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Weekly Market Flash

Fed, earnings and geopolitics test markets

January 23, 2022

Equity markets continued to suffer this week, with US and technology under pressure. The S&P 500 index lost 5.7%, and is now -8% off its highs, while the Nasdaq lost 7.5%, and is now -14% off its highs on 19 November, 2021. Europe has held up much better, perhaps helped by the European Central Bank's (ECB) more wait-and-see attitude, with a loss of just 1% on the week – and only 4% off its highs. During the week, markets were driven largely by the Federal Reserve (Fed) and earnings expectations, and fears were compounded by rising geopolitical tensions as Russia was threatening to invade Ukraine.

Highlights

- The market is pricing in more than one Fed hike next March (one hike plus a less than 10% probability that it will be 50 bps and not 25 bps), and a total of four full hikes for the year.

- A slight element of support for markets finally came from the PBOC, which, confirming economists' expectations, finally cut rates a second time. The first PBOC press conference of 2022 has confirmed a clear shift in policy focus from deleveraging to growth, more monetary easing ahead and the deployment of a broad range of instruments.

- Our expectation of earnings providing little relief to markets materialized. Guidance weighed more on valuations, especially in the case of Netflix. Next week is critical from an earnings standpoint as Microsoft, Tesla, Apple, Mastercard and Visa hit the tape.

- On Thursday, the Fed finally released the long-waited white paper on central bank digital currencies in the US.

Markets & Macro | Fed, earnings and geopolitics test markets

"...the US 10-year bond marked a 2-year high at 1.88%, and real rates marked their highest since March 2021, now around -0.6%."

Is a March rate hike on the cards?

When it comes to Fed policy and interest rates – the risk factors that worry investors the most – the US curve continued its inexorable march of repricing the Fed, perhaps with some delay compared to the conditions that were already in sight in the autumn (possibly, the delayed effect is due to the interruption driven by the Omicron variant and the possibility of new lockdowns that did not materialize).

At this point, the market is pricing in more than one hike next March (one hike plus a less than 10% probability that it will be 50 bps and not 25 bps), and a total of four full hikes for the year, while the US 10-year bond marked a 2-year high at 1.88%, and real rates marked their highest since March 2021, now around -0.6%.

Our view: In addition to the above, it should also be noted that the average tone of the economic data published in recent weeks has not been exciting. While there was nothing serious to note – with the exception of retail sales in December, which was down a good three percentage points month-on-month (but Omicron was certainly responsible for the debacle) – the feeling is that the economic cycle has entered a phase of moderation (we will get confirmation from global PMIs next week), just when the Fed decided to fight rampant inflation and put growth on the back burner (employment looks solid without the need for financial support).

The strength of the labor market, at a micro level, is also starting to be seen in corporate earnings, with banks reporting this week that they are facing a major increase in wages. It is likely that the FOMC will tolerate a slightly less bright economy if it has to bring inflation back up to the mandate level (the concept of FAIT, flexible average inflation targeting, seems to have been forgotten!). While we could call the Fed's increased prudence virtuous, it must be acknowledged that it is not a good environment for margins and profits, which are expected to grow by 8-10% in 2022, after growing 40% in 2021.

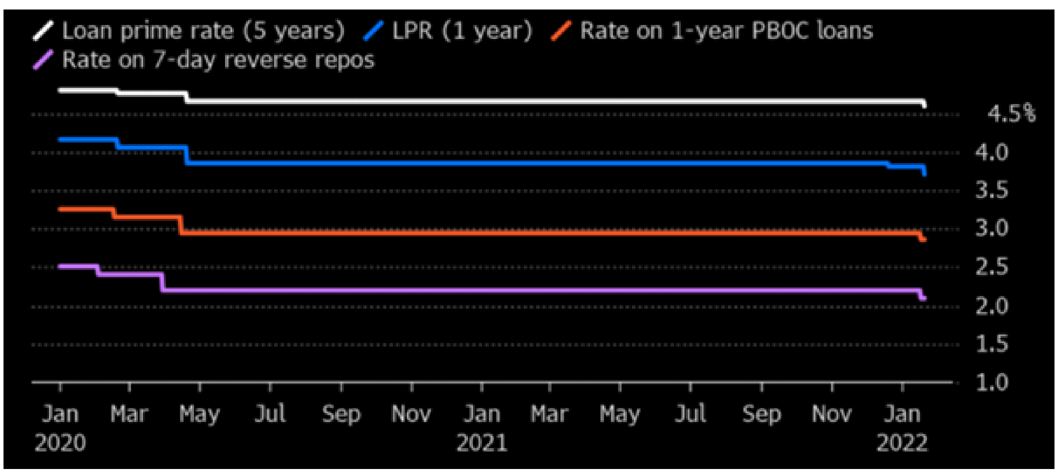
"It is likely that the FOMC will tolerate a slightly less bright economy if it has to bring inflation back up to the mandate level..."

