Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis WEEKLY

Letter finalised at 3pm Paris time March 23 - 27, 2015

Highlights of the week

- **Europe:** New signs of improvement. S&P raises Hungary's sovereign rating.
- **United States:** Divergent signals. A few indicators were improving.
- **Emerging markets:** In China, the flash HSBC manufacturing PMI the lowest in 11 months. The Brazilian GDP for the Q4 2014 is negative at -0.2% yoy.
- **Markets:** Developed market rates were at a standstill and dollar was down against virtually all currencies. CDS were less resilient than cash bonds. Consolidation week on equity markets.

Key focus

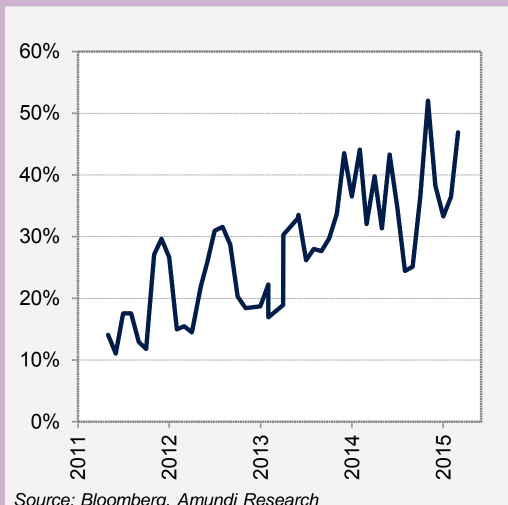
The search for yield continues!

The announcement of a large-scale quantitative easing (QE) programme has amplified the easing of Eurozone sovereign bond yields. The current German 10-year rate is positioned around 0.21%, a 23 bp decline since the QE programme was officially announced on January 22. Conversely, the credit markets have not displayed any dominant trends since then. The HY and IG indices hit their lowest point in late February, before spreading once again to return to their pre-ECB announcement levels. How can we explain these mixed performances? And why are we staying positive on the medium-term euro credit markets?

The credit markets' disappointing performance can be explained by:

- **The primary market's strong trend.** This surge in popularity weighed down the cash markets. Volumes of new issues on the IG segment total €120 bn year-to-date. This rebound in activity is tied to the arrival of US issuers, drawn by exceptionally low interest rates. Thus non-Eurozone companies make up half of funds raised over the first months of the year – a number well above the one seen in 2014 (see graph). This enthusiasm is also visible on the high yield market, with a spate of first-time issuers and issuers rated B or lower.
- **The extremely low yields.** This limits the potential for spreads to tighten. The IG and HY yields are now at historically low levels (respectively: 0.9% and 3.8%).

Euro bonds issued by non-Eurozone IG companies (in % of total volume)



Source: Bloomberg, Amundi Research

The current pace of issuance reflects the willingness of corporates to take advantage of low interest rates. This trend should continue in 2015**. Nonetheless, we are staying positive on the euro credit markets:**

- **The ECB's QE is truly going to change the game for euro bond markets.** The additional €60 bn in monthly demand for 19 months (for a total of €1,140 bn) is a radical departure for the supply/demand balance on the euro bond markets. Remember, the ECB's purchases will be made in a market that is growing very slowly. Expansion of the euro sovereign market is slowed by restrictive fiscal policies. For example, in 2014 the net supply of long-maturity sovereign debt came close to €200 bn – a much lower amount than the €600 bn in sovereign debt purchases planned by the ECB. This asymmetry will drag down sovereign rates: the share of outstanding debt offering negative yield is growing fast.
- **By itself, the QE's announcement had significant consequences on investment flows.** The analysis of data published by EPFR shows an acceleration in weekly flows toward funds, and the ETFs invested in the primary European asset classes of the universe of risky assets. In the seven weeks that followed the ECB's announcement, nearly €3.3 bn was invested in IG funds – an average weekly inflow of €470 million, versus an average of €95 million in H1 2014 and €255 million in H2 2014. The European HY market analysis shows an even more marked rebound and an acceleration in demand for that asset class.

