MARKET FLASH: A WEEK OF POLITICAL AND GEOPOLITICAL DECLARATIONS

June 2nd, 2017

Donald Trump has decided to quit the Paris climate agreement failing a renegotiation which would better reflect US national interests. All responsible people know the agreement is not renegotiable so the question is how the US is likely to leave and when, as well as the decision's impact on other countries. The agreement's exit scenario is supposed to take 4 years which in theory means the next elected US president in November 2020 will actually be the person to decide.

In the meantime, US federal environmental policy will become meaningless. The news is not all that surprising as it was flagged in cuts to the federal environmental agency's budget, an eventuality we warned investors about in our SRI Chronicles dated January 2017. In fact, the Trump administration can do as it pleases while remaining in the Paris agreement as the deal's decisions are not binding and leave each country to increase or diminish its commitments as it sees fit. That is why a good deal of US organisations and companies are pushing for the US to stay in the agreement. The real reason behind Donald Trump's decision is domestic. He is simply honouring a campaign promise and satisfying most Republican party voters. For us, the news bizarrely seems to echo Brexit.

The obvious risk for the Paris climate deal and the future of our planet is that other G20 countries might follow suit. As the US withdrawal could jeopardise the $100bn in annual payments to the green fund, we might imagine a similar move from an oil-exporting country like Saudi Arabia or India. The upcoming diplomatic agenda is very busy with India's prime minister visiting France to discuss, among other things, the Paris accord, a Europe/China climate summit and the G20 in July. As a result, we will soon know if the Paris agreement is seriously under threat or whether this is yet another, temporary episode of the US playing the isolationist card.

On the markets

Markets generally shrugged off a number of political and geopolitical declarations.

- The G7 summit ended with tension between the US and Germany as well as the eurozone as a whole. Donald Trump criticised other countries for contributing much less money to NATO than the US and also queried the large US trade deficit with Germany. Angela Market retorted by saying Europe could no longer count on its traditional allies in the same way.
- In Italy, Matteo Renzi suggested elections could be held this autumn instead of May 2018. That would mean parties agreeing on a new electoral bill but they might succeed. If so, the new system could be German-style with proportional voting and a minimum of 5% of votes required to sit in parliament.

- In the UK, an opinion poll suggested Theresa May might lose her absolute Commons majority at next week's elections. Note, however, that the poll was in stark contrast to previous soundings.

In economic data, final PMI figures were as expected. US consumer confidence edged lower in May but remained at historically lofty levels. Investors were also reassured by jobless figures from the private ADP research institute.

Apart from a fall in Italian equities and widening Italian spreads with Germany, trading was quiet ahead of June's ECB and FED meetings.

We continue to prefer eurozone risk assets to the US due to (i) improving economic conditions, (ii) better-than-expected European company results, (iii) cheaper valuations and (iv) rising inflows into eurozone equities. At the tactical level, we also prefer Japanese equities to other emerging countries which have performed very well since the beginning of the year. In government bonds, we are cautious on Germany as we expect a shift in the ECB's stance in coming months.

EUROPEAN EQUITIES

European markets retreated at the beginning of the week amid political uncertainty in Spain where the government's stability seemed in question and fears that Italy might stage an early election. They then rallied on upbeat European economic indicators.

Manufacturing PMI for May in the eurozone posted its highest advance in 6 years. With the exception of banks, energy and telecoms, there was a clear recovery in all listed sectors. French auto stocks gained on upbeat May registrations which rose by close to 9%. Air traffic remained buoyant as global passenger numbers jumped 10.7% in April. **Ryanair** gained ground as its annual results (to end March 2017) came in as expected. **Nokia** continued to rise on the resolution of its patent dispute with Apple. **Elior**'s half-yearly results confirmed favourable trends in North America and showed that UK growth had accelerated. **Marks and Spencer's** full-year results came in 4% higher than expected. **Metro** was down mainly on poor visibility over the group's spinoff plan as well as disappointing second quarter results.

