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MARKET FLASH: STAGFLATION OR TRANSITION?

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Initially, First Republic Bank's poor results -massive outflows coupled with a promise to sell around $100bn in assets- sent bond yields lower. At one point, markets were expecting a 75bp cut to the Fed's rates by the end of 2023.

All US economic data point to growth slowing, whether regional Fed surveys (Richemont, Chicago and Philadelphia), consumer confidence indicators or the sharp contraction in durable goods offers (ex-defence and transport). In addition, US first-quarter growth slowed to only 1.1%, when 1.9% was expected, admittedly due to massive destocking.

However, the resilient labour market and a rebound from 4.4% to 4.9% in the Fed's preferred core inflation indicator in the first quarter rapidly reversed the trend on bond markets. In spite of major monetary tightening, the US consumer has still not stopped spending and US tech company results are still robust.

All this is likely to make the Fed's job more complicated when it meets on May 2-3. The ECB is facing the same problem amid increasing wage pressure. Germany's public sector workers, for example, have secured a 11% rise. And yet, comments from central bank officials this week were clearly accommodating. Sweden said rate increases would soon be over and Czechia and Hungary both opened the door to a rate cut.

In Japan, the new BoJ governor is even sticking with the bank's ultra accommodating, negative-rates and yield curve control policies. He hopes wage increases will push inflation up to around 2% before considering a return to normal conditions.

We have moved from negative to neutral on the dollar, mainly because US yield curve inversion has gone too far but also because the dollar has recently uncoupled from interest rate movements.

With lending slowly deteriorating, risk premiums do not look attractive enough to us and we would suggest caution on equities, especially in the US. We remain upbeat on corporate debt and are taking advantage of rising government bond yields to gradually reinforce duration.

EUROPEAN EQUITIES

Markets edged lower over a week full of earnings reports. The ECB made relatively hawkish noises. Looking beyond the short term economic outlook, board member Fabio Panetta said geopolitical tensions and less globalisation could lead to inflation lasting. The IFO, Germany's business climate index, edged higher from 93.4 to 93.6 in a sign that industrial demand was picking up.

In company reports, **Philips** (healthcare equipment) reported upbeat results as easier supply conditions helped it meet its bumper order book; margins also improved after a massive redundancy plan. In pharma, **Novartis** raised guidance thanks to a strong increase in volumes that management expect to last. In consumer staples, both **Nestlé** and **Danone** showcased strong pricing power with excellent figures. **Pernod Ricard**, however, was more impacted by slowing demand although management is optimistic for the end of 2023. **AB Foods**, **Primark**'s parent company, suffered from falling household purchasing power.

European tech companies released downbeat reports. Results were satisfactory at **ASM** and **Dassault Systèmes** but ASM's reduced order book and a slowdown in software licenses suggest both sectors could be facing a bigger challenge than expected as the cycle turns down. After the plunge in electricity prices in the first quarter, profits at **TotalEnergies** fell 27%. The group is to sell its oil sands activities in Canada. In hotels, **Accor**'s results beat expectations and the group is more optimistic on REVPAR in 2023. In the luxury sector, **Kering**'s disappointing results, especially in China and North America, set it apart from its rivals.

US EQUITIES

US indices moved in line with company earnings reports. On Thursday, the S&P 500 jumped 1.96%, its biggest daily rise since the beginning of the year. Investors cheered results from companies like **Meta/Facebook** (+13.9%), **Eli Lilly** (+3.7%), **Honeywell** (+4%) and **eBay** (+5.1%). **Meta** rocketed 11% after an earnings beat on the back of rising ad spending.

In sharp contrast, **Snap** (Snapchat's parent company) plunged 20% after the bell due to a first-quarter sales miss despite a rise in user numbers. The company gave no guidance.

Microsoft soared 9.7% on better-than-expected earnings. The group's cloud business made a big contribution but the stock was also bolstered by management's confidence in future contributions from artificial intelligence. However, the chances of the group buying video-game maker **Activision** look unlikely after the UK's competition watchdog opposed the acquisition.

Alphabet also beat expectations thanks to a rebound in ad revenues but the stock failed to shine due to more nuanced comments from management on IA solutions.

Amazon ended up dipping 1% in after-hours trading after jumping 11%. The group said revenue growth had slowed in its AWS cloud division from 16% in the first quarter to 12% in April.

Intel was up 5% in extended trading following upbeat remarks from management on profitability in the second half of 2023. The group sees margins rising on a production ramp-up and the end of destocking. **Texas Instruments** fell on soft guidance for the current quarter. Due to lower parcel volumes, **UPS** expects annual revenues to be at the low end of forecasts ($97-99.4bn), or below the $98.1bn pencilled in by analysts.

Destocking was chiefly responsible for first-quarter GDP growing by a disappointing 1.1% or much lower than the 1.9% expected. Consumer spending was up by a robust 3.7% YoY, a boost for those who think a soft landing is possible. However, prices rose by 4% QoQ, up from 3.9% in the previous quarter, and above the 3.7% expected. Weekly jobless claims slowed markedly to 230,000, or below the 248,000 expected.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX fell 0.70% and 0.35% over the period as concerns over banks hit Wall Street and investors worried about global growth. The yen also edged higher.

Construction, Electric Power & Gas and Real Estate rose 3.21%, 1.51% and 1.33%, respectively, as economic uncertainties pushed investors into defensive domestic demand stocks. Marine Transportation and Iron & Steel fell 5.52% and 3.67% as value stocks sold off. Securities & Commodities Futures tumbled 5.29% on financial market worries.

