CROSS ASSET

INVESTMENT STRATEGY

CIO VIEWS

CHARTING AN INVESTMENT PATH THROUGH THE FOG

THIS MONTH'S TOPIC

FED VS ECB: DEEPER DECOUPLING OF MONETARY POLICIES?

Research & Macro Strategy

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

CIO VIEWS

Charting an investment path through the fog

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

While in 2017 financial markets largely ignored geopolitical risks, as they were more inclined to read the Goldilocks narrative, this mood now appears to be changing. In an environment that is already becoming more volatile, amid less accommodative central banks, demanding valuations, endogenous/technical new features of the market (liquidity deteriorating, crowded trades), a significant shift in fundamentals is not required to trigger market movement. A butterfly may do the trick. At the time of writing, **geopolitical events** are dominating the news flow. These new tensions come at a time when trade frictions continue to be in the spotlight. On top of this, there are multiple hot political flashpoints. The first is the US/China relationship, where the focus is now on the practices in technology and intellectual property transfers. The second front relates to the US and Russia, given new sanctions and, most importantly, increasing tensions in Syria and instability in the Middle East. Regarding financial markets, the geopolitical noise is translating into frequent swings, inflows into perceived safe-haven assets (gold, sovereign bonds) and higher oil prices, with the consequence of added uncertainty in monetary policy actions. Central banks, in fact, are already facing the conundrum of how quickly to remove accommodation, as some recent economic data and surveys highlight some moderation of activity while inflation risk appears to be on the upside, potentially amplified by geopolitical and trade tensions.

We see **three key ways in which investors can navigate through this 'fog'**.

First is to keep a strong focus on the macro backdrop, separating noise from fundamentals. There are no signs of any major economic slowdown, though evidence is accumulating that global growth is losing momentum and has arguably peaked. US fiscal stimulus and pro-cyclical policy mixes in the Eurozone and Japan may impact the length and the amplitude of the cycle, but current cycle dynamics should continue. Going forward, it will be key to distinguish between what is merely cyclical and what is structural in order to manage the short-term risk environment while looking at long-term forces driving financial markets. All in, this means keeping a **moderate and vigilant bias towards risky assets,** coupled with **a bias towards short duration**, combining exposure to the cyclical forces and to forces of rotation in style and sectors while **progressively preparing portfolios for the next performance cycle**.

This directly leads to the second way to navigate this phase: **embrace investment strategies with high flexibility and diversified sources of returns.** We think that this cycle's late phase is likely to extend further. Therefore, investors need to be ready to adapt to different scenarios which could emerge by monitoring a comprehensive range of indicators and acting rapidly when they begin to flash red.

The third focus – **as a long-term investor** – is to seek the most risk-rewarding bottom-up opportunities across the board. This means detecting underlying sector trends, such as regulation or disruptions in technology, or looking at country dynamics in emerging markets that will reveal winners and losers.

High Conviction Ideas

MULTI-ASSET

We keep our slightly positive view on risky assets, as fundamentals are still supportive. However, increased tensions on trade and the deterioration in macro momentum are suggesting a more defensive and well diversified regional equity allocation within the US, Europe and Japan, and low directional exposure in a phase of a maturing financial cycle.

FIXED INCOME

Tensions have temporarily calmed down in the bond market as a consequence of higher geopolitical risk, but the cyclical consolidation phase is intact. A cautious stance on duration and a focus on capital preservation remain key. On credit, we advocate a stronger focus on selection and liquidity management. On FX, though some rebound in the dollar may occur in the short term (in the short term, fiscal stimulus is positive for growth), the medium-term path for the USD looks to be down.

EQUITIES

Despite the noise of geopolitical issues, we remain constructive on global equities. The cyclical corporate profits landscape is supportive, but largely priced in, unless a structural change in earnings starts to materialise. Market valuations now look to be more attractive across the board, even though volatility is here to stay. EM remain selectively attractive, with a stable dollar and a positive commodity outlook. We see low contagion risk from Russia.

REAL ASSETS

In seeking to enhance portfolio diversification, European private debt may help to widen the spectrum of opportunities. An appropriate investment horizon is necessary to exploit the illiquidity premium, as well as a strong security selection to target attractive yields, with a focus mainly on cash-flow generating assets, and limit risk.

MACRO

Towards a decoupling between the United States and the Eurozone?

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

A few clouds have appeared in the European sky (drop in confidence and business surveys, rise in oil price). On the other hand, most signals remain positive in the United States, where the economy is expected to accelerate, boosted by the fiscal stimulus. Should the economic decoupling between the US and the Eurozone strengthen, it would likely accentuate the divergence in monetary policies.

- The Eurozone economic surprise index has continued to slide into negative territory, falling to its lowest level since the summer of 2012. It is certainly not a leading indicator. But, the very significant fall indicates that growth expectations were (are still?) too high (note that the consensus expects 2.4% growth for the Eurozone in 2018).
- The drop in surveys (PMI, ZEW index in Germany) also corroborates the idea that the growth peak has passed.
- Lastly, the oil price has jumped to US$75/bbl (Brent), its highest level since November 2014, based on the backdrop of tensions in the Middle East, a drop in US stocks, and the willingness of OPEC countries (Saudi Arabia notably) to raise the price between US$ 80 and US$100/bbl. Although the rise in the oil price, when expressed in euros, has been dampened by the appreciation of the European currency, the price of a barrel in euros has reached its highest level in almost in almost four years (€ 62). The rise in oil price, should it continue, could certainly handicap more the economic activity in the Eurozone than in the United States.

> "Should the economic decoupling between the US and the Eurozone strengthen, it would likely accentuate the divergence in monetary policies."

Against this backdrop, we have revised down slightly our GDP growth forecasts in the Eurozone this year, from 2.4% to 2.3% in 2018 and 2.0% to 1.9% in 2019 (however, without taking into account the recent rise in oil price). We do not believe that it is a turning point for the Eurozone. Bear in mind that at this level in 2018, growth would still remain more than a full percentage point above its potential. The Eurozone continues to enjoy strong domestic demand prospects. The recent increase in wages in Germany, for instance, should support purchasing power and domestic consumption. In addition, global trade has remained robust and confidence high by historical standards even though it has dropped.

That said, we observe that the business climate is more sensitive to external shocks in the Eurozone than it is in the United States. The threat of protectionist measures brandished by Donald Trump is of concern to many Europeans, starting with the Germans. Remember that the US is Germany's largest export market. The combination of protectionist measures and a rise in oil prices would be a dangerous cocktail for the economic activity, not to mention that it would put central banks in difficulty because of the impact on inflation. This may encourage the Fed to make more rate hikes while it would probably delay the normalisation process in the Eurozone.

The Strategist view

US Libor-OIS widening does not reflect a deterioration of credit risk

- What is affecting the US Libor-OIS spread? The US Libor-OIS (Overnight Indexed Swap) spread has widened significantly since the start of the year, reaching a nine-year high. While the movement has been very fast, we believe it doesn't reflect market stress (in the banking sector in particular). It is predominantly a US$ story, as the spreads in Euro and GBP are almost unaffected. It relates to changing demand/supply dynamics in the money markets linked to the tax reforms in the US (repatriation of foreign holdings by US companies). Most importantly, it does not reflect a deterioration in credit risk. In contrast to 2008, there are no concerns regarding banks fundamentals.
- These tensions should continue to weigh on spreads. In fact, it remains uncertain exactly how long repatriation flows will last, though these should decrease in the coming quarters. We do not expect Libor to move materially higher thanks to the bilateral FX swap lines that exist between the Fed and the ECB and BoJ. But if this situation were to endure for too long, it would get on to the Fed's radar. Cross currency swaps have not shown signs of tension.
- What higher Libor means for fundamentals? The Libor has a direct effect on the amount US households pay for adjustable-rate mortgages and consumer loans. The cost of funding in dollars has increased further for companies' foreign subsidiaries, in general, European and Japanese. The spreads widening translates into tighter financial conditions, highlighting a sort of 'shadow hiking'.

