Farro Capital

Markets Commentary

Reading the tea leaves

17th Jan 2023

Looking back, it was a very tough year for markets with almost every long duration financial asset down on average 20% in dollar terms.

Absent Santa rally, this year too was feared to be not so rosy but as we often forget, markets have an uncanny ability to price the expected and bring out the unexpected.

And unexpectedly so, what a start to 2023 it has been.

All major equity indices and 8 out of 11 global equity sectors are now sitting above their 200 DMA with cyclicals outperforming defensives YTD and with equity volatility at lows not seen since March-22 (see charts below). Even the dead have started walking with ARK and Bitcoin up ~16% & ~25% YTD.

If we look back a bit in the long term: on 1-year basis, only the technology, discretionary and communication sectors are now down more than 10% whereas all other sectors – especially the old economy – have recovered significantly, are approaching April-22 levels and are down only single digits. E.g., MSCI global materials is now down only 6% over 1 year, after a huge rally from Oct-2022 lows.

MSCI World AC

S&P 500

Stoxx 50

Hang Seng

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Add to it the tightening of US and EU High-yield credit spreads, compression in US interest rate volatility, and weakness in dollar amid sterilization of quantitative tightening, what we are seeing is a considerable improvement in global financial conditions. (See table below). The lone ranger is yield-curve, which is flashing red, but nobody seems to care – we will get back to it later.

What's more interesting? In the last 1-year, European equities have now outperformed US equities by a wide margin, both in Euro and USD terms. Stoxx 600 is back to level where it was prior to Russia invasion of Ukraine whereas EUR/USD is just a tad below. Who could have conceived that year ago!

Cross asset performance

	30-Nov-22	30-Dec-22	13-Jan-23	Since Dec 2022	YTD 2023
S&P 500	4080	3840	3999	-1.99%	4.16%
NASDAQ	11468	10466	11079	-3.39%	5.86%
DOWJONES	34590	33147	34303	-0.83%	3.49%
STOXX 600	440	425	453	2.84%	6.51%
HANG SENG	18597	19781	21739	16.9%	9.90%
US Equity Volatility	20.58	21.67	18.35	-10.84%	-15.32%
US Rates Volatility	127.3	121.6	113.6	-10.78%	-6.63%
US HY Spread	4.55%	4.81%	4.29%	-0.26%	-0.52%
US CCC Spread	11.30%	11.57%	10.68%	-0.62%	-0.89%
US HY bonds	75.0	73.6	76.6	2.25%	4.09%
EU HY Spread	5.06%	4.94%	4.62%	-0.44%	-0.32%
EU HY bonds	90.1	89.7	91.5	1.59%	2.11%
AT1 Bonds	23.3	23.8	24.7	6.19%	4.00%
EM Corp bonds	42.5	42.8	44.0	3.46%	2.78%
2yr US Yield	4.38%	4.24%	4.22%	-0.16%	-0.02%
10yr US Yield	3.68%	3.88%	3.51%	-0.18%	-0.38%
30yr US Yield	3.80%	3.97%	3.61%	-0.19%	-0.36%
10-2 US Curve	-0.70%	-0.56%	-0.72%	-0.02%	-0.16%
10yr US Inflation BE	2.34%	2.30%	2.19%	-0.15%	-0.11%
10yr US Real Yield	1.34%	1.56%	1.31%	-0.03%	-0.25%
10 yr German Bund	1.93%	2.44%	2.14%	0.21%	-0.30%
10yr Italian Bond	3.88%	4.57%	3.99%	0.11%	-0.59%
BTP Spread	1.95%	2.13%	1.85%	-0.11%	-0.29%
10 yr China Bond	2.93%	2.89%	2.93%	0.00%	0.04%
EURUSD	1.032	1.079	1.082	4.84%	0.28%
Gold	1746	1830	1923	10.14%	5.08%
Oil	80.55	80.51	80.07	-0.60%	-0.55%

What's happening under the hood?

