

## What could break this market?

We have seen a more rapid decline in equity valuations in recent days, but there hasn't really been a trigger, a sort of "Lehman shock", that has caused a credit event. Perhaps it is a question of when and not if we get to that point...

### The continuous decline in sentiment

The sentiment has turned extremely quickly and continues to deteriorate. Euro Equities Sentix sentiment index has dropped to a new historic low of -49. The scary part is the comment Sentix gives: "Usually, such extremes in sentiment occur near market lows. However, very strong declines in sentiment can also trigger one last big avalanche, accompanied by shortcovering actions. This was the case in August 2008, for example. With the bankruptcy of Lehman Brothers, the high level of pessimism was discharged into sharply falling share prices." US equities do not look better. In fact, Sentix suggests a final sell-off could still be ahead, as sentiment below -42 points has only been achieved 8 times before and prices fell by a further -4.3% on average in the following month, ugly dates:

- 7<sup>th</sup> September 2001
- 24<sup>th</sup> January 2003
- 31<sup>st</sup> January 2003
- 26<sup>th</sup> September 2003
- 10<sup>th</sup> August 2007
- 7<sup>th</sup> March 2008
- 6<sup>th</sup> March 2020

### April Manufacturing PMI data hides the truth

The PMI Manufacturing number last week were also pointing towards declines in most instances. Importantly, while the headline figure remains in expansion (apart from China), this is mostly due to supply chain delays (15% of index), high inventories (10%) and employment (20%). The other two measures, which show growth, output (25%) and new orders (30%), in many instances declined and were in contraction with the major outlier being the US where the expansion continued. The question is, once

China emerges out of its lockdowns, will lead times improve immediately, leading to lower delays and lower inventories and, at the same time, higher outputs and new orders? I think there is a chance that we could see output increase and all other categories decline.

#### April Manufacturing PMI

Country	April Manufacturing PMI	March Manufacturing PMI	Comment
Australia	58.8	57.7	Easing of border restrictions led to higher demand
Brazil	51.8	52.3	Rising global uncertainty cited as key drag on external demand
Canada	56.2	58.9	Near-record expansion in purchasing activity
China	46	48.1	Sharpest drop in activity since Feb 2020
Colombia	54.4	52.1	Strong upturn in new orders
Czech	54.4	54.7	Slowest improvement in 17 months
Eurozone	55.5	56.5	Output growth at 22-month low
France	55.7	54.7	Output constrained by war in Ukraine
Germany	54.6	56.9	Output and new orders fell to lowest since mid-2020
Global	52.2	52.9	Output index dropped to 48.5, mostly due to China
Greece	54.8	54.6	Production expansion slows 13th month in a row
India	54.7	54	Slowing consumer goods, all else rising
Ireland	59.1	59.4	New order growth eased slightly
Italy	54.5	55.8	Index is artificially high due to delivery delays
Japan	53.5	54.1	Supply chain delays amongst worst in history
Kazakhstan	49	46.8	Output and new orders down
Mexico	49.3	49.2	Factory orders fell for the 26th month in a row
Myanmar	50.4	47.1	Recovery linked to improvements in domestic market
Netherlands	59.9	58.4	Boost in consumer good demand
Philippines	54.3	53.2	Highest reading since Nov 2017
Poland	52.4	52.7	Decline in new order books
South Korea	52.1	51.2	War in Ukraine and China lockdowns impacted shipping and port capacity negatively
Spain	53.3	54.2	Transport strikes, shortages and high prices negatively impact demand
Taiwan	51.7	54.1	Softer demand due to China lockdowns
Thailand	51.9	51.8	Confidence declines, demand rises
UK	55.8	55.3	Confidence at 16-month low
USA	59.2	58.8	Pre-production inventories expanded at steepest rate on record

Source: IHS data

## Has deflation already started?

As Central Banks catch up with market rate hike pricing, there are actually a number of industries reporting a decline in prices already. I will list them here:

