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Weekly Market Flash

Will value stocks continue to outperform?

January 30, 2022

This week was extremely volatile across equity markets. But despite the great fear caused by the speed of the movements and the extent of the losses "below the surface", the main stock indices managed to contain their losses, while the major US indices even managed to finish in the green for the week, thanks to good company reports from the usual big tech names. Extreme oversold conditions in most tech names, light positioning, and month-end rebalancing flows should allow equity markets to find some stabilization/recovery in the coming sessions.

Highlights

- At the FOMC press conference, it seemed as if Powell was using the four most dangerous words in investing: "this time it's different", when he was referring to the level of inflation and the strength of the labor market.

- Regarding the Russia-Ukraine standoff, there was some relief this week for Russian assets, which recovered 2%, and the Ruble.

- An agreement between most Italian political parties seems to have been found for the election of the President of the Republic.

- So far, 169 out of the 500 S&P 500 companies have reported Q4 CY2021 earnings. The companies that reported had an average revenue surprise of 2.8% and an average earnings surprise of 5%.

- In the venture capital space, FTX US has raised USD400 million in its first external fundraising round. The gives FTX US a valuation of USD8 billion, placing it among the world's most valuable private crypto firms.

- Fitch Ratings has revised its forecast for companies with a junk credit score: the default rate will climb to 1%-1.5% in 2023 from a record low 0.5% in 2021. Still, that remains below the historical non-recessionary average of 2.2%.

"...Powell was using the four most dangerous words in investing: "this time it's different", when referring to the level of inflation and the strength of the labor market."

Markets & Macro | Will value stocks continue to outperform?

A more responsible central bank could lead to curve flattening.

During the week, the market's attempt to bounce back (which began with a resounding recovery of almost 5% for the Nasdaq index in a few hours toward the end of Monday's session), was rejected by Federal Reserve (Fed) Chair Jay Powell. On Wednesday, during the press conference following the Fed meeting, he adopted a decidedly hawkish tone, one beyond all expectations. Volatility continued to be very high, but started to fall below the important 30 level on Thursday, paving the way to a nice short covering rally on Friday, with the Nasdaq index posting a healthy gain of above 3% on Friday. This allowed the index to gain 1 bps (!) for the week.

At the FOMC press conference, it seemed as if Powell was using the four most dangerous words in investing: "this time it's different", when referring to the level of inflation and the strength of the labor market. It must be said that the previous rate hike cycle, which began in 2015 and ended in 2018 (with a vertical fall in the markets that could not withstand the final acceleration of rates), had been much more gradual and diluted over time than what rates are discounting today – which are five full hikes for this year and two more in the next two years, for a total of nine hikes for the cycle. In fact, three key concepts were introduced by Powell: 1) the tapering of Fed purchases will end in March and coincide with the first rate hike; 2) the Fed could decide to raise rates at any meeting if it saw fit; 3) the runoff of the balance sheet (it is not yet clear when it will start) could be faster than in the past.

“...while we have not been surprised by this part of the movement in stock prices as rates rise, there are also reasons to doubt whether the momentum will continue or not.”

Our view: Since the beginning of the year, the Fed's sudden caution has been very favorable for value stocks. Indeed, the value sector of the S&P 500 index has outperformed the growth sector by as much as 8.16% since the beginning of the year. The prospect of raising interest rates is hurting the longer-term, more expensive stocks, while favoring cheaper stocks with more immediate cash flows. Our thinking, however, is that while we have not been surprised by this part of the movement in stock prices as rates rise, there are also reasons to doubt whether the momentum will continue or not.

For example, beyond the short term, we could potentially see a more attentive and responsible central bank, and this could lead to a flattening of the curve. This is what we are seeing now, with the risk of the curve flattening excessively, thus sending worrying signals for economic growth. This scenario could potentially result in a return to rewarding long duration securities, and hence technology, once again (at least in relative terms). On the other hand, the opposite scenario would see a central bank that is indifferent to inflation, with the market sooner or later likely to price in a sharp steepening of the curve, and perhaps even a marked depreciation of its own currency. This, in our opinion, would be a worse environment for growth stocks, rather than the one we’re living in.

