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Weekly Market Flash

An upcoming reality check for a growth market

July 9, 2023

The last couple of weeks, which included the closing of the first half of 2023, have highlighted several divergences between major global assets that are worth analyzing. In fact, as can be seen from Figure 1 summarizing the returns since the beginning of the year, the buoyant start to 2023, dominated by the flows that made all indices rise indiscriminately, has lost strength. At the same time, it appears that there are only a few assets that are in the positive over the longer term, and bonds in particular are still suffering greatly.

Highlights

▪ The performance of the Eurostox 50 index is normalizing, having lost 3.5% in the past week. The big gains, which seem solid and safe from corrections for the time being, are in technology and especially Big Tech (Nasdaq is up 31% year-to-date and Fangs is up 74%).

▪ Turning to last quarter's numbers, earnings fell 3.4% year-on-year in Q4 2022 and 1.5% in Q1 2023, after the huge post-pandemic rebound. This quarter should see an even bigger drop, 7% year-on-year.

▪ In fixed income, year-to-date corporate debt returns have advanced just 3%, which is a significant disappointment compared to the initial expectations of up to 10% returns. Meanwhile, average spreads in either the US or Europe do not seem to compensate enough for the risk of recession.

▪ In the crypto space, the potential approval of Bitcoin ETFs represents a significant milestone for the industry. The sustained interest from major financial institutions like BlackRock, coupled with their track record of successful ETF approvals, suggests a higher likelihood of regulatory clearance.

"There are now several important indexes with lackluster or even negative returns..."

Markets & Macro | An upcoming reality check for a growth market

Q2 earnings season will be in focus.

Figure 1 highlights that the robust start to the year for markets has lost strength. The performance of the Eurostox 50 index is normalizing, having lost 3.5% in the past week, and is now 5% away from the highs (it had risen by 16% year-to-date). There are now several important indexes with lackluster or even negative returns (including Dow Jones, S&P Equal weighted, Switzerland, England, and China).

"These returns are even more shocking in light of the fact that yields have started to rise again in the last two weeks..."

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

Equity Indices	Last Value	2 Weeks	Ytd
MSCI World	2,924.19	3.40%	13.84%
Nasdaq	13,660.72	5.28%	31.12%
S&P 500	4,398.95	4.60%	15.58%
S&P Equal Weighted	6,033.54	5.50%	6.20%
DJ Industrial	33,734.88	1.94%	2.94%
Nikkei	32,388.42	4.76%	25.55%
Eurostoxx	4,236.60	-2.33%	14.86%
Swiss SMI	10,874.90	-4.89%	4.39%
FTSE 100	7,256.94	-4.85%	-0.64%
Canada	19,831.04	-0.45%	4.18%
Shenzen	3,825.70	-0.66%	0.11%
Hong Kong	18,365.70	-2.03%	-4.72%
MSCI EM	980.66	0.80%	4.40%

Equity Sectors	Last Value	2 Weeks	Ytd
S&P value	159.80	5.29%	11.07%
S&P Growth	69.58	4.39%	19.56%
S&P Defensives	1,554.99	1.93%	1.68%
ARK Fund	43.73	11.84%	39.98%
Fangs	7,738.36	8.59%	74.10%
S&P Banks	80.71	3.67%	-18.37%
Euro Stoxx Banks	80.79	2.64%	15.78%
S&P Energy	80.79	3.47%	-5.85%
Gold Miners	29.45	-3.16%	2.76%

Commodities	Last Value	2 Weeks	Ytd
BBG Commodities	101.91	1.83%	-9.66%
BBG Agriculture	66.37	1.96%	-3.56%
BBG Energy	32.58	2.94%	-20.99%
BBG Precious Metals	216.72	-1.48%	0.84%
BBG Industrial Metals	141.25	-0.86%	-14.56%
Gold	1,925.05	-1.10%	5.54%
BBG Brent Crude TR	1,011.87	2.86%	-4.71%
BBG WTI Crude Oil TR	179.96	2.03%	-5.92%

