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Weekly Market Flash

Short covering supports market rally

February 27, 2022

In this shocking week, which saw the entire Western world taken aback by the invasion of Ukraine by the Russian military, markets ended with a formidable rally. After the shock of Thursday morning, which was the start of military operations, US equity indices began to show signs of resilience and a desire to recover. The paradox is that, in our view, it was the very difficulties that were plaguing the market – and in particular the technology sector – that set the stage for a market recovery.

Highlights

- The S&P 500 index managed to close up 0.8% for the week and the Nasdaq up 1.08%, while Europe was down by 2.5%.
- Bond yields rose, with the US 10-year treasury yield back to roughly 2% after hitting a week low of 1.844% on Thursday.
- Analysis of various historical recourses began to circulate investors' desks, reminding them that the impact of wars on markets has been decidedly limited (with the exception of the 1970s).
- Given Ukraine and Russia's positions as major commodity exporters, inflationary pressures are expected to intensify unless there is a quick resolution to the military conflict, without additional major Western sanctions.
- The crypto market rallied hard on Friday to almost recover the losses after Russia invaded Ukraine. The move was primarily driven by the short covering.

Markets & Macro | Short covering supports market rally

"...Russia seems to have made its calculations and is well prepared to face a deterioration in conditions for its capital market."

US markets gain relative strength.

The market rally at the end of this week was led by Wall Street – the S&P 500 index managed to close up 0.8% for the week and the Nasdaq up 1.08%, while Europe was down by 2.5%. Positioning and sentiment were particularly extreme before Thursday, especially in technology, and, within that, in the more speculative sectors, often linked to the working-from-home theme of the pandemic.

When the war broke out (this time an actual war, rather than the "War on Covid" which we used to refer to during the lockdowns), short covering started on these names and the unexpected reversal gave support to the market. In fact, the day before the invasion, the S&P 500 index had made an important "technical" breakout, which had prompted investors to resign themselves to further declines in the weeks ahead. As a result, we can speak of a false signal, which further supported short covering.

Our view: The announcement of US sanctions, which came on Thursday evening with the market already looking for an excuse to accelerate the recovery, was decisive. Despite the aggressive backlash in calling the sanctions "very tough", the truth is that the sanctions announced seem very bearable for Russia, which in any case seems to have made its calculations and is well prepared to face a deterioration in conditions for its capital market.

But the fact remains that not excluding Russian banks from the SWIFT messaging system, with the consequent continuity of energy supplies in Europe, was a huge sign of relief. It has thus become clear that Putin has no intention of engaging in economic retaliation (which he certainly cannot afford at the present time). From an economic point of view, we should remember that despite its political dimension (decidedly hypertrophic at this point), and its population of 144 million inhabitants, the Russian economy is decidedly small, with a GDP of about USD1.5 trillion. As a result, the economic adversity that the country will face, especially if the war is more prolonged than expected, will not affect the world economy if only to an insignificant extent (with the world GDP at USD85 trillion, Russia weighs less than 1.7%).

"Markets hate uncertainty, especially if it is prolonged in time. So the idea of having a clear winner in a short period of time is optimal for markets..."

The realization that the most violent and aggressive phase of the war will be extremely rapid has further ensured a return to calm. Markets hate uncertainty, especially if it is prolonged in time. So the idea of having a clear winner in a short period of time is optimal for markets, which are ready for a new equilibrium and new geopolitical arrangements to adapt to. The fact that Western politicians have already shown that they do not want to support the unfortunate Ukrainians as a matter of democratic solidarity is further reassuring. The only hope for the Ukrainians (coinciding with a risk for the markets) is that they manage to transform the military occupation into prolonged urban guerrilla warfare, with damage for both sides and enormous suffering for the civilian population, pushing Western governments (starting with the European ones) to make some economic sacrifice in order to push Russia toward a diplomatic solution to the crisis – albeit this is a distant scenario for the moment. However, the situation is evolving as we write, with Ukrainians showing heroic resistance, and some countries already cutting Russian banks off from Swift. As a result, we are likely to see prolonged uncertainty and an even more complex scenario.

Analysis of various historical recourses began to circulate investors' desks, reminding them that the impact of wars on markets has been decidedly limited – with the exception of the 1970s, when the oil price dynamic was long-lasting and therefore had a negative impact on Western economies. Markets on average anticipated the official start of wars, but the negative impact did not last long and instead represented pullbacks, offering investors buying opportunities.

