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Weekly Strategy Update

26 March 2015

SUMMARY

- Temporary US slowdown?
- More confidence in positive European outlook
- More monetary easing in China?
- European & Japanese equities outperforming US
- Asset allocation: changes to long USD vs CHF

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After members of the Federal Reserve's monetary policy committee trimmed their interest-rate projections, we naturally got some pushback on our view that the Fed could still hike rates in June. US data has been weak and inflation has been low, so why would the central bank hike at all? We see the weakness in the data as temporary and found confirmation in the latest numbers. We think there is a risk of the Fed hiking too late.

PMIs for March have been coming in and the first results are mixed, with improvement in the eurozone, but weakness in China and Japan. To us, our macroeconomic outlook of decent growth in the US, a bounce in the eurozone and less upside in Japan and China still seems right.

We think this is positive for risky assets and after our rotation from European investment-grade corporate bonds to high-yield, we have not made any major changes to our asset allocation this week.

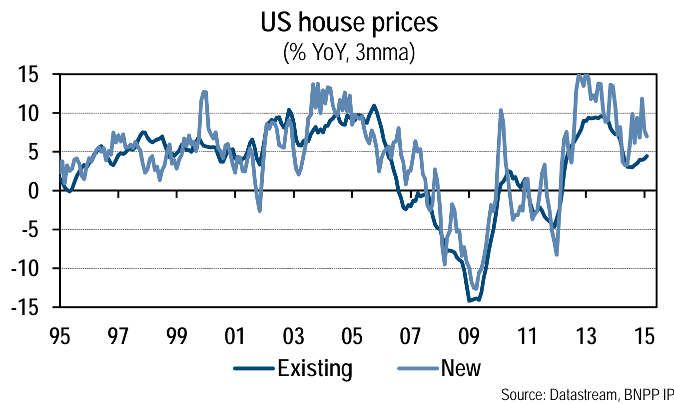
US: THE BENEFIT OF THE DOUBT

The weakness in the US economy has become more widespread. The Chicago Fed National Activity Index has for three months now indicated that the economy will grow at below trend. Several regional indicators of sentiment in the manufacturing sector have come in below expectations. Consumption has also disappointed.

In the assessment of the economic outlook, I would give the US the benefit of the doubt, though. The weakness in consumption is out of sync with fundamentals. Consumer confidence has fallen lately, but this came after a strong improvement in the second half of last year. Household income growth has been strong. Real disposable income was up by 4.2% YoY in January and by 5.2% on a six-month annualised basis. This is a combination of modest growth in hourly earnings, falling inflation, higher

employment and more hours worked. The housing market has regained momentum after weakness up to the middle of 2014. In March, new home sales reached their highest level in seven years. Existing home sales rose and inventories of homes for sale are now close to record lows. House prices are rising. The average price of new homes was up by 4.6% YoY in February and for existing homes up by 5.4%. Increases in the median home price are even stronger. Home price increases support household wealth.

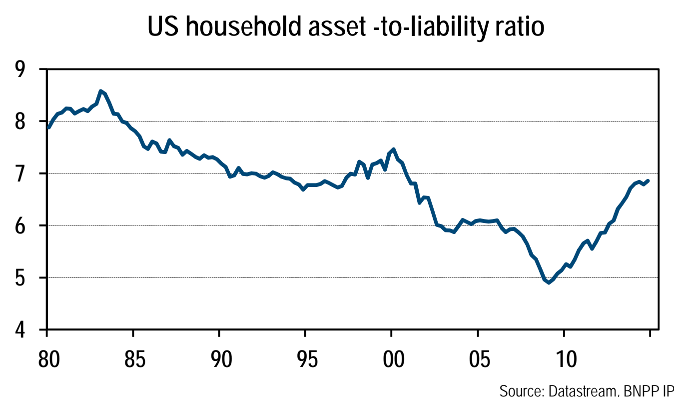
US house prices
(% YoY, 3mma)



Source: Datastream, BNPP IP

Households are borrowing only modestly, so the asset-to-liability ratio has improved sharply to its highest since 2000, during the dot.com bubble. Lower debt relative to income and record low interest rates have taken the funds that households need to service and repay debts to record lows. So households may be more cautious than before the financial crisis to spend the windfalls of low oil prices and rising house prices, but the weakness in spending looks overdone.

