Amundi
ASSET MANAGEMENT

Cross asset investment strategy

#06

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This document is solely for the attention of journalists and professionals of the press/media sector

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After the “great recession” and deflation, is the “great stagnation” now the main challenge?

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Deflation has posed a threat to developed economies since the early 1990s, a threat that has materialised in Japan, the United States, and the euro zone, albeit to varying degrees but in all cases in truly concrete ways. Japan is one of the most striking examples.

Risks are currently the greatest in the euro zone, but the good news here is that the ECB is taking those risks seriously, having addressed them on several occasions.

History has taught us clearly that such situations do not resolve themselves naturally, and that’s one reason why central bankers have successively used the least orthodox and the most spectacular tools to counter these trends. Japan has probably been too slow, the United States extremely reactive, and the euro zone less prompt in identifying these risks. All in all, monetary policies have been – and still are – highly accommodating.

From irrational exuberance to the global liquidity glut

In the course of the last 20 years we have experienced several very distinct phases. “Irrational exuberance” was a concept put forth in 1996 by Alan Greenspan to warn against a probable abnormal overvaluation of equities. The bursting of the tech bubble made this concept very popular… and Greenspan can be blamed for getting the diagnosis correct (the formation of bubbles) but for having failed to prescribe the necessary remedy.

The “**bond yield conundrum**” is another concept that Greenspan developed, in 2005, for the purpose of drawing attention to how low long-term rates were in comparison to short-term ones. Several explanations were put forth then to explain this phenomenon. According to the proponents of the “**global savings glut**” theory (made popular in 2005 by Ben Bernanke), there is an imbalance between global savings and investment that says low long-term yields are due to receding in volatility in interest rates and, hence, in interest rates. Other research maintains that low yields are due to receding volatility in inflation alone. Other authors have pointed the finger at the global recycling of savings, suggesting that the stock-piling of dollar-denominated securities by Asian central banks and, more generally, non-residents, is the cause of the vanishing relationship between short-term and long-term rates. In other words, the savings deficit in developed economies has been offset by surplus savings and deficits in productive investment in emerging markets. Note in passing that this “natural” recycling has made it possible to finance deficits painlessly, US deficits in particular, and that this recycling has not made it possible to correct behaviour that leads to excessive debt. It has also exacerbated the gaps between the actual valuations of certain assets and their real fundamentals.

The **global liquidity glut** that is a hallmark of the current situation is due to extraordinarily accommodating monetary policies, both conventional and unconventional. It is not enough to say that there is a liquidity glut. The excesses of liquidity must be shown: i.e., if the money supply expands faster than nominal GDP on an ongoing basis, we can say that there is liquidity glut. It so happens that this has clearly been the case worldwide since the mid-1990s, with globally accommodating monetary policies. This state of affairs is even more striking in the United States since the launch of QE, and for more than three years in the euro zone. This situation has resulted in extremely low interest rates, as well as in a significant expansion in credit aggregates (prior to the financial crisis) and in monetary aggregates (since the financial crisis).

The essential

The financial crisis triggered a “great recession” in developed economies, and the fight has been on everywhere against the risks of deflation. By reacting aggressively, the United States has returned to the path of growth. Things have been made more difficult in the euro zone by a second crisis – the debt crisis. Economic policies delayed the recovery but the recovery did come in 2013. The ECB is keeping close watch on this trend, as seen in its 5 June decisions. However, the recovery has been disappointing everywhere, and that has given new impetus to fears of a “great stagnation”.

Proponents of this theory say that shrinking returns on factors of production, education and productive capital, as well insufficient technological innovations should lead to a great stagnation that could last several decades. Be that as it may, the consequences of a “great stagnation” or, simply, the economic damage caused by fears of a great stagnation point to low short-term interest rates, low long-term yields, and below-trend returns on risky assets. In other words, in this configuration, fears of higher (short- and long-term) interest rates are receding, while the risk profiles of equities and corporate bonds are increasingly asymmetric.

> “The eurozone has probably not been quick enough to identify the risks of deflation”

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True, policies had sought to facilitate deleveraging in the private sector (banks, companies, and households) and in the public sector. To head off a new collapse in asset prices (equities and real estate, in particular) that might trigger a new negative wealth effect that could drive economies into situations of recession, deflation and depression, aggressive, non-conventional measures became necessary.

Ultimately, the one thing these four distinct situations (irrational exuberance, the bond market conundrum, the global savings glut, and the global liquidity glut) have in common is excessive valuations of financial assets on both the equity and bond markets.

The question now is how long yields will react to the reversal in monetary policies (once they take shape). Two points are to be addressed here:

1. Can there be quick radical reversals in monetary policies?
2. Do current conditions point to a rise in long-term yields?

Answers to these two questions can be found in economic growth and the sustainability of the recovery. According to Larry Summers and Paul Krugman among others, the US economy may now have entered into a phase of long-term weak growth. This concern is also shared by the former Fed chairman, Ben Bernanke who nonetheless reiterated during Amundi's recent international forum (June 5): "I am not sure to understand the current long term yields but I understand part of them: slowly recovering economies cannot produce high yields".

> "The global liquidity glut has resulted in extremely low interest rates, as well as significant expansion in credit aggregates and monetary aggregates"

From the risks of deflation to fears of a "great stagnation"

What is intriguing to a number of observers is the weakness in investment and productivity gains despite the economic recovery. It is hard to point to the exact causes, as there seem to be so many of them. Some believe that this is due to the severity of the financial crisis and lack of available credit for new companies. Other point to weak domestic demand, while still others suggest that broad demographic trends are to blame. All this is feeding fears of a "**great stagnation**" or "**secular stagnation**".

If an economy is unable to expand the quantity of factors of production, if it does not invest in education, and if it is unable to accumulate productive capital, it does not generate growth, barring technological progress. In the long term, technical progress is the main factor in growth. In other words, any decline in innovative capacities inevitably produces a decline in potential growth.

> "No rise in yields on the horizon"

Gordon (2012) has identified six "headwinds" that are pushing against US growth, some of which are quite relevant to many other advanced economies ("*Is US Economic Growth Over? Faltering Innovation Confronts the Six Headwinds*", CEPR Policy Insight, n° 63 (see also VoxEU.org, 11 September 2012)):

- **The ageing of the population** has resulted in a lower workforce participation rate and weaker gains in productivity. Baby boomers are gradually exiting the workforce, birth rates are often too low, and longer lifespans are maintaining pressure on economic activity.
- **Globalisation** is exerting downward pressure on wages in developed economies, due to competition from emerging economies and industrial offshoring. The equalisation of prices of factors is inevitably to the detriment of the highest-wage countries, i.e., advanced economies.
- **Deleveraging in the private sector and the need to stabilise public debt** will cut into disposable income and consumer spending. Returning public debt to a sustainable trajectory will also put downward pressure on GDP growth rates.

- **The plateau in educational attainment** has a negative impact. The constant increase in higher education costs has led to a sharp increase in student debt and is tending to discourage low-income people from pursuing their studies.
- **Rising inequality** is depriving a majority of the population of the fruits of growth. Nothing in the current environment suggests that income equality will stop widening.
- **Energy and the environment** will gradually cut into the budget that households devote to other consumer items.

To proponents of this theory, the Great Recession brought significant changes into stark relief, including declining returns from factors in production, education, and productive capital, as well as insufficient technological innovation, leading to a great stagnation that could last several decades. Sustained stagnation is not a new idea. It tends to appear whenever the economy slows over a long stretch. It was popular in the 1930s, for example (Alvin Hansen, *Full Recovery or Stagnation?* (1938)).

Be that as it may, the consequences of a "great stagnation" (or, more simply, the economic damage caused by fears of great stagnation) are rather clear:

- low short-term rates;
- low long-term rates;
- high asset prices.

Paul Krugman, one of the proponents of the great stagnation' theory mentioned during Amundi's recent international forum:*"It is hard to see where a major growth could come from. The current low growth situation can last a very long time". "There is a new normal, low interest rates, high asset prices, and people who think about the normalisation of interest rates are almost surely wrong".*

In other words, there is little concern over higher interest rates, while risks incurred in risky assets are increasingly asymmetric. The ECB has indeed measured the risks of "deflation" and "major stagnation."

> "The usual risk indicators on the equity markets (higher volatility, higher yields, wider corporate bond spreads, over-investment in equities and under-investment in cash, etc.) are not (yet?) in the danger zone"

The ECB announces new measures for promoting business lending and economic growth

On June 5, the ECB made the decision to ease its monetary policy once again. Several measures were unveiled:

- A drop in the repo rate from 0.25% to 0.15%;
- A decline in the rate for deposits with the Central Bank, now in negative territory at -0.10% (this involves between €40 and €50 billion which, in the best of cases, would be paid back into the real economy – if the banks decided to put it toward loans to businesses);
- The end of the SMP programme sterilisation (this involves €165 billion);
- Setup of preparation for an ABS buying programme. We know how keen the ECB is to revitalising this market which, unlike its American counterpart, has weathered the financial crisis successfully (US default rate nearly 18% during the financial crisis versus less than 2% in Europe);
- Extension of certain technical measures, including measures related to collateral and to normal one-week refinancing operations (MRO);
- The setup of a new targeted LTRO, the T-LTRO. With such long-term targeted refi operations, banks will be able to borrow up to 7% of their total loans outstanding to the eurozone non-financial private sector (excluding mortgages). The ECB will conduct two additional TLTROs in 2014 – the first in September, and the second in December – at a rate of 0.25%. The ECB will reserve them exclusively for banks that lend to businesses, precisely those (in this case SMEs) that have no access to the capital market and

> "No major change in our asset allocation"

depend almost exclusively on banks. If these liquidities do not reach these businesses, the banks will be sanctioned in two years and must repay the amounts lent out. This programme is not very different in spirit – or even in form – from the British ("funding for lending") or Hungarian ("funding for growth") programmes. The prominently-displayed goal is to kick-start credit and growth: "*This time, we are determined that these funds shall not be used to buy sovereign bonds*" said a decisive Mario Draghi.

Like the LTRO (which had supplied banks with medium-term liquidity and eased fears of bank failures considerably) and the OMT programme (never set up, though the prospect of it had eliminated the deposit wars that banks were waging in some countries, specifically Spain), there is reason to believe this new programme will be a game-changer for the ECB's policy. The markets are right to praise these new measures.

> The BCE is adamant that the sums raised through the T-LTRO should be injected into the real economy

We can never predict the effectiveness of any measures adopted, but, to say the least, the T-LTRO is suitable for reducing the fragmentation of bank credit and reviving loans to SMEs, and recent experiments in this area have had the expected success. Remember, the slow growth of credit overall is not necessarily representative, given the fact that a good number of large corporations have liquidities, and others are financed via the financial markets, not the banks. (In just over a year, for example, there have been more than 70 new high-yield issuers in Europe.) One last thing: the ECB's timing is excellent; trying to channel loans when banks are not lending does not make much sense. But today, with improved economic conditions, better job markets, the peak achieved (or nearly) on bad debts, the very advanced deleveraging cycle, the decisive improvement in the banks' liquidity conditions, and good capitalisation levels, the T-LTRO could, in fact, be the shot in the arm that economies were waiting for.

> The BCE's timing is faultless

Asset allocation: long-term growth and risky assets: the main challenge

Long US yields have dropped by 50bp since the start of the year, from 3% to 2.5% currently, while German yields have fallen by 57bp, from 1.92% to 1.35%. In this environment, peripheral spreads have narrowed by 190bp in the case of Portugal, 74bp in Spain, 60bp in Italy, and 25bp in France. What is truly intriguing is the decline in US and German long yields, which "normally should have" tracked growth upwards, and in Germany's case should have been driven up by the receding in risk aversion and rotations into peripheral countries. Nothing of the kind has happened. So if this decline in long bond yields is due to a revision in long-term growth prospects, "normally" there should have been a severe correction on the equity markets. Not only has that not happened (equity markets are up on the year to date in all large countries except Japan and Russia), but there has been no 10%-plus correction in more than two years. True, the usual risk indicators on the equity markets (higher volatility, higher yields, wider corporate bond spreads, over-investment in equities and under-investment in cash, etc.) are not in the danger zone. Although current conditions do not point to an immediate and severe correction on the equity markets, it's probably best not to get too greedy at this stage.

> The long term weak growth outlook underpins the enduring low level of interest rates

All in all, we are making no major change in our asset allocation, which continues to overweight risky assets. Even so, our allocation is less and less aggressive. A recap of our positions:

- In **equities**, we still prefer the eurozone and Europe to the US, Japan and emerging markets as a whole. Within emerging markets we prefer the Gulf states, Mexico, Peru, Greece and Indonesia. We remain neutral on China, Brazil and Turkey. We continue to underweight countries like Russia, Malaysia, Taiwan, Chili and South Africa.
- In **corporate bonds** there is obviously less and less value to be captured from spreads that have narrowed constantly; that said, we prefer high yield,

ratings around BBB, and financials. In **sovereign bond**s there is still some potential for narrower spreads vs. Germany and it is increasingly urgent to stick to what is liquid and what is demonstrably solvent. Not because we expect a resurgence in the banking or sovereign debt crisis, but simply because questions on excessive valuations will be increasingly legitimate. We are sticking with our long duration on euro zone core countries (Germany, in particular).

- As for **exchange rates**, we are still long the USD, AUD and GBP and short the JPY and RUB, among others… and short the EUR, but to a lesser extent. We moved back to a long position a few weeks ago on a few Asian currencies that we felt had hammered excessively (mainly the INR, IDR, COP and KRW).

ASSET ALLOCATION SHORT TERM OUTLOOK

	- -	-	●	+	++
CASH					
USD			●		
EUR			●		
SOVEREIGN BONDS					
United States			●		
Eurozone (core countries)			●		
Eurozone (periph. countries)			●		
United Kingdom			●		
Japan			●		
Emerging market debts		●	●		
CORPORATE BONDS					
Investment Grade Europe			●		
Investment Grade US			●		
High Yield Europe				●	
High Yield US			●		
EQUITIES					
United States				●	
Eurozone					●
Europe excl. eurozone				●	
Japan				●	
Emerging markets			●	●	
CURRENCIES					
US dollar				●	
Euro		●	●		
Sterling				●	
Yen		●			
Emerging market currencies			●	●	

(--) Significantly underweighted (UW)
(-) Underweighted
(●) Neutral
(+) Overweighted (OW)
(++) Significantly overweighted

PORTFOLIO TYPE

Equity portfolios

- Prefer Eurozone equities
- Stay neutral to overweight US
- Stay overweight on Japanese equities
- Beta of portfolio being reduced
- Stay underweight on EMG equities: wait for better entry points… and be highly selective
- Within emerging markets
  - Stay overweight Gulf States, Mexico, Peru, Greece and Indonesia
  - neutral China, Turkey and Brazil
  - stay underweight Russia, Malaysia, Taiwan Chili and South Africa
- Stay selective on financial securities
- Maintain long USD, short JPY and EUR
- Long IDR, INR, COP and KRW

Bond portfolios

- Maintain overweight position on credit vs. sovereign bonds, especially on European HY
- Maintain overweight position on Italy, and to a lesser extent on Spain
- Maintain underweight/absent from peripheral countries having liquidity – solvency issues
- Long duration on core eurozone
- Maintain underweight position on emerging debt, selectivity required
- Remain selective on financial securities
- Maintain Long USD and GBP, short JPY and EUR
- EMG currencies… stay highly selective, long IDR, INR, COP and KRW

Diversified portfolios

- Neutral to underweight US equities
- Prefer Eurozone and Japanese equities
- Stay underweighted on EMG equities… towards a gradual and selective comeback,
- Maintain long position on corporate bonds and convertibles
- Maintain overweight position on credit vs. sovereign bonds of core eurozone countries
- Stay underweighted on EMG debt
- Maintain overweight position on Italy
- Maintain Long USD, short EUR
- Maintain low cash exposure
- Long IDR, INR, COP and KRW

