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Weekly Market Flash

Preparing for global tightening

September 26, 2021

Stock markets, following a soft close on Friday last week, started this week in panic mode – driven by the financial debacle of China's Evergrande. Some went so far as to evoke the scenario of a new Chinese Lehman, with potential international financial contagion and a significant economic and social impact on China. However, markets stabilized early, as early as Tuesday, partly thanks to some reassuring signs of no contagion risk and the occasional liquidity injections from the People's Bank of China (PBOC) into the local financial system. In addition, there was the realization, which we share, that there are other key driving factors for Western markets at the moment.

Highlights

- The September FOMC statement and Fed Chair Powell's press conference confirmed that a November taper announcement is very likely, while the conditions for reducing the pace of US Treasuries and mortgage securities is not fully in place, but it is close.

- PMIs published in Europe and the US were disappointing, confirming that economic growth peaked in the middle of the summer and is now settling at lower, but still solid, levels.

- Recent earnings releases and guidance changes suggest that tech valuations' treadmills are running faster, while supply chain disruptions are hitting earnings and the outlook.

- The Evergrande saga continued this week with financial regulators ordering the company to focus on completing unfinished properties and repaying individual investors, while avoiding a near-term default on dollar bonds. In term of contagion, the effect has been contained to Chinese high yield bonds.

"...unless there is a shocking piece of news, we are heading for a global tightening."

Markets & Macro | Preparing for global tightening

Taking a constructive, but cautious, stance.
The week was packed with economic data and central bank actions, starting with the Federal Reserve (Fed). Overall, having had so many monetary policy decisions, we can draw a fairly clear-cut balance (with a few minor exceptions): the signal is clear and strong, and we are moving toward a very gradual but inexorable normalization of balance sheets, and then of interest rates. The statements by the Bank of Australia, the Bank of Norway – which has also raised rates by 25 basis points (bps) – and the Bank of England all point in this direction.

Our view: While the caution to which we have become accustomed to during the pandemic has not been absent, the need to normalize monetary leverage is crucial. And this seems to be independent of the level of economic growth, the labor market and inflation itself. So, unless there is a shocking piece of news, we are heading for a global tightening.

For example, the September FOMC statement and Fed Chair Powell's press conference confirmed that a November taper announcement is very likely, while the conditions for reducing the pace of US Treasuries and mortgage securities is not fully in place, but it is close. The surprises came from two fronts: the pace of tapering should be much faster than the previous experience in 2013, and the end of the tapering process should also take place within six months. But even more surprising was the direction of the interest rate forecast presented in the dot plot. Like in the previous meeting, no one expects a rate hike this year, but the Fed is now evenly split for 2022 – with nine policymakers projecting no rate hikes, while nine forecast at least one hike. The big change concerns 2023, with the median short-term target at 1.0% for the end of the year (versus a prior estimate of 0.625%).

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The interesting part we picked up on in the message, which is not surprising as it fits perfectly into the current debate in the markets, is that economic growth expectations have not been adjusted upward in the face of rising rates. Indeed, 2021 growth expectations were downgraded to 5.9% versus a prior estimate of 7.0%, with very slightly faster growth in 2022-23. On the contrary, the inflation forecast for this year was raised to 4.2% versus a prior estimate of 3.4%, but with almost no change to inflation forecasts for 2022-23 (2.2%).

Elsewhere, on the economic data front, PMIs published in Europe and the US were disappointing, confirming that economic growth peaked in the middle of the summer and is now settling at lower, but still solid, levels. This is the second month of decline in activity in a row, and the downsizing is quite pronounced, although levels were high and therefore activity rates are still robust. Markit (the provider of the series) spoke of peak demand, and the impact of bottlenecks, noting that price indices point to accelerating and the highest rises in 21 years.

