

Strategy and economic research

Market Insights

KEY TOPICS

The Fed and the dollar: a complex link

The US economy has shown signs of running out of steam. Publication of FOMC meeting minutes followed last week by Ben Bernanke's appearance before Congress, reinforced the scenario of slowing activity in the US. It is clear that the fate of the dollar, at least in the short term, is intrinsically linked to the normalisation of US monetary policy. A prolonged monetary status quo associated with a sluggish recovery in the US would be more dangerous for the dollar than a return to the money press induced by a double dip.

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Equities: towards a more defensive sector rotation

Investor attention has shifted away from the euro zone to focus on the strength of US economic growth going forward. The risks of a double dip recession seem overblown, but leading indicators were bound to reverse direction at some point given the levels reached thus far and the fact that temporary effects have disappeared. That time has come. Historically, this type of situation has resulted in a 5% average decline in equity markets over three months. And this is generally the time when defensive stocks come back into favour at the expense of cyclical and financials. However, that general observation must be seen in light of the risk of value traps among defensive stocks and, for banking stocks, the prospect of no change in interest rates for a long period and the release of stress test results.

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China: A Mid-Year Review

Fears of a hard landing in China are overdone. We expect GDP growth to moderate in the second half of the year, along with lower than anticipated inflation risks. On the currency front, we continue to expect very gradual RMB appreciation with rising two-way volatility.

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Amundi Market Insights is taking a break in August. We will be back in early September

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The Fed and the dollar: a complex link

The US economy has shown signs of running out of steam over the past few weeks. Publication of FOMC meeting minutes, and new macroeconomic forecasts, followed last week by Ben Bernanke's appearance before Congress, reinforced the scenario of slowing activity in the US. It is clear that the fate of the dollar, at least in the short term, is intrinsically linked to the normalisation of US monetary policy. As such, a "premature" hike in interest rates by the Fed, insofar as it would be the result of vigorous domestic demand and a drop in the unemployment rate would, in all probability, lead to a cyclical appreciation of the US dollar. In contrast, long-term monetary status quo in the US would end up dragging down the dollar, especially if the recovery in the rest of the world encourages other central banks to normalise their monetary policies more quickly than the Fed. But what about the impact of further expansionist monetary policy by the Fed? Certainly not the expected fall in the dollar!

> The option of increasing money supply is dragging down interest rates...

The recovery is more sluggish than expected by the Fed in April. Two weeks ago, the Fed's forecasts for 2010 were revised slightly downward. Moreover, the Fed inched its unemployment forecast up and inflation forecasts down for 2011.

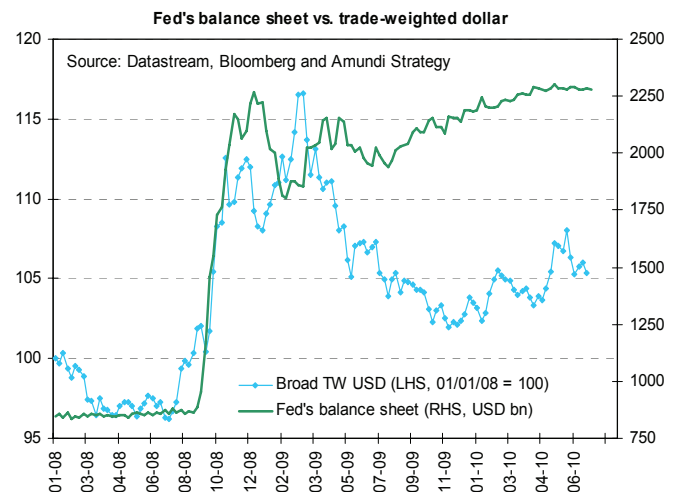
Last week, Ben Bernanke went even further by highlighting the unusually high uncertainty which surrounded the Fed's forecasts and overtly reminded us that the Federal Reserve could make an about face with quantitative monetary policy if conditions demanded it. So what does this mean in more specific terms? Simply that the US may once again turn to the money presses in order to monetise public debt or, more likely, to re-implement other asset purchase programmes (MBS). Admittedly, Bernanke did also remind us of the plethora of measures that would enable the central bank to shore up its balance sheet. But, what the markets took away from this more than anything, was the Fed's Chairman concern. Against this backdrop, already extremely low rates fell slightly and the two-year Treasury yield declined to its all-time low (0.56%).

> ...But would it weigh on the USD?

As a result, the dollar is under renewed pressure against the euro, the yen and sterling. From a theoretical point of view, a faster increase in the money supply in one country than the rest of the world tends to depreciate the currency of the country in question, due to the risks of inflation incurred when increasing money supply. Any country other than the United States which announced that it may have to implement such a policy would immediately witness a plunge in its currency.

