EDMOND DE ROTHSCHILD

MARKET FLASH: THE FED STAYS HAWKISH

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With the July 4 holiday in the US and the second quarter earnings season imminent, it could have been a quiet week. Instead, volatility resurfaced on both equity and bond markets as advanced indicators unsettled investors.

First, manufacturing data missed expectations. In the US, manufacturing ISM fell to 46. In the eurozone, it was revised down to 43.4 due to weakness in Germany (40.6) and Italy (43.8). In China, it fell back to 50.5. The same falls were also seen in services in China and in the eurozone. The big surprise was China where services PMI fell from 57.1 to 53.9 in June. Initially, equity markets rose on assumptions these figures would result in Beijing rolling out stimulus measures. And better news on inflation like ISM Prices Paid suggested central banks would find it easier to mark a monetary tightening pause.

But the Fed minutes changed the picture: the bank will remain rather restrictive due to excessive inflation and a red hot jobs market. As it now looks certain that the Fed will hike by 25bp in July, US Treasury yields duly rose. Weekly employment data and ADP private sector job creations were both stronger than expected and bond yields returned to March highs. Nevertheless, Friday's jobs report showed a bigger-than-expected slowdown in job creations in June, 209,000 down from the revised 306,000 for May and less than the 230,000 expected. The unemployment rate fell from 3.7% to 3.6% as expected. Services ISM in the US beat estimates. Interest rate volatility rebounded and equity markets fell. Falls on Wall Street were limited but Europe underperformed over the week.

Overall, we are somewhat cautious on risk assets. We still like duration, mainly in Europe where the ECB's rate hikes are already factored in. But in the US, investors are struggling to recognise that the Fed might raise rates again after this month's move.

EUROPEAN EQUITIES

European equities tracked US equities lower due to data which suggested there was more monetary tightening to come. And yet, Europe's definitive PMIs moved into negative territory this week amid a fall in inflation which should normally indicate a more relaxed approach to monetary policy. However, the trend in the US seems to be weighing more in the balance.

Market falls are also to be seen in the context of the worsening situation in Ukraine with the possibility that the Zaporizhia nuclear power station might come under attack. Elsewhere, Saudi Arabia and Russia said they were to extend output cuts. Oil prices rose on the news.

Ahead of the second quarter earnings season, company news remained upbeat. New car registrations in France rose 11.5% in June due to a boom in electric vehicle sales. Sweden's **Volvo** saw its sales soar 33% in the same month. Tourism is also thriving. Both **Ryanair** and **Wizz Air** said traffic in June was sharply higher. In fact, Ryanair said it was its best month ever as far as passenger numbers were concerned.

US EQUITIES

Wall Street gave back some of the gains made at the beginning of the week when private sector jobs creations came in at 497,000, or more than double the 225,000 estimated. Markets took this to mean the Fed would remain restrictive.

Nerves were also frayed by Services ISM rebounding from 50.3 to 53.9 in June, its 6th rise in a row. Analysts had pencilled in 51.2. The VIX volatility index surged 9% to a month high of 15.44. WTI oil prices rose 2% to $71 after Saudi Arabia and Russia decided to cut output further. OPEC was due to meet in Vienna on Friday July 7.

McKinsey said shortages in metals required in the transition push would undermine the move to electric, wind and solar power. The report recommended raising investment in mines and refineries from $3 to 4 trillion, a 50% increase on the preceding decade. Bitcoin gained 2.64% to a 13-month high after BlackRock's CEO referred to it as “digital gold”.

Facebook launched Threads, a rival to Twitter, in 100 countries. Europe was not included due to data protection rules. The app has no advertising yet and 30 million people signed up on its first day. **JP Morgan**, **Morgan Stanley**, **Wells Fargo** and **Citigroup** gained ground after passing the Fed's stress tests. **Fidelity National Information** sold a majority stake in Worldpay to a private equity consortium.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX ended the week 1.39% and 0.83% lower after the FOMC minutes wiped out hopes for a rate cut this year and global equity markets tumbled on weak US June PMIs. The yen also stopped sliding. And yet indices had started the week on the front foot due to an upbeat June Tankan survey and a weak May PCE reading in the US.

Marine Transportation added 7.13%, as investors continued to shift from value to growth. Insurance and Banks gained 1.86% and 1.72% on the Fed's hawkish tone. **Daichi Life**, for example, gained 4.87%. On the other hand, Pharmaceuticals fell 4.62% led by **Daiichi Sankyo** after a disappointing trial result for its antibody-drug conjugate (ADC) for lung cancer. **Chugai Pharmaceutical** also lost 6.57%. Precision Instruments shed 2.97% on concerns about a possible global slowdown. Land Transportation lost 2.90% on profit taking.

Z Holdings, an internet platform provider, jumped 6.71% on news that it was considering switching from Google's search engine to its South Korean parent company Naver. **Nissan** advanced 4.85% on the weaker yen. **Japan Exchange Group** plunged 7.18% on profit taking after the equity market rally seemed to have peaked. **Terumo Corp.**, a manufacturer of medical supplies, declined 5.20% on slowdown worries.

The US dollar was traded in the 144s as traders eyed possible government intervention. The government had already stepped in at these levels.

EMERGING MARKETS

The MSCI EM Index had consolidated slightly by 0.2% as of Thursday. India (+0.8%) led gains. Korea edged 0.3% higher while China finished down 0.5%. Brazil and Taiwan retreated by 2.2% and 1.2%, respectively.

