EDMOND DE ROTHSCHILD

MARKET FLASH: EQUITY AND CREDIT MARKETS SHOW RESILIENCE

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Investors may be focusing on interest rate pressure but macroeconomic forces are gradually returning. Inflation and restrictive monetary policies are causing global growth to slow. PMIs in the eurozone rebounded slightly but remained soft. Germany, for example, is still looking weak compared to its neighbours and fuelling fears of an imminent recession. The German economy is clearly contracting due to rising interest rates and its previous reliance on Russian energy and Chinese demand. The property sector is also struggling. In the 2000s and 2010s, its global trade model was efficient but seems to have reached its limits due to globalisation shifts. To adapt, Germany needs to invest in technology and energy transition while refocusing on its European market. Fortunately, there is significant budgetary leeway but Berlin needs to avoid being hedged in by its previous constraints. Germany's underperformance is due to cyclical and structural factors, notably energy and interest rate shocks. Meanwhile, Italy's weak growth rate is creating budgetary headaches.

In China, the central bank is arguing for structural reforms to get the economy going. China's problem is that it must act to avoid falling into the same trap as Japan. Its economic situation is worrying and growth prospects are downbeat.

On markets, worries over inflation, and fears that central banks might be late in pivoting from restrictive policy, took long government bond yields to record highs. Another concern is oil: Brent crude swept above $96 for the first time since November 2022 after US inventories fell and supply side tensions mounted. High oil prices should curb consumption and provoke a slowdown; only then could Brent fall below the $85-90 range. As a result, energy led sector gains on equity markets. But poor economic data in Europe and high government bond yields also weighed on markets and the euro.

We note that yield stocks came under some pressure in this interest rate environment. Equity markets will only stage a short term rally if economic data produces some reassuring signs on disinflation and companies continue to post resilient figures.

We tactically reinforced equity weightings during the August low and are sticking to this position. We assumed economies would manage to cope with a high interest rate environment. Over the medium term, we remain cautious on risk assets. High oil prices are a risk for growth and will feed through faster than the end of monetary tightening.

In fixed income, we remain overweight duration, a stance we feel should provide protection during the economic slowdown.

EUROPEAN EQUITIES

September's PMI showed the economy was slowing but not enough to stop interest rates rising. Government bond yields continued higher and Brent crude hit $96. Consumer confidence also remained depressed. Both German and French indices came in below expectations. Europe's equity indices lost ground after hitting a 3-month low.

In company news, semiconductor giant **ASM** International raised guidance but not enough for investors. The stock came under pressure, a reflection of the sector's high expectations. In ready-to-wear clothes, Sweden's **H&M** posted a better-than-expected third quarter profit thanks to massive cost reductions. The group has closed stores since the beginning of the year as inflationary pressures ate into sales. Similarly, **Asos** saw third quarter sales slump 15% and revised guidance lower to take account of de-consumption. **Air France** has ordered 50 A350 planes from **Airbus** and has an option on 40 more. The catalogue cost is more than $16bn. Eventually, Air France could be the largest global operator of A350 planes.

US EQUITIES

Moves on Wall Street were relatively limited over the last 5 trading sessions up to Thursday. The S&P 500 slipped 0.68%, the Nasdaq was more or less unchanged (+0.07%) and the Russell 2000 gained 0.76%.

Macroeconomic indicators were mixed. Weekly jobless claims came in at 204,000. Existing home sales fell 18.8% in August. However, manufacturing PMI came in at 49.2 when analysts were going for 48.2 and durable goods orders rose 0.2% when they were expected to fall 0.5%. Oil prices pushed even higher with WTI closing close to $94.

In energy stocks, **Nextera**, the largest US wind and solar power group, cratered 15.69% after sharply revising down its growth prospects. The group now sees production rising 5.8% (vs. 12-15%) largely due to higher interest rates.

In materials, **Cleveland**-**Cliffs** rose 6.57% after raising prices for some of its steel products. A tonne of hot-rolled steel will now cost a minimum of $750.

In consumer stocks, **Nike** bounced more than 9% after the bell on upbeat results and a sharp 10% YoY drop in stocks. This might mean fewer special offers in the future. **Coty** slumped 6.15%, correcting the previous week's gains, after the company said it would create 33 million new shares in an increase of capital to mark its listing on the Paris Bourse.

Micron Technology fell 5.34% after the group said destocking would mean higher net losses in the next quarter than previously indicated. **Accenture** shed 4.33% due to disappointing guidance due to weakness in new orders.

The UAW strike in Detroit continued. The union threatened to extend the strike from today if talks on new agreements failed to make sufficient progress. The strike moved into political territory after Joe Biden appeared on a picket line to show his solidarity and Donald Trump gave a speech in the Detroit area.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX fell further, declining by 2.14% and 1.59% mainly because of increasing upward pressure on interest rates in both the US and Japan and stronger commodity prices.

Mining rose 4.34% due to rising commodity prices. Pharmaceuticals gained 1.24% led by **Chugai Pharmaceutical** (+8.25% on a bullish broker recommendation) and **Daiichi Sankyo** (+7.16% on progress in the development of an anticancer agent with **AstraZenec**a). On the other hand, Marine Transportation and Electric Power & Gas fell 5.69% and 3.95% on profit taking. Nonferrous Metals dropped 3.41% after the copper price weakened due to China's deteriorating economy. **Sumitomo Metal Mining**, for example, shed 5.38%.

