PLEION WEALTH PARTNERS

Weekly - June 27, 2022

PERFORMANCES 2022	
EQUITIES	
MSCI World	-18.9%
S&P 500	-17.9%
Nasdaq	-25.8%
Stoxx 600	-14.6%
SPI	-14.7%
Nikkei	-6.7%
China	-10.0%
Emerging	-17.9%
BONDS	
CHF Corp	-7.2%
US Govt	-9.8%
US Corp	-14.6%
US HY	-12.6%
EUR Gvt	-14.1%
EUR Corp	-12.1%
EUR HY	-12.1%
CURRENCIES	
USD index	+8.7%
EURUSD	-6.9%
EURCHF	-2.4%
USDCHF	+4.9%
USDJPY	+17.3%
EM FX	-1.6%
COMMODITIES	
Gold	+0.5%
Silver	-7.9%
Brent	+46.2%
Copper	-15.1%
CRB index	+28.5%

House of Cards

Typically, monetary policy tightening works with a lag on the real economy. However, this time is different. We are already seeing the impacts of the Fed sudden shift. JPMorgan Chase is laying off hundreds of employees in its home-lending business, and it is not the only one. Wells Fargo, the biggest US mortgage lender, is also shrinking its division. Earlier in the month, 2 large US real estate brokers (Compass and Redfin) announced their aim to reduce their workforces given clear signals of a housing market downturn.

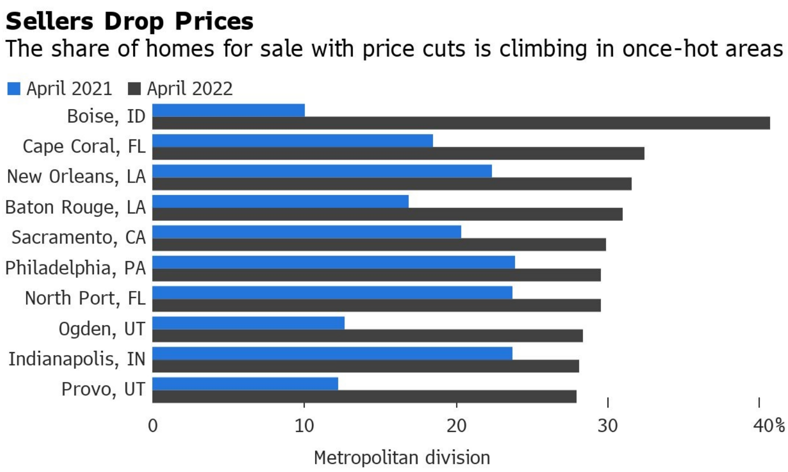
Real economy is suffering

While the Fed has re-affirmed its willingness to curb inflation by sharply raising Fed Funds, mortgage rates have skyrocketed to their highest level since the Global Financial Crisis. The 30-year fixed mortgage rate climbed temporarily above 6.0% last week - a 14-year high - against 3.2% at the start of the year. It is not just mortgage rates that are spiking. Credit card interest rates are rising too to around 20%. Auto and small business loans are following.

Sales of higher priced homes are holding up well. By consequence, a growing number of homeowners, which believe the housing market is topping out, are rushing to put their homes on the market. But a more challenging context has already forced almost 20% of them to cut prices in May, the most since October 2019, according to the Redfin broker.

Furthermore, one of the big shifts that took place during the pandemic, the accelerated migration to the suburbs and less expensive cities in the South and Mountain West, is moderating now that workers are returning to the office and workplaces.

Downward pressures on house prices are resurfacing



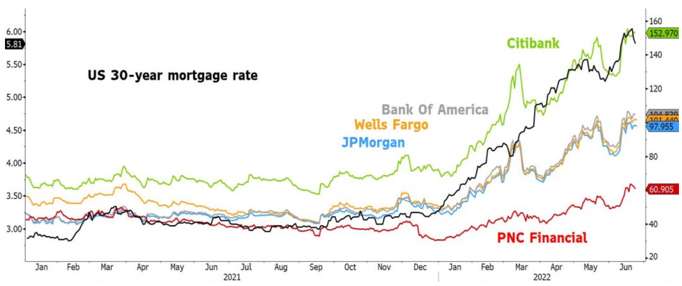
Source: Redfin, Bloomberg

Most of the past few weeks US housing data released showed that the demand is decelerating. Total housing starts dropped 14% in May to a 1.5 million unit, a relatively strong level still, but the lowest since April 2021. Single-family starts declined 9.2%, the third consecutive monthly drop and down 5.3% on a year-over-year basis. Sales of existing homes fell 3.4% in May to a 5.41 million unit per annum. They have now fallen back to their pre-pandemic level. The NAHB Housing Market Index – a survey used to take the pulse of the housing market - fell two points to 67 in June, marking the sixth consecutive monthly decline and its lowest reading since June 2020.
Higher prices and interest rates have reduced affordability

Markets are ringing the alarm bell

The consumer stance/mindset is not the only tangible tool to measure the effectiveness of the Fed monetary policy tightening. Powell has repeated in the past few months that tighter financial conditions, which have meaningfully compressed since this year, will have a broad impact on the economy.

