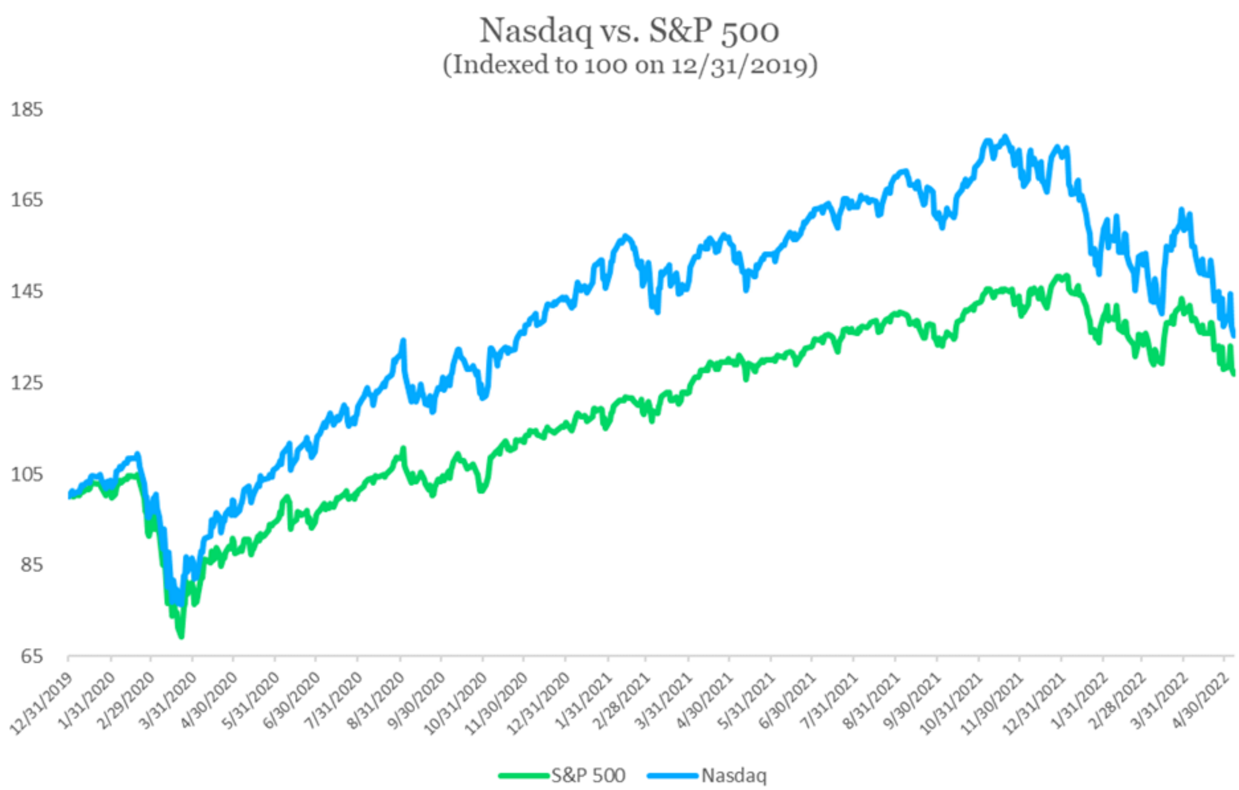
RockCreek

MAY 6, 2022

SO, WHAT NOW?

We began this quarter with a focus on five themes: geopolitical tensions, inflation, monetary tightening, jobs, and growth – and Covid. This was the week for central banks to take center stage. First the Federal Reserve and then the Bank of England hiked rates, by 50 and 25 basis points respectively. Markets still don't know what to make of it. After jumping 3% on Wednesday, US equities slumped back on Thursday and ended the week down. Tech stocks that powered the S&P up during the pandemic are now suffering.



Market turmoil isn't what the Fed wants. But Fed Chair Jerome Powell sees bringing down inflation as his top goal now, not soothing investors. He also took responsibility this week for getting the job done. That means there is more tightening to come. It is less clear when the monetary squeeze will hit the US labor market – which is still running hot on most measures, including the 428,000 jobs added in April. Robust job growth shows continued resilience in the US economy. Investors looking for another upside from Friday's labor market report can find it in the hourly earnings data. Although up 5.5% from a year ago, the monthly and three-month data show wage increases slowing to an annual rate of 3.7%. Not so good for real incomes, but helpful for inflation dynamics.

