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MARKET FLASH : NUMEROUS RISKS

It was one of those strange weeks where both equity and bond markets fell together. Jerome Powell's very optimistic comments after the latest FOMC were backed up by strong macroeconomic data. Last week's jobless claims fell to a 49-year low and new industrial orders in August increased by their biggest margin in 11 months. US 10-year Treasury yields logically continued higher towards the 3.25% mark as the yield curve steepened and the trend spread to Europe's core country yields.

Tougher financial conditions are a fresh source of vulnerability and volatility for emerging markets, both as concerns local debt and equity indices. Increased risk aversion is linked to the stronger dollar as well as the US interest rate and credit cycle. US monetary tightening may be a gradual process but some emerging countries are coming under pressure to tighten monetary conditions to stop their currencies depreciating.
In Europe, political factors weighed on markets. The budget proposals from the Italian coalition in power rekindled investor concerns and the resulting tension on spreads was almost exclusively limited to Italian government bonds.
We are now facing a number of risks, quite enough to suggest we should steer clear of equities. Far from it. Equity fundamentals are still robust both in the US and Europe where earnings growth expectations are still at a high 10% for 2019. That is why we are sticking to our investments in both zones while continuing to ring fence equity risk with dynamic hedging strategies.

EUROPEAN EQUITIES

European markets turned lower over the week, taking the MSCI Europe Total Return index's year-to-date performance to zero. Investors continued to worry about Italy even if Rome sent out some positive signals indicating that government debt and the deficit were on a 3-year downward trend. However, higher long bond yields, especially in the US, resulted in strong sector disparities. Energy and insurance outperformed while property and luxury underperformed. Europe's oil majors made particularly strong gains as oil prices returned to 2014 levels.

Ahead of the third quarter earnings season, **Ryanair** issued a profit warning citing the impact of strikes and higher oil prices. The news dragged down the entire sector. Auto suppliers also came under pressure as **Valeo**'s CEO suggested the coming months would be difficult on the Chinese market after a fall in new registrations there over the summer. The news compounded recurrent fears over the introduction of WLTP standards in Europe.

In the telecoms sector, stocks with exposure to Italy came under fire after the 5G auction resulted in the 4 operators paying a total of €6.55bn, or much more than the €2.5bn the government was hoping for. More positive news this week came from **Casino** which is to sell 55 Monoprix outlets for €565m as part of its €1.5bn disposal programme. And **Akzo Nobel** finalised the expected sale of its Specialties division for €7.5bn with €5.5bn being returned to shareholders. This could be increased if no acquisitions are made.

France's national assembly approved a privatisation bill allowing the government to sell its stake in **Aéroports de Paris**.

US EQUITIES

Markets retreated with the **S&P** losing 0.4% over the week and the **Nasdaq** ending 2% lower.

Jerome Powell said the outlook for the US economy was remarkably positive. He added that actual real interest rates were just above zero but that they should move out of accommodating territory towards a neutral level. US 10-year Treasury yields reacted by jumping from 3.08% to 3.20%, their highest level since 2011. The very long end of the yield curve followed suit by steepening from 3.23% to 3.35%. Upbeat macroeconomic data subsequently underpinned the Fed chairman's comments. Non-manufacturing ISM hit 61.6, or higher than expectations of 58, to reach its highest level since 1997. Manufacturing ISM came in at 59.8 vs. 60, or in line with analysts' expectations.

Interest rate shifts triggered strong sector disparities. **Financials** gained on higher bond yields, with banks up 2% over the week while insurance groups gained 1.9%. But long-duration sectors were hit with **internet stocks** tumbling 4.9% and software down by more than 2%. We should, however, put this into perspective as **software stocks** are still up 28% year to date while the bank index is flat.

JAPANESE EQUITIES

On October 2, the Nikkei 225 hit its highest level in almost 27 years as concerns about US trade policy receded. US President Donald Trump and Japan PM Shinzo Abe agreed the US would not impose additional tariffs on Japanese car exports to the US during their bilateral trade discussions.

But after a long upward run since mid-September, the Nikkei 225 succumbed to profit-taking by short term investors. The TOPIX shed 0.88% over the week.

Economically sensitive sectors such as Oil & Coal Products, Mining and Wholesale Trade outperformed the TOPIX. General trading company names climbed with **Itochu** up 8.73% and **Mitsui** 4.26% higher. Banks and Insurance were also firm as US bond yields rose.

On the other hand, Real Estate and Air Transportation were relatively weak. And **Unicharm** and **Shiseido**, which had been gaining on robust tourist figures, lost 6.49% and 4.82% respectively.

According to Tokyo Stock Exchange data, gains in the second half of September were fuelled by non-resident buying. Foreign investors became net buyers after being net sellers in the first half of the month. Their aggressive buybacks of Nikkei 225-related instruments including index futures and ETFs, superior in market liquidity, were behind September gains and a relatively high NT ratio (=Nikkei225/TOPIX).

EMERGING MARKETS

China's server hack story in Businessweek together with Vice President Mike Pence's harsh rhetoric raised serious concerns on US China relations beyond tariffs and the trade war.

Education names in China were under pressure on news that the US was mulling a ban on student visas for Chinese nationals. **Tencent**'s share buyback continued this week with a new strategic reorganisation announcement to establish 6 business groups which will focus on cloud and content growth. Its online music arm, **TME**, also filed for a $1bn IPO in the US. The finalised CBIRC rules on banks' wealth management products (WMP) will allow public fund WMPs to invest in stocks and offer more flexibility for subsidiaries. Macau gaming numbers were stronger than expected: the first 4 days of the Golden Week saw total growth of 21/33% in total/mainland visits.