However, by mere dint of its central role in the international monetary system, the dollar has unique de facto status which supersedes the traditional mechanisms that operate for other currencies.

Despite the crisis, the US financial markets have remained the most important in the world. The dollar remains the main invoicing currency in international trade. According to the BIS, it was used in 86% of transactions in 2007, or only slightly less than in 2001 (90%). For comparison purposes, out of a total of 200% (each currency being counted twice), the euro was ranked second in 2007 (well behind with 37%). The next triennial BIS report will be published end 2010 and is highly anticipated as it will provide information about the impact of the financial crisis on the use of the US currency. However, it is likely that it will confirm these estimates. The study published by the ECB in July showed that the financial crisis has not altered the euro's international role in 2009. It is difficult to see why the result would be any different for the greenback, all the more so given that emerging countries' central banks continue to hold the vast majority of their assets in US dollars. Moreover, the collapse of Lehman Brothers clearly showed that the dollar remains the ultimate safe-haven currency.



Against this backdrop, additional expansion of the monetary base in the US could even go hand in hand with an appreciation of the greenback. It is clear that the Fed would only start to buy up assets again by creating money as a last resort (very sharp deterioration in the US economy, deflationary threats). This scenario is clearly not on the cards. But if it were to occur, it would be misguided to believe that economic activity would hold up in the rest of the world, either in Europe or in the major emerging markets. The threat of another drop in global growth would occur alongside a sharp rise in risk aversion on a global scale, with a knock-on effect on the dollar!

In other words, and this is not the least of the paradoxes, a prolonged monetary status quo associated with a sluggish recovery in the US would be more dangerous for the dollar than a return to the money press induced by a double dip.

Didier Borowski

Equities: towards a more defensive sector rotation

> Markets have shifted focus

The MSCI World index went through two distinct periods between mid-2008 and end-2009: a harsh 51% correction until March 2009 caused by the subprime crisis and the collapse of the financial bubble, followed by a 62% rebound from March to December 2009 amid a downturn in risk aversion and rising valuation multiples. Since then the market has entered a third phase, trading sideways without any real direction (-5% from 1 January to 20 July 2010) but with sizeable swings from one month to the next, and sometimes one week to the next.

Last month, which began with a sharp drop followed by a partial recovery, was characteristic of this new phase. But whereas a short while ago the euro zone was in dire straits, the themes have changed and investors are more concerned with the strength of future growth in the USA, and possibly China.

The renewed concern over the USA – the risk of a double dip was mentioned – is linked to the recent publication of a series of more mixed statistics, notably for employment, housing and consumer confidence. Furthermore, a leading indicator such as the ISM manufacturing index, while still showing expansion (>50), fell sharply from 59.7 in May to 56.2 in June.

Conversely, systemic fears regarding the euro zone have calmed down, as witnessed by the success of sensitive debt issues by Spain, Portugal and Greece (the latter tapping the market for the first time since late April) and the relative indifference with which Ireland's rating downgrade was met. Europe's renewed credibility stems from a variety of factors, such as the end – without incident – of the ECB's one-year refinancing programme, the upcoming announcement (23 July at 6 p.m.) of European bank stress test results, the final adoption of the European Financial Stability Fund, with €440 billion in guarantees, and newfound discipline in Greece, which cut its government deficit nearly in half in first-half 2010. Newfound confidence in the euro zone and more mixed outlook for the USA triggered a rapid recovery of the euro, which climbed back to \$1.30 on 20 July after dropping to \$1.19 in early June from \$1.43 at the start of the year.

> Quarterly results not necessarily decisive

The results season has just begun, so it would be premature to draw any conclusions. However, it is likely to play out favourably, given the very undemanding year-on-year comparison (Europe -42% in Q2 2009), a more forgiving exchange rate effect and the fact that companies have cut their breakeven points sharply and should thus get a real boost from even a mild rebound in activity. Even so, the expected good results may have only a limited impact on markets, as in Q4 2009 and Q1 2010, when despite the positive outcome all initial gains were

lost – and then some – due to the lack of longer-term visibility on factors such as sovereign risk, sustainable growth and banking reform.

> Keep a close eye on stress test results

The other key event in the days ahead will be the release of European banks' stress test results and their ability to calm financial markets. To do so, they will have to be not only successful – which they almost certainly will be, given statements to that effect in recent days – but also convincing. There are no problems with the assumptions used for the macroeconomic scenario, which are even more conservative than those used in the USA. However, the assumptions for sovereign risk, house prices and recapitalisation requirements for banks that fail the test will need to be analysed closely. For example, of the 19 banks tested in the USA last May, the 10 that failed were given one month to raise their capital or request TARP assistance. What will happen to failing banks in Europe?

