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Weekly Strategy Update

12 February 2015

SUMMARY

- US labour market strength raises market speculation about Fed rate hike
- More signs of improvement in the eurozone
- Confidence in Japan returning slowly
- India growing faster than China?
- Profits taken on long US homebuilders

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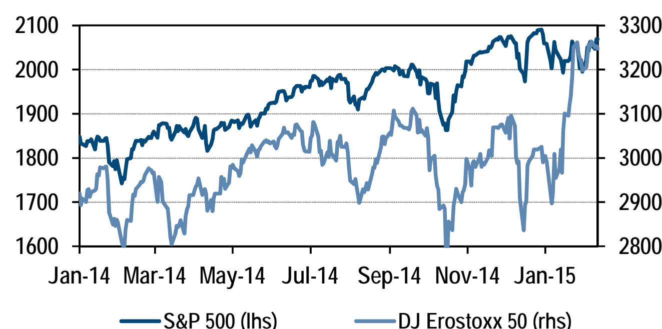
The latest US labour market report was positive, but did not boost US equities. It did raise market expectations of an early rate hike by the US Federal Reserve. While the US S&P 500 equity index has broken just above its recent 2000-2050 point range, more positive economic or earnings data may be necessary to get it to advance further.

S&P500 & DJ Eurostoxx 50



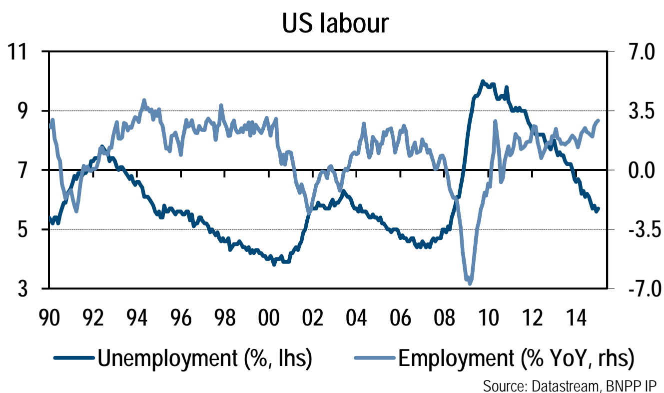
Source: Datastream, BNPP IP

European equities took a breather after the surge in late January. The positive news on growth and monetary policy is now discounted. Japanese and emerging equities do not have much momentum either. US, UK and even Japanese bond yields have risen, but yields in the eurozone have remained low. Uncertainty about the outlook for Greece and to some extent for Ukraine have supported safe-haven assets. Of course the prospect of bond purchases by the ECB has capped yields. In our

core asset allocation, we remain neutral on equities. Fundamentally, we are positive, but for the near term, we prefer to be cautious. In our flexible multi-asset approach, we took profits on our long position in US homebuilder equities.

STRONG US LABOUR MARKET SHOULD KEEP THE FED ON COURSE

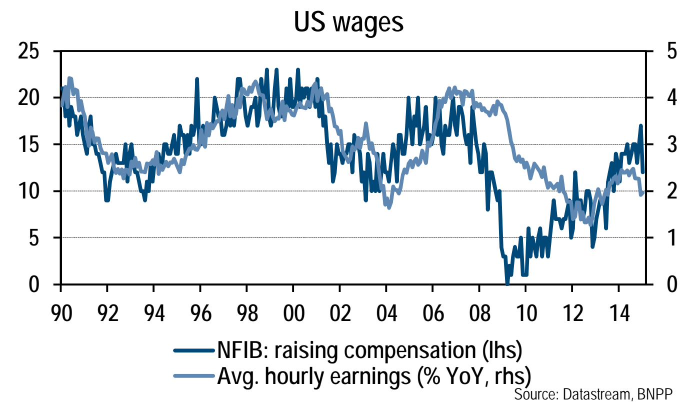
Job growth in January was strong at 257 000 net new jobs, and the upward revisions to the November and December data were impressive at 147 000. Apart from the surge in May 2010 when the government hired people to carry out the census, job growth has not been as strong as it was last November since March 2000. For job growth as strong as in the past three months, we have to go back to November 1997. Of course, total employment has increased, which should lead to stronger job growth in absolute numbers. But even in relative terms, job growth has been strong. On a three-month annualised basis, job growth has not been this strong since May 2000.



