MARKET FLASH: LOTS OF NEWS

May 5, 2017

On the markets

For many markets it was a short holiday week but there was lots of news.

- The Fed stuck to its stance at its latest meeting even though economic data was looking mixed. Manufacturing ISM fell from 57.2 to 54.8, or more than expected, but services ISM rose from 55.2 to 57.5 or above consensus expectations. Janet Yellen preferred to focus on the strong labour market. Investors expect another rate hike in June. US bond yields started to rise a little again.
- After last weekend's summit, the stand-off is now on between the UK and the European Union over Brexit talks. Discussions are scheduled to start before the June 8 parliamentary elections in the UK and will first tackle exit conditions and then the future relationship.
- A drop in China's PMI figures triggered a fall in metal prices and commodity stocks. Oil also suffered a big drop amid investor doubts on OPEC agreeing to prolong production cuts at its May 25 meeting and confirmation that shale oil production was rising.
- In France, the debate between second round presidential candidates Marine Le Pen and Emmanuel Macron led to an increase in pro-Macron polls. As a result, non-resident investors are returning to European equities now that the threat of a Euro crisis has receded. Eurozone risk assets consequently outperformed other geographical zones and government bond yields fell.

And there was more good news in the ongoing earnings season. In the US, first quarter results were 13% higher than in 2016 with 10 out of 11 sectors seeing improvements. With more than half of European company results now in, almost 70% have done better than expected, the highest score since 2003. Results have risen 26%, a 7-year best. We have as a result maintained our upbeat stance on European equities. In fixed income, we prefer financial bonds. We have maintained low duration and reinforced convertible bond weightings.

EUROPEAN EQUITIES

First quarter results continued to help markets move higher. Despite the drop in oil prices, relief over French election opinion polls and excellent composite PMI data in the eurozone reinforced investor confidence. Sector performance was very varied. Consumption (**LVMH** is now the biggest market cap in the CAC 40), food, banks and construction all made appreciable gains while mining and energy lost further ground due to lower commodity prices.

Auto stocks were also hit by US sales which had their fourth disappointing month in a row. Notable good news included **Air France** which said summer reservations were upbeat and reiterated its 2017 objectives. **Thales** saw first quarter sales rise to EUR 3.06bn or +11% like for like with excellent contributions from Aerospace as well as emerging countries which were up 16% and now represent 30% of group sales.

Arkema's sales rose by a robust 13% and the group confirmed its guidance. **Adidas** had an excellent quarter and the stock performed very well. **Veolia** released upbeat figures which pushed the utilities sector higher.

In M&A news, **Akzo** is still examining **PPG**'s third bid. Elsewhere, **ITV** said CEO Adam Crozier was leaving. He arrived in 2009 and had succeeded in helping the stock price recover. **Accor** jumped after indications it was in exclusive talks with sovereign funds over the sale of 80% of **HotelInvest**. The deal could be decided before the end of the first half of this year.

US EQUITIES

The S&P ended the period slightly higher. March PCE inflation (the measure the Fed prefers) rose 1.6% or in line with market expectations but slightly below the +1.7/1.8% trend seen in recent months. Manufacturing ISM fell to 54.8, down from 57.2 in the previous month. Non-manufacturing data, however, remained strong, rising to 57.5, its second highest level since the fourth quarter of 2015.

The FOMC communique appeared to play down the economy's relative weakness in the first quarter and preferred instead to focus on the vigorous labour market. Household consumption remains robust and companies are now investing more.

The House of Representatives finally approved healthcare reform. Democrats voted against and the bill is now expected to trigger a number of amendments when it goes to the Senate for approval. Looking beyond the impact on the sector, the news was viewed as positive by the market as it clears the way for fiscal reform in coming months.

With 379 company earnings reports in, 285 have managed to beat expectations while 86 have fallen short. Median EPS rose 14% compared to the first quarter of 2016 and was 4.79% higher than expected. Disappointing results from **Facebook**, **Tesla**, **Charter** and **Viacom** dominated the headlines. Results from **Mondelez** and **Delphi**, however, came in better than expected.

The market's apparent stability masked a collapse in telecoms and energy, which fell more than 3% and 2% respectively, as well as gains from tech and healthcare stocks.

