Amundi
ASSET MANAGEMENT

RESEARCH
STRATEGY
& ANALYSIS

#11
MONTHLY

Cross asset investment strategy

November 2016

Document finalised at November 16, 2016

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

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Key topics, scenarios and asset allocation

Asset allocation: 2017 and beyond

1 Elections in Europe, Brexit, financial stability in China and the direction of budgetary and fiscal policy… four key factors in the years to come?

PHILIPPE ITHURBIDE, *Global Head of Research, Strategy and Analysis*

A year ago, we were reiterating our forecasts on a 2 to 3-year horizon and, once again, this is the subject matter of this special edition. This exercise is particularly important against a political backdrop that is becoming more complex (a new President in the United States, France, etc.), in a world where monetary policy is extremely accommodative (United States, Eurozone, United Kingdom, Japan, China, etc.), but which for the most part have reached their limits and hence the temptation of budgetary and fiscal stimulus measures in many cases. It is against this backdrop, which is unprecedented in many ways, that our analyses, forecasts and investment strategies have been formed.

A year ago, our main forecasts were supported by the economic backdrop detailed below:

- World growth once again in the vicinity of 3%;
- Economic growth driven in many countries by domestic demand and no longer by world trade, which is now shrinking;
- No hard landing for China but a monetary policy stance (and economic policy in general) that remains highly accommodative;
- The Fed's extreme cautiousness which, although expected, turned out to be far more prudent than figures then suggested. We expected one fed funds rate hike in late 2015 and another in 2016, far fewer than the consensus view;
- The extension of QE (Quantitative Easing) programmes in Japan and in the eurozone;
- Control over rates of inflation;
- An improving growth outlook for the eurozone but a European Central Bank that was expected to stay highly accommodative such that we again stated that we did not expect any monetary tightening whatsoever in the next 3 to 5 years;
- Continuing ultra-low rates, in particular in the eurozone, and the dangers of negative rates;
- A mild recovery in the economic situation of emerging countries, and, in any case, the end of the woes that were besetting these areas for more than 4 years;
- The continuation of the recession in Russia and Brazil;
- A gradual recovery in commodity prices, with a target crude oil price of $55-60.

The major investment themes discussed were focused on key fundamental trends, in particular:

- The search for yield and spreads as investors' basic motivation in a world of ultra-low interest rates;
- A flattening of yield curves linked to control/lack of inflation and action by the central banks;
- The renewed vigour of the yen;
- An equity market recovery, in particular in the European markets where our

The essential

In an ultra-low or even negative interest rate environment, maintaining an overweight stance in emerging market assets (equities, debt and currencies), in credit (vs. government bonds) still makes sense, while continuing our search for yield and spreads. "Alternative" and "real" assets also remain attractive from a diversification and yield standpoint. 2017 is nevertheless expected to be a more complex year than 2015 or 2016.

However, there is no denying that the negotiations over Brexit, (with the risks on the United Kingdom but also on the political cohesion of the European Union), the situation in China (credit bubble, exchange rate policy and capital account opening policy), the limitations of monetary policy or the prospects for a change in the direction of budgetary and fiscal policies (with the United States probably showing the way with the new leadership), or finally the different elections in Europe (and the rise in populist movements) are likely to bring about meaningful change in current trends. This is what our stress tests clearly show. Anticipate periods of severe stress and the implementation of portfolio hedging. The year 2017 seems to be a pivotal year for financial markets, particularly for bond yields and emerging markets.

With a political backdrop that is becoming more complex, a world where monetary policy is extremely accommodative and hence, there is the temptation of budgetary and fiscal stimulus measures

recommendation was to focus on value stocks while favouring quality stocks in the United States, taking account of the differences in the maturity of the cycle and valuations between both markets;

- Renewed interest in the emerging markets after three or four years of weakness: the undervaluation of these markets, their underweighting in international portfolios, and the improving overall economic situation should, with the spread levels (an oasis of spreads in a desert of ultra-low or even negative interest rates) and valuation levels reached, draw renewed interest from investors.
- The recovery in emerging market currencies and, more broadly, all undervalued currencies, with the yen and commodity currencies in the lead;
- Continued overweighting of credit, especially high-yield;
- Continued overweighting of peripheral eurozone bonds, protected by the ECB's QE programme (which we expected would be extended to corporate bonds);

"Winning bets in 2016"

With a year's hindsight, we note that our central scenario and our investment recommendations were broadly confirmed by actual events: growth maintained at around 3%, hopeful signs in Europe, the recovery of emerging markets and the appreciation of several emerging currencies, the overweighting of bonds with spreads, interest rates (short and long) holding steady at ultra-low levels, the Fed's extreme caution, no increase in long-term rates, the maintenance of financial stability, etc. were all "winning bets".

What must we anticipate for 2017 and beyond? How do the election of Donald Trump and the forthcoming elections in Europe change the growth outlook and market expectations? Will the negotiations over Brexit really take place and what should we fear at this stage? These are the major questions.

"How do the election of Donald Trump and the forthcoming elections in Europe change the growth outlook and market expectations? Will the negotiations over Brexit really take place and what should we fear at this stage? These are the major questions"

It is still possible to present a number of different scenarios, and the factors that trigger similar growth scenarios may come from highly different events, which generates significant change to market impacts, investment themes, etc. For transparency, as we usually provide this, we are presenting three separate scenarios:

1. Our central scenario developed in detail (see page 24 and following);
2. Our worst-case scenario in terms of global growth;
3. Our best-case scenario in terms of global growth.

To be more precise, we are also presenting stressed scenarios (tied to specific events/risks that we believe are the most credible), as well as the related forecasts and expected returns. Five different forecasts and expected returns scenarios are developed on pages 14 and 15.

The following tables detail factors regarding the backdrop, monetary policy directions, the impact on the financial markets (forex, sovereign and corporate bonds, equity and commodities, for advanced countries and so-called emerging markets), investment themes and asset allocation strategies.

Among the risk factors (some of which had already been identified in November 2015), six of them catch our eye (see pages 16-21) for a detailed analysis of all the risk factors identified) because they still represent significant concerns for 2017-2020:

1. **Brexit: the 2016 vote, negotiations as from 2017.** Of course, the idea of a referendum was nothing new: in January 2013, David Cameron, then Prime Minister, promised that if the Conservative Party won the 2015 parliamentary elections, the government would start negotiations with the EU on getting new accommodations before calling the referendum on whether the United Kingdom would remain in or leave the Union. Mention of the referendum was included in the Queen's Speech of 27 May 2015, and was expected to be held before the end of 2017. At the time we identified this event as one of the main challenges ahead and put forth a few possible scenarios. It was only on 17 December 2015 that the European Union Referendum Act received Royal Assent and, on 20 February 2015, the date was set: the

"The Leave vote won, but we are really only at the beginning. The main difficulties have yet to come"

Macroeconomic and financial scenarios at a glance

The table below details factors regarding the backdrop, monetary policy directions, the impact on the financial markets: forex, fixed-income, credit, equity and commodities, for advanced countries and so-called emerging markets.

CENTRAL SCENARIO AND ALTERNATIVE SCENARIOS		
Alternative scenario 1 (more pessimistic)	Central scenario	Alternative scenario 2 (more optimistic)
Probability: 15%	**Probability: 70%**	**Probability: 15%**
Global growth heads toward 2% in 2017 and 2018, or even lower	Growth remains stable at around 3% in 2017 and intensifies slightly in 2018	Global growth picks up to 4% - 4.5% in 2017 and 2018
MACRO SCENARIO		
China and/or the United States are unable to stabilise their growth and the impact on the emerging economies increases. Advanced countries decline, global growth deteriorates while monetary policy, the Fed's included, goes back to being accommodating. The decline in global trade and commodity and industrial prices intensifies, adding to global deflationary pressure.	Reflation continues. World growth is expected to remain close to 3%, without significant acceleration except in some EM countries which should make up the ground lost with the fall in commodity prices (Brazil, Russia). China revitalises its economy without having to resort to a strong depreciation of the RMB. Trump tempers his positions and obtains a modest stimulus package which extends the cycle into 2018.	Governments adopt a more expansionist stance for fiscal policies. The subsequent investment recovery and wage acceleration generate an acceleration of growth (in US and Europe notably). Growth in EM countries accelerates, sustained by external demand.
MONETARY POLICY		
Monetary policy becomes (or remains) accommodating nearly everywhere. The Fed's monetary tightening cycle never gets off the ground. The ECB accelerates the pace of its QE programme and credible rumours of QE4 in the United States become amplified.	The Fed continues to raise its key rates at a gradual pace (fed-funds rate at 1.25%, end 2017). The resulting tightening of monetary conditions (rise in long-term interest rates and dollar appreciation) encourages the Fed to be cautious. The ECB extends its QE beyond March 2017. The ECB, the BoJ, the BoE and the PBoC remain accommodative.	The policy mix is progressively rebalanced in the US: monetary policy becomes more restrictive following the expansionist stance of fiscal policy. The Fed raises its key rates by 100/125bp in 2017 (2 to 3 more rate hikes than in the central scenario). The ECB QE continues so as to avoid interest rate contagion from the US and to maintain real interest rates at low levels in the eurozone.
FINANCIAL MARKETS		
Fixed income markets - Long-term yields drop once again, especially in the United States, and the low-rate environment becomes widespread across maturities and countries. Weaker peripheral eurozone countries. **Forex market** - Emerging and commodity currencies are weakened once again. Crisis in the EMG. USD down vs. developed currencies. **Corporate bond markets** - Solvency issues return to front and centre (health of companies in Europe, leveraging in the US, solvency in China). **Equity markets** - EPS recovery reverses. Correction of equity markets. The downside reaction of equities is dampended by the action of central bankers. **Commodities** - Prices decline further, except for gold, which benefits from rising risk aversion.	**Fixed income markets** - Increase in US bond yields at first (with steepening curve). Bond yields remain low in Europe and Japan (negative rates and QE maintained). **Forex market** - Upward pressure on the US dollar, because of rates divergence. Upward pressure on the euro will appear late in 2017. Heterogeneous performance of EM currencies. **Corporate bond markets** - The expected rebound in US growth is positive for US credit (rising US dollar and long rates two potential handicaps). The CSPP supports the Eurozone market **Equity markets** - EPS recover. The US market rises further in this cycle, which is crucial for other markets. Beware that bond yields rise not too much given the high valuation of the US market. **Commodities** - Bottom out. Continued gradual rebound which nevertheless remains moderate.	**Fixed income markets** - Rise of LT yields becomes more generalized. **Forex market** - EM currencies, particularly commodity producers, begin to appreciate sharply again. **Corporate bond markets** - Corporate and sovereign credit spreads are maintained at low levels. EMGs and private debt continue to hold appeal, as oases of spreads in a desert of ultra-low rates and spreads. **Equity markets** - Stronger recovery of EPS. The equity cycle moves on. **Commodities** - Rapid rebound in commodity prices (industrial and agricultural, to the detriment of precious metals).

Themes and asset allocation

The table below details the themes that we believe are the most appealing based on the different scenarios. It also focuses on asset allocation strategies.

SCENARIOS: OUR BELIEFS		
Alternative scenario 1 (more pessimistic)	Central scenario	Alternative scenario 2 (more optimistic)
Probability: 15%	**Probability: 70%**	**Probability: 15%**
INVESTMENT THEMES		
Equity - Quality, minimum volatility and sustainable dividends lead. - Defensives outperform cyclicals. **Fixed income** - Search for safe-haven investments (German bonds in Europe, US Treasury bonds in general). - Increase the liquidity bucket. **Forex** - Stay away from commodity and EM currencies. Short USD vs developed currencies. Sharp JPY appreciation. **Commodities** - Buy gold. - Decline in industrial commodities prices	**Equity** - Financials, Value and Infrastructure thematics rebound first. - Keep some quality and sustainable dividends in portfolio. **Fixed income** - Searching an entry point for US Treasuries. - Performance of inflation linkers will be linked to the amplitude of the fiscal stimulus. **Forex** - Preference for high carry currencies. Long USD vs G3 for some time. **Commodities** - Gradually rebuild long positions on all commodities.	**Equity** - The rebound of Value is sustainable. - Cyclicals outperform defensives. **Fixed income** - More intense discussions about an ECB tapering, underweight core countries euro bonds. - Search for spread and yields (peripheral debt, high yield, private debt and EMG debt). - Reduce the liquidity bucket. **Forex** - Long EM and commodities currencies. Less CNY downward pressure. More upward pressure on the euro. **Commodities** - Bet on a widespread recovery in prices, favour industrial and agricultural commodities over gold.
ASSET ALLOCATION		
Equity markets - Prefer the US market. **Fixed-income markets** - Overweight US and developed countries with higher rates (Australia, NZ) vs Eurozone. - Count on a widening of credit spreads and sovereign spreads in Europe. - Remain outside the «emerging» markets. **Emerging debt** - Favour USD-denominated debt over local debt. **Forex market** - Further depreciation of commodity and EM currencies vs G3 currencies. Short USD vs JPY. **Commodities** - Long on gold.	**Equity markets** - Rather neutral geographically. - Value markets (Eurozone and Japan) could benefit from the reflation, but this must be accompanied by currency depreciation for them to truly stand out. - At the margin prefer Japan to Eurozone. - More neutral on emerging markets. Buy only if exchange rates stabilize. **Fixed-income markets** - At first, a steepening of the US yield curve. - Overweight Eurozone vs US. - Stay away from BTPs until the political situation gets clearer in Italy. Underweight Ireland. **Emerging debt** - Re-entry points, be selective on local debt. **Forex market** - Preference for high carry currencies (RUB, INR). Long USD vs G3. Long USD vs CNY and low-carry Asian currencies. **Commodities** - Increase global exposure.	**Equity markets** - Prefer more cyclical markets: Eurozone, Japan or even Emerging markets if US bond yields and the USD don't rise excessively. **Fixed-income markets** - Overweight US vs Eurozone. - Increase exposure on inflation-linked bonds. **Forex market** - Long EM currencies. Long EUR vs developed currencies. **Commodities** - Long commodities.

referendum was announced for 23 June 2016. The rest is history. Everyone – or nearly everyone – awaited the referendum with apprehension as the United Kingdom-EU relationship was so beset by emotional and political back-and-forth… The rise of populism and extremist political parties (hailing from the right in the core countries of the Europe and from the left in the peripheral countries) did not escape anyone's notice, nor did the mistrust or even hostility of the British people toward the EU and the EMU. This is why we never assigned a probability of less than 50% to the eventuality of Brexit. This was undoubtedly a more reasonable stance than some starry-eyed optimists, who were incapable of imagining such an outcome. The Leave vote won, but we are really only at the beginning. The main difficulties have yet to come. In the absence of a reversal (non-compliance with the referendum, new referendum, policy change etc.) it is during the first quarter of 2017 that Article 50 of the Treaty of Lisbon is likely to be invoked, this article specifically giving the green light to the start of negotiations between the UK and the EU. We repeatedly discussed the issues and consequences for both the United Kingdom and the EU (see *Post-Brexit in a Few Questions and Answers,* Cross Asset Investment Strategy Monthly, July-August 2016). Let's just remember that although the shock of Brexit has quickly receded (decline in volatility, return of financial stress to its pre-referendum level), it will undoubtedly rear its head again in 2017, as negotiations progress and political deadlocks occur. The economic outlook for the UK (and the GBP) will again be challenged by investors, as will the political cohesion (and the long-term vision) of the European Union. This will add volatility to the financial markets and doubts over the future of Europe. Only the presence of QE by the ECB seems likely to contain any rise in sovereign credit spreads. Let's be fair though: it is currently very difficult to say what will happen and even to be sure that the Brexit will really happen. The lack of any contingency plan in the UK, the lack of negotiations between the UK and the EU countries (pending the activation of Article 50), and the nature of the debate (which opposes pragmatists to ideologists of the Brexit) make the situation rather confused. Do not rule out holding a new referendum in one year.

The negotiations over Brexit will add volatility to the financial markets and doubts over the future of Europe. Only the presence of QE by the ECB seems likely to contain any rise in sovereign credit spreads

Let's be fair: it is currently very difficult to say what will happen and even to be sure that the Brexit will really happen

2. Negative interest rates in the eurozone, and then in Japan in 2016 – situation unchanged in 2017 and the adoption of expansionist budgetary and fiscal policies? We have consistently highlighted the dangers and ineffectiveness of negative rates. We reiterated these in the inset on page 9, which highlights the importance of banks' profitability and the impact on lending to businesses, notably SMEs. Negative interest rates are also having an impact on the earnings and long-term financial positions of life insurance companies and pension funds, which have to contend with higher liabilities and the deterioration of asset/liability matching. It is an undeniable fact that negative rates act like an adaptation accelerator for some business models… but they also contribute to the chronic weakness of the industries concerned, first and foremost banks (see inset below) life insurers and pension funds (see for example *«Low/negative interest rate environment, secular stagnation… impact for asset management»,* Amundi Discussion Papers Series # 15, April 2016). It comes as no surprise that there have been lower lending volumes to SMEs ever since the financial crisis. While large and medium-sized companies have been able to turn to the financial markets for funding, this low volume represents a real handicap for our economies (in Europe, 80% of net job creation originates from SMEs). All in all, sustained rates in negative territory in the eurozone – which is highly probable – is not good news for the economy. It is for this reason that expectations are now focusing on budgetary and fiscal policy (see inset, page 28). Foresee tensions on US bond yields following the upcoming stimulus policy: improving expectations of growth will go hand in hand with a rise in inflation expectations, which will make the Fed forecasts credible (the «dots»), and this will give a boost to the dollar against the euro. This will be sustainable if GDP growth progresses, which is not fully guaranteed. European bond yields will follow US rates, but at a much slower pace, due to weaker growth expectations and to the presence of the ECB's EQ. Still, in the budgetary and fiscal sphere, the United States will undoubtedly lead the way and Europe will probably follow. As

We foresee tensions on US bond yields following the upcoming stimulus policy: improving expectations of growth will go hand in hand with a rise in inflation expectations, which will make the Fed forecasts credible (the «dots»), and this will give a boost to the dollar against the euro

2017 is an election year in several European countries (including France and Germany), there is little doubt that these themes will soon make their way into the debates. On this theme, Europe is not in the best position, not because of lack of room for manoeuvre (Germany is the best example of this), but due to a less open debate on these policies. Budget austerity has certainly now taken more of a back seat, and budget policy is now fairly neutral. However, it is difficult to do any more: the Stability and Growth Pact, the European Fiscal Compact and the European Semester are strict frameworks that have been strengthened over 2011-2013, and which make any budget stimulus virtually impossible at the national level. The ideological atmosphere in Europe is therefore developing more slowly than in the rest of the world, and it is in the eurozone that budget austerity has been the harshest over recent years. It is certainly in the eurozone that public action is the most needed in our opinion, and it is in the eurozone that this public action lacks boldness, whereas it would be useful to boost the real disposable income of households (high propensity to consume) and rekindle (public and private) investment.

Raising real disposable personal income and rekindling investment have become a necessity. There is little doubt that these themes will soon make their way into political debates in Europe

> The impact of the negative interest rates on European banks

YASMINE DE BRAY, THOMAS LAPEYRE, *Equity Analysis*

The prospect of a lower for longer interest rate environment is negative for the banks' revenues and profitability.

Peripheral banks are impacted more rapidly than core banks as their loan book tends to reprice quicker. Italian and Spanish banks have retail mortgage loans with rates directly linked to the level of euribor rates. The core markets (ie French, Benelux, German markets) are priced off the longer end of the curve.

Even if the market does not expect any further rate cuts (which is positive for banks' Net Interest Margins in the periphery), the forward euribor rates are not expected to come back in a positive territory before year-end 2020. This is a continued drag on the banks' Net Interest Margins in the periphery. Each 25bps downward move of short term interest rate in benchmark rates is a negative pre-tax profit impact of 5% for the European banks on average (-9/-10% for Spain and Italy and -2/-4% for banks in core Europe).

The gap between core Eurozone and peripheral countries widened: The required loan growth is higher in the periphery (almost 6%) than in the core countries (2-3%) to offset the pressure on the Net Interest Margin due to low rates. But the current loan growth in the periphery (down in Spain and slightly up in Italy) is much lower than the required loan growth.

The ECB should care about the deteriorated demand in the periphery: last October, the ECB left its policy unchanged, requesting time to make decision on QE, and considering growth conditions as stable and relatively unchanged from the September assessment. In reality, the latest ECB lending survey showed deteriorating demand in the periphery vs core countries.

The ECB policy remains a key influencing factor for the banks' profitability: The negative deposit facility rate applied by the ECB remains a key drag on the banks' Net Interest Margins (questioning the transmission to the lending growth in particular in the periphery) that would be partially offset by the benefit of the TLTRO2 (in particular for banks in the periphery).

The biggest risk is that the European banking sector replicates the Japanese banks experience: Over the past 15 years, the Japanese banks experienced 33% Net Interest Margin pressure but only half of this was offset by volume growth.

All in all, sustained rates in negative territory in the eurozone – which is highly probable – is not good news for the economy

3. Change to the yuan exchange rate regime in 2016 - continuing opening of capital account in 2017: China is opening its capital markets, liberalising its capital account and would like to see the yuan's exchange rate regime become decreasingly fixed. It is a monumental task, considering the weight of China and what has still to be done (for more details, see «*The emergence of the yuan as an international currency : where do we stand now?*» Amundi Discussion Paper Series # 18, October 2016). Whilst the Chinese authorities are moving forward in stages and despite its long-term beneficial effects, the process is undermining short-term financial stability, and we will undoubtedly experience some phases of tension on the renminbi, on growth in China and on capital flows… all the more so since, as we are dealing with China, a hard landing, the real estate bubble and risks of defaulting companies, etc. are recurring themes.

China is liberalising its capital account and this is undermining short-term financial stability. We will undoubtedly experience some phases of tension on the renminbi, on growth in China and on capital flows

4. The gradual rise of populist movements: we have already mentioned this theme in our publications, a theme that continues to gain ground. What's intriguing / concerning is the rise in extremist parties (extreme right-wing parties in Europe's hard-core countries, and extreme left-wing parties in the peripheral countries) and populism, which is reflected in protectionist, anti-immigration, and pro-public-deficit issues. Inevitably, some parties will be tempted by these themes, to please an electorate increasingly sensitive, and rightly so, to widening inequalities, the tax burden and job insecurity. Historically, such policies (in particular turning inward) generally result in phases of very weak (or no) growth and higher inflation. These phases of economic stagnation and strong public deficits inevitably lead to periods of recession and political and financial instability. Some elections are particularly important: Italian referendum early December (and general elections in February 2018 … or even before in case of early elections), general elections in the Netherlands in March 2017, presidential elections (23 April and 7 May 2017) and legislative elections (11 and 18 June) in France, general elections in Germany in autumn 2017… After the United Kingdom and the United States, the change in leadership continues, and it is now affecting the eurozone. It is not only about seeing the coming to power of parties favourable to fiscal and tax policies and wishing to put an end to budget austerity, but of seeing new leaders that are hostile to globalisation and European Monetary Union. This is why in 2017, the financial markets are entering a very challenging environment on the political front.

5. Risk of a rise in long-term interest rates. Since the financial crisis, expectations on long-term interest rates have always been incorrect. Many observers believed that the pick-up in growth in advanced countries was, with the rise in price indices, a good reason to anticipate a rise in long-term interest rates. This was underestimating key factors such as fears of secular stagnation, the weight of QE programmes, budgetary austerity in Europe, ongoing deflationary pressures … In short, long-term interest rates have not only continued to decline, but more importantly they have entered negative territory, dragged down by key rates which are themselves negative (Europe and Japan in particular) and dragging with them the yields of high quality corporate bonds. The environment is in the process of changing, due to the United States and the election of Donald Trump. The rise in long-term interest rates can in fact come from five sources: i) a significant rise in the growth outlook, ii) a reversal of interest rate policies, iii) the end of QE, iv) ua resurgence of inflation, or v) a reversal of budgetary and fiscal policies. Donald Trump's election will modify, at least initially, growth expectations, which will impact other factors. This is particularly true given the potentially more accommodative budgetary and fiscal policy ahead. The debate underway in the United States or to come in Europe regarding budgetary and fiscal policies is therefore crucial for interest rates. But in Europe, only continued QE can prevent long-term interest rates from following their US counterparts. It should be noted that the continuation of the rise in US bond yields will crucially depend on growth forecasts. We are not counting on an acceleration of the cycle, which means that after 6 months, relying on a fall in bond yields seems reasonable at the time of writing. The level reached by US government bonds should make it a preferred target for all investors who, at that time, will be looking for interest rates and carry.

6. Is there a risk of a collapse in emerging markets (and economies)? Emerging markets was our call in 2016, after four difficult years: a drop of commodity prices, fears of hard landing in China, a fall in EMG currencies, the end of the US QE, the (even timid) reversal of the Fed interest rate policy, recurring capital outflows ... and specific risks that are often well identifiable (Russia, Brazil in particular). The renewed strength of these markets was linked to a number of factors: Fed prudence, global growth maintained at a decent level, stabilization of Chinese growth, The stabilization and then the rise in the price of oil,flagrant undervaluation of many currencies, attractive return (an oasis of rates and spread in a desert of ultra-low or negative interest rates and spreads), the underweighting of these asset classes (EMG equities, EMG currencies and EMG debt) over all international portfolios. In

In 2017, the financial markets are entering a very challenging environment on the political front

After the United Kingdom and the United States, the change in leadership continues, and it is now affecting the eurozone. It is not only about seeing the coming to power of parties favourable to fiscal and tax policies and wishing to put an end to budget austerity, but of seeing new leaders that are hostile to globalisation and European Monetary Union

In Europe, only the continuation of the ECB's EQ can prevent bond yields from following US ones, driven initially by renewed confidence in growth, inflation expectations and the credibility of Fed forecasts in the field of monetary policy

theory, EMG markets do not like short-term rate hikes or long-term rate hikes, and one would be tempted to become negative again - at least for a while - towards emerging assets. It should be remembered that the rise in rates (short and long) linked to an upward revision of growth forecasts is not in itself negative, on the contrary. This does not alter our underlying scenario as regard emerging markets. However, there is a need to remain cautious in the short term, and to reduce exposures in these markets: uncertainty remains about the realization, albeit partial, of D. Trump's program, including (prohibitive) tariffs, negative impact on world trade... Discussions around these themes might destabilise the emerging markets as a whole.

There are multiple extreme risks causing concern on the financial markets

Extreme risk (ER)	Concern	Recent example	Trigger event	Risk level	Probability
ER#1: A radical shift in economic policy	Important impact on exchange rates and long rates	Abenomics in Japan, stimulus policy in France in 1981	Major turning point in budgetary and fiscal policies	Moderate	30%
ER#2: A poorly understood change in monetary policy	Bond crash	February 1994	Poor communication by the Fed or the ECB	Moderate	30%
ER#3: A bursting of the credit bubble in China, with a hard landing (Growth of 3% over the next two years)	Renewed slump in the emerging markets	1997 – 1998	Default of large corporations, an indicator of domestic demand in China	Moderate	20%
ER#4: Collapse of global growth (around 2%)	Widespread stock market crash	2000, 2008	Plunge in demand in China, the United States or in Europe, further weakening of the economies of the emerging countries as a whole	Moderate	15%
ER#5: Substantial and sudden devaluation of the yuan	Widespread stock market crash	1994	Failure by the Chinese central bank to take action to control the depreciation of the yuan	Low	10%
ER#6: Renewed fall in oil and commodity prices	Another downturn in the producer countries	1985 – 1986, 2013 – 2014	Global growth expectations, surplus production (oil)	Moderate	20%
ER#7: A new crisis in Europe post-Brexit	Sovereign crisis or widening sovereign spreads	2011 – 2012	Political dissension following the Brexit negotiations	Moderate	20%
ER#8: Liquidity crisis	Financial crisis	2008	Sales of illiquid assets (credit, bonds)	Moderate	20%
ER#9: The coming to power of parties that are hostile to Europe	Tensions in Europe, expectations of the disappearance of EMU …	No precedent	Political dissension in Europe, depreciation of the euro, deterioration of sovereign spreads, increase in volatility	Moderate	20%

What are the macro-hedging strategies?

Redesigning/implementing macro-hedging strategies is necessary because the new extreme risk factors referred to above are all potential generators of a major crisis. It is worth recalling that over the course of the past two years, we have heard some alarm bells in all these themes: China changed its exchange rate regime and caused the yuan to depreciate, Brexit laid bare the weaknesses of the UK and Europe (the former had no Plan B and the latter no unity); even

though the first alarms were raised in 2015 (European crisis, the Fed, China, the yuan, emerging markets, commodities prices, liquidity, volatility), commodity prices plunged and the low liquidity of some markets (regarded as liquid) were the subjects of a good deal of commentary… In short, some risks were well-identified early on but the fact that the probabilities associated with them are low should not give us any reassurance. The probabilities of occurrence are hard to quantify but this is not the main point: the consequences of such risk scenarios are so severe that asset allocation and macro-hedging activities should take them into consideration. Our recommendations are as follows:

Increasing long-term exposure to US Treasury bonds and German Bunds makes sense in terms of protecting the portfolios from risks 3, 4, 5, 6, 7, 8 and 9. The ultimate safe haven, there should be strongly negative correlations with the equity markets in the event of a crisis.

Going long on volatility makes perfect sense, particularly in scenarios 2, 3, 4, 5, 8 and 9. We can go long on volatility by creating a diversified long-volatility portfolio (several currencies, including EMG currencies and/or currencies + equities), naturally choosing the lowest volatilities (and the most liquid vehicles). Volatility swaps and variance swaps, which deal in actual volatility, and Forward Vol. Agreement, which deals in implied volatility, or investing in structurally long volatility funds, are the products generally used to buy volatility. Buying equity volatility or currency volatility will provide more protection than buying fixed-income volatility, particularly in Europe and Japan, where the bond markets are administered and would continue to be so in the event of a financial crisis.

Increasing the liquidity of portfolios is in line with risks 2, 3, 4, 5, 7, 8 and 9. This is a natural and legitimate response, except that returns are nowhere near where they should be, and even less so today (with negative interest rates) than a year ago. Favour USD cash over EUR or JPY cash.

Going long on the USD is especially useful in scenarios 3, 4, 5, 6, 7 and 9. During a crisis, the dollar benefits from being a safe haven, which makes it a countercyclical currency (which moves against the equity markets).

Going long on the JPY in scenarios 3, 5 and 6. Like the dollar, but to a lesser degree. The fact that it is still somewhat under-priced could prove to be a valuable asset.

Buy gold in scenarios 2, 3, 4, 5, 7, 8 and 9. With volatility, gold is undoubtedly, in any panic phase, financial crisis, debt crisis or liquidity crisis the ideal macro-hedging instrument. It is indeed the only risky asset class – among US equities, private equity, real estate, hedge funds, and commodities – that rose during the Gulf War, the LTCM failure, 11 September 2001, the 2002 recession, the Great Recession, and the sovereign debt crisis, which truly sets it apart as an asset. It represents a debt to no-one (unlike bonds or equities) which, against a backdrop of a high-debt economic and financial crisis, is undoubtedly extremely valuable.

The probabilities of occurrence are still hard to quantify but this is not the main point: the consequences of these risk scenarios are so severe that asset allocation and macro-hedging activities should take them into consideration

With volatility, gold is undoubtedly, in any panic phase, financial crisis, debt crisis or liquidity crisis the ideal macro-hedging instrument

Conclusion

Overall, maintaining an overweight stance on emerging market assets (equities, bonds and currencies) in credit (vs. government bonds) still makes sense, while continuing our search for yield and spreads. Similarly, “alternative” and “real” assets still look attractive from a diversification and yield standpoint.

However, there is no denying that the negotiations over Brexit, China’s policy (economic policy, but especially exchange rate policy and capital account opening policy), the limitations of monetary policy or the prospects for a change in the direction of budgetary and fiscal policies, the change in leadership in the United States and the forthcoming elections in Europe are likely to bring about meaningful change in current trends.

- Negotiations on the practical aspects of Brexit are expected to weaken the pound and undermine the UK’s growth potential, prompting the Bank of England to maintain accommodative monetary policy for a long time to come.

These negotiations could also substantially weaken European cohesion, which is not particularly good news in an election year.

- The US elections pave the way for budgetary and fiscal stimulus which is likely to have an impact on the dollar and fixed income markets, as well as the election debates in Europe. This change in trend on the other side of the Atlantic is a form of disinhibition towards budgetary stimulus measures, or even towards populist themes.
- The elections in Europe will open against the backdrop of a change in leadership that has started in the United Kingdom and the United States. The increase in proponents of a more expansionary budgetary and fiscal policy, as well as some forms of protectionism (goods and people) is an established fact. What some call populism also goes hand-in-hand with a rejection of the establishment and, in the case of Europe, a rejection of EMU, the euro and the political constraints (loss of sovereignty) that accompany it.
- So far, the financial markets have given *carte blanche* to the central banks, with QE and lower interest rates working towards financial stability (synonymous with low volatility), greater safety for government debt and low funding costs for businesses. However, the central banks have done the maximum possible (they certainly outdid themselves in the area of interest rate levels), and the growth and employment pictures remain disappointing overall. Resorting to budgetary and fiscal policies alters the long-term outlook for interest rates, but only if QE is halted, which does not enter into our prognosis. Anticipate spikes of volatility nonetheless.
- As has been the case for more than a decade, China remains a major source of concern. Capital account opening continues, and the economic situation (real estate and credit bubble, risk of a hard landing, capital outflows, etc.) is not really that reassuring, even though growth has been steady for three quarters now. However, the improved health of the emerging market economies is a guarantee of stability that cannot be ignored, even if, at the first stage, there is a good reason for the change of leadership in the United States to destabilise these markets.

2017 indeed seems to be a pivotal year for the financial markets, especially for long-term interest rates.

The negotiations over Brexit, China, the limitations of monetary policy, the prospects for a change in the direction of budgetary and fiscal policies, the change in leadership in the United States and the forthcoming elections in Europe are likely to bring about meaningful change in current trends

Central scenario and alternative scenarios: Amundi's forecasts

ONE-YEAR FORECASTS						
	Current level	Central scenario	Risk scenario 1	Risk scenario 2	Risk scenario 3	Optimistic Scenario
		World GDP growth stable at around 3%	Sharp slowdown in Europe	Hard landing in China	US growth significantly down	Stronger world growth
FX						
EUR/USD	1.08	1.1	1	1.2	1.25	1.15
USD/JPY	109	110	100	95	95	115
EUR/GBP	0.86	0.9	1	0.9	0.9	0.9
USD/CNY	6.87	7.2	7.2	7.6	7.2	7
USD/BRL	3.43	3.4	3.4	3.8	3.5	3
MONEY MARKETS						
Euribor 3 Mth	-0.31	-0.30	-0.50	-0.50	-0.4	-0.2
Eurodollar 3 Mth	0.91	1.4	1	0.25	0.25	1.9
FIXED INCOME						
2 Yr US	1.01	1.50	0.90	0.20	0.20	2.00
2 Yr JPY	-0.18	-0.40	-0.40	-0.60	-0.5	0
2 Yr GER	-0.64	-0.60	-0.80	-0.90	-0.7	-0.2
2 Yr GBP	0.21	0.10	-0.30	0.00	0	0.5
10 Yr US	2.26	2.30	1.70	1.00	1	2.8
10 Yr JPY	0.01	0	0	0	0	0
10 Yr GER	0.23	0.30	-0.30	-0.30	-0.2	0.8
10 Yr GBP	1.39	1.50	0.50	0.80	0.8	2
10 Yr spread France	50	30	70	50	50	20
10 Yr spread Italy	173	130	250	150	150	80
10 Yr spread Spain	122	100	250	150	150	80
INVESTMENT GRADE						
Spread IG Europe	116	70	230	200	180	60
Spread IG US	135	100	130	230	230	80
HIGH YIELD						
Spread HY Europe	402	330	800	600	500	300
Spread HY US	494	380	500	700	900	300
EMERGING MARKET DEBT						
Spread JPM EMBI Global div	358	370	450	530	500	310
EQUITIES						
MSCI EMU	189	200	160	150	140	220
MSCI US	2061	2150	1890	1750	1670	2250
MSCI Japan	842	880	720	660	660	970
MSCI EM	839	900	780	600	650	1000

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Central scenario and alternative scenarios: Amundi's expected returns

ONE-YEAR EXPECTED RETURNS					
	Central scenario	Risk Scenario 1	Risk Scenario 2	Risk Scenario 3	Optimistic scenario
	World GDP growth stable at around 3%	Sharp slowdown in Europe	Hard landing in China	US growth significantly down	Stronger world growth
FX					
EUR/USD	1.85%	-7.41%	11.11%	15.74%	6.48%
USD /JPY	0.92%	-8.26%	-12.84%	-12.84%	5.50%
EUR/GBP	4.65%	16.28%	4.65%	4.65%	4.65%
USD/CNY	4.80%	4.80%	10.63%	4.80%	1.89%
USD/BRL	-0.87%	-0.87%	10.79%	2.04%	-12.54%
MONEY MARKETS					
Eurodollar 3m	1.16%	0.96%	0.58%	0.58%	1.41%
Euribor 3	-0.31%	-0.41%	-0.41%	-0.36%	-0.26%
FIXED INCOME					
2Y Germany	-0.72%	-0.34%	-0.15%	-0.53%	-1.47%
2Y US	0.06%	1.23%	2.59%	2.59%	-0.91%
2Y UK	0.39%	1.05%	0.55%	0.55%	-0.28%
2Y JPY	0.25%	0.25%	0.65%	0.45%	-0.54%
10Y Germany	-0.40%	5.02%	5.02%	4.12%	-4.93%
10Y US	1.88%	7.30%	13.63%	13.63%	-2.64%
10Y UK	0.36%	9.36%	6.66%	6.66%	-4.14%
10Y Japan	0.06%	0.06%	0.06%	0.06%	0.06%
10 Y France	2.03%	4.00%	5.98%	4.99%	-1.93%
10Y Italy	5.38%	-0.27%	9.14%	8.20%	5.38%
10Y Spain	2.82%	-5.63%	3.76%	2.82%	0.00%
INVESTMENT GRADE					
Investment Grade Euro	3.09%	-3.39%	-1.77%	-0.20%	0.90%
Investment Grade US	5.05%	2.87%	3.98%	3.98%	3.03%
HIGH YIELD					
HY Euro	4.57%	-14.68%	-7.51%	-7.10%	4.39%
HY US	7.84%	-2.99%	-7.40%	-14.18%	8.70%
EMERGING DEBT					
JPM EMBI Global Diversified	4.78%	2.86%	2.20%	4.18%	5.44%
EQUITIES					
MSCI EMU	8.1%	-12.9%	-18.1%	-23.4%	18.7%
MSCI US	5.61%	-6.92%	-13.66%	-17.51%	10.43%
MSCI Japan	5.99%	-12.96%	-20.07%	-20.07%	16.66%
MSCI EM	9.55%	-4.71%	-26.10%	-20.16%	21.44%

Risk Factors

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The table below presents 16 risk factors with probabilities assigned. It also develops the most credible market impacts.

[RISK # 1] **The perception of a significant change in the US policy-mix** [PROBABILITY] **60%**

ANALYSIS The US elections resulted in a victory for D. Trump, who will be the 45th President of the United States. This election undoubtedly represents a great change in the philosophy of America, less determined now by a logic of «world policeman» and more self-centred, according to D. Trump's statements. Beyond this major inflection, the question is also now whether economic policy will be strongly altered, notably through fiscal and tax policy. How will monetary policy accompany these changes? These are all crucial questions. We know that tax cuts and a revival of infrastructure spending are planned, and that the impact on the budget deficit can be very high, with the usual consequences on long rates, public debt... and monetary policy. We also know that the American Congress (even if it is a Republican one) will not unconditionally back the new president on these subjects: it is indeed not favourable to large budget deficits. Having said that, even if the changes remain moderate with regard to the campaign promises, not betting on significant changes would undoubtedly be a mistake.

MARKET IMPACT The victory of D. Trump brings uncertainty on many points: its international role, NATO, trade agreements, climate agreement, anti-migrant policy, trade policy, protectionism and possible tariffs ... Its future actions represent an additional risk for the financial markets (notably on the dollar, ambient volatility and long rates). The risk of a major shift in economic policy, leading to a widening of deficits, is not marginal at this stage, especially since it will take more than two months before These questions (taking office on 20 January, and then discussions with the Congress).

[RISK # 2] **Italy: referendum and electoral law: two ingredients for an upcoming political crisis** [PROBABILITY] **20%**

ANALYSIS Italy will hold a referendum on 4 December. Voters will be asked whether they approve of amending the Italian constitution to transform the current Senate of the Republic into a Senate of Regions, composed of 100 senators mainly made up of regional councillors and mayors. Even if the Trump's victory could help to the victory of the no to the referendum in Italy (an additional disinhibition of the populism, as well as the movement of rejection of traditional political parties and establishment), there are four possible scenarios:

- **A vote in favour of reform (this is not what the polls indicate at the moment), and Matteo Renzi stays in office as prime minister.** Without a doubt, this would be the best-case scenario: there is no political crisis, the government is stable, reforms continue, and European countries are satisfied. But he will have to win the general elections of February 2018, which is far from certain. In any case, in the event of a tight victory (which would be the case), the prospect of general elections would weigh on the Italian context. Moreover, at the end of the mandate, it would be impossible to change the electoral law (and reintroducing, for example, proportional voting).. Recall that this law allows the winner of general elections not only to gain investiture for the being prime minister, but also a comfortable majority in the Chamber of Deputies. The lack of agreement between the right-wing and left-wing traditional parties (and / or the poor deferral of votes between these parties) could well favour the takeover of the «Five Star» populist party (in Italian "Movimento 5 Stelle" or "Cinque Stelle", or "M5S").
- **A vote against reform, and Matteo Renzi stays in office as prime minister,** two events that were completely incompatible less than two months ago, because the Prime Minister had himself announced his resignation and the end of his political career if the referendum were rejected. He has since reconsidered, because his fate does not have to be tied to a Senate reform, and also, probably, after discussions with his European partners (Germany and France in the lead), who want to keep a quality front man like Renzi (constructive and reform-minded), despite its low popularity in Italy in place. Polls currently give a "no" victory to the referendum.
- **A vote against reform, Renzi steps down, and a new technical government (or a coalition government) is put in place:** an unpleasant scenario, because the new government would probably see it as their mission to put constitutional reform first. Italy downplaying new reforms and beating a political retreat would be harmful.
- **A vote against reform, Renzi steps down, and preparations are made for another round of general elections:** this is clearly the worst-case scenario, which could initially lead to a political instability / crisis and certainly lead to a period of stoppage for reforms and, secondly, to a new majority. It should be recalled that the general elections, initially scheduled for February 2018 would then be advanced, and that the probability of seeing the populist party «Five Stars « prevail in Italy this time (to constitute a government with a parliamentary majority) would be high. The electoral law favours the winner of the elections by giving him a parliamentary majority indeed.

