NOVUM
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Weekly Market Flash

Time to withdraw the “transitory” term

December 5, 2021

The week was particularly volatile across markets, with two hot fronts overlapping and fueling investors' concerns. The first part of the week saw heavy losses in the value space as concerns regarding the Omicron variant prevail – while in the second half, growth stocks came under heavy pressure following Powell's comments on monetary policy. Heavy positioning and significant gains accumulated during the year sparked a selling wave with the Nasdaq down 2,6% for the week, and down 6% from its recent peak on November 22. The heavy pressure in the “work-from-home” names shows that the strongest element pressuring markets is not the virus, but the fear of less liquidity support – if not a policy error by the Fed! Yet, watching beneath the surface, we see a sound and welcomed dynamic in the most speculative names in the tech area.

Highlights

▪ In Powell's speech, the response to inflation was much more aggressive than expected: the risk of more persistent inflation has increased and it is perhaps time to "withdraw" the term "transitory" from US inflation.

▪ The flattening of the US Treasury yield curve over the week (with short-term rates rising and long-term rates declining) reflected bond market angst about the direction of monetary policy.

▪ The Goldman Sachs Non-profitable Tech index and the Ark ETF indices are in largely negative territory for the year at -21% and -25%, respectively, while the Nasdaq is up 17%. This week alone, with the Nasdaq down a moderate 2.6%, the two indices have lost 14% and 12%, respectively.

▪ Bitcoin traded rangebound this week, while on Friday it followed tech names in the sell-off, showing once again a high correlation with the Nasdaq.

▪ Government bonds were one of the few assets that saw a positive return in November as investors moved into safe havens. High yield bonds, on the other hand, had a torrid month, with USD and EUR posting -1.01% and -0.58%, respectively, in total return.

“On the subject of the virus, it is clearly not only the Omicron variant that is worrying the markets.”

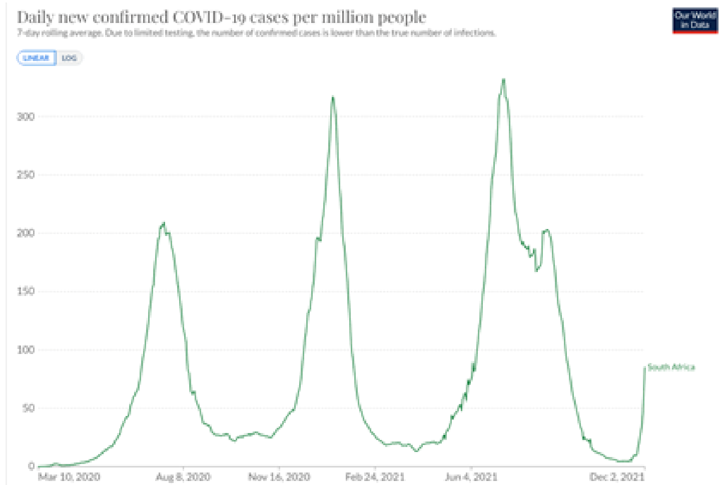
Markets & Macro | Time to withdraw the “transitory” term

Political pressure builds for controlled inflation.

On the one hand, markets are facing the evolution of the virus, and of the Omicron variant in particular, with the picture still unclear (although the darker scenarios that raised concerns a week ago have now been averted). On the other, markets are dealing with the evolution of monetary policy, with a considerable increase in uncertainty following Powell's statements on Tuesday before the Senate Banking Committee.

On the subject of the virus, it is clearly not only the Omicron variant that is worrying the markets. The number of cases in South Africa continues to rise dramatically, although we must bear in mind the low vaccination rate in the country at around 20% (Figure 1).

Figure 1: Cases in South Africa



Source: Our World in Data, as at December 3, 2021.

"...the 'zero Covid' strategy that public health officials have pursued since the start of the pandemic has failed, and that we will probably have to get used to living with the virus for a long time."

Our view: Contagions are on the rise around the world, especially in Europe, and many countries are gradually resorting to restrictive measures – albeit much fewer than at the time of the lockdowns – and in most cases the measures only affect the unvaccinated. This, however, is increasing tensions and a sense of intolerance between what has now become veritable factions, for or against vaccines.

The issue is exacerbated by the fact that, in a sense, vaccines have not fulfilled their promise to end the pandemic. It is true that the risks of hospitalizations and deaths are greatly reduced (although not eliminated) after vaccination, but fully vaccinated individuals can still catch and spread the virus, as data in recent weeks has shown. This means that the 'zero Covid' strategy that public health officials have pursued since the start of the pandemic has failed, and that we will probably have to get used to living with the virus for a long time. However, this leaves us optimistic, since we believe in people's ability to adapt to the most adverse conditions. It seems likely that Covid will gradually become a kind of influenza, where there is a vaccine/booster available each year depending on which strain is most likely to be prevalent.

