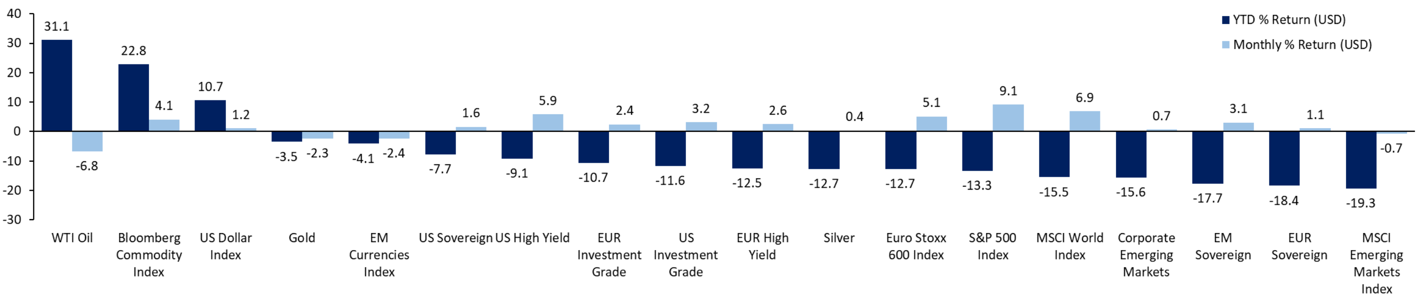
August 2, 2022

Monthly Market Wrap, July 2022

The Fed delivered yet another "unusually large" 75bps rate hike to combat persistent inflationary pressures. US Real GDP contracted by an annualized 0.9% in 2Q22, its second consecutive decline. Small business optimism is at a decade low meanwhile small business forward outlook dropped to a new all-time low. Earnings growth may remain positive, but it is decelerating (fast). We are only seven months into this bear market for US equities. Restoring price stability remains the number one goal for central branks globally, even if it comes at the cost of slower growth. The number one objective is to bring demand back in line with supply via tighter conditions.

Chart 1. Asset Class Return YTD (USD Base)



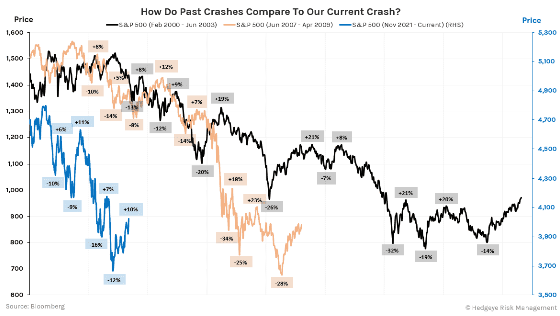
Equities

Today's current bear market only lasted 20% as long as 2000, and 37% as long as 2008. Bear market bounces can be violent. July was a prime example, yet still small by historical standards. For 2000, the average bounce was +15% vs. -18% down moves. For 2008, the average bounce was +12% vs. -19% down moves. Today, the average bounce is +9% vs. -12% down moves. The largest market bounces were +21% in 2000 and +23% in 2008. Our current max bear market bounce (+12%) is lower than the average for 2000 and 2008 **(Chart 2)**. Conditions are different, but it helps to contextualize today's market volatility vs. history. Despite having its best month since November 2020 (+7.9%), the MSCI World is still down 14.2% YTD.

The S&P 500 paired some losses **(Chart 3)**, +9.2% (-12.6% YTD). The Nasdaq 100 bounced even more, up 12.6% (-20.3% YTD), but remains in bear market territory. Positive performance was led by mega-cap tech and clean energy companies (i.e., solar) as earnings turned out to be better than feared for some of the names (e.g. Amazon, Apple, Tesla, Netflix, Google) and congress voted the climate bill. Sector-wise, the overrepresentation of mega cap name in the indices meant consumer discretionary (+18.9%) and information technology (+13.5%) were the best performing sectors despite earnings growth turning negative at the sector-level (Discretionary -16.9% YoY, Info Tech -2.6% YoY). Upbeat forward guidance contributed to the month-end rally. However, we like to remind ourselves how it did not take long for Microsoft and others to pull and cut guidance not long after publishing their earnings just under 3 months ago.

