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Weekly Market Flash

Central banks grow increasingly impatient with rates

January 16, 2022

Equity markets had another tense week, which ended with a slight decline overall, but was characterized by a lot of volatility and deeper losses. Three forces are currently driving the stock market, and more specifically the tech sector, which is attracting investors' attention: 1) the prospect of reduced liquidity conditions due to central banks tightening; 2) the cleansing that was largely initiated in the second half of last year, to the detriment of the exuberant valuations of the tech world's most speculative sector, and which has continued with the start of 2022; 3) the approaching earnings season, which analysts are more afraid of than in the past, as recent company guidance has been downwardly biased (cost pressures from wages and supply chain disruption are a clear risk to corporate margins).

Highlights

▪ In the US, the inflation figure saw a further increase to 7.0% year-on-year, in line with consensus. Core inflation, excluding food and energy component, also reached a new high of 5.5% year-on-year, driven by healthy increases in car and clothing prices.

▪ For the first time in over a decade, the BOJ appears to be discussing how soon they can start telegraphing a possible interest rate hike, which could come even before inflation hits the 2% target.

▪ Major US equities recorded their second consecutive weekly loss. Concerns over rising interest rates and inflation signals played in favor of short duration value assets and against long duration assets.

▪ The earnings season kicked off with JP Morgan and Citigroup reporting last Friday. Lower than expected trading revenues and a drop in commercial and consumer loans from a year earlier pressured these stocks on Friday.

▪ Institutional adoption for Crypto will be the main theme in 2022, as we saw this week. The first main event came from the mayor of Rio de Janeiro, who announced the city's plan to incentivize the use of digital money and boost the city's economy. The second event was the launch of Tesla with Dogecoin payments in online stores.

▪ The bond market reacted very calmly to the inflation print. The only significant shift saw 10-year breakevens drop and the 10-year real yield consequently rise, but both stayed within recent ranges.

"This week was a reminder that all major central banks (aside from the People's Bank of China) are starting a coordinated tightening."

Markets & Macro | Central banks grow increasingly impatient with interest rates

We favor short duration across bonds and equities.

Equity markets ended the week with a slight decline (-0.5% for major indices), but they were characterized by much volatility and deeper losses during the week, which were recovered in the last hour of trading on Friday. The balance was heavier for the more speculative technology stocks, with the Ark ETF down 5% and the Goldman Sachs Non-Profitable Tech index down 3%.

As mentioned earlier, there are three forces currently driving the stock market – and more specifically the tech sector. One of them is the prospect of reduced liquidity conditions due to central banks tightening. In fact, this week was a reminder that all major central banks (aside from the People's Bank of China) are starting a coordinated tightening. Federal Reserve (Fed) President Powell had managed, during his hearing on Monday, to be hawkish on inflation but reassuring on markets. The other Fed

members were not so soft, starting with deputy Brainard, who said that the change of course on rates would come as soon as the US Treasuries purchases are over, paving the way for an initial hike in March. Board member Waller is of a similar opinion, considering three interest rate hikes in 2022 to be a good starting point and therefore leaving the door open to further hikes. The market is now fully expecting a cycle of three hikes in 2022, with the possibility that three will not be enough.

Our view: But it is not only the Fed that has shown signs of impatience with interest rate levels. The big surprise of the week, if only for its highly symbolic value, came from the Bank of Japan (BOJ). For the first time in over a decade, the central bank appears to be discussing how soon they can start telegraphing a possible interest rate hike, which could come even before inflation hits the bank's 2% target, encouraged by rising prices and a more hawkish Fed. While an actual rate hike is hardly imminent and the BOJ is on track to maintain an ultra-loose policy for at least the rest of this year, financial markets may underestimate the central bank’s willingness to gradually scale back its once-radical stimulus program.

Powell's credibility is evidently high as the mid-week inflation figure saw a further increase to 7.0% year-on-year, in line with consensus. Core inflation, excluding food and energy component, also reached a new high of 5.5% year-on-year, driven by healthy increases in car and clothing prices. We also note that the rent component, which had been quite subdued until the past few months, started to contribute positively at 4.2% year-on-year.

