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Weekly Strategy Update

18 September 2014

SUMMARY

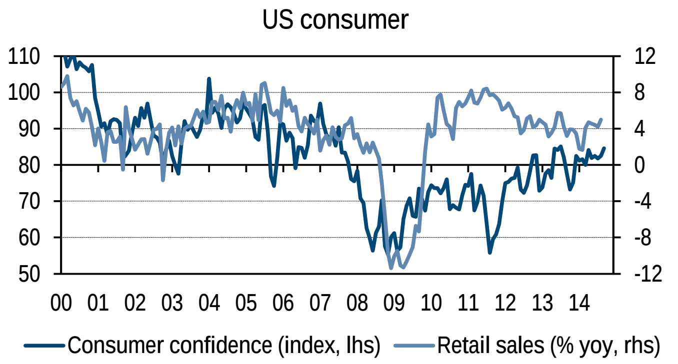
- Fed projects slightly faster pace of hikes and emphasises flexibility
- Chinese central bank reacts to low growth
- Asset allocation: positioning for a Scottish No to independence vote

This week, all eyes were on the policy meeting of the Federal Reserve. The subsequent news conference was a good moment for Chair Janet Yellen to give fresh clues on the course of monetary policy after the Fed winds up its asset purchases in October. So far, the Fed had said it would keep US policy rates low for a "considerable period" after the end of quantitative easing. Markets had been eager to see whether the likely timeframe for the first US interest rate hike had changed. The Fed kept the "considerable period" pledge. Given the speculation beforehand that this could be altered, leaving it unchanged was essentially dovish. But the slightly higher rate projections and Yellen's emphasis on flexible and data dependent policy, together with the recent strong economic data led markets to a more hawkish view.

And of course, the Scottish referendum loomed large. A rejection by the Scots of independence would be negative for our long eurozone versus UK equities position. Since the rationale for the position has already been weakened by the slowdown of the eurozone economy, we decided to close it. In our flexible multi-asset allocation, we sold put options on the British pound versus the US dollar. We took profits on part of our short duration position in US Treasuries and we implemented a long oil versus short industrial metals position.

US ECONOMY HUMMING ALONG

Data from the US continued to give positive signals on the strength of the economy. Consumption growth was modest in July, but retail sales indicated stronger growth in August. With the rebound in August, retail sales growth accelerated to 5.0% YoY. Stripping out volatile petrol and car sales, annual growth was slightly slower at 4.8%. Consumer confidence improved further in September. According to the University of Michigan survey, confidence rose to its highest in over a year.



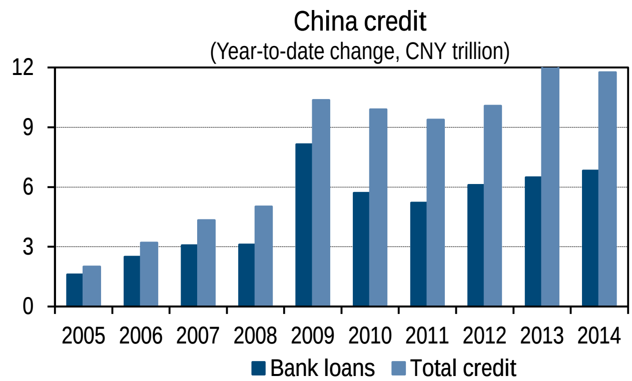
Source: Datastream, BNPP IP

News from the industrial sector was mostly positive. Industrial production fell in August, but this came after a strong July when car production had been boosted by some firms not having their usual summer shutdowns. Thus, the advance in August was smaller than normal on a non-seasonally adjusted basis and production declined when adjusted for seasonal patterns. This was also the reason why manufacturing production fell by even more. However, sentiment indicators are generally giving positive signals about the industrial sector. The Empire Manufacturing Index, measuring sentiment in the New York region, surged in September. At 27.5, it came in at its highest since October 2009. The strength of the headline index, which is not an average of the components, was misleading since the components were less positive. But even when taking that into account, the overall picture of the manufacturing sector looks bright.

