

# Tactik

Letter



July 2010

SINOPIA 

HSBC  Global Asset Management

## Global economic environment

**Indicators of activity published since the beginning of the year have been surprisingly strong and reflect a solid cyclical recovery for the world economy.** They have also produced upward revisions in consensus growth forecasts, which in the case of emerging countries have been very significant. The IMF has raised its 2010 forecast for world growth recently, from 4.2% to 4.6%, although it has left its estimate for 2011 unchanged at 4.3%.

**Thanks to both domestic and external demand, Asian and Latin American countries are reporting the most impressive rebounds of all.** Indeed, some are racing ahead of their potential growth rates, notably China, Brazil and India. **Recoveries among developed countries have been more modest, with considerable disparities.** Japanese activity has picked up smartly because robust Asian demand has boosted the country's exports, industrial production and investment. In contrast, the USA has benefited from positive trends in domestic demand that have overwhelmed negative contributions from foreign trade. In Europe, the recovery is proving anaemic in peripheral euro zone countries but Germany is performing well as the euro's depreciation has aided its export sector.

**Growth will have been vigorous over the first half, but a cyclical slowdown now appears to be taking place.** The very latest indicators suggest a pause in the upswing or even a reversal. **The recovery is faltering, but this is normal after an acceleration in activity and so far leading indicators do not point to the sort of severe correction that could lead to renewed recession.** They are down markedly, but from very high levels.

**That said, pressure on the financial markets following the European debt crisis has altered perceptions of risk via its potential impact on the real economy,** and Europe has specific risks of a double dip stemming from fiscal consolidation programmes. We do not deny these risks, but they appear exaggerated. The euro's depreciation and a durably accommodating monetary policy are likely to offset the negative of fiscal austerity on growth, at least in part. Moreover, the markets underestimate the magnitude of the recovery and the impact of the European Union's initiatives to deal with the crisis and to meet the financing requirements of the countries most seriously affected by it. **We accept only that uncertainty over the economic outlook has increased and that the world economy has started a deceleration phase.**

**Some observers believe that the crisis in Europe will trigger another slump in world growth.** In our view, dynamic activity in emerging countries and the fiscal and monetary leeway that these same countries possess limit this risk. It seems to us that world activity, buoyed by emerging countries and the USA, is robust enough to withstand less encouraging prospects in the euro zone.

Were pressure to intensify or persist, of course, it could weigh more on international activity than currently supposed. Analysts expect a moderate deceleration in growth in the second half and next year. The consensus forecast is for world GDP to increase 3.5% this year and 3.3% in 2011.

## In the USA – the coming slowdown

**The American economy is still expanding but the recovery is slowing.** Some leading indicators have been disappointing, although they do not in any way suggest a contraction in activity and offer no confirmation of double-dip scenarios. They are down slightly, but remain at satisfactory levels and close to their historical highs. **Analysts are starting to revise their second-half growth estimates down, and projections for 2011 could be affected rather more because of a substantial carryover effect at the start of the year.** All in all, growth could amount to just over 3% this year and will be markedly weaker in 2011. Consensus forecasters are looking for 3.3% in 2010 and 3.1%, which in view of recent data looks rather optimistic.

**Several factors are contributing to the deceleration in activity.** The property market has slumped again – intentions to buy dropped 30% in May alone – because of the expiry of the tax credit for first-time buyers. Fiscal stimulus is petering out. The reconstitution of stocks, which had contributed greatly to the rebound in activity, is gradually coming to an end. Ongoing reforms to the financial sector and healthcare system are contributing to uncertainty and could encourage a wait-and-see attitude among firms. Given rising savings rates and the sluggishness of the labour market, consumer spending growth will remain modest in historical terms. Lastly, **the European debt crisis and pressures on the financial markets are undermining confidence, and were they to last they could become more of a threat to the American economy's growth profile.** By the same token, a return to normality would permit an improvement in confidence compatible with solid and durable growth.

Inflation surprised to the downside in May, at 2% yoy after 2.2% in April, and this led analysts to cut their estimates for 2010 and 2011 to 1.7% in each year, compared with 2.1% and 1.9%, respectively, a month before. Substantial surplus capacity as shown in the low capacity utilisation rate (74.1% in May, compared a long-term average of 81%) and stubbornly high unemployment will continue to put downward pressure on prices in the near term.

