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Weekly Market Flash

Focusing on the short end

March 6, 2022

The deterioration of events in Ukraine this week sent investors (understandably) into a panic, with European assets collapsing. However, US assets held up almost surprisingly well; geographical proximity to the conflict (not to mention the nuclear threat, linked to Kremlin hints or clashes near Ukrainian power stations), as well as the direct geopolitical implications for Europe, are responsible for the underperformance. On the other hand, the US market acted as a safe haven – and not just US Treasuries, but equities too – thanks to the geographical distance from the conflict, and energy independence.

Highlights

▪ This week, investors sought refuge in defensive stocks, including consumer staples, utilities and real estate. Meanwhile technology (especially expensive tech), financials and consumer discretionary stocks crumbled under the weight of higher inflation risk.

▪ Energy stocks performed the best as oil prices reached as high as USD120 per barrel during the week. At the same time, a stronger-than-expected nonfarm payroll figure fueled inflation fears although average hourly earnings were slightly below expectations.

▪ Fed Chair Powell pointed out in his Senate testimony that the Fed is unlikely to derail from its upward cycle, at least in the initial phase. The tightening of financial conditions is starting to be visible in other forms as well: credit spreads, albeit gradually, have started to widen.

▪ Most of the cryptos followed the sharp sell-off in equities this week. The big outlier in this environment was LUNA.

▪ Rating agencies have downgraded Russia's long-term foreign currency debt rating. However, such moves have so far been rare for corporation bond issuers, with most non-financial debt still rated as investment grade.

“Given that by definition it is totally irrational to price in a nuclear conflict, we believe that at the moment, the market is pricing in a decidedly catastrophic evolution of the conflict.”

Markets & Macro | Focusing on the short end

“Duration” remains key.

As far as our asset allocation is concerned, it is necessary to divide our analysis into two distinct phases and elements: the core of the military crisis in Ukraine, and the new macro environment that will emerge once the conflict ends (we assume this will happen, without presuming to predict how long it will last).

Our view: At this stage, given price action and the understandable level of anxiety and tension arising from the flow of news, we feel able to say that we are almost more alarmed by the long term than the short term. Indeed, given that by definition it is totally irrational to price in a nuclear conflict (there would be no tomorrow for mankind, so any asset would be worth zero), we believe that at the moment, the market is pricing in a decidedly catastrophic evolution of the conflict. The possibility of a ceasefire or even a peace agreement between the parties is underestimated at this point, and if there is any sign of a breakthrough in the coming hours, the impact on European markets would be enormous. We are merely reasoning in terms of probability and market sensitivity – we are not claiming to be military experts.

“The fear of Covid and lockdowns now seem a distant memory, which given the nightmare we are experiencing in Europe, we can almost remember with melancholy.”

Paradoxically, the post-war macroeconomic scenario almost worries us more. This does not mean that we will experience an epochal bear market in risky assets but managing portfolios in the new environment will be decidedly more difficult, and expected real returns should be lower. Let’s assume that, fortunately, economies (both European and US) enter this crisis from a solid position, with high growth rates and healthy consumer balance sheets, thanks to years of rebalancing (post GFC) and the huge, perhaps excessive, fiscal stimulus to cope with the pandemic. The February jobs report is the latest example of the strength of the US economy, even showing an accelerating trend, in line with the definitive reopening of the economy we are experiencing. The fear of Covid and lockdowns now seem a distant memory, which given the nightmare we are experiencing in Europe, we can almost remember with melancholy. At least we have learned that with vaccines and various individual or collective protections, we can defend ourselves against the virus.

The labor market has 678,000 jobs, with an average of 900,000 jobs recovered per month in the post-pandemic period. As a result, the unemployment rate has fallen to 3.8%, approaching the historical minimum of 3.5%. The paradox is that this figure comes at a time when markets need more than ever to see "bad data for the economy that is good for markets", leaving the Federal Reserve (Fed) with the space or pretext to cut rates or do other forms of easing. Instead, not to mention the relentless inflation levels, it seems that the economy is running above potential, and that the Fed's tightening, albeit slightly tempered by the natural tightening of financial conditions that is occurring, is unavoidable despite the war. Fortunately, some relief came from lower wage growth, which grew much less than expected, at 5.1% year-on-year (YoY) instead of 5.8%. Having said that, we are still talking about considerable wage growth, well above the sum of target inflation (2% for the Fed) and productivity (around 2%). The explosion in commodity prices (not only energy, but also in metals and soft commodities), and this will further impact inflation. It no longer matters whether its core or headline, which will fall much more slowly than before the crisis, from current levels of between 5% and 7% YoY in the US.

“Unlike similar episodes in the past (assuming there are any in recent history), the rates market has only marginally revised its expectations...”

