MARKET FLASH: “UNDER PRESSURE”

February 16, 2018

On the markets

This week's catalyst was January’s CPI in the US. Following a larger-than-expected increase in wages in the previous week, all eyes were on CPI due to mounting concerns that inflation might get out of hand and push long term bond yields higher. In the end, prices rose 0.5%, or higher than the 0.3% expected. Markets initially overreacted but the rebound in risk assets nevertheless resumed in a sign that the correction earlier on in the month was primarily technical. Overall inflation was stable at +2.1% YoY but a surprise surge in prices is still the number one investor concern because of the potential impact on interest rates. As a result, markets would be vulnerable if growth were to soften and inflation were to continue to rise.

Elsewhere, January’s retail sales, released at the same time as the inflation data, slowed from +5% to 3.9% YoY, a disappointing figure which weighed on the US dollar on Wednesday. The other currency market worry was the likelihood that the Trump administration’s $200bn infrastructure spending programme would worsen the budget deficit. US consumption should nevertheless hold up in the first quarter of 2018 thanks to lower household taxation, but a good deal of estimated growth is expected to come from company investments. In the eurozone, Germany’s fourth quarter GDP advanced 2.9% while in Italy it rose by 1.6%. Both suggest growth is accelerating and spreading throughout the zone. Higher investment is a strong sign of a sustainable and fundamentally healthy cycle.

As for fourth quarter 2017 earnings, 74% of US companies and 97% of Japanese companies have now reported. In Europe, 50% of results are in. EPS grew between 15-17% across all three regions, the best performance since the first quarter of 2017. Sales also grew at a brisk 8%. In the US, EPS was up by 15% or +13% excluding energy. 10 out of 11 sectors saw earnings grow. In Europe, 54% of Stoxx 600 companies beat expectations with earnings up 17% (+10% ex energy). In both Europe and the US, cyclicals did better than defensives, a sign of the cycle’s momentum.

The recent correction on global markets took the S&P 500 back to its 200-day moving average and European markets back down to levels seen in January 2017. We took advantage of the sell-off to increase equity exposure. While maintaining our European equity overweight, we increased our US, emerging country and Japan scores by one notch.

EUROPEAN EQUITIES

European markets rallied amid upbeat fourth quarter earnings reports. The CAC outperformed on excellent company results. Fourth quarter growth accelerated to 5.5% from what was already a 9-month high of 4.7% in the previous quarter.

Cyclicals were particularly strong, led by capital goods, technology, semiconductors and corporate services. Defensives like consumer staples lagged. Meanwhile, the euro appreciated further to 1.25 against the US dollar while bond yields edged higher on small signs of inflation reviving in the US.

Airbus shone this week after 2017 EBIT beat estimates and free cash flow was much higher than expected. This was down to very strong deliveries in the fourth quarter and favourable currency effects (with US dollar exposure hedged). The group now sees 2018 EBITDA rising 20% and free cash flow at the same level as 2017.

Capgemini also did well with like-for-like fourth-quarter growth accelerating sharply to 5.6% thanks to double digit growth in the US and Europe. Sales rose 4% over the year and new orders were markedly higher in the fourth quarter. The operating margin rose 20bp to 11.7% in 2017. FCF generation was once again upbeat and should remain above €1bn in 2018.

Renault also fared better than expected with EBIT coming in at €3.8bn and 6.6% in margins. The group made higher-than-expected savings on purchases and also benefited from an improved mix. Management is now aiming to keep operating margins above 6% in 2018. **EDF**'s sales were in line, EBITDA was slightly better than expected and EBIT came in at €5.6bn or much higher than the €5.1bn expected thanks to cost savings. 2018 guidance was in line and reassured investors, but the stock was hit by possible new competition in France's hydroelectric power market.

Among relatively disappointing figures, **Nestlé**'s like-for-like growth in the fourth quarter was 1.9% or less than the 2.4% expected. 2018 sales are expected to rise by a modest 2-4% and margin improvements should be in line with the targets set for 2020. The group said it did not want to renew the **L'Oréal** pact nor increase its stake. **Crédit Agricole** also disappointed the market with net profits (ex exceptionals) coming in only a little higher than expectations.

US EQUITIES

Against all expectations, US markets bounced sharply after the CPI for January came in at +2.1%. Over the last five trading sessions, the S&P500 surged 5.8% while the Nasdaq jumped 7%. Retail sales fell 0.3% when they were expected to rise 0.2%.

