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The ECB – still ready

The political stalemate in the US and the subsequent shutdown of parts of the US government dominated headlines this week. Somewhat in the shadow of this, the ECB kept its rates on hold and once again stressed its readiness to act if necessary.

Macro update

The US government failed to reach an agreement on the temporary funding measure, resulting in all non-essential government bodies being shut down. The last government shutdown in 1995 lasted for 21 days. A two-week shutdown would cut fourth quarter GDP growth by as much as 0.5 percentage points. There was a time when we would have seen a more severe market reaction. US interest rates decreased at the beginning of the week, when markets were digesting the postponement of tapering the Fed's bond-purchase programme. In the second half of the week, the focus shifted to the US debt ceiling, causing interest rates to rise again. We expect the shutdown to be short and its effects on the real economy to be limited.

The government shutdown and political stalemate have increased focus on the deadline for raising the debt ceiling later this month. If Congress fails to raise the debt ceiling, the US could risk a technical default; this would have major consequences. However, thus far at least, investor concerns about the debt ceiling appear to be limited. The US five-year sovereign credit default swap has risen quite sharply over the last few days, but is still roughly in line with the average since 2009. It certainly remains below the peak levels of late July 2011 during the last debt ceiling debate. Treasury yields declined at the beginning of the week, suggesting that worries about the US fiscal deadlines have ultimately spurred demand for US government bonds. In contrast, the dollar has clearly weakened against both the euro and the yen. Lastly, equity markets have fallen back, while implied equity volatility has risen, suggesting a modest move out of risky assets within the US towards government bonds, and a modest move out of US assets altogether as well. Nevertheless, the closer we move to the debt ceiling deadline, market concerns will likely intensify. Still, if the debt ceiling stalemate in 2011 is anything to go by, the fall-out is not likely to be very dramatic,

Equity index performance in local currencies

	Value	One week (%)	Year-to-date (%)
MSCI ACWI	382.64	-0.6	12.6
S&P 500	1678.66	-1.2	17.7
EuroStoxx 50	2902.12	-0.6	10.1
DAX	8597.91	-0.9	12.7
Nikkei 225	14024.31	-5.0	34.9
Hang Seng Index	23114.17	-0.0	2.0

Important rating changes

Company	From	To
Samsung Electronics	Buy	Hold
TKH Group	Buy	RL
Citigroup	RL	Hold
Goldman Sachs	RL	Hold
Procter & Gamble	Hold	Buy

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0.3	-2.3	8.7
German Bunds 2-year	0.2	-2.7	13.3
Japan 2-year	0.1	-0.1	-0.3
US Treasuries 10-year	2.6	-3.1	100.5
German Bunds 10-year	1.8	-1.3	37.1
Japan 10-year	0.7	-4.5	-11.5

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	80.71	0.94	-15.48
iTraxx Euro 5-year	100.80	1.60	-28.21
JPM EMBI+	352.93	13.38	7724

Performance data is as of 12:00 pm Friday, 4 October

Source: Bloomberg

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as long as politicians agree on a solution. Overall it seems that investors buy the idea – as do we – that US politicians will not be foolhardy enough to risk a default.

As expected, the ECB left rates unchanged; the impact on European rates markets was negligible. ECB President Draghi gave little new information and largely repeated previous statements. Rates will remain low for an extended period and all available instruments will be considered, including a new LTRO if deemed necessary. Stronger forward guidance from the ECB is currently not necessary. Key European interest rates also declined when the Fed decided to delay the start of tapering off its bond purchase programme in September. If short-term rates do start to rise, either as a result of the Fed starting to taper off and/or strong economic data that confirm the economic recovery is gaining traction, the ECB could step up its forward guidance.

Eurozone retail sales rose markedly in July and August this summer, with the 0.5% month-on-month rise in July followed by a 0.7% jump in August. The three-month growth rate increased from 0.3% to 0.5% between June and August, suggesting that sales gained some momentum during the third quarter as a whole. That said, individual country data shows some one-off positive impact from the holiday season, as Spain (+3.8% month-on-month) and Portugal (+4.8% month-on-month) registered the sharpest rises in sales of all eurozone countries in August. There will probably be some 'payback' in September. Still, if sales were to fall by around 1% in September, growth will have been a touch stronger in Q3, quarter-on-quarter, than in second quarter's 0.3%. Improving fundamentals behind consumption have resulted in a rise in consumer confidence since December 2012. All in all, the stage for a sluggish recovery of private consumption seems to be set.

Bond markets update

Sentiment on the credit markets remains constructive. Demand for bonds remains healthy and investors are absorbing new issuance well. Investment-grade issuance is on par with 2012 and now ahead of the full-year redemption schedule; this additional supply has not resulted in a market re-pricing. Senior bank supply of EUR 87 billion is low compared to the expected redemptions of EUR 220 billion this year, and is the main reason behind this sector's outperformance. Looking at last month's performance, European investment-grade corporates returned +0.7%, bringing the year-to-date performance to +1.4%. The investment-grade universe underperformed the European high-yield universe. This segment of

the corporate bond market delivered a return of +1.2% last month, bringing the performance to +5.9% this year. We remain constructive on the asset class. Improving company fundamentals and side-lined cash will support spreads going forward.

