Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research, Strategy and Analysis — WEEKLY

Letter finalised at 3pm Paris time — Sept. 28 - Oct. 2, 2015

Highlights of the week

- **United States:** Disappointing September labor market figures, 140K net jobs against 200K expected.
- **Eurozone:** Inflation slightly negative once again. French public deficit expected at 3.8% of GDP in the 2016 Draft Budgetary Plan.
- **EM:** RBI cut rates by 50 bp. Further deterioration in the Brazilian public accounts. China's September official manufacturing PMI slightly better than expected.
- **Markets**: US dollar and developed bond yields down because of bad US macro figures. Regain of volatility on credit markets while equity markets remain hesitant.

Key focus

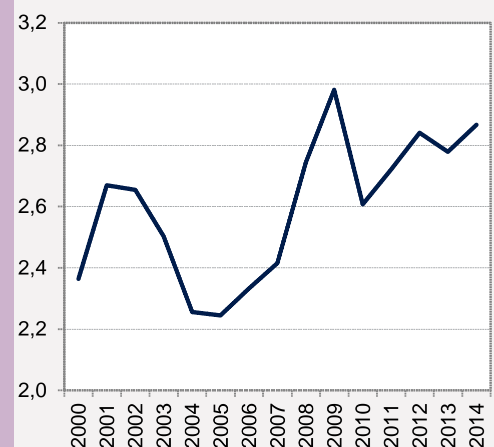
US businesses re-leveraging while profit growth slows

US business fundamentals have taken a turn for the worse over the last few quarters. For the majority of them, the debt ratio has increased due to the combined effect of lower profits (passive re-leveraging) and higher debt (active re-leveraging).

US businesses have been re-leveraging since 2010. Businesses benefited fully from the Fed's ultra-accommodating monetary policy. Exceptional financing terms meant businesses could raise record amounts on the financial markets (equities and bonds). The size of the IG bond market has virtually doubled since the Lehman crisis.

Issuers have mainly financed mergers and acquisitions and share repurchases. Activity on both these markets has accelerated to the very high levels that prevailed before the crisis. Activity on the M&A market is essentially the result of the multiplication of large-scale operations within the consolidation of the health, telecoms and energy sectors. So streamlining activity wins over business investment. In this gloomy economy, it is still a challenge for businesses to preserve their revenue and margins.

US IG – Net debt to Ebitda



Source: Bloomberg, Amundi Research

Investment spending has been disappointing overall compared to the substantial capital raised. Likewise, the investment recovery post-crisis has varied widely by sector. Most sectors have not regained their pre-crisis momentum. Only the energy sectors, before the recent drop in oil prices, had any significant investment recovery.

Profit growth weakened in H1 2015. The strong dollar and the drop in oil prices had a major impact on growth in revenue and profits for US issuers in the first half of 2015. Remember that the dollar bonds are still very exposed to the energy sector, 17% and 14%, respectively, of the IG and HY debt market. It is very important to understand that margin expansion has contributed much more than revenue to profit growth. Margins have increased, due to shrinking production costs and very limited wage increases, to reach all-time highs.

Refinancing risk? The Fed has adjusted the US economy's potential growth outlook downward. The revision stems from the gloomy outlook on global growth and the persistent weakness of investment. Thus, this debt will reach maturity in a weak-growth environment. This risk will not materialise in the short term (except for certain businesses in the energy sector):

- US businesses have accumulated record amounts of cash in their balance sheets over the past few years. The liquidity ratio is close to 50%. This cash is essentially concentrated in high tech, health and consumer products.
- The coverage of interest by profit, or coverage ratio, remains satisfactory thanks to historically low financing costs.