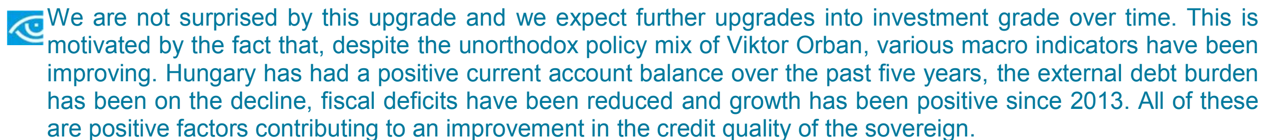
The ECB's purchases will maintain appetite for credit, faced with the lasting weakness of sovereign rates. We expect a compression of spreads and of yields in the euro market.

The week at a glance

> Other events

Hungary>

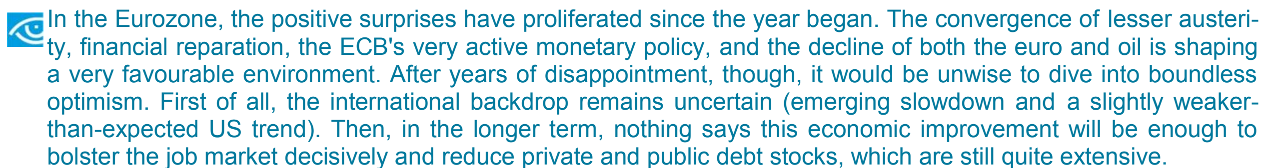
On March 20, Standard & Poor's raised to BB+/stable the sovereign rating of Hungary from BB. The Agency mentioned the reduction in the external imbalances, lower exposure of the banking sector to exchange rate risk and hence reduced vulnerability to external shocks, among the main reasons for the upgrade. Currently Hungary is rated Ba1 stable by Moody's and BB+ stable by Fitch.


We are not surprised by this upgrade and we expect further upgrades into investment grade over time. This is motivated by the fact that, despite the unorthodox policy mix of Viktor Orban, various macro indicators have been improving. Hungary has had a positive current account balance over the past five years, the external debt burden has been on the decline, fiscal deficits have been reduced and growth has been positive since 2013. All of these are positive factors contributing to an improvement in the credit quality of the sovereign.

> Economic indicators

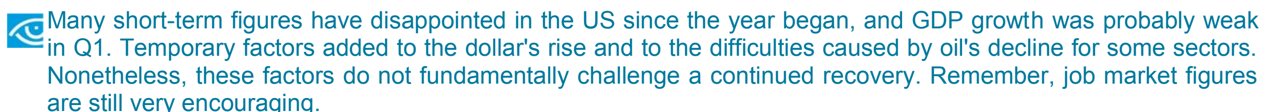
Eurozone >

New signs of improvement. The Eurozone's **Composite PMI index** (preliminary estimate) rose to 54.1 in March (vs. 53.3 in February and 53.6 expected). The German Composite **PMI index** also improved, while France's eased (but stayed at a level indicating expansion). The German **IFO index** rose again to 107.9 (compared to 107.3 expected and 106.8 in February), reaching its highest level since August 2014; its two components (current situation and expectations) improved. **Lending to the private sector** declined by only -0.1% over one year in February, compared to -0.2% in January (excluding securitisation, it was up +0.6%). **M1 and M3 monetary aggregates** were up in February by +4.0% and +9.1% respectively over one year (vs. +3.8% and +8.9% in January). **Construction sector output** rose +1.9% in January (after falling back -0.8% in December). Over one year, the increase was +3.0%. France's **budget balance in 2014** was -4.0% of GDP, better than the official target (-4.4%). Finally, the central banks of Spain and Portugal increased their **GDP growth forecasts** (+2.8% vs a previous forecast of +2.0% for Spain, +1.7% vs a previous forecast of +1.5% for Portugal).


In the Eurozone, the positive surprises have proliferated since the year began. The convergence of lesser austerity, financial reparation, the ECB's very active monetary policy, and the decline of both the euro and oil is shaping a very favourable environment. After years of disappointment, though, it would be unwise to dive into boundless optimism. First of all, the international backdrop remains uncertain (emerging slowdown and a slightly weaker-than-expected US trend). Then, in the longer term, nothing says this economic improvement will be enough to bolster the job market decisively and reduce private and public debt stocks, which are still quite extensive.

