November 20, 2023

THIS WEEK

Inflationary Quirks

Last week's US consumer price index (CPI) data sparked an "everything rally" with Treasuries, corporate bonds and equities all strengthening together.

The headline CPI for October was unchanged month-on-month (MoM), for the first time since July last year, while the year-on-year (YoY) increase in prices slowed to 3.2%, 0.1pp below consensus expectations but still slightly higher than June's 31-month low of 3.0% YoY. There was more good news on core inflation, which strips out volatile food and energy prices – prices rose by only 0.2% MoM, the lowest level since February 2021, which took YoY core CPI to 4.0%.

A big part of the moderation in headline inflation came from energy prices, which dropped -2.5% MoM, removing -0.2pp from the total for the month. Overall, services costs rose 0.3% MoM, down from 0.6% in September, helped by slowing inflation in shelter costs, the single largest component in core CPI and which also rose by only 0.3% MoM in October.

However, investors should be alert to changes in calculation methodology – last month's major change concerned medical insurance costs. The statisticians now use a two-year moving average rather than the unsmoothed data it has relied on until now. Although this will improve data going forward, it did have a major impact in October – it meant that medical insurance costs are calculated to have fallen -34% last month, removing -0.2pp from the October total.

Furthermore, inflation expectations look like becoming entrenched. The latest Michigan consumer confidence data showed that both one-year and five to ten-year inflation expectations have bounced since September, from 3.2% to 4.4% for the former and from 2.8% to 3.2 % for the latter.

Bottom Line

According to Bloomberg's probability calculator, traders' expectations for a last rate hike have collapsed. Before the last Fed meeting on November 1st, they saw a 42% chance of a rate hike by next January – as of this morning, the probability has crumbled to only 2%. However, we would caution that entrenched expectations and statistical quirks like the medical insurance calculations could keep policymakers on the alert for lingering inflationary pressures.

Equities	Last	% 5D	% 1M	% YTD
MSCI World	2 985.19	2.9	3.3	14.7
S&P 500	4 514.02	2.2	3.2	17.6
Nasdaq Composite	14 125.48	2.4	4.4	35.0
Russell 2000	1 797.77	5.4	1.8	2.1
STOXX 600	455.82	2.8	1.3	7.3
Euro STOXX 50	4 340.77	3.4	4.5	14.4
SMI	10 737.37	1.7	-0.7	0.1
Topix	2 391.05	2.3	4.3	26.4
MSCI EM	976.52	3.0	2.7	2.1
China CSI 300	3 568.07	-0.5	-2.0	-7.8
VIX	13.80	-2.6	-22.8	-36.3
V2X	13.85	-13.7	-30.3	-33.7

Fixed Income	Last	5D bp	1M bp	YTD bp
US 2Y	4.89	-18	-32	46
US 10Y	4.44	-22	-40	56
German 2Y	2.96	-10	-28	20
German 10Y	2.59	-13	-29	2
Swiss 2Y	1.29	-2	6	8
Swiss 10Y	0.96	-12	-17	-62
USD IG Spread	120	-9	-14	-23
EUR IG Spread	126	-4	-12	-15
USD HY Spread	389	-3	-16	-80
EUR HY Spread	460	-6	-9	-52
EM Sovereign Spread	397	-7	57	3

Currencies	Last	% 5D	% 1M	% YTD
Dollar index	103.92	-1.8	-2.2	0.4
EURUSD	1.092	2.1	3.2	2.0
GBPUSD	1.246	1.9	2.3	3.1
USDJPY	149.63	-1.2	-0.1	14.1
EURCHF	0.966	0.2	1.5	-2.3
JPM EM FX Spot	47.89	1.3	2.8	-4.0
USDCNY	7.214	-1.0	-1.4	4.6

Commodities	Last	% 5D	% 1M	% YTD
GSCI Spot	556.75	-0.2	-5.9	-8.7
Brent Crude Oil	80.61	-1.0	-10.3	-6.2
Gold	1 980.82	2.1	3.0	8.6
Copper	8 267.00	2.9	3.7	-1.3
Bitcoin	36 418.61	-2.3	28.0	120.2

