Confidence must be earned

Amundi ASSET MANAGEMENT

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INVESTMENT STRATEGY

CIO VIEWS

KICK-OFF 2019 WITH COURAGE AND DISCIPLINE

THIS MONTH'S TOPIC

DEMAND SUPPORTS ITALIAN DEBT ISSUANCE AS PRIMARY MARKETS MOVE INTO THE SPOTLIGHT

Research & Macro Strategy

CIO VIEWS

Kick-off 2019 with courage and discipline

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

After a tough December, which led to an abrupt valuation reset, risk assets rebounded in the first weeks of the year, boosted by a market-sympathetic turn in Fed rhetoric and an increased optimism on trade negotiations. As the current reasons for optimism should be confirmed, **we believe it is time to re-approach the areas of risk assets where the correction has brought value back**, especially in **emerging markets**. In our view, investors should start 2019 with a disciplined approach, but also have the courage to look beyond short-term noise in search for long-term value. The four areas to watch are:

1. **Economic outlook**: Signals of a mild deceleration in global growth are apparent. We cut our US growth expectations for 2019 and 2020, with potentially more revisions still possible down the road. However, we do not expect a recession (at least for the next 18 months) and buoyant labour markets should continue to support personal consumption. The EU economy, while slowing, should remain resilient, helped by loose monetary policy and some fiscal loosening (visible in Germany, France and Italy, for different reasons). China's soft landing has so far been well managed, with the government very proactive on policy, and EM growth showing signs of stabilisation (although with divergences). Yet, risks regarding global growth are skewed to the downside, in our view, and the market – also alerted by more dovish Fed rhetoric – will closely watch the forward-looking indicators (eg, PMIs – disappointing) before removing recession risk from the radar.
2. **Fed policy**: The Fed's communication strategy now seems to be more sensible to market volatility. With the Fed abandoning any pre-set policy path, and likely ending the tightening process in H1 (we now expect one hike in 2019), upside pressure on interest rates looks to be fading and the idea of central bank (CB) liquidity drying up could be of less concern than feared during the year-end blues.
3. **Earnings**: This could be a headwind for risk assets. After a strong increase over the past two years, EPS growth is expected to decline sharply in 2019, due to a deceleration in global GDP growth, fading impacts of US tax reform, declining sector contributions from oil and commodities, and rising labour costs. But most bad news already seems to be priced in as confirmed by the more muted reactions to negative news.
4. **Trade disputes**: Progress in trade negotiations is key. The direction towards cooperation seems clearer, encouraged by the weaker economic activity in China, with spillovers in the US which are pressuring the leaders to seek solutions. But markets will require tangible actions before repricing lower trade risk.

In addition, we continue to maintain a strong **long-term awareness of the structural fragilities** of the current economic/political/social framework. Long-term challenges remain: the China-US relationship; the Chinese delicate soft landing phase; DM CB with little room for manoeuvre to fight recessions; global debt at skyrocketing levels; global growth engines losing steam; and rising inequalities: each of these factors, all the more if combined together, represent a recipe for social unrest. Last year was a period focused on the sequence of repricing in asset classes: EM first, EU equities second, US equities and DM credit at the end. We are now approaching **a new sequence when some asset classes will bottom out (starting with EM)** while some others can still experience some further repricing or liquidity issues (low-quality debt). In our view, investors seeking to build resilient portfolios should increase liquidity buffers, focus on valuations, and identify the asset classes that could offer interesting entry points in order to start rebuilding some risk exposure in asset allocation.

** EM = Emerging Markets, DM = Developed Markets, ECB=European Central Bank. FAANG= Facebook, Amazon, Apple, Netflix, Google*

High Conviction Ideas

MULTI-ASSET

We maintain our overall defensive stance, but we seek to cautiously increase risk exposure, as risk assets should be supported by more dovish CB stances and China's expansionary polices. In DM credit, we think most of the widening is now behind us, as the market is discounting recession risks. We prefer EU credit, considering the better fundamentals and a relatively more favourable technical backdrop. We think investors should add duration in the US.

FIXED INCOME

We expect the prevailing uncertainty and growth deceleration to cap any significant increase in interest rates. With no strong duration conviction, we believe investors should seek opportunities in relative value strategies, keeping a preference for US duration. EU credit is better valued, and we suggest taking advantage of the rich supply in the primary market to reintroduce some risk exposure. Also, the US high yield is now more attractive, as is EM debt (also in LC).

EQUITIES

Focus continues to be on the sustainability of earnings and names that can deliver over the medium term. The US earnings outlook, although weakening, still looks positive for the year. We have become more constructive on the FAANG after the correction. In Europe, we seek value in cyclicals, in many case now discounting a recessionary environment. EM equity, cheap on a relative value basis vs DM, could be the first to benefit from a Fed pause, a solution on tariffs or stronger stimulus in China. Opportunities may be seen at the single country level (eg, India, with growth still well above the rest of the region).

MACRO

A year in two stages

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

2019 begins with a synchronised global slowdown. All recently published data, particularly trade and manufacturing data, show that economic activity is slowing in all countries simultaneously. In China, exports and imports contracted sharply in December, as did most Asian economies. In Europe, growth also seems to be slowing more sharply than expected. Germany - the Eurozone economy most exposed to the manufacturing sector and world trade - seems to be the most affected. Finally, in the US, business investment shows early signs of weakness (deterioration of ISM indexes or confidence of small businesses); and the rise in credit spreads will certainly weigh on investment in 2019.

In these conditions, should we fear a fall in global growth? Or is it a temporary slowdown? The slowdown in world trade is likely the result of uncertainty over trade between the US and China. **The global uncertainty index reached its highest level in December.** The previous peak was just after Donald Trump's election. The sharp trade tensions between the two countries are a key source of uncertainty. It is indeed in the US and in China that it has increased most significantly over the recent period. An increase in uncertainty tends to weigh on the trade of many countries through a slowdown in investment and disruption of production chains.

That being said, the US and China concluded a truce on December 1 that both parties have every interest in respecting, given the darkening economic outlook.

> “After a brutal valuation reset, some value is back in risk assets.”

Since then, the Chinese authorities have sent conciliatory signals. Donald Trump has now interest in finding a compromise given the clouds that accumulate on the US economy (end of fiscal stimulus in sight, tightening in financial conditions, impact of a shutdown that does not seem ready to end). Under these conditions, a destabilisation of world trade could end up weighing heavily on the US economy. It is noteworthy that world trade has been experiencing over the past years mini-cycles (short periods of acceleration or deceleration) which temporarily give the illusion of a synchronised global economic cycle. The last episode dates from 2017, when world trade rebounded. The year 2018 began with the theme of a synchronised global recovery that did not last long. The strength of global trade led economists to be overly optimistic (especially in Europe, where growth forecasts were revised up sharply). Today the slowdown in world trade is likely to lead to an error of the same type but in the other direction. Subject to China and the US continuing to settle their dispute through negotiation, growth in world trade is expected to stabilise by mid-2019 to a level close to that of world GDP (3.5%). Economies are not at the same stage of their cycle. Considering the determinants of domestic demand, we expect advanced and emerging countries to decouple in the second half of the year, with the continuing slowdown in advanced economies (especially in the US) and a stabilisation or even re-acceleration of growth in emerging countries.

ISM= Institute for Supply Management. The survey measures the economic activity in the manufacturing sector.

The Strategist view

Main changes since November outlook

A few changes have occurred in the macro-financial environment in the last three months. Economic growth slowed globally, trade disputes translated into weaker world trade growth. Financial conditions tightened sharply, US Treasury yields experienced positive flows based on a flight to quality (moving down 50 bps since October 2018).

Furthermore, **we adjusted our Fed forecast** (one hike in 2019, depending on economic data) and revised our US Treasury yield accordingly (10Y T Bond at 2.9% end-2019). In the euro area, we now see no rates hike in 2019 and revised the 10Y Bund to 0.35% by end-2019.

We also **revised downward our EPS growth expectations:** fundamentals remain slightly above trend in the US (6.7% in 2019), but this last leg of late-cycle dynamics could see some headwinds that go beyond margins and relate to revenue generation in the future. This will result in an eroding of our sales projections (manufacturing and wholesale, while retail continues to be supported by solid consumption). The reporting season will shed some light on top-line guidance.

In terms of **investment consequences,** the combination of more patient and flexible monetary policy stances, encouraging tariff negotiations, and economic intervention of Chinese authority could positively affect risk assets (and represent risks should they fail to materialise) and might help for a positive reaction after the brutal valuation reset. However, our broad set of risk sentinels (liquidity, credit spreads, earnings) keep us vigilant and aware of medium-term risks. Concretely, this translates into a positive bias towards risk assets and a flexible duration management in fixed income.

