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KEY TOPICS

Dichotomy + divergence = doubt

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Latin America – Risk lies in above-potential growth, not in a double dip

In Latin America, as in the rest of the world, the recent deceleration in the growth pace of a broad range of activity indicators has left investors wondering if a soft patch is around the corner. Indeed, the region's prosperity has been increasingly tied, since earlier in the decade, to booming global trade and commodity prices. Our view however is that it is not the possibility of a double dip but rather of "growth excesses" that constitute the key risk to monitor in Latin America.

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Dichotomy + divergence = doubts

> Macroeconomic conditions are uneven

The most recent readings – retail sales, inflation, industrial production, the Philadelphia Fed index – are a little more uneven than before, leading some observers to question the recovery's sustainability. As a result, there has been renewed debate over the four Rs: reflation, recovery, rigour and risk. But another topic attracting attention is the natural slowdown in economic growth and the improvement in external competitiveness resulting from currency movements.

The likely deceleration – some might say a levelling-off – is affecting all index components (leading, coincident and lagging), notably labour market sentiment, but also ISM purchasing managers, purchasing intentions and home sales. World growth is likely to steady, but with the potential for developed countries revised downward. The minutes of the latest FOMC meeting only fanned the flames with additional concerns regarding the Fed's perception of the economy (is another stimulus needed?) and, once again, its exit strategy (bringing the size and structure of its balance sheet back to normal).

> Hard to reconcile macro and micro data

The start of the Q2 2010 earnings reporting season in the USA has gradually attracted investors' attention. It will be an opportunity for some to realise and others to confirm the favourable impact that the economic recovery and companies' adjustments have had, not only on sales growth but also on improved earnings quality. This will give support to – if not catalyse – equity indices during this cyclical phase of top down/bottom up convergence. The positive impact of cost adjustments will be paired with a currency impact on European export companies: the classic elasticity measurement shows that a 10% change in the euro/dollar results in an initial 4% increase in EPS.

The Q2 US reporting seasons is off to a roaring start, with many announcements beating consensus expectations. For example, Intel reported the strongest quarterly revenues in its 42-year history. These figures show a rebound in Chinese and European growth and a stronger-than-expected outlook for revenues and margins.

As a result, Q2 figures are likely to be good. They will be helped by the previous year base effects, even though Q1 already delivered a high percentage of upside surprises. As with the macro indicators such as the IfO, in order to discern the trend it will be necessary to distinguish and analyse the difference between data on the current situation and the renewed momentum with respect to guidance.

> What to make of European bank stress tests?

The approach is virtually identical to the one adopted in the USA last year, with a similar contribution to financial market normalisation. In consequence, three questions need to be answered about the near-systemic measurement of the resilience of European banks' solvency and liquidity.

The first question concerns methodology, notably the assumptions used in the simulation models: growth, inflation, unemployment, cumulative size of write-downs of personal and business loans, loan loss provisions by sector (commercial real estate, for example), and size of the haircut on sovereign debt (5%, 10% or 30%).

The second question is how the results will be published as a function of a baseline or extreme scenario. This is a necessary, but not necessarily sufficient, condition for stabilising growth expectations and the ability to offer credit and to give reassurance on the strength or vulnerability and the profitability outlook of the banking sector, which makes up between 17% of 22% of indices.

The last question concerns the impact on markets: the announcement of results and implied calculation of additional capital needs will not be enough to trigger a rapid unwinding of safe-haven or flight to quality positions. Even though the first goal is to stabilise markets, the way the results are interpreted may yet cause doubts: if needs are slight, there will be questions about how relevant or credible the results are; if capital needs are too great, some countries will plunge back into a negative spiral.

Announcements by the Committee of European Banking Supervisors have eased fears about the relevance of bank stress tests, but what about the situation for the insurers?

The European results are due out on 23 July. In 2009, as they awaited their stress test results, US banks gained 82%, outperforming the S&P by 62%. The same is unlikely to happen in Europe, chiefly because US banks were initially valued at a P/B of 0.5x compared with 1.0x for European banks today.

