NOVUM
CAPITAL PARTNERS

Weekly Market Flash

An environment for cautious yet opportunistic positioning

October 3, 2021

Wall Street had a bad quarter-end, with several factors – from politics, to the growth-inflation mix (stagflation fears), to the earnings season, to the end of Jay Powell's term at the Federal Reserve (Fed) – weighing on the market. The Nasdaq 100 index was down -5.73% for the month of September and -6.3% from its highs, while the S&P 500 index down -4.76% in September, and down more than -5% from its highs at the beginning of the month. This is the first time in 2021 that a correction of this magnitude occurred, and in fact, it was finally a corrective phase worthy of the name – even though, in historical terms, corrections in a bull market phase tend to be higher at roughly 10%. Overall, this week confirmed an extremely volatile and tense market environment. Our impression is that the corrective or consolidation phase is not yet over, and should last at least throughout the earnings season.

Highlights

▪ On the economic front, the topic of the moment is the fear of stagflation, i.e. a world with low growth and high inflation. It is difficult to enter the debate with a strong and conclusive opinion on the subject.

▪ This September lived up to the month's reputation as the worst for US equities. Major global benchmarks ended the month down significantly, with the last trading week being the worst weekly performance for the Nasdaq index since February.

▪ Higher inflation expectations linked to a spike in energy prices and hawkish central banks were the big stories of September. As a result, it was a very difficult month for sovereign bonds.

▪ The GBP/USD pair has made a clear breakthrough in the 200 daily moving average, reaching its lowest levels of the year in a kind of perfect storm for sterling – weakened by Britain's shortage of truck drivers and a surge in energy prices, while a hawkish-sounding Fed and worries about Chinese growth boosted the greenback.

"...the corrective or consolidation phase is not yet over, and should last at least throughout the earnings season."

Markets & Macro | An environment for cautious yet opportunistic positioning

Finding opportunities in commodities and financials.

This week, on the US domestic political front, there were a number of conflicts between the parties. On Thursday evening, Nancy Pelosi, spokeswoman for the House of Representatives, had to remove the bipartisan vote on the USD550 billion infrastructure plan from the agenda because it was clear that the numbers to pass it didn't exist. Several so-called "progressive" Democrats refuse to vote on it ahead of the budget, because they want to use it as a tool to pressure "moderate" members who question the size of the "Build Back Better Act" (the social redistribution plan that would raise taxes on individuals, corporations and dividends).

At last, the Continuing Resolution to refinance the administration's activities until 3 December was approved, but this vote had already been discounted beforehand. The third step would be the approval of the budget, but the moderates seem adamant on USD1.5 billion, which means that the original USD3.5 billion is likely to be almost halved by the end of the negotiations. And the Democrats have until 18 October (or the end of the month according to some estimates) to approve it, or the depletion of the extraordinary resources will produce – in the absence of an increase in the debt ceiling – a technical default. Treasury Secretary Yellen has said she favors a bill that would remove the debt ceiling, but with both parties using it as a tool for political pressure, it seems unlikely that a qualified majority for its abolition will be achieved.

The second warning factor for the market comes from the earnings front. In particular, the theme is that of difficulties in the supply of raw materials and the consequent pressure on margins, and the difficulty for companies to reach their targets due to supply constraints. A strong signal in this regard came from home retailer Bed, Bath and Beyond, which saw its EPS fall dramatically short of expectations. In fact, we had recently been talking about an incoming earnings season far less bright than the last two, as we tracked a gradual but inexorable deterioration in analysts' expectations not only for Q3, but also for Q4 and the full year 2022. We recall that the average surprise in reported earnings relative to expectations over the past two quarters has been in the double digits, while companies are gradually reducing guidance, in an attempt to lower expectations so as not to disappoint.

"We do not believe that we are facing a possible bear market, mainly due to the fact that the demand side is still very solid."

A further element of tension, which is still under the radar but which we believe could increase in the near term, is the dynamic linked to the new Fed Chairman that Biden will have to appoint in the coming weeks, given the imminent expiry of Powell's term. We enclose, for our clients only, a recent note from David Zervos, Jefferies' highly regarded strategist and a great Fed watcher (having also worked there). We believe the note perfectly explains the risks involved, which the market has not yet dwelled on, as it has understandably been distracted by other factors.

On the economic front, the topic of the moment is the fear of stagflation, i.e. a world with low growth and high inflation. It is difficult to enter the debate with a strong and conclusive opinion on the subject, and it matters little at the moment as we have to manage portfolios pragmatically. It is clear that Europe seems particularly fragile at the moment, because inflation, especially inflation resulting from the explosion of energy and natural gas prices, is starting to hit consumer demand and purchasing power. As an example, September inflation in Europe came out in line with expectations, but with headline at 3.4% and core at 1.9%, both are at the highest levels since 2008. And the numbers still don't reflect the jump energy bills (it's been calculated that the natural gas price in Europe has reached the equivalent of USD190 per barrel of oil).

