RockCreek

JULY 8, 2022

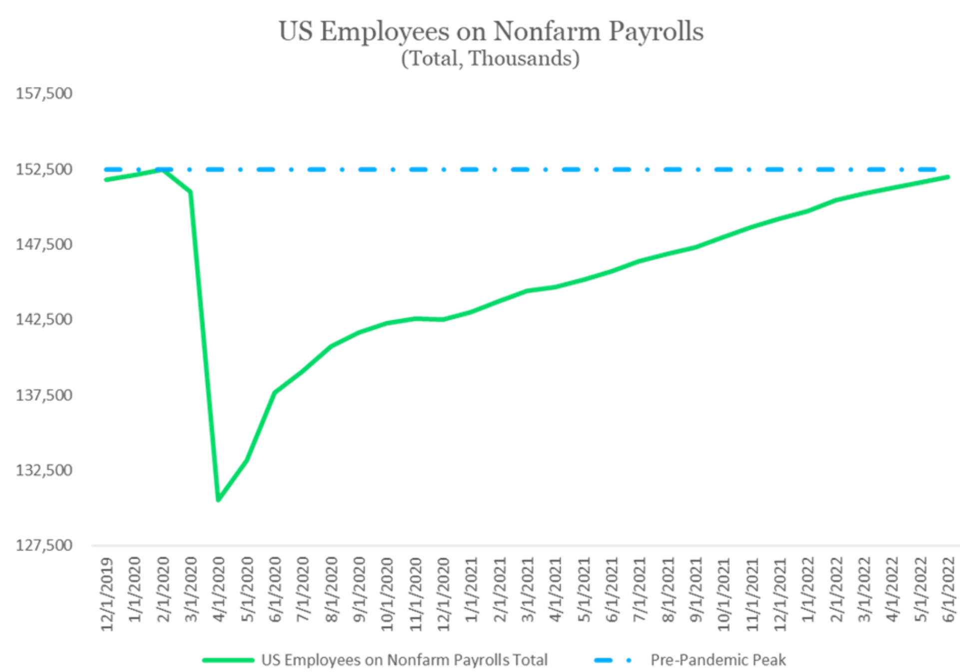
STAG OR FLATION – MARKETS CAN'T DECIDE

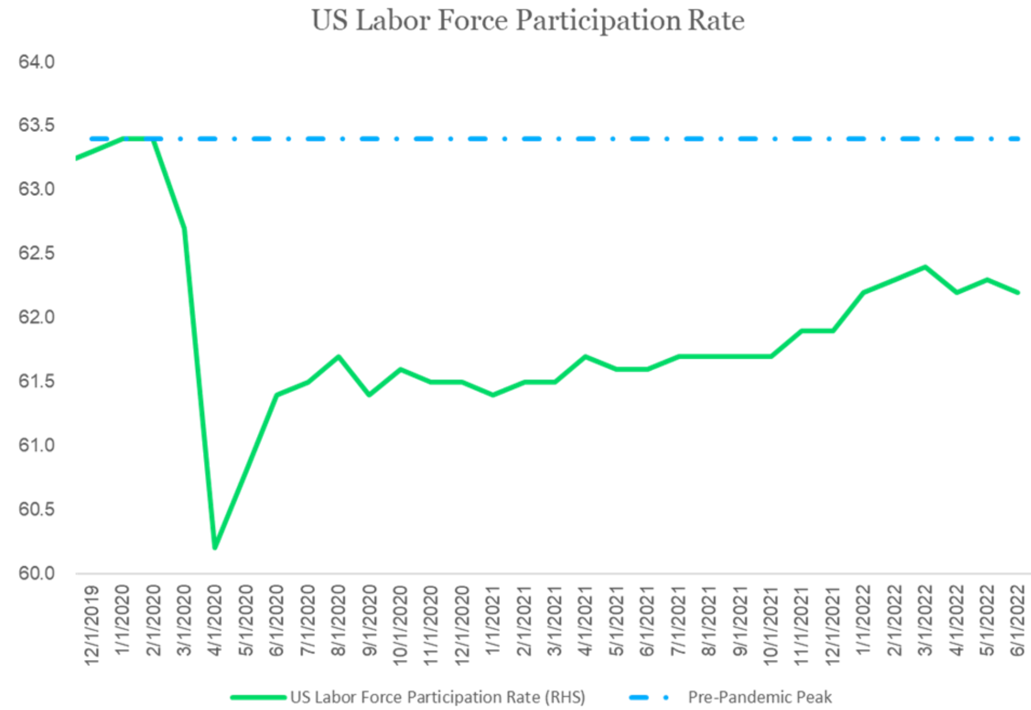
This year's July 4th holiday left few people feeling happy. The bad news seemed to be everywhere. Airports were in chaos. Drivers were paying twice as much as a year ago to get away. Food and fun cost more. The University of Michigan Consumer Sentiment Index hit an all-time low, reflecting worries of rising costs and a slowing economy.

