RockCreek

SEPTEMBER 30, 2022

STORMY WEATHER

As Hurricane Ian battered Florida this week, financial markets in the US were hit by a storm from an unexpected quarter – the UK. Despite its developed market status, deep markets, and reliable institutions, London could not withstand the clash between new Prime Minister Liz Truss' planned fiscal expansion – announced a week ago – and the Bank of England's tightening monetary policy.

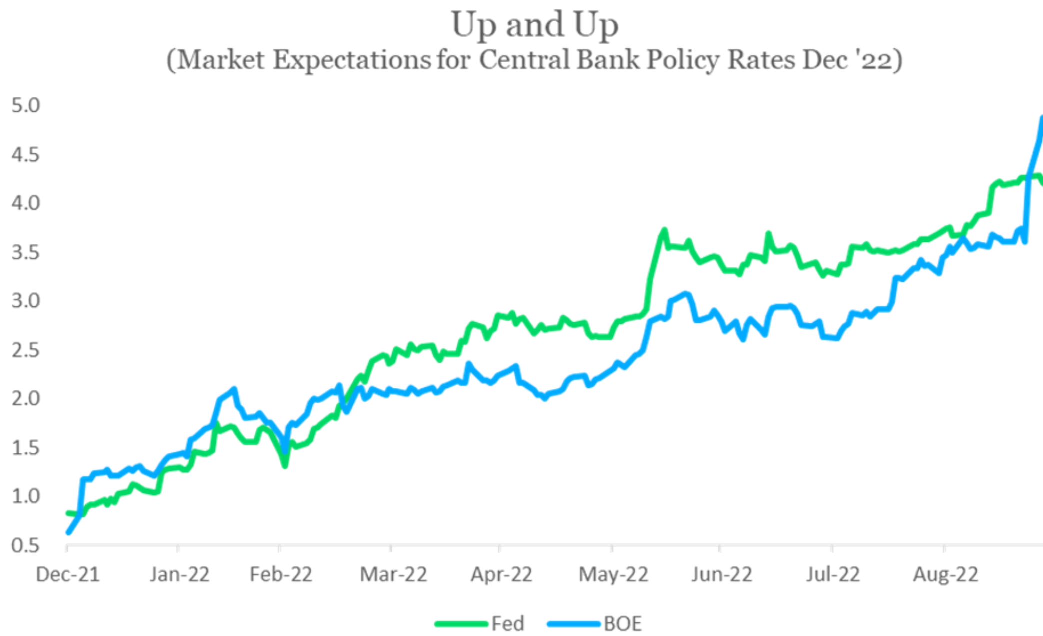
As is often the case in times of stress, market concerns were contagious. It did not take long for the dramatic moves in London's bond markets to spill over into the US. This week's volatility in Treasury markets was the worst in recent memory, and by some measures more severe than in March of 2020. Rising geopolitical tensions, as Russian President Vladimir Putin ramped up actions and rhetoric against Ukraine, and the West more broadly, did not help sentiment.

By Friday's close, yields on 10-year US and UK government bonds had come off their intra-week peaks, thanks to emergency intervention by the Bank of England (BOE) on Wednesday. This stalled spiraling increases in yields on UK government bonds, or gilts, which were being dumped by over-levered UK pension funds, caught wrong-footed by the bond market turmoil. At the end of the week, 10-year government borrowing costs remain significantly higher than they were before the Truss government's fiscal announcement – some 60 basis points in the case of the UK and closer to 10 basis points on this side of the pond. And the crisis in the UK's multi-trillion pension fund industry was not over (see below).

Further evidence that inflation remains stubbornly high in both Europe and America came on Friday. In the US, the Fed's preferred inflation metric – core PCE – ticked up to 4.9% in August from a year ago, rising 0.6% month on month from July. In Europe, headline consumer prices rose by a startling 10% from a year earlier in September, pushed up by a 40% jump in energy prices.

Looking ahead, next week will bring important indications of labor market pressures in the US, with reports on job openings and unemployment. Rising unemployment – and some slowdown in job creation – will be bad news for workers and for economic growth. But it's the main path that the Federal Reserve has noted will ease inflation and thus end the tightening cycle now driving up interest rates, pushing the dollar to record highs and worrying investors.

