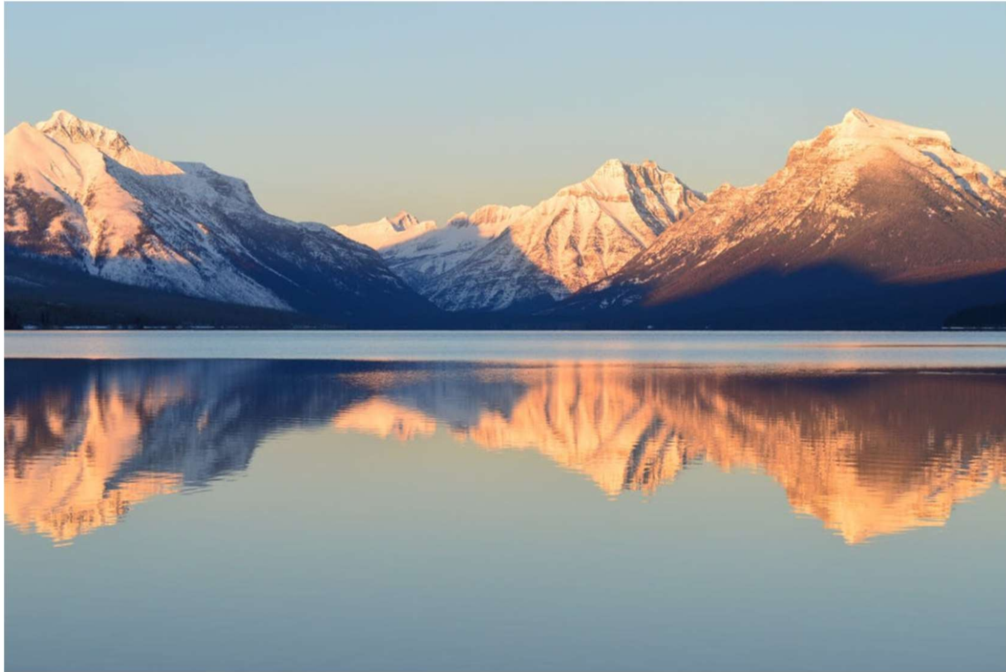
朱雀基金
Rosefinch Fund
T [021]2030 5888 F [021]2030 5999
A 58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
上海市浦东新区海阳西路 555 号/东育路 588 号前滩中心第 58 层，邮编：200126

Rosefinch Weekly

The Three Major Challenges Facing the Market



There are three major challenges facing the market today: Ukraine conflict, commodity volatility, and FED tightening cycle.

On the Ukraine conflict, there was another round of negotiations by Russia and Ukraine in Turkey last week. There is a lack of significant breakthrough with little prospect of immediate agreements. Two key issues remain: international security guarantee for Ukraine and territorial status of Donbas region. Despite the temporary ease of tension, there has not been a fundamental shift in the Ukraine situation.

On the commodity side, Brent oil traded from $116 down to $105 last week. The Russian withdraw from Kiev area had a marginal positive impact, while the US daily sale of 1 million barrels from its strategic oil reserve had bigger impact. EU Natural gas did have a brief rally last Wed on worries of Russian supply interruptions, but reverted to levels that now less than half of its peak in March. Even though the oil and gas prices have come off the highs last week, there is a systematic increase in energy cost as supply security becomes a major concern. Furthermore, there was relative low capital investment in the energy extraction infrastructure, which may see energy cost elevated in the foreseeable future.

The Ukraine conflict is a vivid reminder to European nations that over-reliance on traditional energy import channels threatens their energy supply security and inflation management. For the coming year, the European nations will stock up energy supplies and proactively manage their energy situation ahead of next winter season.

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For the longer term, the Ukraine conflict has accelerated the transformation of global energy framework. Europe and US will likely increase their new energy infrastructure build out in order to reduce their dependency to fossil fuel imports. Photovoltaic, wind, and nuclear power generation capacities will increase as these countries increase their national energy security. **New energy has become more than an economic issue, but a national security issue.**

FED has official started hiking to chase the curve and tackle inflation with a backdrop of relatively healthy employment and financial situations. US rates continue to rally with 2y at 2.47%, 5y at 2.56%, 10y at 2.39% and 30y at 2.44% as of last Friday. Both 2y-10y and 5y-30y showed inversion, causing market concerns about recession. Since 1990, there had been 4 recessions in 1989, 2000, 2006, 2019, all of which had US yield curve inversions. Historically, the UST 2y-10y inversion leads recession by about 17 months. While there's always inversion before recession, inversion doesn't necessarily lead to recession every time. The financial market usually price in bearish sentiments on future expectations, but it doesn't always play out as market expects. Looking at the current situation, US may indeed move into recession territory as inflation hits demand, real incomes decrease, and consumer confidence falls. **These leading indicators may increase probability of future US recession, but need to be confirmed by more economic indicators.** Looking ahead, we need to monitor closely US economic indicators to see if recession will turn from expectation to reality. For US stocks, given the usual gap between curve inversion and actual onset of recession, the pivotal point to the downside isn't here yet.

US yield curve inversion has limited impact to China since most of China's domestic assets are priced according to Chinese fundamentals. We did see drop in China's March manufacturing PMI from 50.2 to 49.5 and non-manufacturing PMI from 51.6 to 48.3 due to the pandemic impacts. At the same time, the construction PMI rose slightly from Fed's 57.6 to 58.1, showing infrastructural investments are having impacts. Recently we saw faster implementations of the "steady growth" policies, with emphasis on overall size and structural coordination. Last week Northbound Stock-Connect saw net purchase of 22.9 billion RMB, reversing the previous three weekly outflows. Domestically, under the "dynamic zero" pandemic policy, Shenzhen has largely reverted to normal, Jilin province and Shanghai are also being actively managed. **We'd expect Chinese equity market to respond positively as the pandemic situation stabilizes.**

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