

Inflation in United States

Inflation peaked last June. The Fed risks killing “aggregate demand” if it doesn’t change course on rates.

Summary

The “Inflationists” won the inflation debate in November 2021, but their victory was “transitory”, as US inflation peaked seven months later in June 2022, at +9.1%. It currently sits at +6.4%, annualising at +3.2% over the last seven months. The US Federal Reserve’s effort to cool inflation, is not only working, but has worked its way through to the point where the focus should now shift from inflation to growth.

Raising interest rates further could easily sacrifice “aggregate demand” and kill the US economy’s clearest bright spot in recent years—a strong job market. A recession leading to inevitable rate cuts would undo the progress made so far by the Fed in coming out of “zero rates.” It would be better to focus on the medium-term trend in data, than to panic with one print which is above expectations.

We all should take heart that in Fed Chair, Jerome Powell we have a person who is less academic and more practical, thus well suited to ignoring the baying mob and staying focused on economic growth, just as much as inflation, and seeing through the “transitory” impact of Covid-19 on the inflation numbers.

We are in the favourite part of the US Presidential cycle. The third year of a Presidential cycle tends to be the most bullish for US equity markets, with a median return of +17% with positive returns an incredible 95% of the time. It’s no surprise then that the equity markets have held up well over the last two months.

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Easing inflation and seasonality both doing their job to keep getting the dip buyers at every opportunity. Melt-up (with some sideways moves) is the trade, whether the equity bears like it or not.

“Inflationists” won the inflation debate in 2021, but…

Over the past 12 months, as the US Federal Funds Target Rate (FDTR) climbed to +4.75% from +0.25%, inflation sparked a furious debate that turned into an obsession within the commentariat.

Between March and November 2021, the US Consumer Price Index (CPI) rose from +2% (the US Federal Reserve’s target inflation rate), to +6.5%.

At the November 22, 2021, Federal Open Market Committee (FOMC) meeting, Fed Chair, Jerome Powell announced that the Fed would stop characterizing the high US CPI prints as “transitory.” The inflationists, led by the likes of former US Treasury Secretary Larry Summers, took a victory lap, and rightly so.

The “Inflationists” won the inflation debate, but their victory was “transitory,” as US inflation peaked seven months later in June 2022, at +9.1%. It currently sits at +6.4% (annualising at +3.2% over the last seven months – a lengthy enough timeframe to reach such a conclusion.)

The November 2021 announcement by the Fed, was largely symbolic, as the Fed’s job is to manage “expectations.” You don’t expect a central bank to be alarming in its communication. It leaves that to politicians and the talking heads on television, who love sensationalism more than rationalism, and rarely, if ever, have “skin in the game.”

We are now almost in the Spring of 2023. Inflations peaked eight months ago and since then, inflation has been coming down steadily, yet some continue to agitate for a higher Fed Funds Rate.

As recently as last week, Summers doubled down by saying, “the Federal Reserve’s efforts to cool inflation aren’t working as well as hoped.”

I would say:

- US CPI is down from +9.1% to +6.4% (and annualising at +3.2% over the past seven months)
- The US yield curve has inverted to an extent not seen in the last 40 years
- The risk of a recession is rising
- Goods prices are in disinflation
- Housing starts have declined for nine months in a row

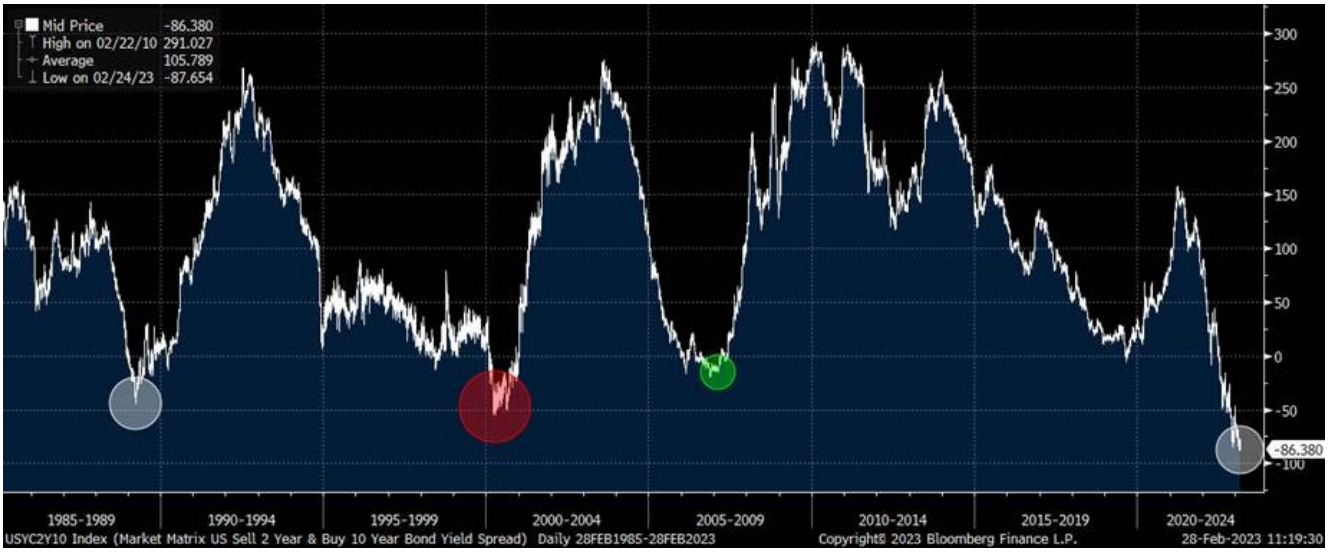
All the above, are signs that the Fed’s effort to cool inflation, is not only working, but has worked its way through to the point where the focus should now shift from inflation to growth.

The Fed has raised short-term rates to such a high level that the spread between 2 year and 10 year Treasurys (chart below) at -86 bps, is at a worse level than the one observed in 1987 (Russian default,

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Asian financial crisis, Long Term Capital Management(LTCM) collapse), in 2000 (the Dotcom crisis) and in 2007-08 (the Great Financial Crisis).

US Treasury 10-year yield minus US Treasury 2-year yield



Source: Bloomberg

Besides, there's more to the headline CPI number than meets the eye. So, let's take a closer look at the CPI data:

- The core goods inflation is already negative, and volatile energy prices have collapsed. The only thing keeping headline CPI high is "shelter". Shelter makes up 34% of the US CPI basket and remains stubbornly high at over +9%. However, crucially, the shelter data lags the actual housing/rental market data by 8-12 months
- The CPI ex-shelter data (chart below) is already in disinflation. as of June 2022 to the current data. From June 2022 to January 2023, CPI ex-shelter, is annualising at i.e. -1.6% p.a. i.e. disinflation

US Consumer Price Index (all items, ex-shelter)

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Source: US Bureau of Labour Statistics (BLS)

So, "shelter" should peak and roll over during the March -June 2023 period.

What happens to headline CPI data once its largest component normalises/ goes negative, as the current rental data indicates? Disinflation is the answer. The Fed knows "disinflation" is what it will have deal with for years to come, and it has set in already.

If this is not a sign that the Fed has done enough and the focus should stay on growth, then I don't know what is. Thankfully, the Fed is not run by the likes of Summers, else we'd be in an economic depression now, due to policies to combat "inflation" brought on by transitionary factors.

Regular readers of this Newsletter will recall my concern that "disinflation" is where we are headed, and the short bout of inflation we have seen, is the result of Covid-19 and the accompanying fiscal spending.

Those still demanding the 1970s "Volcker shock" ought to read this newly published paper. The researchers at the Fed have concluded that Covid caused a "demand reallocation shock," not a startling conclusion you might say. What's more interesting is this – the reallocation shock *"is able to explain a large portion—3.5 percentage points—of the increase in US inflation, post-pandemic."*

Covid-19 didn't lead to an increase in "aggregate demand" to a new level. It shrunk "aggregate supply," as fewer goods were made globally, due to Covid-induced disruptions. As restrictions eased, supply has caught up and inflation declined. Why then still this obsession with inflation you might wonder, even as there's plenty of evidence that inflation has peaked. There's a simple explanation.

Last time the world worried about inflation, was in the 1980s when the then Fed Chair Paul Volcker raised rates to +20% to curtail inflation plunging the US economy into its worst recession since the end of World War II. For much of the last four decades, inflation has taken less of macroeconomists' and policy analysts' time, so much so, that they are now in danger of overdoing it with their prescription to deal with a short-term burst in inflation.

However, could the inflationists force the Fed's hands to take interest rates to +6%?

The probability of this happening is low, however, I wouldn't bet against it, as the market did force the

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Fed's hand in June last year.

Last June, as the CPI vaulted to +9.1% and the inflation-is-here-to-stay noise grew, the Fed hiked rates by 75 bps (after hiking 50 bps in May). It was the first of four 75 bps hikes last year. It's worth noting that the CPI has been in decline ever since that June print.

What I am certain about is that if the Fed Funds Rate gets to +6%, the rate cuts that ensue will be much deeper than currently anticipated – most likely over 200 bps when the cuts start.

Data released on Friday by the US Commerce Department indicate that the Fed's preferred inflation gauge—the Personal-Consumption Expenditures (PCE) price index—rose +5.4% in January from a year earlier. The PCE core index, which excludes food and energy and is seen as a better predictor of future inflation, rose by +4.7%.

Both readings, were on the higher side of the market's expectations, so expect the clamour for a 50bps hike at the next Fed meeting on March 14 to grow.

Markets will continue to be in panic mode with every data that prints hotter than expectations.
Importantly, the Fed doesn't expect inflation to slow down quickly, and they've already said so. The Fed's Q4 2023 core PCE inflation forecast is +3.5% y/y which is very achievable.

The core PCE with new rent data (swapping in new rents for all rents using the Zillow and Apartment List numbers) is already at +3.4% i.e. the Fed will not be in panic mode and they have started using "disinflation" in communication and have guided for a 25bps increase.

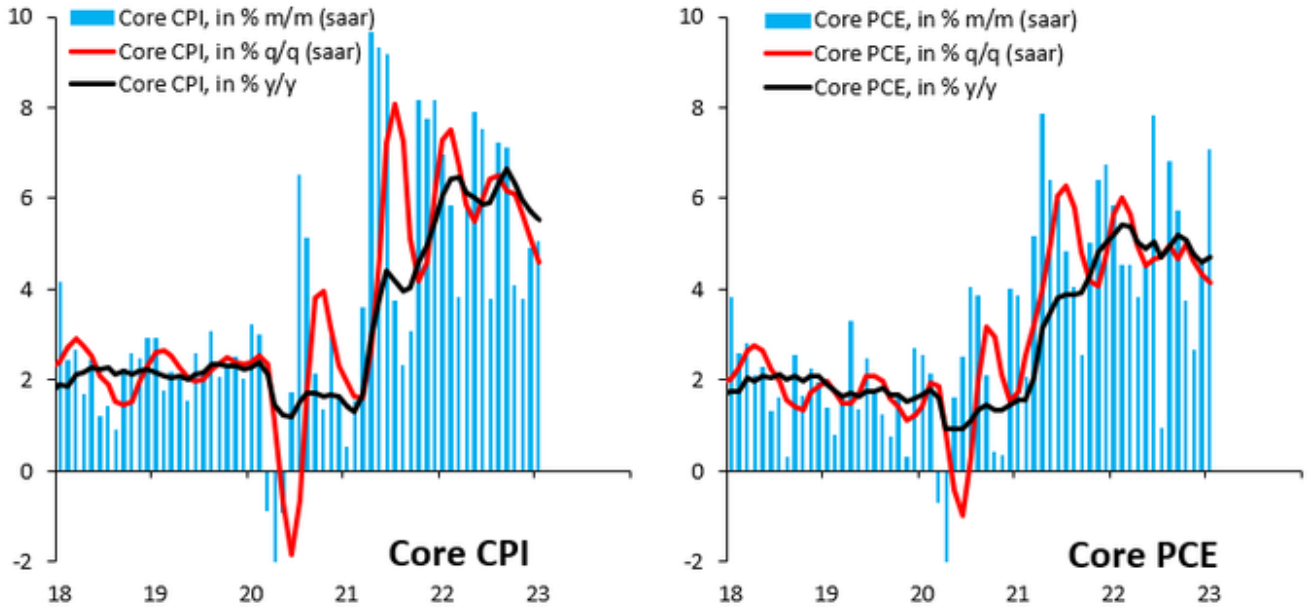
We all should take heart that, in Powell, we have a person who is less academic and more practical, thus well suited to ignoring the baying mob and staying focused on economic growth just as much as inflation and seeing through the "transitory" impact of Covid-19 on the CPI prints.

In my opinion, the Fed will see through the noise in the January data. Besides, the Fed has only just locked in one 25bps hike given the language change in its last statements "in determining the extent of the future increase in the target range, the committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation and economic and financial developments."

As the chart below indicates, whatever the quibbling and noise in the data, disinflation in core CPI (left hand side) and the PCE (right hand side) is happening.

Core US Consumer Price index (CPI), & core Personal Consumption Expenditure (PCE)

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Source: Robin Brooks, Institute of International Finance (IIF)

Raising rates further could easily sacrifice "aggregate demand" and kill the US economy's clearest bright spot in recent years—a strong job market that is delivering higher gains to low – and moderate-wage workers. If the "transitory" inflation of the past 20 months forces the Fed to push the economy into a recession, then it would undo the progress made so far by the Fed in coming out of "zero rates."

Melt-up (with some sideways moves) is the trade, whether the equity bears like it or not. That's the reason the S&P 500 has held up so well in face of better-than-expected US Jobs report, a higher headline CPI report and better than expected Retail sales number. It's better to focus on the medium-term trend in data than to panic with one print which is above expectations.

Markets and the Economy

Did the S&P 500's (SPX) closing low in October last year, mark the start of a new bull market (20%+ rally on a closing basis without a -20% decline in-between)?

From the Bear's perspective, it hasn't been a convincing rally. More than four months past the October lows, the SPX is only up +10.8%, and its maximum gain was +16.9%. Here we are 135 days removed from that October low, and the SPX still hasn't reached the +20% threshold for a bull market. The Bears do have a point, even if it's purely observational. To find a bull market, where it took the SPX longer to reach the +20% bull market threshold, one must go back to 1962. The ten bull markets between then and now all reached the +20% point faster.

I am reminded of what the great pragmatist and former Chinese leader Deng Xiaoping, famously said, "it doesn't matter if a cat is black or white, so long as it catches mice."

So, as someone who believes we are in an uptrend in SPX, it doesn't matter if the number of days to get to +20% is 140 days or 200 days, so long as the trend continues and the market keeps ticking up with some sideways consolidation.

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Take a look at the chart below. There's little doubt that the downtrend in place for much of last year has been broken (a very constructive development from a technical perspective) for well over four months, and we are in a steady rally. A well-defined short-term uptrend is in place for the SPX.

The 50-day and 200-day moving averages have held up well. In technical analysis, we like to say "old resistance becomes new support" and we've seen a great deal of that since last October.

The economic data backdrop looks steady, as PMI data around the world has started to perk up, China's reopening offers the hope of a further normalization of supply chains and global activity, and central banks globally seem to be nearing peak hawkishness for the cycle.

S&P 500 Index – 12-month price chart



Source: Bloomberg

You may be sick of politics and political shenanigans. You may not be interested in voting for either the Democrats or the Republicans. However, if you are holding US equities, then you can't ignore the statistics during the third year of the US Presidential cycle.

