Market Review June 2022

Oil Price Shock

Brent crude has risen by 40% this year, from $77 per barrel in Dec 2021 to as high as $120 in July 2022.

During March, oil prices touched $123.20 for a brief period which was a 59% increase on 2021 year-end levels. Another fact that is evident from the above chart is the fluctuation in oil price trends whereby if we look at a time horizon of 2.5 years, the world oil and gas prices have been subject to demand and supply shocks and sometimes both simultaneously. The price of brent crude oil declined from a "relatively normal" $68 a barrel at the end of 2019 to $14 a barrel in April 2020 as the initial spread of covid-19 pandemic took the world by surprise. However, two years later, in March 2022, the price of brent crude soared to $123 a barrel after Russia invaded Ukraine. Now it is trending downwards again amidst growing fears of a recession in the US. But the price could rise sharply if the Chinese economy bounces back from the slowdown induced by its zero-Covid policies. Oil and gas prices are also volatile because short-term demand for energy responds much faster to changes in growth than to price changes. So, when there is an energy shock, it can take a huge price change to clear the market.

An Ensuing Emerging Market Debt Crisis

Developing countries continue to suffer the biggest hit from this year's oil price shock as many are dependent on imported fuel and are being crushed by a combination of high international prices, weak currencies and competition (for resources) from rich nations whose economies are rebounding from the pandemic.

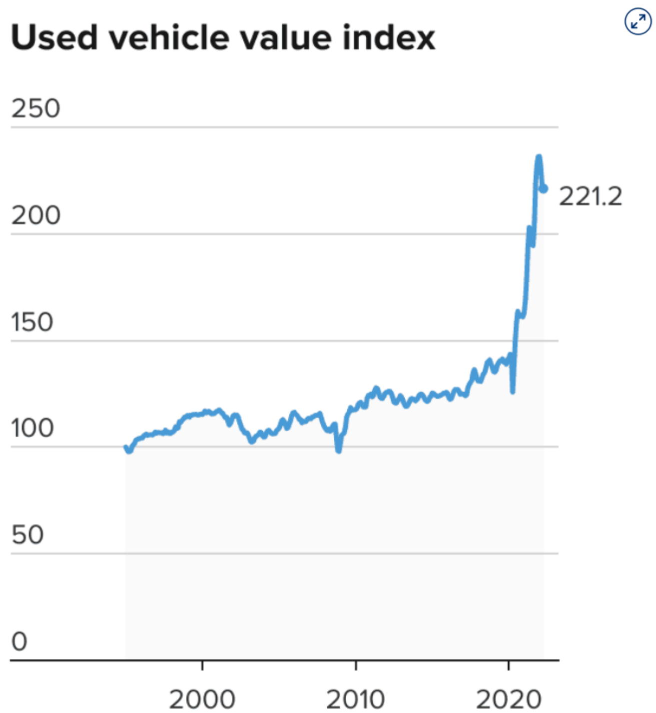
Higher energy/fuel bills are taking inflation to unprecedented levels in these economies that are already struggling with record food prices. This dual combination of energy and food price hikes is leading to social unrest and protests from citizens in emerging economies like Sri Lanka, Laos, Nigeria and Argentina to name a few. Governments in these emerging economies are faced with the dilemma of either cushioning the blow of higher prices by reducing taxes or increasing subsidies (which have a detrimental impact on state finances). The crisis is mainly the result of the twin forces of recovering demand after the pandemic and sanctions on Russia over its invasion of Ukraine, which disrupted global flows of energy, especially to Europe.

For some relatively poorer nations, the effects of higher oil prices feeds into a downward spiral, where fuel import bills hurt the economy and further weakens the currency, making oil imports even more expensive. Emerging markets had already been suffering disproportionately from strained finances amid the covid-19 pandemic even before this year's headwinds struck. Investors have pulled $50B from emerging market bond funds during 2022 indicating a flight from this key asset class. The net outflows from EM fixed income funds during 2022 are the most severe in at least 17 years; far worse than were recorded during a bout of acute concern about China's economy in 2015.