JAPANESE EQUITIES

With the yen weakening against the US dollar, Japanese stocks were firm in quiet trading ahead of a long market holiday. The TOPIX gained 0.52% on Monday and 0.68% on Tuesday. Investors focused on companies which reported strong earnings and gave upbeat guidance. Export-oriented companies with growing expectations for margin improvement were also in demand. The bullish market mood was driven by expectations of upward earnings revisions and the weaker Yen, especially as corporate guidance is often based on very conservative foreign currency assumptions.

Tokyo Electron reported a 41% leap in earnings and a higher dividend, sending the price to a 17-year high. **Yamaha** jumped more than 17% on Tuesday after announcing it hoped to make record operating income in the current fiscal year.

Looking at the earnings result of Japanese companies for the last fiscal year (ending 31 March 2017), foreign demand sensitive firms were relatively firm despite the yen strengthening to around 112 against the US dollar. This was achieved by promoting overseas production and conducting the appropriate FX risk controls. For example, **Sony**, previously known as an exporting company, is now a company with yen appreciation risk tolerance as it has increased the amount of US dollar-denominated procurement.

EMERGING MARKETS

China's PMI moderated to 51.2 in April vs. expectations of 51.7. Non-manufacturing PMI also declined to 54 from 55.1. This expected slow-down was not really a big concern as liquidity is gradually tightening (the SHIBOR has been at an all-time high over the last 2 years) and consumption is still very resilient. This was seen in very strong results from the autos sector: **Guangzhou Auto**'s sales jumped 66% EPS 99% YoY thanks to the turnaround of its joint venture with FIAT, strength in its own brand business and 38% growth at its Honda joint venture. **BMW**'s results revealed that the Brillance joint venture saw EPS soar 99%, with a significant 470bp net margin improvement on the back of higher DRAM and NAND prices.

Samsung Electronics reported a 46% increase in EPS, despite modest revenue growth (+2%), mainly on a 1,670 bp margin improvements in its semiconductor business. The company also significantly improved corporate governance by cancelling its treasury shares (13% of its outstanding shares).

In India, **ICICI** Bank results were slightly better than expected (+189% YoY), on account of a higher net interest margin. More importantly, restructured assets were cut in half. The 1% increase in YoY profits for ICICI Prudential were misleading as premiums rose 31% annually. However, under Indian accounting standards, costs are booked upfront and not amortised over the life of the policy, so strong premium growth is not reflected in earnings.

Elsewhere, the government has given the green light to the Reserve Bank of India to issue an ordinance on NPLs which will effectively help resolve the problem.

In Brazil, **Itau** posted a 20% increase in YoY EPS growth and 21% in ROE, but provisions were less than expected. So far, consumer companies have been beating expectations with better top line figures and lower financial expenses. The Pension System Reform was approved in the Lower House's Special Committee with 60% of the votes. We expect the final bill to be voted in the Lower House in the next three weeks.

In Mexico, consumer and business confidence and PMI rebounded in April. **Grupo Mexico** beat expectations with a 34% increase in EBITDA. FCF generation was strong at USD 295m vs. a negative USD 148m in the first quarter of 2016.

We continue to remain upbeat on emerging markets due to a revival in earnings growth. China is intentionally moderating growth to make it more sustainable and we are seeing meaningful reforms in Argentina, Brazil and India.

COMMODITIES

Oil prices suffered a spectacular fall over the week, losing almost four dollars from Thursday's high to Friday morning's low. It was especially baffling as there did not seem to be an obvious reason for the plunge. Recent news items included: (i) fresh worries over China where first quarter GDP might have marked a peak, (ii) reduced tension in Libya which might lead to the civil war ending and therefore a return to full output, (iii) somewhat disappointing US weekly statistics which showed crude oil inventories falling less than expected and (iv) first quarter results from US producers which confirmed that shale production was growing. All in all, nothing really new or important although all these factors presumably weighed on market sentiment.

