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Weekly Market Flash

Has the normalization begun?

November 13, 2022

This week finally saw a positive surprise, with the US headline CPI for October coming in at 7.7% year-over-year (YoY), compared to a consensus of 7.9% YoY. The market's response was exceptional, and performance was a function of the sensitivity of assets to interest rates. For instance, the Nasdaq index rose 8.8% on the week, but the ARK fund was up 14.7%! However, all global stock markets did well, with the MSCI World index up 6.6%. At the same time, it is obvious that with only one favorable inflation figure, and with a labor market that is still decidedly tight, we cannot in the slightest think that the battle of the central banks is over—and that we can return to the previous paradigm. But the news remains extremely positive and should be welcomed. The normalization of the emergency had to start somewhere.

Highlights

▪ Following the inflation surprise, the market sees the end of tightening and is discounting a more accommodative monetary policy, with the Fed Funds terminal rate falling by over 50 basis points (bps), to 4.90%.

▪ Rumors in China of an easing of anti-Covid measures were finally confirmed by the authorities, after a couple of weeks in which uncertainty, and even denial by the authorities, prevailed.

▪ US Treasuries performed well across the board, with the 2-year yield down 32 bps for the week and the 10-year benchmark down 34 bps. The same dynamic was evident in Europe, with yields on the 10-year Bund to 2% (-17 bps), and BTPs to 4.04% (-41 bps).

▪ In the primary credit market, US high grade issuance is running about 12% behind last year's pace, and Europe's debt market has been even more sluggish, with issuance falling about 20% from last year.

▪ Last week we witnessed a Lehman moment on the digital world. The question is, who will intervene to restore trust in a world dominated by moral hazard and greedy fresh billionaires?

"The benign CPI figure has clashed with the Fed's rhetoric and analysis over the past few months..."

Markets & Macro | Has the normalization begun?

Waiting on the Fed's response.
The decline in the US headline from September is noticeable, when inflation had peaked for this cycle at 8.2%. And the core figure was even better, up only 0.3% month-on-month and 6.3% YoY versus the consensus of 0.5% 6.5%, respectively.

The benign CPI figure has clashed with the Federal Reserve's (Fed) rhetoric and analysis over the past few months, which has been extremely aggressive and focused on fighting inflation, despite the obvious deterioration in the macro picture—which led to the inflation surprise through a moderation in demand. The market sees the end of tightening and is discounting a more accommodative monetary policy, with the Fed Funds terminal rate falling by over 50 basis points (bps), to 4.90%.

> "After Thursday's favorable data, the market rightly limited itself to ruling out the possibility of a 75 bps rise at the next meeting..."

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

Equity	Last Value	Ytd
MSCI World	2,674.08	-15.66%
Nasdaq	11,323.33	-27.11%
S&P 500	3,992.93	-15.07%
DJ Industrial	33,747.86	-5.50%
Nikkei	28,263.57	0.18%
Eurostoxx	3,868.50	-7.10%
Swiss SMI	11,127.15	-11.11%
FTSE 100	7,318.04	2.36%
Canada	20,111.51	-2.71%
Shenzen	3,788.44	-21.68%
Hong Kong	17,325.66	-23.47%
MSCI EM	935.73	-21.89%

Bond Indices	Last Value	Ytd
US Inv Grande	104.57	-19.10%
US High Yield	74.45	-10.85%
Euro Corps	227.83	-13.58%
JPM Europe Govies	9,399.99	-11.62%
US Treasuries	2,171.46	-13.14%
China Aggregate	250.50	-6.97%
EMBI Global	736.85	-19.87%
EMBI Local	119.29	-13.38%

Commodities	Last Value	Ytd
BBG Commodities	116.88	17.86%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	68.28	12.32%
Gold	1,771.24	-3.17%
Silver	21.70	-6.88%
BBG Brent Crude TR	1,142.62	52.56%
BBG WTI Crude Oil TR	209.36	36.74%

FX	Last Value	Ytd
DXY Index	1,275.89	8.73%
Bbg JP ASIA	99.00	-8.38%
Bbg JP LATAM	39.79	-2.67%
EUR Index	119.64	-0.93%
EUR/CHF	0.97	-6.06%
GBP Index	622.01	-8.91%
EM FX Index	1,627.42	-6.17%
JPY/USD	138.81	-17.10%
CNY/USD	7.10	-10.44%
Bitcoin	16,792.46	-63.76%

Source: Bloomberg, as at November 11, 2022. Performance figures in indices' local currencies.

