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Weekly Market Flash
Market sentiment reverses on robust data

February 12, 2023

The release of extremely strong economic data last week, in particular the US labor market report and the ISM services, seems to have changed the tone across markets. Although performance since the start of this year remains explosive (as shown by the major equity markets' performance in Figure 1), to say the least, the 'good is bad' theme—which refers to strong economic data resulting in a negative impact on market performance—seems to have returned.

Highlights

- The Fed Funds strip closed by discounting a June-July rate spike to 5.125%, which is almost exactly two more 25 bps hikes, and continues to discount a cut by year-end—although it no longer has the 50 bps cut it was discounting before the labor market report.
- There has also been talk and consequently movement in the rate options market, suggesting that the peak rate will reach 6%—almost a percentage point higher than the current consensus.
- Two Kraken subsidiaries announced a settlement with the SEC concerning Kraken's on-chain staking program. Because of this settlement, Kraken has agreed to end its on-chain staking services for US clients.
- The mood across both hedge fund managers and allocators is overall upbeat on the back of the relatively strong industry performance in 2022, with the HFRX Global Hedge Fund Index finishing last year down 4% (relative to the sharp reversal of both equities and fixed income).

"...the market continues to fear the Fed's policy tightening as a harbinger of an economic slowdown..."

Markets & Macro | Market sentiment reverses on robust data

Rates rise, while hard landing concerns return.

Rates movements across the US Treasury yield curve, as well as other sovereign bond yield curves including Europe, have been important. The terminal rates on Fed Funds have risen significantly, followed in part by long-dated rates. The logical consequence has been a further inversion of the yield curve, which suggests that the market continues to fear the Fed's policy tightening as a harbinger of an economic slowdown—and that the potential for a hard landing has returned.

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

Equity Indices	Last Value	Ytd
MSCI World	2,783.91	7.13%
Nasdaq	11,718.12	12.05%
S&P 500	4,090.46	6.71%
DJ Industrial	33,869.27	2.33%
Nikkei	27,670.98	6.05%
Eurostoxx	4,197.94	10.98%
Swiss SMI	11,130.46	3.74%
FTSE 100	7,882.45	5.84%
Canada	20,612.12	6.62%
Shenzen	4,106.31	6.07%
Hong Kong	21,190.42	7.13%
MSCI EM	1,013.67	6.05%

Equity Sectors	Last Value	Ytd
S&P value	154.84	6.73%
S&P Growth	62.40	6.67%
S&P Defensives	1,538.63	0.61%
ARK Fund	39.15	25.32%
Fangs	5,541.93	24.61%
MSCI Financials	141.63	8.40%
S&P Energy	90.21	3.13%
Gold Miners	29.62	3.35%

Commodities	Last Value	Ytd
BBG Commodities	108.68	-3.66%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	70.06	1.80%
Gold	1,865.57	2.28%
Silver	22.00	-8.14%
BBG Brent Crude TR	1,067.38	0.52%
BBG WTI Crude Oil TR	190.47	-0.42%

FX	Last Value	Ytd
DXY Index	1,237.34	-0.74%
Bbg JP ASIA	102.17	0.97%
Bbg JP LATAM	40.50	1.89%
EUR/CHF	0.99	0.33%
GBP Index	621.34	-0.24%
EM FX Index	1,687.70	1.64%
JPY/USD	131.36	-0.18%
CNY/USD	6.81	1.23%
Bitcoin	21,646.93	30.88%

Bond Indices	Last Value	Ytd
US Inv Grade	107.76	2.52%
US High Yield	74.78	2.05%
Euro Corps	232.97	2.33%
JPM Europe Govies	9,516.72	3.11%
US Treasuries	2,210.27	1.00%
China Aggregate	261.52	2.45%
EMBI Global	781.80	1.76%
EMBI Local	126.68	2.42%

Source: Bloomberg, as at February 10, 2023. Performance figures in indices' local currencies.

"...it is one thing to discount terminal rates between 4.90% and 5.125%, as was the case until a few days ago, and it is quite another to talk of rates at 6%!"

