October 16, 2023

THIS WEEK

CPI Anniversary

Almost exactly twelve months ago, on October 12th 2022, the S&P500 index of the leading US companies hit its low for the cycle, since when it has rallied 21.0%. One of the factors driving the rebound was the growing realisation that headline inflation might be headed lower.

The very next day, October 13th, saw the release of the US consumer price index (CPI) for September. Headline inflation for the month was up 8.2%, not too far from June 2022's cycle peak at 9.1%, but investors took heart from the recent trend in month-on-month (MoM) changes in prices. In Q2, prices had risen at an annualised rate of 10.5% but in Q3 this had fallen to only 2.4%. Although the inflation battle was not yet won, this represented a chink of light at the end of a long tunnel.

One year later, the September 2023 CPI report was published last week showing headline inflation at 3.7% and core inflation at 4.1%, both well above the Federal Reserve's (Fed) 2.0% target. Moreover, headline CPI rose at an annualised 4.1% over Q3, which marks a sizeable acceleration versus the same period last year. In addition, certain components of core inflation are showing signs of gaining momentum – for example, services ex-housing saw prices increase by 0.6% MoM in September, up from 0.0% in June and the highest level in a year.

Furthermore, households still seem worried about the inflation outlook. The New York Fed's survey of consumers shows a pick-up in three-year ahead inflation expectations in September from 2.8% to 3.0%, the highest since last November. And the University of Michigan October consumer confidence showed a bounce in both one-year and five to ten-year inflation expectations, the former from 3.2% to 3.8% and the latter from 2.8% to 3.0%.

Bottom Line

Given recent robust macro data and the stickiness in both CPI and inflation expectations, further Fed tightening would not seem outlandish. However, traders have become convinced of the contrary. According to Bloomberg's probability calculator, they only see an 8% chance of a rate hike in November, down from 31% last week, and they still anticipate around three 25bp rate cuts next year.

Equities	Last	% 5D	% 1M	% YTD
MSCI World	2 862.14	0.6	-3.2	10.0
S&P 500	4 327.78	0.4	-3.1	12.7
Nasdaq Composite	13 407.23	-0.2	-2.9	28.1
Russell 2000	1 719.71	-1.5	-6.6	-2.4
STOXX 600	449.18	1.0	-1.0	5.7
Euro STOXX 50	4 136.12	-0.2	-2.1	9.0
SMI	10 900.30	0.6	-0.7	1.6
Topix	2 308.75	2.0	-2.9	22.0
MSCI EM	951.31	1.5	-2.4	-0.5
China CSI 300	3 663.41	-0.7	-2.0	-5.4
VIX	19.32	10.7	43.3	-10.8
V2X	20.18	8.2	22.3	-3.4

Fixed Income	Last	5D bp	1M bp	YTD bp
US 2Y	5.05	-3	8	63
US 10Y	4.61	-19	36	74
German 2Y	3.14	1	-3	38
German 10Y	2.74	-15	9	17
Swiss 2Y	1.24	1	-1	2
Swiss 10Y	1.07	-9	3	-51
USD IG Spread	133	-2	3	-10
EUR IG Spread	138	-1	9	-2
USD HY Spread	412	-10	38	-57
EUR HY Spread	471	-4	32	-41
EM Sovereign Spread	346	-61	-35	-48

Currencies	Last	% 5D	% 1M	% YTD
Dollar index	106.65	0.6	1.8	3.0
EURUSD	1.051	-0.7	-2.1	-1.8
GBPUSD	1.214	-0.8	-2.8	0.5
USDJPY	149.57	0.2	1.4	14.1
EURCHF	0.948	-1.6	-1.1	-4.2
JPM EM FX Spot	46.40	0.2	-2.6	-7.0
USDCNY	7.305	0.1	0.5	5.9

