EDMOND DE ROTHSCHILD

MARKET FLASH: US INFLATION RAISES CONCERNS

• Investors initially focused on the positive sign of a slight year-on-year slowdown in services ex shelter inflation but several Fed officials spoke up to remind markets that rates would continue to rise.

• Equity markets started the week on the front foot but turned lower as investors digested higher bond yields.

• We are cautious on equities and we still like corporate debt but are neutral on duration.

Economic data hogged the headlines, especially in the US where they wrong footed expectations of central bank hikes. Disinflation may be ongoing in the US but prices rose 6.4% in January, down from December's 6.5% but above expectations of +6.2%. Core inflation (ex food and energy) also slipped from 5.7% in December to 5.6% in January but still above the 5.5% analysts had pencilled in.

Investors initially focused on the positive sign of a slight year-on-year slowdown in services ex shelter inflation but several Fed officials spoke up to remind markets that rates would continue to rise. Producer price inflation then came in well above expectations, adding more substance to their comments. At the same time, retail sales rose by a surprisingly high 3% in January, after falling 1.1% in December, and the NAHB confidence indicator rebounded more than expected in February.

Some Fed officials even suggested rates might be raised by 50bp in March. Government bond yields in the US and Europe rose by around 20bp across all maturities. The yield on 10-year US Treasuries returned to 3.9% and the equivalent Bund revisited recent 2.5% highs. Investors also adjusted Fed hike expectations and now expect a 25bp increase at the next three Fed meetings.

Equity markets started the week on the front foot but turned lower as investors digested higher bond yields. European equity markets did better than others thanks to good company results and reassuring messages on trading. In addition, there were a number of announcements of increased dividend payouts and share buybacks.

Markets have stormed ahead since the beginning of the year so we are cautious on equities as rate increases have still not been factored in. We still like corporate debt but are neutral on duration.

EUROPEAN EQUITIES

Equity markets ended the period higher. With more than half of Stoxx Europe 600 results in, the surprises keep on coming and resilience is the key word. 60% of companies beat expectations and by 8.4% on average. The figures were a stark contrast with macro data. Industrial production in the eurozone for December fell 1.1% YoY, or more than the 0.8% drop expected. Indices nevertheless hit record highs during the week. The CAC briefly topped 7,380 and the Footsie broke above the symbolic 8,000 mark.

Tourism (+4%) led gains over the week on upbeat guidance from companies like **TUI** which said reservations were looking good for the coming months. Marriott in the US confirmed the trend. Luxury players **Kering**, **Hermès** and **LVMH** all sounded optimistic notes on Chinese consumption recovering. **Louis Vuitton** is even raising prices by up to 20% in its Chinese outlets. **Hermès** once again posted exceptionally good figures for 2022 but **Kering** was hit by falling sales at **Gucci**. In telecoms, **Orange**'s figures beat estimates. **Renault** followed suit and also raised guidance on 2023 margins beyond expectations. In retail, both **Carrefour** and **Ahold** managed to cope with rising costs and said they were confident margins could be protected. **Nestlé**, however, said it had been unable to pass on all its production cost rises in 2022 and would have to raise prices in 2023. **Pernod Ricard** also intends to raise prices in China and the US but does not expect demand to suffer. Unlike its peers, **Barclay**'s fourth-quarter results were disappointing. Wage costs soared and its investment banking division had a lacklustre quarter.

US EQUITIES

The S&P500 edged 0.22% higher over the period while the Nasdaq added 0.56%. Markets stopped on their upward march after an inflation figure came in slightly above expectations and various Fed officials chose to intervene with hawkish comments.

Consumer prices rose 6.4% YoY, or more than the +6.2% pencilled in by analysts. The Cleveland Fed's Loretta Mester and James Bullard (St Louis) weighed on sentiment by arguing for a 50bp hike in March.

At the same time, various upbeat economic data suggested a soft landing was on the cards. January's retail sales, for example, rose at the fastest pace in 2 years, up 3% MoM after a 1.1% fall in December, and better than the 2% expected. The New York's Fed business index for February came in at minus 5.8, up from minus 32.9 in January and much better than the -18 expected. And the NAHB rose from 35 to 42, its best monthly increase since mid-2020.

Elsewhere, Washington said it would be releasing 27 million barrels of strategic oil reserves after Russia's decision to cut production by 5%.

Since the Inflation Reduction Act (IRA) was passed, $90bn has already been spent on new projects (source: Climate Power). From Ohio to Georgia, investments are piling into energy storage ventures. The IRA's war chest totals $369bn in tax credits and subsidies lasting beyond 2030. Its success has even triggered a wave of IPOs in the sector, already 10 in 90 days, a record since 2017. Only 3 of the 270 IPOs in 2021 concerned this sector.

In results news, **Cisco** jumped 10% after the bell on an earnings beat. The group also revised sales guidance higher and its CEO, Chuck Robbins added fuel to the fire by predicting an excellent 2023.

Excellent results from **Airbnb** (*+13.3%*), **Analog Devices** (*+7.5%*) and **Roblox** (*+26%*) also underpinned sentiment.

In contrast, **Tesla** lost 5.6% after recalling 360,000 vehicles on account of a problem with its autonomous driving software. The National Highway Traffic Safety Administration (NHTSA) claimed the software could cause crashes.

Bloomberg said **Bank of America** was about to follow **Morgan Stanley**, **Citi** and **Goldman Sachs** in cutting investment banking headcount.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX rose 0.41% and 0.81% over the period after a weak start due to rising US bond yields. However, markets recovered towards the end of the period as these concerns receded on the biggest drop ever in expectations for wage growth and the strongest increase in US retail sales in 2 years.

