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Weekly Market Flash

Getting used to volatile markets…

March 13, 2022

It was another stormy week, which ended with moderate gains for European stock markets. The Eurostoxx 50 index was up 3.7%, in a rare moment of outperformance against the S&P 500 index, which ended the week down 2.8%. In our view, the origin of the recovery is all in the violent overhangs, after the previous week had seen losses of over 10 percentage points, with record outflows in search of safe havens such as gold and cash – but also energy, which at this stage is being used as "insurance" against equity losses.

Highlights

▪ The effects of the ECB meeting pushed yields on European government bonds up, with the Bund at 0.26% and further widening of peripheral spreads with the BTP 10-year spread at 162 bps.

▪ US Treasury yields went up 20 bps for the week against a backdrop of further inflation increases (year-on-year CPI was up to +7.9%, the highest in 40 years) and the approaching of the Fed tightening campaign.

▪ Following the US and UK bans on Russian oil, oil prices reached a record level of USD139 per barrel.

▪ Confusion reigns over Russian bonds, as payments to foreigners were halted under a set of Russian capital controls designed to insulate the economy from sanctions triggered by the invasion of Ukraine.

▪ The Biden administration finally revealed the digital assets' roadmap for the US. This is a historic step for the policymaking process and subsequent adoption to a broader audience of institutional investors.

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Markets & Macro | Getting used to volatile markets…

Rate hikes back on the cards.

This week, what triggered the short-covering phases were some opening signals from the leaders of the battling countries, where we find Zelensky's willingness to compromise more credible, and Putin's more illusory, given the current balance of power. The headlines attributed to Putin on Friday – "certain positive shifts in talks with Ukraine" – which came just before the weekend when the siege of Kiev is starting, have in fact deluded European markets in the morning, while in the evening, the US began to fall again in view of the uncertainty of the weekend's events.

Our view: The knowledge that the G7 is almost certainly finalizing new sanctions against Russia is certainly not helping sentiment and recovery prospects. Compared to the previous week, the balance of this week showed a greater willingness to compromise on the Ukrainian side and a slightly less aggressive tone on the Russian side. Diplomatic attempts are multiplying, but a real peace agreement will probably have to pass through a deterioration of the military framework, and wait for the full impact of the sanctions to wear down Russia to a significant extent – and also for Putin to make some concessions compared to his initial demands. We believe this will take a matter of weeks, rather than days. At the same time, the new regime of high volatility now seems to be firmly established in financial markets, and between central bank tightening, commodity inflation (especially energy) and geopolitics, it seems clear that we will have to get used to the idea.

On the macro front, however, unfortunately we cannot find much relief, especially on the subject of inflation and the monetary response from central banks. Despite the shock of the war, which should typically generate expectations of monetary easing to support economies and markets, expectations of a Federal Reserve (Fed) rate hike in 2022 have returned to where they started. The start of the conflict had in fact generated such a shock that rates had fallen all along the curve, while the explosion in commodity prices (not only energy, but also metals and food) has brought rates back to where they started, thus increasing the risk of economic slowdown through the double blow of a higher cost of money and a lower purchasing power due to inflation.

"While the economic slowdown is now firmly established (and thus embedded in the market), the risk is that the next shoe to drop will be corporate earnings expectations..."

While the economic slowdown is now firmly established (and thus embedded in the market), the risk is that the next shoe to drop will be corporate earnings expectations, which could come in the next few weeks, coinciding with the release of Q1 2022 earnings. Indeed, it is strange that against a backdrop of stimulus withdrawal and inflationary impacts on demand, corporate profits and margins are not impacted. The market continues to expect S&P 500 earnings to rise by 7.5% in 2022, more than 9% in 2023, and margins to expand beyond the 12-13% mark over the next two years (given that we are already at the high end of the historical range for corporate margins, typically between 7% and 12%).

Looking at Europe, the only solace to be found is in the price action and cheap stock market valuations. With a drop of 20% from the highs, we can say that the risk of an economic recession (typically associated with a 25% drop in the market) is practically fully discounted.

The European Central Bank (ECB) on Thursday made yet another turnaround, setting an end date for net APP purchases despite the uncertainty arising from the war in Ukraine. Following a press conference in which President Lagarde sought to offset the decidedly hawkish interventions, the effects on rates, especially of peripheral countries, were marked, with rises in the region of 20 basis points (bps). Net purchases of APPs will be phased out, from EUR40 billion in April, to EUR30 billion in May and then EUR20 billion in June.

