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Weekly Market Flash
Will we see a summer correction?

July 18, 2021

Stock markets seem to have officially entered the summer season, with low volumes and limited volatility prevailing. In the coming weeks, we believe that some weakness in equity markets may emerge – as markets tend to need some consolidation before resuming an upward direction – but a deep correction is more unlikely, at least in the absence of any unexpected news. Although the scenario of a summer correction seems attractive, it must be acknowledged that this scenario is highly awaited by the investment community (which we tend to read as a sign that investors are eager to buy any weakness); the Fed, unlike other central banks, still appeared dovish in its latest remarks; the current earnings season will likely not disappoint, since it is favored by significant base effects; and finally, while economic activity has certainly reached a peak for the year, it remains at considerable absolute levels.

Highlights

- The S&P 500 Index and Nasdaq Composite reached new intraday highs before retreating on Thursday and Friday in a correction. The sell-off was led by value sectors, which were impacted by the negative sentiment resulting from the Delta variant. This seemed to outweigh the upside surprise in inflation data and the retail sales beat.

- The Bank of New Zealand announced the end of its QE program; the Bank of Canada decided to reduce Treasuries purchases from CAD3 billion to CAD2 billion a week; and the Bank of England saw Saunders become the second member in two days to talk about stimulus withdrawal.

- The Q2 earnings season kicked-off with US banks largely beating earnings expectations. Overall, 39 S&P 500 companies have reported their Q2 earnings. The average sales beat was 4.76% and the average earnings beat was 23.7%.

- In the primary market, banks were the biggest issuers of US investment grade debt this week. In Europe, loan and bond total issuance has passed the EUR150 billion mark and now tops all but one of the full-year tallies since the 2007 credit crisis.

“...we are looking at the price action across the sector and geographical levels in recent weeks, which should enable us to take advantage of some excesses...”

Markets & Macro | Will we see a summer correction?

Opportunities emerge in recent price action.
At the current time of the summer season, it seems useless to add directional risk to portfolios. However, we are looking at the price action across the sector and geographical levels in recent weeks, which should enable us to take advantage of some excesses and gradually rotate portfolios in favor of cyclical stocks – or markets that have perhaps suffered excessively.

Our view: Reopening trades have suffered in the past month due to a mix of macroeconomic and COVID-related variables. First of all, investors are worried that the economic momentum could suddenly evaporate following the resurgence in the number of cases and particularly the Delta variant, as well as the possibility of more vaccine-resistant variants (which remains unproven so far). And combined with a slowdown in the inoculation process in many countries due to the population’s resistance, the reopening of economies following the acceleration in May and June could be delayed.

The sense of uncertainty is amplified by the different responses that the political class is undertaking. For example, in England, despite the jump in Delta variant infections in recent weeks (new cases have reached a peak of 48,000 this week), the government has decided to fully reopen the economy. At the opposite end of the spectrum is France, where President Macron announced this week the need to show a digital health pass (or a negative test) to access most public recreational activities.

Admittedly, the level of infections (not to mention hospitalizations) in Europe is still very low, but the flood of reports of tourists stuck in quarantine due to outbreaks does not help. It is no coincidence that the travel & leisure sub-index of the Stoxx 600 is marking the lowest point since the beginning of March (tourism represents a very important and substantial part of many southern European country economies, for example in Italy it makes up around 13%-14% of GDP).

"...we have to consider a tail risk in our constructive analysis for cyclicals: that the Delta variant, or some new variant, has a chance of being able to survive any vaccine and thus generate another health emergency."

Despite the obvious uncertainty around the epidemiological situation, we still assign a relevant weight to the fact that the increase in cases is largely hitting the non-vaccinated (and those that have not yet received two shots of the vaccine) and younger people. It is also worth remembering that there are still many people who have not received both doses of vaccine, which is necessary to get complete protection. On the other side, it is now clear that the virus will be completely eradicated before the whole world, including emerging market countries, has reached a significant proportion in vaccinated citizens. This is to say that economic actors have likely already accepted the coexistence and adapted their behaviors accordingly.

At the same time, we have to consider a tail risk in our constructive analysis for cyclicals: that the Delta variant, or some new variant, has a chance of being able to survive any vaccine and thus generate another health emergency. But our style is to try and take rational decisions based on available news and probabilities of a scenario. So, while conscious of existing risks, we still see a sense of opportunity in recent price action.

