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BONHÔTE

Near-certain recession already priced in

Overview

Is the market starting to think ahead to a post-crisis period?

Last week was constructive for equity markets, which gained between 2% and 6%, depending on the marketplace, over the week as a whole. However, no real substantive changes were seen. The market is still trying to gauge just how determined central banks are in combating inflation. Every word is being scrutinised and every number analysed to calculate the likely scope of rate hikes.

In the US, Jerome Powell's testimony before the Senate Banking Committee was the main source of information last week, although very little news was forthcoming. But the Fed is equally aware that a soft landing for the economy will be difficult to achieve. Powell also reminded his listeners that while the Fed does have a real mandate to drive inflation down to 2%, many factors outside of its control will be decisive as to whether it can hit this target or not.

Last week was constructive for equity markets

As stated in our earlier publications, the only policy instrument available to central banks in its fight against inflation are rate hikes, but these also have the effect of reducing demand across the economy. But this alone does not address the real factors driving inflation higher at the moment, which are fossil fuel prices, grain prices and supply chain bottlenecks. Government measures would be far better as this would allow the offending inflation components to be perfectly targeted and could be enabled or deactivated at will.

Among the most specific measures, a broad-based temporary reduction in fuel and gas duties would probably be most appropriate. In extremis, price controls – even temporary ones – would also help manage the transition. In the longer term, massive investments in renewable energy are vital but cannot address the inflation issue in the short term.

The market is today pricing in a near-certain recession in the US economy. This will be costly for governments because a weak economy means lower tax revenues.

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Yet targeted price controls by governments – partly financed by windfall taxes on companies gaining from the heady price conditions – would mean that central banks could be less hawkish in raising interest rates and cut the economy some slack. A scorched earth policy is rarely the right one.

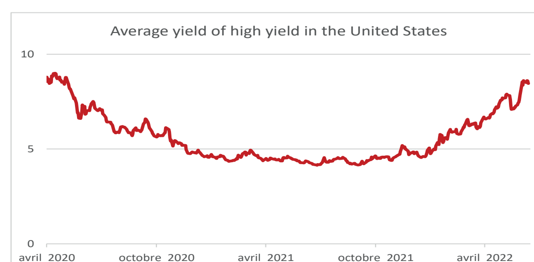
The SMI bounced up almost to support at 10320 after momentarily entering oversold territory. Short-term momentum has shifted back to positive. The previous support at 11270 which is now a resistance seems reachable this week.

Key data

	USD/CHF	EUR/CHF	SMI	EURO STOXX 50	DAX 30	CAC 40	FTSE 100	S&P 500	NASDAQ	NIKKEI	MSCI Emerging Markets
Latest	0.96	1.01	10'823.12	3'533.17	13'118.13	6'073.35	7'208.81	3'911.74	11'607.62	26'491.97	1'011.18
Trend	↓	↓	↓	↓	↓	↓	↓	→	→	↓	↓
YTD	5.07%	-2.47%	-15.94%	-17.80%	-17.42%	-15.09%	-2.38%	-17.93%	-25.81%	-7.99%	-17.92%

(values from the Friday preceding publication)

High-yield bonds could soon be worth a punt



Expectations of a recession have driven government bond yields down over the past two weeks. Two factors have combined to fuel this trend. First, even if central banks raise short-term rates, long-term yields are a picture of the expected economic cycle.

In the event of a recession, which is defined as two consecutive quarters of negative growth, central banks would have to lower rates to boost the economy once the short-term war against inflation had run its course. The second factor explaining the decline in long-term yields is that, when the economic fog thickens, government bonds act as safe havens. Long-term yields have therefore fallen quite sharply, shedding up to half a percent in a fortnight.

Credit spreads have risen in parallel while yields on lower-quality bonds are now priced at over 8.5% in the US. This is becoming attractive as the average one-year default rate has risen only slightly (currently 2.1%). According to Moody's, in a baseline market scenario, this default rate could rise to 3.3% within the space of a year. But this would still be below the historical average of 4.1%. We think this asset class is worth watching closely.

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