DC ADVISORY

Weekly round up (Week 29)

The second-quarter earnings season kicked off last week and appears to have met market expectations: a anchor point grounded in companies' own fundamentals, against a backdrop of geopolitical uncertainties.

Earnings from major U.S. banks set an encouraging tone, with better-than-expected results highlighting the resilience of both U.S. households and corporate borrowers. The next key focus will be the earnings reports from companies in the artificial intelligence sector, along with their earnings forecasts and capital expenditure (CAPEX) plans.

This resilience was bolstered by lower-than-expected U.S. inflation data (see Chart of the Week). Both the Consumer Price Index (CPI) and the Producer Price Index (PPI) for June came in below consensus estimates, providing some relief to the fixed-income markets and most likely ruling out the prospect of a rate hike by the Federal Open Market Committee (FOMC) on July 29. The decline in yields was a welcome development for a market that spent much of the early summer assessing the risk of a monetary policy misstep rather than debating the direction to take. It also contrasts somewhat with the situation in the eurozone, where the European Central Bank (ECB) continues to weigh persistently high inflationary pressure against the first tentative signs that German fiscal support may be beginning to feed through to final demand. For European investors, this divergence could raise the question of which central bank—the Fed or the ECB—is most likely to find itself out of step.

However, last week was also marked by the hearing of new Chairman Kevin Warsh before the U.S. Congress, during which he adopted a more hawkish tone than the more moderate inflation figures would have suggested. This contrast between reassuring economic data and a firmer tone could keep volatility high in the fixed-income markets and influence the U.S. Treasury yield curve. While the U.S. yield curve steepened amid falling yields ("bull steepening"), supported by June's inflation figures, the German yield curve flattened amid rising yields ("bear flattening"). As a result, the spread between U.S. and European sovereign bonds has narrowed, ending several months of outperformance by European bonds relative to U.S. Treasuries.

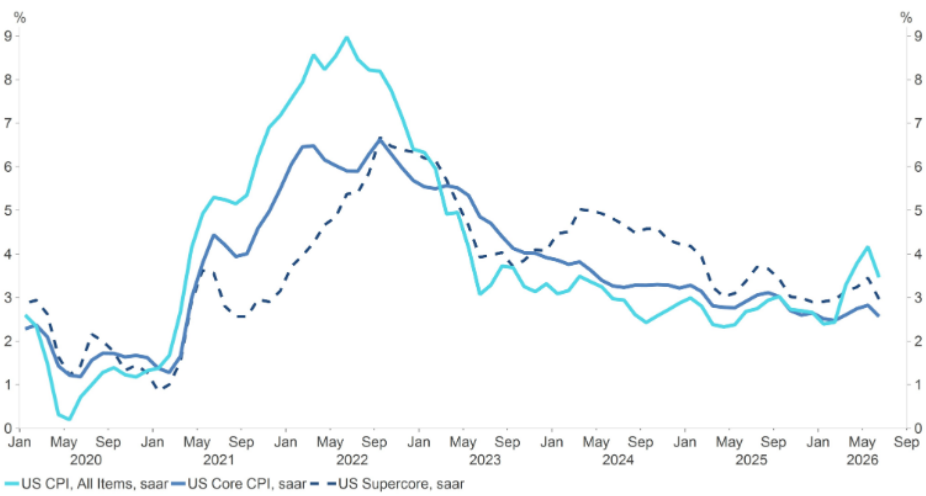
At the same time, a political risk premium could reemerge on European bonds. In Italy, the controversial electoral reform championed by Giorgia Meloni narrowly passed the Chamber of Deputies after an initial setback, but still faces a more challenging vote in the Senate. In France, attention is already turning to the April 2027 presidential election, after Marine Le Pen (National Rally) officially announced her candidacy, having been declared eligible by the Court of Appeals. It is still too early to call a winner, but current polls place her in a favorable position in most conceivable scenarios.

In the equity markets, a sector rotation has taken place, shifting from software stocks to infrastructure companies focused on artificial intelligence. The main catalyst was undoubtedly IBM, whose earnings greatly disappointed investors, causing the stock to plummet 25% in a single trading session. This reaction spread to the entire software sector, as investors grew increasingly concerned that companies would shift their spending from traditional software services to AI infrastructure. Until last week, this scenario was largely viewed as a future risk; it now appears to be becoming a reality. European technology and software stocks were not spared, as the decline in their U.S. counterparts weighed on investor sentiment toward the most highly valued growth stocks.

Aside from earnings season, economic data released last week confirmed the overall resilience of the U.S. economy, with early signs that falling oil prices are beginning to support household and business activity. The question now is whether this positive effect will be lasting or merely temporary. The answer will depend largely on how long energy prices remain subdued, given that the easing of tensions in the Middle East remains fragile.

Finally, a development that could prove more significant in the medium term than last week's headlines suggest: Japan is exploring ways to encourage its own citizens to hold a larger share of Japanese government bonds (JGBs). The implications extend far beyond Tokyo. A structural shift toward greater JGB holdings by domestic investors could, to some extent, result in lower Japanese demand for government bonds from other developed markets—a significant factor given Japan's position as the largest foreign holder of U.S. Treasury bonds, with more than $1,100 billion, and as a regular, albeit smaller, buyer of European government bonds, particularly Gilts and Bunds.

Overall, the market's focus shifted repeatedly last week: from geopolitics to corporate earnings, from rate hikes to rate cuts, and from software to artificial intelligence infrastructure—whatever the future may hold.



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