Weekly - May 23, 2022

PERFORMANCES 2022	
EQUITIES	
MSCI World	-17.8%
S&P 500	-18.1%
Nasdaq	-27.4%
Stoxx 600	-10.6%
SPI	-10.6%
Nikkei	-6.2%
China	-17.9%
Emerging	-16.0%
BONDS	
CHF Corp	-4.6%
US Govt	-8.1%
US Corp	-13.0%
US HY	-11.0%
EUR Gvt	-10.5%
EUR Corp	-8.6%
EUR HY	-8.3%
CURRENCIES	
USD index	+7.3%
EURUSD	-6.8%
EURCHF	-0.7%
USDCHF	+6.6%
USDJPY	+10.9%
EM FX	+0.5%
COMMODITIES	
Gold	+1.4%
Silver	-5.8%
Brent	+46.2%
Copper	-4.1%
CRB index	+34.6%

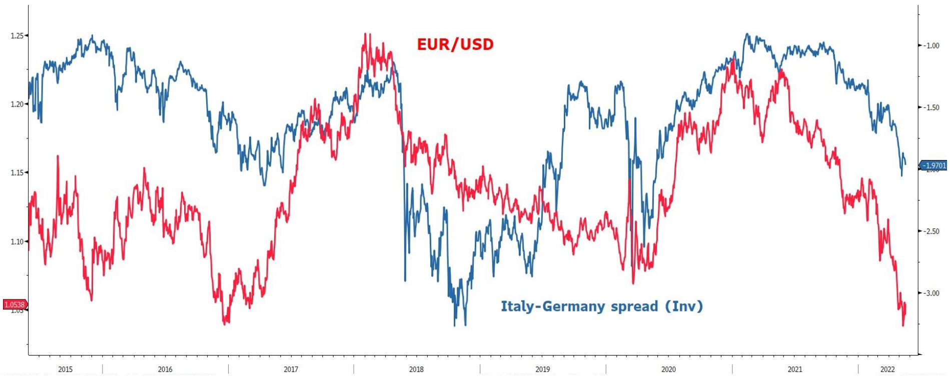
Cracklings

Italian bonds are having a rough ride this year. The volatility has been fueled by the European Central Bank purchasing program tapering. Its influence has declined and will end by July. More recently, mimicking the Fed, an elevated inflation has prompted an ECB member to mention that a 50bps rate hike should not be excluded.

Italy, burdened by a long-standing high public debt level, remains vulnerable to higher yields which arise the issue of debt sustainability. While there are reasons for volatility in the medium term (2023 general election and ECB tapering), the debt sustainability risk remains contained. First, as the average maturity of the debt is above 7 years, the transmission of higher rates will take time. Second, the Italian government has adopted a prudent attitude on the fiscal front. It has resisted internal pressure to increase deficits.

Italian bonds will remain one of the most affected assets by monetary tightening. Since the ECB announced its tapering, investors have started to discount the lower demand from the buyer of last resort and spread has widened.

Italy-Germany spread and EUR



Source: Bloomberg

Italian debt sustainability is not a concern. Eurozone fiscal decisions have been taken