Risk Factors

JUNE	RISK LEVEL
UNITED STATES: LABOUR MARKET IMPROVEMENT INSUFFICIENT	
The labour market remains the dominant concern in determining the pace of monetary policy normalization, but it is not the sole indicator to be monitored closely. The markets are now positioned for an end to QE in Q3 2014 and the first interest-rate increase six months later, but the recent J. Yellen's speech was more dovish than the previous one. The Fed predicts the Fed funds rate to reach 1% at the end of 2015 and 2.25% in 2016.	MODERATE RISK =
UNITED STATES: A RAPID AND WIDESPREAD INCREASE IN LONG-TERM INTEREST RATES	
One of the major risks for the US real estate sector, equity markets and the emerging markets resides in the rise in long-term US interest rates. If this rise is too sharp and too rapid, it will significantly weaken these asset classes. It will be critical for the Fed to steady the pace and its volatility. Surely one of the Fed's biggest challenges. The current context (fears of "major stagnation") is postponing any fear of a rapid, extensive rise in long-term rates	LOW RISK − +
JAPAN: INVESTMENT REMAINS SLUGGISH	
Growth has returned to Japan, and corporate profits are rising again. Missing from the equation, however, is a recovery in investment; without it, growth is unlikely to accelerate, while concerns about the sustainability of growth (and of the equity markets) and the country's creditworthiness will once again be raised. Without more solid growth, the equity market will be at risk.	HIGH RISK =
EUROZONE: BANKING CREDIT REMAINS AT A STANDSTILL	
Banking credit continues to suffer in the peripheral countries, as reflected in business lending rates, the level of unsuccessful credit applications and interest rates on loans to SMEs. Deleveraging by banks and businesses is continuing in some of the southern countries, and this has not been without consequence for employment (SMEs account for between 75% and 85% of jobs in the eurozone), investment, overall domestic demand and, consequently, growth. The ECB's recent decisions (T-LTRO) reduce this risk significantly, especially since the troughs in activity have been reached.	LOW RISK − +
EUROZONE: DEFLATIONARY RISKS INTENSIFY	
The economic recovery is weak, and the signs of deflation are easily read. The ECB has taken this into account and has been sending clear messages for several months. The very recent decline in rates is one more move in the right direction, and another drop in the euro would be good news besides. For now, the financial markets have hailed the ECB's decisions. They are seen as neither too little nor too late.	LOW RISK − +
EUROZONE: LONG-TERM INTEREST RATE HIKE AND EURO APPRECIATION	
Sovereign spreads are narrow, but financial stress is very weak. Even though the risks are increasingly imbalanced, there are no hikes in long-term rates or widening spreads in store. US long-term rates should not increase in the coming months, and the same is true for European rates. The euro should stay between 1.30 and 1.40 over the coming quarters, and capital (in)flows should offset the (slight) widening of interest-rate differentials.	LOW RISK − +
CHINA: DEBT, LOW PRODUCTIVITY, SHADOW BANKING, WEAK POTENTIAL GROWTH... TOO HEAVY A BURDEN?	
China will now need to scale back debt (rein in lending and shadow banking; reduce debt and doubtful loans), restore stronger potential growth and achieve higher productivity (population dynamics will hinder rather than help in this regard). Future growth will be weaker, but it should be of better quality. Wages in China are now higher than in some of its neighbouring direct competitors. China has still room for manœuvre to accompany such a - long – transition, but the stake and task to come are nevertheless colossal.	MODERATE RISK =
EMERGING ECONOMIES: A MORE PRONOUNCED DECLINE IN GROWTH	
The emerging economies now must now face (i) the end of the US QE programme, ii) a rise in long-term US interest rates; and (iii) a deterioration of their own economic fundamentals (financial vulnerability in some countries, a weak currency in others, inflationary fears, excess credit). The downfall of certain emerging countries' currencies will impact the growth of profits in the developed world, namely in the US and in Europe, while concerns about growth in the developed countries also present a risk, since these accentuate concerns about the emerging economies.	LOW RISK − +
CURRENCY WARS	
The depreciation of the yen has led to a deterioration in Asian trade relations. The distortions resulting from Japan's competitive advantage have been so strong that many countries have seen their economic and financial situations worsen. In the past months, number of emerging currencies depreciated too … but it is not the case for the Chinese Yuan. That is the reason why the Chinese central bank has recently modified its FX policy. Currency war, renewed protectionism and competitive devaluation are still high on commentators' agendas.	MODERATE RISK =

Macroeconomic picture

	JUNE	
AMERICAS		**RISK FACTORS**
UNITED STATES	> **No cyclical slowdown.** GDP contracted in Q1 (-1% annualised) due to high levels of destocking. The weak performance is especially due to exceptional weather conditions this winter. Consumption remained very strong. Surveys show a rebound in activity in Q2. But the economy is still a long way from full employment (low participation rate, very high levels of forced part time workers and long-term unemployed). > **Households:** having reduced debt they stand to benefit from the rise in real wages that is taking shape and favourable wealth effects (rebound in real estate, equity gains). > **Businesses:** the share of profit (after tax) to value added reached its highest level in 60 years in Q1 2014 (14%). Moreover, the Tobin's Q ratio (market value of a company divided by the replacement value of its fixed assets) moved above 1 in Q1 2014 for the first time since 1996: a very propitious sign for investment. > **Fed:** end of tapering in sight (October). In its communication it will try to avoid any sharp hardening of monetary and financial conditions. No hike expected before mid-2015.	**> Rise in long-term interest rates** **> Slowdown in productivity and low growth in the active population, prelude to an era of broad stagnation**
BRAZIL	> **GDP growth slowed in Q1** (+0.2% after +0.4% in Q4) due to the slowdown in consumption. Growth (+1.9% year-on-year) was below its average over the last four years. > **Inflation continued to rise.** At 6.3% in April, it continued to worry the central bank (BCB) whose decision to leave rates unchanged during its last monetary policy committee meeting (Selic rate unchanged at 11% on 28 May) does not necessarily mean the end of monetary tightening.	**> Continued slowdown** **> Price pressure (World Cup)**
EUROPE		
EUROZONE	> **A very mixed recovery:** the euro zone is still divided. In Q1, Germany was the main growth driver and France was at breakeven (zero growth). Spain rebounded on the back of domestic demand. However, GDP in Italy and Portugal contracted again. > **Surveys point to a solid environment in all countries barring France.** Germany should continue to be the main growth driver, even if growth slows down. > **Bank lending continues to decline.** Furthermore, the interest rates on loans granted to SMEs in the peripheral countries are still too high. > **Deflationary pressure is accentuating.** Inflation slowed down in May (+0.5% year-on-year on average) in the euro zone but also in Germany despite strong activity. Household anticipations fell everywhere, opening the door to potential action by the ECB.	**> Inflation too low** **> Excessive risk-taking by investors**
UNITED KINGDOM	> **Continued strong growth in Q1.** Household consumption was no longer the only activity driver, investment in production was also strong. Exports however continued to lag. > **Unemployment continued to fall amid persistently weak productivity.** But inflation also declined enabling the BoE to play for time before having to raise key rates (probably not before next year).	**> Rapid growth in property prices** **> Scottish independence referendum**
ASIA		
CHINA	> **The economy is stabilising.** The PMI surveys (official and HSBC-Markit) rebounded, marking the end of a downward cycle for these indicators. The two economic environment surveys show a rebound in order books in the manufacturing sector in May despite a fall in exports, which tends to confirm that the measures taken to stabilise China's economy have had an effect. > **Inflation continued to fall in April (+1.8% year-on-year).** Consumer prices fell by -0.3% in one month (significant moderation of food prices). > **Trade data still strong.** The trade balance in May was at USD18.5 billion, driven by good export data.	**> Continued deterioration in credit quality** **> Pressure on interbank liquidity**
INDIA	> **While we await the new government's agenda,** the figures that comprise the current account balance should continue to recover. However, a key question remains. A recovery in investment could lead to a further deterioration of the trade balance through an increase in imports. A pick-up in direct investment flows would be required, which will depend on what the government announces	**> Deterioration of the current account balance** **> Emergence of inflationary tensions**
JAPAN	> **Q1 saw a sharp acceleration in growth (+1.5%)** just before the VAT hike (1 April). According to the initial surveys, private domestic demand did not fall as sharply as had been expected in Q2. Also, public demand (stimulus plan) is a supporting factor. > **The economy grew at an average rate that was well above the trend since 2012,** underpinned by domestic demand (consumption and private investment). Exports, however, showed little growth despite the yen's depreciation. > **Gradual reflation.** As excess capacity dissipates, inflation is accelerating. But remember that the acceleration of core inflation from 0.7% to 2.3% in April was due to the rise in VAT. **Basic wages are starting to increase (sharpest rise since 1995),** which is encouraging but it is still not enough to offset the rise in prices.	**> Insufficient wage increases** **> Lack of structural reform**

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Macroeconomic and financial forecasts

MACROECONOMIC OUTLOOK

- **United States:** cyclical recovery is underway. GDP fell in Q1 (essentially due to weather conditions), but the fundamentals are solid and growth reaccelerated. The current environment points to a continued increase in consumption and a rebound in corporate investment.
- **Japan:** we continue to anticipate stable but uneven levels of growth (GDP probably declined in Q2, although recent statistics indicate that the damage after the April VAT hikes is probably limited). Wage rises are key to the recovery, households having seen their purchasing power erode with the rise in imported product prices caused by the yen's depreciation.
- **Eurozone:** low growth and disinflation in sight. 1) All or nearly all countries will show positive growth in 2014 but unemployment will remain high (Germany being the exception). 2) Germany will be the main driver, while Spain could continue to rebound. 3) Domestic demand in Italy will recover only slowly while it will remain restricted in France. 4) Bank lending to SMEs in peripheral countries remains stringent, weighing on investment.
- **Emerging Countries vs. Developed Countries:** the emerging block is particularly fragmented. The recent financial crisis will weigh on the growth of certain countries but does not constitute a systemic risk. The emerging block should see pretty much stable growth in 2014, while growth in advanced countries will almost double. Despite a slowdown in activity, Asia will continue to be the most vigorous emerging market.
- **Brazil:** having to chose between weak growth and persistently high inflation could force the central bank to continue its monetary tightening.
- **China:** growth should stabilise at around 7.5% in 2014. Fears of a hard landing are disappearing but growth in bank lending is still a cause for concern.

Annual averages (%)	Real GDP growth. %			Inflation (CPI. yoy. %)		
	2013	2014	2015	2013	2014	2015
US	1.9	2.3	3.0	1.5	1.7	1.9
Japan	1.5	1.5	1.5	0.3	2.4	1.9
Eurozone	-0.5	1.0	1.3	1.3	1.0	1.2
Germany	0.5	2.0	1.8	1.6	1.4	1.6
France	0.3	0.8	1.1	1.0	1.0	1.1
Italy	-1.9	0.6	0.9	1.3	0.8	1.0
Spain	-1.2	0.7	1.2	1.5	-0.2	0.9
UK	1.8	2.7	2.3	2.6	1.9	2.0
Russia	1.3	0.8	2.0	6.5	6.0	6.0
Turkey	4.3	2.5	3.0	7.4	7.0	6.5
China	7.7	7.5	7.5	2.8	3.2	3.0
India	4.4	5.0	5.5	9.5	8.0	7.5
Indonesia	5.8	5.0	5.8	7.0	6.0	5.5
Brazil	2.3	2.2	2.5	5.8	5.5	6.0
Developed countries	1.3	1.9	2.3	1.3	1.6	1.7
Emerging countries	4.7	4.8	5.1	4.5	4.5	4.2
World	3.0	3.3	3.7	2.9	3.1	3.0

Source: Amundi Research

KEY INTEREST RATE OUTLOOK

- **FED:** the Fed will continue its QE3 tapering policy by lowering its monthly purchases by $10bn per FOMC and the QE program will end in October/November. No intention to hike key rates before H2 2015.
- **ECB:** after June's announcements, the ECB will do more only if the inflation continues to disappoint negatively. Rate normalization will not occur before at least 2017.
- **BoJ:** further quantitative easing measures expected in the coming months.
- **BoE:** clear improvement of the labour market conditions may prompt the BoE to raise its rates before the Fed.

	05/06/2014	Amundi + 6m.	Consensus Q4 2014	Amundi + 12m.	Consensus Q2 2015
US	0.25	0.25	0.25	0.25	0.38
Eurozone	0.15	0.15	0.15	0.15	0.15
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.50	0.75

LONG RATE OUTLOOK

- **United States:** we maintain the view that long-term yields will rise in 2014. The acceleration of growth as well as technical factors (the decrease of the Fed's purchases will be larger than the decrease of the net supply of US treasuries in 2014) will put a upward pressure on yields. The rise of yields will be the most important on intermediate maturities. The traditional bear flattening, associated with a rise in key rates, already began but the 2 y. yield remains anchored by the Fed's qualitative forward guidance.
- **Eurozone:** the yields of core countries will rise only slowly as growth and inflation will remain low in 2014 and 2015 and also as the ECB will keep a zero rates policy for a long time. The peripheral spreads should continue to tighten over the coming months.
- **United Kingdom:** the solid growth trend and the gradual recovery of the labour market mean that we are pricing in a rise in yields in line with the United States, if not more rapid.
- **Japan:** the BoJ controls all the Japanese yield curve. As long as QE continues, there is no reason for rates to move significantly.

2 Y. Bond yield forecasts

	04/06/2014	Amundi + 6m.	Consensus Q4 2014	Amundi + 12m.	Consensus Q2 2015
US	0.39	0.60/0.80	0.72	1.00/1.20	1.07
Germany	0.05	0.20/0.40	0.30	0.20/0.40	0.47
Japan	0.09	0.10/0.20	0.12	0.10/0.20	0.13
UK	0.70	0.80/1.00	1.19	1.20/1.40	1.68

10Y. Bond yield forecasts

	04/06/2014	Amundi + 6m.	Consensus Q4 2014	Amundi + 12m.	Consensus Q2 2015
US	2.58	2.80/3.00	3.15	3.00/3.20	3.44
Germany	1.41	1.60/1.80	1.96	1.80/2.00	2.18
Japan	0.62	0.60/0.80	0.82	0.80/1.00	0.90
UK	2.66	3.00/3.20	3.18	3.20/3.40	3.44

CURRENCY OUTLOOK

- **EUR:** downside bias on the EUR/USD. The short-term interest rate differential between the US and Germany will progressively widen with the divergence of the Fed and ECB policies.
- **USD:** the gradual reduction in securities purchases by the Fed, the less dovish tone from the FOMC and the growth perspectives (better than in other advanced economies) are expected to underpin the US dollar.
- **JPY:** the yen is expected to continue to weaken, especially with new announcements from the BoJ and with the rising trade deficit.
- **GBP:** moderately to the upside. Fundamentals are improving more sharply in the United Kingdom. The rate spread is expected to underpin the pound.

	02/06/2014	Amundi + 6m.	Consensus Q4 2014	Amundi + 12m.	Consensus Q2 2015
EUR/USD	1.36	1.30	1.32	1.30	1.30
USD/JPY	102.50	105	108	110	110
GBP/USD	1.68	1.63	1.65	1.63	1.66
USD/CHF	0.90	0.96	0.94	0.96	0.94
USD/NOK	5.99	6.15	6.09	6.08	6.17
USD/SEK	6.66	6.77	6.69	6.62	6.65
USD/CAD	1.09	1.15	1.12	1.15	1.11
AUD/USD	0.93	0.95	0.89	0.95	0.93
NZD/USD	0.84	0.90	0.83	0.90	0.86

1 Breaking the Eurozone's chicken-and-egg deadlock: now Germany must agree to save France and Italy from Spain's deflation

NICOLAS DOISY, *Strategy and Economic Research – Paris*

Spain remains the one source of deflation in the Eurozone due to its legacy of large excess capacity

With excess productive capacity at one fifth of total output and still rising as capital keeps growing faster than output, Spain is the Eurozone's main deflationary country, thus calling for fast action. The main proximate cause of this excess capacity is output collapsing under the capital stock ever since the Great Recession, even if investment has also decelerated. Looking ahead, this excess capacity reflects the continued accumulation of capital at a pace faster than output ever since the early 1990s (when Spain decided to join the euro), i.e. a dynamic typical of so many traditional capital bubbles.

If the capital stock has indeed decelerated ever since the late 2000s, it has not yet decreased while (nominal) output has remained flat: as such, Spain's problem today is to kick start growth again, since the alternative (destroying more capacity) is potentially even more damaging for the economy. Indeed, destroying such excess capacity until the long term equilibrium is recovered would imply a commensurate debt forgiveness. Otherwise, it would, in turn, feed into further deflation, at least in the short term. Accordingly, the only real alternative is to prop up the denominator of the ratio.

As a result, Spain is now the one powerful source of deflation in the Eurozone calling for expedient action to the extent that Spanish deflationary forces keep spreading towards France and Italy. Indeed, as evidenced by the sketch of the in-/de-flation circuit in the Eurozone, not only is Spain's excess capacity translating into (potentially sustained) deflation at home, but it is also feeding into deflation forces that are adding to the domestic ones already at work due to excess capacity in France and Italy. Accordingly, being the main danger, Spain should be the ECB's central priority.

> The inter-connection of deflationary pressure in the Eurozone

Deflationary pressure can be approximated with excess capacity in productive capital to the extent that the latter is financed with debts, whose excess burden tends to depress activity and inflation. Accordingly, the empirical approach in this paper rests on the following assumptions:

- Capacity is excessive when the capital/output ratio deviates from its long term average;
- Capacity being financed with debt, if capacity is excessive, so are the associated debts;
- To this extent, excess capacity is a sign of excess debt and deflationary pressure.