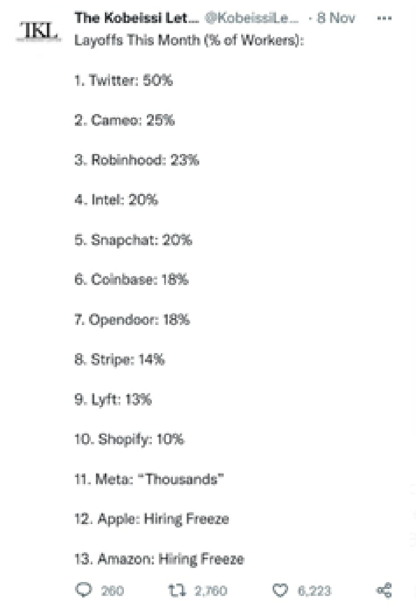
Our view: The coming weeks will therefore be crucial in understanding the Fed's response to market movements. In the last two days of the week, some signs of easing by Fed Governors were seen. Then will come a further hike in December (by 50 bps and no more than 75 bps), but above all, the economy must absorb the heaviest dose of rates hikes, which occurred between September and November.

As we've previously said, we are still a long way from the 2% inflation target level considered optimal by the Fed, but right now what matters is the direction. On top of this, it will help the weakness of the economy, which is only now beginning to respond to the 375 bps of hikes made during this cycle, to which at least another 50 bps will be added in December. In fact, this is what we are talking about: after Thursday's favorable data, the market rightly limited itself to ruling out the possibility of a 75 bps rise at the next meeting, reducing it to 50 bps. At the same time, let's not forget that between now and the meeting, we will still see a labor market report (first week of December), and another inflation figure (second week of December).

> "The news of significant layoffs continues to arrive for different reasons, but still attributable to the rise in rates."

With regard to the labor market, among other things, the news of significant layoffs continues to arrive—in particular in two opposing sectors—for different reasons, but still attributable to the rise in rates. On the one hand, real estate, which is seeing a real collapse of business. On the other hand, tech, which is suffering due to the financial downsizing of valuations (and therefore access to cheap capital), in addition to the decline in advertising revenue, which is the main source of income for the most important platforms. Figure 2 provides a concise recap of the most striking layoff announcements in the tech sector.

Figure 2: Layoffs in the Tech Sector



Source: Twitter, as at November 11, 2022.

"Unlike in the past, when the Fed refrained from commenting on stock market rises, this time we expect again hawkish—if not annoyed—comments should we cross that area."

A second element of impetus to the market came from China, where rumors of an easing of anti-Covid measures were finally confirmed by the authorities, after a couple of weeks in which uncertainty, and even denial by the authorities, prevailed. Specifically, it was announced that quarantine for travelers arriving from abroad will be reduced to five days from seven, a negative test obtained in the two days preceding the flight will be sufficient for travel, and close contacts of those testing positive will no longer be subject to quarantine. There will be no more mass swabs in regions with outbreaks, and an end to the penalization of airlines that have imported the most cases. While this is nothing like the level of freedom in the western world (which has long since been completely normalized), the direction is still the right one. Asian stock markets responded accordingly, and with them the whole commodity block.

"At levels above 4'000 for the S&P 500 index, an economic recession (which we strongly believe is about to start) is not priced in at all."

As far as the market is concerned, and in particular we are referring to the S&P 500 index, at this point it is important to make some general reflections. As expressed recently, we start from our neutral positioning taken last month after the decision to increase the equity exposure in our asset allocation. That was a purely tactical decision, based on technical factors and the view that inflation was an 'old' theme by which investors got obsessed. Our target for this phase is in the 4,000 – 4'100 area (which, given the violence of the movements, is being reached much earlier than expected, putting us in front of an early decision). The main reason is that the recovery of the index, this time combined with strong US dollar weakness and a fall in yields, constitutes an abrupt, and unwanted, easing of financial conditions. We expect the Fed push back soon, as the message to keep financial conditions tight for some time has been very clear, as a tool to slow consumers' demand. So unlike in the past, when the Fed refrained from commenting on stock market rises, this time we expect again hawkish—if not annoyed—comments should we cross that area.