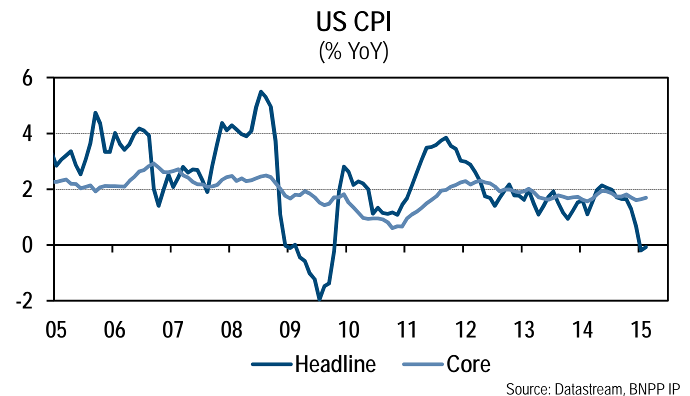
US household asset -to-liability ratio



Source: Datastream, BNPP IP

The weakness in the manufacturing sector is at least partly due to severe winter weather and labour disputes at west coast ports. Still, the Markit national manufacturing PMI has held up well. In March, it rose marginally to 55.3, pointing to solid growth. The improvement in the new orders index is also positive, especially as new orders for non-defence capital goods have fallen for six straight month up to February. These declines predate the West Coast ports labour disputes and the severe winter weather, so they are not to be dismissed easily. However, the services sector PMI for March has yet to be released, but it was at 57.1 in February according to Markit and 56.9 according to the ISM. So there is no weakness in this sector.

US CPI
(% YoY)



Source: Datastream, BNPP IP

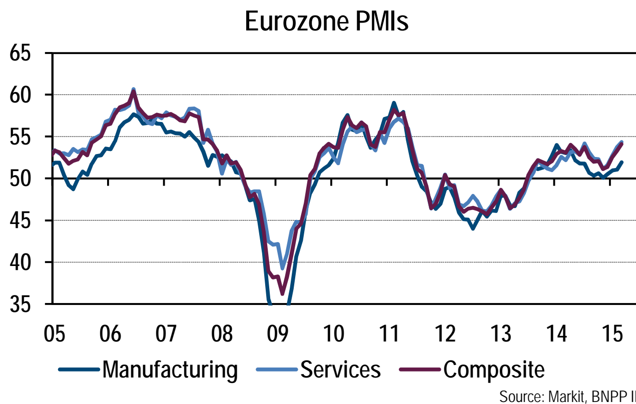
This matters for the Fed outlook, although labour market data and inflation will be more important. The strong labour market is a main reason for our now aggressive-looking call for a June rate hike. But February's inflation data was also supportive at the margin. The Fed has said it must be reasonably confident that inflation will return to its 2% target before it will hike rates. Headline and core inflation were both up 0.2% MoM last month. Headline inflation is still low at -0.1% YoY due to the drop in oil prices, but core inflation rose by a notch to 1.7% YoY. Core inflation has been remarkably stable for two years. The Fed does not look at these CPI data, but at the personal consumption deflator, which is 30-40bp lower than the CPI on average. Thus, it has more ground to recover, but inflation may be bottoming, which should gradually give the Fed more confidence.

EUROZONE: POSITIVE VIEW CONFIRMED

The positive news from the eurozone continued this week. The PMIs for the manufacturing and the services sectors were stronger than expected in March. As in recent months, Germany did better than France, but the PMIs in both countries indicate that the domestic economy is becoming a more important driver of growth. This view was also supported by the further improvement of consumer confidence in the eurozone.

In Germany, the Ifo index beat expectations in March. The index is on its way to erase the losses of 2014 and points to solid growth in the eurozone's largest economy. I would think the weak euro is of more importance for German manufacturers than the Greek situation. In

France, the INSEE index of business confidence broke out of the range it has been in since September 2013 to rise to its highest in almost three years. However, unlike the Ifo, the INSEE is still below its long-term average.



In the UK, CPI inflation fell to a record low of 0% in February (the history goes back to 1989). As in most other countries, falling energy prices played a large role in the decline. Core inflation was 1.2%, which is still the low since 2008. The Bank of England's chief economist caused a stir by arguing that the BoE should be ready to hike rates, but might also cut rates. He said: *"Even without any asymmetry in risks to the inflation outlook, a case can be made for policy easing today"*. We think a rate cut in the UK is unlikely. Chief economist Haldane has not deviated from the consensus in the BoE's monetary policy committee at any of the 10 meetings he has attended, even though he is on the dovish side among policymakers. His comment clearly runs counter to governor Carney's views, who recently said it would be *"extremely foolish"* to cut rates. We expect the BoE's first move to be a hike, given the strong UK economy. A cooling housing market should only be welcomed by the BoE. But a hike will not come soon, in our view.

PMIs IN JAPAN AND CHINA WEAKEN

Manufacturing PMIs in Japan and China came in weaker than expected. Japan's PMI fell for the second straight month and only just held above 50, the level separating growth from contraction. In China, the index has hovered around 50 for months and fell below this level in March. This does not mean that the manufacturing sector is contracting, but it confirms that growth is slowing.

In Japan, sentiment among small business owners improved sharply in March. This index plunged after the consumption tax hike last April, but it has now recovered. Survey respondents were more positive about employment, financing conditions and profits and saw higher capacity utilisation. The caveat is that small business owners were less upbeat about next month's outlook.

