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Weekly Market Flash

EMs, DMs, and Diverging Policies

June 27, 2021

Following the attempt to send a prudent signal to markets in the FOMC meeting, Federal Reserve (Fed) speakers, headed by Chairman Powell, rushed to reassure investors of their dovishness this week. Markets, of course, welcomed the message with a strong recovery in US equities largely in the earlier part of the week. At the same time, the Bank of England (BoE) policy meeting was on the dovish side of expectations. In particular, the Committee's remarks contrasted with a sharp increase in the bank's outlook for inflation, which officials now see peaking at 3% - half a point higher than their forecast just six weeks ago. However, the BoE did not appear to be in a hurry to tighten monetary policy, and it was made clear that premature tightening should not hamper the recovery.

Highlights

- The rise in the Delta Covid variant in the UK has likely played a role in the BoE's decision – and in fact, registered cases surpassed 15,000 a day this week.
- Mexico's central bank unexpectedly raised borrowing costs for the first time since late 2018. This was a split decision as concerns mount that persistently elevated inflation may threaten the economic rebound.
- In the US, an agreement was reached on the bipartisan infrastructure plan. The bipartisan delegation presented President Biden with a USD1.2 trillion plan that includes USD579 billion in new spending to renovate roads and bridges across the country.
- The PBOC injected liquidity into the Chinese financial system for the first time since March.
- The EBA warned banks that requalifying legacy bonds should not lead to overly complex capital structures and, above all, it shouldn't create multiple layers of Tier 2 instruments.

"...developed markets central banks are willing to fall behind the curve, letting inflation run higher than in the past, with the justification of labelling it a 'transitory' phenomenon."

Markets & Macro | EMs, DMs, and Diverging Policies

Inflation drives varying central bank action.
At the BoE meeting, as expected, QE measures were left unchanged, despite the acknowledgment of the improving economic environment and the raised forecasts for growth and inflation. As mentioned, the BoE did not appear to be in a hurry to tighten monetary policy, it was made clear that any downside risks would need to be managed promptly.

The rise in the Delta Covid variant in the UK has likely played a role in the BoE's decision – and in fact, registered cases surpassed 15,000 a day this week. This is despite Bloomberg's recent study which supports the thesis that vaccines keep the Delta variant under control. Indeed, with 47% of the UK population immunized (including over 60% of adults), the numbers suggest that the percentage of hospitalized over new cases is falling, the percentage of deaths over 75 years old is falling (as this is the most vaccinated category), and that the trend of hospitalizations is rising – but only in the age categories with the lowest vaccinations, while over 65 years old is stable at minimum levels.

Elsewhere in central bank activity, following last week's move to hike rates by Russia's central bank, Mexico's central bank unexpectedly raised borrowing costs for the first time since late 2018. This was a split decision as concerns mount that persistently elevated inflation may threaten the economic rebound.

Our view: We view this action as confirmation of an ongoing trend: developed markets central banks are willing to fall behind the curve, letting inflation run higher than in the past, with the justification of labelling it a 'transitory' phenomenon. On the contrary, emerging markets central banks, which have a far different experience of rising prices and the associated economic and social malaise, are proving far more prudent when dealing with the current jump in inflation.

A summer of idiosyncratic opportunities.

“The Fed itself, after the FOMC’s hawkish surprise and the subsequent spike in market volatility, has tried to reassure markets and step away from headlines.”

In the US, after several weeks of negotiations, an agreement was reached on the bipartisan infrastructure plan on Thursday. The bipartisan delegation presented President Biden with a USD1.2 trillion plan that includes USD579 billion in new spending to renovate roads and bridges across the country. However, the plan is a far cry from Biden’s initial USD2.2 trillion proposal. In terms of financing, the current bill has no tax increases, but it is instead financed by more stringent tax collection policies and unspent funds from previous packages. Further, uncertainty remains on whether the Congress will approve the proposal.

Elsewhere in the US, the Fed promoted the top 23 US banks that passed the stress tests with reassuring success. US banks would therefore continue to show excellent levels of capital even in the face of the scenarios defined by the Fed, which foresaw a collective loss of around USD500 billion. Consequently, the Fed announced that the limits imposed on share buyback plans and dividend payments will cease on June 30, and from Monday the institutions will be able to announce their moves.

