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Asset allocation: Amundi investment strategies

US elections, the yuan in the SDR, monetary and fiscal policies, etc. – what has truly changed?

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Last month we looked into the key issues that market participants are concerned about: the Italian referendum, Spanish politics, the Brexit aftermath, US elections, the tightening (if any) in US monetary policy, the options open to the ECB, etc. These are all important issues but their ultimate outcomes will not all necessarily reverse the major market trends. True, a sudden tightening by the Fed, a shutdown of the ECB securities buying programme, the resignation of Mateo Renzi after the Italian referendum, and so on would probably all have a considerable market impact (see our section on risk factors, page 10 and thereafter).

But this is not our baseline scenario. Without underplaying the risks, we don't expect the aforementioned events to trigger any reversal in trend. So what is worth keeping a close eye on in the coming months?

Monetary policies: what else can be done?

For many years now policy-makers have been vying with one another in ingenuity to restart the economic machine and restore the solvency of economic agents and over-indebted governments. Many new measures have been taken (LTRO and TLTRO in the euro zone, quantitative easing in Europe, the US and Japan among others, quantitative and qualitative easing in Japan, massive purchases of securities of all types, including shares in some cases, etc.), but nothing has worked, even when the measures have come with a steep depreciation in the national currency. Growth is not accelerating; inflation is not back; and global trade is slowing. Yes, it's nice to see global growth above 3% for the fourth consecutive year, but this is probably as good as it gets.

If **Japan** is the standard for Europe, then Europe is in trouble. The Bank of Japan has lowered its interest rates into negative territory; it is buying up Japanese government bonds aggressively (it is now the largest holder of JGBs); it has allowed its balance sheet to balloon to more than 80% of GDP; and it has just taken a new step: yield targeting. Everything will be done to keep long bond yields at 0%. True, anchoring long bond yields so low does have some advantages, but it – and, incidentally, negative rates – also maintains a deflationary environment. Yes, more than 95% of Japanese debt is held by Japanese entities, led by the BoJ, but, unless you think that the sky's the limit for the BoJ, the day will come when international investors will be needed, and they will not be eager to invest in Japanese debt that is trading at zero or negative yields (not to mention to take on currency risk). The ECB hasn't gone this far, but the similarities are troubling. We don't expect the ECB to start buying up shares (as this wouldn't have a sufficient impact on household wealth) or financial institutions' debt (that would run counter to its current thinking and would raise issues of "consanguinity" and moral hazard). Nor do we expect it to cut its interest rates again (as that would now be counterproductive) or to change the capital key for buying up assets (this may be easy to do technically, but would be politically complex). But we do expect QE to keep running after March 2017. Its virtues (and limits) are well-known but this is not the time to shut it down, as that would remove the safety net under government bonds on the eve of elections in Italy and elsewhere. Better to stick with QE and get out of negative rates. But is that even possible?

The essential

Brexit, volatility/financial stability, negative rates/cost of capital for banks, deglobalisation, and the US elections are key drivers of the current market environment and asset allocation considerations. They remind us, in case we needed to be, that we shouldn't lower our guard just because of the "aggressive" role that central banks are playing on the financial markets.

Without getting carried away and reversing our asset allocation positions (in which we restore risk in emerging asset classes, continue to overweight peripheral vs. core euro zone countries, and overweight corporate bonds in bond portfolios), we remain on a cautious footing. We are not complacent on risk, which is, in fact, far greater than what conventional metrics suggest, mainly because central banks are smoothing out volatility. The US elections, the Italian referendum, the Spanish political situation, the current and future discussions on whether (or not) the ECB will stick to QE, and, above all, the wait for the next Fed FOMC meeting all suggest how misleading the current low levels of volatility are and how dangerous it is to underestimate risk.

Being aware of the risks does not mean reversing positions, particularly on markets with low liquidity, as it would then be very hard to get back into these markets, when the time comes. Unless we believe that coming events are likely to trigger a complete reversal in trend, we don't want to be locked out of these markets. Protecting and hedging looks wiser in the current environment.

> "The ECB's back to the wall?"

The **Fed**, meanwhile, has been hinting at rate hikes for two years now and has failed to deliver. No doubt it is feeling nostalgic for 2004-2006, when it raised rates on 17 occasions and created leeway that it used energetically in 2008, in the wake of the financial crisis. It would be hard to do so this time, given China's behaviour (summer 2015 and January 2016), the criticisms of some large emerging economies (India in particular) and the shift in US economic activity (which is moving steadily towards its growth potential, which, itself, has been lowered to about 1.8%). If need be, the Fed could very well undertake a fourth round of non-conventional measures (QE4).

