EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

MARKET FLASH: CAUTION IS THE ORDER OF THE DAY

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On the markets

In spite of better-than-expected manufacturing ISM in the US, investor risk perception is being essentially coloured by international political issues. On the eve of fresh customs barriers against China and amid rather tense talks with Canada over NAFTA, the US trade deficit has increased, the first impact of the trade war, and worries over protectionism have resurfaced. Whatever Donald Trump might think, the rise in the trade deficit was the biggest since March 2015 and is running at around $70bn a month so far this year. What's more, the looming mid-term elections, and the risk of more measures from the White House, are making investors more cautious. As a result, both developed and emerging country markets lost ground over the week. And yet safe-haven assets have not really moved: the US dollar is still at 1.16 against the euro and US 10-year yields have not fallen. At the same time, implicit equity volatility has only edged higher.

Given the long list of risks around today - trade, global liquidity, the eurozone's political environment and China- it might be tempting to avoid markets in coming weeks. We beg to disagree. First, these risks have all been clearly identified and are partly discounted. Second, the fundamental situation is still robust; in fact, some macroeconomic indicators suggest growth in developed countries could soon accelerate after recently appearing to slow down. On the other hand, we have tactically reduced exposure in risk budget terms. We have, for example, neutralised equity exposure and are now even slightly underweight emerging country equities.

EUROPEAN EQUITIES

Europe fell sharply due to the US possibly slapping tariffs on $200bn in Chinese imports and the failure to reach an agreement with Canada over NAFTA. Stocks which had held up well in the first stage of the sell-off then fell prey to targeted selling. Tech stocks, led by semiconductors, led declines. Luxury plays also fell on worries that China's economy was slowing.

However, long bond yields narrowed substantially and Italian spreads tightened after Italy's vice Prime Minister, Matteo Salvini said the draft budget would after all comply with Europe's deficit rules. Bank stocks rebounded on the news.

In company news, **Safran** continued to perform well after boosting annual guidance and settling outstanding issues with **Dassault Aviation**. **Publicis** hit a low not seen in more than 2 years, the effect of **WPP**'s disappointing margins and little sign of like-for-like growth acceleration. WPP is expected to reorganise after its CEO was replaced. **Biomérieux** rebounded sharply after its results beat consensus expectations and management revised guidance higher. **Sodexo** fell after its investors day failed to reveal any marked catalysts. **Altran** suffered a relapse on disappointing FCF and despite management claiming that the loss announced by Aricent over the summer was an isolated case.

In an active week for corporate transformation news, **BNP** said it planned to place 17% of First Hawaiian, a move that should improve its CET1 by 5bp. **Generali** is in talks to buy a stake in Sycomore AM. **Edenred** unveiled an alliance in Brazil with **Itau Unibanco**, a deal which could be EPS-enhancing from 2019. **Scor** soared after rejecting a friendly, €43-a-share bid from **Covea**.

US EQUITIES

In a shortened *Labor Day* week, markets succumbed to profit taking after recent records. Technology was particularly hard hit and drove the S&P 0.8% lower while the Nasdaq tumbled by 2.3%. Strong theme rotation favoured value at the expense of momentum/growth.

Upbeat macroeconomic data probably acted as a catalyst for a shift which was amplified by worries that the tech sector might suffer from tighter regulation. Manufacturing ISM came in at a 14-year high of 61.3, sweeping past expectations, with new orders jumping from the previous month's 60.2 to 65.1.

Amazon briefly joined the intimate circle of stocks capitalising more than a trillion dollars. The group's capitalisation has soared by more than $400bn in this year alone. **Micron** slumped 9% after its CFO warned that the DRAM memory sector was still struggling and that business had recovered less than expected at the beginning of 2018.

Defensives like utilities (+2.2%) and consumer staples (+1.2%) led gains while technology (-2.6%) and energy (-2.3%) were the worst performers. Sector rotation was mainly due to persistent trade tensions and investor worries that falling emerging country currencies might result in their economies slowing.

