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Weekly Market Flash

Tensions ahead between the markets and the Fed

May 14, 2023

The week was an uncertain one for global markets, with marginal losses for the major equity indexes. The trend of the single days was often schizophrenic, with continuous changes of market direction depending on the news that came in from the macro front, monetary policy, and US domestic policy—especially as the debt ceiling debate heats up in view of the now imminent June 1 deadline.

Highlights

▪ The US is nearing its debt limit of USD31.4 trillion, and if it defaults by June 1, there could be several negative consequences such as non-payment to entities like Social Security recipients and Treasury securities holders, credit rating downgrades, higher borrowing costs, and a partial government shutdown.

▪ The T-bills curve has become distorted with the T-bills maturing before June 1 trading at a significantly lower yield than the longer-dated issues one. For instance, the T-bill maturing June 1 has seen its yield surge more than 100 bps this month alone to 5.46%.

▪ The US banking index has now lost 27% since the beginning of the year, after 3.5% this week.

▪ There was some confirmation of the slowdown underway, mainly from initial jobless claims, which have been steadily above 250,000 over the last few weeks after being below 200,000 over the last 12 months. The consumer confidence from the University of Michigan was also down six points.

▪ The Bank of England raised its rate to 4.5%, the highest level since 2008, and another hike in June is expected.

▪ In the hedge fund industry, there has been a growing dominance of the multi-strategy managers model. The growth these managers have experienced since 2018 has outpaced the industry.

"The US banking index has now lost 27% since the beginning of the year, after 3.5% this week."

Markets & Macro | Tensions ahead between the markets and the Fed

The effect of the rate hikes is beginning to be felt.
From a macro point of view, the most relevant data published this week was the US Senior Loan Officers' Opinion Survey on Bank Lending Practices (SLOOS).

“…small banks are being forced to liquidate loss-making assets to meet liquidity needs, large banks are simply losing profitability…”

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

Equity Indices	Last Value	Week	Ytd
MSCI World	2,814.86	-0.15%	9.20%
Nasdaq	12,234.49	0.03%	17.26%
S&P 500	4,109.02	-0.60%	7.66%
S&P Equal Weighted	5,742.81	-1.07%	0.72%
DJ Industrial	33,168.30	-1.44%	0.78%
Japan Nikkei	29,388.30	1.51%	13.80%
Eurostoxx 50	4,317.88	-0.04%	16.35%
Swiss SMI	11,564.73	0.24%	10.91%
UK FTSE 100	7,754.62	0.83%	5.69%
Canada TSX	20,407.56	-0.57%	6.50%
Shenzen CSI	3,937.76	-3.06%	1.80%
Hong Kong HS	19,627.24	-3.17%	-0.23%
MSCI EM	977.82	-0.36%	3.00%

Commodities	Last Value	Week	Ytd
BBG Commodities	101.21	-1.70%	-10.28%
BBG Agriculture	66.45	-2.23%	-3.45%
Gold	2,014.34	-0.12%	10.43%
Silver	23.96	-6.63%	0.04%
BBG Brent Crude TR	940.23	-1.63%	-11.46%
BBG WTI Crude Oil TR	169.69	-1.61%	-11.29%

FX	Last Value	Week	Ytd
DXY Index	1,231.06	0.96%	-1.25%
EUR/CHF	0.9745	-0.70%	-1.52%
GBP Index	640.11	-0.66%	2.77%
EM FX Index	1,689.81	-0.29%	1.76%
USD/JPY	135.70	0.67%	3.49%
USD/CNY	6.96	0.71%	0.86%
Bitcoin	26,329.33	-10.82%	59.19%

