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

Weekly Strategy Update

30 October 2014

SUMMARY

- **ECB's banking assets review has limited impact**
- **China: yes, there are risks, but no, we don't foresee a hard landing**
- **Asset allocation: new corporate bond and currency trades in our flexible multi-asset allocation**

Market sentiment has improved. Equity markets have partly erased the losses incurred earlier this month, taking US equities close to previous peaks. But European, Japanese and emerging equities have lagged. Government bond yields have risen more pronouncedly in the US than in Germany. Yields in Japan, however, have trended even lower. The prospect of low inflation – lately strengthened by falling oil prices – is keeping a firm lid on bond yields in many countries. Even in the US, yields are still significantly lower now than they were in the middle of September. Last week's main event was the publication of the results of the Asset Quality Review and the stress test by the ECB and the European Banking Authority (EBA) on the 130 largest European banks. The results were broadly in line with market expectations and do not change our economic outlook or market views. We have kept our overweight in equities, but made some other changes to our asset allocation.

AQR: POSITIVE WITHOUT A BIG IMPACT

The AQR and the stress tests combined revealed that 25 banks had an overall capital shortfall of EUR 24.6 billion in the case of the adverse scenario, looking at their balance sheets as at the end of 2013. But as these banks have already raised about EUR 15 billion between January and September, the actual shortfall is a more modest EUR 9.5 billion. The banks that failed make up 3% and the banks that passed narrowly another 20% of total EU bank assets.

There was a relatively high number of banks from 'peripheral' countries that failed the test, including three each from Greece and Cyprus. None of the Spanish banks stumbled, but it must be said that the sector had already been recapitalised as part of Spain's bailout programme in 2012. Calm on Italian bond markets showed that investors were not overly concerned that the

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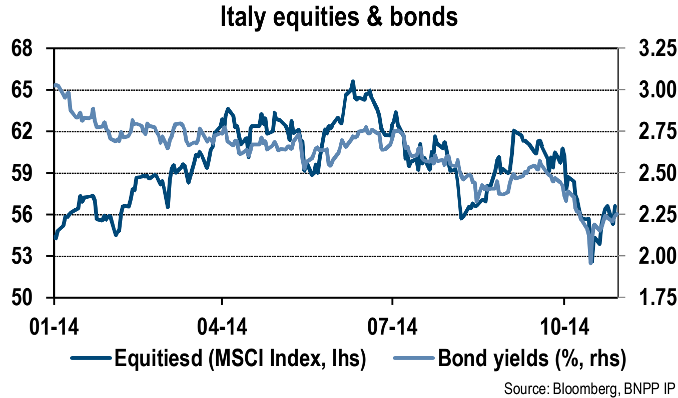
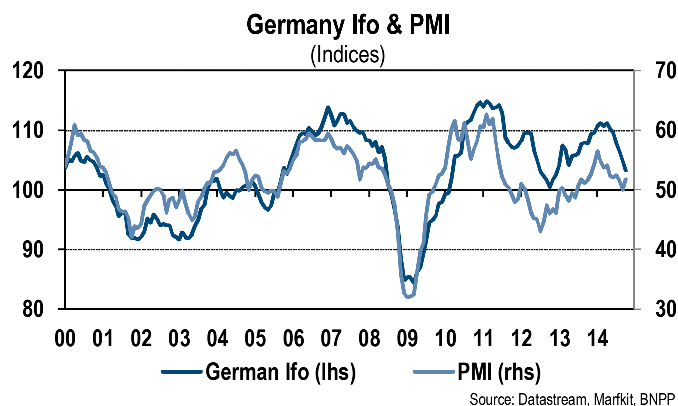
government would have to support any troubled banks in that country.



Source: Bloomberg, BNPP IP

Looking ahead, the AQR and the stress tests have lifted a veil hanging over the European banking sector, so interbank liquidity and banks' willingness to lend should now improve. The ECB bank lending survey has signalled a greater willingness to lend. However, this does not change our view on the European economy. We were not concerned about the AQR results and had expected some banks to fail, but only limited damage overall. We do not see this leading to a surge in lending since demand for credit is weak. Data released this week showed that growth in eurozone monetary aggregates rose somewhat in September. Bank lending to the private sector was still 1.2% lower than in September last year. However, bank lending grew on a monthly basis. The YoY declines have moderated since the start of the year. So there is some improvement, but only at a slow pace.