Source: Bloomberg, 17.11.2023

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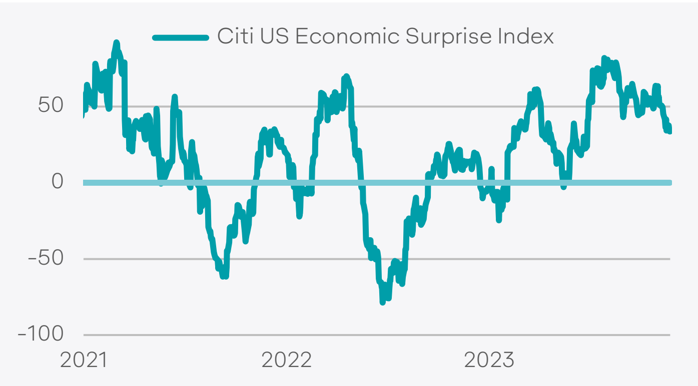
EQUITIES

Last week, the MSCI World index of global equity markets gained 2.9%, its third advance in a row. The recent jump has taken the index back above all its major daily moving averages (DMAs) and has broken the pattern of lower highs and lower lows which commenced in late July. Thanks to the rally, all the major DMAs are back in a rising pattern, an encouraging sign from a technical perspective. However, the speed of the rise – up a massive 9.3% in just over three weeks – means that a pause could be in order before traders begin to talk about a push above the highs for the year.

US . The S&P 500 index underperformed the global average with a 2.2% advance last week, taking gains for the last three weeks to a handsome 9.6%. Like the MSCI World, the S&P 500 has broken decisively out of its correction pattern turning all its main DMAs higher in the process. If a pause ensues, the 100-DMA which lies around -2.3% below Friday's close should provide some initial technical support.

As noted in our page 1 editorial, last week saw an "everything rally" with some catch-up by recent laggards. This has helped broaden participation in the market's advance – three weeks ago, only 24.6% of S&P500 members were trading above their 200-DMA – by the end of last week, the proportion had shot up to 54.5%. Over the week, the Russell 2000 small-cap index jumped 5.4%, taking it back into positive territory for the year to date while the Goldman Sachs index of Non-profitable Tech stocks soared 8.8%. The Russell 1000 Value index rose 2.8%, slightly outperforming its Growth counterpart, which still managed a creditable 2.1% advance for the week. Among large-cap tech-heavy indices, the Nasdaq Composite, NYSE FANG+ and Magnificent Seven indices all rose by 2.4% last week. At the sector level, all eleven sectors advanced for the week, led by Real Estate and Materials which rose 4.5% and 3.7% respectively while consumer staples and energy brought up the rear with gains of 0.5% and 0.9%.



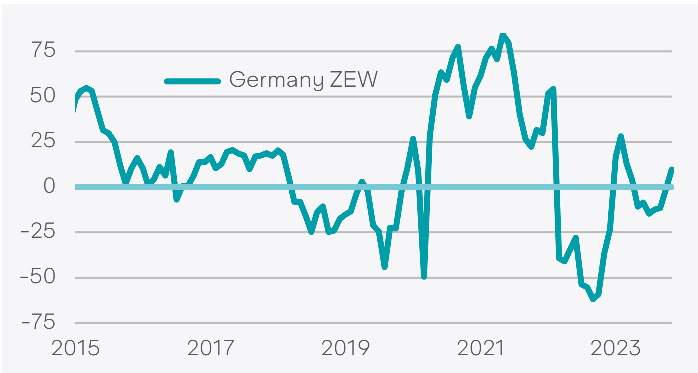
Source: Bloomberg

There was a weaker tone to last week's macro data and Citi's economic surprise index, although still positive, slipped to its lowest level since late June. Retail sales declined -0.1% in October after a 0.9% jump the previous month, pulled lower by weak auto sales. Industrial production also fell last month, down -0.6% MoM after a modest 0.1% increase in September – activity was depressed by the strikes in the auto industry where output fell -10% MoM. The National Federation of Independent Businesses' survey of small business optimism slipped to a six-month low in October while the National Association of Home Builders' November index hit its lowest level since January. One bright spot was provided by the new Speaker of the House of Representatives. Mike Johnson, who managed to push through a stopgap spending bill to avert government shutdown, with more support from opposition Democrats than from his own Republicans.

