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Weekly Market Flash

The Fed paradox

February 13, 2022

Given geopolitical tensions, Federal Reserve (Fed) comments and US inflation, this week saw US markets close in the red, with losses of around 2%, while markets across the rest of the world ended up. On the geopolitical front, US national security advisor Sullivan's statements late Friday afternoon – "Russia could use a provocation to invade next week during the Winter Olympics" – sent equity indices plunging. On the inflation front, there was yet another nasty surprise with the release of the US CPI print for January, which saw headline come in at 7.5% year-over-year (YoY) against 7.2% expected. However, it is worth noting that the US market, which was likely thinking of peak inflation due to base effects (which will inexorably improve over the coming months and help inflation change direction), reacted extremely well to the data, with marginal losses and an unexpected recovery attempt on Thursday afternoon.

Highlights

▪ The current earnings season was surprisingly healthy, albeit the level of beats (sales and earnings) continue to trend below the levels of the past six quarters.

▪ US government bonds sold off across the curve. 2-year yields jumped the most in more than a decade, while 10-year yields rose above 2%. In this environment, credit markets weakened globally. Spreads pushed wider.

▪ Cryptocurrency adoption is growing worldwide: the CEO of Uber announced that it will accept bitcoin as payment in the future, while in the near future BlackRock will allow its clients to trade cryptocurrencies through Aladdin.

▪ Chinese developers' bonds and stocks rallied following reports on new regulations that would make it easier to tap cash from home presales, potentially easing a liquidity crunch.

"...the feeling now is that it is clear to everyone that the Fed (and behind it, all the other central banks in the developed world) acted extremely late in the face of the inflation explosion..."

Markets & Macro | The Fed paradox

Is the inertia undermining the Fed's credibility?

In addition, this week, St Louis Fed President Bullard was quick to cool spirits and the market suddenly changed course. Bullard made explicit reference to 50 basis points (bps) to start the tightening cycle as early as March (and the market did not hesitate to incorporate almost 100% probability of this event) and as much as 100 bps of increases by July. In addition to Fed Funds in the 1.00-1.25% area, Bullard would like to start actively reducing the Fed's balance sheet in the second half of the year, selling bonds before letting them mature (remember that according to many econometric models, 100 bps of BS reduction is equivalent to 8-20 bps of rate hikes).

According to Bullard, it may be necessary to hold an emergency meeting to raise rates before the next FOMC in March. As a result, markets are now pricing in between six and seven hikes by the end of the year, but even more incredibly, rates are discounting 5-6 bps of hikes before the next meeting, so believing the emergency hike hypothesis!

Our view: Our comment on these statements is twofold: on the one hand, the feeling now is that it is clear to everyone that the Fed (and behind it, all the other central banks in the developed world) acted extremely late in the face of the inflation explosion, with the rhetoric of "transitory". Once the error was

realized (without acknowledging it), the Fed, under constant pressure from politicians (we note that we are in an election year), is letting the interest rate market play the role of driving the tightening of financial conditions (which is accelerating, since in addition to interest rates, credit spreads have started to widen). In the meantime, there are also what we consider to be excessive Bullard-like remarks, which certainly do not help to maintain calm and contain volatility.

"...it is possible that the tightening we are witnessing could excessively suppress demand itself, through credit tightening and the wealth effect."

In our view, the problem is that there is no middle ground in monetary policy and market expectations. Since it is by no means certain that the inflation problem is caused by excess demand (on the contrary, we remain of the school of thought that it is linked to supply, and will therefore gradually fall in the coming months), it is possible that the tightening we are witnessing could excessively suppress demand itself, through credit tightening and the wealth effect. All of this is occurring in a context where sentiment is extremely low. In conclusion, one could argue that the current inertia is significantly undermining the credibility of the world's most important financial institution. The paradox is that while the Fed continues to allow the market to raise expectations and intervenes verbally, it is continuing, and will do so until March, to intervene in the market with weekly purchases of US Treasuries that increase the balance sheet. We were used to hearing a regime of criticism directed only at the European Central Bank, but now the same comments are being made about the Fed!

