NOVEMBER 11, 2022

A LITTLE GOES A LONG WAY?

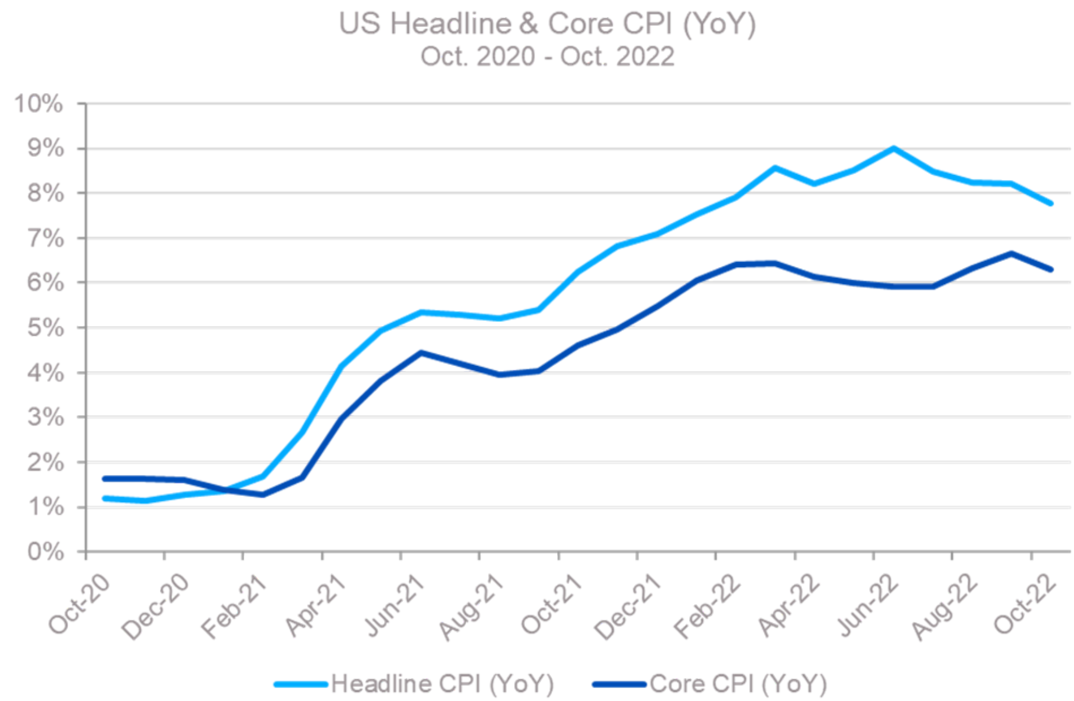
Yes – the inflation news this week was good. So were the signs from the midterm elections that Americans care about democracy, voting in the main against candidates that threaten it. Russia's withdrawal from Kherson, the one major city in the Ukraine that its forces have taken, was also welcome. Finally, the steps that China announced to soften its strict zero policy were a reason for markets to cheer. However, none of these events signaled a satisfactory end to the issue at stake. The initial market reaction to Thursday's inflation data showed an inordinate desire to believe the best, rather than a sober look at what lies ahead. By Friday, the S&P 500 generated a strong 6.0% return for the week, while the tech-heavy NASDAQ Composite returned 8.1% over the same period.

