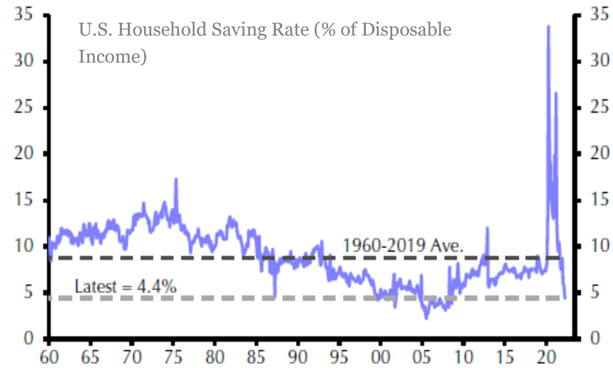
MARKET OUTLOOK

2022/June

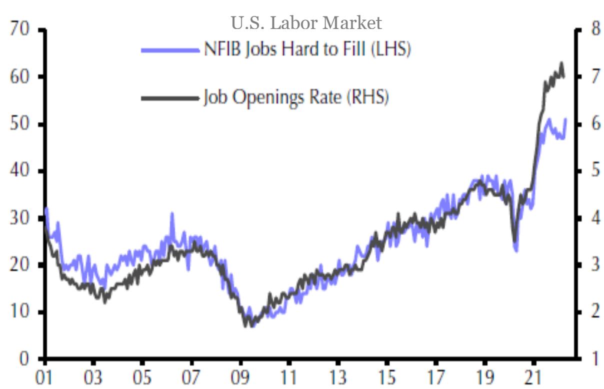
THE US CONSUMER: PLEASURE AND PAIN OF THE US ECONOMY

As the fading of both fiscal stimuli and the one-time effect associated with the reopening of the economies takes hold, investment professionals are rushing to estimate the amount of savings the US consumers can rely upon for future consumption. Given the abnormal savings rate over the past two years, we estimate that amount to be substantial, although the year-to-date performance of financial markets has indeed reduced it remarkably. Nonetheless, we can assert with a margin of safety that the US consumer remains the engine of the US economic growth; it is less indebted compared to the years anticipating the great financial crisis, its wealth has grown massively over the past decade, and it is currently enjoying one of the tightest labor markets in history, with the ratio of job openings/supply almost at 2x. Therefore, all is good…not really.



Source: Capital Economics

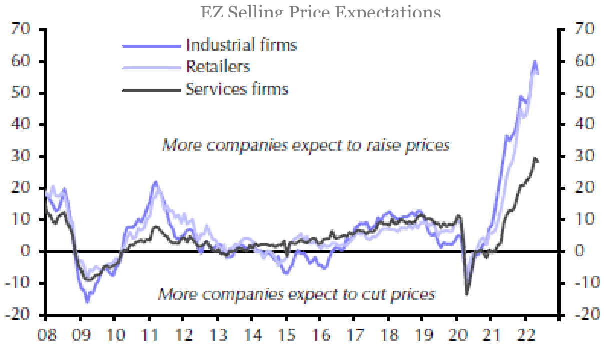
The other side of the coin displays an economy that was allowed to overheat (thank you FED!) as demand was stronger than ever on the back of the free money issued to the population by the federal government; struck by externalities such as pandemic-related supply chain disruptions, and a reckless war whose effects are reverberating across the globe, it gave birth to what many define as a new inflation regime. Indeed, inflation is at 40 years high, and what was once classified as temporary, is now risking becoming sticky (or stickier). But the FED comes to the rescue! It started with a change in tone at the press conferences in late 2021, where it anticipated that inflation was getting out of hand, but what followed was unexpected, as much as a storm while navigating peacefully at sea. The series of above-expectations rate hikes caught many by surprise, especially because we were told for months that inflation above target was accepted. However, only the fools don't change their minds, and the FED members are no exception to the rule. And too bad if this turns out to be the second mistake in a row, where an aggressive monetary stance is being applied to an economy that is already on a downward path; we prefer to enter a FED-induced recession that many predict should only be mild, then facing a wage-price spiral that risks sending the whole economy in a stagflation environment. Not forgetting that the healthy US consumers can help push the guillotine further out in time.



