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Weekly Market Flash
The price to pay for the delay

June 19, 2022

The S&P 500 index ended this week down -5.8%, its worst weekly performance since March 2020. The Nasdaq and Europe indexes did little worse, losing -4.5%. A confluence of factors caused stock markets to sink: the increasingly aggressive rate hikes that central banks are implementing, in a context of high inflation, which continues to depress consumer confidence and purchasing power. On top of this, the first signs of a slowdown (albeit from very high levels) in economic activity are beginning to appear (especially in sectors sensitive to the first rate rises, such as housing in the US, and in the labor market, with the first redundancies being announced). And finally, the icing on the cake – the energy crisis in Europe, which is not only seeing sustained prices, but the first slowdowns in gas supplies by Gazprom are emerging, to the detriment of France, Germany and Italy, so short-term rationing cannot be ruled out.

Highlights

▪ The Swiss central bank unexpectedly raised rates by 50 bps, while the Fed, with its 75 bps hike (in line with expectations), had succeeded in sending a softer message. Meanwhile, the Bank of England raised rates, while the Bank of Japan further resisted pressure to stop its policy of limiting yields on the 10-year maturity.

▪ Of the major equity markets, only Chinese markets advanced after the government approved several fixed asset investment projects worth around USD18.1 billion in May.

▪ Surging recession fears are crippling the appetite for risk assets and that has crypto traders remaining cautious about buying the dip in Bitcoin.

▪ The US treasury 10-year yield went up from 3.02% on Thursday last week, up to 3.47%, and finally came down to 3.22%. In Europe, the Bund yields spiked up to 1.75% and the BTP to 4.16%.

“The Swiss National Bank’s shock has dampened sentiment on international stock markets.”

Markets & Macro | The price to pay for the delay

Focus is on capital preservation.

A very strong theme that is emerging within the tightening dynamics by central banks is the different reaction function in different countries to the rise in prices. In order of firmness in the current response, in Switzerland, the central bank unexpectedly raised rates by 50 basis points (bps) – albeit it was starting from a good -0.75%, so we are still in negative territory. The Swiss National Bank’s shock, which had not prepared the market at all for the intervention, has rewarded the Swiss franc, which is now approaching parity against the euro, but has dampened sentiment on international stock markets.

The Federal Reserve (Fed), with its 75 bps hike (in line with expectations), had succeeded in sending a softer and more reassuring message, but the respite was short-lived as concerns over growth then prevailed; meanwhile, the Bank of England raised rates by 25 bps (as expected, but delivered hawkish tones in its comments), while the Bank of Japan further resisted pressure to stop its policy of limiting yields on the 10-year maturity.

As for the European Central Bank (ECB), on the other hand, which had telegraphed its first hike of 25 bps in July last week, there was an emergency meeting to start the preparation of an anti-spread spread instrument, on which some details began to leak out by the end of the week. Any bond purchases will probably involve the sale of other bonds, so as not to disrupt the efforts to fight inflation. The study on the instrument is expected to be completed for the July 20-21 meeting. Christine Lagarde told finance ministers that the instrument could be activated if bond spreads widen beyond certain thresholds or if market movements exceed a certain speed.

“Central banks have put themselves in a real corner; it is now clear that they have made the mistake of persisting in defining the inflationary phenomenon. as transitory...”

Our view: It must be said that the mere existence of a draft anti-fragmentation instrument has helped a great deal in containing peripheral spreads, starting with the BTP (from 224 bps to 192 bps on the week); however, the technical details remain to be seen, and above all the infamous conditionalities that in our assumptions will be unavoidable. We find it hard to imagine that major purchases can be approved without the inclusion of clear clauses on the budgetary policies of the target country. Most likely, a lighter framework than the passage to the ESM is required to activate Draghi's OMT (whatever it takes – which would involve unlimited purchases), but it is still necessary to make the Northern countries digest the non-proportionality of government bond purchases.

In our opinion, central banks have put themselves in a real corner; it is now clear that they have made the mistake of persisting in defining as transitory the inflationary phenomenon that began as early as the second half of 2021, in the midst of the economic boom from the reopening in the US (and more gradually in Europe), and with the enormous fiscal stimulus of the Biden administration (made up mainly of consumer subsidies, and not of support for businesses).