If markets had initially hoped to see some light on the Ukraine crisis with the announcement of the meeting between Blinken and Lavrov in Geneva on Friday, the return of realism and some uncertain and worrying statements by Biden (including "Putin will likely move in on Ukraine"), have contributed to worsening sentiment. Unfortunately, in the best case scenario we can hope that the talks will drag on for months without achieving any real progress, since the positions are so far apart. But it is not far-fetched to think that Putin is trying to exploit internal European divisions and US hesitation for a show of strength, not a real invasion – but perhaps some incursions aimed at destabilizing Ukraine and taking some more territory. On the Western front, however, the only concrete action was mentioned in a WSJ piece, which reported that the US had given Estonia, Lithuania and Latvia the green light to send arms to Ukraine.

A slight element of support for markets finally came from the People's Bank of China (PBOC), which, confirming economists' expectations, finally cut rates a second time. This time it was the Loan Prime Rates (LPRs): the one-year LPR was cut by 10 bps to 3.7% and the five-year LPR was cut by 5 bps to 4.60%. The one-year LPRs mainly affect corporate and household lending rates, while the five-year LPRs affect mortgages.

While the cuts are decidedly modest, the direction is important, given that the Chinese economy had already shown ample signs of slowing down in the second half of 2021, and that the central bank had not touched rates since April 2020, despite the crisis in the property sector and the various bankruptcies of developers. To reinforce the message, the PBOC urged China's banks and large lenders to increase lending to businesses and households.

Figure 1: China's Loan Prime Rates



Source: Bloomberg, as at January 21, 2022.

"...the collapses of Peloton and Netflix may perhaps represent a definitive return to normality and the reopening of the society after two years of pandemic..."

Peloton and Netflix collapses suggest return to normality.

With regard to the ongoing dynamics in the technology sector and, in particular, the more speculative names that exploded higher in the wake of Covid and the monetary response to the shock, we have already expressed our view that the selloff in these names has been ongoing for many weeks, and that it is a healthy development for financial markets seen from a broader lens. This week two more striking cases have reinforced this view, adding that the collapses of Peloton and Netflix may perhaps represent a definitive return to normality and the reopening of the society after two years of pandemic (clearly excluding the discovery of new, more dangerous variants).

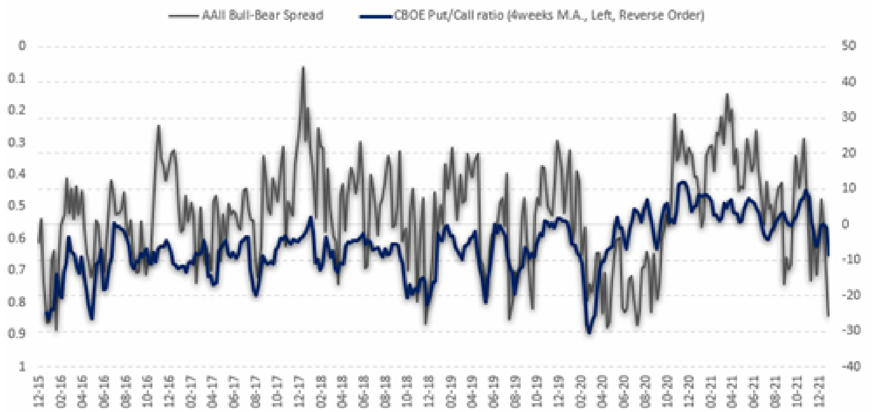
As for Peloton, shares fell a further 13% and are now down 85% from their highs, after the company reported that it is halting production of its bicycles and treadmills for two months after noting a "significant reduction" in demand. Netflix, another symbol of the stay-at-home trade, also suffered heavily after the release of its results. Shares lost 24% this week and are down 42% from their highs in

November, both for the numbers presented and the lowered prospects for subscriber growth in the coming quarters.

