EDMOND DE ROTHSCHILD

MARKET FLASH: MORE SIGNS OF ECONOMIC WEAKNESS APPEAR

- **Major economies are showing signs of weakness, leading to a fall in interest rates.**
- **Equity markets fell, dragged down by the latest economic data but also by a fall in tech stocks.**
- **In this uncertain context, we have maintained a neutral stance on equities and duration.**

US inflation has not yet hit the 2% target but July's PCE stabilised with total inflation at 2.5% and the underlying indicator at 2.6%. Overall Manufacturing ISM for August rose from 46.8 to 47.2 but the production and new orders indices were down again. Services ISM edged higher from 51.4 to 51.5, a good sign especially as domestic orders accelerated sharply. But the jobs market, which is now a focus of investors, showed several signs of weakening. The JOLTS report indicated a drop in new openings and the ADP survey said the same for non-farm job creations. In addition, the jobs index in services ISM fell from 51.1 in July to 50.2. The fall shows companies gradually reducing headcount but without triggering a rise in redundancies and jobless claims. As a result of this less buoyant jobs market, the probability that the FED will kick off its rate-cutting cycle with a 50bp move is now as high as a 25bp cut. Canada's central bank has already made its third 25bp cut.

Eurozone inflation fell less markedly as services inflation is still an issue. However, the zone's economies need more cuts as growth is still struggling with soft demand both at home and in China. Beijing has not yet rolled out significant stimulus measures and Chinese PMI indices show that industry is suffering from weak demand. Switzerland provided this week's pleasant surprises. Manufacturing PMI jumped from 43.5 to 49 and services from 44.7 to 52.9. And inflation fell to an annualised 1.1% from 1.2%, or a bigger move than expected.

Overall, major economies are showing signs of weakness, hence the 20bp drop in Treasury yields and a 14bp fall in German Bund yields. Equity markets also fell, dragged down by the latest economic data but also by a fall in tech stocks. Tech started to retreat after a sharp drop in Nvidia following a US Justice Department decision to subpoena the group for alleged antitrust practices. Japanese stocks also lost ground after the yen continued to rise and wagesrose by a surprising 0.4% YoY.

Investors are focused on economic data so political developments are currently being overshadowed. In France, Michel Barnier was appointed prime minister and in the US Kamala Harris took the lead over Donald Trump in election opinion polls (48.1% vs. 46.2%).

Caution is the watchword today and we are still neutral on equities and also on duration as rate cuts have already largely been discounted by markets.

EUROPEAN EQUITIES

After an excellent August, markets suffered a kickback. Amid a transition from the rate-tightening cycle which began in July 2022 to the rate-cutting cycle which started on June 12, risk appetite looks very limited. Europe's momentum looks safe but investors in the US are lying in wait for macro data. Europe tends to track the US so markets are looking for more signs of a soft landing in the US. In the meantime, cyclicals are out and defensives are in.

The news that Michel Barnier was to be France's new prime minister had little impact on French debt markets and on the CAC 40 which continued to underperform. Investors are nonetheless wary of the incoming government's chances of success. In macroeconomic indicators, PMI fell to 49.1 in August from 49.4 in the previous month and industrial production remained weak.

Most sectors ended the period lower with cyclicals like tech and consumer discretionary leading losers. Basic resources were hit by Europe's struggling industries and the persistently complicated situation in China. Energy stocks were weak as Brent Crude flirted with $70. The OPEC + cartel has apparently not found the solution to get prices back to its $80-85 target. On a more positive note, the property sector seems finally to have turned the corner thanks to falling interest rates; Utilities, telecoms and consumer goods performed well as investors moved into safe haven defensives.

In company news, **Atos** revised guidance lower but the news had little impact on the tech sector as the group's market cap is now low. Management said trading was difficult, especially in the US due to reducing spending on tech. Following its recent IPO, first half sales at **Exosens** were in line at €186.9m. Management reaffirmed the 2024 objectives mentioned at the time of the listing, i.e. like-for-like sales growth of 15-20%, and +30% including acquisitions.

In the autos sector, **Volvo Car** dropped its ambition to be fully electric by 2030. The group said the transition to EVs was proving increasingly complicated. The sector was already suffering from its cyclical status and the news added to the gloom both for it and the Volvo share. At the same time, investors approved **Volkswagen**'s announcement that it might have to close down production sites in Germany to help reduce cost and restore margins.

US EQUITIES

US markets fell sharply over the week, with the S&P 500 down 2.57% and the Russell 1000 Value 2.06% lower. As the rotation out of tech accelerated, the Nasdaq 100 tumbled 5.62%.

