MARKET FLASH

September 30, 2016

On the markets

Financial markets moved erratically mainly because of uncertainties surrounding Deutsche Bank which is facing a fine imposed by the US Department of Justice. The event hit European bank shares hardest, dragging them down by around 8% over the month and weighing on Europe's main indices.

Elsewhere, OPEC surprised everyone by finding an agreement to trim production at its informal meeting in Algiers. This gives us a little more visibility on oil price trends and we expect oil to continue trading between USD 40 and 50 in coming months. The agreement is good for all risk assets as excessively low oil prices increased the risk of bankruptcies in the sector.

Macroeconomic data was largely upbeat this week, especially in the US, where the Conference Board's household consumer index hit a 10-year high, and in Germany where the IFO business survey rebounded in September to a 2-year high. There is still considerable political uncertainty in the US: despite Hillary Clinton's success in the first of the Presidential TV debates against Donald Trump, the contenders are still neck and neck in the opinion polls. In Italy, the date for the referendum on constitutional change has been fixed for December 4. The vote could have an impact on investors' perception of political risk in both Italy and Europe, especially as the opinion polls are still indecisive.

We are fully aware that Deutsche Bank's future as well as looming political events could risk exacerbating market volatility but we also note that uncertainties over central bank behaviour, whether the US Fed, the ECB or the Bank of Japan, have been waning and should continue to do so. And today's economic environment is a little healthier than we expected. This has led us to accentuate our slight equity overweight by buying Japanese and emerging market equities. The eurozone remains our main overweight.

EUROPEAN EQUITIES

Markets were choppy over the week. OPEC's surprise agreement on production helped oil stabilise around USD 49 and galvanised markets for a short period. The news meant that stocks in the energy, base products and utilities sectors managed to post positive returns over the week. In contrast, the potentially huge (USD 14bn) fine imposed by the US department of Justice on **Deutsche Bank** for alleged mis-selling of mortgages put markets on edge, especially after reports that some well-known hedge funds had cut exposure to the bank's clearing services. This surge in risk aversion hit the entire financial sector.

In company results, **Capita Group** (UK, business services) issued a profit warning on its full-year 2016 figures. The company now expects like-for-like growth of 1% (rather than 4%) due to a slowdown in its businesses. 90% of its activity is in the UK. In contrast, **Smiths Group** is expected to raise its outlook after beating consensus expectations for the second half ending July 31. Both sales and margins beat estimates, with particularly strong performance in its medical and detection divisions. Only its oil and gas business continued to suffer. The news was less good at **Wolseley** which said sales had slowed across its business spectrum. The group is to conduct a strategic review of its activities and postpone its share buyback programme. At the Paris auto show, **Renault** unveiled a multi-year agreement with **Microsoft** on connected cars. The CFO also delivered a trading update which showed sales had risen by a robust 14.3% in July-August compared to +4.6% for the sector as a whole. **Iliad** said it had concluded an agreement to distribute CanalSat progammes to its Freebox customer base.

Elsewhere, **Telefonica** is considering listing 30% of its mobile subsidiary O2. And in M&A news, specialty chemicals company **Lanxess** has paid USD 2.1bn to acquire its US rival **Chemtra**. The price tag represents a reasonable 10 times the target's EV/EBITDA ratio and funding the deal will not require a rights issue.

US EQUITIES

US equities edged lower in the absence of any major news on the economy. The first debate between presidential contenders Hillary Clinton and Donald Trump resulted in a relative victory for the former according to opinion polls. Both candidates performed cautiously. Meanwhile, the consumer confidence indicator hit its highest level since mid-2007 as expectations improved. New home sales in August hit 609,000 units, down from the 659,000 in the previous month but higher than the 600,000 expected.

In company news, M&A rumours resurfaced in the semiconductors sector with a possible bid from **Qualcomm** on **NXP**. Both stocks surged on the rumour. **Nike**'s quarterly figures were robust but the stock slipped back as investors judged the company's guidance rather timid.

