MARKET FLASH: MARKETS ARE CHALLENGING CENTRAL BANKS

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• The Fed and ECB are still making restrictive noises to beat inflation, with more hikes expected in the eurozone and a resumption in the US after this month's pause.

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Equity markets are now simply ignoring the Fed and the ECB. Indices have kept on rising and are now above levels seen in March 2022 when the Fed launched its fastest tightening cycle in 40 years. In fact, tech stocks are overwhelmingly responsible for the S&P's upward march this year. 10 stocks account for 90% of the rise.

And yet the Fed and ECB are still making restrictive noises to beat inflation, with more hikes expected in the eurozone and a resumption in the US after this month's pause. Higher short-term rates in the eurozone helped push the euro to 1.095 against the dollar.

The ECB could mark a pause in September if conditions are favourable, i.e. several months with underlying inflation falling. But the bank nevertheless raised its inflation expectations for 2023, 2024 and 2025, an admission that it is incapable of getting inflation back to its 2% target before 2026. For 2025, it sees inflation falling back to 2.3% but still short of the target.

In the US, the Fed opted to skip a hike, leaving benchmark rates at 5-5.25% to take account of the rapid rises since March 2022 and the need to appraise the impact of the lingering bank crisis. Committee members recognised the resilience of the economy and labour market and their dot plot suggests another hike in July.

Japan's central bank unsurprisingly stuck to its accommodating stance and bond buying. It is targeting zero per cent +/-50bp on 10-year government bond yields but is watching wage inflation closely. The news boosted the dollar to 141 against the yen.

China, meanwhile, reinforced its monetary stimulus amid signs that the recovery is stalling. Short term and one-year rates were cut by 10bp in an effort to drive investment and consumption. This followed data showing industrial production growth had slowed to 3.5% from 5.6% in April. And the 12.7% rebound in retail sales over 12 months was lower than expected. Private sector investment has also fallen back over a year due to the ailing property sector.

Elsewhere, gas prices broke with a downward trend by rebounding sharply to €41/MWh after news that a field in the Netherlands, Europe's largest, was to close earlier than expected.

We are maintaining our defensive stance on equity markets. We continue to like duration: government bond yields are attractive ahead of any slowdown in inflation and they also afford protection should a gradual contraction in lending lead to an economic slowdown. We still like the euro against the dollar due to the divergence between Fed and ECB policies.

EUROPEAN EQUITIES

Indices ended the week marginally higher with cyclicals leading gains. Due to rising risk appetite, oil prices also edged higher and gas prices jumped after 3 fields in Norway ran into operating problems. The ECB's decision to raise rates by 25bp surprised nobody but the bank's inflation expectations did. It raised its forecasts for underlying inflation in 2024 from 2.5% to 3% and sees inflation falling back to only 2.3% in 2025 (2.2% previously), or short of its 2% target. As a result, we can expect more rate hikes in the coming months. On labour markets, recent UK data suggest wage demands are still excessive.

Elsewhere, the week saw the death of Italy's former prime minister, Silvio Berlusconi. He was the driving force behind Forza Italia and his disappearance could result in the party losing influence in the three-party coalition, thereby making the government more stable.

In company news, **Shell** raised output guidance. Management had previously said production would fall by 1-2% a year, but now it is to remain stable until 2030. The group also said it would massively increase shareholder returns. In artificial intelligence news, **Accenture** said it would invest $3bn to double headcount in its IA division. **Ubisoft** said it was closely monitoring IA opportunities in video games, another example of IA pushing companies to reshape strategy.

In financials, **Deutsche Bank** warned that its trading revenues could fall by at least 15%, or more than expected. Elsewhere, the UK's fashion and cosmetic retailer **Asos** returned to the black in its third quarter despite sales falling. The new strategy is finally bearing fruit. In 3D printing, **Prodways** reduced 2023 guidance, citing wait-and-see attitudes among customers for new industrial projects. The company's 2028 objectives were, however, maintained. In telecoms, **Vodafone** and **CK Hutchison** agreed to merge their UK businesses.

US EQUITIES

The S&P 500 gained 3.07% and the Nasdaq 4.11% over the last five trading sessions following the Fed's decision to skip an interest rate rise. At the same time, the US economy turned lower: industrial production fell 0.2% in May after rising 0.5% in April, the Philly Fed index retreated and import prices were down 0.6% compared to a 0.4% rise in the previous month. All of which reassured investors that the Fed would be less hawkish.

