NOVUM
CAPITAL PARTNERS

Weekly Market Flash
Are we heading toward a 'no landing'?

February 19, 2023

This week ended with global equity markets essentially unchanged, with the MSCI World Index losing 0.15%. But below the surface, regional movements were significant, with the divergences between market performances quite wide—highlighting the importance of trying to interpret the messages contained in the price action. While the US market was unchanged, with the S&P 500 index down very slightly (-0.15%), Europe was up 1.8%, and China was down 1.75% (Shenzhen CSI 300 index). The week was full of data, which together with the speeches of the various Federal Reserve (Fed) members, generated considerable movement in the rates world that redefined the economic scenario for the US. In particular, the 'no landing' theme (i.e. no recession, or rather, a re-acceleration of the economy in progress), has replaced the debate on the 'soft' or 'hard' landing scenario.

Highlights

- The 3-month annualized change in US core CPI inflation is now 4.6%, from 4.3% the month before—more than double the Fed's target. In terms of producer prices, the monthly headline figure reached a 7-month high of 0.7% (versus 0.4% expected), which means that on a year-to-date basis it only fell to 6.0% (versus 5.4% expected).

- On the US growth front, regional surveys and industrial data, and the housing market, showed signs of strength or recovery, but retail sales in particular rebounded strongly in January (3.0% month-on-month)

- The repricing on Fed Funds was remarkable, with the market even expecting the terminal rate to be higher than the Fed's Dots Plot (in the 5.30% area) for the first time in this cycle.

- 82% of the S&P 500 index companies having reported Q4 2022 earnings and provided guidance—with 68% beating estimates, which is below the 5-year average. The magnitude of earnings beat (1.3%), on average, is also significantly below the 5-year average of 8.6%.

- In USD, corporate non-financial primary market supply has gotten off to a torrid start. Year-to-date, more than USD129 billion has priced versus USD54 billion at this point last year, a pickup of 127%, as issuers look to price debt before their borrowing costs rise further.

"The nascent improvement in inflation seems to have stalled, at least in the short term."

Markets & Macro | Are we heading toward a 'no landing'?

Terminal rate expectations are higher than the Fed's Dots Plot.

This week, on the data front, the most significant releases were January's US CPI, together with revisions to the previous months' series, which together helped to negate the disinflationary trend that seemed to have set in since mid-December. With regards to inflation, recent revisions of the seasonal factors of the CPI showed much less disinflation in the last months of 2022 than previously believed. The nascent improvement in inflation seems to have stalled, at least in the short term. Indeed, the 3-month annualized change in core CPI inflation is now 4.6%, from 4.3% the month before—more than double the Fed's target.

"On the growth front, all the smaller data showed signs of strength or recovery, but retail sales in particular rebounded strongly in January..."

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

Equity Indices	Last Value	Ytd
MSCI World	2,779.88	7.03%
Nasdaq	11,787.27	12.76%
S&P 500	4,079.09	6.48%
DJ Industrial	33,826.69	2.35%
Nikkei	27,513.13	5.44%
Eurostoxx	4,274.92	13.03%
Swiss SMI	11,256.29	4.91%
FTSE 100	8,004.36	7.64%
Canada	20,515.24	6.19%
Shenzen	4,034.51	4.21%
Hong Kong	20,719.81	4.75%
MSCI EM	999.42	4.59%

Equity Sectors	Last Value	Ytd
S&P value	154.98	6.83%
S&P Growth	62.09	6.14%
S&P Defensives	1,545.64	1.07%
ARK Fund	41.86	33.99%
Fangs	5,537.34	24.53%
MSCI Financials	141.22	8.11%
S&P Energy	84.49	-3.41%
Gold Miners	28.41	-0.87%

Commodities	Last Value	Ytd
BBG Commodities	106.53	-5.56%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	70.03	1.75%
Gold	1,842.36	1.01%
Silver	21.73	-9.29%
BBG Brent Crude TR	1,027.11	-3.28%
BBG WTI Crude Oil TR	182.70	-4.49%

