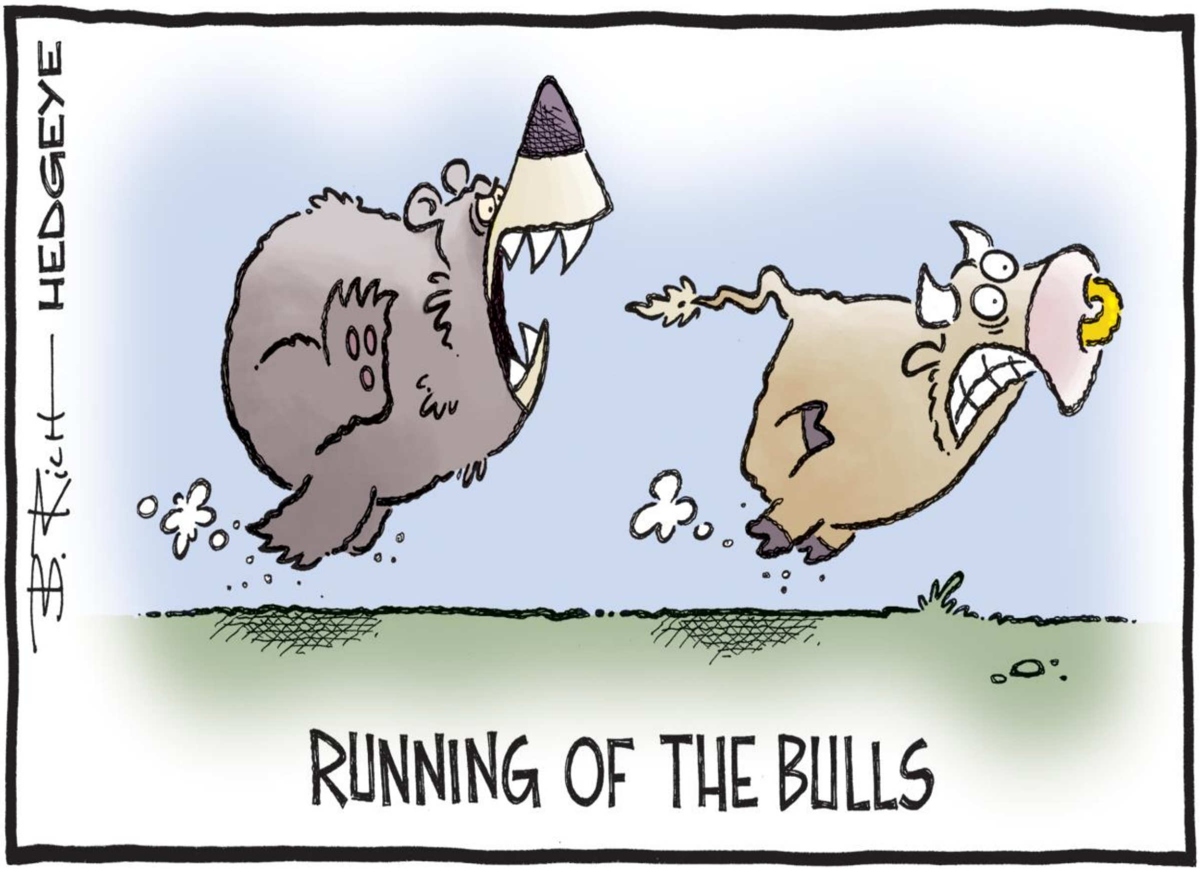
Market Review February 2022



After a strong end of the year, equity indices have stalled for the first month of the year. In an environment that has been more volatile in recent months, investors have tended to focus on risks (which were already known and latent). Although the escalation of tensions between Russia and the US has contributed to the worries, the real trigger for the market decline was to blame to the US central bank. We have repeatedly said that central banks are "our friends" but that they have to do their job...the much firmer tone set by J. Powell at the last FOMC meeting has caused some tension in the financial community. In addition to the fact that the tapering will be accelerated to end in March 2022 (instead of June), the prospect of starting the rate hike cycle sooner than expected gave a message of a much less accommodating monetary policy to come. Indeed, before this meeting, the consensus was betting on 3 rate hikes in 2022 with the first intervention in June. From now on (since the January meeting), the market expects 5 hikes in the next 12 months, with a first hike of a quarter point in March. This tightening is justified by inflation, which has been struggling to come down for 9 months and remains at levels not seen since the 1970s. The phenomenon is also affecting Europe, albeit to a lesser extent.