At the asset allocation level, we therefore remain constructive but cautious for the coming weeks. The deterioration in the inflation/growth mix inevitably leads to greater volatility in the market, and consequently a lower risk tolerance – especially for retail investors, who have missed out on flows in this corrective phase. In addition, we are heading into earnings season for the third quarter, where variables related to supply chain difficulties could show up in both results and growth projections. Therefore, we would be surprised if indices once again comfortably returned to previous highs before a period of consolidation – and possibly further cleansing of speculative positions. But let's also remember that the level of economic growth is still absolutely positive, and that above all, the consumer remains structurally very healthy thanks to the recovery of the labor market and a solid balance sheet, due to a strong wealth effect from property and financial markets and an extremely low cost of debt (negative in real terms). In this context, it is difficult to envisage more than a correction in equities!

A special mention goes to the US tech sector, whose performance is a key variable in everyone’s asset allocation. The extraordinary performance of tech stocks and the rich valuations give investors an unavoidable sense of fear. The recent Chinese crackdown on their equivalent Big Tech companies (and their collapse) reinforced this tension. And price action in the Nasdaq has also been disappointing and volatile recently. This notwithstanding, we admit we hesitate to embrace such fears. Singling out the key drivers of growth stock performance, we don’t envision elements for an imminent collapse:

“We are actually reassured by the Fed’s new stance. A central bank more prudent toward inflation should be highly welcomed by investors…”

1. The coming earnings season should still prove favorable for tech stocks. While earnings disappointments could come in the form of higher labor and/or material costs due to shortages and inflation, and also in the form of lower revenues caused by supply chain disruptions, this should largely impact other names more than Big Tech.
2. Regulation risks (China style) should be very low, since it is not in Western economic culture, and the bipartisan agreement should be found in the coming mid-term election year.
3. We are actually reassured by the Fed’s new stance. A central bank more prudent toward inflation should be highly welcomed by investors, since the risk at this point is an excessively expansionary monetary policy with rising inflation. As we learned, the adverse consequences to growth stock valuations from an uncontrolled rise in long rates, an “ahead of the curve” central bank is welcomed – and let’s remember, we’re still talking of zero rates for the next 12 months, in a context of positive growth!

Equities | Energy stocks outperform in wild week

Supply chain disruptions hit earnings.

Major global equity markets ended a wild week that started with a sharp sell-off on Evergrande contagion fears. By mid-week, stocks rebounded following a well-balanced Fed statement on tapering and on the back of the PBOC’s liquidity injection. During the week, energy stocks outperformed within the EuroStoxx and S&P 500 indices by a wide margin. Financials also performed strongly, boosted by rising yields. Utilities underperformed across the board.

Reopening stocks, including airlines and cruise operators, made material gains as negative news around the Delta variant receded. Carnival reported a wider-than-expected Q3 loss, but maintained a bullish tone on 2022 bookings. Meanwhile crypto-related, stocks such as Nvidia and Square, came under pressure on Friday following the PBOC's announcement to deem all crypto transactions illegal.

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Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,798.00	0.62%	-1.50%	15.28%
S&P 500	4,455.48	0.52%	-1.40%	19.86%
Nasdaq	15,047.70	0.03%	-1.35%	17.34%
Euro Stoxx 50	4,158.51	0.76%	-0.79%	19.61%
Swiss Market	11,817.20	-0.89%	-4.69%	13.56%
FTSE 100	7,051.48	1.27%	-0.76%	12.38%
CAC 40	6,638.46	1.15%	-0.52%	22.08%
DAX	15,531.75	0.27%	-1.92%	13.22%
FTSE MIB	25,968.84	1.28%	0.12%	19.49%
Nikkei 225	30,248.81	-0.82%	7.69%	11.17%
Hang Seng	24,192.16	-2.92%	-6.24%	-8.98%
CSI 300	4,849.43	-0.13%	0.93%	-5.37%

Source: Bloomberg, as at September 24, 2021. Performance figures in indices' local currencies.

