Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research, Strategy and Analysis — WEEKLY

Letter finalised at 3pm Paris time — **February 1 - 5, 2016**

Highlights of the week

- **United States:** Disappointing nonfarm payrolls despite another decline in the unemployment rate**.** Contraction in industrial activity, slowdown in services.
- **Eurozone:** Slight downgrade in the European Commission's 2016 growth forecasts. Still no government in place in Spain.
- **Emerging markets:** Chinese manufacturing PMI relatively close to previous figures.
- **Markets:** German yields back to extremely low levels. USD sharply down and Euro effective exchange rate back to its end-2014 levels. Credit spreads widening and more dips on equity markets.

Key focus

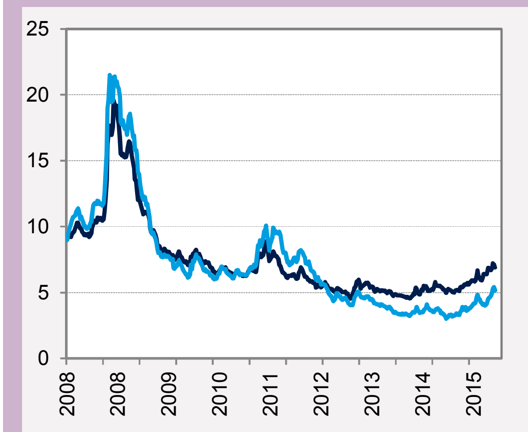
US High Yield: Tempting yields but defaults are accelerating

The year so far has been marked by jittery nerves on the equity and bond markets. Investors are wary of the consequences of a more serious slowdown in the Chinese economy and falling oil prices. Fears are rising over the weakness of the global economy. So what is the right stance to take on the US High Yield market?

We reiterate our very cautious view of US HY. The fundamentals of high-yield issuers are likely to continuing worsening, due to the following factors:

- **US economic growth remains shaky, with wide disparities between sectors.** Growth in the services sector – which has thus far been driven by solid domestic demand – slowed in January far more than expected. The industrial sector is being dragged down by the strong dollar and weak growth in foreign markets. We expect US growth to slow, due mainly to the gradual deceleration expected in the pace of job creations.
- **Corporate earnings are being squeezed hard**: (1) there is little room left to improve margins; (2) financing costs have increased; and (3) the dollar's recent gains has hit exporting companies hard. More specifically, US HY is heavily exposed to the manufacturing sector and, in particular, the energy, metals and mining sectors (17% of the universe).
- **US corporate debt leverage has not been this high in a decade**. In recent years issuers have raised record amounts, mainly on the bond and equity markets, to fund M&A and share buyback.
- **Financing conditions have toughened in recent months for the most heavily indebted issuers**. The percentage of issues with spreads over 1000bp has skyrocketed in the energy, materials and retailing sectors. This points to an increase in defaults in the coming months. The US HY default rate is likely to hit 5% at end-2016 vs. 2.8% currently

Yield in %



Euro HY BB-B Non-Fin
US HY BB-B excluding Utility & Energy
Source: Bloomberg, Amundi Research

With 9% yields, US HY valuations remain far more attractive than European HY, with its yields of only 5%. This difference is due in part to: (1) the European universe's under-exposure to energy sectors; and (2) the higher credit quality of Euro HY issuers. The European HY default rate should stabilise at its current 2% level. On the dollar credit market, we reiterate our cautious stance on HY and are overweighting IG. We prefer solidly profitable, domestic demand-driven sectors

The week at a glance

Other events

Eurozone >

Spain still has no government. The Spanish king has asked the head of the socialist party (PSOE), Pedro Sanchez, to form a government, following the failure of the incumbent prime minister, Mariano Rajoy (of the rightest Popular Party) to form a majority after no clear victor emerged from the 20 December elections. Pedro Sanchez, whose party controls just 90 of 350 seats in Parliament, will have to form a coalition with – or at least obtain the parliamentary support of – several other parties, including at least the radical left party Podemos and either the centre-right Ciudadanos or some of the other radical left or regionalist parties.

