For professional investors

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Weekly Strategy Update

29 January 2015

SUMMARY

- Signs of improvement in the eurozone: the ECB's timing may have been spot on
- US: consumer strength versus disappointment on the producer side
- Now overweight emerging Asian equities versus broad emerging equities
- ECB-related hedge closed
- Profits taken on long in Spanish bonds

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So the ECB delivered and financial markets liked it. The eurozone central bank skilfully managed expectations ahead of last Thursday's decision. We gave our assessment in a flash note distributed last week, so it suffices to say here that we see this as a positive move for the eurozone economy and for equity markets.[1] Another major event for investors was the Greek election, in which far-left Syriza came close to winning an absolute majority. Its rhetoric after the victory and its choice of a coalition partner – the right-wing Independent Greeks who agree with Syriza only on their opposition to austerity measures – suggest that tough debt and bailout negotiations lie ahead with the Troika of the European Commission, the ECB and the IMF. Markets appeared complacent about the risks immediately after the election, but in recent days, Greek bond yields have risen significantly amid growing concern.

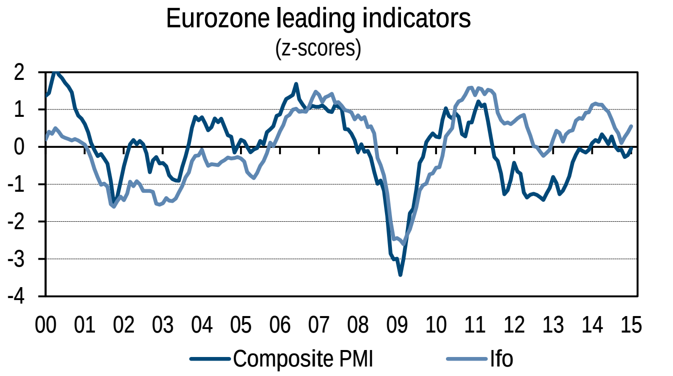
In our asset allocation, we have kept our equity overweight, as we see signs of improvement in parts of the global economy. We implemented an overweight in emerging Asian equities versus broad emerging equities. We closed our long position in US 10-year government bonds versus French 10-year government bonds and we took profits on our long 5-year Spanish government bonds after they benefitted from the ECB news.

[1] *ECB crossing the Rubicon,* flash note by Multi Asset Solutions, 22 January 2015

ECB: LUCKY TIMING?

One of the objections of Jens Weidmann, President of the German Bundesbank, to quantitative easing now was that the fall in oil prices could trigger stronger growth in the eurozone. However, most of the other members of the ECB's governing council were not prepared to wait any longer. It may be that the ECB has been lucky in the timing of it announcement as there have already been some positive developments.

The credit cycle is improving. An ECB survey of banks showed that an increasing number of banks are easing lending standards. Lower funding costs, fewer balance sheet constraints, improved access to market financing and greater pressure from competitors have led to an easing of lending standards. Margins on corporate and household loans in particular were lowered. Banks also reported stronger loan demand across all categories: corporates, mortgage applications and consumer credit.



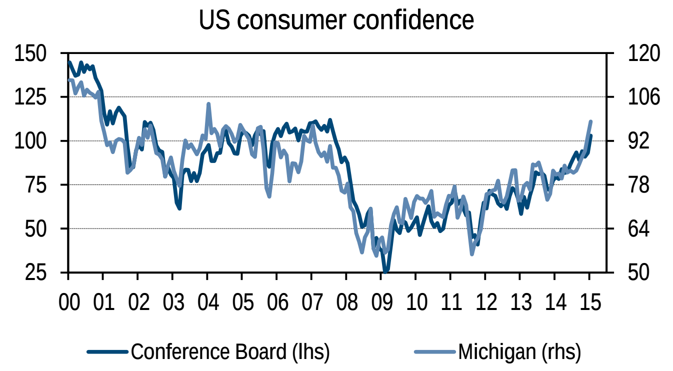
Source: Datastream, BNPP IP

Other positive signs could be seen in the leading indicators: the manufacturing and services PMIs rose in January. The composite PMI is now above the average of the last quarter of 2014. In Germany, January's Ifo index came in stronger than expected, while consumer confidence rose to a record high. Both the current assessment and the outlook component of the Ifo index point to accelerating growth. French business confidence has stalled lately, after having recovered from a dip last year. In January, French consumer confidence held on to November and December's strong gains.