Europe . European equities outperformed the US for the first time in three weeks. The STOXX 600 (a pan-European index which covers the Eurozone as well as non-euro markets like the UK and Switzerland) rose 2.8% last week and the Euro STOXX 50 (which covers the largest companies in the Eurozone) jumped 3.4%, while the S&P500 gained only 0.3% in euro terms, due to a -2.1% drop in the dollar against the single currency. At the country level, the best performances were recorded by Sweden and Germany which rose 5.5% and 4.5% respectively – at the other end of the scale, Portugal gained only 0.5% as investors come to terms with Prime Minister Antonio Costa's resignation in the wake of a corruption scandal. Among sectors, the only weakness was in energy which shed -0.5% on the back of a -1.0% drop in Brent crude prices. Like in the US, the strongest sector was rate-sensitive real estate which jumped 6.1% on the week, followed by a 4.4% gain in industrials (all figures in EUR terms).

Thanks to its bounce last week, the STOXX 600 index closed marginally below its 200-DMA last Friday after breaking through its shorter DMAs in the preceding days. However, the technical picture does not look too promising with the main DMAs all still trending lower. It would take a more decisive break above the 200-DMA to break the recent pattern of lower highs and lower lows and put July's year-to-date high in traders' sights.

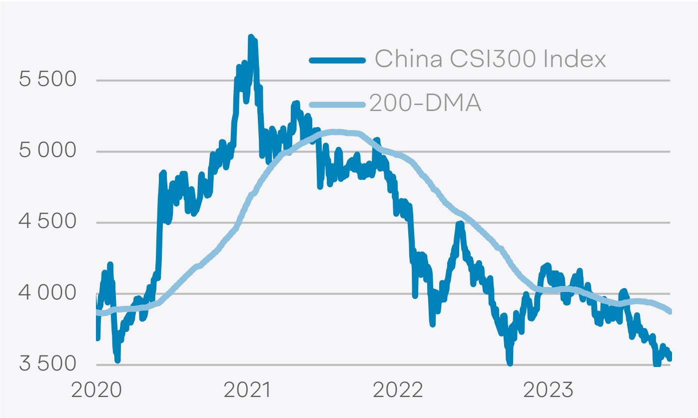
Last week's macro data reports from the eurozone were mixed. For example, industrial production dropped -1.1% MoM in September, a swift reversal after August's 0.6% advance – all main sectors saw falls apart from capital goods. On the other hand, the expectations component of ZEW's survey of German market economists rebounded to its highest level since March.



Source: Bloomberg

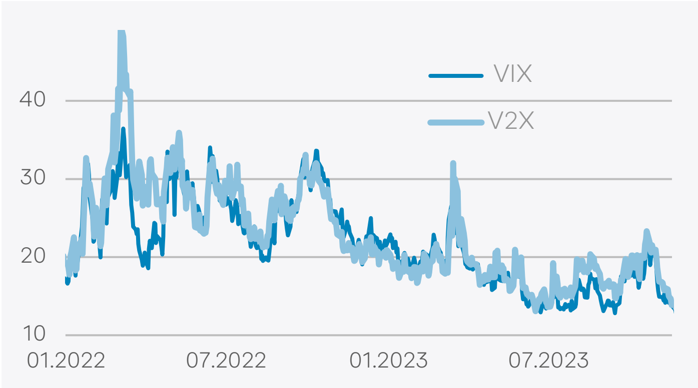
Asia . China's activity data for October came in ahead of expectations. Industrial production rose 4.6% YoY, up from 4.5% in September while retail sales jumped 7.6%, much better than the consensus forecast of 7.0% and well above September's 5.5%. However, there are still worrying pockets of weakness, most notably in the real estate sector. For example, new home prices fell -0.3% MoM in October, the fourth consecutive monthly fall. According to Reuters, "dozens" of cities saw falling new home prices, the most since the peak of last year's zero-Covid restrictions. It came as no surprise therefore to learn on Wednesday that China had pumped the equivalent of $200bn into the financial system via the medium-term lending facility – this is the biggest injection of cash since late 2016.