**The Federal Reserve will maintain a highly accommodating monetary policy in order to bolster activity and prevent expectations of disinflation taking hold in the long term. Consensus analysts do not believe in a rate hike anytime soon and have revised their forecasts of tightening in the next 12 months down, from 100bp a month ago to 50-75bp today.**

## In the UK, inflation is still too high

Consensus forecasters expect GDP growth in the **UK** to amount to 1.3% in 2010 and 2.3% in 2011. **The new budget plan, designed to reduce the government deficit to 3% of GDP in 2015, is based on growth forecasts of around 2.8% between 2012 and 2015. These appear optimistic.** In a context of austerity, household consumption could be penalised and this means growth will have to stem from foreign demand. Unfortunately, recent trends cast doubt on this possibility. Industrial production and exports were unchanged in April and May and the PMIs proved a disappointment in June, with that for manufacturing down from 58 in May to 57.5 and that for services down from 55.4 to 54.4. **Household income will decline because of cuts in social security benefits, and the unemployment rate will not decline in 2011.** Fiscal consolidation elsewhere in Europe will not help British exports, and the property sector will not be any more dynamic. House prices stopped rising six months ago; indeed, they have declined by an average 0.3% per month since then. Although they are 7.5% up on their lows recorded in April 2009, house prices are still 17% below their August 2007 peak and we may therefore rule out property-related wealth effects. Analysts expect an inflation rate higher than 2% in 2011. Its persistence above the BoE's 2% target this year (3.3% in May) has divided the Monetary Policy Committee, and the BoE's credibility is in play. Its ability to anchor inflation expectations is at stake. Even so, according to analysts, it will not start to normalise its monetary policy before next year. **The 75bp in tightening expected over the coming 12 months would leave the BoE's key interest rate at 1.25%, which would still imply very accommodating monetary conditions.**

## In the euro zone, the ECB will remain accommodating

For the **euro zone**, consensus forecasters expect limited increases in GDP worth 1.1% this year and 1.4% in 2011. **Downward revisions have been minimal so far but the fiscal consolidation now extending to all Member States poses a major risk to growth in 2011.**

The recovery was made possible by stimulus policies and changes in stocks. The phasing out of stimulus measures this year and the austerity due in 2011 are therefore raising questions over the strength of domestic demand. Unexpectedly, Germany has announced another round of budget cuts amounting to €10 billion per year out until 2016 in order to hit the Maastricht budget deficit limit of 3% of GDP as early as 2013. The reduction in scrappage bonuses in France is starting to dent car sales, which contracted by an average 10.6% yoy in May and June. **The latest purchasing manager surveys rule out a significant acceleration in activity.** The euro zone's manufacturing PMI fell from its April highs in May and June. While the euro's depreciation will buoy exports, it will not suffice to raise output to pre-crisis levels. At 75.5% in Q2, the capacity utilisation rate compares badly with its long-term average of 81.4%. Against this backdrop, the labour market is not improving. At best, the unemployment rate will stabilise at a high level (10.3% expected in 2010 and 2011, after 9.4% in 2009), and this is inconsistent with vigorous growth sustained by private demand. Inflation eased from 1.6% yoy in May to 1.4% in June. **Very moderate price increases point to the continuation of an exceptionally accommodating monetary policy and of unconventional measures, which will help ease pressure on the financial markets.**

## In Japan – a new debate on taxes

In **Japan**, 2010 growth forecasts have been revised higher still over the past month, by 0.8 point to **3.2%**. The estimate for 2011 is an unchanged 1.7%.

The positive momentum on expectations for 2010 reflects robust export growth and a surprisingly strong gain in industrial production in Q1. **Indicators in early Q2 suggested a slight deceleration.** Industrial production expanded by an average 0.5% mom in April and May, down from 1.6% mom in Q1, while machinery orders contracted 2.5% mom after declining 0.5% mom in Q1. Export growth eased from 2.5% mom to 0.6% over the same period. **Even so, trend indicators such as the Tankan and METI indices confirm that these developments represent a moderation in growth rather the start of a contraction phase.**