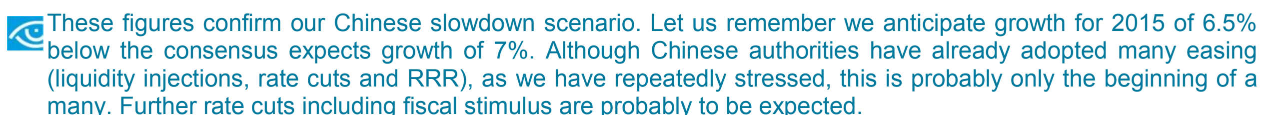
United States >

Divergent signals. A few indicators were improving. Thus, **sales of new homes** far exceeded expectations in February (539,000 on an annualised basis, the highest number since February 2008. Meanwhile, **sales of existing homes** were very close to expectations (4.88m on an annualised basis). The preliminary estimate of the Composite PMI index came to 58.6 in March (vs. 57.1 in February). But other numbers continued to fall short. Thus, **durable goods orders**, which were expected up slightly, fell back -1.4% in February. The orders excluding defence and aviation (used to predict corporate investment expenditures) also fell by -1.4%. Furthermore, January's durable goods order figures were adjusted downward. **Consumer prices** were stable, over one year, in February (after a -0.1% decline in January), while prices ex food and energy rose +1.7% (vs. +1.6%). Finally, **Q4 2014 GDP** growth was confirmed at +2.2% (annualized, 3d estimate).


Many short-term figures have disappointed in the US since the year began, and GDP growth was probably weak in Q1. Temporary factors added to the dollar's rise and to the difficulties caused by oil's decline for some sectors. Nonetheless, these factors do not fundamentally challenge a continued recovery. Remember, job market figures are still very encouraging.

China >

The flash HSBC manufacturing PMI stood at 49.2 in March against 50.7 in February, the lowest in 11 months. The consensus expected a figure much higher at 50.5. The index of new orders also declined from 51.2 to 49.3, while export orders increased slightly. Other indicators such as production, employment, purchases and property prices also fell.

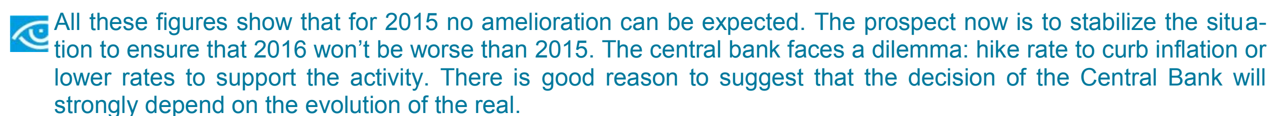

These figures confirm our Chinese slowdown scenario. Let us remember we anticipate growth for 2015 of 6.5% below the consensus expects growth of 7%. Although Chinese authorities have already adopted many easing (liquidity injections, rate cuts and RRR), as we have repeatedly stressed, this is probably only the beginning of a many. Further rate cuts including fiscal stimulus are probably to be expected.

Brazil > **The Brazilian GDP for the Q4 2014 is negative (-0.2% yoy),** but less degraded than expected by the consensus that was counting on -0.7% and above better from the previous (-0.6%). However, this improvement may only be temporary in that other monthly indicators are far from positive.

The **unemployment rate** stood at 5.9% in February, above the consensus (5.7%) and a year ago (5.1%). Real wages also fell for the first time since October 2011 (-0.5% yoy in February).

According to the quarterly report on **inflation**, inflation in 2015 should be about 8% and should stay above the target of 4.5% (±2%) and back to 5% at the end of 2016.

Other indicators were bearish: foreign direct investment, government revenues, etc. Only positive sign, even if it could be interpreted as such, a less deteriorated current account but that seems to be more due to a contraction in domestic demand (lower imports) that an increase in exports.



All these figures show that for 2015 no amelioration can be expected. The prospect now is to stabilize the situation to ensure that 2016 won't be worse than 2015. The central bank faces a dilemma: hike rate to curb inflation or lower rates to support the activity. There is good reason to suggest that the decision of the Central Bank will strongly depend on the evolution of the real.

