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Weekly Market Flash

Will Europe continue to outperform?

May 15, 2022

This week marks the sixth consecutive week of declines for Wall Street indices, which is a rare occurrence. Europe, meanwhile, was saved thanks to Friday's solid day which saw a 2% rise on the week, the exact opposite of the S&P 500 index decline at over -2%. In fact, it is quite impressive to note the outperformance of the Eurostox 50 index since the end of March, which is now 8% better than Standard and Poor's. This trend appears to be counterintuitive, especially given the background of the war and the energy crisis that impacts Europe much more than the US. However, there are a number of possible reasons for Europe's outperformance – which indeed plays against our structural positioning in favor of the US, but at the same time represents an opportunity for the future.

Highlights

▪ In the US, a stronger than expected CPI print and lower than expected University of Michigan consumer sentiment figure added to the uncertainty.

▪ In China, stocks rallied on the back of supporting comments from politicians and a drop in Covid cases. Nonetheless, there were no signs of the liquidity crisis plaguing the property sector easing.

▪ In the crypto space, there was tremendous selling pressure for Luna, which resulted in the coin losing 100% of its value in a matter of hours. Meanwhile, Bitcoin has broken below USD30,000 and could bottom soon.

▪ Bond markets also witnessed a fresh bout of risk aversion. In Europe, German 10-year yields fell as much as 14 bps, while the Italian BTP outperformed with the spread over Bunds down 15 bps. US equivalent yields dropped 11 bps.

“The center of the market storm in recent weeks has been the technology sector, which has increasingly started to suffer from rising rates across the world...”

Markets & Macro | Will Europe continue to outperform?

The rally may have some support.

Given the ongoing war and energy crisis, which has a significant impact on Europe due to its need for imports versus the independence of the US, it is surprising to see European markets outperform. However, we take a look at some of the possible reasons for this trend today.

Our view: One key reason is the performance of technology companies. The center of the market storm in recent weeks has been the technology sector, which has increasingly started to suffer from rising rates across the world—in particular, led by the US Federal Reserve (Fed). The higher implied duration of growth stocks, which discount earnings growth rates deferred into the distant future, makes the tech sector much more sensitive to rate movements. Once the repricing of multiples in this sector has been triggered, it is traditionally very difficult to interrupt this process, besides the fact that the starting point was very high (certainly for the more speculative sectors, but also for Big Tech, which is something we are all becoming aware of belatedly). In Europe, on the other hand, technology stocks weigh decidedly less (around 11% in the Eurostox 50 index

versus 25% for the S&P 500 index), while value stocks are short-lived thanks to lower Price-to-Cash flows. The P/Cash flow is in fact 5.5 in Europe and toward 14 in the US.

Secondly, the decline of the Euro against the US dollar since the beginning of the year has now reached around 10% (at the beginning of 2021, we were at 1.22!). Therefore, it is well known that the depreciation of the currency, especially if controlled, plays in favor of the reference stock market. At the same time, the earnings season in Europe went well, perhaps better than in the US, and growth expectations in Europe are decidedly more moderate for the next two years, so there are fewer adjustments to be made in the event of negative surprises in the economies. It should also be noted that the theme of war is fading on the horizon, with the market seeming to have priced in the scenario of a semi-permanent frozen conflict – but mostly without escalation or devastating tail risks. Finally, of the two central banks, the Fed is decidedly more hawkish than the European Central Bank (ECB) at the moment – and although we remain convinced that central bank tightness is a necessary evil for the long-term goal of regaining credibility (which is indispensable for maintaining a premium on multiples), in the short term it scares domestic markets.

"Ultimately, we consider Europe's outperformance to be temporary and not sustainable in the long term."

