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Weekly Market Flash

Markets remain upbeat despite slowdown ahead

January 29, 2023

It's been another (very) positive week for global equities, this time driven by the US market (S&P 500 index was up 2.47%), with technology leading the way (Nasdaq index was up 4.3%). The MSCI World index posted a respectable 2.2% gain, and is up 7.14% for the year. In a way, this is quite a paradoxical dynamic—especially given that it was precisely US economic data that reinforced the softer macro picture. Against this backdrop of a slowing economy, but with the US central bank still intent on raising rates, it is surprising to see the strength and performance of the stock market. But the picture is decidedly complex, and partly counterintuitive—and requires a number of factors to be considered.

Highlights

- Disappointing data came through from the US (the various activity surveys, retail sales and industrial production in December, and GDP and personal consumption expenditures).

- The Bank of Canada decided to pause its rate hike cycle, in order to monitor the lagged effect of the hikes.

- In Tokyo, overall inflation rose by 4.4% versus expectations of 4.1%, while in Australia, inflation was 1.9% quarter-over-quarter versus expectations of 1.6%.

- 30% of companies have reported earnings so far, and projected earnings for Q4 are down 5% year-over-year. However, analysts continue to expect a slight decline for the first half of 2023, but offset by an acceleration in the second half of the year.

- Over the past week, Bitcoin has been outperforming Ethereum—which is odd because, during most risk-on periods for crypto, Ether typically performs better than Bitcoin.

- In the private equity space, fund valuations are top of mind—and expectations are that 2023 will be the year that valuations will fall back to earth.

"On the first reading of Q4 US GDP, half of it came from inventories and government spending—components that will reverse in the first half of 2023..."

Markets & Macro | Markets remain upbeat despite slowdown ahead

But expectations rise for a soft, rather than hard, landing.

This week saw some disappointing data come through from the US—from the various activity surveys, to retail sales and industrial production in December, to GDP and personal consumption expenditures. We also note that on the first reading of Q4 2022 US GDP, against substantial growth of 3% quarter-over-quarter (annualized), half of it came from inventories and government spending—components that will reverse in the first half of 2023, thus favoring a GDP contraction with an unfavorable base effect.

Figure 1: Year-to-Date Performance of Major Indices

Equity	Last Value	Ytd
MSCI World	2,785.84	7.14%
Nasdaq	11,621.71	11.08%
S&P 500	4,070.56	6.12%
DJ Industrial	33,978.08	2.60%
SPX Value ETF	154.46	6.47%
SPX Growth ETF	232.20	8.38%
Nikkei	27,382.56	4.94%
Eurostoxx	4,178.01	10.32%
Swiss SMI	11,332.30	5.62%
FTSE 100	7,765.15	4.26%
Canada	20,714.47	7.13%
Shenzen	4,181.53	8.01%
Hong Kong	22,688.90	14.70%
MSCI EM	1,051.19	9.96%

Bond Indices	Last Value	Ytd
US Inv Grade	110.50	4.81%
US High Yield	76.16	3.44%
Euro Corps	233.20	2.43%
JPM Europe Govies	9,437.06	2.25%
US Treasuries	2,239.40	2.33%
China Aggregate	261.87	2.59%
EMBI Global	795.78	3.58%
EMBI Local	128.77	4.10%

Commodities	Last Value	Ytd
BBG Commodities	111.61	-1.06%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	68.71	-0.17%
Gold	1,928.04	5.70%
Silver	23.60	-1.46%
BBG Brent Crude TR	1,066.09	0.39%
BBG WTI Crude Oil TR	190.12	-0.61%

FX	Last Value	Ytd
DXY Index	1,222.19	-1.96%
Bbg JP ASIA	103.15	1.94%
Bbg JP LATAM	40.95	3.02%
EUR Index	122.33	0.47%
EUR/CHF	1.00	1.15%
GBP Index	632.67	1.58%
EM FX Index	1,701.00	2.44%
JPY/USD	129.88	0.95%
CNY/USD	6.78	1.68%
Bitcoin	22,987.90	38.99%

Source: Bloomberg, as at January 27, 2023. Performance figures in indices' local currencies.

