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Weekly Market Flash

Are we at the start of a new bull market? Unlikely.

April 2, 2023

The absence of any further contagion following the banking crisis that hit the US and Europe in quick succession allowed equity markets to post strong gains in the last week of the quarter. Since the fourth quarter of 2022 had also been notably positive (with the stock market lows recorded at the beginning of October), there have been two positive quarters in a row. This statistic is rather anomalous for a (possible at this point) bear market. But while price action, sentiment, and positioning speak very clearly (in favor of a continuation of the recovery in equity prices, or even new highs as in Europe), the contradictions with macro fundamentals, and the reading that the rates market provides on the evolution of the real economy, are enormous.

Highlights

▪ EPS forecasts for the next 12 months are showing very few signs of weakness. Only in the US has there been a decline, but a moderate one, and one that has already stopped.

▪ Performance of the banking sector in the US is heavily negative (-17.5%), weighed down by regional banks. In Europe, the sector underperformed the index (7.7% versus 14.4% for the Eurostoxx 50).

▪ Expectations on monetary policy did not move much in the past week, even given the stabilization of the banking sector—the Fed's cuts in the second half of 2023 are all still present.

▪ Corporate bond markets are relatively unworried about the bank collapses: the spread on US high grade corporate bonds was 143 bps, still below the 150 bps level often associated with stress. For junk bonds, spreads averaged 480 bps, a level that often climbs closer to 800 bps in times of trouble.

▪ Some sense of stability has been returning to the banking sector. The risk premium on US financial sector debt eased to 170 bps, having soared to 188 bps on March 15.

"...the contradictions with macro fundamentals, and the reading that the rates market provides on the evolution of the real economy, are enormous!"

Markets & Macro | Are we at the start of a new bull market? Unlikely.

Fundamentals and rates contradict equity markets.

In addition to technical factors, the equity world continues to stick to very favorable corporate earnings trends.

Figure 1: Year-to-Date Performance of Major Indices

Equity Indices	Last Value	Week	Ytd
MSCI World	2,791.44	3.78%	7.89%
Nasdaq	12,221.91	3.38%	17.05%
S&P 500	4,109.31	3.50%	7.48%
DJ Industrial	33,274.15	3.22%	0.93%
Nikkei	28,041.48	3.27%	8.45%
Eurostoxx	4,315.05	4.46%	14.39%
Swiss SMI	11,106.24	4.72%	5.09%
FTSE 100	7,631.74	3.14%	3.55%
Canada	20,099.89	3.21%	4.61%
Shenzen	4,050.93	0.60%	4.67%
Hong Kong	20,400.11	2.43%	3.51%
MSCI EM	990.28	1.93%	3.99%

Equity Sectors	Last Value	Week	Ytd
S&P value	151.76	4.04%	5.11%
S&P Growth	63.89	2.95%	9.55%
S&P Defensives	1,550.70	0.00%	1.40%
ARK Fund	40.34	6.92%	29.13%
Fangs	6,190.01	4.21%	39.21%
S&P Banks	82.04	4.85%	-17.93%
Euro Stoxx Banks	82.83	6.32%	7.70%
S&P Energy	82.83	6.34%	-4.34%
Gold Miners	32.35	2.54%	12.88%

Commodities	Last Value	Week	Ytd
BBG Commodities	105.51	2.41%	-6.47%
BBG Agriculture	68.03	3.27%	-1.15%
Gold	1,969.28	0.00%	7.96%
Silver	24.10	0.00%	0.60%
BBG Brent Crude TR	1,007.11	7.09%	-5.16%
BBG WTI Crude Oil TR	181.24	9.35%	-5.25%

FX	Last Value	Week	Ytd
DXY Index	1,230.24	-0.56%	-1.31%
EUR/CHF	0.9922	0.00%	0.26%
GBP Index	633.33	0.61%	1.68%
EM FX Index	1,691.69	0.39%	1.88%
USD/JPY	132.86	0.00%	1.33%
USD/CNY	6.87	0.00%	-0.36%
Bitcoin	28,388.05	-0.03%	71.64%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	109.61	0.13%	4.98%
US High Yield	75.55	2.65%	4.20%
Euro Corps	231.65	-0.35%	1.75%
JPM Europe Govies	9,660.71	-1.17%	4.67%
US Treasuries	2,254.15	-0.55%	3.01%
China Aggregate	260.47	0.02%	2.04%
EMBI Global	785.53	0.40%	2.25%
EMBI Local	129.66	1.47%	4.83%

Source: Bloomberg, as at March 30, 2023. Performance figures in indices' local currencies.

