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Weekly Market Flash

Will things get worse (before getting better)?

March 27, 2022

Wall Street continued to recover this week, with the S&P 500 index up 1.8%, while the Eurostoxx 50 index underperformed again (-0.8%) as the macro environment deteriorated. Incredibly, for us, the S&P 500 index is only 5.5% off the all-time highs recorded in early January, and well above the levels prevailing on 24 February, the day the war in Ukraine began. We note that our mistrust of the price action is based on the deteriorating inflationary environment caused by the explosion of commodity prices (energy being the most important), and the response of the interest rate market, with the Federal Reserve (Fed) following up with multiple hawkish statements – with tones not seen since the 1990s.

Highlights

- On the military front, we believe that Russia is heading for a near-defeat, or at least that it will certainly not be able to win the war.
- The market is currently pricing in eight rate hikes from the Fed between now and the end of 2022, with only six meetings available.
- PMIs in Europe held up well, but Germany's IFO registered a vertical collapse, marking the lowest value since January 2021 at 90.8, against 98.5 in February.
- Government bonds sold off across the board: 10-year US Treasury yields went up 20 bps and German Bunds followed with an increase of 14 bps.
- In the primary market, US investment grade bond sales came at a steady pace, with companies undeterred by higher borrowing costs. European corporate issuance has also sprung back to life, as has activity in the US junk bond market.

"It is difficult to believe that this (hiking) cycle will be implemented without any mishaps on the stock market..."

Markets & Macro | Will things get worse (before getting better)?

Risk of stagflation is rising.

Investment houses are now rushing to raise their tightening forecasts, thus bucking the Fed and pushing repricing across the curve. The market is currently pricing in eight rate hikes between now and the end of 2022, with only six meetings available. In other words, we should see two 50 basis points (bps) hikes.

Our view: It is difficult to believe that this cycle will be implemented without any mishaps on the stock market, given a number of factors. For instance, the overall leverage of the system is bearable, but precisely because of low rates, while various indicators of economic activity (especially on the consumer side) have started to show signs of weakness in recent weeks, and are likely to get worse in the coming weeks given the dynamics in place on the commodities and purchasing power front. Although PMIs in Europe held up well (better than expected), the balance of economic data in Europe is decidedly negative, as is reasonable to expect after the first four weeks of the war. In particular, the IFO, the most important leading indicator in Germany, registered a vertical collapse, marking the lowest value since January 2021 at 90.8, against 98.5 in February.

With the weakness of the euro and the explosion of gas and oil prices, a stagflation scenario is becoming much more likely in Europe than in the US. With the war in Ukraine, the world has changed dramatically, and the first signs are beginning to be seen in Europe. New supply chain disruptions on top of old ones (Covid-related) with a high risk that in some cases these chains will be broken forever, and high uncertainty and fear will weigh on both supply and demand in the coming months.

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The German economy, with its strong export orientation, is significantly exposed to geopolitical risks at the moment. While Germany's powerful fiscal response to the pandemic had enabled domestic consumers to weather difficulties from the pandemic very well, supply-side constraints and Germany's energy dependence risk being negative structural factors that cannot be resolved by fiscal measures. All the more so since the increased fiscal effort already announced (which is around 2% of GDP) will be entirely geared toward military spending, which in our view is decidedly unproductive.

On the military front, we believe, to put it bluntly, that Russia is heading for a near-defeat, or at least that it will certainly not be able to win the war. On the ground it seems that a takeover of Kiev is unthinkable, while news leaked this week suggests that the Russians are beginning to change their rhetoric in order to claim victory on the domestic front. In fact, information has been leaked that the so-called 'special operation' must end by May 9. This is the date on which Russia has always celebrated and remembered the victory over Nazism, so it has enormous symbolic value. This is all in a context in which Ukrainian snipers are killing colonels and generals with surprising ease (five dead generals is a lot, without counting the overall estimate of military casualties of around 10,000), and morale among the soldiers is very low (so much so that thousands of mercenaries have been called up to carry out the assault operations).

Another fundamental aspect is that the declarations on the objectives of the invasion have been recalibrated on the defence of the Donbass, and no longer on the neutrality and demilitarization of the entire country. All this (unfortunately) does not mean that the end of the war is near, starting with the fact that the Ukrainians seem to have no intention of giving up the Donbass, even less in view of the relative strength against the enemy, which has emerged as the conflict has evolved. Heavy weeks therefore remain on the horizon.