In **China**, the Caixin manufacturing PMI moderated to 50.5 in June from 50.9, and services PMI also decelerated to 53.9 from 57.1 in the previous month. On the geopolitical front, the US Treasury secretary Janet Yellen is visiting China, aiming to recalibrate ties between the two countries. The Chinese government imposed restrictions on exporting Gallium and Germanium that are crucial to the semiconductor, telecommunications and electric-vehicle industries. This represents an escalation of tit-for-tat responses to mounting technology export restrictions in the US and Europe. China's state banks are offering local government financing vehicles 25-year loans and temporary interest relief to ease tensions in the $9 trillion debt market. **Ant financials**, Alibaba's fintech arm, is reportedly to be fined at least RMI 8bn ($1.1bn), a move which may turn the page of regulatory scrutiny. The authorities released a "Renewal of Negotiated Rules on National Reimbursement Drugs List" draft, providing a more moderate renewal rule for innovative drugs. The new regime is viewed as strong policy stimulus for innovative drugs. June EV sales surprised on the upside: **BYD** had record second-quarter sales and **Li Auto** led the way among EV startups. **Nio** and **XPeng** deliveries also picked up. **Moderna** signed an agreement to invest $1bn in China for R&D and manufacturing mRNA medicines.

In **Korea**, June exports dropped 6% YoY, their slowest pace this year. **Foreign Direct Investment** rose 54% YoY to a record high in the first half, driven by EU and UK investors. Preliminary second quarter guidance at **Samsung Electronics** was slightly higher than market consensus thanks to improving memory-market conditions and solid mobile earnings.

India's Manufacturing PMI in June came in at 57.8, the second highest figure this year. According to the Centre for Monitoring the Indian Economy (CMIE), new investment projects announced in the second quarter moderated sequentially but remained 10% higher than in 2022. June two-wheeler sales in rural and urban areas rose 19% and +8% YoY, respectively, but electric sales decelerated after a government subsidy cut. **Tractor** registrations rose 34% YoY thanks to better trade terms for farmers and favourable crop prices. **Bajaj Finance** said loans had risen by a robust 32% YoY, or ahead of market expectations.

In **Brazil**, the lower house approved the first round of tax reforms. They aim to simplify the tax system by introducing VAT. The government also announced a tax reduction for cross-border purchases for goods under US$50 (C2C and B22C). Manufacturing PMI declined to 46.6 from 47.1 in May. The Chinese carmaker **BYD** is to set up a large production plant in Brazil for a total investment of $600m.

In **Mexico**, **OMA** said air traffic had risen by 14% in May. Mexico's **Viva** signed a preliminary deal for 90 Airbus A321 jets.

In **Chile**, the central bank said interest rates could go down soon. Elsewhere, according to Economy Minister Nicolas Grau, existing contracts with SQM and Albemarle will be respected and any change must be made by mutual agreement. The new lithium bill will be sent to Congress at year end. **SQM** signed a new long-term purchase agreement with **LG Energy Solution** for 2023 2029, more than doubling the initial volumes agreed.

CORPORATE DEBT

CREDIT

Interest rates jumped in the US and Europe after surprisingly strong US jobs data. On Thursday, rates in Europe gained 15bp over the session. Yields on the 10-year Bund soared to 2.62% on Friday morning from the previous week's close of 2.39%. In the US, 10-year Treasury yields broke above 4%, rising from 3.84% to 4.03% over the week. At the same time, credit premiums for investment grade companies held up well and tightened by 5bp to 155bp. High yield also tightened slightly to 440bp but the Xover widened to 426bp as markets became nervous.

Returns naturally reflected these developments. Investment grade lost 0.57% over the week, taking YTD gains to +1.45% due to higher yields. High yield edged 0.10% lower as its shorter sensitivity shielded it from rate rises but was still up 4.26% year to date. Actuarial yields for investment grade were 4.5% and 7.6% for high yield, still good entry points for carry strategies.

After a becalmed June, the high yield new issues market started to stir with the following deals: **Profine** B 9.375% 2028, **Avis Budget** BB- 7.25% 2030, **Cirsa** B 7.875 % 2028.

Euro CoCo premiums were more or less unchanged around 860bp but interestingly **Abanca** raised €250m at 10.625% call 2028, the third such deal since the Credit Suisse collapse (Bank of Cyprus and BBVA had previously had issuers). Big AT1 issuers had already refinanced in the first quarter before the Credit Suisse affair but these deals augur well even if they are still relatively small as they will help lift uncertainties over upcoming calls.

CONVERTIBLES

Rate moves and equity volatility were in focus during the week. One of the most interesting news items was Beijing's announcement that it would impose export restrictions on two key rare earth metals used in making semiconductors and other electronic products. Semiconductor companies such as **Wolfspeed** and **NXP Semiconductors** traded higher. The news fuelled volatility in the sector following the Dutch government's decision on the previous Friday to prevent **ASML Holding NV** - a company with a near-monopoly on the machines needed to make the most advanced semiconductors - from selling some of its machines to China. Wolfspeed also benefited from an agreement with **Renesas** for a 10 year silicon carbide wafer supply contract. In the US, **Rivian**, the automotive technology company, rallied after delivering the first Amazon electric vans in Europe and beating quarterly production expectations. The primary market was muted during the week in all regions.

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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