Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

Letter finalised at 3pm Paris time

July 27 - 31, 2015

Highlights of the week

- **United States:** The economy recovered distinctly in Q2. Contradictory signals on inflation.
- **Eurozone:** Spanish growth, confidence, bank lending and inflation: the improvement continues.
- **Emerging:** Turkey's Central Bank Governor hinted at switching from the current unorthodox monetary policy approach towards a more simplified policy structure. Rate cut in Russia and one more rate hike in Brazil.
- **Markets:** Bond yields fell slightly in the developed countries, the US dollar lost some ground and volatility is still the name of the game in equity markets.

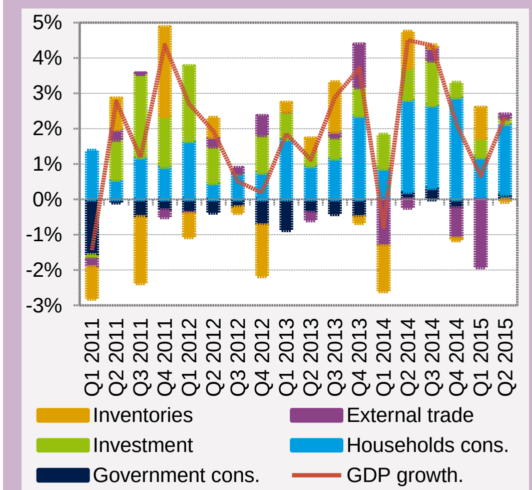
Key focus

US: GDP figures reassuring but not shining. The Fed still in wait-and-see mode.

Though unspectacular, US GDP growth figures for Q2 (in addition to an upward revision of Q1 figures) send a rather reassuring message (*details in Economy section*). With the re-acceleration in consumer spending (after a pause in Q1, though relative to a very strong push at end-2014), US growth can turn the page on the slowdown since the start of the year, caused by a sharp fall in investment in the energy sector and an accumulation of temporary factors.

The pieces are in place for the recovery to continue in the second half. US households have reduced their debt, and their purchasing power is being boosted by an improving job market and falling oil prices. As such, they should maintain positive consumption momentum (an item that makes up nearly 70% of GDP) even if clear signals of wage acceleration are still missing. Likewise, households are gradually increasing their investment in real estate, which, after a pause in 2014, has been sending out encouraging signals in the last quarters. Although business investment cannot be expected to produce any miracles at this stage in the cycle (corporate margins have probably peaked), it should at least recover a little from its weakness in the first half. Taken together, these support factors are likely to offset the negative effect of the dollar's appreciation, which will still affect sectors that are exposed to the international situation. The external environment is not entirely unfavourable; true, the US economy is not fully immunised against the slowdown in emerging countries (starting with China), but on the other hand, the eurozone continues to improve. Thus the US expansion cycle is not over yet.

Contributions to US growth



Source: Datastream, Amundi Research

Nonetheless, growth potential has been checked considerably by the crisis (less investment, lower quality of a large number of jobs, etc.), an analysis confirmed by the involuntary publication of the Federal Reserve staff's economic projections prepared for June's FOMC. In fact, Fed economists estimate that growth potential is now around 1.70/1.80%. Looking ahead to 2.40% growth in 2016 and 2.23% in 2017 (Q4-Q4), the potential output gap will be filled sometime in 2017. Monetary tightening would be called for, then, not by a significant improvement in the economy, but by the fact that targets are less ambitious than before.

In the short term, the Fed maintained its wait-and-see positioning at July's FOMC. Its press release published on Wednesday July 29 is virtually identical to June's. The assessment of labour market trends is slightly more positive. More importantly, the statement indicates that only "some" further improvement of the labour market conditions is needed to hike rates. The projections of fed funds by the Fed's economists, which were revealed involuntarily, corroborate the scenario of an extremely slow increase in the years to come; they predict fed funds in the vicinity of 1.25% at end-2016, 2% at end-2017, and 3.30% for the long term. We think fed funds will be increased at year's end, but the labour reports on August 7 and September 4 will be more decisive than ever.

The week at a glance

> Other events

Brazil >

On July 28th, S&P revised the outlook on Brazil's BBB- sovereign rating to negative. S&P's rating revision is motivated by the fact that the agency believes that there is greater than one in three chance of further slippage in policies and that return to growth will take longer than expected.

As S&P has the lowest of the agency ratings for Brazil this move came as a surprise to us, since we were expecting rating actions from Fitch and Moody's limited to one notch. Brazilian external bonds did not react much to the news and the CDS tightened slightly, implying that the rating action was already priced in.