And a week that began with yet another horrific mass shooting in the US – this time outside Chicago at a 4th of July parade – ended with former Prime Minister Shinzo Abe – Japan's longest-serving leader – gunned down by an assailant wielding an apparent homemade shotgun.

Ominously, and less reported, Covid may be creeping back up. In the US, the 14-day average of new cases jumped by 8% this week, while in China new lockdowns were reported under its apparently relentless zero-Covid policy. As equity markets recovered to close up for the week (S&P +3.18%; Nasdaq +5.5%; Dow + 1.93%) is the biggest danger for investors a looming economic slowdown or continued high and rising inflation?

Friday's labor market news pointed clearly to the latter. Payrolls continued to rise strongly in June – up 372,000 – and the jobless rate stayed low at 3.6%. Wage growth also came in slightly higher than expected at 5.1 % over a year ago. This will keep the Federal Reserve laser-focused on inflation. The continued strength in the US economy can frighten bond markets but it has been good for the dollar. The euro slid and flirted with parity with the dollar for the first time since 2016.





Source: RockCreek, Bloomberg

Firm Fed

Unemployment is a lagging indicator in normal times. Of course, the times are far from normal. Economic forecasters are grappling with uncertainties from the pandemic, a war, and sanctions on the world's second largest energy exporter. Their models are not fit for purpose against this unpredictable backdrop.

Luckily for Federal Reserve policy makers, they have some time before their next move. Importantly, by July 27th, they will have June's CPI inflation report. It was the shock of climbing consumer prices and worsening consumer expectations of inflation that triggered the Fed's surprise 75 basis point rise last month. Another large rate increase is still likely this month.

Remember: however much others may be worrying about economic slowdown, this week's minutes from the Fed's June meeting – and Chair Powell's remarks in Portugal last week – show that the central bankers are focused, above all else, on winning back credibility as inflation fighters.

Across the Atlantic, some European Central Bank (ECB) policymakers believe that they need to move faster as well, trailing the possibility of a 50 basis point move in their meeting a week before the Fed. As we noted, the Europeans have a tougher time ahead. Tightening financial conditions to fight inflation risks not only recession, but also strains on the euro itself – the "fragmentation" risk as bond spreads widen. ECB President Lagarde is walking a narrow path.

Bond Market Waves

Like in a bad storm at sea, when the ship lists dangerously to one side and then to the other, US bond markets tilted with waves of sentiment this week. Recession – or stagnation – fears sent bond prices up (and yields down) on hopes that the Federal Reserve would stop tightening sooner than seemed likely just last month. Then still-strong labor market indicators mid-week, and the release of hawkish Fed minutes, reversed the moves.

Finally, today's solid labor market report sent yields higher once again, with the front end of the curve selling off more drastically than the back. In an indication of just how swiftly events are moving, rising rates on the short end coincided at week's end with a sharp decline in the key economic long-term rate: the cost of mortgages.

Recession fears nevertheless remain present in market pricing in both rates and commodities. Despite the day-to-day gyrations, key parts of the yield curve continue to flatten. 2s10s has once again inverted and 5s30s is also flatter on the week. Today's movements only exacerbated that trend as conviction that interest rate hikes will continue sent 2yr and 5yr yields 10 basis points higher each, while 10s and 30s moved 10 and 8 basis points, respectively.

When these curves first inverted back in April, many pundits rightly pointed out that an additional favorite harbinger of recession – flattening or inversion of the 3 month to 10 yrs spread – had still not happened. That curve has not yet inverted, but it has flattened by approximately 100 basis points since that time and is likely to continue to do so if Fed policy continues at its current aggressive pace, without evidence of a pick-up in growth.