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Our view: Despite the combination of a slowing economy and a hawkish central bank, equity markets remain strong. But there are a number of reasons why:

1. Market positioning, especially vis-à-vis US equities, was very defensive. With the European market (supported by mild weather and low valuations) and Chinese market (supported by the smooth reopening) so strong at the beginning of the year, a catch-up phase is understandable.
2. Since the first phase of the bear market was due to the rise in interest rates and the consequent fall in multiples, in the short term, any news that raises hopes of an end to rate hikes is taken positively. The clear economic slowdown that is now underway, and signs of an easing in rising prices (and a fall in energy prices) are tailwinds to such hopes.
3. As we are objectively close to the end of the rate cycle—the debate around the Federal Reserve (Fed) focuses on plus or minus 25 basis points (bps) of further hikes, whereas in the past months the dispersion of forecasts was much greater—bond market volatility has plummeted, and with it equity volatility. And we know that volatility always moves in the opposite direction to equities.
4. The market is embracing the thesis that we are heading for a soft and not a hard landing. If this is the case, the picture changes, as a soft landing would provide a cushion to corporate profits (they would instead contract—and heavily—in the event of a hard landing). We keep thinking that a hard landing will eventually materialize, as both the rate hikes and the liquidity withdrawal have not fully impacted the corporate and consumer sectors as yet; when the last rate hike will be incorporated, spending and investments should contract, as soft data are already suggesting.
5. The corporate earnings season is not having much of an impact on the market, despite being far from bright. With 30% of companies reporting so far, projected earnings for Q4 are down 5% year-over-year. However, analysts continue to expect a slight decline for the first half of 2023, but offset by an acceleration in the second half of the year, which should provide 4% growth for the whole of 2023. We are therefore still a long way from predicting an earnings recession.
6. It has been the case in the past that markets went up in the final stages of the tightening cycle, with the curves inverted, only to start falling again when the cuts materialized—coinciding with the real hard landing.

“We keep thinking that a hard landing will eventually materialize, as both the rate hikes and the liquidity withdrawal have not fully impacted the corporate and consumer sectors as yet.”

Confirming the positive tone in markets globally, investors focused their attention on positive news over negative news during the week. The (partly expected) decision by the Bank of Canada to pause the rate hike cycle, in order to monitor the lagged effect of the hikes, was seen as a premonitory sign of what the Fed might do the same as early as next week. In contrast, upward inflation surprises in Japan and Australia were not noticed. In Tokyo, overall inflation rose by 4.4% versus expectations of 4.1%, with core at 3% versus 2.9% expected. The International Monetary Fund itself urged the Bank of Japan to allow the 10-year yield to rise further, due to rising inflation risks. It was a similar situation in Australia: 1.9% quarter-over-quarter versus expectations of 1.6%, while year-over-year was 7.8% versus expectations of 7.5% and 7.3% previously.

"The decision by the Bank of Canada to pause the rate hike cycle was seen as a premonitory sign of what the Fed might do the same as early as next week."

Cryptocurrencies | Crypto remains resilient

Expectations of a soft landing support Bitcoin.

Something unusual has been taking place in the crypto market recently. For the past week, we've seen Bitcoin outperforming Ethereum. This is odd because, during most risk-on periods for crypto, Ether typically performs better than Bitcoin.

Our view: So, why is this happening? One possible explanation is that Bitcoin is more liquid than Ether. This means that it's easier for market players to buy and sell Bitcoin, and it's also easier for them to short the currency (put on a market hedge). As investors become more bullish on a US soft landing scenario, they may be unwinding previous bets against Bitcoin, which is causing a short covering rally. This, in turn, is driving up the price of Bitcoin more than Ether. Another thing to note is that the resilience of cryptocurrencies (and other risk assets) has been surprising in light of the short covering we've seen in recent weeks. The volatility of crypto has declined and it's aligning with other similar asset classes.