Consequently, as Jay Powell pointed out in his Senate testimony this week, the Fed is unlikely to derail from its upward cycle, at least in the initial phase. In fact, unlike similar episodes in the past (assuming there are any in recent history), the rates market has only marginally revised its expectations, with the expected number of rate hikes down from 6.5 to 5.5 for the cycle starting in mid-March, with a 25 basis points (bps) hike telegraphed by Powell himself. The tightening of financial conditions is starting to be visible in other forms as well: credit spreads, albeit gradually, have started to widen, the slope of the yield curve is now close to inverting (25 bps on 2-10-year), and money market spreads have also started to move this week (Figure 1).

Figure 1: Money Market Spreads

Source: Bloomberg, as at March 4, 2022.

The key word in our asset allocation, which is already defensive at the moment due to the geopolitical framework, will therefore be “duration”, under the assumption that the war poses a stop to the globalization process and the cancellation of the “peace dividend” from which we benefited from in the past 30 years. In other words, we will focus on short duration assets in both fixed income and equities. In fact, we are preparing to short a basket of long government bonds (Bunds, Treasuries, Oats and Btps) as soon as signs of conflict stabilization arrive (not before, as we are aware of the safe haven flows into government bonds).

In equities and all risky asset classes, we will look for yields and dividends, seeking as much visibility and stability in flows as possible. Commodities will be part of our asset allocation, but without excesses, since by definition commodities do not offer any yield, so they will technically underperform inflation unless further constraints will reduce their supply. We can certainly consider precious metals as safe haven assets, and oil as a portfolio hedge, as geopolitics and energy needs will remain central themes for years to come.

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Equities | Between a rock and a hard place

Defensive and value stocks look best positioned.

The military conflict in Ukraine weighed on all major global equity markets, especially Europe, the most vulnerable to an escalation scenario and the most dependent on Russian energy exports. Investors sought refuge in defensive stocks, including consumer staples, utilities and real estate. Meanwhile technology (especially expensive tech), financials and consumer discretionary stocks crumbled under the weight of higher inflation risk.

Energy stocks performed the best as oil prices reached as high as USD120 per barrel during the week. At the same time, a stronger-than-expected nonfarm payroll figure fueled inflation fears although average hourly earnings were slightly below expectations.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	33,614.80	-1.23%	-0.77%	-7.15%
SPX Index	S&P 500	4,328.87	-1.24%	-1.01%	-8.94%
CCMP Index	Nasdaq	13,313.44	-2.76%	-3.17%	-14.79%
SX5E Index	Euro Stoxx 50	3,556.01	-10.42%	-9.36%	-17.04%
SMI Index	Swiss Market	11,300.13	-5.73%	-5.73%	-12.24%
UKX Index	FTSE 100	6,987.14	-6.67%	-6.28%	-4.92%
CAC Index	CAC 40	6,061.66	-10.23%	-8.97%	-15.16%
DAX Index	DAX	13,094.54	-10.11%	-9.45%	-17.57%
FTSEMIB Index	FTSE MIB	22,464.86	-12.84%	-11.61%	-17.51%
NKY Index	Nikkei 225	25,985.47	-1.85%	-2.04%	-9.70%
HSI Index	Hang Seng	21,905.29	-3.79%	-3.85%	-6.38%
SHSZ300 Index	CSI 300	4,496.43	-1.68%	-2.31%	-8.99%

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

"We believe that the price action of last week, especially in Europe, has started to price in the risk of recession."

Our view: As discussed last week, the war would only exacerbate the already fragile inflation outlook. Sanctions on Russia have the potential to significantly curb the output of certain commodities, pushing inflation higher. And the spike in commodity prices resulting from the war puts a lot of pressure on the Fed to act aggressively. Yet the uncertainty of the impact from the Russian sanctions makes it difficult for the Fed to act decisively, as evident by the congressional testimony of Fed Chair Powell last week. Mr. Powell stated that he was leaning toward a 0.25% rate hike in March. The Fed is behind the curve and it has to walk a very tight rope between taming inflation and plunging the economy into a recession. The European Central Bank is in an even tougher spot, having maintained a dovish stance so far, and given the larger exposure of the European economy to Russia.

We believe that the price action of last week, especially in Europe, is beyond pricing in Russia exposure risk and has started to price in the risk of recession. Any sign of de-escalation between Russia and Ukraine is likely to lead to a sharp rally in European equities, given that valuations are at multi-year lows. According to Deutsche Bank data, European P/Es are near the bottom of a 7-year range on an absolute basis. We reiterate our view from last week that the inflation genie is out of the bottle and central banks are facing a tough challenge of bringing inflation under control without triggering an unintended economic slowdown. Under current conditions, defensive and value stocks offer a better risk/reward vis-à-vis growth stocks, until the Fed pivot point is reached.