We are in the favourite part of the Presidential cycle. As the chart below from Goldman Sachs research indicates – the third year of a Presidential cycle tends to be the most bullish for US equity markets, with a median return of +17% with positive returns positive an incredible 95% of the time. Intuitively, this makes sense, as US Presidents begin eyeing re-election in the third year of their first term, and promote growth and market-friendly policies to boost their chances of re-election.

Whatever the reason, going back to 1932, when Democrat Franklin D. Roosevelt defeated Republican Herbert Hoover in the race for the White House, the stock market performance in the third year of the Presidential cycle has been impressive. This is a statistic that mustn't be ignored.

A key point that the table below doesn't indicate yet is significant:

- The first six months of the third cycle year have averaged a gain of +12.6%, with all 18 of the returns being positive. The second half of the third year has averaged a much softer return of

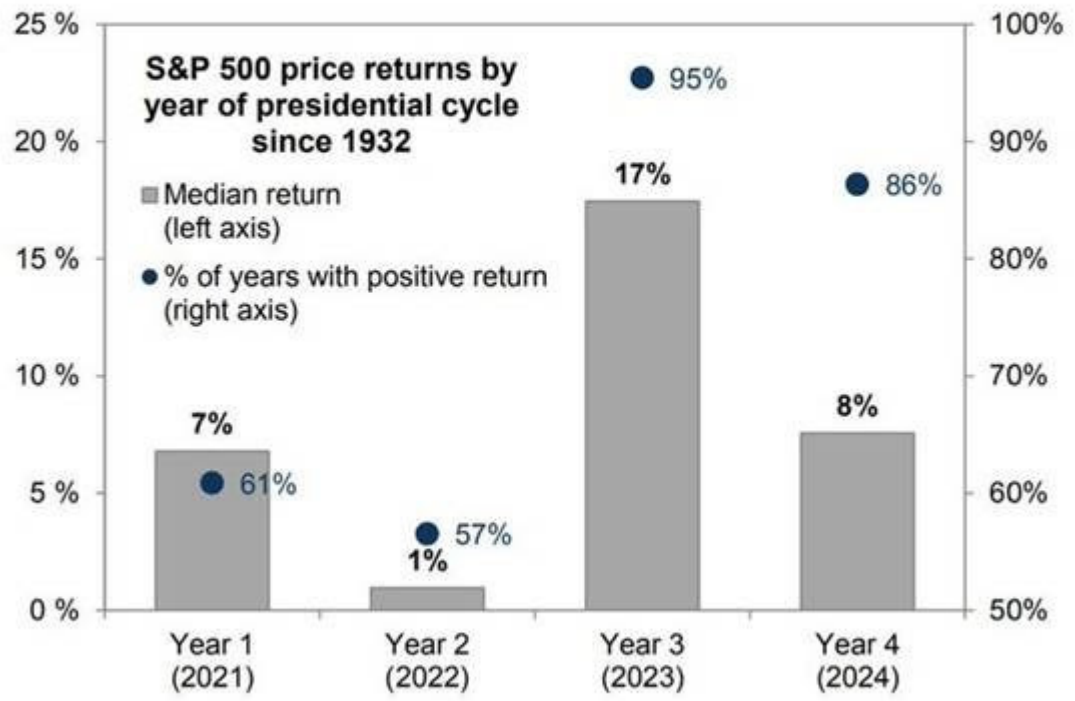
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+3.93%. So, if you are still waiting for that market drop then you've missed the Jan month impressive return and you might miss the whole of H1 if you don't act fast

And if you are wondering how the third year performed, after stocks suffered in the prior year? Then the stats are even more impressive.

- The third year of the cycle has seen a big bounce-back. In the eight years that the second year of the cycle was negative for the SPX, the third year averaged a gain of nearly +25%, with all eight returns positive. By comparison, after a positive second year in the cycle, the index averaged a gain of approximately +10% in the third year with a positive return 80% of the time.

Exhibit 7: S&P 500 returns by year of presidential cycle
November to November



Source: Goldman Sachs Global Investment Research

It's no surprise then that the equity markets have held up well over the last two months. Easing inflation and seasonality both doing their job, to keep getting the dip buyers at every opportunity.

What's even more impressive is the performance of Chinese equities, as China has fully re-opened after the Covid lockdown. China's central bank, the People's Bank of China (PBoC), is injecting a record amount of liquidity (chart below) into the market. On the 15th of this month, the contents of President Xi Jinping's speech at China's central economic work conference in December last year, were published in

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the party journal, Qiushi.

Titled “Several Major Issues in Current Economic Work”, the speech emphasises on expanding domestic consumption – “Prioritize the recovery and expansion of domestic consumption this year… consumer credit support should be reasonably increased .. the need to innovate consumption scenarios, and fully release consumption potential. The need to increase the consumption capacity of low and middle-income residents who have a high propensity to consume but are greatly affected by the epidemic. Rolling out policies aimed at stimulating spending on housing and unlocking consumer savings.”



Source: Bloomberg

Unlocking consumer savings is the crucial point. According to figures from the PBoC, Chinese savers had bank deposits totalling US$2.6 trillion in 2022, up a whopping +80% from 2021.
It also bodes well for Chinese equities.

Post-Covid China is a very different China and it is amped for plenty of growth and change. A growing China, with a larger consumer base bodes well for the European economy, particularly one which counts China as its major export destination.

Joe Ngai, Chairman of McKinsey & Co. Greater China put it best – “if China’s GDP grows at a conservative +2% annually for the next 10 years, the total cumulative growth will be equal to India’s GDP today. If China’s GDP grows at +5%, the total cumulative growth for the next 10 years will be equal to todays’ GDPs of India, Japan and Indonesia are put together. If you are looking for growth the answer is very simple – the next China is China.”

It’s not just China that is easing, but Japan too.

The market is failing to consider the scale of easing/liquidity injection in both China and Japan, the second and the third largest economies in the world, respectively.

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After an equity market correction of -63% from February 2021 to October 2022, Chinese equities are up +53% since their October lows and the Chinese Yuan is stronger by +7%,

More economic growth lies ahead.

Benchmark Global Equity Index Performance (2022, 2023 YTD and 3 months)

Ticker	Name	Country	2022 Performance (Lcl Ccy)	2023 Year-To-Date (Lcl Ccy)	3 month performance (Lcl Ccy)
FTSEMIB Index	FTSE MIB INDEX	Italy	-13.3%	16.0%	11.8%
IBEX Index	IBEX 35 INDEX	Spain	-5.6%	14.2%	12.3%
CAC Index	CAC 40 INDEX	France	-9.5%	12.7%	8.2%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	-11.7%	12.1%	7.2%
DAX Index	DAX INDEX	Germany	-12.3%	10.5%	6.9%
CCMP Index	NASDAQ COMPOSITE	US	-33.1%	9.6%	-0.0%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	-15.1%	6.2%	4.1%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	0.9%	6.1%	4.4%
NKY Index	**NIKKEI 225**	**Japan**	-9.4%	5.2%	-1.9%
IMOEX Index	MOEX Russia Index	Russia	-43.1%	4.4%	3.4%
SPX Index	**S&P 500 INDEX**	**US**	-19.4%	3.7%	-2.4%
MXEF Index	**MSCI EM**	**Emerging Markets**	-22.4%	1.1%	-0.5%
HSI Index	HANG SENG INDEX	Hong Kong	-15.5%	0.0%	6.4%
INDU Index	DOW JONES INDUS. AVG	US	-8.8%	-0.8%	-4.9%
MXTR Index	MSCI TURKEY	Turkey	159.2%	-2.4%	6.1%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	5.4%	-3.7%	-6.0%
MXIN Index	MSCI INDIA	India	1.6%	-7.3%	-11.0%

Source: Bloomberg

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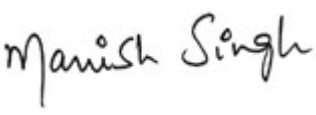
With short-term rates pricing in Fed Funds at well over +5%, earnings yields are only slightly above 6-month US Treasury bill yields.

With so much return available risk-free at the front of the curve, equities have work to do keeping valuations high enough amidst falling earnings estimates.

This is where Structured Products become a useful means of investing in equities. They offer a degree of capital protection, while at the same time helping pick good entry points in the market, and also offer means to clips coupons in a flat to negative market.

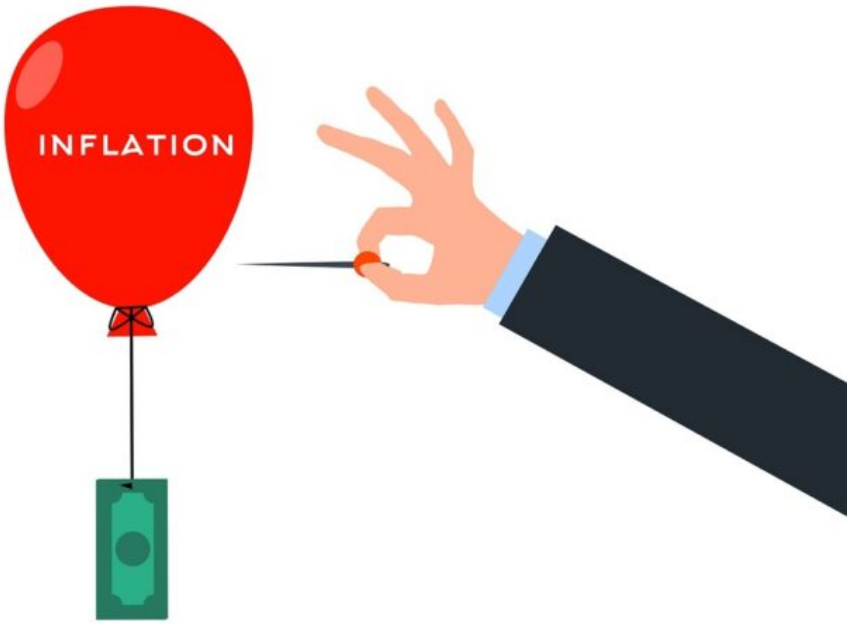
For specific stock recommendations and Structured Product ideas please do not hesitate to contact me or your relationship manager.

Best wishes,



Manish Singh, CFA

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“The US headline inflation at +6.5% doesn’t convey the full picture of where inflation is headed. Inflation is crashing. The new bull run may already be here”

Summary

The new Bull market is already here – Chinese equities, the EuroStoxx 50 and Emerging Market equities – have broken their downtrend and are up more than +20 to 30% from their recent lows. However, there is no Bull market for US equities yet.

The relaxation of China’s strict zero-Covid policy has boosted the economic growth prospects and the likely export prospects of the Eurozone. Add to this, the warmer weather in Europe, which has helped temper the intensity of the energy crisis feared over the last quarter, and Europe may actually avoid a recession by the looks of things and the US may experience one. How ironic would that be?

After negative returns in 2021, last year, US Treasuries, arguably, the safest asset in the world, returned -17%. Their worst returns since the State of Massachusetts ratified the United States Constitution and became the sixth US State in 1788. In their 250 years history, US Treasuries have never had three consecutive years of negative returns. So, it’s safe to conclude (and history is onside) that 2023 will be a positive year for investment in US Treasuries. The US is nearing the end of the interest rate cycle and rate cuts lie ahead.

Given how negative sentiment is towards economic growth and US equities, the biggest contrarian trade for 2023 would be: The US avoiding a recession as the Fed relents and does not raises rates to +5.25%. The S&P 500 in such a case could have a +20% year.

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The US ISM index has continued to drop, the OECD leading indicators have dipped into contractionary territory, yield curves have inverted, recession talk is everywhere…and yet over the last three months, copper prices have risen +28%. Dr Copper seems to be telling us something. China's re-opening is a big boost to the global economy and copper prices. This, in my view, is the key macro development that will have a profound effect on asset prices this year. So stay tuned!

Skate to where the puck is going to be…not where it has been

Equity markets have started the year on a positive note with European, Chinese and Emerging Market (EM) equities, continuing to build on their rally that began in Q3 last year.

The new Bull market is already here – Chinese equities (ASHR) are up over +30% from their lows, the EuroStoxx 50 (SX5E) is +26%, and the MSCI Emerging Market Index (EEM) is +24%, as they have all broken their downtrend.

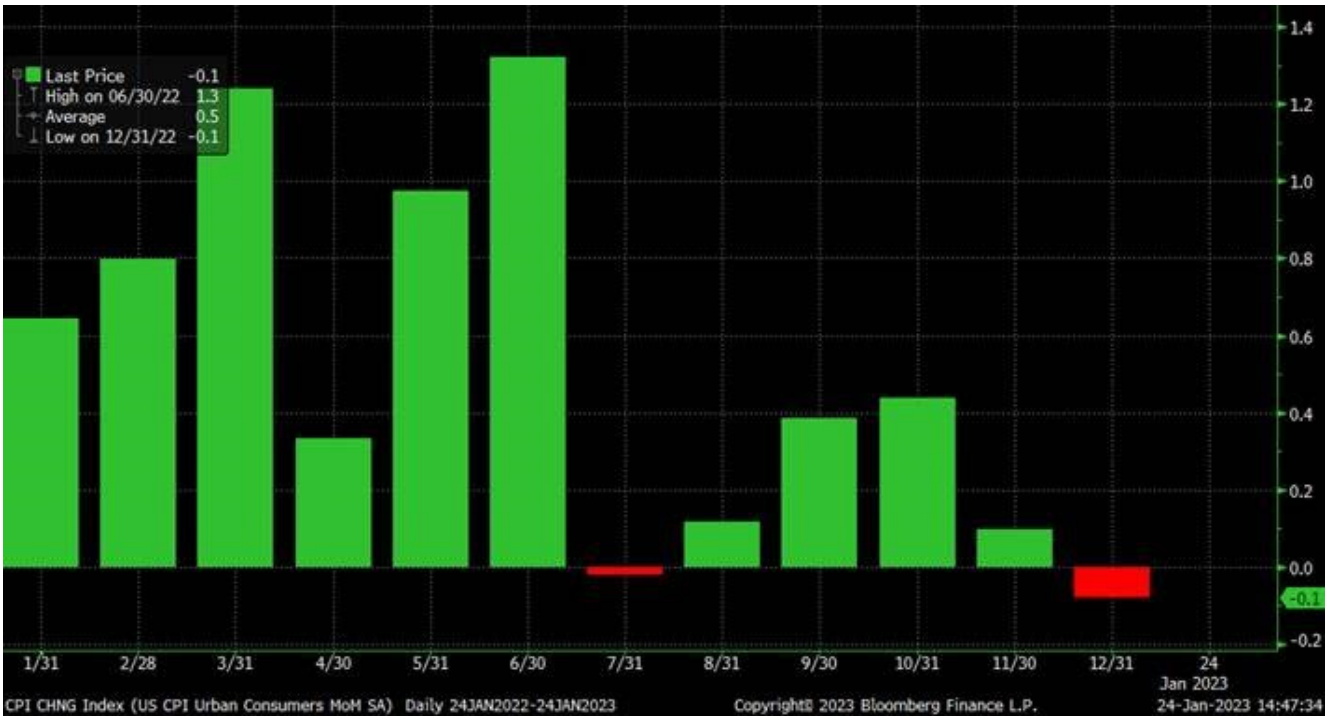
However, there is no Bull market for US equities yet. The S&P 500 (SPX) and the NASDAQ (QQQ) are up +12% and +10% respectively from their October lows. The focus in the US still seems to be on inflation and interest rate hikes by the US Federal Reserve (Fed).

If the US does experience a recession, much of the blame will rest with the Fed, which has continued to raise rates, despite all signs that inflation is not only under control, but has collapsed.

