EDMOND DE ROTHSCHILD

MARKET FLASH: OVERTIGHTENING RISK?

• Since the Fed and ECB turned more hawkish, terminal bond rates have been repriced.

• Jerome Powell minimised the idea of a pause and instead promised more hikes to come if the economy failed to slow down faster.

• We are still cautious on equities. We remain upbeat on duration as it looks attractive and should offer protection should the economy slow. We continue to take a constructive view of corporate debt.

Central banks have been in the spotlight over the last two weeks. When Fed chair Jerome Powell appeared before the House of Representatives this week, he minimised the idea of a pause and instead promised more hikes to come if the economy failed to slow down faster. At the same time, he underlined the sharp fallback in inflation. The tables have been turned: a rate hike is now not conditional on inflation rising again, rather a pause is conditional on the economy slowing.

In the UK, inflation started rising again, up 8.7% over a year, with food prices shooting up more than 18%. The Bank of England's credibility is now at stake and it had to raise rates by an unexpected 50bp.

Only a few hours before, Norway's central bank also raised rates by 50bp after inflation accelerated to 6.7% amid particularly robust activity.

Nevertheless, this approach is not shared by all and some central banks in emerging economies even eased conditions. China massaged its benchmark rate slightly lower while Hungary, Czechia and Brazil left rates unchanged ahead of a move towards an easing cycle.

Diverging views are likely to accentuate among central banks as we expect disinflation to continue in the US and Europe over the coming months. The difference between the ECB's chief economist Philip Lane, who is urging caution, and Isabel Schnabel, who would prefer to overstep tightening and then cut back if necessary, are probably harbingers of the clashes to come.

This macro environment is good for dynamic currency management. We are taking profits on our long-euro-against-dollar position as the Fed has turned more hawkish. We continue to believe risk premiums are still not attractive enough. Liquidity will contract due to issuance from the US Treasury, asset disposals and tighter lending conditions. As a result we are still cautious on equities. We remain upbeat on duration as it looks attractive and should offer protection should the economy slow as the latest eurozone PMIs seem to indicate. We continue to take a constructive view of corporate debt.

EUROPEAN EQUITIES

Indices ended the period lower as stubborn inflation fuelled hawkish sentiment among central banks. In Norway, Switzerland and the UK, they even raised rates and said more might follow. Disappointing economic data added to the malaise: eurozone manufacturing and services PMI missed expectations and fell further.

The worst performing sector was basic resources, followed by cyclical sectors like construction and consumer discretionary, both still affected by China rebounding less than expected. In chemicals, **Lanxess** warned on soft demand and revised down guidance. Against all expectations, the group saw no recent recovery in China.

There was more to celebrate in aerospace and tourism. At the Paris Air Show, **Airbus** won a contract to deliver 500 planes to India's **Indigo airline**, the biggest deal in aviation history. And ADP (Aéroport de Paris) said passenger numbers in May were higher than in 2019. The autos sector also shone: car sales in Europe jumped 18% in May YoY, the tenth rise in a row, due to a 71% surge in demand for electric cars. The segment is rising on government subsidies and orders for corporate fleets.

US EQUITIES

The S&P 500 gained 0.21% and the Nasdaq was more or less flat (+0.03%) over the last five trading sessions.

Jerome Powell, appearing before the House of Representatives and Senate, said that the economy would have to slow to below trend levels if inflation was to come down. He also covered recent banking turmoil, declaring that it had served as a reminder that existing supervisory and regulatory procedures were appropriate. Janet Yellen said recession risk was falling in the US and suggested that a slowdown in consumer spending might be necessary to curb inflation given the solid labour market.

Elsewhere, weekly jobless claims were unchanged, another indication that the labour market was still resilient. Sales of existing homes in May were largely unchanged (4.3 vs. 4.25 million) as high mortgage rates continued to weigh on demand and deter owners from putting their properties up for sale. Housing starts, however, hit a 13-month high in May (1.63m vs. 1.4m expected) and building permits turned sharply higher, rising 5.2% MoM vs. +0.6% expected.