Our view: Recent earnings releases and guidance changes suggest that tech valuations' treadmills are running faster, while supply chain disruptions are hitting earnings and the outlook. In particular, there are four key companies we're paying attention to:

- Adobe reported Q3 earnings on Tuesday which beat the consensus estimate. Despite the solid results, the stock price lost 3.6% as investors had hoped for a wider beat. Analysts' earnings and price target upgrades following the earnings release fell on deaf ears with valuations becoming even more challenging post a roughly 25% year-to-date rally.
- Salesforce.com, a stock the market penalized for the expensive Slack acquisition, lifted its revenue guidance, sending the share price up around 10% over the following three days. The self-help story and the integration of Slack is proving to work, forcing analysts to raise their estimates and upgrade their views on the stock.
- Nike's revenue guidance reflected the negative impact of supply chain disruptions in Vietnam and Indonesia due to Covid-related lockdowns. Market fears were confirmed on the earnings call, sending the share price down roughly 7% on Friday and spreading to other footwear stocks like Adidas, Puma, Sketchers and Crocs. This is probably the first time we've seen a major consumer discretionary name adjust its guidance downward to reflect the negative impact of supply chain problems (we had a glimpse of the problem on the On Holding IPO roadshow).
- FedEx's share price fell as supply chain problems and the labor shortage led to the company missing sales and earnings forecasts. The company also lowered its guidance while reiterating that it will hike shipping rates.

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Fixed Income & Credit | Limited contagion from Evergrande saga

Chinese IG market holds steady.

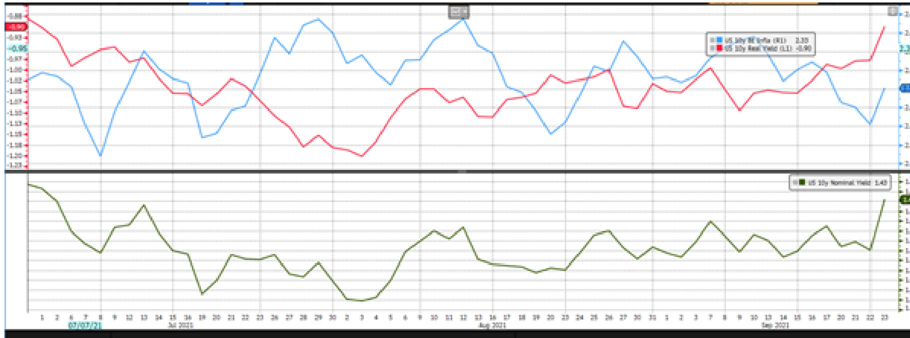
This week, apart from Turkey's central bank that unexpectedly cut its rate despite accelerating inflation, has seen some central banks start to use monetary tools in an attempt to control inflation. First, and as mentioned earlier, the Fed meeting was on the hawkish side. In June, there were no rate hikes forecasted until 2023, but now six members see a 25 bps raise next year and three members see two such hikes. Second, Norway delivered the first post-crisis interest-rate increase (from zero to 0.25%) among economies with the world's 10 most-traded currencies – and officials signaled an accelerated cycle of hiking to come in response to a robust

rebound from the pandemic. Finally, the Bank of England meeting saw its members clearly increasingly worried about inflation, and the market reappraise rate hikes. Prior to the meeting, markets were pricing the first 15 bps move in May 2022, but now the timing of the first hike is brought forward to February.

"Yields on 10-year US Treasuries were up 13 bps to 1.43%, with both higher real rates and inflation breakeven driving the advance."

Overall, yields on 10-year US Treasuries were up 13 bps to 1.43%, with both higher real rates (7.9 bps blue line) and inflation breakeven (4.9 bps red line) driving the advance. US 10-year yields have been trading in a roughly 10 bps range for the last month, before breaking out higher.

Figure 2: 10-year US Treasury Yield



Source: Bloomberg, as at September 24, 2021.