"…the stock market, and tech in particular, is decidedly oversold with sentiment extremely negative."

Our view: At this point, as our chart of the week shows, the stock market, and tech in particular, is decidedly oversold with sentiment extremely negative. As an example of how depressed sentiment is, below is the AAII survey chart with the Bull-Bear spread at its lowest since March 2020 (during the full Covid-shock), and the CBOE Put/Call ratio almost as extreme. The coming week will report the main Big Tech, and in these conditions the bar for a rebound is decidedly low.

Figure 2: Sentiment Remains Depressed



Source: Bloomberg, as at January 21, 2022.

Regarding our asset allocation, with some luck, at the 1.85% level, we decided to close our tactical short bet on the US 10-year. We took into account some factors, which, if corrected, could also affect the equity market, and in particular the tech sector. The terminal rate (Fed Funds priced for end 2024) has risen by 30 bps to 2.12% today. In order to see a meaningful rise of US Treasury yields (10-year and beyond), one will likely need one of the following conditions:

- A meaningful reset of the terminal rate (around 50-100 bps). But if this would happen, the curve would likely flatten, so it is difficult to foresee a further significant rise in 10-year yields. Equity markets would also selloff more in this scenario, which will likely reignite a demand for safe assets (US Treasuries), as we've seen in the last few days of trading.
- The Fed completely abandons its inflation mandate, letting the economy running super-hot (but we're seeing the opposite at the moment).

"…what began as a sell-off in non-profitable tech stocks extended to other parts of the market, turning into a full on risk-off meltdown (as evidenced by the drop in 10-year yield)."

Equities | Equities price in higher rates

Excesses remain across the market.

The S&P 500 index had its biggest weekly drop in more than a year while the Nasdaq Composite, which lost around 8%, saw its biggest decline since the beginning of the pandemic.

In this holiday-shortened week, what began as a sell-off in non-profitable tech stocks extended to other parts of the market, turning into a full on risk-off meltdown (as evidenced by the drop in 10-year yield). Long-duration assets were exceptionally vulnerable as the Fed's tightening plans weighed heavily on the lofty valuation levels that have been propped by the low interest rate environment.

"The magnitude of the sell-off cannot be underestimated, although it is entirely understandable in light of the excesses we've talked about..."

Figure 3: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,265.37	-4.55%	-5.63%	-5.63%
SPX Index	S&P 500	4,397.94	-5.67%	-7.66%	-7.66%
CCMP Index	Nasdaq	13,768.92	-7.55%	-11.98%	-11.98%
SX5E Index	Euro Stoxx 50	4,229.56	-1.00%	-1.51%	-1.51%
SMI Index	Swiss Market	12,355.54	-1.36%	-4.04%	-4.04%
UKX Index	FTSE 100	7,494.13	-0.64%	1.53%	1.53%
CAC Index	CAC 40	7,068.59	-1.04%	-1.07%	-1.07%
DAX Index	DAX	15,603.88	-1.76%	-1.77%	-1.77%
FTSEMIB Index	FTSE MIB	27,061.40	-1.75%	-1.04%	-1.04%
NKY Index	Nikkei 225	27,522.26	-2.14%	-4.41%	-4.41%
HSI Index	Hang Seng	24,965.55	2.39%	5.57%	6.70%
SHSZ300 Index	CSI 300	4,779.31	1.11%	-4.17%	-3.26%

Source: Bloomberg, as at January 21, 2022. Performance figures in indices' local currencies.

Our view: As mentioned in last week's Market Flash, our expectation of earnings providing little relief to markets materialized. Guidance weighed more on valuations, especially in the case of Netflix. Next week is critical from an earnings standpoint as Microsoft, Tesla, Apple, Mastercard and Visa hit the tape.

The magnitude of the sell-off cannot be underestimated, although it is entirely understandable in light of the excesses we've talked about in past issues of this publication, including meme stocks, non-profitable tech stocks, SPACs, etc. Clients familiar with our market update presentations will recall our "famous" chart contrasting the S&P 500 index levels to the money supply, which argued for normalization. In many ways, China continues to represent the playbook for what's happening in the US ever since the pandemic began.