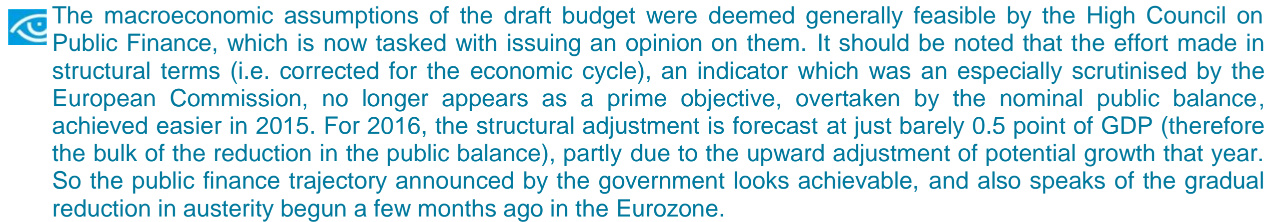
In this environment of rate hikes (even if we anticipate that the fed fund raising cycle will be slow and limited), weak growth, and re-leveraging, we prefer a more selective approach, and **we prefer dollar issuers which have the ability to generate profits as well as a low debt ratio, or which are in a deleveraging phase.**

The week at a glance

Other events

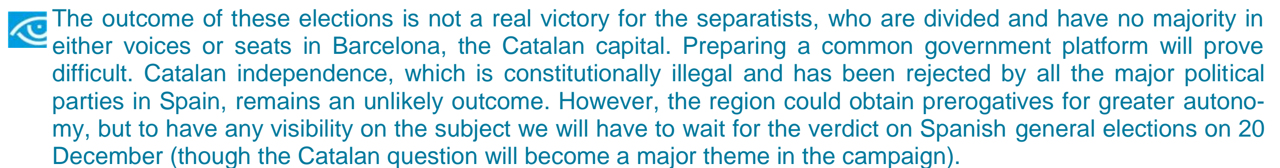
France >

Savings to fund tax cuts, and gradually less austerity in France. The draft budgetary plan for 2016 was presented at a meeting of the Council of Ministers on 30 September. It sets out a public deficit of 3.8% in 2015 and 3.3% in 2016, after 3.9% in 2014 (recently revised downward by INSEE). The plan for 2016 includes €16 billion additional savings, notably to finance the income tax cut (€2 billion) and the additional reduction in corporate taxes and contributions (€9 billion). These public finance forecasts are based on growth and inflation assumptions of 1% and 0.1% for 2015 and 1.5% and 1% for 2016.


The macroeconomic assumptions of the draft budget were deemed generally feasible by the High Council on Public Finance, which is now tasked with issuing an opinion on them. It should be noted that the effort made in structural terms (i.e. corrected for the economic cycle), an indicator which was an especially scrutinised by the European Commission, no longer appears as a prime objective, overtaken by the nominal public balance, achieved easier in 2015. For 2016, the structural adjustment is forecast at just barely 0.5 point of GDP (therefore the bulk of the reduction in the public balance), partly due to the upward adjustment of potential growth that year. So the public finance trajectory announced by the government looks achievable, and also speaks of the gradual reduction in austerity begun a few months ago in the Eurozone.

Spain >

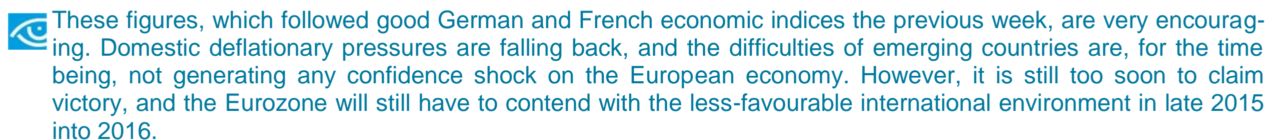
Catalan separatists win a majority of seats, but not votes, in regional elections. Separatist groups won 72 seats out of a total 135 in elections on 27 September. This means they gained a majority of seats but only 48% of electoral votes. One of these groups, the extreme left party CUP, which holds 10 seats and is therefore indispensable in creating a majority, has made it known that in these conditions it did not consider that the elections constituted a plebiscite, and that it would not support a unilateral declaration of independence. In addition, the German Chancellor called on the Catalonian President to respect Spanish law, which does not allow the region to secede.


The outcome of these elections is not a real victory for the separatists, who are divided and have no majority in either voices or seats in Barcelona, the Catalan capital. Preparing a common government platform will prove difficult. Catalan independence, which is constitutionally illegal and has been rejected by all the major political parties in Spain, remains an unlikely outcome. However, the region could obtain prerogatives for greater autonomy, but to have any visibility on the subject we will have to wait for the verdict on Spanish general elections on 20 December (though the Catalan question will become a major theme in the campaign).

