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Weekly Market Flash

Will markets soon switch to “selling the fact”?

April 11, 2021

Markets advanced this week, led by large US tech companies in particular, while their Chinese peers posted losses amid clear signs of credit tightening from Chinese authorities. Despite this, the overall environment remained incredibly benign for investors, with volatility declining. In our view, there are three clear themes driving the current environment – the economic recovery in the US and the subsequent reaction of the US Federal Reserve (Fed), the looming change in fiscal policy mix, with new spending plans no longer financed by an increase in debt but rather more taxes, and a changing geopolitical scenario with an underappreciated deterioration in US-China relations.

Highlights

▪ The IMF released its World Economic Outlook, revising up slightly their global GDP growth forecast to 6.0 % for 2021 and 4.4 % for 2022.

▪ Chairman Powell reiterated that the recovery is incomplete and uneven, and that real progress on domestic vaccination campaigns is needed to start considering reducing asset purchases.

▪ US Treasury Secretary Yellen proposed a plan for a new global corporate tax code that would bring back USD2 trillion in overseas corporate profits to the US. The impact on multinational earnings would be material.

▪ Earnings are projected to grow 20.2% in Q1, and should accelerate further to 49% year-on-year in Q2, thanks to favorable base effects.

▪ US junk bond spreads dipped below three percentage points for the first time since 2007 as investors piled into the asset class. Yields are close to the all-time lows of 1997, fueling a surge in borrowing.

▪ For now, Credit Suisse should have sufficient capacity to absorb the significant financial impact, but a one-notch ratings downgrade on average cannot be ruled out in the coming few quarters.

“We believe the picture of a robust cyclical acceleration in the US in Q2 and Q3 2021 is being confirmed one after the other.”

Markets & Macro | Will markets soon switch to “selling the fact”?

Recovery strengthens, but Fed reaffirms accommodative stance.

Equity markets advanced this week with US Big Techs outperforming with a gain of over 4%, while their Chinese peers posted losses of 3% during the week amid clear signs of credit tightening from Chinese authorities. Despite this, the VIX index declined below 17 points.

Our view: We believe three major themes are, or ought to be, on top of investors’ radars in the current environment:

- the ongoing economic recovery in the US – and the Fed’s subsequent reaction function.
- the looming change in the fiscal policy mix, with new spending plans no longer financed by an increase in debt but rather and increase in taxes.
- a changing geopolitical scenario with an underappreciated deterioration in US-China relations.

Looking at recently published macro data, the most important economic releases were stellar in the US – from the labor market report to the manufacturing and non-manufacturing surveys (which printed all-time record readings in many sub-indices). We believe the picture of a robust cyclical acceleration in the US in Q2 and Q3 2021 is being confirmed one after the other. The spectacular level of US activity is perfectly represented by the NY Fed weekly economic indicator (Figure 1). European data, too, showed surprising resilience, despite the fact that the surveys were taken during the last round of lockdowns.

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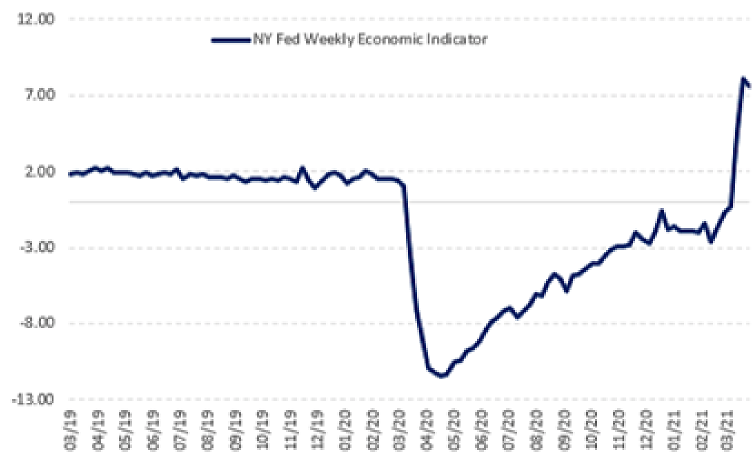
The IMF released its World Economic Outlook, revising up slightly their global GDP growth forecast to 6.0 % for 2021 and 4.4 % for 2022. The stronger growth outlook mainly reflects faster recovery in advanced economies, and especially in the US. In fact ,growth in 2021 is going to be much less synchronized than previous recovery cycles due to the different impact of the pandemic and of the consequent responses both in terms of lockdowns and policy countermeasures.

Figure 1: NY Fed Weekly Economic Indicator



Source: Bloomberg, as at April 9, 2021.