Let's look at the data for US inflation. The chart below lays out the month-on-month change in the US Consumer Price Index (CPI) index, a measure of US inflation.

A glance at the chart will tell you that the six-month prints from July 2022 to December 2022 couldn't be more dissimilar from the prior six-month prints.

US Consumer Price Index (CPI) month-on-month change – 1 year chart



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Source: Bloomberg

The US CPI hit a 40-year high in June last year, after months of sustained price increases. However, since then, the monthly gains have slowed down sharply.

US Inflation has declined over the past three to six months, due largely to falling energy prices and prices of goods, such as used cars. There are certain signs that soaring rents and other housing costs are cooling, amid a sharp slowdown in demand, although this isn't expected to show up in official CPI measures, until later this year, such is the quirkiness of the CPI calculation.

A simple calculation will reveal:

- The US CPI annualised at +10.4% in the first half of 2022, and
- The US CPI annualised at +1.8% in the second half of 2022 which is close to the average annual inflation rate of +1.7% between 2010 and 2020

Taken together, it left the headline inflation at +6.5%, which still doesn't convey the full picture of where inflation is heading.

One should be more concerned about where inflation is heading and not where it is. As the ice hockey great Wayne Gretzky once said: "A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be."

The "inflation puck" is already below the Fed's target rate of inflation of +2%.

The Fed has continued to sound hawkish and kept the relentless focus on the headline number, as it seeks to overcompensate for past mistakes. This has led many to stay focused on rate hikes rather than see the impending pause, followed by rate cuts, as data deteriorate.

In my opinion, there is no need for the Fed to raise rates any further. However, I don't run the Fed and therefore, I reiterate what I wrote in the December Market Viewpoints – "The Fed will be forced into cutting interest rates in Q3 as it responds to recession."

The more the Fed raises rates from here, the more it begets a recession and rate cuts down the line. The market knows this and as such, you have seen a steady rally in risk across asset classes.

When looking at annual change (chart below), 2022 marked the most aggressive (largest) move for the Fed Funds Rate in the last 50 years.

The US Federal Funds Target Rate (upper bound) – Annual change

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Source: Bloomberg

Financial conditions are very tight and the economic data isn't getting any better.

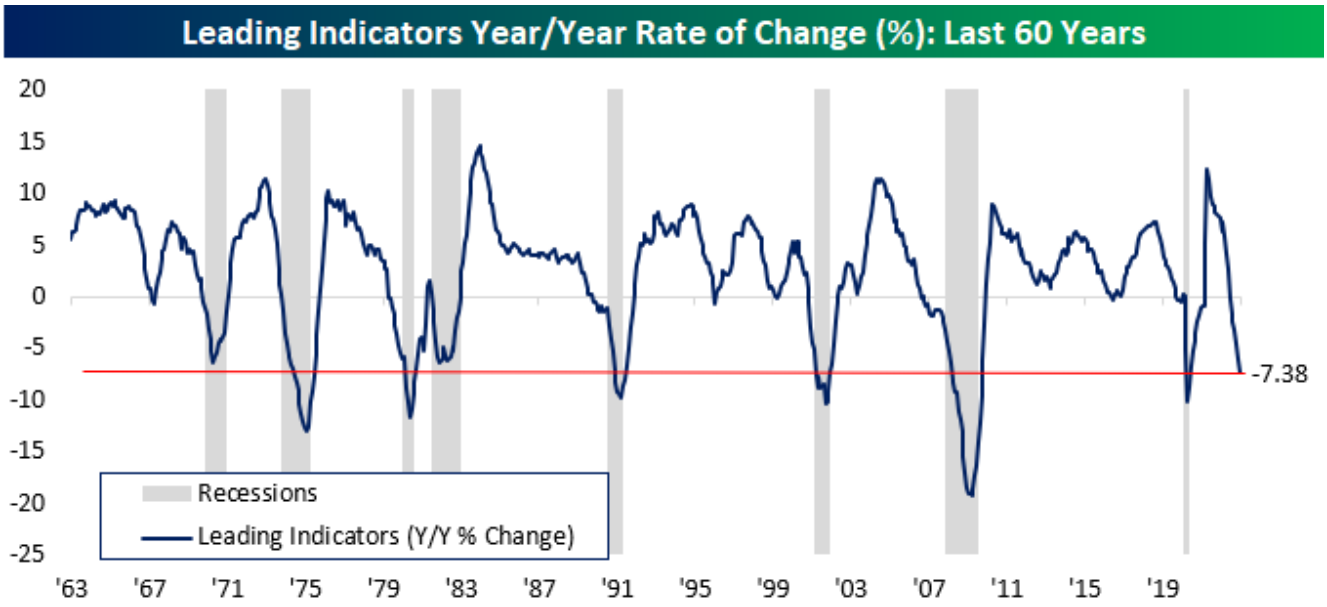
Earlier this week, the crucial Conference Board's Index of Leading Indicators reading (chart below) dropped -1.0% versus already weak expectations of a decline of -0.7%.

Not only that, but November's reading was also revised down from -1.0% to a drop of -1.1%

- On a Year-on-Year (YoY) basis, the index of Leading Indicators is now down -7.4%, the weakest YoY reading since the Covid-19 lockdowns and the level we saw during the 2008-09 recession induced by the Great Financial Crisis (GFC)
- The chart below shows the YoY change in Leading Indicators since 1963 with the red line indicating the level as of December 2022. Since 1960, there has never been a time when the YoY reading was as low or lower than it is now and the economy wasn't in a recession
- There were also two other periods where the economy had a recession, and the YoY change wasn't even as negative as it is now

December's decline in the index of Leading Indicators was the third straight month of over -1% drops. In every prior period since 1963, where there were at least two consecutive month-on-month declines of at least -1%, the economy was already in a recession.

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Source: Bespoke Invest

Are we already in a recession?

Well, the data is weak across the board. However, in the current President Joe Biden economy, two conservative quarters of negative GDP isn't considered a recession. Additionally, the employment leg is still holding strong and consumers are still spending the savings they accumulated during the recent lockdown.

That being said, I have no doubt that the Fed must be getting worried about the recessionary indicators turning a brighter shade of red.

The Fed will very likely increase rates by +0.25% next week. That increase would bring the Fed Funds Rate to a range between +4.5% and +4.75%.

Most Fed officials projected in December that rates would rise to a peak between +5% and +5.25%. That would imply two more +0.25% increases, after the likely increase next week.

A Fed Funds Rate at +5.25% is not my base case and rates at that level will make a US recession even likelier. However, I do see a scenario in which Fed does take rates to +5.25%.

The Fed has rightly turned its focus recently toward a narrower subset of labour-intensive services, by excluding prices for food, energy, shelter and goods.

Inflation in this narrow category is running at +4.4%, up from around +2.3% on average between 2010-19. This data will reveal, if higher wage costs are passing through to consumer prices.

If services inflation is high, because pay checks are rising in lockstep with prices, then Fed officials would want to see more hiring slowdown to avoid a 1970s-style wage spiral setting in i.e. rates will have to go higher, possibly to +5.25%, unemployment will rise and wages will moderate. The US jobs market has been tight, with an unemployment rate of +3.5% in December matching multidecade lows.

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In such a scenario, a US recession is even more likely than it already is, given a lot of growth data is already flashing red.

I maintain that rates will have to be cut in the second half of this year by as much as 150 bps (if not more), as a recession ensues.

Markets and the Economy

Fashionistas will tell you that Europe sets the trends. This certainly seems to be the case as far as equity markets are concerned, with the Eurostoxx 50 (SX5E) outpacing the S&P 500 (SPX) by a wide margin (see table below). It goes to show what "unloved/oversold" assets can do when they change course.

Benchmark Global Equity Index Performance (2022, 2023 YTD and 3 months)

Ticker	Name	Country	2022 Performance (Lcl Ccy)	2023 Year-To-Date (Lcl Ccy)	3 month performance (Lcl Ccy)
HSI Index	HANG SENG INDEX	Hong Kong	-15.5%	14.1%	46.3%
FTSEMIB Index	FTSE MIB INDEX	Italy	-13.3%	10.0%	16.5%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	-11.7%	9.8%	15.6%
CAC Index	CAC 40 INDEX	France	-9.5%	9.6%	13.0%
IBEX Index	IBEX 35 INDEX	Spain	-5.6%	9.4%	14.4%
MXEF Index	**MSCI EM**	**Emerging Markets**	-22.4%	8.9%	22.2%
DAX Index	DAX INDEX	Germany	-12.3%	8.3%	14.3%
CCMP Index	NASDAQ COMPOSITE	US	-33.1%	8.1%	3.1%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	-15.1%	5.7%	7.4%
NKY Index	**NIKKEI 225**	**Japan**	-9.4%	4.9%	0.1%
SPX Index	**S&P 500 INDEX**	**US**	-19.4%	4.6%	4.8%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	5.4%	4.1%	1.3%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	0.9%	4.1%	9.9%
INDU Index	DOW JONES INDUS. AVG	US	-8.8%	1.8%	6.0%
IMOEX Index	MOEX Russia Index	Russia	-43.1%	0.9%	2.5%
MXIN Index	MSCI INDIA	India	1.6%	-1.9%	-0.6%
MXTR Index	MSCI TURKEY	Turkey	159.2%	-2.0%	28.6%

Source: Bloomberg

The relaxation of China's strict zero-Covid policy has boosted growth prospects and likely export prospects of the Eurozone. Add to this, the warmer weather in Europe, which has helped temper the intensity of the energy crisis feared over the last quarter.

On economic activity front, on Tuesday, S&P Global said its composite output index for the US, a closely watched survey of business activity, was 46.6 in January, a slightly better reading than December's reading of 45. In Europe, however, the index rose to 50.2 from 49.3. A reading above 50 points to an expansion, while a reading below that level points to a contraction.

Europe may avoid a recession by the looks of things and the US may experience one. How ironic would that be?

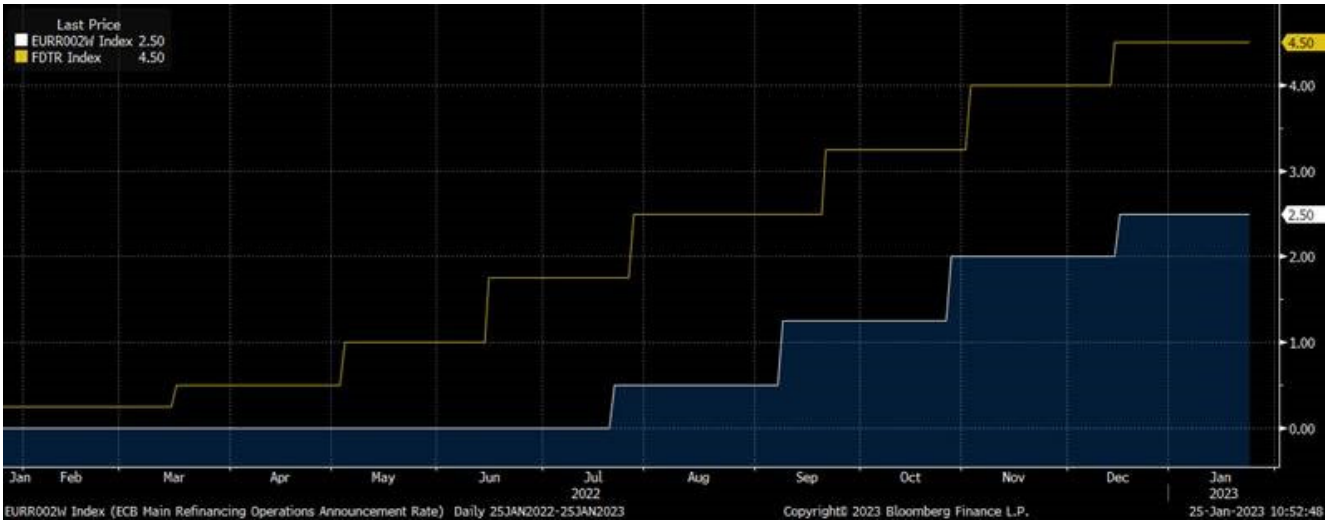
One clear explanation for all this – the difference between Eurozone and US monetary policy

In the Eurozone, interest rates didn't start increasing until July, and we have seen a total increase of +2.5% (see chart below).

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In the US, rates started increasing in March, and we saw an increase of +4.5%. The US got to +2.5% rate when the Eurozone was still at 0% in July. If there's one consolation – rates in Europe have further to rise, perhaps another +0.75% to +1%, while the US may be nearing the end of its rate-increase cycle.

12-month chart – ECB main refinancing rate and US Fed Funds Rate



Source: Bloomberg

As the trade-weighted US dollar (DXY) has pulled back -9.5% from its high in September, Emerging Market currencies versus the US Dollar have risen over +10%, on a total return basis. As a result, over the last three months, Emerging Markets equities (EEM) have outperformed US equities (SPX) by over +20%.

Also, if rates were to go higher in the US, then other markets will have consternation too i.e., no rapid rise in equities to a higher level.

As I wrote in my December Newsletter, I see a +10% year for US equities, and we have seen half of this already.

Technically, a lot is going on for the SPX (see chart below).

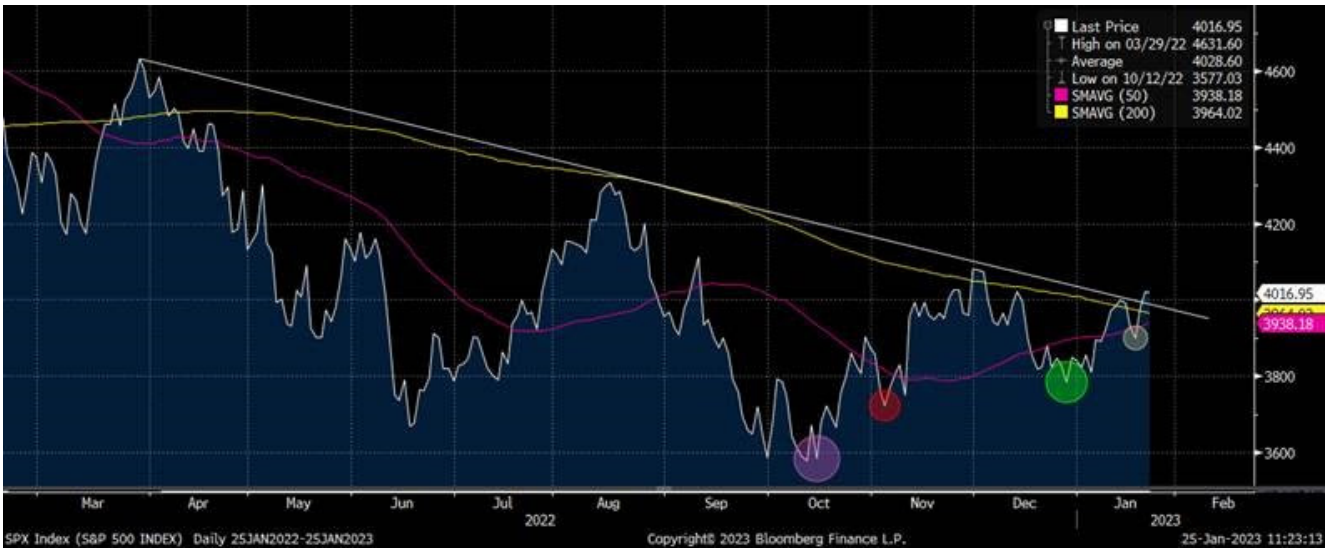
A clear break above the 200-day moving average (DMA) will be very positive for the SPX. Also, what we have seen recently are higher lows (filled circles in the chart below), a sign that momentum is building up.

