



MARKET FLASH: POLITICAL RISK IS BACK

February 23, 2018

On the markets

Trading remained erratic with no major underlying trend. Investors continued to focus on central banks, and specifically the latest FOMC and ECB minutes to be released. They contained no new developments: the Fed is confident inflation will gradually move higher towards its target level while the ECB took comfort in the ongoing recovery and continued to think soft inflation required its expansionist monetary policy to be maintained.

Economic data over the week testified to the solidity of the recovery but with a few nuances. In the US, the Michigan survey and PMI data on household and company confidence came in higher than expected, probably because they were boosted by Washington's stimulus measures, while Europe's manufacturing and services PMI- as well as the IFO- slipped back more than analysts had expected even if they remained at lofty levels.

In the run-up to Italy's elections and the SPD's vote on whether to join a grand German coalition, there was some tension on Italian government bond spreads with Germany. Previously, markets had brushed off worries over these electoral risks.

▶ EUROPEAN EQUITIES

European markets edged higher as long bond yields fell back and the euro lost ground against the US dollar. The week's fourth quarter results suggested growth in 2018 would be stronger and there were significant upward earnings revisions, especially in industrial cyclicals, technology, hotels and media. Stocks boasting upward top-line revisions generally performed well.

Among companies reporting upbeat results, **Bouygues'** EBIT and FCF were both sharply higher than expected. Sales in its telecoms division rose 6.08% and management expects them to increase by more than 3% this year. The construction order book rose 7%, hitting a record at the end of December. The dividend is to be increased. **Orange's** fourth quarter sales also rose with France (40% of total sales) up for the first time since 2009. The group is to press on with cutting debt.



Accor reported satisfying fourth quarter and full-year figures. RevPar rose significantly and annual EBIT came to €492m, or more than consensus expectations as well as the company's own guidance. Margins rose by an annualised 130bp. The group said talks over disposals were nearing completion and that RevPar would rise further in 2018. **Saint Gobain's** figures were in line with expectations as was operating profit despite the cyber-attack in June and July. Like-for-like fourth quarter sales rose 6.5% (+4.7% for the full year) and margins improved, a sign that the group was able to raise prices despite pressure on commodity prices.

Veolia reported upbeat 2017 results with growth accelerating again in the fourth quarter. France turned positive again and FCF generation was significant. The group maintained its 2018 and 2019 targets and sees EBITDA this year beating last year's performance.

ProSiebenSat1 gained from the sharp bounce in TV advertising in the fourth quarter and announced the sale of 25.1% of its **Nucom** e-commerce division to **General Atlantic** and the appointment of a new CEO. The group expects higher sales and an EBITDA margin of around 25% in 2018 which is in line with consensus expectations. **FNAC-Darty's** 2017 sales missed expectations but the group said its gross margin had increased significantly and that it had exceeded post-merger synergy targets. FCF generation remained robust.

Among disappointments, **Ingenico** had a good 2017 but sounded a downbeat note for 2018, particularly in the first half. **Technicolor** had a very disappointing second half across all divisions but particularly in Special Effects, usually its growth driver. Guidance for 2018 was below expectations. The disposal price for its patents division is also not clear.

▶ US EQUITIES

Indices fell back with the S&P bumping against the 2,750 mark before ending the period 1% lower. Investors were absorbed by the FOMC minutes which delivered a relatively hawkish message, triggering the market retreat, a rally in the US dollar and a higher bond yields. All this went on in lighter trading, with volumes 10% below levels seen since the beginning of the year. January's existing home sales fell 3% when they were expected to rise 0.5%.

The FOMC minutes noted various factors which would warrant monetary tightening even if the Fed was careful to state that continuity of policy was still the watchword. But the market chose to focus on statements in the document that economic conditions were dynamic, the US dollar weak and the possibility that lower imports might have a bigger impact on the economy. US 10-year Treasury yields promptly rose from 2.87% to 2.95%, their highest level since January 2014.

Walmart tumbled 10% after growth in its e-commerce business tailed off slightly even though it remained at close to an impressive 25% a year. Management also said it would soon have to up investments. **United Technologies** (+5%) had a good week. The company has solved problems in aircraft engine production and the CEO said it was planning to spin off the conglomerate into three distinct and separately listed entities, Aerospace, Lifts and Climate Control. Elsewhere, **GE's** CFO ruled out any possibility of a capital increase.