MULTI-ASSET

Ready to step into more rewarding risks

MATTEO GERMANO, Head of Multi-Asset

Concerns regarding a more pronounced slowdown of the US economy, with a recession happening sooner than later, shook risk assets at the end of last year. We expect global economic slowdown to materialise in 2019, centred in 4Q18-1Q19. In the short term, risks to global growth remain skewed to the downside. Margins are deteriorating as higher unit labour costs and trade pressures erode companies' revenues. However, despite risk sentiment remaining fragile, (mainly due to a clear deceleration in the economic and profit cycles) we think that these concerns are overdone. The current valuations of equities and credit, even considering the early January short-covering rally, reflect excessive recession fears. Corporate fundamentals, EPS revisions, and CB dynamics are the key variables to monitor, and considering the more coordinated dovish efforts from CBs, we believe there is room to cautiously increase risk allocation.

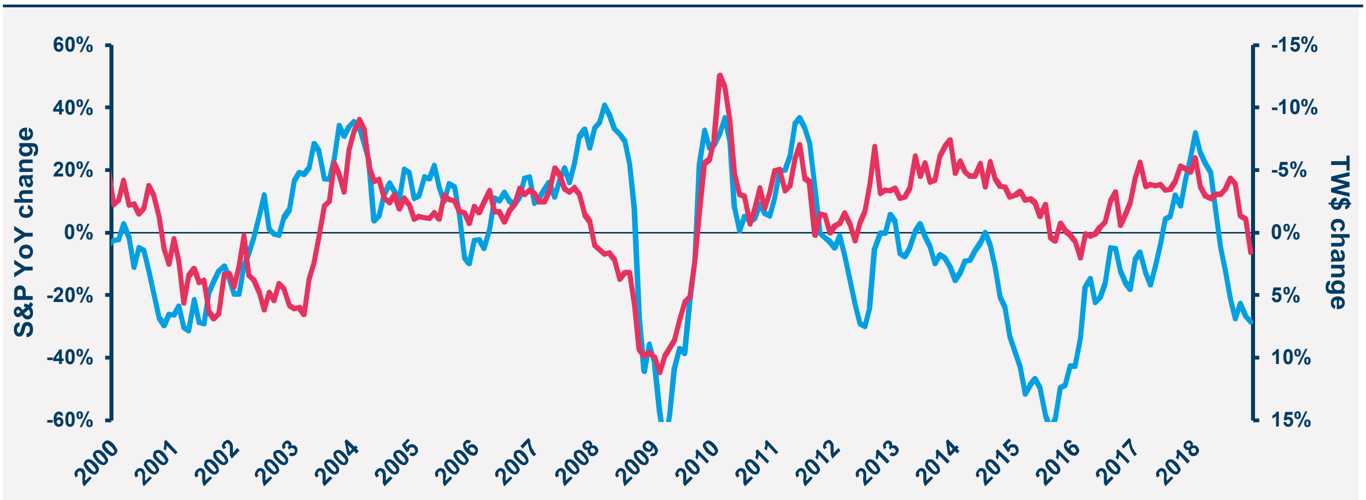
High conviction ideas

We started the year with a defensive stance in terms of risk allocation, with limited exposure to equities. This was due to the weaker momentum in the global expansion, downward revisions to earnings, and persistent geopolitical and idyosincratic risks. We are now gradually turning more constructive on risk assets, due to appealing valuations, but we highlight the need to be vigilant. In equities, we prefer Japan and EM; both regions are the main beneficiaries of the current wave of optimism (tariffs, dovish Fed) and interesting valuations. Within EM, the key is to be selective. China appears to have discounted a lot of negative news and is benefiting from the attractiveness of the high dividend yields of companies in the HSCEI* index. Further, negative momentum in revisions seems to be bottoming out in Asia, though revisions are still deteriorating in other areas.

> "Based on a more coordinated effort from Central Banks, we believe there is now room for selectively increasing risk allocation."

In fixed income, we have recently become constructive on credit, as we think most of the spread widening is behind us. Corporate fundamentals look sound and leverage is stabilising (but from elevated levels in the US). We prefer European credit on account of better fundamentals and technicals and the high hedging costs for US assets.

A stop on the trade-weighted US dollar index should benefit risk sentiment



Source: Amundi analysis on Bloomberg data. Data as of 2 January 2019. Data refers annual changes in the S&P500 index and in the Federal Reserve US Trade Weighted Broad Dollar.

On govies, we expect US yields to stay low; we suggest long duration positions with a focus on the mid part of the curve (5 years). We don't see value in core EU rates (we maintain a negative view on 2Y Germany in particular).

In the FX market, the US rally stopped at end-2018, with continued turbulence in US stocks markets, the drop in ISM data, and the US government in a partial shutdown. Moreover, one of the biggest drivers of the dollar – rate differentials vs the rest of the world – has receded since November vs the G10 universe. We believe that the USD is exposed to headwinds in the medium term, but as US rates moved quickly, we don't see a major directional trend and we prefer to keep a neutral stance. EM FX momentum has been recovering strongly since the beginning of 2019 and still appears quite robust.

Risks and hedging

While the risks linked to extreme valuations have diminished, there clearly are some geopolitical risks (Brexit progress, Italian fiscal discipline, US/China trade negotiations). We believe investors should maintain gold and yen exposure as hedges. Gold could also benefit from a more dovish Fed stance.

**HSCEI = Hang Seng China Enterprises Index.*

FIXED INCOME

Benefit from credit and EM bond repricing

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

Overall assessment

The US interest rate market moved from pricing two hikes to pricing only one rate hike in the space of few weeks, following the shift in rhetoric at the Fed and the weaker global economic performance. The move in rates was fast and possibly exaggerated, however we believe the downward pressures on yields will continue, especially for the US bonds. While the balance-sheet of the Fed is shrinking, there is enough uncertainty to keep the demand for perceived safe heaven assets alive. A cap in US rates is a positive factor for EM bond while the broad spread widening has also restored some value in credit.

DM bonds

We suggest maintaining a long duration preference in the US while staying defensive in core Europe, as we consider the current valuations unattractive, particularly on the short end of the curve. Overall, we do not see a strong case for higher yields. We think investors should exploit relative value opportunities. At the curve level, we suggest keeping a flattening bias in the EMU; in core markets, we like Belgium and France. We are now neutral on UK rates: valuations seems excessively high but the downward revision of economic growth prospects is likely leading to a more dovish Bank of England.

> "After the recent selloff, value has been restored in some areas of the credit market, in both Europe and the US."

On European credit, the recent spread widening has opened up opportunities; we consider the upcoming supply in the primary market as a chance to reload some risk, moving from a defensive to a neutral/slightly positive stance. We focus on selection and mitigating idiosyncratic risk, which could rise as the ECB steps out from the corporate purchasing programme, especially in the context of poor liquidity. We are also becoming more constructive on US credit. Selective high-yield names look better remunerating, given the benign default outlook. We also see opportunities in commercial mortgage-backed securities (CMBS) and in non-agency MBS.

