NOVUM
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Weekly Market Flash

Is the economy strong enough?

April 10, 2022

It was an eventful week, which saw a slight correction in the S&P 500 index (-1.3%), and a more pronounced one for the Nasdaq index (-3.86%). However, it is worth noting that despite ongoing concerns around the war, inflation and tightening from the Federal Reserve (Fed), the S&P 500 index is still trading 7.5% above its mid-March low, and the Nasdaq also remains comfortably above its March lows. With earnings season just around the corner, investors will indeed have their work cut out for them in what could be a crucial stretch in signaling where markets will head at year-end. And over the coming weeks, it is likely that economic data, along with corporate guidance (rather than the Q1 numbers themselves), will be key in helping to answer the question that everyone wants to know: is the economy, and the market, strong enough to withstand a round of monetary tightening that we have most likely not seen since 1994?

Highlights

▪ Fed minutes showed that many board participants would have overwhelmingly voted for a 50 bps hike had it not been for the outbreak of the war. And on the money market front, expectations are for almost three consecutive 50 bps hikes in the coming months.

▪ The ECB sounded less convinced of inflation returning to target this year. Market expectation for European policy rates for the end of 2022 are at 0.63%, meaning the end for negative rates.

▪ The French presidential election, which will take place (the first round of the two) as early as this Sunday, is an element of caution, given that the margin in favor of Macron for the final victory in a possible second round against Marine Le Pen has suddenly narrowed.

▪ The cost of insuring Russia's government debt surged to signal a record 75% chance of default within the year after foreign banks declined to process about USD650 million of dollar payments on its bonds.

"The minutes support the scenario that the Fed may announce the start of quantitative tightening at its next meeting in May."

Markets & Macro | Is the economy strong enough?

Equities remain resilient, for now.

The theme of inflation and the response of central banks have been dominant this week, with an impressive sequence of hawkish statements between minutes – from both the European Central Bank (ECB) and the Fed – and verbal interventions. As for the Fed, which hiked "only" 25 basis points (bps) in March, the minutes showed that many board participants would have overwhelmingly voted for a 50 bps hike had it not been for the outbreak of the war in Ukraine. And on the money market front, expectations are for almost three consecutive 50 bps hikes in the coming months! The pace should then pick up with three further 25 bps rises in the second half of the year. The minutes (along with public statements by Fed members) support the scenario that the Fed may announce the start of quantitative tightening (QT) at its next meeting in May. At this point, the Fed would have to start reducing its balance sheet in a natural way (i.e. by letting US Treasuries and MBS expire and not renewing them), for a total of USD95 billion per month.

“It’s impressive to see that the stock market is holding up quite well overall. In particular, if we compare this tightening cycle with the 2018 cycle, it will likely be much more aggressive.”

Our view: In view of these numbers, it’s impressive to see that the stock market is holding up quite well overall. In particular, if we compare this tightening cycle with the 2018 cycle, it will likely be much more aggressive. For instance, in 2018, the rise was 200 bps cumulative, spread over a long period (beginning in 2016), and the QT was about half that (USD50 billion per month) compared to the 95 bps forecast.

Even more surprising, however, was reading the ECB's minutes. We say this because the growth/ inflation mix in Europe is even worse than in the US right now. The impact of the war on energy prices (which has a much greater impact on European consumers and companies) and on sentiment is much stronger on the continent. It is therefore difficult to understand this aggressiveness, which is in fact contributing to the underperformance of European stock markets at this stage compared with the US. The ECB has also managed to argue that the economies' "extremely strong" starting level and the anchoring of inflation expectations will manage to avoid a stagflationary scenario despite the shock caused by the war. And all of this comes after spending the entire of 2021 describing the rise in prices as "transitory".

Rate dynamics and inflation expectations were primarily responsible for the stock market's pain, particularly in the technology sector during the week. Indeed, the rise in rates across the curve was in the region of 25 bps. In particular, the Fed's accelerated QT announcements succeeded in significantly steepening the curve by 30 bps during the week, while only last Friday had the 2-year-10-year closed in negative territory at -8 bps, sparking debate over the recessionary signal provided by the inversion.

On the other hand, it must be said that greater use of the balance sheet could imply less need for rate action, while still achieving the desired tightening of financial conditions needed to bring inflation down. We remain surprised (and therefore cautious) by the resilience of equities at this stage. With the amount of tightening ahead of us, the risk of over-tightening is high, in addition to the fact that the only significant example of a balance sheet runoff (that of 2018) ended badly, with -20% on the S&P 500 index in the final quarter of the year.

