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Weekly Market Flash

Could central banks soon follow the BOC's hawkish move?

April 25, 2021

Markets consolidated this week, following a bumpy start with sharp losses driven largely by profit taking and concerns of virus contagion in many emerging markets (EM) countries. We believe these fears are legitimate to some extent since a full and clear return to normality requires that the whole world is rid of the virus, not just the developed economies. This is the lesson we learned from the ability of the virus to circulate in a globalized world.

Highlights

- This week's ECB meeting was largely uneventful, while the BOC left the policy rate unchanged at 0.25% – but decided to reduce its weekly asset purchases for the second time to CAD3 billion per week from CAD4 billion.
- Bitcoin breached the USD50,000 threshold this week, and it is finally in oversold territory.
- China A-share indexes decoupled from other major global indexes, rising significantly, supported by USD2.5 billion of inflows from Hong Kong investors via Stock Connect.
- Q1 earnings season had another strong week. The 121 S&P 500 index companies that reported so far beat earnings by 34.35% and revenues by 5.79%.
- AlphaCredit identified an error related to the accounting of its derivative positions, which resulted in an impairment of MXN4.1 billion, or roughly USD205 million.

Markets & Macro | Could central banks soon follow the BOC's hawkish move?

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BOC reduces weekly asset purchases for second time.

At the start of the week, markets were driven mainly by profit taking and fears of virus contagion in many EM countries – as well as Japan, with the government declaring a 10-day state of emergency ahead of the Olympics this summer. However, by the end of the week, equity markets consolidated, shrugging off many attempts to turn risk averse, including the virus deterioration in India, the slow vaccine rollout in EM countries, the recent disappointing SPACs and IPOs, ARKK-related names coming under pressure, the Bitcoin correction underway, Russia pressuring Ukraine, and Bloomberg reporting that President Biden will propose raising capital gains taxes for the wealthier.

Central bank meetings were also in focus during the week, although the European Central Bank (ECB) meeting was largely uneventful. Elsewhere, the Bank of Canada (BOC) left the policy rate unchanged at 0.25%, but decided to reduce its weekly asset purchases for the second time to CAD3 billion per week from CAD4 billion, given the clear improvement in the economic recovery.

Our view: The hawkish shift from the BOC raises the question of how quickly other central banks could be moving, particularly since the Federal Open Market Committee is gathering next week – although in our opinion, the Federal Reserve's (Fed) position is remarkably different. It is not just that the BOC wants to flex its muscles being hawkish, and risk tightening financial conditions too fast – which can also take place with a stronger Canadian dollar.

But Canada's labor market conditions are also very different. Canada is much further along its recovery, with employment now being only 1.5% below the pre-COVID peak. This compares to a more than 5% gap in the US, equivalent to 7 million jobs still missing from the peak. Even if the Fed was to follow the BOC's reaction function, a December taper would require US payrolls to grow at a near 600-700k pace every month before equivalent levels of employment are reached. Compared to a very strong recovery exhibited by business surveys, the explosive housing market and consumer spending, one could affirm that the most important variable for the Fed is still lagging materially. And this happens at a time when the new administration has stated its intention to let the economy run at full cylinders in order to reduce income and wealth inequalities. Lastly, the Fed has just recently changed its mandate, creating an asymmetric reaction function to rising prices.

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On the other hand, the ECB meeting had, in line with expectations, no impact on markets. There were no surprises from the meeting: the European economic outlook is improving, but the central bank remains extremely cautious with negative rates and a generous asset purchase program. President Lagarde stressed that there was no discussion on reducing purchases under the PEPP. The Governor repeated that PEPP is extremely "flexible" which, as ever, is just a euphemistic way of saying that the ECB is engaged in spread targeting. Asset purchases under the PEEP will continue to be conducted at a higher pace compared to Q1 and this will remain the case until we hear anything different at the next meeting in June.

As we're quite used to, some impact on the Euro arrived the day following the ECB meeting, when anonymous ECB sources intervened to correct the focus – even when there was no need. The unnamed official's message is that the Governing Council is expected to have a heated debate in June, because some members would like to start talking about slowing down PEPP purchases in the third quarter, while others prefer to show more caution. Evidently, the market took this obvious clarification for what it is: a move by the hawks to make their voices heard, following a meeting in which the doves still had a clear upper hand.

Elsewhere, Bloomberg reported that President Biden could propose raising capital gains taxes for the wealthier. However, the proposals should not have been such a surprise. The idea of doubling the capital gains tax for the rich was partially known: it was included by Biden in the last election proposals in October. It is by no means a given that it will be passed in the Senate, and probably not in its entirety. Republicans in the Senate are likely to oppose fiercely. And, as is well known, the Democratic majority rests on the vote of Vice President Harris, while moderate/centrist Democrats are not very supportive of these initiatives. It is more likely that they'll accept an increase in the corporate tax - not to the 28% indicated by the administration, but rather to a more acceptable 25%.

However, it is unlikely that we will see such a measure before autumn, as part of a package of measures that includes an infrastructure plan and a more complete tax reform. This notwithstanding, the resilience of equity markets is impressive. Two things emerged from the news: uncertainty on the tax subject will linger for the remainder of the year, while the willingness of the administration to target income inequalities is strong and clear to investors.

