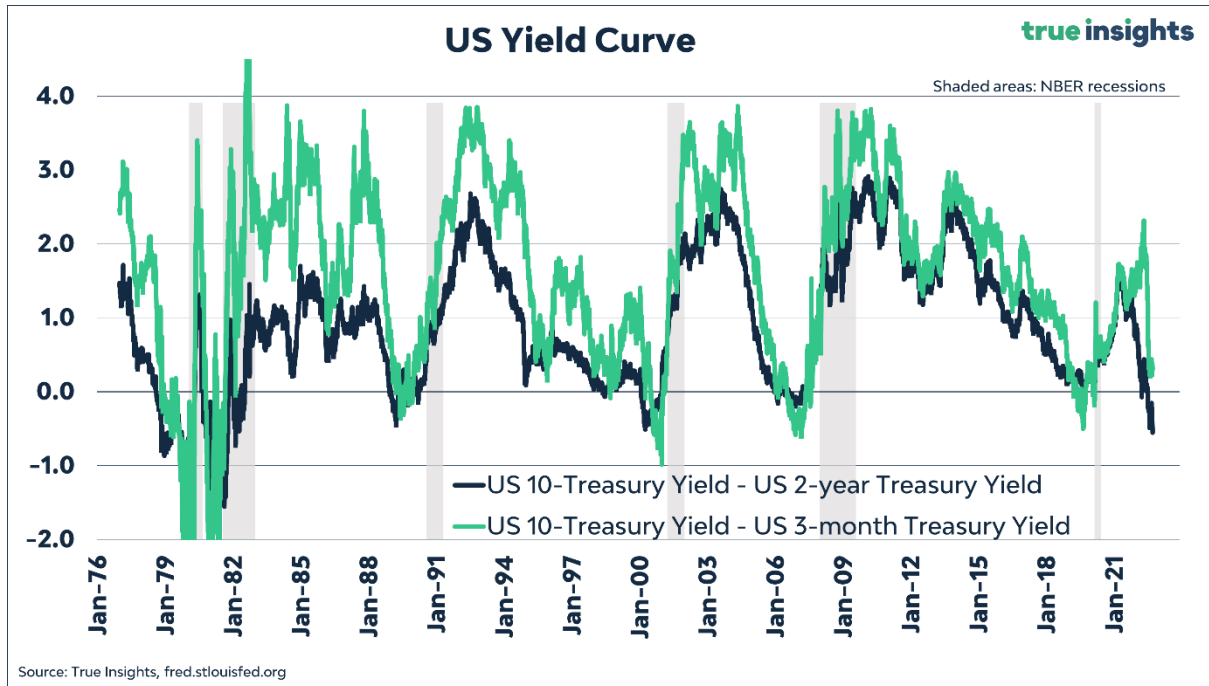
The latest Fed forecasts show a rising unemployment rate going forward.

But, so far, the labor market has shown zero signs of weakness. Initial jobless claims have dropped to close to 200K in recent weeks, which is very low from a historical perspective.



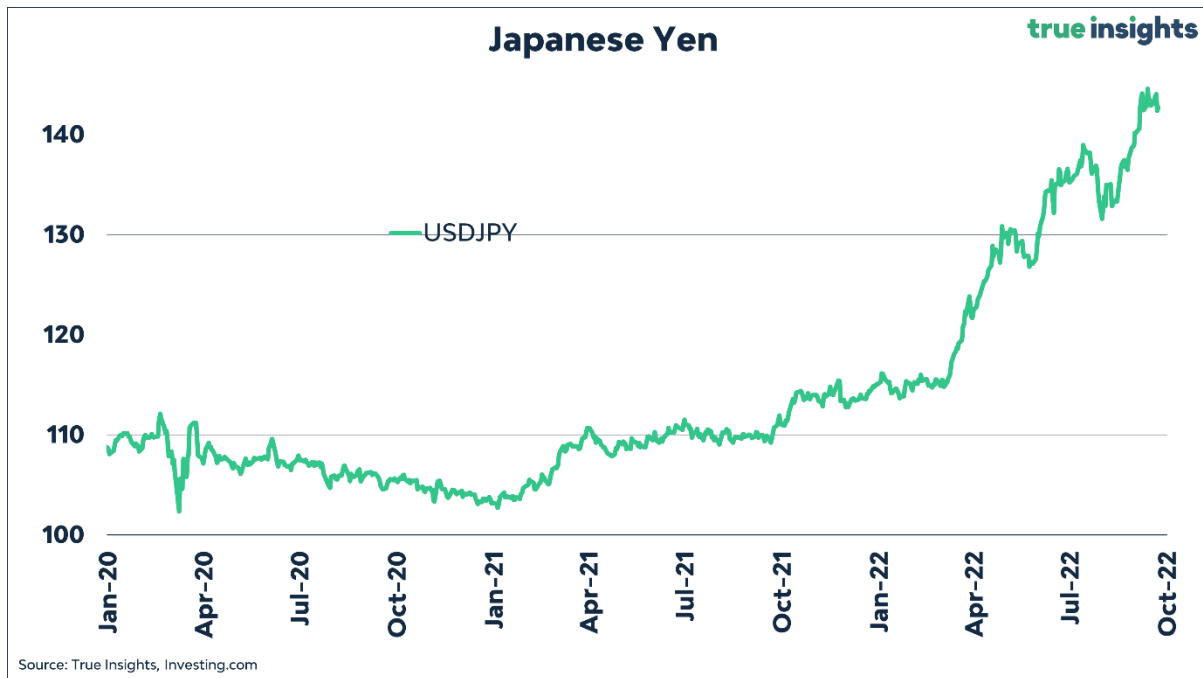
## Recession coming?

