MARKET FLASH: A VERY BUOYANT START

April 28, 2017

On the markets

The week got off to a very buoyant start. The French presidential first round results sent eurozone systemic risk lower. And the other good news came from indications that economic momentum in the zone was still improving. Germany revised its economic growth forecasts higher. Confidence surveys rose further and the IMF raised its outlook for global growth. But in the US, sentiment appears to be waning as the Trump administration struggles to respect its campaign promises. However, the Treasury secretary finally presented his fiscal reform measures. Corporation tax will be cut by 15%, households will only have three tax brackets and death duties on property will be scrapped. But there were no measures to increase fiscal revenues which should logically cause the government deficit to worsen even if the debt ceiling has not yet been renegotiated. At the same time, the administration has decided against leaving the NAFTA treaty and is now looking to renegotiate terms.

European indices enjoyed strong rebounds on the day after the French election news. Banks and cyclicals led gains. International equities followed suit but less markedly although the NASDAQ hit a new closing high above 6,000. German yields, however, rose. In a reflection of lower systemic risk in France, the Bund/OAT spread narrowed by close to 20bp, falling back below 50bp. The euro rebounded sharply.

Following the general sigh of relief after France's election news, we will be looking closely at potential inflows from non-residents. Pending the second round of both the presidential election and June's parliamentary elections, we prefer to wait for more attractive entry points before reinforcing equity weightings. European equities will clearly be the strategic option to favour due to earnings momentum and attractive relative valuation, but, over the nearer term, market conditions do not warrant upping positions. On bond markets, we have closed out hedges on French government bonds and remain underweight core European country debt.

EUROPEAN EQUITIES

The rebound has given way to a wait-and-see mood. European markets were reassured and galvanised by the French presidential election's first round results. All sectors, apart from basic products, moved higher with banks and building materials leading gains.

More than 100 companies reported quarterly results and most beat estimates. Like-for like growth turned positive over the quarter across all sectors.

Consumer discretionary, and luxury and cars in particular, benefited most from this momentum. **Kering** reported impressive results with a 32% jump in luxury (+48% for Gucci) while **Hermès** continued on its buoyant trend, especially in Asia. **Safran**, **AstraZeneca**, **Bayer**, **Saint-Gobain**, **Sanofi**, **Vinci**, **SKF**, **BBVA**, **Beiersdorf**, **Nokia**, **Renault** and **Bureau Veritas** all rose on excellent figures which easily beat estimates. In contrast, oil and basic products were hit after results from **Technip** and **Total** revealed the impact of lower prices after Libya restarted two oil fields.

Elsewhere, Bernard Arnault and his family offered to buy the 26% in **Christian Dior** not yet held and said Christian Dior would be sold to **LVMH** for EUR 6.5bn in enterprise value. The aim is to fully integrate the Christian Dior brand within LVMH. **Akzo** received its third bid from **PPG**. The bid has been increased by 8% and the move will increase pressure on Akzo as PPG has agreed to pay hefty break-up fees if the deal founders.

US EQUITIES

The S&P gained 1.4% to flirt with the 2,400 point mark while the NASDAQ crossed the symbolic 6,000 threshold for the first time ever. Markets cheered reduced political risk in France as well as upbeat quarterly results in the US. New home sales remained buoyant in March at 621,000 but durable goods orders rose by a slightly disappointing 0.7% when a 1.3% increase was expected.

In the **White House's fiscal proposals**, corporation tax could be cut from 35% to 15%, the number of income tax brackets would be reduced and an exceptional levy on earnings repatriation would be introduced. No details were given on the BAT (Border Tax Adjustment) or R&D tax deductibility. Most importantly, **no calendar was provided** but observers all appear to think the reforms would come in at the end of 2017 or beginning of 2018 at the earliest.

Of the 272 companies to have reported quarterly results, 206 have beaten expectations while 59 have fallen short. Aggregate EPS came in at USD 30.23 or 12.80% higher than in the first quarter of 2016 and 3.17% more than consensus expectations of USD 29.30.

Telecoms and **property** shed 2% over the period while materials, consumer discretionary and technology all gained more than 2%.

JAPANESE EQUITIES

Japanese equities advanced with the TOPIX up 3.3% over the period. It rose for four days in a row but ended flat on Thursday. The market climbed as the US dollar surged above 111 against the Yen on receding concerns about North Korea as well as higher long-term US treasury yields. The market did not react much to the BoJ's decision to maintain its current policy stance at its April 26-27 meeting.

Banks (+5.3%), Nonferrous Metals (+4.9%) and Precision Instruments led advances. **Canon**, Japan's leading precision equipment manufacturer, jumped 7.2% during the period thanks to robust earnings.

Export stocks also gained on the weaker yen and the lack of visibility on the border adjustment tax. Strong gains were made by automakers **Toyota**(+4.5%), **Mazda** (+7.1%), **Subaru** (+4.3%) and **Honda** (+4.2%) as well as electronic component makers **Kyocera** (+6.3%) and **Murata Manufacturing**(+5.4%).

Yahoo Japan Corporation plunged 10% on Thursday due to a downward revision in its earnings forecast which has operating profit declining for two consecutive fiscal years. **Rakuten** also lost ground on disappointing figures from its Rakuten Securities affiliate.

EMERGING MARKETS

Emerging market equities ended the period sharply higher. India, Brazil, Indonesia and Turkey made strong contributions even if currencies were weakish against the US dollar and despite commodity prices. That would suggest that market gains were due to strong earnings momentum both in Latin America and in Asia.

Asian insurance giant **AIA** swept past estimates of an18% increase in new business by reporting a 54% surge YoY for the first quarter, mainly thanks to strong performance in China, Hong Kong and Malaysia.