The Market's Wild Ride

It was a wild week for equity markets. Although indices ended close to where they began, there were startling price swings in between. After a short-lived relief rally on Wednesday following the Fed announcement, Thursday saw a brutal sell-off, led lower by technology. The Nasdaq Composite lost 5% on the day – a downturn not seen since the early days of the pandemic.

This inflation-driven flight to safety in market sentiment goes beyond simply a growth to value rotation. High dividend paying stocks have been strong outperformers, which is atypical in such an inflationary environment. They are being rewarded for their safe-haven status as investors grapple with recessionary concerns, as well as fears of inflation. The energy sector already traditionally performs well during times of inflation and is also stretched after some years of lower investment. The war in Ukraine has just exacerbated the underlying supply/demand problems.

We have seen in this volatile market technology continue to get trounced – and not just expensive tech. Pain has been widespread across the sector mostly independent of market capitalization, sub-sector, or profitability. This is a clear sign of forced selling. Attention is focused squarely on the potential negative outcomes of higher interest rates. All the market punditry is about how bad economic conditions could get and how low capital markets can go. Currently healthy earnings, large order backlogs, and other fundamental underpinnings are having little positive impact on tech stocks.

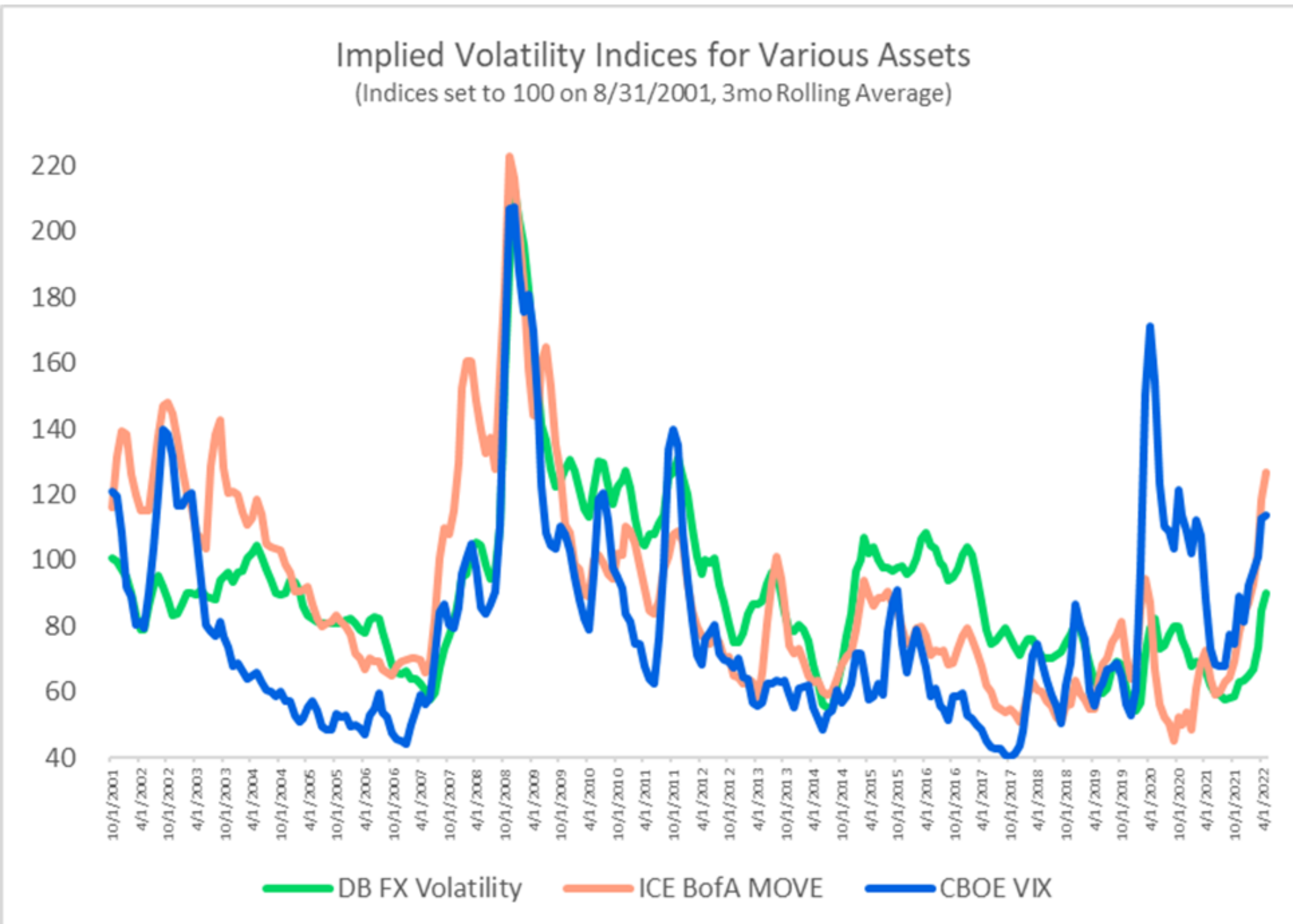
Amazon and other online retailers like Wayfair and Shopify had unexpectedly large earnings disappointments. Much of this may be because of consumers reverting to pre-Covid behaviors and returning to brick and mortar stores, rather than reducing spending overall. According to data from FactSet, the S&P 500 – excluding Amazon, which represents an outsized portion of the index – would be on pace for a blended year-over-year earnings growth rate of 10.1% (compared to 7.1% with Amazon included). That is below the 5-year average growth rate of 15.0% but still ahead of the 10-year average of 8.8%. That is not bad in the context of an abnormally tough comparison from a year ago. At a more micro level, strong numbers from Booking Holdings and others only underscored a healthy consumer with the willingness and means to travel.

