Farro Capital

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Reading the Tea Leaves

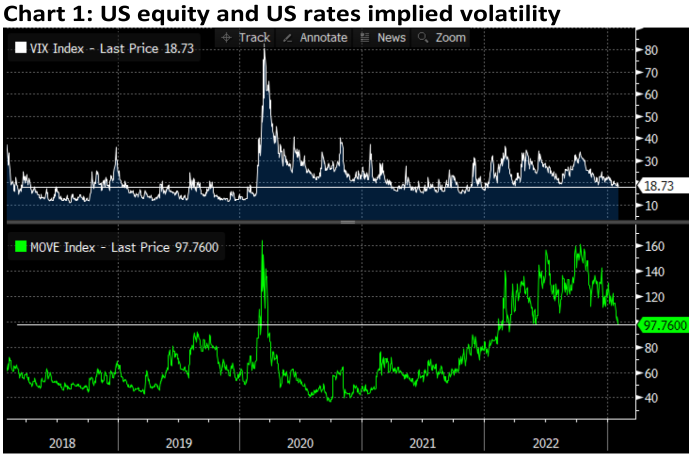
"The future is already here; it's just unevenly distributed" – William Gibson

Usually, we find this famous quote by a speculative fiction author and often used by "inventors" apt for "markets" too. However, at this juncture, it seems that the future is now looking rather evenly distributed in the market, especially equities. In the build-up to FOMC, we have been highlighting the "inflection point" in markets amid the "divergence" between signal from risk assets and yield curve. Now that Jerome Powell clearly stated in his press conference that the disinflationary process has begun and that FED is not concerned with improving financial conditions, markets have marched on to greener pastures of a soft landing.

Why does it seem so?

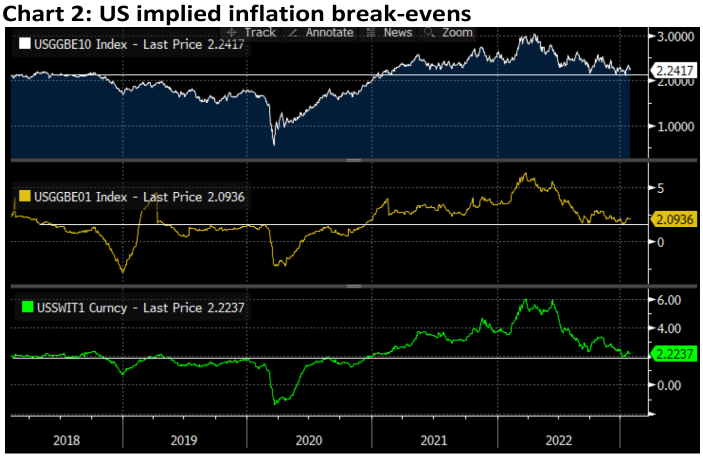
First, equity and interest rate vols are reaching levels which if broken would be commensurate with a regime change in financial markets (chart 1). Furthermore, it's happening when 10yr and 1yr US Inflation break-evens along with 1yr USD inflation swap are falling towards just 2% (chart 2) at the same time as global economic growth is trending better than feared (chart 3) i.e., a favorable inflation vs growth-unemployment trade-off. Meanwhile, markets do not believe that Central banks will walk the talk e.g., FED median dot plot is showing no cut in policy rates in 2023 but rates market is pricing in 40-50bps cut. Finally, cyclicals have been outperforming defensives and 10 out of 11 global equity sectors have crossed over 200 DMA with most of these sectors down only single digits from peak levels (chart 4).

Chart 1: US equity and US rates implied volatility



Equity (VIX), Interest rates (MOVE)

Chart 2: US implied inflation break-evens



10yr break-even (USGGEB10), 1-yr break-even (USGGBE01), 1-yr Inf Swap (USSWIT1)

Chart 3: Economic Surprise Indices (EU, US, G10)

Green (G10), Yellow (EU), Pink (US)

Chart 4: S&P Global Sectors normalized since Jan 2022

Lower Panel (Tech, Discretionary, Communication), Upper Panel (All other sectors)

Turning over specifically to the US, with S&P and dollar liquidity as global barometer of risk, there are three interesting takeaways.