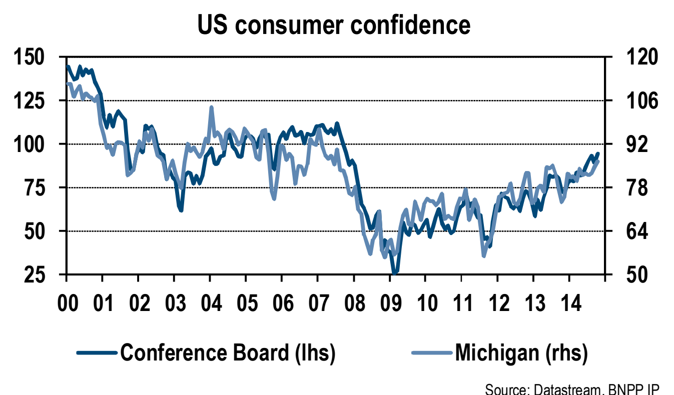


Source: Datastream, Markit, BNPP

PMIs improved by more than expected in October. The eurozone manufacturing PMI came in at 50.7 after 50.3 in September and ahead of the Bloomberg consensus calling for a fall to below 50. With the services PMI unchanged at 52.4, the composite PMI showed a 0.2 point increase to 52.2. A strong gain in the German manufacturing PMI was met by a further decline in France. The services sector PMI fell in both countries. The German Ifo index showed that Germany, and by extension the eurozone economy, is not out of the woods yet. The current and outlook components both fell to levels not seen in almost two years. This points to a further downturn in Germany. Last week, my colleague Reinhold Knaus pointed out that some of the weakness in Germany should be temporary. Falling oil prices and a lower euro should be supportive. The Ifo index showed more optimism than the PMI. However, growth was most likely still very modest in Germany in the third quarter.

US: MODERATION

US data, including the Markit PMIs and durable goods orders, have shown signs of economic moderation, but given the levels of most data, this is not a reason for concern, in my view. The trend in the housing market has slowed from strong gains to more modest improvement. New home sales tend to be volatile from month to month, but it is positive that the surge in August was followed by a small further gain in September. Last month's existing home sales were still lower than a year ago, but they have now improved in six out of seven months. Pending home sales also improved in September. The annual increase in home prices shown by the Case-Shiller index continued to moderate in August, but other home price indicators have shown signs of bottoming in annual terms. We are positive on the US housing market. It is the one sector in the US with probably the largest amount of pent-up demand. Compared with car sales or business investment, housing has much further to go to return to the historical average, even if those levels were lower than the peaks in 2005/07. The improvement in the labour market and the recent decline in mortgage rates should also be supportive. In our asset allocation, this is reflected in our overweight in US home builders' equities versus US small caps.



