For professional investors

BNP PARIBAS
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Weekly Strategy Update

13 June 2013

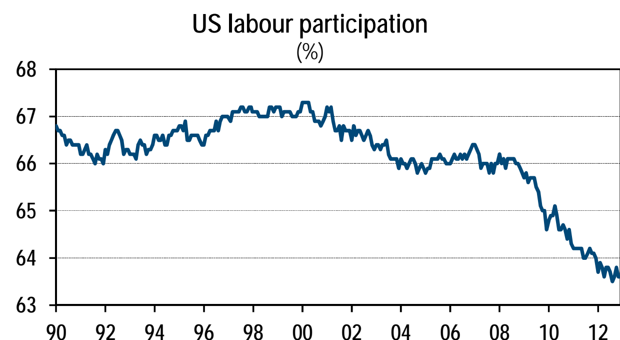
SUMMARY

- Taking profit on underweight inflation-linked bonds
- Now overweight US real estate versus US equities
- New long-duration position in German bunds

Equity markets have entered a jittery phase where good economic news can be negative for markets and where what central bankers say can have a big impact. At such a time, we prefer to be neutral on equities, a position we haven't changed for a while. We have made several changes to our model portfolio, though. We implemented a long US real estate versus US equities position. Demand and supply factors for US real estate are generally positive, in our view, and valuations have improved lately. We also implemented a tactical long duration position in German bunds. We think the recent rise in yields has lifted them above fair value. We took profit on our underweight in inflation-linked bonds after expectations for inflation drifted lower.

US: NOT TOO HOT, NOT TOO COLD?

The US labour market report is traditionally the economic report with the biggest potential impact on markets. This has only increased with the Fed's focus on the labour market. The data for May was not good enough to bring on the notion of an early slowing of the Fed's asset purchases, but not weak enough to raise fears of a strong economic slowdown, either. Payrolls grew by 175 000. The previous two months were revised lower by a cumulative 12 000, reinforcing the trend of somewhat modest employment growth. Employment growth in the household survey - which tends to be more volatile - was stronger, but an even stronger increase in the labour force led to a small rise in unemployment. This was actually the first increase in the participation rate since October last year.

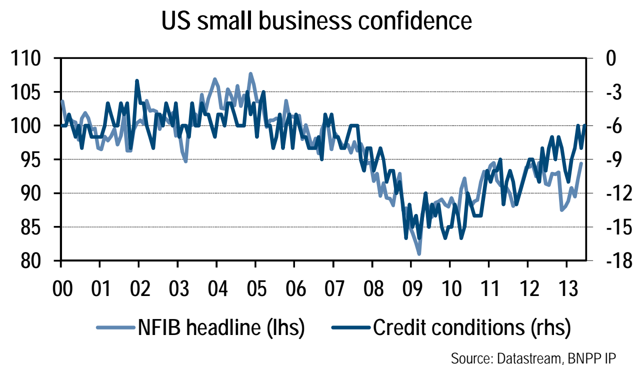


Source: Datastream, BNPP IP

It is too early to see a trend here, but it shows that the large overhang of labour supply, as seen in the low participation rate, may keep unemployment elevated for a while if these people return to the labour force. This will keep hourly earnings, currently rising at a modest 1.9% YoY in nominal terms, at bay.

US small business owners have become more optimistic in the past few months. This continued in May, when the NFIB index rose to its highest level in a year. The slowdown that started in April last year is now almost undone. The index is only a notch below its post-recession peak. According to the survey, credit conditions are improving. Employment intentions, and intentions to raise compensation, are not stellar, but they are positive.

