Weekly Update

C0 | EXTERNAL PUBLICATION

Storm in a China teacup


Alan Mudie
(41) 22 819 0255
alan.mudie@socgen.com


Xavier Denis
Head of investment Strategy
(33)1 5637 9817
xavier.denis@socgen.com


Antonio Bertone
Global strategist
(33)1 42 13 24 06
antonio.bertone@socgen.com


Sophie Fournier
Global strategist
(33)1 42 14 59 36
sophie.fournier@socgen.com


Paul Beecham
Editor in chief
(33) 1 56 37 39 61
paul.beecham@socgen.com

All data taken from Bloomberg.

In recent weeks, the drop in the Chinese yuan (CNY) against the US dollar (USD) has garnered much investor attention. The 3.2% drop in June was the sharpest on record, eclipsing the 2.6% fall in August 2015. What's going on? Is China using currency weakness to fight US protectionism?

The first thing to bear in mind when looking at the CNY against the USD is that this has long been a managed exchange rate regime. Even after China moved timidly towards a freer float, CNY volatility against the USD has remained extremely low. Since June 2010, weekly annualized volatility for USDCNY has been 2.7% versus 9.4% for EURUSD. As a result, moves in the CNY can appear more dramatic than they are in reality – year-to-date, the yuan is only down 1.8% against the dollar while the euro has shed 2.6% and the JP Morgan emerging currency index -7.4%.

This being said, China has committed to continue to give greater flexibility to its exchange rate. Over the past 12 months, CNY volatility has reached 4.7% versus 6.7% for the EUR. In addition, China has moved away from its close monitoring of the yuan against the dollar in recent years – it now focuses more on the China Foreign Exchange Trade System basket, a trade-weighted index of the CNY against 13 currencies (which was derived from the broader Bank for International Settlements CNY index) and a better measure of China's overall competitiveness. As the XX-hand chart below shows, although the CFETS index has weakened somewhat since launch in December 2015, the CNY still remains close to its highs since the turn of the century.

In this light, recent moves in the yuan hardly look like a deliberate devaluation to save Chinese exporters. Moreover, China's current account balance has been weakening in recent years – the first quarter 2018 surplus reached 0.9% of GDP, the lowest since at least 1998 and far below the 9-10% reached in 2007-2009. Again, this hardly reflects an under-valued currency, but rather the gradual transition to a more domestically-driven economy. And indeed, the rebalancing of China's growth engines is best achieved with a stable currency.

This is not to say that all is well in China. Indeed, weak macro data in May (retail sales growth was the lowest since 2003, fixed asset investment growth the lowest since 1999) has prompted the central bank to inject liquidity by easing reserve ratio requirements. Investor worries have also been heightened by the US decision to slap 25% import tariffs on over 800 imports from China worth some USD34bn starting on July 7. Moreover, the Shanghai domestic A-share market recently entered bear-market territory, having declined 23.2% from its January high.

Bottom line. China's long-cherished ambition to position its currency as a rival to the dollar requires gradual relaxation of exchange controls and adopting a more freely-floating regime. We believe Beijing is unlikely to abandon these long-term strategic imperatives for short-term gains in competitiveness. Similarly, a lurch lower in the currency might exacerbate the risk of outflows by domestic investors. The most probable outcome in our view is that the China will maintain currency stability against the CFETS basket, meaning it will allow some weakness against spikes in the dollar.

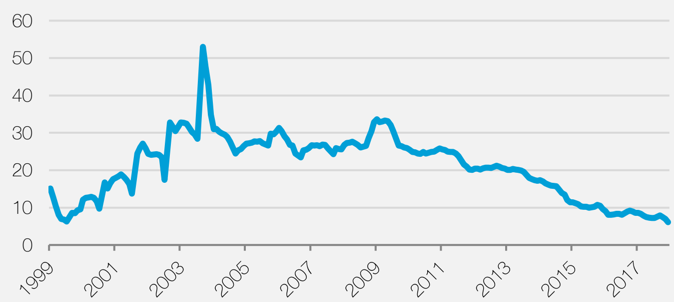
Trade-weighted yuan close to historic highs

