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Weekly Market Flash

The rate market continues to challenge central banks

January 22, 2023

It was an interlocutory week on the stock markets. The major European and US indices were rather volatile during the week, but ended it with limited losses of around -0.5%. Only China continued its rally, with gains of over 2.5% in Shanghai. The main reason for this movement was the series of negative macro data from the US. While not much impact was expected from the macro front, the intensity and continuity of the negative surprises inevitably attracted attention. Overall, there is further evidence of weakening activity and a more benign inflationary environment. And it seems to be becoming increasingly clear that the market may be right that the Federal Reserve's (Fed) next rate hike, the first one in February, may be the last in the cycle.

Highlights

- Retail sales fell 1.1% on a monthly basis, while November's contraction (-0.6%) was also revised to an even weaker -1% on a monthly basis. Industrial production also saw the third consecutive monthly contraction.
- On the labor market front, despite still solid aggregate data, announcements of layoffs continue in two key sector—namely technology and finance.
- A Bloomberg report had clearly spoken of the possibility that the ECB might want to slow down the pace of rate hikes. After the planned 50 bps rise on February 2, the ECB would (according to the report) reduce the next rise to 25 bps, which would then be the penultimate one.
- As the cloud of uncertainty regarding the Fed's hiking cycle clears gradually throughout the course of this year, we expect defensive stocks to play a less meaningful role in portfolios.
- Credit has started the year with an impressive global rally. Bonds of all stripes have surged between 3% and 4% from the start of the year, one of the best performances since 1999.

"On the price front, a confirmation of the improving trend came from the PPI, which was below expectations."

Markets & Macro | The rate market continues to challenge central banks

Markets discount 300 bps of cuts from rate peaks.

A number of data releases came through this week: retail sales fell 1.1% on a monthly basis (an extremely high number, and worse than the -0.9% the market was expecting), while November's contraction (-0.6%) was also revised to an even weaker -1% on a monthly basis. On the price front, a confirmation of the improving trend came from the PPI, which was below expectations.

“...we can see that in volume terms, sales have been stagnating for several months now—and are recently starting to fall in absolute terms.”

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

Equity	Last Value	Ytd
MSCI World	2,725.40	4.79%
Nasdaq	11,140.43	6.47%
S&P 500	3,972.61	3.55%
DJ Industrial	33,375.49	0.78%
SPX Value ETF	151.02	4.10%
SPX Growth ETF	224.41	4.75%
Nikkei	26,553.53	1.76%
Eurostoxx	4,119.90	8.78%
Swiss SMI	11,295.02	5.27%
FTSE 100	7,770.59	4.33%
Canada	20,503.21	5.92%
Shenzen	4,181.53	8.01%
Hong Kong	22,044.65	11.44%
MSCI EM	1,036.24	8.40%

Bond Indices	Last Value	Ytd
US Inv Grade	110.55	4.86%
US High Yield	76.17	3.45%
Euro Corps	233.09	2.39%
JPM Europe Govies	9,489.98	2.82%
US Treasuries	2,240.19	2.37%
China Aggregate	261.87	2.59%
EMBI Global	794.02	3.35%
EMBI Local	127.83	3.34%

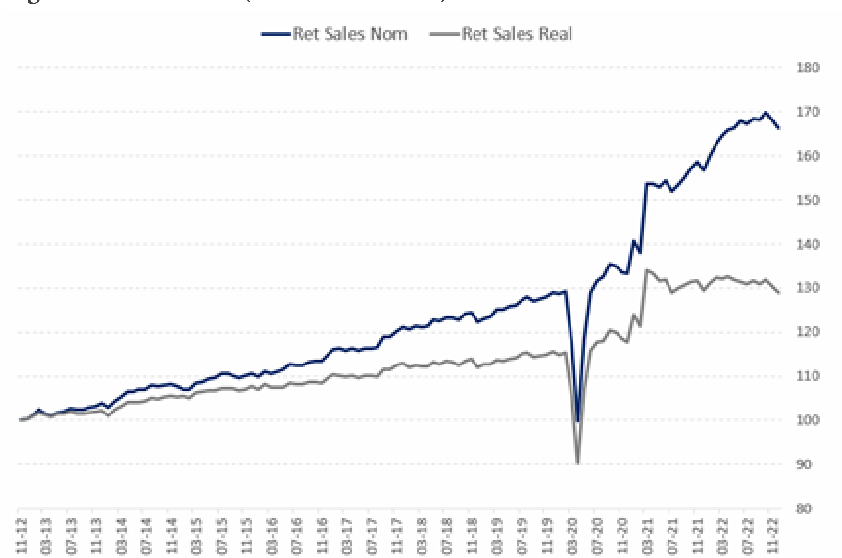
Commodities	Last Value	Ytd
BBG Commodities	112.13	-0.60%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	67.37	-2.11%
Gold	1,926.08	5.60%
Silver	23.93	-0.09%
BBG Brent Crude TR	1,083.33	2.02%
BBG WTI Crude Oil TR	194.63	1.75%

FX	Last Value	Ytd
DXY Index	1,224.86	-1.74%
Bbg JP ASIA	103.10	1.89%
Bbg JP LATAM	40.52	1.94%
EUR Index	122.08	0.27%
EUR/CHF	1.00	0.91%
GBP Index	633.54	1.72%
EM FX Index	1,697.30	2.21%
JPY/USD	129.60	1.17%
CNY/USD	6.78	1.68%
Bitcoin	22,742.39	37.50%

Source: Bloomberg, as at January 20, 2023. Performance figures in indices' local currencies.

