NOVUM
CAPITAL PARTNERS

Weekly Market Flash

How long can Europe’s outperformance last?

November 20, 2022

Despite the enthusiasm generated by last week's low CPI figure from the US, the S&P 500 Index closed the week slightly down on last week (-0.6%), as the Federal Reserve (Fed) continued to emphasize that inflation is not yet under control and needs to be countered. Still surprising, in the eyes of many, was the European market's best performance, thanks to better-than-expected conditions—namely, warm weather averted a major energy catastrophe and, fortunately, the crisis between Russia and Ukraine did not escalate significantly.

Highlights

▪ The glimmers of reopening in China have also fueled domestic market strength (KWEB is up 42% from October lows). At the same time, Covid cases are exploding, and various reports this week argue that the Chinese health care system cannot handle a further expansion of the contagions.

▪ St. Louis Fed President James Bullard’s speech this week was striking, with a statement that the Fed Funds rate should settle in the 5-7% area—this was certainly not good news for equities.

▪ Various companies in the retail sector offered contrasting perspectives on their consumers and strategies. Value retailers such as Walmart gained market share through write-downs and inventory clean-up, while luxury retailers such as Burberry remain protected by resistance from high-end consumers.

▪ 2022 has represented a shift with global monetary tightening and geopolitical tensions leading to spread widening, increased price dispersion and a growing distressed universe—these factors are contributing to improved prospects for credit-oriented hedge funds managers.

“The fact that still remains is that inflation is much higher in Europe—and the ECB's action is clearly lagging behind.”

Markets & Macro | How long can Europe’s outperformance last?

Inflation remains high, and the ECB behind.

The European market was up 1.45% on the week, and up 19% from October's lows. However, the fact that still remains is that inflation is much higher in Europe—and the European Central Bank's (ECB) action is clearly lagging behind.

“It is possible that an element of support for Europe came from China, to which the continent is very closely linked through exports.”

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

Equity	Last Value	Ytd
MSCI World	2,658.90	-16.08%
Nasdaq	11,146.06	-28.21%
S&P 500	3,965.34	-15.60%
DJ Industrial	33,745.69	-5.39%
Nikkei	27,899.77	-1.11%
Eurostoxx	3,924.84	-5.67%
Swiss SMI	11,045.49	-11.77%
FTSE 100	7,385.52	3.39%
Canada	19,980.91	-3.28%
Shenzen	3,801.57	-21.40%
Hong Kong	17,992.54	-20.50%
MSCI EM	943.01	-21.26%

Bond Indices	Last Value	Ytd
US Inv Grande	105.81	-18.15%
US High Yield	74.23	-11.11%
Euro Corps	229.87	-12.81%
JPM Europe Govies	9,514.90	-10.54%
US Treasuries	2,174.20	-13.03%
China Aggregate	248.47	-7.73%
EMBI Global	748.25	-18.63%
EMBI Local	119.12	-13.50%

