The Way We See It

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It's still all about the Fed and Inflation concerns

INSIDE THIS ISSUE

1. Review of Developments
2. Market Outlook
3. The Way We See It

A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

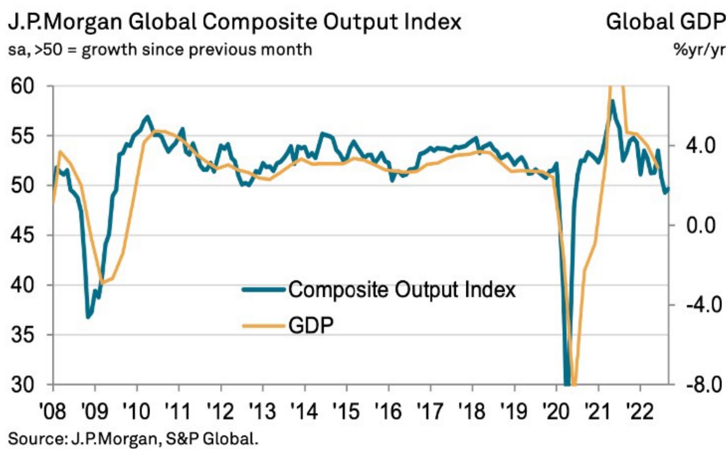
Review of Developments
- Global Economies

Over the month and quarter ending September, key US data economic releases showed that the employment and household consumption trends remain strong. Similarly, both headline and core inflation rates in the US continued to surprise on the upside. This underlined the Fed's Chairman's hawkish warnings at Jackson Hole in August, followed by a similar tough-talk at the September FOMC meeting: to combat inflation is the key priority, even at the cost of a possible recession. Hence, the Fed's strategy is to continue to raise interest rates aggressively, and the quantitative tightening program (which will reduce free liquidity significantly) will continue to be enforced in the months ahead.

Across the other side of the Atlantic, European economies continued to struggle against high natural gas and oil prices, together with a slowdown in the global trade trend. In the U.K., the expansionary mini-budget announced by the new government caused a temporary disruption in their local bond and currency markets, forcing the Bank of England to intervene with a renewed injection of liquidity in order

to bring about stability. In the Asia Pacific region, China continued to implement expansionary policies to try to boost its sluggish domestic economy, which continued to be affected by lockdowns in a number of major cities and the continuing crisis in its property market. Within the Emerging Markets universe, economic growth is slowing significantly, and the risk of debt default continues to rise as a result of a very strong US Dollar, high US interest rates, and the reduced appetite of global investors to lend to weak and indebted nations. We attach charts of the latest Global PMI trends. They reflect a continuation of the softening trend of real GDP growth.

J.P.Morgan Global Composite PMI™



- Global Markets

Short-lived bear market rallies in Q3

Risk assets, including long-dated bonds, ended weaker in the month and quarter of September. One should point out that there were a number of rallies within this overall bearish trend, notably in the period from July through to mid-August. However, the increasingly hawkish Fed and higher interest rates quickly curtailed the bullish sentiment. The Fed warned that the US cash rate will be raised above 4% p.a. by year-end. It is projected to peak next year at about 4.6% p.a. Both trading and fundamental investors were net sellers over the periods under review. Investors have been increasingly concerned that the Fed's blunt tool of tight monetary policy will, sooner or later, result in a recession in the US and globally. As a consequence, the risk of a large fall in

corporations' sales, profit margins, net earnings, and, hence dividends, is increasing.

Over the periods under review, long-dated government bonds, corporate investment bonds, high-yield bonds, stocks, and economic-sensitive commodity prices and currencies, all fell. The US once again led all other major equity and bond markets down. The safest and best out-performing asset class is, once again, US dollar cash.

The US Dollar remained strong over the period under review, helped by the aggressiveness of the Fed's tightening policy and the overall defensiveness of the global investment world.

Market Outlook
- Global Economies

Positives are to be offset by negatives

While there are both positive and negative factors operating in the US and the world economy in the next few months, the potential growth positives are likely to be offset by negatives.