And the Empire Manufacturing Index surprised investors by falling to 13.1 (vs.17.7 in the previous month) when expectations were for it to rise to 18. In a sign of renewed risk appetite, US dollar weakness returned as the greenback lost 2.3% against the euro and the VIX volatility index tumbled from 33 to 19.

Core inflation came in at 1.8% ex food and energy, an indication that consumer price rises were relatively reasonable. The figure was slightly up on last year's average but still in line with levels seen since 2013. The market was primarily concerned that the Fed might be behind in its monetary tightening cycle and would be forced to accelerate its moves, but that scenario has failed so far to materialise. True, the PPI came in at 2.2%, or higher than the 2% expected, but its impact on the PCE should be measured.

Elsewhere, Donald Trump unveiled the broad outlines of his budget which will increase deficits by $984bn or twice the amount he suggested last year. The environment budget has been slashed by 25% while spending on defence (+13%) and immigration controls will both rise sharply. Note that it is traditional for the budget to be rejected when it first goes before Congress.

Sector performance was marked by a strong revival in buying in the most cyclical sectors. **Technology** rose 9%, **financials** 7% and **industrials** ended the period 6% higher while **energy** only gained 1.8%.

JAPANESE EQUITIES

Tokyo was weak in the first half of the week as the yen posted strong gains against the US Dollar. The market then stabilised as US volatility receded and investors bargain-hunted for oversold stocks. Over the week, the TOPIX edged down 0.73%.

By sector, Other Products (+2.42%), Mining (+2.14%) and Precision (+1.37%) outperformed with positive returns.

There was strong performance from game producer **Nintendo** (+5.79%) and **Sumitomo Metal Mining** (+8.60%) while SPE manufacturer **Tokyo Electron** enjoyed a solid 8.61% rebound on record earnings after a ten-year interval. Cosmetics producer **Shiseido** (+6.37%) gained on a probable three percent plus wage increase and **Otsuka Holdings** (+6.21%) was cheered by favorable sales growth in new medicines.

In contrast, Marine Transportation (-3.62%), Land Transportation (-2.49%), and Electric Power & Gas (-2.97%) underperformed this week. The Transportation Equipment sector fell 3.04% due to the stronger yen. Other losers were pharma companies like **Eisai** (-6.73%) and **Daiichi Sankyo Company** (-4.88%).

The Abe administration proposed reappointing Haruhiko Kuroda as the central bank governor. The current monetary easing policy is expected to continue to ensure an exit from deflation and aim for a sound increase in CPI toward the 2% target.

EMERGING MARKETS

Emerging markets rebounded by 5.23%, driven by **China** where 385 million people were heading home for the traditional Chinese New Year.

Strong determination over deleveraging emerged in the latest credit data: incremental Total Social Financing was RMB 3.06 trillion in January, vs. consensus of 3.15 trillion, primarily led by a 91% YoY slump in shadow financing. Strong new corporate loan growth of 15% YoY was mainly due to:

1) large companies which are being forced to turn away from bond issuance and resort to bank loans amid rising corporate bond yields
2) SME & private companies' financing demand being channelled back to bank loans due to tightening on entrusted/trust loans and NSCAs (non-standard credit assets).

The Internet sector continued to shine in China: **Weibo** reported a stronger-than-expected 87% surge in fourth quarter EPS and 77% in sales. It also provided robust revenue growth guidance for the current quarter of 68-73% YoY. **Baidu** beat fourth quarter estimates (sales rose 29% YoY) and gave first quarter revenue guidance of 25-32% YoY. Apart from progress in AI and autonomous driving technology, the upcoming IPO of its video streaming services iQiYi is also a short-term catalyst.

India's headline CPI inflation decelerated marginally to 5.1% YoY in January from 5.2% YoY in December. Food inflation moderated to 4.7% YoY from 5% YoY in December, as food prices declined sequentially and core-core inflation (inflation ex-food, fuel and housing) remained steady at 4.3% YoY in January. Industrial production growth moderated to 7.1% YoY in December but was still above expectations. The NPL cleanup is accelerating: RBI substituted various resolution schemes into a new simplified version which is stricter on implementation, recognition of NPLs, and higher provisioning. Banks will have to take a one-time hit to book value in the near term, but it will improve ROE & profitability in the future. This is a fast-forward step in the right direction and prepares banks for IFRS.

