EDMOND DE ROTHSCHILD

MARKET FLASH: CENTRAL BANKS CAUTION WARRANTED

• First Citizens Bank's purchase of Silicon Valley Bank's deposit and loan portfolios allayed the threat of a systemic bank crisis.

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

First Citizens Bank's purchase of Silicon Valley Bank's deposit and loan portfolios allayed the threat of a systemic bank crisis.

In the US and Europe, authorities were quick to act, rapidly saving Credit Suisse and guaranteeing deposits in failed US banks. The US Treasury Department may have refused to grant a blanket deposit guarantee but it made it quite clear that it would step in to help any ailing institutions.

America's regional banks are nevertheless still fragile and will have to raise interest paid on deposits and tighten lending conditions to stabilise outstandings. This means the Fed no longer has to raise rates by as much to defeat inflation. Traders are now banking on a terminal rate below 5%.

Massive use by banks of discount window/BTFP funding means the Fed's balance sheet has started growing again. This new liquidity injection triggered a rebound in US equities with tech stocks leading the way. It also entailed fresh dollar falls.

Over in Europe, retail sales fell in Germany and France. And yet the strong US labour market and falling energy prices have spared confidence levels judging from upbeat Conference Board data in the US and the IFO rebound in Germany. Japan stands apart with a 6.6% jump in retail sales.

The ECB's job has just got more complicated. Several monetary committee members say rate hikes must go on. They argue that core inflation (ex-energy) is still very high even if the overall figure fell from 8.5% to 6.9% in February due to cheaper energy and a favourable base effect. It even halved in Spain (3.3% vs. 6%) while core inflation resists at 5.7%, still an uncomfortable level.

With lending volumes slowly falling, we believe risk premiums are not at attractive enough levels so we remain cautious on equities and the US in particular. We are, however, upbeat on Chinese equities as they boast attractive valuations in a post-Covid environment. We still like corporate debt and are neutral on duration.

EUROPEAN EQUITIES

Markets recovered after a worrying period due to **Deutsche Bank**'s share price plummeting. Sentiment was boosted by **First Citizens Bank**'s acquisition of some of **Silicon Valley Bank**'s assets. Markets were also lifted by the return of Sergio Ermotti as CEO at **UBS**. Worries that economic growth would suffer lasting effects from the recent financial turmoil gradually receded, allowing highly cyclical sectors to rise.

Meanwhile, inflation in March halved in Spain (3.3% YoY vs. 6%) and in Germany it fell from 8.7% to 7.4% as expected. However, the drop was almost totally due to falling energy prices. Core inflation is still high and is even trending higher.

In company news, **Novartis** had promising results for its breast cancer treatment. Among mounting warnings from consumer companies, **Next** reduced its price increase expectations for the coming months in an attempt to preserve demand. It is the same story at **H&M** but the group has slashed its costs to help it maintain margins. In renewable energy, **Neoen**'s €750m increase of capital was more than one and a half times oversubscribed. **Temenos** (financial software) signed a contract with one of the biggest US domestic banks to modernise its core banking platform. The amount and the bank in question were not disclosed but the contract is likely to be significant for a company the size of Temenos. In semiconductors, **Infineon**, raised its objectives, citing better-than-expected resilience in its industrial and auto end markets.

US EQUITIES

The first quarter of 2023 got off to a flying start before a banking crisis rekindled uncertainties over interest rates and the state of the economy.

The latest weekly jobless claims were more or less in line with expectations (198,000) but GDP only grew by 2.6% instead of the 2.7% most analysts had pencilled in.

Traders are now expecting the Fed to mark a pause in rate hikes at the next FOMC in May and are also hoping for a drop in borrowing costs shortly after. As a result, tech performed well with the Nasdaq around 14% higher over the quarter compared to +5.5% for the S&P 500.

