MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 058 // **February 21, 2022**

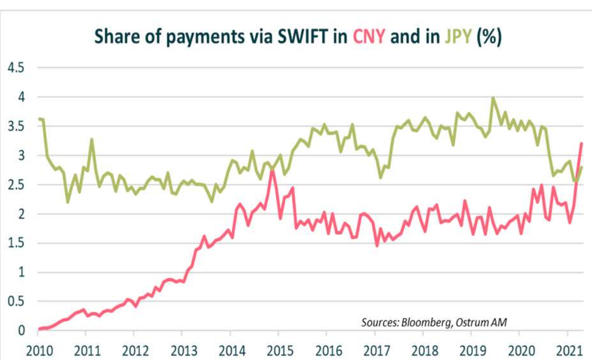
Topic of the week: The underlying factors behind the fall in European stock markets

- **The decline in European markets of around 3% in 2022 reflects an increase in risk aversion, given the announced monetary tightening and geopolitical uncertainties ;**
- **High volatility hides a multitude of underlying trends and significant stylistic and sector rotations ;**
- **The distribution policy, coupled with the "value" bias, are winning criteria. Uncertainty about margins weighs on the quality factor. The difficulties related to Brexit are also resurfacing on the British market.**

Market review: The Ukraine crisis hit markets further

- **Ukraine replaces monetary tightening as main source of volatility ;**
- **Pullback in Bund yields, yield curve re-steepens sharply ;**
- **Fund outflows continues across credit, high yield ;**
- **Some signs of stability in sovereign spreads.**

Chart of the week



The yuan's share in SWIFT transactions now exceeds that of the yen.

The strong increase at the beginning of the year is related to the Regional Comprehensive Economic Partnership , which came into effect on January 1, 2022. It is the largest free trade agreement in the world, bringing together 15 Asian countries, or 1/3 of the world's GDP and population.

China should take full advantage of this agreement by accelerating its trade with member countries.

Figure of the week

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Source : Ostrum AM

Ukraine and Russia taken together account for nearly 25% of world grain exports, making them the world's largest exporters. A conflict in Ukraine would generate a rise in food prices which are already at high levels.

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● **Topic of the week**

The underlying factors behind the fall in stock markets

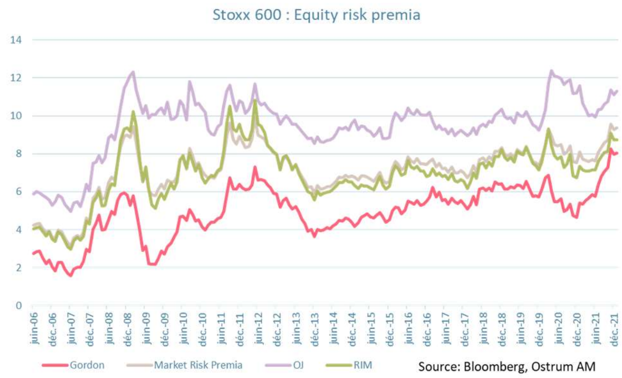
The equity markets have fallen since the start of the year after a very strong run in 2021. The 4Q 2021 earnings season is not the chief reason for the valuation adjustment. Monetary tightening recently announced by the ECB, pressure on profit margins, the return of Brexit uncertainties and the geopolitical situation are the sources of multiple investment trends impacting the broad European equity market.

Aversion to both macro and geopolitical risks

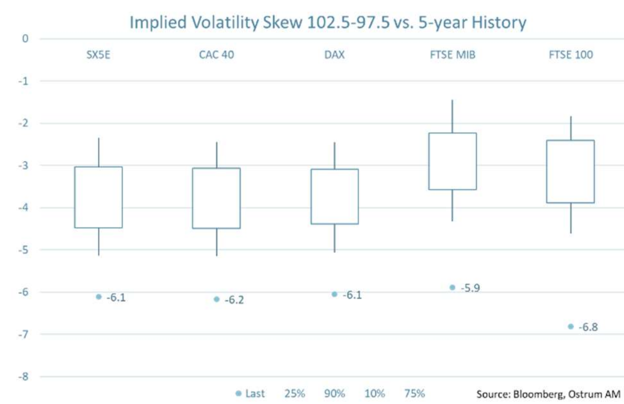
The year 2021 ended with a high performance for European stock markets. The Stoxx Europe 600 index returned 24.9%, including dividends, last year. Economic growth fueled by the deployment of fiscal stimulus plans and expansionary monetary policy have continuously supported valuation multiples.

