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MARKET FLASH: RATE-PROOF ECONOMY?

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• The situation in the US is not as thorny but core PCE has not fallen as much as expected and the ISM prices paid index has started rising again.

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

Disinflation started to appear at the end of September but is starting to run out of steam. In Europe, the trend has even reversed. Inflation is running at 9.3% in Germany, 6.1% in Spain and has accelerated to 7.2% in France. Core inflation in Europe even hit a new high at 5.6%, making the ECB's task more complicated.

10-year inflation expectations for Europe jumped to 2.6%, or 15bp higher than in the US, a token of investor wariness over the ECB. The bank will have to regain credibility so will most probably have to go for 50bp hikes at its next two meetings.

The situation in the US is not as thorny but core PCE has not fallen as much as expected and the ISM prices paid index has started rising again. There is nevertheless some room to fall further due to the lag in taking rental trends into account.

10-year US Treasury yields moved above the key 4% level while terminal rates hit 5.4% in the US and close to 4% for the ECB.

Against this backdrop, the new Bank of Japan governor's optimism that inflation will naturally fall back to 2% was surprising. He will find it hard to avoid some easing in the bank's Yield Curve Control policy.

Growth data are much more mixed. Worsening manufacturing ISM in the US and France point to a recession but services and retail sales suggest activity is accelerating again.

Some of this global resilience is due to China's reopening. Manufacturing PMI in China hit a fresh 10-year high and equity markets jumped 5%.

We, however, think that business conditions and company margins will gradually suffer from the end of massive budgetary stimulus and the lag in monetary policy transmission.

With such persistently high inflation and rising terminal bond rates, we believe risk premiums are not at sufficiently attractive levels so we are cautious on equities and the US in particular. We did, however, reinforce Chinese equity exposure following the market's 10% correction. We are upbeat on corporate debt and neutral on duration.

EUROPEAN EQUITIES

Sentiment was mixed over the period. First, eurozone economic sentiment slipped from 99.8 to 99.7 in February, or well short of the 101 expected. Reduced business confidence in manufacturing and services was primarily the cause but at the same time there were signs of a sharp slowdown in the outlook for factory gate prices. In addition, provisional inflation data in the eurozone cast serious doubts on any hopes for a rapid decline. Inflation in France, Spain and Portugal rebounded by 0.9%, 1% and 0.3% in February. What's more, core inflation (ex-energy and food, the ECB's preferred gauge) actually accelerated due to services. The data, as chair Christine Lagarde pointed out on Thursday, all add support to ECB monetary committee members wanting to tighten further

Two themes stand out, labour markets and pricing power.

The Franco-Swiss temping agency **Adecco** said the jobs market had been slowing for several months. The group's results for the fourth quarter were sharply lower and hiring has continued to slow since the beginning of the year, usually a harbinger of a fall in economic activity to come. As for pricing power, luxury sector companies are apparently still impervious to a slowdown. Both **Moncler** and Aston **Martin** said the outlook for 2023 was much better than expected. **Moncler** is betting on resilient demand and a rebound in China while **Aston Martin** is hoping for a boost to profitability based on its pricing power. The world's biggest brewer **AB InBev** also has pricing power. Fourth-quarter sales missed but the group's profitability was better than expected. In contrast, **Beiersdorf** sees demand slowing this year after an exceptional 2022. Nevertheless, the group plans to continue increasing prices, a move that will put the brakes on demand but improve profitability. Management added that sales in China had recovered strongly in February. In stark contrast, poor pricing power at **Puma** has led management to expect a very complicated 2023. Increased demand in China will not be enough to offset high commodity, transport and marketing costs.

Elsewhere, **Casino** and **Ocado** both reported disappointing figures. Higher inflation is pushing customers towards hard discount outlets. There was sharply diverging guidance among logistics companies: **Kuehne+Nagel** is very optimistic but **Hapag-Lloyd** sees its profits collapsing in 2023. In chemicals, **Evonik** said the outlook was clouded. As with **BASF** last week, big companies in the sector are cautious on 2023 results and neither lower energy prices nor a Chinese rebound are likely to make a difference.

US EQUITIES

The S&P 500 ended in negative territory this week and was down 0.77% as at Thursday close in a volatile market backdrop. Investors' sentiment surveys continue to point to a more bearish stance (the AAII bull-bear spread shows the most negative reading since December). Investors remain concerned on the potential downside risk to earnings, deteriorating liquidity and flow dynamics, as well as rising geopolitical tensions. Market participants continue to look at future interest rates hints from Central bankers. Fed's Atlanta President Bostic said on Thursday that he favored a 25 bp hike, flagging recent stronger than expected economic data: Unit labor costs were revised higher for Q4, February ISM manufacturing was largely in line but prices-paid component moved back into expansionary territory after four months of deceleration. Pending home sales for January surprised to the upside. Swaps market now show expectations for additional four rate hikes through July, bringing the peak rate to 5.50-5.75%.

On the corporate front, the WSJ reported that **Pfizer** would be in early talks to acquire biotech company **Seagen** for more than $30bn. Seagen is developing antibody-drug conjugate and has already 4 products approved on the market.

The Q4 earnings season is coming in its final stage with 95% of companies having reported in the US. EPS growth was sequentially much lower than Q3 with companies seeing contraction in earnings on a year on year basis. Last week many retailers released their Q4 reports with a fiscal year ending in January. For most, the outlook remains very cautious with **Target** mentioning that it would take 2 years to get back to Pre Covid operating margins level and **Lowes** in the DIY segment mentioning that growth is completely stalling. Some positive surprises came from department stores **Macy**'s and **Nordstrom** which published better early spring sales than expected and lower markdowns.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX gained 1.46% and 0.98%, respectively, on a rebound on Wall Street and comments from the future BoJ governor that the bank would remain accommodating.

