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Weekly Market Flash

Are central banks making a notorious policy mistake?

July 3, 2022

The week just ended coincided with the close of the first half of the year. And it was extremely rich in events, macro data, speeches by central bankers, and frenetic price action across the market. During the semester, with the exception of commodities, all asset classes posted significant losses. In terms of total return, we have just witnessed the biggest drop in the S&P 500 index in a six-month period in the last 60 years, at just over 20%. As we have said previously, price action between inflation data and economic data, and central bank interventions, was at times schizophrenic. However, the overall message seems quite clear, with the rates market looking one way (growth, or rather downturn), and central banks looking the other way (inflation, which is typically a lagging variable). In short, the feeling is that investors are telling central bankers that they are, once again, making a notorious monetary policy mistake.

Highlights

- Bank of America's semiconductor analyst cut estimates forecasts for the entire sector by roughly 15% on average. Should the second quarter of the year confirm the challenging outlook for the entire sector, we'd expect other analysts to follow suit.

- In June, US consumer spending fell for the first time this year, suggesting an economy on a somewhat weaker footing than previously thought.

- Data this week showed that miners played a big role in the crypto selloff.

- As fears of a recession grow, government bonds ended the first half of the year on a better tone. US Treasury 10-year yields, from the highs of 3.45%, fell to the 3% area on Friday.

"What is even more impressive is that the 'risk parity trade' has completely collapsed."

Markets & Macro | Are central banks making a notorious policy mistake?

Growth surprises may not be over.

As mentioned, with the exception of commodities, all asset classes posted significant losses during the semester, from equities to credit and sovereign bonds. Among currencies, the US dollar dominated, along with LatAm currencies (thanks to commodity exports). And we have also witnessed the biggest drop in the S&P 500 index in a six-month period in the last 60 years. But what is even more impressive is that the 'risk parity trade', i.e. the mix of US treasuries and S&P 500 index stocks that traditionally managed to weather crises thanks to the duration component, has completely collapsed. Losses of over 20% even for this type of portfolio, and great discomfort for the most prudent investors, who have traditionally given up a certain upside (given by equities) in favor of stable returns.

Price action between inflation data (always high, above expectations in Europe) and economic data (almost always weak, especially in the US), and central bank interventions (always hawkish), was at times schizophrenic. However, investors seem to be telling central bankers that they are making a policy mistake. In particular, three scenarios seem to be emerging:

1. In an benign scenario, the Federal Reserve (Fed) reaches its target, growth slows down – but without a recession (soft landing) – and the terminal rate coincides with what is currently priced in, i.e. in the 3%-3.5% area.
2. In another scenario, inflation does not fall. As a result, the terminal rate is to be much higher than 3%-3.5%, resulting in an unfinished selloff across risky assets, with considerable risk of a financial accident (typically a major credit event).
3. Finally, a different scenario could see CPI come off, with a 3% (or lower) terminal rate, but this is because the economy is already technically in recession.

"We need to be cautious for a few more weeks, because the growth surprises may not be over – and we may even see a credit event in this scenario."

The feeling, looking at the collapse in implied inflation expectations and sector-wide losses, is that the third scenario has taken hold this week. And if it is the right one, we need to be cautious for a few more weeks, because the growth surprises may not be over – and we may even see a credit event in this scenario. On the one hand, it seems very strange to us, that with employment data still very strong and companies in the midst of an economic reopening, that growth could slow down so quickly. On the other hand, we have to recognize that this cycle has been extremely rapid and violent.

On the central bank front, some details of the European Central Bank's (ECB) famous anti-fragmentation plan, which we have followed closely over the past few weeks, began to emerge during the forum. In addition to the division of countries into donors, recipients, and neutrals for reinvestments of the pandemic scheme proceeds, the criterion of conditionality for new purchases (i.e. of a real selective QE, not reinvestments) was clarified. While the statement that the new instrument being prepared should not undermine the fiscal responsibility of beneficiary countries, our understanding is that this implies the imposition of conditionality, and monitoring – but it remains to be seen by whom – of the fiscal balance sheet.

