NOVUM
CAPITAL PARTNERS

Weekly Market Flash

How do we translate the Fed's message?

November 6, 2022

This week, all eyes were on the Federal Reserve's (Fed) meeting and Fed Chair Powell's words. The Fed delivered its fourth consecutive 75 basis points (bps) hike, bringing the Fed Funds rate to 4%. Despite the market's seemingly hawkish interpretation, and worrying price action in the hours following the press conference, there actually seemed to be something for everyone. At the same time, the week was negative for global equity indices, with the MSCI World Index losing -2.1%. However, beneath the surface, both sectoral and geographic dispersion was very strong, confirming an acceleration of a trend well underway during the year.

Highlights

- The tone of the FOMC conference was hawkish. The market, following Powell's press conference, realized that the dovish/pivot turn is still a long way off.

- One dynamic that has emerged over the last two weeks is the divergence between central banks, after a phase of alignment (over the last six months) in the fight against inflation.

- In China, speculation about a relaxation of the zero-Covid policy in the coming months intensified. A Bloomberg article also reported that authorities are considering eliminating a system that penalizes airlines based on the number of cases they import into the country.

- After the frenzy of the SPAC phenomenon during 2020 and 2021, the volume of new "blank-check" vehicles has decreased dramatically in line with the traditional IPO processes.

"Europe's outperformance compared to the US can also be explained by the news and hopes coming from China..."

Markets & Macro | How do we translate the Fed's message?

Heading toward 'slower for longer'.

It was a negative week for equity indices around the world. Technology stocks suffered the most, led by Big Tech (the Nasdaq index was down -5.65%), which continues to weigh on the US (the S&P 500 index fell -3.65%), precisely because of the strong weight of technology in the index (over 20%). It is therefore no coincidence that the European market, full of financial and value stocks, managed to rise 2.05% during the week. The same applied for the Nikkei index, which was up 0.5% this week, and down less than 2% since the beginning of the year.

Europe's outperformance compared to the US (now up a good 7% since the start of the year, with the Eurostox down -15% compared to -21% for the S&P 500 index) can also be explained by the news and hopes coming from China, in particular with the end of the zero-Covid policy. Europe is in fact much more exposed to the Chinese market (exporters) than the US is.

“As far as the Fed is concerned, the most important message is that it is 'slower for longer'.”

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

Equity	Last Value	Ytd
MSCI World	2,499.79	-21.22%
Nasdaq	10,357.47	-33.36%
S&P 500	3,721.07	-20.91%
Nikkei	27,663.39	-1.98%
Eurostoxx	3,574.81	-14.16%
Swiss SMI	10,656.31	-14.87%
FTSE 100	7,128.17	-0.44%
Canada	19,113.57	-7.62%
Shenzen	3,647.90	-24.59%
Hong Kong	15,339.49	-32.29%
MSCI EM	873.02	-27.14%

Bond Indices	Last Value	Ytd
US Inv Grande	100.15	-22.52%
US High Yield	72.11	-13.65%
Euro Corps	225.97	-14.29%
JPM Europe Govies	9,381.74	-11.79%
US Treasuries	2,141.29	-14.35%
China Aggregate	245.26	-8.92%
EMBI Global	718.18	-21.90%
EMBI Local	114.10	-17.14%

Commodities	Last Value	Ytd
BBG Commodities	113.36	14.31%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.93	11.75%
Gold	1,621.02	-11.38%
Silver	19.12	-17.97%
BBG Brent Crude TR	1,128.63	50.69%
BBG WTI Crude Oil TR	206.91	35.15%

FX	Last Value	Ytd
DXY Index	1,345.73	14.68%
Bbg JP ASIA	95.64	-11.49%
Bbg JP LATAM	39.63	-3.06%
EUR Index	117.63	-2.60%
EUR/CHF	0.99	-4.78%
GBP Index	609.62	-10.72%
EM FX Index	1,583.15	-8.72%
JPY/USD	147.99	-22.24%
CNY/USD	7.32	-13.12%
Bitcoin	20,151.08	-56.51%