> Increase the weighting of defensive sectors

Despite increasingly attractive valuations, the conditions for a genuine equity market rally in developed countries are unlikely to come together in the near term. For that to happen, visibility on the pace of growth will have to improve and the double dip scenario – which we find exaggerated – will have to give way to a more moderate scenario of a square-root recovery.

But whether it turns out to be double dip or square root, leading indicators were bound to reverse direction at some point. That moment has arrived in the USA and China. Europe is likely to follow, although the drop will be less steep. To adapt to the new circumstances, we have looked at the period from 1976 to the present to see how such a change has generally impacted on markets and which sectors are performing best three months after a downturn in leading indicators.

From a directional standpoint, markets declined by an average of 5.4%. Defensive sectors fell only 3.6%, thus exhibiting more resilience than cyclicals, which lost 5.8%, and financials, which fell 6.8%.

However, it is harder to draw conclusions about the European banking sector because interest rates are likely to remain low for quite some time and the "quality" of the stress tests will be a determining factor. Furthermore, among cyclical stocks, it will be important to stick to companies with reasonable ratios and good visibility on growth. Lastly, among defensive stocks, investors will need to distinguish between those likely to make a comeback and those that are value traps.

Ibra Wane

China: A Mid-Year Review

> Fears of a Hard Landing are Overdone

Despite increasing noise about a sharp slowdown in economic growth, we maintain our central scenario that China will be able to manage a soft landing. Second quarter GDP rose 10.3% y/y, following a stellar 11.9% y/y gain in the first quarter. Fixed investment growth eased slightly, but continues to grow above 25% y/y, after rising 25.9% y/y in the first five months of the 2010. Lower infrastructure-related investment growth was offset by stronger private capex and real estate investment (+38% y/y) in the first half of the year. Even so, a pick-up in the allocation of stimulus funds has spurred a mild rebound of public investments and infrastructure construction in June. Although lower than anticipated by many market participants, industrial production rose 13.7% y/y in June, compared to 16.5% y/y in May. With regard to domestic demand conditions, retail sales rose 18.3% y/y in June (+1.5% m/m). Taking a closer look at the data breakdown, urban area retail sales rose 18.7% y/y in June, while rural area retail sales grew 15.9% y/y. The apparent disconnect between the slowdown of industrial production while demand side indicators remained robust is likely due to gradual supply-side adjustments.

Export growth moderated only slightly to 43.9% y/y in June, from 48.5% y/y in May. Interestingly, import growth slipped to 34.1% y/y in June, from 48.3% y/y in May. As a result, the trade surplus widened slightly to USD 20bn (vs. USD 19.5bn in May). Fears of a structural trade deficit in China were overdone. We have now returned to the pre-crisis level of monthly trade surpluses. Still, we expect the momentum of export growth to weaken from July. Imports of commodities are also likely to normalize, driven by declining real estate investment and the end of the inventory building cycle.

Regarding macro policies and administrative measures, we believe the government remains vigilant to avoid premature tightening of monetary and fiscal stimulus. This is the reason why we think the risks of further administrative tightening are fairly low for the second half of the year. We expect Chinese policymakers to remain on hold through the end of this year, before gradually loosening administrative measures in early 2011. We think that timing would be viewed by most market participants market friendly. While we expect real estate prices to continue falling in the coming months, most of the regulatory risks are now fully priced in and we think there is little risk of a pilot real estate tax in Shanghai. The possibility of weaker external demand, driven by a double dip in the US economy, and a severe inventory correction in China should not be ruled out at this stage. Still, while GDP growth will be much slower in the second half of the year, an outright collapse of the Chinese economy is unlikely. Overall, we expect lower investment growth, which should be partially offset by strong domestic consumption and a rising contribution of net exports to overall growth.

While we continue to think that most optimistic forecasts for 2010 will have to be revised, the most pessimistic projections will also need to be revised upward. As a result, we have maintained our view that China's GDP growth should be around 9.5% in 2010.

> A Wait and See Approach on Monetary Policy

On monetary and inflation fronts, consumer prices unexpectedly moderated in June. CPI rose 2.9% y/y, compared to 3.1% y/y in May. On a m/m basis, CPI fell 0.1% in June, compared to a rise of 0.3% m/m in May. This drop in inflation came earlier-than-expected, and was primarily attributed to declining vegetable prices. PPI rose 6.4% y/y in June, compared to a 7.1% rise in May, translating into a decline of 0.6% m/m. We expect both CPI and PPI to continue to soften over the summer, before picking up again on a m/m basis starting in September. China's M2 money supply growth eased further in June to 18.5% y/y (+21% y/y in May). New loans moderated further, coming in at RMB 603.4bn in June, compared to RMB 639.4 bn in May, and 774bn in April, as loan demand eased somewhat on the back of curbs on infrastructure investment and tightening in the property sector.

