ANALYSIS & STRATEGY

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OIL: OUTLOOK AND CONSEQUENCES?

The consensus at the start of the year seemed fairly clear, with most of the investment banks expecting the barrel price of oil to move within the narrowish band of $50-65. These projections were generally supported by the following arguments:

- Saudi Arabia would continue to play the game of reducing production to boost prices ahead of the Aramco IPO expected in the next 12-18 months.
- A significant rise in the barrel price would lead to an increase in the supply of US shale oil, thereby limiting the potential for barrel price rises.

However, the barrel oil price has risen steadily since the start of the year, with the price up around 20% taking Brent beyond $77, way above the early-year forecasts. There are several reasons for this, in our view. Firstly, it is worth noting the positive upgrades to global growth since the start of the year, which will push up forecast demand for oil as a result. Secondly, US shale oil is a light-density oil, which limits the possibilities for it to be used instead of OPEC oil should supplies of the latter fall; it is also more expensive to refine, requires more investment and offers a lower yield than heavier oils. Lastly, a number of specific events have impacted oil-producing countries such as Venezuela and Angola that have reduced the supply of oil.

Will these factors disappear in the short term? We think this is unlikely, and as such, do not expect to see much of a drop in the barrel oil price over the next few months. What will be the consequences of this high oil price? The initial impact is obvious, with inflation expected to rise in the coming months, which supports our positive view on inflation breakevens. US inflation could reach 3% in July this year, for the first time since 2011. Another, less immediate consequence would be a negative impact on global growth in the longer term, i.e. the opposite of what happened after inflation nosedived in 2014-2016. However, this would take at least until 2019 to feed through.

Meanwhile, the leading macroeconomic indicators are stable, which is reassuring and lends weight to our global growth scenario of close to 4%. We are nonetheless reducing our equity exposure after a significant rise in the markets over the last six weeks. We think European yields will continue to rise and take a positive view on inflation breakevens.

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FIXED INCOME

A paradigm shift is threatening the existence of sector stalwarts...

Traditional retailers are currently facing a paradigm shift following the emergence of online specialists such as Amazon, Alibaba and Zalando. In this environment, many retail giants are experiencing significant operational difficulty and bankruptcy protection announcements are coming thick and fast all over the globe. The most striking example is Toys R Us, a toy retailer with global reach that had a particularly high level of debt for many years before succumbing to the impact of the internet and changing consumption patterns. Holders of Toys R Us 2018 bonds have suffered significant losses, of almost 85% since the beginning of September 2017 (source: Bloomberg). There are plenty of similar stories, such as Sears, an iconic store chain of the post-war consumer society, and RadioShack, a chain of US electronic stores, or in France, Vivarte, owner of brands including La Halle. We expect this trend to continue over the coming years, especially for the most indebted companies, as the rising default rate for US high yield issuers - now close to 11.5% - shows.

8.3% YTM

offered by US retail sector HY

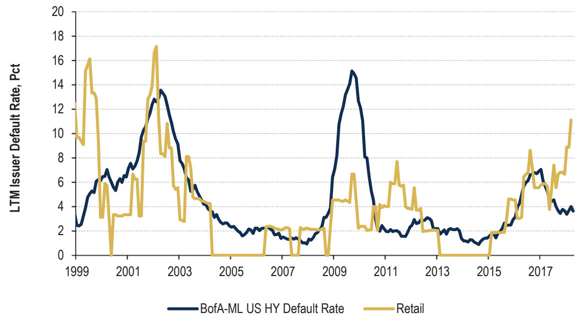
...as well as providing a source of investment opportunities

Retail now offers the highest yield of any sector (the average US YTM is 8.3%). These high yields may seem attractive, but default rates are also climbing. To eliminate the issuers most exposed to the growth of online retailers, we therefore need to be highly selective, in terms of:

