NOVUM
CAPITAL PARTNERS

Weekly Market Flash
A (somewhat) surprisingly stable market

April 30, 2023

US equity indices recorded another positive week, driven by FANG companies (2.95%), which posted excellent earnings results overall. This week the S&P 500 index (0.89%) also approached the highs of the year, and reached very close to the key level in the 4'200 area. This comes just ahead of the Federal Reserve (Fed) meeting next week, in which the last rate hike of the tightening cycle—a likely 25 basis points (bps) hike to 5%—could take place.

Highlights

▪ European markets consolidated this week (-0.53%). Banks in particular (-2.95%) suffered from bad economic data and the retracement of rates.

▪ Q1 GDP in the US was revised downward by far more than expected (1.1% annualized quarter-on-quarter).

▪ Overall, the earnings season is going well, with 81% of companies beating EPS estimates, on average by more than 6%. The FANGs did particularly well, led by Meta, Microsoft, and Alphabet.

▪ First Republic saw an ongoing flight of deposits from the bank (of around USD50 billion), despite support from the big American banks (of around USD30 billion), which threw the bank's stock and its bonds into a downward spiral.

▪ In the US over the last month, investment grade spreads have tightened almost 30 bps and junk bond spreads narrowed 68 bps.

▪ UniCredit has announced that it will exercise its option to redeem an AT1 bond early. The bank will repay the EUR1.25 billion note at face value on June 3, adhering to market convention by calling these bonds at the earliest opportunity.

“Banks in particular suffered from bad economic data and the retrace-ment of rates...”

Markets & Macro | A (somewhat) surprisingly stable market

Returning to a defensive stance.

Compared to the US equity market, Europe consolidated this week (-0.53%). Banks in particular (-2.95%) suffered from bad economic data (the economy stagnated in Q1), and the retracement of rates, which benefited from the drop in inflation.

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

Equity Indices	Last Value	Week	Ytd
MSCI World	2,835.93	0.55%	9.83%
Nasdaq	12,226.58	1.28%	17.13%
S&P 500	4,169.48	0.89%	9.16%
S&P Equal Weighted	5,892.43	0.15%	3.26%
DJ Industrial	34,098.16	0.86%	3.53%
Nikkei	28,856.44	1.02%	11.67%
Euro Stoxx 50	4,359.31	-0.53%	16.36%
Swiss SMI	11,437.14	0.27%	9.44%
FTSE 100	7,870.57	-0.47%	7.08%
Canada	20,636.54	-0.16%	7.60%
Shenzen	4,029.09	-0.06%	4.14%
Hong Kong	19,894.57	-0.90%	0.99%
MSCI EM	977.05	-0.27%	2.85%

Equity Sectors	Last Value	Week	Ytd
S&P Value	154.39	0.92%	6.94%
S&P Growth	64.84	0.92%	11.18%
S&P Defensives	1,592.55	1.00%	4.13%
ARK Fund	35.92	-4.54%	14.98%
FANGS	6,119.18	2.97%	37.62%
S&P Banks	81.28	-1.79%	-18.46%
Euro Stoxx Banks	85.13	-2.95%	10.75%
S&P Energy	85.13	0.18%	-1.68%
Gold Miners	33.58	-0.09%	17.17%

Commodities	Last Value	Week	Ytd
BBG Commodities	104.31	-1.20%	-7.53%
BBG Agriculture	66.65	-2.11%	-3.16%
Gold	1,989.99	0.35%	9.10%
Silver	25.05	-0.12%	4.59%
BBG Brent Crude TR	1,018.61	-1.29%	-4.08%
BBG WTI Crude Oil TR	185.21	-1.32%	-3.18%

FX	Last Value	Week	Ytd
DXY Index	1,226.82	0.14%	-1.59%
EUR/CHF	0.9854	0.49%	-0.42%
GBP Index	642.15	1.04%	3.10%
EM FX Index	1,687.35	-0.13%	1.61%
USD/JPY	136.30	1.60%	3.95%
USD/CNY	6.91	0.31%	0.20%
Bitcoin	29,330.50	7.55%	77.34%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	109.93	0.85%	5.64%
US High Yield	75.36	0.49%	4.39%
Euro Corps	233.27	0.70%	2.46%
JPM Europe Govies	9,753.90	2.14%	5.68%
US Treasuries	2,266.23	0.88%	3.56%
China Aggregate	259.95	-0.28%	1.83%
EMBI Global	789.50	0.91%	2.76%
EMBI Local	130.64	0.59%	5.62%

Source: Bloomberg, as at April 28, 2023. Performance figures in indices' local currencies.

