MARKET COMMENTARY

Markets caught by Ukraine worries and Fed jitters: what next?

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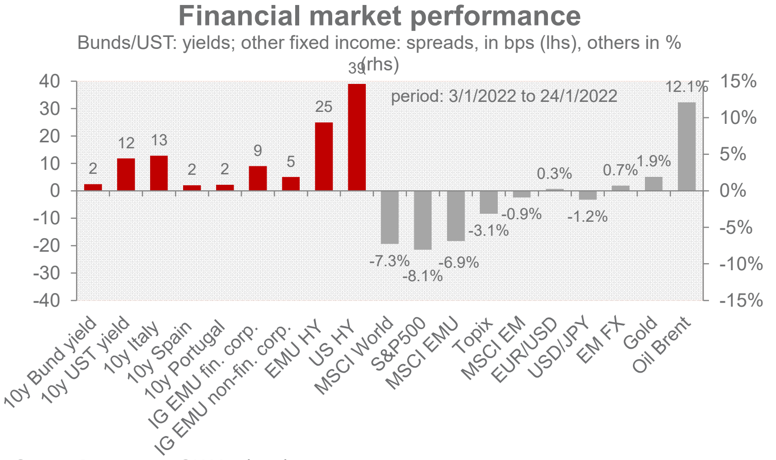
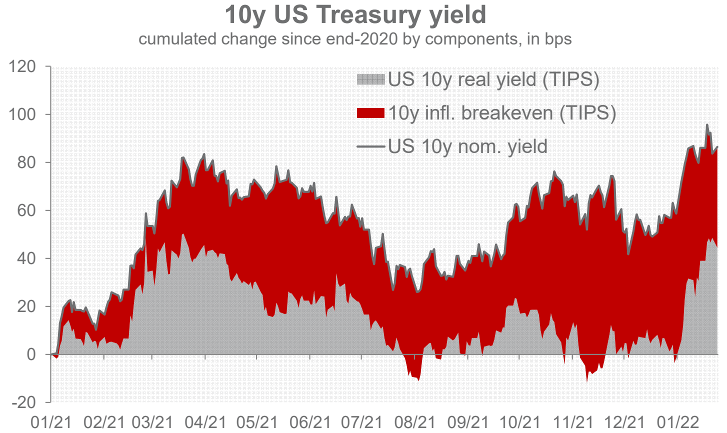
- **Global equity markets have retraced sharply recently amid worries about a looming Fed lift-off and tensions around Ukraine. An escalation of the conflict and subsequent sanctions by the West may add to worries about energy supply for Europe, adding to virulent inflation uncertainties.**
- **With the conflict over Ukraine looming, and China's zero-Covid policy slowing the normalisation of the supply chain, volatility is likely to remain elevated in the near term. Indeed, we entered the year with only a prudent overexposure to risk assets in anticipation of higher market volatility, headwinds from trimmed policy support and higher real yields.**
- **That said, as the global recovery continues and corporate earnings grow further (if more slowly), the recent correction will ultimately offer buying opportunities, with the outlook for Value and Energy equities particularly benign. Credit is likely to extend its resilience too.**
- **Yields have more leeway to rise on the looming withdrawal of monetary policy accommodation – and a further spike rise in real yields is a key variable to watch as they anchor asset valuations across the board. Yet the recent correction in yields is a reminder that strong short-term spikes in yields quickly prove self-defeating, with mounting risk aversion then favouring the safe haven of core government bonds. We thus expect the rise in long-term real yields to be moderate and orderly.**

Financial markets have come under strong pressure in January amid a double blow from the Fed's hawkish pivot and mounting tensions over Russia and Ukraine. The S&P500 temporarily dipped into correction territory yesterday (implying a >10% decline from peak). A recovery over final hours notwithstanding, it now stands 8% lower than in early January. The equity sell-off has been led by rate-sensitive growth and major IT stocks that had previously soared into highly overvalued territory; they are now suffering from a steep repricing of US rate expectations and yields. With longer dated inflation expectations defying the rise in commodity prices, the increase in real yields has been even more pronounced, burdening valuations of growth stocks (which suffer disproportionately from a higher discount factor applied to future earnings). As a result, the Nasdaq Composite's decline temporarily summed up to >19% temporarily, close to bear market territory (commonly defined as a 20% retrenchment from peak). And while overall investor positioning had been muted, equity markets had seen unabated fund inflows even into 2022. This disconnect may have added to the recent market turmoil.



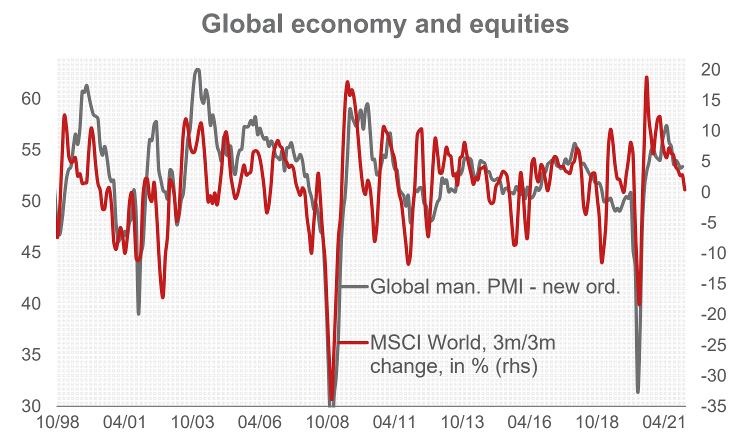
Source: Datastream, GIAM calcuations



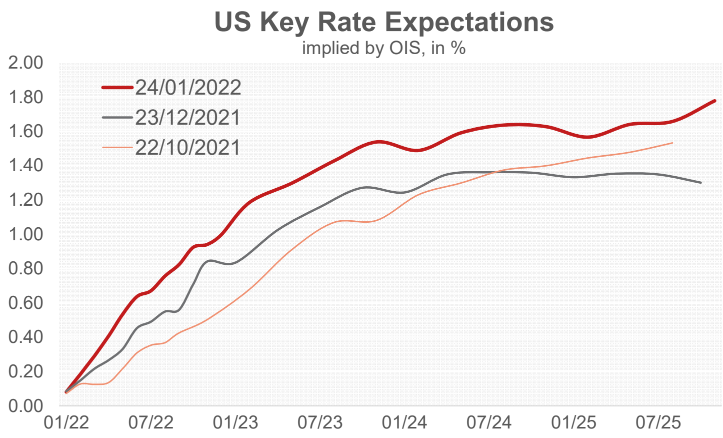
Source: Datastream, GIAM calculations

Tomorrow's Fed meeting is unlikely to provide relief. With more sustained inflation pressures rising, fuelled by high energy prices, a hot labour market and soaring rents, the Fed will prepare markets for a March rates lift-off. The risk of renewed supply chain disruptions in China/Asia on Omicron is also adding to price risks. We now expect even four Fed rate hikes this year, supplemented by the start of the reduction of the balance sheet in the summer. Yet the Fed will also be keen to not pour oil on the fire of recent market nervousness.

Geopolitical risks around Ukraine are just adding to uncertainties and energy inflation risks in particular. The West has threatened to impose far-reaching sanction in case of a Russian invasion into Ukraine, with a suspension of the Nord Stream 2 gas pipeline on the table. The latter could trigger cuts in Russia's gas supply to Europe. Though guaranteed by contracts, Russia may still aim to retaliate by running down local gas storage in Europe while cutting supply, as it had been accused of already recently by the IEA. Worries about energy supply and low gas inventories in Europe may intensify energy price pressure further, with the price of Brent already eyeing 90 US$/bbl. The risk of oil supply disruption has been pushing up price expectations: within ten days the March futures shot up by nearly 6 US%/bbl, adding to the headwinds for real disposable income of consumers and to inflation headaches at central banks.

