Amundi ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

July 21 - 25, 2014

Highlights of the week

- **World:** the IMF lowered its 2014 growth forecast to +3.4%, but maintained its 2015 prediction at +4%.
- **Eurozone:** mixed signals for the business climate. The contraction in bank lending slows.
- **United States:** inflation stable above 2%; real estate and durable goods orders figures mixed.
- **China:** sharp rebound in manufacturing output in July.
- **Markets:** euro below $1.35. Solid start to the earnings season.

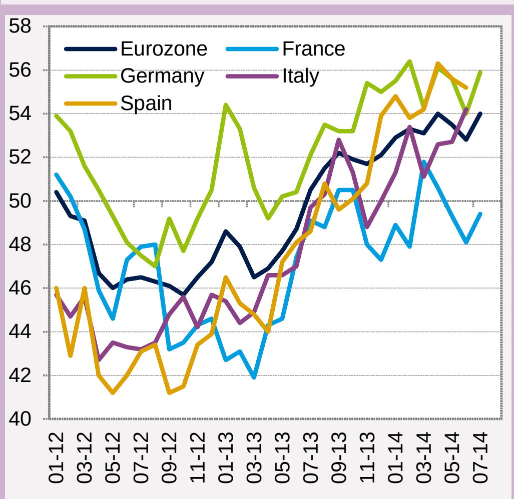
Key focus

The Eurozone's Brave New World: the debt burden keeps muting the recovery

After rather dismal readings in the past few months, the PMIs have come out this month with a promise of a marked rebound in the Eurozone, with the essential exception of France though. Indeed, the soft data indicate that economic activity should bounce back to a three-year high in the third quarter of this year, after output statistics came out frustratingly low in the first quarter. Meanwhile, the second quarter could even have ended with activity fully flat (i.e. growth at 0%) in Germany, according to the Bundesbank, and the French official forecast will surely be revised down.

This raises question of whether the recovery is finally gaining traction after a false start a year ago, when the recession was hastily declared over in the Eurozone after good GDP data for 2013-Q2. So far, the recovery appears to have followed an "on/off" path and remained more elusive than real to the extent that rebounds heave been rather short-lived. All this is taking place in a global context that might well be taking a low-flation/low growth turn, if only based on America's performance so far, a factor whose impact is likely to be compounded by China's difficult property bubble-burst.

Composite PMI in Eurozone



Source: Markit, Amundi Research

While these external engines of growth seem unavailable to fuel a proper recovery, growth in the Eurozone continues to be held back also by the excessive and, above all, rising burden of its debts. Lack of economic activity is now making (public and private) debts less sustainable by the day, if only because of the following mechanical impact: as long as (nominal) output rises at a slower pace than the stock of debt, the debt service is bound to eat a growing share of the wealth created each year, unless it is substantially reduced, one way or another, so as to let private agents breathe again.

The ultimate question is thus: can the Eurozone shift its current macro-economic strategy in such a way to alleviate this concern? The answer is: it looks like a close call, even with the help of the ECB. Indeed, the ECB is expected to help in two respects: (i) with the Asset Quality Review, meant to rid bank balance sheets of impaired assets and allow them to start lending again; (ii) with further non-conventional measures, €400bn of T-LTRO plus potentially some form of credit easing if not a proper Quantitative Easing for the eurozone (QE-Z). Crucially though, fiscal policy will not be of assistance in this regard.

Since two levers are out of the Eurozone's leadership hands (the global environment and fiscal policy), the fate of the recovery is thus dependent on a real debt-burden alleviation, by the ECB or someone else. The issue at hand is thus whether the ECB will go for non-conventional measures early and large enough to reverse today's incipient debt-deflation dynamics. This seems to be the case, as the euro-dollar has resumed its downward trend through the 1.35 level. However, based on the announced liquidity injections of €400bn in the autumn, the ECB's implicit target of 1.20 remains far.

The week at a glance

> Economic indicators

World >

The IMF lowered its global economic growth forecast for 2014 and kept it unchanged for 2015. For 2014, the bank projects global GDP growth of 3.4% (vs. 3.7% projected in April). For 2015, it still predicts 4% growth with, on the whole, a slight upward adjustment for the developed countries, and a slight downward one for the emerging countries.

