



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



### **As Markets Wobble, Central Banks Need To Be Cautious With QT To Avoid Market**

As we [discussed in last week's column](#), markets are in turmoil as recession fears increase around the globe. Central banks had thought that inflation would be a temporary phenomenon due to transitory factors, but instead it proved to be a persistent feature of the post-pandemic world, exacerbated by additional supply-chain constraints and the rise in energy prices due to the war in Ukraine. As a result, they have all turned hawkish (with a few exceptions, such as the BOJ) and started policy normalisation programs.

Now central banks are assuring the public that a recession will not take place as a result of the series of shocks that have hit the global economy, but they are also warning that they cannot guarantee a “soft landing” will take place. Hence the market now fears that a recession may in fact occur at some point in 2022. This is causing a free fall in equity indices, with the S&P now exhibiting [the worst start to a year since 1939](#), entering a bear market. It is also causing a fall in long-term bond yields. As we discussed last week, this can be interpreted as the market fearing an outright recession more than a stagflationary shock, as the contraction in economic activity would tame inflation somewhat by reducing aggregate demand.

A combination of lower risky asset prices, economic deceleration and rising recession fears may induce central banks to adopt less aggressive policy normalisation plans than initially anticipated. At the same time, their normalising rates and withdrawing liquidity at the time the economy is wobbling may be a very risky strategy, especially at a time when governments are also considering fiscal consolidation plans. For example, the final communique of the G7 meeting held [in Germany at the end of last week](#), under German leadership and presided over by the German Finance Minister Lindner, called for a reduction of the debt that states had accumulated to fight the pandemic.


This combination of higher inflation and policy interest rates, reduced economic growth (or even recession), high public indebtedness and reduced central bank liquidity could be particularly dangerous for the most fragile countries. In the Eurozone, for example, Italy has already witnessed a sizeable increase in its yield spreads versus Germany in the last few weeks (with the 10y yield spread having surpassed 200bps), a larger widening than that experienced by similar countries such as Portugal and Spain.

In September 2019, while [the Fed was implementing its first round of Quantitative Tightening](#) (QT), at some point the reduction in liquidity proved excessive. As a result, the US Treasury market became really unstable, with long-term treasury yields spiking. The Fed had no other option than interrupting its QT program and re-starting asset purchases again (in this case, for the smooth functioning of the transmission mechanism of monetary policy).

This may happen again in the US and in other jurisdictions, chiefly in the UK and in the Eurozone. In particular, in the Eurozone, the ECB has not specified whether a new facility to keep the intra-EMU spreads will be launched at the time QT is announced. [For now, the ECB prefers to continue to keep some form of “constructive ambiguity” regarding this choice](#), preferring to say that, at the right time, the ECB is ready to re-start the Pandemic Emergency Purchasing Program (PEPP), or to use its re-investment policy to keep the spreads in check, or to come up quickly with a new facility. This choice is also motivated by the decision to avoid any legal challenge related to the adoption of a new instrument by the Governing Council.

Some analysts suggest that a new version of the Outright Monetary Transactions (OMT, with lighter conditionality) may be used in this case. But the positions within the Governing Council clearly differ. However, time is running out. If the ECB intends to end its net asset purchases in June and start increasing rates in July, when market liquidity will be further reduced by the summer season, one cannot rule out a market accident involving the most indebted and more fragile countries such as Italy. So, it may be preferable for the ECB to specify what it intends to do in case an unwarranted increase in spreads occurs, instead of rushing to find a solution after a market accident has already occurred.

#### ***Our Recent Publications***

 [Financial Warfare Against Russia: Stakes for Gulf Investors and Funds](#), by Gulf State Analytics, 12 May 2022

 [GEOPOLITICAL CORNER: The West and the Rest: The War In Ukraine Has Exposed The New Global Division Of Power](#), by John C. Hulsman, 17 May 2022



Looking Ahead

**The Week Ahead: PMIs To Decrease In DMs; US Q1 GDP To Shrink, While Germany Q1 GDP is Expected To Rise; US Core-PCE To Ease**

**In the US**, in Q1, according to the second estimate of GDP, the economy is expected to shrink by -1.4% q-o-q (p: 6.9%). In April, core PCE is expected to ease further to 4.9% (p: 5.2%). In May, services and manufacturing PMIs are expected to decrease to 55.4 (p: 55.6) and 57.9 (p: 59.2) respectively.

**In the EZ**, in May flash estimates are expected to show: i) manufacturing PMI to decrease to 54.9 (p: 55.5); ii) services PMI to decline slightly to 57.5 (p: 57.7); and iii) composite PMI to decrease correspondingly to 55.3 (p: 55.8). Consumer confidence in May is likely to recover slightly to -21.1 (p: -22). **Among the largest EZ economies**, Germany's Q1 GDP is seen advancing by 0.2% q-o-q (p: -0.3%) and at 3.7% y-o-y (p: 1.8%).