"...there are many factors that continue to make us doubt that the two consecutive positive quarters represent the beginning of a new bull market."

Figure 2 highlights that the EPS forecasts for the next 12 months are showing very few signs of weakness (green line is Europe; grey line is S&P 500 index; red line is China). Only in the US has there been a decline, but a moderate one, and one that has already stopped.

Figure 2: EPS Forecasts (12 Months)

Source: Bloomberg, as at March 30, 2023.

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Our view: However, proving that bear markets are particularly frustrating and difficult to navigate, there are many factors that continue to make us doubt that the two consecutive positive quarters represent the beginning of a new bull market. In particular, when it comes to the US market, first of all, corporate margins and multiples are not depressed and expanding, but on the contrary are starting from high levels and have begun to contract. For instance, EBIT margins are now around 12%, compared to an all-time high of 13%, and an average of 9-10%. Multiples (forward P/E) are at 18.5, after an all-time high at 24 and the historical average at 16. In addition, interest rate curves are heavily inverted (they have often reached historical lows) and the central banks' rate hike cycles coming to an end in the past have always coincided with stock declines, not bullish phases.

“It remains to be seen whether the effects of the banking crisis of the last few weeks will be enough to deal the final blow to the economy by tightening lending standards...”

Another element that is difficult to reconcile is the performance of the banking sector, which in the US is heavily negative (-17.5%), weighed down by regional banks, which are more tied to economic activity and small and medium-sized enterprises on the ground. In Europe, the sector underperformed the index (7.7% versus 14.4% for the Eurostoxx 50). Since the banking sector plays a crucial role in the transmission of monetary policy, especially in a tightening phase, it is legitimate to continue to have concerns. Finally, as mentioned last week, expectations on monetary policy did not move much in the past week, even given the stabilization of the banking sector. More specifically, the Federal Reserve's (Fed) cuts in the second half of 2023 are all still present.

Taking into account that inflation figures are still high (core CPI is above 5% in both Europe and the US), and that consumption figures are still not falling (as desired by the Fed), our view is that monetary policy is still not tight enough to slow demand. At the same time, as has been the case in the past few weeks, given the financial imbalances of recent years, incidents are starting to happen. It remains to be seen whether the effects of the banking crisis of the last few weeks will be enough to deal the final blow to the economy by tightening lending standards (quantitative studies suggest it is as though the Fed had raised rates by another 100-150 bps).

Unfortunately, the answers to this conflict will likely emerge in the coming months or even quarters, so we will have to arm ourselves with a great deal of patience as we wait for fundamentals to prevail—while keeping our critical judgement open to the possibility that inflation will come back more quickly than expected, and that central banks will have the opportunity to ease policy without the economy going into recession. This is a scenario that is difficult to imagine, but nevertheless possible.

“But beneath the surface, small US companies are feeling a bit of financial stress...”

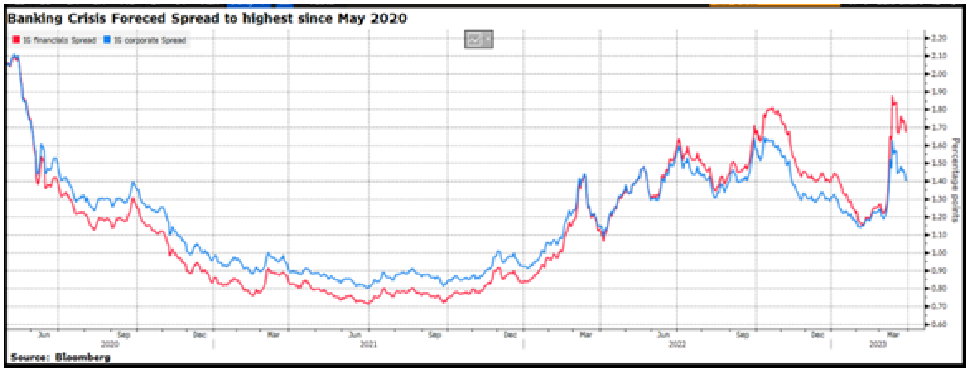
Fixed Income | Bond markets stabilize, but stress remains

Opportunities in AT1 bonds are emerging.

Corporate bond markets are relatively unworried about the latest string of bank collapses. The spread on US high grade corporate bonds was 143 basis points (bps), still below the 150 bps level often associated with stress. For junk bonds, spreads averaged 480 bps, a level that often climbs closer to 800 bps in times of trouble. But beneath the surface, with the Fed hiking rates, lingering issues around inflation, some challenges around securing workers, and wage pressure, small US companies are feeling a bit of financial stress. One sign is the rise in bankruptcy filings by small firms—those with less than US7.5 million in debt—that were up more than 28% through March compared to the same period in 2022. For those companies, lending conditions are expected to materially tighten, because many more banks, especially small ones, will tighten their purse strings.