The bulk of the downward revision for 2014 is due to the poor performance by the US economy and by that of several large emerging countries at the start of the year. For 2015, the bigger picture remains that of moderate acceleration in global growth driven by improvement in the developed countries. We are seeing a slight increase in the 2015 forecast for the United States (+3% vs. +2.9% previously), the eurozone (+1.5% vs. 1.4%), the United Kingdom (+2.7% vs. +2.5%) and Japan (+1.1% vs. +1%). Within the eurozone, the 2015 projection for Spain was revised sharply upward (+1.6% vs. +1%) while France's was lowered (+1.4% vs. +1.5%). Among the major emerging countries, we are seeing several downward adjustments, for China (+7.1% vs. +7.3%), Brazil (+2% vs. +2.6%) and, above all, Russia (+1% vs. +2.3%).

Eurozone >

Mixed signals for the business climate. Though preliminary PMI indexes for July were higher than expected, except for manufacturing in France (see page one), this is not the case for the German IFO index, which fell again for the third consecutive month. This downturn involves both the IFO's current situation component and its expectations component.

Contraction of bank lending slowed. Bank lending to the private sector fell back -1.7% over one year in June, a lesser contraction than in May (-2%). The downturn was -0.6% on real estate lending (vs. -0.7% in May) and -2.3% on business lending (vs. -2.6% in May).

The eurozone recovery plods along. Financial reparation continues, but the IFO (like the ZEW last week) shows that the sharp deceleration in the German economy in Q2 may have spilled over into the start of Q3. The rise in geopolitical tensions (especially in Ukraine) may be a factor.

United States >

Inflation stable above 2%; real estate and durable goods orders figures mixed. The rise in consumer prices was 2.1% over one year in June – a pace unchanged from May. Not including volatile components, prices decelerated slightly (+1.9% vs. +2% in May). On the real estate market, although existing home sales exceeded expectations in June, new home sales were a major disappointment. Conversely, the PMI manufacturing index fell slightly, though it stayed high (56.3 in July, down from 57.3 in June). Lastly, durable goods orders ex-defence and aviation rose more than expected, but from a May figure that had been revised significantly downward.

Though the US economy is continuing its rebound after the decline in activity in Q1, weakness in the real estate sector – essential for generating the "wealth effects" that support consumer spending – is ongoing. Moreover, a sign of a major pick-up in investment still remains to be seen.

China >

Sharp rebound in manufacturing output in July. According to the flash estimate, the HSBC manufacturing PMI stood at 52.0 in July vs. 51.0 expected and 50.7 in June. This is its highest point since January 2013, and for the second consecutive month, it is in the territory of expanding activity (>50). The new orders sub-index stood at 53.7, an 18-month high.

After the trough of Q1, it does appear that the recovery plan introduced by Beijing at the start of Q2 continues to underpin manufacturing activity as the second half begins. Even though the central government has ruled out a massive recovery plan, monetary policy should remain accommodating, to ensure the recovery's consolidation. However, there are still significant pitfalls. The slowdown in real estate could seriously undermine the Chinese economy in the second half of the year.

> Financial markets

Fixed-income

Bond yields rose slightly during the week, nothing spectacular, +2 bp in Germany (1.18%), and +4 bp in the US (2.52%) and UK (2.61%). Japanese bond market is still isolated, with a decline by 1 bp at 0.53%. Sovereign spreads slightly down during the week, the current context pleading in favour of search for yield and spread. The top performer of the week was Greece, with the 10-year spread down 10 bp at 498 bp. Italy (-7 bp) and Spain (-6 bp) trade at 155 bp and 138 bp respectively.

Foreign exchange

No big move during the week, apart from the EUR/USD parity, currently below 1.35. Emerging currencies globally stable during the week, including the ruble which remains stable against the dollar despite the recent event.

Credit

The credit markets performed well in the beginning of the week, underpinned by solid eurozone figures (PMI) and positive surprises in China. CDS indices reacted positively. Spreads on the majority of corporate bonds also tightened. They have now returned to the levels witnessed before the 2008 crisis.

Demand for credit products was driven by weak sovereign rates and central banks' accommodating monetary policies. The yields offered are extremely low. Against this backdrop, securities with poor liquidity should be avoided.

Equity

Equities hold better this week, with a rather promising earnings season. The European markets slightly picked up after a few weeks of poor performance. Of the first 168 companies in the S&P 500 to publish, the surprises were positive in 65% of cases for sales, and 77% for earnings. Europe, which publishes with some delay with the US, is a little less significant. Yet of the first 105 companies, the ratios are also fairly encouraging (52% for sales and 57% for profits).

