NOVUM
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Weekly Market Flash

Will tech stocks sustain the market rally?

June 11, 2023

In the week leading up to the Federal Reserve (Fed) meeting, the market witnessed two surprise hikes by the Reserve Bank of Australia and the Bank of Canada (BoC), which both raised rates by 25 basis points (bps) against expectations for unchanged rates. The BoC's hike is particularly significant for two reasons: first, because of the geographical proximity to the US, a factor that makes the two economies very synchronized; second, because the BoC was the first to go into "pause" back in January, and the market thought the cycle was over. At this point, the market has been forced to wonder whether the Fed will follow with a hike of its own next week, or whether it will postpone the (now almost fully priced in) hike until July.

Highlights

▪ Economic data has been good in the US, but in Europe there has been some weakness in both supply-side and consumer data.

▪ The combined capitalization of Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla and Nvidia alone is worth 30% of the S&P 500 index, compared to 22% at the start of 2023.

▪ In Ukraine, the infamous military counteroffensive to recover occupied territories has begun. The first impacts have been seen on the agricultural market: the price of wheat has risen by 6% in the last week.

▪ Global bonds suffered after two shock interest rate hikes this week served traders a reality check that central banks are far from done in their fight against inflation. Shorter-maturity yields are close to their highest since March.

▪ Hedge fund performance this year has been challenged at the industry level, while strategy performance and dispersion has almost been the perfect mirror image of last year with the most directional and market sensitive strategies performing well.

"The market has continued to be very buoyant over the past two weeks, but the sectoral and geographic dynamics have changed considerab-ly..."

Markets & Macro | Will tech stocks sustain the market rally?

AI and Big Tech drive market growth this year.
The market is convinced (80%) that we will see the Fed "skip" the hike this week, barring any big surprises from next week's inflation data (core CPI is expected at 5.2% year-over-year from 5.5% year-over-year in April). In fact, this week's ugly jobless claims data fueled doubts that the labor market is slowing down. Meanwhile, the market has continued to be very buoyant over the past two weeks, but the sectoral and geographic dynamics have changed considerably since the beginning of the year—when Europe, value stocks and financials led the gains. Now, it is largely technology and AI stocks in the lead, with Europe even going negative in the two weeks that have ended.

> "The Citi Eco Surprise Index for the US and Europe has also been diverging..."

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

Equity Indices	Last Value	2 Weeks	Ytd
MSCI World	2,885.63	2.04%	12.18%
Nasdaq	13,259.14	2.18%	27.20%
S&P 500	4,298.86	2.22%	12.81%
S&P Equal Weighted	5,877.80	2.77%	3.29%
DJ Industrial	33,876.78	2.37%	3.26%
Nikkei	32,265.17	4.36%	24.94%
Eurostoxx	4,289.79	-1.10%	16.14%
Swiss SMI	11,254.42	-1.57%	8.02%
FTSE 100	7,562.36	-0.85%	3.47%
Canada	19,892.06	-0.14%	4.03%
Shenzen	3,836.70	-0.37%	-0.48%
Hong Kong	19,389.95	3.43%	-0.63%
MSCI EM	1,002.33	3.03%	5.90%

Equity Sectors	Last Value	2 Weeks	Ytd
S&P value	156.05	2.82%	8.46%
S&P Growth	67.94	1.93%	16.75%
S&P Defensives	1,542.43	1.10%	0.86%
ARK Fund	42.51	8.72%	36.08%
Fangs	7,448.73	4.52%	67.59%
S&P Banks	82.09	5.45%	-17.21%
Euro Stoxx Banks	81.33	0.13%	12.93%
S&P Energy	81.33	3.25%	-6.07%
Gold Miners	31.08	2.20%	8.44%

Commodities	Last Value	2 Weeks	Ytd
BBG Commodities	100.96	0.88%	-10.50%
BBG Agriculture	66.62	2.34%	-3.20%
BBG Energy	30.69	-3.01%	-25.55%
BBG Precious Metals	223.41	1.56%	3.96%
BBG Industrial Metals	144.71	1.57%	-12.47%
Gold	1,961.19	0.76%	7.52%
BBG Brent Crude TR	959.87	-2.43%	-9.61%
BBG WTI Crude Oil TR	170.80	-3.16%	-10.71%