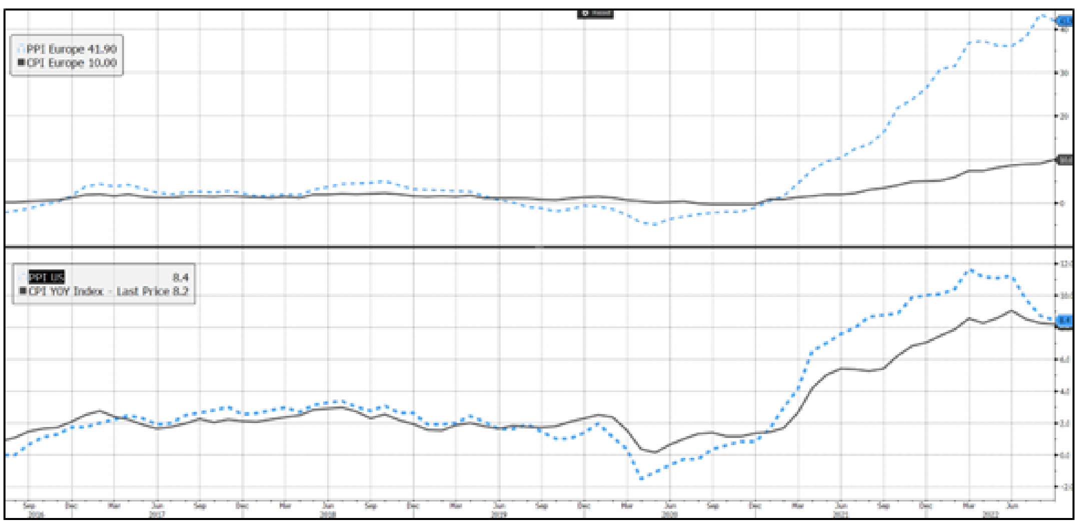
Commodities	Last Value	Ytd
BBG Commodities	114.79	15.76%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.35	10.79%
Gold	1,750.68	-4.29%
Silver	20.94	-10.15%
BBG Brent Crude TR	1,064.61	42.14%
BBG WTI Crude Oil TR	190.40	24.36%

FX	Last Value	Ytd
DXY Index	1,282.40	9.28%
Bbg JP ASIA	98.60	-8.75%
Bbg JP LATAM	39.22	-4.06%
EUR Index	119.83	-0.77%
EUR/CHF	0.99	-4.98%
GBP Index	626.61	-8.23%
EM FX Index	1,621.44	-6.51%
JPY/USD	140.37	-18.02%
CNY/USD	7.12	-10.73%
Bitcoin	16,620.06	-64.13%

Source: Bloomberg, as at November 18, 2022. Performance figures in indices' local currencies.

Our view: As Figure 2 shows, PPI and CPI, besides being at lower absolute levels in the US, have taken on a very different direction in Europe. So while we shall see how this develops, we continue to view Europe’s outperformance with some suspicion.

Figure 2: European PPI and CPI



Source: Bloomberg, as at November 18, 2022.

“…the statement that the Fed Funds rate should settle in the 5-7% area was certainly not good news for equities.”

It is possible that an element of support for Europe came from China, to which the continent is very closely linked through exports. The glimmers of reopening in China have also fueled domestic market strength (KWEB is up 42% from October lows). Of course, progress is incremental and gadget-like, and much remains uncertain, keeping demand expectations low and preventing a painful commodity rally. Moreover, just as we have confirmed that the reopening in China is taking place, Covid cases are exploding, and various reports this week argue that the Chinese health care system cannot handle a further expansion of the contagions. An editorial appeared in the People's Daily stating that the country would be able to achieve a 'dynamic zero-Covid', while there is talk of building new hospitals.

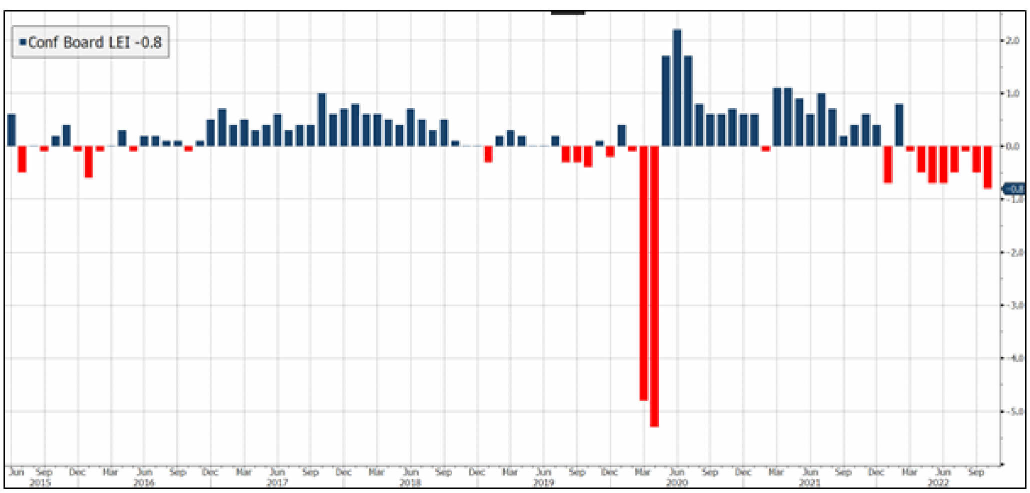
Elsewhere, in the US, St. Louis Fed President James Bullard’s speech this week was striking. Although inflation is starting to decelerate and the markets have completely ruled out the possibility of another 75 basis points (bps) hike in December, the statement that the Fed Funds rate should settle in the 5-7% area was certainly not good news for equities. In particular, the past 12 months have seen the fastest rise in Fed Funds rates since 1981, and the fastest rise in ECB rates since the creation of the Eurozone. With the lagged effects of an almost unprecedented tightening, it remains to be seen how far the Fed will continue on its upward path. And macro data released this week continued to confirm the slowdown in economic activity, despite the resilience of the consumer, supported by employment, against all other variables.