We cannot make any predictions about the way the people will vote. We can only rely on the polls. But how reliable are they? The British referendum (Brexit) and the US elections showed, if necessary, the weakness of the polls or the inability to capture the "hidden votes" (not reported in the polls) and the rejection rates of the candidates of the traditional parties. The rise of

Risk Factors

populism (which is synonymous with rejection of the establishment, rejection of political parties, rise of protectionism, rejection of globalization, anger against rising inequalities, refusal of centralization, hostility to reforms of social systems...). A reality that is easy to identify in lots of countries. A rejection of the Italian referendum is likely, but it does seem to us that the likelihood of Matteo Renzi staying in office is high whatever the outcome. **However, the real problem of Italy is not necessarily the coming referendum, but rather the electoral law, likely to tilt the political landscape on a single election (in February 2018 or earlier in case of early elections)** ... this would represent a major change after 5 years of political stability.

MARKET IMPACT Renzi's resignation (which would bring about new elections) would trigger a period of political instability, or potentially even crisis. It would be very bad news for a country that is lagging behind in terms of economic growth (particularly in comparison to Spain, its "comparable" on the markets). Nonetheless, its debt is protected by the ECB and continues to attract investors (seeking yield and spread). A political crisis would strongly weaken its equity and bond markets.

[RISK #3] Misinterpretation of the Fed's intentions... or misjudgement by the Fed [PROBABILITY] 30%

ANALYSIS The election of D. Trump blurs the messages a little: it is doubtful that the new president confirms J. Yellen for a second term in 2018, and it is also known that he criticized the "complacency" of monetary policy. It is difficult to understand the message: how to have at the same time stronger growth, a weaker dollar and a more restrictive monetary policy? A misinterpretation of the intentions / decisions of the Fed was already a major risk factor. Since the elections, the situation has gotten worse. With GDP growth of around 2%, inflation close to 2% and a full-employment situation, the Fed funds rate should be, in a normal cycle, much higher than it is today. The Fed is technically «behind the curve». But this is all the more true given that, in half of cases (six out of the last 12 times), since 1945, monetary tightening cycles have been followed by a US economic recession within two years. This is undoubtedly what the market is fearing in the event that the Fed moves too quickly and, in particular, too strongly. For the moment, the Fed remains cautious. It is well aware that growth levels and the current cycle have not up until now warranted a significant increase in rates, and, that the reversal of an ultra-accommodating monetary policy that has been in place for eight years carries more importance than usual. In the Fed's case, it is looking to keep the dollar from appreciating (the Fed's models show that a 10% appreciation in the real effective dollar is equivalent to 175 bp in monetary tightening). Inflation indicators are now close to the Fed's target, and the US central bank (J. Yellen and S. Fisher) has for several months prepared the markets for monetary tightening, by the end of the year. This may happen, but beware: Over the last few weeks, long-term rates have risen again, and since the election of D. Trump, expectations of rate hikes have been postponed. The Fed must avoid any communication errors. Markets could react poorly if rates are increased prematurely, excessively or without a sound rationale, or in case of an important surprise.

MARKET IMPACT If the Fed fumbles, we will have to count on a sharp downturn in equities and on contagion into the emerging markets, which have already been weakened. Such a situation would widen spreads and rates between Europe and the US, and further weakening the euro, two arguments in favour of European risky assets.

[RISK # 4] A «hard landing» for China / the credit bubble bursts [PROBABILITY] 20%

ANALYSIS China's business model has changed in the past decade. Growth is not as export-led as it used to be, and domestic demand has become the key driver for growth. Such an evolution has some drawbacks: there are signs of excessive lending, debt is ballooning, industrial competitiveness has eroded and productivity gains are falling. In simple terms, potential growth is down. The question is not whether future and potential growth will be lower. That is already a given. Rather, it is whether growth risks falling sharply (and far) below its potential (5% at present vs. 10% 15 years ago). In other words, will China experience a large-scale economic crisis? A more severe contraction of Chinese growth would add to an already long list of global deflationary pressures. The most recent indicators have reduced this risk, with annualised GDP growth stabilising around 6.7% for the last three quarters. The introduction of 45% tariffs (as D. Trump promised during the campaign) would be conducive to the initiation of this negative spiral, but we do not believe at all in the adoption of a such a measure.

MARKET IMPACT Such a scenario would have a very negative impact, and its cascading effects would be especially disastrous: vulnerability in the banking systems, vulnerability in the financial system, vulnerability from China's public and private debt, impact on commodities and emerging countries, impact on the currencies of commodity-exporting countries, advanced countries, and emerging countries… The Fed would cut its «tightening cycle» short, and the ECB would pursue its QE.

[RISK # 5] Collapse of global growth [PROBABILITY] 15%

ANALYSIS A hard landing by the Chinese economy would mean a plunge in global growth, but other circumstances are possible. The continued decline in commodity prices and global trade, an excessively restrictive US monetary policy, and the structural weakness of European economic activity are all stirring fears of a decline in global growth. Until now, the slowdown in the emerging world has been a tangible reality, while the «advanced» world has been moving forward for four years now. Another slowdown in the "advanced world" could come from the secondary effect of the EMG countries (drop in exports), another dip in investment, jobs… in short, from domestic demand, at present the key driver for growth.

Risk Factors

MARKET IMPACT Putting aside the use of expansionist economic policies (especially the fiscal policy), we may fear the return of a currency war, among the emerging countries on the one hand, and between the advanced and the emerging world on the other. Expect a dramatic underperformance by risky assets, equities, and credit.

[RISK # 6] A recession in the United States [PROBABILITY] 20%

ANALYSIS We expect growth of 2% in 2017 (vs. 1.6% in 2016), followed by a slight acceleration in 2018 (2.2%). Growth is therefore likely to remain slightly above its potential over the next two years. At this juncture, a recession in the United States is not a possibility, but the Fed's lack of room to manoeuvre is worrying. The current situation is totally different from 2004-2006. Over those two years, the Fed managed to hike interest rates 17 times—a total of 400 basis points—giving itself leeway, which it was quick to use once the financial crisis hit. Today that context is very remote. The Fed is behind in its economic cycle and financial stability, and to a lesser degree the US dollar, cannot afford such interest rate hikes. What is also worrying is the uncertainty about the future economic policy. The analysis and quantification of D. Trump's campaign program leads to the anticipation of a recession : protectionism (and impact on Mexico and China in particular), anti-migrant plan (with a reduction in the labor force and the population, as well as an increase in the cost of labour), renegotiation of commercial treaties, etc. While this program is unlikely to be adopted as it stands, the uncertainty that is opening up is not favourable to the short term growth.

MARKET IMPACT A recession in the United States would be catastrophic for the global economy, and Europe, despite being in better health, would not be spared the impact. Short rates would remain low for a very long time and the Fed, with no leeway in terms of conventional monetary policy, would have no choice but to go ahead with QE4. Do not expect a positive impact on risky assets. The initial impact will be negative, and the lack of credibility of central banks would certainly add volatility and stress. Expect further, and substantial, budget imbalances.

[RISK # 7] Sharp devaluation of the yuan [PROBABILITY] 10%

ANALYSIS For a few days in the middle of August 2015, China gave the impression that it was abandoning its exchange rate policy, preparing the markets for a major depreciation of the yuan (in 1994, it devalued the yuan by 30%). These same fears reared their heads again in early January. Until now, China has used monetary policy, budgetary policy, fiscal policy, and revenue policy as stimulus tools, careful not to use the exchange rate policy. Moreover, it promised the G20 it would not, and the yuan is now part of the SDR (and has been since 1 October). In 2016, China amended its foreign exchange system, and it is managing a gradual depreciation of the yuan. The implementation of a protectionist policy in the United States would be fatal, the Chinese authorities would be incapable and unwilling to pursue this FX policy, especially since the yuan is not notably undervalued. Beyond the very negative immediate consequences on the financial markets, an abrupt devaluation (of at least 10% in one day) would, without a doubt, be interpreted as an admission of weakness in terms of the economic policy as a whole. A very low risk, but with potentially very great harm, because China's top challenge now is opening its capital account: attracting international investors means accepting a less-independent monetary policy, a more volatile exchange rate, different rules between the onshore market and the offshore market, more volatile capital flows, less easily administrated markets that are more dependent on international investors, greater transparency on the state of businesses, and, specifically, State-owned businesses… in short, a fairly radical change in governance. A strong devaluation of the yuan would be a very bad decision.

MARKET IMPACT In this type of scenario, expect a widespread downward movement in the markets. A surprise devaluation would be the start of a more intense currency war, especially in Asia. Monetary policies would become extremely accommodating to keep currencies from appreciating. A blow to the euro, and to the European economy, because EMG currencies make up more than 70% of its effective rate.

[RISK # 8] Continued slowdown in the emerging economies (commodity prices fall again) [PROBABILITY] 20%

ANALYSIS Falling commodity prices, the dip in Chinese growth, and the coming shift in US monetary policy are all factors that, over recent years, have raised fears of a repeat of the 1997-1998 crisis (when emerging markets collapsed across-the-board). We should remember that emerging markets have been under stress since the US ended its QE programmes. Asia had been able to withstand that stress, driven by the strength of the Chinese economy and its ability to curb difficulties, and because it is essentially a commodity-consuming zone. Corporate defaults and leading activity indicators have occasionally put the markets on high alert, but the resources brought to bear by Chinese officials (cuts in interest rates and in mandatory banking reserves, injection of liquidities, fiscal and tax measures, maintaining currency policy, etc.) ultimately put everything right. The risk is that domestic demand will unravel and economic policies will become completely ineffective. This risk has nevertheless declined during recent months: the rise in oil prices (increased cohesion at OPEC) and the influx of capital (except for China) have, in particular, given these markets fresh colour.

MARKET IMPACT Even though the drop in oil prices is, and has been, a plus for commodity-consuming advanced countries, it is hard to believe that these countries would be totally isolated. With the decline in commodity prices, we should count on the continued decline in EMG currencies as well as capital flows out of the EMG. Choose asset classes from the advanced countries, and safe havens.

Risk Factors

[Risk # 9] The post-Brexit issue weakens the United Kingdom in a lasting way [PROBABILITY] 50%

ANALYSIS *"Brexit means Brexit, and we're going to make a success of it»*. Such was Theresa May's position on the day she was appointed Prime Minister. *«There will be [...] no second referendum,»* she added. *«There must be no attempts to remain inside the EU, no attempts to re-join it through the back door, and no second referendum. The country voted to leave the European Union, and it is the duty of the Government and of Parliament to make sure we do just that.»* We now know a little more: the Prime Minister has announced that Article 50 will be triggered in the first quarter of 2017. According to estimates, the impact on the GDP would be significantly negative. The UK could "lose" between 2.5% and 9.5% of its GDP. Trade volume and costs would be affected, specifically in financial services, chemicals, and automobiles, all sectors that are highly integrated in the EU. The risk for the UK resides in its future capacity to trade freely on the single market, to acquire the desired independence without the EU's constraints. It seems unlikely, and in any case that is what is at stake in the negotiations that will begin no later than the second quarter of 2017... and that could last two years (to find out more, read our report, «*Post-BREXIT in a few questions and answers*», Cross Asset Investment Monthly Strategy, Amundi, July 2016). Let's be clear (fair) though: it is currently very difficult to say what will happen and even to be sure that the Brexit will really happen. The lack of any contingency plan in the UK, the lack of negotiations between the UK and the EU countries (pending the activation of Article 50), and the nature of the debate (which opposes pragmatists to ideologists of the Brexit) make the situation rather confused. Do not rule out holding a new referendum in one year.

MARKET IMPACT In such a case, we would expect additional weakening of the pound sterling and long-term GDP of the British economy, two factors that could prolong the monetary status quo. Without a doubt, we would also see increased fragility in eurozone financial assets.

[Risk # 10] A new European crisis tied to Brexit [PROBABILITY] 20%

ANALYSIS Brexit is unlikely to impact the EU too much, from a purely economic standpoint. Hardest hit would be those with close ties to the UK, especially Ireland, but also Luxembourg, Belgium, Sweden, Malta, and Cyprus, if we look at the nature of exports, direct investment flows, and the financial sector. The risk is primarily a political one: that other European countries might extol a Europe "à la carte," and/or demonstrate deep divisions in terms of how to handle the UK's exit. The European institutions are regularly showing their limits because the "dogma of convergence" did not prepare them for such risk scenarios. The task was to respond to challenges like Europe's governance deficit, the lack of coordination in budgetary policies, the failure of supervision of budgetary imbalances, competitiveness gaps between countries, the unfinished nature of the mechanism meant to support countries facing difficulty and the failure to appreciate the interdependence of member states (while the ECB's anti-contagion mechanism has evolved significantly, the same cannot be said on the budgetary front). The recent UK referendum has added a new layer of uncertainty. Managing the UK's exit from the EU is akin to managing the most complex divorce in history. One thing is sure: this is an important test of Europe's capacity to (once again) manage a crisis, convince Europe that there is a plan for it, and remove any attempts at a Europe "à la carte" that could pop up here or there in the EU. A new European crisis, if it were to occur, could be fatal, unless there is a (highly unlikely) great leap towards federalism. Note that negotiations with the UK will come right in the middle of an election year in France and Germany, which is most certainly not an ideal political configuration. It will be necessary to reconcile the Europeans with the European idea, and in particular to reassure the Eurosceptics. It will not be easy. Before the Brexit and before the US elections, the European situation was already complicated.

MARKET IMPACT The negative impacts are all too well known: widening of sovereign and credit spreads, rise of volatility—only this time it would certainly be accompanied by a severe weakening of the Euro. A new European crisis could very well confirm the scenarios of the zone breaking apart, or, at the very least, the weaker countries exiting it… unless the exit scenario tempts the most solid of them, which is highly plausible, because they will end up becoming tired – from a political standpoint – of economically and financially supporting the struggling countries.

[Risk # 11] Greater financial instability [PROBABILITY] 40%

ANALYSIS Action by central banks has enabled financial stability to return. Lower short- and long-term rates, reduced volatility and tighter credit spreads are all factors that have generated an environment of greater stability. However, beware. This stability has a contrived aspect that should not be underestimated. Central banks cannot resolve all of the problems by themselves (jobs, investment, growth, etc.) and, if the current conditions do not improve more significantly, a certain level of disillusion/disappointment may well set in, which could in turn become a source of instability. Moreover, monetary policies have reached their limits, both negative rates and QEs, and it is quite difficult to expect any more from them. The macroeconomic response would eventually come from fiscal and tax policies, and, traditionally, public spending has far fewer stabilising virtues for the financial markets than lower interest rates.

MARKET IMPACT Greater financial instability would lead to a rise in volatility and credit spreads, particularly in Europe, where the labour market is weaker and the political and social risks are greater.

Risk Factors

[Risk # 12] Liquidity crisis [PROBABILITY] 20%

ANALYSIS Aside from the risk scenarios outlined above, which could lead to the liquidation of positions and/or portfolios, it is worth recalling once again that the prevailing liquidity constraints call for additional caution. Since the 2008 financial crisis, the decline in investment banks' inventories, the regulatory constraints that have led major players to buy and retain large volumes of bonds, the reduction in proprietary trading and market-making activities and the domination of central banks through QE programmes have all "drained" the fixed-income markets, and closing a position or portfolio now requires more time (seven times longer than before the financial crisis of 2008 if we are to believe the Bank of England). Even though bid-ask spreads have tightened since the financial crisis (due to the drop in interest rates), tradeable volumes are down sharply, as is the speed of execution, two major reflections of liquidity—or the absence thereof. Remember, the less liquid the markets are the less prices reflect fundamentals, the more they can be manipulated, the higher the risks of contagion are, the higher and more unstable volatility is, and the lower their capacity to absorb shocks. Not exactly reassuring.

MARKET IMPACT This needs to be incorporated into investment decisions and should be taken into account in portfolio-building constraints and stress tests. Expect exit or macro-hedging plans for the less liquid portfolio segments or those that are likely to become less liquid in a crisis.

[Risk # 13] Banks collapse [PROBABILITY] 10%

ANALYSIS This risk seems highly exaggerated to us. Still, we are not optimistic: negative rates are penalising the banks, the high cost of capital reflects the weight of past crises, fears of a new crisis, uncertainty over regulation, and the difficulty for investors to discriminate against banks and against banking systems are the primary factors in the banks' underperformance – an underperformance that was amplified by the UK referendum precisely because it adds uncertainties over growth. Nor are we overly pessimistic. The banks of 2016 have nothing in common with the banks of 2008 or 2011: not only have they raised very large amounts of capital, but the ECB's anti-crisis system is now well-established, with banking supervision and stress tests. Moreover, the ECB's liquidity access facilities have drastically reduced specific risk and systemic risk for more than two years. However, it is easy to show the close link between the banks underperforming and long rates dropping into negative territory, and the question that arises is, in fact, how well the banks can contend with rates staying in negative territory. We do not anticipate a collapse, but rather continued pressures on profitability, increased by the issue of digitalisation, which is pushing the banks to reduce their debt and remain conservative on credit.

MARKET IMPACT Among the factors causing fragility, the inability to discriminate is no doubt the most concerning: Deutsche Bank, bad news on Italian banks, all of it causes waves of stress, widening spreads, and plummeting bank securities. No need to go into detail on the implications on financial stability or the economies if there should be any bank failures.

[RISK # 14] Geopolitical risks intensify [PROBABILITY] 70%

ANALYSIS Geopolitically, the markets are now operating against a difficult backdrop: Syria, Islamic State, terrorist attacks and migrant flows are some of the forces weakening diplomatic ties among countries, especially in Europe. The United States officially entered this debate with the election of D. Trump and the anti- migrants plan (11.3 million if one believes in its program) and construction of a wall on the Mexican border. Do not expect these ongoing problems and conflicts to be quickly resolved.

MARKET IMPACT There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are clearly identified and specific, but will this be enough to have zero impact on growth prospects or on the financial markets? Nothing is certain at this stage.

[Risk # 15] Political risks intensify (electoral calendar, populism, etc.) [PROBABILITY] 70%

ANALYSIS Politically, the markets are now operating against a very difficult backdrop. In 2017, many elections will be held, and some are especially important: general elections in the Netherlands in March 2017, presidential elections (23 April and 7 May 2017) and legislative elections (11 June and 18 June) in France, and general elections in Germany in the autumn of 2017. What's intriguing / concerning is the rise in extremist parties (far right-wing parties in Europe's hard-core countries, and far left-wing parties in the peripheral countries) and populism, which is reflected in protectionist, anti-immigration, and pro-public-deficit issues. Inevitably, some parties will be tempted by these issues, to please an electorate increasingly sensitive to widening inequalities and the tax burden. Historically, such policies (especially protectionism) generally result in phases of very weak (or no) growth and higher inflation. These phases of economic stagnation and strong public deficits inevitably lead to periods of recession and political and financial instability.

MARKET IMPACT The current political risks are clearly identified, but the prospect of major elections in Europe will lead to an increase in volatility and questions on the governance and future leadership of the EU. But will this have an impact on growth prospects or on the financial markets? The answer is yes.

Risk Factors

[Risk # 16] **A rise in European bond yields** [PROBABILITY] **30%**

ANALYSIS Since the financial crisis, expectations on long rates have always wrong. At best, the anticipated decline was too low ... but many have also believed that the resumption of growth in the advanced countries, with the United States in the lead was, with the rise in price indices, a good reason to anticipate a rise in bond yields. Underestimating the key factors such as - the fear of - secular stagnation, the role and impact of QEs, fiscal rigour in Europe (austerity), maintaining deflationary pressures ... In short, long rates not only continued to decline, but they have mostly entered into negative territory, driven by key negative short rates (Europe and Japan in particular) and impacting in the same way high-quality corporate bonds. The yield search in this ultra low or negative desert favoured three oases of spreads: emerging debt, private debt and high yield debt. What is the risk? The increase in long-term rates can come from five main sources: (i) a significant upturn in growth prospects, (ii) a reversal in interest rate policies, (iii) the end of QEs, (iv) a resurgence in inflation, or / and (v) a reversal of fiscal and fiscal policies. The first three are not materialized, the fourth is not yet a concern, only the fifth is gaining momentum in the United States... and it will undoubtedly impact the first four. This is why the current debate in the United States or in Europe on fiscal and tax policies is crucial for interest rates.

MARKET IMPACT The risk of bond yields rising significantly in Europe is lower for historical reasons and in view of the European constraints caution in the case of the United States: sensitivity to long-term interest rates has risen with the rise of releveraging of corporates (now at its historical high). It should also be noted that any rise in long-term rates is a hindrance to monetary policy and to the potential for higher interest rates.

Underlying Trends

Europe: a burdensome political uncertainty

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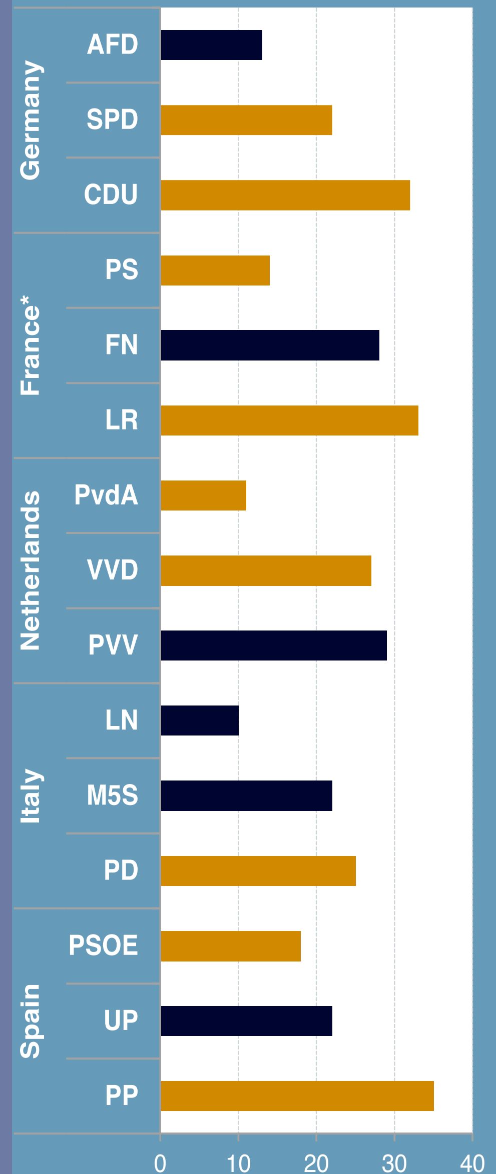
Important elections will be held at the end of 2016 and in 2017 in several major eurozone countries. A sluggish recovery, the refugee crisis and the terrorist threat (not speaking of the potential spillovers of the US presidential election) have increased the influence of populist and/or Eurosceptic parties and are making the situation of ruling governments all the more complicated.

In Italy, the referendum on the Constitution will take place on **4 December 2016**. According to opinion polls, Yes and No votes are very close, with a high undecided rate (30% of voters are undecided). If the Yes vote wins, it will reinforce the position of Prime Minister Matteo Renzi. If the No vote wins, the Italian President will either retain Matteo Renzi or appoint another leader from the Partito Democratico (PD). As the controversy on reform within the PD grows, the likelihood of a winning No vote increases. Either way, it is likely that the general elections, now scheduled for 23 May 2018, will not be moved forward. In fact, the rise of two populist parties on the extreme right, the Five Star Movement (M5S) and the Lega Nord (LN), which are polling just behind the PD in surveys, is a real threat. M5S repeated outpolled the PD until Matteo Renzi reoriented his social policy by advocating an anti-poverty programme and by setting up an anti-poverty fund.

Parliamentary elections in the **Netherlands** will be held on **15 March 2017**. For now, public opinion polls give Geert Wilders' party, the Party for Freedom (PVV), an extreme right-wing populist party, a lead over the current Prime Minister, Mark Rutte, who belongs to a coalition formed by the People's Party for Freedom and Democracy (VVD), a liberal/conservative party, and the Labour Party (PvdA). Mark Rutte is attempting to win back public opinion by redirecting his policy toward social and security issues and his budget, unveiled in September, reflects this. Should the PVV win, it will find it difficult to govern because the Dutch electoral system promotes fragmentation and will require the formation of coalitions, which the major parties refuse to do.

The first round of the presidential election in **France** will be held on **25 April** and the second on **7 May**. The Socialist Party (PS) and Les Républicains (LR) primaries are taking place now. The two leading parties running neck-and-neck in opinion polls are the LR and the National Front (FN). The PS is in third place but will urge voting for LR in the event of a second-round contest between the LR and the FN. For now, public opinion indicates that Alain Juppé is the preferred candidate to win the LR primary. At this time the LR platform does not seem to be influenced by the themes favoured by the FN (reinforcing national security, calling the European project into question, encouraging increased French birth rates, etc.), even though they agree on supporting SMEs. But the campaign season is only getting started. The inclusion of a few social reforms in the LR platform could boost its popularity, such as the restoration of the 39-hour work week, the sliding scale unemployment benefit system, or revising the permanent employment contract (CDI).

In **Germany**, general elections will take place in **September 2017**. Chancellor Angela Merkel, whose popularity has been sliding recently and who has suffered a number of setbacks in local elections, is likely to announce whether she will run for another term at the beginning of December. Opinion polls continue to give her party (CDU, centre-right) the advantage. However, any number of coalition governments are possible (even one without the CDU that would bring the SPD (the socialists), the far left and the Greens under the same umbrella cannot be ruled out). The Eurosceptic and anti-immigrant party, the AFD, will probably get into parliament but none of the historical parties are expected to agree to ally with them. However, in the event of a new crisis in the eurozone in 2018, the forthcoming elections and a rise in Eurosceptic



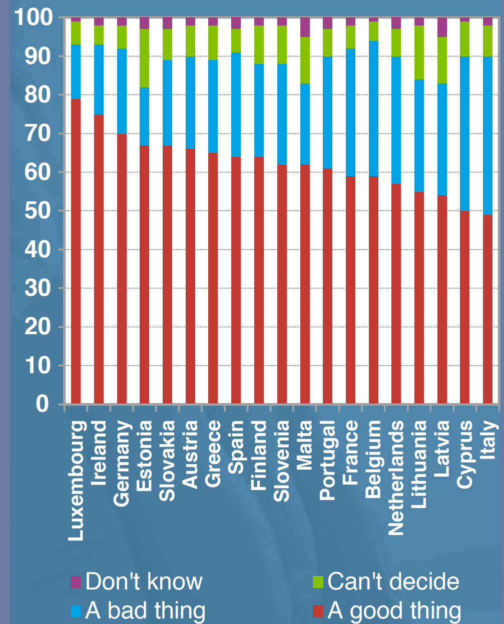
*Positions of the leading candidates in the primaries.
Source : Amundi Research

sentiment could complicate responses from the ruling Government (out of fear of an additional loss of popularity).

After 10 months of political crisis, Spain now has a minority government (thanks to the opposition Socialist party's decision to abstain rather than block its approval). However the government's capacity to pass difficult decisions into law without a majority in Parliament remains very uncertain.

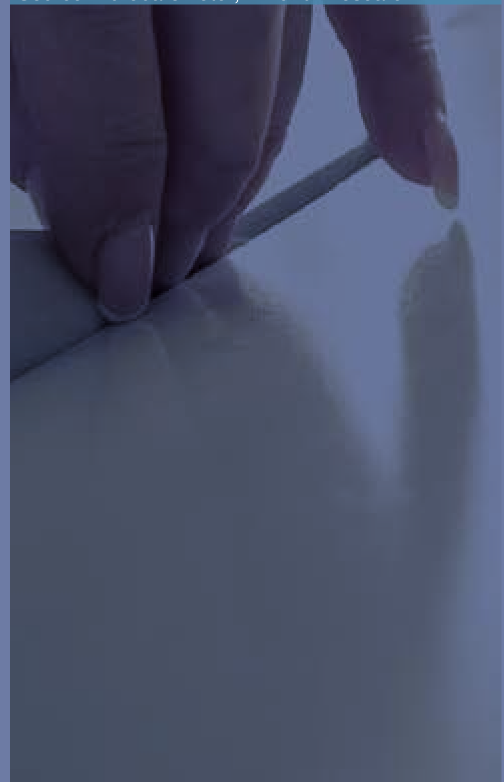
Lastly, the **Brexit** problem will linger throughout 2017 and perhaps beyond. The British government has announced its intention to trigger Article 50 of the Treaty of Lisbon by March 2017, which will initiate a 2-year countdown at the end of which the country will lose its status as a Member State. The deadline may be extended, but only with the unanimous consent of the other members of the EU. Taken at face value, the latest pronouncements by the British Prime Minister have increased the likelihood of a ***Hard Brexit*** (total divorce from the Single Market), with the UK taking full control of immigration flows (which the other Member States deem incompatible with access to a Single Market for goods and services). However, such pronouncements probably reflect the staking out of a position in preparation for negotiations with the dual aim of sounding tough on Europe and reassuring to the most Eurosceptic movements within Britain's Conservative Party. Lastly, it is not very likely that the British Government will sacrifice the interests of London as a financial centre, for which preserving the European passport for financial products and services is vital. In any event, a final agreement is very unlikely before 2018 and negotiations may continue well beyond then. The recent London High Court's ruling that the government must submit the activation of Article 50 to Parliament could also influence the timetable and content of negotiations.

Is having the euro a good thing or a bad thing for the economy ?



Source: Eurobarometer, Amundi Research

Italy 4 December 2016
Netherlands 15 March 2017
France 25 April - 7 May
Germany September 2017
Spain
Brexit



Macroeconomic scenario in 2017 and beyond

2 2017: a lynchpin year dominated by global reflation (United States, China) and political uncertainty

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For the 5th consecutive year global growth has remained close to 3% in 2016. This stability masks very different economic cycles within both emerging countries and advanced countries[1]. We anticipate that global growth will remain close to 3% in 2017 and 2018, without any significant acceleration, except in a few emerging countries coming out of recession and/or making good the activity lost during the fall in commodity prices (Brazil, Russia).

Weaker global growth can be attributed to both structural factors (slowdown in global growth potential, slowdown in world trade) and short-term factors (the fall in commodity prices at the beginning of the year has undermined producing countries, starting with the US). However, the dynamics are very different according to country. **In advanced economies**, the United States, which is at the «end of the cycle», will probably need to resort to fiscal policy in order to support growth by the year 2018. Within the eurozone, the cyclical recovery is still far from complete, just judging by the labour market: the unemployment rate is declining but is still well above its 2008 levels in many countries. **In emerging economies**, the fall in commodity prices since mid-2014 has adversely affected producers. However, as in advanced countries, economic cycles have significantly decorrelated from each other (domestic demand plays a dominant role).

Our 2017 scenario is based on six key ideas: (1) the expansion cycle continues in the major advanced economies but at a slow pace; (2) domestic demand remains the cornerstone of the economies (whether advanced or emerging); (3) the Chinese authorities manage to conduct an orderly slowdown of their economy in 2017 and 2018 despite increased vulnerability (property bubble, unsustainable private debt in the medium term); (4) The expansionary fiscal policy in the United States extends the cycle but has no impact before the end of 2017; (5) commodity prices stabilise at a slightly higher level than their current level ($55 for a barrel of Brent); (6) the rise in inflation related to the base effect is temporary and monetary policies remain very accommodative.

The outlook for 2018 will depend on governments' ability to re-balance their policy mix by resorting more to fiscal policy. We first develop a few very general characteristics of the global economic cycle before returning to look at the outlook for the major economies with more granularity.

1. World trade is no longer a growth driver[2]:

- **The weaker trade in 2016 (zero growth year-on-year in August) can be largely attributed to the fall in commodity prices from mid-2014 to the beginning of 2016.** The contraction was most marked in emerging countries. World trade in goods looks set to rebound in 2017 and 2018, underpinned by the continuation of the cycle in developed countries and the emergence from recession of a few major emerging countries. However, we cannot expect to return to the expansion rates of the 2000s.

[1] *It continues to be customary to make a distinction between advanced economies and emerging economies, even though the dividing line between the two is more and more blurred. The fragmentation within each of these two areas requires a granular examination in order to determine the outlook. Nonetheless, the distinction between "advanced" and "emerging" countries is still relevant when it comes to studying or assessing the overall picture of global growth (economy, potential growth, world trade).*

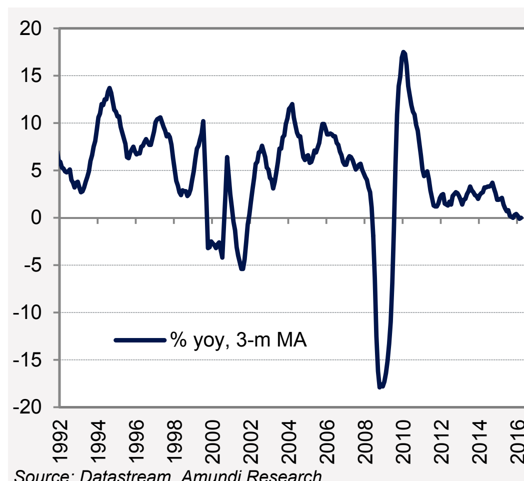
[2] *World trade has slowed significantly in recent years, with virtually zero growth in H1 2016.*

The essential

Our 2017 scenario is based on six key ideas: (1) the expansion cycle continues in the main developed countries but at a slow pace; (2) domestic demand remains the cornerstone of the economies (whether developed or emerging); (3) the Chinese authorities manage to conduct an orderly slowdown of their economy in 2017 and 2018 despite increased vulnerability (property bubble, unsustainable private debt in the medium term); (4) The expansionary fiscal policy in the United States extends the cycle but has no impact before the end of 2017; (5) commodity prices stabilise at a slightly higher level than their current level ($55 for a barrel of Brent); (6) the rise in inflation related to the base effect is temporary and monetary policies remain very accommodative.

We are expecting global reflation to continue and are forecasting global growth close to 3% in 2017 and 2018, without any significant acceleration, except in a few emerging countries coming out of recession and/or making good the activity lost during the fall in commodity prices (Brazil, Russia).

1 World trade (cst prices, % yoy)



Source: Datastream, Amundi Research

- **The slowdown in world trade is structural:** while it increased twice as fast as global GDP between the beginning of the 1980s and the great financial crisis (7% vs. 3.5%), its growth has been less rapid than the growth in GDP since 2011[3]. This represents a major break with the 30 years that preceded the Great Recession of 2008-2009. The rise in protectionist pressures can be partly attributed to the rejection of a globalisation that no longer provides the same benefits as in the past.

2. Global potential growth is slowing. The slowdown in productivity, that we observe globally, can be largely attributed to this trend. The ageing population is already having visible consequences, with a slowdown (or even a decline) in the working-age population in several countries. The origins of the weaker productivity are the subject of numerous debates (no more gains related to innovations, growing importance of low added value services in the economies etc.). While measurement problems are sometimes put forward as an explanation, it is nevertheless striking to observe that this slowdown affects countries whose productive structures and positioning in the cycle are very different, which militates for an explanation of a structural nature more than for a simple measurement problem. The weaker nominal growth potential has major consequences on the equilibrium level of interest rates and will mark the economic outlook of the decade to come[4].

3. The investment rate is stagnating. In developed countries, the investment rate in volume terms has stopped increasing, without having returned to its 2008 level. For the last few years, we have observed that it has also stagnated in emerging countries, where investment had nevertheless been more dynamic than in developed countries in the first few years after the great financial crisis. Despite very accommodative monetary and financial conditions and abundant savings, companies prefer (and it is striking in the US and eurozone) share buybacks and external growth operations (mergers & acquisitions) to internal growth operations. This choice seems to result from the few demand opportunities.

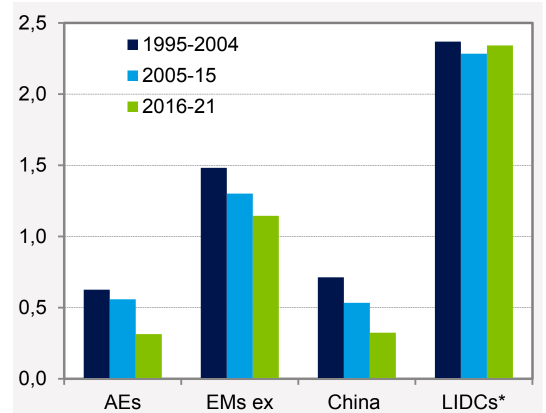
This trend - which is to the detriment of productive investment – casts doubts over the effectiveness of monetary policy. Corporate decisions may be justified at a microeconomic level but produce undesirable effects at a macroeconomic level. Therefore, when there is less investment, there will be less chance of seeing new innovations stimulate productivity. In other words, the weak investment today jeopardises tomorrow's potential growth and monetary policy is powerless to contain this phenomenon.

4. A gradual re-balancing of economic policy towards fiscal policy. In light of the ineffectiveness of monetary policy to kick start investment again, international organisations (IMF, OECD) as well as G20 governments have made the same diagnosis: it is necessary to re-balance the policy mix by resorting more to budgetary and fiscal policy[5]. The OECD has therefore called for use to be made of the room for manoeuvre provided by the reduction in interest expenses on debt (caused by the general decline in bond yields). The aim is twofold: it involves not only supporting global demand (and therefore ensuring new demand opportunities) but also improving productive supply by putting in place infrastructure programmes where they are needed (in the US and Germany for example) and/or by financing the energy transition. Public programmes must be designed so as to generate private investment spending in their wake.

While G20 governments agree on the principle of deploying fiscal policy, no concerted initiative is being studied. In the US, the divisions between

From now to 2018, the outlook will depend on governments' ability to resort more to fiscal policy

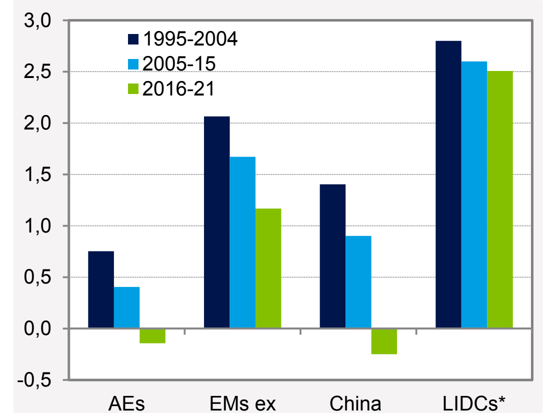
2 **Population growth (%)**



(*) LIDCs: Low-income dev. countries
Source: IMF, Amundi Research

The ageing population will continue to drag down potential growth

3 **Working-age population growth (%)**



(*) LIDCs: Low-income dev. countries
Source: IMF, Amundi Research

[3] *We do not consider the trends over the period 2008 to mid-2011 which are skewed by the collapse and the catching up effect that ensued. Since mid-2011, a new cycle seems to be underway.*

[4] *With as a major consequence seeing equilibrium interest rates remain very low.*

[5] *Wherever possible, without putting at risk the debt sustainability in the medium term, given that the deterioration in the public finances (deficit-to-GDP and debt-to-GDP ratios) is inevitable in the short term. Hence the importance of implementing structural reforms at the same time.*

Congress and the White House make the measures announced during the election campaign very uncertain. In the eurozone, the forthcoming general elections in France and Germany prevent any large-scale initiative next year. We will therefore have to wait until 2018 at best to see fiscal policy impact global economic activity.

5. Widespread reflation. But the inflation genie is not out of the bottle. The rise in commodity prices will result in a rise in inflation rates (expressed year-on-year), with a peak at the beginning of 2017: this is a simple base effect related to the rise in oil prices observed since the lows in February 2016. This base effect will diminish during 2017 with the stabilisation of oil prices which we anticipate. We have observed a concomitant trend towards reflation in some countries (China) in line with the gradual disappearance of excess capacity in some sectors. Moreover, in other countries nearing full employment, core inflation could pick up significantly (US and Germany) albeit from very low levels.

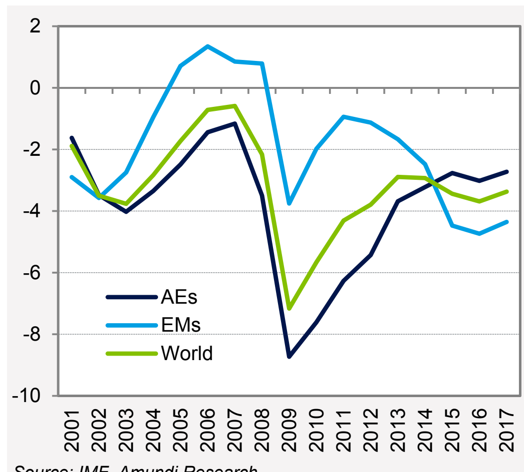
The rise in inflation is perceived to be desirable after years of excessively low inflation, well below central banks' targets. The connection between growth, unemployment and inflation has been profoundly altered: upward pressures on wages remain contained even in countries where the unemployment rate is low (US and Germany). Structural core inflation seems to have weakened considerably.

6. Economic cycles that are increasingly domestic and therefore increasingly autonomous. Since 2011, we have observed a negative correlation between the trade of emerging countries and the trade of developed countries, which had not happened during the last 30 years. This development, which should be viewed in the context of the slowdown in world trade, implicitly means that the domestic component of the economic cycle dominates. The «decoupling» between countries, which has already been underway for several years6, in reality concerns both developed and emerging countries:

- **Within developed countries,** the US is at the end of the cycle but this is not the case for eurozone countries. In Europe, growth in the UK is expected to slow substantially whereas the cycle looks set to continue for its eurozone neighbours (albeit at very different paces)
- **Within emerging countries,** growth remains robust in India whereas it is slowing in China. Brazil, Russia and South Africa have specific characteristics which far outweigh the fact that they are commodity producers. The outlook for Brazil remains gloomy whereas Russia is benefiting fully from the rise in oil prices.

Ultimately, economic cycles have become more autonomous with the increased importance of crucial domestic factors. This is good news for the stability of the global economy, even though it is naturally necessary not to forget that a deterioration in the economy of some major countries (United States and China in particular) is still liable to affect the overall global outlook.