There are no illusions then that the path to stabilizing peripheral spreads is still tortuous. On the one hand the instrument certainly has the characteristics to be effective, but it remains to be seen if and which countries will be willing to sign up to the program, with the winds of populism always threatening (especially in Italy at the moment, with elections scheduled for spring 2023).

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In conclusion, it is clear that the setting up of the vehicle is instrumental to the normalization of interest rates, in the sense that the Governing Council intends to proceed with the normalization of rates, without allowing itself to be overly conditioned by the widening of spreads. Besides, one cannot even ask the central bank to work miracles in a context of high inflation. Fiscal policy (European in this case) should play its part, in short, and not leave all the burden on the central bank, whose hands are fairly tied at the moment. In the absence of a common debt instrument, thus easing the burden on the single states, it is difficult to save the boat with the monetary instrument alone, as has happened in the past.

Equities | Will semiconductor sector woes spell trouble for the entire market?

Sector sees significant earnings forecast downgrade.

Global equities retreated on fears that central banks' tighter monetary policy would plunge the economy into recession. As mentioned earlier, the S&P 500 index had the worst first half of the year since 1970. Defensive sectors like utilities, health care and consumer staples, as well as energy stocks, ended the week on a positive note. Consumer discretionary and information technology / communication services stocks were the worst hit. Meanwhile, Chinese stocks advanced following news that China has cut the quarantine time from 14 to seven days for travelers coming from abroad.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,097.26	-1.27%	1.05%	-13.54%
S&P 500	3,825.33	-2.18%	1.06%	-19.12%
Nasdaq	11,127.84	-4.12%	0.90%	-28.58%
Euro Stoxx 50	3,448.31	-2.40%	-0.19%	-17.54%
Swiss Market	10,770.40	-0.49%	0.27%	-14.08%
FTSE 100	7,168.65	-0.54%	-0.01%	-1.02%
CAC 40	5,931.06	-2.34%	0.14%	-14.89%
DAX	12,813.03	-2.33%	0.23%	-19.34%
FTSE MIB	21,354.65	-3.46%	0.29%	-19.39%
Nikkei 225	25,935.62	-1.98%	-1.73%	-8.93%
Hang Seng	21,859.79	1.01%	NA	-4.82%
CSI 300	4,466.72	1.83%	-0.73%	-8.67%

Source: Bloomberg, as at June 30, 2022. Performance figures in indices' local currencies.

"In many ways, semiconductor stocks are the proverbial canary in the coal mine."

Our view: During the week, Bank of America's semiconductor analyst cut estimates forecasts for the entire sector by roughly 15% on average. This is one of the first material sectorial earnings forecast downgrades we've seen in a while. Micron Technology's disappointing guidance also weighed on the entire sector. In many ways, semiconductor stocks are the proverbial canary in the coal mine. Should the second quarter of the year confirm the challenging outlook for the entire sector, we'd expect other sector analysts to follow suit, downgrading their respective sectorial forecasted earnings and raising the probability of an economic downturn.

Crypto & Blockchain | Miners play a big role in selloff

Indicators suggest we're at maximum pain.

The price discount of 99% at which FTX is in talks to acquire a stake in BlockFI is worrisome for the industry (on Friday they confirmed the detail FTX US will grant BlockFi a USD400 million line of credit and receive an option to acquire BlockFi at a variable price of up to USD240 million based on its performance). After rumours that FTX passed on deal to purchase Celsius due to a deficient balance sheet, Sam Bankman-Fried (CEO/founder of FTX) seems to have become the lender of last resort that everyone wants. The strong balance sheet of his veteran company in crypto guaranteed to him a large amount of liquidity that has put him in a privileged position where he could end up owning a large chunk of digital companies.

"The amount that needs to still happen is hard to tell, but many indicators suggest we are at maximum pain."