Economic indicators

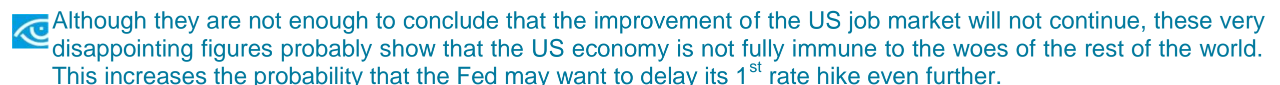
Eurozone >

Inflation negative once again, but only because of lower oil prices. Economic confidence is on the rise. The change over one year in the general price index for the Eurozone as a whole turned slightly negative (-0.1%) again in September, according to a preliminary estimate. Meanwhile, the change in core inflation stayed positive (+0.9%) over one year, unchanged compared to August, and quite a bit above the low point still seen in April. In addition, the **European Economic Sentiment** Index was higher than expected, at 105.6 (compared to 104.1 expected and 104.1 in August), its highest level since June 2011.


These figures, which followed good German and French economic indices the previous week, are very encouraging. Domestic deflationary pressures are falling back, and the difficulties of emerging countries are, for the time being, not generating any confidence shock on the European economy. However, it is still too soon to claim victory, and the Eurozone will still have to contend with the less-favourable international environment in late 2015 into 2016.

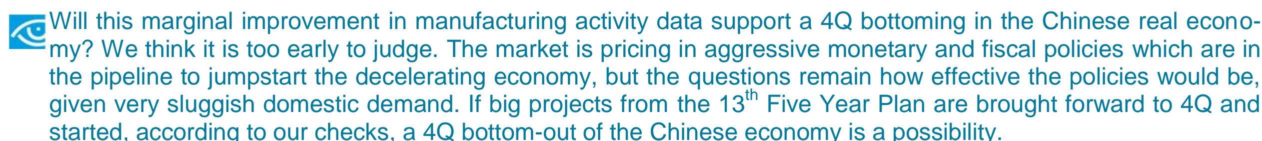
United States >

Disappointing September labor market figures. The US economy generated a meager 142k net jobs in September, much less than forecast (201k). July and August net new jobs figures were revised down a total -59k. The unemployment rate remained unchanged at 5.1%, while the participation rate hit a new low at 62.4%. Average hourly earnings increased +2.2% over the last 12 months (the same pace as in August) while average weekly hours declined slightly to 34.5 hours (vs 34.6 in August). Among the only good news was another decline in the U6 unemployment rate (also including people working part time for economic reasons and people marginally attached to the labor force) that hit a new low at 10% (vs 10.3% in August).


Although they are not enough to conclude that the improvement of the US job market will not continue, these very disappointing figures probably show that the US economy is not fully immune to the woes of the rest of the world. This increases the probability that the Fed may want to delay its 1st rate hike even further.

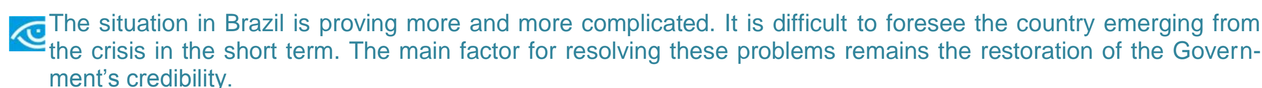
China >

China's September official manufacturing PMI came in slightly better than expected at 49.8 (vs. consensus and prior at 49.7). The improvement is from production (52.3 vs. prior 51.7), new orders (50.2 vs. prior 49.7), and new export orders (50.2 vs. prior 49.7). However, the reading remained in contraction territory, as we expected from last week's letter. China's Caixin September manufacturing PMI final reading was also revised up slightly to 47.2 (vs. consensus and flash reading at 47).


Will this marginal improvement in manufacturing activity data support a 4Q bottoming in the Chinese real economy? We think it is too early to judge. The market is pricing in aggressive monetary and fiscal policies which are in the pipeline to jumpstart the decelerating economy, but the questions remain how effective the policies would be, given very sluggish domestic demand. If big projects from the 13th Five Year Plan are brought forward to 4Q and started, according to our checks, a 4Q bottom-out of the Chinese economy is a possibility.

