Confidence must be earned

Amundi
ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY

CIO VIEWS

10 YEARS FROM LEHMAN: REALITY CHECK

THIS MONTH'S TOPIC

DEADLINE FOR THE ITALIAN BUDGET LAW APPROACHES: WILL WE REMEMBER THE 27TH NIGHT OF SEPTEMBER?

Research & Macro Strategy

CIO VIEWS

10 years from Lehman: reality check

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

The collapse of Lehman Brothers 10 years ago marked the beginning of the 2008 financial crisis. The legacy of the crisis reveals to us a series of paradoxes, with consequences for both the economy and financial markets.

1. The missed deleveraging: If the pace of debt accumulation has slowed down, deleveraging in absolute terms has hardly happened at all post crisis. The prospect of higher rates and the exhaustion of the cyclical upswing open up questions about debt sustainability. Assessing areas of vulnerabilities that could translate into idiosyncratic risks will be key to preventing capital impairment.

2. The two sides of liquidity: Despite the macro excess of liquidity in the balance sheets of Central Banks (CB), we are facing a micro deterioration of market liquidity due to post-crisis regulations. The challenge for asset managers is to implement strategies to deal with this liquidity paradox**.**

3. A medicine with uncertain collateral effects: The response to the crisis was a massive (cyclical) stimulation of growth, mainly through monetary policy, then followed by the fiscal arm – even in the Eurozone. But the nature of the crisis and its genesis in the credit cycle significantly prolonged the healing process. New imbalances emerged in the form of asset price inflation. Unless some form of productivity shock materialises, in the long term markets will tend to readjust to their fundamentals (for example, equity markets to return to earnings growth) and lower returns.

4. Inequalities and instability have increased, not decreased: With the recovery involving the financial sphere rather than the real world (asset inflation replacing goods and wage inflation), and the widening of inequalities, the support for populist parties rose in many countries. In addition, the increased importance of China as a global political and economic player has added further complexity to the whole picture. Protectionism is another consequence of the more inward-looking political attitude. The globalisation theme has not run its course, but investors must assess powerful shifts in the structure of global growth towards more “domestic” engines via active global approaches.

With a short-term perspective, the economic slowdown we see ahead is likely to reveal sets of risks well beyond the classic ones (stronger growth leading to higher inflation and higher rates), such as cracks in the most imbalanced situations, political risk (tariffs/uncertainties regarding US policy action) on the macro side, and liquidity and positioning on the market side. Risk-off sentiment may emerge, triggered by idiosyncratic situations (Turkey and Italy as the most recent examples) reviving the appeal of the “Western core”. Core assets and core rates should receive some support; in equity we should expect to see a rotation of styles versus quality and value. Peripheral bonds and emerging markets could suffer in the short term, however, as the threat of much higher rates and a much stronger dollar are largely behind us, this general repricing should be seen as an entry point (excluding idiosyncratic situations) for long-term investors.

High Conviction Ideas

MULTI-ASSET

We are neutral on risk assets due to rising uncertainties. In equity, we maintain a preference for the US, with limited exposure to Europe (basic materials), the UK, and Japan. We are cautious on EM. In fixed income and FX, we still play CB divergences with limited duration and inflation-linkers. We are very cautious on credit. Hedges are still in place in case of a deterioration of the current scenario.

FIXED INCOME

We don't think CBs will change their plans due to idiosyncratic stories, even if spillovers are visible (flows into core bonds and a sell-off of fixed income risk assets), we remain cautious on duration (shorter in Europe than the US), and we have raised our credit quality/liquidity focus. The USD should remain strong in the short term, but most of the appreciation is behind us. Through the year end, this could give some relief to EM assets, currently under pressure.

EQUITIES

We favour strategies to deal with a maturing phase of the market and we focus on quality, less leveraged companies, a reduction in stock/sector concentration risks and a balanced approach between cyclical and defensive sectors. It is not time yet to become outright defensive, in our view, as the earnings outlook is still constructive. However, volatility should trend higher due to trade noise, the approaching US mid-term elections, idiosyncratic stories and tighter financial conditions. We still favour the US market given its superior earnings growth.

REAL ASSETS

With lower returns expected ahead for most traditional asset classes, investors should continue to search for sound risk/return potential as well as diversification benefits. In this respect, private debt solutions, especially those focused on the most senior and secure parts of capital structures, could represent attractive ways to complement traditional fixed income exposure.

MACRO

Global growth: still decent but multiple risks ahead

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

Global growth: still decent but multiple risks ahead. The year began with a synchronised global recovery as most economies benefited from a buoyant environment. The risk of inflation and CB mistakes dominated investors' fears. Since the spring, clouds have accumulated globally. The second half began under less happy auspices than the first, with a less buoyant economic climate and many risk hotspots. On the one hand, growth in the Eurozone was weaker than expected in H1 (after a strong second half of 2017). On the other hand, large EM have seen their macrofinancial situation deteriorate with the USD appreciation, which puts countries where private sector debt is denominated in USD into strong difficulty. For example, Argentina and Turkey are in crisis today. These are idiosyncratic shocks that in theory, should not spread. However, many EM were distrusted by investors during the summer. In addition, Donald Trump's protectionist threats have multiplied. The proximity of the mid-term elections (6 November) is encouraging him to implement his promises of the presidential campaign on trade. Europe has been relatively spared for the moment, but in view of Donald Trump's recent statements, one cannot rule out taxation on auto imports. That said, for now, China remains the subject of the most aggressive protectionist measures.

Added to the threats of a trade war are risks of very different nature:

- US sanctions on Iran, which tend to drive up oil prices.
- The fiscal slippage in Italy. Relations are tense in the coalition government on what strategy to follow and the size of the budget deficit (see box below).
- Brexit negotiations are stalling and governments (in the UK and in the rest of the EU) are openly preparing contingency plans in case of no agreement by 31 March 2019 (hard Brexit).
- The Turkish financial crisis may get even worse (we anticipate a recession in the coming quarters).

The multiplication of risks increases global uncertainty. If we continue to anticipate further global expansion, it is at a slightly slower pace in the Eurozone, China and, on average, in EM. The US economy, for its part, remains supported by fiscal policy, the effect of which is expected to weaken in 2019. The risks to growth are clearly on the downside over the next 18 months. As for the upside risk to inflation, without having disappeared, it has weakened (except of course in countries where the currency has fallen). Inflation is a lagging indicator of activity; an inflationary surprise would be short-lived if, as we believe, the world economy slows down.

The Strategist view

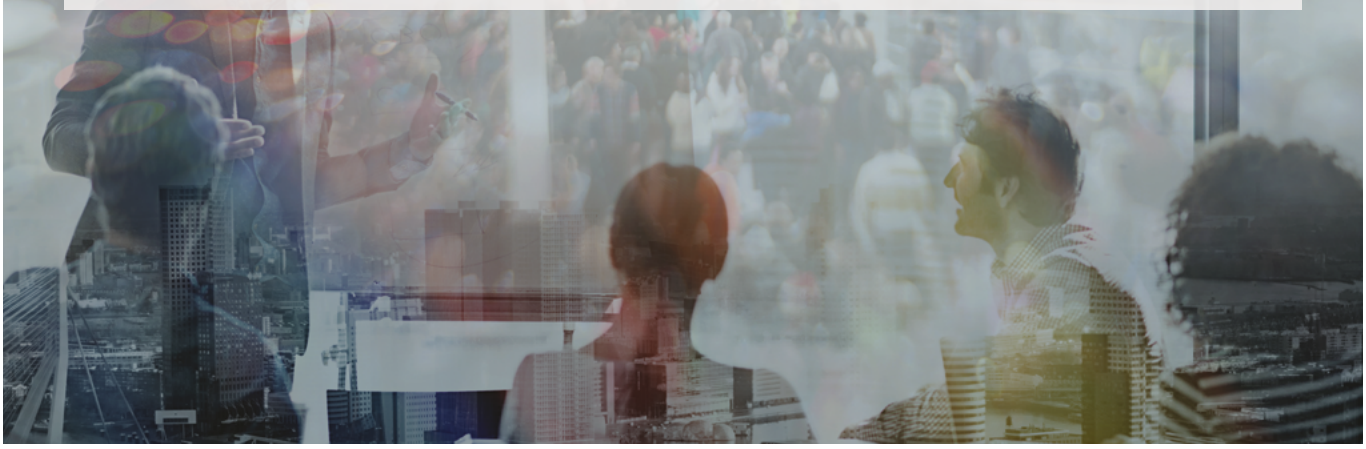
Political uncertainty weighs on Italian Government Securities (BTPs) as the "moment of truth" on budget law approaches.

Italian BTP spreads trended higher in August, reaching levels close to recent highs recorded in May in the 10Y maturity, while **short-term maturities proved more resilient**. **The Moody's announcement to postpone any decision until the end of October**, in order to wait for the fiscal budget to be released in September, gave some relief to BTPs and put more pressure on the government to be more cautious on the fiscal side. Recent data in demand trends saw foreign investors sharply reducing their exposure in May and June, although July saw a slight recovery and a return to lower levels of liabilities. Italian banks increased their holdings of BTPs, offsetting most of the effect of non-residents selling. Net supply pressure in the remainder of 2018 is likely to decline compared with what took place in H1 and should turn slightly negative in H2; the pace of gross issuance is likely to almost halve with respect to the first five months. Mid-month auctions in August have already been cancelled and the same is also likely to occur in December.

Despite lower purchase volumes from the ECB in the coming months, negative net issuance should reduce the pressure on BTPs. Depending on the outcome of the budget proposals and the targeted deficit on GDP for 2019, a sort of "spread consensus" has been built for BTPs' spreads: a 0.8% deficit/GDP ratio would match an average spread level of 150 bp, a 1.8% ratio would be consistent with a level of spread slightly higher than 200 bp, while 3% would mean a 300 bp spread. A strong confrontation with the EU with a very aggressive deficit projection higher than 6% would lead, according to consensus estimates, to spread levels between 450-500 bp. At the moment, BTPs are implying a deficit closer to the 3% threshold rather than the 1.8% level, which, according to the very latest "leaks" and reassuring statements released by both the PM and the Finance Minister, looks more likely. There seems to be some value in current levels in the case of a responsible budget in the 1.8% area. **Volatility in BTPs is likely to remain until September**, amplified by lower liquidity and political uncertainties. On a positive note, the net non-performing loans of Italian banks saw a strong drop in June to levels not seen since 2010: the noise on the political side doesn't seem to be affecting Italian banks' progress on this path.