As far as interest rates are concerned, no clear indication has been given by the central bank, but the market continues to expect the first hike in December this year, while we will have to wait until the beginning of 2023 to see the end of negative rates. The updated macro forecasts have been greeted with understandable scepticism by the market, as they have been revised down very little from their December valuations(!). According to the ECB, GDP is expected to grow by 3.7% in 2022 and 2.8% in 2023. Inflation is then expected to fall rapidly from 5.1% to 2.1% next year.

"At this point, the risk is that a worsening of economic conditions in Europe will lead to a huge turnaround, resulting in a loss of credibility and confidence in the institution."

Unfortunately, the balance of this meeting is that the pressure from the northern hawks has not abated for the time being in the face of the events in Ukraine; on the contrary, the rise in commodities is evidently being dealt with in a linear fashion by increased tightening. It is a pity that, with the ongoing conflict, the central bank has not shown the flexibility and patience to wait for geopolitical developments before giving a strong signal in any direction. At this point, the risk is that a worsening of economic conditions in Europe will lead to a huge turnaround, resulting in a loss of credibility and confidence in the institution. The only positive news on the European front seems to be that on the fiscal side, European leaders are considering joint bond issuance for energy and defence spending. This should mitigate the negative impact of interest rates, although the issue of peripheral financial fragmentation remains, which should be addressed by targeted bond purchases by the ECB.

Equities | End of the dip-buying decade

Oil 'risk premium' likely to widen.

"We expect the risk premium assigned by the market to oil-sensitive economies/ markets to prevail and possibly widen..."

It took an inflation print of roughly 8% to bring an end to 13 years of the "buy the dip" mentality. US stocks ended the week on a negative note following extremely volatile sessions, confirming that Nasdaq is in bear market territory. Trading volumes were particularly high on Monday, exacerbated by short covering trades and margin calls. And following the US and UK bans on Russian oil, oil prices reached a record level of USD139 per barrel. Meanwhile, European equities rebounded from oversold territory on hopes of war risk containment.

Figure 1: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	32,944.19	-1.91%	-2.67%	-8.93%
SPX Index	S&P 500	4,204.31	-2.84%	-3.82%	-11.53%
CCMP Index	Nasdaq	12,843.81	-3.51%	-6.57%	-17.79%
SX5E Index	Euro Stoxx 50	3,686.78	3.72%	-5.98%	-13.95%
SMI Index	Swiss Market	11,495.69	2.42%	-3.44%	-10.11%
UKX Index	FTSE 100	7,155.64	2.80%	-3.65%	-2.26%
CAC Index	CAC 40	6,260.25	3.28%	-5.99%	-12.38%
DAX Index	DAX	13,628.11	4.07%	-5.76%	-14.21%
FTSEMIB Index	FTSE MIB	23,041.20	2.57%	-9.34%	-15.40%
NKY Index	Nikkei 225	25,162.78	-3.17%	-5.14%	-12.56%
HSI Index	Hang Seng	20,553.79	-5.87%	-7.74%	-11.87%
SHSZ300 Index	CSI 300	4,306.52	-4.22%	-4.75%	-12.83%

Source: Bloomberg, as at March 11, 2022. Performance figures in indices' local currencies.

Our view: It's all about oil. With oil prices at the heart of current inflationary pressures, we see a divide between oil-dependent and oil-independent assets. We expect the risk premium assigned by the market to oil-sensitive economies/markets to prevail and possibly widen as long as oil capacity remains constrained in the face of robust energy demand. Within this new framework, we expect the less energy-sensitive sectors to outperform the more energy-sensitive ones.

"This is a historic step for the policymaking process and subsequent adoption to a broader audience of institutional investors."

Crypto & Blockchain | A new phase for digital assets

Bitcoin holds firm.

On Wednesday, the Biden administration finally revealed the digital assets' roadmap for the US. This is a historic step for the policymaking process and subsequent adoption to a broader audience of institutional investors. Some compare the executive order to the Clinton administration's "Framework for Global E-Commerce" in the 1990s, and we all know how that success story turned out. The six key priorities are the following: protect consumers, mitigate systemic risk, control illicit use, promote and support US leadership in technology, and last but not least, explore a US central bank digital currency (CBDC).

