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Weekly Market Flash

Finding logic in the market madness

March 7, 2021

The normalization in rates continued to dominate price action in global markets this week, with a resurgence in heavy selling on the stocks and sectors that rallied for most of the second half of 2020 and early 2021. Companies with exposure to electric vehicles, the cloud, semiconductors, ESG, blockchain, clean energy and various technology subsectors suffered sizeable liquidations. Evidently, the repricing of these sectors is driven by rates to a certain extent, but it also represents investors abandoning these themes – potentially for a longer period.

Highlights

- Major US indices ended the week mixed. Rate-sensitive growth stocks came under severe pressure, while value stocks, especially energy, gained, due to an OPEC+ deal driving oil prices higher.
- Fed Chair Powell's comments at a panel organized by Wall Street Journal this week disappointed markets which were hoping for a mention of yield curve control. This led to a sharp correction in bonds and equities.
- US non-farm payrolls rose 379k in February, with January's data also revised upwards.
- In China, the National People's Congress unveiled China's policy stance and growth objectives for 2021, including a growth target of 6% versus expectations of 7.5%-8%.

Markets & Macro | Finding logic in the market madness

"...the rise in yields is tied to an improving macro picture, with which significantly negative real rates are no longer consistent."

Is the strike of the Fed put lower that what's priced in?

The repricing action in stock markets heavily impacted the Nasdaq this week and dragged down overall indices. Tesla has lost 30% from its highs at the end of January – and such performances have been the norm in certain sub-sectors. To some extent, rates volatility has been a key driver of the repricing – but the stock market movements also represent investors abandoning these themes, potentially for a longer period – causing a capitulation where positioning is excessive, with investors rushing to protect gains (or limit losses, for those who entered late).

Investors had hoped that the highly awaited virtual interview by Federal Reserve (Fed) Chairman Powell with the Wall Street Journal would calm the action in rates markets, particularly the rise in real rates. Powell noted that the outlook for the economy has improved recently, but reiterated that the Fed is still a long way from fulfilling its dual mandate. He also reiterated that the Fed's employment and inflation targets are still some way off, and that the Federal Open Market Committee (FOMC) will not give attention to any elevated inflation readings in the short term, but will look to the medium term – in line with the new "average inflation target" mandate. He called the recent bond market moves "notable" and said that they "caught his attention", but emphasized that the Fed focuses on a broader range of financial conditions and he would only be worried by a persistent tightening in financial conditions. When asked about the possibility of extending the duration of future Fed asset purchases, Powell said that the current purchase plan was "appropriate."

Our view: Real rates rose by 15 bps for the week to -0.60%, which represents a tightening of financial conditions. But it is also a sign that the rise in yields is tied to an improving macro picture, with which significantly negative real rates are no longer consistent. And this was confirmed by a very solid US labor market report, with non-farm payrolls rising 379k in February, with the data for January also being revised upwards. And with the US economy being quite advanced in the vaccine distribution process, additional large gains are expected in the coming months.

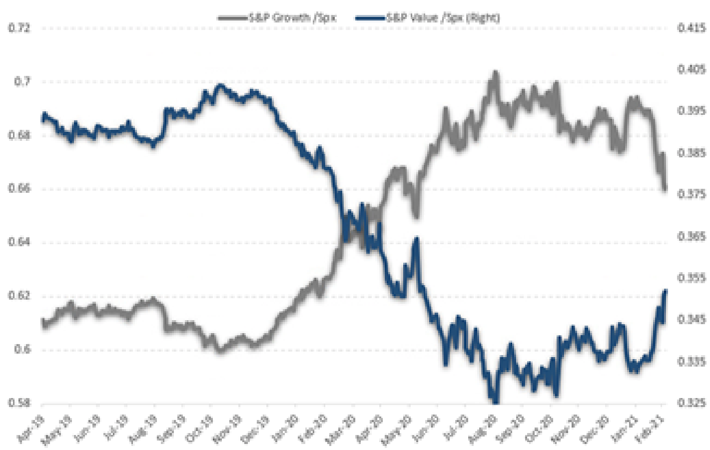
With the current mix of a resilient economy (after the initial collapse in economic activity at the onset of the pandemic, economic agents adapted to the new environment far better than expected by analysts), and the prospects of a full economic reopening coming sooner than expected, wasting ammunition to protect the economy and markets from real rates currently at -0.60 % would not be prudent. This is particularly true in the context of the approval of a new US stimulus package which is 9% of US GDP, and which follows the 5% of GDP package that was approved by the Trump administration only three months ago.