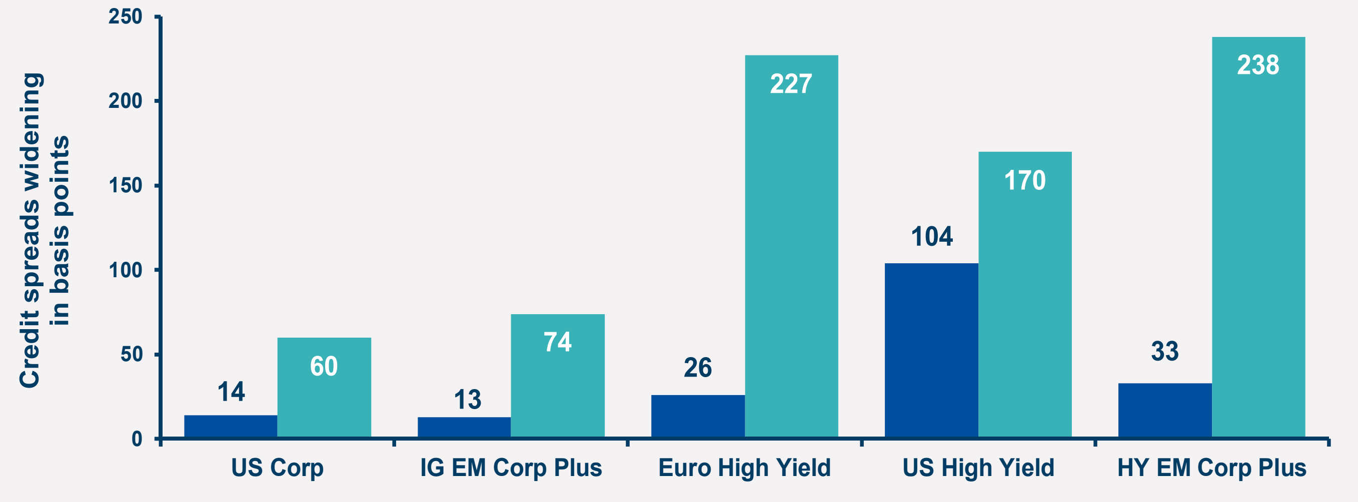
EM bonds

We believe that the tailwinds which are favouring the asset class will persist in 2019 – a more dovish Fed, a relaxation of US-China trade tensions, moderate growth with no hard landing. Relatively robust fundamentals in EM and less CB hawkishness will also support inflows. Country selection will be extremely important. We prefer countries where monetary policy could turn supportive for the economic cycle, considering specific vulnerabilities and idiosyncratic risks. With US interest rates remaining around the current levels, valuations now look attractive. We think investors could benefit from carry returns, and we like high-yielding countries, such as Brazil, South Africa and Indonesia. Local currency markets offer the highest potential, we think, should we see a materially weaker dollar.

FX

The more dovish Fed stance could weigh on the USD, but conditions in the EU (political uncertainty, growth slowdown) are not sufficiently robust to call for a significant appreciation of the currency. We are tactically more defensive on British sterling, due to Brexit uncertainty. We are becoming more positive on the Japanese yen, as the Bank of Japan (BoJ) looks to be starting to refine its policy.

Spreads widening in credit markets



Source: Amundi analysis on Bloomberg data. Data as of 2 January 2019. Data refers the changes in the option adjusted spreads for the ICE BofAML indexes.

EQUITY

Sustainability of earnings in focus

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

Overall assessment

Equity markets have experienced a broad-based recovery since the start of the year, after the turbulent December. Going forward, the outlook for global equities appears uncertain, due to the international economic slowdown, political uncertainties in Europe, and trade tensions. However, the asset class remains attractive as risk premia are historically high. Selection will be the name of the game, with a strong focus on sustainability of earnings growth, valuations and appealing dividend yields as a way to remain defensive in this phase.

Europe

In Europe, while the slowdown is materialising, growth forecasts remain relatively resilient, and we see the general de-rating as a source of opportunity in the market. Our focus is bottom up and we see areas of value emerging following the 2018 dislocation. We maintain a generally balanced top down stance with limited skews. On cyclicals, some names have excessively repriced, Industrials in particular offer good opportunities both in the quality cyclical and in the quality defensive compartments. We prefer this cyclical exposure to other areas such as materials. Banks look extremely cheap, but we prefer exposure to the higher quality names in the core over the peripheral banks at this stage. On defensives, in contrast, some areas have become relatively expensive. We are less positive on Consumer Staples given valuations that appear complacent and given the disruption that several of the staple companies face, which expands the range of outcomes (uncertainty) in our forecast. Healthcare among the defensives have more compelling risk reward in our view.

US

Assuming no major downward revisions in earnings – which does not seem likely at this point – the US market continues to be supported. Volatility will likely remain high as the market navigates through negative earning revisions. The market has already digested earning revisions in certain industries, such as energy and capital goods, but it seems likely that there is still room for further revisions, even in those industries, and in financials. We have increased our preference for the big tech/FAANG sector, which now offers more reasonable valuations and the most durable business model in the US economy. In general, this should be a good environment for active management. Valuation superiority plus avoiding the worst negative revisions, particularly in cases where they're not priced in, should be rewarded on a relative basis.

> **"Given persisting volatility, we would seek to take advantage of this by adding good-quality companies at more compelling valuations."**

Emerging Markets

We are more constructive on EM equity as we expect the fundamental picture to stabilise and improve in 2019, and the growth premium vs DM could start widening again from the second half of the year. EM equities look cheap on a relative basis and a global investor underweight in EM provides strong technical support. Despite this positive outlook, we continue to monitor risks linked to the direction of the US dollar, the uncertainty around trade negotiations, and the sustainability of China's growth. At a regional level we have favour countries with positive growth outlooks (China, India) and very attractive valuations (namely, Russia), while we are more defensive on countries with expensive valuations (Chile, Thailand) and would avoid countries with high political risk (namely, Turkey).

Composite Valuation Indicator (CVI) of the US and European Equity markets

Source: Amundi Research. Data as of 2 January 2019. CVIs are based on a basket of criteria in absolute terms – Trailing PE, Forward PE, P/B, DY, PCF and ranked in percentile from 0 to 100% the percentage of time this basket was cheaper since 1975 (0% never been cheaper; 100% never been more expensive).

REAL ASSETS

European Real Estate: drivers and challenges

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

An asset class facing numerous challenges in 2019

Last year was positive globally for real estate markets, despite concerns about Brexit. For instance, the demand for office space was higher than the decade average in many European markets (with, however, some decrease over the course of the year). In the context of low returns for many asset classes, and declines experienced by stocks markets, especially at the end of 2018, the appetite for investing in real estate is set to remain strong. For example, the volume of the transactions in France hit a record last year. In 2019, and for the years after, the real estate markets will face many challenges, both structural and cyclical. However, we believe that the asset class will be able to cope with the ongoing transformation as already happened in the past.

> "2018 was a positive year globally for real estate markets. Investor appetite for real estate remains strong. In 2019, and for the years thereafter, real estate markets will see many challenges, both structural and cyclical."

Structural transformations in progress

Over the last few years, transformations were seen in the different asset classes in real estate. The office market is facing the evolution of working methods at big corporation given new trends such as flex desk or desk sharing, teleworking, and the rise of co-working spaces, among others. The evolution of consumption habits and the emergence of online business meant that many companies had to rethink their strategies and adopt a multichannel approach (both physical and digital): they needed to use better data in order to meet customer needs and to offer a better user experience. In addition, they had to rethink location choices and experiment with new formats. On the other side, logistics have benefited from the rise of e-commerce. Logistics face a major transformation in areas such as the need for optimization via XXL warehouses and last mile logistics. The residential sector is changing as well, with, for example, the growth of service residences for senior citizens and co-living demand. These transformations should continue over the next few years. Thus, it is key to remain focused on these changes, especially as the transformations are not fully defined yet and the real estate sector continues to evolve. Furthermore, the real estate industry has prior experience with regard to reacting to structural transformations. We believe that investors need to consider these transformations in their strategies in order that the assets in their portfolios address changes in the structure of the sector. Obviously, attention must be paid to economic fundamentals and the changing nature of real estate assets.

A difficult economic context in 2019

This strong focus is even more important in the context of high values and relatively low differentiation regarding rates of return: in Europe, a reduction of this gap was observed in the past few years in city centres, as well as downtown and suburbs, with occasionally a gap reaching its lowest level for 10 years.

The 10-year rates of government bonds in Europe increased less than anticipated in 2018. However, they should grow slightly in 2019 according to our central scenario. At the same time, financial conditions will be less easier on global scale, than in previous years. The main European real estate markets are currently benefitting from a positive spread between prime office yields and 10-year bond rates. This gap could decrease and thereby dampen the impact of 10-year rate's increase on return rate. The principal European real estate markets could see stable performances in 2019 for prime assets, even if some punctual increases are not to be discarded in a changing environment with political risks. On the

> "We believe that investors need to consider these transformations in their investment strategies so that portfolio allocation addresses changes in the sector."

basis that few offers have been observed in numerous city centre markets such as Paris, Berlin, and, to a lesser extent, Amsterdam, a moderate rise of market rent could occur in offered sectors. To keep a balance, it is also necessary to remain attentive to office space production and the rise in demand. The economic environment will be key because a slowdown could potentially impact demand for offices and stop the potential rise in rents. Leased assets, which supply rental yields, are a key component in the global performance of real estate and thus represent premium assets in a diversified strategy. Moreover, the possibility of an increase in inflation by 1.5% in the Eurozone could lead to a rise in indexed rent, which should be positive for performance.

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 on a 3-6 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 (+/++/+++). This assessment is subject to change.