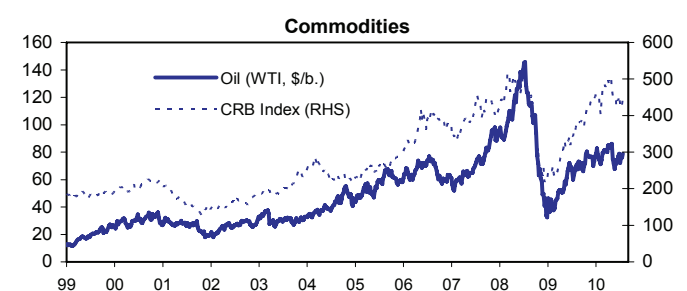
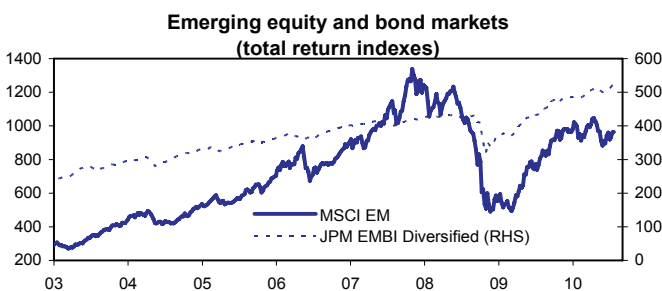
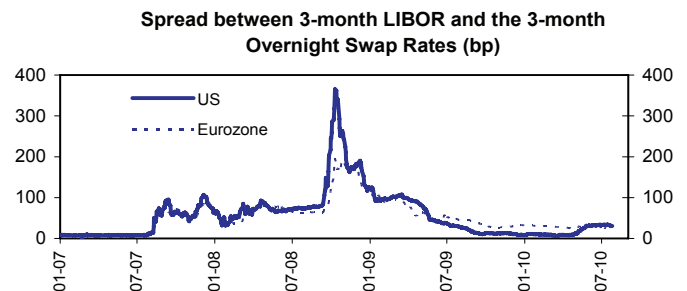
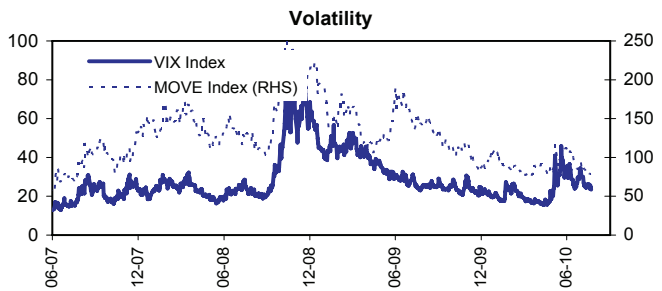
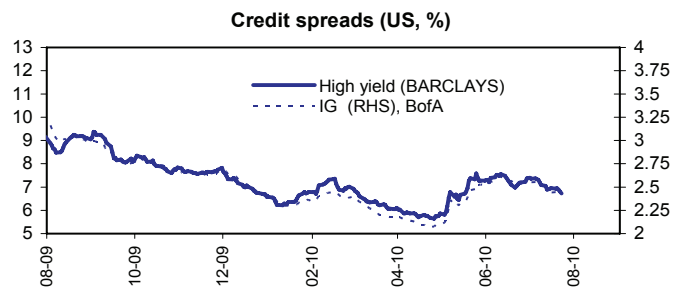
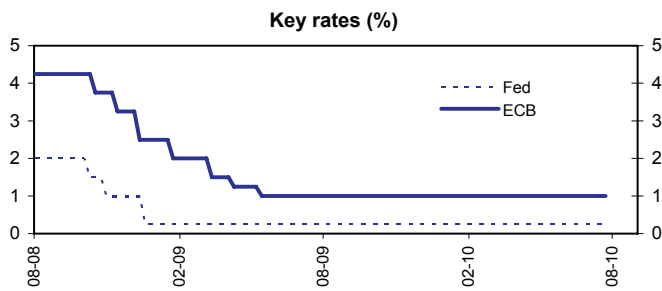
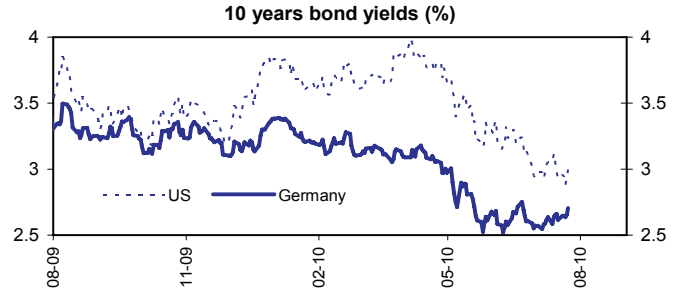
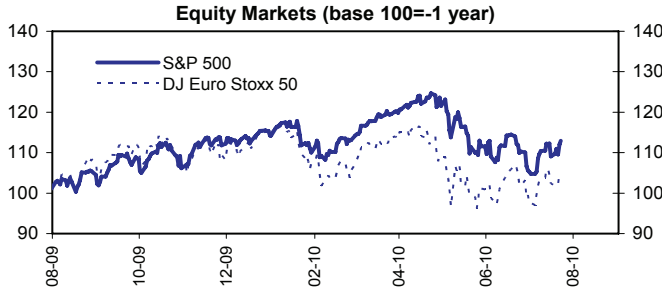
PBOC sterilization activities combined with aggressive reserve requirements hikes since early this year, abruptly dried up inter-bank liquidity and inter-bank interest rates rose noticeably (7-day repo rates rose above 3%). In response, the PBOC has already started to inject liquidity heavily (RMB 224bn in May, 517bn in June, and 155bn during the first week of July). We expect the repo rate to remain around 2% in Q3.10, while volatility remains high. Chinese policymakers seem to be willing to tolerate a slight uptick in headline CPI over the summer. As a result, we currently expect the People's Bank of China to raise the benchmark policy rates once this year, by 27bps in 4Q.10, versus 54 bps previously forecasted.

