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Weekly Market Flash

Markets recover despite rate hikes & banking concerns

May 7, 2023

This week ended with a strong recovery on Wall Street, which allowed global indexes to make up for the losses accumulated during the week. Hopes of a solution to the banking crisis were complemented by a solid labor market report for April (despite suspicious revisions to previous months and many other indicators pointing to weakness in the labor market) and Apple's good quarterly report, which supported the tech sector.

Highlights

▪ Both the ECB and the Fed raised rates by 25 bps week, bringing rates to 3.50% and 5.00% to 5.25%, respectively.

▪ Retail sales (in real terms) in the Eurozone fell by -1.2 % in March, contracting for the sixth consecutive month.

▪ Regional banks contributed to market volatility after regulators took control of First Republic Bank. The S&P Regional Banks Select Industry Index ended the week down 10%, bringing the total return to -40% since the February 2023 peak.

▪ The FDIC is expected to submit a proposal as early as next week, whereby larger banks will bear most of the cost of replenishing the Deposit Insurance Fund. In addition, deposit guarantees are expected to rise further, above the current USD250,000 limit.

▪ Despite the regulatory storm, monthly active developer activity in the crypto industry remains strong. Builders continue to drive the industry and technology forward, even in the face of hostile regulatory environments and the absence of clear regulatory guidelines.

"The Fed effectively eliminated any latent forward guidance, thus becoming data dependent and formally opening the door to a pause."

Markets & Macro | Markets recover despite rate hikes & banking concerns

Hopes for end to banking crisis support markets.

Both the European Central Bank (ECB) and the Federal Reserve (Fed) raised rates by 25 basis points (bps) this week, bringing rates to 3.50% and 5.00% to 5.25%, respectively. The Fed effectively eliminated any latent forward guidance, thus becoming data dependent and formally opening the door to a pause. Fed Chair Jerome Powell again addressed the recent tensions in the regional banking system, following the failure of the third bank within two months.

“The slowdown in the pace of tightening is probably related to the weak credit growth revealed by the latest Bank Lending Survey...”

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

Equity Indices	Last Value	Week	Ytd
MSCI World	2,821.99	-0.44%	9.37%
Nasdaq	12,235.41	0.09%	17.23%
S&P 500	4,136.25	-0.78%	8.31%
S&P Equal Weighted	5,807.90	-1.41%	1.81%
DJ Industrial	33,674.38	-1.23%	2.25%
Nikkei	29,157.95	1.88%	12.84%
Euro Stoxx 50	4,340.43	0.03%	16.58%
Swiss SMI	11,554.24	1.11%	10.65%
FTSE 100	7,778.38	-1.15%	5.85%
Canada	20,542.03	-0.46%	7.11%
Shenzen	4,016.88	-0.30%	3.83%
Hong Kong	20,049.31	0.79%	1.78%
MSCI EM	981.66	0.52%	3.40%

Equity Sectors	Last Value	Week	Ytd
S&P Value	152.13	-1.46%	5.37%
S&P Growth	64.68	-0.25%	10.90%
S&P Defensives	1,582.74	-0.62%	3.49%
ARK Fund	37.39	4.09%	19.69%
FANGS	6,163.75	0.73%	38.62%
S&P Banks	75.27	-7.27%	-24.38%
Euro Stoxx Banks	80.23	-1.20%	9.42%
S&P Energy	80.23	-5.76%	-7.34%
Gold Miners	35.40	5.42%	23.52%

Commodities	Last Value	Week	Ytd
BBG Commodities	102.96	-1.30%	-8.73%
BBG Agriculture	67.96	1.97%	-1.25%
Gold	2,016.79	1.35%	10.57%
Silver	25.67	2.44%	7.15%
BBG Brent Crude TR	955.79	-6.17%	-9.99%
BBG WTI Crude Oil TR	172.47	-6.88%	-9.84%

FX	Last Value	Week	Ytd
DXY Index	1,219.39	-0.61%	-2.18%
EUR/CHF	0.9814	-0.41%	-0.83%
GBP Index	644.36	0.34%	3.46%
EM FX Index	1,694.65	0.43%	2.05%
USD/JPY	134.80	-1.10%	2.81%
USD/CNY	6.91	-0.05%	0.16%
Bitcoin	29,304.46	-0.17%	77.18%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	108.54	-0.92%	4.31%
US High Yield	74.76	-0.36%	3.56%
Euro Corps	233.57	0.13%	2.59%
JPM Europe Govies	9,760.98	0.07%	5.76%
US Treasuries	2,267.61	0.06%	3.62%
China Aggregate	261.12	0.45%	2.29%
EMBI Global	788.68	-0.10%	2.66%
EMBI Local	131.69	0.80%	6.47%

Source: Bloomberg, as at May 5, 2023. Performance figures in indices' local currencies.

The ECB's hike was accompanied by different and decidedly hawkish tones. Indeed, President Christine Lagarde kept the door open to further rate hikes. Over the past eight months, the ECB has raised interest rates at all meetings, a total of 375 bps. On the balance sheet front, it was announced that reinvestments in the asset purchase programme (APP) portfolio would be discontinued in July, a somewhat more aggressive move than expected, which impacted periphery spreads.

