MARKET FLASH: GEOPOLITICAL TENSIONS INTENSIFY

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• External inflation, from energy and supply chain problems for example, continued to wane but core inflation is proving stickier, especially in the eurozone where it continues to accelerate.

• We have raised our cautious take on risk assets by a notch and increased exposure to money market funds and we are still upbeat on corporate debt and neutral on duration.

Geopolitical tensions mounted and the dollar rose ahead of the first anniversary of the beginning of the Russo-Ukrainian conflict. Joe Biden and Vladimir Putin accused each other of being responsible for starting the war. Moscow suspended its participation in the START programme (reduction and limitation of strategic offensive nuclear arms). China reaffirmed its unwavering support for Russia but called for talks to stop the war degenerating into an international conflict. The UN voted in favour of a non-binding resolution (141 votes for, 7 against and 32 abstentions, including China and India) reaffirming Ukraine's territorial integrity and urging Russia to withdraw its troops.

Elsewhere, the property sector suffered the aftermath of monetary tightening. Construction in Europe fell 2.5% in December. Sales of existing homes in the US have plunged 40% since their January 2021 highs and house prices have fallen 3.6% since their June 2022 peak.

However, PMIs moved back into expansionary territory in the US, Europe and Japan thanks to a rebound in services. Manufacturing stayed in negative territory with new orders still on a down trend. The European Commission's consumer confidence indicator rebounded further in February but is still at very depressed levels.

External inflation, from energy and supply chain problems for example, continued to wane but core inflation is proving stickier, especially in the eurozone where it continues to accelerate. As long as labour markets remain buoyant, central banks will stay restrictive to avoid a wage/inflation spiral. The ECB's Isabel Schnabel and the FOMC minutes reminded markets that the tightening cycle was not yet over and that core inflation trends would remain in focus. What's more, economic activity is still strong because of budgetary support measures and China's reopening.

Kazuo Ueda, who will become governor of the Bank of Japan in April, is expected to stick with his predecessor Haruhiko Kuroda's monetary policy. He told Japan's parliament that the bank would have to continue with monetary easing to underpin the economy and create the conditions for companies to increase wages.

Risk premiums have mechanically contracted further due to advanced economies proving resilient and persistent inflation, a possible source of more price rises. This leaves little room for any earnings disappointment. Due to strong GDP growth data and wage inflation, we have raised our cautious take on risk assets by a notch and increased exposure to money

market funds where returns are high enough, pending any new data that might lead us to change our stance on equities and credit. We are still upbeat on corporate debt and neutral on duration. In government bonds, we prefer eurozone debt to US Treasuries.

EUROPEAN EQUITIES

Indices were unchanged over the period thanks to encouraging guidance from companies and results that were less downbeat than feared. February's PMI backed up the prevailing optimism: the eurozone's composite index rose from 50.3 in January to 52.3 but with a bigger contribution from services than manufacturing. The data are reassuring but will also encourage central banks to continue tightening for some time to defeat underlying inflation and ease labour market conditions. The Bank of France's governor said that investors were overreacting on future rate hikes.

Elsewhere, gas prices fell back below €50/MWh despite Vladimir Putin's aggressive comments. At this level, the price is equivalent in final energy terms to oil prices so the switch should end.

In company results, results at **Stellantis** swept past expectations. The group also announced an ambitious share buyback programme. However, management sounded a cautions note on the outlook as pressure on margins is on the horizon. Vehicle equipment supplier **Forvia** (ex-Faurecia) reassured investors on its outlook. The group will be hit by higher wage and energy costs this year but hopes they will be offset by reduced commodity inflation. UK supermarket chain **Tesco** raised wages by 7%, the third increase in 10 months, due to persistent labour market tensions. **Danone** reassured investors on its pricing power as sales held up despite several price increases.

E-commerce group **Zalando** is to lay off hundreds of people due to less buoyant consumer discretionary prospects. Oil group **ENI** disappointed investors with its new shareholder return policy. Just like **BP**, the group has decided instead to boost investments in production.

US EQUITIES

US indices registered sharp falls over the last 5 trading sessions up to Thursday with the S&P 500 down 3.26% and the Nasdaq 3.98% lower. Sentiment turned negative on fears of future monetary policy moves after manufacturing and services PMIs beat expectations and hit 8-month highs.

The FOMC minutes showed the bank's determination to fight inflation was still intact.

Weekly jobless claims came in at 192,000 or less than the 200,000 estimated, a strong indication that the labour market was still thriving. But fourth-quarter GDP growth was revised down from an initial 2.9% to 2.7%.

In contrast, retailers reported generally disappointing results, triggering concerns over consumer appetite. **Walmart** and **Home Depot** both lost more than 7%, sending indices much lower.

The VIX volatility index jumped 8% to levels not seen since mid-December as risk aversion returned.

Elsewhere, **McKinsey** is to lay off 2,000 mainly support staff in one of its biggest ever redundancy plans.

In a gesture to the competition authorities, **Microsoft** agreed to give **Nintendo** access to its *Call of Duty* game for 10 years should its $75bn acquisition of Activision Blizzard go ahead.

Intel slashed its dividend to its lowest level in 16 years to preserve cash and focus on a recovery plan.

Netflix cut subscription rates in more than 100 countries, mainly in low-income regions or those with fewer subscribers.

In semiconductors, **Nvidia** jumped 13% on a results beat and improved guidance. Demand has accelerated for chips used in AI and second generation search engines like **ChatGPT**.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX fell 2.14% and 1.29%, respectively, after US bond yields rose on higher-than-expected US producer prices and weakness on Wall Street as growth stocks including tech sold off.