Source: Datastream, BNPP IP

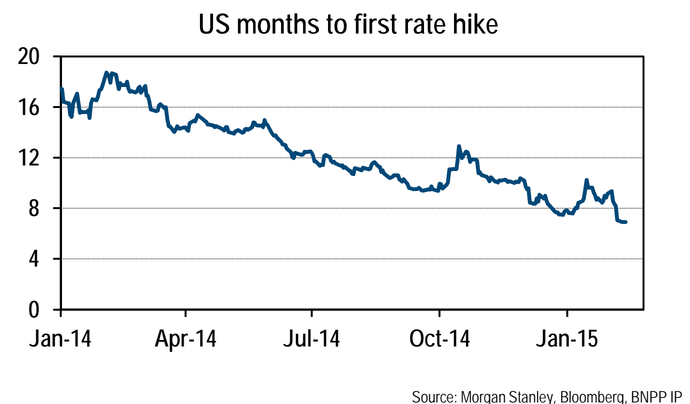
However, the unemployment rate did tick up to 5.7%, but for a good reason: a record increase in the labour force. Thus, with the labour market improving and separate data showing increasing dynamism in the labour market (more job openings, stronger hiring and more workers voluntarily leaving their jobs) in December, more people have been drawn back to the labour market. The implication is that wage growth could stay muted. Average hourly earnings rebounded after December's surprise fall, but at 2.0% YoY, growth is not strong. Household income is rising more quickly, though, due to the increase in employment and the drop in oil prices.

The index measuring sentiment among small business owners fell in January. This was out of line with the labour market data and with the recent surge in consumer confidence. But the NFIB index had risen strongly in the previous two months, so this could just be a temporary setback. According to the survey, small business owners are still willing to hire workers and to increase borrowing, although they were slightly less willing to raise compensation. Still, the level of this last sub-component indicates stronger wage growth.



Source: Datastream, BNPP

Bond yields rose after the labour market report. Market expectations of the first Fed rate hike, which had drifted back in time after weaker US economic data, were brought forward. The graph below shows the months to the first rate hike as calculated based on market data by Morgan Stanley: on 2 February, markets had expected the first hike to be 9.4 months away, on 9 February, this had fallen to less than 7. That puts the first hike in September. For us, the latest labour market data have bolstered our view that rates will be hiked as early as June.

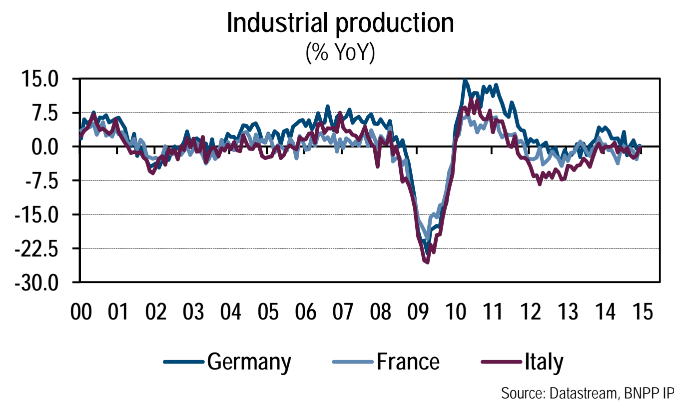


Source: Morgan Stanley, Bloomberg, BNPP IP

EUROPEAN DATA: TREND REMAINS POSITIVE

In recent weeks, I have highlighted the positive factors that have lined up for the eurozone. And indeed, this trend has continued. German industrial production

rebounded in December, as well as manufacturing orders and exports. It is too early to tell if the recent sideways trend in Germany's manufacturing data has now changed, but annual growth rates flipping from negative in November to positive in December are a welcomed improvement. Furthermore, industrial production in France and Italy was strong.