FX	Last Value		Ytd
DXY Index	1,226.82	-1.53%	-1.59%
EUR/CHF	0.9749	0.43%	-1.48%
GBP Index	658.41	2.77%	5.71%
EM FX Index	1,677.40	-0.09%	1.01%
USD/JPY	142.21	1.15%	8.46%
USD/CNY	7.23	2.28%	4.74%
Bitcoin	30,206.79	12.88%	82.63%

Bond Indices	Last Value		Ytd
US Inv Grade	105.54	-0.23%	2.09%
US High Yield	73.85	0.79%	3.34%
Euro Corps	231.60	0.26%	1.73%
JPM Europe Govies	9,847.45	2.46%	6.69%
US Treasuries	2,196.43	-0.87%	0.37%
China Aggregate	252.22	-1.79%	-1.20%
EMBI Global	788.02	1.55%	2.57%
EMBI Local	132.61	1.81%	7.21%

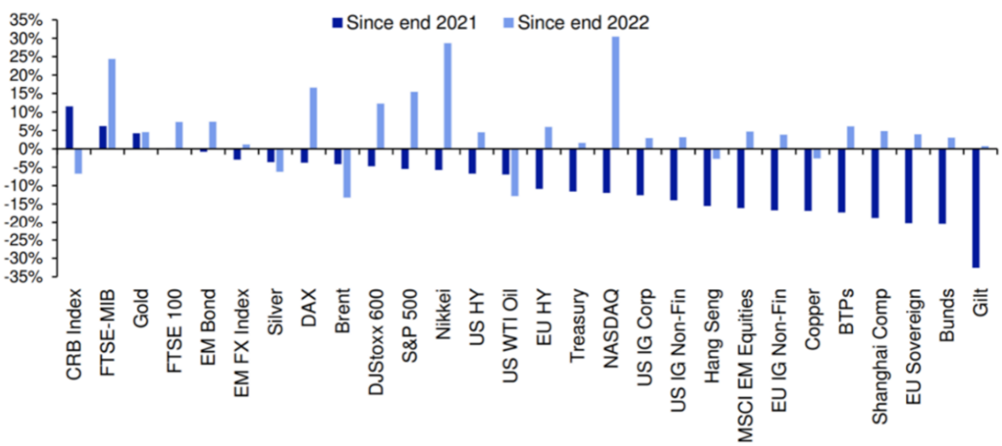
Source: Bloomberg, as at July 7, 2023. Performance figures in indices' local currencies.

Our view: The big gains, which seem solid and safe from corrections for the time being, are in technology and especially Big Tech (Nasdaq is up 31% year-to-date and Fangs is up 74%). These returns are even more shocking in light of the fact that yields have started to rise again in the last two weeks, and by now the most important bond indexes have erased the gains—of around 3%-4%—that they had accumulated in the first six months. It seems, for the time being at least, that unlike in 2022, the valuations of growth stocks are no longer sensitive to the increase in the discount rate. This is likely due to the advent of the AI theme, which is disrupting the classic market paradigms.

To our classic table we have added a chart from Deutsche Bank (Figure 2), which shows the accumulated returns since the beginning of 2022 (18 months). This chart shows how few assets are in the positive over the longer term, and bonds in particular are still suffering greatly.

Figure 2: Total Return Performance of Major Global Financial Assets in H1 2023 and Over the Last 18 Months (USD)

"With a fairly uncertain macro picture, the market's attention will shift to the US and European Q2 earnings season over the coming weeks."



Source: Deutsche Bank, as at July 7, 2023.

With a fairly uncertain macro picture—there were some signs of weakness not only in soft data, but also in the labor market on Friday—the market's attention will shift to the US and European Q2 earnings season over the coming weeks. The last two earnings seasons surprised positively compared to a consensus that had greatly downgraded expectations due to the impact of rate hikes on growth, which was greatly overestimated.

