Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

July 14 - 18, 2014

Highlights of the week

- **Eurozone:** May inflation confirmed at +0.5% YoY; production in construction down.
- **United States:** retail sales up; mixed data on industry and real estate.
- **China:** GDP growth reaches +7.5% YoY in Q2.
- **Markets:** risk aversion on the rise with geopolitical risk. Safe-haven assets were favoured. Equity markets worldwide are stabilizing.

Key focus

The BRICS get their own development bank

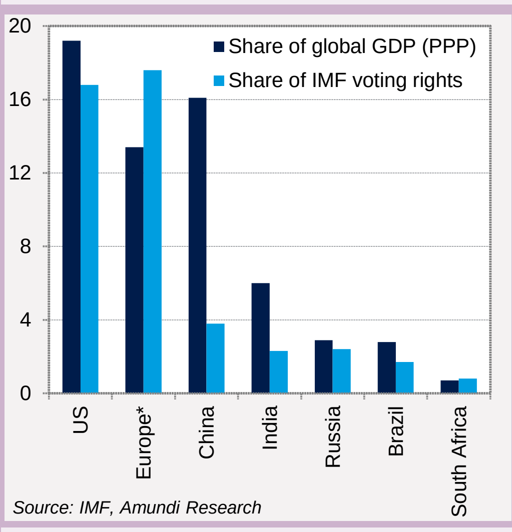
During the sixth BRICS summit held in Fortaleza, Brazil on July 15-16, **five large emerging countries, Brazil, Russia, India, China and South Africa, signed an agreement creating a development bank and a common foreign reserve.** This agreement comes as the reform of voting-rights in the IMF, which is supposed to give the BRICS more weight, has been stalled in the US Congress for months.

The aim of the development bank, which will be based in Shanghai, **will be to finance large infrastructure projects** in these countries and, subsequently, in other emerging countries. It will have a rotating chair and US$50 bn in initial capitalisation in the form of equity and guarantees. Ultimately, the development bank should hold US$100 bn.

In addition, **the BRICS also signed a "framework agreement" introducing a common foreign reserve.** The fund will hold US$100 bn, US$41 bn of which will be paid by China, US$18 bn by India, Russia and Brazil, and $5 billion by South Africa. It will become operational in 2015. **The fund's objective is to allow its members to protect themselves in case of sharp depreciation of their currencies** such as those that occured in May 2013 after the Fed's tapering was announced.

The creation of these two institutions has been a long-standing objective of the BRICS and, in itself, is good news. **These institutions are designed as a counterweight to the organisations created in the wake of the Bretton Woods agreements in 1944 (IMF and World Bank).** The BRICS feel they are underrepresented within these bodies, although they make up more than 40% of the global population and nearly 30% of global GDP in purchasing power parity in 2014. Even before seeing these two new institutions at work, many questions arise: (i) **Will the countries being aided consent to unofficial guardianship by China,** which will be the top financial contributor? (ii) Will the very different political and economic objectives pursued by the member countries allow the cohesion of these institutions? (iii) **How will the IMF and World Bank react to these emerging "counterparts"?**

An unfair allocation of IMF voting-rights



Source: IMF, Amundi Research

** In this graph, Europe is represented by the four largest countries, namely the UK, Germany, France and Italy.*

For now, **we can ask ourselves whether these two new emerging institutions will be able to work together.** In addition, the fragmentation of global economic governance into multiple organisations is highly likely to engage the will to take effective, coordinated action to re-establish global economic and financial stability. However, **by giving themselves their own bodies, the BRICS should become more and more influential and counterbalance decision-making globally.**

The week at a glance

> Economic indicators

Eurozone >

Production in construction down, particularly in Germany. Across the eurozone as a whole, construction declined 1.5% in May vs April. This is largely attributable to a sharp decrease in Germany (-4.9%, declining for the third month in a row). In France, the decrease was less severe (-0.7%), although it represented the fifth consecutive month of decline. In contrast, construction in Spain was up 1% over the month. The figure for Italy is not yet available.

