Weekly Macro and Markets View

20 June 2022

Highlights and View

The FOMC lifts the fed funds target rate by 75bps, the largest increase since 1994

In deviating from its clear guidance, the Fed looks panicky and loses significant credibility, creating higher volatility and making its future job more challenging.

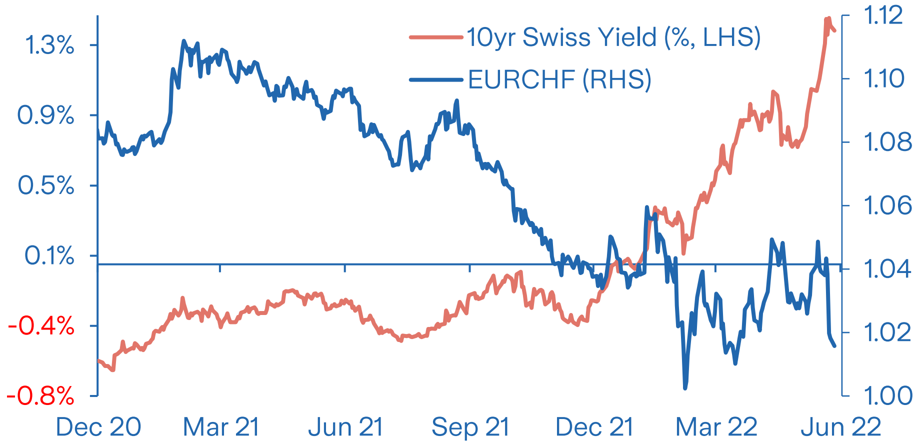
The Bank of Japan leaves monetary policy unchanged

BoJ Governor Kuroda is unlikely to join the hawkish chorus of global central banks as core inflation remains contained in Japan.

Financial assets plunge as investors take fright and price in an imminent recession

Record declines in some stocks suggest investors are capitulating, leading to oversold conditions and the potential for a bounce, though a protracted recovery is unlikely while rates and inflation are on the rise.

The SNB surprises, and signals more to come



Source: Bloomberg

The Swiss National Bank delivered a surprise 50bp rate hike last week, moving ahead of the planned ECB lift-off in July. This was the first hike in 15 years, triggering a stronger franc and amplifying global rates and bond market volatility. They also lifted the inflation forecast, but this was expected given their dovish view expressed in the last meeting. More surprising was the removal of an assessment that the Swiss franc is strong or highly valued, which has been part of the monetary statement over the past decade. A key reason for the hawkish shift appears to be a desire to avoid a slump in the currency, given aggressive policy tightening in the rest of the world. There was also a focus on reverting to using the policy rate as the main instrument, rather than relying on sizable FX reserves to offset any currency weakening. While the rate hike will limit depreciation pressures, the SNB will be in a more challenging position should significant economic and geopolitical risk materialise. This could lead to renewed strong demand for safe haven assets, including the Swiss franc.

A bond market sell-off, which was triggered by the Fed's 75bp hike, intensified on SNB's hawkish shift, in part on speculation that the BoJ would move in a similar direction. Yields stabilised later as the BoJ has remained dovish. The ECB's ad hoc meeting to address fragmentation risk also reduced upward pressure on yields, along with rising recession risk.

US

The Fed panics and lifts rates by 75bps

Despite its earlier guidance, the Fed accelerated its tightening path and lifted the fed funds target rate by 75bps to a range of 1.5% to 1.75%, the largest step since 1994. While this moves the Fed closer to its projected terminal rate, the FOMC's future job is likely to be more challenging as its forward guidance has become much less reliable and this is likely to create more volatility in financial markets. Meanwhile, producer prices ticked down on an annual basis in May though price pressure remains substantial in the near term. The latest economic data confirm that monetary tightening and high inflation are leaving their mark on activity. Both retail sales and industrial production slowed in May while some regional manufacturing surveys are signaling further headwinds. The slowdown is particularly pronounced in the housing market with building permits falling 7% MoM in May following the 3% MoM drop in April while housing starts drop more than 14% MoM.