China's stimulus is having little impact on the country's stock markets so far – the CSI300 index of the leading stocks on the Shanghai and Shenzen exchanges shed -1.4% last week, the weakest performance in the region. The strongest performance was recorded by tech-heavy Taiwan which rose 2.9% - confidence was no doubt boosted by signs of détente between Presidents Biden and Xi at last week's Asia-Pacific Economic Cooperation summit in San Francisco. Overall, Asian emerging markets gained 0.8% last week, lagging Latin America and eastern Europe which jumped 2.5% and 3.7% respectively (all figures in euro terms).



Source: Bloomberg

Volatility . Implied volatility indices – also known as "fear" indices – measure the cost of option protection, which soars in times of trouble. In recent weeks, both the US VIX and Europe's V2X index have collapsed back towards their lows for the year. The VIX finished last week at 13.8 points, as did the V2X, down from October's highs of 21.7 and 23.3 respectively. This suggests a degree of investor complacency as we head into the end of the year.



Source: Bloomberg

Style factors . Value stocks outperformed Growth last week for the first time in three weeks. The MSCI World Growth index advanced 2.8%, while Value rose 3.1%. The weakest factor last week was Quality however, which gained 2.2%. For the year to date, Growth and Quality continue to lead the way, up 28.7% and 25.3% respectively, while Momentum and Value still lag having returned 6.8% and 1.8% respectively.

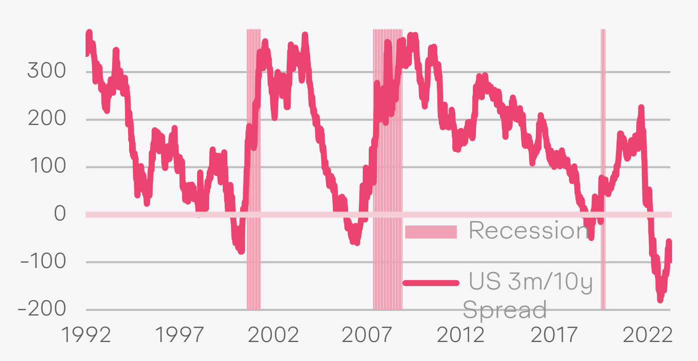
Bottom Line

In anticipation of a possible year-end rally, we have raised our equity exposure to the high end of the Neutral range.

FIXED INCOME

As highlighted on page 1, investors took heart from the US inflation data and pushed bond prices higher last week – the Bloomberg Global Aggregate Index, a proxy for diversified high quality bonds, rose 1.9%, its third gain in four weeks. This takes the index back into positive territory for the year to date, up 0.2%. The sharp rally from October's lows for the year has seen the index jump 4.2%, taking it above the 50 and 100-DMAs, both of which have begun to turn higher. The next resistance lies 0.5% above Friday's close at the 200-DMA – a weekly close above this level would take the index back into the sideways trading range which held sway between January and August.

US . Just two months ago, on September 20, traders were pricing in a 54% chance of a 25bp rate hike in Q4 according to Bloomberg's probability calculator. Today, that probability has completely disappeared. In the interim, traders concluded from the Fed meeting on November 1 that rate hikes were off the table, despite chair Jay Powell's protestations to the contrary. Powell acknowledged that tightening financial conditions in October had done some of the Fed's work for them. But the rapid easing since the start of the month has taken conditions in the complete opposite direction. Ten-year (10y) Treasury yields have slumped from 5.0% a month ago to 4.44% at the end of last week. Moreover, credit spreads have tightened, and the dollar has lost ground against its main trading partners, further adding to the easing in conditions. In addition, the conviction that inflationary risks are now behind us (see page 1) has further reinforced market optimism.



Source: Bloomberg

Turning to the US yield curve, it is striking to note that its inversions (i.e., when long yields are well below short-term rates) have widened since late October as long yields have fallen quicker than short rates. 2y yields are down from 5.22% a month ago to 4.89% on Friday. This leaves the 2y10y inverted by -45bp, down from -16bp at end-October, but we are still a long way from the 42-year record inversion at -111bp we reached in July. At the very short end of the curve, 3m rates are little changed at 5.39%. down from October's 5.51% high. This means that the 3m10y curve is now at -95bp, a very rapid widening after October's peak at -50bp but still a long way above early May's all-time record inversion at -180bp. However, this volatility in the curves does not mean that the all-clear has sounded. As shown on the chart, recessions in the US tend to occur when yield curves have begun to flatten after deep inversions. Today's yield curve may be telling us that a hawkish Fed may end up pushing the economy into recession in its efforts to quash inflation.

