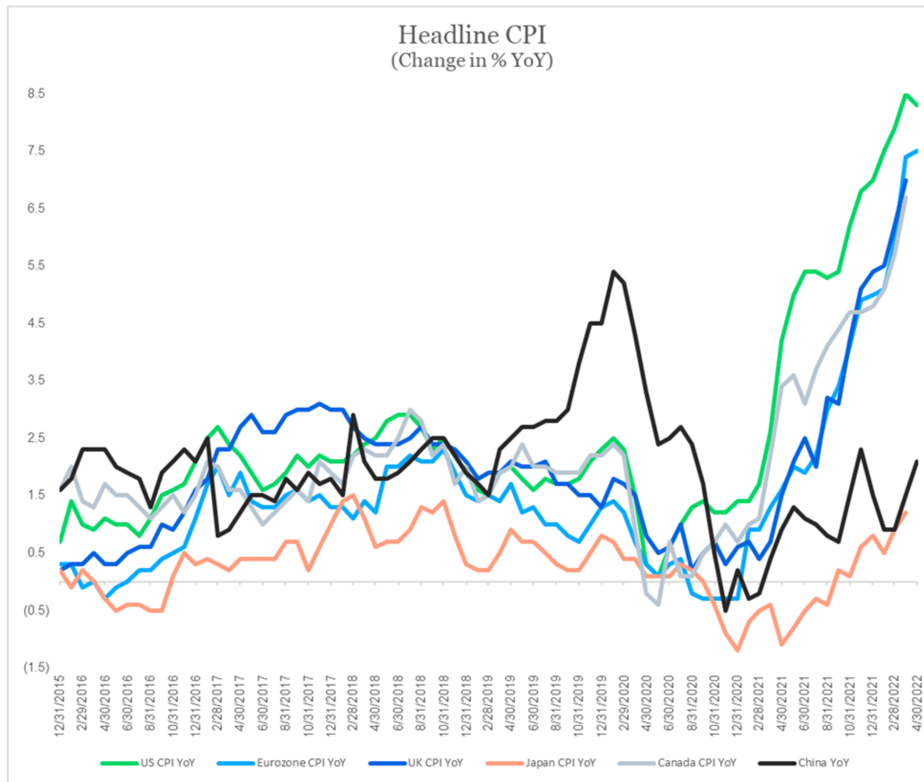
RockCreek

FRIDAY, MAY 13, 2022

# NO LASTING RELIEF

**Interest rates will go higher for longer, with attendant risks for both stocks and bonds. That was the message from this week's data here and in Europe, reinforced by central bank comments. Markets reacted with a sea of red. A rally at week's end still left equities down for the week.**

**Yes, US consumer price inflation edged down last month, confirming that the March annual rate may have been the peak. But April's 8.3% headline rise over a year ago was above most expectations. And a more detailed look at the numbers showed a worrying rise in prices for services – still the bulk of consumer spending – and shelter, even as goods prices slowed. Across the Atlantic, European Central Bank (ECB) President Christine Lagarde let the other shoe drop. A rate rise in July is likely, she said. Not surprising, as eurozone inflation is at record highs and Germany, historically allergic to inflation, this week reported price increases of 7.4% in April, the highest since German reunification more than three decades ago.**




1133 CONNECTICUT AVENUE N.W. | WASHINGTON, D.C. 20036
156 FIFTH AVENUE | NEW YORK, NY 10010

The five interconnected themes that we are watching this quarter – geopolitics, inflation, monetary tightening, jobs, and Covid – remain key to the outlook.

With Finland and Sweden on a path to join NATO, Russian President Vladimir Putin will continue to rail against the West and to order his army to fight on in Ukraine. If this is met with tightening sanctions, notably on energy, look for the European economy to suffer, weakening output by more than is currently forecast by economists or priced in by markets. The US is in a stronger position, **as we have noted before**. But as the Fed tries to get ahead of higher inflation, it has embarked on a rapid and steep tightening path. This week's bond market movements show that investors fear the Fed may overdo it and tip the US economy into recession, despite still strong labor markets.

Finally, COVID remains a serious risk to the global economy through its impact on China, the world's second largest economy. Investors who have poured money into China over decades of rapid growth are now right to be concerned. The current leadership under President Xi Jinping has doubled down on what looks like a serious policy mistake: continuing a zero-covid policy, with production stoppages and drastic lockdowns, despite Omicron's high transmissibility and less severe health impact. This comes on top of the shock to the economy of last year's regulatory tightening against tech companies and real estate. As a result economic indicators are beginning to point to a sharp slowdown, possibly even a contraction, in China's manufacturing sector.