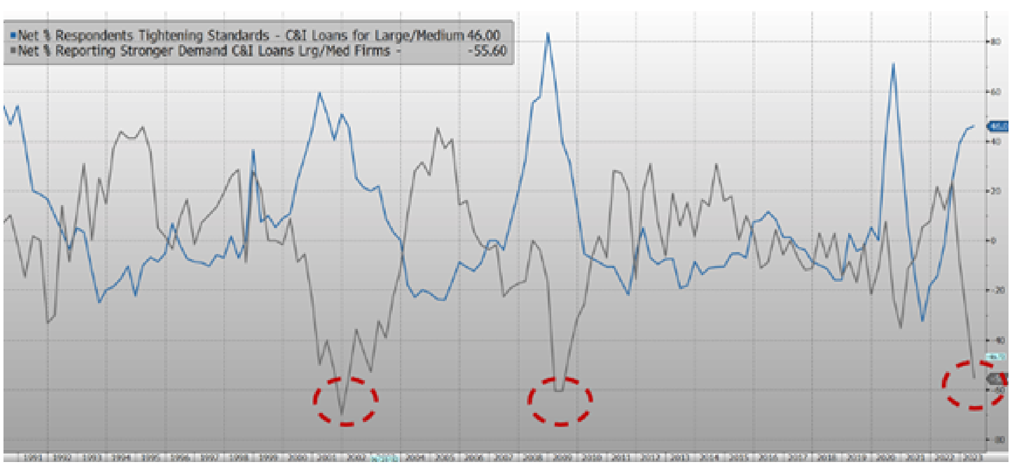
Equity Sectors	Last Value	Week	Ytd
S&P Value	150.39	-1.14%	4.17%
S&P Growth	64.62	-0.10%	10.79%
S&P Defensives	1,580.98	-0.11%	3.38%
ARKK Fund	37.71	0.86%	20.71%
Fangs	6,338.17	2.84%	42.57%
S&P Banks	72.20	-3.97%	-27.39%
Euro Stoxx Banks	78.30	1.11%	10.63%
S&P Energy	78.30	-2.41%	-9.57%
Gold Miners	33.54	-5.27%	17.01%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	108.45	-0.09%	4.22%
US High Yield	74.37	-0.52%	3.02%
Euro Corps	234.12	0.24%	2.84%
JPM Europe Govies	9,804.05	0.44%	6.22%
US Treasuries	2,273.02	0.24%	3.87%
China Aggregate	260.34	-0.30%	1.99%
EMBI Global	792.12	0.44%	3.10%
EMBI Local	131.08	-0.46%	5.97%

Source: Bloomberg, as at May 12, 2023. Performance figures in indices' local currencies.

In Figure 2, which presents the supply and demand balance of credit for medium/large companies, the headline figure (the blue line) shows the net percentage of banks that tightened lending standards for commercial and industrial (C&I) loans to 46%. The figure is not too bad (worse was feared in the wake of the regional bank crisis), but it is still in line with a GDP contraction. Needless to say, the dynamics were more evident at the smaller banks, consistent with the crisis of the regional banks.

Figure 2: Tightening Lending Standards



Source: Bloomberg, as at May 12, 2023.

“The US consumer has been the prop of the US economy for the past two quarters, supported by the labor market and the savings accumulated during the pandemic.”

Evidently, the effect of the rate hikes of the past 18 months on the economy and the banking system is beginning to be felt. There are now many alternatives to bank deposits with attractive yields being offered to borrowers. The consequence is what we are seeing: small banks are being forced to liquidate loss-making assets to meet liquidity needs, large banks are simply losing profitability (central bank funding is extremely expensive, well below the yields offered by long-dated US Treasury bonds), and they have less room to lend anyway. The US banking index has now lost 27% since the beginning of the year, after 3.5% this week.

But the most surprising part of the survey concerns the demand side for loans (the gray line). The US consumer has been the prop of the US economy for the past two quarters, supported by the labor market and the savings accumulated during the pandemic. As can be seen from Figure 2, such low levels of demand for credit have only been seen to coincide with the recessions of 2001 and 2008.

“...the coming weeks will see a lot of tension between markets and the Fed, should the Fed's language not begin to change, endorsing market pricing on rates...”

On the economic front, some confirmation of the slowdown underway arrived this week, mainly from initial jobless claims (steadily above 250,000 over the last few weeks after being below 200,000 over the last 12 months) and the consumer confidence from the University of Michigan (down six points relative to past month). The worst part is that inflation expectations embedded in this series jumped to 3.2% over 5-10 years from 2.9% the month before, serving as a reminder to the Federal Reserve (Fed)that it probably cannot afford to ease monetary tightening just yet.

