CIO Newsletter Asia

House of cards

3rd Quarter 2022

Over the last few weeks, investors' concerns have broadly focused on three key questions. Firstly, **with their worst first half of a year ever, have global markets already priced the extreme possible consequences from an incredibly sharp and global reversal in the cost of money?** Second, **after Shanghai's lockdown, has China faced the worst** and **is there some hope for a recovery for its domestic stock markets in the second half of 2022**? Finally, after the positive correlation experienced between bonds and equities prices over the last several months, **how can investors secure their portfolios' resilience while leaving some space to chase any possible opportunities of positive returns**, at least in some pockets of the global markets?

Jean-Louis Nakamura
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Facing those interrogations, **we have persistently advised to exercise caution and favored portfolios' resilience over attempts of dip buying**. If central banks were sincere when prioritizing the fight against inflation, they would then only stop the tightening of monetary and financial conditions either when price pressures decelerate materially and persistently or if a further market capitulation would threaten the overall stability of the financial system. Both outcomes may take time and, meanwhile, actual tighter liquidity and monetary conditions would only increase the depth of an incoming - if not already ongoing - recession. In this process, **many emerging economies will be under increasing pressures to restrict their own financial conditions even faster**, at the risk of giving back much of the outperformance they were able to accumulate in the first half of the year due to their booming commodities exports and/or the benefits from their belated re-opening post the Delta-variant.

China is in a different dynamic. Having faced a sharp deceleration along 2021 that culminated with a recession-like situation this spring, China has likely reached the limit of its patience for self-imposed public health and macro policy restrictions. **The downturn that began with unusually disciplinarian stance on all areas of economic policy could metastasize into long-term political risks as the country is releasing a fresh batch of approximately 11 million college graduates to the job market over the summer**. Even if zero-Covid strategy is maintained formally until the end of 2022, we expect future virus waves to be managed in a more pragmatic way. The rollout of all easing measures announced since the Lunar New Year should finally translate by improving economic data through the summer. **Onshore equities markets (A-shares) have started to price this scenario, rebounding from their lows reached at the end of April**, by roughly 15%-20% while proving immune to the turmoil in developed markets. **Even under our shallow recovery assumptions, we believe there is space for similar returns within the next few months**.

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After de-risking our conviction multi-assets portfolios massively in late January and then again between mid-April and mid-May, **we do not think the time has come yet to stand against a large wave of likely unfavourable developments over the next months.** Portfolios' resilience remains the priority, with **the most efficient hedges for the second half of 2022 potentially different from the successful ones during most of the first half**. While commodities might still offer some protection against adverse geopolitical developments, their most cyclical components are at risk of giving back rapidly should growth scare dominate ultimately. Symmetrically, **sovereign bond yields have started to regain their diversifying capacity as activity data increasingly point to a recessionary outcome in the US and in Europe**. In the meantime, however, cash remains king to keep overall risk under control **while China A-shares might be one of few reserves of positive returns over the summer**.

In our Newsletter released in the first days of 2022[1], we were highlighting that, at each start of a new US monetary tightening cycle, **investors tended to under-estimate the pace at which the Fed was willing to hike policy rates, while FOMC members usually over-estimated the level of interest rates that would break growth and trigger recessions.** So far this year, global markets have been undergone the first part of this process, **with investors guessing how fast and how long central banks may have to tighten monetary conditions until inflationary trends reverse persistently**. This discovery stage – that usually translates into a long and painful period of declining stock prices - has experienced 3 to 4 phases and is still unfolding.

The first phase took place between December and January when the Fed, comforted by the strength of the US economy, **made clear its support would be withdrawn faster than telegraphed to the markets until late 2021**, with some FOMC members mentioning then for the first time the possibility of 50 bps hike in a single FOMC meeting. **The second phase started with the brutal Russian invasion of Ukraine** that pushed energy and other commodities prices to **extreme levels and made clear inflation pressures will not revert rapidly. The third phase** hit markets again in early April and extended further over the June FOMC meeting as **FOMC members began to call for explicit prioritization of inflation fight over recession risks or market volatility**. This revised guidance led investors to raise their expectations of an unusual series of 50 bps hikes through the summer that morphed into a series of at least two hikes of 75 bps in June and July, after the release on June 10 of re-accelerating US headline CPI in May.

