MARKET FLASH: INVESTORS ARE PRESSING THE PAUSE BUTTON

January 13, 2017

On the markets

The economic environment is still clearly robust but markets appear to be losing steam. After six months of the reflation theme, investors are pressing the pause button. In economic indicators, the NFIB index, which measures US small company optimism, shot up to a 10-year high. This was by far the biggest monthly surge ever. All survey sections rose, led by indications on future activity. It remains to be seen whether this enthusiasm will translate into concrete action. If so, we can soon expect to see SME activity accelerating. In Europe, the headline event was Germany's 1.9% growth in 2016 which was slightly better than expected and marked a 5-year high. But China's trade figures contrasted with upbeat performance in developed countries.

Further improvements in economic indicators failed to stop global indices stabilising. Europe and Japan saw a slight correction as the Stoxx 50 and Nikkei slipped 1% and 1.64% respectively over the period. Sector rotation was also interrupted with banks and autos weighing on indices. Donald Trump's press conference had no effect on market consolidation but indices had already chalked up strong gains since his election victory in early November. Consolidation was also due to market positioning: stock gains had been very fast in recent months, mirroring the rapid upgrade in macroeconomic forecasts. With shorts on US bond futures at record levels, net long positions on oil close to historic highs and Yen shorts also very high, it is hardly surprising that markets have paused for breath.

So far, equity markets have proved more resilient than other markets. This is because the US dollar has been weakening for a few weeks, yield curve steepening has been interrupted and interest rates in both Europe and the US have fallen back significantly.

Against this backdrop, we are still upbeat on the upside for equities. As far as geographical allocation is concerned, the eurozone should continue catching up due to realistic expectations of earnings increases, attractive valuations and the fact that international investors are underweight the zone. This week we reinforced Japanese equity exposure following market weakness. On bond markets, we remain neutral on US duration, positive on inflation-linked bonds in Europe and we are still positioned midway on the European yield curve. Note that we have maintained exposure to Greek sovereign debt but have reduced positions on German 2-year bonds.

EUROPEAN EQUITIES

Europe consolidated in moderate trading volumes and oil prices fell back slightly. Financials and autos, however, came under attack while pharmaceuticals were hit when Donald Trump lambasted their pricing policies.

In autos, **Volkswagen** said it had agreed a USD 4.3bn fine imposed by the US but then **Fiat** was also embroiled in an emissions cheating scandal over diesel cars sold in the US. The stock plunged. Luxury fared better. **Richemont** saw third quarter like-for-like growth rebound sharply (+5%) led by jewellery sales in Asia and in China in particular. In distribution, **Metro**'s October-December 2016 first quarter was a little disappointing and margins could come under pressure. But **Marks & Spencer** reported a 2.3% rise in sales or more than expected. In industry, **Airbus** rose on news of a USD 3.8bn order from Aviation Capital Group in the US. **Cobham** revised down guidance on results from GBP 255-275m to 245m and expects to pass on its dividend. The stock fell sharply.

In M&A, **Ipsen** acquired a US biotech specialised in oncology and the treatment of pancreatic cancer. **L'Oréal** paid a steep 8-times sales to acquire 3 cosmetic brands from **Valeant**. Talks between **Actelion** and **Johnson & Johnson** seem to be making progress with as yet unconfirmed reports of an agreement on the price tag.

US EQUITIES

US equities were more or less unchanged in a week dominated by Donald Trump's press conference and Janet Yellen's comments on monetary policy.

The President-elect spent most of his time on personal issues, and in particular on rumours of a compromising video made in Russia in 2013 and management of latent conflicts of interest between his business interests and his role as President.

Janet Yellen spoke on the current economic environment and said she saw no short term obstacle to further robust performance. In her opinion, unemployment was at historic lows, the jobs market was solid, there were incipient signs of wage growth and inflation had risen from a low and was currently just a little below the Fed's 2% target.

In company news, healthcare stocks were hit by the Republican Party's increasing interest in reforming the Affordable Care Act and Donald Trump's suggestion that drug prices should be more competitive with more drugs manufactured in the US. In M&A news in the sector, **Ariad Pharmaceuticals**, which specialises in cancer research, said it was being acquired by Japan's **Takeda Pharmaceutical**. The price tag is around US 5.2bn which represents a premium of more than 70% on the last quoted price. In autos, the Environmental Protection Agency said it was looking into the possibility that **Fiat Chrysler** had, like Volkswagen, cheated on diesel motor emissions tests.