> "Volatility on BTPs will remain elevated until September, when there will be more clarity on budget law.*"

See this month's topic for a more in-depth analysis



MULTI-ASSET

Cautious and selective

MATTEO GERMANO, Head of Multi-Asset

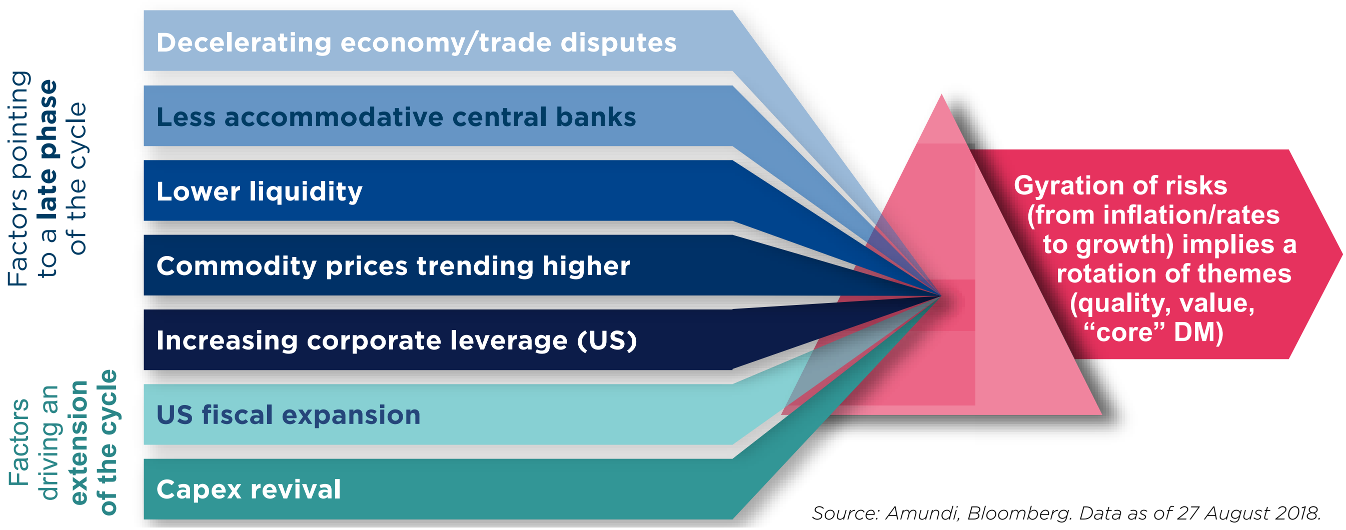
Asset class returns have been mixed this year to date: the persistently robust growth in the US has allowed the equity bull market to continue, posting a 20% EPS growth. Performance has been poor for EMs, as investor sentiment deteriorated on the back of a stronger dollar and higher US rates. Countries more dependent on external financing saw the value of their currencies fall. China suffered the tariff threat from the US administration; particularly weak was the IT/technology sector in Asia. Our central scenario is still for a continuation of this phase leading to a late cycle, global solid growth but we see it decelerating as inflation trends mildly higher, with risks tilted on the downside. We expect CBs to stick to their path of very gradually normalising monetary policy in this relatively favourable macroeconomic outlook. Global trade tensions are set to continue and idiosyncratic issues (such as the crisis in Turkey) will emerge more frequently as the liquidity in the system deteriorates and financial conditions get slightly tighter. We continue to prefer relative value stories and themes rather than directional exposures and we continue to focus on solid fundamentals to better navigate uncertain waters.

> “We continue to prefer relative value themes and to focus on solid fundamentals to better navigate uncertain waters.”

High conviction ideas

From a cross-asset market perspective, we stay close to neutrality on global equities, consistent with the idea of being in a mature financial cycle. It is difficult to see a major correction in equity markets when growth is strong and earnings are good (we anticipate that the US Q2 & Q3 earnings seasons will be good), though positioning is beginning to be a worry, with holdings of US equities close to all-time highs. Investors should play themes that we like to call “the last race for risk assets”, focusing on equity markets with stronger earnings growth with a preference for US and UK equities versus European names. We favour a rotation to value in Europe, with a preference for value stocks versus the EMU index. In fixed income, we look for value in the theme centred on CBs’ asynchronies. We have a defensive approach on the German short end of the curve and UK real rates; we have a neutral view on US duration; and we are cautiously positive on corporate IG and inflation-linked bonds (10Y US, EUR, JPY and US 2/10 inflation steepener). We have systematically trimmed our preference for credit. While we keep a neutral view on EM (both equity and bond),

Moving to a late phase of the cycle



Source: Amundi, Bloomberg. Data as of 27 August 2018.

identifying “EM winners versus leftovers” remains one of our main themes. We search for the most valuable relative value opportunities, focusing on countries with stronger fundamentals and less external vulnerabilities. We prefer China to the global EM from a positive medium-term perspective. Overall, we consider EM valuations attractive but we prefer to look for entry points after the US mid-term elections, when we expect some easing of trade tensions and when most of the electoral events in EM should be over.

Risks and hedging

Hedging remains an important element to consider in this phase of high geopolitical uncertainty and a maturing financial cycle. We keep gold as a hedge. The JPY (versus USD and AUD) could also contribute to protecting investors' portfolios from trade tensions. It is also worth including hedges to specific risks, such as on the credit market (HY), which could be negatively affected in case of liquidity stress, or to a material deterioration of the scenario (protecting from an S&P500 correction).

FIXED INCOME

Core appeal, but not time to be overly defensive

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

Overall assessment

The appeal for core bonds continues due to both the geopolitical tensions and erupting idiosyncratic stories in EM. The Turkish crisis is the latest in signalling that conditions have become tougher for EM debt. Selectivity is increasingly the name of the game to limit the effects of country-specific vulnerabilities and imbalances. As the tide that lifts all boats, notably ultra-accommodative monetary policy, is approaching an end and financial conditions become tighter, investors should continue to explore opportunities in credit, but with a more cautious attitude in the areas of the market that benefit most from the buyers of last resort (CBs), notably low quality/low liquidity bonds. We are still cautious on duration, but, especially in the US, investors should consider reducing their shorts as we move closer to a neutral rate.

> “Idiosyncratic stories support core bonds.”

DM government bonds

The 10Y German bond yield remains anchored to year-to-date lows, benefiting from the flight to quality effect as a response to the Turkish crisis (with a potential impact on European banks) and tensions on Italian govies. The next weeks will be critical for the Italian budget law and noise will remain high. The Italy-Spain spread being close to historical peaks means markets are confident about the ECB's toolkit to reduce contagion risk. We don't believe that these frictions will impact on the ECB's announced plans. Eurozone CPI is close to the CB's target and economic conditions remain sound, despite some challenges. Hence, in the tug of war of idiosyncratic stories and sound economic conditions, we expect core rates to remain in the current trading range.

DM corporate bonds

We have taken a more conservative and selective approach on credit in recent months, even if we do not think it is yet time to be too defensive. Investors have started to price in a peak of global economic activity, less supportive technical conditions and diverging fundamentals between the US and Europe. EU companies continue to be very cautious, with low leverage and high cash ratios. US companies remain confident in the economic cycle, increasing leverage and decreasing their cash ratios.

We prefer short-term maturities/floating rates and higher quality bonds. Opportunities are rising in subordinated bonds in Europe, but again a focus on selectivity is paramount.

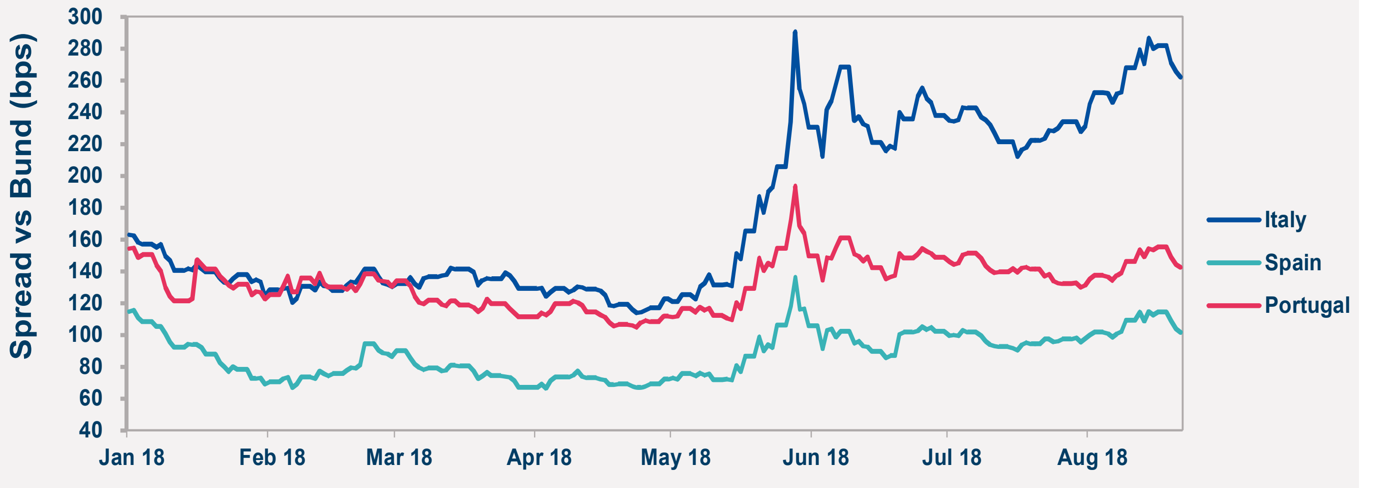
EM bonds

We remain prudent on the asset class at the moment, as some political noise is expected ahead of Brazilian elections in October. Our preference is for hard currency bonds over local currencies due to valuations, the risk-off environment and EM FX fragilities versus the USD. Our favourite picks are Mexico (agreement with US on trade and attractive risk/return profile in local currency (LC) sovereign debt), Serbia (good fundamentals and appealing risk/reward) and Argentina (after the IMF support). We are cautious on Turkey (LC) .We don't expect US sanctions on Russian sovereign debt, but volatility will remain high. Through the year-end, when we expect easing trade tensions and a stabilisation of the USD, EM bonds will be back in focus, with attractive yield premiums for long-term investors.

FX

The USD should remain well supported in the short term versus main currencies thanks to the US economy's strength and CB divergences. However, US elections in November could weigh on the greenback, giving some relief to EM FX.

