

“Germany’s policy to prioritise “trade” over everything else, has come back to bite hard, as Europe faces its winter of discontent. With EUR/USD at parity, Europe’s exports would be so much more competitive only if it had the oil & gas at reasonable price”

Summary

Not long ago, Europe (read the European Union) was concerned about the direction in which the US was going. Phrases like “terminal decline,” “too divided” and “too dysfunctional” appeared regularly in the European press and diplomatic channels. Many in Brussels openly questioned the international order led by the United States and ridiculed its then President Donald Trump. In September 2018, in a speech at the United Nations General Assembly, when Trump accused Germany of becoming ‘totally dependent’ on Russian energy, German diplomats were caught on camera laughing and German Foreign Minister Heiko Maas could be seen smirking alongside his UN colleagues. EU leaders considered America’s decline as inevitable and started to distance themselves from the US. Then Russia invaded Ukraine, and everything changed.

Germany’s policy to prioritise “trade” over everything else has come back to bite hard, as Europe faces its winter of discontent. Europe’s delusion of independence was a sand castle, as in reality, it depended on Russia for its energy, China for its trade and the US for its trade and security. With the EUR/USD exchange rate at parity, Europe’s exports would be so much more competitive only if it had the oil & gas

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at the reasonable price needed to run manufacturing, industries, agriculture or even its tourism industry. Everything is underpinned by energy. Energy is responsible for at least half the industrial growth in a modern economy, while representing less than one-tenth of the cost of production.

US Fed Chair Jerome Powell's comments at the Jackson Hole summit last week, highlighted that the Fed is preparing to shift from a phase of rapid and large interest rate increases, to potentially smaller increases, focusing on slowing demand and then holding the rates instead of cutting them too soon. Unfortunately, Powell can't take the most meaningful step to tame inflation – prevent the fiscal authorities from increasing spending by hundreds of billions of dollars in spending programs once every few months. This is also a mid-term election year in the US. Seasonality indicates that the S&P 500 (SPX) could be in for a nice rally as we head into the final quarter of the year. In a mid-term election year, the SPX bottoms by the end of Q3 and has a real flourish in the last quarter with the index up +6.0% on average, so big year-end rallies are common.

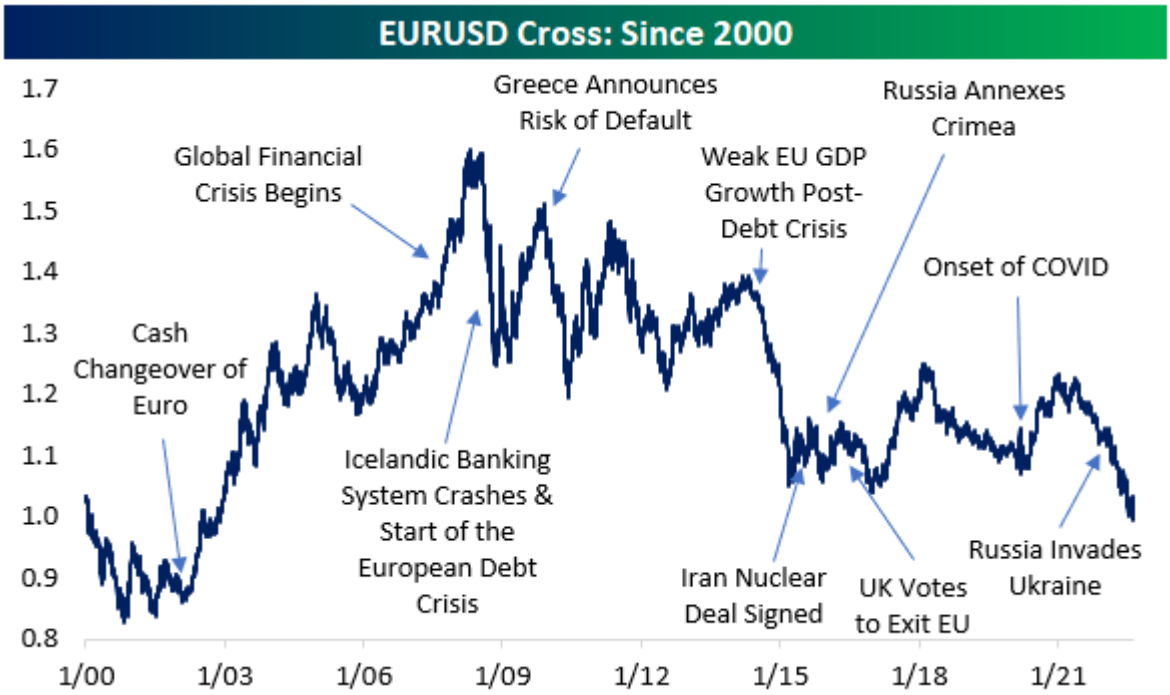
"German irrationality" is Europe's Achilles' heel

The EUR/USD exchange rate stood at 1.60 in the summer of 2008. Last week, the Euro fell below parity and there it remains. For the first time in nearly twenty years, the US dollar is more valuable than the Euro.

The last time the Euro traded at this level versus the dollar, we all printed out directions from MapQuest for our long drives, there was no such thing as social media with MySpace still six years away yet everyone was starting to chat on MSN messenger, the iPhone was still a dream in Steve Jobs' eyes, Nokia 3310 was the bestselling phone with everyone playing Snake (the unwieldy and addictive game that came as standard with every handset), and all you could do with your phone was make calls and send SMS messages, the Baha men and everyone else was asking '*Who Let the Dogs Out*', the first MP3 had just been launched and we were all using a website called Napster to download music and it took forever on that dial-up internet which went Screeeech . . . hisss . . . squawk (interspersed with whistles and chirps), the frustration, however, no way diminished the excitement of getting online.

The chart below summarizes the major events that have impacted the Euro since the turn of the century. It's been a wild ride!

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Source: Bespoke Research

One would expect that with such a weak currency, the Eurozone would be printing record trade surpluses and the economy would be growing at over +3%, instead, the Eurozone is moribund, inflation is running at over +10% and the region is staring at a recession. The European Central Bank (ECB) is forced to raise rates precisely when the economy is suffering and it has also morphed into a "political lender" as it helps to keep the lid on the Eurozone's sovereign debt crisis from flaring again.

Not long ago, Europe (read the European Union) was concerned about the direction in which the US was going. Phrases like "terminal decline," "too divided" and "too dysfunctional" appeared regularly in the European press and diplomatic channels. EU leaders considered America's decline as inevitable and were preparing for this eventuality, by taking measures to be less dependent on the US.

Many in Brussels openly questioned the international order led by the United States and ridiculed its then President Donald Trump. In September 2018, in a speech at the United Nations General Assembly, when Trump accused Germany of becoming 'totally dependent' on Russian energy, the German diplomats were caught on camera laughing. German Foreign Minister Heiko Maas could be seen smirking alongside his UN colleagues.

There's a reason why everyone in Europe is terrified of Germany. If this is the attitude when they are weak and vulnerable, then you can imagine what it would be when they are in a position of strength. Well, you don't have to imagine it, just read about it in history. The fear of Germany has shaped Europe's policy and all the consequences flow directly from it.

Then Russia invaded Ukraine, and everything changed. Europe's grand thinking of building ever closer trade ties with rival global powers China and Russia are in tatters, and American strength has reasserted itself. Europe discovered it had in fact become more dependent on America and not less.

Germany has made a series of mistakes in its (and by extension the EU's) foreign policy, yet nobody

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dared to stand up and criticise – barring Poland and Hungary who know their history lessons well.

History tells us that "German irrationality" is Europe's real Achilles' heel and it seems nothing has changed in over a century. In 1897 Europe was, collectively, the hegemon and goliath of the world in almost every sense – economic, trading and military power. Europe covers roughly 7% of the land mass of the Earth, but by 1800 it ruled 35% of the globe and by 1914 a staggering 84%. Even America was still an emerging and localised power mostly concerned with completing its conquest and colonisation of its own continent. Germany, put paid to Europe's dominance spectacularly as German jealousy of the British Empire blew things up in Europe and led to two world wars, that devastated the continent.

Europe's delusion of independence was a sand castle, as in reality it depended on Russia for its energy, China for its trade and America for its trade and security.

In pursuing a policy of "independence from America", Europe found itself in the worst of all worlds and in a desperate attempt to save itself, has rushed back to clinging even more closely to Washington than ever before. The very leviathan it ridiculed and derided, is now its saviour, as an energy crisis and a belligerent Russia threatens to ravage the continent. The US has increased its military presence on the continent, and Europe has started importing American gas.

The new world order is more about security than trade, something EU-philes don't seem to understand. The EU is an empire that can't protect itself. It is trade-focused and that is what has led to its military weakness.

Wrong policy choices always come home to bite. In last month's Market Viewpoints I highlighted German folly concerning its trade policy and that is pretty much the story of the continent – reliance on cheap energy to ramp up exports and no efforts to secure energy independence. Europe's exports would be so much more competitive with a weak Euro, only if it had the oil & gas needed to run manufacturing, industries, agriculture or even its tourism industry. Everything is underpinned by energy. This is the reason China is so focused on securing its energy supply and the US is in an enviable position of being energy abundant, so much so, that they can export energy.

Energy is a foundation stone of the modern industrial economy. Energy provides an essential ingredient for almost all human activities – cooking, heating, lighting, health, food production, storage, mineral extraction, industrial production, transportation etc. Energy is the engine of economic and social development. The history of industrialisation has shown us that if a nation has to move beyond subsistence, then access to energy, for its broad section of the population, is the necessary condition.

Research has indicated that energy is responsible for at least half the industrial growth in a modern economy, while representing less than one-tenth of the cost of production.

Europe therefore has tough days and cold winter nights ahead. Humility and long-term planning will serve it well. However, for now, the Euro is likely headed lower and the international order if anything, is more dependent on the American military, economic, and financial might now than ever before.

Like any sell-off, the Euro will rebound and I see 0.84 as that rebound level. If the US Federal Reserve (Fed) pivots, then the rebound could be sooner, but the Euro will likely spend a long spell below or close to parity, given the economic and political mess that's facing the Eurozone.

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As for “dysfunctional America”, the social unrest today in the US is nothing like what it was during the 1960s when the Vietnam War and the Civil Rights movement caused social upheaval. What Europeans simply don’t understand is that America has never been “orderly” or “restrained.” Switzerland it isn’t. Americans have always been loud, divisive and more concerned with individual rights than with collective responsibility, as in Europe. But the difference between the US and the rest of the “dysfunctional/divisive” democracies (say Latin America) is that when the chips are down, Americans know how to forget any differences, save the nation and re-build to a new level of strength.

Markets and the Economy

The S&P 500 (SPX) has had quite an impressive run lately, with a +10% gain since the mid-June low. However, the index remains more than 15% below its all-time high seen on the first trading day of 2022.

A fall in headline inflation from +9.1% to +8.5% added more legs to the rally in August. This was the first negative surprise to headline inflation in over 6 months.

Gas prices in the US have moved down to $3.95/gallon (national average), $1.06 below their all-time high in mid-June and at their lowest levels in over 5 months.

Regular readers of this newsletter will know my view that the US cannot afford to have higher rates due to the high level of debt in the US economy.

I repeated this on CNBC two weeks ago – There is no way the U.S. can sustain an interest rate beyond 2.5% in the long term

We will likely see another +0.50% hike in the Federal Fund Rates (FFR) at the September 21 meeting of the US Federal Open Market Committee (FOMC) which will take the FFR to +2.75%. However, over the medium term, the state of debt, the deficit and economic growth in the US means that the FFR will stabilise in the +2.25% to +2.5% range.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

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Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)	July-August 2022 Performance (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	62.9%	32.0%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	5.4%	14.0%
MXIN Index	MSCI INDIA	India	27.3%	2.3%	12.8%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	-1.4%	3.6%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-2.4%	8.5%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-9.4%	-0.4%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-12.0%	-4.8%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-12.5%	4.9%
CAC Index	CAC 40 INDEX	France	28.9%	-14.0%	5.9%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-14.7%	-7.7%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-16.4%	7.2%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-17.7%	4.3%
DAX Index	DAX INDEX	Germany	15.8%	-19.0%	1.5%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-19.4%	0.6%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-21.0%	2.8%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-24.0%	10.1%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-37.3%	2.9%

Source: Bloomberg

In terms of data:

- 1. US consumer spending barely rose in July, but inflation as indicated by Personal Consumption Expenditure (PCE) – which the US Federal Reserve prefers to the CPI – eased considerably, which should give the Fed room to sound less hawkish. The PCE price index decreased by -0.1% in July, the first MoM negative print since April 2020
- 2. On an annual basis, PCE rose +6.3% in July from a year earlier, down from +6.8% in June. The core PCE which excludes volatile food and energy prices—increased +4.6% in July from a year ago, down from +4.8% in the year through June
- 3. World Container Index (WCI) publishes weekly indices on the cost to move containers between ports around the world on a spot basis. The latest data published by WCI indicate there has been a significant easing in the freight cost. Pre-pandemic shipping costs ran around $1600 per 40-foot box from Shanghai to Los Angeles. That number rose by nearly a factor of 10 through the peak in 2021 but it's fallen by half since that peak. On average across a range of shipping routes, container costs have fallen by -42% from the peak. This is just the latest data confirming that supply chains have eased dramatically over the last six months.
- 4. At the current level of 34.4, the Prices Paid component of the Dallas Fed report is now at its lowest level since October 2020, and besides the Richmond survey, every other Prices Paid component is at its lowest level since at least January 2021. This month was the second month in a row, that all five Prices Paid components of the regional Fed surveys declined on a month-over-month basis.

