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Weekly Market Flash

Is good news for the economy bad for equities?

September 19, 2021

The week saw equity markets consolidate, continuing the weakness that began in early September. Despite a seemingly benign inflation figure, interest rates started to rise again, giving strength to the US dollar. This put pressure on all risky assets, including commodities, with precious metals leading. In this environment, we believe it is even more important to maintain the barbell approach across our asset allocation, given that the inflationary picture remains dangerous and uncertain.

Highlights

- In the US, jobless claims rose slightly, but remain at post-pandemic lows, while August retail sales were strong. Meanwhile, the first favorable inflation surprise in seven months was not enough to assuage concerns regarding the temporary nature of the price hike.
- The S&P 500 index closed below its 50-day moving average for the first time since June 18, which was disappointing action after a bullish bounce for the index on Wednesday.
- China Evergrande Group's distress is sending shockwaves through the market for junk debt from the nation, with average prices for Chinese speculative-grade dollar bonds extending declines below 85 cents, the lowest levels since 2012.

Markets & Macro | Is good news for the economy bad for equities?

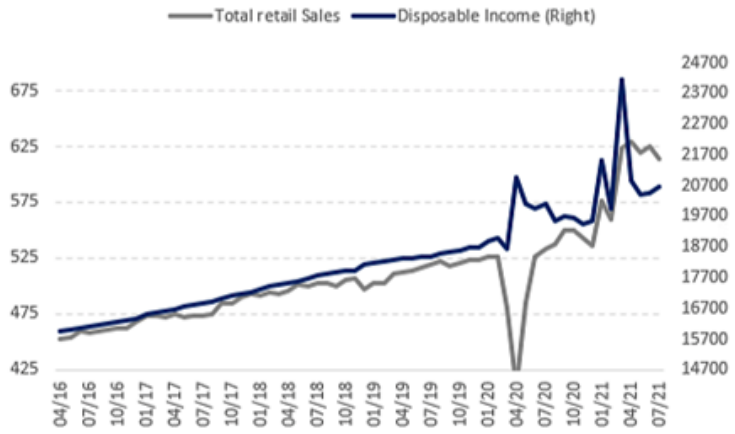
"While it's true that the already weak month of July saw downward revisions, this was not enough to eliminate the strength of the numbers..."

Important to maintain a barbell approach.

US economic data fueled suspicions that the US economy is not in too much of a hurry to slow down. Jobless claims rose slightly, but remain at post-pandemic lows. In fact, the rise was due to a seasonal adjustment, while the total number of claimants, which is relative to the previous week, fell. We also note that emergency subsidies fell because they are expiring in most of the states that still provide them.

August retail sales were strong, with the control group coming in 2.5 points above expectations. While it's true that the already weak month of July saw downward revisions, this was not enough to eliminate the strength of the numbers – which could be down to the effect of the child benefit mailing and the +5.4 in online sales, which seem to indicate that the Delta variant has produced a new increase in goods consumption. Still, the signal that demand remains strong is hard to dismiss. Figure 1 shows the explosion in retail sales, buoyed by government-subsidized disposable income during the pandemic.

Figure 1: Retail Sales versus Disposable Income



Source: Bloomberg, as at September 17, 2021.

Looking over at inflation, the first favorable surprise in seven months was not enough to assuage concerns regarding the temporary nature of the price hike. In fact, the headline figure came out 0.3% versus expectations of 0.4%, and the core figure was 0.1% versus expectations of 0.3% (year-on-year 4% versus expectations of 4.2%). However, the details of the figure do not offer all that much reassurance that inflation is temporary in nature. In fact, it was the "reopening" or Covid-sensitive components such as restaurants, hotels, airline tickets and car rentals that weighed on the "core" number. As a result, the slowdown in prices seems more related to the August impact of the Delta variant, and as such (hopefully) transitory, while the more stable components continued to rise.

"The surprising strength in US data has had the paradoxical effect of increasing pressure on equity markets – "good news for the economy is bad for equities"..."

And in Europe, inflation has also become a hot topic, following the price spike in the energy sector – particularly in natural gas. Governments' efforts to prevent inflation from becoming a problem for purchasing power are generally understood to be taking root. Various resolutions have been drawn up by European countries. For example, in France, the government has agreed to pay certain categories a EUR100 energy voucher. In Italy, the government has budgeted as much as EUR3 billion to contain the increase in tariffs, and in Spain, too, the debate has been heated.