Positives include: the likely gradual re-accumulation of inventories thus boosting GDP growth in the US, together with increased spending by the government and the potential corporate spending on CAPEX. In China, the gradual re-opening of its major commercial cities and easing of Covid rules, combined with a modest easing of fiscal and monetary policies should help to modestly boost its GDP in H2. In addition, as the majority of countries have started to re-open and encouraged tourists and foreign workers to return, this will add to GDP growth and help to alleviate the shortage of labour in many countries.

Having said that, should the Fed tighten too aggressively in order to tame inflation within a short time frame, the US economy may not escape a recession scenario in the coming 6-12 months. This scenario is gaining high credibility.

Other negative factors again focus on still-elevated inflation, still-tight global monetary policy tightening,

and continuing selective supply bottleneck issues. High inflationary pressures are likely to force central banks in major OECD countries to continue to raise rates through to year-end. In addition, while supply-side bottlenecks appear to ease a little, the complete suspension of gas and oil exports from Russia to Germany and other European countries would continue to hurt their economies. The US government has recently announced an overall review of the export of semiconductor chips to China. Lastly, the difficulty in finding workers to fill low-skilled services jobs in major economies, compounded by China's zero-Covid policy, continued to cause unfavourable imbalances in demand and supply. In brief, the world economy is expected to remain in a fragile and weak phase.

The Way We See It

- Global Markets and Investment Thematics

Market to range trade with downward bias

The above economic, monetary, and geopolitically unbalanced backdrop is expected to prevail until year-end and possibly spread through to the first half of next year. As a result, our core investment view remains unchanged - global financial markets are likely to trade within a wide range, in a volatile manner, with a downward bias.

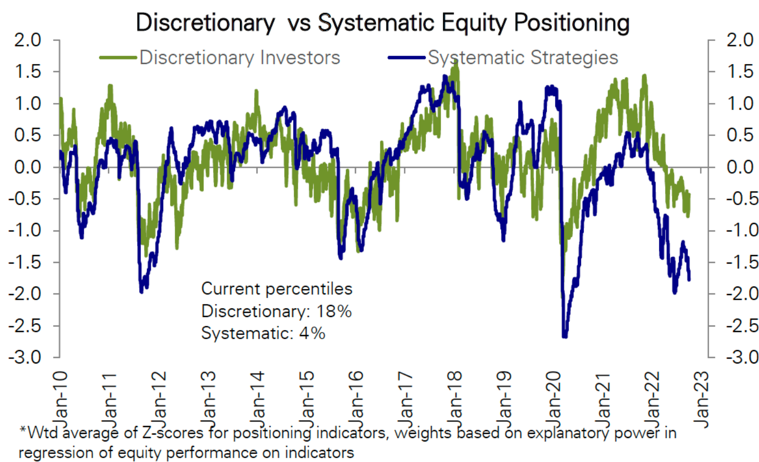
Investors are advised to remain defensive in their portfolios

Consequently, we continue to advise that it would be sensible for investors to continue to adopt a defensive strategy in overall terms, consistent with our key message since November of last year. This translates into a strong focus on quality and lowly-geared assets that can deliver predictable cash flows, and, until the Fed pivots, an overweighting in US-dollar-denominated short-dated Treasuries and Investment Grade corporate bonds.

In addition, as selective growth stocks with a healthy cash flow generation capacity, strong business franchises and good management have also suffered from falls in their share prices along with the overall global markets, long-term investors should take advantage of these opportunities to selectively add.