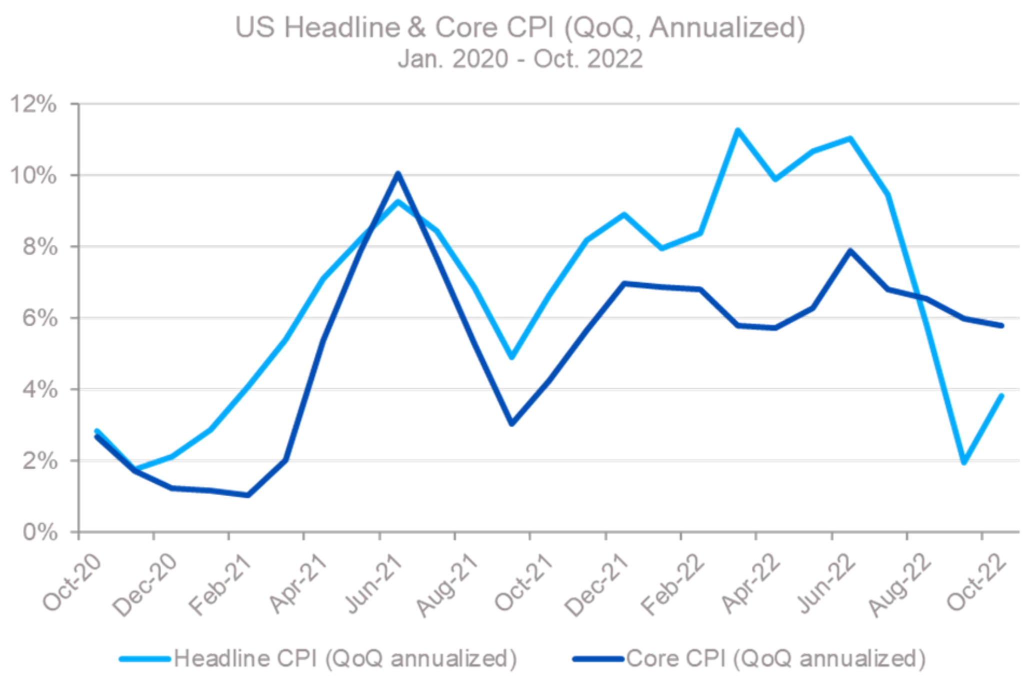
Other notable events this week included the climate meeting in Egypt – COP27 – where leaders from around the world gathered to follow up on the work from the meeting a year ago in Glasgow. Since then, extreme weather around the world – from devastating floods in Pakistan to drought in the Horn of Africa, which leaves 22 million people at risk of starvation – has only increased the urgency of action. (See more on the first week at COP27 below).

As we noted last week, the Fed has been looking to slow the pace of rate rises, after the extraordinary run of four consecutive increases of 75 basis points between June and November. The Fed wants to avoid tightening so sharply that it triggers financial instability. Inevitably, as rates rise some problems emerge. This week's financial turmoil came in the form of the collapse of FTX, a crypto currency platform based outside the regulatory net of the US. Some wondered if the bankruptcy could trigger a "Lehman" moment, and even if that is not the case it does have an Enron or MF Global feel. FTX's implosion is surely a devastating blow to crypto; however, the broader repercussions on markets are still unclear.

As for the Fed's future moves, a 50 basis point increase was always likely in December. Market pricing has moved towards this view since Thursday's Consumer Price Index came in better than expected, at 7.7%. Already, Fed policy makers have begun to hint at a new phase of the monetary tightening, with lower interest rate hikes. The New Year could even see a return to the 25 basis point moves of old.

But what is less certain – and more important – is how much further the Fed will raise rates in 2023 before pausing. On this, the markets are still more optimistic than many economists, pricing in a likely terminal rate at the end of next year of just 4.41%. This would still leave financial conditions far from restrictive, with interest rates remaining negative in real terms unless inflation evaporated. Would that be enough to curb the wage rises that the Fed worries about? This month's labor reports have shown that the market remained tight through October. True, unemployment claims crept up at the beginning of November. But they are still not far from pre-pandemic norms, when unemployment was low.





Source: RockCreek, Bloomberg

A sober assessment is also warranted for the other pieces of good news this week. The war in Europe is going to drag on for some time yet, as described below. And in America, the midterm results are so close overall that it will be some time before we know which party will control congress.

Uncertainty – as well as the surprise that early results were so different than experts had predicted – may have contributed to market wobbles on Wednesday. As of Friday afternoon, Republicans seem likely to end with a small majority in the House, although many races remain too close to call. The Senate is likely to depend on the outcome of a run-off in Georgia between Democrat Raphael Warnock and former footballer Herschel Walker.

Why the surprisingly good performance by Democrats overall? An interesting analysis by New York Times Chief Political Analyst Nate Cohn suggested that in states – and districts – where democracy, and abortion rights, seemed to be on the line, voters plumped for stability. Michigan was a prime example. In other places – such as Virginia, New York, Florida – where these issues were not at stake in the races, voters expressed the more usual tendency to rebuke the party in power, citing the economy and crime as their main concerns and voting heavily against Democrats.