Visibility is low, and there are some big obstacles to a PSOE-led coalition, particularly the very wide divergences of views between Podemos and Ciudadanos (on the issues of economic policy and the possible holding of a referendum in Catalonia), and the reluctance of a large swath of PSOE itself to link up with regional parties, and even Podemos. Even if such a coalition was formed, it could be highly unstable. Two other possible scenarios are either a grand coalition of PP and PSOE (currently rejected by PSOE, but that could change), or the holding of new elections. The markets will have to keep any eye on this political risk. Even so, we think it is very unlikely, even if Podemos does enter the government, that Spain will become embroiled in a face-off with European institutions as intense as the “Greek crisis” of 2015.

Economic indicators

Eurozone >

The European Commission has slightly lowered its 2016 growth forecasts. The Commission cut its 2016 GDP growth forecasts to 1.7%. Country by country, its new forecasts are 1.8% for Germany, 1.3% for France, 1.4% for Italy, and 2.8% for Spain. All these forecasts are 0.1pp lower than the Commission put out in autumn 2015, except for Spain, for which the forecast was raised by 0.1 pp.

While the euro zone is currently well into a cyclical recovery, external risks must not be overlooked, such as emerging market fears and the slowdown in US growth. Such risks could indeed put something of a drag on European growth, but it is expected to stick to its positive trajectory (our growth forecast is of the same order of magnitude, albeit slightly more conservative at +1.5% for euro zone GDP in 2016).

United States >

Disappointing nonfarm payrolls despite another decline in the unemployment rate. The US economy generated 151K new jobs in January (lower than the 190K consensus forecast and the downwardly revised figure of 262K for December). The unemployment rate declined to 4.9%, its lowest since February 2008, vs 5% in December. Average hourly earnings advanced 2.5% over one year, more than the +2.2% forecast by the consensus and after an upwardly revised advance of +2.7% in December. The participation rate increased to 62.7% (vs 62.6% in December). Average weekly hours increased very slightly to 34.6 vs 34.5 in December. **Activity is contracting in industry and slowing in services.** The ISM Manufacturing index rose only very slightly in January and remained in negative territory (48.2 vs. 48.4 forecast and 48 in December). The non-manufacturing ISM fell far short of forecasts at 53.5 (vs. 55.1 forecast and 55.8 in December). The main components of these indicators were down, on the whole, except for “new orders” in the ISM manufacturing, which rose to 51.5 (and into positive territory for the first time since October).

Part of the disappointing nonfarm payroll figures can be explained by a correction after abnormally strong December data. However, combined with the decline in the non-manufacturing ISM, these lower job figures still strengthen the case for a deceleration of the US economy that is no more limited to the manufacturing sector. We have recently reduced our 2016 growth forecast to 2% (vs 2.2% previously and believe that, while recession fears are exaggerate, US growth should gradually slow to its potential (significantly below 2%) in 2017.

China >

China’s January official manufacturing PMI came in slightly weaker than expected at 49.4 (vs. consensus at 49.6 and prior at 49.7). **China’s Caixin January manufacturing PMI**, came in slightly better than expected at 48.4 (vs. consensus at 48.1 and prior at 48.2).

China’s official manufacturing PMI has stabilised around the 49.4~49.8 level for five months in a row now, though it remains in contraction territory. From the breakdown, the slight weakness in January’s official manufacturing PMI was mainly led by the slowdown in imports (-1.2ppt), production (-0.8ppt), and new orders (-0.7ppt). On the contrary, Caixin Manufacturing’s marginal improvement was driven by new orders (+0.8ppt), which reflect a slow recovery in demand from domestic SMEs. China’s central bank, the PBoC, has likely injected over RMB 2 trillion into the system to support the weakening economy, and we think the PBoC should cut the RRR in light of the Bank of Japan cutting its interest rate into negative territory.