Additionally, talks have begun to prepare the OPEC meeting on May 25. A consensus view on making new production cuts seems to be emerging but nothing has yet been decided. The risk is that OPEC and Russia will get fed up with abandoning market share to US shale oil producers, especially if global inventories fail to fall. Their reaction might be to once again let market forces regulate supply and demand. As a result, traders reduced long positions and the fall was aggravated by prices breaking below key technical and psychological levels. But at least the sell-off will put some pressure on OPEC to act and we expect Brent crude to return to USD 50 in the coming days.

Worries over China are linked to April's PMI falling to 51.2 vs. 51.8 in the previous month as well as recent measure to reduce lending. This fuelled a drop in metal prices which fell by an average of 2.5% on the LME. **Iron ore** ended the period 5% lower. Note that the Philippines Congress has refused to confirm the appointment of the very controversial Environment and Natural Resources minister who had promised to stop all open-cast mining. The refusal has removed the threat hanging over **nickel** production.

CORPORATE DEBT

CREDIT

Europe's corporate debt markets had a strong week. Traders appeared to have a clear idea of who might become French president, especially after the debate between the two remaining candidates. As a result, French corporate bonds, high beta plays and cyclical sectors outperformed. High yield funds saw slight inflows and so-called cash bonds outperformed CDS. The Xover tightened further to 258bp, down from 266bp while the iTraxx Main was unchanged at 64bp.

There was only one issue over the week, **Norican** (B2/B) which raised EUR 340m with a Senior Secured 6NC2.5 to refinance existing debt and the shareholder advances which had helped fund its acquisition of **Light Metal Casting Solutions Group** (LMCS) at the end of April. The deal gave Norican access to the aluminium market. The new entity should make EUR 557m in sales and EUR 74m in EBITDA.

In significant quarterly earnings news, **Nexans** (BB) reported in line with expectations. Sales came to EUR 1.13bn, +1.2% like for like due mainly to its Transmission, Distribution and Operators business which was up 5.9% to EUR 485m. Results at packaging company **Smurfit Kappa** (Ba1/BB+) were slightly higher than expected with sales rising to EUR 2.12bn. But EBITDA and margins slipped 1%.

Elsewhere Moody's downgraded **Ericsson** to BB+ with a stable outlook. Fitch upgraded **Groupama** from BBB- to BB+, helping its Tier 2 debt move back into IG territory.

CONVERTIBLES

The primary market remained calm amid the on-going earnings season, yet we saw two deals in the US. **HubSpot**, a provider of cloud-based marketing and sales solutions, announced a USD 350m 5-year convertible issue with a coupon pricing range of 0.25% -0.50% and a 35% conversion premium. **AMAG Pharmaceuticals**, a biopharma company specialised in the preservation of stem cells and the development of novel treatments for anaemia and cancer, is to raise USD 250m with a coupon of between 2.75%-3.25% and a conversion premium between 37.5%-42.5%.

In Asia, the week was rather quiet due to Japan's Golden Week holiday and other holidays in the region. **CRRC**'s first quarter results were rather disappointing with net profits down 42% YoY to RMB 1.15bn RMB on lower deliveries, delayed orders and higher-than-expected administrative expenses, etc. In the rest of Asia, China's regulator approved the spin-off of the brokerage affiliate of **Zhejiang ExpressWay**, an infrastructure company that operates expressways. The spinoff had been in the pipes since 2012 and will help clarify the company's structure.

In Europe, **Telecom Italia**'s first quarter numbers outpaced all expectations: sales rose 8.5% YoY to EUR 4.82bn. Ebitda was in line but the margin rose to 41.3% from 38.6% at the end of the first quarter of 2016. **Vivendi** extended its grip on Telecom Italia by appointing 10 board members out of 15 during the AGM. Elsewhere, **IAG** jumped more than 5% following a 9.7% increase in earnings due to lower fuel costs, a 3.3% rise in traffic and a payroll cut.

In the US, **Square** (mobile payment solution provider) posted some impressive numbers with 36% growth in Ebitda and a 39% increase in revenue due to growth in its subscription and service based segment. **Akamai** (Internet Content) posted a modest beat but gave weak second quarter guidance with management saying revenue growth for its media business will continue to come in below historical growth rates. Of note was another strong performance from South America's eBay equivalent **MercadoLibre** which saw a 73.8% YoY increase in revenue mainly on stellar results in Mexico and Brazil.

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