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Weekly Market Flash
Facing a fragile market

April 24, 2022

A week that had opened extremely well – especially in Europe following the Easter break – ended in the worst possible way, especially in the US. Thanks to the strength of the first few days of the week and Friday's early close, Europe was able to close practically flat. The Nasdaq index (-3.8%) and the S&P 500 index (-2.75%) suffered heavy losses. Moreover, this was the third consecutive week of losses for all the indices mentioned. It is difficult to identify a specific catalyst for the sudden change in sentiment that led the US market to turn sharply on Thursday – from a 1.5% rise, the S&P 500 index closed down 1.5%. This price action speaks for itself, and indicates a fragile market despite an apparently already very defensive positioning.

Highlights

▪ The market is anticipating 10 Fed hikes by the end of this year. In Europe, the market is expecting a rise of 85 bps between now and December.

▪ On the war front, the illusions of a peace agreement have faded, and observers are resigning themselves to a prolongation of the conflict in the Donbass. Unfortunately, the destruction of cities and territory could accelerate in the coming weeks after the Russian takeover of Mariupol.

▪ Chinese markets staged one of the worst weekly performances of this year on the back of China's strict Covid lockdowns. Foreign outflows reached USD1 billion so far this month, after a USD7 billion outflow in March.

▪ The nominal 10-year US Treasury yield is four percentage points lower than core inflation (and even further below headline inflation). Even the Fed's favorite measure of market-based inflation forecasts (the 5-year/5-year breakeven) is now at its highest since 2014.

"It is clear that the respective central banks are now in a state of panic over inflationary trends, which are looking less and less transitory..."

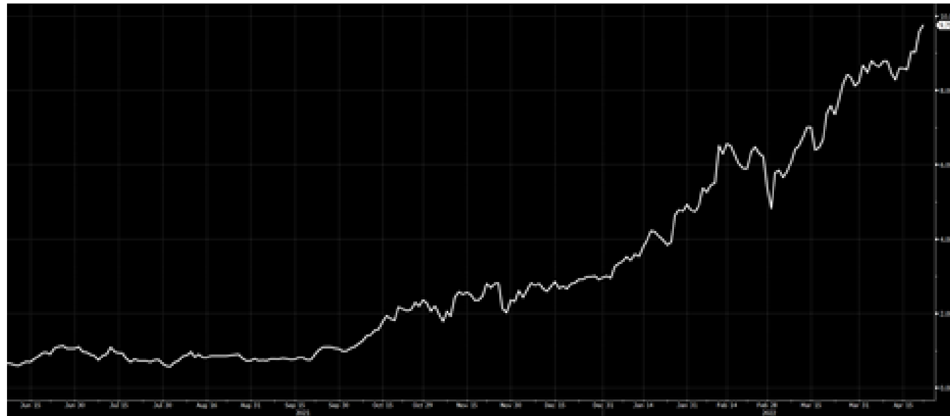
Markets & Macro | Facing a fragile market

The depressive effect of inflation is starting to emerge.

What certainly didn't help markets this week were Lagarde and Powell's statements at an IMF panel. It is clear that the respective central banks are now in a state of panic over inflationary trends, which are looking less and less transitory as the days go by, unlike economic growth, which is showing signs of slowing sharply in both Europe and the US.

On the interest rate front, the repricing of Fed Funds was impressive. The market is now anticipating 10 hikes by the end of this year, the first three of which will be 50 basis points (bps)! In Europe, on the other hand, the market is expecting a rise of 85 bps between now and December.

Figure 1: Number of Fed Hikes Priced in by Year-End



Source: Bloomberg, as at April 22, 2022.

Our view: The strength of the market up until Thursday was more surprising to us, rather than the weakness of the last two days. The main issue that rightly worries the market is the depressive effect that inflation is starting to have on incomes, and consequently on consumption, investments and sentiment in general. The other elements of concern in this context are the war in Ukraine, the continuing very tight lockdowns in China to cope with new waves of Covid, and corporate earnings expectations (not so much current results, which are not doing badly).

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On the war front, the illusions of a peace agreement have faded, and observers are resigning themselves to a prolongation of the conflict in the Donbass. Our opinion is that unfortunately the destruction of cities and territory could accelerate in the coming weeks after the Russian takeover of Mariupol. The paradox here is that we should hope for a rapid advance of the Russians, in order to hope for the end of hostilities. Instead, the heroic resistance of the Ukrainians, now very well supported by the new US and British military furniture, will inevitably lead to an increase in violence by the Russian army. Only in Mariupol have we seen evidence of Russian destructive capacity (previously experienced in Chechnya and Syria), with a spiral that could develop in the coming weeks. With greater resistance, greater strength, in short. And all this could lead to further sanctions against Russia, as public opinion in European countries could push politicians on the continent to align themselves even more with the positions of the US and the UK. Oil and (possibly, but unlikely) Russian gas could be affected.

