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News Flash n°3

Why markets are back to pre-war levels?



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After suffering a steep correction between 22 February and 8 March, with drops of 9% by the Stoxx Europe 600 and 12.2% by the EuroStoxx 300⁽¹⁾, the markets have staged a robust rally.

During the lapse of time from 22 February, the day before the invasion of Ukraine, to 22 March, the MSCI World gained 3.7% in local currency and 6% in euros. The US rose by 7.8% in euros, Europe was almost level, and the Eurozone down slightly. On the year to date, the MSCI World is down by just 5.2% in local currency and by 3% in euros. The picture is somewhat different on the fixed-income markets, which, with recent new declines on top of their year-to-date losses, stand at -5.5% in corporate bonds (iBoxx EUR Corporates), -4.9% in government bonds, and -5.1% in high yield⁽²⁾ market (ICE BofA Euro High Yield Index)⁽¹⁾.

What's behind this rally?

The erasing of almost all losses since early March is due, in part, to the geopolitical situation. It indeed appears to be bogged down, but the market seems to be betting that negotiations will yield results. Meanwhile, the possibility of an embargo on fossil fuel exports from Russia appears to have been ruled out for the moment. The United States, and perhaps Great Britain too, would have liked to ratchet up pressure on Vladimir Putin by cutting him off from revenues derived from fossil fuel exports, but this is being prevented by the dependence of some European countries, such as Germany, Austria and Italy, on those energy sources, and the lack of any alternative. This has triggered a pullback in commodity prices from their 8 March peak, particularly of natural gas, the price of which has halved, although oil prices remain highly volatile.

In China, the market swoon had accelerated, particularly in tech stocks, with a 41% drop in the Nasdaq Golden Dragon China Index at the bottom⁽¹⁾. The Chinese authorities' determination to rein in what was beginning to look like a market crash ended up stopping this dynamic.

Paradoxically, and contrary to expectations, central banks do not appear to have shifted gears, despite fears that the war could undermine growth. Indeed, on an especially hawkish⁽³⁾ tone, the Fed reiterated its plan to raise rates on a sustained basis without ruling out an increase of 50 basis points (bp), an unusually high level. Its stance triggered a robust upward movement, particularly on 2-year yields, which are up by 45bp since the start of the conflict and by 140bp on the year-to-date. The repercussions were more modest on longer maturities, with 30-year yields up by just 30bp and 60bp, respectively⁽¹⁾.

(1) Source: Bloomberg, 22 March 2022.

(2) High yield bonds are issued by companies or governments having a high credit risk. Their financial rating is below BBB-, based on the Standard & Poor's scale.

(3) Stance in favour of a less accommodative monetary policy in order to combat an increase in inflation.

Past performance is not a reliable indicator of future performance and is not constant over time. The performance of the indices is calculated with dividends reinvested.



This flattening in the yield curve⁽⁴⁾ may be read in two different ways. The more pessimistic of these, and in line with historical experience, is that it is a harbinger of the start of a global economic recession. The second, and more optimistic, interpretation, is that the Fed, after regarding inflation as a transitory problem, is now throwing everything it has to head off an inextricable wage-price spiral. This also helps keep long bond yields at relatively low levels with regards to inflation, even if they are up slightly, while real rates remain in negative territory, thus supporting equity valuations. Meanwhile, the seven rate hikes currently priced in the markets help keep the Fed from a situation in which it has no choice but to pick up its pace in the long term.

How has the macroeconomic environment evolved?

Inflation dynamics differ markedly from one side of the Atlantic to the other. In the US, they are driven mainly by wage increases in the lowest income brackets: +11%, vs. +4% in higher brackets⁽⁵⁾. Savings piled up by higher-income persons is nonetheless allowing them to offset a potential loss in purchasing power, which limits the impact on consumption. In the Eurozone, we have not seen any comparable wage increases, but savings there are nonetheless abundant.

In reaction to this loss of purchasing power, macroeconomic forecasters have revised their growth outlook downward. The revisions have been modest on a global scale, but much more significant for the Eurozone. Indeed, the OECD expects growth there to be 1.4% lower than it had forecast at the start of the year. The ECB has slashed its forecast by 0.6% to +2.8% for 2022. These new forecasts have thus far had little impact on corporate earnings forecasts, which are now about 4% lower than they were at the start of the year⁽⁶⁾, while in the US they are 5% higher⁽⁷⁾.

Moreover, investors had already “capitulated” during the week of 7 March, with a historic spike in European equity fund redemptions estimated at 13.5 billion euros⁽⁸⁾.

We pointed out in our News Flash of 25 February 2022 that, of 19 geopolitical events that have occurred since 1945, in 78% of them, the markets had erased their losses within three months⁽⁹⁾. We agree that, in this case, it happened even faster.

What can we expect in the coming weeks?

We believe that the current situation reflects a certain complacency in a context that is still uncertain regarding the outcome of the Russian-Ukrainian war and the potential embargo on Russian fossil fuels. That being said, in an environment in which, despite Fed rate hikes, money is still extremely cheap, investors still have abundant liquidity. Accordingly, as soon as they spot a glint of light at the end of the tunnel, they are likely to rush back to assets that provide them, on the basis of 2022 earnings, dividend yields and earnings that are well above those of other asset classes.

Moreover, beyond the geopolitical context, the markets are walking a tightrope. Inflation trends, which are being driven mainly by commodities, are being supported mainly by households through higher prices and, in part, by narrower company margins that nonetheless are still very high. This balancing act may nonetheless continue to play out as long as bond yields remain low and could help head off a recession triggered by a negative wealth effect⁽¹⁰⁾, particularly in real estate.

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(4) A graphic depiction of bond yields based on their various maturities. In a stable environment, with no inflationary pressures or excess debt, interest rates tend to track bond maturities upward.

(5) Federal Reserve, March 2022.

(6) Source: Morgan Stanley, March 2022.

(7) Source: Goldman Sachs, March 2022.

(8) Source: Bank of America, March 2022.

(9) JP Morgan, 24 February 2022.

(10) A propensity to adjust one's ability to spend based on an appreciation or depreciation of one's asset values.

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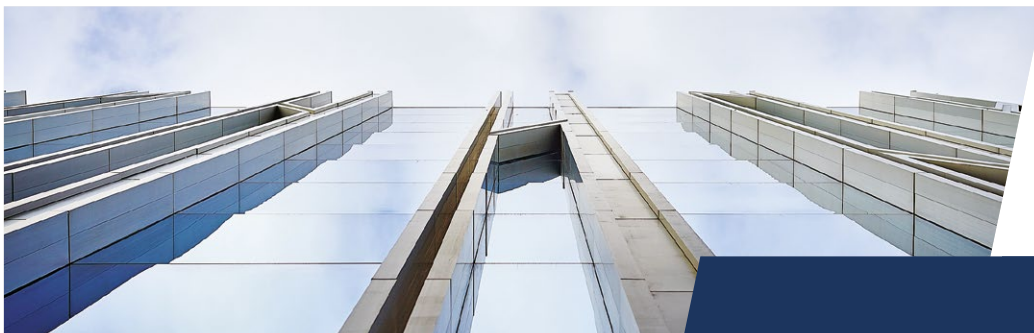
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