Meanwhile, on the Russia-Ukraine standoff: there was some relief this week for Russian assets, which recovered 2%, and the Ruble. Indeed, Russia has not ruled out further talks with the US in order to get further reassurance on the West's interest in Ukraine (since Moscow's expected short answers have been described as disappointing). With a further meeting between the foreign ministries next week, it would appear that we are entering one of the scenarios we had outlined, namely a slow and inexorable dragging out of the crisis for months without anything concrete happening. Clearly, in this scenario Ukraine remains destabilized (Moscow's likely target), while markets will feel free to avoid pricing in any tail event by postponing it from week to week. To confirm the possibility of postponement, another example would be the imminent start of the Winter Olympics in China, where some media stories have reported that China would urge Russia not to escalate military tensions before the end of the games (on 20 February).

“Net net, if the scenario is confirmed in the next few hours, BTPs and Italian equities should open strong on Monday, helping our long Italy trade!”

Elsewhere across the market, there is another piece of positive news that seems to be emerging as we write our weekly: an agreement between most Italian political parties seems to have been found for the election of the President of the Republic. With incumbent President Mattarella being reappointed, the best possible scenario seems to be coming true: 1) It is a continuation of the status quo, so no surprises for markets (as they are always unwelcome); 2) part of the agreement implies the continuation of the Draghi government, that was at risk to fall either for Draghi’s own appointment to the preseidency, of due to a breakup of the supporting coalition. Net net, if the scenario is confirmed in the next few hours, BTPs and Italian equities should open strong on Monday, helping our long Italy trade!

Equities | Will earnings surprises reach a six-quarter low?

Industrials lead earnings misses.

So far, 169 out of the 500 S&P 500 companies have reported Q4 CY2021 earnings. The companies that reported had an average revenue surprise of 2.8% and an average earnings surprise of 5%.

Our view: If the remaining S&P 500 companies reported earnings surprises of similar magnitude as seen so far, this would be the lowest level of earnings surprises in six quarters.

Energy companies led the sales surprise at 11.8%. Utilities reported the worst surprise at -6.8%. On the earnings front, financials reported the best earnings beats at +9.7%. Meanwhile, industrials reported the worst miss at -20.7% surprise.

"The Nasdaq composite index is struggling to find a bottom after the RSI has fallen into oversold territory for the first time since the pandemic..."

Figure 1: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,725.47	1.34%	-4.36%	-4.36%
SPX Index	S&P 500	4,431.85	0.79%	-6.93%	-6.93%
CCMP Index	Nasdaq	13,770.57	0.02%	-11.96%	-11.96%
SX5E Index	Euro Stoxx 50	4,136.91	-2.14%	-3.62%	-3.62%
SMI Index	Swiss Market	12,104.44	-2.03%	-5.99%	-5.99%
UKX Index	FTSE 100	7,466.07	-0.37%	1.15%	1.15%
CAC Index	CAC 40	6,965.88	-1.45%	-2.50%	-2.50%
DAX Index	DAX	15,318.95	-1.83%	-3.56%	-3.56%
FTSEMIB Index	FTSE MIB	26,565.41	-1.43%	-2.46%	-2.46%
NKY Index	Nikkei 225	26,717.34	-2.92%	-7.20%	-7.20%
HSI Index	Hang Seng	23,550.08	-5.67%	0.90%	0.65%
SHSZ300 Index	CSI 300	4,563.77	-4.51%	-7.53%	-7.62%

Source: Bloomberg, as at January 28, 2022. Performance figures in indices' local currencies.

Chart of the week

The Nasdaq composite index is struggling to find a bottom after the Relative Strength Indicator has fallen into oversold territory for the first time since the pandemic selloff in March 2020. The support in area 14,200 points, which previously acted as support, can now be a difficult hurdle to overcome. If it will fail to break to the upside this threshold, the next support is at 12,500 (at -9% for Spot level).