However, some tensions continue to linger as a consequence of such strong economic data. In fact, investors anticipate a rise in rates well in advance with respect to the Fed's dot plot. Yet, the Fed continues to try and convince investors that its focus remains on the still fragile status of the labor market (8.5 million jobs remain short compared to pre-Covid levels of employment), and the reaction to the coming spike in inflation will be much different than in the past.

"The Fed will probably start to signal a possible tapering during the second half of 2021, if jobs continue to grow at the rate of 900,000/1 million per month!"

This week the message was reinforced through the minutes of the latest meeting, and in a speech held by Chairman Powell at the IMF. He reiterated that the recovery is incomplete and uneven. In addition, the uneven progress of domestic vaccination campaigns poses a risk to the global economy. Real progress, not just expectations, is needed to start considering reducing asset purchases. The March labor market report was a glimpse of what he sees as brilliant progress – and to think about starting to remove stimulus, the Fed needs to see a series of similar progress. Inflation is not an issue at the moment. A simple rise in prices does not constitute inflation. If inflation comes, the Fed will react, but keep in mind that the US has a 25 year history of low inflation (this is despite anecdotal evidence that costs are rising for many key inputs for companies, like materials, logistics and labor). The Fed will probably start to signal a possible tapering during the second half of 2021, if jobs continue to grow at the rate of 900,000/1 million per month!

Figure 2: Eurodollar Spread

Source: Bloomberg, as at April 9, 2021.

Holding a very cautious view on markets.

On the fiscal side, we see a material change in the political environment after the bonanza of fiscal spending during the pandemic. This week, US Treasury Secretary Yellen proposed a plan for a new global corporate tax code that would bring back USD2 trillion in overseas corporate profits to the US. The impact on multinational earnings, which were the main beneficiaries of globalization of production over the last two decades and the exploitation of tax arbitrages between countries, would be material.

"...such a discontinuity in fiscal policy should be taken seriously, while investors tend to minimize and treat such measures as a continuation of all emergency measures to deal with the pandemic, focusing on short-term gains..."

Our view: While the market has understandably not been affected by such news, since the implementation of the proposal is quite difficult to realize, we believe it is relevant to dig into the overall context of this is happening. First, Biden has just announced a very expensive infrastructure plan of USD2.3 trillion over an eight-year period, which mainly contains measures for physical infrastructure including bridges, roads, highways, public transport, railways, charging stations for electric vehicles, modernization of the electricity network, and diffusion of broadband. These measures are to be financed over a 15-year period by raising corporate tax from 21% to 28% and raising the so-called minimum tax on international profits to 21% from around 13% at present. This is why the administration wants other countries to follow suit, ensuring that US-based multinationals remain competitive. The domestic pushback against the announced increase in taxes (and the slim Democratic majority in the senate) adds to the complexity.

Our opinion is that such a discontinuity in fiscal policy should be taken seriously, while investors tend to minimize and treat such measures as a continuation of all emergency measures to deal with the pandemic, focusing on short-term gains and gaining exposure to the companies potentially benefiting from the spending programs. Bigger government and higher taxes have historically meant lower corporate profitability.

The second area where we start to have a divergent opinion from most financial commentators is America's confrontation with China. Following the very tense summit in Alaska last month, negative news flow has not yet abated – and it not only affected US companies but the western block altogether. Chinese citizens' (not the government) boycott forced Swedish fast-fashion retailer H&M to close 20 stores in China due to its stance on Xinjiang cotton, while Nike is also under severe pressure for the same issue. A bill is currently being discussed in the US in order to address economic competition with China, as well as humanitarian and democratic values.

While Trump's approach was apparently unpredictable, but still pragmatic and business-oriented, the new administration appears to be ideological in nature, and thus more strategic than tactical. Human rights issue (such the Uighurs) are much more difficult to compromise on. And this is happening in a context where the western population seems more diffident toward China after the explosion of the 'imported pandemic'. The recent tensions remind us of the pressure over social networks back in January after the Capitol Hill attack by protesters. That was the point when social media corporations could no longer resist and decided to ban Trump and other extremist organizations from their platform services.

"Our goal is to start reducing our equity exposure in a positive market environment, on strength."

At an asset allocation level, we have one last hesitation before translating our very cautious view into an outright defensive portfolio construction: the beginning of a potentially very positive earnings season, which could emerge as soon as next week. Earnings are projected to grow 20.2% in Q1, and should accelerate further to 49% year-on-year in Q2, thanks to favorable base effects. Equity prices should also be supported by upward EPS revisions and positive guidance thanks to the advanced reopening in the US.