However, Fed officials are making resolutely restrictive noises. The Boston Fed's Susan Collins said on Thursday that rates would have to rise further to defeat inflation. At the Richmond Fed, Thomas Barkin said the Fed would be forced to continue tightening if high inflation persisted. Fed Fund futures are 51% betting on the Fed staying put in May with 48.5% going for a 25bp rise.

In a sign that demand for liquidity is stabilising, banks borrowed $152.6bn from the Fed's two programmes in the week ending March 29, compared to $163.9bn in the previous week.

In company news, the UK's competition watchdog said **Microsoft**'s acquisition of **Activision Blizzard** would not harm fair trading in the video games sector.

The **Apple** developers conference will take place between June 5 and 9. A new virtual reality headset could be unveiled.

Electronic Arts is to lay off 800 people representing 6% of its workforce and a $170-200m charge. The group is also reducing its office space. **Disney**'s redundancy plan began this week: 7,000 jobs are to be axed.

Tesla is to build a battery production facility in Texas in partnership with China's CATL. The White House could express reserves.

JAPANESE EQUITIES

Both the NIKKEI 225 and the TOPIX gained 1.33% for the period although upside was limited even as concerns over systemic risk among financials in the US and Europe abated. Bond yields started to rise again and the trend was influenced by investors unwinding positions at the end of the fiscal year.

Rubber Products rose 4.33% after Japan's largest tyre market Bridgestone upped 2023 earnings guidance and increased its dividend. Transportation Equipment and Air Transportation gained 2.87% and 2.68%, respectively, on bargain hunting after big falls.

Other Financing, Securities & Commodities and Insurance continued lower, dropping 1.02%, 0.80% and 0.76%, respectively, as financials bore the brunt of concerns over systemic risk.

On the plus side, pharma group **Otsuka**, the bank **Resona** and **Mitsubishi Heavy Industries** bounced by 5.77%, 5.38% and 4.90%, respectively, following falls.

M3, a healthcare services platform, and **Z Holdings**, an internet provider, fell 3.78% and 3.43%, respectively, on concerns over prolonged interest rate hikes and a possible economic slowdown. **Japan Post** slipped 2.78% after detaching its dividend.

The dollar rose from the high 130s to mid 132s against the yen after the yen's safe haven currency status weakened and systemic risk concerns receded.

On Wednesday, the prime minister, Fumio Kishida announced that the government would draw up a "new capitalism" plan in June, focusing on wage increases, innovation and efforts to resolve social problems through support for start-ups. Major companies have reportedly concluded their annual labour talks with average wage increases of 3.8% for the next fiscal year, the biggest rise in about three decades.

EMERGING MARKETS

The MSCI EM Index was 1.47% higher as of Thursday, with Brazil (+5.17%) Mexico (+4.15%) and Chile (+4.88%) leading the rally. China, India, and Korea gained 1.15%, 0.35% and 0.71% while Taiwan retreated by 1.16%

In **China**, March manufacturing PMI was 51.9, beating market estimates while non-manufacturing PMI also improved to 58.2 versus 56.3. **CAAM MTD** sold 387,000 electric vehicles in mainland China, +10% YoY and +1% MoM. YTD sales amounted to 1.15m units, +18% YoY. Brazil and China have reached a deal to conduct trade and financial transactions in their own currencies, avoiding the US dollar as an intermediary. **Meituan**'s fourth quarter results beat at the top and bottom line as demand recovered. With Jack Ma's return to mainland China, **Alibaba** is restructuring into six independently run entities. Each unit will be free to manage how it competes and could even arrange fundraising including IPOs. **China Merchant Bank** beat NIM and capital expectations while **Tencent** resumed its buyback programme.

