January 16, 2023

THIS WEEK

Of Central Banks and Prices

In recent quarters, the monthly US inflation reports have become the key date in traders' calendars, often triggering outsize moves in bond and equity markets.

Last week's CPI report proved the exception to the rule – the month-on-month and year-on-year changes in both headline and core readings all came in bang in line with consensus forecasts. The details of the report had something for both bulls and bears. Bulls could point to the -4.5% MoM drop in energy prices and the smallest increase in food prices in two years. Bears focused on the 0.5% MoM increase in services and the 0.8% jump in shelter prices.

The Federal Reserve (Fed) will also have focused on two surveys of consumers' inflation expectations – from the NY Fed and the University of Michigan – which carried the same message. Expectations have eased lower on a one-year horizon but have ticked higher on a five to ten-year view.

This squares with messaging from the Fed. A number of policymakers have begun to suggest that the size of the next hike on February 1 might be 25bp rather than 50bp, as already reflected by Bloomberg's policy rate calculator. However, they also insist that rates will be hiked above 5.0% and stay there until the end of the year, which would come as an unwelcome surprise to the market consensus for a pivot to lower rates by this summer. So, no change in the Fed's "higher-for-longer" mantra. And no change in our Bottom Line:

Bottom Line

Fed chair Jerome Powell has often referred to the early 1980s in recent months, when the Volcker Fed cut rates as inflation moderated, only to hike them to new highs when prices reaccelerated. He clearly does not want to repeat this policy mistake, which suggests that market hopes of a Fed pivot this summer are misplaced. In our view, investors should not be in such a hurry to fight the Fed.

Equities	Last	%5D	%1M	%YTD
MSCI World	2 735.72	3.2	0.7	5.1
S&P 500	3 999.09	2.7	-0.5	4.2
Nasdaq Composite	11 079.16	4.8	-1.6	5.9
Russell 2000	1 887.03	5.3	3.0	7.1
STOXX 600	452.54	1.8	2.2	6.5
Euro STOXX 50	4 150.80	3.3	4.1	9.4
SMI	11 290.79	1.3	1.4	5.2
Topix	1 903.08	1.5	-3.2	0.6
MSCI EM	1 029.85	4.2	6.7	7.7
China CSI 300	4 074.38	2.3	3.3	5.2
VIX	18.35	-13.2	-18.6	-15.3
V2X	17.34	-6.2	-14.9	-17.0

Fixed Income	Last	5Dbp	1Mbp	YTDbp
US 2Y	4.23	-2	1	-19
US 10Y	3.50	-5	0	-37
German 2Y	2.59	1	45	-17
German 10Y	2.17	-4	24	-40
Swiss 2Y	1.04	-8	15	-18
Swiss 10Y	1.09	-18	-6	-50
USD IG Spread	134	-10	-5	-9
EUR IG Spread	135	-7	-9	-5
USD HY Spread	407	-30	-19	-62
EUR HY Spread	473	-33	-49	-40
EM Sovereign Spread	404	-10	14	10

Currencies	Last	%5D	%1M	%YTD
Dollar index	102.20	-1.6	-1.7	-1.3
EURUSD	1.083	1.7	1.9	1.2
GBPUSD	1.223	1.1	-1.1	1.2
USDJPY	127.87	-3.2	-5.7	-2.5
EURCHF	1.004	1.6	1.7	1.4
JPM EM FX Spot	51.29	2.0	2.2	2.8
USDCNY	6.701	-1.9	-3.6	-2.9

Commodities	Last	%5D	%1M	%YTD
GSCI Spot	605.79	5.7	1.6	-0.7
Brent Crude Oil	85.28	8.5	5.7	-0.7
Gold	1 920.23	2.9	6.0	5.3
Copper	9 185.50	6.9	8.1	9.7
Bitcoin	19 813.55	17.0	11.6	19.8

