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Weekly Market Flash

Will history repeat itself linearly?

November 28, 2021

This week saw an abrupt change of sentiment between Thursday and Friday, with dizzying falls across global stock exchanges, and an extended risk off sentiment across all cyclical raw materials. The discovery of the new South African Covid variant Omicron, which is even more transmissible than the Delta variant, threw investors into panic on Friday – in a day which was reminiscent of when Covid peeped out in Italy and then spread throughout Europe and the rest of the Western world. This time there are two fears: as Figure 1 shows, the spread of this variant is exponential compared to what happened with other variants; second, it is not clear if this variant is able to "pierce" the vaccine. This is the real element of panic, which would throw away our certainties about the safety of medicine that we have rightly applauded since the announcement of the Pfizer vaccine one year ago.

Highlights

▪ The volatility on the S&P 500 index exploded by 50% from 19 to 29 in a few trading hours (the US was open half a day due to Thanksgiving).

▪ The market eliminated one of the three rate increases expected from the Fed in 2022. The entire US Treasuries curve fell by around 10 bps, and the US dollar weakened despite strong risk aversion.

▪ President Biden renominated Powell as Fed chair. Lael Brainard, who was viewed as more dovish than Powell, was nominated to be the vice chair.

▪ Bitcoin continues to behave more like a risk asset than an inflation hedge. When Biden renominated Powell, gold went down while Bitcoin rose. And amid the news about the new variant, gold rose while Bitcoin fell.

▪ India announced that it will introduce a ban on almost all private cryptocurrencies, while in the US, financial regulators FDIC and OCC on Tuesday released an inter-agency policy agenda for regulating cryptocurrencies: the so-called “crypto sprint”.

“The key to understanding the dangerousness of this new variant and the market trend in the coming weeks lies in the hope that the rapid trend in South Africa was allowed by the very low rate of vaccination in the country...”

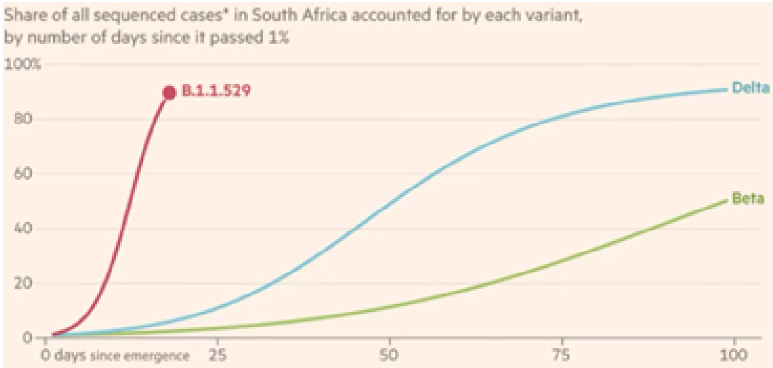
Markets & Macro | Will history repeat itself linearly?

New variant, more volatility, and the year-end rally.

It is useless to report on the spread of the new variant across the rest of the world, with the first cases already reported on Friday – and already rapidly increasing all over the world on Saturday.

> "…there is the fact that the new variant has many mutations on the protein spike, which could make current vaccines ineffective."

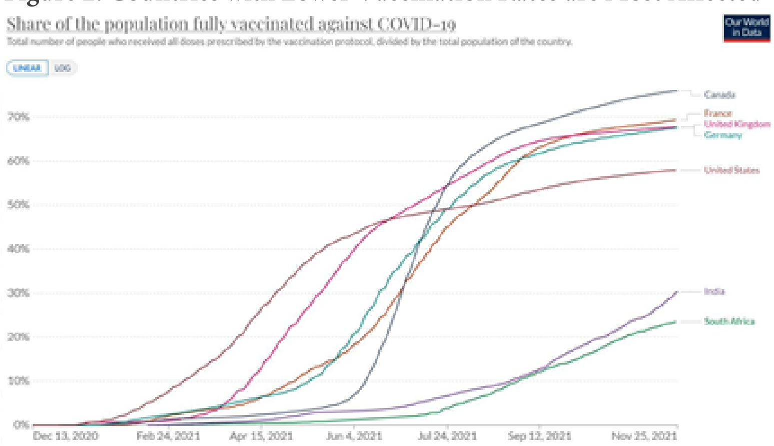
Figure 1: Spike in Omicron Cases



Source: FT, as at November 26, 2021.