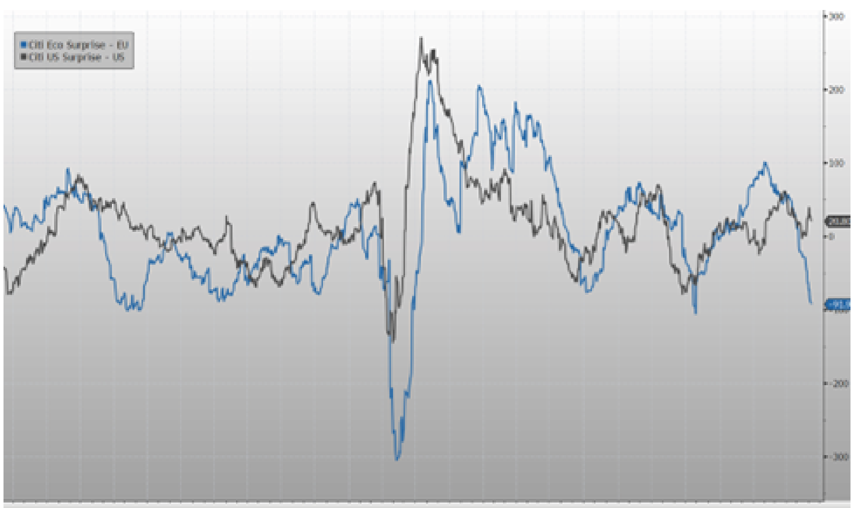
FX	Last Value		Ytd
DXY Index	1,234.24	-0.93%	-0.99%
EUR/CHF	0.9708	0.01%	-1.89%
GBP Index	650.25	1.49%	4.40%
EM FX Index	1,688.39	0.57%	1.68%
USD/JPY	139.40	-0.85%	6.31%
USD/CNY	7.13	0.94%	3.36%
Bitcoin	25,752.65	-3.76%	55.70%

Bond Indices	Last Value		Ytd
US Inv Grade	106.76	0.60%	2.93%
US High Yield	74.72	1.43%	4.00%
Euro Corps	233.22	0.96%	2.44%
JPM Europe Govies	9,891.56	2.91%	7.17%
US Treasuries	2,227.75	0.54%	1.80%
China Aggregate	255.15	-0.65%	-0.05%
EMBI Global	788.57	1.62%	2.64%
EMBI Local	132.48	1.71%	7.10%

Source: Bloomberg, as at June 9, 2023. Performance figures in indices' local currencies.

Moreover, as we have noted more recently, the general tenor of economic data has been good in the US, especially on the consumer and labor market fronts—but in Europe there has been some weakness in both supply-side data (industrial production, PMIs) and consumer data (sentiment and retail sales). The Citi Eco Surprise Index for the two areas, has also been diverging (Figure 2).

Figure 2: Diverging Surprise Indexes



Source: Bloomberg, as at June 9, 2023.

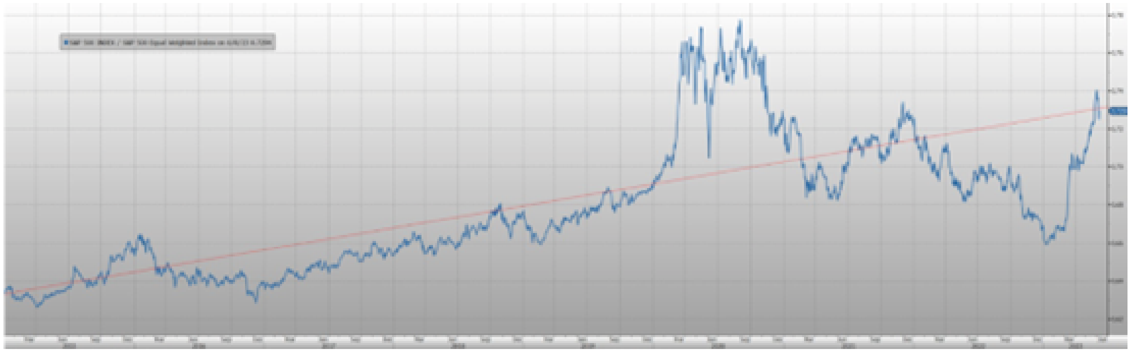
Another factor that penalized Europe is the same one that had supported it at the beginning of the year—the disappointment over China's economic reopening, which is happening much more slowly, and less intensively, than in the West after the pandemic. European luxury names had been bought as a proxy for the Chinese market, and the disappointment over the Chinese trade has finally made itself felt in Europe in the last few sessions, with some delay and less intensity.

