Confidence must be earned

Amundi ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY

CIO VIEWS

STAY ON COURSE, DESPITE LOOMING NOISE

THIS MONTH'S TOPIC

WHERE WILL THE NEXT FINANCIAL CRISIS COME FROM? ARE WE READY TO CONFRONT IT?

RESEARCH STRATEGY & ANALYSIS

CIO VIEWS

Stay on course, despite looming noise

PASCAL BLANQUÉ, Group Chief Investment Officer
VINCENT MORTIER, Deputy Group Chief Investment Officer

While still benefitting from a global synchronised growth outlook (likely peaking), financial markets are getting nervous, experiencing the fatigue of a more mature phase with new sources of volatility arising. For the future, it will be key to anticipate **how the exit of Central Banks (CB) from unconventional policies will unfold, while talks about protectionist policies start to intensity and we enter a phase of "slowing economic acceleration",** with growth above potential in most Developed Markets (DM), but decelerating in 2019.

President Trump has recently signed tariffs into law in an effort to boost the competitiveness of US producers, reduce the widening US trade deficit, and, ultimately, reinforce his nationalistic political support. **At this stage, we do not expect to see a full-blown trade war, despite some recent escalation with China.** However, **this is emerging as a new source of volatility just when liquidity is diminishing and financial conditions are expected to tighten.** Consequences of protectionist threats could be far-reaching if the disputes spread further: the potential for retaliation and that more industries are targeted could undermine confidence and investment decisions. This could end up threatening the benign growth scenario in a kind of *stagflationary* environment, further adding to CBs' conundrum: wait longer before going ahead with the removal of monetary stimulus (especially the ECB and the BoJ) or react more aggressively (the Fed) to supply side inflationary pressures, which could be exacerbated by the tight labour market conditions. The US February labour report highlights that the slack in the labour market is shrinking, and shows a particularly resilient goods producing sector in terms of payroll creation. Hence, the Fed would likely progress with rate hikes in an effort to cool down cyclical price pressures. On inflation, however, we don't see a structural change yet, as the response of wages to a tighter labour market still appears to be very limited (flat Phillips curve).

With this backdrop, **our view is that investment opportunities will be in the relative value space**, due to: the decoupling (different monetary policy stances) between the Fed, on the one hand, and the ECB and BoJ, on the other; different stages of the economic cycle for different countries; and sensitivity to external factors.

In **fixed income**, **we continue to see global upside pressure on rates**, though with different adjustment speeds. In terms of investment strategy**, we advocate broadening sources of diversification in different directions**: adopting a global approach, which combines multiple alpha[1] strategies, and a more diversified approach within the credit market. **On the equity side, earnings should continue to be the real driver of returns.** The outlook is still constructive here. However, in the medium term, it is crucial to assess the scope of a structural upward revision of the trend for earnings to assess the potential of further market upside, or on the other side, the risk of a "boom and bust scenario", like in the 1990s. In Europe, we expect earnings to grow at a trend of around 6% (slightly higher for cyclical sectors). In the US, we see forces at work that could potentially lead to structurally higher earnings per share (EPS), including the consequences of President Trump's fiscal policies (ie, infrastructure and capex revival). However, to label this a structural revision, in our view, we would also need an acceleration in productivity growth and we are still cautious on this. Hence, we expect an extension of the current earnings cycle, but we currently see it as more cyclical than structural. On equities, as volatility is trending higher, defensives may be back in focus, but it's probably too early to see a massive rotation towards defensive sectors.

All in all, we believe it is key to maintain an active investment approach, with a strong focus on both stock selection and sector allocation. As there are still clear **risks of a new market correction** (new sources of volatility, no rotation of style/sector yet, and valuation not particularly compelling), **hedging strategies remain paramount.**

[1] *Alpha: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.*

High Conviction Ideas

MULTI-ASSET

Increased tensions on the trade side and signs of peaking macro momentum call for enhancing diversification, ie, trimming risk in the European and Japan equity exposure while increasing the preference for US equities. The US market should still benefit from strong economic growth and the extension of the cycle thanks to fiscal policy. We keep our positive view on risky assets, as fundamentals are still supportive, but structural hedges remain crucial in this complex transition period towards a more mature market phase.

FIXED INCOME

With upward pressure on interest rates to continue, it seems appropriate to stay short duration based on fundamentals and, in Europe, on valuations as well. We are still constructive in credit on fundamental grounds, advocating a more cautious approach going forward; we believe the carry remains a protective element. Broadening the sources of returns and limiting concentration risk are crucial in this environment. In this regard, we favour securitised assets in the US, and exploit opportunities across the credit continuum in Europe.

EQUITIES

Investors are in the process of adjusting to a structurally higher level of volatility. EPS growth is still healthy globally, so the fundamental picture has not changed materially, but concerns about peaking momentum and potential escalation towards a trade war are elements to watch. Going forward, we expect that the market will be more selective at the sector/stock levels.

REAL ASSETS

With high valuations in public markets and low/rising interest rates, investor allocation to private equity markets has surged and will likely remain strong: we believe that private equity is well positioned to provide good absolute returns and portfolio diversification. In our view, adopting new differentiated strategies will be important to finding hidden champions and succeeding in a competitive landscape.

MACRO

Global economic expansion not in danger, unless...

PHILIPPE ITHURBIDE, Global Head of Research
DIDIER BOROWSKI, Head of Macroeconomic Research
MONICA DEFEND, Head of Strategy, Deputy Head of Research

The rise in protectionist tensions, the drop in some surveys, and the publication of some disappointing data have raised doubts regarding the global economic cycle. **We believe this fear is premature.**

Synchronisation of global growth: is this the end?

No, economies are quite differently positioned in this cycle and most economies remain primarily driven by domestic demand. **In the Eurozone**, it's true that several surveys have shown declines in the recent period and that «economic surprises» have been seen to appear in negative territory. But, we note that the survey data had soared in previous months (for some at their highest levels since the launch of the euro), and when expectations are high, it is not surprising to be «disappointed» by some numbers. At the end of the day, our leading indicators continue to point to strong GDP growth in 2018 at twice the potential of the Eurozone for the second year in a row. **In the UK**, the agreement regarding Brexit reached with the EU over a transitional period until the end of 2020 could bring new life to the economy. **In the US**, growth in Q1 is likely to be weaker than expected (see estimates from the Atlanta Fed or NY Fed), but surveys remain solid and growth should be stimulated by tax cuts and the increase in public spending. **In Japan**, the recovery continues at a moderate pace, supported notably by business investment. Finally, **in emerging economies**, growth appears to be stabilising at around 5% on average. At the end of the day, **global expansion is not at risk but the pace of growth may slow.**

Can global trade fall?

No, we think it is very unlikely. It is clear that regarding the Trump administration's tariffs, we are already starting to see some retaliatory measures from China, with more potentially on the way. However, to the extent that targeted products represent a small share of world trade, this should not have a significant impact (as retaliation is also likely to be modest).In the meantime, the White House is postponing the start of the fight. Canada and Mexico have been exempted, as have EU countries (in extremis). Finally, it should be noted that the US is very isolated: no country wishes to enter into a wider trade war.

> **"While we do not think that current actions on tariffs will undermine the global trade potential, these are certainly becoming a source of uncertainty that could dampen investors' confidence."**

Is inflation likely to accelerate?

Yes, but at a gentle pace, and more in the US than in the Eurozone. In emerging countries, inflation remains largely under control. With the gradual removal of global excess capacity, it is natural to expect a rise in cyclical inflation and wage pressures, especially in the most advanced countries in the cycle (eg, the US). However, we observe that «a-cyclical inflation» has considerably slowed in recent decades: as a result, we expect the prices of many goods and services to remain under pressure even if growth accelerates (effect of globalisation, Amazon effect, etc).

Are central banks likely to accelerate monetary policy normalisation?

No, they will likely stick to their gradual approaches. Their communication remains very cautious. By revising upward (from two to three) the number of rate hikes expected in 2019 (the "dots"), and expecting two more in 2020, the FOMC sought to reassure observers concerning the continuation of the cycle in the coming two years while avoiding increasing market tensions in the short term. The tone of the ECB communication remains, for its part, particularly accommodative. The end of the Asset Purchases Program (APP) is conditional on the rise in core inflation. And, the ECB has said it intends to maintain its strong «forward guidance» on interest rates, which will only increase «well after» the end of the APP. In the end, despite recent turmoil (political or financial), global growth remains firmly anchored. The slowdown expected next year, mainly in advanced economies, is not the prelude to a reversal of the cycle. It would take a big financial shock, in particular in the bond markets, to change

The Strategist view

US fiscal and trade policy in the spotlight

US debt

- Increased deficit projections in the budget pose questions on how the funding needs are going to evolve over the next few years. The Tax Cuts and Jobs Act (TCJA) reform approved last year would increase the net issuance of long-term Treasury bonds (LT) to about US$649bln in 2018 and US$867bln in 2019. Such figures would have to be increased with the inclusion of the Budget Act Effect and the infrastructure plan effects on the deficit, if enacted as well. LT net issuance would go up to US$724bln in 2018 and US$1022bln in 2019.
- The US curve has historically steepened on increasing budget deficits, as the back end tends to price in a higher term premium. If the deficit were to materialise as per CBO (Congressional Budget Office) and TCJA projections, the budget deficit/GDP ratios would reach -3.36 % in 2018 and -4.45% in 2019, which could generate quite a substantial steepening.
- However, the increase in the deficit takes place in an unusual time of a late cycle phase while the Fed is normalising rates. The steepening effect could be mitigated, if not completely offset, by the sell-off of the front-end of the curve on top of markets pricing in additional tightening from the Fed.

US tariffs

- Since 1990s, US$ has lost value during each occasion when the US has adopted protectionist measures (Reagan vs Japan in 1983-84 and George W Bush with foreign steel in 2001-02).
- Tariffs talks are a source of uncertainty and can dampen investors' confidence.