The key to understanding the dangerousness of this new variant and the market trend in the coming weeks lies in the hope that the rapid trend in South Africa was allowed by the very low rate of vaccination in the country (Figure 2), and that this variant does not have worse effects than the other variants on vaccinated subjects.

Figure 2: Countries with Lower Vaccination Rates are Most Affected



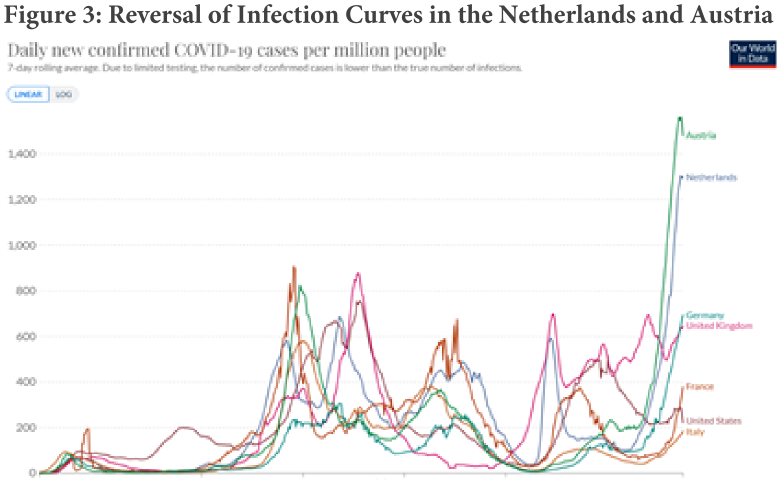
Source: Our World in Data, as at November 26, 2021.

> "…it's interesting to note that after just a few days of restrictive measures in the Netherlands and Austria, we were seeing a clear reversal of the infection curves."

Unfortunately, of what little we know about this variant, there is the fact that it has many mutations on the protein spike, which could make current vaccines ineffective. BioNTech has announced that it is expecting the first data from lab tests on how it interacts with its vaccine in two weeks at the earliest.

Elsewhere, it's interesting to note that after just a few days of restrictive measures in the Netherlands and Austria, we were seeing a clear reversal of the infection curves.

Figure 3: Reversal of Infection Curves in the Netherlands and Austria



Source: Our World in Data, as at November 26, 2021.

Our view: As naive as it would be to think that history repeats itself linearly, the market has matured a typical pattern for new variants in the past, having gone through the Beta, Delta and Gamma variants relatively unscathed. If we follow the same path this time, the initial panic reaction might even return more quickly than would be natural to think after a panic day like what we saw on Friday. To give another measure of the level of tension reached, the volatility on the S&P 500 index (the VIX index) exploded by 50% from 19 to 29 in a few trading hours (the US was open half a day due to Thanksgiving).

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An interesting aspect at the macro level will be to understand what consequences this variant will have on monetary policy expectations – in particular on the Federal Reserve (Fed) and Bank of England, who had recently announced a significant change of course in a restrictive key, which was already starting to damage the "cyclical trade". The first consequences were immediately seen on Friday afternoon, with the market eliminating one of the three rate increases expected from the Fed in 2022. The entire US Treasuries curve fell by around 10 basis points (bps), and the US dollar weakened despite strong risk aversion.

