EDMOND DE ROTHSCHILD

MARKET FLASH: WAITING FOR JACKSON HOLE

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Sharply lower PMIs in the US and Europe helped halt the rise in oil and bond prices that had pushed equity markets lower in August. The indicators may still be in over 50 in the US but they moved further into contraction territory in Europe, particularly in Germany and the UK. Manufacturing PMI actually stabilised, the sign perhaps that post-Covid destocking is ending, but services are now falling sharply.

China, meanwhile, continued to ease very moderately. After benchmark rate cut, the PBoC only trimmed 10bp off its 1-year rates, taking them to 3.45%. And 5-year rates were left unchanged at 4.20%. These levels are still high given ongoing disinflation, and even deflation. The GDP deflator, consumer price and production indices are all negative. Hopes were high that China's economy would bounce on reopening but exports, investment and consumption are all disappointing. The slowdown in loan growth reflects the private sector's attempt to reduce debt. This is especially true for the property sector.

Germany is particularly exposed to disappointing Chinese growth. It affects its own growth levels and increases disinflation. Germany's producer prices have tanked 6% over 12 months and the IFO business climate index is still falling. We will be paying particular attention to the impact of China's slowdown on big European exporters and price momentum.

In company news, Nvidia rounded off an upbeat earnings season with excellent results; they show that the artificial intelligence boom is still going strong but the trend is not capable of giving a further lift to the rest of Wall Street.

As for our asset allocation, the next few months will focus more on growth prospects rather than the approaching terminal rate. As a result, we have gradually been reinforcing exposure to government bonds over the last few weeks. The aim will be to prepare our portfolios for a cyclical downturn with a sharp slowdown. This means positioning for some easing in European and US bond yields. Given the inexorable economic slowdown and the slim equity market premium vs. high quality bonds, we still prefer debt markets to risk assets. We believe being overweight duration is judicious and should offer protection as economies slow and disinflation continues. Recent CPIs and news out of China support this view.

Over the shorter term, we took advantage of recent equity market declines to reduce hedging on US and European equities. In fixed income, we have tended to increase exposure to the longer part of the yield curve.

EUROPEAN EQUITIES

Europe had a mixed week due to PMI data coming in much lower than expected. The composite index for August tumbled to 47 from 48.6 when analysts were expecting 48.5. Manufacturing and new orders were again down but the main disappointment was a drop in services, especially in Germany. The figures send a strong signal to the ECB that its monetary tightening is starting to have the desired effect. There will now be calls for the bank to ease soon.

For the time being, high interest rates are still hitting the UK's property sector where **Crest Nicholson** issued a profit warning, citing worsening trading conditions due to higher borrowing costs and reduced demand for housing. The group sees no improvement before the end of 2023. The real estate platform **Rightmove** also said property prices had fallen by 2% in the UK over a month, the biggest shift in 5 years.

With 88% of MSCI Europe company results in, **CRH** (cement) beat estimates and raised guidance. The group is also pressing on with its share buyback programme. In video games, one man's loss is another man's gain: the UK's watchdog has still not ruled on **Microsoft**'s acquisition of **Activision** but in an attempt to win over the Competition and Markets Authority, the US group is to transfer cloud gaming rights for current and new Activision Blizzard games to France's **Ubisoft** for the next 15 years.

US EQUITIES

The S&P continued to consolidate in the absence of economic catalysts and ahead of the Jackson Hole central bank symposium. Yields on benchmark 10-year US Treasuries hit a 15-year high of 4.32%, triggering doubts on the chance of a soft landing in the US.

Nvidia's blow-out results dominated the headlines. The microchip maker crushed already particularly ambitious estimates with $16.5bn in sales when analysts were going for $11bn. And operating profits were $7.78bn compared to $5.89bn expected. CEO Jensen Huang said the results were driven by enormous demand for AI solutions as data banks throughout the world shifted to generative AI and faster, high-performance chips. The group revised guidance on third-quarter sales to $16bn,or sharply higher than consensus expectations of $12.5bn.

The picture was entirely different in retail. **Foot Locker** and **Dicks Sporting Goods** sank 33% and 25% after posting mediocre figures. The results reflect pressure on low-income households and dragged down other stocks like **Nike** and **Under Armour**. Elsewhere, **Macy's** (department stores) delivered cautious guidance which suggest consumer discretionary will have a more difficult fourth quarter.

Banking stocks were hit by downgrades from S&P and other rating agencies. Regional banks were the worst affected.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX rebounded by 2.09% and 1.49% mainly due to global interest rates temporarily peaking and a surge in tech and AI stocks after Nvidia reported record quarterly revenues and delivered upbeat guidance. **Tokyo Electron**, for example, jumped 6.28%.

Pulp & Paper, Banks, and Securities & Commodities Futures rose 3.62%, 3.09% and 2.89%, respectively, as these sectors contain a number of large-cap value stocks especially those with a PB ratio below 1. On the other hand, Air Transportation and Land Transportation edged 0.77% and 0.15% lower on profit taking among tourism plays. **Oriental Land** (theme parks) lost 2.21%

Panasonic (electronic products) rebounded by 5.54% after falling due to a 1Q23 operating profit miss. **Mitsubishi Heavy Industries** gained 5.31% after a leading Japanese broking firm raised its target price. Elsewhere, cosmetics company **Shiseido** and **Kao Corp.** (consumer products) shed 2.44% and 1.83% on worries over China's deteriorating economy.