Source: RockCreek, Federal Reserve



Source: RockCreek, Bloomberg

In Florida, the devastating storms and flooding have been met with a united and effective government response, although this cannot take away the pain for those residents whose homes are underwater or washed away. In the UK, policy makers have been unable, so far, to demonstrate a coherent and credible response to market turmoil. The Bank of England's emergency action on Wednesday to support prices of government bonds, or gilts, and ease strains on Britain's multi-trillion-pound pension funds, gave markets only a brief respite.

There are idiosyncratic reasons to worry about the UK (see below). More important for investors is the global risk-off sentiment triggered by London's troubles this week. Expect gloom in the US and other major markets to continue. Unlike in other recent times of market stress, Federal Reserve policy makers are determined not to let up with rate hikes until there have been some months of clearly waning inflation pressures. Underlying optimism in US markets led equities to jump briefly on Wednesday.

Underlying optimism in US markets led equities to jump briefly on Wednesday. But by the end of the week, reality set in – on both sides of the Atlantic. Asia was not unscathed, with bond yields rising across the region albeit by much less than in the UK. Japan's 10yr bond move was modest (yields up 2 basis points) given the BOJ's control over that tenure, but ASEAN markets saw yields higher by some 15 basis points on average.

Equities

The S&P 500 ended down 2.9% for the week and down 9.3% for the month as corporate data showed increasing signs that central bank tightening was taking effect on the global economy. The Q3 earnings season is already looking much less rosy than the one before. Recent weeks have brought earnings disappointments and profit warnings across many parts of the economy. CarMax's report late Wednesday of a profit miss amid declining sales signaled the used car boom is quickly coming to an end. Rite Aid not only reported falling revenues from COVID vaccines and testing, but also cited pressure on consumer spending and supply chain challenges contributing to its bigger-than-expected loss.

Europe's Stoxx 600 moved 0.6% lower for the week, ending September down 6.6%. Unsurprisingly, Europe's ongoing energy crisis is dramatically curtailing discretionary spending across the region. The UK's FTSE slipped 0.5% for the week and -4.1% for the month. UK fast fashion brand Boohoo, which has seen an 87% drop in its share price this year, issued a profit and sales warning. Goldman Sachs now expects EPS in the region to fall 10% next year. Whereas consensus forecasts margins to be flat, they are still highly susceptible to slowing growth and costs related to energy, labor, and interest rates.

UK troubles deeper than one mini-budget

Chancellor Kwasi Kwarteng's announcement of tax cuts and energy subsidies a week ago was widely panned, including by the International Monetary Fund (IMF) and, more surprisingly, by the White House and Treasury Secretary Yellen. The US government no doubt saw an opportunity to push against a conservative push for tax cuts on the wealthy. Financial markets gave an immediate and decided thumbs down, with gilt yields up sharply and a collapse in sterling. The Bank of England struggled to regain control of the government debt market mid-week, as pension funds unloaded gilts to meet collateral demand, pushing yields up still further.

Why did the stress show up in pension funds? Many pension plans in the UK, much like US corporate plans, defease their liabilities (LDI) using long-dated government and inflation-linked bonds, usually through swaps. At the same time, they tend to use their cash assets to buy 'less risky' US investment-grade credit, which is then swapped to sterling. These swap positions have left them in the unenviable position of holding short positions in US dollars and long positions in UK government bonds.

The sharp rise in gilt yields and drop in sterling resulted in significant margin calls by counterparties on both swaps, triggering liquidity problems in some funds. To meet these margin calls pension plans had to sell their bond holdings, leading to the proverbial 'selling vortex', with further downward pressure on assets exacerbating liquidity problems and then raising solvency issues. To help maintain financial stability the Bank of England was left with little choice but to pivot sharply from quantitative tightening to easing – a pivot at odds with their stated policy of reducing inflation through tightening monetary policy.

We are not sure that this is the end of the story. As with all financial crises, the immediate trigger is only the first chapter. In this case, as is usual, the market turmoil laid bare deeper concerns about the sustainability of policy. Since the Brexit vote, successive Conservative party leaders have struggled to define a path for the UK economy that responds to voters' apparent desires and makes economic sense.