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

Our view: The optimism around China, in the current oversold market environment, has given further support to the value segment over growth, and to all commodities, especially the more cyclical ones. Asian markets were positive during the week, with Hong Kong and Shanghai booming at 8.5% and 7.5%, respectively, during the week. Speculation about a relaxation of the zero-Covid policy in the coming months intensified. In addition to the persistent rumors, there were some small concrete signs—for example, a Bloomberg article reported that the authorities are considering eliminating a system that penalizes airlines based on the number of cases they import into the country, and the approval of the BioNTech vaccine for expats for the time being. There was also some good news for Wall Street-listed Chinese tech companies, with US authorities reportedly ending the first round of on-site inspections early.

As far as the Fed is concerned, the most important message is that it is 'slower for longer'. After the famous Wall Street Journal article of a fortnight ago, the problem was that the market paid too much attention to the part of the article that referred to the gradual tapering (which will in fact happen), rather than to the rest of the article which stated that the terminal rate will be higher than expected, and will remain at that level for longer than expected. The initial statement had deluded the market, mainly because of this sentence: "the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation".

“The market, following Powell's press conference, realized that the dovish/pivot turn is still a long way off...”

The market, following Powell's press conference, realized that the dovish/pivot turn is still a long way off, and the selloff in the last few hours of trading has been heavy. Powell was direct, saying that it is still very premature to be thinking about a pause, and also highlighting that the hiking cycle had three important components: 1) the pace the Fed gets to the terminal rate, 2) how high the terminal rate needs to get, and 3) how long policy needs to stay restrictive. Only the first part is therefore modified, while the other two are still in full swing.

But in general, the whole tone of the conference was hawkish. The emphasis was, once again, on the need to slow demand, taking the risk of a hard landing—but relying on the fact that the labor market is still very strong. The fact remains that the time for 75 bps rate hikes is almost certainly coming to an end, and the FOMC will be confronted with incoming macro data, which could progressively refute Powell's theory that the US economy is still robust and therefore remains on high alert.

Another dynamic that has emerged over the last two weeks is the divergence between central banks, after a phase of alignment (over the last six months) in the fight against inflation. Some central banks, including the European Central Bank, the Norges Bank, the Bank of England and the Bank of Canada, have started to moderate their tones, showing a less impulsive and a more wait-and-see attitude. The basic idea is to slow the pace of increases (or balance sheet contraction) in order to have time to monitor the effect of what has been done so far, without overstretching the economies by unnecessary tightening. The Fed, on the other hand, is decidedly more aggressive, and wants to see results quickly, whatever the cost. And in this cost it also puts asset prices. Powell seemed almost annoyed during the press conference when a journalist asked him what he thought of the positive market response to the Fed statement, saying that it was not his target! As we have already mentioned, the level of the S&P 500 index, through its influence on financial conditions and the wealth effect, is an integral part of Fed policy.

"...the level of the S&P 500 index, through its influence on financial conditions and the wealth effect, is an integral part of Fed policy."

The bottom line is that we don't feel the Fed's message was so hawkish per se, but it was relative to expectations that as usual had gone too far. At the bottom line, technically, for the first time since before the summer, there has been a change in language, and a realization that 400 bps of upside is a lot—so the pace of upside in the future will be slowed. From the point of view of markets, and in particular of the S&P 500 index, how do we translate the Fed's message? More than bearish per se. Even here, let's say that we are in a range where the upper part is probably between 3'900 and 4'000, and the lower part around 3'500, i.e. the mid-October lows.

Equities | Stock and sector selection more important than ever

Shifting to single stocks and value.

Hopes of a Fed pivot were dashed after Powell stressed the importance of focusing on the magnitude of the rate hikes (a "higher terminal rate") rather than the pace.