This is by far the most aggressive monetary policy tightening cycle since the start of the monetary union. The slowdown in the pace of the tightening (from 50 bps to the current 25 bps) is probably related to the weak credit growth revealed by the latest Bank Lending Survey (published this week), which showed that the rate hikes so far are leaving clear marks on the financing of the economy. The bottom line is that lending standards have tightened further, more than expected, while the demand for credit for mortgages and loans has fallen 'robustly' due to high interest rates, declining investment, and falling real estate. It will be even more interesting to analyze the survey for the US banking system—the Senior Loan Officer Survey, which is due to be released next week—in light of the regional bank crisis, which shows no sign of abating.

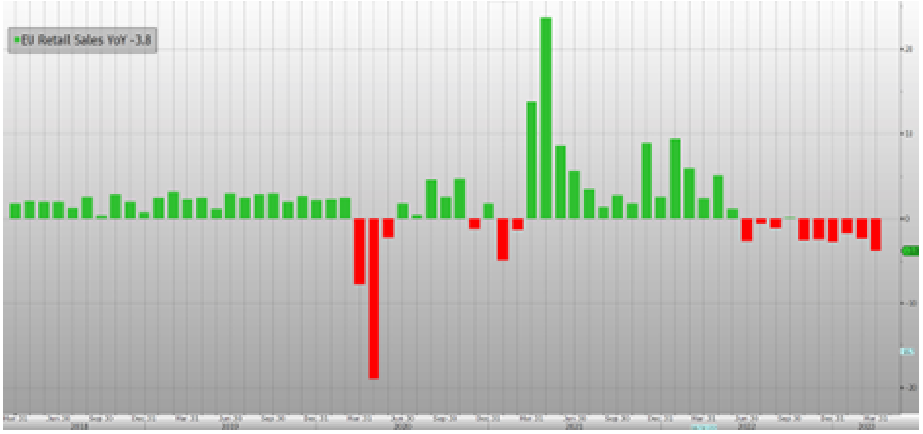
“The weakness of economic data is clear, so any further hike runs the risk of being a mistake...”

Our view: Although Lagarde has admitted that the job is not done, since inflation is still far from the 2% target, it is difficult to imagine that the next hikes will return to 50 bps. The weakness of economic data (both on the consumption side and on the investment and production side) is clear, so any further hike runs the risk of being a mistake and of strangling the economy without waiting for inflation to normalize and take its natural course.

In this regard, retail sales (in real terms) in the Eurozone fell by -1.2 % in March, contracting for the sixth consecutive month. Figure 2 shows that in real terms, consumption in Europe has been steadily shrinking, with the weight of inflation weighing on the purchasing power of consumers, who consequently reduced volumes. On the other hand, nominal sales (and consequently profits) of companies are increasing thanks to higher prices. But we wonder how sustainable this surprising dynamic still is, with companies unlikely to be able to continue raising prices to compensate for the loss of sales volumes.

“Despite attempts at stabilizati-on, it is by no means certain that the crisis is over...”

Figure 2: Eurozone Retail Sales



Source: Bloomberg, as at May 5, 2023.

Elsewhere, the week was a deadly one for US regional banks, which are struggling to get out of crisis mode, amid deposit runs and (probably) speculative attacks that are fueling the climate of fear and depositors' own fears. The market's concern is that while it is credible that the US banking system is sound and resilient (as Powell argued in his press conference), one wonders what might happen to banks' balance sheets when a marked economic slowdown hits. For the time being, outside of the duration mismatch that affected SVB, the classic asset impairment problem that typically occurs during a recession has not yet occurred. So, despite attempts at stabilization, it is by no means certain that the crisis is over—especially if we think of loans to commercial real estate and residential, in which the regional banks are leaders.

“For the time being, the problem is not the solvency of the system, but the banks' profits.”

For the time being, the problem is not the solvency of the system, but the banks' profits. With interest rates at the current level, the logic is that banks, in order to keep their deposits (their best funding), must offer customers rates that cancel out their profits. This does not directly threaten a bank, as bad loans did in 2008. And low profitability makes it much more complicated for banks to raise new capital, even in the form of equity. Big banks, on the other hand, are hurt by the contribution increases they have to make to the FDIC to preserve the system, in addition to a general risk aversion toward the industry.

In any case, the FDIC is expected to submit a proposal as early as next week, whereby larger banks will bear most of the cost of replenishing the Deposit Insurance Fund, which has been depleted in recent weeks. In addition, deposit guarantees are expected to rise further, above the current USD250,000 limit —which supported indexes toward the end of the week.

Equities | Quality will continue to deliver

Apple’s earnings beat expectations.

The S&P 500 Index closed lower for the week following comments from Powell that suggested that cutting rates might not happen as fast as the market had hoped. Also, equity markets might have started to price in the long-ignored US debt ceiling risk. Among the sectors in the S&P 500, information technology performed the best, while energy shares dropped in response to the crude oil price correction. Regional banks contributed to market volatility after regulators took control of First Republic Bank. The S&P Regional Banks Select Industry Index ended the week down 10%, bringing the total return to -40% since the February 2023 peak.

