



global weekly

Investment
Communication
2 August 2013

Waiting for September

Mixed second-quarter results saw equity markets move sideways this week. US Treasury yields rose slightly on the back of strong US macro data, while German Bund yields were stable as the economic recovery in Europe remains fragile. What could have been a big week was actually tame, as markets await the September meeting of the US Federal Reserve.

Macro update

FOMC holds off from tapering or changes in guidance

At its meeting this week, the Federal Reserve policy committee left its statement broadly unchanged, holding off from any slowing of the pace of its asset purchases or even any hints in that direction. Its guidance on the economic conditions necessary for the central bank to start steering short-term interest rates upwards was also left unchanged, despite indications that it is considering lowering the threshold unemployment rate from 6.5%.

The policy committee also noted that the US economy was expanding only modestly but that growth is expected to pick up. At the same time, the labour market had improved, but the unemployment rate remained high. On a slightly dovish note, the policy committee recognised that inflation “persistently below its objective could pose risks to economic performance” but expected it to move back to its target rate over the medium term.

We continue to believe that the FOMC will gradually begin to slow the pace of its asset purchases at the September 17-18 meeting. There is also a possibility that it might change its forward guidance to indicate an even later start of rate hikes, but we think that the risk that it will be perceived to be behind the curve could well prevent such a move. Our base case is that the first policy rate hike will come in early 2015.

ECB steps up its guidance, warning that market rate expectations are unwarranted

The ECB kept its policy rates on hold but continued its campaign to dampen market expectations of rises in short-term interest rates. ECB President Mario Draghi reiterated the forward guidance introduced last month that “the Govern-

Equity index performance in local currencies

	Value	One week (%)	Year-to-date (%)
MSCI ACWI	376.51	0.4	10.8
S&P 500	1706.87	1.0	19.7
EuroStoxx 50	2808.64	2.8	6.9
DAX	8410.73	2.2	10.7
Nikkei 225	14466.16	2.4	39.2
Hang Seng Index	22190.7	1.0	-2.1

Important rating changes

Company	From	To
Samsung Electronics Co Ltd	Buy	Hold
Wessanen	Buy	Hold
Schneider Electric	Buy	Hold
Procter & Gamble Co	Buy	Hold
Ryanair Holdings Plc	Hold	Sell

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0.33	0.4	9.8
German Bunds 2-year	0.15	-0.2	23
Japan 2-year	0.12	-0.7	2.7
US Treasuries 10-year	2.71	13.5	118.2
German Bunds 10-year	1.67	-0.4	29.9
Japan 10-year	0.80	-0.8	1.9

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	74.37	-2	-31.12
iTraxx Euro 5-year	96.57	-6.9	-58.78
JPM EMBI+	329.30	11.5	12.41

Performance data is as of 12:00 pm Friday, 2 August

Source: Bloomberg

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ing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time." He also took a step further, explicitly communicating that current expectations for rate hikes in money markets are "unwaranted". This obviously suggests that the ECB feels that the downward adjustment still has a way to go, given its current view of a "subdued outlook for inflation extending into the medium term (and) given the broad-based weakness in the real economy and subdued monetary dynamics".

Bond market update

Weak demand from banking sector in second half 2013

The possibility of the Fed tapering its quantitative easing programme dominated fixed income demand in the second quarter. Demand for bonds, however, is not only determined by the Fed's asset purchases: the banking sector also used to be a major buy-side player.

But bank demand is diminishing. The banking sector suffered a blow from recent changes to regulatory capital requirements. Under the new rules, large banks will be required to include unrealised gains and losses on their assets-for-sale portfolios in regulatory capital. This will likely create more volatility in capital ratios and result in lower bank demand for securities.

There are also eight institutions that are considered global systemically important banks. This group includes Goldman Sachs, UBS, Citigroup and BNP Paribas, for example. These eight institutions are now required to maintain a minimum supplementary leverage ratio, based on total rather than risk-weighted assets, and including many off-balance sheet exposures. Since these banks account for a large share of total securities holdings in the banking system, a reduction of their balance sheets to meet leverage targets may also negatively impact the banking sector's demand for bonds.

Short-term dislocation in credit markets

Stronger economic growth will support credit quality of cyclical companies and financials, resulting in tighter credit risk spreads. And, eventually, fundamentals will also prevail over technicals (waning demand from the banking sector and higher interest rates) also leading to tighter credit spreads. Dislocations within corporate bonds, however, may persist in the short term.

EM assets in stable condition

Emerging markets assets finally stabilised at the end of the month, as US Treasury yields fell from their 2.75% highs to a

stable 2.5% level, following the release of US non-farm payrolls. Ben Bernanke eased Fed tapering concerns during his two-day Humphrey Hawkins testimony, after likely becoming uncomfortable with the rise in yields and its possible consequences for the economic recovery. The Fed Chairman's cautious tone regarding the economic outlook and an emphasis on the data dependency for tapering, restored calm to emerging markets and led to a strong recovery, with yields returning to pre-selloff levels.

Equities update

Markets moved sideways this week, as second quarter earnings were a mix of disappointment and very positive surprises. European equity markets slightly outperformed the US.