> Economic indicators

Eurozone >

Spanish growth, confidence, bank lending and inflation: the improvement continues. In line with expectations, **Spanish GDP** rose +1% over Q2 (after +0.9% in Q1), its fastest quarterly pace since 2007. In addition, though it was expected slightly down, the European Commission's **Economic Sentiment Index** for the Eurozone rose in July (104 after 103.5 in June). The same is true of the **IFO Index** (German business climate), which was also higher than expected, rising to 108 in July (after 107.5 in June). The **volume of bank lending** to the private sector confirmed its return to positive territory (+0.6% overall over one year in June, or +1.6% for consumer credit and +0.1% for business credit). Finally, although **headline inflation** remained unchanged in July at +0.2% YoY, **core inflation** rose to 1% YoY (vs forecast and June +0.8%).

These figures put some perspective on the impact of the Greek crisis on the vigour of the Eurozone's economic recovery, at least in the short term. The acceleration of Spanish growth contrasts nicely with the situation in Greece (Ireland, a late GDP publisher, also released this week a strong +1.4% advance in Q1 while Belgium's Q2 GDP growth was a slightly above forecast +0,4% after an upwardly revised similar figure in Q1). The behaviour of Germany's indices also shows it is holding up well despite the slowdown in the emerging countries. Conversely, while bank credit is on the rise, there is still no true acceleration. Note, too, that in the immediate vicinity of the Eurozone, a key economic partner is also doing well: The UK's GDP advanced +0.7% in Q2.

United States >

The economy recovered distinctly in Q2. According to a 1st estimate, US GDP rose +2.3%, on an annualised basis, in Q2. This is slightly less than expected (2.5%), but the number takes into account Q1 growth that was adjusted upward (+0.6% vs. -0.2%, according to the previous estimate). In Q2, personal consumption rose +2.9%, public spending was up +0.8%, and housing investment gained +6.6%. By contrast, non-housing investment fell back -2% (primarily due to a -4.1% downturn in investment in equipment). International trade made a slightly positive contribution (+0.1 pp, with a +5.3% rise in exports, partially offset by a +3.5% increase in imports), whereas changes in inventory took -0.1 pp from quarterly GDP. However, signals on inflation were contradictory. The core **Personal Consumption Expenditure deflator** (Core PCE: the Fed's gauge of inflation) exceeded forecasts, rising +1.8% in Q2 (vs 1.6% expected and +1%. Conversely, the **Employment Cost Index** made increased only +0.2% in Q2, its slowest pace since 1982.

Even though the initial estimates on US GDP then frequently give rise to very significant adjustments, these figures are encouraging (see Editorial). Note that the Bureau of Economic Analysis took the opportunity, with this publication, to adjust past figures, by changing the coefficients used to recognise seasonal variations: the "residual seasonal effect" (which, for a few years, have caused growth to be almost systematically weaker in Q1 than in Q2/Q3/Q4), should be reduced.

> Monetary policy

Turkey >

At its quarterly inflation report meeting, Turkey's Central Bank Governor hinted at switching from the current unorthodox monetary policy approach towards a more simplified policy structure. The effective policy rate currently rests somewhere in between the 7.5% repo rate and the 10.75% overnight lending rate. The central bank is conducting a reassessment on reducing the complexity and adopting a single rate policy framework. The central bank increased its end-2015 inflation forecast from 6.8% to 6.9%.

A move to a simplified structure will be positive from a credibility perspective as it would be viewed as a step towards greater policy orthodoxy. In terms of liquidity conditions, however, it is unlikely to have a tightening impact as the Central Bank is already funding the market at the upper end of the policy corridor. The net impact of adopting a more orthodox policy may actually be looser policy at the margin.

Russia & Brazil > **While the Russian Central Bank conducted a new rate cut by 50 bps to 11%, the Brazilian Central Bank had no choice but to proceed with a further increase,** 50 bps with a rate of 14.25 % with inflation of over 8%.

These announcements are in line with market expectations. The Russian cut reflects a downward trend in inflation although the latter remains at a high level +15%. The Brazilian hike is explained by two factors: an upward inflation trend and a downward revision of the outlook on the debt by S & P. Furthermore, the statement suggests that this may well be the end of the tightening cycle since it is stipulated that 14.25% is a level consistent with the inflation target of 4.5% for 2016. In our view, it might be a short pause because if the Real remains at such a low level imported inflation could rise and make 2016 inflation target too low.

India > **Indian government buried the controversy about RBI independence**. Modi administration seems to step back from its former plan of a seven persons monetary policy committee which majority would be appointed by the central government. Jayant Sinha, minister of state for finance, stated that the draft of the Indian Financial Code which contained this proposal was a “simple input” into the debate and not representative of government thinking.

