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Weekly Market Flash
Further volatility, and opportunity, incoming.

July 11, 2021

Volatility returned to financial markets this week, with the S&P 500 index hitting an all-time high before suffering a sharp global equity selloff that began on Thursday. Anxiety about future growth prospects led to an acceleration in the flattening of the US Treasury curve, which was accompanied by big declines among cyclical and Covid-sensitive assets. Overall, there seems to be the gradual realization that the vaccination programs alone won't prove to be enough to get economies back to full normality, with rising cases worldwide and a prevalence of the Delta variant. The challenge in Asia (ex-China) and emerging countries is the low vaccination rate, which makes a new wave of Covid, with the Delta variant, a much more serious problem compared to Europe and North America.

Highlights

- Cases are rising worldwide. In Tokyo, a state of emergency has been lifted for the entire period of the Olympic Games, preventing spectators from entering the stadiums. There are also record cases in South Korea, with authorities considering new measures.

- US PMI and ISM data disappointed this week, with the non-manufacturing ISM dropping almost four points to its lowest level since February.

- The ECB published its Strategy Review, where the biggest headline was that the Governing Council would now have a symmetric 2% inflation target over the medium term, rather than the previous target of "below, but close to, 2%".

- Euro high grade credit spreads approached fresh lows after the ECB signaled it was willing to let inflation run a little hotter. US high grade corporate bond yields fell below 2% this week for the first time since February as Treasuries rallied, while spreads edged wider to around 83 bps.

- The PBOC cut its RRR by 50 bps, which equates to a RMB1 trillion liquidity injection. According to policy analysts, the move was less about easing and more about allocating additional credit to SMEs that are feeling margin pressures from raw material costs.

"...these deteriorating numbers do little to stem the market's growing perception that peak growth is behind us."

Markets & Macro | How fragile are markets?

Further volatility, and opportunity, incoming.
In addition to the low vaccination rate in emerging countries, other elements of increasing tension are the risk of a slowdown in China, which has yet to be confirmed but is starting to be priced into the region, and the political pressure on Big Tech. And the latest disappointments (although from very high levels) in US PMI and ISM data this week only supported these fears.

Our view: Indeed, the growing pessimism that was evident in the performance of bonds, and in the growth versus value trade (and in the underperformance of cyclical Europe and emerging markets versus US tech) has spread to the broad indices. In particular, the non-manufacturing ISM was the first big and relevant economic disappointment in the last several weeks. The figure showed a drop of almost four points to its lowest level since February (60.1 from the previous 64.8 and against estimates for 63.5). The deterioration was also reflected in the sub-indices. While new orders dropped only 1.8 points to an all-time high of 62.1, business activity dropped 5.8 points to 60.4. The employment sub-index (-6 to 49.3) was also disappointing, and decidedly difficult to make it consistent with the 850,000 new jobs, of which 642,000 in services recorded in the same month. The report likely reflects the difficulties in hiring due to a lack of supply. And these deteriorating numbers do little to stem the market's growing perception that peak growth is behind us.

Overall, in strategic terms, we prefer to read the recent price action in fixed income – specifically the bull flattening of the curve with the 10-year yield down to 1.30% – with a sense of caution. On the equity side, while it is true that US indices sit at all-time highs, the rally is very isolated at a geographical level and concentrated to the US tech mega caps, which are often treated as a safe haven.

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The message from fixed income, typically related to a macroeconomic framework, is a warning sign that should not be dismissed as a technical move driven by short covering of extreme positions. The move started as soon as the Federal Reserve (Fed) changed its message in a slightly prudent direction, hinting toward tapering in the relatively distant future – specifically, not before 2022 begins. The move in the opposite direction in rates (declining despite fewer purchases from the central bank) means a relevant portion of the market is worried about the fragility of the market in any attempt of monetary policy normalization.

In terms of asset allocation, we took the opportunity to reduce half of our moderate underweight positioning in equities, benefiting from the weakness on Thursday, but with an awareness that the summer months could be volatile – creating more opportunities to buy at attractive prices.

ECB shifts inflation language.

In Europe, the main story was the announcement of the European Central Bank's (ECB) long-awaited Strategy Review, where the biggest headline was that the Governing Council would now have a symmetric 2% inflation target over the medium term, rather than the previous target of "below, but close to, 2%".

Our view: This announcement puts the ECB on the same path undertaken last year by the Fed, and reaffirms the principle that the determination of central banks around the world is ever stronger to generate some inflation over the coming years in order to reduce the debt burden accumulated by governments and individuals during the pandemic. In the statements, there was also some language that sounded more tolerant of above-target inflation, saying that in order to maintain the symmetry of the inflation target, "especially forceful of persistent monetary policy measures" could be required when close to the lower bound to avoid low outcomes becoming entrenched.