With the Fed delivering in June the first 75 bps hike since 1994, Fed funds rates' range now stand at 1.5-1.75% vs 0-0.25% only at mid-March, **in what has already been the most precipitated tightening move since the late 1970s.** More is yet to come if markets' expectations and the FOMC's latest guidance were any guide. As for the latter, FOMC members unanimously see the Fed funds rates getting close to 3.0% by the end of the year (while they were only two who believed policy rates would top 1% last December), with a median projection for their year-end level at 3.4% and a peak level at 3.8% next year. Fed funds futures – priced immediately after the FOMC meeting – pointed to the market expectation of even more frontloaded rate hikes, with implied Fed Funds rates hovering above 3.6% by year-end, before a gradual reversal in 2023.

Each episode of re-pricing the future trajectory of policy rates have led to higher long-term rates, bear-flattening curves, falling stock prices, widening credit spreads and higher **stock-bonds correlation lethal to many diversified portfolios**. The more these episodes repeat, the bigger the pain on key asset prices. Guessing their horizon and terminal levels is therefore key in shaping a central scenario for the second half of 2022. **It remains possible to frame the answer to this question along the following three parameters:**

1. the possible trajectory of inflation over the next few months;
2. the sensitivity of US and global growth to tighter financial conditions and how much markets and bottom-up analysts have priced in so far; and
3. the true central bankers' tolerance towards lower activity and severe financial instability.

- **On the first point, the headline US CPI figure for May has shaken the broad consensual view that inflation may have peaked in March.** While we continue to believe core inflation should revert over the second half of 2022, **there are a few reasons to fear headline inflation data could remain close to current levels, or even surprise further on the upside, through the summer.** First, even if they are receding somewhat recently, both energy and food prices components remain under the threat of unfavorable geopolitical developments and persistent demand/supply mismatches. Complete disruption of Russian gas delivery to European countries is now well advanced, **with dire consequences in terms of energy rationing by the next heating season**. The supply shortage of refined oil and fuel is unlikely to improve fast, unless the US rapidly convince Middle East producers to increase their exports of refined products. Demand at the pump in North America is usually stronger during the driving season. Within the next few months, the possible implementation of a complex G7 scheme to cap the prices of Russian crude oil could lead Russia to cut its output significantly and usher in a dramatic new episode of surging global prices.

  The situation is also worrisome on the food component's side. Unfavorable weather conditions in Europe or South Asia, combined with the severe destructions and/or export disruptions in Ukraine, Russia and Belarus should lead to reduction in global wheat production by 4.5 million metric tonnes over the next 12 months [2]. After their dramatic surge

[1] See « The Truman Show », Asia CIO Newsletter, January 2022.

[2] USDA World Agricultural Supply and Demand Estimates (WASDE), 12 May 2022

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at the outset of the war, wheat and other cereals' prices have reverted recently, partially in hopes that some solution could be found to channel Ukrainian production to export markets. However, here again, increasingly fragmented cereal markets – with India's ban on grain exports and Russia's weaponisation of food supply – is likely to keep soft commodities prices extremely volatile in the very near term.

For a long time, central banks have hoped that a rapid reversal of core CPIs could come to their rescue, as initial Covid related disruptions were supposed to fade. Such hopes were also dashed partially during the spring, as prices of a broader set of goods and services accelerated further. While the initial manpower shortage of freight workers in ports and trucks eased, airports and the hospitality sector are now facing hiring difficulties as economies re-open and holiday season starts. With demand shifting to services that is more sheltered from international competition, US workers have re-gained some transitory bargaining power they aim at using to partially offset the pain from higher prices. Finally, rent inflation, a large contributor to core inflation as it takes up 30% of US CPI basket and around 15% of US PCE basket, may be extremely slow to decline, even if house prices correct at the onset of recession. **While we still expect those developments to revert by year-end, especially with growth under threat (see below), core inflation figures are, however, unlikely to decelerate meaningfully in most developed and emerging economies within the next two to three months.**

- With inflation prospects still very elevated for (a bit) longer, markets raised their policy rates expectations further before and after the last round of central banks' meetings. **This move has been all the more brutal since it has been global**. Even central banks that were usually seen as more dovish or were so far patient – like the Reserve Bank of Australia, the European central bank, the Swiss National Bank - have surprised investors by raising their policy rates faster and/ or sooner than initially expected. **The divergences in monetary policies have probably peaked and, with them, the bulk of USD appreciation.** While we do not expect any significant USD reversal as long as the Fed does not review its current course of action, there is an increasing possibility to see the bloc of G10 currencies getting firmer together relative to some weaker emerging ones.