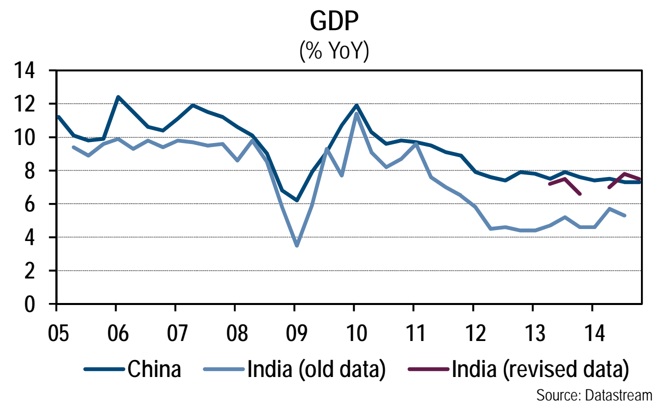


Source: Datastream, BNPP IP

In the third quarter of last year, industrial production in the eurozone had fallen. Data for the fourth quarter so far indicated a decent increase, which should have supported GDP growth. This won't make much of a difference for monetary policy. The ECB has given us a clear roadmap for the next two years and growth will have to be very strong (and inflation will have to turn quickly) for the ECB to change its stance. That does not seem likely to us.

INDIA: GROWING FASTER THAN CHINA?

Revised GDP numbers now show that the Indian economy grew much more strongly in recent years. According to the previous numbers, growth had almost halved from 9.4% in 2010 to 5.2% on average in the three quarters through the third quarter of 2014. The revised data only go back to the second quarter of 2013, but show a less pronounced slowdown. For the most recent three quarters (up to the final quarter of last year), growth was revised up to 7.4%. Annual growth in the fourth quarter of last year now exceeds growth in China. The new numbers have been met with scepticism since they do not fit with other indicators. The manufacturing index dipped below 50 in late 2013 and has only recovered gradually. Industrial production growth was strong in November last year, but had fluctuated around zero for several years before. Indian exports have not been strong either. So we would take the idea that India is now growing more strongly than China with a pinch of salt. This could still happen though. India has a significant potential if the right reforms are implemented, while China's rebalancing from an investment-led to a consumption-led economy could slow growth.



Source: Datastream

Several indicators highlight China's slow growth. This has also put downward pressure on inflation. January data showed that inflation was falling on all measures: for headline, non-food, services and producer prices. Falling food prices (mainly pork, due to base effects) and oil prices can explain the declines for a large part, but not fully. Slow growth leads to disinflationary pressures. Not just in China, but due to its size, also abroad.

Elsewhere in Asia, some Japanese indicators have been more positive lately. In January, consumer confidence improved for the second straight month. It is still well below the levels seen right after Prime Minister Abe came to power, but it is recovering from the slump after last year's consumption tax hike. Consumer spending has also trended upward lately. The Economy Watchers' Survey, which gives a broad indication of economic expectations, improved further in January. The strong gains in the outlook component are particularly encouraging. This makes things tricky for the Bank of Japan. A modest cyclical upturn, supported by low oil prices, reduces the need for more quantitative easing. But low oil prices also lead to lower inflation, far below the BoJ's target of 2%. As long as inflation expectations hold up – as they have so far – the BoJ may wait and see (although it is not really waiting since it is already carrying out a massive quantitative easing programme). Additional action at a later date should not be ruled out.

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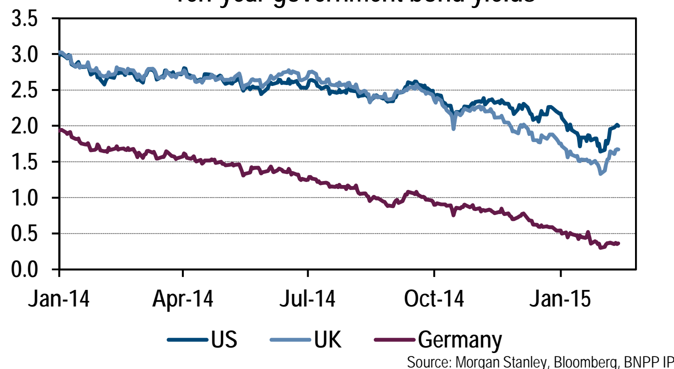
ASSET ALLOCATION

Core positions

We have not changed our core asset allocation. We are fundamentally positive on global equities, but political developments around Greece and Ukraine pose a risk. Fourth-quarter company reports in the US have so far shown sluggish sales. The share of companies surprising positively on earnings has lagged that of the previous season. In the eurozone, earnings surprises have fallen, while sales surprises have stayed strong. Taking all these developments into account, we remain neutral on equities. We are overweight Asian emerging markets versus the broad emerging market index since we expect Asian economies and equities to benefit more from low oil prices and quantitative easing than emerging economies outside this region.



