EDMOND DE ROTHSCHILD

MARKET FLASH: VOLATILITY IS BACK

• In the US, numerous advanced indicators are down and still pointing towards a recession

• In Japan, the central bank once again wrong-footed investors by being leaving rates unchanged even if inflation rose

• We are tactically more defensive on the equity market and however, more upbeat on corporate debt

US consumer confidence has recovered but numerous advanced indicators in the US are down and still pointing towards a recession. The Empire Manufacturing index, which saw a strong drop in new orders, is one example and the New York Fed's services indicator was also lower. The Philly Fed index edged higher but the data still suggested the environment was tricky. However, several of these indices showed a slight recovery in 6-month expectations. The Fed's Beige Book confirmed that the economy was slowing and the same message could be seen in retail sales, down 1.1% in December with November's figures revised lower, and industrial production which came in 0.7% lower.

In contrast, eurozone data was better than expected. November's industrial production was up 1% and January's ZEW advanced indicator beat expectations, coming in at +16.7 when it was minus 23.6 in December.

In China, expectations for fourth-quarter GDP were very low due to widespread disruption after the zero-Covid policy was abandoned. But the figures were better than expected and GDP stabilised, helped by a rebound in December consumption.

In Japan, the central bank once again wrong-footed investors by being leaving rates unchanged even if inflation rose to 4% YoY in December.

After a strong New Year bounce, indices lost ground on disappointing US economic data, the US debt ceiling gridlock, mixed fourth-quarter results from the first companies to report and persistent comments from central banks that further rate hikes would be necessary.

As a result, we are keeping a close eye on equity market technicals. Volatility on fixed income and equity markets has diverged, leading us to be tactically more defensive. We are, however, more upbeat on corporate debt. We believe ECB rate hikes are now factored into government debt so we are reinforcing duration in the eurozone.

EUROPEAN EQUITIES

Markets ended the week on a cautious note on (i) expectations the ECB would be more hawkish, (ii) worries over persistently volatile energy prices and (iii) worse-than-expected fourth quarter results from the first companies to report. At the Davos economic forum, ECB chair Christine Lagarde stressed that inflation was too high, suggesting that, as in the US, further interest rate rises were coming. Defensive sectors were in favour over the week and tech was sidelined. Gas prices slumped 15% at the beginning of the week to around €55/MWh, their lowest level since September. High inventories in China sent LNG tankers towards Europe while wind farm production was strong.

In company news, **ADP** said December air traffic was running at 94% of pre-pandemic 2019 levels. Some companies like **ASM International** (semiconductors) are enthusiastic about China's reopening. Luxury players like **Burberry** and **Richemont** are also upbeat despite disappointing sales. But **Unilever**'s CEO sounded a more cautious note on consumer staples as he feels costs will continue to exert pressure in the coming months. And **Procter and Gamble** reported poor sales for the fourth quarter. In preannouncements, **Fnac Darty** (retail) said its free cash flow had deteriorated significantly in 2022. Software company **Temenos** took advantage of upbeat figures to announce that its CEO was standing down. In chemicals, **BASF**'s preliminary 2022 results indicated a loss due to Russia and Covestro issued a profits warning.

US EQUITIES

Wall Street ended the week in negative territory with the S&P500 and Nasdaq down 1.78% and 0.73%. Sentiment was affected by poor economic data and hawkish comments from the Fed.

Retail sales fell 1.1% MoM in December, their biggest fall in year. Industrial production was down 1.7% when it was expected to be only 0.1% lower. Production prices continued to move back towards normal levels, rising 6.2% YoY or better than the 6.8% pencilled in by analysts.

Sales of new homes were down for the fourth month in a row but jobless claims fell to lows not seen since September. Despite headlines on layoffs, the labour market seems particularly buoyant.

The Fed's vice chair Lael Brainard, who has usually been a dove, said on Thursday that rates would have to stay higher for some time to rein in inflation.

John Williams at the New York Fed said that, with such persistently high inflation and supply and demand imbalances, there was clearly more work to be done to get inflation back to the 2% target and keep it there.

According to Refinitiv, S&P500 fourth-quarter earnings are expected to be down by 2.2% on average.

Banks were as usual the first to report and the picture was mixed. Results at **JP Morgan**, **Bank of America**, **Wells Fargo** and **Citigroup** were upbeat thanks to higher interest rates and only a limited increase in provisions. **Morgan Stanley** also benefited from resilient asset management results. However, **Goldman Sachs** was hit by poor investment banking results. The bank also made more than 3,000 people redundant.

Microsoft is also expected to lay off 10,000 people, or about 5% of its workforce. The group also announced that its artificial intelligence chatbot (developed by Open AI) would soon be added to its Azure cloud platform.

KKR followed Blackstone's lead in curbing redemptions in its property fund.

Netflix won many more new subscriptions than expected and said co-founder Reed Hastings was standing down as co-CEO to become chairman of the board.

JAPANESE EQUITIES

The NIKKEI 225 ended the period 0.17% lower and the TOPIX edged 0.39% higher after a volatile week. Following weakness driven by speculation the BOJ might make more changes to its monetary stance, markets rebounded sharply when Chairman Kuroda left policy unchanged.