While there is no telling of when these stimulus excesses normalize, we point out that false rallies are likely to occur (false as long as they are not supported by a monetary policy pivot or positive earnings surprises) and that what is happening in credit markets probably matters more than what we are seeing in equity markets. On the positive side, investment grade corporate bond spreads, which widened initially, were then supported technically with heightened demand on the back of a move in rates. Also, despite high yield bonds trading lower, there is a sense that the asset class remained orderly.

Market data compiled by Deutsche Bank suggests that positioning is only in line with the historical average, dropping from the extreme levels at the end of last year. Valuations dip below the elevated levels of last year and are currently below the 2 standard deviation mark (S&P 500 forward P/E at 19.5x compared with a historical average of 15.7x).

"...false rallies are likely to occur, and what is happening in credit markets probably matters more than what we are seeing in equity markets."

Chart of the week

The Nasdaq composite index's relative strength index has fallen into oversold territory for the first time since the pandemic began in March 2020, after it broke the support at level 14200 on Friday. That support previously acted as resistance when the index was rallying and a support where past selloffs stalled.

Figure 4: Nasdaq Composite Index

Source: Bloomberg, as at January 21, 2022.

Crypto & Blockchain | Fed releases paper on digital currencies

Sentiment weakens across the market.

“Most of the sharp corrections have occurred during the Asia market opening, while during the US opening, declines were very smooth…”

We spoke with a number of asset managers this month, and many of them are increasing cash during this volatile period to deploy later in the year. The mantra is to invest in infrastructure and solutions for the scalability of the protocols. Elsewhere, unsurprisingly, Andreessen Horowitz's venture capital firm is at it again, announcing this week that it is looking to raise an additional USD4.5 billion in capital for a new cryptocurrency fund. This combined amount is more than double the size of its last USD2.2 billion cryptocurrency fund, which launched in June 2021.

On Thursday, the Fed released the long-waited white paper on central bank digital currencies in the US. Despite their assessment that the introduction of a CBDC would represent a highly significant innovation in US money, the Fed does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law.

Market action: All major digital assets traded in negative territory after a sharp decline from Thursday to Friday. About USD750 million in long crypto derivative positions were liquidated between Thursday and Friday. Bitcoin led the liquidation with USD250 million, followed by ether with USD163 million, and SOL with USD10.9 million.

Market sentiment is pessimistic and investors are in a wait-and-see mood. Most of the sharp corrections have occurred during the Asia market opening, while during the US opening, declines were very smooth but there has not been a significant rebound after some key price supports were broken. However, the RSI is in oversold territory. The long-term bullish trend on the monthly timeframe, with higher lows and higher highs, remains the case until BTC finishes the month above about USD35,000.

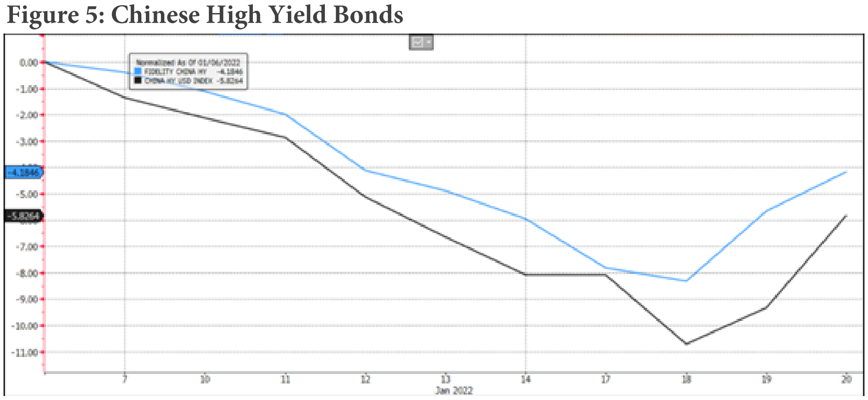
Fixed Income | A choppy start for Chinese property

PBOC is armed with the right tools.

“…the Chinese high yield index is already pricing in the worst case for Chinese high yield property sector.”

When we proposed our investment idea on Chinese high yield, we always knew that: 1) timing is an imperfect science; 2) it would not have been a walk in the park because of the wall of refinancing in USD facing the property developers in Q1 2022. Although our selected funds have lost 5% (which is less than the index), recent announcements by the government are starting to confirm our thesis that the property market would not be allowed to disintegrate.

