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Weekly Market Flash

# Is the Goldilocks moment temporary?

April 18, 2021

Despite a stronger-than-expected inflation report, and extremely robust economic activity reports during the week, market behavior was typical of the "Goldilocks" environment that we became used to before COVID hit the world and financial markets: yields decreased and equities rallied, driven by growth! Commodities also rose, with precious metals finally recovering. On the other hand, Chinese stocks continued to underperform global markets. In terms of asset allocation, this week's very positive price action allowed us to begin implementing our defensive strategy amid favorable conditions.

## Highlights

- US retail sales rose by a much better-than-expected 9.8% in March, while headline CPI was higher-than-expected at 2.6% year-on-year.
- The US earnings season kicked off with 23 S&P 500 index companies reporting Q1 results. Companies are reporting earnings that are 54.7% above estimates and revenues that are 7.3% above estimates this season.
- Following the regulator's pressure on tech companies, the People's Bank of China continued to withdraw liquidity this week. The central bank renewed around USD23 billion in maturing repos.
- In the US, possibly capitalizing on strong earnings, JP Morgan sold a record USD13 billion 5-part bond deal, the largest transaction ever by a bank, and it was two times oversubscribed.

## Markets & Macro | Is the Goldilocks moment temporary?

"What is becoming clear is that the Fed will let inflation overshoot its 2% target for as much as possible. As we mentioned previously, this is the second and indirect easing from central banks."

### Markets priced in strong data and high inflation.

Market behavior this week was typical of a "Goldilocks" environment: yields decreased and equities rallied, driven by growth. Commodities also rose, with precious metals finally recovering. In fact, the technical picture for gold appears to be more constructive, where a base has probably been formed with the double bottom at 1'680.

After a very strong labor market in March, which was able to generate a million jobs, and the reception of the USD1,400 paychecks, US consumers and businesses responded extremely well in April's reports: retail sales rose by a much better-than-expected 9.8% in March, while business sentiment surveys surged to all-time highs (including the NY Fed Empire State and Philadelphia Fed's Manufacturing outlooks). The recovery in the labor market was confirmed by a post-pandemic low of 576k in weekly jobless claims. Meanwhile, headline US CPI was higher-than-expected at 2.6% year-on-year. But the market reaction in rates demonstrates that this was already priced in. The debate now shifts to whether the inflation spike is temporary or not.

**Our view:** What is becoming clear is that the US Federal Reserve (Fed) will let inflation overshoot its 2% target for as much as possible. As we mentioned previously, this is the second and indirect easing from central banks. Letting inflation rise and keeping rates stable implies real rates going deeply negative, which is damaging to bondholders in nominal terms. This dynamic can easily explain the positive performance in metals and risky assets. To provide another example, the 30-year Treasury yield declined to 2.25%, well below the inflation print at 2.6%!

But the decline in yields – the 10-year Treasury yield declined by 15 basis points (bps) to 1.57% in the last two weeks – has different explanations, starting from the extreme sentiment and positioning accumulated in the past months. On the demand side, Japanese investors buying looked to be very strong this week – Japanese inflows into foreign bond markets typically start to pick up in April and tend to peak in the summer. Geopolitical tensions, in particular the imposition of new US sanctions on Russia, also played a role in the yield dynamics. Further, with economies reopening and stimulus in full swing, strong economic data was likely to be more than expected. As a result, there was not much to sell in fixed income.

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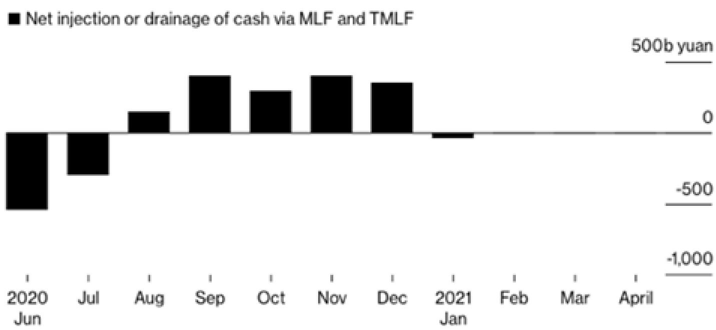
At the same time, the curve flattened by 15 bps this week. In our view, this can be read as a sign that most investors believe that either economic strength will be temporary, or that the Fed will reverse course soon, removing stimulus earlier than expected – which is not at all our case.

Elsewhere this week, Chinese stocks suffered and continued to underperform global markets. Following the regulator's pressure on tech companies, the People's Bank of China (PBOC) continued to withdraw liquidity this week. The central bank merely renewed around CNY156 billion, or USD23 billion, in maturing repos – but traders were expecting a net injection, given that it is tax season and large public bond issues are expected. The central bank's stance appeared in the context of some tensions around one of the most important Chinese asset managers, China Huarong Asset Management, falling into financial stress. It also means that the fear of contagion is limited, and that a controlled haircut on the issuer's bonds is being negotiated.

**Figure 1: PBOC Withdraws Liquidity**




Source: Bloomberg, as at April 16, 2021.

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In terms of asset allocation, the positive price action this week allowed us to begin implementing our defensive strategy in favorable conditions. In last week's publication, we explained our reasons to start reducing our exposure to equities, and this week's positive economic and earnings news hasn't changed this plan: we think that current levels of indices and equity multiples incorporate much of the positive news, while the global policy (fiscal versus monetary) and economic (growth versus inflation) mix is deteriorating. Thus, we started to evenly trim our single lines equity exposure, shorted very small amounts of equity futures, and added some volatility exposure to our portfolios. Sticking to gold also remains part of the strategy. We plan to buy some downside protection via options in the coming weeks, in order to reduce the cost of our protection.

