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Weekly Market Flash

Central bankers suggest a pause in tightening is near

February 5, 2023

Central bank meetings dominated the week, with rate announcements coming out in line with the market's expectations—50 basis points (bps) hikes for the European Central Bank (ECB) and the Bank of England (BoE), and a 25 bps hike for the Federal Reserve (Fed). But, more importantly, were the central bankers' statements, which had major consequences for the rates market and therefore the stock markets.

Highlights

- The market is already expecting inflation in the US to fall rapidly to around 2% toward the end of the year, and almost 50 bps of Fed rate cuts by the end of 2023.
- The US Labor Department reported an unexpected increase in nonfarm jobs, while the ISM services sector activity jumped unexpectedly.
- This week, the 10-year US Treasury yield moved down from 3.5% to 3.33%, but even more impressive was the fall in yields in Europe: yields on 10-year bunds (-20.4 bps) saw their largest daily decline since 2011, and for BTPs (-39.3 bps), it was one of the best daily moves since 1993.
- The earnings decline of the companies that have reported Q4 earnings so far are -5.3% year-on-year. Analysts expect Q1 2023 earnings to decline by 4.2% and Q2 2023 earnings to decline by 2.9% year-on-year, with growth rebounding strongly in the second half of the year to 3.4% and 10.5% in Q3 and Q4, respectively.
- Just 24 hours after a 25 bps rate hike, the US high grade funding landscape was still dominated by insatiable investor demand. Companies paid -5 bps in new issue concessions after tightening spread guidance nearly 30 bps on final books that were 6.6 times oversubscribed.

“Powell also indicated that the FOMC is targeting two more 25 bps hikes, suggesting that a pause is in sight at the May meeting.”

Markets & Macro | Central bankers suggest a pause in tightening is near

ECB joins the Fed with a less hawkish message.

Fed Chair Jerome Powell's conference this week was very balanced, with dovish tones compared to what he had accustomed markets to in recent months. In particular, he did not have a confrontational attitude toward the two key themes: inflation expectations and the possibility of rate cuts as early as the second half of the year. In fact, the market is already expecting inflation in the US to fall rapidly to around 2% toward the end of the year, and almost 50 bps of rate cuts by the end of 2023. Powell did not dispute this possibility, asserting that indeed consumers’ inflation expectations are back under control, stable just above 2%. In a nutshell, he acknowledged that the disinflation process is ongoing.

Powell also indicated that the FOMC is targeting two more 25 bps hikes, suggesting that a pause is in sight at the May meeting. In other words, it puts the end to tightening quite close. Powell added that the easing of financial conditions (a central element in the Fed's decisions) only worries him if it is material—and he doesn't see much difference between now and December (which surprises us, given the rally in equities and bonds in recent weeks).

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

Equity Indices	Last Value	Ytd
MSCI World	2,820.74	8.49%
Nasdaq	12,006.96	14.78%
S&P 500	4,136.48	7.86%
DJ Industrial	33,926.01	2.45%
Nikkei	27,509.46	5.43%
Eurostoxx	4,257.98	12.45%
Swiss SMI	11,349.39	5.78%
FTSE 100	7,901.80	6.10%
Canada	20,758.34	7.37%
Shenzen	4,141.63	6.98%
Hong Kong	21,660.47	9.50%
MSCI EM	1,038.71	8.67%

Equity Sectors	Last Value	Ytd
S&P value	157.24	8.39%
S&P Growth	62.77	7.30%
S&P Defensives	1,561.95	2.13%
ARK Fund	42.85	37.16%
Fangs	5,732.21	28.87%
MSCI Financials	142.45	9.00%
S&P Energy	85.96	-1.73%
Gold Miners	30.32	5.79%

Commodities	Last Value	Ytd
BBG Commodities	107.07	-5.08%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	69.22	0.58%
Gold	1,864.97	2.25%
Silver	22.35	-6.69%
BBG Brent Crude TR	988.55	-6.91%
BBG WTI Crude Oil TR	175.28	-8.37%

FX	Last Value	Ytd
DXY Index	1,233.70	-1.03%
Bbg JP ASIA	102.70	1.49%
Bbg JP LATAM	40.57	2.08%
EUR/CHF	1.00	0.98%
GBP Index	618.79	-0.65%
EM FX Index	1,707.86	2.85%
JPY/USD	131.19	-0.05%
CNY/USD	6.80	1.48%
Bitcoin	23,377.08	41.33%

Bond Indices	Last Value	Ytd
US Inv Grande	110.54	5.17%
US High Yield	76.39	4.25%
Euro Corps	234.98	3.22%
JPM Europe Govies	9,616.19	4.19%
US Treasuries	2,238.22	2.28%
China Aggregate	263.47	3.21%
EMBI Global	800.21	4.16%
EMBI Local	128.76	4.10%

Source: Bloomberg, as at February 3, 2023. Performance figures in indices' local currencies.

