Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research, Strategy and Analysis WEEKLY

September 16 - 20, 2013

Highlights of the week

- **The Fed is maintaining its quantitative easing programme for now –** a decision which took the vast majority of market participants by surprise.
- **US:** residential real estate begins to show signs of weakness.
- **Germany:** surveys continue to indicate solid growth.
- **Foreign exchange:** the euro breaks $1.35 for the first time since February. The yen remains stable against the dollar.
- **Equity markets: fleeting euphoria?** After hailing the Fed's decision, the equity markets stabilised on Friday.

Key focus

The Fed's status quo: is it really a surprise?

Since May, a great many speeches had been made by Fed members, laying the groundwork for a reversal of its asset-buying policy. A market consensus emerged, with less than 5% of international investors counting on the status quo, and a decline of at least US$10 bn (from $85 to $75 bn) in monthly security purchases was expected. However, in the end, the Fed is staying put, and investors are pleasantly surprised (see following pages).

Has the Fed changed its tune?

The answer is no. Though the status quo comes as a surprise, the very accommodative tone of its announcement does not.

• (1) The labour market is still sluggish. The rapid decline in the unemployment rate is misleading. The participation rate is at its lowest level since the end of the 1970s, and job creation has been slowing over the past few months.

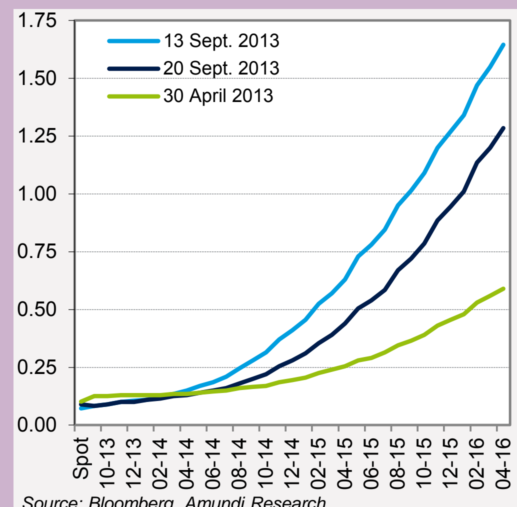
• (2) Inflationary pressures are virtually non-existent. Though wages have slightly risen (+2.2% yoy in August), the measure used by the Fed to gauge underlying tensions on prices is very low; the personal consumption expenditures deflator (excluding food and energy) rose 1.2% yoy in July (vs. 2% a year ago).

In addition, two other very different factors have played a role:

• (1) The rise in interest rates (+130bp on the 10-year Treasury bond yield since early May) has been fully passed on to mortgage rates. Therefore, this is a true tightening of financing conditions, which is likely to drag down activity in the second half of the year; the signs of a slowdown in real estate activity are increasing (see next page).

• (2) The debate over the debt ceiling is back at the forefront, with much higher tensions than expected between Congress and the White House. A budget compromise must be reached before October 1, or new lines of public spending will be eliminated. Not to mention that if no agreement is reached by mid-October, the threat of a US default on payment will resurface. This is an extreme risk that may stir up the markets.

Abrupt shift in monetary policy expectations



Source: Bloomberg, Amundi Research

Monetary policy expectations were revised downward over the week. That said, long-term interest rates have fallen relatively little. This means investors remain convinced that the Fed will stop buying assets in 2014, but more gradually. The Fed wins this round!