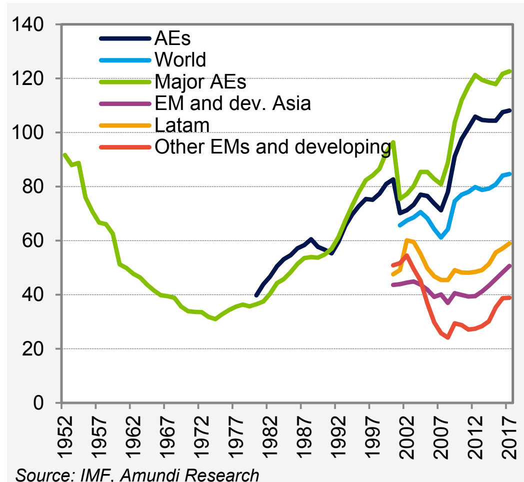
4 **Public deficit (% of GDP)**



Source: IMF, Amundi Research

> "Widespread reflation... but core inflation has weakened considerably"

5 **Public debt (% of GDP)**



Source: IMF, Amundi Research

[6] *The decoupling observed worldwide between surveys (PMI indexes) conducted in the manufacturing sector and those in the services sector confirms the "decoupling" narrative: manufacturing (the sector most exposed to world trade) is slowing but the services sector, by nature more dependent on domestic demand, particularly consumer demand, is slowing only slightly if at all.*

> Why is world trade slowing?

Despite numerous studies on the subject, the slowdown in international trade in recent years continues to raise many questions.

A slowdown that is hitting goods more than services.

Annual growth in the volume of goods traded fell from 9% between 2000 and 2007 to around 3% between 2012 and 2015, taking into account that annual volume growth in global GDP slowed from 4.5% to 3% between these two periods (so the relationship between the two, i.e. trade revenue elasticity has therefore fallen from around 2 to 1).

From a geographical perspective, this slowdown was not entirely synchronised between the developed countries (where the most severe slowdown coincided with the eurozone sovereign debt crisis in 2012, before giving way to a slight acceleration) and emerging countries (more affected in 2014-2015, notably because of the slowdown in China and difficulties experienced by commodity producers).

All categories of goods have not been impacted in the same way.

The slowdown has been particularly severe for capital goods, intermediate goods and durable consumer goods. Non-durable consumer goods have been less affected.

Services have also been impacted, but to a lesser degree: service volumes declined from 9.5% between 2000 and 2007 to 4.5% between 2012 and 2015 (a sharp slowdown, but they remain at a higher rate than global economic growth). Certain sectors have come out relatively unscathed, such as information and communication technologies and financial services.

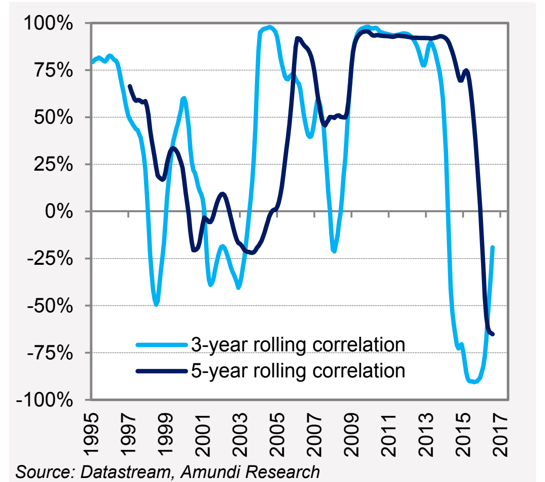
The slowdown in investment is the main culprit, but it is not the only one.

As to the reasons for the slowdown, the IMF, which covered the topic in its October 2016 *World Economic Outlook*, concluded that the primary cause is weak global growth itself, and insufficient investment in particular, which usually generates high international trade flows (this explanation is consistent with the fact that capital goods are particularly concerned). The other frequently-mentioned factor, a decline in the trend of international fragmentation of production processes (as illustrated by the weak level of trade in intermediate goods), is relevant also, but to a lesser degree. The impact of the rise in protectionism (or at least a resistance to any further free trade), although not ruled out, is further down the list.

Recent developments in certain trading activities may be underestimated.

Also of note (in particular perhaps) is that the IMF mentions the possibility that several services activities (including free services via new technologies) are being substantially underestimated by current measurement tools.

6 Correlation between EM's and AE's imports (at constant prices)



Source: Datastream, Amundi Research

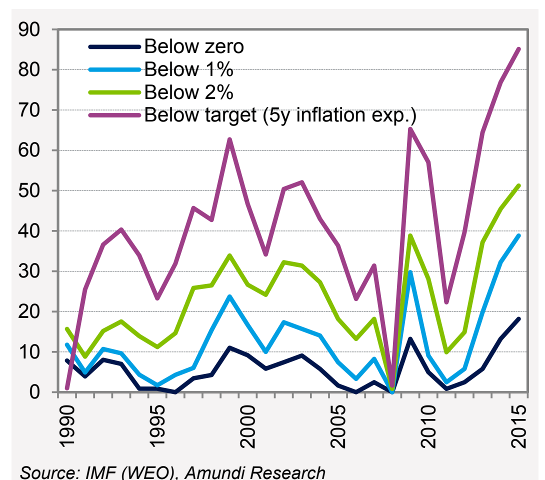
> "International trade has become a drag on global growth"

The US: expansionary fiscal policy will prolong the business cycle

Growth slowed sharply in H1 2016 before rebounding in the third quarter, driven by temporary factors (restocking, jump in agricultural exports). The fall in oil at the start of the year weighed significantly on the energy sector, whose contribution to the economy has grown significantly with the development of shale gas. Investment in capital goods and corporate earnings fell, the rate of job creation slowed, and wages saw little growth. Residential investment contracted, undoubtedly in conjunction with the political uncertainty linked to the presidential elections. By and large, consumption was the only factor keeping the economy afloat in 2016. However, it was not enough to offset the weakness of the other components of GDP.

In 2017 and 2018, household demand is expected to subside. Higher commodity prices are likely to weigh on household purchasing power in early 2017. At this stage in the cycle, it is highly unlikely that companies will be able to increase wages to offset the rise in energy prices. In fact, with the slump in productivity gains, unit labour costs tend to increase more rapidly despite wage moderation, putting corporate margins under pressure. But there is no reason why this ultimate growth driver should stall: (1) on average, households have reduced their debt levels over the last few years, unlike companies; (2) their financial and property wealth is close to a historical high; (3) job creation should continue to underpin their spending.

7 Share of countries with low inflation (sample of 120 countries), %



Source: IMF (WEO), Amundi Research

Underlying Trends

Coordinated fiscal stimulus: the upcoming change in policy-mix?

ANNE-CHARLOTTE PARET, *Strategy and Economic Research*

Budgetary policy as an instrument of economic policy has not always been he rage. The criticism most often levelled against it is that it requires substantial budgetary leeway and lacks responsiveness (because it takes time to implement and benefits are felt only after some delay). Nonetheless, pushed by the IMF, the idea of budgetary stimulus has come back into vogue and goes by the name of "coordinated fiscal policy".

The accommodative monetary policies pursued by the major central banks are beginning to run out of steam and economic recovery remains subdued. Against this backdrop, the budgetary tool, which had been shelved since the eurozone crisis (leading to large-scale budget consolidation programmes) is coming under consideration once again as a potential solution. **Indeed, in today's environment, a fiscal package rolled out simultaneously in several countries could deliver a positive growth surprise, with an effect more pronounced than usual.** In fact, fiscal multipliers, which help quantify the impact of such a fiscal package on growth, have every reason to be higher in today's context[1]. First, the major central banks have created a protracted low interest rate environment (even though expectations are beginning to change in the United States). The effect of crowding out investment caused by rising interest rates, ordinarily expected subsequent to the deployment of fiscal stimulus measures, would therefore be lessened or indeed be totally absent today. Second, fiscal multipliers also depend on the structure of the budget expansion: spending increases should stimulate growth more than tax cuts do (as the latter are likely to be absorbed by firms and households). This holds even more if focusing on infrastructure expenditure or spending targeted to low-income households. Considering that quantitative easing measures have successfully relieved congestion in the supply of credit to businesses, tax cuts should less likely be absorbed by businesses for purposes other than investment. Finally, while such stimulus measures individually carry the disadvantage of being driven out by imports (for relatively open economies), the advantage of a coordinated strategy would be one of allowing countries to mutually benefit from stimulus measures deployed in foreign countries, thereby giving rise to a virtuous cycle. Hence, the IMF dictum: "The Whole Can Be Greater Than the Sum of its Parts".

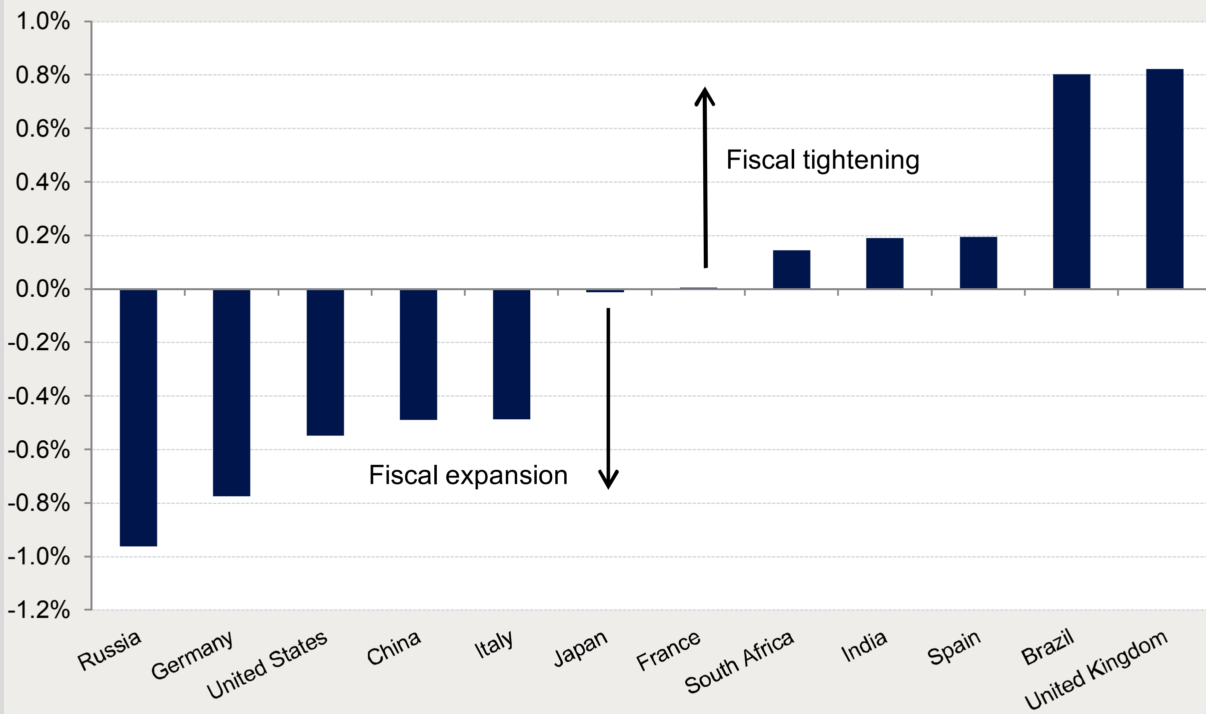
That said, **is such an initiative foreseeable sometime in the next two years**? In the developed world, **Japan** is already implementing policy stimulus and is likely to pick up the pace in the event of an external shock or if growth struggles to recover (in particular, the VAT hike has been postponed again, and a new stimulus package announced in August).In the **United States**, the situation is uncertain. Although Donald Trump's program's relies on a wide range of tax cuts, his propositions will be curtailed by the Congress and the House of Representatives, where a majority against too heavy deficits should loom (even with a Republican majority). The impact of the fiscal policy will therefore depend: i) on the implementation of infrastructure expenditures and on the nature of the tax cuts ultimately voted (those targeting high income households stimulating consumption only to a lesser extent); ii) on the nature and scale of the expenditure cuts aimed to finance the lower tax burden. If the economy significantly slows, a stronger budgetary expansion would become necessary, partly because automatic stabilizers are relatively weaker in the United States (they contribute less to the smoothing of cyclical economic fluctuations). In the **Euro area**, the likelihood of a budgetary expansion appears remote. Albeit austerity measures are now a thing of the past and the European Commission has a more lenient attitude with respect to the budget recommendations[2] to follow, public debt ratios remain high and leave little fiscal space. This is especially so since cyclical factors should soon cease to contribute to the reduction of government deficits as the output gap gradually narrows. Moreover, following the Juncker Plan and the fiscal impulse provided by Germany (primarily in response to the influx of immigrants), it is not clear that Europe is prepared to propose a new sweeping budget plan. As to the BRICS, the likelihood of seeing any fiscal stimulus measures is also uneven. In **Brazil**, fiscal consolidation measures have been introduced to cope with an alarming rise in government debt (specifically, a cap on spending may be ratified by Parliament before the end of the year). In **South Africa**, fiscal policy is constrained by a debt ratio that has been on a rising trend for several years. **Russia** too has experienced an alarming rise in government debt (linked to the 2014-2015 decline in oil prices) leaving little budgetary for further expansion. In **India**, relatively strong growth and an ambitious deficit target (3% of GDP for 2018, versus 7% in 2015) does not point to any budgetary stimulus in the near term. On the other hand, in **China**, where the economy is transitioning to more sustainable growth, budgetary policy is providing some support to domestic demand. This trend should continue to avoid an overly sharp slowdown in growth (around 6.5% in 2017 compared to the anticipated 6.7% projected for 2016), with potentially non-negligible impacts for its trading partners (compared to a situation with no fiscal intervention).

The simultaneous introduction of expansionary fiscal policies at the international level could produce results beyond the usual expectations against the current backdrop (because of the durable low interest rate environment and because positive spillovers are likely to reinforce each other, should coordinated deployment occur). Moreover, their financing would be eased by central banks' quantitative easing (in particular BoJ and ECB). Nevertheless, such coordination would hinge on both the removal of political uncertainties (evolution of

[1] *For more details on fiscal multipliers' determinants, see "Fiscal Multipliers: Size, Determinants and Use in Macroeconomic Projections", IMF, September 2014.*

[2] *In August, Portugal and Spain avoided the sanctions they were facing due to their budget slippage.*

bipartisan compromises at the American Congress, results of the upcoming elections in Europe and emergence of political consensus supporting such a stimulus package in the eurozone) and the future outlook for growth. The emergence of such a situation would be more likely in case of a significant negative shock. **Assuming such a stimulus has the intended effect on growth, it could even benefit to countries public debt dynamics via a positive "buoyant growth - low interest rate" mix.** It would help debt trends in countries where interest rates are exceptionally low, especially those enjoying a safe haven reputation (United States, core European countries and Japan), which is shielding sovereign interest rates even more against a potential rise. Finally, in these countries, inflationary pressures, which traditionally form the counterpart to budget stimulus, would be, for once, quite welcome.



Note: The structural adjustment is the change in structural balance (expressed in percentage of potential GDP). It corresponds to the reduction in general government deficit which is due neither to the effects of the economic cycle nor to one-offs. Estimates of structural balance can differ, namely due to the difference in the estimation of the output gap and temporary one-offs in revenue and expenditure items.

Source: IMF World Economic Outlook (October 2016), Amundi Research

The cycle is drawing to an end. After seven years of uninterrupted growth (at an average annualised quarterly rate of 2%), we expect GDP to return to its potential level in 2017[7]. Growth potential was significantly weakened by the great financial crisis, the slowdown in productivity, and demographic changes. We believe it will not exceed 1.5-1.7% over the next two years. After that, all will depend on the capacity of companies to revive productivity gains. **The cycle drawing to an end does not mean that the economy will fall into recession.** On the domestic front, there are no major imbalances that would drag the economy in this direction. Even if companies have been weakened (high debt, margins under pressure), they have not overinvested.

The labour market: support is set to dwindle. The economy is gradually approaching full employment. Job creation is likely to continue slowing and the participation rate is likely to increase. It is difficult to estimate an equilibrium participation rate. It is probably much higher than its current level, so that job creation will continue to grow at a rate higher than is necessary just to hire the new entrants on the labour market. We anticipate a slowdown in monthly job creation to around 100-130k in 2017, versus 180k in 2016 and 230k in 2015.

Corporate earnings: a normalisation is under way. After several years of sustained growth, corporate earnings fell in 2016. The fall in commodity prices at the start of the year weighed heavily on the profitability of the energy sector. But this does not explain all, since there has been a broad slowdown in corporate earnings. The sharing of value added was too heavily slanted towards profits. The beginning of a normalisation had been expected in 2016, notably following the rise in unit labour costs. Profit margins are set to remain under pressure and earnings should therefore continue to grow but at a slower pace than nominal GDP.

Inflation: upside risks in the short term but no real threat. In light of low productivity gains, wage increases (+2.5% in 2016) could in theory affect unit labour costs fairly quickly and therefore core inflation. However, the link between wages and unemployment distended sharply during this cycle (the Phillips curve has flattened): wage inflation remains contained despite the steady fall in unemployment. Unit labour costs have certainly increased more rapidly than average (+2.4%) but this is not the case for core inflation, which has remained well below its long-term average. Profit margins have helped to absorb upward pressure on costs. Result: on average over the cycle, inflation (total and core) fell to its lowest level since the beginning of the 1960s. In other words, the Fed did not fulfil its mandate to maintain average inflation close to its target rate[8]. As such, there would be no reason why it would overreact to the first signs of upward pressure in 2017, all the more so if they were to result solely from a temporary base effect on energy prices.

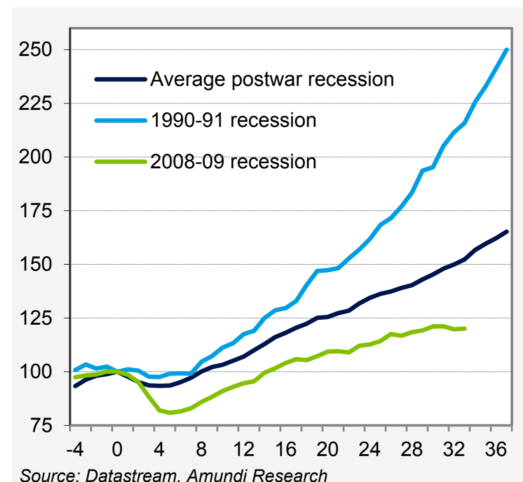
Eurozone: the recovery will continue, but at a slower pace as temporary drivers lose momentum and political uncertainty remains high

The eurozone has been recovering since late 2013, but at a much slower rate than in previous cycles. The main driving force is still consumer spending, and although there has been some improvement in investment, it is taking time to recover. There are still considerable disparities between member states.

In 2016, despite the risks, growth remained close to 1.5%, slightly above its potential.

- The recovery picked up temporarily at the start of the year, boosted by lower fuel prices, the falling euro, the easing of austerity measures and temporary factors (exceptional spending sparked by the mass arrival of refugees in

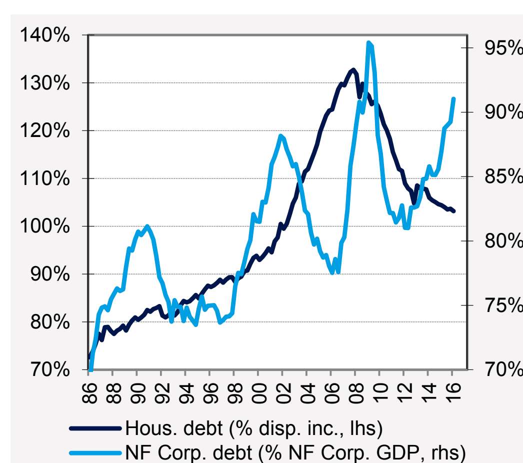
8 US: Business Investment (Level indexed to 100 at each business cycle peak, nb of quarters to peak)



Source: Datastream, Amundi Research

> The end of the cycle does not mean a recession

9 US: Household vs non-financial corporate debt



Source: Datastream, Amundi Research

[7] *In other words, in our scenario the output gap, which has been negative since 2007, should narrow and close by this horizon. Never in post-war history have so many years been needed to purge excess capacity. Quarterly growth has been 2% on average since mid-2009 – a very low rate in comparison with the cyclical recoveries of the past.*

[8] *2% for the consumer price index as measured by the national accounts (PCE deflator).*

Underlying Trends
President TRUMP
Three scenarios for the US economy

DIDIER BOROWSKI, *Research, Strategy & Analysis*

In all likelihood, President Trump will not keep all of the promises he made as a candidate. On many subjects, the President-elect already seems to be backtracking (wall between Mexico and the United States, expulsion of immigrants). Of course, the President does have a majority in Congress, but the majority in the Senate (one seat out of 100) is too small to allow the President to dispense with moderates, who are deeply hostile to any budgetary drift (unless the economy slows down significantly). **Under these circumstances, there is deep uncertainty over the policy that will *actually* be implemented**. **It will most likely be several months before we have a clear vision of the new administration's main priorities. We can discern three scenarios.**

Downside risk scenario (15%)
The President is exactly what he promised to be as a candidate. There is a long list of downside factors:
- Protectionist measures: customs barriers, challenges to trade agreements, confrontation with China (exchange rate). Retaliation against partners (global trade shock, currency war).
- Withdrawal from NATO, isolationism, rejection of the Paris climate agreement.
- Expulsion of immigrants and tensions with neighbouring countries (especially Mexico).
- Loss of the United States' credibility on the world stage, or even domestically.
- From a fiscal perspective: tax cuts focus on high-income earners and are entirely financed by cuts to social spending (healthcare, education, etc.). The negative effect of these cuts to spending outweighs the positive effect of tax reductions (the wealthy have a lower marginal propensity to consume).

Growth plunges. The risk of recession re-emerges.

Upside scenario (15%)

The "candidate as maverick" gives way to a moderate president who consequently surrounds himself with advisors.
- Donald Trump renounces protectionist measures and moderates his position on controversial topics (immigration, trade).
- From a fiscal perspective, the president convinces his majority to launch a "real" stimulus plan (i.e., with a significant increase in the budget deficit). Cuts to taxes and infrastructure spending are passed at the same time, along with a possible increase in the federal minimum wage (in order to gain some democratic votes). The stimulus lasts several years. Most of the spending adjustments are postponed. The deficit increases significantly (from 1.5% to 2% of GDP). Budget and fiscal multipliers are exploited to the full. Growth and inflation (2018-2019) are revised upward substantially: GDP growth is between 2.5% and 3% of GDP in 2018, after 2% growth in 2017. The Fed supports the reflationary trend by hiking its key interest rates throughout 2017.

Central scenario (70%)
The White House and Congress come to a compromise, with concessions on both sides. A modest fiscal stimulus plan is passed in the first half of 2017. Priority is given to tax relief, a topic on which all Republicans agree. Tax cuts are revised downward and focus more on the middle class. Spending cuts are spread out over several years to minimise the shock on business and preserve the stimulus effect of short-term fiscal policy. The budgetary cost of infrastructure spending is contained by prioritising the financing of public/private partnerships. As they take a long time to implement, they have little impact on growth in 2017-2018.
The budget deficit grows slightly (+0.7% of GDP, i.e., $130bn) in 2017-2018. The risk of recession falls significantly. Without a fiscal plan, we estimate that US growth will slow down in 2018 (1.6%). Growth stabilises and even accelerates slightly in 2018 (from 2% to 2.2%). This stimulus helps extend the cycle by maintaining the rate of expansion at its average from the 2009-2016 period, or slightly higher. However, at the end of the cycle (full employment) wages and underlying inflation accelerate significantly. Monetary conditions tighten (increase in long-term interest rates and the dollar). The Fed is maintaining its monetary gradualism (three interest rate hikes over the next 12 months).
At this stage, we believe that the downside and upside risks will neutralise each other. If growth stabilises around 2%, it is unlikely that fiscal policy will be as proactive as is currently assumed. However, the threat of recession would increase the chances of a stimulus plan as described in the upside scenario. Ultimately, fiscal policy must be more reactive than proactive.

Germany, a technical rebound in consumption after it stalled in the wake of the terrorist attacks in 2015). Encouraging signs were seen on the investment front in both Germany and France.

- From Q2 onwards, the recovery fell back in line with the trend seen since early 2015[9]. The uncertainty caused by the UK referendum at the end of June and growing concerns about banks (Italian banking sector and Deutsche Bank) have not weighed on growth.
- The **positive credit cycle** continued. Total bank lending to businesses was up by around 2% year-on-year (excluding securitisations and sales), compared with a drop of 0.1% a year earlier.
- The recovery had a slightly better impact on the **labour market** (employment was up by 1.4% year-on-year at the end of Q2, versus 0.9% a year earlier).
- However, **core inflation** failed to rise (still below 1%) while total inflation remained negative for much of the year owing to energy prices.

Cyclical factors mean the recovery will continue in 2017...

The eurozone will remain in catch-up mode, allowing growth to remain above its potential (estimated at around 1%) in 2017 and, to a lesser extent, in 2018. Significant slack remains in a majority of member states (the European Commission estimates the eurozone's output gap at -0.7% for 2017).

- Employment will remain on the path seen in 2015-2016 owing to cyclical effects and also because the benefits of labour market reform in several countries (Italy and Spain and, to a lesser extent, France) in recent years have not all filtered through. This will boost household income and consumer spending.
- Improvements in employment and consumption, combined with extremely accommodative monetary policy, will allow the positive credit and investment cycle to continue.

...but some of 2016's growth drivers are set to weaken or fade away...

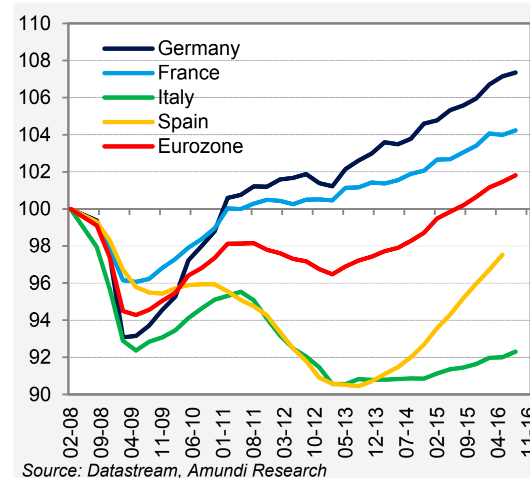
Certain factors that made a very positive contribution to growth in 2016 will lose steam.

- Improvements in purchasing power arising from low oil prices will not be repeated (even if prices were to fall again, which is not our core scenario) and their impact on consumer spending growth will decline.
- Positive effects of the **euro's decline in 2015** (margins, competitiveness) will gradually weaken.
- While **budgetary policy** may still provide some support, it will have less of an effect than in 2016 (when budgetary easing amounted to around 0.2pp of GDP, based on the change in the cyclically-adjusted primary deficit as calculated by the European Commission). Spending related to refugees in Germany will not rise as much, the easing of austerity in Italy and Spain will be curbed by European Stability Pact obligations, and France is unlikely to ease its policy before the end of 2017. Despite calls by international organisations (IMF, OECD) and the recent announcement that the Juncker investment plan was being doubled, European budgetary policy is unlikely to converge towards a truly coordinated stimulus strategy before 2018.

...while political risk will remain an obstacle...

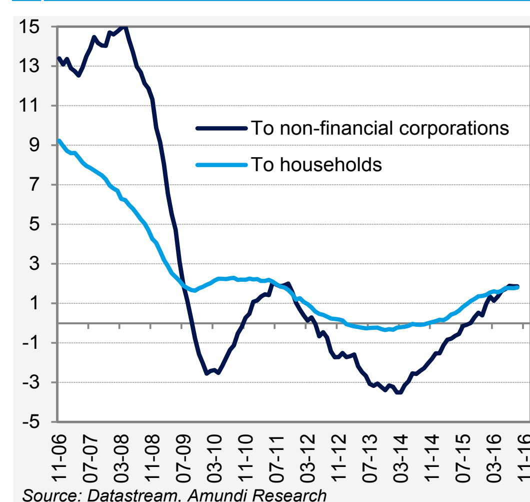
The particularly busy political schedule in late 2016 and 2017 (see inset) includes elections that are likely to see the rise of Eurosceptic parties (though they are unlikely to take power), and a weakening of incumbent governments or the formation of fragile coalition governments. Brexit will also fuel uncertainty throughout 2017. This environment may not be enough to break the recovery's momentum, but it will cloud economic visibility. Business confidence (and even consumer confidence) will be affected, which will penalise investment and, possibly, durable goods consumption.

10 **Volume GDP, basis 100 in 2000**



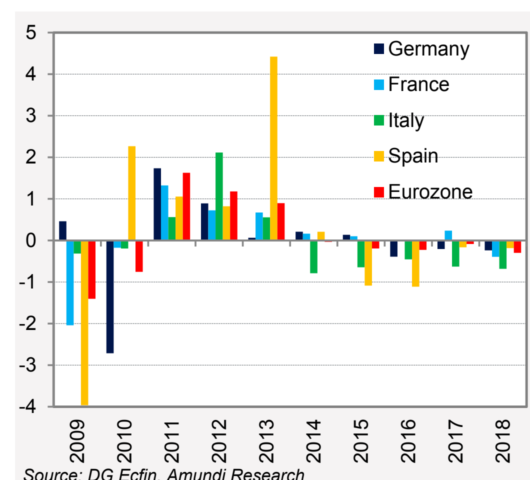
Source: Datastream, Amundi Research

11 **Annual growth in bank credit, %**



Source: Datastream, Amundi Research

12 **Cyclically-adjusted primary balance, annual variation in % of potential GDP**



Source: DG Ecfin, Amundi Research

[9] *Excluding Ireland, where exceptionally high figures meant that it alone accounted for 0.4pp of eurozone growth in 2015, allowing it to post growth of 2%.*

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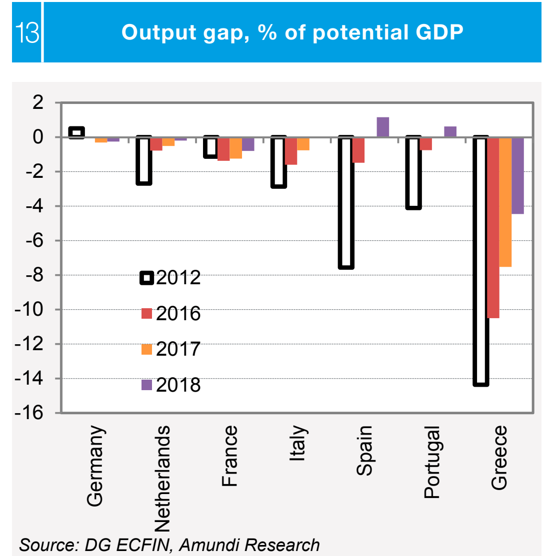
...and the external environment will deteriorate slightly

In 2017 and 2018, the eurozone can count on slight improvements in a number of emerging economies that faced difficulty in 2015 and early 2016 (although they may be exposed to negative spill-overs from the recent US election). However, this will not be enough to offset the economic slowdown of its key partner, the United Kingdom, and the decline in the Pound Sterling (exports to the UK represent 4% of the eurozone's GDP). Support in the form of demand from the United States should be more or less stable in our central scenario in 2017 and may increase in 2018.

Taking these four factors into account (continuation of cyclical dynamics, partial loss of the temporary growth drivers seen in 2016, intensifying political risk), we forecast a slight deceleration of growth to 1.3% for 2017, compared to a probable 1.6% for 2016. We also forecast 1.3% growth in 2018, a year in which political risks might well diminish but positive cyclical factors will lose some of their strength.

13 Output gap, % of potential GDP



Source: DG ECFIN, Amundi Research

> Eurozone: outlooks for the components of GDP

Private consumption will remain the main driver of the recovery, supported—to different degrees depending on the country—by improvements in employment (and, in Germany, by rising wages). However, it will not see the same growth as in 2016, when it got a boost from lower oil prices and fiscal easing. Furthermore, political risks could influence households to behave more cautiously (higher savings rates).

Investment will see a slight rise, benefiting from low interest rates, higher consumption and, to a lesser extent, modest stimulus efforts (Juncker plan) and the reforms of recent years. However, political risks will remain an obstacle (uncertainty around Brexit and US politics, lack of political visibility in France and Germany, concerns about the banking system and the continuation of reforms in Italy). Investment in construction will increase due to cyclical effects, although at very different rates from country to country. It will be a non-negligible contributor to growth in Germany and France.

Public consumption will rise significantly in Germany (although less so than in 2016) and more modestly elsewhere (due to European budgetary constraints). New austerity measures are likely in Spain. In France, budgetary visibility is low (continued tightening has been announced for 2016, but some presidential candidates are proposing considerable easing in 2018).

Foreign trade will contribute negatively to growth. The slowdown of the UK economy will hurt exports, and will not be completely offset by the improvements in some of the emerging economies. In 2018, US growth should however become somewhat supportive. The continued rise in domestic demand will be reflected in a new increase in imports.

Significant disparities will remain between member states:

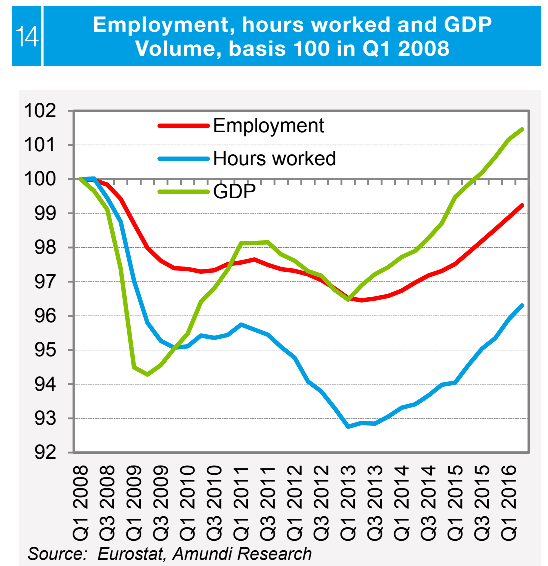
- In **Germany**, whose economy is already close to potential, growth will slow down. Private domestic demand will remain robust (very low unemployment, rising wages, very low interest rates), but the increase in public spending will not be as strong as in 2016 (when it rose sharply due to the refugee crisis). Finally, the UK slowdown will take a modest toll on foreign trade.

- In **France**, growth in 2017 will remain similar to the slow pace observed in 2016. It will be bolstered by improvements in corporate margins and construction, despite the absence of budgetary support. However, fall of the Pound Sterling will hurt foreign trade. A similar pace of growth is likely to be seen in 2018, but this will depend on the budgetary choices made by the new government.

- In **Italy**, the improvement on the labour market observed in 2016 will continue, keeping growth slightly positive although lower than that of the other large eurozone members. Continued reform momentum could have positive impacts on business confidence and investment. However, this could become compromised in the event of a "No" victory in the referendum on 4 December 2016. Continuing uncertainty about the state of the banking sector will remain an obstacle.

- In **Spain**, growth will slow down after catching up in recent years. Starting from a higher basis of comparison, consumer spending in particular will not see the same progression. Furthermore, the needed reduction to the structural deficit

14 Employment, hours worked and GDP Volume, basis 100 in Q1 2008



Source: Eurostat, Amundi Research

(which has widened again since 2015, mainly due to the political climate) will necessitate new tightening measures.

Finally, **headline inflation will increase** in the first half of 2017 owing to the base effect of rising oil prices, but core inflation will remain very low. Labour markets remain weak and unlikely to see wage increases (Germany may be the exception). However, core inflation may accelerate slightly in 2018.

UK: stagflationary pressure in sight

2016 was marked by the Brexit victory in the June referendum. Before that, growth in the UK was already slowing (2.2% on average in 2015 and in H1 2016 vs. over 3% in 2014), showing a rate of expansion much weaker than before the great financial crisis (+3% on average between 1998 and 2007). The UK economy has not escaped the structural slowdown (fall in growth potential) observed in developed countries. That said, **the resilience shown by it to the "shock of uncertainty" caused by Brexit is striking.** The rapid appointment of a firm and determined new prime minister (Theresa May) helped to reassure the British people. Growth remained close to 2% in Q3, even though many had feared a recession. Investment slowed but consumption held up well. The fall in sterling (-20%) to its lowest real effective exchange rate in 40 years is nevertheless having a deep impact on the economic outlook.

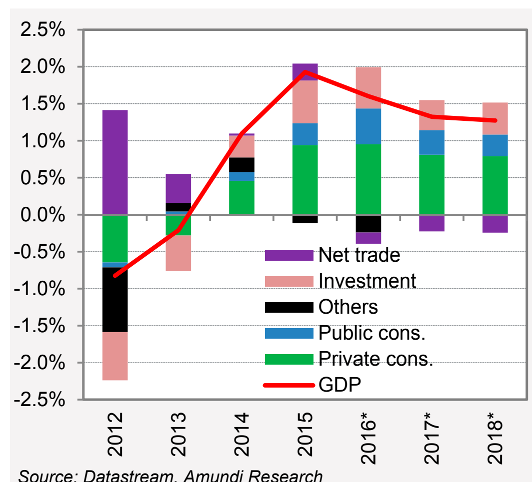
Political uncertainty continues to threaten domestic growth. Most studies show that the medium-term outlook has darkened with the prospect of exit from the EU. Against this backdrop, investment is likely to continue slowing in 2017 (because of fears over future markets). What's more, inflation is set to accelerate sharply. In fact, imported inflation caused by the fall in the currency will add to the base effect linked to energy prices: **the rise in consumer prices will temporarily move above 3% in H1 2017.** The loss in purchasing power will weigh on household demand, which will further darken the outlook for investment. Exports will not be strong enough to offset this shock. Under these conditions, we anticipate a sharp slowdown in growth (1% on average in 2017). As a result, the policy mix will be more expansionist, which will help to avoid a recession. On the one hand, the BoE is likely to retain if not accentuate its accommodative monetary policy. On the other, the government is likely to introduce fiscal stimulus. In this scenario, growth would speed up moderately in 2018.

There is however considerable uncertainty around these projections. Politically, there is no guarantee that parliament will be swift in authorising the government to trigger Article 50 of the Lisbon Treaty[10]. Negotiations with the rest of the EU are likely to be long and strained, and we are unlikely to see any real progression before the elections in Germany next autumn. The UK government said it is ready to organise a "hard Brexit". Is this stance for negotiating purposes or is it a strategic choice? Only the future will tell. In the meantime, it reinforces uncertainty and could negatively impact confidence in the economy.

Japan: fiscal policy to be the central tenet of growth

2016 has been a busy year for the Bank of Japan, which has been aggressively trying to pump up inflation and economic growth since April 2013. In fact, **the yen has climbed to its early-2014 level, while the core CPI has slipped back**

15 **Contributions to GDP growth annual average *Forecasts**



Source: Datastream, Amundi Research

[10] *A referendum of the people is a consultation and does not have legal status. Without the triggering of Article 50, the process of withdrawal from the EU cannot get underway. The London High Court ruled that the government must seek approval by parliament for withdrawal (the government has appealed the decision). Nearly six months after the vote, the UK's exit is not yet set in stone, leaving space for theories on the possibility of a reversal. Any U-turn would however be very costly politically (loss of the country's credibility internationally, failure by the prime minister to follow through on promises). It is hard to imagine the parliament going against the vote of the people without sparking a serious political crisis, and making a general election inevitable (along with a new prime minister and probably also another referendum). This scenario is highly unlikely. However, it is possible that parliament will force the prime minister to review her schedule, which at present involves triggering Article 50 before the end of March 2017.*

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into negative territory. Export volumes have been flickering at the same level for the last four years. The annual pay rise is the smallest in three years, despite Prime Minister Abe repeatedly requesting a substantial wage increase. The BoJ, that has already purchased almost 40% of outstanding JGBs, has ultimately shifted its strategy in favour of targeting the yield curve rather than conducting purchases by a fixed amount. The government implemented an economic stimulus package worth $280 billion (roughly 6% of GDP), making Japan the only large country echoing the G-20's recommendations in terms of fiscal policy.

> Japan: expected behaviour of each GDP component

Steady income gains should support consumer activity

Growth in wages is likely to accelerate in 2017, reflecting the tightest labour market in a quarter century.

The government is showing stronger commitment in favour of wages. Firstly, PM Abe has once again requested a marked pay rise for 2017, notwithstanding whittling corporate earnings. The Ministry of Health, Labour and Welfare raised the minimum wage by a record 3.1% in October. The Diet just approved a lump-sum payment to low-income earners. Secondly, the government is providing more job opportunities to housewives by increasing the number of day-care spots and extending childcare hours. At the same time, the government is eager to achieve equal pay for equal work in order to reduce the gap between permanent and temporary positions, while encouraging companies to increase employment or compensation through corporate tax credits.

The stronger yen and the weaker Chinese yuan could take their toll on income from tourism. However, the trend has shifted from one-time, extravagant shopping to repeated and sustainable service-driven fashion.

Public spending: the hottest spot

Following the JPY 3.2 trillion budget increase that was agreed in October, the government will enact the rest of its planned spending (JPY 3 trillion) included in the recent economic stimulus package in 2017. The total size of the budget is JPY 96.7 trillion (USD 930 billion, of 20% of GDP), of which non-discretionary expenses (social security and debt servicing costs) account for 57.8%. However, the proportion of public works spending has risen under PM Abe's directives. On the regional front, Metropolitan Tokyo is ready to reinforce infrastructure ahead of the 2020 Olympics.

More companies are poised to increase business investment

Corporate earnings seemed to reach a trough in Q3 2016 and quickly recover thereafter. Companies are likely to break the curse – the combination of faltering EM economies (China in particular), an oil supply shock and consumers' hesitance. The service sector will facilitate investment in order to reduce payroll costs and streamline operations. At the same time, encouraged by the government's initiative to boost competitiveness, manufacturers will increase R&D spending and launch projects targeted to non-residents.

Drag from net exports.

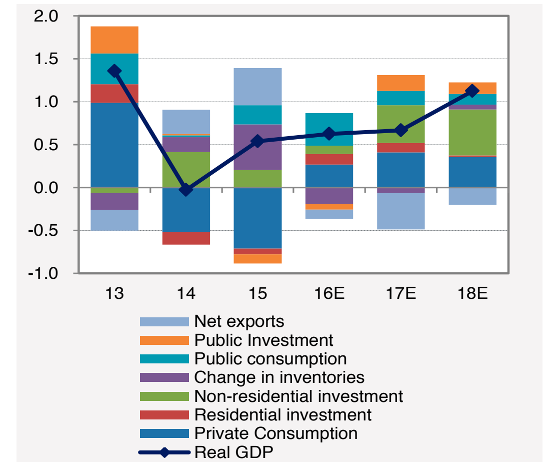
Exports are expected to show a modest pick-up in 2017, thanks to stabilisation of the yen and a more buoyant Asian market. Furthermore, higher demand in high-end mobile phones will drive procurement of Japanese-made parts and devices. Meanwhile spin-offs of unprofitable and labour-intensive business lines by companies, as well as reconstruction projects in disaster areas, should drive imports.

