MARKET FLASH :
LOSS OF BEARINGS

Over the summer, we reduced exposure to equities, partly because we felt new risks had not necessarily been discounted by the markets but also for technical reasons. The equity market sell-off originated in the US and came out of the blue. It is, of course, impossible to isolate the one event that might have triggered the slide. However, Donald Trump, never at a loss for a comment on stock market events, immediately blamed the Fed. And yet the Fed has taken nobody by surprise, only tightening in line with what its dot plots had always suggested since the spring of 2017 and despite the economy expanding faster than expected. It is, however, highly likely that rises in US long bond yields and oil prices in recent weeks ended up disrupting investor bearings and prompting a wave of profit taking.

As far as sectors are concerned, growth stocks fell more than others. Admittedly, their year-to-date returns had spiralled, setting them up for a correction due to their high multiples as US Treasury yields hit fresh highs. Luxury stocks in Europe came under attack despite excellent results, a typical development when positions are being unwound. It was the same story with US tech stocks and cyclicals due to concerns over growth rates, particularly in China. As for fund flows, this episode recalls the first quarter when systematic funds cut exposure, triggering strong selling pressure. But over and above monetary and economic cycle fundamentals, the US market reaction is, in our view down, to its concentration (MSCI World returns are mainly due to the US) and polarisation both in terms of sectors and growth/value styles.

All in all, there are two ways to interpret recent market moves. On the one hand, shifts in the US yield curve have extended the US cycle, reminding equity investors that growth is spreading and no longer such a rarity. This has naturally reduced the valuation premium on visible growth stocks. On the other, mounting concerns over China due to persistently high trade tensions have undoubtedly weighed on investor sentiment.

We are convinced that the economic environment is still healthy and that earnings momentum has further to go, even if investors are starting to think about the end of the cycle. A US recession might possibly occur in 2020 but even if markets are supposed to anticipate events, it is still too early to position portfolios for such an eventuality- historically, markets start factoring in recessions one of two quarters before- especially as Beijing is introducing fresh measures designed to stimulate lending. That is why we think this fall back is mainly technical and why we are closely watching markets for tactical buying opportunities.

Over the medium term, we continue to believe that the robust US cycle and tighter financial conditions augur for higher volatility than in the past, a situation that will require active management of risk.

EUROPEAN EQUITIES

European markets tracked US stocks sharply lower as Berlin slashed its growth forecasts for 2018 -from 2.3% to 1.8% and for 2019 from 2.1% to 1.8%- and amid worries that persistent Italian budget worries might lead to downward revisions from rating agencies. Strategists at Morgan Stanley also cut the outlook for the luxury sector while JP Morgan reduced its outlook on chemicals.

A strong surge in risk aversion triggered strong selling of previously must-have, high-multiple structural growth stocks like **Kering**, **Safran**, **Dassault Systèmes**, **Amadeus**, **Airbus** and **Wirecard**. Cyclicals like semiconductors, chemicals and aerospace were also hit. Tech stocks sold off amid fresh US-China tensions and semiconductors suffered after Swiss valve maker **VAT Group** reduced worker hours. Luxury stocks plunged after China confirmed that upmarket goods brought back into the country would be taxed and on news of Morgan Stanley's sector downgrade. **LVMH** was hit despite posting 10% like-for-like growth for the third quarter. Industrials also fell sharply after **PPG** spoke of higher commodity prices and a less buoyant Chinese market.

Among defensives, consumer staples and pharma offered little protection by falling in line with indices. Telecoms and utilities were, however, generally in favour with investors.

In corporate transformation, **Dialog Semiconductor**, unveiled an agreement with **Apple** to sell some of its factories and technical teams for $600m. It also announced new contracts with Apple. **Ingenico** said it had been approached over a strategic deal. **Natixis** is reportedly considering merging its payment services business with that of Ingenico.

US EQUITIES

The S&P plunged 5.4% and the Nasdaq by 5.9%, reducing year-to-date returns to +2% and +6% respectively. The S&P suffered its worst trading session since February and the Nasdaq last saw such a sell-off after the Brexit referendum result. The catalysts were (i) a fresh escalation in Donald Trump's stand-off with China, (ii) concerns over a macro slowdown in China after companies like **PPG** (chemicals) and **Fastenal** (industrial distribution) sounded very cautious notes and (iii) the looming results season.