Using relative excess capacity as a gauge, a simple econometric model shows how deflation forces in France and Italy are also fed by Spain, while Germany keeps using its natural shield against them. Indeed, the (nominal) capital stock/GDP ratios of all four countries[1] are systemically inter-connected:

- German capacity is naturally shielded from excess capacity in the Latin countries;
- Spain's huge excess capacity is fuelling deflation pressure at home and in Italy and France;
- Excess capacity in Italy and France is also worsening the nascent deflationary at home.

1 Representing 80% of the Eurozone's GDP, these four countries together are a good proxy.

Mildly deflationary, France and Italy are caught between a Spanish rock and a German hard place

France and Italy are the main recipients of Spain's deflationary pressure that comes on top of their own mild deflation, which is itself due to their small excess productive capacity of 3% to 4% GDP. Indeed, as shown by the mentioned sketch (graph 1), part of the disequilibrium in Spain (i.e. part of the

The essential

The Eurozone's rising deflationary pressure comes indirectly from the accumulation of large (and still growing) excess capacity in productive capital in the Latin members of the bloc. Indeed, while Germany has resumed the clearing of its Reunification excess capacity since it has exited the Great Recession, France, Italy and Spain have not even yet started to do so.

Since it is carrying by far the largest such excess capacity (20% GDP) due to its credit bubble, Spain is the main (if not the exclusive) source of deflationary pressure in the Eurozone, a fact confirmed by declining and already negative price and wage inflation there. Barring any meaningful debt reduction, this calls for a determined reflation strategy Eurozone-wide.

Indeed, with Germany not investing enough to lift them out of their trap before long, France and Italy are left at the mercy of Spain's nascent deflation on top of their own smaller excess capacity. Beyond the instinct of self-preservation of the German political class, the reason for this is also that Germany refuses to re-import the periphery's bubble at home.

All in all, this leaves the ECB as the only white knight capable of reflating Spain for the sake of the other two Latin countries… under the Bundesbank's tight and powerful guidance. The aim will be for the ECB to do just enough for France and Italy not to let the Eurozone into a deflationary trap, but not more in order to contain inflationary risks in the longer term.

> "Should there be no non-conventional reflation strategy in the Eurozone, France and Italy are bound to finally become deflationary under the influence of both Spain and Germany"

Spanish excess capacity) forces its way into the French and Italian economies, just like in a slow motion contagion from the former to the latter. Interestingly, there also seems to be some retro-action from Italy onto Spain, whereby each country is taking the other down a deflationary path.

At the other end lies Germany, which (i) is shielded from all those deflationary forces by virtue of its unique position as the Eurozone's paymaster and (ii) keeps clearing its own excess capacity. A legacy of Germany's Reunification, this excess productive capacity started accumulating in 1995 and peaked in 2004 first. After an artificial decline under the cyclical acceleration of output fed by the rest of the Eurozone in 2006-08, Germany's excess capacity peaked again in 2010. Since then, the German recovery has rekindled productivity growth there, thus reducing excess capacity again[1].

As a result, should there be no non-conventional reflation strategy in the Eurozone, France and Italy are bound to finally become deflationary under the influence of both Spain and Germany. Indeed, while clearing their own excess capacity to avoid painful repercussions would be in France's and Italy's interest and reach, fighting the deflationary forces coming from Spain on top of their own would prove much more difficult. This is all the more true, since Germany is still clearing excess capacity (i.e. raising the apparent productivity of capital), which is, in itself, also deflationary.

Only the ECB can reflate the Eurozone, as Germany's investment is not sufficient to save the day

As long as the burden of the debts behind the excess stocks of productive capital is not reduced, reflating the Eurozone remains the only viable strategy in order to quell deflation at the source. As a matter of fact, restoring the capital/output ratio back to equilibrium requires that either (i) the stock of capital (i.e. the numerator of the ratio) is reduced (implying a forgiveness on related debts that looks pretty unlikely at this stage) or (ii) (nominal) output is raised by raising real output (i.e. kick-starting growth) and, above all, the price (i.e. the deflator) of output (i.e. kick-starting inflation).

The widely shared hope that Germany can and will reflate the Eurozone seems misplaced if only because it goes against the mentality of a country that is anyhow too small to do the job alone. Indeed, with its output representing only a quarter of the euro bloc, Germany is not big enough to reflate the whole rest of the Eurozone (i.e. three-quarters of the monetary union) on its own. Thus, unless Germany agrees to re-import the periphery's bubble at home for the sake of the euro, this is far from a realistic strategy, despite some early signs of investment re-accelerating again since 2010.

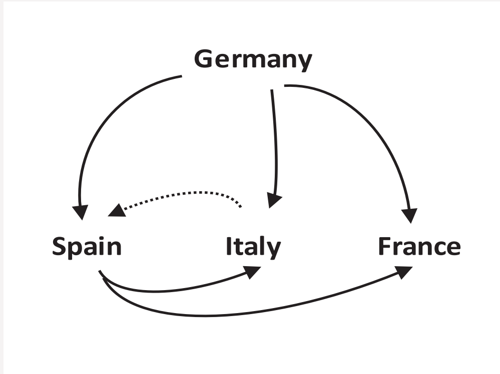
So, only the ECB can thus do the job of saving the Eurozone from its incipient deflation, as the sole owner of the money printing press needed to prop up the denominator of the capacity ratios. The only obstacle to such a move is, as is now widely recognised, political to the extent that the German psyche seems restive to such a bold strategy because of the associated inflation risks in the medium to long term. In this respect, the only solution would be for the rest of the Eurozone to provide Germany with institutionally credible assurances to this end, which still looks unlikely.

Conclusion

All in all, the analysis of excess productive capacity in the Eurozone heavyweights allows to draw a map of deflationary forces that puts the onus of resolving this self-reinforcing deadlock on the ECB. However, based on official and informal communications, it seems that the measures currently envisaged by the ECB would be far from doing the trick, since they do not include any notion of a proper quantitative easing (QE) and rather focus on less powerful (i.e. less dangerous, in a German mind) levers, such as cutting policy rates and/or prolonging the 2011-12 LTRO liquidity to banks.

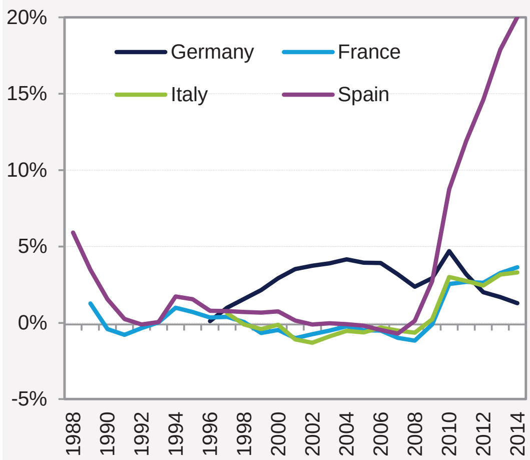
1 *Whenever (apparent) capital productivity rises, this means that (excess) capacity in capital is declining, since the former (Y/K) is simply the inverse of the latter (K/Y), which also measures the capital intensity of production.*

1 Eurozone: the inter-connection of de-/in-flation pressure



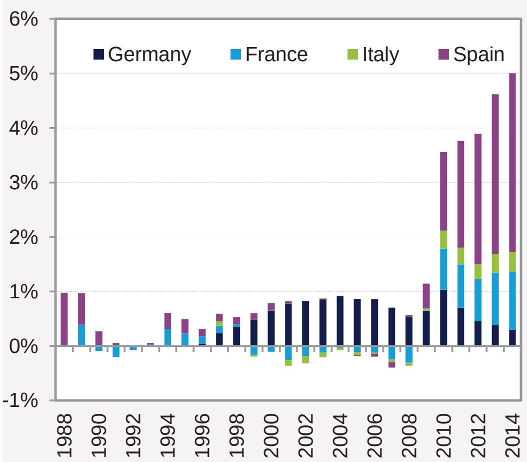
Source: OECD (data), Amundi Research (estimations)

2 France, Germany, Italy & Spain: excess capacity in capital (in % domestic GDP)



Source: OECD, Amundi Research

3 Eurozone: excess capacity in capital (in % Eurozone GDP)



Source: OECD, Amundi Research

2 Greece: on track for an economic recovery despite a probably uncertain political climate

TRISTAN PERRIER, *Strategy and Economic Research – Paris*

Greece has just reached major milestones in terms of economic adjustment and financial normalisation, after years of austerity and reforms primarily imposed by its bailout creditors (i.e. the EU and IMF, whose combined plans exceeded €200 bn):

- **The country achieved,** in 2013, both a primary budgetary surplus (+0.8% of GDP), validated by the European Commission, and a current account surplus (+0.7% of GDP, a first since records began in 1948).
- **It returned to the sovereign bond market** in April 2014 with its first issue (€3 bn in five-year debt with a 4.75% coupon) since it was rescued by the May 2010 international bailout.
- **Several Greek banks also successfully issued bonds and shares** since the start of this year, after the country's financial system was extensively restructured.

Additionally, there are signs that Greece is now poised for, at least, a cyclical economic rebound, after a deep and prolonged recession during which its GDP shrank by nearly 25% between 2007 and 2013.

The majority of the large international institutions expect a turnaround for the Greek economy in 2014:

- The European Commission and the IMF currently forecast GDP to grow by +0.6% this year, while the OECD sees it slightly down by -0.3%.
- They also expect growth to accelerate significantly in 2015: +2.9% according to the EC and IMF and +1.9% according to the OECD. This upswing will stem primarily from increased exports and a less negative contribution of fiscal austerity.

A number of short-term indicators do support this rebound scenario:

- **In Q1 2014, Greece posted its best performance since 2010 in terms of 12-month GDP growth,** down just -0.9% compared to Q1 2013 (it does not publish growth figures for comparing two consecutive quarters). Over the same period private consumption rose 0.7%, its first increase since Q1 2010.
- **Monthly business climate indicators are improving.** Despite a few fluctuations, Greece's manufacturing PMI averaged 50.9 since the beginning of the year, on par with slight growth in the sector. In addition, the European Commission's current Economic Sentiment Indicator was significantly higher than in 2013 (see graph).
- **Unemployment is slightly down.** The unemployment rate, after peaking at 27.9% in September 2013 dropped to 26.8% in March 2014. According to Labour Ministry's figures, the Greek economy created roughly 100,000 net jobs since the beginning of this year (although, probably, partly through the legalization of previously hidden work).
- **Exports grew** 5.4% in volume in Q1 2014 compared to Q1 2013, their strongest 12 months increase since the end of 2010.

For the longer term, significant challenges surely remain, as the country still has to reinvent its growth model, that formerly put too large an emphasis on government and non-tradable sectors. Yet several factors point to a substantial improvement of the country's growth potential:

- **Wages dropped considerably** during the financial crisis. Unit labour costs fell roughly 16% since 2009, according to the ECB, while the EU estimates a drop in the real effective exchange rate of 21.6% from 1009 to 2014. This adjustment will likely have a lasting effect on export competitiveness, even if deflation pressures in the eurozone now slow the relative adjustment of Greece's prices as compared to its partners.

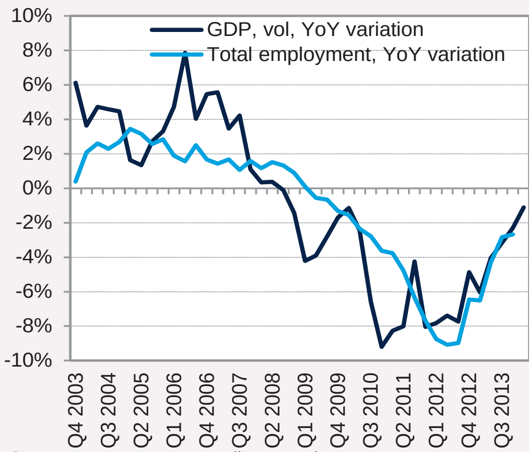
The essential

After it reached significant economic and financial milestones in recent months, Greece will likely experience an economic rebound.

While the risks related to the country's solvency appear to be modest on the short-term, the political risks cannot be ignored. However, they are more likely to delay economic improvements than to prevent it altogether. Greece's very high level of public remains a risk for the long-term, whose actual consequences depend on potential agreements between the country and its creditors.

> Short-term economic indicators are improving

1 **Greece: GDP and employment**



Source: Datastream, Amundi Research

> The government majority remains very fragile

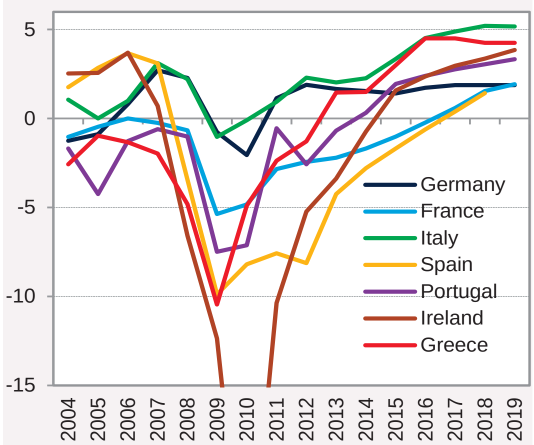
- **Significant structural reforms,** have been made in many areas (among which the public sector, the tax system, social protection, the job market and the product and services markets) even though they were met with resistance. While in absolute terms, as measured by OECD competitiveness indicators, Greece is still below the eurozone average, it is still the country that has made the most significant effort during the 2008-2013 period (as measured, for instance, by the OECD's Reform Responsiveness indicator, see graph). These reforms (of which some are still ongoing) are generally believed to have a positive effect on a country's growth with a 2-4 year time lag, after, for most of them, negative short-term effects.
- **Additionally, a still-very-hypothetical easing of budgetary constraints would also speed up this dynamic.** Improving budgetary and economic results would provide Greece with arguments to try to negotiate with the Troika (particularly the IMF, which is very strict in this regard, and whose aid will continue until 2016) a loosening of the tight primary surplus objectives assigned to the country (target GDP of 4.5% for 2016, currently deemed necessary to reduce the debt-to-GDP ratio to 120% by 2020).

With regard to liquidity and solvency, the risks are greater in the long term than in the short term:

- **The effective interest burden is not as high as implied by the debt/GDP ratio and market interest rates** as most (approximately 75%) of Greece's debt is held by European institutions and the IMF, and is accompanied by a substantial system of preferred rates and deferred payments. Thus, despite a very high debt-to-GDP ratio (175% in 2013), Greece's effective interest costs to GDP is around 4.6% in 2014, according to EC figures, a figure comparable to Italy's, and 5.3% in 2015. Average debt maturity (16 years as of the end of 2013, before April's bond issue) is much higher than that most other eurozone countries.
- **After its 2013 primary surplus** (and high probability that it will exceed its 2014 1.5% of GDP objective, judging from the monthly figures since January), **Greece appears to have a good chance of obtaining an OSI,** (Official Sector Involvement, a restructuring of its debt held by public institutions, here the bilateral loans from the EU and those from the EFSF, as it would probably not apply to the bonds held by the ECB and the IMF loans). The content and terms of such an agreement have yet to be finalised (and approved by the Greek parliament). However, given the already low interest rates on this part of public debt, for which repayment is currently only set to begin very gradually in 2020, this OSI, although pushing some of Greece's major repayments further in time, would only have a modest effect on short-term liquidity constraints.
- **A funding gap will persist in 2014-2016** (between €10 and €15 billion, according to most estimates), but there are several potential solutions to bridge it, such as:
  - a new long-term bond issue;
  - more short-term bills issues;
  - mobilising positive cash balances remaining in public sector organizations;
  - using the residual €11.5 billion buffer in the Hellenic Financial Stability Fund (HFSF), which is consolidated in the government's finances;
  - adjusting privatisation choices and priorities (including the gradual withdrawal of the government from the banking sector);
  - finally and most significantly, new financing from European partners (disbursements from the current programme end in 2014), in addition to OSI. Indeed, senior German politicians recently hinted that such an aid extension was a possibility, while precising that probably no more than €10bn would be necessary, much less than previous bailout amounts.

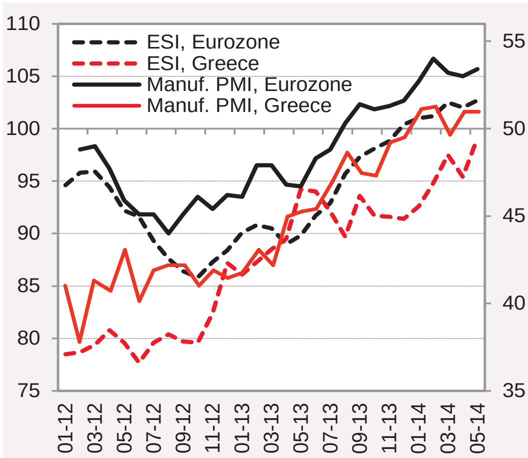
Each of these proposals involves different amounts and poses unique challenges, but the list shows that Greece is not yet out of solutions.