The economy is expected to register stable (+0.7%) growth in 2017 and build up steam in 2018 (+1.1%), running substantially above potential (roughly 0.3%). Core inflation should thus accelerate (+0.8% in 2017, 1.1% in 2018). However, this will not put an end to loose monetary policy: As in most advanced economy, this is a necessary reflation policy after years of excessively weak inflation.

Emerging economies: towards better?

After several difficult years, the economic context became favorable to the majority of emerging countries. There are several reasons for this: (1) the rebound in commodity prices brought a breath of fresh air to the producing countries and the ongoing agreement of the OPEC countries limits the risk of further oil price declines. (2) With the arrival of Trump in the US Presidency, the

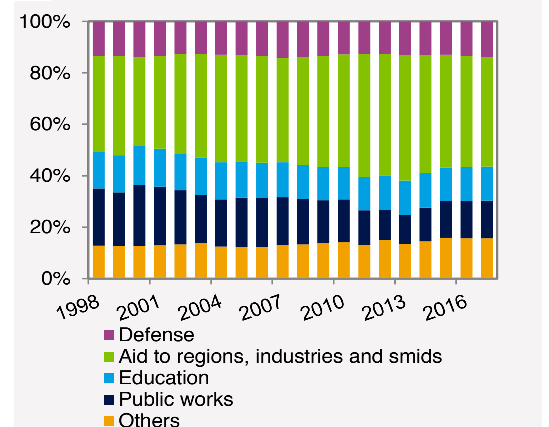
16 Japan: Contributions to GDP growth (%pts)



Source : Datastream, Amundi Research

Japanese growth will accelerate in 2018 thanks to the fiscal stimulus plan and a rise in household consumption supported by rising wages

17 Japan Discretionary budget by purpose



Total outlay less social security expenses & debt-service

Source : Japan MoF, Amundi Research

likelihood of higher US rate hikes increases. But some of these are already priced by markets. The impact on emerging economies should therefore be limited. (3) The stabilization of the Chinese economy has played a key role in the perception of risks on a global scale. (4) In an environment of low or even negative interest rates, the search for yields leads investors in advanced economies to turn to emerging countries that offer higher yields for risks that are not bigger (political risks are currently affecting both advanced and emerging countries). Under these conditions, **growth should stabilize in emerging countries in 2016 (4.1%) and then accelerate in 2017 (4.6%). Given the sluggishness of world trade, the main driver will remain private consumption. However, investment should improve somewhat but remain below past rates.**

> The worst seems to be behind for the emerging economies but the election of Trump as the new US President increases the downside risk

Differences between countries will however remain marked. In terms of growth, the Asian countries (China and India but also Indonesia, Philippines) will continue to lead the way. **Moreover, the results of the US presidential elections represent a source of uncertainty detrimental to the recovery of the emerging economies and the downside risk is in this context higher.**

China: stabilisation in the Chinese economy has played an essential (and probably still under-estimated) role in improving the global economic outlook in 2016. After China's bottoming-up (that we expect for end 2016) stabilisation should continue until the end of 2017.

> China: expected behaviour of each GDP component in 2017

- **Consumption**: we expect retail sales to stabilise at their current level or below, but with an upside trend in in the services sector.
- **Investment:** we expect manufacturing and property investments to see downside risks, while infrastructure investment will benefit from growth stimulation policies.
- **Net exports**: we expect exports to extend their current weakness given weak demand from overseas, but raw material imports are likely to continue their upward trend on the back of strong domestic infrastructure demand.

China: policy outlook in 2017

- **Monetary policy:** we think the PBoC will remain accommodative with aggressive easing especially through various liquidity provisioning tools.
- **Fiscal policy:** we think MOF will aggressively promote both fiscal (expanding the budget deficit) and quasi fiscal (through public investment banks) measures.
- **FX policy:** we think the PBoC will continue to promote a market based mechanism for the RMB exchange rate, and will be a global FX stabiliser relative to other countries in 2017.
- **Reforms:** SOE reform and supply side reform (with a focus on overcapacity reduction) are still the key reforms for which markets should watch out.
- **Other:** The 19th National Congress of the Communist Party of China will be held in Oct/Nov 2017 with a focus on leadership transition. As such, most policies until then will promote economic, political, and social stability in China.

> Stabilisation in China is positive for emerging economies

Emerging markets, commodities and cyclical sectors are the primary beneficiaries of this situation. The reasons for Chinese economic stabilisation are both **bottom up,** with the private sector showing vitality, and **top down,** with infrastructure investment playing a major role. We do not think China meets any of the specific conditions for a hard landing. The country should be able to delay its problems while trying to solve the pressing issues of debt and property bubbles. We are forecasting Chinese GDP growth of 6.4% in 2017 and a gradual depreciation of the Renminbi (USD/CNY at 7.2 by the end of 2017).

India: we continue to hold the view that India's growth will slightly undershoot market expectations in 2017 and beyond, despite positive factors including a normal monsoon year, strong urban and rural consumption demand, and a monetary easing cycle. Sluggish private investment is the major hindrance for a sustainable investment cycle pickup. We are forecasting GDP growth in India of 7.5% in FY2017.

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We expect higher oil prices and a nascent investment recovery will continue to act as headwinds for the current account balance, which will have a more visible deficit in a year or two. However, we believe the RBI holds sufficient reserves to tackle any pronounced volatility in the INR, and the INR, whose parity should remain resilient (USD/INR to be at 70 by the end of 2017).

> India: the key issues in 2017

- **Monetary policy:** we continue to hold our view that RBI's inflation outlook has been lagging to a certain extent. Inflation has been much weaker than the RBI expected, and hence we believe the RBI has to remain accommodative longer than the market expects, and ease more than the market expects.
- **Fiscal policy:** fiscal policy is expansionary, with less fiscal consolidation than expected next year. In addition, the government will implement new measures that will be positive for investment.
- **FX policy:** we believe the RBI holds sufficient reserves to tackle any pronounced volatility in the INR, and the INR would still be an outperformer within EM currencies.
- **Reforms:** Reform momentum should continue in 2017. The focus is to facilitate business operations and to implement key reforms: GST, Bankruptcy, FDI liberalisation, deeper corporate bond markets. However, a too speedy implementation might bring downside risks.
- **Other:** general elections (result in April/May 2017).

South Korea: the South Korean economy has been hit by the MERS epidemic in 2016, which resulted in low consumption and investment in construction. For 2017, based on the low comparison base, we believe the South Korean economy has some upsides, but these are balanced out by the anti-graft bill, ongoing corporate restructuring, and weaker construction investment. We expect South Korea to post real GDP growth of 2.7% in 2017.

We expect authorities to maintain an expansionary policy mix. The BOK should remain accommodative in light of the downside risks from both domestic (anti-graft bill and corporate restructuring) and overseas (weaker exports) markets. The fiscal stance will remain supportive.

As for the currency, we expect the BOK to continue to act in order to mitigate market volatility. Downside risks include the scale and speed of the Fed's rate hike programme, uncertainties in the eurozone including Brexit, and geopolitical risks from North Korea. We expect USD/KRW to be at 1180 by the end of 2017.

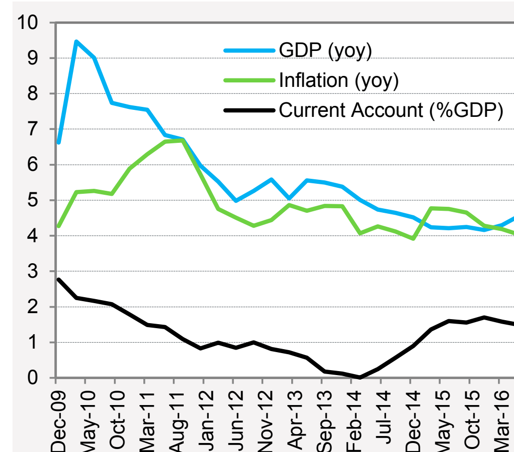
Other key Asian ex Japan countries: in Indonesia, Malaysia, Thailand and the Philippines, growth will be slightly above expectations, partly due to fiscal policy. Because of more vigorous investment (public and/or private), the current account balance will deteriorate in all these countries. However, in Malaysia, commodity prices stabilisation will play the opposite way. In Thailand, where the current account deficit is more than 10% of GDP, the Baht will remain under pressure, which could cause the central bank to intervene. In the Philippines, political risk will have to be monitored. Regarding monetary policy, inflationary pressure could lead the central bank to increase its policy rates. Conversely, in Indonesia, inflation is under control and the central bank has room to cut policy rates (we believe they will be cut by 50bp).

Central and Eastern Europe: household consumption will remain sustained by the strength of the job market and will stay the main engine of growth

Russia: after a marked adjustment, Russia should emerge from the economic slump in which it has been plunged for two years and return to positive growth rates, although contained (+ 1 / + 1.5% in 2017). In the other countries, growth should continue at rates close to those of 2016 - with the exception of Romania, which starting from a peak of nearly 5% in 2016, is expected to experience a deceleration.

Private consumption will remain the main driver of growth. Labour market conditions (low unemployment rates) will contribute to raise wages so that the

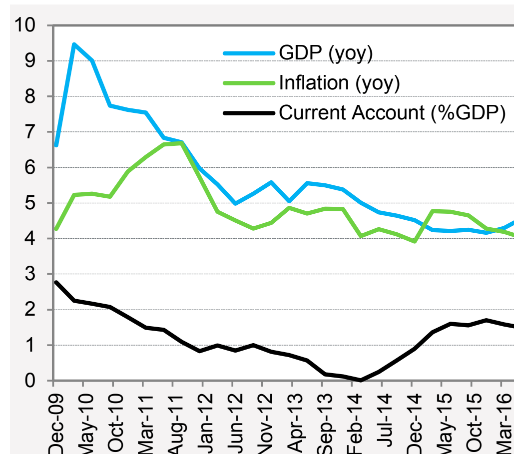
18 Global Emerging Indicators



Source: Bloomberg, Amundi Research

> "Asia should continue to do well"

19 GDP Growth per Emerging Regions



Source: Bloomberg, Amundi Research

> "Russia should emerge from recession by 2017 and the rest of emerging Europe should continue to grow at sustained pace even though the peak is undoubtedly passed"

purchasing power of households will continue to increase. In Turkey, private consumption, supported by domestic credit expansion, will also continue to be the main contributor to growth.

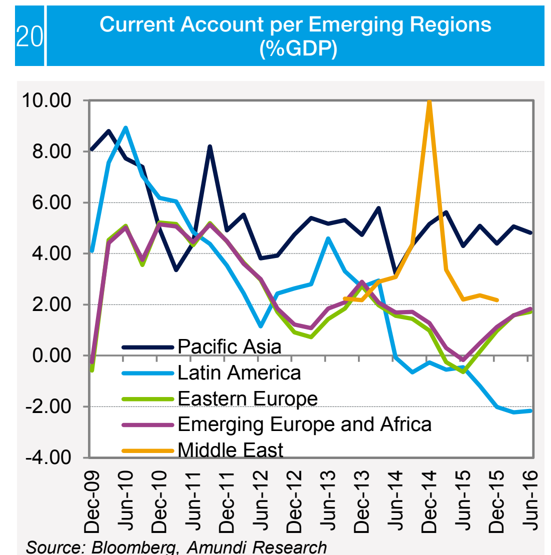
Although it is unlikely to return to past growth rates, **investment should also rebound** in several Central European countries with the renewal of funds from the European Union but also in Russia with The rebound in oil prices and in Turkey if the political context does not lead to capital outflows.

On the other hand, the lack of dynamism in global trade will be a brake on growth.

Monetary and fiscal policies will remain, on the whole, a supporting factor for growth. Inflation should be moderate, so that monetary policy should remain accommodative in most countries. **Russia** is still expected to make some rate cuts even though inflationary expectations and questions on the financing of the fiscal deficit should limit the extent of easing. Turkey could continue its bearish cycle even if inflationary pressures and market worries do not support this. Differences should be more pronounced in terms of fiscal policy. In **Russia, Turkey, Poland and Romania,** room for maneuver is exhausted and calls for fiscal tightening. In the **Czech Republic and Hungary**, fiscal revenues in 2016 were relatively large and could finance a more expansionary fiscal policy if needed. In addition, the expansion of domestic demand occurred in most countries without generating major imbalances. Indeed, inflation has remained subdued, current account deficits, if any, are modest and capital inflows high enough to keep external borrowing requirements low.

However, the risks remain to the downside in these countries. Specifically, political risks tend to increase and the credibility of fiscal policy in some countries such as **Poland and Turkey** is beginning to be questioned. Markets will therefore carefully scrutinize the various budget announcements and will not hesitate to sanction countries where the risk of slippage is considered too high. In addition, rising commodity prices will be a brake on household consumption. Turkey is part of this trend, with growth stimulated notably by household debt and a relaxation of monetary policy, but with increased fiscal and inflationary risks. On the other hand, even if it is not zero, the impact of the Brexit should be moderate.

20 Current Account per Emerging Regions (%GDP)



Source: Bloomberg, Amundi Research

Latin America:
contrasting situations between countries

Brazil will still have to wait to recover positive growth rates. Even if the political situation seems better, the growth factors are still at half-mast. The labor market remains stifled: the unemployment rate is steadily rising and real wages are falling, which weighs on household consumption. The decline in investment is less marked but continues to weigh on the recovery. Moreover, the budgetary and monetary authorities will have to carry out a binding policy-mix to ensure their credibility with the markets. The fiscal consolidation needed to stabilize the debt-to-GDP ratio is therefore expected to severely penalize growth. In an environment where the risk of fiscal slippage is not zero and inflation expectations are still high, the Central Bank has little room for maneuver. Thus, with the exception of a marked and sustained rebound in oil prices (above $ 70 per barrel), growth is expected to be still negative (-0.5%) on average in 2017. According to our estimates, Brazil will come out of the recession in 2018 but in the presence of a marked uncertainty on the presidential elections, investment could be left behind.

> “In Latin America, the situations will be contrasted. Brazil will still be left behind”

In the rest of Latin America, the situation remains highly contrasted. Venezuela, on the brink of political implosion, is expected to post a major recession (-5%). Argentina, supported by a voluntary and rigorous policy mix, should be able to reverse the current trend and possibly return to growth in positive territory. In Mexico, Peru, Chile and Colombia, growth is expected to continue at current rates. However, for Mexico, the situation could worsen due to the victory of D. Trump in the US presidential elections.

Africa and the Middle East: the rebound in commodity prices is a supportive factor, but (geo) political risks remain a brake on growth.

In the Middle East and Africa, higher commodity prices are expected to help rebound economies that have been hardly hit by falling prices. However, taking into account the various political unrest, the situation remains complicated for some. South Africa is expected to have passed a low point and return to a growth rate of close to 1% as long as the problems of corruption and governance do not lead to a major new social conflict.

In Africa and the Middle East, (geo) -political risks remain a brake on the recovery

Conclusion

Since spring, the economic context had become more favourable for emerging countries. However, many of these countries have been weakened in recent years by multiple shocks so that they have little room for maneuver and therefore lack a cushion to absorb any additional shock. Subsequently, the results of the US elections are a new source of stress for emerging markets. Trump's protectionist speeches during the presidential campaign help reinforce the perception of emerging risk. Undoubtedly, the adoption of a very protectionist agenda would have negative effects on the emerging countries.

However, we believe that this impact should be relatively limited. First, there is a gap between campaign promises and what is feasible from a political standpoint. It is indeed unlikely that the new US administration will be able to adopt some of the most protectionist measures. On the other hand, as mentioned above, world trade has slowed down considerably in recent years. In both emerging economies and advanced economies, growth is now driven more by domestic demand and in particular by private consumption. A strengthening of protectionism would certainly be detrimental but should have fewer effects than a few years ago when most emerging economies were driven by external demand. Finally, we note that fundamentals have improved in emerging countries.

From our point of view, the economic risk for emerging countries lies more in the consequences of US fiscal policy, notably on US long-term interest rates and the dollar. With the recent rise in US bond yields, investors' portfolios (in the US in particular) have been rebalanced to the detriment of emerging assets. Having said that, looking ahead, we do not believe that interest rates will jump (a large fiscal stimulus in the US is unlikely, there is no strong acceleration of inflation to come). The global reflation is indeed modest, the Fed will remain cautious and, as a result, we expect the upward pressure on long-term interest rates to remain contained.

In the short run, the global environment (US trade policies, interest rate changes) can weigh on capital flows in the emerging economies and thus on their currencies. However, it is key to keep in mind that most emerging currencies are not undervalued and that medium-term themes (catching up process, demography) remain supportive for emerging economies[11] in the long run.

Real GDP Growth (%)

		2015	2016	2017	2018
World	Amundi	3.3	3.0	3.2	3.3
	Consensus		2.9	3.3	3.4
Developped	Amundi	2.1	1.5	1.6	1.7
	Consensus		1.5	1.6	1.7
Emerging	Amundi	4.2	4.1	4.4	4.5
	Consensus		4.1	4.6	4.7

Source: Bloomberg, Amundi Research

[11] *In particular, note that potential growth, while slowing, will remain stronger in emerging economies than in advanced economies in the coming years.*

Underlying Trends
Oil market: what is the scenario for 2017-2020?

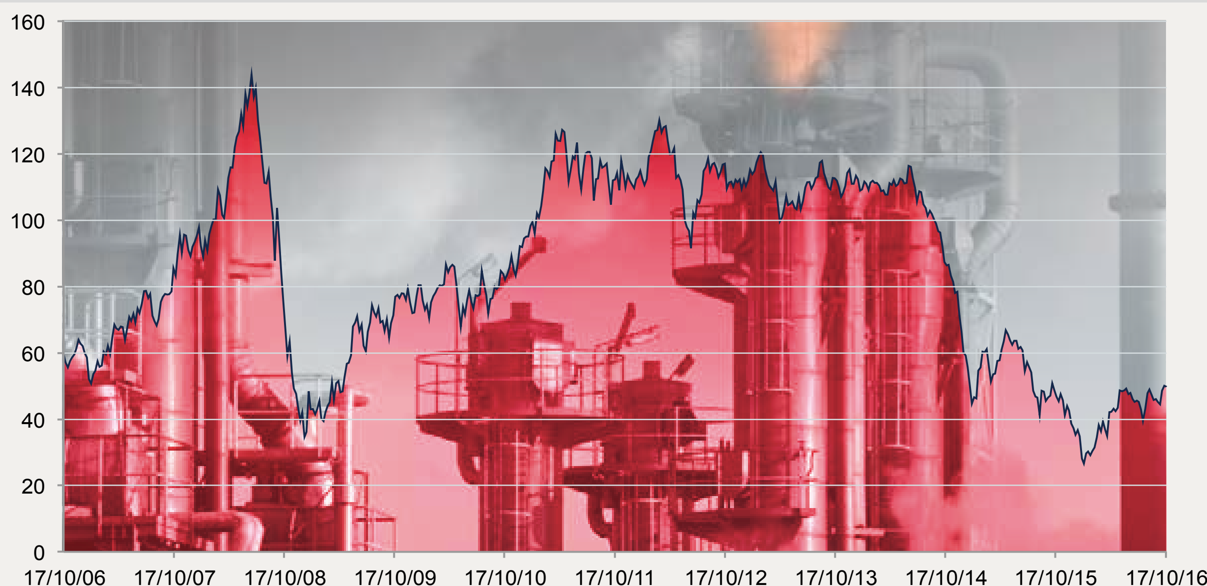
EMMANUEL MARTIN, *Equity Analysis*

In recent months, there have been more and more signs of a rebalancing of the oil market.

On the demand side, the International Energy Agency (IEA) has slightly downgraded its growth outlook for global demand; however, demand should remain relatively strong, expanding by approximately 1.2 MB/d in both 2016 and 2017.
The negative effects observed in China and a number of OECD countries have finally been largely offset by positive surprises in some non-OECD countries, especially India. India, with an estimated annual consumption of 4.3 MB/d and growth of approximately 300 KB/d this year (+7.5% vs. 2015), is emerging as a new major consumer on the global level.

On the supply side, the slump in upstream investment spending has led to a sharp decline in non-OPEC production, especially in shale oil in the United States, which was the source of excess global supply in recent years and led to the collapse of oil prices in late 2014.
According to the most recent forecast published by the IEA, non-OPEC production will have fallen an average of 900 KB/d in 2016, before rebounding by 400 KB/d in 2017.
Spearheaded by Saudi Arabia, OPEC decided in late 2014 not to scale back production, allowing prices to collapse. It sought to slow the development of shale oil in the United States, but also, at least as importantly, to rid the market of expensive production, situated on the upper end of the cost curve.
In late September, OPEC surprised most observers by announcing a production target range of 32.5 to 33 MB/d. If the deal is confirmed in late November, this will reduce production by 0.3 to 0.7 mb/d according to recent OPEC production estimates.
Many analysts remain sceptical of the effectiveness of the deal at limiting the growth of global supply. Although it would be slightly premature to draw definitive conclusions, OPEC's recent announcement marks a genuine shift in attitude on the part of Saudi Arabia, which has succeeded in finding a compromise with other major exporters, including Iran.
All of the major exporters have suffered enormously from the drop in oil prices in the last two years, and the market environment facilitated the signing of a deal that had broken down in Doha in April of this year. Since the lifting of the sanctions imposed by the UN, Iran has considerably increased its production levels, which have reached an average of nearly 3.7 MB/d according to the IEA, representing an increase of 760 kb/d since the beginning of the year. Iran has nearly returned to its 2012 production level, before the UN sanctions were imposed. This situation undoubtedly facilitated the signing of the agreement.

Brent oil price, 10 years (USD/bbl)



Source: Datastream, Amundi Research

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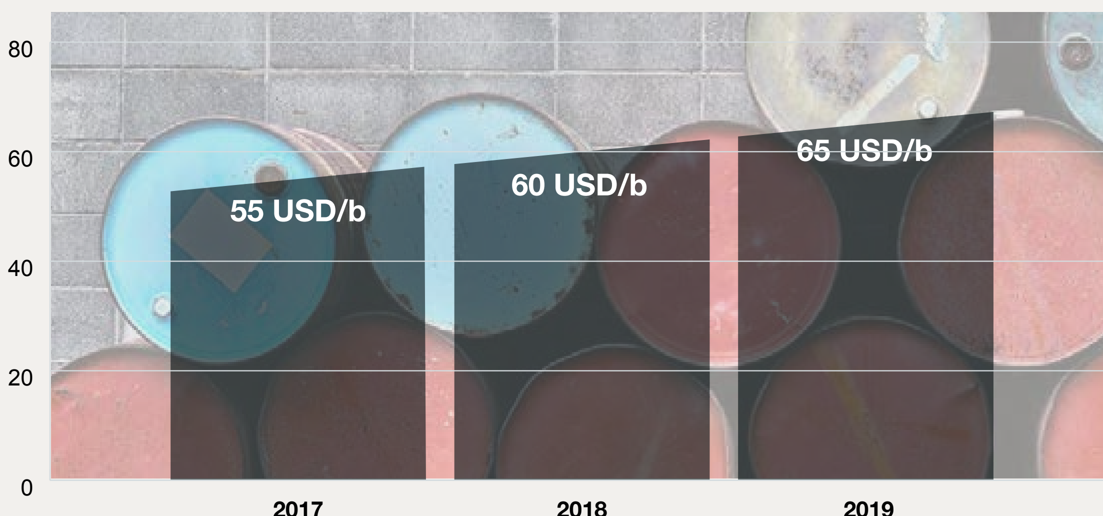
Outlook for 2017-2020:
Demand should continue to rise each year by an average of nearly 1 MB/d until the end of the decade.
For now, the rapid growth in the global inventory of electric cars has not impacted the growth profile of global demand. Although it does represent a serious threat to the oil industry, this should only significantly materialise in the medium term.
Currently, vehicle transport accounts for approximately 55% of oil consumption, with light vehicles accounting for just over half of this total. Thus, nearly 30% of oil consumption could be threatened in the medium-to-long term by the spread of electric cars.
But the fact remains that by 2020, assuming global economic growth of approximately 3% per year, global oil demand should grow an at average rate of 1 MB/d or slightly more; this amounts to an average annual growth rate of around 1%.
With regard to supply, US shale oil production should resume its growth trend in the first quarter of 2017, expanding at a slightly more moderate rate than before the recent crisis. However, US shale oil producers have continued to improve productivity, and US shale oil volumes are expected to grow by approximately 1 MB/d starting in 2018, assuming a Brent oil price of US$60 a barrel.
This does not mean, however, that this source will be enough to keep up with all of the growth in demand, as the rate of decline in mature conventional deposits will have a long-term impact on supply. That is why other sources of supply will still be needed in order to balance the global market. This is particularly true of offshore conventional deposits, or at least the most profitable of these, which—thanks to the sharp decline in costs over the past three years—can generate satisfactory profitability with oil prices at approximately US$60 a barrel. These types of deposits should become the market's marginal source of supply in the medium term.
For now, we are maintaining our baseline scenario as established at the beginning of the year: a slow and gradual rebalancing of supply and demand on the global oil market in 2017, with Brent at an average US$55 a barrel in 2017, US$60 a barrel in 2018 and US$65 a barrel in 2019, which is currently our outlook for the medium-to-long term balance.

Forecast for average Brent oil price



Source: Amundi Research

AMUNDI MACROECONOMIC FORECASTS								
Annual averages (%)	Real GDP growth (YoY %)				Inflation (CPI, YoY %)			
	2015	2016	2017	2018	2015	2016	2017	2018
US	2.6	1.5	2.0	2.2	0.1	1.3	2.5	2.3
Canada	1.1	1.2	1.9	1.9	1.1	1.9	2.1	1.5
Japan	1.0	0.6	0.7	1.1	0.8	-0.1	0.8	1.1
Eurozone	2.0	1.6	1.3	1.3	0.0	0.3	1.3	1.2
EMU-North*	1.4	1.5	1.3	1.4	0.2	0.5	1.3	1.6
EMU-Peripheral**	3.3	1.8	1.6	1.4	-0.2	-0.1	1.1	1.2
Germany	1.5	1.7	1.4	1.5	0.1	0.4	1.5	1.3
France	1.3	1.2	1.2	1.2	0.1	0.3	1.2	1.0
Italy	0.8	0.9	1.1	1.2	0.1	0.0	1.1	1.0
Spain	3.2	3.1	1.8	1.1	-0.5	-0.4	1.3	1.1
UK	2.2	1.7	1.0	1.5	0.1	0.7	2.5	1.9
Emerging Europe	-0.1	1.1	2.0	2.4	9.3	5.3	4.8	4.7
Russia	-3.7	-0.7	1.0	1.8	15.5	7.6	5.5	5.0
Turkey	4.0	2.6	3.0	3.0	7.7	8.0	7.8	7.6
Asia ex-Japan	6.2	6.0	5.9	5.7	2.4	2.3	2.5	2.5
China	6.9	6.7	6.4	6.0	1.4	1.2	1.5	1.4
India	7.6	7.5	7.6	7.6	5.2	5.4	5.2	5.2
South Korea	2.6	2.6	2.7	2.7	0.7	1.2	1.2	1.2
Indonesia	4.8	5.0	5.2	5.2	6.4	4.5	4.5	4.5
Australia	2.4	2.9	2.7	2.9	1.5	2.5	2.1	1.7
Latin America	-0.1	-0.2	1.1	2.0	5.4	9.6	7.5	5.0
Brazil	-3.8	-2.5	-0.5	1.4	9.0	8.0	6.0	5.5
Mexico	2.5	2.0	2.0	2.2	2.7	2.8	3.0	3.0
Africa & Middle East	3.3	2.2	2.6	3.0	4.5	5.3	6.0	4.6
South Africa	1.3	0.8	1.0	1.2	4.6	6.4	6.0	5.5
Developed countries	2.1	1.5	1.6	1.7	0.2	0.8	1.8	1.7
Emerging countries	4.2	4.1	4.4	4.5	4.0	4.0	3.9	3.3
World	3.3	3.0	3.2	3.3	2.4	2.6	3.0	2.6

Source: Amundi Research — *Last update: 11-2016*

* Germany, Austria, Belgium, Netherlands, France, Finland
** Spain, Italy, Greece, Portugal, Ireland

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Monetary politicies in 2017 and beyond

3 2017: A transition year for the central banks?

VALENTINE AINOUZ - BASTIEN DRUT - KARINE HERVE - MO JI,
Strategy and Economic Research

Eight out of ten central banks in G-10 countries eased their monetary policy in 2016

Again in 2016, the central banks of the developed countries loosened their monetary policies just a bit more: except for the Fed and the Bank of Canada, the central banks of all the other G-10 countries (Australia, Canada, Germany, Japan, New Zealand, Norway, Sweden, Switzerland and the United Kingdom) all loosened their monetary policies, either by lowering key interest rates or by inflating their balance sheets.

After eight years of zero interest rate fed funds, the Fed implemented its first rate hike in December 2015. Meanwhile, in January, Stanley Fischer, Vice Chairman of the Board of Governors, predicted three to four hikes in 2016 but so far the FOMC has implemented none. Crippled by weak growth (economic growth on a rolling 12-month basis has been under 2% for the past year) and by higher volatility in job creation figures, the FOMC repeatedly delayed the second round of fed funds rate hikes in the current cycle and sharply lowered its projections for the fed funds rate ("dot plots").

For their part, the ECB and the BoJ have stepped up their accommodative policy. In March, the ECB decided to expand its monthly asset purchases from €60 billion to €80 billion and to include investment-grade bonds issued by non-bank corporations in its Corporate Sector Purchase Programme (CSSP). Meanwhile the BoJ began applying a negative interest rate (-0.10%) to the excess reserves of bank in January, causing a very negative reaction by bank stocks, before adopting a new strategy on 21 September directly targeting the long end of the yield curve (target of 0% for 10-year rates).

While the size of the Fed's balance sheet has remained unchanged since the tapering of QE3 ended (year 2014), the expansion of the aggregate balance sheet of the three largest developed-country central banks (ECB, BoJ and the Fed) has not been this large since the 2008/2009 crisis.

The Fed might be helped by the new administration to pursue its Fed funds tightening cycle

With just one Fed funds rate hike so far (in December 2015), it is difficult to talk about an interest-rate tightening cycle. The US economy is far weaker and more sluggish than before (with an unemployment rate about the same as it is today and wages are roughly 4% higher today than at the end of 2008). During the symposium in Jackson Hole, Wyoming, Janet Yellen stated in a speech on 26 August that the case for an increase in the federal funds rate had strengthened in the months before, with the continued solid performance of the labour market and the improving outlook for growth and inflation. However, a worse than expected report on employment a few days later (but frankly not that bad, with an initial estimate of 151,000 new jobs for the month of August) had cooled the enthusiasm of some members of the Board of Governors, who decided to allow additional time before deciding to tighten monetary conditions. Governor Lael Brainard justified the Fed's wait-and-see attitude in the following points ("The 'New Normal' and What It Means for Monetary Policy", a speech delivered on 12 September):

1. Inflation has been undershooting, and the Phillips curve has flattened
2. Labour market slack has been greater than anticipated
3. Foreign markets matter, especially because financial transmission is strong
4. The neutral rate is likely to remain very low for some time
5. Monetary policy options are asymmetric.

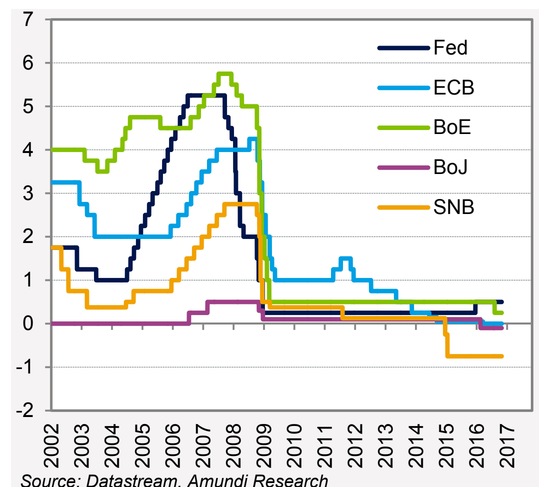
The essential

Again in 2016, the central banks of the developed countries loosened their monetary policies just a bit more: except for the Fed and the Bank of Canada, the central banks of all the other G-10 countries all loosened their monetary policies, either by lowering key interest rates or by inflating their balance sheets.

After years of procrastination, the projections for the fed funds of FOMC members for 2016/2017 seem more credible with the new US administration (slightly higher growth and inflation). However, the rise of the effective exchange rate of the US (the rise of the fed funds will actualize the divergence of monetary policies) will prevent a rapid tightening cycle. The ECB will pursue its QE at the current pace and validate that key rates will not be cut further. The BoJ will pursue its QE and should not change its long rates target.

Emerging economies are divided into two groups: commodity-exporting countries which, due to the sharp depreciations of their currencies, have experienced very high levels of inflation and other countries that have faced deflationary pressures. The monetary policies of countries with low levels of inflation have been and should remain accommodative and those of other countries should become so, in line with the decline in inflation. However, US monetary policy could become a game changer if the Fed's rate hikes were more pronounced than expected.

1 Main central bank rate



Source: Datastream, Amundi Research

Underlying Trends
QE and negative interest rates
Monetary policies have reached their limits

PHILIPPE ITHURBIDE, *Global Head of Research, Strategy and Analysis*

Monetary policy has reached its limits. Interest rates are in negative territory, and this is now counterproductive. The financial fragmentation and dysfunctions of the interbank market cannot be solved by the ECB alone: disintermediation, economic growth and the relaying of fiscal and fiscal policies are indispensable levers. The ECB faces problems of liquidity on sovereign debt, which clearly shows the limits of an administered market.

The foundations of ECB policy

What the ECB is trying to do is quite clear: i) provide liquidity to banks, ii) keep short-term rates low, iii) anchor long bond yields at low levels while eliminating or mitigating deflationary pressures, iv) ensure favourable financing conditions through low short- and long-term interest rates.

What it is not explicitly trying to do is also clear: i) fund public deficits directly, ii) provide direct support to banks by buying up distressed assets (unlike the US QE) or bank bonds, for example, iii) drive the euro down (unlike Japan, which wants a weaker yen).

What it is doing indirectly: i) reducing sovereign default/insolvency: it is buying up almost twice the net issuance of the entire euro zone; ii) fostering the development of a "non-banking" system: negative rates + a flat curve = weaker bank profitability at a time of digital = expansion in the bond market; iii) contributing to reduced liquidity on fixed-income markets.

Assessing the impact of the ECB's monetary policy

Monetary policy (QE and interest rate policies): seven channels for transmitting monetary policy to the real economy:

1. **Interest-rate effect:** Drive interest rates as low as possible and keep them there. The ECB has pulled this off.
2. **Spread effect:** Narrow spreads, especially for peripheral countries. The ECB has also pulled this off but to so it is buying up more than twice the net issuance of the entire euro zone.
3. **Wealth effect:** Boost economic agents' wealth, mainly by driving up the equity and real-estate markets. Mixed results: the equity markets have fallen on the whole since QE was first announced. Buying up sovereign bonds and guaranteeing low rates for a long time is not enough to drive up the equity markets.
4. **Bank lending effect:** Boost bank lending, particularly to SMEs. The ECB has, on the whole, been successful, but:
   - **The impact has been a mere blip in credit surveys.** Many companies are taking advantage of low rates and investors' quest for spreads to refinance on the capital markets (e.g., Sanofi issued a three-year bond at a rate of -0.50%; no bank can top that).
   - **Mid-market and small cap companies are a cause for concern.** They depend very closely on banks and bank lending to them has fallen for the sixth consecutive year.
5. **Currency effect:** The objective was to drive down the euro, which is a plus for competitiveness. This is not an explicit goal of the ECB (which has no mandate to steer the euro's exchange rate), but the QE announcement did weaken the euro. Albeit for a brief period – the euro levelled off in 2015 with the drop in emerging currencies, the yuan depreciation, the yuan's change of regime, and the end of the dollar's appreciation. Now there are no longer any positive and automatic effects on corporate profits, for example.
6. **"Inflation expectations" effect:** The ECB wanted to eradicate deflationary pressures and trigger a virtuous price-consumption cycle. It has not really been successful at this, at least for the time being. Yes, deflationary risks have receded, but the price-consumption spiral has not reversed itself, and inflation expectations are still very low.
7. **"Confidence" effect:** Achieving a significant and sustained increase in confidence indicators is necessary for investment and growth. QE's impact here has been mixed, but, clearly, without ECB action these indicators would have dropped once gain.

Overall, the ECB's monetary policy has been very useful in guaranteeing low rates (and spreads), to make creditors (including states) more solvent and less risky, to limit market volatility... no doubt about it. But everything is somewhat artificial, as this is based on the ECB's presence in the interest rate markets: the ECB buys more than the total amount of Eurozone net issuance, and it reassures financial markets. As a consequence, long-term interest rates remain at low levels. Two questions at this stage:

- Can the downturn in liquidity have adverse effects on the valuation of these assets?
- How long will this situation last? Has the ECB accepted to resemble - voluntarily or unintentionally - to a "Japanese-style" situation, with an impression of "never-ending QE", with eventual debt monetization?

In sum, QEs have an impact on financial assets (price, volatility). The table below highlights the criticisms that we identify against QEs and negative rates. Even if we understand the current need for QEs, we must not ignore the shortcomings. Similarly, we can understand the lack of confidence in negative rates. To persevere in this direction is counterproductive.

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

The QEs' dangers	The dangers of negative rates
1st criticism: QEs are keeping interest rates (short and long) at artificially low levels; **2nd criticism:** The more time goes by, the harder it is to exit QE; **3rd criticism:** They are dampening market volatility artificially; **4th criticism:** They are getting market participants accustomed to a quiet environment; this "new normal" is anything but normal; **5th criticism:** They are skewing asset values; **6th criticism:** They are generating potential bubbles; **7th criticism:** They could be causing financial crises; **8th criticism:** They are encouraging governments to drag their feet on fiscal and tax matters (on the flip side, they are allowing governments to have more proactive fiscal and tax policies without the drawbacks, such as rate hikes); **9th criticism:** While low rates are a tax on savings, QEs (and negative rates) are a subsidy on debt accumulation; **10th criticism:** QEs have shrunk risk premiums and squeezed spreads to such a point that spread-rating matrices mean nothing now. Some investors, for example, can no longer buy bonds, as the spread no longer corresponds to the rating or the risk incurred. What is the solution: no longer invest or revise spread-rating matrices and raise portfolio risk? **11th criticism:** QEs tend to deteriorate market liquidity.	**1st criticism:** They are not truly necessary for access to financing. Companies have access to the capital markets (except SMEs, which rely closely on banks); **2nd criticism:** A reduction in banks' deposits with the ECB if any in no way ensures an additional increase in bank lending to companies in the least favoured regions; **3rd criticism:** Having negative rates in no way guarantees that the interbank market will work better; **4th criticism:** Banks have liquidity (which they then deposit with the ECB) precisely because the ECB is injecting so much of it; **5th criticism:** The reduction of rates into negative territory is undermining banks' profitability (all banks, both core and peripheral); **6th criticism:** By sending short and long rates into negative territory, the ECB is also sending negative signals to the financial markets… and on banking stocks; **7th criticism:** They widen the gap between interest rates and banks' cost of capital.

Conclusion

The ECB will undoubtedly maintain an accommodative monetary policy for the next few years, even if its actions have reached their limits. To reverse the current policy would not make much sense in the current context. But for an impact on growth to be more evident, it is now necessary that income, budgetary and fiscal policies take over. Support for consumption through increases in real disposable income and investment by targeted public spending becomes an inevitable consequence: tax cuts and the revival of infrastructure spending are often mentioned, including in the United States (in the programs of D. Trump and H. Clinton, both candidates in the recent presidential election).

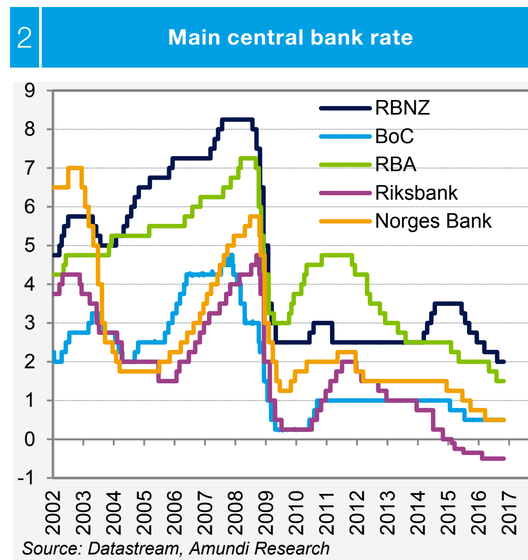
For further details

Drut B. et Ph. Ithurbide – *"ECB QE Monitor"*, Monthly issues, Amundi.
Ithurbide Ph. 2016, *"Low / Negative interest rate environment, secular stagnation... Implication for asset management"*, Amundi Discussion Papers Series #15, April.

The most recent median projections of the federal funds rate (dot plots) submitted by the members of the FOMC show one rate hike in 2016 (December) and two in 2017. After the repeated downward revisions of the 'dots', the latest 2016/2017 projections seem more credible with the new US administration (slightly higher growth and inflation, see section 'economics'). The sharp rise of the inflation expectations that followed the US elections will reassure FOMC members, worried about the weakness of inflation expectations over the last quarters. However, the rise of the effective exchange rate of the US (the rise of the fed funds will actualize the divergence of monetary policies) will prevent a rapid tightening cycle (cf. the speech of Stanley Fischer in November 2015 « *The Transmission of Exchange Rate Changes to Output and Inflation* »). Moreover, the arguments of Lael Brainard (see above) remain largely valid.

Furthermore, it is important to underscore that the Fed acts through its balance sheet and not only through its rate policy. Over the course of its QE programmes, the Fed accumulated $2.4 trillion in Treasury securities on its balance sheet. In 2016, $232 billion of those securities matured and were reinvested along the yield curve. No less than $200 billion in Treasury securities held by the Fed will mature in 2017. This is likely to influence long rates. Key market dealers in T-bills (the *Survey of Primary Dealers* conducted by the Federal Reserve Bank of New York) do not expect rolling over maturing Treasury securities to begin winding down before mid-2018.