Relative outlook and convictions by major asset class

	Asset Class	1 month change on view	Underweight	Neutral	Overweight
GOVIES	US	→			●
	US linkers	→			●
	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	↗			●

Currency views

FOREX	EUR vs USD	=
	EUR vs GBP	=
	EUR vs JPY	-
	USD vs JPY	-

LEGEND

↘	Downgrade	+	Positive
→	Unchanged	=	Neutral
↗	Upgrade	-	Negative

Source: Amundi, as of 16 January 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

Demand supports Italian debt issuance as primary markets move into the spotlight

BERTONCINI SERGIO, Head of Rates & FX Research
USARDI ANNALISA, CFA, Senior Economist

Finalised on 29/01/2019

The essential

In a year that will see the end of net PSPP purchases by the ECB and an increase in projected net issuance, we focus on Italy's funding strategy and primary market outlook for 2019, a topic likely to become more closely monitored on the markets' radar screens over the next quarters. Despite a challenging H2 2018, trends in the average cost of funding and average debt maturity have not yet shown a material impact on Italy's debt structure, as we will show in this piece.

The very start of 2019 saw quite a strong and successful new issuance activity run by the Italian Treasury, and thanks to brisk demand, in just a few weeks Italy has already collected roughly 10% and 50%, respectively, of overall gross and net issuance for the whole year, according to our latest projections and guidelines from the Italian Treasury. It also must be noted that deal reception and post-issuance performance were generally encouraging not only for Italian BTPs but also for new debt issued by other peripheral countries, confirming that yield search is still alive in the Eurozone in the context of a more dovish monetary policy environment. However, despite these promising signs and the recent tightening in spreads following the budget agreement between the government and the European Commission, the macro picture still looks weaker than last year and downside risks have increased, also due to external factors.

Italy's funding strategy, primary market outlook for 2019 and the structure of Italian debt

Italy has recently published the yearly document in which the Treasury outlines its funding strategy for the upcoming 12 months *("Linee guida della gestione del debito pubblico - Anno 2019" MEF)*

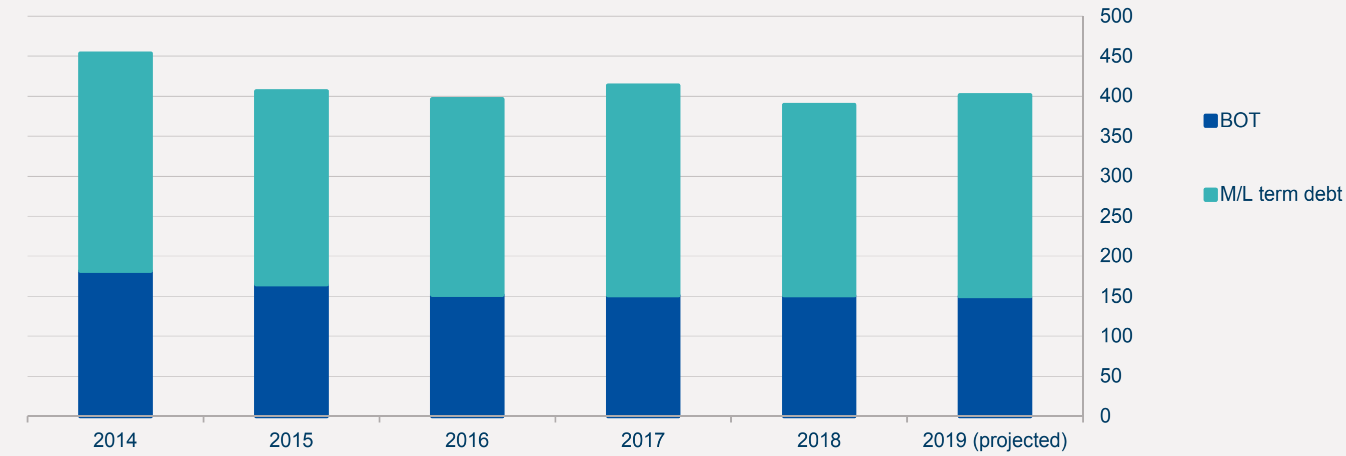
The guidelines outlined by the Italian Treasury on its funding strategy for 2019 show several detailed goals, but in a nutshell they point to transparency, managing primary market activity in a regular and forecastable way, and concentrating issuance where potential demand looks more robust and market depth greater. The diversification of the investor base is another goal for 2019, which could be targeted by possibly issuing in foreign currency.

The Italian Treasury also aims to optimize the mix between the average funding maturity and average funding cost over the year, which certainly looks more challenging than in previous years.

A challenging year in terms of issuance volumes

- 2019 Italy's **M/L term debt issuance** is estimated to be in the **EUR 250bn** area and will offset:
    - redemptions (higher than in 2018) amounting to EUR 201bn, with a EUR 17bn increase vs the previous year,
    - the cash deficit, expected to be EUR 50bn area (close to 2018 level).
- The **BOTs** (Bills) component should remain stable in the **EUR 150bn** area.
- Therefore, projections for 2019 point to an **overall funding volume** close to **EUR 400bn**, higher than the EUR 390bn issued in 2018.

1/ Italian Government Debt: yearly issuance, by type of instruments (in EUR bn)



Source: Bloomberg, Amundi Research. Data as of 25 January 2019

Among the curve segments, in relation to 2018, supply is expected to be lower at the belly of the curve (5 and 7-yr) and higher at the short end (2 and 3-yr) and long end (10-yr and 15-30 yr)

The expected distribution of the issuance mix among different curve segments seems to point to the goal of consolidating the structure achieved in recent years, in particular with a higher average maturity, while containing funding costs in light of the strong steepening in the yield curve in the latest quarters. Since early May 2018, in fact, 3-yr and 5-yr maturities have recorded quite a steepening vs the corresponding 2-yr, while the opposite took place in the 7-yr to 10-yr and extra-long segments. Moving onto a more detailed analysis by curve buckets we summarize the main points below:

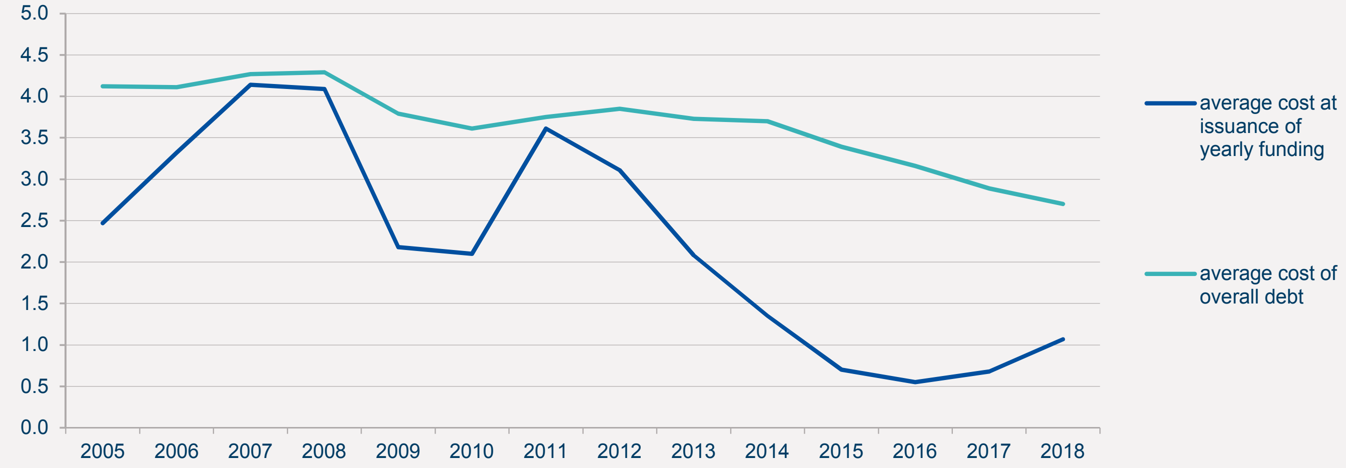
- **3-yr and 5-yr BTP**: 3-yr and 5-yr BTPs respectively totaled EUR 36bn and EUR 31bn of new issuance in 2018, with a calibration of volumes vs the 3-yr (in percentage of the overall issued debt). Total issuance in 2019 on these two maturities should remain in line with the 2018 calibration, and probably more skewed towards the 3-yr rather than the 5-yr. The Treasury expects a positive net issuance on the 3-yr (more than EUR 24bn in redemptions) and a negative net issuance on the 5-yr (EUR 47bn redemptions).
- **7-yr BTP**: Gross supply is expected to be lower this year than the EUR 33bn volume recorded in 2018, mainly because of lower redemptions in this tenor: however, net supply will be positive, increasing the weight of this segment in overall debt.
- **10-yr BTP**: Issuance amounted to EUR 36bn in 2018. With gross supply expected to be above EUR 48bn this year, this tenor will continue to play a significant role in 2019. At the same time, however, net supply in this segment should be slightly negative.
- **15, 20, 30 and 50-yr BTP**: in its guidelines, the Italian Treasury mentioned the goal of remaining active in this segment, despite more challenging market conditions. Consistent with this goal, the Treasury has already issued a new EUR 10bn 15-yr bond and depending on market conditions may sell a new 30-yr. Last year, a total volume of EUR 30bn was issued in the extra-long maturities segment and Italy targets similar issuance volume in the next 12 months. Taking into account a significant maturity in the 15-yr segment of close to 23bn, net issuance should be positive in this segment.

