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MARKET FLASH: THE BURDEN OF PROOF CHANGES SIDES

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Central banks in the US and Europe are now not so keen to start cutting rates. With inflation still running above target and labour markets on form, they have all warned of the risk of acting too soon. The chances of a March rate cut are now running at 20%, down from 70% only a month ago. After the ECB meeting on January 25, markets were 70% betting on an April move but the odds have now fallen to less than 40%.

Bond markets fell while equity markets brushed off the news, preferring to focus on earnings. This equity-bond market decorrelation marks a break as both markets had been marching in tune since the end of 2021. Investors will now be scrutinising inflation data and they expect to see some easing. But if inflation were by chance to turn higher, any rise in bond yields would necessarily hit equity markets where risk premiums are now very low. In a sign of ongoing disinflation, production prices have fallen by 10% YoY in Europe and 2.5% in China. On the other hand, SLOOS (Senior Loan Officer Opinion Survey on Bank Lending Practices), the Fed's quarterly survey, said that lending conditions had eased after a few quarters of tightening.

Indices are hitting new records mainly because of star performers like high-quality blue chips: they have significant cash hauls which means immunity to interest rate movement and they have also posted upbeat results. Companies with the heaviest debt burdens are obviously the most sensitive to interest rate shifts. European company results pale a little in comparison to US reports, a reflection of the gap in economic growth between the two zones. In 2023, sales in cyclical sectors fell 5% compared to a 4.5% increase in the US. Sales in defensive sectors slipped 1.5% (+7.5% in the US).

The week also saw a rebound on Chinese equity markets, mainly driven by small and medium caps. After its director was sacked, the China Securities Regulatory Commission (CSRC) triggered a short squeeze by tightening up rules on margin calls and short selling.

We remain overweight fixed income with a preference for the shorter end of the yield curve. Carry is still attractive and bonds will provide diversification should there be a return of risk, stemming, for example, from US regional banks. We are still vigilant on equities. Our neutral bias is due to somewhat thin risk premiums.

EUROPEAN EQUITIES

Indices edged higher in another quiet week with no significant economic data. Jerome Powell dashed hopes for a March rate cut and sent real interest rates sharply higher in the US and Europe. And yet the European earnings season remained upbeat with excellent company reports offsetting central bank comments. Earnings, rather than macroeconomic news, dictated sector moves

Banks were hit by recent falls in interest rates and fears that US commercial property woes might prove contagious. Bonds issued by **Deutsche Pfandbriefbank AG** (PBB) cratered after a broker said the bank had significant exposure. But the problem does not concern all banks and Italian banks continued to surprise. UniCredit once again reported top-quality results and management is now expecting net profits this year to hit €8.6bn, or much more than the €7.8bn pencilled in by analysts.

Novo Nordisk's share run appears to have no limits. The share performed well this week after the company said production of its flagship drug Wegovy was to be increased by the acquisition of 3 sites from subcontractor Catalent for around €11bn. However, the group's US rival **Eli Lilly** has appealed to the competition authorities as the CDMO is the main supplier for both groups.

TotalEnergies upped its dividend by 7% for FY 2023 but failed to offset disappointment over a fourth-quarter business decline due to falling oil prices.

The luxury goods sector continued to benefit from tailwinds. Markets were reassured when **Kering**'s results were in line.

US EQUITIES

It was another busy earnings week in the US but the flow should start to slow. Semiconductors stole the limelight with stellar results from **ARM** thanks to an upswing in the smartphone cycle and its AI market exposure. The stock rocketed by close to 50% in one session and managed to upstage somewhat disappointing figures from peers like **Axcellis Technologies** which cut first-quarter guidance. **Palantir** also soared thanks to strong demand for its AI products.

In apparel, the **Ralph Lauren** share price flirted with 2014 levels thanks to upbeat guidance for 2024. In contrast, VF Corporation tumbled after reducing its forecast, mainly because of poor sales of The North Face. one of its biggest brands.