Brazil >

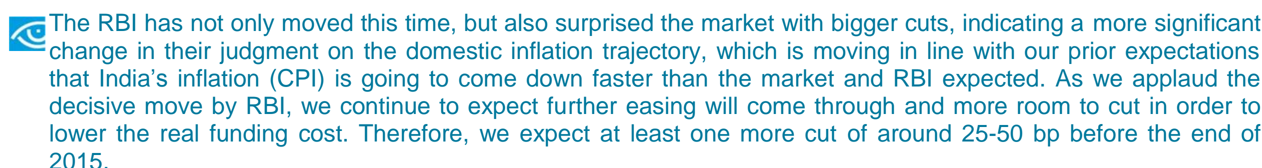
The deterioration in the public accounts has become more marked. The deficit and public debt came out at respectively -9.2% and 65.3% of GDP. **The labour market continued to deteriorate** with an unemployment rate of 8.6%. In conjunction with these poor figures, **all confidence indicators show a decline** (consumer, industrial, construction, services and retail).


The situation in Brazil is proving more and more complicated. It is difficult to foresee the country emerging from the crisis in the short term. The main factor for resolving these problems remains the restoration of the Government's credibility.

> Monetary policy

India >

The Reserve Bank of India (RBI) surprised the market by cutting 50 bp rather than 25 bp from both the Reverse Repo Rate (RRR) from 6.25% to 5.75%, and the Repurchase Rate (RR) from 7.25% to 6.75%. The RBI kept the Cash Reserve Ratio (CRR) unchanged at 4%, as expected.


The RBI has not only moved this time, but also surprised the market with bigger cuts, indicating a more significant change in their judgment on the domestic inflation trajectory, which is moving in line with our prior expectations that India's inflation (CPI) is going to come down faster than the market and RBI expected. As we applaud the decisive move by RBI, we continue to expect further easing will come through and more room to cut in order to lower the real funding cost. Therefore, we expect at least one more cut of around 25-50 bp before the end of 2015.

> Financial markets

Fixed-income

Poor US macro figures weigh heavily on developed bond yields. The German and US 10y. yield lost respectively 14 and 23 bp, reaching new multi-month lows to 0.51 and 1.94 %. The 10y. inflation break-even rate fell to a new low since 2009, falling below 1.50%. Spanish spreads tightened on all the maturities, in the wake of the regional elections on the previous Sunday.

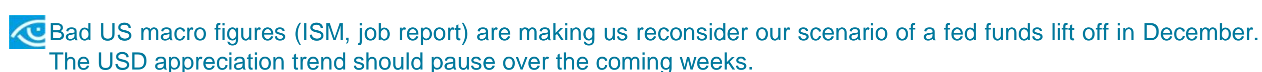
Bad US macro figures (ISM, job report) are making us reconsider our scenario of a fed funds lift off in December. The probably of a delay of the first fed funds hike to 2016 increased strongly.

Bad news for DM could be good news for EM. Credit spreads and EM currencies are moving in close relationship. EMBI Global Diversified spread has reached 470 bp in a context of spiking EM-currency volatility. Worth highlighting is the rise in EM spread ahead of currency volatility. This last upside swing in EM FX volatility is consistent with a pace up of capital outflows from emerging markets.

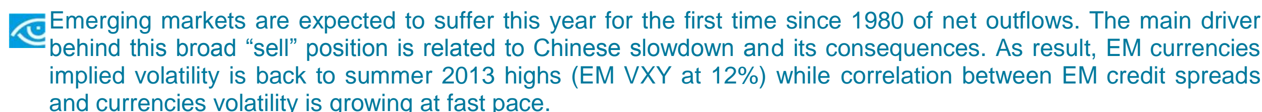
The latest employment figures in the US will be definitively helpful as they reduce the probability of a liftoff this year. This should help to stabilize spreads in the short run. Considering that the correlation between crude prices and sovereign spreads is even stronger, spreads will tighten sustainably as soon as clear signs of a cyclical bottoming of the Chinese economy are visible.

Foreign exchange

The US dollar down because of bad US macro figures. It lost ground vs the majority of developed currencies. The EUR/USD parity rose to 1.13. The USD/JPY parity fell below 120. Emerging currencies continued to lose ground versus developed currencies.


Bad US macro figures (ISM, job report) are making us reconsider our scenario of a fed funds lift off in December. The USD appreciation trend should pause over the coming weeks.

