Monthly | Finalised at 8 October 2018

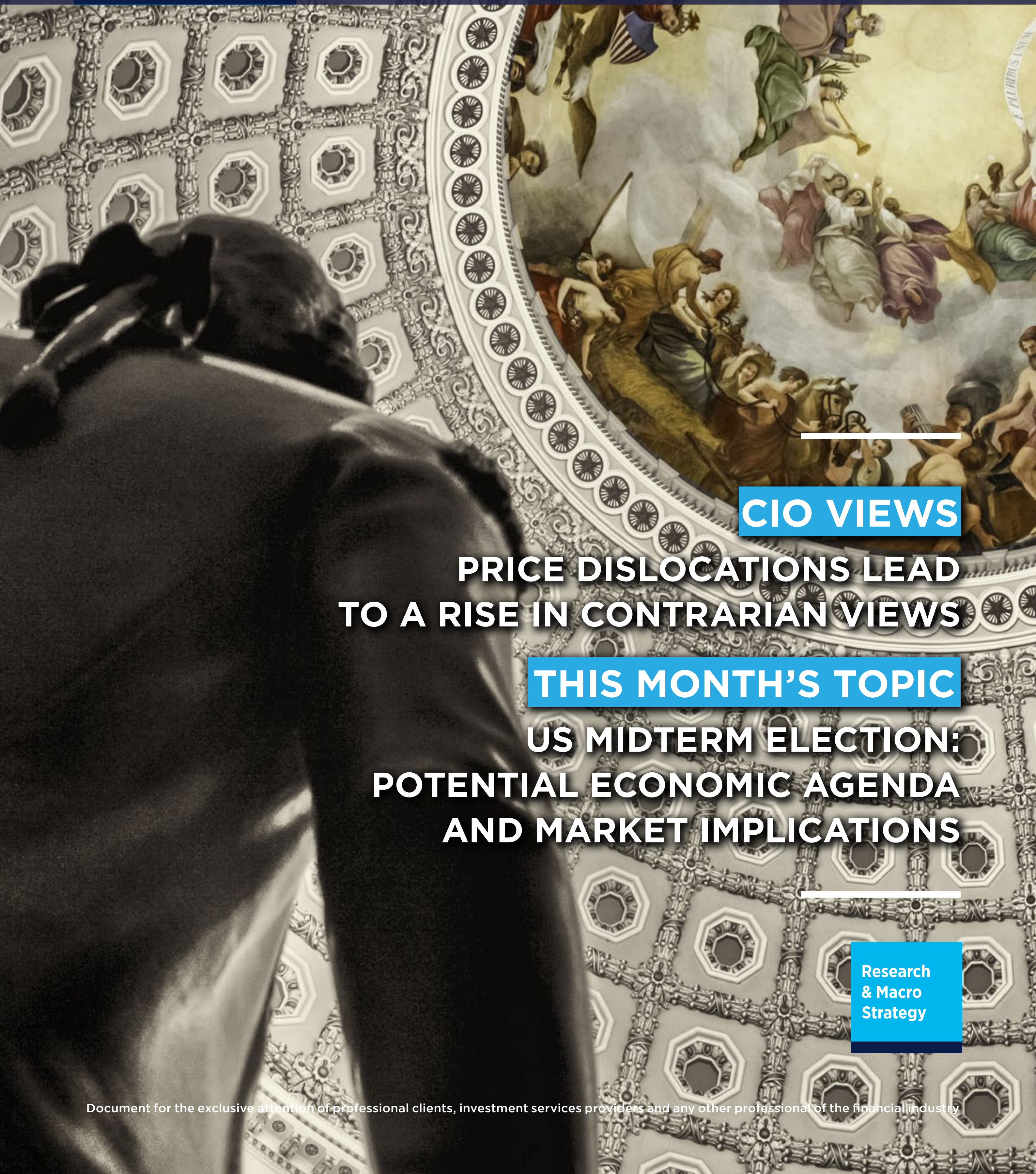
October 2018 # 10

Confidence must be earned

Amundi ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY



CIO VIEWS

PRICE DISLOCATIONS LEAD TO A RISE IN CONTRARIAN VIEWS

THIS MONTH'S TOPIC

US MIDTERM ELECTION: POTENTIAL ECONOMIC AGENDA AND MARKET IMPLICATIONS

Research & Macro Strategy

CIO VIEWS

Price dislocations lead to a rise in contrarian views

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

The hot summer in emerging markets (EM) has been a key investor theme in the third quarter of this year. While the ongoing US/China trade tensions continue to weigh on investor sentiment, the sequence of country-specific stories (Turkey, Argentina and South Africa) contributed to the almost **indiscriminate repricing of EM assets**, starting with plummeting EM currencies. The causes of the collapse seen in the currencies' values in these countries are different (need to apply for IMF aid for Argentina; balance of payment crisis in Turkey, accelerated by the perceived lack of independence of the central bank; the start of an economic recession in South Africa, with additional concerns regarding the land reform plan). However, what **all these countries had in common are some areas of vulnerability,** starting with government deficits and dependence on foreign funding, often denominated in USD, which resulted in a higher exposure to multiple headwinds that are surfacing in this late phase of the cycle. On the opposite side, strong economic momentum in the US (with 4.1% GDP growth in Q2 2018, the highest level since Q2 2014), shrinking global liquidity, higher US rates, and a strengthening US dollar are all forces driving outflows from EM and making US assets more attractive. Yet, **in a late cycle phase, a small size problem** (Turkey+Argentina+South Africa make up only around 3% of the global economy[1]) **can turn into a catalyst for a risk-off mode in the EM area. However, we do not expect to see a broader market capitulation or systemic risk.** The trigger for either of these issues would be a marked slowdown in China, which is not our main scenario. In fact, credit growth in China, certainly a higher risk for global economy, is showing further signs of stabilisation, with Chinese policymakers acting to keep the monetary stance on the easing side and shifting the fiscal stance to be more supportive.

Going forward, in a phase of slowing global economic momentum and a late business cycle, we expect market participants to remain vigilant in light of upcoming political events. In this new phase, directional markets leave room for less directional markets, with **more divergences in styles/factors and higher rotation** in investment themes, to extract the remaining value. In our view, recent dislocations will lead to value entry points opening up. **Opportunities may arise in some quality and value parts of equity markets**, in relative value trades across yield curves, and in currencies to play CB divergences. In this environment, **Europe**, which has not been in favour to the same extent as the US, **will become more attractive**, in our view, supported by cheap valuations (assuming that Italian headwinds dissipate -- our assumption beyond likely tensions arising first). In **EM, price dislocation has been more pronounced. Significant noise will continue to be a distraction in the short term, but we think an entry point will open up in the coming months** (after Brazilian and US mid-term elections). This will require a selective approach to countries and names with decent fundamentals, though having been disproportionally hit during the selloff. Strong portfolio construction discipline, with a focus on liquidity management and macro and bottom-up research, will represent the compass to navigate this market phase and indicate how/when to rotate into the most compelling themes. **With less beta-driven markets, expect alpha[2] to be the name of the game in the coming months.**

[1] *Source: IMF, GDP based on PPP, share of world (Percent of World), 2018.*

[2] *Alpha – Alpha measures risk-adjusted performance, representing excess return relative to the return of the benchmark. A positive alpha suggests risk-adjusted value added by the manager versus the index. Beta – Beta measures an investment's sensitivity (volatility) to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.*

High Conviction Ideas

MULTI-ASSET

In a context of risk asset neutrality, we favour US equity and we are becoming more constructive on European equity based on valuations. We remain very selective on EM assets in the short term, and believe investors should look for better entry points. On duration, we are still cautious and still favour gold and hedges to protect against a possible increase in geopolitical tensions.

FIXED INCOME

Factors backing the short duration stance in the US are receding and we think it is time to reduce the short duration bias there, while we keep it in Europe and Japan. We have become increasingly cautious on credit over the summer, with a strong focus on quality and liquidity. On EM bonds, short-term volatility could persist, but valuations have become attractive.

EQUITIES

Valuation as a support factor has not worked over the last 12 months, but we now expect a reversal of this trend. As a result, we are rotating towards the value theme in the US equity market. In Europe, investors should consider playing value with a strong quality focus, and balancing cyclical and defensive exposures to continue to benefit from the still-positive economic backdrop.

REAL ASSETS

The current environment requires investors to be selective when looking for well-priced private equity targets with attractive long-term returns. We see opportunities in European small and mid-caps, with a focus on companies able to take advantage of disruptive trends.

MACRO

More risks of trade war and synchronised slowdown

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

On 17 September, US President Trump announced that the US will place (as of 24 September) a 10% tariff on an additional c.$200bn of imports from China. Furthermore, as of 1 January 2019, those tariffs will rise to 25%. In retaliation, China has announced new tariffs of 5-10% on $60bn of goods imported from the US. The White House said that it would further raise tariffs on approximately $267bn of additional imports in case of further retaliation from China. For now, this threat from the US side seems to be avoided given the Chinese moderation. We estimate that the measures taken could remove 0.1-0.2% from US growth in 2019. If the US increases its tariffs to 25%, it could cut 0.6% from Chinese growth. Regarding the Chinese side, however, one should not underestimate the capacity of the authorities to stimulate growth: they have recently relaxed both fiscal and monetary policies and this should offset at least 0.3% of the negative impact mentioned above (i.e., all of the negative impact coming from the rise in tariffs to 10% on $200bn). Moreover, China has room for manoeuvre to do more if necessary. The US authorities, on the other hand, have less leeway: fiscal policy is already very expansionary and the Fed intends to continue to raise key rates.