The leading US market is showing more and more signs of maturity: high margins, High Yield spreads topping out, and performance vs volatility at extreme levels. The market's vulnerability to a 10-15% drop increases in the second part of the year. The approaching end to QE slated for October, mid-term elections (November 4), and a possible resumption of budget talks could serve as catalysts. Yet until then, earnings, which at first look are better than expected, are shoring up the markets.

Key upcoming events

Economic indicators

US: GDP growth for Q2 is expected at +3.0% annualized qoq. Real estate market figures are expected to decline slightly. **Eurozone:** inflation is expected to be stable in July.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
28 July	US	Pending home sales, MoM, June	0.2%	6.1%
29 July	US	S&P/Case-Shiller 20 house price index, YoY, May	9.8%	10.8%
	US	Consumer confidence, July	85.5	85.2
30 July	Spain	GDP, QoQ, Q2	0.5%	0.4%
	Germany	CPI, YoY, July	0.8%	1.0%
	US	GDP, QoQ annualized, Q2	3.0%	-2.9%
31 July	Italy	CPI, YoY, July	0.2%	0.3%
	Eurozone	CPI, YoY, July	0.5%	0.5%
	Eurozone	Unemployment rate, June	11.6%	11.6%
1 August	China	Manufacturing PMI, July	51.3	51.0
	Brazil	Industrial production, YoY, June		-3.2%
	US	Core PCE, MoM, June	0.1%	0.2%
	US	Change in nonfarm payrolls, July	230 K	288 K
	US	Manufacturing ISM index, July	56.0	55.3

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
28 July	Italy	Long-term (inflation-linked bonds), amounts not available on Friday
	Italy	2 years, € 2 Bn
	Germany	Short-term, € 2 Bn
	France	Short-term, € 8 Bn
30 July	Italy	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Worth watching: another US$10 bn reduction in securities buying volume is expected at the FOMC.

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	25/07/2014	Over 1 week	Over 1 month	Ytd
S&P 500	1978	0.0%	0.9%	7.0%
Eurostoxx 50	3175	0.3%	-2.4%	2.1%
CAC 40	4331	-0.1%	-2.9%	0.8%
Dax 30	9644	-0.8%	-2.3%	1.0%
Nikkei 225	15458	1.6%	1.3%	-5.1%
MSCI Emerging Markets (close -1D)	1081	1.7%	3.8%	7.8%
Commodities - Volatility	**25/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	106	0.4%	-6.6%	-4.1%
Gold ($/ounce)	1298	-1.0%	-1.6%	8.1%
VIX	12	0.4	0.8	-1.3
FX markets	**25/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.34	-0.7%	-1.5%	-2.4%
USD/JPY	102	0.5%	0.0%	-3.4%
EUR/GBP	0.79	0.0%	-1.5%	-4.9%
EUR/CHF	1.21	0.0%	-0.1%	-1.0%
Fixed Income markets	**25/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	0.04	-	--	-40 bp
Euribor 3M	0.21	+1 bp	-	-8 bp
Libor USD 3M	0.23	-	-	-1 bp
2Y yield (Germany)	0.03	-	--	-19 bp
10Y yield (Germany)	1.15	-1 bp	-11 bp	-78 bp
2Y yield (US)	0.49	+1 bp	+1 bp	+11 bp
10Y yield (US)	2.48	--	-8 bp	-55 bp
Eurozone Sovereigns 10Y spreads vs Germany	**25/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+41 bp	-1 bp	-3 bp	-22 bp
Austria	+25 bp	-1 bp	-6 bp	-9 bp
Netherlands	+20 bp	-1 bp	-4 bp	-11 bp
Finland	+14 bp	-1 bp	-7 bp	-6 bp
Belgium	+39 bp	-2 bp	-6 bp	-23 bp
Ireland	+110 bp	-2 bp	--	-49 bp
Portugal	+249 bp	-2 bp	+30 bp	-171 bp
Spain	+139 bp	-5 bp	+1 bp	-83 bp
Italy	+157 bp	-6 bp	-2 bp	-63 bp
Credit markets	**25/07/2014**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+61 bp	-	+2 bp	-9 bp
Itraxx Crossover	+250 bp	-	+16 bp	-37 bp
Itraxx Financials Senior	+68 bp	-1 bp	+7 bp	-19 bp

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