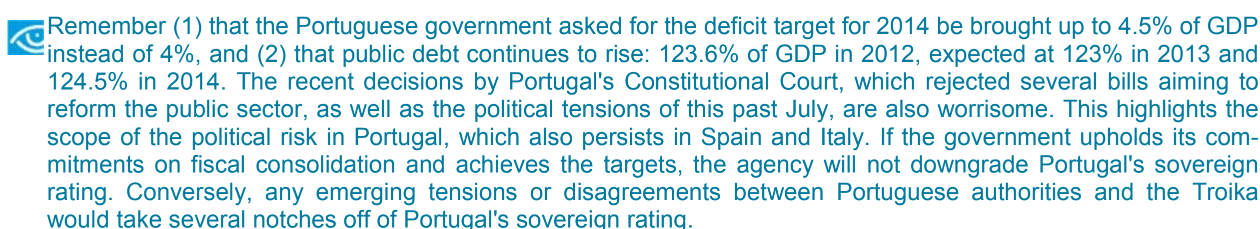
In these conditions, the Fed prefers to stay in wait-and-see mode. Ben Bernanke is insisting that there is no predetermined agenda to put an end to asset-buying. This is especially true when it comes to raising key rates.

The resulting correction on monetary policy expectations (see graph) backs up our scenario: the Fed will not stop buying assets before next summer or even next autumn, and there will be no hike in the fed funds rate before the first half of 2015. Then, the Fed's strategy will be data dependant and gradual – especially since the restrictive fiscal policy should cap GDP growth in the medium run. The goal is to manage an increase in long-term rates that is in line with fundamentals. The Fed will probably need several months to fine-tune its diagnosis. Still, we should keep in mind that the debate may very quickly come back to centre stage next November or December, and that the risks are asymmetrical (upward) on long-term rates. **Meanwhile, investors are free to keep profiting from low real interest rates.**

The week at a glance

Other events

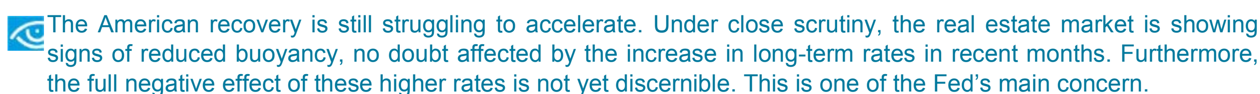
Portugal > **Standard & Poor's (S&P) warns Portugal's sovereign rating may be downgraded in the coming months.** Despite some positive surprises on the economy (stronger-than-expected exports, stable unemployment, and positive growth in GDP in Q2 for the first time since 2009), the agency fears that Portugal is not prepared to achieve the budget deficit reduction target, set in agreement with the Troika at 5.5% of GDP in 2013, and will eventually be forced to ask for a second financial bailout.


Remember (1) that the Portuguese government asked for the deficit target for 2014 be brought up to 4.5% of GDP instead of 4%, and (2) that public debt continues to rise: 123.6% of GDP in 2012, expected at 123% in 2013 and 124.5% in 2014. The recent decisions by Portugal's Constitutional Court, which rejected several bills aiming to reform the public sector, as well as the political tensions of this past July, are also worrisome. This highlights the scope of the political risk in Portugal, which also persists in Spain and Italy. If the government upholds its commitments on fiscal consolidation and achieves the targets, the agency will not downgrade Portugal's sovereign rating. Conversely, any emerging tensions or disagreements between Portuguese authorities and the Troika would take several notches off of Portugal's sovereign rating.

Economic indicators

US > **Consumer prices are up less than expected.** The CPI rose +0.1% in August, and +1.5% yoy (vs. +1.6% expected and +2% in July). Excluding energy and food, the index rose 0.1% and +1.8% yoy (as expected).

The majority of real estate data are disappointing. The NAHB index of real estate developers' confidence was expected to rise, but remained stable in September. August's numbers on housing starts and building permits are down below expectations. However, sales of existing homes are up above expectations. In addition, despite a slight rebound this week, mortgage requests are stuck in a distinct bearish trend.


The American recovery is still struggling to accelerate. Under close scrutiny, the real estate market is showing signs of reduced buoyancy, no doubt affected by the increase in long-term rates in recent months. Furthermore, the full negative effect of these higher rates is not yet discernible. This is one of the Fed's main concern.

Eurozone > **The trade balance is improving in Italy, but worsening in Germany, Spain and France.** An initial estimate of the eurozone trade balance shows an increased surplus. Nonetheless, in seasonally-adjusted data, exports fell back more than imports in July. Compared to June 2013, July's numbers show a slight deterioration in France and Spain (deepening of the deficit) and Germany (erosion of the surplus), while Italy improved its surplus.

