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Weekly Market Flash

Should rising commodity prices be a concern?

May 2, 2021

This week saw commodity prices continue to rise, which, when accompanied by shortfalls in production across several sectors due to a microchip shortage, could (and should) soon start to worry investors. Such supply bottlenecks could hit the European industrial recovery harder, as warned by German auto manufacturers, which are particularly dependent on foreign supplies of microchips. This dynamic is one of the key reasons for our recent change in asset allocation: over the past few weeks, we decided to reduce our exposure to equities and to risky assets in general.

Highlights

- The last week of April saw commodity prices rise by another 1.8%, bringing gains for the month up to 7.8%.
- As expected, the Fed kept monetary policy and its message unchanged. Powell described the incoming increases in inflation as largely temporary and said that the labor market still has too much spare capacity to allow for sustained inflationary pressures.
- It was the most anticipated week of this earnings season, with 180 S&P 500 constituents reporting results. Technology and communication services stocks' earnings were in focus with FAAMG reporting earnings that beat consensus estimates.
- CCC-rated bonds outperformed in the fixed income space. Investors betting on recovery in pandemic-battered sectors like energy and retail have been rewarded with a total return of 6.57% on CCC-rated bonds.

Markets & Macro | Should rising commodity prices be a concern?

"The increase in commodity prices over the past few months, with the Bloomberg Commodity Index rising by 47% from the lows in March 2020, is evident in any economic indicator from the supply side."

Reducing our exposure to risk.

The last week of April saw commodity prices rise by another 1.8%, bringing gains for the month up to 7.8%. This dynamic, accompanied by shortfalls in production across many sectors (from cars to computers to any kind of durable good with some electronic functionality), due to a microchip shortage, could (and should) soon start to worry investors. Such supply bottlenecks could hit the European industrial recovery harder, as warned by German auto manufacturers, which are particularly dependent on foreign supplies of microchips.

Our view: The surge in commodity prices is driven by real shortages of raw materials as much as the anticipation of future demand. Stimulus spending, rebounds in manufacturing and construction, the economic reopening with travel and the return of drivers are all eating into inventories, while economic optimism and the prospect of big infrastructure spending have also contributed to the rally.

The increase in commodity prices – and therefore the pressure on prices – over the past few months, with the Bloomberg Commodity Index rising by 47% from the lows in March 2020, is evident in any economic indicator from the supply side (Figure 1). This dynamic is one of the key reasons for our recent change in asset allocation: over the past few weeks, we decided to reduce our exposure to equities and to risky assets in general. The paradox of our analysis is that the full reopening of the global economy will bear some underappreciated consequences. For instance, liquidity should shift from financial markets to the real economy, both in terms of credit to corporates shifting their focus to investments in order to increase their capacity and accommodate demand, and savers no longer being stuck at home using their subsidized savings to invest in the stock market.

At the same time, there is a mechanic effect of investment flows, due to the anticipatory nature of financial markets that are built to price in any news flow in advance of three to six months. This applies to both earnings (the current season is proving explosive and expectations appear to be climaxing, with growth for 2021 at 25% year-on-year and 15% for 2022), and to the economy (US GDP should grow more than 10% year-on-year in Q2, and gradually decline to 2.5% year-on-year in the middle of next year).

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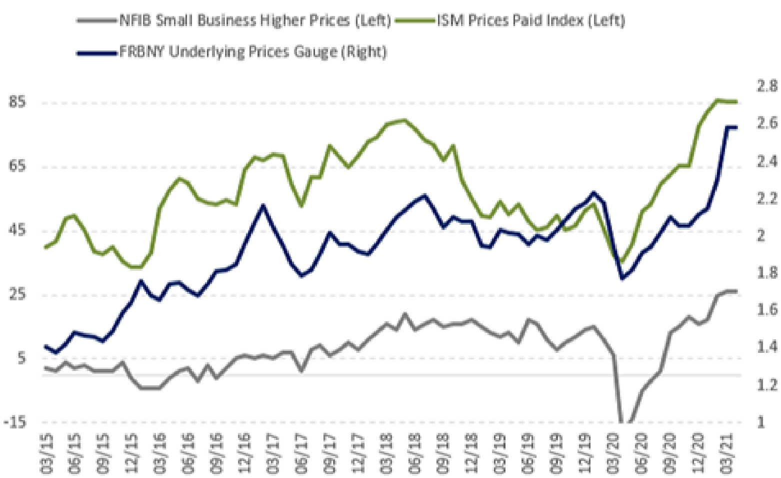
Figure 1: Commodity Price Rise Evident in Economic Indicators