2 Main central bank rate



Source: Datastream, Amundi Research

The ECB will remain highly accommodative in 2017

Although until recently there was consensus on the fact that the ECB would extend its QE programme beyond March 2017 (the scheduled end of the programme for now), a short article by Bloomberg poisoned the bond markets with doubt. However, this article did not contain anything of substance: it merely said that a consensus had formed among the members of the Governing Council that monthly asset buying under the quantitative easing (QE) programme would have to be tapered in €10bn increments once the ECB comes to a final decision on the ending the programme. Nothing more. Nothing very surprising because not many thought that the ECB would abruptly halt its asset purchasing programme. Nothing very specific, either, because the article's sources asked to remain anonymous. At his press conference of 20 October, Mario Draghi completely debunked the rumour of a tapering of the ECB's QE programme that had so agitated the markets recently: "a kind of a random statement made by somebody who didn't have any clue or information about that". We are a far cry from Ben Bernanke's speech of May 2013 when he said that the Fed might slow the pace of its asset purchases (the final decision was taken only seven months later).

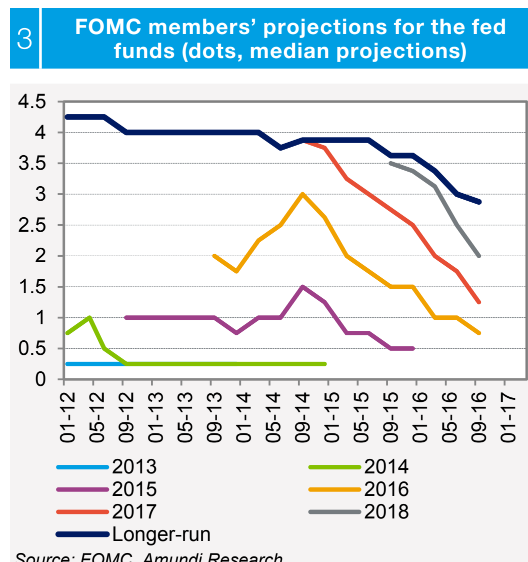
The key features of the ECB's monetary policy in 2017 will be announced when the Governing Council meets on 8 December 2016. **The ECB is expected to extend its QE programmes beyond March 2017 because:**

- Although headline inflation is rising, **core inflation is still very low in the eurozone** (0.7% in October) and has been on a fairly downward trend recently. Remember that ECB press releases indicate that its QE programme will run beyond March 2017 *"if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim."*
- Improvement in the labour market has been stagnating for the last half year: for the past five months, the unemployment rate has been stationary at 10.1% of the labour force. This has further slowed the acceleration of inflationary pressures.
- Tapering QE will presumably lead to a sharp rise in long rates, a widening of sovereign spreads and, most significantly, a sharp appreciation of the euro. These factors will make the return of inflation to its 2% target all the more difficult.

Theoretically, on 8 December the ECB could:

- Continue with rate cuts (with stimulating the economy as the stated justification),

3 FOMC members' projections for the fed funds (dots, median projections)



Source: FOMC, Amundi Research

- Raise interest rates (with preserving financial stability as the stated justification),
- Adjust its forward guidance on interest rates,
- Continue QE as it stands,
- Increase the size of QE,
- Reduce the size of QE,
- Taper QE but roll over maturing bonds (like the Fed),
- Taper QE and not replace maturing bonds,
- Abandon the key capital rule for purchases of sovereign bonds,
- Buy bank bonds,
- Buy equities.

What it is likely to do...in our view:

- The ECB will not reduce its interest rates any further: adopting a negative interest rate policy has already been shown to be counter-productive;
- It will continue QE at the current pace, although there is a statistically significant likelihood that it will reduce its monthly purchases;
- It will not modify the weighting distribution of its purchases: it's easy to do on the technical level, but it's more complex on the political level. This will mean buying more debt of countries maintaining a high number of issues, namely, the countries with the highest deficits;
- It will not buy banking securities: that runs counter to its current thinking and could raise issues of a "consanguineous relationship", moral hazard, etc;
- It will not buy equities: not enough impact on household wealth.

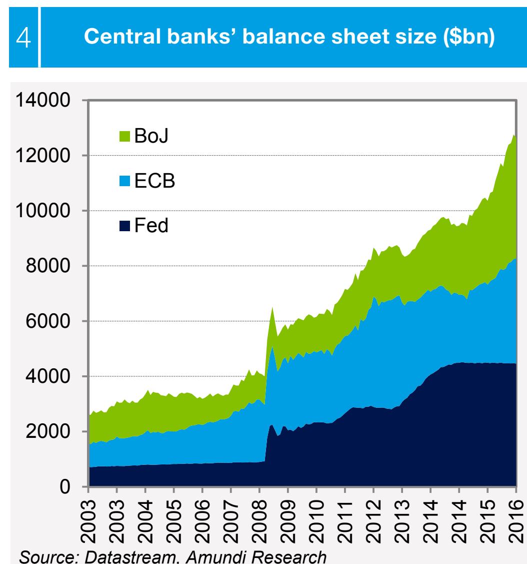
When the Governing Council met on 20 October, Mario Draghi did not let slip the slightest indication regarding the evolution of his policy, and in particular his asset purchasing programme. The lack of consensus among Council members is probably very high. The Governors are speaking out more and more on the negative effects of ultra-accommodating monetary policy (see box). However, the recent rise of the long-term yields will facilitate the decision of a QE extension (tightening of the financial conditions).

The BoJ had already introduced a negative-rate system in January 2016 and, on 21 September, it decided to focus on long rates (the 10Y JGB yield target is now explicitly 0%). It clarified that the short-term rate, like the long rate target, may be lowered if need be. Furthermore, the BoJ has vowed to continue inflating its balance sheet until core inflation permanently stabilises above 2% (Haruhiko Kuroda recently admitted that this would not take place before the end of his term of office (March 2018)). A full assessment of the measures adopted since the arrival of Mr. Kuroda at the helm of the BoJ shows that the 1-year – 2-year segment is the one stimulating the Japanese economy the most. **To further lower this end of the yield curve, the BoJ could further lower the short-term interest rate or redirect JGB purchases to this segment (over the past few years, purchases have been concentrated on 5-year, 10-year and 20-year maturities) in 2017. Changing the long rate targets is not expected to be on the agenda for 2017.**

The BoE lowered its key interest rates to 0.25% and resumed its QE policy in August. Lower growth in preparation for Brexit will lead the BoE to do more in 2017 (a further rate cut and extension of the QE programme). In any event, the pick-up in inflation linked to the depreciation of the GBP will not make the BoE tighten its monetary policy.

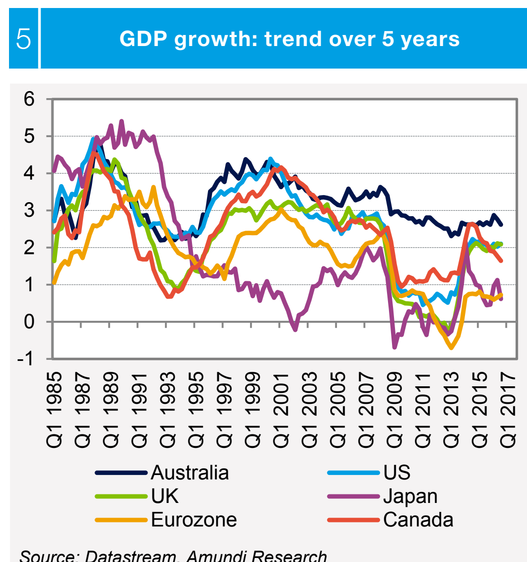
The central banks of commodities-producing countries (Australia, Canada and New Zealand) may cut interest rates once more in 2017: 1) because of lower growth potential, 2) because of the risks facing the Chinese economy and in particular with regard to China's real estate market.

4 **Central banks' balance sheet size ($bn)**



Source: Datastream, Amundi Research

5 **GDP growth: trend over 5 years**



Source: Datastream, Amundi Research

> Why are investors so sceptical on the outlook for European banks?

There's no point in looking for parallels with 2008: banks have now shored up their solvency, liquidity and capital structures considerably to comply with new regulatory restrictions. The CET1 ratios of the euro zone's largest financial institutions averaged 13% at the end of 2015 vs. just 7% in 2008 (source: ECB). Note that some specific banks remain undercapitalized in peripheral countries. Banks are now suffering from a generalized dearth of profitability, due in part to an environment of low/negative rates.

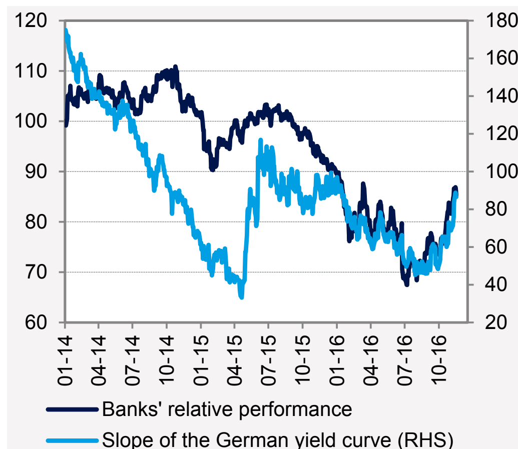
The ECB denies that its ultra-accommodating monetary policy has ultimately undermined the euro zone's banking system. Mario Draghi pointed out the positive impacts of low interest rates for banks: (1) capital gains in bond portfolios; (2) enhanced borrower solvency; and (3) increased lending volumes. However, the vice-president Constancio recently admitted that these positive effects decline with time and are likely to fade out at some point. More importantly, Mario Draghi blamed "overcapacities in the European banking sector". The IMF came to a similar conclusion in its latest GFSR. It should be noted that this strategy takes time and is hard to implement in the current environment.

No wonder financial stocks are taking a beating on the markets: these squeezes on profitability on top of increasingly strict capital requirements have contributed to the sharp drop in return on equity. ROE is below the cost of equity at many banks.

But to what extent can bond investors also be affected? Investors are concerned about the large amount of non-performing loans held by European financial institutions – €950bn at the end of 2015, or 7.1% of total outstanding loans. This is high by international standards and higher than in the US and UK (source: ECB). Non-performing loans are concentrated in peripheral countries: Greece (34% of total loans), Italy (18%), Ireland (15%) and Portugal (12.8%). This is a particular point of concern for these banks, which may have an increasingly hard time shoring up their equity by: (1) setting aside income as reserves (lower profits); or (2) raising new capital (little appetite on the equity market). In the event that market recapitalisation fails, since 1 January 2016 bond investors must help shoulder the burden of recapitalising distressed banks.

On the macroeconomic front, banks' ability to generate enough resources to finance the economy must not be undermined by the interest-rate environment and increasingly stringent regulatory constraints. Accumulating equity must definitely not be an end in itself.

6 The relative perf.of Eurozone banks' stocks vs the index is correlated to the slope of the curve



Source: Datastream, Amundi Research

"Banks are now suffering from a generalized dearth of profitability, due in part to an environment of low/negative rates"

Monetary policy in Emerging countries: towards more accommodative policies in 2017?

Even if the situation of Emerging countries is heterogeneous, the monetary policy will be globally more accommodative in 2017, or at least as accommodative. However, if US fiscal policy translated into a sharp rise in US interest rates, central banks in emerging markets could change their policies.

Towards more monetary easing in China

We expect that the PBoC will keep the tone of prudent monetary policy throughout 2017:

- We think PBoC has to remain **accommodative with aggressive easing** to help stabilize the overall Chinese economy during the political transition year in 2017.
- We do not agree with the general logic spreading within the market – 1. A slight pickup in inflation in 2017 will lead to PBoC tightening; 2. Economic pickup and stabilization will result in a tighter monetary policy stance in 2017. (We think that the PBoC's only option is easing in order to help stabilise the overall economy.)
- In terms of easing i.e. liquidity provisioning tools, we expect no interest rate cut, one or no RRR (Reserve Requirement Ratio) cuts. OMO (Open Market Operations) and SLF/MLF (short or medium term loan facilities) will still be the major easing tools.
- PBoC may ease more in H217 vs. H117, due to further property slowdown in H217.

"Central banks should continue their easing cycles unless US monetary policy tightens considerably"

- We expect the downtrend of the 7-day repo rate to fall below 2% in 2017, while the real interest rate continues to go down given now that the PPI is back to positive territory. We anticipate a slight upside for the CPI and PPI in 2017.

Central Europe: the reflation is on track, so no major change from a Central Bank standpoint

In Central Europe, and notably in Poland, Hungary, the Czech Republic and Romania, despite inflationary pressures (increased commodity prices, job market tension), inflation will remain limited (deflationary pressures from the euro zone) and will undoubtedly not exceed the targets set by the Central Banks. As a result, in an environment where growth should stabilise at current levels, the Central Banks can be expected to keep their rates unchanged through the end of 2017.

In Russia, the steep downturn in inflation should allow the Central Bank to make big interest rate cuts by end-2017.

In Russia, inflation has decreased considerably and may even pass below the upper limit of the target band (5-6%) set by the Central Bank of Russia (CBR) for end-2016, paving the way for new interest rate cuts in 2017 and 2018, but not before. The CBR clearly stated in its last press release that it plans to remain cautious, as non-food prices have fallen less than expected. Furthermore, the CBR is highly likely to keep its policy rate unchanged pending the Fed's decision in December. If the Fed decides to hike its rates, this would weigh on all emerging currencies, and thus on inflation in countries with a high pass-through. If the rouble stabilises and inflation is contained by the end of 2017, we think a 150-200 bp cut in the CBR's policy rate is feasible.

The Central Bank of the Republic of Turkey (CBRT) will want to complete the convergence between its main rates, which should result in another cut in the financing rate.

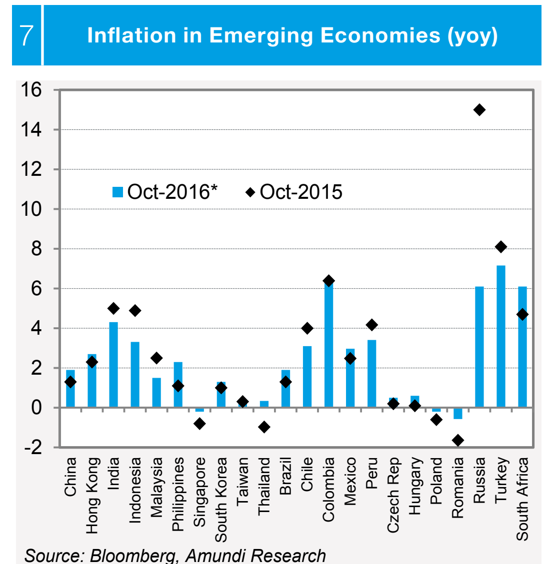
The economic climate in Turkey (persistently high inflation with rising inflation expectations and a fiscal policy seen as lax) calls for the tightening of its monetary policy. However, in a bid to simplify its monetary policy (convergence of financing, borrowing and repo rates), the CBRT has made the choice few months ago to reduce its overnight lending rate rather than climbing the repo rate. But, contrary to all expectations, the CBRT has kept rates unchanged in October. In its press release, it states that future decisions will be data dependent, understand the evolutions of the FX and of external accounts. In an environment more favorable to emerging economies, the FX might not been hurt by marked downward pressures especially as this October decision could enhance the credibility of the CBRT. By the end of 2017, the overnight lending rate could fall by additional 75 bp down to the repo rate level of 7.5%.

The South African Reserve Bank (SARB) is among the most limited in terms of options, making the prospect of a rate cut very unlikely.

South Africa is still suffering from an adverse economic and political environment. Although inflation declined in H1 2016 in South Africa, it still hovers above the upper limit (6%) set by the SARB. In addition, the recent depreciation of the Rand (due to the lacklustre economic environment and, more importantly, internal political problems) may intensify and weigh even further on inflation. Tensions plaguing the African National Congress have been escalating, particularly between President Zuma and the current Finance Minister (P. Gordhan). Against this backdrop, the SARB will probably maintain the status quo through the end of 2017.

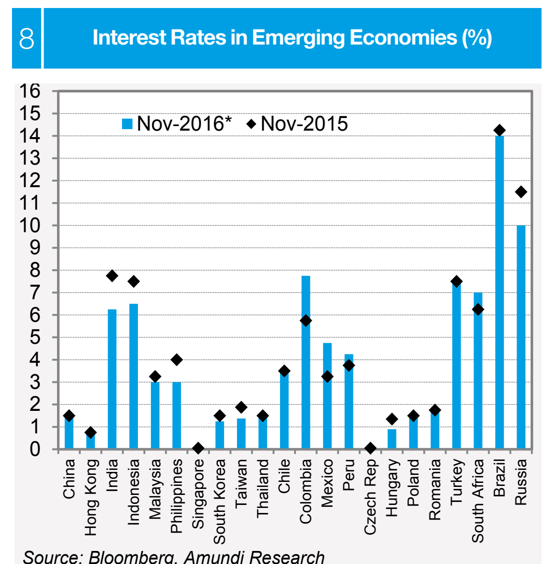
In Latin America, inflation has declined significantly in many countries thanks to the stabilisation of commodity prices and exchange rates. Central Banks can be expected to end their tightening cycle, and may even instigate rate cuts.

7 Inflation in Emerging Economies (yoy)



Source: Bloomberg, Amundi Research

8 Interest Rates in Emerging Economies (%)



Source: Bloomberg, Amundi Research

Inflation has fallen in most Latin American countries and should continue to do so. As a result, most Central Banks in the region should have more leeway to relax their monetary policy. Inflation has decreased sharply in Brazil, and may fall below the upper limit (6.5%) set by the Central Bank (BCB) by the end of the year. If there are no additional shocks, the disinflation process should continue in 2017. The BCB can thus be expected to carry out rate cuts, but this is likely to depend on fiscal policy developments. The current outlook seems to conducive to rate cuts of 200 bp by end 2017 and additional ones in 2018 leading the Selic at 10% end 2018.

In Mexico, the peso's depreciation has weighed on inflation. In September, core inflation climbed above 3% and should continue to rise through the end of the year. The Mexican Central Bank (Banxico) adopted a more aggressive tone in its last press release. The appointment of D. Trump to the US Presidency also changes the situation for Mexican monetary policy, at least in the short term. Indeed, since the results, the peso has kept on depreciating. Faced with this shock, the Banxico will undoubtedly be compelled to raise its rates in the coming months to support its currency.

In other countries such as Chile, Peru and Columbia, falling inflation and stabilised growth will lead Central Banks to stay on hold.

Central bank rates forecasts

	End 2013	End 2014	End 2015	14/11/2016	Amundi + 6m.	Consensus Q2 2017	Amundi + 12m.	Consensus Q4 2017
US	0.25	0.25	0.50	0.50	0.75	0.90	1.25	1.10
Eurozone	0.25	0.05	0.05	0.00	0.00	0.00	0.00	0.00
Japan	0.10	0.10	0.10	-0.10	-0.20	-0.10	-0.30	-0.10
UK	0.50	0.50	0.50	0.25	0.25	0.20	0.00	0.25
Canada	1.00	1.00	0.50	0.50	0.50	0.45	0.25	0.55
Australia	2.50	2.50	2.00	1.50	1.50	1.30	1.25	1.30
Sweden	0.75	0.00	-0.35	-0.50	-0.50	-0.50	-0.50	-0.40
Norway	1.50	1.25	0.75	0.50	0.50	0.45	0.50	0.50
Switzerland	0.00	-0.25	-0.75	-0.75	-0.75	-0.76	-0.75	-0.74
China	6.00	5.60	4.35	4.35	4.35	4.20	4.35	4.10
India	7.75	8.00	6.75	6.25	6.00	6.00	5.75	5.95
Brazil	10.00	11.75	14.25	14.00	13.00	11.85	12.00	10.90
Mexico	3.50	3.00	3.25	4.75	5.25	5.15	5.50	5.40
Russia	5.50	17.00	11.00	10.00	9.25	9.05	8.25	8.20
Turkey	4.50	8.25	7.50	7.50	7.50	7.65	7.50	7.70
South Africa	5.00	5.75	6.25	7.00	7.00	7.15	7.00	7.05

Bond markets in 2017 and beyond

4 The US elections reshuffle the cards for the fixed-income markets

BASTIEN DRUT, *Strategy and Economic Research*

Bond yields down everywhere in 2016... before the US elections

Without exception, 10 y. yields have fallen in all G10 countries (Germany, the United States, Japan, the United Kingdom, Canada, Australia, New Zealand, Norway, Sweden, Switzerland) during the 10 first months of 2016. This can mostly be explained by the attitude of central banks: except for the Fed and the Bank of Canada, central banks in all other G10 countries eased their monetary policies, either by lowering key rates or expanding their balance sheets.

Overall, yield curves flattened even more in developed countries, with the short segment of the curve falling less than the long segment. At the end of Q3 2016, yield curves had not been this flat since 2008, in the case of Germany and the United Kingdom, and 2007 in the United States. Historically, this kind of shift is observed at the end of the economic cycle, when unemployment is close to its cyclical low.

The US elections (8 November) have broken the fixed-income markets' dynamic observed during the first part of 2016. After these elections, long-term yields have risen dramatically in several developed countries, largely as long-term inflation expectations have risen, while the latter were historically low. The rise of long-term inflation expectations had already begun several weeks before the elections but intensified after the victory of Donal Trump and of the Republicans at the Congress.

- In the United States, 10-year interest rates fell 50 bps over the 3 first quarters of the year before coming back to early-2016 levels. The main reasons for the decline during the first part of the year are the weakness of US growth and the the repeated postponement of a second fed funds rate hike during the cycle, which had still not occurred as of this writing (whereas in January the Vice Chair of the Board of Governors, Stanley Fischer, believed there would be three to four interest rate hikes in 2016).
- At the time of writing, German long-term interest rates are around 30 bps below the early-2016 levels. This is partly linked to the fact that the ECB accelerated the pace of its QE programme (from €60bn to €80bn per month starting in April) and that the Bundesbank appeared to have reached the PSPP issue share limits for securities with maturities close to 10 years. Over the last months, German securities purchased under the PSPP had an average maturity of 11/12 years.
- In Japan, the situation is unique because on 21 September the Bank of Japan decided to introduce yield-curve control and target a zero-percent 10-year rate.

The United Kingdom is one of the countries where bond yields have dropped the most: following the referendum on Brexit, the BoE cut its key interest rate and reactivated its QE programme, which significantly pushed down interest rates.

Upward pressure on the yields with the rise of headline inflation and inflation expectations

The US elections have accelerated the rise of long-term yields and of steepening of the yield curve ("bear steepening") which had started at the end of Q3. First, this move had been triggered by the rumours about a possible reduction of ECB securities purchases and the imminence of the rise of headline inflation (realization of inflation base effects). The major part of the rise of long-term yields can be explained by the rise of inflation expectations. The expectation

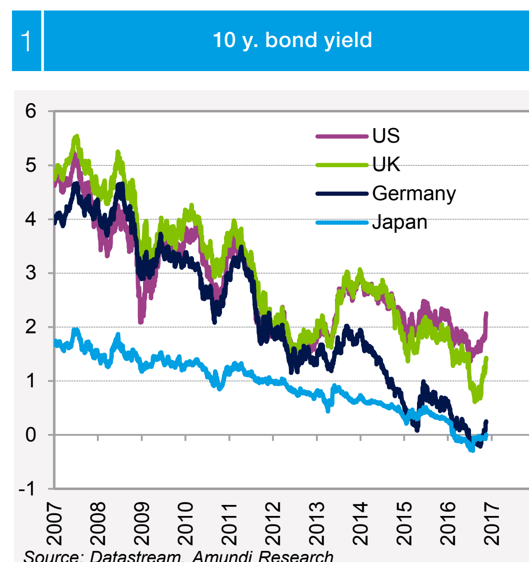
The essential

Without exception, 10-year rates fell in all G10 countries during the first three quarters of 2016, what can be explained by the strengthening of accommodative monetary policies (lowering key interest rates, expanding balance sheets) in almost all countries. Since October, long-term rates are rising and this rise has accelerated since the US elections.

Several factors will favour an increase in long-term interest rates: rising total inflation, increase of the fed funds rate in December, likely pro-growth measurer from the US government. However, we doubt that this will become a trend that will persist throughout the whole year 2017 and the opportunity to be long again will resurface rather soon: the expectations in terms of US fiscal easing are very high and the monetary policies at the global level will remain very accommodative (massive asset purchases for the ECB and the BoJ), which will weigh again on long-term yields.

> "One very big difference between the "taper" and the "Trump" tantrums is about the USD"

1 — 10 y. bond yield



Source: Datastream, Amundi Research

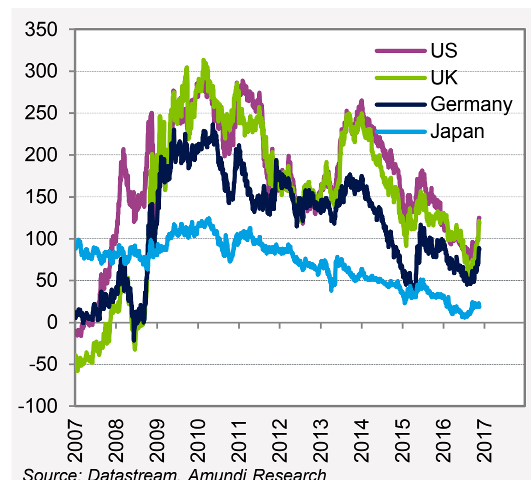
of fiscal stimulus measures from the new US government gave more credibility to a possible normalization of long-term inflation expectations. In November, December and January the impact of base effects on inflation will continue to be felt (rising total inflation, oil prices bottomed out mid-January 2016), which should bring breakeven inflation rates up. This would lead to the yield curve steepening slightly at end-2016 and the very beginning of 2017. This being said, this is important to note that the 10y. inflation break-even rate was already at 1.90% at mid-November and it is unlikely to see it rise above 2.20% ("normal" level outside crisis periods) as the "secular stagnation" hypothesis is far from being invalidated. The inflation expectations could cross this level only in case of very powerful fiscal policies from the new US administration.

The current rise of long-term yields recalls the 2013 "taper tantrum". Bond sell-offs are often associated with a dramatic change in expectations. In May 2013, the fact that Bernanke evoked a QE tapering for the first time gave birth to the idea that fed funds policy would be tightened far more than previously expected. The US 10 y. yield rose from 1.60% to 3% at the beginning of September 2013. There was a lot a market buzz about an announcement of the start of tapering at the 18 Sept. 2013 FOMC. But the the tapering had been delayed and the following sentence appeared in the FOMC statement "*The Committee sees the downside risks to the outlook for the economy and the labor market as having diminished, on net, since last fall,* ***but the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market.***" This triggered a 2 year long decline of long-term yields and fed funds expectations have been progressively altered. The "Trump tantrum" comes from the idea that fiscal measures would improve substantially the growth and the inflation outlooks. Higher inflation expectations should please FOMC members in the first place as they have been complaining about the weakness of inflation expectations for two years. **One very big difference between the "taper" and the "Trump" tantrums is about the USD.** During the Taper tantrum, the ECB and the BoJ were not acting aggressively and the PBoC was not yet reluctant to let its renminbi appreciate with the USD. Nowadays, the ECB and the BoJ are purchasing like never before and the PBoC does not tolerate any appreciation of the trade-weighted RMB (as a consequence, the RMB depreciates vs the USD). The trade-weighted USD will remain a recurring problem for the Fed (on the top of that, imported inflation will be depressed by USD appreciation) and a Fed communication about the tightening of financial conditions through currency appreciation could be the trigger the end of the "Trump" tantrum.

Historically, the link between long-term yields and the fiscal balance has been very weak in the US. At the time of writing, we have very few details about the fiscal policies that will be implemented by the new US administration. One question everybody has in mind now is: « Could a rise of the deficits lead to a sharp rise of LT yields ? » Not knowing what will be the fiscal measures does not prevent us from thinking to the impacts of higher fiscal deficits on the long-term yields. **Historically, the link between long-term yields and the fiscal balance has been very weak in the US, and even almost nonexistent over the last decades.** However, the 2009 episode provides a particularly interesting counterexample. Amid the Great Recession, the Bush and then the Obama governments launched substantial stimulus packages (the *Economic Stimulus Act of 2008* was signed into law in February 2008 and the *American Recovery and Reinvestment Act* of 2009, far bigger, has been signed into law in February 2009), which induced a dramatic increase of the net issuance of US Treasuries at the beginning of 2009. The US 10 y. yield started to climb rapidly from the low of 18 December 2008 (2.08%) to 3.90% on 20 Feb. 2009. That would be tempting to attribute the rise of LT yields to the rise of the net issuance but this calls for two remarks:

- US Treasuries were historically expensive at this time (more than 3 standard deviations in basic models) as this followed one of the biggest and most prolonged risk-off episodes in history. Actually, the sharp rise of the 10y. yield just brought it back to fair value.

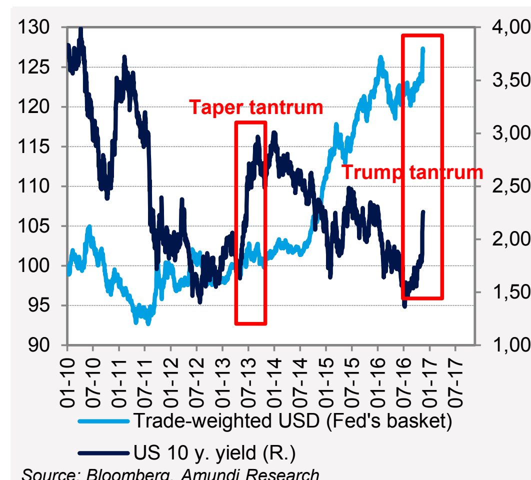
2 **Slope of the yield curve (2 years - 10 years)**



Source: Datastream, Amundi Research

> The ECB's and BOJ's large-scale asset purchase policies will encourage investors in these regions to search for yield abroad, especially in the United States, what is likely to prevent a sustained rise of long-term yields throughout 2017

3 **Trade-weighted USD (100 at the beginning of 2010) vs US 10y. Yield**



Source: Bloomberg, Amundi Research

- The net issuance of US Treasuries had been extremely elevated in 2009 ($1550 bn, ie around 11% of GDP)

In other words, the rise of deficits in itself will give birth to a negative technical factor for the US Treasuries only if fiscal deficits are massive, which is not the most likely according to us.

Central banks will continue to play a dominant role on the bond markets

As in previous years, changes in the fixed-income markets in 2017 shall continue to track at least partly with the monetary policies of the major central banks as:

- the ECB and BoJ keep purchasing massive amounts of sovereign debt
- the Fed continues to reinvest along the entire the yield curve for the maturing Treasury securities it holds ($200bn).
- the central banks of commodities-producing countries (Australia, Canada and New Zealand) may cut interest rates once more due to: 1) the weakening of potential growth in these countries and 2) risks related to the Chinese economy.

For a little while longer, the ECB's and BOJ's large-scale asset purchase policies will encourage investors in these regions to search for yield abroad, especially in the United States. **This factor is likely to prevent a sustained rise of long-term yields throughout 2017.**

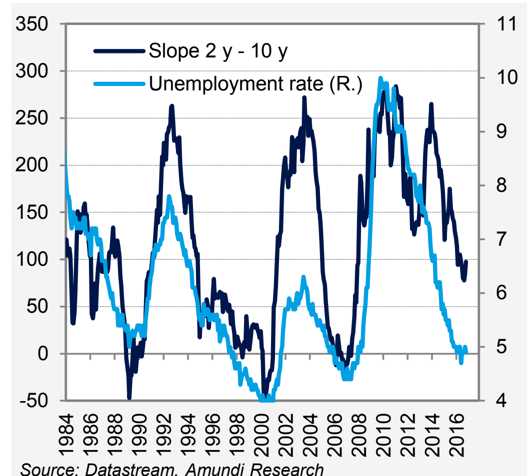
That said, **central banks are increasingly operating under the assumption that they have reached the limits of what their unconventional monetary policy measures can do**. Today, there is a clear awareness that the negative effects of these policies could overwhelm the positive effects if such policies are left in place too long (the reduction in bank profits could lead banks to tighten their lending terms, which would run counter to the ECB's goal). This has led the Bank of Japan to bring its long-term interest rates back into positive territory. In this respect, the ECB could indicate that it has no intention of cutting its deposit rate any further in future, or even that it could bring it back up to promote financial stability.

In addition, although we believe that the ECB will continue its QE programme, it must make some technical adjustments to it. These would extend the PSPP's feasibility from several months (raise the issue share limits for bonds not subject to collective action clauses), but the only rule that would allow this programme to be extended over the long term is giving up on the capital key. This would significantly favour Spanish and Italian bonds, and French bonds to a lesser extent, over German bonds. The Irish bonds will be under pressure as 1) the PSPP issuer share limit is close and 2) the projects of tax overhauls in the US can be to the detriment of Ireland.

Political risks continue to be a threat for some European countries

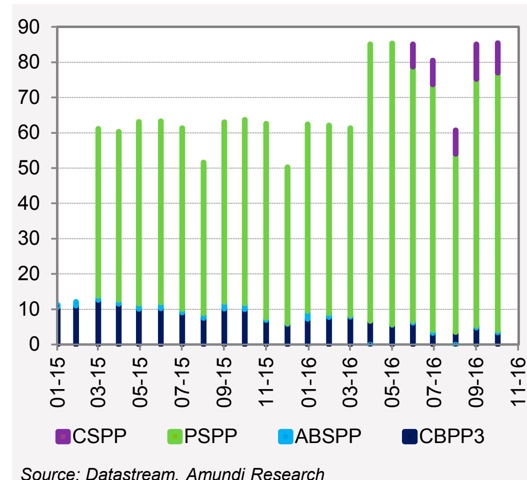
The upcoming elections in Europe (2017 for France and Germany, 2018 for Italy) are likely to reveal a breakthrough for Eurosceptic parties. In this respect, Italy is clearly where the risks are greatest, because practically all polls have declared the Five Star party the winner of the next elections. The fact that its leader Beppe Grillo has publicly declared that he is in favour of a referendum on leaving the euro is clearly going to weaken Italian bonds. Already, the performance of Italian bonds compared to other European countries are negatively correlated with the performance of the Five Star movement in the polls.

4 US: slope of the yield curve vs unemployment rate



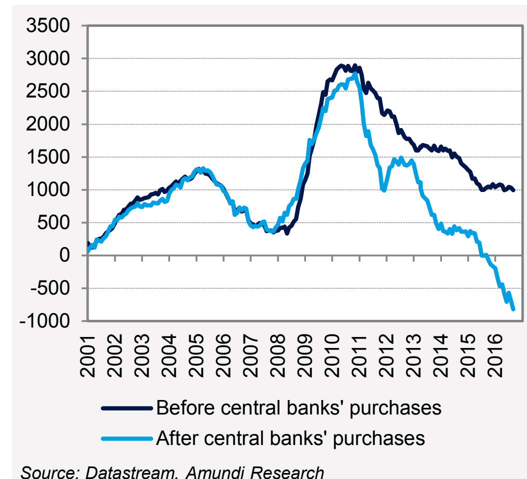
Source: Datastream, Amundi Research

5 ECB monthly purchases (€bn)



Source: Datastream, Amundi Research

6 G3 countries: net issuance of sovereign bonds ($bn, 12 m. rolling sum)



Source: Datastream, Amundi Research

2 y. bond yield forecasts										
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
US	0.36	0.63	1.04	0.99	0.80/1.00	1.10	1.32	1.40/1.60	1.34	1.56
Germany	0.20	-0.08	-0.34	-0.63	-0.60/-0.40	-0.58	-0.57	-0.60/-0.40	-0.52	-0.50
Japan	0.10	-0.03	-0.05	-0.10	-0.40/-0.20	-0.31	-0.04	-0.40/-0.20	-0.37	0.03
UK	0.57	0.51	0.65	0.22	0.00/0.20	0.30	0.33	0.00/0.20	0.38	0.54

10 y. bond yield forecasts										
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
US	3.01	2.17	2.27	2.25	2.40/2.60	1.92	2.39	2.20/2.40	2.13	2.53
Germany	1.94	0.54	0.63	0.32	0.20/0.40	0.29	0.44	0.20/0.40	0.41	0.54
Japan	0.74	0.33	0.25	0.03	0	-0.07	0.07	0	-0.06	0.11
UK	3.03	1.76	1.96	1.41	1.40/1.60	1.38	1.58	1.40/1.60	1.56	1.72

10y. yield spread										
	End 2013	End 2014	End 2015	14/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
France	63	30	35	43	40	45	42	30	52	44
Italy	215	134	97	171	150	145	172	130	152	179
Spain	220	107	115	120	110	105	124	100	116	129
Netherlands	29	14	14	15	15	/	15	15	/	14
Austria	34	17	17	27	25	/	26	25	/	29
Finland	21	11	11	18	15	/	23	15	/	25
Belgium	62	29	29	36	30	/	42	30	/	48
Ireland	150	70	70	63	80	/	71	100	/	81
Portugal	425	215	215	332	350	/	351	350	/	402

Source: Bloomberg, Amundi Research

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Forex market in 2017 and beyond

5 Political factors will continue to play the leading role

BASTIEN DRUT — ROBERTA FORTES,
Strategy and Economic Research

Idiosyncratic factors and unexpected political events played a huge role on FX markets in 2016

Idiosyncratic factors and political events played a major role in foreign exchange markets in 2016. While the main movements in the foreign exchange market had been dictated by developments in monetary policy over the last few years, it was political factors that played the leading role in 2016.

Specifically, two political events (not detected by opinion polls) had a strong repercussion on the Forex markets: the surprising outcome of the UK's European Union membership referendum (Brexit) and the US presidential election. The Brexit victory has generated huge uncertainty over the UK's economic outlook and has heavily impacted the pound (-18% in nominal effective terms over the first 10 months of the year).

The US presidential campaign and the election outcome exerted a strong influence on the currency markets. Each time Donald Trump did better in the opinion polls, this coincided with a depreciation of the Mexican peso while the confirmation of the Republican candidate as the new president led the currency to reach a record low against the US dollar. Other currencies such as the Canadian dollar and emerging currencies also suffered from the election outcome as the Republican programme envisages major changes in immigration policy and US trade agreements (especially with Canada and Mexico).

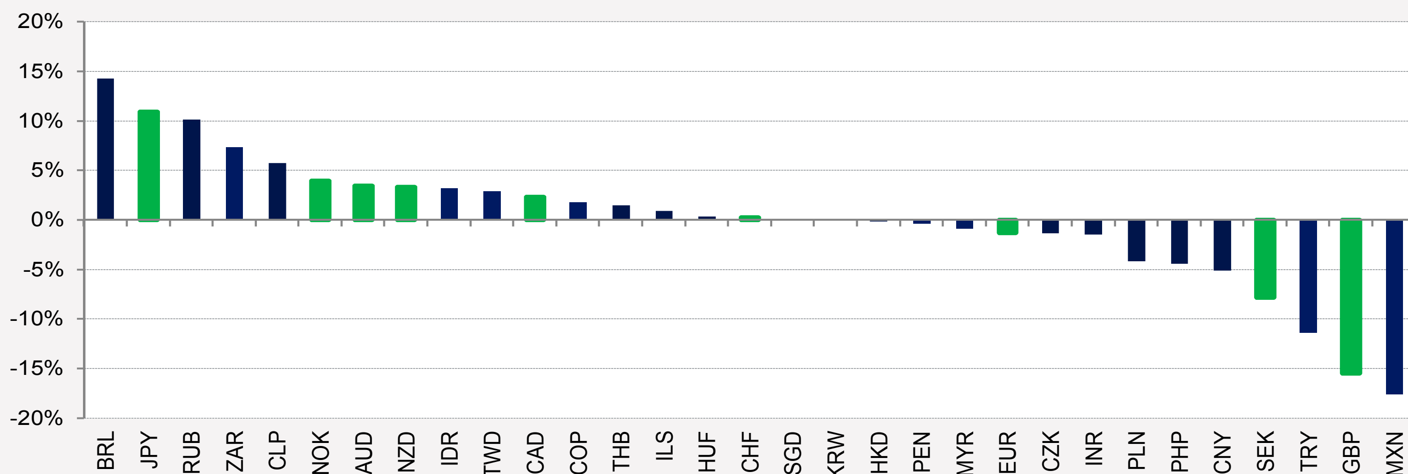
Political factors also explain the strong performance of the Brazilian Real. The BRL has gained 30% against its trading partners and it is (by far) the best performing currency of the year. The end of a political crisis - which culminated in the impeachment of the president Dilma Rousseff and the rise to power of the more "market-friendly" vice-president Michel Temer - renewed market expectations and investors' confidence that the new government could adopt more orthodox policies and important structural reforms, taking the country out of recession. This better economic prospect associated with higher yields certainly made the currency highly attractive to investors.

The essential

Idiosyncratic factors and political events (Brexit, US elections) played a major role in forex markets replacing monetary policy of major central banks as the main determinant of exchange rates as it was the case in the past years.

The consequences of political ruptures in 2016 will continue to be felt in the foreign exchange market in 2017. The dollar is expected to temporally benefit from long-term interest rates divergences and monetary policy between the United States and major advanced economies. That said, unless the new US administration unveils a large fiscal stimulus plan, it is unlikely that the long-term interest rates divergence to continue indefinitely in 2017. Over the course of the year, we assess rising risks could emerge for the euro due to a progressive rise in inflation and the likely resurgence of issues about the duration of the ECB's quantitative easing programme.

Variation against USD in 2016 (until 14 November)



Source: Datastream, Amundi Research

The yen, in contrast, has strengthened. The surprising political events of the year combined with the increased distrust in the effectiveness of the BoJ's monetary policy contributed to the JPY appreciation. But it is important to note that the JPY was one of the most undervalued currencies at the beginning of 2016, which is what probably prompted Japanese investors to massively hedge their USD exposure.

Almost all the commodity currencies (with the notable exception of the Mexican peso) appreciated again vs. the USD in 2016. Over the first 10 months of the year, the CRB metals index and oil prices rose by 28% and 33% respectively. Against this backdrop, the RUB appreciated 15.4%, the CLP 8.4% and the NOK 7.3%. Numerous commodity currencies were very undervalued at the beginning of the year.

Lastly, note that the renminbi lost 4.1% vs. the USD over the year while the CFETS index (the currency basket tracked by the Chinese authorities) lost 6.5%.