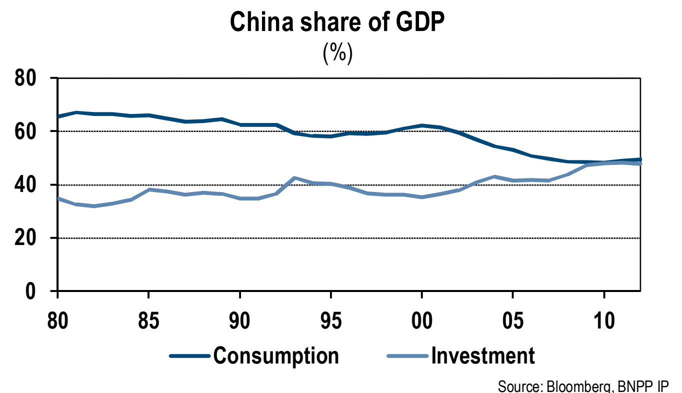
Source: Datastream, BNPP IP

Recent trends in housing have not had a big impact on consumer confidence, which has been improving essentially since the middle of 2012. In October, the Conference Board's index of consumer confidence jumped to its highest since October 2007. This shows how big the difference between perception and reality can be. US GDP and household consumption peaked in the final quarter of 2007 and bottomed in the second quarter of 2009. Consumption had recovered the lost ground in the final quarter of 2010, well ahead of total GDP, which did not recover until the third quarter of 2011. So consumption actually led the economy out of recession. Business investment only recovered fully in the third quarter of last year. The recent improvement in consumer confidence has brought it back to average levels outside recessions, but not yet to the peak of July 2007. This discrepancy between perception and reality is probably due to the housing and labour markets. The housing market is still way below its pre-crisis peak. It should be, given that that was a bubble. But housing activity is even below its longer-term averages, especially taking population growth into account. Employment only recovered fully in May this year. Anyway, the improvement in consumer confidence bodes well for household spending.

CHINA: STABILISING?

Third-quarter growth data had provided some relief for market fears of a hard landing and more recent data has confirmed this. Industrial production recovered in September to show 8.0% growth YoY after August's unexpected dip to 6.9%. Retail sales growth slowed to 11.6% YoY. This is the slowest pace in more than a decade, but there is a price effect. Looking at inflation-adjusted retail sales by simply subtracting inflation from nominal retail sales reveals that household spending growth has been fairly stable at around 10% this year. In 2012 and 2013, the decline in the growth levels had also been less pronounced than shown in the nominal data. The manufacturing PMI improved marginally, but a leading index by the Chinese statistics bureau moderated in September. So the data argues against a sharp decline in growth, but does not signal much improvement either.

The risks for China are clear. Too many residential properties are being built. This partly reflects a mismatch: too many houses for the middle class and too few for lower-income households. So in terms of GDP growth, a drop in middle-income home building could be compensated for by an increase in social housing. That still leaves the oversupply of middle-income homes, which has shown up in developers' inventories and a significant stock of empty second or even third homes.



Source: Bloomberg, BNPP IP

Another risk is investment, which has remained high in the face of the stated aim to rebalance the economy towards greater consumption. Consumption did make a larger contribution to GDP growth than investment in each quarter so far this year, so there is room for optimism. At least the trend of an ever increasing share of investments in total GDP has stopped in recent years.

Yet another risk is in credit growth. This has wobbled lately and the growth rate has slowed, but credit is still growing ahead of GDP and since the amount of debt outstanding also exceeds GDP, the debt-to-GDP ratio has continued to rise. The authorities are trying to halt this, but progress has been limited. Their challenge is to strike the right balance between growth and deleveraging.

That said, I think the risk of a financial crisis is low at this point. The authorities simply would not let it happen and have enough levers to pull to prevent it. But being cautious on the growth outlook seems reasonable to me.

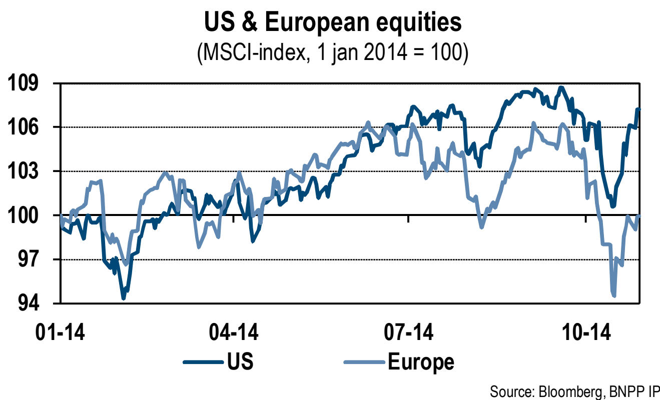
ASSET ALLOCATION

Core positions

Equity markets have recovered from their lows earlier this month, although the extent of the recovery differs from region to region. We think the rally has further to go. The US economic outlook is still positive and in the eurozone, the publication of the AQR and stress tests results have removed some uncertainty. The process of submitting national government spending plans to the European Commission also seems to be running more smoothly

than could have been expected. In China, recent data show that fears of a hard landing may be overdone. In the meantime, monetary policy is still highly accommodative on a global scale, with growing market talk that the ECB will add to the range of assets it will buy, possible extending it to corporate bonds.

