EDMOND DE ROTHSCHILD

MARKET FLASH: GEOPOLITICAL RISK MOVES CENTRE STAGE

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The situation in the Middle East has raised geopolitical risk significantly. Markets were only briefly reassured by Joe Biden's visit to Israel and the decision to send two aircraft carriers to the Mediterranean. Leaders in Arab nations cancelled meetings with the US president, choosing to heed their population rather than international calls for talks to take place. Faced with Washington's promise to provide military support to Israel, a move that will worsen the budget deficit just as the support for Ukraine has, the lull on bond markets soon petered out. US 10-year Treasury yields had fallen 20bp in the previous week but rebounded by more than 30bp to flirt with 5%. Two other factors are driving inflation concerns, the US economy's resilience and oil prices which moved back above $90 after Iran called for an oil embargo on Israel.

Retail sales rose 0.7% in September vs. 0.3% expected and August's data were revised higher. Industrial production also rebounded by 0.3% in September when it was seen rising by only 0.1%. The property sector picture, however, is mixed as rising rates feed through. The NAHB confidence index, building permits and sales of existing homes all fell last month but housing starts rebounded.

Inflation in the UK came in at 6.7% over a year in September, or more than expected. Underlying inflation was up 6.1%.The figures appear to show the economy is slowing less than expected.

China also surprised on the upside. GDP rebounded by 1.3% in the third quarter, underpinned by industrial production (+4.5% over 12 months) and retail sales (+5.5%). Beijing's 5% growth target now looks possible again but the flip side is that the good news means there is less need to provide budgetary and monetary stimulus.

Meanwhile, there were several central bank statements ahead of meetings at the end of this month and in November. The most closely anticipated was Jerome Powell's speech to the Economic Club of New York. He said current interest rates were not too restrictive and that another hike would depend on economic activity.

Higher government bond yields and fresh geopolitical risk are having an impact on risk assets. Accordingly, we are now more cautious because of the fraught situation in the Middle East. Any extension of the conflict to Iran could have even more negative consequences on markets. We are sticking to our duration positions as they provide protection.

EUROPEAN EQUITIES

In the previous week, fresh Middle East tension left markets mixed as rising bond yields wiped out earlier gains.

This week, government bond yields moved back to pre-conflict levels. The move was compounded by upbeat economic data in the US, a reflection of stubborn inflation.

Iran's call to impose an oil embargo on Israel, diminishing hopes for strong stimulus in China and some mixed company figures sent the Euro Stoxx to a 7-month low. Property was the hardest hit sector while consumer stocks survived.

Holland's giant semiconductor producer **ASML** said new orders had plunged 42% over the third quarter compared to the previous quarter. The drop was due to economic uncertainty, a trend that is likely to continue in the present quarter. That would mean flat sales in 2024 when analysts are expecting a 4% rise. Unsurprisingly, the stock fell on the news.

Edenred released upbeat results with sales underpinned by strong momentum. Third quarter sales were €634m compared to consensus expectations of €624m. The group is now expecting EBITDA to be in the upper reaches of the €1.02-1.09bn spread announced in July.

In healthcare, **AstraZeneca** fell due to disappointing results from a lung cancer drug trial.

In cosmetics, **L'Oréal's** results were in line despite a slowdown in Asia. Management is still upbeat on the beauty market outlook and its capacity to win market share.

The UK's **Rentokil** fell sharply after a results miss due to poor demand for pest control solutions in the US. Management sees the US market performing less well than expected over the full year but is still confident it can achieve $60m in synergies from its acquisition of **Terminix**.

Rumours swirled in the payments business universe on a possible bid for **Nexi** from **CVC Capital Partners**. The rumours boosted **Worldline** which was trading at a 2016 low but not **Adyen** which is still considered to be too expensive.

US EQUITIES

One week into the earnings season, Wall Street fell as long bond yields rose. Over the last 5 trading sessions up to Thursday evening, the S&P 500, NASDAQ and Russell 2000 lost 1.63%, 2.64% and 1.81%, respectively. Results have so far been slightly better than expected for banks and positive for telecoms.

Elsewhere, weekly jobless claims fell again, moving below 200,000 in another display of labour market resilience. At the same time, new home sales fell to a 2010 low as mortgage rates for 30-year loans rose above 8%.