We expect the weak data in China to trigger a policy response. With low inflation, the central bank has room to cut interest rates or the reserve requirements for the banks. The latter cut would be more effective.

We don't expect any policy changes in Japan. The Bank of Japan has a relatively positive economic outlook and may be ready to look past low inflation caused by energy prices. Moreover, some officials have emphasised the negative impact of quantitative easing: imported inflation through a weak yen undermines household spending power.

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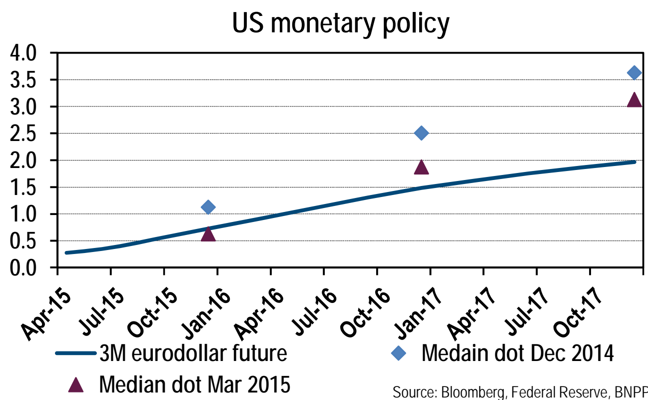
ASSET ALLOCATION: TACTICAL CHANGES IN LONG USD vs CHF

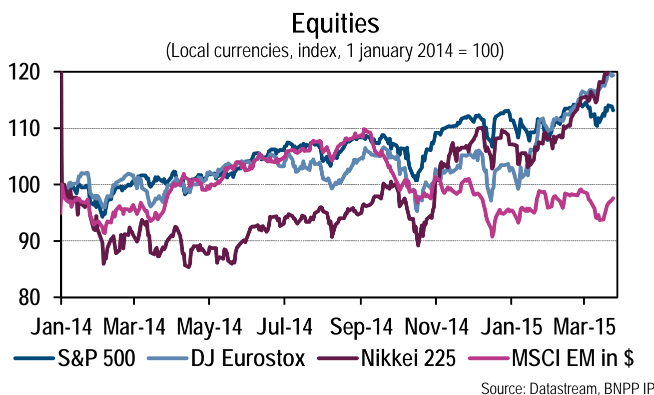
Core positions

After the volatility late last year and in January, US equities marched to a record high in early February. This was out of line with disappointing macroeconomic data and a small market correction followed in early March. The prospect of the Fed moving more slowly on rate hikes supported the markets later this month, but the S&P500 did not return to new highs. A data-dependent Fed policy will cause more volatility in equities, in our

view, and we may even enter a period where good economic data is interpreted negatively by equity markets as it may imply earlier or more aggressive Fed hikes.



In Europe and Japan, markets have kept their upward momentum, with Europe and Japan outperforming the US year-to-date in local as well as common currencies. Especially in Europe, the economic outlook is improving and with low corporate margins giving high operational leverage, this may boost earnings. But after the recent strong performance, a lot of positive news has now been discounted.



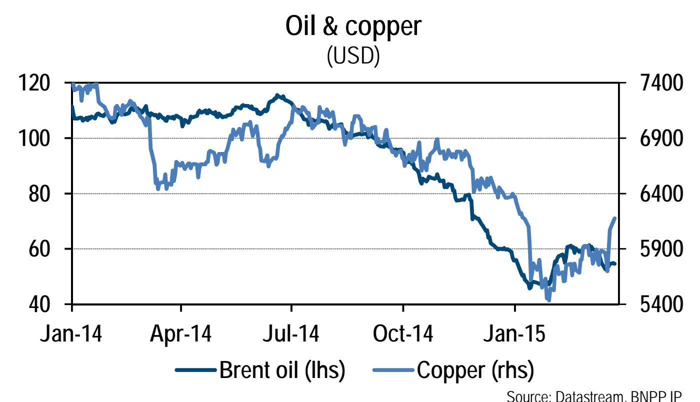
Emerging markets' lacklustre economic and earnings performance has been reflected in emerging equities. Although performance varies widely from country to country, the MSCI EM index is up by only 2.3% in US dollars. This is still better than the US.

With our equity overweight, we are prepared to look past the economic weakness in the US and we think markets should be supported by broad improvements in Europe and more modest advances in Japan. The Fed may be moving closer to rate hikes, but monetary policy generally is far from restrictive. Quantitative easing in the eurozone and Japan and rate cuts in several emerging markets make global monetary policy supportive for equities, in our view.