Now it is really difficult to understand the level of risk on the economies from the horse doses of tightening they are orchestrating. The feeling is that in order to contain the now galloping inflation, which is becoming entrenched in the minds of economic actors, growth will have to collapse vertically, and this is what the markets are discounting in recent weeks. In fact, this week even the most cyclical assets have suffered, starting with oil and industrial commodities. The paradox of this situation is that inflation is a lagging indicator of economic activity. Just as the explosion of inflation came six to nine months later than the expansion of 2021, in the next six to nine months, we could find ourselves in the midst of a recession and rapidly falling inflation. After all, this seems to be the price to be paid for the delay.

“...after years in which the creativity of central banks in inventing economic support measures rewarded investment choices in search of risky assets, the opposite now applies.”

In terms of investments, the consequences for investors are enormous: after years in which the creativity of central banks in inventing economic support measures rewarded investment choices in search of risky assets (high spread bonds and equity growth for instance), the opposite now applies. Preserving capital is the only rule, and to do so we try to follow the central banks that are best able to protect their consumers' purchasing power from inflation. The immediate financial consequence is currency appreciation – the Swiss franc and the US dollar are examples of this. The long-term consequence is the protection of the bond market and the containment of the risk premium on equity.

Equities | Markets start pricing in a recession

Energy stocks come under attack.

The S&P 500 index entered a bear market and closed around 24% below its January 2022 peak. Statements by Fed policy makers confirmed that the Fed was determined to get ahead of inflation, sending the S&P 500 index down this week. At the same time, poor housing and retail sales data stoked recession fears.

Of the major equity markets, only Chinese markets advanced after the government approved several fixed asset investment projects worth around USD18.1 billion in May. Also, May industrial production data surprised positively. As mentioned in last week’s publication, the government is beginning to address the deteriorating economic situation that's resulting from the zero-Covid policy. The economic picture remains fragile with the unemployment rate in 31 major cities rising to a record 6.9%, and the youth unemployment rate is at a record 18.4% according to Bloomberg, and the property market is still not showing visible signs of stabilization.

> "While the probability of a recession has been rising, it is still at around 31%."

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	29,888.78	-4.73%	-9.26%	-16.91%
S&P 500	3,674.84	-5.75%	-10.98%	-22.34%
Nasdaq	10,798.35	-4.76%	-10.58%	-30.71%
Euro Stoxx 50	3,438.46	-4.47%	-9.24%	-17.83%
Swiss Market	10,451.31	-5.71%	-9.99%	-16.62%
FTSE 100	7,016.25	-4.07%	-7.59%	-3.17%
CAC 40	5,882.65	-4.92%	-8.93%	-15.68%
DAX	13,126.26	-4.62%	-8.77%	-17.37%
FTSE MIB	21,788.87	-3.36%	-11.08%	-17.99%
Nikkei 225	25,963.00	-6.69%	-4.83%	-8.94%
Hang Seng	21,075.00	-3.28%	3.88%	-8.65%
CSI 300	4,309.04	1.77%	10.35%	-12.24%

Source: Bloomberg, as at June 17, 2022. Performance figures in indices' local currencies.

Our view: Within the S&P 500 index, energy stocks lost -17.2% last week and materials stocks lost -8.3%, in a wide divergence from spot commodity prices. Our explanation for this divergence is that the market has entered a phase of pricing in a recession. While the probability of a recession has been rising (according to the Bloomberg Recession Probably Forecast Index), it is still at around 31%.

Nonetheless, with energy being the only sector up on the year (at 31.4% higher as of June 17), we would recommend reducing the heavy overweight exposure to energy stocks to slight overweight/neutral, out of concern that a prolonged market correction would begin to put pressure on the profitable positions of the year.

> "Since the news broke out of a delay in the Merge, stETH lost its peg to ETH, threatening those positions collateralized with stETH, which in turn led to heavy redemptions from Celsius."

Crypto & Blockchain | Celsius collapse adds to risk-off sentiment

Traders remain cautious about buying Bitcoin's dip.