MULTI-ASSET

Low directional risk amid market swings

MATTEO GERMANO, Head of Multi-Asset

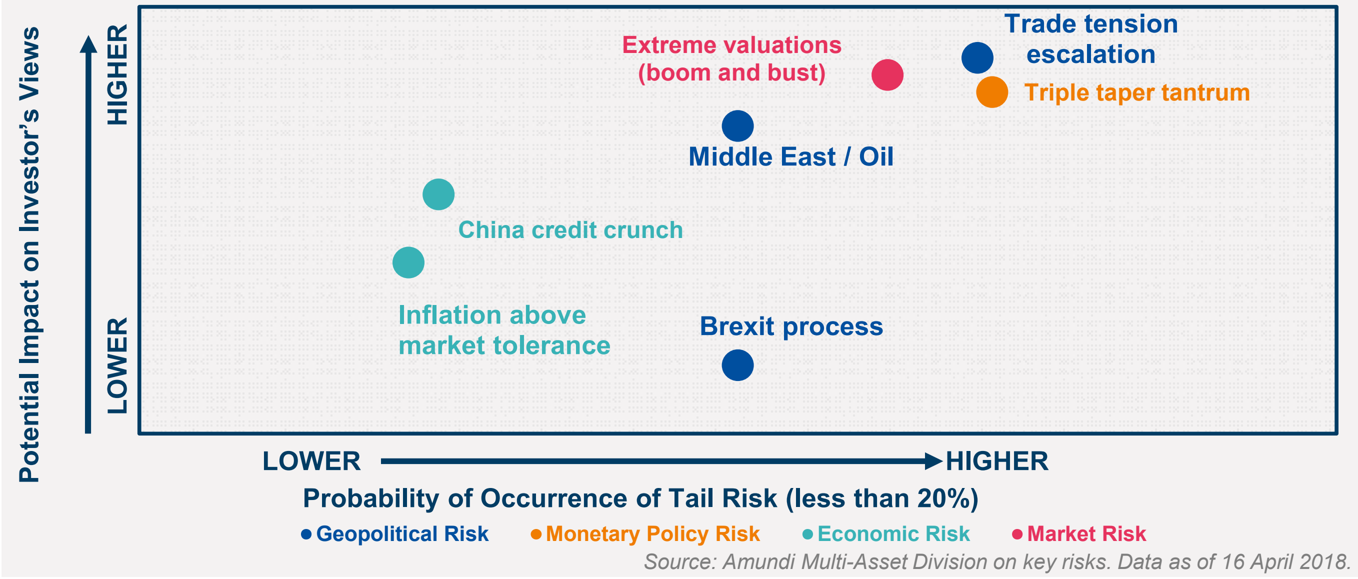
Knee-jerk and volatile equity reactions to perceived risks are signs that market nervousness is high, amid expectations of tighter financial conditions. This new phase, in which market complacency appears to be over, needs to be managed with a higher focus on capital preservation, reducing concentration risk and keeping low directional risk exposure in multi-assets portfolios. Relative value opportunities, as opposed to directional positioning, will be key. CB asynchronies will remain a dominant theme in this environment, given the different countries' positioning in the cycle. In light of a changing investment backdrop, and with structural themes also at play (debt, regulation, digital disruption), multi-asset investors should combine short-term convictions (timeframe of weeks or a few months) on earnings surprises/momentum or dislocation ideas, with medium-term themes (i.e., intrinsic value linked to fundamentals, sector disruption, EM country transition) in order to diversify sources of returns and manage short- and long-term risks.

High conviction ideas

We maintain our constructive view on risky assets, as fundamentals are still supportive and valuations are not yet at extreme levels, and have become more compelling after the recent (modest) correction. However, increased tensions on the trade side and the potential peaking of economic growth would suggest a defensive and well diversified regional equity allocation within the US Europe and Japan. We are positive on Japanese banks and US energy (which should benefit from the recent strengthening of the oil price). In EM, we are reassessing the investment case for Russia (relative to EM), given the recent remarkable deterioration in political risk. We are still constructive on China, based on the theme of transitioning towards a more mature market. We remain positive on European credit, which has so far proved quite resilient. On the government bond side, higher 10Y break-evens (in Europe, the US and Japan) remains our central case, as our macro forecasts call for a gradual but steady increase in price dynamics. We are still expecting an upward shift of the German yield curve during 2018, and we believe investors should be positioned accordingly (via short positions on both the Schatz and the

> "Dynamic management of hedging is crucial as the risk map rapidly evolves."

Multi-Asset Amundi Top-Down Risk Matrix



Source: Amundi Multi-Asset Division on key risks. Data as of 16 April 2018.

Bund). In the US, we think the curve is currently too flat. More inflation risk premia should be discounted, as recent inflation data have surprised to the upside and the fiscal deficit is set to increase.

On FX, we maintain a cautious view on GBP (both vs EUR and USD), as a natural hedge against Brexit risk. On EM FX, we like the Chinese Yuan vs USD and EUR, as it is supported by positive fundamentals on the macro side, a broadly fair valuation, and positive technical factors, such as positive carry and possibility of attracting more flows on the back of global bond benchmark inclusion of Chinese onshore bonds.

Risks and hedging

The dynamic management of hedging becomes crucial in the current environment. To hedge from the risk of increased protectionism and trade taxes, SPX put options and long yen positions vs the A$ could help smooth market volatility. Gold exposure may help to protect against geopolitical risks. On credit, we believe investors should carefully manage liquidity risk and the risk of spread widening. The asset class has very elevated valuations and further spikes in volatility could be mitigated by buying protection in the segment of the market most vulnerable to a risk-off mode (HY). The indicated hedges should also work in case of a rapid and unexpected deterioration of the macro outlook.

FIXED INCOME

Divergent forces at play call for higher flexibility

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

Overall assessment

A pause in the upward trend in yields seems driven more by a flight to quality effect, than a change in fundamentals. The growth outlook is still strong, even given a peak of some economic indicators in March. This is, in our view, a sign of a stabilisation of growth at a high level, while the cycle is ageing, and not yet a change in the economic picture. In the US, pro-cyclical fiscal policies in a phase of upbeat sentiment are increasing the risk of inflation acceleration. Four out of six US inflation drivers (retail and producer price, labour costs and commodity prices) are moving into the "heating up" zone. With divergent forces at play, investors should maintain a flexible approach amid rapidly evolving market conditions and diversify sources of returns. Credit markets are still a valuable source of carry, as well as EM debt. Inflation protection securities are also important, along with currency strategies that bring no credit, duration and liquidity risk.

> "Swings in the markets call for a tactical approach to duration management and risk exposure."

DM government bonds

Core govies remain unattractive across the board. Gradualism is the cornerstone of CB strategies and communication, with widening divergences between the Fed (more hawkish) and the ECB (more dovish). Overall, we continue to believe that the strong commitment to removing excessive monetary accommodation is intact, with the risk of a more aggressive Fed in 2018, if geopolitical risks do not deteriorate. A short duration bias is still appropriate, especially in the Eurozone and Japan. In the US, the combined effect of flight to quality on the long end and pressure on short-term maturities is keeping the yield curve extremely flat, with 2-10Y spread close to the pre-crisis level. Additional pressure on US yields could come from the US fiscal expansion and the upward trend of the oil price.

DM corporate bonds

Credit spreads widened as a consequence of risk-on/risk-off dynamics, but the market remains relatively resilient, as fundamentals are still good with no major imbalances. In the US, the recent spread move opened opportunities

to selectively increase exposure to IG credit in some "over-adjusted" segments or sectors, especially those that benefit from higher oil prices. In HY, the default outlook is still benign across the board, and spread widening can be seen as a tactical play in search of additional sources of return. In a more volatile phase, investors should focus on enhancing diversification (loans, catastrophe bonds, residential mortgage back securities), and a concentration on security selection will be increasingly important.

