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Weekly Strategy Update

23 October 2014

SUMMARY

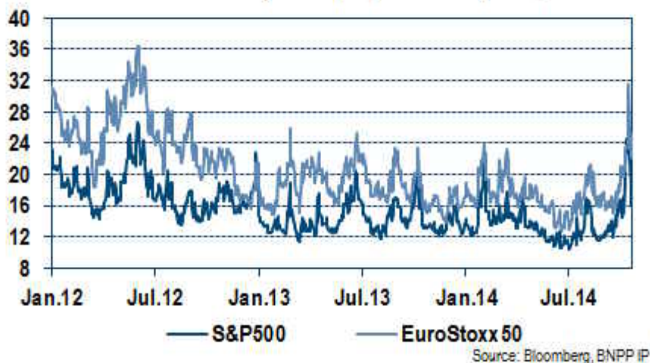
- **Turmoil in financial markets in October**
- **US: following the pack?**
- **Asset allocation: going overweight equities**

Concerns about global growth were highlighted in the autumn update of the IMF outlook: the forecast for global growth was trimmed to 3.3% for 2014, which would mean no acceleration from 2013, and to 3.8% for 2015. Weaker-than-expected US data fuelled investor fears that weakness in other regions could drag down the economy. A mix of geopolitical risks (unrest in Ukraine, fighting in the Middle East, demonstrations in Hong Kong) and spreading Ebola in western Africa added to the rising uncertainty among investors. The resulting market turmoil tested the limits of previous sell-offs in the bull market. Our fixed-income trades suffered from the risk-off mode, but we regarded the market reaction as overdone and offering opportunities. We implemented a couple of trades to take more market exposure. Our biggest step was the move in equities from a neutral weighting to an overweight.

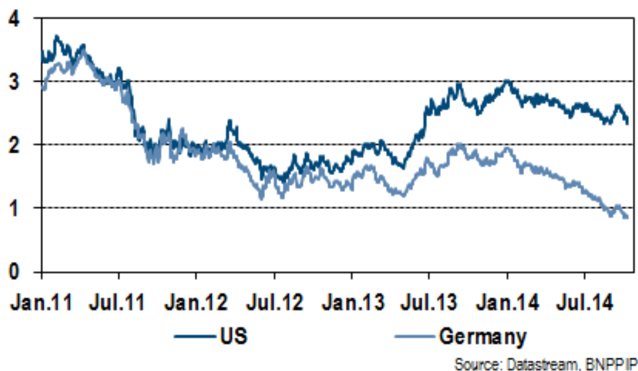
MARKETS: TURMOIL IN OCTOBER

The market environment has deteriorated over the course of October, driven more and more by investor concerns about world growth. The risk of the eurozone falling into recession had already been highlighted by the IMF. Concern that the US economy would not be able to withstand global headwinds halted the downtrend of the euro against the US dollar. Nervousness in global markets culminated after the publication of weaker-than-expected US retail sales. The S&P500 share index dropped to its lowest since April and the EuroSTOXX 50 hit a 2014 low. Other risky assets suffered as well. The growing risk-off mode showed up in spiking equity market volatility and sharp moves in safe-haven assets.

Historically, the volatility in US Treasuries was even more impressive, with an intraday trading range of 30bp in US 10-year yields and the 10-year German Bund yield falling to an all-time low of 0.715%. In the context of previous bull market selloffs, critical levels were reached and investors had to decide whether there was now a buying opportunity.



This broad-based-risk-off mood may explain the huge swing later triggered by better-than-expected US data. The S&P index was able to reverse most of the previous losses and, to a lesser extent, European equities were able to do the same. An illustrative example of the market mood is that a Reuters story on rumours of the ECB extending its asset-buying to corporate bonds was sufficient to lift equity markets and Bund yields on Tuesday.



Financial markets remain challenging. Investors now have to review the fundamentals and ask what the likely consequences of recent market stress are for the real economy and for monetary policy. An even greater challenge is to decide whether this environment is a buying or selling opportunity. We saw it as a chance to buy since we are still constructive on global growth.