Figure 2: Crypto Volatility Declines

"...the resilience of cryptocurrencies (and other risk assets) has been surprising in light of the short covering we've seen in recent weeks."

Source: Bloomberg, as at January 27, 2023.

Elsewhere, projects that are worth keeping an eye on are the platforms that enable blockchain networks to connect and scale. These are one of the most innovative crypto projects, after the merge of Ethereum blockchains, and they address one of the biggest challenges facing the crypto industry —the lack of interaction between different projects. For example, Polkadot was created by Ethereum co-founder Gavin Wood, and it's seen the biggest jump in active developers of all major crypto protocols. Another similar blockchain is Polygon which aims to create a multi-chain blockchain ecosystem compatible with Ethereum.

There are many uses of this Blockchain technology, but the partnership with the Indian police in Firozabad has an interesting application in particular. They started using Polygon for reporting crimes. In short, the new portal coming from North India's Firozabad police uses OxPolygon modular blockchain. Once the grievance is registered, the system will generate a unique number for the complainant. Nearby police stations will have a special QR code that will direct complainants toward the grievance form. This involves a process of recording accountable information that's immutable, and not easy to hack, manipulate, or change.

Private Equity | Fund valuations in the spotlight

"...the mismatch between where private market valuations sit, compared not only with public markets but also with where the secondaries market is pricing assets, is a common theme..."

Liquidity is king.

As the market awaits for the fourth quarter's audited and in many occasions outsourced fund marks, the mismatch between where private market valuations sit, compared not only with public markets but also with where the secondaries market is pricing assets, is a common theme these days among LPs. However, it is not clear if the wide discount in secondaries pricing is a function of the abilities of buyers in the market amid a year of record supply, or just explained by simply too high prior NAVs, driven by the changed market conditions.

Our view: The private equity community met in the south of France this week and, as per the initial fresh feedback received from our LP network, the event was more subdued compared to last year´s one held in September. These events always provide a good barometer of market sentiment, and on this occasion fund valuations were top of mind for keynote panelists and attendees, where the consensus was that 2023 will be the year that valuations will fall back to earth. In general terms we agree, as we have been saying previously, that the general trend will be toward fund markdowns although we foresee a wide dispersion among GPs. While former NAVs are likely inflated in many cases, still reflective of past loose financial conditions, we believe the key variable going forward will be liquidity and access to funding at different stakeholders´ levels.

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In that regard and coming back to the initial discussion, secondaries implied discount surely incorporates a part of lower growth prospects and expected return. However, a large part must be attributed to the source of liquidity in the fair price discovery process. The same could be applicable at a portfolio company level. Best in class GPs operating their positions with a safety margin of runway, as long as growth milestones are still on track, are under much less pressure to adjust valuations downward. Oftentimes these managers lift provisions by conservatively cutting valuations by 20-25% in their best performing assets (in the absence of a better proxy) to reflect worsening conditions. At a fund level, two-fold. On the one hand, access to funding for new buyout deals has become a hassle during the last few months. With the syndicated loan and high yield market shut down for the moment, the opportunity is building up for private credit platforms that at the same time are enduring lending conditions. On the other hand, tight new fundraising is shifting the balance of power in LPs favor by acting as an indicator of GPs market validation.

Bottomline, fund managers who have a stronger liquidity position at various levels and who have remained disciplined in their capital deployment activity over the cycle will enjoy much lower volatility in fund prices, while maintaining the ability to raise capital for new funds. In an environment of higher cost of liquidity, in the traditional buyout PE side, we are committed to high scale managers with ample access to funding that provide flexible /creative solutions to fund new deal activity. These days, liquidity is king.

Week Ahead | Key events to watch for

- **On the macro front, there will be meetings of the major central banks**—from the Fed, to the European Central Bank, to the Bank of England.
- **There will be important data releases** including the labor market report in the US and the CPI in Europe.
- **On the corporate side, we enter the heart of earnings season**: Big Tech, the oil majors and key names in the health care sector will be reporting.

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