Ultimately, we consider Europe's outperformance to be temporary and not sustainable in the long term. In particular, the issue of central bank credibility is a priority; the weakness of the Euro, coupled with the resilience of energy prices (not only oil, but also and above all gas), will only further damage the European system, with the usual aggravation of economic divergences between the North and South. Further, although we think it is likely that the pressure on US technology stocks is not over (given that the Fed seems dangerously far from giving any easing signals on rates for the time being), it seems short-sighted to bet on the outperformance of a stock market due to the fact that technology weighs little in the index. Conversely, for the long term, we argue the opposite, since only from technology and innovation can we expect high and rising growth rates.

In the near term, however, at the operational level we have moderately increased our equity exposure, buying both Europe and the US, around the 4'000 level for the S&P 500 index. Although we believe that the repricing phase for rates and equities is not yet over (given the inflationary environment and the huge effort that central banks have to make to bring inflation under control, hurting growth), we felt that the conditions for stabilization were now sufficient to try to reduce our underweight to equities, with a discrete risk/reward to trade. We remain cautious and vigilant, but hope that the rally will have some support from the extreme positioning, some signs of exhaustion in the price action this week, an expected consolidation in rates, but above all an economic environment that is still quite solid, even if less buoyant (we are referring to the US of course, less so to Europe).

"We remain cautious and vigilant, but hope that the rally will have some support from the extreme positioning..."

Equities | Waiting for more attractive entry levels

Cautious despite the current positioning.

This week, US markets remained nervous as none of the major risks abated – including monetary policy tightening, high inflation, slowing growth / weaker margins, China's "zero Covid" policy and the geopolitical risk in Ukraine. The stronger than expected CPI print and lower than expected University of Michigan consumer sentiment figure also added to the uncertainty. Widening corporate credit spreads also emphasized the worsening risk appetite across the asset class spectrum.

Meanwhile, as mentioned earlier, European equities rebounded despite ECB officials signaling increasing interest rates in July. Chinese stocks rallied on the back of supporting comments from politicians and a drop in Covid cases. Nonetheless, there were no signs of the liquidity crisis plaguing the property sector easing. The Chinese yuan's weakness against the US dollar amplified the sector's woes given the developers' high US dollar-denominated debt exposure.

Figure 1: Global Equities Market Performance

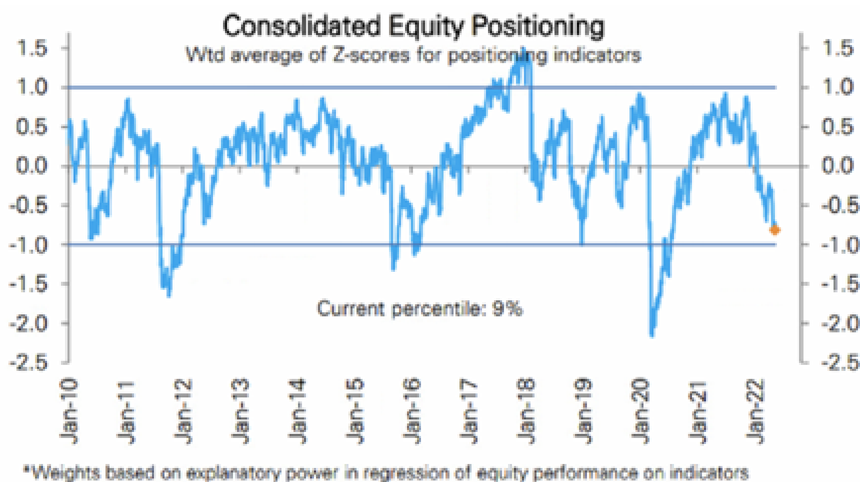
	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	32,196.66	-2.08%	-2.28%	-10.81%
S&P 500	4,023.89	-2.36%	-2.53%	-15.13%
Nasdaq	11,805.00	-2.77%	-4.23%	-24.34%
Euro Stoxx 50	3,703.42	2.37%	-1.45%	-11.96%
Swiss Market	11,650.42	-0.53%	-3.79%	-7.12%
FTSE 100	7,418.15	0.45%	-1.62%	1.92%
CAC 40	6,362.68	1.77%	-1.98%	-9.69%
DAX	14,027.93	2.59%	-0.50%	-11.69%
FTSE MIB	24,048.29	2.44%	-0.84%	-10.76%
Nikkei 225	26,427.65	-2.13%	-1.57%	-7.32%
Hang Seng	19,898.77	-0.50%	-5.90%	-14.64%
CSI 300	3,988.60	2.06%	-3.54%	-19.19%