The market's confidence is uncertain, because if we look beyond Powell's words, the situation looks decidedly gloomier. In fact, it is certainly not the first time in recent decades that we have seen such high inflation, but the difference comes precisely from the level of interest rates. As you can see from Figure 1, even in the 1980s, inflation was running at today's levels – but the Fed's rates were averaging around 5-6%.

“...it is certainly not the first time in recent decades that we have seen such high inflation, but the difference comes precisely from the level of interest rates.”

Figure 1: Inflation vs. Fed Funds Rate

Source: Bloomberg, as at January 14, 2022.

“The market digested the figure very well, although it does add pressure on the Fed, as the underlying inflationary pressures are unlikely to abate in the coming months.”

The market digested the figure very well, although it does add pressure on the Fed, as the underlying inflationary pressures are unlikely to abate in the coming months. On the one hand, the unfavorable base effects will last for another three to four months – while on the other hand, the labor market, as seen in the latest reports, looks decidedly strong and tight, putting pressure on wages. In all this, an important component of inflation, rents (which account for 30% of headline CPI and almost 40% of core), have just started to rise.

A parenthesis is due on the labor market, as the latest report, released on Friday 7 January, was quite controversial. Non-farm payrolls rose by a weaker 199,000 units in December versus a consensus expected 450,000. Yet, payrolls were revised up to a combined 141,000 in October and November. However, civilian employment, an alternative survey that often deviates from payrolls in the short term but tends to match them in the long term, grew rapidly, with a gain of 651,000 in December and an increase of 1.09 million in November. The construction of the civil employment survey makes it possible

to better capture the start-up of small and medium-sized enterprises: we can reconcile this with the dynamic of the high "job quit rate" mentioned earlier. Many professionals are leaving large companies in favor of the world of start-ups (partly driven by the fact that they are not in the business world).

It is clear that the market has fully embraced the theory that inflation will fall rapidly over the coming months, thanks to a confluence of cyclical and structural factors. On the one hand, the fiscal stimulus with consumer cheques is coming to an end. On the other hand, bottlenecks in the production chain seem to have peaked, such as delivery times and the exponential rise in energy prices. But this mean reversion has been going on for a while, and in the meantime we are at 7%.

"...although we recognize the merits of all the risk factors we have listed, we do not yet feel it is time to change our constructive view on equities."

Certainly one could say that the concept of a risk premium doesn't seem very popular at the moment with investors, who have once again demonstrated to prefer the buy-the-dip mentality. As far as our asset allocation is concerned, although we recognize the merits of all the risk factors we have listed, we do not yet feel it is time to change our constructive view on equities. We certainly believe that the upside this year is limited compared to last year, and that in the event of a shock, the Fed Put is much further away – given the inflation theme that it would have to take into account even in the face of growth threats. Our caution on inflation for the moment is reflected in a sector allocation that favors short duration assets, both in the bonds and equities sectors. We are therefore staying long on energy, oil, precious metals and big cap tech, while keeping a short on US rates and no exposure to speculative technology stocks.

Equities | Market volatility likely to remain elevated

Earnings season to provide little relief.

Major US equities recorded their second consecutive weekly loss, bringing the year-to-date loss on the S&P 500 and Nasdaq Composite indexes to 2.1% and 4.8%, respectively. Concerns over rising interest rates and inflation signals played in favor of short duration value assets and against long duration assets. For example, the long duration Goldman Sachs Non-Profitable Tech index lost 36% from its mid-November 2021 high. The energy sector (a value play) within the S&P 500 index has been the best performing sector year-to-date, up 16.4%. Rising geopolitical tension between Russia and the West over Ukraine also played a role in dampening investor sentiment during the week.

"Concerns over rising interest rates and inflation signals played in favor of short duration value assets and against long duration assets."