US & European equities
(MSCI-index, 1 jan 2014 = 100)



Source: Bloomberg, BNPP IP

We are overweight US versus European equities. The reasons are the brighter outlook for the US economy and US company earnings and an M&A cycle favouring US equities. We kept our overweight in European large caps versus small caps since large-cap companies should benefit more strongly from slightly improved global growth. We consider European small caps expensive.

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 in risk-off markets and amid a glut of new supply.

Government bond yields rose slightly, more so in the US than in Germany. But even in the US, yields are still lower than a month ago. Falling inflation is keeping a tight lid on yields. While falling oil prices may benefit growth, the impact on inflation should be more noticeable in the near term. This may feed deflation fears, but we think this is overdone. However, we are neutral German Bund duration.

We are neutral on global real estate. The ECB's dovish stance should cap bond yields, which should benefit real estate. We believe our view of very modest growth in the eurozone and somewhat stronger growth abroad is better reflected in an overweight in large caps versus small caps.

We are neutral on convertible bonds, commodities and cash.

Flexible multi-asset positions

We opened a long position in European investment-grade bonds versus US investment-grade corporate bonds. We think the releveraging cycle is much further advanced in the US than in Europe. In other words, US companies have borrowed more in recent years. The divergence in monetary policy between the US and the eurozone should also support European investment-grade debt. Even with the current ECB programme to buy asset-backed securities and covered bonds, investors may rotate into corporate bonds if yields on ABS and covered bonds fall. If the ECB were to buy corporate bonds directly, there would be further support for the asset class. In the US, the Federal Reserve will most likely end its government bonds purchase programme this month.

We opened two currency trades. We are long the Mexican peso versus the British pound, the Australian dollar and the New Zealand dollar. And we are long the Canadian dollar versus the New Zealand dollar and the Japanese yen. In both cases, the short positions are equally weighted. Arguments for the first trade are that the peso is cheap in relative terms and that the Mexican central bank may tighten monetary policy more aggressively than the central banks of the other three countries. The shorts in the Australian and New Zealand dollar offer protection in a scenario where China slowed down or commodities weakened further. The pound may be vulnerable to uncertainties ahead of the May 2015 general election in the UK. The second trade is also driven by valuations, especially of the Canadian versus the New Zealand dollar. On monetary policy, the Bank of Canada recently dropped its easing bias, while we think that the Bank of Japan may step up its asset purchases early next year.

We closed our short duration position in US Treasuries and our short in UK Gilts. Both positions suffered from extreme volatility, so we decided to cut our exposure, especially since the Gilt position was correlated with our equity and credit positions.

We are long Norwegian bonds versus Bund futures, but did not hedge the currency. Norwegian bonds offer a positive carry versus Bunds and are AAA rated. If the

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Bloomberg and Datastream are the sources for all data in this document as at 29 October, unless specified otherwise.

currently strong economy were to weaken, we could lose on the currency, but gain on the bonds. So far, the trade has benefited from the strength in the Norwegian krone versus the euro.

In commodities, we have a long position in diversified commodities excluding industrial metals versus a short in diversified commodities excluding energy. Actually, this is a long crude oil versus short industrial metals position. We view the current weakness in oil prices as temporary given the pricing power of the OPEC cartel, uncertainty about future Libyan oil production and an insufficient premium for geopolitical risks. We see the outlook for industrial metals as negative since markets are oversupplied, the adjustment process is slow, there will be additional mine supply and demand is insufficient.

We are overweight US homebuilders versus US small caps. Homebuilders have underperformed significantly over the past 18 months, even though the longer-term housing market improvements are still in place. For us, current valuations look attractive; homebuilders have large order books and profits should continue to grow decently. The trade did well initially, but recent weaker housing data has erased the gains.

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.

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