Following the outperformance of the European market in the first part of the year (where the determinants were macroeconomic and sectoral), the US market decisively regained relative strength following the geopolitical events. The US economy suddenly appeared more solid, with the consumer in good shape thanks to the reserves accumulated through the Covid fiscal stimulus and the strong labor market, but above all the energy independence and the impermeability to any kind of sanctions toward Russia (it is not by chance that Biden made clear during the press conference that the veto on SWIFT was imposed by European countries). In particular, all of a sudden the prevalence of the tech sector in the indices proved to be an advantage, being less dependent on raw materials, labor and cyclicality.

"While the impact on Fed funds expectations was completely neutral over the week, European rates were able to stop their (dangerous) rise thanks to various verbal interventions by ECB members at the outbreak of the crisis."

The only element of relief for European markets compared to the US came from monetary policy. While the impact on Fed funds expectations was completely neutral over the week, European rates were able to stop their (dangerous) rise thanks to various verbal interventions by European Central Bank (ECB) members at the outbreak of the crisis. As Figure 1 highlights, the interest rate market cleared a good 15 basis points of tightening by the start of 2023, resulting in great relief for all peripheral country spreads (and partly for equity indices, but only on Friday, once it became clear that the war would be short-lived and that sanctions would not have major economic consequences).

Figure 1: ECB Interest Rate Futures

Source: Bloomberg, as at February 25, 2022.

Equities | The signal and the noise

Inflationary pressures are set to intensify.

"The Fed's clinging to the transient hypothesis meant missed opportunities to nip inflation at its earliest stages..."

A surprise full scale invasion of Ukraine disrupted equity and fixed income markets. However, the Western response was not as severe as some investors had feared, which, as mentioned earlier, caused equities to rally sharply toward the end of the week. Major US indexes closed flat to up during the holiday-shortened week – the real estate, healthcare and utilities sectors led the S&P 500 index during the week, while consumer discretionary, financials and consumer staples underperformed. Bond yields also rose, with the US 10-year treasury yield back to roughly 2% after hitting a week low of 1.844% on Thursday.

European markets took the brunt of the invasion risk, given the continent's reliance on Russian gas and the risk of higher inflation and slower economic growth.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,058.75	-0.03%	-2.85%	-5.99%
SPX Index	S&P 500	4,384.65	0.84%	-2.77%	-7.80%
CCMP Index	Nasdaq	13,694.62	1.10%	-3.75%	-12.37%
SX5E Index	Euro Stoxx 50	3,970.69	-2.54%	-4.78%	-7.39%
SMI Index	Swiss Market	11,987.31	-0.19%	-1.96%	-6.90%
UKX Index	FTSE 100	7,489.46	-0.05%	0.74%	1.87%
CAC Index	CAC 40	6,752.43	-2.55%	-3.52%	-5.49%
DAX Index	DAX	14,567.23	-3.16%	-5.84%	-8.29%
FTSEMIB Index	FTSE MIB	25,773.03	-2.76%	-3.87%	-5.37%
NKY Index	Nikkei 225	26,476.50	-2.33%	-1.90%	-7.99%
HSI Index	Hang Seng	22,767.18	-6.41%	-3.98%	-2.69%
SHSZ300 Index	CSI 300	4,573.43	-1.67%	1.36%	-7.43%

Source: Bloomberg, as at February 25, 2022. Performance figures in indices' local currencies.

Our view: Amid the geopolitical noise, little attention was paid by equity markets to the University of Michigan Consumer Sentiment reading which came at 62.8 for February, slightly above expectations (61.7), but still at the lowest level in the past decade. According to the Director of Consumer Sentiment Survey at Uni. of Michigan, Richard Curtin, "The Fed's clinging to the transient hypothesis meant missed opportunities to nip inflation at its earliest stages; aggressive actions are now needed to avoid the potential establishment of an inflationary psychology that acts to form a self-fulfilling prophecy".