EM bonds

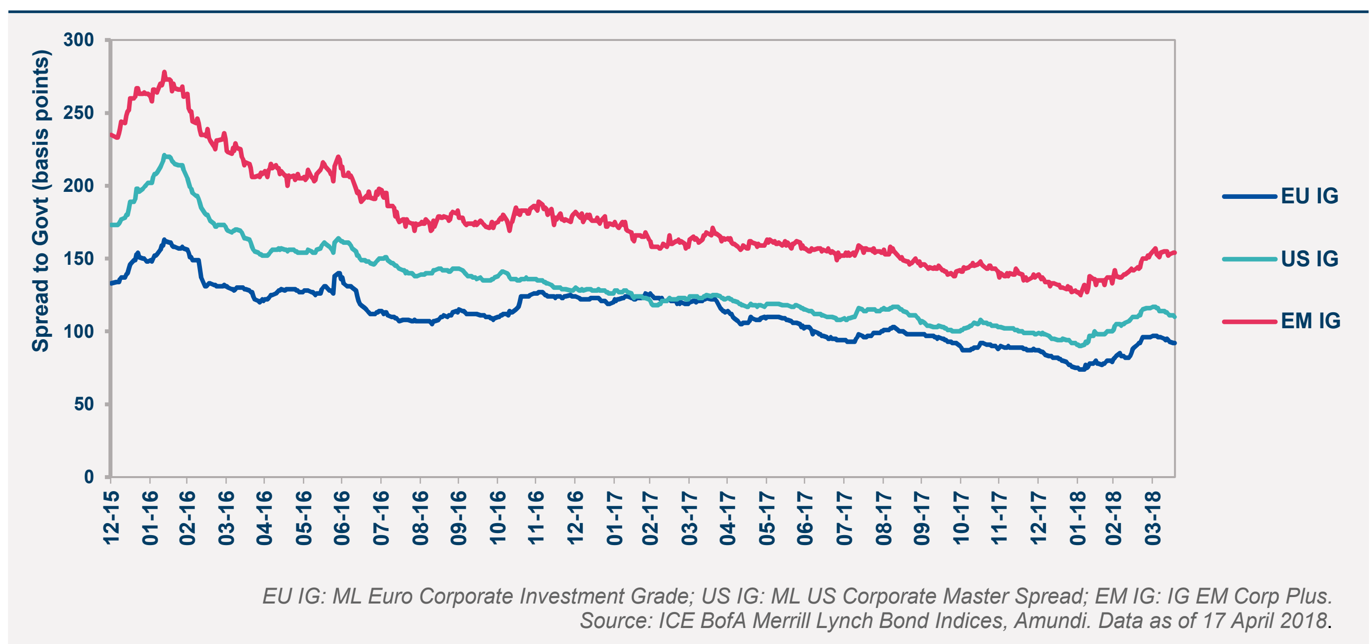
Idiosyncratic stories are at the forefront. Sanctions are affecting Russian assets, but risk of broad contagion is limited, and tactical opportunities may open at more reasonable prices. The faster-than-expected inclusion of China's bonds into the Bloomberg Global Aggregate Index has been welcomed by investors and the country as a sign of further liberalisation of Chinese financial markets. Renminbi appreciation vs the USD also reflects an improvement in sentiment. Positive developments are apparent in Latam (Brazil, Colombia and Mexico) while Turkey and India may be under pressure due to higher oil prices. Despite a modest spread widening (EMBI index), the asset class retains its appeal for carry reasons, with a strong focus on country/security selection.

FX

Downward pressure on USD vs G10 currencies should remain in place in the medium term. The JPY is well supported due to its safe-haven asset status. We keep our negative view on sterling.

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

Credit spreads



EU IG: ML Euro Corporate Investment Grade; US IG: ML US Corporate Master Spread; EM IG: IG EM Corp Plus.
Source: ICE BofA Merrill Lynch Bond Indices, Amundi. Data as of 17 April 2018.

EQUITY

Fundamentals are the compass in choppy markets

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

Overall assessment

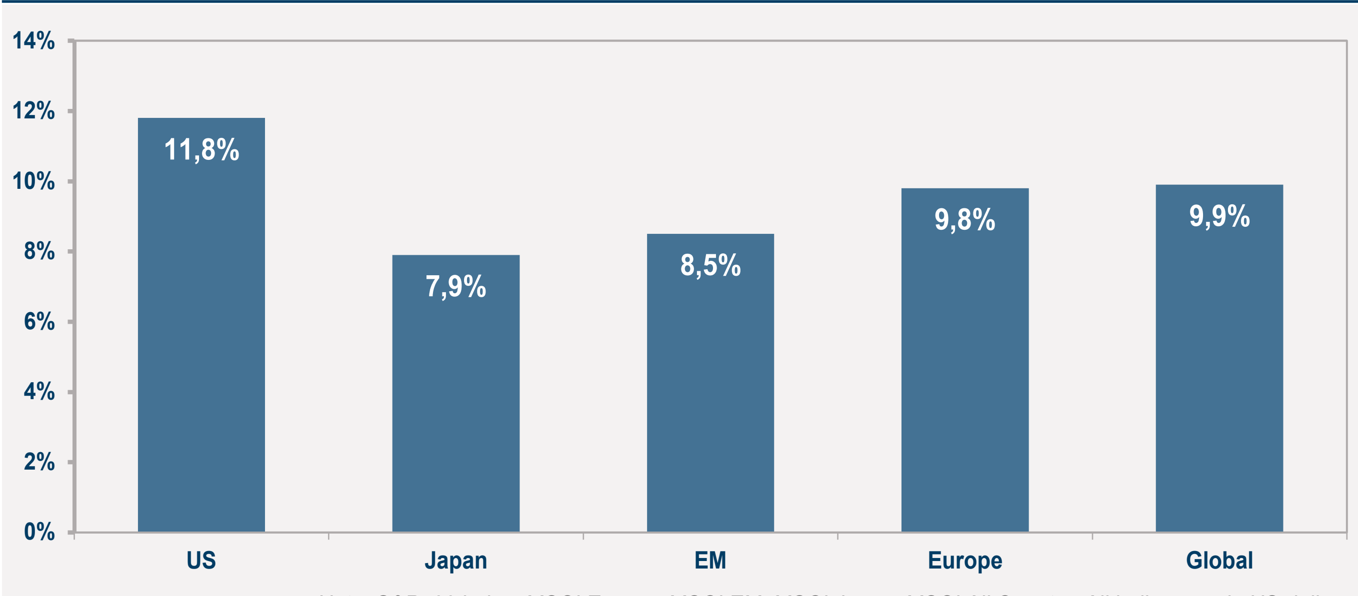
The second leg of market downside has driven some rotation in the market, pausing the outperformance of cyclicals vs defensives. But it's too early, in our view, to call for a structural rotation of themes, and the trend favouring cyclicals is not definitely over. Currently, sentiment indicators are neutral, but not negative, cash has not been raised massively in investors' portfolios, and valuations have become more compelling across the board (especially in Europe and Japan). We believe that the fundamental picture (earnings growth) is still consistent with a constructive view on equities, with swings in the market and most of opportunities for investors coming from bottom-up selection.

> "Earnings sustainability and reasonable valuations are key to navigate this market phase."

Europe

Fundamentals have not changed materially, but in this new more volatile phase of the market, there is a mild repricing of defensive themes. Due to the still-positive macro picture, with capex acceleration and strong domestic consumption, the earnings season should be supportive for the market and the euro appreciation effect should start fading in the second quarter. We believe that the fall in yields, as a consequence of geopolitical risk, is temporary. Despite market fluctuations, we remain constructive on banks and insurance, and prudent on real estate, telecoms and utilities. As the cycle is maturing, we also pay great attention to sustainability of earnings. We also believe that a balanced approach, with limited sectorial or stylistic biases, is appropriate, as the opportunities lie more at the bottom-up level.

Amundi Forecast EPS Growth - December 2018 (YoY)



Note: S&P500 index, MSCI Europe, MSCI EM, MSCI Japan, MSCI All Country. All indices are in US dollar.
Source: Amundi Research, Bloomberg, Factset, as of 17 April 2018.

United States

Fundamentals are generally strong across the US market: US consumption is quite healthy, as lower taxes, easing regulation in many sectors and rising capex/R&D are overwhelming other pressures, such as wages, raw materials, logistic costs and increased competition. Market support is expected to come from the earnings season, with the boost from tax reform in a contest with strong economic expansion. Broad market valuations have become more attractive, but some hyper-growth stocks are still excessively valued, and the market has started to become more selective. On FANG*, we believe these companies will continue to be the target for increasing regulation on privacy issue. However, we note that the equally-weighted tech has been outperforming the market-cap-weighted tech sector, reiterating the importance of active selection. Here, we like companies that could benefit from an expansion of IT spending, supported by tax reform. Good examples are cloud infrastructure and applications. Selection will be the name of the game also in sectors such as consumer staples and telecoms, which can be affected by secular disruption. We favour stocks with sustainable business models and reasonable valuations (opportunities in banks, energy stocks), while we are cautious on industrials, where cyclicality is over-priced.

Emerging Markets

The past earnings season highlighted positive momentum as well as EM resilience vs DM despite trade talks. This is a sign, in our view, of greater attention to domestic growth stories and reduced imbalances. For this year, we have revised up EPS forecasts to the upper single-digit range, mainly due to the oil outlook and supportive global trade. Our preference is still for cyclical sectors. China is the country where earnings forecasts have increased the most, due to stronger domestic demand. On Russia, we are still constructive on stocks that are exposed to domestic recovery and oil, but we have become more and more selective as the country risk has increased, due to recent sanctions and Syria tensions.