10Y Govt bond spreads vs Bund



Source: Bloomberg, Amundi Research. Data as of 27 August 2018

EQUITY

Strong earnings season

YERLAN SYZDYKOV, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

Overall assessment

Divergences have increased as a consequence of idiosyncratic stories (the Turkish crisis weighed on the EU market, but also EM were strongly hit by the risk-off mood), while the US market is re-approaching historical highs. Earnings are up, also owing to strong growth. Divergences should remain in place in the coming months, softening next year when some of the one-off US EPS growth will be over. For Q3 and Q4, the earnings outlook is constructive for global equities in the context of sound growth, modest rises in interest rates and barring an escalation of the trade dispute into a trade war. The US continues to be our favourite market due to the strong

EPS growth premium and improving relative valuations (thanks to EPS growth). As the cycle matures, (higher oil prices and input costs), stock picking will remain crucial, with a preference for quality, less leveraged, companies.

Europe

The outlook remains moderately positive, but with some vulnerabilities. The Turkish crisis could impact EU banks, which have around 150 billion of USD in Turkey. Even if this is not a problem for their balance sheets, from a P&L perspective a jump in provisioning could dent their results and affect MSCI Europe EPS growth. The recent weakness of the EUR/USD is supportive, but this tailwind should prove temporary (until Q1 2019). In trade weighted terms, the depreciation versus the USD was balanced by an appreciation versus EM currencies.

United States

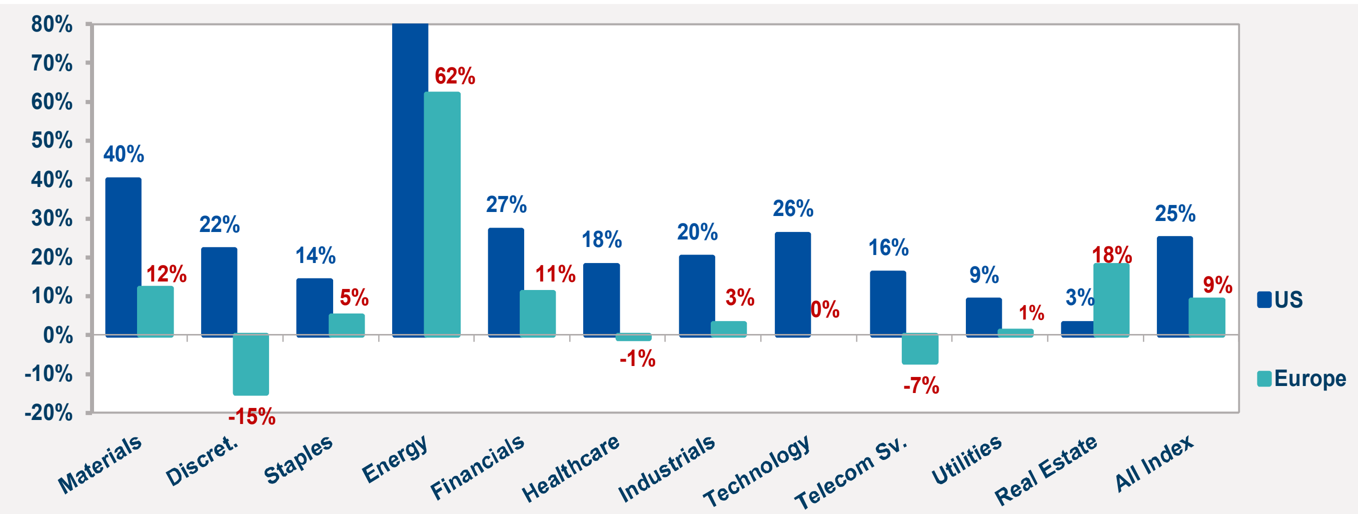
The US market is enjoying one of the longest bull markets in history, but this is not enough to call for an imminent turning point. The economy is growing nicely, small business optimism is solidly close to an all-time high and capex plans are solid. The earnings boom incorporates the tax reforms effect, which added about 8% to this year's EPS growth. The outlook for earnings is still positive for 2018 and 2019. However, we believe that a "quality check" to the portfolios is warranted at this stage, as well as the implementation of more defensive strategies (such as reduced stock/sector concentration or increased focus on valuations and lower volatility). This year most of the S&P's performance is explained by a few sectors (IT, consumer discretionary and energy) and the breadth of the market is decreasing. Areas we view as needing attention are the IT sector, which is exposed to possible retaliation measures just when the growth/value ratio is stretched globally, the strong USD appreciation, which could hurt more global exporters, and the near flat yield curve. Approaching the US mid-term elections, we expect some political noise, but an overall positive backdrop.

> "US earnings supremacy continues."

Emerging markets

The recent sell-off improved valuations and, if there is no more negative news on the growth side, EM equity could rebound a bit from its depressed levels. In the last quarter, we revised downwards EM EPS forecasts to a range of 5-9% (versus the previous 6-11%) for FY2018 and we are more conservative than the consensus. We remain prudent on the asset class, with some challenges ahead. World trade growth is set to decelerate for 2018 as well as EM exports, idiosyncratic political uncertainty is high (Brazil/South Africa/Turkey) and there is uncertainty on US policies. On the positive side, we see the commodity outlook as favourable. As investment ideas, we like Greece and oil-related themes. We are also positive on China as most of the concerns on economic slowdown or on trade tensions seem to be priced in, valuations are very compelling, and we see policy reaction supporting the economy

US and Europe: Q2 2018 earnings growth by sector



Source : Amundi, Thomson Reuters Eikon. Data as of 27 August 2018. US = S&P500. Europe = Stoxx 600

REAL ASSETS

Private debt: diversified strategies to invest in Europe

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

A fast-growing market in Europe

The European private debt market has expanded significantly over the last 10 years. According to Preqin's Private Debt Quarterly Update (Q2 2018), while the largest proportion of private debt fund activity has occurred in North America over the past year, the European market has seen the largest gross growth rate (Q2 2018 aggregate capital target increased by 52% versus Q2 2017). This trend is being fuelled, in particular, by the increased adoption of non-bank lending. Disintermediation is clearly intensifying in Europe, with the proportion of private debt-backed deals in the region gaining traction steadily over time. Across Europe, after the UK, France and Germany were the second and third most disintermediated markets in terms of deals in 2017. Nonetheless, many investors are looking to the European private debt market with increasing attention and interest given the sound risk-return potential, as well as the diversification benefits it may offer their portfolios. Overall, European issuers want to diversify their funding sources and arrangements, while investors are looking for increased yields and diversification.

We expect this to be a long-term trend and thus expect the European private debt market to see strong growth and offer compelling opportunities over the coming years.

> "The European private debt market is set to offer compelling opportunities over the coming year, but deep expertise is needed to exploit them."

Watch out for opportunities

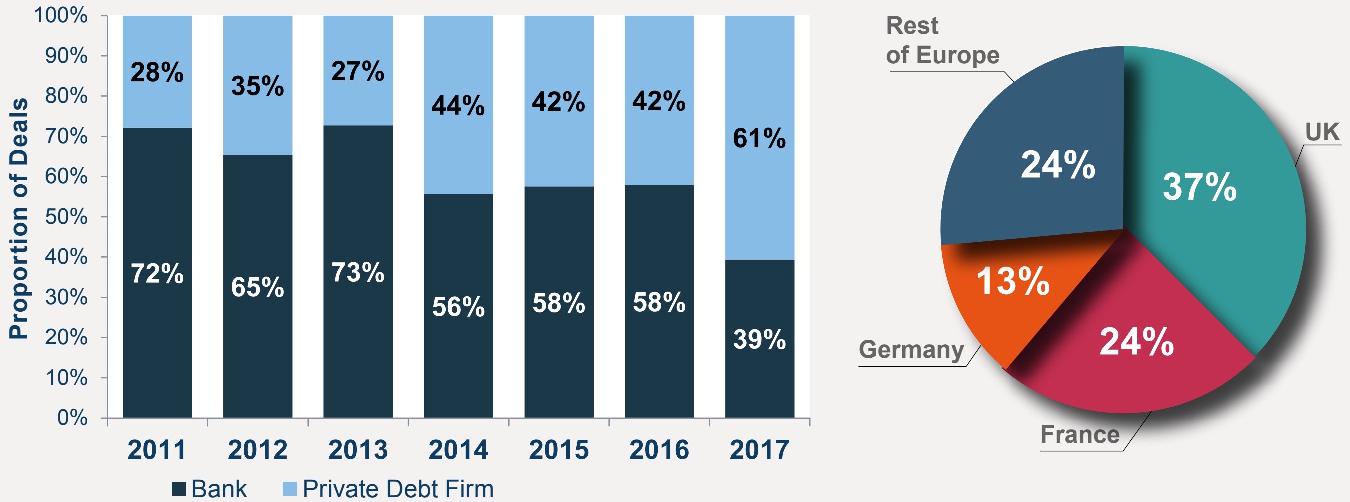
We firmly believe that this asset class can no longer be ignored in strategic diversified allocations.

The European market offers numerous investment opportunities, due to a diversified economic landscape.

However, a broader opportunity set requires fund managers to remain extremely disciplined and rigorous with regard to selection in order to find the appropriate risk-adjusted return transactions. Moreover, the pronounced diversity among European countries (each member state currently still has its own banking regulation and system, fiscal law and insolvency proceedings) makes the combination of strong local roots and intimate knowledge of European countries and of their local players a must-have factor for success. The overall investment situation is made even trickier by the current market players operate in, marked by a combination of unconventional monetary policies, the end of quantitative easing, and expected rising interest rates. In this changing and challenging environment, very deep expertise is needed for building diversified investment strategies that can help address investors' needs and concerns.

We are convinced that investing in the most secure and senior part of capital structures can provide downside protection against a possible turnaround in the credit cycle, while offering attractive long-term returns. In addition, we favour floating rate assets as they can help to protect portfolios from rising interest rates and offer a relatively attractive yield. Finally, we think that portfolios need to be modelled with an optimal allocation to liquid and illiquid assets, and a strong complementarity with traditional fixed income.

Private debt-backed deals in Europe



Source: Preqin, Amundi Research, June 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	↗	●		
	-/=	Euro core	→	●		
	=/+	Euro peripherals	→			●
	-	UK	→	●		
	-	Japan	→	●		
CREDIT	=	US IG	→		●	
	+/=	Euro IG	↘			●
	=	US HY	→	●		
	=/+	Euro HY	→			●
	=	GEM debt hard cur.	→		●	
	=	GEM debt loc. cur.	→		●	
EQUITIES	+	US	↗			●
	=/+	Eurozone	→		●	
	=/+	UK	→			●
	=	Japan	→		●	
	=	Pac. ex Jap.	→		●	
	=/+	Global EM	→		●	
	+	Convertibles	→			●

Currency and real assets

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

LEGEND

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

Source: Amundi, as of 29 August 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

Deadline for the Italian budget law approaches: will we remember the 27th night of September?

