NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Has inflation reached its peak?

June 13, 2021

When it comes to inflation, equity markets appear to really like the word “transitory”. This week, the US CPI report once again exceeded expectations with headline inflation out at 0.6% in May, versus the consensus of 0.5%. On a yearly basis, prices increased by 5%, which is the largest annual increase since August 2008. But details of the report showed reopening-sensitive categories dominating price pressures for the second straight month. Thus , there is the perception that this will be the peak of inflation for this cycle – suggesting that the worst is behind us.

Highlights

- Almost 60% of the month-over-month increase in US CPI came from six components — used cars, rental cars, vehicle insurance, lodging, airfares and food away from home.

- The ECB left its monetary stance unchanged, confirming that the pace of PEPP purchases will continue at a much higher pace than earlier in the year. It revised up its growth projections for the eurozone to 4.6% for 2021 (from 4% in March) and 4.7% for 2022 (from 4.1% in March).

- The S&P 500 index reached a record high this week, driven by tighter US Treasury yields, which boosted the valuation of long-duration assets. Healthcare stocks outperformed, thanks to Biogen’s gains on the back of the FDA’s approval of its Alzheimer’s drug.

- MicroStrategy has taken another step toward transforming itself from a software company into a Bitcoin repository, with the offering of the first-ever junk deal to fund Bitcoin purchases.

“...fixed income markets rallied hard both in the US and in Europe over the week, in a very counterintuitive reaction.”

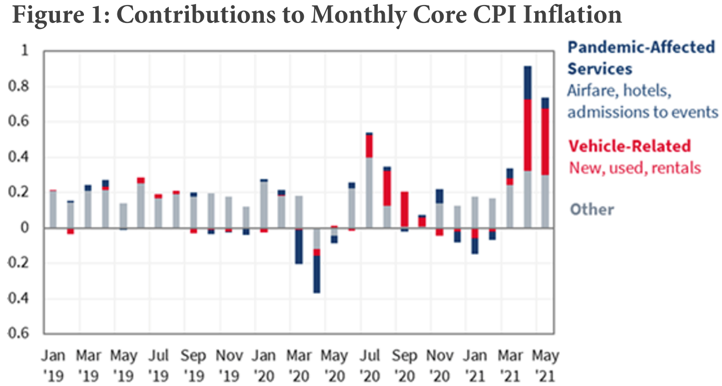
Markets & Macro | Has inflation reached its peak?

Central banks remain accommodative despite inflation spike.

The US CPI report came out with headline inflation at 0.6% in May versus the consensus of 0.5%. The core reading (ex-volatile energy and food components) also came out stronger-than-expected at 0.7%. On a yearly basis, prices increased by 5%, which is the largest annual increase since August 2008, while the core reading is up 3.8%, well above the Federal Reserve’s (Fed) long-term threshold of 2%.

Our view: However, details of the CPI report showed reopening-sensitive categories dominating price pressures for the second straight month. Almost 60% of the month-over-month increase came from six components — used cars, rental cars, vehicle insurance, lodging, airfares and food away from home. Thus , there is a perception (market betting) that this will be the peak of inflation for this cycle. This suggests that the worst is behind us and that upcoming data will be more benign.

Figure 1: Contributions to Monthly Core CPI Inflation



Source: BLS, CEA Analysis.

“In the current environment, it is difficult to think that the current benign pricing of the interest rate market can last much longer.”

Meanwhile, when it comes to inflation, equity markets appear to really like the word “transitory”. However, this week’s reading was the largest seasonally-adjusted increase in core CPI since 2008. At the same time, central banks’ support for asset price inflation continued this week, with ongoing support. Next week, the Fed’s meeting is scheduled to take place – but the market is betting on no surprise at all, with dovish members prevailing once more.

Elsewhere, fixed income markets rallied hard both in the US and in Europe over the week, in a very counterintuitive reaction. The move can certainly be explained by positioning, after a huge consensus was built around the reflation theme over the past few months. It seems clear that nobody has bonds to sell, even on these high numbers, in our opinion.

