Weekly Market Flash

Collapsing real rates support equities

October 24, 2021

Equity markets continued their positive trend this week. The S&P 500 index was up for seven consecutive sessions and closed at new highs on Thursday. The gains were supported by a number of factors, starting with corporate earnings, which are beating estimates by wide margins – no doubt helped by lower estimates over the previous weeks. At the same time, various technical aspects relating to positioning and sentiment also facilitated the price action, including a collapse in market volatility.

Highlights

▪ The eurozone PMI dropped from 56.2 to 54.3 in October, the lowest reading in six months. And the Fed Beige Book showed that economic activity in the US grew at a modest to moderate pace from late August through to the first week of October.

▪ In surprising news, Bundesbank president Weidmann resigned, after being reappointed for his second 8-year long term in 2019.

▪ 23% of the S&P 500 index constituents reported earnings. The aggregate sales surprise was 2% and the aggregate earnings surprise was 13%. Earnings surprises, so far, have been led by financials, technology and health care.

▪ In the primary market, while new issue concessions climbed slightly from the year-to-date averages and book order subscriptions were lower, activity was very strong with junk bond issuers selling USD8 billion during the week. Cruise operator Carnival returned to the junk bond market to sell USD2 billion in senior unsecured bonds.

▪ The PBOC broke its silence on Evergrande and said financial risks posed by the distressed property developer, which is on the brink of a USD300 billion debt restructuring, are “controllable.”

“The AAII survey has moved from a preponderance of bears to a net preponderance of bulls very quickly.”

Markets & Macro | Collapsing real rates support equities

But risk of rising energy costs remains.

A number of technical aspects related to positioning and sentiment helped equity markets remain positive this week. For example, market positioning had looked decidedly poor following the September correction and subsequent consolidation in the first few weeks of October. However, sentiment indicators changed their face. The Fear and Greed Index has more than doubled in value over the past 10 days and is now in rather strong "Greed" territory. The AAII survey has similarly moved from a preponderance of bears to a net preponderance of bulls very quickly.

Figure 1: Fear & Greed Index

Source: CNN, as of October 22, 2021.

Another factor was the collapse in volatility in equity markets, in sharp contrast to what is happening in the interest rate world. As Figure 2 suggests, the VIX index (US equity market volatility is the orange line) has broken its lows for the year, while the Move index (bond market volatility is the red line) is at its highest. The upward trend in yields is still strong, and has been driven by two elements in recent weeks: (1) rising inflation expectations (both in the US and Europe, with 5-year inflation swaps at 2.60% and 2.15%, respectively), and (2) the repricing of short-term money market rates.

"The vicious circle of rising energy prices would likely raise inflation expectations further, and force another repricing in the money market..."

In fact, the market now expects a full rate hike in the US by September next year, five hikes in New Zealand, three in Canada, four in the UK, and one each in Europe and Switzerland. The controversial dynamic in the interest rates world remains that the bulk of the adjustment is happening in inflation expectations, while nominal rates are not rising as much. The consequence is that real rates are collapsing, thus offering some support to equity valuations.

Figure 2: Volatility in the Equity vs. Bond Markets

Source: Bloomberg, as of October 22, 2021.

Our view: Our view on the markets remains moderately cautious. We are maintaining our slightly defensive positioning, with an overweight in value sectors. In particular, we have a significant position in the energy sector, which plays a stabilizing role in our portfolios. We continue to believe that the main risk to equity markets over the next few weeks could come from a further rise in energy prices as winter progresses and inventories dwindle, especially in Europe. The vicious circle of rising energy prices would likely raise inflation expectations further, and force another repricing in the money market – as mentioned earlier, this has already happened in countries from the US to the UK. All of this is against a backdrop of economic data, which is starting to show some cyclical weakness.

"...the balance of votes in the ECB would not change much, since the majority of governors are already clearly in the dovish camp."