Europe . Like in the US, rate hike expectations have also crumbled in the Eurozone, despite some hawkish talk from European Central Bank (ECB) officials. Immediately after the ECB's last 25bp hike on September 14th, Bloomberg's probability calculator estimated a 45% chance of another hike before the end of this year. As of Friday, that probability had disappeared completely with traders now showing a 1.3% chance of a rate cut at the next policy meeting on December 14th. As in the US, 3m German rates have fallen much more slowly than 10y Bund yields, which has of course accentuated the inversion of the German yield curve. The 3m10y spread reached -113bp at the end of last week, a steeper inversion than in the US and tantalisingly close to the record -119bp we saw in mid-September.

On the macro front, one of the few data reports last week was the final October CPI for the Eurozone. This showed headline prices rising 2.9% YoY in October, the slowest advance since June 2021. Core CPI has also begun to decline hitting 4.2% last month, down from the Eurozone's all-time high which was recorded in March this year at 5.7%.

After reaching a low for the year at 156bp, the yield spread between 10y Italian BTPs and German Bunds ground steadily higher to reach 218bp in mid-October, the highest level since January. Since then, the spread has tightened rapidly reaching 177bp last Friday, an indication that risk appetite has returned to markets that investor concerns about the sustainability of Italy's debt levels are back in abeyance.

Credit markets . The return of risk appetite has also boosted interest in corporate bonds, helping corporate credit spreads (the difference in yields versus sovereign bonds) to tighten across the board last week. Investment grade spreads (at the higher quality end of the credit spectrum) fell by -9bp in dollars to reach the tightest level since April 2022. In euros, IG spreads fell by -4bp to 126bp, just above February's 118bp low for the year. At the weaker end of the credit spectrum, high yield spreads tightened -3bp in USD and -6bp in EUR. At Friday's levels of 389bp in dollars and 460bp in euros, high yield spreads are well down from their end-October highs of 438bp and 495bp respectively, which suggests that any lingering concerns about credit risk are beginning to fade.

Bottom Line

We continue to build a position in US duration (i.e., sensitivity to changes in rates) via an ETF of 7-10 year maturity Treasuries. This provides a hedge against a weaker economy triggering a reversal in monetary policy.

CURRENCIES

The dollar index – which measures its value against its six major trading partners among advanced economies – dropped -1.8% last week, its second decline in the past three weeks. Since reaching its high for the year in early October, the index has lost -2.9% dipping below both the 50 and 100-DMAs. This modest correction has broken the previous pattern of higher highs and higher lows, which puts the emerging bull trend on hold for now. The index is now sitting just 0.3% above its 200-DMA, which may provide some support. If that level breaks decisively however, a resumption of the bear trend which commenced in October last year could be on the cards.

EUR . The euro jumped 2.1% against the US dollar last week, its second weekly advance in three. The rally from the early-October lows around the critical support level at 1.05/1.06 has improved the technical picture. The cross-rate is back above all its major DMAs and the 50-DMA has begun to track higher. The 100 and 200-DMAs both lie around -1.1% below Friday's close and should offer some support if we run into a bout of profit-taking.

GBP . Sterling rose 1.9% against the US dollar last week, the second gain it the last three weeks. Growth remains sluggish – October's retail sales fell -0.3% MoM against expectations for a 0.4% increase. The recent rally has pulled the spot-rate just above the 200-DMA, which has stabilised trading after the sharp falls between July and October. However, the main DMAs are still trending lower so further gains will be necessary before the technical picture begins to improve.

CNY . The People's Bank of China's efforts to prop up the renminbi appear to be working. After holding its mid-rate against the US dollar virtually unchanged for two months, the PBoC finally started to adjust it higher this morning. China operates a "managed float" for its currency which is allowed to float in a +/-2.0% band around the mid-point daily fixing. The spot rate's discount to the fixing had remained uncomfortably high around -1.7% in recent weeks, perilously close to the bottom of the trading band. However, last week's 1.0% rally against the dollar narrowed the discount to -0.7%, emboldening the central bank to start a gradual move to strengthen the renminbi.