If anything, strong fundamentals are being treated as bad news because of an expected impact from monetary policy. Markets would likely greet signs of a recession favorably right now simply because it would mean less tightening from the Fed – as discussed below. Given this current paradigm, expect more volatility and macro driven moves with less attention to fundamentals, until we see clear indications inflation is coming under control.

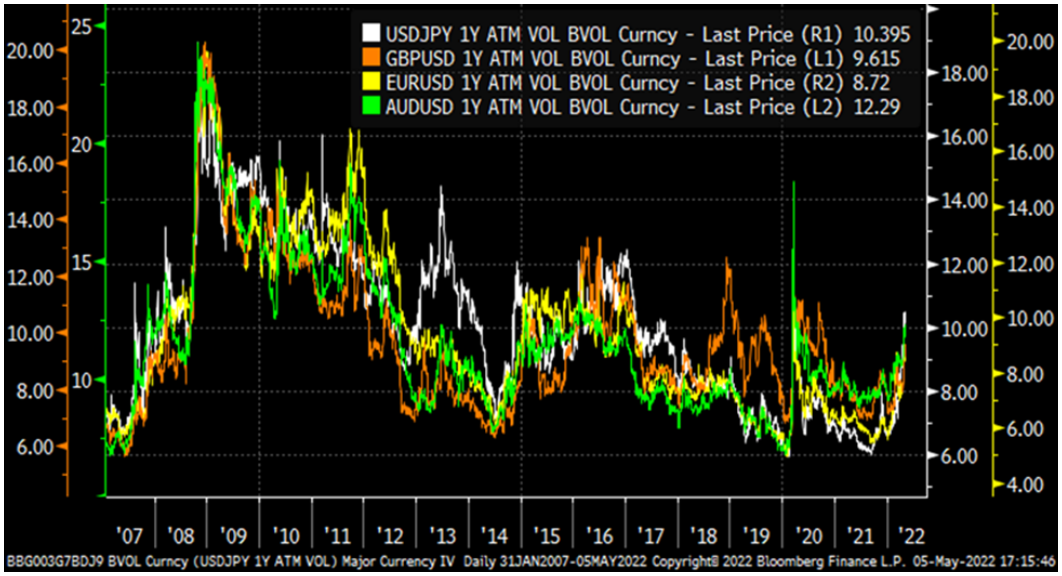
Rollercoaster: it's not all about equities, volatility is up all over