The implied recession probability derived from the 10-year – 2-year and 10-year – 3-month yield curves remains elevated at above 60% but is not rising. This is because the 10-year yield continues to implode higher. In fact, the 10-year – 3-month yield curve has steepened even as the 10-year – 2-year yield curve is now the most negative since the early 1980s.



## Bank of Japan – pushing itself against the wall.

The Bank of Japan remains one of the key outliers concerning monetary policy. The BoJ kept monetary policy unchanged, and Governor Kuroda emphasized that the Japanese economy – which has yet to fully recover from the COVID crisis – still needs support and that the central bank must continue easing. There will be no change in forward guidance, let alone a rate hike, anytime soon.

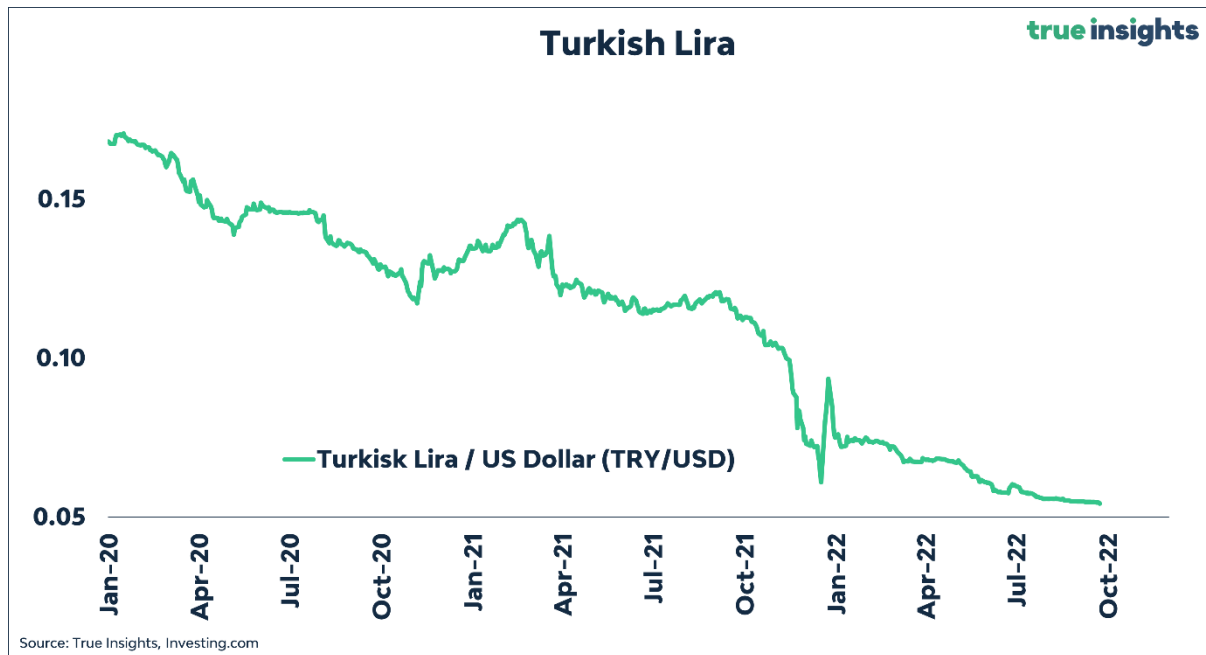


With the Federal Reserve pivoting toward even more tightening, the Japanese yen succumbed to the growing monetary policy divergence, falling to almost 146 against the US dollar. Shortly after Kuroda finished his speech, the Bank of Japan intervened. It was the first time since 1998 that the central bank went into the markets to support the yen. However, most of the time, this kind of currency intervention lasts only so long. The Bank of Japan needs to end yield curve control or increase rates to ignite a sustainable yen reversal. When that happens, expect the move to be huge, and we are ready to capitalize on it.

