Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

Letter finalised at 3pm Paris time **July 18 - 22, 2016**

Highlights of the week

- **Markets:** The German 10Y yield moved briefly back into positive territory; relatively calm week for the major currencies. Credit markets fared well this week;fairly calm markets.
- **United States:** Real estate recovery continues to support growth.
- **Europe:** The business climate worsens considerably in the United Kingdom, remains resilient in the Euro zone.
- **Emerging Markets (EMEs):** Rating agencies start reviewing Turkey's credit rating; mixed signals from economic activity in Russia.

Key focus

Wall street goes into extra time!

The S&P500 has just broken past its all-time highs (admittedly not yet by much) that it had already been testing for more than a year. This comes three weeks after the UK referendum to exit the European Union, which sends interesting signals.

First, the explanation is a simple one - Brexit is driving all of the world's central banks to be more accommodating. Even the Fed, which wanted to raise rates, has had to revise its plan. The decline in long-term interest rates, to even lower levels than before, has done the rest. The good jobs numbers for June, expressing an improvement in the US economy, revealed a sweet spot that could continue.

Several comments are called for:

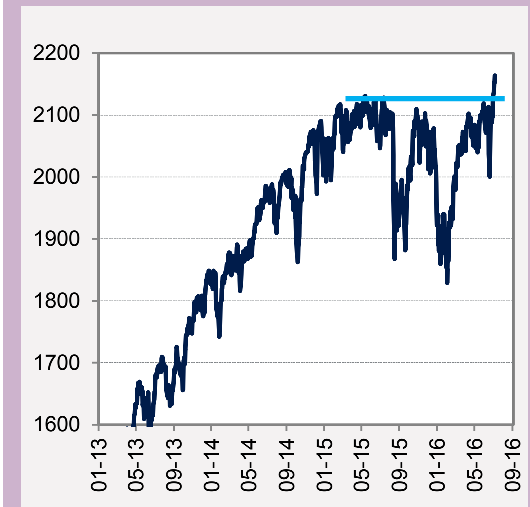
- Breaking past all-time highs is a positive sign on the economic cycle. Brexit should not do too much damage to global growth, which is expected to stay around +3%.
- Remember, the global economic cycle and the investment cycle are being driven, for some months still, by the oil counter-shock.
- As far back as 1998, the oil counter-shock (associated with the Fed easing rates) had allowed the markets to go into extra time.... until 2000.
- In 1986, the oil counter-shock did the same... before resulting in the crash of 1987.
- The situation on rates also calls to mind the Conundrum of 2004, when the Fed could not make long-term interest rates rise. At the time, keeping rates lower than necessary had helped prolong the cycle and build up the subprime bubble.

Conclusion

Admittedly, the US market is expensive, which does not bode well for its very-long-term performance. It is likely that with a PER above its long-term average, its performance will be lower than its long-term average performance (6.5% in real data, dividends reinvested). But this does not determine its performance in the nearer term.

The US market is clearly the leader in this cycle. Yet an investment cycle only ends when leading stocks break their resistance to the downside, which is the opposite of what is happening today. If the signal launched by the US market is confirmed, it would be rather favourable to the equity asset class.... at least for a while. With Brexit generating such uncertainty, this is good news.

The S&P500 broke past its all-time highs



Source : Datastream, Recherche Amundi

The week at a glance

> Other events

Turkey > **Following the failed coup attempt last week, two rating agencies have taken rating actions.** Moody's to put its Baa3 rating on Turkey "review for downgrade" on July 18th and S&P downgraded to BB with a negative outlook from BB+ (already non-investment grade) on July 20th. We suspect that Fitch may take a negative rating action also.

We are not surprised by these downgrades. With the reversal of capital inflows and extended political uncertainty, Turkey is highly likely to have a balance of payments crisis and problems to service its debt, especially given large external debt servicing needs and low international reserves.