## Chart of the week

As we highlighted in our Market Flash publication on March 14th, gold/US dollar (XAUUSD) has bounced, and found support on a long-term trend line. This week the retracement accelerated after the break of the resistance at the 1765 level amid a retreat in bond yields. The next target is at the 1850 level (200-day moving average).

"...gold/US dollar (XAUUSD) has bounced, and found support on a long-term trend line."

**Figure 3: Gold/USD Bounces**

Source: Bloomberg, as at April 16, 2021.

## Equities | Earnings season starts off with a bang.

### Companies report earnings that are 54.7% above estimates.

Major US indexes recorded new highs, rising for the fourth consecutive week. Within the S&P 500 index, health care stocks were especially strong, while mining stocks were boosted by copper prices. Tech stocks lagged slightly during the week. European stocks also rose on hopes of a strong recovery and better-than-expected results from LVMH and SAP. Strong GDP data in China was received negatively by equities, on fears of further liquidity tightening.

**Figure 3: Global Equity Market Performance**

| | Value | WTD % Chg | MTD % Chg | YTD % Chg |
|---|---|---|---|---|
| Dow Jones | 34,200.67 | 1.18% | 3.73% | 12.33% |
| S&P 500 | 4,185.47 | 1.39% | 5.41% | 11.91% |
| Nasdaq | 14,052.34 | 1.10% | 6.10% | 9.24% |
| Euro Stoxx 50 | 4,032.99 | 1.38% | 3.03% | 14.13% |
| FTSE 100 | 7,019.53 | 1.59% | 4.74% | 9.94% |
| CAC 40 | 6,287.07 | 1.91% | 3.62% | 13.56% |
| DAX | 15,459.75 | 1.48% | 3.01% | 12.69% |
| FTSE MIB | 24,744.38 | 1.29% | 0.39% | 11.71% |
| Nikkei 225 | 29,683.37 | -0.28% | 1.73% | 8.78% |
| Hang Seng | 28,969.71 | 0.94% | 2.08% | 6.73% |
| CSI 300 | 4,966.18 | -1.37% | -1.62% | -4.70% |

Source: Bloomberg, as at April 16, 2021. Performance figures in indices' local currencies.

"...according to FactSet polling, analysts expect the overall S&P 500 earnings to have grown by roughly 25% year-on-year in Q1 2021."

**Our view:** The US earnings season kicked off with 23 S&P 500 index companies reporting Q1 results. Solid results from JP Morgan and Goldman Sachs reinforced the positive sentiment about this earnings season.

According to Bloomberg, companies are reporting earnings that are 54.7% above estimates and revenues that are 7.3% above estimates this season. And according to FactSet polling, analysts expect the overall S&P 500 earnings to have grown by roughly 25% year-on-year in Q1 2021.

**Figure 4: Q1 2021 Earnings Surprise**


Source: Bloomberg, as at April 16, 2021.

"In today's environment of tightening Chinese financial conditions, Huarong will probably face restructuring."

## Fixed Income & Credit | Asian bonds suffer selloff

### Huarong concerns weigh on market.

The fixed income market this week was marked by the woes of Huarong Asset Management, as the company failed to file its 2020 preliminary results before a key March 31st deadline. Talks of a possible debt restructuring surfaced, while S&P put Huarong on negative credit watch – which further incited talks of potential bankruptcy or restructuring. At the beginning of this week, the company's bonds fell 15pts and continued to sell off an additional 10-12pts until April 14th, when concerns eased on a report that the company will fully repay a SGD600 million offshore bond due April 27th.

**Our view:** Originally established in 1999 as a warehouse for bad assets, Huarong has expanded aggressively into fields including banking, trusts, asset management, leasing and securities broking. In the four years to 2018, its assets grew almost five-fold and in 2018, chairman Lai Xiaomin was detained for corruption and was finally executed last January. The new management never succeeded in de-risking the business. In today's environment of tightening Chinese financial conditions, Huarong will probably face restructuring. A default would seriously endanger a core tenet of Chinese investment: the assumed government backing for important state-owned enterprises, or SOEs.

The recent news flow makes it legitimate to have serious concerns about Huarong's credit profile. The weakness resides in the nature of the guarantee between Huarong Asset Management Co (the parent company) and Huarong Finance (issuers of the offshore bonds). In China, the keepwell structure is widely used, however, keepwells are very different from a guarantee. For example, there are variations in definitions of events of default, as well as in trigger events leading to actions to be taken by the keepwell provider (normally the onshore parent company). All in all, the structure does not directly secure a legal obligation from Huarong and makes the offshore bonds subordinated to the onshore bonds. Therefore, selling pressures will likely continue to build, keeping real money international investors away.

The Huarong affair has impacted Asian credit, which sold off the most since the onset of the pandemic. Activity in the primary market, on the other hand, was only marginally affected. Asian borrowers issued more than USD13 billion in USD, including Tencent Holdings Ltd (A1/A+) with a USD4 billion multi-tranche deal, which was five times oversubscribed and with the 2061 maturity selling for a yield of 3.94%. In the US, possibly capitalizing on strong earnings, JP Morgan sold a record USD13 billion 5-part bond deal, the largest transaction ever by a bank, and it was two times oversubscribed. The longest portion of the offering, a 31-year tranche, was sold at 107 bps above Treasuries for a yield of 3.32%.

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### Week Ahead | Key events to watch for

- **There will be limited relevant economic data next week, with only European PMIs** attracting attention. The ECB will also hold its policy meeting and press conference on Thursday, but no major change is expected.
- **US earnings season will heat up,** with 80 companies reporting, and 54 companies in Europe reporting.

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