FX	Last Value	Ytd
DXY Index	1,242.35	-0.34%
Bbg JP ASIA	101.26	0.08%
Bbg JP LATAM	40.79	2.64%
EUR/CHF	0.99	0.10%
GBP Index	621.86	-0.16%
EM FX Index	1,674.19	0.82%
JPY/USD	134.15	-2.26%
CNY/USD	6.87	0.44%
Bitcoin	24,587.12	48.66%

Bond Indices	Last Value	Ytd
US Inv Grade	107.04	1.84%
US High Yield	74.56	1.75%
Euro Corps	231.75	1.79%
JPM Europe Govies	9,453.81	2.43%
US Treasuries	2,201.55	0.60%
China Aggregate	258.72	1.35%
EMBI Global	775.41	0.93%
EMBI Local	125.59	1.54%

Source: Bloomberg, as at February 19, 2023. Performance figures in indices' local currencies.

Producer prices, which surprised well above expectations, also reinforced this view. The monthly headline figure reached a 7-month high of 0.7% (versus 0.4% expected), which means that on a year-to-date basis it only fell to 6.0% (versus 5.4% expected). Thus, based solely on the January data, we saw an acceleration of inflation in both the CPI and PPI compared to the situation in the fourth quarter. Meanwhile, on the growth front, all the smaller data (regional surveys and industrial data, and the housing market) showed signs of strength or recovery, but retail sales in particular rebounded strongly in January (3.0% month-on-month), after worrying declines in November and January.

"The repricing on Fed Funds was remarkable, with the market even expecting the terminal rate to be higher than the Fed's Dots Plot for the first time in this cycle."

Our view: As the "Fixed Income" section details, the repricing on Fed Funds (and consequently on the entire US Treasuries curve) was remarkable, with the market even expecting the terminal rate to be higher than the Fed's Dots Plot (in the 5.30% area) for the first time in this cycle. Figure 2 shows the performance (normalized) from the market bottom on 30 September 2022 of the three indices (S&P 500 index in grey, Eurostoxx 50 index in green, and Shenzhen index in red), which we can make some observations from.

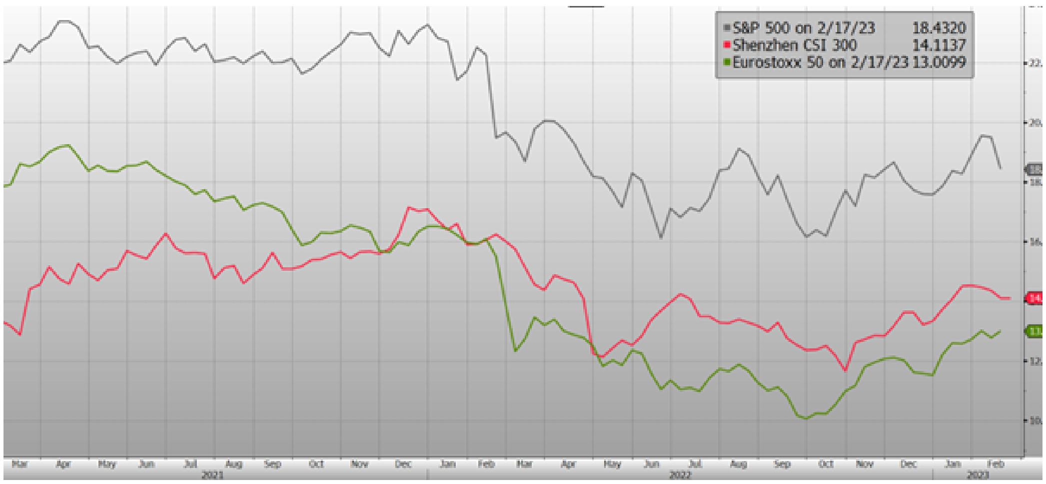
Figure 2: Market Performance (Normalized)

Source: Bloomberg, as at February 19, 2023.