Iron & Steel rose 9.70%, led by **Nippon Steel** (+12.24%), which stuck to its FY2022 earnings guidance and dividend plan. Marine Transportation and Mining gained 4.61% and 4.54%, respectively, on strong US economic data.

Air Transportation and Services fell 2.16% and 2.03%, respectively, on profit taking after strong performance on expectations the number of foreign tourists would rise. Precision Instruments lost 1.79% led by **Olympus** which revised down 2022 earnings guidance.

Nissan Motor jumped 7.85% on a surge in April-December profits due to the weaker yen and better sales. **Asahi** rose 6.24% after the group said full-year net profits in 2023 would hit record highs.

Shimano, a bicycle components maker, slumped 10.25% on a sharp drop in 2023 guidance due to slow sales of high-end bicycle components in Europe. **Shiseido**, a cosmetics maker, fell 5.33% on lower guidance for 2023 due to the weaker yen and higher commodity prices. **Sysmex**, a health care equipment maker, shed 5.20% after disappointing earnings for April-December 2022.

The dollar rose from the mid-131s to 134 against the yen on expectations a higher CPI print would mean rate hikes in the US had further to go. At the same time, the appointment of Kazuo Ueda, an academic and former BoJ board member, to be the bank's next governor, reduced uncertainty on future monetary policy.

EMERGING MARKETS

The MSCI EM Index closed the week flat as of Thursday, China was again unchanged while India rebounded slightly. Both Taiwan and Korea underperformed, down 1.5% and 1.2%, respectively. Brazil rebounded by 2.1%.

In **China**, amid an overhang after some clarification of the balloon incidents, aggregate financing data surprised on the upside in January and was the second highest on record. New RMB loans also hit a record high, beating expectations, largely driven by central bank window guidance, as individual credit demand remained subdued amid weak consumer confidence. New home prices in major cities including Beijing rose in January for the first time in a year, aided by favorable policies and the end of the zero-Covid regime. Domestic passenger flight volume almost returned to 2019 levels during the first week after the Chinese New Year. The authorities continued to approve online games in February, with 87 new licenses including games operated by **Tencent** and **NetEase**. **Ford** will build new battery production capacity of 3.5GWh in Michigan with technology and services provided by CATL.

In **Korea, LGChem** is to invest $75mn to acquire a 5.7% stake in Piedmont Lithium, South Korea's first move to secure onshore ITA-compliant lithium.

In **India**, January's CPI rose 6.5%, or more than the 6% expected, breaching the top-end of the RBI's inflation target. The trade deficit in January fell to below $18bn after a year-long-wait, with both merchandise exports and imports contracting. **Tata**'s **Air India** signed an agreement with **Airbus** and **Boeing** to purchase jetliners, possibly the largest deal in commercial aviation history. Boeing launched its first Global Support Center in India.

In **Brazil**, Lula postponed talks on a new inflation target. The finance minister brought forward the announcement of the new fiscal framework from April to March. **WEG** reported solid results, maintaining outstanding operating performance. **NuBank** reported better-than-expected results, driven by stronger NII and lower expenses. In fast fashion, **Renner** reported weaker-than-already-feared results due to poor sales and higher provisions at **Realize**, its finance arm.

In **Mexico**, **OMA** reported another set of solid results with passenger traffic 9% above 2019 levels while international traffic remained the highlight thanks to the nearshoring trend. The company announced an extraordinary dividend, adding another 2% to its dividend yield. **Vesta**, real estate, also reported strong fourth-quarter results, with EBITDA beating expectations on high occupancy rates. GLA continued to expand sequentially. **Femsa** raised €3.2bn by reducing its stake in Heineken from 14.76% to 8.13%.

CORPORATE DEBT

CREDIT

The bond rally was interrupted by higher risk-free rates. Yields on Germany's 5 and 10-year debt rose by around 20bp over the period. But credit premiums were more or less unchanged at approximately 140bp for Investment Grade and close to 410bp for High Yield. The Xover continued to flirt with the 400bp level. It has traded between 390 and 410bp since the end of January, so has hardly reflected the 80bp tightening since end December.

Higher yields took Investment Grade bonds 0.61% lower over the week (reducing YTD gains to 1.5%). High yield dipped 0.23% over the period (+3.97% YTD). Actuarial yields on Investment Grade and High Yield are currently 4.07% and 7%.

Financial bond performance levelled off after a strong rally since January. Euro CoCo spreads widened by 21bp as investors focused on macroeconomic news. The new issues market was quiet with slightly less appetite for new deals due to smaller issue premiums than early in the year. **Swedbank** sold a USD-denominated AT1 at 7.625% and the order book topped $3.5bn.

There were no new high yield deals. Inflows to both high yield and investment grade remained high.

In company results, **Air France** returned to profit (€500m) in the fourth quarter with operating profits above pre-Covid levels despite a sharp increase in fuel costs.

CONVERTIBLES

It was a very busy week for new issuance. With the end of the earnings season and blackout period, companies began to turn to convertibles to refinance debt or divest holdings.

Europe saw several deals. The German food delivery company **Delivery Hero** raised €1bn to buy back its 2024 and 2025 maturities. The new issue due 2030 will pay an annual interest rate of 3.25% and saw enough investor demand within minutes of launch. **Balder**, the Swedish property developer, raised €500m to extend its debt maturity structure. The company's decision to issue convertibles meets a need to boost its credit metrics amid a rout in the country's real estate market. It will also reduce refinancing risk and reinforce its investment-grade rating.

Towards the end of the week, **Femsa**, the Mexican beverages holding, raised €500m with a bond at 2.625% exchangeable into Heineken stock. The bonds will mature in 2026. This issue reflects the company's move towards simplifying its business structure and the proceeds will go on refinancing debt.

Australia's **Centuria**, an industrial REIT which manages property throughout Australia and New Zealand, raised $300m due 2026.

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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