MARKET FLASH: CENTRAL BANKS MAKE THEIR INTENTIONS KNOWN

September 22, 2017

On the markets

PMI data suggest global economic growth is still strong. The eurozone is still accelerating with confidence at peak levels. Inflation is admittedly still soft, and lower than expected, but reflation is ongoing. US price indices came in higher than expected and, in the eurozone too, August inflation rose 1.5% YoY, up from +1.3% in July.

The **ECB** had already suggested that it would announce the end of QE in October and the **Fed** has now unveiled details on its monetary tightening. Benchmark rates were left unchanged but from October, the bank will be reducing its balance sheet by an extra $10bn a month so as gradually to hit $50bn a month. The Fed also said the US economy was strong and raised its growth forecasts to 2.4% for 2017. This all led the market to raise the odds of a rise in Fed fund rates by year end to almost 70%, up from less than 40% two weeks ago.

The **Bank of England** looks set to follow suit. A statement from its committee members confirmed that the bank intended to raise rates in coming months, albeit gradually and to a limited extent. Only the Bank of Japan is sticking with its highly accommodating bias. It has left its rates and 10-year bond yield target unchanged with one committee member even suggesting that current policy is not accommodating enough if the 2% inflation target in 2019 is to be met.

US 10-year Treasury yields hit 2.27% though the rebound lost some steam over the week. European yields followed with the Bund rising to 0.46% compared to 0.36% at the beginning of September. International equity markets were, however, relatively stable although there was significant sector deviation and rotation. European equities gained a little more than 0.6% compared to +1.8% for Japanese equities. US markets were flat. Interest-rate sensitive sectors like banks gained ground as did oil stocks.

We remain cautious on government bonds and prefer corporate debt. We are still sellers of duration in core European countries. We also continue to be overweight European equities as they should gain from today's growth environment and we have also reinforced Japanese equities.

EUROPEAN EQUITIES

The confirmation by the Fed of the forecast of a rate hike was coming at the end of the year sent the euro lower against the US dollar and helped European long bond yields rise further. Equities made modest gains, depending on each sector's interest-rate sensitivity. Utilities, telecoms and property logically fell while financials, which were also boosted by rumours of sector consolidation, benefited in full. Energy stocks also remained buoyant thanks to rising oil prices.

The market was also driven by M&A news. Belgium's **Solvay** (chemicals) sold its nylon division to Germany's **BASF** for €1.6bn in enterprise value. The acquisition will help BASF reinforce its presence on high-growth markets in Asia and the Americas. Because of the disposal, Solvay revised its 2017 guidance lower and said performance would also be hit by the strong euro. **Thyssenkrupp** officially unveiled a memorandum of understanding for a 50/50 European steel joint-venture with **Tata Steel**. This will allow Thyssenkrupp to deconsolidate its steel business and, in comparable terms, reinforce its presence in capital goods areas like lifts, auto parts and industrial solutions. It will also boost its capital base. Italy's **Cementir** has sold its Italian assets to **Italcementi**, a subsidiary of Germany's **HeidelbergCement**, for €315m in enterprise value. This marks another step in the sector's consolidation in Italy.

Total said it had bought stakes in two renewable energy companies, one specialised in solar power and the other in energy efficiency. Both acquisitions reflect the group's determination to include climate change activities in its overall strategy. **Siemens** acknowledged that it was still in talks with **Alstom** and **Bombardier** over railway industry consolidation, notably to ward off the threat from their Chinese rival CRRC.

US EQUITIES

US markets trod water over the week but the S&P still hit a new high of 2,508.

Markets no longer seem concerned by the verbal escalation between Donald Trump and King Jong-un. Instead, tax reform returned centre stage: last Tuesday, two members of the Budget commission agreed on the project's salient points, notably a $1.5 trillion tax cut over the next 10 years. The FOMC meeting ended up as expected. The Fed will start to trim its balance sheet by $10bn a month from October and gradually increase the amounts. The bank also said a further rate hike was probable before the end of 2017, followed by three more in 2018. Janet Yellen said the US economy was robust but that she was mystified by the absence of inflation.

Rumours over a possible tie-up between **T-Mobile** and **Sprint** resurfaced now that the regulator is seen as being slightly more open to this sort of deal. A merger would reduce the number of mobile operators from 4 to 3 and possibly reduce today's stiff competition. **Apple** fell following a lukewarm reception for its new iPhone 8 from specialist publications and blogs. Apple also recognised that its latest smart watch had encountered connectivity problems. Elsewhere, **Anadarko** jumped more than 10% after unveiling a hefty $2.5bn share buyback (its market cap is $27bn). Consumer electronics retailer **Best Buy** posted upbeat figures but disappointing guidance sent its share 8% lower over the week.

Financials and **cyclicals** were the week's best performers thanks to Janet Yellen's statements. **Property, consumer staples and utilities** ended the week lower.

JAPANESE EQUITIES

The TOPIX gained 1.8% over the week, sprinting to a two-year high on Wall Street's record-breaking advance and yen weakness after the Fed said it would start shrinking its bloated balance sheet and go for another rate hike before the end of 2017.

In contrast, the Bank of Japan kept its monetary easing on hold. This was no surprise for the market but highlighted the difference in monetary policy between central banks.

The market was also boosted by rising expectations of Lower House elections, a move that would strengthen the present cabinet. Strong earnings from domestic companies also lifted investor sentiment.