Figure 2: Nasdaq Composite Index

Source: Bloomberg, as at January 28, 2022.

"Many asset managers continue to launch new innovative funds, including Blackrock, which requested to launch its first product on digital assets."

Crypto & Blockchain | Investors remain confident in digital assets

New products continue to enter the market.

Despite the price of crypto token having fallen sharply, many deals occurred in the past week, suggesting investor confidence in digital assets has not been shaken. In the venture capital space, FTX US, the US affiliate of cryptocurrency exchange FTX, has raised USD400 million in its first external fundraising round. The investment gives FTX US a valuation of USD8 billion, placing it among the world's most valuable private crypto firms.

On the SPAC side, digital asset trading platform Apifiny Group goes public with an agreement of USD530 million. Many asset managers continue to launch new innovative funds, including Blackrock, which requested to launch its first product on digital assets. The ETF is called the iShares Blockchain and Tech ETF, and it would invest in companies involved in the development and deployment of crypto technologies. It is worth noting that the ETF will not invest in crypto directly or indirectly via crypto derivatives, but in equity assets.

Market action: Investors continue to hope for a bounce in the equity market, questioning whether we are next to an another "crypto winter" like what occurred in 2017-2018. This time, the correction can be wider including the huge universe of decentralized finance tokens. In a recent article on the New York Times, Paul Krugman pointed out that a crypto bear market would disproportionately affect the more vulnerable people in society, referencing research which finds that 55% of crypto investors do not have a college degree and anecdotal evidence that it is particularly popular among the working class. In the meantime, Bitcoin has stalled below USD40,000. That level flipped from be a Support during the rally to becoming a Resistance in the correction.

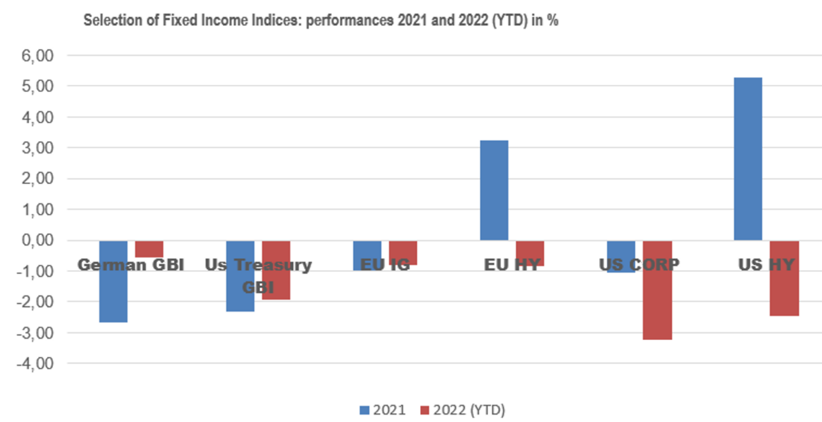
"Bitcoin has stalled below USD40,000. That level flipped from be a Support during the rally to becoming a Resistance in the correction."

Fixed Income | Do higher rates mean higher defaults?

New issuance will remain robust.

This week, the Fed made clear its intention to raise interest rates in March and keep tightening after that. Yields have therefore increased across all major fixed income segments and year-to-date returns are negative (the red bars).