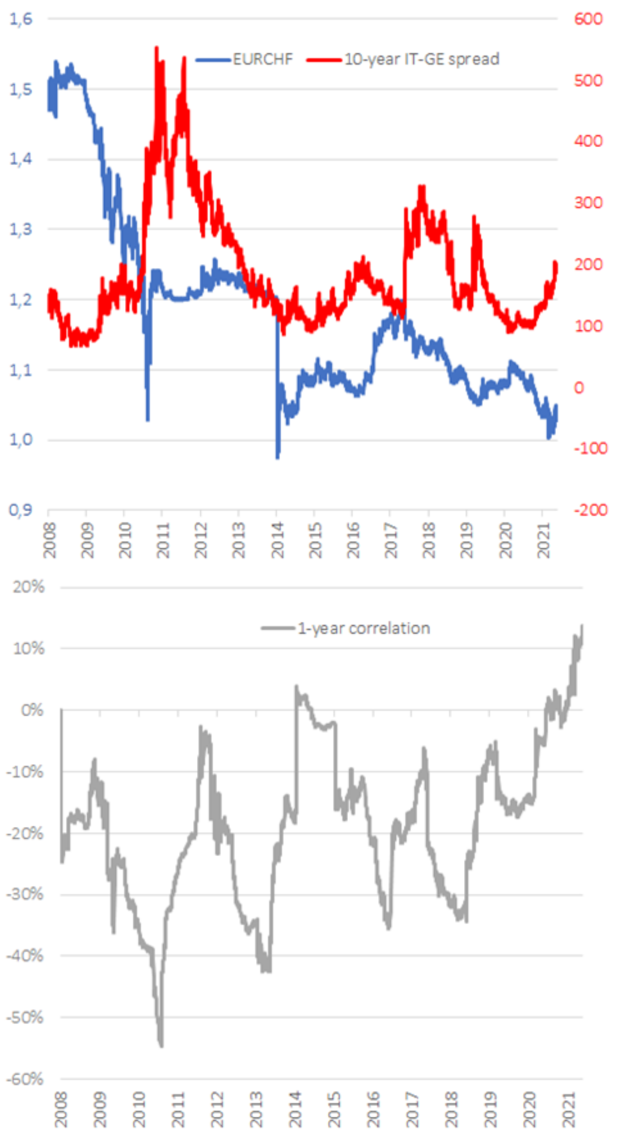
The current worsening risk appetite environment and monetary conditions tightening are toxic for peripheral sovereign bonds. The Italian-German 10-year yield spread will visit, like in the previous crises, the 250bps to test the ECB credibility

SNB surprised again …

The CHF has recently retraced most of its March-May weakness supported by the current risk-averse environment. It has also been helped by the SNB president Jordan. He said that "the SNB is ready to act if inflation risks materialize". This unnerved a market thinking that the SNB would prefer to delay rate hikes and allow an ECB tightening cycle to lift EUR/CHF. After all, the SNB has accumulated CHF500bn of FX reserves in fighting CHF strength.

Recently Jordan made the revelatory point that a weaker real CHF would be inappropriate given the Swiss inflation threat. The SNB wants at least a stable real exchange rate. As Swiss inflation is 4% lower than in the eurozone, the EUR/CHF could be 4% lower in nominal terms over the coming year to stay stable in real terms.

EUR/CHF and Italian spread correlation



Source: Heravest

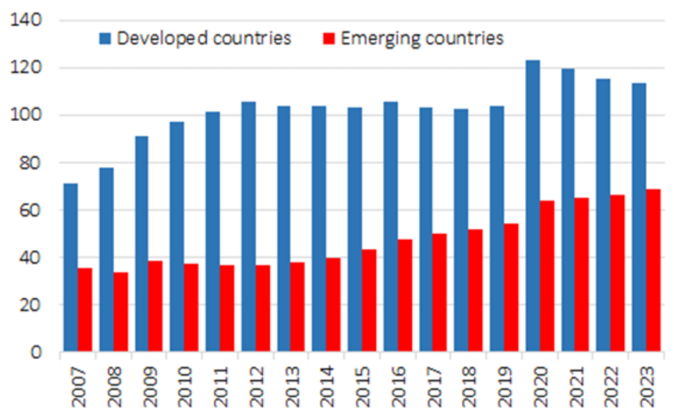
The correlation between peripheral spreads and the EUR/CHF has generally been unstable. However, when the 10-year Italy-Germany spread breaks above (and below) the 200bps level, the negative correlation between both reached its peak. The correlation has strengthened recently but remains weaker than it was in previous episodes. This is partly linked to the fact that the EUR is already embedding a lot of negative news.