Our view: The surprising strength in US data has had the paradoxical effect of increasing pressure on equity markets – "good news for the economy is bad for equities" – ahead of next week's FOMC meeting. Indeed, after the disappointing payrolls and consumer sentiment data in August, coupled with Powell's extremely dovish testimony in Jackson Hole, analysts had postponed the tapering announcement by two months until the November meeting. After the latest developments, however, it is more than possible that the announcement will be made as early as next Wednesday, which would remove one of the key elements of this equity rally – namely the extreme liquidity injections by central banks, led by the Fed.

At the same time, there is not much positive news from Congress on the fiscal front. Bloomberg reports that the approval of Biden's tax package is likely to be delayed by weeks, if not months, due to disagreements among the Democrats over how to fund it.

Nonetheless, we believe the medium-term outlook for the equity market remains moderately constructive, based on two key assumptions: 1) the absence of viable alternatives in the investable assets landscape; and 2) a still favorable economic growth environment for the months ahead, as evidenced by this week's economic data. In terms of asset allocation, we believe it is even more important to maintain the barbell approach, as the inflationary picture remains dangerous and uncertain. On the one hand, there are extremely short duration assets, or companies with strong balance sheets, which can benefit from rising commodity prices. On the other hand, long duration assets such as growth companies and crypto assets, or Big Tech, should benefit as a "place to hide" if Covid were to return as a dominant theme in the coming months.

"In terms of asset allocation, we believe it is even more important to maintain the barbell approach, as the inflationary picture remains dangerous and uncertain."

Chart of the week

The S&P 500 index closed below its 50-day moving average for the first time since June 18. It was disappointing action after a bullish bounce for the index on Wednesday. In the last few months, we saw strong pullback at this level, mostly confirmed by the bottom, with the RSI at 40. However, prior to this extraordinary rally, the level at which the index was considered as oversold was at 30. The next supports where further dip-buyers can appear is at 4400/4350 area.

Figure 2: S&P 500 Index

Source: Bloomberg, as at September 17, 2021.

Equities | Fireside chat with Charles Gave

This week we had the pleasure of welcoming Mr. Charles Gave to our office, co-founder (with Anatole Kaletsky) of Gavekal, one of the most successful and respected independent research boutiques in the financial world. We took his presentation as an opportunity to list the main points of his ideas, which are decidedly extreme and out of the mainstream – and offer our comments on some particularly strong statements.

"The lack of adequate yield in the traditional asset classes is pushing US and European investors into equities at multi-year allocation highs despite their unease about the economic outlook."

- *The strategic definition of 1)* ***a contract*** *(buying debt – lending capital or "renting money") and 2)* ***equity*** *(giving money away against a stake in a company).*

Our view: (VT): This is a nice definition. It prepares the ground for his analysis, since very often investors do not differentiate between the two asset classes in their analysis. One can be constructive on equities in a country, while having opposite views on government or high grade corporate bonds. High yield bonds should instead be associated to equities in this framework.

(KK): It's been our experienced that most portfolio problems tend to stem from ignoring the relative ranking of asset classes across the risk/reward spectrum. The lower interest rate has muddied the picture for most investors, causing them to take excessive risk within their portfolios.

- *It is totally irrational to enter a* ***contract*** *with US or EU governments (and corporates indirectly). The opposite applies to China.*

Our view: (VT): I totally agree. This is a theme we've been riding in our asset allocation for the past year. There is no reason to hold fixed income instruments with negative yields (in nominal or real terms), while the opposite applies to China, where positive yields and a stable and appreciating currency prevails. Further, as Charles said, "if China wants to really compete with the US dollar, they need to build a very deep, liquid, open government bond market to offer a safe harbor to all their trading/investors partners to park the CNY".

(KK): TINA ("There Is No Alternative") is a term that's growing is use lately in developed markets, in relation to equity markets. The lack of adequate yield in the traditional asset classes is pushing US and European investors into equities at multi-year allocation highs despite their unease about the economic outlook. The opposite is true in China, thus causing the equity markets of the US and Europe to decouple from Chinese equity markets.

"The divergences between North and Southern interests should increase with higher inflation."

- *In the West, one can buy equities, but with very short embedded duration (due to the high risk of yields rising and hitting valuations of growth companies). Oil-related companies are the best buy in this environment, as they should benefit from the silly policy of limiting extraction of the past three to four years.*

Our view: (VT): This is an interesting concept: any investment has an embedded duration (in terms of sensitivity to rates, given by the cashflow profile of the investment). So, I agree on the fact that if we're entering a period of higher inflation, short duration assets should be preferred!