Inflation was confirmed at +0.5% (year-on-year) in June, identical to the figure for May. Core inflation came in at +0.8% year-on-year, a slight increase over May's +0.7%. Based on Eurostat harmonised data, consumer price inflation was +1.0% in Germany, +0.6% in France, +0.2% in Italy and 0% in Spain.

The poor construction figures will be a drag on Q2 growth. The decline in Germany, even after a sharp rise in Q1, is a disappointment, following signs of significant slowdown in consumption and manufacturing. In France, weak construction activity is becoming a lasting trend, spelling trouble for the recovery. In Spain, however, the figures show a continuing improvement, albeit from a very weak starting point. Q2 thus probably saw a slight reduction of the divergences between the core and periphery of the eurozone, although thy remain wide in absolute terms.

Eurozone >

Retail sales up but mixed signals on manufacturing and real estate. Retail sales were up 0.2% in June, slightly failing expectations; however, this is based on a May figure that was revised up. Industrial output also rose 0.2% (also below expectations) over the same period, but from a May figure that was revised down. Meanwhile, capacity utilisation fell slightly to 79.1%. In contrast, July's Empire State Manufacturing Survey pointed to a strong expansion in the New York region. Finally, in real estate, the NAHB index (reflecting housebuilders' confidence) saw a significant recovery in July while the figures on building permits and housing starts were disappointing, declining from May's levels.

Despite the upturn that followed the soft patch in Q1, the US figures are not pointing to a spectacular surge in the recovery for the moment. The real estate sector, which is needed to generate the wealth effects that can boost household consumption, continues to disappoint compared to what was anticipated in late 2013.

China >

GDP growth reaches +7.5% YoY in Q2. Thus GDP growth was slightly higher than expectations as well as growth posted in Q1 (+7.4%). Quarter-on-quarter, GDP was up 2.0% in Q2, compared to +1.8% expected and +1.4% in Q1. Consumption and investment contributed the most to growth, with +4 percentage points (pp) and +3.6 pp respectively. Net exports contributed very slightly negatively, at -0.2 pp.

Industrial output rises and retail sales stagnate. Industrial output stood at +9.2% vs. +9.0% expected and +8.8% in May. Retail sales made gains in line with expectations, at +12.4% compared with +12.5% in May.

Although this round of cyclical indicators is encouraging, we should remain prudent on the economic outlook for the second half of the year. This slight acceleration in GDP in Q2 reflects the impact of government support more than an actual recovery. However, the breakdown of growth in GDP in Q2 demonstrates Beijing's desire to encourage growth in consumption to reduce the economy's dependence on investment and exports. Moreover, the vast majority of investment is still financed by public authorities – primarily via the credit channel, not the private sector – reinvested corporate profits or entrepreneurs' savings. In terms of risk factors, the real estate slowdown could force authorities to deploy new support measures. Nonetheless, the central government is ruling out a massive recovery plan in order to avoid feeding fears over the already very high debt of local governments. The hard-landing scenario is receding a bit further, but we are holding onto our +7.5% growth projection for 2014, with a downward bias. As a reminder, Beijing's growth target is +7.5% for 2014.

> Monetary policy

Brazil >

The Central Bank of Brazil (BCB) left the Selic policy rate unchanged at 11% at its Monetary Policy Committee meeting (COPOM) on July 16, despite inflation that hit 6.5% in June and exceeded the upper limit of the target that the Central Bank set for itself (4.5%±2%). Committee members made the same remarks as at their last COPOM: "after evaluating the macroeconomic scenario and the outlook for inflation, the COPOM decided unanimously to, at this juncture/moment, leave the Selic policy rate unchanged at 11%, without a bias."

This pause in the tightening cycle begun at the previous COPOM (May 28) comes after a 375 bp increase in the Selic rate in the space of a single year. Nonetheless, inflation is still on the increase. Elsewhere, recent inflationary tensions have been fed by a record drought driving food prices up, and by the World Cup causing hotel and airfares prices to skyrocket. Thus COPOM members expect inflation to decline in the coming months, but they are not closing the door to a continued cycle of monetary tightening; meanwhile, US rates should come back up once tapering ends. The next COPOM will be held on September 3.

