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Weekly Report

China: Diminished inflation danger?

When China reported a lower-than-expected CPI growth of 1.5 % y-y, many investors seemed to think that inflation fears had previously been grossly exaggerated. The 50 basis point increase of the reserve requirement ratio (RRR) just the following day hit markets therefore by surprise. The relatively moderate growth in the January CPI figure was however a result of lower meat prices. The timing of the Chinese New Year, which occurs this year in February instead of January, represented an additional factor. Consequently, the sharply rising trend in CPI inflation should resume in February. Contrary to the inflation wave of 2007, the current situation is much more threatening: Now first signs of wage inflation can be detected in China, which historically is much more difficult to unwind than commodity-related price increases. Many coastal areas have reportedly increased minimum wages by 10-15 % and companies show difficulties in retaining their work force without rising salaries. Additionally, the government has raised public pensions in January. House prices continued to accelerate on a monthly basis, rising 9.5 % y-y. Pressures in the pipeline are also mounting: Inflation at the producer level surged by 4.3 % y-y, reflecting partially base effects that are likely to drive the rate up further over coming months and purchasing prices jumped by 8 %. Despite the increase in the reserve requirement ratio and credit quotas, liquidity and credit growth are still hyper-expansionary. We therefore expect aggressive tightening to continue with multiple RRR hikes and a first increase in the benchmark interest rate around April.

Foreign Exchange

We have been for some time positive on the GBP. While this assessment was correct against the EUR, it was less rewarding against the USD. The quarterly inflation report released last week did not help to rise interest in the GBP: While a sharp increase well above the 2 % target in December was acknowledged and a further rise in January was anticipated, the report also suggested that this pickup largely reflected the impact of one-off adjustments, which should impact inflation only on a temporary basis. Inflation was stated to remain below the target for much of the forecast period. Importantly, the tone of the report suggested that the February decision to suspend its policy of quantitative easing might be reversed. We expect the UK economy to accelerate from the dismal 4Q growth of just 0.1 % (which should be revised upwardly) and do not anticipate a resumption of bond buying. We would therefore expect the GBP to strengthen also against the USD from the current level. The close call for the upcoming election represents an important uncertainty, though.

	Short-term trend	Last
EURUSD	→	1.3601
USDCHF	→	1.0777
USDJPY	→	90.010
GBPUSD	↑	1.5664

Fixed Income

Mid-January we cautioned investors that taking additional risk in high-yield bonds was poorly rewarded as spreads had massively shrunk at that stage. While most expected that an eventual correction in lower quality bonds would stem from doubts about the economic recovery or a company default, it was indeed sovereign debt that finally led to renewed focus on quality. Investors have indeed fled junk bonds in masses, which resulted in the largest sell-off of this category since March 2009. Spreads between the yields on non-investment grade bonds and US Treasuries have widened by more than 100 basis points only since mid-January. Is it now time to step in? We still consider it somewhat too early as spreads between high quality and junk are still not rewarding enough, particularly now that liquidity is in the process to be taken out of the financial system in a serious way. As currently demonstrated by China, every single tightening announcement is followed by a negative market reaction, even though most investors exactly know that several tightening measures have to follow. Another buying opportunity should emerge later in the year.

	Forecast end 10	Last
US 10y T %	4.80	3.69
Fed funds	2.25	0-0.25
Bund 10y %	4.00	3.20
ECB rates	1.50	1.00

Stocks

Autonomy (AU/ LN), a global leader in infrastructure software, announced a GBP 500 million convertible. The company intends to use the proceeds for additional investments and will potentially pay the $ 197 million bank loan it still carries from the Interwoven acquisition. We consider the drop in the stock prices subsequent to this announcement as an excellent opportunity to create new positions. Acquisitions will inevitably be part of the strategy to be the dominant platform for unstructured data. We would emphasize that all historical deals have been highly accretive and added another dimension to the company. Given the acceleration of organic growth ex mega-deals, the improving demand environment and a strong product line-up we have a price target of £17. The correction in companies with cyclical character offer again an interesting buying opportunity. We like to highlight FedEx (FDX), which should benefit from accelerating international demand. Also on the national level, the situation has significantly improved allowing FDX to ease its discounting practice. Freight should gain market share. We expect raising operating margins. PT $ 100.

	Forecast end 10	Last
S&P 500	1230	1078
NASDAQ	2450	2184
DJ STOXX 600	270	242
SMI	7000	6441