CITĒ GESTION

Newsletter : From Fed to ECB | July 2022

Key Take-Aways

- This first half-year was the worst for the S&P500 index in more than 40 years, with only the energy sector posting positive returns. The second quarter was particularly harsh for US equities, with the Eurostoxx50 and the CSI 300 outperforming the S&P500 by 6.75% and 23.40% respectively.
- As inflation continues to surprise to the upside, central banks globally have also become even more hawkish than previously expected. After the Fed raised rates by 75 bps, the most since 1994, the Swiss National Bank also delivered an unexpected rate hike of 50 bps.
- In this world of higher inflation and tightening financial conditions, the US 10 year Treasury yield closed the month just above 3% and the Bund yield rose to 1.34%. To ease fears of fragmentation in the Eurozone, the ECB discussed the need for a tool to avoid stress among lower sovereign credit.
- Financial assets' performance have been negatively impacted by recession fears, as macro indicators have came in below economists' expectations, with PMIs coming in just slightly above a contraction level.
- We're still unsure if we can call a peak in yields, however, it may be appropriate to say that fixed-income returns have bottomed, as now interest income should offset the last portion of capital losses from a rise in yields.
- Valuations in the S&P500 are now below their 10-year averages and may imply high average single digit returns for the medium/long-term. Nonetheless, as central banks keep on removing liquidity from the market we anticipate that short-term volatility should remain elevated.
- As concerns about inflation and global slowdown marked the first half of the year, the US Dollar was a beneficiary of this, playing its role as a safe haven. Against the EUR, the USD is already trading close to a 20 year high. On the other hand the JPY has depreciated significantly against the USD, as inflation and rates remain low in Japan. Finally the surprise rate hike in Switzerland has pushed the EUR/CHF to trade below parity.

June Review : SNB raised rates against all odds

For the first time since September 2007, the Swiss National Bank raised its key interest rates by 0.50 bps, bringing the rate to -0.25%. Following in the footsteps of the US Federal Reserve, which raised rates by 0.75 bps for the third time this year. June 30th will have brought to a close what has been one of the worst first half-years in over 40 years for the S&P500. The major developed equity indices lost more than 7% during the month of June, while the Chinese indices gained between 7.20% (HSCEI) and 12.15% (CSI 300).

The US indices all posted a negative performance of more than -8%, except for the Dow Jones, which lost -6.56%. The Nasdaq finished the second quarter down -22.27%, followed by the Russell 2000 at -17.21%, the S&P500 at -16.11% and the Dow Jones at -10.78%.

In Europe, the scenario was identical, with indices losing between -3.07% (PSI 20) and -12.85% (FTSE MIB) in June. It is worth noting that the second quarter of this year was particularly difficult for the US, with the Eurostoxx50 and the CSI 300 outperforming the S&P500 by 6.75% and 23.40% respectively.

The energy sector remains the only US sector to be positive since the beginning of the year, with a 6-month increase of 31.64%.

The dollar index rose again by 2.88% to 104.685, an increase of 9.42% YTD.

The yen posted the biggest 6-month loss against the greenback, falling a staggering 17.94%, followed by the cable, down 10%, the EUR/USD -7.79% and the USD/CHF +4.62%.

The US 10 year Treasury yield closed the month just above 3%, an appreciation of 17 bps. "The Bund yield rose by 21 bps to 1.34%. Bond indices resumed their correction, with the Bloomberg Global High Yield and JPMorgan EMBI indices falling 7.53% and 5.54% respectively, while the Bloomberg Global Aggregate and Core Developed Govt indices lost 3.21% and 1.22%, further underlining the move towards credit quality.

The Bloomberg Commodity Index contracted 10.88% to 117, led by natural gas which fell by 33.41%.

