EDMOND DE ROTHSCHILD

MARKET FLASH : ITALY UNDER PRESSURE

The week started in wait-and-see mode ahead of the Fed meeting. European investors were also cautious in the run-up to Italy's budget announcement. Mario Draghi had previously surprised markets by saying in an address to the European parliament that inflation had seen a relatively vigorous rebound. He expects it to run at 1.7% on average up to 2020. The euro and interest rates gained ground after he spoke.

As expected, the Fed raised its benchmark rate by 25bp to 2.25%. Since December 2015, it has increased by 2% and it is now above core PCE inflation, the Fed's preferred measure. As a result, its communique no longer referred to monetary policy as "accommodating". Given the strong US economy and the low risk of recession, rate rises will continue to be gradual. Second quarter GDP growth was confirmed at an annualised 4.2% and consumer confidence is at record highs not seen since 1999-2000. Bond markets had probably discounted this rate hike and yields actually softened after the FOMC. But the US dollar rose, notably against the euro.

The euro's weakness was accentuated by the Italian situation where the Liga and the 5 Star Movement finally reached an agreement on setting the targeted budget deficit at 2.4%. This was higher than the target demanded by finance minister Giovanni Tria but he chose not to resign. It was also more than expected by investors. The decision goes against the deficit trajectory that the EU wanted Italy to adopt. In coming weeks, the budget proposal will go before Italy's parliament while talks take place with Brussels. The market reaction was strong but remained relatively concentrated on Italian bonds and equities. For Europe as a whole, bank stocks fell the most. German yields retreated but the move towards refuge assets was relatively restricted.

EUROPEAN EQUITIES

While the EU-UK talks continued to drag out because of the Irish border issue, investors turned their attention to Italy ahead of the publication of its 2019 budget. The finance minister wanted the deficit to comply with commitments to the EU by being set at 1.6% but was disavowed. In the end, it was fixed at 2.4% with the same level for 2020 and 2021. Italy's long bond yields widened by 20bp on the news and the FTSE MIB index underperformed the European index by 2% over the week. Elsewhere, a crop of IPOs has been scheduled for the coming weeks.

Little earnings news this week but **BMW**'s profit warning came as a surprise as the group had reiterated its 2018 guidance when it released its first half results. Now it has slashed its operating margin forecast for the full year from 8-10% to less than 7%. It is also expecting earnings to fall. Management highlighted the negative impact of new European vehicle emission standards (WLTP) which came into force on September 1st and triggered massive destocking along with price cuts for models which would have failed to meet the new demanding standards. It also cited trade disputes, notably higher customs tariffs in China.

Germany's **ThyssenKrupp** conglomerate is considering splitting into 2 distinct groups, ThyssenKrupp Industrials (lifts, automotive components and construction) and ThyssenKrupp Materials (materials trading, a 50 % stake in the future joint venture with **Tata Steel Europe**, steel-related processing operations and marine services).

US EQUITIES

The S&P 500 edged lower over the last 5 trading sessions as US-China trade tensions escalated again on the implementation of new import tariffs on $200bn and $60bn worth of goods. Industrials with exposure to international trade naturally lost ground and trade worries also weighed on other industrials and commodity prices.

Energy, however, gained 2% after the OPEC summit failed to reach a consensus on holding back price rises.

As expected, the Fed raised its benchmark rate by 25bp to at 2/2.25%. Fed chair Jerome Powell confirmed that rates would only rise gradually so as to maintain a balance between the economic recovery and any risk of overheating.

The new communications sector, which now includes telecoms as well as **Netflix**, **Google** and **Disney** led gains with a 2.5% rise while financials and commodity stocks ended the period 4% lower.

JAPANESE EQUITIES

After 8 consecutive gains, Japanese stocks prices fell back slightly on Thursday as domestic corporate investors adjusted positions ahead of the end of the first half of fiscal year 2018. Market sentiment remained upbeat, but market participants were cautious over the aggressive US stance on trade policy concerning Japan. The TOPIX edged down 0.22% for the week.

US President Donald Trump and Japanese PM Shinzo Abe had a summit meeting over the trade talks and agreed to go for a bilateral 'Trade Agreement on goods (TAG)' rather than a multilateral TPP. They also agreed that the US should not impose additional tariffs on Japanese made cars during the talks. This means that Japan has managed to avoid the worst 25% tariff scenario for the moment. The main topic at the talks will concern opening up the market further for US beef and other agricultural products.

By sector, Pharmaceuticals, Precision Instruments and Chemicals outperformed, notably **Eisai** (+5.36%), **Ono Pharmaceutical** (+3.95%) and **Takeda Pharmaceutical** (+3.95%). **Shiseido** (+6.45%) and **Kao** (+4.36) also advanced.

On the other hand, the market was nervous over auto stocks ahead of the US-Japan summit. **Suzuki** fell 6.67% and **Nissan** lost 4.70% but **Toyota** was relatively firm, edging up 0.11%.

EMERGING MARKETS

China cancelled trade talks with the US saying a resumption of trade negotiation required more American sincerity. Another round of import tariff cuts was announced, targeting industrial products, in an effort to incentivize companies to step up capex and upgrade facilities. Industrial profit growth slowed further to 9.2% in August from 16.2% in July.