Our view: The impression we get is that the FOMC's conviction in its hawkish view has waned, and that it is openly taking the view that the macroeconomic picture may be evolving in the direction of what rates are discounting. In practice, we believe that an important element that had characterized 2022 has been removed—namely, the Fed's hawkishness. Evidently, although headline inflation is still above 6%, the Fed believes that the 450 bps of hikes it has made are sufficient, for the time being, to be able to breathe a sigh of relief in the fight against inflation.

"We believe that an important element that had characterized 2022 has been removed—namely, the Fed's hawkishness."

The ECB, on the other hand, was even more dovish in communicating its intentions, but perhaps less clear in its motives. Once again, ECB President Christine Lagarde changed her tone in front of journalists. In December, she had strongly emphasized the inflationary risks and challenged the market's predicted scenario—but this time, she highlighted the improvement in the macro picture, pointed out the faster-than-expected decline in inflation, and illustrated the impact of the rate hikes on demand and credit supply (the lending survey released this week had moreover anticipated this, conspicuously).

On both the growth and inflation fronts, risks are now seen as more balanced, although upside risks to prices remain on the sidelines. Although the willingness to raise interest rates by another 50 bps at the March meeting was communicated, the commitment was less firm than expected. A message therefore closer to that of the Fed, but even more unexpected, and from our point of view, more problematic, for two reasons: 1) a continually changing message and attitude is not optimal for a central banker, who should give a sense of preservation and stability to economic actors, and 2) the disinflationary path in Europe has not yet started. Indeed, core inflation just this week showed an upward figure for the Eurozone compared to December. The impression is that the willingness to raise further is due to the internal debate between hawks and doves, rather than solid econometric analysis. Despite this, the consequence was one of the biggest rises in European sovereign bonds in a decade, thanks to investors' hopes that the ECB cycle will be shorter than expected.

The central banks' doubts have thus given further support to investor sentiment, which sees the soft landing and disinflation theses being validated. Figure 2 highlights the performance of some key stocks and major indices since the beginning of the year. What emerges, in our eyes, is far from reassuring. Apart from a few exceptions (Meta among them), it is clear that the strength since the beginning of the year is entirely due to the expansion of multiples (and this, in turn, is attributable to what has happened in the world of rates, and their stability). In many cases,

"The central banks' doubts have thus given further support to investor sentiment, which sees the soft landing and disinflation theses being validated."

paradoxically, the best performing stocks have seen a reduction in earnings estimates! In other words, this is far from reassuring. Our thesis on the earnings recession to come seems to have strengthened rather than weakened, since the direction of estimates, net of the Q4 we are seeing, is down. As for multiples, however, we can only express skepticism about this recent movement. Let us not forget the macroeconomic and geopolitical environment after the war and the pandemic, so multiples above 20 seem very difficult to justify in our eyes.

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Figure 2: Best Performing Stocks and Indexes This Year

	BeST Earnings Today	BeST Earnings End 2022	BeST Earnings Change	Best PE Ratio Today	Best PE Ratio End 2022	Best PE Ratio Change	YtD perf %
Microsoft	9.3	9.6	-2.5%	28.0	25.1	11.8%	8.9%
Amazon	2.9	2.7	8.6%	36.5	31.0	17.7%	27.8%
Tesla	4.2	5.3	-21.5%	46.4	23.1	100.5%	57.6%
Apple	6.1	6.2	-1.7%	25.1	20.9	19.8%	17.8%
Meta	11.3	10.2	11.3%	17.0	11.8	43.6%	59.8%
Google	5.7	5.9	-2.3%	18.5	15.2	22.0%	19.3%
Nvidia	3.3	3.3	0.0%	65.8	44.8	46.8%	46.8%
AMD	3.2	3.7	-13.7%	27.7	17.7	56.7%	35.2%
JPM	12.9	12.9	0.5%	10.8	10.3	4.5%	5.0%
Berkshire	13.0	13.0	0.7%	23.7	23.9	-0.6%	0.1%
Visa	8.5	8.3	2.1%	27.0	25.1	7.5%	9.7%
Caterpillar	15.6	15.1	3.7%	15.8	15.8	0.0%	3.8%
Exxon	10.6	11.3	-6.1%	10.7	9.8	9.2%	2.5%
		Average	-1.6%		Average	26.1%	22.6%