"Another consideration that is likely worrying investors is the new paradigm, which beyond having a huge impact on the composition of market performers, can be difficult to adjust to from a psychological perspective."

While we were absolutely struck, as most investors, by the violence in the market movements in the last two weeks, it seems to us that what's happening has some logic. Investors have to adapt to a new financial environment with extremely loose fiscal policy and monetary policy that is just supportive enough to allow governments to fund their spending programs in the bond market. The hurdle for renewed monetary policy measures is probably higher than investors expected and this has caused the recent volatility. In other words, the strike of the "Fed put" is lower than what is priced in.

Another consideration that is likely worrying investors is the new paradigm, which beyond having a huge impact on the composition of market performers (with an unwelcome inversion in market leadership from growth to value, as highlighted in the chart), can be difficult to adjust to from a psychological perspective. Further, while we have learned in the past year that monetary printing is basically unlimited, fiscal profligacy must be reversed one day or the other.

Figure 1: Inversion in Growth versus Value Leadership



Source: Bloomberg.

"Further, while we have learned in the past year that monetary printing is basically unlimited, fiscal profligacy must be reversed one day or the other."

We also had two reminders of the limits of accommodation this week from the UK and China. In the UK, Chancellor Sunak announced higher taxes for the wealthier and for corporations in order to balance the budget in the medium term.

In China, the National People's Congress unveiled China's policy stance and growth objectives for 2021. Chinese authorities have signaled clear intentions for policy normalization. The key message out of Beijing has been that macro policy will emphasize "continuity, stability and sustainability." The growth target for the year was quite disappointing too at 6% versus expectations of 7.5%-8%. The idea is that less effort will be put into shoring up growth, and instead the focus will be on reducing imbalances, first and foremost credit growth and total debt. This is also reflected in the lowering of the fiscal deficit target from 3.6% of GDP to 3.2%. While such announcements were not supportive to local and global markets in the short term, we welcome such confirmation of prudent and stable policies as a warrant for healthy economic growth. Since we have structural exposure to the Chinese currency and the bond market, this week's events reinforce our stance, particularly on the potential for FX appreciation in the medium term.

Equities | Market appears to be indecisive about inflation

Raising our inflation hedges through commodity and energy stocks.

"The reaction of the equity market to a strong NFP figure of 379k underscores the market's indecisiveness regarding inflation expectations: stocks rose, then fell and finally rose aggressively after several stocks hit key technical support levels."

Rising yields once again dominated trading activity, leaving major US indices mixed. Rate-sensitive growth stocks came under severe pressure, especially high growth technology stocks. The ARK Innovation ETF lost 10.19% during the week, pushing the year-to-date performance into negative territory at -5.96%. Value stocks, especially energy, gained, due to an OPEC+ deal driving oil prices higher. European stocks were also mixed. Value sectors (energy, materials, financials and autos) comprise a bigger weight in European indices than in the US. Meanwhile in China, hawkish remarks from Chinese regulators regarding bubbles led to higher volatility in Chinese equities. The market tone was rather cautious ahead of the National People's Congress.

The aforementioned comments from Fed Chair Powell disappointed markets which were hoping for a mention of yield curve control. This led to a sharp correction in bonds and equities. The reaction of the equity market to a strong NFP figure of 379k (200k expected) underscores the market's indecisiveness regarding inflation expectations: stocks rose initially, then fell sharply and finally rose aggressively after several stocks hit key technical support levels.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,496.30	1.85%	1.85%	3.29%
S&P 500	3,841.94	0.84%	0.84%	2.56%
Nasdaq	12,920.15	-2.05%	-2.05%	0.37%
Euro Stoxx 50	3,669.54	0.96%	0.96%	3.63%
FTSE 100	6,630.52	2.51%	2.51%	3.31%
CAC 40	5,782.65	1.40%	1.40%	4.32%
DAX	13,920.69	0.97%	0.97%	1.47%
FTSE MIB	22,965.63	0.51%	0.51%	3.68%
Nikkei 225	28,864.32	-0.35%	-0.35%	5.22%
Hang Seng	29,098.29	0.43%	0.43%	6.88%
CSI 300	5,262.80	-1.39%	-1.39%	0.99%

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

"...rising bond yields reflect the expectations of stronger economic activity and an improving economy – which is what is currently happening in the US."