MULTI-ASSET

Exploiting relative value opportunities

MATTEO GERMANO, Head of Multi-Asset

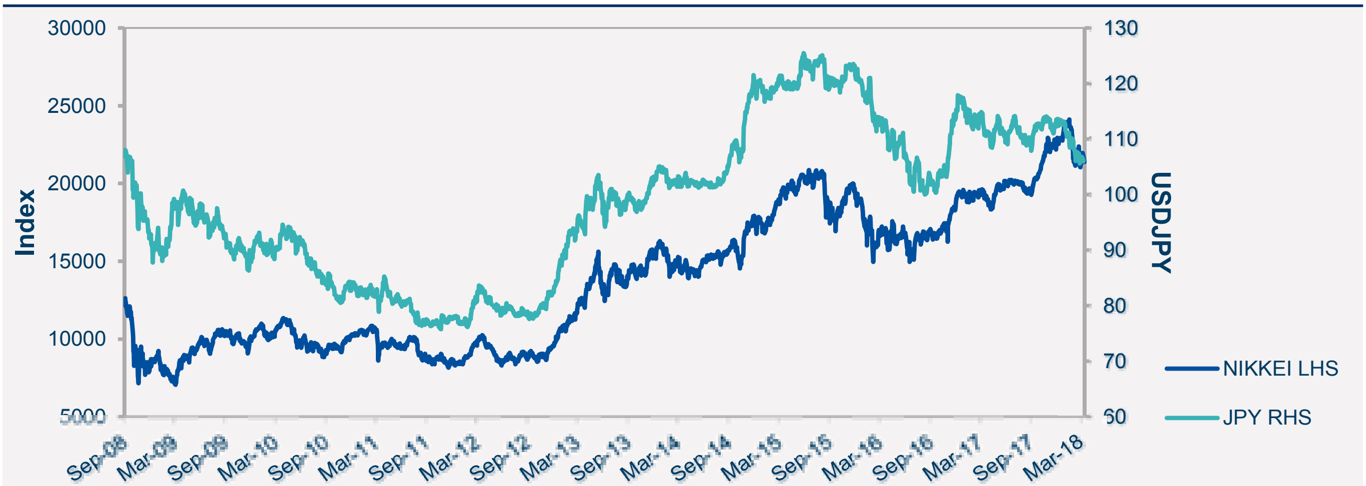
Our central case scenario remains one of synchronised recovery fueled by solid consumption and strengthening capex growth. GDP growth is expected to remain above potential in 2019 (in most countries), but will likely slightly decelerate from 2018 levels. We expect inflation to remain benign and not to force the major CBs to dramatically change course in terms of recalibrating their monetary policies. That said, downside risks have recently increased, mainly due to the recent protectionist measures announced by the US; these disputes could continue for a while. We do not expect an escalation into a full-blown trade war, but we will continue to closely monitor the evolution of political tensions. With these conflicting dynamics in place, we believe the best strategy to deal with uncertainty and deliver returns is to exploit relative value opportunities across all markets rather than directional positioning.

> "Facing new sources of volatility in the market, we think is it time to focus on enhancing diversification, trimming risks in the European and Japanese equity exposure, while increasing our preference for US equities."

High conviction ideas

We maintain our positive view on risky assets, as both macro and micro fundamentals are still supportive. However, increased tensions on the trade side and the potential deceleration in macro momentum point to enhancing diversification by reducing our European and Japanese equity exposure while increasing our preference for US equities (both at an overall market level and particularly in the US energy sector). The US market currently enjoys better macro momentum and an extension of the cycle, courtesy of the recent massive fiscal stimulus. On the other hand, the excessive strengthening of both the euro and the yen means we have a more cautious view on the European and Japanese markets. In equities, we maintain a relative value conservative focus on EM. We favour Russia (thanks to the positive oil price outlook) and Hong Kong Stock Exchange Hang Seng China vs the overall Emerging Market index (based on meaningful Chinese structural changes regarding exposure to financials with relatively cheap valuations and overall light investor positioning).

NIKKEI and the Yen



Source: Bloomberg, Amundi Research. Data as of 15 March 2018

In fixed income, we are still positive on European high grade corporates, which exhibited resilience during the recent February risk-off episode (mainly due to the ongoing Corporate Sector Purchasing Programme by the ECB). On the government bond side, we expect higher 10Y break-even rates (in Europe, the US and Japan), as our macro forecasts call for a gradual increase in pricing dynamics throughout this year. We're still expecting higher German yields along the curve in 2018. We see value in different curve plays -- in particular, in the US, where we expect some steepening in the 2-10Y segment. We think the curve is currently too flat for two reasons: more inflation risk premia should be discounted and the US fiscal deficit is set to increase as a result of the tax cuts and infrastructure plan. In the FX market, we continue to like the NOK vs the € and the NZ$ vs the A$. In EM, we like the Chinese renminbi vs the € and the US$. The renminbi is supported by positive fundamentals on the macro side, a broadly fair valuation, and positive technical conditions, such as positive carry and the possibility of attracting more flows on the back of benchmark inclusion of Chinese onshore bonds.

Risks and hedging

Given the possibility of further spikes in volatility, investors should seek to protect capital with efficient hedging strategies. Gold exposure, for example, could protect from geopolitical risks (with the risk indicator reaching the highest level since 2003): long yen positions vs the US$ and vs the A$ could also protect from tail risks. We are also conscious that credit market valuations are high and could be affected by further spikes in volatility and nominal rates; therefore, we believe investors should carefully manage credit and liquidity risk in the most speculative areas of the market.

FIXED INCOME

Diversify sources of return

ERIC BRARD, Head of Fixed Income
MAURO RATTO, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment Management

Overall assessment

The global economic outlook is consistent with less accommodative CBs and interest rates moving on an upward trend. We have revised our projected US GDP growth up to 2.9% in 2018, and we expect the global output gap to close this year, driving inflation cyclically higher. Historically, aggregate indices were able to offer diversification from equity through the duration channel and credit spread cushion. In the new market environment, high duration, low but rising interest rates, and tight credit spreads leave investors with very little protection. So, it is important to broaden sources of diversification in an effort to protect income and capital and achieve decent total returns.

DM government bonds

> **"Carry, relative value and FX strategies as well as diversification out of the traditional space, to extract value in bonds."**

We still favour a short duration bias on core govies (shorter in the Eurozone vs the US). The 10-year yield differential between the Treasury and Bund is very high, due to CB asynchronies. We expect it to close as the ECB starts to engineer the exit path from unconventional measures. Duration positioning should be short in Japan as well (the BoJ could lift the 10-year yield target, and the unwinding of negative interest rate policies should then follow) and in the UK (inflation pickup). Curve movements can also provide opportunties: a flattening of the Euro yield curve is likely, as the 5-30Y segment is too steep in core markets, and we could expect a repricing of the short end of the curve when the ECB becomes less dovish. On the short end of the US curve, we don't see particular value yet, but there is no reason to be too short due to current levels of rates. On peripheral bonds, we are still positive (Italy and Spain) as well as on inflation linkers in both the Eurozone and the US.

DM corporate bonds

Macro conditions and fundamentals are good, but valuations remain high. We are constructive on this asset class, but investors should consider strategies to reduce credit risk (short dated bonds, higher liquidity, and upgrades in quality). In the Eurozone, demand is high and the growth outlook supportive: we keep a positive view on subordinated bonds (financials and non-financials), where spreads are still attractive. In the US IG space, leverage is decreasing (although it is still high), sales are robust and capex is recovering. We prefer banking, insurance and energy. We believe that investors should consider other diversification strategies, such as securitised assets in the US or alternative credit stories in Europe.

EM bonds

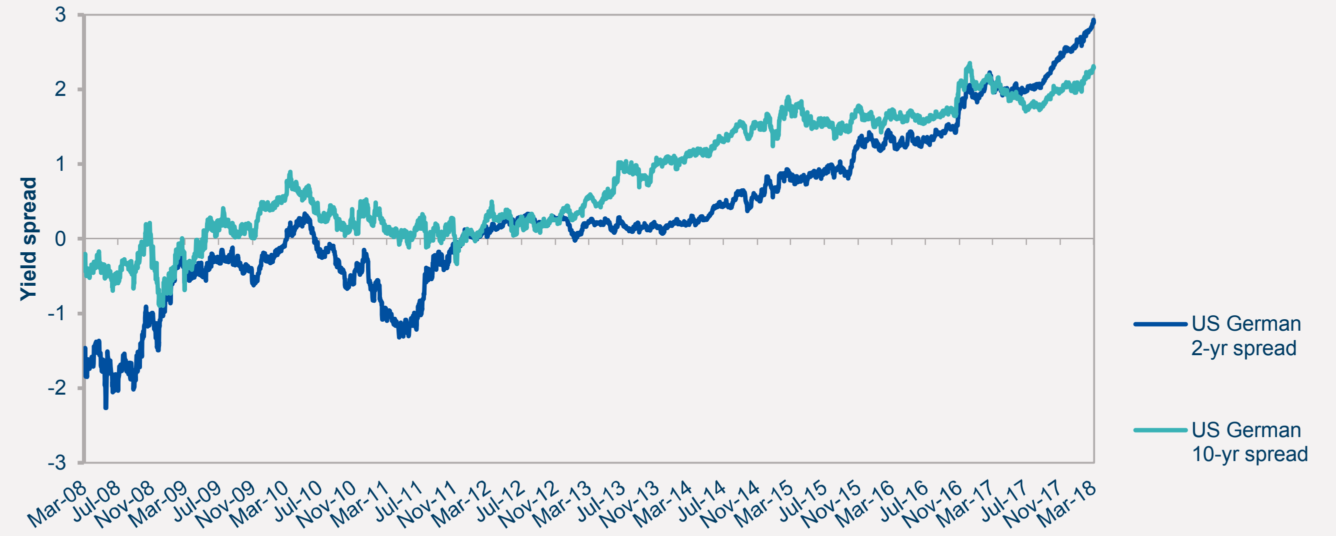
The US rate outlook will continue to drive risk sentiment globally in the next few months, but we see a relatively good resilience of EM debt to higher rates (modest spread widening). Economic fundamentals remain strong and many countries are at the earliest stages of the cycle (ie, Russia and Brazil). Reduced volatility for commodities and a weak dollar are also supportive for the outlook of EM currencies, even though the evolution on trade policy has to be carefully watched. We reiterate our view that there is little upside from spread compression and EM bonds remain a carry trade story for 2018. Short-term debt offers, in our view, a good risk/reward balance. Corporate debt is still favoured vs sovereign, thanks to the benign default outlook. At the country level, selection remains key: we look at Brazil (still good value with improving fundamentals), Russia (as oil play, plus improving domestic conditions), and Mexico, and are recently more constructive on South Africa, based on the changing political landscape. Hedging strategies (where spreads are too tight) can be considered at this stage to mitigate risk.

