For professional investors

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Weekly Strategy Update

15 August 2012

SUMMARY

- **Central banks' comments: lack of details**
- **Slightly better data in the US; towards a eurozone recession**
- **Equities, real estate to neutral, overweight duration**

For our analysis on the ECB's Governing Council meeting on 2 August, please see our Flash note *No big step from the ECB*. Since then, several official comments were made in order to dampen expectations about rapid bond purchases. No surprise that the more severe comments are from Germany with former ECB chief economist Otmar Issing stating that ECB bond buying is wrong. Benoît Coeuré (member of the ECB's executive board) stressed the irreversibility of the euro but claimed that the ECB should ensure that central bank loans help small and medium-sized enterprises and consumers. Mario Draghi made it clear and simple: the Spanish government now has the floor. If Mr. Rajoy does not officially seek EFSF's aid (and accept conditionality), nothing will happen. Time for action has not come yet in the eurozone but it is noteworthy that, until then, the magic "whatever it takes" Mario Draghi's formula seems to be efficient on peripheral rates (see chart) despite the lack of details.

2-year bond yields (in %)

Source:Factset, BNPP AM

In the US, the message from 1st August FOMC statement is that monetary policy will be data dependent: "*The Committee will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed to promote a stronger economic recovery and sustained improvement in labour market conditions in a context of price stability.*" This conclusion sounds like QE3 as the labour market is still depressed: despite the 172 000 net job creations in the private sector for July, the monthly average stands at 151 000 so far this year (compared to 175 000 in 2011) and the unemployment rate rose to 8.3%.

Nevertheless, the minutes of the June meeting revealed that the members of the FOMC were not as a whole ready to introduce new measures, even if they are discussed during meetings. During the monetary policy

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report to the senate Q&A session, Ben Bernanke explicitly stated that non-conventional measures could include purchases of Treasury securities and mortgage-backed securities, use of the discount window or a cut in the rate of interest payable on excess reserves (IOER). It is not a done deal that the Fed chairman is any more specific in late August when he is expected to deliver the opening address at the Kansas City Fed Symposium in Jackson Hole, paving the way for a QE3 announcement at the 13 September meeting. Anyway, employment data will be key to any decision. The situation in the eurozone could play a part too as the Fed chairman is still very worried by this issue, which he said risked giving rise to volatility on the financial markets.

Investors are expecting central bankers to do everything. The latter have already cut their interest rates to very low levels and have now begun to do a lot of talking, since communication has become a fully fledged tool of monetary policy. Their words are not so easy to interpret sometimes. We still think that new "unconventional measures" will be taken but the timing of any decision is quite tricky.

GLOBAL PMI POINTS TO SLIGHLY BETTER GROWTH IN JULY, BUT STILL POOR

The JPMorgan Global Output PMI rose slightly from June to July thanks to an improvement in services. Nevertheless, at 51.7, the composite PMI is one of the weakest in three years. Moreover, new orders and employment components are boding ill for the coming months. The eurozone is seriously lagging as activity contracted for the sixth month in a row, while the US manufacturing Ism was below 50 for the second consecutive month (49.8 in July). Remember that the 50 threshold is the dividing line between expansion and contraction in industry and that, according to the Institute for Supply Management, no recession occurs throughout the economy until the ISM manufacturing index is below 42.6. The economic momentum in the US has stopped deteriorating since mid-July as illustrated by the economic surprises" index, which expresses the gap between market economists' expectations and the data actually published. It is still in negative territory but improved from -60 to –20.

Source: Bloomberg, BNPP AM

In the US, retail sales in July surprised positively with a 0.8% m/m increase for total retail sales (+0.8% for retail sales ex Autos) after three straight months of decline. Figures for June were revised down but not very significantly. This result should transfer in a 4% annualized growth of real private consumption (after a 1.5% in Q2) but such a strong pace is not likely to continue for the whole of Q3 given the still sluggish recovery of the labour market and some uncertainties about the "fiscal cliff" story. A 2% growth in PCE for Q3 seems more likely for the time being and would not be a bad result.

POOR GROWTH IN JAPAN FOR Q2, SHOULD BE BETTER FOR THE REST OF THE YEAR

Japan's economy expanded by only 0.3% QoQ in the second quarter (versus an expected 0.6% and a strong 1.3% in the first quarter). Still it is the fourth quarter of expansion in a row. Domestic demand remained solid in the wake of investment (both public and private) while private consumption hardly rose (+0.1% QoQ). On the contrary, the net exports subtracted 0.1%-point from GDP growth as external demand faded. Post earthquake reconstruction expenses are likely to continue to support activity in the second half of the year according to several leading indicators of public spending. The latest Tankan survey pointed out a stronger capital expenditures sentiment (+4% YoY forecasted for FY2012 vs. -1.3% according to the previous survey). Prospects for the rest of 2012 are not so bad for the Japanese economy and, given the carry-over effect of 2.4% so far, the 2.5% YoY GDP growth expected by the consensus for 2012 seems a little shy.

