ANALYSIS & STRATEGY

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ITALY, THE UK, THE USA… THE AUTUMN IS ALL ABOUT POLITICS

It did not take an expert to know that politics would be in the news throughout the month of September, and October looks set for more of the same.

Let's start with Italy. Despite Giovanni Tria's efforts and announcements of a budget deficit below 2% of GDP, it was Matteo Salvini and Luigi Di Maio who held sway in the end, with a 2019 deficit target of 2.4%. The figure is not that alarming in itself, especially in light of the deficits France and Spain are running, but even that level may not be maintained (growth forecasts are probably too high), and it will not allow the stabilisation of Italy's debt.

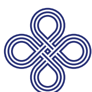
It is likely that the European Commission will take exception to this slippage, but it only has limited sanctioning powers to apply. President Mattarella, who made no public pronouncements this summer, could be included in the discussions and use articles 81 and 97 (on debt sustainability) in an attempt to reverse certain positions, but that looks unlikely. In view of all these developments, our positioning on Italy remains unchanged: we will steer clear of the country with the political situation so unclear.

Meanwhile, Donald Trump has renegotiated NAFTA (as the US-Mexico-Canada Agreement), and although not much has changed, it could win him some votes in the mid-term elections. Mr Trump's threats to China have been implemented with a 10% tariff on $200 billion of Chinese imports; the market had feared a 25% rate (which is slated for 2019) and China's retaliation has so far been modest (tariffs on imports of $60 billion), which is why the markets have barely reacted.

The Brexit negotiations remain difficult, with the EU rejecting the Chequers plan. Theresa May has few viable options, and even if she manages to reach an agreement with the EU (at the price of significant concessions), she will find it very hard to get it through Parliament. The current impasse means that the chances of a new referendum, which was not on the cards just a few weeks ago, now seems slightly less unlikely.

There has been some improvement in the emerging world, with Turkey's central bank finally increasing interest rates and Argentina obtaining sufficient guarantees from the IMF ($50 billion + $7 billion) to reassure the markets. Not all of the problems have been solved, but the situation has stabilised.

In this highly uncertain environment, dominated once again by political issues, our bets remain limited: no exposure to Italy, few short positions on core inflation and financials, and equity exposure approaching that of the indices. We continue to hold a moderately positive view on emerging markets (but on a selective basis).



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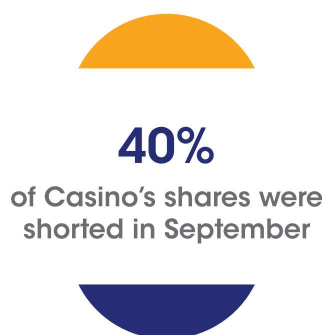
FIXED INCOME

ATTACK ON CASINO: RIGHT OR WRONG?

New consumption habits with a focus on local shopping and home deliveries have shaken up France's traditional retail model. French retailers will have to evolve to survive, and at the same pace as the new shopping habits are taking hold. While most investors expect to see sector consolidation, the spectacular string of US/UK retail defaults has drawn greater attention to retailer indebtedness, as analysts look for the next company to falter.

The Rallye Group, which includes French retailer Casino and is known for its debt at every level plus financial complexity, has crystallised the market's fears for the retail sector. Under pressure from short selling, as of 5 September Casino shares had lost 47% of their value since the start of the year. This is no longer about fears; this is a stock under attack. We now see Casino as undervalued, with a lower market cap than the estimated valuation of Monoprix.