> Financial markets

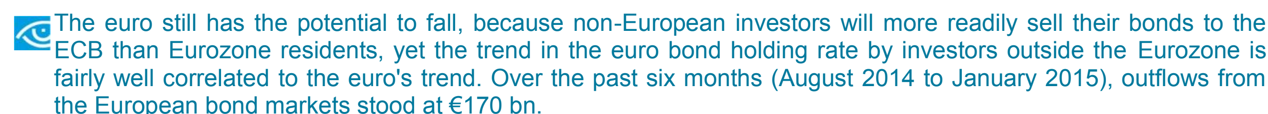
Fixed-income

Developed market rates were at a standstill, staying virtually stable over the week. The German and US 10-year rates closed out the week at 0.20 and 1.96%, respectively.

Throughout the year, the ECB's QE will exercise strong downward pressure on European rates. The rise in US rates will be limited.

Foreign exchange

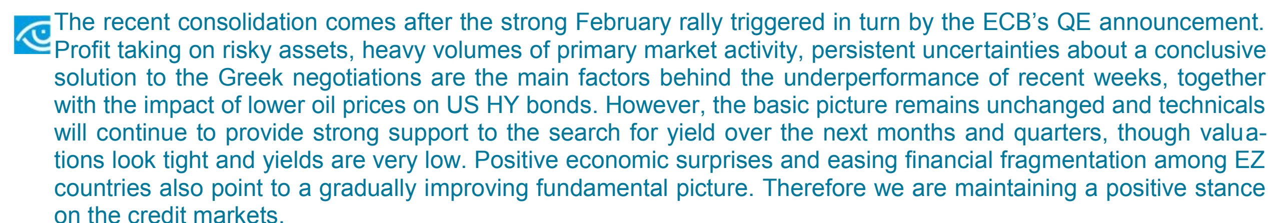
The dollar was down against virtually all currencies except the pound. The EUR/USD exchange rate neared 1.10, and the USD/JPY exchange rate fell slightly under 120.



The euro still has the potential to fall, because non-European investors will more readily sell their bonds to the ECB than Eurozone residents, yet the trend in the euro bond holding rate by investors outside the Eurozone is fairly well correlated to the euro's trend. Over the past six months (August 2014 to January 2015), outflows from the European bond markets stood at €170 bn.

Credit

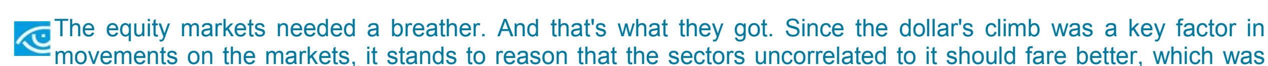
CDS were less resilient than cash bonds to higher peripheral bond spreads and profit-taking on European equities over the week. European HY spreads moved wider by only a few basis points while the Itraxx crossover proved to be more closely correlated to weaker risky assets. Uncertainties on the issue of Greek reforms weighed on credit markets, but at the same time economic surprises were generally positive, sustaining the investment case for higher beta corporate bonds such as BBB-rated, financial and speculative grade bonds. The primary market is getting busy again, probably also ahead of the Easter holidays, following a less torrid path over the last several days.



The recent consolidation comes after the strong February rally triggered in turn by the ECB's QE announcement. Profit taking on risky assets, heavy volumes of primary market activity, persistent uncertainties about a conclusive solution to the Greek negotiations are the main factors behind the underperformance of recent weeks, together with the impact of lower oil prices on US HY bonds. However, the basic picture remains unchanged and technicals will continue to provide strong support to the search for yield over the next months and quarters, though valuations look tight and yields are very low. Positive economic surprises and easing financial fragmentation among EZ countries also point to a gradually improving fundamental picture. Therefore we are maintaining a positive stance on the credit markets.

Equity

Consolidation week. The dollar's decline and the rise in oil prices (geopolitical tensions in Yemen) were a pretext for the markets to consolidate after the early-year surge. This was especially true for Eurozone markets, but Wall Street was not benefiting either. In Europe, alongside the oil producers, banks held up better than most other sectors.