**The latest changes to economic and tax policy will be decisive in sustaining growth and employment.** The yen's appreciation (about 10% in the year to the beginning of July) does not bode well for exporters, and deflation persists in the domestic economy. The inflation rate is not as negative as it was (-0.9% yoy in May), but while deflation is set to dissipate slowly it is still not ruled out even at the end of next year. According to consensus analysts, annual inflation will be -0.1% in Q4 2011. The labour market is struggling, with an unemployment rate that has been rising steadily since February and was reported at 5.2% in May. Faced with an estimated government debt to GDP ratio of 227% in 2010, the government has unveiled a budget programme that aims to eliminate the primary deficit (i.e. excluding interest costs) by 2020, although it is lacking in detail. **Tax reform is to be debated until March 2011, with particular emphasis on increases in VAT – currently 5% – and cuts in corporation tax, which is higher in Japan than in most other G20 countries.** Identifying the appropriate balance between fiscal, economic and monetary policies will not be easy. **The government will probably continue to press the Bank of Japan for even more monetary easing.**

## Emerging countries – slower growth in China

In **Latin America**, economic indicators have again been stronger than expected. **Growth is based on rebounds in consumption and investment that themselves stem from highly expansionary economic policies and improved terms of trade.** The upturn in domestic demand has also fuelled an import boom, however, and although exports are benefiting from the world recovery foreign trade will make a negative contribution to regional growth this year. Limited surplus capacity has rekindled core inflation, although base effects have helped lower headline inflation rates. In this context, Brazil has raised its key interest rate again, by 75bp. Consensus analysts expect growth of 4.8% this year and 3.8% in 2011.

In **Asia**, in contrast, exports have been driving growth. **The region's prospects are still being revised higher, and significantly, because of very positive momentum in the first half. Regional growth will remain very strong, at 8.5% in 2010 according to consensus forecasters, but a slowdown is expected in the second half as a result of less helpful base effects and monetary tightening . GDP is projected to increase 7.5% in 2011.** Asian central banks are proving extremely vigilant on inflation risks and interest rates have already been raised in India, South Korea, Malaysia and Taiwan. Monetary policy will be normalised at a moderate pace, however, and 25bp rate hikes are expected in all countries over the coming three months. And with tightening totalling between 25bp and 125bp over the coming year, regional monetary policies will remain accommodating with respect to economic growth. India is expected to tighten the most over the period, i.e. by 125bp.

In **Eastern Europe**, domestic demand is weak and growth prospects depend heavily on euro zone countries. The region could suffer more than others from any sharp downturn in European activity and pressure on financial markets, were it to persist. In Russia, the recovery has stemmed from industrial activity and exports, which have benefited from higher oil prices, and its strength has been no surprise. Over the past three months, consensus growth forecasts for 2010 have been revised markedly higher, from 4.5% to 5.2%, but opinion is divided on the need for additional monetary easing in the near term. Only a small minority of analysts believe that rates will be cut again in the coming three months.

Tangible signs of a deceleration in activity have appeared in Asia. In **China**, GDP growth was 10.3% yoy in Q2, well down on the 11.9% reported in Q1, and June's figures on retail sales, industrial production and urban investment all point to **moderating activity from very high levels.** The country's PMI declined for the second month in a row in June, to 52.1, suggesting a further slowdown in industrial activity in the months ahead. **But there is absolutely no indication of a severe downturn.** In our view, the deceleration is under control. It is related to measures to tighten credit and government limits on new investment projects, and the authorities have enough leeway to relax economic policy if needs be.

**According to consensus analysts, Chinese growth will decelerate from 11.1% yoy in the first half to 9.8% in the second. If they are right, GDP will increase by between 10.2% and 10.5% this year, given a substantial carryover effect from the first six months.** According to the latest IMF forecasts, growth will amount to 10.5% this year and 9.6% in 2011, compared with consensus numbers of 10.2% and 9%, respectively.

## Our valuation signals

	Bond markets <sup>(1)</sup>	Equity markets
United States	N-	+
Euro zone	N-	N+
Europe ex-EMU	--	N+
Japan	N+	N+
Developed World	N-	+
Emerging Markets	N+*	N+

<sup>(1)</sup>10-year bonds N: asset properly valued ; +: asset undervalued ; -: asset overvalued

\*Sinopia calculations according to each country's weight in the CDXEM index (CDS Spreads), the signal is relative to 5-year government bonds and is risk-adjusted

	Current rate	3-month rate forecast <sup>(1)</sup>	Valuation Signal
USDJPY	88.49	87.47	N+
EURUSD	1.22	1.22	N-
GBPUSD	1.50	1.50	N+
EURCHF	1.32	1.37	N-

<sup>(1)</sup> Sinopia

A positive (negative) valuation signal corresponds to an expected appreciation (depreciation) of the foreign currency against the USD or EUR.