One final point, which is certainly premature today, but which we will probably elaborate more on in the future, is that our bet is that the last leg of the market's decline will occur just as earnings fall. It may seem contradictory in the current environment (given inflation fears), but our view is that with prices falling it will be corporate profits that will suffer, while multiples have already had their structural adjustment. At levels above 4'000 for the S&P 500 index, an economic recession (which we strongly believe is about to start) is not priced in at all. An economic contraction would lower corporate revenues, and as a consequence of operational leverage, earnings would fall by a much bigger number.

Fixed Income | Bond curves are inverting

Spreads remain wide, liquidity dries.

"Indeed, even with the surge in risk sentiment, yield curves measure (historically a good signal of future recession), are in inversion territory."

US inflation finally cooled in October, by more than forecast, giving Fed officials room to slow down their steep interest rate hikes. Investors pared their Fed rate hike bets for December and cut their forecast for the peak rate next year to below 5% (4.9%, sometime around May instead of 5.09%, and 4.40% for end-2023, signaling confidence a of rate cut).

Our view: Against this background, US Treasuries performed well across the board, with the 2-year yield down 32 bps (4.33%) for the week and the 10-year benchmark down 34 bps (3.815%). The same dynamic was evident in Europe, with yields on the 10-year Bund to 2% (-17 bps), and BTPs to 4.04% (-41 bps). However, inflation at a near 8% will not persuade the Fed to change course. Indeed, even with the surge in risk sentiment, yield curves measure (historically a good signal of future recession), are in inversion territory. Not only in the US, but even in Europe. With the European Central Bank firmly committed on bringing inflation back toward target, but already conceding that Euro zone economic growth is bound to weaken, an inversion of the German yield curve (the red line) is by now a reality.

Figure 3: Government Bond Curves Invert

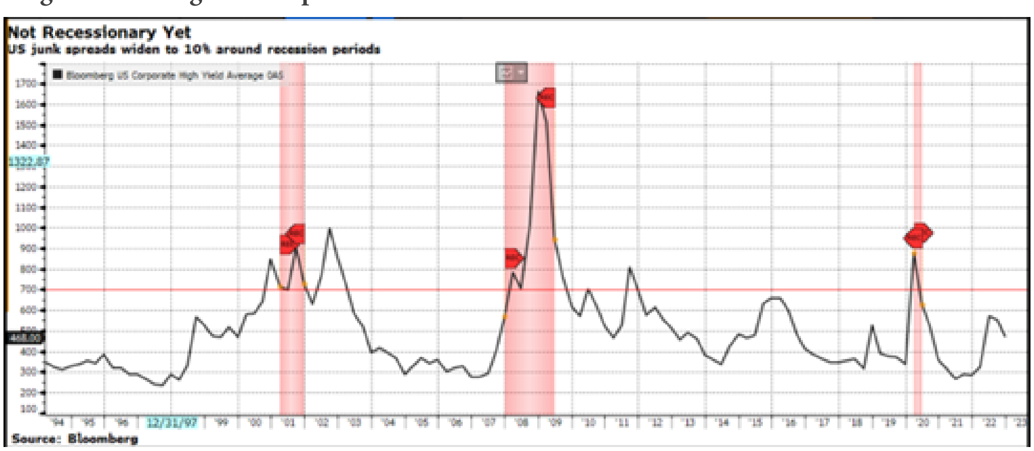
Source: Bloomberg, as at November 11, 2022.

"European junk spreads are at levels consistent with a Eurozone recession without an accompanying financial crisis."

On this gloomy horizon, what are the conditions of the credit market? In Europe, which has been at the forefront of economic disruptions caused by the war and the consequent energy inflation, high yield credit spreads have unsurprisingly widened.

