EDMOND DE ROTHSCHILD

MARKET FLASH : RISK APPETITE RECOVERS

After a difficult 2018 and a tricky start to 2019, markets seemed to wake up to particularly depressed valuations across the globe. Risk appetite revived as the US and China resumed trade talks, the Fed struck a more accommodating note and China unveiled stimulus measures to help lending. Investment flows moved back into equities, led by the US, emerging countries and then Europe.
US markets remained upbeat ahead of the fourth quarter results season, the next real indication of the state of affairs. 28% of S&P500 companies are due to report in the week of January 28. Results are seen rising 14.5% on average but markets will be focusing on guidance for 2019 which was recently revised down from +7.3% to +6.4%.
Uncertainty over the extent of downward US company revisions and the success of US-China trade talks are the two main obstacles that have to be cleared before risk appetite recovers across the board. That said, markets have already discounted these revisions and have even overreacted.
The US dollar slipped after the Fed's more cautious tone and signs of progress in US-China talks, helping emerging country currencies to advance, and particularly the renminbi.
Brent crude has rallied to above $60 and higher oil prices have bolstered inflation expectations, sending government bond yields higher.
European equity markets also saw a significant rebound on strong sector rotation into cyclicals. However, Brexit uncertainty is still clouding prospects and weighing on investor sentiment.

EUROPEAN EQUITIES

Despite disappointing industrial production data from Germany, European markets pushed higher on hopes of significant progress in US-China trade talks and the Fed's promise to be patient and responsive. Cyclicals like autos, industrials, tech and oil services logically gained from this new-found optimism.

But with fourth quarter results looming, the rebound is still fragile; the trade talks have so far only yielded modest results and there are mounting concerns over China's economy. As a result, defensives were once again in favour at the end of the week. Car suppliers had led the recent rebound but turned lower. **Osram** said demand in auto markets was soft, and particularly in China.

In distribution, **Tesco**, the UK's largest retailer, announced better-then-expected Christmas trading, a contrast with **Morrisons** and **Sainsbury** which had lacklustre end-of-year sales. In France, **Fnac Darty** reckoned the yellow jacket protests had hit fourth quarter sales to the tune of around €45m, a somewhat limited impact which will nevertheless hit any improvement in 2018 EBIT. Management also confirmed that synergies with Darty represented €130m and that it was targeting a margin of between 4.5-5% and 5% in market share gains.

Sodexo beat its first-quarter sales thanks to a rebound in the US education sector and an improved contribution from healthcare. Forecasts for 2019 have been maintained but the group said second half margins could fall. In Italy, **FinecoBank** announced an impressive €6.22bn in inflows in 2018 despite difficult market conditions.

Korian is to acquire three companies in Spain, France and Germany with a combined €70m in sales. **Ingenico** completed its acquisition of Paymark, New Zealand's biggest electronic payment network. **Alstom** and **Siemens** are in talks with the European Commission over further asset sales in the hope of a getting the green light for their merger by February 18. Cevian Capital bought a stake in **Nordea** and will have a seat on the board.

US EQUITIES

The New Year rebound continued with the S&P adding 2.6% and the Nasdaq 3.7%.

US-China trade talks continued while Donald Trump and the Congress remained in conflict over the Mexican border wall project with federal agencies still in shut-down.

Jerome Powell reaffirmed the Fed's flexibility, confirming the December FOMC minutes which indicated that an increasing number of committee members preferred to be more patient over monetary policy changes.

The oil rally continued with WTI ending the week at around $53. The first trading figures for retailers were considered disappointing.

Department store **Macy's** tumbled 18% on like-for-like fourth quarter sales which only rose 1%. House builders **Lennar** and **KB Homes** had mixed fourth quarter results but their shares rose on higher orders.

Utilities lagged due to a 25% drop in **PG&E**, California's biggest electricity producer. The group has been downgraded by ratings agencies and could face bankruptcy due to its involvement in last year's fires.

JAPANESE EQUITIES

Japanese equities made a relatively positive start to 2019 as investor sentiment improved on strong US jobs data as well as Jerome Powell's suggestion that the Fed's rate hike policy would be more flexible. The TOPIX rebounded 3.46% for the week with the JPY/USD trading around 108.

While defensive stocks in domestic demand related sectors performed better in the fourth quarter of 2018 than external demand stocks, the situation changed a little bit.

Although Apple's announcement of a ten per cent cut in new iPhone production hit electronic parts manufacturers like **Nidec** and **Murata**, the top ten performers in the TOPIX100 also included excessively-oversold economic sensitive names as well. Not only **Takeda Pharmaceutical** (+13.06%) and **Recruit Holdings** (+11.60%) climbed but **Tokyo Electron** (+12.66%), **Komatsu** (+10.86%) and others also rebounded. On the other hand, some of the domestic demand related names in Retail Trade, Chemical and Food underperformed on worries over a slowdown in Chinese consumption. **Kao** (-6.82%) and **Unicharm** (-5.72%) sank and **Shiseido** tumbled 5.65%. Investors seemed to be rebalancing portfolios.

According to TSE statistics, non-Japanese investors turned out to be JPY 5.7 trillion net sellers of Japanese equities in 2018, the largest amount since 1987 and more than during the 2008 global financial crisis. The BoJ were key net buyers of JPY 6.5 trillion of ETFs.

EMERGING MARKETS

Emerging markets improved after the Fed's said it would be more patient over future rate hikes. Although a "test and verify" type of agreement between the US and China is expected after 3 days of negotiation in Beijing, the statements issued by both parties appeared to be uninspiring: progress has been made, but a long list of outstanding issues has not been sorted out yet. Currency markets adopted a positive take on the outcome, with the renminbi up more than 1.8% over the week.