The markets see this as an optimistic take for democracy and institutional stability. Another indicator to watch will be the gubernatorial race in Arizona, where the winner will oversee the next elections in this purple, and disputed, state and Kari Lake, who has not committed to abide by election results, is running close.

European War

A setback in Kherson is a huge blow for President Putin. But it may allow Russia's military to develop and protect a stronger line of defense just east of the city and the Dnipro River, still well within Ukraine's borders. From there, Russian artillery will still be able to deliver crushing blows to Ukraine's infrastructure, if not its morale. Many experts now expect the war to slow down as winter freezes the land. It may still be too soon for either side to accept negotiations.

President Putin believes time is on his side. President Zelensky believes that with more arms from the West, he can push Russia further out of his country. As the war goes on, the risk of escalation also rises. It is good news that US National Security Adviser Jake Sullivan has been holding private conversations with Russian counterparts to warn of the consequences of nuclear or dirty bombs. Another area where escalation has been possible, but avoided so far, is cyber. Both Russia and Ukraine have important capabilities in these areas. But it is possible, as expert Marcus Willett argues, that the West has overestimated Russia's ability to use cyber weapons effectively, just as it did with conventional weapons.

Interest rates still on the rise, even if inflation slows

Investor eyes are on inflation data because persistent and unexpected price increases have been the driver for Fed interest rate hikes. Of course, it is also important to pay attention to labor markets. Potential wage pressures are what the Fed has been most concerned about, as Chair Powell has repeatedly pointed out.

The jury is still out on whether a labor market easing can occur without a hard landing and sharp increase in unemployment. The Fed will have a chance to see more data – including the jobs report for November – before making its next move. This week's data from the Atlanta Fed wage tracker showed wages a tick higher, at 6.4% in the three months ending in October, still well above what would be consistent with the Fed 2% target.

In the meantime, the consumer price data on Thursday did give a number of reasons to cheer, even if market enthusiasm was overdone. The overall headline rate of inflation – which is what matters for the here and now – continued to decline, whether measured month on month or versus a year ago. As energy and some food prices have moved down, it has become clearer that the much-watched annual rate peaked in June, when it hit 9.1%. October's 7.7% price increase was not only lower than the September print, it was better than expected. As for elections, so for economic data: expectations matter.

Nevertheless, Thursday's release augurs well, with a warning that the data have disappointed before. The Fed will have another CPI print to consider, the day before it meets in mid-December.

A Record Setting Thursday

Equity markets have been desperate for signs of anything that would give the Fed justification to halt or at least ease its interest rate tightening campaign. As such, Thursday's surprise CPI reading was received with jubilation, justifiably too much, as markets raced towards a record-setting day. The S&P 500 recorded its largest single day rise since April 2020. In fact, it was the S&P 500's best performance after a CPI report on record.

Technology stocks have been hardest hit by surging inflation and rising interest rates and thus benefited strongly from the news. Apple's market cap surged by $190.9 billion on Thursday, setting a record for the biggest ever for a US-listed company. Despite its 9% share price increase, it remains down about 19% year-to-date. It was also a good day for CEOs of big tech companies. Thirty-two US billionaires made a collective record $59 billion in gains from their shareholdings. Amazon's 12% rise made Jeff Bezos alone an estimated $10.5 billion. Meanwhile, layoffs and cost-cutting measures made by big tech companies to adapt to tougher economic conditions are being welcomed by investors wanting to see improved bottom-line results.

While profitable tech companies did very well, it was the unprofitable companies that saw many of the largest share price gains. Carvana for instance jumped more than 30% Thursday, though it remained off about 96% this year. Carvana is one of the more heavily shorted stocks and a good portion of its rise could be attributed to a short squeeze as short sellers rushed to get out of the way. The market has been very eager to trade a 'Fed pivot' and patient investors will be watching to see whether the market is getting ahead of itself as we end the year.

Asian Changes

For much of this year we have written about our bearish stance on North Asia. For the most part, the markets have confirmed our base case, although China's easing of its strict zero Covid policy has led to an understandable market bounce.