Source: Bloomberg, as at April 30, 2021.

Is the rise in inflation temporary?

As expected, the Federal Reserve (Fed) kept monetary policy and its message unchanged this week. Chairman Powell acknowledged the improvements in the US economy and the progress of the vaccination campaign, but made it clear that the road to the Fed's goals is still long and that risks and uncertainties remain. On inflation, Powell again described the incoming increases as largely temporary and said that the labor market still has too much spare capacity to allow for sustained inflationary pressures.

"This means that inflation prints will be high in the short-term simply due to the low levels we are coming off of, and due to supply chain bottlenecks..."

Our view: The relaxation on inflation is due to base effects. This means that inflation prints will be high in the short-term simply due to the low levels we are coming off of, and due to supply chain bottlenecks, which the Fed expects will be resolved as companies and workers return to normal. However, markets still strongly disagree on this point, based on the uninterrupted rise in market-based inflation expectations, due to the massive money printing of the past months.

Elsewhere, the US administration published the third part of Biden's "Build Back Better" agenda. The first part was the relief package, the American Rescue Plan, which has already implemented, while the second part was the infrastructure package – the American Jobs Plan. The plan will cost roughly USD1.800 trillion spent on education, families and children. This is decidedly the most progressive part of his program, with measures typical of the European social-democratic system. It is no coincidence that comparisons between Biden and Roosevelt or Lindon Johnson are abound in the press these days.

The plan will be partly financed over 10 years by higher taxes on high-income households, with very difficult negotiations with the Republicans still allowing markets to bet on a much reduced impact in terms of higher taxes on corporates and individuals. This is also a reason why the administration is pressing ahead on such characterizing programs, since if they don't manage to achieve material results before the 2022 mid-term elections, they run the risk of being inconclusive and potentially lose the next presidential elections in 2024. And in another sign of left-wing direction of the administration's policies, Biden has signed an executive order on a very controversial issue: raising the minimum wage up to USD15 per hour for contract workers in the US federal government.

Equities | Cost pressures, chip shortage: key risks to earnings

Maintaining our cautious view on markets.

Most major global indexes recorded a weekly loss, despite a few of them reaching new highs during the week. Chinese indexes were mostly lower as the government continued its crackdown on internet companies.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	33,874.85	-0.50%	2.78%	11.30%
S&P 500	4,181.17	0.04%	5.34%	11.83%
Nasdaq	13,962.68	-0.38%	5.43%	8.55%
Euro Stoxx 50	3,974.74	-0.68%	1.93%	12.92%
Swiss Market	11,022.34	-1.53%	0.94%	5.61%
FTSE 100	6,969.81	0.50%	4.08%	9.26%
CAC 40	6,269.48	0.26%	3.57%	13.50%
DAX	15,135.91	-0.94%	0.85%	10.33%
FTSE MIB	24,141.16	-1.00%	-1.91%	9.15%
Nikkei 225	28,812.63	-0.72%	-1.25%	5.66%
Hang Seng	28,724.88	-1.22%	1.30%	5.92%
CSI 300	5,123.49	-0.22%	1.59%	-1.58%

Source: Bloomberg, as at April 30, 2021. Performance figures in indices' local currencies.

It was also the most anticipated week of this earnings season, with 180 S&P 500 constituents reporting their results. Technology and communication services stocks' earnings were in focus with FAAMG reporting earnings that beat consensus estimates.

