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Weekly Market Flash

Does China's equity recovery remain in doubt?

July 4, 2021

The US labor market report did not disappoint expectations of a strong recovery, with a large beat in June of 850k versus the consensus of 720k, following the miss in May. With the report having the effect of raising the monthly average gain over the past three months well above the 500k hurdle mentioned by many Federal Reserve (Fed) members, it will be important to keep monitoring Fed speakers in the coming days and weeks – as they could likely start preparing markets for an official tapering announcement at Jackson Hole in August. Meanwhile, the People's Bank of China (PBOC) scaled back the short-term cash injections, reversing the effect of the previous week's injection and leading to net drainage of funds from the financial system. Combined with reports of profit-taking activity from domestic investment funds, this resulted in a major negative effect on Chinese equities.

Highlights

▪ While US stocks advanced, European and international equities suffered during the week. European markets were affected by the diffusion of the Covid Delta variant, which is dominant in the UK making up 99% of new cases, and over 90% of new cases in Russia and Indonesia.

▪ In its latest policy meeting, the PBOC mentioned that it would "keep the macro leverage ratio basically stable", which suggests that the central bank would not tighten policy in the near term.

▪ Government bonds remain in negative territory on a year-to-date basis. However, on a quarterly basis, performance was divergent with US Treasuries rising 2.29% and Bunds falling -0.66%. In credit, the US Corporate Investment Grade Index gained 1.6% in June, but it remains down 1.27% for the year, while the high yield segment continues its overperformance and is up year-to-date both in the US (3.81%) and in Europe (3.01%).

Markets & Macro | Why have European assets underperformed?

Delta variant dampens sentiment.
The US labor market report revealed that pandemic-sensitive industries led gains once again in June, with leisure and hospitality jobs up by 343,000. Details of the report were also solid, with wages staying firm – average hourly earnings were up 0.3% in June, and more importantly, wage pressures are broadening out and average hourly earnings are now up at a robust 5.9% annualized pace over the last three months. However, thanks to an higher than expected unemployment rate reading (5.9% versus 5.6% expected), a sense of Goldilocks continued to prevail across US markets. Growth stocks and the Nasdaq index led the overall encouraging week for US assets.

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On the other hand, European and international equities suffered during the week. European markets were affected by the diffusion of the Covid Delta variant, which is dominant in the UK making up 99% of new cases, and over 90% of new cases in Russia and Indonesia. In the US and Israel, the variant makes up around 30% and 43%, respectively. That said, in countries with high vaccination rates such as the UK and US (62% and 57% of adults have been vaccinated with two doses, respectively), the impact on hospitalizations remains modest. Hospitalizations and deaths are growing by a limited amount, and are mostly hitting the unvaccinated.

Our view: The gap between the cases and hospitalizations tends to confirm the effectiveness of vaccines in transforming the Covid to a normal flu – although for a full eradication of the virus, we would need a very high rate of vaccinations not only in developed countries, but also in the emerging world. And unfortunately, the situation is much more worrying in emerging countries, with low levels of vaccination, and little chance to accelerate this, due to a lack of vaccine stock and poor infrastructure.

The only positive factor is that the advance of the Delta variant, while worrying some investors, is producing a re-acceleration of vaccination rates, which are currently noticeable in the US, UK and Israel.

This raises the question: following a favorable stint for European assets, which offered a "place to hide" for international flows, why have they now underperformed? In our opinion, there are three key drivers:

"The EU recovery fund has been fully priced in, while the path toward policy normalization is apparently set."

1. Since the recent peak in forward inflation expectations (coincident with the Fed's minor change of rhetoric hinting at tapering), long end rates have stabilized and growth/tech sectors started to outperform value stocks. And the lack of tech's presence in European indices is well known to investors.
2. The varying reactions of European politicians in terms of limitations to economic activities in the context of a new spike in cases, relative to the US.
3. The sense of "peak fiscal policy support" already impacting Europe. The EU recovery fund has been fully priced in, while the path toward policy normalization is apparently set. After investors' short honeymoon with Germany's green party leading the polls for September's general elections, the wind has abruptly changed. As polls once again favor the traditional center-right CDU party, attention has shifted toward new party leader Armin Laschet's political agenda. Laschet's program foresees a swift return to fiscal orthodoxy in Europe. He's leaning toward a lean state with little intervention. Laschet recently stated that the EU's recovery fund should be seen as a one-off event in extraordinary times, and doesn't constitute the "European Hamiltonian revolution". As a consequence, EU's fiscal rules should be restored soon, with single states balancing their budgets over the economic cycle.

Equities | Does China's equity recovery remain in doubt?

PBOC reverses impact from previous cash injection.