Market dynamics changed at the start of 2022 is reshuffling the cards. The hawkish pivot of Central banks in most Western economies exposed some fragilities in the equity market. The international political situation, with the heightened risk of war in Ukraine, has revived volatility on the financial markets. In addition, the energy price shock, linked to the ongoing tensions with Russia, amplifies the existing pressures on production costs and the global supply chain. Indeed, the increase in raw material prices, hiring difficulties or higher shipping costs are major obstacles to profit growth. The ability to maintain pricing power varies across sectors driving significant allocation shifts between equity factors.

All of the above contribute to a significant increase in risk premiums. On the Stoxx Europe 600, based on various estimates, the risk premium was anywhere between 8.03% and 11.31% at the end of January. Compared to the 2021 average, the risk premium is up sharply by 72 bp to 159 bp depending on the methodology used.



The rise in risk premia is also reflected in equity derivatives markets by a greater asymmetry in implied volatility. The left skew of the distribution is characteristic of "normal" investor risk aversion. In 2022, the demand for hedging increased the volatility conditional on the fall in prices (which determines the price of this insurance). The asymmetry has increased well beyond the historical distribution over the last five years, which includes the pandemic shock. The extensive use of option hedging also avoided capital outflows from equity funds. Indeed, the high volatility in January did not lead to panic selling. On the contrary, flows to equity funds have indeed picked up.



Monetary tightening and shareholder return policy

On February 3, 2022, the ECB surprised investors by adopting a hawkish rhetoric following on from the Fed and other monetary authorities in developed countries. Inflation above 5% in January indeed justifies a gradual reduction in the current monetary stimulus. A rise in interest rates this year is no longer seems impossible. Money markets (represented by 3-month Euribor futures contracts) quickly priced in a scenario of two rate hikes, i.e. 50bp in total. Raising the deposit rate likely requires putting an end to asset purchase programs beforehand.

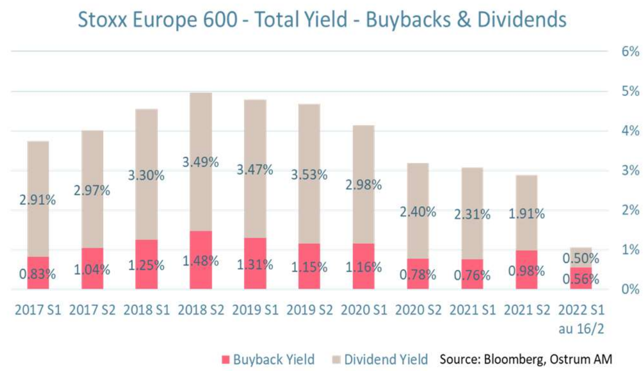
The excess liquidity associated with quantitative easing has played a big role in the expansion of multiples in the economic catch-up phase. Rising interest rates are, all other things being equal, a negative for equity valuations. The discount factor of future earnings or dividends increases, so that a decline in prices is necessary to keep the risk premium unchanged. It should be noted that the end of the CSPP will represent a direct increase in the cost of capital for European companies, which should raise equity risk premiums.

Growth stocks, which valuation depend heavily on long-term earnings expectations, are more exposed to an increase in interest rates, especially as the term structure has steepened recently. The underperformance of growth stocks vis-à-vis the value group (usually defined as stocks trading at a discount to net assets) stems from this increase in long-term rates in particular. Value stocks, almost by definition, represent low-duration assets (in the Macaulay sense). There is therefore a direct analogy with the bond world. This value trade also encompasses stocks distributing a high share part of their net income and whose activity depends directly on interest rates, such as banks and even insurance.

The shareholder payout policy is clearly a differentiating factor currently. The index of stocks paying higher-than-average dividends outperforms the European market by almost 8% so far in 2022. The potential for distribution remains significant so that dividend expectations are still pointing to the upside. Indeed, 8% growth in corporate earnings in Europe is expected in 2022.