Our view: A fortnight ago we decided to tactically increase our exposure to US equities (via a simple combination of options, a risk reversal), as we believed that the earnings season would surprise the (notoriously defensively positioned) market in a positive way.

Our hunch stemmed from the economic conditions that prevailed during the first three months of the year: still high, and profit-driven, inflation, in combination with still solid growth, as evidenced by the Q1 GDP published this week. This mix, we recognize, is still ideal for corporate earnings, as the cost of debt is not yet such as to impact corporate profitability (as per our analysis, which we will share with clients during our meetings). And at this point we can say that, with earnings season in full swing, the analysis has proven to be correct. In general, the earnings season is going well, with 81% of companies beating EPS estimates, on average by more than 6%. The FANGs (not surprisingly, companies with very little debt) did particularly well, led by Meta, Microsoft (which is not really one of the FANGs), and Alphabet. Amazon did less well, and next week we will see Apple publish earnings.

"As for GDP, we should not be fooled by the apparently disappointi-ng headline figure, which was in fact revised downward by far more than expected…"

As for GDP, however, we should not be fooled by the apparently disappointing headline figure, which was in fact revised downward by far more than expected (1.1% annualized quarter-on-quarter). The truth is that destocking removed 2.3 percentage points, without which the figure would have been well above 3%. Consumption was slightly below expectations but still robust, while investment grew only slightly (0.7%), held back by declines in equipment and housing. Adjusted for exports, inventories and government spending, GDP would have been 2.9%. The only blemish remains consumption. As we had analyzed during the quarter, both retail sales and real consumption expenditures (which cover 70% of the economy) spiked significantly in January, while the trend remains weak. And we are well aware that the weather had been extremely mild in January, favoring purchases in the retail sector as well.

"What dampened market gains was the resurgence of the regional bank crisis…"

What dampened market gains (the S&P 500 index was up only 0.89% despite overall bright earnings) was the resurgence of the regional bank crisis, with the third bank, First Republic, practically blown up within a few weeks. The publication that the flight of deposits from the bank had continued (of around USD50 billion), despite support from the big American banks (of around USD30 billion), threw the bank's stock and its bonds into a downward spiral. Initially, it seemed that First Republic might succeed in a kind of blackmail attempt on the big banks, demanding to purchase bonds at above-market rates. The rationale for those banks would be that the loss of a few billion dollars would be less than the USD30 billion in FDIC fees if First Republic failed. If the plan had succeeded, it would then have been much easier to recapitalize the bank, with a collection and underwriting plan already in place. But after a couple of convulsive days (and some volatility in the markets), it is now clear that the bank will go under FDIC management over the weekend to be liquidated, because no private capital solution can be found.

“We expect next week to be very dynamic with 180 S&P 500 index companies scheduled to report their Q1 earnings...”

What is (somewhat) surprising is how well the market is holding up, which in our view is still conditioned by an extremely defensive positioning, and a short-term view (which we live with, opportunistically). Month-end flows also likely played a role this week.

In addition, the market continues to view the three bankruptcies as isolated cases (when in the meantime facilities have been put in place to address liquidity crises or other problems related to the depreciation of bond portfolios), with no consequences for the provision of credit to SMEs in the coming months. Our view is that the problems of these banks will result in a tightening of credit conditions, which will affect not only the cost of money, but also the amount of credit granted to society.

As a result, with the market likely to attempt to attack the key level of 4'200 for the S&P 500 index coinciding with a likely neutral if not dovish Fed, and still acceptable economic data, we will try to take advantage of the upcoming rally to reduce our equity exposure again and return to a defensive stance. This is in anticipation of an economic slowdown that we believe is due as a result of the end of the rate hikes—and the credit crunch that is likely coming.

Fixed Income | Spreads tighten as credit access falls

“With investors seemingly reluctant to decide if signs of labor market weakness are positive or negative, we expect markets to focus intently on the guidance of Big Tech...”