The last element of caution we need to mention is linked to the French presidential election, which will take place (the first round of the two) as early as this Sunday. The margin in favor of Macron for the final victory in a possible second round against Marine Le Pen has suddenly narrowed, by around 5 percentage points, depending on the poll house. If the outcome of the first round were to see Le Pen close to Macron after Sunday's round, paired at around 25%, the level of tension in European markets would rise sharply in the coming days.

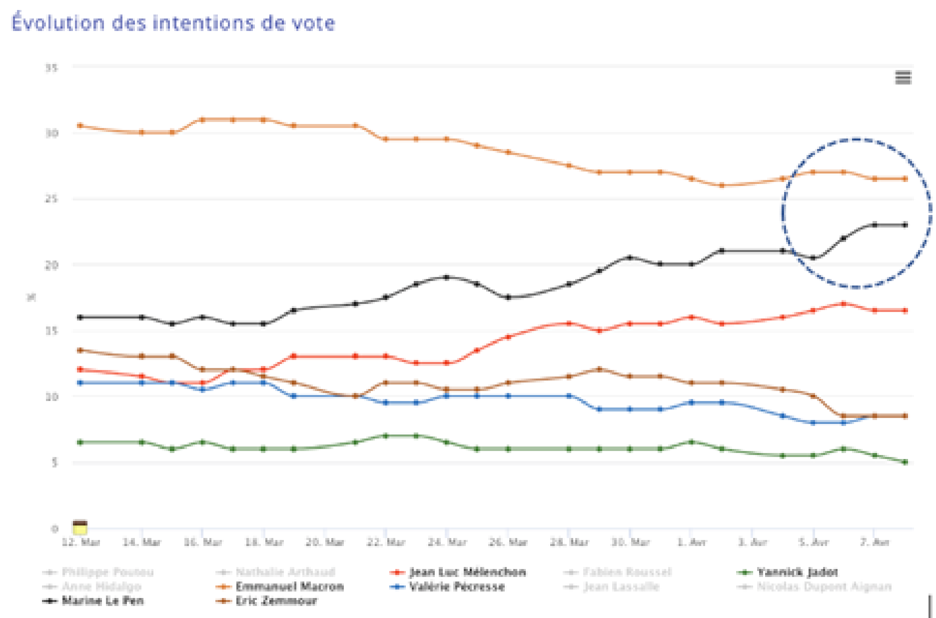
“We have learned on several occasions in recent years, polls often tend to underestimate support for the populist candidate, since voters are often ashamed and hide their real intentions from pollsters.”

The unexpected recovery of the Front National is certainly linked to the weakness of Macron and all the moderate candidates in this delicate phase, in which the lower and middle classes (precisely those of the populists) are seeing their real salaries crushed by the surge in raw materials (this time, not only energy). A very unexpected dynamic also helped her in the race: the presence of an even more extreme candidate (Zemmour) allowed her to appear more presentable to the center. Le Pen is also a cunning and experienced politician, one who very skilled in campaigning. We were particularly struck by how the candidate, who is notably anti-immigration, managed to erase her pro-Putin past, even supporting the reception of Ukrainian refugees in France. We wonder if the fact that 85% of French voters support helping Ukrainians who have fled the conflict, and that 60% are in favor of sending arms to Ukraine, played a role in all of this.

While we recognize that we, ourselves, who are so focused on the issues of war, did not (also) have this market risk on our radar, we can only raise our guard against this no longer being a tail risk. In fact, as we have learned on several occasions in recent years, polls often tend to underestimate support for the populist candidate, since voters are often ashamed and hide their real intentions from pollsters. The fact remains that Le Pen is a decidedly anti-European candidate, and there are many economic measures in the name of statism and against the free market and competition in her program. Needless to say, her victory would come at the worst possible time for Europe, with a war at the doorstep and divisions within the ECB between the hawks (from the North) and the doves (from the South) growing.

> “A victory for Le Pen would come at the worst possible time for Europe, with a war at the doorstep and divisions within the ECB between the hawks and the doves growing.”

Figure 1: French Election Polls



Source: NSPPolls, as at April 8, 2022.

Equities | Has sentiment translated to slower demand?