Commodities	Last	% 5D	% 1M	% YTD
GSCI Spot	595.85	3.5	-2.8	-2.3
Brent Crude Oil	90.89	7.5	-1.1	5.8
Gold	1 932.82	5.4	1.3	6.0
Copper	7 949.00	-1.2	-5.6	-5.1
Bitcoin	26 976.51	-3.6	2.9	63.1

Source: Bloomberg, 13.10.2023

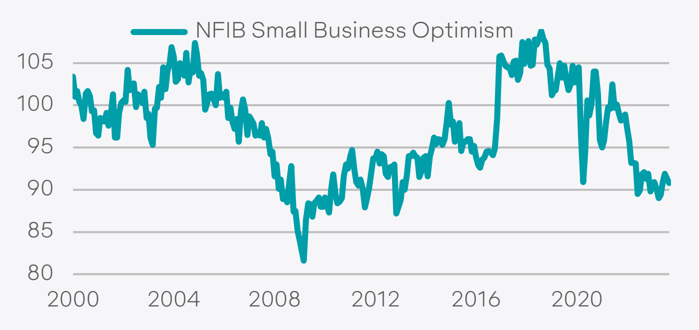
EQUITIES

Last week, the MSCI World index of global equity markets rose 0.6%, its first advance in four weeks. The index closed last week just above the 200-day moving average (DMA), which is rising steadily, and -2.0% below the 50-DMA, which has turned lower since the index hit a 15-month high in late July. A continuation of the rally back above the 50 and 100-DMAs would be necessary to avoid any further chart damage and to open the door to new cycle highs.

US . The S&P 500 index underperformed the global average with a 0.4% advance last week, its second consecutive gain. The index continues to trade between the 100- and 200-DMAs, both of which continue to rise. The 50-DMA is declining however and now sits just above the 100-DMA. We continue to expect further consolidation in the S&P 500 until we get a clear idea of Q3 earnings trends and the outlook for 2024.

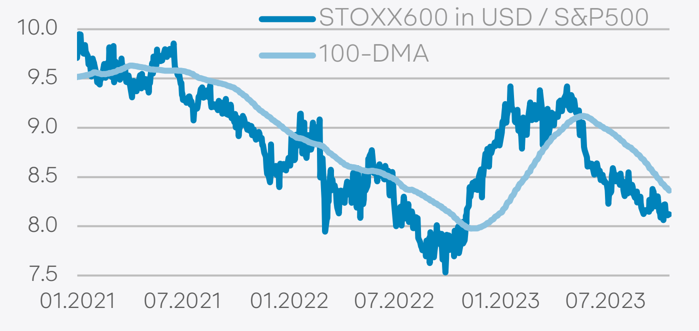
As noted in previous commentaries, Value stocks tend to do better than Growth when long-dated bond yields are rising, but that relationship appears to have held no sway last week. Treasuries rallied last week on safe-haven buying on the back of the Israel/Hamas conflict which pushed ten-year (10y) yields -19bp lower while MSCI's US Value index gained 0.7% and US Growth only added 0.1%. This meant that Growth and tech-heavy indices like the Nasdaq Composite lost ground last week, down -0.2%, while the NYSE FANG+ index – which houses the ten leaders of the last decade – shed -0.6%. At the sector level, energy led the way with a 4.6% advance as oil prices jumped on supply disruption fears while rate-sensitive utilities gained 3.5%. Among last week's laggards, consumer discretionary – which is home to Amazon and Tesla, two FANG+ heavyweights – fell -0.6%.

Among last week's macro data, there were signs of weakening confidence. At the consumer level, the flash results from the University of Michigan's October survey fell for the third straight month to the lowest level since June. Similarly, the National Federation of Independent Businesses' September poll of small business optimism fell to a four-month low. Inflation is respondents' prime concern and a net 43% of responses see conditions deteriorating over the next six months. Last week also saw the Congressional Budget Office revise its estimate for this year's budget deficit up to $1.7 trillion, some 7.7% of GDP and up from $1.4tn in 2022. The CBO highlighted that this was mainly due to smaller revenues, in particular tax receipts and Fed remittances to the Treasury.



