EDMOND DE ROTHSCHILD

MARKET FLASH: THE ECB TAKES RATES TO RECORD LEVELS

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The ECB raised rates for the tenth, and perhaps last, time in a row despite calls over the summer from central banks in Mediterranean countries to nurse growth in the eurozone. By revising inflation forecasts higher and growth lower for 2023 and 2024, the ECB opted to aim for credibility by reaffirming its determination to get inflation back to its 2% target. At any rate, this 25bp rise is one more risk for eurozone growth but was seen by investors as sufficiently credible for them to revise inflation expectations lower. As a result, long bond yields eased and risk asset valuations found support. However, ECB chair Christine Lagarde failed to stop the euro sliding. It fell to 1.063 against the dollar, its lowest level since May this year.

Resilient retail sales and new jobless claims suggest that the US consumer's purchasing power has been lifted by wages increasing more than inflation. August inflation rose from 0.2% in July to 0.6% in August but mainly because of higher energy prices. The disinflation trend was confirmed by a fall in property inflation.

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We raised risk in portfolios at August's low and have stuck to this tactical, opportunistic position. Over the medium term, we remain cautious on risk assets. Higher oil prices could jeopardise growth and will feed through faster than any benefits from monetary tightening coming to an end. We still prefer bonds with attractive yields.

EUROPEAN EQUITIES

European equities had a good week. The ECB raised rates again but markets think this is the last time and that maintaining them at these levels for long enough will eventually get inflation back to the 2% target.

Basic materials led sector gains thanks to a strong performance from copper. In energy news, **Total** decided to cap petrol prices at €1.99 a litre despite rising crude prices due to production cuts. Associated British Foods, which owns **Primark**, raised guidance again and said demand momentum remained strong despite inflation. First half figures at **Inditex**, Zara's parent company, blew past expectations but markets are wondering how resilient the group will be in the US where consumers are less upbeat.

The packaging sector witnessed a big deal. Ireland's **Smurfit Kappa**, the world N° 3, merged with the global leader **WestRock** in the US to diversify geographical clout. The combined group will be listed in the US and London.

US EQUITIES

Wall Street ended the last 5 trading sessions higher with the S&P 500 gaining 1.25%, the Nasdaq 1.31% and the Russell 2000 0.64%.

The CPI was up 0.6% in August, its biggest monthly rise this year. Core CPI, ex food and energy, rose 0.3% MoM and 4.3% YoY when analysts were going for +0.2% and 4.3%, respectively. Surging oil and gas prices drove the index higher.

Oil was the focus of macroeconomic concerns over the week because of the impact on inflation. WTI and Brent crude are now flirting with levels last seen in November 2022 due to expectations demand will be higher than supply up to the end of 2023. Cuts by Saudi Arabia and Russia have left the market with a significant deficit. Over the last 3 weeks, WTI has jumped 13% to more than $90.

In tech company news, **Oracle** tumbled 13.5% after quarterly revenues missed expectations and cloud growth slowed sharply. **Meta** gained 4.4% thanks to its IA model which will compete with GPT-4. Apple showcased its new models but shed 1% as Beijing's decision to ban government agencies from using its smartphones continued to weigh.

The Food and Drug Administration approved new Covid vaccines from **Pfizer** (-0.4%) et **Moderna** (+4.1%) but failed to make a decision on an updated shot from **Novavax** (-12.9%).

First Quantum (+3.8%) managed to reach an agreement with trade unions in Panama to avoid a strike in its flagship mine.

In autos, talks between the UAW and the Big Three (**GM**, **Ford** and **Stellantis**) broke down. The union will officially go out on strike today, Friday September 15. How serious the strike will be is yet to be seen.

ARM's listing on the Nasdaq was a big success. The share soared by close to 25% on its first day of trading. Parent company **Softbank** still holds close to 90% of the equity.

The Fed is due to meet next week with markets still betting on a pause despite recent data.

JAPANESE EQUITIES

After a weak start due to fears US-China relations might be hit by reciprocal smartphone restrictions and a statement from the Bank of Japan's governor that there might be enough data by the end of 2023 to end negative rates, markets recovered. Investors reasoned that August's CPI data would only have a limited impact on interest rates. The yen also weakened.

Banks surged 6.57% as interest rates rose after the comments from the Bank of Japan's governor. **Mitsubishi UFJ Financial Group** and **Resona Holdings** jumped 7.45% and 7.42%. Oil & Coal Products added 5.97% on solid commodity prices. Securities & Commodities Futures gained 5.03% on increased share trading. On the other hand, Machinery and Electric

Appliances fell 1.67% and 1.22%, respectively, due to China's worsening economy. Services lost 1.17%, led by profit taking on **Recruit Holdings**.

Kansai Electric Power gained 7.22% on news its last nuclear power plant being checked was about to restart. **Mitsubishi Heavy Industries** lost 5.47% due to reports IHI was recalling aircraft parts. **Recruit Holdings** and auto parts maker **Denso Corp**. shed 3.52% and 3.46% on profit taking.

The yen improved from the high-147s to the low-146s against the dollar on Monday due to the possibility that negative rates might be coming to an end. But the dollar then rebounded to the mid-147s as the focus shifted to the actual interest rate differential between the US and Japan.