Japan Exchange Group, (securities operator) gained 5.12% after revising earnings and dividend guidance higher for FY2024. Elsewhere, **Kubota Corp**. (agricultural machines) and **Recruit Holdings** tumbled 6.08% and 5.30% on profit taking.

The dollar strengthened from the mid-147s to the low-149s against the yen, briefly touching the mid-149s at one point. The shift was primarily due to the widening interest rate differential between the two countries.

EMERGING MARKETS

The MSCI EM Index was down 1.64% this week as of Thursday's close. India (flat) outperformed while Brazil was down 1.85% and China entered a risk-off period and corrected by 2.3% before a strong rebound on Friday ahead of the Golden Week holiday.

In **China**, August industrial profits rose by 19.1% YoY, beating estimates by improving from the -5.7% YoY and -1.1% YoY in July. President Xi Jinping said China would step up efforts to achieve annual economic and social development targets. The US and China agreed to set up working committees for economic and financial matters. The committees are reportedly to have regular communications ahead of a Biden-Xi meeting during the APEC summit. **Alibaba** filed to list its logistics unit **Cainiao** on the Hong Kong stock exchange. It will retain more than 50% of the shares after the spinoff. Tencent and Alibaba joined forces to enhance advertising and traffic synergy during the Double 11 shopping festival. **BYD** is considering setting up new manufacturing plants in Mexico. **Evergrande** missed bond payments and is revisiting its restructuring plan: the chairman is under investigation over suspected 'crimes'. **Ping An** announced the resignation of co-CEO Jessica Tan due to personal and family reasons. Current chief HR officer Michael Guo will replace her.

In **Korea**, LG CHEM and **Huayou Group's** subsidiary are building a LFP battery cathode material plant in Morocco to supply the US with OEMs, capitalising on Morocco's IRA subsidy eligibility through the US FTA. Elsewhere, **Samsung** SDI is set to invest $2bn on a second EV battery plant in partnership with Stellantis in the US.

The Bank of **Thailand** raised rates by 25bp to 2.5%, the 8th hike in a row, despite lowering this year's inflation and growth forecasts.

In **India**, the pace of credit growth moderated marginally in August (from 19% in July to 18.3%). Apple plans to increase production in India more than fivefold within the next 5 years. It surpassed $7bn in the country last year and is aiming for $40bn. The latest data from telecom regulator (TRAI) indicated that India mobile subscribers increased by 2.7m to 1,146m in July 2023, with **Jio** gaining market share. In the IT sector, **Accenture** forecast full year earnings and first quarter revenue below consensus, a sign that high inflation and interest rates would continue to impact enterprise spending through next year.

In **Brazil**, the central bank released hawkish monetary committee minutes that drew attention to fiscal results. Credit growth came in at 9% YoY in August, with individual loans decelerating to 11.5% (versus 12.2% in July). According to Serasa, small companies increased their bad debt payments, confirming the trend of asset quality improvement. **WEG** is to buy electric motor generator company **Regal Rexford**.

In **Mexico**, the central bank kept interest rates unchanged. The Supreme Court debate on electricity reform was postponed. The Governor of Santa Catarina declared that the potential investment from **Tesla** and suppliers has soared to $15bn over the next two years, or 3 times more than initially announced. Tesla's factory will double in size. The Governor also said state permits required for the factory to initiate its operations had already been awarded. **Banorte** announced it will hire 1,200 employees for nearshoring.

CORPORATE DEBT

CREDIT

Increased interest rate volatility had a rather negative effect on markets. Investment grade credit spreads were relatively unchanged over the week but high yield widened by 25bp at moments of peak stress on Thursday. Over the week, investment grade fell 0.6% and high yield 0.2%. Subordinated financials shed 0.6% due to interest rate stress.

There were a few attractive new issues. Italy's **Webuild** raised €450m at 7% due 2028. Portuguese bank **BCP** raised €500m in senior preferred bonds at 5.7% due 2026.

CONVERTIBLES

Global convertible bonds valuations were overall lower this week as equity markets fell on fresh worries over China's property sector and a "higher-for-longer narrative" from central banks. Volumes were driven by single name activity news.

In Europe, **AMS-OSRAM** announced a new financing package which plans to secure a total of €2.25bn through a combination of a capital increase, new corporate bonds and other financing instruments in an effort to cover financing needs until 2026. The company expects to address the near-term balance sheet concerns if successful and shift the focus to growth opportunities. This is good news for their 2025 and 2027 convertible bonds.

Cellnex announced the sale of a 49% stake in Cellnex Sweden and Cellnex Denmark to Stonepeak, for an estimated amount of €730m. This marks Cellnex's second de-leveraging effort after the sale of sites in France for merger/antitrust reasons. This agreement along with additional strategic options for portfolio assets will help Cellnex to crystalize value and accelerate its deleverage plan.

In the US, the content delivery network company **Cloudflare** traded higher after it unveiled several partnerships, including with **Meta Platforms**, **Nvidia**, and **Snowflake**, in an effort to bolster its AI capabilities. **Nextera Energy Partners** negatively surprised the market, after cutting its dividend distribution growth outlook to 5-8% (6% target) from 12-15% (12% target). The company stressed that the current interest rate environment made significant growth difficult to maintain.

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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