ANALYSIS & STRATEGY

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THE POLITICAL RISKS HAVE RECEDED SOMEWHAT...

February was relatively calm, enabling the rebound observed in January to continue, with the equity markets on the rise, government bond yields slightly higher and the credit markets showing a marked improvement.

In the United States, Q4 GDP growth surprised to the upside at 2.6% qoq, despite the sharpest drop in retail sales in a decade (-1.2% in December). The indicators are now pointing to a modest recovery in Q1, on the back of robust industrial output numbers and a rise in the services PMI.

Figures also edged up in the eurozone, with the services and composite PMIs at 52.8 and 51.9 respectively. Are we starting to see the reversal of the downtrend in place over the last year? It is too soon to draw any conclusions, but it looks like the European economy has moved beyond the bottom of the cycle, thanks in part to the range of budget stimuli implemented in the different countries.

China's economic data has not seen a rebound, but nor has it deteriorated. The various stimulus plans announced by the Chinese government are starting to bear fruit (rise in new loans), but the full effects should take a little while to emerge.

Reassured by the slightly rosier macroeconomic picture, the markets also welcomed the progress made on some of the current political issues.

For example, President Trump has announced that he would delay the proposed tariff hike, but without giving any more information on the postponement. Significant efforts "appear" to have been made on technology transfer and intellectual property protection. Is this real or fake news? The markets have decided that the progress is real, and are now expecting a positive outcome to the negotiations, with the various tariffs imposed being lifted.

The situation in the UK also became slightly clearer with Theresa May's announcement of a vote on her deal on 12 March, to be followed - if this fails to get through the UK parliament - by a second vote on "no deal" on 13 March. If this also fails, it will be followed by a third vote on extending Article 50. As there is very little chance of the May deal or "no deal" being approved, an extension to Article 50 seems to be the most likely option. The extension would, however, have to be for a fairly limited period.

Lastly, and although this is currently having less of an impact on the financial markets, the political situation in Italy seems to be turning in favour of the League, after the results of elections in Sardinia which saw the Five Star Movement lose a lot of ground. This victory for the right followed a similar reversal for 5SM two weeks ago in Abruzzo. The League now seems to be well placed to form a government, if the current administration falls in the coming months. This would very likely be good news for Italian assets.

In this environment, we are maintaining our preference for the emerging markets, although we have taken profits on Chinese assets as these have done extremely well since the start of the year. We also continue to be positive on Spain and Portugal, and on subordinated financials. European inflation expectations also seem to still be too low in our view, given the recent oil price movements.

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FIXED INCOME

FIRST NON-CALL FOR AN AT1 BOND

In the end, Santander decided not to call its AT1 bond issued in euro in 2014 on the first call date, which was a first for the asset class.

This was probably a lack of foresight from the Spanish bank: it did not refinance its 2019 AT1 debt early, unlike most other banks. As a result, Santander had probably been unable to obtain regulatory approval before the redemption, which is required before each call in order to ensure the issuer has sufficient capital and that the refinancing costs are at least equal to the cost of the existing debt.

1st ever
non-call

However, this non-call was widely anticipated by the market through spread widening in 2018 (making the call less attractive) and following statements made previously by the finance director. The impact was therefore negligible, both on the non-called Santander bond (-1% after the announcement, then +0.5% in the following days) and on the AT1 market, which rose by 0.2%.

What are the likely consequences of this first ever non-call?

The Santander bond in question, which was issued in 2014, is callable every three months, with the next call date being 13/03/2019. Although the bank is not allowed to state its intention to exercise the call from a regulatory standpoint, we expect it to proceed at this next opportunity, as the bond appears undervalued to us, yielding 12.10% (annualised call rate) and 6.7% (perpetual maturity), with Santander having rushed to issue a new bond in early February.

It should not be assumed that other banks will roll over their AT1 subordinated debt, and we recommend investing on a case-by-case basis, particularly on short calls, although we consider this to carry a moderate risk. It is worth keeping a close eye on UK banks with bonds maturing in the second half of 2019, given the extreme uncertainty over Brexit…unless an agreement can be reached before then.

All in all, this event does not seem to have had a significant impact on the subordinated bank debt market, which has continued to show strong growth since the start of the year, helped by banks' solid fundamentals, the accommodative stance of the central banks and the easing of some of the political risks at play.

Santander 6 1/4 perpetual

EQUITY MARKETS

AUTOMOTIVE SECTOR: TRANSITION AND PERFORMANCE

February 2019 was another positive month for global equities. So far this year, the main indices are up by around 11-12%, with rises across the board almost wiping out the correction that took hold at the end of 2018. And although investors were actively underexposed to equities in the end-2018 downturn, this is still the case. We can also say that the fever pitch reached in December 2018 in terms of the political risks threatening economic activity and global trade is now behind us. The possibility of gaining some time (Brexit and US-China trade negotiations) and the more accommodative central banks are bolstering the markets. The issue now is whether there is a risk of underexposed investors being encouraged to return to the market because of its positive performance.

In our view, this risk is low: the easing of geopolitical tensions has already been factored in by the market; the 2018 results season has confirmed the deterioration in growth expectations and has yet to be incorporated into the consensus; and lastly, the macroeconomic conditions are unlikely to improve before the start of the third quarter.

After a record high reached in early 2018, followed by a 25% drop, it is worth looking at the case of the automotive sector as a general illustration of how the markets are performing.