Upward pressure on the dollar in the short/medium term

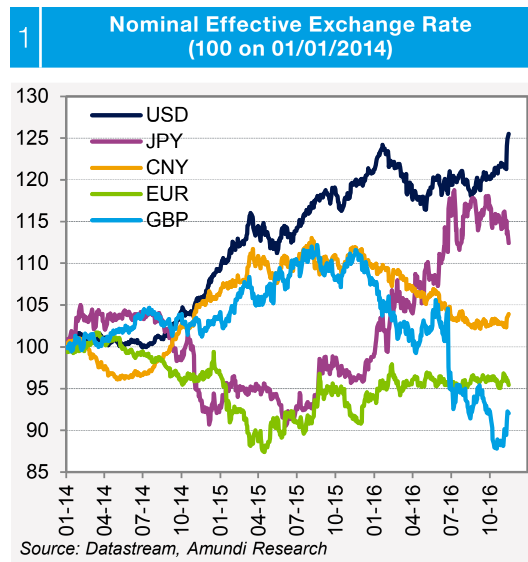
The outcome of the US elections has accelerated the upward move of long-term yields and bear steepening, a movement which started at the end of the third quarter. The anticipation of fiscal stimulus measures by the new US administration has given more credibility to the assumption of a normalisation of long-term inflation expectations, a trend which is expected to continue in the coming weeks (see the Fixed Income section). Given that Japanese long-term interest rates are being targeted by the Bank of Japan and that the ECB will be determined to counter the rise in long-term rates, the divergence of long-term interest rates together with the divergence in monetary policy among major central banks (we expect an increase in fed funds rates in December 2016 and two further hikes in 2017, while the ECB and the BoJ might continue with their massive asset purchasing programmes) will certainly exert upward pressure on the dollar against the euro and the yen. It is therefore very likely that the EUR/USD parity will move temporarily below 1.05 and the USD/JPY parity will move above the 110 level. It is important to bear in mind that the current situation is fundamentally different from the «taper tantrum» episode of 2013 when the dollar's effective exchange rate remained relatively stable despite the sharp rise in long-term interest rates: at that time, some emerging market currencies weakened significantly against the US dollar (the "fragile five"), but the dollar remained weak against the euro, the yen and the renminbi (the ECB and BoJ were much less aggressive than at present). That said, we do not believe the bullish trend for US long-term rates will extend throughout 2017, but rather that a relatively high peak may be reached early in the year, followed by a re-adjustment thereafter.

The dollar's effective exchange rate is mainly driven by two variables: 1) the differential in interest rates between the US and the rest of the world; and 2) commodity price trends – oil in particular. While we expect the first to move upwards temporarily, it is not the case for the second. Oil prices have traded within a relatively wide range ($40-50/bbl.) in recent months and are likely to rise only very gradually in 2017 and thereafter (see "Oil Scenario, 2017-2020"). The dollar is therefore expected to appreciate in the short/medium term. Assuming a large-scale budget plan, an increase in the interest rate differential would give additional support to the dollar. On the other hand, a faster than expected slowdown in the labour market (some indicators such as job creations or, more generally, the Fed's Labour Market Conditions Index are sending out signals of a slowdown) would lead the Fed to be more cautious in its tightening cycle, or even (in the event of a downturn) to reverse course (cutting rates or even starting the QE programme again), which would be very bad news for the dollar.

The euro and the risk of the erosion of the effects of the policy pursued by the ECB

It is indisputable that the unconventional policies pursued by the ECB (negative deposit facility interest rate and QE) allowed the value of the

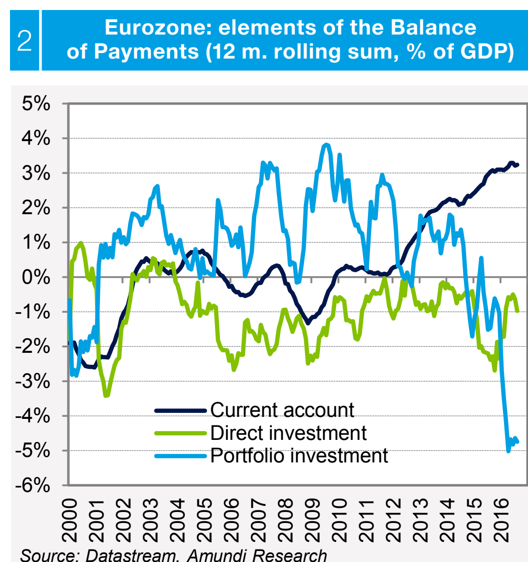
1 Nominal Effective Exchange Rate (100 on 01/01/2014)



Source: Datastream, Amundi Research

> The divergence of long-term interest rates and also the divergence of monetary policy will add an upward pressure on the dollar against the euro and the yen in the short/middle run

2 Eurozone: elements of the Balance of Payments (12 m. rolling sum, % of GDP)



Source: Datastream, Amundi Research

euro to begin falling sharply, in June 2014 (the first reduction in the deposit facility rate to below zero). Although the EUR/USD parity rate was fluctuating between 1.35 and 1.40 in H1 2014, it has been in the (wide) range of 1.05 to 1.15 since the beginning of the 2015. While the eurozone is running an exceedingly high current account surplus (about €350 bn over the past 12 months), which is usually positive for the currency, investment outflows (European investors engaged in massive buying of foreign bonds with non-European investors gradually shedding their euro positions) are hitting record levels (around €500 bn over the past 12 months). Clearly, the policies being pursued by the ECB are keeping the euro at a substantially lower level than the fundamentals would justify (very high current account surplus). Moreover, the ECB has explicitly acknowledged this (ECB Economic Bulletin, No. 3, 2016, Box 4). Against this backdrop, the one legitimate question here that we can ask is: to what extent does the euro risk meeting the same fate in 2017 as the yen in 2016 (strong appreciation)? In fact, while we think that the ECB's asset purchasing programme will continue for some time to come (see the section on monetary policy), how much longer will European investors continue to make massive purchases of foreign bonds, especially US bonds? Furthermore, as the market turmoil caused by a Bloomberg dispatch without much meaningful content ("*ECB Said to Build Taper Consensus as QE Decision Nears*", 4 October) showed, the theme of QE tapering by the ECB could make a comeback in the second half of 2017 as inflation picks up in the eurozone. At that time, risks will be tilted to the upside for the euro.

Political developments will remain a key variable for the trend in the pound

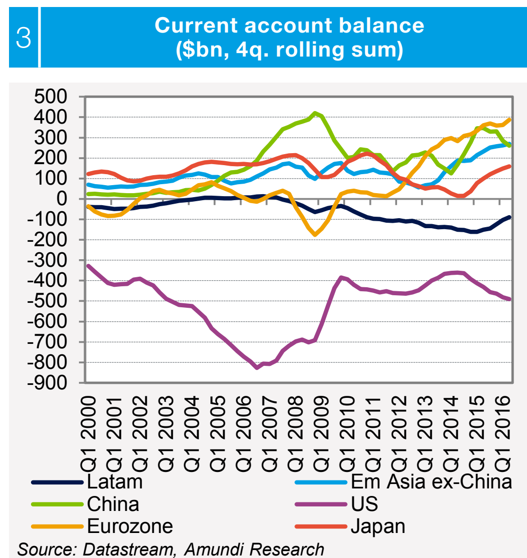
The British referendum on European Union membership (Brexit vote) has been the main driver of sterling in 2016. It gave rise to considerable uncertainty over the future of the British economy. In particular, two events were responsible for the main movements in the GBP/USD exchange rate: 1) the Brexit vote itself on June 23 and 2) on October 2, prime minister Theresa May's stated intention to trigger Article 50 "no later than March 2017". The important question now is "what's next for the pound?" For sure, politics will play a crucial role in setting the tone for the currency in the short/medium term – certainly more important than fundamentals. Further details on how the Brexit process will end will impact the currency: while a "soft Brexit" may calm markets, possibly preventing further depreciation, a "hard Brexit" would undoubtedly trigger a further fall in sterling as it would signal the need for deeper structural changes in the UK and therefore generate a new round of uncertainty. Consequently, in such a scenario, it is highly possible that concerns may arise on the soundness of the external sector: currently, the country has a current account deficit of nearly -6% of GDP and more than 500% of GDP for external liabilities. Given the increased uncertainty over the country's economic future, a sell-off of the country's assets cannot be ruled out and markets would start looking at fundamentals and at the country's ability to finance its current account deficit.

The Chinese economy will continue being a major player for the Forex market in 2017

It is clear that the development of the Chinese economy dictates the trend in a number of raw materials (for instance, China accounts for three quarters of global demand for some metals) and therefore the trend in currencies' "raw materials". In recent years, the slowdown in the Chinese industrial sector (services have gradually taken over the role of main growth driver) has weighed on metal prices, the Australian dollar, the New Zealand dollar as well as the Brazilian real and the South African rand. These currencies will certainly be penalised over time by the changes in the Chinese economy via one or other of the following channels:

- decline in commodity prices;
- central banks would have to accept the new paradigm of lower potential growth and adopt a more accommodative monetary policy;

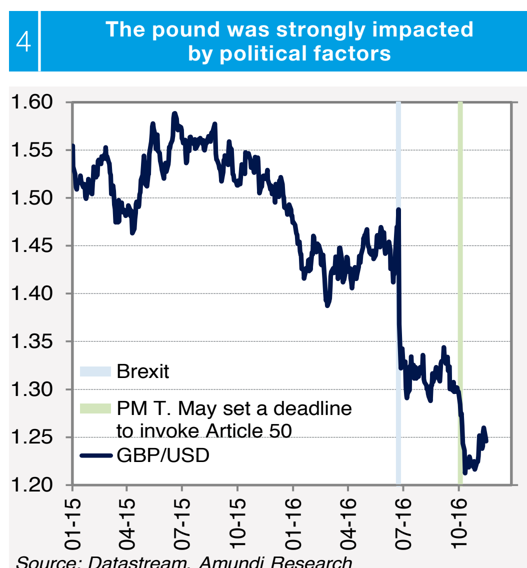
3 Current account balance ($bn, 4q. rolling sum)



Source: Datastream, Amundi Research

> "The policies being pursued by the ECB are keeping the euro at a substantially lower level than the fundamentals"

4 The pound was strongly impacted by political factors



Source: Datastream, Amundi Research

> "A "hard Brexit" would undoubtedly trigger a further fall in sterling"

Underlying Trends

The renminbi – the challenges of a future international currency

PHILIPPE ITHURBIDE, *Global Head of Research, Strategy and Analysis*

In the future, the Chinese currency (RMB) will undoubtedly be an international currency, playing a major role in Asia, as the US dollar and euro do in their respective zones. Competing with the dollar on the international level will take much longer, and it is a highly ambitious goal.

What is an international currency?

An international currency has four main characteristics:

1. **Liquidity:** developed financial markets, a fully-convertible currency, no or few capital controls, etc;
2. **Acceptability:** the currency must be accepted everywhere;
3. **Stability:** erratic fluctuations must be eradicated and the currency must be a safe haven;
4. **Predictability:** the political and monetary authorities' role in responding must be known and understood.

Furthermore, an international currency has four different functions:

1. First and foremost, it must be a **reserve currency** and appear in central banks' foreign currency reserves;
1. It must also be an **intervention currency**, and thereby contribute to the stability of the foreign exchange markets;
1. It must be a **settlement currency,** for its country's trade, but also and most importantly, third-party trade;
1. Finally, it must be a **reference currency,** especially for debt and potentially commodities.

Are we moving towards a tri-polar (USD, EUR, RMB) world?

The benefits of an international currency are well known: it affords easier financing on the capital markets (an international currency is accepted and will be held on all balance sheets, including those of central banks), and, in some cases, it forces third-party countries to stabilise their exchange rates. History recalls that moving to a multipolar system (as regards all functions of an international currency) would require a significant, negative shock on the international currency, i.e. the US dollar. This was particularly the case in the 1970s, which saw the emergence of several currencies (with some of the functions of an international currency), including the Swiss franc, Deutschmark, pound sterling, Japanese yen and French franc. The low liquidity of some of these currencies, and the size and importance of their countries, meant they were unable to retain and increase this new role. Nevertheless, even in the absence of a dollar shock, the Chinese currency is gradually emerging as an international currency, thanks to the efforts made by Chinese officials to make the yuan the major currency in Asia as a reserve currency, an intervention currency and a settlement currency. It should be noted that for **the renminbi to really become an international currency, it will have to be much more widely used in cross-border trade, financial transactions and third-party trade (trade that does not involve China), areas in which the US dollar has been predominant so far.**

We should remember that Japan never succeeded in promoting the yen as an international currency. The lessons for China from the Japanese experience are crystal-clear:

- The liberalisation of capital markets represents a prerequisite for the internationalisation of the currency;
- Confidence in the economy is crucial;
- Domestic markets have to be attractive to foreign investors and foreign financial institutions in order to increase the need to use the currency;
- Bargaining power in trade invoicing currency helps to install the currency as an international one;
- Domestic financial centres must be developed as regional centres;
- The relative stability of the RMB in Asia is a prerequisite for this currency to be used and accepted as an international currency, and as a substitute for the US Dollar.

The emergence of the RMB as an international currency will have major consequences. The USD never had a real contender in the past, and a tri-polar system (USD, EUR and RMB), more precisely a system of competing international currencies, may be unstable at certain points in time. History recalls that the instability is essentially due to the capacity and incentives for investors, including central banks, to shift the composition of their international portfolios and FX reserves in response to events and shocks. These shifts create more volatility in the foreign exchange markets. In sum, **the stability of the future tri-polar system will depend on the (political, social, financial and economic) stability of the countries issuing these international currencies.**

RMB: undeniable progress, that is likely to continue

The road is still a long one for the renminbi, however, progress is visible nonetheless:

- More than 10,000 financial institutions now denominate their transactions in RMB.
- The renminbi is now used to settle almost 20% of China's trade.

- The renminbi is now the third most important currency of global issuance on letters of credit for trade-related purposes.
- There are 15 official offshore RMB clearing centres in the world – a number that keeps increasing.
- China has bilateral swap agreements with more than 30 central banks, for a total value of RMB 3.2 trillion.
- The PBoC has started diversifying FX reserves into other currencies, especially in Asia. At present, around 62% of China's FX reserves are USD denominated assets; 20% are EUR denominated assets, which is in line with other emerging market countries.
- The renminbi is gaining ground as a component of FX reserves. A number of central banks and sovereign wealth funds have evidently diversified their holdings to include renminbi reserves and investments or have plans to do so. This is the case for the central banks of Australia, Austria, Brazil, Indonesia, Malaysia, Korea, Thailand, Pakistan, South Africa, Venezuela, Nigeria, Hong Kong and Macau. The Reserve Bank of Australia (Australia is an important trading partner for China) invests around 5% of its foreign currency assets in renminbi securities in China. The Japanese Finance Ministry, the Kuwait Investment Authority and the World Bank also hold renminbi bonds.
- Our results clearly suggest that the RMB has risen as a major reference currency for EMEs and its influence seems to go well beyond its neighbourhood area.
- Note that the RMB as a reserve currency held by foreign central banks will increase after the SDR inclusion in October 2016.

Some projections conclude that by 2020-2025, 30% of China's trade should be invoiced in RMB, making the RMB the fourth largest global payment currency. Daily RMB FX turnover would exceed $500 billion (three times higher than its current level). The offshore RMB (dim sum) debt market would also amount to $500 billion (up from around $90 billion in 2013). China would represent 30% of global equity market capitalisation (bigger than the US) and 20% of the global fixed-income markets (as large as the euro market). However, there are prerequisites for this, in terms of the RMB's exchange rate regime and capital controls, and it is not as simple as it would seem, with the debate still raging in China over opening up the capital account.

Opening up the capital account: major challenges, and risks
Opening up the capital account would imply restraints on the economic policies adopted. It would certainly lead to:

- A less independent monetary policy;
- A more flexible, floating (or almost floating) exchange rate regime;
- A greater role for international players in determining asset prices;
- Mandatory transparency of economic indicators, state-owned companies, monetary, fiscal and foreign exchange policies;
- Independent statistical offices.

History has shown us that opening up the capital account carries a number of risks. Analysing what happened in Scandinavia in the 1980s allows us to make several points:

- A gradual approach to opening up the capital account (like Denmark adopted) is better than the "big bang" solution (used by Sweden and Finland);
- History also recalls that financial liberalisation does not necessarily pave the way towards financial crises, except when policy makers, regulators and central banks do not sufficiently understand the effective operation of newly deregulated financial markets;
- Moreover, to avoid boom-bust cycles, reforms need to be properly sequenced to minimise pro-cyclical effects;
- Lastly, the financial supervisory system has to be reformed prior to or, at the latest, simultaneously with financial liberalisation.

The common thread in these structural and gradual changes is the question of the Chinese currency's value, and how it is managed. The undervaluation of the yuan has been debated for the past two decades, particularly because it plays a more dominant role in determining the valuation of emerging countries' currencies and hence the rest of the world's. While the question of the renminbi being undervalued was relevant before the Great Recession, the current valuation of the renminbi is far less clear. We tend to conclude that **the RMB is globally in line with fundamentals.**

For more information,

Bastien Drut, Philippe Ithurbide, Mo Ji, and Eric Tazé-Bernard, 2016, *"The emergence of the renminbi as an international currency: where do we stand now?"*, Amundi Discussion Papers Series #18, October 2016.

- central banks would also need to fight against the strength of these currencies as part of the rebalancing of these economies outside the mining sector, as manufacturing in China is slowing.

Moreover, a turnaround in the Chinese real estate market or renewed market stress linked to this issue, would be very negative for them. Furthermore, this would encourage the Chinese authorities to devalue the renminbi against the dollar much faster in order to regain competitiveness on international markets (do not forget that China's real exchange rate is still more than 25% higher than in 2008).

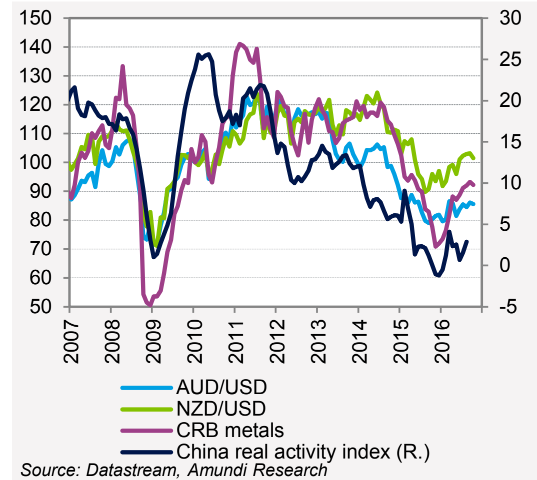
Fundamentals – currency valuation and macro (lower growth prospects) – point to further currency devaluation against the dollar. For the moment, the Chinese authorities have been quite efficient at avoiding sharp movements in their currency, despite strong capital outflows: certainly, capital controls and the use of FX reserves might have helped to avoid sharp movements. The expected temporary appreciation of the dollar will certainly encourage the Chinese authorities to depreciate the renminbi against the dollar in order to preserve the stability of the currency against the basket monitored by the PBoC (CFETS basket). In our main scenario, we expect the USD/RMB to turn around 7.20 at the end of 2017. However, it is important to note that the downside risks for the currency are high. Hence, a disorderly depreciation of the renminbi would be very negative for emerging currencies. We have shown in a recent publication ("The renminbi, the new cornerstone of emerging currencies, July 2016") that, since the August 2015 devaluation, the RMB has become the dominant reference currency for numerous emerging currencies. Since this currency reform (announcement that the PBoC would no longer measure the renminbi against the US dollar alone, but rather against a basket of thirteen currencies, often referred to as the CFETS basket), the slightest fluctuations in the renminbi now have a greater impact on trends in emerging market currencies than in the past.

This fact certainly adds another risk factor negative aspect to the already complicated scenario for EME currencies as: 1) the prospect of a widening interest rate differential between the United States and the rest of the world could lead to portfolio outflows from these economies – a rebalancing is extremely likely especially in countries with less sound external accounts (i.e. Turkey, Brazil, Colombia) and 2) the foreign trade policy of the new US administration is likely to play a major role if it is substantially revised (we still have little evidence at this stage). All in all, the trend in emerging market currencies will largely depend on the individual characteristics of each country and, especially, their macroeconomic fundamentals.

What do valuation metrics tell us?

Assessing currency valuation is not a straightforward task. A wide range of models is available to assess the value of exchange rates. One of the most widely used methods to assess the value of exchange rates is the Purchasing Power Parity (PPP): one of the ways to look at it is to measure the deviation of the Real Effective Exchange Rate (REER) relative to its long-term average. However, there are reasons to think that the real effective exchange rate (REER) could be influenced in the medium/ long-term by a certain number of macroeconomic fundamentals instead of returning to its average. This is clear, that fluctuations in the REER are primarily linked to terms of trade (defined as the ratio of export prices to import prices) and are also linked to changes in a country's relative productivity. This is why we run a Behavioural Equilibrium Exchange Rate model (BEER) - which takes into account key cyclical drivers for a currency such as the terms of trade and productivity. The trend in the real exchange rate is obviously linked to the dynamics of the balance of payments, which captures all financial flows and transactions among residents and non-residents. Another category of FX models, the Fundamental Equilibrium Exchange Rate (FEER) models, state that a current account balance that is too high requires an appreciation of the currency while one that is too low requires depreciation of the currency. This type of model also has its drawbacks as they are normative models and the current account target is arbitrary.

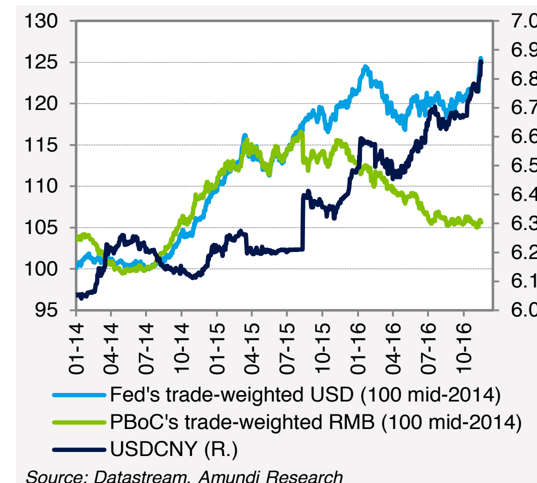
5 Real activity index in China vs AUD/USD, NZD/USD and CRB metals (100 in 2010)



Source: Datastream, Amundi Research

The expected temporary appreciation of the dollar will certainly encourage the Chinese authorities to depreciate the renminbi against the dollar in order to preserve the stability of the currency against the basket monitored by the PBoC (CFETS basket)"

6 CFETS basket (Chinese authorities' currency basket) vs USDCNY



Source: Datastream, Amundi Research

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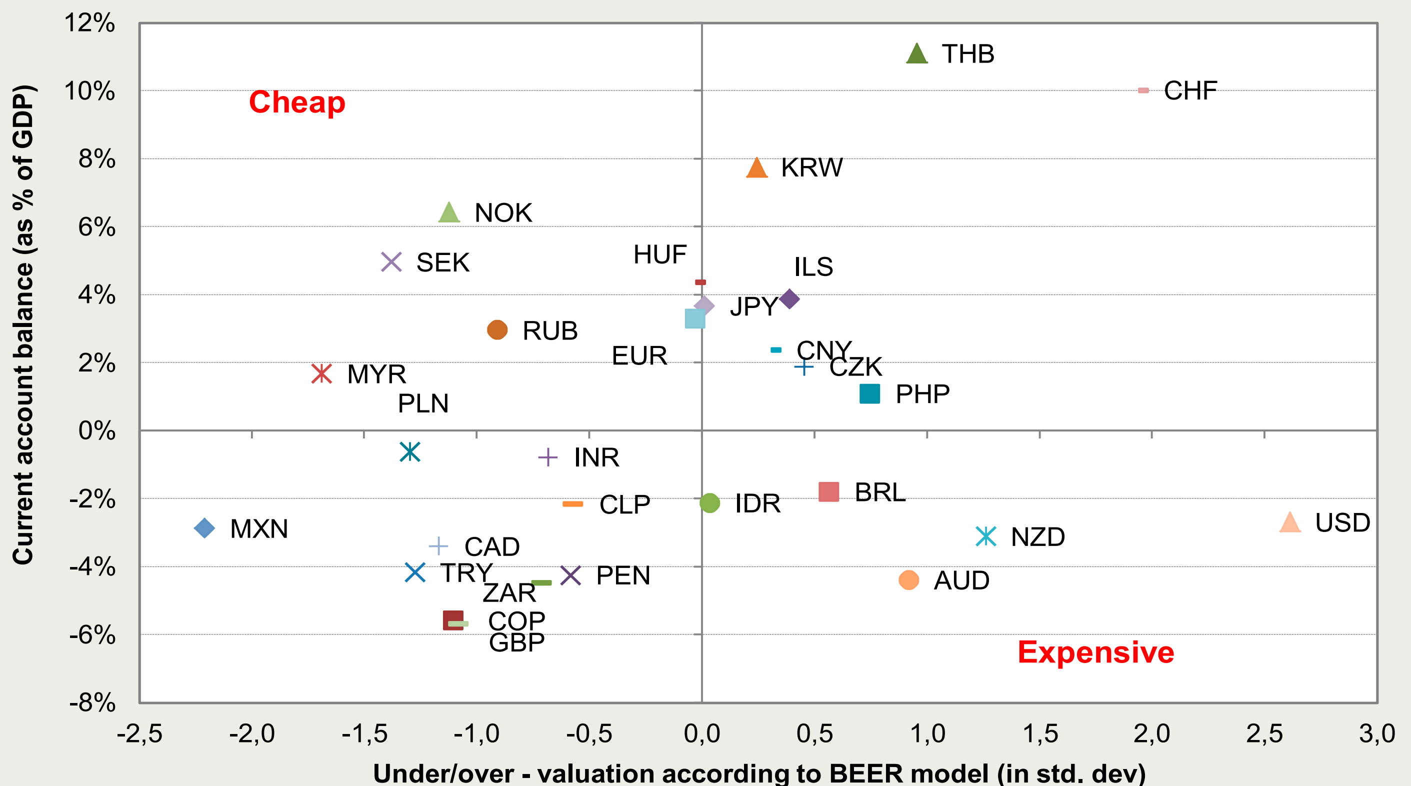
These models do not always offer consistent signals. For a small group, the signals are consistent.

- **Globally, the valuation models show that the BRL, AUD, NZD and USD are too expensive**: 1) they run substantial current account deficits and 2) they are significantly overvalued in the BEER model.
- **In contrast, the valuation models also show that the NOK, SEK, RUB and MYR are too cheap**: 1) they run substantial current account surpluses and 2) they are significantly undervalued in the BEER model.

Several currencies are very undervalued according to the BEER model but the currency depreciation of the last few years has not been effective in reducing the current account deficit. The South African rand (ZAR) is in exactly this situation. On top of that, net foreign direct investment turned negative recently. In this case, when considering the loss of competitiveness and the sluggish economic growth, it is hard to believe that the ZAR might be overvalued.

Several currencies are very overvalued according to the BEER model but the currency appreciation of the last few years has not contributed to reducing the current account surplus. The Swiss franc is in exactly this situation. In the case of Switzerland, portfolio outflows are sizeable, which mitigates the importance of the current account surplus. Besides, Switzerland is a very specific case as the SNB balance sheet ballooned with its FX interventions to contain the currency appreciation: the size of the SNB balance sheet is now well above 100% of GDP.

Under/over-valuation according to the BEER model vs current account



Source: Datastream, Amundi Research

Exchange rates forecasts								
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Amundi + 12m.	Consensus Q4 2017
EUR/USD	1.38	1.21	1.09	1.07	1.05	1.09	1.10	1.11
USD/JPY	105	120	120	110	115	106	110	108
GBP/USD	1.66	1.56	1.47	1.25	1.17	1.23	1.22	1.27
USD/CHF	0.89	0.99	1.00	1.00	1.00	1.01	0.95	1.00
USD/NOK	6.07	7.50	8.85	8.45	8.29	8.21	7.73	8.04
USD/SEK	6.42	7.83	8.43	9.19	9.05	8.63	8.45	8.35
USD/CAD	1.06	1.16	1.39	1.35	1.40	1.33	1.45	1.29
AUD/USD	0.89	0.82	0.73	0.75	0.75	0.74	0.70	0.74
NZD/USD	0.82	0.78	0.68	0.71	0.70	0.70	0.70	0.70
USD/CNY	6.05	6.20	6.49	6.87	7.10	6.85	7.20	6.90
USD/INR	61.86	63.12	66.16	67.84	70.00	67.61	70.00	67.00
USD/BRL	2.36	2.66	3.96	3.43	3.40	3.40	3.40	3.40
USD/MXN	13.10	14.74	17.27	20.43	20.00	18.50	19.50	18.35
USD/RUB	32.86	60.00	73.03	65.38	63.00	63.81	60.00	63.00
USD/TRY	2.15	2.34	2.92	3.32	3.40	3.23	3.60	3.30
USD/ZAR	10.47	11.57	15.50	14.28	14.30	14.59	14.40	15.00

Corporate bond markets in 2017 and beyond

6 Growth versus technical factors!

VALENTINE AINOUZ - SERGIO BERTONCINI,
Strategy and Economic Research

2016: what a year so far for credit markets!

Performances delivered by US and European corporate bonds are quite positive year to date in absolute terms and also relative to their corresponding government bonds, especially with respect to other risky assets like equities: this is particularly apparent in the EUR markets and especially in some sectors, the financial segment above all. In the US it was mostly the recovery of oil prices which supported the credit markets' rally from February's lows, together with a more dovish attitude by the Fed. Not only has the FOMC abstained from raising rates so far in 2016 but it has also steadily revised down the "dot plot" in its quarterly meetings. In Europe it was the QE2 announced by the ECB in March which further intensified the search for yield. The BoJ's decision to adopt a NIRP at the beginning of the year and the ample package of new measures delivered by the BoE last August also had similar impacts. One year ago, when we wrote our 2016 outlook, we underlined the new record reached by the percentage of EUR fixed income debt in negative yield territory, which then stood at an "amazing" 20%. As we are writing now, that percentage has doubled, with new asset classes joining this strange "club" this year. Corporate bonds were the last to fall below zero yield: currently, around 10% of IG corporate debt finds itself in negative yield territory, but even more importantly, a remarkable 40% is now trading very close to the zero yield threshold.

Technicals: ECB CSPP likely to continue keeping downward pressure on spreads...

The CSPP became operational by mid-September, but it has already produced dramatic effects on the EUR credit markets. The ECB's CSPP reached EUR 38 bn in purchase volume by the end of October but at the same time we also have to consider that this first period of purchases included two months of poor activity (July, just after Brexit and August, which is usually the least active month of the year on the primary markets). In fact, in September, the acceleration of the programme (up to EUR 10 bn in monthly purchases for the first time), was possible also thanks to a stronger weight of purchased volumes on the primary market: the same trend took place in October If the initial rate of purchases simply remains stable, an additional amount of around EUR 40 bn is likely to be added by the ECB to its corporate bond portfolio during the next five months of (already) planned purchases. As such, around half of the planned corporate bond purchases still have to be implemented by the ECB before March 2017. A possible extension of the QE is likely to have a more powerful relative effect on corporates than on govies, as it would mean a sizeable increase in the total CSPP portfolio: in case of a six-month extension at the current pace (EUR 80 bn per month), for example, this would mean an additional EUR 50 bn in corporate bond debt volume, representing a remarkable 60% increase in the total size of the CSPP, which is much more than the corresponding increase in the programme dedicated to government bonds. What about the feasibility of an extension of the CSPP, then? It is true that the ECB so far has "touched" a large number of bonds, or around half of all eligible instruments: however, in terms of outstanding debt the ECB portfolio is likely to reach just around 11% of the current value of the eligible universe by March 2017: as such, the scarcity issue linked to current limits looks more related to government bonds that to corporate bonds. Taking into account these considerations, therefore, we expect technical factors will continue to support European credit markets in 2017.

The essential

Year to date performances delivered by EUR and USD corporate bonds are quite positive relative to other asset classes: in the Eurozone the "game changer" was the ECB CSPP, in the US the main driver was the recovery of the energy and commodity-driven sector.

We believe that in 2017 the ECB will continue to play quite a role in sustaining the asset class, not only through direct purchases, but also indirectly, keeping the primary market active and supporting investment inflows into corporate debt. Our models show that the average spreads of IG non-financial bonds eligible for the CSPP became tight compared to their fair values. Financial issuers continue to offer attractive valuation

On the other side of the Atlantic, the expected rebound in US growth triggered by Trump election is positive for US credit. The fundamental of US companies should remain stable and default rates trending down from the current "mini cycle" peaks, but at the same time the leverage cycle is clearly ahead of the European one and. We must be vigilant about the impact on corporate fundamentals of the rise in long rates, the appreciation of the dollar and rising protectionism risk. Technical factors will probably be less supportive than in the Old Continent. Fair value regressions show that corporate bonds still offer value in both US IG and US HY camps. We remain cautious about the lower-rated segments of the US HY segment.

Technical factors will continue to support European credit markets in 2017

US and European companies are at very different level in the credit cycle

Debt leverage by US companies stabilised at historically high levels in 2016. In recent years, companies have raised record amounts on the financial markets thanks to exceptional financing conditions. The IG bond market has virtually doubled in size since the collapse of Lehman Brothers. Issuers have primarily funded M&A activity and share buy-backs. Investment spending has proved to be sluggish overall. More recently, debt leverage by US companies has stabilised. On the one hand, the pace of debt growth has stopped increasing in the non-manufacturing sectors, and has even diminished considerably in the manufacturing sectors, especially energy. On the other hand, the manufacturing industry reduced its losses in 2016. The fundamentals of US companies should remain stable in 2017. It is very important to underline that a marked rise in long-term interest rates would be very harmful to the US economy, since high debt levels are not concentrated in any single sector but are widespread.

By contrast, European companies have low debt overall. This difference can be attributed to the low growth in their profits since the crisis, which has driven them to preserve their cash flows. A portion of the debt raised has even served to increase issuers' cash reserves. The question today is what the effects of the CSPP have been on European companies' fundamentals. Investment grade issuers currently enjoy exceptional financing conditions. There is a strong incentive to use debt to finance share buy-backs or increase dividends. We do not anticipate a widespread deterioration of European companies' fundamentals. Only well-rated companies with strong cash flow visibility should increase their debt leverage.

Good news from the US default cycle: the end of this commodity-sector mini cycle is in sight

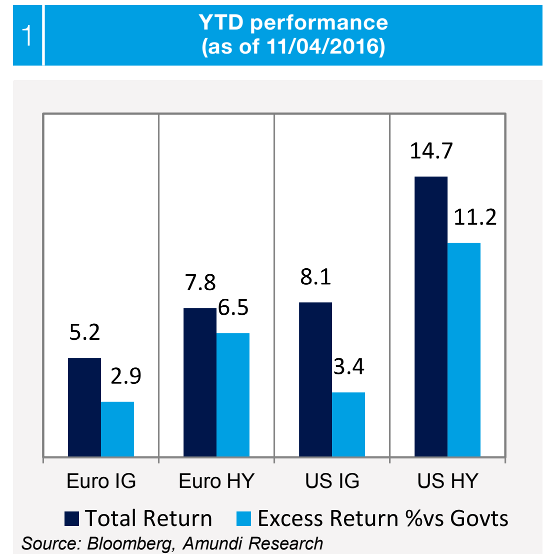
As we outlined in September's issue of the Cross Asset, a peak in the US default cycle is getting closer and will likely occur in Q1 next year: the time lag between distress ratios and default rates points to a 6%/6.5% peak in US default rates by February-March 2017 and then to a subsequent fall to around 5% in the following two quarters. The entire cycle has been driven by the dramatic swings in oil and commodity prices over the last two years or so: if commodity sectors are excluded, in fact, US HY default rates remained relatively stable, rising only to 2012 levels. Deepening the analysis among different rating categories, furthermore, US BB-rated defaults reached a sort of 1.4% "peak" in this commodity-driven mini-cycle: however, this peak represents just 25% of the typical recessionary peak in the 4% area. Spreads are still at almost three times current default rates for this high quality speculative grade category. The B-rated segment has been mostly impacted by defaults in commodity sectors, as default rates jumped from 1.5% to 5.2% in the last eight months: at the moment the default rates are higher than spread levels (484 bp), and midway from cyclical lows to recessionary peaks. Finally, CCC-rated bonds reached 16% default rates, higher than current spreads by just above 1,200 bp.

As far as Europe is concerned, HY default rates are likely to remain very low in 2017, as was the case in 2016. In fact, low exposure to energy and high average credit quality of the European speculative grade universe, together with impact of the ECB's CSPP will keep defaults from rising in the old continent. The BB segment, furthermore, is also going to be supported indirectly by the ECB's CSPP: on one side M&A activity may target the speculative grade segment more than in past years, on the other some companies may turn CSPP-eligible if they are deemed to be "rising stars" by just one rating agency.

The CSPP will sustained the search for yield

If the CSPP is the catalyst, the driver of tighter spreads looks increasingly like the too well-known search for yield force. The "gravity" exerted on yields and spreads by the ECB's QE has led to stronger, more stable private demand for the asset class: in fact, in the 32 weeks following the ECB's announcement,

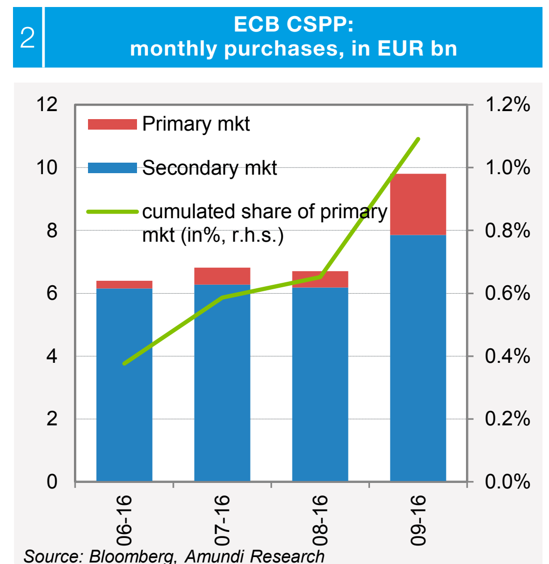
1 **YTD performance (as of 11/04/2016)**



Source: Bloomberg, Amundi Research

> The CSPP triggered a de-correlation from risk aversion indicators

2 **ECB CSPP: monthly purchases, in EUR bn**



Source: Bloomberg, Amundi Research

> A possible extension of the QE is likely to have a powerful relative effect on corporates

flows into EUR IG funds and ETFs were always positive. The search for yield supporting corporate bonds is likely to be more and more powerful in the short segments of the curve: as we are writing, EUR HY account for 65% of the remaining positive yield available in the one-to-three-year segment, where both core and peripheral govies, together with covered bonds and quasi-government bonds no longer offer any yield at all. In a nutshell, a slim four per cent of the outstanding debt accounts for two thirds of the remaining yield, while almost eighty per cent of fixed income markets charge investors with a negative return. The situation is not much better in the three-to-five-year segment where peripheral bonds still offer a slim 14% of remaining yield.

> What are the major trends observed on credit indexes?

US IG (assets: $6.161 trillion in Q3 2016)

- The US IG index has doubled in size in six years.
- The weight of defensive sectors (consumer goods, technology and healthcare) has increased considerably, reaching 23% of the nominal value of the US IG index at the end of October 2016 compared to 11% in 2007. These issuers raised record amounts to finance M&A activity and share buy-backs.
- Companies on the US IG index also took advantage of the historically-low interest rate environment to increase the average duration of their debt. Issues on 10+ year maturities have reached unprecedented amounts in recent quarters. The average duration of the US IG index was 7.2 years in Q3 2016, compared to 5.8 years at the end of 2008.
- The weight of non-domestic issuers on the US IG market fell from 32% to 29% between 2012 and 2016, after rising from 10% to 32% between 2004 and 2012 (nominal value).

US HY (assets: $1.313 trillion in Q3 2016)

- The size of the US HY index has stabilised since mid-2014 following continuous growth. Volumes of new issues have remained contained, particularly in the energy sector.
- The weight of BB-rated issuers has risen steadily since 2003. They now account for over 50% of the index.
- The duration of the US HY index has remained stable over the past decade.

Euro IG (assets: $1.948 trillion in Q3 2016)

- The size of the Euro IG market has remained relatively stable on the 2010-2015 period and has slightly increased since.
- Non-financial issuers have used the extremely advantageous financing conditions to extend the average maturity of their debt. The duration of the Euro IG NonFin index was 5.3 years in Q3 2016, an increase of 15 months since 2011.
- The number of non-European companies issuing on the euro market has accelerated since 2013 (40% of the index in Q3 2016, compared to 34% in December 2012). These non-domestic companies, which are drawn by the highly attractive financing conditions on the euro market, are mostly domiciled in the United States, the United Kingdom, Switzerland, Australia and Sweden.

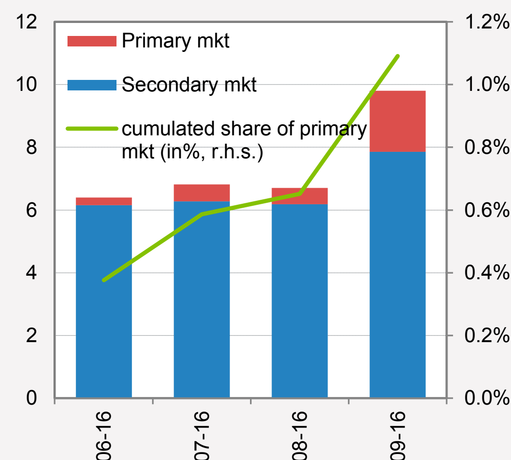
HY Euro (assets: $307 billion in Q3 2016)

- The size of the HY market has stabilised after strong growth between 2009 and 2015.
- BB-rated debt represents two-thirds of the European market.
- The top 25 issuers on the index account for nearly 40% of the Euro HY debt.

Valuations: the other side of the "CSPP coin"

As we pointed out in September's Cross Asset issue, the CSPP was the real game changer for European credit markets in 2016: the flexibility of the programme, together with its sustained purchase trajectory, which is spread widely across a very large number of bonds that cover all IG ratings, curve buckets and sectors with issuers from many countries, contributed to its effectiveness. **The major good news is that the CSPP triggered a de-correlation from risk aversion indicators like equity implied volatility**, if we consider Brexit a sort of first market "stress test" on the programme's trajectory. However, all this has been achieved at the "cost" of a substantial tightening in valuations offered by the asset class, especially by non-financial issuers.

