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Weekly Market Flash
Is a correction likely ahead of the year-end rally?

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This week was rather muted for financial markets. Equity indices were weak, with limited losses despite the S&P 500 index falling five sessions in a row. Interest rates halted their climb, mainly due to solid 10-year and 30-year US Treasury auctions, but breakeven rates widened both in Europe and the US – signaling doubts over the transitory nature of inflation, as claimed by central banks. In this context, next week's US inflation report assumes a strong relevance in guiding market sentiment and expectations over the FOMC tapering announcement coming up on September 22th. As we recently mentioned, we wouldn't be surprised to see a sideways or even corrective phase to continue in markets in the coming weeks, in an attempt to consolidate 2021's gains and set the stage for a year-end rally from October.

Highlights

▪ Fed emergency unemployment benefits of USD300 per week expired this week, after about half of US states having already halted payments during the summer.

▪ At the Q&A following the ECB meeting, President Lagarde clarified that the announcement is not a tapering but a recalibration of a flexible instrument such as the PEPP: it was judged that the maintenance of expansive financial conditions was achievable with purchases at a lower pace. The PEPP will continue until March 2022, or however long it takes.

▪ There has also been significant profit-taking in the cryptocurrency world following the start of legal tender for Bitcoin in the state of El Salvador – here, too, we consider the correction to be healthy.

▪ In the trial of Epic Games against Apple, a federal judge ruled in favor of Apple on nine out of 10 counts – however, the ruling is a clear net negative for Apple.

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Markets & Macro | Is a correction likely ahead of the year-end rally?

Signs of normalization begin to emerge.

The Wall Street Journal published an article on Friday that argued that Federal Reserve (Fed) members are looking for an agreement at their next meeting to begin reducing purchases from November onward. According to the paper, Fed Chair Powell may signal to the next FOMC that the process will begin at the November 2-3 meeting. While this is nothing particularly revolutionary, September 22 is not far away – and given the conditional tone used by Powell in Jackson Hole, perhaps expectations of tapering in November have room to strengthen, after markets found some relief in Powell's cautious tone. We previously mentioned that we wouldn't be surprised to see a sideways or even corrective phase to continue in the coming weeks.

Our view: At the same time, it is difficult to find a clear culprit for the weakness seen in equity markets this week. Perhaps we can say that a sense of normality, compared to the huge fiscal and monetary stimulus received in the middle months of the pandemic, is beginning to prevail, making it difficult to enter a new economic paradigm that is no longer characterized by extraordinary financial conditions. A number of events this week served as reminders to investors, including:

- Fed emergency unemployment benefits of USD300 per week expired this week, after about half of US states having already halted payments during the summer. Ending this assistance either reduces consumer demand or increases labor supply in the US economy. Of course, the second outcome would be preferable due to the ongoing "labor shortages" we are hearing from companies, but it is more likely that we will see demand weakness.

“Although both the Fed and the ECB are putting off the plan for as long as possible, without ever clearly saying the word "tapering", the direction is now clear to investors...”

- In the UK, the government announced a number of tax initiatives, which, although minor in magnitude, do not fail to have strong symbolic value in the post-pandemic economic context. In fact, two taxes – National Insurance and the tax rate on dividends – have been raised by 1.25% each in order to rebalance the government's expenditure. While the magnitude of the increase is not significant, it is important to note that the UK may simply be ahead of the curve in normalizing government budgets, in the context of unfavorable demographics, increased health care and spending and pandemic debt accumulation. The UK government had already expressed caution following the end of the most critical phase of the pandemic, and it is welcome that it has given a clear signal that it wants to rebalance public finances – and not without the help of the central bank and inflation, which is also well above target (3.80% year-on-year in July).
- In the US, while it looks likely that the bipartisan infrastructure bill will boost spending by about USD550 billion over the next decade, it remains very uncertain whether the administration can pass a partisan bill of up to USD3.5 trillion in extra spending targeting the poorest. Key Senator Manchin (Democrat) continues to struggle and apparently does not even support half the package. Nancy Pelosi is already beginning to tone down the demands: there is now talk of an unspecified amount, which "will not exceed USD3.5 billion".
- The European Central Bank (ECB) meeting, which had a decidedly dovish tone, highlighted a clear undercurrent theme, namely the gradual tapering of central bank bond purchases (Figure 1). Although both the Fed and the ECB are putting off the plan for as long as possible, without ever clearly saying the word "tapering", the direction is now clear to investors – and while many emerging market central banks have already raised rates in recent months, other developed country central banks in the UK, Australia, New Zealand and Canada have reduced their purchases.
- Regarding the ECB meeting, the most important piece of the statement is when the central bank announces that purchases will be conducted for the next three months at a "moderately lower" pace than in the last two quarters. As the pace between March and September was reported to be "significantly faster" than the first quarter, the message is that not all of the increase would be cancelled. The unanimous decision reflects the improved picture, which is also visible in the updated growth and inflation forecasts. In the Q&A, ECB President Lagarde clarified that this move is not a tapering but a recalibration of a flexible instrument such as the PEPP: it was judged that the maintenance of expansive financial conditions was achievable with purchases at a lower pace. The PEPP will continue until March 2022, or however long it takes, and the ECB has not yet decided how they will manage its expiry. The discussion may take place in December. In any case, they have other tools, including the APP, to continue the support.

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Figure 1: Decelerating Pace of Global Central Bank Bond Purchases

Source: Bank of America.

