

Monthly Market Musings: Consolidation and rising tail risks

- Equity markets hit new year-to-date lows in May, consistent with slowing growth and recession risks.
- Growth concerns support consolidation in bonds, but inflation is yet to peak and central banks seem some distance from a pivot.
- Tail risks for bonds are substantial in both directions.

The monthly performance of major equity indices was near flat in May (S&P 500 +0.1%, MSCI World -0.2%). The Bloomberg Global Aggregate bond index gained 1%, with developed market government bond yields mixed (depending on market and part of the curve) and credit spreads mostly tighter. Broad measures of bond and equity volatility eased from the high levels reached in prior months.

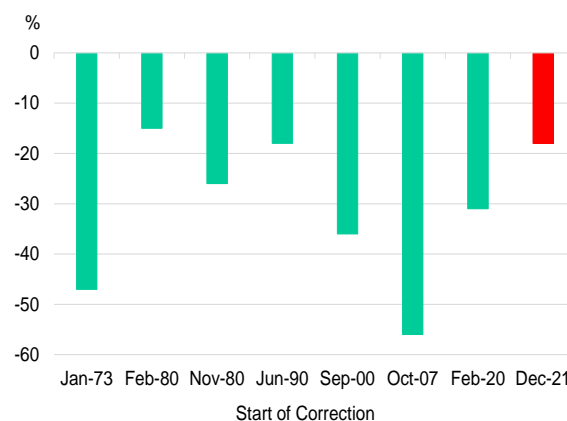
Overall monthly asset class performance masks major underlying macro tensions. Intramonth, equities made year-to-date lows before staging a late recovery. Heightened growth concerns weighing on risk assets finally spilled over to slow the relentless sell-off in bonds. Meanwhile, markets are still navigating historically high inflation. This backdrop implies much larger tail risks ahead in both directions for bonds, even if range-trading persists near term.

Pricing a slowdown in growth

Ahead of a recovery over the last week, the S&P 500 hit a new low for the year in May, marking an 18% decline since the end of 2021. As we discussed in last month's update (see [Nowhere to hide](#)), a correction in equities of this magnitude is consistent with heightened recession risk pricing. Chart 1 shows the peak-to-trough drawdowns in US equities ahead of recessions over the last 50 years averages 32%. Many

analysts point out that taking an even longer term view the average is 24%, while non-recession drawdowns tend to be around 10%.

Chart 1: S&P 500 drawdowns ahead of recessions



As we also outlined in our last note, equity markets have run ahead of the slowdown in actual data. Chart 2 shows the recent correction is already consistent with a decline in the US ISM below 50, which is typically seen in recessions or significant downturns.

Taking into account the more pronounced slowing in China than the US, global growth forecasts are being revised down sharply – by over 1 percentage point for 2022 over the last 3 months. As Chart 3 shows, downward revisions of this magnitude are typically associated with a larger rally in bonds, but this relationship remains impacted by high inflation.

Chart 2: S&P 500 vs ISM

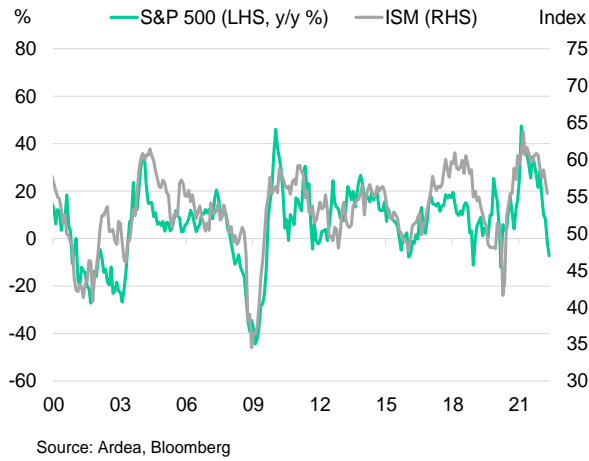
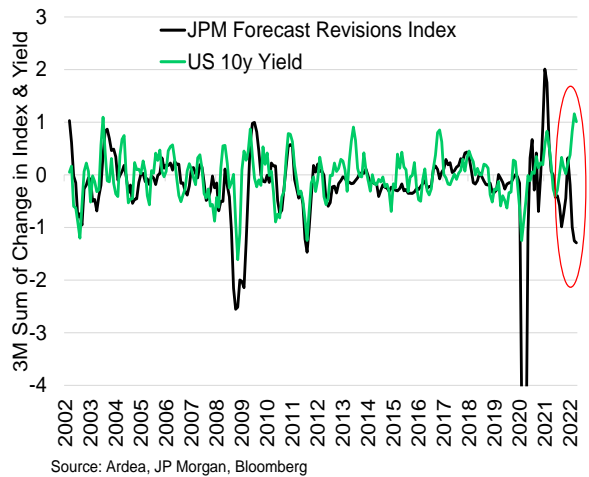


