NOVUM
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Weekly Market Flash

Will monetary policy have to finish the job?

February 26, 2023

It was a negative week for global stock markets, which lost -2.5%, evenly between Europe and the US, in line with the MSCI World Index. China, on the other hand, disconnected from the rest of the world, with the Shenzhen CSI Index rising 0.66% despite the volatility in Western markets, which resulted in a significant strengthening of the US Dollar Index by 1.3%. However, it was actually the fourth week in a row that this index had risen, totaling 3% for the month. It is therefore possible that the China reopening theme is picking up again, after a healthy consolidation in which the Chinese market had lost over 5% from its January highs.

Highlights

▪ US jobless claims were below 200,000 and below market expectations. PCE, which accounts for 70% of US GDP volume, grew by 1.1% (in real terms), confirming the strength of retail sales released last week.

▪ Although the Fed Funds peak is still expected to be below 5.5%, studies and banks are beginning to forecast levels of 6%.

▪ In the VC space, interest in other markets such as India and wider Southeast Asia positioned themselves as alternative growth and venture markets. This is widely expected to remain in the foreseeable future.

▪ Coinbase recently announced its entry into the Ethereum Layer 2 rat race. This move comes as the exchange looks for ways to diversify its revenue streams and stay ahead of the competition in the rapidly evolving cryptocurrency market.

"This week was characterized by a series of economic data, which continue to support the no-landing theme."

Markets & Macro | Will monetary policy have to finish the job?

Global consumers are overconfident.

This week was characterized by a series of economic data from both Europe and the US, which continue to support the no-landing theme. PMIs published around the world were strong, accelerating and above the line between contraction and growth. The labor market shows no signs of slowing down, with US jobless claims below 200,000 and below market expectations. And finally, the most important figure of the week, personal consumption expenditures (PCE), which account for 70% of US GDP volume, grew by 1.1% (in real terms), confirming the strength of retail sales released last week.

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

Equity Indices	Last Value	Ytd
MSCI World	2,779.88	7.03%
Nasdaq	11,787.27	12.76%
S&P 500	4,079.09	6.48%
DJ Industrial	33,826.69	2.35%
Nikkei	27,513.13	5.44%
Eurostoxx	4,274.92	13.03%
Swiss SMI	11,256.29	4.91%
FTSE 100	8,004.36	7.64%
Canada	20,515.24	6.19%
Shenzen	4,034.51	4.21%
Hong Kong	20,719.81	4.75%
MSCI EM	999.42	4.59%

Equity Sectors	Last Value	Ytd
S&P value	154.98	6.83%
S&P Growth	62.09	6.14%
S&P Defensives	1,545.64	-1.40%
ARK Fund	41.86	33.99%
Fangs	5,537.34	24.53%
MSCI Financials	141.22	8.11%
S&P Energy	84.66	-3.41%
Gold Miners	28.41	-0.87%

Commodities	Last Value	Ytd
BBG Commodities	106.53	-5.56%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	70.03	1.75%
Gold	1,811.04	1.01%
Silver	20.76	-9.29%
BBG Brent Crude TR	1,027.11	-3.28%
BBG WTI Crude Oil TR	182.70	-4.49%

FX	Last Value	Ytd
DXY Index	1,242.35	-0.34%
Bbg JP ASIA	101.26	0.08%
Bbg JP LATAM	40.79	2.64%
EUR/CHF	0.99	0.10%
GBP Index	621.86	-0.16%
EM FX Index	1,674.19	0.82%
JPY/USD	134.15	-2.26%
CNY/USD	6.87	0.44%
Bitcoin	24,566.78	48.53%

