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Weekly Market Flash

Is inflation no longer temporary?

October 17, 2021

Robust corporate earnings on Wall Street supported both sentiment and equity markets this week, with the MSCI World index climbing 2.15%. Indeed, a much lighter positioning in equities also played a role in the recovery, as all indicators we monitor had materially improved during the September selloff. Cash levels, sentiment indicators and put/call ratios were favorable to a rebound in stocks; short covering certainly played a role in the recovery, with the S&P 500 index up more than 3% in the last two sessions of the week. Overall, our analysis of the market for the short term remains unchanged: we believe that we are in a consolidation phase, justified by a number of objective difficulties that need to be resolved before the market can recover and reach new highs.

Highlights

- Buoyed by positive earnings surprises from US banks and a drop in US Treasury yields, most global equity markets enjoyed another week of equity gains. In the US, the real estate sector outperformed the S&P 500 index, while the communication services sector lagged.
- 'H' shares in China performed well, rising by 2% this week, thanks to a Bloomberg story which reported on Chinese authorities planning to relax their measures to curb property speculation.
- The Fed minutes unavoidably confirmed that tapering could be announced on November 3, starting mid-month and ending mid-2022, thus providing for a reduction of USD15 billion per month.
- Bloomberg reported that of the USD142 billion of dollar bonds trading at distressed prices (meaning trading at yield premiums of 10 % above their benchmark rates), 48% were issued by companies in China’s real estate sector.

“We remain cautious, and all the more so following this week's significant recovery.”

Markets & Macro | Is inflation no longer temporary?

Energy remains a good portfolio hedge.

Alongside the recovery in equity markets this week, 'H' shares in China also did rather well, rising by 2%. Specifically, a Bloomberg story which reported on Chinese authorities planning to relax their measures to curb property speculation provided support to the market. At a meeting in late September, regulators reportedly told banks to speed up mortgage approvals and allowed them to securitize mortgages to free up book space. Over the next few days we should learn the outcome of the arrears of Evergrande, for instance, whether the company will manage to pay within the grace period, or renegotiate where possible (on loans), or whether there will be a technical default. In this context, China's troubled real estate companies are multiplying, and it is a matter of time before a few foreign bond coupons result in a technical default.

Our view: In the short term, we believe we are in a consolidation phase, justified by a number of objective difficulties that need to be resolved before the market can recover and make new highs. In fact, fears about inflation and the state of the Chinese economy persist, and the issues of the government shutdown, debt ceiling, and the budget law are only delayed for a few weeks.

We remain cautious, and all the more so following this week's significant recovery. The inflation/growth mix is still in the midst of a delicate phase, as shown by September’s US payroll report as a perfect demonstration of the effects of a less elastic supply of labor. In fact, despite the fact that most unemployment benefits had expired at the time of data collection, labor market participation fell sharply.

Job creation has been weak, likely due to the unavailability of skilled workers, while the unemployment rate continues its (albeit artificial) decline, and earnings growth has risen to almost 5% year-on-year. Needless to say, the persistence of this dynamic can only be negative for corporate margins.

"...since the summer, breakevens have reversed, with 10-year inflation expectations recording new highs."

Moreover, investors, and to some extent central banks, are now abandoning the belief that inflation will be a temporary phenomenon, but rather a lasting, if not permanent, one. Since the beginning of the year, the 2-year breakeven inflation rate rose far above the 10-year breakeven inflation rate, at 3.2% versus 2.5%, respectively. This implies that investors expected inflation to be elevated for only a short period of time. But since the summer, breakevens have reversed, with 10-year inflation expectations recording new highs. And since May, the 2-year breakeven inflation rate has fallen, while the 10-year breakeven inflation rate is now testing its recent high. All this points to is persistent US inflation, which seems to be the new reality for investors.

In this context, the Federal Reserve minutes unavoidably confirmed that tapering could be announced on November 3, starting mid-month and ending mid-2022, thus providing for a reduction of USD15 billion per month (USD10 billion in US Treasuries and USD5 billion in mortgages). As a result, we took advantage of the rally to take a more defensive position through put options on the main indices. On the other hand, we did not touch our exposure to the energy sector, despite the fact that the rally tempted us to do so. Our view remains strong that oil (and energy in general) is a good hedge for portfolios, and no longer a directional investment position.

