Tactical Watcher.com

Your eyes and ears on the markets

November 2nd 2021

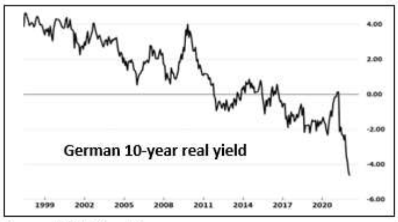
DIVERGENCE & WHISTLE

Cenbanks are walking an extremely fine line, based on the growing divergence between their "transitory" scenario (which is a very risky bet) and bond markets' hawkish expectations. Should policymakers be proven wrong, they would lose all credibility and this would whistle the end of the "everything party/bubble", with the dramatic consequences and freefall of the markets that would unfold. In that regard, seeing bond vigilantes (already) at work + noting that Lagarde was asked last week to stop short of disagreeing with market anticipations (in order not to trigger any negative reaction) is hardly reassuring.

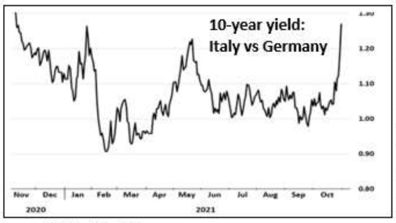
Powell may find the right words this week but this will not change the fact that, on a midterm view, the Fed is playing a dangerous game. Failure is no longer an option for cenbankers. They went too far, and it is already too late for a U-turn.

Meanwhile, technically, we will pay attention to an index like the US small-cap Russell 2000, as the latter is looking ready to break out on the upside. This would confirm that the melt-up scenario of the bull camp, based on continuous inflows, is finally taking shape in the US. At the right moment however, such a possible outlook has still to be balanced with the CSI 300 & A 50 Chinese indices, which look ready to accelerate on the downside. The divergence/dispersion between the different regions round the world is increasing, and the jury is still out as to who will be the winner eventually.

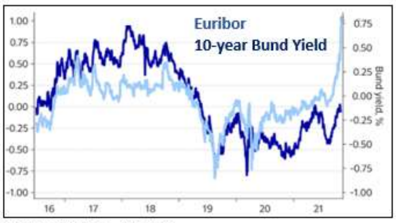
GERMAN BUND REAL YIELD & vs ITALY & vs EURIBOR + WORLD INTEREST RATES EXPECTATIONS + PHILLIPS CURVE + US EMPLOYMENT COST INDEX + US GROWTH vs VALUE STOCKS + US SMALLCAPS RETURN YTD + US BUYBACKS BLACKOUT