Nevertheless, the Fed said its monetary tightening cycle was not yet over. Its dot plot now sees two more quarter point rises before the end of 2023. At the press conference, Jerome Powell said the committee was in favour of more hikes but that a hike in July was not a done deal. Fed fund futures are 60% expecting a 25bp rise next month.

Meanwhile, artificial intelligence continued to boost certain share prices. **Microsoft** (+3.2%) triggered the tech rally by hitting a market cap of $2.5 trillion, a new record, after the group made bullish comments on its AI outlook and Chat GPT's contribution. Software group **Adobe** gained 3% in extra-hours trading after beating quarterly expectations and raising guidance on AI's contribution. In contrast, health insurance giant **UnitedHealth** Group plunged 6.4% on Wednesday after cutting guidance. The group said its costs would rise significantly due to more and more old patients going for operations after putting them off during the pandemic. The news affected the entire sector, notably **Humana** (-11%), **CVS Health** (-7.8%), and **Cigna** (-3.1%).

The European Commission accused **Google** of distorting fair trading in online advertising. It warned that after completing its survey, it could order Google to sell some of its ad services.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX rallied 5.83% and 4.68% on strong US equity markets on investor expectations that US interest rates would remain unchanged, non-domestic inflows into stocks with relatively attractive valuations and yen weakness due to assumptions that the BoJ would stick to its easy monetary policy at its June meeting. The NIKKEI 225 and TOPIX revisited 2023 highs over the week.

Transportation Equipment jumped 10.47% as investors bought cyclicals on expectations of a global recovery while the yen weakened. Wholesale Trade added 9.24% as general trading companies remained in vogue. **Marubeni**, for example, soared 13.16%. Securities & Commodities Futures rose 6.99% thanks to strong equity markets. Only Marine Transportation fell, dipping 0.37% after **Ocean Network Express**, the joint venture container company owned by 3 major Japanese shipping companies, cut its dividend.

Cyclicals like **Kubota**, an agricultural machinery maker, and **Komatsu** a construction machinery maker, jumped 10.59% and 10.37% respectively. Pharma group **Eisai** plunged 7.55% on heavy profit taking after last week's surge on FDA approval of its Alzheimer drug, Lecanemab. In construction, **Sekisui House** shed 1.54% after first quarter operating profits missed expectations by a large margin on disappointing US house building. **East Japan Railway** slipped 1% as investors focused more on growth and cyclical stocks rather than defensive and domestic plays.

The dollar strengthened from the high 138s to the low 140s against the yen as investors presumed the BoJ would continue with its easy monetary policy and the Fed said it had not finished with rate hikes despite skipping one in June.

EMERGING MARKETS

The MSCI EM Index continued on its strong rally and was up 3.1% as of Thursday's close. China, (+4.3%) led gains on hopes for stimulus over the weekend. Brazil rallied 5.7%, followed by Taiwan (+4.6%).

In **China**, the PBoC cut both short-term interest rates and MLF by 10bp, sending a strong signal for broader easing and further growth support measures amid weak macro data: May aggregate financing data was lower than expected while industry production was up 3.5% YoY, down from +5.6% in the previous month. Youth unemployment hit a record high of 20.8%. On a brighter note, electricity consumption in China was up 10.5% MoM, while retail sales growth decelerated to +12.7% YoY from 18.4% in April. US Secretary of State Anthony Blinken is expected to travel to Beijing this weekend to repair deteriorating relations and keep communications open. Saudi Arabia's investment ministry signed $10bn-worth of investment agreements with Chinese companies across a wide range of sectors such as renewables, automotive research, real estate, minerals and supply chains. On the corporate side, **Huawei** revised up its smartphone shipment guidance for 2023 from 30 to 40 million. **Trip.com**'s outbound travel bookings surged 12 times ahead of the Dragon Boat holiday.

In **Taiwan**, monthly sales at **TSMC** were up 19% MoM, or ahead of consensus. **Korea**: the US Department of Commerce is reportedly to allow South Korean and Taiwan chip makers to keep and expand operations in China by extending the grace period.

India's May CPI came in at 4.25% vs. 4.75 % in April, the lowest reading since April 2021. Domestic air traffic momentum continued, jumping 36% YoY in May. Smartphones entered the league of the five most exported commodities by value in FY23, almost doubling their

2022 score. **Vodafone** submitted a rescue plan to the government and plans to raise Rs70bn from investors. **Ashok Leyland** partnered with **Aidrivers** for autonomous electric terminal trucks.

