MARKET FLASH: INTEREST RATE VOLATILITY AND ITS POSSIBLE IMPACT

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- **Although real US GDP grew at an exceptional pace in the third quarter, some commentators believe the figures could be overstating the US economy's strength.**
- **We continue to be cautiously positioned because of the fraught situation in the Middle East. Any extension of the conflict to Iran could accentuate negative consequences on markets.**

Geopolitical tensions rose by another notch, rekindling concerns over energy prices but also driving volatility on bond markets to levels last seen during the 2008 financial crisis. Yields on 10-year US Treasuries recently moved above 5%, a high not seen since 2007. And, over the last month, price swings on US 30-year bonds have been more pronounced than for US equities. Such a rapid increase can fuel worries over financial stability, notably for banks and other financial institutions. The latest IMF Financial Stability report suggests that rate rises and volatility could feed through to the real economy by undermining commercial property, fuelling bank stress through non-syndicated private sector loans and impacting liquidity on the US Treasury bill market.

Despite these risks, no major financial crisis has yet erupted. The banking sector appears to be better capitalised and more resilient than before the 2008 crisis. Financial condition indicators are currently high but have yet to breach alert levels as seen in the Fed's latest indicator which serves to measure the finer details of an impact on the economy.

Although real US GDP grew at an exceptional pace in the third quarter, some commentators believe the figures could be overstating the US economy's strength. This means it is crucial to keep a close eye on (i) interest rates, (ii) financial conditions over the next few months and (iii) upcoming decisions by the Fed on benchmark rates.

The ECB's approach, meanwhile, is already bearing fruit as inflation in the eurozone fell to 4.3% in September. The drop was due to energy price falls since 2022 but also to some moderation in services. Excluding food and energy, inflation only rose by an annualised 3.1% in the third quarter. Moreover, the outlook for factory gate prices is still falling across all sectors.

And, as the ECB's latest survey points out, borrowing has become more expensive due to higher long bond yields. Bank lending is still restrictive and net demand for loans fell more than expected in the third quarter.

The business climate in the eurozone is still weak ; composite PMIs have now been in recession territory for 5 months. Business climate surveys see no sign of things improving over the short term. It is therefore difficult to argue that inflation is due to excess demand, especially as the savings rate of European households is still high.

The ECB will have to take on board these factors in its future monetary policy decisions. On Thursday, it left rates unchanged for the first time since July 2022. Chair Christine Lagarde said she was confident that inflation would improve but still warned that another hike might be needed if there were any bad surprises. Government bond yields dipped slightly after her press conference.

Higher government bond yields and fresh geopolitical tensions weighed on risk assets over the week. We continue to be cautiously positioned because of the fraught situation in the Middle East. Any extension of the conflict to Iran could accentuate negative consequences on markets. We are still long duration as it should provide protection.

EUROPEAN EQUITIES

The previous week saw markets fall after sovereign bond yields soared. The yield on 10-year US Treasuries moved above 5% for the first time since 2007. This week they stabilised at slightly lower, but still high, levels.

On Thursday, the ECB decided to leave rates unchanged after 10 hikes in a row, the fastest pace of rate increases in the bank's history. The news failed, however, to compensate for mostly disappointing quarterly earnings and the Stoxx Europe 600 ended the period lower, albeit with significant sector disparities.

Autos led losers. Results at **Mercedes** fell short of expectations and the group revised its outlook for the end of the year lower. Basic resources, however, were lifted by upbeat figures from Sweden's steel maker **SSAB** and by optimism over China which continued to drive industrial metal prices.

In consumer discretionary, sales growth at **Hermès** slowed but still came in above expectations despite price rises. The results show demand remains resilient, allowing Hermès to maintain its famous pricing power. In Germany, **Puma** said solid European demand and an encouraging recovery in China had more than made up for soft sales in the US. In short, there are still positive signs in the luxury and mass market segments.

In Switzerland, **Logitech** (consumer peripherals and software) jumped after the group raised guidance on sales and earnings for 2023. Significant cost reductions compensated for some weakness in sales.