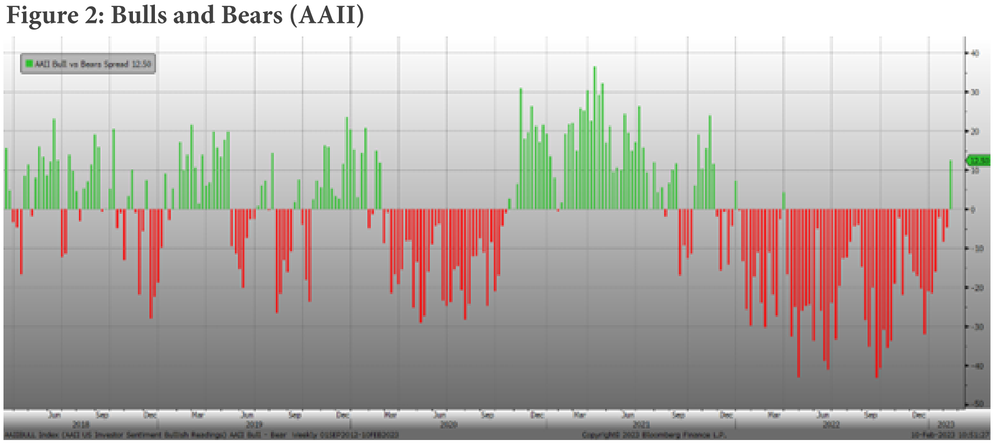
While Federal Reserve (Fed) Chair Jerome Powell was still moderately dovish in an interview earlier in the week, other Fed members including prominent economist John Williams were notably more hawkish. The Fed Funds strip closed by discounting a June-July rate spike to 5.125%, which is almost exactly two more 25 basis points (bps) hikes, and continues to discount a cut by year-end—although it no longer has the 50 bps cut it was discounting before the labor market report.

This week there has also been talk and consequently movement in the rate options market, suggesting that the peak rate will reach 6%—almost a percentage point higher than the current consensus. It is clear, therefore, that these scenarios have put no small strain on equity markets, resulting in a return of the bid for the US dollar: it is one thing to discount terminal rates between 4.90% and 5.125%, as was the case until a few days ago, and it is quite another to talk of rates at 6%!

"Thanks to favorable base effects, year-on-year core CPI is expected to fall from 5.7% to 5.4%."

Our view: The tightening of financial conditions resulting from the movement on rates comes at a time when sentiment was improving significantly. As Figure 2 shows, the difference between the Bulls and the Bears expressed by the American Association of Individual Investors (AAII) had reversed after a year of prevalence of the bears! Against this backdrop, the release of the US CPI figure on Tuesday next week becomes crucial for markets. Thanks to favorable base effects, year-on-year core CPI is expected to fall from 5.7% to 5.4%. But the focus should be on the month-on-month figure, expected at 0.3%. For the markets to hold, it is crucial that there are no surprises.

Figure 2: Bulls and Bears (AAII)



Source: American Association of Individual Investors, as at February 10, 2023.

Europe, meanwhile, is in a rather paradoxical situation. On the one hand, as we have previously mentioned, there are some extremely supportive elements for European equity markets, especially linked to the expectations that the market had built in a few months ago. The energy crisis and the consequences of the war have made Europe essentially uninvestable in the eyes of foreigners, but partly also for Europeans themselves.

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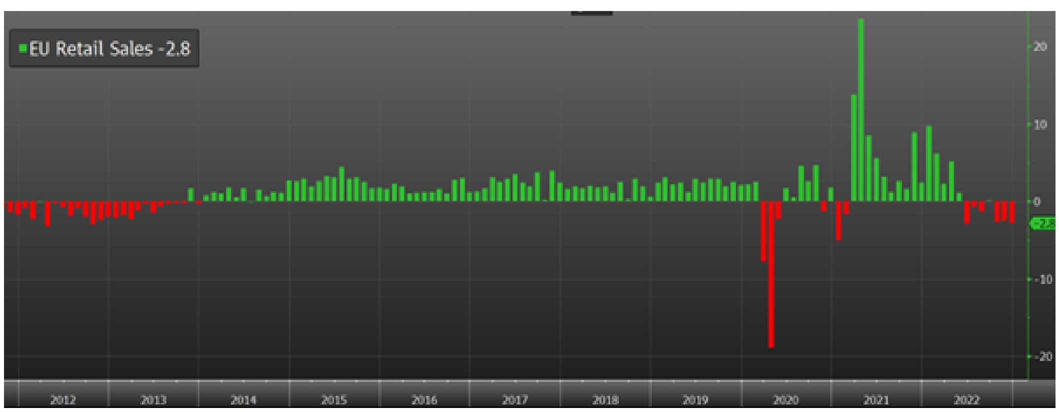
Hence there was extremely defensive positioning in the market, if not outright short. In addition, the mild weather, and the accumulated gas glut, suddenly disproved all the more extreme theses about energy rationing. In all this, the earnings growth of companies in the Eurostox 50 index in 2022 was remarkable (around 18%), and valuations are low (the P/E of the index had reached 10!).

