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Weekly Market Flash

A new kind of 'Goldilocks'

January 15, 2023

The start of the year has been a risky one for markets. Leading gains have been European and Chinese equities, due to a mix of factors including the reopening in China and an expectation of a rapid reduction in inflation (both in Europe and the US) that would allow central banks to be less aggressive in raising rates. And indeed, as we shall see, there is also now talk of significant cuts for the Federal Reserve (Fed) as early as the end of 2023. According to this rhetoric, among other things, the soft landing in Europe and the US would be guaranteed by the growth support coming from China's reopening. In short, this is a new type of 'Goldilocks' scenario—a term which we had completely forgotten about in 2022, and a scenario for which investors, including us, were definitely not positioned for.

Highlights

- The US labor market report was still strong, but with hourly earnings moderating. Meanwhile, CPI in Europe and the US both slowed, albeit remained at high levels.
- The market is expecting a very different Fed rate trend than the central bank's Dot Plot predicts. Against an expected peak at 5.12%, the market believes that the Fed will stop at 4.90%, and that it will already cut rates by 50 bps in the second half of 2023!
- The cryptocurrency market has seen a significant resurgence in recent days, with Bitcoin retaking the USD21,000 mark for the first time since the collapse of the FTX exchange.
- Over the past 24 months, there has been an incredible value destruction in the health care/biotech space, creating opportunities for investment.

"...data published in the first two weeks of this year contributed to the change in recent sentiment with respect to the macro scenario."

Markets & Macro | A new kind of 'Goldilocks'

New year, new market sentiment?

Until a few weeks ago, or even a few days, the scenario was a stagflationary one, with stagnating (or even shrinking) growth and high inflation. But a number of data published in the first two weeks of this year contributed to the change in recent sentiment with respect to the macro scenario. For instance, the US labor market report was still strong, but with hourly earnings moderating, while CPI in Europe and the US both slowed, albeit remained at high levels. And the price components of indices like the ISM manufacturing and services further added to the sentiment shift. Figure 1 summarizes the performance of asset classes since the start of the year, highlighting the extraordinariness.

"The European market has gained almost 10% in a fortnight and is now practically only one percentage point away from its all-time highs."

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

Equity	Last Value	Ytd
MSCI World	2,720.09	4.57%
Nasdaq	10,994.82	5.08%
S&P 500	3,978.63	3.69%
DJ Industrial	34,193.55	3.21%
SPX Value ETF	152.38	5.04%
SPX Growth ETF	222.55	3.88%
Nikkei	26,119.52	0.10%
Eurostoxx	4,157.37	9.71%
Swiss SMI	11,286.26	5.19%
FTSE 100	7,856.50	5.47%
Canada	20,295.49	4.81%
Shenzen	4,074.38	5.24%
Hong Kong	21,738.66	9.90%
MSCI EM	1,018.31	6.50%

Bond Indices	Last Value	Ytd
US Inv Grade	110.80	5.09%
US High Yield	76.54	3.95%
Euro Corps	232.16	1.98%
JPM Europe Govies	9,486.53	2.78%
US Treasuries	2,246.33	2.65%
China Aggregate	262.97	3.02%
EMBI Global	785.34	2.22%
EMBI Local	127.64	3.19%

