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## Weekly Market Flash

# Is the market ready to absorb accelerated tightening?

December 12, 2021

We have now reached the last, but nevertheless crucial, week of 2021, which will see two important central bank meetings – the Federal Reserve (Fed) and the European Central Bank (ECB). The evolution of the Omicron variant remains in the background, with conflicting reports of high infectivity and low mortality, but the gloomier scenarios conjured up when the news broke seem averted. The past week has seen major indices rebound strongly from the losses of late November/early December. This recovery not only reflects these strong fundamentals, but it is a possible sign that the market is ready to absorb an acceleration of the taper/rate hike to counteract rising inflation without too much trauma.

*This will be the last edition of our weekly Market Flash for the year. In the coming days, the Novum investment team will focus on the preparation of our Outlook for 2022, which as usual will use the form of a Q&A, hoping to entertain our readers in a light and interactive form.*

## Highlights

- Earnings revisions have continued to rise for both the fourth quarter of 2021, and for the full year 2022 and 2023, with growth expected to exceed 8% in both years.
- The inflation print this week, with the headline number at +6.8% year-on-year, was the highest in 39 years. However, it was also completely in line with expectations.
- Major global equity markets rebounded as concerns about the Omicron variant receded. Chinese equities also responded positively to the RRR cut for banks by the PBOC.
- Bitcoin prices continued to fluctuate with high volatility affected by a massive market for derivatives and year-end profit taking.
- The embattled Chinese developers sector had to surrender and acknowledge the need for a debt restructuring of two high-profile names – Evergrande and Kaisa.

"While the initial market momentum was provided by a wave of short covering, in our opinion the continued rally seems to be a confirmation of the equity market's robustness."

### Markets & Macro | Is the market ready to absorb accelerated tightening?

**Recovery reflects strong market fundamentals.**

The past week has seen major indices rebound strongly from the losses of late November/early December. Gains were well distributed between Europe and the US, and between growth versus value sectors, all in the region of 3-4%.

**Our view:** While the initial market momentum was provided by a wave of short covering, in our opinion the continued rally seems to be a confirmation of the equity market's robustness. This is underpinned by the strength of consumer sentiment (supported by a strong wealth effect and a recovering labor market), and the continued rise in earnings revisions. Earnings revisions have continued to rise for both the fourth quarter of 2021 (the release of which in early January will set the tone for the first few sessions of 2022), and for the full year 2022 and 2023, with growth expected to exceed 8% in both years.

This week's recovery not only reflects the strong fundamentals, but it is a sign that the market may be ready to absorb an acceleration of the taper/rate hike without too much trauma. The inflation print this week, with the headline number at +6.8% year-on-year, was the highest in 39 years. However, it was also completely in line with expectations, and should in any case mark the peak for this cycle, as from next month the base effects will become extremely favorable – at least for a normalization of the series.

The presence of the new variant, which arrived in the winter period when the seasonality of the virus would have already hit, as well as the Fed's reduced liquidity in the financial system, will certainly contribute to keeping volatility high in the coming months; but, as we showed last week with the divergence between the Nasdaq and non-profitable tech indices, the scenario is not necessarily bearish for quality stocks, both in the tech sector and elsewhere.

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Moreover, as far as the Fed is concerned, there is good reason to think that the market has incorporated a more hawkish but not overly austere attitude into prices. It is true that the Fed is rightly a pioneer in global monetary policy, but we must also consider the context in other countries. This week, for example, rumors picked up by Reuters have offered a preview of the ECB's approach to purchasing once the PEPP (pandemic emergency program) expires in March. In practice, sources inside the central bank have stated that the decision will still be taken in December and that the consensus is leaning toward increasing the existing program (the asset purchase program – APP) either with a new amount, or with a temporary increase in the size of the purchases. The purchases will still be smaller than the PEPP, but a form of "geographic flexibility" will be extended to the APP to avoid risks of market fragmentation.