In Brazil, distribution giant **Cia Brasileira de Distribuicao** (CBD) released robust figures. Operating margins improved, the cost of debt fell and the overall picture showed that Brazil's dynamic conditions were starting to feed through to companies.

Among US-listed Chinese education stocks, **TAL Education**, a specialist in class and internet tutoring, reported a very strong increase in results. Fourth quarter sales (up to end February) soared by more than 80% YoY with a 70% jump in enrolments. This was primarily due to activities starting in 3 new cities and an extra 33 education centres compared to the previous quarter. Net earnings saw an even more impressive 196% increase thanks to the structure's pronounced operational leverage: one teacher can cover 300 internet pupils as easily as 5. The professional future of millions of young Chinese people depends on one exam, the "Gaokao". Spending on extra tuition grew four times as fast as China's GDP in 2016 and 2017 seems to be following the same trend.

COMMODITIES

The first round results of France's presidential elections sparked a resurgence in risk appetite which pushed **gold** prices down a little despite the fall-back in the US dollar. The gold ounce lost USD 20 to settle around USD 1260-70. Central banks bought a lot more gold in the first quarter, added 66 tonnes compared to end-of-year levels. Russia bought 65 tonnes, thereby offsetting China which interrupted purchases 6 months ago to maintain its foreign exchange reserves. Nonetheless, Chinese physical demand (jewellery and investment) remains strong and some estimates point to 139 tonnes being imported in March.

In **base metals**, the big event this week was the drop in **metallurgical coal** and a slight rebound in **iron ore**. Coke prices slipped to USD 250/tonne compared to more than USD 300 in mid April as Australia appears to be returning to normal after Cyclone Debbie. All railways are now running again and prices should continue to return to normal levels. Iron ore rebounded to around USD 68-69/t amid signs of incipient destocking in China.

With no major news this week, **oil** prices stabilised at the bottom of the USD 50-51 range for Brent crude and USD 48-49 for WTI. According to some sources, a Joint Technical Committee bringing together OPEC and non-OPEC members met last weekend and agreed to recommend extending the output cut for a further 6 months after June. An official decision will be taken in Vienna on May 25. Compliance with the cut is running at a high 98%.

Weekly data from the US Department of Energy (DOE) were pored over by traders. Crude inventories fell by 3.6 million barrels while petrol and distillate stocks rose as refinery utilisation rates increased. Imports of crude oil rose 14% over the week as OPEC's destocking from floating storage approached its end. Oil was also impacted by Libya's El Sharara field restarting after frequent stoppages in recent months. Libyan production is therefore expected to return to 700,000 b/d compared to 490,000 previously.

CORPORATE DEBT

CREDIT

High yield markets and financials generally rose on news that Emmanuel Macron and Marine Le Pen were through to the second round of France's presidential elections. Political risk fell in line with the reduced probability of a Frexit. The Xover followed the narrowing Bund/OAT spread by falling as low as 269bp. The iTraxx Main was unchanged at around 67bp.

Companies jumped on this favourable environment to refinance debt at cheaper rates. **Travelex** (financial services) raised EUR 360m with a 5NC2 bond, **Netflix** (media) sold a Senior Unsecured EUR 1bn NCL, **Senvion** (wind turbines) issued EUR 400m with a NC2 bond and **Atalian** (services) sold a EUR 600m maturity. Faced with strong investor appetite, books were several times oversubscribed and yields were towards the low end of the spread. There were no financial bond issues this week but **Banco Sabadell** is expected to issue Tier 1 debt soon.

In big acquisition deals, the **Bertrand Group** (Burger King, France) bought the **Flo Group** which runs the *Hippopotamus*, *Taverne de Maître Kanter* and *Bistro Romain* restaurant chains. In the US, **Becton Dickinson** (medical technology) is expected to buy **C.R. Bard** for USD 24bn in cash and equity. Completion is expected in the autumn.

CONVERTIBLES

It was an eventful week in both the primary and the secondary markets. On the primary side, French tyre manufacturer, **Michelin**, returned to the market in Europe to tap its recent zero-coupon, equity-neutral 2022 convertible bond issued in January; the company added USD 100m million to the existing 500m. Meanwhile, in the US, there were also a couple of new issues. Most notable was a USD 450m, 2.25%, 7-year convertible bond from biotech, **Neurocrine Biosciences**. The company, which develops medications for neurological and endocrine hormone-related diseases, required financing for its R&D pipeline and to market its recently approved drug Ingrezza.

In the secondary markets, we saw the first round of the French presidential election inspiring renewed interest in European CBs broadly while the start of the first-quarter earnings season generated some high volatility in some companies. US convertible issuers which saw significant moves on earnings reports during the week included **OSI Systems** (+10% on optimism on potential for accelerating demand and improving leverage), **Teradyne** (+8% beat and guidance raised on strong semi test outlook), **ServiceNow** (+4% on stronger billings growth in all geographical zones) and **Nabors** (-10% as better top line performance was offset by a sharp acceleration in costs). Elsewhere we saw notable, earnings-inspired moves from **BE Semi** (+11% on better-than-expected orders and profitability), **Yandex** (+10% on higher sales guidance), **Outokumpu** (-11% as upbeat first quarter performance was marred by a problem at the company's ferrochrome smelter) and **Technip** (-6%) announced the Chairman was standing down.

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EDMOND DE ROTHSCHILD ASSET MANAGEMENT (SUISSE) S.A.
8 rue de l'Arquebuse – PO Box 5441 – 1211 Geneva 11
T + 41 58 201 75 40 – contact-am-ch@edr.com
ch.edram.com