In M&A, **Broadcom** quite logically reduced its bid on **Qualcomm** by 4% to \$117bn after Qualcomm raised its bid on **NXP** to \$44bn.

Over the last 5 trading sessions, technology, industrials and utilities were the best performers. Energy, telecoms and consumer staples all posted significant losses.

▶ JAPANESE EQUITIES

Over the week, the TOPIX edged up 0.51% despite investor nerves over possible rises in US Treasury yields and US dollar weakness around 106-107 to the yen. Domestic individual investors, convinced by the favorable earnings outlook, played a big role in buying oversold names, offsetting the selling pressure from abroad seen so far this month. On average, the current P/E ratio on the Topix's 1-year forward earnings is 14.98, or still within the average 14-16 times spread that has been in place since Shinzo Abe became prime minister.

By sector, Other Products (+2.29%) including **Nintendo** (+2.92%), Other Financials (+1.85%) and Warehousing & Harbour Transportation (+1.84%) outperformed. **Otsuka Holdings** (+5.74%) remained strong with the market appreciating its successful revenue diversification after the expiry of a key patent. Smartphone parts producer **Nitto Denko** rebounded 4.77% after its recent correction.

In contrast, Rubber Products (-3.22%), Mining (-2.67%), and Insurance (-1.35%) underperformed. **Bridgestone** tumbled 4.70% on profit-taking after announcing record earnings. **Japan Tobacco** lost 3.47% on disappointing cigarette sales, and brewery producer **Asahi Group Holdings** shed 3.37%.

▶ EMERGING MARKETS

Emerging markets were flat this week. During the **Chinese New Year Golden Week** (Feb 15-21), tourism revenue reached RMB 475bn (\$75bn, +12.6% YoY): some 386 million trips by tourists were made (+12.1%). Chinese consumers spent RMB 926bn (\$146bn) on shopping and restaurants, +10.2% YoY compared to an 11.4% increase last year.

The consumption upgrade trend was reaffirmed with consumers focusing more on quality than quantity. **Chroma ATE**, the leading testing and measurement instruments maker in the Greater China market, reported strong fourth quarter sales growth of 88% YoY with net income up 132% YoY. Although there was a slight miss on margins, the company delivered a resilient earnings outlook, supported by rising demand for EV battery testing and penetration into different semiconductor testing areas.

In **India**, the MPC minutes revealed some macro concerns. Most members noted that inflation continued to rise in a broad-based fashion and that upside risks were building up. On the growth front, they also acknowledged the positive trend of most high-frequency indicators and sounded more confident on the growth outlook. However, it was also pointed out that the recovery was at a "nascent stage" and therefore warranted a "cautious approach" to monetary policy.

In **Thailand**, tourist traffic and spending momentum continued. The Ministry of Tourism & Sports said tourism in January rose 10.9% with 3.5 million tourists and spending was up 11.6% to Bt189bn. Tourist traffic from the Eurozone hit a record high and visitors from South Asia zone rose more than 20%.



In **South Africa**, the new budget framework is aiming to cut the deficit from 4.3% in 2017/18 to 3.6% in 2018/19 and in 2019/2020, and then 3.5% in 2020/21. Gross general government debt is now seen stabilising at the lower level of 56% of GDP.

In **Brazil**, **Iochpe** posted solid fourth quarter results with sales up 27%, EBITDA 23% higher and reduced gearing. **Mercado Libre** saw GMV rise 63% YoY in USD, but operating results were lower than expected due to higher expenses on winning customers. Meli introduced free shipping in Argentina which we think is the right strategy to adopt. **Banco do Brasil's** results surprised positively on lower provisions and better asset quality. Local newspapers said the government would need to cut R\$14bn of the 2019 budget due to the non-approval of social security reform this year. The Minister of Finance announced that the fiscal budget would be much tighter next year.

In **Mexico**, **Asur** reported satisfactory results with EBITDA up 5% and higher commercial revenues per passenger. **Gap** results disappointed on lower commercial revenues. On the macro front, headline inflation came in lower than expected for the first half February at 0.20%. However, core was 0.30% or slightly higher than the 0.29% expected.

Despite higher volatility, we remain confident on emerging markets.