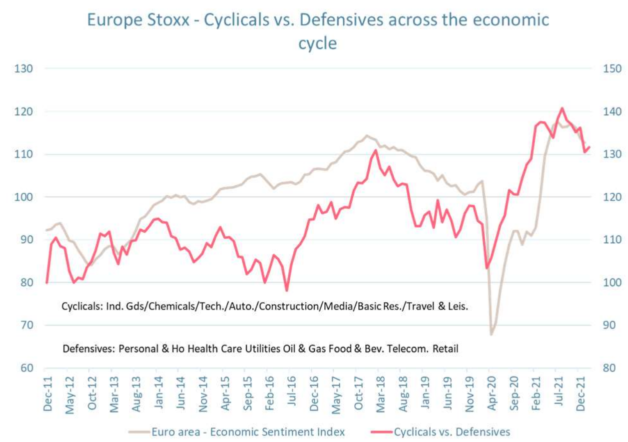
In addition, it appears that many European companies are willing to increase their share buyback programs, which will have an accretive effect on earnings per share over several years. The available cash does indeed provide room for maneuver in this area.

Dividend futures also indicate upside potential. Dividend contracts for the Euro Stoxx 50 point to a likely return to 2019 levels as early as this year. This would represent an increase in payouts of 11% compared to 2021 and 45% compared to the low point of 2020.



The cycle factor

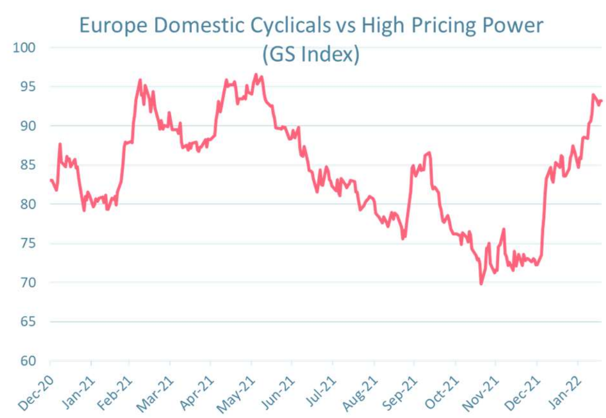
The economic recovery has been very strong in the euro area, but the leading indicators have started to weaken. Higher energy prices are undeniably a drag on growth. Moreover, the drop in unemployment to 7%, i.e. the lowest level since 1998, indicates that the output gap (gap to estimated potential output) has shrunk.



Most of the catching up is done. The growth slowdown is generally supportive of defensive stocks with lower earnings cyclicality. We can probably question the defensive or cyclical classification of the different sectors. Our classification also takes account the level of financial risk implied from its stock market behavior. Still, the defensive/cyclical split used here tracks the turning points of the economic cycle described by the European Commission's business survey. A continuation of the current downtrend would argue for an overexposure to defensives.

Margin pressures

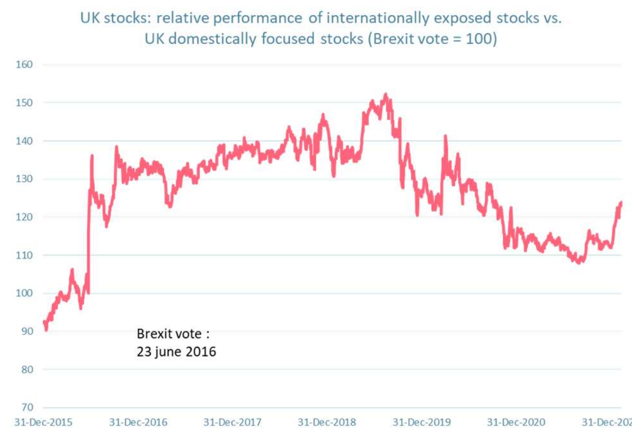
The study of total returns reveals that the quality factor loses in 2022. This factor is generally associated with good visibility on earnings and a reduced level of financial leverage. It is probably the earnings "visibility" aspect that is in doubt today. The inflationary environment makes profit margins more uncertain in most sectors. The consumer staples group is particularly under strain. This risk is all the greater for companies that have thrived on their ability to maintain high and/or stable margins over time and are hence richly valued. Visibility translates directly into valuation points (PER). Despite a positive quarterly earnings season, overall, the risk of margin erosion requires a discount. The Goldman Sachs index comparing domestic cyclicals to stocks with high pricing power shows a significant underperformance of the latter so far in 2022.