30%
reduction required in CO_2 emissions by 2030

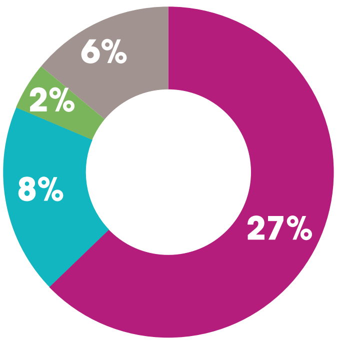
An alignment of the planets drove the sector until the start of 2018. From a low point at the start of 2009, the automotive sector has enjoyed growth of close to 12% per year, supported by improving profitability thanks to favourable lending conditions, falling costs, underinvestment and positive currency effects favouring European manufacturers. The improvement in lending conditions on the back of the accommodative monetary policies of the central banks boosted the automotive industry's pricing power by 2-3%. This effect, coupled with low inflation, enabled the automotive sector to expand its profitability to record levels.

The turning point came in 2018, with one of the sharpest falls since the financial crisis: -20%. The performance of European vehicle manufacturers was hit both by the threat of a trade war (risk of a tariff hike of between 2.5% and 25% on European exports to the USA, with the potential impact on German manufacturers' earnings estimated at €1.7-2.5 billion), and by the introduction of the new WLTP emissions tests. The new regulations impose a CO_2 emissions target of 95 g/km in 2021, and then 75 g/km in 2025/30, and carry a fine for non-compliance of €95 per additional gram of CO_2. Meanwhile, a combination of factors is weighing on the automotive industry: the slowdown in China, shrinking margins and cash flow (which in some cases will no longer cover dividends), and the biggest challenge of all, the structural transition to electric vehicles.

Since the bottom reached in early 2019, the European automotive sector has fully participated in the market rebound, outperforming the global index by almost 3%. Attractive valuations and, in general, above-consensus 2018 results have supported the recovery, although the announcements were accompanied by some rather nuanced comments. Sector firms are anticipating an uncertain and volatile environment in 2019. As such, the strong pricing power of the top-end manufacturers makes them better placed than mass market players, whose financing margins have already begun to decline, suggesting that they will be less able to move on prices. A highly selective approach will therefore be essential given the structural challenges, the partnerships announced for electric vehicles and possible sector consolidation.

THE REBOUND CONTINUES

The apparent progress in the US-China trade negotiations boosted risky assets over the month. President Trump announced that he would not proceed with the 10-25% tariff hike on $200 billion of Chinese imports on 1 March. At the same time, the Republicans and Democrats reached an agreement in principle on financing the federal budget.
The appetite for risky assets was further fuelled by the accommodative tone of the central bankers. The Fed reiterated that it would pause its monetary tightening and take a more flexible approach to managing the size of its balance sheet.
In terms of equity markets, the S&P 500 rose 2.97% (in USD), the Stoxx 600 put on 3.94%, the CAC 40 climbed by 4.96%, and the MSCI Emerging Markets (EUR) edged up 1%.
On the government bond markets, the 10-year Bund tightened by 3 bp to 0.18% after bottoming out at 0.08%. In the United States, the 10-year Treasury yield went up by 9 bp over the month, to 2.72%, on a better-than-expected Q4 2018 GDP performance: 2.6% annualised, after 3.4% in Q3 2018. Full-year GDP growth was 2.9% in 2018, after 2.2% in 2017.
In the European **periphery,** Italy's 10-year yield tightened to 2.75%, in light of the political uncertainty and direction of the economic data. The risk of early elections has substantially increased, along with the tensions between the government's two leaders (Luigi di Maio and Matteo Salvini). Moreover, Fitch affirmed Italy's BBB rating with a negative outlook.
On the oil market, benchmark WTI and Brent barrel prices went up by more than 6% over the month to $56.06 and $65.41 respectively.
On the credit side, yield spreads between investment grade and high yield indices tightened during the period, by 13 bp and 52 bp respectively, to 1.07% with modified duration of 5.3 and 3.69% with modified duration of 4.2 respectively. In the United States, high yield credit spreads tightened by 45 bp over the month (performance: +1.69%) according to the ICE BofAML US High Yield Index (return: 6.49%, modified duration: 4.40).
In forex, the dollar rose against all developed country currencies (except GBP). The euro-dollar cross closed at 1.1382.
On the emerging markets, the JP Morgan Global Diversified Sovereign Index tightened by 21 bp over the month, to 337 bp on 28 February.
With the markets on the rise, as we go into March we are gradually reducing overall risk accordingly, with a cut in equity market exposure to 43%. We maintain our positive view on the emerging markets. In fixed income, little has changed and we are maintaining our low duration exposure. We remain diversified across emerging market debt, high yield bonds and subordinated financials.



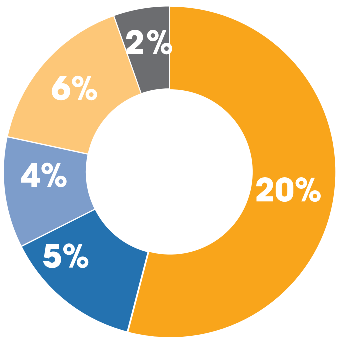
EQUITY EXPOSURE: 43%

UNITED STATES
We have taken some profits on US equities.

EUROPE
We are slightly reducing European equities.

JAPAN
We are maintaining the position initiated last month.

EMERGING MARKETS
Our strategic positioning remains unchanged.



FIXED INCOME EXPOSURE: 37%

DEVELOPED GOVERNMENT BONDS
We have slightly reduced our position.

INFLATION-LINKED BONDS
No change on this diversification theme.

FINANCIAL/SUBORDINATED DEBT
This strategic position remains unchanged.

EMERGING MARKET DEBT
This strategic position remains unchanged.

HIGH YIELD CREDIT
No change to the position initiated at the start of the year.

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