



# Weekly Strategy Update

19 January 2012



## SUMMARY

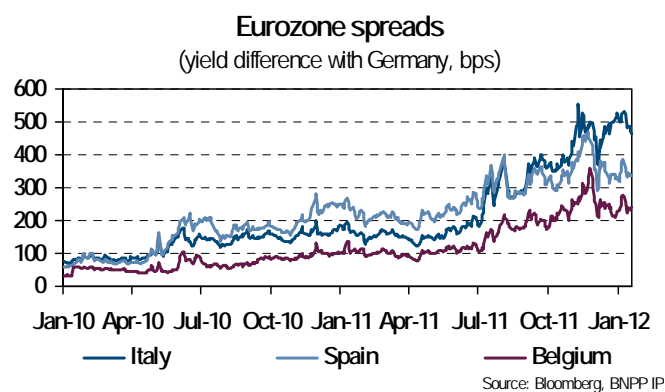
- S&P downgrades leave markets unaffected
- China moderating, not falling
- Asset allocation team takes profit on its underweight European versus US equities

Standard & Poor's, the rating agency, downgraded the debt of nine eurozone countries and of the EFSF, the eurozone bail-out fund. Markets shrugged and moved on. In fact, bond spreads fell for most of the countries after the downgrade. Data on retail sales in the US, industrial production in the eurozone and growth in China confirmed that global economic growth is slow. However, only the eurozone appears to be in recession. We left our investment strategy recommendations unchanged. In our asset allocation, we took profit on our underweight Europe versus the US. As a result, we are underweight equities with a preference for emerging markets versus developed equities.

## LIMITED IMPACT OF S&P DOWNGRADES

S&P downgraded the ratings of Cyprus, Italy, Portugal and Spain by two notches and those of Austria, France, Malta, Slovakia, and Slovenia by one notch. Austria and France thus lost their AAA-rating. As several guarantors of the EFSF were downgraded, the bail-out fund itself

also lost its AAA-rating. The downgrades by S&P underline the difficult situation in the eurozone, where austerity is being imposed in a low-growth or even recessionary environment. Markets barely reacted to the news. Only in Portugal, which was downgraded below investment-grade to junk status, did risk spreads increase.

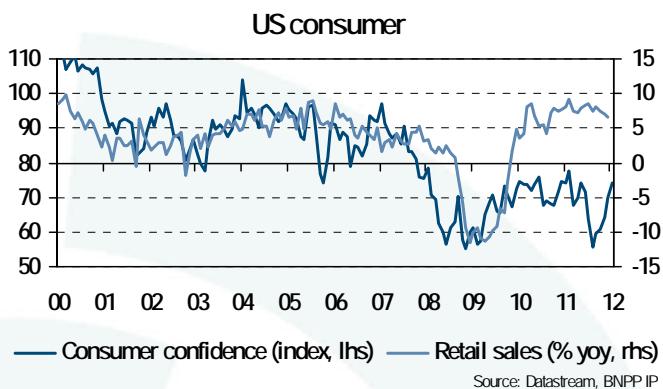


We think there are several reasons for the muted market reaction. Firstly, the downgrades were widely anticipated – risk spreads on virtually all eurozone countries' bonds widened in the second half of last year. Secondly, many eurozone countries are still very creditworthy borrowers with low default risks. Thirdly, the other rating agencies left their ratings unchanged. And lastly, the risk that lower government bond prices would lead to funding problems in the banking sector had already been significantly reduced with the ECB's unlimited three-year loans to the sector.



## US RETAIL SALES SOFTEN IN DECEMBER

After several months of strong growth, US retail sales softened in December, growing by only 0.1% MoM. Excluding volatile car and gasoline sales, core retail sales were unchanged. Retail sales were particularly strong in September and October, but grew at a slower pace in November. We have said before that strong retail sales looked unsustainable to us, as income gains are not keeping pace and household wealth is not growing. However, there are also reasons not to become too negative. The labour market has improved somewhat and consumer confidence increased further in January.



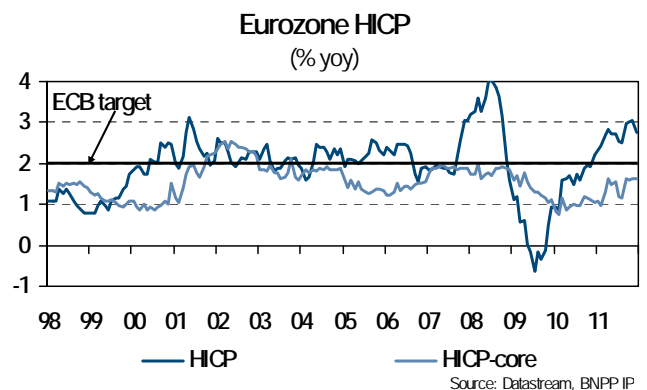
The US trade balance widened in November, in both nominal and real terms. Exports fell while imports continued to grow. With the US growing faster than Europe and its currency recently strengthening, trade will probably not add structurally to US growth in the coming quarters.

US industrial production increased 0.4% MoM in December, a bit below expectations. Production data for October were revised from -0.2% to -0.3%. The annual growth rate fell to 2.9%, the lowest pace since February 2010. However, this annual growth still reflects weak production in the spring of 2011, after the Japanese earthquake and tsunami. Looking at production data in the past few months and to the ISM-manufacturing index, the industrial sector looks to be in decent shape.