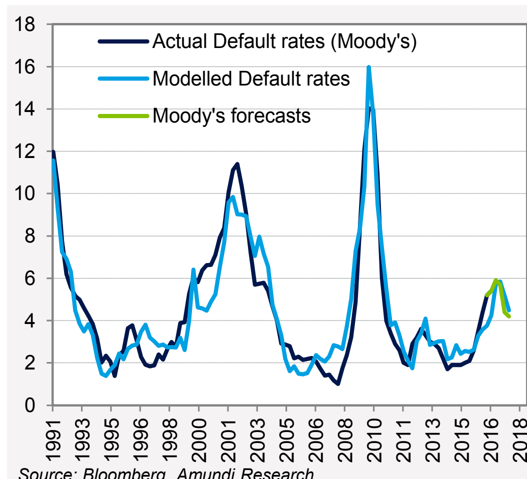
3 Our projections on US HY default rate vs actual and projected Moody's default rate (in %)



Source: Bloomberg, Amundi Research

> "European companies have low debt overall"

4 Our projections on EUR HY default rate vs actual S&P default rate (in %)



Source: Bloomberg, Amundi Research

Our models show that the average spreads of IG non-financial bonds eligible for the CSPP became tight compared to their fair values, especially among high rated names: the combination of negative rates and low spreads is particularly true for short-duration segments, where HY bonds are almost the only yield suppliers left. Our very latest indications from regressions run on BBB non-financials show that current spreads are rich by around 15 bp vs. levels justified by the usual explanatory factors. At the same time, after trading very wide vs. their fair values in Q1, HY bond spreads have steadily compressed the gap since the ECB's announcement and are now very close to their modelled spreads. A closer look into the EUR HY market shows that spreads and YTM look more attractive in the short segments in the non-financial sector, both with respect to the additional duration risk required to move forward and with respect to the steeper government bond curves. This is due to the fact that corporate bond curves look quite flat in maturities beyond five years; furthermore, this segment also tends to be less liquid and less populated by speculative grade bonds. In contrast, CSPP non-eligible BBB financials seem cheap by around 35 bp vs. their fair values. Also among IG financial bonds, however, the issue of yield concentration in fewer and fewer bonds is evident: as we are writing, in fact, senior bonds make up more than 70% of outstanding debt but just 40% of available yield. Subordinated debt, of both banks and insurance companies, concentrate 60% of yield in the remaining 30% of debt. Our calculations show that 50% of overall yield available in financials is concentrated into BBB subordinated bonds, which account for just 17% of overall financial debt.

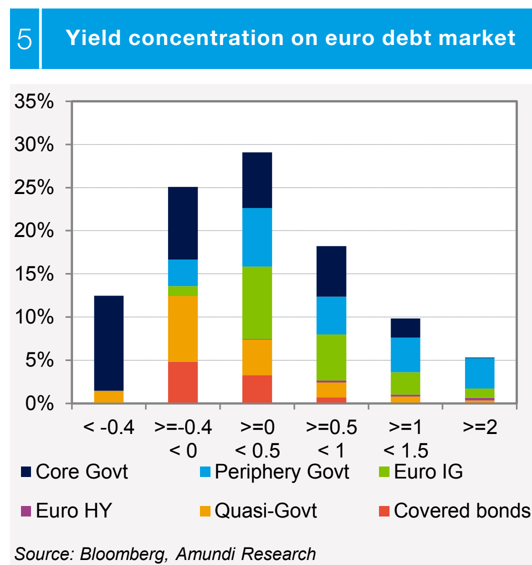
Fair value regressions show that on the other side of the Atlantic corporate bonds still offer value in both IG and HY camps. The very recent rebound in equity implied volatility partially reduced the gap still existing between market spreads and fair value spreads of US corporate bonds. However, spreads still look cheap for both speculative and investment grade, thanks to the recent stabilization of corporate profits to GDP ratio, of corporate debt to GDP ratio and in relationship with bank lending standards, after previous quarters' deterioration. The comparison between EUR and USD IG corporate spreads and yields is in favour of American corporates. As expected, a look at the numbers underlines that the gap in favour of USD debt is quite widespread and relatively in line for financials and non-financials if the comparison is rating-homogeneous. However, if we compare USD-denominated A-rated debt with EUR-denominated BBB-rated debt, the yield gap is still mostly positive but it looks significantly higher for non-financials.

Conclusion

The expected rebound in US growth is positive for US credit. Fair value regressions show that corporate bonds still offer value in both US IG and US HY camps. However, we must be vigilant about the impact on corporate fundamentals of the rise in long rates and the appreciation of the dollar. We remain cautious about the lower-rated segments of the US HY segment. In the euro market, the continuation of the CSPP will be an important support factor for the euro credit market. Our models show that the average spreads of IG non-financial bonds eligible for the CSPP became tight compared to their fair values. Financial issuers continue to offer attractive valuation.

> "A peak in the current US default "mini-cycle" is getting closer"

5 **Yield concentration on euro debt market**



Source: Bloomberg, Amundi Research

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Emerging debt in 2017 and beyond

7 More left in the turnaround story

ABBAS AMELI-RENANI,
Strategy and Economic Research

Emerging Market assets have been the darling of 2016. As of end-September, EM Debt was up 17% and 15% across Local-currency and Hard-Currency debt respectively. Despite the strong performance in 2016, we maintain a positive outlook on emerging market debt in the year ahead. Admittedly, risk factors remain, such as (i) China's growth and the risk of the bursting of the housing and credit bubble, or (ii) the prospect of monetary policies becoming less accommodative, or iii) the possible adoption of D. Trump's program measures that are not conducive to global trade and emerging economies. Despite these risks, and the necessary caution, especially before we can see more clearly the decisions of the US Congress, we continue to favor Hard Currency debt compared to local debt. In the latter we favour EM rates to EM FX exposure.

We believe three key factors will continue to drive positive returns for EM assets in 2017: Technicals, Fundamentals, and Valuations. We will address each of these in turn:

1. **Strong Technicals:** EM debt assets have seen more than USD 50bn of inflows in 2016, the highest since 2012. Will these inflows continue going forward? We believe they will. We think there is a comparison to be made between today's post-Brexit environment, and the Greek financial crisis of 2010-2012. Those three years marked an extreme level of political uncertainty in the Eurozone, and the wider European Union, as well as the financial crisis that gripped much of the continent's peripheral countries. The heightened level of political and economic uncertainty in Europe during the 2010-2012 period made Emerging Markets look more attractive in comparison. As a result, EM Debt was recipient to its largest inflows ever recorded during those three years, leading to a total return of 45% and 36% in hard currency and local currency debt, respectively. We think the current political risks in developed markets, including the repercussions of Brexit and the highly uncertain elections in the likes of Germany and France in 2017, add to the attraction of Emerging Markets, where we believe the political cycle has troughed and will likely see an improvement in dynamics going forward. In addition the absence of yield in developed markets, further adds to the attraction of EM debt, above and beyond what was the case in 2010. As such, we do not think the inflows year-to-date are at risk of reversal. Rather, we expect these inflows to continue over the next twelve months.

   On the supply side, EM sovereigns went through 2014 and 2015 with negative net issuance of external debt. Net issuance will be positive in 2016, but only because of unprecedented external borrowing from Argentina and GCC countries. Without these countries, net issuance in the rest of EM sovereigns will most likely be negative. Furthermore, even EM corporates are likely to experience negative net issuance of debt in 2016, as Chinese corporates resort back to borrowing in their domestic market rather than the external market. Negative net supply adds to the technical support for EM assets: we see more demand for EM debt as inflows continue, whilst supply continues to diminish.

2. **Healthy fundamentals:** Fundamentals in Emerging Markets are better than consensus has been arguing for in our view. The key weakness is on the growth side, where we do not expect to see a significant acceleration in the context of a Chinese economy that is at best stabilizing and at worst continuing to slow down. But as bond investors, we are more mindful of external vulnerabilities, particularly when it comes to hard currency debt. On this front a key metric is current account balance. Investors

The essential

EM debt assets have had a stellar 2016. The rally is not over. Remember the Greek Financial crisis of 2010-2012? The financial and economic woes of Europe added to the attraction of EM debt, leading to unprecedented inflows and returns during those three years.

Brexit may do the same for Emerging Markets… Three factors will drive continued positive returns going forward: strong technical factors encouraging inflows; much better than consensus fundamentals; and still attractive valuations. Three major concerns dominate: China, the post-election of Trump situation and the gradual end of accommodative monetary policies. The election of D. Trump may be a favourable factor... but only if growth expectations grow and tariff increase do not materialise. The risks related to China will probably be limited, despite some occasional jolts. Finally, it is unlikely that the impact of a possible tapering will be as negative for the emerging markets as in 2013. EM countries have much lower external vulnerability, and investors are not as overweight as they were when taper tantrum hit. Hard currency debt remains our preferred asset class within EM fixed income.

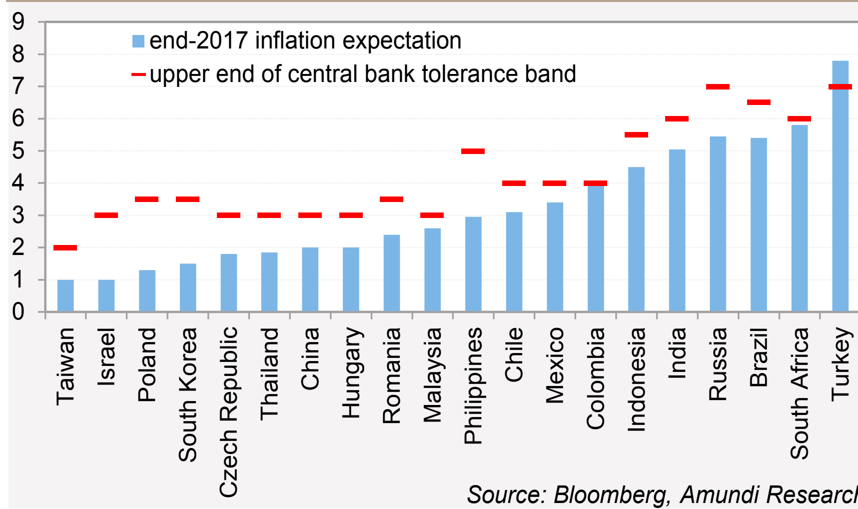
The current political risks in developed markets, including the repercussions of Brexit and the highly uncertain elections in the likes of Germany and France in 2017, add to the attraction of Emerging Markets

will remember the 2013 taper tantrum sell-off that was concentrated on the so-called 'fragile 5' of India, Indonesia, South Africa, Turkey and Brazil. Since then we have seen significant improvements in all these countries, and the average current account balance amongst major emerging market countries is its highest level since the early 2000s. We have also seen continued deleveraging from external debt amongst EM sovereigns. This has been achieved despite the huge negative terms of trade shock of 2014-2015.

3. **Valuations are far from being expensive:** Let us start with Hard Currency sovereigns, where the benchmark now has a spread of ~350b, roughly in the middle of its five-year range. We have tightened significantly this year, especially since Brexit, and the key question is whether spreads con tighten towards 250bps, the lower-end of the 5-year range. Many argue that such a spread tightening would be unwarranted given that 250bp takes us back to mid-2014 levels when oil prices were above $100pb. We disagree, and believe that it would not be unreasonable to see EM sovereign spreads tighten towards 250bp even with oil prices remaining stable around $50. The key driver of EM spreads is fundamentals, and given our view that EM external vulnerabilities have actually been falling in previous years, especially since mid-2014, the return of spreads to those levels would be justified. This is particularly the case given that technical in emerging markets are significantly better today than they were in mid-14. This is all the more the case due to the prevalence of negative yields in developed markets.

   On the local debt side, we have also seen a meaningful compression in rates. However, EM local bond yields remain high compared to US Treasuries. More importantly, when we compare the real yield on EM rates compared to DM rates, we see a differential that is close to multi-annual highs. The point is that EM rates have lagged the significant compression in inflation, and there is room for further tightening. This is particularly the case when we look at forward-looking inflation expectations. These suggest that looking into end-2017, every single major EM country – with the exception of Turkey – is expected to have inflation at or below the central bank's upper target. We continue to see plenty of value in high yielders such as Brazil, Russia and Indonesia.

Inflation expectations well within central bank targets

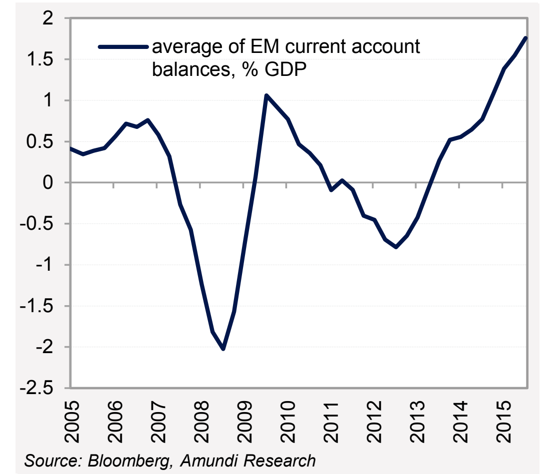


Source: Bloomberg, Amundi Research

QE tantrum: can a reduction in central bank purchasing programs hurt emerging markets?

There is growing concern that a tapering of asset purchases by developed market central banks, including BoJ and ECB, can cause another sharp sell

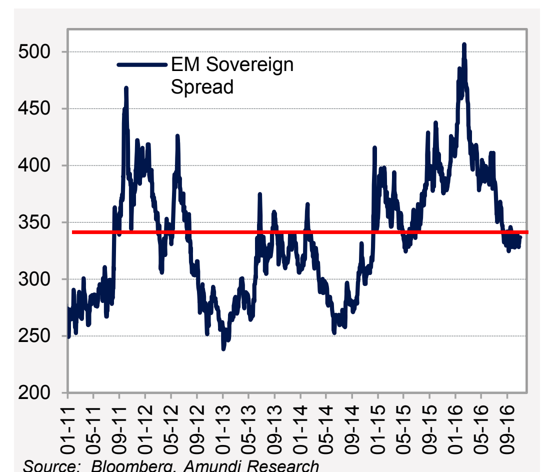
1 improving current account balances



Source: Bloomberg, Amundi Research

> EM debt assets remain cheap given fundamental developments of past few years

2 spreads mid-range, room for more tightening



Source: Bloomberg, Amundi Research

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

off in EM assets. We acknowledge that should central banks in developed markets adopt a more hawkish tone, EM assets are likely to suffer as they are characterised by a negative beta. However, we think EM debt can be surprisingly resilient even in an unlikely scenario of asset purchase tapering by major DM central banks, for a number of reasons:

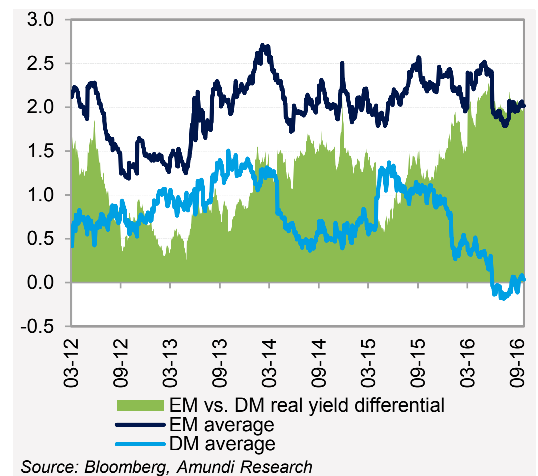
1. EM fundamentals are much healthier today compared to the taper-tantrum episode of 2013. As we argued, there has been a substantial reduction in current account deficits across the EM space, even in commodity exporters such as Brazil and Indonesia. The significant reliance that EM countries had on portfolio inflows in order to finance their C/A deficits back in 2013, is no longer an issue. We see much healthier balances of payments across EM, including in the fragile five.

2. The market went into 2013 in no way prepared for commentary surrounding tapering of QE by the FED. Going into 2017, further rate hikes by the Fed are very much expected, and there is widespread discussion around tapering of asset purchases by the ECB, BoJ and a general discussion about the inefficiency of monetary policy at current levels. Whilst there are arguments that pricing is complacent, we think the shock from tighter DM monetary policy would not be as significant as it was in 2013.

3. The three years preceding 2013 saw unprecedented inflows into Emerging Market assets and very high returns. The market was significantly overweight EM. By contrast, the three years preceding 2016 saw three years of almost no inflows, very negative returns on local debt and largely flat returns on hard currency debt. Therefore the underlying technical going into 2017 are healthier than they were in 2013.

EM fundamentals are much healthier today compared to the taper-tantrum episode of 2013

3 EM real rates are much higher than DM



Source: Bloomberg, Amundi Research

Trump tantrum: Can the Trump election permanently endanger emerging markets?

The election of Donald Trump to the presidency of the United States has to do with the decline of the emerging markets. It must be said that the reading of its campaign program was not satisfactory for these markets: prohibitive tariffs, a very significant and negative effect on world trade, and a significant and negative impact on the US debt, deficits and global growth. The question is how far this program can be applied. We will not have a clear and definitive answer for a few months (investiture to the presidency on 20 January, then negotiations with Congress), but we already know that some of Trump's «spectacular» measures cannot be adopted: the United States will not send back to their country of origin 11 million migrants, they will not impose 45% tariffs on China, they will not dramatically increase their deficits and debts ... The Congress will not accept it, even if it is dominantly republican. While waiting to learn more, the uncertainty clash associated with the election of D. Trump has done its work.

For emerging markets, two distinct scenarios can be distinguished:

- Either the new US government causes deficits and recession, which will be extremely damaging for risk aversion, volatility and risky assets such as emerging.
- Either the new government is able to «boost» growth expectations, which will go hand in hand with a resurgence of some inflation expectations, a rise in bond yields rates and Fed rates. At first mixed for the emerging countries, this scenario of stronger growth should be favourable to them, and the technical factors, the fundamental factors and the valuation aspects developed above will return to the foreground.

In short, it is not because interest rates are rising that emerging markets will necessarily suffer. The reason they go up is much more important. If this rise is motivated by a rise in growth expectations, emerging markets will benefit. This is the scenario we believe, at least for 2017.

The significant reliance that EM countries had on portfolio inflows in order to finance their C/A deficits back in 2013, is no longer an issue. We see much healthier basic balances across EM, including in the fragile five

Conclusion

We do not fully eliminate the risk associated with the central bank's asset purchase programs or the risk arising from Donald Trump's election to the White House, but it seems that the main risk we identify for Emerging markets by 2017 is still the macroeconomic situation of China. Whilst we expect stabilization to continue into end-2017, there is a risk that the sharp rise in house prices will trigger tighter policy by Chinese authorities. There is also a risk that capital outflows resume at pace, exerting more downward pressure on the currency. Of particular concern to us is the continued build-up of corporate debt, which remains on an unsustainable footing. However, we believe the domestic nature of this debt, and the fact that a majority of corporate debt is quasi-sovereign, should ensure that any deleveraging process is smooth rather than disruptive.

In summary, we think strong technicals, healthy fundamentals, and still attractive valuations, should ensure that total returns remain strongly positive in 2017. We think a tapering of asset puchases by DM central banks is unlikely to have as negative an effect on EM as it did in 2013. The key macro risk for EM remains China, but a sharp deterioration there is a tail risk, and not a base case risk.

In short, it is not because interest rates are rising that emerging markets will necessarily suffer

Equity markets in 2017 and beyond

8 How long can we stay in extra time?

ÉRIC MIJOT, *Strategy and Economic Research*

This investment cycle, which began in 2009, is particularly long. The United States is its uncontested leader. The rising trend has only been interrupted once, in 2011 (end of QE2 and loss of AAA rating on US debt). In comparison, Europe has experienced two recessions (2008 and 2012), emerging markets have undergone a series of collapses in commodities prices (especially in 2011 and 2015), and Japan had to await the election of Shinzo Abe in 2012 before it could take advantage of a plunge in the value of the yen (from 2012 to 2015), half of which has since been regained.

We know that the investment cycle often ends when the leading market reverses course. As such, can this US market cycle last much longer? Will 2017 mark a turning point?

2016: a year marked by the oil countershock, then an abrupt jump in long-term interest rates

Since the end of January, the first part of the year has been marked by the rebound in oil prices, which triggered a recovery in the equity markets (see charts 1 and 2). This was a major bottom, ending a correction that lasted 10 months (April 2015 - February 2016) and thereby also a stock market cycle. Then, as summer began, concerns about Brexit prompted equity markets to over-correct to the downside (especially in the eurozone). They quickly bounced back, leaving the underlying trend unchanged.

Long-term interest rates also hit bottom, supported by the idea that recovering energy prices would then halt the drop in inflation. Two other factors helped drive this trend: 1) rising populism in the United States and Europe, making it increasingly evident that fiscal policies must take over from monetary policies, 2) the Bank of Japan's decision on 21 September to move its long-term interest rate target close to 0% and to continue its accommodative policy as long as inflation does not exceed its target rate for an extended period of time. The recovery in long-term interest rates and the proactive policies implemented by authorities have finally induced sectoral rotation toward cyclical sectors and markets (including Japan and the eurozone) worldwide.

The other key event in 2016 was the US market's entry into bubble territory

In the last few years, this publication[1] has discussed the possibility that this cycle would end this way.

Right now, shares on the US market are trading at more than 18 times 12-month trailing earnings. Remember that there is a clear relationship between the PER and inflation (see chart 3). The market costs more when inflation is slightly positive and becomes increasingly less expensive when inflation is too high or, conversely, deflation prevails. The "Rule of 20" fits right in with these observations and therefore provides some insight. When market PER rises above 20-CPI level, it has begun to overshoot. This was the case before the crash of October 1987 (see chart 4) and again in December 1996, when Greenspan described the market's excessive valuation as "irrational exuberance". Keeping in mind the Fed's 2% inflation target, which also corresponds to our inflation forecast for 2017, the threshold for considering valuations to be excessively high could very well be 18x (20-2), or the average PER in a low-inflation regime (0%-3%).

Based on these considerations, the US market just entered a bubble. The PER on 12-month trailing earnings is indeed 18.5x. We should add that the

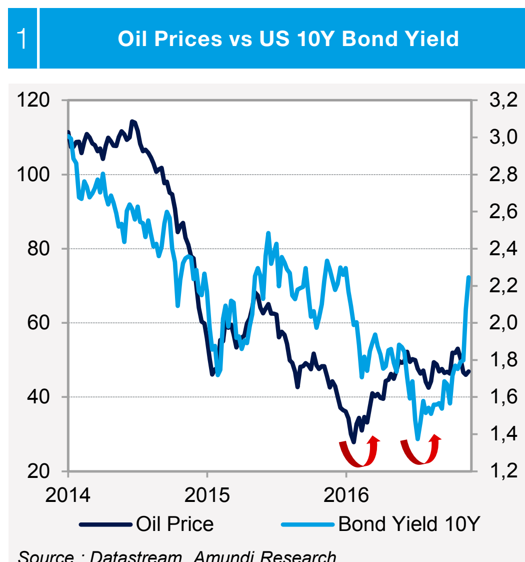
[1] *See the March 2014 Cross Asset Investment Strategy: "Equity markets: should we fear a new bubble?»*

The essential

After more than seven years of a bull market, the US has entered bubble territory. Investment cycles often end when the leading market reverses course. After looking back at previous bubbles (1987, 2000 and 2008), we must be vigilant as the second half of 2017 approaches. However, this cycle could also last longer. At this stage the situation offers more cause for uncertainty than concern. Although Donald Trump's election was a surprise, it does not call our reading of the markets into question, and the shift in policy mix to more fiscal spending is positive for equity over bonds.

Regionally speaking, positioning is more neutral. In fact, the reflation resulting from the election of Donald Trump is positive for value stocks versus growth. This should theoretically benefit the eurozone and Japan but in practice this must be accompanied by long-term depreciation of their currencies to stand out compared to the United States. Upcoming votes in Europe also necessitate a risk premium. Market shocks resulting from these events could create entry points. Finally, the election of Donald Trump disrupted emerging markets as an investment theme at the very moment when they need a boost, which has moderated our constructive view.

1 Oil Prices vs US 10Y Bond Yield



Source : Datastream, Amundi Research

financial community seems to be convinced that the paradigm has changed, which is typical for bubble formation. The market consensus is that the new era of "secular stagnation" will lead to "lasting low interest rates", which in turn justifies equity valuations and transforms the "lack of alternatives" into a reason to buy.

At this stage the situation offers more cause for uncertainty than concern

First, let's look at the context for recent bubbles. In 1986 and 1998, oil counter-shocks had already extended economic and market cycles. They ended up overshooting and then crashing. The market upswings that followed the rebounds in oil prices at those times lasted 12 months (October 1986 to October 1987) and 18 months (October 1998 to March 2000). The subprime bubble also consisted of an additional market upswing that lasted 14 months (June 2006 to October 2007). Given that this time the low was hit in February 2016, repeating this scenario would mean that 2017 should have two stages: a positive period to start with, then a more difficult one later on. It would therefore be prudent to review the situation in the second quarter of 2017.

In fact, the number of risks that could easily support this kind of scenario will be concentrated in the second half of 2017:

- The Communist Party Congress in the autumn is reason enough to expect that China will maintain its stabilisation policy at least until it occurs. Investors may wonder about how long this support will last as the congress date approaches.
- It is also possible that negotiations between the US White House and Congress to pass a budget could be problematic.
- Brexit negotiations should be in full swing after the German elections in October, which could stoke fears.
- Finally, the market could begin to speculate about the possibility of the ECB tapering off its own asset purchase programme.

However, the nature of each bubble is different. The bubble that concerns us today is based on very low "dictated" long-term interest rates, even though they could be allowed to rise slightly. We must not forget that US long-term interest rates were capped at 2.5% over the nine years from 1942 to March 1951 in order to finance the war effort[2]. Determining how long the current extreme situation will last is therefore rather complicated. It may even last beyond the first half of 2017, particularly seeing as this cycle has developed rather slowly.

Another key point of reference is that US corporate profit margins peaked in the last quarter of 2014 (see chart 5). Since 1950, such highs precede recessions by an average of six quarters, which means the recession should have already begun. However, this is not an average cycle. Meanwhile, the longest period between a profit margin peak and a recession is 15 quarters, which was the case in the 1960s and the end of the 1990s, which were both bubbles. If such an extreme were to repeat itself, the recession would not start before 2018, which still leaves plenty of time for valuations to overshoot.

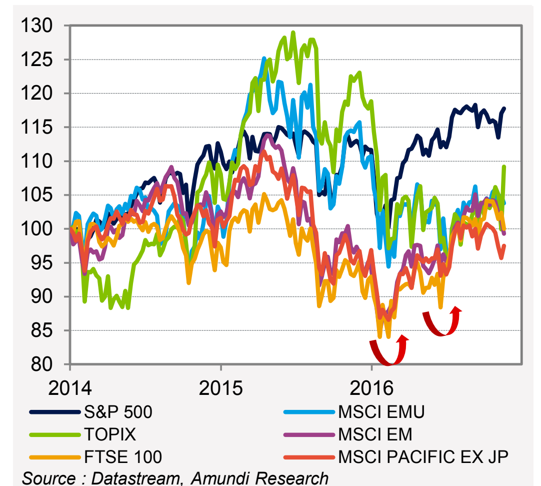
For this to occur, profits must start moving back up. In 1998 or 2006, for example, profits were on an upswing (see chart 6). Bubbles cannot form without hope...

What criteria should be used when investing in equity today?

Aside from short-term movements, we believe the performance of equity markets depends on the direction of two key variables: profits and long-term interest rates. There are four possible scenarios:

1. **A rather positive scenario (reflation): long-term rates climb somewhat but corporate earnings simultaneously recover slightly.** Value stocks will do best in such conditions, especially banks. As a result, the eurozone and Japan should perform well.

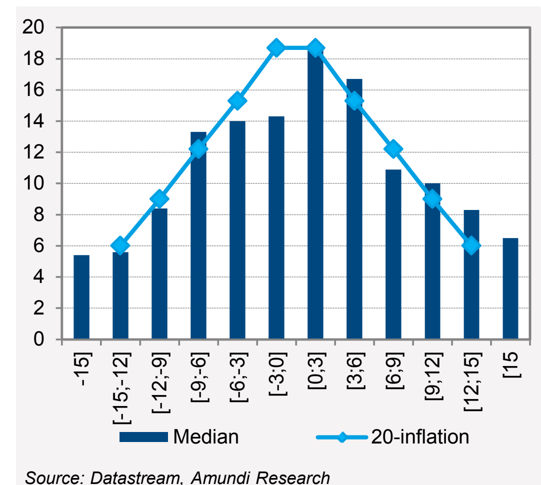
2 Main equity markets



Source : Datastream, Amundi Research

> "The leading market (the US) has entered bubble territory"

3 PER and Inflation



Source: Datastream, Amundi Research

[2] *See the Discussion Paper entitled "Central Banks: the First Pillar of the Investment Cycle" – November 2015*

2. Another rather positive scenario (fluctuation): profits do not recover but long-term interest rates continue to stay low. Quality stocks will lead the pack. US and emerging markets will perform better than the rest.

3. The most positive scenario (bubble): long-term interest rates stay low while profits begin to move back up. This situation would be conducive to bubble formation, pushing growth stocks to the forefront once more. Emerging markets would benefit the most in such a scenario.

4. A negative scenario (relapse): long-term rates recover but profits don't. It would be good to adopt a defensive stance. The US market would do better than the other developed and emerging markets.

These four scenarios promote radically different positioning. The probabilities for each scenario to occur are rather similar depending on the horizon in question, but **it is possible that the situation moves temporarily through scenario one (reflation) before resuming the path to scenarios 2 (fluctuation) or 3 (bubble) or even 4 (relapse).**

Our analysis of the performance of different investment styles suggests this (see chart 7). If we restrict ourselves to Value and Growth investment styles overall, it is worth noting that each time the cycle is good for growth stocks, it ends up exaggerating the performance of growth vs value. This shift takes place in three stages. There is an initial surge, then a retracement in favour of value stocks, and finally growth stocks race far ahead. Up until now, 2016 has experienced a retracement in favour of value stocks, but it benefited the commodities sectors more than financials (especially in Europe). This retracement has therefore been extremely gentle until now. It has not yet ended, based on the fact that it generally stops on the 24-month average of the Growth/Value ratio. This would be consistent with a scenario for long-term interest rates in which the recent upswing could last even longer before hitting a ceiling.

The surprise election of Donald Trump does not call our reading of the markets into question, but it does add some nuance:

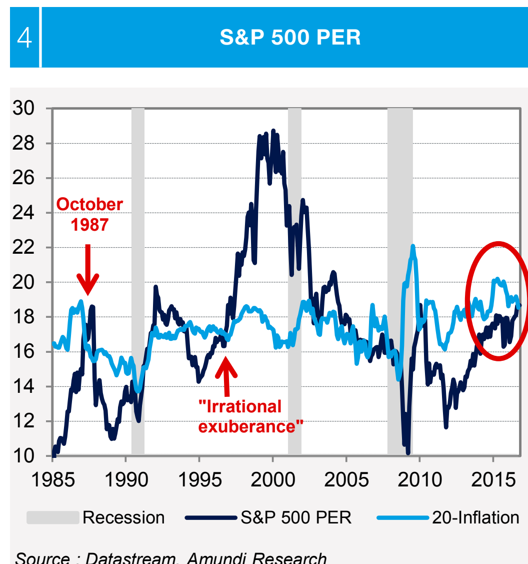
- One thing is clear: his election, combined with the fact that the Republicans control both the House and the Senate, lends credence to the market conviction that fiscal policy will take over from monetary policy to support the economy.
- One thing is certain: his economic plan, even if defanged by Congress, is reflationary by its very nature. It is also decidedly pro-business (corporate tax cuts, less regulation). This will encourage higher profits (at first, the decrease in corporate tax will more than offset the increase in wages) and higher interest rates. The mix favours equity over bonds.
- One thing is uncertain: the profile of the increase in long interest rates will have an impact on market issues. Will the increase last, which would extend the lifecycle of the value theme, or will it be brief, as with the Greenspan conundrum of 2004? This uncertainty reduces predictability in terms of geographic allocation.
- We have one conviction: if the increase in interest rates is excessive, it will end up popping the bubble in equity.
- Finally, the foreign policy of the new president, particularly with respect to China, Russia, Mexico and the Middle East, could also generate market shocks.

Finally, where are the different regions positioned in the current investment cycle?

By now, regular readers of our publications are familiar with our interpretation of short cycles[3]: GDP fluctuates around its potential, in accordance with four phases (i, ii, iii and iv) that correspond with different market behaviours.

[3] *See the Discussion Paper entitled «The Short Investment Cycle: Our Roadmap" – October 2014*

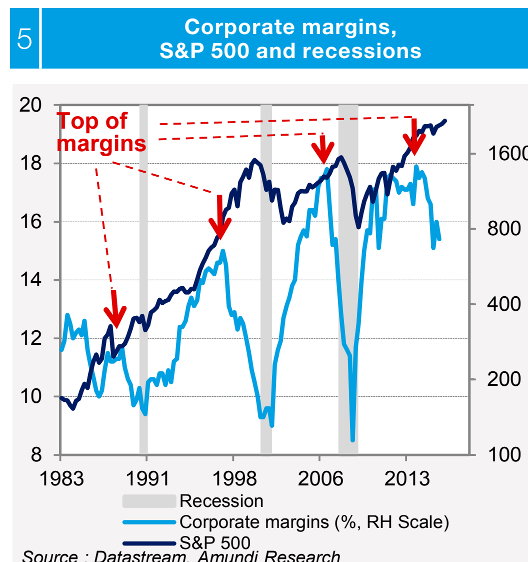
4 S&P 500 PER



Source : Datastream, Amundi Research

> Falling margins, but still some room before a recession

5 Corporate margins, S&P 500 and recessions



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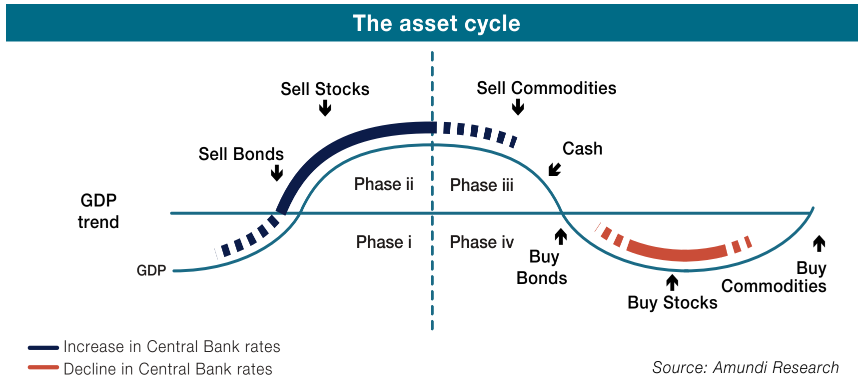
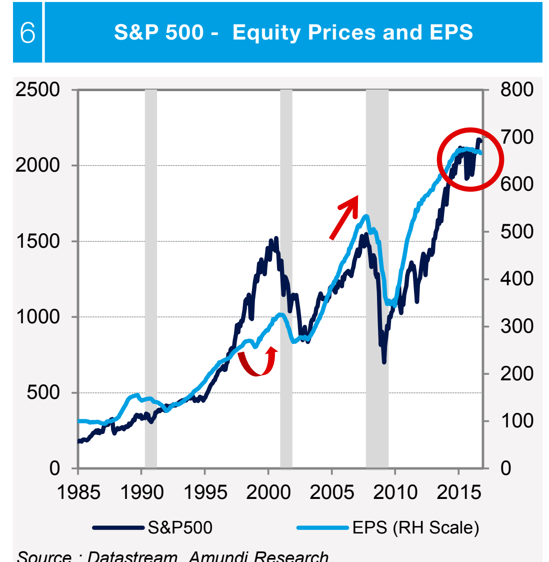


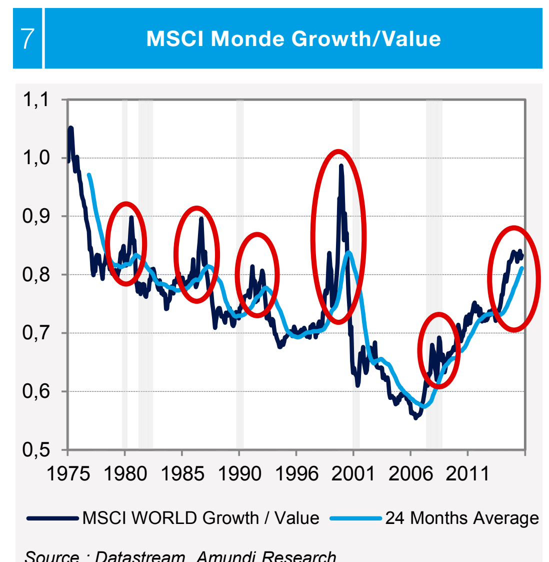


The US market (neutral in relative terms) entered phase iii of our roadmap when the Fed taper ended (mid-2014). This stage normally corresponds to stable Fed interest rates, and this time it is related to a stable Fed balance sheet. This period is conducive to bubble formation, especially since the end of the 1990s (very low interest rates). The oil countershock recently strengthened this hypothesis, as we have just seen. Companies should be able to record profits of at least 5% after two years of stability. Donald Trump's pro-business plan is not expected to end this trend in 2017. The leading market (the US) still has some room to rise in this cycle, which is also key for other markets.

The eurozone and Japan (neutral for now - between the two slight preference for Japan in local currency) are in phase ii. Economic growth is only slightly higher than its potential, but monetary policies remain accommodative. As both of these markets are cheaper and positioned further back in the cycle than the United States, there were already several reasons they could have risen higher than the US market in 2016, but several factors stood in the way until now: 1) the Fed put its determination to increase interest rates on the back burner for much of the year, stabilising currencies to the detriment of European and Japanese profits, 2) fears sparked by Brexit reinforced investor wariness towards Europe, and 3) banks suffered from negative interest rates and the difficulties experienced by Deutsche Bank and Monte dei Paschi di Siena. At present, the eurozone and Japan are good candidates to take advantage of the reflationary theme (a steeper yield curve is good for banks under pressure), but this must be accompanied by long-term depreciation of their currencies for them to truly stand out compared to the United States. Upcoming votes in Europe also necessitate a risk premium. Shock results for these events (Italian referendum, elections in the Netherlands, etc.) could also create buy opportunities.

> "The retracement in favour of value stocks is not yet over"

Emerging markets (also more neutral) are between phase iv and phase i. They are beginning to recover. The stabilisation of both the Chinese economy and the US dollar contributed to this phenomenon in 2016. After the first rebound of emerging markets, which once again have reached our tactical target (the resistance level of around 920, which had been a support from 2010 to 2015, for the MSCI Emerging Markets in USD), fundamentals must now support expectations. This could be the case because of two factors: 1) the oil countershock should contribute to renewed profits, 2) as usual, interest in the emerging markets has first focused on debt. As a result, a decline in interest rates, pushed even further down by the decrease in inflation, helps make financial conditions more accommodating. We should add that the Communist Party Congress in autumn 2017 is reason enough to expect that China will not reverse its support policy before then. However, the election of Donald Trump just disrupted emerging markets as an investment theme (increase of long-term interest rates and the US dollar, impact on world trade and foreign policy) at the very moment when they need a boost, which has moderated our constructive view. An increase in US customs tariffs on Chinese products could lead to a decline in the RMB, which would have negative implications for emerging markets across the board. We would buy only if exchange rates stabilise.



Conclusion and upcoming themes:

Maturity of the economic cycle in the United States: the leading market has entered a bubble, which is no incentive to make high-stakes gambles.

Change of the policy mix toward more budgetary spending: a positive shift, all other things being equal, for equity compared to bonds. The methods and negotiation time required to successfully carry this off have yet to be determined.

Hike of long-term interest rates: regionally speaking, positioning is more neutral. Value markets (eurozone and Japan) could theoretically perform well during this period, but for this to happen, it must be accompanied by currency depreciation

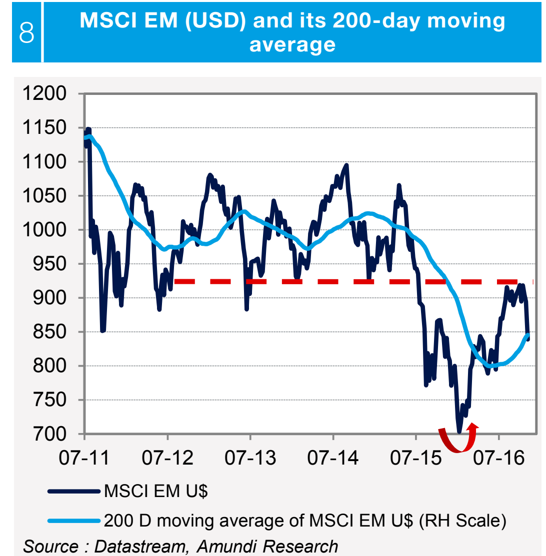
Elections in Europe: political uncertainty, heightened by the election of Donald Trump (rise of populism) justifies a risk premium for Europe, which also needs even more support from profits and the participation of financials. Shocks related to these events, would be buying opportunities.

Brexit: for the moment, focus on large-cap international stocks rather than small-cap domestics in the United Kingdom.

US elections: infrastructure and defence stocks will almost certainly benefit. Healthcare is a more contrarian theme. It is both defensive and undervalued due to the negative impact of US election campaigns. After elections, this theme often comes back after being oversold. Small caps, which are less international and therefore more sensitive to any corporate tax cuts, also have a role to play.

Chinese Communist Party Congress in fall 2017: there is no reason for China to reverse its economic policy in the first part of the year, which gives other emerging markets time to recover. However, the election of Donald Trump has moderated our constructive view. A decline in the RMB would weaken emerging markets across the board. Buy only if exchange rates stabilise.

