

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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A Story of Extremes

- With inflation looming in the backdrop, the consensus among Fed governors for a faster rate hike is slowly gaining momentum
- The Fed is clearly on a sticky wicket and the bond market has noticed its predicament, pushing up yields on two- and 10-year bonds to highs seen during periods of distress
- Oil remains another worry for the market and we do not see any respite soon – despite OPEC+ meeting this week. A \$150 oil doesn't appear a distant possibility
- We believe the recent stellar performance of equities is devoid of fundamentals, and continue to remain underweight the asset class
- ASEAN and GCC remain our preferred equity markets

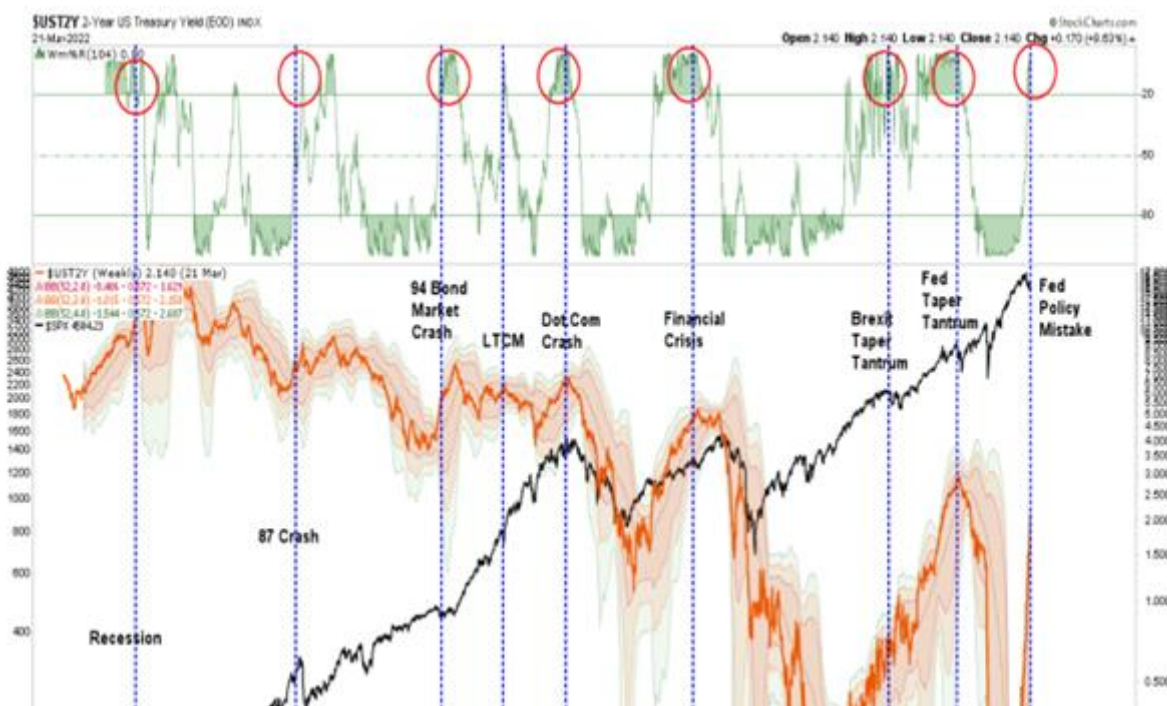
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Fed governors want faster rate increases – bonds take fright

Last week saw the Fed governors almost wishing to outdo each other in terms of their expectation on how frequently the policy rate should be increased. Board member Loretta Mester said she supported some 50bps rate hikes in 2022, advocating the need to raise the policy rate to 2.5% by the end of this year. James Bullard repeated in a speech that he favoured an even quicker pace of rate hikes. The building consensus is that the central bank will increase interest rates in increments of 50bps, which reflects its angst at the fast pace and stickiness of inflation.