Equity update

Equity markets were almost one percent down this week, when the US government partially shut down and worries about the country's debt ceiling began to surface in earnest. Only Japan showed an above-average decline, despite sharply improved sentiment amongst large Japanese companies in the third quarter. Markets in mainland China are closed for public holidays for the first week of October. Some companies with broken books reported this week: Monsanto saw disappointing numbers as demand for its seeds is strongly correlated to corn prices that have fallen by over 40% over the past year. EasyJet had better news: in line with market expectations, the budget airline tightened its FY13 guidance towards the top end. Samsung Electronics' preliminary Q3 operating profits slightly exceeded analyst expectations on strong semiconductor performance. Consumer staples, as a sector, are under relative pressure, lagging behind the broader market. British supermarket Tesco missed market expectations with its first half-year results, as Europe was very weak. Another giant, Unilever issued a profit warning, as sales growth slowed in emerging markets in particular due to currency weakness there. We remain underweight in the sector. The possible merger/cooperation between Roche and Novartis is gaining traction after both CEOs gave positive remarks. Such a deal could boost M&A activity in the healthcare sector. In this regard, we discuss M&A in our latest Equity Strategy Monthly, published earlier this week.

Next week sees the Q3 earnings season kick off, with Alcoa traditionally leading the pack, and followed later by US banks. In anticipation of next week, earnings expectations have generally been revised downwards.

Stocks to watch: US financials

Next Friday, JPMorgan and Wells Fargo will report their Q3 results, followed by the other big US banks the week thereafter. In recent months, most of these banks hit the front pages when they settled probes related to mortgage-backed securities or other accusations. Legal issues will remain an issue, but most banks have already taken provisions. Longer term, we remain positive about US banks. Their underlying business has improved, capital ratios are healthy and they are able to increase shareholder value. Third-quarter expectations

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fell in September due to growing fears of a decline in trading revenues. Trading in fixed income in particular suffered this summer. Mortgage banking is threatened by a drop in refinancing, albeit coming from very high levels. Looking at the positive, stronger equity markets have helped asset and wealth management. Moreover, the banks' borrowers' credit quality has improved, which will in turn reduce losses and M&A. IPO volumes are also increasing; this is expected to result in higher fees in the coming six months when deals close.

Currency outlook

The EUR/USD continued to move higher during the week. Although the (partial) shutdown of the US government had limited impact on the financial markets in general, the US dollar was clearly out of favour in currency markets - especially against the euro and the yen. This was not the only driver pushing the EUR/USD higher: The ECB's rate decision and ensuing press conference had a greater impact on the currency pair. The market is somewhat disappointed that Draghi remains dovish while not, however, taking any actual measures, reacting as if it doubted whether the ECB would ever ease monetary policy further. Around the same time, it became clear that Italy's coalition government had survived the confidence vote. The EUR/USD rallied to above 1.36 before consolidating. The US is facing headwinds from the US political stalemate and the rapidly-approaching debt ceiling. As long as these uncertainties persist, the dollar is not likely to recover. Once US politics calm down and US data surprise positively, the dollar may rally again.

The Japanese yen strengthened towards 97 against the dollar on safe haven demand. Japanese domestic data releases were mixed last week. On the bright side, the manufacturer outlook improved and market implied inflation expectations continue to rise. However, the government's and central bank's efforts to reflate the economy through increased consumer spending have yet to occur. Not only did the unemployment rate rise, both household spending and labour earnings declined in August, the latter suggesting that the government needs to do more to stimulate consumer spending given that the sales tax will be raised from 5% to 8% in April 2014. As expected, the Bank of Japan left monetary policy unchanged, maintaining its outlook that the economy is recovering moderately. Inflation is likely to rise gradually. We expect the USD/JPY to rise towards 105 in the coming months with improving risk appetite US yields rising faster than in Japan, as the market anticipates that the Fed will start tapering its bond purchase programme later this year.

Currency forecasts

	Today	Q4 2013	Year-end 2014
EUR/USD	1.3624	1.28	1.10
GBP/USD	1.604	1.54	1.38
USD/JPY	97.06	105	120

Source: ABN AMRO Group Economics

Asset allocation

Global Investment Committee discussions focused on the US fiscal mess' impact on the market. Given that the shutdown is only expected to impact US growth very modestly, the GIC made no changes to the asset allocation. Our investment policy continues to reflect a 'risk-on' positioning with a strong overweight in equity (profiles 2 to 6), a neutral in property and commodity (profiles 2 to 6) and a strong underweight in bonds (profiles 1 to 5). Hedge fund allocations occur only in the 'defensive' profiles (overweight) and the more 'balanced' profiles (neutral). Cash is overweight in risk profiles 1 to 4 and underweight in profiles 5 and 6.

New publications

Equity Strategy Monthly

Emerging Asia, which was once known for its enviable current account surpluses and high growth rates, is not as important as it once was to global growth. With developed markets gaining traction and finally recovering from the financial crisis that began after the collapse of Lehman Brothers in 2007, momentum has shifted. Global growth is now being led by developed markets and the US in particular.

Bond Markets Monthly

Bond prices started September on a bumpy road, driven by speculation about the Federal Reserve's (Fed) monetary policy outlook, but ended the month rather flat, despite the partial shutdown of the US federal government. Reduced geopolitical risk in Syria and a sign of a pick-up in global manufacturing activities helped restore risk appetite, leading to a strong rebound in equity prices, especially in the US. The Fed's unexpected decision not to start tapering off its bond-purchasing programme supported risk, although the effect was partly offset by uncertainty over the US fiscal issues.

Next week's calendar

Important dates next week

		Date
Construction spending	US	7 Oct
PMI services	CN	8 Oct
Manufacturing orders	DE	8 Oct
NFIB small business optimism	US	8 Oct
Economy Watchers Survey	JP	8 Oct
Industrial production	DE	9 Oct
BoE size of asset purchase programme	GB	10 Oct
Initial jobless claims	US	10 Oct
Retail sales	US	11 Oct
UMI consumer confidence	US	11 Oct
Business inventories	US	11 Oct

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