Chart 3: Global growth forecast revisions and US 10y yield

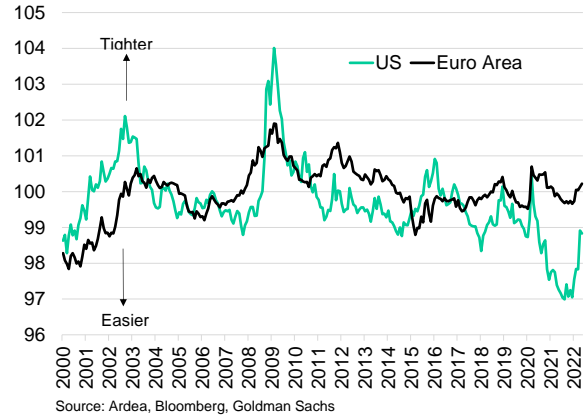


The recent tightening of financial conditions – higher yields and weaker risk assets – is impacting major economies, alongside weaker real incomes with high inflation.

Prior to COVID, the last major correction in risk assets followed a tightening of financial conditions in late 2018. The Fed was at the time more advanced in its tightening cycle and ultimately reversed course due to concerns about growth, which then saw bonds rally. The Fed pivot came at a higher level than present in broader financial conditions indices (Chart 4). The strike on this “Fed put” is now likely to be much lower in risk assets/higher in bond yields in an environment of high inflation. The Fed and other central banks are unlikely to relent on the

inflation fight this early in the cycle. The May Bank of America Fund Manager survey suggested most participants now see the Fed put at around 3529 on the S&P 500 (some 17% below current levels).

Chart 4: GS Financial Conditions Index – US and Europe

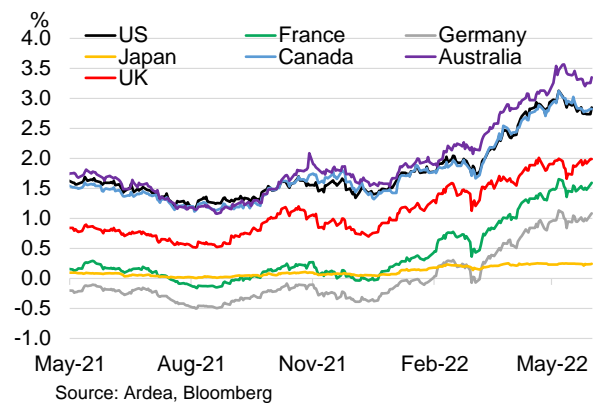


Bonds consolidate amid large tail risks in both directions

In our last [note](#) we outlined three factors that could support a turnaround in bond performance: 1) inflation data pulse turns lower; 2) risk asset correction deepens significantly; 3) higher yield levels increase the valuation appeal of bonds.

Of these three factors, the depth of sell-off in equities and associated growth concerns have been a key support for bond markets in recent weeks. The relentless rise in yields from January to April stalled in most markets (Chart 5).

