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Weekly Market Flash

Central banks, once again, adapt to markets

October 31, 2021

The week was characterized by very high volatility on interest rates, with action from both investors and central banks driving a significant repricing of monetary policies in the major developed countries. Equity markets, on the other hand, did not get too disrupted; any hint of weakness generated by movements in interest rates, or by some disappointing corporate results – for example, from Apple and Amazon – turned into buying opportunities. With 11 gains in the last 13 sessions, the S&P 500 index once again made new highs in an euphoric mood as markets wait for next week's Federal Reserve (Fed) meeting.

Highlights

▪ The Bank of Canada ended its quantitative easing program earlier than expected this week, and shifted forward the expected timing of interest rate hikes by six months.

▪ The ECB remains the most dovish central bank in terms of hike guidance (not before 2023), despite the slight change in tone at its latest press conference. The central bank indicated that the PEPP will indeed be terminated in March.

▪ This week was the busiest of the Q3 earnings season, with all Big Tech reporting results. But despite weak tech earnings, the S&P 500 index recorded the best month of 2021, closing at 4,605.38, up 6.91%.

▪ According to Bloomberg, 56% of the S&P 500 index companies have reported Q3 2021 results. Of these 279 companies, 82% have reported earnings above consensus estimates. The magnitude of the earnings surprise is around 10%, compared with a 16% beat in Q2 2021 and around 22% in Q1 2021.

"At the risk of stating the obvious, it is unlikely that rate hikes (or the threat of rate hikes) and the end of QE are going to do anything to alleviate the factors driving up prices."

Markets & Macro | Central banks, once again, adapt to markets

Market rejects ECB's scenario.

The change in rhetoric by some central banks this week generated real "VaR shocks" on the 2- and 3-year maturities of the curves. It was interesting to see how, once again, it was the central banks that had to adapt to market movements – and not vice versa.

Our view: On the other hand, we had previously commented that the continued publication of inflation figures well above the 2% target, as well as problems in the supply of raw materials and labor resources for companies, meant that the transitory theories advocated by central bankers were no longer credible. Developed markets (DM) central banks put themselves in a tiny corner months ago by stating that inflationary pressures were transitory. At the risk of stating the obvious, it is unlikely that rate hikes (or the threat of rate hikes) and the end of QE are going to do anything to alleviate the factors driving up prices. We all know that it would be far "too simple" if DM policymakers flipping the switch – from hiking rates to ending asset purchases – will manage to interrupt the transmission mechanism between transitory, supply-side price pressures and CPI expectations....

So, let's take a look at the week's main events in detail. Firstly, the Bank of Canada is the latest to have taken strong measures in order to counter the inflationary risk this week, ending its quantitative easing program earlier than expected and shifting forward the expected timing of interest rate hikes by six months. Once again, the shift came as supply side disruptions and worker shortages forced the central bank to change its estimate of potential output lower. Economic growth forecasts were revised lower, while inflation is expected to stay higher for longer.

Next, expectations are mounting for a similar hawkish shift from the Reserve Bank of Australia next week, after its latest bond purchase announcement this week, with a reduction of purchases. These interventions generally increased the tendency for the curves to flatten, with widespread and sharp falls in yields on the long end, which left traders stunned at a time of such strong inflationary pressures. However, it is true that positioning on Treasuries was very thin, making the risk of a short squeeze high.

"Lagarde reiterated that what the market is pricing in in terms of hikes is not in line with their scenario and view on inflation."

The Fed, on the other hand, seems to be stuck in an intermediate position, with greater hawkishness but with a clear separation between tapering and rate hikes (so much so that only one hike is expected in 2022). In our view, there are a couple of reasons that can possibly explain the relative dovishness of the Fed compared to other central banks. One is the global role of the Fed in providing liquidity conditions, due to the reserve status of the US dollar. The second lies within the coming end of the Fed President, which is due for the end of the year. Since the reconfirmation of Powell is all but assured, we wonder which central banker would make a serious hawkish turn in policy right before the potential end of his term. As for the effect on markets, we dare not imagine what the impact would be if the Fed had made a shift in recent weeks, similar to what has happened in Australia and Canada, for example – and we can only hope that nothing comparable happens in the immediate future.

The European Central Bank (ECB), on the other hand, remains the most dovish central bank in terms of hike guidance (not before 2023), despite the slight change in tone at its latest press conference. Analyzing President Lagarde's press conference, three main aspects emerged. Firstly, they took a close look at inflation, which was the focus of their discussion. They remained of the firm belief that it is largely temporary in nature, although they admit that it will last longer than they expected. Secondly, they indicated that the PEPP will indeed be terminated in March. The decision was expected in December, so this action is a slight reinforcement. Finally, Lagarde reiterated that what the market is pricing in in terms of hikes is not in line with their scenario and view on inflation.

In general, the performance was in line with expectations, but with a couple of nuances that perhaps suggest that there is some debate between the hawks and doves within the Governing Council:

1. The decision to announce the end of the PEPP indicates a certain determination: they could have waited until December. Perhaps they want to prepare the market for the decision, or perhaps they want to implicitly signal that the pace of purchases will decline further.
2. The rejection of what the market had expected did not seem very vigorous. A sign that perhaps some members do not want to rule out so strongly raising rates next year.