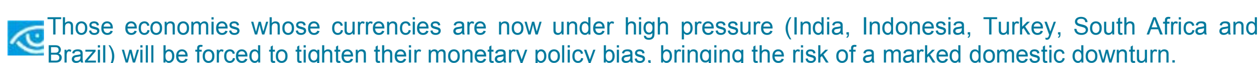
Foreign trade, which has been a boon to Southern European countries, reducing the intensity of their recession over the past semester, played in favour of Italy in July. In Spain, the monthly deficit figure is much less than in July 2012. However, we still think that foreign trade's momentum will not easily offset sluggish domestic demand in those countries, where the recovery will remain very slow and uneven in 2014.

Germany > **The ZEW is up above expectations.** The ZEW index, reflecting investor confidence in Germany, is up strongly at 49.6 (vs. 42 in August). This is its highest level since December 2009.

The ZEW is highly volatile, but this solid figure is still reassuring, while several German data releases had come up short in past weeks.

Monetary policy

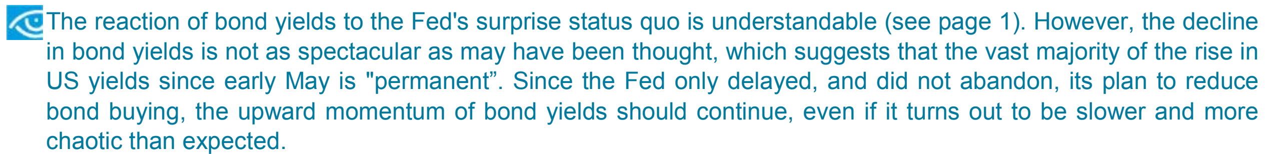
India > **India's central bank raises its interest rates**. Raghuram Rajan, the new Governor of the Reserve Bank of India and former Chief Economist of the IMF, decided, to everyone's surprise, to raise India's key rates by 25 bp to 7.5%. This is the central bank's first interest-rate hike since 2011. The message accompanying this decision is very clear: no easing before inflation and the currency stabilise. Inflation figures for the month of August were published at the start of the week: 6.1%, 30 bp above the expectations of the consensus.


Those economies whose currencies are now under high pressure (India, Indonesia, Turkey, South Africa and Brazil) will be forced to tighten their monetary policy bias, bringing the risk of a marked domestic downturn.

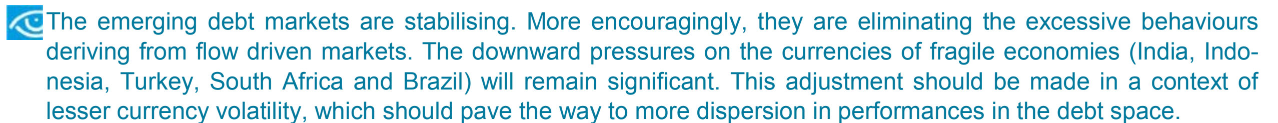
Financial markets

Fixed-income

The Fed causes rates to fall. The US 10-year bond yield fell from 2.88% to 2.73%, and the 2-to-5-year segment flattened. The drop was less marked in Europe: the German 10-year yield went from 1.98% to 1.94%. The profile of key-rate expectations has been radically altered: whereas before the FOMC meeting, the markets expected that Fed funds would increase in Q1 2015, they now anticipate an initial increase around mid-2015. On the primary market, it is interesting to note that Spain issued €2 bn in three-year debt at an average rate of 2.22%, the lowest since April 2010.

