For professional investors

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Weekly Strategy Update

14 August 2014

SUMMARY

- Global growth should remain steady
- Some encouraging signs from emerging markets
- Asset allocation: reduced overweight in European high-yield corporate bonds

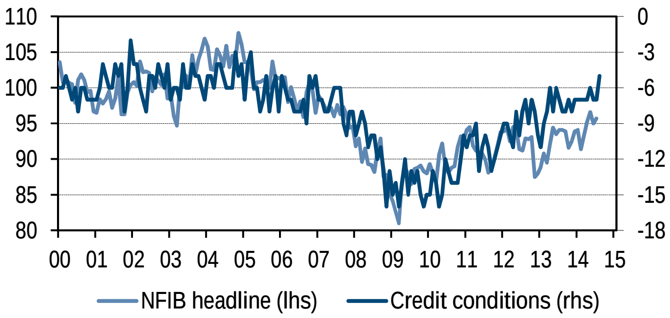
Markets have been hit by a toxic mix of geopolitical tensions, including those in Ukraine, Iraq and Israel/Gaza. Looking at the behaviour of the various asset classes, I think the unrest in Ukraine had the biggest impact. European equities suffered more than those in the US, although economic developments in the old continent have also been less favourable. But despite the unrest in the Middle East, oil prices have not risen. The safe haven flows have gone to government bonds. Accordingly, yields in the US and Germany have fallen, in Germany even to record lows. Although yields look low in light of the current growth and inflation outlook, we think there is too much uncertainty at this point to take a short duration position. In fact, we have de-risked our model portfolio by reducing our overweight in European high-yield corporate bonds.

GLOBAL ECONOMIC CYCLE TURNING?

Amid disappointing news from the eurozone and mixed data from emerging markets, you might ask whether the global economic cycle is turning down. I do not think this is the case. The US economy is doing relatively well and although some data from the eurozone was negative, there have also been positive developments. We have seen encouraging signs from emerging markets.

We do not think the US economy can continue to grow at 4.0%, as it did in the second quarter. The rate was flattered by the largest contribution of inventory building in almost three years. But more importantly, we expect consumption to continue to grow at around 2.5%. Flat retail sales in July and a downward revision for June looks a bit too weak given improvements in the labour and the housing market, but is sets the stage for another quarter with modest consumption growth. We don't see the other components of GDP lifting the overall growth rates much above the 2.5% level. By the way, in our view, such a growth rate would be close to trend growth.

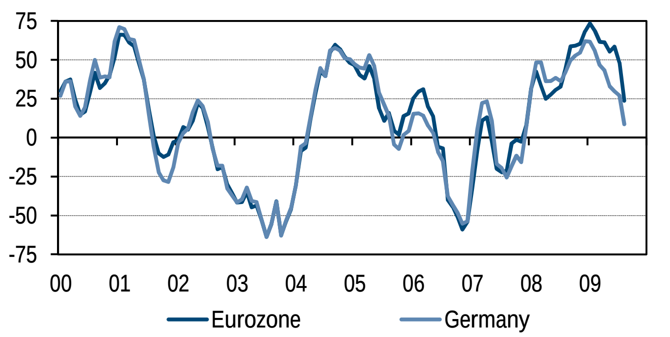
US small business confidence



Source: Datastream, BNPP IP

Encouraging in the most recent data has been the increase in confidence among small business owners and in the services sector. The NFIB index suggests less bullishness among small business owners than the ISM non-manufacturing index. The increase in July was modest after June's steep drop, but it confirmed that the trend is up. More positive than the increase in the headline number was the improvement in credit conditions for small businesses. On balance, the NFIB survey respondents were still negative, but their number was the smallest since 2006. This confirms the positive credit cycle in the US, which has also shown up in the Federal Reserve's survey of banks' senior loan officers and in bank credit data. After a slowdown late last year, bank credit growth has accelerated, most notably in commercial and industrial loans.