JPY . Last Monday, the yen recorded a new 33-year low against the dollar before staging a 1.3% rally, taking advantage of the dollar's broad-based weakness. However, the technical picture still looks weak – the spot-rate sits below all the main DMAs, each of which is trending lower. Nonetheless, traders should be wary of intervention by the Japanese authorities. Last year, the Ministry of Finance was successful in sparking a 17.4% rally – it might pay to be prepared for a rerun.

COMMODITIES

GSCI . After the previous week's sharp -3.4% fall, the GSCI spot commodity index fell another -0.2% last week, the fourth decline in a row. The weakness was concentrated in energy which shed -0.9% while industrial and precious metals gained 1.2% and 3.0% respectively. The spot index remains well below all its main DMAs, which continue to trend lower – hardly a promising setup in technical terms. However, the May and June lows which lie around -5.2% below Friday's close could provide some much-needed support.

Energy . After a massive 27.3% jump in Q3, Brent crude oil prices have been under pressure, tumbling -15.4% since the start of October. The last four weeks have all seen losses including last week's -1.0%. The spot price is now back below all major DMAs and a retest of June's lows around \$72/\$73 per barrel (/b) cannot be ruled out.

The outlook for crude prices will depend on a variety of factors. Will US GDP growth be as strong as the 2.0% forecast by the Atlanta Fed GDPNow model, or will it be as weak as suggested by the inverted yield curves? Will OPEC+ output cuts win out over the rise of supply from other sources? Over the past six weeks for example, US crude oil production has remained stable at its all-time high of 13.2 mb/d, 0.1mb/d above the previous record in March 2020. Moreover, the US is edging closer to easing sanctions on Venezuela, which controls the world's largest proven oil reserves, and which currently produces around -2.5mb/d less than its historic peak output. This coming Sunday, the OPEC+ cartel will hold its regular meeting in Vienna, which will be eagerly anticipated given that its massive output cuts have not proved successful in stabilising oil prices thus far.

After soaring 41.2% during the second week in October, European natural gas prices have fallen for the past five straight weeks, including last week's -3.4% decline. This leaves prices still down -41.0% since the start of the year and takes the spot price back to the top of the wide trading range between €25 and €45 per megawatt/hour which has prevailed most of the time since last spring. The price remains above the main DMAs and the 100-DMA is set to break above the 200 for the first time since last winter.

Metals . Industrial metal prices were mixed last week. Copper and iron ore, the two outperformers since the start of this year, rose 2.9% and 2.5% respectively. The weakest metal was again nickel which shed -2.0% last week, taking year-to-date losses to -43.7%.

Gold prices rose 2.1% last week taking year-to-date returns to 8.6%. Spot prices have been trading above the 200-DMA since mid-October and both the 50 and 100-DMAs look set to break above the 200-DMA in coming weeks. This technical pattern is known as a "golden cross" and generally considered a harbinger of further upside. Since 2020, gold prices have made three attempts to break above \$2050 per ounce. With bullion closing last week at \$1980, another attempt could be on the cards.

AGENDA

Monday November 20th . Germany October producer price index (PPI). **China** People's Bank of China sets loan prime rates.

Tuesday November 21st . US October Chicago Fed national index, existing home sales, publication of minutes of last Fed meeting. **France** October retail sales.

Wednesday November 22nd . US October durable goods orders. November final University of Michigan consumer sentiment survey. **Eurozone** November flash consumer confidence survey. **UK** Chancellor presents autumn budget statement.

Thursday November 23rd . Purchasing Manager Indices (PMI) flash surveys for manufacturing, services and composite for Eurozone and UK. **US** Markets closed for Thanksgiving. **France** November manufacturing confidence survey.

Friday November 24th . PMI flash surveys for manufacturing, services and composite for US and Japan. **US** Markets close early for Black Friday. **Germany** November IFO business climate survey, Q3 GDP final estimate. **UK** November GfK consumer confidence survey. **Japan** October national consumer price index (CPI).