Financial markets

Fixed-income

German yields are back to extremely low levels, the 10 yr yield having temporarily fallen below 0.30%. The 2 yr yield reached a new historical low to -0.50%. The long-end of the curve flattened slightly. US yields fell with the nonmanufacturing ISM but rose by some bps after the job report. The 10 yr yield is back to its lowest level since early-2015.

The (tepid) wage acceleration and the drop of the unemployment rate shows that we cannot yet bury the fed funds tightening cycle. However, the FOMC will be extremely cautious. German yields appear now too low to take aggressive long position. However, coming ECB actions justify to stay long peripherals.

Foreign exchange

The USD sharply down, with weak US figures (nonmanufacturing ISM). Euro effective exchange rate increases by nearly 2% on the week and comes back to its end-2014 levels. The yen is up more than 3% vs the USD over the week and the USD/JPY parity is back to 117, i.e. levels prevailing before the BoJ rate cut in negative territory. The euro gained 2% in trade-weighted terms over the week and comes back to its end-2014 levels. The renminbi is very stable vs the USD since mid-January and lost 1.3% in effective terms.

The sharp appreciation of the euro is on the key elements that will prompt the ECB to make bold announcements on March 10. The two factors behind the USD strengthening since the summer 2014, i.e. the sharp fall of commodity prices and the divergence of monetary policy between the Fed and other central banks, are running out of steam. Moreover, the sharp appreciation of the USD in December/January, at a time where macro figures started to disappoint, has been clearly exaggerated. In the short-run, the USD may weaken further but the measures that the ECB will announce in March will put a downward pressure on the EUR/USD parity.

Credit

Amid falling equities, credit spreads turned to the upside during the week on both sides of the Atlantic: CDS spreads in particular widened more than the corresponding corporate bond spreads, as they are usually more strictly correlated to equities. European financials were among the hardest-hit sectors in the credit markets, as well as in equity: iTraxx senior and subordinated financial indices suffered from significant upward movements in credit risk premia, as spreads are currently back to end-2013 levels. Non-financial CDS were more stable. At the same time, oil's slight rebound failed to support the US HY segments as it occurred the week before.

Risk aversion is dominating the credit markets in this early part of the year. Among other consequences, the risk-off mood is inexorably affecting companies' ability to tap the bond markets for debt refunding. Usually, activity in the primary corporate bond markets tends to be very busy at the start of the year, but this time new debt issuance by the financial and non-financial sectors dropped by between 50% and 70% yoy in January. Furthermore, covered bonds (better supported by the ECB's asset purchase programme) accounted for around half of the overall disappointing volumes of new debt placed by financials: this seems to confirm the challenging funding conditions which are affecting the High Yield bond market even more. In this respect, in fact, January saw almost no European speculative grade issuance and it followed very weak issuance levels in the second half of 2015 (just €18 bn) vs. a higher volume of €57 bn in H1 2015. More challenging funding conditions suffered by corporates probably represents one of the various forms of unwanted tightening in financial conditions on the radar of the ECB, which, as we know, is likely to deliver more easing in March.

Equity

Equity markets: more dips. Equity markets fell further this week, with the drops of 3% by the MSCI World AC, 4% in Japan and the euro zone, and as much as 6% in Italy. Wall Street held up better, giving up just 2%, but emerging markets were the relative beneficiaries, with a +3% rally in USD by the MSCI EM (-0.5% in local currencies).

While economists wring their hands over a slowdown in global growth, a resurgence of deflationary pressures, and an increase in credit risk, equity markets are more than ever being driven by oil prices, China, and central banks. Against this backdrop, the week's main news was the shift in tone by the Fed after disappointing figures (PMI services). This reinforced market participant's conviction that the Fed would suspend its tightening cycle. This, in turn, pushed the USD down (-3.3% vs. EUR on the week) and, notwithstanding the new fall in oil prices, provided some relief to commodities-related sectors (in relative terms, +1% for oil and +4% for basic materials). The banking sector suffered another bout of weakness on the Italian "bad bank" discussion and, more broadly, on questions over credit risk.