In the US, the outlook is still good and financial conditions remain accommodative, but they are likely to tighten with the rise in interest rates and the appreciation of the USD.

> “The prospect of a synchronized slowdown in the global economy is now gaining ground fast.”

Thus, the probability of a recession in the next 12 months tends to increase, based on our estimates: at between 10% and 20%. While low, it is now much higher than the historical average. If the Fed continues, as we expect, to raise its key rates by 25bp/quarter, by mid-2019, this would lead to an increase in interest charges for companies that have significantly re-leveraged during this cycle. The impact on investment would potentially be significant, as the expansionary effects of fiscal stimulus will recede next year.

The weakening of world trade shows that the protectionist rhetoric is a shock of uncertainty that has begun to spread to real economic activity (confidence shock, disruption of chains of production). Even if the US and China decide to negotiate after the US mid-term elections, uncertainty about global trade is increasing.

In Europe, growth has already slowed and confidence has weakened due to this uncertainty and to the rise in the oil price. Furthermore, there is the political risk related to the potential for a hard Brexit or a marked fiscal slippage in Italy.

Finally, the outlook for EM (taken as a whole) has deteriorated, with the dollar rallying and the monetary conditions tightening in many countries simultaneously. Ultimately, the potential for a synchronised slowdown in the global economy is now gaining ground fast.

The Strategist view

Risk-off mode for now.

Generalised market disturbance: Financial volatility mainly related to the difficult state of global politics has shaken investors, but has not yet destabilised economic and macro fundamentals. Based on this perspective, however, a remarkable diverging trend has emerged, with the US (almost at the peak of the cycle) outpacing the rest of the world. Fundamentals have proved resilient to the uncertainty so far. However, we think that tighter financial conditions, including exchange and interest rates, could trigger significant market strains at current valuation levels.

Long-term rates under pressure: The US yield curve remains -- and will remain, in our view -- flat, due to the difficulty of pricing in a decent inflation premium in the US and given weaker fundamentals elsewhere. In Italy, BTPs move primarily on political developments. Since the end-August auction (which was exceptionally strong), BTP flows have been centred around bank buying, which has compensated for a big chunk of international investor outflows, and strong short covering on better-than-expected news on the fiscal front. From here, additional spread tightening might occur, should the political picture and rating agencies remain constructive, and budget deficit be confirmed below 2%, with credible measures included in the government's plan.

EM still the key focus: The biggest risk relates to GEM FX spillover effects on GEM bonds and equities. Turkey looks to be the most vulnerable to this dynamic, but is followed by the more fragile countries with large funding needs (eg, South Africa, Chile). While the environment is very tough and we keep a short-term negative view on the asset class, our base scenario is for these risks to remain idiosyncratic.

BTP= Buoni Poliennali del Tesoro, Italian government bonds.
GEM FX = Global Emerging Markets currencies

MULTI-ASSET

Stay neutral, seek value

MATTEO GERMANO, Head of Multi-Asset

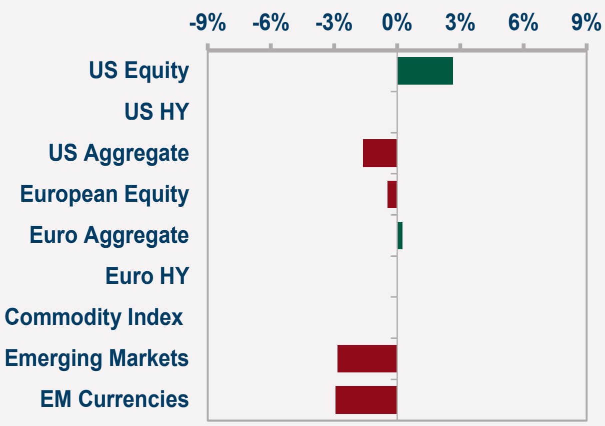
Global economic expansion continues, but momentum is weakening. We are seeing some deceleration in certain emerging markets while political and geopolitical noise remains elevated (trade disputes, elections). As a result, the fragility of investor confidence can suddenly translate into a risk-off mode in some asset classes, as we have seen over the summer in the EM space. Yet, that concern did not cause a "flight-to-quality" and subsequent outperformance of DM assets. Instead, the US ended up as the clear winner, thanks to a combination of hope (earnings, productivity and capex growth), fear (safe-haven status, repatriation of funds) and momentum. Returns so far in the third quarter clearly support this pattern, as the US equity market continues to post new highs while most other markets are either flat (European and EM equities, aggregate bond indexes). Against this backdrop, we remain cautious on risk asset exposure and focus on themes that are backed by either strong economic momentum or compelling valuations.

High conviction ideas

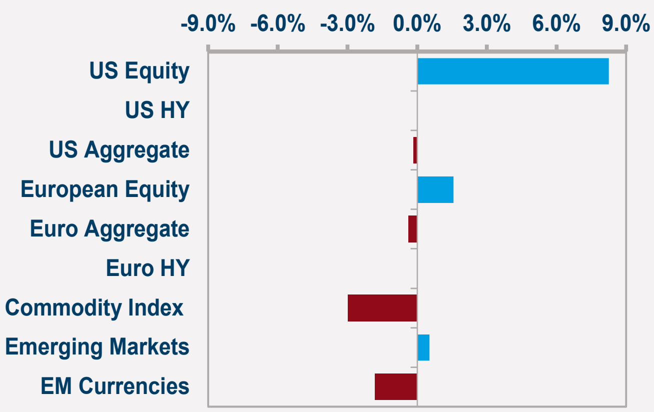
> "It's time to be positioned for a late cycle, favouring selective equity themes (US, value) and being prudent on credit."

In terms of risk assets, we maintain a positive stance on the US equity market, supported by positive growth momentum and earnings growth trends. In European equities, we favour value themes in the search for defensive exposure and we are gradually becoming more constructive overall. In fact, while the Italian budget and Bavarian elections may keep uncertainty high in the short term, we believe we are approaching a phase where European equities will become more attractive, as valuations are increasingly appealing. We also have a positive view on the UK equity market, where we see a combination of valuations, flows and earnings revisions supporting this call, which also benefits from the defensive nature of this market in a late cycle environment. However, we will continue to carefully assess the evolution of Brexit negotiations to confirm this view going forward. At a sector level, European basic materials remains our top call, based on good fundamentals, reasonable valuations, and an ongoing favourable economic environment for commodities. In bonds, we suggest a limited duration exposure while investors seek opportunities by actively playing curve positioning and relative value between US and German bonds which should benefit from diverging CB stances. Currencies also offer fertile ground to play these divergences, with geopolitical themes also offering

Performances H1 2018



Performances QTD in 2018



Source: Bloomberg, Amundi Research
Data as of 21 September 2018. Past performance is no guarantee of future results. Equity indexes are from MSCI, bond indexes are from JP Morgan and BofA Merrill Lynch. All indexes are total return in local currency

some attractive opportunities. In this regard, we are negative on the GBP amid uncertainty related to Brexit negotiations. On inflation, our central case continues to expect a gradual increase in price dynamics, but we think that the case for inflation-linked bonds in the US has receded, as we see limited further upside/overshoot risk in US inflation in the future. We maintain a cautious stance on credit markets and also on EM assets. Here, we confirm our preference for China within the EM equity universe on the basis of attractive valuations and the more constructive medium-term outlook for China, following the recent change in policy towards a more supportive stance.

Risks and hedging

Markets remain vulnerable and we think it is sound policy to keep hedges in place and consider some exposure to gold in an effort to hedge against rising geopolitical tensions and to take advantage of a potentially softer stance from the Fed. Exposure to the JPY (vs the USD and AUD) could also benefit from the safe haven status of the JPY.

FIXED INCOME

Reassessing duration views

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

Overall assessment

While global economic fundamentals remain sound, with some signs of deceleration, uncertainty will continue to dominate based on upcoming elections, CB actions and trade discussions. Core government yields (US, Germany) will likely remain range-bound, as demand for "safe" assets should counterbalance the upward rate pressure driven by the economic backdrop. We think it is key that investors focus on quality and liquidity across the board while seeking opportunities that may emerge after a period of noise -- for example, in selective EM bonds.

DM government bonds

At current yield levels and given market expectations (Fed hikes well priced into the market), we think the case for a short duration bias on US Treasuries is receding while we keep a short duration view on Europe and Japan. Within Europe, we continue to expect the yield differential between 5Y and 30Y bonds to decrease (flattening), as the curve appears too steep at current levels. At the country level, we see tactical opportunities in selective peripheral countries (eg, Spain and Portugal).

