NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Growth outpaces value as Covid fears return

November 21, 2021

This week, markets have suddenly had to reckon with the rapid increase of Covid cases across Europe – or at least in some countries, which happen to have lower vaccination rates among the population. At the level of impact on financial markets, the news came against a backdrop in which some dynamics were already (casually) underway in the previous days. Specifically, all value trades were already vastly underperforming the growth sector during the week, and this was brutally amplified on Friday.

Highlights

▪ The growth component of the Russell 2,000 index managed to rise 2.60% during the week, while the value equivalent lost 1.8%. The Nasdaq index rose an honorable 1.24%, while the S&P 500 index remained flat, but moderately positive.

▪ European equities suffered the most, and rates quickly fell in Germany, as curves flattened and breakeven inflation corrected. The double blow of falling sentiment-rates devastated banks, which lost over 3% on Friday.

▪ Corporate debt across the world broadly sagged as inflation fears mounted. Investment grade credit in the US and Europe, and high yield total returns, all weakened.

▪ In the primary market, US investment grade bonds struggled to absorb the USD56 billion of new supply sold, while US junk bonds showed no signs of fading demand for new issues yet.

▪ The sharp repricing of the EUR/USD pair shows that traders are lowering expectations for a quick move toward USD1.10 support, a risk that has been in focus recently given that the ECB reaffirmed its dovish stance.

"Looking at the percentage of the population vaccinated, it is striking, and in a sense reassuring, that the countries most affected are those with the lowest vaccination rates."

Markets & Macro | Growth outpaces value as Covid fears return

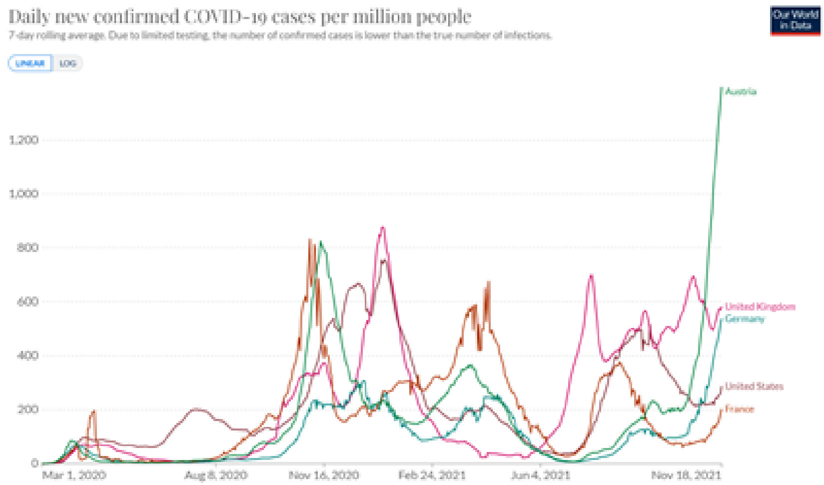
European markets reawaken to Covid.

Against a rapid rise in Covid cases across Europe, Austria announced a national lockdown starting Monday, as well as making it mandatory by law to vaccinate as of February 1, 2022. In Germany, the Health Minister has also announced that he cannot exclude a new national lockdown, after restrictions for the unvaccinated were announced on Thursday. However, we note that since then, the statements of the German minister have been downgraded by the same ministry.

Our view: For most of the most affected countries, Figure 1 shows that the spike in cases happened quite rapidly in the last two weeks. The exception is the UK, where cases have been high and constant since the summer, as high vaccination rates and number of infections have apparently provided some degree of herd immunity.

> “European equities suffered the most, and rates quickly fell in Germany, as curves flattened and breakeven inflation corrected.”