We keep our long yen / short euro position.

### And there's Türkiye

Turkish inflation is running at 80%, the highest level in 24 years. Most central banks are pondering just how much tightening is needed to kill inflation. So even though this was not the first time, the Turkish central bank shocked markets by unexpectedly lowering its key rate from 13% to 12%. Interestingly, the Turkish lira was virtually unchanged for the day, but we wouldn't dare touch it currently.

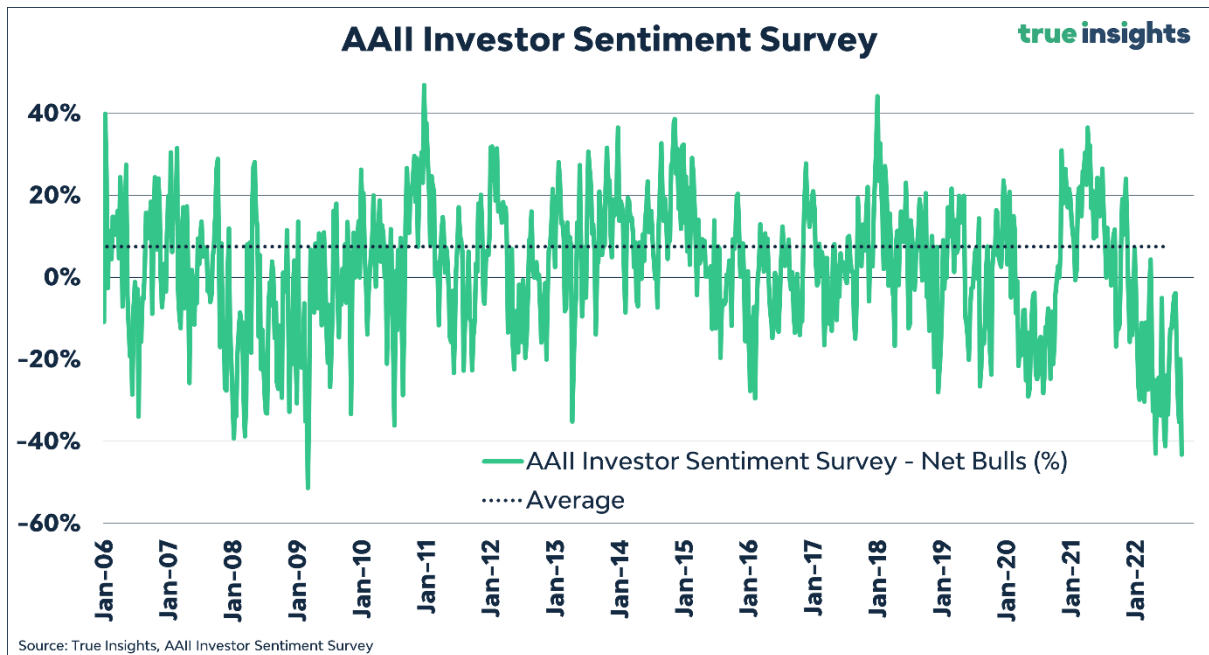


## The war

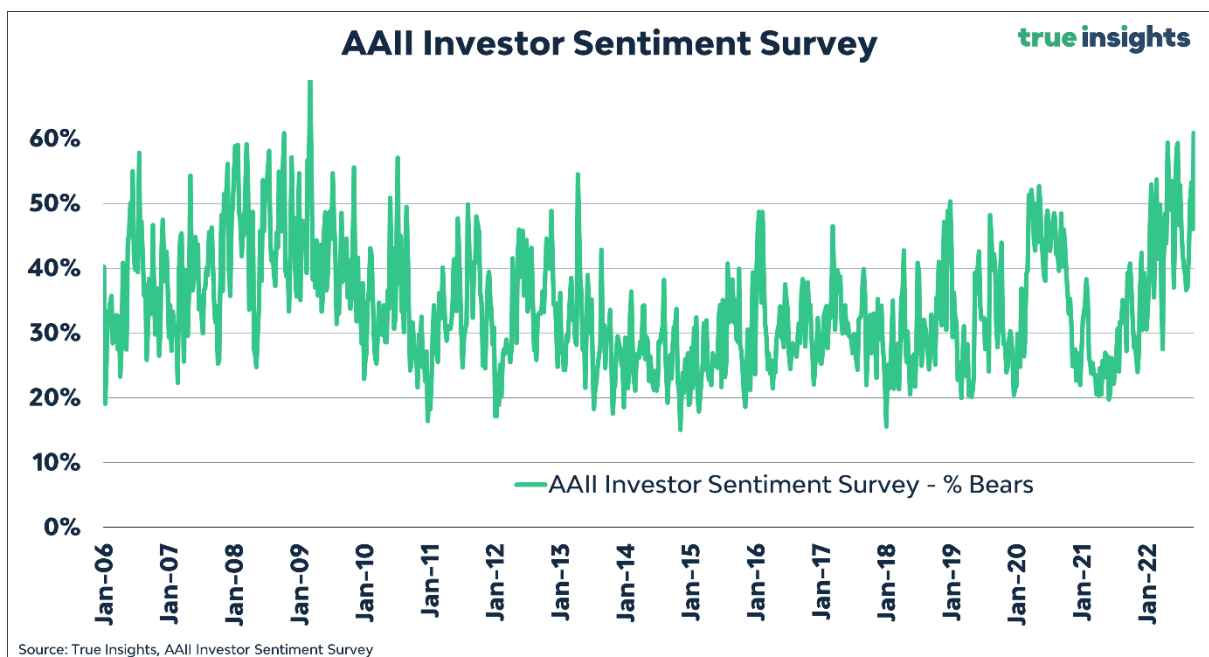
The impact of geopolitical events and tensions on financial markets and asset classes is hard to quantify. Especially those that are binary by nature. Putin has called up no less than 300,000 reservists to regain control of the Ukrainian war. We don't know how this war will progress or end. What we do know is that Putin has made this war extremely personal, meaning any Russian defeat will be his defeat. This increases the risk of 'erratic' behavior, which will be reflected in markets by a higher risk premium.