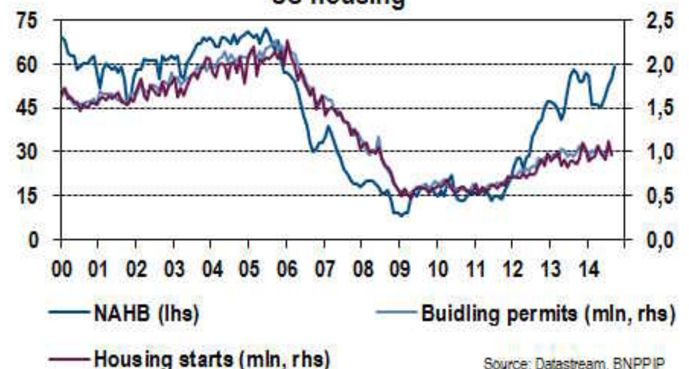
US: GLASS HALF FULL OR HALF EMPTY?

We expect the US economy to remain on a solid growth path. Growth should weaken after a very robust second quarter (4.6% saar), but remain strong enough to give a positive impulse to the world economy. The US economy is still on a strong footing due to robust domestic demand.

A favourable labour market is also supportive of the US consumer. Initial jobless claims last week fell to a 14-year low after the strong rise by 248 000 in September's non-farm payrolls.

Markets paid more attention to weaker data and the turmoil worsened after the publication of retail sales last week. Small business confidence fell in September to 95.3. The Empire Manufacturing index plunged to 6.17 from 27.54 in October and core retail sales fell unexpectedly by 0.2% MoM. The reaction to these disappointments seems overdone to us and we would emphasise that the glass is half-full for the US economy. The Empire Manufacturing index is still close to its long-term average and future business confidence is still running quite high historically. That is even clearer in the case of the Philly Fed index, which fell from 22.5 only to 20.7 in October. And even the "shock" in retail sales number still translates in a nominal 3.8% saar rise for the third quarter, which is less than the previous quarter's 6.5%, but still pretty good in our view.

The tide for the data flow later turned positive. The housing sector signals a higher contribution to third and fourth-quarter growth. Across the board, housing (starts, permits, existing home sales) had a strong September and the latest data points to a substantial acceleration in the third quarter, having returned to fourth-quarter 2013 levels. Industrial production rose by a strong 1.0% MoM in September, with third-quarter production 0.8% up on the previous quarter. Finally, the University of Michigan consumer confidence index published last Friday continued its upward trend, rising to 86.4 in October, and the outlook component was near a post-recession high.



Against this background, Fed watching will continue ahead of the CPI data issue and the FOMC meeting next week. The Federal Reserve's policy decisions are likely to become more and more data-dependent. Volatility will

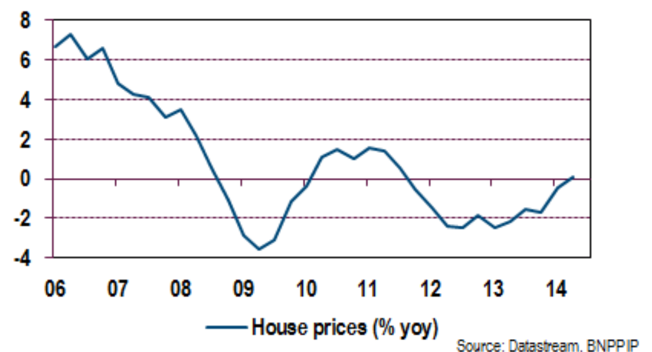
likely be driven by published data and comments by Fed members. We expect the FOMC to announce the end of tapering, still keep interest rates low for a considerable time and to commit to a market-friendly normalisation of key rates.

EUROZONE: SHOULD WE WORRY ABOUT GERMANY?

