Level Four Capital Management

WEEKLY INSIGHT

Highlights

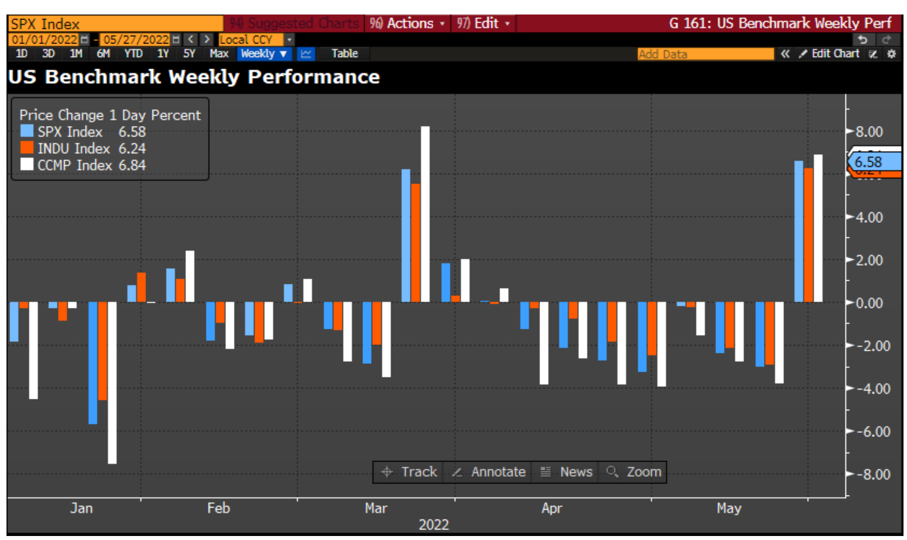
- Despite 2022 being the fourth worst start to a year for the S&P 500, stocks snapped their seven week losing streak with all major indexes gaining more than 6%.
- All 11 sectors closed higher, with defensive sectors such as Healthcare, Utilities, and Real Estate lagging. However, the worst performing sector, Healthcare, still managed to close up over 3% on the week.
- There was no one specific catalyst that pushed markets into the green for the week. Consensus for the move higher was a contrarian buy signal being driven by depressed sentiment and positioning, amongst other reasons.
- The release of Fed minutes reaffirmed the Central Bank's next steps, looking to raise rates by 50bp at each of the next two meetings, followed by additional smaller hikes to curb inflation. Currently the year end Fed Funds target rate stands at 2.745%.
- Retailers were amongst the best performers on the week (XRT +10.1%) after earnings and consumer spending data was released.
- European leaders agreed on a partial ban of Russian seaborne oil and petroleum imports after weeks of negotiations. The Euro STOXX index gained 3.59% last week.
- In China, several districts started to ease mobility restrictions as COVID-19 infections dropped. The Shanghai Composite index gained 2.73% last week.

Market Commentary

U.S.

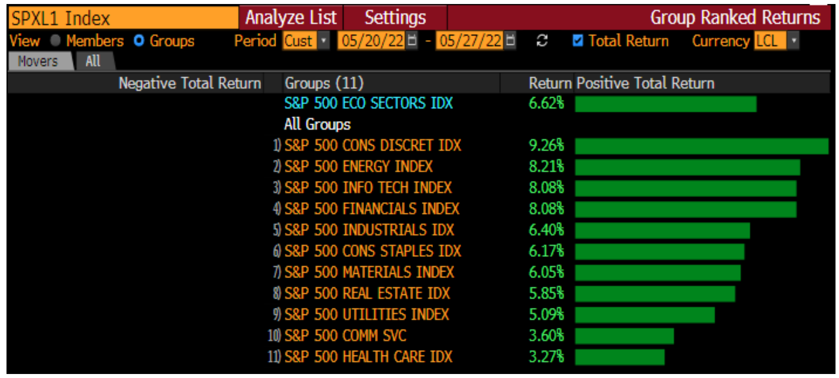
The S&P 500 and NASDAQ snapped a streak of seven straight weekly declines, while the Dow Jones broke an eight week streak. All major indexes rallied sharply, gaining more than 6% over the five days; with the S&P posting its largest weekly gain since November 2020, (NASDAQ posted its best gains since late March). Treasuries were firmer with the curve steepening, as the 2-year yield fell back below 2.5%, the 10-year around 2.75%, and the 30-year bond below 3%.