For instance, the eurozone PMI dropped from 56.2 to 54.3 in October, the lowest reading in six months. Needless to say, once again the explanation for the slowdown is supply-side shortages, which are beginning to hit harder than initially expected; price pressures are also continuing to work against the consumer. The survey indicated a record high of businesses increasing their prices, which adds to concerns about how temporary inflation will actually be. Similarly, in the US, the Federal Reserve's (Fed) Beige Book showed that economic activity in the US grew at a modest to moderate pace from late August through to the first week of October. According to the data collected from the Fed's 12 districts, the main reasons for the slowdown in US economic growth are supply chain difficulties and labor shortages.

Who will replace Weidmann?

In surprising news, this week we learned that Bundesbank president Jens Weidmann resigned, apparently for personal reasons, after being reappointed for his second 8-year long term in 2019. It is certainly possible that the outcome of the recent general election, with a reversal of government leadership from the conservatives to the left, may have played a role. We also note that Weidmann had already lost several battles in the European Central Bank (ECB), starting with the vote against the initiatives to implement Draghi's "whatever it takes".

Our view: The successor will be chosen by the new government in Germany, and investor speculation has already begun. The possible names are those of current ECB board member Isabel Schnabel, Bundesbank Vice-President Claudia Buch or Finance Ministry Chief Economist Jakob von Weiszäcker, and all of them would be decidedly more moderate than Weidmann's hawkish line. That said, the balance of votes in the ECB would not change much, since the majority of governors are already clearly in the dovish camp. would say that just as an excess of tightness damaged the European economy 10 years ago, However, we would say that just as an excess of tightness damaged the European economy 10 years ago, with Trichet's famous rate hike in the midst of a recession and credit crunch, an excess of dovishness at a time of overt inflationary pressures could do the same damage. The ECB has lost its most formidable critic – and that might not be as good as it appears.

"The magnitude of the earnings and sales surprises are trending below the last two quarters' levels."

Equities | Does Snap's guidance spell trouble for Facebook?

Apple privacy change has bigger-than-expected impact.

The S&P 500 index rose for the third week in a row, reaching an all-time high level of 4544.90. Positive earnings surprises contributed to the overall positive sentiment. All sectors across the index ended the week up, led by real estate, health care and financials, but the communication services sector fell, as it was negatively impacted by Snap's earnings release. On Thursday after market, Snap (Snapchat's parent) revealed a Q4 guidance that fell below estimates. The company blamed Apple's new privacy rules for the lower-than-expected guidance. Snap's share price dropped by roughly 27% on Friday, dragging with it other social media companies such as Facebook and Twitter, which are expected to be impacted by the new Apple privacy settings too.

Figure 3: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	35,677.02	1.12%	5.50%	18.30%
SPX Index	S&P 500	4,544.90	1.66%	5.58%	22.38%
CCMP Index	Nasdaq	15,090.20	1.30%	4.46%	17.70%
SX5E Index	Euro Stoxx 50	4,188.81	0.20%	3.62%	20.72%
SMI Index	Swiss Market	12,056.21	0.79%	3.55%	15.86%
UKX Index	FTSE 100	7,204.55	-0.39%	1.73%	14.98%
CAC Index	CAC 40	6,733.69	0.09%	3.28%	23.98%
DAX Index	DAX	15,542.98	-0.28%	1.85%	13.30%
FTSEMIB Index	FTSE MIB	26,571.73	0.52%	3.68%	22.52%
NKY Index	Nikkei 225	28,804.85	-0.91%	-2.20%	6.43%
HSI Index	Hang Seng	26,126.93	3.15%	NA	-1.64%
SHSZ300 Index	CSI 300	4,959.73	0.58%	NA	-3.19%

Source: Bloomberg, as at October 22, 2021. Performance figures in indices' local currencies.