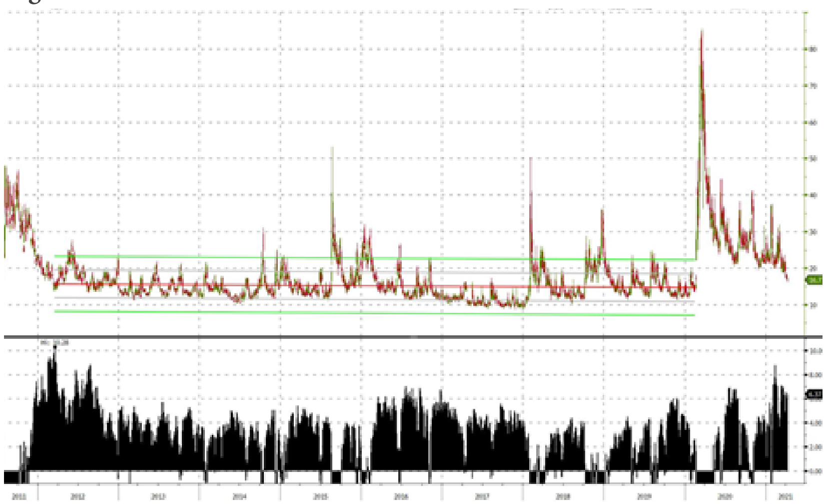
Our goal is to start reducing our equity exposure in a positive market environment, on strength. Still, we have to keep in mind that the relevant market correction in the tech space in February occurred in the context of very positive economic data and Q4 2020 earnings releases. In our opinion, "sell the fact" can occur at any time...

Chart of the week

The VIX index is continuing its normalization process of mean reversion that accelerated after the cash index had finally broken the 20% level. It seems to now be back in the pre-pandemic range when the average was 15%, while a move above 22.5% was considered a two-sigma event (or a low probability tail).

However, the middle part of the VIX futures curve tells a different story with very high expected volatility for late summer and early fall. The spread between the VIX index (spot) and the fourth futures contract stands near the highest level since 2012 (see second panel). The gap makes it expensive to buy long-dated hedges.

Figure 3: VIX Index



Source: Bloomberg, as at April 9, 2021.

"…the middle part of the VIX futures curve tells a different story with very high expected volatility for late summer and early fall."

Fixed Income & Credit | Low yields drive record quarter for high yield bond sales

Performance remains positive, for now…

During the first quarter of 2021, the most important story was the massive hike in US long-dated rates. Indeed, the 0.82% rise was the largest since 2016. The sell-off was not confined to the US but it also reached Europe, where investors have begun to anticipate a vigorous economic recovery once the vaccines are distributed. The negative performance of the 10-year treasury is therefore not surprising, nor is the loss of the Bund and the BTP (although not as severe).

Our view: In credit, spreads generally tightened over the quarter. However, given the low starting levels at the beginning of 2020, the very limited compression seen in the investment grade sector was not enough to offset the rise in rates – hence the marked negative performance of US corporates and the only slight negative performance in Europe. The situation is different in high yield: US junk bond spreads dipped below three percentage points for the first time since 2007 this week as investors piled into the asset class. Yields are close to the all-time lows of 1997, fueling a surge in borrowing as companies look to lock in historic rates, making the first quarter the busiest ever for high yield bond sales. So far, performance has been positive, but with such little margin for error priced in, disappointment on the economic growth front could have serious repercussions.

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Elsewhere in the fixed income space, Credit Suisse has been involved in two serious accidents one after the other, suggesting the bank has a higher risk appetite than may be expected from a wealth manager. For now, according to major credit analysts, there should be sufficient capacity to absorb the significant financial impact. However, a one-notch ratings downgrade on average cannot be ruled out in the coming few quarters.

Credit Suisse recorded a CET1 ratio of 12.85% in Q4 2020, which is 2.85 percentage points above the minimum capital requirement and translates into a buffer of CHF7.85 billion. UBS estimates that the impact of a CHF1 billion loss on the CET1 is about 26 basis points. Thus, the bank should be able to withstand a CHF6.1 billion loss – CHF1.5 billion from Greensill and CHF4.6 billion from Archegos – and the CET1 would still be above 11%. Moreover, Swiss AT1s contain a dividend stopper. Hence if Credit Suisse is paying equity dividends (which it has already stated), it cannot skip AT1 coupons, so the market should regain some comfort. Prices on AT1 bonds have also recovered to some extent over the last few days. Nevertheless, our take is to wait for further clarification on the fall out after recent losses.

Week Ahead | Key events to watch for

Next week marks the beginning of US earnings season – kicked off by banks – as well as the release of key economic data.

- **Elsewhere in the US, the March CPI reading** (which should start to give answers to whether the stimulus packages and the pent-up demand will lead to a lasting spike in inflation), and retail sales and industrial production will be published.
- **China will also be releasing its Q1 GDP**.
- **Thursday will see an important decision on rates** from the Central Bank of Turkey, as a first sign on the new course after the abrupt replacement of the central bank governor.

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