Property developers were under pressure as Guangdong province plans to phase out pre-sales for residential property. **Tencent** continued its share buyback which is now heading for 15 consecutive days. **Brilliance** was weak after BMW revised down full-year guidance due to trade tensions. On the positive side, index providers are casting a vote of confidence in mainland Chinese stocks: the FTSE Russell will start to include China A-shares in its index with a target weight of 5.5% of the EM index by 2020, while MSCI proposed to increase the A-share weight in MSCI EM index to 3.4% by May 2020, up from 0.7% currently. Although the PBoC did not follow the Fed's 25bp hike, Hong Kong commercial banks raised prime lending rates for the first time in 12 years as HKMA followed the move.

Central banks in **Indonesia** and in the **Philippines** delivered rate hikes of 25bp and 50bp respectively while maintaining a hawkish stance. In **Thailand**, the current account surplus narrowed to $0.8bn in August from 1.1bn in July, owing to a strong improvement in imports.

In **India**, the fiscal deficit continued to widen in August to 3.7% of GDP due to weaker receipts. The INR hit new lows despite hikes in customs duties, quasi liquidity infusion for banks and open market operations from the government. Payment default by **IL&FS** backed by systematic important financial institutions has raised serious concerns among investors on the credit conditions of non-bank financials. **Yes Bank** touched its lowest level since May 2016 after seeking to extend its CEO's tenure while denying that it had window dressed corporate accounts to conceal NPLs.

The current account deficit in **Brazil** shrank to $0.7bn in August versus 4.4bn in July. Foreign Direct Investment was also better than expected at $10.6bn. Support for Jair Bolsonaro, the presidential front-runner, stalled in the latest opinion poll, indicating a high rejection rate that might prevent him from winning the election. Luis Caputo, **Argentina**'s central bank governor, resigned this week. The IMF finally expanded the much-needed bail-out to $57bn for the country with conditions such as tighter policy, budget savings and a freeze in the money supply. A "No Intervention" zone for the Peso was also introduced to preserve foreign reserves.

COMMODITIES

Brent crude broke above the psychologically important level of $80 after failing to do so in May and June. Back then, OPEC had decided to increase output through better compliance with quotas, a move that de facto limited oil price rises. This time, the joint OPEC/non-OPEC ministerial committee (JMMC) did not recommend increasing production to above quota levels. Note that quota compliance in August was 129% so there is a little wiggle room since Venezuela's output is still declining and Iranian exports started falling even before sanctions kicked in. India says it does not plan on buying any Iranian crude in November and Japan and South Korea have already halted imports. The US energy secretary sees no reason to sell some of the country's strategic reserves on the market as he feels it would only have a limited impact and for a short time.

All in all, the situation is not likely to worry the Saudi oil minister who says markets have enough supply and that his country has the necessary reserves to increase supply if necessary. Saudi Arabia took the same view in the second quarter of 2008 when oil jumped from $100 to 147 in only 3 months. Riyadh said it was all the fault of traders speculating. The neutral zone between Kuwait and Saudi Arabia might be a solution for balancing out markets. Its capacity is 500-600,000 b/d but its two main fields stopped production in October 2014 and May 2015, officially for environmental reasons but more probably because of tension between the two countries.

Restarting drilling has been mooted several times but recent price rises make it all the more probable. Even so, oil prices are likely to continue higher over the short term as supply is perceived to be strained and demand has so far not been dented by higher prices.

CORPORATE DEBT

CREDIT

The Fed's rate hike was factored in and had no real impact on spreads.

Bonds issued by **Thomas Cook** (B1/B+) fell on a profit warning. The summer heatwave forced the group to cut prices and management is now expecting operating profits to fall by 13% in the 2017/18 financial year. Construction group **Astaldi** cannot proceed with its increase of capital as it has not yet sold the Bosphorus bridge. As a result, it has asked a court in Rome for protection from its creditors while it restructures its debt.

Textile company **Takko** (B2/B) reported a disappointing 7.8% fall in sales and a 25.9% decline in EBITDA partly due to adverse weather. Holland's discount retail chain **Hema** (B/B-) also disappointed the market with a 21.9% fall in second quarter EBITDA. **BUT** (B2/B) saw sales rise by a satisfying 1.8% but adjusted EBITDA was minus €1m or as expected despite a slowdown in new housing.

Casino (Ba1/BB) said it had been approached by **Carrefour** (Baa1/BBB+) with a merger proposal but had not taken it up. Carrefour, however, denied the rumour.

In new issues, US natural gas group **Chesapeake Energy** raised $1.25bn over 6 and 8 years at 7% and 7.5%. Eurotunnel's parent company **Getlink** (BB/BB+) raised €550m over 5 years at 3.625%. Italian cork company **Guala Closures** (B1/B+) raised €455m with a floating rate 6-year maturity. **Société Générale** raised $1.25bn with an AT1 at 7.375%.

CONVERTIBLES

The FOMC meeting crystallized attention and trading was very thin. The Stoxx Europe 600 slightly outperformed the S&P500, and the €/$ stepped back from 1.178 to around 1.16 after the FOMC meeting and ECB statements. The move came with some yield curve flattening which cancelled out some of the recent gains made by financials.

In Australia, **Xero Investments Limited** (software for online accounting systems) raised $300m over 5 years at 2.375% to finance the potential repayment of existing term debt, acquisitions and investments in complementary businesses.

On the secondary market the **Folli Follie** saga is close to its end. **FF-Group**, a Greek-listed jewellery chain, said huge 2017 sales in China were fake and that Asia sales for the year will be revised down by $1bn, or about 90 per cent. **Tesla** CEO Elon Musk Is being sued by the Securities and Exchange Commission which has charged him with misleading investors. And **Nyrstar** repurchased €10m of its Senior Notes due 2019; the group was also downgraded to CCC+ by S&P.

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