According to Bloomberg, 23% of the S&P 500 index constituents reported earnings. The aggregate sales surprise was 2% and the aggregate earnings surprise was 13%. Earnings surprises, so far, have been led by financials, technology and health care. The magnitude of the earnings and sales surprises are trending below the last two quarters' levels. As expected, several companies highlighted labor, materials and/or chip shortages as reasons for a lower guidance or outlook. Next week is promising to be a very busy earnings week with Big Tech reporting (Facebook, Microsoft, Alphabet, Amazon and Apple) as well as other blue chips like AMD, Twitter, Visa, McDonald's, eBay, Shopify, Exxon and Colgate.

"Morgan Stanley argued that if Tesla were to maintain this pace, it would become the most profitable mass auto company."

Our view: Snap's guidance could spell trouble for Facebook and to a lesser extent Google. While the Apple privacy changes were well flagged and anticipated, the magnitude came as a total surprise. Facebook's results and guidance on Monday are critical for the stock.

On a separate note, Tesla's results were outstanding, with a solid Q3 beat and a free cash flow for the quarter of USD1.328 billion, ahead of the Street's expected USD1 billion. Deliveries were also ahead of estimates, proving the company's ability to execute flawlessly despite the chip shortage that's plaguing the sector. The stock closed up yesterday at USD909.68, an all-time high level.

The most interesting reaction to the Q3 earnings came from Morgan Stanley, which is a long time bull on Tesla. It emphasized the point that Tesla's annualized Q3 profitability (EBITDA) is approaching the level of GM and Ford (around USD13 billion), at a fraction of the revenues and despite reducing the average selling price year-on-year. Morgan Stanley argued that if Tesla were to maintain this pace, it would become the most profitable mass auto company. We see the Texas and Berlin plants as strong catalysts for the stock, which are expected to reach pre-production unis by year-end.

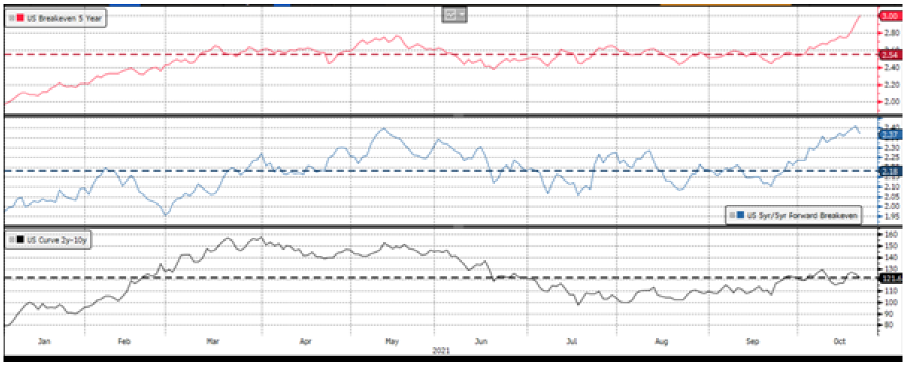
Fixed Income & Credit | Evergrande's risks are "controllable"

But defaults expected to rise.

Worries about rising inflation (the red and blue lines) have shrunk the gap between shorter- and longer-term Treasury yields (the black line). This type of yield curve flattening historically hurt investment grade corporate bond returns. UBS strategists expect Treasury yields to continue rising, resulting in total returns for US high grade corporates of -3%, making it the worst year for performance since 2008. So far, the index is down by about -2%.

"This type of yield curve flattening historically hurt investment grade corporate bond returns."

Figure 4: US Breakevens vs. Treasury Curve



Source: Bloomberg, as at October 22, 2021.

Despite this, in the primary market, while new issue concessions climbed slightly from the year-to-date averages and book order subscriptions were lower, activity was very strong with junk bond issuers selling USD8 billion during the week. Cruise operator Carnival returned to the junk bond market to sell USD2 billion in senior unsecured bonds at the lower end of price talk (6% for a 2032 maturity), after drawing orders of more than USD3.3 billion. Carnival is very actively reducing interest expenses but still has a wall of debt to climb (USD198 million of debt maturing in Q4, USD2.4 billion in 2022 and USD2.5 billion in 2023). According to Bloomberg analysts, the company may not generate free cash flow until mid-2022, provided all ships are in the water and sailing by the spring as planned.

