NOVUM
CAPITAL PARTNERS

Weekly Market Flash

The big growth debate

September 4, 2022

On the return from the summer holiday, major global stock markets are close to levels seen at the end of July. However, the period in between—and as is now customary in the post-Covid world, with monetary policy normalization and the ongoing war in Ukraine—witnessed a lot of volatility.

Highlights

▪ Looking at the main assets since the beginning of the year, little has changed in the underlying trend, with equity markets generally in deep red. In the currencies space, the US dollar has accelerated its strength against all currencies.

▪ Gold, in a context of great geopolitical tension and the collapse in equities, is the great disappointment of this year.

▪ Credit witnessed very strong gains in July, however, only a month has passed since then, and the momentum of July's optimism faded with the much stronger-than-expected US jobs report.

▪ Under pressure from central bankers determined to quash inflation even at the cost of a recession, global bonds slumped into their first bear market in a generation. The Bloomberg Global Aggregate Total Return Index of government and investment grade corporate bonds has fallen more than 20% below its 2021 peak.

Markets & Macro | The big growth debate

Earnings will remain the key market driver.

"Gold, in a context of great geopolitical tension and the collapse in equities, is the great disappointment of this year."

Looking at the main assets and financial variables since the beginning of the year, little has changed in the underlying trend, with equity markets generally in deep red—albeit there are a few exceptions, including Japan, which thanks to the weakness of the Japanese yen is almost flat. In the currencies space, driven by the firmness of the Federal Reserve (Fed) and the currency's safe haven status, the US dollar has accelerated its strength against all currencies. However, there is one exception, which is incredibly the Russian ruble. Bonds are—and are likely to remain so in the near term—deeply at a loss due to the impact of inflation and the repricing of rates.

Meanwhile, there has been some change in the commodities area. We note that gold, in a context of great geopolitical tension (in addition to the war and sanctions, August also saw the reawakening of tensions between China and the US regarding Taiwan) and the collapse in equities, is the great disappointment of this year. Evidently, the rise in interest rates, and hence the opportunity cost of holding gold, is too strong to resist, along with the indisputable fact that the Fed, and to a large extent other western central banks, are fighting or have already fully recovered their credibility.

Lastly, oil corrected by a notable 20% due to several factors—including the concrete prospect of a finalization of the Iran nuclear deal (which would bring new supply to the market), the prolonged lockdowns in China, the continued release of strategic reserves in the US, and above all, the potential of a global recession that is now almost inevitable given the tightening of monetary policy.

"Following a 24% drop in the S&P 500 index between January and June, the summer rebound was mighty, exceeding 18%."

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

Equity	Last Value	Ytd
MSCI World	2,610.26	-17.98%
Nasdaq	11,921.87	-23.37%
S&P 500	4,013.59	-14.89%
Nikkei	27,650.84	-2.84%
Eurostoxx	3,544.38	-15.06%
Swiss SMI	10,891.71	-13.11%
FTSE UK	7,281.19	1.50%
Canada	19,467.74	-6.42%
Norway	1,490.25	4.74%
Shenzen	4,023.61	-16.93%
Hong Kong	19,452.09	-14.59%
MSCI EM	976.14	-18.79%

Commodities	Last Value	Ytd
BBG Commodities	119.25	20.25%
BBG Base Metals	222.94	-22.42%
BBG Agriculture	68.29	12.33%
Gold	1,713.44	-6.40%
Silver	18.05	-22.60%
BBG Brent Crude TR	1,085.24	44.90%
BBG WTI Crude Oil TF	200.69	31.08%

Bond Indices	Last Value	Ytd
US Inv Grande	108.74	-16.40%
US High Yield	74.93	-11.05%
Euro Corps	232.25	-11.91%
JPM Europe Govies	9,526.00	-10.43%
US Treasuries	2,237.36	-10.50%
China Aggregate	257.64	-4.32%
EMBI Global	754.51	-17.95%
EMBI Local	119.38	-13.32%

FX	Last Value	Ytd
DXY	1,298.19	11.05%
Bloomberg JP ASIA	100.09	-7.54%
Bloomberg JP LATAM	40.65	-0.56%
EUR Index	117.74	-2.96%
EUR/CHF	0.98	-5.87%
GBP Index	618.64	-9.60%
EM fx	1,636.25	-5.70%
JPY	140.20	-17.90%
CNY	6.90	-7.89%
Bitcoin	20,327.93	-57.27%

Source: Bloomberg, as at September 2, 2022. Performance figures in indices' local currencies.

Our view: As Figure 2 highlights, following a 24% drop in the S&P 500 index between January and June, the summer rebound was mighty, exceeding 18%. The factors that triggered and fueled the rally were fourfold: an extremely negative positioning and sentiment that had built up in late May/early June (for which, a few good news were sufficient to reverse the trend), a better-than-expected Q2 earnings season (released in July), a seemingly dovish Fed message after the mid-July hike, and finally a US inflation figure (released on 10 August) that was finally below expectations—a possible sign of a turnaround.

Figure 2: S&P 500 Index Over the Past 3 Years

Source: Bloomberg, as at September 2, 2022.

