EDMOND DE ROTHSCHILD

MARKET FLASH: INFLATION GOES ON VACATION

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US inflation was expected to fall back but not as much as it did. Over a month, it weakened to 0.18% with core inflation at 0.16%. Base effects and a lull in transport and property prices were behind the drop. Using the Fed's metrics, annualised core inflation over 1, 3 and 6 months came in at 1.9%, 4.1% and 4.6%. Even so the Fed is expected to raise rates again at the end of this month but clearly it has room to delay any other move. So will July mark the end of the monetary tightening cycle?

On bond markets, 10-year US Treasury yields fell 20bp over the period. The equivalent Canadian bond moved 15bp lower even though the central bank raised rates by 25bp. As long as growth continues to be so resilient, equities, and risk assets as a whole, keep moving higher.

China is even facing deflation risk again. CPI was flat and producer prices sank 5.4%. Stimulus measures like the timid lending push, lower interest rates and targeted boosts to the property market have so far failed to convince the private sector. Markets are now expecting more stimulus to revive growth. Nevertheless, Asian exports to China recovered.

Meanwhile, the dollar lost 2% against the euro this week due to a shift in perception. We believe the decline is due to the worsening deficits in the US amid full employment and not the likely end to interest rate hikes.

We are still somewhat cautious on risk assets ahead of another drain on liquidity. We remain overweight duration which looks attractive and should offer protection in a slowdown as disinflation continues. We still like corporate debt.

EUROPEAN EQUITIES

Equity indices rebounded sharply after some good news outside Europe. First, Beijing announced a stimulus plan that will benefit sectors like luxury goods, construction and chemicals. And then US inflation came in lower than expected so the Fed might be less restrictive. Andrew Bailey, head of the Bank of England, also said he was confident inflation would fall back more rapidly as restrictive policies started to have an impact on the economy.

In company news, Ireland's **Kingspan** reported excellent figures due to its construction and energy renovation divisions, especially in the US. Industry demand also showed signs of resilience. In autos, **Renault** posted an 11% rise in first half sales, particularly in its most profitable segments. Portugal's **TAP** airline said passenger numbers had risen 30% in the first half compared to the same period in 2022. In banks, Norway's **DNB** reported a sharp rise in its quarterly results. Admittedly, they were driven by higher interest rates but the strong economy also boosted business with private and corporate accounts. In renewable energy, **Waga Energy** (biomass) won its first contract in the US, a token of the sector's strength. In chemicals, **Clariant** reduced guidance for 2023. However, a move lower was largely discounted and was in the event less than expected so the sector traded higher over the week.

US EQUITIES

Reassuring inflation data sent indices into positive territory after a slow start to the week in thin markets. Inflation fell to a 2-year low of 3% YoY with most compartments - goods, services and shelter- falling to the same degree. Core inflation (ex-food and energy) fell from 5.3% in May to 4.8% YoY, its lowest reading since 2021. Analysts had been expecting 5%.

Previously, Mary Daly at the San Francisco Fed had said two hikes in a row would be needed to beat inflation but that the tightening cycle was coming to an end. Loretta Mester (Cleveland Fed) said on Wednesday that rates would have to rise a little more to anchor inflation around 2%.

Nasdaq is to rebalance its Nasdaq 100 index to correct concentration in stocks like Nvidia, Tesla, Microsoft, Apple and Amazon. The exact changes will be announced on July 14 and come into effect on July 24. Banks came under pressure after Fed vice chair Michael Barr said he was in favour of bolstering capital bases for average sized banks like **KeyCorp** and **PNC**.

Video game maker **Activision Blizzard** jumped 10% after a Californian federal judge ruled against the FTC's demand to suspend Microsoft's takeover. According to the Financial Times, **Nvidia** is in advanced talks with **Softbank** to take a stake in semiconductor and software design company ARM when it lists. For the first time, Cathie Wood's Ark Investment fund cut its exposure to **Coinbase**, the biggest crypto currency exchange.

Salesforce gained 3,9% after raising prices on some cloud services for the first time in 7 years. **Meta** rose after users of its Threads network, a rival to Twitter, reached 100 million barely 5 days after its launch, a record for a new app.

JAPANESE EQUITIES

The NIKKEI 225 and TOPIX fell 2.53% and 2.44% as Wall Street seemed to have priced in two more rate hikes this year and investors fretted about the BoJ possibly moving away from its yield curve control approach when it next meets. The yen also rallied against the dollar and profit taking occurred after the market hit a 33-year high on July 3.

Mining gained 2.29% as crude oil prices rose. Fishery, Agriculture & Forestry and Retail Trade climbed 2.20% and 1.46%, respectively, as investors shifted to domestic demand related stocks. Pharmaceuticals declined 4.87% due to profit taking on **Eisai** and disappointing news from **Daiichi Sankyo** regarding the unsuccessful clinical trial of its new lung cancer drug. Transportation Equipment lost 4.81% due to the stronger yen and Electric Power & Gas shed 3.73% as energy prices rose.

The dollar tumbled from the low 144s to the mid 138s in anticipation of the BoJ's policy adjustment.