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As a result, with the exception of the last three days, investors sold growth stocks (which are more sensitive to monetary tightening) throughout the month to shelter in more defensive sectors. This is why, for once, the Nasdaq (-8.52% over the month) drop significantly more than most other indices, such as the Dow Jones Industrial, which fell by "only" 3.3%. Logically, Europe held up better thanks to its value bias and with the support of oil and financial sectors. The European banking sub-index rose by more than 6%, while the oil sub-index soared by more than 8%, helped by the rise in oil prices (+16.8% to $88 per barrel).

Does this mean that central banks are no longer "market friendly" and that we should be back on the warpath? We don't think so!

Market evolution at the end of January 2022

	Equities in Local Currencies							
End of December	MSCI World	S&P 500	EuroStoxx	CAC	Spain	Switzerland	MSCI EM	CSI 300
Perf 1 Month	-5,34%	-5,26%	-2,88%	-2,15%	-1,16%	-5,04%	-1,93%	-7,62%
Perf 3 Month	-3,64%	-1,95%	-1,79%	2,47%	-4,91%	0,98%	-4,47%	-7,03%
Perf YTD	-5,34%	-5,26%	-2,88%	-2,15%	-1,16%	-5,04%	-1,93%	-7,62%

	Commodities				Currencies vs EUR			
End of December	WTI Oil	Brent Oil	Gold	Copper	USD	JPY	GBP	CHF
Perf 1 Month	17,21%	17,27%	-1,75%	-2,21%	1,24%	1,21%	0,66%	-0,36%
Perf 3 Month	5,48%	8,09%	0,77%	0,11%	2,91%	1,89%	1,10%	1,64%
Perf YTD	17,21%	17,27%	-1,75%	-2,21%	1,24%	1,21%	0,66%	-0,36%

	Bloomberg Indices Bonds Total returns							
End of December	Global Aggregate	US Aggregate	Euro Aggregate	US 10 Year Treasury	German 10 Year Bund	Global Credit	Global High Yield	Emerging Sovereign $
Perf 1 Month	-2,05%	-2,15%	-1,12%	-2,36%	-1,81%	-2,95%	-2,54%	-2,63%
Perf 3 Month	-2,47%	-2,12%	-1,09%	-1,59%	-1,95%	-3,45%	-2,71%	-2,74%
Perf YTD	-2,05%	-2,15%	-1,12%	-2,36%	-1,81%	-2,95%	-2,54%	-2,63%

Source: Bloomberg 31/01/2022.