▶ COMMODITIES

Oil prices pushed higher, with Brent crude breaking above \$65 and WTI trading at \$62-63. In the absence of major news, traders focused on weekly data from the US Department of Energy.

The price rise was chiefly motivated by last week's fall in crude, petrol and distillate inventories.

US crude exports surged to 2 million b/d over the week, a surprising development considering that the Brent-WTI spread has fallen from \$6/7 dollars at the end of 2017 to a little above \$3 in February. **Libya's national oil company (NOC)** evacuated its employees from the El-Feel field (90,000-100,000 b/d) after security staff went on strike over wages. It is still not clear if production will be stopped.

Elsewhere, Mohammad Barkindo, OPEC's secretary general, said the oil market rebalancing had "massive momentum". This followed the conclusions of the OPEC/non-OPEC Joint Technical Committee (JTC) which said it expects supply and demand to balance out between the second and third quarters of this year. The JTC also said OECD inventories were 74,000 barrels above their 5-year mean (the cartel and its allies are hoping to reduce global stocks to this mean).

The **gold** ounce lost \$17-18 over the week on the back of the stronger dollar, as measured by the DXY index, and the FOMC minutes which were viewed as hawkish. The Fed has been comforted in its opinion that it has to continue raising rates.

The US Department of Commerce (DoC) has advised the Trump administration to introduce fresh customs duties (Section 232) on steel and aluminium imports. The DoC recommended raising duty on imported steel and aluminium by at least 24%, and 53% for countries like China, Brazil and Russia, as well as the introduction of quotas. Donald Trump has until April 11 to approve these recommendations.



▶ CORPORATE DEBT

CREDIT

Credit market spreads widened with the Xover moving from 257bp at the beginning of the week to 275bp.

The subordinated financial primary market reopened with T2 issues from **Société Générale** and **Svenska Handelsbanken**. Elsewhere, **Unipol** raised €500m at 3.875% to reimburse €300m in subordinated loans previously held by **Mediobanca**. In return, Mediobanca invested €250m in the new issue. The ongoing earnings season is generally upbeat with no real surprises.

After being upgraded by Moody's and Fitch, **Faurecia** made a highly anticipated return to the bond market and raised €700m with a 2025 maturity. **Orpea**, Europe's biggest retirement homes company, carried out its first non-convertible bond issue. **Vallourec's** results beat expectations but the group is cautious for this year.

In M&A, **Monoprix** (Casino group) is in exclusive talks to acquire **Sarenza** in a bid to accelerate its digital transformation.

CONVERTIBLES

The primary market returned after a blackout period. In Europe, Spain's **Ence Energia y Celulosa** (pulp and renewable energy) issued a €60m 5Y 1.25% coupon convertible bond for refinancing purposes. In the US, virtual banking solutions provider **Q2 Holdings** came to market with a \$200m 5Y 0.75% coupon convertible for general corporate purposes,

including working capital, capital expenditure, potential acquisitions and strategic transactions. In another US deal, cloud identity access management company **OKTA** sold a \$300m 0.25% coupon convertible bond for general corporate purposes.

There was also a rare deal from Australia; **Seven Group Holdings** issued a A\$350 2.2% coupon convertible to repay legacy debt at its recently consolidated **Coates Hire** company. **Grand City Properties** announced a tender offer for its 2022 convertible bonds, replacing them with new 2027 straight bonds in an attempt to lengthen its average debt maturity.

In earnings news, **Valeo** disappointed investors as second-half EBIT missed by 3% and 2018 organic growth guidance was only 5%. The shares reacted by tumbling 9%. **Nexity** posted very solid FY17 results with revenues up 14.1% YoY to €3.51bn or better than expected. 2018 guidance was strong thanks to order book expanding by 15% in volume as underlying demand for French housing remained strong. In the US, **Macquarie Infrastructure Corporation** shares crashed 41% as the company slashed 2018 EBITDA guidance, due to the loss of some oil storage contracts, and cut the dividend by 31%. In Asia, the Thai convenience store chain **CP ALL** reported a better-than-expected 23% YoY jump in earnings, with a 3% YoY rise in basket size and gross profit margins up. This should be underpinned over the medium term by resilient domestic demand coupled with strong growth in tourism (+11% YoY in January).



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