EDMOND DE ROTHSCHILD

# MARKET FLASH: ACKNOWLEDGING DISINFLATIONARY FORCES

***• The Fed raised rates by 25 basic points to 4.75% and said further hikes would be needed***

***• The ECB said there were persistent inflationary pressures with another 50 basic points rise to come in March***

***• We continue to prefer corporate debt to equities and in fixed income, we like total return carry strategies***

**The shift in what central banks said counted for more than what they actually did. As expected, the Fed raised rates by 25bp to 4.75% and said further hikes would be needed. However, during his press conference, Jerome Powell acknowledged that the US was in a disinflationary process that might lead to a soft landing and soon warrant a pause in the bank's tightening cycle.**

**The about turn in phrasing sent interest rates tumbling and markets soaring. This looming monetary policy shift led us to position ourselves for yield curve steepening (5-year rates falling more than 30-year yields).**

**The Bank of England also referred to deflationary pressures in developed economies and said it would proceed cautiously given the weak economy. The market immediately anticipated the end of the tightening cycle and yields on 10-year gilts fell 30bp.**

**True, the ECB said there were persistent inflationary pressures with another 50bp rise to come in March but it failed to convince markets that it was determined to remain restrictive.**

**The latest macroeconomic data in the US showed wage inflation decelerating to an annualised 4.1% and a drop in PMI confidence figures. The US labour market is proving particularly resilient with redundancies in the tech sector largely offset by hirings in tourism. This has led to contradictory messages between the Job Openings and Labor Turnover Survey (JOLTS), which is sharply higher, and ADP data which point to a significant slowing in job creations.**

**Elsewhere, company results have been slightly below expectations but management is lowering guidance, particularly in tech and especially at Apple and Alphabet.**

**Central banks are pivoting but the economic cycle is worsening so we continue to prefer corporate debt to equities where we favour emerging markets rather than the developed zone. In fixed income, we like total return carry strategies. In government debt, we prefer the US to the eurozone.**

## EUROPEAN EQUITIES

Unsurprisingly, the ECB raised its benchmark rate by 50bp to 2.5%, its highest level since 2008. Chair Christine Lagarde said another 50bp was scheduled for March but she refused to be drawn on what would happen afterwards. The rise, along with a 50bp hike from the Bank of England, encouraged hopes that the rate tightening cycle was nearly over. Equity markets then made strong gains on Thursday. Hopes were underpinned by inflation falling from an annualised 8.9% to 8.5%, a quicker slowdown than expected. GDP growth was also slightly above expectations even if driven by an improvement in the foreign trade balance. Consumption remained depressed due to strong inflation.

In bank news, **Santander** reported upbeat results and **UniCredit** had its best results in 10 years and raised shareholder returns by €1.5bn. However, others like **UBS**, **ING** and **Deutsche Bank** preferred to remain cautious for 2023. In tech news, France's software company **Dassault Systèmes** jumped after excellent 2022 results. The picture in healthcare was mixed with disappointing results at **Roche** but with guidance in line and more resilience from **Novartis** in its fourth quarter. Unlike Tesla and Xpeng, **BMW** is to raise prices for certain models sold in China, citing higher commodity and logistics costs. The decision reflects the need to reconcile volumes and profitability at a time of rising inflation amid an economic slowdown**.**

## US EQUITIES

It was an eventful week with close to a third of S&P500 companies reporting and central banks commenting on their monetary decisions.

The Fed's Jerome Powell was less hawkish than in the past. He said the bank had made progress in its fight against inflation and that the disinflation process had begun. But he added that further rate rises would be needed in the coming months. The markets chose to focus on the chance for a soft landing, especially as more and more economic data seem to be getting worse. The ISM came in at 42.5, household confidence was lower than expected and wages rose 1% QoQ, or less than analysts had foreseen. The Nasdaq soared 1.7% in its best January since 2001.

Nonetheless, companies and especially tech giants, sounded notes of caution. **Apple**, **Amazon** and **Alphabet** all reported a slowing in demand for consumer electronics, e-commerce, cloud computing and digital advertising.

**Apple** had its softest Christmas season in 4 years due to supply chain issues and poor iPhone and Mac sales. It was the first time since 2015 that Apple had missed fourth-quarter expectations. **Amazon** highlighted slower consumer spending and softer AWS cloud computing expenditure, previously a strong growth driver. **Alphabet** was hit by a drop in fourth-quarter spending on advertising. AI search engines will be a core focus of the group if it wants to compete with ChatGPT.

Other disappointments concerned **Electronic Arts**, down 10% after a game launch was postponed, and **Snap** (-16%) on a slump in fourth-quarter advertising and its first-ever warning that future revenues would be down.

In sharp contrast, **Meta Platforms** staged an impressive rally. Facebook's parent company rocketed by 20% thanks to a $40bn share buyback and an aggressive statement from CEO Mark Zuckerberg on expectations for an improvement in profitability in 2023.

## JAPANESE EQUITIES

The NIKKEI 225 edged 0.14% higher and the TOPIX fell 0.67%. Upbeat news like global interest rates peaking, China's reopening and the Bank of Japan's persistently accommodating stance were offset by worse-than-expected results from Japanese manufacturers and the stronger yen.

Electric Power & Gas rose 3.81%, led by **Tokyo Gas** and **Chubu Electric Power**. Electric Appliances gained 0.89% as investors bought semiconductor manufacturing equipment makers after a sharp rise in the Philadelphia Semiconductor Index (SOX). Pulp & Paper rose 0.81% on expectations the stronger yen would push down commodity costs.