Chart of the week

The 10-year US Treasury yield is rising toward key resistances. The closing above 1.29% is a strong signal that would imply increasing trend momentum, and consequently the re-start of the reflation trade after a long summer break.

Figure 2: 10-year US Treasury Yield

Source: Bloomberg, as at September 10, 2021.

"While the Court finds that Apple enjoys considerable market share of over 55% and extraordinarily high profit margins, these factors alone do not show antitrust conduct. Success is not illegal."

Equities | Is Apple's ecosystem under pressure?

Ruling is negative for Big Tech.

Major US and European indexes pulled back from all-time highs this week on growth and inflation fears. Defensive sectors – utilities and consumer staples – held up best, while real estate and industrials fared the worst. Small-cap stock indices lagged the large-cap benchmarks, and value stocks underperformed growth stocks. Also, Japanese and Chinese equities extended their gains for the third consecutive week in a row.

Figure 3: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,607.72	-2.11%	-2.06%	14.63%
S&P 500	4,458.58	-1.68%	-1.37%	19.89%
Nasdaq	15,115.49	-1.61%	-0.92%	17.84%
Euro Stoxx 50	4,170.35	-0.75%	-0.60%	19.84%
Swiss Market	12,060.64	-2.36%	-2.82%	15.78%
FTSE 100	7,029.20	-1.51%	-1.09%	12.01%
CAC 40	6,663.77	-0.39%	-0.25%	22.42%
DAX	15,609.81	-1.09%	-1.42%	13.78%
FTSE MIB	25,686.47	-1.45%	-1.24%	17.87%
Nikkei 225	30,381.84	4.30%	8.16%	11.66%
Hang Seng	26,205.91	1.29%	1.51%	-1.45%
CSI 300	5,013.52	3.52%	4.33%	-2.19%

Source: Bloomberg, as at September 10, 2021. Performance figures in indices' local currencies.

"While the ruling is a clear net negative for Apple, it opens the door for a slew of other regulatory questions on what Big Tech can and cannot do with regard to their "walled gardens"."

Elsewhere, on Friday, in the trial of Epic Games against Apple, a federal judge ruled in favor of Apple on nine out of 10 counts. However, the judge also issued an injunction that prohibits Apple from preventing App Store third-party developers from opting to collect payments directly from their app users by "linking out", thus cutting out Apple's 30% take rate. Apple's share price slid by 3.3% on the news.

Some key excerpts from the ruling include: "Having defined the relevant market as digital mobile gaming transactions, the Court next evaluated Apple's conduct in that market. Given the trial record, the Court cannot ultimately conclude that Apple is a monopolist under either federal or state antitrust laws. While the Court finds that Apple enjoys considerable market share of over 55%

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and extraordinarily high profit margins, these factors alone do not show antitrust conduct. Success is not illegal. The final trial record did not include evidence of other critical factors, such as barriers to entry and conduct decreasing output or decreasing innovation in the relevant market. **The Court does not find that it is impossible; only that Epic Games failed in its burden to demonstrate Apple is an illegal monopolist”.**

Our view: While the ruling is a clear net negative for Apple, it opens the door for a slew of other regulatory questions on what Big Tech can and cannot do with regard to their “walled gardens”. We also want to point out that Apple has not yet indicated if it will appeal the ruling, which suggests that a final verdict may be several years away.

At the same time, it’s important to note that like other Big Techs looking to self-regulate ahead of a regulatory crackdown, last year, Apple lowered the take rate to 15% for apps with less than USD1 million in annual sales on the Apple platform. Following Friday’s ruling, the real threat is not whether Apple’s take rate will come under further pressure, but rather how many of the top third-party developers are likely to try to circumvent the Apple take rate by linking directly to consumers. Note that the direct linking process is not frictionless as the user has to opt to leave the convenience of the App Store payment and subscription system to log onto the website of the developer and enter their data and payment information. The process would have to be repeated by the user for every game or app that is created by a different developer. One argument raised by analysts who see a limited impact on Apple is how likely is it that a user will subscribe to a period membership with a certain developer knowing that today’s hottest game is not necessarily tomorrow’s top game. In other words, developers would still have to entice the users/consumers to opt in favor of paying the developer directly, instead of the Apple platform.

According to Morgan Stanley, 20% of Apple’s App Store revenues come from the top 20 developers. If these top developers decided to test out a direct model, this would translate to a low-single digit percentage impact on revenue and maybe mid-single digit percentage impact on profit. Most analyst reports we have seen come to similar conclusions.

The bigger question is whether a multiple compression on the Services vertical’s growth and profitability is warranted given the potential for increased regulatory pressure. One strong argument against this line of thinking is that in the ruling, the judge did not find Apple to be a monopolist under federal or state antitrust laws. In our opinion, while the financial impact of Friday’s ruling may be limited, we believe that the likely extended uncertainty that comes with it will raise doubt in investors’ minds about the strength of the ecosystem’s defenses. Apple will have to make up for the slack by delivering upside from the hardware product cycle.

Week Ahead | Key events to watch for

- **Next week is packed with US macro data**: the highlight will be the August CPI. It will be important to see if the declining trend in inflation will be confirmed, proving the Fed's "transitory" case ahead of the following week's FOMC meeting. Retail sales, industrial production and the University of Michigan's preliminary consumer sentiment index (after its collapse in August) for September will also be of interest, while weekly initial jobless claims will be in focus due to the expiry of federal unemployment benefits.

- **On the political side**, it will be the last campaigning week in Canada ahead of presidential elections, to be held on the 20th of September.

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