	BeST Earnings Today	BeST Earnings End 2022	BeST Earnings Change	Best PE Ratio Today	Best PE Ratio End 2022	Best PE Ratio Change	YtD perf %
S&P 500	214.4	218.5	-1.9%	19.5	17.6	11.0%	7.9%
Nasdaq	385.8	392.8	-1.8%	31.6	26.6	18.7%	16.0%
SX5E	329.5	329.5	0.0%	12.8	11.5	11.4%	11.3%
Nikkei	1361.6	1381.0	-1.4%	20.2	18.9	6.9%	5.4%
Shenzen	286.4	290.2	-1.3%	14.5	13.3	8.4%	7.0%
HSI	1800.5	1786.3	0.8%	12.0	11.1	8.6%	9.5%
		Average	-0.9%		Average	10.8%	9.5%

Source: Bloomberg, as at February 3, 2023.

Equities | Earnings expectations support a soft landing scenario

Earnings growth forecast to rebound in second half of 2023.

Major US and European stock markets continued to rise in February, with the S&P 500 index reaching its highest intraday level since August. The increase was driven by positive economic data and fourth quarter earnings reports, as well as 'less hawkish' signals from the Fed. The Nasdaq Composite index was boosted by a 23% increase in Facebook's parent company, Meta Platforms, but was dampened by disappointing results from Apple, Alphabet and Amazon.

Technical factors such as a "golden cross" in the S&P 500 index and short covering by hedge funds appeared to accelerate this week's gains. The busiest week of the earnings season and economic data resulted in multiple crosswinds for investors. As noted above, the Fed raised interest rates by a quarter point, and Powell acknowledged disinflation was at an early stage, which was interpreted as more dovish than expected. All this caused bond yields to rise. Investment grade corporate credit spreads moved tighter and high yield bonds tracked equities higher, as investors embraced risk.

"The busiest week of the earnings season and economic data resulted in multiple crosswinds for investors."

Friday, however, brought a major surprise when the US Labor Department reported an unexpected increase in non-farm jobs. Also, the ISM services sector activity jumped unexpectedly. Chinese equities were down after the Lunar New Year holiday, with investors locking in gains as they grew cautious about the reopening and recovery path.

Our view: The S&P 500 index is currently trading at 18.4x next 12-month P/E ratio, which is above the 10-year average, at a time when earnings and sales surprises for the Q4 2022 reporting season are below the historical average beat levels. According to FactSet data, the earnings decline of the companies that have reported Q4 earnings so far are -5.3% year-on-year.

“This brings the expected 2023 earnings growth to 3%, in line with the expectation of a soft landing.”

Looking ahead, analysts expect Q1 2023 earnings to decline by 4.2% and Q2 2023 earnings to decline by 2.9% year-on-year, with growth rebounding strongly in the second half of the year to 3.4% and 10.5% in Q3 and Q4, respectively. This brings the expected 2023 earnings growth to 3%, in line with the expectation of a soft landing. Friday’s surprising non-farm payroll data should, at a minimum, throw some doubt on this argument, at least with valuations at the high end of the historical range.

Fixed Income | A paradoxical reaction

Companies pay -5 bps in new issue concessions.

After the expected interest rate hikes delivered by the Fed and the ECB this week, the government bond market staged on of the biggest rallies seen in a decade. The 10-year US Treasury yield moved down from 3.5% to 3.33%, but even more impressive was the fall in yields in Europe: yields on 10-year Bunds (-20.4 bps) saw their largest daily decline since 2011, and for BTPs (-39.3 bps), it was one of the best daily moves since 1993.

Our view: This is a rather paradoxical reaction seen in the light of the comments of the presidents of the two central banks. The Fed said explicitly that “ongoing increases in the target range will be appropriate”, while President Lagarde poured oil on troubled waters with a vehement “no, no, no” when asked if the ECB would finish raising rates by March. On the contrary, what investors have chosen to hear is something like "a couple more rate increases, and we are done”. Investors did not care that financial conditions in the US remain as loose as they have been for almost a year. The bond markets focused on falling inflation and the prospects of a soft landing/recession, and did what they do under these assumptions—rally.

“On the contrary, what investors have chosen to hear is something like "a couple more rate increases, and we are done”.”

In this “inflation versus the economy” drama, as in any good movie, there was a twist. This came with the much stronger than expected employment data for the month (the US added 517,000 jobs, far exceeding estimates of 188,000). Labor market data well above expectations sent bond yields higher (the 2-year US Treasury rose from 4.09% to 4.25%, while the 10-year from 3.39% to 3.50%), even though it was a restrained move given the massive jump in jobs. However, the very strong payrolls report might finally convince investors that the Fed will not cut rates this year.