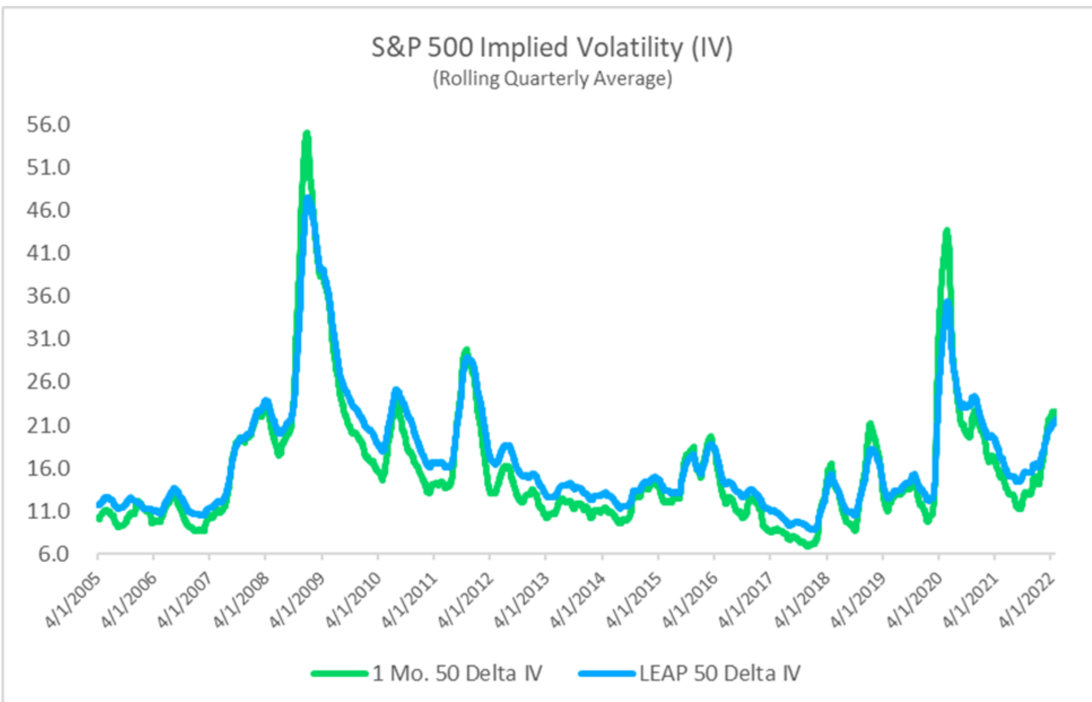
The huge swings in equity markets captured attention this week. Bond markets – and FX – have also been marked by turmoil.

Increased volatility in equity markets could not go unnoticed, as evidenced by the S&P 500 rallying 3% on May 4th, only to fall by 3.6% on May 5th. What has, perhaps, gone unnoticed is that implied volatility has also picked up, and it has done so across asset classes. In equities, despite shorter term flare ups in the past few years, the VIX index is at its highest level since 2011. Similarly, if one excludes brief periods in 2020, FX implied volatility – measured by the CVIX – is at its highest level since 2017. The MOVE index, which measures rates volatility, is at its highest level since the Global Financial Crisis.



While these indices tend to measure shorter term implied volatility, the spike in implied vol is also higher across maturities. LEAP option implied vol on the S&P 500 is also at multi-year highs. It is worth noting that short term implied volatility has moved higher on a relative basis. Similarly, 1yr implied volatility on many major and emerging market currencies are at their highest levels since 2016.





So, what does all of this mean for investors? The moves higher in implied, not just realized, volatility suggest that market participants expect uncertainty for the foreseeable future. This is driven in large part by the broad divergence in economic, inflationary, and monetary policy conditions globally. It is possible that these moves indicate an anticipated regime shift. More immediately, these developments in implied volatility across the surface have created trading opportunities in volatility and relative value strategies. At RockCreek, some of our best performing investments in 2022 have been those focused on fixed income relative value and volatility trading. It is a reminder that having diversifying strategies in a portfolio can pay large dividends during times of uncertainty.

Who is setting monetary policy: markets or the Fed?

Part of the art of central banking is judging how much market moves are going to affect the monetary stance and whether they will go in the central bank's desired direction of tightening or loosening financial conditions. This week's market action complicated life for the Federal Reserve. Chair Powell made clear – speaking into the camera at the top of his Wednesday press conference – that inflation is too high and that the Fed intends to address it. Nevertheless, for a while on Wednesday, it seemed that Chair Powell had inadvertently signaled dovishness, by saying that the Fed is not "actively considering" a 75 basis point rate. By Thursday, the reality sank in that he meant what he said about fighting inflation. The policy tightening he pointed to for the coming months, albeit in 50 basis point steps, would be one of the steepest on record.

