MARKET FLASH: PROTECTIONIST FEARS ABATED

September 21, 2018

On the markets

Donald Trump advanced further on his protectionist drive by unveiling a staggered timetable for tariffs on Chinese imports to the US while increasing the amount to $200bn. The targeted goods will be first be taxed at 10%, rising to 25% from 2019. If China retaliates by going for US agriculture, the US President will increase targeted products to $267bn. Markets were reassured when China's riposte was measured and investors chose to refocus on the economy which looks strong enough to absorb most of the dispute's harmful consequences. Protectionist fears abated further when Beijing ruled out a renminbi devaluation. Investors decided that both Donald Trump and the Chinese were for now proving more reasonable than had been feared and sent risk assets higher, especially in emerging countries.

There were also positive signals on Japan's economy. Strong second quarter growth and the government's fiscal policy helped underlying inflation edge higher in August while wages took off for the first time in 20 years. Manufacturing PMI also rose to 52.9 from 52.5 in August, thanks to a rebound in export orders. The stock market made further gains, taking the rise over the last fortnight to 7%.

Note that recent US dollar weakness has helped emerging markets rebound, with the exception of India.

In Europe, all eyes were on Theresa May and the Brexit talks. The Salzburg summit made absolutely no progress on settling the issue but Europe remained united against the UK's prime minister and she was forced to promise new proposals would be made on Northern Ireland's border, the key stumbling block in the talks. A deal is still possible before the European council next meets on October 18 and 19.

Elsewhere, uncertainties over Italy's budget should lift from September 27 when the government is to present its roadmap. The targeted deficit should be less ambitious than initially announced by Giovanni Tria but prime minister Giuseppe Conte said in Salzburg that it should not be over 2% of GDP.

European markets started to rebound on September 10 and have since advanced 4%. Note that the rally has seen value stocks outperform at the expense of quality.

In bonds, sovereign yields have risen due to the probably limited impact of protectionism on the global economy. US 10-year yields hit 3.08%, a level that has only been reached three times since 2011. European government bonds followed suit with the yield on the 10-year Bund up to 0.48%.

EUROPEAN EQUITIES

Sentiment on the global economy, and especially China, picked up over the week. Investors were reassured when Donald Trump's import duties turned out to be 10% and not the expected 25%. China's relatively restrained riposte was more good news.

Cyclicals, and especially those which had fallen the most, staged strong rebounds. Global cyclical gains included base materials with **Eramet** soaring 30% over 5 trading sessions, autos and their suppliers like **Valeo, Faurecia,** and **Plastic Omnium**, and semiconductor stocks like **STM**. Financials joined the party as long bond yields rose and tensions over Italy's budget preparations abated. Oil services remained on an uptrend due to rising oil prices but defensive and growth stocks fell, especially pharma and tech names. The bad news came from specialist distributors **Ceconomy, Zalando** and **Tom Tailer** which issued profit warnings due to weather conditions.

In corporate transformation news, **Volkswagen** said its coach and truck division **Traton** should be ready to list by the end of 2018. **Nestlé** is to sell its **Gerber Life Insurance** affiliate to the unlisted **Western and Southern Financial Group** for $1.55bn. The deal is part of the group's move to refocus on food and mass market healthcare under pressure from the **Third Point** hedge fund. It also said it might dispose of its Skin Health division. **Casino** confirmed that it was mulling the sale or closure of 20 loss-making hypermarkets out of the 110 it runs in France. **Linde** jumped on reports that **CVC** was about to buy its US assets after the merger with **Praxair. Thor Industries** is to buy Germany's **Erwin Hymer**. It rival **Trigano** fell as investors reasoned that current valuations left little room for upside.

US EQUITIES

It was a good week on Wall Street with the S&P gaining 0.9% to another all-time high despite mixed macroeconomic figures. The advance was the result of excessive caution prior to Donald Trump's announcement of fresh customs duties. In the event, investors were relieved that actual implementation was to be less severe than initially feared. The Empire Manufacturing index came in at 19 or lower than the 23 expected and down on the previous month. Housing starts rose by a sequential 9% while existing home sales were flat.