Last week, US President Joe Biden announced that he will cancel $10,000 in US federal student loan debt for borrowers making under $125,000 a year or for couples making less than $250,000 a year. Biden is playing Santa Claus again as the US mid-term elections are around the corner.

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US taxpayers will pay for this. Thanks to Biden, now every American will become saddled with student debt.

If you worked your way through school, you received nothing, and now you will pay for others who cannot or will not pay off their student loans. If your parents saved for you to attend college, they don't receive a refund and will now pay for the student loans of others via taxes.

The irony of Biden's policy is there are over 11 million unfilled jobs in the US. That means there are millions of opportunities for those with student debt to earn the money to pay off their debts. Next time, Biden will be better off offering everyone a free college degree, and the US will save billions on the cost of issuing and then cancelling loans.

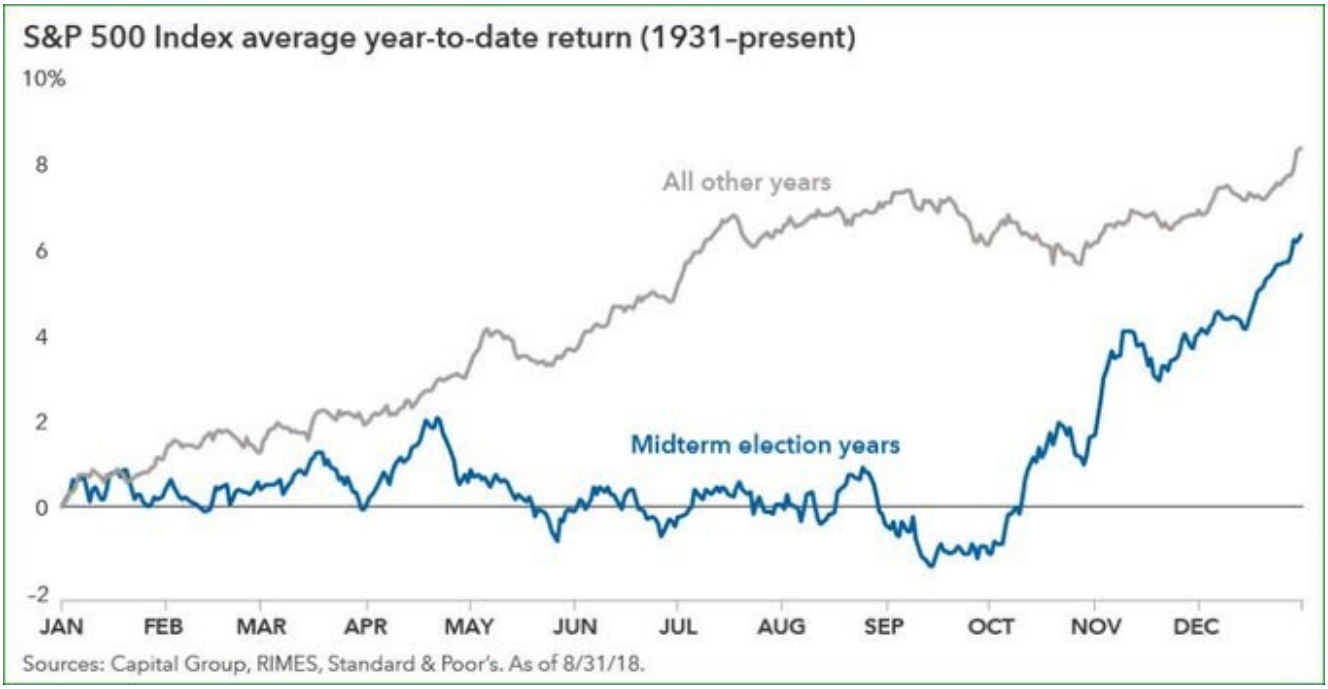
The reason I bring up the mid-term elections for discussion, is the seasonality of SPX returns during a mid-term election year.

In the post-WWII period, the SPX has gained +5.03% on average in mid-term years, but it pales in comparison to the average gain of +8.95% for all years.

Further, in a mid-term election year, the SPX bottoms by the end of Q3 (see chart below from Capital Group) and has a real flourish in the last quarter with the index up +6.0% on average, so big year-end rallies are common. One to watch out for.

The adage that markets don't like uncertainty, seems to apply here. Early in the year, there is less certainty of the election's outcome and the subsequent effects on future policy changes therefore the markets tend to oscillate for most of the year, gaining little ground until shortly before the elections. Markets tend to rally when results are easier to predict, in the weeks leading up to the election and continue to rise after the polls finally close and the winners are declared.

S&P 500 index performance and US midterm election year seasonality



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Fed Chair Jerome Powell's address at the Kansas City Fed's annual symposium in Jackson Hole, Wyoming was the most eagerly awaited event last week and he didn't disappoint. He offered enough to both the hawks and the doves.

Powell said the economy "continues to show strong underlying momentum" and added "we are moving our policy stance purposefully to a level that will be sufficiently restrictive to return inflation to 2%."

The hawkish part was – while the Fed's current rate setting is in a "neutral" zone, such a level of rates is "not a place to stop or pause" when inflation is so high and the labour market is so tight. Bringing inflation down was likely to "require maintaining a restrictive policy stance for some time," he said. "The historical record cautions strongly against prematurely loosening policy."

The dovish part was – the next rate decision "will depend on the totality of the incoming data and the evolving outlook," he said. "At some point, as the stance of monetary policy tightens further, it will likely become appropriate to slow the pace of increases."

Powell's comments highlighted that the Fed is preparing to shift from a phase of rapid and large rate increases, to potentially smaller increases focusing on slowing demand and then holding the rates instead of cutting them too soon.

Unfortunately, Powell can't take the most meaningful step to tame inflation – prevent the fiscal authorities from increasing spending by hundreds of billions of dollars in spending programs once every few months.

Inflation is ultimately a political choice, even though we look to central banks to tame it. It's easy to create inflation – just print and give away lots of money to everyone. By the same measure, it's easy to create deflation too – raise taxes. The key to the future outlook for inflation, therefore, is not an economic model, but the political choices, desires and wants of the population.

Despite the sharp declines last week in response to Powell's comments at Jackson Hole, most sectors remain above their 50-day moving averages (DMA) with the only two exceptions being Communications Services and Health Care.

It remains to be seen whether last week was a pause in the sharp rally off the June lows or a resumption of the bear market, but if the majority of sectors can stay above their 50-DMAs, the bulls still have hope to cling to.

Benchmark US equity sector performance (2021, 2022 YTD)

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Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance	July-Aug 2022 Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	46.4%	15.8%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	4.5%	8.0%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-4.6%	3.1%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-10.9%**	**-0.7%**
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-11.4%	9.4%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-14.7%	7.2%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-15.7%	6.2%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-18.9%	5.2%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-21.4%**	**10.0%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-23.2%**	**16.1%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-30.2%**	**1.6%**

Source: Bloomberg

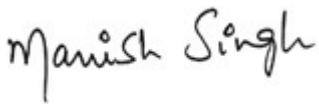
Since both the bears and bulls seem vindicated, volatility abounds, and structured products are the perfect vehicle to monetise income and retain an upside in market performance.

Seasonality indicates that the S&P 500 could be in for a nice rally as we head into September/October. So, please bear that in mind.

There are plenty of high-quality stocks in the consumer, tech, industrial and health care sectors that are trading at -15% to -20% on a YTD basis, and present a good opportunity to invest, 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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Europe has a tough winter ahead, but it seems the energy problem may start early. The Nord Stream pipeline gas supply not coming back on later this week, will push Germany into a very tenuous situation and a deep recession.

Summary

Germany's political decision to distance itself from the US (and the UK for that matter) and follow *Ostpolitik* (German for "new eastern policy") to build a greater Europe it thought it could shape and then benefit from – has been its greatest post-WWII miscalculation. Even more inexplicable, has been Germany's failure to change course as the Soviet Union disintegrated at the end of the 1990s. Instead, Germany chose to rely even more on Russia and provided Russia with the leverage that it now has over energy supplies to the European continent.

Russia is constraining gas supplies right now to ensure that European countries cannot fill their storage for winter months. The Nord Stream pipeline is now shut for regular maintenance and is due to reopen on July 21. Russia may well decide to ratchet up the pressure and not reopen the Nord Stream pipeline, or at least not turn it on for a few days or weeks, thus cutting supplies to zero. Russia is suffering economically and not turning the taps back on may move Russia's suffering level from 6 to 7 but, in Europe, the pain level could jump from 2 to 7, and that will have catastrophic outcomes economically, socially, and politically. Is Europe prepared for this?

Inflation in the US hit a new high of +9.1%, yet the bond market does not seem in any way panicked. The yield on the 10y US Treasury is now down to +2.9%. It was at +3.5% a month ago. The long end of the bond market is screaming what's coming after the interest rate hikes – rate cuts. Commodity prices continue to weaken. Base metals (Copper and Aluminium) prices have fallen by a third or more from their

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highs. Oil prices have fallen by almost -20% over the last six weeks. Growth concerns and recessionary fears are growing.

In a directionless equity market such as the present, volatility abounds, and structured products are the perfect vehicle to monetise income and retain a participation in market performance.

Wandel durch Handel ("Change through trade") has had its day

As is becoming evident with every passing month, Germany's decision over the last two decades to shut down German nuclear plants and replace them with more Russian gas and coal is proving to be a case of economic vandalism on a continental scale. Former German Chancellor Angela Merkel has a lot to answer to, for the disaster that Germany's industry faces if Russia were to cut-off energy supplies.

However, Germany's decision to work closely with Russia is not Merkel's doing alone. It goes back to the 1970s when Germany's Chancellor was Willy Brandt. Since then, successive German Chancellors have put German business interests above all else. Ironically, that same hardnosed policy risks being Germany's undoing.

In the post-World War II world, since at least the 1970s, Germany has aggressively pursued the policy – *Wandel durch Handel or* "Change through trade" which has seen it embrace autocracies (China), kleptocracies (Russia), and theocracies (Iran) in the name of doing business or as Jörg Lau in an article in the German weekly Die Zeit put it "*Die deutsche Liebe zu den Diktatoren* (The German love for Dictators)" . Strikingly, this approach to value "stability", and achieve "change through trade" above all else, has remained dominant for the last 50 years and has earned Germany rich dividends. However, the present energy crisis brought on by the Russia-Ukraine war, suggests that the approach has had its day and is quite dangerous in the longer term for Germany (and by extension Europe's) interests.

In my opinion Germans, particularly the Social Democrats, have mistakenly given this policy more credit than it deserves, for Germany's unification and success over the last 50 years. Indeed, West Germany's acceptance of the post-war territorial order and the renunciation of German claims for the lost lands in the East, persuaded then USSR President Mikhail Gorbachev to accept that Germany was no longer a threat to the Soviet Union, and hence West and East Germany could unite. However, without the support of the United States, Article 5 of the North Atlantic Treaty Organization (NATO) which states that – an attack on one member of NATO is an attack on all of its members – German unification would not have happened or indeed succeeded.