"But for the time being, it remains a situation to be monitored, because a possible flop in the Chinese economy is not a factor to be underestimated..."

China's performance (although its bottom occurred one month later, at lower levels) is disappointing, and the theme of reopening still remains to be proven. With some optimism, we can say that the recent retracement of around 6% may be an opportunity to re-enter the trade (which we ourselves are seizing, but with a capital-guaranteed product, precisely so as not to get burned). China's economic recovery, the amount of savings available to Chinese citizens (at least part of which should go to finance both domestic consumption and flows to the stock exchange), plus an important valuation gap vis-à-vis the US (Figure 3), should represent a good risk-reward for the trade. Chinese equities are trading at 14 P/E, five points below the US ratio. But for the time being, it remains a situation to be monitored, because a possible flop in the Chinese economy is not a factor to be underestimated—as one of the reasons why investors have been buying Europe since late 2022 has been indirect exposure to the Chinese market. It is the same for commodity prices, with oil having suffered in the past week, and back below levels prevailing at the end of last year.

Figure 3: Market Valuations



Source: Bloomberg, as at February 19, 2023.

Europe, as mentioned here before and as is clear from Figure 3, objectively benefits from a significant valuation gap (green line). Despite the 29% rally from the lows, the PE on next year's earnings remains at 13, the lowest of the three. The price action, and the reports we read about financial flows, seem typical of allocation decisions made at a central desk, and which have to be implemented regardless of the news flow and the cyclical scenario. Every day, a small piece of buying has to be executed automatically, pushing the index up in a gradual and constant manner. Typically, however, these flows are interrupted without possibility of prediction, and the correction is often rapid, in view of a new scenario.

"On the earnings side we remain of the view that the erosion on margins from the lagged effect of rate hikes has not yet been felt..."

On the earnings front, while the rebound in EU earnings has been remarkable post-pandemic, a divergence is emerging against the US market. While, far from complete, a repricing of S&P earnings has already started (now more than 5% of expected profits have been trimmed from the 2023 consensus), the same measure in Europe remains sticky at the highs. So there is a lot of room for missing expectations here in case the economy disappoints and the same dynamics on corporate margins applies.

As for the US, there was a disappointing performance, at least in relative terms compared to Europe. The recovery from the lows is 13%, and in the last two weeks, with the change of pace in the economy's data, the pressure from rates seems to be weighing mainly on the tech sector once again. Valuations at 19 P/Es do not help, since the relationship between multiples and interest rates is by definition inverse. Therefore, on the earnings side we remain of the view that the erosion on margins from the lagged effect of rate hikes has not yet been felt (even on the economy), and this ongoing repricing will amplify the impact—with the risk that the recession is further away, but it may be harder.

Equities | What is micro telling us about the macro?

"Nothing changes sentiment like price"

With 82% of the S&P 500 index companies having reported Q4 2022 earnings and provided guidance, a clearer micro picture is emerging. Of the companies that have reported, according to FactSet data, 68% beat estimates, which is below the 5-year average. The magnitude of earnings beat (1.3%), on average, is also significantly below the 5-year average of 8.6%. The sub-par earnings season, however, was well-anticipated by the market, thanks to a well-telegraphed expected recession. But do the corporate earnings reports support the now prevalent view of a 'no landing' scenario? Below we sampled some of last week's earnings reports to see what the micro can tell us about the macro.

"The sub-par earnings season, however, was well-anticipated by the market, thanks to a well-telegraphed expected recession."

Deere (DE US)

The giant farming equipment manufacturer reported a strong quarter as cash-rich farmers kept demand for tractors alive. Deere's CEO, John May, stated "Deere is looking forward to another strong year on the basis of positive fundamentals, low machine inventories, and a continuation of solid execution".

