MARKET FLASH: SECTOR ROTATION CONTINUES

December 8, 2017

On the markets

Sentiment was mixed at the beginning of the week with, on the one hand, the vote in favour of US tax reform and, on the other, deadlock over talks between the UK and Europe. The tax reform proposals will now go through a reconciliation process with the House of Representatives before a final vote by the end of the year. As for the UK, the week ended on an up-note as an agreement was reached ahead of the European summit on December 14-15 and there was progress over the final cost, expat status and the Irish border question.

Elsewhere, economic data confirmed that the global economy was doing well. Admittedly, the final ISM and PMI indicators in the US were slightly below expectations but they remained at lofty levels. European indicators held no surprises and European equity markets outperformed. The US saw market sector rotation with tech underperforming and financials outperforming. Commodities also returned centre stage by falling and pushing Asian indices into the red. Investors are worried that the Chinese slowdown might weigh on demand for metals.

Last month, we had slightly reduced exposure to equity risk for tactical reasons. It seemed to us that the improving economic environment had not ruled out the risk of short term volatility. We continue to invest in risk assets but more cautiously.

EUROPEAN EQUITIES

As the year end approaches, investors started to reduce sectors and assets which had done well this year. Technology saw heavy selling in the US, Europe and especially Asia where tech large caps had gained the most ground. In contrast, defensives advanced.

In Europe, an agreement on Basel III regulations was reached. Banks will have at least 5 years to adapt to the new rules and the final draft will hit European banks less than was expected.

In stock news, **FNAC Darty** unveiled its ambitious “Confiance +” strategy which will seek to pursue it multichannel distribution model. This means (i) reinforcing on-line distribution, launching new subscriber services and opening kitchen product corners in large retail outlets, (ii) expanding in developing markets, (iii) increasing the number of franchises and (iv) reinforcing cross-selling between the two brands. The operating margin is expected to be between 4.5% and 5% over the medium term or above current expectations.

Orange announced strong growth prospects at its Investor Day. Fibre deployment will be accelerated almost everywhere in Europe and capex will peak in 2018 before falling back. A new costs savings plan for €1bn over 2 years was also unveiled. The group is ready to embrace limited external growth but has ruled out any cross-border deals due to lack of synergies and high execution risks, and any sharp increase in the cost of content.

ProSiebenSat1 confirmed its 2017 targets and is now banking on EBITDA of 25% over the medium term. The group is to create 3 divisions: entertainment (including TV + digital), content production global sales and commerce.

In military aviation, **Dassault Aviation** and **Thales** gained when Qatar exercised an option to buy a further 12 *Rafale* planes and took out an option for 36 other planes.

Among this week's disappointments, **Elior** lost further ground when its guidance came in below expectations. **Dialog Semiconductors** continued lower after recognising that **Apple** could theoretically manage without its services. An affiliate of Chinese chip maker **Tsinghua Unigroup** took advantage of this to increase its stake in the company.

In M&A, **Elliott** acquired 5.3% of **Uniper**, **Peugeot** signed an agreement on electric motors with Japan's **Nidec** and **Casino** extended its agreements with **DIA**.

US EQUITIES

In a relatively stable week, the S&P edged 0.4% lower, taking its YTD returns to 18% vs. 27% for the Nasdaq. October's durable goods order fell 0.8% and non-manufacturing ISM came in at 57.4, down from 60.1. Last week's sector rotations continued with tech losing 1% over the week while financials added 1%.

Congress extended the Federal budget deadline by 2 weeks to avoid hitting the debt ceiling, for the moment at least. Talks between Republicans and Democrats seemed to be going smoothly. There were rumours that corporation tax would be a little above 20% while the Alternative Minimum Tax might be abandoned. The big news was the emergence of a new theme, the plan for government spending on infrastructure, which should be unveiled at the beginning of 2018.

Lululemon soared 8% on upbeat quarterly figures with like-for-like sales up 8% and encouraging prospects. **General Electric** brushed off the news that it was to lay off 12,000 people. The entertainment industry was actively traded on news that **Disney** and **Twenty-First Century** had resumed talks. **Comcast** might also be interested in certain Fox assets. **Twenty-First Century** gained 7% over the week.

JAPANESE EQUITIES

The TOPIX dropped 0.57% over the week in sluggish trading.

On Wednesday, the Nikkei 225 plunged, posting the biggest fall this year on concerns that Donald Trump's decision to recognise Jerusalem as Israel's capital would increase tension. The downswing accelerated when the Yen strengthened against the US Dollar. Profit taking after the Nikkei average broke below its 25-day moving average also dragged the market down. Tech stocks were relatively weak during the period.

However, on Thursday the market bounced back on bargain hunting, apparently led by overseas investors.

By sector, the best performers of the week were Construction (+2.05%), Fishery, Agriculture & Forestry (+1.84%) and Foods (+1.80%). **Daito Trust Construction** advanced 7.78%, hitting a record high on strong performance in November. Other major winners included food company **Ajinomoto** (+4.38%), beverage maker **Kirin Holdings** (+3.94%) and cosmetic producer **Shiseido** (+3.08%).