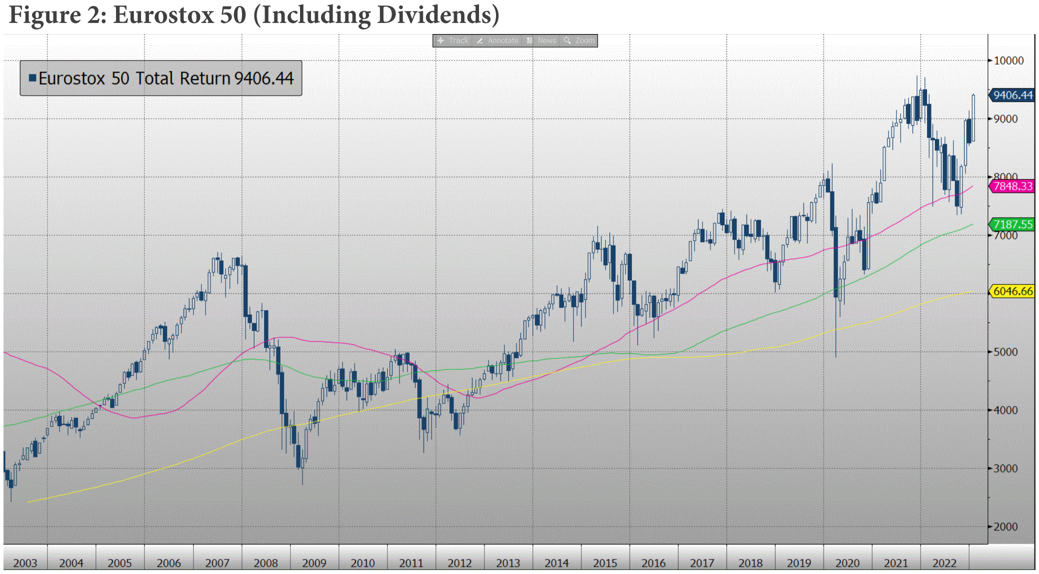
Commodities	Last Value	Ytd
BBG Commodities	111.51	-1.15%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.50	-1.93%
Gold	1,913.71	4.92%
Silver	24.13	0.73%
BBG Brent Crude TR	1,049.38	-1.18%
BBG WTI Crude Oil TR	189.76	-0.80%

FX	Last Value	Ytd
DXY Index	1,225.35	-1.70%
Bbg JP ASIA	103.43	2.22%
Bbg JP LATAM	40.81	2.69%
EUR Index	122.24	0.40%
EUR/CHF	1.00	1.38%
GBP Index	624.24	0.22%
EM FX Index	1,694.53	2.05%
JPY/USD	127.71	2.67%
CNY/USD	6.71	2.83%
Bitcoin	19,238.23	16.32%

Source: Bloomberg, as at January 13, 2023. Performance figures in indices' local currencies.

Our view: It is important to note the performance of the European market, in particular, which has gained almost 10% in a fortnight and is now practically only one percentage point away from its all-time highs. Figure 2 shows Eurostox 50 including dividends, which we ourselves rarely observe. The graph is quite different from the index without dividends, due to the fact that dividends in Europe contribute more to index performance than in the US. In short, the (monthly) graph seems clear—it looks like a bull market, and last year's was a major correction.

Figure 2: Eurostox 50 (Including Dividends)



Source: Bloomberg, as at January 13, 2023.

"2022 should end with annual GDP growth for the continent of over 3%."

So much for the coming war, the energy crisis, double-digit inflation and rate hikes from the European Central Bank (ECB). The gains are probably to be explained by a different impact of these same variables. The war, beyond the psychological impact, did not produce material consequences on economic activity, which, let us not forget, was benefiting from the post-pandemic reopening effect. 2022 should end with annual GDP growth for the continent of over 3%. The sanctions produced a gas price explosion, which was indeed short-lived, with prices now back to acceptable levels. Inflation, for its part, positively influenced corporate profits, with European corporates being able to pass on higher costs to consumers for the time—thanks to more resilient than expected

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demand. The exit from negative rates then supported the banking sector, which is important for the Eurostox 50 index, thanks to the effect on interest margins, which had been penalized for years. Finally, multiples are objectively better than in the US, with a PE of 14.5 on trailing earnings and 12.5 on earnings over the next 12 months.

Going forward, it remains to be seen whether this performance is sustainable considering that a number of factors will be introduced to the market:

1. The effect of the rate hikes over the last six months, and the next 125/150 basis points (bps) that the ECB will deliver, on the economy,;
2. The slowdown that is already manifesting itself in the US;
3. The effect that the Chinese economic reopening is having, and will have, on commodity prices.

A final thought, which might explain Europe's surprising performance, especially vis-à-vis the US, is the following. The ECB's response to the inflation shock (which was even stronger in Europe) was much later and less intense than that of the Fed. The ECB did what many would have attributed to the Fed, i.e. it was more accommodative, betting for a long time that the inflation explosion would be temporary. The Fed, on the other hand, took the problem head-on at some point, deciding to sacrifice growth at any cost. A central bank more pro-growth than one would have thought, perhaps driven by the need to take a few risks so as not to sink the economies, which were already tested by the pandemic. We will only see in the coming months whether the bet was a winner, in terms of the behavior of inflation on the continent.