**FANG: Facebook, Amazon, Netflix, Google.*

REAL ASSETS

Private debt: a staple of portfolio allocation

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

A positive backdrop for private debt market

The private debt market is experiencing significant growth. Investors' demand has progressively evolved over recent years (ca. +60% in the last five years) and the private debt industry assets under management reached a new high of US$638bn as at June 2017, according to Preqin's Private Debt report.

We believe that the private debt segment will continue to attract investors driven by a combination of structural and cyclical factors. Regarding the first aspect, the growth of the private debt market is supported by unsteady situations between supply and demand. Since the 2008 crisis, the debt supply from the banks has been extremely constrained by national and international regulations, such as Basel III. On the other hand, the demand for debt has picked up on the back of economic recovery, with many companies looking for financing (for leveraged buyouts, investments, external growth, for example).

In addition to those structural factors, we are experiencing one of the longest cycles of unconventional monetary policies with lasting low rates, which had a significant impact on traditional asset classes. The removal of unconventional monetary policies will be very gradual, in our view, and interest rates are not likely to rise sharply in the near future in the Eurozone.

All in, we believe that private debt may help to fill a gap in an ever more disintermediated world. It also addresses investors' need for yields and diversification in the fixed income space.

The case for leveraged loans

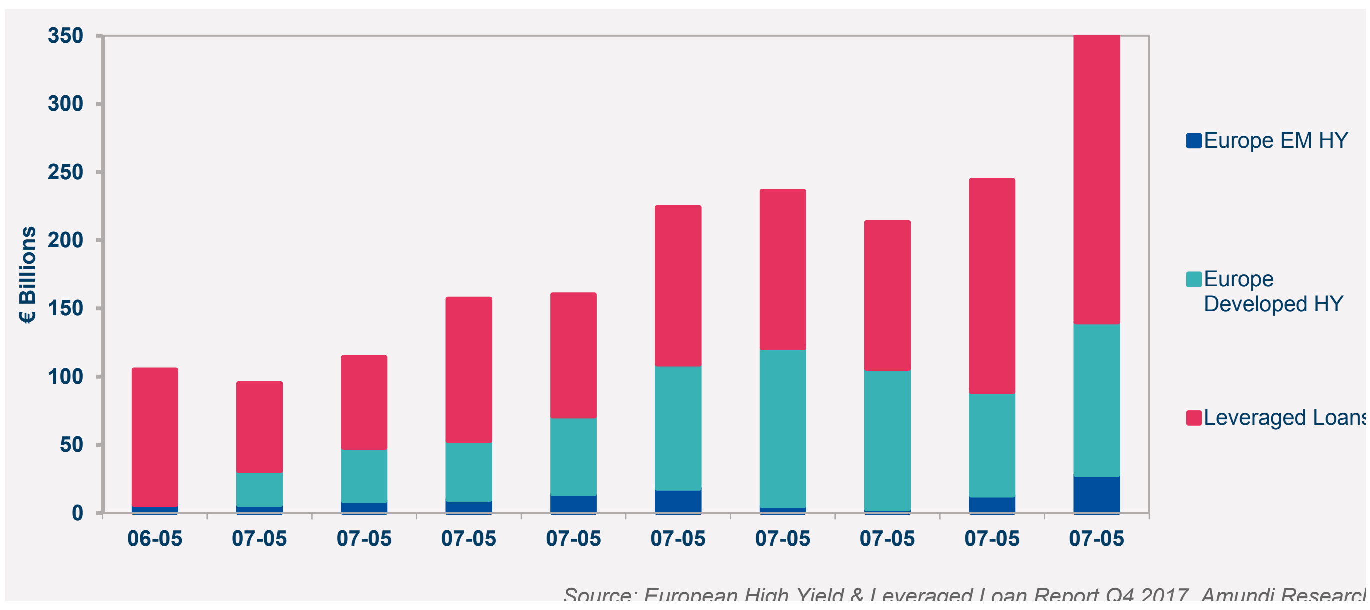
Without replacing listed bonds, we consider that private debt now has a central role to play as part of a global fixed income strategy. Private debt helps investors to capture additional premiums that traditional fixed income cannot offer. This is all the more essential in a diversified portfolio, as it is not strongly correlated to traditional assets. Leveraged loans, for instance, are an attractive complement to publicly traded HY bonds based on the prospects of rising interest rates. Leveraged loans are backed by floating rate structures, which provide an interesting defensive feature. In 2017, European leveraged loan issuances increased by 37.9% yoy, to €195.3bn, surpassing issuances in the HY European market. The market is therefore deep enough to enable managers to implement stringent selection criteria and yet retain a good level of diversification. Managers indeed currently operate in the historically most challenging, rapidly changing environment, and the private debt market is not immune to risks such as weakening legal structures and issues with documentation. We are convinced that deal selection is more crucial than ever. We believe investors should focus on the most secure and senior part of capital structures, as this will be hit last in case of a credit cycle turnaround.

> "In a world of yields at historical lows, the private debt market is increasingly attracting investors seeking to diversify fixed income sources of returns."

Investors should also favour floating rate structures, should rates rise. We believe this conservative approach will be key to helping investors with long-term investment horizons capture illiquidity premiums while mitigating risk.

Correlation: The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).

European Leveraged Issuance by Type



Source: European High Yield & Leveraged Loan Report Q4 2017, Amundi Research

Asset allocation: multi-class outlook

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

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

Relative outlook and convictions by major asset class

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

Currency and real assets

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

LEGEND

–	Negative
=	Unchanged
+	Positive
●	Underweight
●	Neutral
●	Overweight

Source: Amundi, as of 17 April 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

Fed vs. ECB: towards a stronger decoupling of monetary policies?

DIDIER BOROWSKI, Head of Macroeconomic Research

Finalised on 2/05/2018

The essential

US and European economies both continue to expand but at different paces. While US growth will likely pick up this year, boosted by an expansionist fiscal policy, the Eurozone cycle probably peaked last year. What effect could this have on the Fed and ECB monetary policies? How are "global risks" (protectionism, geopolitical risks) likely to play? After setting out some thoughts on the new constraints facing central banks we argue that looming global risks could push the Fed to hike interest rates further and the ECB to hang fire for longer, posing risks to the normalisation of its monetary policy.

US and European economies both continue to expand but at different rates. While the US economy will likely accelerate this year, boosted by fiscal policy, the Eurozone cycle probably peaked last year. So, how will the cyclical gap between the US and the Eurozone play into the decoupling of monetary policies? And how will the ECB and Fed set monetary policy this year and next? How will they factor in "global risks"? Can the ECB still normalise its monetary policy? Investors are mulling these questions and the answers they come up with will have an impact on financial markets.

1. The cyclical gap lies behind the decoupling of monetary policy

The Eurozone as a whole is lagging the US. It is still at mid-cycle while the US economy is operating at full employment. In the US, the recovery has continued unabated since mid-2009. In the Eurozone, the current cycle took 4 years longer to get under way (Q2 2013) and at the end of the day GDP growth was slower than in the US. As a result, the peripheral economies, hardest hit by the sovereign debt crisis, are still a long way off full employment. Inflationary pressures, which we are starting to see in the US, are still not coming through in the Eurozone. Subsequently, there is no surprise to see a 3-4 year lag between the Fed and ECB policies.

When will the cycle end? All eyes are on the US. The US economy was the first to get back on its feet and the Fed was the first central bank to start normalising its monetary policy, with an initial hike in December 2015. In the US, the current cycle is set to become the longest in American history[1]. And nothing suggests it is nearing its end, as yet. We are not yet seeing signs of overheating and, unlike in the 1990s, we have not seen an overinvestment from companies. They are still building up capacity in response to rising demand.