I do not see new lows (barring an inflation spike, and a re-aggressive Fed). A rip-roaring rally can be ruled out as long as recession fears overhang. Not until the Fed indicates it is willing to cut rates, will you see a stable up-trend.

Until then clipping coupons and investing in income strategies on a basket of oversold/attractively priced equities or broad market equity indices are sensible trades to do.

1-year price chart: S&P 500 Index

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Source: Bloomberg

US Treasuries' (10 Year US Govt bond), arguably the safest asset in the world, returned -17% in 2022. This is its worse return since 1788. Yes, you read that correctly, the worse return since Massachusetts ratified the United States Constitution and became the sixth US State in 1788.

2022 was also the second year in a row of negative returns for US Treasuries. In their 250 years history, US Treasuries have never had three consecutive years of negative returns.

So, it's safe to conclude (and history is onside) that 2023 will be a positive year for investment in US Treasuries. The US is nearing the end of the rate cycle and rate cuts lie ahead.

By the same reasoning investment in investment grade bonds – 2 to 5-year duration – seem to be a sensible trade. The Investment grade yield curve, at the shorter end, is more elevated and offers investors an attractive yield of +4% to +5%. Besides, any future rate cuts will impact shorter end 2y bonds more than the 10y bonds.

Benchmark US equity sector performance (2022, 3 month, 2023 YTD and 2023 YTD relative to the S&P 500 index)

Ticker	Name	2022 Performan	3 month performan	2023 Year-to-Date (YTD) Performan	2023 YTD Performance (relative to S&P 50
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**-38.2%**	**7.7%**	**12.7%**	**7.7%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**-36.8%**	-2.5%	**9.7%**	4.9%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**-28.4%**	6.7%	**7.7%**	**2.9%**
XLB US Equity	MATERIALS SELECT SECTOR SPDR	-14.3%	12.2%	7.2%	2.5%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	-28.7%	10.0%	7.1%	**2.4%**
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	-12.4%	9.0%	5.4%	0.8%
XLE US Equity	ENERGY SELECT SECTOR SPDR	57.6%	1.9%	3.2%	-1.4%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	-7.2%	9.6%	2.0%	-2.5%
XLP US Equity	CONSUMER STAPLES SPDR	-3.3%	2.5%	-1.6%	**-6.0%**
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**-3.6%**	1.6%	**-1.7%**	-6.0%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	-1.5%	5.5%	-2.6%	-6.9%

Source: Bloomberg

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Former UK Prime Minister Margaret Thatcher once said – “Nothing is more obstinate than a fashionable consensus.”

Given how negative sentiments are towards economic growth and US equities, the biggest contrarian trade for 2023 would be: The US avoiding a recession as the Fed relenting and not raising rates to +5.25%. The S&P 500 in such a case could have a +20% year.

Let me give you something to chew on as you, if only briefly, dwell on this constructive/bullish view.

Copper is often described as “the metal with a PhD in economics” as it forecasts economic expansion and contraction. The chart below plots the price of copper alongside the US ISM Manufacturing PMI index, one of the most reliable monthly indicators of US economic activity.

The ISM index has continued to drop, the OECD leading indicators have dipped into contractionary territory, yield curves have inverted, recession talk is everywhere … and yet over the last three months, copper prices have risen +28%.

Dr Copper seems to be telling us something. China’s re-opening, as it abandoned its misguided zero-Covid policy, is a big boost to the global economy and copper prices. It is the key macro development that will have a profound effect on asset prices this year.

Chinese mortgage rates are at record lows, household cash piles are at record highs, and the Chinese government has scrapped its “three red lines” which restricted bank lending to the real estate sector. The resulting demand boost by itself, could explain the sudden rebound in copper prices and hence economic activities.

So, I would caution against too much pessimism.

Price chart: Copper and ISM Manufacturing PMI index (NAPMPI)



Source: Bloomberg

And here’s some data to mull over as you make up your mind:

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- The S&P 500 has historically posted stronger gains in February and for the remainder of the year when January has been an up month
- Including 2023, there have been 13 years since WW2 where the SPX gained in January after posting declines in the prior year. Those years have seen a strong rest-of-year return with an average gain of +16% from the end of January through December and positive returns 10 out of 12 times.
- In the eight prior years since WW2 where the SPX gained at least +4% in January, after posting a decline in the prior year, the index rallied at least +10% for the remainder of the year all eight times with an average gain of +21%

The SPX is currently up +4.6% month-to-date after falling -19.4% in 2022. With four trading days to go this month, let us hope this gain is maintained.

For specific stock recommendations and Structured Product ideas please do not hesitate to contact me or your relationship manager.

Best wishes,

Manish Singh

Manish Singh, CFA



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The Fed Funds rate is expected to get to +5%. The US economy will likely enter a recession by mid-2023 and the Fed will be forced into cutting interest rates in Q3.

Summary

Europe is not out of its energy crisis and a long spell of severe cold weather could make it worse in Q1 of 2023 as well as the winter of 2023, when storage would run low. It will take more than warm words from the politicians in charge to avert a major recession next year on the Continent.

Over in the US, the recent bout of high inflation, precipitated by two key factors – excessive money supply growth, and self-inflicted supply-side restrictions driven by lockdowns, are now in the rear-view mirror. Inflation is falling and money-supply growth is now flatlining. However, with the US Federal Reserve (Fed) still insistent on raising rates from current levels, the fate of a US recession in 2023 is sealed. The US economy will likely enter a recession by mid-2023 and the length and depth of this recession will depend on how quickly the Fed responds.

The Fed will be forced into cutting interest rates in Q3 as it responds to the recession. The Fed Funds rate -currently at +4% and expected to get to +5% – will end 2023 in the +2.75% to +3% range i.e. a 200bps rate cut over Q3-Q4 2023 levels.

A recession doesn't have to be doom for equities and markets tend to bottom before recessions start. Market sentiment towards equities continues to be bearish. If you turn bullish when everyone else is bullish, then you are buying late in the cycle. There is an opportunity cost to it which accumulates over time. Instead, I recommend you focus on equity market internals and invest in tranches over time. In my opinion, we saw the bottom on the S&P 500 at the 3600 level in June 2022 when inflation peaked at +9.1%. My end-of-2023 target for the S&P 500 is 4,290 i.e., +10% up from current levels.

The record US Dollar rally that we have seen this year ran out of steam in October. The US Dollar will continue to weaken, as concerns about the US economy grow and inflation fears recede further in Q1 and Q2 of next year.US dollar weakness will certainly help earnings for companies that generate a large portion of their revenues outside of the US.

"Baby It's Cold Inside"

Temperatures are plummeting across Europe and it is -3 degrees today in London, as I write this note.

The arrival of a wintery storm "Troll of Trondheim" is expected to bring snowfall to the UK over the weekend. It is getting colder by the day. Meanwhile, energy prices remain extremely high.

Thankfully, it is also the time of the year when Christmas/wintery songs take over the airwaves, so there is some cheer in the air. It's safe to say, that if you are not living in a cave, you'll likely hear Baby, It's Cold Outside a few times over the rest of December.

The song won the Academy Award for best song in 1950 where it featured in the film "Neptune's Daughter" starring Ricardo Montalban and Esther Williams. In one scene, as Esther tries to stand up,

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Ricardo pulls her back down by tugging her arm, points to the cold weather outside and serenades her with – baby it's cold outside – to persuade her to stay.

High energy costs and the drive to reduce energy bills this winter in Europe, may see this now Christmas classic – baby it's cold outside – turned on its head as Esther responds to a lovestruck Ricardo's overtures with – baby it's cold inside. And who would blame Ricardo if he didn't have proper heating on?

Gas prices in Europe are still five times as great as what is considered to be normal levels.



Europe is not out of its energy crisis and a long spell of severe wintry weather could make the energy crisis worse in Q1 of 2023 as well as for the winter of 2023, when storage would run low. It will take more than warm words from the politicians in charge to avert a major recession next year on the Continent.

In the UK, the government has approved the first new coal mine for 30 years in Cumbria. I hope other governments across Europe follow the lead and deal with the energy crisis which could devastate industry, life, and livelihoods. Those focusing on 2050 and "net zero" would agree that we need to make it through 2023 first.

If there is one thing that has concerned the markets more than anything this year, it is inflation.

As we head into 2023, the big question is – What is the outlook for US inflation (CPI) and the outlook for the US Fed fund Target Rate (FDTR)?

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Here is what I believe happens in 2023:

- US inflation slides more rapidly than anticipated with US CPI getting to +4% by the end of Q1
- The US economy enters into a recession by mid-2023
- The US Federal Reserve (Fed) is forced into cutting rates in Q3 as it responds to the recession. The Fed Fund rate (currently at +4% and expected to get to +5%) will end 2023 in the +2.75% to +3% range i.e., a 200bps rate cut over Q3-Q4 2023 levels

Allow me to explain.

Regular readers of this newsletter will know that I believe inflation is not a problem in the medium term and that we will be back to the disinflationary period of pre-Covid years.

In the April 2021 Market Viewpoints I wrote "the last 250 years of US inflation can be summarised as – a very long period of little or no inflation, a couple of decades of high inflation in the 1970s-80 and back to more than three decades of low inflation. My gut tells me that we will see a short burst of high inflation but over the medium-term, inflation is not a significant risk."

We have seen a bout of high inflation in terms of levels the CPI reached. I would say any Year-over-Year (YoY) CPI print of +7% and over, can be classified as "high inflation."

- US CPI reached +7% in December and is still above that level. However, the good news is that the data suggests US CPI peaked in June this year at +9.1% and has been coming down steadily since
- The November US CPI report is due next week. The current estimate for November's Month-on-Month (MoM) CPI is +0.3%
- If CPI comes in at that +0.3% MoM for November, it will take the YoY CPI reading down to near +7% (last print +7.7%)
- However, a decline in the MoM CPI for November, let us say -0.1% (not impossible given the sluggishness of recent macro data) will get us to +6%

We had big MoM US CPI prints in February (+0.8%) and March (+1.2%) of this year. As they drop off the annual CPI calculation and are replaced by new prints for February 2023 and March 2023, the CPI will move down quickly. I expect the CPI number down into the +4% range by next spring.

If that happens, we definitely won't need a Fed Funds Rate at +5% for long i.e., the short burst of high inflation is over, and we are in for moderate levels going ahead.

This recent bout of high inflation was precipitated by two key factors – excessive Money supply (M2) growth, and self-inflicted supply-side restrictions driven by lockdowns. Both factors are now in the rear-view mirror. M2 is the measure for the currency in circulation that includes M1 (physical cash and

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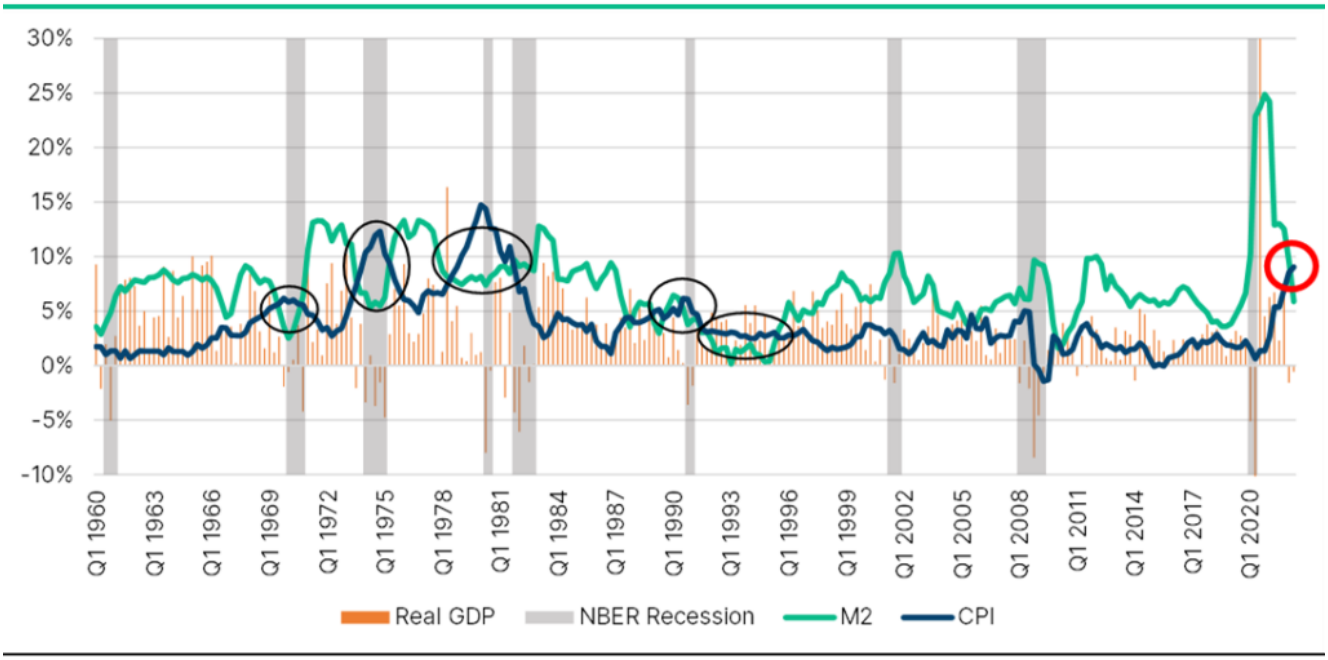
checkable deposits) as well as “less liquid money”, such as savings in bank accounts. M2 growth which got to as high as +26.8% in Feb 2021 is now flatlining (more on this further down, and in the chart below).

The Western world has been out of lockdowns since February and even China has now cast off its “zero-Covid” policy. The local authorities across China are paring back some of their strictest Covid-19 control measures, even as the number of new infections remains elevated. This is good news for the supply side (as well as bringing Chinese consumption demand back online)

The chart below plots the year-on-year (YoY) growth rate of US inflation (CPI) and the growth rate of M2 supply.

As you would guess, CPI follows the increase in M2, with a lag as prices generally respond to the increase in money supply working its way through the economy impacting demand.

Figure 3: YoY change in quarterly M2 and CPI, annualised quarterly change in GDP, with recessionary periods shaded



SOURCE: U.S. BEA (FROM FRED), NBER, BOARD OF GOVERNORS OF THE FED (FROM FRED), U.S. BLS (FROM FRED), STEVEN ANASTASIOU
*UPPER AND LOWER Y-AXIS BOUNDS SHORTENED FOR LEGIBILITY - ACTUAL ANNUALISED Q2 2020 REAL GDP WAS -31.2 PER CENT, AND Q3 2020 REAL GDP WAS 33.8 PER CENT.

The M2 supply kicked into high gear around January 2020 and continued to increase as various stimulus efforts to deal with Covid-19 were implemented. The M2 growth eventually peaked a year later in February 2021 at +26.9%. At the time, the inflation was at +1.68%. Since then, the M2 growth has been coming down and inflation has been rising.

Any challenges (foreseen or unforeseen) on the supply side just make the CPI worse. This is what we saw with Covid-19. It was not just the M2 increase but the restrictions on supply that had a bearing on the CPI too.

The red circle in the chart above highlights “the inversion” – the rate of change of M2 and the rate of change of CPI crossing each other i.e., prices rising faster than money supply. This inversion is often a predictor of a recession ahead and in my opinion, we have crossed the Rubicon. With the Fed still

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insistent on raising rates, and as per the Fed's projection of at least a +100bps rise ahead, the fate of a US recession in 2023 is sealed. The length and depth of the recession will depend on how quickly the Fed responds.