Key upcoming events

Economic indicators

US : Markets expect a slight improvement in consumer confidence. **Zone Euro** : Industrial production is expected to rise in December.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
February 9	US	JOLTS report - Job Openings		5.431 M
February 10	UK	Industrial Production, MoM, December	-0.1%	-0.7%
	China	New Yuan Loans (CNY)	1900.0 Bn	597.8 Bn
	Japan	PPI, YoY, January	-2.8%	-3.4%
February 12	US	Retail Sales, MoM, January	0.1%	-0.1%
	US	Consumer Sentiment - Michigan, February	92.5	92
	Eurozone	GDP, QoQ, Q4	0.3%	0.3%
	Eurozone	Industrial Production, M/M, décembre	0.3%	-0.7%

Source: Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
February 8	France	Short-term, € 7 Bn
	Germany	Short-term, € 3 Bn
February 9	Germany	30 years, € 500 Mn
February 10	Germany	2 years, amounts not available on Friday
	Italy	Short-term, amounts not available on Friday
February 11	Italy	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
10 March	European Central Bank (ECB)
14 March	Bank of Japan (BoJ)
16 March	Federal Reserve (Fed)
17 March	Bank of England (BoE)
21 April	European Central Bank (ECB)
27 April	Federal Reserve (Fed)

Date	Upcoming political events
May 2016	G8 Shima (Japan) summit
November 2016	Presidential elections in the United States

Source: Amundi Strategy

Market snapshot

Equity markets	05/02/2016	Over 1 week	Over 1 month	Ytd
S&P 500	1915	-1,3%	-5,0%	-6,3%
Eurostoxx 50	2902	-4,7%	-8,7%	-11,2%
CAC 40	4227	-4,3%	-6,9%	-8,9%
Dax 30	9354	-4,5%	-9,3%	-12,9%
Nikkei 225	16820	-4,0%	-8,5%	-11,6%
MSCI Emerging Markets (close -1D)	740	-0,4%	-3,8%	-6,9%
Commodities - Volatility	**05/02/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	34	-0,8%	-5,4%	-7,6%
Gold ($/ounce)	1146	2,5%	6,4%	8,0%
VIX	22	1,6	2,5	3,6
FX markets	**05/02/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1,11	2,7%	3,5%	2,5%
USD/JPY	117	-3,2%	-1,5%	-2,7%
EUR/GBP	0,77	1,1%	5,0%	4,3%
EUR/CHF	1,11	0,2%	2,3%	2,0%
Fixed Income markets	**05/02/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0,23	--	+2 bp	-10 bp
Euribor 3M	-0,17	--	-3 bp	-4 bp
Libor USD 3M	0,62	+1 bp	-	+1 bp
2Y yield (Germany)	-0,48	-	-11 bp	-14 bp
10Y yield (Germany)	0,32	--	-22 bp	-31 bp
2Y yield (US)	0,75	-2 bp	-26 bp	-30 bp
10Y yield (US)	1,88	-4 bp	-35 bp	-39 bp
Eurozone Sovereigns 10Y spreads vs Germany	**05/02/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+33 bp	+2 bp	-4 bp	-3 bp
Austria	+27 bp	+3 bp	-2 bp	--
Netherlands	+13 bp	+2 bp	-5 bp	-4 bp
Finland	+25 bp	-1 bp	-4 bp	-4 bp
Belgium	+45 bp	+1 bp	+11 bp	+11 bp
Ireland	+69 bp	+6 bp	+19 bp	+17 bp
Portugal	+280 bp	+25 bp	+83 bp	+92 bp
Spain	+132 bp	+14 bp	+17 bp	+18 bp
Italy	+123 bp	+14 bp	+28 bp	+27 bp
Credit markets	**05/02/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+106 bp	+13 bp	+25 bp	+28 bp
Itraxx Crossover	+410 bp	+41 bp	+81 bp	+96 bp
Itraxx Financials Senior	+113 bp	+22 bp	+35 bp	+37 bp

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