Elsewhere, Alexandre Bompard, CEO of Fnac-Darty is seen moving to the same position at **Carrefour**. Beijing has reportedly raised its stake in **Dialog** from 3.2% to 4.2% and **Lanxess** rose after Warren Buffet bought 3% of the company. The EU has given the green light to **Vivendi's** move to take the control of **Telecom Italia** provided it sells Persidera (a digital terrestrial TV operator). **PPG** has walked away from its efforts to bid for Akzo by refusing to make a new offer. The stock was unmoved by the news. It has risen 26% year to date compared to +8.5% of its sector.

US EQUITIES

In a short week, the S&P edged 0.6% higher, taking its year-to-date advance to 8.5% compared to 16% for the Nasdaq. April inflation, using the Fed's preferred PCE source, rose 1.5% or in line with expectations. May's manufacturing ISM rose slightly from 54.8 to 54.9 but the new orders component jumped to 59.5. In contrast, home sales slipped 1.3%, a disappointing figure as the market was looking for a 0.5% rise.

A number of FED members made statements ahead of the usual pre-committee meeting blackout. A rate increase is probably going to be announced. John Williams (San Francisco Fed) said that if the US economy were to continue improving at this rate, there could be four rate hikes in 2017. But 10-year Treasury yields refused to budge and traded towards 2.2%.

Heads of leading investment banks like JP Morgan, Bank of America and Morgan Stanley said second quarter activity looked mixed with a lower contribution from sales and trading. In company results, internet security giant **Palo Alto** reported excellent figures on new product sales and the stock soared by close to 17%.

Over the week, defensive sectors like telecoms, utilities and healthcare gained around 1.5% while cyclicals like energy and financials slipped 0.4%.

JAPANESE EQUITIES

The TOPIX gained 1.1% over the week, rebounding on Thursday after weakness on the previous day. There was strong buying after the Finance Ministry announced a better-than-expected 4.5% increase in year-on-year capital spending by Japanese corporates in the January-March quarter, a 9-year high. The market's rise was also attributable to the increase in effective job openings to job seekers ratio in April. Small-cap stocks remained solid on strong retail buying.

By sector, the best performers were Metal Products (+2.8%) and Chemicals (+2.6%). **Tokyo Electron**, a leading manufacturer of semiconductor production equipment, rose 3.6% due to a large-scale upward revision of mid-term management plans on the back of brisk demand for semiconductors. **Panasonic Corporation**, a leading consumer electronics maker, gained 4.9% on news it was reinforcing its auto components business for use in driverless cars.

In contrast, Iron & Steel (-2.5%) and Oil & Coal Products (-2.1%) were weak. Major losers included struggling machinery and electronics giant **Toshiba** (-4.1%), top steel producer, **Nippon Steel** & **Sumitomo Metal** (-4.1%) and leading nonferrous metal producer **Sumitomo Metal Mining** (-3.5%). Oil refining companies, **INPEX Corporation** (-2.1%) and **JXTG Holdings** (-2.1%), also came under selling pressure due to falling crude oil prices.

EMERGING MARKETS

After three weeks of solid gains, the last week in May saw a moderate correction.

China's manufacturing PMI remained at a high 51.2, or slightly above expectations. Commodity prices caused some moderation but demand came in strong via the new order component and made up for the rest. In another positive sign of economic vitality, PME data were better than those for big groups. Finished goods inventories improved significantly, falling from 48.2 in April to 46.6. Steel and coal inventories are at 18 month-lows which would suggest activity should strengthen further in the third quarter, possibly leaving the second quarter as the year's low point.

Brazil's central bank went ahead with another 100bp cut in interest rates but was more cautious about any further moves due to the persistently uncertain political climate The same mood could been seen among Brazil's large groups and SMEs: no impact on April's sales from ongoing political turmoil but worries that the situation might change. Investors, at any rate, have been reassured by the Real holding up and a sharp rise in the latest PMI data to 52 from 50 in April.

China's e-commerce and on line payment giant **Alibaba** continued on its acquisitions spree but this time went for a more traditional asset by buying 200 million shares, or 18%, in HK-listed **Lianhua Supermarket**, thus becoming its second biggest shareholder. Lianhua operates 3,618 shops across 19 provinces so this is a very interesting logistical move for Alibaba, giving it access to Lianhua's client base and with the hope of extending its Alipay payments system.