Financial markets then gave another twist to the tightening stance. When stocks fall, bond rates rise, or the currency strengthens, financial market conditions automatically tighten. That, in turn, affects economic activity. Rising financing costs – whether for consumers, home buyers, or companies – will tend to crimp demand. A stronger dollar also makes exports less attractive and boosts imports, again curbing demand for US-made goods. So, as Fed officials consider their next moves – including in the form of comments from Chair Powell, newly confirmed Vice Chair Lael Brainard, and others on the policymaking committee – they will be gauging the impact of markets on the economy as well as the impact of their actions on markets. Another known unknown: what impact will quantitative tightening have on liquidity conditions? The plan laid out this week met market expectations.

As some investors fear recession, others worry that the Fed may not move far or fast enough to bring inflation down to the 2% target that most regard as "price stability". Wage trends will be a major determinant. Friday's jobs release gave some modest relief on this front, as the month-on-month wage increase eased to 0.3 percent. At the same time, wage rises for those at the bottom of the income scale have outstripped inflation, even if this is not true for average wages. A report from Realtime Inequality by economists at the University of California, Berkeley showed that lower paid workers had average increases of nearly 12% in 2021, well above inflation, and are gaining in real terms this year as well.

War drags on: apart from sending arms, what should we do?

In Europe, the focus remains on geopolitics. Monetary policy and finance officials are as focused on the Ukraine conflict as their defense and intelligence colleagues. This week, the European Union moved close to agreement on phasing out Russian oil imports – unthinkable before Russia's invasion. Discussions continue behind closed doors on the even more drastic step of banning gas imports from Russia. No surprise that central bankers are bracing for higher energy prices for longer. The Bank of England's gloomy recession forecast as it raised policy rates another 25 basis points on Thursday owed much to the impact of higher energy. As we have noted, the conflict is causing food prices to skyrocket.

But recession is not inevitable. Economists Jean Pisani-Ferry and Olivier Blanchard note that fiscal policy can help the most vulnerable in Europe. They point out that if governments provide transfer payments to help offset the impact on real incomes of higher food and energy prices, this could dampen a push for higher wages and ease strain on monetary policy. Not all policies are equal: subsidies to energy payments would be counterproductive by keeping up demand and prices for Russian oil and gas. On the other hand, special tariffs or taxes on Russian energy could hurt Putin's revenues and may be as effective as an outright ban, the economists argue.

Covid Contrast: another sad US milestone – and Omicron versus China's zero Covid policy

In the US and other advanced economies, Covid is now being viewed mostly in the rear-view mirror. This is an illusion. Cases are rising again in the US – luckily the Omicron variants remain less deadly. The direct economic impact of this surge is limited in countries where vaccination rates are high and health systems functioning.