The earnings season kicked off with JP Morgan and Citigroup reporting last Friday. Lower than expected trading revenues and a drop in commercial and consumer loans from a year earlier pressured these stocks on Friday. European stocks also pulled back during the week on Fed policy tightening concerns, but have fared much better than their US counterparts on a year-to-date basis. Chinese markets remained under pressure, with the CSI 300 index now down 4.3% on the year. A rebound in Chinese technology names boosted the Hang Seng index to a 4% return on the year.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	35,911.81	-0.88%	-1.13%	-1.13%
SPX Index	S&P 500	4,662.85	-0.29%	-2.11%	-2.11%
CCMP Index	Nasdaq	14,893.75	-0.28%	-4.79%	-4.79%
SX5E Index	Euro Stoxx 50	4,272.19	-0.74%	-0.52%	-0.52%
SMI Index	Swiss Market	12,525.63	-2.13%	-2.72%	-2.72%
UKX Index	FTSE 100	7,542.95	0.79%	2.17%	2.17%
CAC Index	CAC 40	7,143.00	-1.04%	-0.03%	-0.03%
DAX Index	DAX	15,883.24	-0.40%	-0.01%	-0.01%
FTSEMIB Index	FTSE MIB	27,543.96	-0.27%	0.72%	0.72%
NKY Index	Nikkei 225	28,124.28	-1.24%	-2.32%	-2.32%
HSI Index	Hang Seng	24,383.32	3.79%	3.57%	4.22%
SHSZ300 Index	CSI 300	4,726.73	-1.98%	-5.02%	-4.32%

Source: Bloomberg, as at January 14, 2022. Performance figures in indices' local currencies.

Our view: We expect equity volatility to remain elevated amid broad macro volatility with inflation data weighing on the rate hike picture. We expect little relief from this earnings season as companies are likely to maintain a cautious guidance on the back of rising wage and material costs, and as Omicron disruptions extend, even if Q4 2021 earnings surprise positively.

"We expect little relief from this earnings season as companies are likely to maintain a cautious guidance on the back of rising wage and material costs..."

Crypto & Blockchain | Crypto and risky assets remain correlated

Is Bitcoin's upside limited?

Institutional adoption for Crypto will be the main theme in 2022, as we saw this week. The first main event came from the mayor of Rio de Janeiro, who announced the city's plan to incentivize the use of digital money and boost the city's economy, such as offering discounts when paying taxes with Bitcoin. They also decided to allocate 1% of the treasury reserves to cryptocurrencies. This step helped the crypto universe after a difficult December in which institutional flows were lacking.

The second event was the launch of Tesla with Dogecoin payments in online stores. Dogecoin has increased over 4000% since Musk pre-announced the news with a tweet on December 20, 2020. This is not the first step for Tesla in Crypto, as we remember when Musk-helmed Tesla first enabled bitcoin payments for Tesla cars in March 2021. Then less than two months later, they pulled the plug, but in October, the company previewed a resumption of crypto payments in an SEC filing.

Market action: Market action continues to show a high correlation between traditional risky assets and cryptocurrency markets, when previously they were considered completely uncorrelated. It is likely that the correlation will remain positive to some degree for the foreseeable future – until a more significant adoption event or even more drastic levels of inflation than currently occur.

"Market action continues to show a high correlation between traditional risky assets and cryptocurrency markets, when previously they were considered completely uncorrelated."

Chart of the week

The holding support was placed by the billionaire Mike Novogratz, who announced early this month that Bitcoin would possibly fund a bottom at the USD38,000-40,000 area. The market front ran the billionaire and started to buy in the USD39,000 area. For the moment the support remains intact, which could keep buyers active over the short term.

But the upside could be limited due to the strong resistance zone of USD45,000-47,000. The relative strength index (RSI) on the daily chart is rising from extreme oversold levels, similar to what occurred in late September, which preceded a price rally.

Figure 3: Bitcoin Price

Source: Bloomberg, as at January 14, 2022.

Fixed Income & Commodities | More now equals less later

Primary market activity remains elevated.

The bond market reacted very calmly to the inflation print. The only significant shift saw 10-year breakevens (the blue line) drop and the 10-year real yield (the red line) consequently rise, but both stayed within recent ranges.

> "The old mantra of "more now equals less later" has come back to the fore, implying that earlier and stronger rate action from the Fed means a shorter and smaller tightening cycle."

