NOVUM
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Weekly Market Flash

The ongoing uncertainty of monetary policy lags

March 5, 2023

The stock market closed the week with a strong rally, which was largely spurred by short covering following speculation that the Federal Reserve (Fed) may not raise rates above the levels that were expected earlier in the week, i.e. potentially above 5.50%. After three consecutive weeks of losses, the S&P 500 index rose 1.90%, the Nasdaq index by 2.50%, the Shenzhen CSI300 index by 1.7% and the Eurostox 50 index, which led again, by 2.8%.

Highlights

- China services and manufacturing PMIs were well above the key level of 50, while in the US, too, the ISM indices both came out strong—particularly for the services sector, where inflationary pressures are concentrated.

- Eurozone core CPI came out at an all-time high of 5.6% year-over-year versus an expectation of 5.3%. The rate market moved accordingly, especially for the short-end of the curve, where the market came close to pricing ECB rates at 4% by year-end.

- Taiwan-based Foxconn Technology is considering a major expansion in India—more specifically, Foxconn would increase iPhone production in India from six million units to 20 million units, and to triple the number of workers to 100,000.

- In credit, yields have been climbing for the past month, but US issuance keeps rising, across both high grade and high yield. February closed out with over USD150 billion in sales, the highest total for that month ever. Last week, the US junk bond market also effectively reopened and priced about USD5.8 billion.

"The week, as was the case throughout February, was characterized by a mix of strong data for both growth and inflation."

Markets & Macro | The ongoing uncertainty of monetary policy lags

Risk of policy error grows.

The week, as was the case throughout February, was characterized by a mix of strong data for both growth and inflation. In particular, on the growth front, China finally showed that the reopening is real and is translating into an acceleration of economic activity (services and manufacturing PMIs were well above the key level of 50). In the US, too, the ISM indices both came out strong—particularly for the services sector, where inflationary pressures are concentrated (while we have learned that in the goods sector, with the normalization of transports and the end of supply bottlenecks, inflationary risks are lower).

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

Equity Indices	Last Value	Ytd
MSCI World	2,757.97	6.29%
Nasdaq	11,689.01	11.87%
S&P 500	4,045.64	5.69%
DJ Industrial	33,390.97	1.15%
Nikkei	27,927.47	7.09%
Eurostoxx	4,294.80	13.56%
Swiss SMI	11,190.09	4.29%
FTSE 100	7,947.11	7.38%
Canada	20,581.58	6.69%
Shenzen	4,130.55	6.72%
Hong Kong	20,567.54	4.28%
MSCI EM	988.03	3.44%

Equity Sectors	Last Value	Ytd
S&P value	153.39	5.74%
S&P Growth	61.78	5.61%
S&P Defensives	1,511.78	-1.15%
ARK Fund	40.46	29.51%
Fangs	5,528.94	24.34%
MSCI Financials	139.55	7.06%
S&P Energy	87.26	-0.24%
Gold Miners	28.63	-0.10%

Commodities	Last Value	Ytd
BBG Commodities	108.31	-3.98%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	68.48	-0.50%
Gold	1,856.48	1.78%
Silver	21.26	-11.24%
BBG Brent Crude TR	1,068.34	0.60%
BBG WTI Crude Oil TR	190.41	-0.46%

FX	Last Value	Ytd
DXY Index	1,246.95	0.03%
Bbg JP ASIA	100.96	-0.22%
Bbg JP LATAM	40.95	3.02%
EUR/CHF	1.00	-0.60%
GBP Index	624.62	0.29%
EM FX Index	1,675.47	0.90%
JPY/USD	135.87	-3.50%
CNY/USD	6.90	-0.08%
Bitcoin	22,365.91	35.23%

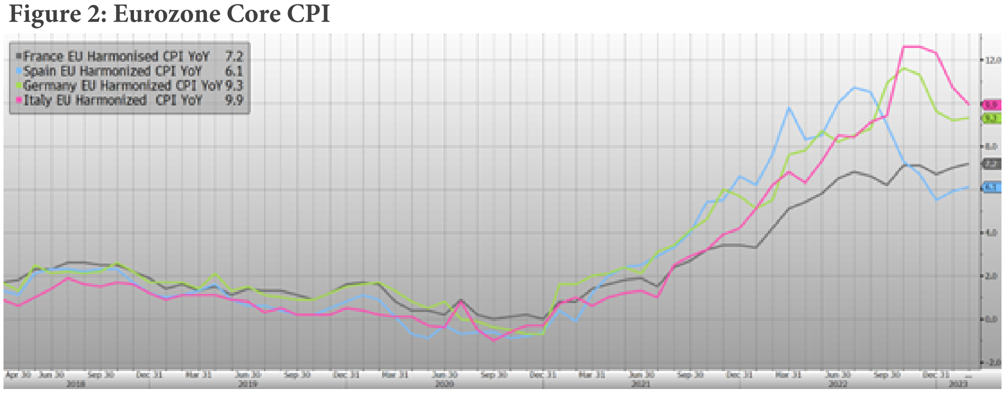
Bond Indices	Last Value	Ytd
US Inv Grade	106.17	1.37%
US High Yield	74.72	2.59%
Euro Corps	228.29	0.27%
JPM Europe Govies	9,440.22	2.28%
US Treasuries	2,187.17	-0.06%
China Aggregate	257.92	1.04%
EMBI Global	772.63	0.57%
EMBI Local	125.58	1.53%

Source: Bloomberg, as at March 5, 2023. Performance figures in indices' local currencies.

"The shock of the week, at least from our point of view, came from the inflation data in Europe."

But the shock of the week, at least from our point of view, came from the inflation data in Europe. In all the countries that published as the days passed, before the aggregate figure, there were marked upward surprises, and in France and Spain they even accelerated compared to previous months. The most important figure for the European Central Bank (ECB), the Eurozone core CPI, came out at an all-time high of 5.6% year-over-year versus an expectation of 5.3%. The rate market moved accordingly, especially for the short-end of the curve, where the market came close to pricing ECB rates at 4% by year-end.

Figure 2: Eurozone Core CPI



Source: Bloomberg, as at March 5, 2023.

"The paradox, once again, is the divergence of current indicators from leading indicators, both in Europe and the US."

Our view: The paradox, once again, is the divergence of current indicators from leading indicators, both in Europe and the US. On the one hand, we continue to see strong economic data, high inflation, and now excellent financial conditions, driven by the stock markets. On the other, the curves are inverted to unprecedented levels, and leading surveys (where central banks report on credit transmission conditions in the private sector) are signaling a marked deterioration in progress, which is accompanied by a contraction in M2.

The risk of a policy error in either direction is significant for both the Fed and the ECB right now, due to the uncertainty of monetary policy lags. But the stock market, for the moment at least, has already made its choice: there is no hesitation for the time being, especially in Europe. Last year, following every movement on rates, the market would correct heavily, partly because the focus was on corporate valuations and multiples. This year, on the other hand, investors prefer a more benign reading of inflation on equities: this supports sales and margins, which have been rising throughout 2022 (especially in Europe, while in the US there was a downturn in the fourth quarter). So they are more reluctant to sell after strong inflationary data—they are fed up with selling, only to find the indices higher later. The market in particular is driven by the banking sector, which is known to benefit from rising rates, as they are slow to adjust the return on deposits relative to the rise in the cost of money. As long as tightening does not cause asset deterioration (and this seems to be averted after the bank capital reforms following the GFC), inflation is an advantage for them.

“But in all this, it is important to acknowledge that for several months now, all the soft data have been pointing to the start of a marked economic slowdown...”

In all of this, a certain myopia prevails (which is the missing link in the analysis), brought out by the inversion of the curves and the leading surveys mentioned—the famous monetary policy lag, which sooner or later will be felt by both consumers and businesses. Consumers will have to reduce consumption to cope with the loss of spending capacity due to inflation and the cost of money, and businesses will have to lay off workers to restore their profitability, which will also trigger a vicious circle since layoffs lead to an increase in the savings rate and thus in consumption.

But in all this, it is important to acknowledge that for several months now, all the soft data have been pointing to the start of a marked economic slowdown—which, however, is slow in coming (indeed, as mentioned, we are experiencing a re-acceleration of the economies, with the contribution of China’s reopening). We will therefore have to wait for this new wave of rate hikes to be felt, and for the stock markets to return to incorporate the effect on margins and profits in a classic boom/bust cycle.

Equities | The many faces of the reshoring trade

Foxconn is set for Indian expansion.

In a week where markets were obsessed with rate moves, an important news headline went largely unnoticed. Foxconn Technology (2317 TT), formally known as Hon Hai Precision Industry, is considering a major expansion in India. This was not your typical geographic expansion news headline, but rather a meaningful one, for two reasons. First, the large scale of this potential expansion into India—Foxconn would increase iPhone production in India from six million units to 20 million units, and to triple the number of workers to 100,000. Second, Foxconn, a Taiwan-based company, is Apple’s main and most important supplier.

“This is not the first time that companies have considered expanding into India. Many have tried (and sometimes failed) but we can’t help but think that this time is different.”

Foxconn’s expansion into India would not have been possible without the direct consent of Apple itself. This is not the first time that companies have considered expanding into India. Many have tried (and sometimes failed) but we can’t help but think that this time is different. This time is driven by geopolitical necessity and the need to diversify production away from China. And it certainly doesn’t hurt to see the Modi government dangling the incentives carrot to attract these major players.

Another piece of important news during the week was Tesla’s announcement to build a plant in Mexico. According to Morgan Stanley research, the Tesla plant is 10% of the bank’s total expected FDI pickup from nearshoring and the largest single investment in Mexico. Currently, Mexico exports USD450 billion to the US (China last exported USD550 billion). Morgan Stanley thinks that a Tesla plant could generate around USD15 billion exports, or a roughly 3.5% increase in exports to the US.

Our view: In the past we discussed how factory automation companies are clear winners of the reshoring trade, given the need to build new plants closer to home and replicate supply chains across multiple industries. Today we are focusing on the winning economies of the nearshoring/friendshoring trend: India and Mexico, both of which have low labor costs, but Mexico has a better advantage due to proximity to the US and having a free trade agreement with the US.

"We see the current weakness as an opportunity to gain exposure to this fast growing economy that is a clear friendshoring winner."

These two economies are expected to see real GDP grow by 6.9% and 1.3%, respectively, outpacing the US and EU, and in the case of the former, outpacing China too. Both countries' central banks are still fighting inflation, with the Reserve Bank of India expected to raise the key rate to 6.75% in the second quarter to tame inflation (the current level is 6.5%). Mexico's key rate is also expected to peak at 11.50% in the second quarter, from the current level of 11%.

The MSCI India index is down 6.2% year-to-date, in large part due to the allegations made by Hindenburg Research against companies owned by Mr. Gautam Adani. The index is dominated by financials (26%), technology (16%) and energy (12%) and is trading at 19.8x 12-month forward P/E, a punchy multiple despite the correction, but far below the >38x peak of 2021. We see the current weakness as an opportunity to gain exposure to this fast growing economy that is a clear friendshoring winner. Meanwhile, the MSCI Mexico index is up 21.63% and is dominated by consumer staples (31%), financials (19%) and communications (15%) sectors. Despite the strong rally, we find the valuation (14.6x 12-month forward P/E) still acceptable as it is slightly below the historical average of the past 10 years, and not excessive on a relative basis to emerging markets.

Fixed Income | Not the time to take excessive risk

IG part of the market remains attractive.

"Companies have been issuing bonds at a near-record pace in Europe this year and there's no sign of that slowing anytime soon, even as they lose the ECB as a buyer."

In credit, yields have been climbing for the past month, but US issuance keeps rising, across both high grade and high yield. US Treasury yields across the curve above the 4% level may be prompting some firms to bring issuance forward to avoid potentially even more expensive financing in the coming months. February closed out with over USD150 billion in sales, the highest total for that month ever. Last week, the US junk bond market also effectively reopened and priced about USD5.8 billion.

Among the junk issuers, Teva Pharmaceutical (Ba2/BB-), one of the largest generic drugmakers in the world, managed to increase the size of its cross-currency bond offering in a sign of strong investor demand. Pricing guidance tightened during the marketing process in further signs of robust interest for the deal: the dollar tranche maturing in 6.5 years was upsized to USD600 million from USD500 million and was offered at a yield of 7.875% after initial talk of 7.875%-8.125%, while a euro tranche of the same maturity was increased to EUR800 million from EUR500 million for a final price of 7.375%, below initial guidance of 7.5%-7.75%.

The deluge of sales seemed to weigh on demand, however. Stanley Black & Decker (A/Baa2) priced 10 basis points (bps) to 20 bps wide of initial price discussions with investors, a rare display of investor pushback after recent strong new issue pricing performance. To give context, Black & Decker (A/Baa2) priced the 5-year tranche (2028) at a yield of 6.025%, equal to 155 bps above US Treasuries (initial price level was 175 bps). Among issuers that tapped the markets with multi-tranche deals, Colgate-Palmolive (AA-) priced a 5-year tenor at a yield of 4.62%, and John Deere (A) offered a 2-year at 5.05%, while AstraZeneca (A) came with a 10-year tranche offered at 4.91%. Companies have been issuing bonds at a near-record pace in Europe this year and there's no sign of that slowing anytime soon, even as they lose the ECB as a buyer. AT&T (Baa1) offered a 2-year term floating rate debt at 3-months + 40 bps (equivalent to a 3.20% coupon) and Ford Motor Credit (BB+) sold the first sterlingdenominated junk bond in 10 months (2026 maturity at 99.999 to yield 6.875%, 1.10% over Gilts).

Our view: Our view on credit remains unchanged. The January rally faded after questions emerged about persistent inflation and tightness in labor markets. In the investment grade market, there are attractive returns, without having to take a lot of credit risk and stretching to the high yield part of the market. The fear of rising rates will put pressure on lower quality borrowers and if rates stay higher for longer, most levered borrowers will come under pressure. Since it is possible to get an interesting return in the short-end of the investment grade curve (5% in USD and 3.5% in EUR), why take risk in high yield when margins for high yields borrowers could come under pressure?

Week Ahead | Key events to watch for

- **The most important data of the week comes on Friday with the US employment report**. But Fed Chairman Powell's testimony before the House and Senate committees could also move markets, and significantly.

- **Other key data releases will be UK GDP** and economic activity indicators in Germany.

- **In China, the 14th National People's Congress begins**, while on the economic front we will see the release of inflation data. Finally, in Japan, the Bank of Japan will comment on monetary policy.

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