MARKET FLASH: ALL EYES ON THE ECB

December 9, 2016

On the markets

In a very busy week in the eurozone, equity markets made strong gains thanks to the Green party's candidate winning Austria's presidential elections and the ECB's monetary policy committee and in spite of Italians voting "no" in their constitutional referendum.

The Italian referendum result triggered Matteo Renzi's resignation, leaving the President the choice of appointing a new administration or calling new elections. The market had discounted the PM's defeat but the result nevertheless pushes back any chance of much-needed economic and fiscal reform. That explains why Moody's downgraded the outlook on Italy's debt from stable to negative while maintaining its Baa2 rating.

At its December 8 meeting, the ECB surprised markets by extending its asset purchasing to December and "beyond if necessary" and reducing the monthly amount from EUR 80 to 60bn starting in April 2017. Mario Draghi was keen to stress the ECB's proactive stance and denied that this was the beginning of tapering. All options are now open. The bank also changed its technical criteria. It can now buy bonds with yields above the deposit facility rate and, for the time being, over longer maturities. This is designed to calm fears of it running out of assets to buy.

Markets had pencilled in a 6-month extension and reacted strongly to the news with a sudden steepening of yield curves. The yield on the 30-year German Bund rose by 20bp over the week although short term rates remained low thanks to the ECB. Bond yields also rose in the US where they hit 2.43% on 10-year Treasuries.

Equity markets reacted positively to all these developments and preferred to focus on QE extension and the ECB's determination to watch over proceedings. International equity markets rose further, adding more than 2.5% in local currency. The prize went to the Euro Stoxx which rebounded by more than 5.5% while the Dow Jones and S&P500 both hit new closing records. Sector rotation continued with, for once, cyclicals and banks leading advances.

We remain upbeat on European equities as well as on cyclicals and financials. We have, however, taken some profits on equity markets by selling into strength. And we have slightly upped our exposure to subordinated financial bonds.

EUROPEAN EQUITIES

Equity markets rallied after brushing off the “no” vote in Italy’s referendum. Instead, investors focused on the ECB’s decision to extend its QE programme and indices jumped by close to 4%. Pharma stocks remained under pressure after Donald Trump said drug prices needed to come down. The sector posted the lowest rise over the week. But banks enjoyed a big catch-up along with autos with stocks like **BMW**, **Peugeot** and **Renault** gaining close to 10%. November new registrations and auto sales also rose 20% in China. In hotels, REVPAR rose 1% in France in November. **Accor** is the group with the biggest exposure to France and this week announced its purchase of a stake in **Banyan Tree** as part of its plan to expand in Asia.

In a busy week for M&A, **Actelion** was actively traded on rumours of **Johnson & Johnson** sweetening its bid but also on a possible move from Sanofi. **Amundi** paid around EUR 3bn to win the tender for **UniCredit**’s investment firm affiliate, **Pioneer** (EUR 225bn in assets under management). **Orange** is reportedly a possible buyer if ever Canal+ is put on sale. **Vivendi** said it had continued to buy **Telecom Italia**’s ordinary shares and now has close to 24%.

In transatlantic tie-ups, **Linde** is said to be willing to resume talks with **Praxair** in the US over a possible merger of equals. Talks had been broken off last summer. The FT said **Coach** in the US was possibly eyeing **Burberry**; several other bid approaches have apparently already been rebuffed. **Altice** confirmed that it was planning a US listing for its cable businesses (Cablevision and Suddenlink) by mid-2017.

US EQUITIES

Indices gained further ground and the S&P and Dow Jones both hit record highs. The S&P was up 2.5% on the week and by close to 8% since the beginning of November. Most of this surge occurred after Donald Trump's election victory. Non-manufacturing ISM rose from 54.8 to 57.2, yet another upbeat performance after last week’s manufacturing ISM which came in at 53.2 vs. 51.9 and the consumer confidence index which hit its highest level since August 2007 at 107.1. October’s durable goods orders rose 4.6%.