Financial markets

Fixed-income

The risk of geopolitical instability is driving developed bond yields rates down as investors seek safe havens. On Thursday, the German 10-year bond yield hit its all-time low, at 1.15%. France issued €4 bn in five-year debt at 0.55% - a new all-time low. The US 10-year bond yield fell just below 2.50%. Earlier in the week, Janet Yellen's statements ("If the labor market continues to improve more quickly than anticipated by the Committee, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned") had driven US bond yields up slightly and flattened the curve, especially on the five-to-10-year segment. Note that Canadian yields dropped furthest over the week, in response to a very cautious Monetary Policy Committee Meeting on the inflation trend. Finally, peripheral spreads fell to a similar extent to the previous week's increase.

As has been the case since the start of the year, the US yield curve is divided into parts, with yields of maturities of five years or less especially sensitive to Fed members' statements and developments in the labour market, and yields of longer maturities much more sensitive to geopolitical risks and bad news on growth. So this is no standard bear flattening, because, since the year began, the two- and three-year rates have risen, the five-year rate has dipped slightly (10 bp), and yields for longer maturities have fallen much more substantially. German yields will stay low, for an extended period. Finally, the tightening of peripheral spreads is showing signs of obvious collapse, and now more than ever, liquidity should be the priority.

Foreign exchange

Yellen's statements (*cf.* fixed income section) and the risk of geopolitical instability are shoring up the US dollar, which appreciated over the week against virtually all currencies, specifically European currencies (EUR, SEK, HUF, CZK and PLN). The EUR/GBP parity hit a new low since August 2012. The New Zealand dollar lost 1.5% against the US dollar, with the publication of lower-than-expected inflation (1.6% year-on-year in Q2). The ruble lost 2.2% against the dollar, returning to a more than two-month low. The Brazilian real also lost ground in response to poor statistics on the jobs front. Finally, note that the one-month implied volatility of the USD/JPY exchange rate hit a new all-time low on Thursday.

We keep the idea of a gradual appreciation of the US dollar compared to developed currencies over the second half of the year. Note that, despite geopolitical uncertainties, the yen – traditionally a safe-haven currency – is not appreciating against the US dollar; the evolution of this parity being asymmetrical.

Credit

The credit markets widened slightly, affected by geopolitical tensions with Russia. The primary market slowed down, and will probably not get going again until early September. The euro and dollar credit markets are now showing very low yields (Euro IG: 1.5%, US IG: 3.0%, Euro HY: 3.7%, US HY: 5.4%). Sovereign rates are at (or nearing) all-time lows. Volatility indexes on the various asset classes (equities, currencies, rates) are also going extremely low.

Interest for credit products is driven by low sovereign rates. And the credibility of monetary policy played a large part in reducing the markets' volatility. The Fed is remaining very cautious about the still-fragile US economic recovery. The ECB could announce new non-conventional measures to combat low inflation and fragmentation that persists in the eurozone. In this context, credit is still attractive.

Equity

Despite further signs of tension with Russia, the MSCI World equity index was back in drive this week and now perches quite close (-0.5%) to its all-time highs of July 3. All of the major regions were in on this upward movement, including Europe. This is an important detail because, for four weeks, Europe had stood out for moving in the opposite direction of the other regions.

While the fundamentals remain mixed – confirmation of a slow recovery, with the latest indicators rather disappointing – this good performance by equities underlines the lack of any real alternative: most bond yields have sunk quite low after falling again since the start of the year. Elsewhere, the proliferation of M&As, with Pharmaceuticals and Media in the forefront, has also inspired optimism. Note, too, that after dropping 10% since June 10, equities in the eurozone banking sector seem to want to stay where they are; operators have put the systemic nature of Portuguese bank Espirito Santo in perspective. In the next few days, in addition to geopolitical tensions, we will be watching the earnings season very closely. We will also remain vigilant toward the US market. It has done very well up to this point, but could be challenged by the autumn, with the actual end of the Fed's QE in October and mid-term elections in November.