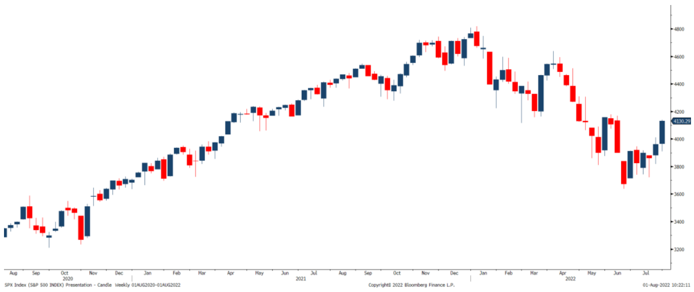
Despite Russian gas supply fears and a deteriorating economic outlook in Europe, the EuroStoxx 600 was up 7.7% (-8.4% YTD). The region saw a broad based strong sector performance with industrials topping the ranks (+14.3%) as curve sensitive sectors like insurance and banks lagged (+1.4 to +1.7%). Regionally, France was amongst the best perfumers, up 8.9% (-8.0% YTD).

Chart 2. Bear Markets Comparison (2000, 2008, Today)



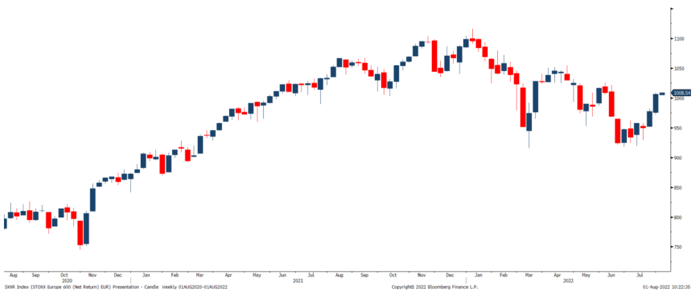
Source. Bloomberg, Hedgeye

Chart 3. S&P 500 Index (Weekly)



Source. Bloomberg, MAM Research

Chart 4. EuroStoxx 600 Index (Weekly)



Source. Bloomberg, MAM Research

Fixed Income

Economic data provided more evidence of a slowing economy. Inflation rose to fresh new highs, growth data disappointed, and PMIs showed slowing economic activity. Labour stayed strong, but real wages remain negative. Laser focused on inflation, the Fed raised rates by 75bps. Function of rising fears about a Fed induced recession, US 10-2 treasury spread **(Chart 5)** declined to its lowest point in over two decades, at -25.2bps, with the front end of the curve falling at a slower pace (2Y down from 2.95% to 2.88%) than the long end (10Y down from 3.0% to 2.65%).

High inflation in Europe forced the ECB to deliver its first hike in over a decade, taking the eurozone out of negative rates. To ensure smooth transmission of monetary policy, it announced a new tool: Transmission Protection Instrument (TPI), enabling the ECB to purchase specific securities to counter "unwarranted market dynamics". The tool is flexible by design, but the ECB is still yet to agree the criteria for activation. In the short term, the ECB will continue to depend on the flexibility of the Pandemic Emergency Purchase Programme to target its bond purchases. The announcement contributed to halt a credit spread widening observed across the sovereign market (i.e., Italy, Spain, France).

With the Fed acknowledging a significant tightening of financial conditions and abandoning forward guidance, odds for a worst case recessionary impact on defaults and earnings declined but are not eliminated yet. The Fed is still far from done. However, it was enough to allow HY spreads to contract materially in July **(Chart 6)**. Zombies issuers are a manageable in a mild recession, but much more problematic in a prolonged/deep recession.

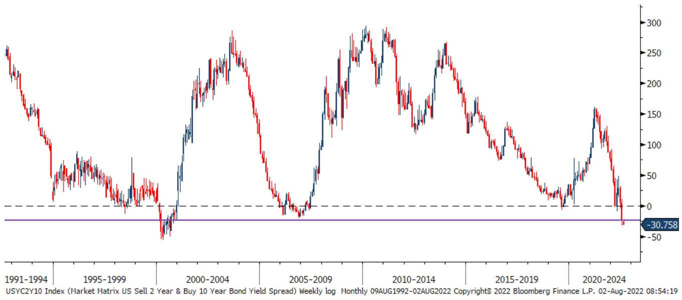
Currencies

The US Dollar continued to strengthen, reaching a 20-year high. However, the perceived change in tone from the central bank paired with rising recession risks and lower treasury yields sent the currency lower towards the end of the month. The dollar is still up 1.2% in July (+10.4% YTD) **(Chart 7)**.