Here is how an increase in Money supply (M2), followed by an increase in CPI and an increase in interest rates bear on the economy to cause a recession that begets rate cuts:

- When the M2 increases, but prices remain largely the same there's initially an increase in the real demand for goods and services. However, the increase in M2 is only demand stimulatory until the prices of items eventually rise and reduce demand
- Once prices rise sufficiently, the level of real demand, all else being equal, and in absence of any productivity gains, reverts to its pre-stimulatory level. As demand contracts, businesses scale back their output. Central banks and businesses realise – the money supply did not create any new wealth (How could it – it was not invested in a productive capacity as is often the case with stimulus checks)
- A recession follows and interest rates are cut

Even as the S&P 500 (SPX) has moved down and sideways, the percentage of stocks above their 200-DMAs continues to grow and show positive breadth divergence. It is a sign of market internals getting stronger despite the prevailing bearish narrative.



Source: Bespoke Invest

A focus on the medium term will spare you the anxiety of short-term volatility. In this sell-off, the SPX bottomed at 3600 in June and here we are end of the year, with the SPX at 4,000.

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Income strategies earned (accumulated) a carry of +8% if you stayed invested or invested when everyone was bearish mid-year. We saw the same in the depths of Covid-19 driven market sell-off in Q1 2020. Central banks can change the narrative without any warning. It can lead to a shallower recession (or a recession avoided)

If you turn bullish when everyone else is bullish, then you are buying late in the cycle. There is an opportunity cost to it which accumulates over time. Instead, In recommend you focus on market internals and invest in tranches over time. My end-of-2023 target for the SPX is 4,290.

Recession does not have to be doom for equities and markets tend to bottom before a recession starts. In my opinion, we have seen the bottom on the SPX at the 3600 level in June 2022, when inflation peaked at +9.1%.

Markets and the Economy

Given the year we have had, it was a solid November and Q4 year-to-date for the equity markets (see table below).

Benchmark Global Equity Index Performance (2021, 2022 YTD and QTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)	2022 Quarter-To-Date (Lcl Ccy)	November 2022 Performance (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	128.4%	44.7%	22.4%
MXIN Index	MSCI INDIA	India	27.3%	4.9%	6.9%	3.4%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	3.2%	-1.7%	-3.1%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	1.4%	8.6%	6.7%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-3.1%	7.6%	1.4%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-5.1%	12.3%	5.1%
CAC Index	CAC 40 INDEX	France	28.9%	-6.8%	15.7%	7.5%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-7.2%	17.4%	5.7%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-8.4%	18.6%	9.6%
DAX Index	DAX INDEX	Germany	15.8%	-9.7%	18.4%	8.6%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-11.5%	17.3%	8.6%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-11.9%	6.0%	8.9%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-14.9%	15.5%	26.6%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-17.0%	10.4%	5.4%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-21.3%	10.7%	14.6%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-29.2%	4.7%	4.4%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-42.7%	11.0%	0.4%

Source: Bloomberg

The US mid-term election year "seasonality" that I first mentioned in the August's Market Viewpoints kicked in, in a very timely manner, and delivered solid double-digit returns over the months of October and November. Let us hope it lasts the next couple of weeks into year-end and we finish the year in a flourish with a "Santa rally" to close the year.

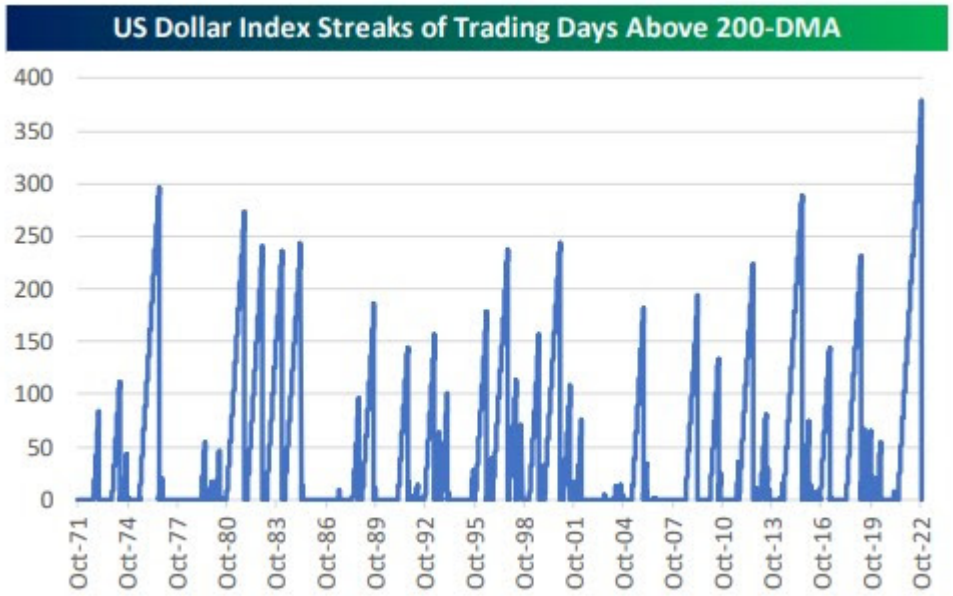
On a Year-to-Date (YTD) basis, we are still down -15% to -20% across the major indices and, more so, if you measure the returns in US Dollars.

The record US Dollar (USD) rally that we have seen this year, has now run out of steam, as US interest rate expectation have moderated. The recent decline in bond yields has been accompanied by a big drop in the USD as well. This is a complete reversal of the sticky trend of – higher rates, higher US dollar and lower stock prices – that we saw in Q3.

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While the SPX moved back above its 200-Day Moving Average (DMA) this week after 162 trading days below it, the US Dollar Index (DXY) finally broke below its 200-DMA last week for the first time in more than 350 trading days (chart below). The streak of closes above the 200-DMA for the US dollar was easily its longest on record dating back to the 1970s. The next-longest streak ended at 231 days in March of 2019. You may recall that a "Fed pivot" followed by rate cuts started within six months of that. As I have mentioned above, I expect the Fed to start cutting rates in Q3 2023.

US inflation peaked in June and the US Dollar peaked in October when the US Dollar Index (DXY) hit a peak of 114. Since then, the DXY has been trundling down and currently sits at 105. At 105, the DXY is still 10-point higher than at the beginning of the year. I expect the USD to continue weakening, as concerns about the US economy grow and inflation fears recede further in Q1 and Q2 next year. USD weakness will certainly help earnings for companies that generate a substantial portion of their revenues outside of the US. The market has factored this in as well. Since the US dollar's peak, stocks that generate 50%+ of their revenues outside the US have averaged a gain of +18.3%. Stocks that generate all their revenues domestically are up just +11.8% over the same period.



Source: Bespoke Invest

Market sentiment towards equities continues to be bearish. The average upside target for SPX for 2023 is +2.2% (range -5.3% to +14.4%, median +3%) as per the forecasts of the nine Global investment Banks (Goldman Sachs, JP Morgan, UBS, Citi, Morgan Stanley, Deutsche, Barclays, Bank of America, and Credit Suisse).

The American Association of Individual Investors' (AAII)'s weekly investor sentiment survey, shows the percentage of investors who are market bullish, bearish, or neutral on stocks. The most recent survey had more bears than bulls for a record 35 weeks in a row (see chart below). It is the longest streak since 1987. It is safe to say the consensus is bearish.

"Nothing is more obstinate than a fashionable consensus" as former UK Prime Minister Margaret Thatcher once said. Consensus does not happen by magic; it must be driven and forged. Beware of a

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consensus driven by 24×7 doom-mongering and flashing headlines on television. Focus instead on the medium term and let's learn from history. Being bearish and seeking the "safety of consensus" can be fashionable, but it could also lead to lost opportunities.

As the analysts at Goldman Sachs' GIR recently put it: *"in the 20th century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21.5% prime rate in 1980; and the Great Depression of the 1930s, when unemployment ranged between 15% and 25% for many years. America has had no shortage of challenges. without fail, however, we've overcome them. in the face of those obstacles — and many others — the real standard of living for Americans improved nearly seven-fold during the 1900s, while the Dow Jones Industrials rose from 66 to 11,497."*

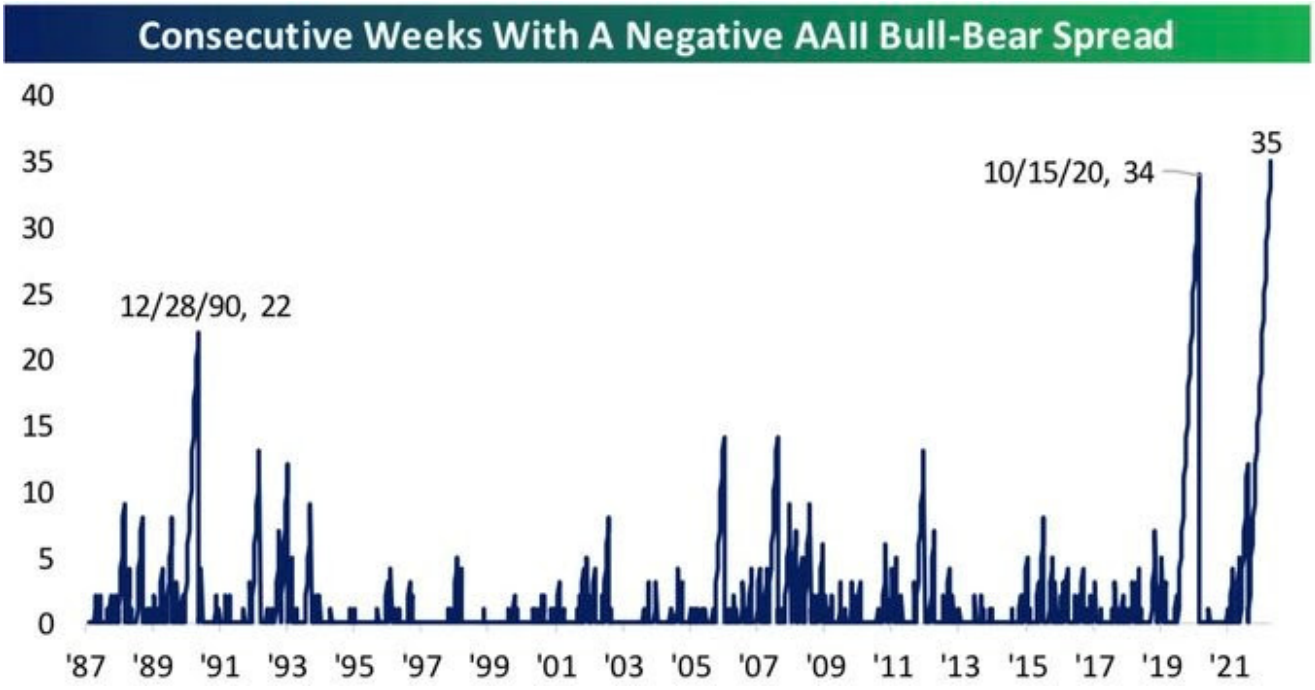
We live in a world which is constantly evolving. Emerging market growth lies ahead of us. We have left the pandemic behind and, while the economic damage from it will take time to heal, lessons have been learnt. The damaging lockdowns of 2020-21 are unlikely to be repeated.

I have no doubt fossil fuel will be back in demand more than anyone prices in.

There is more data, and that data needs more security. Tech, SaaS, cyber-security, big-data, semi-conductor stocks etc., are not a fashionable investment, but a necessity for the long term.

Barring a nuclear war, we are not reversing the trend set over the last two decades of innovation and change. A single Google search today requires more computing power than it took to send Neil Armstrong and eleven other US astronauts to the moon.

It means that now is the time to keep building up your long equity positions before more investors turn from bearish to neutral and eventually to bullish.



Source: Bespoke Invest

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A few quick comments on the bond market.

In what has been accurately described as the – worst year in history for US Treasuries – we have now seen a nice bounce over the last six weeks. The 20+ Year Treasury ETF (TLT) is now up over +18% since mid-October and is in the process of breaking above the top of its 2022 downtrend. TLT has only seen a month-over-month rally of over +15% during three other periods since its inception in 2002. Prior sharp one-month moves higher for TLT have come during periods of significant weakness for stocks that ultimately marked attractive entry points.

20+ Year Treasury ETF (TLT): 12-month price chart



Source: Bloomberg

In terms of equity sector performances

- The Energy sector (XLE) remains up +53% YTD see table below), with less than a month to go in 2022
- The only other sector ETF that is close to turning green is Consumer Staples (XLP). It was green at the start of the week and then slipped
- Four sectors are underperforming the broad SPX) – Communication Services (-23%), Consumer Discretionary (-18%), Real Estate (-11%), and Technology (-9%).

Looking at sector breadth, even though Energy is up the most YTD, it currently has the lowest % of stocks above their 50-DMAs (73.9%). Five sectors have more than 90% of stocks above their 50-DMAs: Industrials, Consumer Staples, Materials, Technology, and Utilities. These sectors are showing signs of

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momentum building up.

Industrials has probably been the most stand-out sector recently. It has rallied the most QTD and it has the most stocks above their 50-DMAs and the second most stocks above their longer-term 200-DMAs.

Benchmark US equity sector performance (2021, 2022 YTD and QTD, 2022 YTD relative to the S&P 500 index)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance	2022 Quarter-To-Date(QTD) Performance	2022 YTD Performance (relative to S&P 500)
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	51.8%	17.0%	82.9%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	-0.4%	8.8%	20.0%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-1.0%**	**15.2%**	**19.3%**
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-1.2%	14.2%	19.1%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-5.6%	20.6%	13.8%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-9.5%	20.5%	9.0%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-11.4%	14.0%	6.8%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-24.6%**	**10.4%**	**-9.1%**
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-25.7%	**6.9%**	**-10.5%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-31.6%**	-1.9%	-17.6%
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-36.3%**	**3.3%**	**-23.3%**

Source: Bloomberg

With sector indices still recovering, it is time to keep building your long positions.

- Tailwinds for equities: Strong seasonality, over bearish investors, less hawkish Fed, moderating inflation
- Headwinds for equities: Recession risk ahead, good short-term rally so far i.e., consolidation of levels, SPX still not above 200 DMA

As I have been saying since June at least, there are plenty of high-quality stocks in the Consumer, Technology, Industrial and Healthcare sectors that are trading at -20% to -25% on a YTD basis, and present a good buying opportunity, be it directly or via Structured Products.

Structured Products in investment portfolios offer an investor the opportunity to benefit from prevailing market volatility. If you can take a 3–5-year investment view, the stocks and/or indices underlying the products do not necessarily have to rally for one to earn 10-12% in income from the products annually.

For instance, last week, we launched a 5-Year product on a basket of (Disney, Pepsi, Nike, and Constellation Brands) where the coupon was +15.6% per annum, the protection barrier was set at 60% at maturity and the losses do not accrue from 100% but from the 60% level, if the barrier is reached at maturity. In summary, therefore, Structured Products offer: Equity exposure, solid income, and good downside protection.

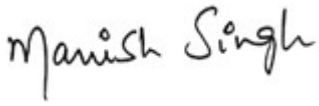
For specific stock recommendations and Structured Product ideas please do not hesitate to contact me or your relationship manager.

Anyway, all that is left for me to say this year, is to thank you for your time and attention.

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I also wish you and your families all the best for the holiday season as well as a very Happy New Year. And if you celebrate Christmas – I hope you have a great one and stay warm.

Best wishes,



Manish Singh, CFA



Republicans could control both the House and Senate following upcoming Midterm elections in the US. What impact would this have on fiscal policy, on inflation and ultimately on bond and equity markets.