Market action: More data this week showed that miners played a big role in the selloff. In theory, miners sell in a bull market and accumulate during bear markets. In a normal environment, this mechanism should rebalance demand, supply and price and create liquidity for miners to reinvest. However, due to the better financing options given a lower yield cost, during July 2021 to March 2022, miners were net accumulators preferring leverage with debt on their balance sheet. At the same time, the positive outlook attracted new investors that build new machines and drive the hash rate higher (a measure of how hard it is to mine a Bitcoin block), which recently hits new ATH, making it more expensive to mint a new block. In this difficult environment, miners entered a negative spiral where they were forced to sell the accumulated supply due to the rising costs of financing and harsh rate to compensate lower profitability.

As we assisted in traditional finance, deleveraging is a painful event. The amount that needs to still happen is hard to tell, but many indicators suggest we are at maximum pain. In the past, the bottom of the prices happened at the peak of the hash rate as it will force to shut down operations from miners and decrease supply.

Fixed Income & Currencies | Is now the time to jump back in?

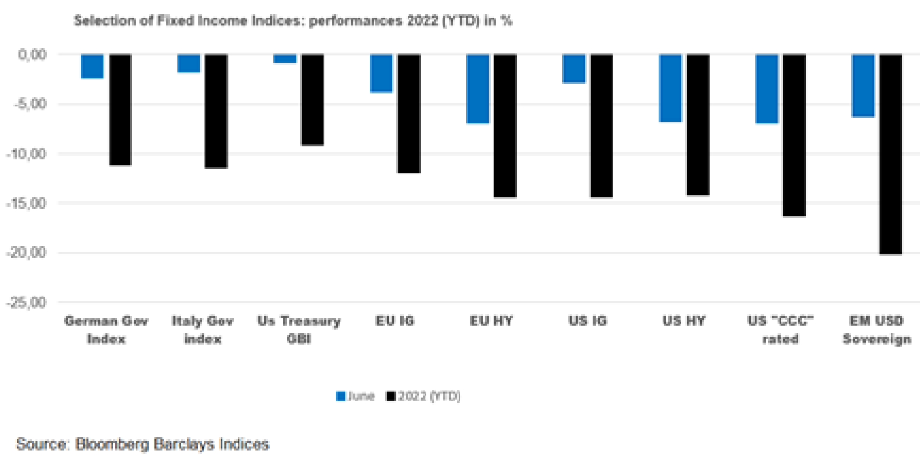
But the market could get worse.

In June, US consumer spending fell for the first time this year, suggesting an economy on a somewhat weaker footing than previously thought amid rapid inflation and Fed hikes. The fact that central banks need to act fast because they misjudged inflation has roiled markets and investors are beginning to bet that the economy will buckle under aggressive tightening.

"As fears of a recession grow, government bonds ended the first half of the year on a better tone."

As fears of a recession grow, government bonds ended the first half of the year on a better tone. US Treasury 10-year yields, from the highs of 3.45%, fell to the 3% area on Friday. That said, the late-June rally in Treasuries trimmed a year-to-date loss (-9%) that eclipses even the biggest annual losses since the early 1970s.

Figure 2: Fixed Income Performance in June



Source: Bloomberg, as at June 30, 2022.

Our view: Corporate bonds globally have been suffering all year, but with the recent growing signs of slowing economic growth, the segment crossed key levels, signaling the market could get much worse. Spreads on US high grade corporates topped 150 basis points, while their European counterparts widened to 200 bps. For US junk bonds, CCC rated spreads crossed 1000 bps, a level often seen as distressed. While the worst may be over, there are currently few who say now is a good time to jump back in. This is especially true in Europe, where the ECB has yet to raise rates to tackle record inflation.

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Chart of the week

Triple top in the EUR/JPY currency pair. The formation is a bearish signal for the pair. Traders are tactically playing bearish in case the Bank of Japan slows its massive buying program. This trade differs from the USD/JPY because the lower negative carry allows for a tactical long play on the JPY.

Figure 3: EUR/JPY Performance

Source: Bloomberg, as at June 30, 2022.

Week Ahead | Key events to watch for

- **Important economic data on the US labor market** will be released. Since this seems to represent the last bastion of defense for the US consumer, it will be closely watched.

- **Given the hint of inflation transmission**, from headline to core CPI, it will be important to monitor the wages component.

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