40%
of Casino's shares were shorted in September

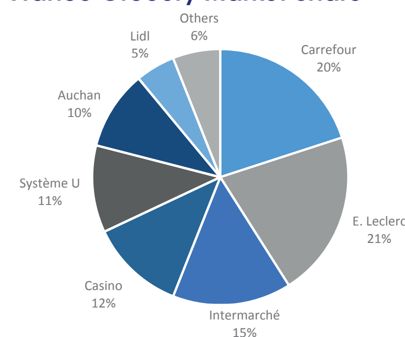
Going back to the group's structure: most group debt is held by Casino's parent Rallye, which forces Casino to pay a large dividend each year so that Rallye can pay its debt interest. To obtain financing, Rallye lends Casino shares to banks. The more the Casino stock falls, the more shares Rallye has to pledge in exchange for this financing. The idea of the short sellers is to drive down the Casino share price as low as possible, in order to dry up Rallye's financing and cause its default, so that Casino no longer has to service the debt of its parent. At this stage, one theory could be that Casino has come under attack in order to protect its future and enable it to make essential investments. But it is just a theory.

In practice, Jean-Charles Naouri, Casino's CEO and main shareholder has been successfully running the group's strategy for 26 years. Yes, the group is highly indebted, but we don't see the situation as critical. To meet the new demand, ensure its supply conditions and secure its financing sources, the group has an array of options.

Outside the group's traditional support from French banks, as shown by the credit line obtained by Rally this month with no collateral, we think it likely that Casino will get together with an online player such as Amazon or a traditional French retailer that would offer synergies and greater competitiveness. Similarly, to meet its cash requirements, the group also has property and other assets it could sell in the short and medium term, such as its stakes in Cdiscount, Monoprix or GPA in Latin America.

Casino is still a well-known company with various possible financing sources, which should enable it to secure its future and achieve a strategic transformation, while also being a good candidate for potential sector consolidation. Casino has also revealed that it held talks with Carrefour in September, and there are market rumours of discussions between Casino and Auchan, which we think would make more sense from a competitive standpoint.

France Grocery Market Share



For the 12 weeks ending 22 Aug 2018.
(source: Kantar Worldpanel, CreditSights)

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EQUITY MARKETS

POLITICAL ISSUES ARE CAUSING GEOGRAPHICAL AND SECTOR POLARISATION

After a difficult summer for the European equity markets, they remained lacklustre in September, despite a slight rebound in France and Italy. Global economic growth is still on track, as are expected full-year corporate earnings in Europe; however, the European market is in negative territory in 2018, while the US market continues to break new records.

An analysis of stock market performances shows a clear geographical and sector polarisation caused by political announcements and situations. Put another way, the risk premium applied to the European markets, and particularly the eurozone, remains high. Moreover, capital flows are indicative of international investors' wariness on the eurozone, although the 'fundamentals' appear to point to a positive performance in 2018. The three 'political' reasons that we have already underlined are hindering the markets:

Trade war

After months of threats, recriminations and negotiations, NAFTA was replaced by its close cousin, the USMCA "US-Mexico-Canada Agreement". Canada joined Mexico in the agreement on 30 September, which should not have a major impact on the nature of trade between the three countries. This new positive for international trade was eclipsed by a fresh announcement by President Trump that he would carry through on his threat to impose an additional 10% tariff on $200 billion of Chinese imports from September, rising to 25% from 1 January 2019. China reacted by announcing new customs duties from 5% to 10% on $60 billion of US goods from October. The US had previously announced that if China retaliated, it would put tariffs on almost all Chinese imports. This escalation of announcements has once again increased the pressure and concern over the potential consequences of this opposition.

No progress on Brexit at the Salzburg summit

The risk of a 'no deal' is fairly high, and will remain in place until the December summit at best. There is no guarantee that an agreement will be found by the Brexit deadline of midnight on 29 March 2019. The UK's International Trade Secretary, Liam Fox, estimates the probability of "no deal" at 60%. BoE Governor Mark Carney has informed the government of the economic and financial risks associated with Brexit.

Italian budget vote

Despite the pressure exerted by Five Star leader Luigi Di Maio, in saying that he would not vote for the 2019 budget unless all his promises (introduction of a basic income, reduction in the retirement age and higher pensions) were included, Finance Minister Giovanni Tria attempted to keep the deficit target at 1.6% of GDP. In the end, an agreement between the Five Style Movement and the League was reached for a deficit target of 2.4% of GDP between 2019 and 2021, a considerable way off the 0.8% Brussels was looking for from next year. This new source of conflict with Brussels is keeping tensions high in the eurozone.