Materials and consumer discretionary led gains over the week. Property and energy were the biggest losers.

JAPANESE EQUITIES

The TOPIX dipped 1.3% after last week's strong start to the year. Equity markets adopted a cautious stance as the yen rebounded by 2% against the US dollar and 0.8% against the euro. But expectations of upward earnings revision and political stability continued to attract global investors to the market. Higher analyst earnings estimates on the back of the yen's decline from around 100 to 110 against the US dollar also provided support. And yet, US President-elect Donald Trump's threats against Toyota, Japan's top automaker, made some traders cautious.

The best-performing sector was Oil & Coal Products (+1.5%), while Insurance (-3.7%) led losses for the second week running.

Toyota lost 2.9% due to Donald Trump's Twitter attack on its plan to build new plants in Mexico. CEO Akio Toyoda then announced a USD 10bn investment in the US over the next 5 years soon after the comment.

SoftBank, which said it would be investing USD 50bn in the US and creating 50,000 new jobs, rose 3.4%. In early December, CEO Masayoshi Son had a successful meeting with the US President-elect.

EMERGING MARKETS

Emerging market stocks rose to two-month highs, led by strong gains in Russia, Brazil, Hong-Kong-listed China stocks, India and Chile. Korean rallied to its highest level since July 2015 after **Samsung Electronics** hit a fresh all-time high. **Taiwan** gained 0.7% to a June 2015 high and Russian dollar-denominated stocks surged 2.1% week on week.

The big news was a significant move from **Brazil's Monetary Policy Committee** (COPOM) which made a deeper 75bp cut in interest rates (Selic) to 13%. The decision was unanimous. The bank's two previous rate cuts in this easing cycle were each for a quarter point. The acceleration should be taken positively: outflows should be limited as the yield remains high and attractive. Further cuts are expected this year.

In **India**, inflation continued to fall in December to 3.4%, almost a 2-year low. Industrial production rebounded thanks to a low base effect so it is still not totally convincing but at least stabilising. Indian IT service provider **TCS** reported a slightly better-than-expected 10.9% rise in EPS YoY with a top line up 8%. Margins improved further to 30% vs. 29.1% last year.

Russian asset prices were underpinned by the ongoing belief from that Donald Trump might pursue a friendlier policy than President Obama, with hopes that Western sanctions imposed on Moscow during the Ukraine crisis might be eased.

In **China**, industrial product inflation (PPI) accelerated, rising 5.5% in December, thanks to the low base effect (PPI fell 6% in December 2015) and rising commodity prices. CPI inflation moderated owing to a high base effect and decelerating food price increases. CPI is at healthy 2.1% currently. This augurs well for earnings growth in sectors like Energy, Materials, Financials and Industrials.

In company news, Chinese **Sunny Optical**, global leader in dual camera lenses, and **Largan Precision**, its Taiwanese peer which supplies Apple, both reported solid earnings this week. Thanks to an improvement in its product portfolio, Largan's gross margin increased from a historical high of 68% in the third quarter of 2016 to 70.7% in the fourth despite a 13% annual drop in sales. Sunny enjoyed very strong December shipments: its handset lens sets jumped 106% year on year to a record 50 million units, thanks to the adoption of Dual Camera by several Chinese brands like Huawei, Vivo and Oppo. Both companies are great proxies for investors wanting to bet on increasing adoption of dual-camera smartphones. They are expected to rise from 3.7% of total global smartphone shipments in 2016 to around 16% in 2017.

COMMODITIES

Oil prices were more volatile this week, with Brent crude falling to a low of USD 53 before moving back above USD 55. Weakness appeared on news of record 3.51 million b/d exports from Iraq in December from Persian Gulf ports; a development which made traders worry about compliance with quotas. But news from other producers like Angola, Saudi Arabia, the UAE, Kuwait, Oman and Qatar was positive. Saudi Arabia even indicated that its daily output had fallen below the 10 million mark although its quota is 10.05 million b/d. Russia also seemed to be party to the production cut with a 100,000 b/d drop to 11.1 million in January.