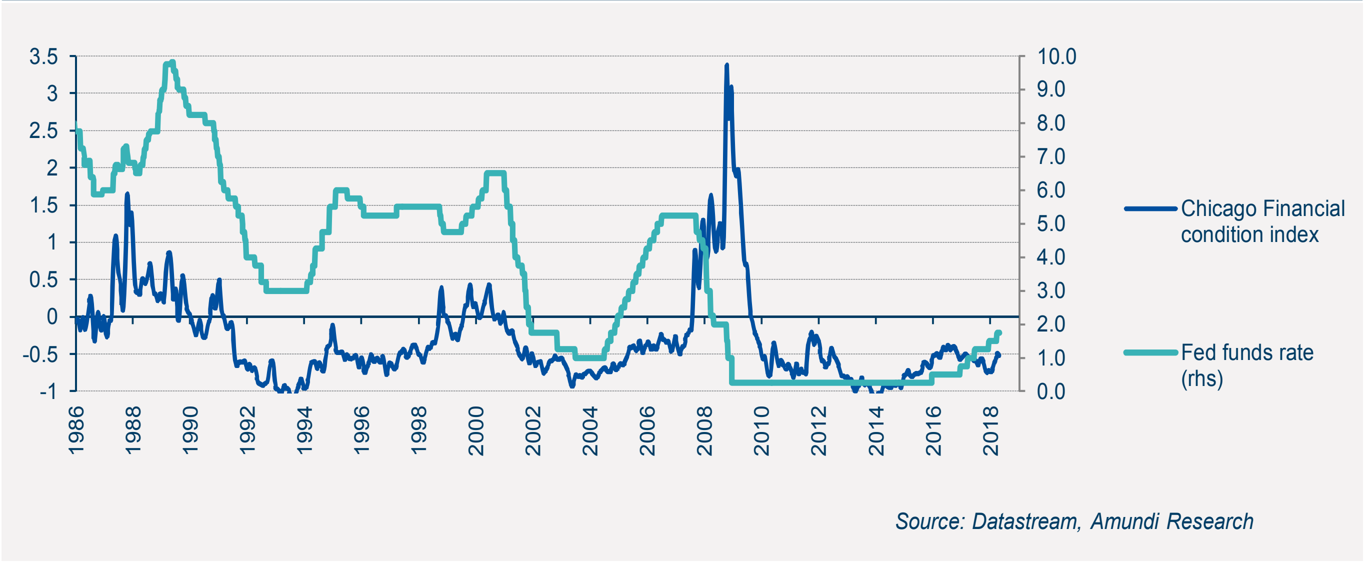
Economic cycles are not dying of old age. However, as time wears on, they can run into certain imbalances, particularly with a build-up of debt (from governments, non-financial corporates and households). In the US, Trump's fiscal policy has set public sector debt on an unsustainable path. We forecast the public budget deficit at over 5% of GDP in 2018 and 2019. Also, companies have taken advantage of extremely low rates in recent years to releverage themselves. It would only take a sudden and brutal rise in interest rates to derail the recovery.

In the Eurozone, in contrast, public finances are gradually improving. Debt-to-GDP ratios are stable or falling. But bear in mind that interest payments are under control because growth is relatively strong and interest rates are low. And rates are low because the ECB has maintained its QE (helped too by negative short-term rates). Should these rates rise a little too fast, the recovery would stop.

[1] *Remember that 1990-2000 was until now the longest cycle (120 months) seen in the US since the NBER began measuring cycles in the mid-19th century. If this cycle, currently the second-longest. If this cycle, currently the second longest one, continues until summer 2019, it would become the longest cycle ever seen in the US.*

The fear is not so much the economic cycle itself as the financial impact on the real economy from poorly calibrated monetary policies (or from a financial crisis).

1/ US: financial conditions vs. fed funds rate



Source: Datastream, Amundi Research

2. Monetary normalisation looks trickier

Central banks were already in uncharted territory and their job has now become a lot harder, for at least 4 reasons: 1) Trend inflation has fallen to the point where it is running below central bank targets, making usual reaction functions (such as the Taylor rule) ineffective. 2) Lower potential growth means a lower equilibrium interest rate (central banks have less need to raise rates to neutralise their monetary policy). 3) Higher public and private debt makes economies potentially more sensitive to rising rates. 4) The excess of “central bank liquidity” tends to inflate asset prices (both financial and real estate assets), raising the spectre of a bubble.

In a cyclical upswing, even without inflation, it is clear that central banks need to remove excessive accommodation to head off the danger of asset price bubbles. But how fast should they act?

The reaction function of central banks has become inderterminate. Central banks are sensitive to financial conditions insofar as these affect global demand. However, monetary and financial conditions also partly depend on the monetary policy that central banks pursue. This feedback between monetary policy and market conditions is further complicated by a lack of certainty when it comes to measuring either, the equilibrium interest rate, potential growth and trend inflation. With the weakening of the relationship between growth and inflation (partly due to the flattening of the Phillips curve) central banks have literally lost their bearings. Specifically, if goods and services inflation remains below target at the peak of the cycle, should central banks start worrying about what an overly low interest rate might do to financial stability? And if so, to what extent?

In addiition, QEs have blurred the boundary between fiscal and monetary policy. Debt service would become an issue for borrowers if interest rates rose too sharply. Which means that, looking forward, the accumulation of debt will force central banks to impose a kind of financial repression, i.e. keep real interest rates low to preserve the sustainability of public finances. In these circumstances, asset purchases have become a standard tool in the central banks’ toolbox. It remains to be seen however how long such policies will be compatible with price stability.

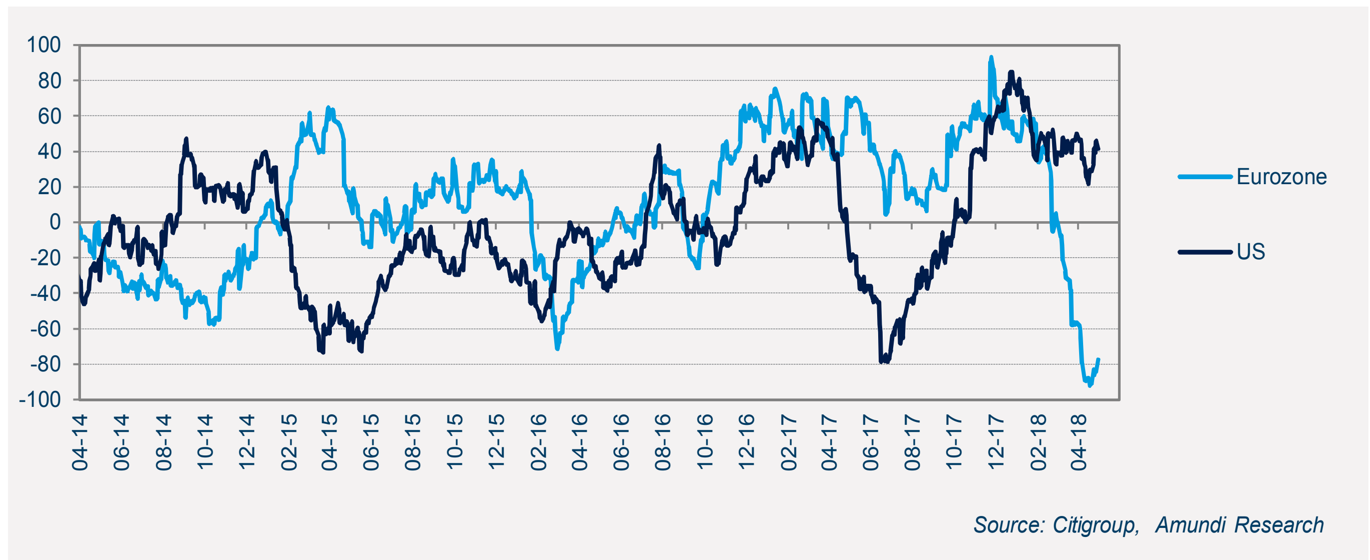
One way or another, these very general questions are at the crux of the monetary policy debate in the US and Eurozone alike.

In these circumstances, big central banks have given a key role to their communication. They routinely broadcast their own reading of events and their forecasts and even their intentions. Central bankers are trying to compensate for the absence of rules by beefing up their communications policy, with a strong role given to forward guidance.

Aware of the potentially catastrophic impact of a bond crash, they are promising to reel in excess monetary accommodation little by little. The idea is to persuade investors gradually to revise their interest rate expectations without triggering financial turbulence. But such gradualism on the part of central banks is still ambiguous. Several Fed members, for instance, consider that raising rates by 25bp each quarter would still be gradual.

Market players are still a long way from pricing in such a pace of tightening. Many doubt the Fed will even follow the dots, which are less aggressive. The uncertainties are legion. Doubts hover over the continuation of the cycle, the return of inflation and financial stability. As for the ECB, where normalisation has not really started, we are as yet seeing no gap between the ECB's intentions and market expectations. But there are legitimate questions about the ECB's room for manoeuvre.

2/ **Economic surprise indexes**



Source: Citigroup, Amundi Research

3. Aside from the economic cycle, the Fed and ECB face very different situations

The US needs a rebalancing of its policy mix…

With taxes being cut and public expenditure boosted, the US economy will be artificially boosted this year and next. But the "extra growth" will come at the price of a big leap in the budget deficit and public borrowing, adding to the financing needs of the US economy[2].