Source: Bloomberg, as at May 13, 2022. Performance figures in indices' local currencies.

“Widening corporate credit spreads also emphasized the worsening risk appetite across the asset class spectrum...”

Our view: Positioning and sentiment indicators are still pegged at extreme low levels, giving rise to sharp counter trend rallies like we saw on Friday. According to Deutsche Bank, the positioning extreme is mainly due to systemic strategies. By contrast, discretionary investor positioning is closer to neutral. Modest year-to-date equity outflows, especially when compared with bonds flow, leave us cautious despite the attractive positioning picture. Instead of chasing rallies, we have been gradually trimming exposure to the technology stocks and have been slow to deploy the proceeds as we await better entry levels for defensive stocks.

Figure 2: Equity Market Positioning



Source: Deutsche Bank, as at May 13, 2022.

“Modest year-to-date equity outflows, especially when compared with bonds flow, leave us cautious despite the attractive positioning picture.”

Crypto & Blockchain | Luna’s price collapses amid hyperinflationary pressure

Systemic risk is limited.

It took an hour in a weekend of low liquidity to destroy one of the largest decentralized finance protocols. Fear, time and panic were the main elements to generate the domino effect. The first move started on Anchor’s field, a well-known Achille’s heel of the TERRA ecosystem. This is a DeFi protocol that allows users to enjoy a financial system of loans based on stablecoins. The idea is simple: a lender

deposits their UST, the native stablecoin of the TERRA ecosystem, in Anchor – and that UST was used to make collateralized loans for interest accrual. Anchor's interest rates are generated via staking rewards from major proof-of-stake blockchains.

"With low liquidity at that time of the morning, the more BTC sold the lower Bitcoin tanked."

The timing was not a coincidence. That morning, Luna Foundation Guard (LFG) was removing USD150 million in liquidity in anticipation of 4pool, a bigger pool of liquidity of USD3 billion more than the actual USD350 million in 3pool. At the same time, the striker windrowed another USD350 million, which let the Anchor Protocol collapse, draining all the liquidity of the application that was part of the reserves. The withdrawn UST was aggressively sold on Curve (a decentralized liquidity provider) and Binance (a soft regulated centralized exchange), which created a small depeg.

There was some panic that followed because Bitcoin was weak early the same morning, following the weak opening of NASDAQ futures, and the small UST depeg. At this point, LFG, given the liquidity drained on the reserves, started selling the bitcoin accumulated as collateral in the last week to restore the peg. With low liquidity at that time of the morning, the more BTC sold the lower Bitcoin tanked. This increases panic, resulting in more UST selling pressure, which started the death spiral. Finally, the domino effect spread, with mass panicking and mass congestion hitting the chain, as they suspended withdrawals with a consequent bank run from the TERRA ecosystem with tremendous selling pressure for Luna – resulting in the coin losing 100% of its value in a matter of hours. In fact, the stability mechanism of TERRA was designed to accelerate the supply of Luna in the case of a de-peg and a market cap contraction, which led to the complete collapse in the price of Luna caused by hyper-inflationary pressure.