When it comes to banks, some sense of stability has been returning to the banking sector. The risk premium on US financial sector debt eased to 170 bps, having soared to 188 bps on March 15, the highest since May 2020. It’s still unusually elevated compared to the rest of US high grade, which it tends to track fairly closely.

Figure 3: Corporate and Financials Spreads

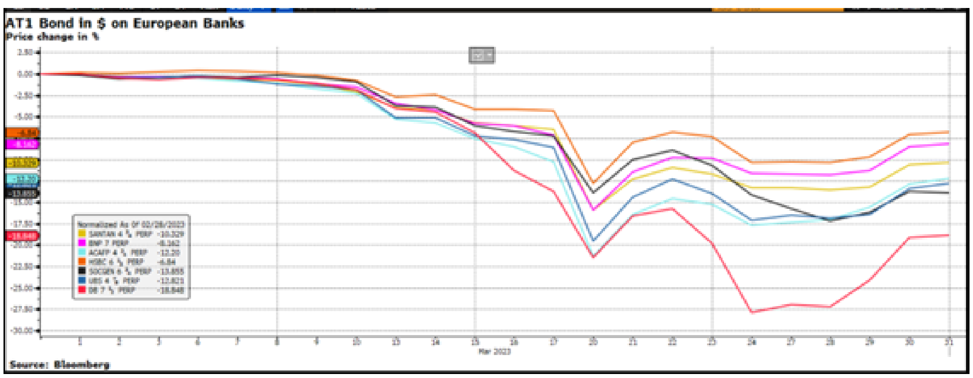


Source: Bloomberg, as at March 30, 2023.

"While many shun AT1s, asset manager Robeco says recent spread widening created the possibility for "equity-like returns" in the financial sector."

From here, spreads could tighten at least for systemically important banks and large European lenders (which, by the way, have higher liquidity coverage ratios than US peers). But a very different view concerns Additional Tier 1 bonds. After the government-brokered acquisition of Credit Suisse by UBS wiped out the riskiest tier of debt while still preserving equity, sentiment remains muted and anchored to a narrative according to which "until you cannot rule out any more bank failures, you do not want to be in the highest risk tier".

Figure 4: European Banks AT1 Bonds



Source: Bloomberg, as at March 30, 2023.

"We are avoiding the lowest rated bonds (especially below BB-) and we are wary of subordinated credit that tends to be more correlated to equity markets..."

While many shun AT1s, asset manager Robeco says recent spread widening created the possibility for "equity-like returns" in the financial sector. Indeed, some positive news is developing. For example, the European Central Bank's green light to UniCredit for its 2022 share buy-back program for EUR3.4 billion should reassure markets, and it demonstrates the solidity of the European banking system and its regulation. At the same time, according to Reuters, UniCredit has filed for approval to exercise the call of its AT1 6.625% Perp-call 03/06/23 (EUR1.25 billion). The reset of this AT1 is 639 bps (at today's spread equivalent to a 9.5% coupon), which of course cannot be compared to current refinancing levels in a market still in a crisis of confidence (probably a double digit coupon).

According to Oddo research, the AT1 bucket is 1.97% for a requirement of 1.88%. A repayment without reissuing new bonds would therefore require mobilizing Common Equity (CET1) to fill the bucket. This does not seem to be an issue given that the CET1 at end-2022 was 571 bps above the requirement (14.91% versus 9.21% requirement). Leverage is also not an issue, as the 6% ratio leaves 257 bps of leeway (EUR24 billion). UniCredit can therefore afford to call the bonds without reissuing new ones (if market conditions do not allow it to do so). Unicredit has time until the beginning of May to announce the call.

Our view: We remain unchanged and cautious in fixed income. We prefer to stay up in credit quality and like investment grade corporates, which, in the case of a recession, should experience less spread widening. For the moment, we are avoiding the lowest rated bonds (especially below BB-) and we are wary of subordinated credit that tends to be more correlated to equity markets—which would likely decline in a recessionary environment.

Week Ahead | Key events to watch for

- **The second quarter opens with three important data in the US**: ISM services and manufacturing data, and the key March labor market report. The latter will be decisive for the Fed's decision on a further rate hike in May, with market expectations split 50-50 over a 25 bps hike.

- **In Europe and Asia**, there are a few economic indicators of note.

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