Cyclicals like Electric Appliances, Machinery and Real Estate rose 2.82%, 2.78% and 2.58%, respectively, on expectations of strong global economic growth.

Electric Power & Gas and Pharmaceuticals fell 2.93% and 2.37%, respectively, in a switch from defensives into cyclicals. Securities & Commodities Futures declined 1.31% on lower equity trading volumes and scant investment banking deals.

SMC, a factory automation devices maker, jumped 7.19% on stronger-than-expected February Manufacturing PMI in China. **Ajinomoto**, a food company, gained 7.02% after revising up guidance on FY2022 net profits and the group's decision to cancel treasury stock and introduce a progressive dividend policy. **Tokyo Electron**, a semiconductor manufacturing equipment maker, advanced 5.02% after the Philadelphia Semiconductor Index (SOX) rose and news of the construction of a state-of-the-art chipmaking factory in Hokkaido by Rapidus, likely to cost JPY 5 trillion. **Chugai Pharmaceutical**, **Kansai Electric Power** and **Nitori Holdings**, a furniture and interior goods chain store, shed 6.20%, 5.21% and 4.41%, on profit taking and less interest in defensives.

The yen weakened from 135 to around 137 against the dollar on expectations of a wider interest rate gap between the US and Japan. The Fed is expected to continue tightening due to resilient US economic data.

EMERGING MARKETS

The MSCI EM Index had gained 0.9% as of Thursday's close. China and Mexico led the recovery, up 2.7% and 3.2% respectively. Taiwan was more or less flat while Brazil retreated by 2.3%.

China's manufacturing PMI came in at 52.6 in February, up from 50.1 in January, and its highest reading in 10 years. Non-manufacturing PMI also rose to 56.3%, beating expectations. The Chinese authorities unveiled a national plan to develop the country's digitisation industries. In property news, China is to introduce 17 new measures to expand financing for home rentals. **Haidilao** issued a positive profit alert after efficient cost reductions. Fourth-quarter earnings at **Li Auto** beat consensus and its sales target for the first quarter of 2023 was also ahead of expectations. **NIO** missed on fourth quarter results due to a lower gross profit margin but management remained confident it could double volumes in 2023. **Tencent** set up a team to develop a ChatGPT-like product.

In **Hong Kong**, rules on wearing facemasks both indoors and outdoors are set to be scrapped. **Techtronic** results were in line and management offered solid clarification after the recent short report.

In **India**, services PMI saw its largest expansion in 12 years. India's GDP growth slowed to 4.4% in the fourth quarter, although growth for 2021/22 was raised to 9.1% from 8.7% as part of an earlier revision. **Foxconn** Chairman Young Liu met Indian Prime Minister Narendra Modi to discuss India's tech and innovation ecosystem. The meeting was followed by the announcement of Foxconn's plan to invest $700m in India to ramp up local production. **Adani Group** stocks rallied sharply on Friday after Florida-based GQG Partners invested nearly $1.9bn.

In **Brazil**, non-annualised real GDP for the fourth quarter fell 0.22% QoQ or more or less as expected and the government announced a partial reversal of fuel tax exemptions as well as new levies on oil exports. **Meli** reported upbeat results while **Weg** announced a new investment in Brazil to build a factory to increase production of lithium-based battery packs.

In **Mexico**, nominal credit grew by 13% YoY and 0.6% MoM in January. Employment in January rose by 2.82 million (5.1% YoY) and by 2.49 million (4.3% YoY) for the economically active population. Salaried employment rose 5.4% YoY. Mexico's President said **Tesla** would be building its next giga-factory in Monterrey (Northern Mexico). The investment runs to $5bn.

CORPORATE DEBT

CREDIT

Strong persistent core inflation and economic activity continued to drive expectations of further central bank tightening. Yields on US Treasurys gained 11bp while the equivalent Bund added 15bp. Even so, credit premiums were unchanged over the period.

Investment grade yields were running at 4.4% and at 7.3% for high yield. The Xover oscillated between 400-420bp.

In financials, new issue momentum led to three new CoCo deals. **Barclays** raised £1.5bn at 9.25%, **HSBC** $2bn at 8% and Spain's **Caixabank** €750m at 8.25%. CoCo spreads showed resilience by tightening by 10bp over the week. Fourth-quarter bank results remained upbeat with strong margin growth at **Banco Comercial Português**, **Permanent TSB** and **Ibercaja**.

Despite interest rate volatility, high yield spreads proved highly resistant, largely due to inflows easily exceeding new issuance. Israeli pharma **Teva** (BB-) refinanced 2bn-worth of 2025/2026 bonds with USD and euro tranches, €800m at 7.375% due 2029 and €500m at 7.875% due 2031. The deal's attractive premium ensured heavy demand and the bond also traded higher on the secondary market.

CONVERTIBLES

In a very active week for global convertibles, most of the activity was driven by a strong primary market.

After last week's remarkable new issuance in the US, it was Asia's turn to catch-up: **Iqiyi**, the Chinese video and entertainment company, raised $600m at 6.5% over 5 years to refinance debt. Shortly afterwards, **Wynn Macau**, the hotel and casino operator, raised $600m at 4.87% due 2024. The proceeds will go on reducing annual interest expense and lengthening its debt maturity. The deals went down well as 2023 is expected to be a year of recovery with the loosening of travel restrictions between China, Hong Kong and Macau and strong pent-up consumer demand.

Convertible issuance is currently being driven by two main factors: coupon savings compared to straight bonds and attractively priced call options for investors.

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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