8 **MSCI EM (USD) and its 200-day moving average**



Source : Datastream, Amundi Research

The shift in policy mix to more fiscal spending is positive for equity over bonds

Underlying Trends
Our maps on international equities

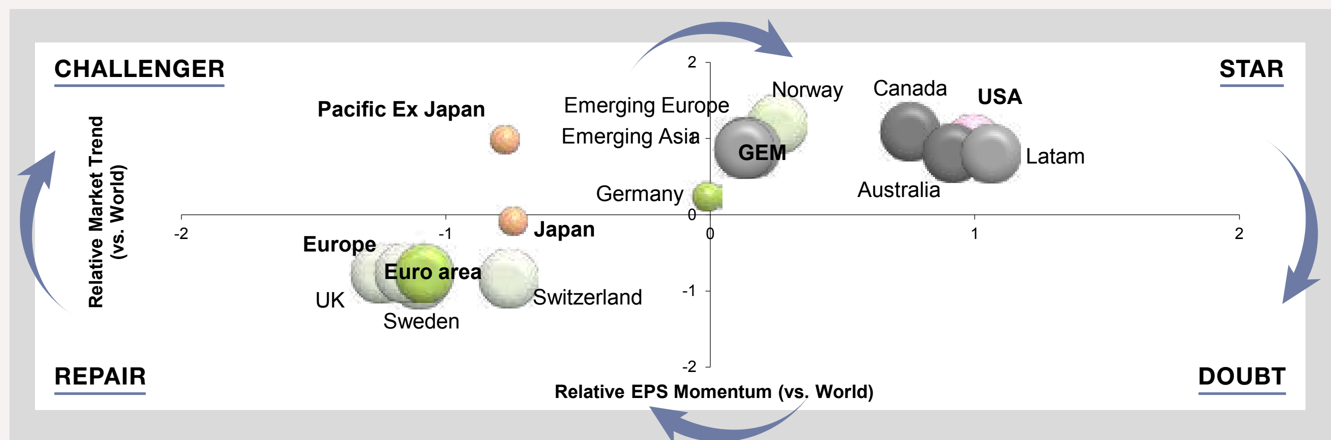
ÉRIC MIJOT, *Strategy and Economic Research*

These maps are decision-making tools. Their purpose is to compare the markets with one another in a sort of snapshot of the current situation. They highlight current issues and suggest some objective responses.

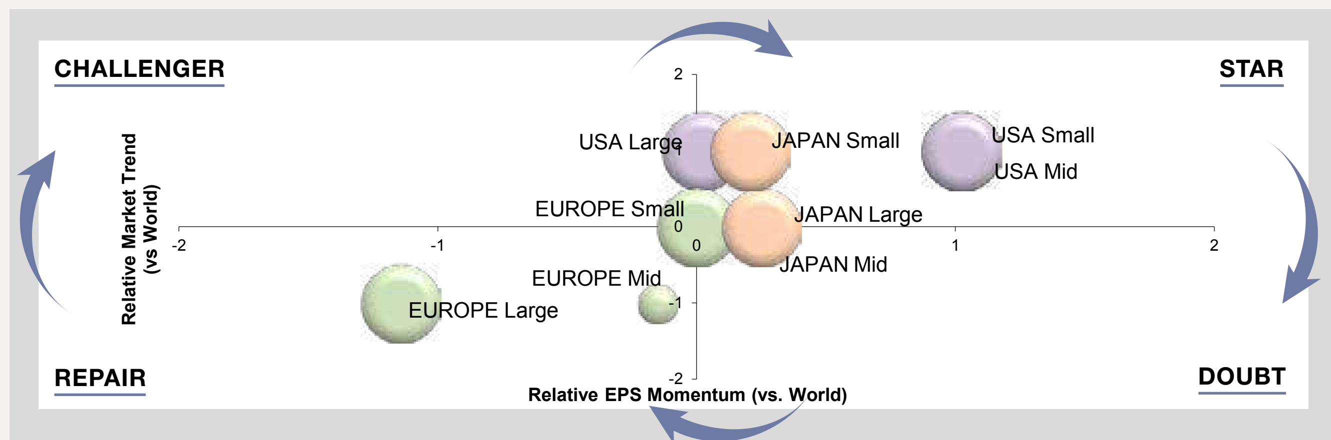
Interpretation

The equity markets are positioned along three axes. The horizontal axis expresses earnings momentum (earnings indices and "net up"); the vertical axis expresses price momentum (market indices and flows); and the circle sizes express valuations (P/E and P/BV). These three dimensions are measured in dollars and relative to the MSCI World. The colours refer to geographical regions (the US, Asia, EMU, Europe ex-EMU, and GEM), or to sector groups (financials, cyclicals, commodities, and defensives). As markets behave ahead of earnings, the natural rotation is clockwise.

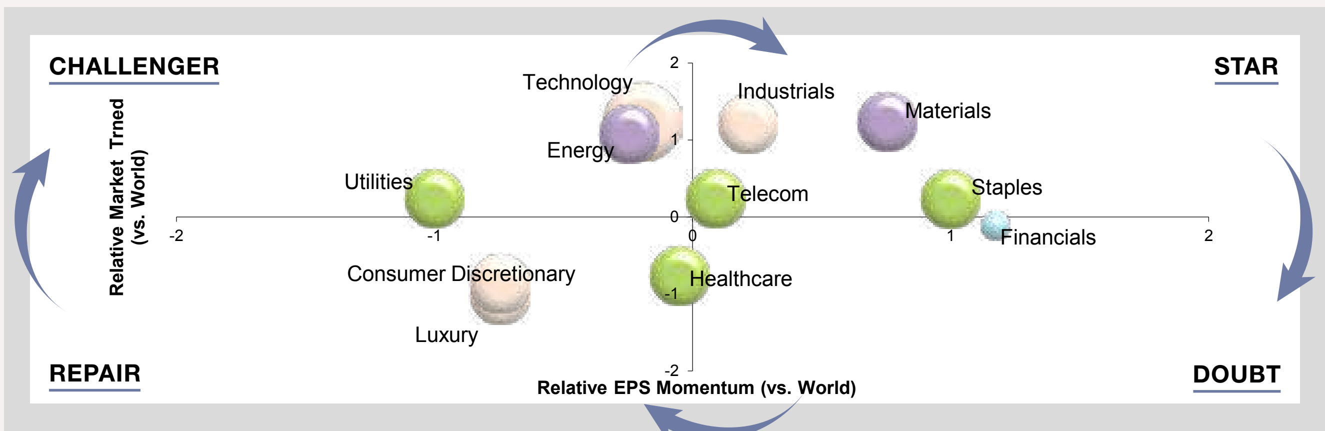
The global map still places the **United States** in the STAR zone. It has been joined by the **emerging markets.** The **Latin American, Canadian** and **Australian** markets have been leading (rebound in commodities) and have now been joined by **the emerging markets in both Asia** and **Europe. Developed Europe** and **Japan** trail behind the rest (REPAIR). Earnings suffered due to foreign exchange and the problems affecting the banks. They therefore have significant room for recovery as long as these constraints are lifted.



The global map by size (market capitalisation) shows that for each region of the developed world, **small caps** are ahead of **large caps**, when viewed clockwise. This implicitly shows an overall shift toward themes that are both more cyclical and domestic. Interesting to note that the very beginning of a year is often beneficial for small caps.

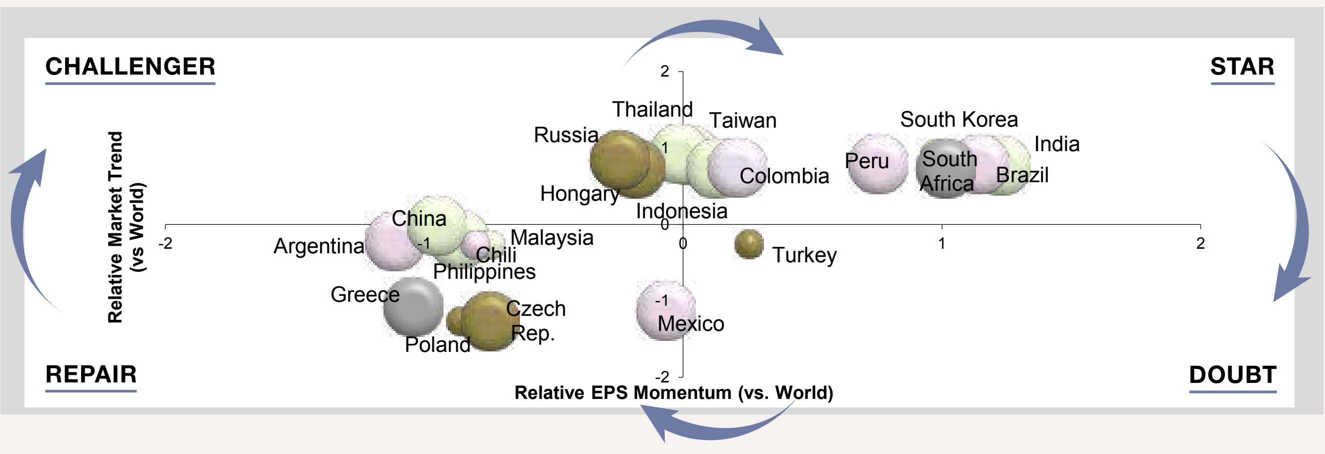


The global map by sector also shows a stronger appetite for cyclical sectors: **basic materials, energy, industrials and technology** (sectors in the STAR zone or close to it). Next are **the defensive sectors (in green),** which could come back to the foreground later. Among them, **healthcare** is oversold and could represent an opportunity after the US elections. **Financials** are in a position (DOUBT) that is influenced by the weight of US financials. It should be noted that they are not very expensive (as represented by the small size of their circle) compared to the Technology sector (large circle).



- **STAR** (upper right)
The markets are outperforming with reason, as earnings are also outperforming earnings elsewhere in the world. The larger the circle, the more the market has priced this in and the lower the potential.
- **DOUBT** (lower right)
The markets are underperforming but earnings are still holding up. Is this temporary?
- **REPAIR** (lower left)
The markets are underperforming with reason, as earnings are also underperforming. The smaller the circle, the more risk is priced in and the greater the potential. But watch out for value traps!
- **CHALLENGER** (upper left)
The markets are outperforming but earnings are not yet keeping up. Is this a shift towards a new trend?

The emerging markets map clearly demonstrates the trend for the last few months, which runs from the REPAIR zone to the STAR zone. We can easily see markets dependent on commodities **(Brazil, Peru, Colombia, and South Africa)** in the STAR zone. **Russia,** which is still in the CHALLENGER zone, is getting there as well. **Mexico** is a unique case: the US election has had a negative effect on its currency. Although some Asian markets **(India, Korea, Taiwan, Thailand and Indonesia)** have managed to join the top performers, **China** is still in behind (between REPAIR and CHALLENGER).



Equity markets for 2017 and beyond

9 Which are the sectors for tomorrow?

IBRA WANE, *Strategy and Economic Research*

2016 Stock market review

From 1 January to 1 November 2016, the **MSCI indices of the eurozone**, the **United States**, and the **emerging markets** (in USD) varied by **-5%, +3% and +14%**, respectively. Notwithstanding the **substantial differences** from one region to the next, we see a few **common features** at the sectoral level.

We note the very good overall performance of the **energy and commodities** sectors driven by the **strong rebound in oil prices** since the lows of January 2016 **and the reassuring signals coming out of China** (growth stabilisation, reduction in the amount of capital outflows, etc.). Conversely, **healthcare and telecommunications** are in **last place** in most regions (see Graph 1).

At first glance, this 2016 stock market review, with the excellent performance turned in by late-maturing cyclical sectors (energy, basic materials) and the muted performances of defensive ones (healthcare, telecoms and utilities in the eurozone and healthcare, telecoms and consumer staples in the United States), **may seem typical for stocks having reached their peak in the economic cycle**.

However, in several respects since 2008, this cycle of recovery has been out of the ordinary. Not only longer in duration but significantly slower, this recovery is anything but certain. Next year will be no exception to the rule with world growth along the lines of 3% for the fifth consecutive year since 2012! Incidentally, when we take a close look at the primary reasons behind the recovery of oil prices or China's growth, **ambiguities appear that bring some perspective to the extent of cyclical improvement**:

- The **oil** price recovery would appear to be due more to a **better discipline among producers** than to a genuine improvement in final demand[1].

- **Likewise, the nearly simultaneous**[2] **recovery in long rates at the end of the summer is due to a fairly weak trio of factors:** 1/ the post-Brexit-referendum relief, 2/ the rise in headline inflation and 3/ the growing awareness that the different central banks have done just about all they can do in the area of monetary accommodation. However, this recovery in 10-year rates remains very limited so far. Although long rates have risen on average by nearly 40 bp relative to their summer lows, between 23 June (UK referendum) and 1 November, US, French and Japanese rates ultimately rose only 8 or 9 bp. Meanwhile, the Bund was stable and UK Gilts fell 23 bp.

- **Lastly, although China's growth was where it should be**, with an increase of +6.7% in each of the first three quarters of 2016, the surge in credit does not seem to be sustainable. As major elections are scheduled in autumn of 2017, the likelihood of a sharp deceleration in the Chinese economy between now and then appears limited but a later slump is still possible.

To sum up, although the 2016 stock market year may look like the start of a traditional cycle high, in reality several factors seem biased, which calls for prudence when it comes to predicting the next phases.

Investment cycles and sector performance

Before laying out our convictions for 2017 and beyond, we briefly recall how the different investment cycles and sector performance have ensued since the start

[1] *According to the International Energy Agency, after an increase of +1.9% in 2015, the growth of world oil demand is expected to slow to +1.3% in 2016.*

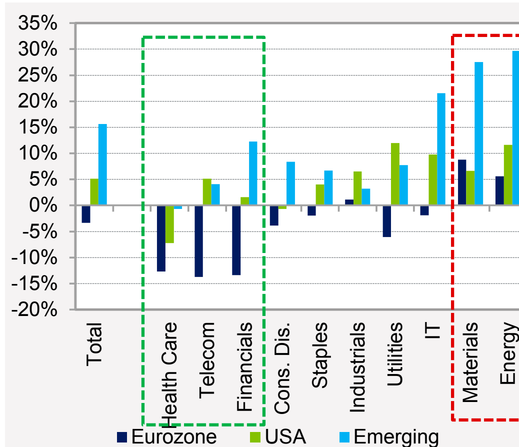
[2] *+38 bp on US 10-year rates from the low reached on 8 July 2016 to 21 October, +22 bp in the UK, and +11 bp in Germany and France.*

The essential

On both sides of the Atlantic, the excellent 2016 performance of late-maturing cyclical sectors and the declining performance of most defensive sectors clearly suggest that we are about to reach a cyclical high.

However, the markers of this cycle – recovery in the price of oil, higher interest rates, Chinese growth – nonetheless appear fairly biased and vigilance is called for as to the sequencing of the next sectoral phases, especially since 2017 could go through two separate phases. For the next few months, barring a major electoral surprise, we will continue to focus on a pro-cyclical allocation in the United States where, paradoxically, the economy is expected to pick up momentum between now and mid-2017. The eurozone, with its lukewarm growth, political uncertainty and growing discontent caused by negative interest rates argues for a relatively diversified allocation. We will be placing the emphasis on earnings, geographical exposure and modified duration. By combining these different criteria, energy, basic materials, IT, food, beverages & tobacco and banks should perform well over the next few months.

1 MSCI Eurozone, Europe, Emerging (USD) perfomances by sector YTD (as of 1/11/16)



Source: Datastream, Amundi Research

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of the great financial crisis. In a "normal" environment, economic and stock-market cycles come one after another – recession, trough, start of a recovery, expansion, peak, slowdown, recession – with defensive sectors outperforming at the start of a recession and cyclical sectors in recovery phases.

The US market: an example of classic behaviour. With hindsight, the behaviour of the MSCI USA is fairly straightforward, and its sector performances have been in line with expectations. Thus, taking the Lehman Brothers collapse in September 2008 as a starting point, we clearly see the different periods (see Graph 2) with the initial market crash (-43%) during the financial crisis, followed by a powerful rebound (+52%) against the backdrop of an easing of the recession beginning in the spring of 2009. Next, that recovery expanded from the spring of 2010 to the spring of 2013, leading the market in its wake (+49%) until a monetary policy change in course from May 2013 (pre-tapering) to October 2014 (the end of tapering) signalled the apex of the market cycle (+22%). Since then, the market has moved into a more wait-and-see phase (+4% since October 2014). At the same time, on a sector level, we clearly see (see Graph 3) the relative outperformance of the defensive sectors in the initial phase of the recession (consumer staples, telecoms and healthcare) and, conversely, the cyclical sectors early in the recovery (financials, consumer discretionary and industrials). Likewise, today, in this more fluid cycle downswing where the market has been treading water for two years, even though energy and utilities have come back into favour since the beginning of the year, the sectors that have fared best year-to-date are those related to consumer spending – consumer discretionary and consumer staples, and especially IT[3] – whose purchasing power has benefited from the continued improvement in the labour market and low fuel prices.

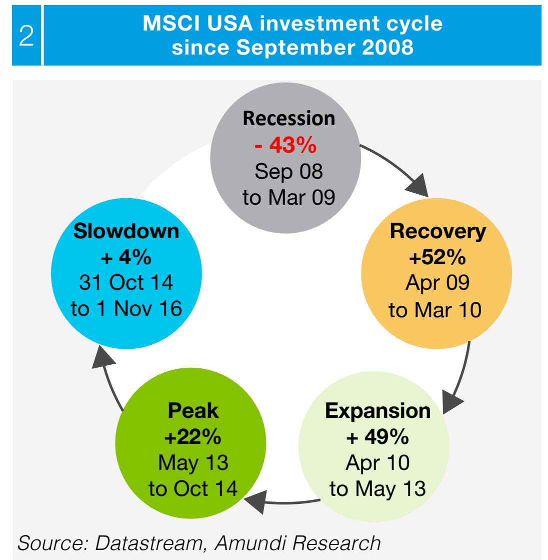
The eurozone: an example of a biased cycle. The trajectory of the MSCI EMU Index (see Graph 4) is different from its American counterpart, because Europe has been through two recessions over the period instead of just one (the 2008-2009 financial crisis, then the sovereign crisis of 2011-2012). This means that while both markets went through very similar trends in the first two phases of the cycle (collapse, then initial rebound, -42% and +33% in Europe vs. -43% and +52% in the US), by contrast, the European rebound begun in autumn of 2009 soon topped out (spring of 2010) and fell back down in autumn of 2011. Overall, from 30 June 2010 to 25 July 2012, the eurozone lost ground (-12%) while Wall Street took off (+30%). Ultimately, it was only after 26 July 2012 and Mario Draghi's famous "***Whatever it takes***" remark that the MSCI EMU Index, six months before the actual economic recovery, was set free, gaining +74% from 25 July 2012 to 31 March 2015 vs. +55% for the MSCI USA Index for the same period. By contrast, subsequent to the new phase of monetary easing and the peak of growth observed in spring 2015, eurozone equities entered a more wait-and-see phase (-14% for the MSCI EMU Index compared to +2% in the United States). Going beyond the specifics of timing, sectoral strategies in the eurozone (see Graph 5) are, with just a few shades of difference, similar to those of the United States; namely, clear outperformance by defensives (telecoms, consumer staples and healthcare) early in the recession, before cyclicals took over (financials and industrials) as the recovery took hold. However, it is worth recalling that during the sovereign debt crisis, consumer discretionaries —which were expected to underperform—got away unscathed thanks to the saving grace of emerging market growth. Likewise, although some defensive sectors such as healthcare and consumer staples were sought out, others, such as utilities or telecommunications, underwent a correction virtually identical to that of financials.

The macroeconomic climate for 2017 and beyond

According to our central scenario, world growth in 2017 will be up slightly relative to 2016 (+3.2% vs. +3.0%). However, this virtual standstill conceals **three different trends**: the peaking of the recovery cycle in the developed

[3] *In the US, the IT sector's characteristics are fairly similar to those of consumer discretionary owing to stocks like Apple and Microsoft, while in Europe, with SAP and Amadeus for example, they more closely resemble industrials.*

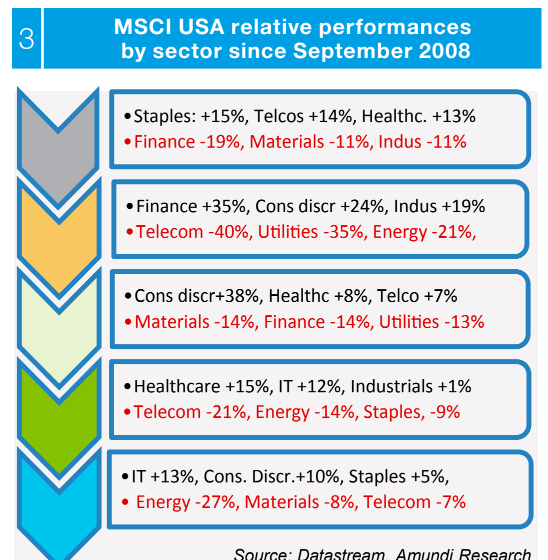
2 **MSCI USA investment cycle since September 2008**



Source: Datastream, Amundi Research

> In 2016, the recovery in oil prices prevailed over other factors

3 **MSCI USA relative performances by sector since September 2008**



Source: Datastream, Amundi Research

countries, the continuing transition in China and a gradual recovery in other emerging countries driven by commodity producers. **Furthermore, among the developed countries, headline inflation should significantly increase** (1.7% vs. +0.8% in 2016 and +0.2% in 2015) due to the very unfavourable base effects of crude oil prices. Meanwhile, core inflation, which remains quite subdued, should pick up as the labour market recovers. **However, starting in 2018, world growth is expected to run out of steam.** This goes for the developed countries and for China, too, where growth is projected to slip by about 0.2 points. By contrast, the other emerging countries should be the only places on earth where growth should stabilize or eventually accelerate.

In the longer term, barring a pick-up in productivity[4], global growth potential is expected to be limited to around +3.0%, with +1.3% for the developed countries and +4.3% for the emerging markets (including China). **Such slow growth**, far below the rate prevailing prior to the great financial crisis (+4.1% on average from 1997 to 2007, including +2.8% for the developed countries), **does not mean the disappearance of cycles**. Indeed, unlike a traditional cycle, investment has barely picked up and so the risk of decompression in the event of a crisis is limited. On the other hand, the rapid deterioration of growth potential in the developed countries has made these economies more vulnerable to the slightest of fluctuations (interest rates, exchange rates, commodity prices, etc.).

To put it simply, eight years after the great financial crisis, the global economy is still recovering. Against this backdrop, the slight acceleration expected in 2017 should be put into perspective as it more closely resembles a mini-cycle than a traditional cycle**. In other words, the pressures on interest rates and the pro-cyclical sector rotations that we are beginning to see are probably more transitory than genuinely long-lasting.**

Our sector convictions for the future

As we have seen above, **investment cycles and sector performance are intertwined** – cyclical sectors outperform early in the cycle followed by defensive sectors late in the cycle – although occasionally previously unknown cross-cutting factors are added into the classic patterns.

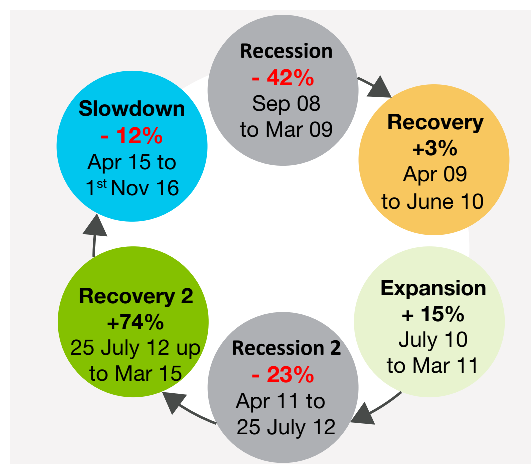
As for the **United States**, the country has completed a full cycle since September 2008 and, since the end of **tapering** (October 2014), has been back in that famous "**slowdown**" phase, where growth is still positive but decelerating (+5% QoQ annualised in Q3 2014, +1.4% in Q2 2016). In **principle**, the next phase of the cycle is "**recession,**" which would necessitate a more defensive sectoral rotation. But **the fact is** a recession does not appear imminent. In the **short term** (second half of 2016), **US growth is expected to accelerate** (upward trend due to the inventory valuation effect and foreign trade). Then, after the H2 2016 peak (>2.5%), it is expected to remain in the area of +2% in 2017 with, as usual, household consumption as the main driver. Furthermore, the U.S. post-election cycle suggests a little more budgetary expenditure that will only prolong the recovery. Finally, the **"slowdown"** observed from mid-2015 to mid-2016, rather than changing into a **"recession"**, is expected to find **fresh impetus** at least in the first half of 2017.

In the short term (second half of 2016), US growth is expected to accelerate (>2.5% in H2 2016) for reasons predating the presidential election (upward trend due to the inventory valuation effect and foreign trade). Furthermore, in 2017 and 2018, it is expected to remain in the area of 2.2%, or slightly above potential growth (+1.8%). As implementing even just some of Donald Trump's plan will boost consumption and infrastructure investment, this suggests the recovery will continue. Finally, the "slowdown" observed in mid-2015 to mid-2016 is expected to find fresh impetus before hitting its peak.

- For the next six to nine months, this points to a relatively offensive sector allocation (see Chart 6). Its precise calibration will nevertheless depend on

[4] *Except for a few short periods – the end of the 1980s, second half of the 1990s – we have been observing an almost continuous deterioration in productivity in developed economies for the past 50 years…*

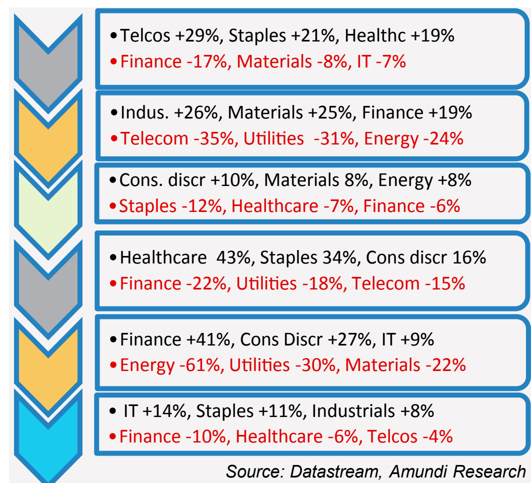
4 MSCI EMU investment cycle since September 2008



Source: Datastream, Amundi Research

> 2017 may be divided into two separate phases

5 MSCI EMU relatives performances by sector since September 2008



Source: Datastream, Amundi Research

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Mr. Trump's abilities and room for manoeuvre, as the newly elected President is notoriously more protectionist and interventionist than most of his party's delegates. Although the next few months may be dynamic, the second half of 2017 could, in contrast, prove more uncertain. The honeymoon period each new president enjoys will be coming to an end. The budget negotiations between the White House and Congress and/or international trade negotiations could take a delicate turn. The debate on Brexit and the ECB **taper could resurface**. When the time comes, we will opt for a more diversified allocation. Until then, we will continue with a scenario in which, even if it means mutual concessions, Donald Trump and Congress will work out a compromise.

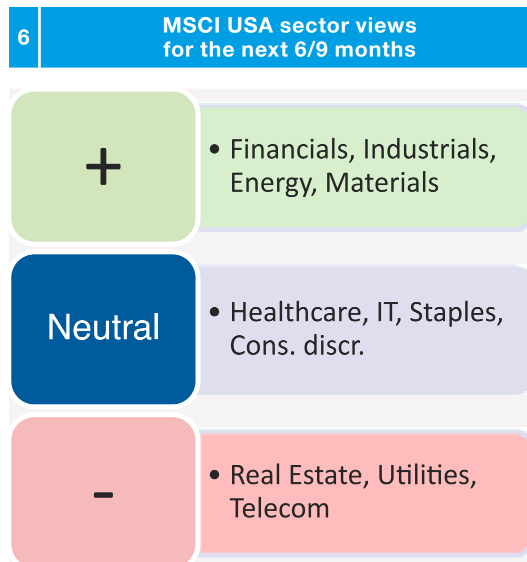
- When we consider that the economy will be relatively promising in the next few months, with a slight uptick in inflation and US long rates, **this would argue in favour of financials,** as banking stocks are sensitive to a reduction in non-performing loans and positively correlated to higher interest rates. In addition, the much stricter financial regulations established since 2008, like the Dodd-Frank act, could be loosened significantly. In contrast with banking stocks, real estate could suffer from rising interest rates.
- **Traditional cyclical sectors** such as manufacturing are also expected to have no problem adapting to this reflationary period, especially since proactive budgetary measures may open the door to new opportunities. With respect to **energy** and **basic materials,** these l**agging** cyclical sectors have made a nice comeback since the start of the year. However, they have still turned in the worst performance for two years running. While their recovery should pick up in 2017, Mr. Trump's win – given his lack of enthusiasm for environmental standards – will give an additional boost to the mining sector (coal, iron ore, etc.), conventional energy (coal, gas, oil, etc.) and basic materials (cement, plate glass, steel reinforcement bars…).
- In contrast, in a fairly buoyant environment with slightly higher interest rates, **relatively defensive sectors that provide yield, such as utilities** (+3.8% of DY) **and telecoms** (+4.6% of DY) **will become less attractive.**
- There is also the special case of the healthcare sector. Since early this year, this sector has had a hard time after Hillary Clinton took a firm stand on controlling the cost of medication. Furthermore, even more recently, several pharmaceutical groups have underscored the keener competitive climate and the tightening of reimbursement criteria pervading in the United States. The unexpected victory of Mr. Trump will spark a catch-up effect. However, this can only be temporary. In a relatively pro-cyclical configuration, it seems unlikely that a sector such as healthcare could outperform over the long term while a reconsideration of Obamacare could only be a stopgap solution.

As for the eurozone – as the European economy and financial cycles have been far too uneven since the referendum on Brexit and the plunge of the pound to continue thinking in a holistic way – **it is far behind the US in the recovery cycle.**

Nonetheless, after two recessions between 2008 and 2012, the eurozone has been on a growth track since Q2 2013, with fourteen quarters of consecutive growth since then. After the +1.5% growth expected in 2016, **this cyclical "mini recovery" should continue into 2017 (+1.3%) and 2018 (+1.3%). However, the eurozone will be unable to accelerate** due to the fading positive effects of cheap oil and a low euro. Likewise, if headline inflation rises in H1 2017 due to the base effects of energy, then core inflation will remain far below the ECB's target owing to the weakness of the labour market, with the exception of Germany. **Moreover, the political agenda over the coming months** (rise of populism, the referendum in Italy, elections in France and in Germany, continuing negotiations on Brexit, etc.) looks very tricky.

In this context of unstable growth, low inflationary pressure and the weakness of the European project, **the ECB should retain an accommodating bias.** After successive expansions of its asset purchasing programme, it has little room for manoeuvre. As **negative interest rates** are coming under increasing criticism, it is unlikely that the ECB can go any further down that path. Likewise, **the**

6 **MSCI USA sector views for the next 6/9 months**



> "In the United States, cyclical sectors are expected to continue outperforming over the first half of 2017"

debate over future tapering that has opened up in recent weeks **also seems premature**. In any event, the current mechanism, which is scheduled to end in March, will be extended a few months more and, at most, changed slightly. Fundamentally, a more restrictive shift in monetary policy is not expected to occur before autumn of 2017.

At the sector level, this combination of sluggish growth, political uncertainty and narrow manoeuvrability, both at the monetary and budgetary levels, **leads us to a less pro-cyclical allocation than in the United States** but one that is nonetheless **relatively diversified.** This diversified allocation will primary place the accent on one (or more) of the following: substantial extra-European exposure, solid earnings and positive modified duration.

As to the first aspect, **a predominately extra-European geographical mix** would capture the groundswell of the emerging economies and the US recovery while protecting against the weakness of the eurozone and the post-Brexit imbroglio. From this standpoint, whether cyclical or defensive, sectors such as basic materials (53% of sales outside Europe vs. 41% for the MSCI Euro Index average), **IT** (59%), and **food, beverages, and tobacco** (68%) appear well-placed.

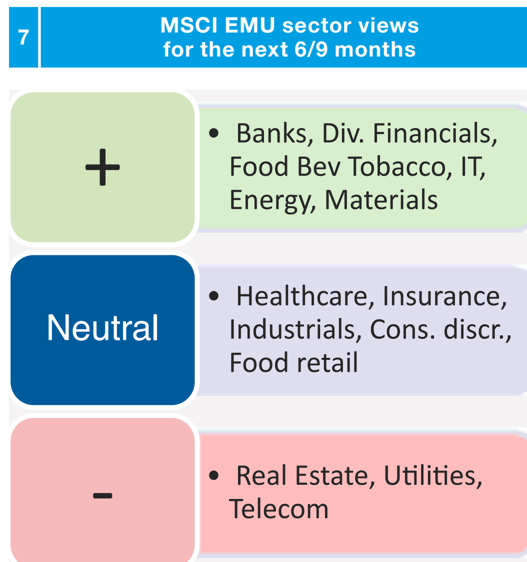
As to corporate earnings, this factor is expected to take on more importance because valuation ratios have tightened and the downward trend of interest rates is seen running out of steam, barring occasional episodes of stress. This earnings theme should extend to **basic materials, food, beverages & tobacco, IT** and **energy** for which projected 2017 earnings are moving higher by +11%, +17%, +21% and +35%, respectively, vs. +7% on average for all other sectors combined, except for the financial sector.

The special case of financials. This sector, which alone accounts for 18.6% of the total capitalisation of the MSCI EMU Index, is divided into three sub-sectors of varying importance: banks (11.0%), insurance (6.2%) and diversified financials (1.4%). **This sector was hard hit during the crisis**, with an aggregate loss of -62% in EPS since the end of 2007, including a drop of -72% for banks vs. 48% for the entire MSCI EMU Index. **Furthermore**, **this sector is fairly domestic**, with only 30% of its net sales outside Europe, including 23% for banks alone. **According to the IBES consensus, financial-sector profits should rise +16% in 2017**, including +6% for insurance stocks, +13% for banks and +26% for diversified financials. This oft heralded recovery could once again prove to be premature. The fact remains that with the halt in the downward trend of interest rates that appears to be shaping up and the hope of finding a lasting solution to the specific problems at a number of Italian banks and Deutsche Bank, it will be hard to remain on the sidelines of this sector looking ahead. This renewed interest is expected to primarily focus on banks as the EPS of insurance companies, which has been better preserved, is less likely to rebound. Furthermore, the dividend yield of insurance companies, albeit attractive, may be relegated to the background during the first part of the year.

At the other end of the spectrum, real estate, telecommunications and utilities, which are without any real earnings momentum and vulnerable to the slightest pressure on interest rates, are expected to pale into insignificance in the first half of the year. The same goes for **healthcare** which, although inherently international with 69% of its sales outside of Europe but poorly placed at the earnings level, may suffer for a few months. This is why, like in the United States, we prefer to hold it in reserve until the "Quality" theme re-emerges.

Between these two extremes, industry and consumer discretionaries, which stand out honourably in terms of exposure outside of Europe (both at 51%) and in earnings growth (+9% and +13 %) **are expected to appear mid-way down the rankings.**

7 **MSCI EMU sector views for the next 6/9 months**



> In the eurozone, our allocation will be more diversified than in the United States

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Addendum
Macroeconomic and financial forecasts

Amundi macroeconomic forecasts								
Annual averages (%)	Real GDP growth (YoY %)				Inflation (CPI, YoY %)			
	2015	2016	2017	2018	2015	2016	2017	2018
US	2.6	1.5	2.0	2.2	0.1	1.3	2.5	2.3
Canada	1.1	1.2	1.9	1.9	1.1	1.9	2.1	1.5
Japan	1.0	0.6	0.7	1.1	0.8	-0.1	0.8	1.1
Eurozone	2.0	1.6	1.3	1.3	0.0	0.3	1.3	1.2
EMU-North*	1.4	1.5	1.3	1.4	0.2	0.5	1.3	1.6
EMU-Peripheral**	3.3	1.8	1.6	1.4	-0.2	-0.1	1.1	1.2
Germany	1.5	1.7	1.4	1.5	0.1	0.4	1.5	1.3
France	1.3	1.2	1.2	1.2	0.1	0.3	1.2	1.0
Italy	0.8	0.9	1.1	1.2	0.1	0.0	1.1	1.0
Spain	3.2	3.1	1.8	1.1	-0.5	-0.4	1.3	1.1
UK	2.2	1.7	1.0	1.5	0.1	0.7	2.5	1.9
Emerging Europe	-0.1	1.1	2.0	2.4	9.3	5.3	4.8	4.7
Russia	-3.7	-0.7	1.0	1.8	15.5	7.6	5.5	5.0
Turkey	4.0	2.6	3.0	3.0	7.7	8.0	7.8	7.6
Asia ex-Japan	6.2	6.0	5.9	5.7	2.4	2.3	2.5	2.5
China	6.9	6.7	6.4	6.0	1.4	1.2	1.5	1.4
India	7.6	7.5	7.6	7.6	5.2	5.4	5.2	5.2
South Korea	2.6	2.6	2.7	2.7	0.7	1.2	1.2	1.2
Indonesia	4.8	5.0	5.2	5.2	6.4	4.5	4.5	4.5
Australia	2.4	2.9	2.7	2.9	1.5	2.5	2.1	1.7
Latin America	-0.1	-0.2	1.1	2.0	5.4	9.6	7.5	5.0
Brazil	-3.8	-2.5	-0.5	1.4	9.0	8.0	6.0	5.5
Mexico	2.5	2.0	2.0	2.2	2.7	2.8	3.0	3.0
Africa & Middle East	3.3	2.2	2.6	3.0	4.5	5.3	6.0	4.6
South Africa	1.3	0.8	1.0	1.2	4.6	6.4	6.0	5.5
Developed countries	2.1	1.5	1.6	1.7	0.2	0.8	1.8	1.7
Emerging countries	4.2	4.1	4.4	4.5	4.0	4.0	3.9	3.3
World	3.3	3.0	3.2	3.3	2.4	2.6	3.0	2.6

Source: Amundi Research *Last update: 11-2016*

* Germany, Austria, Belgium, Netherlands, France, Finland, ** Spain, Italy, Greece, Portugal, Ireland.

Exchange rates forecasts								
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Amundi + 12m.	Consensus Q4 2017
EUR/USD	1.38	1.21	1.09	1.07	1.05	1.09	1.10	1.11
USD/JPY	105	120	120	110	115	106	110	108
GBP/USD	1.66	1.56	1.47	1.25	1.17	1.23	1.22	1.27
USD/CHF	0.89	0.99	1.00	1.00	1.00	1.01	0.95	1.00
USD/NOK	6.07	7.50	8.85	8.45	8.29	8.21	7.73	8.04
USD/SEK	6.42	7.83	8.43	9.19	9.05	8.63	8.45	8.35
USD/CAD	1.06	1.16	1.39	1.35	1.40	1.33	1.45	1.29
AUD/USD	0.89	0.82	0.73	0.75	0.75	0.74	0.70	0.74
NZD/USD	0.82	0.78	0.68	0.71	0.70	0.70	0.70	0.70
USD/CNY	6.05	6.20	6.49	6.87	7.10	6.85	7.20	6.90
USD/INR	61.86	63.12	66.16	67.84	70.00	67.61	70.00	67.00
USD/BRL	2.36	2.66	3.96	3.43	3.40	3.40	3.40	3.40
USD/MXN	13.10	14.74	17.27	20.43	20.00	18.50	19.50	18.35
USD/RUB	32.86	60.00	73.03	65.38	63.00	63.81	60.00	63.00
USD/TRY	2.15	2.34	2.92	3.32	3.40	3.23	3.60	3.30
USD/ZAR	10.47	11.57	15.50	14.28	14.30	14.59	14.40	15.00

Source: Bloomberg, Amundi Research

Addendum
Macroeconomic and financial forecasts

2 y. bond yield forecasts										
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
US	0.36	0.63	1.04	0.99	0.80/1.00	1.10	1.32	1.40/1.60	1.34	1.56
Germany	0.20	-0.08	-0.34	-0.63	-0.60/-0.40	-0.58	-0.57	-0.60/-0.40	-0.52	-0.50
Japan	0.10	-0.03	-0.05	-0.10	-0.40/-0.20	-0.31	-0.04	-0.40/-0.20	-0.37	0.03
UK	0.57	0.51	0.65	0.22	0.00/0.20	0.30	0.33	0.00/0.20	0.38	0.54

10 y. bond yield forecasts										
	End 2013	End 2014	End 2015	16/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
US	3.01	2.17	2.27	2.25	2.40/2.60	1.92	2.39	2.20/2.40	2.13	2.53
Germany	1.94	0.54	0.63	0.32	0.20/0.40	0.29	0.44	0.20/0.40	0.41	0.54
Japan	0.74	0.33	0.25	0.03	0	-0.07	0.07	0	-0.06	0.11
UK	3.03	1.76	1.96	1.41	1.40/1.60	1.38	1.58	1.40/1.60	1.56	1.72

10y. yield spread										
	End 2013	End 2014	End 2015	14/11/2016	Amundi + 6m.	Consensus Q2 2017	Forward + 6m	Amundi + 12m.	Consensus Q4 2017	Forward + 12m
France	63	30	35	43	40	45	42	30	52	44
Italy	215	134	97	171	150	145	172	130	152	179
Spain	220	107	115	120	110	105	124	100	116	129
Netherlands	29	14	14	15	15	/	15	15	/	14
Austria	34	17	17	27	25	/	26	25	/	29
Finland	21	11	11	18	15	/	23	15	/	25
Belgium	62	29	29	36	30	/	42	30	/	48
Ireland	150	70	70	63	80	/	71	100	/	81
Portugal	425	215	215	332	350	/	351	350	/	402

Source: Bloomberg, Amundi Research

Addendum
Macroeconomic and financial forecasts

Central bank rates forecasts								
	End 2013	End 2014	End 2015	14/11/2016	Amundi + 6m.	Consensus Q2 2017	Amundi + 12m.	Consensus Q4 2017
US	0.25	0.25	0.50	0.50	0.75	0.90	1.25	1.10
Eurozone	0.25	0.05	0.05	0.00	0.00	0.00	0.00	0.00
Japan	0.10	0.10	0.10	-0.10	-0.20	-0.10	-0.30	-0.10
UK	0.50	0.50	0.50	0.25	0.25	0.20	0.00	0.25
Canada	1.00	1.00	0.50	0.50	0.50	0.45	0.25	0.55
Australia	2.50	2.50	2.00	1.50	1.50	1.30	1.25	1.30
Sweden	0.75	0.00	-0.35	-0.50	-0.50	-0.50	-0.50	-0.40
Norway	1.50	1.25	0.75	0.50	0.50	0.45	0.50	0.50
Switzerland	0.00	-0.25	-0.75	-0.75	-0.75	-0.76	-0.75	-0.74
China	6.00	5.60	4.35	4.35	4.35	4.20	4.35	4.10
India	7.75	8.00	6.75	6.25	6.00	6.00	5.75	5.95
Brazil	10.00	11.75	14.25	14.00	13.00	11.85	12.00	10.90
Mexico	3.50	3.00	3.25	4.75	5.25	5.15	5.50	5.40
Russia	5.50	17.00	11.00	10.00	9.25	9.05	8.25	8.20
Turkey	4.50	8.25	7.50	7.50	7.50	7.65	7.50	7.70
South Africa	5.00	5.75	6.25	7.00	7.00	7.15	7.00	7.05

NOTES

NOTES

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