To be fair, the executive order does not establish specific positions that the administration wants agencies to adopt, nor does it impose new regulations on industry. But the agencies have 180 days to explore the six topics and may create the potential for upside catalysts and the new phase for the digital assets. Click here to read further information.

Chart of the week

Bitcoin is holding extremely well against the Nasdaq, while it is in a consolidation phase known as the Triangle pattern. The break will be determinant to understand the next trend. A break below the red trend line would lead to a retreat to the June 2021 low at 28805, where it can consolidate into a new long-term buy area. On the other hand, a break above the green line will lead to new ATHs.

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Figure 2: Price of Bitcoin

Source: Bloomberg, as at March 11, 2022.

Fixed Income | Will payment in rubles be a default?

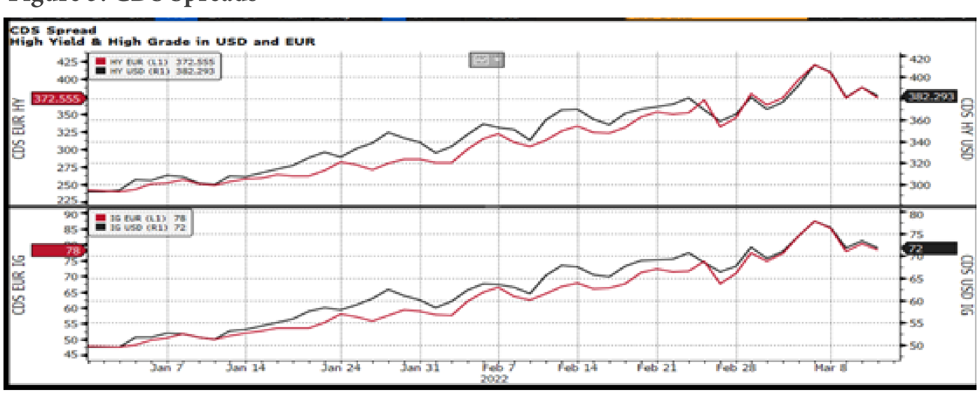
Confusion reigns over Russian bonds.

The effects of the ECB meeting pushed yields on European government bonds up, with the Bund at 0.26% (an increase of 25 bps for the week) and further widening of peripheral spreads with the BTP 10-year spread at 162 bps. In the words of Jim Read of Deutsch Bank, "It's quite clear that the ECB won't allow Italian spreads to gap out but they also probably won't devise a policy tool to deal with it until it threatens to. So the market may need to push for it if it wants it". US Treasury yields went up 20 bps for the week against a backdrop of further inflation increases (year-on-year CPI was up to +7.9%, the highest in 40 years) and the approaching of the Fed tightening campaign.

"Default swaps on high grade euro company debt climbed to the highest in nearly two years..."

Measures of corporate credit risk have also moved wildly in recent days, especially in Europe, where the big buyer, the ECB, is progressively exiting the market. And during the week, default swaps on high grade euro company debt climbed to the highest in nearly two years, while the index of default swaps on junk-rated companies spiked beyond 400 bps for the first time since 2020.

Figure 3: CDS Spreads

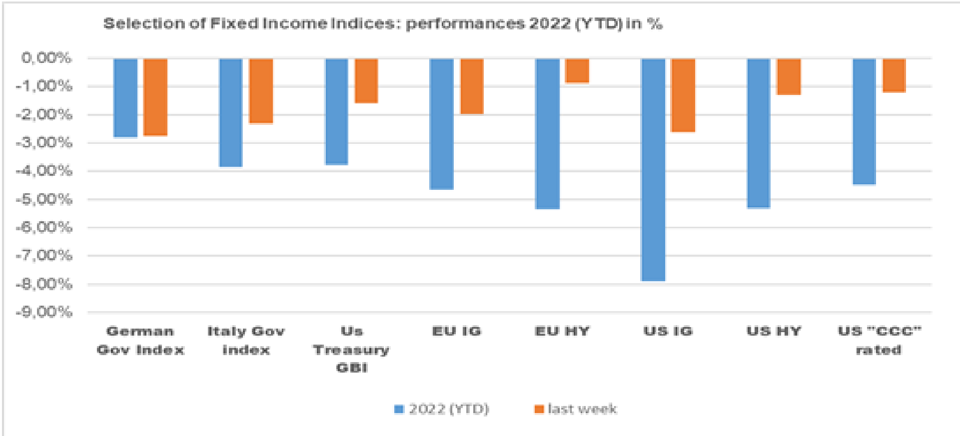


Source: Bloomberg, as at March 11, 2022.