All 11 sectors closed higher, with all registering gains of at least 3.2%, despite the lack of a true market moving catalyst. Growth outperformed value slightly, and Cyclicals and Consumer Discretionary were among the largest outperformers led by retail (XRT +10.1%), autos, restaurants, and homebuilders (XHB +6.9%) following better-than-expected consumer spending numbers.



Source: Bloomberg as of 06.01.22

Defensive sectors such as Healthcare and Utilities were among the largest relative laggards, but there were no pockets of outright weakness, as they still gained over 3% respectively on the week.



Source: Bloomberg as of 06.01.22

Both the bearish and bullish narratives remained intact, with the consensus for the move higher being:

- Contrarian buy signal being driven by very depressed sentiment and positioning
- Potential that peak inflation is now behind the United States
- China Policy support and the easing of COVID-19 restrictions in Shanghai
- Falling Treasury yields
- Resilient consumers who continue to show that balance sheets of households remain strong
- Strong inflows into the U.S. of more ~$21.8B - the most in ten weeks
- More flexible Fed who is willing to go beyond the neutral rate to stem inflation

However, even as the risk-on tone came back into the market environment for the first time in nearly two months, many, including Morgan Stanley's Mike Wilson, have continued to reiterate caution during bear market rallies, given the headwinds that persist.

INFLATION & FEDS IMPACT ON THE ECONOMY

There was some focus this past week surrounding the Fed's rate hikes and the start of quantitative tightening (QT), which in many ways, have started to cool the overheating economy. Based on the Fed's preferred measure of inflation growth, core personal consumption expenditures (PCE), April's inflation showed signs of slowing compared to March. Core PCE fell to 6.3% versus the March headline number of 6.6%, and registered its third straight month of PCE growth at 0.3% m/m.

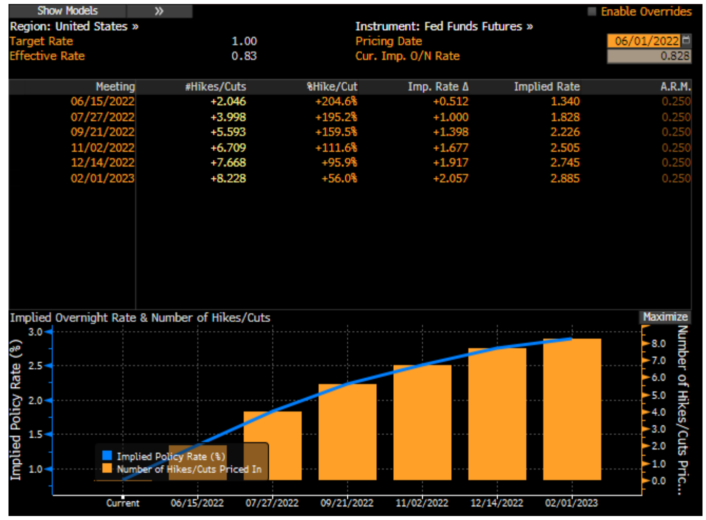
Also, in focus is the current housing slowdown. Data released showed new home sales fell 16.6% m/m in April and 26.9% y/y, well below the consensus. Although rates on the week fell 15bp (the largest weekly decline since April 2020 at the start of the pandemic), the average 30-year mortgage rate still stands at 5.35%, well above the 3.01% average a year earlier according to Bankrate. With housing making up over 30% of CPI, another inflation metric widely watched by market participants, and continued improvement in supply chains, inflation may be set to moderate for the remainder of the year rather than continue to spike as was feared.

Source: Bloomberg as of 06.01.22

FED POLICY

Fed minutes gave further clarity into the potential path of rate hikes and policy normalization, with the Central Bank reaffirming their outlook, which calls for 50bps hikes in the coming two meetings, followed by gradual hikes over the remaining portion of the year.

However, until recently, investors have been left guessing as to whether or not the Fed would potentially hike rates past the "neutral rate" which is seen to be 2.5%. Following the release, the minutes hinted at additional flexibility down the road, which provided the market with some optimism, knowing Central Bankers are not opposed to going further in raising rates if needed in order to kill inflation. In the bond market, most Fed officials and Fed fund futures all seem to be largely in agreement with the current year end Bloomberg fed funds rate estimate standing at 2.745%.