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THE POLITICAL STRUGGLE IN ITALY

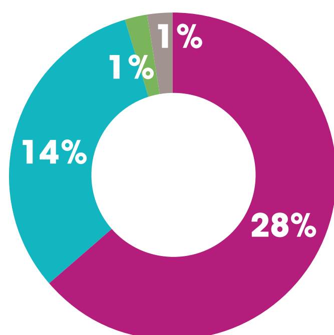
The Italian government has decided on a budget deficit target of 2.4% for 2019. This compares unfavourably to the 0.8% announced by the previous government, the 1.6% supported by Giovanni Tria and the 1.9% consensus forecast. The next dates to watch out for are 15 October, when Italy has to submit its budget to the European Commission, the end of October, when the EC issues its recommendations, and 26 October, for the rating announcements by S&P and Moody's.

Surprising no one, on 24 September the United States imposed customs tariffs on Chinese goods ($200 billion), and China retaliated immediately with tariffs on US goods ($60 billion). Lastly, at the European summit in Salzburg, the EU rejected Theresa May's Chequers plan for Brexit: the border between Northern Ireland and the Republic of Ireland and the free movement of goods and services are the main stalling points.

On the macroeconomic front, the US data confirmed the dynamism of the country's growth, despite the risks from protectionism. In the eurozone, the latest figures point up growth of 0.5% for Q3 2018 (1.9% in annual terms). The central bankers did not spring any surprises. The ECB again opted for the monetary policy status quo. The Fed increased its interest rates by 25 bp. The chances of a fourth and final hike for the year in December are rated at 70% by the market consensus.

In international equities, the markets were almost balanced at the end of the month, except for Japan, which was up by more than 5% in yen. On the government bond markets, nominal yields for the main developed countries (except Japan) tightened under pressure from US interest rates, and particularly the rise in real rates. The credit markets are generally performing well, with the United States outperforming Europe. On the forex markets, the EUR/USD cross was stable at the end of the month, at 1.1604. The best-performing emerging market countries, in terms of currencies, were Turkey (+8 %), South Africa (+4 %), Colombia (+3 %) and Russia (+3 %). In commodities, Brent rose 6.8% to $80/barrel (a four-year high). On the emerging markets, the JP Morgan Global Diversified Sovereign Index was down 35 bp over the month, at 335 bp.

Going into a very busy October, we have the same mixed feelings, between caution and opportunity. We are keeping our exposure to the equity markets almost unchanged, at close to 44 %, retaining our focus on the United States and Europe. On European yields, we are maintaining our low duration exposure to core nominal yields, and our diversification in inflation-linked bonds. We continue to hold a small component in emerging debt and subordinated financials.



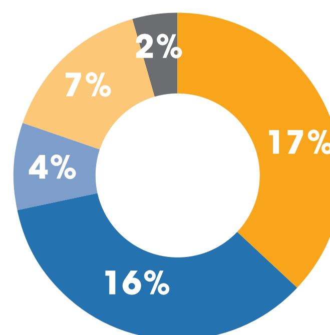
EQUITY EXPOSURE: 44%

UNITED STATES
We are maintaining our exposure to US equities.

EUROPE
We are maintaining our exposure to European equities, with good diversification across styles.

JAPAN
We have added a very small position.

EMERGING MARKETS
We have also initiated a small position on this theme.



FIXED INCOME EXPOSURE: 46%

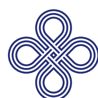
DEVELOPED GOVERNMENT BONDS
We have made a slight reduction to overall modified duration.

INFLATION-LINKED BONDS
We are retaining our bet on inflation-linked bonds.

FINANCIAL/SUBORDINATED DEBT
The position is unchanged.

EMERGING MARKET DEBT
We are maintaining our position after adding to it in early summer.

HIGH YIELD CREDIT
We have initiated a new investment of 2% in European High Yield.



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