EDMOND DE ROTHSCHILD

MARKET FLASH: CONGRESS APPROVES THE DEBT CEILING AGREEMENT

• Joe Biden and House of Representatives speaker Kevin McCarthy reached an agreement to suspend the US debt ceiling until 2025.

• Ahead of central bank meetings this month, the inflation/growth match is still the main topic.

• We are cautious on risk assets. In bonds, we are still looking for yield and prefer corporate bonds, with a focus on short-dated instruments. We have reinforced duration.

Over the weekend of May 27-28, Joe Biden and House of Representatives speaker Kevin McCarthy reached an agreement to suspend the US debt ceiling until 2025. In return, government spending will be kept at current levels (and not reduced as Republicans wanted). Risk assets acknowledged this news with a rebound after the vote in both houses.

Ahead of central bank meetings this month, the inflation/growth match is still the main topic. Eurozone inflation data in May was rather reassuring with the first estimates coming in below expectations in Spain, France and Germany. Spain was the most impressive: inflation over 12 months fell to 2.9% from 3.8% in the previous month. Over a month, it fell 0.2%.

The growth picture is, however, still mixed. In the US, the advanced manufacturing index in Dallas hit a low not seen since 2020. In Chicago, it fell back to 40, wiping out the rebound since the start of 2023. Manufacturing ISM fell to 46.9, dragged down by new orders falling to 42.6. Employment, however, continued to perform well, hitting 51.4, with JOLTS data recovering in April and weekly jobless claims treading water at rather low levels.

The week's setback was in China which reported disappointing advanced economic indicators. Manufacturing PMI remained below 50, falling further to 48.8 in May. Non-manufacturing stayed at a high 54.5 but it was still down on the previous month. The data sent all equity markets lower midweek as they rekindled fears about the impact on global growth. There was some reassurance, however, when Caixin manufacturing PMI for China edged higher and was still above 50. The divergence between the two indicators results from geographical and sector differences as well as survey dates.

Markets rebounded at the end of the period after Congressional approval of the debt ceiling deal and expectations that Beijing would go for more stimulus. Several Fed officials spoke before the blackout period and mentioned the possibility of a rate hike pause this month. Their words and falling inflation data helped bond yields ease over the week.

Given today's levels, we are maintaining our stance on Chinese equities but are generally cautious on risk assets. In bonds, we are still looking for yield and prefer corporate bonds, with a focus on short-dated instruments. We have reinforced duration.

EUROPEAN EQUITIES

Indices edged lower over a choppy week due to the US debt ceiling crisis and eurozone inflation data. Investors were pleasantly surprised by the inflation figures. A significant drop in energy prices, rather than lower food prices, was mainly responsible. ECB chair Christine Lagarde nevertheless reiterated that underlying inflation was too high. The jobs market is stretched and inflation could be boosted by the knock-on effects of higher wages. At the same time, household and company confidence levels in the eurozone fell sharply in May, both in services and in industry where thin order books had an impact.

In company news, **Coface** (credit insurance) reported much better results with an 11% rise in insurance premiums and higher service revenues. The group also said bank stress worries could reduce lending to companies just as corporate failures continue to increase. In food and beverages, **Nestlé** fell on the surprise departure of its finance director. The sector is currently confronted with a rather complicated environment. Weak consumer spending, particularly in the US, was confirmed by lacklustre figures from **Rémy Cointreau.** In energy stocks, Germany's **Uniper** enjoyed a paradigm shift. Previously, the main importer of Russian gas, the group was saved from bankruptcy by Berlin a few months ago. But it now expects to make more than €2bn this year thanks to the dramatic fall in gas prices. In autos, Volkswagen said it wanted to avoid a price war in China, particularly in the EV segment, but insisted it would not sacrifice profitability to volume growth.

US EQUITIES

May saw more index dispersion with the Dow losing more than 3% and the Nasdaq gaining 6%. The S&P edged 0.5% higher. For the first trading day in June, the S&P500 rose 0.99% and the Nasdaq 1.28% after the House of Representatives approved the motion to raise the debt ceiling.

Sentiment was also underpinned by indicators that seemed to show inflationary pressure was easing. ISM Manufacturing Prices Paid slowed sharply to 44.2 in May, down from 53.2 in April and lower than the 52.3 expected. Unit wage costs rose 4.2% QoQ in the first quarter, down from 6.3% in the previous quarter and the 6% expected. On the other hand, the private sector created 287,000 jobs in May, or much more than the 170,000 expected. Unfilled job vacancies rose to a three-month higher of 10.1 million, up from 9.7 million and above the 9.4 million pencilled in by analysts.

In company news, **Salesforce**, the global CRM leader, tumbled 7% in extra hours trading after saying it expected sales to rise by only 10% this year, the slowest pace ever for the company.

Amazon agreed to pay $30m to the Federal Trade Commission (FTC) to end litigation concerning Alexa's privacy violations.

Berkshire Hathaway raised its stake in Occidental Petroleum to 25%. WTI rose 3.75% to $70 before the OPEC summit, thanks probably to short covering as inventories have risen.

The distributor **Advance Auto Parts** plunged 35% after revising down guidance and cutting its dividend. The group blamed rising costs and supply chain problems.

Microsoft asked for its appeal against the UK competition watchdog's decision to block its acquisition of **Activision Blizzard** to be held in July in an accelerated 4-5 day hearing.