> **"We think it is time to reduce the short bias on US duration and continue to focus on quality and liquidity in credit markets."**

DM corporate bonds

While the near-term growth outlook appears supportive, future Fed policy considerations and market valuations support cautious positioning on credit, with a focus on liquidity. Opportunities should be played across and within sectors. In the US investment-grade space, we like banking, insurance and energy names, given their valuations and credit cycle positioning. We are more cautious in basic materials and tech on valuations and on pharma due to concerns about the business model. Loans also continue to offer opportunities against a backdrop of strong fundamentals, rising profits and low defaults. In Europe, we also keep a defensive stance with a focus on short-term issuance, and we continue to seek selective opportunities in financial subordinated bonds.

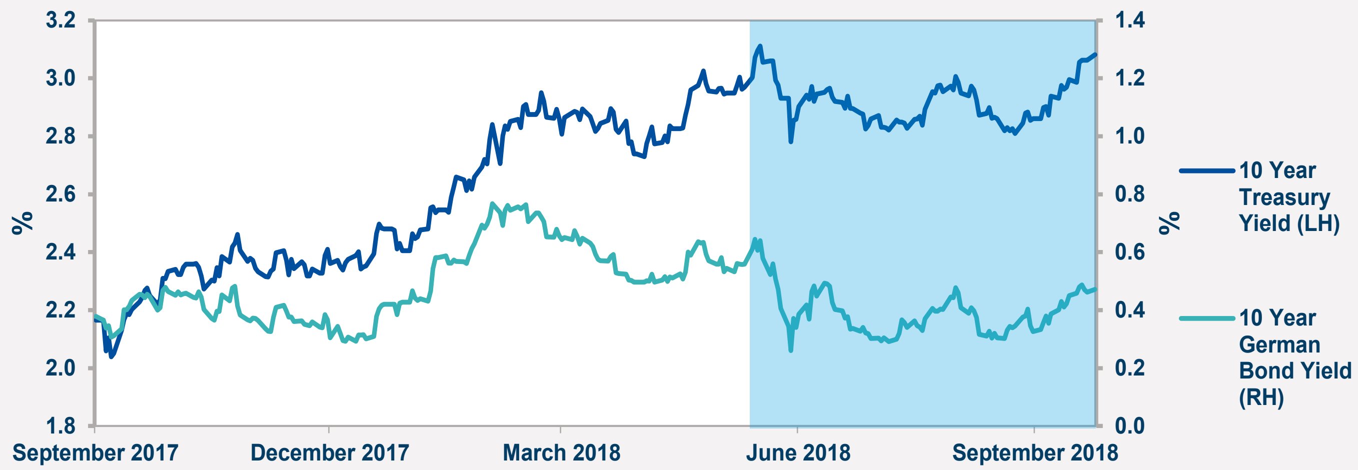
EM bonds

We expect volatility to remain high as we move towards US mid-term elections, which could drive some hostile talks on the trades/tariffs/ sanctions front. The weakening in the risk sentiment at a time of tightening liquidity has resulted in some EM being caught in the selloff and as a consequence now offering very interesting valuations. An example is Mexico, where we think the local sovereign debt shows compelling value, with an almost 8% yield on the 10Y bond in LC for an investment-grade country (as of 18 /9/18). We think Mexico is likely to enjoy a period of calm before year-end, when the president-elect will take over, while NAFTA headlines are softening. In contrast, we are cautious on Turkey local debt. Recent lira weakness has been impacting inflation expectations, and although the CB finally delivered a rate hike, the focus will be on upcoming budget, with the expectation of meaningful fiscal policy tightening.

FX

Ongoing and rising concerns on trade disputes continue to support the USD in the short term and to add volatility for EM currencies, where local politics are also contributing to uncertainty. We are positive on the USD, as global growth and rising inflation are supportive. On EM, we remain cautious on EM Asia currencies, which are more vulnerable to trade wars, and on Brazil, due to approaching elections.

Core bond yields in trading range



Source: Bloomberg, Amundi Research - Data as of 21 September 2018.

EQUITY

Quality and value stocks in focus

ALEXANDRE DRABOWICZ, Deputy Head of Equity
YERLAN SYZDYKOV, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

Overall assessment

In the medium term, the US market outlook remains positive, but with trade disputes and mid-term elections ahead, some volatility may emerge in the coming weeks. As European equities is the most unloved asset class following €40bn of outflows this year, any good news on known unknowns like Italy/Brexit/trade war would see a rally in the asset class. We believe that risks are now symmetrical, as the markets have already adjusted to these risks. Globally, the growth vs value ratio appears excessive, having reached end-1990s levels. Thus, the risk of correction is increasing. In our view, the best way to navigate this phase is to focus on quality stocks that seek to deliver sustainable earnings growth in the future and that are currently trading at reasonable prices.

Europe

Q2 earnings growth stabilised around 9%. The more favourable FX environment was balanced by higher input costs and weaker economic momentum. Earnings-wise, energy and real estate improved the most while consumer discretionary, telco and healthcare lagged. In Europe, we would play value with a strong quality focus, and balance cyclical and defensive exposures to continue to benefit from the still-positive economic backdrop. We would seek out sustainable business models that can continue to deliver solid earnings growth. Industrials, for example, offer some interesting late-cycle opportunities, particularly in capital goods with a focus on attractive valuation opportunities.

> "European equity could rebound in the short term, as most of the bad news flow seem priced in."

United States

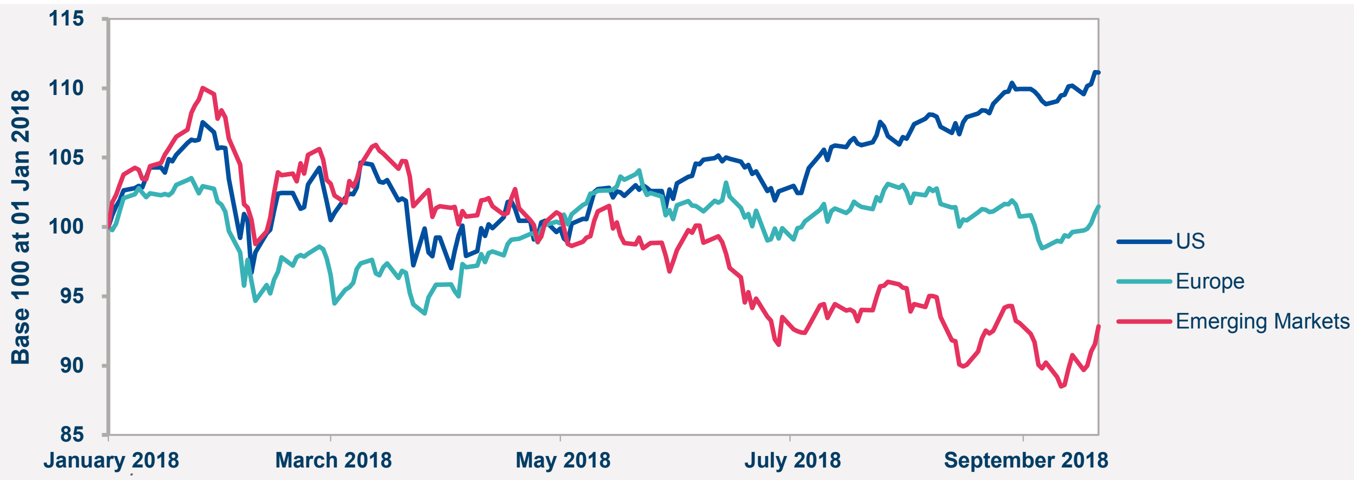
Some noise in the short term is expected, as trade tensions intensify and US elections spur uncertainty. The medium-term outlook is still constructive and is supported by some healthy rotation in sectors and themes that occurred over the summer. The dominance of FAANG* stocks in the first half of the year (+30.4% NYSE FANG+ Index in H1 2018 vs +1.6% for the S&P500) is now reversing (-4.3% NYSE FANG Index QTD vs +7.8% for the S&P500). Another possible rotation to come could be towards value. Valuation has not emerged as a positive factor for the past 12 months and its poor performance is on par with other notable inflection points in the market since 1990: tech bubble, housing bubble, Euro/Greek debt crisis, and the peak of the Trump trade situation. In each of these cases, there was a reversal of the performance of the valuation factor. We find the most value in capital goods, housing repair and remodel-levered stocks, banks, and telecom, and are cautious on tech/FANG. Areas of concerns are related to possible retaliation in trade disputes and the strength of the US dollar, which could impact the capital goods and transportation sectors. The flattening of the yield curve is also an area to watch: should it persist, it could negatively impact banks and trigger a review of the sector.

Emerging markets

EM equity has been hit over the summer, with few significant exceptions, such as India, which has posted strong returns quarter to date. EM earnings per share revisions are deteriorating amid some challenges (trade disputes, FX spill overs) and country-specific stories in a context of expected moderate global economic slowdown. However, the selloff has been stronger than the deterioration in the earnings trend. This could pave the way for a tactical rebound in an overall scenario that requires cautious positioning. In terms of themes, we remain constructive on oil, due to politics-related supply disruptions (Iran, Venezuela) and US shale logistics bottlenecks.