China's external trade figures for December remained upbeat. Oil imports even hit a record 8.57 million b/d, a 12.5% increase on the month and +14% for 2016 as a whole. **CNPC**, the state oil company, expects to see demand rise 3.4% in 2017 to 11.88 million b/d. December saw robust copper imports, up 29% on the month and 2% on the year. But iron imports stabilised at minus 3% in December (+7% in 2016 as a whole) thus providing confirmation of an improvement in Chinese demand.

Metal prices rose over the week on US dollar weakness following Donald Trump's press conference which provided little light on economic policy. Nickel, however, failed to follow the trend due to Indonesia's decision to ease certain bans on exporting low grade ore. Indonesia was traditionally a big exporter of nickel and bauxite ore (the source of alumina which helps make aluminium) but in 2014 decided to ban exports of both. The idea was to promote the local processing industry and export the metal rather than the ore. It is still too early to estimate how much extra ore will now be exported but the nickel deficit expected by the market is likely to narrow and affect pricing.

Gold also gained from US dollar weakness and flirted with USD 1,200/oz.

CORPORATE DEBT

CREDIT

After a relatively quiet December, the first two weeks of 2016 were rather busy. Spreads on the Itraxx Main and Itraxx Over were little changed, rising by 2bp 5bp respectively. In company news, **SNCF** awarded the **Alstom-Bombardier** consortium a EUR 3.75bn contract to build 255 suburban trains. The first tranche will be for EUR 1.15bn. Elsewhere, the European Commission approved the **Areva** rescue plan provided that Areva divests its nuclear reactor business. The plan will involve a EUR 4.5bn cash injection from the French state. In the US, **Fiat Chrysler** was told it was in violation of the Clean Air Act. 100,000 cars are concerned. The news triggered heavy selling but opportunistic buyers emerged at the end of the trading session after the group had denied the charges.

There were four big new issues. **Jaguar Land Rover** raised EUR 500m with a 7-year non-call life euro bond, **Cellnex** issued a EUR 300m bond due 2025, **Talk Talk** a GBP 300m maturity and **Telecom Italia** a EUR 1bn bond due 2023. Given strong investor interest, Talk Talk and Cellnex were able to increase their issue size and pitch the coupon towards the low end of the proposed spread.

The Additional Tier 1 market saw a USD 1bn perpetual non call 7 issue from **Standard Chartered**.

CONVERTIBLES

New issues gave some rhythm to the second week of 2017. In Europe, Italian cable manufacturer, **Prysmian**, priced EUR 500m of zero coupon 2022 convertibles with a 41.25% premium. The proceeds will be used for external growth opportunities. **ImmoFinanz** also returned to the market with EUR 300m in 7-year convertible bonds at 2% (and a 0.5% step down in case of IG status). The bonds came at a 30% premium and simultaneously offered incentives to convert the outstanding 2018 issue.

In Japan, **Ezaki Glico** (a confectionary company which makes the "Pocky" chocolate sticks) raised JPY 30bn with a 7-year zero coupon mostly to finance the expansion of its operations into South East Asia. And in the US, **Nice System** raised USD 225m in 7-year convertibles to help repay a term loan it took on as part of its recent acquisition of call-centre operator, inContact. **Nabors Industries**, a Texas-based land drilling contractor, priced USD 500m in 7-year convertibles at 0.75%.

There was also a lot of news from CB issuers at this week's JP Morgan Healthcare conference. Highlights included: comments from medical device manufacturer, **Nuvasive**, which reported a strong finish to 2016 and an optimistic outlook for 2017; and from genetic sequencing equipment developer, **Illumina**, which launched a new product designed to reduce processing times by two-thirds; it also announced fresh cooperation with IBM and also with start-up NRGene using big data to develop molecular breeding tools for use in agriculture. Elsewhere, **Sainsburys** reported stronger-than-expected sales on reduced price deflation in food and outperformance from its recently acquired Argos non-food business over the Christmas period. S&P cut its rating on **CGG** by 2 notches to CCC- (negative outlook).

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