So the eurozone economy was brightening before the ECB decided to launch fully-fledged QE. The ECB can claim some credit: speculation about full-scale central bank pump-priming has of course weakened the euro further in recent months, supporting growth in the eurozone.

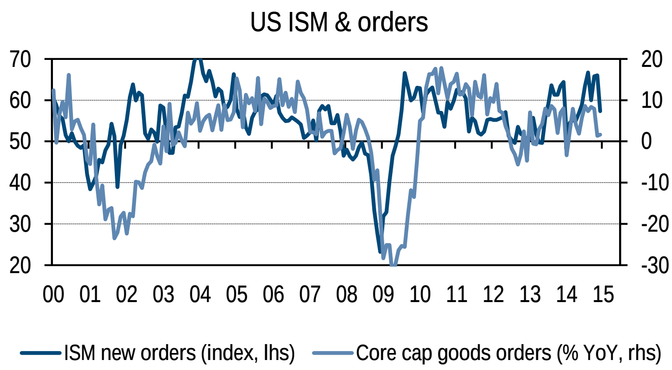
US: CONSUMERS VS. PRODUCERS

After the surge in the University of Michigan's consumer confidence index, the Conference Board's measure of consumer confidence recorded its biggest monthly jump since November 2011, taking it to its highest since August 2007. Respondents were more upbeat about the labour market.



Source: Datastream, BNPP IP

Sentiment is also supported by the housing market where homebuilders' sentiment appears to be holding up and housing starts improved. Both are still in a gentle uptrend. Sales of existing and new homes were strong. Average prices of new homes jumped, although these can be volatile. Average prices of existing homes ticked up, although they have not yet recovered the losses incurred last summer. The less volatile S&P/CaseShiller index of home prices has resumed a steady uptrend in the three months to November. A modest uptrend in house prices may be the most positive outcome for consumers. It reduces the number of owners with negative equity, without making homes unaffordable.



Source: Data stream, BNPP IP

Data from the corporate sector has been less positive lately. Regional measures of producer confidence mostly point to more modest growth in the sector. The Markit

PMI for the manufacturing sector slipped in January, while the PMI for the services sector improved. As a result the composite index was stronger. Data on durable goods orders and shipments was however weak in December. Total orders were dragged down by a slump in aircraft orders; even excluding aircraft and defence orders, core capital goods orders fell for the fourth straight month. Shipments of such goods fell for the third straight month. This implies business investment fell in the fourth quarter of last year. It may take time to recover.

Are US manufacturers suffering from a strong dollar or have low energy prices led to lower demand for mining, oil and gas field equipment? ISM manufacturing data shows that export and domestic orders have fallen, so it is not just a dollar story. Orders for mining, oil and gas field equipment have been volatile, but until last November, they did not show a downtrend. The fact that the weakness in orders is not just due to dollar strength or weak oil prices may be worrying since it implies more widespread weakness. Nonetheless, with domestic demand looking solid, we think the corporate sector could rebound swiftly.