The performance of the Japanese yen is further evidence of the validity of our view. The currency has traditionally acted as a stabilizing factor in global portfolios, appreciating as volatility rises. Instead, we have seen the currency remain unchanged as equities have fallen, and weakness in the yen has returned when stocks recovered, betraying those who believed in the currency's role. Gold, treasuries and volatility itself continue to fail to support portfolios, for a variety of reasons. All that remains is oil, options or cash, at least at this stage of the market.

Chart of the week

The USD/JPY currency pair climbed to a new 4-year high. Technically, it seems ready to break a decade trend line, while fundamentally, it looks very high here. A big headwind comes from the nation's yield differentials, which could widen even further. Other pressures are also coming from the need to import energy commodities. Resistance levels are 114.5/118.6, and support levels are 112/110.

"Technically, the USD/JPY seems ready to break a decade trend line, while fundamentally, it looks very high here."

Figure 1: USD/JPY Performance

Source: Bloomberg, as of October 15, 2021.

Equities | How healthy is the consumer?

Consumer and healthcare giants report next week.

Buoyed by positive earnings surprises from US banks and a drop in US Treasury yields, most global equity markets enjoyed another week of equity gains. In the US, the real estate sector outperformed the S&P 500 index, while the communication services sector lagged. Market participants welcomed news of the US easing travel restrictions on vaccinated individuals, in a sign that the Delta variant risk is receding. At the same time, investors were unphased by the lower-than-expected preliminary University of Michigan sentiment reading for October (71.4 versus 73.1 expected and below the prior reading of 72.8). While high yield trading volumes remained light, the high yield ETF (HYG US) reversed its correction trend on the back of bank earnings surpassing expectations.

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Elsewhere, supply chain constraints gripped headlines; our discussions with executives in the packaging, shipping and consumer discretionary industries confirmed that these supply chain disruptions and labor shortages are still plaguing their businesses with limited visibility on when these issues would resolve. Some even expected the labor shortage to be permanent.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	35,294.76	1.58%	4.34%	16.98%
SPX Index	S&P 500	4,471.37	1.84%	3.86%	20.38%
CCMP Index	Nasdaq	14,897.34	2.18%	3.12%	16.19%
SX5E Index	Euro Stoxx 50	4,182.91	2.69%	3.41%	20.48%
SMI Index	Swiss Market	11,961.34	1.67%	2.74%	14.94%
UKX Index	FTSE 100	7,234.03	1.97%	2.12%	15.43%
CAC Index	CAC 40	6,727.52	2.55%	3.18%	23.87%
DAX Index	DAX	15,587.36	2.51%	2.14%	13.62%
FTSEMIB Index	FTSE MIB	26,489.18	1.68%	3.14%	21.88%
NKY Index	Nikkei 225	29,068.63	3.64%	-1.30%	7.40%
HSI Index	Hang Seng	25,330.96	1.99%	NA	-4.64%
SHSZ300 Index	CSI 300	4,932.11	0.06%	NA	-3.74%

Source: Bloomberg, as at October 15, 2021. Performance figures in indices' local currencies.

Our view: With consumer and healthcare giants like Johnson & Johnson, Procter & Gamble, Nestle and Intuitive Surgical due to report next week, we should be able to get a better picture of how companies are dealing with inflationary pressures – and how healthy the consumer is. We also look forward to hearing from ASML and ABB to get a better sense of near-term corporate capex plans. In the meantime, we take some comfort in US banks' earnings from last week. We also would characterize the earnings results of portfolio holdings LVMH, SAP and Taiwan Semiconductors as solid and supportive.

"...of the USD142 billion of dollar bonds trading at distressed prices, 48% were issued by companies in China's real estate sector."

