UBS

The bankruptcy of crypto exchange FTX—while driven by company-specific factors—underlines the threat to speculative assets as global liquidity ebbs. (ddp)

Strains from tightening increase, despite hopes of Fed pivot

14 November 2022, 1:16 pm CET, written by UBS Editorial Team

The S&P 500 closed on Friday with a rise of 0.9%, taking gains for the week to 5.9%, the best outcome since June. The main impetus remained hopes of a dovish pivot from the Federal Reserve, after data last week showing a smaller-than-expected increase in both headline and core inflation for October.

Investor sentiment has also been helped by global developments; China laid out plans to support the struggling property sector and has outlined a recalibration of its economically harmful zero-COVID policy. Meanwhile, data continues to show that a mild Northern Hemisphere winter so far has made it easier for European nations to build up gas in storage—reducing the threat from reduced supplies from Russia.

But we believe it is too soon to assume a shift in Fed policy. Fed Governor Christopher Waller said at the start of the week that the central bank still had "a ways to go" before ending rate hikes. That chimed with remarks last week from San Francisco President Mary Daly, who said the release was "far from a victory."

In addition, we are seeing signs of financial fragility as the knock-on effects are felt from the end to more than a decade of ultra-easy monetary policy.

The bankruptcy of crypto exchange FTX—while driven by company-specific factors—underlines the threat to speculative assets as global liquidity ebbs. The news that FTX had failed left other digital exchanges seeking to calm anxiety among clients regarding the safety of their funds. FTX, which was valued earlier this year at USD 32 billion, had just USD 1 billion of easily sellable assets and USD 9 billion of liabilities, according to a report by the Financial Times. The value of Bitcoin fell close to 23% last week and is now down 64% year to date.

Recent developments support our longstanding view that cryptos are a highly risky investment proposition, given the potential asset runs along with limited transparency or regulatory oversight. The reduction in central bank liquidity has added to the vulnerability of this market.

Disruption in the UK gilts market in 2022 starkly illustrated the challenges facing governments who try to increase borrowing at the same time as central banks sell government bonds to try and reduce inflation. While there were idiosyncratic aspects of events in the UK, the set of challenges facing the UK are not unique, and a risk for next year is that the UK might be a forerunner of financial instability in other markets. In the Eurozone, we are monitoring the risk that the unwinding of quantitative easing could prompt stress in bond markets. The ECB's Transmission Protection Instrument is designed to mitigate these challenges, but it remains unclear how it would work in practice, and it is unlikely to be deployed proactively, notably in markets that would have to experience disruption first.

In the US, as the Fed conducts quantitative tightening, we are monitoring for the risk of a funding squeeze. This would be similar to 2019, when the Fed's balance sheet run-down caused an undue tightening in dollar funding conditions. A key challenge is that the process of quantitative tightening reduces banks' excess reserves faster than lending made against those reserves is unwound. This effectively increases leverage, and the system's vulnerability to shocks.

So, as the effects of tighter policy intensify, we continue to favor a defensive investment stance. In equities, we are least preferred on the technology sector, which is most susceptible to higher rates. Instead, we favor sectors that are less vulnerable to a slowing economy and higher rates—including consumer staples and healthcare. Value looks set to continue to outperform growth, in our view, given that inflation—though past its peak—will likely remain elevated for some time to come. In fixed income, we prefer high grade and investment grade bonds, which offer greater protection against weaker growth.

Main contributors - Mark Haefele, Vincent Heaney, Christopher Swann, Alison Parums, Jon Gordon

Content is a product of the Chief Investment Office (CIO).

Original report - Strains from tightening increase, despite hopes of Fed pivot, 14 November 2022.

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2021. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.