EMERGING MARKETS

The MSCI EM Index had rebounded by 1% this week as of Thursday's close. Brazil (+6.1% in USD) led gains. Taiwan (+2.5%) and Korea (+1.6%) also outperformed. India gained 0.8% and China dipped 0.2%.

China's headline CPI inflation turned positive (+0.1% YoY in August) thanks to rising crude oil prices. PPI deflation also eased to 3% YoY from -4.4% in July. The TSF rose 9% YoY in August on the back of stronger loan growth and higher government bond issuance. Industrial Production was up 4.5% and Retail Sales 4.6% higher, both head of estimates and prior numbers. As expected, the PBoC announced a 25bp RRR cut as expected, the second this year. Shenzhen further relaxed home buying eligibility criteria in the latest series of measures. Several additional cities, including Jinan, Qingdao, and Zhengzhou, also lifted home purchase restrictions. The government cut the risk weighting of insurance company investments in CSI-300 and **STAR** stocks and the CSRC pledged more capital markets support. The European Commission is to launch an anti-subsidy investigation into EVs from China. Country Garden won creditor approval to extend repayment of another onshore bond by three years. Battery makers **EVE Energy** and **Gotion** are to speed up gigafactory openings in the US.

Taiwan's exports narrowed the YoY decline to 7.3% in August, marking the 12th consecutive monthly decline. In **Korea**, **Samsung** is reportedly raising mobile memory chip prices by 10-20%. **Thailand**'s government plans to waive visa requirements for Chinese travellers for 5 months.

India's August headline CPI inflation came in at +6.8% YoY, or below expectations, due to falling vegetable prices. Industrial output was up 5.7% in July after +3.8% in June. August Passenger Vehicle sales rose 9% YoY. **Nvidia** announced AI partnerships with Reliance Industries and **Tata Group** to develop cloud infrastructure and language models as well as generative applications.

In **Brazil**, August IPCA inflation was 4.6% YoY, or below expectations, driven by food and services. The figures showed a trend change from July's inflation which was higher than consensus. Brazil also benefited from further stimulus in China (RR cut) and better China PPI, driving mining commodity prices upwards. Elsewhere, Congress said it was not in a rush to approve the ending of tax benefits for investments (MP1185) nor the HC plan framework bill. President Lula sent a bill to congress which aims to increase ethanol in blended petrol and encourage airlines to start using green diesel.

In **Mexico**, CPI inflation moderated to +6.1% YoY in August, its lowest level since December 2021. In August, bank loans accelerated to 10% YoY (vs. 9% in July). Banxico reported that 9.3% of Mexican companies saw production, sales and investments increase thanks to reshoring. The European Commission's president said the EU should aim to complete a free trade agreement with Mexico this year. The Federal Aviation Administration (FAA) announced the reinstatement of Mexico's CAT1 level, allowing Mexican airlines to open new routes between Mexico and the US.

CORPORATE DEBT

CREDIT

New issuance calmed down after a fortnight of exceptionally heavy investment grade deals. But in high yield, **Coty** (BB) raised €500m at 5.75% due 2028. **Banijay** (B+) raised €500m at 7% due 2029; the issue was announced on the previous Friday but placed during the week. **Fnac Darty** was meant to refinance its 2024 maturity with a new 2029 bond but eventually preferred to go for a less expensive bank loan. The decision reflects how HY companies are struggling to refinance as high rates hit balance sheets. In financials, **BBVA** sold a USD CoCo at 9.375% as the AT1 market continued to return to normal conditions. Polish bank **Millenium** sold a senior non-preferred bond at 9.875% due 2027. S&P upgraded **Banco Comercial Portugues** from BB+ to BBB-.

Credit premiums remained upbeat with the Xover moving below 400bp to 390bp (as of Thursday evening) and High Yield cash bond spreads down to 425bp. Investment grade premiums stayed around 152bp and Euro CoCos were similarly largely unchanged at around 850bp. As in the previous week, volatility came from the government bond segment after the ECB raised rates by another 25bp. The move was seen, however, as the last hike. Yields on Germany's 10-year Bund eased on the news by close to 6bp but then returned to last week's 2.62% when trading started on Friday morning.

Investment grade returned 0.16% over the week, taking YTD gains to 3%. High yield rose 0.36% or +6.45% since the beginning of 2023. These returns demonstrate the wisdom of carry strategies, a focus we have recommended for more than a year. After almost nine months, markets have returned around three-quarters of the actuarial yield as of end 2022. At the time of writing, actuarial yields for investment grade were 4.4% and 7.5% for high yield, still good entry points for carry strategies. We still think the risk/return profile is very attractive as we can build predominantly IG portfolios yielding 5% gross over 5 years.

CONVERTIBLES

Convertibles ended the week higher thanks to US macroeconomic data and the ECB's reassuring comments. However, trading was largely concentrated on new issues and convertible index adjustments

In headline share price movements, Germany's **MTU Aero Engines** tumbled by close to 15% over the week after an exceptional charge relating to turbine inspections. The company nevertheless maintained its guidance for 2024.

On an active new issues market, Japan's JFE Holdings announced the conditions for its JPY 90bn deal. Elsewhere in Japan, investment group **Jafco** raised JPY 15bn due 2028.

In the US, **Amphastar Pharmaceuticals** raised $300m at 2% due 2029. The issue came at a 35% premium.

In Europe, Spanish IT company **Indra Sistemas** wants to avoid share dilution by buying in its October 2023 1.25% convertible.

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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