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Weekly Market Flash

A challenging environment for containing the spread

July 24, 2022

It was a very positive week for global equity markets, with average gains of over 3% in Europe and the US. This came despite the tightening of central banks being in full swing, while on the other hand, growth data – from PMIs to corporate surveys to leading indicators of the labor market to corporate announcements – started to show that the slowdown could easily turn into a hard landing, rather than a soft one.

Highlights

▪ The ECB hiked rates by 50 bps this week, removing the negative rates that have been in place since 2014. This was also sweetened with the announcement of the new Transmission Protection Instrument.

▪ Given the backdrop of continued political turmoil in Italy, the gap between the 10-year Italian yield over bunds widened to 230 bps from 185 bps at the beginning of July.

▪ 104 S&P 500 index constituents reported 2Q earnings. According to FactSet, this earnings seasons continues to be weaker than normal with the magnitude of positive earnings surprises falling below the five-year average. 68% of the 104 companies reported EPS that beat estimates, which is below the five-year average of 77%.

▪ Musk announced that Tesla sold 75% of the holding of Bitcoin, but he made clear that they are not abandoning crypto and this should not be taken as some verdict on Bitcoin.

Markets & Macro | A challenging environment for containing the spread

“With two inflation figures between now and the September meeting that could be explosive, the market is pricing in almost 100% for another 50 bps hike at the next meeting.”

Italy-German spread widens by 15 bps.

It was a very busy week in Europe, with the European Central Bank (ECB) meeting taking place – which saw the central bank raise by 50 basis points (bps), removing the negative rates in place since 2014 – the government crisis in Italy, economic data and Russian gas supplies.

Our view: Firstly, gas flows on Nordstream 1 resumed after the planned maintenance shutdown. However, operating conditions remain uncertain and well below normal operating levels (between 30% and 40%). The EU launched a 15% gas rationing plan (self-imposed) to avoid a shortage of stocks during the winter, which was, however, immediately rejected by Spain and Portugal. Consequently, Russia's negotiating strength in the coming months remains high, should it decide to continue the war and demand a stop to Western arms shipments.

When it comes to the ECB, apart from adjusting rates, many important indications on monetary policy and the new anti-fragmentation instrument were given during the press conference. For the future path of interest rates, forward guidance (as already done in the US) was eliminated. Decisions will be made as each meeting approaches, without any pre-commitment, depending therefore on the prevailing conditions. With two inflation figures between now and the September meeting that could be explosive (the Euro weakness of the last year will start to weigh), the market is pricing in almost 100% for another 50 bps hike at the next meeting.

At the same time, the Transmission Protection Instrument (TPI) was approved (unanimously). This instrument, it was explained, is to be added to the OMT (the most important one, introduced in Draghi's time, which takes over the redenomination risk, in the face of a passage under the ESM and the scrutiny of the country), the APP (Asset Purchase Program, used for the expansion of monetary policy), and the PEPP (pandemic program). The ICC, which is unlimited in size (but will be sterilized), will be used in the event of an 'unwarranted' widening of the spread, should the monetary policy transmission be ineffective. There are also several conditionalities associated with the instrument: fiscal sustainability of the target country, absence of significant macroeconomic imbalances, compliance with EU fiscal rules, absence of infringement procedures, and sound and sustainable economic policies, as already defined by the recovery fund.

"It must also be acknowledged that the mix of a rate hike and the introduction of the instrument appears quite coherent and pragmatic."

It must also be acknowledged that the mix of a rate hike and the introduction of the instrument appears quite coherent and pragmatic. On the one hand, rates have (finally) been raised to cope with rising inflation – while on the other, a flexible, but not too generous instrument is introduced to help countries in difficulty. It should be pointed out, however, that the judgment of eligibility for use of the instrument remains in the hands of the Governing Council and will therefore not happen automatically, when a certain spread level is reached (as the market had hoped).

The consequence for the week (with the impetus of the fall of the Draghi government) is that the Italy-Germany spread widened by another 15 bps, with the trend clearly expanding. While this is not a disaster, considering the reassuring symbolic value Draghi gave Europe and the world, the picture remains very unstable. The President of the Republic has therefore set the date for the next elections, 25 September, and we will see, quite anomalously, the electoral campaign take place in the middle of summer, with the populist forces of the center-right in clear advantage according to the polls. Overall, this is a challenging environment for containing the spread!