Markets wait for earnings season to start.

With earnings season due to start next week, trading volumes throughout the week were light, and performance varied by market and sectors. Comments from Fed Governor Lael Brainard about reducing the Fed balance sheet “at a rapid pace as soon as [the] May meeting” were ill-received by investors. And the hawkish Fed minutes weighed on sentiment as well.

> “With investor sentiment at low levels, this earnings season could prove to be important for market direction.”

Meanwhile, election uncertainty in France negatively impacted the CAC 40 index, which was down 2% during the week. Elsewhere, the commodity-heavy FTSE 100 index closed up 1.75%, while China’s zero-Covid policy curbed risk appetite in Chinese equity markets.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,721.12	-0.23%	0.17%	-3.94%
S&P 500	4,488.28	-1.24%	-0.90%	-5.46%
Nasdaq	13,711.00	-3.85%	-3.57%	-12.19%
Euro Stoxx 50	3,858.37	-1.41%	-1.00%	-9.77%
Swiss Market	12,507.69	2.97%	3.17%	-1.24%
FTSE 100	7,669.56	1.87%	2.17%	5.13%
CAC 40	6,548.22	-2.04%	-1.68%	-8.25%
DAX	14,283.67	-1.13%	-0.91%	-10.08%
FTSE MIB	24,819.15	-1.37%	-0.81%	-8.86%
Nikkei 225	26,985.80	-2.46%	-3.00%	-5.51%
Hang Seng	21,872.01	-0.76%	1.67%	-6.19%
CSI 300	4,230.77	-1.04%	2.15%	-14.34%

Source: Bloomberg, as at April 8, 2022. Performance figures in indices' local currencies.

Our view: With investor sentiment at low levels, this earnings season could prove to be important for market direction. Analysts forecasts have so far been resilient, thanks in large part to energy companies' upward earnings revisions. Consumer sentiment is also at a multi-decade low – and whether this sentiment has translated to slower demand is what we will be looking for in the earnings announcements and management conference calls.

"The hope is that what San Francisco was for Web 2.0, Miami wants to be for Web3..."

Crypto & Blockchain | Miami: The center of the crypto revolution?

Bitcoin remains absent from this year's trends.

This week in Miami saw the world's most important Bitcoin event – an essential occasion given the kind of non-traditional networking which is characteristic of the new crypto world. Accompanying the event was the iconic Wall Street bull transformed into a more futuristic version representing the bull market for crypto, as if to poke fun at traditional finance.

The big absentee instead was the president of El Salvador who forfeited at the last minute due to problems in his country. Expectations were high for any announcement from him on something new, perhaps a government bond in Bitcoin. It was during last year's edition of the conference that Bukele first revealed plans to make bitcoin legal tender in El Salvador.

The choice of Miami was no accident. Many cite it to be a very friendly environment aided by local officials, particularly Miami Mayor Francis Suarez, who has gained national attention by attracting tech investment and becoming one of America's most crypto-friendly mayors. Miami, famous for its beaches, is looking to establish itself as the center of the crypto revolution on an influx of workers and venture capitalists looking for a chance to make it big. The hope is that what San Francisco was for Web 2.0, Miami wants to be for Web3, despite the lack of any famous university. But still, there are some ingredients helping the rise: a growing population, the choice among token enthusiasts and dealmakers to live in a warm, seaside location rather than a polluted big city, and helped by an environment increasingly geared toward a work-away-from-office model. Also, the support from the significant family wealth down there, and their different kind of risk profile, sustain the industry.

"Despite the hype from the conference, this year Bitcoin is largely absent from several of the hottest trends in crypto such as NFTs and DeFi."

Chart of the week

Despite the hype from the conference, this year Bitcoin is largely absent from several of the hottest trends in crypto such as NFTs and DeFi.

Bitcoin looks to have a big resistance at 48,000, close to the 200-days moving average. The low realized vol showed is the consequence of the lack of a short-term trend, where mean reversion strategies are the winner. The 50-day crossing the 100-day is a longer-term bullish indicator.

Figure 3: Price of Bitcoin

Source: Bloomberg, as at April 8, 2022.

Fixed Income | Russia's technical default draws nearer

Two more Russian corporates miss payments.