"...the impact of the speech on the market was significant and unlikely to be reversed unless the Fed's message turns softer in future speeches..."

But once the momentum was lost, the market had a bearish acceleration with the Fed symposium in Jackson Hole in the penultimate week of August. This event, in our view, was a real cold shower. The tones used by Powell were much more aggressive than expectations that were already hanging in the Hawkish direction. It is worth recalling the main points of the speech, because the impact on the market was significant and unlikely to be reversed unless the Fed's message turns softer in future speeches:

- The Fed's main objective at present is to bring inflation back to target. Without the condition of price stability, the economy does not function well.
- It will take time, and will require actions to reduce—by force—demand. This will require a period of growth below potential and a weakening of the labor market.
- The stance will be intentionally moved into restrictive territory. Past experience advises against reducing the restrictiveness of monetary policy prematurely.
- It must be avoided at all costs that the inflation phase changes public expectations, becoming entrenched.

“Today, conditions are decidedly different… and the Fed appears to be basing its analysis on lagging indicators…”

In practice, it is to be ruled out that a weakening of the economy and markets will stop the Fed’s hand, because this weakness is an expected factor and one that is considered necessary to restore price stability. It is also quite ironic that a speech such as, although sensible in itself, is also decidedly ill-timed—as is often the case with us portfolio managers. 12 months ago, when inflation was already high (core inflation was over 5%), and economic activity overheated, it would have been received differently. But back then, central bankers were talking about transitory inflation, weakness in the labor market, and the need for accommodative policy. All central banks were doing QE aggressively and forward guidance was pointing to zero rates for quarters to come.

Today, conditions are decidedly different, with economic activity slowing, housing activity in deflation, and numerous shocks underway—and the Fed appears to be basing its analysis on lagging indicators such as employment and inflation to justify a continued ultra-aggressive stance. As a result, the risk of a second monetary policy mistake (after the delayed tightening toward the end of the lockdowns) appears palpable and is what scares investors.

Looking ahead to the coming weeks, the most important variable to drive the market will be the Q3 earnings season, which starts in mid-October. With central banks now very clear and hawkish, economies slowing but still solid, and the European gas crisis certainly severe but definitely embedded in prices (and the single currency), we consider earnings to be the main market driver. It should be added that multiples, although certainly not cheap, have already dropped a lot, from 31 to 19 for the S&P 500 index (Figure 3).

Figure 3: P/E and 1-year Forward P/E For the S&P 500 Index

Source: Bloomberg, as at September 2, 2022.

“With all the uncertainties prevailing, we think being a bit agnostic toward market direction is a wise choice.”

The big debate, which will be largely clarified with the Q3 earnings season and the outlooks that companies will give, concerns growth (or a decline in it) for 2022 and 2023. The forecasts, which have been coming down in these last weeks, see growth around 7% for both periods. Now, we recognize that traditionally, in an economic recession, given the "operating leverage" effect of companies, a contraction of at least 5%-10% in profits would be normal. However, it is true that we are in a particular cycle (due to the reopening from lockdowns and the accumulated excesses), whereby the inflation regime guarantees a structurally higher nominal GDP growth rate (and corporate profits are a nominal variable). As a result, we cannot rule out that if the economic slowdown were to be softer than expected, nominal growth could remain around 5%, and profits remain flattish year-on-year. In short, this is not necessarily a disaster.

During the summer, in terms of our asset allocation, we assumed a neutral stance, increasing equity exposure very marginally. With all the uncertainties prevailing, we think being a bit agnostic toward market direction is a wise choice. Our goal is to start increasing risk exposure either on weakness (should the S&P 500 index head toward 3’500, attractive value would start to emerge from valuations), or once the Fed’s message softens in relation to better inflation dynamics—which we think is likely, since many anticipatory components of inflation point in that direction.

Fixed Income & Commodities | Up in quality and seniority

Short-term rates reprice upward.

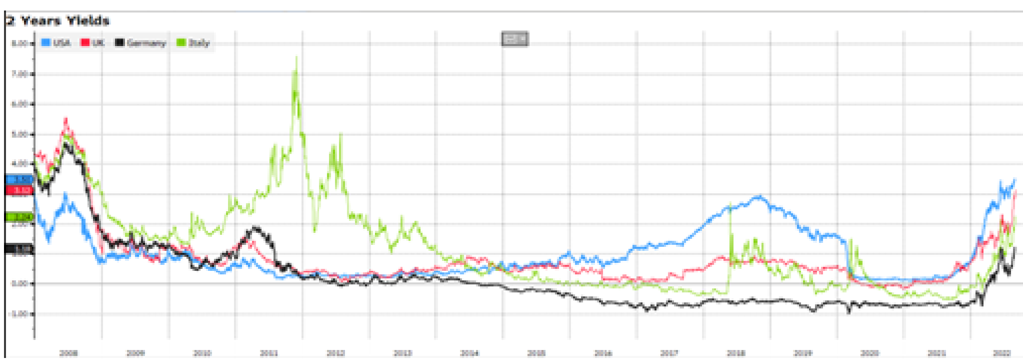
In mid-June, concerns about growth slowing and some signs that inflation was peaking gave rise to a positive market narrative: US inflation had peaked, rates would hit a terminal level of 3.25% in the first quarter, a recession was inevitable, and central bankers would be forced to pivot and cut rates with inflation, driven by energy, returning below 4%. All this proved supportive for fixed income, leading credit to witness very strong gains in July: US high yield was up 5.9%, US investment grade up 3.24%, EUR investment grade up 4.7%, and EUR high yield up 5.08%. In Europe, the announcement of the European Central Bank's (ECB) new anti-fragmentation tool, the Transmission Protection Instrument (TPI), was unable to overcome Draghi's resignation and BTPs (1.7%) did not keep up with Bunds (4.6%).

