EDMOND DE ROTHSCHILD

MARKET FLASH: GEOPOLITICAL RISK IS BACK

- **The eurozone is still suffering from the conflict's consequences and energy prices in particular are taking a toll as we enter winter.**
- **The ECB is coming under increased pressure to ease its monetary policy and put a brake on the economic slowdown.**
- **In Japan, the chances of the central bank tightening monetary policy are mixed.**

The war in Ukraine had been overshadowed by the conflict in the Middle East but has now returned centre stage due to an escalation. Just a few days before leaving the White House, Joe Biden gave Kiev the green light to use US long-range missiles against Russia. Moscow reacted by firing ballistic missiles into Ukraine for the first time, providing confirmation that it had changed its nuclear weapon doctrine. Both Ukraine and Russia seem to be going all out to gain some advantage before any peace talks under Donald Trump's aegis see the light. The new US president is committed to stopping the war. Any peace discussions will be particularly arduous but assets linked to Ukraine have outperformed since the election so investors are anticipating a breakthrough.

In the meantime, the eurozone is still suffering from the conflict's consequences and energy prices in particular are taking a toll as we enter winter. The current cold spell and weak wind power generation in Germany sent European gas prices up to close to €49/MWh, a high not seen since October 2023. Electricity prices were also dragged higher. High energy prices are continuing to weigh on European manufacturing and November's PMI in both France and Germany came in at 43.2. But the key point in the latest data was the rapid deterioration in services PMI. It fell into contraction territory at 49.2 in the eurozone after household confidence fell in November. Economic, fiscal and geopolitical uncertainty weighed on sentiment along with the collapse of Germany's government and fears that France might soon follow suit. The Barnier government's draft budget was not approved by France's national assembly and was sent to the Senate to be amended but with no guarantee that the final product will go through in both houses. The government will probably resort to the 49.3 procedure but the chance of prime minister Michel Barnier winning the ensuing no-confidence vote is in doubt as the National Rally is threatening to vote with the left.

Against this backdrop, the ECB is coming under increased pressure to ease its monetary policy and put a brake on the economic slowdown. A 25bp cut in December now looks almost certain according to some rate-setting committee members but markets are 50% betting on a 50bp move. As a result, European bond yields fell but the euro also slumped to a new low of $1.042. The lack of appeal for European assets is reflected in equity indices underperforming US markets. Wall Street is benefiting from bond markets calming down and the hope of a moderate being appointed to head up the US Treasury department.

In Japan, the chances of the central bank tightening monetary policy are mixed. On the one hand, the bank has to take disappointing economic indicators into account and on the other, inflation, excluding volatile components, is proving stubbornly high. Even so, the likelihood of a rate rise is now running above 60%.

We are still fully invested in equity markets and are tactically overweight the US. We continue to like carry, especially in investment grade and shorter maturities. However, we

have downgraded emerging country debt from positive to neutral due to US dollar strength and uncertainty over trade conditions.

EUROPEAN EQUITIES

A fresh escalation in the Russo-Ukrainian conflict saw Kiev launching long-range US and British missiles into Russia. Vladimir Putin reacted with a decree extending the potential use of nuclear weapons, a move that triggered a 5% jump in natural gas prices in Europe.

Elsewhere, markets were influenced by data showing wage inflation in the eurozone accelerated sharply in the third quarter to 5.4%, up from 3.5% in the previous quarter. The jump was largely due to a strong increase in Germany where wages jumped 8.8%. Meanwhile, PMI data in the continent's leading countries came in lower than expected and remained anchored in restrictive territory. Even so, the Stoxx 600 ended the period flat. Energy and IT outperformed while property and autos tumbled.

In tech, France's **Soitec** (semiconductors but no AI exposure) gained ground after reporting its results. The figures were in line but investors liked the fact that the group had reiterated its 2025 targets, especially as many companies in the same sector had revised down guidance. The mobile phone segment recovered significantly, jumping 160% over the quarter.

Several auto groups unveiled cost-cutting measures to deal with persistently weak sales. **Ford** is to lay-off 4,000 people in Europe by 2027. **Volkswagen**'s unions suggested management reduce dividend payouts and suspend some bonuses to save a further €1.5bn.

In beauty retail outlet news, **LVMH**'s **Sephora** said the chain would be intensifying its UK expansion plans. Its CEO, Guillaume Motte, said the firm wanted to double its size in the UK by opening at least 20 new stores and reinforcing online sales. The goal is to challenge chains like **Boots**.

US EQUITIES

Wall Street advanced over the period, with the Nasdaq 100 outperforming even if the trend reversed sharply at the end of the period. All eyes were on **Nvidia**'s quarterly results. In the end, the figures had little impact in spite of relatively disappointing indications on fourth-quarter margins and growth. Guidance was below some very high expectations but slightly better than investor consensus. Demand is still outstripping production and the quarter is viewed as marking a transition before the **Blackwell** chip makes its mark.