Europe ZEW-index



Source: Bloomberg, BNPP IP

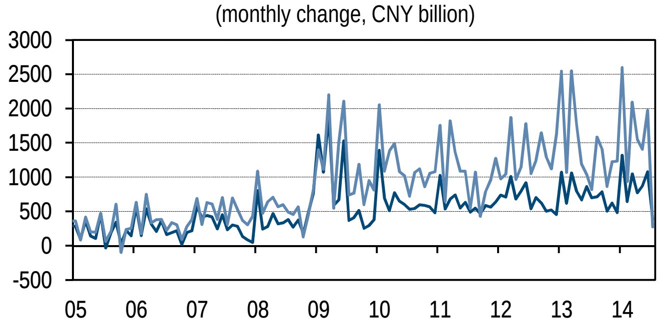
In the eurozone, the steep drop in the German ZEW index was disappointing. For the eurozone as a whole, the index fell to its lowest since December 2012. The monthly drop was the third-largest on record. Only in September 2000 and in August 2011 did the index for the eurozone fall more quickly. Of course, the level of the index is still clearly above the levels seen in the recessions of 2008/09 and 2011/12. Developments in Germany were comparable although in a historical context, less extreme. The ZEW index can be volatile so big changes should be not be taken too literally.

The composite PMI rose in July due to an increase in the domestically oriented services sector, but the reading in manufacturing was flat. The Economic Sentiment Index has only levelled off. We interpret this more as a delay in the eurozone recovery than a turn downwards. We expect the fallout of geopolitical tensions to be modest. If so, there is no negative shock that could explain a change in the direction of economic growth. Industrial production in eurozone member countries was mixed in July. In Germany, the annual growth rate turned negative; in Spain and the Netherlands it was weak, while data from France and Italy was strong. The sharp drop in German manufacturing orders was a concern, but exports held up better. For the region as a whole industrial production fell for the second straight month in June, bringing annual growth to a standstill. O the positive side, the euro is finally responding to weaker data in the eurozone and should provide further support.

In Japan, GDP shrank sharply in the second quarter. The 6.8% QoQ annualised decline was far worse than expected. Of course this was due to April's increase in the sales tax. Consumption fell by almost 20% and residential investment (home sales are also subject to the tax) a massive 35.3%. Falling business investment contributed to the decline in GDP. This has nothing to do with the tax hike, but follows a surge in investment in the first quarter. Compared with the tax hike in 1997 the fallout is bigger this time. Leading indicators suggest improvement ahead. Of course, consumers have been hurt by rising inflation and very modest wage gains, but this looks set to improve. The impact on inflation of the tax hike and the depreciation of the yen should wear off, while a tightening labour market should support incomes. That said, growth will be modest at best. For now, the growth and inflation outlook does not point to any imminent change in monetary policy. Market expectations for further monetary easing are again moving forward, now into 2015.

The main news from China was a collapse in new bank loans and in total social financing in July. Although this was the weakest data in years, one has to realise that it came after a surge in June. Even despite the weak numbers, up to July, credit had expanded more quickly this year than it did last year. In a statement, the People's Bank of China mentioned the seasonal pattern as a source of the weakness, but also muted demand for credit due to the correction in the real estate market and the general slowdown in growth, as well as greater caution among banks as non-performing loans rise. The slowdown in credit is not due to any monetary tightening. Interbank rates have not changed much in recent months. In fact, the PBoC has taken targeted easing measures. I do not expect the central bank to ease policy more broadly in the form of a general cut in reserve requirements or a rate cut. Growth is important for the authorities, but so are more balanced economic developments.

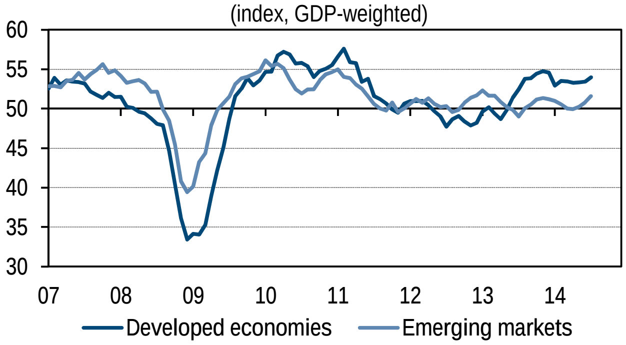
China credit
(monthly change, CNY billion)



Source: Bloomberg, BNPP

In emerging markets, our GDP-weighted manufacturing PMI rose to 51.6. This is its highest since March 2013 and the rise was mostly due to a strong improvement in China (where the services sector PMIs unfortunately declined), but also in Taiwan, South Korea and Brazil. The PMIs are still below 50 in those last two countries though.