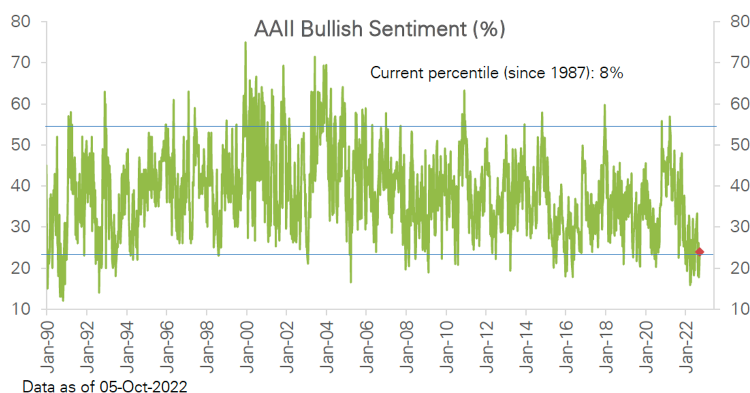
From an investor's sentiment and positioning perspective, as we noted in our Review section, both Quantitative- and Algorithm-focused and Fundamental investors have been, and are likely to continue to be forced to further reduce their exposure to risky assets. We are not altogether surprised to see this, as we previously communicated to our clients.

Discretionary vs Systematic strategies divide



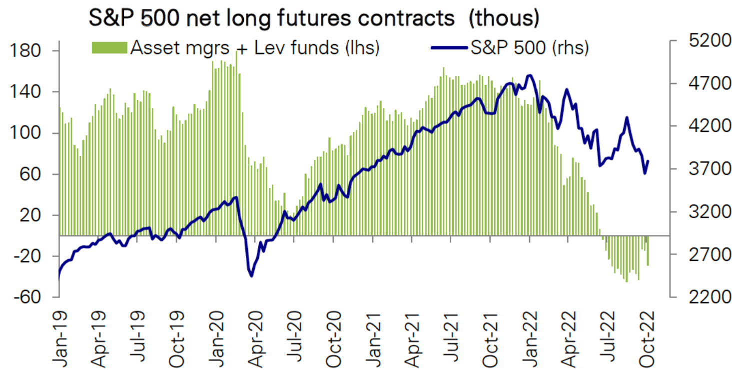
Source : CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

Investor bullish sentiment



Source : Deutsche Bank Asset Allocation, Barron's, Haver

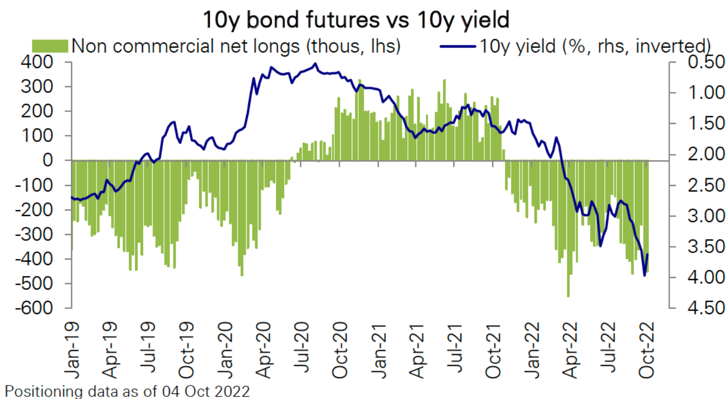
S&P 500 futures positioning



Positioning data as of 04 Oct 2022

Source : Deutsche Bank Asset Allocation, CFTC, Haver

10y treasury notes futures positioning



Positioning data as of 04 Oct 2022

Source : Deutsche Bank Asset Allocation, CFTC, Haver

The charts above show the extent to which all investors (Quantitative-driven Systematics and Fundamental investors) have, significantly, been reducing their exposure to equities and long-dated bonds, based on their view that the current stagflation may turn into a recessionary environment in the coming 6-12 months.

The substantial net short position in US equity futures and long-dated bonds is the clear proof of investors' current bearishness.

Investors have been reducing equities & long-dated bonds

Finally, we highlight that Investors' sentiment is bearish and their positioning in equities is underweight, relative to their historical averages. This suggests that a fair amount of bad news, outlined above, has already been discounted. Therefore, any unexpected good news from the Fed's pivot from their current tight policy is likely to send prices of equities and other risky asset classes up strongly, and quickly.

To summarise, it remains our strong belief that a sustainable bull market in equities and corporate bonds will return at some stage, in the coming 12-month period. But it would only occur when valuations fall further to reflect the likely US and global recession, and, more importantly, when the US Fed and other major central banks are perceived to switch from the current tightening to a pause, or an easing mode.

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