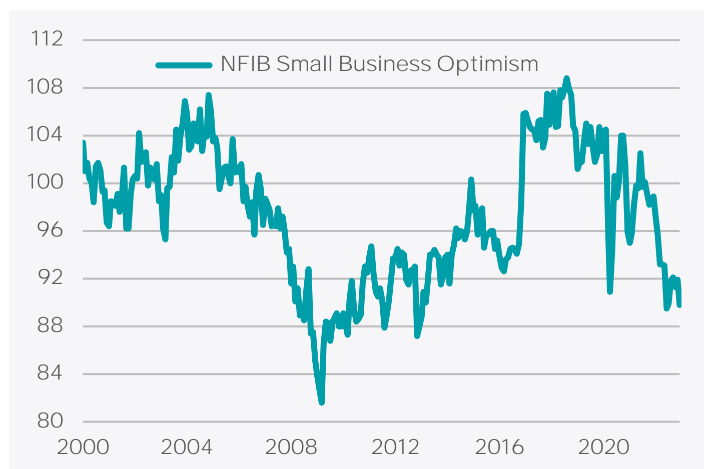
Source: Bloomberg, 13.01.2023

EQUITIES

Global . The MSCI World global equity index added another 3.2% to its 2023 rally last week. The breakout attempt we mentioned in last week's report appears to have been successful for now with the index back at its early-December high and the 50-day moving average (DMA) just about to break above the 200.

US . US stock indices made progress again last week, gaining 2.7% but still lagging the global average. Cyclically sensitive sectors like Consumer Discretionary outperformed defensive areas like Consumer Staples, up 6.0% and down -1.4% respectively. Information Technology was also strong, up 4.7% on the week, which helped tech-heavy indices such as the Nasdaq Composite and the NYSE Fang+ index – named after tech titans Facebook, Amazon, Netflix and Google – which gained 4.8% and 8.6%.

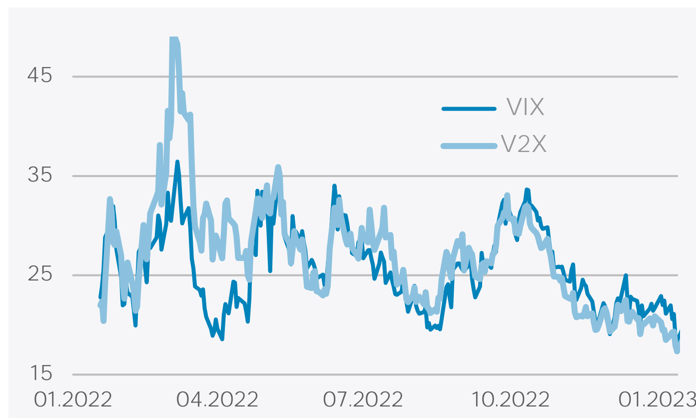
The University of Michigan's preliminary consumer sentiment survey for January hit a nine-month high, well above expectations. The survey is generally considered to be heavily influenced by perceptions about inflation – unlike the Conference Board's consumer confidence survey which rather reflects job market prospects – which was supportive for risk-on sentiment. On a less-encouraging note, the National Federation of Independent Business – the heartbeat of the US economy – reported that small business optimism hit the second lowest level in nine years.



Source: Bloomberg

Last week's rally pulled the S&P500 index to just above the 200-DMA, where it also meets the downtrend line linking the January, March, August and December highs. This means stiff resistance will need to be overcome before any further advances are possible.

