ANALYSIS & STRATEGY

MONTHLY NEWSLETTER

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AN END-OF YEAR RALLY?

Oil prices tumbled 22% in November, making it the worst month since October 2008.
No fears of recession or systemic banking crisis this time, but a confluence of negative factors: projected growth is down, driving down oil demand; sanctions against Iran are partially lifted; production in the US is unexpectedly high; and Saudi Arabia has had record production, though it said it wanted to decrease it... not to mention the major speculative positioning on oil. Another reason for the scale of the slide is market conditions, which are still fragile due to political uncertainties.

Logically, this movement drove core rates and inflation breakeven points down; the latter were especially bad in the eurozone, with, for example, German 10-year breakeven inflation rates down 18 bp over the month, which is the widest swing seen since early 2016.

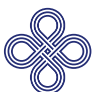
The Brexit debate continues, with the agreement between the European Union and the UK government reached on 25 November. The UK now needs to get this agreement through the House of Commons, which is scheduled to vote on it on 11 December. Right now, it is hard to imagine the agreement being passed. So, does Theresa May step down? Will there be new elections? Or a second referendum? We still think that a Hard Brexit can be avoided, but it could be a rocky road ahead.

Investors were all riveted to the G20 summit slated for the end of the month in Argentina, with two key issues to address: trade tensions between the US and China, and discussions of a possible reduction in oil production by OPEC + Russia. And - for once this year - hopes were not dashed:

- Donald Trump and Xi Jinping agreed on a 90-day "truce" in their trade war;
- OPEC and its allies are working on an agreement to reduce production by 1.3 million barrels a day.

The last big news item is Jerome Powell's about-turn: after saying on 3 October that monetary policy was still far from equilibrium (hawkish), he has said that it was in the end rather close. This change in tone has gone a long way towards calming the financial markets.

Ultimately there could be a year-end rally, especially in emerging markets (currencies, fixed income and equities), which have been the main beneficiaries of recent developments and also the markets that have suffered most this year. A rally in Europe is also a possibility, but it will depend on whether or not political issues are resolved.



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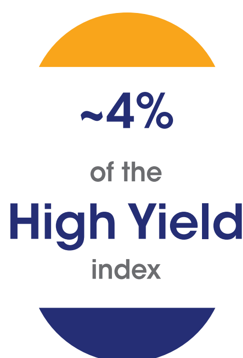
FIXED INCOME

GENERAL ELECTRIC, THE NEXT "FALLEN ANGEL"?

For more than a month, General Electric (BBB+) has been drawing the attention of the Investment Grade and High Yield markets in the US as well as Europe.

General Electric is a historic American conglomerate that achieved the highest valuation in the world in 2001, with capitalisation in excess of $500 billion, and now seems to be nearing the end of the cycle. The group is also one of the most complex, operating globally on a dozen different segments, with a major financial services subsidiary, GE Capital, that has both a complex structure and enormous leverage.

With $115 billion in gross debt, General Electric is the 10th largest issuer of US Investment Grade bonds (BoA index). In addition to the debt burden, the group has provisioned $22 billion for an ongoing investigation by the SEC, and has $12 billion in debt maturing in 2019. All of this together has stoked major uncertainty over the group's situation, driving the bonds down 10-20 points in two months, according to the issuing entities, while shares have halved in value (-56% since January). Today, the group's bonds are trading at the price of a B-rated bond (highly speculative investment).

