NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Can anything go well in the coming months?

May 22, 2022

This has been yet another week in a row (and in fact, the seventh!) that ended on a negative note for global stock markets. Once again, markets were led down by the US, with a veritable collapse of around 4% on Wednesday, after a double whammy of very gloomy corporate results sank sentiment. Needless to say, the variables are the same, but there was the addition of clear signs of distress arriving from the corporate world: costs are beginning to have a significant impact on company margins. In the first wave of rising commodity prices, while we noted that companies had managed to pass on the costs to the end consumer, we did express doubts about the sustainability of this paradigm.

Highlights

- This week, the S&P 500 index has also officially entered bear market territory, with a 20% loss from its January 3 highs, sending a clear signal to the Fed that the expected tightening might be too aggressive to bear.

- After an extremely weak set of data for April in China, the consequence of the drastic containment protocols implemented by Chinese authorities, and as Shanghai is now progressively re-opening, the PBOC has decided to resume its easing campaign by cutting its 5-year Loan Prime Rate by a more aggressive 15 bps to 4.45%.

- Activity on bitcoin options suggests rising bearish sentiment among investors that are buying protection, as the put/call ratio for bitcoin options reached yearly highs.

- This week, government bonds yields came down, with US Treasuries gaining momentum as a growing sense of angst over the health of the global economy pummeled stock markets. The safe haven bid brought down the 10-year yield to 2.81%, the lowest since late April.

"The US dollar, with its weakness, had initially deluded investors into thinking that equity markets could find support. "

Markets & Macro | Can anything go well in the coming months?

A short-term stabilization may be in the cards.

What was impressive this week was the fact that markets continued to fall without interruption, despite the fact that all indicators of sentiment, positioning, economic growth forecasts and even corporate earnings are now at levels comparable with 2008- or 2000-style economic and financial crises. Moreover, the percentage of investors who expect stagflation, meaning a period of below-trend growth and above-trend inflation, is at its highest since 2008, when oil soared to USD140.

Our view: A novelty in this week's price action came from the performance of the US dollar, which, with its weakness, had initially deluded investors into thinking that equity markets could find support. This was short-lived, however. The Dollar Index depreciated by 1.4%. We are used to seeing an appreciating US dollar accompanying the equity selloff.

The weakness can instead be explained by other factors:

1. First of all, there is the realization that the US macro picture is deteriorating. Over the last few days, US economic data have started to disappoint significantly, starting with the housing market, which is very sensitive to the rise in mortgages and banks' lending. But several surveys of both consumer and business sentiment have also surprised on the downside. And a small sign of a slowdown also came from the labor market, with initial jobless claims that may have reversed the trend.

"...it remains to be seen whether the terminal rate around 3% will be enough to bring inflation under control, and it is understandable to have doubts about this."

2. The rates market is responding to both data and risky asset trends. On the monetary side, futures have already cleared 30 basis points (bps) of Fed Funds rate hikes, while the 10-year has fallen from a peak of 3.10% to 2.79% today. On the subject of rates, it remains to be seen whether the terminal rate around 3% will be enough to bring inflation under control, and it is understandable to have doubts about this.

   But we find it normal in market trends that significant repricing phases on rates, such as this one, occur in "phases" with interruptions and even reversals, allowing time for events to incorporate the new pricing levels and for the economy to adjust. Indeed, it is true that although the Federal Reserve (Fed) has raised rates by only 75 bps to date, financial conditions, driven by forwards, have been doing the rest of the tightening work (starting with the fall in equities which increases the cost of capital and produces a negative wealth effect on consumers).

3. The weakness of US stock indices, and in particular the Nasdaq index. Indeed, one of the reasons why a country in fiscal and commercial deficit was able to betray the macro rules that should see a weak currency was the attractiveness of the capital market to the rest of the world. But the moment technology also 'betrays', it is logical that flows stop. This week, the S&P 500 index has also officially entered bear market territory, with a 20% loss from its January 3 highs, sending a clear signal to the Fed that the expected tightening might be too aggressive to bear.
4. Lastly, positioning. After months of bullishness and speculative buying (buying US dollar was an easy way to hedge against losses on risky assets), this component of the market found itself far too long in the US dollar.

"Conditions are on track, in the sense that it is difficult to think of anything that will go well in the coming months..."