JAPANESE EQUITIES

After the US and Canada failed to reach an agreement over NAFTA renegotiations and worries over the US-China trade dispute resurfaced, Japanese stocks turned weak again especially in economic sensitive sectors.

In addition, Japan was hit by two big natural disasters this week. A fierce typhoon attacked the Osaka area and led to Kansai International Airport closing for a while. And a destructive earthquake hit Hokkaido, triggering traffic disruption and a blackout in the region. In these extraordinary conditions, the TOPIX declined 2.47% over the week.

Due to concerns over mounting damage from the natural disasters, Insurance and Real Estate, and Air-transportation sectors fell. **Sompo Holdings** lost 6.20% and **MS&AD Holdings** sank 5.48%. Economically sensitive sectors also suffered broad losses. In addition, inbound tourism demand plays like **Shiseido** fell on worries that tourist numbers would fall after damage to Kansai International Airport.

Mining was the only sector which showed positive returns despite weakness across the board. **Fast Retailing** rose 4.77% due to a favorable earnings outlook from improved margins and impressive sales growth in August in its **Uniqlo** store network.

Despite all this, note that Japanese stocks were surprisingly resilient even after the disastrous March 11 2011 earthquake in eastern Japan.

EMERGING MARKETS

China's forex reserves declined slightly by $8.2bn to 3.1 trillion in August, an indication that its weakening currency had not yet triggered any significant capital outflows. Caixin manufacturing PMI for August was 50.6, down from 50.8 in July and below market estimates. China's tax bureau decided to lower personal income tax but raise effective social security charges starting from Jan 2019. The State Council took up measures to mitigate market concerns over potentially more stringent social insurance collection, by keeping the current local policies on collection unchanged till further notice while pledging no meaningful increase in corporate burdens on a general scale.

Ctrip reported upbeat 2Q18 results with revenue up 13.3% YoY and an encouraging operating margin improvement trend thanks to the recovery of its high-margin business.

Management also guided on 13-18% top-line growth with a 20% operating profit margin for 3Q18. **Tencent** continued to deliver weak performance on further negative headlines suggesting online gaming might be hit by a special tax.

In **Korea**, tech names underperformed on the prospect of lower NAND prices and an easier supply-demand picture for DRAM memories. In **India**, the rupee's depreciation continued with the finance minister again attributing the fall to external factors like higher oil import demand rather than trade war related outflows.

In **Brazil**, the highlight was the stabbing of Jair Bosonaro, the right-wing candidate, at a campaign event. Although his injuries are not fatal, it is unclear whether he will stay in the race. On the macro side, August inflation came in lower than expect. Despite the 20% currency depreciation, the inflation outlook remains benign because of significant labour market slack and low GDP growth. The central bank is expected to keep interest rates unchanged at 6.5%.

In **Mexico**, **OMA** posted another month of high-single digit traffic growth, expanding 8.9% YoY, mainly due to domestic traffic. **Walmex**, nevertheless, disappointed with weak same store sales up 5.9% or below the +6.8% expected by the consensus. Macro data is on the right path and real wage growth has turned positive. Nominal wages grew 5.8% YoY in July with inflation at 4.8% y/y, a real increase of 1% YoY. Consumer confidence increased 18.4% YoY in July, while consumer credit growth remained healthy at 7.6% YoY as of June (but below FY17 average growth of 10.8%). Formal employment remained resilient at +3.5% YoY in June vs. overall employment growth of 3.2% YoY in June. And remittances increased 15.2% YoY in MXN terms in July (+10.2% YoY in US dollars).

The **Argentinean market** enjoyed a strong rise as the country continued its negotiations with the IMF to obtain a credit line of $5-10bn.

In **Turkey**, all eyes are on the government's decision over interest rates this month. The market is expecting a 500bp hike. In **Russia**, August CPI jumped from 2.5% in July to 3.1% due to food inflation.