- *ECB tightening and weakening macroeconomic conditions are a toxic cocktail*
- *We will experience wider peripheral spreads until the ECB adjust its stance*
- *The EUR/CHF downside risks is non-negligible, especially given the SNB higher tolerance for a strong CHF*

Fixed income. Emerging sovereign debt is concerning

Over the past 2 years, emerging countries have been affected the most. Multiple countries are on the brink of default and are negotiating support plans with multilateral lenders, such as the IMF, World Bank and Paris Club. Pakistan has signaled a high likelihood of default soon unless it receives official financial supports. Sri Lanka fell into default for the first time as the government struggles to halt an economic meltdown. Some governments, such as Lebanon, Zambia, and Suriname, defaulted in 2020. They are currently in uncured default without access to international markets. Last year, Belize missed multiple foreign currency payments. Larger EM countries experienced similar issues. Argentina defaulted on $108bn of its foreign and local currency debts in early 2020. Egypt is showing signs of a balance of payments crisis. Russian sanctions could trigger its first foreign currency default since the Bolshevik Revolution. Deteriorating creditworthiness and the possibility of a widespread debt crisis across the EM is a major risk.

Government debt (% GDP)



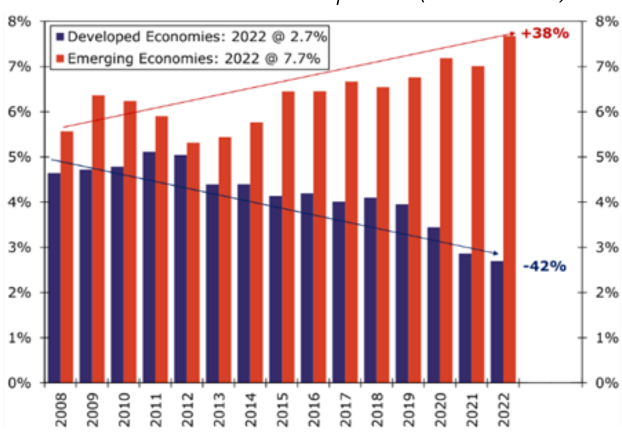
Source: IMF

Since 2008, most countries have experienced substantial debt increase. After the Global Financial Crisis, the European debt crisis, and the pandemic, developed countries debts have risen to 115% from 80% of GDP. In the EM space, it has jumped to 66% from less than 35%. The stock of EM sovereign debt and its rise may not seem worrisome; however, it should be more nuanced.

While the developed economies debt burden has risen more rapidly since 2008, recent dynamics are encouraging. According to the IMF, their debt peaked in 2020 and is on a downward trajectory. It should fall to 116% by year-end. In EM markets, the IMF expects the debt to rise further in the coming years. Despite higher commodity prices and the post-COVID recovery they failed to reduce their debt, and this is more concerning.

The most worrisome is the rising cost of debt servicing. In 2008, EM governments spent 5.6% of their total revenues on bond interest payments. This ratio has increased by 40% to 7.7%. At the same time, it has decreased by 40% to less than 3.0% in the developed world. This is primarily a result of central banks bond buying programs which have compressed yields. Most EM central banks either cannot legally engage in asset purchasing programs or do not have balance sheet capacity to purchase debts.

Governments interest expenses (% Revenues)

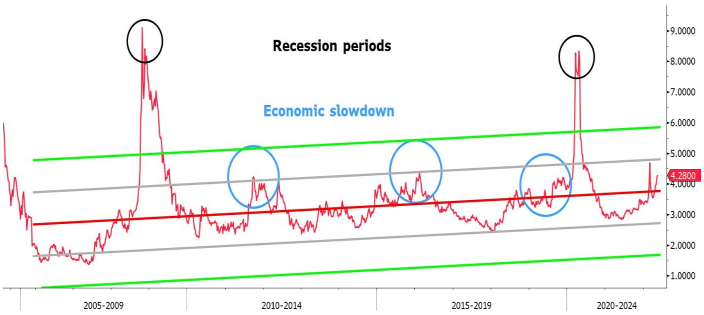


Source: Wells Fargo

Currency fluctuations are another risk. Although most of the EM economies borrowing is in local currencies, USD borrowing hit a record high of 30% last year.