Returning to the Omicron variant, cases in the UK have doubled every 2.5 days in the last two weeks, which is worrying in itself, and we read that health officials fear Omicron cases could rise to over a million by the end of the month. The rapid spread of this variant in a country with a high vaccination rate forces one to consider the potentially devastating ramifications for less vaccinated countries. At the same time, the Ministry of Health indicated that early data showed that Omicron caused only mild symptoms for fully vaccinated citizens.

## Equities | Into thin air

### Narrowing breadth rears its head.

Major global equity markets rebounded as concerns about the Omicron variant receded. The S&P 500 index ended the year at its highest level ever of 4,712. Despite the rally in Big Tech, the Nasdaq Composite index failed to reach its November high of 16,000, ending the week at 15,630. The small-cap Russell 2000 index also ended the week at the 2,212 level, around 9.5% below the November high.

"On Friday, Apple, Microsoft and Tesla alone represented 42% of the S&P 500's 0.95% daily return."

Meanwhile, Chinese equities responded positively to the Reserve Requirement Ratio (RRR) cut for banks by the PBOC. The magnitude of the cut was well-measured and far from the "bazooka" that some China bulls had hoped for.

**Figure 1: Global Equity Market Performance**

| | | Value | WTD % Chg | MTD % Chg | YTD % Chg |
|---|---|---|---|---|---|
| INDU Index | Dow Jones | 35,970.99 | 4.05% | 4.45% | 19.71% |
| SPX Index | S&P 500 | 4,712.02 | 3.84% | 3.22% | 27.14% |
| CCMP Index | Nasdaq | 15,630.60 | 3.62% | 0.62% | 22.06% |
| SX5E Index | Euro Stoxx 50 | 4,199.16 | 2.92% | 3.37% | 21.23% |
| SMI Index | Swiss Market | 12,607.73 | 3.55% | 3.68% | 21.16% |
| UKX Index | FTSE 100 | 7,291.78 | 2.38% | 3.35% | 16.81% |
| CAC Index | CAC 40 | 6,991.68 | 3.35% | 4.03% | 28.86% |
| DAX Index | DAX | 15,623.31 | 2.99% | 3.46% | 13.88% |
| FTSEMIB Index | FTSE MIB | 26,721.98 | 3.02% | 3.52% | 23.90% |
| NKY Index | Nikkei 225 | 28,437.77 | 1.46% | 2.21% | 5.20% |
| HSI Index | Hang Seng | 23,995.72 | 0.96% | 2.40% | -9.59% |
| SHSZ300 Index | CSI 300 | 5,055.12 | 3.14% | 4.74% | -1.27% |

Source: Bloomberg, as at December 10, 2021. Performance figures in indices' local currencies.

**Our view:** Despite the impressive recovery of the S&P 500 index, the weight of Big Tech as a percentage of the total S&P 500 market capitalization has been rising steadily. On Friday, Apple, Microsoft and Tesla alone represented 42% of the S&P 500's 0.95% daily return. Big Tech (Apple, Microsoft, Meta, Alphabet and Amazon) contributed around 38% of the S&P 500's 3.82% week-to-date return and around 65% of the Nasdaq 100's 3.95% week-to-date return.

The narrowing breadth of the market restarted in May and has been gaining strength ever since. Year-to-date (YTD), Big Tech has contributed 26% of the S&P 500 return, compared with a negative contribution in January 2021. If we include Tesla and NVIDIA (Big Tech+), the YTD contribution to the S&P return is 32%, and 47% April 2021 to-date.