Elsewhere, the economic issue of paying for gas in roubles is an interesting one. Putin's decision to impose payment for energy supplies in roubles (deviating from the current flows in euros or US dollars) from countries considered hostile is a risky and interesting strategic move at the same time. If European governments were to agree to this (which is far from obvious, indeed), it would entail a rebalancing of the Russian Central Bank, which has been put out of business by freezing its assets. Since Russian exporting companies have to convert their revenues into roubles, the (sanctioned) central bank is currently being replaced by the (as yet unsanctioned) exporting companies, in the sense that they are able to do the rouble conversion. If Western companies were to comply, we would in fact be directly supporting the rouble on the markets with constant purchases to meet payments. The fact remains that it is difficult to find enough roubles on the interbank market to meet energy supplies, hence the implicit recourse, once again, to the central bank (the only one to hold enough roubles), which would thus be rehabilitated, despite the sanctions! And countries such as Italy have already explicitly stated that they do not want to give in to blackmail (this is in fact a breach of supply contracts already signed), and Germany has also made statements in the same direction.

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The consequence of this intervention was first of all to make the rouble recover a lot of ground, which had almost halved following the start of the conflict and the introduction of the harshest sanctions (Figure 1). The point is that if we decided not to comply, private Russian companies would be de facto obliged to cut off gas and oil supplies, so in effect Putin would have indirectly imposed counter-sanctions. Evidently, the rise in oil and gas prices since the start of the conflict (30% for gas, 20% for oil) has given Russia strength, as it knows that it can sell its materials on other markets, albeit probably at a discount compared to the prices prevailing on the global markets.

Figure 1: Russian Rouble Performance

Source: Investing.com, as at March 25, 2022.

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Equities | Can the market keep up its momentum?

Q1 earnings season is approaching.

Most global equities ended the week higher, especially long-duration assets. This came as a surprise to many market participants given that the US 10-year Treasury yield rose from 2.15% at the end of the prior week to 2.47%. Since March 14, Goldman Sachs's Non-profitable Tech Index gained 29%, while the US 10-year Treasury index yield rose by 34 bps.

Japan's stock markets recorded the biggest gains, with the Nikkei 225 index gaining 4.9%. The Bank of Japan's governor, Haruhiko Kuroda, reiterated its very accommodative monetary policy while expectations of further economic stimulus boosted sentiment. And in China, confusion about the fate of dual-listed Chinese stocks weighed on share prices. Despite last week's positive comments from Chinese officials, US regulators described speculation about an agreement as "premature".

"The moves can be explained by a combination of light positioning and meaningful participation by households."

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,861.24	0.31%	3.03%	-3.60%
SPX Index	S&P 500	4,543.06	1.81%	3.98%	-4.35%
CCMP Index	Nasdaq	14,169.30	1.99%	3.10%	-9.27%
SX5E Index	Euro Stoxx 50	3,867.73	-0.83%	-1.31%	-9.67%
SMI Index	Swiss Market	12,121.67	-0.52%	2.29%	-4.77%
UKX Index	FTSE 100	7,483.35	1.16%	0.96%	2.42%
CAC Index	CAC 40	6,553.68	-0.90%	-1.47%	-8.17%
DAX Index	DAX	14,305.76	-0.74%	-1.07%	-9.94%
FTSEMIB Index	FTSE MIB	24,558.74	1.40%	-3.36%	-9.82%
NKY Index	Nikkei 225	28,149.84	4.93%	6.12%	-2.17%
HSI Index	Hang Seng	21,404.88	-0.03%	0.11%	-8.21%
SHSZ300 Index	CSI 300	4,174.57	-2.14%	-4.22%	-15.50%

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

Our view: Last week's trading activity in the US market was anything but normal. While generally subdued, there was notable buying activity taking place during the last hour of trading. The moves can be explained by a combination of light positioning and meaningful participation by households. According to a Goldman Sachs note published on Friday, "leveraged investors have participated in the current sell-off by aggressively reducing their equity exposure. Short covering by these participants helps to explain why some of the longest duration equities have recently risen sharply in the face of rising interest rates and a more hawkish Fed." Additionally, the outflows from bonds meant that the funds had to go somewhere, thus supporting the TINA ("There Is No Alternative") narrative for equities. With positioning and sentiment still at record low levels and trading volumes largely subdues, we would not rule out the possibility of equities making further near-term gains. A fast approaching Q1 earnings season and a refocus on inflation and margin pressure is likely to present a hurdle to the current market momentum.