In **Brazil**, retail sales declined 1.6% MoM in April, or slightly better than the 2.2% drop expected. On its investor day, **Hapvida** said price readjustments had been implemented, which was better than expected. **Itau** also had its Itau Day: management disclosed that ROE in the retail segment could be better than expected in 2023, due to robust growth in the SME, insurance and some other retail credit lines.

In **Mexico**, **Reforma** said that at least 30% of Mexican companies had been benefiting from new contracts after the arrival of foreign companies.

CORPORATE DEBT

CREDIT

It was a choppy week on debt markets due to rates moving higher in the US and Europe. The Fed skipped a rate hike and the ECB's 25bp rise opened the way to a pause but yields still rose sharply over the week. Yields on Germany's 5-year Bund had gained 20bp to 2.62% by Friday morning. Yields on the 2-year Bund rose from 2.89% to 3.12%. However, credit premiums were more resilient with the Xover tightening slightly to 402bp. The trend on high yield bonds was even more pronounced with premiums tightening by around 15bp to 430bp. Investment Grade premiums tightened by 4bp to 158bp.

Unsurprisingly, higher yields affected returns. IG lost 0.5%, taking YTD gains to 1.74%. High yield, which is less sensitive to rates and impacted more by premium shifts, ended the week 0.12% higher (+4.8% YTD). Actuarial yields for investment grade were 4.4% and 7.4% for high yield, still good entry points for carry strategies. Market levels continue to reflect a soft recession scenario. Company earnings are still generally good which suggests the economy is somewhat resilient.

In financial debt, Euro CoCo premiums stabilised around 800bp to call. Since the **Credit Suisse** affair, new Euro CoCo issuance had been subdued. But this week **Bank of Cyprus** made an exchange offer on its AT1 (December call) with a perpetual bond call 2028 at 11.87% for the same amount (€220m). And **BBVA** sold a new perpetual bond, call 2028, raising €1bn at 8.375%, or a spread to call of 550bp. The deal lifted uncertainty on how it would refinance its ATI call September 2023. Elsewhere, **Abanca** issued a Tier 2 bond and **Athora** a senior bond. To wind up a week of good news on financials, S&P upgraded two Irish banks, moving **AIB** to BBB- and **Bank of Ireland** to BBB.

CONVERTIBLES

Convertible markets spent the week focusing on Fed and ECB monetary committee meetings and followed equity markets higher.

Airlines and cruise companies performed well with **Carnival** jumping 20%. Elsewhere, Germany's **Siemens** is to invest €2bn in high tech starting with a new €200m site in Singapore. The group has twice upgraded guidance on its software-based products. The stock gained more than 4% over the period. In new issuance, railway operator **Tokyu** raised JPY 60bn (€430m) in two tranches, a 2028 zero coupon maturity with a 17% premium and a 2030 maturity at 12%. This was the largest Japanese issue since October 2021 Since the beginning of 2023, Japan has raised more than $1bn in new convertible issues.

GLOSSARY

• Investment Grade: bonds rated as high quality by rating agencies.

• High Yield: corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.

• Senior debt benefits from specific guarantees. Its repayment takes priority over other debts, known as subordinated debt.

• Debt is considered to be subordinated when its redemption depends on the earlier payment of other creditors. To offset the higher risk, subordinated Senior debt has priority over other debt instruments.

• Tier 2 / Tier 3 : subordinated debt segment.

• Duration: the average life of a bond discounted for all interest and capital flows.

• The spread is the difference between the actuarial rate of return on a bond and the rate of return on a risk-free loan with the same maturity.

• The so-called "Value" stocks are considered to be undervalued.

• Markit publishes the Main iTraxx index (125 leading European stocks), the HiVol (30 highly volatile stocks), and the Xover (CrossOver, 40 liquid and speculative stocks), as well as indices for Asia and the Pacific.

• EBITDA: Earnings before Interest, Taxes, Depreciation, and Amortization.

• Quantitative easing describes unorthodox monetary policy from a central bank in exceptional economic conditions.

• Stress Test: a process which simulates extreme but possible economic and financial conditions so as to assess any impact on banks and measure their resilience to these events.

• The PMI, for "Purchasing Manager's Index", is an indicator of the economic state of a sector.

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