All this does not change the likely course of Fed policy. Officials have continued to hint at a roadmap which includes a first US rate hike this summer. We would agree, although it is ahead of market expectations. This being said, low and most likely negative headline inflation and monetary easing by many central banks globally may cause the Fed to delay the first hike. In its January meeting, the Fed's monetary policy committee made only some small changes its press release. It still feels it can be patient when it comes to normalising its monetary policy stance. Fed-Chair Yellen has clarified this patience before as meaning at least two Fed-meetings. This implies no rate hike before June. And is the Fed still wanted to hike rates in June, it would have to remove the patience wording at the next meeting in March. Still, the Fed it was slightly more upbeat growth. The committee now sees solid growth and strong job gains instead of modest growth and solid job gains. The boost to consumer spending power from low oil prices was explicitly mentioned. So the Fed sees lower oil prices as positive on balance. It also thinks sees inflation falling further in the near term, but expects the downward impact on inflation to be temporary. Despite these more upbeat statements, bond markets interpreted the statement dovish. 2-year and 10-year yields fell after the release. This was most likely due to the fact that the Fed said it will also look at international developments when it considers the timing of the first rate hike. With weak growth abroad and many central banks easing policy, markets became even less convinced about a rate hike as early as June. We stick to our June call for now. In mid-February Fed-Chair Yellen have her semi-annual testimony before Congress. She will undoubtedly use these occasion to clarify the Fed's intensions.

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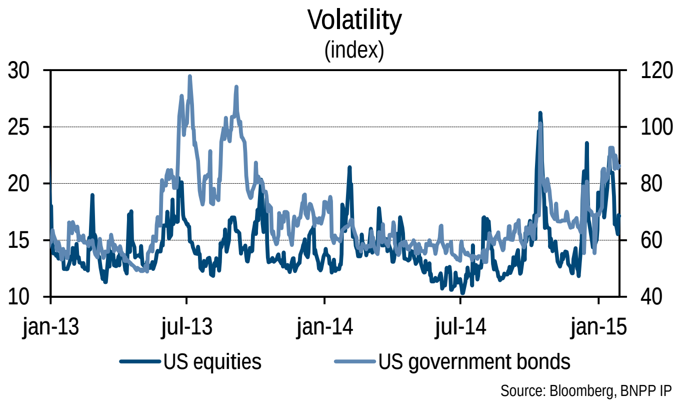
ASSET ALLOCATION

Core positions

Markets have remained choppy. Volatility in US and German equity markets and in US bond markets is still elevated.



Monetary policy remains a key driver for markets. The ECB turning to fully fledged QE is positive. And the eurozone central bank is not alone. The Bank of Canada has just cut key rates. Expectations for the first rate hike in the UK have moved backwards after growth disappointed slightly in the fourth quarter. The Danish central bank cut rates twice to defend the peg of the krone vis-à-vis the euro. The Bank of Japan is still in the middle of a massive easing programme and in several emerging markets, monetary policy has been eased or may do so in the near term (China, India, South Korea and Singapore). If the Fed postpones a rate hike until after the summer, this may be positive, but it also fans uncertainty.

Of course monetary policy has not been the only driver. Economic data in the US has been mixed lately, as said above. We expect this to be temporary and have actually become more positive on global growth.

The Greek elections also had an impact. After the confrontational tone of the new prime minister, Greek yields have surged. An extension of the bailout programme has to be agreed by February. If nothing happens, the Greek government will run out of cash in June. The prospect of a standoff has led to some contagion to other 'peripheral' eurozone bond markets, although yields there are still historically low.

Finally, the company earnings season in the US has seen disappointments, including banks and large multinationals. Slower trading on financial markets, lower oil prices and a strong dollar are leaving their mark. Expectations had been scaled down prior to the earnings season, but that does not obscure the fact that results so far have not been strong.

For now we have not changed our equity overweight. Given the strong support from monetary policy and with investors reducing their equity positions further, we remain overweight. We have also kept our overweight in investment-grade credit. However, in view of the market volatility, we are monitoring these positions closely.

We did implement an overweight in emerging Asia equities versus broad emerging equities. Low oil and commodity prices are favourable for most emerging Asian economies, while they weigh on some countries outside this region, most notably in Latin America. We also think the liquidity created by the Bank of Japan and the ECB is more beneficial for Asian emerging markets. These countries have also shown more willingness to reform their economies. Finally, the Chinese economy appears to be bottoming out, although downside risks remain.

