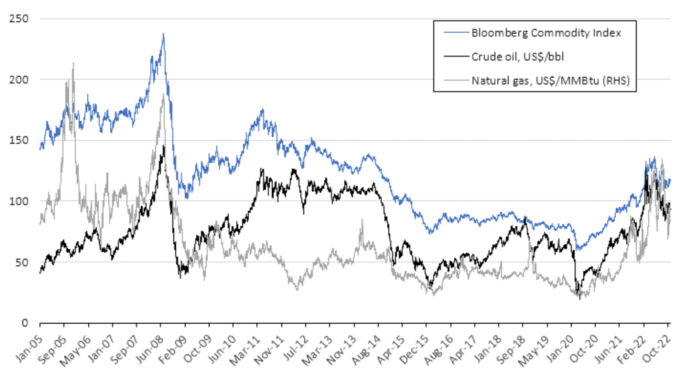
Index House View

A bit more visibility

Over the past two quarters inflation, rates and fundamentals have produced some visibility on where we should be going in 2023. In particular considering the reduced pressure coming from energy prices, we think a plateau in inflation could be in sight.

Energy has seen the beginning of a trend inversion since September this year. The jump in oil and natural gas is now about 40-50% retraced, as shown below.

Commodity prices, absolute values



Relative prices (base: January 1st, 2015)

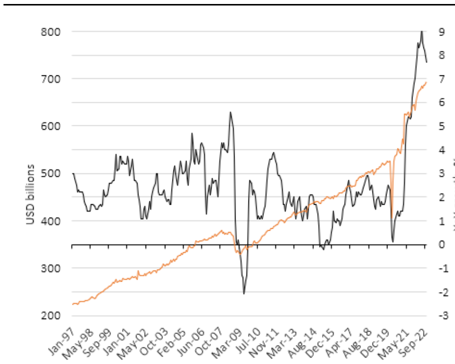
Source: Bloomberg, Index & Cie calculations

However, consumer and producer prices have not yet adjusted to this turn.

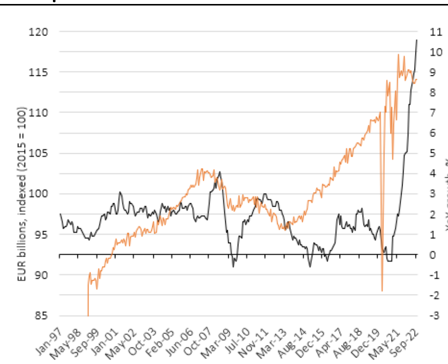
The consumption element of CPI does not seem to have been touched significantly so far in US, Europe and China. This means that rising interest rates in the Western world have not yet diminished the consumer spending attitude.

Orange lines below are retail sales, black ones CPIs.

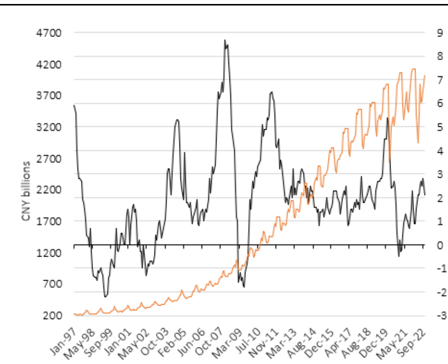
United States



Europe



China



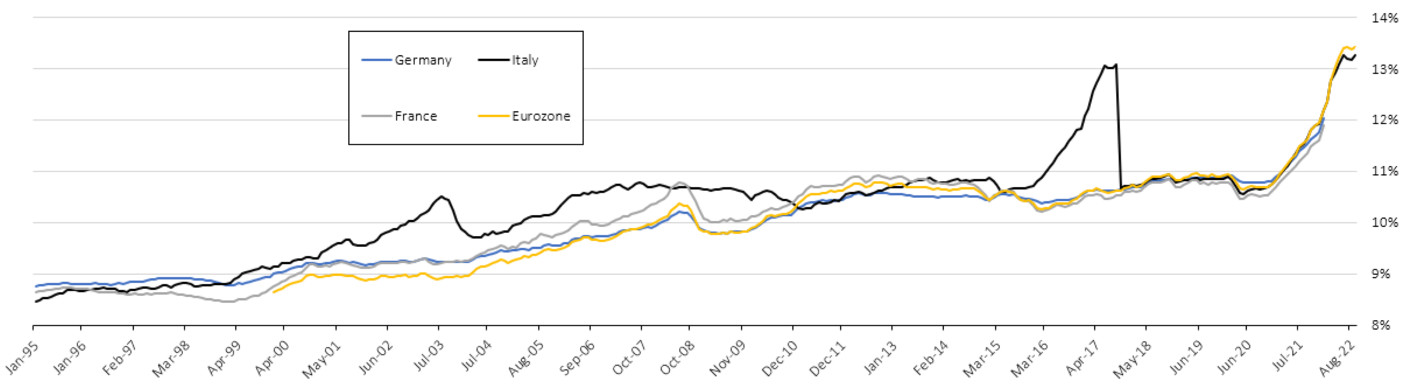
Source: Bloomberg

These readings are partially surprising in the China case because of the zero-COVID policy restrictions. These policies have already damaged the Chinese internal market and the country's trade balance.