The VIX index remained stable at 28.70.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	3,785	-0.86	-0.24	-8.26	-16.11	-19.97	15
Nasdaq	11,029	-1.33	-1.80	-8.65	-22.27	-29.22	20
Russell 2000	1,708	-0.66	-0.15	-8.23	-17.21	-23.45	16
Euro Stoxx 50	3,455	-1.69	0.54	-8.74	-9.35	-17.39	10
Stoxx 600 EUR	407	-1.50	1.21	-8.00	-9.08	-14.42	11
FTSE 100	7,169	-1.94	2.13	-5.53	-3.80	-1.01	10
SMI	10,741	-0.65	2.75	-7.49	-10.48	-14.31	14
NIKKEI 225	26,393	-1.54	0.97	-3.14	-5.02	-7.32	14
CSI 300 China	4,485	1.55	3.47	10.43	7.29	-8.30	12
MSCI EM Index	1,001	-1.20	0.78	-6.63	-11.40	-17.57	10

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	3,785	-0.86	-0.24	-8.26	-16.11	-19.97	15
UTILITIES	356	1.10	3.38	-4.98	-5.09	-0.56	19
ENERGY	546	-2.04	1.39	-16.91	-5.29	31.64	9
TELECOM	186	-1.56	-1.45	-7.69	-20.71	-30.16	13
CONS STAPLES	750	0.05	0.84	-2.50	-4.62	-5.58	19
REAL ESTATE	256	0.07	-0.21	-6.90	-14.72	-20.11	33
CONS DISCRET	1,078	-1.54	-3.03	-10.80	-26.16	-32.82	18
MATERIALS	463	-1.18	0.12	-13.84	-15.90	-17.90	13
HEALTH CARE	1,494	-0.31	0.83	-2.66	-5.91	-8.33	16
INFO TECH	2,223	-1.33	-1.30	-9.32	-20.24	-26.91	18
FINANCIALS	523	-0.87	0.88	-10.90	-17.50	-18.73	11
INDUSTRIALS	738	0.30	1.76	-7.40	-14.78	-16.79	15

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	104.685	-0.40	0.24	2.88	6.48	9.42
EUR-USD	1.0484	0.40	-0.37	-2.33	-5.27	-7.79
USD-JPY	135.72	-0.64	0.57	5.48	11.52	17.94
USD-CHF	0.9551	0.01	-0.60	-0.46	3.53	4.62
EUR-CHF	1.0011	0.41	-1.02	-2.77	-1.97	-3.51
GBP-USD	1.2178	0.45	-0.67	-3.36	-7.31	-10.01
EUR-GBP	0.8609	-0.07	0.31	1.07	2.20	2.33
JP EM FX Index	51.64	0.10	0.00	-2.16	-3.46	-1.75

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	3.01	-8	-7	17	150	150
Germany	1.34	-18	-9	21	151	151
UK	2.23	-16	-9	13	126	126
SWITZERLAND	1.07	-17	-16	18	120	120
Japan	0.23	-0	-0	-1	16	16
US IG Spread	169	4	7	29	69	69
US High Yield spread	591	21	44	168	321	321
EUR High Yield spread	681	41	64	178	335	335

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	117.0	-4.28	-3.19	-10.88	-5.92	18.03
Gold Spot $/OZ	1807.3	-0.58	-0.85	-1.64	-6.72	-1.20
Crude Oil WTI	105.8	-3.66	-0.34	-7.77	5.46	37.37

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	28.7	0.55	-0.34	2.52	39.64	11.49

Source: Bloomberg 06/30/2022

Macro and Rates : Recession Risk

The war against inflation is "unconditional". This month provided a clear translation of this sentence. Unexpected or not, central banks are acting with no concession to normalize monetary policy rates, sometimes in a brutal manner.

"Whatever it takes" is not market-friendly. Western central banks are all-in against inflation. In the US, The Fed delivered a 75 basis points hike in June. While the decision was not entirely unexpected, it brought into financial markets an unexpected level of volatility. The Bank of England (BoE) also pulled the trigger for its fourth rate hike in 2022, pushing its official Bank rate to 1.25%. Even the usually very placid Swiss National Bank (SNB) surprised the market with a 50 bps lift and a martial statement. The European Central Bank (ECB) on its side, confirmed their decision to accelerate its rate lift-off and discuss the need for a tool to avoid "fragmentation" among lower sovereign credit in Europe. Only Japan, who attempted to generate inflation for several decades, holds on and left its monetary policy unchanged.