FX

Our 2018 target for the €/US$ is still at 1.25, with an upward bias towards the 1.25-1.30 range. We have a negative bias on UK sterling and the yen vs the euro and the US$ dollar.

Carry trade: A trading strategy that involves borrowing at a low interest rate and investing in an asset that provides a higher rate of return. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

US-Germany yield differential



Source: Amundi, Bloomberg. Data as of 23 March 2018.

EQUITY

Beyond the noise

DIEGO FRANZIN, Head of Equities
MAURO RATTO, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

Overall assessment

We are living now in a more volatile market phase. Factors behind it are switching from a fear of a rise in bond yields to a fear of peak momentum. Beyond the noise, the earnings outlook is still solid (no recession ahead) in our view, but positive economic surprises are needed for an imminent new lag of upside. Cyclicals are still outperforming defensives, with no major rotation of themes in the market yet.

> "Fundamentals have not changed. Things to watch are the pick-up of momentum and the evolution of trade talks."

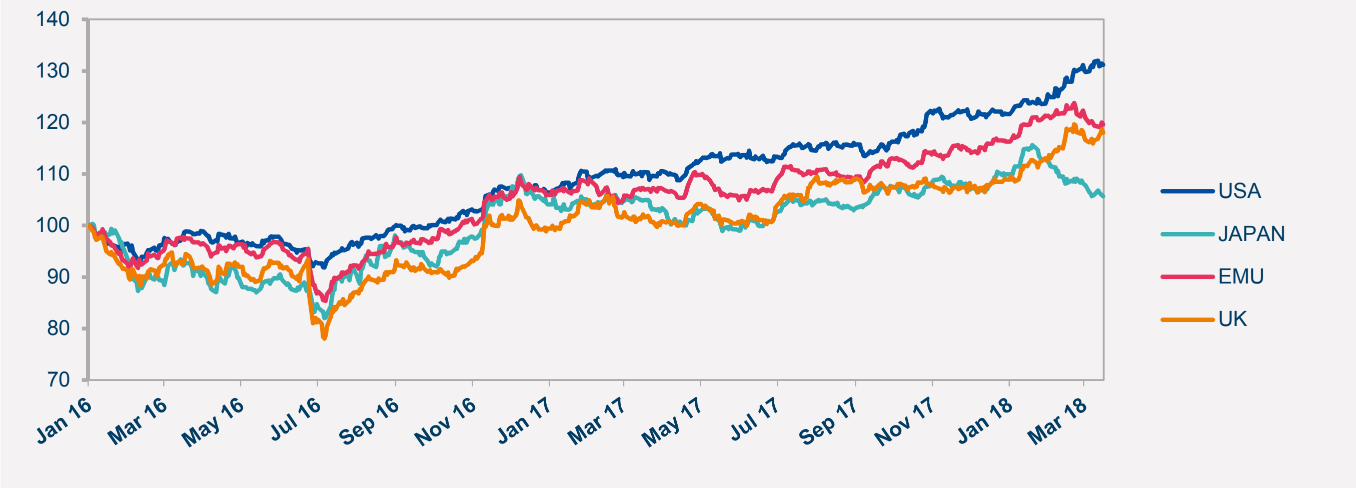
Europe

The market is in a broad trading range, with asymmetric price action during the earnings season (market over-penalising companies that did not meet targets and muted reaction for companies beating targets). This, we believe, is a sign of fatigue, where markets are getting nervous due to the current level of valuations. With divergent forces at play and elevated risk (trade talks, peaking momentum), a strong bottom-up focus is needed to identify companies more exposed to benign factors (domestic growth stories). We believe investors should play the market with a focus on energy, banks, insurance and with a short bias on real estate, telecom and utilities. In the search for cheap defensive stocks, consumer staples (food/retail) may be interesting, as some companies are discounting a too pessimistic outlook. Small and mid-caps, more domestic and less impacted by tariffs talks, can provide good opportunities to play the European growth story.

United States

Fundamentals remain relatively strong across the US market. As we move from the first part of the Trump agenda (lower taxes and less regulation) to the second (trade), the road is likely to be bumpier. Trade wars are

MSCI Cyclicals /defensives



Source: Datastream, Amundi Research. Data as of 15 March 2018. A reading above (below) 100 indicates a higher (lower) performance of MSCI Cyclicals versus MSCI Defensives

at best neutral to earnings, more likely somewhat negative, but never positive. Critical points to watch are raw materials price increases, competitive pressures, and trade policy as an offset to the tax reform windfall. Most companies have signaled confidence in the ability to get enough pricing power to offset raw materials costs and wage pressures. However, at the top of the agenda are logistics costs pressures: transportation costs are skyrocketing and some companies seem better positioned than others at managing logistics/ inventory. So, selection on this front will prove to be an important factor. In tech sector, cloud spending is the biggest tax reform beneficiary and should still support the mega cap outlook, even though these companies are not cheap in terms of valuation.
While software and services continue to compound, the profit acceleration in semiconductors is noticeable, as the market is still valuing the industry as a deep cyclical even though the broadening of its end-markets suggests a more stable business cycle. We note that the market is still according too much of a discount to banks just as their business models stabilise, rates go up and regulatory pressure lessens. Again, bottom-up will be key in 2018, as multiple themes will get traction in the market.

Emerging Markets

EM equities retain a sizeable valuation gap with main DM equities. The dividend yield (4.2% for the high dividend MSCI EM index) is attractive and represents a way to optimise equity income exposure at a reasonable price. The asset class is also appealing on P/E ratios, which are close to historical lows, in absolute terms. The earnings outlook is also constructive: Q4 reporting season involved more than half of the index stocks and at the time of writing 4Q17 yoy growth (current reporting quarter vs the same quarter one year ago) is close to 20% in US$ confirming the positive momentum that we believe will remain in place in 2018. However, country/ sector divergences persist: earnings revisions remain in general positive, with some exceptions (ie, Mexico and Malaysia). At the regional level, we hold a positive view on Latin American domestic-driven stories (ie, Brazil), are selectively optimistic in EMEA (Russia), and maintain a positive outlook on Asian economies (China). We are now more constructive on South Africa, due to the changing political framework.

REAL ASSETS

Private equity: new records, strategic thinking needed

PEDRO-ANTONIO ARIAS, Global Head of Real & Alternative Assets

A new high for private equity (PE) market

The PE industry posted a strong year in 2017, as global assets under management reached a new record of US$2.83tn as at June 2017, up 9.6% from the end of December 2016, more than doubling the size of the industry at the end of 2006. This has been its ninth consecutive year of growth since the global financial crisis. The fundamental driver behind investors' interest and confidence in PE has surely been its ability to deliver steady attractive returns. PrEQin Private Equity, the asset class benchmark, has consistently outperformed the S&P 500 TR and MSCI World TR indices since the start of 2005, and performed strongly over one- (+17.3% annualised return), three- (+13.4%) and five-year (+15.4%) time horizons to June 2017. In the context of high valuations in public markets and low/rising interest rates, investor capital allocation to PE markets will likely remain strong: we believe that private equity may also be well positioned to ride the business cycle and provide attractive absolute returns and portfolio diversification.

The benefit of active minority shareholder strategies

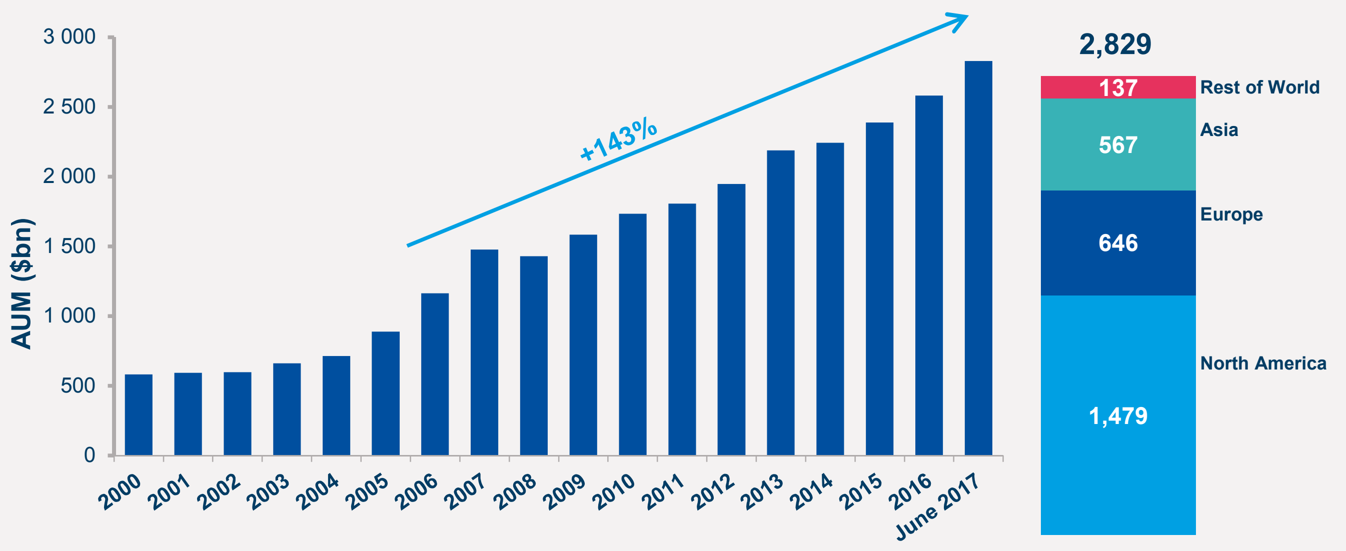
On the back of strong performance, new capital flew into the PE market reached a record high of US$453bn in 2017, the highest level ever raised in any year. In response to increased investor demand, new firms have entered the private equity asset class, thus making the landscape highly competitive. According to PrEQin data, over the past decade, the number of active private equity funds in the market has increased consistently: there are a record number of 2,296 funds globally as at January 2018 (+26% compared to January 2017). The increasingly stiff competition will be one of the biggest challenges that fund managers will face in the private equity space over the coming years. Private equity managers also have to deal with five global megatrends that are reshaping the investment environment (technology, globalisation, and demographic, environmental and societal changes). The above effects will require fund managers to experiment with new strategies to differentiate themselves from competitors and exploit their potential to find the hidden industry champions that are most likely to benefit from least one of the five major megatrends.