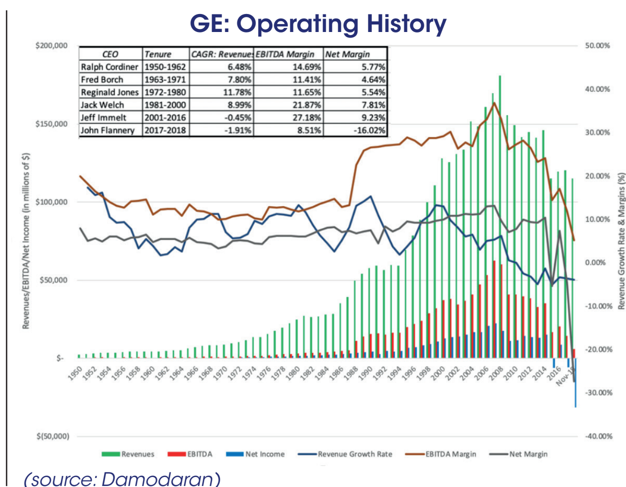


Given the group's systemic weight, the situation is worrisome to the entire High Yield market. With the debt it carries, if GE moved into High Yield, a three-notch downgrade, it would be the largest issuer with debt amounting to 3.7% of the index. Market players agree that the High Yield market would have a great deal of trouble collecting that kind of debt.

Nonetheless, we do not expect General Electric to move into High Yield in the short or medium term, for several reasons:

- General Electric is still turning a profit on most of its businesses, and can – and should – restructure.
- GE's capacity to deleverage will keep it out of High Yield.
  The group can easily reduce its debt by raising at least $20 billion in the short term, through a possible IPO of the Healthcare portion (up to 40%), or by selling its stake in Baker Hughes, cutting its dividend, etc.
- The weight of General Electric's debt in the Investment Grade loan portfolios of Wall Street's five largest banks can provide support in avoiding liquidity problems.
  On the single $19.8 billion line of credit expiring in 2020, guaranteed to GE by six banks (out of a total of $41 billion in credit lines), Morgan Stanley makes up 6% of its Investment Grade loan portfolio, and Goldman Sachs 4%.

For the above reasons, we are confident that the group is capable of deleveraging over the short and medium terms and, as a result, the market reaction seems exaggerated and more reflective of the tighter bond climate in recent months.



CEO	Tenure	CAGR: Revenues	EBITDA Margin	Net Margin
Ralph Cordiner	1950-1962	6.48%	14.69%	5.77%
Fred Borch	1963-1971	7.80%	11.41%	4.64%
Reginald Jones	1972-1980	11.78%	11.65%	5.54%
Jack Welch	1981-2000	8.99%	21.87%	7.81%
Jeff Immelt	2001-2016	-0.45%	27.18%	9.23%
John Flannery	2017-2018	-1.91%	8.51%	-16.02%

(source: Damodaran)

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EQUITY MARKETS

THE MARKET REGAINS SOME LIFE AFTER A CONSTRUCTIVE G20

The first weekend of December's G20 summit in Argentina was highly anticipated by investors. The key point of this meeting of leaders was the dinner between Xi Jinping and Donald Trump.

It ended with a three-month truce on trade. Mr Trump postponed the effective date of a 25% tariff initially scheduled for 1 January. China, in turn, massively lowered its import duties on vehicles made in the US and sold in China.

With a view to a longer-term agreement, the Americans want to launch discussions about three key topics: intellectual property theft, non-tariff obstacles, and "forced" technology transfers.

Concessions from China on these issues could mean the start of a long-term agreement.

As December gets underway, we are maintaining our 'equity' exposure, primarily for the following reasons:

- attractive valuations in several geographic areas (Europe, China, and Japan);
- a rise in US rates that is expected to slow down, weakening the dollar and benefiting the US and emerging economies;
- brisk capital inflows to the US and a return to the emerging markets;
- and better (or at least steady) business margins, carrying over into 2019.

Still, many political risks persist. In Europe, the situation appears to be easing somewhat, with Mr Salvini's government ready to make concessions so that its budget will be approved by the European Commission. The main risk is still Brexit. A decisive vote is scheduled for 11 December in the UK Parliament to approve the agreement negotiated with Brussels. If it does not pass, the UK could be in uncharted waters, and headed for a "Hard Brexit".

Finally, while the additional time given by the US administration to negotiate with China is crucial, it is not enough by itself. A long-term agreement is necessary to keep investments from plummeting in the US. A rekindled trade war would impose a severe burden on the global economy and the financial markets. The shadow of the political risks that defined 2018 still looms over 2019 and could be the reason for the high volatility on the equity markets.

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THE OIL HEADACHE

Risk aversion is not really abating. This month, the focus of concern is the massive drop in oil prices (Brent is down 22% over the month to $59.14), penalised by the risk of a supply/demand imbalance.

And yet the political risks looming since the year began have eased somewhat. With regard to tariffs, a ray of hope emerged from the China/US dinner that closed out the G20. On Brexit, the European Union and the United Kingdom have finally reached an agreement. The next step will be ratifying the deal in the UK Parliament. Against this backdrop, international equities are regaining a bit of colour, except in Europe: S&P 500 +2.04%, Nikkei 225 +1.96%, MSCI Emerging in USD +4.69%, and lastly Eurostoxx 50 at -0.69%.

As for the confidence and business indices, the news was not good for investor confidence, particularly in the eurozone and China.

In its wake, 10Y nominal rates fell overall, in Germany (-7 bp to 0.31%) and the US (-16 bp to 2.99%), prompted by a precipitous drop in breakeven inflation.

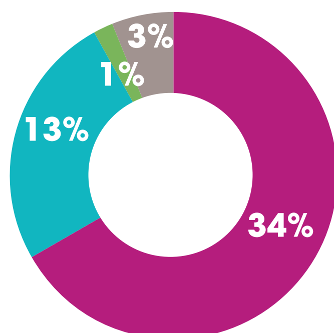
In Italy, despite the risk of an excessive deficit procedure, the spread over the German 10Y narrowed 20 bp to 290 bp (peak at 326 bp). The 2Y Italian rate stood at 0.84% on 30 November (-22 bp over the month), while the Italian 10Y closed at 3.21% (-21 bp over the month).

For the central banks, the US Federal Reserve also helped drive sovereign spreads down: Chairman Powell's statements are for a more gradual increase in rates than previously indicated. However, the 25-bp increase in the Fed funds interest rate expected at the committee meeting of 19 December has not been challenged.

On the credit market, note that financial and High Yield debts are still under pressure.

On the forex market, the dollar was ultimately stable against the euro at 1.1317, though only after twitching to 1.15 and 1.1216.

We face this last month of 2018 with the feeling of a possible rebound on the markets. And that is why we are maintaining our equity market exposure at 51%, with a majority position on the American market. On European yields, we are maintaining our low duration exposure to nominal Core yields. We have also reduced our diversification on European inflation-linked bonds. We continue to hold a small component in emerging debt and subordinated financials.



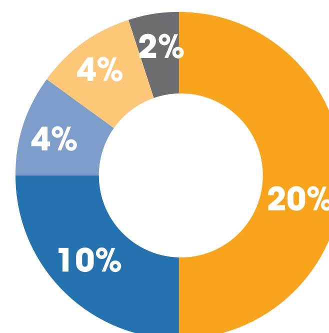
EQUITY EXPOSURE: 51%

UNITED STATES
We are maintaining a large position in US equities.

EUROPE
We are slightly reducing European equities.

JAPAN
We are maintaining our small position.

EMERGING MARKETS
We are increasing our position.



FIXED INCOME EXPOSURE: 40%

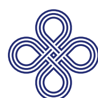
DEVELOPED GOVERNMENT BONDS
We have reduced overall modified duration in the wake of the major flight to quality.

INFLATION-LINKED BONDS
We are sticking with inflation-linked bonds and refocusing on the US market.

FINANCIAL/SUBORDINATED DEBT
The position is unchanged.

EMERGING MARKET DEBT
We have maintained our investment of 4% in this asset class.

HIGH YIELD CREDIT
We have maintained our investment of 2% in European high yield.



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