As central banks front-load their interest rate hikes and accelerate the pace of monetary tightening, we start to observe economic weakness and macro data deterioration. While inflation remains the immediate concerns, the words "recession" and "hard landing" are becoming viral.

Several macro indicators came in significantly below consensus estimates. PMIs around the world, both manufacturing and Services, slowed considerably in June, flirting with the 50 level, if not already below in some countries. In the US, Retail Sales posted their first drop in five months in the last release and wage growth showed some signs of softness, Existing Homes Sales declined for a four consecutive months as rates rise.

In Europe, inflation is about energy, so seeing consumer confidence there approaching a 40-year low is a concern with no positive side-effect. Germany's ZEW survey in June remained negative, Spanish inflation reached double digit at 10.2% year-on-year. In the UK, GDP contracted by -0.3% in April with inflation hitting another 40-year high in May at 9.1%.

Only China seems isolated. Inflation remains relatively contained with CPI at 2.2%. Industrial Production and Retail Sales, still in the soft side, surpassed expectations and more importantly, China's biggest cities record zero Covid cases. After a difficult fight against Covid, Shanghai and Beijing have now reached zero locally transmitted cases, the first time since mid-February. This has led to the first easing in international travel restrictions in more than 2 years.

The impact of the sharp policy normalisation is not only visible in the economic activity. The perspective of a recession is palpable in the commodity complex and rates.

Commodities have printed their first month in negative return since November last year. Copper, particularly sensitive to macroeconomic conditions, fell into bear market territory, and oil prices, despite the war that keeps on raging in Ukraine, is falling after a double top in June. While it is too early to claim victory on inflation, the deflating price action on commodities observed recently is encouraging for the coming months, as reflected by some inflation expectation indices.

Interest rates tend to agree with the idea that inflation may have peaked or should be close to. Market participants, boosted by recession fears and lower inflation expectations, are going for a much less agrressive Fed than some weeks ago. Indeed, the peak in Fed fund is now priced at 3.4% by February 2023 followed by a first rate cut as early as May 2023.

Are commodities telling us something? For sure, yes: a sharp slowdown will be playing out, assuming a recession can be avoided. In this environnement, bad news on growth could be good news for markets only if it implies some easing of inflation. At this point, a pause in the commodity rally combined with an unclogging of the global supply chains would be encouraging to lessen price pressures. Equities historically tended to fall into rising inflation, and rise after it topped out, provided no recession followed. Waiting for an inflation inflection, investors will face extreme volatility.

Fixed Income: Bond Market Bottom?

«We understand better how little we understand about inflation». Jerome Powell could not have been more transparent. At the ECB Forum on June 29, Fed's chairman challenged the Philipps curve model and its ability to produce inflation by the fact some data were missing to the model, notably that the model did not take into account the recent collapse of the supply side.

The release on the US inflation report on June 10th came as a shock for financial markets. Headline and Core CPI both exceeded expectations, with the topline figure hitting a fresh 8.6% peak on a year-on-year basis. While the level of headline CPI inflation may not be at a record, the magnitude of the inflation shock is. In other words, inflation is a problem and the Fed is behind the curve. This was for sure the conclusion of the FOMC, as they delivered what was dismissed 6 weeks ago: a 75 basis point rate hike pushing the US 10 year yield at 3.5%, the top of this cycle so far before falling rapidly below 3% on the back of poor macro data.

Should we consider that a peak in yields has been reached?

First, it is important to recognize that a bottom in bond market returns is not synonymous with a top in bond market yields. Returns will always bottom before yields peak as interest income offsets the last portion of capital losses from a rise in yields

Looking at the length of Fed tightening cycles from the first hike to the last one, we see that it is pretty typical for the bond market's return (defined as the Bloomberg Treasury Total Return Index) to trough soon after the commencement of a tightening cycle, if it hasn't already done so before the first rate rise. Yields, on the other hand, only tend to peak in the three months preceding the end of the cycle.