"Bitcoin breached the USD50,000 threshold this week, and it is finally in oversold territory."

Chart of the week

Bitcoin breached the USD50,000 threshold this week, and it is finally in oversold territory. For the bulls, it is important to see a weekly close above the 100-day moving average. If this fails, the longer-term support (the 200-day moving average) is in the USD 34,500 area.

Figure 1: Bitcoin Breaches USD50,000 Threshold

Source: Bloomberg, as at April 23, 2021.

Equities | China A-shares decouple from global indexes

Companies report earnings that are 34.35% above estimates.

"China A-share indexes decoupled from other major global indexes, rising significantly, supported by USD2.5 billion of inflows from Hong Kong investors via Stock Connect."

US stocks ended the week little changed in a very volatile environment, amid low trading volumes. On Thursday, news about President Biden considering raising the capital gains tax for the wealthy sent markets lower. However, as we mentioned earlier, the reaction was very contained and largely reversed the following day. Meanwhile, European and Japanese equities were weighed down by rising Covid-19 cases. China A-share indexes decoupled from other major global indexes, rising significantly, supported by USD2.5 billion of inflows from Hong Kong investors via Stock Connect.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,043.49	-0.42%	3.30%	11.86%
S&P 500	4,180.17	-0.11%	5.30%	11.79%
Nasdaq	14,016.81	-0.25%	5.83%	8.96%
Euro Stoxx 50	4,013.34	-0.38%	2.64%	13.70%
FTSE 100	6,938.56	-1.12%	3.56%	8.72%
CAC 40	6,257.94	-0.32%	3.30%	13.20%
DAX	15,279.62	-1.17%	1.81%	11.38%
FTSE MIB	24,386.09	-1.30%	-0.92%	10.26%
Nikkei 225	29,020.63	-2.23%	-0.54%	6.35%
Hang Seng	29,078.75	0.46%	2.55%	7.22%
CSI 300	5,135.45	3.49%	1.81%	-1.37%

Source: Bloomberg, as at April 23, 2021. Performance figures in indices' local currencies.

Our view: The Q1 earnings season had another strong week, with US and European companies still beating earnings expectations by a wide margin. The 121 S&P 500 index companies that reported so far beat earnings by 34.35% and revenues by 5.79%, according to Bloomberg.

Netflix disappointed on the number of new subscribers, while major US airlines had weak results but cited meaningful travel demand pickup. Luxury stocks in Europe delivered strong beats. NCP portfolio holdings Intuitive Surgical and ASML beat EPS estimates by 33% and 23%, respectively. Both stocks gained roughly 8% post results.
Next week is another busy earnings week with Tesla reporting on Monday; Alphabet, Microsoft, Visa and AMD on Tuesday; Apple and Facebook on Wednesday; and Amazon, Mastercard and Total on Thursday.

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Fixed Income & Credit | High yield default forecasts scaled back

But low yields provided limited cushion.

AlphaCredit, the Mexican lender specialized in consumer lending and financing for small and medium enterprises, identified an error related to the accounting of its derivative positions, which resulted in the restatement of its financial statements for 2018 and 2019. Although AlphaCredit cannot predict the full impact of the restatement, it has announced an impairment of MXN4.1 billion, or roughly USD205 million.

Our view: AlphaCredit is technically insolvent. The impairment represents 18.2% of Alpha Holding's assets and compares to equity of MXN2.8 billion as of Q3 2020. In addition, the company has nearly MXN19.0 billion of debt as of Q3 2020. JP Morgan made a first estimate of the recovery value at around 33%. The ALPHSA 10.0% '22s fell more than 44 cents to 34 cents on the dollar.

Alpha Credit is a popular non-bank financial lender in Latin America and it is widespread in investor portfolios. Importantly, while not all Non-Banks Financial Institutions (NBFI) have similar issues as

“...junk yields are close to an all-time low, giving buyers very little cushion when companies miss payments or go bust.”

Alpha Holding, this news has impacted the entire complex. In fact, Credito Real, where we hold some positions, was particularly hurt. Credito Real 9.5% 2026 bond fell more than 9 cents to 99 cents on the dollar. For the moment, company management has not yet released any comment. Credito Real will report Q1 2021 results on Thursday, April 29th.

In a different vein, but still linking back to companies' failures, rating agencies have heavily scaled down forecasts for double-digit defaults in US credit markets. Fitch Ratings cut its forecast for this year's junk defaults to just 2%, thanks to ample liquidity amid government stimulus. S&P Global Ratings is less optimistic, projecting the US trailing 12-month speculative-grade corporate default will be 5.5% by December (much less than the 12.5% feared in October 2020). Moody's Investors Service expects defaults to fall to 4.2% over the next year, from a current rate of 7.5% for the 12 months through March. With this optimism, junk yields are close to an all-time low, giving buyers very little cushion when companies miss payments or go bust.

Week Ahead | Key events to watch for

- **Next week is dominated by corporate earnings and the FOMC** meeting and press conference. The Bank of Japan will also gather on Thursday, but no major change in policy is expected.
- **Economic data will include the first realease of Q1 GDP** for the US and the Euro Area.

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