Semiconductors dictated the trend and the sector's underperformance was among the largest seen this year. Investors are increasingly turning cautious over AI plays. All eyes this week were on giant semiconductor maker **Broadcom**. The group's results were satisfactory but fourth-quarter revenue guidance disappointed investors in spite of data centre demand. To make matters worse, the US justice department subpoenaed **Nvidia** in a search for evidence of a violation of antitrust laws. The group is accused of making it trickier for customers to switch to other providers and putting pressure on buyers only to use Nvidia chips. **C3.AI**, (corporate IA software) also plunged. The group has been struggling to turn a profit and the chances of doing so are looking less and less likely.

Elsewhere, discount chain store **Dollar Tree** plummeted after management revised down guidance on full-year sales and said US consumers were struggling because of the economy. The chain's customers are concentrating on basic goods and shunning non-essential items.

EMERGING MARKETS

The MSCI EM index was down 2.13% this week as of Thursday. Taiwan, Korea, China, Mexico, India lost 5.09%, 4.27%, 2.30%, 1.82% and 0.37%, respectively. Brazil was up 0.38%.

In **China**, Manufacturing PMI came in at 49.1, or below economist estimates of 49.5 and July's 49.4. PMI for the non-manufacturing sector came in at 50.3 in August, up from 50.2 in July. New EV sale momentum continued, jumping 32% YoY in August. Several cities rolled out additional incentives, including subsidies and mortgage support, to encourage home buyers to upgrade to new properties. Shanghai and other cities lifted trade-in subsidies to stimulate consumption. **Guotai Junan** announced plans to acquire **Haitong Securities**; the biggest deal in China's brokerage industry will create a mega-entity with $230bn in assets. **Alibaba** plans to add WeChat Pay as an option on its core e-commerce platforms. Quarterly figures at **Nio** were in line and guidance was underpinned by improved margins.

In **Taiwan**, Manufacturing PMI for August came in at 51.5, so continuing in expansionary territory. The government will raise the monthly minimum wage by 4.08% in 2025.

In **Korea**, **Aust** exports rose 11.4% YoY, or in line with expectations. **SK Hynix** will start mass-producing its most advanced high-bandwidth memory chips, 12-layer HBM3E, by end-September.

In **India**, Manufacturing PMI decreased to 57.50 points in August from July's 57.9. Services PMI expanded further from 60.4 to 60.9 in August, taking the composite PMI to 60.7 vs. the previous reading of 60.5. **Gujarat Gas** announced a restructuring plan to simplify its corporate structure. **TVS Motor**'s overall 2W volumes for August rose 14% YoY and 12% MoM. **Adani Green Energy** unveiled a JV with **Total Energies** to manage a portfolio of solar projects totaling 1150 MW. The cabinet approved a new OSAT plant for **Kaynes** with capacity of 6.3 million chips/day for an investment of Rs 3300 cr, or around $413 million.

In **Brazil**, Manufacturing PMI fell by 3.6 points in August to 50.4. Services PMI also declined to 54.2 from 56.4. GDP rose 3.3% YoY in the second quarter vs. the 2.7% expected. **WEG Motors** signed a BRL630m agreement with **Kroma** to build a solar complex. **Petrobras** tapped global bond markets to borrow $1bn.

In **Mexico**, the newly elected lower house is scheduled to discuss and vote on President Andres Manuel Lopez Obrador's judicial reform proposal. Manufacturing PMI decreased to 48.5 in August from 49.6. Unemployment in August was running at 2.93%, or in line with expectations. **BYD** paused its Mexico EV factory plans until after the US election.

CORPORATE DEBT

CREDIT

Falling interest rates dominated the first week of September after PMIs came in slightly lower than expected. Yields on 10-year US Treasuries fell 20bp to 3.70 (as of Friday morning) ahead of the much anticipated jobless data in the afternoon. Yields in Europe followed suit with the 10-year German Bund 15bp lower to 2.16%. Investment grade spreads were unchanged around 115bp as high inflows continued. But high yield spreads widened by around 10bp to 350bp and the Xover moved to 305bp.

News that Michel Barnier was to be the new prime minister went down well with markets but had no big impact on spreads. The OAT-Bund spread stuck at around 70bp.

New issuance revived after the summer break with financials leading the wave of new deals which were largely absorbed in secondary trading. In CoCos, **ABN** raised €750m at 6.375%, **Bank of Ireland** €600m at 6,375%, **BNP** $1bn at 7.375%, **Alpha Bank** $300m at 7.5%, **HSBC** in two tranches, each for more than $1bn, **UBS** $1.5bn at 6.875% and **ING** $1bn at 7.25%. The dollar-denominated issues were up to 10 times oversubscribed.

With risk-free rates performing well, investment grade bonds returned 0.3% over the week, taking YTD gained to 2.9%. High yield slipped 0.02% as interest rates offset a slight widening in spreads. The segment is still up by a robust 5.6% YTD thanks to resilient spreads.

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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