The Fed did not just leave the “considerable period” untouched, but is essence the whole press statement was unchanged. The assessment of the labour market was slightly more dovish though. But markets looked at it from a hawkish side. The euro and the yen depreciated sharply while US bond yields increased a few basis points. But the Fed was not hawkish enough to spoil the party for equity investors. The S&P500 equity index was up at the end of the day, albeit marginally. So why this hawkish interpretation? The Fed now projects a somewhat stronger pace of rate hikes than after the June meeting. Moreover, Yellen said at the press conference that keeping rates low for a considerable time after asset purchases end (which will be in October) is not a firm promise of timing. In fact, Yellen emphasised flexibility and data dependency. As US economic numbers have been strong, this flexibility was seen mostly as possible earlier rate hikes. Finally, there were now tow dissenters on the monetary policy committee instead of one.

MORE STIMULUS IN CHINA

Data from China has been disappointing or even outright weak lately. New bank loans and total social financing (a broader measure of credit growth which takes the shadow banking system into account) fell steeply in July. August’s rebound was smaller than expected. Hence, up to August, total social financing increased by less than in the first eight months of last year, even though the economy is now roughly 10% bigger.



Source: Bloomberg, BNPP IP

After having lost market share last year, banks are doing better this year. New bank loans have so far increased by more in absolute terms than last year. This may all be due to government attempts to reign in shadow banking. The result is that bank lending and total social financing are growing more slowly. At 13.3% YoY for outstanding bank loans and 16.9% YoY for total social financing, annual credit growth rates are at record lows. This should have a dampening impact on China’s credit-driven economy.

Indeed, retail sales growth slowed in August to 11.9% YoY. This matches April’s growth rate, which was the slowest since June 2004.

Source: Bloomberg, BNPP IP

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This was however resilient when compared with industrial production where growth plunged to 6.9% in August not far from the trough of 2008, when the financial crisis ripped through the global economy. Growth in fixed asset investment slipped too. At 16.5% YoY, it came in at the slowest rate since December 2001. Government-driven investment in infrastructure has held up reasonably well, but investment in manufacturing and especially real estate has cooled. Other indicators of a weakening domestic economy were the fall in imports and the moderation in inflation in August.

Although the authorities have so far refrained from major stimulus measures and opted for a more targeted approach, this string of weak data prompted RMB 500 billion of liquidity injections into China's five largest banks. The People's Bank of China used its Standard Lending Facility, a tool for managing short-term liquidity in the banking system which was introduced in 2013. The SLF was used extensively in 2013, when outstanding loans were close to RMB 400 billion from July through September. They have been at zero from March this year onwards.

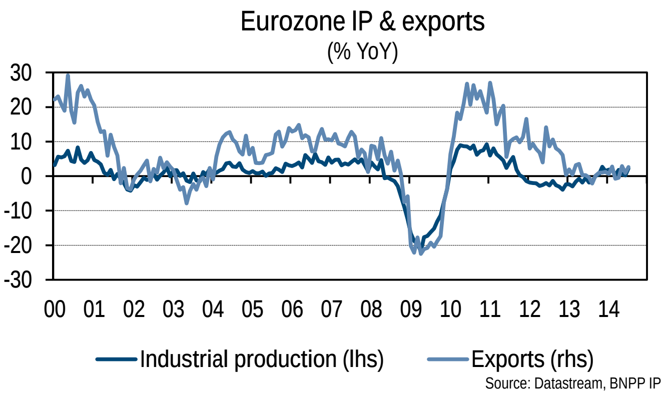
It is unlikely that the central bank is just managing liquidity this time. The amount of the injection is large, roughly 3.5% of GDP. As a point of reference, the Fed's asset purchases since January 2013 have amounted to 8.5% of GDP and if the ECB manages to expand its balance sheet by EUR 700 billion with its newly announced policy measures, it would amount to 7% of GDP. Moreover, there is ample liquidity in the Chinese banking system, as evidenced by the low interbank interest rates. The PBoC chose the maximum duration of three months for the SLF loans. And finally, the decision was taken after the string of weak data mentioned above.

The impact on the economy depends on whether the loans will be extended after three months. If so, the effect is comparable to a 50bp cut in reserve requirements. Of course, such a cut has now become less likely. The fact that there was no official announcement of this action shows that the PBoC is still reluctant to be seen stimulating the economy.