This global tightening in funding conditions, combined with on-going inflationary pressures, is now expected to produce a recessionary impact on the world economy. At least up till the start of the spring, manufacturing and services PMI, supported by the re-opening of European and some South-Asian economies post Delta outbreak's disruptions, had proved quite resilient to the un-anticipated shock of the war in Ukraine and the spike in energy and food prices. However, unsurprisingly, **more granular data have been deteriorating rapidly in many large economies.** High prices start discouraging durable good purchases, while energy inflationary tax is crowding out other expenses. Inventories are building fast, which is supporting production in the short-term but will make it vulnerable in the second half of 2022. With US 30-year mortgage rates at 6% (vs close to 3% on average last year), affordability has deteriorated massively. Transactions, housing construction and mortgage refinancing shall follow a (sharp) downward trend over the next few months. **Ultimately the synchronised carnage in both equities and bonds markets year-to-date have wiped out more than USD 30 trillion of wealth in global markets,** with – here again – unavoidable negative consequences for the demand from US consumers highly sensitive to financial and real estate wealth effects.

In the latest update of their economic forecasts, New York Fed economists revealed considerably more pessimistic outlook than in their previous March release. They now see an 80% probability for a hard landing (a 1990 recession like scenario)[3]. More recently, The Atlanta Fed updated its GDPNow real GDP growth estimate for the second quarter of 2022, downgrading it from +1% one month ago to -2.1% as of July 1. While not always consistent with later official GDP estimates, this important indicator suggest the serious possibility that, after a surprise negative growth in the first quarter, the US economy could actually already be in a situation of "technical recession". **This signal diverges seriously from the message sent both by PMI indicators, still above the threshold of 50, and the strength of the US labor market, a divergence however already experienced at the start of the 2000-2001 recession.**

How far have markets priced in this recessionary outcome? It is quite remarkable that the worst fall in combined equities and bonds markets experienced so far has taken place in an environment of relatively contained volatilities. S&P500 implicit volatility (ViX) has hardly hit 30% this year, below the 40% observed on average during the 2000-2002 bear market and far below the levels hit during the Covid pandemic or the global financial crisis (GFC). Equities' average allocation remains high and cash exposures are still low in investors' positioning as measured by recent AAII[4] surveys. On the bottom side, earnings growth expectations for 2022 and 2023 remain positive and could surprise (significantly) to the downside in the second half of the year. Finally, in terms of valuations, forward earning P/E ratios for the S&P500 are now back to their 25-year average (16) but still far above the bottom reached at the end of the 2008-2009 recession (9). **In other words, markets could have already integrated a scenario of a global recession, but may not have priced the risk of a prolonged period of economic contraction or a systemic financial crisis yet.** As the reality of higher policy rates will materialise, and if tighter monetary conditions persist longer than expected, there is room for stocks' multiples to contract further.

Under the policy playbook we have been living in for the last 15 years at least, the simple threat of a global recession should have some stabilising effects on policy

[3] See "The New York Fed DSGE Model Forecast - June 2022" - Federal Reserve Bank of New York, June 17 2022.
[4] American Association of Individual Investors

expectations and growth assets' prices. Both Fed funds futures and inflation expectations are now signaling an earlier reversal in policy rates in early 2023 and a further compression in long-term inflation developments. Combined with the recent cooling in some commodities prices, this is another evidence that an increasing number of investors do now believe the slowdown/contraction in economic activity may come faster and could be material enough to force the Fed to pause or even reverse the course of action somewhere in the first part of 2023. **In other words, we may already be in the early stage of the second phase of the dynamic reminded in our introduction, the phase where central bankers are forced to acknowledge they have gone too far**, if not in their actual rates hikes delivery, at least in terms of future policy guidance. As explained earlier, this phase is usually the ultimate step before a more sustainable market rally.

