Macro Outlook Summary

October 2022

Last month the timing of our scepticism towards any market rebound was misplaced as a strong rebound did indeed occur. In the absence of true shocks the bullish trend has continued through November and taken the sting out of many equity index returns for the year. The DAX was -25% YTD at the end of September and as of writing is now -9%. Pressures to sell have entirely gone and professional investors are hoping things stay as they are going into year end. We feel certain the Fed will hike by 50bps on 14th Dec but that's surely already priced in, so equities and credit could close the year on a firmly positive note.

That does not mean however that we're out of the woods. The issue lies with central banks and the path they are being forced to follow. Chair Powell may sound a less hawkish note on 14th Dec but only to reiterate that 75bps hikes are done and 50bps moves are the new. Optimists will read more into the guidance which is understandable given the persistently dovish posture from Lagarde and seemingly disoriented BoE's Bailey. But the counterpoint to this more gradualistic tightening will be higher terminal rates. Perhaps partly for theatre Bullard recently cited 7% as his expected Fed Funds end point. We're a very long way away from that and even close would undermine current equity valuations. Slower tightening will take longer to bite which changes the timeline of our thinking but not the big picture. As terminal rate expectations keep rising so we think next year will witness equity indices marking lower lows at some point and deliver the needed capitulation we and many others have been talking about. A final cautionary tale on central banks is worth making.

The central bank winner of the wooden spoon in September was the UK's BoE. Rising gilt yields in September triggered by Kwasi Kwarteng's budget morphed into a gilt melt down as 10Yr yields jumped from 3.2% mid-Sept to 4.5% by month end. On a 10Yr bond this equates to a -14% loss which is shocking. The cause was a chain reaction of unexpected linkages. Defined benefit pension schemes have all used Liability Driven Investing (LDI) analytics to calculate their gilt FI need and then model their income shortfall. The game has then been to use those gilt books as prime collateral to leverage gilt, equity and derivatives positioning and generate supplemental income. With everything in free fall in September the gilt collateral was hit with sequential margin calls into the end of the month, triggering repeated selling and deleveraging. Seemingly unaware of this activity or risk the BoE were forced to re-activate QE style gilt buying to head off a true disaster. For a regulator supposedly supervising and preventing systemic risks this looks like a bit of an oversight. It also highlights the existence of ongoing systemic risks which the burdensome regulatory reporting regime does not address and are still very poorly understood. Drawing comfort from 'much better regulation' should be tempered with considerable caution.