

Weekly Market Flash

A tough, but transitional, environment for risky assets

February 20, 2022

The now usual mix of inflation and geopolitical news (which intersect given the impact of geopolitical tensions on commodities) led to another negative week for the MSCI World. This was the sixth negative week in seven weeks since the start of the year, with the index now down 7.5% year-to-date. As we write, at least a partial occupation or invasion of the DNR/LNR seems likely; if escalation were to stop at this stage, we can speculate that it would be an intermediate scenario with limited further sanctions against Russia that should not touch the banking system and consequently energy supplies. It remains to be seen, however, whether the Russians then intend to extend the offensive, with far greater economic consequences. At the same time, the bombardment of inflation-related newsflow has not ceased either. In fact, the dynamic is beginning to have a structural impact on markets and consumer sentiment, which in both cases are increasingly showing signs of taking the inflationary environment into account in their investment and consumption decisions.

Highlights

- The UK January CPI surprised on the upside again; the situation was very similar in Canada, with the CPI at 5.1%. The US January PPI got less attention, but the direction was the same. The only country to be an exception to the trend is China.
- Major US indexes posted losses for the second week in a row over concerns of a Russian invasion of Ukraine. European shares were also negatively impacted by the volatile situation. The CSI 300 and the Shanghai Composite indexes were the only two major global indexes to close in positive territory.
- Bitcoin was down 5% over the past week as investors reduced their exposure to risk, with the support at USD40,000 being tentatively breached.
- The geopolitical risk around Ukraine has diminished the probability of aggressive central bank action and pushed yields on 10-year US Treasuries back beneath 2%.
- US investment grade bond sales surged in the middle of the week, but issuers had to sweeten terms to get deals done. Companies paid 19 bps in new issue concessions on average, about four times higher than the 2022 average and almost 10 times higher than they did in 2021.

“The only country to be an exception to the trend is China, which as we know has adopted the opposite and decidedly more cautious monetary policies than the Western bloc...”

Markets & Macro | A tough, but transitional, environment for risky assets

Managing portfolios is challenging, for now.

As mentioned earlier, at least a partial invasion of the DNR/LNR now seems likely. In the face of a possible incursion, it remains to be seen whether the meeting arranged for the end of next week between Russian Foreign Minister Lavrov and US Secretary of State Blinken will take place, given that for the US, the condition was that there be no military invasion by the Russians.

In terms of inflation-related newsflow, in the UK, the January CPI surprised on the upside again (albeit slightly). The January headline CPI came in at 5.5%, compared to expectations of 5.4% year-on-year (YoY). The situation was very similar in Canada, with the CPI at 5.1% (versus 4.8% expected), having exceeded 5% for the first time since 1991. The US January PPI got less attention, but the direction was the same with the monthly reading coming in at 1.0% (versus 0.5% expected), and above all economists' estimates. The annual figure came out at 9.7% (versus 9.1% expected).

“Inflationary dynamics have the paradox of pushing consumers to anticipate spending, even more so if in the presence of a stock of cash...”

The only country to be an exception to the trend is China, which as we know has adopted the opposite and decidedly more cautious monetary policies than the Western bloc since the Covidium broke out. Indeed, it is striking to see downward surprises in this area, in addition to the absolute level of inflation (0.9% in January on an annual basis, against 1.0% forecast). As a result, this data leaves the Chinese central bank with little room for maneuver to provide liquidity to the domestic market (which it did immediately, in small doses), hence the People's Bank of China Governor Yi Gang's statements announcing further support for "key areas" and "weak links".

Our view: Another very impressive figure, and this time a positive one, was retail sales in the US. Excluding car sales, the gain was 3.3% month-on-month, well above expectations. On a YoY basis, retail sales increased 13% overall! What is striking about this figure is the complete divergence from the consumer sentiment data that has been published recently (Figure 1). How can we reconcile the message of the two series? Our interpretation is that retail sales are growing at a likely unsustainable pace, supported by two elements: 1) the accumulation of cash savings from the USD5 trillion in post-Covid fiscal stimulus ; and 2) remember that retail sales are a nominal measure. Inflationary dynamics have the paradox of pushing consumers to anticipate spending, even more so if in the presence of a stock of cash, which by definition depreciates over time, diminishing purchasing power. In short, a nice paradox too, and a convoluted one.

