EDMOND DE ROTHSCHILD

MARKET FLASH: THE FED AND ECB STICK TO RESTRICTIVE POLICY

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• We would advise caution on equities. Duration looks attractive and could afford protection as higher benchmark rates finally start to weigh on economies. We are still upbeat on corporate debt.

At the ECB forum in Portugal, ECB chair Christine Lagarde once again urged caution over the chances of core inflation falling rapidly. As a result, we can expect more rate hikes in Europe, especially in July, to stifle the price-wage spiral, even at the risk of slowing growth for some time.

The Fed is also seen hiking in July after recent data pointed to a resilient US economy. Consumer confidence has rebounded and new orders are up. The property market is clearly over the worst judging from a rebound in new home sales, mainly thanks to limited supply and persistently high household purchasing power. In addition, the third estimate of first quarter growth in the US was revised sharply higher due to strong services and an improvement in the trade balance.

In emerging countries, however, monetary easing looks imminent. China has already cut rates and Brazil could soon follow suit as inflation is now back to the central bank's target.

The Bank of Japan, meanwhile, said its accommodating monetary stance was justified by inflation still running below 2%. And yet Japan's economy and demand still look robust: retail sales rebounded in May, with tourism leading the way.

China's recovery, however, is running out of steam. Official PMI for June pointed to an anaemic rebound: poor new orders, and especially exports, left manufacturing in contraction territory for the 3rd month in a row. Services and construction are expanding but at a slower pace. Stimulus measures could be announced when the Politburo meets at the end of July. Targeted areas are household consumption and property and the aim is to hit 5% growth this year.

Markets once again appeared to be defying gravity this week. US equities recovered all the previous week's losses despite bond market tension. We still think risk premiums are insufficiently attractive and we would advise caution on equities. Duration looks attractive and could afford protection as higher benchmark rates finally start to weigh on economies. We are still upbeat on corporate debt.

EUROPEAN EQUITIES

PMI in the eurozone and the UK had previously fuelled risk aversion but this week upbeat data from the US helped markets rebound, benefiting cyclicals like energy, autos and consumer discretionary. Italy's inflation fell back more than expected in June while lending to companies and households continued to slow over a year. These indications of slowing economies could weigh on future ECB rate decisions. Even so, ECB chair Christine Lagarde said rising wages naturally increased inflationary risk and reinforced the need to roll out restrictive monetary policy. She also said that the ECB would raise rates in July unless there was a significant downturn in the economy. Elsewhere, the failed rebellion in Russia had relatively little impact on markets.

In company news, **Associated British Foods**, Primark's parent company, confirmed that the sector was doing well and raised guidance for 2023. The group's ready-to-wear lines for summer are proving popular thanks to good weather. Next said the same thing last week, echoing positive indications from **Inditex** and **H&M**. In hotels, **Accor** raised its 2023 outlook. Management now sees activity trending higher for some time and the group plans to open 1,200 hotels over the next 5 years with better-than-average profitability on the cards.

US EQUITIES

Wall Street rebounded on upbeat macroeconomic indicators and good results from banks. Durable goods orders for May rose 1.7% from 1.1% in April, or better than the 0.9% decline expected. And in another sign of resilient US demand, the Conference Board's consumer confidence index for June jumped to 109.7 -its highest level since January 2022- from May's revised 102.5, or higher than the 104 expected. Moreover, new home sales jumped 12.2% in May, up from +3.5% in April when analysts were expecting a 1.2% drop. The Case-Shiller index also reported that house prices had risen 1.7% MoM. Brent crude prices fell sharply at the beginning of the week as investors factored in worries over an economic slowdown but the EIA, the US energy agency, said crude inventories fell by 9.6 million barrels over the week when they were seen down by only 1.5 million. This is another indication of strong demand for oil in the US.

In company news, semiconductor groups like **NVIDIA** and **Micron** came under pressure after press reports that Washington was considering banning sales of IT chips to China. **General Mills** said price rises would not offset slowing sales as consumers were being more careful and spending less. In contrast, **Delta Airlines** raised its full-year guidance, citing strong summer demand. In autos, car rental company **CarMax** said it had managed to maintain profits in today's difficult environment by cutting costs and prices to offset lower volumes. Banks were in demand after the Fed's annual stress test failed to detect any obvious weaknesses. The report said banks could withstand another $540bn in losses and still comply with minimum capital requirements. The sector rose on the news, with **JP Morgan**, **Bank of America** and **Wells Fargo** leading gains.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX edged 0.09% and 0.01% lower. Indices initially followed Wall Street lower where tech stocks came under pressure and investors rebalanced portfolios for the end of the month. Stocks then rebounded thanks to upbeat US economic data, a bounce on Wall Street and yen weakness.

Marine Transportation and Air Transportation rose 3.27% and 2.95%, respectively, as investors shifted from value to growth stocks. Banks added 1.78% on hawkish comments from the Fed. Wholesale Trade fell 3.42% on profit taking with **Marubeni** down 5.58%. Pulp & Paper shed 2.71% on profit taking over concerns on prolonged yen weakness. Real Estate declined 2.31% after the National Tax Agency decided to raise inheritance tax on high-rise residential condominiums.