Summary

It's now universally accepted that the US Federal Reserve waited too long to begin raising interest rates. The Fed cannot make up for that mistake by overcompensating and tightening rates too far. US mortgage rates topped +7% for the first time in more than two decades, extending a string of steep increases that have stymied housing demand. US mortgage demand has fallen to nearly half what it was a year ago. A housing slowdown sets a chain reaction of a slowdown in the economy. Recent earnings reports indicate that businesses are already factoring in a recession for 2023. No wonder then that the talk of a "Fed

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pivot" has started surfacing.

The Fed, however, can't take anything for granted, as headline inflation is still over +8%. The Fed's hands are tied by the loose fiscal policy thus far of the US administration. The Fed may be in luck however, and about to get some help. Polls indicate the Republican party is set to take control of both the Senate and the House of Representatives in the midterm elections in early November. A Republican-controlled Senate and House will not approve any more stimulus bills. That's good news for inflation, as the over $4.9 trillion in stimulus over the last two years, has been a key driver of high inflation in the US.

Equity markets have seen a nice rally this month with the S&P 500 (SPX) and Dow Jones Industrial Average (DJIA) up+7.5% and +11.6% respectively. The talk of the "Fed pivot" has helped, as has the realisation that equities are oversold, and the earnings season has not been as bad as many thought it could be. Therefore, it is not time to dump equities but to build a position in them. Granted that bond yields are attractive again as well. Investors, once again, have the luxury to build both a bond and equity portfolio.

Mid-term elections and a "Fed Pivot" on the horizon

US economist and Nobel Laureate, Milton Friedman once said – *"It always takes 6-12 months to quantify a move in rates impact on the underlying economy."*

The US Federal Reserve (Fed) has raised interest rates by 300 basis points (100 basis points = 1%) over the last six months i.e. the Fed has tightened significantly and the impact of this will only be fully felt over the next six months.

We are already seeing signs of it in the US housing market. As high rates crimp demand, and home prices have started to rollover sharply.

The longer-dated Case-Shiller home price index data released earlier this week for August, indicated US home prices falling by -9.81% month-over-month (annualized rate). That marks the first back-to-back monthly declines since the start of 2012. The Case-Shiller index looks across 20 different key metro regions in the US.

Furthermore, US mortgage rates have topped +7% for the first time in more than two decades, extending a string of steep increases that have stymied housing demand. US mortgage demand has now fallen to nearly half what it was a year ago, according to the Mortgage Bankers Association (MBA).

Housing numbers are a very important data to gauge the health of the US economy. The American fetish of home ownership doesn't stop at buying a house – as "keeping up with the Joneses" often then takes over. Associated spending starts adding up, which is good for the growth figures of the economy – buying furnishings, manicuring the lawn (i.e. spending at Home Depot), upgrading the car to match the house (or better the neighbour's car), and joining the same country club as the neighbours!

A housing slowdown, therefore, sets a chain reaction of a slowdown in the economy. High interest rates also raise rents, as house mortgage affordability, and hence house ownership, decline.

No wonder then the talk of a "Fed pivot" has started surfacing.

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Last Friday, *Wall Street Journal* (WSJ) reporter, Nick Timiraos – widely regarded as the mouthpiece of the Fed – published an article titled "Fed set to raise rates by 0.75% and debate size of future hikes."

The key lines from the article are as follows – "Some officials have begun signalling their desire both to slow down the pace of increases soon and to stop raising rates early next year to see how their moves this year are slowing the economy. They want to reduce the risk of causing an unnecessarily sharp slowdown."

It is now universally accepted that the Fed waited too long to begin raising interest rates. The Fed can't make up for that mistake by overcompensating and tightening rates too far. At the same time, the Fed can't take anything for granted, as headline inflation is still over +8%.

The twelve districts of the US Federal Reserve



Source: US Federal Reserve

The Fed's hands are tied by the fiscal policy moves of the current government, which is still largely expansionary, and the impact of the Student Loan Forgiveness Initiative has not yet been factored in.

The program promises to cancel up to $20,000 of student debt for individuals who make less than $125,000 a year, or married couples who make less than $250,000 a year. The program has been challenged in the US courts by Republican-run states. If the courts allow the administration of US President Joe Biden to proceed, debt cancellation could begin almost immediately for the more than 22 million borrowers who have already signed up for the program. At a minimum, this would mean an over $400 billion boost to spending, as loan repayments are ploughed back into consumer spending.

Recent earnings reports indicate, that businesses are already factoring in a recession for 2023, which means they are adjusting forecasts, changing buying patterns and delaying big purchases. They are also not as desperate to hire as they were nine months ago, as the monthly US jobs report indicates. The US

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economy is a massive ship, it won't turn on a dime, but ratcheting up interest rates has already changed the course. Raising rates much more from here, would be reckless and lead to economic damage, the extent of which we don't know yet.

Besides, this is not the Paul Volcker Fed of the 1970s and nor can it afford to be. In the 1970s, the US debt to GDP was approximately 40%. Today, it's well over 100%. Debt service cost adds up very fast if rates stay too high. Unlike his academic predecessors, the current Fed Chair Jerome Powell has a background in investment banking and Private Equity. Powell worked at the investment bank Dillon Reed, specialising in financing, merchant banking, and M&A from 1984-90 and at the Carlyle Group, the Private Equity and asset management giant, from 1997-2005. Nobody knows better than the Private Equity guys what debt and debt service costs can do to a business, and a nation for that matter.

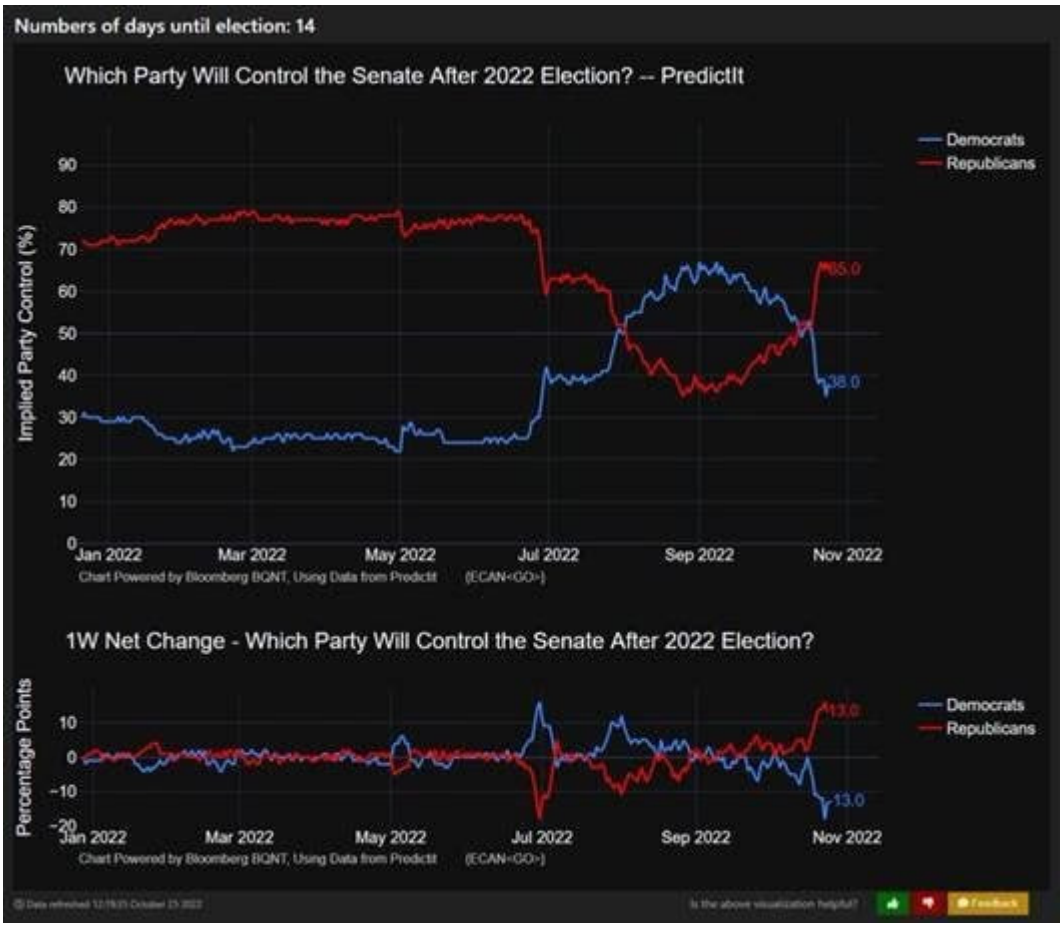
The problem of inflation has been complicated as the Fed has received little help from the fiscal side. The Fed tightens while the Biden administration spends like there's no tomorrow. The total stimulus under the Biden administration is over $5 trillion. The US Congress has raised the debt ceiling more than 45 times. There are hardly any US lawmakers willing to stop deficit spending. The current US national debt of $31 trillion can easily climb to $40 trillion by the end of the decade and all this debt needs servicing.

Until fiscal spending slows, raising rates will have very little effect on inflation. Passing the "Inflation Reduction Act" and expecting inflation to come down is akin to throwing soup at an Old Master painting and expecting the climate change issue to be solved. The Fed may be in luck however and about to get some help.

The recent Republican surge to control the US Senate may be levelling off, but the gap the Republicans have opened up on the Democrats remains substantial (see chart below).

Mid-term election betting odds: Who will control the US Senate?

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Source: Predictit

Tuesday night's debate in the key Senate seat in Pennsylvania didn't go well for Democrat nominee John Fetterman. He opened his first answer by saying, "Hi, good night, everybody," rather than "Hi, good evening."

In the debate, Fetterman was asked to state his view on Natural-Gas fracking, an important economic driver in parts of Pennsylvania. In the past, Fetterman has opposed fracking. On the night he said – "I do support fracking, and I don't, I don't—I support fracking and I stand, and I do support fracking." Make of that what you will. It seems it's good night and goodbye to Fetterman in Pennsylvania after that debate, which was more like an Amtrak derailment than a car crash. The debate outcome has further boosted the Republicans with mid-term elections less than 2 weeks away.

In the House of Representatives, Republicans need to pick up just five seats to take control of the House. A Real Clear Politics (RCP) poll of polls predicts that the Republicans could pick up +12 to +47 seats with an average of +29.5 seats.

With the Republicans controlling both the House and the Senate, fiscal stimulus will be checked and more oil and gas production will be back on the agenda. The adoption or the expectation of adoption of the two policies will exert downward pressure on inflation. In a nutshell, fiscal policy is about to get restrictive in the US.

Therefore, I believe that the Fed will be well-placed to change its stance before the end of the year.

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However, we are not going to the low rates of the past decades anytime soon.

One thing that is often overlooked is how much globalization played a part in taming inflation in the 1980s-90s. China's cheap labour and Saudi Arabia's cheap oil were key to bringing down costs from the double-digit inflation rates we saw in the 1970s. China's cheap labour is gone, and the Saudis want to keep energy prices high.

Only a concentrated effort to increase oil and gas production in the US and globally can change the energy supply balance and bring inflation down to the +2% that the Fed targets.
The world needs and will always need cheaper energy supply to preserve lives and livelihoods. Energy is the lifeblood on which the world runs and hence life is sustained. Therefore, we need more and cheaper energy supplies now, and less talk of how we are going to get to "net zero" by 2050.

Markets and the Economy

Markets have seen a solid rally this month with the S&P 500 (SPX) and Dow Jones Industrial Average (DJIA) up+7.5% and +11.6% respectively (table below)

The talk of a "Fed pivot" has helped, as has the realisation that equities are oversold and the earnings season has not been as bad as many thought it could be.

With the US likely heading into a recession (more on this below), equity bears have had a change of heart and are happy to deploy more cash and start building a long position in equities, with the main indices still down more than -20% from their highs.

A bright spot is that the 3,600 level on the SPX is holding up well and we have seen three tests of that level already since June.

We got to 3,600 in June and it's October now. The SPX hitting the 3,600 level in June also coincided with the peak US Consumer Price Index (CPI) print of +9.1%.

The SPX index doesn't spend much time around the 3,600 levels and bounces back very sharply. It's back to 3800 as of now, a quick +7% rally in a week.

Benchmark Global Equity Index Performance (2021,2022 YTD and MTD)

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Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)	October 2022 MTD Performance (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	94.6%	23.3%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	9.4%	4.2%
MXIN Index	MSCI INDIA	India	27.3%	0.9%	2.9%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	-4.6%	2.2%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-5.9%	4.5%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-9.8%	6.7%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-11.8%	11.5%
CAC Index	CAC 40 INDEX	France	28.9%	-12.9%	8.2%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-16.6%	8.0%
DAX Index	DAX INDEX	Germany	15.8%	-17.3%	8.4%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-18.2%	8.4%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-19.9%	-3.6%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-20.1%	6.2%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-30.2%	-1.9%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-31.0%	2.1%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-36.5%	-13.7%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-43.2%	9.9%

Source: Bloomberg

A silver lining seems to be appearing on the horizon as far as US CPI is concerned. All the big Month-on-Month (MoM) prints in Q4 2021 will start dropping off as Q4 2022 prints start coming in. Starting with the next CPI monthly print, any headline MoM print below +0.7%, gets the YoY CPI number into the 7.5%-7.7% level. That will be cheered by the markets.

Fiscal policy is about to tighten in the US, as a Republican-controlled Senate and House will not approve any more stimulus bills. That's good news for CPI from here on as the over $4.9 trillion in stimulus over the last two years has been a key driver of high inflation in the US.

The $1.9 trillion stimulus package in March 2021 was preceded by almost $3 trillion in stimulus the previous year. The US economy received over +20% of the Gross Domestic Product (GDP) in increased public spending. That dwarfed the early 2021's output gap of around +4% of GDP.

With several different areas of the US bond yield curve becoming inverted this year, the probability of a US recession has been on the rise. One part of the yield curve, that has remained positively sloped, is the spread between the 10-year and 3-month US Treasury yields. That was the case until Wednesday. The 3-month/10-year yield spread — historically the most accurate predictor of recessions on the yield curve — has now inverted.

Yield curve inversion is not in itself bearish for equities. Per the table below (from True insights), US equities have realized a return close to the long-term average between Yield curve inversion and the start of the recession.

One more key point to note: the SPX performance in the year leading up to the yield curve inversion.

Historically, the SPX's median change in the year leading up to an inverted yield curve has been a gain of +7.9%. In the current period, the SPX has declined over -18% in the year leading up to today's inversion, which would be the weakest performance leading up to an inversion of any period in at least the last 60 years.

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So, it's not time to dump equities but to build a position in them. Granted that bond yields are attractive again too. Therefore, investors once again, have the luxury to build both a bond and equity portfolio.

US Yield Curve inversions, US Recessions, and S&P 500 Index Performance			
Based on the 10-year – 2-year US Yield Curve			true insights
Start date recession	**First inversion 10Y - 3M**	**lag (months)**	**S&P 500**
Feb-80	Aug-78	17	6.5%
Aug-81	Sep-80	11	4.7%
Aug-90	Dec-88	20	17.1%
Apr-01	May-98	34	2.1%
Jan-08	Dec-05	24	8.1%
Mar-20	Aug-19	6	5.2%
Average		19	7.3%
Median		19	5.8%

Source: True Insights, NBER, Investing.com, Bloomberg,

If you want to see what high energy costs are doing to the world, then look no further than Europe.