Our view: As a result, and as we have mentioned recently, the debate in the European Central Bank will be heated during the meeting in December, with the North-South front very hot on what to do about inflation on the one hand, and on the other hand the need to support peripheral governments with their high budget deficits and an economic recovery that actually has just started – which, although very strong at the moment (Italy, France and Spain are growing at a rate of 5-6% in Q3), is notably far from reaching absolute pre-Covid GDP levels.

"...let us remember that the problems we are constantly reading about are nothing more than a consequence of a rapid and full return to normality after almost two years of lockdown!"

In terms of asset allocation, the difficult scenario described leads us to maintain our current cautious and opportunistic positioning on certain themes: commodities-related, as well as financials due to the positive correlation with interest rate pressures in the absence of a balance sheet crisis. As for the directionality of equity indices, we remain at the window, slightly hedged, waiting for a good opportunity to increase exposures. We do not believe that we are facing a possible bear market, mainly due to the fact that the demand side is still very solid. In addition, the Covid and Delta variant front is evolving remarkably well, thanks to vaccine progress.

Overall, it remains to wait for the knots to unravel on the supply side and the future of the Fed and fiscal measures in the US. On supply-side issues, we want to keep a positive tone for the medium term: just as the Covid shock response of economic players (companies and consumers) has been formidable in terms of adaptability, we believe in the entrepreneurial ability to adapt and find solutions even in the face of supply constraints. It is only a matter of time, and companies will adapt their production structure to meet the new challenges associated with the full reopening of our economies. Indeed, let us remember that the problems we are constantly reading about are nothing more than a consequence of a rapid and full return to normality after almost two years of lockdown!

Equities | Valuations matter again

Are rising yields more damaging than supply chain disruptions?

This September lived up to the month's reputation as the worst for US equities. Major global benchmarks ended the month down significantly, with the last trading week being the worst weekly performance for the Nasdaq index since February. A late rally on Friday softened the blow of the correction. Within the S&P

500 index, only the small energy sector ended in the green, up roughly 5.8%. Healthcare and information technology were the worst performing sectors, down 3.5% and 3.3%, respectively.

Rising yields, debt ceiling uncertainty and failing stimulus talks among policymakers all weighed negatively on sentiment. Supply chain problems remained on top of investors' minds. Like Nike in the previous week, share prices of Bed Bath & Beyond and Kohl's fell sharply after the companies warned of the negative impact of supply chain failures and rising labor costs on this holiday shopping season. Meanwhile, reopening trades, especially travel and tourism, rallied on the back of the news from Merck regarding its trial drug that could reduce Covid-related deaths materially.

"Rising yields, debt ceiling uncertainty and failing stimulus talks among policymakers all weighed negatively on sentiment."

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,326.46	-1.36%	1.43%	13.72%
S&P 500	4,357.04	-2.19%	1.15%	17.24%
Nasdaq	14,566.70	-3.19%	0.82%	13.59%
Euro Stoxx 50	4,035.30	-2.91%	-0.32%	16.13%
Swiss Market	11,575.37	-2.05%	-0.58%	11.24%
FTSE 100	7,027.07	-0.26%	-0.84%	12.08%
CAC 40	6,517.69	-1.71%	-0.04%	20.00%
DAX	15,156.44	-2.42%	-0.68%	10.48%
FTSE MIB	25,615.31	-1.36%	-0.27%	17.86%
Nikkei 225	28,771.07	-4.38%	-2.31%	6.30%
Hang Seng	24,575.64	1.64%	NA	-7.49%
CSI 300	4,866.38	0.35%	NA	-5.04%

Source: Bloomberg, as at October 1, 2021. Performance figures in indices' local currencies.

Our view: Valuations matter again. We noticed that the sharpest corrections occurred in the SaaS stocks, with the loftiest valuations. The Goldman Sachs "8x EV/Sales software basket" was down 5.5% last week. While supply chain disruptions are unlikely to have a material impact on software stocks, rising yields are far more damaging and are likely to be longer lasting than the supply chain bottlenecks.

"While supply chain disruptions are unlikely to have a material impact on software stocks, rising yields are far more damaging..."

Fixed Income & Credit | US high yield outperforms in weak September

Higher inflation expectations weigh on performance.

Higher inflation expectations linked to a spike in energy prices and hawkish central banks were the big stories of September. As a result, it was a very difficult month for sovereign bonds, which saw a rise in yields across all major bond market. Over the month, US Treasuries are down -1.2%, and in Europe, Bunds (-1.5%), OATs (-1.4%) and BTPs (-0.8%) also followed.

Figure 2: Bond Market Performance

	Yield		total return	
Government	Current	Change 1M	1M	YTD
10Y US Treasuries	1.50	18	-1,23	-3,20
German Gov	-0,19	21	-1,46	-2,89

	current		spread change		total return	
Credit US & EUR	spread	Yield	1M	YTD	1M	YTD
US High Grade	89	2,14	-3	-14	-1,20	-1,12
US High Yield	315	4,21	-1	-71	0,12	4,68
EUR High Grade	85	0,34	-1	-8	-0,85	-0,36
EUR High Yield	304	2,5	1	-51	-0,07	3,69
Emerging Mkt						
EM $ SOV	295	4,29	10	9	-2,24	-2,01
EM SOV (LC)		4,08			-0,37	0,90
* curncy ret					-1,21	-2,14
* TR Converted $					-1,58	-1,23

Source: Ice of BofA indices, as at September 30, 2021.

