EDMOND DE ROTHSCHILD

MARKET FLASH: WHILE THE FOCUS IS ON THE DEBT CEILING ISSUE…

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Markets are nervously watching to see how the US debt ceiling crisis pans out. In the meantime, they have to deal with confusing economic data and the latest CPI from the UK has called the ongoing disinflation process into question.

Activity surveys show a big divide between manufacturing and services.

Europe's manufacturing PMI fell to a post-Covid low while services accelerated higher to 55.9. It is the same story in the US: services PMI rose more than expected to 55.1 while manufacturing fell to 48.5.

Germany officially entered recession territory after first-quarter GDP contracted by 0.3% after a 0.5% decline in the previous quarter. The US grew by 1.3% thanks to a persistently robust jobs market and strong consumption. Real wages, however, fell sharply.

In Japan, which is still enjoying negative interest rates and an undervalued yen, growth accelerated and the equity market hit its best level in more than 30 years.

Manufacturing, exports from Asian tigers like South Korean and Taiwan, and demand for commodities generally act as advanced economic cycle indicators. Current levels all suggest a recession is in the offing but while the other economic data (employment, services, corporate profitability, etc.) do not point to any further slowdown in activity..

Partly because of central bank worries, the other big focus during the period was persistent inflation. James Bullard at the St Louis Fed, for example, argued for another two rate hikes.

Concerns were amplified by the latest inflation reading in the UK. Inflation slowed less than expected to an annualised 8.7%, and core inflation even started to rise again to 6.8%, sending gilt yields much higher and sterling lower. The Bank of England could struggle to raise rates by 110bp, the level priced in by markets for the end of the year.

We continue to believe risk premiums are still not attractive enough. Liquidity will contract due to issuance from the US Treasury, asset buybacks and tighter lending conditions. As a result, we are still cautious on equities. We have been taking advantage of higher rates to reinforce duration and we remain upbeat on corporate debt.

EUROPEAN EQUITIES

Indices ended the period lower due to disappointing economic data. Composite PMI for the eurozone in May fell from 54.1 to 53.3, or lower than the 53.5 expected. The print was dragged down by more weakness in manufacturing. It fell from 45.8 to 44.6 as new orders lost steam. In France, INSEE's business climate index was disappointing for both manufacturing and services. And weak manufacturing sent Germany into a technical recession. In the UK, underlying inflation in April hit a 30-year higher of 6.8%, up from 6.2% in March.

Consumer discretionary pulled the European index lower as signs of faltering demand in the US and worries that Covid could resurface in China hit luxury groups like **LVMH** and **Kering**. On a more positive note, **Ryanair** reported record results even though demand for air travel was still 5-10% lower than in the pre-Covid period. In M&A, software company **ESI Group** confirmed that it had started talks with a potential buyer. In the media sector, **Bolloré** sold 1.5 million **Vivendi** shares to keep its stake below 30% and thus avoid being forced to launch a full takeover bid.

US EQUITIES

Wall St once again started the week under pressure from the debt ceiling crisis ahead of the June 1st deadline. However, concerns were partly allayed by the prospect of strong growth in artificial intelligence sectors and **NVIDIA**'s blowout figures. Performance deviation between the Nasdaq and the S&P 500 has been exceptional since the beginning of the year and it widened even further over the week.

Elsewhere, US growth slowed but there was still no sign of a recession thanks to relatively strong consumer spending. Nominal household spending rose 7.3% in the first quarter, or 3 percentage points better than the usual trend. Meanwhile, residential property seems to be stabilising. Sales were a little better than expected and builders like **Toll Brothers** said the market was reasonably active.

The FOMC minutes showed that the Fed was still split between marking a pause and raising rates again. But all monetary committee members agreed that the fight against inflation had to continue.

In company news, semiconductor group **NVIDIA** soared 25% on Thursday after its results swept past expectations thanks to heavy demand for AI chips. The group also boosted its guidance for the current quarter with sales expected to come in around $11bn compared to market expectations of $7.2bn.

Citigroup has finally decided to list **Banamex**, its retail banking business in Mexico. The listing was originally scheduled for 2025 and Citigroup initially wanted to sell the bank.

Microsoft launched an appeal against the UK's Competition and Markets Authority (CMA) which had blocked its acquisition of video game market **Activision Blizzard**.

JAPANESE EQUITIES

The NIKKEI 225 rose 0.74% and the TOPIX slipped 0.54% over the period. Markets continued their bull trend supported by 1) relatively good results, 2) the BoJ's ongoing easy monetary policy and 3) the weaker yen but profit taking emerged after the Nikkei 225 touched 31,000 and the Japanese government said it would tighten export controls on semiconductor manufacturing equipment.

Mining and Oil & Coal Products advanced 4.15% and 1.41% as commodity prices rebounded. Electric Power & Gas gained 3.73% after the government approved electricity bill rises and electric power companies boosted earnings guidance. **Kansai Electric Power** gained 6.44%. Textiles & Apparel fell 4.48% on selling of domestic demand stocks as markets turned risk-on. Land Transportation and Air Transportation shed 4.40% and 3.70% on concerns over new Covid cases in China and their impact on tourists from abroad. **East Japan Railway** and cosmetics group **Shiseido** tumbled 6.08% and 6.04% on the news. Elsewhere, **Dai-ichi Life** lost 6.04% due to prolonged financial market turmoil and the US debt ceiling crisis.