Positioning aside, it is easy to imagine that Thursday’s numbers will be snubbed by the Fed as much as the previous ones have been, as they show similar characteristics with a large contribution from categories that are temporarily distorted. The European Central Bank’s (ECB) stance this week only reinforces this feeling as they have confirmed their dovish message entirely, despite reopening and upgrading growth and inflation forecasts. The central bank left its monetary stance unchanged, confirming that the pace of PEPP purchases will continue at a much higher pace than earlier in the year. It revised up its growth projections for the eurozone to 4.6% for 2021 (from 4% in March) and 4.7% for 2022 (from 4.1% in March). However, the improved growth outlook would appear, for the ECB, to have a limited impact on inflation, which is seen below target in the medium term. Indeed, the headline inflation forecast for 2023 remained unchanged at 1.4%. Evidently, major central banks are not about to take their foot off the accelerator.

“...it is worth noting that unless central banks reverse course in the coming weeks (which is unexpected and unlikely in our view), the only surprises potentially affecting financial markets in the near term might come from geopolitics.”

The abundance of cash plays a role for long-dated US Treasuries as long as it does for other financial assets: this week showed an excess of cash in the US money market forcing investors further out on the yield curve. The Fed’s Reverse Repo Facility (a money market instrument used to drain liquidity from the market) jumped to an all-time high of USD535 billion. Another element of support for US Treasuries was the recent fading of Biden’s infrastructure bill – at least in magnitude. In fact, the House and Senate leaders are working on infrastructure spending plans, but no easy solution on how to pay for the investments seems to be in sight.

In the current environment, it is difficult to think that the current benign pricing of the interest rate market can last much longer. Even the normalization of the temporary components will not allow inflation to reach levels consistent with a US 10-year Treasury below 1.5%, nor that the US economy will be consistent with real rates at -0.87%.

At this point, it is worth noting that unless central banks reverse course in the coming weeks (which is unexpected and unlikely in our view), the only surprises potentially affecting financial markets in the near term might come from geopolitics. In fact, the pressure on China from the US and Europe to clarify the origins of the virus is intensifying. The publication in the Wall Street Journal of a report showing that the hypothesis of a laboratory origin is plausible is likely to increase tensions between China and other countries. Further, President Biden used the G7 meeting to engage allies in a common front against China. This tactic has been evident since the start of the presidency and is the main change from Trump's isolation, in the context of an approach that remains hostile, albeit with a greater tendency towards dialogue. The Chinese authorities, for their part, have accelerated the implementation of a package of retaliatory measures in response to Washington's action.

Chart of the week

Last week, we wrote about where the 10-year US Treasury was in mid-March – when we thought that the widening had gone too far and too fast, with the (weekly) RSI at an extreme. Ahead of the next FOMC meeting, we are looking at some fast indicators, including the daily RSI, to find short-term support for where to add to our short position on 10-Year US Treasury note futures. Figure 2 shows the Fibonacci (range 0.5% to ~2%) level to indicate the entry point of our trade.

“Ahead of the next FOMC meeting, we are looking at some fast indicators, including the daily RSI, to find short-term support for where to add to our short position on 10-Year US Treasury note futures.”

Figure 2: 10-year US Treasury

Source: Bloomberg, as at June 11, 2021.

Equities | European equities remain a safe haven

Swiss stocks lead performance.

The S&P 500 index reached a record high this week, driven by tighter US Treasury yields, which boosted the valuation of long-duration assets – in particular, technology stocks. Healthcare stocks outperformed, thanks to Biogen’s gains on the back of the FDA’s approval of its Alzheimer’s drug.

Meanwhile in Europe, stocks gained on the back of the ECB’s decision to continue its bond purchasing activity. Chinese equities lost ground for the second consecutive week as credit data for May showed slowing new credit growth.

Figure 3: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,479.60	-0.78%	-0.10%	13.65%
S&P 500	4,247.44	0.43%	1.08%	13.83%
Nasdaq	14,069.42	1.85%	2.36%	9.50%
Euro Stoxx 50	4,126.70	0.91%	2.18%	18.29%
Swiss Market	11,841.30	2.34%	4.21%	13.68%
FTSE 100	7,134.06	0.94%	1.68%	12.29%
CAC 40	6,600.66	1.36%	2.46%	20.98%
DAX	15,693.27	0.00%	1.76%	14.39%
FTSE MIB	25,717.42	0.57%	2.17%	17.28%
Nikkei 225	28,948.73	0.02%	0.31%	6.23%
Hang Seng	28,842.13	-0.21%	-0.89%	7.16%
CSI 300	5,224.70	-1.01%	-1.81%	0.67%

Source: Bloomberg, as at June 11, 2021. Performance figures in indices' local currencies.

