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Weekly Market Flash

Could a market correction be coming up?

January 24, 2021

The S&P 500 index has rallied almost 17% since the week prior to the US presidential election, when it bottomed at 3'305 among the uncertainties around a contested election and social upheavals. With the index now at 3'850, and evidently much positive news being priced in, we reiterate that we think a phase of consolidation/correction is necessary to restore the market's health. As a result, we decided to reduce risk in our managed portfolios this week, taking profit on an overweight equities position that we had built prior to the election.

Highlights

▪ US indexes closed higher this week, while European stocks were held back by concerns over prolonged lockdowns. Chinese stocks advanced as economic data highlighted the country's remarkable recovery: Q4 GDP came in at 6.5% year-on-year.

▪ In her testimony this week, Janet Yellen emphasized that tax reform would not be an immediate priority, while noting that the US needs "to take on China's abusive, unfair and illegal practices."

▪ On the data front, we're witnessing a clear deterioration of the US labor market, with jobless claims remaining extremely high (above 900k, after having bottomed at 625k in October).

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Markets & Macro | A market correction coming up?

Positive news priced in, elements of concern emerging.

After bottoming at 3'305 the week prior to the US presidential election, the S&P 500 index has rallied nearly 17% to 3'850—suggesting that the market has incorporated much positive news and the clearance of several key risks. In fact, during this 3-month period, equities have benefited from a number of events:

- A clear election outcome, with little credible margin of dispute.
- An extremely moderate winner who built up a very balanced and experienced team, with limited room for the more extreme left wing of the party.
- The announcement of the vaccines in the western world with unthinkable efficacy ratios, and the subsequent speedy approval for mass production and distribution.
- Continuous policy support from central banks—with the European Central Bank increasing and prolonging the PEPP and all other central banks reinforcing their dovish message at any occasion.
- Two significant fiscal programs in the US and Japan in the order of USD900 billion and USD700 billion, respectively.
- The Georgia runoffs providing an unexpected win to the Democratic candidates, likely due to the chaos created by Trump in the weeks prior to the election. With the Democrats in control of the Congress, a new USD1.9 trillion fiscal package has been announced by the newly elected President.

- The January 6th event at Capitol Hill, which, despite the shock, saw markets rally once investors realized it represented the end of Trump's unconventional political experience. The hope is that calmer heads will prevail within the Republican party and bring in a more traditional leadership, and a constructive opposition in the Congress.
- The installment of Janet Yellen at the Treasury. Her choice has been celebrated as a guarantee of smooth cooperation and alignment with the Federal Reserve (Fed).
- A strong start to the Q4 earnings season, with companies beating expectations—and in some cases, by a wide margin.

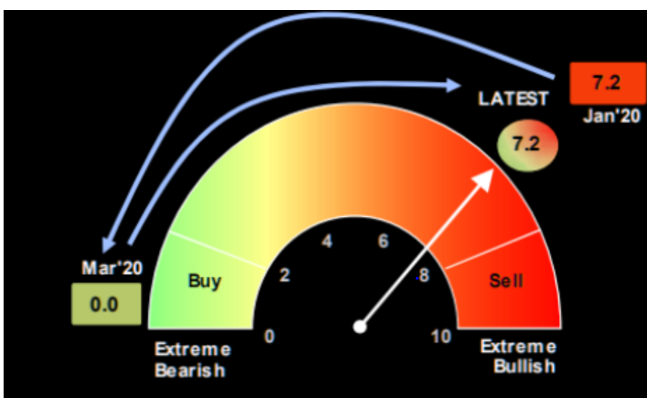
"In our opinion, consensus and positioning appear quite extreme, with so many technical surveys and indicators flagging overextended conditions..."

Our view: As we mentioned last week, we think a phase of consolidation/correction is necessary to restore the market's health at this point. In our opinion, consensus and positioning appear quite extreme, with so many technical surveys and indicators flagging overextended conditions—including total calls traded volume, the CBOE put/call ratio, the BofA Bull & Bear indicator and the FMS survey of overweight equity exposures.

Figure 1: Asset Allocation - Global Equities

Source: BofA Global Fund Manager Survey.

Figure 2: BofA Bull & Bear indicator



Source: BofA Global Investment Strategy.

"With all the aforementioned positive news priced into markets, we struggle to see any short-term catalyst pulling markets up."

