



EDMOND DE ROTHSCHILD ASSET MANAGEMENT

MARKET FLASH: *THE CALM ABOVE THE STORM*

- **Concerns over massive investment needs in AI mounted over the week and resulted in steep falls for US tech giants.**
- **Kevin Warsh's appointment as Fed chairman weighed on sentiment because of his calls to structurally shrink the Fed's balance sheet.**
- **In Europe, Christine Lagarde continues to express confidence in the current monetary stance despite below-target inflation, while several ECB members warn of the disinflationary and restrictive impact of the euro's appreciation on financial conditions.**

Global equity indices appear to be holding up but brutal sector rotation is going on in the background. The main victim is technology, and particularly software. Concerns over massive investment needs in AI mounted over the week and resulted in steep falls for US tech giants, even those with upbeat results. And improvements to Anthropic's new model with its impressive results in IT code generation fuelled concerns over the ability of software companies to compete. As a result, the sector lost further ground and is now down by close to 30% since last October's peak. The correction was particularly violent in market segments exposed to retail investors who are nursing significant losses, including from the crypto asset sell-off, and are now forced to unwind positions across all risk asset classes.

To a lesser extent, Kevin Warsh's appointment as Fed chairman also weighed on sentiment because of his calls to structurally shrink the Fed's balance sheet. He thinks the Fed should stop injecting liquidity into financial markets as it contributes to asset price rises. His comments seem to suggest the Fed might be less willing to intervene during market stress phases but Donald Trump's nominee is also keen on continuing to cut rates to underpin company funding and consumer lending. Warsh, a former Fed governor, is known for his very restrictive stance at the height of the subprime crisis but is not as worried by inflation today. He is convinced productivity gains from AI will help fuel strong growth but without pushing up inflation.

In Europe, ECB chair Christine Lagarde said she was still confident that current monetary policy was efficient even if annualised inflation came in at 1.7%, or much lower than the bank's target. Several ECB members, however, were keen to stress that the euro's strong appreciation had been disinflationary, an element that needs to be closely watched as it results in tighter financial conditions in the eurozone. As the BLS survey showed this week, these conditions have already led to loans becoming more difficult to obtain.

Investors will be closely watching this weekend's parliamentary elections in Japan. PM Sanae Takaichi's majority is expected to be reinforced and could even reach two-thirds of the Lower House, allowing her to sidestep any opposition from the Upper House. If so, her fiscal expansion programme could be extended to boost nominal growth, a move that would hit the yen and Japan's interest rates but which would bolster local equity markets.

We are still keen on Japanese and emerging country equities. We continue to prefer the short end of the curve to the long end as well as investment grade credit.

EUROPEAN EQUITIES

The earnings season continued to drive markets. In the background, the ECB unsurprisingly left its rates unchanged on the grounds that the economy was robust and that Europe's inflation had slowed to 1.7% in January. For 2025 as a whole, eurozone GDP rose 1.5% with Poland (+3.6%) and Spain (+2.8%) contributing the most. France grew by 0.9%, a confirmation of some resilience, while Germany was up 0.2% following a slight rebound in the fourth quarter.

Over the week, there were major shifts out of sectors investors think will be hit by AI. IT services and software tumbled after Anthropic AI said its tools had improved markedly. The news affected **Publicis** which struck a cautious note in its post-earnings comments. But telecoms led by **Orange** gained ground because of the efficiency gains and cost cutting opportunities that AI might provide. In healthcare, investors ditched **Novo Nordisk** as the prospects for its obesity and diabetes drugs appeared to them less interesting than those of **Eli Lilly**. Price cuts in the US also weighed on sentiment. **Novartis** gained ground after solid figures and reassuring guidance for 2026 even if growth is expected to be more moderate than expected. In banks, **BNP Paribas** rose on upbeat fourth-quarter results and a small upward revision to its 2028 targets. **Société Générale's** net results were the bank's best ever but the share saw profit taking due to its recent sterling performance and lack of visibility beyond 2026. **Stellantis** booked a €22.5bn write down and will not pay a dividend for FY 2025. The implication is that the group's restructuring programme will be more sweeping than expected. The chemicals sector was in vogue thanks to **Henkel's** acquisition of **Stahl** which has **Clariant** as a minority shareholder. Press reports that the European Commission might extend carbon quota periods for industrials also lifted the sector. If true, this would boost energy-intensive chemicals groups but would be bad for construction material companies like **Heidelberg Materials** and **Holcim** which have made sizeable investments in carbon capture and storage infrastructure.