The ECB's move has been taken by investors as moderately dovish, given the commitment to "lower for longer rates" that is formally embedded in the monetary policy statement. The ECB will likely confirm in September that PEPP net purchases won't continue beyond March 2022, but the low medium-term outlook for inflation means the PEPP stimulus will be at least in part replaced by additional non-pandemic stimulus.

"This announcement reaffirms the principle that the determination of central banks around the world is ever stronger to generate some inflation over the coming years…"

A relevant and symbolic point of the review is the acknowledgment that housing costs in the current price basket are underestimated. From now on the growth of house prices will also be taken into account, and not just the rent component, as is already the case in the US. The growth of property prices is largely underestimated by the old idea that buying a house is not a cost (yet it is, taking amortization into account) and that it is only a problem in the cost of living of those who live in located accommodations. In many European countries we should now expect upwardly revised inflation figures, since the cost of housing weighs in at only 10% on average, unlike the 30% figure in the US.

Chart of the week

This week the reflation trade had another leg of correction. The move has a relevant technical component, as an unwinding of position in a crowded trade, and a more worrying fundamental reason, as a cold market response to changes in the Fed's dovishness. We would now expect the generic 10-year US Treasury in a trading range between 1.29/1.47 for the rest of the summer.

Figure 1: 10-year US Treasury

Source: Bloomberg, as at July 9, 2021.

Equities | Did the PBOC ease monetary policy?

PBOC cuts RRR for the first time since April 2020.

"According to policy analysts, the PBOC's move was less about easing and more about allocating additional credit to SMEs that are feeling margin pressures from raw material costs."

Major US indexes ended this holiday-shortened week on a mixed note. In particular, growth stocks outperformed for the second week in a row, driven by Big Tech. On the other hand, the disagreement among OPEC+ members affected energy stocks negatively. The steep rally in US Treasuries weighed on sentiment leaving inflation bulls and bears equally puzzled by the magnitude of the yield fall. Additionally, rising cases of the Delta variant seemed to heighten the uncertain outlook.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,786.35	1.06%	0.86%	14.76%
S&P 500	4,352.34	1.71%	1.30%	16.73%
Nasdaq	14,639.33	1.96%	0.94%	13.98%
Euro Stoxx 50	4,084.31	-0.88%	0.49%	17.16%
Swiss Market	11,964.84	-0.29%	0.19%	14.86%
FTSE 100	7,123.27	-0.16%	1.23%	12.25%
CAC 40	6,552.86	-1.06%	0.69%	20.35%
DAX	15,650.09	0.27%	0.77%	14.08%
FTSE MIB	25,282.41	-0.89%	0.72%	15.57%
Nikkei 225	28,783.28	-0.88%	-0.03%	5.72%
Hang Seng	28,310.42	-3.14%	-1.80%	5.50%
CSI 300	5,081.12	-2.91%	-2.73%	-1.74%

Source: Bloomberg, as at July 9, 2021. Performance figures in indices' local currencies.

Meanwhile, the People's Bank of China (PBOC) cut its reserve requirement ratio (RRR) by 50 bps on Friday, a few days after the State Council issued a statement calling for "using monetary policy tools, including cuts in the RRR" to reduce financing costs for companies. This move, which equates to a RMB1 trillion liquidity injection, was unexpected given the market was pricing in neutral monetary policy for the second half of 2021.

Our view: According to policy analysts, the PBOC's move was less about easing and more about allocating more credit to SMEs that are feeling margin pressures from raw material costs. One thing to watch is whether the PBOC will roll over its RMB400 billion MLF coming due in July or let it mature. In case of the latter, the net injection from the RRR cut and lending facility maturity would be roughly RMB400-500 billion, confirming the policy analysts' view that the RRR cut is not an act of monetary easing.

"With equity positioning still at the high end of the historical range (despite sentiment becoming more neutral than positive), we don't expect this earnings season to settle the growth versus value debate."

The move is also likely to be the first sign that: Beijing is potentially slightly more concerned by a growth deceleration than initially wanted; it was time to ease credit conditions; a brisk tightening/deleveraging is likely close to an end, and a more targeted and pragmatic approach will be implemented in the future.

Also in China, the large techs sector seems to have been decimated as a consequence of the Xi's crackdown that began late last year with anti-Jack Ma's vengeance - and further escalation followed this week after Didi's IPO in the US. In our opinion, if there were questions as to whether the Party was satisfied that China's home-grown tech companies were sufficiently humbled by the regulatory blitz which began late last year when Beijing froze Ant's IPO at the last minute, the initial obvious answer is: no.

Beijing also seems determined to discourage Chinese corporates' listing in the US. Reports suggest that China Securities Regulatory Commission will close a key loophole that until now allowed Chinese companies incorporated outside of China to list overseas without chancing a veto from Beijing. We believe the risk here is whether the current strategy has not become counter-productive if one of the goals was also to boost the financial center status of Hong Kong as an alternative to the US.