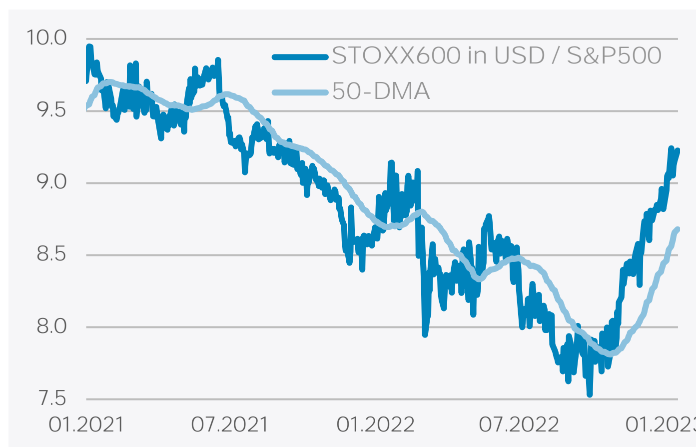
Implied volatility. The major implied volatility indices – the US VIX and the European V2X – both shifted sharply lower last week. The VIX plunged -13.2% while the V2X shed -6.2%, taking both to 12-month lows. Low implied volatility reflects investor optimism that they don't need to pay up for option protection, and suggests a degree of complacency at these levels.



Source: Bloomberg

Europe . European equity markets' flying start to 2023 continued last week. The Euro STOXX 50, which covers the largest companies in the Eurozone, rose 3.3% while the STOXX600, which includes the UK and other non-euro markets, rose 1.8%. After taking the euro's 1.7% advance against the dollar into account, both continued their recent run of outperformance versus the US. Within the region, defensive markets like Switzerland and Denmark lagged (both down -0.3% in euros) while the leaders included industrial heavyweights like Sweden and Germany (up 3.8% and 3.3% over the week).

Thanks to euro strength, last week's bounce in prices continued the four-month run of STOXX600 out-performance over the S&P500. The technical picture looks solid – both the 50 and 100-DMA are rising – but a period of consolidation of recent gains looks likely.



Source: Bloomberg

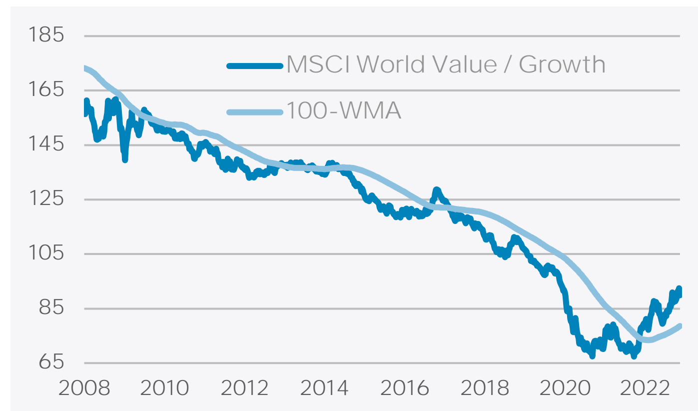
Data releases continued the recent run of positive surprises – Citi's Eurozone economic surprise index hit the highest level since the summer 2021 post-lockdown recovery. For example, November industrial production surprised on the upside, bouncing 1.0% MoM after dropping -1.9% the previous month. And Germany's initial estimate for 2022 GDP growth was 1.9%, which suggests that Q4 was flat, which would be a significant positive surprise.

Asia . Last week saw a modest acceleration in YoY CPI in China, from 1.6% in November to 1.8%. PPI on the other hand fell -0.7%YoY in December, admittedly an improvement from November's -1.3%. We expect that such low inflation levels – which would be the envy of many a developed world central banker – will not last. As China reopens, the economy should follow the playbook from post-lockdown western economies – a surge in demand combined with lingering infections creating supply chain disruptions and sparking intense inflationary pressures.

Source: Bloomberg

Emerging markets outperformed advanced economies last week – up 2.3% versus 1.4% - with broad gains across regions, let by Eastern Europe which gained 3.6%. In Asia, Korea and Japan led the way, rising 3.7% and 3.1% respectively, boosted by strengthening currencies. Singapore and India brought up the rear, both bourses unchanged over the week (all figures in euro terms).