Markets are focusing on two microeconomic stories in the near term: European bank stress tests and second-quarter earnings. But the backdrop is still dominated by the medium-term issues of slowing economic growth – natural for this point in the cycle – and the consolidation of developed countries' public finances. How can the two sets of issues be reconciled to eliminate uncertainty? Current trends and momentum, not to mention the "second derivative", argue in favour of maintaining only a reasonably positive bias on market direction; but they also confirm the importance of arbitrage strategies (relative value, volatility), which take advantage not just of low interest rates, but more importantly of the dispersion in share price movements.

Patrick de Fraguier

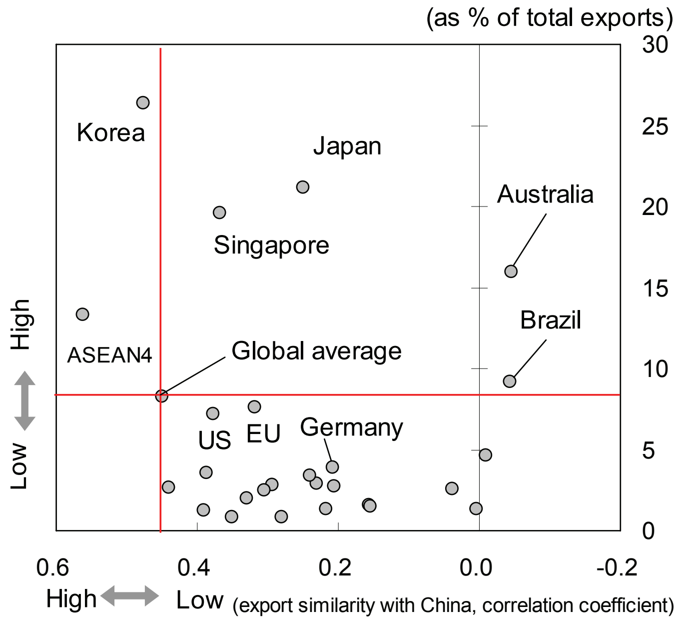
Japan well positioned for China's domestic demand expansion

> More freedom in wage hikes and RMB

The Chinese economic model is gradually changing. Pressure on wages is increasing and the moderated fluctuation of the RMB (in June) should give more purchase power to china. In addition, the 12th 5-year plan which is starting from 2011 is going to state "double income plan". This strongly suggests that the Chinese economy in now in the take-off phase and shifting the main drivers of economic growth to domestic demand expansion, moving away from the export-driven growth model which has been supported by cheap labour. If so, there will be further business opportunities for foreign companies which supply goods and services to China.

Japan is well-positioned for this domestic demand growth story because it provides a higher export exposure to China with less direct competition. The chart below shows the export exposure of different countries to China, and the extent to which their exports are in competition.

Export exposure to China



Note: Export similarity is obtained by first calculating the proportions of each item in each country's total exports (SITC codes, three-digit classifications) and then calculating correlation coefficients for the countries compared to China. The higher the correlation coefficient, the closer is the resemblance in comparative advantage. And the greater is the export similarity. Source: Nomura Securities, on 2008 UN data.

> Why the increase in JPY denominated assets?

Furthermore, China increased the Yen denominated bond position of its foreign reserves by 1.28 trillion yen in the last 5 months (January - May 2010).

There are several good reasons for China to maintain or increase, the Yen denominated bond position. First and foremost, there is the need to cope with the increasing volatility and credit risk of European sovereigns, and secondly, it helps in the preparation of currency basket interlocking movement characteristics. Also, the main asset recently bought was short term bonds, which may be considered as a kind of stand-by liquidity for future investment. So in addition to currency diversification, this increase in its yen bond exposure may presage an M&A operation targeting Japanese companies.

In fact, considering the accelerating wage hike possibilities and the RMB appreciation trend, Chinese companies are facing the need to improve their competitiveness quickly and dramatically. If so, it is not too much to surmise that they are becoming more interested in Japanese technology and knowhow.

Deregulation of permitted activities of the CIC, China's sovereign wealth fund responsible for managing part of China's foreign exchange reserves, may also be on the cards. The CIC, which holds assets valued at $200 bln, has started to allocate less funds to the country's major banks and is considering more investment in the US, currently concentrating on equities, bonds and real estate. This diversification of activities may also apply to Japan.