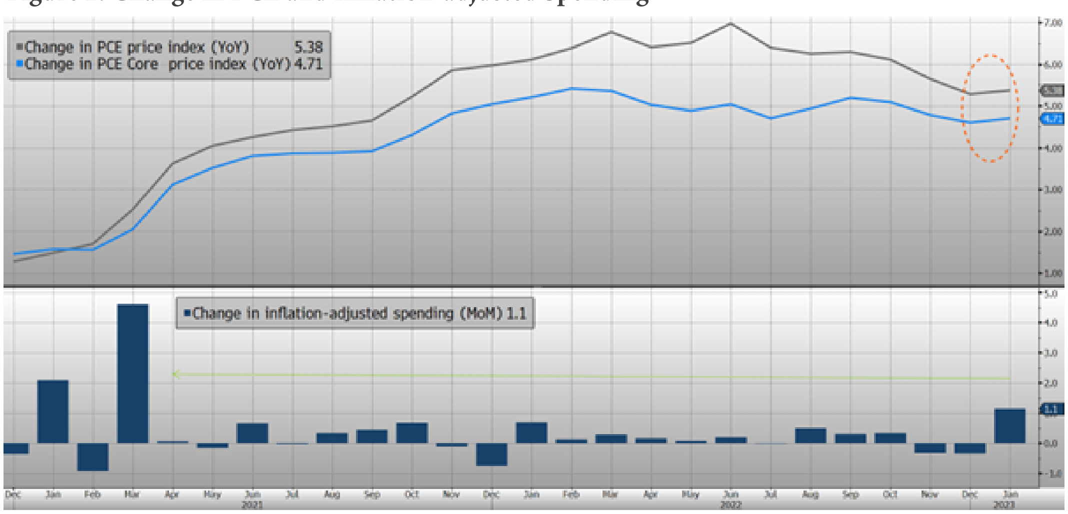
Bond Indices	Last Value	Ytd
US Inv Grade	107.04	1.84%
US High Yield	74.56	1.75%
Euro Corps	231.75	1.79%
JPM Europe Govies	9,453.81	2.43%
US Treasuries	2,201.55	0.60%
China Aggregate	258.72	1.35%
EMBI Global	775.41	0.93%
EMBI Local	125.59	1.54%

Source: Bloomberg, as at February 26, 2023. Performance figures in indices' local currencies.

"These economic conditions are exactly the opposite of what is needed, and what the Fed has explicitly stated it wants to achieve, to reduce the level of inflation..."

Our view: The problem in all of this is that these economic conditions are exactly the opposite of what is needed, and what the Federal Reserve (Fed) has explicitly stated it wants to achieve, to reduce the level of inflation, bringing it rapidly back toward 2%. In fact, the two price indicators published together with the PCE (headline and core) surprised heavily to the upside (by more than 0.4%), and are both in the 5% area (Figure 2).

Figure 2: Change in PCE and Inflation-adjusted Spending



Source: Bloomberg, as at February 26, 2023.

"While it may be difficult to imagine that with an economy that will sooner or later go into recession, bonds could record a second year of negative returns..."

The market's reaction was therefore fairly linear, with equity and bonds down, and the US dollar up, supported by volatility and the inexorable repricing of Fed Funds. Although the Fed Funds peak is still expected to be below 5.5%, studies and banks are beginning to forecast levels of 6%. Since the start of 2023, bonds have halved their gains in the last two weeks. While it may be difficult to imagine that with an economy that will sooner or later go into recession, bonds could record a second year of negative returns—as the inflationary environment and the end of QE are certainly not favorable to the asset class.

“On the contrary, the highly inflationary climate in which we find ourselves in is somewhat fueling consumer spending...”

The paradox of this phase is that on the one hand, the leading indicators continue to show signs of an oncoming recession, but on the other hand, the economy continues to push and re-accelerate as soon as financial conditions ease (as has been the case between October and now). Evidently, it occurs to us that without a real phase of corporate layoffs (evidently not just the tech sector in the US), global consumers are feeling overconfident and are not putting the brakes on spending, despite the loss of purchasing power resulting from inflation. On the contrary, the highly inflationary climate in which we find ourselves in is somewhat fueling consumer spending, as the awareness that next month's goods and services will cost more is now spreading!

As a result, it seems inevitable that central banks' monetary policy will have to finish the job, generating a tightening of financial conditions that will put companies in a position to cut jobs to maintain their profitability. On this front, the process seems to be underway (at least in the US), since corporate profits already started to fall in the fourth quarter of 2022—so we should not wait long.

Private Equity | Is now the time to invest in Asian VC?

The region offers unique opportunities—as well as unique challenges.

Geopolitical tensions in China, together with the fragility of the country's real estate market and the uncertainty generated by the zero-Covid policy, dampened local and foreign activity in the venture capital (VC) markets in 2022. At the same time, interest in other markets such as India and wider Southeast Asia positioned themselves as alternative growth and venture markets. This is widely expected to remain in the foreseeable future.

Our view: Our fundamental approach to private equity is underpinned by a strong bias toward developed markets, i.e. US and Western Europe. However, we maintain an opportunistic investment approach toward emerging markets, with Asia being the leading emerging powerhouse in terms of technology innovation.

“...while the Indian market appears more tested and attractive than it did before, investors should be aware that the depth of the market and the track record of managers will need time to consolidate.”

In particular, in India, the entrepreneurial ecosystem has matured over the last few years which has attracted the arrival of a strong domestic and foreign VC presence. Government and private sector initiatives introduced over the last decade have facilitated the development of financial and digital infrastructure, creating a fertile set of opportunities for start-ups operating in the domestic consumer and enterprise space. Consumer tech, fintech and software-as-a-service (SaaS) dominated investment activity, leading to an increase in the number of Indian unicorns in recent years. On the flip side, while the Indian market appears more tested and attractive than it did before, investors should be aware that the depth of the market and the track record of managers will need time to consolidate.

