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NEWS

How to tackle the downward market spiral?

The markets are caught up in a vicious cycle which has worsened in recent days.

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Jean-Marie MERCADAL
Head of Investment Strategies
OFI HOLDING

The current logic stands as follows: interest rates are too low in relation to inflation, which is at a more than 40-year high. Central banks are tightening their monetary policies and interest rates are therefore rising rapidly. So long-maturity assets including equities are deflating, and a serious slowdown is taking shape… Is there any way that this negative chain of events can be cut short?

Central banks currently find themselves in a very uncomfortable position indeed. They were instrumental in helping economies emerge from the Covid-19 crisis but are now coming under fire for having failed to realise the scale of the inflationary surge now affecting most of the world's countries, with the notable exception of China whose monetary and economic cycle is completely out of sync.

They are therefore now in the process of raising their key interest rates in an attempt to curb inflation, with the risk that this might trigger an economic slowdown or even a recession. The ECB is also facing a fresh bout of tension between euro zone countries regarding the sovereign debt market, as spreads[1] between "southern" countries and Germany are widening. As it tries to handle all this pressure, it has said that it is considering introducing a new mechanism to keep these tensions under control, although it has not yet said what it will involve. In short, central banks appear to be enduring current events rather than forestalling them.

This is the backdrop against which both the ECB and the Federal Reserve released statements this week.

The **ECB** held an emergency meeting on Wednesday in an attempt to ease tension between euro zone countries regarding the sovereign debt market, as spreads between "southern" countries and Germany are widening. Isabel Schnabel, the ECB's head of market operations, confirmed that there were "no limits" to the bank's commitment to prevent fragmentation within the euro zone, and her words managed to ease some of the pressure on the spreads of the zone's most indebted countries. No details have been released about the planned mechanism as yet. As far as rates are concerned, a 25bp increase in the key interest rate is expected in July (although the market is pushing for more) followed by a likely 50bp hike in September and another increase before the end of the year, with the yield curve pointing to a key interest rate of over 1% by year-end.

The Fed's meeting, on the other hand, was a scheduled one. Jerome Powell acknowledged that steering monetary policy was a tricky exercise because "there's always a risk of going too far", but inflation is his biggest concern right now. That said, he admitted that growth is now at risk even though he considers the US economy to be on a very solid footing. He therefore announced a 75bp increase in US money-market rates, the biggest single hike made since 1994. He nevertheless pointed out that he does "not expect moves of this size to be common" and that decisions taken will be data dependent.

Fed Funds rates are therefore now fluctuating within the 1.50%/1.75% range. All 18 FOMC members now see them reaching around 3.3% by the end of this year and up to 3.75% by end-2023, although there is a great deal of uncertainty as it all depends on whether or not inflation is brought under control. GDP growth is now expected to reach 1.7% this year and next.

So the big question for the coming months is when is inflation going to peak? There are now doubts about whether today's high inflation really is only temporary, a scenario that has so far been widely shared by the world's central banks. The current rise in bond yields will only be brought to a halt if this inflationary surge reverses.

From this perspective, today's inflationary surge is being driven by some very temporary factors while others seem to be more structural.

There are two main temporary factors at play:

- A sharp rise in energy and agricultural commodity prices. This is partly the result of the robust economic recovery that was activated when the world's economies reopened post-Covid. It has been magnified, as we all know, by the conflict in Ukraine. There is no real short-term visibility on a rapid resolution of this conflict, in which case energy and agricultural prices could remain under a great deal of upward pressure over the coming weeks. Meanwhile, Western economies are showing serious signs of slowing down, but China appears to be reopening following its Omicron wave and its economy is picking up. Note also that oil prices are already rather high. Even if they settle at these levels, slower growth in oil prices should slow the increase in inflation.
- Bottlenecks resulting from turmoil in global trade flows and the recent lockdowns enforced in China. The situation here appears to be improving gradually and the worst seems to be over. Waiting times for container ships trying to enter the world's main ports are beginning to shorten, and factories in China are getting up and running again. So although 10.5% of the world's shipping fleet was still unavailable in April, this was an improvement on the 13.8% unavailability rate recorded in January.

Meanwhile, there are two structural reasons why inflation could stay high over the coming years:

- The beginnings of "deglobalisation". The post-Covid world appears to be a different one from before. The health crisis underlined the risks of depending too heavily on factories located in far-off countries. So we might begin to see a move towards reshoring, especially as the sharp increase in intercontinental trade has been negative for the world's carbon footprint. In addition, today's intense geopolitical situation is encouraging countries to become rather more inward-looking. So we are beginning to see a reversal of the trend that had largely helped to keep Western countries in deflationary mode, lowering the prices of industrial goods and consumer staples. This theme is now a widespread and commonly accepted one.

[1] *Spread: difference between rates.*

- The costs of the energy transition. Efforts to cut carbon emissions within a relatively short timeframe are going to free up enormous amounts of capital to replace existing energy infrastructure. Such destruction/reconstruction comes at a cost, which will have to be passed on to users.

We therefore expect inflation statistics to remain highly volatile in the near future, but there is a chance that inflation might peak quite soon. For the time being, inflation expectations priced into index-linked bonds are holding quite steady at 2.60% in the USA and 2.20% in the euro zone. **Based on this assumption, the rise in bond yields should begin to reverse.**

European High Yield bonds, a segment offering yields of 7% on average, seem to have priced in a recession and the monetary tightening cycle; we find them attractive at these levels.

The drop in the equity markets could ease if our scenario of stabilising bond yields materialises, and **we might see some rather abrupt technical rebounds** since valuation multiples are reasonable. Visibility as a whole remains quite poor, nonetheless, especially on corporate earnings. There have been no rounds of downward earnings revisions as yet. They will probably come eventually given the slowing economy, but it is difficult to predict on what scale. PERs[2] currently lie at around 17 for US equities and 12 for European equities, so the equity markets would be able to cope with some minor downward revisions. We therefore expect to see some more bouts of high volatility, and equity indices might possibly fall back further still. But we would advise investors to get ready to reinvest during such bearish phases - assuming we are right in saying that bond yields are going to begin stabilising.

[2] *PER: Price to Earnings Ratio. A stock market analysis indicator: market capitalisation divided by net income.*
The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

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22, rue Vernier 75017 Paris - FRANCE • Tel.: +33 (0)1 40 68 17 17 • www.ofi-am.fr