NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Is being long energy the best hedge?

October 10, 2021

Equity markets managed to interrupt the downtrend that had set in since the beginning of September thanks to some positive news – although the news only resolved some of the risks, and only temporarily. The consolidation scenario, rather than a sharp correction, is therefore still the most likely, at least until the earnings season (which will start next week) reassures investors about the outlook for the supply chain disruptions.

Highlights

- After several weeks of bipartisan negotiations, the US Senate approved a bill that increases the debt limit by USD480 billion beyond the current ceiling of USD28.4 trillion.
- Putin declared that Russia is ready to supply more gas to the bloc countries on a purely commercial basis.
- Oil prices rose to new highs this week as OPEC+ countries decided to keep raising production at the limited incremental pace agreed in the past months, notwithstanding the significant gap between supply and demand due to the full reopening of economies.
- The ECB is studying a new purchase program, to replace the PEPP when it expires in March 2022. This program will unhook the purchases from the Capital Key rule, so as to be able to focus on the countries that need most financial aid.
- This week also saw a weak September US non-farm payroll (NFP) figure. The well-below-consensus NFP report didn't manage to make a dent in yields, however, as a higher-than-expected average hourly earnings report (0.6% versus 0.4% expected) stocked inflation fears.
- Since the start of October, high yield bonds fell on a total return basis (US -0.22% and EUR -0.45%), while US and European investment grade spreads widened. Nevertheless, even riskier high yield companies are having little trouble selling debt.

"...it would be naive to think that the issue of the cost of energy bills and the impact on consumers is over."

Markets & Macro | Is being long energy the best hedge?

Energy crisis remains biggest risk for winter.
Looking across the markets, the three elements that have improved short-term sentiment.

1. The US Senate approved an increase in the debt ceiling that will allow the US to fund itself until early December. After several weeks of bipartisan negotiations, the Senate approved a bill that increases the debt limit by USD480 billion beyond the current ceiling of USD28.4 trillion. The action will provide funding to the Treasury until mid-December, at which point an additional debt limit increase or suspension would be required. The risk of a technical default will be back on the table as early as November. On the positive side, the Democrats now have more time to draw up the fiscal plan, which will perhaps be a little better and a little more abundant. But it's understood that moderate Democrats don't want to overspend and raise taxes in any case, so the original USD3.5 billion remains a mirage – which is probably why McConnell accepted the compromise.

2. The other positive newsflow concerned rising gas prices in Europe. Following the price explosion in recent weeks, with gas now five times its starting price, Putin declared that Russia is ready to supply more gas to the bloc countries on a purely commercial basis. The move could allow the controversial Nord Stream 2 pipeline to gain a definitive opening from Germany (one of the countries most affected by the price rise). The news then triggered a drop in the price of gas of almost 50%, and gave some respite to European stock markets.

However, it would be naive to think that the issue of the cost of energy bills and the impact on consumers is over. Even at or below current levels, the cost of gas is a shock to the EU and Asian economies, and probably less so for the US. All analysis indicates that gas stocks are low (as are coal stocks in China), and it is not clear how and for how long Putin will follow up on his words.

“Even with gas prices stabilizing at current levels, some underlying issues would likely remain and could in fact grow worse as the energy transition proceeds. This could have a potential impact on longer run inflation…”

At the same time, the events of the past few days have made it clearer that there is a structural vulnerability on the energy front that may accompany us, with acute phases and periods of respite, for years to come. In fact, oil prices, which are already up around 50% this year, rose to new highs this week as OPEC+ countries decided to keep raising production at the limited incremental pace agreed in the past months, notwithstanding the significant gap between supply and demand due to the full reopening of economies. The combination of gas shortages (pushing substitution demand for oil) and the prospects of a cold season have the potential to drive oil prices on even higher.

Our view: The energy issue remains one of the biggest risks to the market in the winter months, in our view. Even with gas prices stabilizing at current levels, some underlying issues would likely remain and could in fact grow worse as the energy transition proceeds. This could have a potential impact on longer run inflation, and demand conservation will be required as the burden is shared across households, governments and businesses. The output from energy intensive industries is also at risk.

Each of the energy crises that have affected economies in the past have different origins, but the consequences for the economies are similar, and in particular it impacts low income communities the most. As the world embarks on ripping apart the old energy infrastructure and investing in new energy projects, the supply-demand gap remains unbalanced. This doesn’t make new green energy policies wrong, however. This is the price we pay to move toward cleaner energy.

In any case, these dynamics give us additional food for thought for our asset allocation. Our long position in the energy sector therefore has a dual role. On the one hand, this sector retains all the potential for medium-term gains. On the other hand, a traditionally risky position is suddenly becoming a significant portfolio hedge, with the function of stabilizing performance and (paradoxically) reducing risk. If the main risk to equity markets comes from the world of energy, then being long energy is, at least at the moment, the best hedge to hold. In our view this hedge is much better than US Treasuries and bonds in general, which continue to suffer from rising inflation expectations.