Source: Bloomberg

Europe . European equities underperformed the US for the third week in a row. The STOXX 600 (a pan-European index which covers the Eurozone as well as non-euro markets like the UK and Switzerland) rose 1.0% last week and the Euro STOXX 50 (which covers the largest companies in the Eurozone) shed -0.2%, while the S&P500 gained 1.1% in euro terms. At the country level, the only markets to lose ground last week were heavyweights France and Germany, down -0.8% and -0.3% respectively. Given the strength in energy prices last week, it was no surprise to see Norway top the leader board with a 5.4% jump. The other significant advance came from Greece – stocks closed 3.3% higher on the week taking year-to-date returns to 26.8%, by far the strongest advance in Europe this year. Among sectors, the only weakness was in consumer discretionary which shed -2.6% on the back of disappointing results from LVMH, the luxury goods bellwether. Unsurprisingly, the strongest sector advance was in energy which bounced 6.0% (all figures in EUR terms).



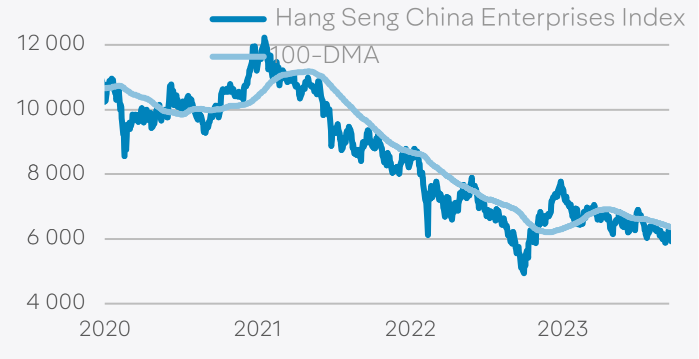
Source: Bloomberg

Despite its bounce last week, the STOXX 600 index failed to break through its major DMAs last week although it did touch the 50-DMA on Thursday before dipping lower on Friday. With both the 50 and 100-DMAs now below the 200-DMA, the technical picture does not look promising. However, a decisive jump above the 200-DMA would break the recent pattern of lower highs and lower lows and put July's year-to-date high in traders' sights.

Although Citi's economic surprise index has improved from its low point in early July, the majority of eurozone macro reports continue to undershoot forecasts. However, there was some more encouraging news on industrial production over the summer. For the Eurozone as a whole, output rose 0.6% MoM in August, well above expectations, versus a fall of -1.3% in July. Similarly, Italy saw production rise 0.2% versus a fall of -0.9% in July. These brighter spots were somewhat overshadowed by Germany, Europe's dominant producer of industrial goods, which saw output contract -0.2% MoM in August, the fourth consecutive decline.

Asia . Last week saw China's state fund, Central Huijin Investment, increase its stake in China's four biggest banks for the first time since 2015's -40% crash in the Shanghai Composite index. Officials have also revived talk about a stock market stabilisation fund, worth potentially up to CNY 1 trillion ($136.9bn). These measures come on the back of the release of China's September inflation data. Rather than edging higher to 0.2% YoY, headline CPI was unchanged last month pitching the country closer to deflationary territory again. Producer prices remain mired in recession – the PPI fell -2.5% YoY in September – which doesn't augur well for Chinese corporate margins.