> "The S&P 500 index (market cap) outperformed the same equal-weight index by 10%."

But the dominant theme, as mentioned earlier, is AI and technology. In fact, that of the last two weeks is only an acceleration from a trend that started at the beginning of the year. The S&P 500 index (market cap) outperformed the same equal-weight index by 10%. The combined capitalization of Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla and Nvidia alone is worth 30% of the S&P 500 index, compared to 22% at the start of the year. Further, a research note from Alpine Macro provided Figure 3, which led us to share some thoughts. The expanding gap between the S&P 500 market cap and its equally weighted index is generating many doubts on the sustainability of the market rally, but it's possibly not as alarming as it may seem.

> "The AI and tech-driven growth propelling the S&P 500's market cap marks a return to this trend following a sharp decline post the economic reopening..."

Figure 3: S&P 500 Index vs. S&P 500 Equal Weighted Index



Source: Bloomberg, as at June 9, 2023.

Our view: Figure 3 gives a sense of mean-reversion to the long-term trend—the AI and tech-driven growth propelling the S&P 500's market cap marks a return to this trend following a sharp decline post the economic reopening. During that time, higher interest rates had a disproportionate impact on larger tech companies compared to value stocks. One explanation for this could be due to the concentrated benefits of AI. Essentially, the largest tech firms reap the earliest benefits from technology advancements due to their size and high productivity levels. This natural advantage leads to increased earnings and stock valuations such as the ones we are observing with AI, driving up the ratio as a very small number of firms capture the vast amounts of upside available.

Another explanation refers to the evolving business models of Big Techs. For instance, today's large corporations are characterized by their adaptability and quick response to market shifts. With their significant market hold, they can capitalize on both internal and external innovations, seizing opportunities in ways that smaller companies often can't. But what could stop this trend, which has been strong in recent weeks? Between financial stability factors (such as the US regional bank crisis, and Credit Suisse in Europe) and geopolitics, we would pay more attention to the latter.

> "In terms of geopolitics, Europe seems to be more exposed at the moment, in the light of the Ukrainian counter-offensive launched..."

Elsewhere, in terms of geopolitics, Europe seems to be more exposed at the moment, in the light of the Ukrainian counter-offensive launched, somewhat quietly, in recent weeks. The China-US front, on the other hand, seems less tense currently. Indeed, it seems that Blinken's trip to China, which had been postponed in February because of the balloon crisis, will take place in the next few weeks—a symptom of thawing between the parties.

In Ukraine, the infamous military counteroffensive to recover occupied territories has begun, and the first response, cynical and ruthless on the Russian side, was the destruction of the Kakhovka dam, which caused severe flooding in southern Ukraine. The first impacts have been seen on the agricultural market and in particular on the price of wheat, which has risen by 6% in the last week. Then there is another event, of a meteorological nature, which could gain weight in the coming weeks: the arrival of El Nino, widely predicted for this year, poses a risk to the downward trend in food prices which has helped inflation to fall in recent months. Events such as this and the floods in Ukraine could provide a further inflationary impulse, and consequently damage economic growth. Finally, at the same theme, the situation in Panama should be monitored, as there are serious concerns about low water levels in the lake that feeds the Canal; limits on the weight of boats and increased tariffs are already in place.

Fixed Income | Will the Fed hike rates next week?

“Two shock interest rate hikes served a reality check that central banks are far from done in their fight against inflation.”

Short-term yields reach March highs.

Global bonds suffered after two shock interest rate hikes this week served traders a reality check that central banks are far from done in their fight against inflation. Investors were caught on the back foot after the BoC joined Australia’s central bank in surprising markets with more rate hikes to combat stubbornly fast consumer price gains. Shorter-maturity yields are close to their highest since March.

Figure 4: Two-year Yields Rally

Source: Bloomberg, as at June 9, 2023.