US small business confidence



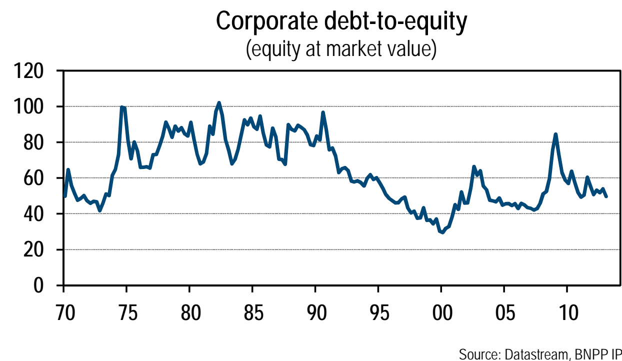
Source: Datastream, BNPP IP

The Fed's Flow of Funds data for the first quarter of the year, a comprehensive set of data about financial stocks and flows in the US economy, showed several trends. Firstly, households are no longer paying down debt. Outstanding mortgages still fell on an annual basis, but this was compensated by an increase in consumer debt. The ratio of household debt to income rose somewhat from the previous quarter and was the first increase since the third quarter of 2009. It may have been temporary, as disposable household income fell due to the tax hikes at the start of the year. In broader terms, the household debt ratio has fallen significantly from its 2007 peak. It's still quite high from a longer-term perspective, but household deleveraging seems mostly over for now. The historically high ratio pleads for the continuation of low interest rates though, as it keeps households vulnerable to a sustained increase in interest rates.

Secondly, households are benefiting from rising stock markets and house prices. Household net worth, the difference between total assets and total debts, surged by USD 3 trillion in the first quarter. It was the biggest quarterly gain in years and it took net worth to a record high (in nominal terms). We have written about the wealth effect before and retain the view that it may be smaller than before the financial crisis. Wealth is heavily skewed to higher income groups. That is no different from previous episodes of rising wealth, but lower and middle-income groups in particular, whose spending tends to react more strongly to changes in income and wealth, were bruised by the crisis and may be more inclined to rebuild savings.

Thirdly, the corporate sector is taking advantage of low interest rates. Total liabilities of the non-financial corporate sector increased by 4.2% YoY, with especially strong growth in corporate bonds and bank loans. Even though corporate debt is at a record high in absolute terms and relative to GDP, this is no reason for concern. Interest payments are low relative to cash flow or profits, and rising equity values have kept the debt-to-equity ratio in check. Furthermore, the corporate sector has on average lengthened the maturity of its debts.

Corporate debt-to-equity
(equity at market value)



Source: Datastream, BNPP IP

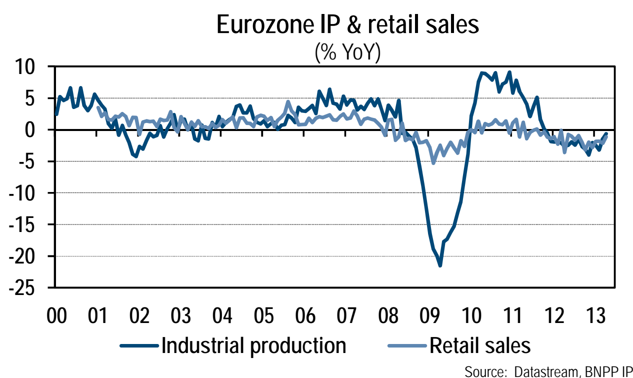
All in all, the data shows that the US economy is getting through its soft patch and may improve later this year. A risk in our view is still the short-term impact of tax hikes and government spending cuts. We think the data still rules out an early slowdown of asset purchases by the Fed.

NO ACTION FROM ECB OR BOJ

Last month's comments from ECB president Draghi had raised the possibility of another rate cut, but the ECB decided to leave rates on hold this month. This also avoided the thorny discussion about what to do with the deposit rate, which is currently at zero. The absence of a rate cut was a bit of a disappointment for the markets. The ECB did not close the door to rate cuts, but it would take a deterioration of the data to do it. Some members of the council were in favour of an immediate cut, though. The ECB marginally lowered its growth and inflation

forecasts, but this was simply an adjustment to recent data releases. The ECB foresees the economy recovering slowly this year and next. It will not be enough to put upward pressure on prices, so interest rates will stay low. The ECB still sees the fragmentation of the eurozone banking sector as a problem, but at this point it sees neither the need for, nor the possibility of, taking any measures to address this.

The view of an economic recovery in Europe was confirmed by April industrial production. Production rose, taking the annual growth rate from -1.6% in March to -0.6% YoY in April. As recently as November last year, production was falling at a -3.8% YoY pace. Looking through the monthly volatility, production has improved in the core and in the periphery even though production in many countries is still lower than a year ago.



Source: Datastream, BNPP IP

Retail sales were still weak in April, although the trend has improved here too. The traditional recovery in the eurozone starts with exports, after which investments, employment and consumption follow. With high unemployment and fiscal austerity suppressing income growth, this looks like the most likely sequence again even though it may be a bit delayed.