"...the market's decision to reward these mega cap companies' economic scale, strong balance sheets, and high earnings visibility with multiple expansion wasn't irrational."

Our view: As mentioned earlier, the Fed raised interest rates by 25 bps, in line with expectations. Our takeaway from Powell's press conference is that the Fed exercised maximum flexibility and data dependence, which is exactly what is needed at this point in the monetary policy cycle. This disappointed some market participants, who expected the Fed to explicitly announce a pause in rate hikes. We see this affirmation by the Fed unlikely given the still hot labor market—evident by the latest nonfarm payrolls report.

We also take note of Powell's straightforward response to the question about the 2% inflation goal and whether the Fed would be okay for a prolonged period of 3% inflation: *"I think we're always going to have 2% as our target, and we're always going to be focusing on getting there… But ultimately, we're not looking to get to 3% and then drop our tools. We have a goal of getting to 2%. We think it's going to take some time. We don't think it'll be a smooth process. And, you know, I think we're going to need to stay at this for a while."*

On the subject of earnings, Apple, the last of the Big Tech to report earnings, delivered solid iPhone revenue figures that beat street forecasts. The market was already bracing for a negative surprise given the material weakness in the PC market. Nevertheless, Apple proved that it still has sufficient operating levers that allow it to deliver solid results despite a weaker macro picture.

Several strategists highlighted in recent weeks the poor market breadth and how the year-to-date S&P 500 Index rally has been largely been driven by a handful of technology-focused companies. In our view, the market's decision to reward these mega cap companies' economic scale, strong balance sheets, and high earnings visibility with multiple expansion wasn't irrational. This earnings season proved that it was justified especially with two major sectors (financials and energy) facing undesirable odds. In short, the market rewarded quality because quality delivered. And we believe that quality will continue to deliver (and possibly command higher multiples) as long as the rest of the market looks fragile, unpredictable, and leveraged.

Cryptocurrencies | Industry remains resilient and innovative

Crypto continues to face significant challenges.

"Despite these obstacles, the crypto market has remained strong."

The world of cryptocurrency has been no stranger to challenges, and this quarter has been no exception. From increased regulatory scrutiny to battles between the SEC and the CFTC over digital asset classification, the industry has been facing some significant headwinds. However, despite these obstacles, the crypto market has remained strong. Some of the biggest names in the industry, including Gemini, Kraken, and Paxos, have found themselves in the crosshairs of regulatory agencies. Meanwhile, Coinbase and Binance, two of the most popular crypto platforms, have received warnings for alleged violations, with each citing different regulatory lenses and jurisdictions.

Despite the SEC's claim of an open-door policy for crypto companies to discuss registration, the reality is often frustrating for these businesses. Many operators are left without a clear path to follow, leading to dissent within the SEC itself. Commissioner Hester Peirce, for example, has criticized the SEC's regulatory process, calling it *"difficult, lengthy, unproductive and labyrinthine."* The challenges facing the industry also include difficulty accessing basic financial services from national banks. Some companies are becoming more conservative in their business activities in the US, with Coinbase obtaining a Bermuda license and planning to open an offshore exchange as a redundancy mechanism. DeFi projects are also restricting US users from accessing their applications, and companies are exploring offshore strategies.

“While regulators and banks may be making it difficult for crypto companies to operate in the US, the industry is finding ways to adapt and thrive.”

The industry has found allies in places like Switzerland, Japan, Hong Kong, and Dubai, which have adopted crypto-friendly regulatory stances. These places are providing viable alternatives for crypto innovation to flourish elsewhere. For Example, Switzerland’s crypto scene remains busy despite the crypto-winter, with new businesses being established and a variety of crypto projects launched. The new laws on distributed ledger technologies (DLT) have been in force for over a year now and the Swiss crypto scene, as well as the Swiss regulator FINMA, have had plenty of opportunities to put the legislator’s provisions on DLT into practice.

Our view: Despite the regulatory storm, monthly active developer activity in the industry remains strong. Builders continue to drive the industry and technology forward, even in the face of hostile regulatory environments and the absence of clear regulatory guidelines. In conclusion, the crypto industry is facing significant challenges, but it remains resilient and innovative. While regulatory agencies and national banks may be making it difficult for crypto companies to operate in the US, the industry is finding ways to adapt and thrive. The future of the crypto market is full of surprises, and it will be fascinating to see how these challenges shape the industry in the coming months and years.

Week Ahead | Key events to watch for

- **Following the possibly 'last' Fed hike, comes the April CPI** report in the US. Needless to say, this will be an important market mover, with the market discounting the possibility of a rate cut as early as July.

- **The Bank of England is expected to raise rates** one last time before taking a break.

- **Inflation data will be published in China**. Meanwhile, the earnings season draws to a close with Disney, Paypal and Toyota publishing results.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**	**Carlos De Andres Perez**	**Maxime Glasson**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	Senior FX, Crypto & Derivatives Portfolio Manager	Senior Equity Portfolio Manager	Senior Private Equity Funds Manager	Senior Hedge Funds Manager