With all the aforementioned positive news priced into markets, we struggle to see any short-term catalyst pulling markets up. On the other hand, there are some elements of concern that are likely to weigh on sentiment. For instance, we believe investors were very forgiving with Yellen's testimony. After being used to Trump's aggressive and unpredictable communication, investors focused on the polite tone of the Treasury Secretary—and looked past any of the negatives. In summary, Yellen emphasized that tax reform would not be an immediate priority and that the administration does not intend to reverse the entirety of the 2017 tax cuts (but that eventually parts of that bill will be repealed). She also cited that she would work with the OECD on what the appropriate corporate tax rate should be.

On China, she used strong words—defining the country as "clearly our most important strategic competitor"— and that the US needs "to take on China's abusive, unfair and illegal practices."

On the data front, we're witnessing a clear deterioration of the labor market, as expressed once again this week by the extremely high level of jobless claims (above 900k, after having bottomed at 625k in October). We also believe that the risk of a second negative contribution from the January payrolls is high.

"...scientists are analyzing how effective the vaccines are against new mutations, and the risk is that the vaccines are ineffective..."

Finally, we're still in the middle of a long and difficult winter with a high number of coronavirus cases and lockdown extensions. There is a major tail risk emerging lately—scientists are analyzing how effective the vaccines are against new mutations, and the risk is that the vaccines are ineffective, and that vaccinating against the old variants will not be enough to end the pandemic this year. While this is not a central case, it is something to consider in investment decisions.

Equities | Value stocks lose lead to growth

US and Chinese markets advance, as European stocks slip.

US indexes closed higher this week. Netflix reported strong subscriber gains, which boosted the company's share price and most of the communication services sector. Apple, Facebook and Alphabet were also strong. Morgan Stanley was especially positive on Apple going into this earnings season, forecasting solid results.

Value stocks lost the lead to growth stocks, with energy and financials shares lagging. Meanwhile, European stocks were held back by concerns over prolonged lockdowns, and Japanese equities were relatively unchanged for the week. Chinese stocks, on the other hand, advanced as economic data highlighted the country's remarkable recovery: Q4 GDP came in at 6.5% year-on-year.

Our view: This week we took profit on our Brazilian exposure given the monetary and fiscal policy uncertainties. We expect the central bank to turn hawkish fairly soon, in response to core inflation moving above target.

Chart of the week

We updated our chart on the S&P 500 futures. As we've highlighted recently, the short-term bull trend has shown some signs of fatigue, and we don't see much room for upside. The pattern shown below is called the rising wedge, and typically this suggests a reversal. If the breakdown happens, the 50 SMA at 3'690 could be reached very quickly before buyers will come back and start to buy the dip.

"As we've highlighted recently, the short-term bull trend has shown some signs of fatigue, and we don't see much room for upside."

Figure 3: S&P 500 Futures

Source: Bloomberg.

Fixed Income & Credit | CREAL: Resilient asset quality metrics?

“CREAL has been coping well against the headwinds from the pandemic, and indeed it has increased its geographical and business diversification through acquisitions.”

Company increases business diversification through acquisitions.

This week, we have been looking into a recent new bond issue from Credito Real in USD (8% 21.01.2028 maturity, BB+ rated, with a yield to maturity of 7.23%, 200k+1k).

Based in Mexico, Credito Real (CREAL) is a non-bank financial institution focused primarily on consumer financing. After its foundation in 1993, the company has grown strongly and has expanded its offering in both the US and Central America. The company’s portfolio has also been expanded to include used car loans and SME financing. In Mexico, CREAL is the leading lender to the low and lower-middle income classes of the population.

Our view: The company has been coping well against the headwinds from the pandemic, and indeed it has increased its geographical and business diversification through acquisitions.

While the slowdown in the Mexican economy is impacting the company’s funding costs and asset quality, its high exposure to the resilient payroll lending segment should support the resilience of asset quality metrics. In fact, on November 20th, Fitch affirmed the BB+ rating on Crèdito Real stating it “has shown that it could contain asset quality deterioration well compared to peers, benefited by its concentration in the payroll segment, which has been relatively stable through the cycles.”

Week Ahead | Key events to watch for

- **The highlight of the week will be the Fed’s first monetary policy decision of the year** on Wednesday. After some confusion on the tapering debate in the first week of January, some reassurance from Chairman Powell is expected.

- **On the economic data side, Q4 GDP readings for a number of countries will be released**, including for the US, France and Germany. Sharp divergencies will emerge, with the US showing a positive growth number (consensus is for 4.5% growth), while European countries contracted (with French GDP down a severe -6%).

- **Attention will also be on earnings season**, with 122 S&P 500 companies reporting in the coming week including Apple, Microsoft, AMD, Facebook and Tesla.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	FX and Derivatives Portfolio Manager	Senior Equity Portfolio Manager