Adding geopolitical risk to the equation makes the risk/reward for risky assets even worse. Our caution in recent weeks has been underpinned by the fact that if an adverse event were to occur, unlike in recent decades, we would be unlikely to have the Fed ready to intervene to support markets. It would be very difficult, up to a certain point at least, to explain to politicians (and consequently voters) that the tightening path to deal with inflation should be interrupted (or even reversed) to support Wall Street!

Equities | An equilibrium between rates and earnings

Earnings season is surprisingly healthy.

"Value sectors energy and materials outperformed on the back of a surprisingly high CPI print..."

The tug-of-war between concerns over quantitative tightening and earnings strength ended the week in favor of the former. Rising geopolitical tensions in Ukraine tilted the odds in favor of the fear sentiment, with major US indexes ending the week lower, led by the interest rate sensitive technology stocks. Value sectors energy and materials outperformed on the back of a surprisingly high CPI print, which is in fact the highest inflation print in four decades.

Inflation concerns were reflected in the University of Michigan consumer sentiment February reading (Figure 1). The survey's chief economist, Richard Curtin, called the February result (the lowest level since 2011) "stunning", adding that "recent declines have been driven by weakening personal financial prospects, largely due to rising inflation, less confidence in the government's economic policies, and the least favorable long-term economic outlook in a decade." High yield bonds were also negatively impacted by the CPI print and Bullard's hawkish comments. The high yield ETF (HYG US) ended the week down 1.33%.

Figure 1: Michigan Consumer Confidence Index

Source: Bloomberg, as at February 11, 2022.

> "…it is important to not lose sight of the dynamics between quantitative tightening and earnings growth."

European equities rallied, driven by value stocks and strong earnings from blue chip companies like Siemens and Linde. Reopening trade proxies and autos also fared better on governments easing COVID-related measures. Japanese equities closed in positive territory despite concerns of monetary policy normalization. Bank of Japan governor, Mr. Kuroda, continued to assure the market that the central bank would maintain current trajectory.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,738.06	-0.96%	-1.07%	-4.28%
SPX Index	S&P 500	4,418.64	-1.79%	-2.09%	-7.16%
CCMP Index	Nasdaq	13,791.15	-2.16%	-3.11%	-11.79%
SX5E Index	Euro Stoxx 50	4,155.23	1.78%	-0.37%	-3.10%
SMI Index	Swiss Market	12,231.97	0.76%	0.04%	-5.00%
UKX Index	FTSE 100	7,661.02	1.92%	2.63%	3.79%
CAC Index	CAC 40	7,011.60	0.87%	0.18%	-1.86%
DAX Index	DAX	15,425.12	2.16%	-0.30%	-2.89%
FTSEMIB Index	FTSE MIB	26,966.10	1.36%	0.57%	-0.99%
NKY Index	Nikkei 225	27,696.08	0.93%	2.57%	-3.80%
HSI Index	Hang Seng	24,906.66	1.36%	5.31%	6.45%
SHSZ300 Index	CSI 300	4,601.40	0.82%	1.50%	-6.86%

Source: Bloomberg, as at February 11, 2022. Performance figures in indices' local currencies.

Our view: While the recent geopolitical developments between Russia and Ukraine have thrown a wrench into the risk equation for equities, it is important to not lose sight of the dynamics between quantitative tightening and earnings growth. On the monetary policy front, we believe that the shockingly high CPI print combined with the bi-partisan political support for tackling inflation provide the Fed with material ammo to address inflation decisively. The substantial savings amassed by households from the government stimuli is likely to provide an additional cushion for the Fed to act boldly. And despite recently widening credit spreads, the credit market is still orderly, giving policymakers less incentive to pivot. We continue to monitor the credit market closely for signs of stress.

The current earnings season was surprisingly healthy, albeit the level of beats (sales and earnings) continue to trend below the levels of the past six quarters. Yet, according to FactSet, during January, analysts decreased earnings estimates for S&P 500 companies for 1Q CY2022, representing the first decrease since Q2 2020. We believe that this is primarily driven by factoring in inflationary pressures.