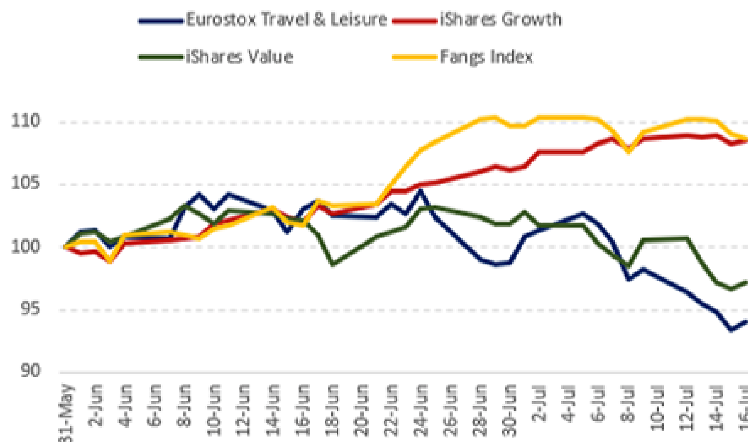
On the US fiscal front, the road doesn't look as smooth as previously discounted for the bipartisan infrastructure plan, with various media outlets talking about evanescent consensus. Fiscal spending programs are certainly one of the factors supporting value plays. But at this point, expectations should have normalized enough to generate positive surprises in case of a deal announcement.

Adding to the woes on the cyclical trade are a few peripheral central banks, from the Bank of New Zealand, which announced the end of its QE program this week, to the Bank of Canada, which decided to reduce Treasuries purchases from CAD3 billion to CAD2 billion a week, to the Bank of Korea, where a board member voted for a rate hike. And last but not least, the Bank of England (BoE) saw Saunders become the second member in two days to talk about stimulus withdrawal, suggesting that the tapering debate is well underway here as well. This hawkish shift in communication over recent weeks has brought into focus the issue of how long extreme monetary policy support can be prolonged for, even in a context of the permanence of the virus in our societies.

"...the divergence seems excessive to us, and we'll benefit from such weakness to moderately add exposure toward Europe and value stocks."

Figure 1 clearly shows the ongoing dynamics below the surface of stock markets indices. The European travel & leisure sector and the value sector in the US have lost around 5% in the last month and a half, while the FANGs and the US growth sector have gained almost 10%. As we said, the divergence seems excessive to us, and we'll benefit from such weakness to moderately add exposure toward Europe and value stocks.

Figure 1: Diverging Sectors Below the Surface



Source: Bloomberg, as at July 16, 2021.

Equities | The price of complacency

Is the market running out of positive catalysts?

Last week, the S&P 500 Index and Nasdaq Composite reached new intraday highs before retreating on Thursday and Friday in a correction. The sell-off was led by value sectors, which were impacted by the negative sentiment resulting from the Delta variant. This seemed to outweigh the upside surprise in inflation data and the retail sales beat.

"It is important to remember that equities are pretty much the only asset class that hasn't yet normalized for the excessive positioning, unlike Treasuries, gold, commodities and crypto."

Similar to last week, investors sought refuge in Big Tech, thanks to their stronger balance sheets and better earnings visibility. European stocks, which are largely thought of as a value play, were not immune to the rise in COVID-19 cases. Despite the European Central Bank's (ECB) attempts to assure the market that inflationary pressures would prove to be transitory, some market participants were still concerned about pre-mature monetary policy tightening.

The Q2 earnings season also kicked-off with US banks largely beating earnings expectations. However, the quality of the beat was mixed as investment banking activity strength was partially offset by a trading slowdown. Overall, 39 S&P 500 companies have reported their Q2 earnings. The average sales beat was 4.76% and the average earnings beat was 23.7%. So far, the sales and earnings beats are ahead of the beats seen in the past three quarters. Nevertheless, the market reaction to these results was very muted with the aggregate 1-day average price move of 0.26% to the earnings beats. Volumes were also light, thus exacerbating the moves in many stocks during the correction at the end of the week.

Our view: With positioning at the high end of the historical range, and the market running out of positive catalysts for the time being, low summer volumes and inflation uncertainty have left equities vulnerable. The division among Federal Reserve (Fed) and ECB policymakers about the appropriate response to the inflation surprise is certainly of no help either.