Mortgage rate and US bank credit premium (5-year CDS spread)



Source: Bloomberg

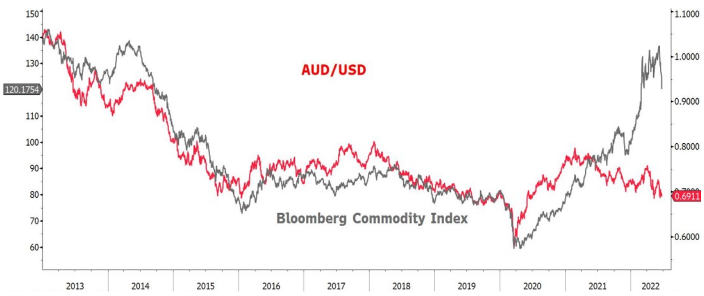
The higher mortgage rates, which are usually seen as a positive indicator for the banking sector, are adding pressure on their balance sheets. Even if reserve ratios remain very elevated, the risks of foreclosures are pushing the top US banks credit spreads wider. The MOVE Index which measures the US Treasury bonds volatility hit its highest level since 2020 adding pressure on financial institutions risk budgets. Finally, the US yield curve continues to send clear signs of economic slowdown. The 10-year minus 2-year yield spread has slumped again close to zero. A signal of higher recession risks.

- *A housing shock would freeze bank lending as the risk of bad loans increases*
- *Falling home prices would erode household wealth, dent consumer confidence, and potentially curb future development*

Currencies. Nasty time for commodity related currencies

The AUD is down against all G10 currencies over the past week while there has been a flurry of RBA communication. The RBA reinforced its message of multiple further rates hikes ahead. The June 7th meeting minutes showed substantial discussion about sticking with 25bps increases. Governor Lowe pushed back against market pricing, saying that the July 5th meeting debate will likely be again 25bps vs. 50bps. This comment, along with a general pairing back of the exuberance, has scaled down expectations. December pricing has come off from a high of around 3.9% to around 3.25%.

Link between AUD and commodity prices



Source: Bloomberg

Several familiar themes are in play to also explain the recent AUD weakness like falling commodity prices, central banks' aggressive tightening, global growth deceleration and struggling global equity markets. Recession risks have hammered metals like copper, aluminum, nickel, iron ore and oil prices too.

In Norway, the central bank has stepped up the pace of its tightening cycle, by hiking rates by 50bps for the 1st time, after having previously implemented three 25bps rate rises since last September. That was more than the consensus was expecting but came not as a huge shock as most of the indicators Norges Bank looks at have been significantly more hawkish than in March. It has also upgraded its rate path projections to include a 3.0% terminal rate by mid-2023.

A clear disconnect in period of stress

Source: Bloomberg

The reaction in EUR/NOK appeared rather counterintuitive given the hawkish surprise delivered, with the pair quickly jumping back to 10.50 after a brief and very contained drop.

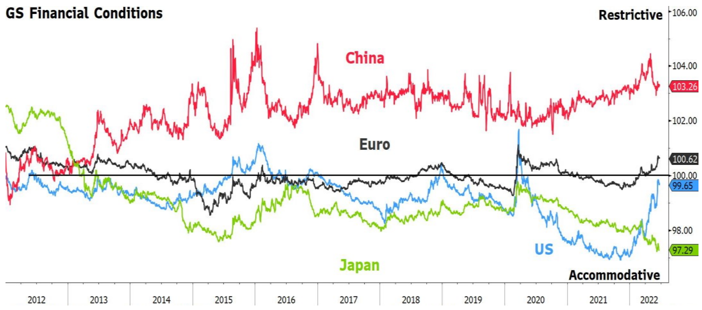
The NOK is 10% weaker than the central bank March expectations in trade-weighted terms, while the ever-increasing amount of tightening being priced into USD and EUR markets had also pointed to a more aggressive response from Norges Bank. Inflation has come in above expectations, too. The only thing that has not changed much from the March forecasts is the oil price.

The low-liquidity character of the NOK makes it unattractive in periods of unstable risk sentiment.