(KK): We are constructive on oil companies in the medium-term. A lack of capex spend over the past decade has put a cap on global output levels. While Covid lockdowns still present a short-term headwind, we see the high free cash flow yield as supportive for remaining in the trade.

- *In Europe, especially in Nordic countries, there is a new risk associated with the European Central Bank's compression of yields (often negative): pension plans are being underfunded, since no sufficient yield is available to serve pension liabilities. Avoid big and old companies with long history and high pension burdens.*

Our view: (VT): This is an underappreciated problem that I think could become a major theme in the long term, and also one of the reasons why we prefer US markets to Europe. The divergences between North and Southern interests should increase with higher inflation.

(KK): This risk has always been in the back of our minds. That being said, the strong performance of equity markets has narrowed the underfunded status of many of the defined benefit plans. Nonetheless, we consider this to be a source of balance sheet risk that we'd rather avoid unless the company's fundamentals are sufficiently strong to overcome pension losses.

- *Tail risk (low probability) is inflation staying high with high debt levels. Portfolio insurance is via commodities, including gold.*

Our view: (VT): This is a simple concept, but uncontroversial. Precious metals are under pressure these days due to the tapering attempt by the Federal Reserve, but the trend and the fundamental case remain.

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- *The best strategy for managing money in Asia today: stay long RMB government bonds (with a positive real yield – as it was in Germany back in the day) and buy stocks in peripheral countries when local governments make silly moves, generating panic and selloffs (as it happened in Europe, with Italy, Spain or France).*

Our view: (VT): While this is an interesting concept, he made it a bit too easy. In "real" portfolio management, buying into a crisis is not that easy.

- *Less bullish on Chinese stocks as the government doesn't want and need foreign stock investors anymore, but wants to build credibility as a financial center and part of the reserve system. Hence China will guard currency stability and positive (real) rates. See RMB denominated commodity futures market as sign for their ambition.*

Our view: (VT): The recent crackdown on many economic players totally proves this point.

(KK): Social stability has always been the overarching goal of the party. We see no signs of the party looking to abandon equity markets as a mechanism for transferring wealth. The regulatory crackdown is a response to monopolistic behaviors that were created by unchecked capitalism. This shouldn't be confused with the role of equity markets in the eyes of the party. President XI Jinping's announcement on September 2 that China will set up a stock exchange in Beijing for SMEs supports our view that equity markets still play a critical role in China's financial system.

"We see no signs of the party looking to abandon equity markets as a mechanism for transferring wealth."

- ***On France:*** *the new fragile country in the EU, while Italy seems to be doing better. Huge there is a budget deficit, increasing government debt, a high current account deficit, an overwhelming state presence in the economy and (consequently) low productivity. A very divided society and a political leadership with no backbone.*

Our view: (VT): I tend to agree on the preference for Italy relative to France, but, once more, a bit too extreme. Experience tells us that being so extreme does not pay much in the investment world. Further, central banks are there to avoid such a crisis, and so far they proved their ability to achieve their goals, from the GFC to the pandemic.

Fixed Income & Credit | The risk of Evergrande

Will the damage be contained?

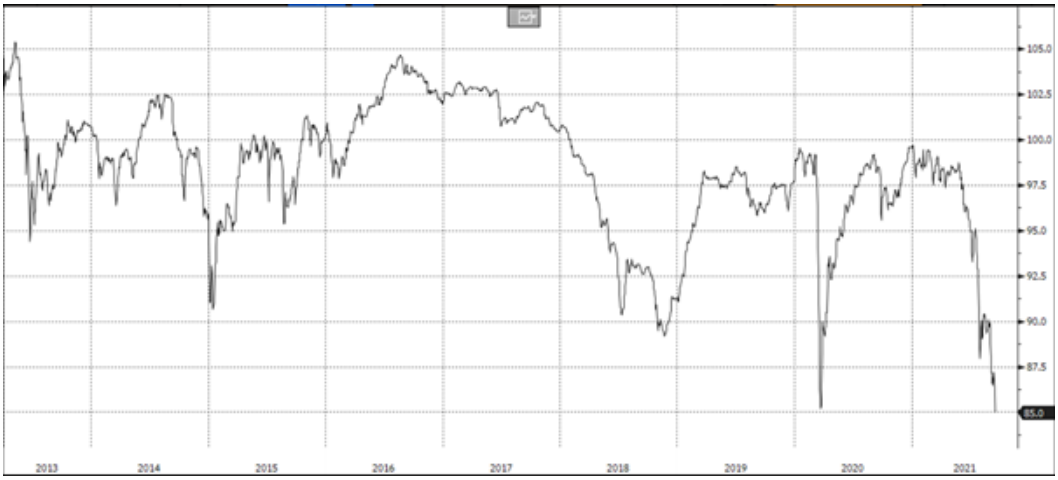
This week the primary market continued at a fast pace both in Europe and in the US. In general, issuance was well absorbed by investors, with book orders almost three times covered on average. In investment grade, financial companies accounted for nearly 70% of sales. Three of the top six US banks – Bank of America, JPMorgan and Morgan Stanley – brought riskier deals with longer maturities to attract an investor base desperate for yield.