Elsewhere, the message from **McDonald's** was mixed: earnings beat expectations but management moderated investor sentiment with downbeat comments on the medium term outlook. In contrast, **Chipotle** once again beat expectations and said demand was still strong. **Mattel** had a slight fourth-quarter miss but full year guidance was raised. It was the opposite at **Baxter**, a fourth-quarter beat but a downward revision to first-quarter guidance. **Mohawk**'s share price rose even though the company expects to earn less than expected in the first quarter. **Centene** was more optimistic and said revenues were holding up.

In healthcare, **Vertex** had a fourth-quarter beat but its first-quarter guidance was slightly disappointing. Unlike **Eli Lilly** which confirmed its position as sector leader by raising first-quarter guidance. **CVS Health** did better than its peers in terms of Medical Loss Ratio but trimmed guidance.

Not every social media company is like Meta. **Snapchat** and **Pinterest** both tumbled after results missed optimistic expectations, notably for sales. And in the payments sector, **Paypal** confirmed its fallen angel status: the company is still struggling, mainly because of lower eBay volumes. Light Speed also fell sharply due to weak individual user transactions.

Oil enjoyed a strong rally at the end of the period but not all sector companies benefited.

Jerome Powell was the guest last Sunday on the CBS “60 minutes” programme. He confirmed that markets were getting ahead of themselves over rate cut expectations. He also said the US had to get to grips with its debt levels.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX rose 2.37% and 1.13%, both hitting a 34-year high at the February 8 close. Markets were initially range bound due to US data and Japanese company results but rose sharply after BoJ Deputy Governor Shinichi Uchida said on Thursday that even if the BoJ were to end its negative interest rate policy, it would be hard to imagine taking a path after that to keep raising interest rates rapidly.

Transportation Equipment rose 9.69% led by **Toyota** (+13.75%) which revisited its record high after significantly revising up profit guidance for this year. Fishery, Agriculture & Forestry gained 3.97% as sector leaders boosted earnings guidance for 2024. Other Financing Business gained 3.45%, led by **Orix** after another rise in its April-December 2023 pre-tax profits. On the other hand, Marine Transportation fell 3.33% on profit taking. Textiles & Apparels dipped 2.96% led by Toray Industries after disappointing earnings guidance for the current year. Electric Power & Gas slipped 2.68% as investors locked in profits over concerns about the weakening yen.

Softbank (communications and internet holdings) jumped 14.86% after its **Arm Holdings** subsidiary blew past fourth-quarter results and boosted first quarter guidance. **Toyota** company **Denso** (automotive components) soared 11.31% along with its parent company. Elsewhere, **Daikin Industries** (air conditioners, fridges, etc.) tumbled 9.27% on disappointing fourth-quarter figures. In telecoms, **KDDI** fell 7.86% on profit taking as investors digested its bid for **Lawson. Oriental Land** (theme parks and hotels) ended the period 7.05% lower after leaving its 2024 guidance unchanged.

The dollar strengthened from the mid-146s to the low-149s against the yen following BoJ Deputy Governor Shinichi Uchida’s comments.

EMERGING MARKETS

The MSCI EM Index had returned 1.57% this week as of Thursday. China rebounded by 3% and India was up 1.2%. Korea (+3.56%) outperformed again on hopes of shareholder return reform measures. Brazil lost 1.5%.

In China, market performance was boosted by the news that the government wanted to extend support to equity markets through financial federal institutions buying more ETFs. In addition, Beijing lifted more property purchase restrictions. On the macro side, January saw deflation (-0.8% YoY, versus 0.4% expected and -0.3% in December) driven by food prices. The PBoC maintained an easing bias in its fourth-quarter monetary policy report. On the geopolitical side, US and Chinese officials held talks about economic issues in Beijing. In results news, Alibaba performed in line with 5% revenue growth and increased its buyback programme by $25m for the next three years. Yum China reported better than feared fourth-quarter results, surprising on its SSS growth (+4%) and restaurant margins (+170bps) In regulation news, the Ministry of Education published an update draft on their website clearly legalising K-12 non-academic tutoring as well high-school academic tutoring. In addition, China replaced the head of its securities regulator.

Korea's market continued to perform well on the back of the government's pragmatic proposal of a tax reduction on dividend payments and other measures. The programme still needs to be approved in Congress after the April general election.

