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Will The Mid-Summer Rally in Equity Markets Last Until the Autumn?

Since mid-June 2022, the S&P 500 equity index has risen more than 15%, reaching 4228 points at the end of last week. This rally has helped the index (and similar indices around the globe) exit bear market territory, defined as a fall in equity prices of at least 20% from its recent peak, which it entered in June just before this rally begun.

The index is still down 11% year-to-date, but only 5% from one year ago. It is actually up 45% over the last three years, and an astonishing 500% since March 2009, when the post-Global Financial Crisis (GFC) rally begun. The index has been one of the major beneficiaries of the massive liquidity injections made by central banks around the world in the last 14 years, with various round of QE to combat the various shocks the global economy underwent in the period, and in particular the GFC and the Covid-19 pandemic.

This introductory background serves the purpose of providing some context for one of the hottest debates among market participants in this period; namely, will this mid-summer market rally last, at least until the autumn, and possibly beyond? As we know, market participants tend to have a short-term horizon for their decisions. But putting things into context here may help to provide an answer.

We discussed recently about the asynchronous nature of financial and business cycles, with financial cycles typically anticipating the developments of the real economy. In this context, we warned that we could see markets rallying when the economy was entering a recession, having fallen in advance, before the economic cycle turned downward. In this case, the key indicators that markets are watching are inflation data and the response of central banks. If inflation starts showing signs of peaking and central banks signal that they can stop their tightening cycle soon, markets would be ready to rally.

This is what has fuelled the mid-summer rally so far. Inflation has shown some (mixed) signals of peaking, and the Fed, at its July FOMC meetings, said that it is now data dependent, and not on a pre-set course of action.

What about the future? The real economy shows further signs of deceleration globally, starting in China and Europe, and a contraction in economic activity taking place at the end of this year cannot be ruled out. The US has already exhibited two consecutive quarters of negative growth meanwhile, but various one-off factors seem to convince policymakers that this still does not represent even a technical recession.

On the other hand, labour markets remain tight, on both sides of the Atlantic. And with unemployment rates still at historical lows, wage growth remains strong, pushing up domestically generated inflation. In the UK, for example, inflation has surprised on the upside again, and market participants now expect another 50bps rate increase in September by the Bank of England.

Central banks will not stop increasing rates until they are sure that inflation is tamed, even if this implies a strong deceleration, and potentially even a contraction in economic activity (to some extent, this is in fact what central banks are trying to engineer). Central banks, which have a longer time horizon than market participants, know that markets can suffer some additional losses (precisely because some equity indices have rallied 500% since the QE experiment began), if such losses are the price needed to pay for reining in inflation. So, the mid-summer rally may come to an abrupt halt when central bank activity resumes in September.

The real puzzling piece in this jigsaw is the following: if a debt crisis accompanies the upcoming economic downturn, the reaction function by central banks may change, and they may instead be more inclined to safeguard the integrity of the overall financial system rather than rapidly bringing inflation down to target levels. But in that case, more wealth destruction in the equity and sovereign and corporate bond markets would be assured, even with less hawkish – or even accommodating – central banks.

Looking Ahead

The Week Ahead: US QoQ GDP To Contract; UK Retail Sales To Shrink; PMIs To Fall in DMs, Even Below 50 In EZ

In the US, the second estimate is expected to show that in Q2 GDP has contracted by 0.8% q-o-q (*p:* -1.6%). In July, core-PCE is likely to decrease to 4.7% y-o-y (p: 4.8%). According to flash estimates, in August, manufacturing PMI is expected to decrease to 51.9 (*p*: 52.2), whereas services PMI is seen increasing to 49.1 (*p:* 47.3). August's consumer sentiment is expected to rise to 55.2 (*p:* 51.5).

In the EZ, according to flash estimates, in August, manufacturing and services PMIs are likely to decrease to 49 (*p*: 49.8) and 50.5 (*p:* 51.2). As a result, composite PMI is likely to fall to 49 (*p:* 49.9). August's Consumer Confidence is expected to dip to -28 (*p:* -27).

In the UK, according to flash estimates in August, manufacturing and services PMIs are likely to decrease to 51.3 (*p*: 52.1) and 52 (*p:* 52.6). As a result, composite PMI is likely to fall to 51.3 (*p:* 52.1).

Among the largest EZ economies, in Q2 German GDP is expected to stagnate q-o-q (p: 0.8%) and decelerate to 1.4% y-o-y (p: 3.6%).