Market comment: The systemic risk was limited due to the relative disconnection between ecosystems and the relative small dimension of the crypto world. What can have consequences is the wealth effect of this event. TERRA was the second biggest blockchain in terms of total assets locked, and many non-professional crypto investors invested, some allocating a wrong risk size to the investment with a large part of their life's saving lost in these few days. Cryptos went in full panic mode with a temporary depeg of USDT, a stablcoin that is used for most of the derivatives of Bitcoin and Ethereum. Trust may have faded for a while and volume could continue shrinking in the next months. We would like to conclude with a quote from Raoul Pal, CEO of Real Vision: "Crypto is a long-term investment for me, not a trade. In the thesis is clear expectations of 60% corrections. Without that kind of volatility, you don't get the exponential upside."

"The systemic risk was limited due to the relative disconnection between ecosystems and the relative small dimension of the crypto world."

Chart of the week

Bitcoin has broken below USD30,000 and could bottom soon. It is nearing the important levels of support that should not be broken. Investors are not rushing at all to catch the falling knife.

Figure 3: Price of Bitcoin

Source: Bloomberg, as at May 13, 2022.

Fixed Income | Nowhere to hide

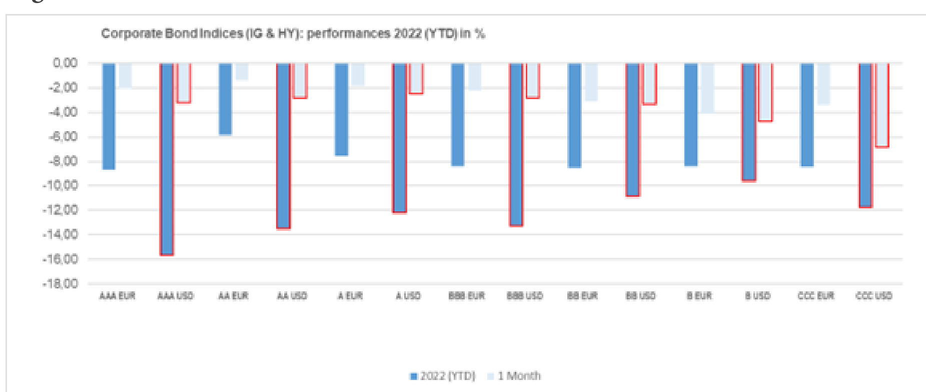
> "...from a macro perspective, the focus rotated from inflation to growth, with growing fears for a hard rather than soft landing."

Spreads likely to continue widening.

In April, the annual inflation rate only fell modestly (two tenths) and remains far too high and over 8% to ease the Fed and consumers' anxiety. Non-energy goods prices have begun to fall, some services prices continue to accelerate, while, on the supply side, tensions remain high and are likely to lead to further shortages. With such a mixed bag, central banks including the Fed and ECB appear determined to raise borrowing costs until they have confirmation that demand is moderating. Therefore, from a macro perspective, the focus rotated from inflation to growth, with growing fears for a hard rather than soft landing.

Against this background, a fresh bout of risk aversion, which triggered an outburst of deleveraging in the financial system, brought back to live the safe haven status of government bonds. In Europe, German 10-year yields fell as much as 14 basis points (bps) from 1.13% to 0.85%, while the Italian BTP outperformed with the spread over Bunds down 15 bps. US equivalent yields dropped 11 bps from 3.12% to 2.84%. But in credit, there was nowhere to hide.

Figure 4: Bond Performance



Source: Bloomberg, as at May 13, 2022.

Our view: In previous market downturns, investors could seek to avoid losses by focusing on higher quality credits, This time, due to spreads that were too low to begin with, the combination of rate hikes spurred by soaring inflation and concerns about an economic slowdown are affecting all corporate bonds. Looking ahead, if the final destination will be a recession by the end of 2023, aside from the occasional bounces, the direction of spreads will likely be for a further widening.

Week Ahead | Key events to watch for

- **Next week's important data is US retail sales**, which, given the US consumer sentiment conditions on Friday (the Michigan Sentiment was at 59 versus 64 expected), may disappoint expectations.
- **We will also see retail sales in China and the UK**, with different underlying dynamics, but similar risks to the downside.

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