Chart of the week

The Euro Stoxx suffered a sharp move after the breakout of the neckline at the 3850 area. As showed by the RSI, the index is now in oversold territory, while the next important support is in the 3500 area, at the lows of February 2021.

"Under current conditions, defensive and value stocks offer a better risk/reward vis-à-vis growth stocks, until the Fed pivot takes place."

Figure 3: Euro Stoxx Index

Source: Bloomberg, as at March 4, 2022.

Crypto & Blockchain | Trading volumes between Bitcoin and RUB reach 9-month high

LUNA outperforms the market.

Crypto exchange executives refuse to impose a unilateral ban on Russian accounts because this would be a slap in the face of the reason why crypto exists. It would be a break from early pioneers who conceived the idea of the blockchain precisely to circumvent the global banking system. As Facebook hasn't banned Russian users and Google has not blocked off Russia, exchanges would avoid to block ordinary Russians' accounts as they are using crypto as a lifeline now that their currency has collapsed.

"As Facebook hasn't banned Russian users and Google has not blocked off Russia, exchanges would avoid to block ordinary Russians' accounts..."

However, they can collaborate on detecting the activities of the oligarchs. The transparent and public nature of the ledgers means that every crypto transaction can be scrutinized by anyone, and those sanctions-evading activities will be able to be detected and investigated even in the months and years ahead. Larger centralized exchanges like Binance, Kraken and Coinbase has built-in mechanisms to help identify and mitigate bad actors, and they have KYC and AML procedures in place, which would help agencies trace assets to a specific user. Moreover, we should consider that the crypto market is too small for hiding the Russian capitals. Meanwhile, trading volumes between Bitcoin and the Russian rouble have hit a nine-month high, according to data from cryptocurrency research firm Kaiko.

Market activity: Most of the cryptos followed the sharp sell-off in equities after Russia bombed Europe's largest power plant and the Ukrainian voice condemning Russian on a violation of ceasefire. The big outlier in this environment was LUNA, the native staking token of the Terra protocol, which is holding very well. The main reasons that explain the overperformance are primarily the raise of USD1 billion of bitcoin reserves, and the constant inflow of assets to the protocol. Unlike longer-established stablecoins, such as those issued by Tether and Circle, the TERRA protocol is an algorithmic alternative that does not use any collateral to maintain their price, which makes it more difficult to block the blockchain as there are no physical and centralized collaterals.

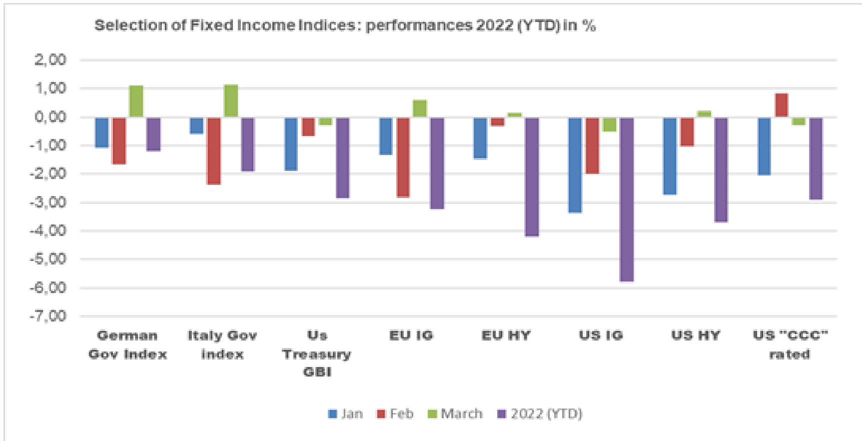
Fixed Income | Russia corporate bonds disconnect

> "As investors dumped risk assets, they found a haven in junk bonds (at least in relative value terms)."

Credit ratings and pricing don't match.

Geopolitical concerns and safe haven flows could not entirely free sovereign bonds from the grips of higher inflation and more aggressive central banks.

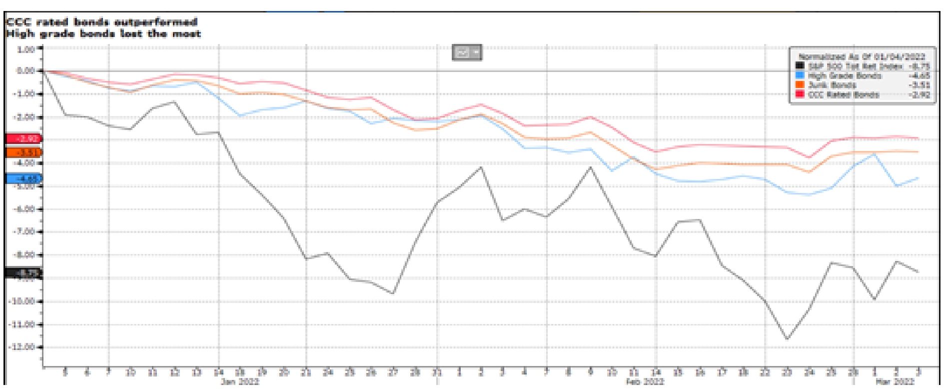
Figure 4: Performance of Fixed Income Indices



Source: Bloomberg, as at March 4, 2022.

