Sanctum Wealth

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY **BY GARY DUGAN**

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Deflating Exaggerated Worry

- **Better-than-expected US inflation data boosts the markets' mood**
- **Inflation, though, is not beaten and growth is on the wane**
- **Crypto industry challenges show that risks lurk in the financial system**
- **We continue to favour non-US equity markets although we would not rush back into equities at present**
- **As the hopes of a broader reopening of the Chinese economy gain ground, we would encourage investors to keep an eye on the metals sector**

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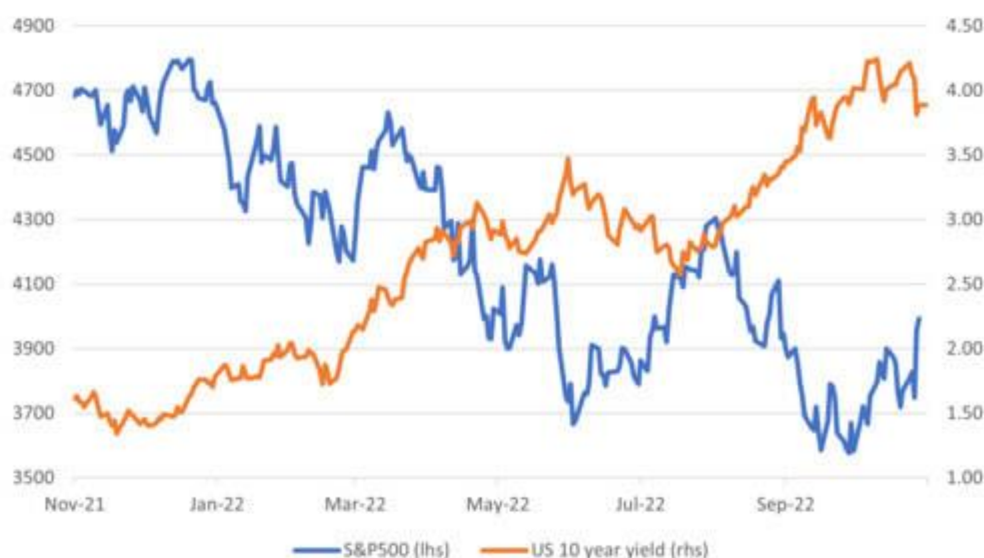
What a difference one number can make! We knew that markets were primed to react to any word from a central banker that implied a pivot to comparatively easier monetary conditions ahead. However, it ultimately proved to be just one 'good' inflation data point that turned sentiments around. The US inflation data for October, at 7.7% against expectations of 7.9%, boosted sentiments and set expectations of more realistic rate increases rolling. Ironically, the previous month's headline inflation number was worse than expected when it hit 8.2% and eventually remained unrevised.

Equity markets ended the week up 4-8%, US 10-year government bond yields retreated 40bps to 3.84%, and the trade-weighted dollar weakened 4.1%. Our favoured assets from last week, Chinese equities and REITs both performed better than the averages, as previous underperformers notched up solid gains. The Hang Seng index rose 7.2%, and the US REITs sector advanced 6.5%, outpacing the S&P500's 5.9% return. Government bonds outpaced private credit as investors felt encouraged on hopes that central bankers would go a little soft on raising interest rates. The credit market is still somewhat wary of the risks of an economic slowdown.

Chart 1: Markets Rally as Inflation Surprises to the Downside



Source: Bloomberg

Considering the tumultuous year that we have had, we have tried to focus on the good news. However, as we draw lessons from the past, it is also essential not to rejig your portfolio strategy because of one data point and, more importantly, to take stock of all that is going on.

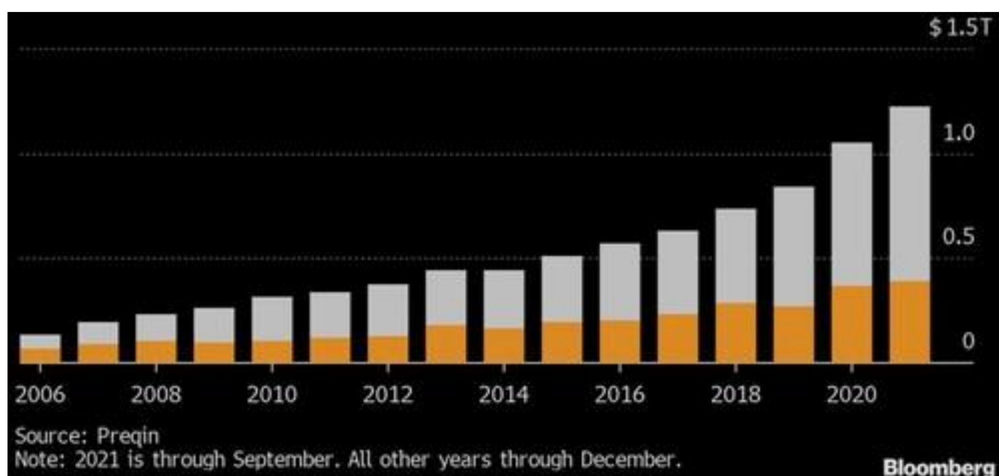
One good inflation number is unlikely to deter the Fed from increasing interest rates by a further 50bps when it meets in December. However, the market would still hope that the Fed will not have to increase the interest rates wildly. Hence, the market moved to discount a peak in the Fed funds rate at 5%, and not higher.

