FLASH

Brief updates on portfolios, markets & more 18 February 2022

Your questions answered

Below are answers to our Client's most frequently asked questions (FAQs) on inflation, the Fed, FOMC minutes, Russia/Ukraine, our portfolio positioning and Gold as a hedge.

FAQ 1.
US inflation numbers have been red hot. What comes next?

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Syz PRIVATE BANKING

FAQ 1 —

US inflation numbers have been red hot. What comes next?

The current market narrative is very much shaped by surging inflation numbers. On Monday, US PPI Final Demand jumped to 1.0% MoM in January from 0.4% revised upward, while YoY metric remained high at 9.7% YoY. Economists were expecting softer prints on the back of base effects, which did not materialize. Last week, US January CPI rose 7.5% from a year ago, exceeding the 7.3% estimate and marking the largest gain since 1982. The rise in prices was broad-based across goods and services. Higher food, electricity, housing and used car prices led the hike. The acceleration in rents is likely to prove sticky, supported by rising home prices, a tight labor market, and the lowest rental-vacancy rate since 1984. With services inflation picking up, the return to more moderate price increases will likely take longer than central banks are willing to tolerate.

Still, there are signs that inflationary pressures could soon start to ease:

- Services inflation is on the rise as spending shifts away from goods to services on the back of an improvement on the omicron-variant front. As such, goods inflation is likely to start easing as supply chains and inventory normalize. Take the example of automobile prices. Used car inflation was 41% YoY and new car inflation was up 12% YoY. But the month over month price increase is starting to decelerate. Moreover, auto manufacturers (General Motors, Ford, etc.) are projecting strong production growth this year, which means that rising prices are likely to moderate if not reverse.
- Still on goods inflation, we observed that shipping costs have been easing since mid-November. For instance, the Cass Freight shipment volumes in January turned negative for the first time in 16 months. Supplier delivery times have been improving as well. This means that the supply chain bottlenecks are starting to clear.
- The New York Fed and Philly Fed survey data for February showed expectations for future pricing starting to recede.

Bottom-line: The inflation issue will not get resolved soon and should remain above the Fed's target for some time. However, we do not expect inflation to get much worse, for the following reasons: 1) More difficult comps as the year progresses; 2) Pandemic distortions starting to fade; 3) The tightening of monetary conditions is likely to have an effect as well. Therefore, we continue to expect that price increases will peak soon (possibly March) and moderate more meaningfully in the second half of the year. This is one of the reasons why long-term market-based inflation expectations have stayed relatively stable despite CPI hitting 40-year highs.

FAQ 2 —

What to expect from the Fed?

Between a strong January jobs report, surprisingly resilient retail sales, unemployment rate near historic lows and recent inflation data, the Fed needs to quickly shift away from its ultra-loose monetary policy and start hiking interest rates.

Over the last few weeks, the market has started to anticipate a more aggressive tightening pace. With St. Louis Fed President James Bullard expressing his support for raising rates by 1% by July, the two-year Treasury yield has jumped the most since 2009. At the time of our writing, the bond market is now pricing in between six and seven rate hikes this year.

There is indeed a perception in the market that the Fed is behind the curve and that the FOMC needs to restore its credibility. As such, the Fed could very well decide to hike rates by 50 basis points in March (instead of the typical 25pbs). Additional rate hikes could then take place in May and June. However, we would not be surprised to see a more gradual pace after June. As we mentioned earlier, we expect inflation starting to moderate in the second half. Moreover, the Fed might need some time to assess the effects of the first rate hikes of the cycle.

Bottom line: with inflation at a 40-year high and becoming broad-based, the economy no longer needs help and the Fed should normalize its policy. We expect rate hikes and quantitative tightening (QT) later on. However, current market expectations (between 6 and 7 rate hikes) might be too aggressive.

FAQ 3 —

Did we learn anything from the FOMC minutes published on Wednesday?

The short answer is NO. As usual, FOMC minutes are backward looking (the meeting took place on January 25-26th) but the market was expecting clues about the amplitude of the March rate hikes as well as the pace of balance sheet reduction later in the year. We did not get more clarity on both outcomes as the minutes provided little new information that markets were not aware of. There was some attention given to a comment that the Fed Funds rate could increase at a faster pace than the post-2015 period. But this is not a surprise given the Fed projections and what the market has already priced in. On the dovish side, some members expressed their concerns about monetary tightening happening too quickly. Meanwhile, a few "hawks" said they were in favor of ending net purchases (QE) sooner than currently planned. The minutes also emphasized the data dependence mode from the Fed, particularly around inflation ("if inflation does not move down as they expect, it would be appropriate to remove policy accommodation at a faster pace than we currently anticipate").

The market reacted rather positively to the minutes. Stocks picked up Wednesday evening after the release. Treasury yields were all lower on the day with the short-end declining most (2Y -7bps, 20Y -1bp). The odds of a 50bps hike in March dropped from around 70% earlier in the day to just below 50% by the close. The yield curve erased a lot of the post-Bullard bear flattening.

Bottom-line: The lack of hawkish surprises (rather than outright dovishness) explains the somewhat quiet market reaction to the FOMC minutes release. It also reinforces our

view that a lot of hawkishness seems to have been already priced in by the market.

FAQ 4 —

What's our take on Russia/Ukraine geopolitical risk?