Source: Bloomberg, Ostrum AM

The return of the « Brexit trade » ?

Since the June 2016 referendum, stocks with the most exposure to global markets have outperformed the UK market. Fiscal support following the pandemic crisis had reversed the trend last year, to the benefit of locally oriented businesses. Since then, the threat of activating Article 16 or domestic political risks have returned to the forefront. Furthermore, the domestic inflationary pressures, partly linked to the consequences of Brexit, will weigh on the earnings of companies most reliant on domestic demand. Moreover, the only lever available to the BoE to reduce price pressures is precisely to constrain domestic demand. Multinationals have regained momentum in recent weeks.



Source: Bloomberg, Ostrum AM

Conclusion

The decline in equities since the start of the year appears traceable to a multitude of factors. The risk premium increased, the asymmetry in implied volatility is large. The announced monetary tightening favors "short duration" stocks with a generous payout policy. The economic slowdown entails support to defensives whilst high margins are pressured. Lastly, political and monetary risks result in differentiation in equity returns within the UK market.

Axel Botte

Market review

The Ukraine crisis hit markets further

The risk of escalation in Ukraine weighs on equity markets

The nervousness of the financial markets stemming from the expected monetary tightening gave way this week to a different source of volatility almost exclusively linked to the crisis situation in Ukraine. The verbal contests between Russia and the United States are undermining European diplomatic efforts. A meeting between US Secretary of State Anthony Blinken and Sergei Lavrov is scheduled for this week. Combat is nevertheless intensifying in eastern Ukraine, with both sides accusing each other of being responsible for this escalation.

On the financial markets, gold, dormant since June 2021, regained its safe haven status to briefly trade above the $1,900 threshold. Other raw material prices are up, in particular metals (palladium, iron) and agricultural commodities (wheat, fertilizers) exported by Russia or Ukraine. The Chinese authorities have once again intervened to counter speculation on iron ore. The barrel of oil (Brent at $96), however, is down about $4 in five sessions. The dollar's geopolitical risk premium is deflating slightly as the US yield curve steepens. European equities plunged 2% in five sessions, causing credit spreads to widen further. Investors' concerns resulted in an increase in implied volatility and large protection buying on credit derivatives. Spreads on European sovereign debt are still trading near their 2022 peak but there were no further upward acceleration this week.

As regards the economic situation, US data releases remain solid. Residential real estate activity is upbeat but housing starts remain below building permits due to recruitment and supply difficulties in this sector. Retail sales erased December's weakness by jumping 3.8% in January. The recovery in vehicle sales is accompanied by a broad-based increase in consumer goods spending. Inflation is not expected to decline in the short term. Producer prices, up 9.7% year on year, as well as import prices will continue to spread through the retail sector. The US CPI probably has not peaked yet. This same observation can be in the United Kingdom where inflation (CPI at 5.5%, RPI at 7.8%) and retail sales are clearly calling for a new monetary tightening.

Expectations of ECB rate hikes reflected in the Schatz yield (2-year bond) have diminished somewhat. However, François Villeroy de Galhau suggested that the APP would end in the third quarter, implicitly confirming the possibility of a rate increase before the end of the year. Asset allocators reduce their duration risk by targeting 1-3 year maturities which contribute to curve steepening. In this context, insurers, the largest buyers of long-dated bonds, have been able to reduce the average maturity of their purchases without giving up too much yield. Current Bund price gyrations mainly reflects news from Ukraine. The German 10-year yield traded in a wide weekly range of 0.20% to 0.33%. The Bund's asset swap spread (60bp) also shows excess demand for the risk-free asset. This is a reason behind explains the high demand for EIB and ESM bond issues this week. Sovereign spreads are barely benefiting from the pullback in Bund yields. Italian bonds trade about at 163 bp, just 4 bp below the 2022 highs. The 10-year OAT, despite the welcome fall in unemployment rate in the fourth quarter, seems to be heading towards the 50 bp spread mark against Bunds. In the United States, the Treasuries market increasingly focus on the international situation. The 2-year bond rally priced out one rate hike for march 2022, yet market participants are still projecting another 6 hikes this year. The modest curve steepening (coming after a very strong flattening movement last week) has a disproportionate impact on long-term mortgage rates. The 30-year mortgage rate is approaching 4%, which, given the rise in house prices over the past two years, will dampen residential investment demand. This upward trend on long-term mortgage rates may force the Fed to sell MBS outright in the next phase of quantitative tightening.