We are neutral on high-yield bonds. Volatility has risen in a market that has become less liquid. Worryingly, in the US, we have seen more issuance. Some companies in the energy sector are struggling with lower oil prices.

We are neutral on US and German duration and global real estate, convertible bonds, commodities and cash.

Flexible multi-asset positions

We closed our long US 10-year versus French 10-year government bonds position, which we had implemented as a hedge against disappointing news from the ECB. When 'peripheral' yields initially held even after the Greek elections, we closed the trade. With the uncertainties around Greece, we have held on the other hedge, which consists of put options on the EuroSTOXX 50. These expire on 20 February.

We closed our long 5-year Spanish government bond position. This trade had already done well before the ECB meeting and the yield fell further after the decision in favour of full-scale QE. We decided to lock in the profits.

We are overweight US homebuilders' equities. Recent gains make us cautious since they could lead to a short-term correction, but since we see more upside potential, we have kept the trade given the attractive valuations, large order books and expected decent growth in profits.

We are long 30-year versus 10-year Japanese government bonds. Yield curves have been flattening throughout the world and the Bank of Japan is buying government bonds across the curve, out to 40 years. At the very long end, the Japanese yield curve is steeper than those of Germany, the US, the UK and Switzerland. The scope for lower 10-year yields is limited, in our view, but the 30-year yield does have room to fall further.

We are short 10-year Australian government bonds versus 10-year US Treasuries. Thus, we would benefit from an increase in the spread between US and Australian bonds. As for US yields, market expectations for the first rate hike are shifting back, as said, while there is stronger institutional demand for US government bonds. The three-month interbank rate in Australia is about 2.5 percentage points higher than the US rate.

We are overweight Mexican USD debt versus US 10-year Treasuries. We expect Mexican bonds to benefit from sound and improving fundamentals, falling inflation and low official rates. Mexico should withstand the downside risks in China better than other Latin American countries.

We have a small long position in 5-year forward US inflation swaps. Expectations of 5-year inflation five years from now are low partly due to low oil prices and dollar strength, but this should be temporary. They should not impact long-term inflation expectations.

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US inflation expectations
(5-year expectations 5 years from now)

Source: Bloomberg, BNPP IP

We are long European investment-grade senior financial bonds. Financial disintermediation trends in Europe should result in smaller bank balance sheets and improved leverage ratios. New regulation should improve capital ratios. We expect banks to build a higher capital bar by issuing more equity and subordinated debt to protect other parts of the capital structure.

We are overweight German real estate versus US real estate. Monetary policy is more favourable for German real estate. In Germany, residential real estate is relatively more important and we believe it offers value.

We are long the Mexican peso vs. sterling and the Australian dollar in two separate trades. The peso is relatively cheap and the Mexican central bank may tighten policy more aggressively than the Australian central bank.

We are long the Canadian dollar versus the New Zealand dollar. While markets do not expect rate hikes in Canada, but see further hikes in New Zealand, we believe rates could still rise in Canada and hold steady in New Zealand.

We are long the Indian rupee versus the South Korean won. A stronger Indian economy, the Indian reform agenda and the strong won possibly inducing monetary easing argue in favour of the rupee. The Reserve Bank of India may cut rates by 50bp in the next three months, but higher real rates in India should still support the rupee.

We are long the US dollar versus the Swiss franc. After the Swiss national bank decided to abolish the peg on the franc, we closed our short franc versus the Czech koruna and swapped it into a short Swiss franc versus the dollar on the view that the franc is now heavily overvalued versus the dollar. Moreover, monetary policy divergence in the coming months should work in favour of the dollar.

Bloomberg and Datastream are the sources for all data as at 28 January, unless mentioned otherwise.