** FAANG= acronym for Facebook, Amazon, Apple, Netflix, Google.*

Regional markets performance



Source: Bloomberg, Amundi Research
Data as of 21 September 2018. US = S&P500. Europe = MSCI Europe, Emerging Markets = MSCI Emerging Markets.
Total return indexes in local currency. It is not possible to invest in an index

REAL ASSETS

Look for selective opportunities in private equity

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

Private equity investing in challenging times

The private equity market is now navigating challenging times. On the market side, the landscape has become increasingly competitive, with the number of private equity funds in the market continuing to grow (52% rise in the number of funds raising capital at the start of Q3 2018 compared to the beginning of Q3 2017, according to the most recent Preqin figures).

This has led to an expected slowdown in fundraising activity as the overall activity seen in recent years was too abundant to be sustainable in the longer term. On the macro side, the current environment is characterised by low yield, economic growth that is still sound but decelerating, and political and geopolitical risks, which require investors to be even more selective when looking for well-priced target with attractive long term returns.

Despite heavy competition and a challenging market landscape, investor sentiment towards the private equity asset class still seems positive, thanks to its search to address investor needs, such as diversification, risk-adjusted returns, and inflation hedging. When it comes to performance, private equity has recorded steady returns, consistently outperforming the S&P500 Index over the last 10 years. So, the real challenge is to implement the right strategy to attract new investors looking for high absolute potential returns and portfolio diversification.

Where are the most attractive opportunities?

It is now getting more difficult to find attractive opportunities, especially in developed markets, as valuations are higher than a few months ago and this may lead to lower returns in the years to come. So, it is paramount to select the right geographic area and the appropriate companies.

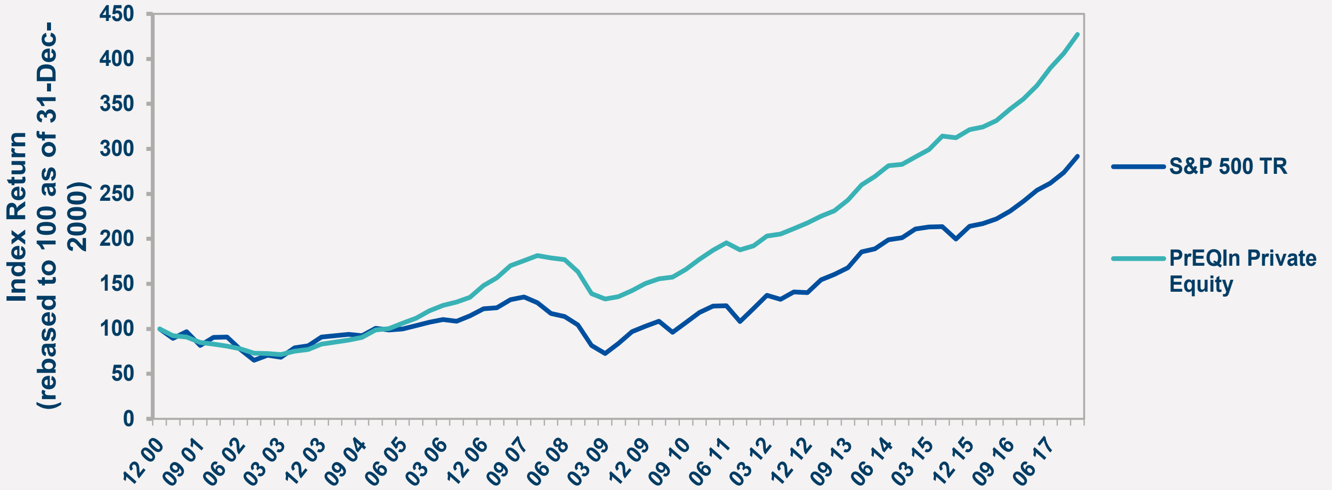
We think Europe still offers a positive economic backdrop and we expect private equity to remain in demand in this geographic area. In this respect, we believe Western European countries may offer good investment opportunities, but we think it is key to have an excellent deal flow, solid local knowledge, insights and networks. Looking at the market, investors should consider focusing on private European small and medium-sized enterprises (SMEs) that have demonstrated their strength over a meaningful time horizon.

> “Small and medium enterprises may offer opportunities to capture structural disruptive trends.”

However, within the SMEs market, there are a multitude of compelling business stories requiring managers to adopt a highly tailored strategy. In order to unlock the most value out of private equity investing, investors should consider combining top-down and bottom-up approaches for stock selection and playing the five key global megatrends that, in our view, are reshaping the investment landscape (demographics, environment, technology, social changes and globalisation).

Then, in each sector, it is key to identify factors that make a company well equipped to create value for investors over the long term. These are: the quality of the management team and its involvement in the capital structure; having solid fundamentals and a history of profitability; the ability to gain competitive advantage by having consistent organic growth and a strong desire to seek external growth though internationalisation; a flexible approach and the agility to adapt rapidly to changing environment conditions. Finally, investors may look at those adopting the principles of ESG (environmental, social and governance), which is a core element in value-creation.

Private equity vs S&P500 TR Index



Source: Preqin, Amundi Research
As of 31 December 2017. Past performance is no guarantee of future results.

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

	Asset Class	1 month change on view	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

↘	Downgrade
→	Unchanged
↗	Upgrade
●	Underweight
●	Neutral
●	Overweight

Source: Amundi, as of 21 September 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

US Midterm Election: Potential Economic Agenda and Market Implications

PARESH UPADHYAYA, Director of currency strategy, US portfolio manager

Finalised on 21/09/2018

The essential

In the upcoming US Midterm elections on November 6, there are high expectations of divided Congress, with the Democratic Party taking control of the House of Representatives and the Grand Old Party (GOP) retaining control of the Senate. Other scenarios are possible: the Republicans could maintain control of Congress, or the Democrats could sweep both the House and the Senate. In this piece, we examine some of the reasons the most likely election outcome is a divided Congress. We then look at the economic agendas for both parties, and potential issues around their implementation. Finally, we analyse possible investment implications on US equities and fixed income markets.

Uphill Battle for GOP

Political fundamentals point to a favourable backdrop for the Democrats to regain control of the House. Currently, Republicans control both chambers of Congress – the House majority is 237-193, with 5 vacancies; the Senate majority is a narrow 51-49. The Democrats need to gain 23 seats in the House and 2 seats in the Senate to take control.

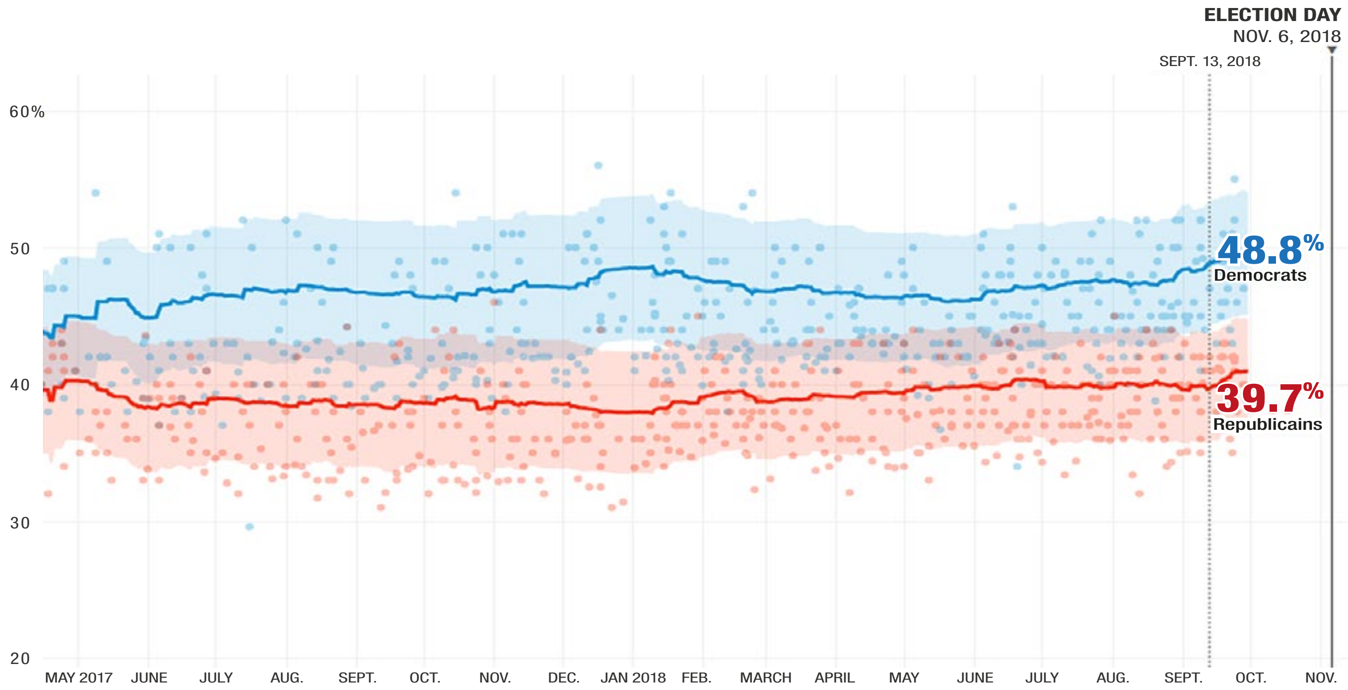
The House has more potential to flip to the Democrats than the Senate because there are many more marginal Republican seats compared to marginal Democratic seats. There are 23 districts that voted for the GOP House candidate and Secretary Hillary Clinton in 2016, compared with 7 districts that voted for the Democratic House candidate and Trump. On the other hand, the Democrats are clearly on the defensive in the Senate with the need to defend 26 seats out of 35 seats that are up for reelection. In addition, Red State Democrats will be trying to win reelection in states where Trump's margin of victory was at, or exceeded, 20% (Missouri, Indiana, Montana, North Dakota and West Virginia).