ANNALISA USARDI, Macroeconomic Research
SERGIO BERTONCINI, Credit Strategy

Finalised on 30/08/2018

The essential

Italian budget discussions are going to intensify as the 27th of September approaches, date of publication of the document outlining the new budget law and when there should be more clarity on the key economic projections and deficit targets. In these focus we make a few scenarios on budget deficit in order to understand the level of flexibility available and to link these different scenarios to recent trend in GDP growth and to what they could imply in terms of spread levels offered by Italian debt.

Our findings show that current spread levels already imply an easier fiscal stance, including some of the flagship measures of the government plan. We also analysed the technical picture of Italian sovereign bonds in terms of perspective supply over the next months and investigated recent trends on the demand side. under this respect and together with structural trends in funding cost, average maturity and sensitivity to the rate risk we found some supportive notes. Relative value is investigated too, versus other sovereign bonds and periphery corporate bonds, showing limited impact so far from higher Italian spreads on other fixed income segments.

Italy, our short-term view on the economy: decelerating growth, low inflation and rising interest rates make an explosive mix for public finances which means that a primary surplus is an absolute necessity for stabilising the debt trajectory

We revised our projections for GDP growth downwards to 1.1% in 2018, gradually decelerating towards 2019-2020 potential of just below 1%. Our revision is based on a lower contribution to growth by Investments and Personal Consumption compared to 2017 as under current law, their growth dynamics are expected to moderate. **On the inflation front, there are no strong signals of a sustained pickup in core inflation either,** linked to modest wage dynamics and a still open output gap. There has been a recent acceleration of broader measures of inflation supported by the energy base effect but according to our projections, this acceleration should fade by year-end. **Risks to growth are skewed to the downside due both to e**xternal factors (e.g. trade war, geopolitics) and domestic factors (political uncertainty), which could have an adverse economic impact on consumer and business confidence, investment, hiring decisions, interest rates and financing conditions for corporates.

Still one month to go until we have clarity on the Budget Law but growth and political development are increasingly intertwined

Lower growth could have a significant impact on the political front as it could exacerbate the contrast between the M5S and League coalition and the Finance Minister and could also increase friction between M5S and League on how to implement certain fiscal expansion measures (universal income vs flat tax), should the decision be to keep it contained.

Currently, **we expect that both M5S and League will temporarily overcome their programmatic differences and show some pragmatism about the implementation of the fiscal expansion package (i.e. limited fiscal**

expansion), with their minds focused on the May 2019 European Elections as their new political goal. In the meantime, **we expect rhetoric to become occasionally confrontational with the EU**, with a diplomatic role for the Finance Minister to keep dialogue open. As per recent news, though, the risk that deficit could hit the 3% level seem to have decreased and the Government appears more inclined to adopt a gradual implementation of their program.

We should have clarity by around 27 September when key figures for GDP, deficit and debt projections will be announced. Other key events will be:

By 15 October, the 2019 Draft Budget will be submitted to the EU Commission.
By 20 October, the government should submit the Budget Law to Parliament for debate.
Between end of August and end of October, Fitch 31/08 (BBB outlook stable), Moody's end of October (Baa2, outlook negative) and S&P 26/10 (BBB outlook stable) sovereign rating review.

So far, little clarity and many assumptions. But exactly how flexible are Italian finances? Walking a tightrope

Key public finance indicators as presented by the previous government as targets for 2018 and 2019 are likely to be difficult to achieve due to a weaker macroeconomic performance than assumed when the budget was presented. In addition, neutralisation of the VAT hike would reduce fiscal space by a further EUR 12.4bn.

Many assumptions have been made over the past month and seeking to determine the degree of flexibility available, we provide a few examples here.

Case 1: **implementation of very minimal program, including only the very initial implementation of a flat tax for small businesses and VAT hike neutralization, funded by a mix of savings and revenues**. This scenario would be comparable with that reported in newspapers targeting a deficit of 1.8% and compatible with the implementation of only a few fiscal measures set out in the government contract.

Case 2: partial initial implementation of certain flagship measures proposed by both League and M5S, funded by a mix of savings and revenues and with some internal rationalization in terms of tax expenditure (e.g. implementing some form of universal income/support for people on low incomes but cutting the EUR 80 support introduced by the previous government). This scenario would be just a little more parsimonious than that apparently priced in by the BTP-Bund spread (according to a Bloomberg survey, the current spread is aligned with a 2.7% deficit).

Case 3: as a benchmark, we consider the **full implementation in one go, using estimates of all measures introduced in the government contract.**

In Case 1 and 2, we assume that the government will decide against deficit financing for all measures and seek to source as much as possible from a combination of measures for up to EUR 20bn. **Case 3 would require deficit financing**.

The government could look at the possibility of funding the program using a mix of measures, such as fighting tax evasion (which accounted for EUR 20bn in 2017, EUR 16bn on average over the past 5 years), reducing the cost of politics, a tax amnesty and reducing tax expenditures. It is vital that a mix of tax evasion revenues and proceeds from other sources be found or the deficit will rapidly fall to the 3% range or below, even in Case 1. With this budget, the government is clearly walking a tightrope.

There is also hope of finding fiscal space by negotiating flexibility with the EU commission. Should the Finance Minister succeed in obtaining some flexibility (e.g. not having to introduce the planned change in the cyclically adjusted deficit of approx. 0.6% of GDP), this would generate up to an additional EUR 10bn which could be used to partly cover the VAT hike neutralisation. But this outcome would only be likely, albeit partially, on the assumption of a sensible budget to start with (i.e. not viable in Case 3). We do not take this additional space into account in our computations. Furthermore, in our estimations, we do not take into account possible positive spillovers on short-run GDP growth of the fiscal package.

Please note that in the absence of any clarity from the government, the cases below represent possible combinations to define a few cardinal points for reference purposes, given the uncertainty hanging over the budget law.

	in euro bn					
	Very "slim" program	**Case 1**	**Partial implementation & rationalisation**	**Case 2**	**Full program in one go**	**Case 3**
	2018 primary balance	**32.6**	**2018 primary balance**	**32.6**	**2018 primary balance**	**32.6**
EXPENDITURES	Not-deferrable expenditures	-3.5	Not-deferrable expenditures	-3.5	Not-deferrable expenditures	-3.5
	Sources to avoid VAT hike	-12.4	Sources to avoid VAT hike	-12.4	Sources to avoid VAT hike	-12.4
	Sources to start flat tax (partial implementation)	-3.5	Sources to start flat tax (partial implementation)	-3.5	Flat Tax (full implementation)	-50.0
					Duties on gasoline	-6.0
			Public Investment	-6.0	Public Investment	-6.0
					Machine Gambling	-7.0
			Recruitment centers reform	-2.7	Recruitment centers reform	-2.0
			Universal income (a)	-16.0	Universal income (b)	-17.0
					Pension system reform	-8.1
					Family support	-8.5
	lower GDP growth impact on deficit	-3.0	Lower GDP growth impact on deficit	-3.0	Lower GDP growth impact on deficit	-3.0
REVENUES			Cutting selected tax reliefs	16.0	Cutting selected tax reliefs	16.0
	Reduce cost of politics	0.5	Reduce cost of politics	0.5	Reduce cost of politics	0.5
					Fiscal peace	25.0
	Fight tax evasion	16.0	Fight tax evasion	16.0	Fight tax evasion	16.0
		=		=		=
	2019 primary balance	**26.7**	**2019 primary balance**	**18.0**	**2019 primary balance**	**-33.4**

The examples above would result in the following key metrics for 2019.

In () are reported the targets set by previous government

	Case 1	Case 2	Case 3
Primary Balance (bn)	26.7	18.0	-33.4
Primary Balance (% GDP) (2019 target: 2.7)	1.6	1.0	-1.9
Estimated Interest Expenditure (% GDP)	3.5	3.5	3.9
Deficit (% GDP) (2019 target: -0.8)	- 1.9	-2.5	-5.8
Debt (2019 target: 128)	129.0	129.6	132.9

(a) Estimates for this measure range from 17 to 35 bn, we take the average and subtract approx 10 bn assuming some income support measures will be cut (e.g. "80 euro" support introduced by previous government)

(b) "best case" estimate assumed in this simulation of Case 3 (from the 17 to 35 bn range of estimates available for this measure)

Please note: should the Finance Minister be succesful in negotiating some flexibility from the EU Commission with regards to reducing the cyclically adjusted primary balance (less than the 0.6% of GDP previously committed), this could free up to additional 10.3 bn (applicable in our opinion only in Case 1 & 2)

Sources : Amundi Research, Bloomberg, MEF, Il Sole 24 ore, Osservatorio dei Conti Pubblici

The debt sustainability matrix is a tool that can be used to gain an effective understanding of how different budget proposals will work out

Change in Debt to GDP ratio under various scenarios of growth and primary balance, for a given level of interest rates

Primary Balance (% GDP) \ Nominal GDP growth	1%	2%	**2,5%**	4%	5%	6%
3,5%	-0,5%	-1,8%	**-3,1%**	-4,4%	-5,7%	-7,0%
3,0%	0,0%	-1,3%	**-2,6%**	-3,9%	-5,2%	-6,5%
2,5%	0,5%	-0,8%	**-2,1%**	-3,4%	-4,7%	-6,0%
2,0%	1,0%	-0,3%	**-1,6%**	-2,9%	-4,2%	-5,5%
1,5%	1,5%	0,2%	**-1,1%**	-2,4%	-3,7%	-5,0%
1,0%	2,0%	0,7%	**-0,6%**	-1,9%	-3,2%	-4,5%
0,5%	2,5%	1,2%	**-0,1%**	-1,4%	-2,7%	-4,0%
0,0%	3,0%	1,7%	**0,4%**	-0,9%	-2,2%	-3,5%
-0,5%	3,5%	2,2%	**0,9%**	-0,4%	-1,7%	-3,0%
-1,0%	4,0%	2,7%	**1,4%**	0,1%	-1,2%	-2,5%
-1,5%	4,5%	3,2%	**1,9%**	0,6%	-0,7%	-2,0%
-2,0%	5,0%	3,7%	**2,4%**	1,1%	-0,2%	-1,5%
-2,5%	5,5%	4,2%	**2,9%**	1,6%	0,3%	-1,0%
-3,0%	6,0%	4,7%	**3,4%**	2,1%	0,8%	-0,5%
-3,5%	6,5%	5,2%	**3,9%**	2,6%	1,3%	0,0%

The shaded grey area shows the combinations of Primary Balance and Nominal GDP growth which, for a given level of interest rates, result in a decline in the debt-to-GDP ratio. The yellow cell is current the projection under April 2018 DEF (Economic and Finance planning Document).