The S&P's new record was accompanied by very strong sector and factor rotation. Tech hardware lost 1.5% while financials led sector gains over the last 5 trading sessions, ending the period 3.3% higher. Stock moves were prompted by US 10-year yields which tightened further to sit securely above 3% and by 2-year yields which hit a 10-year high of 2.8%.

JAPANESE EQUITIES

Despite the US-China trade dispute escalating to a third stage, Japanese stocks made strong gains with the TOPIX ending the period 3.41% higher. Concerns over the dispute receded after Donald Trump announced additional tariffs on $200bn of Chinese imports because the news was considered to be more or less priced in. Higher US bond yields and the weaker yen also encouraged short term investors to buy back oversold names.

All 33 sectors posted positive returns led by insurance. **Dai-Ichi Life Holdings** (+10.40%) and **T&D Holdings** (+9.23%) soared on the back of rising US long terms yields. Low P/E stocks in Financials, Iron & Steel and Oil & Coal Products were also strong and China-related machinery stocks rebounded with **Komatsu** jumping 9.16%.

Tourists visiting Japan rose 4.1% YoY in August, a slowdown due to disastrous wet weather which caused many cancellations. Natural disasters on hotel occupancy rate are expected to continue in September as strong typhoon and quakes hit Japan.

The good news is that land prices of core regional cities rose significantly, especially commercial property districts, due to rapid growth in tourists from abroad, increased spending and more diversification in destinations.

As fully expected, PM Shinzo Abe was re-elected for his third term as LDP leader.

EMERGING MARKETS

In a new round of tit-for-tats, the Trump administration announced another 10% duty on $200bn of Chinese imports, rising to 25% next year. But key consumer electronic products such as smartphones were left out of the list. **China** plans to retaliate by imposing levies on $60bn of American goods while withholding the commitment for a new round of trade negotiations. At the same time, Chinese Prime Minister Li Keqiang said during the summer World Economic Forum that more tax cuts were coming to stimulate domestic consumption and that China would cut costs for trading companies and improve tax rebates for exports. He also pledged prudent monetary policy and said there were no plans to devalue the yuan to boost exports. In Hong Kong, interbank borrowing costs narrowed the gap with U.S. rates, with **HSBC** lifting its short-term rates by 10bp. The move helped the HKD climb 0.63% on Friday versus the US dollar, its largest gain since 2003. **Tencent** continued its share-back program: 1.08 million shares worth more than HFD 342m have been bought back over the last 10 days. **Alibaba** announced during its annual investor conference that it was setting up a new semiconductor firm to develop its own AI inference chips and quantum processor. Apple related smartphone supply chain names such as **AAC** and **Largan** were under pressure as the market estimated that the high price tag on the new iPhone XS/XS Max might weigh on demand.

The 3rd **North/South Korea** summit ended this week: a joint statement was signed with specific denuclearization steps towards a de-facto end to the war on the Korean peninsula. **Samsung Electro-Mechanics** announced a plan to spend more than $500m on a new China plant to expand its MLCC capacity. Samsung Electronics is reportedly to curtail growth in memory chip output next year to keep supplies tight amid an expected slowing in DRAM and NAND demand.

Thailand's deputy prime minister said the government was planning to hold elections on 24 February 2019. This should settle investor nerves on further delays in the election of a democratic government. The country's central bank voted 5-2 to keep the benchmark rate on hold.

In **India**, the Rupee revisited new lows this week before a much-needed rally on Thursday and Friday, helped by a weaker dollar and continued speculation of stronger measures to protect the local currency. The finance minister said that the government was confident it would meet its fiscal deficit target this year and more measures would be in introduced to curb rupee depreciation and the widening current account deficit. **Yes Bank**'s CEO was forced to step down by the central bank earlier than expected over the controversy of bad loan recognition divergence.

With only 16 days left until the first round of **Brazil**'s general elections on 7 October, the rightist candidate Bolsonaro moved ahead in the poll with 28%, although his rejection rate stayed high at 43%. Leftist party candidates PT's Haddad and PDT's Gomes rose in the polls but were still behind. **Argentina**'s primary fiscal deficit was $10.3bn in August, a 58% YoY drop. The accumulated primary deficit was 0.9% of GDP, half of that observed in Aug 2017.