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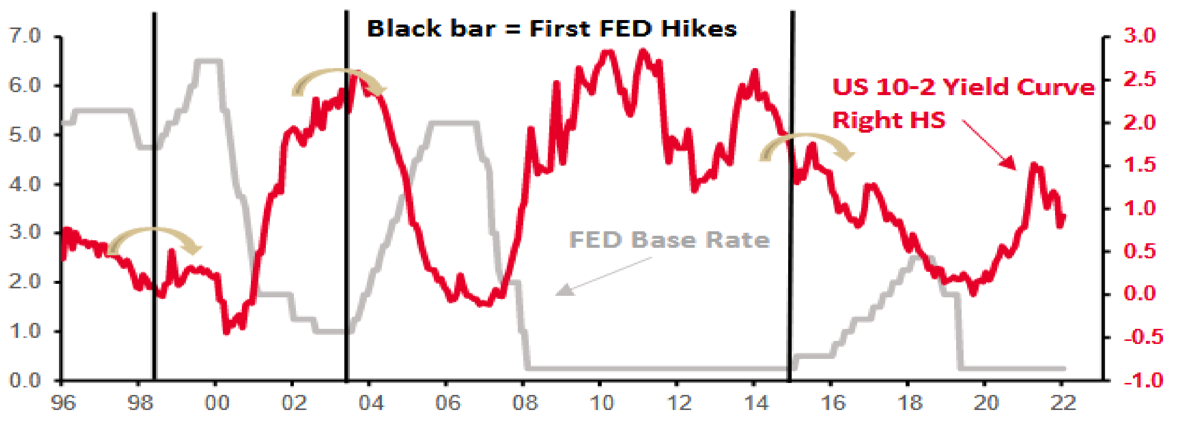
Of course, it was not only equities that came under pressure during the first month of the year. When we say "future rate hike", we also mean pressure on the yield curve. The U.S. 2-year yield has thus skyrocketed since mid-December, reaching a high of 1.20% at the end of January. Even though long rates have also risen, it has been more moderate, which has logically caused the yield curve to flatten. This flattening is quite logical and frequent when a central bank enters a new rate hike cycle, so there is nothing alarming at this stage, at least as long as the spread between the 2-year and 10-year remains in positive territory (it is currently at 60 basis points). A reversal of the latter could be a leading indicator of a future recession to come...but this scenario does not seem to be on the cards, at least for now.

Graph showing Fed funds hikes and curve flattening



Source: SG Cross Asset Research/SG Global Asset Allocation

The ECB has a different stance and therefore the Bund yield curve is evolving differently. The German 10-year has also gone up, but since the European Central Bank is not talking about a rate hike for the moment, long rates have risen more than short ones, which has caused a steepening of the curve between the 2-year and 10-year. The latter even could afford going back above zero for the first time since May 2019. Champagne! This, among other things, allowed the financial sector (banking and insurance) to post excellent performances over the month.
There is a strong probability that the German curve will follow the evolution of the American curve, but with a lag of 6 to 9 months. Moreover, Mrs. Lagarde's commentary at the beginning of February argues in this direction... The Bank of England (BoE) proceeded with its second rate hike at the beginning of February, while the PBOC continues to inject liquidity to support the real estate market and domestic consumption. The divergent monetary policies we talked about in January are carrying on their way.