In company news, tech stocks rallied on Thursday, led by **Amazon** which unveiled a $100m investment plan to help users create and manage IA applications. **Fedex** fell 3% after the bell on disappointing 2024 guidance. The group now expects EPS to be between $16.50-18.50 compared to consensus expectations of $18.31. Management said volumes had fallen due to post-Covid normalisation. **Accenture** fell on Thursday after revising down guidance on sales growth from 9% to 8.5%. The group cited possible cutbacks in IT spending by companies.

Banks also had a difficult Thursday (-2.12%) ahead of a 20% increase in capital adequacy requirements for big players. In addition, **Fitch** said it was worried banks would run into difficulties in the second half due to the slowing economy.

JAPANESE EQUITIES

The NIKKEI 225 fell by 0.66% and the TOPIX edged 0.11% higher on Wall Street weakness following Jerome Powell's insistence further rate hikes were coming and profit taking after a buoyant month in Tokyo. The NIKKEI 225 revisited its highest level in 33 years since March 1990, and the TOPIX returned to July 1990 highs.

Air Transportation rose 5.62% on the news of strong inbound tourist numbers in May. Airline **ANA** gained 4.66%. Wholesale Trade added 4.95% as general trading companies remained in vogue after Warren Buffet increased his exposure to the sector. **Marubeni**, for example, jumped 9.65%. Banks gained 3.06% on higher US rates following hawkish comments from Fed officials. On the other hand, Electric Appliances and Transportation Equipment fell 2.02% and 1.82%, respectively, on profit taking among growth/export stocks. Non-Ferrous Metals declined 1.75% as commodity prices fell due to China's sluggish recovery. **Sumitomo Metal Mining** ended the period 3.84% lower.

Canon, an office & precision machinery maker, jumped 7.04% on its second share buyback (16 million shares or 1.6% of outstanding shares) this year. Semiconductor equipment maker **Tokyo Electron** and **Nitori**, a furniture chain store, shed 3.35% and 3.01% on profit taking.

The dollar moved from the low 140s to low 143s after the BoJ and Fed both stuck to their monetary policies.

The Japan National Tourism Organization announced that foreign visitors to Japan numbered just below 1.9 million in May, or slightly less than the post-pandemic high of 1.95 million in April. Travellers from China, previously Japan's biggest tourist segment, increased 24% to 134,400 in May, though still far below 2019 levels.

EMERGING MARKETS

The MSCI EM Index was down 2.1% this week as of Thursday's close. Brazil (+0.9%) and India (+0.2%) outperformed. Korea lost 3% while China tumbled 4.2% in a 3-day trading week.

In **China**, stimulus efforts were a bit underwhelming: the PBoC cut one-year and five-year LPRs by 10bp to 3.55% and 4.20%, respectively, while NEV purchase tax breaks were extended for another 4 years for a total amount of $72bn. Blinken's visit to China ended with a surprise meeting with President Xi Jinping and both sides came out making positive statements. But Biden then appeared to undermine the visit by referring to Xi Jinping as a "dictator" in a fund-raising event. **Alibaba** continued to accelerate its restructuring by reinstating co-founder Joe Tsai as new chairman while letting current CEO and chairman Daniel Zhang focus on Alicloud's development. **CATL** is to build a $1.4bn lithium extraction plant in Bolivia. Abu Dhabi-backed **CYVN Holdings** will invest $1.1bn in **Nio. AstraZeneca** plans to spin off its China business and list it separately in Hong Kong.

In **Taiwan**, export orders continued to lag and were down 17.6% YoY in May.

South Korea stayed on the Emerging Market list after an MSCI review. **LG Chem** is reportedly looking to sell a $1.6bn stake in LG Energy Solution to fund LFP cathode capex.