According to our 2019 projections for inflation and growth (bolded column) and assuming 10y interest rates close to current levels, Case 1 (green) & Case 2 (yellow) would still be compatible with a decline in the debt-to-GDP ratio. Case 3 (red) would generate an increase in the debt-to-GDP ratio.

Should the Primary Balance slip into negative territory, debt will move higher, going down the column in bold.

The matrix also helps us understand that the debt-to-GDP ratio would decline in the event of significant fiscal slippage (such as Case 3) only if nominal GDP growth were to move into the 5% to 6% range, which would mean either very high inflation of very high growth. It is very difficult to imagine that the fiscal package delivered would result in GDP growth moving into such territory (without first affecting the level of 10y rates).

A return to BTP spread volatility in August as the moment of truth on the government budget approaches

Following some stabilization in July, BTP spreads trended higher again in August, reaching levels close to recent previous highs recorded in May in the 10-yr maturity (286 bp by mid-August vs 290 bp in May). However, the short-term bucket of the Italian yield curve proved to be more resilient to recent volatility than in May, as the 2-yr BTP-Bund spreads reached a peak of 196 bp by mid-August, much lower than 340 bp reached in May and lower than June's 230 bp spread level. Volatility was also lower following the May spike in the short-term segment of the Italian yield curve. After having put Italy on watch at the end of May, Moody's announcement that it was postponing any decision to the end of October pending the release of the budget details in September, gave some relief to BTP spreads in the short term and also helped to put more pressure on the government to keep it from adopting a fiscal stance that is too loose.

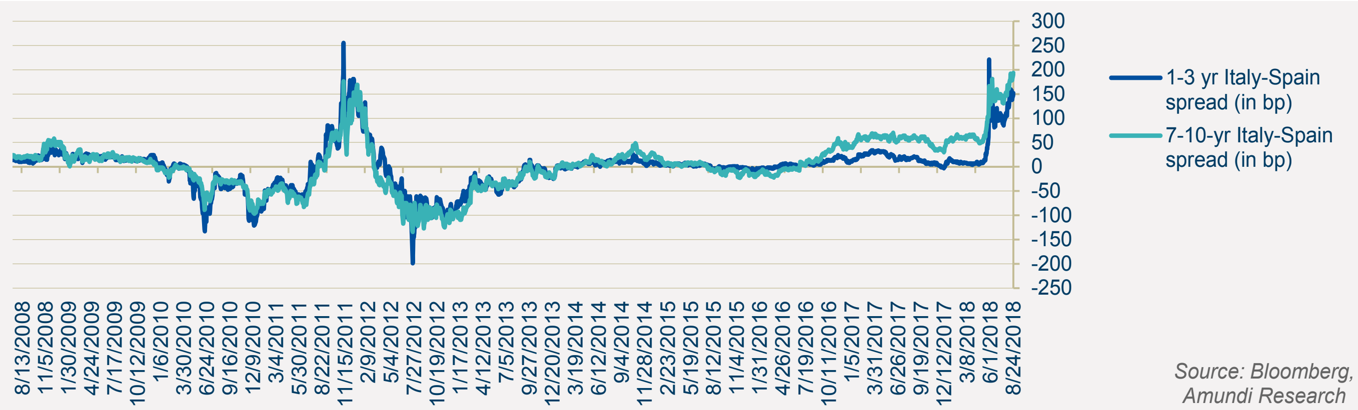
What sort of government budget appears to be implied by current spreads?

According to median forecasts collected in a recent Bloomberg survey of banks, it seems that current market spreads already imply a 2019 debt-to-GDP ratio of close to 2.5%/2.7%, higher than the 1.6%/1.8% threshold which, as we mentioned before, is being reported in government-backed newspapers and compatible with the implementation of only few fiscal measures in the government contract (Case 1, of a very minimal program, outlined in the previous section). Accordingly, this is not an extreme scenario but a more aggressive one than the fiscal easing which is consistent with recent statements. Based on a more in-depth analysis of the results of the survey, depending on the outcome of the budget proposals and target debt-to- GDP ratio for 2019, a sort of spread consensus has been built for the BTP spread. In the survey, a 0.8% debt-to-GDP ratio would match with a median spread level of 150 bp, a 1.8% debt-to-GDP ratio would be consistent with a spread level a few basis points higher than 200 bp, while 3% would appear consistent with a spread in the region of 300 bp. Sharp confrontation with the EU with a very aggressive deficit projection of higher than 6% would lead, according to consensus estimates, to much higher spread levels of between 450 and 500 bp. In a nutshell, therefore, a risk premium has already been attached to the outcome of the budget law and to reassuring statements made by the Finance Minister.

Limited contagion of other periphery sovereign bonds so far while periphery corporate bonds have also shown resilience vs BTPs on a relative basis, showing market confidence in ECB's set of tools

In August, the Italy-Spain spread reached a historical high in the 7-10yr segment, while the spread was recently close to 2011 levels in the 1-3 yr segment. The spike of Italian spreads at new historical highs on long maturities vs Spanish government bonds underlines **market confidence in the ECB's capacity to contain contagion**, thanks to the comprehensive set of tools introduced and built up over recent years and now fully available, together with the ongoing effects of QE and negative interest rates, despite the announced end of new purchases in December. Additionally, periphery corporate bonds remain correlated to Italian sovereign spreads but on a relative basis they have proved to be quite resilient so far compared to past experience. In this case, the CSPP has also been playing quite a significant role, together with a supportive macro and micro picture and financial conditions that are still easy.

Italy-Spain spreads in short- and long-term segments

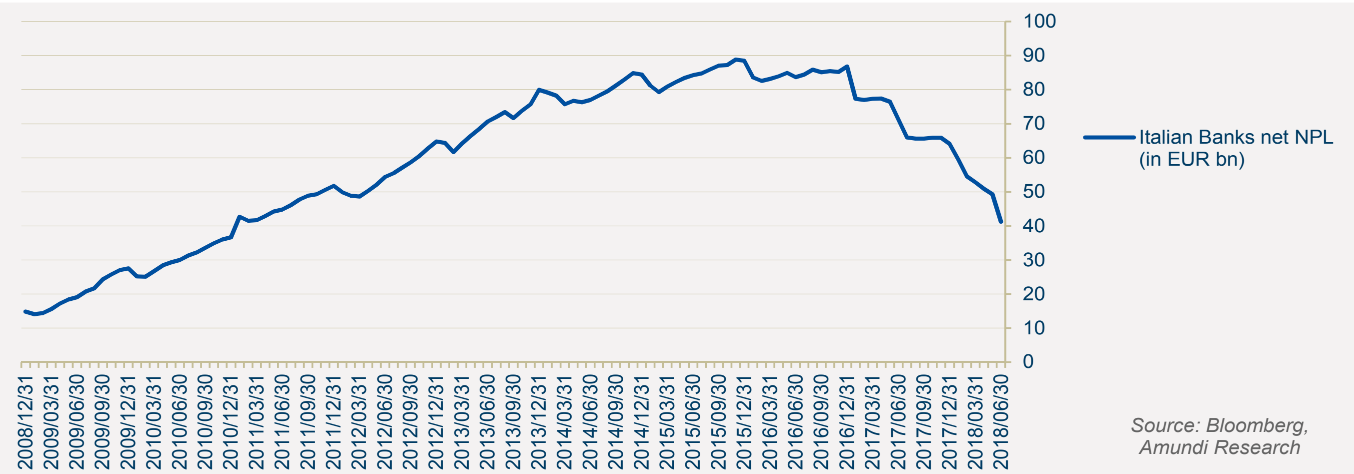


Source: Bloomberg, Amundi Research

Italian banks maintaining easy financial conditions and accelerating NPL stock reductions

Indications from the very latest survey on Bank Lending Standards conducted on Italian banks were mostly in line with signals from banks in other EZ countries. The percentage of Italian banks tightening conditions is still negative despite a slight rise and decelerating loan demand from companies. Accordingly, **lending standards applied by Italian banks remained in easy territory in the July survey**. At the same time, the ongoing reduction of Non-Performing Loans by Italian banks seems to be unaffected by political turmoil and higher spreads, as the very latest figures published on **the stock of Italian banks' net NPLs show a sharp drop in June to levels not seen since 2010 and which have more than halved since end-2016 peaks**. Spread volatility has thus so far not affected Italian banks' capacity to continue down this path.

The ongoing reduction of NPLs by Italian banks accelerated in June



Source: Bloomberg, Amundi Research

What about sovereign debt supply over the coming months?

Looking at trends over recent years, net issuance of Italian sovereign debt has experienced a downward trend, decreasing from yearly figures of around EUR 70/80bn in 2013 and 2014 to the EUR 40/50bn area of the following three years. In 2018 the final figure is likely to be lower than last year, probably in the EUR 30bn area. In fact, as of July, year to date net issuance reached a value of EUR 56bn, lower than average cumulated numbers of the last three and five years.

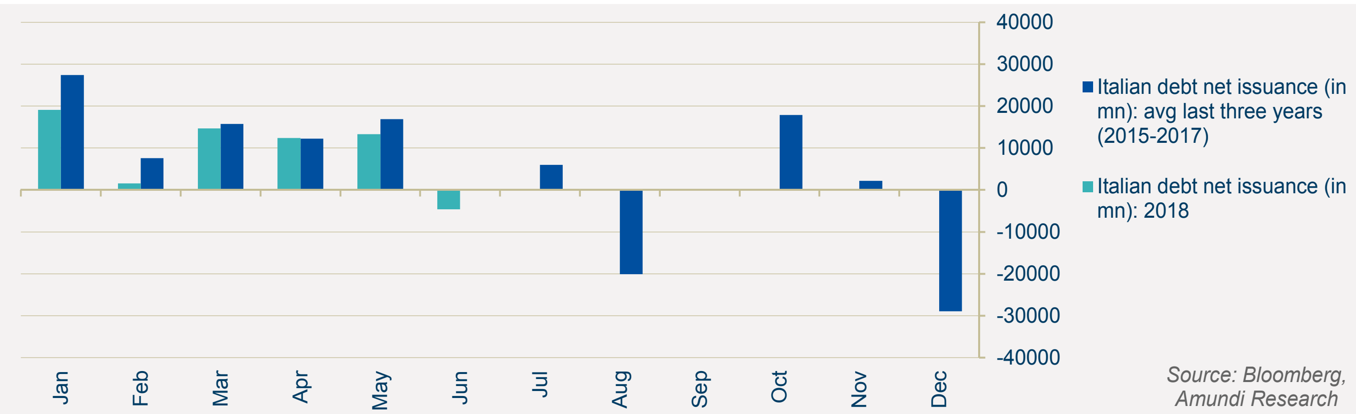
Following recent peaks, net issuance should become negative over the coming months given that the seasonality of net issuance is an established fact, based on monthly data for the last five years. The following points can be made in this regard:

1) H1 always shows a rather steady rise in net issuance to levels close to each year's peak, and then in H2 net issuance tends to fall off (this has been the case over the last 5 years and is also the trend in 2018).