Key upcoming events

Economic indicators

US: June's real estate figures are expected to be relatively stable, just like inflation. **Eurozone:** July's PMI surveys should be stable. **United Kingdom:** GDP growth in Q2 is expected up 0.8% over Q1.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
22 July	US	CPI, MoM, June	0.3%	0.4%
	US	Existing home sales, June	4,970 K	4,890 K
23 July	Eurozone	Consumer confidence, July	-7.5	-7.5
24 July	China	Manufacturing PMI (HSBC), July	51.0	50.7
	Italy	Retail sales, MoM, May		0.4%
	Eurozone	Manufacturing PMI (Germany, France), July	51.7	51.8
	Eurozone	Services PMI (Germany, France), July	52.7	52.8
	UK	Retail sales, MoM, June	0.3%	-0.5%
	US	Manufacturing PMI, July	57.5	57.3
	US	New home sales, June	478 K	504 K
25 July	Japan	Core CPI, YoY, June	3.3%	3.4%
	Germany	GfK business climate index, August	8.9	8.9
	Germany	IFO business climate index, July	109.4	109.7
	UK	GDP, QoQ, Q2	0.8%	0.8%
	US	Durable goods orders, MoM, June	0.5%	-0.9%

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
21 July	France	Short-term, € 7.5 Bn
22 July	Spain	Short-term, amounts not available on Friday
	ESM	Short-term, € 1.5 Bn

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
30 July	Federal Reserve (Fed)
7 August	European Central Bank (ECB)
7 August	Bank of England (BoE)
8 August	Bank of Japan (BoJ)
17 September	Federal Reserve (Fed)

Date	Upcoming political events
10 August 2014	Presidential election in Turkey
October 2014	Presidential election in Brazil
November 2014	Midterm election in US

Source: Amundi Strategy

Market snapshot

Equity markets	18/07/2014	Over 1 week	Over 1 month	Ytd
S&P 500	1971	0.2%	0.7%	6.6%
Eurostoxx 50	3161	0.1%	-3.6%	1.7%
CAC 40	4332	0.4%	-4.4%	0.8%
Dax 30	9704	0.4%	-2.3%	1.6%
Nikkei 225	15216	0.3%	0.7%	-6.6%
MSCI Emerging Markets (close -1D)	1063	0.4%	1.7%	6.0%
Commodities - Volatility	**18/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	106	0.5%	-6.8%	-4.0%
Gold ($/ounce)	1307	-2.3%	2.3%	8.9%
VIX	13	0.5	1.9	-1.2
FX markets	**18/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.35	-0.7%	-0.5%	-1.8%
USD/JPY	101	0.1%	-0.8%	-3.8%
EUR/GBP	0.79	-0.4%	-1.2%	-4.8%
EUR/CHF	1.21	0.1%	-0.2%	-1.0%
Fixed Income markets	**18/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	0.04	-1 bp	+2 bp	-41 bp
Euribor 3M	0.20	--	-1 bp	-9 bp
Libor USD 3M	0.23	--	-	-1 bp
2Y yield (Germany)	0.03	+1 bp	-1 bp	-18 bp
10Y yield (Germany)	1.15	-5 bp	-22 bp	-78 bp
2Y yield (US)	0.47	+2 bp	+3 bp	+9 bp
10Y yield (US)	2.48	-4 bp	-11 bp	-55 bp
Eurozone Sovereigns 10Y spreads vs Germany	**18/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+42 bp	-2 bp	-5 bp	-21 bp
Austria	+26 bp	-2 bp	-6 bp	-8 bp
Netherlands	+21 bp	-1 bp	-3 bp	-10 bp
Finland	+15 bp	-2 bp	-6 bp	-5 bp
Belgium	+42 bp	-2 bp	-7 bp	-21 bp
Ireland	+112 bp	+1 bp	+3 bp	-47 bp
Portugal	+251 bp	-15 bp	+36 bp	-169 bp
Spain	+145 bp	-11 bp	+7 bp	-77 bp
Italy	+164 bp	-5 bp	+16 bp	-56 bp
Credit markets	**18/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+61 bp	-1 bp	+1 bp	-9 bp
Itraxx Crossover	+250 bp	+3 bp	+16 bp	-37 bp
Itraxx Financials Senior	+69 bp	-2 bp	+7 bp	-18 bp

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

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