Our view: Elsewhere, the People's Bank of China broke its silence on China Evergrande Group and said financial risks posed by the distressed property developer, which is on the brink of a USD300 billion debt restructuring, are "controllable." The words used leave no room for a generalized bail out: "In recent years, the company failed to manage its business well and to operate prudently amid changing market conditions, instead it blindly expanded". Nevertheless, the statement has helped stabilize market sentiment – and the China high yield index climbed following the news.

"Evergrande Group is said to have wired the USD83.5 million interest payment on a dollar bond before the end of a 30-day grace period that would have expired on Saturday."

Moreover, Evergrande Group is said to have wired the USD83.5 million interest payment on a dollar bond before the end of a 30-day grace period that would have expired on Saturday. But more payments remain in focus – it has another USD45.2 million of interest due with a grace period expiring next week. Investors are also watching out for Evergrande's property-management arm sale, after it scrapped talks to partly offload it.

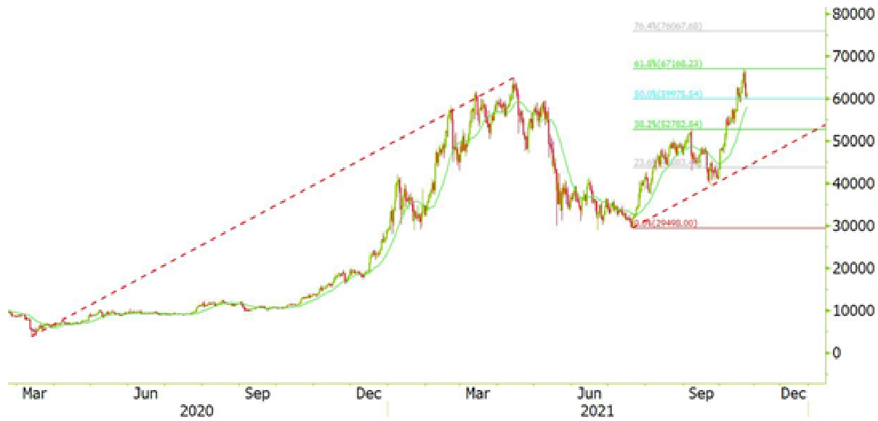
In the meantime, Sinic Holdings Group became the latest Chinese real estate firm to default after missing a USD250 million dollar bond payment, while Modern Land cancelled its request to extend the maturity of a dollar bond (due next week) by three months. In absence of a broad-based easing and with the magnitude of fine-tuning measures unclear, defaults of the weaker issuers will continue to rise over the coming months as maturities will come due.

FX & Commodities | Bitcoin ETF launches

Chart of the week

Buy on the rumor, sell on the news. The euphoria for the launch of the first-ever Bitcoin ETF in the US on Thursday propelled a massive rally for the digital asset, which broke above its April ATH and set up a new one at USD67,000. However, it failed to remain there and two days after the launch of the long-anticipated product, bitcoin suffered a sharp correction to USD60,000. The key supports are USD57,300 / 52,700 and the target 73,000/76,000.

Figure 5: Bitcoin Price



Source: Bloomberg, as of October 22, 2021.

"...two days after the launch of the long-anticipated product, bitcoin suffered a sharp correction to USD60,000."

Week Ahead | Key events to watch for

- **Europe will be in the spotlight with the release of inflation data and the ECB** meeting, which may announce new measures to replace the PEPP program (which expires in March 2022).

- **Corporate results will dominate the week**, with 165 S&P 500 index companies reporting, including many Big Tech giants.

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