100 = 31/11/2015

Source: Bloomberg, 30/06/2018

Slower but still strong

China fixed-asset investment (ex: rural households), cumulative YoY data



Source: Bloomberg, 31/05/2018

This week and next

EUROZONE

- The final figure for manufacturing confidence came out at 54.9 in June and 55.2 for services, thus sending the PMI composite index up to 54.9 (from 54.1 in May).
- Higher inflation and slower job creation saw 3-month average growth in retail sales slow to +1.5% YoY in May, a low since September 2016.
- The unemployment rate continued its gradual decline from 12.1% in 2013 to 8.4% in May and is now very close to its 2008 level.

	Next week's key events	*Per.*	*Prev.*	*Cons.*
10 Jul	German ZEW Survey Current situation	Jul	80.6	78.8
12 Jul	Industrial production, YoY	May	1.7%	2.3%

UNITED KINGDOM

- Manufacturing sentiment (PMI) rose from 54.3 to 54.4 in June while services confidence hit a 7-month high at 55.1. Despite uncertainty about long-term prospects, construction confidence rose to 53.1 in June.
- The Halifax house price index rose 0.3% in June after 1.7% a month before.

	Next week's key events	*Per.*	*Prev.*	*Cons.*
10 Jul	Industrial production, YoY	May	1.8%	1.9%
10 Jul	Goods trade balance (£bn)	May	-14.0	-11.9--

UNITED STATES

- ISM manufacturing confidence beat expectations, rising from 58.7 to 60.2 in June, while the non-manufacturing index printed at 59.1 vs 58.6 a month before.
- Manufacturers' new orders gained 0.4% MoM in May and construction spending was up 0.4% MoM in May.
- Initial jobless claims increased from 228k to 231k last week and continuing claims increased from 1.71m to 1.74m.

	Next week's key events	*Per.*	*Prev.*	*Cons.*
12 Jul	Core inflation, YoY	Jun	2.2%	2.3%
13 Jul	University of Michigan consumer sentiment	Jul P	98.2	98.2

ASIA & EMERGING COUNTRIES

- In Japan, PMI business surveys improved in June, up from 52.8 to 53 in manufacturing and up from 51 to 51.4 in services. Household spending fell 3.9% YoY in May, the most since August 2016.
- In China, PMI composite business confidence edged up from 52.3 in May to 53 in June, mainly thanks to improved sentiment in services (PMI index up from 52.9 to 53.9 in June).
- Despite recent rate hikes in Turkey to quell currency depreciation, headline inflation increased from 12.2% to 15.4% YoY in June, a 14-year high.

	Next week's key events	*Per.*	*Prev.*	*Cons.*
11 Jul	Japan: Core machinery orders, YoY	May	9.6%	10.2%
13 Jul	China: Trade balance ($bn)	Jun	24.9	27.2

Sources: Datastream, Bloomberg, 6 July 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.17	1.20
GBP/USD	1.32	1.35
EUR/CHF	1.16	1.18
USD/JPY	111	110
Brent	$78.3	$75
Gold	$1258	$1250

Forecast figures are not a reliable indicator of future performance

We have changed some of our 6-month targets in our latest Quarterly House Views.

Question time

Past performance should not be seen as a guarantee of future returns.

EQUITIES

What impact will the forthcoming changes to sector categories have?

In September 2018, Standard and Poor's and MSCI plan to revise the Global Industry Classification Standard (GICS) to better reflect business and industry reality.

Over past years, sector classifications and market weightings have changed considerably with the rapid development of new business models. For example, the consolidation of the Telecom industry has left the S&P 500 index with only 3 telecom shares to trade. A major swing from one of the three would automatically have a sizeable impact on the whole sector, making passive benchmarking quite challenging.

In March, MSCI proposed to rearrange three of its eleven sectors and to create a wider Communication Services sector to replace the current Telecom category. To achieve this, some Information Technology (IT) and Consumer Discretionary stocks will change categories.