2 **Primary balance, % of GDP**



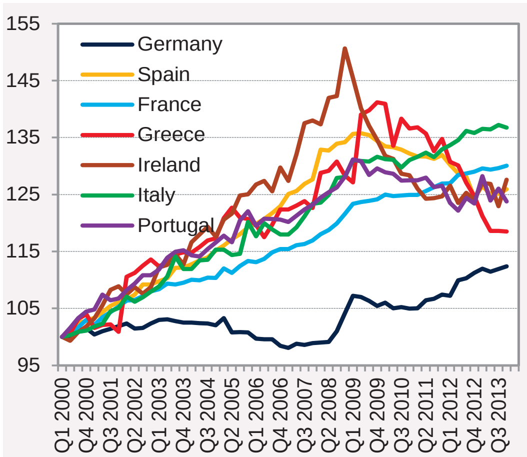
Source: IMF, Amundi Research

3 **Manufacturing PMI and Economic Sentiment Indicator (ESI)**



Source: Markit, DG Ecfin, Amundi Research

4 **Unit Labour Cost, basis 100 in Q1 2000**



Source: Eurostat, Amundi Research

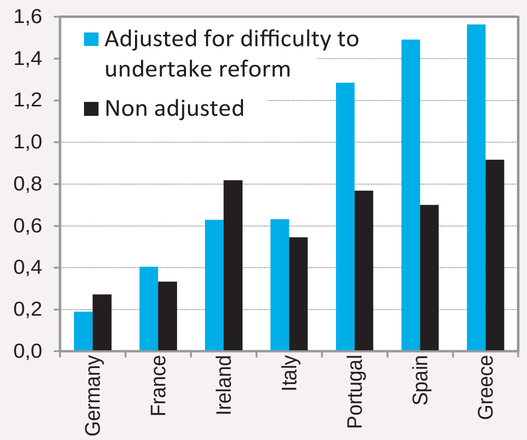
In the short term, the greatest risks lie with the political situation.

- **The government majority (ND/PASOK coalition, 152 out of 300 seats) remains very fragile** and the PASOK has already mentioned the possibility of leaving, although this threat appears to have eased in recent weeks after this party's results at the European (and even more so, local) elections were not as bad as could be expected and after a recent major cabinet reshuffle.
- Even if the coalition lasts until the end of this year, the risk of early general elections is even greater in Q1, 2015, when the new President of the Republic must earn the vote of at least 180 MPs, without which the constitution calls for parliament to be dissolved.
- While the results of early elections is unpredictable, the possibility of a new majority being formed with the radical left-wing Syriza party in the dominant position cannot be excluded. In such a case, there would certainly be very difficult negotiations with the Troika.

Such an outcome, or any new period of political instability, would have highly problematic temporary repercussions on the confidence of investors and key economic players. However, even in such a case, **the most likely scenario would still be gradual stabilisation**, as Greece has few options for rejecting its creditors' conditions while even the Syriza party (and the overwhelming majority of Greeks) do not want to see the country exit the eurozone.

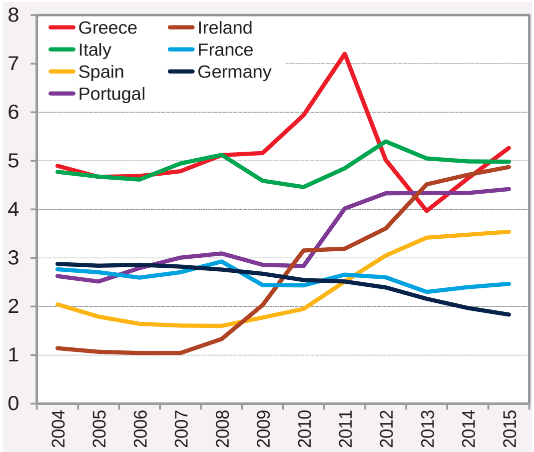
Thus, while the political situation may still trigger substantial bursts of market and economic stress over the coming months, the country's financial normalisation and economic recovery will probably continue beyond this. The country's very high level of public debt remains a long-term risk, whose actual consequences cannot be predicted due to the wide range of potential agreements (and disagreements) that could occur between the country and its official creditors.

5 **Responsiveness to reform according to the OECD**



Source: OECD, Amundi Research

6 **Interest expenditures on public debt, % of GDP**



Source: DG Ecfin, Amundi Research

This document is solely for the attention of journalists and professionals of the press/media sector

3 Weak investment in the US: the result of low profitability or the beginning of secular stagnation?

DIDIER BOROWSKI, *Co Head Strategy and Economic Research – Paris*

In contrast with the upturn in the eurozone, the recovery in the United States not only appears more vibrant but also more robust. After five years of steady growth in private domestic demand, the economic cycle nevertheless seems exceptional for several reasons. This is the slowest recovery since the end of WWII. In accordance with lessons gleaned from research on economic crises that are paired with financial and banking crises, much more time is need for business activity to return to potential (which corresponds to the full capacity utilisation) than would be required in a conventional cycle. One of the most striking aspects of this cyclical recovery is that private non-residential investment seems to be losing steam already, despite highly accommodative financial and monetary conditions along with record profits. Is this a cause for concern? Is the economy already heading down the path towards full employment? And is investment sufficient to renew capital stock? Is the US economy already being threatened by a cyclical slowdown, even though it has yet to reabsorb its surplus capacity? The answers to these questions are not only important for growth forecasts, they will determine the direction of fiscal and monetary policy in the United States.

The essential

In contrast with the upturn in the eurozone, the recovery in the United States not only appears more vibrant but also more robust. Private non-residential investment seems however to be losing steam already, despite highly accommodative financial and monetary conditions along with record profits.

Is the US economy already being threatened by a cyclical slowdown, even though it has yet to reabsorb its surplus capacity? Is this the first sign of "secular stagnation"? Nothing could be less certain. We believe that the reduced profitability of productive (as opposed to financial) investment could explain corporate behaviour over the last few years (share buybacks favoured over fixed-capital investment). If that is the case, the fact that Tobin's q is now greater than 1.0 suggests the investment cycle will continue. The Fed must nevertheless ensure that monetary conditions remain highly accommodative.

The US economy: still far from full capacity

Labour market: the US is still far from full employment. Private sector employment has only just returned to its late 2007 level. However, more than six years after the start of the recession, the same still cannot be said for the total number of hours worked, which is an unprecedented phenomenon in the history of post-war economic cycles. The official unemployment rate has shrunk considerably since 2009, but many discouraged workers have stopped looking for work and are no longer counted among the labour force. Employment has barely improved, and the participation rate has remained at its lowest since the late 1970s. Finally, "involuntary" part-time employment (those who want to work full-time but cannot) is falling, but like long-term unemployment (more than six months) has remained quite high. After all is said and done, excessive labour supply persists, despite the number of jobs created each month (more than 200 000 on average over the past 12 months). At this pace, we believe it will take two to three more years for the US economy to return to full employment. As a result, aside from a few growth sectors, employees have not recovered their pre-crisis bargaining power and therefore the upward pressure on wages should remain limited.

> "The number of hours worked remains below its 2007 level"

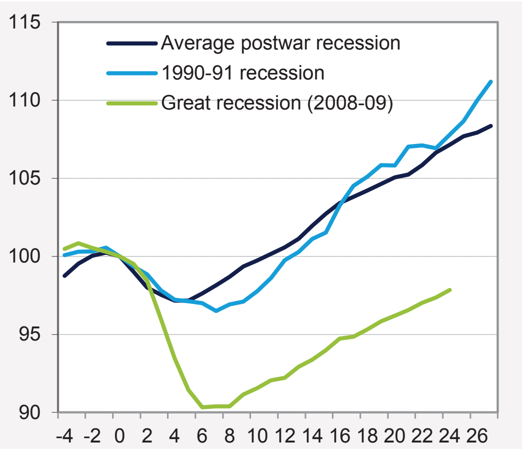
Labour productivity: a structural weakness? Productivity gains have declined sharply in recent years. At an average of less than 1% over the past three years, they are at their lowest since the mid-1990s. As the growth of the labour force has itself been weaker, this slowdown, if structural, means that potential growth will be more sluggish as well.

Investment trends: barely sufficient to renew capital stock. Investment clearly rebounded in 2010 and 2011. However, the recovery has been much less pronounced than in all other post-war cyclical recoveries. In fact, private non-residential investment has hardly returned to its 2007 level! The growth rate of real capital stock has fallen to its lowest post-war level (approximately 1.5%), which means that most investments have only been made to replace obsolete equipment.

That said, the item-by-item breakdown of investment over the past 15 years bodes well as (unfortunately, this breakdown (at constant prices) is not available over a longer period):

- The rate of investment (defined here as the ratio of real investment to real GDP) is at its highest with regard to capital goods and intellectual property products.
- Interestingly, the rate of investment in intellectual property products has proven to be relatively impervious to economic cycles and has grown continuously since 1999 (this item rising from 3% to 4% of GDP over this period).

1 Hours worked (total), indexed at 100 at each peak of the cycle (quarters to peak)



Source: Datastream, Amundi Research

- However, investments in building capacity have been disappointing: the rate of investment in structures has tended to decline over time.

Even if the recovery has fallen short of expectations, it is reassuring that investments in productivity were and still are[1] focused on investments in capacity.

Are the factors determining business investment surprising?

The standard explanatory model links the dynamic of capital accumulation to anticipated outlets ("accelerator model"). It is often enhanced by other explanatory variables, particularly by profits or variables measuring self-financing capacity. Naturally, real interest rates, which change in line with the cost of capital, also play a role in the decision to invest. Lastly, we call your attention to a variable of a very different kind, which played a decisive role in the 1990s: Tobin's q. This is the ratio between the market value of a company and its book value (value of fixed capital at its replacement cost). This variable helped explain the boom in private investment in the late 1990s. When the average ratio exceeds 1.0, it can be assumed that the same holds true for the "marginal ratio". For an entrepreneur, this means that a dollar invested in fixed assets tends to generate more than one dollar of financial valuation for the company, which may encourage him/her to make investments in fixed capital (to the detriment of financial investments).

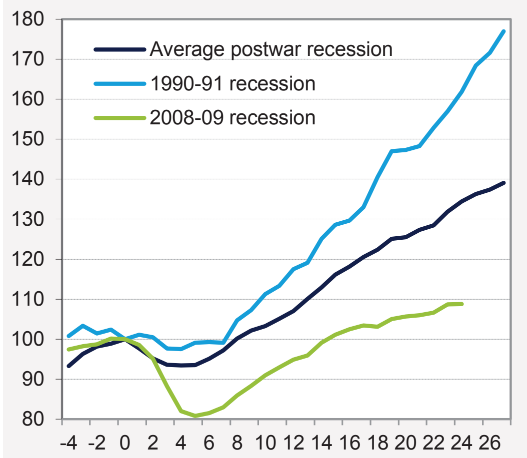
- **"Accelerator Model":** recent studies seem to show that investment has been behaving as expected. In addition, according to recent BEA estimates, the potential growth rate of the economy over the next five years is expected to be 2.2%, much lower than before the Great Recession. This may justify extra caution in terms of investing.
- **In contrast, the rate of investment appears weak when compared to record company profits.** In Q4 2013, before-tax non-financial corporate profits (as a share of added value) reached its highest level since WWII (14% of GDP vs. 8.3% on average over the past 60 years).
- **Are financial conditions sufficiently accommodative?** These questions should be asked inasmuch as real negative interest rates were a decisive factor in past cyclical recoveries. In the current cycle, low inflation made it impossible to trigger a recovery in this way, despite a proactive Fed and its quantitative easing policy. That said, companies have abundant cash resources and, for the most part, the means to self-finance. Nevertheless, they have preferred to buy back their own shares (and pay dividends). It is possible that the real cost of capital has not declined sufficiently. In an inflation-free world, the zero-bound constraint on nominal rates has probably played a role, but this is not be the only factor behind sluggish investment.
- **What is happening to "Tobin's q"?** In a way, Tobin's q measures the relative profitability of a financial investment in comparison to a fixed-capital investment. The fact that it has been lower in recent years may have encouraged share buybacks since 2009, as companies seek to maintain profitability first and foremost in an uncertain environment. It had remained below 1.0 since 2001, but moved back above 1.0 in the fourth quarter of 2013 for the first time since 1996 (see graph). If we leave aside the second half of the 1990s, it is now at its highest post-war level. This trend is not necessarily a good sign as certain analysts might infer that stock markets are starting to get overvalued (from a macroeconomic standpoint). However, this is a "new" factor that will support fixed-capital investment.

Is weak investment a sign of the start of secular stagnation?

The secular stagnation hypothesis (aging population, widespread bias toward savings, slowdown in productivity and decline in potential growth) has recently returned to centre stage. It has the merit of accounting for both low interest rates and sluggishness capital accumulation. The fact that fixed investment has

1 *It is noteworthy that Q1 2014 data have not changed this finding. Investment in structures has continued to decline at an annual rate (-7.5% in Q1 after -1.8% in Q4), investment in capital goods dropped by - 3.1%, but this follows strong growth in Q4 (+10.9%). Finally, investment in intellectual property products has continued to rise (+5.1% in Q1 after +4% in Q4).*

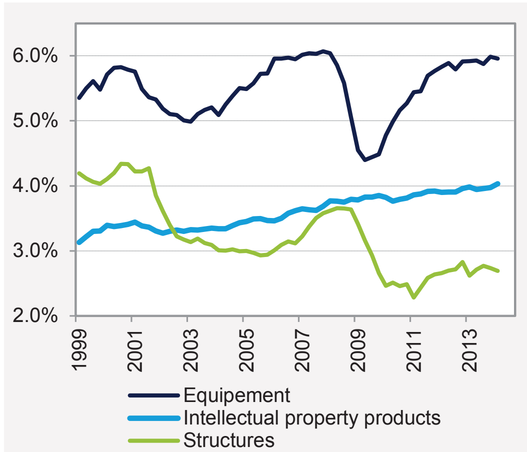
2 Investment (equipment & software), indexed at 100 at each peak of the cycle (quarters to peak)



Source: Datastream, Amundi Research

> "Investment is barely sufficient to renew capital stock"

3 Private investment (% of GDP)



Source: Datastream, Amundi Research

not picked up more significantly may demonstrate a lack of clear prospects. In fact, if business leaders had been convinced straightaway that the recovery was sustainable, they probably would have made more investments of all sorts (including in capacity). At the same time, it is quite puzzling that long-term interest rates have come down since the beginning of the year, whilst (1) the Fed has been buying up fewer Treasury securities, (2) equity markets have continued to rise and (3) volatility for all asset classes has remained at its lowest.

At the end of the day, this might indicate that investors are now anticipating a protracted period of stagnation.Much lower potential growth would in fact go hand-in-hand with a decline in the equilibrium interest rate.

Conclusion: investment should accelerate... but this is not incompatible with lower potential growth

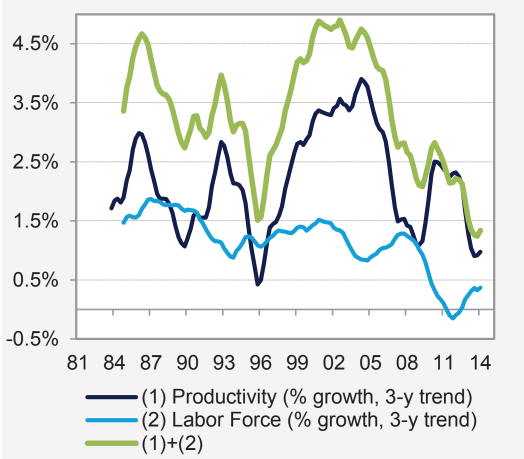
The secular stagnation hypothesis has the advantage of reconciling several recent trends (low productivity, sluggish investment, surplus labour supply, lower long-term interest rates). However, it is also possible to account for these trends with the usual factors determining investment, with the sluggish recovery explained by the extent and nature of the 2008-2009 crisis. The relative profitability of financial investments could have played a decisive role. If this is the case, investment should pick up this year, especially if the stock markets continue to benefit from a global surplus of liquidity and low interest rates. Consequently, it would take two or three more years of above-potential growth to fill the output gap. From now until 2016-17, there is no fundamental reason for the economy to slow down. That said, the continuation of the expansion cycle that started in 2009 is not incompatible with weaker potential growth and lower equilibrium interest rates. The Fed will have to reckon with uncertainty about the type of cycle it is going to have to deal with in 2015. It cannot take the risk of a sharp spike in its key interest rates. It must maintain accommodative financing conditions. Meanwhile, budget policy must remain a tool for macroeconomic stabilisation that the authorities can use in the event of an unforeseen shock in aggregate demand.