It is important to remember that equities are pretty much the only asset class that hasn't yet normalized for the excessive positioning, unlike Treasuries, gold, commodities and crypto. We therefore don't rule out further pressure on equities despite the expectation of another healthy earnings season. We take good note of the University of Michigan consumer sentiment survey last Friday which witnessed a drop back to the lowest level since February, as rising house prices, auto prices, and household durable goods' prices impacted consumer sentiment negatively. What is key to monitor here is whether this leads to a change in the wealth effect of households, and in turn in spending and investing behavior.

Chart of the week

After we warned about the signal of fatigue on the S&P 500 index, the futures didn't move much higher – which confirmed our toppish view. The RSI started to decline from an overbought territory. We still expect a more moderate pullback, while on the back of the continued internal sector rotation we don't expect to see an explosion in volatility. In the long run, it is unlikely to change, as long as we don't see any major trigger.

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Figure 2: S&PFutures

Source: Bloomberg, as at July 16, 2021.

Fixed Income & Credit | The duration-shortening playbook isn't dead yet.

Central bankers diverge on inflation response.

Last week US consumer price numbers showed that inflation is now a fact. However, US yields continued to fall with the 10-year around 1.3%. At the same time, the spread between 2-year and 10-year yields, arguably the clearest bond market indication on the prospects for reflation, is down to 110 basis points.

"All this argues that the duration-shortening playbook is not dead yet: it could take only a couple of hawkish hints to trigger a spike in bond yields."

Figure 3: 2-year/10-year Yield Spread

Source: Bloomberg, as at July 16, 2021.

In the meantime, Fed Chairman Powell stubbornly continues to defend the central bank's stance to continue providing support to the US economy – even as inflation runs at uncomfortable levels.

Our view: Looking elsewhere, however, other central banks aren't taking chances and are well on their way to scaling back stimulus. As we mentioned earlier, in New Zealand, the central bank went from being dovish as recently as April to stopping its bond buying this month and boosting expectations for a rate increase by the end of the year, which drove the 10-year yield up. And Canada's central bank could follow in further trimming bond buying.

Meanwhile, Norway's central bank is preparing for a series of quarterly interest rate increases after the summer. Finally, the BoE has remarked this week that recent progress in the economy suggests that the conditions for considering tightening may come sooner than anticipated. Hawkish BoE comments pushed up rate hike bets, with a tightening lift-off priced in for early 2022, well ahead of the Fed. All this argues that the duration-shortening playbook is not dead yet: it could take only a couple of hawkish hints to trigger a spike in bond yields.

"New issuance of green, social, sustainability and sustainability-linked bonds from corporations and governments worldwide has topped USD575 billion, which is USD100 billion more than all of 2020."

In credit, spreads remain stuck between expensive valuations and policy support. In the primary market, banks were the biggest issuers of US investment grade debt this week with Goldman Sachs bringing a two-part deal for USD5.5 billion, followed by Morgan Stanley and Bank of America for a combined USD16 billion of new bonds. In Europe, loan and bond total issuance has passed the EUR150 billion mark and now tops all but one of the full-year tallies since the 2007 credit crisis.

New issuance of green, social, sustainability and sustainability-linked bonds from corporations and governments worldwide has topped USD575 billion, which is USD100 billion more than all of 2020. Finally, in Chinese property bonds, a segment which recently sold off sharply, a domestic bond default by another property developer and signs of easing repayment risk for the nation's top bad-debt manager occupied investors' attention. Sichuan Languang Development failed to repay a CNY900 million local bond, while Huarong's dollar bonds rallied, driven by its plan to redeem a USD500 million perpetual note in September. Evergrande Group, the most indebted Chinese developer, said it will consider a special dividend to shore up its stock that's trading near a four-year low, risking worsening an already debt-saddled balance sheet.

Week Ahead | Key events to watch for

- **The third week of the month typically sees a very muted macro** calendar. Only PMI surveys will be published in Europe and the US.
- **The ECB meeting and its new average inflation targeting framework** will be presented on Thursday, followed by the traditional Q&A session by President Lagarde.
- **In the Q2 earnings season**, investors' attention will shift to corporates.
- **The spread of the Delta variant** will also gather attention, after latest developments in Europe.

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