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Fiscal deadlines looming

While still digesting the tapering decision by the Federal Reserve, the financial markets are bracing themselves for another major event in the US, as the country faces two important fiscal deadlines.

Macro update

As the fiscal year ends on 30 September, Congress must approve the budget for the fiscal year 2014. Unfortunately, due to the hostile political situation in Washington, it is too late to approve a budget for the total fiscal year, so Congress must resort to a temporary funding measure, known as a continuing resolution. A failure to reach agreement on this continuing resolution would mean that there is no set budget for the federal government, which would force all non-essential government services to close, i.e. a government shutdown. Meanwhile, Congress must also increase the amount of national debt that can be issued by the Treasury. A decision on this debt ceiling must be taken before late October, or the US could potentially default on its debt.

In our base scenario, Congress will approve legislation to keep the federal government funded until mid-December, albeit not without some political struggle between the Republican-controlled House and the Democrat-controlled Senate. This would avoid a government shutdown at the last moment. Attention in Congress is then likely to shift to the next deadline. Indeed, Treasury Secretary Jack Lew recently said that the Treasury will run out of extraordinary measures to avoid hitting the debt ceiling as soon as October 17, after which the Treasury would have insufficient funds to meet all of its obligations. While this does not automatically mean that the US will immediately default, as it still has tax revenues as a source of funding to meet its debt payments, the situation is likely to jolt markets, with safe haven flows supporting Treasuries. A failure to lift the debt ceiling in time will potentially have such adverse consequences to the economy that we believe Congress will ultimately come up with some form of an agreement, even if it is likely to be a last-minute deal.

Macro data from the US meanwhile still paint a mixed picture. While new home sales continued their upward trend, the number has softened somewhat due to the rise in inter-

Equity index performance in local currencies

	Value	One week (%)	Year-to-date (%)
MSCI ACWI	385.61	-0.5	13.5
S&P 500	1698.67	-1.4	19.1
EuroStoxx 50	2922.99	-0.0	11.0
DAX	8664.1	-0.1	13.9
Nikkei 225	14760.07	-0.0	42.0
Hang Seng Index	23292.22	-0.9	2.8

Important rating changes

Company	From	To
Mitsubishi financial	Buy	RL
Sumitomo	Buy	RL
NTT DoCoMo	Buy	RL
China Construction Bank	Hold	RL
CNOOC	Hold	RL

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0.336	-0.1	7.6
German Bunds 2-year	0.191	0.2	15.2
Japan 2-year	0.098	-1.4	0.2
US Treasuries 10-year	2.646	-10.7	103.6
German Bunds 10-year	1.822	-9.9	36.6
Japan 10-year	0.682	0.4	-10.2

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	80.10	9.95	-22.30
iTraxx Euro 5-year	99.20	9.95	-41.51
JPM EMBI+	339.55	25.58	40.54

Performance data is as of 12:00 pm Friday, 27 September

Source: Bloomberg

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est rates. More important, however, is that the inventory of new homes remains tight.

The August durable goods orders report was mixed. Whereas ex-transportation orders fell by 0.1%, after a drop by 0.5% in July, core capital goods orders rose by 1.5%, following a drop by 3.3% in July. Also the core capital shipments were up by 1.3%, having declined by 1.4% in July. We therefore think that the investment outlook remains good.

Bond markets update

Bond markets performed well over the week, with market participants digesting the 'no tapering for now' message from the 18 September FOMC meeting. Government bonds benefited, resulting in lower yields across maturities and flattening yield curves. After this surprise, bond markets seem to have returned to their wait-and-see mode. The German elections may be behind us, but the tapering issue is still lingering and the federal budget negotiations are taking centre stage.

