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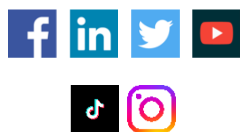

Global X House Views – October

Elevated inflation, currencies, slowing global economic growth expectations, and reduced central bank liquidity remain key economic considerations. Volatility measured by the VIX spiked in September after declining in August. This wall of worry is real, but it is important to recognize that markets often overshoot in both directions. As uncertainty subsides, opportunities may be realized.

Global Macro

Central banks have increased interest rates at the fastest rate on record.[1] The Federal Reserve's (Fed) commitment to bring inflation under control has global economic implications through a stronger dollar, and most central banks now turn more aggressive with their interest rate increases amid stubbornly high inflation and currency weaknesses. Additionally, given that each central bank is focused on balancing their nation's supply and demand, there is the risk that the cumulative negative impact on global economic growth could be greater than expected.

Regional Macro

U.S. Equities	**Over**
International Developed Market Equities	**Under**
Emerging Market Equities	**Neutral**

United States

The Fed faces a challenging balancing act between elevated inflation and slowing economic growth. While some signs point to U.S. inflation having peaked, but it remains at a high level. The strong dollar, high mortgage rates, lower commodity prices, lower demand, and reduced supply chain pressures are likely to help reduce inflation over the next year. Currently, the Fed's dot plot reflects a median expectation for a further 125 basis points increase during Q4 and a terminal rate of 4.5% - 4.75%.[2] November is expected to be a 75-basis point (bp) increase followed by a 50-bp hike in December.[3] Should this occur, it will be the fourth consecutive 75-bp increase.

The Fed is raising interest rates while the U.S. economy remains in a strong position relative to most other economies. Unemployment remains low and pandemic savings provide a buffer for consumption. However, we remain concerned that consumption growth cannot exceed income growth for too long. The potential negative feedback loop between consumption and employment remains a focus area.

We believe Q3 is likely to include elevated spending from the summer of excess. This is likely to be followed by spending curtailment into fall and winter. If history is anything to go by, the odds of a soft landing are reasonably small. We may see a U.S. economic downturn in the first half of 2023.[4]

The Fed accelerated their balance sheet reduction in September to $95bn per month.[5] We expect this faster pace of quantitative tightening (QT) to be a continued source of volatility.

In theory the U.S. dollar should stabilize over the medium-term amid hawkishness from other central banks and slowing economic data. Internationally exposed companies, including tech companies, could benefit from dollar stabilization.

International Developed Markets

The strong dollar is exporting inflation globally, adding pressure on policy makers into more restrictive positions. The pound reached all-time lows against the dollar as the Bank of England and UK Treasury failed to reassure investors on inflation and fiscal stability following Chancellor of the Exchequer Kwarteng's proposed unfunded tax cuts which roiled currency markets. In response, the BOE provided more liquidity to the market by purchasing bonds to help stabilize financial markets. The short-term impact has caused bonds to rally globally, but this action is likely to be short-lived. UK and European companies and consumers face a challenging winter due to the energy situation and currency market are making it more difficult for policy makers to cushion the blow.

European economic growth and inflation trends are a key concern. Energy supply remains uncertain. However, the worst may be behind us. Despite Nord Stream disruptions, Europe has filled 88% of their gas storage capacity.[6] This places Europe in a reasonably solid position to get through the winter. While the risk of a worse than expected winter persists, the energy shock may have already passed. Germany and the UK remain countries of concern. In Germany, where the energy situation is the most acute, two of their three nuclear plants will be kept as reserves until being reassessed in April 2023.[7] This may provide a fresh tailwind for commodities like uranium.

A growing number of countries have taken steps to support their currencies. For the first time since the Asian Financial Crisis, Japan intervened to stem weakness in their currency. Japan is estimated to have spent around $25 billion in currency support.[8] The Bank of Japan has not yet started raising interest rates and their currency is under pressure for moving against the global tide.