Nestle (NESN SW)

The world's largest food group missed earnings due to rising input costs. Interestingly enough, the price increase made in 2022 were not sufficient to offset the cost pressures. The market frowned upon the company's 2023 organic sales growth guidance of 6-8%, most of which is to be driven by price inflation. Speaking to reporters, CFO, Mark Schneider, noted that there is no clear evidence of significant downtrading.

Roblox (RBLX US)

The gaming company that struggled with a post-pandemic growth slowdown surprised the market with better-than-expected Q4 bookings (revenue) and higher engagement figures. In terms of consumer health, CFO Mike Guthrie stated "We're also seeing very, very healthy what we refer to as payer conversion. So more users are becoming payers than ever before, and that's pretty much true across the globe, each individual region is reaching its peak in a payer conversion."

Cisco Systems (CSCO US)

Cisco reported fiscal Q2 revenue of USD13.6 billion, beating the consensus estimate of USD13.43 billion. The company also surprised on fiscal revenue guidance of 9-10.5% versus estimates of 5.7%. Cisco CEO described the overall demand environment as "steady". Corporate customers continued to upgrade networks in response to a growing flow of information, in a sign of a new capex upcycle taking shape in an area of underinvestment in the past few years. The company also confirmed supply constraints are easing materially, leading to a rebound in backlog fulfillment.

"It's no longer a question of how do you land a 747 on an aircraft carrier, but rather how do you land a plane with flaps that seem to be unresponsi-ve.."

Our view: The overall message from last week's earnings is consistent with the one received from the macro data, i.e. consumer demand remains healthy across multiple industries, with no particular signs of weakness. Also, the consumer seems to be largely insensitive to price increases, with unemployment levels still very low. Supply chain problems and margin pressures on corporates also seem to be easing, albeit very inconsistent across industries. With the US and global economy still robust, and with inflation still raging above the Fed's target level, the Fed's job has gotten more complicated. It's no longer a question of how do you land a 747 on an aircraft carrier, but rather how do you land a plane with flaps that seem to be unresponsive.

Fixed Income | Credit market seems well-positioned

Yields rise, but spreads remain stable.

> "The US Treasury market, after downplaying the Fed's announcements on its terminal rate, is now not only discounting that we will get there, but possibly even go further."

Apart from a small minority who never doubted that to tame inflation, rate hikes would have to go further than expected (Deutsche Bank has a new 5.6% terminal Fed Fund forecast), even the bond market had to give up. The US Treasury market, after downplaying the Fed's announcements on its terminal rate (in December, the median forecast by Fed officials was for the policy rate to end the year at about 5.1%), is now not only discounting that we will get there, but possibly even go further (5.30%). This, after January's inflation data (CPI and PPI), showed prices remain stubbornly high. The two-year note's yield, more sensitive than longer maturities to Fed policy changes, climbed as much as 8 basis points (bps) to nearly 4.70%, before stabilizing a touch lower. The 10-year yield also rose to 3.90%, its highest levels so far this year.

Figure 4: Two-year Bond Yields

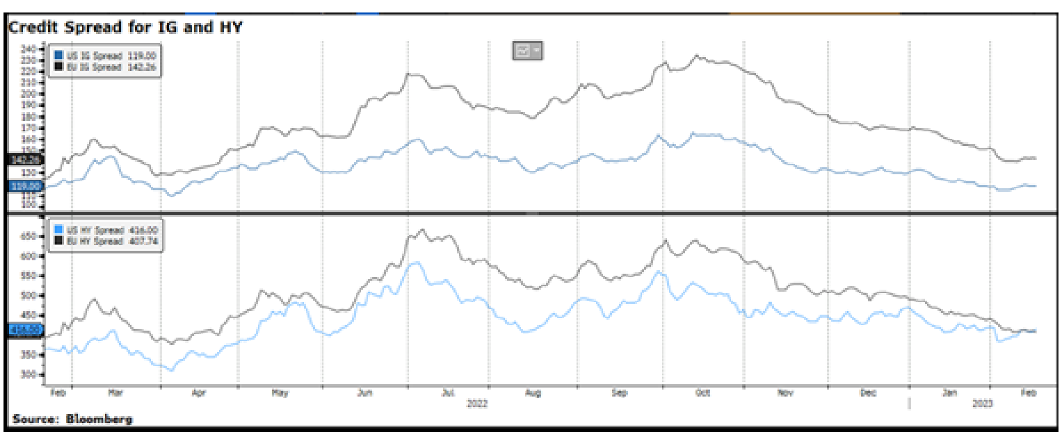
Source: Bloomberg, as at February 19, 2023.