> Long term strategic approach to Japan

According to the "TEIKOKU Databank", Japan's leading corporate data service company, there are 611 Japanese companies which have accepted capital injections from Chinese companies (as of end June 2010), compared to only around 240 companies 5 years ago. These injections have several notable features:

1. Most popular sector is wholesale, representing 323 out of those 611companies

2. Involvement in manufacturers and services has tripled.

3. 202 of the companies have sales between JPY100 mln and JPY1 bln - i.e. involvement is mostly still in medium and small size companies.

A particular example is Laox, a mass merchandiser of consumer electronics listed in the Tokyo Stock Exchange 2nd section, which accepted an injection in June 2009. And in May of this year, Renown, a TSE First Section apparel company which once owned Aquascutum, was bought by a Chinese company.

It may not be a just a story anymore that, as part of China's long term plans for supremacy in the Asian region, they would like to get some influence over the Japanese Yen and over selected Japanese companies.

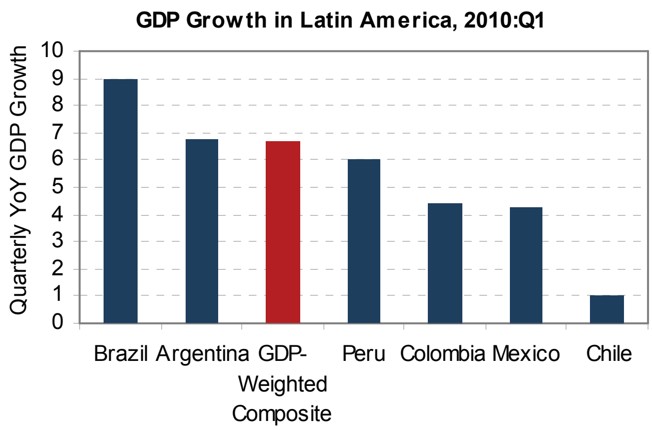
Thus, we think that the Chinese economy will strongly benefit to the Japanese economy, thanks to (1) its strong commercial links and (2) the increasing capitalistic links.

Masanaga Kono

Latin America – Risk lies in above-potential growth, not in a double dip

In Latin America, as in the rest of the world, the recent deceleration in the growth pace of a broad range of activity indicators has left investors wondering if a soft patch is around the corner. Indeed, the region's prosperity has been increasingly tied, since earlier in the decade, to booming global trade and commodity prices. Consumers in Latin America might be willing to spend and businesses willing to hire, but they might need to tighten their belts when policy stimulus measures are gradually phased out and exports volumes and prices fail to return to pre-crisis levels.

The chart above shows the behavior of industrial production in the three largest economies in the region, namely Brazil, Mexico and Argentina. Perhaps counter-intuitively, the contraction in industrial production during the crisis was stronger in economies where growth was largely being driven by domestic demand, like in the case o Brazil, a still relatively closed economy. Terms of trade gains and an associated strong currency, generous minimum wage increases and fairly loose fiscal policy led to booming domestic demand in early 2008. When the global crisis hit Brazil in the fourth quarter of 2008, Brazilian retailers and manufacturers found themselves with large inventories and with no access to credit. The dramatic inventory correction that followed explains the large contraction in industrial output. In Mexico, in contrast, the decline in industrial output was noticeable but less abrupt than in Brazil. The reason is that, by mid 2008, the Mexican manufacturing sector had already gradually shifted to lean inventories due to weak exports demand from the US dating back to 2007. In Argentina, the contraction in industrial activity looks suspiciously shallow, particularly in a country whose government has harvested the reputation of producing unreliable statistics. Yet, one can not deny that, throughout the crisis, the Argentine economy counted on extremely loose monetary policy and fiscal policies. Moreover, neither the government nor the private sector in Argentina suffered much from the pinch of scarce foreign capital, because the economy was already fully adjusted to the sub-optimal equilibrium of limited access to global capital markets since the 2001 default.
Idiosyncratic factors apart, while the recovery in the three economies is healthy and well under way, it is clear that economic activity growth, as captured by industrial production, has started to decelerate. We interpret this as a natural development consistent with the normalization of inventories. Looking ahead, there are two factors – both in the realm of macroeconomic policy management – that will significantly boost the odds of a smooth transition to lower yet healthy growth rates. First, lingering uncertainties about the global outlook continues to put downward pressure on commodities hence food and energy inflation remains very low. In places like Mexico, the persistence of a still sizable output gap is also contributing to very low levels of core inflation. The combination of these factors creates the opportunity for Central Banks in the region to implement a very gradual normalization of monetary policy rates, including cases like Colombia and Mexico that will possibly not hike before 2011. Peru, Chile and Brazil have already started their tightening cycle, but each at a pace that by different metrics can be classified as gradual.
Secondly, fiscal policy can be expected to remain fairly accommodative, particularly in Argentina and Brazil, due to the heavy political agenda over the next 15 months (Presidential elections in Brazil in October 2010 and in Argentina a year later). Even in the case of governments that find themselves with limited access to financing, the ties between the commodity-rich region and Asia (particularly China) are slowly but surely creating access to alternative sources of funding. An example of that was this week's announcement that Argentina had secured a USD 1.5 billion loan from China for the development of the railroad system in the country.



