EDMOND DE ROTHSCHILD

MARKET FLASH: CENTRAL BANKS LOOK SET TO TIGHTEN FURTHER

• In the US, macroeconomic data are still excellent but company reports show demand slowing

• In the eurozone, PMI surveys show that the worst has been avoided

• We are taking profits on equities after the strong rally seen in recent weeks and remain upbeat on government debt and credit

With inflation in the US and Europe slowing and activity still highly resilient, markets extended gains. Macroeconomic data are still excellent but US company reports, from Microsoft and 3M for example, show demand slowing and reduced profitability due to pressure on margins. Banks are expecting default rates to rebound but from still very low levels.

The US grew by an annualised 2.9% in the fourth quarter thanks to household consumption. Nevertheless, a slowdown looks likely in 2023 as the property market is falling. Consumption is also running out of steam as it came in below expectations and company restocking made a positive contribution. Budgetary policy will no longer be able to stimulate growth as the $31.4 trillion debt ceiling was hit on January 19. Pending Congressional approval to raise the ceiling, the federal government is going to have to rein in spending to avoid a default. Democrats are expected to vote down a Republican proposal to change the debt ceiling from a fixed dollar amount to a percentage of national economic output. They argue that it would be pro-cyclical, increasing government spending during the good times and retrenching when times are difficult.

In the eurozone, PMI surveys show that the worst has been avoided. A rebound in wind farm energy production has helped avoid shortages thanks to windy weather returning to the UK. And some nuclear power stations are now back on stream in France. Budgetary stimulus has also postponed the expected slowdown in consumption. Gas prices have halved in the last month so inflation fears should ease as energy accounts for half of price indices. Production prices are still falling back.

To justify slowing the pace of rate hikes, the Fed and ECB would have liked to see some signs of worsening activity and softer labour markets ahead of their meetings in the week to come. We expect them to sound more hawkish as a way of offsetting easier financial conditions following recent market rises. Japan has seen confirmation of inflationary pressures and they are set to continue due to wage increases. The Bank of Japan's accommodating stance is looking increasingly anachronistic and ill-adapted. Haruhiko Kuroda's successor as governor will have to normalise monetary stimulus, starting with negative interest rates and more flexibility in its yield curve control approach.

We are taking profits on equities after the strong rally seen in recent weeks. The Fed and ECB meetings should reiterate their focus on fighting inflation and we expect earnings reports from US tech giants to show sales and margins normalising. We remain upbeat on government debt and credit.

EUROPEAN EQUITIES

Equity markets resumed their upward march after the previous week's pause, underpinned by prospects for a soft landing amid falling inflation. Last year's pessimism over the eurozone now looks overdone after a rebound in January's PMI. However, there are increasing indications of a recession in the UK. Composite PMI fell in January, hitting a low not seen since January 2021 and sending sterling lower.

With more and more results coming in, the picture is surprisingly good overall but companies are cautious over the outlook. Sales and margins at **STMicroelectronics** were particularly good. The group sells to a number of cyclical industries so the figures are a token of the global economy's resilience thanks to strong demand. In the luxury sector, **LVMH** expects to continue on the same growth trajectory as in 2022. Sales in Europe, the US and the Japan rose sharply thanks to strong local demand and a recovery in international travel while Asia was stable due to China's sanitary situation. Travel group **TUI** said demand for premium travel had risen significantly this month; reservations are already higher than in the pre-pandemic period.

The outlook for consumer spending is less buoyant. According to Associated British Foods, its parent company, **Primark** reported robust sales over Christmas but said trading could suffer from shrinking consumer purchasing power in 2023.

For the first time, the UK's National Grid activated a mechanism to reward households who had cut back on heating as a new cold spell hit Europe. It is also worth noting that many companies prefer not to give guidance on like-for-like growth given today's macroeconomic uncertainties. Signify is just one example.

US EQUITIES

Recent macroeconomic data have been mixed with signs of a steep slowdown, especially in the property sector. In stark contrast, nominal fourth-quarter GDP was better than expected, thanks to consumption and inventories. Over the last five trading sessions up to Thursday, the S&P500 gained 4.1% and the Nasdaq 6.1%

Investors focused on hopes for an end to the monetary tightening cycle ending and the chances of a soft landing. Fed fund futures are now 99% expecting a 25bp rise when the Fed next meets on February 1st.

Meanwhile, the labour market is still very strong, despite layoffs in the tech sector, for the moment restricted to Microsoft, Google, Amazon, Salesforce and Spotify.

More than 25% of S&P companies reported over the week and there were fewer and smaller beats than usual.

Growth at **Microsoft** was the lowest in 6 years (+2%), with a sharp deceleration in its cloud business. The group confirmed that it was investing $10bn in OpenAI which is behind the Chat GPT artificial intelligence engine. CRM software leader **Salesforce** gained 3% on news that the activist Elliott Management fund had taken a stake. Defence is one sector which is not in crisis: fourth-quarter EBIT at **Raytheon** and **Lockheed Martin** was up 127% and 7%.

Tesla jumped 7% after the EV manufacturer's profits beat expectations and management said it was looking to deliver 1.8 million vehicles this year. Analysts view this guidance as cautious as new factories in Berlin and Austin should increase capacity from 2023.

AT&T gained 6% on an earnings beat even if guidance for 2023 fell short of Wall Street's estimates. According to Bloomberg, the US Justice Department is about to probe into Google's parent company **Alphabet** for abuse of a dominant position in online advertising.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX ended the period 3.63% and 3.28% higher on expectations interest rates had peaked (especially in the US), China's reopening and the Bank of Japan's decision to stick with accommodating monetary policy.