This controversy has been raised at a difficult juncture for India. Modi reforms agenda need to be paced up to allow RBI to move to a more accommodative stance

Financial markets

Fixed-income

Bond yields fell slightly in the developed countries. The German 10-year bond lost 3 bp, ending the week at 0.67%, its lowest level since the start of June. The US 2-year yield gained several basis points after the FOMC, and reached temporarily its highest level since April 2011. US yields fell after the release of poor Employment Cost Index figures (see the macro section). Italian spreads narrowed by a few basis points, while their Spanish counterparts were stable.

The way in which US yields reacted to the FOMC suggests that US interest rates are likely to rise mainly at the short end of the curve.

The spread of the external sovereign debt index, EMBI Global, is still closely correlated to oil prices, and currently stands at 405 bp. It has been on an upward trend for the past two months, and is likely to keep on rising**.** Low oil prices are still fuelling uncertainties about the exact scale of the fiscal shock caused by the decline in crude prices since June 2014. Growing risks on the Chinese economy do not help as they will also likely to weigh on oil prices. Investors are expecting sovereign ratings to be downgraded especially for oil exporters.

The current context is challenging for commodities producers, and any renewed spike in the volatility of US government bond yields would cause further instability for EM USD denominated debt. We think this is fairly unlikely. Treasuries volatility is fueled by expectations on future Fed policy. As the current strength of the dollar suggests that the Fed's forthcoming normalization is already factored in.

Foreign exchange

The US dollar lost some ground, after the release of the Employment Cost Index figures. The pound rose after the publication of good growth figures (+0.7% in Q2) and strong lending to the private sector. The EUR/USD rose slightly after the release of the Employment Cost Index.

As the monetary policy divergence gains momentum, with the Fed and the BoE on one side and other developed country central banks on the other, the dollar and sterling will continue to appreciate in the months ahead.

Emerging currencies are once again facing downward pressure from the dollar and investors have revised their expectations that the Fed will raise interest rates at its FOMC meeting on 17 September. Almost all the main emerging currencies fell, with the exception of the rouble, which gained 0.3%, and the Indian rupee, which rose by 0.1% after the Modi government seemed to abandon recent plans to revise the Indian central bank's decision-making process. The Brazilian real fell the most, losing -2.5% after Brazil's sovereign rating was downgraded.

Implied volatility on emerging currencies rose sharply. The VXY emerging markets index is at the same level as its developed countries equivalent, at 9.2%. Downward pressure is unlikely to fade in the immediate future as liquidity dries up during the summer holidays. Uncertainties about how far Chinese equities will fall are causing additional weakness, in particular for commodities currencies.

Credit

The euro credit markets did not show any decisive trend this week. They were penalised by fears over China's growth. The good business results for the second quarter confirm the slow recovery seen in the Eurozone.

The proliferating signs of slowdown in the Chinese economy, paired with the drop in equity indices, are weighing down the euro credit markets. Eurozone core business fundamentals would be directly affected by an adverse scenario in China. Auto makers, equipment manufacturers, and even capital goods may make a significant share of their revenues in China, which has been the growth driver in recent years. To a greater extent, many issuers would be affected by a slowdown in Asia and a drop in commodity prices, particularly those in the periphery.

Equity

Volatility is still the name of the game. Now that the paroxysm of the Greek crisis is behind us, the decline in China's market is getting more attention. It fell -8.5% on Monday, July 27, its biggest one-day drop in three years. The Eurozone is a little more fragile as a result. Otherwise, the earnings season is still going well. Out of 127 companies in the Stoxx600, two-thirds did better than expected, both on revenues and earnings (50% and 77% on the S&P500).

The decline in the Shanghai Stock Exchange (which, for now, is still above its 200-day average) is fuelling fears of poor allocation of resources, allocated to stabilise the equity market rather than stimulate growth. All of this is weighing down commodity prices and the volatility of monetary policy expectations across the Atlantic. While lower Greek risk was an entry point to Eurozone equities not long ago, the decline of the Chinese market is not an opportunity to increase emerging equities in the portfolios.

Eventually Chinese government will stabilize domestic equity market. Chinese equity market will end the month of July with the worse monthly decline in six years. The unprecedented measures taken by the authorities should lead to a market stabilization. By Friday, 505 companies have been halted on the Shanghai and Shenzhen exchanges. Further reduction in margin lending is required before a definitive bottoming out of the market.

The very issue is now about the macro spillovers that is to say to what extent both Chinese outlook and global trade is going to be affected ? We still believe that the risk of marked slowdown is high and we believe Chinese authorities will step up measures to support their economy.