Our view: Against this backdrop, we took the opportunity to take stock of the market, the scenario that bonds and equities suggest, and the main risks of something going wrong. We have commented in the past on the divergent signals offered by interest rates and equities. Indeed, rates are discounting as many as three rate cuts between now and the end of the year. Stock markets, for their part, have discounted a mini-contraction of earnings over the next 12 months (of around 5% year-over-year), and expanding multiples (we are back almost to 19, after a low of 16 for the P/E of the S&P 500 index).

What is becoming suspicious is the composition of returns within the main indexes. In fact, the S&P equal weighted index is barely up for the year (0.7%), while the commonly followed S&P 500 index is up 7.88%. The FANGs, instead, are up 42%! This means, as we showed our clients in our quarterly presentations recently, that all returns are concentrated within six to seven stocks, with the rest of the market flat or negative. Further, we also showed that the driver of the FANGs’ performance lies with the rising multiples rather than improved profitability.

The mix of earnings-multiples for the S&P 500 index, in our view, is not so far-fetched, but it implies that all is well on the economic front (i.e., that the recession is soft, and likely around a couple of negative quarters of -0.5%), and that the Fed delivers on the rate cuts the bond market is anticipating, thanks to the presumed drop in inflation—allowing lower rates to support valuations with steady or rising multiples. Our view, therefore, is that the coming weeks will see a lot of tension between markets and the Fed, should the Fed's language not begin to change, endorsing market pricing on rates. If, on the other hand, the Fed stubbornly sticks to its guns on inflation (which is indeed showing signs of slowing, but absolute levels still remain high at around 5%), it will be very difficult for the market to remain supported. As a result, volatility would likely rise with the market correcting downward, possibly driven by Big Tech, where positioning has certainly become a risk factor to monitor.

“On the short end of the curve, US T-bills are suffering from the potential default risk linked to the debt ceiling.”

Fixed Income | Inverted CDS curve indicates pronounced stress

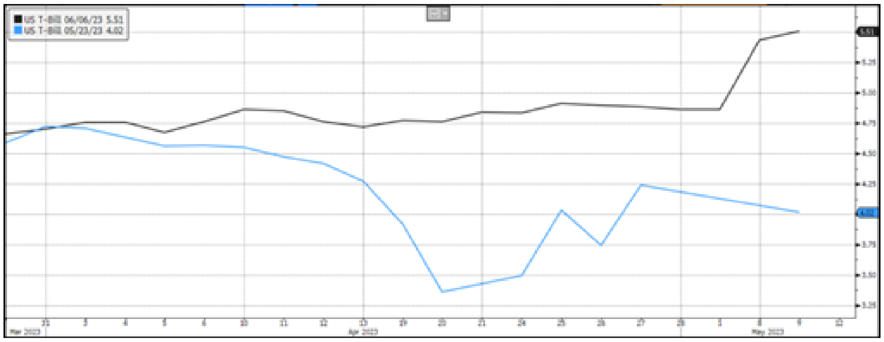
But failure to increase debt ceiling would be positive for bonds.

Renewed fears of a slowdown led to a risk-off move in the market, with concerns about weak data releases, the US debt ceiling, and regional banks. Sovereign bonds benefited from the flight to safety and speculation of central bank rate cuts. The 10-year US Treasury remained pegged at 3.40%, only 10 basis points (bps) above the 2023 lows. European markets were largely in line with the US, with 10-year bund yields at 2.26% and BTPs at 4.15%.

The Bank of England also raised its rate to 4.5%, the highest level since 2008, and another hike in June is expected. On the short end of the curve, US T-bills are suffering from the potential default risk linked to the debt ceiling (Figure 3).

"Investors are assigning a higher probability of a US default compared to previous debt ceiling crises, with the 1-year credit default swap on US Treasuries at 177 bps..."