India's central bank unexpectedly kept its key rate unchanged despite higher oil prices and the rupee's depreciation. The currency fell more than 2% against the US dollar this week. On mounting inflationary pressure, the India government decided to cut retail petrol and diesel prices by 5-6%, which will add INR 100bn to its fiscal burden and mean INR 150bn less in tax revenues for states. State-owned oil marketing companies will absorb another one rupee a litre cut. In the run up to the state elections in November and December and next year's general election, similar populist policies such as farm loan waivers and state tax reductions could weigh further on market sentiment. To contain financial sector turmoil, the government seized control of **IL&FS** this week. **ICICI Bank**'s CEO also agreed to step down for early retirement.

In **Korea**, headline CPI inflation rose to 1.9% in September (vs. 1.4% in August) or towards the BOK's 2% target, thus raising the probability of a 25bp hike at the end-November meeting. **Samsung Electronics** reported preliminary FY 2018 third quarter results with operating profit at KRW 17.5 trillion, or slightly above market consensus.

Brazil's equity market rallied this week as far-right candidate Jair Bolsonaro continued to extend his lead in polls to 32% vs 23% for the left-wing Workers' Party candidate Fernando Haddad. The first-round vote will be held on October 7. **Amazon** is reportedly working on a pilot logistics project with **CargoX** in an attempt to catch up with e-commerce leader **MercadoLibre**. In **Mexico**, August remittances broke another record. The USMCA has officially replaced NAFTA, but Donald Trump said that tariffs on steel and aluminium would remain.

COMMODITIES

Oil prices pushed higher before stabilising at $85 for Brent crude and $75 for WTI. Meanwhile, there was a sharp increase in trading positions speculating on further rises. September tanker movement data showed a sharp fall in Iranian exports which fell to a low not seen since February 2016. Crude exports for the month were 1.6 million b/d, down from 1.83m in August and 2.5m in April before sanctions were announced. Iran is increasing stocks held in tankers anchored off shore and is building more on-shore capacity.

Saudi Arabia once again tried to offer short term reassurance by (i) telling refiners with no contract with the country that they should get in touch and would be supplied and (ii) unveiling a $20bn investment programme over coming years to maintain, or possibly increase, its available capacity by 1 million b/d to 13 million. This is good news but changes nothing on the required short-term supply picture. It also begs the question of what the country's real capacity actually is. Current estimates suggest 12 million b/d.

The fourth quarter should, however, see this rise by around 550,000 b/d thanks to the Khurais and Manifa fields. But hopes we mentioned last week of the neutral zone restarting production have been dashed by Kuwait which is opposed to **Chevron** running the Wafra field even though the group manages Saudi Arabia's share.

Meanwhile, high oil prices are starting to cause problems in some emerging countries. India has just announced tax cuts on petrol and diesel fuel in an attempt to offset higher crude prices. This is part of a growing trend in many emerging countries to bring back subsidised prices.

CORPORATE DEBT

CREDIT

Investors had taken fright at Italy's budget risk but on Wednesday were somewhat relieved when the country's prime minister presented an amended budget draft. But higher sovereign yields the following day in reaction to rising US yields weighed on sentiment. Even so, the Xover only widened by 4bp over the week.

Casino/Rallye bonds started the week higher after an agreement to sell 55 Monoprix sites for €565m was signed. The deal should complete before the end of the year. **Astaldi** (Caa2/D) saw its bonds benefit from a new wave of buying. The group last week asked for protection from creditors due to liquidity problems and is reportedly still in talks with an investor consortium led by **China Merchants Group** for the sale of its stake in Turkey's Bosphorus bridge.

Grifols' bonds held up well despite share price weakness after a report highlighted the competitive risk from a new drug class. In financials, Nordic banks came under attack on fresh rumours of money laundering in Estonia. A Bloomberg report referred to $1,000bn in cross-border deals between 2008 and 2015.

Italy's 5G auction resulted in a €6.55bn gain for the government. **Wind Tre** (B1/BB-) and **Telecom Italia** (Ba1/BB+) are to pay €517m and €2.4bn and the impact on leverage will be approximately 0.1 times.

Eurofins, a pharma lab testing group, is to buy **TestAmerica** from **JSTI** for $175m. The target represents around 7% of the company's sales and will only have a small impact on leverage.

In new issues, **Warner Music Group** (B1/B3) raised €250m over 8 year at 3.625%. Spain's retail chain **El Corte Inglés** (Ba1/BB) raised €600m over 6 year at 3%. **Lloyds** issued a $1.5bn AT1 at 7.50%.

CONVERTIBLES

We saw four deals on the primary convertible market. In Vietnam, real estate developer **Vingroup** tapped its 2023 convertible issued in June for $125m with the proceeds going towards the hospitality business. In the US, **Apollo Commercial Real Estate Finance** issued a $200m 5Y 5.375% convertible to finance the repayment of its existing term debt. Just 3 months after its IPO, **Tilray**, a producer of medical cannabis, came to market with a $450m 5Y 5% convertible to finance working capital and future acquisitions.

Boingo Wireless, a mobile internet services provider, raised $175m with a 5Y 1% convertible for refinancing purposes. **Intu**'s shares jumped 30% as **Brookfield Property Group** confirmed a possible takeover bid on the British real estate company. German real estate names like **Deutsche Wohnen**, **Leg Immobilien** were under pressure with their shares down around 5% on the week due to higher rates globally, with Bund and 10Y Treasury yields at 0.56% and 3.2% respectively.

In the US, **Insmed** won FDA approval for its lung disease drug Arikayce but with a boxed warning on respiratory risk. Asian semis supply chain names fell on news of a possible US chip hack with convertible names like **UMC**, **SMIC** and **Ennoconn** underperforming.

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