EDMOND DE ROTHSCHILD

MARKET FLASH: CENTRAL BANKS KEEP INVESTORS GUESSING

- **There has rarely been so much uncertainty over central bank intentions.**
- **Recession risks have risen sharply.**
- **Significant doubts about central bank responses and the uncertain outcome of the U.S. election have led us to tactically reduce risk in equity markets.**

There has rarely been so much uncertainty over central bank intentions. True, they are caught between signs of economic weakness and inflation which is stubbornly resisting a return to the 2% target. Market volatility fed on US statistics, especially job creations which came in at 142,000, or below the 164,000 expected, but up from 89,000 in July. What's more, the data were revised lower by a total of 86,000 for the two preceding months. The labour market slowdown could have prompted the Fed to speed up rate cuts. Most investors were hoping for a 50bp cut when the Fed meets in September but then core CPI came in to deflate expectations and recent comments from Fed officials suggest they are not keen to start cutting by so much.

And yet, this stubborn inflation is mainly due to shelter which should return to normal after a lag and which has a lower weighting in the PCE, the Fed's preferred inflation gauge. So Fed doves should be reassured and that includes Jerome Power who delivered a very accommodating message at Jackson Hole. And it is surely not pure chance that well-informed press reports have now suggested the 50bp cut is back on the agenda. Still, a mood of uncertainty prevails among investors who are now on average expecting a 35bp cut next week, down from 49bp at the beginning of August. Meanwhile, government bond yields are still trending lower, especially on 2-year Treasuries which have fallen by 16bp since last Friday.

Europe is seeing the same momentum even if the ECB's tone is less dovish than expected. The bank cut its benchmark rate by another 25bp but Christine Lagarde refused to say anything about the pace of further moves lower. Investors could easily have been worried by her statement that the ECB would not have enough data to warrant another move by the time of the next meeting in October but press reports again came to the rescue by qualifying her comments, leaving the door open to this possibility.

Equity markets had a volatile week but still managed to rack up reasonable gains. The driving forces were falls in government bond yields and upbeat comments from Nivida's

CEO on strong demand for AI chips. Nvidia was mainly behind this week's outperformance by the Nasdaq and by Wall Street vs. European markets.

Oil prices swung sharply over the week with Brent crude briefly dipping below $70 for the first time since 2023 on global growth fears. But then a large proportion of US oil production shut down because of Hurricane Francine and Brent rebounded to above $72.

We have tactically reduced equity market risk: recession risks have risen sharply, central bank reactions are in doubt and the outcome of November's presidential elections in the US are uncertain.

EUROPEAN EQUITIES

Tech stocks helped the Stoxx Europe 600 index gain 1.5%. The ECB cut its benchmark rate by 25bp to 3.5% but the move was largely discounted. The Draghi report on Europe came out this week and caused a bit of a stir. It said under-investment was a major problem and recommended a bumper stimulus programme. ECB chair Christine Lagarde praised the report but gave no indication it would have an impact on ECB policy. She thought it was a serious wake-up call for governments but said it was difficult to see how its recommendations could easily be rolled out.

In France, the **Bolloré** group plans to simplify its structure by officially buying in shares in **Compagnie du Cambodge**, **Financière Moncey** and **Société Industrielle de Financière de l'Artois** before a compulsory delisting procedure. The offer will be in cash or in **Universal Music Group** shares. The news sent Financière Moncey soaring 45% while **Compagnie de l'Odet**, which has a controlling stake in Bolloré, gained 8%. **Bolloré** rose by close to 7% to €6.10. French global payments leader Worldline tumbled 17% on Friday following the departure of its managing director, after 11 years in the post, and a downward revision in the outlook for this year.

The autos sector also plunged after **BMW** recalled 1.5 million cars due to braking defects and management's confirmation of persistent problems in China. In addition, **Volkswagen** is struggling. In what would represent an historic turning point, the group is seriously considering closing a car factory and a components site, both in Germany.

Elsewhere, Italy's **UniCredit** took a 9% stake in **Commerzbank**. Any merger could take various forms but would be in tune with the Draghi report which said European banking consolidation was essential. A UniCredit-Commerzbank merger would create a banking giant with a €74bn market cap. In the specialist distribution segment, **Inditex** posted record figures. Sales were up 10% compared to the same half of 2023. The results show that the Spanish giant's economic model is working well amid tough competition.

US EQUITIES

Wall Street bounced sharply over the period, recovering all the ground lost in the previous week. The Nasdaq 100 reclaimed its crown by jumping 4.46% and the S&P 500 ended 3.46% higher. Tech stock concentration returned in force, leaving small caps only 1.82% higher.

Stock rotation benefited AI plays after **Nvidia**'s CEO Jensen Huang, speaking at the **Goldman Sachs** Tech conference, said GPU demand was still as strong. Larry Ellison at **Oracle** said the same, adding that he thought the trend was only just beginning.