The reflation trade accounted for sector performance dispersion. Banks continued to outperform markedly, rising 5% over the week. **Healthcare** was the only loser (-0.3%) due to Donald Trump's comments on how expensive drugs were. Telecoms (+3%) gained after Trump had a meeting with Masayoshi Son (CEO of Softbank, Sprint’s parent company). The meeting led to promises that Sprint would be making investments in the US and the market read this as a harbinger of further sector consolidation.

JAPANESE EQUITIES

The equity market rally continued in Japan. The Topix rose 2%, hitting its highest level since January 4. Investors are expecting to see positive impacts from President-elect Donald trump’s economic programme but sentiment has also been boosted by upward earnings revisions due to the weaker yen and cost-cutting efforts.

This week's top sectors were Marine Transportation (+11%), Oil & Coal Products (+11%) and Electric Power & Gas (+8.3%) while the Pharmaceutical sector dropped 3.7% after Donald Trump said he wanted to reduce drug prices.

Tokyo Electric Power Company also soared 26.7% on news that Japan’s government would be increasing a USD 123bn interest-free loan for the company as compensation for nuclear damage in Fukushima.

On a negative note, **Shionogi & Co.** and **Ono Pharmaceutical** lost 8.6% and 6.9% respectively.

EMERGING MARKETS

The dollar index surged to 14-year highs this month on expectations of more rate rises by the US Federal Reserve and more spending when Donald Trump takes office. But it has since eased 1.5% off those levels. That, and an oil price rally, has provided some relief to emerging assets. Emerging equities benefited from stronger Wall Street closes and a stabilising dollar, with indexes slightly off recent record highs.

China reported upbeat trade figures, with exports and imports both beating forecasts. Exports gained, ending a seven-month losing streak, due to the cheaper renminbi. Imports jumped the most in more than two years on strong demand for raw materials from copper to iron ore. Moreover, China's November PPI showed some encouraging data again, surprising on the upside (+3.3% YoY vs. 2.3% expected). **India**'s central bank unexpectedly kept interest rates unchanged before a possible increase in US borrowing costs this month, as Governor Urjit Patel waited for more clarity on the impact of the cash clampdown.

Brazil's central bank said it might increase the magnitude of interest rate cuts from 25bp to 50bp, starting with the next Copom meeting (Monetary Policy Committee). **Petrobras** increased gasoline and diesel prices, an indication that the price parity system is working. Not so clear, though, was TCU's decision to block further Petrobras asset sales. Nevertheless, the company can maintain the sales currently being discussed. There was a lot of noise in the political arena but so far it has not changed our base scenario that reforms will be approved. Admittedly, it is getting harder to read the political landscape.

This week saw positive news on **Mexico**'s first deepwater auction when 8 of 10 blocks were awarded to investors. Over the next 10 years, this could bring USD 40bn dollars in investment to Mexico's economy. That would help increase Mexican production by 900,000 b/d which is equivalent to one third of Mexico's peak production. **Russia**'s approval of the sale of a EUR 10.5bn euro stake in its largest oil firm **Rosneft** to a consortium formed by **Glencore** and **Qatar** sent Moscow-traded shares to a record high.

COMMODITIES

Last week's historic OPEC agreement sent **oil prices** soaring to a 16-month high. Prices than fell back a little but resumed rising at the end of the period to USD 53-54 for Brent crude. Ahead of the cartel's meeting in Vienna on December 9/10 where non-OPEC participation in the agreement will be decided, markets prefer to err on the side of caution and waiting to see concrete action from all concerned. A complementary agreement would concern a cut of 600,000 b/d mainly by Russia (300,000 b/d).