Germany's political decision to distance itself from the US (and the UK for that matter) and follow Ostpolitik (German for "new eastern policy") to build a greater Europe it thought it could shape and then benefit from – has been its greatest post-war miscalculation. Even more head scratching and inexplicable, has been Germany's failure to change course as the Soviet Union disintegrated at the end of the 90s. Instead, Germany chose to rely even more on Russia and provided Russia with the leverage that it now has over energy supplies to the European continent.

The Nord Stream pipeline runs 760 miles under the Baltic Sea from Vyborg, Russia to Lubmin, Germany

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Last Monday, the Nord Stream pipeline, which supplies the bulk of Russian gas to Europe, closed down for 10 days for routine annual maintenance. The maintenance runs from July 11-21. Repairs that are routine in times of peace, would not be a subject of discussion. However, these are not peaceful times.

The EU (and the West) have made it very clear that they want to suffocate the Russian economy into submission over its transgression in Ukraine. Cast off as a pariah, Russia is only too willing to use its Natural gas supply to Europe as a weapon. Moscow has already cut gas deliveries by more than half of the Nord Stream pipeline's capacity. Russia is constraining supplies right now to ensure that the EU countries cannot fill their storage tanks for the winter months. Russia may well decide to ratchet up the pressure and not reopen the pipeline, or at least not turn it on for a few days or weeks, thus cutting supplies to zero.

Bear in mind Russia squeezed gas supplies to Europe throughout last year leaving the continent's gas inventories at multiyear lows as winter approached. Russia reduced flows through Ukraine to persuade Germany and the European Commission (EC) to accelerate the Nord Stream 2 signoff and they did achieve it, even though the pipeline now lies unused. Russia has already cut gas supplies to Poland, Bulgaria, the Netherlands, Denmark, and Finland over their refusal to comply with a new payment scheme of paying for Russian gas imports in the Russian currency Ruble (RUB).

Russia is suffering economically and not turning the taps back on may move Russia's suffering level from 6 to 7 but in Europe, the pain level could jump from 2 to 7, and that will have catastrophic outcomes economically, socially and politically.

Is Europe prepared for this? The next few days and weeks will tell.

We are not even in the winter months and the pain is clear. France is nationalizing nuclear giant Electricite de France SA (EdF), and Germany is in talks to bail out one of its largest energy providers, Uniper SE, as the stand-off with Moscow chokes the finances of the company. Europe has a tough winter ahead, but it seems the energy problem may start early. Nord Stream supply not coming back on, will push Germany into a very tenuous situation and a deep recession, as industries get devastated. German

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industries rely entirely on gas and most German homes use gas for heating. A recession and economic destruction would have major consequences on the whole of the Eurozone economy, given Germany's importance to the Eurozone.

The German think tank, Agora Energiewende calculates that by investing in energy efficiency and renewable energy alone, 80% of Russian gas imports could be replaced by 2027. If combined with alternative gas supplies such as LNG, it could even be 100%, the think tank suggests.

There is just a small matter of dealing with the winters between now and then…

Russia is using winter as part of their military strategy. Oh! No! Not again… wait, right, they have done this before, haven't they?

The stringent "Climate goals" in the face of the energy crisis represent the West's – have your cake and eat it too – dilemma.

I am all for clean energy and "net zero". However, it must be weighed against reality. Not budging on "net zero," as some are suggesting and not embracing fossil fuels for longer in the face of a crippling energy crisis, would be akin to New Yorkers in 1890 killing all of the horses and burning all of the buggies,10 years before the invention of the auto, in a relentless drive to replace horses and carriage, just because they had had it with the clattering sound that horse carriages made on the cobbled streets.

Losing control of the energy supply, fuelling inflation, and inviting economic misery, is sadly the likeliest path to the historical ugliness that Germany was so desperate to avoid when it chose to pursue *Wandel durch Handel* in engaging with Russia. Life always comes a full circle, and sometimes things that may look good in the short term, could prove to be an epic disaster in the long term.

For everyone's sake, let's hope before winter arrives, a resolution is in place, with all sides seeing the value of compromise, however imperfect it may be for each party.

As the damage to Europe's economy unfolds it could force European leaders to increasingly push Ukraine to seek a peace deal – some like France, already are.

If all else fails, perhaps Frau Merkel can refer to her friendship with Russia and write a polite "Dear Vladimir" letter to President Putin asking him to delay his aggression until Germany becomes energy independent.

Markets and the Economy

The equity market has seen a bounce in July after having a bad June (see table below) which saw the S&P 500 index (SPX) lose -8.4%. The index is down -19% for the year i.e. nearly half of the year's decline has come in June.

Two factors have played a significant role in the swings of asset markets throughout the year – expectations for economic growth and expectations for the path of interest rates. In the first half of the year, the concerns about growth were a much smaller factor, than concerns about how high the Fed Funds Rate (FFR) could go in the US.

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The expectations of the FFR hitting +4.5% by mid-June next year have moderated over the last four weeks, and the expectation now is for FFR to be at +3.5% in June next year. However, as rate rise expectations have shifted downwards, growth concerns abound,, with talk of an impending recession in the US.

Karl Otto Pöhl, President of Germany's Bundesbank from 1980 to 1991 once said – *"Inflation is like toothpaste. Once it's out, you can hardly get it back in again."*

US Consumer Price Index (CPI) data out last week, showed that inflation reached +9.1% in June, higher than May's +8.6% and the highest rate in nearly 40 years.

US Federal Reserve (Fed) Chairman Jerome Powell must certainly feel like he is trying to squeeze toothpaste back into the tube, as he tries to contain inflation. The percentage of items in the CPI basket whose YoY prices are increasing by over +4% is now at a new record high of over 70% i.e. inflation is very broad-based and at over +4% for the majority of items in the basket. This will concern the Fed.

Core inflation, which strips out volatile food and energy components, however, increased by +5.9% in June from a year ago. A slightly slower pace than May's +6% increase. It indicates that the core inflation has levelled off and has started to come down ever so slowly.

Another interesting piece of recent data is US real earnings, which keep dropping. Real average hourly earnings decreased by -3.6%, seasonally adjusted, from June 2021 to June 2022. This does not bode well for consumption. Consumers are getting increasingly squeezed both in magnitude and overtime when it comes to their purchasing power, and this means the Fed's hawkishness is working.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)	June 2022 Performance (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	18.4%	-8.6%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	-1.6%	-5.8%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-7.0%	**-3.3%**
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	-7.9%	-11.5%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-7.9%	**-8.5%**
MXIN Index	MSCI INDIA	India	27.3%	-8.0%	**-5.2%**
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-9.9%	**6.7%**
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-10.9%	**2.1%**
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-13.9%	**-6.7%**
CAC Index	CAC 40 INDEX	France	28.9%	-14.5%	**-8.4%**
DAX Index	DAX INDEX	Germany	15.8%	-17.9%	**-11.2%**
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-17.9%	**-8.8%**
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-18.9%	**-8.4%**
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-21.9%	**-7.1%**
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-22.5%	**-13.1%**
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-26.8%	**-8.7%**
IMOEX Index	MOEX Russia Index	Russia	15.1%	-44.5%	-6.4%

Source: Bloomberg

Amongst all this high inflation data and the expectations of more interest rate hikes, the bond market does not seem in any way panicked.

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The front-end yields (3 months to 2-year maturity) have increased as Fed hawkishness is re-priced, but long-end yields (10 years plus) fell on the day we got a record CPI print of +9.1%. The yield on 10y US Treasury is now down to +2.9%. It was at +3.5% a month ago. Bond yields move in the opposite direction to prices.

Well, the long end of the bond market is screaming what's coming after the interest rate hikes – interest rate cuts.

Bond futures show over a 100 bps of cuts are now priced between Dec 2022 and Jun 2024. It will be the fastest cutting cycle ever immediately after the Fed finished hiking. This is what is helping long-dated bonds rally.

On Tuesday, Japanese bank Nomura Holdings became the first major bank to forecast rate cuts next year. Nomura expects the US Federal Reserve (the Fed), the Bank of England (BoE) and the European Central Bank (ECB) all to begin rate cuts as soon as the middle of next year. In my opinion, the recent set of economic data indicates that, while the near-term inflation numbers may remain high, more rate rises now, only mean more rate cuts next year.

The FFR may get to over +3.5% this rate hike cycle, as some expect. However, over the medium term, the state of debt, deficit and economic growth in the US, mean the FFR will stabilise in the +2.25% to +2.5% range.

Inflation above +9% was cue enough for some in the market to price a 100bps at the July 27 Fed meeting.

A word of caution – the Fed does have its vreputation and credibility to protect. The Fed did not look good last time when it raised rates by +0.75% at its June 14-15 meeting. The Fed's rationale for its more aggressive tightening stance was leaked in a *Wall Street Journal* (WSJ) article. So, worried was the Fed about a particular set of data – the preliminary University of Michigan (UMich) Sentiment report that showed rising inflation expectations, that the Fed saw it wise to signal a +0.75% rate hike ahead of the actual hike.

During the press conference that followed the June Fed decision, Fed Chair Powell remarked, *"…one of the factors in our deciding to move ahead with 75 basis points today was what we saw in inflation expectations….the preliminary Michigan reading, it's a preliminary reading. It might be revised. Nonetheless, it was quite eye-catching, and we noticed that. We're absolutely determined to keep them anchored at 2%."*

In an interesting twist, less than two weeks later, the uptick in inflation expectations in the UMich data, was revised away. The fact that the Fed changed the trajectory of its tightening path on a preliminary report that proved to be a 'false alarm,' is disconcerting and shows the chances of a monetary policy error by the central banks in the febrile economic situation that the world finds itself in. It makes the job of forecasting rates even more difficult. Therefore, please take every extreme/sensational forecast with a huge dollop of salt.

Last week, the International Monetary Fund (IMF) cut its forecast for US GDP growth down to +2.3% from +2.9%. This news is notable for two reasons.

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First, it comes less than a month after the IMF downgraded its growth forecast in the US to +2.9%.

Second, given the indication from the Atlanta Fed's GDPNow model, which is calling for a Q2 contraction of -1.2% following Q1's decline of -1.6%, the US economy would need to grow by +3.2% in the second half to reach that goal. Based on the trend in recent data and the Fed's tightening bias, that level of US GDP growth seems optimistic i.e. the IMF will cut its forecast again. So, we have a clear case of economic slowdown, and the Fed will not ignore this. A +9.1% inflation print, however, has sealed at least a +0.5% increase in the FFR later this month, no matter how weak the data over the next two weeks.

Even if the Fed knows inflation has peaked or is near peak, the Fed will use every opportunity to get rates as high as it can without breaking the economy to give itself the headroom it will need once growth concerns return and they already are. The Q2 US GDP print is likely going to be -1% or worse. That will confirm the US economy is in a recession.

Even as prices have moved marginally up, commodity prices continue to weaken (table below). Base metals)Copper and Aluminium) prices have fallen by a third or more from their high. Oil prices have fallen by almost -20% over the last six weeks. Growth concerns and recessionary fears are growing.

Commodity performance over the last 12 months

Ticker	Name	1 Month Performance	3 Months Performance	YTD Performance	Performance from 52 Wk High
CLA Comdty	NYMEX Light Sweet Crude Oil Future	-7.7%	-4.9%	38.1%	-17.6%
COA Comdty	ICE Brent Crude Oil Future	-6.2%	-4.7%	38.4%	-15.0%
QSA Comdty	ICE Gas Oil Future	-12.4%	7.2%	69.2%	-16.1%
LMAHDS03 Comdty	LME Primary Aluminum 3 Month Rolling Forward	-9.6%	-28.7%	-16.5%	-42.5%
LMCADS03 Comdty	LME Copper 3 Month Rolling Forward	-22.1%	-30.3%	-26.0%	-33.7%
XAU Curncy	Spot Gold Price	-6.5%	-13.2%	-6.0%	-17.0%
KCA Comdty	NYBOT CSC C Coffee Future	-9.9%	-8.4%	-8.7%	-20.2%
Source: Bloomberg					

Benchmark US equity sector performance (2021, 2022 YTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance	June 2022 Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	23.6%	-18.0%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	-2.5%	-5.7%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-5.4%	-3.1%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-7.6%**	**-3.0%**
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-17.9%	-7.8%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-18.6%	-11.3%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-20.5%	-14.4%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-20.9%	-7.6%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-23.9%**	**-9.5%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-28.7%**	**-9.8%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-29.2%**	**-11.0%**

Source: Bloomberg

Investors' nerves are still frayed as equity benchmark indexes are still down over -15% across the board and sector indexes (table above) by over -20% in many cases.