Another DeFi project blew up last week. Celsius Network was one of the leading lending platforms in the Defi space offering attractive yields of around 6-8% on deposits. After denying multiple times that the redemptions from their platform were piling up, Celsius finally suspended withdrawals on the evening of June 12 citing market conditions. Celsius was also one of the largest holders of Staked Ether (stETH), a token pegged to ethereum. That was used as collateral to recursively borrow from AAVE, an Open Source Protocol to earn interest on supplying and borrowing assets with a variable or stable yield. stETH represents ETH locked on the Ethereum 2.0 beacon chain, a chain that runs parallel to the main Ethereum blockchain that will eventually combine with the Ethereum mainnet after the Merge.

On DeFi platforms such as Celsius, stETH is often used as collateral to borrow ETH. The delay in the Merge is in part responsible for Celsius' collapse. Since the news broke out of a delay in the Merge, stETH lost its peg to ETH, threatening those positions collateralized with stETH, which in turn led to heavy redemptions from Celsius. Note that stETH can theoretically be redeemed for parity at some point after the Beacon Chain merges with the Ethereum mainnet, which could make purchasing appropriately discounted stETH attractive for potential buyers looking for arbitrage opportunities.

Three Arrows Capital, known as one of the largest holders of Grayscale Bitcoin Trust (GBTC), an institutional bitcoin product, as well as stETH tokens, both of which have seen steep declines recently and investor of over USD200 million in LUNA tokens as part of a USD1 billion raise by the Luna Foundation Guard in February, an amount that is now essentially worthless since the Terra ecosystem imploded in mid-May. This week 3AC was responsible of massively offload its stETH position. Reports suggest that 3AC borrowed from major lending entities including BlockFi, Genesis and Nexo, in some cases uncollateralized, which makes the full outcome of contagion unclear.

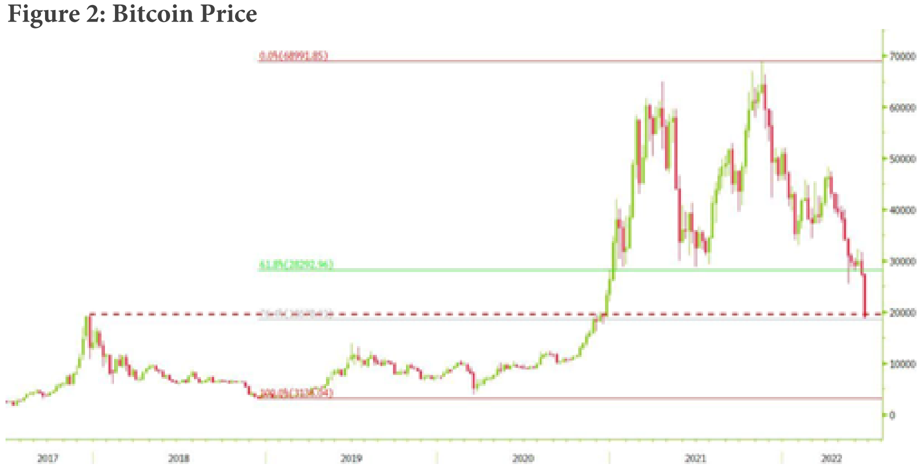
"The Celsius collapse and 3AC liquidation combined with an overall risk-off mode in risk markets over the past week, pushing most flow and positioning metrics to more extreme oversold territory."

Market action: The Celsius collapse and 3AC liquidation combined with an overall risk-off mode in risk markets over the past week, pushing most flow and positioning metrics to more extreme oversold territory. The breach of the USD20,000, with massive trigger of stop losses that amplified the move, put Bitcoin at levels we have not seen since 2020. Surging recession fears are crippling the appetite for risk assets and that has crypto traders remaining cautious about buying the dip in Bitcoin.

Chart of the week

As the sell-off continues with Bitcoin, the market goes into a panic sell-off. With an accelerated decline, we might very well get to see some kind of impulsive rebound – after all the forced liquidation will terminate. The market is focused on the big 76.4% Retracement of Fibonacci at 18.7k – this is the last support indicated on the chart.

Figure 2: Bitcoin Price



Source: Bloomberg, as at June 17, 2022.

"Good quality bonds will get pummelled by rates, given their high duration, while junk borrowers remain exposed to soaring borrowing costs..."