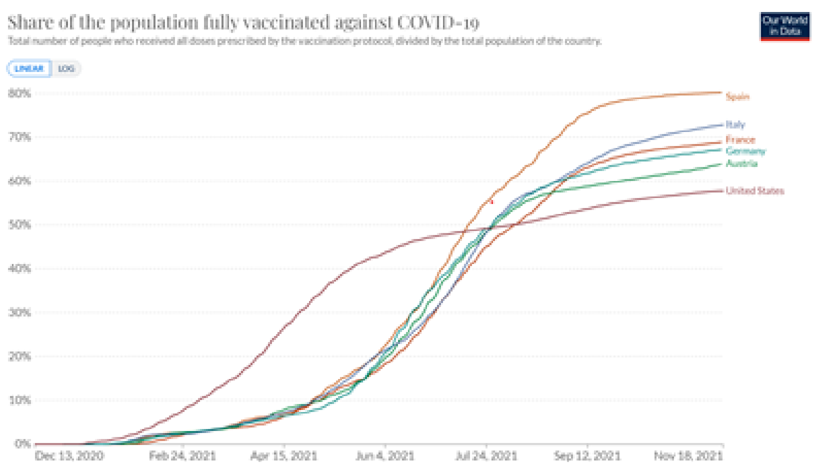
Figure 1: Recent Rapid Spike in Covid Cases



Source: Our World in Data, as at November 19, 2021.

Looking instead at the percentage of the population vaccinated (Figure 2), it is striking, and in a sense reassuring, that the countries most affected are those with the lowest vaccination rates. In fact, the vaccination rate in Austria (64%) is decidedly lower than in Spain (79%), Italy (72%), France (69%), the UK (69%) and Germany (67%). Instead, it might be of concern that the US has an extremely low vaccination rate, which could suggest that the country is simply further behind the curve of infection. But let's also remember that the propensity to resort to lockdowns is infinitely lower in the US, and that this varies significantly from state to state.

Figure 2: Countries with Lower Vaccination Rates are Most Affected



Source: Our World in Data, as at November 19, 2021.

> “In the context of Covid, the peripheral European economies are always considered more fragile because of the scarce margin of fiscal maneuver and the relevance of tourism.”

European equities suffered the most, and rates quickly fell in Germany, as curves flattened and breakeven inflation corrected. The double blow of falling sentiment-rates devastated banks, which lost over 3% on Friday. The paradoxical result was that the worst squares in Europe were Milan and Madrid – considering that Italy and Spain currently have very few cases and a very high vaccination rate compared to their European counterparts. But in the context of Covid, the peripheral European economies are always considered more fragile because of the scarce margin of fiscal maneuver and the relevance of tourism. And then possibly the market, awakened to the Covid risk, looked at the potential for the trend to worsen in Southern Europe with the arrival of colder weather.

On the other hand is the Nasdaq index, which contains all the stocks related to the possibility of "working-from-home". However, the index seems to have an almost maniacal behavior thanks to the retail flows that converge toward the usual suspects. The Nasdaq also managed to shrug off the rather hawkish statements from Federal Reserve (Fed) members at the end of the week. Between Thursday and Friday, in fact, Fed members Clarida, Waller and Williams clearly referred to the need to accelerate the tapering process of Fed purchases, which could end as early as March instead of the initial forecast for June. All of them obviously aimed at containing inflation expectations and pressures on wages, which risk becoming structural.

Risk of persistent inflation rises.

Continuing on the subject of inflation, we would like to report to our clients the contents of a call we had this week with Simon Penn, senior economist at UBS Investment Bank. The purpose of the conversation was to listen to his views on inflation and US Treasury yields, since we have recently opened a short position on the US 10-year.

"...adjusting monetary policy according to a rise in today's prices would be counterproductive."

Simon has a strong traditional economist background – he fully endorses the central banks' attitude to define the current inflation spike as "temporary". He refers to an upward shock to prices rather than a shift of regime. We challenged his views for the sake of the discussion, and he opposed solid technical arguments against fears of a permanent increase in prices. Below are the key takeaways from the call:

- Central banks make their choices based on their forecasts of the state of the economies two years from now. Consequently, adjusting monetary policy according to a rise in today's prices would be counterproductive.
- Central banks can do nothing against rising energy prices. In fact, raising rates today would be a further slap in the face for consumers disadvantaged by rising prices.
- Monetary policy can't do anything against supply disruptions. Central banks fear that by reacting to inflation today, a year from now they will find that not only has inflation declined, but so has growth.
- Despite the benign view on inflation, interesting is the rather upward forecast on the level of the US 10-year: 2.25% at the beginning of 2022, against 1.60% today. The reason for this is the considerably higher "fair value" derived from their econometric models. The distorting effect on the yield level should fade in the coming months.