Equities

Down, down, deeper and down for stocks

Another torrid week for investors saw the rout in financial assets continue, with the MSCI World Equity Index down 5.9%. According to Bloomberg, five of the last seven sessions have seen more than 90% of S&P 500 stocks decline, the worst such period on record. Indeed, year-to-date, this has been the second worst start to the year since the 1920s, only 'beaten' by the falls of 1932. The 'everything rally' has quickly become the everything implosion as we sense real fear and capitulation has now set into investor psychology. Despite the protracted declines this year, this capitulation had been a missing ingredient in helping to form a bottom in stocks. While we acknowledge fears of a recession are fully justified, and indeed predict a technical contraction next year, the most recent moves now appear overdone in the short term. Our own proprietary indicators corroborate this, and we can see a bounce in the offing. However, were this to materialise, it should not be confused with the start of a new bull run. Policy will continue to be tightened while earnings will be squeezed.

Credit

Renewed volatility keeps issuers on the sidelines

Monetary policy action last week brought volatility to US and European markets, with both CDS and cash spreads widening significantly. US HY cash spreads touched 508bps on Thursday and closed the week at 502bps. Credit funds suffered outflows across the board. US HY and leveraged loans funds saw outflows of USD 5.7bn and USD 2.0bn respectively, the largest since the early Covid crisis in 2020. Issuance came to a halt. US IG experienced its first week this year with no issuance and in US HY it was not easy for the two companies that did come to market to attract investors. Intertape Polymer priced its CCC-rated notes at a yield of 14.36%, well above the 11-12% range announced a week earlier, while Entegris also sold its BB-rated notes with a notable discount. With HY underperforming IG since May in the US, the HY/IG spread has continued to decompress and has now reached its historical average at 3.53. While IG credit, especially in Europe, seems to be pricing in a recession, risk reward in HY seems skewed to the downside, especially in the event of a recession.

Japan

The Bank of Japan keeps monetary policy unchanged

The Bank of Japan refrained from joining other major central banks currently hiking policy rates, keeping monetary policy unchanged. Governor Kuroda explained that he doesn't see any urgency to change the Yield Curve Control (YCC) policies, but we note that the BoJ may be on track to own all outstanding JGBs later next year if it keeps buying at the current pace. We believe a widening of the 10yr JGB yield target from +/- 0.25% to +/- 0.5% remains a possibility for the second half of the year. Next year, after Kuroda's second five-year term ends in April, a re-assessment of monetary policy may be in the offing. Meanwhile, both the Business Sentiment Survey for Q2 and the Reuters Tankan for May showed a positive tilt, particularly in non-manufacturing, while capex plans remain optimistic, which is a good precursor to the Q2 Tankan Survey that will be published on July 1. Export and particularly import values surged in May. However, volumes were less convincing as parts shortages persist, particularly in the auto sector. Finally, we want to highlight that the USDJPY moved to 135, a 20-year high.

China

Industrial production and infrastructure spending recover, property investment and retail sales remain weak

As outlined last week, China's economic activity data have started to improve. In line with exports, industrial production in May recovered more than consensus had expected. Several manufacturing industries obviously made up some of the production setbacks following major lockdowns in the province of Jilin and the city of Shanghai, particularly in the auto sector. While auto production tumbled by nearly 32% YoY in April it was down only 7% YoY in May. However, services production remained weak. Fixed-asset investment recovered in both infrastructure and manufacturing but remained weak in the property sector. The surge in infrastructure investment, up nearly 8% YoY, is in line with the government's push to spur growth in order to boost the economic recovery in the second half of the year. Local governments in 24 provinces have announced 11% more projects than last year. Meanwhile, property investments remain weak, down 7.8% YoY, with home sales still down 46% in the first half of June. Retail sales are recovering, but still down 6.7% YoY in May.

What to Watch

- June Flash PMI data will show whether economic growth has remained resilient given the sharp tightening in financial conditions.
- In APAC, we believe the Philippine's BSP will hike its policy rates by 25bps, while Indonesia's BI will stay put and may wait until Q3 before raising its policy rate by 25bps. In Japan, we expect May CPI ex fresh food to remain around 2% YoY. Taiwan, Singapore, and Thailand will report industrial production data for May, while May CPI data will be released in Hong Kong, Singapore, and Malaysia.
- In LatAm, the focus will remain on monetary policy. In Mexico, we expect Banxico to hike the policy rate by 75bps to 7.75%, while the minutes of the last meeting in Brazil will provide us with more insight regarding the next steps of the Central Bank.
- Inflation rates are expected to remain stubbornly high in the UK while retail sales and PMIs are likely to show increasing headwinds for the economy.

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