Commodity Chaos

New red flags on global growth are emanating from the commodity markets. Brent crude has fallen nearly $5 per barrel this week, briefly touching below $100 for the first time since January 2021. Oil joins Industrial Metals, which finished their sixth straight week in the red. These growth-linked metals are now 34% below their mid-March peak.

Rising real interest rates have also wreaked havoc on gold prices as investors dump the yellow metal in favor of more traditional safe haven assets. The precious metal fell more than 3% during the week.

Agricultural commodities snapped a three-week losing streak, led by a bounce in Wheat as continuing supply issues offset recent weakness driven by broader risk off in commodity markets. Countries including Egypt and Jordan took advantage of the recent weakness to snap up some imports as supply issues remain. Corn had a softer rally, and Soy fell slightly this week. Corn and soy markets were likely driven by a convergence of shifting fundamentals and technicals. US exports of those grains continue to fall, but buyers seem to be sourcing supply from South America. In addition, forecasts of drier weather in the US drove some speculators to cover short positions amid low volumes.

The amount of upside left in agricultural commodity prices is unclear, however one could reasonably expect prices to remain elevated until larger supply issues are resolved, as food demand is considerably more inelastic during times of recession compared with other commodities.

A Brief Relief Rally for Equities

Friday's labor market report halted an otherwise enthusiastic market this week. Through Thursday, the S&P 500 and Nasdaq were on their longest winning streaks since March – 4 days! Following such a poor June, equities felt overdue for a relief rally at the start of the month. Recent pullback in energy prices and mixed signs from economic data gave hope that central banks may not have to raise interest rates as much as previously forecasted. As a result, growth sectors like technology and consumer discretionary helped lead the way although much of this sentiment reversed on Friday.

Europe's STOXX 600 also staged a decent rally. Markets appeared to settle down, especially once the Norwegian government intervened on Tuesday to end the country's offshore oil and gas workers' strike. Norway is a major energy supplier for the region and the worker shutdown threatened to cut the country's gas exports by more than half. In addition, the UK's FTSE 100 gained 1.1% on Thursday following news of Boris Johnson's resignation as prime minister. The British pound was able to recover some of its earlier week losses. Johnson's decision is unlikely to have a major impact on UK stocks moving forward, given approximately three quarters of the underlying revenues of the FTSE 100 companies are derived from overseas.

It remains to be seen if the market can regain its positive momentum as earnings season gears up. Recent positive momentum in equity markets should not overshadow warning signs at the micro level. Nike, Restoration, Helen of Troy, Currys PLC, WD-40, McCormick & Co, AbbVie, and Usana Health Sciences are all companies that have lowered guidance within the last several days. Investors should buckle up for more equity market volatility in the weeks ahead.

Boris Breaks

In his typically insouciant way, UK Prime Minister Boris Johnson gave the equivalent of a verbal shrug as he stepped down mid-week after a dramatic 48 hours of resignations, new appointments, and renewed resignations from his government. "Them's the breaks" he commented as he announced that he would leave his job, although he considered it "the best in the world."

The Prime Minister's downfall was caused not so much by policy mistakes – although the resignation letter of Chancellor Rishi Sunak pointed to a difference on taxes and spending – but by moral failings. Johnson's changing story on what he knew and when he knew it about sexual harassment charges against a minister he appointed to a key role came on top of other scandals, including ones surrounding his behavior during Covid when Downing Street held office parties during a strict national lockdown. It proved too much to overcome, even for the bold, risk-taking Boris, who had led the Conservative party to resounding electoral victory in December 2019.

What next for the UK? Its economy is in bad shape. As in the US, the government faces both high inflation and recession fears, but the tradeoff is worse – not least because of the gradually growing costs of Brexit. The campaign for leadership of the Conservative party promises to be brutal but maybe not too long. A new leader would likely have time to choose when to call a general election.

Meanwhile, the policy tussle will center on whether to cut taxes and increase spending and borrowing to ward off the prospect of recession or curb government borrowing to help in the inflation fight. Look for the independent Bank of England to continue to tighten monetary policy even as the economy slows. The interesting split on the Monetary Policy Committee (MPC) between the external members – who voted for a tougher stance at the last meeting – and the Bank insiders may continue.