FANG stocks tumbled 8% over the week, taking falls since the beginning of the month to 12%. A basket of US stocks with Chinese exposure shed 8% over the last fortnight while momentum stocks, the best indicator of hedge fund performance, are down 14% since the start of October.

Commodities and industrials alone fell more than the index. Stock dispersion was more in line, with 50% down by more than 5.4%. This all suggests that this was a technical correction over positioning feeding on worries over China and nerves over third-quarter results than a genuinely fundamental event.

Sector performance was clearly tilted in favour of defensives while industrials and tech and commodity stocks led declines. Relative resilience from long duration sectors like consumer staples and property indicates that the sell-off was not due to interest rate tensions but to macroeconomic concerns over China and nerves ahead of the results season which is expected to show an 18% jump in third quarter earnings.

JAPANESE EQUITIES

Following the sharp fall in the US stock market, Japanese stocks prices lost ground across the board as did other Asian countries. The mood was dominated by mounting risk-off activities among short-term investors worrying about the impact of high US long bond yields and lingering US trade tensions on global corporate earnings. Sentiment was also hit after **Yaskawa Electric Corporation** cut guidance citing US-China trade disputes. The TOPIX lost 5.06% for the week.

Economically sensitive sectors such as Chemicals, Electric Appliances, Machinery and Automobiles that had risen over the last month were particularly weak, and China related names such as **Keyence**, **Fanuc**, and **Shiseido** also saw heavy selling.

On the other hand, domestic demand sectors such as Retail Trade, Real Estate and Insurance were relatively firm. **Daiwa House** and **Sompo Holdings** made positive returns despite the market turmoil. Retailers such as **Don Quijote**, **ABC-MART** and **Aeon Mall** were also strong on solid fundamentals and upbeat earnings.

Many investors are now focusing on July to September earnings which are expected to be positive and due soon.

EMERGING MARKETS

In **China**, the PBoC cut the RRR by 100bp for targeted banks on the last day of the Golden Week holiday. The RMB 1.2 trillion liquidity release will better cushion the pressure of October's tax payment season as well as any gradual impact from trade frictions. It also signals structural easing for SMEs and private sectors. September's exports rose 14.5% compared to +9.1% in August, or better than 8.2% expected. This was possibly due to shipment frontloading and the renminbi's depreciation. This week it lost 80bp vs. the US dollar. Domestic travel revenue during the Golden Week was up 9% YoY versus 14% in 2017. Average spending per visitor recorded its first decline in history.

Tencent's share buyback continued. Other Chinese companies like **CSPC** and **Fosun** have also launched share buybacks to take advantage of market weakness. **BMW** is paying €3.6bn for 25% of **BBA**, raising its stake in the joint venture to 75% and becoming the first automaker to take advantage of China's new policy of allowing foreign companies take majority control of local partnerships. **Sunny Optical** reported a 61% YoY surge in September shipments of handset lenses, or ahead of guidance; this compares with only 1% YoY growth from its competitor **Largan**. **TSMC**'s third quarter USD revenue rose 8.7% QoQ, or at the high end of company guidance. The IMF cut **South Korea**'s growth outlook to 2.8% from 3% in 2018 and to 2.6% from 2.9% next year.

In **India**, the rupee stabilised this week as a State Bank of India official said it was looking to take over NBFC assets to ease liquidity, thereby helping reverse negative sentiments on NBFCs. **TCS** reported 2QFY19 revenue growth of +10% YoY in USD thanks to strong performance from the BFSI and retail segments. Management also guided on strong double-digit top line growth ahead.

In **Russia**, the current account surplus widened to $26.4bn in the third quarter, or above market consensus of $24bn, thanks to oil breaking above $85. The third quarter budget surplus also improved and now stands at 3.5% of GDP.

LATAM markets outperformed other emerging markets. In **Brazil**, Jair Bolsonaro appointed economist Paulo Guedes as future finance minister if he wins and continued to lead the poll for the 2nd round with 45% vs. 41% for Fernando Haddad. August retail sales rose 1.3% MOM, or above market consensus. **Mexico**'s International Negotiations Council confirmed that the US was working on eliminating tariffs on Mexican steel and aluminium.