So comes another 'reality check' for a growth market, and this time positioned longer than in previous seasons. Major companies have continued to communicate the pressures associated with rising inflation, geopolitical tensions, and declining economic activity (with an injection of concern over the credit crunch triggered by the collapse of Silicon Valley Bank). But the surprising aspect of the last few months is that, in addition to technology, which has driven the market thanks to the AI theme, and the support offered to valuations by the containment of long-term rates—which have, however, started to rise again in the last few days with the 10-year back to the dangerous threshold of 4%—the sector that has done best is homebuilders (29% higher year-to-date). This sector is purely cyclical and linked to interest rates, which on mortgage rates have reached 7%!

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It is likely, therefore, that the homebuilders sector was also supported by the idea that the US economy will experience, in the second half of the year, nothing more than a moderate soft landing (GDP contraction of around -0.5% for two consecutive quarters), which is now widely predicted even by economists. The other consequence of this contraction should be to see inflation fall toward 2% rapidly by early 2024. Consequently, after the collapse in earnings growth expectations over the next 12 months (shown in Figure 3, in line with the decline in the manufacturing ISM), we expect this earnings season to reveal early signs of a rebound in corporate prospects.

Figure 3: S&P 500 Forward EPS vs. ISM Manufacturing

Source: Bloomberg, as at July 7, 2023.

In this first part of the year, the resilience of reported profits was due to companies’ pricing power (price increases to protect margins). Although economic growth has been moderate (GDP growth in the first two quarters has been in the range of 1.5%), consumption in particular has been subdued. With inflation figures still high in the second quarter, and consumption growth accelerating slightly compared to the first quarter, it is difficult for this dynamic to stop just now.

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Paradoxically, it is more possible that earnings disappointments will come later, just as inflation falls, while the pressure on labor costs may be slower to ease if the labor market remains strong. Meanwhile, turning to last quarter’s numbers, earnings fell 3.4% year-on-year in Q4 2022 and 1.5% in Q1 2023, after the huge post-pandemic rebound. This quarter should see an even bigger drop, 7% year-on-year. However, this is heavily influenced by the energy sector, so the adjusted number should be just negative, if not positive if there are favorable surprises.

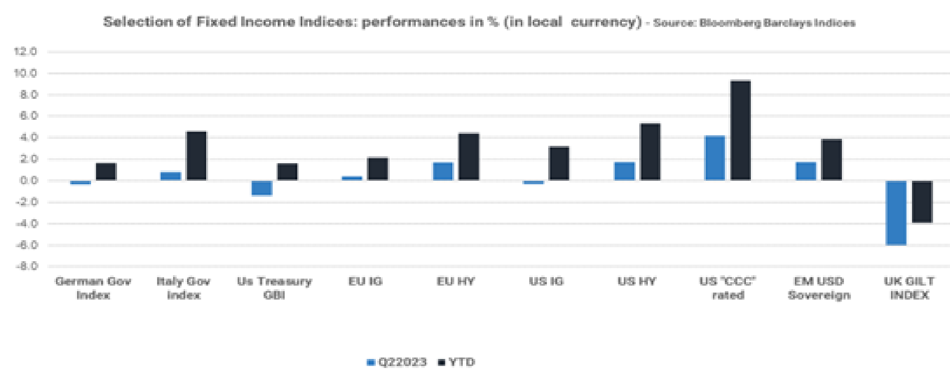
Fixed Income | Are risk premiums accurately reflecting risks?

Elevated yields continue to attract demand for fixed income.

"Year-to-date corporate debt returns have advanced just 3%, which is a significant disappoin-tment compared to the initial expectations of up to 10% returns."

In the second quarter, sovereign bonds faced challenges due to persistent inflation and continuous interest rate hikes by central banks. Among them, Gilts experienced the largest decline, dropping by 6.0%. US Treasuries and Bunds also saw losses, albeit relatively smaller at -1.4% and -0.4%, respectively. Italian BTPs stood out as one of the few performers that gained ground, rising by 0.8%, and the spread between Italian 10-year yields and Bunds tightened by 13.5 bps, reflecting the overall positive sentiment toward risk assets. On the other hand, credit did better due to the narrowing of spreads over the 3-month period.