Fiscal expansion not only increases the risk of overheating (with the economy already at full employment) but also makes the economy more vulnerable to a downturn as fiscal policy will no longer act as a stabiliser. This makes it all the more essential to continue with monetary normalisation. First to avoid an inflationary surprise. Second, to restore some room for manoeuvre in case the Fed needs to run a counter-cyclical monetary policy. In other words, monetary policy should be used to neutralise the currently over-accommodative policy mix[3].

However, despite recent rate rises (+150 bp since December 2015) and the beginnings made on reducing the Fed balance sheet (since October 2017 the Fed has not been reinvesting all the proceeds from maturing papers), US monetary and financial conditions have barely tightened. Monetary policy thus looks too accommodative, particularly regarding inflationary pressures. In these circumstances, the Fed would probably want to offset any inflation surprise with an equivalent interest rate rise, so as to neutralise the impact on real interest rates.

…In the Eurozone, however, the imperative is to keep monetary conditions accommodative for an extended period

For the ECB, the end of its asset purchase program (APP) and the end of negative rates are in view. The consensus is expecting the APP to end by the end of the year (at the latest) with a first rise in the deposit rate around mid-2019. And the ECB is doing its utmost, in its communication, to confirm these expectations. "Patience, prudence and persistence" are the watchwords. Despite a sustained recovery – growth reached 2.5% in 2017, its highest since 2007 core inflation is showing no signs of acceleration rising. Against this backdrop, the ECB's diagnosis is clear. It must maintain highly accommodative monetary conditions for an extended period of time to bring inflation back to its medium-term target. In other words, the ECB prefers to take the (low) risk of a (premature) acceleration in inflation than to risk cutting short the cyclical upswing.

[2] *The gross financing need of the US will reach 24% of GDP in 2018 and 2019 (19% of maturing public debt + 5% of public deficit); the US will then become the 2nd largest economy in terms of financing needs (as % of GDP) among advanced economies, after Japan.*

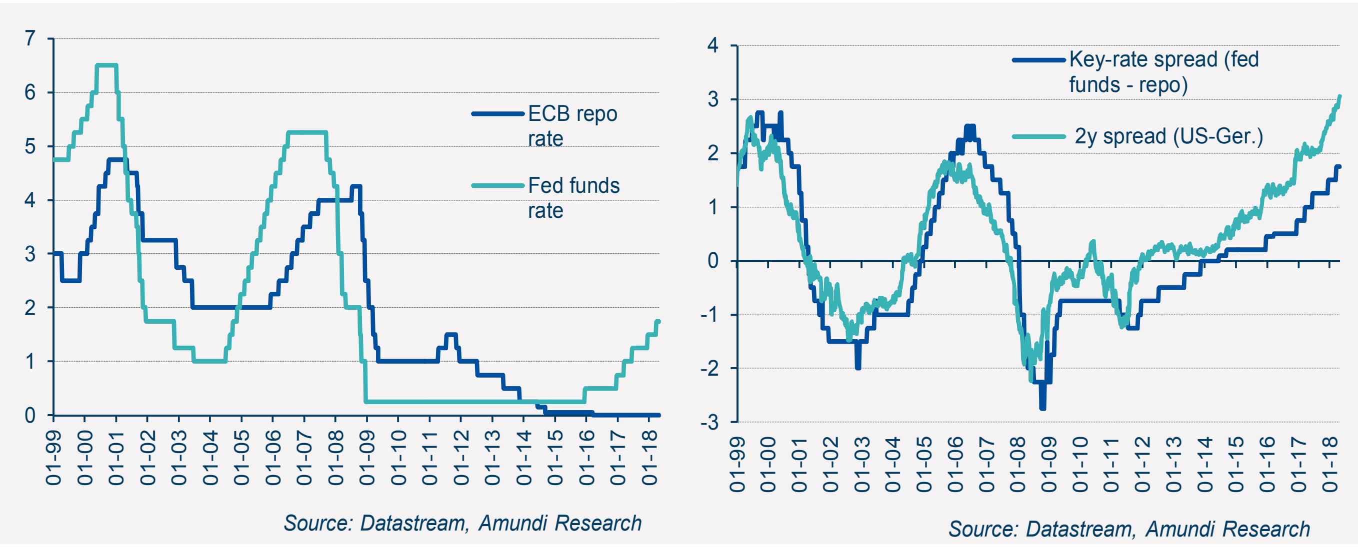
[3] *The rise in debt should theoretically translate into an additional risk premium on Treasury bonds and hence a rise in long-term yields. it is not our objective here to analyse why the risk to Treasuries has failed to materialise. But the Fed may have to take account of this anomaly when it comes to neutralising the policy mix.*

Recent signs of a weakening Eurozone economy (surveys, slowing industrial output and retail sales in Germany) would tend to confirm the ECB in its approach. Remember that unlike the US, the Eurozone has almost no fiscal lever (i.e. no cushion) it can pull in the event of a monetary policy mistake.

And there is an additional argument for the ECB's position. The possible consequences of the Fed's policy on global monetary and financial conditions cannot be ignored. The ECB is worried about tightening financial conditions too early given the current US policy mix, including the threat of contagion from the rise in US rates. This could be particularly counter-productive in a period where the Eurozone economy is going through a soft patch.

3/ **ECB and FED key rates (%)**

4/ **Key-rate spread vs. 2-y bond yield spread**



Global risk could further decouple monetary policy of the Fed and ECB

We see two global risks at the moment. First, there is the risk of protectionism, with Trump's tariff hikes generating retaliation from the EU and China. Second, there is geopolitical risk in the Middle East, with its knock-on effects on oil prices. **Both cases threaten to boost inflation in the US but to slow the economy in the Eurozone.**

- **Rising oil price[4].** In the US the rise in the price of crude would feed through to inflation faster than in the Eurozone, as full employment in the US means employees can demand compensatory wage rises. Remember, though, that in the age of shale gas a rise in the oil price should boost output further. The situation is very different for the Eurozone, a net oil importer. Growth would be harder hit as rising oil prices would erode household's buying power and company margins; and at the end of the day, the inflationary impact would be short-lived.
- **Trade war.** Higher customs tariffs on imports to the US could push up local prices. In the Eurozone, conversely, the effect would be to sap confidence and potentially curtail corporate investment. Business leaders in Europe declared their worries about Donald Trump's mooted protectionist measures. Meanwhile, in the US, threats of retaliation by the EU and China have barely dented business confidence.

In these circumstances, these two global risks would be viewed differently on either side of the Atlantic. The Fed would see a rise in oil prices and/or a customs tariffs as threatening to push up nominal GDP (with little impact on real growth but some effect on inflation). The ECB, however, would see them as putting downward pressure on nominal GDP, with a negative impact on real growth, but little inflationary impact.

All else being equal, these divergent trends in nominal GDP could persuade the Fed to opt for further increases in its key rates while the ECB could be persuaded to further delay any rise. With the ultimate risk that the ECB would not be able to normalise its monetary policy…

[4] *Brent crude has risen to USD 75 a barrel on the back of Middle East tensions. Although a strengthening euro has done much to mitigate rising dollar oil prices over the last year, the euro price per barrel is still at a near 4-year high (EUR 62).*

Risk factors

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

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

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

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

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

Risk # 2 | 75% probability | Greater financial instability

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

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

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

Analysis | Financial markets are now operating against a complex geopolitical backdrop: Syria, Islamic State, Turkey, migrant flows, terrorist attacks, Sunnis vs. Shiites, Arabia vs. Iran. On the one hand, the situation has dramatically eased in Asia with the rapprochement of the two Koreas and the promise of denuclearization of the North Korean leader. On the other hand, the situation in the Middle East has worsened with regard to the Iranian issue (threats of denunciation by the United States of the JCPOA agreement signed in 2015, with a resumption of sanctions against Iran and, as a consequence, the resumption of the nuclear program in Iran). Do not expect a quick resolution of ongoing problems and conflicts. In order to take into account political and geopolitical risks into portfolio constructions on a permanent basis, it is necessary to systematically consider macro-hedging strategies.

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

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

Analysis | The increase in long-term rates can come from at least six sources: (i) a significant upswing in (nominal, real or potential) growth prospects, (ii) more aggressive tightening of interest rate policies, (iii) the "true" end of QEs (the end of reinvesting maturing papers in the US, an even more drastic reduction in the ECB's asset purchasing programme), (iv) a resurgence of inflation or inflation expectations, (v) a massive reversal of fiscal and tax policies, or (vi) a resurgence of specific political risks. All these factors (reality, announced measures, or fears) have gained momentum in the United States, but it seems premature to expect a substantial increase in bond yields.

