Monthly Market Views

International Private Banking Division

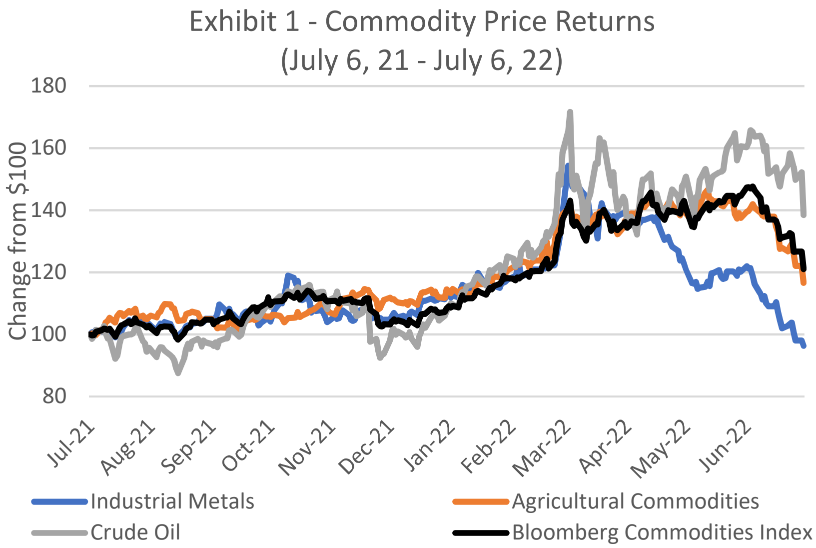
JULY 2022

The first half of 2022 has been one of the broadest negative financial market performance periods experienced in decades. What are the signals clients can follow that may signal a market reversal?

The first six months of 2022 have ushered in negative performance for asset classes ranging from Fixed Income to Equities to Cryptocurrencies. One of the safest places to have been invested during this period have been commodities, which got a significant boost on the back of early-2022 inflation concerns and the war in Ukraine. But even this panacea has turned negative over the past month, as the prices of commodities have dropped significantly. Looking ahead, a major driver of Equity and Fixed Income market performance is going to be the direction of US Federal Reserve policy; which is itself largely driven in the short-term by inflationary data. For active investors, it is important to keep an eye on the path of US Fed policy, which can often times dictate the path of financial markets.

2022 began with global inflation data significantly outpacing expectations. Inflation expectations were further heightened in late-February, following the Russian invasion of Ukraine, as commodity prices jumped significantly. During this period the inflation narrative has been ubiquitous in financial markets news. The idea of being 'behind the curve' on combatting inflation led the US Federal Reserve to hike rates by 0.75% in June and hint at a similar hike in July. While the news media has continued its focus on inflation, financial markets seem to have moved-on.

Fixed Income Market's inflation expectations are not particularly accurate at forecasting inflation expectations. What they do illustrate is whether inflation is perceived as entrenched, and likely to compound. Which at this point seems to be a resounding NO.



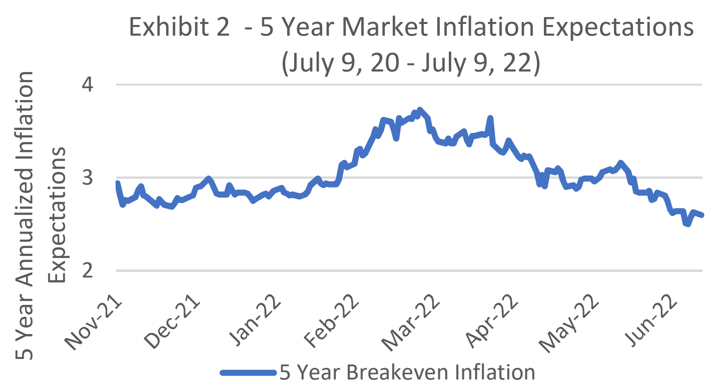
Since peaking on June 7th, broad commodity prices as measured by the Bloomberg Commodity Index have dropped significantly. The overall index is down 17% as of 7/5/22 (Exhibit 1[1] – Black Line). While some of it's underlying components are down even more from their respective peaks, with industrial metals experiencing the largest reversal at -38%. Even agricultural commodities, which gained significantly following Russia's invasion of Ukraine on February 24th, are down nearly -10% compared to their pre-invasion levels.

[1] Source: Bloomberg Terminal (BCOMIN index, BCOMAG index, CO1 Comdty, BCOMTR Index)

As commodity prices have dropped, markets have also significantly reversed their inflation expectations for the US economy. One of the most widely used indicators of the markets expectation for inflation is known as "Breakeven Inflation".