Over the last 5 trading sessions, energy and materials led advances due to news on production quotas. Utilities and energy gave up the most ground.

JAPANESE EQUITIES

Japan's stock markets gained in the middle of the week as the oil price rallied on OPEC's surprising agreement to trim output and Hillary Clinton's performance in the first US presidential debate. Even so, the TOPIX index ended the week 0.7% lower as banks retreated due to growing concerns over systemic risk from German banks. Japan's Insurance and Bank sectors sank 7.2% and 6.6% respectively. **T&D Holdings** and **Dai-ichi Life Insurance** lost 12.6% and 10.4% respectively due to European bank worries as well as expectations that earnings estimates might be revised lower on any move to increase interest rates.

Stocks in the natural resources sectors posted positive performance, especially Mining which jumped 6.2%. Iron & Steel and Oil & Coal Products sectors also rose over 2%. The top gainer this week was **Sumitomo Metal Mining** which soared by 8.2%.

EMERGING MARKETS

Indonesia's central bank cut its benchmark rate by 25bp. There were further signs that **a Chinese recovery** was underway. Industrial earnings rose by an annualised 19.5% in August, sending them into positive territory year to date with a 1.5% gain. **India** saw volatile trading due to tensions over the border with Pakistan.

As expected, **Mexico**'s economic activity index rose by an annualised 1.3% in July. Inflation in **Brazil** fell to 8.97% in August, down from 10.7% last January. This could help the central bank ease its monetary policy in coming months, thereby reducing the impact of financial charges on the country's highly geared companies.

All this good news reinforces our positive stance on emerging markets.

COMMODITIES

To everyone's surprise, OPEC's informal meeting in Algiers resulted in the cartel reaching an agreement in principle to limit output to 32.5/33 million b/d compared to 33.24/33.47 million at the end of August (depending on which figures are used, respectively those provided by OPEC and the IEA). **Oil** prices jumped 5% on the news. The agreement would mean a minimal cut of 0.24/0.74 million b/d on today's 33.24 million or enough to rebalance the global market in the first half of 2017.

This is good news for market sentiment but raises more questions than it answers. For example, does this preliminary agreement undermine Saudi Arabia's efforts over the last 2 years to allow the market to decide on price levels? It is too early to say for sure. Moreover, the agreement does not specify how this production cut would be shared out among OPEC members. And yet Iran is, for the time being, still keen to raise output to more than 4 million b/d compared to current levels of 3.6 million (and 4.2 million before sanctions were imposed). And recent progress in Libya and Nigeria suggests that both countries could also ramp up output to return to previous levels. These questions will almost certainly be answered at the November 30 OPEC meeting unless the agreement is nipped in the bud in the meantime. Iraq, for example, said after the meeting that OPEC had underestimated its potential output. And the agreement makes no mention of Russia's position and yet Moscow has just announced record output of 11.1 million b/d.

All of this means we are still cautious on the future of the agreement although we believe oil prices will benefit from support at USD 45 a barrel up to November while remaining volatile.

After a series of audits, the Philippines Department of the Environment and Natural Resources has recommended that 20 mines, including 18 nickel sites, should be shut down for non-compliance with human rights and environmental standards. This represents half of the country's capacity and 8-9% of global production and would trigger a market deficit.

Elsewhere, central banks were very active buyers of **gold** in August and snapped up a further 27 tonnes according to the IMF. Russia was the biggest buyer, acquiring 20 tonnes followed by China (5 tonnes).

CORPORATE DEBT

CREDIT

Credit markets eyed Deustche Bank's woes after reports that some of its derivatives-clearing clients had reduced exposure to the bank. Spreads widened sharply on the bank's debt, especially its subordinated bonds. The contagion spread to all financial debt. But spreads did not widen as much in other sectors and the week ended with the Main index stable at 73bp and the Xover at 333bp.