- Used car prices declined for the third month running by -1% last month (although climbed, if not adjusted for seasonality)<sup>1</sup>
- Diamond prices are down 24% at the latest rough tender by Petra Diamonds (although this is not seasonally adjusted and was expected to see a decrease)<sup>2</sup>
- House prices in London have declined in single digit amid rising mortgage rates according to White Estates (an agent gave me an example of someone who sold his property to buy another and both prices dropped by roughly the same amount)
- UK news publisher Reach is seeing lower advertising demand linked to the Ukraine/war news<sup>3</sup>
- UK BRC Retail sales slowed in March amidst rising prices<sup>4</sup>

Although this is all looking pretty grim, especially in light of the poor sentiment, some of these items might merely be down to a shift in behavior, as people start spending money on international travel again. In my opinion, this is the real driver behind, as I continue to consider the consumer in a strong position. The sentiment reflects this partly by showing expectations weaker than current conditions. The question is whether those weak expectations will become reality or not.

## A credit event in the making

Not only are the parallels to the 1920 Forgotten Depression striking, there are also elements of the Dotcom bubble and the 2008 Lehman shock visible. While the Dotcom bubble can be compared with the current Tech bubble and, apart from lower equity prices and lower interest rates, this has not caused a major depression back then, the 2008 Lehman shock did. And while a banking crisis comparable to that of 2008 seems unlikely at first, it could be caused not by real estate, rating agencies and MBS, but rather

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<sup>1</sup> <https://publish.manheim.com/en/services/consulting/used-vehicle-value-index.html>

<sup>2</sup>

<https://www.diamonds.net/News/NewsItem.aspx?ArticleID=68664&ArticleTitle=Petra%2bPrices%2bSlide%2b24%2525%2bat%2bRough%2bTender>

<sup>3</sup> <https://tools.eurolandir.com/tools/Pressreleases/GetPressRelease/?ID=4100694&lang=en-GB&companycode=uk-tni&v=r2021>

<sup>4</sup> [https://brc.org.uk/retail-insight/content/retail-sales/retail-sales-monitor/reports/202203\\_uk\\_rsm/](https://brc.org.uk/retail-insight/content/retail-sales/retail-sales-monitor/reports/202203_uk_rsm/)

by commodity traders, as suggested by Zoltan Pozsar<sup>5</sup>. First it was the ECB, then the MAS and now the Fed, all working together to better understand the exposures of commodity market participants<sup>6</sup>. While I'm not allowed to name the sources and cannot verify how accurate it is, I heard that Vitol alone has around \$60bn of credit lines (RCF) mostly with European banks. This week I got information that one of these commodity traders (could be Trafigura) has reached out to a ship-to-ship (STS) transfer firm requesting one LNG transfer per month with a three year commitment (the overall size or number of LNG transfers needed might be higher). The company rejected the contract, as it was Russian LNG. Now, there are a few possible outcomes to this problem:

1. The trader finds another STS transfer firm to work with him (there are not that many, most are very small firms and the STS locations need to be approved by the prevailing governments)
2. The trader sells it to China and India, but incurs higher transportation costs
3. The trader defaults on the contract and either will never deal with Russia again (LNG spikes) or will face losses (bank defaults?)

Ultimately, no central bank will be willing to bail out a trader engaged in helping Russia selling their commodities or a bank that provides financing to such traders. This is what makes this current crisis so difficult, as a spike in commodity prices would lead to rates rising, equities selling off, financials turmoil, leaving no asset class to hide from the carnage. The smartest thing a central bank could do is what the Fed has done in 1920: Crash the economy by raising rates quickly and evaporating demand (although this doesn't solve the Russia commodity problem, it could impact the pricing).



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<sup>5</sup> <https://plus2.credit-suisse.com/shorturlpdf.html?v=53g1-Vvd1-V>

<sup>6</sup> <https://www.federalreserve.gov/publications/brainard-statement-20220509.htm>

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