Rubber Products, Iron & Steel and Pulp & Paper rose 5.23%, 4.01% and 3.07%, respectively, as investors moved into value and commodity stocks on prospects of strong global growth.

Electric Appliances, Precision Instruments and Services fell 3.90%, 3.54% and 3.32%, respectively, led growth stocks amid higher interest rates.

Bridgestone jumped 5.02% on solid FY2023 earnings guidance and a higher dividend. **Asahi** added 4.53% on upbeat FY2023 guidance and strong performance from its European peers. **Nippon Steel** added 3.76% thanks to its high dividend yield and rosy prospects for global growth.

Tokyo Gas tumbled 6.95% after cutting its payout ratio from 50% to 40% in its mid-term business plan. **M3**, a healthcare platform provider, fell 6.88% despite the announcement of a dividend increase for 2022. **Dai-ichi Life** was down 5.39% on profit taking due to prevailing uncertainties about the BoJ’s monetary policy under its new governor.

The dollar remained strong, up from 134 to around 135 yen, on expectations US rates would continue to rise for some time amid resilient US economic data.

EMERGING MARKETS

The MSCI EM Index closed the week 1.2% lower as of Thursday’s close. China and India led the decline, down 1.6% and 2.3%, respectively. Brazil was relatively flat while Taiwan and Korea continued to outperform.

In **China,** geopolitical tensions returned after the meeting between US Secretary of State Anthony Blinken and China's Foreign Minister Wang Yi failed to yield constructive results. President Biden visited Ukraine, while Wang Yi went to Russia, where the Chinese consul called for a ceasefire between Russia and Ukraine through a 12-point proposal. Meanwhile, China is launching a pilot programme for real estate private equity investment funds to support the property market. Chinese tech companies are not allowed to offer **ChatGPT**-like services without official approval. **JD.com** announced a promotional campaign worth RMB 10bn ($1.5bn) to compete against budget e-commerce player PDD, while **Alibaba** 3QFY23 results beat expectations, with multiple segments recovering. **NetEase**'s fourth-quarter earnings slightly missed on a one-off royalty payment, but core competence remained intact, and **Baidu**'s results also beat expectations on effective cost control.

In **Korea,** the central bank paused interest-rate hikes for the first time in a year after producer price inflation slowed to its lowest in two years. **LG Chem** is reportedly to acquire a partial stake in **Nippon Denkai**, a Japanese EV copper foil manufacturer, to improve control of its supply chain.

In **Taiwan, Delta Electronic** said its double-digit CAGR growth target remained unchanged for the coming years thanks to its strong EV business.

In **India**, exports of solar panel shipments hit an all-time high of $171m, nearly all of which was for buyers in the US. **Tata Motors** signed a deal to supply 25,000 electric sedans to **Uber** India. The G-20 Summit in India kicked off with a focus on debt restructuring for Pakistan, Sri Lanka, and Bangladesh.

In **Brazil**, the government decided to resume charging fuel tax in March. Fourth-quarter results at **Mercado-libre** were better than expected, with accelerating GMV growth in Brazil and Mexico. In **Mexico**, fourth-quarter results at **FUNO** were in line. Its industrial portfolio remains the best performing asset class and the main driver.

On the **supply-chain-relocation** front, **Vedanta** and **Foxconn** announced a joint venture to set up the first semiconductor manufacturing facility in Gujarat, India.

CORPORATE DEBT

CREDIT

The pause in the bond rally continued for a second week as investors reacted to higher risk-free rates. Yields on Germany's 10-year Bund returned to 2.5% after dipping to 2% in January. Credit premiums widened slightly, both for bonds and synthetic indices. The Xover rose by 25bp over 3 days to flirt with 425 before retreating to 410 on Friday morning. High yield premiums rose by around 15bp to 425bp while investment grade stayed around 140-15bp.

Over the period, investment grade bonds shed 0.22%, taking YTD returns to 1.35%. High yield fell 0.43% (+3.35% YTD). Actuarial yields for investment grade were 4.15% and 7.15% for high yield, still attractive entry points for carry strategies.

In financials, Euro CoCo premiums rose 50bp. However, **Monte Paschi** raised €750m with a 3-year senior bond at 6.75%. Problems at **Credit Suisse** continued to mount: FINMA, the financial markets watchdog, launched an enquiry into the CEO's "over-reassuring" comments ahead of the increase of capital. The bank's junior bonds lost 2-5 points over the period.

CONVERTIBLES

The US new issues market was active, with nearly $5bn new bonds priced. Two integrated utilities **PPL** and **Southern Company** raised $900m and $1.5bn due 2028 and 2029, respectively. In both cases the proceeds will be mainly used to repay outstanding debt. **Liberty Broadband Corporation** priced $1.1bn in exchangeable bonds into **Charter Communications** stock in a deal intended to repurchase its outstanding 2046 and 2050 securities. **ON Semiconductors** announced a new $1.1bn 2029 convertible to repay outstanding debt.

The new deals kept the market active in addition to earnings-related trading. In the headlines was **Palo Alto Networks** whose shares jumped 13% after raising its outlook for the year and forecasting better-than-expected operating margins.

In Europe, earnings reports were the main drivers, with upbeat results for **Amadeus** and **IAG** in the travel sector, and **BE Semi** and **STM** in the semiconductors space.

In Asia, trading was brisk in consumer sector companies after **Alibaba**'s earnings report.

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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24/02/2023

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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

332.652.536 R.C.S. Paris