EDMOND
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MARKET FLASH :
AUTUMN SETS IN

After a relatively stable week, market declines resumed amid persistent concerns over Italy, economic growth sustainability, central bank policy trends and company earnings. As expected, Moody's downgraded Italy over the weekend but stopped short of pushing it into high yield territory and maintained its stable outlook. The European Commission rejected Rome's budget proposals and Italian spreads widened against the German Bund. Investors are now waiting to see how other rating agencies like S&P and Fitch react.

In the US, markets are worried that higher inflation might push the Fed into adopting a more restrictive monetary stance. In its Beige Book, the bank said prices and wages were rising but at a modest to moderate pace. Moreover, uncertainty over protectionism could hit corporate margins. The earnings seasons has fuelled market volatility and companies that fall short of expectations are being savaged. However, more than 80% of US companies have beaten expectations with earnings up by more than 20% on the third quarter of 2017.

These solid figures and robust US growth have led us to reinforce our US equity exposure by buying into weakness. In our bond allocation, we have reinforced inflation-indexed bonds in the US following the strong rise in real interest rates in recent weeks.

EUROPEAN EQUITIES

Markets have turned autumnal and profit warnings have arrived as the leaves fall. In a difficult week, with the third quarter results season in full swing, a number of companies have cut guidance amid thorny Brexit talks, Brussel's rejection of Italy's budget proposals, rising interest rates and fears that the cycle is ending .

Disappointing earnings sometimes triggered falls of up to 20% intraday, a sign of market nervousness. In the tech sector, **STMicroelectronics** warned of soft gross margins and fourth quarter earnings that would fall short of expectations and the stock lost 15% over the week. **Atos** warned of a slowdown in the US and Germany and sank 30%. However, **Nokia**, which posted figures in line and launched a new cost-cutting programme, proved resilient. It was the same story at **Dassault Systèmes**, which reported a better-than-expected 7% rise in licence sales and **Worldline** which saw like-for-like growth rise by a robust 6.3%.

Autos continued to suffer from a slowdown in China and difficulties over new WLTP standards. One week after **Daimler** cut guidance, **Renault** followed suit by reducing its forecasts for the global and Chinese markets. **Peugeot** also reduced its forecasts for the Chinese and Latam markets. Car suppliers like **Plastic Omnium** and **Valeo** also got hammered, falling by 10-15% over the week. **Faurecia** also lost ground but because of its €1.1bn acquisition of Clarion and not its results.

Even defensives came under attack. **AB InBev**'s figures were disappointing across all zones and Finland's **Fortum** (energy) announced lower hydro-electric production.

Among the week's few good surprises, **Kering** continued to enjoy strong growth thanks to Gucci, **IAG** increased earnings thanks to transatlantic traffic and **Altran** posted upbeat like-for-like growth.

In M&A news, **Fiat** sold its spare parts subsidiary Magneti Marelli to **KKR**-owned Calsonic in Japan for €6.2bn.

US EQUITIES

US markets suffered a sharp correction with the S&P down 2.3%, the Nasdaq 1.8% lower and the Russell off 2.8%. The Nasdaq had its biggest intraday tumble since 2011, losing 4% on Wednesday. The down trend was fuelled by a wave of de-risking and volatility was amplified by thin trading. Erratic market reactions to quarterly results - **3M** down 8%, **Ford** up 10%, **Amazon** 7% higher ahead of its results and down 9% just afterwards - showcased market nervousness and the absence of marginal buyers. But Markit's PMI for October was upbeat with the manufacturing index rising from 55.6 to 55.9, or better than expected, and Services also beat, coming in at 54.7. Durable goods orders advanced 0.8% while economists had pencilled in a 1.5% drop.

The current sell-off is different from previous episodes and especially that of February 2018. This time we have mainly observed fundamental selling while systematic investment flows have been relatively discreet. ETF trading volumes have been generally in line with their 32% average whereas market stress periods tend to surge to around 50% at least. Another example highlighting the role of discretionary fund flows is the behaviour of the S&P last Wednesday. The index lost 3% but three defensive sectors managed to end the day higher.