Our view: Despite the strong earnings beats among technology stocks, the share price reaction was lackluster and to some extent disappointing. A "sell-the-news" type of action was observed in a few stocks post earnings, including Apple, Microsoft and Shopify, which may have been caused by the companies' outlooks.

"Despite the strong earnings beats among technology stocks, the share price reaction was lackluster and to some extent disappointing. "

The two most common issues raised by management teams during this season's earnings calls were cost pressures and chip shortage. Despite a strong demand outlook, several companies warned of potentially missing their sales targets due to the semiconductor shortage. At this point, the effect of the semiconductor shortage is felt across all industries from automobiles, to household goods, to Bitcoin mining equipment. We believe that this is one of the most serious short-term risks to Q2 and possibly H2 earnings. According to the Semiconductor Industry Association blog, "Semiconductor manufacturing is not suited to rapid and large shifts in demand, since it takes time to ramp up semiconductor production. Making a semiconductor is one of the most complex manufacturing processes. Lead times of up to 26 weeks are the norm in the industry to produce a finished chip."

"Despite a strong demand outlook, several companies warned of potentially missing their sales targets due to the semiconductor shortage."

Figure 3: Year-on-Year Monthly Sales Growth % Change in Automotive ICs (2020-2019)

Source: World Semiconductor Trade Statistics Bluebook sales data

Another risk that came to the forefront was the Chinese government heavily criticizing (and public shaming in the media) food delivery companies Meituan and Ele.me for their treatment of delivery workers. On Thursday, a similar tone was struck in the US by Labor Secretary Marty Walsh, who commented on gig contractors: "We are looking at it but in a lot of cases gig workers should be classified as employees... in some cases they are treated respectfully and in some cases they are not and I think it has to be consistent across the board,". While it is unclear how far these two governments will push companies to provide fairer treatment to their workers, we see this risk as another potential source of cost pressure affecting more than just the riding-hailing and food delivery companies. According to the International Labor Organization, in 2017, 55 million people in the US (34% of the workforce) were gig workers. This figure was projected to reach 43% in 2020.

"While it is unclear how far these two governments will push companies to provide fairer treatment to their workers, we see this risk as another potential source of cost pressure affecting more than just the riding, hailing and food delivery companies."

These factors combined explain why investors have been hesitant to push equity prices beyond current levels for the time being. Flow data corroborates this, where data from fund flow tracker EPFR showed investors moving USD57.3 billion to cash in the week to Wednesday. This is the largest inflow to cash since March 2020, according to Bank of America strategist Michael Hartnett.

We added to defensive plays (mainly consumers staples) at the expense of long-duration assets. We also remain positioned for inflation and tapering via our exposure to financials and materials. While we aren't holding our breath, we are closely watching the Chinese government's reform measures for signs of stabilization, as inflows appear to be recovering and market momentum seems to have stabilized post the year-to-date correction.

Chart of the week

The Italian equity Index, the FTSEMIB, was the only major index posting losses (-2%) during April. Profit taking after the Draghi-led rally, nervousness on a slow reopening and a disappointing vaccine campaign were responsible for the underperformance. The week's choppy dynamic combined with most technical indicators indicating overbought levels (see RSI in the panel below) suggest a near-term correction may be likely. We have partially taken profit on our Italy long trade which was established in February, ready to buy the dip if the index reaches our target at 23'500

Figure 4: Italian Equity Index

Source: Bloomberg, as at April 30, 2021.

"We have partially taken profit on our Italy long trade which was established in February, ready to buy the dip..."

Fixed Income & Credit | High yield issuance set for record H1

CCC bonds outperform in supportive market.

In the primary market, the junk bond issuance frenzy continues unabated, and a record first half of the year already looks inevitable. So far, the issuance barrage hasn't derailed the rally, partly because on a net basis (after all the refinancing), it's not as weighty as the gross numbers suggest.