US EQUITIES

Wall Street fell as investors rotated massively out of large cap tech stocks and AI themes. The S&P 500 shed around 2% and the Nasdaq tumbled 4%. The Dow Jones proved a little more resilient. Small caps had significantly outperformed since January 1st but were less resilient. The Russell 2000 ended the period around 1.5% lower.

Macroeconomic data continued to suggest the economy was doing well while returning to normal. Manufacturing ISM moved back into expansionary territory, hitting levels not seen since mid-2022 on a strong rebound in new orders. Services ISM remained solid even if goods orders and jobs slowed. At the same time, several labour market indicators sounded a more cautious note. JOLTS data fell to a low not seen since 2020 and layoffs started to rise with weekly jobless claims also increasing.

Washington managed to end the partial shutdown and, for the moment, the risk of federal administrative paralysis but budget talks remained tense. There were sometimes heated discussions over Iran's nuclear capacity and fresh talks between the US and Russia began with a focus on extending the New START treaty. As a result, the dollar strengthened while

precious metals continued to move erratically. Gold saw big price swings but trading reflected position changes rather than any shift in the economic scenario. WTI fell from more than \$65 to around 63 due to talks on Iran's nuclear capacity, rising US inventories and cautious OPEC indications.

Tech (-5.73%) was the biggest loser over the week as software stocks lost further ground on mounting concerns over AI disruption. Worries were compounded by cloud and AI services plans at **Google** and **Amazon**. Both groups reported strong operating results but announced massive capex to fund AI and data centre infrastructure, rekindling investor alarm over pressure on margins and reinforcing profit taking across the software sector. Also under pressure were consumer discretionary (-3.02%) and communication (-3.22%) on mixed earnings in e-commerce, luxury and media platforms as worries on household demand resurfaced. Financials edged 0.28% lower. Banks held up relatively well but asset management and private equity companies as well as BDCs came under attack because of their exposure to growth and software plays. Some sectors managed to buck the downward trend: consumer staples gained 4.08%, the week's best performer, as major defensive stocks advanced and food and mass market companies posted robust results. Energy gained 2.27%, despite high WTI volatility, as geopolitical tension persisted and sector consolidation momentum held up. Industry (+1.77%) and materials (+2.50%) also stood out on upbeat figures from logistics, equipment and infrastructure companies and a price rebound in industrial metals. Healthcare was more or less flat (+0.06%) as large pharma companies rose and more news-sensitive segments like managed care retreated.

EMERGING MARKETS

The MSCI EM index lost 1.34% in USD this week. India and Mexico were up by 3.07% and 1.49%. China, Korea, Taiwan and Brazil were down by 3.02%, 3.02%, 1.22% and 0.96%.

In **China**, January NBS PMI was 49.3, vs. 50.1 in December. Non-manufacturing PMI also declined, falling to 49.4 from 50.2. President Xi Jinping held calls with both President Trump and President Putin to discuss trade, Taiwan, Iran and geopolitical issues ahead of a planned US-China summit in April. Donald Trump said China was considering lifting its soybean purchases to 20 million tons for the current season and 25 million tons for the next season. **PopMart** is setting up London headquarters for its European operations and opening 27 new stores in the coming year. **BYD's** Hungary factory commenced trial production, with full-scale production expected in the second quarter of this year with a target of 200,000 vehicles annually. **Meituan** agreed to acquire online grocer **Dingdong's** China business for \$717m to strengthen its position in the grocery retail market.