As can be seen in Figure 2, retail sales are a measure of nominal prices. Consequently, if we remove the inflation component from the series (the grey line), we can see that in volume terms, sales have been stagnating for several months now—and are recently starting to fall in absolute terms.

Figure 2: Retail Sales (Nominal vs. Real)



Source: Bloomberg, as at January 20, 2023.

“The market is discounting 50 bps of declines in 2023, from a starting point (peak rates) just below 5%.”

Our view: So we have further evidence of weakening activity and a more benign inflationary environment. And it seems increasingly clear that the market may be right that the Fed's next rate hike, the first in February, may be the last in the cycle. On the other hand, as we have commented previously, it is always a much more aggressive bet to think that the Fed may deliver some cuts by the end of the year. The market is discounting 50 basis points (bps) of declines in 2023, from a starting point (peak rates) just below 5%.

Industrial production also underlined the weakness the US economy is experiencing—it was the third consecutive monthly contraction, -0.7% in December (with November's figure revised from -0.2% to -0.6%). It does not seem coincidental that many data are revised downward in second readings; this is a trend typical of phases of structural weakness. On the labor market front, despite still solid aggregate data (in the sense that on an overall level, the economy is still generating jobs), announcements of layoffs continue in two key sector—namely technology and finance. Microsoft announced 10,000 job cuts (almost 5% of its workforce), while Google will cut 12,000. The next sector that is expected to start downsizing is real estate, since we have already seen that new construction sites are collapsing, so employment is only strong due to the lag between old construction sites to be delivered and new business absent.

“...it is clear that some concern that the central banks want to regain control of the situation by giving strong signals may emerge!”

The fact remains that the rate market continues to challenge central banks, not only in the US but also in Europe. Earlier in the week, a Bloomberg report had clearly spoken of the possibility that the European Central Bank (ECB) might want to slow down the pace of rate hikes. After the planned 50 bps rise on February 2, the ECB would (according to the report) reduce the next rise to 25 bps, which would then be the penultimate one.

However, the minutes of the ECB meeting in December completely contradicted this version! The board appears determined to continue tightening strongly. A significant number of members wanted 75 bps hike, so a compromise was reached, largely to raise rates by 50 bps. This was accompanied by a hawkish message, and an indication that rates should rise above the levels indicated by the market as the target at the time. Moreover, according to Lagarde's comments in Davos, the improvement in the growth picture provided by the slowdown in gas prices is being read as an excuse to tighten monetary policy further.

While it is also true that in January inflation finally showed some signs of slowing down, this has nothing to do with the ECB's rate hikes—but rather with falling energy prices, affected by favorable weather and slowing economies. Another 50 bps rate hike at the February meeting, two weeks from now, seems a done deal and another 50 bps rate hike at the March meeting therefore seems very likely. As a result, after the fall in yields in the first days of the week, the bond market started to calm down, and to reverse gains, especially in Europe. In 10 days, which will be the first week of February, we will indeed have the official Fed and ECB meetings. And with respectively 200 bps and 100 bps of cuts discounted by the market from the rate peak in the next 12 months, it is clear that some concern that the central banks want to regain control of the situation by giving strong signals may emerge!

“But some of these stocks performed so well in relative and absolute terms that we now have trouble justifying owning them.”

Equities | Defensives lose their luster

Value and growth to outperform as policy uncertainty fades.

In 2022 we argued for increasing the allocation to defensive stocks to create a three-way balance between the value, growth and defensive factors. This served portfolios well with utilities and consumer staples outperforming the index by a wide margin during the year.

But some of these stocks performed so well in relative and absolute terms that we now have trouble justifying owning them. For example, Pepsi, a quality consumer staples stock, was up 6.8% last year on a total return basis. The stock is now trading at 23.1x 2023 P/E with an expected 3-year EPS CAGR of around 7.8%. This compares to a 2023 P/E multiple of also 23.1x (calendarized) for Microsoft, with a 3-year EPS CAGR forecast of around 15% or double that of Pepsi’s.