The European recessionary risk was most apparent in currency markets where the euro briefly slipped below parity against the dollar before rallying in response to the ECB's decision to raise interest rates out of negative territory. Normally, a weaker Euro is positive for the export-driven earnings but given recessionary risks are largely focused/driven by gas supply disruption and the subsequent impact on production, the feedthrough scenario is less clear. With Eurozone 2Q22 surprising to the upside and the economy proving relatively resilient to geopolitical headwinds so far, the Euro was able to pair back some losses **(Chart 8)** but remained down 2.5% (-10.1% YTD).

Recession fears and falling long-term rates have been improving the carry differential between the US and Japan in favour of the Yen, despite the BoJ still being deeply accommodative. Further, the peak in commodity prices in mid June has been in favour of the JPY, with a lag, improving the commodity imports picture. Japan's trade deficit expanded for the better part of the year, but should improve incrementally with lower commodity prices. The Yen was gained 1.8% (-15.8% YTD) **(Chart 9)**.

Chart 5. US 10-2 Treasury Spread (Monthly)



Source. Bloomberg, MAM Research

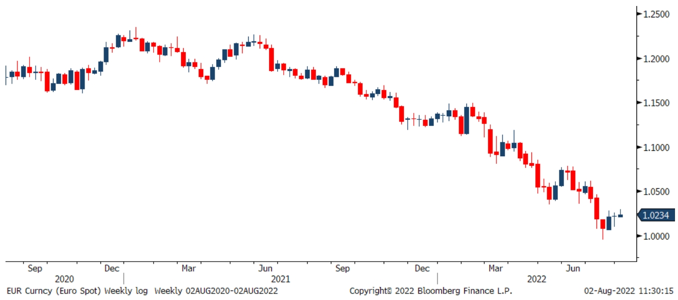
Chart 6. US High Yield Credit Spread (Daily)

Source. Bloomberg, MAM Research

Chart 7. US Dollar Index (Weekly)

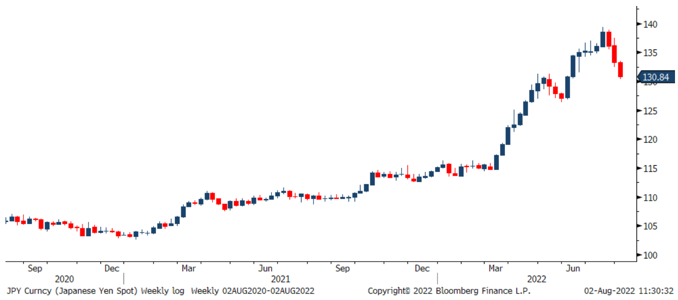
Source. Bloomberg, MAM Research

Chart 8. USD/Euro Spot Exchange Rate (Weekly)



Source. Bloomberg, MAM Research

Chart 9. USD/JPY Spot Exchange Rate (Weekly)



Source. Bloomberg, MAM Research

Commodities

Commodities remain the only asset class with positive returns this year with the broader index up 4.3% in July (+23.5% YTD). Fears over a potential Russian gas supply cut-off to Europe sent natural gas prices vertical.

Energy was the best performing sector, up 12.42% (+78% YTD). Natural gas prices were the main driver of positive returns for energy, up 51.7% (+120.6% YTD) **(Chart 10)**. A set of abnormally hot weather conditions have been an additional tailwind to the commodity amid tight supply and demand dynamics. WTI crude oil meanwhile was down 6.8% (+31.1% YTD) **(Chart 11)** as fears of recession put pressure on prices thus despite Libyan supply disruptions and possible supply risks with OPEC already running at or near fully capacity.

Industrial metals were up on the margin by 1.6% (-8.1% YTD) as rare earth metals and aluminum caught a bid despite recession fears. Copper however continues to flash warning signs at the state of industrial metals demand and broad economic activity, down 3.8% (-19.9% YTD) **(Chart 12)**.