Figure 3: Fixed Income Performance

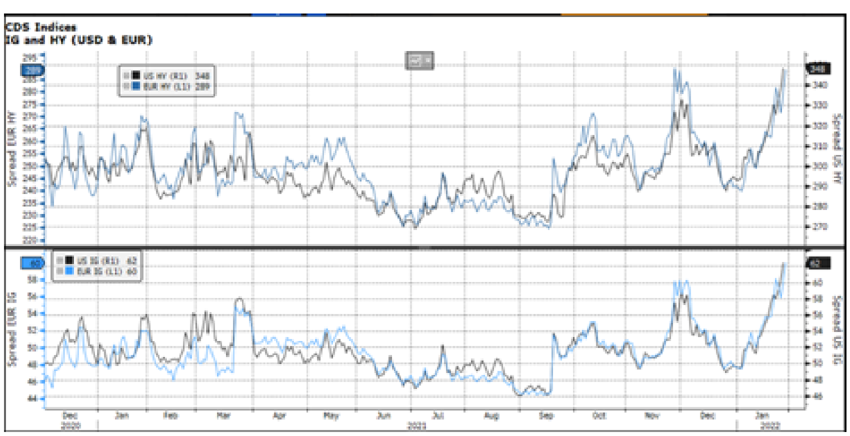


Source: Bloomberg, as at January 28, 2022.

"The fear that the era of ultra-cheap money is over could mean the demise of the lid that was kept on defaults and bankruptcies."

Our view: The fear that the era of ultra-cheap money is over could mean the demise of the lid that was kept on defaults and bankruptcies. This will start to put pressure on riskier issuers. Fitch Ratings has in fact revised its forecast for companies with a junk credit score: the default rate will climb to 1%-1.5% in 2023 from a record low 0.5% in 2021. Still, that remains below the historical non-recessionary average of 2.2%. Credit spreads, while reacting without panic, reached their widest levels since December 2020.

Figure 4: Investment Grade and High Yield Credit Spreads



Source: Bloomberg, as at January 28, 2022.

> “This move will allow developers to access more of the cash held at their local project subsidiaries for debt repayments.”

In the primary market, issuers held off debt sales this week to avoid asset price fluctuations and large US Treasury yield moves. However, volatility seen so far this year is expected to persist and issuance will quickly resume. Despite the recent spike of 50 bps in yields (the black line), the par-weighted coupon – the average borrowing cost for high grade non-financials (the blue line) – shows a secular decline over the past 10 years. With yields still well below average borrowing costs (the red line at 0.7%), borrowing costs should drop further this year as old bonds get replaced by new.

Figure 5: Yields Versus Coupons

Source: Bloomberg, as at January 28, 2022.

The move will drive greater issuance, as companies seek to lock in borrowing costs before they rise much further. Clearly, the difference between coupons and current yields will probably close, given the expectation of higher yields and slightly wider spreads, but the decline in borrowing costs will continue this year. Hence, although negative for investor portfolios, a rate surge shouldn't be a fundamental drag for corporate issuance.

> “...this was less so the case in the European high yield market, where signs that investors aren’t willing to stomach just anything have started to emerge.”

US junk bonds proved to be resilient amid wild equity volatility and investors continued to flock to new issues with orders of more than three times the size of the bond offerings. However, this was less so the case in the European high yield market, where signs that investors aren’t willing to stomach just anything have started to emerge. Junk bond sales in Europe amounted to only EUR90 million so far this week, down from EUR3.3 billion last week, as issuers are getting a taste of how issuance might get more complicated with the tightening of monetary policy.

Some, like football club Inter Milan, are having to pay more than expected. At the beginning of the week, unofficial guidance for the coupon was in the low to mid 6% range. On Wednesday, initial price talks had gone to as high as 7%. Both were consistently higher than the interest rate on its existing bonds (4.875%). The deal (InterMediaCom, B+, 9/2/27) closed at 6.75%. Others are trying to appeal to investors by offering their bonds as a hedge against rising rates. Renta Group, one of the Nordic leaders in equipment rentals (B, B2, B+ 27/01/2027), switched its offering in from a fixed coupon bond into a floating rate one, the first one to do so this year (3 months +4.37%).

Week Ahead | Key events to watch for

- **On the macro front, ISM manufacturing and services, as well as January payrolls**, will be released. With the rate tensions of recent weeks, we bet that 'bad data is good for markets' will prevail again.

- **Corporate earnings season will be very full,** with 111 S&P companies reporting, including Amazon, Meta and Alphabet.

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