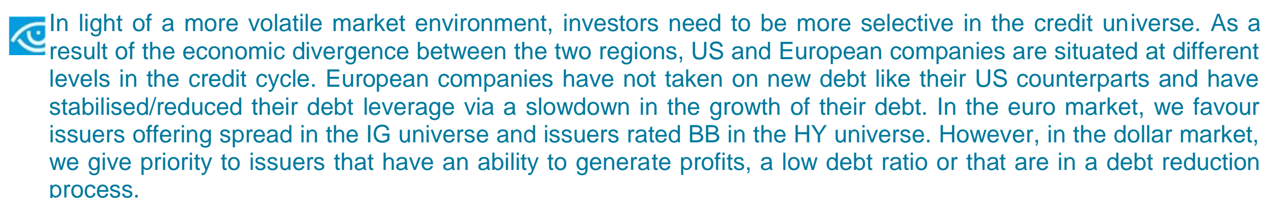
Tentative signs of stabilization in emerging currencies despite soft PMIs data in Russia and Turkey. The currency mix on the rise is made of Asian currencies related to China (South Korean Won +0.9%, Taiwan dollar +0.6%), LATAM ex-Brazil (Mexican Peso +1.1%, Chilean Peso +0.7%) and high beta currencies such as Turkish Lira (+0.9%) or South African Rand (+0.6%). Ruble and real have been once again the downside against USD.



Emerging markets are expected to suffer this year for the first time since 1980 of net outflows. The main driver behind this broad "sell" position is related to Chinese slowdown and its consequences. As result, EM currencies implied volatility is back to summer 2013 highs (EM VXY at 12%) while correlation between EM credit spreads and currencies volatility is growing at fast pace.

Credit

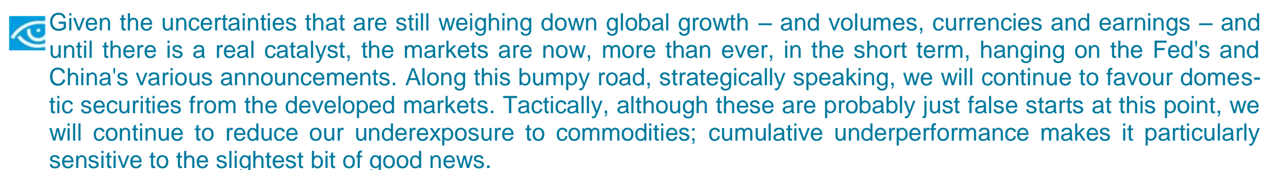
The euro and dollar credit markets were marked by renewed volatility and the substantial widening of spreads this week. Concerns related to the slowdown in developed and emerging economies and the lack of visibility on the Fed's monetary policy predominated. The Volkswagen storm also had a considerable adverse effect on the automobile sector. Indices reached a year high and even returned to the levels observed in 2013 (see graph of the key focus). The most risky securities under-performed.



In light of a more volatile market environment, investors need to be more selective in the credit universe. As a result of the economic divergence between the two regions, US and European companies are situated at different levels in the credit cycle. European companies have not taken on new debt like their US counterparts and have stabilised/reduced their debt leverage via a slowdown in the growth of their debt. In the euro market, we favour issuers offering spread in the IG universe and issuers rated BB in the HY universe. However, in the dollar market, we give priority to issuers that have an ability to generate profits, a low debt ratio or that are in a debt reduction process.

Equity

The market is still hesitant: after the rebound at the end of last week following Janet Yellen's speech, the market took a dive on Monday and then recovered Wednesday with a few regional variants. On Monday, the decline was about three things: a further reduction in corporate profits in China, the repercussions of the VW scandal in Europe, and threats to control drug prices in the US. Wednesday's rally was due to stimulus measures announced in China (see above, lower personal contributions in real estate, and automotive tax cuts), which brought commodities and emerging currencies along in their wake. Furthermore, the announcement of an agreement between Democrats and Republicans to avoid another shutdown was good news to Wall Street.