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The headline US Consumer Price Index (CPI) report has rarely come in weaker than expected complicating matters for equity bulls like me to take/recommend directional trades with a high degree of conviction. In the two years through May's report, there have only been two weaker-than-expected headline CPI reports, which is easily the lowest number over a two-year span in at least twenty years.

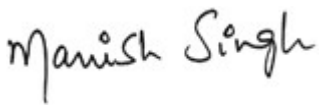
In such a situation it is best to invest wisely. Therefore, my insistence throughout the year for income strategies using structured products.

In a directionless market such as the present, volatility abounds, and structured products are the perfect vehicle to monetise income and retain an upside in market performance. Structured products also help an investor clip coupons, if (and it certainly looks like it) economic growth is going to disappoint, leading to the limited upside for equities.

There are plenty of high-quality stocks in the consumer, tech, industrial and health care sectors that are trading at -10% to -15% on a YTD basis, and present a good opportunity to invest using a structured product. Just last week, we structured and traded one such basket on industrial names with a coupon of +12.75%.

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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Lost in the turmoil of the 1970s, is the fact it was a decade full of breakthroughs in electronic, data-processing and medical technology. The email, the floppy disk, the first real video game, the personal computer all came in 70s. The 70s game us Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot.

Summary

The 1970s get a lot of bad press. It was however a decade not just about gloom, economic crises, bell-bottom trousers and thick sideburns. It was also a remarkable decade, full of breakthroughs in electronic, data-processing and medical technology, including email (ARPANET), the floppy disk (IBM), the first real video game Pong (Atari), and the personal computer (Apple). The 1970s gave us companies like Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot.

So, you see, lost in the turmoil of the 1970s, is the fact that the US economy was going through a painful, yet necessary, transformation. New ventures formed, that in years to come would radically change the US and the world economy. The changes and innovation of the 1970s set the stage for a new type of economy in the future – less manufacturing more services, less labour intensive and higher productivity. Anybody can brand the prevailing economic problems in the 2020s as a "crisis," raise the flag of fear and get bearish. It takes however a mixture of intellectual boldness and gritty determination to see the ongoing innovation in the economy and hence the future.

The equity markets are in oversold territory, however, it's the US Federal Reserve pivot on interest rates and inflation that the market is waiting for, in order for a sustainable rally to set in. For the Fed to do

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this, it has to see the inflation data start falling measurably. If economic data continues to worsen (and they are), inflation will slide and then one can expect Fed talk to change tack and indicate a desire to slow down or pause tightening. Until then, keep your seat belts fastened, volatility will abound.

Were the 1970s really that bad?

Of all the post-war decades, the 1970s is seen as the worst. A decade full of economic woes, sandwiched between the swinging Sixties and the go-getting Eighties.

All you ever read or hear about the '70s is – double-digit inflation, high unemployment, and mortgage rates as high as +20%. The decade witnessed two US economic recessions, at least two severe global energy crises, the unprecedented peacetime implementation of wage and price controls in the US, and the abandoning by the US of the global monetary system established during World War II.

The "energy crisis" played a key role in the economic woes of the 1970s. In a televised speech in 1977, then US President Jimmy Carter donned a sweater to put across his message of "energy conservation" and in doing so became the first US President to make an official appearance before the nation wearing a sweater. The fear of energy shortages, which necessitated production cuts and job cuts, was making things worse. The impact of higher prices would be felt in rising inflation and falling business confidence, which plagued the entire decade.

However, just because inflation is today at +8.3% in the US and talk of 1970s-like economic woes fills the airwaves, I am not writing this newsletter to add to the noise. In the paragraphs below, I intend to dwell on: Were the 1970s really that bad or, were there redeeming features and events that we can take comfort from?

Old Shell Petrol Station 1970s



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Today, we do not have an energy shortage. We have an excess of it, if only we could ship it to where it's needed. The shortage of energy or "peak oil," has often been used as a bogeyman by energy producers and traders, to drive energy prices higher, which in turn drives up input costs for almost everything we produce and consume and use to get around. Energy is the lifeblood of our economy.

Daniel Yergin's book "*The Prize: the Epic Quest for Oil, Money, and Power*" is a fascinating read as to how the old-fashioned "energy crisis" has travelled through time, since the oil industry came into existence in the 1890s.

In 1920, the head of the US Geological Service warned that US reserves would be depleted in exactly nine years and three months. In 1930, just as the feared date of exhaustion arrived, the industry was rocked by the discovery of the huge East Texas field. The ensuing flood of oil sent prices crashing down to 10 cents a barrel during the Depression. A similar fear of shortage after World War II led to new technological developments and the opening up of the huge oil fields of Saudi Arabia, Kuwait and elsewhere in the Middle East. Fast forward to the 21st century and we know what "shale oil" has done for the energy market and geopolitics. The US has become energy independent and its influence on global geopolitics has been enhanced. On the other hand, Russia, the largest energy exporter has seen its standing and influence slump.

In his book, Yergin reminds us that the consequences were the same as in virtually every other "energy crisis" since "Colonel" Edwin Drake struck oil in western Pennsylvania in 1859 – smaller companies slashed spending to survive, larger companies postponed new projects, people were let go, human ingenuity prevailed, new technologies were again deployed, new territories were opened up, and new supplies came through.

The reason I highlight this, is to make just one point – never underestimate human ingenuity in solving a problem to come out of a crisis. In the immortal words of US President Franklin D. Roosevelt – "The only thing we have to fear is fear itself." Those words and the sentiment they convey have and will continue to find an echo in many a bosom for many years to come.

It was not just the US, but the UK too that had its pessimism and gloom in the 1970s. In November 1974, then UK Foreign Secretary (and later Prime Minister) James Callaghan said this to his colleagues – *"Our place in the world is shrinking: our economic comparisons grow worse, long-term political influence depends on economic strength – and that is running out. If I were a young man, I should emigrate."* Yet, what followed the winter of discontent, was over a decade of glorious growth and prosperity under Prime Minister Margaret Thatcher.

Today, we do not have the unemployment problems of the 1970s. The US and the UK have more jobs than the number of people looking for employment. The unemployment rate in many a country is at historical lows and speaks of economic growth and consumption that lies ahead when we are past the headline inflation scare that abounds.

The 1970s were not just about gloom, economic crisis, bell-bottom pants and thick sideburns. They were a remarkable decade full of breakthroughs in electronic, data-processing and medical technology.

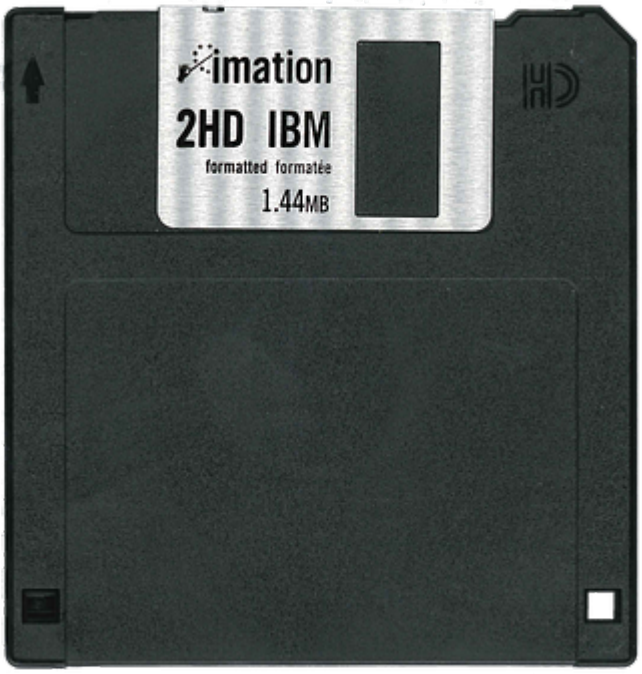
From the first mobile phone to the Rubik's Cube to barcodes, some of the world's greatest inventions emerged during the 1970s. The Email (ARPANET), the floppy disk (IBM), the first real video game Pong

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(Atari), the personal computer (Apple), the cell phone (Motorola), the video cassette recorder (Philips), the digital camera (Cromemco), the Global Positioning System or GPS (US Navy), the portable music player or Walkman (Sony) were all innovations of the 1970s.

The floppy disk may be a largely obsolete technology now, but its legacy remains. I wrote this newsletter in Microsoft Word and each time I wanted to save the document, I clicked on the floppy disk symbol in the top left corner.

An IBM floppy disk



The 1970s gave us companies like – Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot, to name but a few. If you were not a doom-monger in the 1970s and looked on the bright side (as I always advocate readers of this newsletter to do), you felt as though the future was now. Storied Venture Capital firms – Kleiner, Perkins, Caufield & Byers, Sequoia Capital, Apax Partners, New Enterprise Associates and Oak Investment Partners – all were founded in the 1970s. These firms made some of the most notable investments in Tandem Computers, Genentech, Apple Inc., Electronic Arts, Compaq, Federal Express and LSI Corporation to build the technology future that we so take for granted sometimes.

So, you see lost in the turmoil of the 1970s, is the fact that the US economy was going through a painful, yet necessary, transformation. New ventures formed that in years to come would radically change the US and the world economy. The changes and innovation of the 1970s set the stage for a new type of economy in the future – less manufacturing more services, less labour intensive and higher productivity. America, which was dependent on the large manufacturing companies for a large part of the twentieth century, underwent a transformation.

The Great Depression saw the birth of some massive US corporations – General Electric, General Motors, IBM, Disney, Hewlett-Packard (HP), Morgan Stanley, Texas Instruments, United Technologies, and Polaroid Holdings. Google, eBay, Bookings Holding, and Amazon, were created during the 1998 dot.com

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crash.

The entrepreneurial successes of the 1970s and the great Depression convey a fundamental message – hard times are good for business innovation. They lead to what Austrian economist Joseph Schumpeter (1883–1950) called “creative destruction” as talented people are shaken free from the clutches of old institutions and old thinking and the market for ventures and innovations booms. Technology has paved the way for economic transformation and improved quality of life and it’s not going in the reverse. You will see more and not less innovation going forward. You will not make money investing in companies of the future if you get shaken out by a correction. To make lofty returns in Yahoo (YHOO) one had to endure at least five -70% corrections.

The truth is that the 1970s were better than the decades before and the following decades better than the 1970s.

Anybody can brand prevailing economic problems a “crisis,” raise the flag of fear and get bearish. However, it takes a mixture of intellectual boldness and gritty determination to see opportunity. If you see things as the “beginning of something” rather than the “end of something,” you have a very good chance of seeing the future.

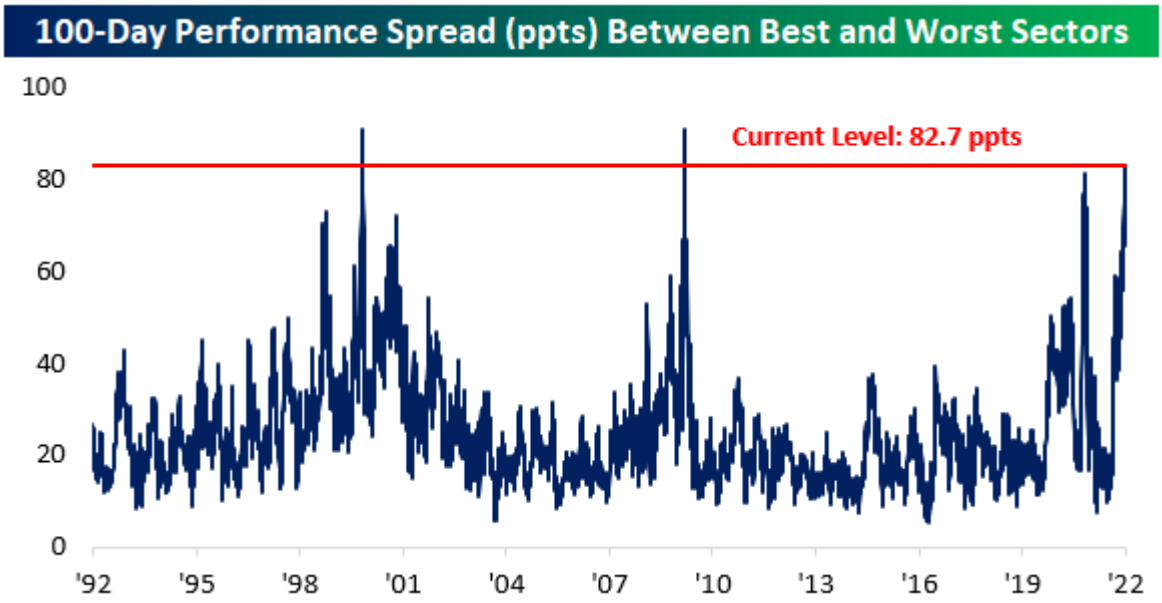
Markets and the Economy

If you are invested in the equity markets, then you know already that they have been extremely volatile this year.