Figure 4: Fixed Income Performance



Source: Bloomberg, as at July 7, 2023.

That said, year-to-date corporate debt returns have advanced just 3%, which is a significant disappointment compared to the initial expectations of up to 10% returns. Initially, this year was anticipated to be a pivotal one for fixed income, with the belief that the Federal Reserve (Fed) would start cutting rates, leading to a rally that would mitigate some of the significant losses experienced in 2022. Unfortunately, due to a robust job market and persistent inflation, this narrative was shattered, as the expectations of monetary policy easing did not materialize.

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Average spreads on US investment grade bonds traded at 125 basis points (bps), after spiking to 163 bps in March during the global banking sector turmoil, while the same measure in Europe traded at about 158 bps following a high of 200 bps in March. At those levels, spreads in either the US or Europe do not seem to compensate enough for the risk of recession. The same is true for high yield, where in the US at 398 bps the spread is far from the 800 bps it historically touches at the dawn of a recession.

Figure 5: IG and HY Credit Spreads

Source: Bloomberg, as at July 7, 2023.

Our view: On one hand, the current pricing of credit reflects an expectation of absolute perfection, assuming rapid disinflation and a significant economic slowdown, which may not be occurring as quickly as anticipated. This implies that risk premiums may not accurately reflect the potential risks involved. On the other hand, the recent retracement of corporate bond yields to their highest levels in over a decade presents a potential silver lining amid the prevailing lackluster expectations for credit performance in the second half of 2023.

“...the current pricing of credit reflects an expectation of absolute perfection, assuming rapid disinflation and a significant economic slowdown...”

These elevated yields, such as around 5% in USD, 4% in euro, and close to 7% in sterling, are likely to attract demand from investors seeking relatively safe and high yielding assets as the global economy braces for an impending recession. The flat or inverted yield curve introduces a new dilemma regarding whether to earn nearly guaranteed high yields in short-term debt or lock in income for a longer period, considering the possibility of significantly lower market rates when short-dated bonds need to be reinvested. While the answer to this dilemma will be influenced by the timing of the recession and the subsequent end of monetary policy tightening, we still think that a good solution dictated by common sense is to be underweight to things that are sensitive to recession risk—high yield—and invest into more defensive asset classes, which would be bonds and specifically investment grade as it gives you a little bit more yield than US Treasuries.

Cryptocurrencies | Is the ETF Bitcoin approval a game changer?

Approval may bring positive developments, but risks remain.

We are now more than 18 months into a 'crypto winter' that began in November 2021, and it has been 19 weeks since the market hit its bottom. Interestingly, this bottom coincides with the ill-fated cover page of The Economist titled 'Crypto's downfall.' At that time, the title captured the extreme bearishness felt by most people, a few months before Sam Bankman-Fried was arrested. Since then, Bitcoin has risen by 93% in USD, reaching new 52-week highs. Throughout this period, the macro outlook for cryptocurrencies has remained fragile, despite occasional rallies fueled by hopes of a pivot from the Fed.

“One notable difference during this crypto winter compared to the previous one is the sustained interest from institutional investors.”

Our view: One notable difference during this crypto winter compared to the previous one is the sustained interest from institutional investors. Cryptocurrencies are increasingly being seen as an institutionalized asset class, with indications that they are here to stay. Institutions such as BlackRock, Fidelity, and Invesco entering the space by filing for Bitcoin ETFs reflect a growing recognition of the potential of cryptocurrencies and blockchain technology.

The involvement of BlackRock, one of the largest asset management firms in the world, is particularly noteworthy. BlackRock has a track record of success in gaining SEC approvals for ETFs, with a staggering 575-1 approval ratio. Out of the approved ETFs, 400 are still actively trading. BlackRock's decision to file for a Bitcoin ETF suggests that the firm sees a high likelihood of approval, as it typically avoids filing for ETFs it deems unlikely to receive regulatory clearance.