Agriculture commodity prices were relatively unchanged, down less than 1% (+9.7% YTD). Unfavorable macro dynamics such as weather and energy prices continue to support elevated prices.

Precious metals paired back some of the month-to-date losses in the second half of the month thanks to, in large part, to lower real rates improving carry. Gold was down 2.3% (-3.5% YTD).

Emerging Markets

Emerging markets continued to underperform last month with the index down 0.3% (-17.8% YTD) **(Chart 13)**.

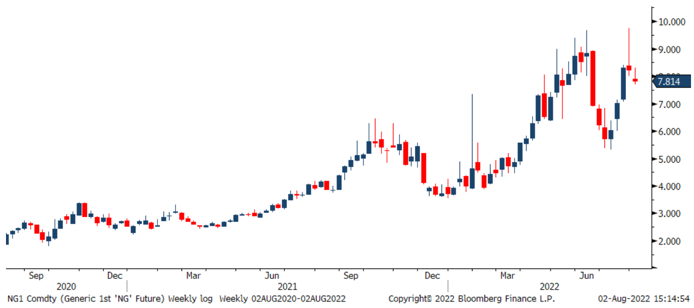
Chinese equities, down 9.5% (-19.7% YTD) were a large negative contributor to emerging market weakness last month. Declines followed new city shutdowns as part of its zero-Covid policy, mortgage boycotts impacting $700bn worth of homes in China, and continued regulatory clampdowns on its tech sector. The property market continued to have an impact on the real estate sector, which was down over 19.9% for the month of July.

Pakistan was the worst performing region, down 17.3%, largely driven by a large decline in its currency (-12%) on deteriorating external liquidity position and financing conditions.

India (on the other hand) was one of the best performing EM markets, up 9.3% (-7.4% YTD). It was followed by Singapore, up 6.0% (-13.3% YTD) and Brazil, up 5.5% (+8.4% YTD). Surprisingly, the later was able to withstand relatively well the price decline in commodity markets despite being fairly correlated to them.

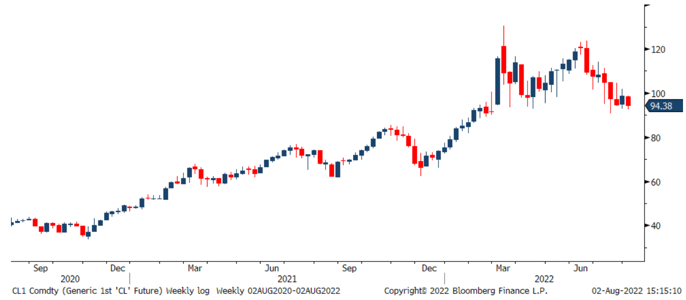
The MSCI Emerging Market FX Index was down 2.4% last month (-4.1% YTD) **(Chart 14)**. The Mexican Peso was down 1.2%, the Brazilian Real dropped 1.6%, and South African Rand 2.1%. CNH continued to weaken against the dollar, down 0.8% (-6.2% YTD).

Chart 10. Natural Gas Continuous Futures (Weekly)



Source. Bloomberg, MAM Research

Chart 11. WTI Crude Oil Continuous Futures (Weekly)

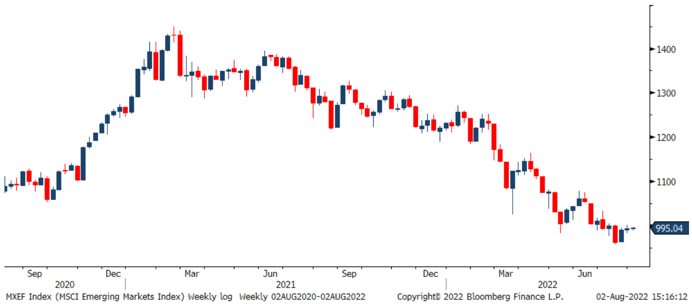


Source. Bloomberg, MAM Research

Chart 12. Copper Continuous Futures (Weekly)

Source. Bloomberg, MAM Research

Chart 13. MSCI EM Index (Weekly)



Source. Bloomberg, MAM Research

Chart 14. MSCI EM FX Index (Weekly)

Source. Bloomberg, MAM Research

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