Another aspect seen yesterday, which is far from surprising, was the clear outperformance of US markets compared to European ones: investors believe that in the event of danger caused by the variant, the policy response would be significantly different in the two continents, with a greater propensity in Europe for lockdowns. Further, US indices are less exposed to cyclical/manufacturing sectors and banks, and much more to tech, social networks, gaming and video streaming. That said, the impact of the news was certainly accentuated by the fact that it came at a particular time of year and also on a particular day. If the scarce liquidity caused by the Thanksgiving break amplified Friday's movements, the extreme positioning on equity and a decidedly serene sentiment that by now looked confidently at how to ride the year-end rally make the coming weeks insidious.

Equities | Between hope and fear

Erratic weeks ahead for markets.

Friday's news about the emergence of a new Covid variant triggered a sharp sell-off in global equities. Prior to that, long-dated assets, particularly technology stocks, were under pressure from rising US Treasury yields. Value stocks that had fared better than growth stocks until Friday took the brunt of the market correction, especially energy and financials. Naturally, travel and leisure were the most impacted sector group on Friday. Reduced liquidity due to the Thanksgiving holiday most probablylikely exacerbated the Black Friday sell-off.

"Lael Brainard, who was viewed as more dovish than Powell, was nominated to be the vice chair."

Figure 4: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,899.34	-3.22%	-2.39%	15.93%
SPX Index	S&P 500	4,594.62	-1.83%	-0.11%	23.89%
CCMP Index	Nasdaq	15,491.66	-2.29%	0.04%	20.94%
SX5E Index	Euro Stoxx 50	4,089.58	-6.36%	-3.70%	18.02%
SMI Index	Swiss Market	12,199.21	-2.53%	0.75%	17.23%
UKX Index	FTSE 100	7,044.03	-4.00%	-2.38%	12.78%
CAC Index	CAC 40	6,739.73	-4.92%	-1.28%	24.14%
DAX Index	DAX	15,257.04	-5.20%	-2.75%	11.21%
FTSEMIB Index	FTSE MIB	25,852.99	-6.25%	-3.27%	19.88%
NKY Index	Nikkei 225	28,751.62	-2.90%	-0.49%	6.36%
HSI Index	Hang Seng	24,080.52	-4.88%	-6.12%	-9.27%
SHSZ300 Index	CSI 300	4,860.13	-0.57%	-1.68%	-5.08%

Source: Bloomberg, as at November 26, 2021. Performance figures in indices' local currencies.

The Omicron news overshadowed the news of President Joe Biden renominating Jerome Powell as Fed chair. Lael Brainard, who was viewed as more dovish than Powell, was nominated to be the vice chair. While the market welcomed the stability that Powell's renomination brought, an expectation of a less dovish Fed began to be priced by fixed income markets. Healthy economic data such as the lowest reading of weekly jobless claims since 1969 helped push Treasury yields higher. Earlier on in the week, the oil market took the news of the US releasing oil from the strategic reserve in stride, given it was widely anticipated and less than what market observers had feared.

"Long-term themes like the metaverse and decentralization were being priced in a matter of days rather than months or years. This type of hubris tends to leave us a bit uncomfortable."

Our view: Early last week, as we contemplated the subject of this week's Market Flash equity section, we thought it was an ideal time to take stock of the potential risks that faced the market going in 2022. But Omicron didn't wait! Although we would have most likely focused on the risks of rising energy prices, geopolitics and inflation, the reasons behind our intention to write about market risks stemmed from our sense that the market has lately been behaving in a manner of complete confidence and perfect visibility. Long-term themes like the metaverse and decentralization (which we are constructive on) were being priced in a matter of days rather than months or years. This type of hubris tends to leave us a bit uncomfortable. And while we probably wouldn't have advocated for outright risk reduction, a little cry for vigilance would have come a long way.