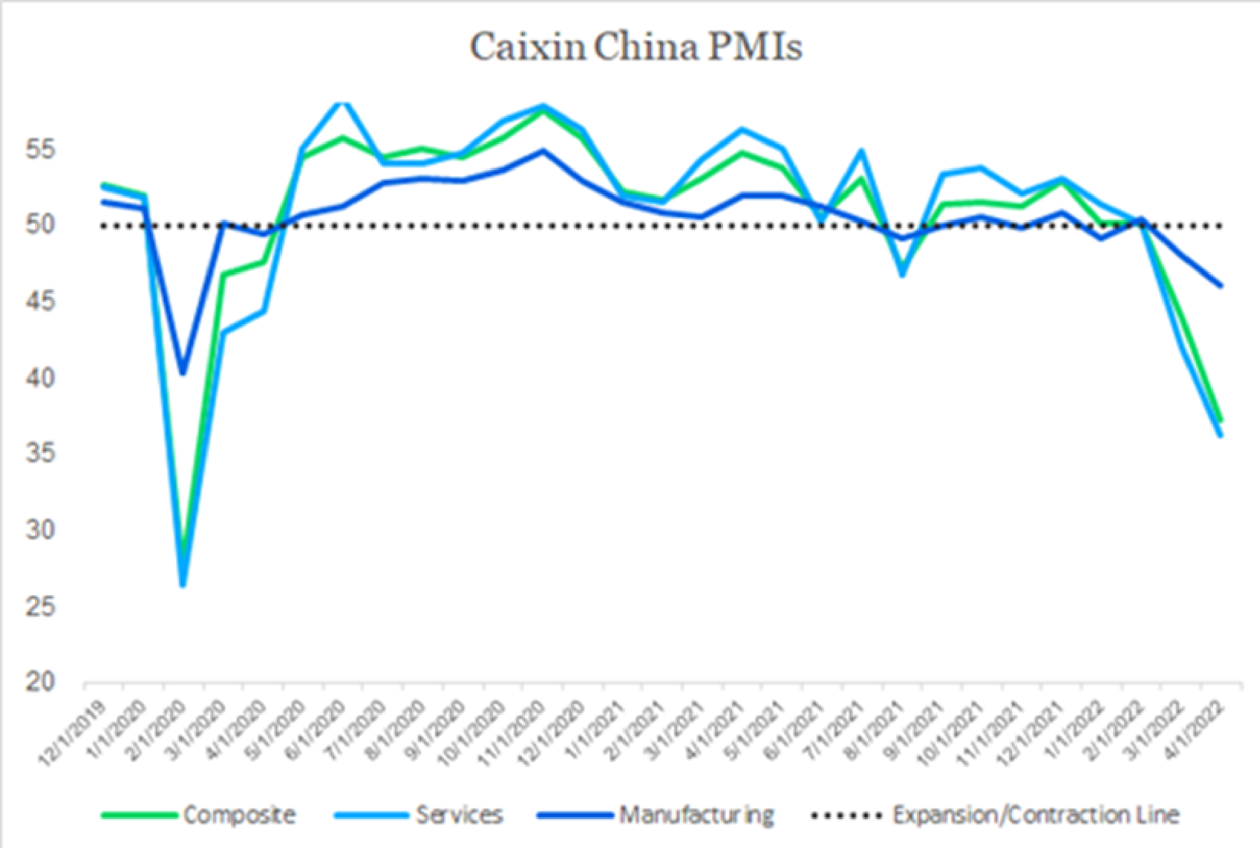
But the virus is not yet done with us. As a reminder of its human toll, the World Health Organization this week reported that Covid caused as many as 15 million deaths worldwide in 2020-2021, far more than the nation-by-nation reports would suggest. In the US, the official count crossed the one million mark, with the likely death toll even higher. As Pulitzer prize winning journalist and chronicler of Covid, Ed Yong, put it earlier this year: "The sheer scale of the tragedy strains the moral imagination." Two years ago, the loss of 100,000 Americans to Covid was described as incalculable. "Now the nation hurtles toward a milestone of 1 million," Yong wrote. "What is 10 times incalculable?" He also spelled out who were Covid's victims: poorer, less well-educated Americans of color. Black children are "twice as likely to have lost a parent to COVID than white ones, and Indigenous children, five times as likely."

Meanwhile, the indirect impact of Omicron is growing as it continues to surge in China. We have pointed to the rising danger to the global economy from China's growth slowdown. The leadership this week indicated its concern, although only in general terms, indicating that measures to support private tech companies could be forthcoming. But as long as President Xi's zero Covid policy remains in place, China and its trading partners will be vulnerable to any contagious variant, even if it is not as deadly as China fears.

Emerging Markets Reel

It was a woeful week for EM equity and FX markets, with little sign the rout would invert in short order. No country, small or large, was spared, including those that benefitted from rising commodity prices earlier this year. Bifurcation within EM seems to be on hold. Indeed, the current sell-off is reminiscent of past developed market downturns - as the US and Europe catch a cold, EM is out with the flu. Structural reasons remain for parts of EM to outperform, including food producers that can capitalize on the inelastic nature of demand and producers of raw materials tied to the ongoing green revolution in Europe and the US.

But China will largely determine the course of overall EM growth. Today, it is still very much a negative factor, as this week's PMI numbers showed. The rhetoric now coming from Beijing could herald a softer stance on private enterprise. But even if it does, it will take time for investors' confidence to rebuild. In the meantime, China's economy is weighed down by a Covid zero tolerance policy that prioritizes saving face over economic growth, a still weak property sector, and increasingly creative methods of capital flight. Rhetoric and cheap Russian oil will not be enough to solve the structural problems Beijing faces just a few short months from the next Party Congress.



RockCreek Update

Afsaneh Beschloss joined Romaine Bostick on Bloomberg's Wall Street Week to discuss the impact of increased inflation on low-income consumers, the risk of recession, and the GDP's impact on consumption. Watch the segment here.

Team RockCreek