Why Democrats are favoured to win the House

Generic Ballot

The Democrats are holding a solid lead in the generic ballot. The generic ballot is based on polls that ask voters which party they would support in a congressional election, Democratic or Republican. Some political strategists believe that due to gerrymandering (politically designed districts by the party in charge); the Democrats need around a 7% lead in the generic ballot to gain a majority in the House. The current generic ballot has an 8.5% Democratic lead over the GOP (Chart 1).

Chart 1: Democrats hold a solid lead in the Generic ballot

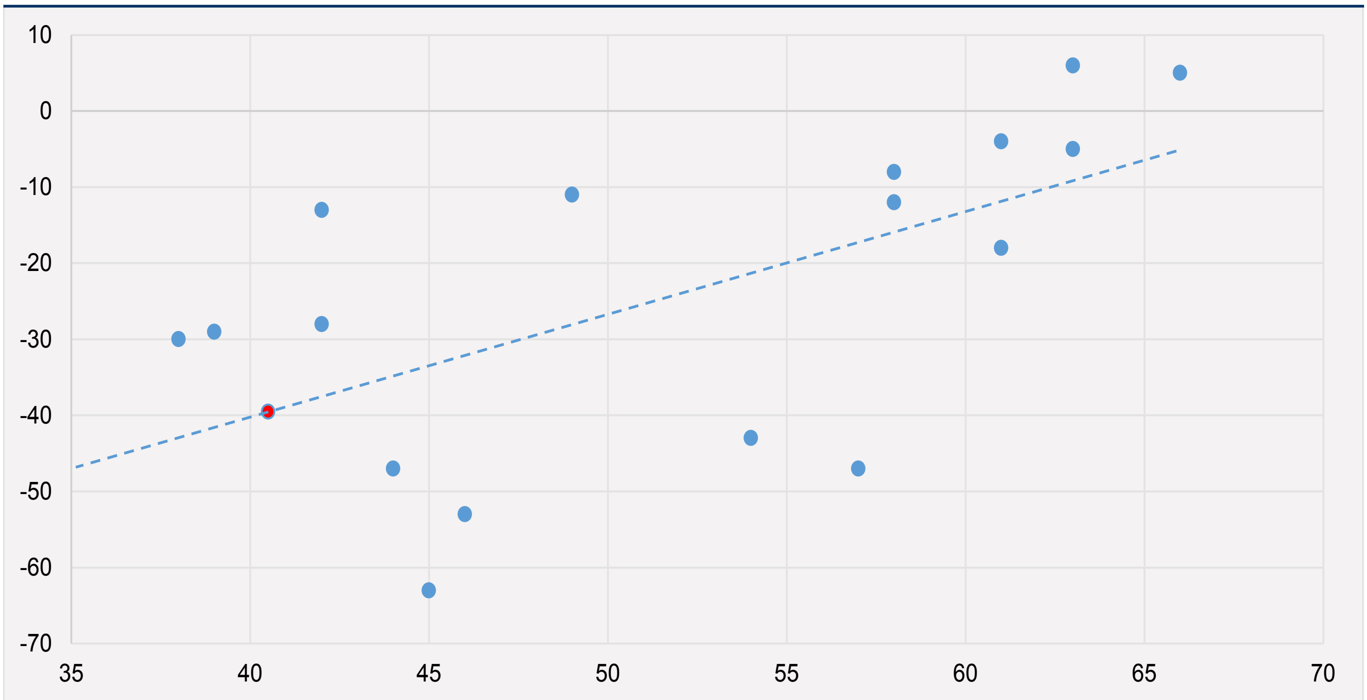


Source: FiveThirtyEight, as of 9/13/18

Trump's Approval Rating

Historically, when a President's approval rating drops below 50%, the ruling party generally loses 25 or more seats in the House. According to our recent average of polls, Trump's approval rating has fallen to 40.5% as of 9/9/18. Based on our correlation of a president's approval rating and seat changes to the House, Trump's current approval rating suggests a potential loss of about 40 seats (Chart 2).

Chart 2: Seat gain/loss in House of Representatives vs. approuval Rating



Source: Amundi Pioneer, as of 9/10/18

Fundraising

Finally, another key indicator of strength is fundraising. Democratic candidates have outraised their Republican counterparties in 71 out of 101 districts. Significantly, Republican incumbents are trailing in two-thirds of those districts.

Policy Implications: Re-emergence of Gridlock

The two parties are running on disparate economic policy platforms. The Democratic Party unveiled "A Better Deal", which is an economic plan aimed at increasing government spending, raising the minimum wage, and expanding healthcare. The Republican Party will focus on decreasing expenditures, introducing more tax reform measures and eliminating the Affordable Care Act (ACA).

Democratic Economic Agenda

- Increase government spending. Democrats want to spend $1 trillion on a long-term infrastructure plan to rebuild roads, bridges, transit, rail etc... In addition, they want to spend $100 billion on education and $70 billion on affordable public housing.
- Raise the minimum wage. While there are no specifics in "A Better Deal" platform, a Democratic bill introduced in the Senate last year proposed raising the Federal minimum wage from $7.25 to $15 by 2024, and indexed the minimum wage to median wage growth thereafter.
- Healthcare. Democrats plan to continue to defend the ACA and look to expand Medicaid, Medicare and Social Security. As part of "A Better Deal", Democrats look to lower prescription drug costs.
- Taxes. Democrats want to reverse corporate and upper income tax cuts
- Other. Paid family and sick leave. Child care/universal pre-K.

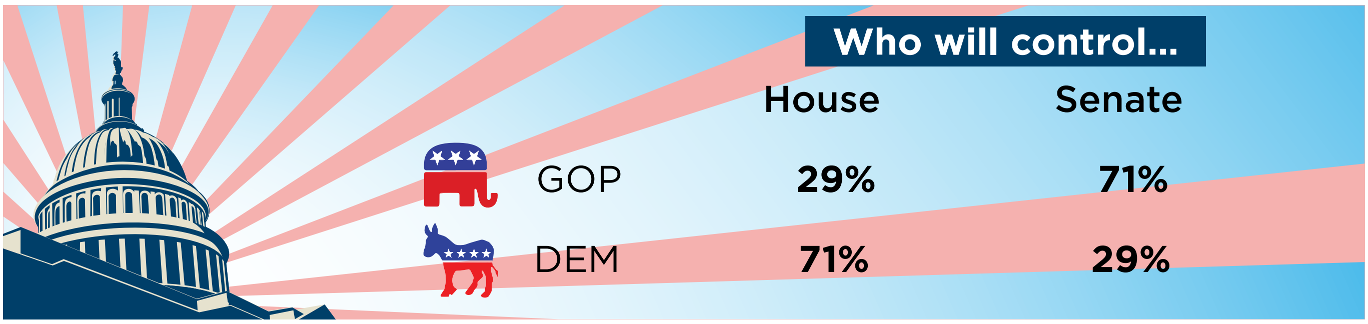
Republican Economic Agenda

- Tax Cuts and Jobs Act 2.0 (TCJA 2.0). The next phase of tax cuts include making the personal income tax cuts permanent and implementing tax incentives focused on retirement and business innovation.
- ACA repeal and replace. There will be another attempt to replace ACA and replace it with a more market oriented healthcare plan
- Welfare reform. Republicans look to cut spending on welfare, which could come in the form of stricter work requirements and reduced funding to states.
- Capital gains. Index capital gains to inflation.
- Immigration. Develop a solution to Deferred Action for Childhood Arrivals (DACA), and allocate more money for border security and construction of a wall between the US and Mexico.
- Infrastructure. Increase infrastructure spending, but not necessarily resurrecting public-private partnerships.

Scenario Analysis

Base Case: Democratic House and GOP Senate

The base case scenario expected by betting markets is for a divided Congress. As of date 9/21/18, investors wagering in hypothetical election futures markets have priced in a 71% probability of a Democratic House and an equal 71% probability of a GOP Senate.



Source: Predictit.org, as of 21/9/18

Under this scenario, there are potentially two general paths.

- In the more optimistic path, there could be some middle ground between House Democrats and Trump. We could expect the budget cap to be increased. There is also scope for a modest increase of $200 billion in infrastructure spending. There may also be movement in criminal justice reform, paid family leave

issues that have been promoted by Jared and Ivanka Trump, and addressing public health concerns, such as increased funding to tackle the opioid crisis.
- Under the more pessimistic path, we could see a stalled Trump legislative agenda, aggressive investigations of Trump and his inner circle, and finally the prospect of impeachment. This would poison the potential for common ground on policy.

Which path is taken depends on the many factors, including size of a Democratic majority, the outcome of the Mueller investigation, and demands from the hard left of the Democratic base. At the present, with polls pointing towards a divided Congress, the bias appears to be leaning towards the more pessimistic path.