## Our investment decisions

### Balanced portfolio

- **Against a backdrop of marked risk aversion and weaker earnings prospects, we have reduced our exposure to international equities by 2%.** Our government bond allocation is unchanged.
- Our asset allocation is now 52% equities and 47% bonds, compared with a 50:50 benchmark split.

### Bond portfolio

- **We remain generally negative on government bonds.** While persistently accommodating monetary policies in developed countries in a context of limited increases in inflation offer support to bond prices, world activity continues to accelerate – despite some nervousness over the US economy – and the gradual withdrawal of unconventional measures against a backdrop of high budget deficits in 2010 could have the opposite effect
- **We continue to recommend country allocation strategies and positions in bonds that still offer opportunities.**

## Equity portfolio

- **Equities stumbled badly at the end of a quarter that featured more uncertainty than in previous months.** The continuing sovereign debt crisis in the euro zone and the signal failure of short-term solutions overshadowed good corporate results and the indices have traded steadily lower since they peaked in April. The S&P 500 corrected 11.9% over the quarter, and like other indices closed the period at its year's lows.
- The capitalisation-weighted MSCI World fell 2.8%, hampered by the weight of cyclical sectors such as energy, semiconductors, industry and banking. **In a context of rising volatility, investors have moved into the most defensive sectors.**
- We have maintained our equities overweight for valuation reasons. We do not see any signs of a poor corporate results season that could undermine the attractiveness of this asset class.
- Although risks have increased substantially in recent weeks, the market is trading in long-term buy areas. Prudence remains essential.

## Currencies

- The **US dollar** suffered from risk aversion and less encouraging economic news in June. It depreciated by an average 1.4% against other OECD currencies.
- Other currencies returned mixed performances. The **euro** was unchanged against the US dollar (-0.2%); the Canadian dollar eased 1% against the greenback, as the rate hike of early June was accompanied by more moderate central bank commentary on future tightening. The **Swiss franc** (up 7.1% against the US dollar) and the **yen** (up 2.9%) benefited from more lax attitudes from their respective central banks on currency appreciation. With a more fundamental theme, the **pound sterling** gained 3% against the dollar following the new government's budget announcement (an adjustment amounting to 9 points of GDP over five years).
- **Our valuation models urge caution on the dollar, which despite significant undervaluation relative to the economic fundamentals suffers from unhelpful carry relative to other OECD currencies.** Because of the decline in risk aversion over the month, we again favour dollar bloc currencies against European currencies in the light of their attractive carry.
- **Notwithstanding its recent appreciation, our long-term signal for the yen is still positive against the dollar.** Among European currencies, **our signals continue to favour the Swedish krona and pound sterling over the euro and Swiss franc.** The latter's rally has been too rapid relative to the fundamentals and has produced the worst signal of all in our valuation models.

## Balanced portfolio

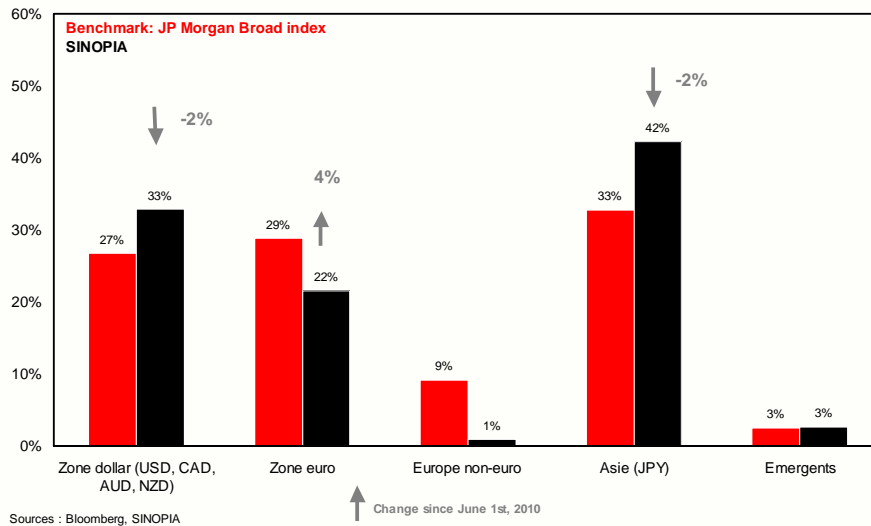
	Allocation	
	Benchmark <sup>(1)</sup>	SINOPIA
Equity	50%	52% ↓
Bonds	50%	47%
Cash	0%	1% ↑

