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Weekly Market Flash
Will value stocks soon come back in favor?

February 7, 2021

The market correction triggered by the squeeze in highly shorted stocks subsided very quickly, lasting two days instead of the "physiological" two weeks that we had envisioned. With several markets reaching new all-time highs, the rapid recovery has once again demonstrated the validity of the principle that financial crises (real, or as in this case, feared) that occur in the context of a cyclical recovery are an opportunity to buy – and not the sign of a possible trend reversal.

Highlights

- Several markets including the S&P 500, Nasdaq, Russell 2000 and Dax indices reached record highs this week. Energy stocks were the best performing stocks, with Brent oil rebounding close to $60/bbl.
- The US labor market report missed the official median average by over a half, 49k versus 105k.
- Mario Draghi is stepping in to form a caretaker government in Italy – with all major parties declaring their support for him. BTP-Bund spreads tightened to just below the 100bps mark, which has not been reached since 2016.
- The investment grade bond market saw several jumbo deals this week, led by Apple's USD14 billion issue. Meanwhile the high yield market is on track to price more than USD7 billion this week, with CCC-rated credits accounting for more than a third of sales.

"As soon as we saw the VIX index collapse earlier this week, along with the sharp decline in key stocks like GameStop, Express, AMC and Bed Bath & Beyond, we immediately covered our underweight in equities and removed our hedges."

Markets & Macro | Correction turns into rapid recovery

Markets reach record highs on encouraging signs.

The global market correction triggered by the squeeze in highly shorted stocks has subsided very rapidly, with several markets including the S&P 500, Nasdaq, Russell 2000 and Dax indices reaching record highs this week. After being forced to retreat last week, Goldman Sachs' prime brokerage unit reported that hedge funds have been adding stocks in both long and short positions this week. Their gross trading flow jumped on Tuesday at the fastest pace since March, and the industry's long-short ratio climbed to the highest since 2011.

Our view: As soon as we saw the VIX index collapse earlier this week, along with the sharp decline in key stocks like GameStop, Express, AMC and Bed Bath & Beyond, we immediately covered our underweight in equities and removed our hedges. Our opportunistic approach saved us from missing out on relevant gains for the remainder of the week.

The other decisive fundamental factor, the pandemic, is also sending encouraging messages overall. Vaccines are multiplying and, where they are being introduced on a large scale, the rates at which the disease is spreading are beginning to change. And this week we saw further positive news with a promising treatment: in an Israeli hospital (Hadassah Medica Center), a drug has been tested to show that it could heal 29 out of 30 patients with severe COVID symptoms in five days – albeit the sample size was small.

Weak US labor data will support bond markets.

The publication of the US labor market report confirmed that “bad news” is “good news” to markets, as a weak economy justifies monetary and fiscal policy support. The headline missed the official median average by over a half, 49k versus 105k. The reality is also that broad-based expectations were likely much higher after some strong job data indicators throughout the week, while revisions were negative by 159k for the two previous months.

“The positive side of the disappointing report is that it will contribute to support fixed income markets and reduce the concerns of an extended disorderly sell-off.”

Our view: The positive side of the disappointing report is that it will contribute to support fixed income markets and reduce the concerns of an extended disorderly sell-off / bear-steepening in the US curve. One of the key risks to the growth/tech sector in equities was precisely that of an abrupt rise in rates, which would harm valuations. And all of this is in a context of a heavy refunding in the US next week, and a fixed income correction that has turned into a global theme.

With the 2-year maturity pegged by the Fed Funds rate at zero for a long time to come (the median of the December dot plot suggests zero until late 2023), and the 10-year breakeven at 2.17% and pressing on the long end of the curve, it is inevitable that the curve will steepen. At some point, the Federal Reserve will have to deal with containing inflation expectations – although Powell has already said that temporary overshoots of the target will be tolerated. Monetary policy does not appear to be a threat for now.

On the fiscal stimulus front, the Democrats are moving forward on budget reconciliation by voting on a series of resolutions in the Senate. The intention is clearly to move forward with the approval of a USD1.9 trillion package if the Republicans don't cooperate. Eventually, the size of the stimulus will likely be a figure at least close to that.

BTP-Bund spread tighten to 2016 levels.

Italy also provided some positive news this week, with the populist coalition that supported the Giuseppe Conte government failing to find a new majority. Mario Draghi is stepping in to form a caretaker government – all the major parties declared their support for him this week, while other endorsements should come in the next few days. This is another blow to populism, following the Trump defeat and the takeover of the Senate with the Democrat win in Georgia.

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BTP-Bund spreads tightened markedly this week to just below the 100bps mark (a level that has not been seen since 2016), and the Italian stock exchange outperformed all other indices on the back of this news.

Our view: We jumped on the bandwagon as soon as we heard the news of Draghi being given the task to form a government. We bought some exposure to the Italian FTSEMIB Index, while also selecting some financial stocks that should benefit from a tightening in the BTP-Bund spread.

In our view, a Draghi government makes a leap forward in efficiency in obtaining and spending EU budget money, greatly improves relations with Brussels and the European Central Bank, and therefore reduces the risk premium of Italian assets. It can also be the interpreter of some instances for the south of Europe. Overall, it is very good news.

This week, the BTP-Bund spread finally broke below the psychological 100bps level. However, if the executive is launched, the spread can cover some of the distance that separates it from Spain (58bps) by going in the direction of the post-crisis low in the 85-90bps area. With scope for further tightening and a stabilization in economic conditions, equity prices and the financial sector specifically, there should be further room for recovery in the months to come.

Figure 1: BTP-Bund Spread

Source: Bloomberg.

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Equities | Will value stocks soon come back in favor?