Emerging Market Equity

China's central bank has taken steps to reduce pressure on the Yuan. They've made it more expensive for traders to bet against their currency.[9]

The strong USD, lower commodity prices, reduced global demand, and the risk off environment creates a challenging backdrop for emerging markets (EM). China remains the key focus. While industrial production and manufacturing production improved slightly, manufacturing PMI has moved into contractionary territory.[10] The World Bank decreased economic growth expectations for China to 2.8% growth in 2022, lowering their 2022 forecast from 4.3% in June.[11] There is a growing risk that China maintains their zero-COVID policy into 2023, further clouding their growth trajectory at a time when global economic growth may be softer.

Asset Class Views

We expect market volatility to remain elevated through the interest rate hiking cycle. Following Jackson Hole and the September FOMC meeting, markets have priced in a more aggressive interest rate hiking cycle for the 4th quarter and into early 2023. At this stage, we prefer equities over fixed income because real yields are still in negative territory. With rising recession risks, we believe it's increasingly important to incorporate a barbel approach that includes longer-duration income like exposures to long duration U.S. Treasuries.

We prefer commodities over other assets, but with a somewhat more muted outlook. A strong dollar and tightening financing conditions could make some commodities slightly less attractive at this stage. Chinese uncertainty also clouds the outlook for economic growth focused commodities.

Sub Asset Class & Industry Views

Increased focus on defensive segments with strong cash flows. Preferred sectors include Health Care, Consumer Staples, and Utilities while discretionary consumption remains an area of concern. For more detail, please refer to our sector views blog post.

Inflation protection could be balanced with quality, defensive equity positions. We also view assets tied to derivatives like covered call strategies and those targeting rising interest rates as potentially attractive with volatility remaining elevated.

Covered call strategies that sell options premiums on some of the major U.S. indexes like the Nasdaq 100 or S&P 500. Markets sold off in September, continuing the push and pull nature of the equity markets recently. Selling options premiums to monetize volatility and stay invested could be appealing to investors.

Product Opportunities

- Silver and silver miners present opportunities. Attractive valuations for silver miners, extreme pessimism on silver futures, and a high gold-to-silver ratio point to a possible rebound. Besides, silver is used to make photovoltaic cells, and solar playing major roles in Europe's clean energy transition and the Inflation Reduction Act create structural tailwinds. A possibly more stable dollar, inverted U.S. Treasury yield curve and higher recession risks in the coming months may remove some of the headwinds to silver.
- Elevated lithium prices continued to drive revenue growth for lithium miners in Q3 2022, while the environment remained a point of pressure for battery manufacturers. Given the ongoing high price environment for lithium and expected widening supply-demand gap, lithium producers continued to look towards expanding production and brining new projects online. For example, in September 2022, Piedmont Lithium announced plans to build the largest lithium hydroxide plant in the U.S. in Tennessee. The plant, which has a production target of 30,000 metric ton per year (tpy), is expected to begin operations in 2025.[12]
- Uranium is a specific segment of the energy market with attractive supply & demand fundamentals, and a changing narrative around nuclear energy. Many countries have either been integrating nuclear power into their energy agendas or have been delaying planned phase outs, bringing additional demand for uranium to the surface.
- Interest rates rose substantially this year as sticky inflationary pressures and the Federal Reserve's subsequent rate hikes caused a spike in bond yields. With the 10-year yield sitting at 3.77% as of September 29th, we believe this could be an entry point for certain duration sensitive assets with stronger yield profiles like preferreds.

Equity markets have been trending down for most of Q2 and Q3. For investors, one way to tackle this is by taking a more nuanced approach towards equities. One solution we prefer in this market environment are covered call strategies, which benefits when market volatility increases given that call writing premiums are positively correlated to volatility. Given that the Fed has taken a hawkish stance, the potential income collected from covered call writing could be particularly attractive to offset some potential market declines. Another solution is for investors to make their equity exposure more domestically oriented towards the US, as the strong dollar affects global markets, and the more positive outlook of the US economy relative to the rest of the world.

Footnotes

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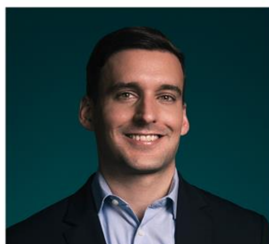

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