> Economic indicators

United States > **The real estate recovery continues to support growth. Housing starts** were higher than expected in June (1,189,000 instead of 1,153,000 expected), but after May's figures were adjusted downward (1,135,000 and not 1,164,000 as announced previously). **Building permits**, meanwhile, rose and were practically in line with expectations (1,153,000 after 1,136,000 in May). Finally, **sales of existing homes** were higher than expected (5.57M vs. 5.48M anticipated). **The index of Leading Economic Indicators** of the US economy published by the Conference Board rose +0.3% in June (vs. +0.2% expected), thanks mainly to the positive contributions from credit conditions, building permits, and jobless claims.

After the doubts that have appeared in recent months, the most recent indicators have reassured us about the continued US growth cycle. However, beyond the short-term numbers, we do not believe there will be a true re-acceleration.

Europe > **The business climate worsens considerably in the United Kingdom, remains resilient in the Eurozone.** According to its "Flash" preliminary estimate, **the UK PMI Composite** index surprised to the downside and returned for the first time in several years to a level suggesting a contraction in economic activity (47.7, vs. 49 forecast and 52.4 in June). Its services and manufacturing components are both in negative territory. Conversely, the **Eurozone PMI Composite** index slipped only slightly (to 52.9, vs. 52.5 forecast and 53.1 in June). The **PMI Composite indices of Germany and France** were both up (the lower manufacturing component in Germany was offset by an increase in services), thus suggesting that the declines occurred in the PMI Composite in Spain and/or Italy. However, **in Germany, the ZEW indicator of economic sentiment** fell far more than expected in July, to a low since the end of 2012 (at -6.8 vs. 9 forecast and 19.2 in June. In France, **the Insee industrial activity index** improved (to 103 vs. 101 expected and 102 in June) although some of its components are sending out mixed signals.

July's indicators are still far from complete (others will be published over the next few days) but, at this stage, we have no reason to backtrack on the recent changes to our forecasts for the UK (GDP growth forecast reducced from 1.8% to 1.1% for 2016, from 2% to 0.2% for 2017) and the Eurozone (GDP growth forecast reduced from 1.6% to 1.5% for 2016, and from 1.5% to 1.2% for 2017).

Japan > **July PMI index pointed to a bottoming out of Japanese manufacturing production.** The index remained below 50 but rose from 48.1 in June to 49.0 in July. The PMI index also showed that price pressure continued to weaken. The indices for exports and new export orders were also negative, possibly due to a stronger yen. It is important to note that exports remained sluggish in May. In particular, in Europe - where volumes had expanded during the previous months - exports moved into negative territory.

Economic fundamentals have been weakening for several months now. The PMI data in July embossed a long-awaited sign of improvement, although the reading below 50 still signals challenging operating conditions.

Russia> **While industrial production grow by 1.7% yoy** - largely higher than in May and expected by the consensus (0.7%)- **retail sales are still lagging (-5.9% yoy in June** compared to -6.1% in May). **Real wages has sharply rebounded from -1% in May (yoy) to +1.4% in June** in line with a stabilization of the unemployment rate to 5.4%. **Real disposable income is still declining** (-4.8% yoy) but to a smaller extent than in May (-6.2%). Price Production Index has also accelerated : 5.1% in yoy versus 3.2% in May.

The difference between the rebound registered in real wages and the persistence of the contraction of retail sales could lead to upside pressure on prices. We are still expected CBR to implement further rate cuts this year as inflation is decreasing but if these risks materialized the magnitude of the cuts might be lower.

Monetary policy

BCE >

The ECB has decided to take its time. As it estimates it is too soon to gauge the impact of the Brexit vote on the growth and inflation outlook for the Eurozone, the governing council refrained from announcing any new measures. Mario Draghi dodged questions on adjustments to the PSPP during the press conference, but he insisted on the ability to adjust its purchase programmes that the ECB showed over the recent months (he was probably referring to the CSPP).