Source: Bloomberg as of 06.01.22

CONSUMER SPENDING

While weakness in some of the retail giants like Walmart and Target had sparked a sell-off in the consumer sector in previous weeks, the release of personal spending data and earnings announcements from retailers were well received, helping to spark a rally in some of the most beaten down names.

INTERNATIONAL

The Bloomberg World Index advanced 4.88% last week, with growth up 5.21% and value up 4.89%. Oil posted its fifth consecutive week of gains with Brent oil up 6.11%, the equivalent of $119.43 per barrel. Key retailers reported first quarter earnings and gave positive guidance as consumer spending remains strong. The Dollar index ticked down from $103 to $101, the lowest level in a month. News of easing restrictions and decelerating COVID cases coming out of China also helped stocks rebound from the lows.

EUROPE

European leaders agreed on a partial ban of Russian seaborne oil and petroleum imports after weeks of negotiations. The proposed sanction package would include a temporary exemption for pipeline crude. Czech Prime Minister, Petr Fiala, commented, "Yesterday proved that the EU is able to maintain unity in the face of Russian aggression. The talks were pragmatic and faster than expected, which is a strong message for Putin." Finland, Poland, Hungary, and Bulgaria still depend on Russia for more than half of their crude imports. The new proposed sanctions package also includes cutting three more Russian banks off the SWIFT system, including Sberbank, which is Russia's largest bank.

Source: Bloomberg as of 06.01.22

European Central Bank (ECB) President, Christine Lagarde, said in an interview at the World Economic Forum in Davos, "I don't think that we're in a situation of surging demand at the moment. It's definitively an inflation that is fueled by the supply side of the economy. In that situation, we have to move in the right direction, obviously, but we don't have to rush and we don't have to panic." Markets are pricing in four 25bp hikes by year end. The Euro-area headline inflation accelerated 8.1% in May, above the consensus of 7.8%. Core inflation advanced 3.8% during the same period. The Euro STOXX index gained 3.59% last week, led by retail, up 7.47%.

APAC

In China, several districts started to ease mobility restrictions as COVID-19 infections dropped. On Sunday, China registered 122 new cases, the fewest since March. Officials announced that bus and subway services would reopen from June. In Shanghai, the municipal government is offering tax rebates for companies and lifted production restrictions for manufacturers. According to online media Shanghai Metals Markets, Shanghai port logistics have improved to 60% of normal efficiency level. Furthermore, authorities announced the end of lockdowns for residents in low-risks area from June. The Shanghai Composite index gained 2.73% last week led by industrials, up 4.6%.

In Japan, the latest figures from Japan's ministry of internal affairs show that Tokyo inflation excluding fresh food grew 1.9% year-over-year, unchanged from a month earlier. Government subsidies helped partially offset the surge in gasoline prices. Bank of Japan Governor, Haruhiko Kuroda, reaffirmed on Monday that he will continue to execute its quantitative easing program through yield curve control and asset purchases to support the economy. He also commented on the recent weakness of the yen and said it was driven by "an abnormal situation where oil prices topped $130 per barrel". Factory output fell 1.3% month-over-month in April amid global supply chain bottlenecks. The NIKKEI 225 index gained 0.16% last week.

Source: Japan's Industry Ministry, Bloomberg as of 06.01.22

EMERGING MARKETS

In Brazil, the government has started the process of privatizing state-controlled utility company Electrobras. The government plans to reduce its stake in the company to less than 50% of voting stock and raise close to $7.4 billion. After his 2018 election, President Jair Bolsonaro pledged to divest several government-controlled assets, but the completion of his privatization program has been slower than expected. According to the latest polls, former President Lula's lead has widened over Bolsonaro in recent weeks. Survey provider Instituto FSB Pesquisa sees 46% of voter intentions in the first round for Lula and 32% for Bolsonaro. Brazilian stocks gained 3.18% last week.

In Mexico, the government struck a deal with major companies to limit prices on basic items for six months in exchange for tariff relief. Finance Ministry estimates that this price pact may slow inflation by as much as 1.5% by year-end. The mid-May inflation reading shows 7.58% year-over-year growth, compared to 7.72% a month earlier. Policy makers indicated that they would pay attention to the Fed tightening cycle, given the proximity between the United States and Mexico. Banxico key rate currently stands at 7%, following the recent 50bps rate hike. Mexican stocks gained 1.83% last week.

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