In healthcare, **Moderna** tanked after cutting revenue guidance for 2025. Management also reduced R&D spending as part of a cost-cutting drive. In software, **Adobe** fell ahead of the market opening after a cut to fourth-quarter EPS guidance overshadowed an upbeat third quarter. The group said its digital media segment's strong performance would not continue in the next quarter. The news was more encouraging for **Unity** where the new CEO Matthew Bromberg said there would be more favourable conditions for small studios, an announcement that showed the new management was in touch with its community. Elsewhere, grocer **Kroger** reported strong second-quarter figures in spite of shoppers continuing to trade down and pressure on their purchasing power. The group's General Merchandise division performed well and the outlook for margins is good. In financials, **Ally** pinpointed higher credit deterioration among borrowers, especially among car buyers. And **JP Morgan** now expects net interest income in 2025 to come in below demanding analyst estimates. **Goldman Sachs** now expects trading revenues this quarter to fall 10%. **Bank of America** said it was happy with current provisioning levels.

EMERGING MARKETS

The MSCI EM index had gained 0.17% this week as of Thursday, its first positive score after two down weeks. Mexico, India and Taiwan led gains, up 3.43%, 2.13% and 0.86%, respectively. Brazil and China shed 0.99% and 0.82%. Korea closed flat.

In **China**, CPI fell more than expected to 0.6% YoY in August vs. expectations of 0.7%. PPI declined 1.8% YoY, also weaker than the market forecast of a1.4% drop. Exports grew 8.7% YoY in August, the fastest pace since March 2023 and imports increased by 0.5% YoY amid weak domestic demand. The government is mulling a draft decision on gradually raising the statutory retirement age. The EU is poised to make small downward adjustments to the additional tariff rates proposed for electric vehicles imported from China. August new electric vehicle sales jumped 43% YoY to cross the 1 million mark for the first time. **Alibaba** was added to the Hong Kong Stock Connect.

In **Taiwan**, exports hit a new high in August, up 16.8% YoY vs. the expectations for 8.5%. The trade surplus hit a record high of $11.5bn. **TSMC**'s August sales were up 33% YoY, and it achieved production yields at its **Arizona** facility on par with established plants back home.

In **Korea**, **Hyundai Motor** and **GM** signed a MOU to explore more collaboration on vehicles, supply chain and clean energy technologies. **LG Chem** is in talks with multiple investors to sell its aesthetics business as part of its efforts to exit non-core assets.

In **India**, August headline CPI inflation increased marginally to 3.7% YoY from 3.6% in July, driven by an increase in food inflation. Industrial production increased 4.8% YoY in August, or slightly ahead of the 4.6% estimated. The cabinet approved infra capex of Rs700bn for rural roads and hydroelectricity plants. **Dixon** said it had on-boarded **HP India** to manufacture notebooks, desktops, and all-in-one PCs under IT hardware PLI 2.0. **NXP Semiconductors** is to invest more than $1bn in India as it boosts R&D efforts. France's **Carrefour** will reportedly re-enter the Indian market after a decade as a "retailer" through a franchise agreement with Dubai-based **Apparel Group**.

In **Brazil**, inflation for August rose 4.24% YoY vs. a previous reading of 4.50%. Retail sales for July grew 4.4% YoY, or in line with expectations. **Gerdau** and **Petrobras** have partnered to pursue decarburization projects. Eletrobras will request a new extension of the Chamber of Conciliation.

In **Mexico**, inflation for August rose 4.99% YoY vs. the 5.06% expected. Industrial production for July grew 2.1% YoY, ahead of expectations of 0.8%. The senate voted to overhaul the country's judiciary, Mexico will allow voters to elect judges at all levels, including for the country's Supreme Court.

CORPORATE DEBT

CREDIT

Risk assets trended higher in the second part of the week amid a bounce in US tech stocks on hopes for interest rate cuts. The high yield segment showcased underperformance in the autos sector with bonds issued by **Antolin**, **Mahle** and **Standard Profil** tumbling by between 2 to 3.4 points. The sell-off was triggered by a profits warning from **BMW** in the middle of the week.

Meanwhile, subordinated financial issuance continued apace. There were four new CoCo deals this week, including from UniCredit, absent from this market segment since June 2021. The latest deals started to suggest investor appetite was waning: order books were less oversubscribed than in the previous week and coupons were less generous. High yield issuance also saw deals from **IGT** and **Perrigo** in the US and Belgian chemicals group **Azelis**. All three were successfully placed.

The big corporate deal news came from **UniCredit** which bought a 9% stake in **Commerzbank**, Germany's second largest bank. UniCredit is also said to have asked for permission to go above 10% in the future. Is the cross-border bank consolidation theme back in vogue?

Over the week, investment grade and high yield returns were flat. Investment grade is now up 3.1% YTD and high yield 5.7% better.

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.

• 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.

• AT1s belong to a family of bank capital securities known as contingent convertibles or “Cocos”. Convertible because they can be converted from bonds to shares (or depreciated entirely) and contingent because this conversion only occurs if certain conditions are met, such as the issuing bank's capital strength falling below a predetermined trigger level.

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