Energy stocks remain best performing YTD.

Major global benchmarks recovered from the previous week's losses, as the GameStop saga quieted down. The de-grossing and de-risking activity of hedge funds was largely completed by Monday. Soon after, investors quickly shifted their attention to Biden's USD1.9 trillion fiscal stimulus and the positive news on the vaccine distribution.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,148.24	3.90%	1.87%	1.87%
S&P 500	3,886.83	4.67%	3.60%	3.60%
Nasdaq	13,856.30	6.04%	7.57%	7.57%
Euro Stoxx 50	3,655.77	5.11%	3.17%	3.17%
FTSE 100	6,489.33	1.28%	0.48%	0.48%
CAC 40	5,659.26	4.82%	2.09%	2.09%
DAX	14,056.72	4.64%	2.46%	2.46%
FTSE MIB	23,083.42	7.00%	4.21%	4.21%
Nikkei 225	28,779.19	4.03%	4.87%	4.87%
Hang Seng	29,288.68	3.55%	7.56%	7.56%
CSI 300	5,483.41	2.46%	5.22%	5.22%

Source: Bloomberg, as at February 5, 2021. Performance figures in indices' local currencies.

"And despite the recent rally in Big Tech, on the back of very strong earnings, the energy sector remains the best performing sector of the S&P 500 index year-to-date."

Energy stocks were the best performing stocks of the week, with Brent oil rebounding close to $60/bbl. And despite the recent rally in Big Tech, on the back of very strong earnings, the energy sector remains the best performing sector of the S&P 500 index year-to-date.

So far, 292 out 500 S&P 500 index companies have reported their earnings. Sales surprises were on average +3.6%, led by basic materials, financials and technology stocks. Earnings surprise was 19.18% on average, led by consumer services, financials, and basic materials. This is the third quarter in a row where earnings surprises were above 15% since 2018.

Figure 3: Energy Stocks Outperform

Source: Bloomberg, as at February 5, 2021.

"We do not rule out a repeat of the GameStop saga or similar pockets of bubbles going forward. We are continuing to monitor liquidity conditions for signs of stress."

Our view: As we mentioned last week, our focus was on the VIX index and the vaccine distribution news. With the VIX contracting from above 30 to almost 20 now, and the vaccine distribution news turning positive, we believe that sentiment will remain positive in the coming weeks. As a result, we expect value sectors to come back in favor after a period of growth outperformance.

We do not rule out a repeat of the GameStop saga or similar pockets of bubbles going forward. We are continuing to monitor liquidity conditions (which are no longer tightening in China) for signs of stress.

Chart of the week

In our Market Flash published on November 15th, the chart of the week showed the sharp rebound of the FTSEMIB (Italian large cap index) futures contract pointing out our year-end target at 22,800 (76.4% Fibo`s retracement of February/March 2020 move).

The recent political development in Italy has boosted the country's equity market, breaking this resistance. In our bullish scenario, the future should likely close the GAP 24,000/24,500 before the full recovery to February's high at 25,500.

Figure 4: Italian Large Cap Index

Source: Bloomberg.

"...with bond investors throwing money at them, tech companies have been able to borrow at rates that might be less than zero after inflation."

Fixed Income & Credit | Getting paid to borrow

Demand for higher yielding debt outpaces supply.

The investment grade bond market saw several jumbo deals this week, led by Apple's USD14 billion issue, as well as Boeing and Altria. Lufthansa also came to the market with EUR1.6 billion of bonds, while UK supermarket chain Asda Group launched the largest sterling corporate bond sale on record. Alibaba's USD5 billion deal, the first test of investor appetite for the company after the headwinds facing its founder Jack Ma, was nearly eight times oversubscribed, allowing the borrower to save 40bps upon execution.

In the tech sector in particular, this year companies have already borrowed nearly a quarter as much as they did in 2020 – and with bond investors throwing money at them, tech companies have been able to borrow at rates that might be less than zero after inflation.

For example, the five-year tranche of Apple's bond has a coupon of 0.7%, which is below US inflation. Broadcom, a chipmaker that supplies Apple and other large electronics makers, raised an impressive USD10 billion in the US high grade market last month to help refinance existing debt. Even high yield corporates are joining the frenzy – Rackspace Technology, a cloud computing company, sold USD550 million of bonds and SK Hynix, a South Korean chipmaker, sold three-year notes last month with a coupon of just 1%.

"While this practice of reverse enquiry has always existed, the current pace of activity is just another sign that investors across the world are struggling to find enough higher-yielding debt to buy."

The high yield market is on track to price more than USD7 billion this week, with CCC-rated credits accounting for more than a third of sales. Chesapeake Energy borrowed USD1 billion to exit bankruptcy, oversubscribed 12 to 1. Leveraged loans had another busy week for launches, making for the biggest two-week period in more than a year.

Our view: Money managers are having a tough time getting their hands on junk bonds and leveraged loans that they're calling up companies and pressing them to borrow, instead of waiting for bankers to bring new deals to them. For example, PetSmart tried to borrow USD4.65 billion in October and failed. After the post-election junk bond rally, the company found investors that were beating down its door, and eventually it was able to sell bonds and loans in January.

While this practice of reverse enquiry has always existed, the current pace of activity is just another sign that investors across the world are struggling to find enough higher-yielding debt to buy.

Week Ahead | Key events to watch for

- **Next week, data highlights will include the January CPI print in the US**, along with industrial production results for many of Europe's largest economies.
- **Italian politics will remain center stage**, with the likely announcement of the new Draghi-led government.
- **There will be a moderate number of earnings releases**, after the big names have already reported and more than 50% of the companies have reported for the quarter.

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