3. A further element of support has come from a Bloomberg report: the European Central Bank (ECB) is studying a new purchase program, to replace the PEPP when it expires in March 2022. This program will unhook the purchases from the Capital Key rule, so as to be able to focus on the countries that need most financial aid, and thus stem any "fragmentation" of financial conditions. It must be said that the ECB has become so flexible thanks to the pandemic, if such a scenario is being envisioned. If the plan described in the report will be converted into action, the old taboo of monetary financing would finally be overcome. We should also see how it will be implemented, and the degree of deviations from the Capital Key. In any case, the report sounds plausible, because a post PEPP scheme is needed, and a new plan has to be elaborated in due time.

“If the main risk to equity markets comes from the world of energy, then being long energy is, at least at the moment, the best hedge to hold.”

Equities | Are weak high yield bonds bad news for equities?

Equity valuations remain at extremes.

Most major global indexes staged a partial recovery rally. Energy stocks were in the lead again, following OPEC+’s decision not to increase production materially. Concerns over the US debt ceiling were temporarily alleviated on Thursday after reports that the Republican senators had agreed to a debt limit extension. The rally that ensued was stopped in its tracks on Friday following a very weak September US non-farm payroll (NFP) figure. The well-below-consensus NFP report didn’t manage to make a dent in yields, however, as a higher-than-expected average hourly earnings report (0.6% versus 0.4% expected) stocked inflation fears. The US 10-year treasury yield ended the week above the sentiment-significant 1.6% level.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,746.25	1.27%	2.71%	15.17%
S&P 500	4,391.34	0.83%	1.99%	18.21%
Nasdaq	14,579.54	0.10%	0.92%	13.71%
Euro Stoxx 50	4,073.29	1.02%	0.70%	17.32%
Swiss Market	11,764.99	1.64%	1.05%	13.06%
FTSE 100	7,095.55	0.99%	0.15%	13.20%
CAC 40	6,559.99	0.65%	0.61%	20.78%
DAX	15,206.13	0.33%	-0.36%	10.84%
FTSE MIB	26,051.01	1.70%	1.43%	19.86%
Nikkei 225	28,048.94	-2.51%	-4.77%	3.64%
Hang Seng	24,837.85	1.07%	NA	-6.50%
CSI 300	4,929.94	1.31%	NA	-3.80%

Source: Bloomberg, as at October 8, 2021. Performance figures in indices' local currencies.

"While the decoupling of equities' and high yield bonds' performance may be attributable to technical factors, we remain vigilant until there is confirmation that the divergence is technical..."

Our view: Could the weakness of high yield corporate bonds be bad news for equities? Despite the temporary resolution on the debt ceiling and the weak NFP report, high yield sellers remained active, pushing the iShares High Yield ETF (HYG) below its 50 day support level. While the decoupling of equities' and high yield bonds' performance may be attributable to technical factors, we tend to take notice and remain vigilant until there is confirmation that the divergence is technical rather than fundamental.

Next week marks the unofficial start of the earnings season with major banks expected to provide a cautious guidance in response to soaring energy prices and supply constraints. With equity valuations still at extreme levels despite strong Q2 earnings beats, a lot is riding on this Q3 earnings season. In our view, the market expects a repeat of the extraordinary "beat and upgrade" cycle of the past five earnings season.

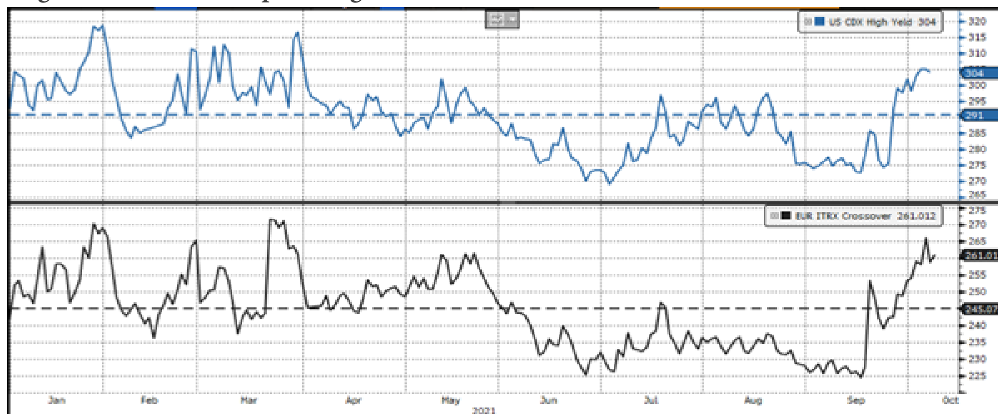
Fixed Income & Credit | High yield companies continue to see excess demand

"...the cost of protecting junk bonds in the US and European credit derivatives markets rose to the highest levels since March."

Credit outlook remains bullish despite concerns.

Since the beginning of the month, high yield bonds fell on a total return basis (US -0.22% and EUR -0.45%), while US and European investment grade spreads widened, as cracks emerged across markets globally. Fears that the inflation genie is out of the bottle, and concerns over potential contagion from China's property sector, have pushed the cost of protecting junk bonds in the US and European credit derivatives markets to the highest levels since early March.