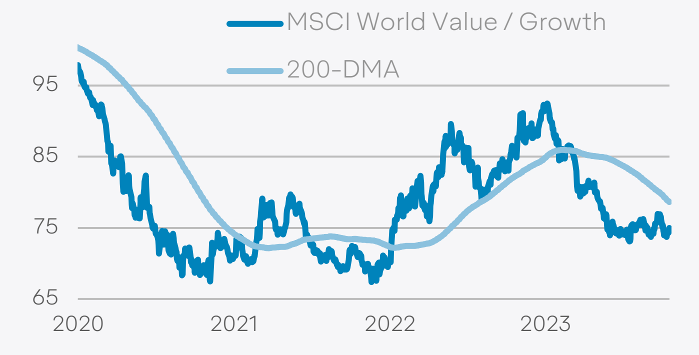
Asia underperformed the other emerging market regions last week – MSCI's Eastern Europe index shot 5.7% higher and Latin America gained 3.6% while Asia returned a creditable 2.2% week-on-week. Onshore Chinese markets reopened last week after the week-long Golden Week annual holiday. Over the week, the CSI300 index of onshore stocks declined by -0.3%, but investors should bear in mind that the holiday means that these stocks had avoided the previous week's -2.9% rout in the offshore Hang Seng China Enterprises index. Elsewhere in Asia, the strongest markets were Thailand and Japan which gained 3.5% and 2.5% 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. Last week, both the US VIX and Europe's V2X index jumped above the average levels for the past twelve months for the first time since March. The VIX soared 10.7% and the V2X 8.2% over the week, a sign that traders may have begun to fret about the economic and market implications of the Hamas attacks on Israel.

Style factors . Value stocks outperformed Growth last week for the first time in three weeks. The MSCI World Growth index advanced 0.3%, while Value rose 0.9%. The best performing factor however was Quality which jumped 1.1%. For the year to date, Growth and Quality continue to lead the way, up 21.8% and 20.4% respectively, while Momentum and Value still lag, having returned 0.4% and -1.0% respectively.



Source: Bloomberg

Bottom Line

In anticipation of the Q3 earnings season and a possible year-end rally, we have raised our equity exposure to the high end of the Neutral range.

FIXED INCOME

With investors seeking safe havens from the tensions in the Near East last week, bonds rallied with the Bloomberg Global Aggregate Index, a proxy for diversified high quality bonds, advancing 0.7%, its first gain in six weeks. The index is still down -2.5% for the year to date and remains well below the major DMAs which have all rolled over. If buyers do not emerge in the fourth quarter, the index on track to register an unprecedented third consecutive annual decline.

US . There was a perceptible change in tone from Fed officials last week. Their message was consistent – the sharp rise in long-dated yields over the past few months has tightened financial conditions appreciably, which has done the Fed's work for it, perhaps removing the need to raise short rates further. Since their lows for the year in April, 10y yields are up a massive 131bp and 30y yields up 120bp. Last week also saw the publication of the minutes of the Fed's September 20 policy meeting. The consensus among policy makers was that the Fed should shift its focus away from the need for further rate hikes and towards the need to keep rates high for some time. Accordingly, Bloomberg's probability calculator now shows only a 32% chance of a rate hike in Q4, down from 48% two weeks ago.

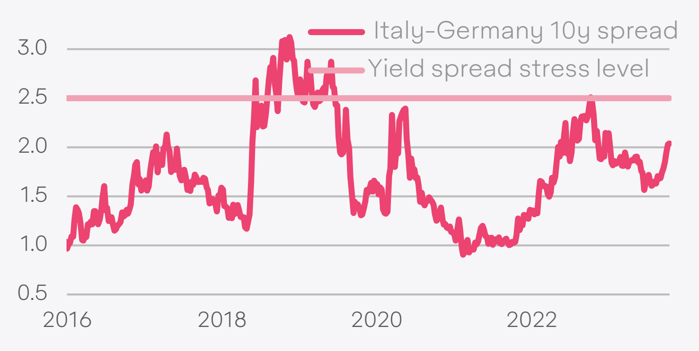
For a discussion of last week's CPI data, please see page 1. In addition, the Bureau of Labor Statistics also published the September producer price index (PPI). Factory-door prices reaccelerated last month – the YoY increase in prices was 2.2%, up from 2.0% the previous month, while the core PPI also rose, from 2.5% YoY to 2.7%. In our view, nothing in the data would warrant the Fed dropping its anti-inflation guard at this stage in the cycle.