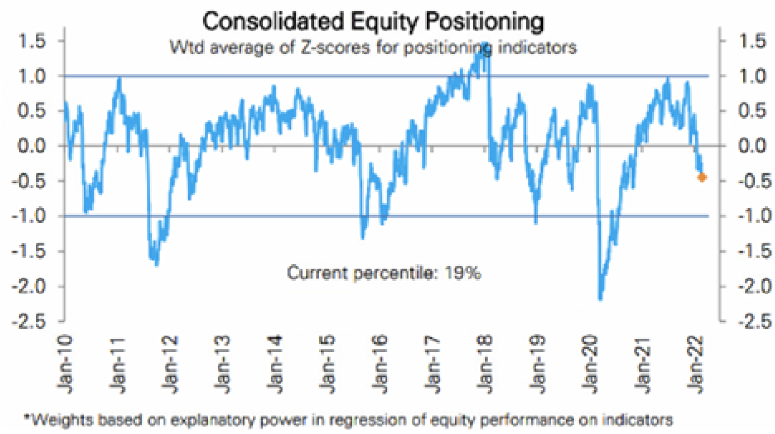
"While the Ukraine conflict may slow the Fed's eagerness to attack inflation, we don't see it as sufficient enough to derail the hiking program."

Given Ukraine and Russia's positions as major commodity exporters, inflationary pressures are expected to intensify unless there is a quick resolution to the military conflict, without additional major Western sanctions. The potential for a supply-side shock to commodities puts the Federal Reserve (Fed) in a tight spot as it tries to tighten financial conditions to lower inflation without triggering lower growth and higher unemployment. While the Ukraine conflict may slow the Fed's eagerness to attack inflation, we don't see it as sufficient enough to derail the hiking program.

The AAII US investor sentiment bearish reading hit a 5 year high of 53.70, suggesting to us that the equity rally witnessed on Thursday and Friday was due to positioning. Deutsche Bank consolidated equity positioning data also corroborates this view (Figure 3). We would not be surprised if this relief rally carried over into the following weeks should macro data releases suggest a less hawkish Fed path. For now though, we don't believe a Fed pivot is on the cards.

“We would not be surprised if this relief rally carried over into the following weeks if macro data releases suggested a less hawkish Fed path.”

Figure 3: Consolidated Equity Positioning



Source: Deutsche Bank, as at February 25, 2022.

Chart of the week

The S&P 500 index is in between two scenarios. Some may interpret the pattern that started in July 2021 as a head-and-shoulders top with the target of the setback near 3700. The profit target for the pattern is the price difference between the head and the low point of either shoulder. This difference is then subtracted from the neckline breakout level (at a market top) to provide a price target to the downside. On the other hand, if we look at the drawdown of the S&P 500 index, this is typically overstretched at 15% that corresponds for the S&P 500 index level at 4095. If this key support holds, it could become the index support for the first half of the year.

Figure 4: S&P 500 Index

“…if we look at the drawdown of the S&P 500 index, this is typically overstretched at 15%…”

Source: Bloomberg, as at February 25, 2022.

Crypto & Blockchain | Is crypto ready for showtime?

"…if the government can use blockchain to track evasions, it would build political support for crypto…"

Crypto recovers almost all losses for the week.

Russia is likely considering using bitcoin or other cryptocurrencies (i.e. stable coins) to evade sanctions. If Russia can use cryptocurrencies in this way, then political support in the US surrounding cryptocurrencies could falter and could trigger measures such as anti-money laundering laws. On the other hand, paying in bitcoin requires conversion to FIAT currency, and the moment they do they get caught. Recent events have shown how the US government has been able to track the activity of some wallets and consequently freeze accounts as soon as they have been converted to FIAT currencies. This could provide a way to track the activity of crypto exchanges that helps support US sanctions – and if the government can use blockchain to track evasions, it would build political support for crypto and show that crypto is ready for showtime.

In fact, cryptocurrency transactions are recorded on public ledgers of the underlying blockchain, making them transparent. So, the possible workaround is to build an own digital currency that can help mask the origin of such transactions. North Korea, for instance, has used digital currencies to mitigate the effects of Western sanctions. But it came as a surprise when the Bank of Russia recently proposed a ban on cryptocurrency trading and mining. So overall, this is a very unclear situation on this side as well.

Market activity: The crypto market rallied hard on Friday to almost recover the losses after Russia invaded Ukraine. The move was primarily driven by the short covering. The market is focused on liquid token to trade better the volatility, and Bitcoin is attracting more flow compared to altcoins.

Week Ahead | Key events to watch for

- **Next week is full of economic data and central bank interventions.** However, news from the war front will certainly remain at the forefront of economic events, especially if the conflict were to see an unexpected escalation, or if further sanctions were to be imposed on Russia in order to slow its war effort.

- **We will also hear from Fed Chairman Powell**, who will testify before the House and Senate committees, the last speech before the Fed Funds decision in mid-March, with the market torn between a 25 bps or 50 bps hike.

- **The Bank of Canada will meet**, with the bank expected to raise rates by 25 bps.

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