> "With the lagged effects of an almost unprecedented tightening, it remains to be seen how far the Fed will continue on its upward path."

Even on the micro front, despite a positive retail sales release this week (1.3% versus 1.1% expected), signs point toward a slowdown, with the usual division between consumer groups still evident. This week, various companies in the retail sector offered contrasting perspectives on their consumers and strategies. Perhaps the most noticeable was the outperformance at both ends of the spectrum: value retailers such as Walmart gained market share through write-downs and inventory clean-up, while luxury retailers such as Burberry remain protected by resistance from high-end consumers. However, Target predicted a frosty festive season and Gap already noted the beginning of a slowdown in demand this month.

Among the various data releases this week, it was interesting to see the conference board's leading index, an aggregate of forward looking indicators. We note that this index has been falling for a good eight months, but this month there was an acceleration, and the director of the Conference Board, Ataman Ozyildirim, commented that we may already be in recession—even though the average distance from the peak is around 11 to 12 months. In any case, it has never happened that a drop of this magnitude in the index has not been followed by a recession. Against this backdrop, the US curve (2-year-10-year Treasury slope at -71 bps) also made a new record high since 1982 in terms of inversion. This indicates that the market considers any further hikes in Fed Funds less and less appropriate.

Figure 3: Conference Board's Leading Index



Source: Bloomberg, as at November 18, 2022.

> "...this index has been falling for a good eight months, but this month there was an acceleration..."

Equities | Be careful what you wish for

What type of recessions lays ahead?

"So far, this earnings season has shown little impact from the tighter monetary policy on earnings growth."

The latest US CPI and PPI data gave the market a lot to cheer for, with a strong rally that caught many investors off guard. Elevated cash levels and bearish sentiment prevalence are the classic ingredients for such dramatic price actions. And while we think that the better-than-expected inflation data may very well mark peak inflation, it still leaves the question of what the Fed's "higher terminal rate" will be. As mentioned earlier, Bullard stated that the Fed's terminal policy rate should reach between 5-7% in order to achieve the Fed's inflation objective.

Our view: So far, this earnings season has shown little impact from the tighter monetary policy on earnings growth. One portfolio company's earnings miss, however, gave us something to think about. On its earnings call, Target's CEO stated that the company is planning for "rapidly softening demand" and that borrowing options for customers are running out. The miss and CEO comments appeared at odds with Walmart's beat and guidance raise, suggesting that Target's woes are company-specific and not part of a wider industry issue. And while that still may be true, it is important to note that Walmart's market share and new customers gains were because of its positioning as the lowest-priced leader. Walmart saw new customer gains from households with an income above USD100,000 and there was noticeable incremental trade-down behavior with private label penetration increasing by 1.30%. In other words, Target and Walmart's earnings results are possibly two sides of the same coin.