During his visit to the US, Indian PM Modi and President Joe Biden announced a series of deals spanning defence partnership, securing supply chains in semiconductors, critical minerals and enhanced cooperation in research and development across sectors. The government cleared $2.1bn for IT Hardware PLI 2.0; $363m in incentives have been spent on 8 PLIs so far this year. The authorities approved **Micron Technology**'s $2.7bn plan to set up a semiconductor testing and packaging unit under the PLI. **General Electric** plans to manufacture F414 engines with state-owned Indian firm **Hindustan Aeronautics**. **Indigo** ordered 500 **Airbus** A320 family aircraft during the Paris Air Show.

Brazil's central bank kept key interest rates unchanged at a six year high of 13.75% and stopped short of endorsing any imminent reductions. A proposed tax reform will include compensation funds to benefit states that lose money under the changes. **Casino** announced the sale of its remaining 11.7% stake in **ASSAI**. **Sunazo** announced a $30 price hike in China.

In **Mexico**, **Banxico** confirmed market expectations by keeping key interest rates unchanged at 11.25% as inflation continued to slow in the first half of June to 5.18% from 5.67%. Mexico's definitive first quarter GDP report shows the economy expanding by 1% QoQ, up from 0.5% in the fourth quarter of 2022 on domestic demand.

CORPORATE DEBT

CREDIT

As in the previous week, bonds suffered a little due to rates and high yield premiums. Yields on Germany's 5-year Bund were at 2.64% on Thursday evening, an increase of 6bp. But there was a strong 15bp rally on Friday morning after disappointing PMI data fuelled uncertainty on the macroeconomic picture. Investment grade premiums showed resilience and stabilised around 160bp but high yield premiums rose from 425 to 440bp for cash bonds while the Xover rose from 400 last Friday to 415bp.

Returns over the week reflected these developments: investment grade lost 0.21%, taking YTD gains to 1.70% after being slightly affected by rates but immune to premium shifts. High yield was naturally worse hit, down 0.5% leaving YTD gains at a still creditable 4.4%. Actuarial yields for investment grade were 4.45% and 7.5% for high yield, still good entry points for carry strategies. Markets are still embracing a soft recession scenario. Company earnings are still generally good which suggests the economy is somewhat resilient.

In new issuance in the HY segment, **Playtech** BB raised €300m at 5.875% due 2028 and **Pepco** BB- sold a 2028 maturity at 7.25%.

In hybrid bonds, property company **Unibail** launched an exchange offer on its July 2023 callable bond against a new issue with a cash payment. Markets applauded the offer.

In financial debt, euro CoCo premiums widened by around 50bp after risk asset shifts. As of Thursday, they were close to 850bp to call after performing well over the past month. Senior and Tier 2 new issuance remained busy with a T2 deal from **Achmea** at 6.75% due 2043 and a Senior Preferred bond from **Alpha Bank** at 6.875% due 2029. Since the **Credit Suisse** affair, **BBVA** and **Bank of Cyprus** have been the only banks to issue AT1 debt.

CONVERTIBLES

Markets drifted lower this week following comments from the Federal Reserve Chair. Technology was the worst performing sector while healthcare and consumer held up well.

In European company news, a press report said **Vodafone** was working with an investment bank to analyse options for its Spanish operations. Telecom firms like **Cellnex** and **Telecom Italia** have been identified among top potential takeover targets.

In Asia, **Cathay Airways** performed well after the company said cargo would take flight in the second half of the year as airport passenger levels climbed back to half pre-pandemic levels.

In the US, **Exact Sciences**, a life sciences firm, published strong study results showing its new Cologuard test, used to screen for colorectal cancer, met all study endpoints.

The primary market was active as well, albeit with smaller deals mostly used to refinance debt. In Europe, **SGL Carbon** issued €118m to refinance its straight bond maturing in 2024. In the US, **World Kinect**, a logistics service company, and **Cerence**, an application software vendor, issued $250m and $200m, due 2028.

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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