The main reason for our caution, which has been widely expressed over the past few weeks and translated into defensive positioning of our discretionary portfolios, is that we are in a completely different monetary policy situation than we have been used to over the past 30 years. Whenever there was a shock to the economy, whatever the nature of the shock, central banks, using increasingly creative and unconventional instruments, would rush to support the market – stabilizing them and indirectly supporting economic activity (through funding conditions for companies and the wealth effect for consumers). This time, however, the specter of inflation (partly induced by the supply shock of Covid and the war, partly by Covid-induced excessive fiscal and monetary stimulus), prevents any relief from central banks, and indeed the opposite. This is at least until inflation, hopefully in the coming months, shows signs of trend inversion.

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This analysis is not intended to send out an overly bearish message to equity markets, at least not for US markets, which remain our favorite. Indeed, as we have said before, the Federal Reserve (Fed) is struggling mightily to regain its credibility, and that is healthy for the economy and markets. As a result, if we see further weakness or even panic in the market over the coming weeks, we will start to rebuild our US equity positions that we lightened at the beginning of the year. This is different for Europe, which is much closer to the brink of conflict, with the problem of energy dependence on Russia, and with the European Central Bank (ECB) only able to raise rates to a limited extent to counteract the same level of inflation as in the US, due to peripheral governments' funding conditions remaining precarious.

Equities | Bouts of short squeezes ahead

Earnings are unlikely to provide much support.

"Within the S&P 500 index, only the real estate and consumer staples sectors ended the week up."

As mentioned, major US equity indexes ended the week in the red, sparked by Fed Chair Powell's hawkish comments on Wednesday. The decline was led by communication services, energy, materials and health care stocks. Within the S&P 500 index, only the real estate and consumer staples sectors ended the week up. Netflix was in the spotlight as the company's shares lost 35% during the week following disappointing subscriber data.

European equities fared better than their US counterparts following President Macron's lead over Marine Le Pen in the first round of the French elections. Nevertheless, European stocks were negatively impacted by the Ukraine war and increased central banks' hawkishness. Meanwhile, Chinese markets staged one of the worst weekly performances of this year on the back of China's strict Covid lockdowns. Foreign outflows reached USD1 billion so far this month, after a USD7 billion outflow in March. Calls by the China Securities Regulatory Commission for banks and insurers to buy Chinese equities had little effect on prices.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	33,811.40	-1.82%	-2.41%	-6.42%
S&P 500	4,271.78	-2.74%	-5.65%	-9.99%
Nasdaq	12,839.29	-3.83%	-9.69%	-17.77%
Euro Stoxx 50	3,840.01	-0.09%	-1.34%	-10.09%
Swiss Market	12,258.33	-1.56%	1.86%	-2.49%
FTSE 100	7,521.68	-1.16%	0.29%	3.19%
CAC 40	6,581.42	0.08%	-0.98%	-7.60%
DAX	14,142.09	-0.15%	-1.89%	-10.97%
FTSE MIB	24,279.63	-1.32%	-1.94%	-9.90%
Nikkei 225	27,105.26	0.04%	-2.57%	-5.09%
Hang Seng	20,638.52	-4.09%	-0.69%	-11.48%
CSI 300	4,013.25	-4.19%	-1.70%	-18.74%

Source: Bloomberg, as at April 22, 2022. Performance figures in indices' local currencies.

"What we expect instead are bouts of short squeezes, like we saw from mid- to end-March within the broader downtrend."

Our view: With positioning and sentiment and extremely low levels, there is an expectation that equities should be set for a strong rebound. While this logic has worked very well over the past decade, it is important to recall that it worked mainly because the Fed put would always kick-in at the right moment. Currently, the Fed put in no longer at play. In fact, the world is about to witness the biggest tightening cycle of the century. What we expect instead are bouts of short squeezes, like we saw from mid- to end-March within the broader downtrend.

Last week's negative price action in the value sectors is concerning to us, suggesting heavy positioning in energy and mining stocks. Earnings are unlikely to provide much support in this environment, with inflation and margin pressures being cited by management teams on pretty much every earnings call that we have followed so far. While we haven't seen signs of "demand destruction" as yet, we have noticed that consumption has begun to shift from goods to services. The surprise jump in the Consumer Sentiment Index, while still early to draw conclusions, provides some assurance that the consumer is still in a good shape despite raging inflation.

Fixed Income | IG corporates: The best place to be?

Many financial assets still offer negative or very low real yields.