Style factors . Rising conviction that falling inflation would enable a central bank pivot and a return to negligible bond yields helped boost Growth stocks last week – the MSCI World Growth index rose 4.7% trailed by Value which gained only 1.9%. The laggard factor last week was High Dividend which rose only 0.7%.



Source: Bloomberg

Bottom Line

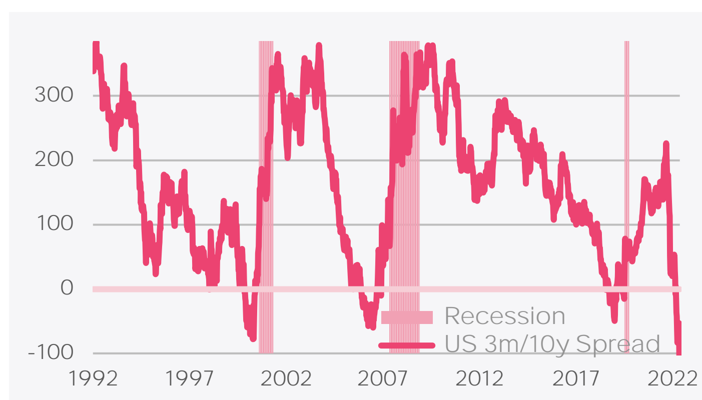
We remain relatively defensive in our allocations. We continue to believe that risks to the downside remain, given the macro challenges faced by companies across the globe, and the risk of downward revisions in 2023 earnings estimates.

FIXED INCOME

This year's rally in the Bloomberg Global Aggregate Index – a proxy for diversified high quality bonds – accelerated last week with the index adding 1.9% to take year-to-date returns to 3.3%. Traders continue to bet on a "Goldilocks" macro backdrop – not too hot, which might stoke wage and price pressures, and not too cold, which might mean a deep recession.

US . US ten-year (10y) yields shed -5bp last week as the rally in fixed income markets continued. Trader optimism was bolstered by talk of rate hikes of "only" 25bp from February onwards and by a positive spin on December's CPI data. Declines in 2y and 3m rates were more modest – down -2bp and -1bp respectively – thereby further accentuating the inversion of the US yield curve (an inversion occurs when shorter-dated bonds yield more than longer maturities).

These moves saw the 3m10y curve steepen to -107bp, another multi-decade low. As shown on the chart, inverted yield curves generally provide a good advance warning of recessions. However, not all traders agree with Treasury investors. As you'll read below, credit spreads – the yield difference between corporate and sovereign bonds – have tightened this year, suggesting confidence in low default risk. And equity analysts have been busy revising 12m-forward earnings forecasts higher, not something you would generally see were a recession looming. For our part, we would not be surprised in inflationary pressures prove persistent and end up pushing 10y Treasury yields back towards recent highs.

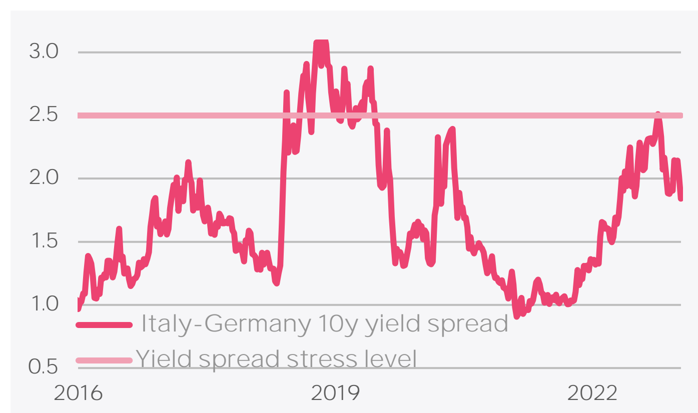


Source: Bloomberg

Europe . 10y German Bund yields eased -4bp lower last week, taking the decline since end-December to –40bp by Friday's close. Unlike in the US, 2y and 3m yields rose over the week, but the result was the same – further inversion of the 2y10y Bund yield curve, which is now the steepest since German reunification in the early 1990s. Moreover, there was further dramatic flattening of the 3m10y spread which ended the week just above zero. And there may be more to come – we continue to expect 3m yields to trend higher as investors begin to realise that the ECB is serious in its intentions.