Overcoming the soft patch in the eurozone cycle requires a strong German economy. But instead, recent disappointments have intensified the debate about a recession in the eurozone. German industrial sector data for August plunged: orders dropped by 5.7% MoM and production fell by 4.0% MoM. September is likely to have somewhat of a rebound. The data is distorted by an unusual holiday pattern, but the current weakness also reflects the headwinds facing exports to Russia, a deterioration in the also quite important emerging markets and weakness in the eurozone, especially in France and Italy. These headwinds should ensure the soft patch for the German economy lasts a while yet and even a technical recession in the third quarter cannot be ruled out. However, the outlook for domestic demand to strengthen on the back of historically low rates and rising employment remains intact. Exports should get a lift from the weaker euro. Some of the pessimism about downgrades for German growth may be overdone in the end. The recent weakness could increase the likelihood that the German government takes stimulus measures. France has proposed a EUR 50 billion investment package by Germany as a counterweight for spending cuts in France and other eurozone countries. This should be seen in the context of the review by the European Commission of the member state budgets for 2015 starting this week. The eurozone still needs to find a delicate balance between the requirements of the Stability and Growth Pact and the need to stimulate growth.

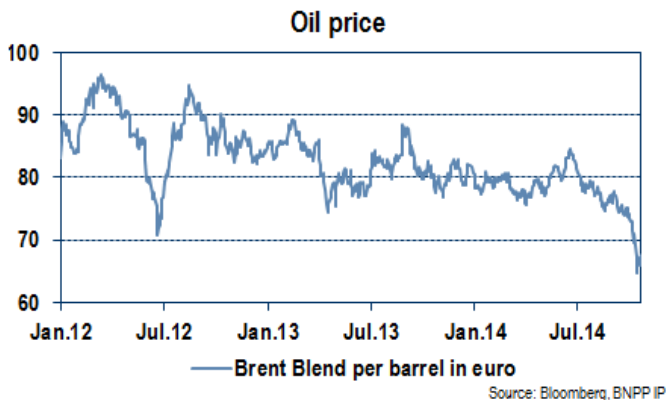
Industrial production data for the eurozone confirmed the fragile situation of the economy, diving in August by 1.8% MoM. For July/August, production is now running 0.8% below the second-quarter average. Weak economic activity is keeping inflation down. In our view, the slightly upward revision of core inflation to 0.8% for September does not change this picture and is not a big relief for the deflation-wary ECB.

There was some good news from the housing market in the eurozone. In the second quarter, housing prices rose by 0.9% QoQ, with pronounced rises in Ireland (6.8% QoQ), Spain (1.7% QoQ) and Portugal (1.6% QoQ). Year on year, house prices are now flat in the eurozone, indicating that the adjustment process in housing markets is in an advanced phase. The headwinds for growth should be declining.



After surprising markets in September with a broad range of measures, the ECB disappointed in October by keeping details on the length and volume of additional stimulus from asset purchases quite vague ("*The programmes will last for at least two years. Together with the series of targeted longer-term refinancing operations to be conducted until June 2016, these purchases will have a sizeable impact on our balance sheet*"). Markets had hoped for more in terms of volumes and a willingness by the ECB to move quickly towards fully-blown QE. Nevertheless, its readiness to fight the build-up of deflation expectations is clear and the ECB has put itself under pressure to do more. It first wants to see the effects of the recently proposed measures in the hope of avoiding full-scale QE. The next moves by the ECB should be quite data-dependent and determined more specifically by the prospects for growth and inflation.

Apart from the weaker euro, there is another factor that could improve the growth outlook of the eurozone. Having moved for quite a while in a trading range, the oil price dropped quite substantially in euros in the course of October, pushing down headline inflation in the short term, but strengthening the purchasing power and private consumption in the eurozone.



ASIA: MODEST DATA

Data out of Japan maintained the picture that the economy is not heading for a strong rebound after the VAT-induced drop. A recession is even possible. This underpins our expectations that the Bank of Japan will increase its quantitative easing, most likely early next year. The Economic Watchers survey was unchanged at 47.4 in September, staying below the boom-or-bust mark of 50. The tertiary industry index fell further in August by 0.1% MoM and final data for August industrial production saw a downward revision of the monthly drop from 1.5% to 1.9%. On the positive side, machinery orders posted a strong rise for the third month in a row (in August 4.7% MoM). This fits with indications in the recent Tankan survey for an improvement in capital expenditure. After a weak August, September trade data pointed to rising activity, with nominal exports rising by 3.1% MoM and imports by 5.0% MoM. This left the trade balance in the red for the 43rd month in a row. The weaker yen should be helping exporters.