The chart below from Bespoke Invest outlines how volatile, compared to prior years. So far in 2022, the S&P 500 (SPX) has averaged an absolute daily move of 121 basis points (bps). Although the broader index has been incredibly weak over the last 100 trading days (down -17.1%), performance among individual sectors has diverged widely, as Energy has gained +50.7% while the Communication Services sector has declined -32.0%. The +82.7% performance spread between the two sectors is one of the highest on record.

Only July of 2009 and March of 2000 saw higher readings.

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Source: Bespoke Invest

On May 16th, America's largest retailer, Walmart (WMT) reported its first quarter results. It reported a strong +3% rise in US same-store sales for the first-quarter, spurred by higher sales of food and health and wellness products. Walmart also raised its sales forecast for the year from +3% to +4% and expects second-quarter sales to rise +5%.

However, Walmart stock declined -11.4% that day. The reason – Walmart missed its earnings expectations, due to elevated cost pressure from fuel prices, higher inventory levels, overstaffing, e-commerce fulfilment etc.

The following day, Target (TGT) reported its earnings and suffered an even bigger stock slump of over -20%. The company said comparable sales grew +3.3% in the quarter ended April 30, which was better than the +0.24% that analysts had expected, but while total revenue grew, net profit fell by more than half. Soaring fuel costs, supply-chain bottlenecks, and inventory growth of +43% were some of the reasons for the earnings miss.

Consumer staples like – Target, Walmart, Costco and Home Depot (HD) have long been touted as "defensive" shelters from the storm buffeting the growth/tech sector, but that levy seems to have been breached. The sell-off in retail stocks, in my opinion, is overdone and it caused the SPX to dip below the 4,000 level.

The most intriguing part of both the WMT and TGT earnings announcements, was the over +30% to +40% jump in inventories, which amount to tens of billions of US dollars. It's the same story at other retailers Kohl's and Abercrombie & Fitch. The main reason for this, is the lingering supply-chain issues that have resulted in many retailers pulling forward inventory purchases to ensure sufficient supply, whilst at the same time consumers unwilling to pay higher prices for essential (consumer staples) goods – thus leading to a pile up in inventories. Higher inventories – be they due to overstocking or fewer items sold – lead to higher operating costs, as inventories have to be stored, moved and managed with no impact to the bottom line.

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This is going to serve as a key input to policymakers at the US Federal Reserve (Fed). If consumers start pulling back, a recession is a done deal. If staples see a decline, then discretionary spending – clothing, personal care and home furnishing, have little hope of holding on. How long could inflation hold up? The Fed will be mindful of not tightening into a recession.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	28.6%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	6.8%
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NKY Index	**NIKKEI 225**	**Japan**	4.9%	-4.9%
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CAC Index	CAC 40 INDEX	France	28.9%	-8.2%
DAX Index	DAX INDEX	Germany	15.8%	-8.4%
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SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-10.6%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-12.8%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-13.5%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-15.3%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-22.5%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-37.0%

Source: Bloomberg

Last week, we saw the Richmond Fed composite manufacturing activity data for May 2022 and it was abysmal. The reading came in at -9, the first negative reading since September of 2021, and the lowest since May 2020. The shipments sub-index swung to -14 from 17, while the volume of new orders was at -16 compared to 6 in the prior month. All very dire.

The flash Purchasing Managers Index (PMI) readings also showed a sharper deceleration. While manufacturing activity fell to a 3-month low, what surprised many was an even larger deterioration in service sector activity. Weakness in manufacturing output was expected, but the weakness in services (which fell from 55.6 to 53.5, a 4-month low) came as a surprise. This is yet another confirmation that inflationary pressures are having a worse impact on the US economy and demand is weakening sharply. The Fed may have to start taking the risk of a recession more seriously.

There was no joy on the new homes sales front either, as the sales plummeted in April by the most in nearly nine years, dented by the combination of high prices and a steep climb in mortgage rates. Purchases of new single-family homes decreased by -16.6%, the weakest since April 2020.

Freddie Mac data show that the average rate on a 30-year mortgage was +5.25% last week. In January 2021, it was +2.65%.

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Meanwhile, in Europe, the European Central Bank (ECB) continues to emphasize that monetary tightening needs to proceed gradually. At the recent World Economic Forum (WEF) in Davos, Switzerland, ECB chief Christine Lagarde remarked – "I don't think that we're in a situation of surging demand at the moment. It's definitely an inflation that is fuelled by the supply side of the economy. In that situation, we have to move in the right direction, obviously, but we don't have to rush and we don't have to panic."

Speaking at the WEF, in a timely reminder to central banks, Nobel laureate and economist Joseph Stiglitz warned that the US Fed raising interest rates won't fix inflation and the US needs a different kind of intervention – supply-side intervention. I made a similar point in my newsletter last month. Higher interest rates can create a barrier to increasing supply and therefore the Fed has to move carefully. Fewer goods are being made globally due to Covid-induced disruptions and changes to production and supply chain, increasing the cost of capital may have the intended outcome of making supplies worse.

With Retail, Food and even Pharmaceutical stocks down for the year, it's only Energy and Utility stocks that are in green (see table below).

Benchmark US equity sector performance (2021, 2022 YTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	59.5%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	5.3%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-2.7%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-3.6%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-4.9%**
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-8.9%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-9.8%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-13.5%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-18.6%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-22.5%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-24.8%**

Source: Bloomberg

The sell-off in US consumer staples (XLP) is overdone, and these remain good defensive stocks to hold in a portfolio.

The Technology (XLK) and the Communications sectors (XLC) are bottoming out, however, several growth stocks are +20% off their lows.

The key reason Consumer Discretionary (XLY) is the worst-performing sector, is due to two stocks – Amazon (AMZN) and Tesla (TSLA). These two stocks account for nearly 40% of the index and both of them are down a whopping -40% year-to-date (YTD).

The equity market is in oversold territory, however, it's the Fed pivot on inflation an interest rates that the market awaits for a sustainable rally to set in. For the Fed to do this, it has to see the inflation data start falling measurably. If economic data continues to worsen (and they are), inflation will slide and then

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one can expect Fed talk to change tack and indicate a desire to slow down or pause tightening.

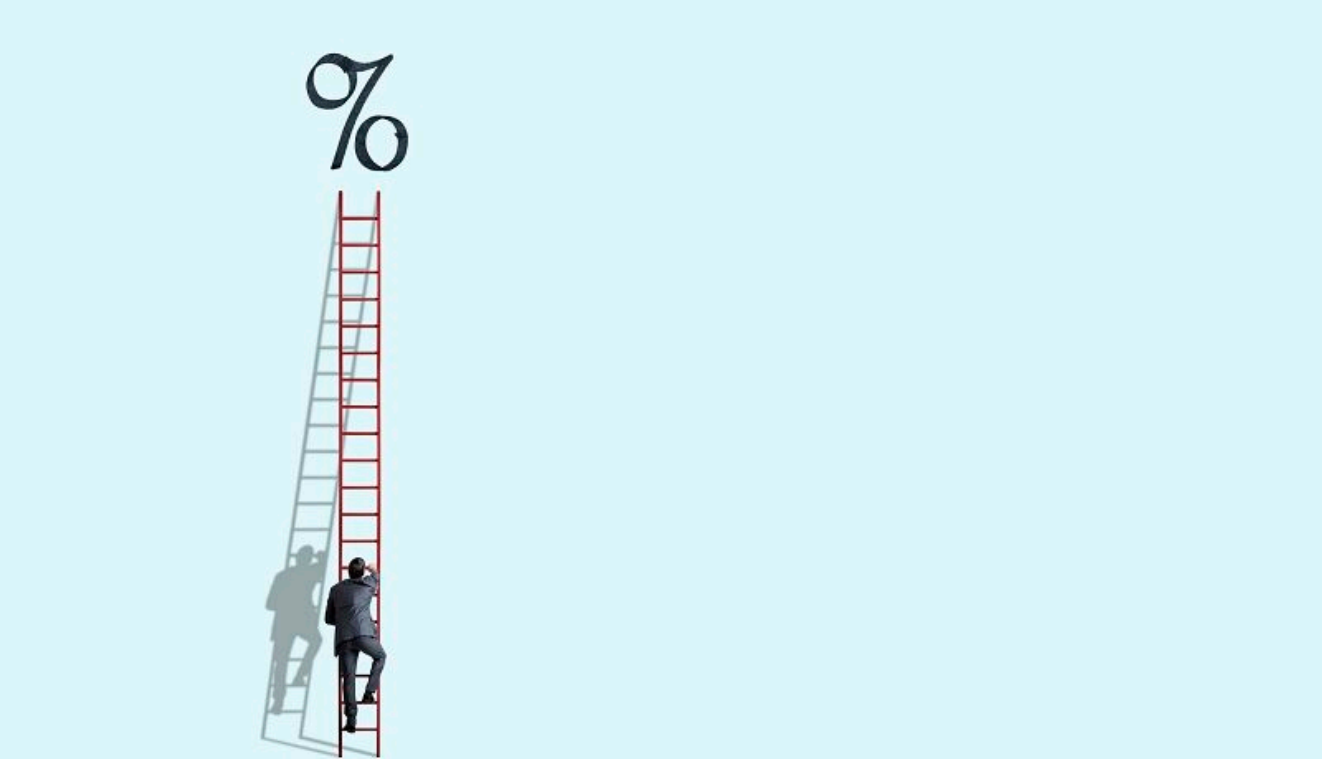
Until then, volatility will abound. In such market conditions, structured products are the perfect vehicle to monetise income and retain an upside in market performance. Structured products also help an investor clip coupons, if economic growth is going to disappoint, leading to the limited upside for equities.

For specific stock recommendations and structured product ideas please do not hesitate to get in touch.

Best wishes,

Manish Singh

Manish Singh, CFA



A man climbs a tall read ladder leading to higher interest rates.

The bond market sell-off is overdone. Given the drop in equities this month, the case for equities, particularly growth and technology

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stocks gets stronger. The pessimism on growth/tech names is overdone and cannot last."

Summary

The US Fed Funds futures market is now pricing in an interest rate increase of 175 basis points over the next three Federal Open Market Committee (FOMC) meetings in May, June and July. Only 6-months ago, markets were pricing two interest rate hikes in 2022 i.e. a 50 bps increase.

If the current pricing plays out (and it often doesn't), the year-over-year period from March 2022 to March 2023, would become the most aggressive tightening cycle conducted by the Fed since March 1988-1989 period. Also, bear in mind, that the economic impact of a +0.50% rate increase today, is equal to a +1% move in 2008, because since then, total public debt has more than doubled. If core inflation decelerates, the conversation will shift very quickly to a 25 bps tightening or even a pause in tightening later this year.

Corporate revenues and earnings growth in the US, in general, remain solid, but the market is focused on bond yields, interest rates and other macro factors. I understand market concerns around inflation and geopolitics. However, investors will also do well to remember – if inflation and supply chain issues do start to subside (and they undoubtedly will), a lower-risk course towards neutral rates could be adopted very quickly and it would substantially reduce the odds of a Fed-induced recession. The Fed is not in the business of causing recessions. Far from it and it's not a choice the politicians (who appoint and mandate Federal Reserve members) would like the Fed to make.

In my view, the bond market sell-off is overdone and a rebound in bond prices is around the corner. Particularly the 5y mark is where bond yields will tighten the most, while the long end may still get buffeted by inflation, with more bond issuances coming down the line. Given the drop in equities this month, the case for equities, particularly growth and technology stocks, gets even stronger. The pessimism on growth and technology names is overdone and cannot last.

Is the Bond market sell-off overdone?

If you think you are nursing a loss holding technology stocks this year, and bonds would have been a safer place to be, then sample this:

A 30 year US Treasury bond bearing a coupon of +1.25%, issued on 15 May 2020, and trading at 90% as recently as December, now trades at 67%. That's a paper loss of a third of your capital, on arguably the "safest paper" in the world.

While technology and growth stocks have been the "pain" trade, it has been even worse in the fixed income market on a risk-return adjusted basis, where long-dated Treasuries have plummeted, as interest rates expectations have spiked.