This conclusion is particularly valid in the case of the Eurozone, where the ECB intends to maintain very accommodative monetary conditions this year and next. This is indeed a necessary condition for inflation to recover gradually. However, the desire to lower the degree of monetary accommodation - including ending QE - remains intact. A moderate rise in European interest rates seems inevitable. But a marked increase is unlikely.

Market impact | A sharp rise in long rates would be bad news in the United States, where the sensitivity of the economy to long-term rates has increased with corporate releveraging: this would weaken growth and in itself would sow the seeds for a future decline in long rates. It should also be noted that a sharp rise in long-term rates would 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 rates.

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

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

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

Risk # 6 | 15% probability | Global trade war

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

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

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

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

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

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

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

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

- **Continued expansion of global activity:** surveys, despite their recent deterioration, remain at high levels, mostly well above their long-term average. Global growth is expected to remain strong in 2018 and 2019. The advanced economies (with the notable exception of the UK) will continue to experience above potential growth. The major emerging economies will also continue to grow at a sustained pace. The ongoing rebalancing in China is progressing quietly. The recovery in most economies is being driven by domestic demand with a positive contribution from investment in many areas simultaneously. The synchronous nature of expansion makes it more robust.
- **World trade:** world trade remained robust in Q1 2018 (+5.4% year-on-year) but seems to have lost some strength at the end of the quarter and at the beginning of Q2. The protectionist measures announced by Donald Trump on steel and aluminium (tariff increases) were once again postponed (to 1 June). If implemented, they will give rise to retaliatory measures (from the EU and China in particular) that will be damaging to trade. We observe that this threat has begun to weigh on the confidence of business leaders (uncertainty about the outlook), particularly in Europe. However, it should be kept in mind that the products being targeted account for a small share of world trade and partner retaliation is targeted at a few products. We continue to expect a slight decline in the world trade to global GDP ratio (i.e., trade growth slightly below that of global GDP). The probability of a real global trade war is low (see risk scenario).
- **United States:** growth came out slightly above expectations in Q1 and is expected to pick up. Surveys still point to GDP growth above potential. The fiscal stimulus voted in December, combined with the bi-partisan plan to increase public spending, will extend the duration of the US cycle. There is no recession to fear in 2018 or 2019.
- **Eurozone:** growth slowed down in Q1 and surveys declined sometimes quite sharply, albeit from historically high levels. This easing of growth does not come as a surprise after a highly robust end to 2017. The rising euro and tensions over trade likely had a negative impact. These developments confirm that the growth peak is behind us. We are expecting a slight slowdown in 2018 and again in 2019, although growth is expected to remain well above its potential. The Eurozone is in fact at mid-cycle, with the prospect of catching up for peripheral countries. The ECB has also promised to maintain its accommodative monetary policy. Furthermore, the perception of political risk has weakened significantly. It has not disappeared completely but has become more local. Specifically, the political situation in Italy remains unclear and new elections cannot be ruled out. However, local tensions are not enough to jeopardise the strengthening of the eurozone that the French and German governments are in the process of negotiating, ahead of the European Council meeting in late June.
- **United Kingdom:** EU countries and the UK are in the process of concluding an agreement for a transition period (limited in time until the end of 2020). But the dissensions on Brexit terms are still strong on the fact of remaining or not in the Customs Union. Uncertainty will continue to weigh on the UK economy, but in a more diffuse way. We expect growth to remain below potential in 2018-2019. The BoE prefers to wait a little longer before raising rates.
- **China:** growth is robust and the transition is under control. The reduction in overcapacity has reduced the downside risks. The economy's growth drivers are now more diversified. Debt, essentially domestic has stabilised. We expect the gradual deceleration of growth to continue and a slow rebalancing (less growth, less debt).
- **Inflation:** core inflation, which is low at this stage in the cycle (especially in advanced economies), is expected to recover gradually in 2018. That said, the slowdown in inflation over recent years is primarily structural (tied to supply factors), while the cyclical component of inflation has weakened (flattening of the Phillips curve). While the pick-up in core inflation promises to be modest, the likelihood of an "inflation surprise" is nonetheless increasing as surplus capacities disappear around the world (we estimate that the global output gap will close in 2018 for the first time since the great financial crisis). The risk is easier to spot in the US (we expect wages to continue to accelerate), given how close the economy is to full employment and how certain temporary factors (such as the drop in mobile phone service prices in the spring of 2017) have disappeared, which will automatically push inflation upward at the end of Q1 2018 (base effect).
- **Oil prices:** oil prices have increased sharply ($75 a barrel for Brent) and are at their highest level in 4 years. This rise is due to tensions in the Middle East (especially in terms of the uncertain future of the agreement over Iran's nuclear activities),

relatively low inventory in the United States and high global demand. Short-term risks are to the upside. However, we have not revised our breakeven price assumption (of around $60), which we expect to reach within 12 months.

- **Central banks will continue to whittle down their accommodative monetary policy.** The Fed will continue to raise its key interest rates (we anticipate two additional 25bp hikes by the end of the year, maybe three if growth and inflation surprise to the upside) and reduce its balance sheet at the announced pace (with a gradual non-replacement of papers reaching maturity); meanwhile, the ECB could put an end to its QE programme as soon as Q4 2018. However, its rhetoric remains particularly accommodating. The end of the Asset Purchase Programme (APP) is contingent on a rise in core inflation, which remains very low at this stage of the cycle. Forward guidance remains unchanged: the ECB will not begin to raise rates until “well after” the end of the APP. This implies that any increase in the deposit rate would not take place until at least mid-2019.

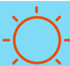
The protectionist measures announced by Donald Trump are dragging down confidence, especially in Europe. However, we believe that the risks to growth are now balanced. The likelihood of a widespread trade war remains low because the measures on the table (from Donald Trump and the retaliatory measures) will ultimately target products that account for a small share of world trade. Furthermore, it seems that the retaliatory measures being planned by the EU are making Donald Trump hesitate, causing him to once again postpone the implementation (until 1 June) of his tariffs on steel and aluminium.

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

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

Consequences:

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



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

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

- Sharp pick-up driven by business investment, global trade, and synchronisation of the overall cycle.
- In a very promising environment, the pro-cyclical US tax policy generates a stronger than expected pick-up in domestic growth in the US. Growth is picking up again in the eurozone after a soft patch in Q1. Stabilisation in China, confirmation of the trend in Japan, etc.
- Central banks react late, maintaining excessively accommodative monetary conditions, hence a “mini boom”.

Consequences:

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

Macroeconomic picture by area

United States

Economy set to expand above potential after Q1 temporary weakness

- While indicators point to softer first quarter activity data, the economic outlook for the year remains solid.
- Domestic demand still posed to be strong: business and consumer surveys show very upbeat sentiment in aggregate, although moderating from the highs. Further improvements in labour market and disposable income, lifted also by the tax-cuts positive effects, support consumption while strong sales and only modestly rising production costs allow for healthy dynamics in corporate profits.
- A slower than usual inflation generation process in the U.S. economy has produced a gradual convergence of core inflation to the Fed's target and current economic conditions support the possibility of a modest overshoot. Headline inflation will be instead higher than core on annual basis, yet remaining on check. Risks tilted to the upside.
- Two more hikes from the Fed now expected, based on this economic backdrop. One additional hike could be in the cards, should inflation surprise on the upside.

Risk factors

- Stronger acceleration of wage inflationary pressures
- Abrupt and protracted tightening of financial conditions
- Unpredictability of U.S. Trade Policies and risks of escalated retaliations impact confidence an real economy
- Geopolitical risks linked to a more hawkish shift of the U.S. Administration (Iran, North Korea)

Eurozone

Despite a series of disappointing figures in Q1, the recovery will continue.

- Business climate indicators and a number of hard data sharply disappointed in Q1. The rising euro, uncertainties related to world trade and other temporary factors weighed on activity after the peak of late 2017. However, the recovery should continue, supported by strong internal drivers (consumption, investment, less restrictive fiscal policies and less political risk than in 2017). Underlying inflation remains weak but should increase slightly in the coming months
- Italian political uncertainty does not carry an immediate systemic risk to the Eurozone. Under the impulse of the German-French couple, institutional changes aimed at improving the robustness of the Eurozone's financial architecture will probably be decided before the 2019 European elections.

