EDMOND DE ROTHSCHILD

MARKET FLASH: ECONOMIES ARE ON A RIDGE LINE

• Disinflation is taking hold and even gaining ground judging from less stretched commodity, durable goods and property prices and, to a lesser extent, reduced wage pressures.

• We will be keeping a close eye on the earnings season as it should determine whether lofty valuations for certain sectors in the US are really justified.

• Our investment focus is to help our portfolios gain from the move to lower bond yields.

So far, economies have been resilient. There has been no significant rise in unemployment and both consumption and corporate profits are holding up. The growth-inflation mix is for the moment at the right temperature for both bond and equity markets. But for how long? That is the crucial question for the next six to nine months.

Services, the most significant factor in the GDP of advanced economies, continued to recover in the first few months of 2023 but now seem to be running out of steam. After rising for 5 months in a row, services PMI fell back in June. According to PMI surveys, the sharpest downturn was in Europe (-3.1 points to 52 in the eurozone and -4.5 points to 48 in France). Confidence in services in China is also falling. Manufacturing, meanwhile, continued to move into recession territory in June. Manufacturing PMI was below 50 in around 85% of countries surveyed. Globally, the decline is mild but much more pronounced in Europe and especially in Germany. New orders fell back and input prices are down. Gloom among heads of industry is partly reflected in weak international trade: export volumes have been treading water since the end of 2022.

Elsewhere, disinflation is taking hold and even gaining ground judging from less stretched commodity, durable goods and property prices and, to a lesser extent, reduced wage pressures. In global terms, producer price inflation returned to roughly 1% over 12 months in May (with even declines in China, Europe and the US) down from a peak of more than 18% a year ago. CPI is now flirting with 6% compared to a peak of 9.5%.

The UK is an exception. Inflation there has been rampant almost everywhere: shelter (rents in London jumped 13% over a year), goods, food and healthcare. Only energy inflation has really turned lower. Despite raising rates earlier and more than in the eurozone, the Bank of England has not yet managed to quell inflation even if the latest figures show signs of incipient stabilisation.

As for blue chip earnings, a bigger focus on the possibility of a slowdown has generally led to downward revisions in estimations. Analysts now expect Eurostoxx 50 earnings to fall 13% over a year and by 8% for companies listed in the US. Note that in the first quarter, earnings were expected to fall 7-8% and actually ended up only declining by 2%. We will, of course, be keeping a close eye on this earnings season as it should determine whether lofty valuations for certain sectors in the US are really justified. Currency effects will also be important, and notably the impact of the euro's appreciation on earnings for eurozone companies.

In 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. We even accentuated the move last week when 10-year bond yields in the US and Germany broke through levels we had earmarked as buying opportunities. Our investment focus is to help our portfolios gain from the move to lower bond yields. We still prefer fixed income but are still somewhat cautious on risk assets as another drain on liquidity looms. We believe being overweight duration is not only attractive but should also offer protection at a time when the latest CPI data point to a slowdown with more disinflation to come.

EUROPEAN EQUITIES

The detail of Insee's July survey generally reinforced the case for a gradual slowdown that should take inflation and the jobs market back to normal levels. In the US, weekly jobless claims were lower than expected, another sign of labour market normalisation. The headline news this week was however second-quarter earnings.

Tech stocks reported mixed figures and triggered some selling. **TSMC** for example, weighed on the semiconductor sector. **ASML**'s results were good but failed to reassure markets. And yet the group raised the outlook for the rest of the year and Chinese demand is holding up. The problem was the company's cautious tone over persistent short term macroeconomic uncertainties. European indices nevertheless held up well during the turbulence. This was thanks to upbeat comments from the basis resources sector which sent the UK market to best performer.