Figure 4: US Breakevens vs. US Yields

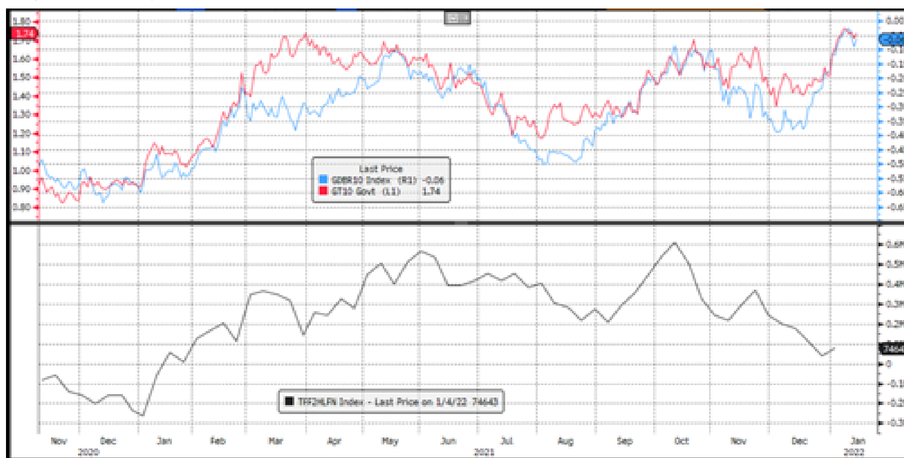
Source: Bloomberg, as at January 14, 2022.

There was also likely a relief rally after Goldman Sachs and other strategists came out with new forecasts of four interest rate increases in 2022. In short, the old mantra of "more now equals less later" has come back to the fore, implying that earlier and stronger rate action from the Fed means a shorter and smaller tightening cycle.

In Europe, despite a rate hike from the European Central Bank, and a QE squeeze farther out than in the US, a positive bund yield is within reach and this time market positioning may be more aligned. According to Bloomberg Intelligence, short positioning looks cleaner and the selloff still has legs, judging by similar sized moves in the past.

> "Short positioning may have helped 10-year bund yields push higher recently."

Figure 5: 10-year Bond Yields



Source: Bloomberg, as at January 14, 2022.

Our view: Short positioning may have helped 10-year bund yields push higher recently. Leveraged investor positions in short contracts in 10-year US Treasury note futures (the black line) have fallen more than 80% since October. Although there is no similar data for Europe, there are figures on the total open interest which have fallen lately. The 3-month rolling average of total open interest on bund futures hit pandemic-era highs in September, reaching more than 1.3 million contracts, but they have since fallen by 100,000 contracts. While there is no way to know how much of this is short positioning, given the high correlation between the bund and US Treasury yields, a similar lower short base in the bund market seems plausible.

“The Fed’s hawkish shift is weighing on order books and price premiums…”

Elsewhere, primary markets have been very busy. Since the beginning of January, US investment grade bond sales have totalled approximately USD100 billion as companies piled in to get ahead of more expensive financing costs that come with likely Fed interest rate increases. However, borrowers have had to pay higher concessions to get deals done compared to 2021. The Fed’s hawkish shift is weighing on order books and price premiums, eroding issuers’ confidence that they can extract aggressive pricing on deals from a usually compliant investor base.

The US junk bond primary market steadily gained momentum after a slow start to the year. Golden Nugget, the casino operator owned by Fertitta Entertainment Inc., sold a USD1 billion secured 7-year note (4.625% from initial talk of 4.75%) and a USD1.25 billion 8-year unsecured bond (6.75%) as part of a broader refinancing. The total deal was downsized to USD2.25 billion from USD3.7 billion. Meanwhile, Europe’s bond market broke records with USD113 billion of sales in a single week as borrowers rush to get ahead of rising interest rates: Discount airline Wizz Air (Baa2/BBB 4 years, priced at MS +105 bps after initial talk of MS +145 bps); Cyprus (BBB-, 0.95% 2032) attracted an order book that covered the deal 7.8x; Ireland (A2, 0.35%, 2032) attracted the largest physical order book at EUR27 billion; Wendel (Baa2/BBB, 1.426% 2034) tightened 35 bps between initial talk and final terms.

And in US leveraged loans, companies launched deals over USD1 billion this week, backing acquisitions and buyouts. Despite some uncertainty over the transition in a post-Libor world, US leveraged loans remain the hottest investments of 2022. Secondary loan average prices continued to tick higher to levels not seen since 2014.

Week Ahead | Key events to watch for

- **Next week will be quiet on the data front** across both Europe and the US; US markets will be closed on Monday (Martin Luther King holiday), and there will be a canonical blackout of Fed members in the week leading up to the FOMC meeting.

- **It will be important to follow the earnings season**, with 39 companies in the S&P 500 index filing reports.

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