The environment for US high yield remains very friendly, with the 5-year Treasury yield at 0.87%, supportive central banks, no substantial jump in credit risk and robust economic growth. Even if the current plans of about USD2 trillion of fiscal spending are derailed and replaced with a smaller plan, it is still additional stimulus to the economy. Therefore, it is not surprising that bonds rated CCC outperformed just about everything in the fixed income space. Investors betting on recovery in pandemic-battered sectors like energy and retail have been rewarded with a total return of 6.57% on CCC-rated bonds, compared with 1.96% on the overall high yield index, and a loss of 3.41% in high grade debt so far this year.

“Investors betting on recovery in pandemic-battered sectors like energy and retail have been rewarded with a total return of 6.57%...”

		current			spread change		total return	
		spread	yld	dur	1M	YTD	1M	YTD
US Government	2Y US Treasuries		0,16	1,91			-0,02	-0,02
	10Y US Treasuries		1,64	9,19			0,88	-6,08
US Corporates	High Grade	94	2,18	7,90	-6	-9	1,37	-3,41
	BBB	116	2,43	7,77	-7	-14	1,39	-2,89
	High Yield	324	4,20	3,54	-19	-62	1,26	1,96
	BB	234	3,38	4,33	-16	-45	1,30	0,85
	B	356	4,49	2,72	-21	-57	1,14	2,13
	CCC	633	7,10	2,27	-21	-170	1,45	6,57

Source: Ice BofA

		current			spread change		total return	
		spread	yld	dur	1M	YTD	1M	YTD
European Government	Euro 10		0,07	8,38			-1,18	-3,37
	German Gov		-0,36	8,00			-0,88	-3,15
	Ita Gov	92	0,55	7,39	10	0	-1,63	-2,42
European Corp	High Grade	85	0,35	5,27	-6	-8	-0,06	-0,77
	BBB	99	0,49	5,11	-9	-13	0,07	-0,39
	High Yield	293	2,40	3,42	-23	-62	0,71	2,19
	BB	226	1,74	3,71	-17	-38	0,63	1,56
	B	396	3,40	2,78	-21	-69	0,61	2,58
	CCC	672	6,19	2,45	-67	-272	1,81	7,41

Source: Ice BofA

		current			spread change		total return	
		spread	yld	dur	1M	YTD	1M	YTD
Emerging Markets	EM $ SOV	278	4,14	8,37	-8	-8	1,78	-3,35
	EM $ CORP	280	3,73	5,21	-1	-10	0,36	-1,23
	EM SOV (LC)		3,89	6,74			0,62	-0,84
	* curncy ret						1,25	-0,54
	* TR Converted $						1,87	-1,37

Source: Ice BofA

Our view: Even if we remain in the skeptical camp who say that current spreads are overvalued, we have to admit that there is no historical precedent for the current market. Never before has there been this level of fiscal and central bank support for the US economy. One should never underestimate the potential for cross-asset volatility if the Fed and/or Biden upset expectations, but tired theories of bubble and burst have to be cast aside. The next leg up in rates will surely hurt high-duration investment grade corporate. But it will take a lot to stop further tightening of spreads, or destabilize the common belief that when things turn for the worse, central banks stand ready to step in.

“One should never underestimate the potential for cross-asset volatility if the Fed and/or Biden upset expectations...”

On a single name level, Ford (Ba2/BB+) reported materially better-than-expected first quarter results, with Q1 automotive revenue, consolidated adjusted EBIT, and margins, meaningfully ahead of forecasts. However, Ford’s investment grade aspirations were dealt a blow when the automaker slashed its full-year guidance due to the computer chip shortage that’s slowing production. Previous market expectations were that Ford could return to investment grade in the 2022 / 2023 time frame.

Week Ahead | Key events to watch for

- **The US April payroll report will take center stage**. Another explosive print of one million jobs created is expected by economists’ consensus. The ISM reports are expected to confirm recent business strength, but could also worry investors due to ongoing rapid increases in prices.
- **The Bank of England gathers this week**, and it should upgrade its economic forecasts. It could be the second central bank, after the Bank of Canada, to taper the pace of its asset purchases.

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