In other words, at best the central banks are behind the curve (the case of the Fed and the ECB); at worst, they have lost their touch and can no longer turn back (BoJ). Except for banks, life insurance companies and pension funds (lots of folks there!), the markets and economic agents are enjoying the environment of low interest rates, whereas these rates actually reflect central banks' inability to restart the economic machine. When remembering that the markets have tended to believe that central banks are omnipotent, there is reason to worry.

> “Central banks are behind the curve”

To sum up, monetary policies will remain accommodating, especially in Europe (including the United Kingdom), Japan, and China. The Fed is still unable to begin a true tightening cycle, and a rate hike by yearend is no longer even a sure thing.

The return of fiscal policies: will the US shoot first?

Monetary policies have reached their limits. That's a fact. Without fiscal policies (stimulus), tax policies (tax cuts) and income-based policies (that would raise real disposable income), it is hard to see how economic and financial conditions can get much better.

The debate on these policies has changed significantly over a little more than one year. Europe has set aside its dogma on fiscal austerity, and the United States itself, despite its heavy debt, is about to launch a massive fiscal stimulus. At least, that's the common point (the only common point?) between the platforms of Hillary Clinton and Donald Trump.

> “Only growth can get us out of this slump, and growth cannot be restored without additional aid on top of low rates”

Keep in mind that negative interest rates constitute a tax on savings, and that quantitative easing (and negative rates) amount to a subsidy on debt accumulation. On an optimistic note, it lets governments have more proactive fiscal and tax policies without the drawbacks. In addition, as central banks can't do everything (low rates, inflation under control, economic recovery, reforms, etc.), during this rather special period (weaker potential growth, decline in globalisation and in exchange rates' impact on growth, lower productivity, demographic decline, etc.) governments need to implement those instruments that they have at their disposal, i.e., fiscal, tax, and income-based policies. Only growth can get us out of this slump, and growth cannot be restored without additional aid on top of low rates. We will discuss all these themes (limits and dangers of current monetary policies, the outlook for fiscal stimuluses, etc.) in our next edition, a special edition entitled “*2017 ... and beyond*”.

To sum up, it's a safe bet that we will see shifts in fiscal and tax policies, with the United States probably leading the way. In the euro zone, maintaining low rates and sticking to QE would probably ensure that the impact on bond yields (which could result from a more aggressive fiscal and tax policy) will be limited. Something to keep an eye on.

> “China is in upheaval”

The yuan in the SDR: what does that really change?

In early October, the yuan was added to the special drawing rights (SDR) basket. As you know, China is in full flux, with a shift from trade-led growth to a more balanced model driven by domestic demand), a change in exchange rate regime, an ongoing opening of the capital account.

All these changes are very important, but many, particularly within the US government, feel that China is either moving too slowly (on opening its capital account and abolishing capital controls) or inappropriately (in depreciating the yuan). Donald Trump has been vocal on this point, threatening to impose 40% customs duties on China!

Since 1 October, the yuan has been a component in the SDR basket of currencies. Created in 1969, just before the collapse of the Bretton Woods gold standard, SDRs are currency reserves managed by the International Monetary Fund (IMF). The basket's composition is based on the following official rules:

- The basket must contain currencies issued by IMF member-states;
- Their weighting must be in accordance with each member-state's export volumes;
- Currencies must circulate freely on foreign exchange markets.

These rules were revised in 2010 to include, in addition to export volumes,

- International financial flows,
- The denomination of international debt securities,
- The composition of central banks' financial reserves.

In October 2015, based on these criteria, it was decided to add the Chinese yuan to this basket, and since 1 October 2016 the SDR basket has consisted 42% of US$, 31% of euros (-7% vs. the previous basket), 8% of sterling (-3%), 8% of yen (-1%), and 11% of RMB. Noteworthy is the fact that the renminbi's allocation came at the expense of currencies other than the dollar. However, keep three things in mind:

- The inclusion of the yuan did not meet, at that time, all the criteria nor guarantees for this decision to be efficient. The best proof is that it did not strictly add anything, neither in terms of information, nor in terms of diversification. The yuan is "stuck" to the dollar...
- To diversify the SDR basket, it was becoming necessary to disconnect the RMB from the dollar on the currency markets, something that Chinese officials did. The change in the RMB's currency regime has resulted in its depreciation, to the great displeasure of the US, and that explains why China and the yuan have become an election issue.
- It is still necessary to further open the Chinese capital account. Some may protest, but this is something that can only be done gradually. Countries that opted for a "big bang" (like the Scandinavian countries in the mid-1980s) still regret doing so. In China's case, given its size and role, a big bang is not even an option.

