EDMOND DE ROTHSCHILD

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MARKET FLASH: THE BOND MARKET COULD SPOIL THE EQUITY MARKET PARTY

- **Moody's withdrew the US's AAA rating due to rising debt, leading to an increase in US Treasury yields.**
- **A budget compromise proposed by the Trump administration was narrowly passed in the House of Representatives, including tax cuts as well as reductions in healthcare spending and green subsidies, but it still needs Senate approval, promising lengthy discussions.**
- **In Europe, the trade threat could substantially hamper growth, while in Asia, China and Japan are already facing economic challenges, prompting authorities to implement monetary easing measures.**

Moody's decided to downgrade the US from AAA, citing sharp rises in federal debt in recent years. The news triggered further rises in US Treasury yields at the beginning of the week. The downgrade occurred during heated debates in the House of Representatives over the Trump administration's budget proposal. In the end, a compromise was reached and the budget scraped through with 215 in favour and 214 against. The budget prolongs most tax cuts made in 2017 and introduces new tax cuts for households while cutting Medicaid spending and green subsidies. The text will now go to the Senate where discussions could be drawn out as the deficit will increase in coming years if nothing changes.

For investors, the compromise offers a little relief but there are still concerns over the US deficit trajectory which is now close to 6% of GDP. Equities fell back and government long bond yields rose, especially for the 30-year Treasury which jumped above 5%. Meanwhile, talks over customs tariffs continued. Washington said countries which fail to reach an agreement will be hit after 90 days. Faced with the trade war, the Fed pushed back rate cut expectations by highlighting inflationary risk. The bank thinks monetary policy is properly calibrated and argues that changing this approach could only be justified if the jobs market worsens. In any case, the US economy looks robust. Composite PMI rebounded in May from 50.6 to 52.1 and jobless claims came in at 227,000 vs. 229,000 previously.

As for Europe's economy, the impact of trade tensions is significant, with Donald Trump threatening this afternoon to apply tariffs of 50% from June 1, which could put the brakes on growth, pushing the ECB into further monetary easing. On the plus side, the European Union and the UK reached an agreement on food, security and defence. This is good news as the European Commission has cut its growth forecasts for 2025 from 1.4% to 0.9% and from 1.6% to 1.3% for 2026. And eurozone PMI fell in May to 49.5 from 50.4 with services worsening although the manufacturing sector proved more resilient.

In Asia, China's industrial production and retail sales both fell, an indication that domestic drivers are not yet ready to replace foreign demand. This weakness pushed the authorities into cutting several benchmark rates by 10bp in an attempt to encourage lending. In Japan, long term government bonds were under pressure as falling exports caused the trade deficit to worsen. Composite PMI fell to 49.8 in May from 51.2, due to manufacturing weakness, and

inflation rose. Elsewhere, Australia's central bank cut rates by 25bp and adopted an accommodating tone. Inflation rose more than expected in Canada and the UK.

On oil markets, prices rebounded at the start of the week due to press reports that Israel might attack Iran's nuclear installations if any Washington-Tehran agreement did not ban Iran from pursuing its nuclear enrichment programme.

In today's uncertain environment, we are maintaining our equity underweight, especially in the US. We believe risk premiums are low given the expected impact of Donald Trump's tariff policy. We are also still neutral on fixed income but with a preference for short-dated bonds and corporate debt. We continue to have a negative bias on the US dollar.

EUROPEAN EQUITIES

Markets focused this week on concerns that US debt levels might not be sustainable. Donald Trump's budget, adopted by the House of Representatives, risks aggravating the US debt mountain and overshadowing any positive effects on growth from lower taxes. Closely watched 10-year US Treasury yields moved above 4.50%, the level most experts consider to be dangerous territory for equities. Yields on the 30-year Treasury broke above 5%. In the eurozone, May's PMI reading disappointed markets, so the pressure is on the ECB to provide more support and quickly. The data stopped the euro's rally against the dollar. Equity market leadership turned defensive after a cyclical rally lasting several weeks. Investors have become more cautious at these valuation levels.

In company news, **LVMH** warned investors of soft demand in Asia in this quarter. The luxury group had missed first-quarter expectations and its statement suggested there had been no improvement so far. In the same sector, **Richemont**'s positioning in jewellery has allowed it to be more resilient. In tech, **Infineon** was boosted by news it was working with **Nvidia** on AI data centre infrastructure. Europe's tourism and leisure sector was underpinned by **Ryanair's** gains. The airline reported a 16% fall in earnings, partly due to legal disputes with reservation platforms, but management sees a buoyant summer ahead with prices trending slightly higher than this time last year. **Diageo** announced a rise in quarterly sales and reaffirmed guidance for fiscal 2025 and even some operational leverage for 2026. Even so, the group expects to cut costs by $500m over 3 years to offset an estimated $150m in extra charges from higher US import duties. In the UK, sportswear distributor **JD Sports** had a disappointing quarter and is particularly cautious on the outlook. The group is on the front line of the trade war: supplies are sourced mainly in Asian countries and the group has large exposure to US consumers.