2) In H2, net issuance always tends to be negative in August and December. A thin market and lower trading volumes are likely to be among the underlying causes of this seasonal occurrence as far as August is concerned. The fact that yearly funding tends to be front loaded in previous months, together with the liquidity issue are probably the reasons behind the very negative net issuance which is common in December.

Accordingly, **supply pressure during the remainder of 2018 is likely to decline** compared to H1. Net supply should stabilize and turn negative in H2 and the pace of gross issuance is likely to almost halve compared to first five months. **These trends should reduce potential pressure from the primary market** as, on the demand side, recent available data show that foreign investors reduced exposure sharply in May and June. In these two months, Italian banks increased holdings of BTPs by EUR 28bn, covering most non-resident selling. July saw a sort of stabilization in these trends as Italian banks increased their holdings only marginally compared to the previous two months, while Target2 liabilities edged down for Italy in the same month. The pace of purchases by the ECB remains in the region of EUR 4bn on a monthly basis but in the last three months of the year it is likely to halve to around EUR 2bn.

2018 monthly net issuance pattern of Italian debt very much in line with average numbers of the last three years



A look at recent supportive structural trends on funding costs, average maturity and sensitivity to the interest rate risk

Over recent years, the profile of Italian public debt has improved not only in terms of lower average cost and reduced sensitivity to the interest rate risk but also in terms of a lower short-term refinancing risk, thanks to an increase in its average maturity. Since 2011, the **average cost of funding** of Italian public debt has declined sharply and over the last three years has been between 0.5% and 0.7%. With a lag of about three years, this trend has finally also impacted the **average cost of funding of the entire stock of public debt** which fell from close to 4.0% in 2014 to the current 2.7%. A breakdown of Italian debt by year of issuance shows that almost two-thirds of outstanding debt has been issued since 2013 in years when interest rates were quite low. Over recent years, an average annual amount of around EUR 400bn in debt was refinanced with less than two-thirds (around 62%) refinanced by issuing bonds and the rest by issuing bills with maturities below or close to one year. Over the last few years, together with a fall in its average cost (likely to continue for at least a few years, unless there is a further sharp increase in the spread) the stock of Italian public debt also saw a **steady increase of its average maturity**, which went from 6.4 years to current levels of close to 7 years. This was made possible mainly by managing the trade-off between the overall funding cost and the short-term refinancing risk in the refunding strategy that was implemented. To put it briefly, the weight of short-term bills (BOT) has almost halved since 2011, decreasing from 9.8% to 5.6%, while the weight of medium- to long-term fixed income instruments has increased from 64% to 72%. This strategy also worked in terms of optimizing the trade-off between the lower cost of funding on the one hand and exposure to floating rate/short-term instruments on the other. The component of floating rate instruments linked to short-term interest rates (mainly with short-term maturities) has halved from 24% to 12% and at the same time the weight of inflation-linked instruments has increased steadily and stabilized at around 11%

Most recent developments in the cost of debt and future outlook

On the back of the increase in Italian bond yields and spreads since mid-May, the average refunding cost of Italian debt has increased slightly in recent months. From a low of around 0.55% at the end of April, the average interest rate paid by Italy on funding increased to 0.75% by the end of June, the latest officially released data at the time of writing. Assuming a stable scenario for current spreads in the remainder of the year, our projections point to a further increase to about 0.85% by the end of the year. **Assuming a stable outlook on spreads for next year as well, our projections point to an average cost of funding rising towards 1.5%, a rate that would still be lower than the 2.77% average cost currently paid by Italy on its overall stock of outstanding debt and also lower than the average rate paid on instruments maturing next year.** According to our calculations, the average coupon of the mid- and long-term fixed income instruments on bonds maturing in the next three years will be 2.7% (2019), 2.34% (2020) and 2.37% (2021) respectively. A further sharp rise in spreads would therefore be needed for a material impact on the cost of funding and thus a reversal of the favourable trend seen over recent years. The other point to be underlined is the fact that, thanks to the reduction in the weight of floating rate instruments and bills, the sensitivity of the cost of funding to a progressive rise in ECB interest rates looks relatively limited. In short, unless a 2011-like move takes place on spreads, Italian debt should still feel the positive lagged effects of interest rate falls over recent years, thanks also to its longer maturity. This is important for assessing debt sustainability in the event of a negative shock to funding costs.

Conclusion

Italian BTPs offer spreads which look consistent with a budget deficit close to the 2.5%/2.7% threshold and so already seem to imply a looser fiscal stance including a partial initial implementation of some of the League and M5S flagship measures, funded by a mix of savings and revenues and some internal rationalization on the tax expenditure front. Accordingly, if the most worrying Case 3 government budget scenario is avoided, short-term technical factors and relative value versus other spread products may support a less volatile pattern of spreads, especially in the short- to medium-term segment of the yield curve. In fact and despite lower ECB purchases, primary market supply should reduce its pressure in the coming months at a time when foreign investors have reduced their exposure in a market environment which sees BTPs as the only remaining providers of spread in the short maturity segment. Our analysis of longer-term trends also shows that, if a spread shock is avoided, the increase in average debt maturity over recent years should continue to support a further, though limited, decrease in the average cost of debt looking forward to 2019.

Risk factors

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The table below presents risk factors with judgmental probabilities (i.e. not market based). It also develops the possible market impacts.

Risk # 1 | 50% probability | Further escalation in trade tensions between the US, Europe and China

Analysis | With tariffs on aluminium and steel, Donald Trump sought to "punish" China. China intends not to over-react but retaliated, with a 15% tariff on 120 products, such as wine, nuts, and steel pipes, and a 25% tariff on 8 other products such as recycled aluminum and pork. It is likely that Trump's threats (e.g. rise in tariffs on auto imports) is primarily a message sent to his electoral base in the run-up to the mid-term elections (6 November). However we should not rule out a much more severe confrontation between the US, China and Europe. Retaliations could lead to further protectionist measures by the White House and thus provoke a chain reaction. Although the probability of an escalation of trade tensions is elevated, that of a chain reaction seems quite limited 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/ boomerang effect); (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 clash, for at least two other reasons: (1) the moderate camp (favourable to free trade) has almost disappeared from the White House and (2) the strategy pursued by Donald Trump seems to benefit him (his rating approval has increased over the past few weeks) and, so far we see little or no impact on business climate in the US.

Market impact | Trade tensions have begun to weigh on business climate (especially in Europe) and may lead to a postponement of some investment projects. Even in the absence of a large-scale trade war, the economy may slow down. A chain reaction would cause a slump in global trade while exacerbating local inflationary pressures in the short run (mainly in the US), putting central banks in a corner. This would cause a general rise in risk aversion (fear of a global downturn). Contrary to what Trump asserts, there has never been a winner in a confrontation of this type. There are only losers.

Risk # 2 | 50% probability | Increased geopolitical risks, with an additional increase in the price of oil

Analysis | Financial markets are now operating against a complex geopolitical backdrop. On the one hand, the situation has dramatically eased in Asia with the promise of denuclearization of the North Korean leader. On the other hand, the situation in the Middle East remains tense with regard to the Iranian issue (denunciation by the United States of the JCPOA agreement signed in 2015, with a resumption of sanctions against Iran and, as a consequence, with a possible resumption of sanctions against Iran and, as a consequence, a possible resumption of the nuclear programme). Tensions in the Middle East are already partly responsible for rising oil prices.

Market impact | There will be regular spikes in volatility. The current geopolitical risks are well identified but many and, by their nature, materialize unpredictably. Other political risks (including the consequences of the new US diplomacy) are 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 # 3 | 20% probability | Political instability in Italy with renewed stress on sovereign spreads in the Eurozone

Analysis | The government coalition between M5S and the League has obscured the European sky. Relations will be particularly tense between Italy and other EU countries, particularly in terms of fiscal policy and migration policy. If the risk of a serious budget slippage should not be ignored, the declarations from the Finance Minister were intended to reassure its partners in Europe: it seems out of the question for the coalition to implement a policy that would put at risk Italy's euro membership. This is why the coalition has said that it would postpone (to 2019 or 2020) many measures of its program. The compromise adopted by the ruling parties has nevertheless allowed a lull, but there is no guarantee that it will last. The presentation of the budget and the reaction of the European Commission and the rating agencies will undoubtedly be quite decisive.

Market impact | In case, however, of uncontrolled budgetary drift in Italy, one would expect a very rapid increase in local interest rates, which would jeopardize the ongoing recovery and the public debt sustainability in the medium term. In this case, it is likely that the coalition will explode, or that the President will veto the financial bill. In both cases, new elections would be inevitable. Keep in mind however that the ECB has anti-contagion tools that it could mobilise to avoid a contagion to other peripheral markets.

Risk # 4 | 20% probability | «Hard Brexit»

Analysis | We identify 4 possible scenarios: **(1) Soft Brexit (50% probability)** with an extended transition period, followed by a specific customs union arrangement, free trade in goods but only partial access for services (intermediate regimes of mutual recognition and equivalences, some oversight by the ECJ…). **(2) Very soft Brexit (20% probability)**, with an extended transition period, after which the UK remains in the EU customs union and in a close-to-EEA relationship relatively to the single market (incl. Few restrictions on movements of people). **(3) A hard Brexit (20% probability), on WTO terms with very little access for services**. **(4) No Brexit (10% probability)**. It would probably require early elections and a major change in government, followed by another referendum. A "no Brexit" scenario may be confirmed only after a long period of uncertainty (withdrawal of the UK's invocation of Art. 50).