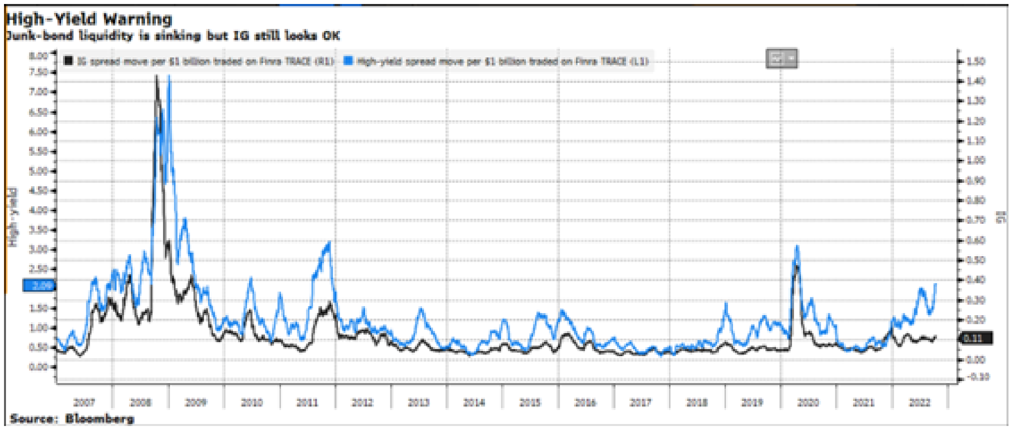
While spreads are far less wide than what we observed during either the Global Financial Crisis or the sovereign crisis, we are nearly at the level seen at the peak of the Covid panic. All in, European junk spreads are at levels consistent with a Eurozone recession without an accompanying financial crisis. In the US, spreads have also widened significantly this year.

Figure 4: US High Yield Spreads



Source: Bloomberg, as at November 11, 2022.

Figure 5: Liquidity is Sinking



Source: Bloomberg, as at November 11, 2022.

"Indeed, even with the surge in risk sentiment, yield curves measure (historically a good signal of future recession), are in inversion territory."

In conclusion, the US and German government bond curves are inverted. European junk spreads are at levels consistent with a Eurozone recession. In the US, junk spreads are not yet at levels indicating an economic contraction, thanks to elevated energy prices. Liquidity in junk bonds is fracturing, but not yet at stress levels. When this happens, the countdown to recession can begin in earnest. Our view remains cautious. In credit we advise to stay up in quality and seniority, and invest in short maturities of investment grade corporate bonds.

In the primary market in general, the context remains tough: US high grade issuance is running about 12% behind last year's pace and Europe's debt market has been even more sluggish, with issuance falling about 20% from last year. That said, this week, global corporate bond markets burst back to life as companies have emerged from earnings blackout periods and seized on a better credit market tone. However, some deals have struggled. Credit Suisse Group had to pay a yield of more than 9%, levels more consistent with junk bonds, on a 11-year fixed-to-floating rate US dollar bond it sold this week. It also offered euro-denominated notes with a stunning 7.75% coupon—the second highest ever for a new senior investment grade bank deal in euros.

"European junk spreads are at levels consistent with a Eurozone recession without an accompanying financial crisis."

Cryptocurrencies | When it rains, it pours

A new wave of crypto deleveraging is underway.

In an industry as fast-paced as cryptocurrency, adaptation to the notorious sins of the traditional banking system has also been rapid. Last week we witnessed a Lehman moment on the digital world. The question is, who will intervene to restore trust in a world dominated by moral hazard and greedy fresh billionaires?

Sam Bankman-Fried, better known as SBF, has a reputation for being the smartest guy in the room. Fellow student of MIT, he studied physics, math, and computer science, ending up in a career as an arbitrageurs trader at Jane Street Capital from 2014 to 2017. He is smart, that some people have compared his role during the recent crypto rout to the financier JPMorgan during the crisis of 1907. He is also smart to control both one of the largest crypto exchanges (FTX) and one of the largest crypto hedge funds (Alameda Research). This is also a bad conflict of interest.