Figure 1: US Retail Sales and Consumer Confidence



Source: Bloomberg, as at February 18, 2022.

“...on the economy-Fed front, we seem to have entered a lose-lose situation on the consumer front.”

In practice, on the economy-Fed front, we seem to have entered a lose-lose situation on the consumer front. In fact, if the previous mantra of ‘bad data is good for markets’ was valid, because the Federal Reserve (Fed) could have the excuse to stay easy, now the opposite is true. Good data means bad news, as it increases the Fed's room to tighten. Bad data – in particular, weak consumer activity caused by rising inflation – also means bad news, as it increases the chance of counter-cyclical monetary tightening to counter the inflation and support the hardest hit consumers, i.e. those with low incomes and no financial assets.

As we have written in recent editions of the Market Flash, beginning with our Outlook for 2022, we have become decidedly more cautious in our message and asset allocation. We are in a particularly critical phase, and likely a transitional one, toward a world with paradigms that are decidedly different from those to which we have become accustomed to over the last 30 years, which have been decidedly favorable to economic development – and in which the real economy and finance have grown with mutual aid (with the interruption of the GFC, in which, however, finance and the economy have suffered in parallel).

In our opinion, the change of context has been brought about by a confluence of factors that coincidentally intersect in the – we think and hope – definitive post-Covid reopening phase. On the Covid front, there is certainly a sense of vulnerability that will remain imprinted on our societies. This is not necessarily negative, but we cannot deny a slight sense of insecurity that could affect the economic and social choices of the most fragile part of citizens, but certainly the whole business world whose functioning implies physical activities carried out by humans. By this we mean lower efficiency and higher costs associated with security procedures that we did not previously conceive. Hence, a contribution in terms of less elasticity of supply.

“...once the emergency phase is over, the inflation shock we are experiencing in the West is a very strong call for caution.”

Science has undoubtedly won over the virus, but the fact that vaccines are not totally effective in preventing the spread of the virus is a further reminder of the vague sense of uncertainty and fragility to which we referred.

On the macroeconomic front, once the emergency phase is over, the inflation shock we are experiencing in the West is a very strong call for caution. The shock has set a clear limit for central bankers, whose attempt to steer the economy, the markets and inflation without restrictions has been abruptly interrupted. Choices have to be made, and trade-offs have to be taken into account. At some point the old principles of macroeconomics come back into play, so if you want economic growth and low unemployment, the consequence is that inflation goes up. While this is very simple, it is something we had forgotten about for decades. In the first phase, we understandably thought that inflation was transitory, linked only to lockdown distortions in key areas of world trade, but it's not so simple.

The paradox of the labor market is particularly interesting: years ago we were debating the problem of robot-human substitution and the consequent galloping unemployment that would afflict our society. Thanks to the pandemic (and the wealth effect offered by financial markets), we find ourselves, especially in the US, it must be said, with a low labor market participation rate, extreme levels of job vacancies, and upward pressure on wages.

Finally, a note on the environment and geopolitics. Regarding the environment, we are learning that the choice to abandon fossil fuels have a price we are paying in terms of energy prices, at least in the transaction phase, which will last for years. As far as geopolitics is concerned, here too we are coming to the abrupt realization that the Pax Americana phase is no longer guaranteed. The US has now abandoned all forms of military interventionism, thus leaving plenty of room for other forces, such as Russia. We also believe that the market's concern about the Ukrainian question transcends the conflict itself, but is based on the problem of the supply of raw materials, the supply of which is not at all elastic, we have understood. It is no coincidence that the US is rushing to seek an agreement with Iran, because there are no other producers capable of filling the gap that would be created by Russia.

To conclude, the macro mix is no longer a benign and favorable input for asset prices; in this context, managing portfolios will certainly be more difficult than in the past. However, it does not mean that, once this information is incorporated, the bull market cannot restart – especially in the US, where the pro-business and innovation culture is more alive than ever, and there are no particular imbalances in terms of debt in both the household and corporate sectors. We should also remember that equity prices are expressed in nominal terms, so a world with higher inflation should indeed favor equity returns, especially relative to the bond world.