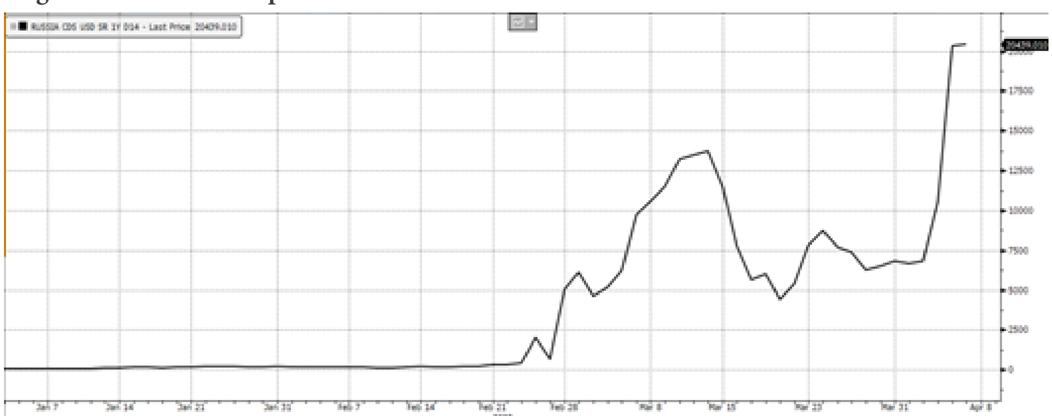
> "This so called QT should be a big factor for the US Treasury curve shape, which remains trapped in a kind of tug-of-war..."

As we've mentioned earlier, the Fed signaled this week that it will reduce its massive bond holdings at a maximum pace of USD95 billion a month, in line with market expectations but nearly double the peak rate of USD50 billion a month the last time the Fed trimmed its balance sheet from 2017 to 2019. This so called QT should be a big factor for the US Treasury curve shape, which remains trapped in a kind of tug-of-war between the irresistible force of the Fed aggressively raising the funds target, and the cumbersome presence of QT. Most likely, only when the Fed will slow or wind down rate hikes in 2023, QT should dominate and push the curve back toward a more typical positive slope.

On the other hand, in Europe, the ECB sounded less convinced of inflation returning to target this year. Market expectation for European policy rates for the end of 2022 are at 0.63%, meaning the end for negative rates. Sovereign bonds had another difficult week, with yields still climbing. 10-year US Treasury yields rose to 2.67% (+25 bps). The same happened in Europe, with Bund yields closing at 0.69% (+19 ps), France OAT 1.24% (+24 bps) and Italy BTP at 2.35 (+29 bps).

Elsewhere in the market, the cost of insuring Russia's government debt surged to signal a record 75% chance of default within the year after foreign banks declined to process about USD650 million of dollar payments on its bonds.

Figure 4: Russia CDS Spikes



Source: Bloomberg, as at April 8, 2022.

Our view: The threat of a technical default has drawn nearer after the Finance Ministry said it was unable to process USD649.2 million worth of coupon payments for its 5.625% 04/042042 Eurobond in US dollars because the transaction was declined by foreign banks. The ministry said it had transferred the full payment in rubles instead and "considers its obligations fulfilled in full". After May 4th, when the 30-day grace period will end, if a minimum quorum is reached, creditors can declare Russia in default. Russian sovereign bonds have cross-default provisions, therefore a default on one issue can accelerate the default on all its outstanding sovereign bonds.

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Two other Russian companies missed payments during the week. Sovcombank PJSC, Russia's ninth largest lender, was the first Russian bank to miss a coupon on its 8% USD subordinated 07/04/2030. The bank said in a statement that it would stop payments on its four notes issued by the Irish vehicle, Sovcom Capital DAC. Russian Railways didn't settle a dollar bond due on April 5th and warned that payments may be delayed or suspended for some time.

Week Ahead | Key events to watch for

- **Next week, although shortened, will still be one of important economic data in the US.** Right in the middle of the rate hikes that we are witnessing, we will see PPI and CPI levels. In addition to these, the University of Michigan's Consumer Sentiment will be equally important in assessing the impact of inflation on the consumer.

- **The earnings season also begins**, as usual with banks, led by JP Morgan and Citi.

- **On the central bank front**, we await decisions from the ECB and the Bank of Canada (which is expected to raise 50 bps).

With the arrival of Easter in the week ahead, there will be no Market Flash next weekend. We will return the following Sunday, April 24th.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX, Crypto and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager