DNCA INVESTMENTS

Market comment
December 2016

By Igor de Maack
Fund manager and spokesperson for fund management team

"The no result in the Italian referendum does not mean Italy will leave the Eurozone."

The markets have blown electoral events out of proportion and turned them into stressful incidents that need to be used wisely. As always, the economy will soon take the upper hand and impose its constraints.

As most opinions polls had predicted, Italian electors voted against Matteo Renzi's proposal to modify the role of the Senate. Following his resignation, the referendum result has opened a period of incertitude, which is nonetheless relatively customary in Italian politics. Early elections will probably be held by 2018 and there is no certitude that the populist Five Star party will be able to command a majority in order to govern. Furthermore, if an exit from the Eurozone is proposed, it will also have to be decided by referendum. The Greek example shows that voters are not necessarily convinced of the benefits of leaving the Eurozone. The result has so far had only a limited impact on Italian interest rates. The spread over German sovereign yields stabilized at around 170 basis points. It is worth highlighting however that Italian 10-year government bonds are yielding almost 2.0% compared to 2.4% for US sovereign bonds of the same maturity. This represents a paradoxical situation for those who believe that the Italian economy is on the brink of collapse. Although the recapitalization of the Italian banking system has certainly been complicated by chronic political instability, the bailout mechanisms put in place by the Eurozone and the Banking Union have at least provided a draft solution, which was inexistent prior to the 2011 crisis.

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The OPEC meeting threw out a pleasant surprise for investors and swiftly pushed oil prices up. A stabilization in oil prices is good news for oil producers and for the sector as a whole, which is largest industrial sector worldwide in terms of capex. OPEC decided to cut back output by 1.2 million barrels per day, with a production target of 32.5 million bpd. The agreement will also require participation from non-OPEC oil producers, which will need to agree to a production cut of 0.6m bpd. Russia and Oman have apparently already agreed. It is always difficult to check out whether these production curbs have actually been implemented as players often get around them or fail to comply, but this move is positive from an economic and political standpoint. Firstly, from an economic perspective, it should balance out oil supply and demand for 2017 and secondly, in political terms, it momentarily eases tension between the two major Muslim religious powers, Saudi Arabia and Iran. The resumption of large projects at higher oil prices should boost return on capital employed for oil majors. It is also worth noting that the oil business, and the commodities extraction sector as a whole, is the largest industry worldwide in terms of capex. OPEC's agreement received a warm welcome from the international financial markets.

After the three political "shocks", namely Brexit, Donald Trump and the Italian referendum, the economy will, as usual, take the upper hand and impose its constraints. For the time being, the European economy continues to expand agains a backdrop of more stable demand, persistently low borrowing costs and a weak euro. The latest round of earnings reports confirmed world growth of around 3% for 2017. Contrary to all expectations, the world has not fallen into disaster either economically or financially, and ultimately this may be the lesson to be learnt from this year, when we have seen three major electoral events, including two that threw up major surprises. US and UK investors have sought to penalize Eurozone markets each time, making them an easy atoning sacrifice, while the US markets literally seem to be hanging in limbo. But yet the Eurozone is still standing and European companies are paying out generous dividends on the back of solid balance sheets and sound cashflow management. Indices in the Eurozone as well as some French indices (CAC 40) are displaying better relative performances than other wider generic European indices. Although it is still too early to make any calls on 2017, events leading to high volatility should nonetheless be used to tactically strengthen positions among the most neglected asset classes, such as European value stocks.

Text completed on December 5, 2016 by Igor de Maack, fund manager and spokesperson for DNCA fund management team.

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