Let's first tackle the obvious:

Once we exclude the big boys (Mega-cap US stocks), US equities underperformance versus EU becomes less discerning. E.g., In global and US equity indices, only three sectors are down > 10% on YoY basis i.e., Tech, Discretionary and Communication, where these US big boys have heavy weights. And if we compare performance since Feb 2020, S&P is still outperforming Europe and the rest of the world by some margin. In short, it's the valuation de-rating of these Big-tech in 2022, following their outperformance from Feb-2020 to Dec 2021, that is broadly contributing to S&P underperformance in the last 1 year. Nifty Fifty of the 70s anyone?

Now let's get to murkier waters:

While China re-opening and better than expected EU economic data have been the key positives for global growth and non-US equities, it's the recent fall in the 1-year US inflation swap to 2.0% that might be signaling a big change in market thinking (see charts below). If inflation swap market signal is correct, a quick return of inflation to normal, when growth and financial conditions are also improving, would suggest an "inflation versus growth/unemployment" trade-off that is contrary to historical tightening cycles.

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Economic Surprise Indices: EU (green), Global (white)

US 1 year Inflation Swap

For such a hypothesis to hold true, perhaps the market is betting on **subdued wage growth** with just a **mild rise in unemployment rate** going forward, by assuming fall in jobs openings or fiscal handouts as substitute for wage inflation. Whether plausible or not, we think it is this hunky-dory scenario (from mild recession to a global soft-landing due to improved growth and reduced inflation) that has been gaining traction off late with US equities recovering, credit spreads tightening, cyclical outperforming defensives, and EU and Chinese equities rallying. In that respect, some US investment banks have already upgraded global growth and downgraded inflation estimates. E.g., Goldman has made US soft landing their base case while CEOs and financial press are following suit.

"Much of inflation's rise appears to have been transitory after all" WSJ, 12th Jan 2023
"Everything we see, there will be a mild recession" Bank of America's Moynihan, 14th Jan 2023

Now quickly back to US yield curve – the only red flash. Wouldn't an extremely inverted yield curve (both nominal and real) amid collapsing inflation suggest otherwise i.e., a typical recession? Time will tell. Perhaps nobody trusts the bond market anymore (note that on a total return basis, the so-called risk-free return has provided return-free risk in the last 10 years) or perhaps the recession has been pushed further into 2024 given strong consumer and corporate balance sheets. It's striking that despite all the hue and cry about YC inversion and Soft PMI data, hard economic data continues to be fine whereas global financials and industrials sectors up ~20% in the last 3 months.

Conclusion

Markets are reaching an inflection point amid divergence between CBs and market expectations.

The recent rally has come on the back of improving economic data, China re-opening and market expecting inflation to fall significantly. However, this same set up of improving global growth and financial conditions may also lead to higher-than-expected inflation, in turn causing the FED to keep hiking and hold rates higher-for-longer. So far, the market is not concerned, hoping for a FED pivot and expecting 40-50bps of rate cuts in 2H23.

That said, one can make a case that it's now time to reduce risk as equity and credit markets seem to be pricing in a lot of good news, transitioning in hope of a mild recession to soft landing scenario. On the other hand, market signal should not be taken lightly with all major equity indices above 200 DMA and majority of sectors approaching levels not seen since April 2022, amid both marginal (improving in economic data) and regime changes (China reopening) we are seeing.

From our vantage point, it's prudent to take some equity risk off the table or buy optionality. Note than VIX is back to lows seen since March 2022, but S&P has breached neither Aug nor Nov highs. However, we will be ready to change tack if the facts change meaningfully given the uncertain nature of this cycle. Most importantly, its "Data" and the "Policy" that will make or break this rally in equities.

Side note: Quantitative tightening (QT) has so far has been and is likely to remain a moot point for risk assets until we see a substantial decline in bank reserves. Bank reserves still sit at a behemoth ~3tr versus ~1tr pre-covid despite 495bn of QT planned for June-Dec 2022. More on this some other time.

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