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Equities | Is a barbell approach no longer suitable?

Equity valuations are being challenged.

Major US indexes posted losses for the second week in a row over concerns of a Russian invasion of Ukraine. Consumer staples was the only sector that outperformed the S&P 500 index as investors sought safe havens amid inflation and geopolitical risks. Energy stocks performed the worst on news of a potential deal between Iran and the West.

European shares were also negatively impacted by the volatile situation in Ukraine. European Central Bank (ECB) officials sent mixed signals regarding how to tackle inflation, with President Lagarde and some Governing Council members emphasizing a gradual adjustment to monetary policy, while ECB Chief Economist Lane hinted that consensus is building around a faster course of action.

The CSI 300 and the Shanghai Composite indexes were the only two major global indexes to close in positive territory, on increased investor risk appetite in response to positive comments from governments officials for state support to the economy. Additionally, both China's CPI and PPI for January came in lower than expected.

Figure 2: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	34,079.18	-1.77%	-2.32%	-5.97%
SPX Index	S&P 500	4,348.87	-1.52%	-3.58%	-8.57%
CCMP Index	Nasdaq	13,548.07	-1.73%	-4.79%	-13.32%
SXSE Index	Euro Stoxx 50	4,074.28	-1.94%	-2.30%	-4.98%
SMI Index	Swiss Market	12,010.09	-1.31%	-1.77%	-6.72%
UKX Index	FTSE 100	7,513.62	-1.30%	0.79%	1.92%
CAC Index	CAC 40	6,929.63	-1.17%	-0.99%	-3.01%
DAX Index	DAX	15,042.51	-2.38%	-2.77%	-5.30%
FTSEMIB Index	FTSE MIB	26,506.79	-1.70%	-1.15%	-2.68%
NKY Index	Nikkei 225	27,122.07	-2.07%	0.44%	-5.79%
HSI Index	Hang Seng	24,327.71	-2.32%	2.10%	3.98%
SHSZ300 Index	CSI 300	4,651.24	1.08%	2.34%	-5.85%

Source: Bloomberg, as at February 18, 2022. Performance figures in indices' local currencies.

Our view: The geopolitical tension in Ukraine was in focus throughout the week, and is likely to continue to be until Russia's intentions become clear. In the background, however, earnings continued to set the tone for risky assets, with several pandemic favorites such as Roku and Roblox reporting results that didn't satisfy investors. Exuberance proxies such as the ARK Innovation ETF (ticker: ARKK US) and the Goldman Sachs Non-profitable Tech basket were down 7.4% and 9.9% on the week, respectively (-31.5% and -26.1% year-to-date, respectively).

We see continued outflows from fixed income, posing a considerable challenge to equity valuations. Last week, the Bank of America Bull & Bear indicator drifted away from the "buy" territory specifically for this reason, despite equity markets' year-to-date declines. Geopolitical risk aside, growing inflation risks (especially as investors and consumers incorporate higher inflation expectations in their investment decisions and consumption habits) and continued inflows into equities (retail investors still "buy-the-dip" causing equity positioning to remain at average historical levels) advocate for abandoning the barbell approach and favoring defensives and value over growth stocks.

Crypto & Blockchain | Crypto adoption progresses

Bitcoin falls 5% in risk-off environment.

After a delay due to the dispute between White House officials and Treasury Secretary Janet Yellen over the scope of a pending executive order that could include a digital dollar, President Biden is expected to issue an executive order next week directing federal agencies to study the risks and opportunities posed by cryptocurrencies and a central bank digital currency (CBDC), and hopefully propose a government-wide strategy to regulate digital assets. This will be another important step toward the official adoption of crypto.

The administration is already engaged in a wide-ranging effort to regulate the sector, while the FBI is grappling with high-profile cases of digital currencies playing a role in ransomware attacks like the Colonial Pipeline episode last year. Ransomware groups often demand their fees in bitcoin. In some of those cases, the FBI has been able to track down and recover some of the ransom, such as in the case of the arrest of a married New York couple, that in 2016 hacked and stole USD3.6 billion from the digital currency exchange Bitfinex. In fact, cryptocurrencies are based on blockchain technology and shared ledgers across a computer network, where records are impossible to change once added.