The ECB's hawkishness will only have been reinforced by a study of wage growth trends published by its economists last week. They conclude their research by saying that "wage growth over the next few quarters is expected to be very strong compared with historical patterns". The reasons include today's robust labour market, increases in national minimum wages and catch-up with current high levels of inflation. This is almost a text-book definition of a wage-price spiral, where higher wages feed into higher prices which feed back into further wage demands. Mme Lagarde's resolve to push through "significant" rate increases at a steady pace will likely have been stiffened by this study.

With risk appetite on the rise, it was no surprise to see 10y Italian BTP yields continue their recent sharp falls, shedding -21bp last week. This has tightened the BTP/Bund spread to 184bp, well below the 250bp level beyond which traders begin to fret about the sustainability of Italy's debt burden.



Source: Bloomberg

Credit markets . This year's risk-on shift has also boosted appetite for corporate credit, particularly in high yield bonds. The HY credit spread – the yield differential between corporate and sovereign bonds – tightened by -30bp in USD and -33bp in euros, meaning that spreads have fallen by -145bp and -176bp respectively since the start of Q4. Investment grade spreads also eased lower, by -10bp in dollars and -7bp in euros, taking them to the tightest level since April and June 2021 respectively.

Bottom Line

Many investors are pushing sovereign yields lower in the hope that economic weakness will slow inflation and prompt a central bank pivot to a more accommodative policy stance. Others are bidding for corporate bonds in the hope that economic weakness – which would damage credit quality – can be avoided. Both cannot be correct.

Overall, we remain defensive in our fixed income allocations. However, some value has been restored in short-dated bonds and niches such as subordinated financials.

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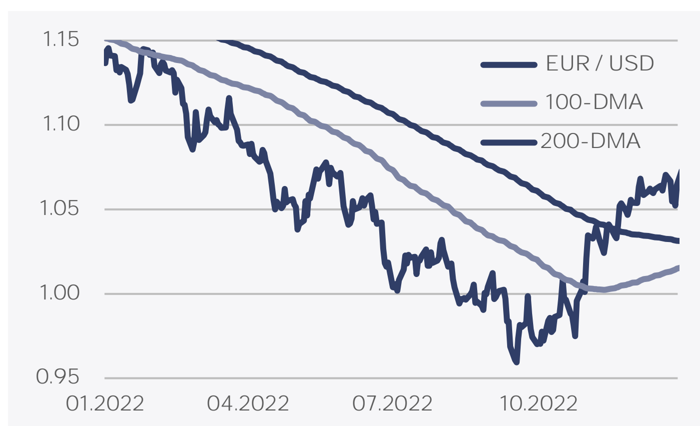
CURRENCIES

The dollar index – which measures its value against its major trading partners among advanced economies – fell -1.6% last week, the sixth decline in the past eight weeks. As highlighted in our recent reports, the 50-DMA has now broken below the 200, accentuating the bearish configuration.

EUR . As we expected, the euro resumed its uptrend with a vengeance last week, gaining 1.8% against the US dollar. Expectations of much higher ECB deposit rates and hopes of a Fed pivot are driving the single currency higher. With the 50 and 100-DMA now both rising, the technical picture also looks encouraging. Looking ahead, we expect a period of consolidation – as the 200-DMA flattens and the 100 rises to meet it – before the next euro bull leg can commence.



Source: Bloomberg

GBP . After a period of relative weakness compared to peers against the US dollar, sterling recorded its third consecutive weekly advance, gaining 1.1% last week. The technical picture continues to look more promising. The 100-DMA has begun to turn higher, and the 50 has now broken above the 200. The next resistance level will be the trend line from the February and December highs which currently lies around 1.2250.