In the US, however, the tech sector began to outperform the rest of the market. It is still difficult to tell whether this is just a temporary phase of realignment after the heavy selloff (which exceeded 30% from the peak to the June lows), or a return to the old trend in which technology led the US market, supported by solid earnings growth. We also note that multiples have normalized. They are still not 'at a discount', i.e. below the historical average, but the excesses of 2021 are no longer visible.

The paradox is that the recovery in technology has been sustained by two factors, one positive and one negative, in our opinion. On the positive side, once again the Fed has regained control of the situation, showing itself to be tough against the threat of inflation (we will see if this is enough, but the market from this point of view now believes in the Fed's willingness to cope with increased price resilience).

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Consequently, as we've mentioned before, inflation expectations beyond next year are under control. On the downside, however, the markets, which are now obsessed with inflation, seem to celebrate any negative macro news (bad news is good news). The yield curve is now firmly inverted (-22 bps on the 2-10 year), while rates are discounting between two to three fed funds cuts after peaking early next year. Against this backdrop, technology can continue to benefit from both the more stable revenue outlook compared to cyclical sectors, and the calming effect on multiples from lower and subdued rates. The extremely cautious positioning and negative investor sentiment are doing the rest. Next week will be full of events, both macro and micro, so we still expect a lot of volatility and more clarity – especially on the corporate earnings outlook.

Equities | A cautious tone during earnings season

Companies preserve capital and cut costs.

Equity investors welcomed signs of fading inflationary pressures, pushing stocks higher this week. The consumer discretionary sector led the rally within the S&P 500 index as Tesla reported resilient earnings; the company's stock was up 13.4% week-on-week. Within the sector, Amazon.com was also up strongly at 7.8% week-on-week. The communication services sector was the worst performing sector after Verizon and AT&T's earnings showed a shift in consumer and business behavior.

Alphabet was also negatively impacted by the earnings results of Snap and Twitter, which revealed weakness in ad spending.

Meanwhile, Bank of America's monthly Fund Manager Survey showed that funds' cash holding level has reached the highest in several years. Also, equity exposure was the lowest since the Global Financial Crisis, which seemed to have sparked a short covering wave on Tuesday. European equities also staged a strong rally despite poor PMI data and the resignation of Mario Draghi. Elsewhere, Chinese equities were mixed as the government seemed to be tempering expectations of a strong stimulus. Premier Li Keqiang also signaled flexibility in China's official growth target of 5.5%.

"Bank of America's monthly Fund Manager Survey showed that funds' cash holding level has reached the highest in several years."

Figure 1: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,899.29	2.00%	3.74%	-11.24%
S&P 500	3,961.63	2.56%	4.73%	-16.18%
Nasdaq	11,834.11	3.33%	7.33%	-24.03%
Euro Stoxx 50	3,596.49	3.49%	4.23%	-13.89%
Swiss Market	11,096.12	1.04%	3.30%	-11.48%
FTSE 100	7,276.37	1.64%	1.57%	0.55%
CAC 40	6,216.82	3.00%	5.06%	-10.70%
DAX	13,253.68	3.02%	3.68%	-16.56%
FTSE MIB	21,211.98	1.77%	0.04%	-19.59%
Nikkei 225	27,914.66	4.20%	5.77%	-1.98%
Hang Seng	20,609.14	1.53%	-5.02%	-9.81%
CSI 300	4,238.23	-0.15%	-5.36%	-12.76%

Source: Bloomberg, as at July 22, 2022. Performance figures in indices' local currencies.

Our view: On top of European central banks' decisions and data releases, next week's busy line up of 104 S&P 500 index constituents reported 2Q earnings. According to FactSet, this earnings seasons continues to be weaker than normal with the magnitude of positive earnings surprises falling below the five-year average. 68% of the 104 companies reported EPS that beat estimates, which is below the five-year average of 77%. Also, the magnitude of the beat (3.6%) was below the five-year average (8.8%). Revenue beats also came below average. And the overall tone of management teams on earnings calls has been fairly cautious – with the usual issues continuing to plague businesses, including supply chain disruptions, cost inflation, FX headwinds and labor shortage.

"Whether this behavior makes the recession risk a self-fulfilling prophecy is likely to take some time."

So far, we see no meaningful signs of consumer weakness in this earnings season. What we see though is that companies are preserving capital, looking for ways to cut capex and opex. Some are also suspending their buyback programs or warning of lower dividend payouts. Whether this behavior makes the recession risk a self-fulfilling prophecy is likely to take some time. Job layoff announcements are still relatively low. However, the busiest week of this earnings season lies ahead, coinciding with the FOMC rate decision and the US GDP next week.