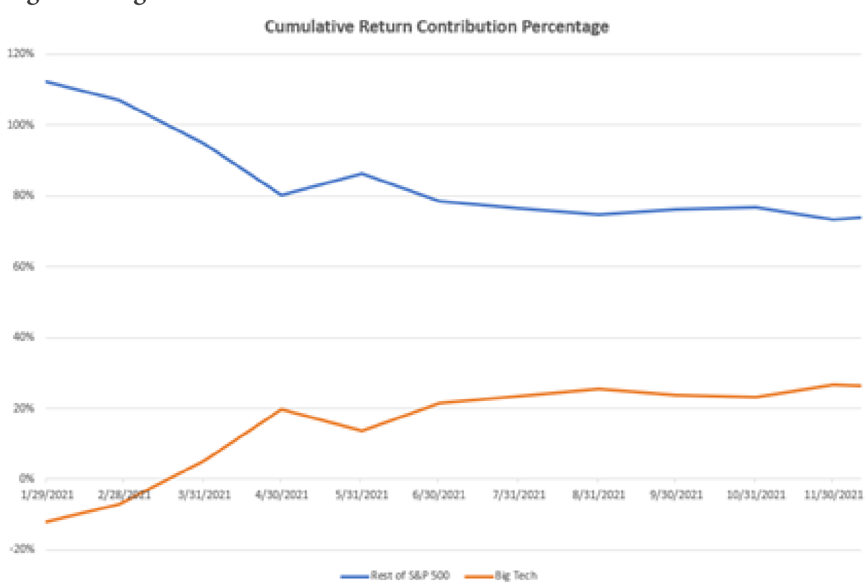
"The narrowing breadth in itself doesn't pose an imminent risk of a correction, but is rather a sign of flight-to-quality (earnings visibility) and light positioning in Big Tech..."

The narrowing breadth in itself doesn't pose an imminent risk of a correction, but is rather a sign of flight-to-quality (earnings visibility) and light positioning in Big Tech (according to Goldman Sachs data, mutual funds are underweight some of the largest stocks due to diversification requirements). Should Big Tech+ continue to outperform the S&P 500, this will pose a big challenge for active managers with diversification mandates.

Also, important to note that non-profitable tech, as measured by the Goldman Sachs non-profitable index, underperformed the S&P 500 for the week but outperformed Nasdaq. Yet the index is still -35% from the February 2021 high and down 18.5% YTD. The index was down 2% on Friday despite the S&P 500 and Nasdaq rally into the close.

Lastly, we have seen a few graphs circulating on social media lately, pointing out that the percentage of Nasdaq Composite members above the 200 day moving average has been declining steadily to around 35% today compared to 80% at the end of 2020. The point of these charts (with a very well selected time frame to create a certain illusion) points out there is risk to the Nasdaq index price. The reality is that if we extend the time period back to 2002, we find very little correlation between the Nasdaq's performance and the percentage of stocks above or below the 200 day moving average.

**Figure 2: Big Tech's Contribution to S&P 500 Returns**




Source: Bloomberg, as at December 10, 2021.

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## Chart of the week

The Ark ETF had another difficult week. Last week the stock's price broke the 50% Fibo's retracement at USD96 with large volumes, and recovered a bit. But the recovery was weak, and the rally turned in another leg of correction. We monitor the support at the USD96 level, if a break at the next support is at USD80.

**Figure 3: Ark ETF**


Source: Bloomberg, as at December 10, 2021.

"...the Ark ETF's recovery was weak, and the rally turned in another leg of correction."

## Crypto & Blockchain | Institutions open up to new world of blockchain

**Bitcoin prices remain volatile.**

Last week, the US House of Representatives Financial Services Committee hearing marked the first time the industry's senior leaders, including the top executives from six major cryptocurrency companies such as Coinbase and FTX, were hosted in the house. This is a clear change in momentum, as the institutions started to seriously approach the new world of the blockchain. Among the questions, Former US Acting Comptroller of the Currency, Brian Brooks, asked why the spot Bitcoin ETFs are safe in Germany, Brazil and Singapore, and not in the US. If this would be the case, GBTC's market price (which is trading at -18% discount) will close the gap to NAV's price.

Aside from this speculative topic, regulators showed their fear on how the rapid growth of cryptocurrencies and stablecoins could put the financial system at risk if not properly monitored. On the other side, industry representatives warned that overly tough restrictions would push the industry overseas.