Market impact | Scenarios (3) and (4) would be accompanied by financial turbulence but for very different reasons. It would probably be necessary to go through a serious political crisis to question Brexit (scenario 4). With regard to (3), even though the likelihood of a hard Brexit has significantly dropped, negotiations get bogged down which is not good news. In the event that the outcome is ultimately unfavourable for the UK, we would see additional weakening of the GBP and below-trend GDP growth.

Risk # 5 | 20% probability | Contagion in the «emerging world»

Analysis | Emerging markets have been suffering for a few months, impacted by the Fed's rate hikes, but also and above all by the rise of fears of a trade war and by the decline of certain specific markets (difficulties in Argentina, China, in Turkey, Brazil…). In short, if the systemic risk is lower given the lesser vulnerability of emerging countries, it is nonetheless true that in the end, all or almost all markets (Russia and India rising sharply) are down since the beginning of the year: -10% for China, -7.5% for Korea… and -12% for the emerging MSCI. A deterioration of the outlook would undoubtedly lead to greater contagion.

Market impact | Credit spreads and equity markets would be highly hurt, all the more so as emerging currencies would suffer first from capital outflows. Beware, the emerging world is not a homogeneous block, but it has a clear tendency to behave like a block when market conditions deteriorate sharply and brutally. That's why - too - caution about emerging markets is required at present.

Risk # 6 | 15% 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). This type of policy mistake is highly improbable today: the Fed is now reporting that it would not over-react should inflation accelerate temporarily. 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.

Risk # 7 | 15% probability | A Chinese "hard landing"/ a bursting of the credit bubble

Analysis | Chinese growth is still solid (and more resilient than many market observers believed one 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 avoid a stronger depreciation of the Yuan.

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.

Risk # **8** | **10%** probability

A long-term and significant increase in long-term interest 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. Nevertheless, these factors seem more unlikely today than at the beginning of the year. This conclusion is particularly valid in the case of the Eurozone: growth is slowing and the ECB intends to maintain very accommodative monetary conditions this year and next. This is indeed a necessary condition for inflation to recover gradually. However, the desire to lower the degree of monetary accommodation - including ending QE by year end - remains intact. A moderate rise in European bond yields seems inevitable. But a marked increase is unlikely (except in Italy).

Market impact | A sharp rise in long rates would be bad news in the US, where the sensitivity of the economy to long-term rates has increased with corporate re-leveraging: 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 stop the rate hikes from the Fed. Another reason not to believe in a long-lasting and wide rise in US and European long-term bond yields.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

Central scenario (70% probability): global growth slows gradually but surely.

- **Growth is slowing worldwide: Since this summer economic trends have diverged.** Growth has weakened in the Eurozone but remains solid in the US. Confidence remains high in spite of rising risks. Emerging economies have been hit by the financial spillover from Argentina and Turkey. The broad-based appreciation of the USD has undermined dollar-indebted economies, leading to capital outflows from emerging economies and a depreciation of their currencies, which has, in turn, stoked inflation. All in all, central banks have begun to move their monetary policies to a more hawkish stance in many EM countries simultaneously. Lastly, the economic slowdown has been more pronounced than expected in China, which has led the authorities to shift course in economic policy.
- **World trade:** Global trade has weakened slightly since the start of the year. The tariff hikes announced by Donald Trump on steel and aluminium were finally implemented on June 1 on Canada, Mexico and the EU. Protectionist rhetoric has pushed down business confidence, particularly in Europe. However, keep in mind that the products targeted so far account for a small share of world trade and that retaliations from trading partners have been moderate. That said, uncertainty is tending to disrupt value chains that have developed in lock-step with the expansion in global trade over the past 15 years. In light of the above, we continue to expect the global trade to global GDP ratio to decline, with growth in trade lagging slightly behind global GDP.
- **United States:** Unsurprisingly, 3%-plus growth is being forecast in Q3 2018, and the US economy continues to create jobs. The job market is becoming tighter and wages are beginning to accelerate. Surveys continue to point to above-potential growth in the coming quarters. Monetary and financial conditions remain accommodative despite Fed rate hikes and the dollar's appreciation. Fiscal stimulus, including tax cuts and higher spending, is what is driving the economy at this point in the cycle. A recession is highly unlikely in 2019, but the cycle-end story will probably return to the fore at some point by next summer, as the fiscal multiplier impact fades and as the effects of monetary tightening show up. We forecast a slowdown in growth by 2020, with GDP growth closer to 2% by then.
- **Eurozone:** We have revised our growth forecasts slightly downward, to 2.0% for 2018 and to 1.8% for 2019. Protectionism has undermined confidence, but the latest surveys suggest that the Eurozone is holding up well. At this stage, we do not expect the new governing coalition in Italy to have a significant impact on the economy (see the "theme of the month" in this edition). Barring an exogenous shock, peripheral economies will remain in catch-up mode, especially as the ECB plans to stick to its ultra-accommodative stance, despite ending its securities purchase programme by the end of 2018. On the political front, illegal migration remains the main issue and is likely to keep tensions high in the run-up to May 2019 European elections. In Germany, elections in Bavaria on 14 October will serve as a test.
- **United Kingdom:** Brexit negotiations have bogged down, and the deadline for reaching an agreement with the EU this year probably won't be met. There are wide dissensions in the UK on Brexit procedures, particularly on whether or not to remain in the customs union. The EU, meanwhile, wants to demonstrate that an exit is not in any country's interest. All in all, we do expect an agreement, but no doubt not until 2019, which will give the UK a transition period until December 2020. We expect this to weigh on growth for as long as the uncertainty persists.
- **China:** The Chinese economy is slowing, due, in part, to the weakening in global growth. Trade tensions with the US continue to grab headlines. The US threat to impose €200bn in tariffs on Chinese goods is taken very seriously by the Chinese government. It is against this backdrop that China has just shifted its economic policy in favour of a pro-growth fiscal policy. We have lowered very slightly (by 0.1pp) our forecast for next year. Even so, the risks to growth now look to be clearly on the downside.
- **Inflation:** Core inflation remains low at this stage of the cycle, especially in advanced economies, and should recover gradually. That said, the slowdown in inflation in recent years is primarily structural in nature, as it is tied to supply-side factors, while the cyclical component of inflation has weakened (with a flattening of the Phillips curve). Core inflation is likely to pick up only slightly in advanced economies. An "inflationary surprise" remains possible but would not last long amidst a slackening in global growth. Things are different in emerging economies, where inflationary pressures are greater in many countries, in reaction to which many central banks have raised their key rates.

- **Oil prices:** Oil prices have increased sharply ($77/bbl. for Brent) to an almost four-year high, due to tensions in the Middle East, OPEC policy, and still-strong global demand. Short-term risks are on the upside. Rebalancing by boosting supply will take time, with US production already at a historic high. Our equilibrium-price assumption (around $75) is our forecast on a 6-to-12-month horizon.
- **Central banks will continue to remove monetary accommodation at a gradual pace.** The Fed will continue to raise its key interest rates. We expect the Fed to follow through with two 25bp hikes in H2 2018 (in September and December) and two additional hikes in H1 2019, followed by a pause, and for it to reduce its balance sheet at the announced pace (with a gradual non-replacement of maturing securities. Meanwhile, the ECB will reduce its monthly asset purchases from €30bn to €15bn in Q4 and end its APP in December. Its first rate hike is not expected until Q3 or Q4 2019.

The protectionist measures announced by Trump have ratcheted up uncertainty worldwide and have probably fed the appreciation in the dollar and capital outflows from emerging economies, which are quite vulnerable to international trade issues. Trump now says he is ready to go further. This threat should be taken very seriously by both China and Europe. A more serious confrontation on trade is likely while at the same time geopolitical risks are predominant in the Middle East, with a risk to oil prices.

Downside risk scenario (25% probability): a marked trade-war-driven economic slowdown, a geopolitical crisis or a sudden repricing of risk premiums.

- The risk of heavier protectionist measures (from the US) followed by retaliations from the rest of the world rises as the 6 November mid-term elections draw near (as Trump seeks to satisfy his electoral base). China, the EU and Canada are particularly exposed to this risk.
- Aggravation of current geopolitical tensions in the Middle East.

Consequences:

- All things being equal, a trade war would be bad news for growth and, in the short term, could prove inflationary. That said, a global trade war would quickly become deflationary by creating a shock to global demand.
- An abrupt repricing of risk on fixed income markets, with an across-the-board rise in spreads on govies and credit, on both developed and emerging markets, and a decline in market liquidity.
- Amidst the resulting financial turbulence, the cycle-end story would resurface in the US.
- Central banks would cease recalibrating their monetary policies and, in the worst, albeit highly unlikely, case, would once again resort to unconventional tools, such as expanding their balance sheets.

Upside risk scenario (5% probability): a pick-up in global growth:

Note that there is now very little likelihood of the upside risk coming to pass, due to the uncertainties surrounding trade tensions between the US, China Europe, in particular against a backdrop of geopolitical risks (Iran), a recession in several major emerging markets (including Turkey and Argentina), political risk in Brazil, a Chinese slowdown, and political tensions in Europe (tensions between Italy and the EU, Brexit). All these factors are making companies more cautious.

- Acceleration driven by business investment and global growth if protectionist tensions fade.
- Pro-cyclical US fiscal policy generating a greater-than-expected acceleration in domestic growth. Growth is reaccelerating in the Eurozone after a dip in H1. Stabilisation in China.
- Central banks would react late in initially maintaining ultra-accommodative monetary conditions.

Consequences:

- An acceleration in global growth would boost inflation expectations, forcing central banks to consider normalising their monetary policies more rapidly.
- An increase in real key rates, particularly in the US.