Just as the BoE did, which wanted to show that it was not panicking, the ECB preferred to remain on hold and to wait new economic projections to announce adjustments to its purchase programmes. On 8 September, the ECB should announce it extends its purchase programmes until September 2017. In its current format, the PSPP will not be feasible for long. Currently, the Bundesbank can only buy securities with a maturity between 7 and 31 years, which means that the stock of German PSPP eligible bonds is shrinking and shrinking. The announcement of a deviation from the capital rule for sovereign bonds purchases is likely, what would mean less purchases of German securities and more purchases of Spanish and Italian securities.

South-Africa, Brazil and Turkey >

The South African Reserve Bank (SARB) and **the Brazilian Central Bank** (BCB) held their interest rate unchanged at 7.00% and 14.25%, respectively. **The Central Bank of Republic of Turkey** (CBRT), in turn, cut its target rate by 25 bp to 8.75% and let unchanged the 2 other official rates.

While the SARB and the BCB has maintained a prudent policy giving their higher inflation (above the target) and a (still) possible interest rate hike this year by the Fed, the CBRT continued to conduct a very accommodative monetary policy which is quite risky in the current context.

Financial markets

Fixed-income

The German 10Y yield moved briefly back into positive territory, closing out the week at 0.00%. The US 10Y went from 1.55 to 1.59%. In Europe, sovereign spreads continued to shrink over the first part of the week, before spreading again after the Governing Council met. Note that YTD 2016, net issues after ECB purchases are negative by about €200 bn.

We are staying positive on Italian and Spanish bonds, because the ECB should make announcements about changes to its sovereign bond buying programme when the Governing Council meets on 8 September. These announcements should be particularly positive for Italian and Spanish bonds.

Foreign exchange

A relatively calm week for the major currencies. The EUR/USD exchange rate is at the 1.10 level, while the USD/JPY is up by 1.2%, closing the week at 106. The Turkish lira lost 5.27% over the week due to the political events.

We are expecting relatively little change on the EUR/USD over the weeks to come. In the short term, the yen may continue to depreciate, with speculations over easing monetary policy. For now, the pound has stabilised, but the risks dragging down the London real estate market (and thus the British economy) mean that it is risky to take any more long positions.

Credit

The credit markets fared well this week. The CDS Main and Crossover indices tightened, respectively, by -3 and -5 bp. The euro primary market opened back up.

Euro zone banks have bolstered their equity considerably. The largest establishments are averaging Tier 1 equity ratio of 13% as of the end of 2015, vs. about 9% in 2012 and 7% in 2008 (source: ECB). Liquidity is still satisfactory at most euro zone banks, driven in part by central bank support. Investors are concerned that banks are less able to generate profits in a risky environment (with high NPL ratios in the euro zone, systemic risk from Deutsch Bank's problems, and UK real estate). Undercapitalized banks may have a harder and harder time strengthening their equity by capitalising their profits or issuing new shares. Mario Draghi's answer: to resolve the problem of non-performing loans in the euro zone, public support would be acceptable for banks in exceptional circumstances.

Equity

Fairly calm markets. The markets are catching their breath at the approach of the European banks' stress tests (to be published on 29 July), but not losing any altitude. Some markets are now above their level at the start of the year: the MSCI Emerging Markets index is 10% and the S&P500 is 6% higher. Others are still below: MSCI EMU is at -8% and Topix at -13%.

The fact that the US market has succeeded in breaking through its all-time highs after attempting to do so for more than a year is a comforting sign for all of the equity markets (see Editorial). For the time being, the emerging markets are benefiting the most from this positive development.