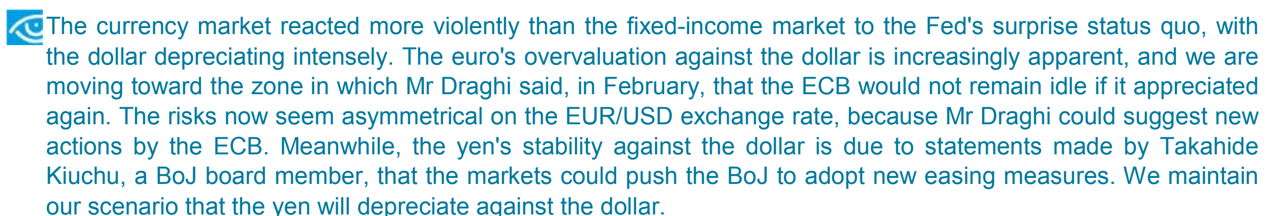

The reaction of bond yields to the Fed's surprise status quo is understandable (see page 1). However, the decline in bond yields is not as spectacular as may have been thought, which suggests that the vast majority of the rise in US yields since early May is "permanent". Since the Fed only delayed, and did not abandon, its plan to reduce bond buying, the upward momentum of bond yields should continue, even if it turns out to be slower and more chaotic than expected.

The Fed offers no respite to the emerging debt markets. The emerging debt markets hailed the Fed's status quo. In the day that followed this announcement, the steepest declines in interest rates were seen on the Turkish markets, with a 70 bp drop (10-year yield at 8.7%), Indonesian markets, with a 36 bp drop (10-year yield at 7.8%) and Indian markets, with an 18 bp drop (10-year yield at 8.2%). Although Turkish interest rates were back at late-June levels, the same cannot be said of Indonesian or Indian interest rates. In India, in particular, short-term rates soared (the 1-month money market rate is above 14%) under pressure from tighter liquidity conditions imposed by the central bank. The Indian curve is becoming increasingly inverted. At the end of this week, gains were partially erased. The dollar appreciated at week's end against most of the emerging currencies.

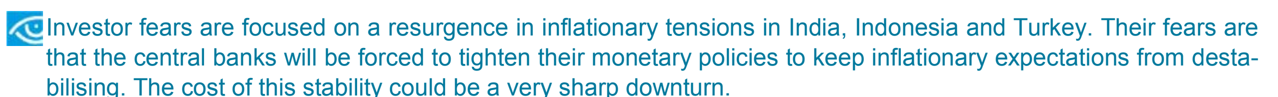

The emerging debt markets are stabilising. More encouragingly, they are eliminating the excessive behaviours deriving from flow driven markets. The downward pressures on the currencies of fragile economies (India, Indonesia, Turkey, South Africa and Brazil) will remain significant. This adjustment should be made in a context of lesser currency volatility, which should pave the way to more dispersion in performances in the debt space.

Foreign exchange

The dollar weakens abruptly after the FOMC meeting. The EUR/USD exchange rate crossed the bar of 1.35, which it had not done since early February. The dollar lost 1.3%, on average, against the developed market currencies, but the USD/JPY has remained virtually stable.

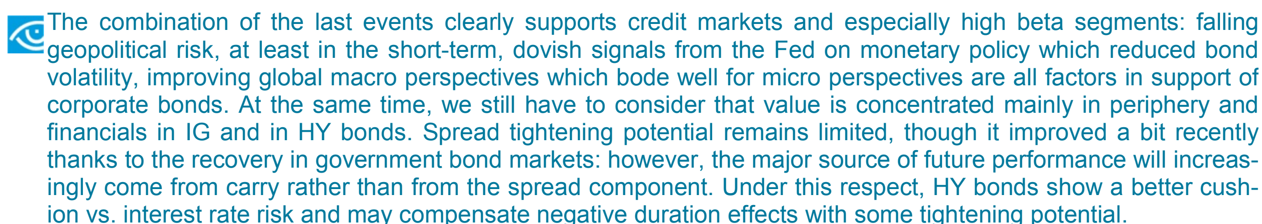

The currency market reacted more violently than the fixed-income market to the Fed's surprise status quo, with the dollar depreciating intensely. The euro's overvaluation against the dollar is increasingly apparent, and we are moving toward the zone in which Mr Draghi said, in February, that the ECB would not remain idle if it appreciated again. The risks now seem asymmetrical on the EUR/USD exchange rate, because Mr Draghi could suggest new actions by the ECB. Meanwhile, the yen's stability against the dollar is due to statements made by Takahide Kiuchu, a BoJ board member, that the markets could push the BoJ to adopt new easing measures. We maintain our scenario that the yen will depreciate against the dollar.