Our view: The latest developments run against the common belief that central banks are on the verge of pausing their rate hikes, particularly given that Canada was one of the first to formally signal a pause back in January. The big question now is whether the Fed might follow up with a hike of their own next Wednesday. In the US, macro data point toward a weakening in demand (see the big jump in the latest US jobless claims survey), a prerequisite for reducing inflationary pressures. As happened in Australia and Canada, where central banks took a pause before raising their rates, the Fed will probably suggest that a hike in July remains a possibility, keeping some leeway in the event of the economy failing to evolve in the desired direction.

“Hopes that the Fed will cut rates after a pause this month aren’t shared by high grade US companies.”

Hopes that the Fed will cut rates after a pause this month aren’t shared by high grade US companies. They’re extending this week’s rush to fund, fearing it’s only going to get more expensive as policy remains tight. Blue-chip US companies sold USD50 billion in bonds bringing the total volume for the year to USD150 billion, just under the top volume in February. Low concessions and decent order books (10 bps in new issue concessions on order books that were on average three times oversubscribed) highlight a robust bid for high grade credit, which companies will continue to hit hard as long as the window stays open. Pharmaceutical giant CVS raked in USD37 billion in orders for a USD5 billion issuance over five parts. Electricite de France SA (EDF) priced a USD1.5 billion Perpetual Non Call 10-year, deeply subordinated hybrid at 9.125%. The deal, announced with talk of 9.5%-9.75%, collected orders for USD10 billion. This made it almost impossible to get an allocation in the primary market, and in the secondary trading the first prices jumped to 102-103.

Hybrid bonds are a type of subordinated debt that firms issue to raise capital more cheaply compared to equity. The part-equity treatment of these bonds is particularly significant amid recession fears as it gives companies a cushion if their health metrics start faltering. Hybrid bonds carry three main risks: 1) subordination: meaning almost no recovery value in a default, 2) coupon deferral: risk minimized by the presence of cumulative push arrears, 3) maturity extension: at the sole discretion of the management, the bond can be extended beyond the first call date with the coupon resetting at a spread decided at issuance. In the case of EDF, subordination is less concerning due to its full nationalization, but the extension risk is more significant. The topic is complex, but to keep it simple, losing equity treatment is a major incentive to call a hybrid at par. In the case of the new EDF bond, thanks to the lack of a step-up on the spread after the coupon resets, the company will be able to skip a call without risking part-equity recognition.

While EDF management is committed to hybrid bonds as a permanent source of financing in its capital structure, and having always used the first call date to refinance, this unusual structure could remove an implicit price floor as certainty of an early redemption diminishes. At the same time, EDF's own call is a decade away. The risk to its reputation by not meeting investor expectations and the need to maintain open access to the hybrid market might push the company to call even if it would be refinanceable at a cheaper rate.

"Two shock interest rate hikes served a reality check that central banks are far from done in their fight against inflation."

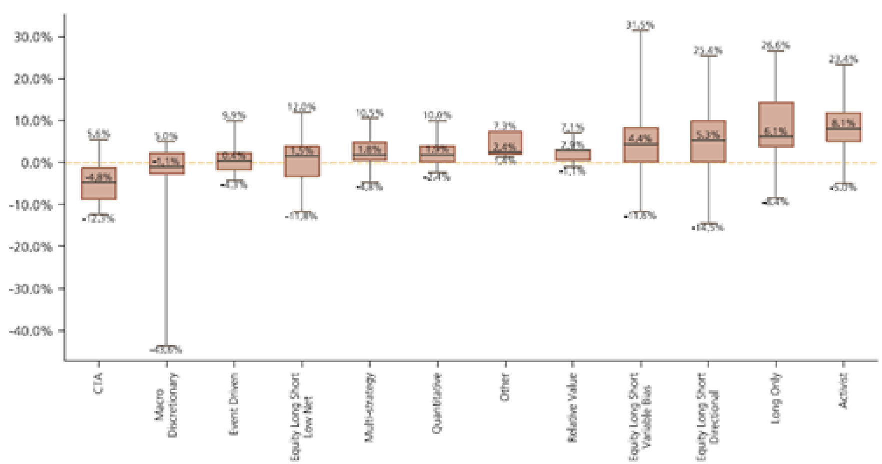
Hedge Funds | Mid-year update: Sharp contrast with 2022 but opportunities seen ahead

Defensive outlook remains.