## Sentiment

If you only read Macro, your view will likely be extremely bearish. But markets are not driven exclusively by Macro (or central banks.) AAll Investor Sentiment has dropped to the lowest level since 2009.

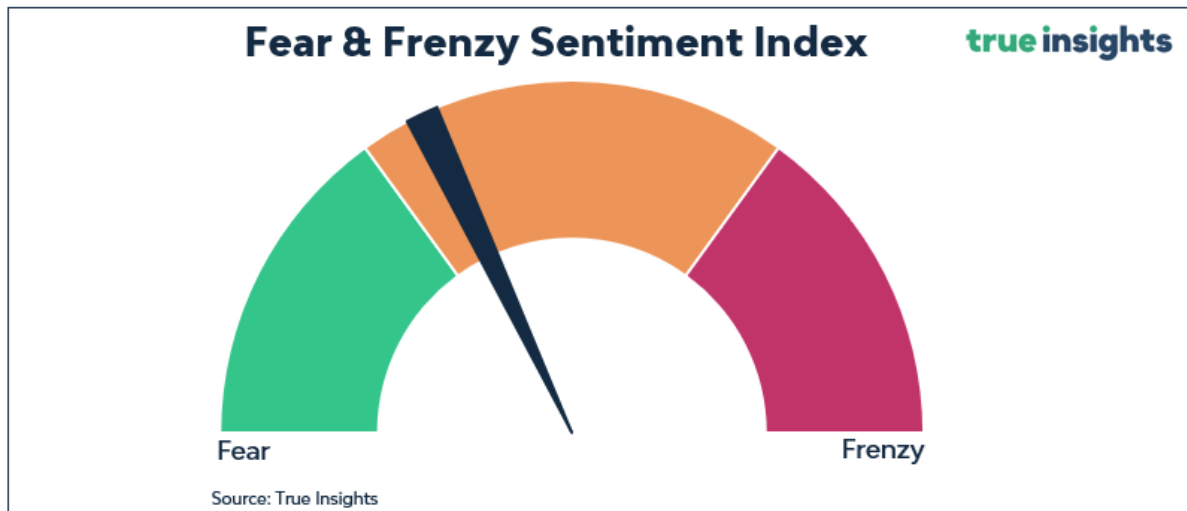


Retail sentiment is the strongest contrarian indicator within our Fear & Frenzy Sentiment Index framework. The latest survey showed that a whopping 61% of the respondents are now bearish, also the most since 2009.



Despite US retail investors being extremely bearish, our Fear & Frenzy Sentiment Index has not dropped into Fear territory. But it is awfully close. The % of S&P 500 Index companies trading above their 200-day moving average dropping below 20 (now at 24) and the Relative Strength Index falling below 30 (now 32) will do the job. This would give a contrarian signal.

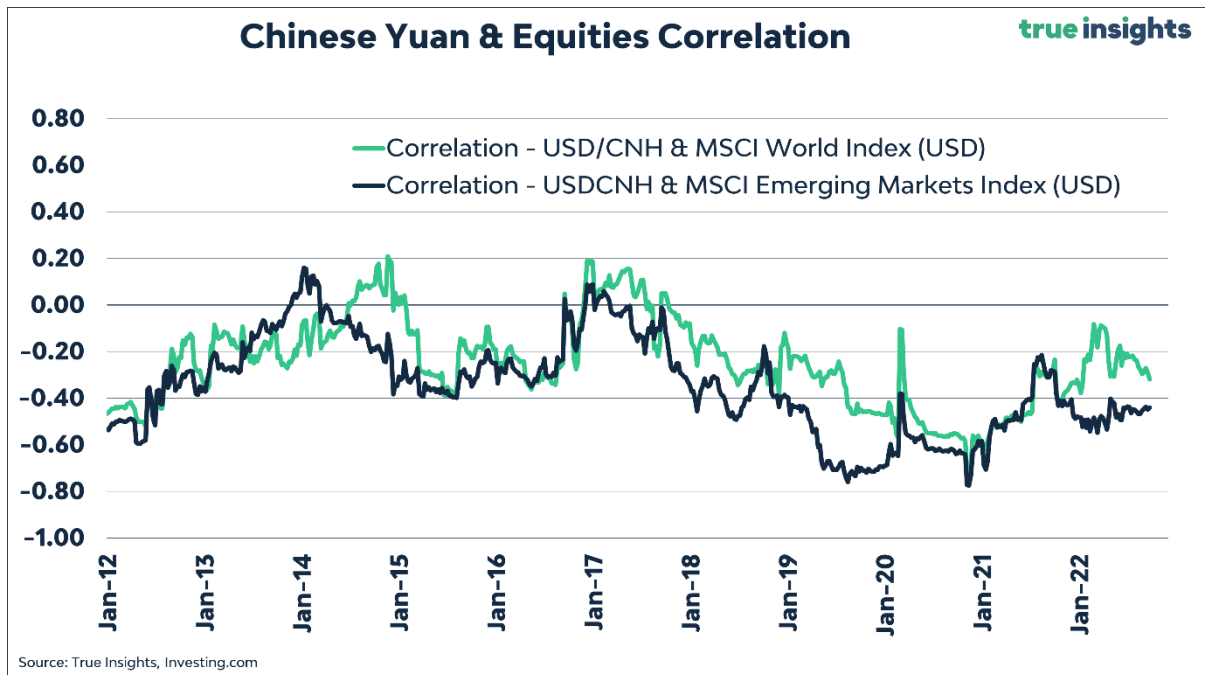




## Yuan

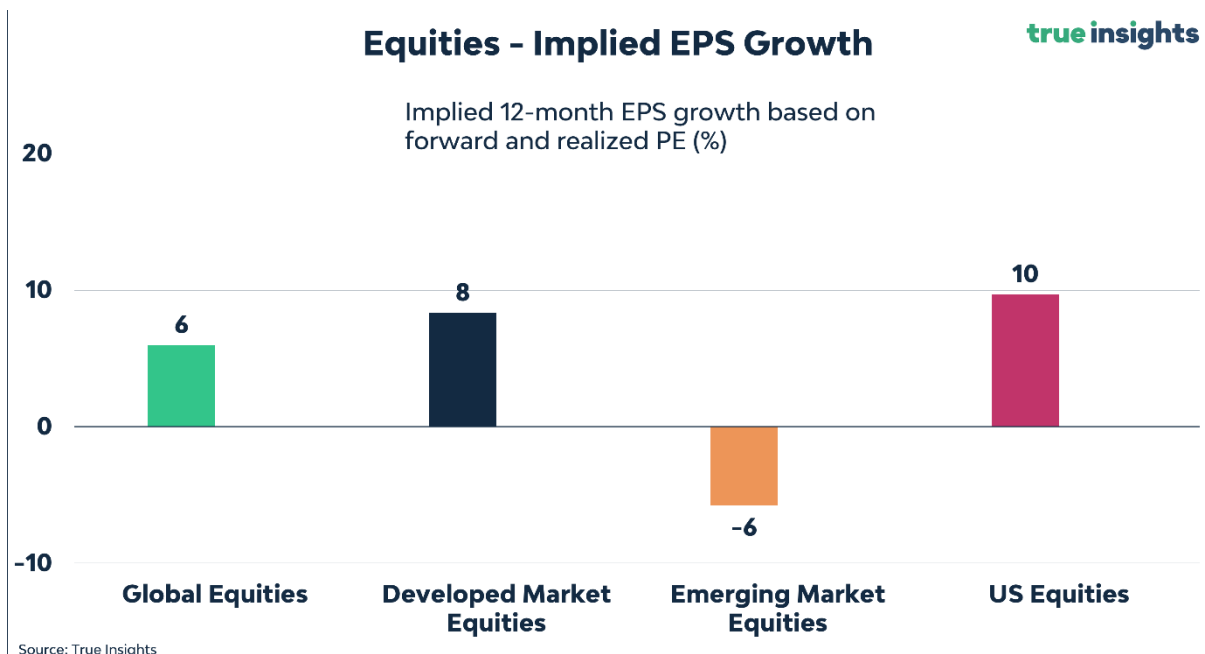


The Chinese Yuan has weakened significantly below the 7 threshold against the US dollar. This has a lot to do with dollar strength, but a lower Yuan means lower equities most of the time.



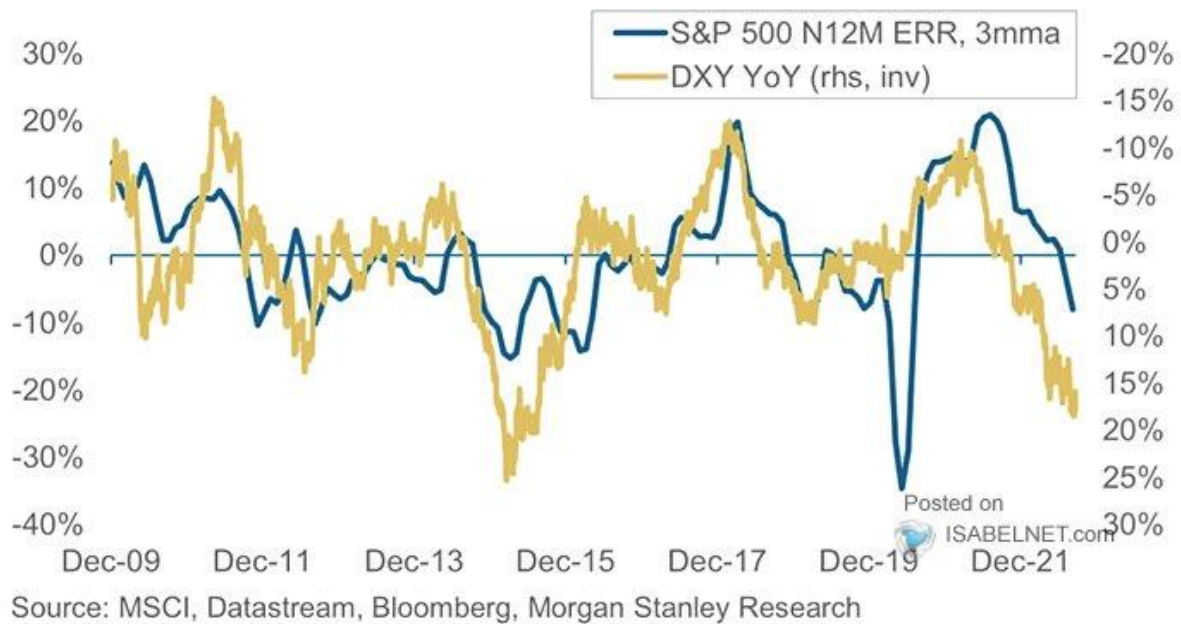
## Valuation

Expected earnings growth of US stocks remains stubbornly high. However, earnings-per-share tend to fall during every recession and major economic slowdown.