On the economic front, the US PMI composite fell, largely driven by services. On the other hand, the Euro area composite PMIs painted an overall positive picture. Business activity grew at the fastest rate in 15 years at the aggregate level. Manufacturing reported a stronger pace of growth (63.1), and the services sector also saw a strong rebound in economic activity (58.0 from 55.2 in May).

The Markit institute also offered some comments to the US data publications, many of which we are getting used to: “Moderations in activity growth were seen in both the manufacturing and service sectors, with goods producers hampered in particular by significant supplier delays and both sectors reporting difficulties finding staff”. The pace of increases for raw materials and fuel was described as “rapid” by manufacturers. And services providers reported higher labor costs. The input prices gauge for manufacturing printed 83.8, up from May – and the highest ever. These costs “were commonly passed on to clients through a steep rise in output charges” this month, as reported by the survey. Employment gauges dropped in both manufacturing and services, with “numerous panelists” citing trouble locating “suitably trained candidates” for vacancies.

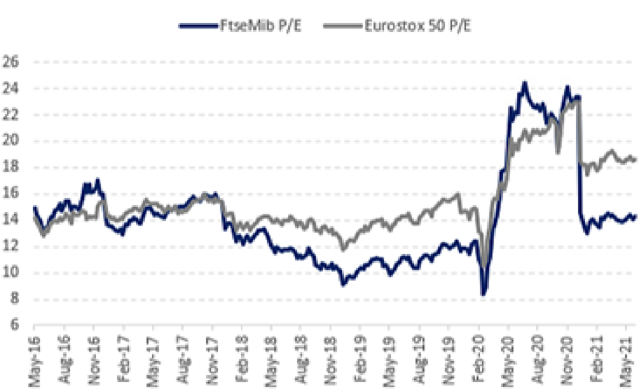
“Since the Italian market showed weakness relative to the Eurostox recently, but still displayed a positive trend, we believe the case for Italian equities remains valid.”

Our view: While none of the above is surprising per se, it does underscore the persistence of the factors that are both pushing up prices and constraining the labor market stateside. This makes it increasingly difficult to describe the re-opening distortions as "transitory".

At a general asset allocation level, it seems to us that the current mix of economic data and fiscal/monetary policy is supporting the case for an uneventful summer. With the current set of information, only some unexpected geopolitical news might derail this course in the summer months (being well aware the US-Sino relations have the potential to escalate at any time). The Fed itself, after the FOMC’s hawkish surprise and the subsequent spike in market volatility, has tried to reassure markets and step away from headlines. The ground is prepared for an announcement of tapering at the Jackson Hole economic symposium at the end of August, but with a very smooth and delayed execution.

Without major directional themes to play, we will aim to generate some extra return in our portfolios with idiosyncratic opportunities. The first is the Italian market, which is a theme that we have played earlier on in the year and on which we took partial profit more recently. Since the Italian market showed weakness relative to the Eurostox recently, but still displayed a positive trend (Figure 1), we believe the case for Italian equities remains valid.

Figure 1: Italian Equities Show Weakness



Source: Bloomberg, as at June 25, 2021.

"The BTP-Bund spread is also at historical low levels and yields are at their lowest – a favorable environment for an indebted country."

In particular, Draghi has provided political stability to the country, managing the vaccination campaign well and obtaining the funds of the NGEU. The lack of political alternatives in the country has implicitly given support for an extension of the current government until the end of the natural term of the parliament (2023). Moreover, domestic equities are trading at a discount compared to EU peers (Figure 2). Despite the recovery in prices, the gap between European peers has not closed. The BTP-Bund spread is also at historical low levels and yields are at their lowest – a favorable environment for an indebted country. Meanwhile, policy support from the European Central Bank is also here to stay. Finally, the lower presence of Italian markets in international investors' portfolios provides further support to this trade.

Figure 2: Italian Equities Trade at a Discount

Source: Bloomberg, as at June 25, 2021.

Equities | PBOC ends China's 3-week losing streak

Chinese equity rebound likely to have legs.

The S&P 500 and Nasdaq Composite indices reached new highs after rebounding from last week's sharp corrections. Signs of inflation moderating in commodity prices boosted equities, while Fed Chair Powell's Congress testimony also assured investors that inflation might be temporary. Meanwhile, rising Covid cases in some countries were largely ignored by the market.

"We believe that the price actions of the week, if anything, highlight the extreme positioning that was in place across different asset classes – not just equities."

Energy stocks led markets this week on the back of the continued oil price recovery as global inventories fell. And China equities ended a 3-week losing streak after the People's Bank of China (PBOC) injected liquidity into the financial system for the first time since March.