Mining and Oil & Coal Products fell 4.24% and 4.12%, respectively, due to softer commodity prices. Pharmaceuticals lost 4.13% as defensive sectors were hit by profit taking.

**Tokyo Gas** and **Chubu Electric Power** jumped 9.46% and 9.23% on softer LPG and crude oil prices and a surprising upward revision in earnings guidance for 2022. **Tokyo Electron**, a semiconductor manufacturing equipment maker, gained 4.26% after the SOX index was released.

**Ajinomoto**, a food company, and **Chugai Pharmaceutical** fell 7.98% and 5.45% on profit taking in among defensives. **East Japan Railway** shed 5.52% after fourth-quarter quarter earnings fell short of market expectations.

The yen strengthened from 130.22 to 128.66 against the dollar after Fed Chairman Jerome Powel's post-FOMC comments which were not as hawkish as expected.

## EMERGING MARKETS

The MSCI EM Index closed the week unchanged as of Thursday's close, with Taiwan and Korea outperforming, China flat and Mexico and Brazil slightly down. India (-1.5%) again underperformed due to worries over the **Adani group**.

In **China**, January's manufacturing and services PMI made a strong comeback at 50.1 and 54.4 respectively, vs. 47 and 41.6 in December. Beijing said Covid-related clinic visits had peaked in December 2022. The CSRC is planning a full registration-based IPO launch, which could be a major milestone in China's capital market reforms. Shanghai and Zhejiang, along with some other provinces, announced new policies to support EV use or investment in EVs and the EV supply chain. The 50 cities' second home prices index turned positive sequentially, the first MoM rise in 17 months. Hainan's duty-free sales were up 20% YoY for the first 5-days of China's new year holidays. Japan and the Netherlands are poised to join the US in limiting China's access to advanced semiconductor machinery. **Baidu** is reportedly launching an AI tool in China in March similar to ChatGPT. **CATL** reportedly aims to raise $5bn in a Swiss GDR listing.

In **Korea**, 2022 earnings at **LG Chem** came in below expectations as weakness in petrochemicals offset growth in battery materials. **SK Hynix** announced a net loss for the fourth quarter due to sharp declines in revenue and memory prices. The company sees demand recovering in the second half of this year but has stuck with its capex cut plan. Fourth-quarter operating profits at **Samsung** were in line, with stronger display and mobile profits offset by weaker memory profits. But capex will be flat in 2023 versus 2022.

**India** unveiled a $550bn budget, one of its biggest ever increases in capital spending, to boost economic growth and job creation while aiming to lower the fiscal deficit before next year's elections. **Adani** pulled its $2.5bn FPO despite it being oversubscribed. January personal vehicle sales rose more than 20% in volume, helped by a low base. **Tata** and **M&M** delivered 18% and 65% YoY growth, led by strong traction in recent launches. Titan's 3QFY23 results were in line with expectations. Management remains optimistic for near and medium term jewelry demand.

**Brazil's** Real strengthened to its highest level since June after the central bank kept interest rates on hold and expressed concerns about rising inflation expectations (2024). **Santander Brasil** reported a significant miss (45% below eps consensus), due to higher provisions, most likely related to Americanas. Loan growth was also weaker than its peers.

In **Mexico**, fourth-quarter GDP was up 0.44%, taking the overall rise in 2022 to 3%. Worker remittances reached $5.36bn in December, or more than consensus expectations. Foreign Affairs Minister Marcelo Ebrard said **Tesla** would soon announce a new investment in Mexico.

On the **supply-chain-relocation** front, **Jabil**, an Apple supplier, began shipping components for AirPods from India to China and Vietnam, marking a significant step for Apple in its supply chain diversification initiative

## CORPORATE DEBT

### CREDIT

Corporate debt saw excellent returns as prices rose and credit premiums contracted. Between Monday and Thursday, investment grade returned 1.2%, taking year-to-date gains to 3.4%. High Yield has returned 4.3% since January 1st, with 1% in the previous week alone.

It was also a good week for financial bonds. Fourth-quarter reports remained strong thanks to higher interest rates. **Santander** and **BBVA**, in particular, announced strong results. And **Raiffeisen** ended 2022 with a creditable 13.5% in CET1 after writing down its exposure to Russia. Positive news and more reassuring comments from central banks sent subordinated financial bonds higher. Euro CoCos in particular gained 1.35% over the period with spreads to call tightening by 60bp. Interest in new issues also revived. Greece's **Alpha Bank** raised €400m with an AT1 at 11.875%, a very aggressive level which boosted all high yield peripheral country bonds.

In the High Yield segment, the mood was also upbeat with the Xover breaking below 400bp for the first time since April 2022. The new issues market was buoyant and last week we saw **Stena**'s BB-rated bond at 7.25% due 2028 and **Foncia**'s B at 7.75% due 2028.

### CONVERTIBLES

Trading was active, driven by company earnings and a busy primary market.

Earnings reports were, however, more challenging, with names In Europe like **Sanofi** declining after forecasting a slowdown in profit growth. In the US, **Ford**'s fourth-quarter profit disappointed as growth slowed in the emerging EV segment. Similarly, in the tech sector, **Bill.com** surprised the market with macro-driven weakness in its customer base.

New issuance continued to be active in all regions. In Europe, **Rheinmetall**, the German defence and engineering group, raised €1bn with a dual tranche issue, one at 1.875% due 2028 and the other at 2.25% due 2030. In the US, **Integer Holdings**, a medical device manufacturing company, raised $435m in senior convertible notes at 2.125% due 2028. In Asia, the Singaporean investment company **Straits** raised SGD 370m with an exchangeable bond into **ESR Group**, a Hong Kong property and logistics company.

**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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