Weekly Market Summary

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How High Will We Go?
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If your stomach was churning all week, you're not alone. With so many crosscurrents of uncertainty in markets, the reasons to worry just keep piling up. War in Ukraine, rampant inflation, energy shortages, disrupted supply chains, stocks meltdown, crypto crash, and now a brewing global food crisis. These were the main points discussed by the slimmed-down crowd that assembled in the Swiss Alps this week for the World Economic Forum.

Amid the gloom, the primary consensus from Davos was that hunger would increase. There's particular concern about the inability of ships to export grain from Black Sea ports, including Odesa, given Russia's invasion of Ukraine. David Beasley, head of UN's World Food Programme said "Failure to open up the ports is a declaration of war on global food security." The problems run way further. Higher energy prices raise agricultural production costs across the board; protectionism is on the rise; and bad weather is an issue from Kansas in the US to India's croplands. Wheat hit a record right after Moscow's initial assault. Corn's not far off an all-time high. The same is true for soybeans. This is likely not the top. 276m people face acute and severe food insecurity -- twice as many as two years ago. Ngozi Okonjo-Iweala, the director general of the World Trade Organisation says the food crisis prompted by the war in Ukraine is a "real worry" which could persist into next year and perhaps longer. If countries can't get fertiliser (of which Ukraine is a big supplier) then yields will be low. Saudi Finance Minister Mohammed al-Jadaan believes the world is not taking it seriously enough. He said, "The MENA region is very, very, very vulnerable. It imports a lot of food, it represents 6% of the population in the world." Before the war, more than 95% of Ukraine's total grain, wheat and corn exports were shipped out via the Black Sea, and half of those exports went to MENA countries.

And right at the start of the Forum, the head of the IMF warned that the global economy faces perhaps its "biggest test since the second world war". Kristalina Georgieva, IMF managing director, said Russia's invasion was "devastating lives, dragging down growth and pushing up inflation." But, speaking on the side-lines of the conferences, she said the global economy could avoid a deep downturn. Speaking on a panel at the forum, Robert Habeck, Germany's vice-chancellor and economy minister, said: "I'm really afraid that we are running into a global recession, with a tremendous effect not only on [the climate], but on global stability." Jane Fraser, chief executive of Citi, said there would be a recession in Europe and a downturn in the rest of the world. It's a question of "Russia, recession and rates" all damaging activity, she added.

Investors were waiting eagerly for the minutes of the Fed Meeting released on Wednesday. Most Federal Reserve officials agreed at their gathering this month that the central bank needed to tighten in half-point steps over the next couple of meetings, continuing an aggressive set of moves that would leave policy makers with flexibility to shift gears later if needed. Markets continued to show traders pricing in 100 basis points of rate hikes over the next two meetings. Fed officials "noted that a restrictive stance of policy may well become appropriate depending on the evolving economic outlook and the risks to the outlook and the risks to the outlook," the minutes said. They said that labor demand continued to outstrip available supply. Atlanta Fed President Raphael Bostic suggested on Monday that a September pause "might make sense" if prices pressures cooled. The minutes showed officials attentive to financial conditions as they prepare to raise rates further. At the meeting, officials also finalized plans to allow their $8.9 trillion balance sheet to begin shrinking, putting additional upward pressure on borrowing costs. Starting June 1, holdings of Treasuries will be allowed to decline by $30 billion a month, rising in increments to $60 billion a month in September, while mortgage-backed securities holdings will shrink by $17.5 billion a month, increasing to $35 billion. The minutes also showed that the Fed staff revised up their inflation forecast. They estimated that the personal consumption expenditures price index would rise 4.3% in 2022 before decelerating to a 2.5% increase next year. PCE numbers just came out showing the rate of inflation slowed to 6.3% in April from a 40-year high of 6.6% in March. That was the first decline since November 2020. A narrower measure of inflation that omits volatile food and energy costs, known as the core PCE, rose a somewhat higher 0.3% in April. The increases in the core rate of inflation in the last three months, however, were the smallest since last summer.

US Equities reacted positively to the minutes. The S&P 500 ended Thursday up 2 per cent, while the tech-heavy Nasdaq Composite advanced 2.7 per cent, the biggest gain for both in a week. Weaker-than-expected Q1 GDP data also helped ease pressures related to persistent Fed tightening this year. Revised figures showed the world's biggest economy contracted at an annualised rate of 1.5 per cent in the first quarter, slightly worse than the previous estimate of 1.4 per cent. Nevertheless, the broad market environment is grim. The benchmark S&P 500 is down 15 per cent on the year so far and is hovering on the edge of crossing the arbitrary threshold of 20 per cent below its latest peak that would mark a recognised bear market. The Nasdaq Composite is down a quarter in 2022 and double-digit losses on exchanges across Europe and Asia are common as investors adjust to red-hot inflation and the rapid withdrawal of central bank support. A sharp rise in Treasury rates this year has also been a massive drag on fixed income. Stocks and bonds falling together is making life difficult for managers of risk-parity and 60/40 like portfolios. Investors aren't used to seeing dramatic losses in their bond portfolios, particularly when equity markets are also declining sharply.

So where do investors go? If history is any guide, inflationary environments and commodities were good friends. Global fund managers positioned themselves for a commodities boom earlier this year, taking their allocations to an all-time high.

This week, oil surged. Brent crude rose above $116 and signs are for a red hot summer. Oil markets are facing an explosive cocktail. Russian output disrupted by its invasion of Ukraine and at risk from further sanctions; dwindling spare capacity in the OPEC+ coalition; scorching temperatures that will scream out for air conditioning use; and a squeeze on refining capacity following years of plant closures. The US is going into the peak period for gasoline with stockpiles at the lowest seasonal level since 2014. Saudi Arabia has indicated it won't ride to the market's rescue by opening the taps when OPEC+ meets next week. Speaking in Davos, its foreign minister insists the kingdom has "done all it can". Hopes are even fading of any supply relief from OPEC nation Iran, as nuclear negotiations that could have removed US sanctions now considered near-dead by even their most enthusiastic diplomatic proponent.

Many investors believe equities could continue to disappoint. Their arguments are that large-cap US equities are in a bear market, and haven't yet seen the sort of capitulatory move emblematic of a more durable bottom. We'll know it's a bottom when people stop asking if it is one. US households' allocation to equities as a percentage of financial assets is at all-time highs, a product of years of stimulus-fueled, monotonically increasing returns. Such stretched positioning is a strong indication of equity underperformance over the next decade. Starting valuations, one of the best long-term predictors of performance, remain very high despite the recent selloff. Others see light forming the market. They believe selling has gone too far and recent price action overestimates the likelihood of a recession. Behind these predictions is also a belief that valuations already account for all the pain that is likely to be visited on the economy and earnings.

Market participants may remain split on the near-term direction for equities. Commodities have many shortcomings as an investment class. They're volatile, and most commodity markets offer considerably less liquidity than stocks or bonds. They are a tiny sliver of the investable market, but they will become ever more difficult to ignore in this new inflationary world.

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