Eager to test our views on the ground, our emerging markets team is in the region this week, meeting with investors and companies in Taiwan, Vietnam, and Singapore. There is broad recognition that markets are trading at record low valuations but there is also no apparent rush to dive in given the high level of uncertainty still surrounding the area's geopolitics. In Taiwan, our team did not detect a sense of urgency nor leave thinking the country is on a war footing. Perhaps this is because of the many times our team was told how close to impossible an amphibious landing via the Taiwan strait is, or how neighboring Japanese controlled islands are bristling with newly installed anti-missile defense systems, or that the US and its allies would simply not tolerate an attempted invasion. Whatever the reason, it's also true the country's strategic crown jewel, TSMC, announced this week a $12 billion investment for its burgeoning operations in Arizona to support the production of its more sophisticated 3nm technology. The chips behemoth is clearly hedging its bets should a Chinese invasion materialize sooner than expected.

In Vietnam, facts on the ground did not reflect one of the worst performing equity markets in the region this year – a reminder that strong growth and market performance don't always go hand in hand. A series of property developer scandals have prompted a heavy hand from the government. This in turn has frozen new credit creation and wreaked havoc on the corporate bond market. In a classic "baby out with the bathwater" scenario, whole sectors, and companies unrelated to the current government crackdown have sold off, reaching record lows.

Why we feel confident markets will return to their senses is that the country managed the pandemic superbly and is fully open for business, has low inflation, under 5%, a young and well-educated workforce, and perhaps most importantly, inflows of foreign money in the form of FDI have been rising rapidly. Multinational companies from near and far are coming to Vietnam to take advantage of tax incentives for land development and infrastructure well suited to exporting. From software, to pharmaceuticals, to jet engine parts manufacturers, to private universities, opportunities abound, and we believe sooner or later the equity market will begin to factor in these developments. Indeed, this may be one of the more attractive entry points for Vietnamese equities since the GFC of 2008.

Meanwhile, we will be looking at the effects of today's updates to China's covid policy, as well as any easing of geopolitical tensions as Presidents Biden and Xi meet on Monday, November 14. In the announcement, the government released 20 detailed measures which include cutting short quarantine periods for inbound travelers and close contacts, reducing the scope of people who are subject to quarantine due to close contact with the confirmed cases and scrapping the flight ban which has been in place since early 2020. The vaccination campaign and storage of anti-COVID drugs are also emphasized. The market is inspired to see the Chinese government start to make some efforts to tread on a correct trail to normalize people's life in China, with both the Chinese and Taiwan indices jumping 7.7% and 3.7% respectively. But we have to monitor the implementation of these policies before we get carried away.

Early indications from the US suggest that that expectations are low for some semblance of productive talks, but we will be monitoring the situation as it unfolds. Topics will undoubtedly range from Taiwan, the Chips Act, Chinese support of the Russian war effort, and the relaxing of supply chain bottlenecks.

Wealth matters – American history too

The plunging stock market this year has made many Americans worry about their savings for retirement. It also puts a spotlight on how much wealth matters for the economy overall, and which factors determine who has it. We know that sharp disparities remain between Black and white Americans, with the former owning more than 80% less wealth than the latter.

A new study, *Jim Crow and the Black Economic Progress After Slavery* by Lukas Althoff of Princeton and Hugo Reichard of LSE shows how education and history play a key part. For many Americans, education, although not an asset that can be traded like financial assets, is critical in ensuring economic independence and well-being and allowing wealth accumulation. The authors argue that disparities today between different groups of Black Americans depend critically on whether their ancestors were enslaved or free before the Civil War, and, after the Civil War, whether they lived under strict Jim Crow laws and segregation. The effects of Jim Crow laws for the hundred years before the Civil rights movement of the 1960s are still being felt – mainly through the impact on educational possibilities.

COP 27 Kicks Off

This week, more than 33,000 delegates from over 190 countries gathered in the Red Sea resort town of Sharm El-Sheikh for the 2022 United Nations Climate Change Conference, or COP27, to negotiate steps to limit global temperature rises. While Glasgow's meeting laid down the basic rules for the implementation of the 2016 Paris Agreement, climate envoys this year, however, are seeking to establish clear mechanisms to achieve a 1.5°C future. This means reducing emissions, helping countries become resilient to climate change and securing technical and financial support for developing countries. Also on the agenda are often overlooked issues of "loss and damage finance" to help countries recover from increasing extreme weather events, establishing a global carbon market to price the effects of emissions into international commerce and eliminating coal use.