There is increasing speculation in Europe about a new long-term refinancing operation (LTRO) in the near future, as ECB governing council members have made comments in that direction. The latest data shows that eurozone lending to companies and households dropped by 2% year-on-year in August, signalling that the eurozone is still struggling to recover. ECB president Mario Draghi signalled earlier that he is willing to use any instrument, including a new LTRO, to keep money-market rates low. This is at the top of the ECB's agenda, as rising short-term rates and a hampering credit system threaten the economic recovery. Arguably, cutting the refinancing rate could be a more effective tool to keep money-market rates low than providing extra liquidity to banks that need to shrink, while struggling with growing amounts of non-performing loans (NPL) on their balance sheets.

Credit markets benefited from lower benchmark yields and a stable spread performance, both in the investment-grade and high-yield segments. New issuance has been absorbed very well, with the record-breaking USD 49 bln issue by Verizon only shortly rippling the surface. This week General Motors also came back to the credit market issuing USD 4.5 bln in three tranches, after being upgraded to investment grade by Moody's. Large amounts of issuance are to be expected in the coming months, as companies will want to lock in the current low borrowing costs. In addition, record amounts of redemptions will take place in 2014. Despite heavy issuance, we expect spreads to perform well in the coming months, as corporate fundamentals are healthy and spreads are becoming less sensitive to rising yields.

In general, credit markets are currently going through a transition period, as government bond markets eventually have to stand on their own feet again in a post-quantitative easing world. Unlike what we have seen during the first spike in yields that occurred in May and June, when rising bond yields were accompanied by widening credit spreads, we are currently witnessing a low correlation between yields and spreads. This supports our view that, ultimately, spreads will once again protect corporate bond investors from rising yields.

Equity update

Whereas the mood in the equity markets was very upbeat for most of the month, last week we saw investors turn more cautious again. Most markets corrected by around 1%, with only the Japanese market bucking the trend.

The inconclusive German elections, where uncertainty about the shape of a new coalition now prevails, speculation about the future course of the Federal Reserve and renewed discussion about fiscal tightening in the US drove sentiment. Meanwhile, stock markets are waiting for more clues on how actual business is developing. The third-quarter earnings season starts on 8 October. The general nervousness is aggravated, as we have now entered the period of possible profit warnings (either negative or positive).

Some European companies, such as Adidas and DSM, have recently warned that especially the weaker US dollar (down on average by some 6% year-on-year) and emerging currencies have hurt their bottom line. General uncertainty about the current strength of the economic recovery in both the US and Europe adds to this mood. We believe, however, that this is only a temporary lapse, with growth indicators soon turning upwards again, helped by continuing growth in the more industrialised emerging economies, such as China, and a better outlook for Japan.

Investors are now clearly focusing on selective subsectors of the equity market, on company-specific stories and on strong themes driven by further industrialisation and innovation. We highlight the very positive stock market trends in industrial areas such as transportation (where FedEx and CSX are our favourites) and automation (ABB is our top pick here), the services side of the energy business (Halliburton, SBM Offshore), online retailing beneficiaries (EBay, Amazon.com) within consumer staples and new technologies that help to raise productivity levels (Qualcomm, ASML). Smaller and mid-sized companies, usually much more innovative than their very large counterparts, are also preferred, espe-

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cially when they contribute to larger companies achieving higher efficiency. Aalberts, Arcadis, TKH, Expedia.com, Gildemeister, KUKA, Accor and Bouygues are our top picks here.

Sector to watch: transportation

With global activity and trade picking up again, transportation-related stocks are making a comeback. Historically, the Dow Jones Transportation Index is a good leading indicator of economic growth and the index is now in a clear uptrend again. Listed airlines are an important component of the index. Consolidation amongst the large, partly state-owned or state-subsidized, players has been going on for many decades. Budget airlines and the new legacy carriers from the Middle East have been making a huge impact on the business over the past years and continue to benefit from the inefficiencies and slow adaptation to new trends that still characterise the large, much older airline companies. Established operators such as Southwest Airlines (NR), and especially European names such as Ryanair and EasyJet, are following a very successful, low cost/high volumes strategy. Train companies are also back in favour, especially in the US, with Burlington Northern bought by Warren Buffet's Berkshire Hathaway a few years ago and the remaining listed firms, such as CSX (Buy), reaping the benefits of higher industrial activity with now also more cargo related to energy (coal, LNG) and agricultural products.