These mostly mixed indicators left US 10-year Treasury yields flirting with 5%, undermining company valuations. The FED, meanwhile, said recent bond yield rises on markets could reduce the need to raise benchmark rates. Markets are now predicting that there are almost zero chances the FOMC will decide on a rate hike at its next meeting (October 31-November 1st).

Middle East tensions sent WTI oil up 7.86% to $89.38. Confirming its safe haven status, gold rose 5.66% to within striking distance of $2,000, In materials, **Alcoa** slumped 9.89% after its third-quarter results were hit by falling metal and alumina prices. Among steel producers, **Cleveland-Cliffs** (-5.52%), **Nucor** (-2.58%) and **US Steel** (-4.62%) fell after the US and the European Union failed to agree on customs tariffs. The deadline for talks is December 30, after which tariffs will once again be imposed.

In banks, upbeat results failed to get stocks higher despite moderate credit risk provisioning. The outlook for 2024 at **JPMorgan** (-0.36%) and **Citigroup** (-3.54%) is still cautious. Among regional banks, **Zions Bancorp** plunged 8.41% after announcing that deposit account interest had been multiplied by 10 over the last 12 months.

In technology, **Nvidia** tumbled 10.32% after the US unveiled new restrictions on chip exports to China. **Netflix** jumped 11.23% thanks to winning 8.8 million new subscribers -when analysts were expecting 5.5 million- and better-than-expected results from the recent introduction of measures like paying for password sharing.

The Detroit car strike continued as management and unions failed to agree on wages and benefits. **Ford** lost 3.92% over the period and **General Motors** 3.27%. **Tesla** plummeted 14.97% after a third-quarter miss.

Markets will continue to focus on quarterly results and macroeconomic data. Joe Biden and Ursula Von der Leyen were due to meet in Washington on October 20 to talk about steel and aluminium.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX indices fell by 3.27% and 3.34% on Wall Street weakness due to a surge in long bond yields and worries that the Israel-Hamas war might send oil prices much higher.

Mining (+5.25%) and Oil & Coal Products (+0.72%) were the only sectors to rise thanks to stronger commodity prices including crude oil. Elsewhere, Pharmaceuticals tumbled 6.76% led by a sharp fall in **Daiichi Sankyo** (-14.9%) after a US district court in Texas ruled that it had to pay Seagen, a US pharmaceutical company, royalties of 8% on sales of ENHERTU in addition to the $41.8m in damages previously awarded. Rubber Products and Air Transportation shed 5.23% and 5.18% as mounting tension in the Middle East sent oil higher.

Canon (office equipment, imaging systems, medical systems and industrial equipment), rose 3.39% on bargain hunting. In pharma, **Shionogi** gained 2.19% after its partner **AnGes** said there had been good progress in a phase 2 clinical trial for a chronic discogenic low back pain drug. **Kao** (consumer and chemical products), rebounded by 1.85% from the previous week's weakness. Elsewhere, healthcare platform provider **M3** tumbled by another 8,38% as investors ditched large-cap growth stocks. **Panasonic Holdings** (electronic products) fell 7.74% on concerns longer-than-expected inflation and heightened geopolitical tension would hit economies.

The yen was range-bound against the dollar in the 149s, a tug-of-war between expectations the government would step in to support the currency and rising US bond yields.

EMERGING MARKETS

The MSCI EM Index was down 2.2% this week as of Thursday. China (-3.9%) underperformed, followed by Mexico (-3%) and Taiwan (-2.4%). India edged 0.4% higher.

China's third-quarter GDP growth accelerated to 4.9% YoY, beating forecasts and raising optimism about an economic recovery. Retail sales rose 5.5% YoY and industrial output was up 4.5% YoY: both were ahead of estimates. Property sales and new housing starts continued to contract but September unemployment fell to 5%, its lowest level since November 2021. The PBoC maintained both 1-year and 5-year Loan Prime Rates unchanged at 4.2%/3.45%, or in line with market expectations. The US tightened restrictions on China's access to AI-accelerating chips and added 2 Chinese AI chip startups to its trade restriction list. China strengthened export controls on battery-making graphite a few days after the advanced chip ban. 17 listed SOEs disclosed share buyback plans during the week. **CATL**'s third quarter results were in line with expectations; the company said margins in the next quarter would be flat but with better volume. **BYD's** third-quarter results beat expectations on better margins thanks to improved volume, product mix and exports. **Sands China** reported an EBITDA margin of 35.3%, or close to the pre-Covid peak of 36.8%.