By sector, the best performers for the week were Mining (+7.4%), Other Products (+5.1%) and Oil & Coal Products (+5.1%). **Nintendo** jumped 9.2% due to brokers upgrading its target price and expectations that new game software would be unveiled at the 2017 Tokyo Game Show over the weekend. Oil companies including **Inpex** (+8%) and **JTXG Holdings** (+4.9%) advanced due to higher crude prices. Financials such as **Dai-ichi Life Holdings** (+5.6%), **Mitsubishi UFJ Financial Group** (+5.5%) and **Mizuho Financial Group** (+3.7%) gained ground on growing expectations for further US interest rate hikes.

On the other hand, Air Transportation (-0.7%) and Food (-0.1%) were relatively weak. **Shiseido Company** fell 3.1% and **Toshiba** (-2.2%) declined for the second week in a row.

EMERGING MARKETS

Emerging markets were stable during the week (in US dollar terms), despite 1) the Fed's hawkish near-term message; 2) increasing political tension in North Korea and 3) S&P's downgrade of **China**'s sovereign rating.

This week's performance proved the resilience of emerging markets. We believe the S&P's downgrade is a useful reminder of some of China's inefficiencies and much-needed structural reforms.

Nevertheless, we believe China is succeeding in rebalancing its economy towards the consumption sector. Lending growth is also decelerating, corporate profitability is improving and the government is proving efficient in rolling out reforms. In other Chinese news, **Tencent** announced the acquisition of a 5% stake in **CICC** to broaden its grasp of financial products.

In **Brazil**, mid-September inflation came in below expectations at 2.56% YoY due to lower food and services prices. In **Argentina**, second quarter GDP expanded to 2.7% YoY, The main growth drivers were investment and private consumption. Elsewhere in Argentina, **Despegar**, an online travel agency, was the country's first IPO this year and was priced at the top of the range.

COMMODITIES

Following the OPEC/non-OPEC agreements, **Brent crude** advanced further and was only $1-2 off its year high of $58. Fundamentals continued to improve especially due to the fall in OPEC exports in recent months. The US Department of Energy's Drilling Productivity Report expects production in the 7 shale oil sites to fall back in coming months, in line with recent trends. Drilling had effectively stabilised since the beginning of July but has just seen a drop of 7 drills out of 749, the largest weekly fall since the beginning of 2017.

Next weekend will see a meeting of OPEC and non-OPEC countries which are part of the production cut agreement. Libya and Nigeria, which are exempt, will also probably attend. The topics will probably centre on greater checks on each country's exports -ultimately a more important factor in balancing the market than production levels- as well as the possibility of extending cuts. They are currently scheduled to end in March 2018. It is still too early to hope for some consensus agreement and, in any case, the decision will be taken later this year.

As a result of Hurricane Harvey, US refiners are planning to postpone maintenance. If so, oil inventories would see a bigger fall than the market currently expects. In the meantime, the latest data shows a sharper drop in oil product inventories compared to rising inventories of crude oil.

Gold prices had flirted with $1,360/oz at the beginning of September but suffered a correction over the week to return to $1,300, the level seen a month ago. Traders are now shrugging off the war of words between Donald Trump and King Jong-un and the FOMC's decision to officially declare the end of quantitative easing had its effect. It now looks likely that a further rate hike will occur in December. Nevertheless, today's environment warrants some stabilisation of the gold price at current levels.

CORPORATE DEBT

CREDIT

Peripheral CoCos performed well following S&P's decision to upgrade Portugal to BBB-. The FOMC held no surprises, and struck a somewhat hawkish note by announcing the gradual reduction of its balance sheet while keeping rates on hold for the time being. European yields rose on Thursday but there was no significant widening in spreads.

It was a very busy week on the primary market. **Petrobas** (B1/BB) issued a USD-denominated senior bond in two tranches, 7 and 10 years. **Avantor** (B2/B) - laboratory equipment - issued a senior bond in USD and EUR for 7 and 8 years. Healthcare company **Stada** (B2/Caa1) issued a euro-denominated senior bond over 7 and 8 years. Mining company **Eramet** (N/R) issued a 6-year euro-denominated senior bond.

It was a thin week for company results. **CMA-CGM** (B1/ B pos) posted a strong 57% increase in sales over a year and a 58% jump in core EBITDA compared to the first quarter. The group benefited from rising volumes and a recovery in freight.

In M&A news, **OHL** (Caa1) is under pressure to reduce its heavy €2.9bn debt (compared to €1bn in market cap) and is reportedly to dispose of a 51% stake or be sold to China State Construction Engineering (CSCE), the largest construction company in China.

In biotechs, **Eurofins** (BB+ estimated) has signed a memorandum of understanding to buy **EAG Laboratories** for $780m so as to expand its presence in the US. The group has the means to fund the deal as it raised €650 in July through a bond issue. The issue took the company's pro forma gearing to 2.5 times.

CONVERTIBLES

It was a busy week for convertible issuance from a wide range of companies. In Europe, **Artemis**, a French holding company, raised € 375m with a zero coupon 5.5 year bond exchangeable into shares of the luxury giant **Kering**.

Another deal came from South African precious metals miner **Sibanye-Stillwater** which raised $450m with a 6-year convertible at 1.875% to refinance a bridging loan facility.

In Japan, pharmaceuticals wholesaler **Medipal Holdings** issued a Y30bn zero-coupon convertible to finance the acquisition of a stake in **JCR Pharmaceuticals** and a share buyback.

In the US we had two new issues: a $325m 3.25% 20 year (8Y put) convertible from auto components manufacturer **Meritor** and a $200m 1.5% 5-year convertible from **Marriott Vacations Worldwide Corp**.

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