MARKET FLASH: CENTRAL BANKS SET THE TONE

June 16, 2017

On the markets

All eyes focused on central bank meetings: the US, Canada, the UK and Japan. Only the ECB (the week before) and BoJ stuck to the same message.

Data on inflation showed it was slowing in Europe and the US. The positive base effects from oil prices have evaporated and the short term trend is less encouraging. But the US Fed was not put off and, as expected, increased its rates by 25bp. The bank said its move was motivated by the same reasons: wage increases, tight labour market conditions and economic growth. It still thinks the sluggish inflation seen in recent months is just a phase and will continue to watch the trend. That means a third rate hike this year is still possible. The bank's more neutral tone might have suggested marking a pause but the gradual tightening process is still intact. The Fed also said it would be reducing its future bond buying and only acquiring a maximum of USD 30bn in Treasury bonds and 20bn maximum in other securities.

The Fed's decisions had already been factored in by markets as had the decisions by the ECB and BoJ to keep policy unchanged. But the Bank of Canada surprised investors by flagging a future rate hike and so did the Bank of England. There are increasing signs that the UK economy is slowing- wage growth is decelerating, retail sales are down and surveys are plateauing- and inflation and Sterling's weakness are still of concern. Although the BoE left its policy unchanged, 3 monetary committee members voted in favour of a rate hike. Clearly, the tone is changing in central banks.

Yields had risen ahead of central bank meetings but reacted to soft inflation figures by falling back to previous, and sometimes lower levels, than at the start of the week. But then the change of tone from the Bank of Canada and the BoE sent bond markets lower. Bund yields moved back above 0.3% and 10-year UK gilts above 1.06%. Currencies followed the trend and the US dollar and Sterling gained ground.

Low oil prices were already affecting equity markets and they were somewhat directionless over the week. European equities saw some profit taking. The 3.5% tech correction in the US was short-lived and markets rebounded.

We have increased our short Bund positions and are now neutral again in 2-year Bunds. We have reinforced equity portfolio hedging via options or by buying volatility. We remain upbeat on European and Japanese equities and underweight US and emerging country equities.

EUROPEAN EQUITIES

European markets continued lower amid concerns over news in the US. They first fell after US tech stocks sank due to worries over Apple's valuation levels. The sell-off dragged down Europe's **ASML**, **SAP** and **STMicroelectronics**. Caution was the watch word after a batch of mixed US macroeconomic figures and scepticism after the Fed raised rates -as expected- but surprised investors by suggesting its balance sheet might shrink in the near future. There were wide sector disparities with more defensive plays like consumption, food and healthcare holding up while all other sectors declined.

Michelin rose after saying commodity price effects would be less than expected in 2017. **ADP** continued to post rising passenger figures, notching up 8.8 million in May. **Nokia** unveiled a new router family boasting significant performance gains. The market reaction was very positive. Cognac shipments rose 12.6% in value (+6.4% in volume) in the period to end May. The product mix also improved across all geographical zones, a promising indication for **Pernod Ricard** and **Rémy Cointreau**.

Nestlé says it is mulling the sale of its US confectionary business (CHF 900m in sales and several brands including Crunch) so as to focus on healthcare and nutrition.

US EQUITIES

Sector disparity prevailed this week. Tech stocks fall back. Markets focused on the Fed meeting which eventually delivered a less accommodating message. Core consumer prices (CPI) came in at 1.7%, a 2-year low and less than expected. Retail sales also disappointed, edging 0.3% lower MoM and May's industrial production was flat.

As expected, the Fed raised rates by 25bp to a 1-1.25% spread. Janet Yellen surprised markets with her optimistic take on the macroeconomic outlook. This was interpreted as a harbinger of further rate hikes. She also mentioned the possibility of shrinking the Fed's balance sheet. The prospect of 4 rate hikes this year is still in play. Yellen thinks the strong labour market is a more important gauge than soft inflation which she views as only fleeting. She remained optimistic that inflation would return to the bank's target of 2%.

In stock news, **Kroger** plummeted 19% due to lower EPS guidance. The company also said the competitive environment was testing and that it had had to resort to intense promotional sales drives. **Nike** was also weak, down 3% after announcing it would be laying off 2% of its workforce and focusing on star products. The bitcoin lost up to 19% in one trading session. USD 10bn has evaporated since June 12.

Over the last 5 trading sessions, financials and property stocks led advances. Tech lost more than 3.5% and consumer discretionary was also weak.

JAPANESE EQUITIES

The TOPIX edged down 0.2% over the week. The market lost ground on Thursday, dragged down by the yen's rise against the dollar on dismal US economic indicators and a decline in US long bond yields. External demand-oriented stocks were weak amid a wait-and-see mood before the Fed meeting, while domestic demand-oriented stocks such as Land transportation, Pharmaceutical and Power & Gas were relatively firm.

The best performing sectors were Construction (+4.6%), Land Transportation (+2.4%) and Air Transportation (+2.4%). **Ono Pharmaceutical** jumped 7.6% on news of a large share buyback of up to 20 million shares. Leading house builders **Daiwa House Industry** (+6.2%) and **Sekisui House** (+4.2%) were buoyant. Other major winners included railway firms **West Japan Railway** (+4.8%) and **East Japan Railway** (+4.2%). **Nintendo** also rose 4.1% when it announced a new game development at a global game show.

In contrast, Iron & Steel (-3.2%) and Nonferrous Metals (-3.1%) were weak. Mobile phone carrier **Softbank** (-6.5%) and chip-making equipment producer **Tokyo Electron** (-5.7%) both lost ground. Other major losers included electronic components manufacturers **Nidec** (-4.3%) and **Murata Manufacturing** (-3.3%).

