MARKET FLASH: MOUNTING CONCERNS OVER TRADE

June 29, 2018

On the markets

Another week of trade tensions was marked by Washington's plan to levy 25% import duties on $34bn in Chinese consumer electronic products and to restrict Chinese investments in the US. It may be tricky to assess the exact economic impact from such measures but the knock to confidence is clear enough. The most vulnerable countries are those with the most open economies and equity markets as in Europe and Taiwan and South Korea in Asia. Japan could also be hit as its auto industry represents 8% of its GDP.

China, meanwhile, has other ways to retaliate. The renminbi has already started to fall, losing 1.5% against the US dollar in a week and 5% since mid-April. Beijing could also sell US Treasuries. China owns more than 1,100bn in US sovereign debt and is its biggest foreign creditor. Any massive selling would immediately hit the US dollar. And measures against US companies in China could be taken, stopping them imposing, or being hit by, extra duties. We do not believe, however that China is actually in a position to use these weapons. Its bond market has just been opened up to foreign investors, making it hard for them to be targeted. Beijing also has enough on its plate trying to stop capital outflows without adding to them. And a depressed dollar from sales of Treasuries would also send the renminbi higher, hardly one of China's objectives.

On the economic data front, eurozone PMI for June were reassuring after several disappointing months. Manufacturing in France and Germany may have come in lower than expected but services surprised on the upside, as did the eurozone's composite index, again thanks to a sharply high contribution from services.

Equity market volatility remained strong and almost all European markets are now in negative territory since the beginning of 2018. The real focus of attention, however, was on bond markets where defensive investors sought safe havens. This explains why 10-year Treasury yields have failed to stick above 3%. The 2-10 year spread also narrowed further, accentuating yield curve flattening. US banks reacted by falling for the 13th session in a row. And oil hit its highest level in three and a half years on worries over supply as well as threatened US sanctions against Iran.

EUROPEAN EQUITIES

European equities continued to fall amid concerns over escalating trade tensions between the US and China. The most cyclical sectors were hardest hit while defensives like food proved more resilient.

A warning from **Osram** (lighting) that the autos market was slowing intensified falls in the sector, and particularly among suppliers like **Continental, Faurecia** and **Plastic Omnium** as well as related tech stocks like **Infineon** and **STM**.

Commodity producers like **ArcelorMittal** were also directly impacted while higher oil prices helped the oil sector.

Markets are struggling to predict the medium-term future and naturally sanction delayed investment or restructuring strategies. **Elior**, for example, saw heavy selling when the group said any recovery would now not start before 2020. **Prysmian** fell sharply on a profit warning related to a problem with a large UK submarine contract and France's **Nexans** followed suite after contracts were postponed. **Carrefour** hit its lowest levels since 2012 after losing more market share in France.

It was a busy week for pharma news. US investment fund **Advent International** acquired **Zentiva**, **Sanofi's** European generics business for €1.9bn**.** **Novartis** said it was spinning off **Alcon** and would be launching a $5bn share buyback before end 2019. **BAE Systems** signed a $18-20bn contract with Australia to build 9 frigates over the next 20 years. French biotech **Eurofins Scientific** revised its 2018-20 sales higher and confirmed that it was targeting a 20% EBITDA margin in 2020, mainly thanks to C**ovance Food Solutions**.

US EQUITIES

It was a down week with the S&P losing 1.4% and the Nasdaq ending 2.7% lower. Consumer month-on-month sentiment edged lower from 128 to 126 and durable goods orders dipped 0.6%, or better than the 1% drop expected. But investors remained focused on fresh fears of an escalation in protectionism on rumours that Washington might restrict Chinese investments within the US. White House advisor Peter Navarro tried to convince investors otherwise but not very successfully. In the end, Donald Trump said he would rely on the *Committee on Foreign Investment in the United States* (CFIUS) if non-US companies tried to take over US firms.

Trade war concerns helped US 10-year Treasuries to rally and yields fell below 2.85%. This in turn caused the yield curve to flatten further and the 10-2-year spread shrank to only 32bp.