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Crypto & Blockchain | Ethereum's bullish path ahead

ETH gets an upgrade in scaling.

Ethereum's merge on the Kiln testnet last week was a success, as the blockchain passed the final public test before its highly anticipated transition from a proof-of-work (PoW) consensus mechanism to proof-of-stake (PoS), which is expected to happen by the end of Q2 2022. This was always the plan as it's a key part in the community's strategy to scale Ethereum via upgrades. However, getting PoS right is a big technical challenge and not as straightforward as using PoW to reach consensus across the network. PoS comes with several improvements to the PoW system: better energy efficiency (environmental benefits), lower barriers to entry (you don't need elite hardware to stand a chance of creating new blocks), and an upgrade in scaling the Ethereum network.

The "staking rate", an indicator that measures the percentage of the total Ethereum supply currently locked into the staking contract so not exchangeable, and now at 8% of the total ETH circulating, has observed a sharp increase recently as inflows have spiked up. When the value of this indicator spikes up, it means a lot of Ethereum is moving into the staking contract right now. Staked ETH cannot be unstaked or transferred on the Ethereum network. This means that investors only stake ETH that they plan to hold long term or if they think the upgrade is close. In fact, exchange client rewards is between 4% to 7% per year, while futures are pricing in that it could be about 10-15% (gross of fees) after the transition. We expect this to be very bullish for Ethereum tokens and negative for other minor PoS protocols.

Market action: Bitcoin is above 42,000 resistance as the 90-day correlation between it and the S&P 500 index rose to 0.49 on Friday, the highest since October 2020. This correlation has only been higher for five days in BTC's history, showing that the current correlation regime is unprecedented historically.

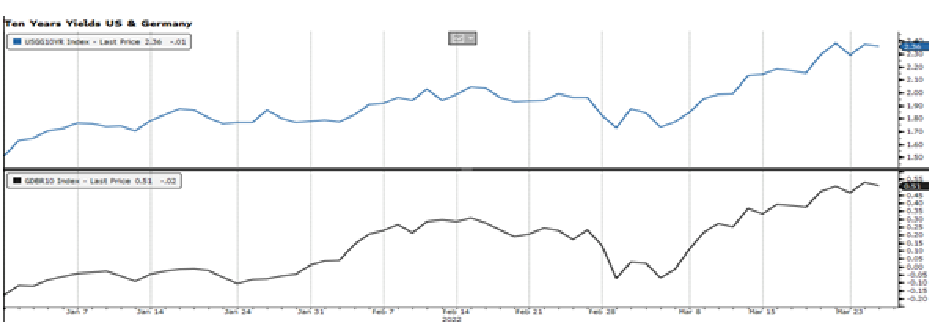
"...investors only stake ETH that they plan to hold long term or if they think the upgrade is close."

Fixed Income | Is China the new safe haven?

Chinese govvies are outperforming USTs.

Earlier this week, government bonds sold off across the board (especially Tuesday). 10-year US Treasury yields went up 20 bps and German Bunds followed with an increase of 14 bps, both extending moves from previous already difficult weeks.

Figure 3: US and German Government Bond Yields

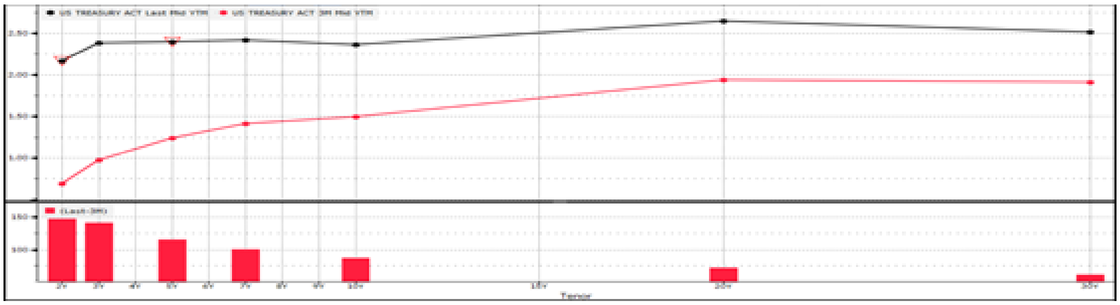


Source: Bloomberg, as at March 25, 2022.