The big market mover was **Microstrategy**, a consulting firm which uses debt to buy as much Bitcoin as possible. The company's market cap briefly hit $100bn but the revenues from its basic business only amount to $500m! In software, investors turned positive on **Snowflake** which started to enjoy strong growth again. The company raised margin and revenue guidance for 2025 and signed a contract with **OpenAI**'s main rival, **Anthropic**. In retail, **Walmart** posted excellent figures driven by strong growth in its "delivery from store" business and market share gains among households with annual income above $100,000. The group's market share gains naturally hit rivals. **Target**'s share price sank after the group slashed guidance for 2025. **Williams Sonoma** (kitchenware and home furnishings) raised revenue and margin guidance for this year even if management sounded a cautious note over Christmas sales.

Muddy Waters, Carson Block's short-seller investment firm revealed that it had shorted cosmetics company **Elf**, citing inventory manipulation leading to revenues being overstated by close to $200m.

The Trump administration said it wanted to simplify autonomous vehicle regulations to help a country-wide roll-out. The news inevitably triggered a surge in the **Tesla** share price.

The Justice Department also officially demanded that **Google** sell its Chrome web browser. It is not yet a done deal but the news amplified Thursday's rotation out of tech stocks. **Netflix** was an exception as it is expected to benefit from last weekend's Tyson vs. Paul boxing match.

EMERGING MARKETS

The MSCI EM index was flat for the week as of Thursday. Korea (+2.8%) outperformed and China edged 0.7% higher. Taiwan and Brazil fell 1.6% and 1.5%, respectively, and India was down 0.7%.

In **China**, 1-year and 5-year LPR were unchanged at 3.1% and 3.6%. The October youth unemployment rate was 17.1%, an improvement from September's 17.6%. Major tier-1 cities continued with the easing property policy. China resumed visa-free travel for Japanese citizens. At the APEC and G-20, President Xi said he was ready to work with the new Trump administration and cooperate with the EU to resolve EV tariff issues. The NPPA released 112 domestic game approvals in November. **Trip.com** reported solid third-quarter results with both revenue and margin beating expectations. **PDD**'s third-quarter growth remained robust and the company reiterated that it was stepping up investments amid pressure from the competition. **Baidu**'s third-quarter results still showed no signs of a breakthrough for its core advertising business. **NIO** announced its results discreetly and the outlook slightly missed consensus expectations despite a strong new model pipeline in 2025.

Taiwan's October export orders rose 4.9% YoY, the best pace since September 2022

In **India**, the Administrative Price Mechanism (APM) announced a cut on gas allocations for gas transportation by 18-20% after 20% reduction in October. The western state of Maharashtra held local elections. The government is poised to permit 100% foreign direct investment in the insurance sector in an attempt to attract global players and boost insurance coverage. **Tata Electronics** agreed to buy a majority stake in Taiwanese contract manufacturer **Pegatron**'s only iPhone plant in India. Gautam Adani was charged by US prosecutors in connection with an alleged scheme to bribe Indian officials.

In **Thailand**, third-quarter GDP rose 3%, or well above the 2.4% expected.

In **Brazil**, the main focus was meant to be on a spending cut package but the announcement was delayed until next week.

In **Mexico**, the 2025 budget announcement was in line with expectations. A request was sent to the Senate to postpone the first round of judicial elections by a popular vote.

In **Argentina**, consumer confidence rose to 45% in November from 42% in October.

CORPORATE DEBT

CREDIT

Nothing managed to derail momentum on credit markets this week. US macroeconomic data, developments in the Ukraine conflict, Nvidia's results and Europe's PMIs had little impact. Investment grade and high yield have now returned 4.2% and 7.7% since the beginning of 2024. The European scorecard for yields is: 2% on Germany's 5-year bonds, 3.2% in investment grade and 5.4% on high yield.

Some of this resilience is due to technical factors like positive inflows and limited new issuance. Investment grade took in €340m over the week (€37bn YTD) and high yield €560m (€12bn).

In new issuance, **Iberdrola**, **Abertis**, and **Roquettes Frères** seized buoyant hybrid debt market conditions to sell bonds. In high yield, **Iliad** issued a B+ bond due 2030 at 5.375% to refinance its 2026 maturity. **Tui Cruise** sold a BB- bond due 2030 at 5%, also to refinance a 2026 maturity.

Despite the economic slowdown in many sectors like industry and consumer discretionary, rating agencies and strategists agree that default rates will remain under the historic 4% average. Company fundamentals are robust, capital markets are thriving, bank capitalisation ratios are running at highs and individual investors and private equity funds are looking for opportunities.

In company news, S&P gave **Intermarché** an investment grade rating (BBB-). This is very good news for the hypermarket chain as it means its recently issued bond can now join indices and become eligible for ownership by a broader investor range. The bond jumped by 2 points on the news and has now gained 6.7% since its July 15 issue date. French medical research lab **Cerba** posted disappointing figures. Regulatory developments and lower prices in France will continue to weigh on the company. Its subordinated (CCC) debt tanked by 3 points so we can expect to see plans for a financial restructuring soon.

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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