Source: Capital Economics

Yet don't think that the neighbor's grass is much greener. The Europeans are currently flirting with a recession, much more than the US is. The old saying "If China sneezes, Europe catches a cold" couldn't be more appropriate; with COVID-related lockdowns at strategically important cities such as Shanghai that hampered global supply chains, European firms were unable to meet domestic demand, while foreign demand was hit as well. The war in the Ukraine, and the related spike in energy prices to which European industries and households are highly exposed to, was the cherry on the cake. On the contrary, a strong labor market and rampant inflation figures resemble the situation in the US. The European Central Bank is thus caught between a rock and a hard place, or multiple hard places; on the one hand, it faces the need to increase rates to combat rising inflation expectations, but on the other the economy is stagnating, and peripheral government spreads are widening; a fine balancing act is needed from Mrs. Lagarde and her team to escape this impasse.

We presume Europe will have to get on its feet all alone, as this time China is totally focused on domestic consumption and won't act as saviour of last resort, especially as the real estate market is in free-fall since mid of last year. President Xi Jinping seems to have found the solution to a structurally slowing economy; all else equal, with youth unemployment sky high and at levels never seen before (at least until the data is available), it is offering higher wages to candidates that have a degree in Marxism, where students are inculcated with the philosophy developed by Karl Marx as interpreted by Xi himself and his revolutionary idol, Ma o Zedong*. Curiosities aside, because the Chinese central bank still possesses ammunitions to stimulate the economy, we should see a recovery in economic activity during the summer months. However, the longer-term outlook is still shaky, as Beijing is not willing to abandon its zero-covid strategy until the vaccination rate among adults over 60s reaches the levels of developed economies, and the real estate market is still in the process of deleveraging.

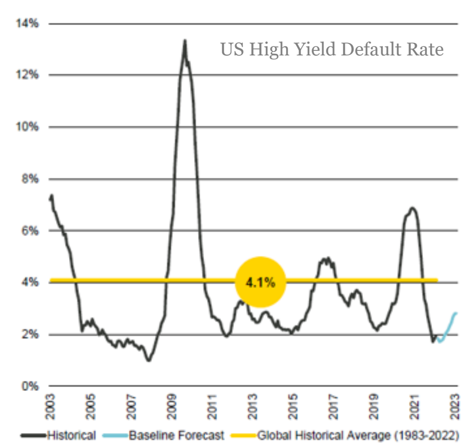


Source: Capital Economics

FIXED INCOME: BACK FROM THE DEAD

The aggressive stance adopted by global central banks in their fight against inflation has caused some casualties among investors, as well as creating some opportunities for those who stood on the side-line. The rise in interest rates experienced since the beginning of the year has been remarkable, to say the least; the US 10Y treasury moved from yielding 1.75% to almost 3.50%, while the German Bund from 0% to 1.75%. The fear of a looming recession has increased the yields of corporate issuers even further, and the former are now approaching the pandemic peaks, a time when we thought the world was about to vanish.

Nevertheless, from a fundamental standpoint, investment grade credit metrics have continued to improve, and profit margins as well as cash balances are very strong. Within higher yielding bonds, the riskier sector of the market, the default rate is beginning to rise, and we expect this trend to continue for some time as the economy decelerates under the tightening pressure of central banks. But current valuations are pricing a very painful outlook, which for the time being is not our base case scenario. The same holds true for emerging markets debt. Therefore, while the chance of feeling further pain cannot be ruled out, we believe both investment grade bonds and the riskier bucket of the market begin to look attractive, from a nominal perspective, of course.