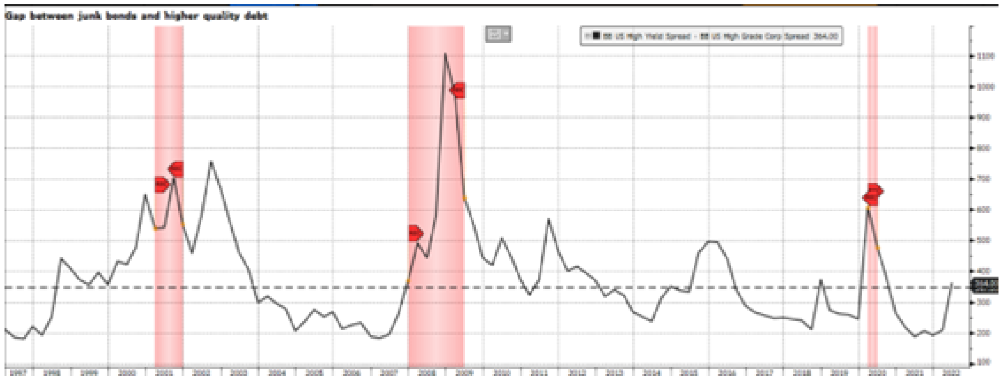
Fixed Income | Credit falls victim to central bank action

Spread between junk and higher quality bonds widens.

This was a week of continuous central bank surprises. After the Fed and the Bank of England, we even saw the Swiss National Bank surprisingly joining the global bandwagon of monetary tightening. With "central bank forward guidance" probably no longer appropriate, government bond yields suffered wild movements. The US treasury 10-year yield went up from 3.02% on Thursday last week, up to 3.47%, and finally came down to 3.22%. In Europe, the Bund yields spiked up to 1.75% and the BTP to 4.16%. Fortunately, there was a marked decline in peripheral spreads after the emergency meeting by the ECB to tackle fragmentation in euro area bond markets. And BTP-Bund spreads, while remaining high, fell from 2.42% to 1.90%.

Our view: Among the collateral victims of central banks' actions is credit. Good quality bonds will get pummelled by rates, given their high duration, while junk borrowers remain exposed to soaring borrowing costs and the economic carnage caused by inflation. Spreads on US junk-rated corporate bonds, an important gauge of risk that signals higher defaults when it increases, surpassed 500 bps for the first time since November 2020, and the spread gap between junk bonds and higher quality debt (black line), a key credit indicator to monitor as recession risk comes to the fore, is getting wider.

Figure 3: Spread Gap Rises



Source: Bloomberg, as at June 17, 2022.

"The willingness of Credit Suisse to remain market friendly with credit investors is consistent with the expected behavior of a bank in restructuring..."

In a primary market still at a standstill, Credit Suisse paid one of the highest coupons (9.75%) by a major lender for its new subordinated AT1 (additional tier 1 notes, the riskiest type of bank debt). Credit Suisse announced to repay its USD 7.125% AT1 at the next call date of 29 July 2022. This is the last AT1 with an equity conversion clause that the group has on its balance sheet. All the other AT1s have write-down clauses in case the high trigger is reached.

Apparently, to simplify its capital structure, Credit Suisse overlooked the economic reasoning: the reset of the AT1 call is five years +5.108%, equal to a rate of around 8.6%. Nevertheless, Credit Suisse decided to issue a new 9.75% AT1 Perpetual – Call 2027 (reset at 5y +6.383%) with full capital write-down if Cet1 falls below 7% (currently at 13.5%). The willingness of Credit Suisse to remain market friendly with credit investors is consistent with the expected behavior of a bank in restructuring (Credit Suisse delivered its sixth profit warning in seven quarters earlier this month). The placement was successful as the bank managed to issue a bigger size (USD1,650 million) than what announced (USD1,500 million).

Week Ahead | Key events to watch for

- **Next week will still focus on the Fed**, thanks to Powell's speech before the Senate and House committees between Wednesday and Thursday.
- **There will certainly be more leaks on the ECB's anti-fragmentation plan** (ahead of the July 21 meeting).
- **The only data of note will be the release of the Flash PMIs** in Europe, the US and Japan.

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