The only (partial) positive news in the week came from China. After an extremely weak set of data for April at all levels (activity, credit demand and trade balance), the consequence of the drastic containment protocols implemented by Chinese authorities, and as Shanghai is now progressively re-opening, the People's Bank of China (PBOC) has decided to resume its easing campaign by cutting its 5-year Loan Prime Rate by a more aggressive 15 bps to 4.45%. The goal is to boost loan demand as consumer and business confidence has been decimated by Covid-related lockdowns and a downturn in the property sector that has seen a string of developer defaults and falling home prices. The same goes for the fiscal authorities, which are launching a huge number of measures and urging local governments to issue bonds in order to finance the stimulus.

We are under no illusions that these measures alone will be enough to lift the local market and reinvigorate the economy, for which it will take a clear signal that the authorities intend to abandon their obsession with the zero-Covid policy. But it has to be said that in an extremely bearish market that is now resigned to losses, it takes little to trigger a notable recovery.

Conditions are on track, in the sense that it is difficult to think of anything that will go well in the coming months... so we think it is legitimate to expect at least a short-term stabilization of markets, although without denying our strategically defensive positioning, out of bonds and still underweight equities despite the small purchase of equities that we executed on discretionary mandates last week. Lastly, Friday night's price action, with a sharp (short-covering driven) rally of 2% into the close for the S&P 500 index, could be a sign of exhaustion preparing the ground for some recovering into the last week of the month (where rebalancing flows should also support equities).

Equities | Don’t chase rallies

Shorted stocks outperform.

“US equities continued their weekly losing streak as earnings results from major US retailers raised fears of consumers pulling back on discretionary spending. ...”

US equities continued their weekly losing streak as earnings results from major US retailers raised fears of consumers pulling back on discretionary spending. The weakness in markets was coupled by declining trading volumes compared with the prior week. European equities also pulled back, but fared better on a relative basis vis-à-vis their US peers. Meanwhile, Japanese stocks had a positive return for the week. Chinese equities rose on the back of the PBOC cutting interest rates to support the property sector.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,261.90	-2.78%	-5.00%	-13.29%
S&P 500	3,901.36	-3.00%	-5.45%	-17.67%
Nasdaq	11,354.62	-3.77%	-7.84%	-27.19%
Euro Stoxx 50	3,657.03	-1.03%	-2.46%	-12.87%
Swiss Market	11,308.98	-2.93%	-6.61%	-9.84%
FTSE 100	7,389.98	-0.17%	-1.79%	1.75%
CAC 40	6,285.24	-0.95%	-2.91%	-10.55%
DAX	13,981.91	-0.33%	-0.82%	-11.98%
FTSE MIB	24,095.00	0.19%	-0.65%	-10.59%
Nikkei 225	26,739.03	1.18%	-0.41%	-6.22%
Hang Seng	20,717.24	4.22%	-3.17%	-11.03%
CSI 300	4,077.60	2.26%	-1.24%	-17.36%

Source: Bloomberg, as at May 20, 2022. Performance figures in indices' local currencies.

Our view: For the past two weeks, we observed aggressive rallies in the heavily shorted names. The lower trading volumes meant that the short interest ratio (which is the short interest divided by the average daily traded value) has been trending higher, despite declines in the short interest as a percentage of free float. This dynamic bodes ill for short sellers who may find themselves caught in short squeezes that are amplified by the low trading environment. This is also bad news for investors who have sought refuge lately in quality and defensive stocks, as these shorted stocks (usually of lower balance sheet quality and/or very high multiples) have started to outperform. We would caution against chasing these rallies as long as the growth and inflation pictures remain hazy/ negative.

“The distribution will prefer developer and pre-attack owners of the token.”

Crypto & Blockchain | TERRA ecosystem (Episode 3)

Bearish sentiment rises on Bitcoin.

After the disastrous collapse that happened last week, it is time to revive the ecosystem, leveraging on the big community. The idea is to create a new Terra chain without the algorithmic stablecoin. The old chain will be called Terra Classic (token Luna Classic - LUNC), and the new chain will be called Terra (token Luna – LUNA). The distribution will prefer developer and pre-attack owners of the token. The decision will be made after a vote among governance token holders, demonstrating how the blockchain is based on the distribution of power.

In the meantime, the Biden administration saw Coinbase’s admission about customers’ vulnerability in a bankruptcy, which was released last week, and will likely call for congressional action to segregate clients’ funds. That type of custodial rule is standard for financial firms, while

crypto exchanges mingle their funds with customers' holdings in the same pot.