JAPANESE EQUITIES

Despite profit taking, the NIKKEI 225 and TOPIX gained 1.13% and 0.15% over the period on foreign buying, reduced fears of a US debt ceiling crisis and the weaker yen.

Precision Instruments jumped 4.43% as investors and index funds bought high-index weightings. Air Transportation gained 3.57% as concerns over new Covid-19 cases in China receded. Banks rose 2.44% on signs the debt crisis in the US was receding. In contrast, falling commodity prices sent Mining, Pulp & Paper and Oil & Coal Products 4.96%, 3.68% and 3.68% lower.

Sumitomo Realty & Development soared 9.57% on attractive valuations. **Tokyo Electron**, a semiconductor manufacturing equipment maker, and **Fujitsu**, an information and communications technology (ICT) products maker, gained 4.97% and 4.25% after US tech stocks rose. Both **Sumitomo Electric Industries**, a wire and cable maker, and **Kubota**, an agricultural machinery maker, fell 4.55% on profit taking. **Mitsubishi Chemical** shed 4.45% on expectations of a broker downgrade.

The dollar weakened from the low 140s to the high 138s against the yen on rumours the government might intervene and equity market strength.

On Tuesday, seven major power companies announced their intention to raise electricity rates for households in June. The increase is expected to be between ¥800 and ¥2,700 compared to the previous month. The increase is to offset recent price hikes in liquefied natural gas and coal used in power generation.

EMERGING MARKETS

The MSCI EM Index was down 1.1% as of Thursday's close. Korea (+1.1%) outperformed, followed by India. China was down 2.5% on weak market sentiment and lack of government stimulus. Brazil also retreated by 1.2%.

In **China**, official Manufacturing PMI in May fell further to 48.8 from 49.2 last month while non-manufacturing dropped to 54.5 vs. 56.4 previously; both were below expectations. Meanwhile, the May Caixin PMI came in at 50.9, or higher than the 49.5 expected. Industrial profits fell 20.6% in the January to April period. New home sales by the 100 biggest real estate developers dropped 14% sequentially, after gains of more than 29% in the previous two months. The government is working on a new basket of measures to support the property market, and it is also considering new tax incentives for high-end manufacturing companies. First-quarter results were a strong beat, with faster revenue growth due to market share gains. **BiliBili**'s first-quarter results were in line with expectations, with improving margins.

Macau casinos saw another strong month in May, with gaming revenue jumping more than 360% YoY, but broadly in line with expectations.

In **Taiwan, Mediatek Partners** with **NVIDIA** is to provide a full-scale product roadmap to the automotive industry.

In **Korea**, industrial output fell 8.9% YoY in April, or more than expected.

In **India,** overall manufacturing PMI came in at 58.7 in May vs. 57.2. India grew 6.1% YoY in the first quarter, or much more than expected. India's gross bank credit off-take rose 15% in FY23, led by Non-Banking Financial Companies (NBFCs), up 30.3% YoY, and personal loans

(+20.6%). **Xiaomi** is to work with **Dixon Technologies** to make mobile phones in India. **Sun Pharma** and **Philogen** will market a skin cancer drug in Europe, Australia, and New Zealand. **Daikin** plans $5.7bn in capex over 3 years, targeting India and Europe

In **Brazil,** GDP grew 1.9% QoQ, or more than expected, thanks to agribusiness (+21.6% QoQ). The public sector surplus for April was R$20.3bn. Loan growth decelerated by 1% MoM to 11.1% YoY

In **Mexico**, **FEMSA** unveiled the price for the sale of its **Heineken** stake and the divestment of Jetro.

In **Chile**, the unemployment rate rose 0.9% over a year to 8.7%, or below the 9% expected. Congress approved a large minimum wage adjustment and the bill raising the nominal minimum wage by a total of 22% in several steps between May-23 and June-24.

Argentina's government confirmed Chinese investments of US$1.7bn in lithium production as the country looks to consolidate its position as a key global supplier of the metal.

CORPORATE DEBT

CREDIT

Indicators showing European inflation was slowing sent bond yields lower while credit spreads were underpinned by signs that activity was still relatively resilient. Markets were also reassured by the Congressional agreement to raise the US debt ceiling. Yields on Germany's 10-year Bund fell 25bp to 2.28% after flirting with 2.55% in the previous week due to bad inflation figures in the UK. As a result, credit markets performed well over the week.

Falling rates and somewhat resilient macroeconomic indicators helped investment grade and high yield return 1% and 0.3%, respectively. The new issues market was relatively calm. Car rental company **Sixt** raised €300m over 4 years and **Universal Music Group** €500m over 8 years.

In financial debt, CoCos returned 0.5% over the week. Greece's debt continued to rise after the first round of elections and the new issues market was reasonably active. **Société Générale** sold a Tier 2 10-year maturity in euros at 5.625% and **Ibercaja** a senior 4-year maturity also at 5.625%.

CONVERTIBLES

With US markets closed for Memorial Day last Monday and pending Congressional approval of a motion to raise the debt ceiling, trading on the convertibles markets was inevitably rather quiet. The Refinitiv Convertible EUR index managed to edge higher over the week.

The luxury sector continued to consolidate. **LVMH** ended the period lower. But tech stocks stuck to recent highs.

In new issuance, a new **Lagfin** exchangeable into **Campari** raised €535m at 3.5% and with a 30% premium. The 2% 2025 exchangeable was redeemed at 125.80%, a 1% premium.

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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