



**R&R Weekly Column**  
**By Brunello Rosa**



## Volatility In Financial Markets Abounds As Recession Fears Increase

Last week, financial markets were in turmoil once again. Global equities decreased on a weekly basis, with the MSCI ACWI index down by -2.2%, the US S&P 500 index dropping -2.4% and the MSCI EMs falling by 2.6%. With this week's negative performance, this year is the second worst start to a year for the S&P 500 in history: -17.5% in the first 91 trading days. Logically, volatility has also risen considerably, with VIX rising to 29.35 (versus a 52-week average of 21.7 and a 10y average of 18.0).

Volatility in markets is increasing as investors are becoming sceptical that central banks will be able to engineer a 'soft landing' for the economy after the series of rate increases that they are planning to implement in coming months in order to tame inflation. Reasons for concern abound, as investors have suffered from: i) the accelerated pace of monetary tightening that most central banks have announced, most recently the ECB, which may be increasing rates already in July; ii) geopolitical news, with Russia threatening a retaliation to a possible admission of Finland and Sweden to NATO; iii) persistently high inflation data; iv) the impact of strict lockdowns in China, which are further disrupting global value chains; and v) increasing recession fears as the global economy is slowing down.

However, last week, something different from previous weeks occurred. US government bond yields (especially in the US and the eurozone) fell amid the sell-off in equity prices. So, the correlation between bond and stock prices went back to negative after being positive recently. Finally, credit spreads widened, with the effective yield on US "junk bonds" (US High Yield Master II) reaching 7.4%, the highest level since May 2020. All this while bank equity prices continue to fall, with the shares of the five largest US banks down between 20% and 25% year-to-date.

How can we interpret all this? In the stagflationary scenario that we have observed so far, the combination of higher inflation, lower growth and higher long-term rates, have led to a parallel decrease of bonds and equity prices (positive correlation). But the increase in recession probability means that inflation may be lowered by the reduction of the demand side of the economy, making stagflation fears less pressing. As a result, there start to be risk-off flows into government bonds, thus lowering their yields.

Additionally, rate increases tend to be good for banks, as they steepen the yield curve on which they profit with maturity transformation. But if rate increases risk causing a recession, the weakening of the economy would be bad for bank profitability. As a result, bank equity prices fall.

In all this, price movements have been exacerbated by the sharp sell-off in the crypto-currency space, where Bitcoin has fallen below the psychological barrier of 30,000 and lots of stablecoins went under stress, with the Terra/Luna trade collapsing and even Tether shortly falling to 95.11 cents on the dollar. With USD 80bn held in assets as collateral, sharp liquidations to keep the peg at 1\$ would eventually also impact traditional markets, not just the USD 1.3tn crypto-asset market.

### Our Recent Publications

📖 *Financial Warfare Against Russia: Stakes for Gulf Investors and Funds*, by Gulf State Analytics, 12 May 2022

📖 *Flash Review: BOE Raises Rates and Begins The Process Of Asset Sales*, by Brunello Rosa and Nato Balavadze, 5 May 2022



Looking Ahead

**The Week Ahead: UK and EZ Inflation Is Expected To Accelerate While The EZ Q1 GDP Is Expected To Slow Down**

**In the UK**, April's core-inflation rate is expected to rise to 6.2% y-o-y (*p*: 5.7%) with CPI inflation surging to 9.1% y-o-y (*p*: 7%). On a monthly basis inflation is seen increasing by 2.6% (*p*: 1.1%). In March, the unemployment rate is expected to stay unchanged at 3.8%. April's retail sales are seen shrinking by -7.2% y-o-y (*p*: 0.9%).

**In the EZ**, in Q1, GDP growth is likely to slow down to 0.2% q-o-q (*p*: 0.3%), while accelerating to 5.0% y-o-y (*p*: 4.7%). April's inflation data is expected to show: i) CPI inflation rising to 7.5% y-o-y (*p*: 7.4%); ii) core-inflation increasing to 3.5% y-o-y (*p*: 2.9%); and iii) monthly headline inflation decreasing to 0.6% (*p*: 2.4%).