The Quarter Ahead: Buffet Received Permission From FERC To Buy 50% of Occidental Stake; Zelenksy Met With Erdogan and Guterres

Warren Buffet got permission from the US energy regulator to buy 50% of Occidental Petroleum stake. Occidental is the largest producer and operator in the Permian Basin. As a result, the shares surged by 10%, pushing their 2022 gains to more than 145%. As the Federal Energy Regulatory Commission reported Warren Buffett's Berkshire Hathaway's proposed stock purchases are *'consistent with the public interest.'*

Zelensky invited President Erdogan and the U.N. Chief Guterres to Lviv. A grain deal boosted by the United Nations and Turkey is working, albeit trade volumes are still modest. Following the meeting, Erdogan warned of 'another Chernobyl' amid ongoing fights at Ukraine's largest nuclear power plant – Zaporizhzhia.

Putin and Macron Agreed to send a team from the International Atomic Energy Agency (IAEA) to the Russian-controlled Zaporizhzhia. Concerns arose last week after shelling intensified around the nuclear power plant. IAEA Director General described the situation as *'very alarming'*.

Last Week's Review

Real Economy: EZ And UK Headline And Core Inflation Rose; EZ QoQ GDP Rose; UK Retail Sales And Consumer Confidence Shrank

In the US, in July, IP decelerated slightly by 3.9% (*p:* 4.0%). In July, retail sales rose by 10.3% y-o-y (*p:* 8.5%), whereas monthly retail stagnated (*c:* 0.1%; *p:* 0.8%)

In the EZ, in Q2, according to second estimate, GPD rose by 0.6% q-o-q (*c:* 0.7%; *p:* 0.5%) and decelerated to 3.9% y-o-y (*c:* 4.0%; *p:* 5.4%). In July, inflation rose to 8.9% y-o-y (*p:* 8.6%) and cooled off to 0.1% m-o-m (*p:* 0.8%) as expected. Core inflation increased to 4.0% y-o-y (*p:* 3.7%) in line with consensus.

In the UK, the unemployment stood unchanged at 3.8% in June, as expected. Headline and core inflation surged to 10.1% y-o-y (*c:* 9.8%; *p:* 9.4%) and 6.2% y-o-y (*c:* 5.9%; *p*: 5.8%). Monthly inflation decreased by 0.6% (*c:* 0.4%; *p:* 0.8%). July's retail sales shrank by 3.4% y-o-y (*c:* -3.3%; *p:* -6.1%) and 0.2% m-o-m (*p:* -0.1%). In August, Consumer Confidence contracted by -44 (c: -42; *p:* -41).

Financial Markets: Stocks and US Yields Fell, while German Bund Yields Rose; Dollar Is Up, While Oil and Gold Prices Are Down

Market Drivers: Fed Officials reported in the minutes of July's meeting that they are still committed to raising rates. However, the uncertainty prevailed over the pace of interest rate hikes and as a result, stocks retreated and yields fell. Core EZ government bond yields increased following a double-digit rise in UK inflation and ECB official Schnabel's comment that fueled inflation worries.

Global Equities: Decreased *w-o-w* (MSCI ACWI, -0.3%, to 655.4). The US S&P 500 index decreased (-1.2% w-o-w, to 4,228.5). In the EZ, share prices were down (Eurostoxx 50, -1.2% w-o-w, to 3,730.3). In EMs, equity prices decreased (MSCI EMs, -0.7%, to 1009.6). Volatility rose to 24.2 (VIX S&P 500, 52w avg.: 23.6; 10y avg.: 18.2).

Fixed Income: *w-o-w*, 10-year US treasury yields down (-13.4 bps to 2.98%). The 2-year US Treasury yields decreased too (-1 bps to 3.24%). The German 10-year bund yield rose (+23 bps to 1.22%).

FX: *w-o-w,* the US Dollar Index was up (DXY, +2.4%, to 108.0; EUR/USD -2.2%, to 1.00). In EMs, currencies fell (MSCI EM Currency Index, -0.7% w-o-w, to 1,655.7).

Commodities: *w-o-w,* oil prices fell (Brent, -2.1% to 96 USD/b). Gold prices decreased w-o-w (-3.0% to 1,760.3 USD/Oz).

Nato Balavadze *contributed to this Viewsletter*

The picture in the front page comes from this website

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Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*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*