Sector reorganizations are nothing new. In 2016 for example, MSCI decided to move Real Estate Investment Trusts (REITs) out of Financials to create a new 11th sector called Real Estate.

According to a recent study from Credit Suisse, Communication Services will represent 9.1% of the US index (vs 2% today) and 5.5% in Europe, Australasia and Far East (EAFE) vs 3.7% now. The sector will see its spectrum extended to include content creation and social media. Although some giants such as Facebook or Google are considered as technology businesses, they actually rely heavily on providing media and communication services. That's why they will shift from IT to Communication Services – a group that will also include ex-Consumer Discretionary stocks, such as Netflix, Disney, Time Warner and Comcast. Conversely, retail-related companies such as Alibaba or eBay will join Consumer Discretionary.

According to Credit Suisse, the weight of IT within the US index will decrease from 25.5% to 21.5% under the changes. The proposed sector switches will affect US indices more than their EAFE peers since IT is much larger there than elsewhere – some 7.4% of US stocks are to be re-assigned vs 1.8% in EAFE.

From the earnings growth perspective, the inclusion of faster-growing companies in Communications will also have greater impact in the US than in EAFE. Expected earnings growth for the next 12 months in the US Communication Services sector would be 10.2% after the switches vs -3.9% now for Telecom. The US Telecom sector has a 5% dividend yield but this will now fall to 1.3%. For EAFE, the impact on dividends is more limited (4.3% to 3.7%).

Fund and ETF managers tracking the current Telecom, IT and Consumer Discretionary sectors will need to adjust to the new benchmarks before end September.

A sector change will of course have no impact on a stock's business model or earnings power. However, divergences in the relative size of index trackers could have some marginal impact on trading patterns as passive managers reflect the new categories in their sector products. Also, some new ETFs have been launched to track the new segments. Finally, the departure of three of the four FANGs will leave just Apple in the IT sector.

New MSCI sector breakdown

Percent of benchmark

	Technology		Discretionary		Telecom	Comm
%	Current	Proposed	Current	Proposed	Current	Proposed
Developed	**18.9**	**16.0**	**12.9**	**10.7**	**2.6**	**7.6**
North America	**25.5**	**21.5**	**13.1**	**10.2**	**2.0**	**8.8**
United States	26.7	22.4	13.5	10.6	2.0	9.1
Canada	4.5	4.5	5.4	4.7	2.2	2.9
EAFE	**7.0**	**6.3**	**12.6**	**11.4**	**3.7**	**5.5**
Europe	**5.9**	**5.6**	**10.8**	**9.4**	**3.4**	**5.2**
United Kingdom	0.9	0.7	8.8	6.1	3.5	6.4
Europe ex-U.K.	**7.9**	**7.6**	**11.6**	**10.6**	**3.3**	**4.7**
France	5.3	4.7	19.3	15.9	2.4	6.3
Germany	13.0	12.1	17.7	17.1	4.2	5.7
Switzerland	0.8	0.8	6.3	6.3	1.0	1.0
Other Europe	9.9	9.9	5.9	5.7	4.4	4.6
Asia/Pacific	**8.7**	**7.5**	**15.5**	**15.0**	**4.3**	**6.0**
Japan	12.5	10.8	20.1	19.4	5.2	7.7
Asia/Pacific Ex Japan	1.0	0.8	6.3	6.1	2.3	2.7

Note: MSCI U.S. and MSCI EAFE

Sources: MSCI, FactSet, Credit Suisse

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	1 bp	➡	1 bp	-2 bp	0 bp
3mth Euribor (EUR)	-32 bp	0 bp	➡	1 bp	1 bp	1 bp
3mth Libor (USD)	234 bp	0 bp	➡	1 bp	64 bp	104 bp
3mth Libor (GBP)	71 bp	4 bp	⬆	-5 bp	19 bp	40 bp
10-year US Treasury bond	284 bp	-1 bp	➡	1 bp	43 bp	51 bp
10-year German bond	29 bp	-2 bp	⬇	-23 bp	-13 bp	-18 bp
10-year French bond	60 bp	-5 bp	⬇	-16 bp	-7 bp	-22 bp
10-year UK bond	131 bp	0 bp	➡	-16 bp	8 bp	-4 bp