Another very surprising dynamic at this beginning of the year (which in our view is having the biggest impact on global equities, allowing for higher multiples) is the trend in interest rates, especially in the short term and linked to the Fed. The market is expecting a very different Fed rate trend than the central bank's Dot Plot predicts. Against an expected peak at 5.12%, the market believes that the Fed will stop at 4.90%, and that it will already cut rates by 50 bps in the second half of 2023! The cuts planned for 2024 include a total reduction of 200 bps. In the Fed Funds strip, there are no longer even two 25 bps hikes predicted for the FOMC on February 1 and March 22. In other words, the market has started to attach a small probability to the fact that the February Fed hike is the last one.

“This negativity is clear from the decline of the market value of Coinbase, a leading cryptocurrency exchange, which keep falling.”

Cryptocurrencies | Crypto market outlook remains bearish

But Bitcoin rallies over USD21,000.

The cryptocurrency market has seen a significant resurgence in recent days, with Bitcoin retaking the USD21,000 mark for the first time since the collapse of the FTX exchange.

Our view: However, despite this rally, the overall consensus among industry experts remains bearish. This negativity is clear from the decline of the market value of Coinbase, a leading cryptocurrency exchange, which keeps falling. Additionally, there have been reports of layoffs at other crypto companies, given that trading volumes remain low and activity subdued.

Hedge Funds | Dislocations in the health care/biotech space

Active management is key to capture opportunities.

Over the past 24 months we have witnessed an incredible value destruction in the health care/biotech space. The easiest way to illustrate this point is that the S&P Biotechnology Index (XBI) is down -41% since the end of 2020. The index drawdown in 2021 was driven by sector-specific headwinds including the US drug-pricing legislation overhang as well as a market frenzy of public financings and IPO. Meanwhile, the performance in 2022 has been largely driven by the broader repricing of long duration assets in the inflationary / rising rates and consequently risk-off environment that marked the year.

"All the managers we have been speaking to agree that the extent of this market dislocation should present compelling opportunities going forward."

At the peak of the drawdown in May 2022, the drug development space had lost over 70% of its enterprise value and many publicly traded companies were trading at levels below their cash holdings.

Our view: All the managers we have been speaking to agree that the extent of this market dislocation should present compelling opportunities going forward. The catalysts often cited are:

- Innovations in large swaths of the health care sector from therapeutics / medical devices and digital health are at all-time-highs and advancing rapidly with companies still able to generate significant revenues from their commercial success to re-invest in their R&D.
- The US drug pricing overhang is now mostly resolved on the back of the Inflation Reduction Act that for the first time in history will allow US federal programs to enter drug price negotiations.
- Large pharma companies are sitting on a large treasure chest from the pandemic era and this, combined with their upcoming patent expiration, could bring a new wave of M&A over the next years.

While M&A has long been a catalyst for the space, most point out that this time around the acquisition wave will be different given the depressed valuations and consequences of the IRA that could drive the opportunity toward SMID companies—why would a large pharma buy a blockbuster drug and negotiate with Medicare/Medicaid instead of buying multiple, smaller, commercially viable innovations.

One data point is never enough and there have been a few false starts to the M&A wave but two deals last year could serve as a broader market catalyst—Global Blood Therapeutics was acquired by Pfizer / Horizon Therapeutics by Amgen. These tailwinds, however, should not hide the fact that health care and biotech is a difficult space to invest in as it often requires specialized skills that we cannot pretend to have, and has historically been better suited for active management on both the long and short side of the book given its rather binary nature—especially when it comes to therapeutics names.

"While M&A has long been a catalyst for the space, most point out that this time around the acquisition wave will be different..."

As we noted recently in our 2023 outlook, we thrive to identify actionable market dislocations in our hedge fund allocation and this one is no different. That is why we have cautiously added to the strategy in the last quarter of 2022 and will continue to look for skilled hedge fund managers—focusing on both their fundamental research and risk management process—to partner with over the coming months.

Week Ahead | Key events to watch for

- **Japan will be in the spotlight,** with the Bank of Japan decision due on Wednesday and the CPI release on Thursday. Volatility on the Japanese yen and 10-year rates has increased sharply in recent weeks, with many rumors of further monetary policy tightening.

- **In Europe, it will be important to listen to President Lagarde's speech** at the World Economic Forum from Monday to Friday.

- **The UK will take center stage** with data on the labor market and inflation.

- **As for earnings,** reports from Goldman Sachs, Schlumberger, Netflix and Procter & Gamble will be published.

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