In shipping we also see a trend towards new building activity, especially in Asia, as new types of cargo (LNG for instance) require new varieties of ships, that also have to be safer/more fuel efficient. In the logistics subsector margins are also picking up. An additional, very positive factor for the uptrend in transportation-related stocks is the fact that fuel prices are on a downward path. The use of LNG/LPG is growing fast in the US and the rest of the world is set to follow, while global crude-oil prices are declining after the spike induced by the Syria conflict.

Currency outlook

Over the last few weeks, the EUR/USD has mainly been driven by the difference in interest rates between the US and Germany. Last week, this trend was broken. Dovish talk by ECB members pushed German yields lower. Surprisingly, these lower yields did not hurt the currency pair. Recently US economic data have diverged. This has hurt sentiment towards the US and in particular towards the US dollar. In addition, uncertainty about the approaching US debt ceiling and the political fight about the budget also left their mark on the dollar. When market sentiment started to improve, the dollar did not benefit because of these doubts. The combination of postponement of tapering the asset purchasing programme by the Fed, doubts about the strength of US economic growth and the political uncertainty hurt the dollar. Next week the ECB will

meet on Wednesday and we expect them to reiterate their dovish stance. When sentiment towards the dollar improves, this should lead to downward pressure on the euro.

The Japanese yen strengthened to below 99 against the dollar early last week, due to a declining risk appetite and narrower interest rate differentials between the US and Japan. Speculation that Japanese officials will stimulate the economy via cuts in corporate tax rates hurt the yen. However, the currency recovered after Finance Minister Aso stated that any economic stimulus has yet to be decided upon. On the bright side, the government's efforts to reflate the economy remain on track. Inflation ex fresh food rose to 0.8% y-o-y in August, the fifth consecutive month of increase. The market-implied two-year inflation expectation has also risen by two percentage points to above 2.2% since late 2012. Because the Bank of Japan (BoJ) continues its asset purchase program, which is capping the upside in yields, real returns are likely to decline. This is negative for the yen. This week, the BoJ is expected to keep monetary policy unchanged.

Currency forecasts

	Today	Q4 2013	Year-end 2014
EUR/USD	1.3501	1.20	1.10
GBP/USD	1.6040	1.45	1.38
USD/JPY	98.96	110	120

Source: ABN AMRO Group Economics

Asset allocation

There are no changes in the current asset allocation. The Global Investment Committee maintains 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), while 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

Emerging Asia Regional Note

The shine is coming off emerging Asia. Growing current account deficits and rating downgrades are increasingly seen. Nonetheless, the global economic recovery will bring benefits to the region, especially to countries with export exposure to the developed world, such as China, South Korea and Taiwan.

Country Note China

Just before the summer, the liquidity crunch in China and the heated debate about whether shadow banking was getting out of control drove investors to the side lines. Liquidity conditions have since stabilised and the new government has

announced various small-scale, growth-supportive policies. On the back of stronger-than-expected economic data and encouraging interim results, the downward revision of the 2013 GDP forecast of a few months ago has been reversed.

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Next week's calendar

Important dates next week

		Date
Industrial production	JP	30 Sep
Consumer prices	EU	30 Sep
Chicago Fed business confidence	US	30 Sep
Tankan business confidence	JP	1 Oct
PMI manufacturing	EU	1 Oct
Unemployment	EU	1 Oct
Construction spending	US	1 Oct
ISM manufacturing	US	1 Oct
Policy rate ECB	EU	2 Oct
ADP unemployment	US	2 Oct
PMI services	EU	3 Oct
Retail sales	EU	3 Oct
ISM non-manufacturing	US	3 Oct
Policy rate BoJ	JP	4 Oct
Unemployment	US	4 Oct

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