EMERGING MARKETS

The MSCI EM Index had rebounded by 2.6% as of Wednesday's close, outperforming developed markets. Markets traded higher across the board with Asia leading gains: Korea +3.9%, China +3.3%, and Taiwan +2.6%. Mexico and India also ended 1.8% and 1.3% higher, respectively. Brazil closed marginally higher.

In **China**, inflation in June was lower than expected, still zero for CPI and minus 5.4% for PPI. However, RMB loans and credit data surpassed expectations, with credit growth reaching 9.3% YoY. In June exports and imports fell 12.4% and 6.8%, or below expectations. The government issued a notice to extend support measures for property project completions. **Ant Group**, Alibaba's fintech division, was fined $1bn by the authorities.

Elsewhere, Premier Li Qiang held meetings with leading platform companies, including **Alibaba** and **ByteDance**, and emphasised the importance of their support for the economy, thereby signalling the end of the tech crackdown cycle. Nine major solar companies issued a joint statement advocating for wafer size standardisation to address supply issues and enhance product applications. Passenger car sales posted a sequential 8.7% rise. NEV sales jumped 25% YoY, taking penetration to 33.7%. Local brands performed particularly well, with a penetration rate of 51.5%. Ant Group announced its intention to buy back 7.6% of its shares, valuing the company at $78.5bn. **Wuxi Biologics** unveiled a proposed spinoff and separate listing of WuXi XDC.

In **Taiwan**, **TSMC** reported a 11% YoY drop in June revenues, or ahead of consensus and guidance. In **Korea**, the government plans to build a new nuclear power plant for the first time in eight years. **LG Chem** raised $2bn through LG Energy Exchangeable Bonds. South Korea export prices were down 14.7% in June.

In **India**, CPI came in at a disappointing 4.8% due to food inflation, but IP beat at 5.2%. The government is considering a ban on most rice exports as local prices surge. **Foxconn** withdrew from a $19.5bn semiconductor JV with Indian metals-to-oil conglomerate **Vedanta**. **Tata Group** is acquiring **Wistron**'s iPhone assembly plant. **Mahindra & Mahindra** is considering divesting a roughly 2-3% stake in its EV business. Two top jewellery companies, **Titan** and **Kalyan**, reported strong first quarter FY 2024 sales, up 21% and 38%, respectively.

In **Brazil**, June IPCA (consumer price index) was lower than expected MoM and up 3.16% YoY, driven by declining food and fuel prices. The service sector rose 4.7% YoY, or well ahead of expectations, despite high interest rates. Retail stocks sold off after last Friday's announcement of a tax exemption for ecommerce cross border import tariff (60% before). The government is reviewing this measure. According to an ANS report, **Hapvida** increased prices for corporate medical plans by 12% in May (versus 10% in March-April and 11% in December).

In **Mexico**, **Antad** (the national association of self-service and department stores) reported a 9.3% rise in SSS in June, a sign of Mexico's upbeat consumer environment. The labour market continued to improve. The government has increased the minimum wage this year.

CORPORATE DEBT

CREDIT

Wednesday's US data showed inflation rising at an annualised 3%, a bigger decline than expected. The news sent interest rates lower. Markets recognised that central bank action was working and that the rate tightening cycle would probably come to an end at the end of the next quarter. Between Monday and Thursday morning, yields on the 5-year German Bund fell by close to 15bp to 2.61% and by 12bp to 2.61% on the 10-year. Credit premiums also benefited with spreads on high yield bonds dropping from 445 to 438bp and from 155 to150bp on investment grade. But the biggest mover was the Xover synthetic index which rebounded from 425 to 380bp over the period.

As of Wednesday evening, returns were all positive. Investment grade gained 0.57%, taking YTD gains to +2.07% due to interest rate sensitivity of 4.5. High yield ended this short period 0.35% higher, or +4.4% year to date. Half-yearly returns demonstrate the wisdom of carry strategies as net yields now amount to around half the actuarial yield as of end 2022. At the time of writing, actuarial yields for investment grade were 4.5% and 7.55% for high yield, still good entry points for carry strategies.

New issuance entered the summer period with only **Telecom Italia** selling a high yield 2028 maturity and no big deal in subordinated financial or hybrid corporate debt. In any case, the black out period ahead of an earnings season is never a busy time for new issuance.

CONVERTIBLES

Trading was active as investors turned risk-on. In Europe, the underlying equity rally was driven by optimism over more economic stimulus in China. The most active sectors were semiconductors, online retailers, property and construction. In the US, cyclical sectors, especially energy and travel, outperformed as the market grew more confident.

In Asia, the big news was **LG Chem** which raised $2bn with bonds due 2028 and 2030 that are convertible into shares of **LG Energy Solution Ltd**. The deal is the largest convertible from an Asian company in almost two years and the biggest ever in South Korea. LG Energy Solution is the 3rd largest producer of electric-vehicle battery makers, behind CATL and BYD, a sector dominated by Asian companies and particularly China.

We expect more new issuance to come: offering lower coupons than straight debt makes convertible bonds more attractive as borrowing costs increase, while fundraising through new equity issuance remains challenging in the region.

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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