Our view: Unfortunately, Pepsi is not an outlier. Several other defensives stocks have seen their valuations surpass those of growth stocks in 2022. As the cloud of uncertainty regarding the Fed’s hiking cycle clears gradually throughout the course of this year, we expect defensive stocks to play a less meaningful role in portfolios. We are therefore reducing exposure to these stocks and concentrating the portfolio weights in the value and growth factors instead. The risk to this approach is that of a deep recession where defensives tend to offer relative protection, regardless of valuation levels.

Fixed Income | Bond rally ushers in heavy new issue

Holding on to a higher-quality bias.

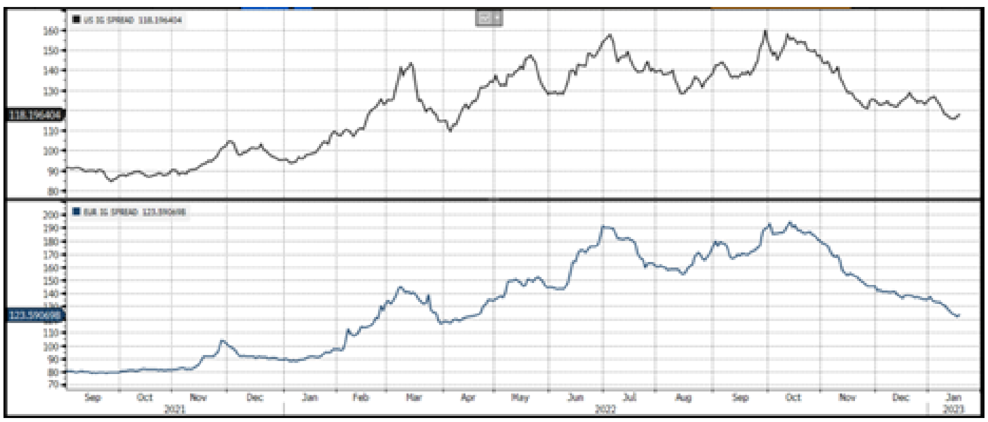
"The deluge of supply has been met with strong demand from many investors, for whom fixed income assets look increasingly attractive..."

Credit has started the year with an impressive global rally. Bonds of all stripes have surged between 3% and 4% from the start of the year, one of the best performances since 1999. Driving this performance was a combination of signs of cooling inflation and some weaker-than-expected US economic data that reinforced expectations for a slowdown in monetary tightening by central banks.

This good start has helped fuel heavy new issue activity from companies to sovereigns. The deluge of supply has been met with strong demand from many investors, for whom fixed income assets look increasingly attractive after the disastrous 2022 brought yields to their highest level since 2008 and, above all, because the prospect of a global economic slowdown offers the potential for further gains—at least in investment grade markets.

US investment grade credit spreads (the black line) hit their tightest in nine months this week, while in Europe (the blue line) they were the lowest since May. At 120 bps in the US, they are, however, far from the 200 bps typically seen during recessions.

Figure 3: Investment Grade Credit Spreads



Source: Bloomberg, as at January 20, 2023.

"We still prefer to be high up in credit quality and prefer investment grade corporates, which in the case of a recession should experience less spread widening."

For blue-chip companies looking to tap the market, funding costs have diminished since the start of this year. In US high grade, companies paid minimal new issue concession (less than 4 bps versus 17 bps) with books well covered (3x) and good compression in the secondary market (-26 bps). Financial firms have led the charge, especially in Europe, where they are looking to repay cheap pandemic-era ECB loans.

For context, Morgan Stanley garnered USD25 billion for its USD6 billion deal with the 5-year tranche issued at a yield of 5.05% (120 bps over Treasuries) trading now at 479%. The junk bond segment is also reopening, albeit more slowly. Norwegian Cruise Line, a regular visitor at the beginning of every year, issued a secured USD600 million bond, increased from USD500 million, for a yield of 8.375%, tighter than initial discussions in the area of 9%. High yield deals have also started to resurface, even in Europe, including a potential 5-year offering from Telecom Italia (B1/B+), which is returning to the market after a two-year absence, with a 5-year deal yielding 6.875% after initial discussion at 7%.

Our view: We remain cautious. We still prefer to be high up in credit quality and prefer investment grade corporates, which in the case of a recession should experience less spread widening. For the moment, we are avoiding the lowest rated bonds (especially below BB-) and are weary of subordinated credit that tends to be more correlated to equity markets—which would likely decline in a recessionary environment.

Week Ahead | Key events to watch for

- **The first estimate of Q4 2022 US GDP**, and consequently growth over the whole year, will be released. PMIs data globally will also come out, while, again in the US, we will see PCE and durable goods orders.

- **Earnings season enters its intense phase.** All eyes will be on Microsoft, Tesla and ASML, among others.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**	**Carlos De Andres Perez**	**Maxime Glasson**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	Senior FX, Crypto & Derivatives Portfolio Manager	Senior Equity Portfolio Manager	Senior Private Equity Funds Manager	Senior Hedge Funds Manager