We find taking stock of where markets stand still a helpful exercise despite the Black Friday sell-off. First, almost all major equity indexes enjoyed phenomenal returns this year. Equity fund managers are sitting on fat returns that they would have looked to defend going into the last month of the year. Positioning levels are also at the high end of their historical average, whether discretionary or systematic. Valuations are close to or above two standard deviations from the historical mean, and the equity risk premium is below the post-Global Financial Crisis average. Counterbalancing factors include the continued strength of the consumer, neutral market sentiment levels, healthy fund flows and non-extended credit spreads. Any change in these two factors, especially consumer sentiment, would probably tilt the market toward the bearish camp.

We believe that drawing conclusions regarding the impact of the Omicron variant is still too early; the scientific community expects us to have answers regarding vaccine response and infectiousness within two to three weeks. In the meantime, with positioning, valuations, and year-to-date performance at extremes, we expect markets to be volatile and erratic. The playbook of last year will serve as a guide for market participants, who will expect the fiscal and monetary machines to do what they do best in order to soften the blow. On the cautious side, the industries that exhibited high degrees of fragility in 2020 will be scrutinized, especially given the astronomic rise of balance sheet leverage. In this tug of war period between hope and fear, we would be reluctant to alter our barbell approach until we have more information on the Omicron variant.

Chart of the week

"The playbook of last year will serve as a guide for market participants, who will expect the fiscal and monetary machines to do what they do best in order to soften the blow."

In a day with volumes thin due to Thanksgiving celebrations in the US, global equity indexes had a panic session amid concerns of the new Omicron variant. The SX5E futures, which traded full day, took out in a single session the 50, 100 and 200 day simple moving averages with no sign of a buy-the-dip rally coming to the rescue. The key supports area to monitor is the range from 4050 to 3895. If it breaks, the next stop is at 3575. On the upside, the index left the gap of the opening to close.

Figure 5: SX5E Futures

Source: Bloomberg, as at November 26, 2021.

Crypto & Blockchain | Governments take new actions on crypto

Crypto players should get more clarity on the road ahead.

"Metaverse tokens have continued to rally in the face of the digital asset correction."

This week we had further evidence that Bitcoin behaves more like a risk asset (very correlated to NASDAQ) than an inflation hedge. The two main episodes to analyze, in our view, are when Biden renominated Powell (and gold went down while Bitcoin rose), and the news about the new strain of the virus (and gold rose while Bitcoin fell).

Our view: Aside from these two big events, the focus was on regulation. After the SEC once again rejected a SPOT ETF, we saw some new steps into crypto from governments. India announced that it will introduce a ban on almost all private cryptocurrencies, while in the US, financial regulators FDIC and OCC on Tuesday released an inter-agency policy agenda for regulating cryptocurrencies: the so-called "crypto sprint". This should represent a to-do list for 2022 that will offer crypto players more clarity on the rules of the road.

Metaverse tokens have continued to rally in the face of the digital asset correction. Grayscale showed in a publication released last week that the revenue from virtual gaming worlds could grow to USD400 billion in 2025. We continue to monitor the developer activity where Solana and Avalanche contributors are fast growing among the layer-1 chain. Next week, the focus is on the Beacon Chain shipping, which is planned on December 1 at noon UTC. This is just one of the steps for the final upgrade for Ethereum from proof-of-work to proof-of-stake. Cardano and Tron have sunk as Etoro blocked US users to open new positions, citing that the unclear new regulatory landscape for crypto is evolving rapidly.

Week Ahead | Key events to watch for

- **A week full of important economic data in the US and Europe overlaps with the dramatic dynamics of the new variant**. As a result, the data may have less impact than its intrinsic relevance. If the Variant Framework were to deteriorate, the data could be read as "old news."

- **In any case, in the US we will see ISM manufacturing and ISM services** indicators, as well as November payrolls. In Europe, the flash CPI would be just as important for the monetary policy outlook.

- **Finally, Powell will testify before congressional committees,** and we will see if the new variant could give the Fed a pretext to calm down the expectations of accelerated tapering.

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