Figure 5: Chinese High Yield Bonds



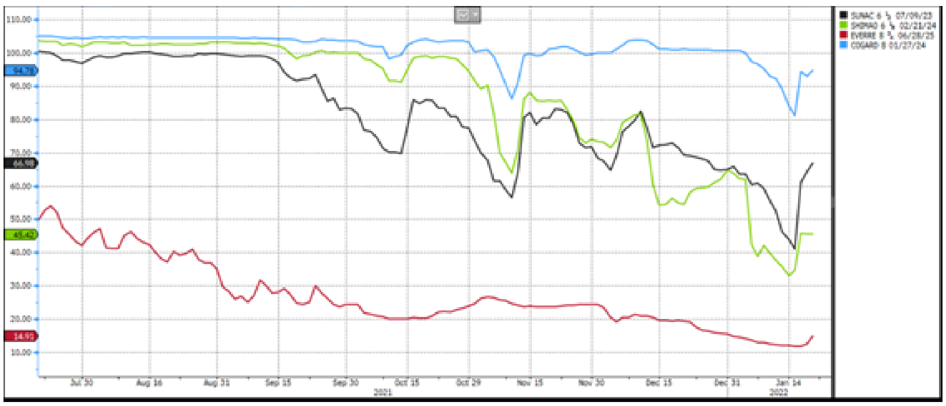
Source: Bloomberg, as at January 21, 2022.

Our view: Since valuation doesn’t help with timing, it can give an indication of the scale of the downside. In an interesting study from Morgan Stanley (“China HY/China HY property credit: stress testing our base case”, 16th January 2022), where a bear case based on the assumption that all Chinese high yield property bonds in the index trade down to 50-60 cents or lower and only Chinese high yield bonds that trade above 50 cents or 60 cents pay their coupons, the downside for the Chinese high yield index ends up in the range of 0.4% to 5%. Hence, the Chinese high yield index is already pricing in the worst case for Chinese high yield property sector.

"This move will allow developers to access more of the cash held at their local project subsidiaries for debt repayments."

At a macro level, it's essential that the PBoC has started monetary easing, as mentioned in our comment. Further, Chinese regulators are reported to be drafting nationwide rules to ease escrow account controls at the end of the month, making it easier for property developers to access pre-sale funds held in escrow accounts. To ensure housing construction completion, unit delivery, and wealth management product repayment, over 70% (lower-tier cities) or 80% (top-tier cities) of the presale is required to be preserved in a bank account during construction. Only when construction projects are 70-80% completed, property developers can obtain a pre-sales permit. This move will allow developers to access more of the cash held at their local project subsidiaries for debt repayments. Figure 6 shows the positive impact of such measures on the bond prices on some selected USD Chinese property developers' bonds.

Figure 6: Chinese Property Developers' USD Bonds



Source: Bloomberg, as at January 21, 2022.

"We knew that Chinese property is a rickety structure: overbuilt, overleveraged, and based on moral hazard."

In a nutshell, the first PBOC press conference of 2022 has confirmed a clear shift in policy focus from deleveraging to growth, more monetary easing ahead and the deployment of a broad range of instruments. That being said, before getting carried away, the industry needs time to mount a recovery and idiosyncratic episodes are still very likely. The central government has initiated easing measures in December 2021. Typically, it takes six to nine months for the transmission and execution at local governments, banks, and financial institutions to happen and the physical market to eventually recover.

In conclusion, this is a choppy start. We knew that Chinese property is a rickety structure: overbuilt, overleveraged, and based on moral hazard. Addressing moral hazard comes with major costs to growth. The PBOC may not come away with the fundamental problem, but they have granular and refined tools to deploy (set different mortgages rates for first, second, third buyers, set mortgages down payment city by city or by first or second buyers, open liquidity taps to real estate developers based on their categories and location).

Finally in 2022, the Chinese Communist Party (CCP) will hold its 20th National Party Congress, where Xi Jinping needs to secure his third term. China, in the run up to the big political event, has zero tolerance for bad news and will not allow the important property sector (35% of GDP) to trigger a collapse in the domestic economy.

Week Ahead | Key events to watch for

- **The coming week will be important above all for corporate results**, with the most important Big Tech companies expected to report (Apple, Tesla, Microsoft).
- **January's flash PMIs** will tell us a lot about supply conditions, although possible disappointments could be mitigated by the Omicron justification, which is now considered transitory if not purifying.
- **Politics in Italy,** with the election of the President of the Republic, has never been so important for markets since Draghi's promotion to President could turn into a negative event, if his departure from the government leads to early elections.

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