Last week was again a confirmation that 2022 is turning into a tough year for fixed income. Amid widespread volatility following the Russian occupation of Ukraine, inflation spikes led by oil price gains and central banks trying to contain prices, even the safest USD corporate bonds lost almost 8%, while equivalent euro-denominated debt lost more than 4.7%.

"...even the safest USD corporate bonds lost almost 8%, while equivalent euro-denominated debt lost more than 4.7%."

Figure 4: Performance of Fixed Income Indices



Source: Bloomberg, as at March 11, 2022.

The primary market for US investment grade bonds was buoyed by AT&T and Discovery's USD30 billion debt offering for the combination of their media businesses. The transaction built the third-biggest order book with demand totalling USD106 billion at the peak. From a relative value perspective, although initial price talk on the new 10-year bonds (4.279% Magallanes Baa3/BBB- 15.03.2032) tightened from 250 bps above US Treasuries to 235 bps, investors were offered an attractive yield pickup. The US junk bond market, in contrast, has slowed to a crawl as rising yields and widening spreads have kept borrowers away. This has been the slowest first quarter for US junk bond sales since 2009. In fact, Goldman Sachs has lowered its 2022 issuance estimate by USD100 billion to USD225 billion.

Our view: Confusion reigns over Russian bonds. Payments to foreigners were halted under a set of Russian capital controls designed to insulate the economy from sanctions triggered by the invasion of Ukraine. Then a decree signed by President Vladimir Putin on March 5th suggested the majority of foreign investors would be paid, not in the currency the bonds were issued, but in Russian rubles. Under the rules introduced on Saturday, debtors can ask a Russian bank to create a special "C" ruble-denominated account in the name of foreign creditors for settlement, while local creditors will be paid through Russian depositories.

"Debtors can ask a Russian bank to create a special "C" ruble-denominated account in the name of foreign creditors for settlement, while local creditors will be paid through Russian depositories."

Despite this, energy giants Gazprom and Rosneft have repaid bonds denominated in dollars – although it's possible the payment order was made before the new rule was announced. On the other hand, bondholders of Russian Railways JSC (EUR 4.90% 6/3/22) haven't yet received the coupon payment. The payment was due on Sunday and this pushed the expected settlement date back to March 9th. A key test will come with the next payments from two Russian Federation dollar denominated bonds, which have coupons due March 16th, with a 30-day grace period.

Will payment in rubles be a default? Possibly, but there is a debate. Some Russian eurobonds have clauses in their documents that address the issue of making payments in a different currency, if changes in law make it difficult to do it any other way. In that case, the borrower needs to reach an agreement with the lender to make alternative payment arrangements. But it is customary that an issuer cannot discharge its obligation to pay a foreign denominated bond by delivering local currency. As someone said "if it could, the international financial community would be awash in Venezuelan bolivars and Argentine pesos."

Elsewhere, in a note published March 4th, S&P Global Ratings said that if sanctions make it impossible for an entity to access foreign currency and it pays in a different currency than the one agreed, the ratings firm may deem this payment a default. Even if investors agree to the payment in another currency, it could be considered a default if "investors receive less than the value of the original promise". And Fitch Ratings downgraded Russia to a single C rating, reflecting the agency's view that a "sovereign default is imminent." In principle, issuers also have a responsibility to treat bondholders fairly and must follow the "pari passu" principle (equal-footing), meaning that they can't treat holders of the same note differently.

In all this mess, investors' legal action will be very difficult because it will likely involve Russian assets and Russian courts that with the current political tensions will be hard to access for foreigners. The bonds that have coupon payments due March 16th are governed by English law, meaning that holders would have to try and sue the Russian government in a UK court to enforce after a default.

Week Ahead | Key events to watch for

- **Next week is key with the Fed's decision on Wednesday.** The central bank is expected to raise rates by 25 bps for the first time since December 2018, amid headline CPI at 7.9%.
- **Thursday will be the turn of the Bank of England**, and here too a hike is expected (it would be the third in this cycle).
- **On the data side, we will have a number of key indicators from the US**, including PPI, retail sales, sales of goods and services, retail sales and home sales.

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