In **India**, **JSW Energy** acquired 1,753 MW of MEIPL's green asset for Rs 10,000 crore. Commerce and Industry Minister Piyush Goyal announced the new foreign trade policy, outlining the vision to take India's goods and services exports to $2 trillion by 2030. The central bank gave **Paytm** an extension to re-apply for a payment aggregator license. Indian banks are set to gain $36bn in deposits as debt funds get taxed under a new policy. Prime Minister Narendra Modi met NXP's CEO Kurt Sievers to discuss ways to strengthen the semiconductor ecosystem, develop a **STEM** workforce and create a start-up ecosystem in

India. The **Adani Group** is seeking to renegotiate the terms of outstanding loans worth $4bn taken out in August last year for the acquisition of its cement assets, **ACC** and **Ambuja Cements**.

In **Korea, LG ES** is to build a W7.2tn LFP (lithium iron phosphate) plant in Arizona. **Micron Technology** results and guidance gave more clarity on the cycle for Korean memory companies – FQ2 (February) was the bottom for data centers, and PC and smartphones are both set to inflect in the second half and capex/capacity utilization is being cut at all DRAM and NAND suppliers.

In **Brazil**, the government presented a new fiscal framework draft. The market welcomed this proposition: having a mechanism to control spending is a good move. March IPCA-15 came in at 5.36% (versus 5.63% in February and 5.33% expected), while industrial activity decreased by 0.3% MoM in January, or in line with expectations. February bank loans decelerated to 12.6% (from 13.6% in January), with government controlled banks at 14% YoY (flat MoM), outpacing private banks. Amid expectations of a new date for President Lula's trip to China, the Brazilian government signalled on Wednesday that partnership agreements would be signed with **Embraer**, **BYD**, and other business giants during the visit.

In **Mexico**, **Banorte** provided positive commentary on business trends in the first quarter and reiterated its bullish outlook for Nearshoring, a potential multi-year growth tailwind.

In **Chile**, the unemployment rate started to deteriorate, increasing expectations for rate cuts in June. The government said it would announce new lithium proposals soon.

CORPORATE DEBT

CREDIT

After **Credit Suisse**'s woes and efforts by hedge funds to pin down the next weak link, markets sought some reassurance, especially in financial debt. **Deutsche Pfandbriefbank** did not call its AT1 April 2023 as expected due to CoCo market stress but investor sentiment improved slightly. Investor worries over **Deutsche Bank** were assuaged after the bank released a detailed analysis of its liabilities and deposit-base granularity. The bank's exposure to US commercial property, an area that markets had identified as the next shoe to fall, is in fact only 4% of outstanding loans.

Premiums to call for Euro CoCos had hit 1,800bp on the day when the Credit Suisse problem emerged, and 1,600bp only a week ago. This week they fell 450bp to 1,150bp. Even so, the market is not yet back to normal and we expect volatility to continue.

High yield premiums on cash bonds tightened to 480bp from 520bp and the Xover followed the same trend to move close to 450bp. Cable company **Nexans** raised €400m at 5.5% due 2028. In a sign of investor appetite, the bond was already trading at 102% two days later. Investment grade premiums tightened by 10bp to 170bp.

As of Thursday evening, investment grade corporate debt had lost 0.7% due to higher risk-free rates. Yields on Germany's 5-year Bund, for example, rose 40bp. Year to date, the segment has returned 1.23%. High yield bonds gained 0.63% over the same period, taking YTD gains to 2.55%.

Actuarial yields on investment grade and high yield are currently 4.25% and 7.5%, still good entry points for carry strategies.

CONVERTIBLES

It was a good week for global convertible bonds on the back of more stable bond markets and rising equities. Tech led the market higher after **Alibaba** announced spin-off plans and the semiconductor sector outperformed following upbeat forecasts from **Micron** and **Infineon**.

The renewable energy space was also stronger after **SolarEdge** said it saw no signs of US residential demand slowing down.

The primary market remained active. Two renewable energy equipment companies, **TPI Composites** and **STEM**, issued their first convertibles. STEM sold a green convertible bond with the proceeds to be used on optimising software capabilities in green energy systems.

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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31/03/2023

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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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