**The Quarter Ahead: Finland And Sweden Joining NATO Is Not Favored By Turkey; G7 Meeting; World Shares Sink**

**Finland is about to apply for NATO membership, as Russia threatens 'retaliatory steps.'** As a matter of fact, a Russian energy supplier said it will suspend electricity to Finland, claiming that the company has not been paid for previous deliveries. In addition, Prime Minister of Sweden Magdalena Andersson, said that Sweden too is moving towards joining NATO, but more cautiously.

**President Erdogan says Turkey does not support Sweden and Finland joining NATO.** This could pose problems to the two countries' move to obtain NATO membership, as all member states must approve a new country joining the alliance. Erdogan justified his stance referring to Nordic countries' hosting of members of the Kurdish Workers' Party, which is considered a terrorist organization by Turkey.

**G7 supports more aid and weapons to Ukraine.** Ukraine and Moldova join the G7 foreign ministers' annual meeting in Germany. The meeting raised concerns over the conflict spilling over into Moldova. Food security concerns also emerged, as Russia's blockage of grain exports pushed prices higher.

**Elon Musk puts \$44 bn Twitter deal 'on hold'.** Musk raised concerns over the number of fake accounts on the platform. The statement weighed on Twitter share prices, dragging them down by as much as 20% in pre-market trading.

**Global equities recorded the longest weekly losing streak since 2008.** Worries about prolonged inflation, tight supplies and possible recession persist. China's decreasing exports, standing at a two-year low, weigh on global growth prospects.

Last Week's Review

**Real Economy: US Inflation Moderates, But Is Still Hotter-Than Expected; UK Q1 GDP Rises; Inflation Rises In France And Germany**

**In the US**, April's core-CPI inflation rate decreased to 6.2% y-o-y (*c*: 6.0%; *p*: 6.5%), with CPI inflation falling to 8.3% y-o-y (*c*: 8.1%; *p*: 8.5%). In April, export and import prices rose by 18.0% y-o-y (*p*: 18.6%) and 12.0% (*p*: 13.0%) respectively.

**In the UK**, according to preliminary estimates, in Q1 GDP advanced by 0.8% q-o-q (*c*: 1.0%; *p*: 1.3%) and 8.7% y-o-y (*c*: 9.0%; *p*: 6.6%), respectively. March's IP rose 0.7% y-o-y (*c*: 0.5%; *p*: 2.1%).

**In the EZ**, ZEW economic sentiment index rebounded to -29.5 in May from -43 in April. March's IP shrank by -0.8% (*c*: -1.0%; *p*: 1.7%).

**Among the largest EZ economies**, April's inflation data showed that: i) In France, inflation accelerated to 4.8% y-o-y as expected (*p*: 4.5%); and ii) in Germany inflation increased to 7.4% meeting market expectations (*p*: 7.3%).

**Financial Markets: Stock Market Plunges, Whereas Bond Prices Are Up; USD Rise; Oil And Gold Decrease**

**Market Drivers:** Investors are becoming skeptical that the Fed will be able to reach 'soft landing'. Investors suffered: i) accelerated pace of monetary tightening; ii) Russia's invasion of Ukraine; iii) persistent hot inflation data; iv) strict lockdowns in China; and v) slowing growth in general. Both EZ and US government bond yields fell amid a sell-off in equities.

**Global Equities** decreased w-o-w (MSCI ACWI, -2.2%, to 629.2). The US S&P 500 index dropped (-2.4% w-o-w, to 4,024). In the EZ, shares were up (Eurostoxx 50, +2.05% w-o-w, to 3,703) despite worries on the economic outlook and high inflation. In EMs, equities declined (MSCI EMs, -2.6%, to 1,005). Volatility rose considerably to 29.35 (VIX S&P 500, 52w avg.: 21.7; 10y avg.: 18.0).

**Fixed Income:** w-o-w, 10-year US treasury yields declined (-21 bps to 2.93%). 2-year US treasury yields fell too (-15 bps to 2.59%). German 10-year bund yield declined too compared to last week (-20 bps, to 0.94%). As investors search for safe havens, bond prices go up, while yields go down.