In the meantime, the Ontario Provincial Police and Royal Canadian Mounted Police ordered all regulated financial firms to cease facilitating any transactions from 34 crypto wallets tied to funding trucker-led protests in the country, called the 'Freedom Convoy'. These are protests against the international travel restrictions imposed by the Canadian government, which requires all entrants to the country to be vaccinated against COVID. Supporters of the truckers have tried to circumvent the blockades by raising

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cryptocurrency donations. The government has blacklisted a number of crypto addresses associated with these efforts. It remains to be seen how effective these measures will be because crypto transactions cannot be vetoed, and wallets are controlled by whoever possesses the cryptographic private keys. On this event we share here an interesting interview to Buterin co-founder of Ethereum, in which he highlighted the role of decentralized technology.

Market action: BTC was down 5% over the past week as investors reduced their exposure to risk, with the support at USD40,000 being tentatively breached. Open conflict could potentially affect bitcoin's hashrate, which could exacerbate the market's weak reaction. The pullback could stabilize between the USD30,000-40,000 support zone.

Fixed Income & Commodities | Has the US Treasury curve flattened too far?

Fixed income forwards are sending a message.

The geopolitical risk around Ukraine has diminished the probability of aggressive central bank action and pushed yields on 10-year US Treasuries back beneath 2%. However, perhaps the Treasury yield curve had already flattened too far, given that front-end yields appear to be priced near maximum Federal Reserve (Fed) hawkishness. The market does a good job anticipating when the Fed is going to hike, which in itself is a reason for yield-curve flattening.

According to Bloomberg intelligence, since the early 1990s the implied one-year forward Treasury three-month/10-year and two-year/10-year curve forwards have tended to price curve moves prior to actual Fed action. This time is no different. Forward curves are already pricing for the potential of a recession in 2023 or 2024, having reached the same levels as the mid-2000s and 2018.

Figure 3: Forward Curves Pricing in 2023/24 Recession End

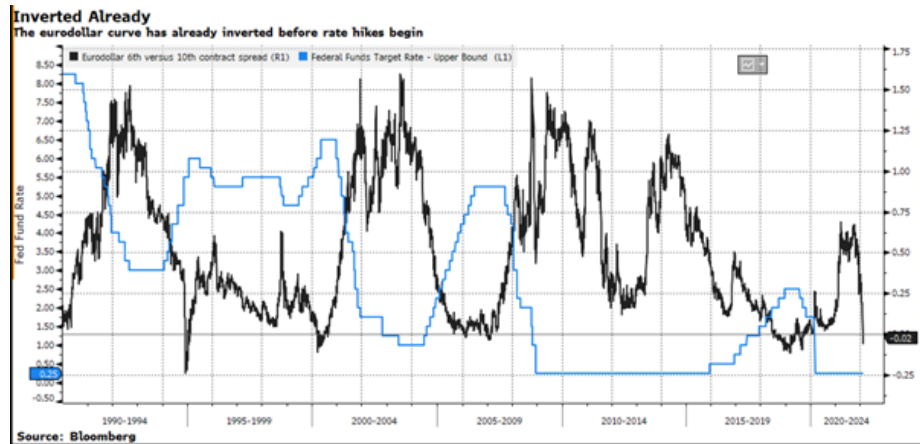


Source: Bloomberg, as at February 18, 2022.

The same message is observed in the Eurodollar curve that is priced for very near aggressive interest rate increases by the Fed and then stopping in January 2023 after seven, or maybe eight, 25 basis points (bps) moves. And the analysis from the Bloomberg “Macro Man Column” observes that the 6th versus 10th contract spread in eurodollars has already turned negative, before rate hikes have even begun. While, during the last cycle, the 6/10 curve didn’t invert until the middle of 2018.

“The Eurodollar curve is priced for very near aggressive interest rate increases by the Fed and then stopping in January 2023 after seven, or maybe eight, 25 bps moves.”