Elsewhere, the Q2 earnings season kicks off with the US banks reporting next week – JP Morgan is confirmed to report on July 13. We put special emphasis on this earnings season which should allow us to determine if corporate earnings have peaked. Another important question will be whether corporates will prioritize capex spending or cash return to shareholders. Signs of how inflationary pressures are developing will be closely watched too. With equity positioning still at the high end of the historical range (despite sentiment becoming more neutral than positive), we don't expect this earnings season to settle the growth versus value debate.

Fixed Income & Credit | Yields in US high yield market reach new lows.

But China's high yield market suffers.

After the recent strong rally, the US Treasury market will have to deal with a wall of fresh supply in the form of new auctions next week. As a reminder of the general picture from June 2020 until April 2021, the Treasury issued around USD200 billion a month in net new Treasuries and the 10-year Treasury yield rose to 1.7% in May 2021.

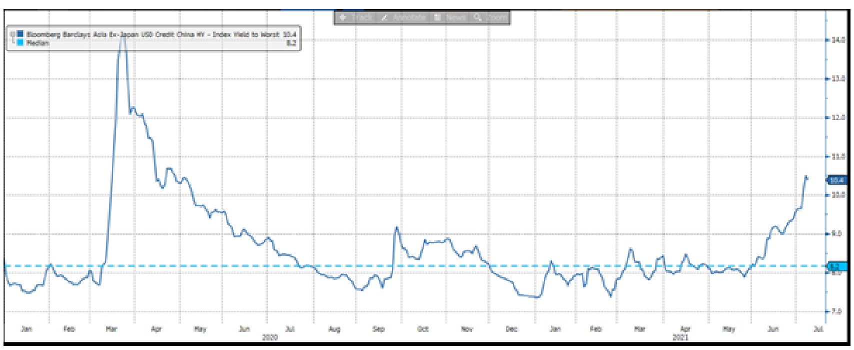
"In US junk bonds, with a thin supply, yield-starved investors flocked to the secondary market and pushed yields to a new all-time low of 3.53%."

Since then, though, issuance has been rather low at just USD78 billion in May and zero since June 25, which could explain why US Treasuries have since rallied to below 1.30%. Monday brings a double whammy of a new 3-year and a 10-year reopening (USD38 billion). We will see what kind of participation there will be at yield of 1.30%.

In terms of spreads, Euro high grade credit spreads approached fresh lows after the ECB signaled it was willing to let inflation run a little hotter. US high grade corporate bond yields fell below 2% this week for the first time since February as Treasuries rallied, while spreads edged wider to around 83 bps. In US junk bonds, with a thin supply, yield-starved investors flocked to the secondary market and pushed yields to a new all-time low of 3.53%. Cruise line Carnival kicked off a tender for its 11.5% bonds sold shortly after the pandemic hit. The company plans to sell new debt to refinance these high coupon bonds and extend the maturity.

Our view: Contrasting this is the picture for China's junk-rated dollar bonds. The last two months have been the worst run since March 2020's pandemic panic, while a repeat of last year's rebound could be much more difficult to achieve.

Figure 3: China High Yield Bond Index



Source: Bloomberg, as at July 9, 2021.

"...preventing systemic risk is an important policy objective for China's policymakers, therefore, even if idiosyncratic risks and high yield defaults will remain elevated, contagion risks will be limited."

China's high yield sector is heavy with bonds issued by property developers, a sector at the brunt of the country's deleveraging campaign, which led to elevated levels of idiosyncratic risks and large underperformance by China B-rated property developers in recent weeks. As usual, preventing systemic risk is an important policy objective for the country's policymakers, therefore, even if idiosyncratic risks and high yield defaults will remain elevated (Tuspark is a recent example), contagion risks will be limited.

Finally, the market for collateralized loan obligations crossed the USD1 trillion threshold globally, a symbolic milestone that signals the maturing of an asset class once considered an esoteric corner of the credit world. CLOs have seen USD81 billion of new issuance year-to-date and demand has been fueled by investors seeking the relatively higher yields offered for securitized products, as well as the benefit of floating rate debt as inflation picks up. Most of the securities composing the USD1.009 trillion of outstanding CLOs have been issued in the US (around 80%).

Week Ahead | Key events to watch for

Next week will be eventful for investors, before we enter a full summer mode.

- **US CPI will be highly awaited**, as it constitutes the first print after the Covid-shock related base effects disappear from the data series.

- **In China, the Q2 GDP reading** will be relevant to assess recent decisions from the Bank of China.

- **On the central bank side,** the spotlight will be on Fed Chair Powell's congressional testimonies, as well as the Bank of Japan's latest monetary policy decision.

- **Earnings season starts this week**, and as usual will be opened by financial institutions.

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