Key upcoming events

Economic indicators

United States: ISM indices are expected relatively stable in July and the July job report should be in line of previous ones. **Eurozone:** Retail sales in June could disappoint. **China:** in July, inflation is expected slightly up while activity is likely to remain sluggish.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
3 August	China	Manufacturing PMI HSBC, July	50.1	50.2
	UK	Manufacturing PMI, July	51.5	51.4
	US	Core PCE, YoY, June	1.2%	1.2%
	US	Manufacturing ISM, July	53.5	53.5
5 August	China	Services PMI HSBC, July		53.8
	UK	Services PMI, July	58,0	58.5
	Eurozone	Retail sales, MoM, June	-0.3%	0.2%
	US	Non manufacturing ISM	56.3	56,0
6 August	UK	Industrial production, MoM, June	0.1%	0.4%
7 August	Germany	Industrial production, MoM, June	0.3%	0.0%
	Brazil	CPI, YoY, July		8.9%
	US	Change in nonfarm payrolls, July	218 K	223 K
	US	Unemployment rate, July	5.3%	5.3%
	China	Trade balance, July	$ 53.35 Bn	$ 46.54 Bn
	China	CPI, YoY, July	1.5%	1.4%

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
3 August	France	Short-term, € 8 Bn
4 August	ESM	Short-term, € 2 Bn
5 August	Germany	5 years, € 4 Bn
6 August	Spain	Long terme, montants non disponibles vendredi
	France	Long terme, montants non disponibles vendredi

Source: Bloomberg, Amundi Strategy

Key events

Worth watching: the ECB and BoJ monetary policy committee meetings.

Date	Upcoming monetary policy committee meetings
6 August	Bank of England (BoE)
7 August	Bank of Japan (BoJ)
3 September	European Central Bank (ECB)
17 September	Federal Reserve (Fed)
28 October	Federal Reserve (Fed)

Date	Upcoming political events
October 2015	General election in Argentina
November 2015	G20 Antalaya (Turkey) summit
December 2015	General election in Spain
May 2016	G8 Shima (Japan) summit

Source: Amundi Strategy

Market snapshot

Equity markets	31/07/2015	Over 1 week	Over 1 month	Ytd
S&P 500	2109	1,4%	1,5%	2,4%
Eurostoxx 50	3579	-0,6%	2,4%	13,7%
CAC 40	5062	0,1%	3,7%	18,5%
Dax 30	11262	-0,7%	0,7%	14,9%
Nikkei 225	20585	0,2%	1,3%	18,0%
MSCI Emerging Markets (close -1D)	894	-1,8%	-8,0%	-6,5%
Commodities - Volatility	**31/07/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	52	-4,0%	-15,2%	-7,4%
Gold ($/ounce)	1092	-0,7%	-6,6%	-7,6%
VIX	12	-1,6	-4,0	-7,1
FX markets	**31/07/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1,11	0,8%	0,1%	-8,6%
USD/JPY	124	-0,1%	0,4%	3,3%
EUR/GBP	0,71	-0,2%	-0,2%	-9,0%
EUR/CHF	1,06	0,2%	1,1%	-11,9%
Fixed Income markets	**31/07/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0,12	--	+1 bp	-26 bp
Euribor 3M	-0,02	--	-1 bp	-10 bp
Libor USD 3M	0,31	+2 bp	+3 bp	+5 bp
2Y yield (Germany)	-0,23	-1 bp	+1 bp	-13 bp
10Y yield (Germany)	0,67	-3 bp	-15 bp	+12 bp
2Y yield (US)	0,66	-1 bp	-2 bp	-
10Y yield (US)	2,20	-6 bp	-22 bp	+3 bp
Eurozone Sovereigns 10Y spreads vs Germany	**31/07/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+31 bp	+3 bp	-13 bp	+2 bp
Austria	+26 bp	+1 bp	-13 bp	+16 bp
Netherlands	+18 bp	+1 bp	-10 bp	+3 bp
Finland	+1 bp	+1 bp	-11 bp	-10 bp
Belgium	+31 bp	+2 bp	-14 bp	+2 bp
Ireland	+56 bp	-1 bp	-25 bp	-15 bp
Portugal	+177 bp	-5 bp	-35 bp	-37 bp
Spain	+121 bp	--	-26 bp	+14 bp
Italy	+114 bp	-4 bp	-34 bp	-21 bp
Credit markets	**31/07/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+63 bp	+1 bp	-10 bp	-
Itraxx Crossover	+286 bp	-2 bp	-30 bp	-60 bp
Itraxx Financials Senior	+74 bp	+3 bp	-13 bp	+7 bp

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