Dassault Aviation could be on the verge of securing an order for 54 Rafale fighters from Saudi Arabia. However, French financial daily La Tribune said this might be an attempt to force Germany to reverse a several-year ban on selling the Eurofighter Typhoon to Riyadh.

German software company **Nemetschek**

bucked the current trend of profit warnings by releasing excellent third-quarter results early. The group also raised its guidance for this year. Management now expects 6-8% growth, up from 4-6%, and also reaffirmed its 2024-25 objectives for growth and improved profitability.

On a less positive note, European markets were choppy after the share price of French payments services group **Worldline** cratered by almost 60%. A major computer outage over the weekend had already disrupted payments for major brand names but then the company reduced its growth forecasts from 8-10% to 6-7%. The sheer size of the sell-off pointed to a loss of investor confidence in the management after the company finally announced that it had severed relations with online merchants who did not comply with its fraud, risk and compliance standards after a move to tougher rules by Germany's BaFin financial regulator.

US EQUITIES

Wall Street lost ground in the second week of the earnings season. The S&P 500, the NASDAQ and the Russell 2000 shed 3.28%, 3.10% and 2.67%, respectively.

A little more than 40% of S&P 500 companies have already reported and around 75% have beaten EPS expectations. However, many robust reports were met with selling due to today's uncertain macroeconomic climate, the lagging effect of the Fed's rate hikes and much tougher financial conditions over recent months.

Core GDP, ex-food and energy, only grew by 2.4% in the third quarter compared to a 3.7% rise in the previous quarter. Weekly jobless claims rose to 210,000 from 200,000. Bond yields eased at the end of the week with the 10-year US Treasury falling back below 5%. Earlier in the period, sales of new homes in September blew past expectations (680,000) by coming in at 759,000. This was in spite of mortgage rates hitting 23-year highs. The news fuelled concerns over long bond yields in the US.

On Thursday, the US carried out strikes on two sites in the east of Syria which were reportedly used by Iran's Islamic Revolutionary Guard Corps and affiliated groups. Gold reaffirmed its safe haven status by gaining 0.52% to flirt with the $2,000 level. WTI oil rebounded to $84.39.

The energy sector saw more M&A deals. After **ExxonMobil** (-4.80%) acquired **Pioneer** in the previous week, **Chevron** (-8.49%) bought its rival **Hess** in a $53bn all-share deal. And **Chesapeake** (-1.90%) is considering a bid on **Southwestern Energy** (-0.28%).

In materials, **Cleveland**-**Cliffs** (+11.28%) said underlying demand was resilient with record deliveries to auto makers and even more cost cutting to come in steel making. **First Quantum Minerals** tumbled 10.27% after reducing guidance on copper, gold and nickel production.

General Motors (-2.66%) and **Ford** (-1.56%) were hit after failing to provide guidance for 2023 due to the UAW strike. The union said it had reached a possible wage agreement with Ford. The text will go to a vote on October 29, putting pressure on the other two Big Three in Detroit, **General Motors** and **Stellantis**, to follow suit.

In tech, **Microsoft** (-1.04%) beat expectations, particularly in its Azure cloud business. **Alphabet** plunged by 11.23% after missing expectations in its cloud computing division. **Meta** shed 7.82% after a cautious message on ad spending for the rest of the year. **IBM** gained 4.17% on a sales beat in its hardware segment.

In telecoms, **Verizon Communications** jumped 9.15% after improving its FCF by cutting CAPEX and reining in costs.

US markets are still tuned to quarterly earnings announcement and macroeconomic indicators. The FOMC is next week. Markets are almost unanimous in expecting rates to be left unchanged, if only because of recent rises in long bond yields.

The US is still at risk of a shutdown as the deadline to reach a budget agreement is November 17. In the meantime, Mike Johnson, a Donald Trump ally, was finally elected as speaker of the House of Representatives

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX continued to decline, shedding 2.64% and 1.76%, respectively, as rising US bond yields and disappointing tech results sent Wall Street lower. A sharp fall in the PHLX Semiconductor Sector Index also impacted Japanese stock markets and concerns over the global economic impact of the Israel-Hamas war continued to exert downward pressure.