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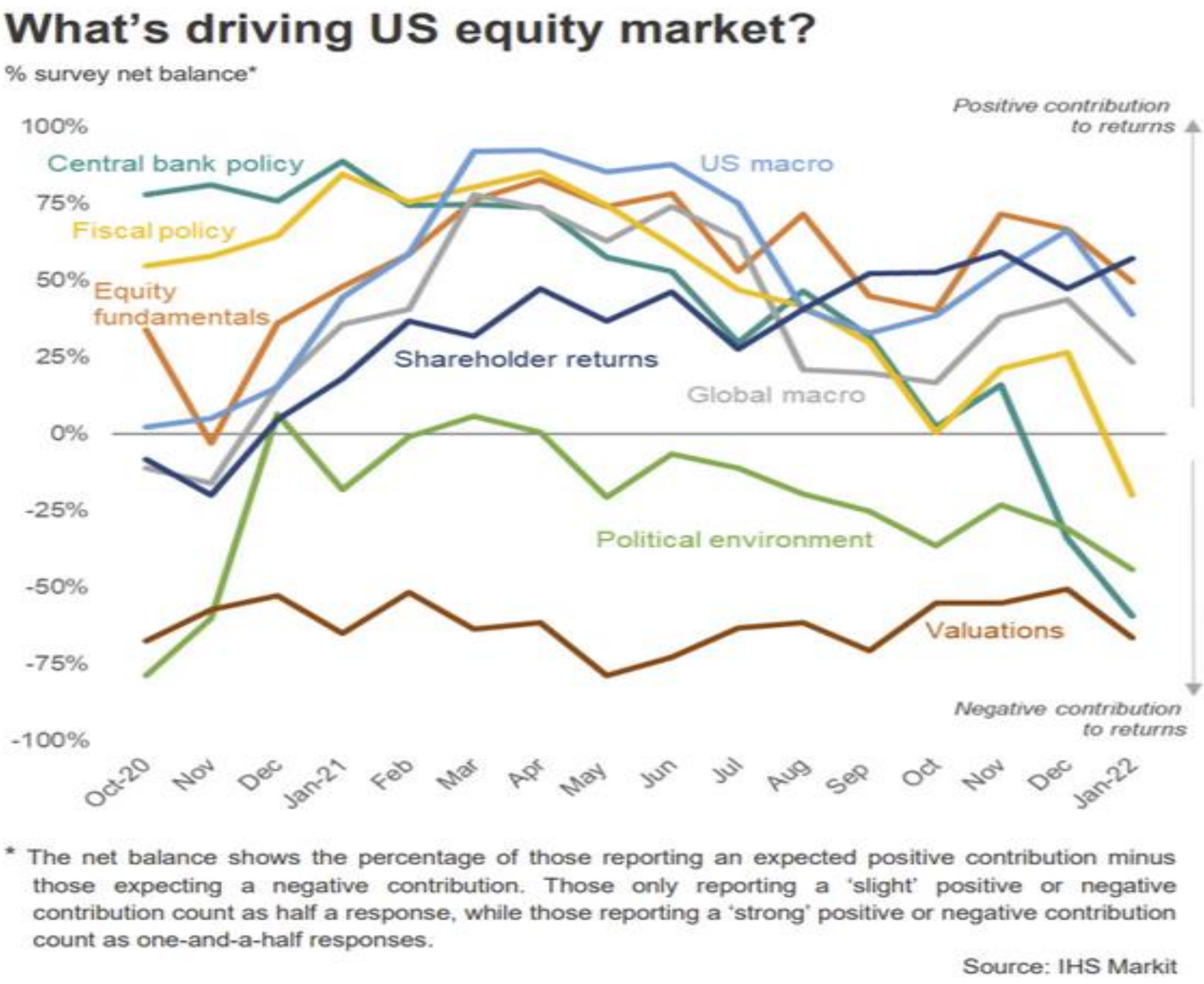

Why are most central banks, and particularly the FED, getting hawkish and acting faster than expected? Simply because inflation, which has long been described as "transitory", seems to be more persistent than expected in all sectors of the economy. At least that is what the economic statistics suggest.

Some components of inflation caused by bottlenecks may begin to dissipate during 2022, if firms return to "normal" post-covid level of activity and can meet demand. Still, in some industries, it will take longer.

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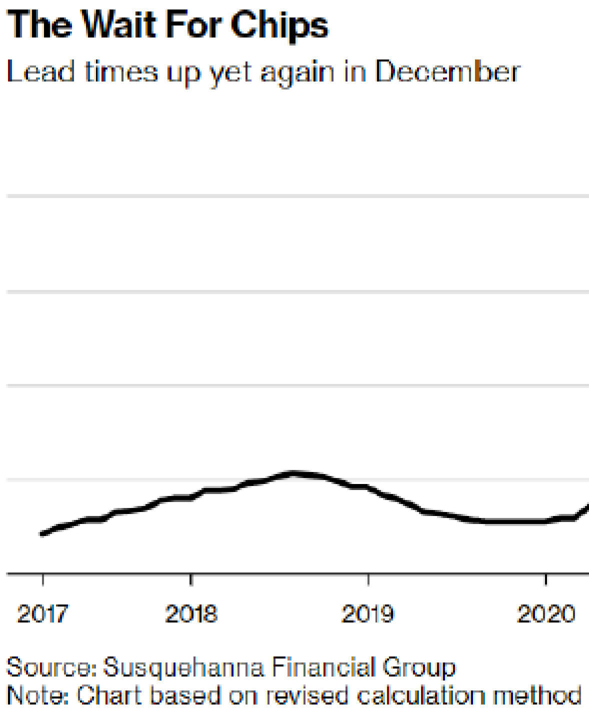

If China maintains its "zero-covid" policy, this could prolong the pressure on production and logistics chains, as bottlenecks would take longer to resorb.