General Electric jumped 9% over the week after deciding to sell its healthcare division and its stake in **Baker Hughes**. **Starbucks** tumbled 6% and hit a low since April 2015 on news that its CFO's departure, originally scheduled for November, was now immediate. **Amazon** made further inroads into healthcare by acquiring **PillPack**, a distributor of prescription drugs; the news once again triggered exaggerated selling of traditional distributors and pharmacies like **CVS Health** and **Walgreen** as well as wholesalers like **McKesson** and **Cardinal Health**. The results of the Comprehensive Capital Analysis and Review (CCAR) bank stress tests were generally in line with expectations. Of note was the Fed's green light to **Wells Fargo** to proceed with a $24bn share buyback, i.e. a 140% payout ratio, an indication of the central bank's confidence in the bank's ability to recover.

JAPANESE EQUITIES

Amid worries over international trade, Japanese stocks remained soft due to weakness in China-related stocks and profit taking on strong performers. The TOPIX ended the period 1.02% lower.

By sector, Oil & Coal Products was relatively strong (+5.93%) in line with the oil price rally. Leading oil refiner & wholesaler **JXTG Holdings** and natural resources developer **Inpex Corp.** rose 4.44% and 3.65% respectively. The Gas sector was also firm. **Osaka Gas** and **Tokyo Gas** rebounded, both gaining 2.67%.

On the other hand, Air Transportation lost 3.69% on higher fuel costs. And Pharmaceuticals and Information & Communication, which had been relatively upbeat so far this year, were hit by mounting selling pressure. Modern casual furniture producer **Nitori** tumbled 7.83% on a slowdown in same-store-sales and **Softbank** sank 6.61%, According to Tokyo Stock Exchange statistics, non-Japan based investors have been the largest net-sellers of Japanese equities so far this year. YTD cumulative net sales amounted to JPY 3.5 trillion as of the third week of June.

On the political front, Prime Minister Shinzo Abe's approval rating bounced back to 52% after plunging to 42% in the previous Nikkei opinion poll.

EMERGING MARKETS

Markets are increasingly concerned over escalating trade tensions. Washington has prepared a text to ban companies in which Chinese interests have at least 25% to acquire strategic US firms. But at the same time, **Beijing** has reduced import duties on South Korean and Indian consumer goods and relaxed restrictions on foreign investors. China's National Development and Reform Commission (NDRC) is looking to make sectors like commercial banks, ship construction and aerospace more attractive to non-Chinese companies.

As expected, the PBoC lowered its required reserves ratio by 50bp to free up around RMB 500bn for debt to equity swaps and RMB 200bn for loans to SMEs. The central bank also adopted a more accommodating tone in its communique, replacing 'appropriate and stable liquidity' with 'appropriate and sufficient liquidity'. The renminbi lost 1.75% this week against the US dollar. But it has, year to date, remained one of the emerging zone's strong currencies and without government intervention. Beijing also took back central control of loan approvals for property renovations. Its aim is better risk control in a complex deleveraging environment and ahead of a possible slowing in growth due to a trade war.

Accenture reported upbeat results with sales 11% higher before currency effects. Earnings have been revised up from +6/8% to +9.5/10%, a good sign for India's IT services companies. **Info Edge** has invested $45m in **Etechaces**, the owner of **Policybazaar**, an Indian insurance broker.

South Korea's monthly industrial production rose 1.1% mainly due to sales of mobile phone components and autos. Its semiconductor industry saw sales fall. **Thailand**'s industrial production rose 3.2% in May, just beating expectations of +3.1%. Tourism revenues hit an all-time high in the first quarter and now represent 14.5% of GDP.

Andrés Obrador from the Morena party is tipped by opinion polls to win **Mexico**'s July 1st presidential election. After an anti-corruption campaign marked by nationalistic leanings, he has adopted a more moderate tone recently and says he will roll out more responsible fiscal policies.

COMMODITIES

OPEC decided to increase production, not by raising quotas, but through 100% compliance with existing commitments. For the 12 countries concerned -Libya and Nigeria are exempt- this will mean an increase of 560,000 b/d. The news will reassure markets over the short term but will only offset Venezuela's 670,000 shortfall on its quota. Some traders had feared a bigger increase of 1.5 million b/d that would have taken production back to pre-quota levels so the agreement triggered short covering and Brent crude rallied to $75.

