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Weekly Market Flash

Calling for caution

February 6, 2022

It was yet another volatile week for markets, a theme which we will likely have to get used, as the inverse relationship between liquidity and volatility is difficult to break. This time, however, it wasn't the Federal Reserve (Fed) that took center stage, but rather the Bank if England (BoE) and European Central Bank (ECB). This confirmed that the issue of inflation and the reduction of monetary stimulus is not just a US problem, but a global one.

Highlights

▪ The European inflation figure had come as a massive surprise with the headline 5.1% YoY, an all-time high.

▪ The ECB's surprise had the undesirable effect of causing the euro to jump (appreciating by 2%-3% against the main crosses), and a widening of spreads of peripheral countries.

▪ The BoE also managed to surprise, and scare, investors. Not only did policymakers raise rates by 25 bps to 0.5%, but four out of nine Governing Council members voted for a double hike, the much-feared 50 bps.

▪ So far, 278 companies of the S&P 500 index have reported earnings for Q4 2021. On average, the companies that reported had a sales surprise of 3.2% and an earnings surprise of 6%.

▪ The decentralized finance platform Wormhole was hacked for about USD320 million, becoming the victim of the Second Largest DeFi Hack Ever and among the top five largest crypto hacks of all time. The attack caused a 10% drop in the value of the Solana cryptocurrency.

▪ Saipem surprised with a big profit warning with EBITDA guided down by EUR1 billion in H2 2021 compared to the previous positive guidance. The company’s bonds took a beating and rating agencies immediately cut their rating.

“...the change in (the ECB's) rhetoric was evident and equally revealing to markets, with significant consequences for currencies, rates, peripheral spreads and equity indices.”

Markets & Macro | Calling for caution

Equities and credit show signs of distress.

After the Fed in December and January, this time it was the ECB's turn. The central bank has so far tried to resist the obvious inflationary pressures. It must be said that the Fed, with Powell at least, had tried to soften the pull, avoiding sudden turns and succeeding in many cases in reassuring markets about the gradual nature of monetary measures. Instead, the ECB's surprise had the undesirable effect of causing the euro to jump (appreciating by 2%-3% against the main crosses), but above all, the widening of spreads of peripheral countries. While the widening trend had indeed already begun in January, after the press conference this week, the spreads of Italy, Greece and Spain widened by 20-30 bps, exacerbating the underperformance of domestic equity markets (as an example, the FtseMib lost 2.8% in the two sessions following the ECB’s announcement).

Our view: Unlike the BoE, which raised rates for the second time this cycle, the ECB took no material action, but the change in rhetoric was evident and equally revealing to markets, with significant consequences for currencies, rates, peripheral spreads and equity indices:

- President Lagarde's stance on inflation suddenly appeared much more alarmed, with a clear upward risk to prices. She was pressed by journalists during the conference, and once pressed, she had to give in, rather belatedly, to the evidence that inflation was no longer 'transitory'.
- Contrary to the recent past, she has no longer ruled out that rates will not be touched in 2022, nor has she rejected what the market is incorporating today (now practically two hikes by the end of the year).
- Lagarde had to admit that in the Governing Council, the concern about the level of inflation is widespread, and therefore there is no longer the classic division between northern hawks and southern doves.
- While rates will not be raised before the end of the purchase programme, she also said that if the picture does not improve, a review of purchases as early as March would be possible.

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After all, it would have been very difficult for Lagarde to (once again) look the other way after the European inflation figure had come as a massive surprise only the day before, with the headline 5.1% year-over-year (YoY), an all-time high. While the 28.6% recorded for the energy component might be a comforting sign (looking ahead – with a favorable base effect), the big surprise was the core component, which instead of falling from 2.6% to the 1.9% expected, settled at 2.3% YoY (up 0.9% on the month).

While the ECB did not find it difficult to surprise the market as it was widely regarded as the most dovish central bank in this tightening phase, the BoE also managed to surprise, and scare, investors. In fact, not only did policymakers raise rates by 25 bps to 0.5%, which kick-started the balance sheet reduction process, but four out of nine Governing Council members voted for a double hike, the much-feared 50 bps.