Credit

	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.1%	➡	-0.1 %	-0.5 %	1.0 %
BAML EURO Corp HY	0.6%	⬆	-0.8 %	-1.2 %	1.2 %
BAML GBP Corp IG	0.0%	➡	0.3 %	-1.6 %	0.6 %
BAML US IG	0.3%	⬆	-0.3 %	-2.9 %	-0.4 %
BAML US HY	0.0%	➡	0.6 %	0.0 %	2.4 %
JPM Global EM Sov. Plus	1.1%	⬆	-4.0 %	-5.2 %	-0.6 %

Exchange rates

	Last	1wk		3mth	YTD	12mth
EUR/USD	1.17	1.1 %	⬆	-4.5 %	-2.7 %	3.0%
EUR/CHF	1.16	0.6 %	⬆	-1.5 %	-0.8 %	6.1%
GBP/USD	1.32	1.1 %	⬆	-5.5 %	-2.0 %	2.3%
USD/JPY	111	0.1 %	⬆	3.0 %	-1.8 %	-2.3%
USD/BRL	3.93	1.8 %	⬆	17.6 %	18.7 %	19.6%
USD/CNY	6.64	0.2 %	⬆	5.3 %	2.0 %	-2.4%
USD/RUB	63.1	0.5 %	⬆	9.4 %	9.5 %	5.3%

Government bonds*

	1wk		3mth	YTD	12mth
United States (3-7yr)	0.0 %	➡	0.2 %	-1.0 %	-1.0 %
United Kingdom (3-7yr)	0.0 %	➡	0.9 %	-0.2 %	-0.3 %
Germany (3-7yr)	-0.1 %	⬇	0.9 %	0.7 %	0.8 %
Japan (3-7yr)	0.0 %	➡	0.0 %	0.0 %	0.2 %

Equities*

	Last	1wk		3mth	YTD	12mth
MSCI AC World	506	0.8 %	⬆	0.3 %	0.0 %	11.3 %
Eurostoxx 50	3 441	2.2 %	⬆	2.9 %	1.1 %	2.4 %
DAX	12 464	2.4 %	⬆	1.3 %	-3.5 %	0.1 %
CAC 40	5 366	1.7 %	⬆	4.3 %	3.8 %	7.0 %
S&P 500	2 737	0.8 %	⬆	3.3 %	3.4 %	14.7 %
FTSE 100	7 603	-0.2 %	⬇	6.8 %	1.2 %	7.5 %
SMI	8 674	2.5 %	⬆	1.0 %	-4.5 %	0.2 %
Topix	1 676	-2.9 %	⬇	-2.6 %	-6.7 %	5.8 %
IBOV Brazil	74 553	3.9 %	⬆	-12.5 %	-2.4 %	18.1 %
MICEX Russia *	2 347	4.3 %	⬆	2.2 %	11.2 %	22.1 %
MSCI EM	1 054	0.9 %	⬆	-8.7 %	-7.6 %	7.2 %
SENSEX 30 India	35 575	1.6 %	⬆	6.4 %	5.9 %	15.3 %
Hang Seng (H-K)	28 182	-0.6 %	⬇	-2.9 %	-3.8 %	14.5 %
Shanghaï Composite	2 734	-1.9 %	⬇	-12.7 %	-17.3 %	-14.8 %

Commodities

	Last	1wk		3mth	YTD	12mth
Brent	$78	0.8 %	⬆	14.7 %	17.5 %	62.7 %
Gold	$1 258	0.7 %	⬆	-5.1 %	-3.5 %	3.0 %
Silver	$16.1	0.4 %	⬆	-2.0 %	-5.6 %	0.6 %

Source: Datastream, on 05/07/2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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