To sum up, the yuan's inclusion in SDR is proof of China's continued adjustment and the yuan's rise as an international currency (see our most recent Discussion Paper: "*The emergence of the Renminbi as an international currency: where do we stand now?*"). There's no going back – the opening of the capital account is necessary, and the yuan will gradually take its place on the international stage, with a gradually more flexible exchange rate regime. This is probably one of the most visible consequences of the Chinese currency's internationalisation over the past year.

> "SDR: the change of the yuan FX regime was a necessity"

> "The rise of the yuan as an international currency is inevitable"

> "China: there's no going back"

US elections: what will the impact be?

US elections are scheduled one month from now. We have reviewed the two electoral platforms in detail. On the positive side: both candidates want to boost growth and cut taxes for companies and households (Trump more for wealthier taxpayers, and Clinton more for households with a high propensity to consume), and to spend more on infrastructures. On the negative side: Trump wants to "send back" more than 11 million

> "The election outcome alone will not dissipate concerns"

undocumented workers and migrants and to impose prohibitive customs duties. While Clinton is less cause for concern, neither Trump, nor Clinton will be able to get their initial plans through Congress. In other words, the election outcome alone will not dissipate concerns. Protectionist measures and any measure that would trigger a serious worsening in public deficits will most likely be amended (Congress, including the Republican-controlled house, would be against this), but many of the stimulus measures will probably be approved. All in all, this could very well be more favourable than we think (for more details, see our coming article on the US elections).

To sum up, the US elections could be a disruptive factor if Trump's platform is passed as it is, but we see little or no chance of that happening. Even so, the run-up to the 8 November elections will stoke volatility but with no reversal of current trends.

So what is our baseline scenario and sources of concern?

Macro scenario and market fears: what's new?

In the United States, growth is running out of steam in the short term against a backdrop of electoral uncertainty. After weak second-quarter GDP growth, monthly data for July and August provided no clear sign of a rebound in the third quarter. The job market remains solid, and inflationary pressures are still moderate (core inflation is at 2.3% year-on-year). The Fed's guidance nonetheless became more hawkish at the September FOMC meeting. Clinton's lead in the polls has shrunk, but after the first debate she is still 6 points ahead.

"Brexit: March 2017 at the latest?"

In the euro zone, note the lack of impact from the Brexit referendum on confidence indices. There is not even any tangible sign of economic slowdown in the UK itself. Quite the contrary. We now know that Theresa May will trigger Article 50 in the first half of 2017, which will inevitably revive the fears over the UK economy that we mentioned in our recent columns. Inflation has remained in slightly positive territory in the euro zone but is still very low (+0.8% year-on-year for core inflation). Polls suggest a highly uncertain outcome of the Italian referendum, in late November or early December. Regardless of the outcome, Renzi will most likely remain prime minister. Politically, the Spanish political stalemate has not yet been revolved, while Angela Merkel's popularity continues to fall, as seen, for example, in poor results in local elections. We had expected 2017 to be a challenging political year in Europe (with many election campaigns) and recent developments back this up.

Conclusion

In light of the above, we reiterate our approach, which is rather constructive on emerging assets, the quest for spreads and equity markets. We continue to overweight long bonds and corporate bonds (and other spread securities, such as peripheral economies). The dollar has little upside potential (a tentative cut in Fed rates will not be enough to boost it significantly). We still see European equities as the most attractive, even though some performance drivers, such as a weak euro and its earnings impact, are no longer there.

Brexit, volatility/financial stability, negative rates/cost of capital for banks, deglobalisation, and the US elections are key drivers of the current market environment and asset allocation considerations. They remind us, in case we needed to be, that we shouldn't lower our guard just because of the "aggressive" role that central banks are playing on the financial markets. Without getting carried away and reversing our asset allocation positions (in which we restore risk in emerging asset classes, continue to overweight peripheral vs. core euro zone countries, and overweight corporate bonds in bond portfolios), we remain on a cautious footing. We are not complacent on risk, which is, in fact, far greater than what conventional metrics suggest, mainly because central banks are smoothing out volatility. The US elections, the Italian referendum, the Spanish political situation, the current and future discussions on whether (or not) the ECB will stick to QE, and, above all, the wait for the next Fed FOMC meeting all suggest how misleading the current low levels of volatility are and how dangerous it is to underestimate risk.

Being aware of the risks does not mean reversing positions, particularly on markets with low liquidity, as it would then be very hard to get back into these markets, when the time comes. Unless we believe that coming events are likely to trigger a complete reversal in trend, we don't want to be locked out of these markets. Protecting and hedging looks wiser in the current environment.