Turning to the subject of monetary policy, the market was confident about the event, not least because extracts from the speech had been posted the day before on the Federal Reserve's (Fed) website, and although it contained indications of more persistent than expected inflation, it seemed to hint at a certain sensitivity to the risks of the variant. Indeed, the rate market expected the Fed to use the new variant as an excuse to slow down the tapering process, which is due to begin in December.

"Indeed, the rate market expected the Fed to use the new variant as an excuse to slow down the tapering process..."

But the political pressure was strong, with many senators on both sides of the aisle ready to criticize the President for being too wait-and-see in the face of the inflation spike that is hurting the weakest consumers. So the response was much more aggressive than expected: the risk of more persistent inflation has increased and it is perhaps time to "withdraw" the term "transitory" from US inflation. Controlled inflation is necessary to ensure a long expansion. It therefore makes sense to consider an earlier closure of the purchase program by a few months.

The asset class most affected by the Fed's change of tone was definitely commodities. As was the case when the Delta variant exploded, the negative effects on demand tend to be temporary, while underinvestments in the sector are persistent and have been building up for years. For this reason, combined with the inflationary environment, we remain constructive on the asset class, which is well represented in our portfolios, particularly in the energy sector.

Tech: cleaning up of excesses.

What happened this week in the tech sector was nothing more than a dramatic acceleration of a trend that started earlier this year. The rise in yields in the first weeks of January, driven by the normalization of economies as a result of vaccine deployment, with the US 10-year bond accelerating toward 2%, triggered a major correction in the Nasdaq – especially in the two sectors that we monitor as indicators of exuberance in tech names (the Goldman Sachs Non-profitable Tech index and the Ark ETF).

The same sector is now under pressure from the prospect of a reduction in the Fed's balance sheet, but little has changed. As Figure 2 shows, the two indices are in largely negative territory for the year at -21% and -25%, respectively, while the Nasdaq is up 17%. This week alone, with the Nasdaq down a moderate 2.6%, the two indices have lost 14% and 12%, respectively!

Figure 2: Performance of Tech Sectors vs. Nasdaq

> "It seems clear to us that the prospect of less liquidity provided by the Fed is causing some of the many mini bubbles that have built up over the past three to four years to burst.."

Source: Bloomberg, as at December 3, 2021.

Our view: It seems clear to us that the prospect of less liquidity provided by the Fed is causing some of the many mini bubbles that have built up over the past three to four years – and which had accelerated due to the large monetary response to the Covid shock – to burst. We therefore welcome what is happening in this space, i.e. a cleaning up of excesses, which after all is not particularly traumatic for the financial system, and in particular for quality stocks, which in our view deserve to remain supported even in a correction phase.

Equities | A mismatch between equity positioning and sentiment

Adjustment phase will keep volatility elevated.

As expected in last week's Market Flash, global equity markets experienced an erratic and volatile trading week. The pullback was attributed to the emergence of the Omicron variant, and the uncertainty it would present to growth.

> "The flattening of the US Treasury yield curve over the week reflected bond market angst about the direction of monetary policy."

Figure 3: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,580.08	-0.76%	0.38%	15.05%
SPX Index	S&P 500	4,538.43	-1.18%	-0.60%	22.43%
CCMP Index	Nasdaq	15,085.47	-2.60%	-2.90%	17.79%
SX5E Index	Euro Stoxx 50	4,080.15	-0.19%	0.44%	17.80%
SMI Index	Swiss Market	12,175.77	-0.19%	0.13%	17.00%
UKX Index	FTSE 100	7,122.32	1.16%	0.94%	14.09%
CAC Index	CAC 40	6,765.52	0.44%	0.66%	24.69%
DAX Index	DAX	15,169.98	-0.57%	0.46%	10.58%
FTSEMIB Index	FTSE MIB	25,938.52	0.33%	0.48%	20.27%
NKY Index	Nikkei 225	28,029.57	-2.51%	0.75%	3.69%
HSI Index	Hang Seng	23,766.69	-1.29%	1.03%	-10.45%
SHSZ300 Index	CSI 300	4,901.02	0.84%	0.99%	-4.28%

Source: Bloomberg, as at December 3, 2021. Performance figures in indices' local currencies.