Figure 3: US T-bills



Source: Bloomberg, as at May 12, 2023.

The US is nearing its debt limit of USD31.4 trillion, and if it defaults by June 1, there could be several negative consequences such as non-payment to entities like Social Security recipients and Treasury securities holders, credit rating downgrades, higher borrowing costs, and a partial government shutdown leading to significant economic damage and job losses. The T-bills curve has become distorted with the T-bills maturing before the June 1 "ex-date" (when the Treasury will have exhausted all its special accounting maneuvers), trading at a significantly lower yield than the longer-dated issues one. For instance, the T-bill maturing June 1 has seen its yield surge more than 100 bps this month alone to 5.46%.

Our view: For years, the debt ceiling was not a significant issue in the US as politicians routinely raised the limit as they spent. However, in 2011, Republicans extracted significant budget cuts before expanding the limit under the Obama administration. Similar episodes occurred in 2013 and 2015. From 2016 until 2023, the problem disappeared due to the political composition of the government. Until today, when once again, while both political parties agree on the need to raise the debt ceiling, Republicans want spending cuts included.

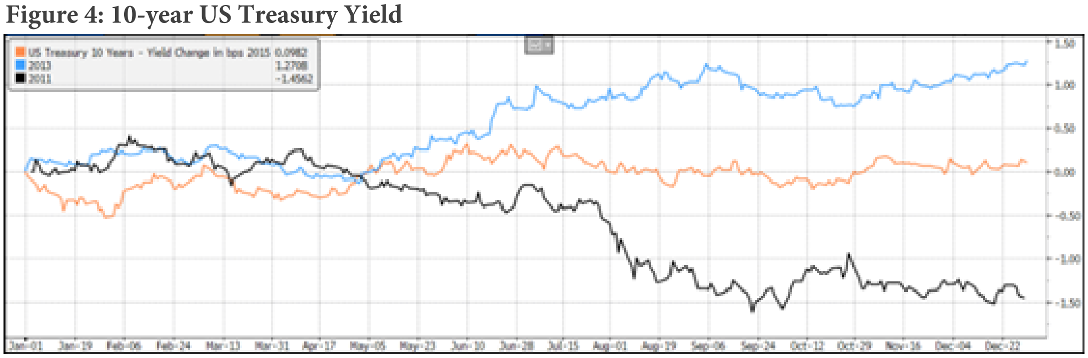
Investors are assigning a higher probability of a US default compared to previous debt ceiling crises, with the 1-year credit default swap on US Treasuries at 177 bps, indicating a risk-neutral default probability of about 3% (assuming a 60% loss in the event of a default). During previous debt ceiling crises in 2011 and 2013, spreads reached a peak of about 80 bps and 78 bps, respectively.

"...the increase in CDS pricing and money-market bills indicates that investors are not confident that rational decision-making will ultimately prevail."

Moreover, the US CDS curve is inverted, indicating pronounced market stress, with 2-year contracts currently indicated at 122 bps. It seems therefore, that the increase in CDS pricing and money-market bills indicates that investors are not confident that rational decision-making will ultimately prevail.

In the past, the 2011 debt ceiling episode is considered the most significant because it involved the largest budget cuts obtained from the Democrats. During this period, bond yields mainly declined. Interestingly, in a risk averse market, US Treasuries remained the only safe haven asset, even though they were at the heart of the increased risk. In conclusion, while some investors are assigning a higher probability of a technical default than the 3.5% chance that the US CDS contract is implying, the negative impact of reduced government spending would not only result from a failure to increase the debt ceiling—but would also have an adverse effect on the economy, causing a positive effect for fixed income.

Figure 4: 10-year US Treasury Yield



Source: Bloomberg, as at May 12, 2023.