In the US financials sector, earnings were strong. While European banks are now also showing improvement, it is at a much slower pace than in the US.

Overall, industrial earnings are signaling an upbeat message for the second half of 2013. Again, this is more true for the US than for Europe, which continues to see very weak demand. Emerging markets demand is clearly slowing, but this should be compensated for by growth in the US and Europe in the second half of the year.

Fading enthusiasm for commodity-related stocks

Stock price trends are closely linked to commodities. But commodity demand has been weak for more than two years and the appetite for oil and base materials continues to be lacklustre. With prices for base materials already trending downward for some time now, unless suppliers can take advantage of lower input and energy prices, the earnings trend outlook remains negative.

Capacity additions are now leading to oversupply, and new investments are being put on hold. But it's not all bad news. Beneficiaries of lower commodity costs include intermediate goods producers and, ultimately, finished product producers as well.

Specialty chemicals manufacturers and car, airplane, machinery and building materials manufacturers are therefore well placed to benefit from lower input prices. The transportation sector may also see margins recover, in particular, airlines, rail, shipping and trucking companies.

Potash prices in free fall

The big news last week was the breakdown of a Russian cartel that was one of two cartels responsible for setting prices for

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potash, an essential ingredient in fertiliser. The Canadian consortium Canpotex is the only other large potash cartel.

The price war was started by the Russian potash company Uralkali and could lead to much lower prices for potash globally. While this is good news for farmers and for food prices, it would hurt the profitability of large producers, such as Potash Corporation, Mosaic, Kali & Salz and Uralkali itself.

Regionally more diversified fertiliser producers that concentrate on the other two essential ingredients in fertiliser, phosphate and urea, are not affected by this event. They will continue to see good prices amid healthy demand.

The fact that one more commodity is now facing pricing pressure, however, is indicative of the unwinding of the commodities boom, which had been driven by high demand from emerging markets and limited supply.

The end of the commodities super cycle is good news for industrial companies. They will gain from lower costs, healthier margins and a more positive growth outlook. This, in turn, can lead to higher employment and an increase in consumer spending power globally.

Reporting calendar

Company	Date
PostNL, Grontmij, HSBC, Veolia, Nippon T&T, Suedzucker	5 August
Porsche, Dominion Resources, Deut. Post, Muenich Re, Credit Agricole, Merck, Standard Chartered, DSM, Walt Disney, Daikin Ind., Emerson Electric	6 August
Kraft Foods, Time Warner, Duke Energy, Hannover Rueckv, Frankfurt, ING, Freenet, Dexia, Devon Energy, Beiersdorf, Swisscom, CSM, Crucell, Agrium, MEMC	7 August
KBC, Adidas, Adecco, Commerzbank, Stada Arzn., Henkel, Aegon, Unicredit, SGL Carbon, TUI, Aviva, Rio Tinto, Nestle, SBM Offshore, Sara Lee	8 August
IVG Immobilien, Fugro	9 August

Asset allocation

The asset allocation remains unchanged. The Global Investment Committee continues to call for an overweight in equities, an underweight in bonds, neutral allocations to property and commodities and a hedge fund allocation only in the defensive (overweight) and the more balanced (neutral) profiles. For more information, read the latest issue of the GIC Update, published on 18 July 2013.

Currency outlook

The euro pushed above 1.33 versus the US dollar, after the Federal Reserve did not provide any signal as to when monetary

stimulus will be scaled back. Prices eased lower towards 1.32, however, after better than expected US manufacturing data was released. Improving US data supported higher US yields, resulting in a stronger US dollar versus the Japanese yen. The Bank of Japan is widely expected to leave monetary policy unchanged next week.

Current account deficits in emerging markets are affecting currency markets, with the Indian rupee and Brazilian real continuing to underperform. Investors fear that capital flows will be reversed when the Fed reduces its bond purchasing programme, which we expect to start later this year. The Chinese yuan, our top Asian currency pick, remained stable as sentiment on China's growth prospects improved.

Currency forecasts

	Today	Q3 2013	Year-end 2013
EUR/USD	1.3211	1.25	1.2
GBP/USD	1.512	1.49	1.45
USD/JPY	99.5	106	110

Source: ABN AMRO Group Economics

New publications

Effective Diversifiers: Hedge Fund Monthly

Hedge fund performance has rebounded after declining in June. The Global Investment Committee continues to call for a hedge fund allocation in defensive profiles, where an overweight position is recommended as an alternative to bonds; and a neutral hedge fund position in more balanced profiles.

- Long/short equity and event-driven hedge funds offer the best return potential.
- An increase in M&A and corporate transactions is positive for event-driven and merger arbitrage funds.
- Bond market volatility opens opportunities for long/short fixed income strategies.

Next week's calendar

Important dates next week

	Date
PMI services	CN 05 August
PMI services	EC 05 August
Composite PMI	EC 05 August
ISM nonmanufacturing	US 05 August
Manufacturing orders	DE 06 August
Economy watchers survey	JP 08 August
Trade balance	CN 08 August
Policy rate	JP 08 August
Industrial production	CN 09 August
M2 money growth	CN 10 August

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