More broadly, the same investment themes apply to the Southeast Asia region, given the rise of internet penetration in markets such as Indonesia and Vietnam. However, the market is highly fragmented across many countries with varying levels of infrastructure development and talent pools, posing unique challenges to scaling and growing businesses. As a result, VC in the region continues to lag behind that of China or India and requires further validation.

In China, the story is more mixed. Consumer tech themes have paused given the market and regulatory headwinds. On the other hand, China's growing emphasis on self-sufficiency and innovation in the clean energy and "deep tech" sectors (such as semiconductors and automation), which are supported by a solid supply chain and advanced manufacturing capabilities, presents a secular growth opportunity for companies in these areas. The main risk continues to be whether the US or the Chinese government will impose further restrictions on investment in these sectors.

In the meantime, any clarification on the lifting of China's zero-Covid policy could boost growth prospects for China, and Asia in general, leading to a renewed increase in deal activity and VC fundraising. For the time being, and due to the still elevated levels of uncertainty, we remain focus on building the core of our allocation in developed VC markets—but we are keeping a close eye on the opportunity in the Asian VC space.

"Layer-2 scaling solutions aim to improve the network's transaction capacity, speed, and efficiency, while reducing transaction fees."

Cryptocurrencies | Coinbase joins Ethereum's Layer-2 rat race

Coinbase remains well-positioned to attract more users.

Coinbase, one of the leading cryptocurrency exchanges in the US, has recently announced its entry into the Ethereum Layer 2 rat race. This move comes as the exchange looks for ways to diversify its revenue streams and stay ahead of the competition in the rapidly evolving cryptocurrency market.

Layer-2 scaling solutions are a set of protocols built on top of existing blockchain networks such as Ethereum. They are designed to improve the scalability, speed, and efficiency of blockchain networks, while reducing the cost of transactions. Layer-2 solutions work by processing transactions off the main blockchain and then consolidating them into a single transaction. This reduces the overall number of transactions that need to be processed on the main blockchain, which, in turn, improves the speed and efficiency of the network. One of the most popular Layer-2 solutions is the Lightning Network, which was developed for Bitcoin. It works by creating a network of payment channels that allows users to transact with each other instantly and without having to wait for transactions to be confirmed on the main blockchain.

Our view: For Ethereum, there are a number of Layer-2 scaling solutions currently in development, such as Optimistic Rollups, zk-rollups, and Plasma. These solutions aim to improve the network's transaction capacity, speed, and efficiency, while reducing transaction fees. Optimistic Rollups, for example, works by bundling multiple transactions into a single batch and then submitting them to the main Ethereum network. This reduces the number of transactions that need to be processed on the main network, and therefore reduces the overall transaction fees.

"As the demand for cryptocurre-ncy trading increases, exchanges are looking for ways to improve their services and attract more users."

Another Layer-2 solution is zk-rollups, which uses zero-knowledge proofs to bundle transactions and create a proof of their validity. This proof is then submitted to the main Ethereum network, reducing the amount of computation that needs to be done on the main network. In summary, Layer-2 scaling solutions are an important development in the cryptocurrency space, as they offer a way to improve the scalability, speed, and efficiency of blockchain networks, while reducing the cost of transactions. As the demand for blockchain applications and transactions continues to grow, Layer-2 solutions are likely to play an increasingly important role in the development of the blockchain ecosystem.

This move by Coinbase is not surprising given the current state of the market. As the demand for cryptocurrency trading increases, exchanges are looking for ways to improve their services and attract more users. By joining the Ethereum Layer-2 rat race, Coinbase hopes to gain a competitive edge and attract more customers who are looking for fast and affordable transactions. While Coinbase has experimented with various projects in the past, not all have been successful. Its NFT platform, for instance, has struggled to gain market share despite the company's brand. However, the exchange's entry into the Layer-2 scaling solutions arena is a promising development, and could potentially be a game-changer for the cryptocurrency market. Overall, Coinbase's decision to join the Ethereum Layer-2 rat race is a smart move that demonstrates the exchange's commitment to innovation and improving its services. With this move, Coinbase is well-positioned to attract more users and maintain its position as a leader in the cryptocurrency exchange industry.

Week Ahead | Key events to watch for

- **In the US**, the consumer confidence report, ISM surveys manufacturing and services, and durable goods orders will be published.
- **In Europe comes the CPI, and in China the PMIs** will be released, which should confirm the recovery of the economy from the reopening.

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