Our view: With his profile of academic origin, the economist seemed very much aligned with the mindset of a central banker, and it was interesting to hear how he thinks about macroeconomic variables – as we are used to dealing with the market and the world of traders. The approach is therefore to "model" the monetary policy choices without getting carried away by the emotionality that can affect investors and consumers with respect to the current surge in prices.

However, it must also be said that rarely in the past have economists or central bankers proven to be able to foresee a significant regime change (as in the early 1970s, to give the most recurrent example today). Therefore, it is our opinion that, as portfolio managers, we must maintain a very vigilant and prudent attitude with respect to this issue, because the risk of a price increase becoming persistent is high. The labor market, with the low participation rate due to the high quit rate, remains the most critical aspect that could influence wages and consequently consumer expectations in a more lasting way.

"...we must maintain a very vigilant and prudent attitude with respect to this issue, because the risk of a price increase becoming persistent is high."

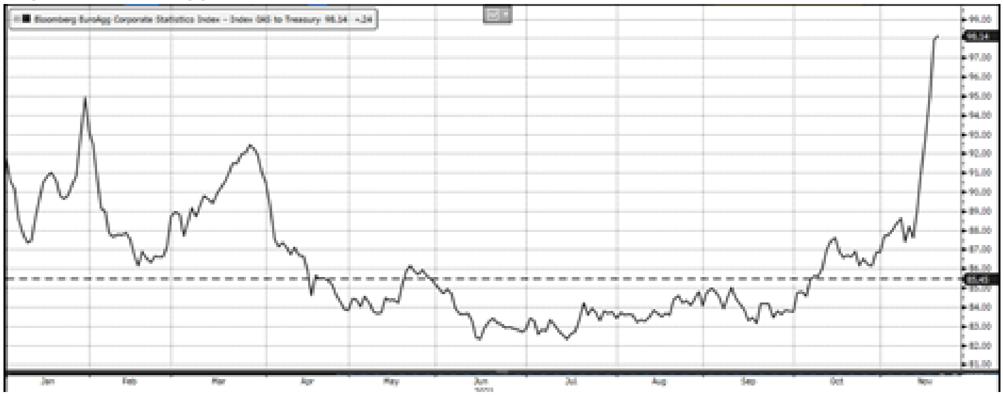
We conclude by reporting the results of the always interesting BofA Fund Manager Survey (388 panelists with USD1.2 trillion in assets participated this month). We find that there is some consistency between what has been expressed in terms of asset performance and expectations for the future, as per central bank forecasts. We will therefore see if the benign scenario, accompanied by aggressive positioning, is matched by equally good performance in 2022: "Clients are ending 2021 with biggest overweight of stocks since August 2013, only 6% think there will be a recession in next 12 months, 61% think inflation is transitory (though 3 of 4 were surveyed before recent CPI data), 30% think the S&P will be "best performing asset class" in 2022 (12% think it will be Bitcoin)".

Fixed Income | High yield continues to offer rate cushions

Demand for junk paper shows no signs of fading.

Corporate debt across the world broadly sagged as inflation fears mounted. Investment grade credit in the US and Europe, and high yield total returns, all weakened. As the European Central Bank (ECB) starts dialing down its quantitative easing efforts, EUR corporate bonds are feeling the pain the most. Average spreads for investment grade notes reached their widest in more than a year.

Figure 3: EuroAgg Corporate Statistics Index



Source: Bloomberg, as at November 19, 2021.

> "Though spreads are still tight compared with historic levels, without the ECB, investment grade valuations are rich and vulnerable to shocks."

Our view: Though spreads are still tight compared with historic levels, without the ECB, investment grade valuations are rich and vulnerable to shocks. As a Morgan Stanley strategist said, "current valuations leave little room for error. Even modest and idiosyncratic stresses can weigh on returns." The forecast is for a negative return of -1.7% in 2022.