In addition, wage pressures that have been relatively subdued in 2021 could really surface this year. If the imbalances in the labor market were to intensify (we are already seeing more job vacancies than unemployed people in the U.S. to date...), we could indeed face an inflation harder to fight, which justifies a more hawkish monetary policy. Central banks have repeatedly said over the past year that the labor market would be the barometer for gauging the tenacity of inflation. These statistics will therefore have to be followed very closely in the coming months.

Still, the consensus is expecting weaker global economic growth next year, which should help inflation to stabilize.

Central banks will therefore have much to do in coming months, and their communication will be determinant in keeping investors' heads cool.

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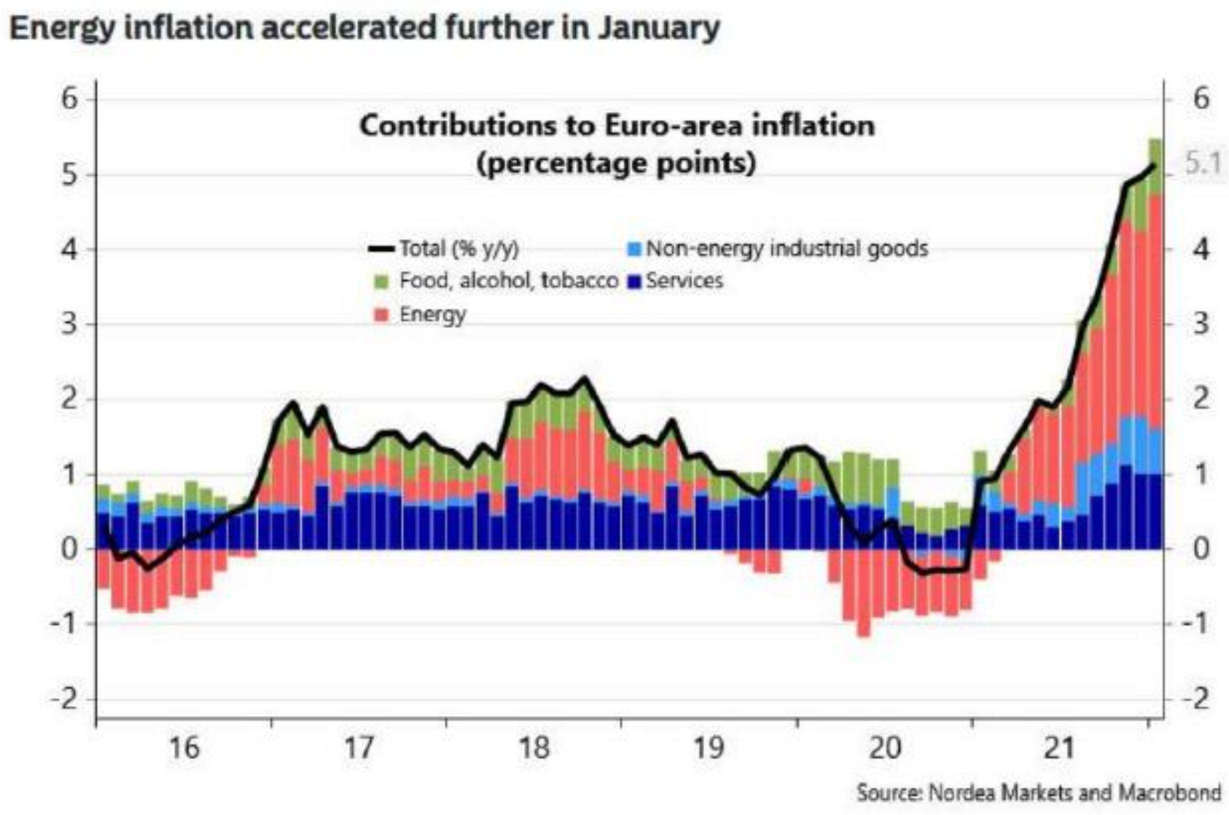

About the tensions between Russia and the United States...what exactly are we talking about? According to satellite images, Russia has amassed more than 100,000 soldiers on the Ukrainian border and is about to launch a vast military operation. At least that is what the United States and its allies fear. Negotiations are underway, but for the moment all discussions remain fruitless. Ukraine seems to be the last straw for Russia. The latter is asking the United States to refrain from setting up new military bases in the countries of the former Soviet Union because it feels threatened by the expansion of NATO on its borders. We can imagine that President Putin will not let go of the matter...