Risk factors

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

United Kingdom

The job market provides an important support despite the Brexit uncertainty

- The weak Q1 GDP growth figure (+0.1%) underestimates the real trend. Brexit-related uncertainty remains detrimental to business confidence. However, job market figures are strong (the unemployment rate reached a new low at 4.2% in February. Nominal wages are increasing while real wages are back in positive territory thanks to the slight decrease in inflation.
- The agreement reached in March with the EU on a transition period after the UK leaves the Union (from March 2019 to end 2020) has not removed all the obstacles to a "soft Brexti". However, this is now by far the most likely scenario, with even a significant probability that the UK will remain in the EU's customs union.

Risk factors

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

Japan

Pace of growth will be inevitably slower, though still above potential

- Brisk global economic growth has benefited exporters, and their buoyancy will ultimately feed through to the domestic economy. Producers are likely to accelerate capital investment to revamp productivity through factory automation. In addition, increasing numbers of foreign visitors and a chronic labour shortage should stimulate capex by service sector. However, the adverse impact of a stronger yen and global economic deceleration will emerge in H2/18.
- On the consumer front, wage growth will remain lacklustre, despite the government's request for a 3% increase. Core CPI should hover in the neighbourhood of 1% as downward pressure from the stronger yen will not completely offset upward pressure from staffing shortages. Depressed real income will therefore continue to weigh on spending.

Risk factors

- Further appreciation of the yen
- Political confusion on the back of a number of scandals
- Geopolitical risks (tensions with North Korea)

China

- The economy looks more resilient than expected, with Q1 growth roughly stable, although credit slowed slightly more quickly recently.
- New property starts were stronger than expected, exports are holding up relatively well and consumption remains healthy, although infrastructure spending looks to have cooled somewhat.
- The CPI is back to the low end of the PBoC's comfortable range after seasonal swings.
- Signs of China's policy stance easing, including recent RRR cuts and messages from the latest Politburo meeting, seem to be offsetting potential downside risks ahead.
- Reforms look to be gathering speed. Following XI's speech in Boao, China revealed its timetables for opening up the financial and manufacturing markets further, which could also help ease tensions with the US.
- Despite recent rumblings over the US/China trade relationship, there are more signs for the two sides to talk.

Risk factors

- **Rumblings over the trade relationship with the US may continue. Keep an eye on US visits to Beijing in May**
- **Geopolitical noises regarding North Korea: keep an eye on North/South Korea Summit, and Trump/Kim Summit**
- **Policy mistakes in managing structural transition**

Asia (ex JP & CH)

India: still on an expansionary path

- Economic activity in India is still on an expansionary trajectory, although lower than its January peak (partly driven by a favourable base effect). The weakest component is exports, which declined in March by 0.7 YoY. The agriculture seasonal production (rice, pulses and cereals) estimate has been revised up, following already very high levels reported one year ago.
- Credit dynamics have recently experienced some weakness, due to higher than usual demand and some supply issues (shortage of notes at the banks machines).
- Inflation keeps decelerating, due to food and vegetable prices. The March headline figure was reported at 4.3% YoY, while core inflation remains higher. The oil price is becoming more and more challenging for India. Current levels could threaten inflation and fiscal accounts.
- RBI is expected to be on hold over 2018. One more board member passed on a tighter stance, according the recent minutes.

Risk factors:

- **The recovery has begun to moderate since February 2018**
- **March inflation still low**
- **RBI on hold**
- **The oil price becoming more and more challenging**

Latam

Brazil: preparing general elections

- Brazil is preparing for general elections on October 7th 2018. April 7th was the deadline for the affiliation by potential candidates to a political party or to resign from executive branch positions in order to be able to run. Official registration will begin in July and will end on August 15th. There is a lot of uncertainty regarding the number of potential candidates, which can range from 11 to 16. There is also a small probability that Lula may be in the race, depending on the decision of the Electoral Supreme Court (the trial will begin on August 15th). The election landscape is fragmented and polarized.
- Compared with past elections, it seems like the focus has shifted away from the economy to other priorities such as corruption, crime and violence and health. The population seems to resent the establishment and to mistrust political institutions, favouring more "non-establishment" candidates.

Risk factors:

- **The election landscape is fragmented and polarized**
- **On the October 7th the first round and on the 28th the second round**
- **Non-establishment candidates seem to be the favourites**

EMEA (Europe Middle East & Africa)

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

- Despite the sanctions imposed by the Trump administration, we maintain our growth scenario unchanged. Indeed, even if the central bank had to pause in its cycle of falling rates, the rise in the price of oil at a high level is an important support of growth.

Risk factors:

- **Decreasing oil prices and increasing sanctions from US**

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

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

Risk factors:

- **Less fiscal consolidation, lack of reforms**

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

- The base effects associated with the *coup d'État* and the end of Russian sanctions are likely to fade. Due to the increasing domestic and external imbalances (increased public and current account deficits) and geopolitical tensions, the Turkish lira will remain under pressure and continue to hamper the economy via imported inflation. This month, the central bank has finally raised one of its key rates in anticipation of the June elections that could weigh on the currency also.

Risk factors:

- **Lax monetary policy, rising inflation and twin deficits, currency depreciation.**

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

Macro and Market forecasts

Macroeconomic forecasts
(9 May 2018)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2017	2018	2019	2017	2018	2019
US	2.3	2.9	2.6	2.1	2.6	2.3
Japan	1.7	1.2	1.0	0.5	0.9	1.1
Eurozone	2.5	2.3	1.9	1.6	1.6	1.6
Germany	2.5	2.3	2.1	1.7	1.5	1.6
France	2.0	2.0	1.7	1.2	1.4	1.5
Italy	1.5	1.4	1.2	1.2	1.1	1.5
Spain	3.1	2.6	2.5	2.0	1.6	1.7
UK	1.7	1.3	1.6	2.7	2.5	2.4
Brazil	1.0	2.2	2.4	3.5	3.2	4.2
Russia	1.5	1.7	1.7	3.7	3.0	4.1
India	6.3	6.7	6.6	3.3	3.9	4.5
Indonesia	5.1	5.3	5.5	3.8	3.8	4.1
China	6.9	6.6	6.4	1.6	2.3	2.5
Turkey	7.3	4.3	4.4	11.1	10.8	9.5
Developed countries	2.3	2.3	2.1	1.8	2.0	1.9
Emerging countries	4.9	5.0	4.9	3.5	3.6	3.7
World	3.8	3.9	3.8	2.8	2.9	3.0

Source: Amundi Research

Key interest rate outlook

	8/05/2018	Amundi + 6m.	Consensus Q3 2018	Amundi + 12m.	Consensus Q1 2019
US	1.75	2.00	2.25	2.25	2.50
Eurozone	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.75	0.75	0.75	1.00

Long rate outlook

2Y. Bond yield

	8/05/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2,52	2.20-2.40	2,76	2.50-2.70	2,88
Germany	-0,58	-0.60/-0.40	-0,43	-0.40/-0.20	-0,30
Japan	-0,13	-0.20/-0.00	-0,13	-0.20/-0.00	-0,12
UK	0,82	0.80/1.0	0,93	0.8/1.0	1,03

10Y. Bond yield

	8/05/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	3.00	2.80/3.0	3.07	3/3.15	3.12
Germany	0.58	0.60/0.80	0.71	0.80/1.00	0.82
Japan	0.05	0	0.10	0.10	0.15
UK	1.48	1.40/1.60	1.64	1.40/1.60	1.72

Currency outlook

	8/05/2018	Amundi + 6m.	Consensus Q3 2018	Amundi + 12m.	Consensus Q1 2019
EUR/USD	1.19	1.25	1.24	1.28	1.27
USD/JPY	110	105	108	105	106
EUR/GBP	0.88	0.92	0.88	0.95	0.89
EUR/CHF	1.19	1.16	1.18	1.18	1.20
EUR/NOK	9.63	9.50	9.40	9.30	9.20
EUR/SEK	10.37	9.70	10.03	9.50	9.75
USD/CAD	1.29	1.25	1.26	1.22	1.25
AUD/USD	0.74	0.77	0.77	0.77	0.79
NZD/USD	0.70	0.70	0.72	0.70	0.74
USD/CNY	6.37	6.30	6.42	6.30	6.46

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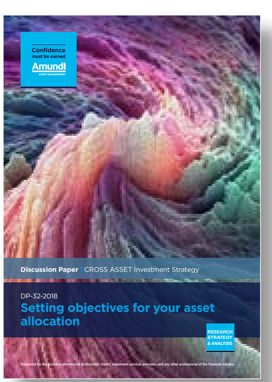

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Chief editor: BLANQUÉ Pascal
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Editor

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Deputy-Editors

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