Except for a short period between late February and early March (the green bar), US Treasuries and Bunds continued their negative trend. Spreads of European periphery government bonds widened as well, with Italian BTPs over Bunds reaching 171 bps in February. In credit, all segments fell for a second month in a row. However, as investors dumped risk assets, they found a haven in junk bonds (at least in relative value terms). Surely, junk (the orange and red lines) is not immune to global volatility and tends to trade lower when equity markets drop.

Figure 5: CCC Bonds Outperform



Source: Bloomberg, as at March 4, 2022.

> "The US high yield market has benefited from the large energy exposure and relatively shorter duration, as well as the presumption that the economy remains healthy."

Being a mid-cap market, dominated by companies who don't have a massive global presence, and are over-indexed to energy, the issuer base is relatively insulated from the Russia-Ukraine war. Finally, the US high yield market has benefited from the large energy exposure and relatively shorter duration, as well as the presumption that the economy remains healthy.

Our view: Three days of relative calm in financial markets allowed the floodgates to open in the US high grade primary market with companies selling over USD50 billion in fresh bonds. New issue concessions averaged 10 bps while issuers saw their trades well subscribed with average book orders of 3.5 times deal size. Among the companies coming to the market, Roche Holding (Aa3) sold USD5 billion of bonds to help finance the repurchase stake in itself from rival Novartis. The 2-year fixed (March 8, 2024) was offered at a 1.88% yield, while the 3-year fixed (March 10, 2025) priced at 2.13%. As clarity emerged on the outlook for rate hikes and the economy, US junk bond borrowers resurfaced as well. Department store chain Macy's (Ba2, BB) sold two bonds of USD425 million each: the tranche maturing in 2030 at a yield of 5.875% (lower than early indication of 6-6.5%) and the notes due in 2032 at yield of 6.125% (6-6.25% indicated).

“More than three-quarters of the bonds issued remain investment grade, while non-financial corporations in Russia are now trading at distressed levels.”

Update on Russia

Secondary market liquidity is highly impaired. In particular, the ability to settle RUB in Clearstream has been severely impacted. External settlements, bridge settlements and new internal settlements (free/against payment) in RU ISINs are no longer executed. Moreover, the Central Bank of Russia has temporarily banned sales of securities by non-residents.

Rating agencies have downgraded Russia's long-term foreign currency debt rating: S&P to CCC- from BB+ (on watch negative), and Moody’s to B3 from Baa3 (outlook remains watch negative). However, such moves have so far been rare for corporation bond issuers, with most non-financial debt still rated as investment grade (according to Bloomberg, on a sample of almost 140 bonds issued by 25 different Russian companies). The result is a massive disconnect between the market’s pricing and corporate credit ratings. More than three-quarters of the bonds issued remain investment grade, while non-financial corporations in Russia are now trading at distressed levels.

Figure 6: Russian Credit Ratings

Source: Bloomberg, as at March 4, 2022.

“Gazprom, the nation’s largest foreign-currency borrower, still has a high grade rating (BBB), but its market-implied rating stands at BB+, one step into junk.”

Gazprom, the nation’s largest foreign-currency borrower, still has a high grade rating (BBB), but its market-implied rating stands at BB+, one step into junk, according to Bloomberg. Gazprom PJSC maturing next week traded at about 55 cents and bonds maturing between one and five years are trading at 35 cents. Russian Railways JSC is rated BBB, but with its bond trading at 50 cents, its implied rating is four levels lower at BB-. The same goes for chemical maker PhosAgro PJSC(BBB-) trading at 27 cents.

On the one hand, the sanctions on Russia haven’t outright banned trading non-Ruble bonds, and despite the much talked about attitude, financials players are rarely deterred by moral qualms when it comes to buying cheap assets. On the other hand, this time risks are unique because the exclusion of some Russian lenders from the global payments/settlement system is making them and their instruments untouchable and uninvestable.

Week Ahead | Key events to watch for

- **The Ukrainian crisis will continue to dominate the markets**, with hopes of some sign of peace (or at least a truce) hanging by the thread of ongoing negotiations.

- **On the economic front, the February US CPI** comes at the worst possible time, with the explosion of commodities, and not just energy, in the background.

- **The ECB meeting will be followed in terms of communication**, given that with Europe under pressure, traders are expecting very reassuring messages from President Lagarde.

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