Our view: Credit spreads were steady but ineffective to stem the upward movement in yields, especially in the investment grade segment where, due to indices' long duration, performance was negative. US high yield bond yields and spreads closed at 4.21% and 315 basis points (bps), respectively, for a slightly positive performance. Yields were a record-low 3.78% and spreads a multi-year low at 302 bps in early July.

"...ESG deals hit a record 25.2% share of all bond sales so far this year; sales under this label reached a third of volumes this month."

Meanwhile, the junk debt primary market experienced its busiest week in more than five months, with more than USD15 billion of bonds being sold. US junk bond investors were undeterred by rising US Treasury yields and wobbling equities as they crowded into Medline Industries' deal with orders of at least USD23 billion (for about USD7.77 billion of bonds) to fund the biggest buyout since the global financial crisis. Blackstone, Carlyle and Hellman & Friedman are selling debt to fund the acquisition of Medline Industries offering a yield of 5.25% on the unsecured tranche (B-/Caa1) and 3.88% on the secured tranche (B+/B1) for an 8-year tenor. Initial price discussions for the secured portion were for a yield in the low 4%, while around 6% for the unsecured.

In Europe, issuers across all sectors sold over EUR24 billion of bonds, pushing monthly sales above EUR200 billion for the first time since January. Highlights of the week include a two-part EUR1 billion deal for McDonald's (BBB+Baa1), yielding 0.9% for a 12-year tenor and 0.5% for the 8-year tranche, and beverage maker Pernod Ricard (BBB+/Baa1) offering 0.3% for a 2029 maturity. Sterling debt sales by corporates also exceeded 2020's annual tally as borrowers rushed to secure ultra-cheap funding costs while they still can.

We also note that in Europe, ESG deals hit a record 25.2% share of all bond sales so far this year; sales under this label reached a third of volumes this month. On the other hand, concerns that regulators will no longer accept vague descriptions of such investing, pushed Europe's biggest asset managers such as Allianz Global Investors and DWS Group to stop using the catch-all term "ESG integrated" in their public documents, and playing down its relevance in interactions with investors. The environmental, social and governance label was stripped off USD2 trillion in assets in anticipation of stricter rules.

Finally, Evergrande. To-date there has still been no payment to holders of a dollar-denominated bond which was due to be paid last week. However, China stepped in to buy a stake in a struggling regional bank from China Evergrande Group (Shengjing Bank in which Evergrande had an original 36% stake, one of its most valuable financial assets worth about USD2.8 billion). This was to limit the contagion in the financial sector. Separately, some holders of a USD260 million bond issued by a company called Jumbo Fortune Enterprises maintain that China Evergrande Group is a guarantor of the debt, and are forming a committee to press their claims if the company doesn't pay off the bond when it matures on October 3rd. In a sign of the worsening outlook for Evergrande, Fitch Ratings downgraded the developer's rating to C from CC on Wednesday.

"China stepped in to buy a stake in a struggling regional bank from China Evergrande Group... This was to limit the contagion in the financial sector."

FX & Commodities | Perfect storm for GBP/USD

Chart of the week

The Cable (GBP/USD) has made a clear breakthrough in the 200 daily moving average. The pair reached its lowest levels of the year in a kind of perfect storm for sterling, weakened by Britain's shortage of truck drivers and a surge in energy prices, while a hawkish-sounding Fed and worries about Chinese growth boosted the greenback.

Stagflation fears, an echo of Britain's experience in the 1970s, raises the prospect of further sterling weakness. The volatility is more similar to an emerging market currency than a G10 currency, as implied on Friday afternoon when the sterling pared deep weekly losses to an afternoon rebound. The level to watch is support 1.3150 and resistance 1.36/ 1.3850.

> “Stagflation fears, an echo of Britain’s experience in the 1970s, raises the prospect of further sterling weakness.”

Figure 3: GBP/USD Performance

Source: Bloomberg, as at October 1, 2021.

Week Ahead | Key events to watch for

- **As we wait for the earnings season to get underway** next week, the events of the coming week concern the economy and politics in the US.

- **On the economic front, ISM non-manufacturing and Friday's labor market** report are the highlights. The labor market will have a decisive impact on the Fed's tapering announcement at the November meeting.

- **On the political front,** we will have news on the topics mentioned earlier: negotiations in Congress will continue with regards to the debt ceiling deadline, as the Democrats seek to pass a USD550 billion infrastructure bill and a USD3.5 trillion reconciliation package.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Please note that any views expressed herein are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions. We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. They may differ from other views expressed for other purposes or in other contexts, and this should not be regarded as a research report. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Investors may get back less than they invested, and past performance is not a reliable indicator of future results