> "The momentum of July's optimism died out completely when the Fed brutally made clear its determination to crush inflation..."

Our view: However, only a month has passed since then—and everything has changed. The momentum of July's optimism first faded with the much stronger-than-expected US jobs report where the total number of nonfarm payrolls exceeded their pre-pandemic peak for the first time. It then died out completely when the Fed brutally made clear its determination to crush inflation and Euro area inflation rose to a record high of 9.1%. The new harsh central bank rhetoric led to a repricing upward of short-term interest rates. For both the Fed and the ECB, as well as the Bank of England, futures markets are now expecting 75 basis points (bps) hikes at their September meeting and higher terminal rates than before.

This shift in the outlook meant 2-year government bond yields (more sensible to short-term expectations) climbed to multi-year highs: German 2-year yields (the black line) rose 92 bps on the month, the largest rise since 1981, and 2-year yields in the UK (the red line) were up 131 bps, the largest rise since 1986.

Figure 4: Short-term Government Bond Yields



Source: Bloomberg, as at September 2, 2022.

> "...under pressure from central bankers determined to quash inflation even at the cost of a recession, global bonds slumped into their first bear market in a generation."

The carnage has gone so far that, under pressure from central bankers determined to quash inflation even at the cost of a recession, global bonds slumped into their first bear market in a generation. The Bloomberg Global Aggregate Total Return Index of government and investment grade corporate bonds has fallen more than 20% below its 2021 peak, the biggest drawdown since its 1990 inception.

Still, as yields rise, demand for government bonds will resurface, aided by lingering expectations that policy makers will need to reverse course should economic slowdowns help cool inflation. On the credit side, market participants have historically watched high yield bonds for signs of an impending recession, and despite every credit index having lost ground over the last month, we are still far away from spreads of 800-850 bps—which are generally considered crack levels associated with a "growth scare".

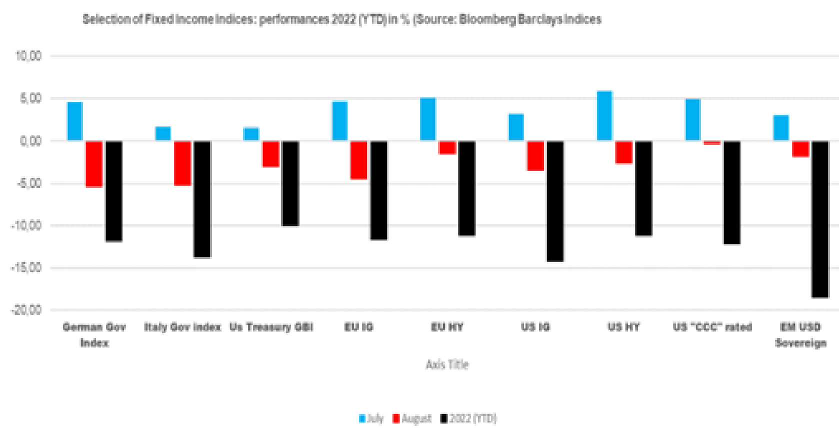
> “With still a lot of risk around, this is a time to maintain a cautious stance across corporate credit, staying up in quality and up in seniority.”

Figure 5: US High Yield Bond Spreads

Source: Bloomberg, as at September 2, 2022.

Our conclusion is that, with still a lot of risk around, this is a time to maintain a cautious stance across corporate credit, staying up in quality and up in seniority. High quality bonds can offer a potential flight-to-safety, when the risk assets like equity, high yield bonds and cryptos are weak. Moreover, high grade bonds would benefit from falling government yields limiting the potential damage. In a risk-off scenario, government bond yields will go lower and lessen the effect of wider spreads.

Figure 6: Fixed Income Performance in July and August



Source: Bloomberg, as at September 2, 2022.

Week Ahead | Key events to watch for

- **Next week is the ECB meeting**, with the market torn between a 50 bps or 75 bps hike.
- **There will also be a speech by Powell** on the same day, which could be used to test the Fed's direction after the Jackson Hole shock.
- **In Asia, there will be China's inflation figure**.
- **In the UK on the political front**, the new prime minister will be announced on Monday.

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

Carlos De Andres Perez
Senior Private Equity Funds Manager

Maxime Glasson
Senior Hedge Funds Manager