Our EM debt concerns draw from tighter Fed monetary policy, economic challenges in China, rising geopolitical and political risks and food tensions/constraints. While EM sovereign spreads have already substantially widened, they are not fully discounting yet a moderate global economic slowdown, like in 2006, 2013 or 2018. The current spread level does not offer any protection against a deeper economic slowdown. In time of crisis, spreads are much wider.

EM sovereign debt spread



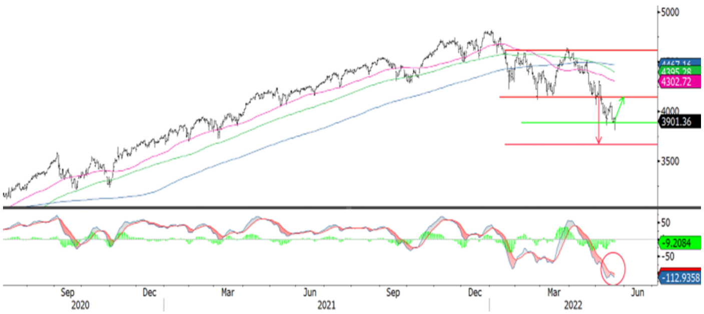
Source: Bloomberg

- *Rising debt, more expensive servicing costs, and higher yields will worsen EM sovereign creditworthiness*
- *With a mounting stress, spreads can only widen*

Equities. Bear market or not Bear market ?

The technical situation is tense. By breaking the support of 4,160 for the S&P 500, we opened the way to the next support of 3,660 (red arrow on the graph), which signified the entry into the bear market. Last Thursday, we had a last hope of a rally with the support of 3'900 (-19% compared to the high of early January) and avoid a bear market, at least momentarily. Last Friday, we witnessed a crazy session with an entry into the bear market, then a recovery in the second part of the session to come back to 3,900 (+0.01% for the session). So, we stay in corrective territory and avoid the bear market. A rebound of 6% remains possible (green arrow on the chart).

S&P500



Source: Bloomberg

We were awaiting the results of the American retailers. It was a tough week for them: -20% for Walmart, -28% for Target, -20% for Dollar General and -15% for Costco. Many analysts, including Heravest, recommended the segment for its defensiveness during an economic downturn. Revenues were good, but inflation, higher costs in transport and supply chain disruptions, that weigh on inventories, put pressure on profits. The sales mix was less favorable with disappointments on sales of high margin products such as televisions, household appliances or bicycles. Walmart acknowledges that it has underestimated the magnitude of a shift in consumer behavior from goods to services like travel. After a flurry of purchases of stay-at-home/work-at-home products, consumers have become more cautious in their purchases. Visa and Mastercard confirm that households are buying more basic necessities (food, gas), limiting purchases of discretionary goods (luxury, TV, PC, electronics, household appliances, cars, etc.). This week, Costco, Dollar General and Macy's will release their results. Walmart and Target have revised downward their guidance for the year.

These retailers' results follow a flow of warnings for the 2nd quarter, affected by the harsh confinements in China and the war in Ukraine. Car sales continue to fall due to cautious consumers, higher vehicle prices, longer delivery times and a lack of choice due to the slowdown in car production. Richemont has published good results, but the group warns of a more chaotic future with the war in Ukraine and its sanctions against Russia, Covid in China and inflation. Its CEO, Johann Rupert, said China's economic problems will last longer than most people think. Richemont was penalized by a 13% drop in the share price.

Share prices of mining stocks have rallied with the slight easing of lockdowns in China and the lowering of the main mortgage rate by Chinese banks to support the economy.