The energy crisis has sowed seeds of political disharmony in the European Union (EU), caused energy-intensive businesses to downsize "permanently" and relocate operations and is set to cause a recession in Germany and Italy in 2023 as predicted by the International Monetary Fund (IMF).

From French tiremaker Michelin to German chemical giant BASF, European industry is starting to crack under the weight of record energy and raw material prices. Chemical/Industrial companies need natural gas and petrochemicals at a reasonable price and not preaching on "net zero" and "climate change." If Europe doesn't secure energy at reasonable prices, companies are going to relocate to regions with more secure access to energy.

This week, BASF announced plans to "permanently" downsize in Europe due to high energy costs in the region. The statement from BASF comes after it opened the first part of its new €10bn plastics engineering facility in China. Spot gas prices are five to six times higher in Europe than in the United States. BASF bemoaned a triple burden of – sluggish growth, high energy costs and over-regulation. BASF bosses have thrown their weight behind a planned expansion in China.

This week, German Chancellor Olaf Scholz put his foot down to approve a contentious deal by China's state-run shipping giant Cosco to acquire a 35% stake in a container terminal in Hamburg, where he used to be mayor. In doing so, Scholz is brushing aside opposition from six of his ministries and 81% of Germans (as per a poll in *Der Spiegel*) who are opposed to the Chinese investment.

Scholz is also about to embark on a trip to China with a delegation of German business leaders, much to the annoyance of President Emmanuel Macron of France. Macron bemoaned the lack of a unified EU approach in dealing with China, saying the EU was acting as an 'open supermarket' to China. Scholz will become the first Western leader to visit China since the start of the Covid pandemic.

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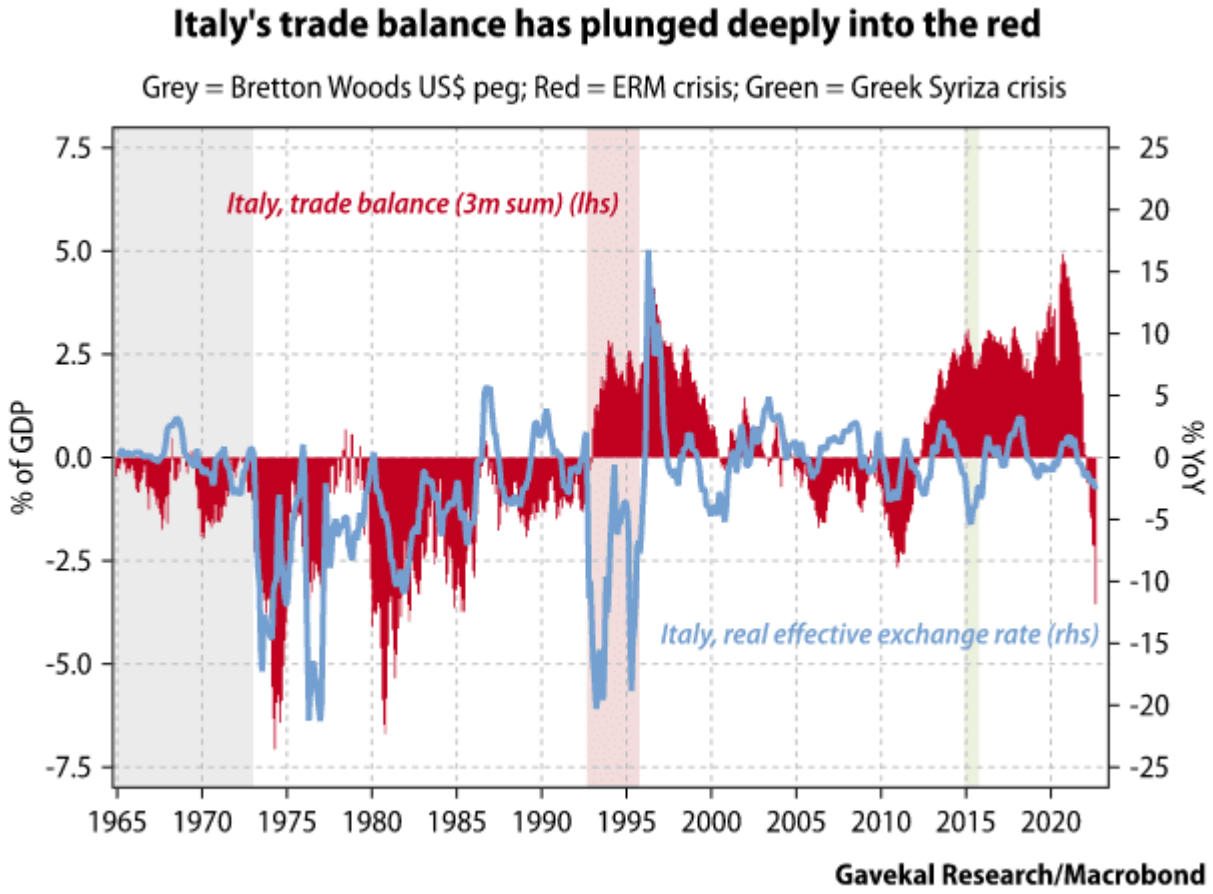
So, it seems, Germany has learnt nothing from overly relying on Russia for cheap energy. It is now putting more of its eggs in the "China basket."

Another way to look at it is – what choice does Germany have?

China is Germany's key market. Germany's trade surplus has disappeared, energy costs are getting prohibitive and debt will mount up. The last thing Germany can afford to do, is make an enemy of China.

And what about Italy?

A new Prime Minister is in place, but the country faces the same old problems of debt and stagnation. Add to that mix – an energy crisis. The energy crisis is more severe for Italy, where in recent years imported natural gas has made up almost +40% of the primary energy mix. Without gas imports from Russia, it is likely that Italian energy users will have to make deep voluntary consumption cuts this winter or face forced energy rationing. Either way, it means economic activity in Italy is set to suffer.



Increased energy import costs have helped to push Italy's monthly current account balance from a surplus equivalent to +5% of GDP in April 2021 to a deficit of -4% in August this year (see chart above). The swing has been compounded by depressed demand for Italy's exports. With around half of exports going to other European economies, which are facing similar headwinds, Italy's non-energy trade surplus has contracted by around -2.5% of GDP over the last two years. This combination will continue to weigh on growth over the winter and possibly beyond.

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A deep recession in Italy now seems a certainty.

Benchmark US equity sector performance (2021, 2022 YTD and MTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance	October 2022 (MTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	60.3%	23.5%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-7.1%	7.3%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-7.2%**	**7.9%**
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	-8.3%	0.2%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-12.6%	11.6%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-14.6%	9.9%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-18.3%	8.8%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-28.6%**	**4.5%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-29.2%**	1.7%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-30.6%	**-0.1%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-38.4%**	**-0.1%**

Source: Bloomberg

The October seasonality I mentioned in my August Market Viewpoints seems to have kicked in already (see the MTD performance in the table above).

Historically it has led to a solid rally starting in October, that lasts until the end of the year. It might dovetail nicely with signs of dovishness from the Fed. So, please bear this in mind.

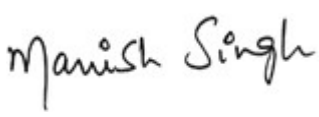
As I've been saying since June at least, there are plenty of high-quality stocks in the Consumer, Technology, Industrial and Healthcare sectors that are trading at -20% to -25% on a YTD basis, and present a good opportunity to invest in, be it directly or via Structured Products.

The reason I keep recommending the use of Structured Products in investment portfolios is that they offer an investor the opportunity to benefit from prevailing market volatility. The stocks and/or indices underlying the products do not necessarily have to rally for one to earn 10-12% in income from the products annually.

For instance, this week, we launched a 5-Year product on a basket of (Apple, Amazon, Google and Microsoft) where the coupon was +15.3% per annum, the protection barrier was set at 60% at maturity and the losses don't accrue from 100% but from the 60% levels, if the barrier is reached at maturity. In summary therefore: Equity exposure, solid income and good downside protection.

For specific stock recommendations and Structured Product ideas please do not hesitate to get in touch with me or your relationship manager.

Best wishes,



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Manish Singh, CFA



Happy New Year and Merry Christmas background with earth and peace word

“Russia’s attack on Ukraine has faltered. The looming energy crisis that could yet devastate Europe. NATO and Europe will be wise to have patience, avoid self-righteousness and assist Putin to “save face” and de-escalate”

Summary

It is evident to everyone in Russia (and around the world) that Russia’s attack on Ukraine has faltered. Russian men, long extolled for their macho culture and patriotism, ready to defend and die for Mother Russia – are seen running for the nearest border. Russia is in a bind. Russian President Vladimir Putin knows full well that he can’t win this war. The West also wants the war to end and deal with the looming energy crisis that could yet devastate Europe, if not this winter then in 2023. The ongoing referendum in the four regions of Eastern Ukraine – offers a ray of hope, even though the referendum itself is a sham.

As the four regions become part of Russia, Putin will move troops and heavy weapons into his new “Russian provinces” and an attack on them would be an attack on Russia. Ukraine President Volodymyr Zelensky’s promise to regain these territories becomes a tricky one for the North Atlantic Treaty Organization (NATO) and the West to support, as it would mean confrontation, possibly even a nuclear

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one with Russia. Europe and NATO will be wise to have patience, avoid self-righteousness and assist Putin to “save face” and de-escalate.

I suppose with the nuclear threat, this will be the path to peace by Christmas. Ukraine may be offered something akin to the “Marshall Plan,” to bring it to the table for a deal.

The UK is becoming the petri-dish for “structural change” that is so badly needed across the Western world – more growth, fewer taxes, lower deficits, sustainable debt, and fiscal rectitude. UK Chancellor Kwasi Kwarteng’s mini-budget and his “plan for growth” announced last week, however, have gone down like a lead balloon. The currency is trading close to parity against the US dollar and the Bank of England (BoE) has started buying UK Gilts again to rein in yields. If it’s any consolation, the economic woe isn’t just being felt in Britain. The Chinese Yuan has tumbled to its lowest level on record, as the US dollar continues to gain ground. The US Federal Reserve (Fed) has raised interest rates dramatically and more hikes are priced in.

However, US financial conditions have tightened a lot and various forward-looking indicators are orange, and ready to start flashing red. It would therefore make a lot of sense for the Fed to take a break and see how the economic situation unfolds in the coming months before hiking rates again. When the readjustment comes, you will be surprised at how quick it will happen. Bonds therefore do offer a very attractive investment opportunity at the current elevated yields.

Peace by Christmas?

Former Soviet Premier Vladimir Lenin once said: “There are decades where nothing happens, and there are weeks where decades happen.”

The retreat of the Russian armed forces from Kharkiv in Ukraine, Russian men (of fighting age) fleeing conscription, Iran’s largest anti-government protests since 2009 led by brave Iranian women, a new King and a new Prime Minister in the United Kingdom, Italy set to get its first women Prime Minister in Giorgia Meloni, Germany’s Green party accepting nuclear power is here to stay, and after 12 years of a Conservative government in the UK finally a Conservative budget but a near run on the Pound sterling … all these things happened in just the last ten days or so!

Staying with Russia, it is evident to everyone in Russia (and around the world) that Russia’s attack on Ukraine has faltered.

Advanced weaponry from the US, superior military intelligence from the UK and the bravery of the Ukrainian fighters, all have damaged irretrievably Russian President Vladimir Putin’s plan to take Ukraine. The Ukrainians have been wonderfully supported by the US, the UK and Poland – to name but a few.

After seven months of war, and not much to show by way of victory, Russia announced the mobilization of a quarter of a million men for a renewed attack on Ukraine.

Russian men (of fighting age) were mobilized and headed for airports, train stations, borders or wherever they could find flights at exorbitant prices – to get out of town. Long lines stretching for many kilometres were seen on the Russia-Georgia border.

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Russian men long extolled for their macho culture, and patriotism, ready to defend and die for Mother Russia are running for the nearest border. This is probably the first instance in history of a country "where people flee not because someone invaded their country, but because they invaded another country" as was eloquently shared by exiled Russian businessman Mikhail Khodorkovsky recently on Twitter.

A much-weakened Russia is treading on thin ice here. In the past, "mobilisation" hasn't worked out well for Russia. The first mobilization in 1914 ended the reign of Tsar Nicholas II. The second mobilisation during WWII was a success due to massive direct military aid from the US. Even before the US entered World War II in December 1941, America sent arms and equipment to the Soviet Union to help it defeat the Nazi invasion. The 1941 US Lend-Lease Act totalling $11.3 billion (or $180 billion in today's currency), supplied needed goods to the Soviet Union from 1941 to 1945 in support of what then Soviet Leader Josef Stalin described to then US President Franklin Roosevelt as the "enormous and difficult fight against the common enemy – bloodthirsty Hitlerism."

This third mobilisation today has Russia as an outcast of the world community, with no ally or military aid to show for it. Besides Russian supply lines to its forces in Ukraine have been mostly destroyed.

If the war continues into the winter, Russian forces will face the same dilemma as faced by German forces invading Russia in 1941, that is, do you deliver ammunition and fuel or will it be food and clothes? On present showing, the Russian Federation risks disintegration in the not-so-distant future.

Russian winter landscape



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Source: Pixaby

Yet in all this doom, there seems to be a ray of hope.

Russia is in a bind. Putin knows full well that he can't win this war. Now that the war is not going Putin's way, he needs a face-saver and a way out.

The West also wants the war to end and deal with the looming energy crisis that could yet devastate Europe, if not this winter, then in 2023.

Germany and Europe may have an adequate supply of natural gas to tide them over this winter, but the energy crisis is not a blip. If the energy supply for industry is not sorted soon enough, Europe faces de-industrialization and crippling stagflation. Energy is not just needed for heating homes in winter. It is also needed throughout the year for industrial production. The cost of production will remain high and that will lead to a loss of production, and factory closures as demand is destroyed and exports become uncompetitive.

On Tuesday this week, we learnt that the Nord Stream 1 and Nord Stream 2 pipelines are both leaking gas into the Baltic Sea, after severe damage that will scupper any remaining hopes of Nord Stream 1 returning to service this winter. Neither Nord Stream pipeline was pumping gas to Europe at the time of the leaks. However, both pipelines were full of pressurised gas and footage showed it bubbling to the surface in the Baltic Sea, causing safety hazards for shipping and aircraft. Gas prices in Europe are still around five times higher than the historical average.

The ongoing referendum in the four regions of Eastern Ukraine – Donetsk, Luhansk, Zaporizhia and Kherson, is Putin's attempt to not only justify the "special military operation" but also to use it as an opportunity to draw a line, offer spurious negotiations and plead for peace. The results of the referendum have started pouring in and I'm going out on a limb here in saying that when the final results are in, the percentage in favour of joining the Russian Federation will be 95%, if not more. The numbers are already in a file somewhere waiting to be published as the official result.

As Stalin said – "It's not who votes that counts, it's who counts the votes." Donetsk, Luhansk, Zaporizhia and Kherson people's republics will therefore join the Russian Federation.

Yes, the referendum is a sham, vote but a significant one. As the four regions become part of Russia, Putin will move troops and heavy weapons into his new "Russian provinces" and an attack on them would be an attack on Russia. Denouncing the referendum won't make any difference. Ukraine President Volodymyr Zelensky's promise to regain these territories becomes a tricky one for the North Atlantic Treaty Organization (NATO) and the West to support, as it would mean confrontation, possibly even a nuclear one with Russia.

At the time of the Cuban crisis, then US President John F. Kennedy wisely said "Keep strong, if possible. In any case, keep cool. Have unlimited patience. **Never corner an opponent, and always assist him to save face**. Put yourself in his shoes – so as to see things through his eyes. Avoid self-righteousness like the devil – nothing is so self-blinding."