COMMODITIES

The headline news was a fresh wave of customs tariffs between the US and China. The US added $200bn and China $60bn but markets were pleasantly surprised that there was no escalation and that the actual tax percentage was lower than expected. Elsewhere, Beijing unveiled a plan via the NDRC to increase infrastructure spending with a focus on transport. All this helped risk appetite rise a little, pushing the US dollar lower and helping commodities rebound.

In another busy week for oil market news, Saudi Arabia implied that it was happy with Brent crude at above $80 over the short term, causing traders to wonder if the country had the capacity to deal with falling Iranian exports. Saudi output is currently running at 10.35 million b/d while theoretical capacity is 12 million and the record to date is 10.66 million. Russia's output has been increasing at a steadier pace and has just hit 11.3 million b/d, beating the precedent record set in October 2016. Russia's energy minister said production could reach 11.5 million b/d by 2021 or above record Soviet era levels.

Ahead of a weekend OPEC/non-OPEC meeting in Algiers, Donald Trump once again took to Twitter, this time to demand that the OPEC monopoly cut prices immediately. OPEC is a cartel, and thus an oligopoly, but there is no plan to increase production quotas. Meanwhile, US inventories continued lower and are now at a low not seen since September 2015. At Cushing, which determines WTI prices, they are at a 5-year low, a situation that could lead to a sharp rise in petrol prices as we approach the mid-term elections. The only way Donald Trump could offset a price rise would be to add to the 11m barrels from the US strategic oil reserves that are already scheduled for release. He could also reduce anti-Iran sanctions but that particular option does not appear to feature on the agenda.

CORPORATE DEBT

CREDIT

The mood was mixed. Recent developments in Italy had been positive with some progress on the budget preparations and a government deficit target in tune with European standards but US-China trade fears persisted. New tariffs were slapped on $200bn in Chinese imports and $60bn in US imports. But the details were less severe than expected and China is reportedly considering reducing this amount from October.

Construction stocks sharply underperformed over the week. **Astaldi** remained mired in uncertainty over the sale of the Bosphorus bridge and its increase of capital although investors were slightly relieved by the sale of its 59.4% stake in the Mestre hospital. **CMC Di Ravenna** and **Aldesa** posted disappointing results with worsening credit indicators and high leverage.

Nyrstar's bonds fell on a profit warning. The metals company said second-half EBITDA would be significantly lower than in the first half. The group's rating was also downgraded by Moody's from B3 to Caa1.

Casino/Rallye's bonds rose after Rallye secured a €500m line of credit due June 30 2020 from 5 banks to help with short term liquidity. **Teva's** bonds outperformed after the FDA approved its anti-migraine drug. 2019 results should rise as a result.

Danske Bank remained under pressure from allegations that its Estonian affiliate had been involved in money laundering. The enquiry is still in progress and could result in both Danish and US fines.

On an a rather active new issues market, insurance groups **Phoenix** and **Groupama** both raised €500m with euro-denominated Tier 2 debt at 4.375% and 3.375%. **BBVA** sold a €1bn AT1 bond at 5.875%. In high yield, **IGT (Ba2/BB+)** raised $750m over 9 years at 6.25%. **AkzoNobel** (paint and specialty chemicals) raised a total of €1.38bn in two tranches, one in euros at 6.5% and the other in US dollars at 8%. **Refinitiv**, Thomson Reuters's Financial & Risk division, raised €860m and $1.25bn at 4.50% and 6.25%.

CONVERTIBLES

The market mood improved, especially in Europe, and convertible bond indices rose in tandem. European convertibles outperformed their US peers, a trend which started at the beginning of September.

There was only one new issue over the week but it was a US jumbo. Splunk Inc (data recovery/analysis software) issued two convertibles, one for $1.1bn over 5 years at 0.5% and the other for $750m over 7 years at 1.125%. The company has no debt and the proceeds will go on everyday business and future acquisitions.

Elsewhere, there were two important news items in the convertible universe. First, Rallye secured a €500m line of credit with no need to pledge Casino share from 5 banks. The deal will provide visibility on the refinancing of short-term maturities. It also takes a little pressure off the Casino share which rebounded sharply. The Rallye/Casino 2022 exchangeable bond did even better, gaining 20 points. Second, metals company Nyrstar issued a profit warning on second half results. This jeopardises any improvement in cash flow generation just when Moody's has downgraded its credit rating.

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