The hedge fund industry experienced notable shifts and performance variations across strategies in 2023 compared to 2022. As we noted in our January outlook, hedge funds performed relatively well last year with performance buoyed by macro managers and multi-strategy funds against the backdrop of equity and fixed income markets reversing sharply.

So far this year, performance has been challenged at the industry level (the HFRX Global Hedge Fund Index is flat year-to-date), while strategy performance and dispersion has almost been the perfect mirror image of last year with the most directional and market sensitive strategies performing well. Meanwhile relative value/multi-strategy managers have shown mixed results—though up in aggregate and macro has generally underperformed as markets whipsawed (Figure 5).

Figure 5: YTD Hedge Fund Performance By Strategy



Source: UBS Capital Consulting, as at April 2023.

"Hopes that the Fed will cut rates after a pause this month aren't shared by high grade US companies."

Our view: As we entered 2023, the consensus view within the industry remained that the most important factors for markets over the next 12 months will continue to be global inflation and inflation expectations. As we now approach the end of the second quarter, these still appear to be the main driving forces in markets albeit with the narrative almost constantly shifting between a soft economic landing, or a hard landing as a result of a stronger than expected inflation picture. As both paths forward remain highly uncertain given their various inputs including some with substantial lag effects, the resulting market environment has also been uncertain with participants continuing to price forward expectations of the global inflation fight.

Despite these conflicting narratives, on the surface major equity and credit markets have generally performed well leaning toward the soft landing scenario and the absence of a policy mistake by central banks. In particular, equity indexes have been lifted by the so-called AI frenzy and credit spreads have tightened favoring beta strategies to which we are and have been for a long time underexposed. However, quick and large re-pricings as well as liquidity dislocations have typically occurred with this

"We continue to maintain our overweight toward less correlated strategies given their ability to generate idiosyncratic returns away from market beta..."

type of regime change and hedge fund managers have in the past shown their ability to capture opportunities when this type of dislocation arises.

With that backdrop, we have therefore remained defensive in our outlook as is often mentioned in these pages. What it means concretely for our hedge fund portfolios is that we continue to maintain our overweight toward less correlated strategies (Relative Value and Macro) given their ability to generate idiosyncratic returns away from market beta:

- Macro, which has been the largest detractor this year after a standout performance last year, was most notably impacted by the outlier moves in interest rates around the banking crisis in March. Indeed, since the end of 2022 , markets were pricing an end to central banks' hiking cycles, However, higher inflation data and more hawkish central banks prompted markets to sharply reprice forward yields in February with many macro managers taking directional short positions. The banking crisis triggered by SVB's demise led to a spike in interest rate volatility and a rapid reversal of market expectations—from clearly hawkish to clearly dovish within days—which caught many managers wrong footed. As a consequence, managers have cut risk and started to reposition their portfolio reflecting the more dynamic nature of markets compared to 2022. With the focus clearly remaining on inflation, growth and macro policy decisions, they should capture opportunities around a potential regime shift or the continuation of inflation-driven pressures. Systematic strategies will also stand ready to capture new trends arising.
- For Relative Value strategies that remain our core allocation, the increased volatility and dispersion across asset classes is presenting attractive relative value and trading opportunities across and within asset classes. However, their ability to move capital efficiently toward the most attractive opportunities will be key to their success given the dynamic market environment. One particular area in Relative Value that we discussed recently is convertible arbitrage, which has so far materialized this year as new issuance picked up with companies trying to reduce their interest expenses in the higher rate environment, and managers effectively capturing these opportunities.

Week Ahead | Key events to watch for

- **The US CPI in May and FOMC meeting** will be in focus next week. The European Central Bank (ECB) and Bank of Japan meetings will also follow, with the ECB expected to raise rates further, while the market will not risk on Japan.

- **Several indicators of economic activity in China** (industrial production and retail sales) will be published, after recent disappointing data.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
Senior FX, Crypto & Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Carlos De Andres Perez
Senior Private Equity Funds Manager

Maxime Glasson
Senior Hedge Funds Manager