However, what if the US central bankers, after being slow to react to inflation spikes, would remain deliberately passive in front of a nascent recession? What if, in their new obsession "to slay the inflation dragon", their policy reaction function would have shifted to a "mini Volcker-like strategy"? Over the last weeks, various FOMC officials have become vocal about the fact that a possible recession could be the necessary price to pay to bring inflation closer to their long-term objectives. On June 29, during the annual ECB Symposium in Sintra (Portugal), Jerome Powell admitted there was "no guarantee that the central bank can avoid a hard recession.... the pathways having gotten narrower". More importantly, he added that "the process is highly likely to involve some pain", suggesting such a perspective should not really derail the Fed from keeping its tightening move on track as long as inflation would not get persistently closer to the its long term target.

This possibility is all the more important since **inflation, and more precisely headline consumer inflation, has become a key political issue almost everywhere**, including in some countries where inflation had been completely absent over more than three decades. In Japan, the BOJ – that had resisted so far echoing the moves of other major central banks – has been under increasing pressure over the last few weeks to amend its super easy policy, as Japanese consumers were experiencing unprecedented increases in prices of widely-consumed goods. The widening gap between BOJ's and Fed policies, which is the only major exception among G10 economies now, prompted a new wave of JPY depreciation and forced BOJ to defend the credibility of its yield targeting framework through massive purchases. Governor Kuroda did not budge, defining new intermediate thresholds –such as wage growth of 3% – before considering a tightening move. However, the proximity of the Upper House elections and the nervousness of Japan's cabinet about recent FX movements and inflations' political spillovers make plausible some tweaks in BOJ's policy in the coming months, under the form of a broadening of the yields' targeted range for 10Y JGB.

- If Central Banks demonstrate too much inertia in front of rapidly decelerating economic conditions, **what could frighten them and make them pause, or more likely revert the current course of monetary tightening?** A financial contamination that would freeze the functioning of key markets and trigger the risk of a systemic meltdown will certainly force policymakers to shift their focus again, as inflation concerns would be then irreversibly replaced by depression and deflation scares. **Are we anywhere close to such scenario?** The conventional answer would be to say no, as banks enter into this crisis in a much more solid position than ahead of the GFC. **However, we are living in a highly leveraged and financially interconnected world, where the interruption of perpetual refinancing in one industry or one market segment could easily propagate and have rapid, global and extreme consequences.**

So far, collapsing cryptocurrencies' prices and default of some crypto exchange places have had no/little impact on the overall stability of the financial system. More worrisome, the widening of the sovereign spreads between the Eurozone member-states forced ECB to organise an emergency meeting on June 15 and agree on a "backstop" mechanism, probably designed as redistributed purchasing keys between peripheral and core bonds. **It is quite fascinating that, even before it proceeded with its first rate hike widely expected in July, the European Central Bank has been already forced to revive an OMT-like instrument**, advanced by Mario Draghi more than 10 years ago in the middle of a major sovereign debt crisis in an attempt to save the Euro "whatever it takes". For the time being, spreads widening has been successfully contained, but **it remains to be seen how the ECB's determination and tools will be tested as it will rise rates and reduce further the volume of net asset purchases.**

The ultimate coup could come from the corporate credit market. A credit crisis could start in Europe, in sectors such as energy utilities where the impossibility to access usually cheaper sources of Russian energy weights on cash-flow and balance sheets, or in the US High yield markets where the substitution of equity by debt, already massive between 2000 and 2008, has accelerated further since the end of the GFC and in particular during the pandemic crisis. Even if non-financial US corporate issuers have benefited from the high growth between late 2020 and end of 2021 to unload part of their leverage, their overall ratio of debt to GDP now stands close to 160%, the highest ever. While spreads for HY issuers have not stopped widening over the last six months, they remain on average quite low (580 bps as of July 1), far from the levels seen at the peak of the 2015 emerging/commodities crisis (820 bps), the 2000-2001 recession or the pandemic crisis (close or slightly above 1000 bps) and much below the extremes experienced during the GFC (close to 2000 bps!). **Any catch-up with some of those highs would translate by a likely complete interruption of poor quality entities' refinancing, forcing major central banks, to not**

only cut policy rates but also renew with massive assets purchase programs.