ABB also reassured markets on European industry resilience. Thanks to its strong pricing power, earnings and profitability rose and the outlook is still good for the rest of the year. But Europe's telecoms sector showed no signs of improvement: **Tele2** plunged after a profit warning due to investment costs, triggering worries that companies in the sector would struggle to cope with much higher interest rates. The sector was already looking fragile following reduced guidance from **Ericsson** and **Nokia** due to a slowdown in demand.

Elsewhere, luxury goods came under pressure over fresh concerns that China was facing a long period of weak growth. **Richemont** reported disappointing figures due to weaker-than-expected demand in the US and fears the situation could get even worse in the coming months.

US EQUITIES

Banks kicked off the US earnings season with encouraging comments on recovery and deposit stability.

The Empire State survey came in at 1.1, or slightly better than the minus 3.5 expected. Prices paid and received fell sharply to mid-2020 levels. Figures from the construction sector reinforced the case for a soft landing. Housing starts were 1.43 million (s. 1.48 expected) and building permits came in at 1.44 million (1.4 million). Retail sales growth slowed in June to +0.2%, down from +0.5% in May.

Telecoms came under pressure after a Wall Street Journal article claimed cables might contain dangerous amounts of lead. But the sector rebounded when **AT&T** said only 10% of its network was affected and the cables in question were being gradually replaced.

Netflix tumbled 7% after the bell when its quarterly sales and guidance fell short of expectations. The news overshadowed a gain of 5.9 million new customers in streaming from April to June. **Tesla** also fell in after-hours trading due to smaller second-quarter margins. The gross margin fell to a three-year low of 18.2%. Elon Musk nevertheless said he would continue to cut prices if interest rates rose further. **Ford** lost 6% on Thursday after announcing price cuts of between 6-15% for its F-150 Lightning F-150 electric truck. The news came at the same time as Tesla unveiled Cybertruck, its first electric truck.

Tech was actively traded over the week. **Microsoft** gained 4% after announcing that its Office suite (*Word, Excel, PowerPoint, Outlook, Teams*) would now include artificial intelligence features. The option will cost an extra $30 for each licence, or much more than the market expected. **Nvidia** hit a new record high, taking its market cap to $1.14 trillion. On the other hand, **IBM** dipped 1% after the close due to a slight results miss on falling server sales. The group nevertheless stuck to its guidance, +3-5% in sales and $10.5bn in free cash flow.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX rose 1.71% and 1.77% on Wall Street strength following weaker-than-expected economic data and hopes for an end to rate hikes. The yen also helped by falling after BoJ Governor Kazuo Ueda, speaking at the G20 finance minister and central bank meeting, said ultra loose monetary policy was here for some time.

Marine Transportation and Iron & Steel gained 5.88% and 3.90% as investors shifted their money to value from growth stocks. Transportation Equipment rose 3.53% due to the weaker yen. On the other hand, Fishery Agriculture & Forestry and Retail Trade fell 1.92 and 1.12%, as investors sold domestic demand related sectors to buy cyclical sectors. Supermarket chain **Aeon** and **Unicharm**, a manufacturer of disposable hygiene products and household cleaning products, lost 2.59% and 2.56%. Insurance shed 1.54% on falling bond yields as concerns over US inflation subsided temporarily.

Pharma group **Eisai** jumped 7.08% as investors flocked to its shares following the FDA's approval of its Alzheimer drug "Lecanemab". **Nissan** gained 6.63% on yen softness. **Marubeni**, a general trading company, advanced 5.37% on rising wheat prices following Russia's threat to attack grain ships leaving Ukraine through Black Sea ports. Elsewhere, **Daiichi Life** fell 3.21% on falling US bond yields.

The dollar strengthened from the mid 138s to around 140 against the yen as hopes for a change in the BoJ's yield curve control policy receded.

EMERGING MARKETS

The MSCI EM Index was down 1% during the week as of Thursday. China (-3.1%) led declines with Taiwan and South Korea down 1.6% and 1.7%, respectively. India added 1.4% while Brazil closed slightly in positive territory.