Volumes in the equity market continue to be relatively muted, with the exception of quarter-end rebalancing activity. Major US equity indexes recorded new highs during the week, on the back of favorable economic data that supported a Goldilocks scenario for equities. Growth stocks outperformed value stocks within the S&P 500 Index, with big tech stocks producing strong gains on Friday.

"…Chinese equities ended in negative territory, with Friday being one of the biggest one-day percentage drops since March."

As mentioned, European equities, which are generally viewed as a value play, fared less well due to concerns of the Covid Delta variant, ending the week slightly down. A similar negative sentiment prevailed in Japan, where returns were down for the week, and the Japanese yen weakened to a 17-month low. Meanwhile, in a holiday-shortened week, Chinese equities ended in negative territory, with Friday being one of the biggest one-day percentage drops since March.

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,786.35	1.06%	0.86%	14.76%
S&P 500	4,352.34	1.71%	1.30%	16.73%
Nasdaq	14,639.33	1.96%	0.94%	13.98%
Euro Stoxx 50	4,084.31	-0.88%	0.49%	17.16%
Swiss Market	11,964.84	-0.29%	0.19%	14.86%
FTSE 100	7,123.27	-0.16%	1.23%	12.25%
CAC 40	6,552.86	-1.06%	0.69%	20.35%
DAX	15,650.09	0.27%	0.77%	14.08%
FTSE MIB	25,282.41	-0.89%	0.72%	15.57%
Nikkei 225	28,783.28	-0.88%	-0.03%	5.72%
Hang Seng	28,310.42	-3.14%	-1.80%	5.50%
CSI 300	5,081.12	-2.91%	-2.73%	-1.74%

Source: Bloomberg, as at July 2, 2021. Performance figures in indices' local currencies.

Our view: On Friday, the PBOC scaled back the short-term cash injections, reversing the effect of the previous week's injection and leading to net drainage of funds from the financial system. Combined with reports of profit-taking activity from domestic investment funds, this resulted in a major negative effect on Chinese equities.

"Needless to say, with last week's liquidity drainage, the PBOC's policy tightness remains uninterrupted, throwing the equity rebound into doubt."

Investors abandoned hope that the liquidity injection of two weeks ago was the beginning of a policy reversal. In last week's Market Flash, we stated that "Should we see further signs of monetary policy tightness coming to an end, we would expect this week's China equity rebound to have legs". Needless to say, with last week's liquidity drainage, the PBOC's policy tightness remains uninterrupted, throwing the equity rebound into doubt.

One thing to note though is that in its latest policy meeting, the PBOC mentioned that it would "keep the macro leverage ratio basically stable", which suggests that the central bank would not tighten policy in the near term. There are also some signs that the government's efforts to cool the property market are finally working.

However, on the macro and political side, news did not help sentiment. For example, both the official and private sector manufacturing PMIs fell by more than 1 point in June, sitting just above the 50 level, signaling the divide between expansion and contraction. This was the third month in a row recording a fall in the index. Export orders also fell to 48.1, well below the line, as a sign that the global manufacturing cycle is likely peaking.

On the political side, Xi Jinping struck a very defiant tone in a speech marking the Communist Party's 100-year anniversary, calling China's quest to gain control of Taiwan a "historic mission", and warning Beijing's adversaries to avoid standing in the way. In an address from Tiananmen Square, Xi hailed the party's successes over the past century and warned that those attempting to pressure China "will surely break their heads on the steel Great Wall built with the blood and flesh of 1.4 billion of Chinese people."

Xi is clearly following his target, which is "making China proud again". Having wiped out any internal opposition, the great struggle of Xi is no longer against counter-revolutionaries or domestic opposition, but it is against anyone outside China's borders who would seek to contain its power.

Overall, in our view, the Chinese equity recovery remains in doubt. With economic data showing growth peaking this cycle and signs of PBOC policy bearing fruit, we have pushed out our expectations for policy normalization.

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Fixed Income & Credit | Have corporate bonds enjoyed their best days?

High yield market may continue outperformance.

Government bonds remain in negative territory on a year-to-date basis. However, on a quarterly basis, performance was divergent with US Treasuries rising 2.29% and Bunds falling -0.66%. Meanwhile in credit, the US Corporate Investment Grade Index gained 1.6% in June, but it remains down 1.27% for the year. On the other hand, the high yield segment continues its overperformance and is up year-to-date both in the US (3.81%) and in Europe (3.01%).

		current			spread change		total return		
		spread	yld	dur	1M	YTD	1M	3M	YTD
USA	10Y US Treasuries		1,48	9,08			1,36	2,29	-4,39
	High Grade	87	2,08	8,15	-4	-16	1,60	2,69	-1,27
	High Yield	302	4,01	3,63	-31	-84	1,40	2,68	3,81