We believe that in this new competitive and evolving scenario, active minority investment strategies in small and medium sized companies, (more flexible to deal with the above megatrends than major corporations) may be a successful way to compete, as these allow market participants to take advantage of synergies in partnership with management.

Adopting an activist approach means taking minority stakes in unlisted companies, remaining very involved in any management decisions, with a medium- to long-term investment horizon on average. In order to create value, activism has to be selective by investing in companies with high-quality managements, robust financial fundamentals and convincing stories on profitability (for example, we believe that ESG companies have a competitive advantage as to benefitting from the above global megatrends and this, could be very beneficial for ESG adoption in private equity). In this respect, we see opportunities in France, Germany and northern Italy. Lastly, since the activist approach requires access to family-owned and owner-managed businesses, geographic proximity plays an important role in maintaining better and more effective relationships with managements.

"The private equity industry still appears to be in very good shape, but the evolving dynamics are pushing for a differentiated investment strategy."

Private equity assets under management



Source: Preqin, Amundi. As of 15 March 2018.

Asset allocation: multi-class outlook

	1 month change	---	--	-	0	+	++	+++
Equities vs govies	↘					■		
Equities vs credit	→					■		
Credit vs govies	→					■		
Duration	→			■				
Oil	→					■		
Gold	→					■		
Euro cash	→				■			
USD cash	→					■		

The table above represents cross asset assessment of 3 to 6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++).

Relative outlook and convictions by major asset class

	3-6 month research view	Asset Class	1 month change	Underweight	Neutral	Overweight
GOVIES	-	US	→	●		
GOVIES	--	Euro core	→	●		
GOVIES	+	Euro peripherals	→			●
GOVIES	-	UK	→	●		
GOVIES	-	Japan	→	●		
CREDIT	=	US IG	→		●	
CREDIT	+/=	Euro IG	→			●
CREDIT	-	US HY	→	●		
CREDIT	+/=	Euro HY	→			●
CREDIT	+	GEM debt hard cur.	→			●
CREDIT	+	GEM debt loc. cur.	→			●
EQUITIES	+	US	↗			●
EQUITIES	+	Eurozone	↘			●
EQUITIES	=	UK	→		●	
EQUITIES	+	Japan	↘			●
EQUITIES	+	Pac. ex Jap.	→			●
EQUITIES	+	Global EM	→			●
EQUITIES	+	Convertibles	→			●

Currency and real assets

FOREX	+	EUR vs USD	→
FOREX	=	EUR vs GBP	→
FOREX	+	EUR vs JPY	→
FOREX	+	USD vs JPY	→
REAL ASSETS	+	Real estate	→
REAL ASSETS	++	Global Infrastructure	→
REAL ASSETS	+	Private Debt	→

LEGEND

−	Negative
=	Unchanged
+	Positive
● (red)	Underweight
● (black)	Neutral
● (green)	Overweight

Source: Amundi, as of 20 March 2018. The 3-6 month return outlook refers to research views based on expected returns by asset class. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. **This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.**

THIS MONTH'S TOPIC

Where will the next financial crisis come from? Are we ready to confront it?

PHILIPPE ITHURBIDE, Global Head of Research

Finalised on 22/03/2018

The essential

The world is not yet fully out of the aftermath of the 2007-2008 financial crisis, when the question is already raised on the risk of another crisis. The question is whether it is possible to move from a regime of growth without inflation and with low rates to one of higher volatility, inflation and interest rates without a financial crisis or any macro-economic shock… Such are the stakes for 2018. The excessively low bond yields, the credit bubble in China or the so-called "excessive" valuation of some equity markets are generally referred to as risky segments, while a badly perceived monetary policy decision or a sudden rise in inflation expectations appear as the most credible crisis-triggering factors, via a repricing of risk premiums. Do not underestimate the crisis-accelerating factors, currently significant, that are potentially the low liquidity of the fixed income markets, the concentration of the positions and the mimicry of investors. However, it is very difficult to bet on a major financial crisis, such as the ones that prevailed in 2000 or 2008. Among the reassuring criteria are the good health of banks, a favourable macroeconomic situation, economies with lower sensitivity to inflation than before, and central banks still credible, predictable, good communicators.

The scenario that seems most likely for 2018 is not a crisis scenario, but rather more nervousness. The market context has indeed evolved. Interest rate policies have reached their limit, the " era of low interest rates forever" is over, the great period of disinflation has ended, and QE programmes will gradually disappear… All this means that the repricing of risk premiums will inevitably result in phases of greater volatility, short and long-term interest rates increases, wider credit spreads, and no doubt regular shocks in the equity markets.

The world is not yet completely out of the 2007-2008 financial crisis, but the risk of a new crisis already arises. The theme of "regime shift" (volatility, interest rate, inflation, etc.) has resurfaced, which led to a marked correction in financial markets in January – February. **With sudden change in regime, the traditional ingredient of a financial crisis is excess liquidity that leads to a credit bubble**: the stock and the evolution of private debt (in particular China) and public debt, as well as the low deleveraging since the 2008 crisis remain a concern. Economic history also teaches that financial crises are seldom anticipated, or more precisely, it teaches us that measures to avoid them are never taken in time.

In reality, crises have all been preceded by often very clear signals, but they have been ignored or underestimated (by regulators, by central banks, investors…). Who really thought in the 1990's that the tech bubble would not eventually burst? Who really believed that the continuing overhang would not create strong economic and financial turmoil in the 1990s? How seriously consider that subprimes and abnormal risk aversion would not turn into deep problems in the middle of the 2000s? As a CEO of a big US bank ironically mentioned as an excuse following the crisis, "as long as music played, we all kept dancing". Similarly, who still believes that the regime of low volatility, low inflation, low rates and excessive valuation of assets can last indefinitely? In other words, to see financial markets change, once again, constitutes a real threat.

Two types of "crises" should be highlighted: **market shocks** (for example, 10% drop) are frequent and most generally salutary, because they allow 'purge' excess positions, or correct excess valuations. These corrections are not alarming for the continuity of the regime. **Financial crises**, on the other hand, often represent real questioning of the existing regime, or even the overall functioning of financial markets and the economy (they are also seen as crises of capitalism and its excesses). Financial crisis ae usually follow periods of excessive valuations or, even worse, bubbles.

The question is whether it is possible to move from a growth regime without inflation and at low interest rates to one of (even moderately) higher volatility and inflation and higher interest rates without a financial crisis or a macro-economic shock … that's the whole issue of 2018.

Where do bubbles come from?

The factors that can develop (and burst) excessive bubbles/valuations are quite well identified:

- **Rationality**: the justification is often found in the underlying macroeconomic situation;
- **Opportunism**: the attractiveness of the corresponding market;
- **(The excess of) confidence**: it is most often provided by the attitude of the central banks (low rates forever", explicit forward guidance, QE programmes when refer to the recent past);
- **Complacency**: it leads to an exaggeration of the existing trends;
- **Mimesis**: when common views and common positions to the largest number of players drive the markets;
- **The sentiment that the period is atypical ("this time is different"):** this sentiment gives some comfort to exaggeration.

Are there markets at risk?

Rightly or wrongly, according to usual comments, three markets may trigger a major shock or a crisis:

- **The first segment of the market that is at risk is undoubtedly the bond market**. There is no price inflation, but asset inflation. Interest rates are 'too low' due to ultra-expansionary monetary policies and QE, excess liquidity in central banks and lower market liquidity. In the bubble situation, prices are far from equilibrium, and this is the problem
- **The second market segment at risk is the credit market in China (Graph 2)**. China's economy continued to grow strongly following the 2008 financial crisis, and the Chinese government is doing its utmost to maintain a growth rate of more than 6%. But this has led to higher domestic debt (government debt, corporate and household debt). A rise in interest rates globally would therefore be significantly detrimental to the Chinese economy. The risk is great to see a difficult decline in China's bubble: it could be poorly controlled by the central authority, the result dependent on its management capacity. Its mismanagement of the stock-market bubble, which it caused and then corrected in 2015, or its management of the Yuan in 2015 and early 2016, may not bode well.
- **The third segment at risk is the US stock market**, which is regarded – sometimes with the wrong arguments - by many investors as being highly overvalued … but whose growth is justified in the strength of the economic activity (higher than potential growth), the lack of inflation, the return of profits, the tax measures, but also the still accommodative monetary policy.

Crisis triggering factors vs crisis- accelerating factors

Within markets suddenly bearish and affected by fire sales, **we must not confuse crisis triggering factors** (change of monetary policy stance, geopolitical shock…) **and crisis-accelerating factors** such as mimesis (reversals of portfolio positions when they are all positioned in the same direction), concentration or the low liquidity… 1994 recalls that there is no need for a significant shock to cause a market drop or even a real crash.