Source: Morgan Stanley, Bloomberg, BNPP IP

US and UK government bond markets have sold off lately. The move in the US was due mainly to positive economic data and expectations for an early rate hike increasing. Expectations for a hike in the UK had been pushed back as well, but have also come in. German yields hardly rose though, as the path of monetary policy in the eurozone is clear now. We do not have any duration positions now. Low inflation and easy monetary policy justify low yields, while improving growth argues for an increase. We think these risks are broadly balanced.

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 global real estate, convertible bonds, commodities and cash.

Flexible multi-asset positions

In our flexible multi-asset approach, we took profits on our long US homebuilders position. The trade had done well after the most recent US housing market data and homebuilders' earnings reports.

We are long 30-year versus 10-year Japanese government bonds. Yield curves have been flattening around 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.

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 from slower growth in China better than other Latin American countries.

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 long Japanese credit versus Asia ex-Japan credit using credit default swaps (iTraxx Japan versus iTraxx Asia ex-Japan). The main arguments for the trade are that we think the BoJ will keep doing whatever it takes to reflate bond prices by means of financial repression. Asia, on the other hand, is likely to struggle with the first round of implementation of structural reforms which will inevitably lead to more defaults in corporate bond space.

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. These factors should not impact long-term inflation expectations.

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. The position has benefited from the recent rate cut in Australia, but we see more room for the peso to appreciate versus the Australian dollar.

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 US dollar versus Swiss franc trade as we think that the franc is overvalued. Furthermore, with Fed hikes expected this year and the Swiss National Bank clearly on hold (if not moving in the other direction), we expect the dollar to appreciate versus the franc.

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 11 February, unless mentioned otherwise.

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MARKET OVERVIEW*

	Indices	Close	5D %CHG	1M %CHG	3m %CHG	YTD %CHG	Currency
MXWO Index	MSCI WORLD	1.722	-0.34	2.68	0.38	0.70	USD
LEGATREH Index	Barclays Global Agg	212	-0.54	0.32	2.43	1.00	EUR
LG30TREH INDEX	Barclays Global High Yield	343	0.47	1.36	-1.09	1.29	EUR
ENXG Index	FTSE EPRA Global REITs	2.449	-3.27	-0.27	7.48	4.31	USD
	Regional Indices						
SPX Index	S&P 500	2.069	1.32	1.99	1.49	0.47	USD
MXEUG Index	MSCI EUROPE x UK	136	-0.31	9.21	11.55	8.62	EUR
UKX Index	FTSE 100	6.847	-0.27	5.32	3.57	4.28	GBP
NKY Index	NIKKEI 225	17.980	1.70	4.55	5.00	3.03	JPY
MSEUCAXJ Index	MSCI Asia Ex Japan	577	-1.27	1.86	1.14	2.37	USD
MXEF Index	MSCI EMERGING Markets	961	-2.14	0.59	-3.50	0.51	USD
jpeiglbl index	J.P. Morgan EMBI $	662.51	-0.81	0.55	-2.21	-0.01	USD
jgenfxgd index	J.P. Morgan GBI-EM local	94.18	-2.05	-3.61	-9.17	-4.03	Local
	Regional Bond yields	%	% 5D	% 1M	% 3M	%YTD	
USGG10YR INDEX	US Generic Govt 10 Year Yield	2.03	1.82	1.91	2.37	2.17	USD
GDBR10 INDEX	Germany Generic Govt 10Y Yield	0.36	0.37	0.48	0.81	0.54	EUR
GUKG10 INDEX	UK Generic Govt 10Y Yield	1.71	1.55	1.58	2.19	1.76	GBP
jpegsoyd index	J.P. Morgan EMBI $	6.25	6.11	6.26	5.77	6.15	USD
jgenvhyg index	J.P. Morgan GBI-EM local	6.20	5.96	6.29	6.44	6.50	Local
	FX						
EURusd Curncy	USD	1.13	1.15	1.18	1.24	1.21	USD
GBPEUR Curncy	GBP	1.35	1.34	1.28	1.27	1.29	EUR
EURjpy Curncy	JPY	135.69	134.88	140.05	143.64	144.85	JPY
EURCNH Curncy	CHN	7.08	7.16	7.33	7.63	7.52	CNH

* As at 12 February 2014. Source: Bloomberg, BNPP IP

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