Markets were disappointed by the Bank of Japan, which did not make any changes to its asset purchase programme. We think it is premature to expect any changes so soon after the programme's start, but after the brutal rise in Japanese government bond yields last month, markets have been jittery, so any words to calm the markets would have been nice. The BoJ seemed content with the improvements in the economy. There are downward risks, in the BoJ's view, although those named were all of foreign origin. For us, it is still unclear whether the BoJ will succeed in its policy of creating inflation without big gains in bond yields. So far so good, bond yields have stabilised in recent weeks.

The People's Bank of China has been silent about monetary policy. Industrial production, retail sales and fixed asset investments on average slowed in May, albeit marginally. However, money growth and bank lending disappointed. The Chinese economy has been driven by strong credit growth in recent years, so a slowdown would be welcome. But it would have a negative impact on the economy. Also negative is the appreciation of the yuan. To stay competitive, producers have cut prices. Producer prices fell by 2.9% YoY in May and have been negative on an annual basis since February 2012. With nominal wage growth still strongly positive and above productivity growth, profit margins at Chinese companies must be under pressure.

ASSET ALLOCATION: SEVERAL CHANGES

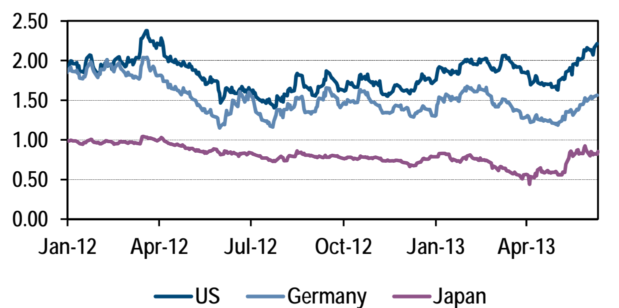
We made several changes to our asset allocation. We have taken an overweight position in US real estate versus US equities. We think rising employment is positive for the demand side of real estate. On the supply side, we see low vacancy rates and low spending on real estate construction as positive. We also think the search for yield among investors is positive for the asset class. What held us back earlier was the expensive real estate valuations when considering the discount to net asset values. With the recent decline in real estate prices, this valuation overhang has disappeared. Also, we no longer regard US real estate as expensive compared with US equities, as the earnings yield discount to equities has closed, and we expect rental/earnings growth for the real estate sector to be more attractive than earnings growth for equities.

Given the recent price action, our low inflation scenario is increasingly priced in to inflation-linked bonds. The market is now priced for inflation to be just 1.3% for the next four years and 1.7% for the next 10 years. In principle, these breakeven rates include a positive "inflation risk premium" so expected inflation is even lower. This has led us to take profit on this trade, which we have had since last September.

Finally, we introduced a new tactical long duration strategy. Our valuation signal for duration has improved in recent weeks with the recent sell-off in nominal government bonds. Nominal yields are at their highest level in four months; real yields (i.e. nominal government bond yields adjusted for inflation expectations) are no longer negative in core countries. Moreover, the short-end of the yield curve reflects what we see as an

increasingly unrealistic expectation of ECB rate hikes within the next two years. The combination of these two factors means that we are moving overweight duration again across our portfolios. Some argue that nominal bonds remain extremely expensive at their current levels. From a very long-term perspective we have to agree with this assessment, but think it is important to consider the particularly subdued nominal growth outlook in Europe when assessing the shorter-term outlook.

Ten-year government bond yield



Source: Datastream, BNPP IP

Where does this leave us in our broad asset allocation? We are neutral on equities, with an above-benchmark allocation to European equities due to our overweight in this asset class versus European investment-grade corporate bonds. Our allocation to US equities is below benchmark due to our underweight US equities versus US real estate. This last relative position also leads to an overweight of real estate in the model portfolio.

We are underweight bonds. Our overweight in emerging market debt in US dollars has been implemented versus eurozone government bonds, so it does not have an impact on our overall bond position. The underweight is driven by our underweight in European investment-grade credit versus European equities.

We have not changed our neutral positions on convertible bonds, commodities and cash.

We remain underweight in the euro versus a basket of currencies, expecting weaker eurozone growth and a favourable interest rate differential to benefit the US dollar.

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