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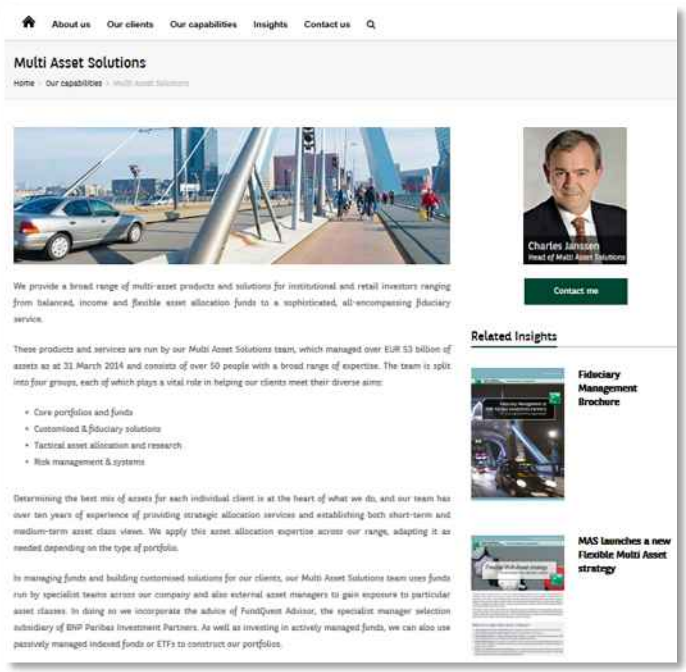

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MARKET OVERVIEW*

	Indices	Close	5D %CHG	1M %CHG	3m %CHG	YTD %CHG	Currency
MXWO Index	MSCI WORLD	1.706	0.66	-1.38	1.25	-0.24	USD
LEGATREH Index	Barclays Global Agg	213	0.14	1.88	2.94	1.50	EUR
LG30TREH INDEX	Barclays Global High Yield	339	0.52	0.21	-2.03	0.17	EUR
ENXG Index	FTSE EPRA Global REITs	2.533	1.89	7.20	11.54	7.85	USD
	Regional Indices						
SPX Index	S&P 500	2.030	0.35	-2.84	2.24	-1.43	USD
MXEUG Index	MSCI EUROPE x UK	135	2.84	7.13	12.50	7.95	EUR
UKX Index	FTSE 100	6.801	1.08	2.89	6.23	3.58	GBP
NKY Index	NIKKEI 225	17.796	2.98	-0.13	16.09	1.98	JPY
MSEUCAXJ Index	MSCI Asia Ex Japan	588	3.26	5.14	5.35	4.34	USD
MXEF Index	MSCI EMERGING Markets	990	1.41	3.92	-0.27	3.51	USD
jpeiglbl index	J.P. Morgan EMBI $	663.66	0.66	0.18	-2.36	0.16	USD
jgenfxgd index	J.P. Morgan GBI-EM local	96.93	0.45	-1.54	-8.38	-1.22	Local
	Regional Bond yields	%	% 5D	% 1M	% 3M	%YTD	
USGG10YR INDEX	US Generic Govt 10 Year Yield	1.81	1.87	2.25	2.30	2.17	USD
GDBR10 INDEX	Germany Generic Govt 10Y Yield	0.38	0.52	0.59	0.88	0.54	EUR
GUKG10 INDEX	UK Generic Govt 10Y Yield	1.49	1.51	1.88	2.24	1.76	GBP
jpegsoyd index	J.P. Morgan EMBI $	6.20	6.28	6.15	5.69	6.15	USD
jgenvhyg index	J.P. Morgan GBI-EM local	5.95	6.13	6.58	6.47	6.50	Local
	FX						
EURusd Curncy	USD	1.14	1.16	1.22	1.27	1.21	USD
GBPEUR Curncy	GBP	1.34	1.30	1.28	1.27	1.29	EUR
EURjpy Curncy	JPY	133.86	136.96	146.65	137.73	144.85	JPY
EURCNH Curncy	CHN	7.10	7.22	7.58	7.79	7.52	CNH

* As at 28 January 2014. Source: Bloomberg, BNPP IP

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