But at this point, it seems to us that there is a lot of consolidation to be done in this market as well, considering a number of elements:

1. The European Central Bank (ECB) is continuing to raise rates, and it is not done yet. The effects of tightening, perhaps even more than in the US, are starting to be felt. Figure 3, which shows retail sales in Europe, speaks for itself. While it is true that the worst economic scenarios have been avoided, the consumer is still reeling from the loss of purchasing power, and the dynamic is impacting consumption volumes. Not since 2013 have we seen a drop in volumes comparable to the current one, with the exception of the pandemic. Consumers are suffering the double squeeze from prices (inflation is at 10%) and rising rates.
2. The ECB is quietly implementing its QE. Its balance sheet has shrunk by another EUR18.6 billion in the last week to EUR7.8 trillion (it was EUR8.8 trillion at its peak). Total assets now amount to 60.3% of Eurozone GDP compared to 32.3% for the Fed, 114.7% for the Swiss National Bank and 132.4% for the Bank of Japan. But what matters is the direction: the ECB's balance sheet is falling faster than the Fed's balance sheet.
3. With the ECB raising rates and reducing the balance sheet (and the end of the energy crisis), one can no longer much rely on the mantra 'a weak Euro at least helps the continent's exports'. The Euro has already recovered more than 10% against the US dollar and the major G7 currencies.

Figure 3: EU Retail Sales



Source: Bloomberg, as at February 10, 2023.

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Cryptocurrencies | Kraken settles complaint on staking program

Will staking providers in Asia benefit?

This week, two Kraken subsidiaries announced a settlement with the US Securities and Exchange Commission (SEC) concerning Kraken's on-chain staking program. Because of this settlement, Kraken has agreed to end its on-chain staking services for US clients. As part of the settlement Kraken will also pay USD30 million to settle charges with the SEC.

"While staking is a relatively new concept in the world of cryptocurrency, it has quickly gained popularity as a way for people to earn passive income..."

Our view: The complaint alleged that Kraken failed to register the offer and sale of its staking program, not disclosing full risk of the activity. Staking activity is much riskier than a risk free investment. The staking provider also takes their tokens and transfers it to another platform, de facto losing control over those tokens, with a consequent counterparty risk.

Staking is a process of holding onto and actively participating in the validation of transactions on a blockchain network in exchange for rewards. It is a way for holders of a particular cryptocurrency to earn passive income by putting their coins to work to help secure the network. In a proof-of-stake (PoS) blockchain, validators are required to hold a certain amount of tokens in their wallet as collateral in order to participate in the validation of transactions. These validators are then responsible for verifying transactions and adding them to the blockchain. The amount of tokens that a validator holds, and therefore the amount of influence they have on the network, is directly proportional to the amount they have staked. The rewards for staking come in the form of newly minted tokens or a portion of transaction fees. These rewards incentivize individuals to become validators and help secure the network.

While staking is a relatively new concept in the world of cryptocurrency, it has quickly gained popularity as a way for people to earn passive income from their investments. It also has the added benefit of improving the security and decentralization of the network.

In conclusion, the decision will limit centralized platforms in US, and the winners will likely be staking providers in Asia. But that could be another good thing for decentralized finance (DeFi) as holders are now more likely to utilize options available in DeFi that are out of the reach of US regulators. After the news, Bitcoin went below 21,000. Investors looking at buying the dip can consider the short term idea of taking advantage of the implied to realized volatility premium, to enter at the long term supports of the 19 000 level.

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Hedge Funds | Taking the pulse of the hedge fund industry

An upbeat mood for the year ahead.

I spent last week in sunny Florida attending two large hedge fund industry conferences and, while both differed in terms of format and content, this type of event always represents an excellent opportunity to meet with industry participants—including hedge fund managers and allocators from all over the world. Below are some of the key findings from these events, which are part of the many factors that we consider to construct our outlook and allocation for our portfolios.

Our view: At these conferences, the "mood" across both managers and allocators was generally upbeat on the back of the relatively strong industry performance in 2022, with the HFRX Global Hedge Fund Index finishing last year down 4%, when both equities and fixed income reversed sharply. Despite the recent rally in equity markets, most pointed that the next five years are unlikely to resemble the past five years as volatility—that has been compressed for so many years post the GFC —has finally come back to markets. And with volatility usually comes dispersion across asset classes, which hedge funds have historically been able to capitalize on.