In terms of the impact on economies and markets, it is difficult at this point to think that the tensions between restrictive monetary policy and risky assets can be resolved quickly. Indeed, commodity prices, the main drivers of inflationary pressures (along with supply disruptions and the labor market), were unstoppable once again this week. In fact, the Bloomberg Commodity Index rose 2.3% this week, for the 7th week in a row (driven by energy, with oil Brent up 4.9%), and is up 81.5% from its low in April 2020. So there is no relief on that front, but it doesn't look like commodity prices are rolling over at all, as policymakers had hoped, and the YoY changes will continue to be unfavorable in the months ahead – as the rises have been gradual and steady throughout 2021. To give another significant example of the inflationary framework, taken from the "micro" world of corporate results, Amazon this week declared that it will increase Prime prices by a whopping 17%. Remember when Amazonification was the clarion call of the no inflation crowd?

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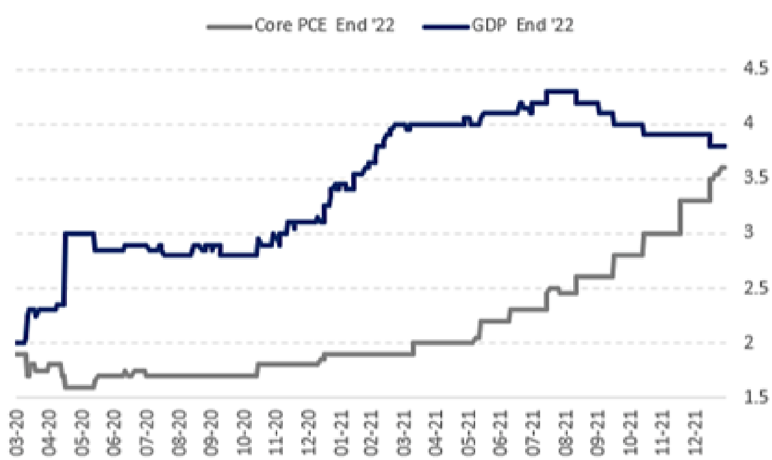
Figure 1: Bloomberg Commodity Index

Source: Bloomberg, as at February 4 2022.

Against this backdrop, we are forced to maintain a more cautious asset allocation than in the past. In terms of equities, we took profits on a tactical position in an Italian small-cap ETF earlier this week following the confirmation of the Draghi-Mattarella duo, thereby reducing the equity portion of our discretionary portfolios. Apart from this action, we do not intend to make any other significant changes in the short term, but unlike in the past, we do not feel ready to "buy the deep", as we have done consistently over the last two to three years. Our experience is that once the interest rate market starts to predict an upward cycle (and this case is unusual compared to the last 30 years, because the inflation spike is very strong), the dynamic is only interrupted when something breaks down either in the economy or in the equity markets. As can be seen from Figure 2, inflationary pressures are increasing at a time when growth expectations are beginning to fall, albeit to levels that are quite respectable for the US.

"...once the interest rate market starts to predict an upward cycle, the dynamic is only interrupted when something breaks down either in the economy or in the equity markets."

Figure 2: Inflationary Pressures Rise as Growth Expectations Fall



Source: Bloomberg, as at February 4, 2022.

Finally, the credit market, which had remained intact until a few days ago, has started to show some signs of increased distress this week (see chart of the week), so we take the signal as a further call for caution.

Equities | Will the earnings season be enough to offset rising yields?

Volatility likely to remain high.

"The credit market has started to show some signs of increased distress this week, so we take the signal as a further call for caution."

Strong earnings and a positive outlook from Big Tech (with the exception of Meta) buoyed major equity indices in the US, against a backdrop of the benchmark US Treasury 10-year yield reaching a two-year high at 1.9085%. High yield bonds, however, continued to send conflicting signals, with the HYG ETF closing the week on a negative note, with outflows continuing from the asset class.

Elsewhere, Japanese equities staged a strong rally, led by reopening beneficiaries. Assurances from the Bank of Japan that it would maintain current policy boosted sentiment as well.