Across credit markets, the trend was no different. However, in the nearer term, the outlook remains more uncertain. On one side, a potential inflection point in inflation, monetary policy, or economic growth could trigger further flows into the corporate bond space. On the other side, a deep recession is not currently priced into spreads and deteriorating corporate fundamentals, and potentially ongoing rate uncertainty will likely keep wide the spread trading range. Therefore, we reiterate our preference for high quality bonds.

Figure 3: US and Europe Investment Grade Spreads

Source: Bloomberg, as at February 3, 2023.

"Just 24 hours after a 25 bps rate hike, the US high grade funding landscape was still dominated by insatiable investor demand."

In the primary market, US investment grade bond sales ebbed and flowed this week as borrowers sought to avoid the volatility that typically comes with a Fed rate decision. However, just 24 hours after a 25 bps rate hike, the US high grade funding landscape was still dominated by insatiable investor demand. Companies paid -5 bps in new issue concessions after tightening spread guidance nearly 30 bps on final books that were 6.6 times oversubscribed. Many investors declined to balk at the tighter levels as average final demand slipped just 13% from peaks to final.

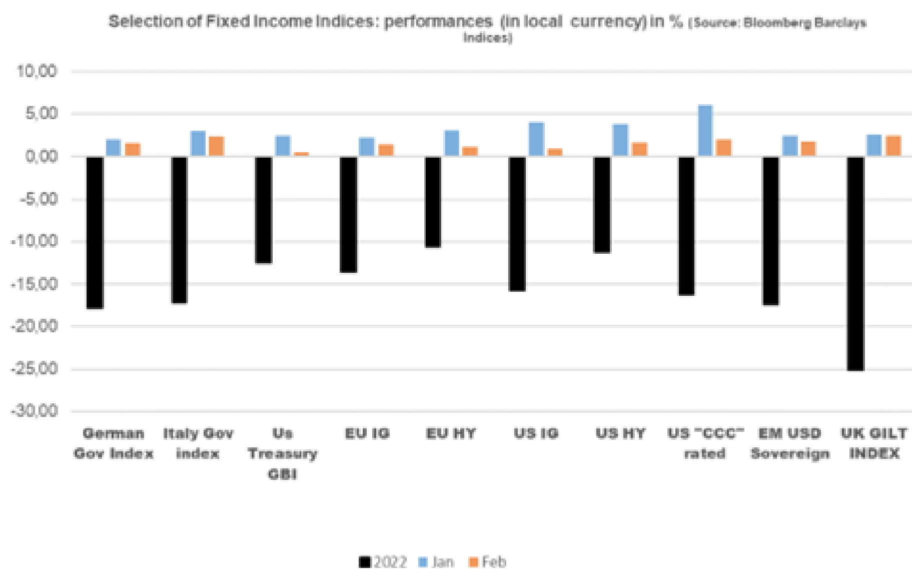
"Companies paid -5 bps in new issue concessions after tightening spread guidance nearly 30 bps on final books that were 6.6 times oversubscrib-ed."

Oracle priced USD5.25 billion across four parts and amassed more than USD40 billion in orders. To give context, Oracle (Baa2/BBB) priced the 5-year tranche (2028) at a yield of 4.53%, equal to 105 bps above Us treasury (initial price level was 145 bps). IBM also sold debt in other currencies, making a welcome return to Europe's debt market, bringing a five-part deal (four euro tranches and one sterling tranche). IBM attracted the largest physical order book at almost EUR10 billion equivalent across the deal. To give context, IBM (A3/A-) priced the 4-year EUR (2027) at a yield of 3.437%, equal to 40 bps above swaps (105.5 bps over Bunds) after initial price level of 65 bps over swaps. In USD, IBM printed USD3.25 billion in four parts, paying 2-10 bps in concessions. IBM got more than USD12.5 billion in orders at the peak but lost more than half of the book after tightening pricing. To give context, the 5-year tranche (2028) was offered at a yield of 4.535% equal to 85 bps above US Treasuries after initial price level of 105 bps.

January fixed income performance summary

After an awful 2022 performance, sovereign bonds have had a very strong start to the year, with gains for US Treasuries (2.5%), Bunds (2.07%) and BTPs (2.94%). In credit, EUR underperformed USD.

Figure 4: Fixed Income Performance



Source: Bloomberg, as at February 3, 2023.

Week Ahead | Key events to watch for

- **On the macro front, only the Michigan Sentiment survey** is noteworthy, in addition to inflation data in China.
- **In terms of earnings data**, the release season slows down, but there are still some important names: Disney, Uber and PayPal will be the main players, along with Toyota, and some major energy companies in Europe.

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