Our view: We believe that the tug of war between inflation fears and growth hopes will continue to dominate market sentiment in the near term. We maintain our cautious view, and look to take advantage of the correction witnessed in some quality growth stocks. 2021 is looking more and more of a stock picking year. At the same time, we continue to raise inflation hedges in the equity portfolio mainly through energy and commodity stocks.

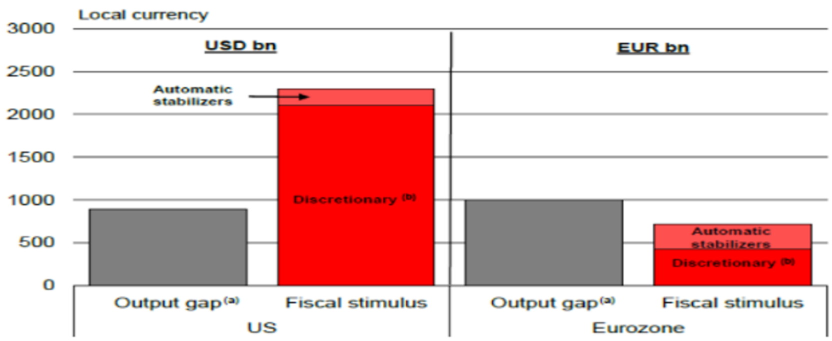
Fixed Income & Credit | Will the ECB ramp up bond purchases?

Fed and ECB react differently to rising yields.

In the early stage of an economic recovery, rising bond yields reflect the expectations of stronger economic activity and an improving economy – which is what is currently happening in the US. But in Europe? Figure 3 shows there is a sharp divergence in terms of fiscal stimulus between the two continents.

“...while the Fed seems not overwhelmingly concerned about the increase in yields for the moment, the ECB is trying to fight it – at least verbally.”

Figure 3: A Very Different Approach to the Crisis



Source: UniCredit Research.

Our view: In simple terms, US growth and employment will receive a massive boost, while in the Eurozone GDP growth this year will remain below the pre-pandemic level. However, Eurozone yields have not been immune to the repricing in broader bond yields.

Following the previous reasoning, the recent spike in yields will not please the European Central Bank (ECB), precisely because this rise is not a reflection of an improvement in growth. On the contrary, it is in part the result of an adjustment of the expectations for policy rates: the first 25 bps hike is now priced in for 2024 – and not 2026 as previously. That is why, while the Fed seems not overwhelmingly concerned about the increase in yields for the moment, the ECB is trying to fight it – at least verbally. In our view, before the lawmakers, especially in Germany, once again return to the subject of fiscal consolidation, the ECB will have no other choice than to ramp up its bond purchases.

FX & Commodities | Is the USD set to rally?

An opportunity to top up our USD hedges.

Chart of the week

“The close above the pivotal resistance at 91.70 would suggest that we could see a pause of the long-term downside trend and a multi-week period of USD gains.”

At the end of this busy week, the USD took over to bring further pressure on markets and commodities. The close above the pivotal resistance at 91.70 would suggest that we could see a pause of the long-term downside trend and a multi-week period of USD gains. We see the move as an opportunity to add USD hedges over the coming weeks, and diversify our USD exposure by adding alternative currencies with higher real rates.

Figure 4: USD Index

Source: Bloomberg, as at March 6, 2021.

Week Ahead | Key events to watch for

- **The ECB press conference is on Thursday.** President Lagard will be asked about the recent sharp rise in government bond yields and the tightening in financial conditions. As a consequence, an alteration in current bond buying programs could be announced.
- **Data highlights include the US February CPI** – with the hope of a benign print reassuring investors – and industrial production for Europe's largest economies.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	FX and Derivatives Portfolio Manager	Senior Equity Portfolio Manager