COMMODITIES

Market turbulence helped restore the attraction of **gold**, previously a forgotten asset. Admittedly, gold and gold stocks have hardly shone year to date, and the gold ounce was down by 8.3% in USD and 4.5% in EUR as of October 10. Most of the fall was concentrated between mid-April and mid-August when it shed 13% in USD.

The summer was particularly difficult due to ETF selling, -3.5% YTD and -7% since the May peak, but mainly because of COMEX traders. They had built up unusually large shorts, so much so that for the first time since April 2001, the market had been net short since August 14. Investors were naturally disappointed that gold had failed to perform during potentially inflationary trade tensions. Gold's role as a safe haven began to be queried.

However, since the end of 2015, gold has proved resilient to 8 Fed rate hikes and has even gained 13% in USD. In fact, the rate hike cycle has come with a gradual lift to inflation, leaving real rates below 1% and thereby maintaining the opportunity cost of holding gold. October 11 saw a surge in risk aversion, and gold jumped by 2.5% in USD while gold stocks gained 6%. Trading was heavy, an indication that shorts were being unwound. In the past, gold has performed better during financial and economic crises than during political and geopolitical upheavals.

Despite today's high prices, **oil** only fell 4% or in line with market declines and Brent crude ended up back at around $80. Hurricane Michael caused an interruption to some of the Gulf of Mexico's operations (720,000 b/d was hit at the worst point) but output is now set to return to normal.

CORPORATE DEBT

CREDIT

Selling pressure came from worries over the impact of US-China trade tensions on economic growth. Nor were investors reassured by comments from Italy's minister of the economy which sent 10-year yields there to 3.71% on Tuesday, a high not seen since 2014. Italy's banks suffered the most from Italian budget woes. Their liquidity has come under increasing scrutiny form the ECB but Reuters maintains that no alarm signal has been observed. Markets also fell after the IMF trimmed its global growth forecasts for this year and next from 3.9% to 3.7%. The Xover widened by 14bp between Monday and Thursday, a rather restrained reaction given severe equity markets falls and higher volatility.

Press reports said **Astaldi**, which has initiated creditor protection measures, is mulling several moves including an increase in capital designed around a pivotal investor, an issue of participation certificates and a debt haircut. The actual plan should be finalised within 45 days. Meanwhile, ISDA said that Astaldi met bankruptcy credit event conditions, a decision which triggered the 2003 and 2014 CDS.

Food retailer **Tesco** outperformed over the week after Fitch upgraded its rating to BBB-. Bonds issued by **Levi Strauss & Co** (Ba1/BB+) edged higher thanks to an impressive 10% rise in third quarter sales and EBIT. **Jaguar** and **Fiat** had a difficult week. Jaguar's sales tumbled 12.3% while Fiat might have to pay $1bn to the US authorities over a diesel court case. **Ceconomy**, the largest Fnac group shareholder with 24%, issued a profit warning, saying 2017/18 results would be lower than previously forecast. They had already been revised lower in September. **Fnac** bonds also slipped on the news.

In a very quiet week on the new issues market, online game designer **Playtech** (B2) raised €530m over 5 years at 3.75%.

CONVERTIBLES

Markets amplified the previous week's falls on concerns over China's economy being hit by trade wars, US 10-year Treasury yields rising to 3.25% and Italy's highly volatile environment. The VIX flirted with 25 and the VStoxx (the Stoxx 600 Europe volatility index) hit 21, with tech and luxury stocks sharply lower. In contrast, defensives like telecoms and value sectors like financials and energy outperformed, albeit only in Europe.

Ahead of the earnings black-out period, **JPM** offered to buy in its $350m bond exchangeable into **Dufry** (Duty-free shops) in return for a new 2021 exchangeable at a better, 25% premium. The offer was taken up to the tune of $205m. Japan's **Park24** (car parks) raised JPY 35bn with a 7-year convertible to fund a recent acquisition and future business expansion. **Karyopharm Therapeutics** raised $150m with a 7-year convertible at 3% to fund marketing of its new Selinexor drug if approved.

On the secondary market, **Ubisoft** was actively traded amid a sector sell-off but the stock benefited from good media feedback on a new chapter of its flagship Assassin's Creed product and rumours that it might buy **Zynga**.

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