The latest selloff in Treasuries stems from Fed Chair Jerome Powell's remark that the central bank is prepared to raise rates in half-percentage points to fight inflation. 2-year yields, which are among those more closely linked to policy expectations, climbed quickly to 2.14% (up 21 bps and 141 bps year-to-date). The impact rippled across the entire shape of the yield curve, with the gap between 5- and 30-year yields down to the lowest level since 2007, and the gap between 5- and 7-year yields in negative territory. Both are signs that tighter policy will slow the economy or even cause a recession.

"If even at a time of war, US Treasuries are not the ultimate safe haven, where should one look?"

Figure 4: US Treasury Bonds



Source: Bloomberg, as at March 25, 2022.

Our view: This turbulence is questioning the ability of bonds to offer protection. If even at a time of war, US Treasuries are not the ultimate safe haven, where should one look? Answer: China. Despite worries over Beijing's association with Russia and the secondary sanctions that might come as a result, Chinese government bonds have already outperformed US Treasuries by over six percentage points.

China's central bank learned a painful lesson over the last two decades. In the years right after the global financial crisis, the People's Bank of China either tightened liquidity or showered its economy with helicopter money, generating a huge real estate bubble that Beijing is still struggling to tame. Since then, China's central bank has been careful not to make drastic monetary policy changes, despite economic challenges caused by the pandemic. Its bond market is now more stable, giving investors safety and certainty.

In the primary market this week, US investment grade bond sales came at a steady pace, with companies undeterred by higher borrowing costs and determined to access funding before Fed rate increases and the Russia-Ukraine war make it more expensive. Order books were at about 4.6 times deal size on average, higher than for many sessions in recent weeks. GlaxoSmithKline gathered peak orders of USD43 billion or five times covered, to help fund Haleon (Baa1/BBB), the consumer healthcare products unit to be separated from GlaxoSmithKline. The 5-year tranche (29/3/26) in EUR priced at 1.25% (swap +55 bps), while the USD 3-year (24/3/24) was offered at 3.25%.

"Companies are undeterred by higher borrowing costs and are determined to access funding before Fed rate increases and the Russia-Ukraine war make it more expensive. "

European corporate issuance has also sprung back to life, with Carrefour, L'Oreal, and Nestle bringing forward new deals. L'Oreal (AA/Aa1) issued EUR3 billion in three parts: the 4.25-year tranche (29/06/26) was priced at 0.875% (swap 12 bps versus 35 bps guidance). Investors poured almost EUR7 billion of orders for three new bond tranches offered by Nestle SA, which issued EUR2 billion of bonds maturing in five, nine and 13 years. Demand was such that Nestle paid minimal new issue concessions (2-6 bps versus a 2022 average concession of 11 bps for issuers similar to Nestle). The 5-year tranche (29/03/27) priced at 0.875%. Carrefour (BBB) issued a 4.6-year tranche (30/10/26) at 1.875%. The US junk bond market came back to life as well, after many weeks of very subdued activity. Ford (Ba2/BB+) sold USD1.5 billion in a 5-year tranche (28/527) for a yield at around 4.95%.

Finally, in the saga of the ever-changing relationship between Russia and global investors, Severstal OAO (Caa2/CC) has become the first Russian company to run out of time to pay interest on its 3.15% USD800 million bond with maturity 16/9/26. Although flush with cash, the steelmaker was unable to settle a USD12.5 million bond coupon (16/3/22) within a 5-business day grace period that ended on March 23. Severstal said it's keen to pay, but Citigroup, acting as correspondent bank of the unit issuing the debt, is blocking the payment.

Week Ahead | Key events to watch for

- **In addition to the events on the military front, next week will be important for the publication of economic data in the US**. ISM manufacturing and services, as well as labor market data, will be crucial to understand if the next Fed hike will be 25 bps or 50 bps.

- **In Europe, inflation data is expected,** with the flash CPI for March, as well as consumer confidence and labor market data.

- **PMIs are also expected in China and Japan**.

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