Figure 2: US and European High Yield CDS

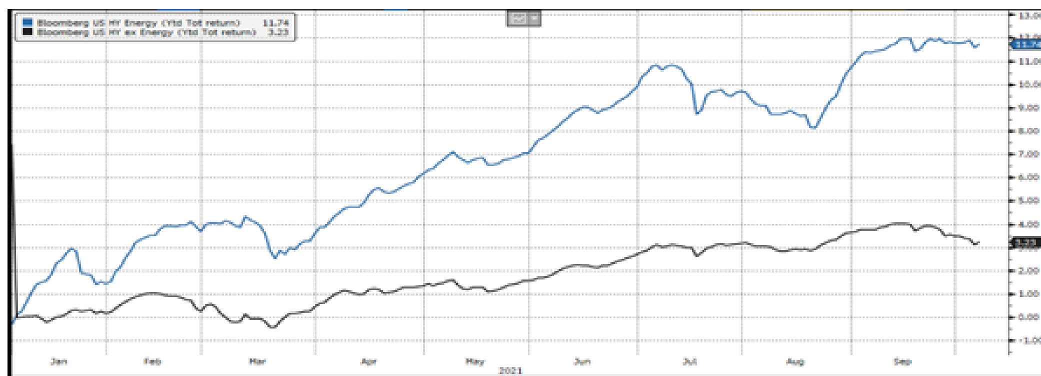


Source: Bloomberg, as at October 8, 2021.

Nevertheless, even riskier high yield companies are having little trouble selling debt. The US junk bond primary market saw a flurry of issuance. Frontier Communications (6%, 2030, “CCC”), tapped the market for the first time since emerging from bankruptcy – and its bonds were oversubscribed by more than three times the deal’s size and sold at the tighter end of talk. Energy companies joined in as oil prices rallied to a seven-year high amid a global energy crunch. Despite the sector having fresh memories of defaults, energy companies have significantly outperformed the rest of the high yield bond market in the past year.

> “Despite the sector having fresh memories of defaults, energy companies have significantly outperformed the rest of the high yield bond market in the past year.”

Figure 3: US High Yield Performance



Source: Bloomberg, as at October 8, 2021.

Our view: On a fundamental basis, while numerous strategists are increasingly worried about duration risk as inflation fears rise, the outlook remains bullish on credit. For example, UBS expects US credit spreads to widen modestly in any risk-off move, and that the Federal Reserve (Fed) tapering (that’s expected to start next month) will be manageable, and that leveraged loans and high yield bonds rated single B have better-than-average value. “Are credit markets too complacent? No. Valuations are not stretched in the context of the macro backdrop with investment grade spreads cheap – 84 basis points (bps) versus 69 bps model – and high yield spreads slightly cheap at 293 bps versus 279 bps model” (UBS: “Corporate debt: how vulnerable are spreads to growth and rate risks?”, 5.10.21)

Another Chinese developer fell into crisis this week after failing to repay a maturing bond. Fantasia Holdings Group, a small developer that ranks only 64th in China’s vast real estate industry of which no one cared, didn’t repay a dollar bond that was due October 4. Yet Fantasia’s failure to make a USD206 million dollar-denominated bond payment led the Chinese high yield dollar-denominated bonds to their biggest selloff in at least eight years. According to Bloomberg (“Fantasia Opens a Pandora's Box for Evergrande” 6.10.21), Fantasia could have repaid the note but chose not to. By breaking the honor code of bond issuance, Fantasia is forcing investors in other developers to consider selling all their holdings. It is closing the refinancing window for the other companies in the sector. As a result, it opened up a Pandora’s Box of financial nastiness.

> “On a fundamental basis, while numerous strategists are increasingly worried about duration risk as inflation fears rise, the outlook remains bullish on credit.”

Finally, the booming demand for credit ETFs has enabled the launch of a new product targeting US high yield specific industry sectors on October 7. BondBloxx Investment Management (founded by ex-BlackRock alumni) plans to create seven ETFs carving up the US high yield debt market (financial, industrial, telecommunication, health-care, energy, consumer cyclical and consumer non-cyclical sectors). Sectorial ETFs are a common practice in equities, but rare in corporate bonds, thus bringing a new level of precision to fixed income investing.

FX & Commodities | EUR/USD RSI sets new lows

Chart of the week

The EUR/USD failed to hold key support levels and is now in oversold territory, with the RSI setting new lows. At this extended level, a retracement is very likely to happen with target 1.1660 and perhaps further. The key support to watch 1.15.

“The EUR/USD failed to hold key support levels and is now in oversold territory, with the RSI setting new lows.”

Figure 4: EUR/USD Performance

Source: Bloomberg, as at October 8, 2021.

Week Ahead | Key events to watch for

- **In the coming week, the focus will shift significantly to US corporate earnings**, given the lack of economic data releases.
- **The release of US CPI data on Wednesday** will weigh on investor sentiment, as it is the last before the Fed’s next meeting. The Fed will also release minutes from their September meeting, which could offer some clarifications on their thinking about tapering.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Please note that any views expressed herein are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions. We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. They may differ from other views expressed for other purposes or in other contexts, and this should not be regarded as a research report. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Investors may get back less than they invested, and past performance is not a reliable indicator of future results