> "The balance between the interest rates outlook ("r") and the earnings growth forecast ("g"), in our view, is currently in equilibrium…"

Elsewhere, the balance between the interest rates outlook ("r") and the earnings growth forecast ("g"), in our view, is currently in equilibrium (especially in the US), but potentially a fragile one. Companies have so far managed to deal with inflation successfully, passing most of it to the end consumer, with little impact on margins. This could change should the recent consumer sentiment indicator reading translate to lower consumer spending. Earnings inflecting lower would herald the equity markets entering the "bear flattening" cycle.

Crypto & Blockchain | Will bitcoin reach USD150,000?

But challenges for institutional adoption remain.

Cryptocurrency adoption is growing worldwide thanks to the support of many companies that are opening up their use. On Friday, the CEO of Uber announced that it will accept bitcoin as payment in the future, while in the near future BlackRock will allow its clients to trade cryptocurrencies through Aladdin ("Asset, Liability, Debt and Derivative Investment Network"), their owner proprietary asset manager's integrated investment management platform. But the most obvious sign of adoption is the presence of crypto exchanges to grab the Super Bowl spotlight today. There's a direct correlation between sports fans and cryptocurrency investors, which is why companies with the most capital are

competing to take market share in sport advertisement. It's no coincidence that European soccer in crisis has seen a flood of money come in from the world of cryptocurrency, which is growing exponentially.

Market action: Bitcoin fell below USD43,000, and is still showing high beta with the tech market. The next important support area is in the range of USD35,000-40,000. In a note released by JPM last week, they forecast the long-term price of bitcoin to reach USD150,000, while the short-term fair value of the cryptocurrency stands at USD38,000 (from the USD35,000 estimated last year). At this level, the total market value of bitcoin would be on par with that of all gold held privately for investment purposes. As Panigirtzoglou wrote in the research, the biggest challenge for bitcoin going forward is its volatility and boom and bust cycles that hinder further institutional adoption.

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Fixed Income | US Treasuries suffer double whammy

High grade bonds sales gain momentum.

The US Treasury market suffered a double whammy this week. On one side, inflation registered one of the fastest rates since the 1980s, and on the other side, a Fed official calling for a full percentage-point increase in interest rates by July. This sparked big moves as US government bonds sold off across the curve. 2-year yields jumped the most in more than a decade, while 10-year yields rose above 2%. In this environment, credit markets weakened globally. Spreads pushed wider.

Figure 3: US Treasury Yields

Source: Bloomberg, as at February 11, 2022.

The junk bond market posted its biggest single-day gain in six sessions on Wednesday, rising 0.27%, while yields retreated from a 15-month high. But the move was totally reversed on Thursday (-0.54%). On a total return basis, after a terrible January (-2.73%) the US junk bond market is down month-to-date to -0.73% (-3.44% year-to-date).

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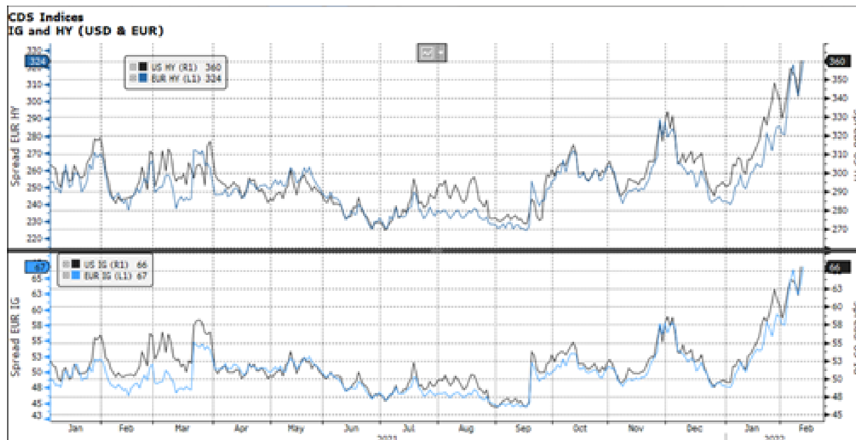
Figure 4: Investment Grade and High Yield Spreads



Source: Bloomberg, as at February 11, 2022.