Of course, it's not always clear when the end of the cycle will be. Current market pricing goes for next March, which would imply a peak in 10-year yields sometime around New Year's or after. However, skepticism that the tightening cycle will endure for another nine months is emerging. Recent macro data certainly suggests the risk of an abrupt end to the tightening cycle should the current trajectory persist.

Thus, while it may be premature to call a peak in yields, it may well be appropriate to say that fixed-income returns have bottomed -- in nominal terms, at least.

US 10 year Treasury Below 3%

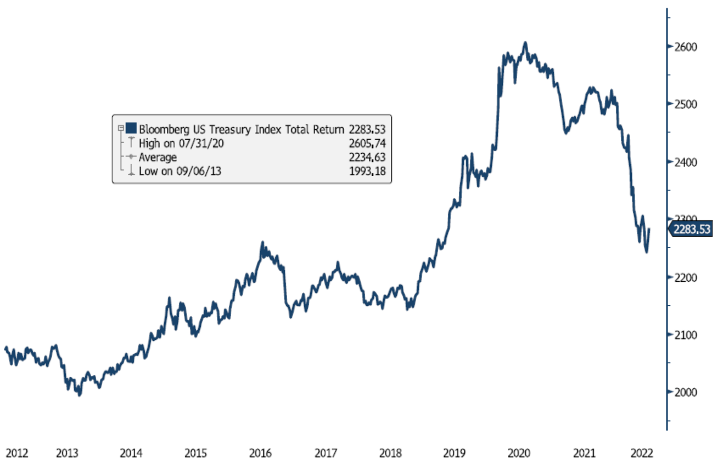
Source: Bloomberg

Fed Cycle Length

CYCLE START	CYCLE LENGTH (TRADING DAYS)	DAYS UNTIL TREASURY INDEX BOTTOM	DAY UNTIL 10Y HIGH
2/4/1994	259	66	196
3/25/1997	1	0	0
6/30/1999	230	29	146
6/30/2004	522	0	520
12/16/2015	1	0	0
12/14/2016	526	2	496
3/16/2022	72	64	64

Source: Bloomberg

US Treasury Total Return May Have Bottomed



Source: Bloomberg

Equity: S&P 500 with worst first half since 1970.

The first semester ended with a challenging month in which investors were confronted with the Fed's decision to hike rates by 75 bps instead of the 50 bps previously expected (this was the greatest increase since 1994), as inflation pressures increased, with the CPI unexpectedly accelerating in May from 8.3% to 8.6%. *This led markets to significantly correct on the backdrop of further tightening of monetary conditions, with the S&P 500 falling by over 8% in June and losing about 20% during the first half of this year.*