Status Quo: GOP House and GOP Senate

Under this status quo scenario, the GOP would push to enact another round of tax reform (TCJA 2.0). This is more likely to succeed than repealing and replacing ACA. However, would likely be another close vote in the Senate. In addition, there is likely to be another attempt at boosting spending on border security that included funding for a wall along the US-Mexico border and hiring more customs and immigration officers. There are also proposals to reform welfare, which put stricter work requirements on welfare recipients. Finally, there could be changes to capital gains tax where it is indexed to inflation.

Complete Sweep: Democratic House and Democratic Senate

This is probably the most underestimated scenario. The market expects only a 29% probability of a Democratic takeover of the Senate, but it could be closer to 40%. History tells us that when there is a wave election, both branches of the legislature flip. Since 1952, every time the House has flipped (5 times) so has the Senate except once and that was in 2010. Given the large number of Red state Democrats, there is little room for error. Under this scenario, the Democrats will look to expand ACA, hike the minimum wage, introduce childcare/universal pre-K, attempt to reverse tax cuts for corporations and upper income families, and shift spending from defense to nondefense. It is highly unlikely any of the Democratic proposals will become law because they will not be able to muster the votes to override a Presidential veto.

Improbable Outcome: Republican House and Democratic Senate

This is the least likely outcome. There are many open GOP seats in the House, making most of them very competitive. This is not true for the Senate, where the environment is more favorable for the GOP with many incumbent Democratic Senators in deeply Republican States. In this scenario, we are likely to see a severely divided government. It is quite likely the GOP will suffer some losses in the House, which means the fiscally conservative Freedom caucus would push to keep fiscal policy tight. In the Senate, the Democrats would look to ease fiscal policy, leading to a classic stalemate.

White House

The prospects of gridlock with a divided government are high. With the Democrats likely to stymie the administration's agenda, what can we expect from the Trump administration?

- Presidential veto. The veto lets President Trump ensure that the Democratic agenda does not become law. It also makes it unlikely that any of the Trump legislation in the first two years, such as the tax bill, can be overturned.
- NAFTA and trade. The President has authority to unilaterally impose trade tariffs or sanctions, as he has on multiple occasions, affecting timber, washing machines, solar panels, NAFTA renegotiations, and China tariffs. With little prospect of accomplishing any new pieces of legislation, Trump may focus his attention on more trade issues such as additional tariffs on China, and target other countries, like Japan.

Foreign policy. This is also the domain of the executive branch. Repeatedly, presidents facing gridlock, or are a lame duck, turn overseas. The President may continue to focus on geopolitical hotspots, like denuclearizing North Korea, and continue to tighten the screws on Iranian sanctions. The President could also try to resurrect the Israeli-Palestinian peace talks, and roll back US involvement in Syria.

Investment Implications

Fixed Income

Under the base case scenario, the economic backdrop will remain robust, with an overheating economy and a rising negative output gap leading to upward inflationary pressures. With the optimistic path, the prospect of modest infrastructure spending would provide additional stimulus to an already booming economy. This could keep the Fed on its current protracted tightening cycle, and signal the potential to tighten beyond neutral. The size of the infrastructure spending and the state of the economy would determine the Fed's tolerance to a likely flat or inverted yield curve. We anticipate periodic overshoot in 10-year yields under this scenario, with more sustained trading above 3%. The Investment Grade (IG) and High Yield (HY) markets should tread water and clip a steady coupon.

However, under the pessimistic path of the base case, in the improbable scenario, and in a complete sweep, where gridlock prevails, the fading of the fiscal impulse could slow US economic activity to around trend by Q4 2019. This could cap the upward trajectory in consumer price inflation. The Fed should signal a pause or a slowing in its tightening cycle. Meanwhile, G-10 central banks could finally begin hiking interest rates, leading towards convergence in global monetary policy. This could lead to a broad-based rise in global yields and limit the potential for a sustained rally in US Treasuries. A slowdown in US growth, combined with market anticipation of sub-trend growth, could raise default concerns, and in combination, could lead to a selloff in the IG and HY markets. We would anticipate a similar market reaction to the status quo scenario where fiscal policy could be growth neutral. Any increase in border security expenditures would be offset by a cut in discretionary spending.

Equities

Under the gridlock situations (pessimistic path of base case, and complete sweep scenario), equity investors will not be able to rely on the GOP reform agenda to support higher equity prices. Instead, they investment views will be focused more on corporate earnings growth. While we believe US corporate earnings could grow 10% or more in 2019, the growth rate could be approximately half of what we expect in 2018 due to the absence of any additional tax benefits. In addition, there are also risks to this earnings forecast if higher than expected inflation, driven by tariffs and wage increases, reduce profit margins. For this reason, we would expect equity returns to be modest at best under a gridlock scenario.

However, under the base case scenario and status quo, equity markets could climb higher. Under the base case scenario, a pickup in infrastructure spending should offset some of the fading impulse from the last tax bill, thereby helping to keep US economic activity well above trend growth. In addition, infrastructure spending should boost the US infrastructure sector and global cement producers with US exposure. According to HSBC's *"US Midterm Elections: What to watch and what's at stake, Sept.5, 2018"*, a $30 billion per annum increase in infrastructure spending would boost 2019 civil engineering output close to 9pp and cement consumption close to 6pp.

Under the status quo - with Republicans maintaining control of Congress - the potential for additional tax reform, which could include a reduction in capital gains taxes, is the most bullish scenario for equity prices in the near-term, assuming earnings grow as expected and trade issues do not cause economic growth to slow.

US Dollar

The impact to the US Dollar (USD) from the midterm elections hinges on whether pro-growth fiscal policy measures are implemented. We see the USD appreciating under our optimistic base case scenario as the potential rise in rates above the neutral Fed funds rate should drive interest rate differentials in favor of the USD. Under the status quo scenario, further tax reform could lead to portfolio inflows into the equity and fixed income markets that would be USD positive. However, under the other scenarios (including pessimistic base case), we anticipate the USD to depreciate as we see the global monetary policy convergence theme dominating, and interest rate differential narrowing against the USD. The prospect of divided government should have a neutral impact on the USD. Going forward the USD will take its cue from the US monetary policy and economic outlook.

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 and China

Analysis | Donald Trump increased US tariffs on Chinese imports and announced an additional increase on January 1st. China's retaliations have remained moderate. It is likely that Trump's threats (e.g. rise in tariffs on auto imports) are 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 and China. Although the probability of an escalation of trade tensions is elevated, that of a chain reaction seems quite limited (25%) for at least two reasons: (1) many sectors in the US would be victims of retaliation which would be counterproductive (strong opposition perceptible in the Republican camp/ boomerang effect); (2) trading partners would be careful not to fall into the trap set and maintain a measured response. That said, we cannot ignore the risk of a clash between China and the US, 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, the US economy is close to full employment and the non-manufacturing ISM reached its highest historical level in October (since the index was created in 1997).

Market impact | Trade tensions have begun to weigh on business climate (especially in the manufacturing sector in Europe) and on the Chinese economy. Subsequently some private-investment projects might be postponed. Even in the absence of a large-scale trade war, global trade, which has started to slow, may thus slow down further. A chain reaction would cause a fall in global trade of goods 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). At the end of the day, a more severe confrontation would only make losers.

Risk # 2 | 50% probability | An additional increase in the price of oil

Analysis | Oil prices continued to rise over the recent weeks (reaching a peak at US$ 86 for the Brent on 4 October before sliding to $83 on 8 October), at its highest level for 4 years. This increase is due mainly to the anticipation of a drop in Iran's oil supply; indeed, the beginning of US sanctions on Iran led, in practice, many countries to stop importing (or to reduce their oil import) from Iran. So far, OPEC countries and Russia have not compensated for the missing supply and US producers are not able to do so (at least not in the short term due to local bottlenecks).

Market impact | The rise in oil prices weighs on household's purchasing power and on corporate profit margins. Domestic demand in the Eurozone is more at risk than in the US. The emerging economies – those which are net oil importers and which have already been weakened by capital outflows – also see their situation deteriorating. In the short term, the increase in oil prices can increase the inflation risk (base effect) and increase the nervousness of central bankers (the Fed and some Asian CBs). But ultimately, induced inflation should remain transient, with little transmission to core inflation if at the same time GDP growth slows down. In the end, a supply shock would (should) prove more deflationary than inflationary.

Risk # 3 | 20% probability | Political instability in Italy with renewed stress on sovereign spreads in the Eurozone

Analysis | The government coalition in Italy (between M5S and the League) has obscured the European sky. Relations between the Italian government and other EU countries are very tense, particularly in terms of fiscal policy and migration policy. The Italian government announced an increase in its budget deficit target for 2019-2021. Although its initial proposal (2.4% of GDP on 3 years) was revised in the following days (with a deficit set at 1.8% in 2021), new projections are far away from the commitment of the previous government: -0.8%, 0.0% and + 0.2% of deficit GDP. For the European Commission and for rating agencies, the projected fiscal slippage may not be considered compatible with the medium-term debt sustainability. The good news, however, is that the government remains apparently concerned about containing the debt-to-GDP ratio. Reactions from the European Commission and rating agencies are expected soon. The "arm-wrestling match" with the Commission just starts out.