Figure 3: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	34,433.84	3.44%	-0.18%	13.56%
S&P 500	4,280.70	2.76%	1.92%	14.78%
Nasdaq	14,360.39	2.36%	4.50%	11.80%
Euro Stoxx 50	4,120.66	0.99%	2.10%	18.21%
Swiss Market	11,999.70	0.49%	5.60%	15.20%
FTSE 100	7,136.07	1.77%	1.81%	12.44%
CAC 40	6,622.87	0.96%	3.02%	21.64%
DAX	15,607.97	1.04%	1.21%	13.77%
FTSE MIB	25,510.50	1.39%	1.59%	16.61%
Nikkei 225	29,066.18	0.35%	0.71%	6.66%
Hang Seng	29,288.22	1.75%	0.73%	8.92%
CSI 300	5,239.97	2.81%	-1.29%	1.20%

Source: Bloomberg, as at June 25, 2021. Performance figures in indices' local currencies.

Our view: We are encouraged by the PBOC's decision to boost reverse repo injections. China's monetary policy recalibration, which began in March, has weighed heavily on Hong Kong and A-share prices. The liquidity injection came sooner than our August expectation. Should we see further signs of monetary policy tightness coming to an end, we would expect this week's China equity rebound to have legs.

"Our preferred plays are the internet stocks – which are trading at a wide discount to US peers – and domestic consumption proxies."

A Morgan Stanley report published last week also suggests that A-share sentiment rose "due to strong momentum with Northbound flow and ChiNext turnover". We believe that the policy reversal could mitigate the negative impact of the well-flagged macro weakness. Our preferred plays are the internet stocks – which are trading at a wide discount to US peers – and domestic consumption proxies.

Figure 4: China M2 Money Supply

Source: Bloomberg, as at June 25, 2021.

Fixed Income & Credit | EBA releases guidance for legacy bonds

Legacy instruments need to be removed.
On Thursday, the European Banking Authority (EBA) warned banks that requalifying legacy bonds should not lead to overly complex capital structures and, above all, it shouldn't create multiple layers of Tier 2 instruments.

"This latest guidance from the EBA shows their preference to call, redeem, repurchase or buyback the legacy bonds."

Our view: Legacy instruments are old, subordinated bonds issued under outdated regulatory regimes. Such bonds will keep receiving beneficial capital treatment until the end of 2021. Some European banks had opportunistically tried to extend the regulatory utility of those legacy instruments by pushing for these legacy Tier 1 structures to be treated as transitional Tier 2, either until June 2025, or even into perpetuity.

The EBA emphasizes that it does not consider it appropriate for institutions to implement a multiple-layered structure for Tier 2 instruments. CET1 instruments need to be subordinated to all other claims and Additional Tier 1 instruments are subordinated to Tier 2 instruments. Therefore, treating a legacy Tier 1 security as Tier 2 creates infection risk (or disqualification) for the entire layer of AT1 capital.

This latest guidance from the EBA shows their preference to call, redeem, repurchase or buyback the legacy bonds. Another option would be to amend the legacy documentation, making the bond contractually senior to AT1/CET1 securities, but junior (either explicitly or implicitly) to current Tier 2.

To make a long story short, all these legacy instruments need to be taken out because they either have non-compliant features or could pose an impediment to resolution, adding complexity in the capital structure – which could give rise to legal risk in the case of a bail-in.

FX & Commodities | EUR/USD Will Remain in a Sideways Trend

Chart of the week

The FOMC meeting was the trigger for a big USD breakout, which was partially reversed with an oversold bounce last week. During the summer lull, we expect the EUR/USD to stay in a sideways trend with the top of the range resistance represented by the 200 daily moving average and the 23% retracement of the April/May bounce - while at the low end it will be a re-test of the April low.

"The FOMC meeting was the trigger for a big USD breakout, which was partially reversed with an oversold bounce."

Figure 5: EUR/USD

Source: Bloomberg, as at June 25, 2021.

Week Ahead | Key events to watch for

- **All attention will be on the US jobs report** on Friday. With the recent change of stance from the Fed, we wouldn't be surprised to see markets reacting to data in the old way: "bad news for the economy is good news for financial markets".

- **In terms of business sentiment in the US**, it wouldn't be surprising to see some signs of deceleration/ normalization in the ISM manufacturing and services sectors surveys.

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