> ...Combined with a Very Gradual Appreciation of the RMB

On June 20th, Chinese policy makers decided to move towards a more flexible exchange rate. This was in line with our expectations both in its timing and its nature (a managed floating regime with a reference to an undisclosed basket, no widening of the trading band and no one-off adjustment). The headline pace of reserve accumulation was merely USD 7.2bn in Q2.10 despite a widening trade surplus and stable FDI inflows. This implies that some hot money left the country in May and early June, which enabled China's policymakers to move on the currency front in a time of much lower speculation on the RMB. Still, the announcement may have contributed to renewed expectations for appreciation in Q3.10, and we expect hot money to return in coming months. We maintain our forecast that the RMB exchange rate will reach 6.6/USD by year end, with rising two-way volatility. We also acknowledge that risks to these forecasts are tilted to the upside. Recent strengthening of the trade surplus supports Chinese authorities efforts to allow further RMB appreciation despite rising uncertainties in Europe and risks of a double dip in the United States.

Jean-Charles SAMBOR

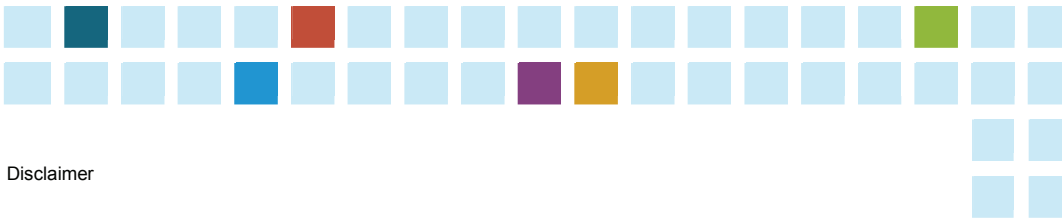
Market Data



Select Global Exchange Rates (July 23, 2010)

	F/X Rate	% Ch. WoW	% Ch. YTD	End year			
				2009	2008	2007	2006
USD/EUR	1.29	-0.8%	-10.5%	1.44	1.39	1.47	1.32
USD/GBP	1.54	0.2%	-5.0%	1.62	1.46	2.01	1.96
GBP/EUR	0.84	1.0%	6.1%	0.89	0.95	0.73	0.67
JPY/USD	87.21	-0.7%	6.0%	92.43	90.64	112.04	119.16
JPY/EUR	112.5	0.1%	18.4%	133.2	126.1	164.9	156.9
CHF/USD	1.05	-0.4%	-1.5%	1.03	1.07	1.12	1.22
CHF/EUR	1.35	0.4%	10.0%	1.48	1.49	1.65	1.61

Sources: Strategy and Economic Research Amundi Group, Datastream and Bloomberg.



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