Last week the further inversion of the US Treasury yield curve reminded investors of the lurking recession risk. Whether the recession is avoidable, shallow or deep is a question that requires a lot more data than what we have now. As such, the outlook for equities is still not certain, despite the latest CPI and PPI data points. We continue to break away gradually from the barbell approach in favor of a value-biased portfolio. Meanwhile, Berkshire Hathaway's accumulation of roughly USD4 billion worth of Taiwan Semiconductors (TSMC) shares highlights the fact that there are pockets of value emerging within the traditionally growth-styled technology sector.

"All these factors are contributing to improved prospects for credit-oriented hedge funds managers."

Hedge Funds | Are we headed toward a credit distressed cycle?

Remaining in "protection mode".

Long / short credit strategies have for long been a staple of the hedge fund industry. However, the post-GFC world marked by low interest rates and quantitative easing (QE) proved challenging for active management strategies. At the same time, the few market dislocations that we have experienced were generally short-lived and concentrated in a few sectors—including the 2015 dislocation in oil and the 2020 one in travel and leisure. In that environment, managers' returns generally lagged the overall industry.

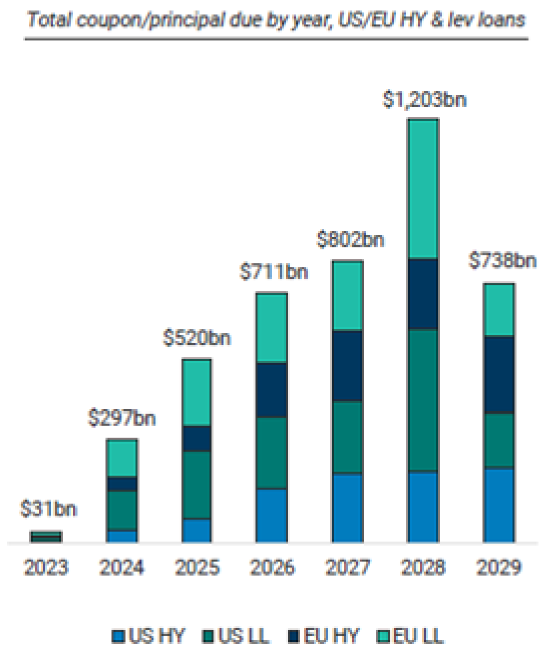
2022 has represented a shift with global monetary tightening and geopolitical tensions leading to spread widening, increased price dispersion and a growing distressed universe. All these factors are contributing to improved prospects for credit-oriented hedge funds managers.

Our view: Our discussions with managers and industry participants suggest that most are for now remaining in "protection mode", given the news flow from central banks' actions, and are therefore mostly staying within the investment grade credit universe and benefiting from the higher yields in their portfolio—a feature they hadn't seen for a long time. Contrary to previous cycles, when central banks were providing relief to markets with monetary stimulus, the ongoing fight against inflation makes it unlikely this time around. Most expect a more industry-wide typical corporate distressed cycle that we have not seen since the early 2000s (higher financing costs / lower margins and potentially lower revenues should a recession hit). Years of QE have also led to a material increase of credit markets globally and the total amount of corporate indebtedness.

"...we do believe that it is still too early to call for a distressed cycle as the "maturity wall" is not expected before 2024..."

While we do believe that it is still too early to call for a distressed cycle as the "maturity wall" is not expected before 2024 (Figure 4), we are ready to capitalize on the improved opportunity set and will for now remain opportunistic in our allocation to the strategy.

Figure 4: High Yield and Leverage Loan Maturities



Source: Goldman Sachs Global Prime Services.

Week Ahead | Key events to watch for

- The coming week will be relatively devoid of significant events, apart from t**he flash PMIs**.
- **The next major market events all come in the next two weeks.** First, there will be important data released in the US (payrolls and ISM); followed by central bank week in mid-December, with the meetings of the Fed, Swiss National Bank, Bank of England and the ECB.

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