In Taiwan, **TSMC's** third-quarter results beat expectations with no further capex cuts, hinting at a smartphone market recovery.

Indonesia's central bank defied expectations by raising its benchmark interest rate by 25bp to 6% after keeping it unchanged for eight consecutive meetings. **BCA**'s upbeat results were in line; loans rose 12% YoY and NIM was flat.

India's wholesale inflation fell 0.26%, the sixth monthly drop in a row. The Prime Minister unveiled a maritime sector blueprint and infrastructure projects with an outlay of Rs 230bn. The government is considering another PLI incentive scheme, after ACC PLI, for batteries to promote electric vehicle adoption. The New Delhi government submitted an EV adoption policy for final approval; the policy warrants a phase wise conversion with a switch to an all-EV fleet by April 1, 2030. Export duty on diesel was lowered to ~$8/b from $10. **Google** will begin production in India of its Pixel 8 smartphones in time to go on sale in 2024. **Suzuki Motor** aims to position its Indian operation as an export hub for electric vehicles. **HDFC** bank beat earnings expectations as lower provisions offset lower NIM. **Ultratech Cement's** quarter was in line and saw volume growth thanks to sustained demand; the company expects further price increases and capacity expansion in the upcoming quarters. **Nestle** India beat expectations on higher margins and also delivered upbeat guidance for the next quarter.

Mexico's Lower House approved a bill to increase concession fees for airport operators from 5% to 9%. **Vesta** reported solid results; management increased guidance for top line growth but said margins would be thinner due to higher costs.

CORPORATE DEBT

CREDIT

It was another difficult week for government bonds and credit premiums. Spreads had been resilient in September but started to weaken this month due to the pressure on corporate refinancing from high interest rates and worries over an economic slowdown. Now geopolitical uncertainty has been added to the mix. Investment grade spreads have widened by close to 10bp to 160bp so far this month and by almost 40bp to 480bp for high yield (+15bp this week alone). The Xover moved to 470bp, its highest level since the middle of March. It was the same story for financial and Euro Coco spreads, now trading at 985bp to call compared to an average of 600bp over the last 5 years.

Yields on Germany's 10-year Bund rose to 2.91% as of Friday morning, up from 2.74% on October 13. US 10-year Treasury yields were at 4.93%, a return to year-to-date highs. They even touched 5% on Thursday.

All this volatility, plus the earnings season blackout, naturally hit new issuance both in the high yield and financial segments. We did, however, subscribe to the new **Santander** Senior 4.625% 2027 4NC3 and the new T2 issue from **Crédit Agricole** at 5.87% due 2033. Of note was the decision by **UBS** to call its AT1 in SGD on November 28. This is a very positive signal from the bank and its treatment of AT1 holders will be closely watched, especially ahead of a heavy new issuance schedule in the coming years. Elsewhere, the first bank results to be posted were strong, and notably those from **Bankinter**, **Bawag** and **Handelsbanken**.

Investment grade fell 0.8% over the period, due to rate and premium shifts, taking YTD gains to 1.8%. High yield was down 0.78% (+5% YTD). Actuarial yields for investment grade were 4.7% and 8% for high yield.

CONVERTIBLES

Markets this week focused on third quarter results.

In the US, **Tesla** missed expectations and reduced sales guidance for the current quarter. The share plunged 15% on the news.

In Europe, Italian payments specialist **Nexi** gained more than 15% over the week on rumours private equity group **CVC Capital** was mulling a bid. **Nexi's** 2027 and 2028 convertibles jumped 3 and 5 points as both have a reimbursement at par clause if the company is taken over.

In ratings news, **Moody's** downgraded **LEG Immo** from Baa1 to Baa2 with a stable outlook. The agency cited rising interest rates, downward pressure on property prices and a market slowdown.

In new issuance, **Taiwan Cement** raised $420m with a green convertible due 2028 and in the US, **Enovis** raised $400m at 4% due 2028 and with a 30% 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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