It is therefore particularly difficult to anticipate the reaction of the West in case of Russian intrusion on Ukrainian soil. Economic sanctions? Military response? All options remain open. Even if the direct impact on the world economy should be fairly low, financial markets could falter, mainly because of a probable surge in the price of oil. The latter is already at its highest since October 2014 due to strong demand and the slow increase in production quotas by OPEC+ countries, it will take no less for it to soar above $100 per barrel. Europe would be more directly penalized because of its "dependence" on Russian gas.

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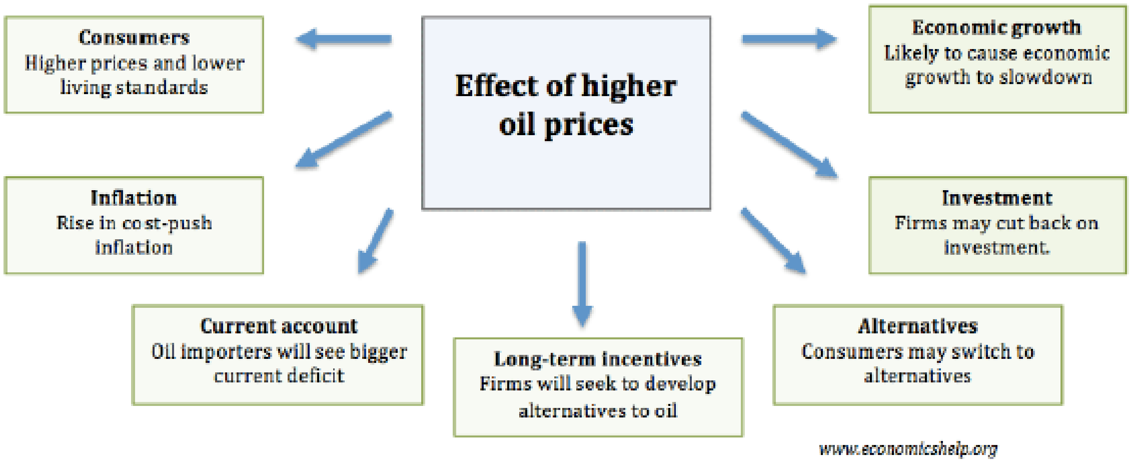

On our side, we are not giving into panic following the January correction. As we wrote at the end of last year, 2022 is going to be a "challenging" year for investments and we will have to be more selective than in the past. Global growth is expected to be weaker this year, but the economic environment remains favorable for risky assets, despite that liquidity will be less abundant than in recent years. Dividends in 2022 are expected to reach record levels, banks have healthy balance sheets and companies will continue to report good normalized post-covid results, even if quarterly accidents cannot be exluded like Facebook.
Inflation will have to be monitored like milk on the stove. Central banks have understood this and if they want to preserve their credibility, they will have to demonstrate their willingness to fight inflationary pressures so that they do not settle permanently.
In terms of geopolitical risks, China remains at the center of our concerns. The Middle Kingdom continues its campaign of intimidation toward Taiwan. The risk of an invasion of the island is a possibility to be taken seriously. It is a "black swan" type of risk (exogenous) that would have negative consequences on the world's stock markets if it were to materialize.
Beware also of "zombie" companies that will be penalized by the recent rate hikes. With performance dispersion increasing, the search for decorrelated investments makes sense.
We wish you a nice month of February and great ski vacation for those who will have the chance to enjoy it.

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