4 Tobin's Q

Source: Datastream, Amundi Research

> A promising sign for productive investment: Tobin's q has moved back above 1.0

5 Labour-productivity trend + Labour-force trend as a proxy of potential growth



Source: Datastream, Amundi Research

4 The bond markets defied forecasts in H1. What's on the cards for H2?

BASTIEN DRUT, *Strategy and Economic Research – Paris*

The bond markets confounded all the predictions for the first half of 2014. While most forecasters expected long-term bond yields to rise in the United States and in Germany with the Fed's tapering of QE, they have declined sharply since 1 January. In this article we look back at the developments of the first half of the year and adjust our expectations for the second half.

Several factors caused US yields to slide in H1

First, let's look at US long-term interest rates. A number of factors drove long-term yields down. First, the Fed's announcement that it would begin the process of tapering its quantitative easing programme (the FOMC's decision to reduce asset purchases by $10bn) boosted optimism about the US economy. Expectations were very high in January, but the results were deeply disappointing, due in particular to the exceptionally harsh winter weather from December to February. Next, geopolitical tensions in Ukraine prompted investors to shift to safer securities starting in March. Lastly, the growing concerns surrounding the Chinese economy (the consensus among economists has been to revise growth forecasts downward every month since the beginning of the year) had an impact on long rates.

While this observation is certainly valid, there are other factors at play: 1) The US 10-year yield is only 10 to 20 bps below its long-term equilibrium level, 2) intermediate yields (3 to 7 years) held up much better than the 10 and 30 years and 3) since last September, the yield curve has been flattening, a feature of periods preceding monetary tightening.

What can we expect from US yields in H2?

What can we expect from the US yield curve in the second half of the year? Bond yields are expected to edge higher, particularly with the pace of US growth returning to around 3% and the Fed almost disappearing from the Treasury securities market as QE3 winds down ($190bn in Treasury note purchases by the Fed in H1 will fall to only $60bn in H2 at the current rate of tapering). On the whole, 10-year bond yields should rise again and end the year slightly below 3%. However, the increase will be sharpest for shorter maturities. The first Fed funds rate hike is expected to happen around the middle of 2015 (don't forget that in March, the median projection for the Fed Funds rate among members of the FOMC was 1% at the end of 2015 and 2.25% at the end of 2016) and the yield curve is expected to continue gradually flattening ("bear flattening"). Two-year yields, still extremely low as a result of the Fed's qualitative forward guidance, will climb more rapidly in H2 and end the year close to 1%.

Peripheral spreads were expected to drop, but not German ones

In Europe, long-term interest rates in the core countries also fell sharply in H1, against all expectations. In mid-May, German 10-years were only 15bp above their historic low (1.16% in May 2013). Obviously, this decline is due to some of the same factors as the drop in US rates (increasing risk aversion due to events in Ukraine), but it was also caused by reasons specific to Europe. In particular, the issue of deflationary risk is taking on greater importance in the eurozone (in May's issue of Cross Asset Investment Strategy, we showed that deflation vulnerability recently increased substantially). Although growth forecasts for Europe were fairly reassuring at the beginning of the year, the outlook for inflation has been revised downwards considerably. By establishing its outlook for inflation at 1.5% on average for 2016, the ECB strengthened its forward guidance, indicating that it would not raise its key interest rates until at least 2017, long after the Fed and the BoE. As even Mario Draghi admitted, euro appreciation has added to deflationary pressures and the ECB will act to prevent a pernicious negative spiral (see "*Monetary policy in a prolonged period of low*

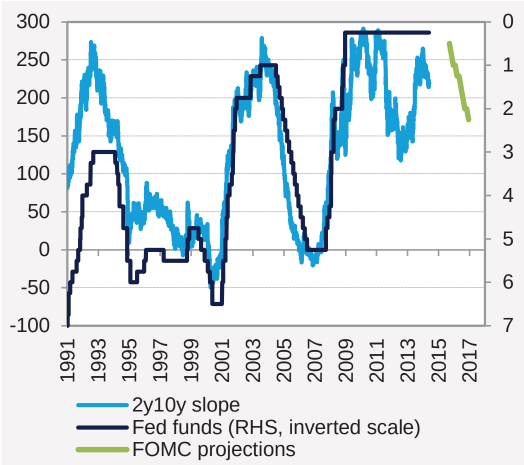
The essential

Developments in the bond markets brought some surprises in the first half of 2014, with an unexpected decline in long-term bond yields in Germany and the United States.

We take a look at the underlying reasons for falling long rates in the first half of the year and adjust our expectations for the second half. Yields in Europe's core countries will remain low for the foreseeable future. Meanwhile, the US yield curve will continue to flatten.

> "The yield curve is expected to continue gradually flattening"

1 United States: fed funds vs slope of the yield curve



Source: Datastream, Amundi Research

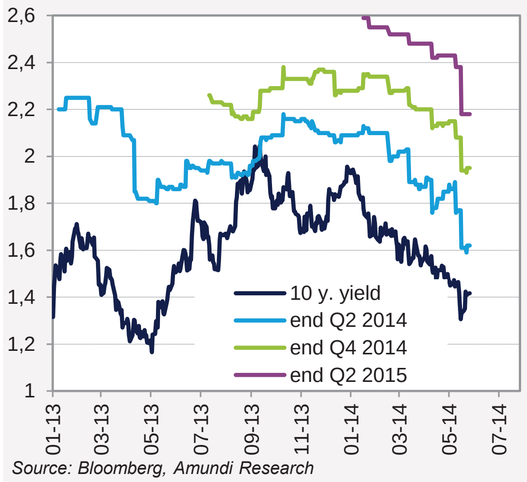
inflation", Mario Draghi's speech of 26 May). As a result, the German yield curve shifted much closer to the Japanese curve. The short end of the curve (the 2- to 5-year segment) flattened dramatically and is expected to remain extremely flat throughout the second half of the year. 10-year German yields, far below their equilibrium level (at around 1.80%) should rebound in H2 but still remain under 1.80%.

Unlike the decline in German interest rates, lower peripheral spreads were expected to fall in the first half of the year. The yield spreads of Spain and Italy, like those of Germany remained on the downward path on which they set out in the summer of 2012. Several factors contributed to this: the interest-rate climate favouring the carry trade, continued deleveraging by banks in southern Europe and capital inflows prompted by the fears about emerging countries. The narrowing spread on the 5-year rate accelerated sharply compared to the 10-year. By contrast, risk premiums on the two-year are showing signs of ending their descent. Many factors that favoured Spanish and Italian bonds in the first half of the year will linger into the second half (low interest-rate environment, bank deleveraging). The easing measures announced by the ECB will be yet another factor boosting peripheral bonds in the coming months. However, it should be kept in mind that government debt trajectories will continue to diverge over the next few years. In particular, Germany's debt-to-GDP ratio is falling fast (the deficit is zero and the debt burden is low) while that of Spain will continue to increase. As the risk premiums for some countries are too low (for instance, Greece, with government debt standing at 174% of GDP, successfully sold €3 billion in 5-year bonds with a 4.95% coupon in April), it's wise to give greater priority than usual to liquid securities.

The US/Europe interest-rate spread expected to widen on medium-term maturities

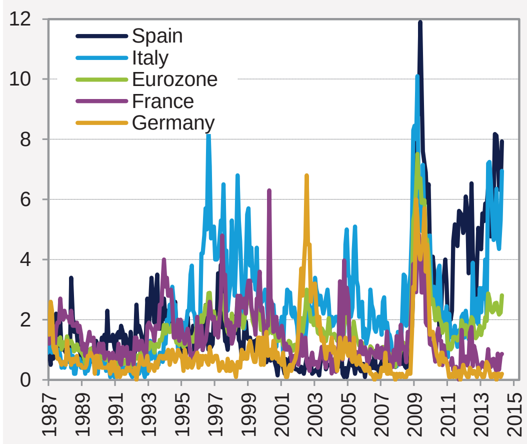
The economic divergence between the US and the eurozone, as evidenced by the widening gap between unemployment rates, first developed into diverging monetary policies and then into diverging bond market performance. Historically, the magnitude of the spread between US and German yields was always greater for short maturities than for long maturities (there are fewer reasons to think that there will be significant gaps in growth between the US and Germany over the very long term). But that was not the case over this monetary cycle due to forward guidance policies practised by the Fed and the ECB (short-term interest rates held to near zero) but, as explained above, US 2-year yields should begin rising soon. The 10-year rate spread is expected to widen a little more but look for spreads to be widest on shorter maturities. The growing difference in short-term interest rates will cause the euro to fall relative to the dollar.

2 German 10y. yield: realised and forecasts from the consensus



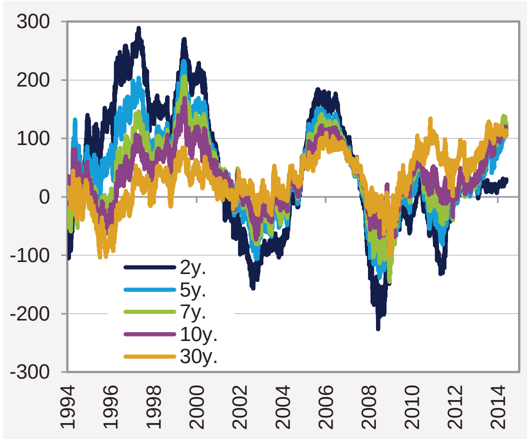
Source: Bloomberg, Amundi Research

3 Share of consumers expecting the prices to fall over the 12 next months



Source: European commission, Amundi Research

4 Yield spread between the US and Germany (in bps)



Source: Bloomberg, Datastream, Amundi Research

5 The Eurosceptic vote: eurozone's leaders got lucky so far, but they must start delivering on reflation and federalization now

NICOLAS DOISY, *Strategy and Economic Research – Paris*
ROGER VICQUÉRY, *Strategy and Economic Research – Paris*

The Eurosceptic vote is sending an implicit but loud message: "Fix this policy-mix!"

While cyclical convergence is a necessary condition for the economic and political sustainability of a fixed exchange rate system, **divergence in the Eurozone** (proxied by intra-zone unemployment dispersion, Chart 1) **reached an all-time peak in 2013.** Had the Euro been a mere fixed exchange rate system with no central bank cooperation via Target 2, the political unsustainability of such a real divergence would have forced a nominal adjustment through the exchange rate: based on past episodes - the 1986-87 Deutsche Mark revaluation and the 1992-94 ERM crisis – the "Euro-peg" would have collapsed somewhere around mid-2010 when intra-zone unemployment standard deviation reached 4.5pp (Chart 1).

On the contrary, as the Euro has been proven unbreakable (thanks to Draghi's "whatever it takes"), **a pro-cyclical policy mix** (fiscal austerity and too tight monetary policy) **has nevertheless further exacerbated unemployment dispersion** in the zone. This has **unsurprisingly triggered voters' reaction.** While, in the decade and a half after the ERM-crisis rise in 1994, the weight of Eurosceptic parties in the European Parliament was steadily reversed, **populists broadly defined now represent between 35% and 45% of the votes** in countries such as France, Italy, Greece and the Netherlands.

> Populism, deflation and the political economy of "sound money": a Gold-Standard cautionary tale from the US "Long Depression" of 1873-1896

At the beginning of the 1870s, following the end of the American Civil War and the Franco-Prussian conflict, **a transatlantic shift from war-time easy money to a global Gold Standard** took place.

The subsequent shortage in global liquidity supply (due to the stickiness of the global stock of gold) contributed to the burst of a railroads and property bubble: that caused a **protracted recession and a two decades long deflation.**

In the United States specifically, the abandonment of silver coinage in favor of gold coincided with a slowdown in the rate of increase in the global stock of gold and a fast rising output, meaning that the price of gold in terms of goods went up (this has the equivalent effect of an FX appreciation), pushing down the nominal price level at an annual rate of roughly -1.7% from 1875 to 1896.

Heavily indebted farmers, notably in the mid-west and southern States of the American monetary union, saw their debt service rise dramatically in real terms, leading to wide-spread defaults and land expropriation by the banks. Supporting inflation through silver coinage, **the anti-establishment agrarian movements started to increasingly gather political consensus,** denouncing a "conspiracy of international bankers" to starve the American farmer. The **inflationist populists ultimately took control of the Democratic Party and came close to winning the presidency in 1896.**

*While all this might sound oddly familiar to the contemporary ear, **what lessons should we draw from this Gold Standard cautionary tale?***

As it has been argued by Milton Friedman[1], inflationist populists were initially right. The refusal to implement the free coinage of silver and the adoption of bimetallism, the then equivalent of quantitative easing, cost the US economy between 40 and 60 points in price level in the 1873-1896 period (See counterfactuals in Chart 2). Contrary to what the partisans of "sound-money" argued, an increase in the money supply would have granted a much better price stability outcome.

The essential

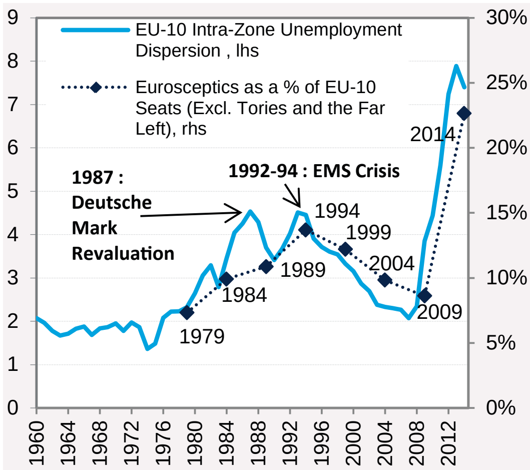
Hardliner Eurosceptic parties have tripled their seats in the EU Parliament, as intimidated in our previous note in last January's Cross Asset *(European political risk in 2014: Eurosceptic "barbarians at the gate"?)*.

Similarly to previous episodes of cyclical divergence within the European fixed exchange rate system, voters have signaled their discontent with a policy-mix that is not resolving the unemployment problem.

Despite an electorally impressive breakthrough, **populists parties will have close to no power to influence policy**. Starting with the nomination of the Commission's President, **the actual risk from now on is that of an intergovernmental deadlock delaying the federalization** of the EZ.

While the weak score of Eurosceptic parties in the periphery is reassuring, **such a deadlock would further feed into already very high Euroscepticism in France and Italy:** EZ's leaders should not push their luck too far. As the history of the **anti-Gold Standard populist movement in the US cautions us, monetary orthodoxy can persistently feed popular discontent.** In this respect, **the ECB has a political responsibility, as the only federal institution in the EZ.**

1 EU-10 (Excl. UK & LX) cyclical divergence and eurosceptic seats in the EU Parliament



Source: OECD, European Parliament, Amundi Research

Lesson #1: The Germans should take inspiration from the father of monetary orthodoxy's critique of the Gold Standard and recognize the quintessential role of fiat money in preventing deflation.

However, by the time the populists had a good shot at gaining power in 1896, the policy they were rightly advocating in 1873 would have been at best harmful since it would have come 20 years too late. Indeed, the 1896 presidential race - that saw silver-inflationists' candidate Bryan accusing the "sound-money" advocates of "crucifying mankind upon a cross of gold" - coincided with the beginning of an inflationary period in the Gold Standard world, following the Klondike's gold-rush. A return to bimetallism in 1896 would have had a fair chance of pushing the US through a period of price instability and very high (if not runaway) inflation.

Lesson #2: Economically justified popular discontent can snow-ball into a political self-perpetuating (potentially long-lasting) contention leading to different but no less harmful economic policies.

Ultimately, the United States got lucky. While the "sound-money" policy followed through the "Long Depression" fed into hardline populism, an **exogenous increase of money supply through the Klondike's new gold fields as well as the pragmatic campaign of 1896 Republican candidate McKinley spared the US a longer period of price and political instability.**

Lesson #3: **The Eurozone too might get lucky... as well as not:** if we might paraphrase Professor Friedman, in a fiat money system, **inflation is "always and everywhere" a monetary as much as a political phenomenon.**

1- Milton FRIEDMAN, *The Crime of 1873*, Working Papers in Economics E-89-12, The Hoover Institution - Stanford University, April 1989

Despite a historic electoral breakthrough, Eurosceptics will not have the political clout to influence policy

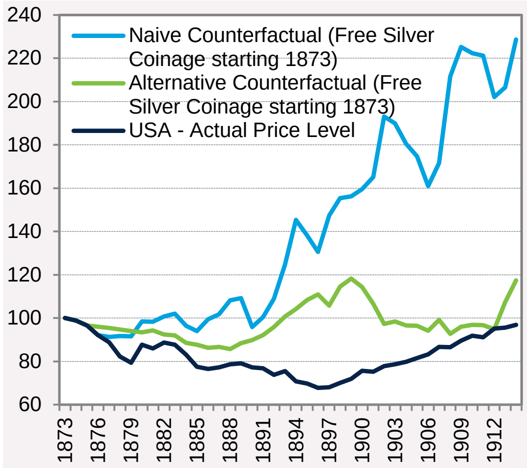
Broadly defined, **Eurosceptic parties were already split between three political groups** in the outgoing legislature: the GUE-NGL (Far Left), the ECR (Nationalist conservatives, eg. Tories) and the Eurosceptic hardliners' EFD (Far Right, eg. UKIP).