Car Prices Have Continue to Surge Amid Mounting Fears of Record Inflation

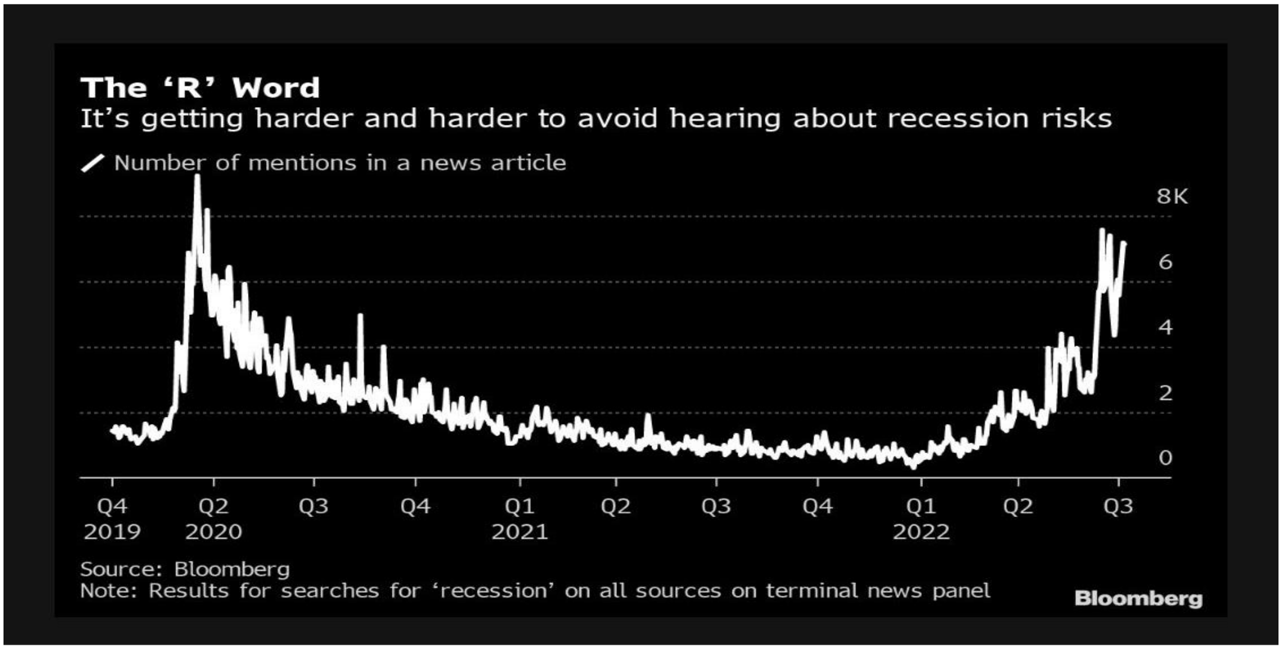
A shortage of semiconductors for vehicles that has prevailed since 2021 and continued supply chain challenges have severally impacted the supply side dynamics for new vehicles. In addition, the pent-up demand for vehicles post covid-19 lockdowns has remained far greater than the supply, sending prices soaring. The cost of new cars in the US has increased by an average of 12.6% since 2021 reaching a national average price of $47,148 during May as surging car prices have become a key contributor to the country's rising inflation.

As automakers struggle to manufacture cars due to part shortages, there are fewer new cars being sold and fewer used cars coming on the market. New and used car prices are inextricably linked. A shortage in new vehicle supplies immediately drives up demand for used ones, creating a shortage there too. Used car and truck prices have increased by 16% over the past year and cumulatively by 50% since the start of the covid-19 pandemic.



Consumers seem to be adjusting their preferences and as a result wholesale used-vehicle prices have fallen from a record high set in January 2022, signaling the worst of sky-high prices related to higher inflation in the U.S. may be behind us. The Cox Automotive's Manheim Used Vehicle Value Index, which tracks prices of used vehicles sold at its U.S. wholesale auctions, declined by 1% in April from March,2022, marking the third straight month of declines from January 2022. The drop-off in pricing comes as Manheim estimates used retail sales declined by 13% in April 2022 from March 2022, suggesting demand is finally showing signs of easing amid the record-high prices.

Recession Fears Take Over!



As the U.S. Fed has turned around policy to fight inflation and decided to aggressively increase interest rates, fears of recession (the dreaded "R" world) have taken over the financial world and investors alike. The above graph which tracks the number of times the word "recession" has been mentioned in news articles underscores that the fear and risk of recession has become a major worry. Despite strong underlying economic numbers on the jobs, consumer spending and GDP growth front, each interest rate hike appears to be bringing behavioral economics more and more into play; further amplifying the risk and fear of recession.

Affordability Crisis Persists

Given sky-rocketing inflation, U.S. house and car prices are touching the thresholds of affordability. The two graphs below track the Housing affordability index and the average monthly car loan payments in the U.S. indicate that the current time is the most expensive for both home and car-ownership.

Housing prices have sky rocketed amidst the covid pandemic and due to the inflationary pressures post economic recovery. Prices climbed more than 30% since 2020, exacerbating a decades long upward trend in house prices. For reference, median housing prices in Q1 2020 were $329,000 however they have now reached $428,700 by Q1 2022. Those prices mark an increase of nearly 80 percent in the past 10 years. The U.S. Government-supported mortgage giant Fannie Mae predicted that inflation and other economic factors could contribute to a possible "modest recession" in 2023. Additionally, current prices are just over 30% more than they were in 2020 and have increased by almost 16% since last year.

In addition, car prices have also significantly contributed to inflation in the US and the below graph shows that the average monthly new and used car loan payments are also reaching unprecedented levels and combined with increasing home prices, these underline the scale of affordability crisis facing the US economy.