Key upcoming events

Economic indicators

Germany : Business climate might deteriorate in July. **United States :** New home sales is expected to increase slightly in June.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
25 July	Germany	IFO business climate index, July	100.8	103.1
26 July	US	Services PMI, July		51.4
	US	CB Consumer confidence, July	95.5	98.0
	US	New home sales, June	560 K	551 K
27 July	Germany	Consumer confidence GfK, August	9.9	10.1
	France	GDP, QoQ, Q2	0.5%	0.4%
28 July	Eurozone	Consumer confidence, July	-7.9	-7.9
	Germany	Unemployment rate, July	6.1%	6.1%
	Germany	CPI, YoY, July	0.4%	0.3%
29 July	Eurozone	CPI, YoY, July	0.2%	0.1%
	Eurozone	GDP, QoQ, Q2	0.3%	0.6%
	France	GDP, QoQ, Q2	0.2%	0.6%
	Eurozone	Unemployment rate, June	10.1%	10.1%
	Japan	Unemployment rate, June	3.2%	3.2%
	Japan	Retail sales, YoY, June	-1.3%	-1.9%
	US	GDP, QoQ, Q2	2.6%	1.1%

Source : Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
25 July	France	Short-term, amounts not available on Friday
	Germany	12 months, € 1.5 Bn
26 July	Italy	Long terme (indexées sur l'inflation), montants non disponibles vendredi
	Italy	Long-term, amounts not available on Friday
27 July	Italy	Short-term, amounts not available on Friday
	Germany	30 years, € 1 Bn
28 July	Italy	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
27 July	Federal Reserve (Fed)
28 July	Bank of Japan (BoJ)
4 August	Bank of England (BoE)
8 September	European Central Bank (ECB)
Date	**Upcoming political events**
29 July	European Banks' stress test results
September	G20 Summit - Hangzhou, China
October 2016*	Italian Constitutional Referendum
November 2016	Presidential elections in the United States

Source: Amundi Strategy

* Estimated

Market snapshot

Equity markets	22/07/2016	Over 1 week	Over 1 month	Ytd
S&P 500	2165	0.2%	3.8%	5.9%
Eurostoxx 50	2970	0.4%	-0.3%	-9.1%
CAC 40	4377	0.1%	-0.1%	-5.6%
Dax 30	10144	0.8%	0.7%	-5.6%
Nikkei 225	16627	0.8%	3.5%	-12.6%
MSCI Emerging Markets (close -1D)	871	0.4%	5.0%	9.7%
Commodities - Volatility	**22/07/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	46	-3.0%	-7.4%	23.9%
Gold ($/ounce)	1325	-0.9%	4.6%	24.8%
VIX	13	-0.1	-8.6	-5.6
FX markets	**22/07/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.10	-0.2%	-2.5%	1.5%
USD/JPY	106	1.2%	1.6%	-12.0%
EUR/GBP	0.84	0.4%	9.4%	13.9%
EUR/CHF	1.09	0.0%	0.3%	-0.1%
Fixed Income markets	**22/07/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.34	--	-	-21 bp
Euribor 3M	-0.30	--	-3 bp	-17 bp
Libor USD 3M	0.70	+1 bp	+6 bp	+9 bp
2Y yield (Germany)	-0.61	+4 bp	-3 bp	-26 bp
10Y yield (Germany)	0.00	--	-6 bp	-63 bp
2Y yield (US)	0.71	+4 bp	-3 bp	-34 bp
10Y yield (US)	1.59	+4 bp	-9 bp	-68 bp
Eurozone Sovereigns 10Y spreads vs Germany	**22/07/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+24 bp	+1 bp	-12 bp	-12 bp
Austria	+22 bp	--	-13 bp	-5 bp
Netherlands	+12 bp	+1 bp	-11 bp	-4 bp
Finland	+15 bp	-1 bp	-14 bp	-14 bp
Belgium	+27 bp	+2 bp	-12 bp	-7 bp
Ireland	+51 bp	+1 bp	-20 bp	-1 bp
Portugal	+310 bp	-3 bp	+1 bp	+121 bp
Spain	+116 bp	-6 bp	-28 bp	+2 bp
Italy	+127 bp	+2 bp	-10 bp	+30 bp
Credit markets	**22/07/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+68 bp	-3 bp	-10 bp	-9 bp
Itraxx Crossover	+319 bp	-5 bp	-20 bp	+4 bp
Itraxx Financials Senior	+92 bp	-5 bp	-8 bp	+15 bp

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