While those groups registered the lowest "cohesion rate" (which indicates the extent to which a political group votes consistently, as measured by VoteWatch Europe) in the 2009-2014 legislature (48.59% for the EFD vs. 94.68% for the most cohesive group, the Greens) **the dramatic increase in seats for hardliner populists in the 2014 election will further widen the Eurosceptics lack of unity.** The three major hardliner parties (UKIP, France's Front National and Italy's Movimento 5 Stelle) are indeed expected to refuse to form a common political group.

In any event, legislation is traditionally passed by the European Parliament with a (very) large cross-party majority. In this respect, the 2014 election weakened the influence of the two major political groups, the S&D/ESP and the EPP, even though they will still enjoy a theoretical absolute majority of seats (Chart 2). **Estimates of parliamentary "actual power"[1]** (taking into account both the ability of the group to impose vote discipline and the group's MEPs participation to votes) **show that a de facto grand coalition with the ALDE's Liberal-Democrats and possibly the Greens will be necessary in order to secure a majority, notably in the Economic & Monetary Affairs area** (Chart 4).

1 - We estimate "Actual Power" in Chart 4 by multiplying each group share of seats by the group's "cohesion rate" in key Economic & Monetary Affairs votes during the 2009-2014 term and by the group's MEPs average rate of participation to votes. Cohesion and participation rates for the Eurosceptic groups that did not exist in the previous legislature are assumed to be those of the EFD ones.

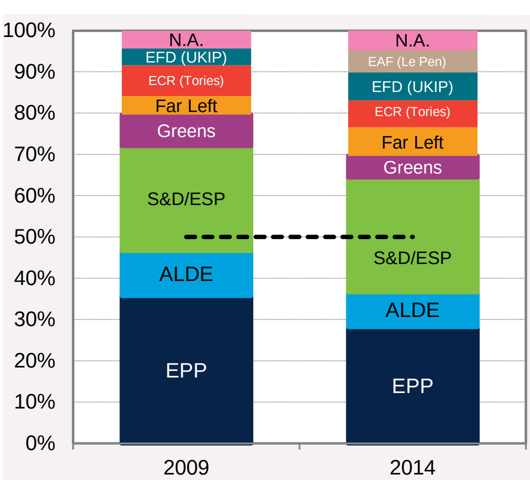
2 USA - Price level during the «Long Depression», Actual and counterfactuals



Source: Friedman (1989), Amundi Research

> In the face of populism, the Germans should remember Milton Friedman's analysis of the "Crime of 1873", when the Gold Standard led to protracted popular unrest in the US

3 Breakdown of seats by political group in the EU Parliament



Source: European Parliament, Amundi Research

The "periphery of the core" (France and Italy) is where the medium-term political risk is likely to rise without a clear road-map towards federalization

While **distrust in the EU institutions,** as measured by the Commission's Eurobarometer, has risen uniformly in the Eurozone, this has yielded very different outcomes in terms of actual voters behavior. With the exception of Greece, **peripheral countries** –despite the harshness of the adjustment programs they went through - **are largely sticking with mainstream pro-Euro parties** (they all lie below the regression line in Chart 5). This makes sense after all, as **programme-countries have seen their per-capita-real-GDP rise between 15%** (Greece) **and 87%** (Ireland) ever since the Maastricht Treaty to this day. On the opposite, **the current Eurozone arrangements are becoming politically more unsustainable by the day in the "periphery of the core", Italy and France,** where voters are paying the price - in terms of unemployment and deflationary pressures - of the periphery bonanza of the 2000s without having enjoyed its benefits, while the ECB, the Eurozone's only genuine federal institution, is simply staying put.

If France, unlike Italy, is protected by its constitutional safeguards, the Front National's score is nonetheless challenging. In the medium term, a **stabilization of approval rates for the Front National at the current levels clearly has the potential of undermining the mainstream French parties' traditional cross-partisan support for the European project.**

On the other side of the Alps, **Renzi's triumph in the European election is without doubt very good news.** Notwithstanding this, **exiting the Euro has increasingly become a commonplace topic in Italian politics.** As shown in Chart 5, while Italy's loss in GDP per capita is roughly the same as that of Spain since 2009, Italians are voting nearly 2 times more than Spaniards for Eurosceptic parties.

Renzi's hegemony on the Italian pro-European camp might further accelerate structural reform and will probably strengthen Italy's voice in European negotiations. But it also means that **there is no spare parachute left for Italy in case Renzi were to fail:** voters will have no Pro-Euro alternative where to turn to. All in all, thanks to **France's institutional strength and Renzi's political skills,** anti-Euro populism has been contained. **However, a deal with Germany must be reached on a strategy aiming at 1) reflating the Eurozone and 2) building viable federal economic institutions,** for the French and Italian Eurosceptics to be kept in check.

Beyond, the "elephant in the room" is an intergovernmental institutional deadlock delaying the "federal big-bang"

While crisis-resolution quick fixes such as the OMT or the Fiscal Compact bypassed the EU Parliament's scrutiny, **the "federalization" required in order for the Euro to survive cannot anymore be pursued through mere intergovernmental dealings.**

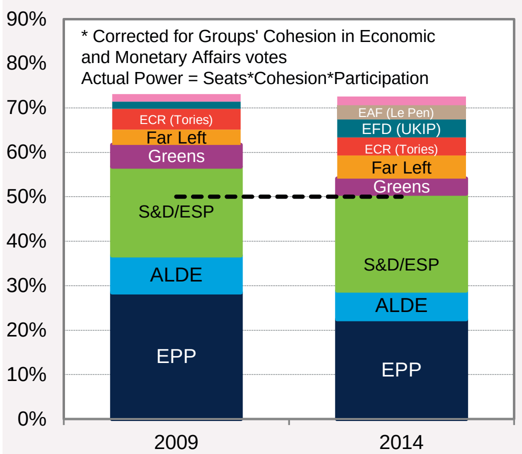
Under the Lisbon Treaty, **the European Parliament is on an equal footing with the Council of Ministers** when it comes to voting legislation in most policy areas. It can also veto the revision of the EU Treaties under the simplified revision procedure as well as the ratification of the treaties the EU has signed (eg. the European Stability Mechanism). It now also **has the power to elect the Commission President,** whose name must however be proposed by the European Council taking into account the parliamentary majority.

Given the issues at stakes, **a post-election institutional deadlock between the European Council and the Parliament,** with the latter refusing to appoint the former's candidate for Commission President, **would be particularly worrisome.** It is difficult to imagine that a Commission President appointed through such a deadlock would have the necessary legitimacy to carry on the EZ's federalization with the trust of both Germany and the Latin countries.

In the short run, the next Commission will need to adopt a carrot and stick approach. **It must adapt the EZ's budget rules to reality** (current budget

"The current eurozone compromise is becoming politically unsustainable in France and Italy"

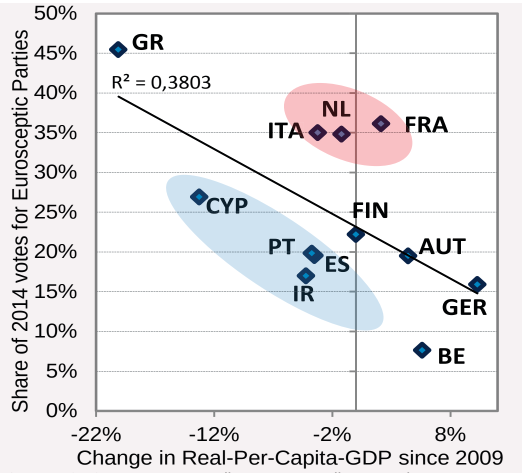
4 Actual power* in Economic & Monetary Affairs by political group



Source: VoteWatch, EU Parliament, Amundi Research

"A lock-in process of building federal economic institutions must be jump-started now"

5 Loss in Per-Capita-GDP since 2009 and 2014 eurosceptic parties consensus



Source: OECD, European Parliament, Amundi Research trajectories cannot be met without an ECB aggressive intervention), possibly accessing to Italy's request to deduct part of investment spending from the deficit rule, while **overseeing the continuation of structural reform in the periphery.**

In the long run, the politically tricky process of "two-speed" integration should also be initiated by the next Commission: for the EZ members to become more integrated, a looser union between the 28 members of the wider EU (and possibly a redefinition of EZ membership) is needed. **Above all, a lock-in process of federal economic institutions building** (from a Euro-wide fiscal capacity to labor-market and fiscal harmonization and possibly debt mutualization) **must be kick-started** now for them to be up and running in the coming decade.

Any crisis-time-style watered-down compromise being reached at any stage of this long-run institution building process would have to be seen as a serious threat to the political sustainability of the Eurozone.

> "A deal on reflation and federalisation must be reached to keep the populists in check"

Conclusion

If the actual **institutional consequences of the Eurosceptic push are largely anecdotic** in the short term, national and European **policy-makers should not push their luck too far** over the longer term. A deal for a reformed policy-mix and viable federal economic institutions must be reached during the incoming European legislature to keep the populists in check.

6 An emerging economies typology following last year stress episode

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It is now well understood that the emerging world is displaying more and more unique characteristics. In fact, more than one year after Ben Bernanke announced that the Fed would begin tapering its asset purchases, the deep-rooted causes of the market turmoil that several emerging countries experienced are still there. In this article, we set out to document migration (formation and dissolution of clusters) and permanency (the stability of a classification) with the aim of creating a fairly exhaustive typology in order to appreciate the main differences between the major emerging economies.

A classification of emerging market economies born from ascending hierarchical analysis

In our last article on this subject (See April's edition of Cross Asset Investment Strategy, "Emerging economies: it is time to revert to simple segmentation principles"), we proposed a system of scoring based on 14 quarterly macroeconomic variables[1] grouped into four categories across a sample of 20 countries considered to be emerging[2].

We recall that our system of scoring is based on these four categories:

1. **Macroeconomic outlook:** growth of real GDP and inflation (YoY % change);
2. **Quality of public balance sheets:** government debt, government deficit, gross external debt (% of GDP) and short-term gross external debt (% of gross external debt);
3. **Investment and savings:** current balance, change in current balance, gross domestic savings and change in gross domestic savings (% of GDP);
4. **Vulnerability:** currency reserves (months of imports), basic balance, trend changes in domestic credit (% of GDP) and M2 money supply (% of FX reserves).

There is a certain trade-off between the completeness of the country profiles and the readability of the scores. We opted for less granularity in order to improve readability. As it happens, the superimposition of all these scores using an average, as is often done, would have very little meaning. To illustrate this point, economic performance, whether growth or inflation-driven, also depends on a country's capacity to save, i.e. the capacity to finance its domestic demand, the health of its public balance sheets and the existence of imbalances, such as excess private sector indebtedness.

For the second step, which involves reclassifying emerging countries based on the scores achieved, we have decided to use the Hierarchical Ascendant Classification (HAC) method. This method of automated classification is frequently used in data analysis and offers two advantages: (i) we start off with proximity measures (here, the scores) between the elements (in this instance, emerging countries) that we wish to merge; (ii) one of the results is the dendogram, which is used to graphically depict the iterative merging of data. We can then get a good idea of the appropriate number of classes into which emerging countries can be classified.

The HAC method is simple. We start by calculating the proximity between 20 emerging countries, then we merge two emerging countries by minimising the

1 To mitigate the volatility of the data, we use weighted averages. The weighting system strengthens the most recent data. The weight of one quarter's data counts for twice that of the previous quarter.

2 China, South Korea, India, Indonesia, Malaysia, Philippines, Taiwan, Thailand, Russia, Turkey, Poland, Hungary, Czech Republic, Romania, South Africa, Brazil, Mexico, Chile, Colombia and Peru.

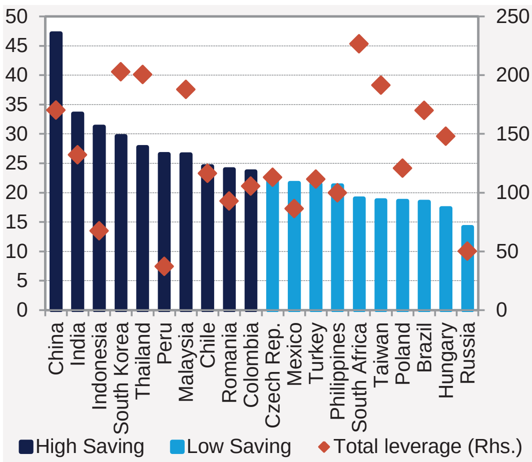
The essential

We have further developed our fundamental approach to emerging market economies. After providing a reminder on the methodology we used, we compare, on a quarterly basis, the structure of the country blocs obtained before and after last year's turmoil.

The goal here is to document migration (formation and dissolution of clusters) and consistency (cluster stability). On the eve of the turbulence, the emerging world was divided into economies with high gross savings and those with low gross savings (or even declining savings). The recovery in domestic macroeconomic variables after the shock led to the dissolution of the low savings bloc of countries. Today these countries are divided into economies running a structural deficit and vulnerable economies (worsening deficits, high debt burden and high inflation).

> "Our approach combines fundamental scores with a simple yet sound statistical classification"

1 Total leverage vs. saving (% of GDP) in Q1 2013



Source: Datastream, Amundi Research

Euclidean distance[3] between the scores, thereby creating a class out of these two emerging countries. We then calculate the proximity between this class and the other 18 emerging countries and again merge the emerging countries by minimising the Euclidean distance[3]. We repeat these steps until all the emerging countries are merged into clusters. These successive mergers yield a binary classification tree: the dendogram.

On the eve of recent turbulence, China and its economic partners were enjoying the best economic performance and considerably high savings

When applied to the main emerging market economies, this automated approach produced four clusters in Q1 2013 before the announcement of tapering by the Fed. The first of these clusters included China and its main economic partners, namely South Korea, Taiwan, Malaysia and Thailand. These economies had the best performance (average growth rate of 4.2% and an average inflation rate of 2.1%). Their gross average savings rate was also the highest: 30% of GDP. We also noted that these economies had some of the highest loan debt burdens. Lastly, the current account balance trend had worsened for only two of these countries, Thailand and Malaysia, mainly due to government debt growth.

The only issue of concern was that their external debt was generally short-maturity debt, which made them ripe for the emergence of liquidity tensions on their debt markets. And all this began occurring just as doubts were forming about the potential emergence of tensions on US long rates.

The other three categories all had lower gross savings (between 18 and 26 GDP percentage points) as well as lower total leverage – government debt plus loans. The distribution between loans and government debt in their total leverage was more balanced. These clusters were minimally distinguished by greater dispersion in their economic growth, which in Q1 2013 ranged from 1.4% to 1.5%. However, for most of the economies in the other three categories, inflation was high (rate between 4% and 5%), with the exception of emerging European economies (Poland, Hungary and the Czech Republic) and Chile. This higher inflation pointed to the existence of surplus domestic demand or structural constraints influencing supply. India was an emblematic case in this respect due to its lack of transportation infrastructures and power generation needs that are not being fully met. Ultimately, all this contributed to the imposition of significant constraints on Indian production. This was also the case for Russia, where the industrial base showed a secular trend toward concentration favouring the mining and oil & gas sectors, which led the World Bank to say that Russia is less industrially diversified today than during the Soviet era[4]. Brazil was another case in point: domestic demand was highly dependent on consumption. Investment, which long favoured the mining and oil & gas sectors, entered a downward trend as regards its percent of GDP, from a high of 21% in 2008 to 18% in 2013.

Economies with low savings and a high debt burden are primarily financed by domestic currencies

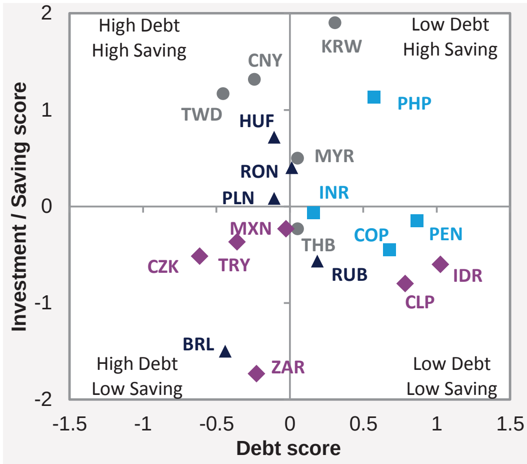
On closer inspection, India, the Philippines, Colombia and Peru fell within the second category. Apart from the Philippines, where the current account surplus stood at 2.7% of GDP, these countries were running high current account deficits, along the lines of 3.5% of GDP. Furthermore, with the exception of Colombia, most of the economies in this category had a high level of inflation. On the eve of 2013's turmoil, the issue of inflation in India was a matter of real concern, leading to import restrictions on some products in the summer of 2013, particularly gold, and then to a shake-up in the governance of the Central Bank of India with the appointment of Raghuram Rajan (setting of an inflation target).