What would trigger the next crisis (if any)?

Several factors are likely to play this role.

(1.) A "repricing" of risk premiums would result in phases of higher volatility, higher short and long term interest rates, wider credit spreads, and without any doubt about frequent equity market drops, except if further expansion of the growth cycle and profit prospects.

(2.) An inflationary shock: Inflation rates are everywhere - or almost - below the target of the Central Bank. Apart from an oil shock or a political will leading to a radically different wage policy, it is difficult to believe that inflation will suddenly and sharply rise. Rather, the current functioning of labour markets is in the opposite direction, but we are not immune to publication of poor inflation indicators or simply rising inflation expectations.

(3.) A monetary policy shock: Monetary policy is often the trigger for financial crises. In February 1994, it was a monetary policy event that triggered the bond crash. In the mid-1990s, the Fed's monetary laxity created a bubble, and then its collapse in 2000. This crisis had even led to a global recession: massive corporate deleveraging, loss of confidence, lower stock markets and negative wealth effects… From 2002 to

2007, it was once again the low rates that, together with abnormally low risk premiums, caused the housing bubble to rise, with the development of a sometimes dubious securitisation. This resulted in the major financial crisis of 2007/2008 (sub-prime crisis, Lehman Brothers bankruptcy...). In 2013, the announcement of the end of the US QE programme (and the effective end of asset purchases in 2014) caused market declines and recession in some emerging countries.

(4.) A disappointment on growth - inflation... financial markets might overestimate both inflation and growth rates. The current economic recovery (with growth above potential, accommodative monetary policies, low inflation, low rates, low volatility, "great moderation") will not become a "new standard" and a return of growth to its potential is highly probable, which will also reduce inflationary risks. The risk is lower today as central banks prepare the ground and never take markets by surprise.

(5.) Some loosening of financial regulations would undoubtedly lead to excessive risk- taking, and even greater complacency than currently prevailing.

(6.) A political or geopolitical shock: There is no shortage of tension areas (Korea, Turkey, Saudi Arabia - Iran, Brexit, rise of populism...), and an unexpected and/or big shock would likely create what is feared, i.e. a repricing of risk premia. Add that an increase in oil prices, as the result of tension in The Middle East, would probably be, as regard a rise in inflation expectations, a more possible trigger factor than an increase in wages.

(7.) An increase in protectionism and self-centrism, would be presumably disastrous ... especially if it leads to a currency war and a fall in globalisation. This will worsen the economic downturn and create a vicious circle that will lead to a new crisis, a much more severe crisis than the 2008 one. It could be an economic, financial and political crisis.

With rare exceptions, contagion effects are inevitable

The magnitude of contagion is mainly linked to economic and financial globalisation, but also to the nature of the crisis. If it concerns a country or zone, and if non-residents have invested little in that country or zone, then contagion remains low. A "simple" repricing of risk premiums, resulting in a moderate rise in interest rates would be less damaging to the real spheres, as interest rates would remain objectively low at the end. But the question of the impact of the financial sphere on the real sphere has always to be raised.

Financial crises: origins and contagion effects

Event	Origin of the crisis	Contagion
1929 market crisis	US stock market	Economic and financial spheres of the developed world
Crisis in the developing countries of the 1980	Mexican sovereign debt crisis	Contagion to all Latin American countries
1987 stock market crash	US stock market	European and Japanese equity markets mainly
Japanese banking crisis 1990	Real estate	Japanese economic and financial spheres
1994 bond crash	US bond market	Global bond markets
Mexico's 1994 currency crisis	Foreign exchange market	Contagion to all Latin American countries (tequila effect), Argentina and Brazil
Thailand's currency crisis 1997	Foreign exchange market	Contagion to all emerging and transition economies (Asia, Latin America, Europe), all economic and financial sectors
April 2000 crash	US stock market	Contagion to all stock markets and real sectors of developed countries
Great Financial Crisis of 2008 (GFC)	US property market (sub-prime)	Contagion to all financial markets and real sectors of developed and emerging countries

Are we ready to confront a crisis?

The capacity to cope with an eventual financial crisis can be assessed against several criteria.

(1.) The vulnerability of countries: What can be said is that emerging countries are currently much less vulnerable than they were at the time of the 2008 Great Financial Crisis or at the time of the Fed's QE tapering: stronger growth, more growth engines, better current account and fiscal balances, higher FX reserves, inflation rates below inflation targets (except in countries like Malaysia and Turkey...).

(2.) The existence - or not - of fiscal and tax room of maneuver: Some countries have been able to rebuild flexibility, such as Germany, for example... but this are isolated cases. For the rest of the Eurozone or for the United States, this is much less secure. At the global level, debt is growing faster than GDP. The debt was considered excessive in 2008: what should we say today? How would financial markets react to rising interest rates?

(3.) The existence - or not - of room of maneuver for monetary policies: we have seen the central banks of the major advanced economies lagging the cycle (Graph 1), the Bank of Japan more than the ECB, and the ECB much more than the Fed. With very low rates, new QE programmes are plausible if, should central banks have to curb a financial crisis and/or to fight threats to the economic activity.

(4.) Financial markets: investors' positioning and liquidity. The more the positions are consensual and / or liquidity is low, and the greater the risk of collapse. No need for a significant shock to cause a market drop or even a real crash. **When liquidity declines, prices become much less powerful in terms of information** as they move away from their fundamentals. **Contagion and volatility risks also tend to increase, while less liquid markets have less shock absorption capacity. Lower liquidity means greater handling capacity**. In total, we can see the issue of liquidity and market positioning in the current context.

(5.) The state of the economy: The situation is good at present, and this is undoubtedly a positive factor in the current circumstances. All growth engines are active: consumption, investment, world trade and fiscal, tax and monetary policies are rather accommodative. In the Eurozone, Japan, the US or China, growth is above potential.

(6.) Debt constraint: It is now clear that the level of debt forces - or even influences - economic policies, including monetary policies. While the debt service has changed little since 2005 (it has even declined in some countries), nominal debt has risen steadily (it roughly doubled in just over 10 years). In other words, a rise in interest rates would raise new issues on the solvency of the States/companies with high levels of leverage. On this point, the world economy is probably not prepared to face a financial crisis (Graph 3).

Three scenarios at play

Scenario # 1: 2018, another year of "great moderation", with low(er) volatility, stability of growth and inflation, low(er) inflation and low(er) interest rates *(probability: 10%)*

2018 will not look like 2017, because the economic situation is changing strongly. The output gaps will be closed in the coming months, unemployment rates go back to structural levels... all of this is to say that growth will not accelerate (the less one can say), and that inflation risks - even moderate - are clear. A situation that is likely to allow central banks, the Fed in lead, to continue to rebuild room of maneuver. The environment of "great moderation" (stability of major economic aggregates, such as growth and inflation), but also low volatility and low interest rates are gradually wiped out.

Scenario # 2: 2018, a year of higher volatility, with regularly hectic financial markets *(probability: 75%)*

It is difficult to bet on a major financial crisis, like that that prevailed in 2000 or 2008. Among the reassuring criteria:

- The health of banks, well-capitalised, reasonably leveraged, and more stable revenues. Banks now give greater weight to retail activities (as was the case in the wake of the emerging markets crisis in the late 1990s);
- A favourable macroeconomic situation;
- Moderate inflation;
- A lower sensitivity of the economies to inflation;
- A low neutral interest rate, which means that closing the gap with these rates is easier or that interest rate policies are less ultra-accommodative than it seems (this is true for the US, but much less for the Eurozone);
- Central banks still credible, predictable, with still a good capacity to communicate.

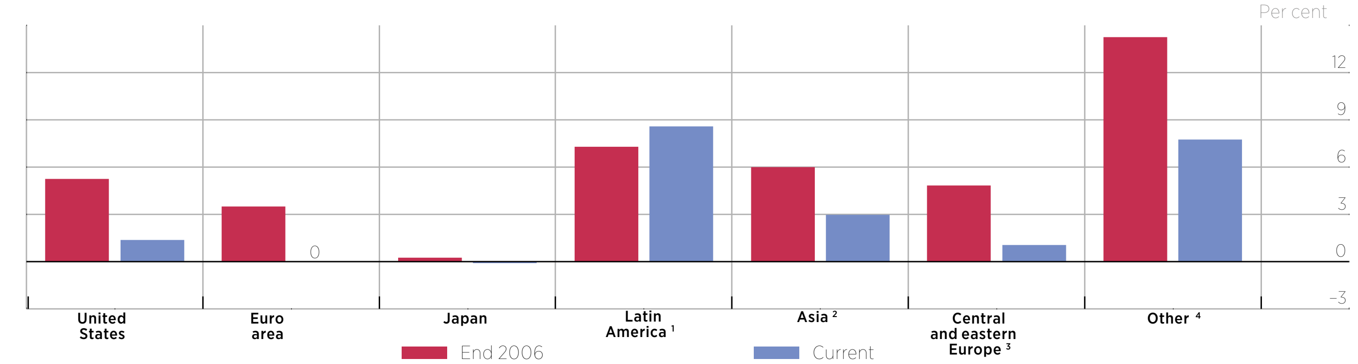
However, the market environment has changed: (i) conventional monetary policies (interest rate policies) have reached their end... and "the era of low rates forever is over", (ii) the great period of disinflation is finished; (iii) unconventional monetary policy (QE) programmes fade slowly. All of this means that the "repricing" of risk premia will inevitably lead to periods of greater volatility, with higher short and long term interest rates, wider credit spreads, and no doubt of regular shocks in equity markets.

Scenario # 3: a major crisis year (*probability: 15%*)

Nothing is impossible, and the possibility of a significant financial crisis cannot be totally ruled out. It is not our central scenario, though. It should be noted that low liquidity and similar positioning of many portfolios provide additional risk to financial markets in the event of a crisis / shock. We have also seen little room of maneuver for central banks, while government debt and government deficits will constrain policies. Clearly, monetary policies in most advanced countries are not in a position to support economies and financial markets in the event of crisis... except to reopen new QE programmes.