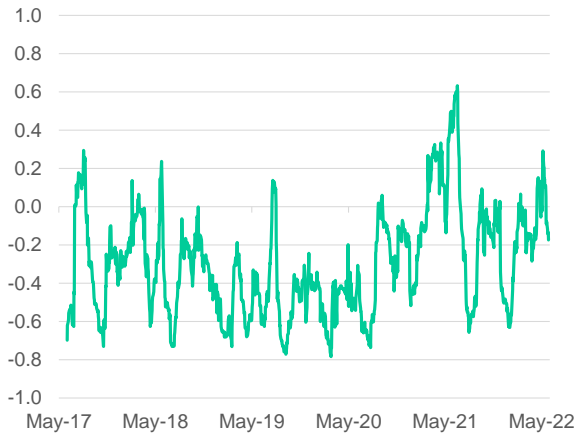
Chart 5: Global 10y yields



The correlation between bonds and equities has

turned from positive to negative (Chart 6), after bonds had failed to provide a defensive offset to weaker equity markets in prior months.

Chart 6: Rolling 30d bond price/equity correlation (US Treasury Index and S&P 500)



Where to from here? Growth concerns and tighter financial conditions could keep yields range-bound in the near term. While this is driving a fall in bond market volatility in recent weeks from the very elevated levels seen in prior months, the tail risks over a longer horizon are potentially very large in both directions. If a major slowdown or recession risk priced by equity markets becomes clearer in economic data and inflation data at least stabilises, then bonds could ultimately rally a lot further.

However, there is yet to be a meaningful turn in inflation data, even as market inflation pricing has recently moderated (Chart 7). Higher frequency indicators such as supply chain indices (Chart 8) have not fallen as much as investors and central banks would have hoped for and inflation reports have shown a broadening of price pressures. Central banks therefore remain cautious and are heavily focused on inflation reports over the next few months before providing any signal that could counter aggressive rate hike pricing. Fed speakers have recently said they will need to see a clear moderation in CPI reports ahead of the September meeting. Meanwhile, the ECB has yet

to move away from negative rates despite headline inflation running at 8.1% y/y.

Chart 7: 10y Breakeven inflation rates

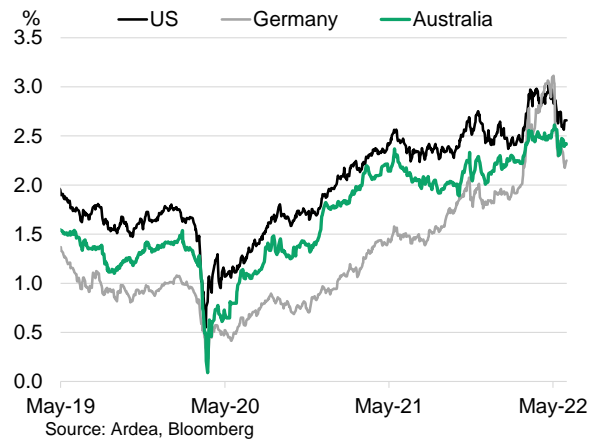
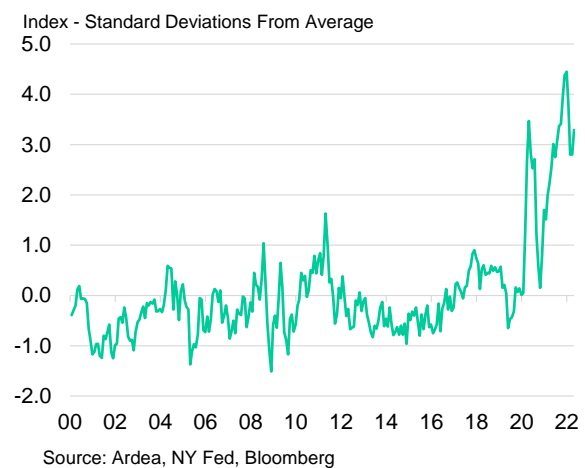


Chart 8: Supply chain pressures index



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