Manufacturing PMI
(index, GDP-weighted)



Source: Markit, BNPP IP

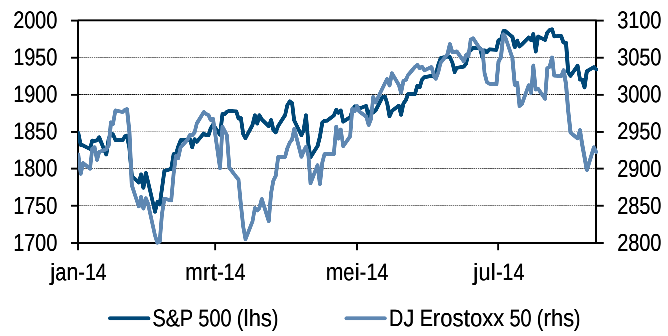
Trade signals in July were also positive, with strong improvements in China and Brazil (where the improvement was so strong that it should be taken with a pinch of salt) and stronger growth in South Korea and Taiwan. Industrial production was more mixed in June, with fairly steady growth in China, a collapse in Brazil and Thailand, modest growth in India, South Korea, Mexico and Turkey and strong growth in Taiwan. A weighted average of 13 large emerging markets showed 6.5% YoY growth in June, which was at the low end of the range of the previous months.

All in all, we conclude that the global economic cycle is not turning down, but not accelerating either. We think the current period of somewhat uninspiring growth will continue.

MARKETS: THE FALLOUT OF GEOPOLITICS

Markets have calmed down in recent days, but earlier there were strong reactions to the latest geopolitical developments. Last week, the S&P500 equity index dropped by 2.8% from a record high, but this was modest compared with the 5.0% plunge in the EuroSTOXX 50 index. This makes sense since Europe would suffer more from further negative developments and economic data there have also been weaker. As part of the de-risking of our model portfolio, we had closed our equity overweight a few weeks ago. At this point, we prefer to stay neutral.

S&P500 & DJ Eurostoxx 50



Source: Datastream, BNPP IP

Investors have clearly sought the safety of government bonds. Ten-year yields in the US and Germany have fallen by more than 20bp. In Germany, yields even closed at a record low on 8 August. In Japan, yields held at only 9bp above the record low of 12 June 2003 when the economy suffered from persistent deflation. We do not expect a general growth slowdown and we think inflation is close to bottoming. The Fed and the Bank of England could start hiking rates next year, but the ECB and the Bank of Japan are still far from doing so. While the fundamentals do not justify current bond yields in our view, we are reluctant to take a short position in light of the geopolitical uncertainties at this point.

Spreads on investment-grade corporate bonds have not changed much, so yields have fallen to extremely low levels. Although high-yield corporate bonds did suffer as spreads widened by more than government bond yields declined, we still see more value in high-yield than in investment-grade. We are still overweight European high-yield, although we have reduced this position somewhat.

Emerging market bonds have suffered less than high-yield. But these bonds had already corrected in the middle of last year and early this year due to the Fed's tapering of its asset purchase programme. We are still overweight local currency bonds since we believe they offer an attractive spread over US Treasuries.

Inflation protection markets in Europe have been hit particularly hard. French breakeven inflation rates – the difference between nominal yields and yields on inflation-linked bonds – fell to 1.29% from 1.47% at the end of July. This has caused a loss in our long inflation-linked versus nominal bonds position. The main reason is the expected impact on food prices from a Russian ban on imports of certain foods in reaction on sanctions imposed by Europe and the US. This has weighed heavily on selected fresh food prices and should depress inflation, which is already low. Based on a rough estimate, we think the impact on inflation could be as much as 2%. Even if softening factors such as limited pass-through of price declines to consumers and supply responses are taken into account, the impact on inflation could be material. Since inflation-linked bonds are tied to headline inflation, market adjustments look sensible. But we think the reaction seen across the inflation-linked curve (from short to long-term bonds) may prove to have been overdone.