CNY . The rally in the renminbi against the US dollar accelerated last week with a 1.9% gain, the third consecutive advance. Sentiment has been aided by the dismantling of the final zero-Covid restrictions and supportive talk from the authorities about targeted stimulus measures. The renminbi has now risen 9.0% from its end-October lows and has powered through the 200-DMA. A period of consolidation now looks necessary before any further advances.

JPY . Last week, yields on 10y Japanese government bonds traded at or just above the higher bound of the Bank of Japan's new +/-0.5% target range, as traders attempt to push the BoJ to widen further. This shift towards marginally more restrictive BoJ policy has revived interest in the yen. The yen soared 3.3% last week, taking its advance since the October low to 17.4%. Here, too, consolidation beckons.

COMMODITIES

GSCI . Last week saw a broad-based advance of commodity prices led by industrial metals and energy. The GSCI spot commodity index jumped 5.7% over the week, almost cancelling the previous week's -6.0% slump. However, all main DMAs continue to trend lower and should offer stiff resistance to this rally attempt.

Energy . After plunging -8.5% during the first trading week of 2023, Brent crude prices then soared 8.5% last week, taking year-to-date performance to -0.7%. The main driver behind last week's bounce was optimism that we'll see a robust recovery in Chinese demand as the nation emerges from its self-imposed zero-Covid hibernation. Moreover, there has been some easing of recession fears in the US and Europe.

Surprisingly, the strength in crude coincided with a massive increase in US inventories, by some 19m barrels – normally such builds in stocks are viewed negatively by traders. However, the increase was somewhat technical in nature – the "polar vortex" of extreme cold in December and early January across central and eastern states forced many refineries in shut down temporarily, diverting crude flows to storage.

We continue to see a brighter medium-term picture. The US has announced that it will commence purchases to restock its depleted Strategic Petroleum Reserve next month, and OPEC+ remains committed to output restraint. Moreover, a combination of environmental pressures and capital-discipline constraints have encouraged major oil groups to prefer share buybacks and dividend distribution to capital expenditure in new capacity, which suggests long-term restrictions on output.

Warm winter weather has kept demand for natural gas in Europe relatively low. European gas stocks started the year at 83.5% of capacity according to Reuters, well above the 70-75% levels we saw on average at this time of year between 2017 and 2021. Prices fell another -6.8% on European futures exchanges last week, to their lowest level since September 2021.

Metals . Industrial metal prices shot higher last week – up 7.7% on the GSCI spot index – with those metals most sensitive to Chinese demand in focus. In particular, aluminium soared 13.0%, followed by zinc, copper and iron ore, which jumped 9.9%, 6.9% and 6.7% respectively. The sole weak spot was nickel which shed -4.6% - however, we expect this weakness to be temporary given nickel's central role in battery technology.

Bottom Line
The outlook for commodities looks brighter and we await an opportunity to add to positions.

AGENDA

Monday January 16th . Davos First day of World Economic Forum. Germany November industrial production. Eurozone November unemployment. US Martin Luther King Day public holiday, stock and bond markets closed.

Tuesday January 17th . European Union meetings of finance ministers (Ecofin). China Q4 GDP figures, December retail sales and industrial production. Germany December consumer price inflation (CPI) data, ZEW economic sentiment survey. UK employment data. Italy December final CPI.

Wednesday January 18th . Eurozone December final CPI data. Japan Bank of Japan policy meeting. US Federal Reserve Beige Book published. December retail sales, industrial production and producer price inflation (PPI). UK December CPI and PPI.

Thursday January 19th . Eurozone December European Central Bank meeting minutes published. UK RICS house price data.

Friday January 20th . China People's Bank of China policy meeting. Germany December PPI. Japan December CPI. UK GfK consumer confidence survey.

Sunday January 22nd . China Lunar New Year, start of the Year of the Rabbit and week-long public holiday.

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