**Market action:** Despite some positive remarks from the hearing, Bitcoin prices continued to fluctuate with high volatility affected by a massive market for derivatives (contracts based on the price of an underlying asset, in this case a cryptocurrency) and year-end profit taking. In a recent article, the Economist journal estimated that there are on average five times more bitcoin derivative trades than spot trades of the coin itself.

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Layer 1 and NFTs were the winners of this year while there is a big dislocation within DeFI tokens. As an example, top 5 Layer 1 coin's prices are trading at around 100 times revenue while we can find many DeFI projects trading from 1 to 2 times the revenue. We keep monitoring projects like Binance, Crypto.com and Uniswap tokens even if they are expensive tokens, as it reflects their solidity and popularity.

Solana suffered a rapid attack (most probably a DDoS attack which refers to many coordinated devices, or a botnet, shattering a network with fake traffic to take it offline), which was solved in a few hours on Thursday morning. The attack reduced the speed of the blockchain from over 2,000 transactions per second to a speed below 500. However, the network has remained online. In September Solana suffered an 18-hour outage that was only resolved after a hard restart while the coin suffered a flash crash during that weekend. Events like these raise concerns about the network's reliability.

## Fixed Income & Commodities | Chinese developers face debt restructuring

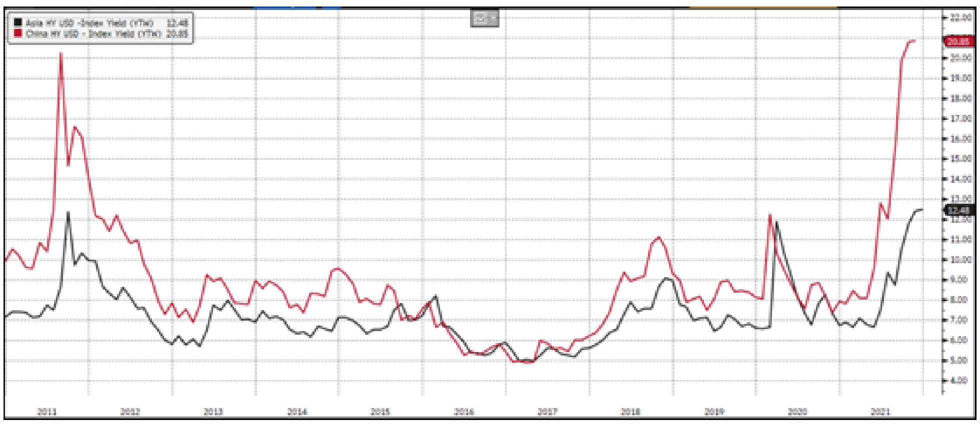
### Default rate will remain elevated.

"Chinese policy makers will almost certainly put international creditors (offshore bondholders) near the bottom of a priority list…"

This week, the embattled Chinese developers sector had to surrender and acknowledge the need for a debt restructuring of two high-profile names – Evergrande and Kaisa. The downgrade of Evergrande to "restricted default" may trigger cross defaults on Evergrande's USD19.2 billion of dollar debt. At the same time, Kaisa, already once emerged from a default in 2015, leaves behind USD11.6 billion outstanding bonds in default.

**Our view:** Bondholders are likely to have little control over what happens next. The power lies with China's Communist Party, including authorities from Evergrande's home province of Guangdong. A bailout is unlikely, with PBOC Governor Yi Gang saying on December 9 that Evergrande will be dealt with in a market-oriented way. Chinese policy makers will almost certainly put international creditors (offshore bondholders) near the bottom of a priority list that includes homeowners, employees, individual investors, suppliers and Chinese banks.

**Figure 4: Asia High Yield Bond Yields**




Source: Bloomberg, as at December 10, 2021.