In India, the Services PMI Business Activity Index rose to 61.8 in January, up from 59 in December. The monetary policy committee voted to keep the repo interest rate unchanged. India's oil minister said the country was not worried about OPEC's output cuts and Saudi Arabia's recent decision not to expand production capacity. According to Bloomberg news, he said there was enough supply in the world. Foxconn said it would invest more than $1.5 billion in an Indian construction project to supply Apple. Tata Motors reported a strong set of results with revenues and EBITDA up 25% and 59%, respectively. Zomato not only beat market expectations on 69% revenue growth and a higher EBITDA margin but also increased its short-term guidance from 40% to 50% growth.

In Brazil, the market consolidated on macro figures:

1) higher than expected inflation at 0.42% MoM (versus consensus of 0.34%) driven by higher personal expenses.

2) the trade balance recorded a surplus of $6.5bn in January, or less than expected, mainly due to an acceleration in imports

3) broad retail sales receded 1.1% MoM/sa in December (0.0% YoY), or below market expectations (+0.4% MoM/sa).

In terms of results, the banking sector was the main highlight. Itau and Banco Brasil reported better-than-expected figures and guidance but Bradesco disappointed with weak numbers due to low client NII, higher provisions and unexpected impairments for two corporates. Bradesco cut 2024 guidance due to its own specific problems. Natura announced a potential spin off of Avon International.

In Mexico, Banxico kept rates on hold on the back of persistent core services inflation. Fourth-quarter results at Cemex were in line with 2023 guidance and management guidance for 2024 was also as expected with resilient prices and volumes.

In Chile, inflation also came in higher than expected in January at 0.7% MoM, driven by food and beverages. Santander Chile reported upbeat results.

CORPORATE DEBT

CREDIT

Macro indicators sent bond yields higher over the week. In the middle of January, markets had mainly been banking on a Fed rate cut in March but expectations for a first move are now in May or June. Next week's CPI will be closely watched. Fed chair Jerome Powell also said that strong growth and buoyant labour markets were no longer necessarily bad for inflation which seemed to suggest rate cuts would occur later than expected. 10-year

Treasury yields gained 6bp to 4.16% and the German Bund added 12bp to 2.36% (as of Friday morning).

Even amid such interest rate volatility, credit markets continued to show resilience. The Xover was unchanged around 325bp. Investment grade spreads stayed around 130bp and high yield is now at 372bp, down 15bp since February 2. However, **bank CoCos** had a bad week as worries over regional US banks resurfaced. Euro CoCo spreads widened by 50bp to 655bp. Even so, the new issues market remained active with dollar denominated AT1 ideals from **ING**, **Swedbank** and **UBS**.

Due to the sharp rise in yields, the duration impact meant investment grade lost 0.46% over the week (-0.84% YTD). High yield slipped 0.16% but the segment has still returned 0.62% since January 1st thanks to spreads holding up.

CONVERTIBLES

It was another busy week for convertible bonds, driven by earnings and M&A deals.

In Europe, **MorphoSys**' shares rose sharply after specialist press outlets reported that **Novartis** was in advanced talks to buy the German biotech. The company is banking on a new drug success for patients with myelofibrosis. In the event of a change of control, the company's convertibles could benefit from a put-to-par clause.

The market focus was once again on **Delivery Hero**. The company pre-released results that implied growth guidance for this year would be in line with improved EBITDA guidance. The shares were volatile during the week. **Qiagen**'s fourth quarter sales and earnings per share came in slightly above consensus and the company's outlook for 2024 was conservative. The stock was little changed despite M&A rumours resurfacing.

In the US, Thoma Bravo announced its intention to acquire **Everbridge**, a software company specialised in communications, in an all cash deal valuing the company at $1.5 bn. The 2024 and 2026 convertibles traded higher after the news. **Snap** plunged more than 30% during the week after posting disappointing revenues, a sign that the company is seeing a slump in its digital advertising business. **Ford Motor** surprised the market with fourth-quarter results that swept past expectations and guidance on higher profits in 2024. **Uber** shares outperformed after the company unveiled better-than-expected fourth-quarter results and first-quarter guidance. The company said it was leveraging technology to improve cross-platform utilisation and should be rolling out new mobility-focused features soon.

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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