The Dow Jones suffered its worst day of the year on Thursday as investors continued to be on edge about the ongoing tensions between Russia and Ukraine. On Tuesday, investors got some relief on the news that Russian troops were pulling back from Ukraine borders. But since then, Western leaders and NATO have cautioned against taking Moscow at its word and US President Biden warned that Russia could be involved in a "false flag" operation.

The Russia / Ukraine crisis geopolitical risk remains elevated, which means that oil and equity volatility is here to stay. It also complicates the task of central banks on tackling inflation as the crisis is pushing energy prices upward.

Looking ahead, we do see the potential scenarios unfolding:

1. (High probability) Ongoing elevated tensions. Talks continue, with no clear solution in sight (although everyone favors diplomatic channels). Risk premium on the ruble and Russian assets to stay elevated for some time.
2. (Medium probability) De-escalation of tensions as an agreement between Russia and US on a new security accord is found => Ruble will strengthen against dollar and Russian assets will rebound aggressively
3. (Medium probability) Escalation of the conflict in Donbas. Russia gets involved in Eastern Ukraine either directly or indirectly. The West retaliates with sanctions
4. (Low probability): full-scale conflict with invasion of Ukraine by Russian troops. Massive sanctions by the West. Ruble collapses and risk premium on Russia assets hit the roof.

Bottom-line: the most likely scenario is tensions to stay elevated until the end of March. Beyond this point in time, Mr. Putin will have less bargaining power as Europeans will be less reliant on Natural gas as the winter season draws to an end. In the meantime, the Russia/Ukraine crisis will continue to put upward pressure on energy prices and thus on short-term inflation expectations.

FAQ 5 —

Should investors de-risk their portfolios?

Market volatility has been on the rise since the start of the year as investors need to adapt to a new interest-rate regime and the potential negative consequences on long-term economic growth. While we believe the uncertainty around the interest-rate and economic outlook should persist in the coming months, we also would like to highlight the importance of avoiding the natural tendency to overreact to short-term market volatility.

Successful investing needs thoughtfulness and composure, and we continue to rely on our macro, fundamental and market indicators instead of reacting ex-post to market action. Despite a potentially less supportive liquidity outlook in the months ahead, the weight of evidence leads us to maintain a positive stance on risk assets and equity in particular. Global growth remains above potential, financial conditions remain supportive, global earnings growth is still well oriented and some segments of the market remain reasonably valued. Our market technical indicators (trend, sentiment, etc.) continue to react rather nervously to recent market volatility but are not flashing red yet.

Bottom-line: Until we get more clarity on the inflation outlook, volatility is likely to remain elevated and stocks might have to go through more corrective phases. In the near-term, Fed tightening will weigh on equity valuations but we are confident that fundamentals are strong enough to offset the upcoming rate-hiking cycle. With real bond yields still in deep negative territory, investors should keep a near-term view and continue to invest into risk assets. In the current macro context, speculative investments and unprofitable growth stocks are the most at risk. We thus recommend our clients to focus on quality. Within the context of a well-diversified portfolio, we also favor some tactical exposure to cyclical plays and the less expensive segments, which includes international equities and value sectors.

AQ 6 —

What is our current portfolio positioning?

Our discretionary portfolio management process relies on the conclusions of our asset allocation committee but also on our proprietary risk-based portfolio construction process.

Since the start of 2022, we have had a positive allocation to equity markets but with some portfolio protection in place (lookback put-spread options) and exposure to broad-based commodities and gold. The recent rise of risk level triggered a modest de-risking of the portfolios (between 3% and 4% equity reduction in balanced portfolios). Nevertheless, we have kept a positive exposure to global equities.

From a country and style perspective, we continue to favor a mix of secular plays (large-caps quality growth names mainly in the US) and some tactical value / cyclical exposure (hence preference for regions such as Europe and Japan). Indeed, the shifting-rate environment has been a catalyst for style rotation within equity markets. Value investments have outperformed growth investments during this phase, and this leadership is likely to continue as long as we stay in this period of adjustment.

On the fixed income side, we keep a cautious stance. While we believe that equity markets could stabilize in the short-run, high yield and lower quality investment grade should continue to suffer from declining liquidity, rising interest rates (as investors will be less likely to seek lower ratings for high yields) and tight valuations. We favor long duration, higher quality bonds over higher yield / lower quality names.

In Forex, we remain positive EUR, GBP and JPY against USD while still cautious on the Swiss Franc and EM currencies.

We remain cautious on Commodities and positive on Gold (see next question).

AQ 7 —

Gold usually suffers when real yields start to rise. They have been diverging recently. Why?

The yellow metal usually exhibits high negative correlation with real yields, i.e the lower real yields the higher the gold price. But they have been diverging recently.

There are several possible reasons that could explain the current divergence:

1. Gold as the ultimate safe-haven and geopolitical risk hedge: in the current context of the Russia-Ukraine tensions, investors cannot find shelter in US government bonds, which are pricing in several interest rates hikes. Gold is therefore one of the very few hedges available;
2. During periods of rate hikes, gold's negative correlation with long-term real rates tends to break down. As Goldman wrote, this has to do with the fact that the rate hikes themselves lead to fears of a growth slowdown and recession and therefore boost demand for safe haven assets, such as gold. This means if inflation fails to slow down in the second half of 2022 and the Fed is forced to hike more than currently expected, gold should be resilient as this would increase fears of a potential recession.
3. Demand coming from emerging markets savers. Gold suffered last year from lower demand coming from Emerging Markets. With the growth recovery in EM, demand is on the rise again.

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

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