The cryptocurrency trading platform Coinbase entered the US junk-bond market with orders of more than USD9 billion for a USD2 billion offering. The bonds priced even lower than guidance set by dealers, leaving little room for upside in secondary trading. The notes traded at 98.50. Finally, in Europe, a rush to secure ethical debt has also helped spur the deal deluge in ESG deals.

Elsewhere, China Evergrande Group's distress is sending shockwaves through the market for junk debt from the nation, as worries grow about its impact on other property firms and the broader economy. Average prices for Chinese speculative-grade dollar bonds extended declines below 85 cents, the lowest levels since 2012, according to a Bloomberg index.

"Average prices for Chinese speculative-grade dollar bonds extended declines below 85 cents, the lowest levels since 2012..."

Figure 3: Chinese Speculative-grade Dollar Bonds



Source: Bloomberg, as at September 17, 2021.

At the same time, UBS published a report titled "Is Evergrande a risk for global financial markets?". First, for the Chinese property sector, the offshore bond market consists of total debt at around USD209 billion, about 70% of which is high yield rated. The total liability of the Chinese property sector is close to USD4.7 trillion. Therefore, the offshore bond market only accounts for 4.5% of total financing for the sector. Evergrande Group's total liability size is around USD313 billion, which is about 6.5% of the total liability of the Chinese property sector. In terms of total offshore bonds outstanding, Evergrande Group has roughly USD19 billion, which is equivalent to roughly 9% of the total offshore bond market and 12% of the total high yield offshore bond market. Other high beta B-rated property developer names make up a further 12.5% of the total high yield offshore bond market.

Second, in case of a full liquidation, instead of an orderly restructuring (base case) the potential contagion emanating from a full liquidation could radiate via three channels:

- Investors getting "extremely low" recovery values (less than 25%-30%), leading to a loss of investor confidence in the broader property sector, the Asian junk bond market and the broader Chinese financial assets.
- Banks and non-banks with large exposures to Evergrande could potentially go under or be forced into restructuring. After all, more than 130 banks and over 120 non-banking institutions have exposure to Evergrande.
- Keepwell agreements not being honored. Keepwell should protect foreign bondholders in case the mainland company runs into financial trouble, but they are basically a "gentlemen's agreement," whose enforceability remains unclear, and a potential violation will force ratings agencies to recalibrate their rating to the downside.

"In this case, the damage seems likely to be confined much more to the domestic financial system than the US crisis was."

Our view: Over the years, China's property sector's upcoming meltdown has been a long-standing favored macro theme. On the other side, there was a time when we believed that the US subprime crisis would be well-contained, and we were wrong. If Evergrande goes under, surely it will leave some nasty consequences elsewhere.

That's quite a conundrum for Chinese authorities, who will try to square the circle with a government-supervised agreement that on the one hand ensures Evergrande delivers the homes and pays the suppliers, and on the other hand allows the bondholders to see some of their money back. In this case, the damage seems likely to be confined much more to the domestic financial system than the US crisis was.

Week Ahead | Key events to watch for

- **It's all politics and central banks in the coming week.** The Fed's decision on Wednesday will be the main highlight, with market expectations having adjusted for a hawkish shift in the past few days. A tapering announcement should consequently not be a shocker.

- **There are also many other central bank meetings** scheduled for this week, but all in the shadow of the Fed (including the Bank of Japan and the Bank of England, alongside a number of emerging markets central banks in Turkey, South Africa and Brazil).

- **Canada's elections will take place on Monday,** while the German election will take place on September 26.

- **On the data side,** the September flash PMIs will be published in Europe.

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