COMMODITIES

The decision by OPEC and some non-OPEC countries to extend production cuts was supposed to provide some stability and visibility on oil markets.
Instead, a week after the news, crude Brent fell back below USD 50 and WTI below USD 48. One possible reason for pessimism resurfacing might be Libyan production which is still recovering and is now between 800,000 and a million b/d. This is weighing over the short term especially as Libya is exempt from cuts. Another reason is Kazakhstan which will see some easing in its quotas so as to allow the Kashagan field to restart operations. But both these factors were expected. Meanwhile, in the US, which is the focal point for markets, EIA figures showed March production only rising by 52,000 to 9,098 million b/d and no change in the highly productive Permian and Eagle Ford fields in Texas. This shows that actual growth is lower than weekly estimates suggested. And the pace of new rigs has slowed in recent weeks, a sign that producers are once again becoming more cautious. Lastly, US weekly inventories fell for the 8th week in a row, partly due to increased exports. Even so, traders

are still worrying that increased US production will stop global inventories falling sufficiently. Furthermore, Donald Trump's decision to quit the Paris climate deal might herald increased drilling activity in the US.

Sentiment on commodity markets remained downbeat with the focus still on tighter lending conditions in China. And yet official Chinese PMI data rose in May and readings in the steel sector were at a 12-month high. Producer price and steel inventory shifts in China also suggest conditions are buoyant thanks to infrastructure construction and property sector demand. But that failed to stop iron ore retreating to USD 56 a tonne, well below the USD 95 it was trading at in February 2017.

CORPORATE DEBT

CREDIT

Credit markets proved resilient despite a general upsurge in risk aversion. Credit risk premiums remained low, largely due to thin issuance. The Main was at 62bp and the Xover at 248bp.

On a generally quiet new issues market, **Casino** (BB+) returned after a 3-year absence and raised EUR 550m with a 5-year maturity at 1.865%. The order book was over four times subscribed. **Superior Industries** (B/B2, the largest aluminium wheel maker in the US and N° 3 in Europe) is expected to raise EUR 240m with an 8NC3 bond in the near future.

First quarter results from companies in our universe show that 2017 has got off to a better start. **SMCP** (B1/B) has, for example, opened 116 sales outlets. Sales at **Sandro** and **Claudie Pierlot** rose 22% while **Maje** achieved a more modest 9% rise but EBITDA climbed 22.7% to EUR 34.3m. **Cerba Healthcare** (B2) saw sales rise by a satisfying 6.1% (+2.1% in like-for-like and +4% from acquisitions). Its three main businesses –specialty drugs, everyday drugs and Central Lab- all advanced. However, the EBITDA margin edged lower to 22.6%. S&P upgraded **Ardagh** from B to B+ and raised the outlook to positive. **CGG** has reportedly agreed in principle a restructuring of its debt. And **Solocal's** CEO Jean-Pierre Rémy will leave the company on June 30 2017.

CONVERTIBLES

Primary market was unusually calm this week. It is time to take a step back and sum up May Issuance: $ 4.9 billion worth of CBs were printed (16 issues), +16% versus same month last year. It is more impressive if you look at the US, according to UBS, the year to date issuance is running more than 400% ahead of 2016 ($ 17.6 billion versus $4.3 billion). In the news this week and in brief, **CGG** (French oil services company) announced on Friday that it reached an agreement for restructuration (extending debt maturities to 2022, right issue, new notes…), escaping a possible launch of bankruptcy procedure. In the US, with oil price falling, Oil/Energy stocks and so CBs were down a significant amount (SM Energy, Chesapeake, Weatherford, Ensco…). Meanwhile, **NXP Semiconductor** is said to receive pressure from largest investors (including Elliott Management) to raise Qualcomm Inc $110/share offer. In Asia, **Larsen & Toubro** (Indian Engineering and Construction Company) beat the Q4 expectations with a consolidated profit increase by 28.1% y/y, with strong order inflows largely driven by government ordering. **Maruti Suzuki India** announced that its domestic sales maintained a double-digit growth at +15.5% YoY in May (impact of new model Baleno and Vitara Brezza). In the meantime in Japan, **Suzuki** witnessed a 4th straight months of growths in Japan, a record April in terms of overseas sales driven by India, Thailand; both offsetting a drop in Europe and China.

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