France break-even inflation

Source: Bloomberg, BNPP IP

Oil prices have not reacted to the recent developments. In fact, they have fallen from levels seen in the middle of June. Gold prices have not moved much either. So investors appear not to see the developments in the Middle East as harming oil production. Investors so far prefer the liquidity of government bonds over gold as a safe haven. We are neutral on commodities.

ASSET ALLOCATION: FURTHER DE-RISKING

Core positions

We remain neutral on global equities. Monetary policy is still supportive, as are global liquidity and the economic cycle, although we are less convinced of the latter. We see valuations as neutral, as long as earnings expectations are met. The recent drop in equity markets tempered upbeat investor sentiment somewhat, but for us, there is too much uncertainty to take a more outspoken view in global equities.

A more constructive view on emerging markets is reflected in our recently implemented overweight in greater China (including the mainland, Hong Kong and Taiwan) versus global emerging markets. We still think negative sentiment is overdone and reflected in low valuations and net short positions.

We are also overweight the eurozone versus the UK. The UK economy has been doing much better than the eurozone, but we think there is more room for company earnings to improve in the eurozone. While earnings in UK and US have recovered, the bounce has not been meaningful in the eurozone. Analyst expectations for UK earnings are improving, but we do not expect this to last. It could even reverse again. A normalisation of monetary policy in the UK and the US, while the ECB is still easing, should have a positive currency effect on eurozone earnings. Finally, we see more room for higher price-earnings ratios in the eurozone than in the UK.

We have reduced our overweight in European high-yield corporate bonds to de-risk our model portfolio, but we still like the carry on these bonds against a backdrop of low default rates and generally decent company balance sheets.

We also like the carry on emerging market debt in local currencies, especially now that currency volatility has faded. The unhedged currency position was recently switched to a hedged position due to the substantial weakening of the euro against the US dollar in recent weeks.

While government bond yields look set to go higher, central bank policy and low inflation should ensure that any rise is gradual. At this point, we lack the conviction to take a short duration position in Germany or the US.

We are long eurozone inflation-linked bonds versus nominal government bonds on the view that the inflation discounted by linkers is too low. If inflation expectations rise, these bonds should outperform nominal bonds.

We are neutral on real estate globally. We are long European equities versus European real estate. Strategists have become increasingly cautious on the European outlook and have downgraded earnings forecasts in recent months, but we are more optimistic about the outlook for European equities. European real estate has done reasonably well, but a quite favourable environment is now priced in. The outlook for European real estate appears much more modest due to low inflation and limiting earnings growth.

We are neutral convertible bonds, commodities and cash.

In principle, the euro should weaken further in the longer run with more monetary stimulus in the eurozone and increasingly less in the US. If, however, investors become convinced that ECB policies are supporting growth and inflation, capital inflows and the region's trade surplus could support the euro.

Flexible multi-asset positions

In our flexible multi-asset approach, we are overweight Italian government bonds versus UK government bonds. Yields are higher in Italy than in the UK, which results in a (small) positive carry, but the main rationale for this trade is that yields in Italy could fall further thanks to ECB policy. The more hawkish Bank of England, which could start hiking rates late this year or early in 2015, may drive up UK yields. If this scenario plays out, price developments of these bonds should work in our favour.

We are overweight Mexican USD-denominated debt versus US 10-year Treasuries. We expect Mexican bonds to benefit from sound and improving fundamentals, falling inflation and low official interest rates. We think Mexico is shielded better from downside risks in China than other countries in Latin America.

In the US, we are long five-year forward inflation swaps (hence the expectations of inflation five years from now). When expectations dipped in late April, we established a long position.

In the US, we are also long high-yield corporate bond versus investment-grade, mainly for the pickup in carry.

In Europe, we are long five-year forwards in investment-grade debt. With less flattening at the long end of the curve than at the short end, there is a relatively large gap between spot rates and five-year forwards. This position should pay off if the gap starts to narrow.

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Bloomberg and Datastream are the sources for all data in this document as at 13 August, unless specified otherwise.

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