Covid Creeps Up

We all want to forget about Covid. And recent travel around the US and internationally shows that many have been throwing masks to the wind, even when crowded on planes and trains with strangers.

Unfortunately, Covid is not done with us. New strains or variants of Omicron are pushing up cases around the world, including in the US. This may help to explain why encouraging people to get back into the office, and into "high contact" service jobs has not worked yet. Labor force participation remains disappointingly low – and slipped back last month.

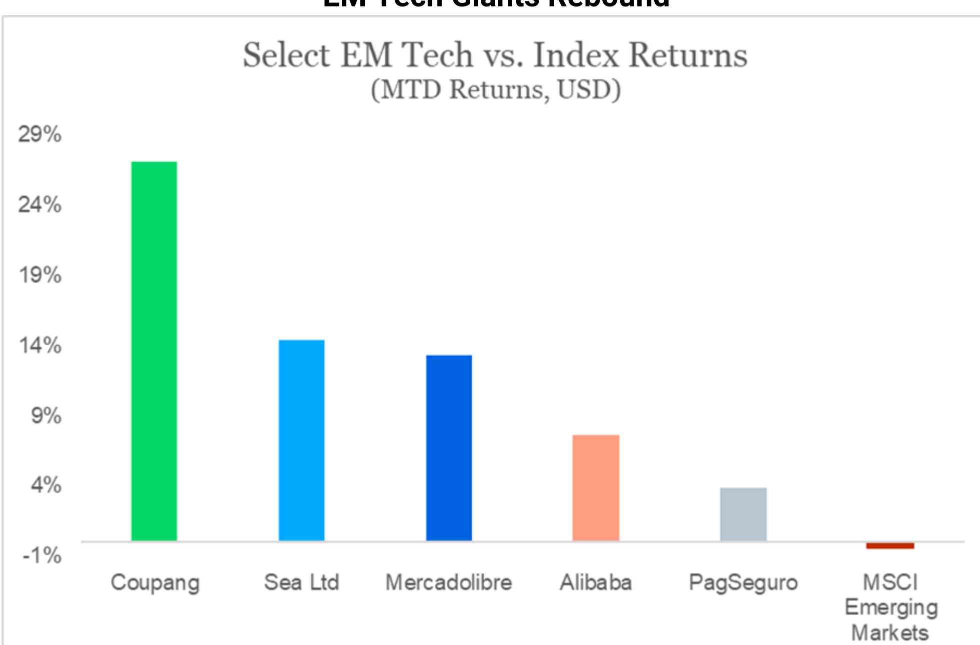
In China, it only took 18 cases to cause Xi'an – a city of 13 million people – to implement week-long "temporary control measures" that would "allow society to quieten down as much as possible," in the words of a city official, to cut down on mobility and slow infection.

Emerging Markets

Uncertainty was the backdrop for emerging markets performance this week. Macro news was mixed, with inflation numbers remaining stubbornly high, commodity prices collapsing, and currencies continuing to weaken versus the US dollar.

Despite this, significant dispersion existed across sectors, with popular tech related growth names rallying double digits while old economy financials and commodity names struggled. Popular ecommerce and payment platforms such as Mercado Libre and PagSeguro in Latin America, Sea Limited in South-East Asia, Alibaba in China, and Coupang in South Korea all saw significant rebounds and remain well below 2021 highs.