The TLT US (the Exchange-Traded Fund (ETF), which tracks a market-weighted index of debt issued by the US Treasury, with remaining maturities of 20 years or more, is down -18% since the beginning of the year and down -30% since August 2020, when bond yields hit a record low.

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The tech-heavy National Association of Securities Dealers Automated Quotations (NASDAQ) 100 index in comparison is down -18% YTD and up +16% since August 2020.

The "Total Bond Market" ETF (BND) is down -9.0%, junk bonds (HYG) are down -7.6% and short-term Treasuries (SHY) are down -2.8%.

The Yield on the 10-Year US Treasury (USGG10YR Index) hit a low of +0.5% in August 2020 as Covid-19 raged. It now sits at +2.8% (see chart below), as the market has raced over the last quarter to price in aggressive interest rate rises by the US Federal Reserve (Fed). Mind you, the US Federal Funds Target Rate (FDTR) over the same period has moved from +0.25% to +0.5% i.e. a 1/10th increase compared to the increase in the yields on 10Y US Treasury bonds (see chart below)

iShares 20+ Year Treasury Bond ETF (TLT US): 5-year Price chart

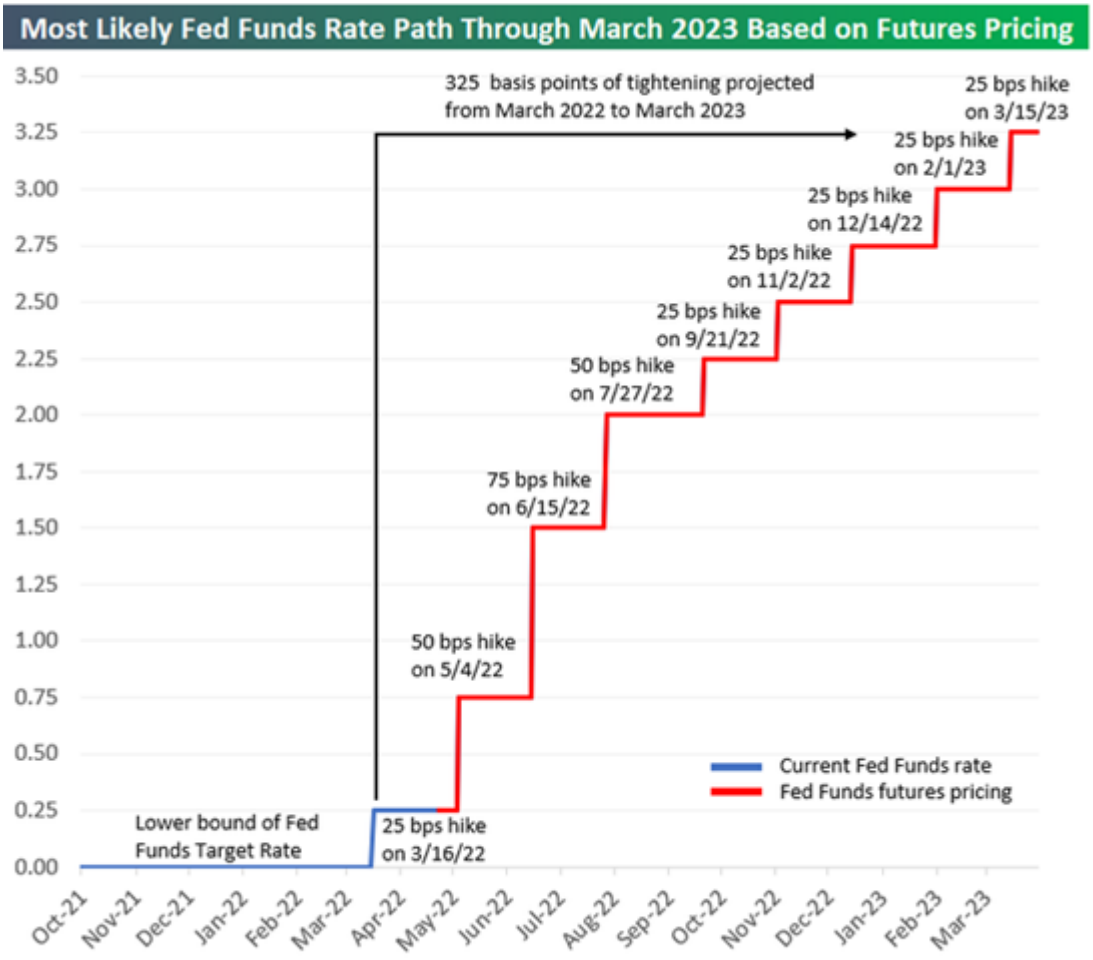


Source: Bloomberg

Bond yields have increased (prices move in the opposite direction to yield) sharply this year.
The Fed Fund futures market is now pricing in (see table below), an interest rate increase of 175 basis points (1 basis point = 0.01%) over the next three Federal Open Market Committee (FOMC) meetings in May, June and July.

If current futures pricing plays out (which it often doesn't), the year-over-year period from March 2022 to March 2023, would be the most aggressive tightening cycle conducted by the Fed since the March 1988 to March 1989 period. Also, bear in mind, that the economic impact of a +0.50% rate hike today, is equal to a +1% move in 2008, because since then, total public debt has more than doubled.

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Created using CME FedWatch tool - https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html

So, the question of the day is: – has the sell-off in the bond market gone too far? Is it time for bonds to rebound? The short answers are: Yes and yes.

Surveys of purchasing managers conducted over recent weeks, indicate a loss of steam in major economies such as Germany, the US and the UK in April. The IMF has downgraded the global growth outlook for the year from +4.4% to +3.6%, down from +6.1% last year. Economic growth is indeed slowing in large parts of the globe, as businesses feel the impact of Russia's invasion of Ukraine, pandemic-prompted lockdowns in China and a sustained high level of inflation.

The Dow Jones Transportation Average (TRAN), which tracks 20 large US companies ranging from delivery giant United Parcel Service to railroad operator Union Pacific, tumbled -12% this month, whereas the 30 stock benchmark Dow Jones Industrial Average (DJIA) index was down only -3%. Changes in transportation demand, reflect changes in the demand for goods and services. For example, in periods of economic expansion, the demand for goods and services typically increases, which in turn increases the demand for transportation.

The Fed would be playing with fire, by moving as rapidly as the interest rate futures suggest.

Frankly, some of the comments I've heard over last few days from Fed speakers and market commentators have been ludicrous. Talks of multiple 75 bps hikes, are not just insane but frankly

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reckless.

In my opinion, it's way too soon to talk about what the future holds for rates, based on two months of price action and with many of the Covid-induced supply disruptions still around.

The Fed is caught in a bind and the issue as ever is SUPPLY and DEMAND

- The fact is, less goods are being made globally due to Covid-induced disruptions and changes to production and supply chain, yet demand has recovered and accelerated
- Inflation is high, yes, however, will GDP growth keep up?
- Until supply catches up to demand, we are going to see inflation. However, higher interest rates can create a barrier to increasing supply and therefore the Fed has to move carefully. That is a big reason why the Fed is talking a big game on raising rates, but falling short of delivering it. It's the right approach.

As we often see in financial markets, the market prices in "news" much sooner and quicker than the actual turn of events.

The Fed has a tough balancing act to follow, tighten too far with supply issues still in place and the economy will be in a perilous stagflation (slow growth/recession coupled with high inflation) zone.

In my opinion, the bond market sell-off is overdone and a rebound in bond prices is around the corner. Particularly the 5y mark is where bond yields will tighten the most, while the long end may still get buffeted by inflation with more bond issuances coming down the line.

Markets and the Economy

I talked about the weakness in the Japanese Yen in last month's Market Viewpoints. The Japanese Yen (JPY) has continued to weaken and at 130 JPY per USD, JPY is down over -13% so far this year.

A few years ago, such a move in JPY would have alarmed the market, but this time around, there seems to be an indifference of sorts.

One reason for that is Japan's relevance to the world. The rise of China has eclipsed Japan more than any other country. Corporate Japan living off old glories and riding the weak JPY wave, has failed to reward and spur innovation in Japan for over a decade if not more. JPY is -66% weaker (chart below) now than it was in 2012. The Chinese Yuan (CNY) is essentially flat over the same period.

A weaker currency is a nice thing to have, but it can soon spiral out of control and become a headache. A strong economy often leads to a strong currency, which was the case with Japan and which is the case with China today. Former Fed Chairman Paul Volcker put it best, *"a nation's exchange rate is the single most important price in its economy; it will influence the entire range of individual prices, imports and exports, and even the level of economic activity."*

Volcker's point was that a strong economy doesn't shy away from having a strong currency. Dealing with

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supply-side problems, by just tolerating currency weakness, is bound to lead to more troubles. A re-tooling of the Japanese economy and businesses, now seem inevitable, or Japan will permanently be consigned to the lower ranks of global leadership.

Today, India, Brazil and Indonesia are producing more unicorns (companies valued at over $1bn) than Japan. India is home to 54 unicorns, Brazil 12, Indonesia 7 and Japan 6. China has over 300 unicorns. Therefore, the world rightly seems to be more focused on China's zero-Covid policy than Japan's policy to engineer inflation in its economy. This trend is unlikely to change and JPY is likely to weaken further.

Japanese Government Bond (JGB) holders may finally realise that a +0.25% yield on 10Y JGB is not a fair compensation, given the weakness in the currency and the lack of growth prospects. Japan's Prime Minister Fumio Kishida has a tough job at hand.

10-year price chart for Japanese Yen (JPY) and Chinese Yuan (CNY)



Source: Bloomberg

Moving on to US equity markets.

As bond yields have increased, equities have borne the brunt (table below).

The S&P 500 index (SPX) is down more than -5.4% month-to-date (MTD) and the tech and growth stock heavy NASDAQ composite is down -9.5% MTD.

April is the third month where the SPX has been down over -5% on an intra-month basis. This just goes to show how volatile the year has been so far. Technology (XLK), Consumer Discretionary (XLY), and Communication Services (XLC) are the most severely punished sectors as the table below indicates with

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many stocks now trading at their 52-week lows.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	31.1%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	4.9%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	1.8%
MXIN Index	MSCI INDIA	India	27.3%	0.1%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-2.0%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-6.7%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-6.8%
CAC Index	CAC 40 INDEX	France	28.9%	-8.5%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-9.9%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-10.0%
DAX Index	DAX INDEX	Germany	15.8%	-11.3%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-11.5%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-11.6%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-14.5%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-16.3%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-17.7%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-36.0%

Source: Bloomberg

US Corporate earnings season is in full swing and some notable earnings this week were:

- Microsoft (MSFT) reported revenue ($49.4B vs $49.09 expected) and earnings per share ($2.22 vs $2.19 expected) that were above estimates despite an incremental $302 million revenue impact from currency and a $130 million operating income impact from halting operations in Russia. Dissecting earnings further, the personal computing, intelligent cloud, and commercial cloud segments all beat estimates. Revenues for MSFT's cloud business Azure and the broader Commercial Cloud business exceeded $23 billion, +35% YoY growth

- Alphabet (GOOG) Q1 revenues were in line with estimates, but the company posted an operating margin of 30.0%, which surpassed estimates by 120 bps. EPS of $24.62 missed estimates by $1.14, and the board of directors authorized a share repurchase program for up to $70 billion. Ad revenue, cloud revenue and other bets beat expectations, while services and other revenues missed and cloud posted a larger operating loss than expected.

- Visa (V) saw payment volume increase +17% YoY, leading to a beat in processed transactions. The Q1 revenues totalled $7.2B vs expectations of $6.8 billion, while adjusted EPS was $1.79, which was 14 cents above consensus. Cross-border volume rose by +38% YoY while service revenue increased by +24%. Profit jumped by +21% due to a rebound in consumer spending.

Revenue and earnings growth, in general, remains solid, but the market is focused on bond yields,

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interest rates and other macro factors.

Only 6-months ago, markets were pricing two rate hikes in 2022 i.e. a 50 bps increase. Today, they are pricing an increase of 150 to 200 bps.

I understand market concerns around inflation and geopolitics. However, investors will also do well to remember – if inflation and supply chain issues do start to subside (and they will), a lower-risk course towards neutral rates could be adopted very quickly and it would substantially reduce the odds of a Fed-induced recession, that is the greatest threat to risk assets and economic growth.

The Fed is not in the business of causing recessions. Far from it and it's not a choice the politicians (who appoint and mandate the Federal Reserve members) would like the Fed to make.