Standing at 56% and 49% of GDP, respectively, the government debt burden of India and the Philippines was particularly high. In contrast, their external debt burden was the lowest, at 17% of GDP. Moreover, their external debt was

3 *Euclidean distance is defined as follows:* $\sqrt{\sum_{i=1}^{n}(x_i - y_i)^2}$

4 *Russian Economic Report No.30: "Structural Challenges to Growth Become Binding", September 2013.*

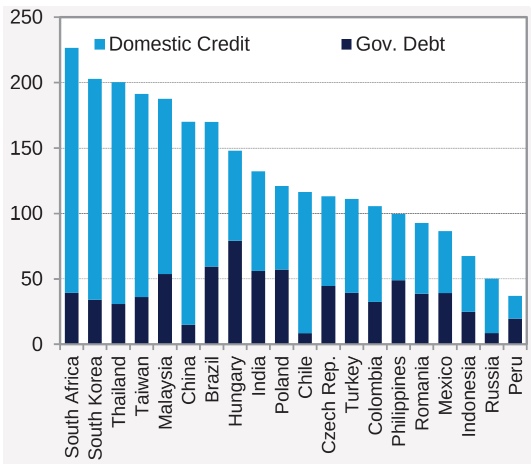
2 **Debt vs. I/S scores in Q1 2013**



Source: Datastream, Amundi Research

> Our approach produced four clusters before the announcement of tapering by the Fed

3 **Total leverage (% of GDP) in Q1 2013**



Source: Datastream, Amundi Research

generally long-maturity debt. This stemmed from the fact that gross average savings in this category was the highest.

Economies with low savings and a high debt burden with financing mostly through foreign currency reserves

The third category was divided into two subsets: Brazil and Russia on the one hand, and the emerging European economies of Poland, Romania and Hungary on the other. In Q1 2013, these economies shared the distinction of high external debt burdens that stood, on average, at 40% of GDP, two-thirds financed by debt funded in reserve currency. This category is comprised of the countries with the lowest levels of gross savings (a little more than 18% of GDP), which explains their greater reliance on financing domestic debt with foreign currency reserves.

Brazil and Russia both experienced deterioration in their current account balance, with, however, one distinct difference: Russia had a current account surplus equal to 5% of GDP while Brazil had a current account deficit of -4.4%.

Economies with substantial borrowing requirements

The fourth and last group included the six other economies in our sample, namely Chile, Indonesia, Mexico, South Africa and Turkey. In this group, the current account balance was in deficit by an average of 3.4% of GDP. Gross saving was down significantly due to growing public debt, which inevitably caused the current account to deteriorate. Public debt was approaching 40% of GDP, with the exception of Indonesia and Chile. Lastly, their foreign exchange reserves were among the lowest (approximately six months of imports). The debt burden relative to GDP was between 40% and 70%, with the exception of Chile, where it had already hit 100%, and South Africa, where it topped 187%, representing the highest debt burden in the sample.

The turmoil led to significant tightening of economic policy

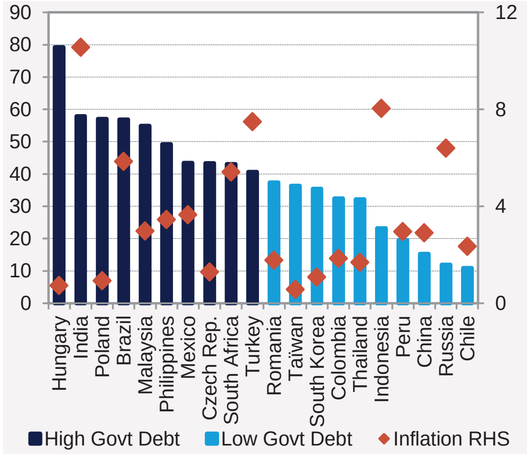
Last year's turmoil and the turmoil at the beginning of this year led to the general tightening of credit and financing conditions for emerging market economies. This tightening was at first external via the return of volatility to the emerging debt markets before becoming internal when the major central banks gradually opted for an inflation-targeting framework. At the prompting of Raghuram Rajan, the Indian Central Bank was the first to make the leap. Russia's Central Bank followed suit before the Central Bank of Turkey gave in to market pressures in late January. Besides this return to monetary orthodoxy, most major economies strengthened their budgetary discipline.

The emerging market economies, by opoting for a strategy designed to promote orthodoxy and, for most of them, structural reforms, took back control of the tightening process, which explains why the markets stabilised in late January. This return to orthodoxy has led to pronounced differences among emerging economies, which we predicted in our 2014 scenario as a recovery in domestic macroeconomic variables.

Shifts in the emerging country typology after 2013's bond market volatility

What was the impact of turmoil on the typology? In broad terms, the typology that emerged in Q1 2013 was mainly based on a division between economies with gross savings (China and its economic partners), India, the Philippines, Colombia and Peru and countries with low, or even declining, gross savings. Post-crisis, we see some consistency in the classifications (the systematic part) such as the stability of the Chinese bloc (the first group) and some migration. Most of these changes concern European economies (Poland, Romania and Hungary), Latin America's commodity-exporting economies (Peru and Colombia) and, last, India. Three blocs have emerged. The first block is comprised of economies with low savings (on average 20% of GDP), low inflation –with the notable exception of India–, structural deficits (current account around -1% of GDP), a high debt burden (between 45% and 80% of GDP) and little in the way of foreign exchange reserves. This bloc is made up of Mexico, a few European economies (Czech

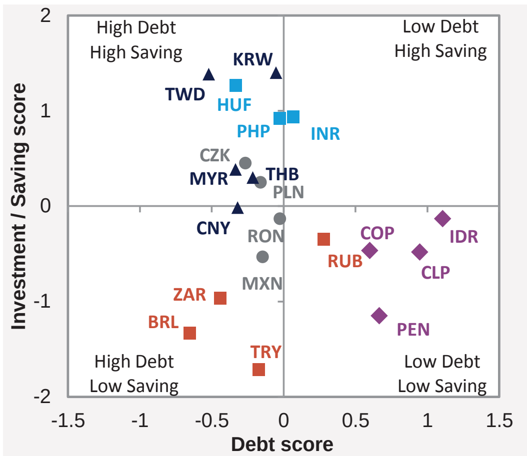
4 Government debt (% of GDP) vs. inflation in Q4 2013



Source: Datastream, Amundi Research

> Following the market turmoil, three major blocs of countries emerged: economies running a structural deficit, China and its economic partners, and vulnerable economies

5 Debt vs. I/S scores in Q4 2013



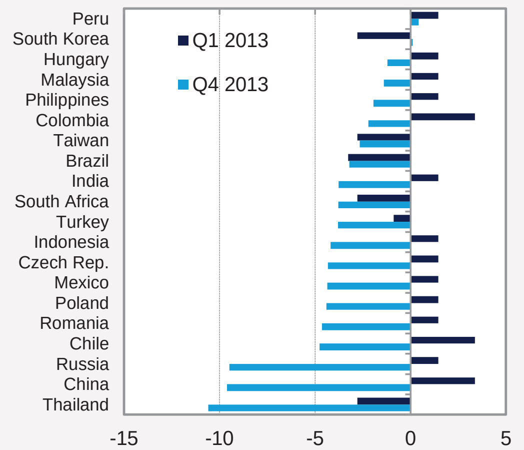
Source: Datastream, Amundi Research

Republic, Poland, Romania and Hungary) and two Asian economies, India and the Philippines. Apart from the two Asian economies, these economies are funded mainly with foreign exchange reserves. China and its economic partners form the second bloc. The economies in this bloc run a structural surplus. The third bloc includes economies running a deficit whose current accounts are gradually deteriorating. Savings in these economies continues to fall due to growing deficits. This bloc is further subdivided into economies with a low public debt burden (between 20% and 30% of GDP): Colombia, Peru, Chile and Indonesia, and those with a higher public debt burden (between 45% and 55% of GDP): South Africa, Turkey,Brazil and Russia.

To conclude, a typology of permanencies

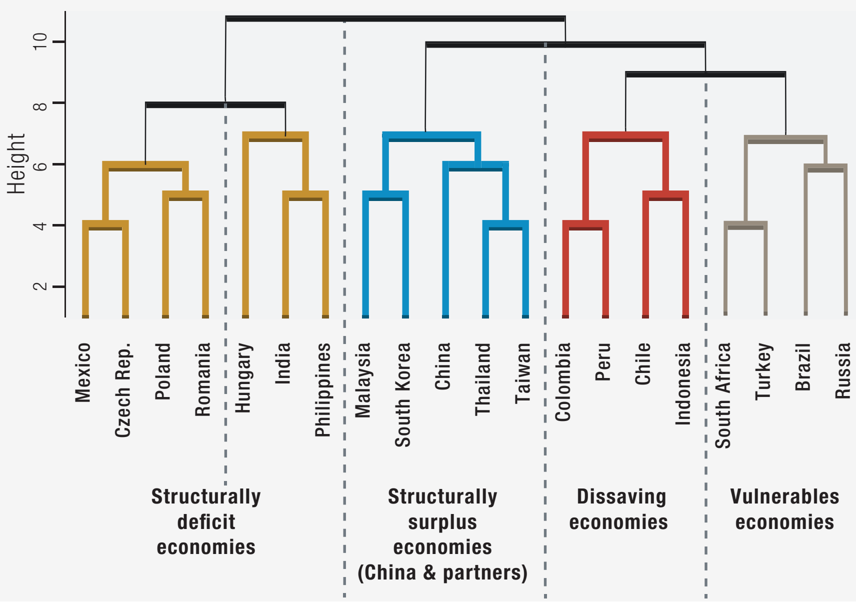
It is clear that our approach, based on a statistical classification of fundamental country characteristics, will, over time, exhibit migration, which can be understood as the dissolution and re-formation of clusters. The benefit of our method resides in the identification of clusters with more stability, which we refer to as permanency. Paradoxically, our choice to favour score readability over more granularity means that there is likely more information in the dissimilarities of their characteristics than in their similarities. A gulf is forming between economies running structural surpluses, those running structural deficits and economies that need to reel in domestic demand. For the first group, the challenge is to implement structural reforms designed to stabilise the deficits. For the second group, notably China, the challenge is to increase domestic consumption, which is equivalent to reducing savings. Lastly, for the most vulnerable economies, the challenge is mainly to cool down domestic demand, which, in the medium term, is unsustainable.

6 Public deficit (% of GDP): Q1 vs. Q4 2013



Source: Datastream, Amundi Research

Dendrogram in Q4 2013



7 Euro corporate bonds: favourable credit fundamentals

VALENTINE AINOUZ, *Strategy and Economic Research – Paris*

Over the last few quarters, Euro IG bonds have been delivering strong returns. Since the beginning of the year, they have returned a total of 4.2% and have outperformed core European government bonds by more than 1.4%. It is reasonable to wonder whether current valuation matches corporate fundamentals. Are fundamentals really a decisive factor in the performance of corporate bonds?

No strong recovery in corporate investment

Across the board, non-financial corporations in Europe are reporting that their fundamentals are improving in terms of credit:

- Companies were able to reduce their debt ratios in 2013 thanks to slowing debt growth. But unlike US corporations, they did not see earnings growth. As expected, investment spending fell considerably. Euro IG issuers still face an uncertain economic future. As a result, they are continuing to pursue a strategy of cash flow preservation, maintaining high cash balances on their balance sheets.
- Issuers are taking advantage of the historically low rate environment and strong investor appetite to extend the maturity of their debt and reduce their funding costs. In March nearly 20% of all issues had maturities ranging from 10 to 15 years. The effective duration of the Euro IG Index is now 4.6 years, compared with 3.9 years at the beginning of 2012.

However, corporations in the peripheral countries carry more debt than their counterparts in the core countries of the eurozone. Their strong dependence on the domestic market limits their ability to deleverage via earnings. In passing, it is worth noting that the utilities and telecom sectors account for 68% of the outstanding debt of peripheral non-financial businesses.

We do not foresee any strong recovery in corporate investment in 2014, particularly in the peripheral countries. Non-financial issuers are only at the beginning of a new debt accumulation cycle. Issuers' financial profiles should remain favourable to bondholders this year.

M&A makes a comeback

The mergers and acquisitions market is beginning to regain momentum in Europe after two years of relative calm. The total value of M&A transactions since the beginning of the year has reached $563bn, which is double the amount seen during the same period last year. Among the largest transactions were: SFR/Numericable (telecoms), Lafarge/Holcim (cement, concrete, etc.), Sopra/Steria and Alstom. This trend will not be reversing any time soon. The environment is favourable:

- Corporate balance sheets remain healthy. They have considerable cash assets.
- Interest rates and prices remain attractive.
- External growth is a good way to revive sales in a slow growth environment.

The impact of mergers on corporate fundamentals is uneven. It has to be assessed on a case-by-case basis and depends on the funding arrangements used and the defensive or offensive tilt of the transaction: defensive M&As are intended to consolidate the company's business model (as in the case of Holcim). In contrast, offensive M&As are meant to satisfy shareholders and they are often unfavourable to bondholders.

Banking fundamentals are improving

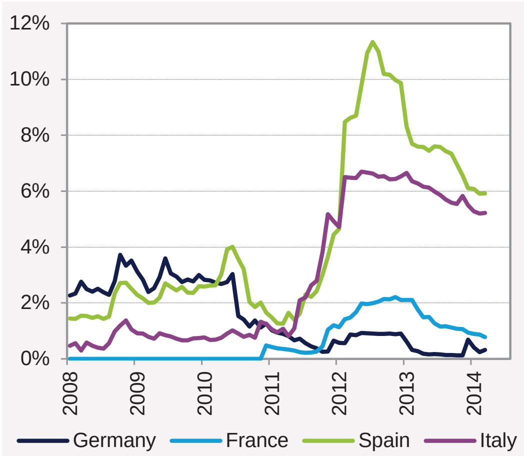
European financial system fundamentals have unquestionably improved over the last few quarters. The financial vulnerability of peripheral banks has been substantially reduced:

The essential

Over the last few quarters, Euro IG bonds have been delivering strong returns. Credit fundamentals are expected to remain favourable for bondholders in 2014 without improving significantly. Non-financial issuers are only at the beginning of the debt re-accumulation cycle.

Non-financial issuers were able to deleverage in 2013 mainly though lower debt growth and a sharp reduction in investment spending. Renewed M&A activity is having very little impact on the credit quality of Euro IG issuers. Financing conditions have considerably improved for peripheral banks. Banks need to remain vigilant to protect the quality of their assets under the pressure of the AQR. However, it should be noted that the amount of non-performing loans on the balance sheets of Italian and Spanish banks is still high and their exposure to domestic sovereign debt is rising steadily. The link between sovereign risk and banking risk shows no signs of unravelling. The changes to fundamentals and position in the credit cycle make it possible to predict the performance of bonded debt. But we are not there yet. Asset performance is now determined by technical factors and monetary policy initiatives.

1 Reliance on ECB financing: LTRO and MRO as a % of total assets



Source: Bloomberg, Amundi Research

- Private and corporate deposits with credit institutions have stabilised thanks to easing financial market stress.
- Today the banks are having less trouble getting funding from the bond market. The search for returns has led to a significant narrowing of peripheral debt spreads, which are now back at the levels they reached prior to the Lehman Brothers bankruptcy. The yield premium demanded compared to core debt has fallen substantially. Keen investor appetite has also prompted banks to issue subordinated debt. Issuers now favour this debt segment in order to strengthen their balance sheets.

However, Italian and Spanish banks are still dependent on the ECB for funding. To stave off the risk of bank failures, the ECB carried out two loan operations (LTROs or Longer-Term Refinancing Operations) with a maturity of 36 months and an interest rate of 1%: one in December 2011 and the other in February 2012. The total amount lent was €1 trillion. This dependence can still be seen today.

On the assets side, the situation is stabilising slowly.

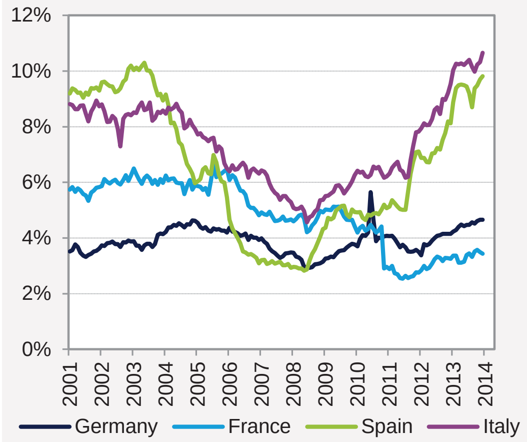
- The amount of non-performing loans is not increasing any further thanks to the modest improvement in economic activity. However, the rate of NPL is still very high in Italy and in Spain (13% and 10%, respectively).
- The amount of sovereign debt held by peripheral banks is still increasing. Investors hungry for yield have increased demand for Italian and Spanish debt issues since the beginning of the year. Italian and Spanish 10-year yields have settled at 2.8% and 2.9%, respectively, their lowest ever. Sovereign debt held by banks remains substantial. The link between sovereign risk and banking risk shows no signs of unravelling.