1) Geography: pressure from online is far more significant in the USA than in Europe. On top of that, US firms tend to restructure their debt much more quickly. It therefore makes sense to overweight European issuers, except for UK retailers.
2) Sector: the high yield retail universe can be split into two sub-segments – food and non-food. Clearly, food retailers are much less affected, while in the non-food sector, there are also sub-segments that are less exposed to online competition (musical instruments, tools, etc.).
3) Positioning: the companies that have been most impacted by online competition are mid-range players.
4) Potential targets: the stress the sector is under will accelerate consolidation, so it will be a good idea to identify which firms are likely acquisitions.
5) Shareholder structure: many issuers are going to need fresh cash to meet their bank covenants and investment requirements. It will therefore be worth favouring assets held by shareholders with the greatest capacity to manage these needs.

As a result, we particularly like names such as Burger King, Casino, Picard, SMCP and Supervalu (US supermarkets), and conversely, we are far more cautious around the likes of House of Fraser (UK department stores), Fresh Markets (supermarkets in direct competition with Amazon/Whole Foods and held by an aggressive fund) and New Look (budget fashion retailer owned by a fund destabilised by the collapse of Steinhoff).

Default rates - overall US HY and US retail sector HY

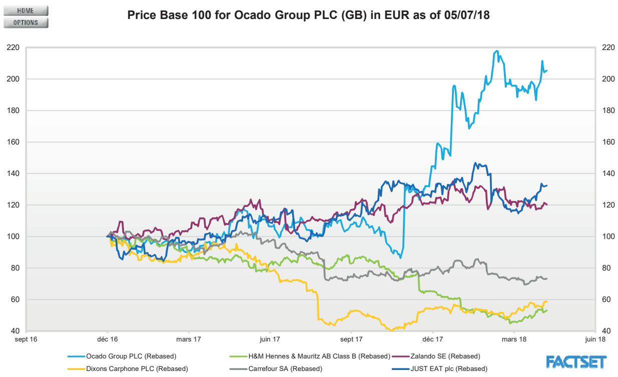


(Source: Bank of America)

EQUITY MARKETS

Since 2017, we have been witnessing a perfect example of "economic Darwinism" in the retail sector. Over the years, the online retail platforms have grown to a level where they are directly challenging traditional firms. In order to adapt to the new consumption habits, we have redesigned the tools we use to monitor investments in this sector.

In 2017, Europe's retail sector underperformed the Stoxx Europe 600 by more than 13%. The diverging stock market performances shown below chiefly stem from growing investor concern over the ability of traditional players to maintain their margins and generate sufficient cash flow. For example, the operating margin of H&M has fallen from 18% in 2012 to a projected 9% this year.



Traditional retailers are caught between:

1) Maintaining the profitability of their bricks and mortar stores despite the ongoing drop in footfall.
2) Trying to grow their online market share while controlling their distribution (by minimising the use of external partners such as Amazon, Zalando and Asos).

At present, the traditional players are not managing to reassure investors of their ability to reverse this trend. However, some US retailers, such as Walmart, have decided to take on Amazon in the online space.

The tyranny of platforms

The arrival of internet platforms in a number of sectors has often led to the emergence of quasi-monopolies, which offer the best choice of products and attract the biggest number of customers. We are investing in these platforms, as we think they will continue to win market share. They may also be the target of multinationals seeking to gain an online presence. For example, luxury group Richemont recently acquired Yoox – Net à Porter in order to develop its e-commerce channel.

We will nonetheless keep a very close eye on their valuations, which can reach stratospheric levels very quickly. In Europe, we are positive on online fashion retailers Asos and Zalando and food ordering website Just Eat.

The way we shop has changed

Online and mobile are now fully integrated into the shopping process. Consumers get ideas, find information and compare prices online before buying something in a store. This applies in the widest sense to all sectors, from retail, through telecoms and media, to travel and leisure.

A number of luxury players have confirmed to us that more than 80% of their customers making an in-store purchase have previously researched the products concerned online.