Given the uncertainties that are still weighing down global growth – and volumes, currencies and earnings – and until there is a real catalyst, the markets are now, more than ever, in the short term, hanging on the Fed's and China's various announcements. Along this bumpy road, strategically speaking, we will continue to favour domestic securities from the developed markets. Tactically, although these are probably just false starts at this point, we will continue to reduce our underexposure to commodities; cumulative underperformance makes it particularly sensitive to the slightest bit of good news.

Key upcoming events

Economic indicators

United States: non-manufacturing ISM is expected to be slightly lower in September, but will remain well above the threshold of 50 (expansion of the non-manufacturing sector). **Eurozone:** retail sales are expected to contract slightly in August. **Emerging markets:** Russian and Brazilian inflation are expected to be very high in September.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
5 October	Eurozone	Retail sales, MoM, August		0.4%
	US	Non manufacturing ISM, September	58.0	59.0
	Russia	CPI, YoY, August		15.8%
7 October	Germany	Industrial production, MoM, August		0.7%
	UK	Industrial production, MoM, August		-0.4%
	Spain	Industrial production, YoY, August		5.8%
	Brazil	CPI, YoY, September		9.5%
8 October	Mexico	CPI, YoY, September		2.6%
	South Africa	Manufacturing production, MoM, August		0.3%
9 October	France	Industrial production, MoM, August		-0.8%

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
5 October	France	Short-term, amounts not available on Friday
6 October	ESM	6 months, amounts not available on Friday
7 October	Germany	10 years, € 4 Bn

Source: Bloomberg, Amundi Strategy

Key events

Worth watching: monetary policy committee meetings at the BoJ and the BoE on 6 and 8 October

Date	Upcoming monetary policy committee meetings
6 October	Bank of Japan (BoJ)
8 October	Bank of England (BoE)
22 October	European Central Bank (ECB)
28 October	Federal Reserve (Fed)
16 December	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	02/10/2015	Over 1 week	Over 1 month	Ytd
S&P 500	1924	-0,4%	-1,3%	-6,6%
Eurostoxx 50	3053	-1,9%	-4,6%	-3,0%
CAC 40	4413	-1,5%	-3,1%	3,3%
Dax 30	9463	-2,3%	-5,8%	-3,5%
Nikkei 225	17725	-0,9%	-2,0%	1,6%
MSCI Emerging Markets (close -1D)	798	1,1%	0,1%	-16,6%
Commodities - Volatility	**02/10/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	47	0,3%	-5,8%	-16,1%
Gold ($/ounce)	1135	-1,0%	0,0%	-4,0%
VIX	23	-1,1	-3,5	3,4
FX markets	**02/10/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1,13	0,8%	0,5%	-6,7%
USD/JPY	119	-1,2%	-1,0%	-0,5%
EUR/GBP	0,74	0,5%	1,1%	-4,5%
EUR/CHF	1,09	-0,4%	0,3%	-9,2%
Fixed Income markets	**02/10/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0,14	-	-2 bp	-29 bp
Euribor 3M	-0,04	--	-1 bp	-12 bp
Libor USD 3M	0,33	-	-1 bp	+7 bp
2Y yield (Germany)	-0,28	-3 bp	-7 bp	-18 bp
10Y yield (Germany)	0,51	-14 bp	-27 bp	-3 bp
2Y yield (US)	0,55	-14 bp	-16 bp	-11 bp
10Y yield (US)	1,94	-23 bp	-25 bp	-24 bp
Eurozone Sovereigns 10Y spreads vs Germany	**02/10/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+39 bp	-1 bp	+4 bp	+10 bp
Austria	+29 bp	-	-1 bp	+19 bp
Netherlands	+19 bp	+1 bp	-1 bp	+4 bp
Finland	+27 bp	--	+9 bp	+15 bp
Belgium	+32 bp	+1 bp	-2 bp	+3 bp
Ireland	+62 bp	-	-4 bp	-9 bp
Portugal	+179 bp	-12 bp	-11 bp	-36 bp
Spain	+129 bp	-10 bp	-5 bp	+22 bp
Italy	+115 bp	--	-6 bp	-20 bp
Credit markets	**02/10/2015**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+93 bp	+8 bp	+19 bp	+30 bp
Itraxx Crossover	+380 bp	+30 bp	+40 bp	+34 bp
Itraxx Financials Senior	+96 bp	+5 bp	+12 bp	+29 bp

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

WEEKLY
Research, Strategy and Analysis

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