This brings us full circle to geopolitics. Relations between the US and China are such that there is no prospect of mutual help to support the global economy. At the recent Washington meetings of the International Monetary Fund and World Bank, leading finance officials from around the world could not even agree on a communique with the usual form of words in favor of a strong international financial system. The US is now considering further sanctions against Chinese products used for solar power, which will hurt industries in both countries, and the potential slow down in the growth of solar as building local US capacity will take time. And tariff relief, which could ease inflation in the US, is not supported in the Biden Administration – it would look too kind to China's exporters.

***What went up is crashing down***

Pandemic-driven lockdowns, record-low interest rates, and massive infusions of liquidity into the system were a boon for technology stocks, to the point where valuations across a large swath of the sector became divorced from reality over the last few years. The subsequent reopening, soaring inflation, and rising interest rates have now brought to bear a jarring correction. Year-to-date, the S&P 500 has lost more than $7 trillion in market value and the Nasdaq has gone deep into bear market territory. The nosedives for hyped-up Covid beneficiaries are well-documented. Peloton and Carvana are down around 90% from their peaks. Netflix and DocuSign have lost 75% or more of their market caps.

These types of losses are reminiscent of the dot-com bubble. The growth segment of the market was very much in need of a correction, but the speed and magnitude caught many investors off guard – as is usually the case with corrections. As recession worries have taken over, pain has spread and there have been fewer and fewer places to hide. Even mega-cap tech stocks, once reliable safe havens, have been caught up in the unwinding. Two stalwarts, Amazon and Apple, have lost approximately 35% and 20% of their value, respectively, since the end of March.

Confidence has been severely shaken, and the market continues to search for a bottom. Depending on your frame of reference, you could draw any number of conclusions about whether this sell-off is still in its early or now in its late innings. On the one hand, the S&P 500's P/E ratio of 19.5 sits below its 30-year average of 20.3. On the other hand, looking farther back, bear market drops in the post-World War II era have taken the S&P 500's P/E all the way down to 12.6 on average. Additionally, we have yet to see a full-blown washout of sentiment for these once high-flying growth stocks. Retail investors are still "buying the dip", which indicates there is not the widespread loss of hope that usually signals a market bottom. The VIX, a good measure of investor fear, is elevated at around 32 but has not exhibited the type of spike that normally accompanies a widespread capitulation. All of this likely points to continued risk and uncertainty as the equity market sizes up the current reality.

Crypto, once considered by some to be a hedge against inflation, has proven anything but. According to data from CoinMarketCap, the total cryptocurrency market cap fell by $449 billion in the past week. While the pain was felt across all parts of the industry, a large proportion of the decline came from the implosion of the stablecoin TerraUSD (UST) and Terra's native staking token Luna (LUNA). The stablecoin, which like money market instruments is meant to maintain its 1-to-1 peg to the U.S. dollar, saw its value fall as low as 30 cents per dollar in what some suspect was an intentional subversion of the protocol.

UST is an "algorithmic stablecoin" which means that , unlike money market instruments and other stablecoins, it is not fully collateralized. Instead, it depends on a complex mint and burn mechanism to maintain its price stability. While we will spare you the details of the protocol here, a complete description can be found on the **Terra Docs repository**. One takeaway from the docs is the explicit statement that "stablecoins are only valuable to users if they maintain their price peg" and that Luna's value is derived by the amount of Terra used ("The more Terra is used, the more Luna is worth"). Given that UST broke its peg in the most dramatic fashion, it would seem Luna's collapse from $80 to $0 would be justified.

The financial fallout is not modest. UST and LUNA had market caps of approximately $18 billion and $28 billion, respectively, a week ago – both in the top ten of cryptocurrencies by that metric. Tether (USDT), the largest stablecoin representing more than $80 billion in value, experienced a disconcerting drop of its own during the melee to $0.95. Ethereum lost one-third of its value this week before finding its footing as the event dented optimism for all DeFi projects, while Bitcoin fell to $26,350, its lowest level since 2020. Going forward, the event also further empowers regulators that have had stablecoins in their crosshairs.

***What to make of inflation?***

The headlines after the release of Wednesday's CPI indicated confusion. Some emphasized that annual inflation had apparently peaked as April's headline increase of 8.3% was down from March. Others pointed to the concerning month on month acceleration in core prices, excluding energy and food, from 0.3 % in March to 0.6% last month. Still other commentators worried that the price data show that inflation is broadening out, beyond the initial upward pressure on goods prices that was exacerbated by the Covid lockdown and supply chain problems. But finally, there is some evidence that wage increases remain contained: good for inflation, but bad for real incomes, as we have noted before.