EM Tech Giants Rebound



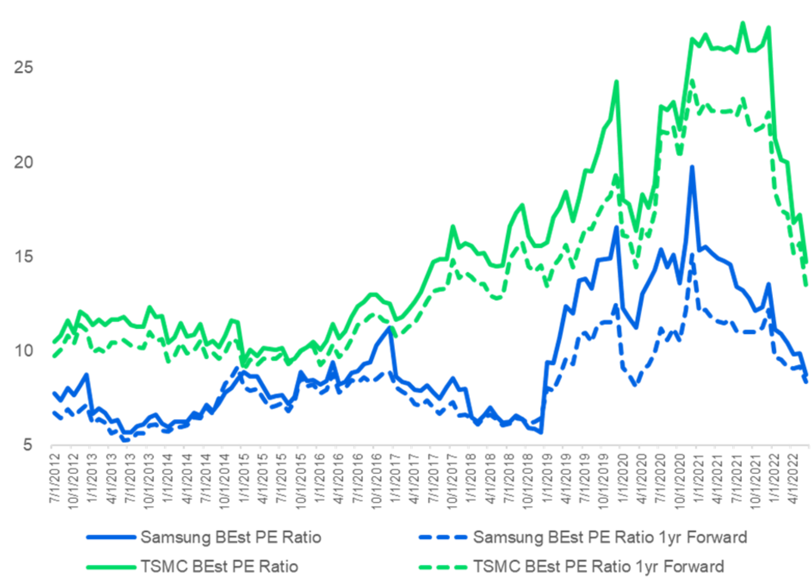
Source: RockCreek, Bloomberg

Within the technology sector, hardware names like TSMC and Samsung surprised to the upside for second quarter earnings, taking many market participants by surprise. This was welcome news for markets - Taiwan and Korea - which have seen steady underperformance through the first half of 2022.

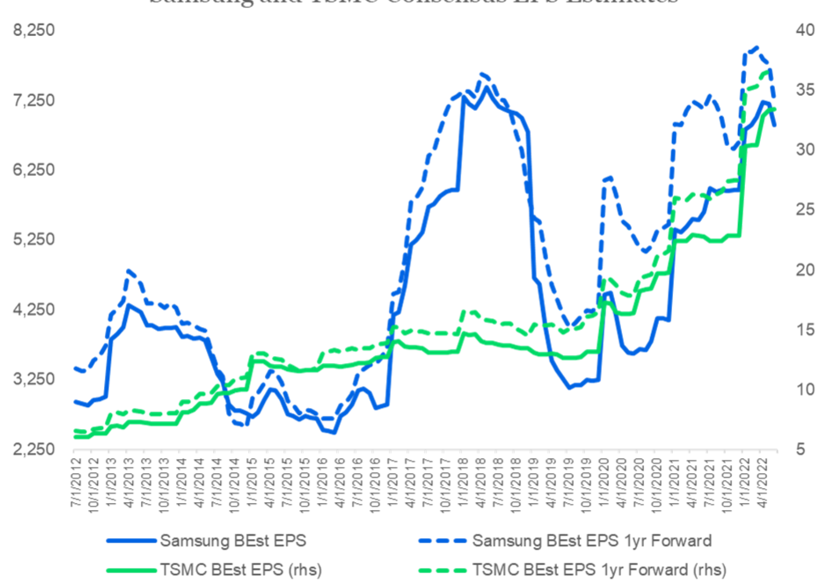
The real question for EM investors is whether this week's moves represent an inflection point of sorts – will cyclical exposures give way to growth or is this a temporary reprieve? Recession and the ensuing demand destruction is already happening in some emerging markets. This should bring inflation pressure in check and importantly allow EM central banks (which were early to hike last year) to start easing.

Longer term, emerging markets have a promising combination of likely easing of financial conditions, improving macro dynamics, and cheap valuations. In the meantime, exposure to disinflationary business models like tech companies may be increasingly attractive, especially at current valuations. Focusing on companies with ROE's higher than the cost of capital, high cash generation and low leverage is where we see the most promising upside.

Samsung and TSMC Forward PE Ratios



Samsung and TSMC Consensus EPS Estimates



Source: RockCreek, Bloomberg

Government spending: helping or hurting?

Many blame the surge in US inflation on the 2020/21 stimulus checks. Defenders say that these helped to ward off hunger and homelessness among the most vulnerable Americans.

Recent research shows, sadly, that many of the neediest recipients felt worse rather than better after getting the money. It was just a temporary boost to income that demonstrated how short of funds they were longer-term. A more upbeat view of the benefits of government spending comes from research showing that – over a long period of years – increased spending tended to boost productivity and growth. The reason, the authors deduce, is that spending on research and development helps to promote private sector innovation.

RockCreek Update

Alifia on Bloomberg in Washington

Alifia Doriwala joined *Bloomberg Surveillance* hosts Tom Keene and Jonathan Ferro live from Washington as the show broadcast from a perch above the White House. She discussed how July earnings could affect consumer confidence, pockets of opportunities in the credit market, and broad opportunities – especially in renewables, in the energy landscape. Watch the segment here.

With more to come,

Team RockCreek