In his speech today, President Biden took a victory lap on passing the Inflation Reduction Act, which expanded health care coverage and spending on climate tech and infrastructure, stating that the US is "putting our money where our mouth is to strengthen accountability in climate risk and resilience." And on the heels of an electoral victory and flanked by his entourage – Secretary of State Antony Blinken, National Security Adviser Jake Sullivan, Special Presidential Envoy for Climate John Kerry and EPA Administrator Michael Regan – President Biden reiterated the US was on track to reduce its emissions by 2030 by 50%, based on 2005 levels.

The future of domestic climate and clean energy legislation is looking optimistic, with Democrats now running state governments in Maryland, Massachusetts, Michigan and Minnesota. Additionally, the EPA announced an updated proposal to reduce methane leaks and waste emissions from oil and gas companies by 87% below 2005 levels. Hopefully, this momentum will lead to more ambitious and equitable policies that spur sustainable job growth alongside investment opportunities.

FTX - Crypto's Lehman (or maybe MF Global?)

One of the major stories of the week was the collapse of FTX, one of the largest crypto exchanges in the world. The story is still developing in real-time, but it appears as though the exchange has a liquidity crunch and is potentially insolvent pending a last minute equity infusion. Earlier this morning, FTX filed for bankruptcy, an undoubtedly shocking chapter in the story of a company whose leader was recently considered to be the modern day J.P. Morgan.

FTX was viewed by many as one of the crown jewels in the crypto space, with an enviable cap table, annual revenues in excess of $1.0 billion, and a lofty valuation of $32 billion. Earlier this year, FTX's founder, Sam Bankman-Fried, rose to prominence after stepping in with several high profile bailouts in the aftermath of the collapse of Luna and the Celsius Network.

While investors are still unpacking the details, it appears as though FTX was misappropriating client funds by making loans to an affiliated proprietary trading vehicle, Alameda Research. Over the weekend, CoinDesk published an article which called into serious question the stability of Alameda Research's balance sheet. A few days later, Changpeng Zhao, founder of rival crypto exchange Binance, tweeted that he would be liquidating a significant stake in FTX's token while alluding to concerns about Alameda Research. At the same time, FTX saw its largest ever daily withdrawals, putting significant strain on the exchanges ability to meet these requests, as (apparently) unbeknownst to Bankman-Fried, FTX was levered at 1.7x.

So what happens next? A stunning nine days after the initial CoinDesk article, it was announced that FTX.com, FTX US, Alameda Research and other affiliated entities filed for chapter 11 bankruptcy. Sam Bankman-Fried will resign and John J. Ray III, famously the one who was appointed to pick up the pieces after Enron's collapse, has been appointed as the new CEO. Investors like Sequoia and Paradigm have marked their respective investments to zero. And yet, long-term ramifications and inquiries of the still unknown cause of FTX's implosion will likely persist well into the future.

We view this as significantly different from the cyclical "crypto winter" phenomenon and more impactful than the crypto implosions earlier this year. Trust in the ecosystem appears to be fundamentally shaken. Bankman-Fried, one of the most important investors across the crypto ecosystem, particularly the Solana blockchain, is headed for the sidelines, stripping the industry of one of its biggest sources of funding. One of the major questions that has yet to be answered is the source of FTX's leverage, as this could have broader ramifications for any potential contagion. For a thoughtful summary on "the issue behind the issue," check out QED's Frank Rotman's recent post.

RockCreek Updates

Bloomberg Surveillance in DC

Alifia Doriwala joined Tom Keene, Jonathan Ferro, and Lisa Abramowicz on Bloomberg Surveillance from the Washington, DC studio to discuss the impact of the US midterm elections for markets, pockets of opportunity from the Inflation Reduction Act, and managing fixed income exposure for clients.

Watch the segment here.

With more to come,

Team RockCreek