In a busy week for quarterly earnings, **Microsoft**, **Ford**, **Tesla**, **Boeing**, **United Technologies**, **Xilinx** and **Intel** reported good figures while **Union Pacific**, **Texas Instrument**, **3M** and **Caterpillar** missed expectations. Unsurprisingly, defensives topped the weekly performance charts. Consumer staples, property and utilities all posted positive absolute returns while industrials and energy lost 5-7%.

JAPANESE EQUITIES

Following a series of sharp falls on US markets and volatility in Shanghai, Japanese stocks declined across the board. The TOPIX ended the week 5.43% lower on mounting concerns over a slowdown in US earnings and the negative impact of US-China trade frictions.

All sectors posted negative returns, notably Glass & Ceramic Products, Metal Products, Machinery and Pharmaceuticals. **Eisai** and **Ono Pharmaceutical** dived 12.95% and 11.92% respectively and **Komatsu** tumbled 11.30% after **Caterpillar** in the US suffered sharp falls.

On the other hand, domestic demand sectors such as Foods (-2.14%) and Real Estate (-2.77%) proved relatively firm. **Daito Construction** even managed to end the period 0.86% higher.

Following the sell-off, the Nikkei 225 index's average PE fell to 12.72, or close to the bottom of the range since Shinzo Abe's administration took over.

EMERGING MARKETS

The week started with Chinese markets rebounding sharply on news of tax credits to underpin middle-class spending on education, healthcare, housing and elderly care. However, positive sentiment faded as most listed companies sounded a cautious note when announcing their third quarter results.

Real estate outperformed as some banks in **China** have lowered mortgage rates, a possible sign that the government might ease the purchase curb as the economy continues to slow.

In third quarter results, **EDU**'s sales jumped 30% or better than expected but earnings were only 6.7% higher. **TAL**'s revenues soared 54%, beating guidance, while earnings were up 34%. Management continued to guide on growth of 30-32% in US dollars for the next quarter. Both education companies have announced share buyback programmes to take advantage of depressed markets. **O-film**, a Sunny Optical rival listed on the A-share market, paid $28m to buy **Fujifilm**'s handset lens and vehicle lens business, making the competition even harsher for camera lens and module makers amid a slowdown in smartphone growth. **CCB** reported solid results with improved NPL coverage. **Hengrui**'s results beat expectations with sales up 26% and earnings 33% higher.

In **Korea**, **Hynix** announced record quarterly results on strong productivity gains, but it delivered muted guidance as DRAM shortages have been easing due to a seasonal demand slowdown which is expected to run into the first quarter of 2019. **SDI** reported strong results, beating expectations by 8% on strong battery and electronic material sales. Margins continued to expand due to operational leverage. Pre-tax profits more than doubled, thanks to improved equity earnings from **Samsung Display**.

In **India**, the fiscal deficit widened to 3.8% of GDP in September18 (12M trailing). **Asian Paints** reported a lower than expected EBITDA margin due to higher raw material prices with low double-digit volume growth.

In **Russia**, **X5** retail's third quarter sales rose 11% and the EBITDA margin came in at 7.4%, or ahead of consensus thanks to discipline over promotions.

Brazil remained focused on the second round of the presidential elections on October 28. **Localiza** reported a good set of numbers with revenues up 32% and EBITDA 27% higher. **CBD** (supermarkets) also reported numbers above the consensus, despite weak **Via Varejo** figures. Ebitda grew by 24% and margins expanded by 30bp. Same store sales accelerated from 4% in the second quarter to 6.4%. **Vale** reported upbeat results with 10% free cash flow.

Argentina's lower house approved the zero primary fiscal budget, a move that strikes us as another step into the right direction.

COMMODITIES

Risk aversion has been spreading on markets since October 9 due to bond market tensions, political risk in Italy and concerns over a trade war. **Oil** markets have not been immune. The MSCI World Net USD index is down 6% but Brent crude and WTI have fallen 10% in US dollars.