**FX:** w-o-w, the US Dollar Index rose (DXY, +0.77%, to 104.5; EUR/USD -1.32%, to 1.04), as economic fears pushed its safe-haven appeal. In EMs, currencies were down (MSCI EM Currency Index, -0.84% w-o-w, to 1,666.66).

**Commodities:** w-o-w, oil prices were down (Brent, -1.0% to 111.22 USD/b). However, oil prices rose on Friday, over fears of Europe implementing an oil embargo to Russia. W-o-w, gold prices decreased (-3.9% to 1,810.3 USD/Oz), as the dollar rose to higher levels.



@RosaRoubini



Rosa & Roubini



Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to [info@rosa-roubini-associates.com](mailto:info@rosa-roubini-associates.com)

[www.rosa-roubini-associates.com](http://www.rosa-roubini-associates.com)

118 Pall Mall, London SW1Y 5ED

## Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	Five Star Movement, Italy
ann.	annualized	m-o-m	Month-on-month
ARS	Argentinian Peso	mb	Million barrels
avg.	Average	mb/d	Million barrels per day
bn	Billion	MENA	Middle East and North Africa
BoC	Bank of Canada	MHP	Nationalist Movement Party, Turkey
BoE	Bank of England	mn	Million
BoJ	Bank of Japan	MPC	Monetary Policy Committee
bpd	Barrels per day	NAFTA	North-American Free Trade Agreement
bps	Basis points	NATO	North Atlantic Treaty Organization
BS	Balance sheet	OECD	Organization for Economic Cooperation and Development
c	Consensus	Opec	Organization of Petroleum Exporting Countries
C/A	Current account	p	Previous
CB	Central bank	P2P	Peer-to-peer
CBB	Central Bank of Bahrain	PBoC	People's Bank of China
CBK	Central Bank of Kuwait	PCE	Personal Consumption Expenditures
CBT	Central Bank of Turkey	PE	Price to earnings ratio
CDU	Christian Democratic Union, Germany	PM	Prime minister
CNY	Chinese Yuan	PMI	Purchasing managers' index
CPI	Consumer Price Index	pps	Percentage points
DJIA	Dow Jones Industrial Average Index	pw	Previous week
DJEM	Dow Jones Emerging Markets Index	QCB	Qatar Central Bank
d-o-d	Day-on-day	QAR	Qatari Riyal
DXY	US Dollar Index	QE	Quantitative easing
EC	European Commission	q-o-q	Quarter-on-quarter
ECB	European Central Bank	RE	Real estate
ECJ	European Court of Justice	RBA	Reserve Bank of Australia
EIA	US Energy Information Agency	RRR	Reserve Requirement Ratio
EM	Emerging Markets	RUB	Russian Rouble
EP	European Parliament	SWF	Sovereign Wealth Fund
EPS	Earnings per share	tn	Trillion
EU	European Union	TRY	Turkish Lira
EUR	Euro	UAE	United Arab Emirates
EZ	Eurozone	UK	United Kingdom
Fed	US Federal Reserve	US	United States
FOMC	US Federal Open Market Committee	USD	United States Dollar
FRB	US Federal Reserve Board	USD/b	USD per barrel
FX	Foreign exchange	UST	US Treasury bills/bonds
FY	Fiscal Year	VAT	Value added tax
GCC	Gulf Cooperation Council	VIX	Chicago Board Options Exchange Volatility Index
GBP	British pound	WTI	West Texas Intermediate
GDP	Gross domestic product	WTO	World Trade Organisation
IMF	International Monetary Fund	w	Week
INR	Indian Rupee	w-o-w	Week-on-week
IPO	Initial public offering	y	Year
IRR	Iranian Rial	y-o-y	Year-on-year
JPY	Japanese yen	y-t-d	Year-to-date
k	thousand	ZAR	South African Rand
KSA	Kingdom of Saudi Arabia	2y; 10y	2-year; 10-year



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