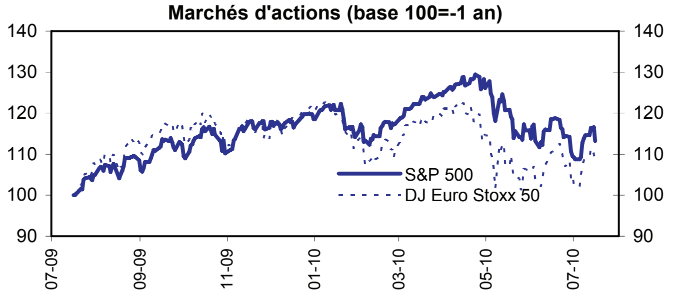
Source: Bloomberg

The chart above shows 2010 Q1 real GDP growth (YoY) in the six biggest Latin American economies, with average growth close to 6%. Chile is the outlier, in large part due to the effects of the violent earthquake that shook the country in February. For the rest of the region, and especially for Brazil, Argentina and Peru, not only growth is strong but also is beyond its potential level (the one consistent with stable prices and normal long run levels of resources utilization). This is a risky situation for the region for two reasons. First, because it can trigger inflationary pressures but most importantly, because it can lead to excessive leverage in a region where governments and households have a fairly low propensity to save. To make matters worse, the region cannot count any more on high and rising exports prices to mask external imbalances. Our view is that it is not the possibility of a double dip but rather of "growth excesses" that constitute the key risk to monitor in Latin America.

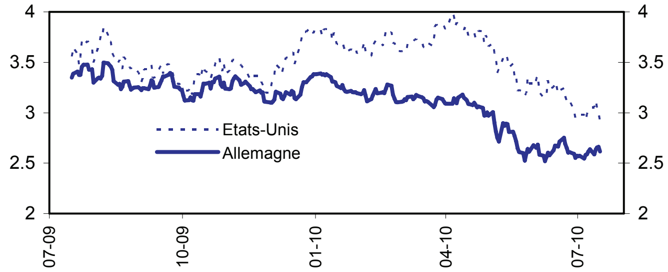
Marcela Meirelles

Market Data

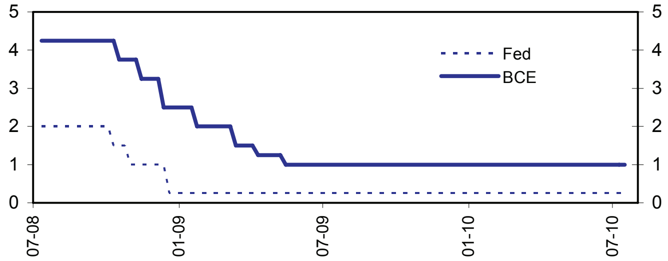
Marchés d'actions (base 100=-1 an)