First, S&P equal weighted index is now only 4.8% below its peak even as S&P 500 is down ~12% (Chart 5) as all sectors except mega-caps heavy ones have recovered well (Chart 6). Therefore, for this rally in the S&P 500 to continue, Mega-caps will need to catch up to the rest of the market. Second, while correlation between 10yr real yield and old economy sectors became less discerning since Sep 2022, correlation between 10yr real yield and Nasdaq had held firm (Chart 7). However, post FOMC, Nasdaq has rallied despite real yield having not budged much while VIX has also gone up. A few days is not a trend, but if this continues it will suggest an increasing risk appetite for longer duration assets. Third, since June-2022 quantitative tightening (QT) has been more of a moot point for markets and banks' excess reserves remain above ~3trn as US Treasury drew liquidity from its account at the FED (Chart 8).

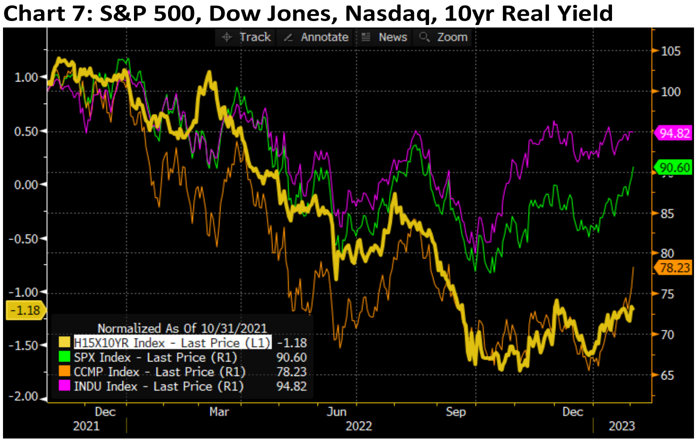
Chart 5: S&P 500 Index vs S&P 500 equal weighted

Upper panel (S&P 500), Lower panel (S&P equal weight)

Chart 6: S&P sectors normalized since Jan 2022

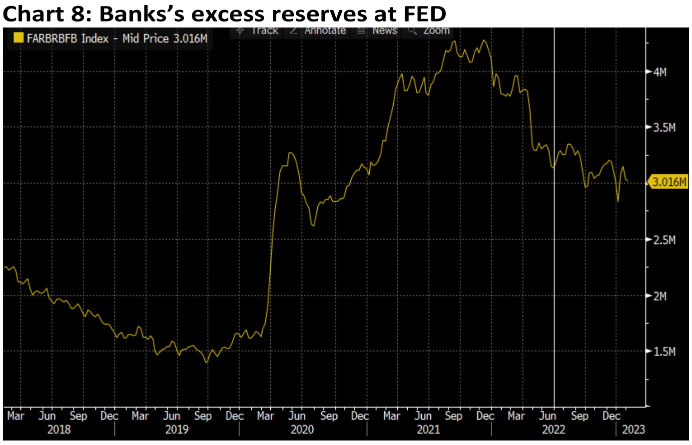
Lower Panel (Tech, Discretionary, Communication), Upper Panel (All other sectors)

Chart 7: S&P 500, Dow Jones, Nasdaq, 10yr Real Yield



Yellow (Real yield inverted), Orange (Nasdaq), Green (S&P 500), Dow Jones (Purple)

Chart 8: Banks's excess reserves at FED



Conclusion

Right or wrong only time will tell, but for now It seems like a Goldilocks Indeed!

We respect the market signal as the market has an uncanny ability to price in the expected. However, in the short term, the market can also be driven by marginal buyers and sellers due to excess optimism and pessimism or positioning. From our vantage point, there is a good chance that consensus EPS estimates for 2H23 turn out to be too optimistic and FED keeps rates higher than market expects amid QT doing its bit from 2H23.

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