Iron & Steel and Mining gained 6.78% and 4.70% as commodity prices continued to rise. Precision Instruments rose 5.20% on China's reopening. All sectors rose over the period.

Suzuki Motor jumped 11.51% on hopes for excellent 2023 results after annualised quarterly profits at its Indian subsidiary Multi Suzuki more than doubled. **Oriental Land**, which operates theme parks and hotels, added 7.92% on expectations visitors would increase when Tokyo lowers Covid-19 to flu status. **Mitsubishi Electric** gained 7.91% as investors moved into cyclicals after China reopened. **M3**, a healthcare platform provider, fell 2.41 % on profit taking.

The yen traded between 129 and 131 against the dollar as US and Japanese interest rates fluctuated.

The head of Rengo, Japan's largest labor union, and the chairman of Keidanren, Japan's Business Federation), the largest business lobby, met on Monday to start wage talks. Both parties agreed on the need for significant pay rises to offset high inflation. Rengo said it would be targeting a pay increase of around 5 percent in this year's talks, its highest demand in 28 years. According to Rengo, average wage increases in last year's talks were 2.07%.

EMERGING MARKETS

The MSCI EM Index ended the week flat as of Thursday's close, with most Asian markets closed for the Lunar New Year. Brazil (+4.4%) outperformed while India (-1.6%) underperformed.

In **China**, domestic hotel and entertainment bookings exceeded pre-covid levels. Hainan duty free sales also recovered, rising 20% YoY for the first 5-day holiday. **BYD** is reportedly in talks with **Ford** to acquire its German plant in what would be a big step overseas for China's electric-car industry. China is also to resume overseas group tours organised by travel agencies or OTA for Chinese citizens to selected destinations starting from February 6.

South Korea's fourth-quarter GDP fell 0.4% sequentially, as exports declined, marking the first contraction since the start of the pandemic. **POSCO Chem** got government approval to export technology used in producing cathodes, a key component in EV battery cells.

In **Thailand**, the central bank raised its key rate by 25bp to 1.5%, or in line with expectations, as the Thai economy continued to gain traction thanks to tourism. Inbound tourists hit 11 million in 2022, or above expectations. The government is targeting 25 million foreign visitors in 2023, of which 10 million from China.

Indonesia's foreign direct investment surged 44% YoY in 2022, led by base metals, mining, transportation, warehousing and telecommunications.

In **India**, the **Adani** group of companies plunged after US investor Hindenburg Research published a short report, accusing them of market manipulation and accounting fraud. **ICICI Bank** reported better-than-expected 3QFY23 results thanks to margin expansion and moderation in expense growth. **Axis Bank** also announced strong results, beating forecasts on higher NIM. Reliance Industries reported strong earnings led by the O2C division**. Maruti Suzuki** had better than expected results driven by a mix improvement and moderation in commodity price inflation.

In **Brazil**, January's mid-month IPCA-15 inflation came in at 0.55% MoM, or slightly above market expectations. However, core inflation missed. The Brazilian real continued to benefit from higher iron ore prices (reflecting China's reopening) and attractive carry as Brazil has one of the highest real interest rates among emerging markets. Talks between Americanas and its creditors continued to dominate the retail market. We expect **MercadoLibre** to benefit from Americanas' collapse after reports of accounting inconsistencies.

In **Mexico**, upbeat results at **Banorte** were in line, showcasing sold NII and better-than-expected loan growth. The company's low earnings guidance for 2023 was in line with consensus expectations.

On the **supply-chain-relocation** front, **Tesla** plans to invest $3.6bn on expanding its Nevada gigafactory. **Texas Instruments** accrued an additional $350m related to CHIPS investment tax credits, taking them to $400m overall. Japan Machine Tool's monthly export orders to India saw a surge in December 2022, soaring 175% YoY to a record high.

CORPORATE DEBT

CREDIT

The trend remained upbeat but markets paused after the New Year rally. Credit premiums were around 440bp for high yield and 150bp for senior investment grade. But spreads on more junior banking debt tightened with Euro CoCo premiums down 40bp to 640bp thanks to robust results. Interest margins at Spain's **Sabadell**, for example, rose 11% in 2022 while earnings were 35% higher. And its CET1 remained at a solid 12.5%.

The black-out period meant little new issuance among financials. However, high yield issuers seized the opportunity of calm markets and narrower premiums. After Telecom Italia and Tereos in the previous week, **Verisure** issued a 2028 maturity at 7.125% and **Italmatch** a 10% bond also due 2028. We subscribed to both.

Between Monday and Thursday, investment grade bonds returned 0.11%, taking year-to-date gains to 2.3%. High yield rose 0.2%, or 3.15% since January 1st.

CONVERTIBLES

It was a good week for convertible bonds as equity and credit markets rallied. Company specific news dominated flows this week ,mainly in Europe and the US.

In Europe, among the main movers was **LVMH** with its shares hitting record highs, driven once more by performance at its core fashion business. **STM** offered a better-than-expected sales outlook with first-quarter and full-year sales ahead of consensus estimates despite a slowdown in the broader semiconductor industry.

On a more negative note, **Remy Cointreau**'s shares fell as results indicated slowing US demand for premium spirits amid high inflation and weaker economic growth.

In the US, airlines were in focus: **Southwest Airlines** jolted the market with results that came in well below expectations despite a guidance update at the beginning of the month. In contrast, **American Airlines** sounded an upbeat note as it expects profits this year to exceed estimates based on the industry recovery stretching into 2023, with demand driven by work and personal trips.

On the primary market front, **Borr Drilling** raised $250m over 5 years at 5% and with a 32.5% premium. Some of the proceeds will go on refinancing its outstanding S350m convertible bond due May 23 2023.

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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