Yet the fundamentals have not changed significantly. Venezuela is less in the news but its oil output has lost 440,000 b/d year to date and 710,000 b/d over a year. It is currently at 1.26 million b/d and could stabilise at 1 million in 2019. Iran's exports have started to fall and were at 1.6 million b/d in September compared to a first half average of 2.2 million. And now two Chinese state companies, **Sinopec** and **CNPC**, say they have not ordered any crude from Iran for November because of fears their businesses might be hit by US sanctions. China, the foremost importer of Iranian crude, imported 640,000 b/d on average in the first half of 2018 and had previously not reduced imports during the Obama sanctions. China's oil demand hit a new record of 12.77 million b/d in September (+440,000 b/d over a year and + 1 million over a month), a figure which probably includes some stock-piling.

These supply side tensions and the wish to avert a price surge led Saudi Arabia at the beginning of the week to say that OPEC countries were producing as much as they could. The price fall than picked up speed amid fears of over-production and worries over a global economic slowdown. US inventories have risen in the last 5 weeks and only exacerbated worries although the rise is in part due to catching up after recent hurricanes interrupted imports and the end of the refinery maintenance period. As proof that Saudi Arabia does not want to see prices falling too much, Riyadh said OPEC could always trim production to offset economic uncertainties and rising global inventories.

Europe's **Total**, **Equinor** and **ENI** reported surprisingly good figures with cash flow reaching levels not seen since 2012 when the barrel was trading above $120. Investment discipline has also been maintained and Total and Equinor have trimmed their capex objectives for 2018.

CORPORATE DEBT

CREDIT

Sentiment was somewhat positive at the start of the week as Moody's cut Italy by one notch to Baa3 but maintained its outlook at stable. But spreads rapidly came under pressure when Brussels rejected Rome's budget proposals and asked it to present another draft. Markets were also swayed by persistent Brexit tensions and uncertainty over US growth prospects due to trade frictions and rising interest rates. Against this backdrop, the Xover widened by 6bp between Monday and Thursday. The ECB stuck to its accommodating stance but it had little impact on spreads.

Rallye and **Casino** bonds started the week on the front foot. Rallye's fully-owned Go Sport subsidiary started exclusive talks with Equistone Partners Europe to sell Courir for €283m. The deal could complete in the first quarter of 2019. Spanish food retailer **Dia** (Ba2/BB-) remained under pressure after restating its accounts to the tune of €56m. Press reports claimed three executives had been sacked.

Peugeot's bonds performed well after the group posted a reassuring 7.8% rise in sales and confirmed its objectives. Pharma testing company **Eurofins** (BB+) saw third quarter sales rise 30.6% with like-for-life growth of more than 5%. Oil and gas contractor **Saipem** (Ba1 /BB+) reported an 11.9% drop in sales over a year but with higher margins. **Valeo**, **Ardagh** and **Superior Industries** all issued profit warnings for 2018. In financials, **Deutsche Bank** reported better-than-expected net profits on a lower-than-expected cost of risk but revenues fell 9% over a year.

French transport group **CMA CGM** (B) launched a CHF 30 a share bid on **Ceva Logistics** in which it already owns 37.56%. The group also unveiled a "reinforced industrial project" for the two companies.

In new issues, **Netflix** raised €1.1bn at 4.625% and $800m at 6.375% over 11 years.

CONVERTIBLES

Risk-off sentiment prevailed in very volatile trading. The Nasdaq, for example, plunged 4.43% on the Wednesday and bounced 2.95% the day after. As for earnings, 230 US companies have reported with more than 80% beating expectations. The tally in Europe is lower, "only" 48% in good surprises for 173 Stoxx 600 Europe companies.

In Europe, **Safran** and **MTU Aero Engines** reported excellent results and upped guidance. **Covestro** also beat expectations but partly due to exceptional items. As a result, and in spite of a cost-cutting programme, the group's ambitions for 2019 are now uncertain due to falling MDI prices. **Valeo**'s results were mixed due to current conditions in the autos sector but essentially because of a less buoyant Chinese market.

In the US, **Illumina** reported a good set of figures but the stock was hit by profit taking after its strong year-to-date run. And following a particularly agitated quarter which had put the group on investor watch, **Tesla** posted a profit for the first time since its listing. **Amazon** and **Alphabet** reported disappointing sales but **Intel** and **Microsoft** both beat expectations.

In Asia, **CyberAgent** (Advertising & Marketing) fell sharply after significantly missing earnings and sales expectations.

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