Fed policy also became another market concern post Fed chair Powell's comments about the nature of inflation, which may be no longer transitory. The flattening of the US Treasury yield curve over the week (with short-term rates rising and long-term rates declining) reflected bond market angst about the direction of monetary policy. A disappointing US non-farm payroll print on Friday was counterbalanced by a drop in the unemployment rate from 4.6% to 4.2%, making it unlikely that the Fed would change its tapering plans.

“One market dynamic that has troubled us for a while now, which we’ve been discussing with clients for a few months, is the mismatch between the positioning in equities and market sentiment.”

Our view: In our previous Market Flash, we focused on the market risks that could sour conditions for equities. Consumer sentiment weakness was one we highlighted as potentially damaging, given how much of the recovery has been driven by consumer demand. Last week, we saw consumer sentiment in Europe regarding general economic conditions and intentions to make major purchases weaken, like we saw in the US two weeks ago with the University of Michigan survey. This turn in sentiment comes at a delicate moment where the Fed is proving to be hawkish in the face of rising (non-transitory) inflation, while the economic outlook is somewhat blurred by the Omicron variant; even though the market is already discounting the Omicron risk based on anecdotal evidence alone. This weakness in consumer sentiment is to be watched closely in the weeks to come for signs of demand destruction as a result of inflationary pressures.

One market dynamic that has troubled us for a while now, which we’ve been discussing with clients for a few months, is the mismatch between the positioning in equities (relatively high by historical standards) and market sentiment (neutral to slightly bearish depending on survey). The correction we are witnessing seems to be addressing this discrepancy by normalizing the pockets of exuberance in the market, especially the unprofitable long duration assets.

We don’t rule out the possibility of market volatility remaining high for weeks to come as this adjustment phase continues. And the risk of contagion cannot be ruled out either, given the concentrated positioning in quality Big Tech names. We note that the weight of Big Tech as a percentage of Nasdaq market cap has been rising again since mid-November. Defensive plays, like consumer staples with pricing power, should outperform under this scenario. Another risk not discussed last week is that of geopolitical risk. Rising tensions in Ukraine and Taiwan have so far been discounted by the market. We hope the market’s assessment of these risks is correct. Patient investors should welcome this normalization and use it as an opportunity to deploy capital into quality companies that get caught in the sell-off, despite having solid fundamentals.

Chart of the week

The last corrections of the Nasdaq E-Mini future stopped around the 100 daily moving average (red line). Indeed, the key support to monitor is the 15400 level (100 DMA). The break of the support could trigger a second leg of correction with target at the 200 DMA at 14500 (-7.5% from Spot).

“The break of the support could trigger a second leg of correction...”

Figure 4: Nasdaq E-Mini Futures

Source: Bloomberg, as at December 3, 2021.

Crypto & Blockchain | Bitcoin remains highly correlated with the Nasdaq

Environment supports our short volatility strategy.

Hackers stole USD120 million from ‘Web3’ crypto project, BadgerDAO. DeFi platforms like BadgerDAO have proliferated recently. A decentralized autonomous organization (DAO), is an organization represented by rules encoded as a computer program that is transparent, controlled by the organization members and not influenced by a central government. BadgerDAO was designed to be a bridge to invest Bitcoin into Ethereum-based DeFi projects by wrapping it. The attack was considered as not sophisticated, and not to have targeted the smart contracts. Instead, it was an attack targeting Badger's web infrastructure. As it turns out, so-called Web3 can depend heavily on good old Web1 security.

> "...the number of open derivatives positions and funding cost for bitcoin remains high, suggesting that the market remains stretched in terms of leverage."

Market action: Bitcoin traded rangebound this week, while on Friday it followed tech names in a massive sell-off, once again showing high correlation with the Nasdaq. The sell-off was triggered at night by forced liquidations with stop losses in the derivatives market. 1,500 BTC alone was sold in less than a minute at the time of the drop. El Salvador President Nayib Bukele,announced with his Twitter account another purchase of 150 BTC for around USD8,700 each. Although this is one of the biggest deleveraging events over the last few months, the Open Interest (the number of open derivatives positions) and funding cost for bitcoin remains high, suggesting that the market remains stretched in terms of leverage. As a consequence, this could generate sharp moves up or down.

The sell-off pushed implied volatility higher, and this is creating a good environment in support of our more defensive strategy on bitcoin , which consists of switching the exposure from delta one (selling physical bitcoin) to a short volatility strategy (selling naked put or selling call on Bitcoin position).