Source: Vontobel

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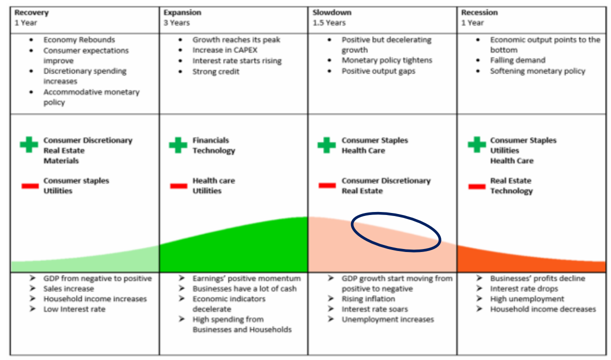
EQUITY: THE FED PUT – WHAT'S THAT AGAIN?

Spoiled by the FED over the last decade, equity investors (and not only them) have been waiting for the former to pivot its rhetoric and begin to relax the grip on financial conditions – the famous FED put. In vain. This time is different, and we believe the FED will end its assault on inflation either when the latter begins to fall, or when the outlook for the US economy becomes extremely grim.

Phases of Business Cycle



Source: JPMotgan

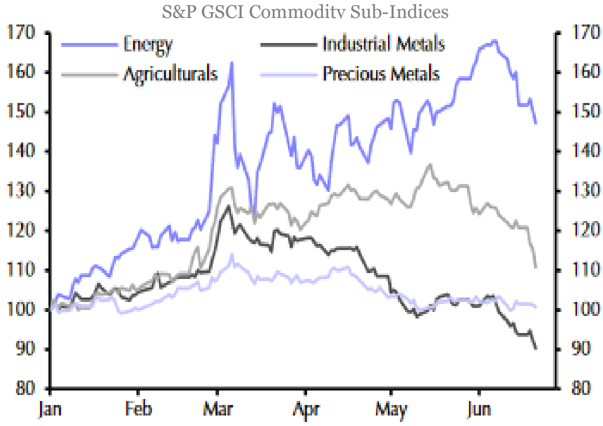
As we write, the major equity indices are deeply in negative territory, sending valuations back to the long-term averages. Earnings estimates have flattened out rather than deep diving, but as analysts begin to lower their expectations by incorporating higher inflation and a softer economic outlook into their models, we believe the short-term outlook for stock prices remains cloudy. Profit margins are at historical highs and with inflation remaining elevated for longer than previously expected, companies will face a hard time in passing on higher input costs to consumers.

Exactly predicting where we stand in the business cycle is not possible but tightening financial conditions and expectations for lower economic growth position us somewhere past the growth peak; in this environment, we would recommend focusing on defensive sectors, offering predictable cash flows and the (partial) ability of passing on higher costs to the end customers; consumer staples and health care companies carry those characteristics, albeit the former may be expensive by now. With the mortgage rate doubling over the past months, avoiding real estate related investments seems an obvious call, as well as staying away from consumer discretionary stocks; the latter are highly cyclical and correlated with the purchasing power of the consumers, which is being eroded by persistently high inflation.

COMMODITIES AND CURRENCIES: LOOKING FOR AN EQUILIBRIUM

The aggressive stance of central banks, paired with global recessionary fears and a general increase in output, is weighing on the prices of many commodities, and we expect this trend to continue in the near term, capping the fantastic returns experienced year-to-date. The risk to our scenario is represented by energy prices, currently highly correlated with the precarious geopolitical situation we are witnessing; a further escalation of tensions could send them soaring and, because of their extensive use in the production of many other commodities (agriculture, industrial metals, etc.), generate a waterfall effect on prices. Thus, be long energy if you want to hedge against a deterioration in the Ukraine.

S&P GSCI Commodity Sub-Indices



Source: Capital Economics

On the currency front, the USD should remain supported by both the hawkish attitude of the FED and recessionary fears, but the upside versus developed markets currencies should be limited as rate differentials will hardly widen further, given other central banks are set to catch up.

*https://www.ft.com/content/36d34b2f-7f69-4224-8322-87d99a820f64

OUR STANCE

Liquidity: Equal-weight	**Bonds**: Equal-weight	**Equities**: Underweight	**Alternatives**: Underweight	**Commodities**: Overweight

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