Last week's US inflation data showed a moderation in disrupted-supply-line inflation, with commodities ex-food and energy easing back. However, housing costs are still a significant source of inflation pressure. Indeed, the service sector, in aggregate, continues to churn out nearly four percentage points of the total inflation figures.

In trying to be more considered in how one should respond to this encouraging figure, it is best to retain a complete overview of what's happening in the world. First, inflation at 7.7% is way ahead of 2% that the Fed still has as its target. Evidently, we have quite a distance to cover before we bring inflation down to that level. Secondly, all central banks appear determined to tame the inflationary pressures even if that means compromising on growth. We are barely at the beginning of the growth slowdown. Although somewhat more reluctantly, that economic downturn is already under way in the US, where, incidentally, activity has been relatively robust.

As much as investors were encouraged by the better-than-expected inflation news, they remain concerned with developments in the cryptocurrency market. The much-discussed failure of FTX, the second-largest cryptocurrency exchange, was yet another example of far corners of the financial system crumbling over when interest rates rose, and credit conditions tightened. Bitcoin has plunged 75% over the past year. While the banks were at the epicentre of the global financial crisis, banks found themselves on the periphery of the current problems because of the regulatory changes. In 2011, the three largest US banks still accounted for 50% of the US mortgage market. By 2016 that had fallen to just 21%, and it is understood to have fallen further since.

Chart 2: The Growth of the Private Capital Market



Source: Bloomberg
Note: orange area denotes cash waiting to be deployed

The challenges in the crypto markets are a salutary wake-up call to investors around the unconventional corners of the financial system that are at risk from tighter monetary conditions. Trying to work out where those weak links in the financial system may reside are more complicated now that banks are no longer the epicentre of the lending world. For those needing a large loan, the banks have not been the starting point for some time now. There has been a phenomenal growth in the private credit market, which, according to estimates, has grown at about 25% per annum over the past two decades to around $1.2-1.5 trillion. Much of the private credit market remains concentrated inside asset management companies such as Blackrock. Last year, Sen. Elizabeth Warren challenged Secretary of State Janet Yellen on why Blackrock wasn't too big to fail, requiring more regulatory scrutiny regarding its vital role in the financial sector. We hope that Elizabeth Warren's words don't turn out to be prophetic!

What next? While better than expected, the current inflation figure is frankly not that encouraging. There's no denying the fact that inflation is still a problem; central banks will, therefore, raise rates further, and growth will take a hit. Bond yields have reverted to where they have been on average over the past three months. Over this period, the US equity market is down 6%, while Europe and Japan are about flat. Hence, one could conclude that markets are logically priced currently and awaiting further developments.

We would not panic and rush back into the markets. However, as we stressed last week, opportunities are emerging, given the scale of selloff that most asset classes, if not all, have witnessed. In our view, **Chinese equities still stand out with pure option pricing on the upside** from the re-opening of the economy. The decision by Chinese authorities to cut the amount of time travellers entering the country must spend in quarantine aided sentiments, helping lift the Hang Seng up nearly 8%. The decision removed a significant restriction on international flights.

We continue to favour non-US markets. In large parts, European equities have suffered a significant de-rating due to their proximity—and vulnerability— to a war zone and concerns about a winter marred by fuel shortages. However, the stabilisation of the euro after last week's rally will help sentiments and take the edge off the inflation problem. Last week, the smart rebound in the REITs sector showed the scope for recovery as investors discounted fewer rate hikes in the future. However, as we said last week, the sector has been unjustly hit, given that the companies continue to announce good dividend increases.

It's worth keeping an eye on the metals sector, given the hopes of a re-opening of the Chinese economy. Ironically, a broad re-opening could have investors fearing an acceleration in global inflation if it prompted a general rise in the commodity prices. The copper sector ETF is up 25% from its 12-month low. Gold's 8.7% rise from its recent low as the dollar retreated from its trade-weighted highs is a salutary lesson for investors who deny its value in portfolios.

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