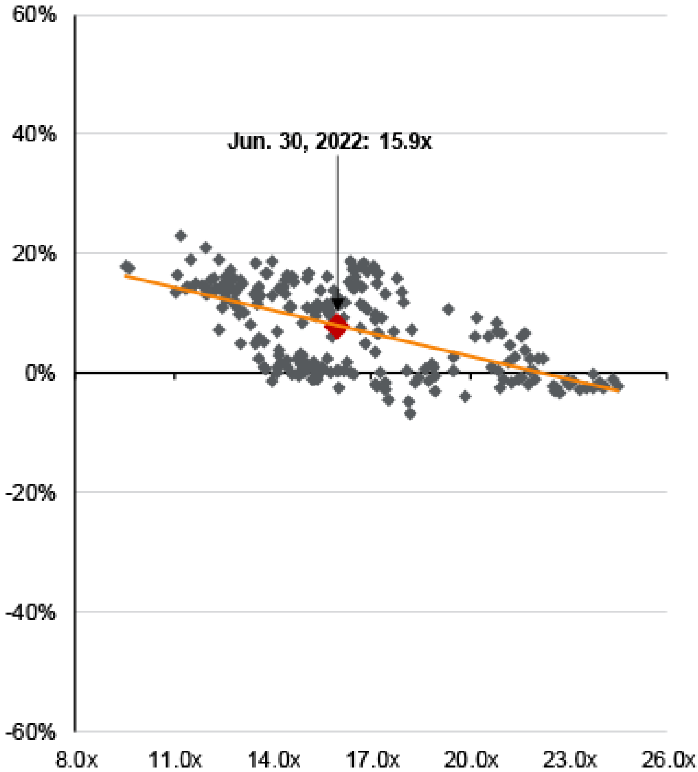
For the second half of the year, a number of risks will continue to bring uncertainty to equities' performance: inflationary pressures (that may not decline as expected by central bank), household spending that decreases (due to lower purchasing power), hiring that decreases, and investment that is also cut. As the war continues in Europe, without an end in sight, this will continue to shadow European equities, namely as the continent is challenged by its dependence on Russian energy that might lead to reductions in industrial production. With all of these risks the probability that central banks are unable to deliver a soft landing increase, and the likelihood that there's a recession over the next 12 months has increased. On the other hand, in Asia, an ease on the quarantine restrictions would be positive for local equities and could be key in unlocking global confidence as diminishing supply chain disruptions could ease inflation.

As we move towards the beginning of the Q2 earnings' season, companies' pricing power will be key as investors better understand if and how much increase in costs are they able to pass to the consumer. It's expected that the net profit margin will stand at 12.4%, in line with that observed in Q4 2021 and slightly above the 12.3% of this year's Q1. For Q2, according to Factset, profits are expected to grow by 4.1% (below the 5.9% expected on the 31st of March). Despite this decrease, *for the whole calendar year, S&P500 earnings are still expected to grow by 10.2%, with revenue increasing 10.7%.*

At current levels, valuations are starting to look appealing with a longer-term context, with the forward P/E ratio trading around 16x, lower than its 10-year average. Taking into consideration the historical relationship between P/E ratios and future returns it starts to be reasonable to expect US equities to deliver close to 10% annual returns over the next decade.

For the medium/long-term, prospects are now brighter. Nonetheless, short-term headwinds persists and as such it remains important to have a balanced equity exposure with both value and growth in the portfolio as well as cyclicals and defensives. Global equity markets may not have yet bottomed as technical indicators still point for a possible 10% further drawdown, and as we're also still 10% away from the average bear market drawdown. Nonetheless, as noise regarding whether or not a recession will occur and how strong it will be, it's important to keep in mind that equity returns tend to bottom out during or before recessions (as markets are forward looking) and as such it is imperative that investors remain with equity exposures in their portfolios in order to avoid missing a market recovery.

Forward P/E and subsequent 5-yr. annualized returns
S&P 500 Total Return Index



Source: J.P Morgan

Forex And Commodities: USD Reigns, EUR/CHF Below Parity, JPY Turning?

Persistent concerns about inflation, bear market and global slowdown made the first half of the year very lousy for financial asset, except for the US Dollar.

This "asset class" is becoming key for non-US investors seeking to reduce exposure to risky assets and hedging against stagflation. The flow of global investors pilling into the dollar was close from new records in June. Considering the current policy (Fed respond forcefully to high inflation), the dollar index could continue on the same trend and reach a new 21st century high by the end of July. Technically, a slippage in EUR/USD below the 1.04 could drive the currency pair toward June lowest level at 1.0359. Breaking this support will expose the asset to more downside level with a new low possible at 1.02. A bearish scenario on the USD is possible if investors start to perceive a combination of US interest rates having peaked and data having stabilized in the Euro Zone. Such scenario would involve a migration of investors from USD to EUR.

Japanese Yen, historically considered as a safe investment, presents today a different situation from the USD.