Another week passed and global bond yields resumed their epic climb as markets brace for the most aggressive Fed rate hikes in 40 years, as well as the likelihood that most global central banks will also tighten. Key benchmarks bond yields spiked up after Powell said that a half-point rate increase is on

the table for next month's FOMC meeting, adding “it is appropriate in my view to be moving a little more quickly”. Moreover, the fact that even a 75 bps hike cannot be ruled out among some Fed officials, has only worsened sentiment. As if that were not enough, several Governing Council members of the ECB verbally endorsed an increase in rates early in the third quarter once asset purchases had ended. Money markets are pricing a quarter-point hike in both July and September, enough to take the ECB’s deposit rate to zero.

“Moreover, the fact that even a 75 bps hike cannot be ruled out among some Fed officials, has only worsened sentiment.”

Figure 3: Government Bond Yields

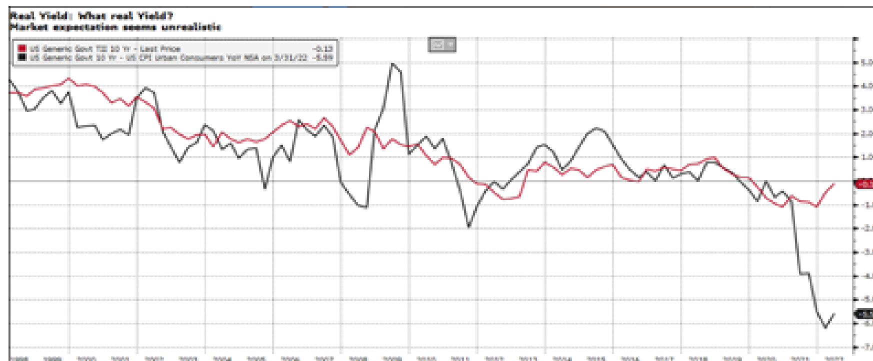
Source: Bloomberg, as at April 22, 2022.

Our view: The policy-sensitive 2-year yield climbed as much as eight basis points on Friday to 2.76%, the highest since late 2018. The same happened in Europe and in the UK. With the 10-year US Treasury approaching the important psychological barrier of 3%, the big question is if this “offers an attractive level to buy”. Hopes are that inflation peaked in March and the double whammy of rate hikes and measures to shrink the Fed’s holdings of Treasuries will accelerate the economic slowdown that lies ahead.

The truth is that financial conditions, measured by the level of real rates, are not too tight, yet. But that is fast changing: the real yield measured by the 10-year Treasury Inflation-Protected Securities (TIPS) has registered an impressive adjustment touching almost zero (the red line), therefore challenging the assumption that real yields will forever stay accommodative. However, there’s an argument that TIPS embody unrealistic expectations for inflation. A brutally simple version of the real yield that subtracts the current rate of inflation from the nominal yield at -5.60 (the black line), is no longer similar to the TIPS yield.

“The truth is that financial conditions, measured by the level of real rates, are not too tight, yet. But that is fast changing...”

Figure 4: Real Yield



Source: Bloomberg, as at April 22, 2022.

But this is no longer the case. The nominal 10-year yield is four percentage points lower than core inflation (and even further below headline inflation). Even the Fed’s favorite measure of market-based inflation forecasts (the 5-year/5-year breakeven, measuring expected average inflation for the five years starting in five years) is now at its highest since 2014. Also, disquieting is the speed with which the market has abandoned its optimistic view on German inflation. Suddenly, the German 5-year/5-year breakeven is almost equal to the US. In a nutshell, however measured, many financial assets are still riding on continued negative or very low real yields.

Figure 5: Medium-term Inflation Expectations

Source: Bloomberg, as at April 22, 2022.

“While all corners of fixed income remain under pressure, investment grade corporates seem the best place to be.”

Elsewhere in the credit space, the riskiest subset of US junk bonds has lost its allure. Spreads on CCC-rated debt – bonds that are most at risk for a default should the economy falter – have widened 125 bps this year, compared to 57 bps for BB rated debt and 69 bps on average for all junk bonds. While all corners of fixed income remain under pressure, investment grade corporates, with short maturities (2-3 years) and offering yields at around 3%, seem the best place to be.

Week Ahead | Key events to watch for

- **Tonight, we will have the final results of the second round of the French presidential election**, which should see a clear victory for outgoing President Macron. We do not even want to think about the impact on European markets of a surprise on this front.
- **There will be a lot of data releases in Europe**, including April CPI and Q1 GDP.
- **The US has an even tighter schedule**, where in addition to Q1 GDP numbers, markets will receive new home sales, personal consumption and other indicators of consumer sentiment and real activity.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX, Crypto and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

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