The credit market suffered historic net selling flows amounting to €7.6bn this week on euro IG funds. These outflows have depleted liquidity across credit markets, which tends to be asymmetrical to the downside. However, there is some investor interest on intermediate maturities. Euro IG spreads have deteriorated by 30bp in 2022 to reach 125bp against Bunds despite heavy CSPP purchases in January (€7bn). The possible termination of the APP at the end of September would lead to a drop in net purchases by the ECB of around €15 to €20 billion this year. The primary market is adjusting (just €11 billion issued this week), as windows to place bond deals are shrinking and new issue premiums are rising. The balance of flows is also unfavorable in European high yield markets (-€853mn). Net selling of high yield in dollars, on the other hand, moderated somewhat. The primary market in European high yield came to a halt. This is the consequence of market volatility and the higher level of spreads. Heavy protection buying on the iTraxx XO pushed spreads towards 340 bps.

On the equity market, the balance of flows remains surprisingly favorable given reported outflows on the credit asset class. The escalating risk in Ukraine spurred option hedging demand rather than equity fund outflows. The Nasdaq underperformed while the European indices recorded a drop limited to 1-2%.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	21-Feb-22	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.45 %	-9	+17	+17
EUR Bunds 10y	0.20%	-8	+27	+38
EUR Bunds 2s10s	65 bp	+1	+10	+21
USD Treasuries 2y	1.47 %	-11	+46	+73
USD Treasuries 10y	1.93 %	-6	+17	+42
USD Treasuries 2s10s	46 bp	+5	-29	-31
GBP Gilt 10y	1.4 %	-19	+23	+43
JPY JGB 10y	0.21 %	-1	+8	+14
€ Sovereign Spreads (10y)	**21-Feb-22**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	51 bp	+3	+12	+14
Italy	171 bp	+2	+36	+36
Spain	104 bp	+3	+34	+30
Inflation Break-evens (10y)	**21-Feb-22**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	244 bp	-7	+7	-16
GBP Gilt Index-Linked	420 bp	+6	+22	+26
EUR Credit Indices	**21-Feb-22**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	126 bp	+7	+27	+31
EUR Agencies OAS	62 bp	+2	+14	+13
EUR Securitized - Covered OAS	65 bp	+3	+21	+19
EUR Pan-European High Yield OAS	397 bp	+17	+80	+79
EUR/USD CDS Indices 5y	**21-Feb-22**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	72 bp	+4	+16	+24
iTraxx Crossover	350 bp	+18	+81	+107
CDX IG	69 bp	+2	+11	+19
CDX High Yield	370 bp	+3	+45	+77
Emerging Markets	**21-Feb-22**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	397 bp	+8	+8	+28
Currencies	**21-Feb-22**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.134	+0.27	-0.05	-0.28
GBP/USD	$1.361	+0.6	+0.41	+0.57
USD/JPY	¥114.83	+0.62	-1	+0.22
Commodity Futures	**21-Feb-22**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$95.5	-$1.0	$8.4	$18.1
Gold	$1 896.2	$25.0	$60.8	$67.0
Equity Market Indices	**21-Feb-22**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 349	-1.58	-1.12	-8.76
EuroStoxx 50	3 998	-1.63	-5.47	-6.98
CAC 40	6 776	-1.12	-4.14	-5.27
Nikkei 225	26 911	-0.62	-2.22	-6.53
Shanghai Composite	3 491	1.80	-0.91	-4.10
VIX - Implied Volatility Index	27.75	1.43	-3.81	61.15

Source: Bloomberg, Ostrum Asset Management

Additional notes

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