EMERGING MARKETS

India's balance of payments swung to a USD 7.3 bn surplus in the fourth quarter of FY17 from a negative USD 1.2 bn last quarter while CPI fell to a 5-year low of 2.2%. Industrial production growth remained at a very low 3.1%. The RBI mandated insolvency proceedings for 12 accounts (25% of sector gross NPLs). Cases will be accorded priority by the National Company Law Tribunal. In FY17, the capital account surplus stood at USD 21.6 bn.

Although inflation is rising, due partially to Ramadan-related food price pressures, the Bank of **Indonesia** kept its policy rate unchanged as private investment and consumption growth remained sluggish.

In **China**, consumption stayed buoyant with total sales of consumer goods in May 2017 in China amounting to RMB2.95 trillion, +10.7% YoY (vs. +10.7% in Apr 2017 and +10% in May 2016). Net online retail sales in May amounted to RMB548bn, +34.3% YoY, vs. +31.7% in Apr 2017 and +32.8% in May 2016. Online retail sales penetration for May was 18.6% (vs. 18.8% in Apr 2017 and 15.3% in May 2016). **Geely** monthly sales volume in May rose 67% YoY. Without any surprise, investment continued to slow: industrial production remained unchanged in May at +6.5%.

Lower oil prices and extended US sanctions hit the **Russian market** over the week. **Brazil**'s retail sales increased 1.5% MoM (above consensus), stronger than the previous month as well (-0.4% y/y in April versus -1.9% y/y in March), mainly driven by supermarkets and apparel sales. Inflation also fell further. In **Mexico**, although May consumer data was slightly softer than expected, Mexican consumer companies have given encouraging guidance for the second quarter. Total nominal wage growth hit its lowest level, because of the spike in inflation, but remittances remained strong, up 14% in MXN in April. The US rate hike triggered broad profit taking in US-listed Chinese internet companies despite higher top line guidance from **Alibaba** the previous week.

COMMODITIES

It was a busy week for **oil** news and prices saw fresh downward pressure. Brent crude hit USD 47, its lowest level since August 2016. The latest IEA report said OECD inventories had risen in April and that the 5-year median level was barely lower. Despite ongoing compliance by OPEC members, and improving performance from non-OPEC countries, higher output from quota-exempt Nigeria and Libya led to OPEC's monthly production rising. Nevertheless, inventory reductions will be more significant in the second half of 2017. Current prices -less than USD 45 for WTI- are not high enough to warrant stepping up US production. To protect their cash flow and investments, producers have only hedged 2017 output for around 50% on average. And there has been little hedging for 2018. As a result, we should see only a limited amount of new drilling and, above all, lower activation of drilled uncompleted wells or *DUC*.

The fact that **gold** edged back to USD 1,255/or after hitting USD 1,298 two weeks ago, was essentially due to the Fed's decision to start shrinking its balance sheet. The overall currency and inflation background suggests gold should trade at USD 1,250-1,300/oz.

CORPORATE DEBT

CREDIT

The high yield market advanced with the Xover index tightening by 6bp between Monday and Wednesday. The mood changed on Thursday as rising German yields dragged down long-dated utility and TMT debt. The Xover widened by 2bp over the session.

The new issues market gained momentum ahead of the summer. **Global Worth**, a Romanian property company, raised EUR 550m at 3% and **Nuovo**

Trasporto Viaggiatori raised the same amount with a 2023 NC1 maturity at E+250bp. Sweden's **Intrum-Lindorff** (credit services) sold several EUR and SEK 5 and 7-year maturities , raising a total of EUR 3bn to refinance its debt.

The earnings season continued. **Galapagos** (B3/B-), which is undergoing restructuring, revised down some of its forecasts for 2017: sales are now seen at EUR 1,100-1,150m with adjusted EBITDA at EUR 100-110m. Management expects the **Kelvion** division to recover in most regions as new orders rose 18% in the first quarter of 2017. Its Enexio division saw new orders fall 30% but it hopes to increase sales in services.

CONVERTIBLES

The primary market remained buoyant with another 3 deals this week and EUR 740m in Europe alone.

Symrise (a German chemicals maker, and in the top 3 in the flavour and fragrance industry) raised EUR 100m with 7Y convertibles at 0.2375% and a conversion premium of 45%. The proceeds will be used for the refinancing of existing loan and capital markets indebtedness and for general corporate purposes. **Astaldi** (an Italian construction company in the railway, subway and airport sectors) issued EUR 140m of 4.875% 2024 convertibles at a 35% premium and bought back part of the old 2019 issue. The remainder of the proceeds will be used for general corporate purposes. **Orpar** (the holding company of spirits and wine company Rémy Cointreau) issued EUR 200m of bonds exchangeable into Rémy Cointreau. The deal was unattractively priced with a 0.25% coupon and a 40% premium. At the same time, **Orpar** will use the proceeds to finance the repurchase (for EUR 170m) of the outstanding 2019 exchangeable.

In the news this week, **Basilea Pharma** said it was in talks with **Pfizer** over distributing and licensing the rights of the antifungal Cresemba (the stock jumped 7% over 3 days). **Vivendi** is said to be considering a hostile bid for **Ubisoft** by the end of the year ; the convertible gained 2.5 points as the market began to price in the ratchet. In the US, **Finisar** (a fibre optic component supplier) reported fiscal 2017 results and Q1 FY18 guidance largely in line with expectations. However, management's outlook for the next 12 months was more optimistic owing to reassurance on the qualification of a key product for Verizon and a forecast acceleration in FNSR's 3D sensing business.

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