On this basis, we have developed expertise using data analysis tools that produce traffic estimates and other indicators. This helps us to project sales trends for the various brands.

EUROPEAN EQUITIES ARE OUTPERFORMING

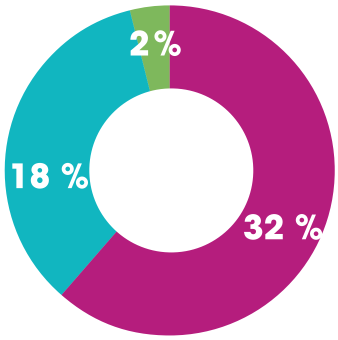
In April, fears over a trade war subsided, contributing to a rebound of risky assets. The main stock markets of developed countries posted positive monthly performances. The European market comfortably outperformed its US counterpart (DJ Eurostoxx 50 +5.2%, S&P 500 +0.3%), moving back to its level at the start of the year.

The rise in commodity and oil prices (Brent +7%) put pressure on interest rates, particularly in North America and Australia. The yield on 10Y US Treasuries quietly passed the symbolic threshold of 3%, while the Bund climbed above 0.60% before falling back to 0.56% at the end of the month. In the USA, the rise in nominal yields stemmed from the rise in both real rates (+9 bp) and inflation breakevens (+12 bp). However, in the eurozone, the rise in nominal yields was mainly driven by the rise in real rates.
On the forex market, the US dollar rose against a basket of currencies (nominal effective exchange rate +1.40%), while the EUR/USD cross went from 1.23 to 1.20.

On the macroeconomic front, US business confidence and activity figures have been pretty good overall, which partly explains the dollar's strength over the month. However, expectations were not really fulfilled in the eurozone following the peaks of late 2017, although this should not affect the positive economic outlook.

On the microeconomic side, results releases from US firms generally came in above consensus, while in Europe, performance was mixed.
Lastly, we note that the ongoing difficulties in the bond market environment of emerging countries continued over the month, both for the yield and currency components.

We are leaving our main international equity and bond allocation blocks unchanged, and continue to overweight equities, principally from Europe, remaining generally cautious on fixed income. Nonetheless, we are making some adjustments: in equities, we are increasing our positions on the US market and taking some profits on Europe and Japan. We are steering clear of emerging equities. As for fixed income, we our maintaining our low structural duration, mainly on the eurozone. We are reducing US inflation-linked bonds and increasing their European counterparts. After the major correction in April, we opened a small position in emerging bonds on tactical grounds.
We are still slightly underweight on credit, continuing to favour high yield and subordinated debt.



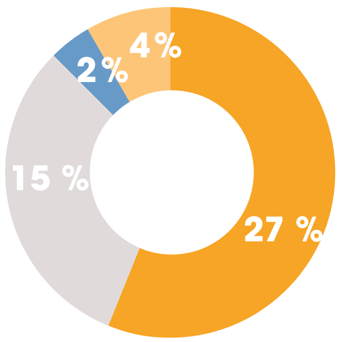
EQUITY EXPOSURE: 52%

UNITED STATES
We are continuing to increase our exposure to US equities after a period of underperformance.

EUROPE
We have taken some profits.

JAPAN
We are also reducing our position in Japanese equities.

EMERGING MARKETS
We still have no investments in this component.



FIXED INCOME EXPOSURE: 48%

DEVELOPED GOVERNMENT BONDS
We have increased this component, which remains concentrated in exposure to US Treasuries.

INFLATION-LINKED BONDS
We are reducing our bet on inflation-linked bonds and have shifted a portion of our US investments to Europe.

FINANCIAL/SUBORDINATED DEBT
We are maintaining a small investment as we await an opportunity to return to this asset class.

EMERGING MARKET DEBT
We have strengthened our position on tactical grounds following the major correction in recent weeks.

HIGH YIELD CREDIT
We remain cautious on this theme.

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