Further weakness in the US in the March or April data could change this. As could a poor first-quarter earnings season (starting in early April). Currently, we are leaning more towards selling on strength than buying on weakness. Regionally, we favour emerging Asia equities over emerging equities generally. Asia should benefit from cheap commodities, global liquidity and progress on economic reforms.

Within bonds, we are overweight high-yield corporate bonds in Europe. Bond yields in general are set to stay low due to the ECB's asset purchases. These may eventually drive yields higher as inflation expectations grow, but we are not there yet. With yields near record lows, we think high-yield provides attractive carry. Defaults are generally low. Even if government bond yields should rise on the back of a brighter economic outlook, narrowing risk spreads on high-yield bonds could mitigate their impact on the asset class.

We are outright overweight European real estate as well as overweight German versus US real estate. We think positive dividend yields and supply factors as well as low funding costs outweigh high valuations. We see more favourable valuations in Germany than in the US. Since vacancy rates in Germany have more room to improve, we see more scope for higher rental income there.



To us, the fall in oil prices looks overdone. A rebound is possible once global growth improves and suppliers are squeezed out of the market. Commodities such as Brent oil and copper have recovered, but the absence of a broad bounce means it is too soon to adjust our position.

Flexible multi-asset positions

We adjusted our long US dollar versus Swiss franc position. We took profits on the trade after the franc weakened, even though we felt the currency was still overvalued. Shortly after the currency strengthened – and

given our view of franc overvaluation, monetary policy favouring the US dollar and possible currency intervention by the Swiss central bank – we re-established the trade.

We are overweight the US consumer discretionary and information technology sectors, which should benefit from improving consumer spending.

We are long Mexican government bonds in USD versus US Treasuries. Although we recently trimmed the trade because of the risk of a rate hike to defend the peso, we think US government bonds face the bigger risk of hikes.

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 like the outlook for Japanese credit. The BoJ may expand its already huge asset purchasing programme if inflation expectations fall.

We have a small long position in 5-year forward US inflation swaps. Low oil prices and dollar strength should not impact long-term inflation expectations.

We are long the Mexican peso versus the British pound trade. The peso looks cheap versus sterling, even more so after sterling's recent gains. We expect financial markets to remain sanguine on the potential political risk from the UK general election.

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.

Bloomberg and Datastream are the sources for all data as at 25 March, unless mentioned otherwise.

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MARKET OVERVIEW*

	Indices	Close	5D %CHG	1M %CHG	3m %CHG	YTD %CHG	Currency
MXWO Index	MSCI WORLD	1.772	1.04	-0.25	2.68	3.67	USD
LEGATREH Index	Barclays Global Agg	214	0.67	0.75	2.38	1.96	EUR
LG30TREH INDEX	Barclays Global High Yield	347	0.74	0.19	2.50	2.44	EUR
ENXG Index	FTSE EPRA Global REITs	2.473	1.29	1.20	4.67	5.30	USD
	Regional Indices						
SPX Index	S&P 500	2.077	-1.05	-1.72	-0.22	0.90	USD
MXEUG Index	MSCI EUROPE x UK	150	1.50	5.41	18.54	19.48	EUR
UKX Index	FTSE 100	6.994	0.70	0.84	5.81	6.51	GBP
NKY Index	NIKKEI 225	19.746	1.03	6.25	10.88	13.15	JPY
MSEUCAXJ Index	MSCI Asia Ex Japan	587	2.04	0.40	5.12	4.14	USD
MXEF Index	MSCI EMERGING Markets	978	2.25	-1.47	2.84	2.29	USD
jpeiglbl index	J.P. Morgan EMBI $	675.57	2.48	0.96	1.94	1.96	USD
jgenfxgd index	J.P. Morgan GBI-EM local	93.19	3.17	-1.75	-5.35	-5.03	Local
	Regional Bond yields	%	% 5D	% 1M	% 3M	%YTD	
USGG10YR INDEX	US Generic Govt 10 Year Yield	1.88	1.92	1.97	2.26	2.17	USD
GDBR10 INDEX	Germany Generic Govt 10Y Yield	0.22	0.20	0.33	0.59	0.54	EUR
GUKG10 INDEX	UK Generic Govt 10Y Yield	1.48	1.60	1.72	1.88	1.76	GBP
jpegsoyd index	J.P. Morgan EMBI $	6.00	6.33	6.14	6.15	6.15	USD
jgenvhyg index	J.P. Morgan GBI-EM local	6.24	6.43	6.13	6.58	6.50	Local
	FX						
EURusd Curncy	USD	1.10	1.09	1.14	1.22	1.21	USD
GBPEUR Curncy	GBP	1.36	1.38	1.37	1.27	1.29	EUR
EURjpy Curncy	JPY	131.03	130.50	135.03	146.83	144.85	JPY
EURCNH Curncy	CHN	6.82	6.76	7.12	7.59	7.52	CNH

* As at 25 March 2014. Source: Bloomberg, BNPP IP

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