The first conference consisted of several panels divided by strategies (macro / multi-strategy and long/short equity), and manager breakout sessions punctuated with fireside chats that included some of the most preeminent investors of our generation;

- *Among macro managers*, the dominant sentiment was that 2022 represented an exceptional year for macro trading—and performance reflected that environment. Since some of the 2022 themes have reversed since last November, they shared their forward-looking views on markets. On the topic of inflation and a forthcoming recession, the general view is that the idea of a soft landing and rate cuts in the second half of 2023 is more wishful thinking from market participants that have grown accustomed to managing money in a low inflationary environment, where correlation in equity and bonds was negative. Inflation is out of the can, and, in a paradigm shift, interest rates are likely to stay higher for longer while the market continues to discount too much of the message of the Fed creating a disproportionately right-tailed distribution that they can trade, albeit more tactically.

  This paradigm shift was a recurring theme with the higher inflation / higher rates axiom supporting the view that this will help to reduce the accumulated public debt over the past 30 years. Most, however, agreed that the China reopening was a surprise and led them to rethink their portfolio, though they are betting on a medium-term growth impulse from the reopening through an indirect positioning (e.g. commodities). On the Bank of Japan (BoJ), which is one of the most discussed macro trades recently, there was no strong consensus view though many point out that the BoJ and their recent USD200 billion QE has resulted in a risk transfer to market participants, and while they like the optionality of the YCC abandon, they also pointed to the risks of trading that event.

- *Multi-strategy managers* echoed similar views and the discussions centered around efficient capital allocation across portfolio managers, which is their moat and the recent growth of their macro and credit allocations. Market liquidity was, however, mentioned as the largest risk they are facing now—given the post-2008 structural shift with the removal of liquidity-providing proprietary trading desks within banks, which has created a void that was not apparent in the artificially inflated asset prices environment that ensued but could prove problematic and lead to large market reversals in the future. Interestingly, they pointed out that the talent war that we have discussed here in the past has started to come off though the market for skilled portfolio managers remains extremely competitive.

- *Long / short equity managers* pointed out that the environment has also changed for them in 2022, as in the ZIRP world it had become very hard to short stocks since bad businesses were given a free pass in the era of cheap liquidity. This has now reversed and should prove a rich hunting ground for fundamental stock pickers whose focus remain on finding good businesses irrespective of a soft or hard landing of the economy. Most also acknowledged that managers should remain mindful of factor exposures and the potential for a large reversal, such as the one that has impacted the industry in 2022 when value outperformed growth.

The second part of the week was spent at a conference that gathered over 2,000 managers and allocators meeting with 30+ managers across a very wide spectrum of strategies and sub-strategies ranging from credit, catastrophe reinsurance, metals trading and fundamental and quantitative equity managers. While it is arguably hard to form investment views in a 30 minute meeting, this has provided an excellent opportunity to connect with differentiated managers. We will be looking at capitalizing on these connections over the coming months for the benefit of our portfolios.

On the allocator side, I had fascinating discussions with a wide range of investors from money managers, multi-family offices, multi-billion dollar single family offices as well as institutional investors (including sovereign wealth funds, pension funds, university and hospitals endowments) skewed toward North America. While most shared the sentiment regarding last year's performance, the most interesting aspect related to the different asset allocation and use of hedge funds that certainly highlights the different utility function across investors.

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There are two examples to illustrate that point:

- I met with the CIO of a large single family office for which hedge funds entirely represent their "public markets" exposure while the rest of the wealth is allocated to private equity in a 50/50 split.
- A discussion with a large university endowment and their positive outlook toward long/short equity, despite the difficult 2022 for that segment of the industry, highlighted that they intend to use this allocation to complement their long only exposure going forward.

Week Ahead | Key events to watch for

- **The US inflation figure** due on Tuesday will be the focus of attention, and we imagine that an out-of-consensus figure, in either direction, could have significant consequences for all assets. Meanwhile, US retail sales and industrial production are also due.

- **The earnings season** is drawing to a close, but there are still some notable names in Europe and the US this week: Coca-Cola, Cisco, Kraft Heinz, Nestle, and Glencore.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**	**Carlos De Andres Perez**	**Maxime Glasson**
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