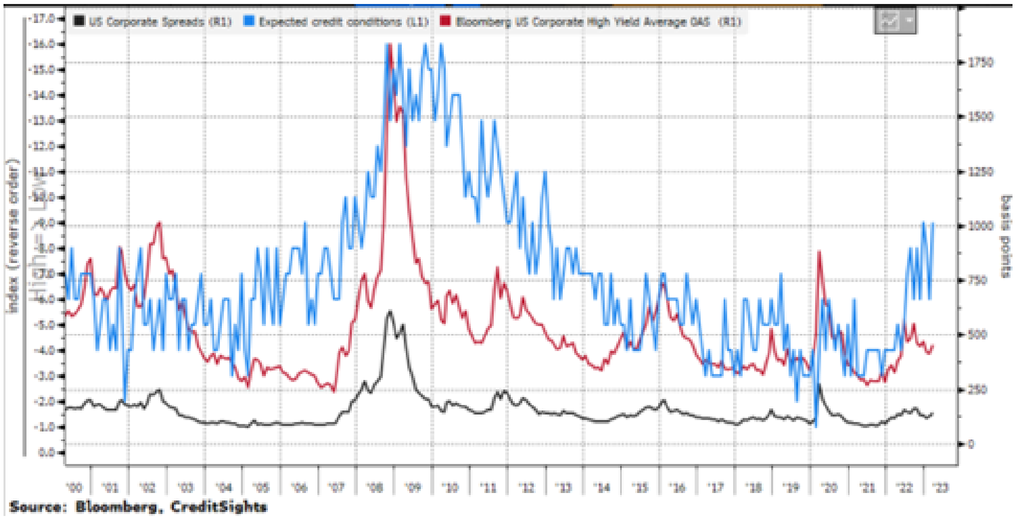
Value in higher-quality, IG corporate credit.

Persistent inflation continues to unsettle the bond market, with Japan, Europe, and the US all expressing concern. The Bank of Japan has signaled a shift in their monetary policy, with a broad-perspective review underway. Despite positive projections and steady policies from US policymakers, core PCE and the Employment Cost Index indicate ongoing inflationary pressures. While inflation has peaked, getting back to the central bank's 2% goal has proved challenging. In Europe, France and Spain experienced rising inflation in April, while the eurozone economy showed moderate growth in Q1 2023. However, German inflation unexpectedly decreased, creating a mixed set of data for the European Central Bank (ECB) to weigh before their upcoming interest rate decision.

Against this background, the possibility of a rise in 2-year Treasury yields looms, ranging between 4.15% and 4.30%. However, given the unresolved issues surrounding First Republic and the health of certain US regional banks, it is likely that the trend of rich US Treasuries getting richer will continue.

In credit, corporate spreads are sending an all-clear signal. In the US over the last month, investment grade spreads have tightened almost 30 bps and junk bond spreads narrowed 68 bps. This tightening is happening at the same time of the ongoing regional bank crisis, which is a sign of reduced access to credit for small- and mid-sized companies. In April, the survey by the National Federation of Independent Business showed companies expect access to credit to shrink (the blue line) and last quarter was the busiest for US bankruptcy courts since 2009.

Figure 2: Corporate Spreads Vs. Expected Credit Conditions



Source: Bloomberg, CreditSights, as at April 28, 2023.

"While spreads could tighten even further, the private credit market poses significant risks that cannot be ignored."

Our view: While spreads could tighten even further through the year due to high cash balances and strong interest coverage ratios in public corporates' balance sheets, the private credit market poses significant risks that cannot be ignored. Shadow lenders have taken on massive bets on illiquid and unrated companies, offering yields of 11% or more on secured loans, leading some investors to believe it's an amazing opportunity. However, the high interest expense is a major burden for small companies. This is not to be underestimated in Europe either, where direct bank credit (which is very sensitive to ECB rate hikes) remains the main financing channel for small- and medium-sized enterprises. Unfortunately, these problems are often hidden because private credit markets are not marked to market as frequently as public markets.

Elsewhere, UniCredit has announced that it will exercise its option to redeem an AT1 bond early, indicating that there is still some life left in this market segment despite Credit Suisse's historic write-down of its notes. The bank will repay the EUR1.25 billion note at face value on June 3, adhering to market convention by calling these bonds at the earliest opportunity. It has also stated that it will not need to issue a new bond as a replacement. Lloyds Banking Group is the next European bank with an upcoming AT1 call decision.

"We see value in investment grade corporates, which in the case of a recession should experience less spread widening."

Overall, we remain cautious. We prefer to stay up in credit quality and see value in investment grade corporates, which in the case of a recession should experience less spread widening. For the moment, we are avoiding the lowest rated bonds (especially below BB-). We are also wary of subordinated credit that tends to be more correlated to equity markets, which would likely decline in a recessionary environment.

Week Ahead | Key events to watch for

- **Next week is important for central banks**, with the Fed and ECB meetings on Wednesday and Thursday, respectively. For the Fed, the market is expecting a 25 bps hike, which should be the last, while for the ECB the market is split between 25 bps and 50 bps hikes.

- **On the macro front, Friday will see the labor market report for the US,** as well as the ISM manufacturing and services indices. In Europe CPI and industrial production will be published.

- **Earnings season also continues**, with Apple, Qualcomm, AM, as well as European automakers and energy companies releasing.

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