Also, in Europe, front-end bonds in Germany surged 20 bps in a week to around 2.9%. The European Union has lowered its regional inflation forecast for 2023 to 5.6% from 6.1%, but simultaneously sees a remarkable turnaround in the economic fortunes, with GDP forecast to grow by 0.9%, three times the amount it had estimated earlier. With the economy proving much more resilient that thought, and with the European Central Bank trying to get its arms around inflation, a 3% yield for two-year notes is not too distant.

> "...the credit market seems reasonably well-positioned and is attracting capital from margins that were in cash, leading to a substantial stability of spreads..."

On the other hand, the credit market seems reasonably well-positioned and is attracting capital from margins that were in cash, leading to a substantial stability of spreads in corporate bonds and high yield bonds.

Figure 5: IG and HY Credit Spreads



Source: Bloomberg, as at February 19, 2023.

In USD, corporate non-financial primary market supply has gotten off to a torrid start. Year-to-date, more than USD129 billion has priced versus USD54 billion at this point last year, a pickup of 127%, as issuers look to price debt before their borrowing costs rise further. Evidence of this is biotech giant Amgen, which amassed USD90 billion of orders for its USD24 billion eight-part offering to fund its acquisition of Horizon Therapeutics in December. To provide some context, Amgen (Baa1/BBB+) priced the 5-year tranche (2028) at a yield of 5.18%, which is equal to 115 bps above US Treasuries (initial price level was 140 bps). CVS also tapped the high-grade market selling USD6 billion of new debt to back its purchase of Signify Health. CVS (Baa2/BBB) priced the 2-years tranche (2026) at 90 bps above US Treasuries (initial price level was 115 bps) for a yield of 5.124%. Philip Morris also raised over USD5 billion to repay debt used under a bridge loan last year that helped fund the USD16 billion purchase of Swedish Match. The 5-year tranche was offered at 5.009%, equal to 110 bps above US Treasuries (initial price level was 130 bps).

"The high-rate cycle leaves investment grade credit reasonably well-protected..."

Our view: Our view remains unchanged. The high-rate cycle leaves investment grade credit reasonably well-protected because high grade companies can weather an interest rate cycle without a severe dislocation. However, with inflation sticky, front-end rates likely to stay at 5-5.25% for longer. And with rate cuts not realized, the higher cost of debt will start to incrementally weigh on below investment grade companies—because as you move down the credit rating spectrum, there is more sensitivity to economic growth and potential volatility.

Week Ahead | Key events to watch for

- **Flash PMI data** will be released around the world, and the PCE (measure of consumption) is due in the US. The latest Fed minutes will also be published on Wednesday.
- **CPI in Japan**, expected on Thursday, will be important—especially given our short position on Japanese rates.
- **The earnings season** is coming to a close, but there are still some important names this week: major US retailers (Walmart, Home Depot), major miners (BHP, Rio Tinto) and Chinese tech giants (Baidu, Alibaba).

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
Senior FX, Crypto & Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Carlos De Andres Perez
Senior Private Equity Funds Manager

Maxime Glasson
Senior Hedge Funds Manager