Looking ahead, and to re-quote Jerome Powell, the path to a happy ending scenario has become extremely narrow. If inflation does not decelerate rapidly and materially over the summer, excessively aggressive monetary conditions will prevail by the year-end and early 2023. The world will plunge into a recession that does not need to be severe to cause more harm to financial assets prices if Central banks do not react to it fast enough, especially if labour markets - in the specific post-Covid context - do not deteriorate rapidly. Rather, **more expansive refinancing conditions will put an increasing pressure on the stability of the House of cards the global economy has become over the last 30 years.** Central banks can try removing the cards at the very top, but as they move down towards the house's infrastructure, they are raising the possibility of a collapse that an ultimate panic selling would try to anticipate. **Such final capitulation would then signal the reversal of monetary priorities and mark the true likely bottom for global markets.**

China is in a completely different dynamic, at least in terms of timing, to some extent leading the way of what could happen to western economies and markets in the coming quarters. After its successful containment of the initial phase of the pandemic and being the first economy to recover fully its pre-crisis level by late 2020, China decided to curb credit growth in 2021, concerned by the high level of debt in some sectors of its economy. Paradoxically, this move precipitated an almost systemic crisis among property developers, with more difficulties for them to rely on external funding while facing collapsing demand for new projects. In parallel, the set of policies implemented under the "common prosperity" priorities led to a crackdown on multiple tech and web-based platforms, dumping their profitability, weighting on their growth and investments. Overall, China's domestic economy, whose apparent strong growth in 2021 was mostly achieved in the very first months of last year and thanks to the substantial support from buoyant exports, entered in 2022 with an extremely weak domestic demand.

Hopes that macro and regulatory policies would reverse rapidly were dashed until March/April as authorities only proceeded with partial, fragmented and sub-scaled measures, denying the systemic nature of what was at work in the housing sector. More importantly, while we identified in January [5] the real risk resulting from the combination of an ultra-contagious variant such as Omicron and the logic of Zero-Covid strategy, the reality experienced in Shanghai between late March and early May went much beyond our worst expectations. Lockdown in Shanghai and seriously disrupted mobility in Beijing led to a complete collapse of retail sales, industrial production as well as an unusual jump in unemployment in April and a de facto situation of recession for China's economy.

Those developments, reflected in a further meltdown in Chinese stocks prices until mid-April, finally triggered a stronger reaction from China's policymakers. While Vice Premier Liu He was pledging in favor of more private and capital markets-friendly measures in March, Premier Li Keqiang called in April to balance priorities better between anti-pandemic fight and economic support. Those vows coincided with a containment in the number of new Covid cases that peaked in mid-April and came down to a negligible level in late May/early June. **They translated into an accumulation of both central and local governments' initiatives on the monetary and credit front** (with cuts in Reserves required ratio and key policy rates between April and May and the multiple expansions of lending quotas), **on the fiscal front** (with the early front loading of local government bond quotas to fund infrastructure plans or the CNY 140 billion VAT credit refund and the phased reduction of car purchase tax), **on the property front** (with the cut in down payment and the easing in home purchase limits decided in some key provinces), **and on the tech regulatory front** (with the end of Didi's anti-Trust probe and the authorisation to re-open its application to new subscribers).

We start to see the preliminary results of the re-opening of Shanghai and Beijing, while the impact from recent policy stimulus is not really felt yet. Suppliers' delivery time that collapsed in April, rebounded in May, recouping 2/3 of their deterioration during the lockdown period. Social mobility, as measured through congestion indexes, is now above levels observed at the same period of 2021. China manufacturing PMI rebounded in May and June to recover (Official) or exceed (Caixin) their pre-lockdown levels seen in February. **Looking forward, obviously, many risks remain. First, China will have to face renewed outbreaks**, as in it is currently the case in Anhui and Jiangsu provinces, possibly in large cities. While Zero-Covid strategy will continue to prevail until next year at least, we may, however, expect a slightly more pragmatic implementation based on the experience from Shanghai lockdown and the outsourcing of mass-testing costs from central social security to local budgets. **Second, the property market's crisis is far from over**, with one among the largest high yield issuers announcing a missed payment on a USD 1 billion bond on July 3.