The flight to safety dragged 10y Treasury yields -19bp lower last week to 4.61%, still very close to the recent 16-year high at 4.88%. With 2y and 3m yields only slightly lower last week, this deepened the inversion of the 3m/10y curve (i.e., when long yields are well below short-term rates) to -87bp, still a long way above early May's record inversion at -180bp. However, this flattening in the curve does not mean that the all-clear has sounded. Recessions in the US tend to occur after 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 . Despite some hawkish talk from European Central Bank (ECB) officials last week, expectations for further policy tightening have collapsed. Immediately after the last ECB meeting on September 14th, when it raised rates unexpectedly by 25bp, Bloomberg's probability calculator estimated a 34% chance of another hike at the next meeting on October 26th. As of Friday, that probability had disappeared completely with traders now showing a 1.1% chance of a rate cut next week. As in the US, 2y and 3m German rates were virtually unchanged last week while 10y Bund yields slid -15bp lower. This has of course accentuated the inversion of the German yield curve which reached -96bp at the end of last week, a steeper inversion than in the US and still close to the record -119bp we saw in mid-September.

On the macro front, there were few data reports last week. One survey worthy of note was the ECB's own August poll of consumers' inflation expectations. They now see one-year ahead inflation at 3.5%, up from 3.4% in July, while the three-year view is up from 2.4% to 2.5%. This indication that households no longer expect the ECB to achieve its 2.0% inflation target in the foreseeable future will surely lend some weight to the hawks' arguments on the governing council.

Since reaching a low for the year at 156bp, the yield spread between 10y Italian BTPs and German Bunds has ground steadily higher to reach 204bp last Friday, the highest level since January. Although this remains below the 250bp BTP/Bund spread which has often triggered ECB intervention in the past, it surely reflects in part the rising tensions linked to the recent spike in long-dated sovereign yields and in part the Italian government's 2024 budget which shows a wider deficit than originally planned, -4.3% of GDP versus -3.7%. This spread will warrant close monitoring in coming weeks.



Source: Bloomberg

Credit markets . In line with the limited recovery in global equities, corporate credit spreads (the difference in yields versus sovereign bonds) tightened modestly last week. Investment grade spreads (at the higher quality end of the credit spectrum) fell by -2bp in dollars and by -1bp in euros. At the weaker end of the credit spectrum, high yield spreads tightened -10bp in USD and -4bp in EUR. At Friday's levels of 412bp in dollars and 471bp in euros, high yield spreads are still much tighter than at the end of last year, by -57bp and -41bp respectively, which suggests that traders are still quite relaxed about credit risk.

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 both reduces our underweight compared to the market and 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 – resumed its upward march last week rising 0.6%, its twelfth advance in thirteen weeks. The acceleration since mid-July has pulled the index 6.9% higher in a tight unbroken channel of higher highs and higher lows. The 50- and 100-DMAs have both broken above the 200-DMA, which itself has turned higher in an encouraging technical pattern. If the advance continues, traders may begin to speculate about an attempt to break above last September's 22-year high.

EUR. The euro tumbled -0.7% against the US dollar last week, its twelfth decline in the last thirteen weeks. The single currency is now well below its 200-DMA – which will represent a resistance level for any rally attempts – and looks set to pull the 100-DMA below the 200 in coming days. Current levels of around 1.05/1.06 are critical – they provided strong support in 2015-2016 in the aftermath of the eurozone crisis.

GBP. Sterling tumbled -0.8% against the US dollar last week, its fifth fall in six weeks. Growth remains sluggish – the August monthly GDP estimate rose only 0.2% MoM after a -0.6% decline in July while industrial production fell another -0.7% after -1.1% in July. The recent correction from mid-July's 16-month high has flattened the 200-DMA and will shortly pull the 50-DMA below the 200. Expectations of BoE hikes have evaporated over the past few months – according to Bloomberg, the expected peak in base rates has been slashed from 6.4% to 5.3%, thereby weakening a key plank of sterling support.