At the same time, Chinese household savings could definitely benefit and create a cushion of demand that will come on line faster than usual – similarly to what happened at the end of lockdowns in Western countries.

From a producer price index (PPI) angle, things are not really cooling down. In Europe, the situation is still alarming and quite dependent on energy prices.

Manufacturing PPI, total market – 2015=100



Source: OECD data

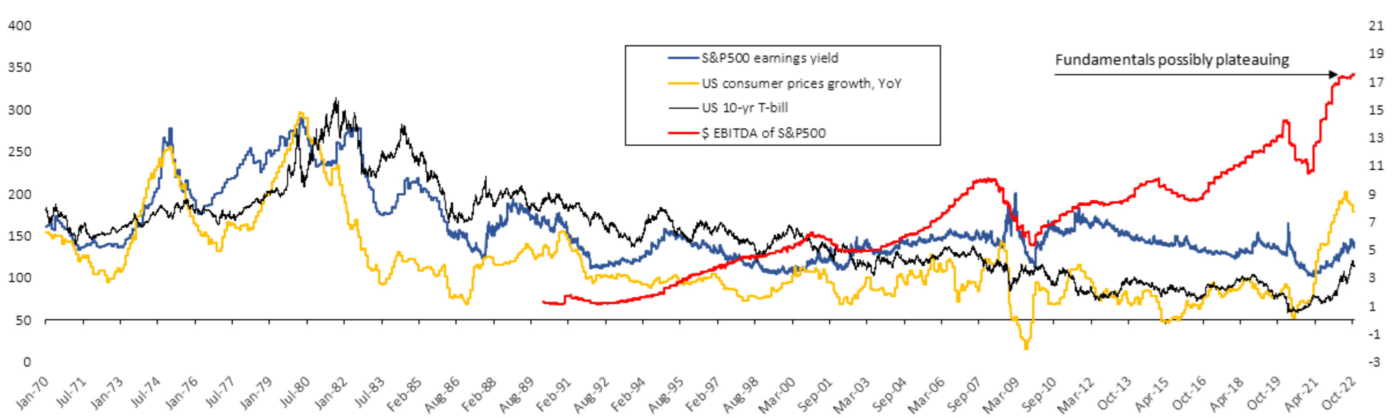
The picture that emerges is possibly one of inflation plateauing.

Although macroeconomic conditions remain heated, there is space for imaging that the worst has passed in inflation terms, and that authorities might be looking to slow down their rate hiking countermeasures – this is the case for the FED.

In the US case, once we put together the various elements here discussed, fundamentals have not really begun correcting just yet. This behaviour is in line with the previous instances of rising rates as a consequence of heating economic conditions.

We expect US fundamentals to correct in 2023, but that does not necessarily mean that capital markets will follow with another substantial leg downward. To illustrate this point, investors have already moved to safer heavens this year, leaving only 13 out of the 60 industries in the S&P500 in positive territory – 3 of which are energy-related.

Major fundamental, macroeconomic and market indicators in the US



Source: Bloomberg

Hope and Malice

A final note on crypto.

Like many in the investor community, we were taken aback by the sudden implosion of FTX. From the appointed liquidators, we learn the firm was managed by a group of young gamers without much care for the corporate checks and systems necessary to manage billion dollar flows. Furthermore, we learnt of the razor-thin cushion of reserves, made exclusively of crypto assets. The leveraged and speculative trading through Alameda Research and the loan collateralization via their native token constitute furthermore evidence of a confused management style, if one worthy of the name.

Our surprise is not on the fragility of the FTX edifice, but on the fact that millions of investors entrusted it. This many people considered a 30-year-old gamer as the supernatural messenger of the crypto world. Our interpretation of this bizarre reality is sociological in nature, and leads us to the overarching consideration that capital markets, including digital asset markets, are based exclusively on hope and malice.

In Greek mythology, and depending on whether we trust Aesop's or Hesiod's version, hope was the only gift (or evil) that was not released into the world when a man (or Πανδώρα (Greek for Pandora), the first mortal woman forged by Hephaestus, god of fire) opened the vase of godly gifts presented by Zeus. Initially, it appears that hope might have had an ambivalent meaning in ancient Greek and Roman times, i.e. both good and bad. Nowadays hope is mostly seen as a positive human feeling. There is ground to say that hope is a natural reflection of the instinct of survival written in our DNA code. Humans are intrinsically wired to hope, and sometimes fervently believe, that things will get better.