Figure 4: Eurodollar Curve Pricing in Aggressive Hiking



Source: Bloomberg, as at February 18, 2022.

“The flattening of the spot Treasury curve is telling the same story of a Fed being in restrictive territory by the middle of next year and then a sudden halt with a risk of subsequent easing.”

Our view: This is nothing particular: the flattening of the spot Treasury curve is telling the same story of a Fed being in restrictive territory by the middle of next year and then a sudden halt with a risk of subsequent easing. However, the only previous time when the first five contracts were so steep and the 6th versus 10th spread was inverted happened in 1994-1995 – a period of aggressive hikes causing an ugly bear market in bonds followed by a strong rally until the mid of 1995, when the Fed cut rates in the middle of that year. In a nutshell, fixed income forwards are sending a powerful message, one in which the trend of higher bond yields may change course faster than currently expected.

Elsewhere in the credit market, US and European investment grade corporate bond spreads widened, while US junk bonds weakened on a total return basis. While the weakness doesn't imply credit fear, with CCC rated bonds outperforming US high yield broadly and investment grade debt as well, investors are growing more concerned about how rates might affect the economy. While the credit fundamentals backdrop continues to be quite positive (low expected default rates), “investors are still terrified of central bank policy errors after a decade of financial repression,” Bank of America strategists said in a note, adding that this is the number one risk for the third straight survey. That chimes with Goldman's call on February 14 to move to an underweight on corporate bonds. Only UBS remains “constructive on credit spreads” in the first half of 2022 and recommend being overweight US high yield versus leveraged loans, as the current underperformance of fixed against floating rate debt is overdone.

“Month-to-date volumes stand at a modest USD8.3 billion, the slowest February since 2009...”

In the primary market, US investment grade bond sales surged in the middle of the week, but issuers had to sweeten terms to get deals done. Companies paid 19 bps in new issue concessions on average, about four times higher than the 2022 average and almost 10 times higher than they did in 2021. The US junk bond primary market ground to a halt this week amid heightened volatility across markets. Month-to-date volumes stand at a modest USD8.3 billion, the slowest February since 2009 and the slowest month since March 2020. Year to-date sales are USD32 billion versus USD73 billion for the same time period in 2021.

Financial issuers including BNP Paribas, Credit Agricole and Deutsche Bank dominated issuance in Europe's primary bond market for the first time in a month, accounting for 41.5% of the EUR31.34 billion (USD35.6 billion) of issuance market wide so far this week. Despite the uptick in activity, overall issuance is still 6.3% behind the same point last year. Friday, EDF (A3/BBB+) announced a €2.5 billion capital raise to take shelter from the impact from regulatory measures. Being 85% government owed, EDF cannot avoid being an instrument of national economic policy. To protect households from energy prices, EDF must sell electricity at EUR42/MWh far below market prices. This will cost EDF EUR8 billion and likely leading to a rating downgrade of one notch. The proposed EUR2.5 billion rights issue will be subscribed by the government. Therefore, a tangible support from the government will probably be more than expected, but not enough to solve EDF's longer-term problems. A broader restructuring of the company is still needed.

“This upward breakout of the symmetrical triangle on the weekly candles is a strong bullish signal for gold.”

Chart of the week

After a year of consolidation, gold is above the USD1,860 level and is beginning to look like a confirmed breakout. The triangle pattern is believed to be one of the most reliable and popular because they help indicate the continuation of a bullish or bearish market. This upward breakout of the symmetrical triangle on the weekly candles is a strong bullish signal. There is resistance in the area between USD1,900 and USD1,920, but a sustained follow-through above USD1,920 would signal a strong advance.

Figure 5: Gold Price



Source: Bloomberg, as at February 18, 2022.

Week Ahead | Key events to watch for

- **Next week will yield economic data in Europe and the US**, but the focus will remain primarily on geopolitics and central banks, with various speeches expected from the Fed, ECB and Bank of England. The Blinken-Lavron meeting is also highly anticipated.
- **With the US closed on Monday, the first February flash PMI data** will be seen in Europe on Monday, followed by the US the next day.
- **Sentiment surveys in Europe and the US** will shed new light on the impact inflation is having on consumers.

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