Confusingly, all of these views are correct. The bottom line is that US inflation remains uncomfortably high; its future path remains uncertain – dependent on exogenous shocks to supply whether from war (and sanctions) in Europe or China's fight against Covid, as well as to wage and price dynamics at home; and the Federal Reserve will continue to raise interest rates and tighten liquidity until it becomes convinced that inflation is securely on a downward path. The Fed will have another CPI reading before its policy meeting in mid-June. That, as well as other data, will feed into its decision. Right now, another 50 basis point increase in the policy rate looks most likely.

***Europe looks East with concern***

Investors in the US may now be seeing the European conflict as almost akin to background noise. In Europe, it is front and center. And if the Russian atrocities shown daily to European audiences continue – as is likely – the pressure to take more drastic economic action will only build. An airtight embargo on Russian energy exports would push up prices sharply. It is being resisted so far because of widespread fears – including in the US – that higher oil prices would worsen inflation and, in Europe, hit output.

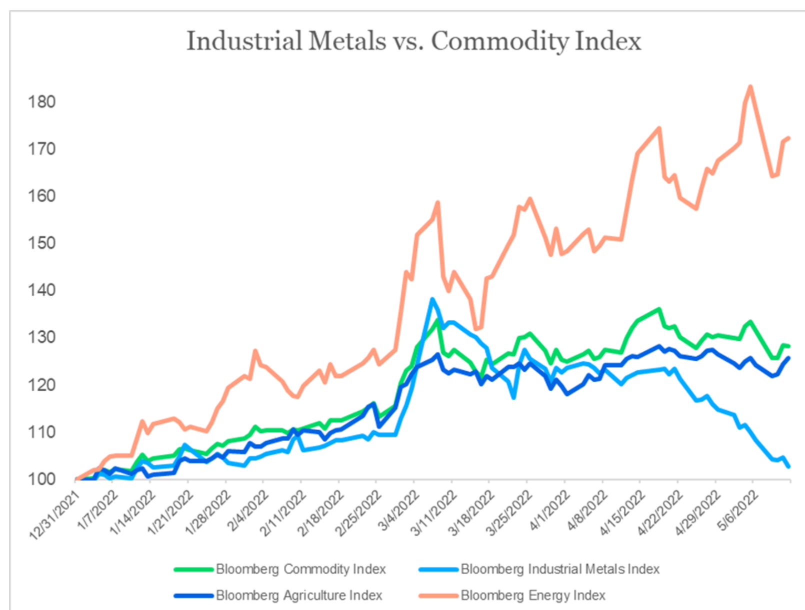
But the political pressure on reluctant governments is rising, not least because Russia is not yet hurting from sanctions as much as many hoped. Russia's income from energy exports has gone up, bolstering its current account surplus, as oil and gas continue to flow. There has been the most focus on the end- users in Europe, notably Germany. But tankers from Greece, insured in London and Norway, are helping to ship Russian oil. And while Russia's central bank is subject to sanctions, Gazprombank is essentially providing many of the services of a central bank – receiving foreign currency and emitting it into the Russian economy. Russia's oil wells are old and hard to cap. The country's storage capacity is limited. That makes Russia, as well as Europe, vulnerable to a stoppage. Within the EU, Greece, Cyprus, and Malta are resisting restrictions on shipping, while Hungary is holding up agreement on an oil embargo. Both issues are likely to be resolved within the EU with agreement on phasing and compensation. That is the right path, given the importance for a stable world order of resisting Russian aggression. But the hit in terms of energy prices will be severe.

Europe is also facing the prospect of rising interest rates and an end to QE. Although the ECB mandate is supposed to rule out monetary financing, QE since Mario Draghi's famous "whatever it takes" has essentially allowed Italy and other debt-heavy Southern European countries to finance a more expansive fiscal policy without bond spreads blowing out. As the ECB moves to tighten, Draghi – now Prime Minister of Italy – will be watching spreads carefully. Luckily for Italy, Draghi now has the opportunity to influence political choices in Europe and beyond in response to Russia.

This week, after speaking to President Biden, he proposed turning the tables on Russia with an oil consumers agreement, or cartel, that would hold down global energy prices and Russia's energy receipts. Not easy to see how that would work without more output from other sources.

***Industrial metal fallout***

Commodity markets show which way the wind is blowing. Of particular note is the underperformance of industrial metals since March 8, 2022. After an initial pop following the Russian invasion of Ukraine, the metals have steadily weakened on concerns over global growth. The conflict in Ukraine, a zero-covid policy in China, and the potential for slowing consumer demand in the US have all contributed to fears of a global recession. As such, it is not surprising to see weakness in industrial metals despite structural tailwinds related to the energy transition. Energy and agricultural commodities have fared better given the demand inelasticity of both groups coupled with the world's greater dependence on Russia and Ukraine for energy and food.