Pulp & Paper rose 1.68% as investors moved into value stocks. Pharmaceuticals gained 1.65% led by **Daiichi Sankyo** (+12.46%) on news that it was to co-develop and sell three ADC cancer drugs with **Merck** and receive up to $22bn including an upfront payment of $4bn from its partner. Foods gained 0.71% as defensive stocks rose due to risk-off sentiment. On the other hand, electric appliances shed 4.35% led by **NIDEC** (-17.12%) on worse-than-expected third-quarter earnings and poor figures from US tech giants. Machinery lost 3.16% due to concerns over a slowdown in China and Europe. Securities and commodities futures ended 2.90% lower due to thin volumes on Japan's financial markets. Oriental Land, the operator of **Tokyo Disney Resort**, and cosmetic giant **Shiseido** rebounded by 2.76% and 2.75%, respectively, on a steady recovery in tourist numbers. Murata Manufacturing (components and capacitors) tumbled 6.43% in the tech sell-off. **Chugai Pharmaceutical** slumped 6.24% on a 13.9% YoY fall in its January-September net profits.

The dollar edged up to the low-150s against the yen as the interest rate gap between the U.S. and Japan widened due to strong US GDP statistics. The dollar hit a new high for the year even if there are some expectations that the government might step in to support the yen.

EMERGING MARKETS

The MSCI EM Index was down 1.57% this week as of Thursday. Korea (-4.13%) underperformed followed by India (-3.61%) and Taiwan (-3.4%). Mexico and Brazil were the top gainers, up 2.61% and 1.83%, and China 0.51% inched into positive territory.

In China, September industrial profits increased 11.9% YoY after a 17.2% surge in August. The authorities announced an additional RMB 1trn in special sovereign debt issuance in this quarter, raising the 2023 fiscal deficit ratio to around 3.8% from 3%, or the first increase since 1998. On the geopolitical front, there were more calls for stable bilateral ties between China and the US. Xi Jinping met with California's governor Gavin Newsom in Beijing and Chinese importers signed a US soy export deal. Regulators are conducting tax audits and reviewing land use by **Foxconn**. **Country Garden** reported their first default on a dollar loan. Stellantis is buying a 21.2% stake in Chinese EV maker **Leapmotor**. Li Ning reported missed expectations with mid-single-digit retail sales in the third quarter and the group also revised down full year guidance. **New Oriental Education** announced a strong beat with its second best quarterly profit, exceeding the pre-double reduction level. **Oriental Yuhong** delivered solid quarterly results with net profit and cash generation coming in above estimates.

Hong Kong will lower stamp duty on share trading to 0.1% from 0.13%. Property levies for foreign buyers are to be cut to 15% instead of 30%, while the tax for residents buying second homes will be reduced to 7.5% from 15%.

In Korea, GDP grew by 1.4%. **LG ES** reported an in line quarter unchanged from preliminary numbers, but macro concerns are clouding the 2024 outlook. **Hyundai motors** reported a beat on the back of premium and EV model sales and maintained its positive outlook for growth this year. Nevertheless, the US OEMs (**Ford**, **GM**, **Tesla**) were more cautious on their outlook for EV demand during their third-quarter conference calls.

In India, the RBI emphasised the need for tight monetary policy to control inflation. **Reliance** is close to acquiring **Walt Disney's** India operations. The Roads ministry is planning Rs2trn worth of projects for tender in the second half of 2024. New rules for battery waste management were introduced with a focus on recycling. **Ola Electric** raised Rs 3,200 crore from investors as it geared up for an IPO. **ICICI Bank** reported upbeat results driven by strong loan growth. **Axis bank** beat expectations by avoiding NIM compression. **Paytm** reported strong revenue growth but saw loan demand moderating in the digital segment. **Amber Enterprises** missed exceptions on a weaker mix but management stayed upbeat about future demand. **Dixon** reported a beat thanks to a 27% increase in Mobile EMS division sales while backward integration helped margins.