Macroeconomic picture by area

United States

GDP rebounds strongly in Q2, supported by domestic demand	Risk factors
• Business sentiment remained strong and surveys further highlighted capex expansion plans. Consumers remained upbeat thanks to rising wages and a strong labor market. • Industrial activity trended higher, supported by resilient demand. Core measures of capital goods orders confirmed their strength while retail sales offered strong readings. On a slightly disappointing note, the productivity trend remained modest with various metrics signaling a deceleration in the housing sector. • The inflation outlook continues to stay aligned with Fed projections, with modest domestic inflationary pressure and PCE measures converging with Fed objectives. • Rates remained unchanged after the August FOMC meeting (1.75% to 2.00%). With monetary policy accommodation gradually coming to an end the policy stance should soon relabeled as neutral. • 25% tariffs against China were implemented (on $16bn, after $34bn in July) with more to come ($200bn). NAFTA: a preliminary Mexico-US agreement was reached.	• Fed tightening to impact interest rate sensitive segments (housing, consumer credit) • Abrupt tightening of financial conditions • Tariffs and retaliation impacting import prices and domestic inflationary pressure • Trade conflict escalation to impact confidence • Geopolitical risks linked to a more hawkish shift of the U.S. Administration

Eurozone

Despite the rise in risks, the recovery will continue	
• After numerous disappointments at the beginning of the year (GDP only rose by 0.8% in H1), economic indicators stabilised over the summer, in line with GDP growth of around 2% per year. Underlying inflation remains stuck at around 1% per year, even though wage increases are expected to enable it to increase slightly in the coming months. • The future attitude of the new Italian government, whose budget promises are incompatible with European regulations, remains a factor of uncertainty. Moreover, the Eurozone is more exposed than the United States to the trade war risk.	• Rise in anti-establishment parties • Rise in the euro • External risks (in particular trade war risks)

United Kingdom

GDP rebounds strongly in Q2, supported by domestic demand	
• Business sentiment remained strong and surveys further highlighted capex expansion plans. Consumers remained upbeat thanks to rising wages and a strong labour market. • Industrial activity trended higher, supported by resilient demand. Core measures of capital goods orders confirmed their strength while retail sales offered strong readings. On a slightly disappointing note, the productivity trend remained modest with various metrics signaling a deceleration in the housing sector. • The inflation outlook continues to stay aligned with Fed projections, with modest domestic inflationary pressure and PCE measures converging with Fed objectives. • Rates remained unchanged after the August FOMC meeting (1.75% to 2.00%). With monetary policy accommodation gradually coming to an end the policy stance should soon relabeled as neutral. • 25% tariffs against China were implemented (on $16bn, after $34bn in July) with more to come ($200bn). NAFTA: a preliminary Mexico-US agreement was reached.	• Fed tightening to impact interest rate sensitive segments (housing, consumer credit) • Abrupt tightening of financial conditions • Tariffs and retaliation impacting import prices and domestic inflationary pressure • Trade conflict escalation to impact confidence • Geopolitical risks linked to a more hawkish shift of the U.S. Administration

Japan

Bumpy road ahead, though still on ascending slope	
• The economy bounced back from its Q1 setback driven by a sharp rebound in household spending and continuously vigorous business investments. However, earthquakes in June followed by heavy downpours and a fierce heatwave in July and August put a halt to factory operations and commercial activities. • The economy should regain strength in autumn as producers accelerate outputs in order to recoup their losses. Corporate Japan plans to expand capital expenditures at the highest pace since 2006 despite trade dispute fears. In the meanwhile, monthly wages scored their largest y/y gain in July with the labour market hitting a 44-year high. Minimum wages are to be raised in October, while more labour-substitution purpose investments are in the pipeline.	• Tariffs and quotas imposed by the U.S. could raise costs and snarl supply chains

China

- The policy stance has turned around meaningfully in response to greater near-term risks.
- The economy is cooling off, with credit growth slowing more than expected, as a result of deleveraging.
- US/China trade tensions have ratcheted up, with tariffs on $50bn products implemented on each other, while Trump may impose tariffs in September on an additional $200bn of China's goods.
- In response, China has shifted its policy stance more meaningfully, through monetary, fiscal and deleveraging measures, and looks more determined to push further reforms and openings.
- Policymakers also took several measures to stabilise the RMB to prevent systematic risks, although greater FX flexibility is being allowed.
- Uncertainty likely to remain relatively high. Keep an eye on further US trade measures and on whether policy supports can help achieve a soft landing of China's economy.

Risk factors

- **US/China trade tensions, with considerable uncertainty in the near term**
- **Policy mistakes in managing near-term risks and the structural transition**
- **Geopolitical noise regarding North Korea**

Asia (ex JP & CH)

- Economic growth remained resilient with macro momentum stabilising. Looking at the countries that have reported their GDP growth for Q2 2018, it's worth highlighting that domestic demand (Households Consumptions and Fixed Investments) performed better than Net Exports.
- In the first half Inflation data was very benign. Oil price spikes and currency weaknesses didn't impact CPI significantly. As expected India's inflation declined towards 4% (pivot level in the CB target range) while inflation in the Philippines kept increasing above the CB target.
- Monetary Policies confirmed their hawkish stance. Most recent actions include an expected 25bp hike by the RBI, a bold 50bp hike by the BSP and an unexpected 25bp hike by the BI.
- Indonesia released its fiscal plan for 2019, with healthy fiscal accounts in 2018 so far and the will to continue on the road of fiscal responsibility.

Risk factors

- **Stable and still constructive macroeconomic momentum.**
- **Inflation still very benign with few exceptions.**
- **Central banks proving a clear hawkish stance**
- **Geopolitical risks weighting on CCY performance**

Latam

- Latin American countries reported resilient economic figures (stronger GDP figures in Mexico, Chile and Peru) with Brazil's macroeconomic momentum lately improving too (Industrial Production stood at 3.5% YoY in June up from -6.6% in May).
- On the inflation side, although the overall environment remained benign, Mexico's inflation decline was interrupted in July, with CPI rising to 4.8% up from 4.6% in June; while Brazil's inflation increased temporarily, due to the May strike, to around 4.5% in June/July up from approx. 3% in May.
- The region's main Central Banks remained on hold in their recent Monetary Policy meetings with Banxico keeping a tighter stance due to an inflation rate struggling to converge to the target.
- As expected, AMLO (Morena Party) won the Mexican elections. In Brazil the political situation remains quite fluid as the October Presidential elections approach.

Risk factors

- **Resilient economic figures with Brazil lately improving.**
- **Inflation higher in Mexico and Brazil.**
- **Central Banks in the area on hold**
- **Busy political agenda continues, next elections in Brazil on 7 October.**

EMEA (Europe Middle East & Africa)

Russia: we forecast 1.7% YoY growth for 2018-2019

- Despite the threat of potential US sanctions down the road, the macroeconomic scenario remains supportive helped by high oil prices. Russia will among the few emerging market sovereigns with the "twin surpluses" in 2018, while accumulating assets at the National Wealth Fund.

South Africa: we lower growth forecast to 0,7% YoY in 2018

- With sizeable current account deficit financed by portfolio inflows (not FDI) and inadequate external liquidity, SA remains vulnerable to EM turmoil.
- These risk are supplemented by vulnerabilities from the fiscal side and contingent liabilities from SOEs.

Turkey: we downgrade forecast a slowdown in growth in 2018 to 1.8%.

- The TRY has dived given large external imbalances, poor external liquidity and non-orthodox policies of the government.
- Investors have lost faith in Turkish assets, while the central bank - a policy instrument of the government --has been unable to hike rates. Turkish corporates have begun to default. This will impact the health of the heavily indebted (in foreign currency) and very large banking sector very negatively.

Risk factors

- **Lower oil prices and stepped-up US sanctions**
- **Fall in commodity prices, capital outflows, fiscal slippage, and delays in structural reforms**
- **Inaction by the CBRT, continued market turmoil, and further drop GDP and in asset prices.**

Amundi ASSET MANAGEMENT

Macro and **Market forecasts**

Macroeconomic forecasts
(6 September 2018)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2017	2018	2019	2017	2018	2019
US	2.3	2.9	2.7	2.1	2.6	2.4
Japan	1.7	1.0	1.2	0.5	0.8	1.2
Eurozone	2.5	2.0	1.8	1.5	1.7	1.7
Germany	2.5	1.9	1.8	1.7	1.8	1.6
France	2.3	1.6	1.7	1.2	2.1	1.6
Italy	1.6	1.1	0.9	1.2	1.1	1.7
Spain	3.1	2.7	2.3	2.0	1.5	1.5
UK	1.8	1.3	1.6	2.7	2.5	2.4
Brazil	1.1	1.2	2.0	3.5	3.9	5.0
Russia	1.5	1.7	1.7	3.7	2.9	4.6
India	6.2	7.7	6.0	3.3	4.5	5.3
Indonesia	5.1	5.2	5.4	3.8	3.5	4.5
China	6.9	6.6	6.3	1.6	2.0	2.3
Turkey	7.3	1.8	-1.0	11.1	15.0	14.5
Developed countries	2.3	2.2	2.1	1.7	2.0	2.0
Emerging countries	4.8	4.9	4.6	3.5	4.1	4.2
World	3.8	3.8	3.6	2.8	3.2	3.3

Source: Amundi Research

Key interest rate outlook

	04/09/2018	Amundi + 6m.	Consensus Q4 2018	Amundi + 12m.	Consensus Q2 2019
US	2.00	2.5	2.22	2.75	2.53
Eurozone	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.75	0.75	0.86	1	1.22

Long rate outlook

2Y. Bond yield

	04/09/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.63	2,7/2,8	2.77	2,9/3,0	2,82
Germany	-0.61	-0.50/-0.40	-0,54	-0.40/-0.20	-0,45
Japan	-0.12	-0.20/-0.00	-0,09	-0.20/-0.00	-0.08
UK	0.71	0.80/1.0	0,79	0.8/1.0	0,89

10Y. Bond yield

	04/09/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.87	3.0/3.15	2.91	3.0/3.15	2,94
Germany	0.34	0,4/0,6	0.43	0,5/0,7	0.53
Japan	0.11	0.10	0.18	0.10	0.23
UK	1.40	1.40/1.60	1.46	1.40/1.60	1.53

Currency outlook

	04/09/2018	Amundi + 6m.	Consensus Q1 2019	Amundi + 12m.	Consensus Q3 2019
EUR/USD	1.16	1.18	1.18	1.20	1.19
USD/JPY	111.28	109	110	107	104
EUR/GBP	0.90	0.89	0.88	0.90	0.87
EUR/CHF	1.13	1.16	1.16	1.18	1.20
EUR/NOK	9.72	9.24	9.23	9.15	9.04
EUR/SEK	10.56	10.00	10.03	9.77	9.85
USD/CAD	1.32	1.28	1.28	1.25	1.26
AUD/USD	0.72	0.74	0.74	0.76	0.75
NZD/USD	0.66	0.67	0.67	0.68	0.69
USD/CNY	6.84	6.78	6.78	6.75	6.57

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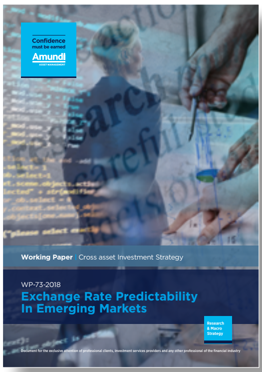

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Document issued by Amundi, "société par actions simplifiée"- SAS with a capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

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