In an attempt to hold on to popular support, Prime Ministers have chosen to break ties more decisively than necessary with their largest trading partner and neighbor, restrict immigration of cheaper labor on which much of British agriculture and industry has depended, and threaten the regulatory convergence that allowed the UK to provide lucrative financial and business services to much of the world. This has weakened the fundamentals of the UK economy and undermined trust in the competence of the government.

New Prime Minister, Liz Truss, was clear in advance about her fiscal plans. Her opponent for the leadership of the ruling Conservative party gave stark warnings about the dangers inherent in cutting taxes and raising spending – on energy subsidies – in the context of today's high inflation and rising interest rates. Truss nevertheless went ahead.

Fear factor

Despite the dramatic increase in realized volatility across rates, equities, and FX, implied volatility in the equity market remains curiously subdued. We are currently witnessing a drawdown of over 23% in the S&P 500 since the beginning of the year. Over the past 10 years, S&P 500 drawdowns of less than 20% have caused the VIX index, which is viewed as a fear index, to shoot up to levels above 35 (the average is 18).

This time around, however, the VIX level is hovering around 30. While there is fear in the market, it is less acute than it has been over past periods of large drawdowns. The CBOE skew index is a good proxy of the market assigned probability of the S&P 500 index dropping by a significant amount. A lower CBOE skew index (120) implies that the market is assigning a lower probability of the S&P 500 experiencing a large drop now than it has historically (average 130). We seldom see a drop in the CBOE skew index when the VIX is high.

In short, while the market appears concerned that there could be further declines, these are not expected to be large. Still, we could see a large pop in the fear index if the S&P 500 heads down sharply to a new low from here, which could be sparked by a rough earnings season.

When the tide goes out...

Warren Buffet applied his famous warning to financial institutions left holding bad assets in the global financial crisis. Markets, more generally, are always vulnerable when monetary tightening gets underway. Trades that look attractive – and safe – in a low interest rate environment suddenly cause problems. Regulations aimed to strengthen financial institutions – such as those governing the huge UK pension industry – may cause them to buckle instead. Stresses transmit rapidly between apparently unconnected markets – Korea, Brazil and Russia during the 1990s Asian crisis; and UK pensions and US Treasuries this week.

So far, US institutions are holding up – good and bad news for US investors. Cracks in the financial system are the only reason that could lead the Federal Reserve to put monetary tightening on hold. Even then, it is likely that the difficulty of maintaining the inflation fight while relieving market stresses would hobble Fed action, just as it is now plaguing the Bank of England.

Safe haven?

Currencies are a relative play. And in the world today, the US dollar looks attractive. Sometimes capital floods into the US as an escape from a risky world. This time, Fed policy is the main factor driving up the dollar and, potentially, causing the world to become a riskier place.

The pound sterling is not the only major currency collapsing. The euro and the yen have weakened by 14% and 20%, respectively, since the beginning of the year. In fact, as highlighted above, these currencies have actually underperformed many emerging markets. The renminbi crossed 7.2 level against the greenback Wednesday, falling to its weakest since 2008. As a result, the People's Bank of China has warned against betting on RMB this week and has asked major state-owned banks to be prepared to sell dollars in offshore markets as it steps up efforts to stem the RMB’s descent.

For Europe, this may bring a welcome respite to industrial exporters hurt by China's weakness and by energy shortages. Imported inflation from the US nevertheless complicates the job of the European Central Bank (ECB). Japan's central bank is still welcoming higher inflation, holding interest rates down along the curve in its continued effort to dislodge disinflation. But monetary policy is increasingly in conflict with the Japanese government's desire to limit the exchange rate decline. Something will eventually give, as former Treasury Secretary Lawrence Summers noted in a gloomy assessment of current risks to the global economy.

The strong dollar helps the Fed in its efforts to curb inflation. It holds down import prices and adds to competitive pressures on US companies from overseas. One element protecting the UK from a more dangerous crisis is its flexible exchange rate regime. But in the past, sharp moves in the currencies of major developed economies have also been seen as a threat to stability.

Housing hit

The recent housing boom was both a symptom and a cause of today's inflation. This week brought indications that the process may be going into reverse. House prices fell in July. With mortgage rates now approaching 7%, more potential buyers will hold off. Just as easy monetary policy kept mortgage rates low and added to house price pressures, the Fed's tightening will feed through borrowing costs to curb demand and prices. Over time, this will help to bring down measured inflation. Shelter costs, which reflect house prices and rents with a delay, are a major element in the consumer price basket.