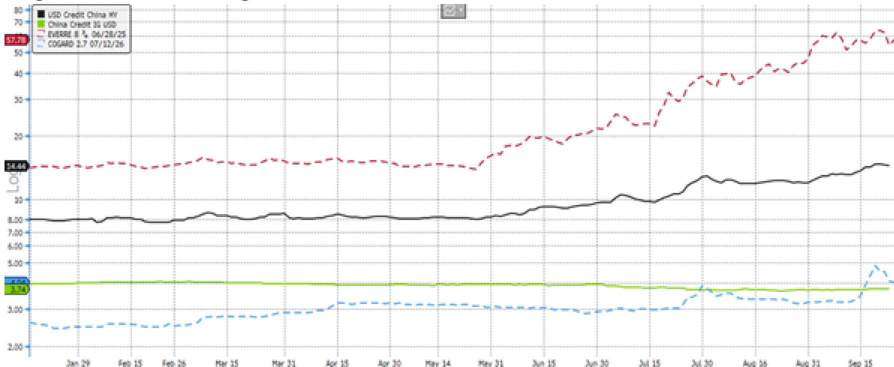
Elsewhere this week, US high-grade corporate bond sales followed an on-and-off pattern as the market navigated the global selloff and the Fed's meeting. Weekly supply was at USD14.45 billion, while the spread on the BB US Investment Grade Corporate Index rallied 2 bps to close at +84, the tightest in over three months. The US junk bond market has seen its busiest week since mid-August with borrowers poised to sell about USD14 billion as yields continue to hover far below 4% and spreads are below 300 bps. Meanwhile, Europe's primary market remained busy with over EUR38 billion of bonds offered. Among the highlights were France's La Banque Postale, which sold EUR750 million of perpetual AT1 notes with a 3% coupon – the lowest ever for a sale of the securities in euros.

"The fact that Beijing finally told local governments to prepare for Evergrande's potential demise has perhaps had a first calming effect."

Finally, the Evergrande saga continued this week with financial regulators ordering the company to focus on completing unfinished properties and repaying individual investors, while avoiding a near-term default on dollar bonds. However, there was no indication that officials offered financial support to the company. Chinese authorities bluntly told major lenders not to expect repayment of interest on bank loans due this week. Earlier in the week, and concerning a separate interest payment on a local bond, Evergrande had issued a vague statement about "resolving" that CNY232 million (USD36 million) coupon due on September 23. But that filing didn't specify how much interest would be paid or when. Moreover, the lack of any concerning a USD83.5 million interest payment due September 23, on a dollar bond, adds to the uncertainty surrounding the developer's struggles.

Our view: In term of contagion to other market segments, measured by yield, the effect has been contained to Chinese high yield bonds (black line), while in the investment grade segment (green line), there has been no effect so far (Figure 3). Even among issuers in the same property developers sector, higher quality names such as Country Garden have held steady for now. The fact that Beijing finally told local governments to prepare for Evergrande's potential demise has perhaps had a first calming effect. "Everything Evergrande and I have belong to the party, the country and the people," said the chairman Hui Ka Yan, in a 2018 speech. Well, ominous words that may soon become reality!

Figure 3: Chinese High Yield and Investment Grade Bonds



Source: Bloomberg, as at September 24, 2021.

Chart of the week

The move up in the US 10-year yield was a rare three standard deviation shift, and there have only been 16 such actual swings in the last five years. Technically, the 50% Fibo's retracement of this year's move was a strong resistance, as it was also the 50-days moving average. Both the supports held well after the summer, and now it is at the top of the range. The next resistance is at 1.53.

Figure 4:

Source: Bloomberg, as at September 24, 2021.

Week Ahead | Key events to watch for

- **In a limited data week**, the focus will be on the flash CPI for the Eurozone.
- **Politics will take center stage**, with elections in Germany on Sunday and the first indications of the colors of the coalition that will lead the country in the next legislature.
- **In the US, the deadline for government funding will expire** – so a solution, likely at the last minute, will be found in Washington, perhaps along with a clarification of the infrastructure plan that should also be approved on a bipartisan basis.

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