China's second-quarter GDP rose 6.3%, or less than the 7.1% expected. June retail sales were up 3.1% YoY, again short of expectations. Industrial output expanded by 4.4% YoY, beating estimates. Elsewhere, youth unemployment reached a concerning new record of 21.3% in June. Beijing's policy approach is becoming more supportive: the government is considering mortgage easing in major cities by relaxing home purchase limits for individuals with a previous mortgage. It also announced policies to boost household consumption including home appliance purchases. The government is also looking at attracting foreign investment and raising wages. The State Council issued guidelines to boost the private economy as part of a 31-point plan including financing support and IP rights. US climate envoy John Kerry met China's top officials to encourage stable relations with the US in the future. There appears to be some common ground and another meeting on climate issues will take place soon. In the corporate sector, **Sunny Optical** issued a profit warning for its second-quarter results, citing weak global smartphone demand and intense competition. **CATL** formed an aviation JV with **COMAC**, a Chinese aircraft manufacturer, ahead of a possible move into electric aircraft.

In **Taiwan**, **TSMC**'s second quarter results were in line but guidance for this quarter and the full year fell short of expectations. For the longer term, management reinforced its positive view 2021-26 with revenues up 15-20% (CAGR), driven by market share gains and a healthy long term GM above 53%.

In **India**, **HDFC Bank** reported positive results with lending up 16% and improved risk management. **Avenue Supermarkets**' June results were disappointing due to lower margins and challenges from high inflation. Revenues at **TCS** rose 7% YoY, or in line with low expectations. **Infosys** secured a $2bn framework agreement for AI/automation apps but cut its FY24 revenue guidance to 1-3.5%.

In **Brazil**, the central bank's monthly activity index for May showed a worse-than-expected 2% MoM decline, thereby increasing the likelihood of an August/September rate cut. The government introduced the "Desenrola" program, allocating $10bn to refinance consumer debt. There are also plans to launch FIES, which will focus on student financing. In the corporate sector, **Weg Motors** reported better-than-expected 2Q24 results due to a stronger-than-expected 22.4% in EBITDA margins on increased transformer sales to the US and Mexico and lower commodity prices.

In **Mexico**, **Banorte** reported upbeat second-quarter results, driven by higher efficiency and a robust 19% YoY increase in lending (+5% QoQ).

Russia decided to terminate the Ukraine Grain Export Agreement and wheat prices rose.

CORPORATE DEBT

CREDIT

In another calm week with low volatility, investment grade returned 0.4% and high yield 0.6%. Ahead of results from non-financial companies, the IG new issues market saw **DS Smith** raise €1.5bn with 4 and 7-year maturities and coupons offering close to 4.5%. **Terna** also raised €650m over 10 years. In high yield, Irish utility **Energia** raised €600m at 6.875% over 5 years to refinance and pay out a dividend to its shareholder.

In financials, the CoCo market stayed strong after the stress tests for UK banks showed how robust the sector was and Nordic banks posted generally better-than-expected quarterly results. However, there was little action on the new issues market due to the earnings season. However, there was a senior bond deal from **Bank of Cyprus** which raised €350m at 7.375%.

CONVERTIBLES

In a very busy week for convertible bonds, South Korean names remained the focal point with solid demand and performance while Hong Kong stayed under pressure. Chinese developers including **Country Garden** extended advances after reports that the authorities were considering easing home buying restrictions in the nation's biggest cities.

In Europe, **Ocado** first-half results were better than expected, mainly thanks to its Solutions business turning EBITDA-positive earlier than expected.

In the US, **American Airlines** raised full-year guidance after its second-quarter results beat estimates. **Alnylam** was also actively traded after the company reported positive data from a trial evaluating an investigational therapy targeting Alzheimer's disease.

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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21/07/2023

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Société anonyme governed by an executive board and a supervisory board with capital of 11.033.769 euros

AMF Registration number GP 04000015

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