Emerging currencies still under pressure. After a rebound in the wake of the Fed's announcement, emerging currencies are under pressure once again. The Indonesian rupiah gave up nearly 2% against the dollar on Friday alone; the South African rand and Turkish lira fell by more than 1%. Neither the Mexican peso nor the Polish zloty are escaping this consolidation movement.


Investor fears are focused on a resurgence in inflationary tensions in India, Indonesia and Turkey. Their fears are that the central banks will be forced to tighten their monetary policies to keep inflationary expectations from destabilising. The cost of this stability could be a very sharp downturn.

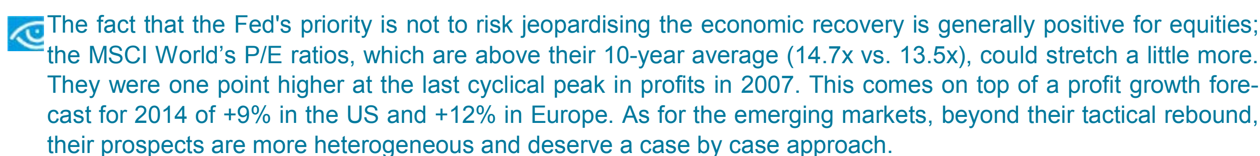
Credit

FOMC more dovish than expected outcome supported a strong recovery in credit markets. CDS once again led corporate bonds in the rally, especially among crossover and HY companies. Primary market remains quite active, confirming the steady demand for spread products also in a normalizing scenario for bond yields. Investment flows continue to be relatively more stable in Europe vs. the US, but in both cases they still are much better than flows into emerging markets.


The combination of the last events clearly supports credit markets and especially high beta segments: falling geopolitical risk, at least in the short-term, dovish signals from the Fed on monetary policy which reduced bond volatility, improving global macro perspectives which bode well for micro perspectives are all factors in support of corporate bonds. At the same time, we still have to consider that value is concentrated mainly in periphery and financials in IG and in HY bonds. Spread tightening potential remains limited, though it improved a bit recently thanks to the recovery in government bond markets: however, the major source of future performance will increasingly come from carry rather than from the spread component. Under this respect, HY bonds show a better cushion vs. interest rate risk and may compensate negative duration effects with some tightening potential.

Equity

Under the Fed's influence. The equity markets are setting new year-to-date highs in the US and Europe. The Nikkei is also rebounding, but is still 7% below its May peak. Obviously, in a first time emerging markets have benefited the most from the surprise effect created by the Fed; they are the ones which had suffered from a possible shift in US monetary policy.


The fact that the Fed's priority is not to risk jeopardising the economic recovery is generally positive for equities; the MSCI World’s P/E ratios, which are above their 10-year average (14.7x vs. 13.5x), could stretch a little more. They were one point higher at the last cyclical peak in profits in 2007. This comes on top of a profit growth forecast for 2014 of +9% in the US and +12% in Europe. As for the emerging markets, beyond their tactical rebound, their prospects are more heterogeneous and deserve a case by case approach.