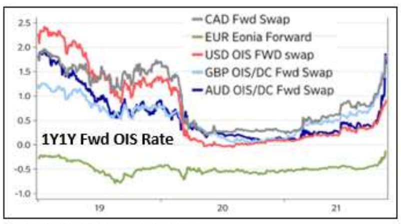
Source WSJ - **Chart 1**



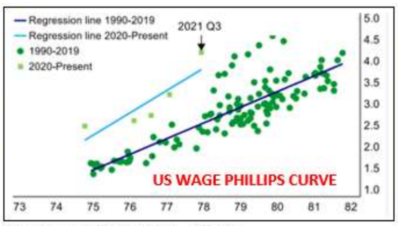
Source WSJ - **Chart 2**



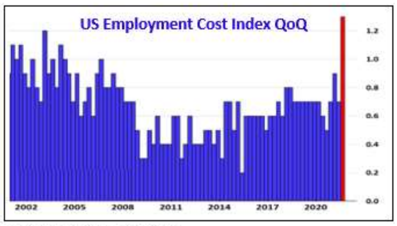
Source Nordea - **Chart 3**



Source Macrobond - **Chart 4**

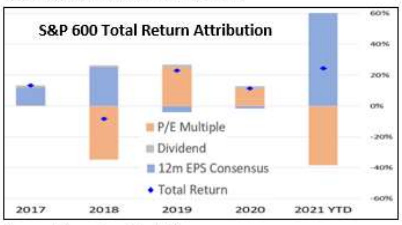


Source Mizuho Securities - **Chart 5**

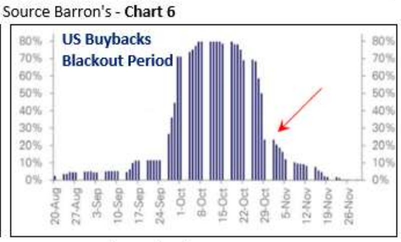


Source Barron's - **Chart 6**

Source Crescat - **Chart 7**



Source Barron's - **Chart 8**



Source Deutsche Bank - **Chart 9**

Lagarde can congratulate herself about the recovery, but what's going on is insane. A real yield of -5% on the 10-year Bund (!) is unsustainable (chart 1) and something will have to give. Either inflation will indeed get back below 2% in 2022 or the bund will enter into a dramatic bear market that the ECB will be unable to control, with renewed tensions on the spreads versus the peripheral countries, as is already the case in Italy (chart 2), and all the snowball effects that will come along with it. No wonder why the ECB is talking about a new program when the emergency purchases will come to an end next year. The European cenbank is cornered, they know it and they may even be unable to ever get out.

We already mentioned it, and it definitively seems that the Phillips curve has shifted (combined to a higher NAIRU – chart 5). This is providing further tailwind to the growing deterioration of interest rates' expectations around the world (chart 4), while it is increasing pressure on the US employment cost index (chart 6), with another caveat: as the current flattening of the yield curve (chart 3) is due to the wall of cash sitting on the sidelines, it will steepen again when investors will realize that inflation is stickier than expected. In that regard, we would somewhat compare the current situation on the markets to that of mid-1986.

Meanwhile, as to whether Wall Street may (still) be able to keep dancing, the focus should remain on value stocks, given the current context + the relative valuations (chart 7) + while Biden may go on with his watered down (second) infrastructure plan + as most of these stocks should be less concerned by a 1% tax on buybacks. US small caps are much cheaper today, following the significant decline in PEs they have fallen victim to since last year (chart 8). Would the Russell 2000 break out on the upside (which still requires confirmation), this index could/should enjoy a few months of outperformance, even though most of US stocks are getting out of their buyback blackout period (chart 9).

Ps: so, not only we are wrong technically, but we are back to a situation of low visibility. We will thus focus on three things for the moment (until we get better clues): 1) the presence of a 9-demark (2-day period) on the S&P 500 + the Nasdaq + the Dow Jones, 2) the attempt of the Russell 2000 to break out on the upside, 3) and the resumption of the bearish trend in China.

NASDAQ COMPOSITE INDEX – DAILY

In theory, whatever the midterm picture, the presence of a 9-demark warning (on the 2-day period) should call for the end of the rally since the low of October (?). Confirmation will however be necessary below the 1st key support.

DOW JONES FUT + S&P 500 FUT – DAILY

Same comment than on the Nasdaq.

RUSSELL 2000 FUT – DAILY

The very key thing meanwhile is whether the US smallcap index may be breaking out on the upside, as this would open the door to a large wave V since the bottom of March 2020.

S&P 400 INDEX – DAILY

While the situation is similar on broad indices such as the Russell 1000 Equal Weighted + Value Line Geometrics indices, the US midcap index is already resuming its uptrend, as shown above. This suggest that we may (at last) enter a few months of reflation outperformance among equity sectors.

CHINA A 50 FUT – DAILY

This is however happening just when the Chinese market is resuming its downtrend, based on our favoured scenario. Wall Street nevertheless seems to remain in its own planet for the moment.

10-YEAR BUND YIELD – DAILY

Although a few days/weeks of sideways consolidation may develop from current levels, we expect the bund yield to break out eventually on the upside in order to reach much higher levels.

EUROSTOXX FUT – DAILY

Like on the Nasdaq & the S&P 500, we are now forced to adopt a wait & see stance in Europe, noting however the presence of a 9-demark warning, while a reversal below the 1st key support is necessary to confirm that the rally since the beginning of October is over (?).