OPEC's agreement on plans to reduce output took the market by surprise and caused a surge in oil prices while lending support to credit markets.

The investment grade new issues market remained underpinned by the ECB's stance. **Total** issued 2 hybrid bonds, **Blackstone** sold a 10-year maturity, **Amadeus** a 4-year bond and **Veolia Environnement** a 7-year and a 12-year bond.

The high yield market was relatively buoyant and saw active issuance. New companies made their debuts: Belgium's **Sarens** ,a medium-sized crane operator, **Schoeller Allibert**, a German plastic packaging company and **DEA Finance**, a German oil company owned by LetterOne. **Air France** also announced it would be issuing a 6-year maturity.

CONVERTIBLES

The market's positive mood after the news from OPEC's meeting in Algiers quickly turned bearish on Friday morning as volatility surged (V2X at 23.5) on the back of Deutsche Bank's woes.

The primary market remained active with five new convertible bond deals over the week. **Crédit Agricole** raised EUR 300m with bonds at a negative yield that are exchangeable into shares of French private equity company **Eurazeo**. The French bank also bought back its existing exchangeable. Spanish IT company **Indra Sistemas** issued a EUR 250m 1.25% convertible bond and simultaneously tendered for EUR 100m of its existing 2018 convertible. Swedish pharmaceuticals company, **Recipharm**, issued a SEK 1bn 2.75% convertible bond and Norway's **Ship Finance** announced a new USD 200m convertible and a buyback of part of its outstanding 2018 bond. In the US, distressed shale gas producer **Chesapeake Energy** issued a USD 1.1bn 10-year convertible to repay existing debt.

In secondary market news, the semiconductor sector was very strong due to speculation that **Qualcomm** intended to bid for its rival **NXP** Semi; the ratchet in the 2019 convertible would be worth 8 points in the event of a takeover offer on NXP at a 30% premium. **Steinhoff** raised EUR 2.44bn EUR by placing new and existing shares to fund its acquisition of **Mattresses Firm** and **Poundland**. In China, property development company **Hsin Chong** came under pressure and slumped 35% on the week after Anonymous Analytics rated the stock a strong sell. The movement cited concerns that the current chairman was using the company to offload personal losses on development projects, thereby boosting the company's debt levels and interest burden.

DISCLAIMER

This document is non-binding and its content is exclusively for information purpose.

The data, comments and analysis in this document reflect the opinion of Edmond de Rothschild Asset Management (France) and its affiliates with respect to the markets, their trends, regulation and tax issues, on the basis of its own expertise, economic analysis and information currently known to it. However, they shall not under any circumstances be construed as comprising any sort of undertaking or guarantee whatsoever on the part of Edmond de Rothschild Asset Management (France).

Any investment involves specific risks. Main investment risks: Main investment risks: risk from investing in emerging countries, capital loss risk, risk from holding convertible bonds, equity risk, interest rate risk, credit risk and sector risk.

All potential investors must take prior measures and specialist advice in order to analyse the risks and establish his or her own opinion independent of Edmond de Rothschild Asset Management (France) in order to determine the relevance of such an investment to his or her own financial situation.

Past performance is not a reliable indicator of future results. Past performance does not include reinvested dividends.

Special warning for Belgium: Please note that this communication is intended for institutional or professional investors only, as mentioned in the Belgian Law of July 20th, 2004 on certain forms of collective management of investment portfolios This notice is also intended only for investors who are not consumers as described in the Belgian Law of July 14th, 1991 on trade practices and information and protection of consumers.

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (France)
47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08
Société anonyme governed by an executive board and a supervisory board with capital of 11,033,769 euros
AMF Registration number GP 04000015 - 332.652.536 R.C.S. Paris –
Tél: +33 (0)1 40 17 25 25 - Fax: +33 (0)1 40 17 24 42
www.edram.fr