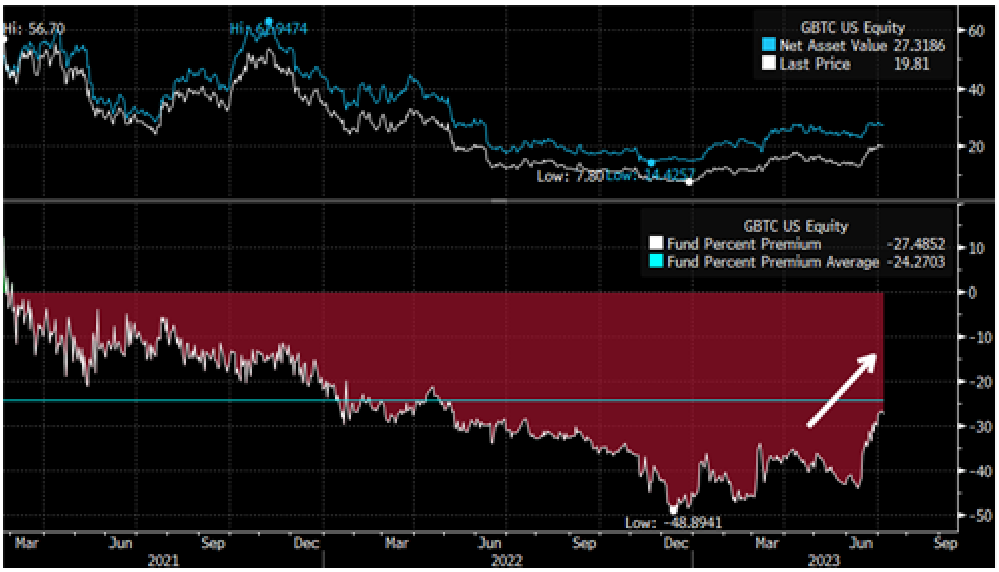
The announcement of BlackRock's ETF filing had an interesting effect on the Grayscale Bitcoin Trust (GBTC). The GBTC discount, which measures the difference between the trust's market price and its underlying Bitcoin holdings, experienced a significant decrease after the news. Investors seem to be feeling bullish today, however. Although the long and extenuating legal battle with the SEC seems endless, BlackRock’s impeccable track record for ETF applications has injected a breath of fresh air into GBTC. If the SEC decided to allow for the conversion of GBTC into a spot ETF, that discount would have disappeared, unlocking approximately USD8 billion in value for investors. This development raises questions about the future dominance of Grayscale in the market. It remains to be seen whether Grayscale will convert its trust into a Bitcoin ETF to maintain its position and consequently lower the management fees, in line with ETF competitors rather than funds. Grayscale CEO Michael Sonnenshein appeared very committed to the conversion despite all the setbacks to date.

While the approval of Bitcoin ETFs may bring positive developments for the market, it is not without risks. One potential risk is the liquidation of positions held by giant ETF investors (worth USD18 billion). If ETFs are approved and the price-to-NAV discount disappears, investors with positions locked in for the past three years may decide to liquidate their positions, potentially causing market volatility.

"While the approval of Bitcoin ETFs may bring positive developme-nts for the market, it is not without risks."

The potential approval of Bitcoin ETFs represents a significant milestone for the cryptocurrency industry. The sustained interest from major financial institutions like BlackRock, coupled with their track record of successful ETF approvals, suggests a higher likelihood of regulatory clearance. However, while this development may signal the end of the Grayscale dominance era, it also poses certain risks, including potential market volatility from position liquidation. Ultimately, the approval of Bitcoin ETFs could be a game-changer, bringing more legitimacy and accessibility to the cryptocurrency market, while also attracting a new wave of investors.

Figure 6: GBTC US Equity



Source: Bloomberg, as at July 7, 2023.

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