Source: Ice BofA

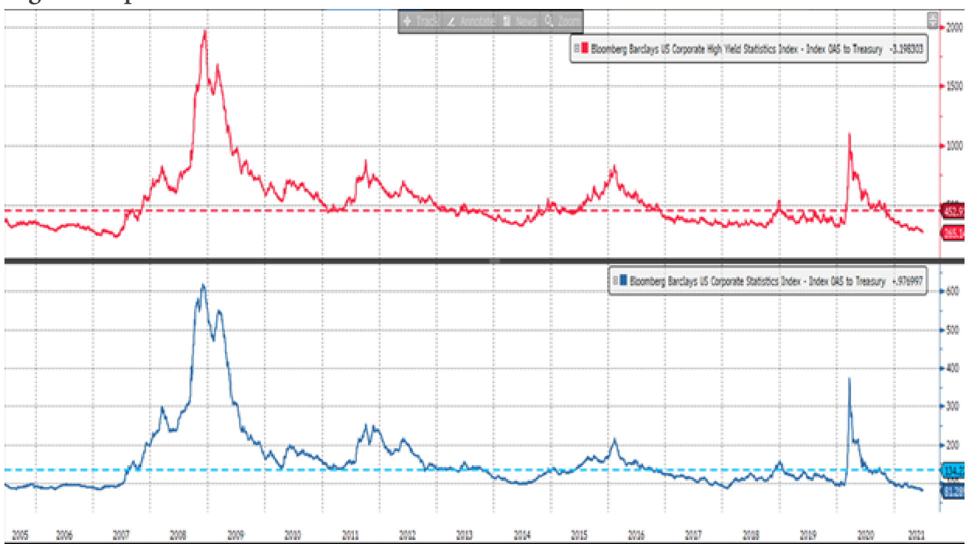
		current			spread change		total return		
		spread	yld	dur	1M	YTD	1M	3M	YTD
Europe	German Gov		-0,38	8,24			0,49	-0,66	-2,82
	High Grade	84	0,32	5,36	-2	-9	0,39	0,05	-0,43
	High Yield	298	2,42	3,51	-1	-57	0,44	1,23	3,01

Source: Ice BofA

Our view: High valuations and the prospect of a gradual unwinding of Fed stimulus suggest that the corporate bond market's best days may already be behind us. Spreads on investment grade bonds narrowed to an average of 80 basis points over Treasuries on June 30, the lowest since 2005 (blue line below), while the risk premium on high yield debt fell to 2.68 percentage points (red line below), the lowest since 2007.

> "High valuations and the prospect of a gradual unwinding of Fed stimulus suggest that the corporate bond market's best days may already be behind us."

Figure 2: Spreads and Risk Premium Decline



Source: Bloomberg, as at July 4, 2021.

We believe it is important to keep in mind that the investment grade market is a long-duration asset class. Therefore, the risk to total return is in the Treasury market with higher rates – and given the tight spread levels, it will be difficult for additional spread tightening to offset higher Treasury rates.

Prospects could also be brighter for high yield. Low default expectations, a reopening economy and an increase in ratings upgrades could fuel a further advance in the second half. Investors are yield starved and high yield bonds, which have yields at an all-time low of 3.71%, have not exactly seen dampened demand until now.

Cheap borrowing costs have sparked an issuance bonanza in the high yield market, with Bank of America calling for levels to hit a record USD500 billion this year. The latest example of this frenzy is lingerie seller Victoria's Secret (B1/BB-) that sold junk bonds and leveraged loans totalling USD1 billion to fund cash payments to L Brands as part of a spinoff. The bond portion saw orders total USD2.7 billion, which enabled an increase in the deal from USD500 million to USD600 million, and a final price equal to a yield of 4.625% - which is well below the initial offer of 5%.

> "This week the price action was very weak with the pair failing to break the 200-daily moving average."

FX & Commodities | Will EUR/USD remain rangebound?

Chart of the week

Last week we noted that the EUR/USD should stay in a sideways trend between 1.21 and 1.17 for the summer period. This week the price action was very weak with the pair failing to break the 200-daily moving average. Now, with the RSI at the lows of the last two years, we need to see a double bottom in the indicator to confirm our range trading forecast.

Figure 3: EUR/USD

Source: Bloomberg, as at July 4, 2021.

Week Ahead | Key events to watch for

As investors are starting to switch to summer mode, with low activity resulting in low volumes and volatility, there are still a number of important events and themes to follow over the coming week.

- **The spread of the Delta variant** will certainly be of interest at least in Europe and Asia, with concerns about the new imposition of restrictions.

- **Economic news will be less impactful** next week, with only the services and composite PMIs from around the world, the publication of the June FOMC minutes, and the G20 of finance ministers and central bank governors.

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