While junk debt underwent a big correction in September and October, the market has since retraced some of that weakness. As usual, the sector has benefited from the reach for higher yields, and the wider spreads offer a larger cushion amid rates gyrations. High yield would inevitably offer greater cushion against rates than investment grade, given its higher credit risk. To judge the true relative potential, one can look at the breakeven histories of both assets as well their ratios. Breakeven (the yield divided by duration) measures the cushion in rising rates before any negative total returns can happen. With the rally (prices up, yields down), Figure 4 shows a drop in this cushion both for investment grade (to 8 bps, red line) and high yield (98 bps, black line). However, the high yield to investment grade breakeven ratio at 12 bps (blue line) is still wide, being above the median line and in the 73th percentile.

Therefore, we can consider that high yield, at this juncture, is still offering a decent rates cushion relative to investment grade. For 2022, we believe this will protect the high yield market from the drag of rates and generate a positive total return (1.5% according to JP Morgan).

Figure 4: EUR High Yield vs. Investment Grade Breakeven

Source: Bloomberg, as at November 19, 2021.

> "In US junk bonds, there were no signs of fading demand for new issues yet, as the primary market priced almost USD28 billion."

In the primary market this week, US investment grade bonds struggled to absorb the USD56 billion of new supply sold, and issuers had to pay some new issue concessions (6 bps versus an average of 2 bps in 2021) to get their deals sold. However, in US junk bonds, there were no signs of fading demand for new issues yet, as the primary market priced almost USD28 billion. Hertz sold its first bonds after exiting bankruptcy. The Caa1 rated car rental company priced an 8-year bond (maturing in 2029) at 5% (versus 5.25% initially discussed) and a 5-year bond (maturing in 2026) at 4.625% (versus 4.75%).

In Europe, ESG-labelled notes accounted for about 60% of the EUR28.1 billion of bonds sold during this week. Maersk issued the first green bond in its history, with proceeds used to finance its planned purchase of 8 green methanol vessels. The EUR500 million bond garnered interest for EUR3.7 billion and enabled Maersk to price at swap + 70 bps after initial price talk of swap at + 95-100 bps. The final coupon of 0.75% is the lowest annual interest ever for Maersk.

FX & Commodities | Will dovish ECB send EUR/USD toward USD1.10?

Chart of the week

"This sharp repricing shows that traders are lowering expectations for a quick move toward USD1.10 support, a risk that has been in focus recently given that the ECB reaffirmed its dovish stance."

The EUR/USD currency pair is once again testing the Fibo's 61.9%. If it breaks, the next stop is 1.104. The RSI is exceptionally in oversold territory. The price is below 2 sigma of the downtrend line started from January 21. On the option side, the repricing in the front-end of euro options suggests the common currency is settling within a new range, and that a move lower toward USD1.10 support isn't imminent. One-week risk reversals are now in favor of euro calls and trade at 0.12 vol, which compares to a reading of -0.67 vol on Wednesday.

This sharp repricing shows that traders are lowering expectations for a quick move toward USD1.10 support, a risk that has been in focus recently given that the ECB reaffirmed its dovish stance. If anything, the euro looks to be settling within a USD1.12-1.15 range into year-end.

Figure 5: EUR/USD Currency

Source: Bloomberg, as at November 19, 2021.

Week Ahead | Key events to watch for

- **In the week of the American Thanksgiving, the publication of economic data at a global level will be scarce**, with only the PMIs and the minutes of the last ECB and Fed **meetings.**
- **It will be important to monitor the evolution of Covid's cases**, especially in Europe.
- **Before the holidays will almost certainly come the announcement of the new Fed president**, who will take office in February 2022. The odds are clearly in favor of a confirmation of Trump (Figure 6).

Figure 6: The Next Fed Chair

Whom will the Senate next confirm as Chair of the Federal Reserve?

Contract	Latest Yes Price		Best Offer			Best Offer
Jerome Powell	66¢	2¢	66¢	Buy Yes	Buy No	35¢
Lael Brainard	37¢	NC	38¢	Buy Yes	Buy No	63¢
Raphael Bostic	1¢	1¢	2¢	Buy Yes	Buy No	99¢
Roger Ferguson	1¢	NC	1¢	Buy Yes	Buy No	N/A
Sarah Bloom Raskin	1¢	NC	1¢	Buy Yes	Buy No	N/A

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Novum Capital Partners SA | Rue des Alpes 7 | 1201, Geneva | +41 22 715 18 00