Nissan jumped 7.62% on the weaker yen. Theme park operator **Oriental Land**, rose 6.39% after raising admission charges. **Tokyo Electron**, a semiconductor manufacturing equipment maker, gained 5.89% after **Micron Technology** surprised by raising guidance for the third quarter. In pharma, **Ono** and **Otsuka Holdings** dipped 5.10% and 4.77% as risk-on sentiment hit defensive plays.

The dollar moved from the low 143s to the high 144s after the ECB Forum in Portugal where the BoJ's governor stuck to easing and the Fed's Jerome Powell reaffirmed his hawkish stance.

EMERGING MARKETS

The MSCI EM Index was down 0.13% as of Thursday. India (+1.3%) led gains while China edged 0.4% higher. Korea and Brazil fell 2.4% and 1.7%, respectively.

Manufacturing PMI in **China** came in at 49 in June, or in line with market expectations. Non-manufacturing PMI remained in expansionary territory at 53.2. Industrial profits were down 12.6% YoY in May, or slightly better than the 18.2% decline in the previous month. On the geopolitical front, US Treasury Secretary Janet Yellen plans to visit Beijing in early July for the first high-level economic talks while the Biden administration is considering new bans on AI chip exports to China. The China Securities Journal said more stimulus for the property sector was coming, including potential changes to purchase restrictions in tier 1-2 cities. The State Council is reportedly to introduce targeted measures to encourage consumer spending on household products. **Alibaba** plans to list its grocery arm **Freshippo** on the HKEX by mid-November and **Shein** has filed for an IPO in the US.

SK Innovation in **Korea** will raise $901m with a new share issue to secure funds for debt repayment and new investments in batteries and other new businesses. As part of a move to improve relations, Korea and Japan agreed to revive a foreign currency swap deal worth as much as $10bn.

In **India**, manufacturing PMI jumped to a 31-month high of 58.7. The first-quarter current account deficit narrowed to a 7-quarter low of $ 1.3bn, or 0.2% of GDP. Crop sowing has been weak in June as cumulative rainfall was 28% below normal in the first 3 weeks of the monsoon season. **Amazon** updated its India investment plan from $12.7bn to $15bn by 2030 and **Google** is planning to invest $10bn in India's digitisation fund. **Vedanta** is looking to deepen its tech push with a $4 billion display factory in India. **GQG Partners** bought stakes worth about $1bn in two **Adani Group** companies from the family trust.

Brazil's monetary council is to introduce continuous inflation targeting starting in 2025 while reaffirming its 3% goal. The government proposed to merge federal taxes (ICMS and ISS) and municipal taxes (ICMS and ISS) into a VAT (Value Added Tax), which will be called IBS (tax on goods and services). **Pao de Acucar** rejected **Glinksky**'s bid for its EXITO supermarket chain in Colombia.

In **Mexico**, first-quarter domestic demand grew 5.3% up from 4.7% in the previous quarter, with private investment up 9.1% (vs. 6.8%). **Banorte** said consumer loans were up 21% YoY in April, for a 13% rise in total loans.

In **South Africa, Prosus** said it intended to unwind cross-shareholdings with its investment arm **Nasper** to reduce the discount.

CORPORATE DEBT

CREDIT

Volatility persisted as rates started to trend higher after the previous Friday's strong rally. Between Monday to Friday morning, yields on the 5-year Bund rose 12bp to 2.56% and by 13bp to 2.43% for the ten-year. IG credit premiums continued to hold up well and were unchanged at 160bp while high yield premiums rose to 455 before returning to 445bp at the end of the period. The Xover, in contrast, performed well, tightening by 15bp to 410bp.

Returns over the week reflected these developments. Investment grade lost 0.21%, taking YTD gains to +1.97% after being affected by rates but immune to premium shifts. High yield slipped 0.14% as its shorter sensitivity made it more receptive to rate shifts. Year-to-date performance was still a significant 4.3%. Actuarial yields for investment grade were 4.4% and 7.5% for high yield, still good entry points for carry strategies.

There were no big high yield deals this week. Investors focused on **Casino** which began a conciliation process. The restructuring plan is still not clear.

In hybrid bonds, **Unibail** completed the exchange offer on its callable 2023 bond. Acceptances amounted to 92%. Investors will now own a 7.25% bond callable in 2028 and receive a 15% payment in cash.

In financial debt, Euro CoCo premiums had a volatile week, rising to 900bp before gradually closing near to last week's 870bp levels. There was no new CoCo issuance but in Senior Preferred bonds, **Caixa Central de Credito Agricola** raised €200m at 8.375% due 2027. The bank had to scale down the issue from €300 to 200m due to soft demand. Burnt by **Credit Suisse**, the market is nervous. **Bawag**'s AT1 bonds, for example, lost several points on Friday.

CONVERTIBLES

Convertibles wound up a good first half with another upbeat performance thanks to European equity indices and strength in financials. In the US, cruise companies were in vogue. **Carnival** jumped 8%.

Tokyo rebounded by more than 2% but Asian markets as a whole were flat.

Following last week's sharp drop in **Siemens Energy** due to problems in its wind farm division, the parent company transferred part of its stake to its pension fund but still lost another 3% over the week.

In new issuance in the utilities sector, **American Water Works** raised more than $1bn at 3.625% due 2026 and with a 22.5% premium.

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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