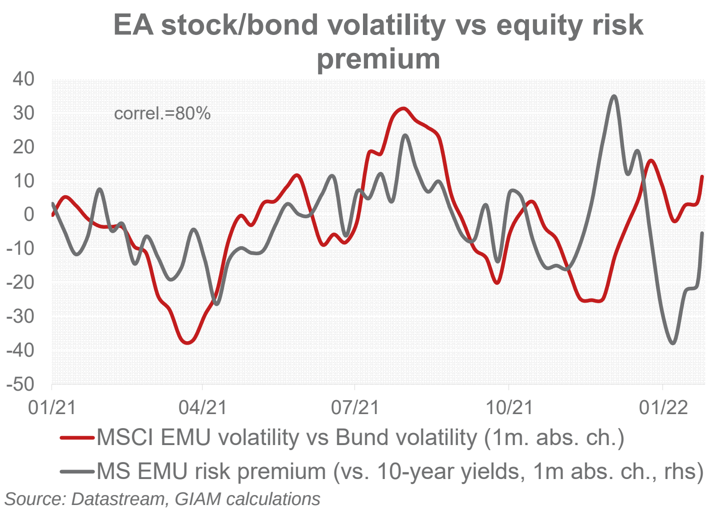


Source: Markit, Datastream, GIAM calculations

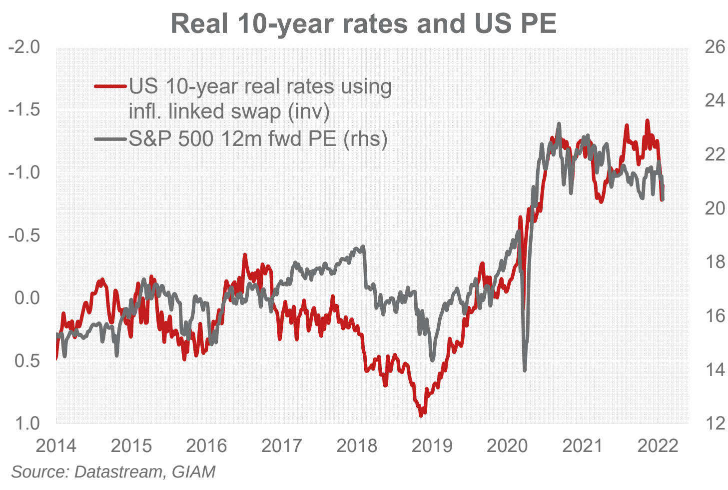


Source: Refinitiv, GIAM calculations

With risks around Ukraine to keep lingering and the Fed set to confirm a significantly more hawkish stance, volatility is likely to remain elevated near term. That said, with the global recovery unlikely to be choked off, the recent market correction may ultimately offer buying opportunities. The pace of the global expansion is overall still consistent with modest upside for equities. Earnings growth is slowing and forward guidance by firms is being trimmed, but overall the earnings season has so far been reassuring. And even if valuations look more challenging against the backdrop of risen real yields, they still do not look extreme.



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

Risk premia on both the euro area and the US market are below historical average, but not excessively so. Persistently high energy prices bode well for energy while we also prefer Value stocks -including financials - which tend to outperform in an environment of rising yields.

Deteriorating risk sentiment has hurt speculative corporate bonds, with HY spreads wider, mostly on the CDS side. Yet European investment grade has proven overall resilient, with the rise in risk premia very muted. As European Credit continues to enjoy the strong backing of the ECB as one of its policy tool and defaults low, we maintain our favourable view on this asset class.

EM spreads have been widening by 23bp year-to-date under the repricing of Fed expectations with an underperformance of HY. Yesterday's move was contained with IG names only widening by 2bp. Russia and Ukraine were the laggards. The EM resilience is partially explained by the low positioning, the supportive Chinese monetary policy and the poor 2021 performance. That said, we keep a neutral stance due to significant downside risks and the negative impact of higher UST rates.

Yields have more leeway to rise on the looming withdrawal of monetary policy accommodation. The recent correction is a reminder, though, that strong short-term spikes in yields can quickly prove self-defeating. Once worries about a too fast pace of policy tightening curtails risks sentiment, the rush for safe havens keeps rise in core bond yields volatile and muted in trend.

The rise in market volatility has been underpinning JPY, CHF and to a lesser extent the USD. The Greenback may still benefit from the Fed's global lead in monetary policy normalisation. But it is still close to peak as much of the Fed's tightening is already priced while a broadening of the global recover further into the year is likely to burden the countercyclical USD.