

How much bad news is priced in?

- While sentiment is very negative, markets are reacting less to war headlines
- Many hurdles remain, suggesting a choppy quarter ahead
- Over the medium term, we remain constructive as a lot of bad news is priced in already

As the Russia-Ukraine conflict enters its second month, markets are becoming less sensitive to war headlines, giving credence to the adage that markets bottom at the start of a conflict, for now. Indeed, February lows have held despite incremental bad news, and markets' recent rebound is starting to send encouraging signals. Still, the second quarter is likely to remain volatile as investors reconcile high inflation and more aggressive interest rate hikes with conflict, growth fears and yield curve inversion. In this scenario, we believe the big question for investors today is: how much bad news is priced in?

Federal Reserve speakers – whether doves or hawks – have increasingly embraced the possibility of accelerated monetary tightening, including 50 basis point hikes at upcoming meetings. Many major Wall Street investment banks have reviewed their outlook for rate hikes higher, and markets are pricing in hikes at every remaining meeting for 2022, which we believe is unlikely given the growth outlook.

While some of the supply-driven inflation appears to be starting to abate as supply chain disruptions ease with economies reopening, food and energy inflation is picking up the baton. This suggests inflation will stay even higher for even longer, weighing on consumer sentiment and potentially destroying demand. Of course, this has led to growth concerns. In the short term, the European economy is more at risk of a significant slowdown due to its exposure to the war in Ukraine and its reliance on Russian energy, but higher costs can bite US consumers as well and weigh on growth as it is already slowing towards trend after the post-lockdown rebound. Still, we do not expect a US recession this year.

Already, bond markets are starting to flash recession signals, with some parts of the curve inverting. For now, the all-important 2-year/10-year curve remains positive, but a mere 20 basis points stand between it and inversion. If Fed speakers continue to ramp up hawkish talk, it may only be a question of time before markets get yet another negative signal, adding another brick to the Wall of Worry.

However, we believe that most of the bad news is already priced in. The yield curve inversion may be only days away, the worst start to a year for bonds in decades suggests markets are already pricing in a very aggressive tightening path for the Fed, investor positioning is very bearish, especially on the institutional side, and inflation expectations have come “unanchored”. How much worse can it get?

In this context, unless investors expect a US recession is imminent, we do not think it is time to reduce risk assets. We maintain our positioning, focused on the second half of the year where we expect markets to recover as growth holds up and central banks pause. While bond yields can overshoot, we believe a lot of the move higher is done. Still, we think the return picture for equities is more attractive and that markets can weather the bond market self-off and ongoing war headlines. Nonetheless, the second quarter is likely to remain volatile as markets wade through the Wall of Worry.

As such, we believe that gold and crypto should continue to act as diversifiers, with the latter pushing above important resistance levels that paint a more positive picture for the asset class as a whole. In addition, crypto's correlation to tech and tech's recent rebound bode well for the space.

April 2022

Esty Dwek | Chief Investment Officer

Equities

The recent rebound has seen indices send a number of positive signals to investors. This does not mean the February lows will hold, but it does bring some optimism that recent momentum can be maintained. Markets have become less sensitive to headlines surrounding the conflict and have moved higher despite higher bond yields. With more attractive valuations, bearish positioning by investors and a lot of central bank tightening already priced in, the outlook for the year as a whole remains constructive in our view, though short-term wobbles are to be expected.

We maintain our overweight allocation as well as our barbell approach, even though we expect volatility to persist in the second quarter. We expect technology to benefit from pricing power and growth fears, while energy should continue to advance, even if oil prices retreat. Having advanced in tandem recently, we believe this trend can continue. We expect the US to do better than Europe given growth risks, and emerging markets to hold up if Chinese regulatory concerns fade.

Fixed Income

The bond market sell-off continues to accelerate as central bankers admit being behind the curve and up their tightening talk. However, at current yield levels and given how many rate hikes are already priced in for this year – both for the Fed and the ECB, among others – we believe that the bulk of the move is likely done, though yields can overshoot in the short term.

Overall, we reduce our underweight to sovereign debt, even though we still prefer taking credit risk over duration risk. Credit spreads could continue to widen on growth concerns over the coming months, but they should stabilise across the spectrum once more clarity emerges on central bank plans and on economic data over the coming quarter.

Currencies

While the dollar often fades after the first interest rate hike, better growth prospects for the US, the Russia-Ukraine war and an ongoing yield advantage should keep the greenback underpinned for now. The euro could gradually recover alongside risk appetite, though growth concerns persist, while the yen is likely to remain under pressure as the Bank of Japan stays steadfastly accommodative and the country's status as a commodity importer weighs on the currency. Emerging markets are split between commodity importers and exporters, with China broadly holding up.

Commodities

Commodities continue to climb on the back of the Ukraine war, with oil and natural gas prices set to remain high even if the conflict ends. Grains have also jumped, though the supply-demand picture appears more balanced. Gold is likely to continue to benefit from its safe haven status, but tighter monetary policy remains an obstacle to much higher prices. Base metals should hold up as demand remains buoyant and Chinese policymakers are intent on supporting growth. Overall, while supply chain bottlenecks appear to be slowly abating, the conflict implies higher-for-longer prices across most commodities.

Crypto

Bitcoin and Ethereum have bounced back and above important resistance levels, erasing the year's losses (for Bitcoin) and painting a more positive picture for cryptocurrencies for the months ahead. Given the increased correlation to tech and the sector's recent upswing, momentum should continue. With long-term holders convinced of the upside and growing adoption more broadly, prices should find longer-term support. Moreover, the growing adoption of NFTs and other blockchain-based innovations, will likely add to demand.

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