In **Taiwan**, **TSMC** unveiled plans to invest \$17bn to produce 3-nanometer semiconductors in Japan in a bid to diversify production of its cutting-edge chip.

In **Korea**, January exports surged 33.9% YoY, or ahead of expectations, while imports rose 11.7% YoY. **LG Energy Solution** agreed to end its joint venture with **Stellantis**, acquiring the partner's 49% stake in **NextStar Energy** as EV demand falters.

In **India**, President Trump said the US would cut reciprocal tariffs from 25% to 18%. The additional 25% duty linked to India's Russian oil purchases would also be reduced to zero after India agreed to scale back imports. The Finance Ministry raised capital expenditure to Rs 12.2 trillion from Rs 11.2 trillion, representing a 9% increase, while the fiscal deficit target was set at 4.3% of GDP, or slightly above market expectations of 4.2%. **Nestle** posted higher-than-

expected third-quarter profit, driven by strong performance across key businesses. **Hyundai** reported a 6% YoY increase in third-quarter net income but missed estimates as the company faced margin headwinds from higher commodity costs. **Bharti Airtel** posted solid results.

In **Indonesia**, miners halted spot coal exports after the government proposed deep production cuts.

In **Brazil**, January manufacturing PMI came in at 47.0 vs the previous reading of 47.6. Industrial production grew 0.4% YoY, or below the 0.5% expected. **Itau** reported good results that were in line with expectations. **Bradesco** also reported better-than-expected results, up 21% YoY and 5% QoQ.

In **Mexico**, the central bank held its benchmark interest rate unchanged at 7.0%, pausing after 12 consecutive cuts. The government unveiled a \$323bn investment plan covering roughly 1,500 projects up to 2030 that will focus on energy and public works. November capital investment fell 6.4% YoY, or worse than the 5.9% estimate. **Pemex** reduced its total debt to approximately \$84.5bn, its lowest level in 11 years.

In **Colombia**, the central bank surprised markets by raising its benchmark interest rate by 100 basis points to 10.25%, the first-rate hike in 33 months. The decision was based on strong economic performance, a sharp increase in inflation expectations, and some deterioration in the current account.

Argentina and the US agreed to cut hundreds of tariffs on each other's goods in a trade and investment deal.

CORPORATE DEBT

This week's price swings on both equity and debt markets were driven by the **Open AI-Anthropic** tussle. On European credit markets, the tech stock plunge was most in evidence among software companies as disruption from the rush into AI fuelled doubts. **ION Group**, for example, has seen its euro-denominated bonds tank by around 10 points since January 1st.

Dispersion continued. High Yield was unchanged over the week but Investment Grade even managed to edge higher as interest rates fell, not because of the ECB's unsurprising decision to maintain its rates but rather because the JOLTS report in the US suggested the labour market there was sluggish.

The earnings season for financials started on the front foot and Euro CoCos ended the period 0.06% higher. In new issuance, **National Bank of Greece** sold its first AT 1 bonds, raising €500m at 5.8%. The order book attracted bids worth more than €5bn.

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.
- EBITDA: Earnings before Interest, Taxes, Depreciation, and Amortization.
- CTA: quantitative strategy which uses futures to invest in a wide range of financial assets, including equity indices, short-term and long-term interest rates, currencies, and commodities.
- The PMI, for "Purchasing Manager's Index", is an indicator of the economic state of a sector.
- AT1s belong to a family of bank capital securities known as contingent convertibles or "Cocos". Convertible because they can be converted from bonds to shares (or depreciated entirely) and contingent because this conversion only occurs if certain conditions are met, such as the issuing bank's capital strength falling below a predetermined trigger level.
- RT1s: perpetual bond issues with early redemption possible after 10 years. Coupon payments are discretionary and non-cumulative.

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EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

47, rue du Faubourg Saint-Honoré 75401 Paris Cedex 08

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332.652.536 R.C.S. Paris