The US bond market noticed the Fed’s predicament and reacted by pushing the yields higher. The US 10-year bond yields rose 18bps to 2.47%, the highest since June 2019. The two-year and 10-year bond yields are now four standard deviations above their respective 52-week moving averages. Such an increase in yields was seen just before the 1987 crash, during the LTCM fiasco in 1998, in 2000 before the dot com crisis and ahead of the Global Financial Crisis. More recently, yields spiked around taper tantrums. History tells us that such sharp spikes in yields create significant problems in the financial markets that eventually lead to economic circumstances that push yields significantly lower. Nevertheless, we see some of the most unprecedented increases in US government bond yields going forward.

Chart 1: US 2-year yield significantly away from long term average signals trouble ahead
US 2year-Tresury yield deviation from one year average



Source: Launce Roberts writing in Seeking Alpha – Surge in Bond Yields says its times to buy bonds

Oil prices are at an extreme with risks to the upside

OPEC+ meets this week, but we do not see the oil market taking a breather. The market does not expect OPEC+ to relent by quickly scaling up production to make good the loss of Russian oil. With an increasing probability of Russian oil essentially disappearing from the market, oil prices cannot fall particularly quickly without demand collapsing. Demand, however, remains resilient.

Analysts at McKinsey added to the growing chorus that oil prices continue to remain a worry, suggesting in a research report last week that \$150 was a not-so-distant possibility. In an analysis published in Oilprice.com Lutz Kilian and Michael D. Plante, economists from the Research Department at the Federal Reserve Bank of Dallas warned that "Should a large part of Russia's energy exports remain off the market throughout this year, a global economic downturn seems inevitable...this slowdown could be more protracted than the 1991 recession following the oil supply shock from Iraq's invasion of Kuwait in 1990."

Chart 2: Oil prices deviate from 200 day moving average by extraordinary amount



Source: Bloomberg

In the US, gasoline prices have surged to a national average of \$4.24, a 48% increase year-on-year, with prices surging as high as \$6 in some parts of the country. One has to expect that the price rise will have some dampening impact on consumer demand. Tepid refinery capacity has only exacerbated the effects of higher wholesale crude prices. The US consumer discretionary sector has already underperformed the broader US market by 10% since the middle of November 2021. However, more under performance could be in store if oil prices remain at their current level.

In the backdrop of such complex macro and geopolitical news, one would expect equity markets to grow nervous. However, contrary to the expectations, markets have put in a stellar

performance. US equities were up close to 2% on the week, with Japan closing 5% higher and Europe declining slightly. Various studies on the long-term performance of global equity markets conclude that macro news does not do an excellent job of sending markets in one direction or the other in the very short term. However, equity markets do eventually succumb. The 2006-07 period, for instance, witnessed deteriorating fundamentals, but equities didn't crack until August 2007 and had to wait until 2008 before they fell precipitously. We suspect that equities will not crack until companies start to sound much more worried about the outlook. They may also wait until bond yields are materially higher still before worrying unduly about the rise in bond yields.

To date, global macro news has remained somewhat encouraging. The Citigroup's Global Economic Surprise Index has remained positive, indicating that economic data has come in above market expectations on balance. Going into the Ukraine crisis, activity was generally strong in the US, Europe and Asia, in part due to the recovery from Omicron.

However, there's a good chance that that is about to change. The weight of the uncertainty around the impact of the sanctions and the materially higher inflation led by commodity must weigh on confidence and real activity going forward.

We remain underweight equities and believe that there could be some dark days ahead as the data reflects the reality of the damage done to supply lines and global trading. We would reiterate that just because equities have held up so far does not mean that they will in the future. Analysts will not mark back their forecasts until companies tell them to. The market is also much more prone to herd behaviour than before. The general consensus is that because the markets have held up, they will in the future, too. The "Fed will always come to the rescue". These analyses are a good reference point for sentiment but not for the fundamentals. A European war, the highest inflation in 25 years and the four standard deviation increase in market interest rates do not typically mark an equity bull market.

Our preferred regions for equity investment include ASEAN and the GCC. The former benefits from a broad re-opening of the economies as Omicron is either seen as less of a threat of something a country is willing to live with.

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