The situation elsewhere in Asia remains mixed, ranging from a 25bp cut taking rates to a record low of 2% in South Korea to economies such as Malaysia and the Philippines doing well. Malaysia reported a strong acceleration in industrial production from 0.6% growth YoY to 6.5% YoY in August and an improvement in export growth from 0.8% to 1.7% YoY. Stronger-than-expected GDP growth in Singapore of 1.2% annualised in the third quarter may be a sign of improving global demand given the country's focus on exports.

Most attention was on China. Inflation fell to nearly a five-year low of 1.6% YoY in September. This points to overcapacity and insufficient domestic demand. In this respect, the much stronger pickup in new loans to CNY 857.2 billion in August is a sign that previous liquidity injections by the People's Bank of China are having a positive impact on economic activity. September trade data was also a bright spot, with export growth accelerating from 9.4% to 15.3%. The accompanying rise in import growth from -2.4% YoY to 7.0% could bode well for a strengthening of overall growth in the future. This will be needed for the government to meet its growth target of 7.5%. At 7.3%, third-quarter GDP growth was better than expected, but it was also the lowest growth rate since the first quarter of 2009. The authorities can be expected to try and fine-tune measures to ensure sufficient growth by taking small steps in adjusting fiscal policy and monetary policy. This should avoid any shocks to growth, but the government will probably allow for gradual slippage of the growth path.

ASSET ALLOCATION

Core positions

Weak US data and especially disappointing retail sales for September triggered a selloff in equity markets. Risk assets reached the limits of previous selloffs in the bull market. We took this as a buying opportunity. Valuations are still not low and despite the risks in the eurozone and China and the concerns that the US economy will falter, the weakness seems overdone. On the contrary, as said, the US economy is on a strong footing and should provide support to the rest of the world. Falling oil prices and the stronger dollar should benefit the US consumer. Low policy uncertainty in the US should help anchor the risk premiums for other assets. We believe the drop in markets offered us a chance to take more market risk. Therefore we have moved from a neutral position to an overweight in equities.

In terms of the regions, already at the start of October, we moved to an overweight in US equities vs. European

equities. The drivers for this decisions are the brighter outlook of the US economy compared to Europe, a more constructive earnings outlook and the M&A cycle favouring US equities. We kept our overweight position in European large caps versus small caps since large-cap companies should benefit more strongly from a slightly improved global growth environment. We consider European small caps expensive.

We opened a long position in European investment-grade bonds. The ECB buying programme for ABS and covered bonds should support this asset class due to portfolio rebalancing effects. In addition, slow growth, low inflation and negative issuance should support demand for such corporate bonds.

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.

We are neutral on convertible bonds, commodities and cash.

Flexible multi-asset positions

We recently reinstated a small tactical short duration position in US Treasuries. We also opened a long Italian BTPS vs. short Gilts position. These trades suffered from the recently quite extreme environment in bond markets. Last week's sharp intraday plunge in US 10-year yields triggered the drawdown limit for this trade and the US short duration position was closed. For the other trade, UK gilts moved down in tandem with US yields and Italian yields came under pressure due to rising risk aversion and renewed discussions about the outlook for Greece. For that reason, the Italian position was closed, but we have kept the short in UK gilts. This still reflects our view that fears over global growth are overdone and there is some setback potential to yields. In this context, the UK appears to be the most exposed due to a quite strong domestic-driven recovery which should push the Bank of England to the forefront of central banks hiking key rates next year.

We have kept our long position in Norwegian bonds versus Bund futures. We did not hedge the currency. Norwegian bonds offer a positive carry versus Bunds and are AAA rated. The strong economy should support the currency. If growth were to weaken, we could lose on the currency, but gain on the bonds.

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. 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, that the adjustment process is slow, and that there will be additional mine supply and insufficient demand.

We are overweight US homebuilders versus US small caps. Homebuilders have underperformed significantly over the past 18 months. 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 closed the long five-year forwards in investment-grade debt.

In anticipation of a No to Scottish independence, we had sold put options on the British pound sterling versus the US dollar. This position expired this month.

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Bloomberg and Datastream are the sources for all data in this document as at 21 October, unless specified otherwise.

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