What we have now is a combination of – a strong economy, high inflation, supply chain issues, and the expectation of a much tighter monetary policy.

What the stock market needs in order to resume the rally, is a combination of – a strong economy, lower inflation, supply chain predictability and stability, and a more dovish monetary policy.

Economic surveys indicate that the US economy is showing signs of weakness and is bound to dampen inflation. Year-over-Year (YoY) inflation prints are likely to slow in the coming months given that the April 2021- July 2021 core Consumer Price Index (CPI) prints, were the fastest month-on-month readings in decades. In March, the core CPI rose +4% annualized, but that represented a big slowdown from the over +6% prints of recent months.

If the core inflation decelerates, the conversation will shift very quickly to a 25 bps tightening or even a pause in tightening later this year.

Benchmark US equity sector performance (2021, 2022 YTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	35.8%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	3.6%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	2.8%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-5.2%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-5.4%**
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-6.2%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-8.4%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-8.4%
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-16.9%**
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-18.8%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-22.0%**

Source: Bloomberg

The markets may have priced in three 50bps hikes but rising mortgage and corporate bond yields, combined with a stronger US Dollar, are bound to slow down the US economy. The Fed therefore will

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very unlikely not match the market's hawkish expectations.

The lockdown in China is also set to weigh on inflation, as Chinese growth slows down and with it demand for commodities. China will eventually abandon the zero-Covid policy, but the 20th Party of Congress Chinese Communist Party (CCP) is due in September and President Xi Jinping will not risk anything. The net result is low growth in China, weakness in commodities and fall in inflation. It might be just the respite that growth stocks and bond markets are waiting for.

Given the drop in equities this month, the case for equities, particularly growth and technology stocks gets stronger. The pessimism on growth/tech names is overdone and cannot last.

In this period of elevated market volatility and geopolitical anxiety, structured products, which offer a degree of capital protection, continue to be a good way to invest. Structured products also help an investor clip coupons, if economic growth is going to disappoint, leading to limited upside for equities.

For specific stock recommendations and structured product ideas please do not hesitate to get in touch.

Best wishes,

Manish Singh

Manish Singh, CFA



Yen Flying in City

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“The S&P 500 has risen +10% since the US Federal Reserve raised interest rates. It’s almost surreal to see that the Japanese Yen has lost more value during March than the Russian Ruble. If the Yen were to continue weakening, China may be forced to weaken the Yuan in a repeat of what we saw in 2014-15.”

Summary

The Japanese Yen (JPY), the world’s third-largest reserve currency, is having a bad month.

At one stage, the Yen was down -7% in March and USDJPY hit 125, a near two-decade low. The last time JPY weakened to such an extent in 2014-2015, China was forced to weaken its currency (CNY) to rebalance the terms of trade. The result of this CNY weakness, was a big rally in Chinese equities. The Shanghai Composite Index (SHCOMP) doubled between February 2014 and May 2015. Given the bearish sentiment surrounding Chinese equities, a series of weak fixings for CNY could deliver a stellar rally in SHCOMP. So, watch out for more moves in JPY and CNY. In view of what’s happening in the world, it’s almost surreal to see that the Japanese Yen has lost more value during March than the Russian Ruble.

Last week, Russia announced that Moscow will now only accept Rubles (RUB) as payment for natural gas deliveries to “unfriendly” countries, which includes the European Union (EU). Russia reiterated this demand this week and is not backing down. Russia supplies around 40% of EU gas consumption. The EU’s trade deficit with Russia of €58.5 billion, is only going to get worse, as the EU has continued to import energy whilst banning any exports to Russia. The EU better be prepared for energy rationing, have enough gold to buy RUB, have aces up its sleeve or be ready to make an embarrassing about-turn. This just goes to show the importance of energy to the world. Russia’s invasion of Ukraine is a despicable and dastardly act, but the economic reality is that Russia cannot be sanctioned and treated like North Korea, without inflicting a huge economic cost to those sanctioning.

The S&P 500 index (SPX) may still be negative territory for the year, it has however surged more than +10% since mid-March. The market is yet to fully embrace the rally and turn bullish. This means there’s more upside to come, particularly when the equity market starts pricing in fewer than six interest rate hikes for the year.

Japanese Yen loses more value than Russian Ruble during March

While everyone is focused on the Ukraine-Russia war, (no Mr Putin, it’s not a special military operation!), the bigger story, in financial circles, is the weakness of the Japanese Yen (JPY).

JPY, the world’s third-largest reserve currency (the US dollar and the Euro being the top two) is on track for one of its worst monthly performance ever (please see chart below).

The prospects of widening US-Japan interest rate differentials have pushed the USD/JPY higher and on Monday JPY hit 125 against USD, the highest since August 2015. That’s a loss of nearly -7% for the month. The Yen has recovered since and currently trades at 122 per USD. If the Yen sell-off resumes,

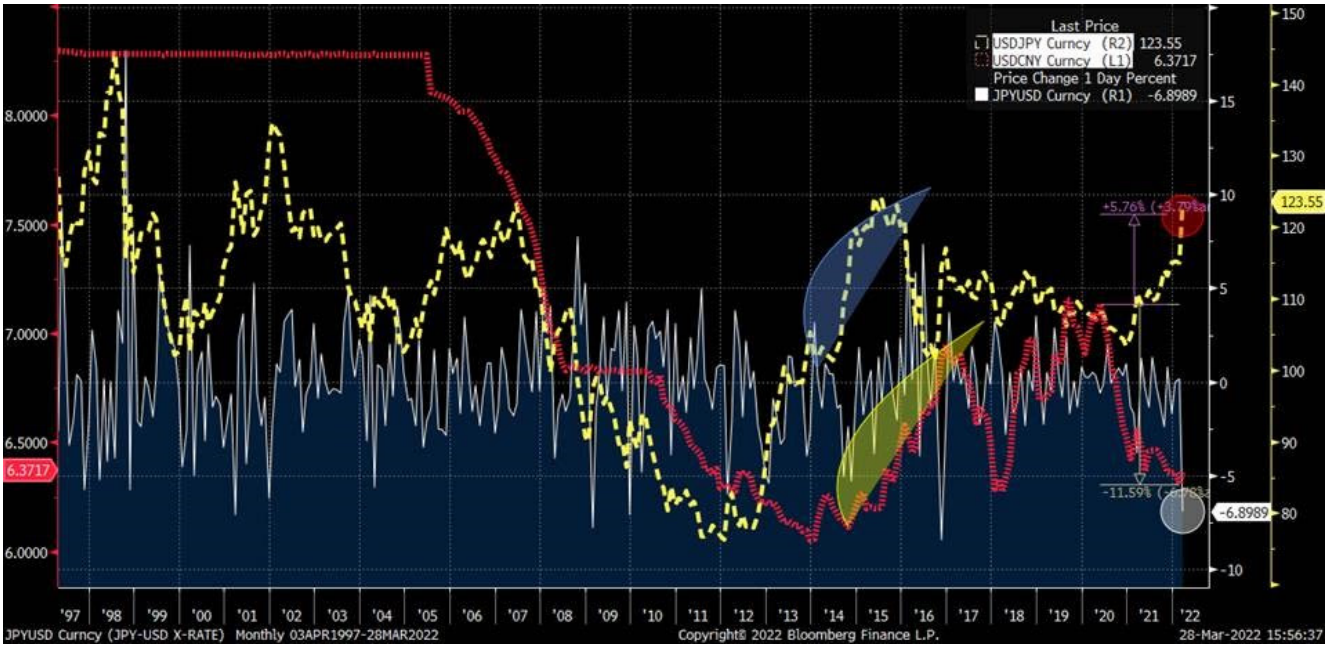
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hitting 125.52, would be a two-decade low for the currency.

The Bank of Japan (BoJ) has pledged to keep monetary policy loose, in contrast with most other major central banks, which are in tightening mode or getting ready to tighten monetary policy. The yield on the benchmark 10-year Japanese Government Bond (JGB) hit a fresh six-year high of +0.250%, even after the BoJ stepped into the market with an offer to buy an unlimited amount of JGBs to defend the implicit +0.25% ceiling set around its yield target.

BOJ Governor Haruhiko Kuroda has repeatedly said the central bank would maintain interest rates at the current ultralow levels, given the fragile economic recovery and as inflation remains well below its +2% target.

25 year chart: Japanese Yen (USD/JPY) price, Chinese Yuan (USD/CNY) price and USD/JPY monthly price change



Source: Bloomberg

I don't believe Japan will be particularly worried about this weakness in the Yen, as it means Japanese manufacturers will have a lower cost in dollar terms and gain an edge over other exporters.

Japan's Vice Minister of Finance for international affairs, Masato Kanda said: "The market determines the exchange rate. We will respond appropriately while maintaining close communication with the U.S. and other monetary authorities."

China, on the other hand, will be watching this with great interest, as the Chinese Yuan has strengthened by over +11% since June 2020 and the JPY has weakened by over -6% in the same period i.e. the terms of trade for Chinese exporters selling to the American consumer is -17% worse compared to their Japanese competitors.

One explanation for this move is that we are seeing a revival of the *"carry trade"* – investors borrowing in

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Yen at low rates, selling the Yen and buying US dollars to earn a higher rate of interest.

If President Donald Trump were still in the White House, he would have cried foul and labelled Japan a currency manipulator by now. US President Joe Biden on the other hand, will welcome a strong dollar, as it pushes the cost of imported goods down and tempers inflation – Biden White House's biggest concern going into mid-term elections.

China on the other hand will be less charitable about the Yen weakness. The last time JPY weakened to such an extent in 2014-2015, the Chinese were forced to weaken their currency CNY to rebalance the terms of trade (see the yellow shaded region in the chart above).

The result of this weakness in CNY was a big rally in Chinese equities. The Shanghai Composite Index (SHCOMP) doubled between February 2014 and May 2015. Given the bearishness surrounding Chinese equities, a series of weak fixings for CNY, if necessitated, could deliver a stellar rally in SHCOMP.

So, watch out for more moves in JPY and CNY.

One other currency is on the move, for entirely different reasons – is the Russian Ruble (RUB). It has rallied +28% this month even as the Ukraine-Russia war rages on. It's almost surreal to see that the Japanese Yen lost more value during March than the Russian Ruble.

The RUB, which touched 177 RUB per US dollar (USD) on March 7, is currently trading at 82 RUB per USD. This is due to targeted market interventions by Russia's central bank and strong Oil & Gas revenues. The RUB may very soon look stronger than before the war. On February 23, the day before the Ukraine invasion RUB closed at 81.67 per USD. So what's changed?

Russia's demand last week that Moscow will now only accept RUB as payment for natural gas deliveries to "unfriendly" countries, which include the European Union (EU), could prove significant and force Europe – which has no access to RUB but needs Russian gas – to ease or end sanctions on Russia.

The demand is designed to make sanctioning nations reconsider their plans, support Russia's currency and in turn support the Russian economy. This is Europe's worst energy crunch since the 1970s and European gas prices surged over +30% after the news of Russian demands for payment in RUB.

Russia is not backing down and it reiterated on Tuesday that it will only be accepting payment for gas deliveries to the EU in RUB after G7 ministers called this arrangement "unacceptable." Russia continues to supply around 40% of EU gas consumption.

In 2021, the total trade in goods between the EU and Russia amounted to €257.5 billion. The EU's imports were worth €158.5 billion dominated by fuel and mining products, and exports totalled €99.0 billion i.e. a trade deficit of -€58.5 billion. This deficit will only get worse as the EU has continued to import energy while banning exports to Russia.

Also, India is set to launch a new system to allow it to make direct Rupee-Ruble payments in trading with Russia. It will allow India and Russia to bypass the US dollar in financial transactions.

This just goes to show the importance of energy to the world. Over the past month, Russia has overtaken both Iran and North Korea to become the most sanctioned country in the world. Western nations will

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realise that Russia is too vast and crucial for the global economy, for it to be sanctioned and treated like North Korea.

Most gas delivered to the EU is paid for in Euros, but Russia wants to change this to Rubles



Source: pixaby

If Russia doesn't back off, how does the EU get RUB to pay for gas given the EU sanctions bar the EU nations from selling goods to Russia?

Well, it seems Russia has thought this through. The Central Bank of Russia announced that starting from March 28, the Ruble will be bound to gold – 5,000 RUB per gram of gold i.e. you want RUB to pay the gas bill, buy them with gold. This in a way completes Russia's plans to sell oil for gold. RUB may be far away from a reserve currency status but the implications of RUB as payment currency for Russian gas is just beginning to take shape.