Chart of the week

The S&P 500 index held above the 3,800 level and now it is testing the top range of the bearish trend line. If it breaks, this could pave the way to test the Resistance at 4,200.

Figure 2: S&P 500 Index

Source: Bloomberg, as at July 22, 2022.

"Investors wonder if the announcement could trigger a new wave of dumping by corporate bitcoin holders..."

Crypto & Blockchain | Will Bitcoin find a top this summer?

Bitcoin holds above 22,000.

Musk announced that Tesla sold 75% of the holding of Bitcoin, but he made clear that they are not abandoning crypto and this should not be taken as some verdict on Bitcoin. Investors wonder if the announcement could trigger a new wave of dumping by corporate bitcoin holders such as MicroStrategy, Galaxy, and Square, in a environment struggling due to the ongoing global economic downturn.

The reaction to the news was to take profit after the early week rally – but following the overnight move, buyers came in and Bitcoin held very well above 22,000. This could be interpreted as a reassuring signal that perhaps the digital asset can find a top during the summer.

"In credit, the slightly greater visibility on central banks helped pull spreads tighter for US and European high grade corporate and high yield bonds."

Fixed Income & Commodities | Markets test ECB's tolerance

UniCredit CDS shoots up.

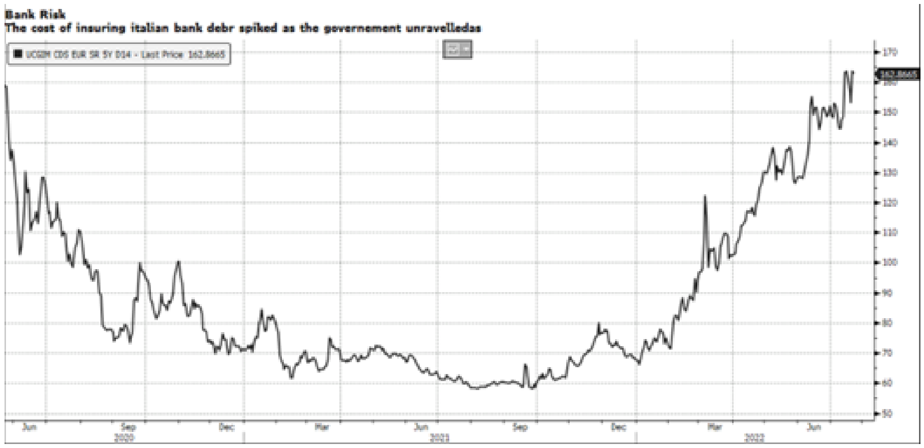
As mentioned earlier, the ECB finally joined the hiking party with a bigger than expected move, sweetened with the announcement of the new Transmission Protection Instrument. However, against the backdrop of continued political turmoil in Italy, the market will test the ECB's tolerance for widening spreads. The gap between the 10-year Italian yield over bunds widened to 230 bps from 185 bps at the beginning of July. Speculations are that the trigger point might be around 250 bps, just above the peak in June, when the ECB called an emergency meeting and announced its anti-crisis tool.

Our view: In the US treasury market, on the other hand, investors are starting to develop a kind of "fear of missing out" at the 3% level, amid concerns that an economic slump might soon make that type of number a thing of the past. After the Philadelphia-area manufacturers' outlook for business conditions slumped to the lowest level since 1979, investors became more pessimistic on the ability of the Federal Reserve (Fed) to keep hiking rates much above neutral and yields on 10-year Treasuries yields collapsed by 20 bps to 2.80%.

In credit, the slightly greater visibility on central banks helped pull spreads tighter for US and European high grade corporate and high yield bonds. However, the political turmoil in Italy put stress on the riskiest portions of the nation's banking debt, such as subordinated bonds. For example, the cost of insuring UniCredit's bonds against default spiked on July 21 to the highest level since May 2020, as shown by credit default swaps.

"The political turmoil in Italy put stress on the riskiest portions of the nation's banking debt, such as subordinated bonds."

Figure 3: Italian Bank Debt CDS



Source: Bloomberg, as at July 22, 2022.

Week Ahead | Key events to watch for

- **The Fed meeting will take place on Wednesday**, with an expected 75 bps rise.
- **Elsewhere in the US next week**, various macro data will be released. In the corporate earnings season, almost all blue chips and big tech companies will be reporting results.

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