Our view: A couple of weeks ago, we stated that "while some central banks are wavering in their resolve to fight inflation, the Fed isn't. Confusing the two or assuming there is a read-across from one central bank's actions to the Fed's is not just erroneous but also dangerous". Our previously stated suspicion that the market was underestimating the timeline for getting inflation under control is now more evident. This is likely to put further pressure on the long duration assets, especially the two Big Tech stocks we highlighted a couple of weeks ago (Apple and Microsoft).

"Our previously stated suspicion that the market was underestimating the timeline for getting inflation under control is now more evident."

Another new dynamic that complicates the inflation picture is China easing its lockdown policies. This led to a Friday rally not only in Chinese equities but also in inflation beneficiaries, including commodity plays. In a way, this confirms our view that we are entering a phase where sector and stock selection will begin to matter more than they did over the last 10 months. The style balanced portfolio (value, growth, defensive), will have to make way for the value-biased portfolio at the expense of the growth (which is negatively impacted by rates) and defensive (excessive valuation) styles. We have begun the gradual process of shifting the portfolio holdings from ETFs to single stocks, and from growth and defensive toward value. In the value style, we do include emerging markets and miners, both of which tend to benefit from US dollar weakness.

Private Equity | Is it the end of the SPAC experiment?

More and more pre-agreed deals get cancelled.

After the frenzy of the SPAC (special purpose acquisition companies) phenomenon during 2020 and 2021, the volume of new "blank-check" vehicles has decreased dramatically in line with the traditional IPO processes. Public listings have been almost completely shut down due to rising interest rates, which challenged the high-flying valuation multiples of those high-growth, non-profitable businesses where SPACs set the spot on.

“…we do expect the pace of deal breaks as well as SPAC dissolution to increase in the foreseeable future with just very few reaching the finish line.”

Our view: Activity within the SPAC segment should be followed from two different angles: on the one hand, new SPAC IPO issuance, and on the other, new business combination deals (de-SPAC activity). On the new listings side, the downward trend started after the Q1 2021 peak (356 listings) continued toward a depressed number of only 35 total SPACs lifted in Q3 (from 79 and 59 in Q1 and Q2, respectively). On the other hand, with declines in value and count, reverse merger activity got hit by the negative direction of market multiples, which is what has brought redemptions rights into play.

A large number of pre-agreed deals at late 2021 or early 2022 valuations are getting cancelled after not passing shareholders vote for an obvious reason. That was the case of the SPAC FinTech Acquisition Corp V and online brokerage firm eToro mutually ended their bid to pursue the combination, which originally valued the business at around USD10 billion. In July, they called the deal off and eToro is now reportedly seeking a new private financing round at a valuation near USD5 billion.

While today, half of the listed SPACs have an associated merger target (according to Prequin data), we do expect the pace of deal breaks as well as SPAC dissolution to increase in the foreseeable future with just very few reaching the finish line. If a higher level of speed and merger certainty were the main added value of the reverse repo compared to a traditional IPO, recent market dynamics pose low upside for the former. However, in the same way that SPACs did not disrupt the traditional IPO route in 2021, we do not believe the rational reduction in SPACs activity will mean the end of the listing route. Be that as it may, the halting of SPACs activity is another blow to the liquidity for private market investors.

Week Ahead | Key events to watch for

- **The US mid-term elections will be the main focus** next week, as will be the US CPI figure, due on Thursday. The market has now discounted a victory for the Republicans, who are expected to take control of at least one of the two chambers. A Democrat victory would be a negative event to reckon with at this point, as it would bring the risk of further fiscal expansion plans—which would put upward pressure on the long end of the curve.

- **In Europe, UK GDP and German industrial production data** will have less of an impact as the earnings season draws to a close, with Berkshire Hathaway, Disney, Occidental, Adidas and BioNTech.

Vittorio Treichler Chief Investment Officer

Flavio Testi Senior Fixed Income Portfolio Manager

Daniele Seca Senior FX, Crypto & Derivatives Portfolio Manager

Karim Khalil Senior Equity Portfolio Manager

Carlos De Andres Perez Senior Private Equity Funds Manager

Maxime Glasson Senior Hedge Funds Manager