- *Global indices of developed countries resist to enter into the bear market*
- *But the micro fundamentals are deteriorating*
- *US discount stores : despite the fall in share prices and more attractive valuations, we will analyze the next results before issuing recommendations*

The war in Ukraine gives a strong, forced and welcome boost to the European energy transition with the REPowerEu

The reduction in European imports of Russian oil, gas and coal and the total shutdown (to be seen!) within 2 years are forcing Europe to invest massively and quickly in renewable energies. This is good, because there is a climate emergency. The International Energy Agency and the IPCC (UN) recommend stopping all fossil fuel projects now.

Last Wednesday, the European Commission unveiled its €300 billion REPowerEU plan, in response to the disruptions in the energy market due to the war in Ukraine and the need to quickly achieve the green transition. The plan highlights 3 ambitions:

1) Energy savings through efficiency and behavior with households and industry. Tax incentives for heating systems, building insulation and appliances.

2) The diversification of energy sources with new suppliers, energy security and the establishment of a common purchasing platform to benefit from the best prices, including hydrogen. Hydrogen corridors will be developed. Hydrogen is one of the priorities for Europeans.

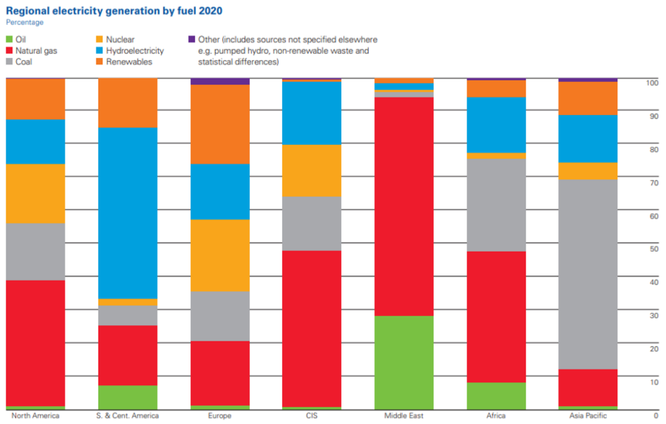
3) The acceleration of the implementation of green energies for independence. Raising the ambitions of the Fit for 55 program with the share of renewables in electricity production rising from 40% to 45% for 2030:

a. Doubling of solar capacities by 2025 (320 GW) and installations of 600 GW by 2030.
b. Obligation to install solar panels on all new buildings and houses.
c. Acceleration of the installation of heat pumps and geothermal energy.
d. Reduction of administrative obstacles for the installation of green energies and recognition of the public interest.
e. Objective of domestic production of 10 million tons of hydrogen and imports of 10 million tons by 2030.
f. Development of biomethane.

4) Reduction of fossil fuels in transport and industry, the two sectors accounting for 59% of CO2 emissions.

In 2020, European electricity production with renewable energies accounted for 41% of total production, broken down into 17% hydroelectric, 12% wind, 8% geothermal/

biomass and 4% solar. Today, wind and solar therefore account for 16% of electricity production in Europe, and this percentage should increase to 45% according to the REPowerEU objectives.



The goals are ambitious. Even the European Commission recognizes this. And the desire to reduce and then stop imports of Russian oil and gas will have a consequence: it will be necessary to use a little more coal in the years to come. Europe wants to find new gas suppliers, Algeria, Qatar, Egypt, Israel, and then in the long term to include them in a global system for the production and use of green hydrogen. The ambitions and objectives focus instead on the period 2027-2030.

- *The energy transition remains a strong long-term theme*
- *Europe is accelerating. The priority areas are hydrogen, solar and wind power*
- *We favor European electricity producers: Orsted (12-month target: DKK 1,000), SSE (£22), Solaria (€30), Encavis (€25), Neoen (€50) and RWE (€50)*
- *We also like lithium producers: Eramet (€200), Lithium America ($40) and Albemarle ($300)*
- *We underweight equipment manufacturers such as Vestas, Enphase, Solaredge, Sunrun, Sunnova, First Solar, Meyer Burger, which are penalized by the rise of metals prices and disruptions in semiconductors, as well as by supply chain disruptions. Their margins are under pressure. But we will certainly overweight them, when supply chains normalize*

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