> "Low volatility is misleading and shows how dangerous it is to underestimate risk"

> Macro Hedging Strategies

	one-month change	0	+	++	+++
Long US Treasuries	→		⊡		
Long Bunds	→	⊡			
Long USD	→	⊡			
Long JPY	→	⊡			
Long volatility	→		⊡		
Long cash USD	→	⊡			
Long Gold	→		⊡		
Long US TIPS	→		⊡		

US elections are approaching and the polls are fueling fears and hopes. H. Clinton increased his lead, but there is still more than two weeks before the deadline. The post-Brexit stress fell, but we know that the UK will activate Article 50 before the end of March 2017. The political difficulties (Italy, Spain ...) are relegated to second place, but the decision of the ECB to continue, amend or stop its QE is of paramount importance.

We keep some macro-hedging strategies (see table).

The table above represents a short investment horizon of one to three months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our aversion to risk and our macro-hedging strategies. They should be viewed in relation to the asset allocation tables. A negative outlook in terms of asset allocation will not lead to hedging. A temporarily negative outlook (negative in the short term but positive in the medium term) may lead us to protect the portfolio, without affecting our long-term outlooks. The application of the strategy is expressed by a position (+), and the scale of the position is expressed by a graded scale (+/++/+++). These strategies are independent of the constraints and considerations concerning the construction of the initial portfolio subject to protection. These are overlay positions.

Asset allocation: multi-class outlooks and convictions

	1 month-change	---	--	-	0	+	++	+++
Equities/gov. bonds	→					⊡		
Corp. bonds/gov. bonds	→						⊡	
Equities/corp. bonds	→					⊡		
Duration	→				⊡			
Corporate bonds	→					⊡		
Oil	→					⊡		
Gold	→					⊡		
Cash EUR	→			⊡				
Cash USD	→				⊡			

The table above represents an investment horizon of six to 12 months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our multi-asset class outlook for a 6/12 month horizon. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++); they are independent of the constraints and considerations that concern the construction of portfolios.

Asset allocation: relative outlooks and convictions by major asset class

		1 month-change	---	--	-	0	+	++	+++
Equities	US equities	→				⊡			
	Japanese equities	→				⊡			
	Euro equities	↓				⊡			
	UK equities	→				⊡			
	Pacific excl. Japan	→				⊡			
	EMG equities	→					⊡		
Gov. Bonds	US bonds, short	↓			⊡				
	US bonds, long	↓				⊡			
	Euro core, short	→		⊡					
	Euro core, long	→					⊡		
	Euro peripherals	→					⊡		
	UK bonds	→				⊡			
	Japanese bonds	→				⊡			
Corp. Bonds	US IG	→					⊡		
	US HY	→					⊡		
	EURO IG	→					⊡		
	Euro HY	→					⊡		
	EMG debt hard currencies	→					⊡		
	EMG local debt	→					⊡		
FX	USD	→					⊡		
	EUR	→				⊡			
	JPY	→				⊡			
	GBP	→			⊡				

The table above represents an investment horizon of six to 12 months. The changes reflect the outlooks expressed at our most recent investment committee meeting. The different lines provide relative outlooks for each major asset class and absolute outlooks for forex and commodities. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++). They are independent of the constraints and considerations concerning the construction of portfolios.

Portfolio type

> Equity portfolios

- Beta of portfolio around 1
- Slight preference for Eurozone vs. US
- Sectors:
  - Overweight Industrials, Retail, Telecoms, Pharmaceuticals
  - Underweight Chemicals, Automobiles, Utilities
- Emerging markets: country selection is key, but a positive bias globally. Within EMG countries:
  - Overweight India, Thailand, Peru, Philippines, Russia
  - Neutral on Indonesia and Brazil
  - Underweight Taiwan, Greece, South Africa, China, Malaysia, Korea, Turkey
- Long positions in EMG currencies

> Bond portfolios

- Maintain overweight position in credit
- Duration: globally neutral, with a short bias on negatively yielding segments and a short bias in GBP and JPY
- Long bias in core Euro
- Emerging debt:
  - Still prefer hard currencies debt (long USD)
  - Increase risk on local debt
  - Play thematics on EMG
- Maintain neutral bias (at best) in GBP
- Slightly long USD vs. EUR
- Long positions in EMG commodity currencies (RUB, BRL, INR), short (CNY, KRW, TWD, CLP), neutral EMG Europe

> Diversified portfolios

- Global risk slightly reduced
- Portfolios globally neutral equities
- Long positions reduced on Eurozone and US equities
- Stay neutral on Japanese equities
- Stay overweight EMG equities
- Keep overweight position on sovereign bonds of peripheral Eurozone countries vs. core (close to fair value, though)
- Keep long US positions (carry + macro-hedging purposes)
- Corporate bonds: positive on HY and on IG
- Long positions in EMG currencies via local currency debt and equities

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