Hedge Funds | The growing dominance of multi-strategy managers

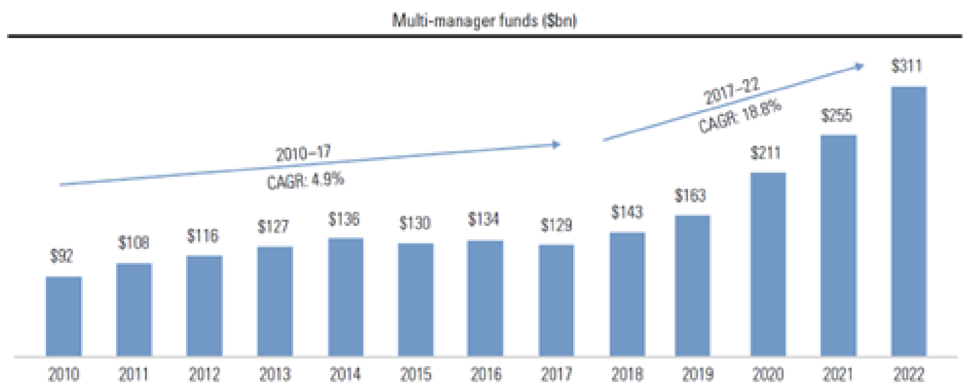
“Investors have been attracted by the strong risk-adjusted and uncorrelated performance that these firms have delivered...”

Solid performance in turbulent markets.

Last week we attended the Morgan Stanley European Hedge Fund conference in Barcelona. Among the many panel discussions, one of them particularly caught our attention as it touched on a topic that has been top of mind for the industry over the past years: the growing dominance of the multi-strategy managers model.

This trend is easily highlighted by the growth these managers have experienced since 2018, which has outpaced the industry (Figure 5). Investors have been attracted by the strong risk-adjusted and uncorrelated performance that these firms have delivered—especially in turbulent markets—beating the hedge fund industry’s average returns. While the panel participants discussed a variety of topics ranging from a growing market footprint given the leverage used by these managers, the extension of liquidity terms offered to investors, as well as the competition for talented investment professionals that has been heating up over the past years, the most important question in our view was: can these managers continue to outperform in the current market environment?

Figure 5: Growth in Multi-manager Funds



Source: Goldman Sachs - Prime Services Hedge Fund Insights & Analytics.

Our view: While the multi manager model itself is not new—some of the largest and well known firms in the space have been around for over 30 years—the post-GFC world that saw the end of banks’ proprietary trading desks triggered a movement of investment professionals away from these desks toward the hedge fund world, and many ended deploying their strategy at multi-strategy firms.

“Far from detracting, this new market environment is actually helpful to most of the underlying investment strategies deployed by multi-strategy firms...”

By definition these firms allocate to a wide range of investment strategies across asset classes. They thrive to find portfolio managers whose return streams are uncorrelated to each other, coupled with strict risk management guidelines and a dynamic/efficient allocation of capital toward the most attractive opportunities. The aim is to deliver higher risk-adjusted returns, lower volatility, and lower correlation to equity and fixed income markets, resulting in better downside protection during markets selloffs.

Over the past few years that have seen a succession of market turbulences, these firms have strongly delivered on that mandate making them a valuable and increasingly sought-after exposure among investors’ portfolios, including ours. The current market environment marked by higher interest rates and volatility, however, raises the question of the sustainability of this outperformance. Far from detracting, this new market environment is actually helpful to most of the underlying investment strategies deployed by multi-strategy firms—especially since these rely on higher dispersion and volatility across asset classes to find relative value opportunities. The higher interest rates world and the associated volatility, however, means an increased reliance on active trading-oriented strategies and a higher capital allocation efficiency given the renewed competition for capital from the yield on cash.

The flipside of the growth we have witnessed over the past years for that part of the industry has also been a growing market footprint, crowding of positions, and the increased occurrence of deleveraging events—these all bear careful monitoring.

Week Ahead | Key events to watch for

- The focus next week will be on the **debt ceiling negotiations in the US**.

- **Presidential elections will take place in Turkey**, an important event for the country, but unlikely to have an impact on other markets (barring an extreme scenario of disputed elections and widespread instability).

- **Earnings season** is almost over, but next week sees the arrival of retailers, including Walmart and Home Depot, as well as Chinese tech giants Alibaba and Tencent.

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