This is something that the US regulation started to deal with in 1933 with the Glass–Steagall legislation. The emergency legislation that was passed within days of President Franklin Roosevelt taking office in March 1933 was just the start of the process to restore confidence in the banking system. Later, after the 2008 banking collapse, the framework was developed and updated to the Volcker Rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act. So, when the adoption of the technology is compared to the adoption of the internet in early 2000, it is also worth showing that the regulation is at the early stage of the 1930s.

"The article was a good chance for Binance to attack FTX, announcing it was ready to reverse owner of 500 million worth of FTT token."

On November 2nd, a report from CoinDesk public showed how "the majority of the net equity in Alameda is actually FTX's own centrally controlled and printed-out-of-thin-air token [specifically, the FTT token]". What's this token? FTT is the native cryptocurrency token of the crypto derivatives trading platform FTX that launched on May 8th, 2019. Among its use cases, such a tool to distribute the profit from trading from FTX, FTT are leveraged tokens, which allow traders to put leveraged positions without the need to trade on margin. If a trader wants to short Bitcoin with 3x leverage, they can simply buy a 3x short Bitcoin leveraged token on FTX.

This purported leak of Alameda's financials demonstrates that the firm's largest asset is its holdings of "FTX Token (FTT)," issued by none other than SBF's FTX Exchange. The FTT token on Alameda's balance sheet is roughly a third of their total assets and equal to 88% of Alameda's net equity. In other words, the firm's largest asset is a crypto token issued by SBF's other company, with a very significant portion of their assets in tokens issued by other related parties. According to CoinDesk's report, Alameda owned USD5.8 billion FTT Token—equivalent to 180% of the total circulating supply of the tokens. Alameda's debt, (collateralized by FTT) in addition to being a lender for FTX clients, is famous for being a counterparty to failed cryptocurrency banks Voyager and BlockFi at the time of 3AC's bankruptcy. Changpeng Zhao, the CEO of Binance, took the news at leap announcing he was selling all of their remaining USD530 million FTT holdings, citing "revelations" about FTX. This spooked the market, leading to the dramatic ~80% decline over the last few days. The article was a good chance for Binance to attack FTX, announcing it was ready to reverse owner of 500 million worth of FTT token.

When it rains, it pours. After the tweet, on Sunday FX saw roughly USD5 billion of withdrawals, the largest by another huge margin. As admitted by SBF, the liquidity of FTX was 0.8x Sunday's withdrawals. Alameda started to Defend the USD22 level of FTT, until Binance announced that it would walk away from an initial offer to acquire its competitor FTX after a review of the company's structure and books, the crypto exchange said in a statement. The market soon realized that they will never be able to cash in a significant portion of FTT to pay back its debt, so the fair market value of their FTT in the event of large sales would rapidly approach USD0.

"Bitcoin has no connection to the FTX debacle, but sentiment swings tend to affect all in crypto."

Our view: What happens after the dust settles? Bitcoin has no connection to the FTX debacle, but sentiment swings tend to affect all in crypto. A new wave of crypto deleveraging is underway. More problematic is that the number of entities with stronger balance sheets able to rescue those with low capital and high leverage is shrinking within the crypto ecosystem. Nikolaos Panigirtzoglou, head of cross asset research, alternative and digital assets at JPMorgan, stated, "One way of thinking about the downside over the coming weeks is the Bitcoin production cost which historically acted as a floor for the Bitcoin price. At the moment this production cost stands at USD15,000 but it is likely to revisit the USD13,000 low seen over the summer months, implying a decline of around 20%-25% from here."

It is worth highlighting a key point in the Satoshi Nakamoto white paper: "making payments over a communications channel without a trusted party". There is nothing trustless in a centralized exchange, which is gambling with users' funds using significant leverage and have little regulatory oversight to care about risk management. Centralized crypto exchange and stablecoins should be regulated like banks for the long-term viability, credibility and stability. In this jungle, the survivors will likely take the spoils and dominate.

Week Ahead | Key events to watch for

- **Next week will be important to monitor the state of the US consumer,** both through economic data and corporate results. We will see retail sales, the housing market, and quarterly reports from Walmart and Home Depot.

- **There will be important global companies reporting earnings:** technology giants in China (Tencent and Alibaba), while in Europe and the US we will see Siemens, NVIDIA and Cisco, closing out the earnings season.

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