During the selloff, the Tether (USDT - the world's largest stablecoin), saw a spike to USD1.025, moving away from its 1:1 peg. During sharp price declines, traders typically convert crypto to tether. This explains the negative correlation with crypto and consequently its status as a safe haven asset.

Ethereum performed better than bitcoin on the back of the news that Kelly has filed for an Ether Futures ETF, the first one to try this since the $BITO ETF launch.

In the meantime, the fight in layer -1 space continues,.Ethereum's dominance across all chains went down to 65% from 98% at the start of the year. The winners are Binance Smart Chain (BSC), Solana (SOL), Terra (LUNA) and Avalanche (AVAX).

> "Fundamentals are still healthy for borrowers in the loan market and year-to-date US leveraged loans beat junk bonds and trashed investment grade debt."

Fixed Income & Commodities | Government bonds win in risk off November

Demand for leveraged loans remains high.

The re-emergence of Covid-19 marked a turbulent month for financial markets. Government bonds were one of the few assets that saw a positive return in November as investors moved into safe havens. Moreover, despite awful inflation numbers in October (US CPI was +6.2% year-on-year while the Euro area was +4.9%), the re-emergence of pandemic fears helped to push back the likelihood of early rate hikes from central banks.

Figure 5: Bond Market Performance in November

	Yield		total return	
Government	Current	Change 1M	1M	YTD
10Y US Treasuries	1,44	-0,13	1,30	-3,28
German Gov	-0,52	-0,22	1,92	-0,97

Source: Ice BofA Indices

	current		spread change		total return		Excess return	
Credit US & EUR	spread	Yield	1M	YTD	1M	YTD	1M	YTD
US High Grade	103	2,29	14	0	0,10	-0,78	-1,00	0,99
US High Yield	367	4,82	59	-19	-1,01	3,42	-1,42	4,50
EUR High Grade	111	0,48	24	18	0,18	-0,88	-1,06	-0,04
EUR High Yield	371	3,06	59	16	-0,58	2,44	-1,30	3,11
Emerging Mkt								
EM $ SOV	333	4,64	37	47	-1,48	-3,46		
EM SOV (LC)		4,19			0,86	0,99		
* curncy ret					-0,64	-3,08		
* TR Converted $					0,21	-2,09		

Source: Ice BofA Indices

“The risk off stance created by the new Covid variant prompted at least six investment grade bond issuers to delay sales earlier in the week...”

German Bunds (1.92%) and US Treasuries (1.3%) ended November in positive territory. High yield bonds, on the other hand, had a torrid month, with USD and EUR posting -1.01% and -0.58%, respectively, in total return. This is the third straight month of losses and the longest losing streak in almost three years. As spreads blew out by 59 basis points (bps), excess return losses for high yield market (return minus the return from government duration adjusted) were worse than high grade bonds (in EUR -1.30% versus -1.06%, in USD -1.42% versus -1%). These are the worst excess returns since March 2020. In Europe, among the worst performers, Telecom Italia fared very poorly, with its bonds posting 7-8% total return losses, after KKR made a bid to buy out the business and its CEO resigned.

Finally, one other bright spot in credit has been loans. Demand for leveraged loans has been high amid a record-breaking year of sales of collateralized loan obligations, which buy up the bulk of new loans. Fundamentals are still healthy for borrowers in the loan market and year-to-date US leveraged loans beat junk bonds and trashed investment grade debt.

Our view: The risk off stance created by the new Covid variant prompted at least six investment grade bond issuers to delay sales earlier in the week, even if issuance has since resumed. The biggest offering came from Daimler Trucks Finance North America (rated A3, stable), a division of Daimler AG, which sold USD6 billion of debt in eight parts to help finance its split from its parent company. The longest portion of the offering, a 10-year security (2.5% 14/12/2031), was priced at 115 bps above US Treasuries, while initial price discussions were in the 135 bps area.

T-Mobile (rated Ba1, positive) issued a USD3 billion three-tranche deal gathering more than USD21 billion in orders at the peak after offering a robust 35 bps in new issue concessions compared with the initial price talk. The USD1 billion 10-year tranche (2.7% 115/03/2032) was priced at 130 bps above US Treasuries, versus initial discussions at 165 bps.

Week Ahead | Key events to watch for

- **The coming week sees a rather sparse economic agenda** with a few minor data points in the US and Europe. The evolution of the Omicron variant and monitoring its impact on the population will therefore be the focus of investors' attention.

- **The Bank of Canada will announce its decision on Wednesday**, while we wait for the Fed and European Central Bank meetings next week.

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