## ECB LEAVES RATES UNCHANGED

The ECB is leaving interest rates unchanged in January. The most obvious reason, underlined by ECB president Draghi in his press conference, was that the bank has been quite aggressive lately. It cut interest rates in November and December and is offering massive liquidity for a long period to the banking system. It will allot

another round of these three-year loans in February. The ECB expects inflation to stay above its target of 2% for several months, before declining to it. This makes sense to us, given the weak economy and more or less sideways moving oil prices. In fact, headline inflation in the eurozone fell from 3.0% in November to 2.7% in December. Core inflation was steady at 1.6% for the fourth straight month.



The ECB also noted that, according to some recent survey indicators, there are tentative signs of a stabilisation in activity at low levels. Last week, this was confirmed by the German ZEW-survey, which increased in January while staying decidedly in negative territory.

Industrial production in the eurozone fell in November for the third month in a row. The 0.1% MoM decline was small – indeed, smaller than expected – but production data for October were revised lower. The pattern was diverse among countries in November, but the trend is clearly down, even in core countries like Germany, France and the Netherlands.

Given the stabilisation in several leading indicators, the recession in the eurozone may be shallow. But, with all the austerity measures still in store and modest global growth, we think eurozone growth will be modest at best for some time to come.

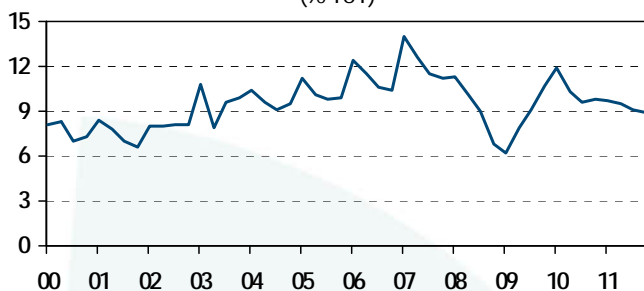
## CHINA MODERATING

China's GDP growth moderated to 8.9% YoY in the final quarter of last year. For the year as a whole, growth moderated to 9.3%, down from 10.4% in 2010. One media comment said that China was stagnating, but this is a significant overstatement. China's slightly lower growth has helped to prevent overheating. The monthly data for December showed that the gentle decline had come to a halt. Export growth was down fractionally from



13.8% YoY in November to 13.4% in December, industrial production improved slightly to 12.8% YoY and retail sales accelerated to 18.1%. The Chinese economy may slow a little further due to slow foreign growth and as a delayed effect of monetary tightening last year, but we do not foresee a hard landing. Headline inflation fell to 4.1% in December and non-food inflation to 1.9%, enabling the Chinese central bank to further ease monetary policy.

**China GDP**  
(% YoY)



Source: Bloomberg, BNPP IP

## INVESTMENT STRATEGY RECOMMENDATIONS

We have not made any changes to our investment strategy recommendations. Moderate growth in the US, a recession in Europe and a mid-cycle slowdown in emerging markets do not provide a favourable background for equities, in our view. Our investment strategy team expects markets to be volatile from time to time and that risk appetite will remain limited. The team sees the downturn in risk assets in the second half of last year as a reflection of economic fears and of the perception that sovereign risk was rising in advanced economies. The magnitude of the market reaction and high volatility also reflect structural fears about the balance of debt in mature economies, which will endure beyond the short-term economic climate. For now, the eurozone still needs to find ways to solve its problems and we thus retain our negative bias towards risky assets.

This is reflected in our negative recommendation for developed equities and our positive recommendation for gold. Regarding developed equities, with the sharp risks to future earnings due to currently high margins, high operating leverage and slower sales growth ahead, we think valuations are not as cheap as they seem. Our recommendation for emerging equities is neutral. Valuations may be attractive and monetary easing may

support emerging equities' performance versus that of developed equities, but our investment strategy team thinks that emerging equities are still driven by risk aversion and cyclical headwinds.

Our investment strategy team is neutral on bonds, including government bonds, credits and emerging bonds. As to government bonds, yields are too low to be attractive even though we do not expect them to change much. Credits should be attractive in a low-growth environment, but the team sees the downside risks from the eurozone crisis and possible higher default rates as too great to recommend credits positively.

The end-of-year rebalancing of investors' portfolios and the strength of the US dollar weighed on gold at the end of last year, in our view. However, we continue to expect investment demand to be strong in 2012, keeping prices well supported.

## GBS ASSET ALLOCATION

In our asset allocation, we have taken profit on our long-standing underweight of European equities versus US equities. We see the large spread of relative growth expectations, consensus calls for 2.2% GDP growth in the US and for close to 0% in the eurozone, as firmly negative for European equities, but two other factors reflect a relative improving situation for European equities versus US equities. The main one is the weakening of the euro against the US dollar, which is positive for export-oriented European economies such as Germany and Sweden. Our proprietary contrarian factor has also moved further into positive territory.

In our equity scorecard, our asset allocation team upgraded the economic cycle factor from negative to neutral, following recent improvements in the US and in emerging markets. We have not moved to a neutral stance on equities, though, for two main reasons. Firstly, other factors in our equity scorecard, such as the market environment and bottom-up analyst revisions are still scoring negatively. Secondly, with our overweight on emerging markets and our recent overweight on credits, we believe we currently have enough exposure to risky assets.

In very broad terms, the model portfolio is underweight equities, neutral on bonds and alternatives (real estate, commodities and convertibles) and overweight cash.



Within bonds, we are overweight credits, which should do well in a low-growth environment and which should be supported by strong corporate balance sheets. We are also overweight emerging bonds in local currencies, as they should be supported by rating upgrades and currency appreciation. We are underweight government bonds, but neutral duration, and we are underweight inflation-linked bonds, as we see the inflation trend and the relatively large exposure to eurozone peripheral countries as the main negative factors.

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