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Economic & Market review – May 2022

Roller coaster month

Inflation upward trajectory continues to dominate headlines in financial markets. Soaring commodity prices and supply chain problems were the two major inflation drivers.

The Fed is expected to hike rates by 50 basis points for each of the next two meetings in June and in July 2022 and ruling out an accelerated move from now.

In addition, at the beginning of June, the Fed embarks on its second quantitative tightening program, five years after its last attempt to run down the central bank's balance sheet, which was ultimately a failure. Concerns over the central bank's ability to tame inflation without triggering a growth slowdown were highlighted after a relatively strong US job reports and higher than expected CPI.

With demand slowing but global goods production at an all-time high, there has been a noticeable buildup in inventory at different points along global supply chains.

Given the multitude of shocks currently hitting the global economy (eg. Zero Covid Policy and liquidity withdrawal by major central banks), recession risks are intensifying especially for Europe. In US, most economists are talking about soft landing or even hard landing.

Global equity experienced high volatility but managed to limit their losses with MSCI World: -0,16%, S&P 500 unchanged, Nasdaq 100: -1,7% and EuroStoxx 50: -0,4. During this month the equity market behaved like a roller coaster with a high dispersion within the sectors. Indeed, some market segments (defensives, staples) are trading near their all-time high in terms of relative valuations while other market segments such as Small & Mid-caps and biotechs are trading near their all-time low in terms of relative valuations.

While real rates drove the nominal rate increase in Germany and US over the past month, rising breakeven inflation accounted for a large part of the bond movements.

US Treasury yields should continue to rise and the curve should flatten again. Only a sharp downward repricing of inflation and hence a more dovish Fed sounding would warrant a structural reversal in the flattening momentum of US rates.

An interesting development over the month was the differentiation within G7 government curves. Globally, G7 government bonds (USDH) delivered a negative -0.5% monthly return. UK and EU were sharply negative, while US and Japan were close to flat. In addition, credit spreads mostly stayed unchanged in May and the default rates are expected to climb steadily over the next year.

Even though the correction in equity markets, the yield gap between equities and bonds (a proxy for the equity risk premium/ERP), has narrowed to one of the lowest levels of the post-Global Financial Crisis suggesting that equities will need to deliver strong earnings growth to outperform bonds and compensate for the extra risk.

Despite a weaker dollar index (DXY:-1,2%), gold prices fell for the second month in a row (Spot: -3.1%). Otherwise, the base metals suffered from worries over a global economic slowdown. Last WTI and Brent advanced further in May and remained supported as Europe was seek to ban all imports of Russian crude oil within six months, China's cities started to reopen, and OPEC stuck to their cautious / gradual monthly production hikes.