What about trends in the cost of funding and the average maturity of Italian debt?

- The **average life of debt** has decreased only slightly, from 6.9 years in December 2017 to **6.78 years at the end of 2018.**
- At the same time, in 2018 the **yearly funding cost** rose for the first time in recent years to **1.07%,** up from **0.7% in** 2015, **0.55% in** 2016 and **0.68%** in 2017: funding costs began to rise from the second half of May.
- A 1.07% the average yearly funding cost is still quite low by both historical standards and relative to **the average cost of the whole stock of outstanding debt,** which fell further in 2018 to **2.7%** (the last available data are for October), down from 2.89% in 2017 and 3.16% in 2016.
- The chart shows trends in both the yearly funding cost and the average cost of overall outstanding debt: thanks to the sharp fall in the yearly funding cost in 2013-2015, a lagged substantial drop in the average cost of overall debt was seen in the following years (down from 3.7% in 2015 to 2.7% in 2018).

- Assuming current yield levels as the average funding costs for 2019, a further but limited rise in the yearly funding cost to 1.3%/1.4% is likely.
- Based on the Bank of Italy's recent indications, the rise in the yearly funding cost that materialized last year should have a limited impact on the overall cost of debt (**see last FSR November 2018**). "*The long average residual maturity of outstanding securities (6.7 years) slows down the transmission of yield increases to the cost of the debt: with no changes in the composition of the stock of securities,* ***a permanent increase of 1 percentage point in yields at issue*** *would lead to an increase in the average cost of debt of about* ***0.1 percentage points after one year, 0.2 points after two years, and 0.4 points after three year****s. Medium-and long-term securities (more than 12 months) maturing in 2019 amount to about €200 billion; taking account of securities with shorter residual maturities and of the need to cover the general government deficit as well, next year's gross issues will amount to about €400 billion.*"

2/ **Italian Government Debt: average cost of yearly funding and average cost of overall debt, in % points**



Source: Bloomberg, Amundi Research. Data as of 25 January 2019

The year started with successful new issuance activity by the Italian Treasury

The Italian Treasury was quite active in the primary market at the start of the year. After just three weeks, in fact, new issuance of M/L term debt issuance already totaled more than EUR 25bn.

- In pure number terms, this means that relative to refunding needs for the whole year, Italy has already covered 10% of overall scheduled gross issuance and a remarkable 50% of its entire 2019 net funding needs.
- In terms of tenor of issued debt, the Italian Treasury managed to place quite long bonds, as the average maturity of new issuance is close to 11 years, almost double the average maturity of its total outstanding debt. This was made possible thanks to EUR 10bn of a new 15-yr BTP and EUR 2.6bn and 1.5bn, respectively, of new 10-yr and new 30-yr BTPs.
- With respect to the much less challenging market conditions of 2018, this year activity is encouraging, as the amount issued year to date totals EUR 1bn more than the amount issued by the same date last year. To make things less simple, January is one of the very few months of 2019 with no redemptions at all.
- Italian Treasury auction results were generally good, both in terms of the amount issued relative to targeted amounts (always at the upper end of the announced auction range) and in terms of bid-to-cover ratios.
- The syndicated 15-yr bond not only collected record orders, amounting to EUR 35.5bn (cover ratio 3.6x), but it also drew quite a high initial offer from abroad, as foreign investors accounted for around two-thirds of the order book, with quite a broad distribution by investor type, not tilted towards long-term investors. A record high volume was in fact allocated to fund managers (55%), while geographical distribution saw a large share allocated to investors based in Germany, Austria and Switzerland (21%) – around double the average historical allocation to these three countries for similar long-dated syndicated BTPs issued in the last four years.
- The spread tightening that followed the closure of the syndicated 15-yr BTP seems to confirm real interest in the country's new debt.
- Among other peripheral countries, following the success of the Italian Treasury, Spain also collected a record order book for a 10-year euro sovereign note, while Portugal and Ireland had already both sold EUR 4bn 10-yr bonds with order books of over EUR 24bn and EUR 18bn respectively.

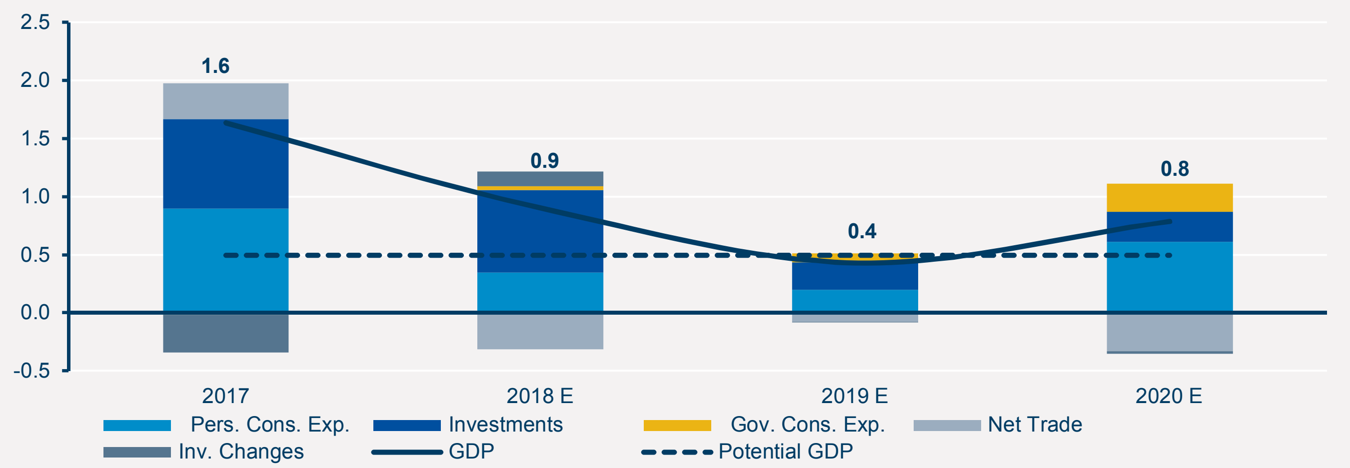
The Italian macro picture looks weaker

Thanks to the final agreement reached by the Italian government and the European Commission on the 2019 budget, pressure on the BTP has somewhat eased, a relief mostly due to the Italian Government's implicit commitment to work within the EU framework of laws and institutions.

Yet we must acknowledge the increased risks of a technical recession in Italy, where the Q3 18 GDP reading was negative and Q4 also looks likely to be very weak. This in turn could put at risk the achievement of the deficit target for the year (2.04%) and the decline in the Debt/GDP ratio as well, because realized growth may be much lower than the assumption used to set the targets. The inflation path also looks likely to remain subdued.

While we expect the Italian economy will grow in the 0.5% range (actual forecast 0.4% YoY average for 2019), slightly below the baseline projections of the Ministry of Economy and Finance and the Bank of Italy (0.6% YoY in 2019), we also think that risks to the downside are high. Significant risks come from the external side: deceleration in global trade and slower growth in key euro area trade partners could weigh on the export-led part of the economy. On the domestic side, the decline in business confidence coupled with a slowdown in capex and private investments may be a drag on internal demand. Consumers still remain overall optimistic even though there has been a slight deceleration in real disposable income, and they have marginally increased their propensity to save, while the labour market keeps slowly declining. On the other hand, lower oil prices could represent an upside risk.