We believe the Chinese economy has genuinely slowed down. The authorities had so far been relaxed about the recent economic numbers and seemed ready to accept growth somewhat below the 7.5% target. But the recent slowdown was too much for them to stomach, so they decided that a stronger policy reaction than the targeted measures taken so far was necessary. This also means that growth still matters for Chinese policymakers and that it should not slow much further.

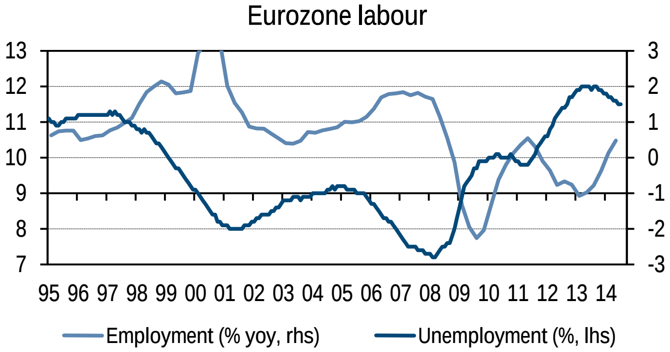
(MODEST) GROWTH IN THE EUROZONE

After eurozone growth flat lining in the second quarter, it looks like it has improved in the third. Having fallen two months in a row, industrial production for the region jumped by 1.0% MoM in July. There were strong gains in Germany and the Netherlands. But growth was more modest in France, unchanged in Spain and negative in Italy. These are partly monthly fluctuations. More importantly, for the eurozone as a whole, production in July was 0.4% above the average for the second quarter. In that quarter, production had been unchanged from the first. Any improvement in growth should be gradual though. External trade was a drag in July, with exports falling and imports rising. Recent euro depreciation should support exports and suppress imports, but this will take some time to materialise. And foreign growth is traditionally an even more important driver for exports than a favourable exchange rate.



Furthermore, leading indicators have recently pointed to a loss of economic momentum. This week, the ZEW indicator for the eurozone continued its steep decline. For Germany, the drop in the expectations component moderated. This index can be volatile and other leading indicators such as the Economic Sentiment Index for the eurozone or the Ifo index for Germany tend to give clearer indications of growth, but the signal of the ZEW index looks quite strong this time.

Despite slow growth, the eurozone economy has been able to create more jobs. In the second quarter, employment rose for the fourth consecutive quarter. At 0.5% YoY, the growth rate was the strongest since the second quarter of 2011. Unemployment has fallen as a result, albeit very gradually. Another implication is that labour costs have continued to rise. In the second quarter, total labour costs increased by 1.2% YoY while unit labour costs were up by 0.9% YoY. Although these are modest increases, they argue against widespread deflation in the eurozone. A more negative implication is that trend growth in the eurozone is low. Even at only 0.5% YoY in the past four quarters, employment has grown and unemployment has fallen. But slow trend growth and low inflation are making it harder to address government debt problems.



Source: Datastream, BNPP IP

In the UK, the minutes of the September monetary policy meeting of the Bank of England showed that seven committee members favoured keeping rates unchanged at 0.5%, while two supported a rate hike. This voting result was unchanged from August. For most members of the policy committee, there was insufficient evidence of inflationary pressure to justify an immediate rate hike. The committee saw indications that growth was likely to ease. The unemployment rate fell by more than expected in July to 6.2%, its lowest since November 2008. But wage growth was still moderate. Complicating the picture for the BoE, house price gains have accelerated lately. We think rate hikes are unlikely this year and expect the BoE to rely mostly on macro-prudential measures to cool the housing market. So far, it has only taken a small step in this direction.

ASSET ALLOCATION

Core positions

We have a neutral view on global equities. Monetary policy should remain a major market driver. Things to watch for are the amounts eurozone banks will borrow from the ECB under the recently announced TLTROs (Targeted Long-Term Refinancing Operations) and any signs that the Bank of Japan is willing to provide more stimulus. On balance, we still see monetary policy as positive for global equities. In real terms, central bank rates are still extremely low, but the economic cycle is less supportive. We have downgraded our assessment of the eurozone economy to negative and we think growth in Japan and emerging market may fall short of expectations. Thus, we see the global economic cycle as negative for equities. We see valuations as neutral as long as earnings expectations are met. Most equity markets have recovered from their dip earlier this month, but at this point, we do not see strong reasons to abandon our neutral position.