Figure 3: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	35,089.74	1.06%	-3.35%	-3.35%
SPX Index	S&P 500	4,500.53	1.57%	-5.47%	-5.47%
CCMP Index	Nasdaq	14,098.01	2.41%	-9.84%	-9.84%
SX5E Index	Euro Stoxx 50	4,086.58	-1.22%	-4.79%	-4.79%
SMI Index	Swiss Market	12,140.25	0.30%	-5.71%	-5.71%
UKX Index	FTSE 100	7,516.40	0.67%	1.83%	1.83%
CAC Index	CAC 40	6,951.38	-0.21%	-2.71%	-2.71%
DAX Index	DAX	15,099.56	-1.43%	-4.94%	-4.94%
FTSEMIB Index	FTSE MIB	26,603.59	0.14%	-2.32%	-2.32%
NKY Index	Nikkei 225	27,439.99	2.70%	-4.69%	-4.69%
HSI Index	Hang Seng	24,573.29	4.34%	5.34%	5.03%
SHSZ300 Index	CSI 300	4,563.77	NA	-7.53%	-7.62%

Source: Bloomberg, as at February 4, 2022. Performance figures in indices' local currencies.

Our view: So far, 278 companies of the S&P 500 index have reported earnings for Q4 2021. On average, the companies that reported had a sales surprise of 3.2% and an earnings surprise of 6%. This is on track to be the lowest level of beats in six quarters.

Companies continue to highlight inflationary pressures from materials and wages as key headwinds. Omicron was also disruptive for several sectors beyond travel and leisure. The price reaction was mostly muted, except for a few mega cap stocks. We expect the volatility to remain elevated as portfolios continue to adjust to rising yields, with bouts of furious short-covering or "buy-the-dip" attempts.

"We expect the volatility to remain elevated as portfolios continue to adjust to rising yields..."

Crypto & Blockchain | The coexistence of blockchains

Wormhole replenishes its blockchain bridge.

On Wednesday, the decentralized finance (DeFi) platform Wormhole was hacked for about USD320 million, becoming the victim of the second largest DeFi hack ever and among the top five largest crypto hacks of all time. The attack caused a 10% drop in the value of the Solana cryptocurrency in the aftermath of the hack. Shortly after the attack, the Wormhole team also offered the hacker a USD10 million bounty to return the funds. In a follow-up tweet, Wormhole said that funds would be added to the bridge to backstop the wrapped ETH on Solana, and a few hours after the hack, they announced that they had recovered the funds.

Wormhole is one of the largest bridges between Solana and other blockchains, that allows users to bridge assets across blockchains. It has over USD1 billion in total value locked and supports six blockchains: Terra, Solana, Ethereum, Binance Smart Chain, Avalanche and Polygon. When a user transfers assets from one blockchain to another, the bridge steps in to lock the transaction and mint a wrapped version, such as wrapped ether (wETh), to its final chain. This allows a person or entity with holdings in one cryptocurrency to make trades and purchases using another, somewhat like being able to fund a bank account in dollars and then use a bank card to buy something priced in euros.

The current discussion about blockchain coexistence is very timely, as shown by the decline of Bitcoin and Ethereum's dominance and the births of many alternative coins last year. What is noteworthy on this topic is the recent tweet from Ethereum co-founder Vitalik Buterin, in which he advocated for the risk of bridging protocols.

"The current discussion about blockchain coexistence is very timely, as shown by the decline of Bitcoin and Ethereum's dominance and the births of many alternative coins last year."

Market action: After the European cash closing on Friday, Bitcoin has finally broken the strong resistance at USD40,000. The timing of the price action is curious, as the priced dipped soon after the important US opening, but the move likely reversed as traders grew more confident that the downside was limited.

Fixed Income | Issuance shifts toward loans

Saipem's bonds take a beating.

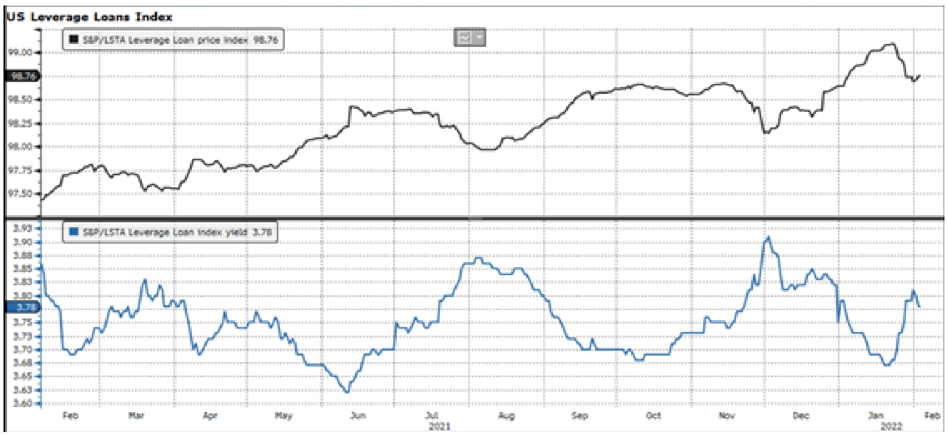
US investment grade bond sales returned to more normal levels this week following the modest issuance caused by the volatility in the second half of January. Aside from Bank of America's USD9 billion jumbo deal, corporates such as Valero Energy (BBB, 4%, 2052) came to the market with book orders nearly 10x the initial size. IBM racked up demand 5x its deal size, issuing USD1.8 billion in three parts (the 5-year with a coupon of 2.2%, issued at swap + 60 bps versus initial talk of 85 bps) and EUR2 billion in two parts (the 8-year with a coupon of 0.875% offered at swap + 57 versus initial talk of 80 bps).