3/ **Italy GDP & contributions**



Source: Thomson-Reuters Datastream, ISTAT, Amundi Research, Data as of 28/01/2019

Conclusion

January saw the first wave of Italian BTPs being well received in the primary market, despite the lack of redemptions. In this respect, there will be redemptions again in the next two months, as EUR 23.1bn in BTPs will mature at the beginning of February and a similar amount will mature in March, therefore offering some support to the secondary market, and indirectly to upcoming auctions. Short-term technicals supported a partial return of foreign demand, as according to available data, "non-residents" had strongly reduced their holdings in the last three quarters of 2018. This would tend to explain the relatively high participation of foreign investors in Italian and other peripheral countries' primary market and the distribution by investor type at a time when ECB rates are no longer expected to move up this year. Italy has already covered a significant portion of yearly net supply by issuing long bonds: its funding strategy aims to optimize the mix of average maturity and average funding costs, keeping the first stable while calibrating issuance across the steeper curve to address the second objective. Despite the slight rise in funding costs, the average cost of overall debt remains low vs previous years and should not be strongly impacted in the next one to two years. However, the year has just started and it remains quite challenging in terms of overall funding needs and supply, as we outlined in the numbers shown in the first section. Furthermore, the main medium- to long-term challenges still relate to the weaker macro trends we analysed in the last section and persisting political uncertainties in the Eurozone (Brexit and European elections, first) and outside the Eurozone.

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	40% probability	Renewed escalation in trade tensions between the US and China

Analysis | US and China ceased fire after a temporary deal reached by President Trump and President Xi during G20 meetings at Argentina. The planned increase of tariff rates in January 2019 paused and the risk of an additional tranche of tariffs on the rest of US imports from China ($267bn) seems to have been also delayed, while negotiations resumed, with signs of China to deliver some of commitments. This should at least help to reduce some downside risks in the near term, with direct impacts on trade to be less concerned, and market sentiment to recover slightly from being very downbeat. That said, this deal is still temporary, and it could take much longer to ultimately solve the problems, as many complicated topics are involved. We cannot rule out a severe confrontation between the US and China.

Market impact | Trade tensions have begun to weigh on business climate (especially in the manufacturing sector) and on the Chinese economy. Subsequently some private-investment projects have probably been 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	20% probability	Major European slowdown

Analysis | Eurozone GDP growth slowed down to only 0.2% QoQ in Q3, after 0.4% in Q1 and Q2 and 0.7% in Q3 and Q4 2017. While Q3 weakness was largely the result of temporary negative factors (a sharp drop in German car production due to a new emission testing regime), the growth momentum in Q4 2018 and Q12019 is slower than what we had anticipated a few months ago. The central scenario remains a continuation of the recovery at a slightly above-potential pace, but risks are clearly tilted to the downside, in particular in the short run. Indeed, the combination of continuing internal political stress and external negative factors (notably a slowdown in the US and/or Chinese momentum) could cause growth to fall further. Lower oil prices are a supportive factor. However, a reversal of this trend would be another drag for the European economy.

Market impact | As the ECB would be left with few tools to face a slowdown, and as a coordinated fiscal stimulus would be very difficult to decide due to the complex European institutional and political environment, a major slowdown would clearly be negative for European assets and the euro.

Risk # 3	20% probability	No-deal Brexit

Analysis | A large majority of British MPs rejected on 15 January the Withdrawal agreement concluded by the EU and UK governments on November 25. However, PM T. May was conforted the following day by the failure of a non-confidence vote triggered by Labour. Parliament also backed her to renegotiate with the EU the so-called “Irish backstop” that remains the main obstacle to ratification. However, the EU’s official position remains that the Withdrawal Agreement, which the backstop is part of, cannot be renegotiated. Our estimate is that there is a 50% probability that an agreement can nonetheless be ratified by March 29 (although even in this case Brexit may be postponed by a few weeks). Indeed, pressure related to an imminent “no deal” risk will increase in the coming weeks and (possibly in conjunction with a few concessions from the EU) may lead to a last minute change in the attitude of enough MPs. We also believe that there is a roughly 30% probability that Brexit will be postponed by several months, as a consequence of a decision to organize a new referendum or a new election, or following an agreement by the EU to give more time to the UK to entirely rethink its position, or if the UK unilaterally withdraws its invocation of Art. 50. The “no-deal Brexit” probability on March 29 is, in our view, of roughly 20%: While the clear majority of MPs opposed to “no-deal” is a safeguard, it remains nonetheless the default scenario if no agreement can be reached on another solution.

Market impact | We must prepare for a dense newsflow in the coming weeks. 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. But should a deal be voted, the Sterling would appreciate and business investment would probably benefit from a drop in uncertainty.

Risk # **4** | **15%** 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) maintained very tense relations with the EU until recently. The government revised down its deficit target, with a smaller budget deterioration in 2019 (2.04% vs. 2.4%). It is not a structural adjustment, but thanks to this revision, the European Commission (EC) has decided not to launch an Excessive Deficit Procedure at this stage. The relationships with the EC have improved at least for the time being.. Incoming data on contracting economic growth in Q3 and weak coincident and leading indicators for Q4 increased the risks of another dip. With slow growth ahead (we expect GDP growth at 0.5% in 2019), tensions with the EC will inevitably resurface later in 2019.

Market impact | There is no systemic risk in our opinion. On the one hand, the rise in Italian bond yields has tightened local financial conditions and that weighs on GDP growth in Italy. But on the other hand, the absence of an EDP gave some short-term relief. Yet, the long-term outlook has not changed much. We perceive risks as remaining domestic. Keep in mind that the ECB has anti-contagion tools that it could mobilise to avoid a contagion to other peripheral markets. All of this should contain the contagion risk on peripheral sovereign spreads and on corporate credit spreads.

Risk # **5** | **15%** probability

Continuation of the contagion in the “emerging world”

Analysis | Emerging markets suffered in 2018, impacted by (1) the Fed’s rate hikes and strong USD; (2) by the trade war rhetoric; (3) by the tightening in domestic monetary conditions (many EM central banks have risen their key rates); (4) by the deterioration of the outlook in several countries at the same time (Argentina, China, Turkey and South Africa). In fact, even though the systemic risk is lower than in the past (given the lesser vulnerability of emerging countries), most EM assets dropped in 2018. The fact that the Fed is close to the end of its tightening cycle and that the USD has peaked is good news for EM markets in 2019. However an escalation in the 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. However, the emerging world is not a homogeneous block, and the market will deteriorate more in the most vulnerable countries, whether due to poor external positions whether due fragile fiscal and political conditions. Some caution about emerging markets is still required at present but the risk probability has reduced. Indeed, we believe EM markets have already priced in most bad news, and at some point, they should become attractive again.

Risk # **6** | **15%** probability

US Recession

Analysis | Recent surveys indicate that the US economy started to slow in Q4. We think that US growth will continue to slow looking ahead, in particular regarding investment. However consumption should remain resilient given the strength of the job market. Given the shutdown, there is no compromise to expect between Democrats and Republican on infrastructure in the short term. All eyes are on the Federal Reserve which is likely to make a pause earlier than expected.

Market impact | Markets are likely to become more circumspect with regard to 2020 growth expectations as the deceleration could become more pronounced and economic signals increasingly mixed as the cycle extends. The best choice for investors is to limit exposure to credit, diversify the portfolio smartly and to take a flexible duration management (close to neutrality at this stage). On the equity side, selection of themes, sectors and single names will be increasingly relevant.

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 (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. Meanwhile, a cease of fire with US on trade tensions could gain valuable time for China to adjust their policy implementations and to better manage short-term risks. 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 | **Major political crisis in Europe**

Analysis | European politics is becoming less predictable due to the rise of various non-mainstream political forces in several countries. In September, the non-mainstream Italian government coalition announced a 2019 budget in breach of European rules, thus opening an episode of tensions with the rest of the Eurozone. Although an agreement was reached, this topic could flare up again due to more fiscal slippage in 2019. In France, where the situation had been stable since the 2017 presidential election, sudden and violent social movements caught the government off guard at the end of 2018 and could complicate the continuation of its supply-side reform agenda. Although less immediately worrying, the political outlook is also uncertain in Germany (where the stability of the government coalition could be questioned) and in Spain (due to the lack of a proper majority in Parliament and the recent rise of a far-right party). More generally, the combination of strong anti-immigrant feelings and frustration towards European institutions remains a tailwind for anti-system political forces. The May 2019 European election will be a major gauge of their progress.