US EQUITIES

Wall Street ended the period lower with the S&P 500 down 1.2%, the Nasdaq off 1% and the Russell 2000 down 2.3%.

Moody's downgrade of US debt sent the dollar 0.8% lower against the euro.

In tech, **Nvidia** (-1.5%) plans to reinforce partnerships with Taiwanese companies, and especially with Foxconn via plans to build a supercomputer. Google's parent company **Alphabet** gained 4.2% after unveiling new AI initiatives to compete with rivals.

Energy slumped 4.6% due to a fall in oil prices. The possibility that OPEC might increase production in July hit **Schlumberger** (-5.5%), **Baker Hughes** (-3%) and **Exxon Mobil** (-5.2%).

Renewable energy stocks sold off due to Donald Trump's budget proposal which includes slashing green subsidies. **First Solar** and **Enphase** plunged 16% and 23.5%, respectively.

Elsewhere, the first effects of the US tariffs policy started to appear in retail. **Target** (-2%) chose to avoid giving guidance for 2025. In contrast, **Home Depot** (-4%), which sells building materials, maintained guidance and reaffirmed that it had no intention of increasing prices.

Other losing sectors this week included consumer discretionary (-1.3%), financials (-2%) and industrials (-0,6%).

EMERGING MARKETS

The MSCI EM index was down 0.56% in USD as of Thursday's close. Mexico and China were up 0.9% and 0.52%. India, Brazil, Taiwan and South Korea lost 1.92%, 1.03%, 0.73% and 0.56%, respectively

In **China**, retail sales growth softened to 5.1% YoY in April from 5.9% in previous months. Industrial production beat consensus expectations of 5.9% by rising 6.1% YoY in April on export diversion. The PBoC cut both 1-Yr and 5-Yr LPR by 10bp. Shanghai city issued a consumer plan including goods trade - in programmes and childcare subsidies. China continued to engage with non-US counterparts, including MOFCOM meeting on ASEAN trade and a meeting with the Netherlands on semiconductor cooperation. According to the CPCA, May retail vehicle sales were up 8.5% YoY. **Xiaomi** introduced its second EV model YU7 SUV during its product launch event, and the self-developed 3nm chip Xring O1 entered mass production. **CATL** had a bumper listing on the Hong Kong market, the biggest IPO so far this year. **Trip.com** results were a mixed bag, with margins below expectations. **Bilibili**'s first quarter remained solid with total revenue up more than 23% YoY.

In **Taiwan,** export orders in April jumped 19.8%, or ahead of the 9.5% expected. The TWD continued to appreciate against the US dollar and inched towards $30. **Nvidia** will be collaborating with **Foxconn** and Taiwan's government to build an AI supercomputing centre.

In **South Korea,** exports for the first 20 days fell 2.5% YoY, led by auto exports down 6.3% YoY. Trade representatives from South Korea and the United States met on the sidelines of the APEC forum.

In **India,** Prime Minister Modi inaugurated a scheme to redevelop 103 railway stations. India's trade minister said that he had had constructive meetings with his counterpart Howard Lutnick for a mutually beneficial trade agreement. The government banned garment imports from Bangladesh via land routes to boost local textile manufacturing. **Zomato**'s shareholders voted to cap foreign ownership at 49.5%. Global oil giants **ExxonMobil**, **BP**, and **Shell** are in discussions with ONGC as they explore a partnership for a $5bn deep-sea project. Foxconn is investing $1.5bn in its India business to cater to **Apple**'s expansion plan. **Suzuki Motorcycle** is investing Rs12bn to build a new manufacturing plant. Bajaj Auto secured a €566m loan to fund **KTM AG**'s insolvency plan. **Dixon**'s first quarter was in line, with an increased focus on exports and backward integration

In **Brazil,** economic activity in March increased 3.49% YoY, or ahead of the 2.9% expected. The EU halted imports of Brazilian poultry after an outbreak of bird flu. The Senate streamlined oil licensing with a new environment bill. **Mercado libre** founder Marco Galperin will step down as CEO and the current head of commerce will replace him.

In **Mexico**, March retail sales rose 4.3% YoY, or ahead of the 2.2% expected. GDP for the first quarter was up 0.8% YoY, or in line with expectations. CPI for the first 15 days of May rose 4.22% YoY vs. expectations for 4.02%. President Sheinbaum had a call with Donald Trump to discuss tariffs on steel and aluminum. FEMSA accelerated its share repurchase programme.

In **Argentina**, **Banco BBVA** reported upbeat results and positive guidance for credit growth. President Milei decided not to extend tax exemptions on soy exports and the tax will be increased by 7%.

CORPORATE DEBT

CREDIT

Credit markets were stable but government bond yields were more volatile. Investment Grade and High Yield had slightly positive returns over the week. The Xover traded in a very tight range. New money continued to arrive in corporate bond funds and current conditions are very favourable for new issuance. On the high yield market, packaging company **Trivium** sold two bonds with yields of 6.625% in euros and 12.25% in US dollars. On the corporate hybrid market, sugar producer **Sudzucker** issued a perpetual bond at 5.95%. On the AT1 market, there were new issues from **BPM** and **KBC**.

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.

• 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.

• 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.

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