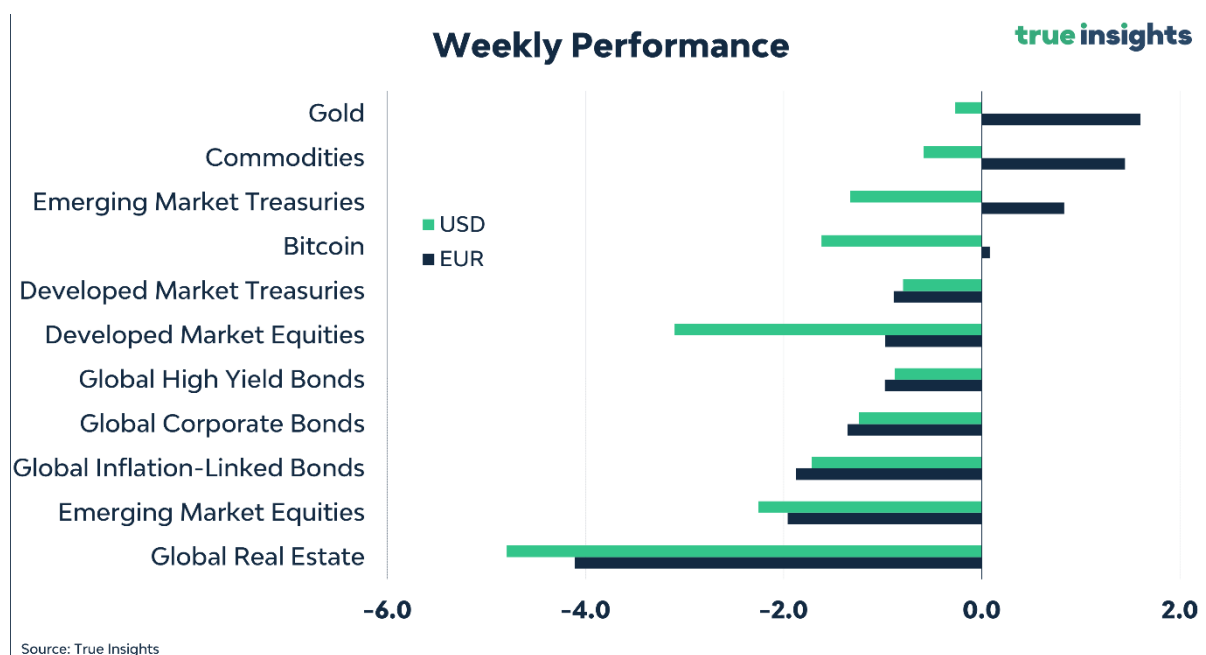
For US companies, the 16% rise in the US Dollar Index (DXY) means depressed earnings from abroad. Roughly 30% of S&P 500 Index earnings come from overseas. According to the Morgan Stanley chart below, earnings will be revised sharply in the coming quarters.

## Strong Dollar = Downward EPS Revisions



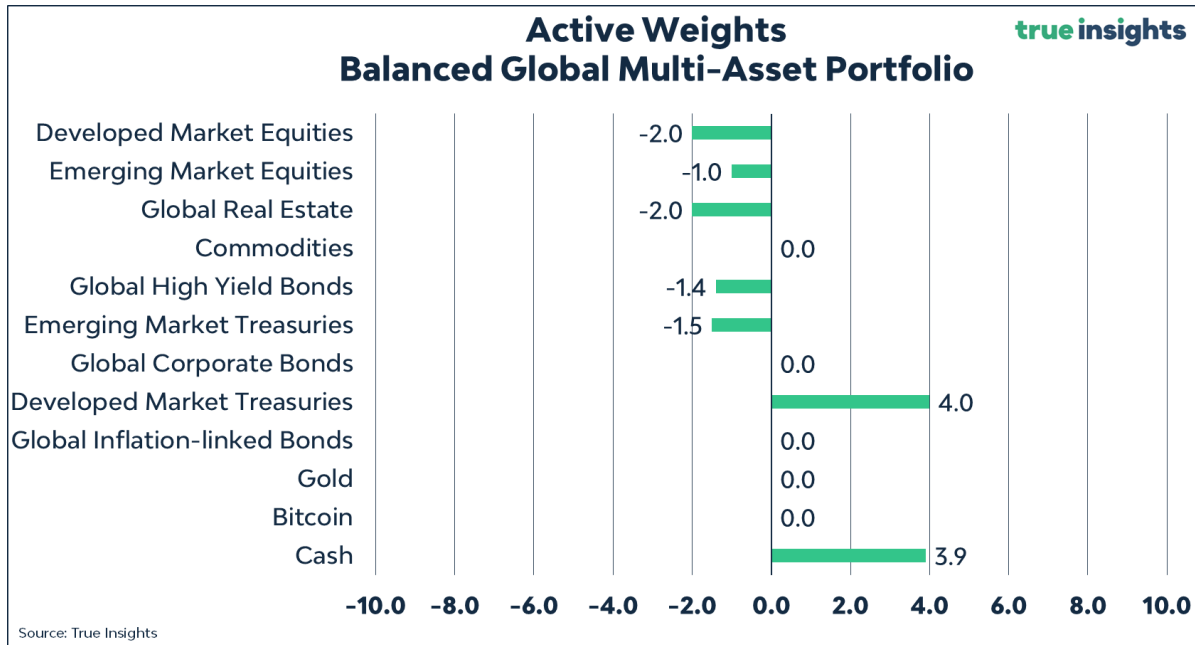
## Markets

Another bad week for risky assets, with Global Real Estate (short/underweight) and Emerging Market Equities (short/underweight) at the bottom of the ranking. The outspoken move in the US dollar, which made a fresh high against the Euro, impacts return data, but gold and commodities (both neutral) top the list.