Market action: Activity on Bitcoin options suggests rising bearish sentiment among investors that are buying protection, as the put/call ratio for bitcoin options reached yearly highs. Overall, the digital currency is holding after the sharp recovery from the lows of USD25.4k during the collapse of the TERRA ecosystem, when Luna Foundation Guard liquidated all the collateral to try to support the peg.

"Overall, Bitcoin is holding after the sharp recovery from the lows of USD25.4k during the collapse of the TERRA ecosystem..."

Fixed Income & Commodities | Is the worst of the sovereign bond rout over?

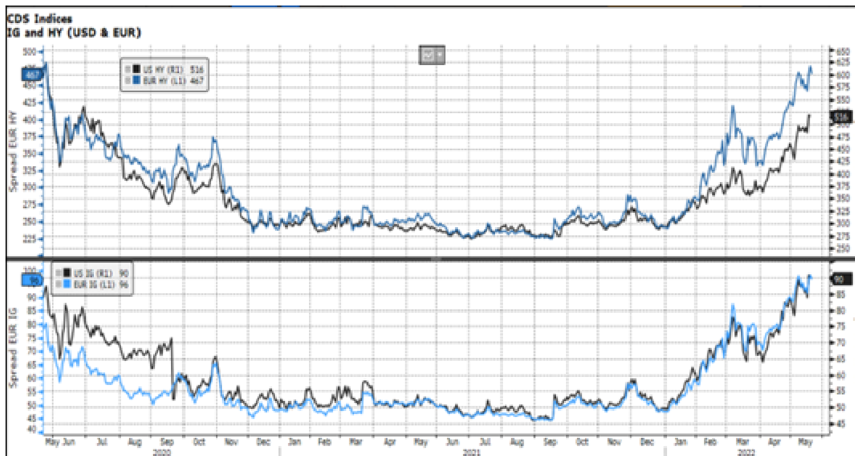
Spread widening set to continue.

This week, government bonds yields came down, with US Treasuries gaining momentum as a growing sense of angst over the health of the global economy pummeled stock markets. The safe haven bid brought down the 10-year yield to 2.81%, the lowest since late April. German 10-year bund yields retreated 10 bps back below 1%. Signs that the economy is losing momentum, financial conditions are tightening, while the Fed is saying policy may go beyond neutral, add credence to the view that the worst of the sovereign bond rout may be over, at least for now.

Our view: Credit has followed equity, with credit default swap prices surging to their highest levels in two years globally, as investors price in more risk that corporate profits will get hit by central banks' rate hikes.

"CDS prices surged to their highest levels in two years globally, as investors price in more risk that corporate profits will get hit by central banks' rate hikes."

Figure 2: Credit Default Swaps Surge



Source: Bloomberg, as at May 20, 2022.

The trend is consistent with US credit investors' positioning. According to a Bank of America investor survey, in May, high yield net positioning dropped to 26% net underweight from 17% overweight in March. Investment grade overweight positioning dropped to 5% from 25% relative to the bank's previous survey in March. The majority of both expect wider spreads over the next three months.

Chart of the week

The Bloomberg Commodity Index is in a typical pattern known as Triangle. This formation is common in a phase of accumulation/decumulation that anticipate an impetuous trend.

“The Triangle formation is common in a phase of accumulation/ decumulation that anticipate an impetuous trend.”

Figure 3: Bloomberg Commodity Index

Source: Bloomberg, as at May 20, 2022.

Week Ahead | Key events to watch for

- **It will be important to follow the release of the minutes from the latest FOMC meeting**, and the various Fed speakers' speeches, to see if the market’s weakness is starting to chip away at their hawkishness.
- **On the data front, preliminary May PMIs from around the world** will be released, and should provide signals on the state of the supply side. In the US, we will see Personal Consumption Expenditures, which is important to understand the real level of consumer spending, adjusted for inflation.
- **On the corporate earnings side**, after the Walmart and Target beatings, more retailers with Macy's and Costco will publish. Hopefully with more negative surprises in store.

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

Please note that any views expressed herein are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions. We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. They may differ from other views expressed for other purposes or in other contexts, and this should not be regarded as a research report. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Investors may get back less than they invested, and past performance is not a reliable indicator of future results