War ratchets up – another inflation risk

Russian President Putin has often told the story about a rat that – when cornered – attacks. He has made clear this week that he prefers to attack when cornered. After losing key territory in Ukraine's east, President Putin has acted on three fronts – military, political. and energy. All carry dangers for Ukraine and Europe – and potentially the world.

First, on the military front, Putin threatened the use of nuclear weapons as he began a partial mobilization to build up the failing Russian army. This week he moved politically, announcing the annexation on Friday of four Ukraine regions into Russia. The danger: Russia may claim that further fighting in this region amounts to an attack on its homeland, warranting a broader military response.

Finally, ratcheting up the energy war with Europe this week, Russia is believed to have been responsible for what NATO called "acts of sabotage" that damaged the Nordstream pipeline that takes Russian gas to Europe. Leakage from the pipes, first detected by Denmark, was quickly linked to a series of extraordinary underwater explosions.

It is clearer than ever that Europe cannot rely this winter on Russian gas to stay warm and keep factories going. Its reliance has already fallen from 40% before the invasion of Ukraine to less than 10%. Losing all access will put more pressure on energy prices.

In addition to the price pressure, the Nordstream leakages have an immediate climate cost. Estimates from Reuters suggest that the methane that had escaped within hours was equivalent to one-third of Denmark's total annual greenhouse gas emissions.

Emerging Markets

Emerging markets sold off in sympathy with developed markets peers this week and provided little refuge to risk seekers.

We are rapidly approaching the much-anticipated Chinese leadership 'election' and rumors are rampant. We see three possible scenarios. First, President Xi firmly cements a third term with his allies representing a majority of the standing committee. Second, President Xi secures another term, but decision making is done collectively with standing committee members. Third, President Xi steps down and his influence is diminished.

Under the first scenario it's difficult to believe much would change, putting a potential economic re-opening of China on hold indefinitely. Under the second, we may see a gradual re-opening. Under the third, assuming leadership takes over that seeks to repair relations with business and foreign leaders, we would expect to see a very positive re-rating. Over the last few weeks, we have seen symbolic gestures from China's political elite that change may be afoot, but of course it's impossible to predict. This uncertainty, in part, has driven a benchmark of Hong Kong-listed Chinese companies to its cheapest valuation ever. Given the binary risk, we have adopted a neutral stance and have raised cash to take advantage of a potential positive spillover effect for the rest of emerging markets, especially North Asia.

Another binary outcome we are watching carefully is this weekend's Presidential election in Brazil. President Jair Bolsonaro has stated that he sees three outcomes (win, be arrested, or be killed) and we suspect only one is personally acceptable. Be that as it may, we would be surprised to see anything but a Lula victory. Assuming Bolsonaro's bluff is called, and with a bit of kicking and screaming he reluctantly accepts defeat, we see promising upside for Brazil. As we've highlighted in previous letters, the combination of record low valuations, cheap currency, decreasing inflation, and positive terms of trade have created the perfect setup for a positive rerating.

One bright spot in EM continues to be currencies. As shown below, many EM currencies have outperformed their developed market counterparts – some have even strengthened against the dollar. For US dollar-based investors this is good news, particularly if exposures have been concentrated in star performers like the Chilean Peso, Brazilian Real, and Indian Rupee. The monetary policy discipline shown by these countries over the past 18 months has allowed them to weather the greenback's impressive run and put them in a position to stimulate growth in 2023 – an advantage developed markets central banks may well envy in a few months' time.

RockCreek Update

Delivering Alpha

Afsaneh Beschloss took part in CNBC's Delivering Alpha summit in New York. Headlining the summit's closing discussion, The Next Big Thing – moderated by TechCheck co-anchor Jon Fortt, she discussed how breakthroughs in climate-smart sectors; biotech; and food, water, and agriculture will shape the world in the decades to come. Watch out for the video soon.

Speaking with Closing Bell anchor Sara Eisen from the summit, Afsaneh discussed growth in ASEAN markets, challenges in China, and opportunities in climate smart innovation. Watch the full clip here.