Among pharmaceuticals, **Eisai** jumped 7.50% after a major broker gave it a top investment rating and raised its price target. **Otsuka** surged 6.88% after first-quarter profits more than doubled year on year.

The dollar rose from the high 138s to low 140s on reports the debt ceiling issue was near to an agreement and strong economic data suggested the US could once again raise rates.

EMERGING MARKETS

The MSCI EM Index was down 1.32% as of Thursday’s close. India stood apart with a 1.27% gain, while tech-heavy markets such as Taiwan and Korea were little changed. China disappointed again, tumbling 3.9% as concerns rose on weakening recovery momentum.

In **China**, the PBoC kept its benchmark lending rates unchanged. **Micron** products failed to pass a cybersecurity review as the latest US-China semi-tech confrontation escalated. Meanwhile, at the G7, President Biden said he expected US-China relations to improve “very shortly”. 86 new domestic games were approved in May, including games from **Tencent** and **NetEase**. **Meituan** reported a strong set of first-quarter results, with revenue and earnings above expectations. NetEase also announced a profit beat, driven by sustainable multiple margin expansion tailwinds. The company is going on the offensive starting in June. **Longi** is confident its solar panel production facility in the US will be up and running before the end of 2023.

Taiwan lowered its 2023 growth forecast to 2.04% as export orders fell in April for the eighth straight month amid a slowdown in global demand for electronics.

In **India**, April CPI eased to 4.7% from 5.7% in March. The trade deficit narrowed to a 2-year low, with imports (-14.1% YoY) falling faster than exports (-12.6%). The windfall tax on crude oil was reduced to zero from Rs 4,100 per tonne. **Dixon Technologies**, India’s largest electronic contract manufacturer, reported a top line beat and sequential margin expansion.

In **Brazil**, **Petrobras** eliminated import parity pricing for domestic fuel sales. Petrol and diesel prices had dropped by an average of more than 12%. **Nubank**’s results trounced consensus income expectations by 50% amid continuing top line growth momentum and NIM expansion. **Meli** reported upbeat results with origination accelerating and short term NPL flattening.

Mexico’s exports declined 2.9% YoY in April but were still 4.2% higher in the first four months of the year. The country continues to benefit from strong demand from the US for manufactured goods.

On the supply-chain-relocation front, **TSMC** is reportedly in talks to receive German government subsidies for as much as 50% of the cost of building its new semiconductor plant there. **Hyundai Motor** and **LG Energy Solution** are to build a $4.3bn EV battery plant in the US amid a push to take advantage of tax credits. **Hyundai** and **Kia** jointly announced a new

EV plant building in Mexico where ICE cars are already being made. **Tesla** executives plan to visit India to deepen its supply chain there.

CORPORATE DEBT

CREDIT

Despite a few slight bumps, credit premiums were more or less unchanged with high yield at 460bp and investment grade at 165bp. Synthetic indices were still around 435bp. Yields on Germany's 5-year Bund fell from 2.50% to 2.40%.

Unsurprisingly, returns were equally flat with investment grade and high yield slipping 0.2% largely due to rate moves. Year to date, IG has gained 1.5% and HY 3.5%. Actuarial yields for investment grade are currently 4.15%, and 7.15% for high yield, still good entry points for carry strategies. Market levels reflect a soft recession scenario. Company earnings are still generally good which suggests the economy is somewhat resilient. In contrast, the troubled supermarket **Casino** chain is now in talks with creditors.

Current market conditions are fertile ground for new issuance both in investment grade and high. New deals included **WPP** 4.12% 2028 BBB for €750m, **Stora Enso** 4.25% 2029 BBB- for €500m, **Vodafone** hybrid 8% 2086 for £500m, **Solenis** 9.625% 2028 Secured for €630m and **Allianz** with a 30-year Tier 2 non call 10 years.

After tightening sharply 10 days ago, Euro CoCos stuck at 900bp. This is much higher than the historic mean of 500bp, a token of the sector's attractive valuations. However, trading in CoCos was quiet. There has been no significant new deal since the **Credit Suisse** incident. The first round election results in Greece revived interest in local banks which gained between 3 and 5 points.

CONVERTIBLES

Market sentiment was generally weak.

The semiconductor sector was in focus after **NVIDIA**'s strong forecast. **SK Hynix** stock jumped over 10% and its convertible bonds also gained.

Meituan's first-quarter revenue came in ahead of consensus with steady growth in the food delivery business thanks to user incentive schemes and support for merchants. The figures boosted overall sentiment in the food delivery space.

In Europe, **GN Store Nord** announced details of a refinancing plan, including a directed issue and private placing of up to 17.3m shares. The company also gave details on repaying its debt maturing in 2024. The convertible traded well on the news.

On the primary market, **Swiss Prime** raised CHF 275m at 1.625% due 2030. The convertibles were priced at the cheap end and could be considered a defensive play. In the US, **Infinera** refinanced its outstanding 2.125% convertible senior notes due 2024. It also entered into separate, privately negotiated agreements with certain institutional investors to reopen and issue $100m in aggregate principal amount of its currently outstanding 3.75% convertible senior notes due 2028. **Dish** surged on a report of talks to sell wireless plans via **Amazon**, a move that could be credit positive for the firm.

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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