Market impact | There is no systemic risk in our opinion. The rise in Italian bond yields has tightened local financial conditions and that will weigh on the ongoing recovery in Italy. And it may even endanger the public-debt sustainability in the medium term. But, at present levels of GDP growth and interest rates, debt is still sustainable. The risk remains domestic since Italian savings are abundant and government-debt securities are mainly held by residents (at 70%): in the short term, they have the ability to absorb the issuance of additional Treasury securities. Moreover, the ECB has anti-contagion tools that it could mobilise to avoid a contagion to other peripheral markets. All of this explains the absence of contagion on peripheral sovereign spreads and on corporate credit spreads.

Risk # **4** | **20%** probability

"Hard Brexit"

Analysis | The political situation in the UK is very unstable, with a government, a majority and a parliament that are particularly divided. 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), we stick to the view that the likelihood of a hard Brexit is low but negotiations get bogged down which is not good news. We expect rising tensions in the coming months. This might even be the precondition to reach a compromise later. In the event that the outcome is ultimately unfavourable for the UK, we would see a weakening of the GBP and below-trend GDP growth.

Risk # **5** | **20%** probability

Continuation of the contagion in the "emerging world"

Analysis | Emerging markets have been suffering since the start of the year, impacted by (1) the Fed's rate hikes, (2) by the trade war rhetoric (3) by the tightening in domestic monetary conditions (many EM central banks have risen their key rates) and (4) by the deterioration of the outlook in several countries at the same time (Argentina, China, Turkey, South Africa and Brazil). In fact, even though the systemic risk is lower than in the past (given the lesser vulnerability of emerging countries), most markets have dropped since the beginning of the year. Fears of more intense trade war between the US and China would undoubtedly push to a larger contagion (because value chains are very integrated).

Market impact | Credit spreads and equity markets would be highly hurt; it all the more true that emerging currencies would remain under pressure with more capital outflows. Even though the emerging world is not a homogeneous block, it has a clear tendency to behave like a block when market conditions deteriorate sharply. That's why caution about emerging markets is still required at present. The rise in oil prices is another factor of vulnerability for many EM countries (oil importers). Having said, that EM markets have already priced in most bad news, and at some point, they should become attractive again.

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) has continued to boost GDP growth in 2018. With growth close to 3%, 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 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 | There is no systemic risk in our opinion. The rise in Italian bond yields has tightened local financial conditions and that will weigh on the ongoing recovery in Italy. And it may even endanger the public-debt sustainability in the medium term. But, at present levels of GDP growth and interest rates, debt is still sustainable. The risk remains domestic since Italian savings are abundant and government-debt securities are mainly held by residents (at 70%): in the short term, they have the ability to absorb the issuance of additional Treasury securities. Moreover, the ECB has anti-contagion tools that it could mobilise to avoid a contagion to other peripheral markets. All of this explains the absence of contagion on peripheral sovereign spreads and on corporate credit spreads. If the Fed accelerates its monetary normalisation (with more rate hikes than expected), credit spreads would probably jump and equity markets fall in the US and probably also in many EMs. 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 economic growth is slowing down but the authorities are working hard to stimulate the economy (through FX management, monetary and fiscal policies) so that the economy is expected to remain resilient. That being said, 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 the NFC debt to GDP ratio had started to drop since late 2017. We will continue to monitor closely the trend in Chinese private debt, especially if the economy slows. 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, etc.

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 remain unlikely. In the case of the Eurozone: growth is slowing and the ECB intends to maintain very accommodative monetary conditions. 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. Having said that, regarding bond yields, risks remain titled to the upside in the short-term in the US (overheating risks with the possibility of additional wage acceleration).

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. Surveys remain high, especially in the services sector, in spite of rising risks. However, the business climate in the manufacturing sector is suffering from weaker global trade and rising oil prices. Emerging economies have been hit by the financial spillover from Argentina and Turkey, due to the broad-based appreciation of the USD (as a substantial proportion of their debt is in dollars). This has led to capital outflows from emerging economies and a depreciation of their currencies, which has, in turn, stoked local inflation. All in all, central banks have simultaneously begun to move their monetary policies to a more hawkish stance in many EM countries. 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 since the start of the year (+3.8% year-on-year in July compared to 4.8% in December). 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 retaliatory measures have been moderate. That said, uncertainty is tending to drag down investment and 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 (the non-manufacturing ISM peaked in October) 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 ongoing monetary policy tightening show up. We therefore forecast a slowdown in growth by 2020, with GDP growth closer to 2% by then.
- **Eurozone:** Last month, we revised our growth forecasts slightly downward, to 2.0% for 2018 and to 1.8% for 2019. It is likely that we will revise our forecasts once again in light of the rise in oil prices, which is particularly significant in euros. Protectionism has undermined confidence (in the manufacturing sector), but the latest surveys (especially in services) suggest that the Eurozone is holding up well. At this stage, we do not expect the fiscal policy announced in Italy to have a significant impact on the economy: the gains from a relaxation of fiscal policy will probably be erased by the tightening of local financial conditions (increase in interest rates). 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 asset purchase programme (APP) 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 are teetering on the brink and the dissension within the Conservative party is particularly acute (especially regarding whether or not to remain in the customs union), to the extent that the deadline for reaching an agreement with the EU this year probably won't be met. We should expect rising tensions over the coming months. The EU, meanwhile, wants to demonstrate that an exit is not in any country's interest. All in all, we do expect a "last minute" 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 Chinese government's retaliatory measures against the US

in the wake of Donald Trump's customs tariffs are extremely measured. China seems to be expecting things to calm down once the US mid-term elections are behind us. China has shifted its economic policy in favour of a pro-growth fiscal policy and an accommodating monetary policy. Even so, the risks to growth now look to be on the downside.

- **Inflation:** Core inflation remains low at this stage of the cycle 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 with rising oil prices and the pick-up in wages (United States, Eurozone) but would not last long (due to a lack of pricing power) and would drag down corporate margins more than final sale prices, all the more so if global growth slackens. 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 ($86/bbl. for Brent as of 4 October) to an almost four-year high. This is primarily due to expectations that supply will decline as US sanctions on Iran begin to take effect, which in practice will mean that many countries will halt (or reduce) their oil imports from Iran. Currently, OPEC and Russia seem reluctant to offset this supply shortage and US producers say they are unable to do so (at least not in the short term). Short-term risks are therefore on the upside. Rebalancing by boosting supply will take time, with US production already very high. Our equilibrium-price assumption (around $75) could be revised up. Uncertainty over oil supply is very high – no-one can predict the extent of the supply shortage.

- **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 one more 25bp hike in December 2018 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 halt its monthly asset purchases at the end of December, as announced. However, it will continue to replace maturing securities (between €160 and 200 billion in 2019) without clarifying its reinvestment policy in order to retain some flexibility. Its first rate hike is not expected until Q3 or Q4 2019.

The protectionist measures announced by Trump have ratcheted up uncertainty worldwide, fed the appreciation in the dollar and capital outflows from emerging economies, which furthermore are quite vulnerable to international to global trade issues. Emerging economies overall are weaker. Advanced economies are sensitive to different kinds of risks (mid-term elections in the US, Brexit, Italy, rising oil prices). Donald Trump's political strategy after the mid-term elections is unclear. In the very short term, a more serious confrontation with China on trade remains likely, at a time when rising oil prices are putting pressure on the manufacturing sector and threatening corporate margins.

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 further protectionist measures from the US followed by retaliations from the rest of the world remains high as the 6 November mid-term elections draw near (as Trump seeks to satisfy his electoral base). China and the EU are particularly exposed to this risk.
- Aggravation of geopolitical tensions in the Middle East. Oil prices could rise above $100.
- The uncertainty over rising trade tensions (primarily between the United States and China) against a backdrop of geopolitical risks (with Iran), crises in several large emerging economies (Turkey, Argentina), political risk in Brazil, a slowdown in China and political tensions in Europe (a deteriorating budget in Italy, Brexit) is encouraging companies to remain cautious.

Consequences:

- All things being equal, a trade war would drag down global trade and trigger a synchronised slowdown in growth and, in the short term, inflation. 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 in 2019

Donald Trump makes an about turn after the US mid-terms, reducing barriers to trade and engaging in bilateral negotiations with China. Domestically, the theme of increasing infrastructure spending could return to centre stage and extend the cycle in the United States.

- Acceleration driven by business investment and a rebound in global growth.
- Pro-cyclical US fiscal policy generating a greater-than-expected acceleration in domestic growth. Growth is reaccelerating in the Eurozone after a dip. Growth picks up again in China on the back of a stimulative policy mix in H1.
- Central banks would react late, initially maintaining 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.
- Risk of boom/bust

Macroeconomic picture by area

United States

GDP growth remains strong amid buoyant confidence

- Confidence remains strong among businesses while surveys are surprisingly positive; some signs of concern reported linked to the escalation in tariffs against China.
- Industrial activity stabilised on an upward trend, supported by domestic demand, with solid orders of capital goods and generally positive retail sales.
- Inflation data remained broadly aligned with the Fed's projections, with PCE measures now at target level.
- As widely expected, the Fed hiked rates in September (2.00% to 2.25%), increasingly confident in its economic and inflation outlook, and suggested a further hike in 2018 followed by progressive gradual tightening of monetary policy in 2019.
- After a first round of tariffs on imports of $50bn, a second round on $200bn of imports from China was implemented. NAFTA: after a preliminary Mexico-US agreement, Canada and US also reached an accord.