Europe and NATO will be wise to have patience, avoid self-righteousness and assist Putin to "save face"

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and de-escalate.

I suppose with the nuclear threat, this will be the path to peace by Christmas. Ukraine may be offered something akin to the "Marshall Plan," to bring it to the table for a deal.

Let's hope calmer heads prevail, the suffering of Ukrainians ends and a solution to Europe's energy crisis consequently emerges.

Markets and the Economy

The United Kingdom is in the news. We have a new King; a new government and it would seem a new radical fiscal policy, that is causing somewhat of a stir – to put it mildly.

The UK is becoming the petri dish for "structural change" that is so badly needed across the Western world – more growth, fewer taxes, lower deficits, sustainable debt, and fiscal rectitude.

UK Chancellor Kwasi Kwarteng's mini-budget (which was anything but mini) in this respect and his "plan for growth" announced last week have gone down like a lead balloon. The currency slumped close to parity against the US dollar. Kwarteng's plan – £45 billion of tax cuts and an estimated £60 billion of spending to cap energy prices – is seen not as a plan but as an audacious political and economic gamble that challenges the Treasury "orthodoxy." It has made many experts and commentators very unhappy.

On Wednesday, The Bank of England (BoE) stepped into the bond markets amid the market turmoil that has sent government borrowing costs soaring. The BoE said it would postpone Quantitative Tightening (QT) – the process of selling government bonds and would start buying bonds again. This brings me to a comment I often use – the Japanification of the Western world is in progress i.e. none of the major central banks in the Western world will be able to shrink their balance sheets just like the Bank of Japan (BOJ) hasn't been able to, despite decades of trying. Every time they try, bond yields rise, sending fiscal balances into a tailspin and the central bank is forced to buy bonds again.

There is growing pressure on Kwarteng to reverse some of the measures he announced, particularly the abolition of the 45% rate of income tax on high earners which very curiously only costs £2bn out of the total of over £100bn of new spending i.e., less than a 2% impact on the budget.

If it's any consolation, the economic woe isn't just being felt in Britain. China's internationally traded Yuan has tumbled to its lowest level on record as the US dollar continues to gain ground. However, such is the political charged atmosphere in the UK, that everything is being blamed on the policies of the four-week-old government of new PM Liz Truss.

Truss and Kwarteng shouldn't buckle and draw inspiration from the experience of PM Margaret Thatcher, when she set about to change the UK economy structurally.

In 1981, Britain was at an economic crossroads. Policies that the Thatcher government, elected in 1979, had been implementing to deal with accelerating inflation and a spiralling national debt were not working. Thatcher and her Chancellor, Sir Geoffrey Howe, changed tack. The 1981 Budget increased taxes by £4 billion – an enormous sum in 1981 prices. Thatcher and Howe faced stiff opposition to this Budget, not just from the Labour and Liberal parties, but also from their own back benches.

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In March 1981, 364 eminent British economists published a letter to Margaret Thatcher in *The Times of London* condemning Howe's budget plans to hike taxes in midst of a recession saying that there was "no basis in economic theory or supporting evidence" for the policy that the Budget was seeking to implement, that it threatened Britain's "social and political stability", and that an alternative course must be pursued.

UK Quarterly GDP growth (1978-84)



Source: Bloomberg

It is said that Thatcher was asked in a heated debate in the House of Commons whether she could even name two economists who agreed with her. She replied that she could: Patrick Minford and Alan Walters. As the story continues, her civil servant said to her when she returned to Downing Street: "It is a good job he did not ask you to name three."

On the face of it, the 364 economists were wrong. The economic recovery that they said would not happen began more or less as soon as the letter appeared (chart above).

A YouGov poll for *The Times* this week indicates that the Labour party has a 17-point lead over the Tories, the biggest since the company began polling in 2001.

Well, polls can be very misleading when a general election is almost 2 years away. In Feb 1981, Labour, with Michael Foot as its leader, had a 16-point lead. Yet, in the 1983 election, Labour lost badly as Thatcher won a stonking victory. She won the largest majority since that of the Labour Party in 1945, with a majority of 144 seats.

Will Truss and Kwarteng hold the line that they have set and see their structural change through? Only time will tell, but there is an illustrious precedent to follow.

Exciting times are ahead politically and economically in the UK. GBP/USD is likely to remain in the parity to 1.05 range for the rest of the year.

Let's now turn our attention to the United States.

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"Treasury securities are considered a safe and secure investment option" says www.treasurydirect.gov

The over -20% decline in long-dated US Treasury bonds (over -30% for iShares Long term Treasury ETF (TLT)) has only happened twice before – in 1931 and 1937. We are witnessing history now.

Everyone tells you bonds are the safest investment. If you are a pensioner who put your money in a long-dated bond with the hope of clipping coupons and selling part of it as the need arose, you are now stuck with a bond you won't sell due to capital loss.

There's no such thing as a "safe asset." In the financial world, it's all relative i.e. safe with respect to what?

Having said that, I do repeat what I have said before – the inflation problem is always "man-made" and thus the redemption from it will also be "man-made." As we now know – Covid led to the shutdown and disruption to the supply chain. Excessive (and reckless) fiscal spending followed and caused inflation.

The US Federal Reserve (Fed) has raised interest rates dramatically – a third straight +0.75% raise earlier this month, with the Fed Fund Rate (FFR) now at +3.25%. Additional a +1.25% increase is being priced in over the next three months. Not surprising then that the Fed forecasts the US unemployment rate to rise to 4.4% next year, from 3.7% today — a number that implies an additional 1.2 million people losing their jobs.

- Deflation is already setting in for some parts of US economy – consumer electronics' prices within CPI have tanked lately, with some (like TVs) with double-digit year/year percentage declines
- The Richmond Fed manufacturing Index has fallen swiftly and is now in contraction
- Say goodbye to the liquidity tide. Growth in M2 money supply (which had reached +26.8% in Feb 2021 and averages +8% typically) is now at +4.1%, slowest since April 2019
- The Atlanta Fed's GDPNow model, now forecasts US GDP growth of +0.3% (q/q ann.) for the third quarter 2022. This is far cry from the over +2% growth expectation less than 12 months ago
- Commodity pressure has intensified. The Bloomberg Commodity Spot Index is now off its peak by -21.7% (worst drawdown since April 2020)
- US Financial conditions have tightened at a pace last seen during the Great Financial Crisis (GFC) of 2008/09, at least when looking at year/year % change
- US Mortgage rates have hit the highest levels since 2002, as a 30y fixed rate loan costs 7% on average. Mortgage costs are soaring and as Doubline founder Jeffrey Gundlach put it – "Thanks to 40% median home price increases over the past two years and the massive increase in mortgage interest rates the monthly payment on the median priced US home is already up about 100% vs. two years ago."
- The S&P 500 has finished in the red on 56% of 184 US trading days YTD. It is on track to have

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the second-highest annual proportion of loss-producing trading days since modern inception in 1957. The “top” spot belongs to 1974 with 57.7%

Therefore, it makes a lot of sense for the Fed to take a break and see how the economic situation unfolds in the coming months, before hiking rates again.

In my opinion, interest rate rises from here on will be very damaging to the US economy and circumstances will force the Fed to stop or change the narrative to a more dovish stance.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)	July-September 2022 Performance (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	59.6%	30.3%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	3.5%	10.1%
MXIN Index	MSCI INDIA	India	27.3%	-3.0%	8.3%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	-5.7%	-2.3%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-8.2%	-0.8%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-15.6%	-8.1%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-16.4%	-10.4%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-18.3%	-3.5%
CAC Index	CAC 40 INDEX	France	28.9%	-20.2%	-2.7%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-22.0%	-1.8%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-23.1%	-3.5%
DAX Index	DAX INDEX	Germany	15.8%	-24.0%	-4.7%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-24.7%	-2.1%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-26.6%	-21.1%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-28.9%	-12.5%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-29.4%	0.2%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-49.2%	-10.9%

Source: Bloomberg

Rising rates will kill demand and it will kill inflation with it. Structural forces – technology and innovation and bad demographics are going to continue to reassert. When the readjustment comes, you will be surprised at how quick it will be. The cycle works like this inflation shock -> demand collapse -> new disinflation.

Therefore, bonds do offer a very attractive investment opportunity at these levels. You could pick +5% to 6% on investment-grade names in the US these days, without going out too long on duration.

The weakness in bond markets puts the weakness in equity markets in perspective. Some bond holdings are down over -20% and so are equity holdings. For most of our entire investment careers (certainly mine), when markets hit turmoil, market commentary would include something like “investors rotated into the safety and security of bonds”. This time around there is no such rotation to do and if you did, you didn’t come out well.

You were and are much better off staying in equities and accumulating positions at lower levels.
The key story of the year has been the Fed’s determination to crush inflation at home by raising interest rates and this has inflicted profound pain at home and across the world – pushing up prices, ballooning the size of interest payments on debt, increasing the risk of a deep recession.

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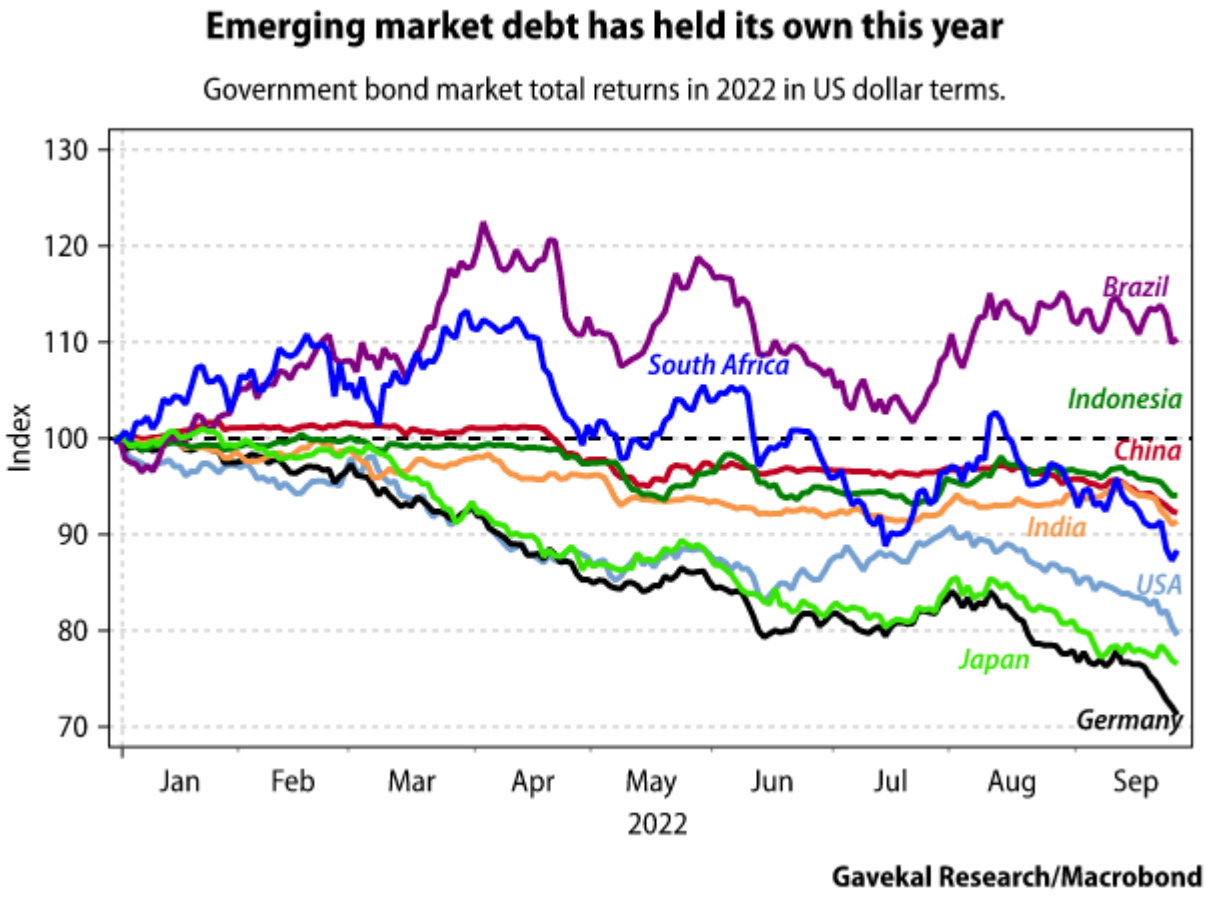
The energy crisis in Europe continues to be a concern.

According to a report in Reuters, in Germany, one in ten mid-sized companies, which provide nearly two-thirds of German jobs, have cut or halted production, because of gas prices reducing demand.

One interesting development this year has been the impressive outperformance of some of the larger Emerging Market bond markets, and even equity markets, despite the Fed's hawkishness and the rise in the US dollar.

Historically, whenever a liquidity crisis occurred, Emerging Markets proved to be the ones that investors rushed to get out. Not this time. Singapore, India, Indonesia and Brazil are all flat or up year-to-date in local currency terms.

This points to an ongoing structural changes in the global economy. A welcome change that gives investors more avenues to invest.



How is it that we are at the lowest unemployment levels yet worried about a recession?

The US dollar is at a very strong level, the US should be having disinflation, yet the inflation in the US is at record levels. All prior models are broken as "supply side" issues have eclipsed everything else. In these circumstances, the Fed continues to hike rates. The Fed is making a mistake.

Inflation has peaked in the US and I suspect we have also seen a peak in the US Dollar too. That said,

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EUR/USD is unlikely to stay above parity and any relief of Fed stopping to hike will be replaced by worries about Europe's energy crisis and the stagnation it will lead to in the Eurozone.

Benchmark US equity sector performance (2021, 2022 YTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance	2022 YTD Performance (relative to S&P 500)	2022 Quarter-to-Date (QTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	30.8%	67.6%	1.5%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	-2.8%	24.6%	-0.8%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-10.5%	14.8%	-4.3%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-12.1%**	**12.6%**	-3.4%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-19.3%	3.5%	-2.2%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-20.5%	1.8%	-1.3%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-23.6%	-2.1%	-6.0%
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-26.4%**	-5.7%	9.5%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-28.5%**	**-8.4%**	-2.2%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-29.3%	**-9.3%**	-10.3%
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-36.0%**	**-18.0%**	**-8.4%**

Source: Bloomberg

There's one more "redemption" to look forward to and a crucial one at that. Please mark October 16, 2022, in your calendar.

The 20th Chinese Communist Party (CCP) National Congress opens on October 16. President Xi Jinping is expected to embark on his third term as general secretary, and I suspect is the day when stringent "Covid lockdown" policies in China will start coming off. China will "re-open" and with that the global supply chain will improve very quickly.

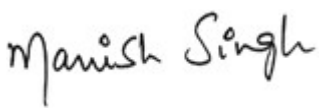
It may still not be enough to stop the US economy from going into a recession, however, supply chain improvement will be a tremendous boost to the US and global economy.

The October seasonality I mentioned in last month's Market Viewpoints is about to kick in soon too. Historically it has led to a nice rally starting in October that lasts until the end of the year. It might dovetail nicely with any signs of dovishness from the US Fed. So, please bear that in mind.

There are plenty of high-quality stocks in the Consumer, Technology, Industrial and Healthcare sectors that are trading at -20% to -25% on a YTD basis, and present a good opportunity to invest in, be it directly or via Structured Products.

For specific stock recommendations and Structured Product ideas please do not hesitate to get in touch.

Best wishes,



Manish Singh, CFA

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