Market impact | Given the still positive economic backdrop, we do not believe that these events will trigger a new round of systemic crisis in Europe. Non-mainstream political forces that are in a position to rule countries (such as in Italy) have shown that they want to blame European political institutions and try to modify them, but not exit the Eurozone. However, this problematic political news flow will continue to generate market stress in 2019 while the difficulty to understand European institutions for outside investors means that European assets will continue to carry a specific political risk premium. Italian government spread vs. Bund could continue to be volatile.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

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

Central scenario (75% probability): global growth slows gradually but surely

- **Growth is slowing worldwide:** 2018 had begun based on the theme of a synchronised global recovery. But this did not last. Since the spring, the protectionist measures taken by Donald Trump have changed the game. Emerging economies, some of which are heavily indebted in dollars, have been weakened due to the broad-based appreciation of the US currency. Moreover, economic activity has markedly weakened in China and in the Eurozone since Q4 2018. Hence 2019 starts with a global synchronised slowdown with predominant downside risks. However, a new factor that arrived lately in the picture has been the oil price drop (since October) that should support the European economies and the EM oil Importers such as India and Turkey.

- **World trade:** Global trade has weakened; it started 2018 at around 5% YoY and in October it has grown by 3.6% YoY. Protectionist rhetoric has pushed down business confidence, particularly in Europe. That said, global uncertainty is tending to drag down investment and disrupt value chains that have developed in lockstep with the expansion in global trade over the past 15 years. However, the truce between China and the US (after the G20 meeting in Argentina) has resulted in a more positive than expected short-term scenario, where the further increase in US tariffs towards China from 10% to 25% at the 1st of January 2019 has been postponed by 90 days (1st of March 2019). And this truce is likely to be extended in time. At the end of the day, we expect global trade growth to stabilise at the same level as global GDP growth.

- **United States:** The US economy has been driven by a very accommodative fiscal policy but its impact should progressively erode this year. We expect growth to decelerate to its potential by early 2020, meaning in practice that the US economy will lose 1pp of growth by the end of the year. Indeed, we expect GDP growth at 2.4% in 2019 and 1.8% in 2020 (yoy growth, would thus slow from 3% in Q4 18 to 2% in Q4 19). This situation will have a negative impact on corporate profits, especially if inflationary pressures materialise by then, which is possible, given the fact that the economy is operating at close to full employment. We do believe that 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 policy tightening show up.

- **Eurozone:** Once again we revised down our growth forecast (from 1.5% to 1.2% in 2019); however we kept unchanged our growth forecast for 2020 at 1.5%. Despite a recovery that has started well after that in the US, Eurozone economies have begun to slow in 2018. The output gap has closed in most countries, and Italy is the only one in the Eurozone (excluding Greece) where GDP has not recovered to pre-crisis levels. In Italy, incoming data and weak coincident and leading indicators for Q4 increased the risks of another dip that prompted the Government to tone down rhetoric. Several factors have contributed to the slowdown in EZ growth in 2018: the slowdown in world trade and, until October, a high oil price have been the most relevant. No wonder, in these conditions it is Germany that has slowed the most abruptly. The possibility of a coalition change in Germany following the defeat of the two major government coalition parties (CDU and SPD) in local elections marks the end of the Merkel era. The loss of the chancellor's leadership may hinder initiatives to strengthen the integration of the Eurozone that were under consideration. In addition, political uncertainties have muddied the waters (Brexit, Italian budget). It will probably be necessary to wait for European elections in May 2019 and a new parliament, a new European Commission, a new Chancellor in Germany, and clarification regarding leadership of the institutions of the EU (Commission, ECB) to make significant progress in strengthening the EU and the Eurozone.

- **United Kingdom:** The political situation in the UK is highly unstable. Many options are still possible. Everything will ultimately depend on the scenario (see section risk factors and our "investment talk" published on the subject on 9 January).

- **China:** Chinese economic growth is slowing down but the authorities are working hard to stimulate the economy (through monetary and fiscal policies) so that the economy is expected to stabilise by mid-2019. 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. Meanwhile, the cease of fire with US on trade tensions should gain valuable time for China to adjust its policy implementations and to better manage short-term risks. 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.

- **Inflation:** Core inflation remains low at this stage of the cycle in advanced economies. 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 the pick-up in wages (United States, Eurozone) but is increasingly unlikely, 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 somewhat 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 decreased sharply: from $86/b (Brent) in early October to $60 in late January. The main trigger at the very beginning of the decline have been the large amount of waivers conceded by the US administration to different countries with regard to the sanctions imposed to Iran oil exports. A moderate OPEC and Non-OPEC production cut decided at the beginning of December together with fear of a more pronounced economic slowdown are keeping oil prices at low levels.

- **Main central banks to turn more accommodative: The Fed should stop its monetary tightening in H1 2019 (we expect at most one rate hike this year, probably not before Q2).** The ECB has ended its monthly asset purchases at the end of December but will continue to replace maturing securities (between €160 and 200 bn in 2019) without clarifying its reinvestment policy in order to retain some flexibility. We do not expect any rate hike from the ECB in 2019 or 2020.The ECB has no room for manoeuvre to normalise its monetary policy, given the economic slowdown and the absence of inflation. In order to maintain very accommodative monetary conditions, we now expect the ECB to launch a new TLTRO (H1).

Downside risk scenario (20% 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 (even after the 90 days agreed during last G20 meeting), followed by retaliation from the rest of the world, remains high. China and the EU are particularly exposed to this risk.
- Uncertainty regarding rising trade tensions (primarily between the US and China) against a backdrop of geopolitical risks, crises in several large emerging economies (e.g., Turkey, Argentina), political risk in Brazil, a slowdown in China, and political tensions in Europe (a deterioration in the budget situation 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 and durable 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 government or credit spreads, for both advanced and emerging economies, and a decline in market liquidity.
- Recession fear in the US.
- 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, 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.
- 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.

Macroeconomic picture by area

United States

Slowing down amid policy uncertainty

- Economic growth is still above potential and consistent with a gradual slowdown, but downside risks are rising. Reported difficulties in reaching a lasting trade deal with China and the government shutdown extension are increasing policy uncertainty and may impact the real economy.
- Personal consumption resilience will become a key factor in sustaining growth in domestic demand, amid risks of a deceleration in investments that are more pronounced than previously expected.
- Business confidence recently declined among small and larger businesses; uncertainty on growth and demand outlook may drive a moderation in capex intentions.
- The labour market remains strong overall in terms of employment and wage growth, underpinning the view of resilient consumer demand.
- The inflation outlook remains benign, with modest inflationary pressures keeping both core and headline CPI in check.
- Fed key change of tone: The Fed will be “patient” and “flexible” on rates; it is open to changing the balance-sheet runoff policy and is listening carefully to market’s risk concerns. We expect one more hike 1H19.

Risk factors

- Concerns over global growth, external and domestic demand are holding back new capex plans
- Tariffs and retaliation are negatively impacting economic performance, both directly (prices) and indirectly (confidence)
- Fed tightening is having a stronger-than-expected impact and with trailing interest rate-sensitive segments (i.e. policy mistake)
- Geopolitical risks linked to a more hawkish shift by the US administration

Eurozone

The recovery continues despite disappointing figures and rising political risks

- Growth was very disappointing in 2018. Temporary negative factors (auto sector in Germany) played a role, but cannot be the only reason behind the deterioration in the economic environment. Rising oil prices (until October), tension over trade and political risks also dragged down growth. Weakness could continue into early 2019 ahead of a moderate rebound (growth forecast for 2019 lowered further from 1.5% to 1.2%).
- While an agreement was reached on the Italian budget, France saw major social unrest in Q4. Political risk will remain high in 2019.

Risk factors

- Stronger political protest movements
- Euro appreciates
- External risks (trade war, slowdown in United States and China)

United Kingdom

Major uncertainty as Brexit approaches

- Despite the lack of visibility on Brexit, the labour market remains strong and real wages are rising, boosted by lower inflation.
- However, Brexit is dragging down confidence and investment. It is very uncertain as to whether the UK Parliament will ratify the withdrawal agreement reached with the EU in November. There are many possible outcomes, including postponing Brexit to well after 29 March. A No Deal seems unlikely, but it cannot be ruled out entirely.

Risk factors

- “No Deal Brexit”
- The current account deficit remains very high

Japan

Fiscal policy and private demand will eclipse tainted export landscape

- Exports in general have weakened, with exports to China (22% of total exports) plunging due to US bans on the China-made products. Meanwhile, demand from the US and Europe remains healthy.
- In contrast, domestic demand is supported by steady income growth and companies’ aspirations to cope with the labour shortage. Global uncertainties appear to be dragging down corporate morale. Yet capex is likely to simply slow its ascent rather than decrease. Moreover, public investment in light of rebuilding in disaster-affected areas should mitigate contagion of the trade dispute.
- As a consequence, inventory adjustment has finally come to an end. The decline in imported oil prices will improve companies’ terms of trade, while a sharp mark-down in mobile communication charges scheduled for April will encourage spending in other areas.