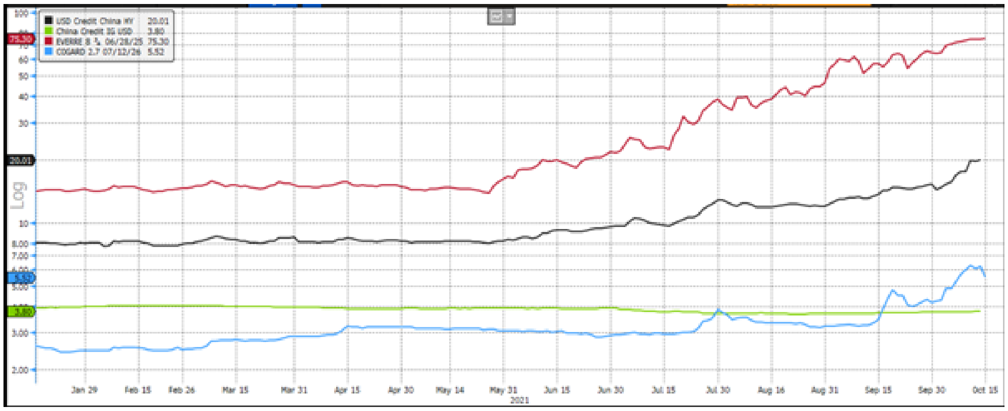
Fixed Income & Credit | China real estate sector woes continue

Risk/reward remains unfavorable.

On October 14, according to Bloomberg, of the USD142 billion of dollar bonds trading at distressed prices (meaning trading at yield premiums of 10 % above their benchmark rates), 48% were issued by companies in China's real estate sector. The Evergrande saga has put much pressure on China's property developers with even the strongest names somewhat hit by the current market stress. Chinese builders are looking to payment extensions or debt exchanges to avoid default on imminent bond obligations as liquidity conditions tighten.

Modern Land (China) Co. is asking holders for a three-month extension on a USD250 million dollar bond due to mature in October. Xinyuan Real Estate has proposed paying just 5% of the principal on a note due October 15 and swapping that debt for bonds due 2023. Separately, Sinic Holdings Group said it doesn't expect to repay a USD250 million dollar bond due October 18 and that may trigger cross-default on its two other notes. Yields of junk rated dollar bonds from Chinese issuers have therefore continued to climb. To take up a graph already used in this publication, since the beginning of September, beyond Evergrande (the

Figure 3: Chinese High Yield and Investment Grade Bonds



Source: Bloomberg, as at October 15, 2021.

"...with investors de-risking, the price of single B bonds has dropped 20–30 points on thin liquidity."

Our view: A recent research paper from UBS ("Asia HY: Making sense of the China property woes", 11.10.21) highlights three risks. Firstly, macro industry risk – as property sales continue to slow, companies are aggressively trying to meet their deleveraging targets (the three red lines) set by the state, but progress is likely going to be held back by slower realized sales in the fourth quarter. Secondly, there is single issuer default risk, as this sell-off has weakened their ability to refinance bonds in the offshore market. Finally, there is market technical risk: with investors de-risking, the price of single B bonds has dropped 20–30 points on thin liquidity. Selling flows should stabilize as bonds trade close to the bottom or to recovery levels (say around 40-50). In conclusion, with measures of regulatory policy relief, such as some loosening on home purchase restrictions or mortgages – which is still very uncertain – risk-reward remains unfavorable for the time being for the sector, even for the best in class.

In the primary market, pricing outcomes for issuers were mixed this week as some companies had to bow and give new issue concessions to get deals done, while orders fell from the average. Iliad, the French telecommunications firm, had to sweeten the terms of its latest issuance to lure increasingly cautious investors. Iliad tightened some covenants (like removing revenue synergy addbacks to Ebitda or including all revolving facilities drawings into the indebtedness ratio calculation) and widened price indications from initial talks to entice US investors who were less familiar with the company and requested better deal conditions. The 5-year dollar tranche issued by Iliad Holdings (B+), where we were active for some clients, was issued with a yield of 6.5% and well received by the market with the price up in the secondary to 103.

"Demand for green bonds is typically so high it commands a green premium, or "greenium," versus conventional bonds."

In Europe primary market, the European Union's debut green bond sale was the highlight this week. The bloc sold EUR12 billion of securities maturing in 2037, after seeing more than EUR135 billion in orders. The deal is just the first in a EUR250 billion program of EU green-bond sales for the coming years. Demand for this kind of debt is typically so high it commands a green premium, or "greenium," versus conventional bonds. The pricing was set at 99.219 (31.6 basis points above the 0% Bund 2036) for a final yield of 0.40%

Week Ahead | Key events to watch for

- **On the economic front, we will see the release of Q3 GDP in China**, while the global Flash PMIs will give an insight into the level of industrial production.

- **On the earnings front, 78 companies** in the S&P 500 index will report during the week.

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