Annex

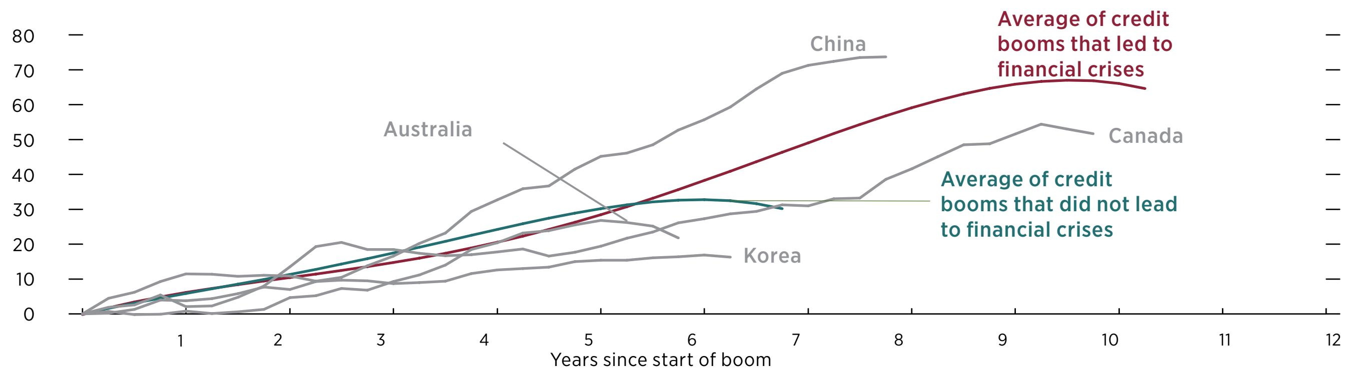
1/ Monetary policies: key rate in 2006 and in 2016



1. Argentina, Brazil, Chile, Colombia, Mexico and Peru.
2. China, Hong Kong, SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.
3 .Czech Republic, Hungary and Poland.
4. Russia and Turkey

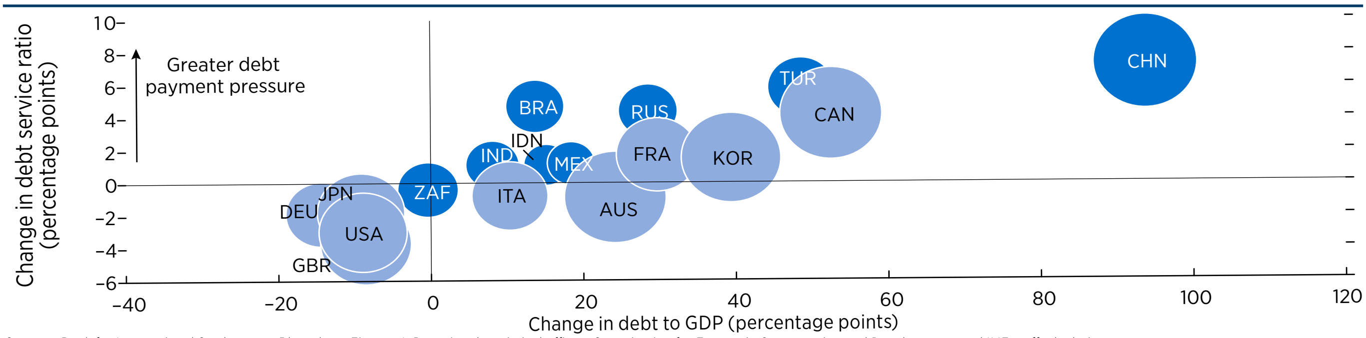
Sources: Datastream; national data; BIS calculations.

2/ Change in Credit-to-GDP Ratio (Percentage points)



Sources: Bank for International Settlements; Bloomberg Finance L.P.; national statistical offices; Organisation for Economic Co-operation and Development; and IMF staff calculations.

3/ Change in Private Non financial Sector Debt and Debt Service ratios, 2006 - 2016



Sources: Bank for International Settlements; Bloomberg Finance L.P.; national statistical offices; Organisation for Economic Co-operation and Development; and IMF staffcalculations.
Note: Debt service ratios are defined as annualized interest payments plus amortizations as a percentage of income, as calculatedby the Bank for International Settlements. In panel 1, the size of the circles is proportional to debt to GDP in 2016. In panel 2, income is gross disposable income plus interest payments (plus dividends paid for firms). Panel 3 shows Group of Twenty economies with higher demeaned nonfinancial private sector debt service ratios and debt levels against past booms. Past booms are for a sample of 43 advanced and emerging market economies where the credit-to-GDP gap rose above 10 percent. The start and end dates of the booms are defined as periods when the credit gap was above 6 percent. Financial crisis dates were taken from Laeven and Valencia 2012. Data labels in the figure use International Organization for Standardization (ISO) country codes.

Risk factors

DIDIER BOROWSKI, Head of Macroeconomic Research
PHILIPPE ITHURBIDE, Global Head of Research

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

Risk # 1 | 75% probability | The post-Brexit environment permanently weakens the UK

Analysis | According to estimates, the UK "could lose" between 2.5% and 9.5% of its GDP in the medium term (depending on the nature of the Brexit). Volume and costs of trade would be affected, especially in the financial services, chemicals and automotive sectors, which are highly integrated sectors in the European Union. The risk for the UK lies in its future ability to trade freely in the single market (the services market, to be more precise), to achieve the desired independence without the EU's constraints. This is the challenge of the negotiations on trade which have hardly started. There are many issues of tension, not just between the UK and countries in the EU, but within the British government itself. The risk of political instability (fall of government, new elections) in 2018 should not be underestimated.

Market impact | Even though the likelihood of a hard Brexit has dropped significantly, and although some pressure has been relieved with the proposed transition period (until the end of 2020), negotiations on trade this year are expected to be tense. In the event that the outcome is ultimately unfavourable for the UK, we will see additional weakening of the pound sterling and trend- GDP growth of the British economy, two factors that could prolong the monetary status quo.

Risk # 2 | 75% probability | Greater financial instability

Analysis | Central banks have made the return of financial stability possible in recent years through lower rates, short and long; maintaining interest rates at low levels across the board; low volatility, tighter credit spreads and the virtual disappearance of sovereign risks in some cases. However, central banks are now determined to recalibrate their policies, despite the recent rebound in volatility. The macroeconomic response to a potential downturn in activity would ultimately come from fiscal and tax policies, and traditionally public spending has far less stabilising power for financial markets than interest rate cuts.

Market impact | Greater financial instability would result in a more pronounced rise in volatility across all financial markets and an increase in credit spreads.

Risk # 3 | 70% probability | Political and geopolitical risks maintained

Analysis | Financial markets are now operating against a complex geopolitical backdrop: Syria, Islamic State, Turkey, migrant flows, terrorist attacks, Sunnis vs. Shiites, Arabia vs. Iran, all of which have strained and weakened diplomatic relations between countries. Do not expect a quick resolution of ongoing problems and conflicts. In order to take into account political and geopolitical risks into portfolio constructions on a permanent basis, it is necessary to systematically consider macro-hedging strategies.

Market impact | There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are well identified and specific, but there are many and, by their nature, materialize as often unpredictably. The magnitude of other political risks (including the consequences of the new US diplomacy) is more difficult to assess at this stage. Is this all likely to affect growth prospects and the direction of financial markets? No one really knows it but it is very likely that this is the case, at least occasionally.

Risk # 4 | 20% probability | A long-term and significant increase in European long rates

Analysis | The increase in long-term rates can come from at least six sources: (i) a significant upswing in (nominal, real or potential) growth prospects, (ii) more aggressive tightening of interest rate policies, (iii) the "true" end of QEs (the end of reinvesting maturing papers in the US, an even more drastic reduction in the ECB's asset purchasing programme), (iv) a resurgence of inflation or inflation expectations, (v) a massive reversal of fiscal and tax policies, or (vi) a resurgence of specific political risks. All these factors (reality, announced measures, or fears) have gained momentum in the United States, but it seems premature and excessive to expect a steady and substantial increase in bond yields. This conclusion holds even more in the case of the Eurozone. But with growth that is now more robust and more sustainable, and low inflation expectations, debates over the end of negative rates and the ECB's QE programme, and comments about the need for fiscal and tax measures that are more favourable to growth, it is a safe bet that the risks of a moderate rise in European rates are higher now.

Market impact | A sharp rise in long rates would be bad news in the United States, where the sensitivity to long-term rates has increased with corporate releveraging: this would weaken growth and in itself would sow the seeds for a future decline in long rates. It should also be noted that a sharp rise in long-term rates would be a drag on any hint of Fed interest rate hikes. Another reason not to believe in a long-lasting and wide rise in US long-term rates ... and EuropeanIt should also be noted that a sharp rise in long-term interest rates would slow the monetary normalisation process. This is another reason for not believing in a sustained and ample increase in US – and European – long rates.

Risk # **5** | **20%** probability | **Pro-cyclical fiscal policy pushes the Fed to raise its rates more quickly than expected**

Analysis | The expansionist budgetary policy (tax cuts and increase in public spending) will boost GDP growth in 2018. With GDP growth well above 2% inflation that is likely to exceed 2% on average this year and an economy that is close to full employment (with a positive output gap), the real fed funds rate should be much higher than it is now, in a normal cycle. So, technically, the Fed is "behind the curve". The Fed must clearly avoid any communication errors. Markets could react poorly if rates surge. The most recent example of a bond crash dates back to February 1994 and was triggered by a 25bp increase in rates (not prepared). However, we note that the short-term positive impact of the budgetary policy should allow the Fed to continue to raise interest rates without increasing the risk of recession and, as such, without damaging the financial markets.

Market impact | If the Fed steps up its rate increases, we will have to bet on a sharp downturn in equities and on contagion into the emerging markets. This situation would be conducive to a widening of spreads between Europe and the US. We expect three rate hikes in 2018. All it would take is for core inflation or wages to pick up more quickly (with still strong growth) to open the door to further rate hikes.