The equity markets needed a breather. And that's what they got. Since the dollar's climb was a key factor in movements on the markets, it stands to reason that the sectors uncorrelated to it should fare better, which was

true for the European banks. This consolidation is healthy, and should be temporary. We expect the equity markets to move above current levels on a twelve-month horizon.

Key upcoming events

Economic indicators

United States: employment figures for March are expected to be strong overall. **Eurozone:** core inflation is expected at +0.7% in March. **China:** the official manufacturing PMI is expected down and still in contraction territory.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
30 March	US	Existing home sales, MoM, February	0.4%	1.7%
31 March	Eurozone	Core CPI, YoY, March	0.7%	0.7%
1 April	China	Manufacturing PMI, March	49.7	49.9
	US	Manufacturing ISM, March	52.5	52.9
	Brazil	Industrial production, YoY, February	-9.0%	-5.2%
3 April	China	Services PMI HSBC, March		52.0
	US	Change in nonfarm payrolls, March	250 K	295 K
	US	Unemployment rate, March	5.5%	5.5%

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
30 March	France	Short-term, € 7 Bn
	Italy	Long-term, € 7.5 Bn
1 April	Germany	5 years, € 4 Bn
2 April	France	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
8 April	Bank of Japan (BoJ)
9 April	Bank of England (BoE)
15 April	European Central Bank (ECB)
29 April	Federal Reserve (Fed)
17 juin	Federal Reserve (Fed)

Date	Upcoming political events
May 2015	General election in United Kingdom
	General election in Spain
June 2015	General election in Turkey
July 2015	General election in Mexico
October 2015	General election in Argentina

Source: Amundi Strategy

Market snapshot

Equity markets	27/03/2015	Over 1 week	Over 1 month	Ytd
S&P 500	2059	-2.3%	-2.2%	0.0%
Eurostoxx 50	3671	-1.5%	2.0%	16.7%
CAC 40	5019	-1.3%	1.4%	17.5%
Dax 30	11861	-1.5%	4.0%	21.0%
Nikkei 225	19286	-1.4%	2.6%	10.5%
MSCI Emerging Markets (close -1D)	962	-0.7%	-2.8%	0.6%
Commodities - Volatility	**27/03/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	56	5.4%	-9.3%	0.6%
Gold ($/ounce)	1200	1.5%	-1.1%	1.5%
VIX	15	2.5	2.1	-3.7
FX markets	**27/03/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.09	0.5%	-2.9%	-10.2%
USD/JPY	119	-0.8%	-0.5%	-0.6%
EUR/GBP	0.73	0.8%	0.6%	-6.1%
EUR/CHF	1.05	-0.8%	-2.0%	-13.0%
Fixed Income markets	**27/03/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.06	--	-12 bp	-20 bp
Euribor 3M	0.02	-	-2 bp	-6 bp
Libor USD 3M	0.28	+1 bp	+1 bp	+2 bp
2Y yield (Germany)	-0.25	-1 bp	-2 bp	-15 bp
10Y yield (Germany)	0.20	+2 bp	-12 bp	-34 bp
2Y yield (US)	0.58	-	-4 bp	-8 bp
10Y yield (US)	1.96	+3 bp	-3 bp	-21 bp
Eurozone Sovereigns 10Y spreads vs Germany	**27/03/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+29 bp	+3 bp	+1 bp	-
Austria	+16 bp	+3 bp	+9 bp	+6 bp
Netherlands	+17 bp	+9 bp	+13 bp	+3 bp
Finland	+8 bp	+3 bp	+6 bp	-4 bp
Belgium	+26 bp	+3 bp	+2 bp	-3 bp
Ireland	+57 bp	-2 bp	+3 bp	-14 bp
Portugal	+156 bp	+11 bp	+6 bp	-59 bp
Spain	+110 bp	+10 bp	+16 bp	+3 bp
Italy	+113 bp	+11 bp	+13 bp	-22 bp
Credit markets	**27/03/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+56 bp	+1 bp	+6 bp	-7 bp
Itraxx Crossover	+262 bp	+4 bp	+1 bp	-83 bp
Itraxx Financials Senior	+66 bp	+1 bp	+11 bp	-2 bp

Source: Bloomberg, Amundi Strategy *3:00 pm Paris time*

WEEKLY
Research, Strategy and Analysis

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