Air Transportation rebounded 2.20% thanks to rising tourist numbers offsetting China's decision to stop issuing visas. Oil & Coal Products and Iron & Steel gained 2.01% and 1.90%, respectively, as commodity prices bounced. Banks and Insurance lost 2.51% and 2.06% on profit taking as global interest rates seemed to have peaked. Non Ferrous Metals fell 1.33% also on profit taking following a surge in copper prices after China decided to reopen.

Z Holdings, an internet platform provider, rallied 6.49% as investors began to view tech stocks as oversold. **Oriental Land**, an operator of theme parks and hotels, gained 4.10% on expectations visitor numbers would rise after Tokyo looked like downgrading Covid to endemic status on a par with influenza. **Ajinomoto**, a food company, rose 3.96% on a shift into defensive stocks. In apparel, **Fast Retailing** sank 6.39 % on worse-than-expected September-November operating profits after poor sales in China. In banks, **Resona Holdings** lost 4.86% on profit taking.

The yen strengthened to the mid-127s before falling back to the mid-131s after the BoJ's decision. It ended the period at the mid-128s on weak US economic indicators.

According to data released by Japan's National Tourism Organisation on Wednesday, the number of foreign visitors to Japan in 2022 was multiplied by 15 compared to 2021 to 3.83 million after border controls were eased. However, this was still 88% lower than the record high of 31.88 million in pre-pandemic 2019 but 1.37 million people visited Japan in December alone, compared to a mere 12,084 a year earlier.

EMERGING MARKETS

The MSCI EM Index ended the week flat as of Thursday's close. China had strong trading sessions with large foreign inflows before the Chinese New Year. India gained 0.6% while Brazil (-0.8%) underperformed.

China's fourth-quarter GDP came in at 2.9%, or better than the 1.6% expected but down on the previous quarter's 3.9%. December retail sales fell 1.8% YoY, or much less than the expected 8.6% plunge and November's 5.9% drop. Industrial production rose by 3.6% in 2022, or higher than the 0.1% estimated. During his speech in DAVOS, China's Vice Premier He LIU confirmed that China was refocusing on growth and opening up to global cooperation after three years of Covid isolation. **Didi** resumed new customer sign-ups in China after an 18-month ban. **Tencent** and **NetEase** scored more wins as China awarded another 88 online game licenses, adding to the 128 licenses given in December. According to the local housing agency, Beijing's secondary home sales were up 40% YoY in January. Official data confirmed that the population had declined for the first time since 1960. **Fosun Group** received RMB 12bn in syndicated loans from 8 banks to jointly promote development of the private economy. Fourth quarter results at **TAL** and **EDU** were in line as momentum continued.

In **Taiwan**, **Makalot** reported solid fourth-quarter results thanks to strong sales to Japanese customers.

Korea announced plans to ease mandatory indoor masks from January 30.

In **India**, **HDFC Bank** reported strong third-quarter results for FY23 with NII up by a better-than-expected 9% QoQ. **Havells** saw strong third quarter topline growth but profits declined more than expected due to increased spending on advertising while high inflation hurt consumer demand. **Siemens** won an Rs 260bn ($3.2bn) order to supply electric locomotives to Indian Railways. **Asian Paints**' earnings came in below expectations due to softer volume growth. **Hindustan Unilever** reported a sales beat; management said rural demand had bottomed and that inflation had peaked.

In **Brazil**, November's unemployment rate continued to improve to 8.1%, its lowest level since April 2015. The economy grew only 0.1% in November compared to October and 2% YoY (FGV). **Cyrela** (real estate) reported strong operating results.

In **Mexico**, **Banorte** posted solid fourth quarter results on higher-than-expected loan growth and a lower cost of risk. Earnings were up 30% YoY and ROE was 19.4%

CORPORATE DEBT

CREDIT

Momentum on credit markets continued. Although the crossover widened by around 10bp to 426bp, cash bonds were stable with premiums hovering around 450bp. Companies seized relatively calm markets to sell debt, with the high yield segment issuing its first bonds of the year. **Tereos** sold a 2028 maturity at 7.5% and we invested in **Telecom Italia**'s new issue.

In financial debt, there were several new issues. We subscribed to the new junior Coco from **Ibercaja** at 9.12%, callable in 2028. Strong buying sent risk premiums on the most junior segment to around 680bp to call, which is 200bp tighter than at the beginning of the year. Upbeat bank results drove the trend. US banks reported good figures overall with better profitability and non-performing loans down on the pre-pandemic level. In Europe, **Bankinter**'s results were also excellent with a ROE of 12% driven by a sharp increase in its net interest margins and CET at 12%.

CONVERTIBLES

The earnings blackout and a short trading week in the US meant no new issuance.

Elsewhere, Spain's **Cellnex** jumped more than 6% on Friday on media speculation of a bid from **Tower** and **Brookfield** in the US. EBITDA at food delivery service **Just Eat Takeaway** for the second half of 2022 came in above broker expectations. The company, which is no stranger to the convertibles market, said it expected 2023 adjusted Ebitda to be around €225m and that growth in the year would be skewed towards the second half. The company is also teaming up with **Sainsbury** in the UK for grocery deliveries.

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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EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

47, rue du Faubourg Saint-Honoré 75401 Paris Cedex 08

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332.652.536 R.C.S. Paris