In the US junk market, banks have a huge debt pipeline (USD100 billion according to Bloomberg) to sell in the coming months to fund buyout deals. Traditionally, the funding is always to split that between high yield bonds and leveraged loans. However, the high yield segment has registered its worst start to a year ever, forcing bankers to scramble and shift the mix more toward loans. McAfee Corp shifted some of the financing for its over USD14 billion leveraged buyout into loans from junk bonds. The initially proposed mix of USD3.3 billion junk bonds and USD5.7 billion loans shifted to only USD2 billion of bonds (Caa2/CCC+, 7.375% 2030). Another example is Barclays, the lead bond arranger for Prince International's purchase of Ferro, who dropped the secured bond tranche and increased the leveraged loan portion. According to Bloomberg calculations, the secured bond looked like it would have an interest rate in the mid-to-high 5% range, whereas the leveraged loan is being proposed as low as 4.8%.

"The leveraged loan market is doing well thanks to its floating rates allure, but recent turmoil in equities and bonds is bleeding over somewhat."

Our view: The leveraged loan market is doing well thanks to its floating rates allure, but recent turmoil in equities and bonds is bleeding over somewhat. The S&P/LSTA leveraged loan index price has pulled back from the 14-year high set in January. For now, the high yield credit markets are still buzzing and new deals continue to flow, it is just that banks are having a tougher time selling them.

Figure 4: Leveraged Loans



Source: Bloomberg, as at February 4, 2022.

"For now, the high yield credit markets are still buzzing and new deals continue to flow, it is just that banks are having a tougher time selling them."

In the European market, Saipem surprised with a big profit warning with EBITDA guided down by EUR1 billion in H2 2021 compared to the previous positive guidance. The reasons are persistent problems with offshore wind contracts, lower margins in the backlog due to increased material costs, and delays due to covid and logistics/supply issues. All this means is that Saipem's net loss should represent more than one third of its equity (EUR2.1 billion). At the end of September 2021, Saipem had liquidity of EUR700 million of cash and the EUR 1 billion 2023 credit facility, which was fully available. However, according to the Italian civil code (Article 2446), banks can ask for a repayment of certain loans, therefore the credit facility may no longer be available and potentially must need to be repaid early.

The two biggest shareholders (ENI 30.54% and the Italian strategic fund CDP 12.55%) stepped in announcing a management reshuffle and strategic reorganization. Saipem's bonds took a beating and rating agencies immediately cut their rating (Moody's from Ba3 to B1 on review for further downgrades). Saipem's 2.75% maturing 05/04/22 lost 10 points to a cash price of 90, while the 3.375% maturing 15/07/26 is trading now below 80. According to the company, there is sufficient liquidity to repay the next maturity. However, in a global restructuring of its capital structure, the 2022 bond could be included in the operation. Valuations are now attractive, but the situation remains very risky. Due to the government's involvement, it is a typical moral hazard trade.

Chart of the week

The iShares iBoxx High Yield Corporate Bond ETF showed signs of weakness during the week. Failure to breakout resistance at 84.9 paved the way for further weakness, as also shown by the MACD trend indicator. The next big support is at USD82.9, and holding the level is determinant for the medium to long-term trend.

Figure 5: High Yield Corporate Bond ETF

Source: Bloomberg, as at February 4, 2022.

Week Ahead | Key events to watch for

- **The US CPI figure is certain to have a major impact** on markets, especially if it surprises estimates (the headline should rise from 7.0% to 7.3%), either direction.

- **The earnings season will continue with the 83 other companies** reporting in the S&P 500 index.

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