<sup>(1)</sup>MSCI World 50%, JP Morgan Broad 50%

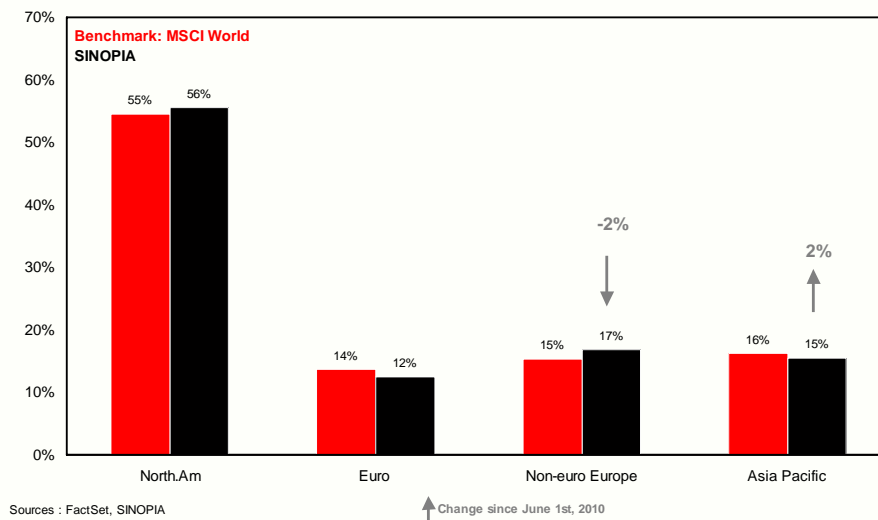
Sources : Bloomberg, FactSet, SINOPIA

Change since June 1st, 2010

## Bonds



## Equities



## Growth and inflation

Annual % change	GDP				Inflation <sup>(1)</sup>			
	2007	2008	2009 F	2010 F	2007	2008	2009 F	2010 F
<b>North America</b>	<b>0.4</b>	<b>-2.4</b>	<b>3.2</b>	<b>3.0</b>	<b>3.7</b>	<b>-0.2</b>	<b>1.9</b> ↓	<b>1.7</b> ↓
United States	0.4	-2.4	3.2	3.0	3.8	-0.3	1.8	1.6
Canada	0.5	-2.5	3.4	3.0	2.4	0.3	1.8	2.1
<b>Western Europe</b>	<b>2</b>	<b>-4.2</b>	<b>1.1</b>	<b>1.5</b> ↓	<b>4.7</b>	<b>0.6</b>	<b>1.6</b> ↑	<b>1.5</b>
Euro zone	0.7	-4.1	1.1	1.4	3.3	0.3	1.4	1.4
France	0.7	-2.5	1.4	1.6	2.8	0.1	1.6	1.5
Germany	1.3	-4.9	1.7	1.7	2.6	0.4	1.0	1.2
Spain	1.2	-3.6	-0.4	0.7	4.1	-0.3	1.4	1.7
UK	0.7	-4.9	1.3	2.3	3.6	2.2	3.0	1.8
Switzerland	1.6	-1.5	1.9	1.9	2.4	-0.5	1.0	1.1
<b>Eastern Europe</b>	<b>4.3</b>	<b>-5.5</b>	<b>3.6</b>	<b>3.8</b>	<b>10.9</b>	<b>6.6</b>	<b>5.8</b> ↓	<b>5.1</b> ↓
Russia	5.6	-7.9	5.0	4.5	13.3	8.8	6.6	6.8
<b>Asia Pacific</b>	<b>3.4</b>	<b>1.5</b>	<b>6.1</b> ↑	<b>5.4</b>	<b>4.5</b>	<b>0.8</b>	<b>2.4</b> ↑	<b>2.2</b> ↑
Japan	-0.7	-5.3	2.9	1.8	1.4	-1.4	-1.0	-0.2
Australia	2.1	1.3	3.0	3.4	4.4	1.8	2.9	2.8
China	9.0	8.7	10.2	9.0	9	-0.7	3.2	3.3
Hong Kong	2.5	-2.8	5.5	4.6	4.3	0.6	2.4	2.8
India (2)	6.4	7.4	8.2	8.4	8.2	11.7	9.9	6.2
<b>Latin America</b>	<b>4.2</b>	<b>-1.9</b>	<b>4.5</b> ↑	<b>3.9</b>	<b>8.2</b>	<b>5.5</b>	<b>7.6</b> ↑	<b>7.0</b>
Brazil	5.2	-0.2	6.7	4.4	5.9	4.3	5.6	4.8
<b>World</b>	<b>2</b>	<b>-2.1</b>	<b>3.8</b> ↑	<b>3.7</b> ↓	<b>4.7</b>	<b>1.4</b>	<b>3.1</b>	<b>2.8</b> ↓