The EU better be prepared for energy rationing, have enough gold to buy RUB, have aces up its sleeve or be ready to make an embarrassing about-turn.

On the Ukraine-Russia war front, there is a guarded sense of relief as the Kremlin confirms the scaling back of the invasion to the 'liberation' of Donbas. It is the strongest indication yet that President Vladimir Putin's aims of war are changing, after the invading Russian forces met a resolute Ukrainian resistance, denying Putin the quick victory he wanted. Over a month into the invasion, Russia has failed to capture any major city and has suffered heavy losses. Let's hope Russian guns falls silent soon and a Ukraine-Russia compromise is worked out to alleviate the suffering of the Ukrainian people.

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Markets and the Economy

The sell-off in the Bond market continues with the US 10y Treasury Yield now over +2.4%, the highest in 2 years.

The US U.S. Aggregate Bond ETF (AGG) is now down -5.8% year-to-date and over -11% since the highs of July 2020, when the US 10y was trading at a paltry yield of +0.54%.

Bond yields are the talk of the town and with the US yield curve getting flatter by the day, as the market prices in an aggressive rate-hiking plan by the US Federal Reserve (the Fed), it seems an inversion of the yield curve – the "2s10s spread" or the difference between the 10-year US Treasury yield and the 2-year US Treasury yield turning negative – is a matter of *"when"* not *"if"*.

The 2s10s spread which was as high as +0.85% at the beginning of the year has now fallen to +0.034%.

Typically, the yield curve slopes upwards. Investors expect more compensation for holding longer-dated bonds, as they expect rising inflation to lower returns over time. This means a 10-year bond typically yields more than a 2-year bond, as it has a longer duration.

A steepening yield curve also signals expectations of stronger economic activity, higher inflation, and higher interest rates. A flattening curve by contrast means the opposite – expectations of weaker economic activity and rate hikes in the near term. The current spread on 2s10s would indicate that the market has been doing the "tightening" job for the Fed.

Does a Yield curve inversion, mean a US recession is imminent?

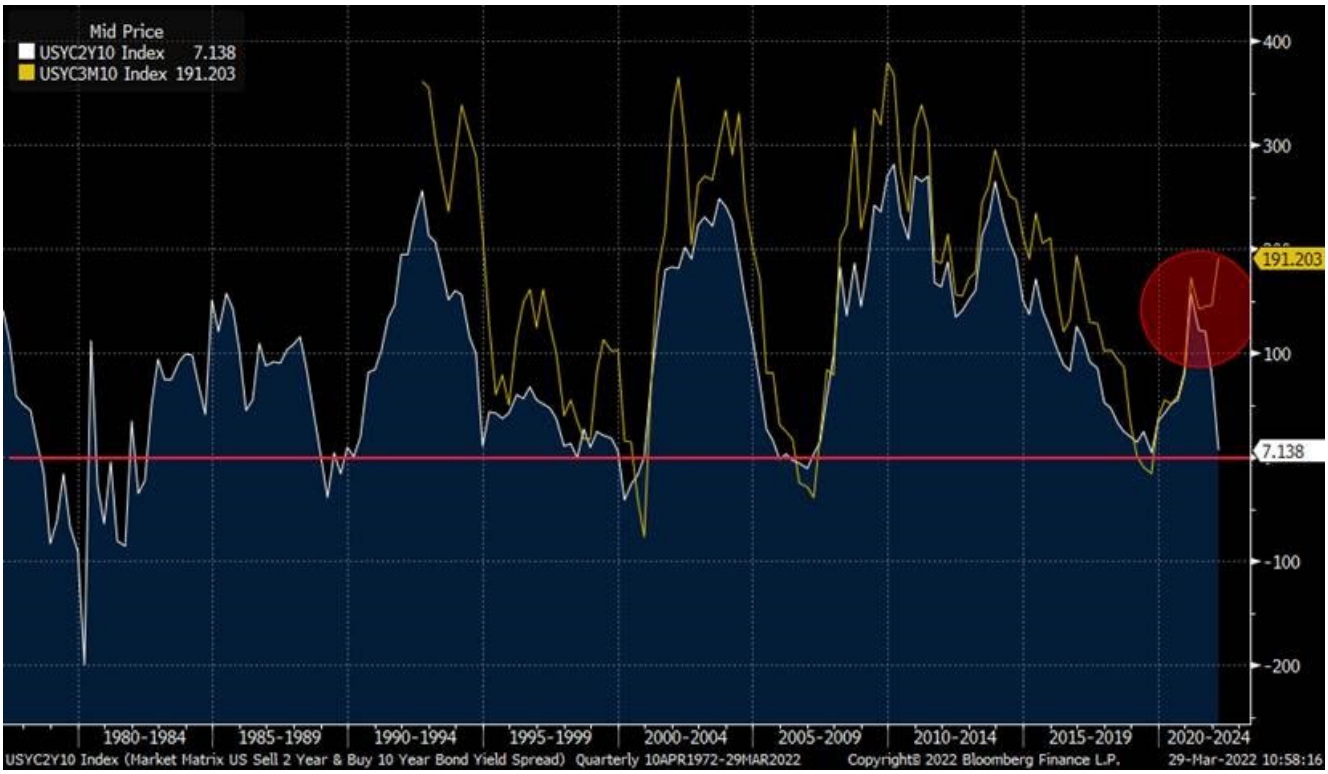
An inversion of the yield curve is an indicator of an oncoming recession. The US yield curve has inverted before each recession since 1955, with a recession following between 6-24 months, according to a 2018 report by researchers at the Federal Reserve Bank of San Francisco. It offered a false signal just once in 1998. The last time the 2s10s inverted was in 2019. The following year, the US entered a recession – albeit one caused by the Covid-19 pandemic.

However, there's an interesting occurrence this time around.

While the 2s10s is indicating slowdown, another closely monitored spread – the 10Yr/3 month spread (the difference in the yield on the 10-year Treasury notes and the 3-month Treasury bills) has been widening (the highlighted red circle in the chart below).

US Treasury Yield curve: 2-Year vs 10-Year

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Source: Bloomberg

You will notice that in all previous cases of curve inversion both the 2s10s and the 10Yr/3 month spread moved in lockstep and inverted.

Has Quantitative Easing (QE) distorted the long end of the yield curve permanently due to massive bond-buying by the US Federal Reserve? Perhaps it has and therefore the 10-year yield is lower and will likely rise when the Fed starts shrinking its balance sheet, thus steepening the curve.

While it's not easy to say whether we will see a recession in the US over the next 6-12 months, what is of little doubt is the concerns about the future economy are building up fast and rising bond yields are indicators of this.

What does this mean for the equity market? Should one be concerned about the equities keeling over?

Not so fast.

Over the last 50 years, there have been six episodes of 2s10s yield curve inversion.
The table below outlines the performance of the S&P 500 index (SPX) in the first year after inversions of the yield curve. You will notice that the performance hasn't typically been negative.

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2-Year/10-Year US Treasury Yield Curve Inversions and Near Inversions: 1976 -						
	S&P 500 Performance (%)					
Date	One Month	Three Months	Six Months	One Year	Max. Gain	Max. Decline
8/17/1978	-0.91	-10.14	-6.10	3.06	3.02	-11.98
12/14/1988	3.11	7.20	17.62	27.47	30.69	-0.37
12/27/1994	1.71	8.81	17.29	32.88	34.43	-0.73
5/26/1998	3.58	-0.90	8.49	19.26	25.00	-12.50
2/2/2000	-1.94	2.64	2.10	-4.23	8.40	-10.25
12/27/2005	2.16	3.59	-1.38	13.55	13.57	-2.61
8/26/2019	3.45	9.11	8.27	20.86	19.64	-22.27
3/28/2022						
Average (Ex 1994)	**1.57**	**1.92**	**4.83**	**13.33**	**16.72**	**-10.00**
Median (Ex 1994)	**2.64**	**3.11**	**5.18**	**16.41**	**16.61**	**-11.11**
	2s10s yield curve never inverted					

Source: Bespoke Invest

- In the December 1994 curve inversion, The SPX index was sharply higher over the following one, three, six, and twelve months.
- In the five other periods where the yield curve inverted, the forward returns for SPX were also generally higher. One, three, and six months later, the SPX was higher two-thirds of the time, and a year later, it was higher five out of six times for a median gain of over +16%.
- The only time it was lower a year later was after the inversion in February 2000 when the SPX fell by -4.23%. That was the "dotcom" bust and on that occasion, the SPX continued to show weakness and didn't bottom until October 2002.

One other key consideration this time around to bear in mind – in all seven prior cases of 2s10s yield curve inversion, the SPX was higher in the three months leading up to the inversion. This time around, if the curve does invert shortly, it will mark the first time that the SPX declined in the three months leading up to an inversion.

The SPX is down -3.4% over the past 3 months.

The SPX may still be negative for the year (table below), it has however surged more than +10% since mid-March.

This recovery in US equity indices has continued to flummox investors who are focused on the surge in bond yields and the insistence by the Federal Open Market Committee (FOMC) that they will act aggressively to clamp down inflation.

In last month's Market Viewpoints I wrote – *"A lot of a bearishness is already priced in to equity markets and there is a likelihood that those expecting more bad news may be hit by surprises …there is room for a catch-up rally in equities. It's time to build back equity exposure."*

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If you did add to your equity position then you must be feeling cheerful. The AAII Net Bulls index (a weekly sentiment survey of AAII members, which asks if they are "Bullish," "Bearish," or "Neutral" on the stock market) that I refer to in the newsletter has recovered from -60 but it still sits at -43 and down from the long-term average of -23.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	21.8%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	14.7%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	2.8%
MXIN Index	MSCI INDIA	India	27.3%	-0.0%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	-1.6%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-3.1%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-3.4%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-3.4%
CAC Index	CAC 40 INDEX	France	28.9%	-5.4%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-5.8%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-6.7%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-7.3%
DAX Index	DAX INDEX	Germany	15.8%	-7.4%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-7.5%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-7.7%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-10.6%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-32.6%

Source: Bloomberg

The market is yet to fully embrace the rally and turn bullish. It means there's more upside to come, particularly when the equity market starts pricing in fewer than six interest rate hikes for the year.

As I've written for a few months now, I do not believe the Fed can deliver on what the market is pricing in – five to six additional rate hikes this year.

On 16th March, I was on Bloomberg TV to discuss the outlook for rates and equities. Please skip to 26 mins at this Bloomberg YouTube link to see my remarks.

Chinese stocks have also seen a turnaround this month, on the back of market intervention by China's Vice-Premier Liu He.

China's Financial Stability Development Committee met on March 16 and the meeting was chaired by Liu He, President Xi Jinping's closest economic adviser. He signalled a shift in policy thinking, with a call to pay more respect to investors' interests. He further indicated that the government would take measures to *"boost the economy in the first quarter"*, as well as introduce *"policies that are favourable to the market"*. Chinese tech stocks like Alibaba (BABA), Tencent (TECHY), JD.com (JD), Baidu (BIDU) are up between +35% to +50% since the announcement.

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In response to Liu He's meeting, the regulatory body that oversees China's securities and futures industry, the China Securities Regulatory Commission (CSRC) quickly came out with a list of things they will do – "Encourage stocks buybacks, encourage mutual fund companies put in their own capital"

When it comes to understanding China, only the words of the Chinese Communist Party (CCP) matter and they have indicated support for the market. This will draw domestic capital into the beaten-down Chinese stocks. Chinese tech stocks have further to run as most of them are still down more than -50% from the highs despite the sharp rally of the last ten days.

Benchmark US equity sector performance (2021, 2022 YTD)

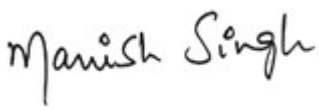
Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	39.6%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	4.1%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	0.4%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-1.4%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-1.2%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-1.3%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-1.8%**
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-7.2%**
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-5.7%
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-7.7%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-9.7%**

Source: Bloomberg

Despite the over +10% rally in the SPX, Consumer Discretionary (XLY), Communications (XLC), and the Technology (XLK) sectors are still down over -7% (see table above) and present the best opportunity for stock picking. Growth and Tech stocks will particularly benefit from any re-pricing in the number of interest rate hikes.

For specific stock recommendations and structured products ideas please do not hesitate to get in touch.

Best wishes,



Manish Singh, CFA

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