Risk factors

- The US administration is set to take a tough line on trade talks with Japan, starting January

China

- Near-term risks to the economy are high, while policymakers seem determined to use cyclical measures to prevent a hard landing.
- Exports look to be suffering and the property sector could soften somewhat going forward but drag from the auto sector will perhaps be smaller.
- More policy measures are under way. There was a strong push of fiscal spending in late 2018, followed by a full RRR cut in early January. The next focus is on further tax cuts and larger local government special bond issuance as announced.
- With policy gradually passing through, overall credit growth looks set to bottom out in coming months.
- US/China trade tensions remain a major uncertainty. While talks in early January showed marginally positive signs, eyes are on the next round of talks scheduled for end-January.
- Downward pressures on RMB have eased somewhat helped by the more dovish FED and softer dollar.

Risk factors

- **Uncertainty in US/China trade talks**
- **Policy mistakes in managing near-term risks and the structural transition**
- **Geopolitical noise regarding North Korea**

Asia (ex JP & CH)

- The first Q4 2018 GDP releases in the area continue to show a mildly decelerating trajectory. China reported its weakest GDP at 6.4% YoY. Philippine GDP has remained stable at 6.0% YoY, growing less than expected, while South Korea surprised on the upside. Overall, domestic demand is proving to be more resilient than external demand.
- The region's inflation figures remained benign. Inflation in the Philippines continued to decline significantly, to 5.1% YoY from 6.0% YoY.
- The BSP and BI recently took a break in their aggressive hiking cycle. Overall, CBs in the region are in a wait-and-see mood, but we do expect some easing in India in the next future.
- The electoral cycle is beginning in the region: the date of 24 March at last been set in Thailand, along with 17 April in Indonesia and between April and May in India. The most "fragmented" outcome is expected in India.

- **Growth outlook decelerating but still decent**
- **Inflation still very benign. In the Philippines, it continues to decline significantly**
- **BSP and BI recently paused in their hiking cycle**
- **The election cycle in the region will be starting soon**

Latam

- More frequent economic figures have confirmed an improvement in economic conditions in mid-sized and smaller countries in the region in comparison with the largest countries. In Colombia, retail sales and industrial production came in better than expected at 10.8% YoY and 4.7% YoY, respectively.
- On the inflation front, the overall environment remained benign. In Mexico, inflation recently paused in its converging path, rising to 4.8% YoY from 4.7%.
- The region's main central banks kept their monetary policy rates unchanged at their recent meetings.
- In Venezuela, the much-awaited regime change may be happening. Juan Guaido, the president of the new opposition-led National Assembly, proclaimed himself as interim president, arguing that President Maduro had usurped the presidency. Meanwhile, Maduro started his second six-year term, following a victory deemed fraudulent.

- **Smaller countries are better positioned for recovery**
- **Inflation is overall benign, with Mexico pausing on its declining path**
- **No changes in monetary policy**
- **Change of regime in Venezuela may be happening**

EMEA (Europe Middle East & Africa)

Russia: we forecast 1.7% YoY growth for 2018 and slightly lower for 2019

- Despite the threat of potential US sanctions down the road, the macroeconomic scenario remains supportive. Russia will be among the few emerging market sovereigns with the "twin surpluses" in 2019, while accumulating assets at the National Wealth Fund.
- The Central Bank may hike again in Q1- 2019 depending on rouble weakness, inflation expectations and external risks.

- **Drop in the price of oil, stepped-up US sanctions and further geopolitical tensions**

South Africa: exit of recession but no miracle

- South Africa emerged from recession in Q3 thanks to the recovery of manufacturing and services. On the expenditure side, household consumption rebounded as well as inventories while private and public investment declined. The contribution of net exports was also negative.
- In terms of policy mix, there is very little room for manoeuvre. The SARB remained on holdbut it is not excluded that it still has to hike in 2019.

- **Increased risk aversion, risk of sovereign notation downgrading, rising social demands in the run-up of elections**

Turkey: we expect double-digit inflation and recession in 2019

- The strong tightening of interest rates, the rebound in the Turkish lira, the fall in the price of oil and the implementation of discretionary measures on some goods, have provided some respite to inflation. However, it should not fall below 20% for several months.
- In this context, household purchasing power and corporate margins are at their lowest. We therefore expect a sharp drop in activity in the second half of 2018 and a GDP recession of 1% in 2019.

- **A too rapid easing of the central bank, a cooling of budgetary policy, a slowdown in activity in the eurozone**

Macro and Market forecasts

Macroeconomic forecasts
(30 January 2019)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2018	2019	2020	2018	2019	2020
US	**2.9**	**2.4**	**1.8**	**2.4**	**2.3**	**2.3**
Japan	**0.7**	**1.0**	**0.6**	**1.0**	**0.7**	**1.3**
Eurozone	**1.8**	**1.2**	**1.5**	**1.8**	**1.5**	**1.7**
Germany	1.5	1.2	1.5	2.0	1.6	1.7
France	1.5	1.3	1.5	2.1	1.5	1.7
Italy	0.9	0.4	0.8	1.1	1.3	1.6
Spain	2.5	2.0	1.8	1.7	1.6	1.9
UK	**1.4**	**1.5**	**1.6**	**2.3**	**2.3**	**2.3**
Brazil	1.3	2.2	2.1	3.7	4.2	4.3
Russia	1.7	1.5	1.7	2.9	5.0	4.3
India	7.8	6.9	7.1	4.0	3.8	4.9
Indonesia	5.1	5.3	5.4	3.2	3.4	4.2
China	6.6	6.2	6.1	2.1	2.0	2.4
Turkey	2.8	-1.0	1.5	16.2	16.5	13.3
Developed countries	**2.2**	**1.8**	**1.6**	**2.0**	**1.8**	**2.0**
Emerging countries	**4.9**	**4.6**	**4.8**	**4.1**	**3.8**	**3.9**
World	**3.8**	**3.5**	**3.5**	**3.2**	**3.0**	**3.1**

Source: Amundi Research

Key interest rate outlook

	31/01/2019	Amundi + 6m.	Consensus Q2 2019	Amundi + 12m.	Consensus Q4 2019
US	2.50	2.75	2.75	2.75	3.00
Eurozone	0	0	0	0	0.1
Japan	-0.1	-0.1	-0.1	-0.1	-0.1
UK	0.75	1.0	1.0	1.0	1.0

Long rate outlook

2Y. Bond yield

	31/01/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.49	2,80/2,90	2.5	2,70/2,80	2.45
Germany	-0.56	-0,50/-0,40	-0.53	-0,50/-0,40	-0.49
Japan	-0.17	-0,20/0,00	-0.16	-0,10/0,10	-0.16
UK	0.75	0,80/1,00	0.75	0,80/1,00	0.76

10Y. Bond yield

	31/01/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.67	2,90/3,00	2.7	2,80/2,90	2.71
Germany	0.17	0,25/0,45	0.22	0,25/0,45	0.27
Japan	0.00	0,10/0,20	0.03	0,10/0,20	0.06
UK	1.23	1.40/1.60	1.27	1,40/1.60	1.32

Currency outlook

	30/01/2019	Amundi + 6m.	Consensus Q2 2019	Amundi + 12m.	Consensus Q4 2019
EUR/USD	1.14	1.17	1.17	1.20	1.20
USD/JPY	110	109.0	110.0	105	108.0
EUR/GBP	0.87	0.89	0.88	0.88	0.88
EUR/CHF	1.14	1.16	1.15	1.18	1.16
EUR/NOK	9.68	9.30	9.50	9.20	9.40
EUR/SEK	10.39	10.05	10.14	9.80	9.95
USD/CAD	1.32	1.30	1.31	1.29	1.29
AUD/USD	0.72	0.72	0.73	0.70	0.74
NZD/USD	0.68	0.68	0.68	0.69	0.69
USD/CNY	6.71	6.8	6.85	6.7	6.75

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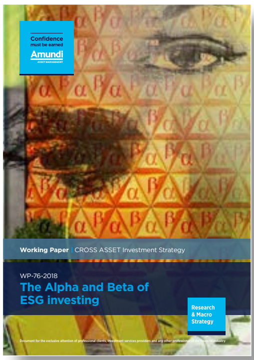

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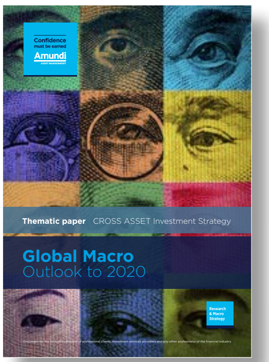

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