Risk factors

- **Tariffs and retaliation negatively impacting the economic performance, both directly (prices) and indirectly (confidence)**
- **Fed tightening impacting interest rate-sensitive segments (housing, consumer credit)**
- **Abrupt and severe tightening of financial conditions**
- **Geopolitical risks linked to a more hawkish shift by the US Administration**

Eurozone

Growth still positive but decelerating in a context of rising risks.

- After a very disappointing year's start (GDP grew by only 0.8% in H1), economic indicators stabilised during the summer, although without validating a strong rebound. Core inflation remains stuck at around 1% per year, but wage increases should allow it to rise slightly in the coming months.
- The announcement of a proposed Italian budget that does not comply with European rules threatens to increase internal tensions in the Eurozone. In addition, the Eurozone is more exposed to trade tensions than the United States.

Risk factors

- **Rise in anti-establishment parties**
- **Rise in the euro**
- **External risks (in particular trade war risks)**

United Kingdom

The job market provides an important support despite the Brexit uncertainty

- Growth rebounded in Q2 (+0.4%), confirming that the weak Q1 figure (+0.2%) underestimated the real trend. The labour market remains in good shape and real wages returned to positive territory.
- However, the uncertainty surrounding Brexit is dragging down confidence and investment. There are still major differences between the negotiating parties standing in the way of an agreement over withdrawal from the EU, and time is running out. The likelihood of a hard Brexit seems to be increasing.

Risk factors

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

Japan

Expecting retrieval activities after rounds of typhoons and earthquakes

- Real GDP is likely to decline in Q3 18 as a result of earthquakes, heavy rains, floods and scorching heat waves. Inventory adjustment in producer goods continues to weigh on growth. The weaker yen has failed to boost exports as the global economic slowdown takes its toll on shipments. The good news is that PM Abe has managed to persuade US President Trump not to impose higher levies on vehicles for now.
- The economy should regain strength in Q4 as producers try to recoup the losses incurred in the previous quarter. Disaster relief and reconstruction projects will amplify the upward momentum. Corporate Japan plans to expand capex at the highest pace since 2006 despite the serious trade dispute. In the meantime, wage growth is strong enough to absorb higher consumer inflation.

Risk factors

- **Tariffs and quotas imposed by the U.S. could raise costs and hamper supply chains**

China

- China's economy is slowing, but the potential slowdown still looks manageable.
- US/China trade tensions have continued. The US announced a 2nd tranche of tariffs on $200bn of Chinese goods, with 10% of the tariff effective from 24th September, and 25% from 1st January 2019. China retaliated on $60bn of US goods with a 5-10% tariff.
- There are signs of the export momentum cooling in China and its neighbours.
- That said, policy supports are also becoming more visible. Credit growth is stabilising, local government bond issuance has been accelerating, while the PBOC has committed to keeping ample liquidity.
- In addition, China continued to push ahead with reforms and initial measures, including a 3rd cut in import tariffs this year, to offer more tax benefits to foreign investors on their FDI, and also cut personal income tax.
- Policymakers are looking to protect the RMB from a further significant depreciation for now.
- There is likely to be continued uncertainty regarding US trade measures, the effectiveness of policy supports, and whether China could push further serious structural reforms.

Risk factors

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

Asia (ex JP & CH)

- Notwithstanding all the noise related to the escalation of the trade issue between China and the US, trade in the region is proving fairly resilient. Some measures have been implemented to weaken the import dynamics in India and Indonesia in order tocorrect the negative dynamics of the Trade Balance and Current Account.
- Inflation figures have remained fairly benign in the region, with the usual exception of the Philippines, where headline inflation is above 6% versus a Central Bank upper threshold of 4%.
- Monetary policies confirmed their hawkish stance. BSP and BI once again increased their monetary policy rates by 50bps and 25bps respectively. In both cases, we expect further tightening to come.
- Tariffs have been implemented on $200bn of Chinese exports to the US, with China retaliating soon after with $60bn of tariffs. Trade protectionism escalation is a risk factor for the countries in the region that are most integrated in the Chinese supply chain.

Risk factors

- **Trade in the region still holding up**
- **Inflation still very benign with the exception of the Philippines**
- **BSP and BI continued with their hiking cycle**
- **Increasing risks for countries integrated in the supply chain with China**

Latam

- Macroeconomic data in Q3 2018 are still signalling some weakness in the largest countries of the region such as Brazil, Mexico and Argentina while the smallest economies keep running at a more robust pace.
- On the inflation front, the overall environment remained benign. In Mexico, inflation in the first half of the month was lower than expected indicating a possible return to a converging path towards the target interrupted in June.
- The region's main Central Banks maintained monetary policy unchanged in their recent meetings. Following the revised IMF plan in support of Argentina, BCRA has changed its Monetary Policy framework, abandoning the inflation target in favour of Monetary aggregate targets.
- According to September polls, the elections in Brazil (on October 7th) will see J. Bolsonaro (PSL) and F. Haddad (PT) going through to the second round (on October 28th).

Risk factors

- **Three largest countries producing a weaker performance than the smaller countries**
- **Inflation turning benign in Mexico**
- **Change of Monetary Policy framework in Argentina**
- **Busy political agenda continues, with upcoming elections in Brazil on 7th and 28th 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 depreciated significantly given large external imbalances, poor external liquidity and non-orthodox policies of the government.
- Despite a sizeable hike in interest rates in September, Turkish assets will remain under pressure. 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**
- **Continued market turmoil, further drop GDP and in asset prices**

Macro and Market forecasts

Macroeconomic forecasts
(8 October 2018)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2018	2019	2020	2018	2019	2020
US	2.9	2.6	1.9	2.5	2.3	2.2
Japan	0.9	1.2	0.4	0.8	1.1	2.0
Eurozone	2.0	1.8	1.8	1.7	1.7	1.9
Germany	1.9	1.8	1.9	1.8	1.6	1.6
France	1.6	1.7	1.6	2.1	1.6	1.4
Italy	1.1	1.1	1.2	1.1	1.6	1.7
Spain	2.7	2.3	1.7	1.5	1.5	2.3
UK	1.3	1.5	1.6	2.4	2.3	2.4
Brazil	1.2	2.0	1.8	3.7	4.9	4.8
Russia	1.8	1.7	1.7	2.9	4.6	4.0
India	7.7	6.1	6.7	4.3	4.7	5.1
Indonesia	5.2	5.4	5.4	3.3	4.0	4.3
China	6.6	6.3	6.2	2.1	2.5	2.7
Turkey	2.3	-1.0	1.5	16.5	16.5	7.2
Developed countries	2.2	2.1	1.7	2.0	1.9	2.1
Emerging countries	4.9	4.6	4.7	4.1	4.2	3.8
World	3.8	3.6	3.5	3.2	3.3	3.1

Source: Amundi Research

Key interest rate outlook

	04/10/2018	Amundi + 6m.	Consensus Q1 2019	Amundi + 12m.	Consensus Q3 2019
US	2.25	2.75	2.75	3.00	3.00
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	0.75	1.00	1.00

Long rate outlook

2Y. Bond yield

	04/10/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.88	2.9/3.1	3.08	2.9/3.1	3.15
Germany	-0.53	-0.4/-0.3	-0.30	-0.3/-0.2	-0.29
Japan	-0.12	-0.2/-0.0	-0.09	-0.1/0.1	0.08
UK	0.86	0.80/1.00	1.00	0.9/1.1	1.10

10Y. Bond yield

	04/10/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	3.20	3.10/3.25	3.26	3.10/3.20	3.29
Germany	0.53	0.65/0.75	0.64	0.55/0.75	0.74
Japan	0.15	0.15/0.25	0.22	0.10/0.20	0.28
UK	1.66	1.6/1.8	1.74	1.70/1.80	1.81

Currency outlook

	02/10/2018	Amundi + 6m.	Consensus Q1 2019	Amundi + 12m.	Consensus Q3 2019
EUR/USD	1.15	1.18	1.18	1.21	1.22
USD/JPY	113.66	109	110	108	108
EUR/GBP	0.89	0.89	0.89	0.90	0.90
EUR/CHF	1.13	1.16	1.15	1.18	1.19
EUR/NOK	9.45	9.25	9.32	9.15	9.20
EUR/SEK	10.38	10.10	10.23	9.90	9.97
USD/CAD	1.28	1.26	1.28	1.24	1.26
AUD/USD	0.72	0.74	0.73	0.76	0.75
NZD/USD	0.66	0.67	0.66	0.68	0.69
USD/CNY	6.87	6.80	6.85	6.76	6.79

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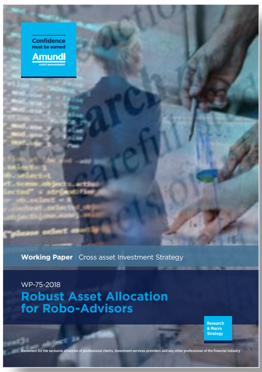

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