Defensive plays **Tokyo Gas** and **Daiwa House Industry**, a construction company, jumped 6.98% and 6.54%. **Canon** gained 5.91% after 2023 guidance came in above market expectations. **Shimano**, a bicycle parts maker, tumbled 10.74% after company guidance for this year missed market expectations significantly. Investment bank **Nomura** plunged 7.74% after a big drop in 2022 earnings. **Sumitomo Metal Mining** shed 5.40% due to soft commodity prices and profit taking after the recent rally.

The dollar slipped from the high 134s to high 133s against the yen on concerns over a possible global slowdown due to a credit crunch, especially in the US.

The Japanese government is bringing forward the lifting of its current Covid-19 border control measures, originally planned to end on May 8, to this Saturday in anticipation of an increase on foreign tourists during the Golden Week holidays.

EMERGING MARKETS

The MSCI Emerging Market index was down 0.9% as of Thursday’s close. With the return of geopolitical noise, India (+2%) outperformed while China, Korea and Taiwan all lost around 2% in USD. Brazil and Mexico slightly outperformed other regions but remained in the red.

China had another busy week for geopolitical developments: Olaf Scholz invited Chinese Premier Li Qiang for talks in Berlin while Xi Jinping had a ”long and meaningful” phone conversation with Volodymyr Zelensky. China’s politburo sent a pro-growth message on Friday, saying China’s economic recovery needed continued fiscal and monetary support for the coming quarters. So far in the first quarter earnings season, most results have been upbeat with more positive forward guidance from listed companies. Earnings at **Anhui Conch Cement** were better than expected on higher volumes even after subdued demand due to lower new starts. At **Ping An Insurance**, NBV growth recovered across all channels, rising 20% YoY. **China Merchants Bank** saw lower NIM and fee income, but a gradual year-on-year improvement is expected.

In **Korea**, **SK Hynix** reported weak first-quarter results as expected while management sounded confident about a second-half recovery and expects double digit QoQ bit growth in both DRAM and NAND, marking an inflection point for the memory segment. Results at **LG Energy Solutions** came in above expectations, with the benefit of Won 100bn from the Advanced Manufacturing Production Credit in its US capacity.

In **India**, the state of Gujarat announced a capital restructuring policy for all state public sector units starting FY24. This could mean higher cash returns for shareholders and an increase in investment. Rural wage growth continued to improve, rising 6% to a 30-month high as new housing starts hit a 9-year high. **Adani** ports will purchase up to $650m in debt using cash reserves in a bid to shore up investor confidence. Fourth-quarter results at **ICICI Bank** were upbeat thanks to decent volume growth and better NIM. EBIT at **Maruti Suzuki** rose 8.1%, the most in 18 quarters, and the group unveiled another 1 million unit capacity addition.

In **Brazil**, retail sales dipped 0.1% sequentially in February. **WEG**'s first quarter showed a softer top line offset by strong margin expansion.

In **Mexico**, exports increased to $53bn in March, the highest amount ever in a single month and a sign that nearshoring is booming. Total exports increased by almost 7% in the first quarter, with 90% from manufactured goods. **OMA** (airports) announced a solid set of results on the back of strong traffic growth. First-quarter results at **FUNO** (REIT) were in line with expectations, with healthy fundamentals in all key verticals.

In **Chile**, the government delivered its long-awaited lithium development policy in which the state will partner with companies in projects to tap more of the world's biggest reserves of the battery metal.

CORPORATE DEBT

CREDIT

In a low-volatility week, credit premiums widened a little, taking investment grade to 162bp (+5) and high yield to 479bp (+12). However, 5-year Bund yields fell 16bp to 2.36%.

Returns over the week were more or less flat with investment grade up 0.09% and high yield 0.13% lower, or +1.67% and +2.93% since the beginning of the year Actuarial yields for investment grade were 4.2% and 7.3% for high yield, still good entry points for carry strategies.

On a persistently dynamic new issues market for high yield, **Loxam** raised €300m at 6.375% BB- due 2028, **Cheplapharm** €425m at 7.5% BB- due 2030, and **Benteler** €525m at 9.375% due 2028. We subscribed to all three and they were largely oversubscribed, another sign that investors are hungry for spread issues.

In financial debt, subordinated issues fell throughout the week, mainly due to rekindled worries over **First Republic Bank** in the US. AT1 calls by **UniCredit** (UCGIM 6.625 EUR) and **Lloyds** (LLOYDS 7.625 GBP) lifted sentiment at the end of the week.

Insurance groups are actively managing their debt, witness two exchange offers and a new Tier 2 issue from **NN Group** and **Ethias** European banks continued to report excellent figures with margins boosted by higher rates, modest or zero deposit flight, and an almost imperceptible drop in asset quality. Details on exposure to risky areas like commercial property have so far reassured investors. In other words, there is no sign of a downturn and management are not expecting any serious deterioration.

CONVERTIBLES

Significant risk apathy persisted in global markets this week as we headed into the busiest week for earnings reports; 43% of S&P 500 companies were due to report. The convertible universe remained in neutral mode as the month end approached with no issuance. Deals in April should be close to $3bn. Historically, May is the biggest month for new issues.

In company news, **STM** plunged by close to 9% despite a strong first quarter and a slight increase in guidance. Markets were concerned about demand from the key automotive sector and bearish analysis from both management and peers (**WolfSpeed** plummeted by around 20% on Thursday). The **Cellnex** board proposed Marco Patuano as new CEO (he was chairman in 2018-2019 and CEO of TIM). In the US, **Enphase Energy**'s first quarter beat expectations in all metrics but, due to weaker domestic demand, management guidance for this quarter was 5% below consensus and the shares cratered 25% on Wednesday.

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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