The dollar was range bound against the yen between the high-144s and the low-146s ahead of Fed Chair Jerome Powell's speech at the Jackson Hole symposium on Friday, 25 August.

EMERGING MARKETS

The MSCI EM Index rebounded by 1.9% this week as of Thursday's close. Brazil and Taiwan (both 3.4% higher) outperformed. Korea gained 3% while China (+1.2%) underperformed.

In **China**, the PBoC kept the 5-year LPR on hold at 4.2% and lowered the 1-year LPR by 10bp to 3.45%. This milder-than-expected move might hit the real estate market and constrain banking flexibility, possibly due to further policy measures in the works that could reduce the urgency to slash borrowing costs. The government is easing home purchase rules in a new push to boost the economy.

Amid evolving geopolitics, President Xi's visit to South Africa for the BRICS summit underscores ongoing diplomatic engagements. Additionally, US Commerce Secretary Raimondo's upcoming visit to China, the 4th US cabinet-level official to do so since June, signifies an ongoing dialogue focusing on US-China commercial relations and potential areas for cooperation.

In company news, **Anhui Conch**'s second quarter results slightly beat expectations, despite a 20% YoY fall in profits. **Baidu**'s solid second quarter results beat expectations with core advertising revenue up 15% YoY. The commercial launch of ERNIE, its AI chatbot, should immediately follow the government's policy finalisation. **Anta Sports** delivered a strong beat in first-half operating profit. **China Merchant Bank**'s results were ahead of expectations thanks to lower-than-expected impairment charges that helped offset a NIM miss.

In **India**, the RBI minutes released Thursday showed members converging on the idea that monetary policy should look through the first round impact of fleeting shocks to headline inflation. **JioFinance**, Reliance Industries' financial service spinoff, began trading on Monday. **Titan** increased its stake in its jewellery subsidiary CaratLane to more than 92%. **MakeMyTrip** witnessed weak volume trends during the second quarter, after a strong first quarter, due to weak seasonality. **PayTM** rallied this week on reports that **Ant** would be offering to sell its $243m stake (3.6%) on the market.

In **Thailand**, Srettha Thavisin from the Pheu Thai party became the country's 30th prime minister, thereby ending political deadlock. His expected pro-economy approach should include populist measures like a 10,000 digital wallet and minimum wage hikes.

In **Brazil**, the Chamber of Deputies approved the New Fiscal Framework. **Itau** sold its Argentine unit for $50m to **Banco Macro**. FEBRABAN (Federacao Brasileira de Bancos) and Brazilian banks are expected to present a proposal to the Ministry of Finance in the coming weeks to reduce credit card revolving debt rates.

In **South Africa**, **Standard Bank** announced a strong set of results with headline adjusted earnings up 35% YoY.

CORPORATE DEBT

CREDIT

In thin summer holiday trading, credit markets were more attuned to macro developments than issuer news. China is slowing and suffering from significant provincial debt levels, an exhausted property sector and youth unemployment. Credit markets are terrified the situation could spread across the globe. As a result, yields on Germany's 10-year Bund were trading at 2.70% last Monday morning, practically a year high, but had lost 20bp to 2.51% by Thursday's close. **Investment grade** credit premiums were stable around 152bp but high yield, which is more sensitive to growth prospects, widened by around 10bp to 455bp. The Xover stayed close to 415bp despite a little volatility over the week which took it to 460bp.

The central bank victory against inflation is taking shape. Economies have slowed a little but the impact is difficult to assess for the moment.

There was no new HY or ATI issuance over the week even though premiums wiped out the Credit Suisse blues and returned to levels seen at the beginning of the year with Euro CoCos at 835bp. The primary market reopening in September will be a good gauge of investor appetite.

As of Thursday evening, returns were all positive thanks to interest rate movements. Investment grade gained 0.42% over the week, taking YTD gains to 2.98%. **High yield** rose 0.26% or +5.45% since the beginning of 2023. These returns demonstrate the wisdom of carry strategies as net yields after 8 months are already equal to approximately two-thirds of the actuarial yield at end 2022. Actuarial yields for investment grade were 4.3% and 7.5% for high yield, or still good entry points for carry strategies.

CONVERTIBLES

Markets remained under pressure this week due to volatility in the corporate and government bond markets.

Convertible bond issuers have been taking advantage of valuations and buying back their debt. This week in Europe, **Global Fashion Group** announced that it had agreed to repurchase €74.6m in aggregate principal amount of its outstanding 2028 convertible bonds, or approximately 27% of the outstanding bonds. **Sika** followed suit by exercising an early redemption option for its 0.15% convertible bonds due 2028. In the US, **RingCentral** is to repurchase some of its outstanding 2025 and 2026 convertible bond notes. **Invitae** and **Chegg** also unveiled agreements to buy back part of their convertible debt.

The earnings season continued. **Splunk** surprised on the upside with strong second-quarter earnings and guidance that drove the underlying stock almost 14% higher during the day. In China, **Anta Sports**' first-half results beat expectations with stronger profit margins but management delivered a softer industry growth outlook.

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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