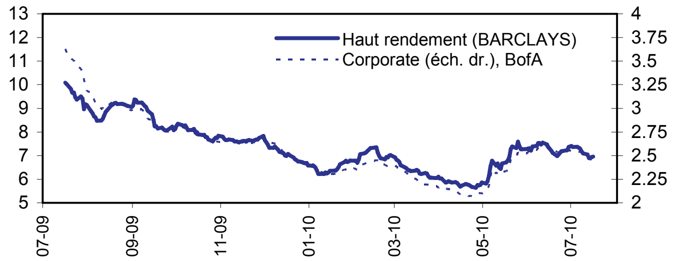
Taux obligataires 10 ans (%)



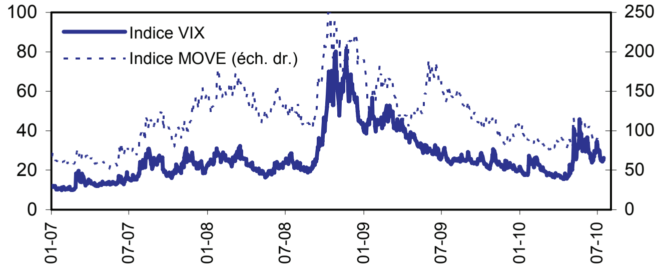
Taux directeurs (%)



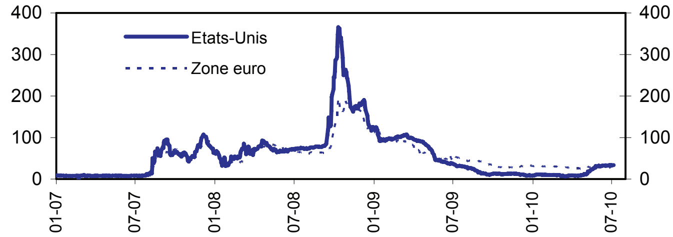
Spreads de crédit (Etats-Unis, %)



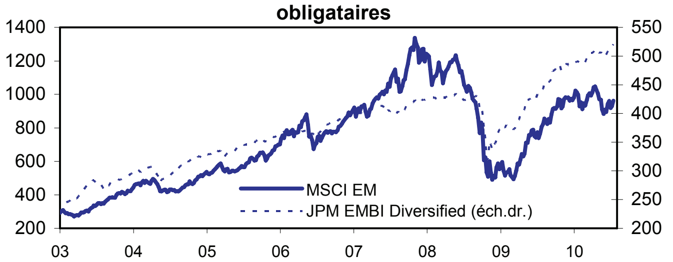
Volatilité



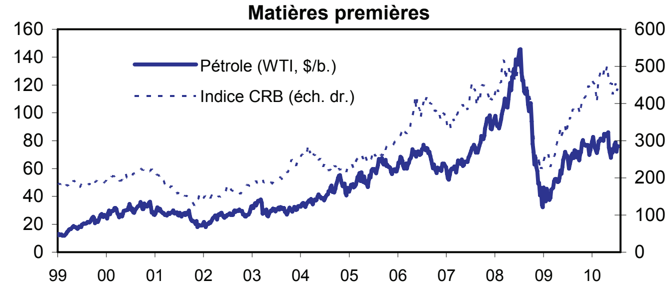
Ecart entre le taux interbancaire à 3 mois et le taux de swap (OIS) 3 mois (pb)



Pays émergents : indice de marchés d'actions et taux obligataires



Matières premières



Taux de change (16 juillet 2010)

	Taux	Var. sur 1 semaine, %	Var. depuis Jan. 2010, %	Fin d'année			
		Appréciation/Dépreciation de la devise locale		**2009**	**2008**	**2007**	**2006**
USD/EUR	1.26	0.0%	-12.3%	1.44	1.39	1.47	1.32
USD/GBP	1.51	0.0%	-6.8%	1.62	1.46	2.01	1.96
GBP/EUR	0.84	0.0%	6.2%	0.89	0.95	0.73	0.67
JPY/USD	88.51	0.0%	4.4%	92.43	90.64	112.04	119.16
JPY/EUR	111.9	0.0%	19.1%	133.2	126.1	164.9	156.9
CHF/USD	1.05	0.0%	-2.4%	1.03	1.07	1.12	1.22
CHF/EUR	1.33	0.0%	11.3%	1.48	1.49	1.65	1.61

Sources : Stratégie et Recherche économique d'Amundi, Datastream et Bloomberg.

Disclaimer

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