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But the continued above-expected surprises on the inflation front – Friday's release of inflation data in Europe saw headline above 4% and core above 2% – pushed investors in Europe to challenge the ECB; the market took the initiative, with a strong selloff in all European bonds (particular weakness in peripherals), and a full hike now priced in for next year. It is clear that the ECB's official macroeconomic and inflation scenario is soundly rejected by the market.

Equities | Big Tech, big misses

But market views issues as short-term.

This week was the busiest of the Q3 earnings season, with all Big Tech reporting results. But despite weak tech earnings, the S&P 500 index recorded the best month of 2021, closing at 4,605.38, up 6.91%. And Microsoft unseated Apple as the most valuable company, after the former reported solid quality earnings while the latter missed earnings due to supply chain issues costing the company USD6 billion.

Meanwhile, the consumer discretionary sector outperformed, led by Tesla, which rallied by 22.5% week-on-week following news of Hertz buying 100,000 Tesla electric vehicles. Energy stocks were the worst performing as oil prices retreated from multiyear highs on news of Iran returning to the negotiation table and a US oil inventory build. Elsewhere, Japan's stock market returns were erratic ahead of the general election on October 31.

Figure 1: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	35,819.56	0.40%	5.93%	18.77%
SPX Index	S&P 500	4,605.38	1.35%	7.01%	24.03%
CCMP Index	Nasdaq	15,498.39	2.72%	7.29%	20.89%
SX5E Index	Euro Stoxx 50	4,250.56	1.52%	5.20%	22.56%
SMI Index	Swiss Market	12,108.17	0.43%	4.00%	16.36%
UKX Index	FTSE 100	7,237.57	0.47%	2.21%	15.53%
CAC Index	CAC 40	6,830.34	1.44%	4.76%	25.76%
DAX Index	DAX	15,688.77	0.94%	2.81%	14.36%
FTSEMIB Index	FTSE MIB	26,875.96	1.14%	4.86%	23.92%
NKY Index	Nikkei 225	28,892.69	0.30%	-1.90%	6.81%
HSI Index	Hang Seng	25,377.24	-2.87%	5.81%	-4.46%
SHSZ300 Index	CSI 300	4,908.77	-0.98%	3.98%	-4.14%

Source: Bloomberg, as at October 29, 2021. Performance figures in indices' local currencies.

> "The magnitude of the earnings surprise is around 10%, compared with a 16% beat in Q2 2021 and around 22% in Q1 2021."

According to Bloomberg, 56% of the S&P 500 index companies have reported Q3 2021 results. Of these 279 companies, 82% have reported earnings above consensus estimates. The magnitude of the earnings surprise is around 10%, compared with a 16% beat in Q2 2021 and around 22% in Q1 2021. Of the five Big Tech companies, Apple, Amazon and Facebook missed and/or guided below expectations, while Microsoft and Google beat and/or guided positively. Even Big Tech companies like Amazon and Apple were not immune to the supply chain disruptions and labor shortages.

In terms of revenues, 75% of the 279 companies that had reported Q3 results so far beat. The magnitude of the beat was low (1.98%) compared with the past four quarters. It is also interesting to note that share price increases have outpaced the upward revisions to EPS estimates over the past few weeks, leading to an S&P 500 forward 12-month P/E multiple expansion from 20.1 at September 30 to 21.1 at October 29. Looking ahead, according to FactSet data, analysts project earnings growth of more than 20% for Q4 2021.

Our view: Despite the big misses by three of the five Big Tech companies, and despite the deceleration in the magnitude of earnings and revenue surprises, this earnings season hasn't so far delivered the kind of disappointment that the bears had hoped for. While the usual problems have inflicted harm on this quarter's earnings (i.e. chip shortages, labor shortages and supply chain disruptions), we believe that the market has taken the view that most of these issues would be resolved within a quarter or two. It is also our opinion that market levels and valuations are well buttressed by solid demand trends and strong consumer spending. Until we see a shake in consumer confidence, consumer willingness to spend, or consumer views on inflation (permanent rather than transitory), it is possible for current above-average valuations to persist.

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Separately, Facebook announced a name change (to Meta), in a strong sign of commitment to the metaverse concept. While there are many ways to play the theme, we believe that the metaverse infrastructure beneficiaries are one of the best ways to gain exposure to the theme. Semiconductor stocks like Nvidia and AMD, which are already benefiting from other secular trends, stand to also benefit from Facebook's USD19 billion metaverse-related capex announcement.

FX & Commodities | Euro pulls back

Chart of the week

The Euro pulled back from the trendline and the 50 daily moving average resistance points. No news triggered the move on the last day of month, in a session dominated by fund flows from rebalances at the end of the month. The move is measured as 2 sigma, which makes it exceptional. At close, Euro buyers stopped the red candle before setting a new low. Key resistances remain at 1.17 with target 1.1920 and support at 1.1490

“The [Euro] move is measured as 2 sigma, which makes it exceptional.”

Figure 2: EUR/USD Pair

Source: Bloomberg, as of October 29, 2021.

Week Ahead | Key events to watch for

- **The coming week will be particularly busy, both in terms of data and central bank meetings**, with the Fed and the Bank of England having to make important decisions on tapering and possibly on rates.

- **In terms of macro data**, in the US we will see both ISM surveys and payrolls for October. PMIs for almost all developed countries will also be released, and it will be important to understand the level of production and whether supply bottlenecks are starting to clear.

- **The corporate earnings season is still in full swing**, with 168 S&P 500 and 85 Stoxx 600 companies reporting next week.

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