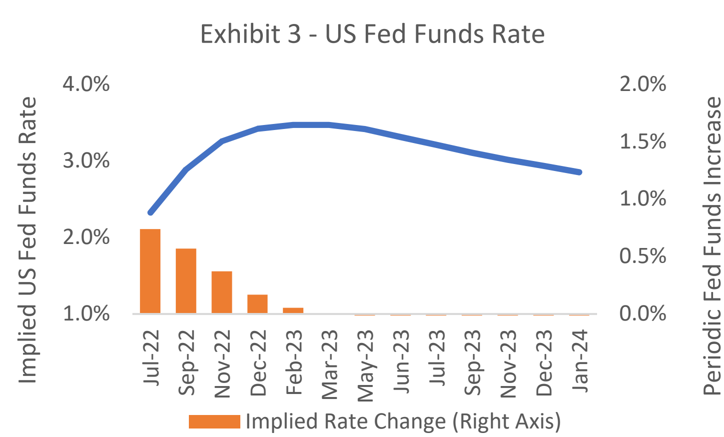
This indicator is arrived at by taking the current yield on a US Treasury and subtracting the yield on an inflation protected US Treasury (TIPS). Exhibit 2 depicts the past two years of the market's inflation expectations for the upcoming 5 years (by subtracting the yield on a 5 year US Treasury from the yield on a 5 year US TIPS).

While inflation expectations rose sharply in the beginning of 2022, peaking at 3.73% on March 25th; they have since precipitously dropped since (Exhibit 2[2]). Fixed Income markets are now pricing in 2.6% annualized inflation over the upcoming five years, with a bulk of that inflation expected to come within the next year. The takeaway from this trend is not that we will not see inflation, since Fixed Income markets inflation projections are not particularly accurate at forecasting inflation expectations. What they do illustrate is whether inflation is perceived as entrenched, and likely to compound. Which at this point seems to be a resounding NO.



A major catalyst for the decline in inflation expectations have been the actions of the US Fed; Which has significantly tightened monetary policy by raising interest rates and decreasing the size of its balance sheet. However, the decline in inflation expectations has come at the expense of declining economic growth. With the overall effect being that the markets reaction function to new data seems to be shifting from a focus on how will new data affect inflation to how will new data affect economic growth.

Arguably the most important signal among all the noise is the future path of US Federal Reserve policy. With the major question being "**Will the slowdown in inflation and growth be enough for the US Fed to take their foot off the breaks in the near future?**" Fixed income markets are currently pricing in five US Fed meetings that culminate in a rate hike[3] (Exhibit 3 – Orange bars), with a terminal Fed Funds rate being reached in March 2023 at a level of 3.5% (Exhibit 3 – Blue line). Following previous Fed-hiking cycles that caused financial market turbulence, markets have historically troughed several months prior to the Fed reversing course. While no past episode is a perfect comparison to today's events, economic data showing declining inflation are likely to give the Fed an impetus to cease financial tightening. And the buildup of these types of data points are likely to be bullish securities issued by quality businesses with strong balance sheets and steady profitability.



[2] Source: Bloomberg Terminal (USGGBE05 Index)
[3] Source: Bloomberg Terminal (WIRP United States)

Economic Overview

	GDP Forecast (2022)	GDP Forecast (2023)	Inflation Forecast (2022)	Inflation Forecast (2023)	Currency vs. USD	IG Credit Downgrade
Argentina	2.9%	2%	62%	53%	-19.0%	N/A
Brazil	1.4%	1%	10%	5%	6.1%	N/A
Chile	2.1%	1%	10%	5%	-13.4%	Low
Mexico	1.8%	2%	7%	5%	-0.4%	Medium
Peru	2.8%	3%	7%	4%	1.4%	Low
Uruguay	4.5%	3%	9%	7%	10.1%	High
Israel	5.0%	4%	4%	3%	-10.8%	Very Low
USA	2.4%	2%	8%	3%	12.7%	Very Low

COVID-19 Overview

	Vaccine Doses / Population	Total Cases	Total Cases/ Population	Last 30 Day Growth Rate
Argentina	224%	9,426,171	19.80%	1%
Brazil	212%	32,896,464	15.20%	2%
Chile	300%	4,084,308	20.42%	3%
Mexico	159%	6,259,325	4.76%	4%
Peru	229%	3,675,152	10.81%	1%
Uruguay	243%	962,251	26.89%	1%
Israel	212%	4,449,647	51.74%	3%
USA	182%	88,593,875	27.01%	2%

Data Source: Bloomberg Terminal, as of July 10, 2022

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