However, with unemployment exceeding 6% at the nationwide level and close to 7% in the largest cities, China's economy can hardly afford to weaken further as nearly 11 million of fresh graduates will apply for their first job this summer. We expect therefore more policy stimulus to come, such as a range of interest rates and RRR supplementary cuts, as well as additional fiscal initiatives, a first one amounting to CNY 300 billion already disclosed by the State council on July 1st, aiming at providing capital for major infrastructures projects lending (leveraged in theory up to CNY 1.2 Trillion), adding to the CNY 800 billion of policy banks' loans opened in May. While still inadequate to bridge the gap between current activity levels and a growth objective for the year (+5.5%) clearly out of reach, such initiatives should

[5] See « The Truman Show », Asia CIO Newsletter, January 2022.

help keep afloat the Chinese economy, allowing a slow healing process for domestic consumption and investment, still far from the V-shaped recovery experienced in 2020. Given the extremely depressed level of valuations reached by Chinese equities during the Spring, such outlook has been good enough to justify a 15~20% rebound that has, in the case of onshore markets (A-shares), proven so far remarkably insulated from the sell-off in developed markets. **Even under our shallow recovery assumptions, we believe there is space for similar returns within the next few months.**

The views and analysis detailed above justify both the recent activity and the current positioning of our discretionary portfolios as well as key recommendations:

- The risk of the diversified component of our multi-assets portfolios was reduced massively in late January and again between mid-May and mid-April, to keep total drawdown under control.
- After the Russian invasion of Ukraine, the portfolio of tactical views also raised its cash exposure very significantly and cut its last exposures in developed equities (US equities were removed in late 2021) with the only exception of limited positions in value /commodity-driven markets (UK and Australia), ultimately removed between May and mid-June.
- Oil and Gold positions were included a bit late, shortly after Ukraine's invasion, missing the bulk of the strong performance from energy commodities.
- Credit portions of multi-asset tactical portfolios as well as DPM fixed income portfolios improved drastically the average quality of credit positions, with a complete removal of residual HY positions in late April/early June for the former.
- Chinese equities, which have been a substantial drag on the performance in late 2021 and during the first quarter of 2022, had been completely removed in early April. We re-initiated however rapidly a position in A-shares in early May as outbreaks appeared under control and policy initiatives became more material. **A-shares now stand as the main single source of risk in our multi-assets portfolios.**
- Looking forward, we continue to believe that **securing portfolios' resilience remains a more relevant strategy than buying the dips**, given the strong uncertainty related to the Fed's reaction in an environment of lower growth with persistently high inflation.
- **The best hedges of the second half of 2022** might however be different from the ones that prevailed over the first half, **as growth concerns should prevail progressively over inflation**.
- While precious metals and energy may still provide some protection against adverse geopolitical developments, more cyclical commodities (industrial metals), as well as value and cyclical stocks could give back part of their recent strong outperformance.
- Emerging markets exposed to commodities (Brazil, Indonesia) or benefiting from their post Delta reopening (India, ASEAN) may similarly generate lower returns in an environment of possible global recession, higher developed risk-free rates and capital repatriation flows.
- Flight to (extreme) quality should intensify further in credit markets. EU peripheral debt may be again under pressure as ECB actually tightens monetary conditions.
- Long-dated sovereign bonds started to retrieve their safe haven status. The recent fall in sovereign yields could be challenged in case of upside inflation surprises during the summer but should ultimately prevail if recession materializes.
- Over the next few months, **China A-shares, more directly exposed to the shifts in domestic demand and more insulated from developed markets' volatility could stand as one of the few return opportunities**, especially in the sectors the most exposed to the re-opening and the infrastructures push.
- **The bulk of the USD appreciation is probably behind us**. However, USD should not reverse as long as an ultimate true capitulation in markets and/or the threat of a financial systemic crisis would not force the Fed to reverse its current guidance/policy.

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Completed on July 3, 2022

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