↑ ↓ Downward or upward forecasts compared to last month      E: estimated    F: forecasts      (1) annual average  
 (2) Fiscal year, April to March      Sources and forecasts: Consensus Forecasts, The Economist, OECD, IMF

## Expected earning growth

% change	2010 F <sup>(1)</sup>	2011 F <sup>(1)</sup>
<b>United States</b>	32	18
<b>Canada</b>	20	21
<b>Euro zone</b>	28	18
<b>UK</b>	40	18
<b>Switzerland</b>	37	12
<b>Japan</b>	152	30
<b>Australia</b>	20	19

Source: SINOPIA calculations with I.B.E.S. expectations      F: Forecasts  
 (1) based on IBES current month's adjustments of companies perimeters changes

## Budgetary balance

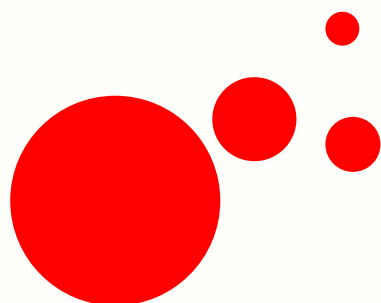
In % of GDP	2010 F	2011 F
<b>United States</b>	-10.7	-8.9
<b>Canada</b>	-3.4	-2.1
<b>Euro zone</b>	-6.6	-5.7
<b>UK</b>	-11.5	-10.3
<b>Switzerland</b>	-0.8	-0.5
<b>Japan</b>	-7.6	-8.3
<b>Australia</b>	-3.2	-2.4

Sources and forecasts: OECD, Consensus

**Central bank rates**

		Central Bank rate	Last change	Date of change	Expected in 3 months	Expected in 12 months
<b>United States</b>	<i>Fed Funds rate</i>	0.25%	-75 bp	16/12/2008	0% / 0.25%	0.5% / 0.75%
<b>Canada</b>	<i>Overnight rate</i>	0.50%	25 bp	01/06/2010	0.75% / 1%	2% / 2.25%
<b>Euro zone</b>	<i>Refi rate</i>	1.00%	-25 bp	07/05/2009	1%	1.25%
<b>UK</b>	<i>Repo rate</i>	0.50%	-50 bp	06/03/2009	0.5%	1.25% / 1.5%
<b>Switzerland</b>	<i>SNB Lib or rate</i>	0.25%	-25 bp	12/03/2009	0.25%	1%
<b>Norway</b>	<i>Deposit rate</i>	2.00%	25 bp	06/05/2010	2% / 2.25%	3%
<b>Sweden</b>	<i>Repo rate</i>	0.50%	25 bp	01/07/2010	0.5% / 0.75%	1.75%
<b>Japan</b>	<i>Overnight rate</i>	0.10%	-20 bp	19/12/2008	0% / 0.25%	0% / 0.25%
<b>Australia</b>	<i>Cash rate</i>	4.50%	25 bp	01/06/2010	4.75%	5.25% / 5.5%
<b>New Zealand</b>	<i>Cash rate</i>	2.75%	25 bp	10/06/2010	3.25%	4.5%

Sources and expectations : Bloomberg, SINOP IA calculations



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