Risk # **6** | **15%** probability | **Global trade war**

Analysis | The steel and aluminum tax increases announced by Donald Trump - if they are actually implemented - will provoke retaliation from trading partners (EU, Canada, China, Korea, etc.). It is likely that Donald Trump's threat is primarily a weapon in renegotiating the NAFTA agreements with Mexico and Canada, as well as a message sent to his electoral base in the run-up to the mid-term elections (November). Retaliation of targeted partners could lead to further protectionist measures by the White House and thus provoke a chain reaction. Although the probability that the measures announced (steel and aluminum, targeted retaliation) are actually implemented is not insignificant, that of a chain reaction seems rather weak for two reasons: (1) many sectors in the US would be victims of retaliation which would be counterproductive before the mid-term elections (strong opposition already perceptible in the Republican camp); (2) partner countries will be careful not to fall into the trap set and maintain a measured response. That said, we cannot ignore the risk of a generalized clash, especially as the moderate camp at the White House (favorable to free trade) is very weakened by the resignation of Gary Cohn (economic adviser).

Market impact | A chain reaction would cause a slump in global trade while exacerbating local inflationary pressures, putting central banks in a corner. This would cause a general rise in risk aversion (fear of a reversal of the global cycle). Contrary to what Trump asserts, there is never a winner in a confrontation of this type. There are only losers.

Risk # **7** | **10%** probability | **A Chinese "hard landing" / a bursting of the credit bubble / devaluation of the yuan**

Analysis | Chinese growth is still solid (and more resilient than many market observers believed on year ago), but the country's economic model is fragile: the excess of credit is visible, non-financial corporate debt has surged since the GFC. The good news is that it has peaked: the NFC debt to GDP ratio has started to drop in late 2017. We will continue to monitor closely the trend in Chinese private debt that currently benefits from the strength of nominal GDP. In the case of hard landing or the bursting of the credit bubble, the Chinese authorities would be unable to maintain the stability of the Yuan, especially since the Chinese currency is no longer undervalued.

Market impact | A hard landing linked to a burst of the credit bubble would have a very negative impact and its cascading effects would be particularly disastrous: vulnerability of banking systems (in China and elsewhere), vulnerability of the global financial system, vulnerability linked to China's public and private debt, negative impact on regional and global trade, and thus on commodities and emerging countries, impacts on the currencies of commodity-exporting countries, advanced countries and emerging countries.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

DIDIER BOROWSKI, Head of Macroeconomic Research
PHILIPPE ITHURBIDE, Global Head of Research

This section provides a reminder of our central scenario and alternative scenarios.

Central scenario (70% probability): global growth is stabilising.

- **Global resynchronisation:** Despite the recent financial turmoil, global growth is expected to remain strong in 2018 and 2019. Surveys remain at high levels and their recent deterioration does not signal a reversal of the cycle. The advanced economies (with the notable exception of the UK) will continue to experience above potential growth. The major emerging economies will also continue to grow at a sustained pace. The ongoing rebalancing in China is progressing quietly – such that the slowdown appears to be under control. The recovery in most economies is being driven by domestic demand, and we note a recovery in investment in many regions (US, Europe, Japan, Asia). The synchronous nature of the global recovery makes it more robust.
- **World trade:** world trade recovered strongly in 2017 (+ 5% yoy). It has so far been stimulated by the resynchronization of the global cycle and investment in capital goods. The protectionist measures announced by Donald Trump on steel and aluminium (tariff increases) will lead to retaliatory measures (from EU and China in particular) that are theoretically damaging to trade. However, it should be noted that steel and aluminium account for a tiny share of world trade and partner retaliation is targeted at a few products. We continue to expect a slight decline in the world trade to global GDP ratio in 2018 (i.e., trade growth slightly below that of global GDP). The probability that protectionist tensions will degenerate into a real global trade war is low (see risk scenario).
- **United States:** growth remains firmly anchored. Surveys still point to GDP growth above potential. The fiscal stimulus voted in December, combined with the bi-partisan plan to increase public spending, will extend the duration of the US cycle. No recession to fear neither in 2018, nor in 2019.
- **Eurozone:** the recovery is widespread, with a pick-up in investment in most countries. Growth is driven primarily by private domestic demand. The Eurozone is at mid- cycle, with the prospect of catching up for peripheral countries. The political risk has weakened, becoming more local. In Germany, the vote of SPD members in favour of the coalition with the CDU-CSU paves the way for a grand coalition favourable to Europe and a strengthened Franco-German couple. In another vein, the reduction in asset purchases by the ECB is likely to be accompanied by a rise in both long-term interest rates in the core countries and the Euro. Hence the slight slowdown in growth expected in 2019. However, thanks to accommodative credit conditions, growth should remain well above its potential in 2018 and 2019.
- **United Kingdom:** EU countries and the UK have concluded an agreement for a transition period (until the end of 2020). The dissensions on Brexit terms are strong about remaining or not in the Customs Union. In her speech of March 2, Theresa May rejects the Customs Union (recently defended in the UK by Jeremy Corbyn), without really clarifying the British approach. Uncertainty will continue to weigh on the UK economy, but in a more diffuse way. We still expect growth to weaken in 2018-2019.
- **China:** growth still robust. The reduction in overcapacity has reduced the downside risks. The economy's growth drivers are now more diversified. Debt remains essentially domestic and has stabilised. We expect the gradual deceleration of growth to continue and a slow rebalancing (less growth, less debt). The transition looks to be under control.
- **Inflation:** core inflation, which is excessively low at this stage in the cycle (especially in advanced economies), is expected to recover gradually in 2018. That said, the slowdown in inflation over recent years is primarily structural (tied to supply factors), while the cyclical component of inflation has weakened (flattening of the Phillips curve). While the pick-up in core inflation promises to be modest, the likelihood of an "inflation surprise" is nonetheless increasing as surplus capacities disappear around the world (we estimate that the global output gap will close in 2018 for the first time since the great financial crisis). The risk is easier to spot in the US(we expect wages to continue to accelerate), given how close the economy is to full employment and how certain temporary factors (such as the drop in mobile phone service prices in the spring of 2017) have disappeared, which will automatically push inflation upward at the end of Q1 2018 (base effect).
- **Oil prices:** we expect prices to stabilise at a level close to their current level. At US$ 66 (Brent), the risk still seems to us to be asymmetric (more risk of seeing it drop). Indeed, if prices stay much above the breakeven point for US shale gas (estimated at around $40 pb), US production will eventually increase and weigh on prices.

- **In 2018, the central banks will continue to whittle down their accommodative monetary policy**, which is excessive in view of the current recovery. The Fed will continue to raise its key interest rates (we anticipate three 25bp hikes in 2018) and reduce its balance sheet at the announced pace (with a gradual non-replacement of papers reaching maturity); meanwhile, the ECB could put an end to its QE programme as soon as Q4 2018, But his recent communication remains particularly accommodating. The end of its asset purchase program is conditional on the recovery of underlying inflation, which remains excessively weak at this stage of the cycle. Moreover, it will start raising its key rates only «well after» the end of the Asset Purchase Programme. This implicitly means that the first increase in its deposit rate would not occur until mid-2019 (at the earliest). Monetary policies will remain generally accommodative because even if a little cyclical inflation materializes, total inflation will remain well below its historical average for the structural reasons mentioned (flattening of the Phillips curve, continued downward pressure on the prices of many goods and services).

  The protectionist measures announced by D. Trump weigh on the markets. Nevertheless, we believe that the risks weighing on growth are balanced. The likelihood of a generalized trade war remains low because the measures envisaged by Donald Trump (as well as the retaliatory measures) ultimately target products that weigh little on world trade. In fact, it seems that the retaliation envisaged by the EU has led Donald Trump to postpone the increase in tariffs on steel and aluminum from Europe.

Downside risk scenario (15% probability): marked economic slowdown due to incorrect economic policy (excessively quick monetary policy normalisation or protectionist measures), a geopolitical crisis or a sudden repricing of risk premiums.

- The risk of increasing protectionist measures (US) rises with the approach of the mid-term elections (Trump seeking to satisfy his electoral base). Retaliation from the rest of the world would be inevitable, provoking an open trade war (US, China, EU).
- The pro-cyclical fiscal policy forces the Fed to accelerate the monetary policy normalisation process.
- International crisis stemming from acute aggravation of current geopolitical tensions (Middle East, Korea).

Consequences:

- All things being equal, a global trade war would be negative for growth and, in the short term, would prove inflationary.
- An abrupt re-evaluation of risks on the fixed income markets, with a global decompression of spreads (govies and credit, on the developed and emerging markets alike). Decline in market liquidity.
- With the resulting financial turbulence, the theme of the end of the cycle resurfaces brutally in the US.
- Central banks cease recalibrating their monetary policies and, in the most extreme case, resort to unconventional tools (expanding their balance sheets).

Upside risk scenario (15% probability): pick-up in global growth in 2018.

Several factors, which are likely to generate higher growth, should be closely monitored:

- Sharp pick-up driven by business investment, global trade, and synchronisation of the overall cycle.
- In a very promising environment, the pro-cyclical US tax policy generates a stronger than expected pick-up in domestic growth in the US. Continued acceleration cycle in the Eurozone, stabilisation in China, confirmation of the trend in Japan, etc.
- Central banks react late, maintaining excessively accommodative monetary conditions, hence a «mini boom».

Consequences:

- A marked pick-up in global growth for the second consecutive year would increase inflation expectations, forcing the central banks to consider normalising their monetary policy much more quickly.
- Rise in real key interest rates (in the US especially).
- Given the resulting financial turbulence, the mini-boom would not last long. There would be a greater risk of a boom/bust (i.e. the bust after the boom).