We are also neutral emerging equities versus developed equities. We expect growth in emerging markets to move sideways in the coming months. In view of the positive developments in Ukraine and a change in election dynamics in Brazil, where the more reform-minded candidate now has a chance to oust the incumbent, we recently closed our underweight in emerging equities.

We closed an overweight in eurozone versus UK equities given the negative economic developments in the eurozone and the likelihood that the Scots will vote in favour of staying in the UK. This outcome would be positive for UK assets and thus negative for the position.

We have a small overweight in European high-yield corporate bonds, where we like the carry against a backdrop of low default rates and generally decent company balance sheets. That said, the asset class has struggled recently amid a glut of new supply.

We also like the carry on emerging market debt in local currencies. Emerging currency volatility has risen lately, with the Korean won, the Indian rupee, the Brazilian real and the Turkish lira, to name but a few, all falling versus the dollar. We think this reflects dollar strength. Our currency hedge reflects the recent substantial weakening of the euro against the US dollar.

Government bond yields rose in the past week in the US, the eurozone and the UK. Monetary policy, especially low rates and the prospect of a slow pace of rate hikes in the years ahead, provides a strong rationale for the level of yields. At this point, we are loath to take a short duration position in Germany.

We are neutral on real estate globally. We are long European equities versus European real estate which has done reasonably well, but where a relatively favourable environment is now priced in. Low inflation and limited earnings growth cloud the prospects for European real estate, in our view.

We are neutral convertible bonds, commodities and cash.

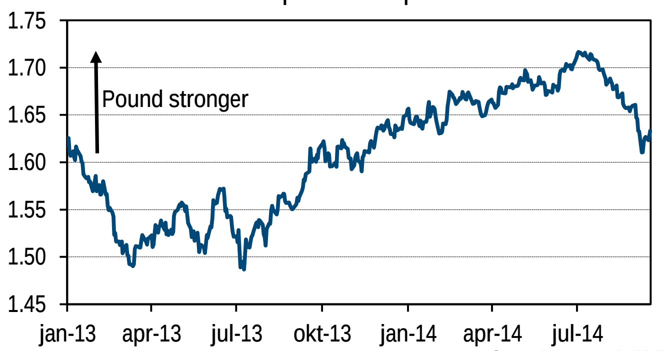
Divergence in growth, inflation and monetary policy could weaken the euro further, although a significant amount of divergence has already been discounted. So the pace of depreciation should slow, making the euro more volatile.

Flexible multi-asset positions

We took profits on part of our short duration position in US government bonds after yields rose markedly in recent weeks. We left the position open ahead of the US policy meeting, expecting the Fed's rhetoric to become more hawkish. This was not the case in the press release, but Yellen's comments at the press conference and the Fed's slightly more aggressive pace of projected rate hikes were. So US ten-year yields increased a few basis points, which was beneficial for this trade.

In anticipation of a No to Scottish independence, we sold put options on the British pound versus the US dollar. The pound had taken a beating over the increased prospects of a Yes, but could rebound if the referendum fails. In that case, the puts should yield a premium.

US dollar per British pound



Source: Datastream, BNPP IP

Another new trade is a long position in diversified commodities excluding industrial metals versus a short in diversified commodities excluding energy. Actually, this trade is a long crude oil versus short industrial metals position. Our relatively positive view on oil is based on the recent softening of energy markets. We view the current weakness in prices as temporary given the pricing power of the OPEC cartel, increased price sensitivity due to tighter inventories and an insufficient premium for geopolitical risks. We see the outlook for industrial metals as negative. We think markets are oversupplied, the adjustment process is slow, there will be additional mine supply and insufficient demand.

We are overweight in US homebuilders versus US small caps. Homebuilders have underperformed significantly over the past 18 months. After a period of weakening housing data, we are now seeing signs of a turnaround. With the longer-term housing market improvements still in place, we felt this was a good time to go long: valuations look attractive; homebuilders still have large order books and profits should continue to grow decently.

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 rates. We think Mexico is better shielded against the downside risks in China than other Latin American countries.

In the US, we have been long five-year forward inflation swaps since April (expectations of inflation five years from now). We are also long high-yield corporate bonds 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, this trade should pay off when spot rates and five-year forwards converge.

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Bloomberg and Datastream are the sources for all data in this document as at 17 September, unless specified otherwise.

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