COMMODITIES

Concerns over trade tensions and emerging country demand continued to weigh on sentiment creating a certain amount of commodity price volatility. **Brent** crude had been flirting with $78 but then gave back $2 a barrel to end the period at $76. **WTI** fell from $70 to $68. The IEA said US output had risen by 230,000 b/d in June following maintenance in the Gulf of Mexico. Onshore production continued to rise, especially in Texas and in New Mexico where the Permian field is located. At 10.67 million b/d, US output is running at a new record and is likely to hit 11 million by the end of 2018.

Hurricane Gordon kicked off the tropical storm season, a yearly event which tends to hit both onshore and offshore production in the Gulf of Mexico to varying degrees. This time, production was only briefly affected. 2017 was a particularly bad year for supply and demand disruption. And should hurricane activity increase, markets would be put under pressure due to sanctions on Iranian exports kicking in. Secretary of State Mike Pompeo said Iran's exports were destined to disappear but that certain buyers might benefit from dispensations.

Elsewhere, metal prices suffered from mounting global trade tensions. The LME index lost 2% over the week with **aluminium** more than 5% lower to $2,040 a tonne or close to the $2,000 floor it has always rebounded off since it moved above that level in August 2017.

India's central bank announced that it had increased its **gold** reserves by 8.5 tonnes to 522.6, the first increase since 2009 when it bought 200 tonnes from the IMF. Iraq's central bank bought 6.5 tonnes, taking reserves to 95 tonnes, its first purchase since 2014. The bank cited low gold prices and its desire to diversify reserves as its reason for buying.

CORPORATE DEBT

CREDIT

Trading was choppy due to mixed European macro data, weakness in emerging countries like Turkey and Argentina and persistent worries over global trade. But corporate debt markets held up well with the Xover tightening by around 9bp between Monday and Thursday. Financials outperformed with Italian banks and insurance groups seeing their spreads tighten after Fitch reiterated Italy's BBB rating and Rome seemed willing to comply with European budgetary requirements.

Astaldi's bonds fell further after the company put back a results announcement from last Friday to later this month. S&P cut its rating by one notch to CCC-. **Casino/Rallye**'s bonds also remained under pressure. At the beginning of the week, S&P said it was downgrading the Casino group to BB, citing high debt levels and its worsening financial situation resulting from share price falls. Some buyers returned during the week.

Atalian (B2/B+), a leading corporate services company, reported a satisfactory 30.8% rise in half-yearly sales thanks to acquisitions and a recovery in like-for-like growth. However, net EBITDA looked to have fallen by 6.7% which suggests profitability is still struggling.

Teva (Ba2/BB) is to launch a partial buyback of bonds which are soon to mature. The group wants to reduce debt and financial charges and will fund the buyback from available cash.

In new issues, **Rabobank** (Aa3/A+) raised €1bn with a 4.625% CoCo.

CONVERTIBLES

There was good news from Argentina where the President and finance minister said the situation could be rapidly resolved and that the budget deficit could be absorbed by 2019. And Turkey's monetary policy seems to be going the market's way. In Italy, comments from Matteo Salvini and Giovanni Tria reassured investors and Italian spreads narrowed sharply. However, equity markets were clearly worrying about any fresh announcements from Donald Trump on Chinese imports. Indices lost ground, with technology, and semiconductors in particular, leading the way even if the sell-off only resulted in a mild rise in volatility.

The new issues market was relatively busy with a deal in Europe after several months of inactivity. **Adidas** raised €500m over 5 years at 0.05% to fund its share buyback programme. In the US, **Perficient** (IT consultancy) raised $125m over 5 years at 2.375% and **Retrophin** (biotech for infant diseases) raised $240m over 7 years at 2.5% to go on a partial buy-in of a 2019 maturity. **Infinera Corporation** (digital optical telecom equipment) is looking to raise $275m over 6 years with a coupon of between 1.875% and 2.375%. The proceeds will be used on a new acquisition.

On the secondary market, **Safran** performed well after reporting upbeat figures. In contrast, **Bayer** hit a 5-year low on poor margins in its pharma and mass market divisions and also on an unpromising outlook. **Sirius Minerals** fell sharply after funding costs for the second stage of its potassium mine project increased by around $500m.

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