Airports of Thailand had strong profit growth of 27% YoY in the latest quarter and 16% growth in revenue with 20% growth in international passengers.

Brazil's central bank delivered a dovish message in its COPOM minutes, not completely ruling out the probability of further cuts in interest rates (the consensus expects the easing cycle to end in March with interest rates staying at 6.75%).

In **Argentina**, the central bank kept rates unchanged. In **Mexico**, **AMX** reported a good set of results due to stronger EBITDA margins in Mexico and higher revenues from Brazil.

In **South Africa**, President Jacob Zuma resigned and was replaced by Cyril Ramaphosa. We view this as a positive development as it strengthens the reformist agenda.

We remain upbeat on emerging markets.

COMMODITIES

The **Brent crude** price rise from $65 to 70 was overdone and mainly due to traders being at record long levels due to favourable backwardation conditions on futures markets. But the subsequent correction from $70 to $61 in only 6 trading sessions was equally excessive. The move this time was due to fresh risk aversion following worries over US inflation. Prices have now bounced to around $65 which is more in line with fundamentals. After all, the IEA in its latest monthly report shows there has been another fall in crude inventories. After dropping by 55.6 million barrels in December, the biggest monthly contraction since February 2011, and by 156 million for 2017 as whole, OECD inventories are at 2,851 million barrels, or only 52 million barrels above the famous 5-year average which is the stated goal of OPEC and its non-OPEC allies.

So, what now? Is this the end of the OPEC agreement? First, it is important to bear in mind that refineries will be going into the maintenance period in March and that means a seasonal rise in oil stocks and a drop in oil product stocks. At the same time, recent US data show output growing again. The latest Drilling Productivity Report says the last known shale oil production figure is 6.54 million b/d (November 2017) and an estimated 6.75 million b/d for March. At that pace, total US output will probably soon exceed Russian and Saudi production levels. That has led the IEA to raise its forecasts of non-OPEC production in 2018 by 250,000 b/d to 1.4 million b/d. All of which suggests OPEC countries should remain disciplined over production cuts. The good news is that global demand is still buoyant and growth estimates have now been revised higher to 1.59 million b/d. Indian demand, for example, rose by 10% in January.

CORPORATE DEBT

CREDIT

It was another volatile week on credit markets with the Xover index swinging between 260 and 280 by the day, and even by the hour.

Investors focused on US inflation data. We witnessed accelerating selling by credit ETFs but also in retail high-yield funds.

In company news, Macquarie joined forces with 3 Danish pension funds to acquire Denmark's **TDC** (telecoms) for €5.5bn, or 8 times EBITDA. France's **Solocal** suspended trading in its shares for 48 hours before unveiling a new strategic plan involving 1,000 job losses. **Rabobank** posted satisfactory figures with RWA rising as expected from 30% to 35%. **Bombardier** and **Faurecia** beat earnings expectations in 2017. In such a volatile market, there were no new issues.

CONVERTIBLES

Another quarter, another beat: **Ubisoft** was up close to 8% following its Q3 results. The videogame developer reported sales of €725m on strong PRI numbers (up 93% YoY amid ongoing strength in the Tom Clancy franchise). Management also maintained its FY18 and FY19 targets. **Gedeon Richter** published its Q4 results with revenue and EBIT in line with consensus; however, the company disappointed with a lower-than-expected net income number and some uncertainty regarding Esmya (temporarily suspended until May 2018 for an ongoing safety review by EMA). Google's Russian rival, **Yandex**, pleasantly surprised investors with updated 2018 revenue growth guidance of 25%-30% thanks to its Uber JV; the share reacted positively, jumping 7.9%.

In the US, **Neurocrine Biosciences** provided an update regarding its Parkinson's asset, Opicapone, which should see its filing date accelerated as the FDA ruled it does not need an additional US-based Phase 3 clinical trial. In Asia, despite most markets being closed after the Chinese New Year, Filipino real estate developer, **Ayala Land**, report strong 21% growth in net income in 2017, driven mostly by robust operations (property sales grew 13% in 2017 versus only +3% in 2016). In Japan, power producer **Kyushu Electric Power** rallied strongly on the news that it had commenced the process to restart its Genkai Nuclear Power Unit Number 3, with other power producers following suit.

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