In Brazil, **Usina Simao** secured its first renminbi loan. The Lower House approved a tax increase for offshore funds. **Santander** expanded its loan book while improving NPL. **WEG** reported a mixed bag with a revenue miss but a margin beat.

In Mexico, **Traxion** published an EPS beat and continued to deleverage despite higher-than-expected capex. **Alsea** saw strong SSS growth and margin expansion in Mexico. **Cemex** beat expectations, driven by Mexico's domestic market where cement volumes saw double-digit growth.

CORPORATE DEBT

CREDIT

Upbeat momentum on European credit markets led to a 9bp drop on euro 5-year yields from 2.78% to 2.69%. Credit premiums also narrowed slightly with the Main down 1bp to 88.5 and the Xover 6bp lower to 466. Investment grade returned 0.36% over the week (+2.31% YTD) and high yield 0.47% (+5.3% YTD).

In financials, the earnings season kicked off well with asset quality resilience, higher margins and solid capital generation. UK banks had a choppy week after lowering NIM guidance but they remain very profitable. **Deutsche Bank** outperformed thanks to positive indications on future capital generation. Over the week, Euro CoCo spreads tightened by 12bp.

As for non-financial companies, the earnings season has so far reflected an overall economic slowdown and strong performance dispersion. France's payment specialist **Worldline** reported a 4.8% rise in sales but revised down guidance. The share plummeted by close to 60% on the news and the bonds lost 2 points. **Nexity's** third quarter was weak but there was no further deterioration and 2023 guidance was confirmed. Third-quarter sales at **Carrefour** were slightly above expectations and full-year guidance was confirmed. Maisons du Monde reported a 9.4% drop in third-quarter sales as pre-announced on **October** 9 when the company issued a profit warning. Third-quarter results at **Plastic** Omnium were generally in line but they came with a big profit warning for 2023. Air **France**, **IAG**, and **Tap Air Portugal** all posted solid figures thanks to an excellent summer season. **FNAC Darty** had a decent third quarter but still issued a profit warning.

CONVERTIBLES

It was an eventful week for global convertible bonds with specific corporate events: earnings releases, debt buybacks, and primary issuance amid volatile interest rates and equity markets.

In Europe, **Worldline** was in the spotlight. As much as 60% of its market cap was wiped out after disappointing earnings and the firm's decision to drop some of its more high-risk clients. The company's warning of a "macroeconomic deterioration" in core geographical zones like Germany hurt the entire financial technology sector and worries spread to US payment companies as well. The event was more an equity story and not a credit event, with the downside risk from here on being a rating downgrade. The 2025 and 2026 convertible bonds, which were already trading out of the money, dropped 2.5 and 3.5 points respectively. **STMicro's** third-quarter revenue and profit came in 1% and 4% ahead of consensus expectations, but management guided on fourth-quarter sales and gross margins slightly below. On the plus side, the company continues to weather the cycle well, with the automotive segment growing and microcontrollers holding relatively steady, although the company reduced expectations on both revenue and gross margin for the upcoming quarter. **HelloFresh** announced a share buyback programme on the redemption of a portion of its convertible bonds issued in May 2020. The programme will run until December 2024.

In Asia, **Vingroup JSC**, Vietnam's biggest real estate development company, raised $300m with a 2028 maturity, a first step in its move to refinance convertibles due 2026. **SK Hynix's** revenue beat expectations, improving from a slide in the previous three months, but with wider-than-expected losses that raised concerns. The group expects 2024 demand growth for both DRAM and NAND to be in the high teens.

In the US, convertible bond valuations were under pressure due to disappointing big tech earnings and cautious comments on demand for the consumer sector. **Southwest Airlines'** earnings were in line with consensus estimates, but the company is slowing growth plans for next year to adapt to softer demand. Management warned that inflation and higher labour costs were putting pressure on earnings.

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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