The communique allowed Iran to save some face and it signed the agreement. Verbal communication, however, has been more confusing with both Saudi Arabia and Russia announcing a 1 million b/d increase. But this would give OPEC the flexibility to offset any fall in Iranian exports, a real risk as the US is putting pressure on buyers to stop dealing with Iran from November 4. Iran currently exports 2.4 million b/d compared to only 1.2 million during the previous sanctions. In other words, the market would not be able to offset any lengthy period of zero Iranian exports. Saudi Arabia could raise its output from end May's 10.1 million b/d to 10.8 million but the summer generally sees higher domestic consumption (an extra 700,000 b/din May-August 2017) and that would limit its export capacity.

In the short term, the market should stabilise at the upper end of the $70-80 price bracket but, depending on the Iranian situation, prices could well rise in the last quarter of 2018.

CORPORATE DEBT

CREDIT

The Xover widened by 20bp over the week. Concerns over mounting trade tensions between the US, China and the European Union remained and the bond new issues market weighed on secondary trading. Shipping companies like **CMA CGM** and auto manufacturers/suppliers underperformed due to threats of a trade war.

Smurfit Kappa (paper) raised €600m over 8 years at 2.875% to fund its acquisition of **Reparenco**. **eDreams Odigeo** issued a profit warning as the company expects short term performance to slow significantly after changing its business model. **Maxeda** (B2, DIY stores in the Netherlands) reported satisfactory results with sales down 1.3% due to bad March weather but EBITDA 21% higher. **Picard** (B2/B, frozen foods) reported a 6.3% increase in quarterly sales with EBITDA 4.5% higher.

The US affiliate of **Deutsche Bank** (Baa2/BBB+) failed to pass the second stage in the Fed's Comprehensive Capital Analysis and Review (CCAR). That means it cannot channel dividends higher to Deutsche Bank AG. **Selecta Group B.V** (B3/B) is reportedly mulling an IPO. Its owner, KKR, appears to have started preparations for a listing in the second half of 2018.

CONVERTIBLES

Convertible new issuance remained active with four new deals in the US. Database software developer **MongoDB** raised $250m with a 6Y 0.75% convertible for working capital purposes. NASDAQ-listed Chinese social network platform **Momo** came to market with a $650m 7Y 1.25% coupon convertible partly to finance its acquisition of **Tantan**. **Zillow Group**, a real estate service online platform, issued a $325m 5Y 1.5% coupon convertible with a concomitant $325m increase of capital to finance possible acquisitions. **Arbor Realty Trust**, a specialised real estate finance company, raised $100m with a 3Y convertible at 5.25% to refinance its old 2019 maturity.

In the rest of the news, Norway sold its entire 9.88% stake in **SAS** (Sweden's airline) for SEK 652m. In telecoms, France's **Eutelsat** declared on Tuesday that it did not intend to make an offer for the UK's **Inmarsat** despite confirming the day before that it was mulling a bid. In Japan, **Sony** bought 9 million Sony Financial shares, raising its stake from 63% to 65.1%.

DISCLAIMER

This document is non-binding and its content is exclusively for information purpose.

The data, comments and analysis in this document reflect the opinion of Edmond de Rothschild Asset Management (France) and its affiliates with respect to the markets, their trends, regulation and tax issues, on the basis of its own expertise, economic analysis and information currently known to it. However, they shall not under any circumstances be construed as comprising any sort of undertaking or guarantee whatsoever on the part of Edmond de Rothschild Asset Management (France).

All potential investors must take prior measures and specialist advice in order to analyse the risks and establish his or her own opinion independent of Edmond de Rothschild Asset Management (France) in order to determine the relevance of such an investment to his or her own financial situation.

Past performance is not a reliable indicator of future results. Past performance does not include reinvested dividends.

Special warning for Belgium: Please note that this communication is intended for institutional or professional investors only, as mentioned in the Belgian Law of July 20th, 2004 on certain forms of collective management of investment portfolios This notice is also intended only for investors who are not consumers as described in the Belgian Law of July 14th, 1991 on trade practices and information and protection of consumers.

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (France)
47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08
Société anonyme governed by an executive board and a supervisory board with capital of 11,033,769 euros
AMF Registration number GP 04000015 - 332.652.536 R.C.S. Paris –
Tél: +33 (0)1 40 17 25 25 - Fax: +33 (0)1 40 17 24 42
www.edram.fr