Just like the previous week, it's no fun when markets go down, but our cautious positioning is clearly adding value. Cash is king.

## Active Weights



## Asset Class Views

### Developed Market Equities

We are underweight Developed Market Equities. Another negative surprise of US inflation numbers forced the Federal Reserve to adopt an even more aggressive policy. In addition, the Fed acknowledges it has to inflict pain on the economy to regain control over inflation. Sentiment is deteriorating, and our Fear & Frenzy Sentiment Index is just a whisker away from Fear. Earnings expectations are coming down but remain positive, which is too optimistic. Together with the elevated valuation of US equities, this provides ample downside. Valuation, especially outside the US, looks decent but not great.

### Emerging Market Equities

We remain underweight Emerging Market Equities. The ongoing decline in China's property sector has forced Chinese authorities to lower interest rates. Not only does this underpin the severity of the problem, but it also means renewed pressure on the Yuan. The People's Bank of China is intervening to halt the depreciation, but so far, with limited results. A weaker Yuan is bad for all risky assets, particularly emerging market assets.

Valuation is almost attractive and expected earnings growth is negative, but not enough to put a floor under the asset class just yet.

### **Global Real Estate**

We are also underweight in Global Real Estate. First, the (US) housing market is slowing faster than expected. This opens the door to a significant decline in house prices, which have gone parabolic in recent years. Second, the latest spike in yields means that the profitability of real estate projects, not just in housing, is decreasing. Third, valuation does not reflect this and remains demanding. Global Real Estate is the most expensive of all equity-related asset classes.

### **Global High Yield Bonds**

The story – and hence the underweight – for Global High Yield Bonds remains the same. Spreads reflect too little recession risk. During the recent turn in sentiment, spreads have hardly moved and lie far below the peak levels of July (680 basis points.) With bond yields rising across the globe, the likelihood of default should earnings go down, as we expect, is growing.

### **Global Corporate Bonds**

Spreads in Corporate Bonds remain closer to their July levels. Yet, based on current levels, Global Corporate Bonds, too, price little risk of a recession. We are neutral as we expect bond yields to go lower, not higher, from here. The relatively high duration makes them more attractive than Global High Yield Bonds. We are neutral.

### **Developed Market Treasuries**

There are many reasons – at least according to our framework – why Treasury yields should fall. Deteriorating economic momentum, the European energy crisis, investor positioning, and absolute and relative valuation suggest lower yields. Since we do not expect to migrate into a new 'yield regime' – also because of the renewed pressure on country debt-to-GDP ratios linked to the spike in energy prices – we stick to our overweight.

### **Emerging Market Treasuries**

We increase the underweight in Emerging Market Treasuries. First, the US dollar has been on a massive winning streak since Jackson Hole. We don't want to fight USD momentum right now. Second, valuation compared to high yield and corporate bonds is unattractive. Third, volatility outside equities is high, and we expect it to stay in the near term. Geopolitical, monetary policy, and China risks are all at play here.

## **Commodities**

We remain neutral on Commodities. The change in supply-demand dynamics is getting clearer. The economic slowdown reduces demand. For energy, rationing because of the crisis makes this worse. OPEC+, however, is keen on keeping oil prices relatively high. To emphasize this, it implemented a symbolic production cut of 100K. Based on our Macro leading indicators like the ISM Manufacturing Index and the Chinese Credit Impulse, downside risks for Commodities loom.

## **Global Inflation-Linked Bonds**

Markets are pricing out inflation risks quickly for both the short and longer term. However, with several indicators pointing to a significant decline in inflation levels in the not-so-distant future, we don't think now is a good time to go overweight inflation-linked bonds. The cyclical component of inflation will likely beat the secular component in the coming months and quarters. We remain neutral.

## **Gold**

We believe that gold will be one of the beneficiaries of structurally higher inflation combined with low bond yields to maintain debt sustainability. But just as for inflation-linked bonds, the cyclical component of inflation will likely be the primary driver in the coming months and quarters. In addition, real yields are rising again, and are negatively correlated with the price of gold. We are neutral.

## **Bitcoin**

Bitcoin offers an interesting long-term investment opportunity representing an insurance value against fiat debasement and financial repression. In addition, though its volatility remains high, so are its diversification benefits. However, Bitcoin will act as any other risk asset in the short term. This means price pressures may linger for longer. This may overshadow – at least in the near term – the ongoing financial integration and regulation.