“The price moves of the last week had a lot to do with positioning rather than facts, in our opinion.”

Our view: Despite peak positioning levels, sentiment indicators have been retreating from their highs, with inflows into stocks slowing down and tech outflows continuing for the fifth consecutive week (according to BAML data).

The price moves of the last week had a lot to do with positioning rather than facts, in our opinion. Light volumes across the board make it dangerous to try to derive conclusions from any recent price moves. However, European equities’ continued their solid performance, especially Swiss stocks more recently. This highlights the continued search for safe havens ahead of the typical summer lull. Consumer staples’ strong outperformance on a quarter-to-date basis confirms investors’ preference for inflation hedges outside the possible full-priced materials sector.

We expect this trend to prevail over the next few months as investors grapple with the nature of inflation (transitory or not), and as we await for clarity on how inflation will affect purchasing power and spending.

Fixed Income & Credit | Bonds meet Bitcoin

Investors try Bitcoin through 7-year junk bond.

MicroStrategy (Ba3/B-) has taken another step toward transforming itself from a software company into a Bitcoin repository, with the offering of the first-ever junk deal to fund Bitcoin purchases. The original plan to sell USD400 million was so well received that the deal was increased to USD500 million and managed to lock in lower pricing. The bond was issued with a 6.125% yield for a 7-year maturity (15/06/2021), and net proceeds will be used to acquire additional Bitcoins.

"...one wonders why there was so much demand when there are more straightforward and potentially more lucrative ways to invest in Bitcoin, like just buying Bitcoin itself."

Our view: While it is ok to offer a novel way to put money into the cryptocurrency, one wonders why there was so much demand when there are more straightforward and potentially more lucrative ways to invest in Bitcoin, like just buying Bitcoin itself. Some of that demand came from investors who want Bitcoin exposure but cannot buy the digital coins outright because of how their funds are structured. Moreover, as US regulators continue to make it difficult for efforts to list Bitcoin ETFs, corporate debt is a safe way for a wide range of institutional investors. So, dipping a toe into Bitcoin through buying 7-year debt yielding north of 6% is a pretty good return for a junk bond issued by a company with a credit profile like MicroStrategy. Buyers were also lured by the protection inherent to secured bonds. The notes and the related guarantees will be backed by MicroStrategy's and the guarantors' assets, including any Bitcoins or other digital assets acquired on or after the closing of the offering, but excluding existing Bitcoins.

Meanwhile, in the primary market, with the ECB confirming that emergency bond buying would continue at a "significantly higher pace" despite substantial upward revisions to the economic outlook, the recovery trade has continued undaunted. And the market has again demonstrated that names most hit by the pandemic are able to issue on attractive financing terms. Beauty product producer Coty (Caa1/B-) sold EUR700 million notes due in 2025 to repay part of a term loan. Helped by the secured format, the bond was rated "B3/B-" and priced at a yield of 3.875%, well below the initially marketed 4-4.25% range. Demand was so strong that it enabled an upsize of the offering by EUR200 million.

Another example of money managers piling up on higher yielding paper is the case of Greek lender Piraeus Financial Holdings SA, which offered a deeply subordinated Additional Tier 1. The Greek bank seized the moment to take advantage of investors' desperate hunt for yield and capitalize on the fact that Greece is set to get EUR32 billion from Europe's pandemic funds to help revive the economy. Piraeus, which completed a EUR1.4 billion- equity raise earlier this year, is in the process of reducing its huge bad loan ratio (45% at the end of 2020) to a target of 10%. The order book was above EUR2.25 billion and the coupon was fixed at 8.75%, well below the 9-9.25% initially marketed. Still, this is about three times the average for similar Additional Tier 1 notes, the riskiest type of debt that banks sell.

Week Ahead | Key events to watch for

- **The Fed meeting is the last big event before the summer pause.** No action is highly expected, but we will see new economic forecasts. It will be interesting to see if the Fed modifies its stance on elevated inflation readings, so far treated as "transitory".

- **In the US,** PPI, Philly Fed, NY Empire, retail sales and industrial production will be published. China will also publish updates on retail sales, fixed asset investments, industrial production and the unemployment rate.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager