MARKET FLASH: A RISKY REFERENDUM

December 2, 2016

On the markets

In recent weeks, the reflationary theme has continued to gain ground, especially after OPEC's agreement to cut production. The ensuing brutal surge in the oil price and its positive impact on oil stocks has only reinforced this paradigm shift. At the beginning of 2016, central banks and investors were focused on deflation, but the view on inflation has now changed radically. Global inflation had been accelerating in recent months and the contribution from the oil price will play a positive role in energy price formation in coming months. The macroeconomic backdrop is still favourable, judging from the latest household consumption figures and Chicago’s regional manufacturing PMI which jumped from last month’s 50.6 to 57.6.

This repricing of inflation has quite logically hit bond markets, notably at the long end of the yield curve. Nominal interest rates have been following this upswing in inflation expectations and have triggered rotation in asset classes and business segments. Performance dispersion between major stock indices was high this week, with oil stocks and financials leading gains while consumer staples lost ground. And the yield spread between US Treasuries and other G7 countries has pushed the US dollar higher, especially against the Yen.

Markets have clearly adopted a more reflationary scenario, a move which is in tune with our asset allocation choices, but there are still political risks. Italy’s referendum is the prime example. That is why we have been reducing our equity overweight, primarily through tactical hedging. And we have also continued to take profits on our US Treasury underweight following steep rises in yields.

EUROPEAN EQUITIES

European equity markets kept an eye on the looming Italian referendum. Up until Thursday, stocks traded in line with oil prices. Uncertainty was eventually lifted when OPEC reached an agreement on cutting production. Energy, base materials and natural resources all rose on the news as the oil price surged while financials advanced on expectations of higher interest rates. Only oil and financials ended the period higher.

Banks were also helped by the ECB which said it would be prepared to buy more Italian government bonds after the referendum if necessary. Upbeat manufacturing ISM in the US and improving unemployment data in Europe failed to stop the market slide over the week.

There was not much sector news this week apart from new car registrations in France which jumped 8.5% in November, taking the rise over 11 months to 5%. But there was more action on deals: **Royal Dutch Shell** is reportedly looking to sell some of its Iraqi oil fields as part of its asset disposal programme. **Rémy Cointreau** has signed an agreement to buy US whisky manufacturer **Westland**, a move which is part of the group's strategy to acquire luxury brands. And, following on from last week's strong performance, **Actelion** made further strong gains as the talks announced last week with **Johnson & Johnson** continued.

US EQUITIES

US markets edged lower after the strong rebound in cyclicals following Donald Trump's election. The S&P500 slipped 0.6% over the last 5 trading sessions.

In economic data, November's manufacturing ISM improved to 53.2 or more than the 52.2 estimated and up on a previous reading of 51.9. Eleven of the 18 sub-sectors rose, notably oil and coal. Annualised third quarter GDP rose 3.2% or more than the 3% expected and consumer confidence came in at a 9-year best of 107.1, sweeping past expectations of 101.3. In jewellery, **Tiffany's** third quarter results beat estimates thanks to a rebound in sales in Japan and a milder-than-expected softening in the US market.

Clarcor (air and liquid filters) agreed to be bought by **Parker Hannifin** for USD 4.3bn, an 18% premium, and insurance group **Allstate** paid USD 1.4bn for **SquareTrade** which insures electronic and household products.

The OPEC agreement to cut production helped energy stocks to outperform. Financials and commodity stocks also made big gains while technology, healthcare and consumer stocks all lost ground.

JAPANESE EQUITIES

The Trump honeymoon rally continued to buoy Japanese equities. The Topix rose 1.6% and the Nikkei 225 revisited a year high as optimism over US expansionary economic policy reduced worries over soft oil prices and the yen's depreciation against the US dollar to below 114.

The oil price surge following OPEC's agreement to reduce output then triggered a global equity rally and expectations of higher inflation. Widening yield spreads between US and Japanese government bonds weakened the yen further and left bullish sentiment in Tokyo intact. Earnings forecasts for export companies are being revised upwards by analysts. And the Quick Consensus DI, which shows the ratio of upward revision in corporate earnings, hit levels not seen since October 2015.

This week's top sectors were Mining (+8.5%), Oil & Coal Products (+6.6%) and Securities & Commodities (+4.3%), while the Air Transportation sector fell 2.4%.

Japanese oil companies like **Inpex** and **JX holdings** jumped 9.1% and 5.9% respectively on expectations that rising oil prices would mean higher earnings.

On a negative note, higher oil prices had negative effects on the airline stocks. **ANA** shed 2.9% on concerns over more expensive fuel.

EMERGING MARKETS

Over the week, emerging markets rebounded by 0.3%, outperforming developed markets (-1.10%). Asian markets (+0.9%) and Russia (+2.31%) outperformed Latin America (-2.79%) which was impacted by a 5% plunge in Brazil.

The headline news was OPEC's agreement to make production cuts at the top end of expectations. Brent crude immediately soared 11%. At the same time US 10 year yields continued to rise, putting pressure on some emerging market currencies. In **Brazil**, the market decline was driven by increasing turbulence on the political front -the Senate speaker is now being investigated by the Supreme Court- and worse-than-expected GDP figures for the third quarter.

The central bank's decision to cut interest rates by 25bp disappointed investors who were hoping for more given sluggish economic data and lower inflation expectations (12-month inflation is running at 4.75%).

As part of its demonetisation scheme, **India**'s central bank decided to increase the reserve requirement on bank deposits collected between September 16 and November 11. Inflation fell further to 4.4% in October. Third quarter GDP was also lower than expected. **Eicher Motors** said demonetisation would have a limit impact on its results.

In **China**, November's PMI and October earnings growth surprised positively. The big news was the announcement that the Shenzhou-Hong Kong connect would be launched on December 5.

COMMODITIES

OPEC managed to surprise markets by agreeing to bigger production cuts than expected. The parties concerned had appeared to be sceptical over progress right up to the day before the news. In the end, and after intense diplomatic discussions over the last 6 months, the cartel agreed to reduce output by 3.4% (1.17 million b/d), thereby ratifying September's agreement in Algiers to take production down to 32.5 million b/d. This is a relatively historic decision as it is the first move in this direction since 2008 when Brent crude was trading at USD 43 and OPEC production was at 29 million b/d Cuts will be spread between OPEC members proportionately to each country's output but room has been made for specific cases. Indonesia, which is a net importer, is not concerned and is leaving the organisation. Libya and Nigeria are also excluded from the agreement as domestic unrest is preventing them reaching normal output levels. As for the delicate subject of Iran, an output reference level of 3.97 million b/d has been set. This is more than current production of 3.7 million b/d but the arrangement will allow Teheran to say it is implementing the 4.6% cut borne by the other countries, while in practice increasing current production by 90,000 b/d to 3.79 million b/d.

The new feature compared to previous agreements is the **creation of a supervisory committee** to oversee compliance. OPEC is famous for only respecting an average of 80% of quota limits. The agreement shows the cartel is trying to win back the credibility that has been eroded over the last 2 years.

The inclusion of some non-OPEC producers like Russia (which will make additional cuts of 600,00b/d) is good for appearances even if we might reasonably have doubts over Moscow actually reducing production. A meeting has been scheduled for December 9 to provide more details. OPEC is hoping for significant falls in excess supply which are stopping prices from rising more. Only lower inventories can justify investment to increase production and replace reserves. The agreement should help stabilise the oil price in a USD 50-60 spread over the next 6 months.

CORPORATE DEBT

CREDIT

This week on European debt markets was practically a carbon copy of the preceding week. Investors focused on three things: Italy's referendum, shifts in European interest rates and oil prices. But credit indices finished the week practically flat with the Main at 80bp (vs. 82 the previous Monday) and the Xover at 340bp (vs. 342). Sentiment on oil majors like **Petrobas**, **Pemex** and **Repsol** was boosted by the OPEC agreement. At the same time, long-duration senior corporate debt issued by utilities and technology, media and telecommunication companies lost ground as core European sovereign yields rose. Elsewhere, Italian bank momentum improved after the ECB said it was prepared to increase its purchases of Italian sovereign debt on a temporary basis if the results of the country's referendum were to send bond yields soaring.

In news on our stock universe, France's financial daily Les Echos said Japan's **JNFL** would be interested in buying a minority stake in **Areva NewCo**. **RBS** failed the UK regulator's annual stress tests and unveiled a series of remedial measures to bolster its capital base. **IKKS** posted sharply lower results and offered disappointing guidance. **Labeyrie Fine Foods**' first quarter results for the 2016/17 financial year were reassuring. **Verallia**'s third quarter 2016 results were satisfactory but its net debt levels and leverage were nevertheless impacted by a EUR 230m repayment of equity contributions to its shareholders. The group reiterated its objectives for 2016.

Thomas Cook is looking to issue EUR 500m in bonds to help reimburse its GBP-denominated 200m bond which falls due in May 2017 and part of the 2020 bond maturity.

CONVERTIBLES

Uncertainty around the Italian referendum weighed on investor sentiment in Europe with the Eurostoxx 50 sliding below 3000. Oil-related CB names were propelled higher by the OPEC deal announced on Wednesday: Galp, ENI, Technip, Tullow and Weatherford rallied but some of the respective convertibles actually cheapened on a delta-neutral basis.

On the negative side, Thursday saw a tech sell off with the NASDAQ falling 1.36% on the day and the semiconductor index finishing down 4.85% as the rotation out of tech/internet names continued. Companies like **AMD** and **Microchip** lost around7% on the day. **Micron** (semiconductors) preannounced strong first quarter results and revised up its gross margin guidance to 25-26% on the back of a strong recovery in DRAM prices.

On the primary side, there were three new issues from small and midcap companies. In Europe Dutch company **BE Semiconductor Industries** came to market with a EUR 125m 2.5% 7Y convertible. In the US, **Evolent Health** (IT and services provider for the healthcare industry) sold USD 110m in 2% bonds and oil and gas services company **Newpark Resources** issued USD 100m in 4% convertibles. On the funds flow side note that Global convertible funds saw inflows of EUR 162m in the previous week.

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