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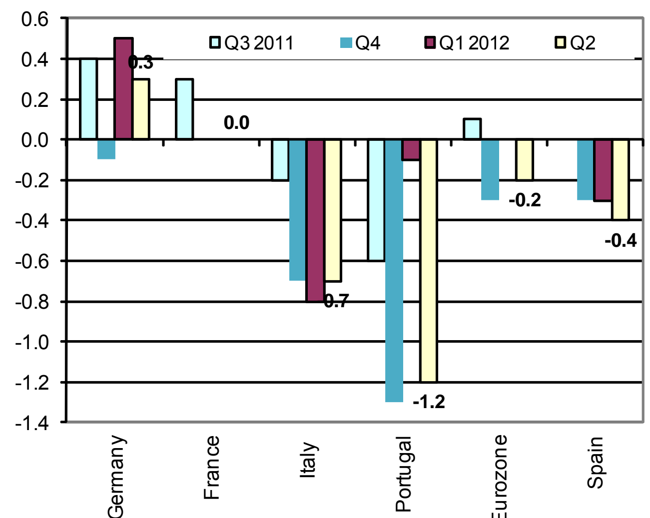
NOT A CLEAR-CUT RECESSION IN THE EUROZONE

According to Eurostat's estimates, GDP contracted by -0.2% QoQ in the second quarter (as expected by the consensus) after remaining steady in the first. The divergence between major countries widened with a contraction of -0.7%, in Italy and -0.4% in Spain versus a stabilization in France and a 0.3% expansion in Germany. Even if a so-called "technical recession" for the whole eurozone has been avoided given the 0% growth in Q1, short term outlook is not promising.

German GDP continued to grow in the second quarter, at a slightly slower pace (+0.3% after +0.5% in the first quarter). The Federal Statistical Office gave some hints about components: positive contributions came from final consumption expenditure and net exports (thanks to a larger increase in exports). Domestic consumption growth (both private households and government expenses) was higher than in the first quarter. This compensated for the decrease in capital formation observed especially for machinery and equipment. German GDP for the second quarter was slightly better than expected but the poor performance of investment and the recent degradation in business surveys (PMI, Ifo) do not bode well for the future.

Details on components are available for France where GDP has been steady for three quarters in a row. INSEE pointed out that total domestic demand (excluding changes in inventories) drove GDP on for only 0.1 %-point while foreign trade balance contributed negatively (-0.5 %-point) and changes in inventories positively (+0.3 %-point). Private consumption contracted from the first quarter (-0.2%) despite a still rapid rise in energy expenditure (+2.7%) due to cold weather conditions in April. The only good news is the 0.6% rise in total investment after a step back in the first quarter (-0.8%). All in all, details could have been even uglier but the difficulties of consumption are likely to persist in the coming quarters given the poor labour market.



Source: Factset, BNPP AM

INVESTMENT STRATEGY: UNCHANGED

After recent comments by Mario Draghi, the most likely scenario at present (which contributed to the rebound of equities since end July: +2.3% up to 10 August for the MSCI AC World in dollars) is a massive purchase of government bonds (mainly Spanish and Italian) by the ECB and the EFSF/ESM, which would look like a monetisation of public debt. Serious hurdles still are that the Statute of the ECB forbids this type of action and firm opposition from the Bundesbank, since this policy could lead to inflation.

Rather than a return of risk appetite, the euphoria on markets is due to expectations of a new "wave" of liquidity. This type of effect is generally temporary and could wane as central bankers seem reluctant to shoot the last bolts in their non-conventional armoury during summer. Given the lack of details regarding potential bond purchases in the eurozone and the tensions within the FOMC about QE3 in the US, we think that the equities are likely to remain range bound. For this reason, in the context of poor prospects for global growth, we decided not to add to our exposure given the poor prospects for global growth. Moreover, following the second quarter earnings season, downward revisions to EPS estimates should happen. Thus we confirm our cautious stance on equities (with a preference for emerging assets). We maintain the positive exposure to credit we adopted in early July.

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ASSET ALLOCATION: EQUITIES AND REAL ESTATE TO NEUTRAL, OVERWEIGHT DURATION

In our asset allocation, we have moved from underweight to neutral in both real estate and equities. There are many negative factors weighing on the market in both cases: notably the uncertainty associated with the sovereign debt crisis, and a weak outlook for earnings. However, those negative pressures are currently offset by market anticipation of further policy assistance on both sides of the Atlantic. We expect that anticipation to build over coming weeks: the Federal Reserve is likely moving towards an additional round of quantitative easing, and the ECB is set to start buying distressed European debt. These moves do not meaningfully alter the depressed growth outlook, but they can provide a short-term positive tailwind for financial markets.

Our regional equity allocation remains unchanged at neutral, and we remain underweight European small cap equities. The earnings prospects of European small caps have been seriously impaired by the unfolding recession in the eurozone. We see little prospect of that turning around in the near future.

In fixed income, we have moved from a neutral to an overweight position in duration (expressed in German government bonds). We have a bias towards long duration assets in an environment in which indicators of global growth are extremely weak and inflation risks are muted. The recent pick-up in yields has brought our assessment of valuation back to neutral, and additional monetary easing has the potential to put further downward pressure on the structure of global interest rates (e.g. through further "forward guidance" from the Federal Reserve).

We are neutral on corporate bonds, and have a relatively large overweight position in emerging market USD-denominated debt. In stark contrast to Europe, we have seen a series of upgrades to sovereign credit ratings in emerging markets. We expect that trend to continue given improving economic governance and also believe that the "search for yield" will provide a persistent bid for relatively high quality spread products.

We are underweight the euro. A weaker currency is part of the adjustment mechanism that will eventually restore the European economy to health. We are expressing that view against a basket of currencies that broadly matches the European trade-weighted exchange rate.

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