**China doubles down**

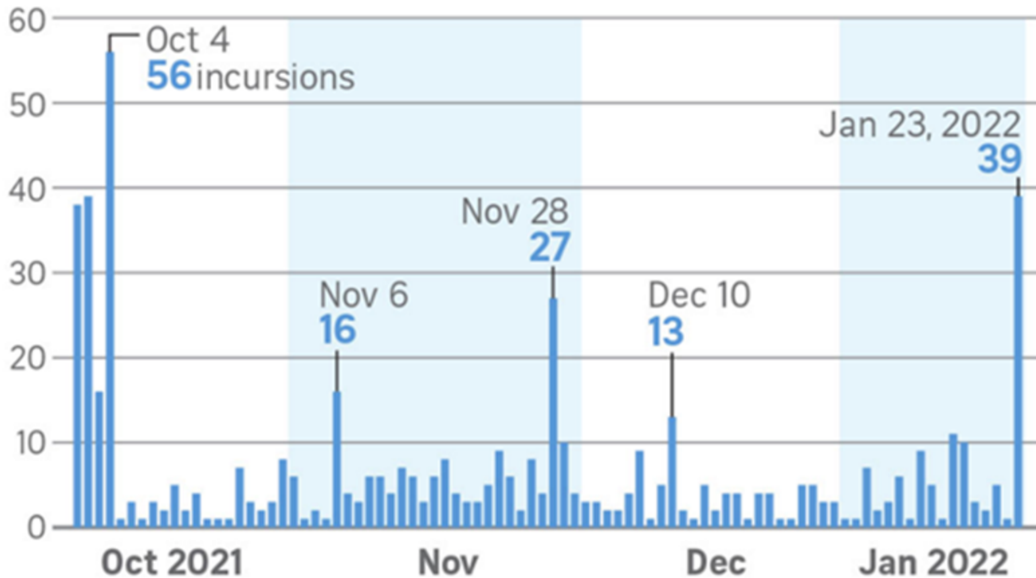
Pressure on emerging market assets continued this week, with every major country and sector selling off. China suffered another difficult week and is now down well over 20% year-to-date in US-Dollar terms, as measured by the MSCI China Index – the worst performing of the major EM markets. On a one-year basis, the MSCI China Index is down close to 40%. Since the outbreak of hostilities in Ukraine, both domestic and foreign investors have been net sellers of Chinese equities, though interestingly this week foreign investors turned tack and were net buyers. It is unclear what drove this sudden (and potentially short lived) change in sentiment. In our view, the risks tied to the ongoing COVID lockdowns, the troubled real estate sector, and regulatory pressures on private enterprise have not dissipated. It is also possible that Beijing may face the same type of lockdowns seen in Shanghai that captured global headlines. Foreign investors may be discounting the Covid disruption and reacting to attractive multiples, a cheap Yuan, and narrowing EM credit spreads. Some may also hope that the re emergence of Premier Li Keqiang will support growth measures.

***MSCI China 12-month forward P/E ratio - from 2018 to present***

*Source: Refinitiv, JPMorgan, MSCI*

US institutional investors, after increasing investments across public and private equity in China over the last few years, face a difficult decision – take advantage of a potentially attractive entry point or suspend any new commitments until there is greater clarity on which direction China, Inc. will take. For its part, Beijing has indicated that it is open for business. At the same time, it has not shied away from maintaining pressure on Taiwan's air defenses, both before the war in Ukraine and as recently as May 6th, when 18 Chinese jets were intercepted.

***Chinese Aircraft Incursions into Taiwan's Air Defense Zone***



## RockCreek Update

RockCreek just launched the **Racial Equity Capital Fund**, backed by Exelon, which is investing debt and equity in minority-owned businesses. Working with black-owned lending institutions and community-based banks, as well as accelerators investing in early-stage companies, we will identify and select businesses for financing and investments to help them grow, create jobs, and strengthen their communities. **Learn more here.**

RockCreek hosted Cherie Blair, Chancellor of the Asian University for Women and AUW students to hear their inspiring story of escaping Afghanistan during the country's fall to the Taliban. Mrs. Blair, Kamal Ahmad, AUW's founder, and the students who led the evacuation recounted their harrowing journey out of Kabul and AUW's ongoing efforts to bring more young women out of Afghanistan to study at AUW and at universities across the US. RockCreek has been working with the Asian University for Women, which is among the best universities in the region, and has also hired students and interns from the University. **Watch the video here**.

Look for the next RockCreek Weekly Letter on May 27, ahead of the Memorial Day holiday.

**Team RockCreek**

**For updates, please follow us on Twitter and LinkedIn**

© Copyright 2022, The Rock Creek Group. All Rights Reserved