- *The AUD is probably more vulnerable to recession anxiety than any other currency*
- *Despite a more hawkish Norges Bank, the NOK should remain vulnerable in the near term. Some material stabilization in global sentiment is needed to re-connect with its attractive fundamentals*

Currencies. The Japanese exception

The BoJ decision to leave policy unchanged underscores the central bank determination to get inflation up and signaled that JPY depreciation alone is not sufficient to tighten policy. As other major central banks, the BoJ does not target the exchange rate. Inflation has picked up, but there is still little response in wage growth so far. April earnings rose 1.7% compared to 2.0% in March and 1.4% a year earlier. CPI inflation has risen (April at 2.5%), but core inflation pressures remain subdued (2.1%) and ex-energy were modest at 0.8%. PPI services inflation at 1.7% is not signaling a worrying inflationary pipeline.



Source: Bloomberg

Before lifting the Yield Curve Control cap, the BoJ will need to see an intensification of inflationary pressures over the summer. The BoJ will also want to ensure that the economic recovery is intact. In April, industrial production fell and the index has pretty much been flat since the start of the year. Recent strength in core machinery orders is encouraging, but again, it has been a mixed picture for 2022 so far.

JPY and yield differential

Source: Bloomberg

The BoJ is therefore likely to remain the last dove, awaiting further intensifying inflationary pressures and economic recovery before tightening policy. In the near term, therefore, only the US bond market will remain on the driver seat.

- *With a BoJ committed to its very accommodative policy, the JPY will continue to be driven by external factors*

Equities. A 1st semester-end rally before correction resumes?

A rally was justified last week: oversold indices, historically low investors' sentiment indicators and a first half of the year among the worst in terms of performance. Above all, it benefited from a decline in the US 10-year from 3.5% to 3%. This rally could continue in the next few days, but we still remain in a pattern of a rally in a bear market.

Historically, the 3rd quarter of a year of mid-term elections in the United States is unfavorable to equities, with a lot of volatility. The latest polls show Republican gains in both houses of Congress. A Republican Congress would mean a paralysis of the Biden Administration.

In 2 weeks, the publication of the results will begin. Downward earnings revisions are expected, but for the moment they have not materialized, surprisingly. We remain at +10.4% in 2022 and +9.3% in 2023. It seems inevitable to us that profits will decline with the global energy and food crisis, inflation, war in Europe and multiple disruptions. But it is true that this is the big unknown, because corporate profits and margins have shown great resilience for several quarters, even years, and an extraordinary capacity to rebound from this health crisis, which is not yet complete. Inflation and falling stock and bond prices are starting to weigh on consumer sentiment, which is becoming more cautious. Walmart and Target had already reported in the 1st quarter that consumers had reduced their spending on discretionary products (household appliances, automobiles, electronics, etc.).

The risk of a spillover from the Ukrainian conflict is real. Lithuania's decision to block goods under Western sanctions crossing Lithuania by rail to the Russian enclave of Kaliningrad has infuriated Russians. The Russian response was the announcement that Iskander missiles capable of carrying nuclear warheads would be sent to Belarus in the coming months. Tensions over Kaliningrad worry NATO. Russia could seize the Suwalki Corridor, linking Belarus to Kaliningrad, and thus block land movements between Poland and the Baltic countries. NATO intervention by sea and air would be complicated, since Kaliningrad is the home port of the Russian Baltic Fleet and an "A2AD bubble" (Anti-Access Area-Denial), based on efficient air defense systems (S-300 and S-400), was installed there. To this, we must also count the Russian air base installed in Belarus. In short, we would undoubtedly be approaching a NATO-Russia conflict.

Regarding the nuclear strategy, NATO is in the "all or nothing", a dissuasion strategy based on strategic nuclear weapons. Russia has a nuclear strategy at 2 levels: tactical nuclear weapons, usable on a battlefield, and strategic weapons. Europeans have so far lived in denial with the Russian nuclear strategy, which has been well known since 2000.

The G7 continues its sanctions against Russia. The latest is a ban on Russian gold imports. To “welcome” this new sanction and the meeting of the G7 and NATO, Russia last Sunday launched missiles at residential buildings in Kyiv.

With the sharp decline in Russian gas exports, Europe is on the verge of a major energy crisis. TotalEnergies, EDF and Engie are issuing a powerful cry of alarm and asking the French people to immediately reduce their consumption of fuel, oil, electricity and gas. European countries are trying to fill their gas reserves for next winter. Germany is also very alarmist. We do not understand why Europe does not take rationing measures, such as those recommended by the International Energy Agency. The risk of recession is becoming inevitable in Europe.

- *In the short term, technical indicators explain the rebound of indices*
- *Inflation, the geopolitical situation and the energy crisis in Europe (it would only be the beginning) justify great caution*
- *Economic cycle justifies defensive sector positioning, Consumer Staples, Healthcare and Utilities*

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