The ECB's Asset Quality Review, a prerequisite for the establishment of the Single Supervisory Mechanism, will require banks to crystallise non-performing loans in their financial statements and to recapitalise. The fundamentals of financial institutions are expected to continue to improve this year.

The changes to fundamentals and position in the credit cycle make it possible to predict the performance of bonded debt. But we are not there yet. Central banks are delivering an environment of low interest rates and abundant liquidity. Against this background, investors are seeking yield at all costs, which has led to irrational pricing. This situation can be expected to last indefinitely, particularly in Europe. In light of the new non-conventional measures we are expecting from the ECB, it is our view that corporate fundamentals will not dictate the performance of corporate bonds this year.

> "NPLs stabilise"

2 Holding of securities - General government debt (as a % of total assets)



Source: Bloomberg, Amundi Research

> "Technical factors guide the markets"

8 The balance of EUR corporate bond demand and supply: current trends and likely developments for the rest of 2014

SERGIO BERTONCINI, *Strategy and Economic Research – Milan*

IG and HY: different balances of power between demand and supply

Technicals are very much a story of demand-supply balance: no doubts this is true for corporate bonds, too. However, some important differences arise between high grade and high yield bonds when corresponding primary markets are considered. The demand for high quality or investment grade bonds tends to be much more stable in time than the demand for high yield bonds. This, for many reasons but mainly because high grade bonds have a broader and more steady investors' base as they represent a closer alternative to government bonds risk reward profile. Furthermore, they rely on a bigger debt size and offer wider sector/issuer diversification than speculative grade bonds. At the same time, temporary spikes in risk aversion may rapidly affect available potential funding at disposals of speculative grade issuers. Contrary to its older US counterparty, the EUR HY bond market has only evolved into a real asset class in the last five years: since 2009 its size has grown fourfold in outstanding debt terms and three times in terms of issue number while the active issuers actually doubled over the same period. The number and AUM size of funds dedicated to EUR HY bonds, as well, evolved in line with this trend. In such circumstances, this evolutionary growth of institutional investors' base should favour less volatile trends in future demand for this asset class. Thus, just to make it very simple without running the risk of being trivial, while there is (almost) always demand for IG corporate bond paper, this is not given in the case of speculative grade bonds. In addressing the demand supply balance this concept is important, as we wouldn't be probably wrong saying that the demand leads supply in the HY bond market and not vice versa as for the IG corporate bonds.

Record flows into funds dedicated to European HY bond funds…

A look at investment flows published by EPFR on funds and ETFs dedicated to EUR HY bonds shows to what extent the search for yield has led to a structural upward shift in demand for the asset class. Just to give an idea, an equivalent of USD 9 net bn net investment flow had moved into it in 2013, while in the first four months of 2014 a USD 7 bn equivalent has already been collected by dedicated investors. The first reported graph shows these flows on a monthly basis since 2009, giving a visual perception of the extent of this new shift since H2-2013. After the outflow suffered in July last year, following "QE tapering" Bernanke announcements, flows returned strongly and steadily. These figures, furthermore, probably underestimate more than in the case of IG bonds, the real demand for HY bonds. Many buy & hold and target-dated funds have been launched recently with a component of HY bonds: at the same time, the search for yield led to the growth of balanced and flexible products which ultimately invest, though partly though funds, into the asset class. Among dedicated products, finally, short-term HY bond funds had a growing success, as they combine a still attractive yield carry relative to available fixed-income alternatives with low duration risk.

…Ultimately spurring a bond issuance which looks extraordinary by historical standards

As we move on from the demand to the supply side let's focus on the second graph reported: the latter exactly corresponds to the first in terms of covered period and is based as well on monthly data. Summarizing main trends just through few data means citing the following numbers: in first four months of 2014 a cumulated supply of USD equivalent 60 bn was placed in EUR HY primary market, representing two thirds of last year overall USD equivalent 90 bn, an absolute historical record for EUR speculative grade bonds. Another way to underline this powerful trend is to consider that 2011 and 2012 overall issuance has already been matched in 2014. The graph shows to what extent European companies profited also from USD

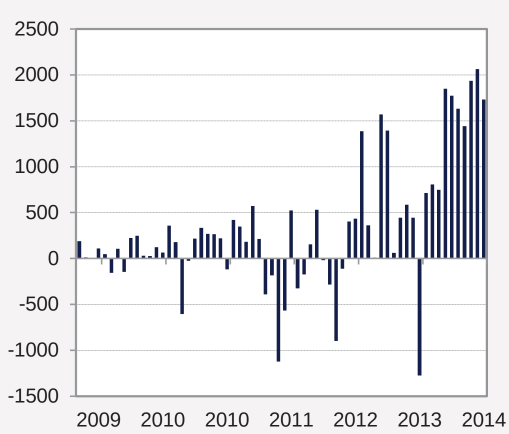
The essential

Record flows into funds dedicated to European speculative grade bonds ultimately spurred a bond issuance which looks extraordinary by historical standards, though this record issuance was partly denominated in US$ and GBP.

As ECB is likely to implement more easing and rates are going to be low for a prolonged period of time strong technical should continue to favor HY bonds. On the IG side and contrary to the last three years net issuance volumes, though slightly negative, remained quite stable so far year to date, as financials were more active after three years of strong balance sheet de-leverage. A sort of rebalancing between supply trends of financials and non-financials will probably accelerate looking forward. The return to a less negative IG net supply or to a positive net issuance looking forward is mainly the expression of a recovering macro and micro cycle and better funding conditions. Under this respect the return of supply seems to be compensated by improving fundamentals and therefore should not weigh too much negatively on credit valuations.

> "The demand leads supply in the HY bond market"

1 Record inflows into funds dedicated to EUR HY bond



Source: Bloomberg, Amundi Research

primary market capability: around half overall issuance of last April record volume, for example, was dollar denominated and this was the case also in some of previous months. Periphery names contributed as well to the rising supply of European HY bonds, as the recovery in periphery government bond spreads led a strong demand for corporate bonds too. Then more recently, the return of M&A activity has been another factor supporting not only this extraordinary growth in HY bonds but also a recovery of the European leverage loans market.

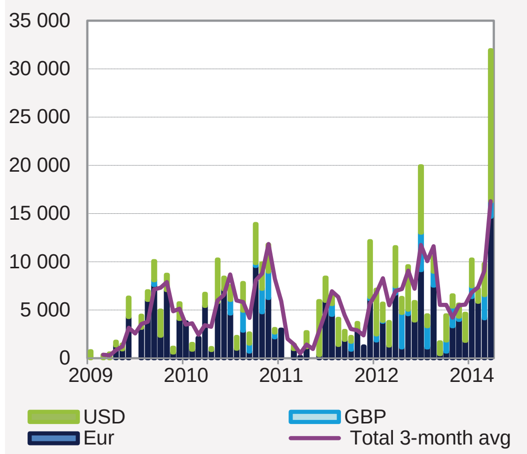
What about EUR IG corporate bonds supply and investment flows?

A look at the third reported graph immediately gives us the perception that the EUR IG primary market looks to experiment a turning phase with respect to the recent past. Contrary to the last three years, in fact, net issuance volumes, though slightly negative, remained quite stable so far year to date. In both 2012 and 2013 April had already delivered a EUR -80 bn cumulated net issuance of combined industrial and financial names, through a steady monthly downward trend. The return of financials to bond funding after three years of balance sheet de-leverage is the main driver of bottoming supply trend in EUR IG bonds, as industrials always contributed positively to net issuance over the last years and they are continuing to do so in 2014.Furthermore, another supportive factor was the return in size of periphery financials in the primary market: this change made possible by improved funding conditions looks coherent with LTROs pay-back and lower reliance on ECB. These figures show that a turning point seems to be close as the worst of de-leverage is behind us and ECB AQR probably accelerated the process. The coming months should therefore see a further re-balancing between the opposite contribution given so far from financial issuers and non-financial issuers, leading to a less negative supply of EUR IG bonds and finally to a return to positive net figures. A re-balancing is therefore likely to take place between EUR and US$ high grade corporate bond supply over the next quarters, as the gap between the two cycles should start to compress. Numbers about overall issuance do not tell the whole story: low quality (BBBs), high duration bonds returned in size: they were and are still favored by investors as the search for yield strengthened in the Eurozone. On the flows side, trends reported by EPFR show that last summer announcements by the Fed triggered a sort of switch from funds dedicated to mid-long duration segments into funds buyers of short term IG paper only. This came from the perceived need to reduce duration risks in bond portfolios at a time when yields were rising. The strong spread tightening delivered by short-term corporate bonds in the following months, especially by periphery names, steepened credit curves and led to a partial return of investors to mid and long term segments of the credit market, as supply trends confirmed. In light of recent signals from the ECB on more and prolonged monetary easing the search for yield is not likely to abate soon, ultimately supporting yield search also through low rated high grade bonds and therefore boding well for investment flows, too. At the same time, the search for yield is likely to continue support the switch from IG into HY bonds in terms of marginal flows.

Perspective trends and conclusions

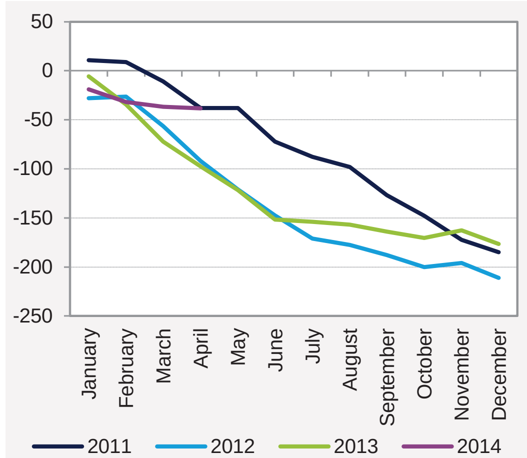
In our outlook for 2014 we forecasted net issuance of EUR IG to remain negative on a net basis but to a lower extent versus previous years, as the worst of the deleveraging in financial system, the main reason behind this, was probably behind us. A sort of rebalancing between supply trends of financials and non-financials is already taking place and will probably accelerate looking forward, confirming trends already delivered year to date. Negative supply has positively contributed to IG spread tightening experimented over the last quarters: the return to a less negative net supply or to a positive net issuance looking forward is mainly the expression of a recovering macro and micro cycle and better funding conditions. In such case, the return of supply seems to be compensated by improving fundamentals and therefore should not weigh too much negatively on credit valuations. Furthermore, pockets of value remain present in IG world among BBB issues and subordinated financial debt. At the same time, ECB likely to move towards more rather than less easing and short-term rates destined to be stable at very low levels for a prolonged period of time favor a continuation of current strong technical for high yield bonds, though valuations look less and less attractive versus past years.

2 European Speculative Grade companies: new issuance by currency (in mm)



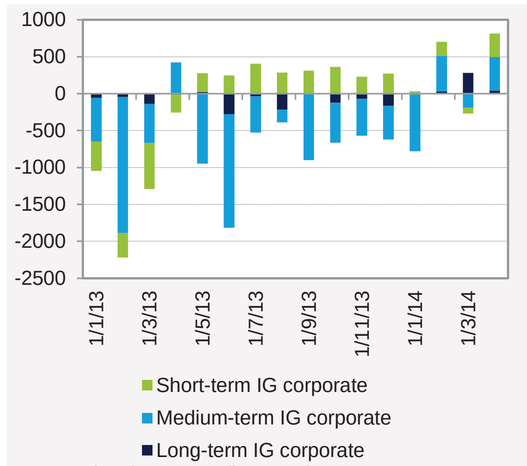
Source: Bloomberg, Amundi Research

3 Eur IG cumulated net issuance (in Eur bn)



Source: Bloomberg, Amundi Research

4 Flows into EUR IG corporate funds, by type of duration, in EUR mm



Source: Bloomberg, Amundi Research

9 An assessment of cross-country valuation dispersion in euro area equity markets

DELPHINE GEORGES, *Strategy and Economic Research – Paris*

Two years after the ECB's change of strategy, the level of fragmentation within the eurozone's equity markets has eased considerably. The substantial valuation differences that emerged between countries during the height of the crisis have narrowed significantly. Nevertheless, we are still a long way from the high level of integration that prevailed up until 2010. Specific risk premiums persist on peripheral country equity markets, linked to the weakness of their economies.

Measuring the segmentation of the euro zone equity markets and the country effect

It's not easy to assess the direct impact of the debt crisis on the equities of the different countries. Country indices have much different sectoral structures, which must be taken into account when analysing the performance and valuation differences between them. Listed companies are multinationals that generate an average of nearly 40% of their revenue outside the euro zone.

We used a robust measurement of the dispersion of valuations between the countries and thus of the segmentation of the euro zone equities market in response to the debt crisis. This gives us an instant measurement of investors' perception of the situation in the euro zone.

We descended to sector level to see the valuation multiples[1] of the different industries (38) within each eurozone country. In an economically and financially integrated zone, the valuation differences between industries in each country must be low and stable over time. In fact, the two key equity valuation determinants, the earnings or dividend growth (g) and the discount rate (r), must converge for a given industry regardless of the geographical area in which it is located.

In an economically integrated area a company's growth potential does not depend on the country in which it is located but rather on the growth opportunities for the industry in the area concerned. The same goes for the cost of equity which determines the discount rate. It requires a common risk-free rate (all the more so in an area of monetary union), a common equity market risk premium and the beta of the industry in question (a function of factors such as cyclicality, sensitivity to commodities, etc.). For each country, we then measure the extent of divergence from the equilibrium situation. This divergence represents the country effect valuation. By aggregating these country effects we get a measurement of the market segmentation. Before the crisis, the low and stable divergence in valuation of industries across euro area countries reflected a strong degree of market integration[2].

Sharp narrowing of valuation differences but not yet normalisation

The debt crisis caused a spike in valuation dispersion, with level of heterogeneity similar to the period preceding the introduction of the euro. Since July 2012, there has been a strong convergence but no return to pre-crisis levels. Naturally there are still higher risk premiums in Spain and Italy (see Charts 1 and 2) linked to their weak economies and significant uncertainty regarding the macroeconomic outlook. As seen on the graph, the earnings yield is currently on average 4% higher for spanish and italian idustries compared to the rest of the euro area.

Two factors underpin the decline in peripheral countries' risk premiums over the last two years:

1. the reduction in differences in financing costs with the convergence of interest rates,

1 We use a cyclically adjusted price_earnings ratio to eliminate the valuation differential that could result from a difference in economic cycle positioning.

2 Cf Bekaert ,G., Harvey C. R, Lundblad, C.T.and Siegel, S., "What segments equity markets", Review of Financial Studies, Vol 24, No 12, October 2011.

The essential

Two years after the ECB's change of strategy, the level of fragmentation within the eurozone's equity markets has eased considerably.

The substantial valuation differences that emerged between countries during the height of the crisis have narrowed significantly. Nevertheless, we are still a long way from the high level of integration that prevailed up until 2010. Certain risk premiums persist on peripheral country equity markets.

"Sharp narrowing of equity valuation differences between the eurozone countries"

1 Differential of valuation attributed to the country effect in Spain

Source: Datastream, Amundi Research

2. the improvement in the economic outlook thanks to structural reforms and more reassuring macroeconomic data.

Questions remain concerning the longer term, with persistently weak investment potentially leading to weaker productivity gains for the companies located in peripheral countries. There is also the risk of higher corporate taxation to reduce public deficits.

The cost of equity in peripheral countries is again converging towards that of the core countries. But normalisation can only be achieved when the high convergence levels that prevailed before the crisis have returned. On the sovereign debt markets, substantially heterogeneous interest rates between the different countries is preferable to the pre-crisis situation of low dispersion so as to reflect differences in economic and fiscal outlook across countries and is compatible with financial integration. On the other hand, the equilibrium on the equity markets is similar to that which prevailed before the crisis, of low dispersion, where industry valuations are the same accross countries. In its last annual financial market integration review, the ECB stressed the need to pursue integration of the equity and bond markets in the euro zone to provide companies with a broader choice of financing. To combat the structural persistence of a "home bias" on these markets, it recommends, among other things, the promotion of greater harmonisation of corporation tax and corporate governance within the eurozone.

2 **Differential of valuation attributed to the country effect in Italy**

Source: Datastream, Amundi Research

3 Cf. Financial integration in Europe, April 2014, European Central Bank

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