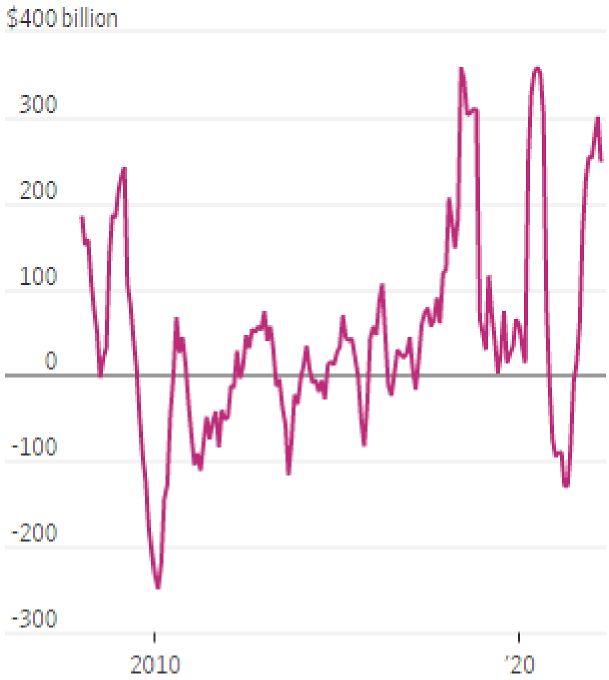
The JPY, hammered by Japan's central bank policy to keep rates around zero, has altered the currency's status as a safe haven asset. The BoJ has reiterated at end of June, that rising interest rates could hurt the Japanese economy, which is dealing with low level of inflation. USD/JPY could test the October 1998 high at 136.89. However, keeping this policy in the long term is not sustainable for the BoJ. According to recent forecasts, inflation in Japan is widening as CPI is expected to increase by 1.9% in March 2023. This acceleration is driven by higher fuel and commodity costs (Japan being a net importer of products). Hence, the BoJ could be forced to adjust its ultra-easy policy within a year.

As for the Swiss Franc, the recent and surprising rising in interest rates by the SNB on June 16, sent the Swiss Franc sharply higher.

EUR/CHF is now trading below parity and the USD fell as low as 0.95. The latest SNB declaration confirmed the need to continue to tighten monetary policy to curb rising inflation but the timing when it will occur is still unpredictable. Furthermore, new investor flows into CHF should arrive following rising concerns around a resurgent Eurozone debt crisis. Hence, a strong CHF should remain persistent.

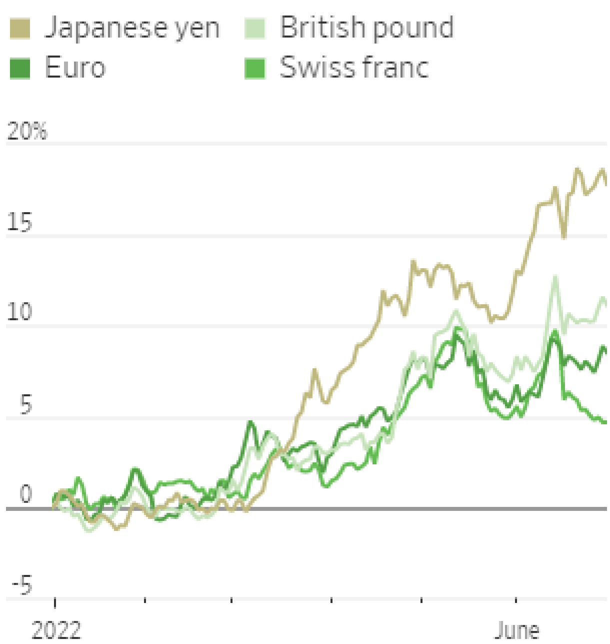
Gold continued to slide lower despite reducing treasury yield, impacted by a strong USD that become more appealing for investors as a capital protection. The target range is at 1785-1815, breaking down this range could be a sign of further decline for the yellow metal. The new focus could be closed to 1750.

Change in Short-term US Capital Inflow



Source: WSJ

The US gains in % vs Selected Currencies



Source: WSJ

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