"The potential for Asian high yield in 2022 will no doubt come from China's high yielding property due to extremely low valuations at present."

Yields are still hovering around levels never seen before and some signals of policy easing by the Chinese government are emerging to avoid widespread contagion risks. Numerous announcements by various bureaucrats linked to the forthcoming Policy Politburo in December indicate a continuing restrictive attitude toward the sector, but also measures to stabilize it, although macro loosening is modest.

The default rate in China's property bond market will continue to stay at elevated levels next year and higher rates will be a headwind for Asia's investment grade credit. But the potential for Asian high yield in 2022 will no doubt come from China's high yielding property due to extremely low valuations at present. At Novum, we are currently exploring the opportunity set.

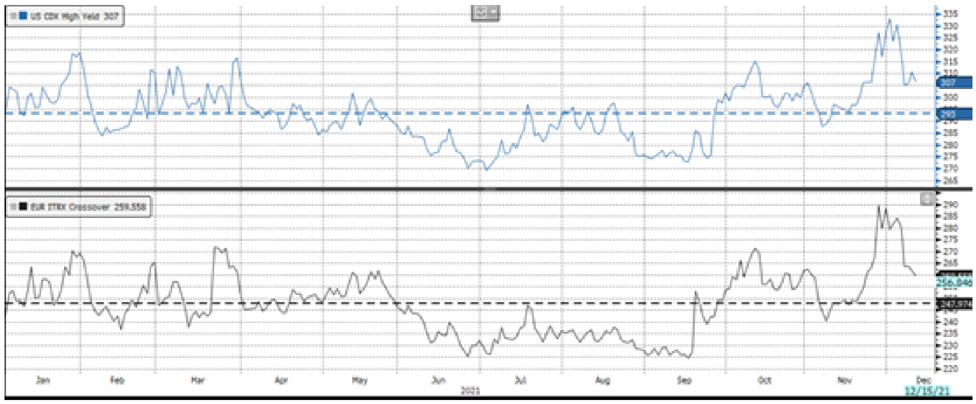
Elsewhere, in the primary market, US investment grade bond sales this week came in higher than expected, after two weeks of volatility caused companies to pay higher new issue concessions to get deals done. Borrowers paid less than 4 basis points (bps) in new issue concessions, driven by a massive order book oversubscription rate of 4.2x on average. Merck (A1/A+) led the way with an USD8 billion offering in five parts to help pay for its acquisition of Acceleron Pharma. Investors received the deal warmly, placing orders totaling USD33 billion at the peak of marketing, and Merck paid about 5-10bps in new issue concession. The offer included a 7-year sustainability bond with a yield of 50 bps above US Treasuries (1.90% 10/12/2028).

US junk bond sales sprang back to life mid-week with the high yield index posting its biggest one-day returns in more than 13 months. Broader junk bond index spreads tightened the most since November 2020 (Figure 4). Sentiment was helped by Fitch Ratings' report forecasting the US high yield default rate for 2021 at 0.5% (just below the record low set in 2007) and only a minor increase to 1% by the end of 2022.

“In Asia credit, Greenland Holding Group (Ba3, negative watch) became the first major Chinese real estate firm to sell a dollar bond in two months…”

In Asia credit, Greenland Holding Group (Ba3, negative watch) became the first major Chinese real estate firm to sell a dollar bond in two months, seeking to price a short-dated offering amid signs of easing curbs on the nation’s property sector. Greenland is the ninth-largest developer in China by contracted sales. The Shanghai-based developer is marketing an eight-month dollar note with final price guidance of 8% (7.974% 10/8/2022).

**Figure 5: US and EUR Spreads**



Source: Bloomberg, as at December 10, 2021.

## Week Ahead | Key events to watch for

- **Next week is decidedly about central banks**, with eight meetings taking place, with the Fed and ECB at the forefront. Of particular note is the Bank of England meeting, where were it not for the rapid release of the Omicron variant, a slight upside of 15 bps would have been fully expected.

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