Key upcoming events

Economic indicators

- **Eurozone:** PMI surveys should be good. The different opinions (IFO, GfK and consumer confidence) are expected to remain on a steep upward trend. **United States:** Watch the real estate sector.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
23 September	China	Manufacturing PMI (HSBC), September	50.9	50.1
	Eurozone	Manufacturing PMI (services), September	51.6 (51.0)	51.4 (50.7)
	Germany	Manufacturing PMI (services), September	52.0 (53.0)	51.8 (52.8)
	France	Manufacturing PMI (services), September	50.1 (49.4)	49.7 (48.9)
24 September	Germany	IFO business climate index, September	108	107.5
	US	S&P/Case-Shiller 20 house price index, YoY, September	12.5%	12.1%
	US	Consumer confidence, September	80.3	81.5
25 September	Germany	GFK consumer climate index, October	7.0	6.9
	US	Durable goods orders, MoM, August	-0.1%	-7.3%
	US	New home sales, August	425 K	394 K
26 septembre	Italy	Retail sales, YoY, July		-3.0%
27 septembre	Spain	Retail sales, YoY, August		-2.0%

Source: Bloomberg, Amundi Strategy

Auctions

- **Worth watching:** The strength of demand for Spanish and Italian auctions.

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
22 September	Germany	Short-term, € 3 bn
	France	Short-term, € 7 bn
24 September	Spain	Short-term, amounts not available on Friday
25 September	Italy	Long-term (inflation-linked bonds), amounts not available on Friday
26 September	Italy	Short-term, amounts not available on Friday
27 September	Italy	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
2 October	European Central Bank (ECB)
3-4 October	Bank of Japn (BoJ)
10 October	Bank of England (BoE)
30 October	Federal Reserve (Fed)
18 December	Federal Reserve (Fed)

Date	Upcoming political events
24-25 October	European Council
19-20 December	European Council

Source: Amundi Strategy

Market snapshot

Equity markets	20/09/2013	Over 1 week	Over 1 month	Ytd
S&P 500	1718	1.7%	3.9%	20.4%
Eurostoxx 50	2927	2.1%	5.0%	11.0%
CAC 40	4204	2.2%	4.3%	15.5%
Dax 30	8676	2.0%	4.5%	14.0%
Nikkei 225	14742	2.3%	10.0%	41.8%
MSCI Emerging Markets (close -1D)	1023	3.6%	9.7%	-3.1%
Commodities - Volatility	**20/09/2013**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent)	110	-2.7%	-1.9%	-2.2%
Gold ($/ounce)	1354	2.1%	-1.2%	-19.2%
VIX	13	-2.1	-2.9	-6.0
FX markets	**20/09/2013**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.35	1.7%	0.8%	2.5%
USD/JPY	99	0.0%	2.1%	14.7%
EUR/GBP	0.84	0.8%	-1.4%	3.9%
EUR/CHF	1.23	-0.4%	0.0%	2.0%
Fixed Income markets	**20/09/2013**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	0.08	-	--	-6 bp
Euribor 3M	0.22	--	--	+3 bp
Libor USD 3M	0.25	--	-1 bp	-6 bp
2y yield (Ger.)	0.21	-1 bp	+1 bp	+23 bp
10y yield (Ger.)	1.94	-3 bp	+10 bp	+63 bp
2y yield (US)	0.33	-10 bp	-1 bp	+8 bp
10y yield (US)	2.73	-16 bp	-9 bp	+97 bp
Eurozone Sovereigns 10y spreads vs Germany	**20/09/2013**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+51 bp	-5 bp	-5 bp	-17 bp
Austria	+39 bp	-1 bp	-4 bp	-4 bp
Netherlands	+37 bp	--	-7 bp	+18 bp
Finland	+23 bp	-1 bp	-5 bp	+2 bp
Belgium	+79 bp	-6 bp	-9 bp	+5 bp
Ireland	+171 bp	-13 bp	-18 bp	-128 bp
Portugal	+520 bp	-25 bp	+70 bp	-50 bp
Spain	+236 bp	-16 bp	-27 bp	-159 bp
Italy	+234 bp	-26 bp	-12 bp	-84 bp
Credit markets	**20/09/2013**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+99 bp	+1 bp	-3 bp	-18 bp
Itraxx Crossover	+395 bp	+3 bp	-28 bp	-87 bp
Itraxx Financials Senior	+140 bp	+2 bp	-6 bp	-1 bp

Source: Bloomberg, Amundi Strategy *6pm Paris time*

WEEKLY
Research, Strategy and Analysis

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