On the other hand, **China** rolled out targeted stimulus plans to cut the tax burden on small and micro-sized firms by RMB 200bn ($29bn) a year for the next three years. The PBoC is providing additional liquidity to banks to lend to small and private companies. Other supportive measures to help automobile and home appliance consumption are also reportedly under study. Automakers continued to deliver weak sales numbers in December. Both **Geely** and **Greatwall Motor** missed their full year 2018 sales targets. Geely is now guiding on flat volume growth for 2019.

Exports in **Taiwan** recorded another month of contraction in December, falling 3% YoY versus minus 3.4% in November due to declines in electronics parts exports to China, Hong Kong and ASEAN countries. Meanwhile, Apple asked suppliers again (for the second time in 2 months) to make about 10% fewer iPhone XS Max, XS and XR in January to March than previously planned.

Samsung in **Korea** announced disappointing preliminary operating profits for the last quarter which will be 25% below the consensus estimates due to DRAM and smartphone weakness. **TSMC** 4Q18 sales rose 11.3% QoQ or in line with guidance, despite December sales falling 8.7%. **Largan** delivered a surprising margin beat in 4Q18 although profit growth missed consensus estimates and first quarter guidance was soft.

TCS in **India** reported 3QFY19 revenue growth of 12% with an EBIT margin of 25.6%, or slightly lower than market consensus due to higher employee and sub-contracting costs. The order book remained strong at +20% QoQ.

Brazil's industrial production fell 0.9% in November, or lower than the consensus. A press report said the new government was considering changing the current federal highways concessions model, giving up demanding cheaper toll tariffs and instead adopting Sao Paulo`s concessions model which favours the best bid in auction.

In **Mexico**, **Walmex** reported December SSS growth of 4.7% or weaker than consensus expectations of 5.8% and down on November's 5.9% reading.

COMMODITIES

The **oil** market continued to return to normal conditions. Brent crude jumped by almost 9% while WTI ended the period 10% higher, the biggest weekly gains since February 2016. US-China talks seemed to be going well but will require further meetings. Investors were reassured by comments from Saudi Arabia's oil minister on the country's determination to see rapid oil market normalisation. He said exports would fall to 7.2 million b/d in January and 7.1 million in February, down from 8.2 million in November. This is much higher than the 800,000 b/d cut unveiled by OPEC that came into force on January 1st. Riyadh has also budgeted for a 7% increase in spending, a long way from the austerity introduced in 2015 when Brent was trading below $60. The budget seems to require an oil price of around $80.

Meanwhile among more volatile producer countries, Libya's output fell below 1 million b/d due to fresh unrest while Nigeria's production could be hit by the February 16 elections.

The **gold** ounce has traded between $1,280-1,300 so far this year. The FOMC minutes struck a relatively cautious tone over future rate hikes. The big development this week came from China's central bank which announced its first gold purchases since October 2016. Gold accounts for 2.5% of its foreign exchange reserves vs. 18% for Russia. The move comes amid serious pressure on China from the trade war and slowing growth. Central banks were particular active on the gold market in 2018. In the third quarter, 148 tonnes were bought, the largest amount since the fourth quarter of 2015.

CORPORATE DEBT

CREDIT

Last week's down trend was reversed thanks to Jerome Powell's new caution on future rate hikes from the Fed and optimism over extended US-China trade talks. The Xover tightened by 25bp and the Main by 8bp.

High yield new issuance resumed with **Telecom Italia** (BB+/Ba) which raised €1.25bn with a 5.25 year Senior Unsecured bond at 4%. The issue price was 99.346% (for a yield of 4.125%) with a 50bp issue premium. The deal was 3.6 times oversubscribed and performed well on the secondary market.

In financials, **UniCredit** (BBB-/Baa3) issued a Senior Non-Preferred bond in two tranches, one for $2.5bn over 3 years at MS+400bp and the other for $500m for the same maturity at MS+390bp. Both bonds then traded above par.

In investment grade, **ArcelorMittal** (BBB-/Baa3) raised €750m with a Senior Unsecured 5-year maturity at MS+210bp. **Fiat Chrysler** said it would be paying $800m to settle a dispute with the US Justice department on suspicions the group had used illegal software to falsify diesel vehicle emissions. According to France's Challenges magazine, Dexter Goei, chairman of **Altice** and Thomas Reynaud, managing director of **Iliad**, had lunch together last Thursday, rekindling rumours of consolidation in France's telecoms market.

CONVERTIBLES

The brutal market correction in the fourth quarter of 2018 was down to diminishing liquidity, trade and political tensions and fears of a recession after global growth estimates were revised lower. 2019 started in the same uncertain mood but sharp market drops have removed some excessive valuations and in some case priced in a recession.

As a result, investors have become more discerning and the healthcare sector has gained the most from this. A conference in San Francisco provided a platform for good news from biotechs like **Insmed**, **Exact Science**, **Dexcom**, **Qiagen** and **Wright Medical Group** which all enjoyed strong rebounds. Tech stocks also performed well, especially cloud plays.

Nevertheless, there is still no clear trend but guidance during the earnings season could provide some indication.

The new issues market remained quiet. **Cellnex** had a €200m tap at 100.8 on its 2026 convertible. **China Yuhua Education** issued a new 363-day convertible, raising HKD 940m at 3% and with a 20% premium.

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