Macroeconomic picture by area

United States

Economy set to expand above potential after Q1 temporary weakness

- Some temporary weakness but the economic outlook remains solid.
- The Fed hiked again by 25 bp, delivering upbeat message on growth and inflation. The economic projections were revised higher for growth and the inflation path moved marginally higher too from 2019. The dots now imply three hikes this year and next.
- A positive environment continues to be supportive for an expanding domestic demand: ISM surveys show very upbeat sentiment among U.S. businesses, with the manufacturing index reaching the highest level in more than a decade; consumer sentiment continues its upward trend, lifted by the tax-cuts positive effects on personal disposable income.
- Inflation scare recedes as US inflation report shows a more measured pace of growth for Consumer Price Index and aligns with Fed view of gradual convergence to the target.

Labor market keeps absorbing residual slack, as labor force participation rate increases and unemployment rate remains stable. Payrolls post again upside surprise.

Risk factors

- Tightening of labor market generates much stronger inflationary pressures
- Abrupt tightening of financial conditions
- More unilateral protectionist trade measures from the U.S. prompting escalated retaliations from other countries
- Geopolitical risks linked to a more hawkish shift of the U.S. Administration (Iran, North Korea)

Eurozone

The recovery continues with a lot of remaining potential

- The recovery remains strong even though some recent business confidence indicators disappointed mildly. The Eurozone economy is being supported by many factors, including a recovery in capex and consumption, lower political risk than in 2017, and strong growth in the USA and Asia. Core inflation remains subdued but is likely to rise slightly over the next few months.
- The indecisive outcome of the Italian elections does not carry an immediate systemic risk for Europe. In Germany, the government coalition deal should allow new initiatives to strengthen Eurozone institutions.

Risk factors

- Rise in anti-establishment parties
- Overreaction by the euro
- External risks

United Kingdom

Growth being slowed by uncertainty over Brexit

- The economy is slowing. Confidence is being undermined by uncertainty over how Brexit will play out. The increase in inflation due to a weaker pound is likely to be temporary. However, unemployment is still very low, at 4.3%, and wages are showing some signs of accelerating.
- An agreement has been reached with the EU for a post-Brexit transition period, from March 2019 until the end of 2020, and this boosted sterling. However, for the agreement to be implemented, an agreement still must be found on thornier issues, such as the Irish border and the future framework of trade relations between the EU and the UK.

Risk factors

- A hard Brexit
- The current account deficit remains very high

Japan

Historical long-running economic expansion has farther to go

- The current expansion has entered its fifth year. While the pace of growth will decelerate from the exhilarating level in 2017, business investment to cope with the chronic labour shortage and the Tokyo Olympic games in 2020 will continue to drive the economy. Meanwhile, investment for the purpose of capacity expansion will taper off on the appreciation of the yen and subsequent faltering exports. On the consumer front, wage growth is likely to remain lacklustre despite the government's request for a 3% pay raise. Depressed real income will continue to weigh on spending.

Risk factors

- The recent surge of the yen: a further appreciation would weigh on confidence
- Geopolitical risks (tensions with North Korea)

China

- The economy has shown no major worrying signs yet. Exports remain strong; property is holding up; and credit is not yet slowing significantly, although monthly data were volatile due to Chinese New Year distortion.
- There have been more convincing signs that structural reforms are ready to accelerate, with the direction reaffirmed, one of largest and widest institutional restructuring plans announced to improve governance efficiency, and pro-reform people in key positions.
- Regarding measures that Trump proposed to target certain Chinese products and sectors under USTR 301 investigation, China's responses so far have been relatively contained, which should help avoid serious escalation and limit macro impacts.
- Further developments bear watching, while there also looks to be some meaningful probability of some kind of trade deals with or without fewer tariffs.

Risk factors

- **The trade relationship with US, with noises perhaps to last for a while**
- **Policy mistakes in managing structural transition**
- **Geopolitical noises regarding North Korea: positive developments with Kim Jong-un making his first visit to China and agreeing to meet US later**

Asia (ex JP & CH)

Moderating recovery since February 2018

- Our India Economic Activity Indicator had been showing a strong economic recovery until January 2018. February figures weakened slightly with regard to electricity generation, freight traffic, exports and government revenues. Overall, the economic cycle is expected to accelerate in 2018 vs. 2017. Inflation data have recently surprised on the downside (4.4% in February), due to weakening food prices. We do expect inflation slightly higher in the next months and then reverting towards 4% in H2 2018. Risk on the upside should come from the increase in Minimum Support Prices (budgeted) announced in June.
- We do expect a neutral stance by the RBI over the course of 2018. A tighter stance is coming from more severe decisions in the credit sector following the PNB fraud.
- The political scenario is becoming more challenging for the BJP on the way to national elections, thanks to a unifying opposition at state level.

Risk factors

- **The recovery has begun to moderate since February 2018**
- **February inflation was unexpected low. Expected slightly higher in the next few months and reverting in H 22018**
- **RBI on hold**

Latam

Subdued inflation leaves room for further easing

- The Brazilian economy keeps expanding at a consistent pace throughout different sectors, driven both domestically and externally. However, as reflected in the capacity utilization ratio (78.1% in January), there is still lots of slack in the economy. Therefore, we do not see any pressure on inflation; in fact, recent CPI prints were still very low (below the lower end of the 3%-6% inflation target range). CBC has cut the Selic rate by a further 25bps in March, showing more dovishness than expected for the near future. Further easing is consistent with the fact that inflation dynamics are more subdued than expected.
- Having given up on passing pension reform, the government is now focusing on bills such as the Eletrobras privatization and federal tax simplification. The risk on these bills is now that a possible resignation by MoF Mireilles, announcing his ticket for the presidential elections, followed by some senior staff, could delay approval.

Risk factors

- **Recovery still on track but lots of slack in the economy**
- **Surprisingly low Inflation gives room for more easing by BCB**
- **Fiscal bills in the pipeline could be delayed by a possible Mireilles resignation**

EMEA (Europe Middle East & Africa)

Russia: we are forecasting growth of 1.7% yoy for 2018-2019

- With our inflation projection at 3% yoy, which is below the CBR's target (4%), we are expecting further key rate cuts. Oil prices remaining above $50/barrel would help to bolster the recovery.

South Africa: we are forecasting growth of 2% yoy in 2018

- Growth surprised to the upside in 2017 (1.3% yoy) and short-term indicators are looking solid in early 2018. Inflation is continuing to slow and should allow the SARB to begin easing its monetary policy before long. The ongoing fiscal consolidation and recent political changes should have a positive impact on the economy.

Turkey: we are forecasting a slowdown in growth to 4.3% in 2018

- The base effects associated with the coup d'état and the end of Russian sanctions are likely to fade Due to the increasing domestic and external imbalances (increased public and current account deficits) and geopolitical tensions, the Turkish lira will remain under pressure and continue to hamper the economy via imported inflation.

Risk factors

- **Decreasing oil prices**
- **Less fiscal consolidation, lack of reforms**
- **Lax monetary policy, rising inflation and twin deficits, currency depreciation**

Macro and Market forecasts

Macroeconomic forecasts
(28 March 2018)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2017	2018	2019	2017	2018	2019
US	2.3	2.9	2.5	2.1	2.5	2.2
Japan	1.7	1.2	1.0	0.5	0.9	1.3
Eurozone	2.5	2.3	1.9	1.6	1.6	1.6
Germany	2.5	2.3	2.1	1.7	1.5	1.6
France	2.0	2.0	1.7	1.2	1.4	1.5
Italy	1.5	1.4	1.2	1.2	1.1	1.5
Spain	3.1	2.6	2.5	2.0	1.6	1.7
UK	1.7	1.5	1.6	2.7	2.6	2.4
Brazil	1.0	2.2	2.4	3.5	3.5	4.4
Russia	1.5	1.7	1.7	3.7	3.0	4.1
India	6.3	6.8	6.6	3.3	4.2	4.6
Indonesia	5.1	5.3	5.5	3.8	3.6	4.1
China	6.9	6.6	6.4	1.6	2.3	2.5
Turkey	6.5	4.3	4.0	11.1	9.5	8.5
Developed countries	2.2	2.3	2.1	1.8	2.0	1.9
Emerging countries	4.9	5.0	4.9	3.5	3.6	3.7
World	3.8	3.9	3.8	2.8	2.9	3.0

Source: Amundi Research

Key interest rate outlook

	27/03/2018	Amundi + 6m.	Consensus Q3 2018	Amundi + 12m.	Consensus Q1 2019
US	1.50	1.75	2.15	2.00	2.55
Eurozone	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.75	0.70	0.75	0.85

Long rate outlook

2Y. Bond yield

	27/03/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.31	2.20/2.40	2.50	2.50/2.70	2.64
Germany	-0.61	-0.60/-0.40	-0.46	-0.40/-0.20	-0.33
Japan	-0.15	-0.20/-0.00	-0.14	-0.20/-0.00	-0.12
UK	0.89	0.80/1.0	1.01	0.80/1.0	1.09

10Y. Bond yield

	27/03/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.85	2.80/3.0	2.93	2.80/3.0	2.98
Germany	0.52	0.60/0.80	0.65	0.80/1.00	0.76
Japan	0.04	0	0.08	0	0.13
UK	1.44	1.40/1.60	1.58	1.40/1.60	1.65

Currency outlook

	27/03/2018	Amundi + 6m.	Consensus Q3 2018	Amundi + 12m.	Consensus Q1 2019
EUR/USD	1.24	1.25	1.25	1.28	1.27
USD/JPY	106	105.0	108.0	105.0	110.0
EUR/GBP	0.88	0.92	0.89	0.95	0.89
EUR/CHF	1.17	1.16	1.19	1.18	1.19
EUR/NOK	9.56	9.50	9.55	9.30	9.33
EUR/SEK	10.21	9.70	9.90	9.50	9.63
USD/CAD	1.29	1.25	1.25	1.22	1.24
AUD/USD	0.77	0.77	0.78	0.77	0.80
NZD/USD	0.73	0.70	0.72	0.70	0.74
USD/CNY	6.28	6.30	6.40	6.30	6.40

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