As usual, the devil is in the detail: Russia has said that the reference level used to calculate the reduction should be November when its output hit a 30-year high. The other question mark hovers over commitments from other countries. As well as Russia, countries like Azerbaijan, Kazakhstan, Oman and Mexico have all confirmed that they will take part. Oman should be cutting production by 30,000 b/d or a similar percentage to Russia. But following the resumption of drilling in the Kachagan field after a delay of several years, Kazakh output is among the fastest growing outside OPEC so there is some doubt as to whether Kazakhstan will cooperate. As for Mexico, its production is in structural decline and any further cuts look impossible. As a result, non-OPEC participation in efforts to rebalance the market should amount to 300-600,000 b/d.

Meanwhile, the EIA has raised its estimations of growth in global demand for 2016 and 2017 but has also upped forecasts for US production which should therefore fall less than expected. The agency sees the market balancing out in the second half of 2017. It has not, however, reduced its estimations of OPEC output so there is some leeway for rebalancing to occur earlier than planned.

Contrary to expectations, China continued to import large quantities of crude in November (+19% YoY and +16% MoM) which suggests that demand is buoyant and that domestic production has continued to fall.

Industrial metal prices corrected over the week as the US dollar strengthened. **Iron** ore was the only exception. Chinese metal imports were very high in November and especially iron ore which hit a new record of 91.98m tonnes, a 13% jump on October. Iron ore demand remains very strong and is also underpinned by recourse to a better quality of ore to replace coke which has soared to USD 290-300/tonne, a YTD increase of 300%.

At its investors' day, **Rio Tinto** confirmed that the industry had changed tack and was now focusing on cash generation and cost-cutting to create value rather than concentrating on volumes.

CORPORATE DEBT

CREDIT

It was a busy week due to the fallout from Matteo Renzi losing his referendum, a development that will create a new period of uncertainty in Italy, and the ECB's indications on future monetary policy on the Thursday.

The ECB extended its asset purchasing by 9 months but said it would be reducing the programme from EUR 90 to 60bn a month between April and December. At the same time, it has not ruled out further extensions if necessary and said it would be prepared to increase the amount or duration at any moment if the economic outlook deteriorated or financial conditions worsened. This was quite enough to satisfy supporters of QE prolongation and reassure those worried about the actual strength of the economic recovery.

Credit risk premiums reacted positively with the Main at 74bp (-3bp) and the Xover at 314 (-13bp.)

In news on our investment universe, **Atalian** reported upbeat results for the FY 2015/16. Sales rose 23.8% to EUR 16.4bn and EBITDA came in at 103m (+15.1%). **Faurecia** signed its third co-enterprise agreement with its Iranian partners. Bids are expected for **Cerba Healthcare** which has been put up for sale by PAI, its largest shareholder since July 2010.

CONVERTIBLES

As expected, the primary market woke up and now seems unwilling to stop. In the US, **Teradyne** (Semiconductor test products and services) issued USD 400m in 1.25% 2023 convertibles partly to finance a USD 500m share buyback. **Zillow** (ecommerce) sold USD 750m in 3% 2024 convertibles and the defence company **AeroJet RocketDyne** issued USD 260m in 2.25% convertibles due 2023 to increase its acquisition clout and repay revolving credit facilities.

In Europe, the fresh and frozen food producer **GreenYard** issued EUR 125m in 2021 convertibles with a 3.75% coupon and **Ensco** (the UK-based drilling company) priced USD 750m in 3% convertibles due 2024 while being cut to junk by S&P.

In Asia, **CRCC** offered RMB 3.45bn in USD-settled 1.5% convertibles due 2021. The net proceeds will go primarily towards domestic and overseas investment projects.

Steinhoff posted very strong fourth quarter results with revenues up 12.1% and an EBIT margin up 12.5% QoQ as it integrates recently acquired businesses. **Sacyr** announced that it had hedged another part of its stake in **Repsol** via a derivative contract and would use the proceeds to pay down a part of the Repsol loan - this is credit positive news for the Spanish construction company. In the US, **Toll Brothers** advanced 13% this week as the homebuilder reported more than 20% growth in fourth quarter orders.

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