CNY. The People's Bank of China's efforts to prop up the renminbi appear to be working for now – the cross rate against the dollar only shed -0.1% last week after falling -1.6% and -0.5% in July and August respectively. China operates a "managed float" for its currency which is allowed to float in a +/-2.0% band around the mid-point daily fixing. Over the past five weeks, the mid-rate has remained virtually unchanged. Nonetheless, the spot rate's discount to the fixing remains uncomfortably high at -1.7%, perilously close to the bottom of the trading band. The Chinese authorities will only be able to relax their guard once the spot rate has begun to converge steadily towards the fixing.

JPY. Since reaching its high in mid-January, the yen has registered a steep -14.5% fall against the dollar and now sits only 0.4% above last October's 33-year low. Traders should be wary of intervention by the Japanese authorities. Last year's interventions by the Ministry of Finance were successful in sparking a 17.4% rally – it might pay to be prepared for a rerun.

COMMODITIES

GSCI. After the previous week's sharp fall, the GSCI spot commodity index jumped 3.5% last week, the biggest weekly advance since late March. Energy and precious metals led the way, up 5.4% and 5.2% respectively, while industrial metals shed -1.3%. The bounce took the spot index to just above its 50-DMA and pulled the 100-DMA ever closer to the 200. As we wrote last week, "if the index bounces from here, the technical set-up will continue to look supportive".

Energy. After a massive -11.3% tumble the previous week, Brent crude oil prices jumped 7.5% last week, the biggest weekly advance since February, on the back of the rising tensions in the Middle East. The speed of the recovery since the -12.9% drawdown between September 27th and October 5th has improved the technical picture. The spot price is now above all major DMAs, each of which is advancing steadily.

The outlook for crude prices will depend on a variety of factors. Will GDP growth be as strong as 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 last week for example, US crude oil production has surged to a new all-time high of 13.2 million barrels per day (mb/d), 0.1mb/d above the previous record in March 2020. Moreover, the US appears to be 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. On another topic, we should note a report published last week by Reuters which highlighted how Western sanctions on oil exporters, notably Russia, have benefited China – according to the study, China has reaped savings of almost $10bn this year on its record purchases of Russian crude.

Natural gas prices in Europe soared 41.2% last week, the biggest weekly surge since June 2022. This still leaves prices down -29.3% since the start of the year but does take the spot price decisively above the wide trading range between €25 and €45 per megawatt/hour which has prevailed since the spring. It also takes the price above its 200-DMA for the first time since October 2022, which in turn improves the technical picture with the 50-DMA set to break above the 200 in coming weeks

Metals. As mentioned above, industrial metal prices fell across the board last week. Copper dropped -1.2% under the weight of growing stockpiles, which have risen every week for the past 13 to the highest level in two years.

Gold prices on the other hand rose 5.4% last week taking year-to-date returns to 6.0%. This took the spot price just above the 200-DMA and has begun to repair the technical damage done by the recent drawdown. Gold's price performance is particularly noteworthy given that it comes against the backdrop of the recent massive rise in sovereign yields (see page 4) – assets like gold which generate no recurring income for investors tend to struggle in periods of rising yields.

AGENDA

Monday October 16th . US October New York Fed Empire manufacturing survey. **Italy** September final consumer price index (CPI). **Japan** August final industrial production.

Tuesday October 17th . US September industrial production and retail sales. **European Union** Ecofin finance ministers' meeting. **Eurozone** October ZEW economic confidence survey. **UK** September unemployment rate and average weekly earnings.

Wednesday October 18th . China Q3 GDP, September industrial production and retail sales. **US** Federal reserve beige book economic survey; September building permits and housing starts. **Eurozone** September final CPI. **UK** September CPI and producer price index (PPI).

Thursday October 19th . US September Conference Board leading economic index and existing home sales. **France** October business confidence survey.

Friday October 20th . UK September retail sales and GfK consumer confidence survey. **Japan** September CPI. **Germany** September PPI.

Sunday October 22nd . Switzerland federal parliament elections. **Argentina** first round of presidential election.

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