



global weekly

Investment
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When paths diverge

The lack of a clear direction and a stream of depressing news has hurt sentiment. Markets perked up after Fed Chair Janet Yellen said that a rate hike was “likely” in 2015.

Markets are uncertain. This is owing to conflicting signals from many corners and increasing divergence. Developed economies are doing well, while emerging economies suffer. The US central bank will be “tightening” its monetary policy when it begins hiking rates, while the ECB is expected to “loosen,” by increasing its monthly asset purchases. China is experiencing a slowdown, but it is expected to be adequately managed by policymakers. Even within China, industrial activity has slowed, while the services sector remains robust. And, up until Thursday night, there was increased uncertainty about the timing of rate hikes in the US. The lack of a clear direction and a stream of depressing news prompted confusion and gloom.

Despite rising market risks and increased volatility, ABN AMRO Group Economics continues to believe that the effects of the deterioration in emerging markets will not impact the recovery in Europe or the US. These economies are expected to continue to strengthen. The fact that growth in advanced economies has significantly broadened suggests that they are not particularly vulnerable to emerging markets in the short term.

This week, US durable goods orders and Germany’s Ifo business climate indicator were both better than expected, with the details for the latter showing that the German economy is healthy and relatively resilient against the slowdown in China. Data from emerging markets, however, point to increasing difficulties. In particular, this is related to the cooling of industrial activity in China, which negatively affects many other emerging markets. Weak commodity prices are another headwind, although they are now stabilising.

Equity markets update

Stock markets around the world turned lower in the course of the week, although share prices recovered on Friday, after

Equity index performance

	Value	One week change (%)	Year-to-date (%)
MSCI ACWI	384,2	-2,5	-7,9
S&P 500	1932,2	-2,9	-6,2
AEX Index	421,5	-1,4	-0,7
EuroStoxx 50	3019,3	-1,8	-1,4
DAX Index	9427,6	-2,5	-1,4
Nikkei 225	17880,5	-0,8	2,5
Hang Seng Index	21186,3	-3,4	-10,2

Important rating changes (RL=Recommended List)

Company	From	To
ROCKWELL AUTOMATION INC.	Hold	Buy
SIEMENS AG	Hold	Buy
Easyjet	Hold	Buy
UBS	Hold	Buy
Deere & Co	Hold	Buy

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0,729	4,9	17,6
German Bunds 2-year	-0,241	-0,4	-17,4
Japan 2-year	0,007	0,0	-5,1
US Treasuries 10-year	2,167	3,2	-33,6
German Bunds 10-year	0,653	-0,9	-31,9
Japan 10-year	0,318	0,9	-20,2

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	86,05	8,67	24,17
iTraxx Euro 5-year	83,09	12,38	21,69
JPM EMBI+	440,06	36,73	131,41

Performance data as of Friday, 25 September.

Source: Bloomberg

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investors reacted positively to the Fed's statement regarding a rate hike in 2015.

There were two reasons for the hesitation of equity investors earlier in the week. First, the World Steel Association reported on Monday that global steel output had declined by 3% year-on-year in August. This raised concerns that the global economy was in less good shape than expected. Commodities, such as oil, steel and copper all lost ground; and companies such as the steel producer ArcelorMittal and commodity-trader Glencore lost some 15% of their share value.

Investors' trust was also put to the test by revelations that Volkswagen has been manipulating emission test data for diesel cars in the US using motor management software. The Volkswagen story dominated corporate headlines this week. The US Environmental Protection Agency (EPA) reported that Volkswagen installed software in diesel cars for the US market to make emission data look better than it actually was. The software was able to detect if a car was in test mode by analysing various sensor data, such as speed and steer movement. A car being tested does not move and there is no movement in the steering wheel. If a car was in test mode, the software adjusted the engine performance to keep emission data below the legal limits. Volkswagen shares dropped by 40% as investors feared that it could be confronted with enormous fines, civil lawsuits and recalls. The software appears to have been installed in 11 million Volkswagen Group diesel vehicles worldwide and the question is if Volkswagen also manipulated data in markets other than the US.

The whole European automotive sector was punished, as investors fear that the emission manipulation practices may not be limited to Volkswagen. The STOXX Automotive Index lost 14% over the week. Despite the strong correction, we think that the European car sector remains too risky to invest in. Authorities in both the US and Europe will start thorough investigations into the vehicle manufacturers and regulations are likely to become more strict. And, although the European car market continues to develop favourably, Chinese demand for European luxury cars is declining, which is another risk for European manufacturers.

In two weeks' time, the third-quarter earnings season will start. In the current volatile environment, investors will be looking for comfort. They will look for evidence that the US and European economies continue to recover and that there is no "hard landing" in China.

Bond markets update

Bond yields in the US and the eurozone continued to decline, as investors digested the mixed messages from the Fed from last week. Investors are worried over the impact of the global developments on global economic growth.

Core government bond markets were again driven by investor risk appetite. As equity markets failed to recover, demand for safe-haven bonds appeared to increase, pushing bond yields down. The uncertainty about the first Fed rate hike also put more focus on the other key central banks. The Chinese central Bank, the Bank of Japan and the ECB are all ready to further stimulate economic growth if necessary. Group Economics expects that the ECB will increase its monthly asset purchases by EUR 20 billion before year-end.

Idiosyncratic risk has increased in European investment-grade credits. This is best illustrated by Volkswagen. Based on the current estimates of potential fines, however, we do not expect that Volkswagen's senior credit rating will be downgraded to high yield. Instead, we expect that the company will keep its investment-grade rating. The turmoil around Volkswagen was the main reason for the increase in credit spreads in the European investment-grade universe this week. Investors wonder if Volkswagen is the only car company using questionable tactics to meet emission standards. For the remainder of the year, we expect European investment-grade credit spreads to decline moderately, thus supporting our current allocation.

Currency outlook

The weakness of the US dollar after the Fed's decision to keep rates unchanged last week was short-lived. Since the meeting, Fed policymakers have clearly expressed that the decision was a close call and that a lift-off this year remains likely. This has boosted the US dollar across the board and heavily weighed on emerging-markets currencies. Moreover, weak economic data in China hurt most Asian currencies in the past week. We believe that financial markets are still underestimating the magnitude of depreciation in the Chinese yuan by the end of this year.

Asset allocation

The Global Investment Committee, at its meeting on 24 September, confirmed its conviction in the fundamentals backing the existing asset allocation. It consists of an overweight in equities, a strong underweight in bonds and overweights in commodities and hedge funds.

Published this week

Bond Report: Volkswagen

Despite the intense turmoil surrounding Volkswagen, we currently do not expect the company to lose its investment-grade credit rating. We therefore decided to keep senior bonds issued by Volkswagen International Finance – the company's financing vehicle – on our Recommended Bond list for now.

China Country Note: Short-term volatility, long-term potential

The Shanghai Composite Index – one of China's mainland or 'A-share' markets – has fallen by 38% from the peak of 5,166 on 12 June until the end of August. A strong increase in market volatility was reflected by the fact that we have seen nine days with drops of more than 5% during that period. Although volatility is expected to remain high in the near term, we believe an overweight allocation to Chinese equities is still warranted.

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