**In the UK**, in May: i) Services PMI is expected to decrease to 57.3 (p: 58.9); ii) Manufacturing PMI is seen decreasing to 55.1 (p: 55.8); and iii) Composite PMI is likely to fall to 57.4 (p: 58.2).

**The Quarter Ahead: Russia Declares Victory At Azovstal; US Delivers Support To Ukraine; G7 Met In Germany; Elections in Australia**

**Russia declared a victory at Azovstal steel plant in Mariupol**, following the months-long battle. It would mean that Russians have complete control of Mariupol, which is a strategic port city. Heavy fights continue in eastern Ukraine, where Russian missiles destroyed the cultural centre in Lozova and injured seven people.

**The US provides additional support to Ukraine**. Senate passes \$40bn aid bill, which would fund military and humanitarian aid. In addition, the US is expected to keep 100,000 troops stationed in Europe in case Russia threatens Sweden, Finland or NATO members.

**G7 plan EUR 15bn aid for Ukraine**. G7 finance ministers and central bank governors met in Germany on 18-20 May. A meeting communiqué also stressed 'elevated debt levels' and inflation that 'have reached levels not seen for decades'.

**The 2022 Australian federal election was held on May 21, 2022**, to choose the prime minister and the ruling party. The Labour party led by Antony Albanese has claimed victory and incumbent PM Scott Morrison (Liberal-National coalition) conceded the result.

**Leisure and business flights rise past 2019 levels for the first time**. Demand rises as COVID restrictions loosen. According to the Mastercard Economics Institute's travel report, global flight bookings for leisure travels rose 25% above pre-pandemic levels in April. Global business flight bookings surpassed pre-pandemic levels too in March, with the return to the office being an important driver.

Last Week's Review

**Real Economy: EZ Quarterly GDP Rises Slightly, While Japan's Economy Contracts In Q1; Inflation Rises In EZ and UK As Expected**

**In the US**, April's retail sales accelerated to 8.2% y-o-y (p: 7.3%).

**In the EZ**, in Q1, according to the second estimate, GDP growth was up by 0.3% q-o-q (c: 0.2%; p: 0.3%). The economy advanced by 5.1% y-o-y (c: 5.0%; p: 4.7%) in Q1. April's inflation data showed: i) CPI inflation rising to 7.4% y-o-y (c: 7.5%; p: 7.4%); ii) core-inflation increasing to 3.5% y-o-y (c: 3.5%; p: 2.9%); and iii) monthly headline inflation decreasing to 0.6% (c: 0.6%; p: 2.4%).

**In the UK**, April's core-inflation rate surged to 6.2% y-o-y (c: 6.2%; p: 5.7%) with CPI inflation soaring to 9.0% y-o-y (c: 9.1%; p: 7%). On a monthly basis, inflation increased by 2.5% (c: 2.6%; p: 1.1%). In March, the unemployment rate edged down to 3.7% (c: 3.8%; p: 3.8%). April's retail sales shrank but less than expected by -4.9% y-o-y (c: -7.2%; p: 1.3%).

**In Japan**, Q1 GDP shrinks by -0.2% q-o-q (c: -0.4%; p: 0.9%), as rising commodity prices weighed on consumption and investment.

**Financial Markets: Stock Markets Suffer; Yields Decreased; USD Down, Oil and Gold Up**

**Market Drivers**: Investors are concerned over economic growth and inflation, as they search for havens. As a result S&P500 is briefly pushed into bear market. Fears rise that inflation that weighs on consumer discretionary spending as well as rapidly rising interest rate sets a stage for a recession.

**Global Equities**: Decreased w-o-w (MSCI ACWI, -0.88%, to 623.6). The US S&P 500 index dropped (-3.05% w-o-w, to 3,901). S&P 500 was down by 20% from its January intraday high. In the EZ, shares were down (Eurostoxx 50, -1.25% w-o-w, to 3,657), as investors are becoming fretful over slowing economic growth. In EMs, equities rose (MSCI EMs, +2.9%, to 1,033). Volatility rose considerably to 29.5 (VIX S&P 500, 52w avg.: 22.0; 10y avg.: 18.0).

**Fixed Income**: w-o-w, 10-year US treasury yields declined (-14 bps to 2.79%), as investors flocked to the safety of bonds amid the stock sell-off. 2-year US treasury yields are virtually unchanged at 2.59%. German 10-year bund yield stayed the same too compared to last week at 0.94%.

**FX**: w-o-w, the US Dollar Index declined (DXY, -1.5%, to 103.0; EUR/USD +1.45%, to 1.06). In EMs, currencies were up (MSCI EM Currency Index, +0.63% w-o-w, to 1,677.14).

**Commodities**: w-o-w, oil prices were up (Brent, 1.2% to 112.91 USD/b). W-o-w, gold prices increased (+2.0% to 1,845.1 USD/Oz).



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## 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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