In contrast, Precision Instruments (-3.23%), Nonferrous Metals (-2.92%) and Mining (-2.16%) were relatively weak.

Nikkei heavyweight **Nitto Denko** tumbled 8.76%, causing the Nikkei 225 to underperform the broader TOPIX. **Fanuc** (-4.98%), a leading manufacturer of machine tool numerical controls and articulated robots, fell 4.98% and pharmaceutical company **Shionogi** ended 4.59% lower.

EMERGING MARKETS

Emerging markets saw some profit taking, particularly in tech, and were down 1.1% in USD. Some investors are probably thinking that US tax reform could lead to new growth opportunities, and there is also a risk of US bond yields rising too fast, which would be negative for the emerging zone.

There were a number of **announcements from central banks** over the week. In China, the CBRC released a consultation draft for revised rules for small banks which will mean tighter liquidity risk management for banks with assets below RMB 200bn. In India, the RBI kept its rates unchanged. Brazil's central bank cut interest rates by a further 50bp.

Macroeconomic news remained upbeat. In **China**, exports rebounded more strongly than expected, rising 10% vs. 2% estimated. Imports followed suit, up 15% vs. +12%. In the autos sector, **Geely** reported a strong 38% YOY rise in car sales in November. Total sales jumped 66%YoY, meeting 99% of the company's annual target.

In **India**, the car industry reported strong 14% growth in November that was also spurred by a favourable base effect due to the November 16 bank note demonetisation. **Maruti** sales jumped 34%.

While we expect some volatility in the next 3 months amid fears that the Fed might tighten monetary policy faster than expected, we are not changing our positive stance on emerging markets:

1. It remains to be seen if a widening fiscal deficit will not once again trigger deflationary concerns for the long term; it is rather strange to see the spread between 2 and 5-year government bond yields at a historical low

2. Emerging market activity is not slowing down.

3. Structural reforms should bear fruit over the medium term: China's more tightly controlled credit policy and more innovation should ensure better quality growth. In India, the Goods and Services Tax (GST) is creating a simpler domestic market. Argentina and Brazil are carrying out courageous fiscal reforms.

COMMODITIES

Oil prices consolidated following the November 30 OPEC summit. Brent crude lost around $1 over the week to $62.6 and WTI ended $1.7 lower at $56.6. With no major news to chew over, markets focused on US inventories, down for crude but sharply higher for oil products like petrol and distillates with refineries working flat out. We should have a better picture, especially as concerns demand, next week when OPEC and the IEA release their monthly reports. China said oil imports surged 19.4% in November compared to October or by 9 million b/d. Chinese demand is still buoyant and the increase in imports is largely due to reduced domestic production.

LNG prices moved above $10/MMBtu to their highest level since January 2015 due to strong Asian demand, particularly in China, and rising oil prices. Chinese appetite for LNG this year has been driven by Beijing's clamp-down on coal as it campaigns to reduce pollution levels and the increasing use of gas-driven boilers in homes. The trend is expected to continue in 2018.

The **gold** ounce lost close to 3% over the week to $1,247 due to the strong US dollar and expectations that the December 13 FOMC meeting would, as expected, decide on its third rate hike this year. And yet, according to the World Gold Council, investors continued to amass gold via ETFs, adding 9.1 tonnes in November for a total of 2,357 tonnes. A slight rebound in November's official manufacturing PMI failed to offset the impact of the rising dollar which hit all base metal prices over the week.

CORPORATE DEBT

CREDIT

Credit markets weakened with the iTraxx Crossover edging higher to 235bp.The HY new issues market remained very busy as if issuers were rushing in to secure funding by December 20 ahead of the year end.

We noted that new issues came essentially from the low part of the HY spectrum and included **Burger King**, **Picard** with a €1.2bn floater and a subordinated loan at 5.25%, **Perstorp** (chemicals), Italy's **Pro-Gest** (packaging), Germany's **Schenck Process** (engineering) and, in the US, **BMC** (IT solutions). In new issues, **Assicurazioni Cattolica** made its market debut with a LT2 at 4.25%.

CONVERTIBLES

The convertible bond market was stunned this week by the precipitous decline of **Steinhoff**. The Frankfurt-listed retailer of furniture and household goods, owner of well-known brands including Conforama and Pepkor, fell by more than 80% (with its various convertible bonds losing around 40 points) between Wednesday 5 Dec and Thursday 7 Dec. This followed the resignation of CEO, Markus Jooste, and news that annual results would be postponed amid speculation over accounting irregularities. Chairman of the Board and 22.7% shareholder Christo Wiese was appointed to take over as acting managing director in the interim. Subsequently, Moody's decided to cut the issue's rating by four notches from Baa3 to B1.

This event notwithstanding, the primary market remained active, with two plain vanilla convertible bonds issued this week. In Europe, **Deutsche Post** returned with a €1bn 7.5-year, 0.05% coupon convertible with the proceeds earmarked for refinancing needs and the reduction of the company's UK pension obligations. In the US, **Cleveland-Cliffs**, an iron ore miner and producer of iron ore pellets for use in steel manufacturing, issued a 7-year, $275m million convertible at 1.5% to help finance the expansion of its pellet production capacity.

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