Like the ancient Greeks and Romans, our societies are endowed with a strong dose of hope. In the financial world, hope makes investors believe that (1) valuations will come back up after every major market downturn, and (2) life-changing fortunes will be attainable. Crypto investors have the same beliefs, multiplied by 10x, plus an additional hope: (3) that a huge user case will eventually render some crypto asset globally indispensable, otherwise known as the "creation of fundamentals". The root of investment-driven hope may be found in the "disenfranchising" of large sections of today's society in the Western world, as suggested by Stephen Diehl in today's Henry Mance Interview, among other courageous crypto-skeptics. The basis of this thought is simple and real: when one cannot find a stable source of income, one will be gradually pushed towards taking more risks to achieve the necessary revenues to sustain his/her own life. This principle is confirmed among traders experiencing increasing losses (see UBS' rogue trader Kweku Adoboli in 2011), as much as among common birds experiencing increasing starvation. As the situation gets more complicated, a human being tends to become more narrow focused and react instinctively, most often forgetting any discipline or method. With the aggravating factor of zero fundamentals, there is nothing but hope to appeal to, becoming ever more relevant in the investor's mind.

Similarly to hope, malice has human survival at its core. Malice means that one enriches himself by way of deception. Malice is most effective when hope is strongest, simply because fundamentals can be fabricated to fit any kind of narrative. We saw this trend countless times in traditional capital markets, even in very mature, sophisticated and liquid environments (see Wirecard as the latest case study). We see the same trend in the young crypto world today. It started with a mythical Japanese developer (rumored to be one of the current masters of bitcoin, enshrouded in thick mystery), then more coins began mushrooming all over, then stable coins appeared, then Initial Coin Offerings came about (none survived), then NFTs (with hundreds of celebrity sponsors, later found guilty of wire fraud), now the metaverse. The common theme here is zero fundamentals.

We and Index & Cie are not pessimistic about crypto or digital assets, but suspect that much work has to be done from a technical perspective to become useful for mainstream businesses. A hint of this feeling came from the Australian Stock Exchange this week, which abandoned plans to introduce a new blockchain-based system for settlement clearing, writing off A$245 million (US$165 million) in pre-tax costs related to the 7-year project. Is this a defeat? No, it is the necessary trial and error that any new technology needs to become useful.

One last consideration around decentralization. Much has been discussed regarding the need for a trustless network that ensures objective execution of whatever operation. The trustless feature can be achieved if participants have somewhat similar weights within a functioning ecosystem, thus eliminating the risk of manipulation (via malice). This is evidently not the case of bitcoin, and it has never been the case since its birth. The table below shows how 2% of today's wallets (addresses) hold 94% of outstanding BTC coins, which in turn equals almost 300bn in USD value. Might it be that Nakamoto-san and his gamer buddies hold the keys to the crypto empire? Whatever the answer, this environment is far from what it purports to be.

Extreme cryptowealth inequality – Top 100 richest bitcoin addresses

Balance, BTC	Addresses	% Addresses		BTC coins	% Coins		USD	
(0 - 0.00001)	3,182,042	7.26%		15.19	0.00%		$246,509	
(0.00001 - 0.0001)	8,192,837	18.71%		353.61	0.00%		$5,737,431	
(0.0001 - 0.001)	10,448,905	23.86%		4,025	0.02%		$65,305,857	
(0.001 - 0.01)	10,794,909	24.65%		40,964	0.21%		$664,636,994	
(0.01 - 0.1)	7,148,425	16.32%		236,186	1.23%		$3,832,145,187	
(0.1 - 1)	3,087,570	7.05%		959,484	4.99%		$15,567,720,845	
(1 - 10)	793,241	1.81%		1,987,403	10.35%		$32,245,801,079	
(10 - 100)	136,344	0.31%		4,368,622	22.74%		$70,881,285,831	
(100 - 1,000)	13,698	0.03%		3,859,394	20.09%		$62,619,011,699	
(1,000 - 10,000)	1,976	0.00%		4,623,908	24.07%		$75,023,324,977	
(10,000 - 100,000)	116	0.00%		2,440,403	12.70%		$39,595,758,911	
(100,000 - 1,000,000)	4	0.00%	2.16%	689,623	3.59%	93.54%	$11,189,200,309	$291,554,382,806
Totals	43,800,067	100%		19,210,381	100%		$311,690,175,629	

Source: https://bitinfocharts.com/top-100-richest-bitcoin-addresses.html

Conclusion

We expect 2022 to finish on a positive note in the overall macro narrative, mainly as energy price pressures ease.

Inflation should continue coming down towards the end of the year, but will not reach a normal level just yet.

Our investment focus remains on bonds in major currencies as the present levels of remuneration will go away soon.

Equities are full of value in the right places, but cautious sentiment will continue to cloud it as we usher into 2023.

Crypto technologies will continue evolving until a real user case emerges, and until that day crypto markets will continue to suffer from an overwhelming dominance of hope and malice over fundamentals.

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