"Investor demand rebounded mid-week with borrowers getting orders of about four times the deal size on average, and companies paying just 3 bps in concessions."

Our view: In the primary market, US high grade corporate bond sales gained some momentum this week. Investor demand rebounded mid-week with borrowers getting orders of about four times the deal size on average, and companies paying just 3 bps in concessions. Junk bond sales were also sluggish in the US as yields rose to a 15-month high. Norwegian Cruise Line returned to the market to refinance expensive bonds issued at the height of the pandemic with coupons of 12.25% and 10.25%. The company was able to get its two-part, drive-by pricing both tranches at the tighter end of talk. The company's outstanding 5.875% March 2026 senior unsecured notes is trading at a yield-to-call of 6.75%. The 5-year secured was issued at 5.875% (B+,15/2/2027), lower than the 6% area indicated. Adding 20 bps for a one-year maturity extension, and then subtracting 120 bps for the secured/ unsecured differential brings fair value to 5.75%. The unsecured priced at 7.75% (B-,15/2/29), on the lower range (7.75%-8%). Adding 60 bps for a 3-year maturity extension takes fair value to 7.35%.

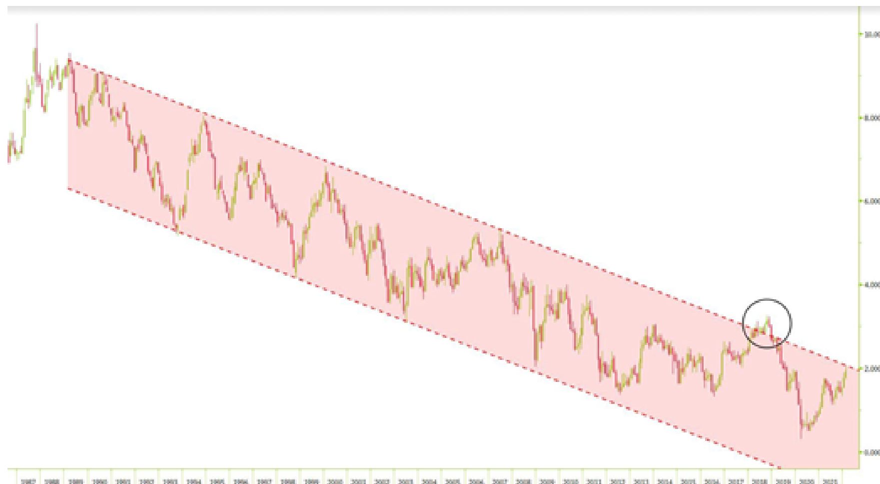
"Chinese developers' bonds and stocks rallied following reports on new regulations that would make it easier to tap cash from home presales, potentially easing a liquidity crunch."

Finally, Chinese developers' bonds and stocks rallied following reports on new regulations that would make it easier to tap cash from home presales, potentially easing a liquidity crunch. The new regulation would replace legions of local rules across the country and allow builders to withdraw and use such proceeds after setting aside the amount required for project building.

Chart of the week

This week we propose a famous chart of the 10-year US Treasury. The decade-long trend started in 1989 and is still in the bull market downtrend. In 2018, the 10-year tried a breakout amid expectations of a normalizing yield cycle, but the attempt lasted seven months. Five years later, it is testing the upper trend band again. Economists average forecast is at 2.21%, while forwards are pricing the 10-year at 2.09%.

Figure 5:



Source: Bloomberg, as at February 11, 2022.

Week Ahead | Key events to watch for

- **The coming week will likely focus on the publication of the minutes of the last Fed meeting** (January), and on the various speakers who will alternate during the week, hoping not to have too many surprises and a softer and more homogeneous communication.

- **We will also see the January CPI** print in the UK.

- **The earnings season has come to an end, while geopolitics remain in the background** with tensions in Ukraine far from resolved despite the illusion of calm following Macron's trip to Russia.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX, Crypto and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

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