Asset allocation: Amundi investment strategies

Macroeconomic and financial trends, linvestment themes for 2017: state of affairs

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As 2017 begins, it is helpful to take stock of the key issues coming into focus. The last few months have seen a theatre of major changes (notably Brexit and Donald Trump's election), and some heavy trends (like the preservation of ultra-low long-term rates or the stability of inflation expectations) are looking threatened. The purpose of this chapter is to take stock of every aspect of our central scenario (for alternative scenarios, refer to our special edition from last November ("*Special edition: 2017 and beyond*"), and the current status of our asset allocation, and of intended changes over the coming months.

The year 2017 opens with themes such as rising long-term rates, risks on emerging markets, a strong return to fiscal policies, risks on world trade and rising protectionism, limits on monetary policies, political uncertainty in Europe (elections, Brexit), geopolitical risks. Three key questions at the beginning of the year:

- **What will be the real impact of Trump's election?** Should we rely on a radical change in the outlook for growth, inflation, and therefore on a reversal of the long-term trend of falling bond yields? Will this be accompanied by a strong appreciation of the dollar? What will be the impact on emerging economies and emerging markets? Will Trump be the new Reagan? Is the "border tax proposal" a "game changer"? Many questions stem from the election of D. Trump and the establishment of a more protectionist administration and more favourable to fiscal and fiscal stimulus. Many questions remain in response but Trump will be in power on January 20 and will also begin negotiations with the US Congress. It should be noted that **the positive impacts of D. Trump's election seem to be overestimated at this stage.** There will certainly be changes in economic policy, but this will not be enough to change potential growth or create a new cycle of growth.
- **Is the European political situation really a major risk factor?** Many people fear a further deterioration of the situation. Are we going to referendums cascading in Europe, on constitutions or on belonging to the European Union? With regard to the upcoming elections (France and Germany in particular), should we fear the change of leadership to come, and is it necessarily for the worse? Is there a credible positive scenario? It seems to us that **the negative impacts of the European political situation are overestimated at this stage.**
- **Brexit: - will this really happen and what should we fear?** The European economy in general and the British economy in particular have resisted the shock caused by the outcome of the referendum, and the Brexit seems to have come second. That seems to be a major mistake. There is indeed little chance that the United Kingdom gets what it wants. The negotiations will be difficult and they can destabilize the cohesion of the EU. Do not underestimate the long-term economic impact on the UK. **The negative impacts of the Brexit process seem to be largely underestimated at this stage.**

The essential

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The purpose of this chapter is to take stock of every aspect of our central scenario and the current status of our asset allocation, and of intended changes over the coming months. One of the key aspects is the reassessment of US growth and the Fed's monetary policy, and the impact of the new Trump Administration's future policies not just on growth, but also on world trade and international diplomacy.

Major macroeconomic and financial themes

We have identified 12 themes for the quarters ahead:

Theme # 1 **Economic growth:** the expansion cycle continues in major advanced economies, but at a slow pace.

Theme # 2 **World trade** is no longer a key factor for growth

Theme # 3 **Economic policies:** the policy mix is gradually rebalancing more towards budget and fiscal policies

Theme # 4	**Inflation:** not yet a risk, but a factor that must now be taken into account
Theme # 5	**Bond markets:** still "dysfunctional" but sensitive to the new American situation
Theme # 6	**Risky assets:** encouraged by the repricing of American growth, at least initially
Theme # 7	**China:** significant risks and challenges, but situation still under control
Theme # 8	**Emerging markets:** a triumphant return in the second half?
Theme # 9	**Currency markets:** the "adjustment variable" of 2017?
Theme # 10	**Political situation** in Europe and **Brexit:** complex and crucial issues for financial markets
Theme # 11	**Geopolitics and immigration:** recurring, long-lasting and destructuring factors
Theme # 12	**Macro-hedging strategies remain a priority**

Theme #1. **Economic growth:** the expansion cycle continues in major advanced economies, but at a slower pace.

Only the United States is seeing its growth rate rise. Some worries about the sustainability of the United Kingdom's growth, no growth in Japan, growth holding steady around 1.3% - 1.5% in the eurozone. The growth of the "emerging block" is rising particularly owing to two countries: Brazil and Russia, which are gradually exiting from recession (Russia before Brazil, in fact). Overall, global growth is rising, and within two years will increase from 3% to 3.3%. In other words, global growth would remain above 3% for the seventh year in a row. We are not banking on an interruption in global growth. Certainly, potential global growth is now weaker: It has actually flagged in many places, due to a combination of factors such as demographic decline, the weight of debts acting as a constraint on economic policies, the decline in productivity gains, the widening of inequalities, potential growth is around 1.5% in the United States, 5% in China, 1% in the eurozone, 0%-0.5% in Japan, etc. Investment is slowing, both in advanced countries and in emerging countries. This is one of the unique features of the current economic recovery. In the United States, the recovery in investment has far exceeded the recovery at the close of the Great Recession, and is far from the average for post-war economic recoveries. The domestic economy, and more specifically consumption, remains the cornerstone of all economies. This is equally true for advanced and emerging economies.

> "The expansion cycle continues in major advanced economies, but at a slow pace"

> "Potential global growth is now weaker"

Theme #2. **World trade** is no longer a key factor for growth

World trade is no longer a key factor for growth. It has been growing slower than GDP since 2011, which marks a break from the past thirty years. Should we call this de-globalisation? Not exactly: although trade in goods is indeed declining, trade in services (particularly financial services) continues to grow. We can cite several reasons behind the decline in world trade and in the reduction of its contribution to global growth:

I. The drop in potential growth, which is widespread and is hampering trade.

II. The convergence of prices (deflationary pressure in advanced countries, growth in prices and wages in countries with initially high competitive advantages), which limits the benefits of trade.

III. The decline in investment: This is one of the major factors driving trade. Its weakness in most countries, whether emerging or advanced, is an obstacle to international trade.

IV. The rise in protectionism (and particularly behavioural protectionism) also represents a trend that is becoming widespread...

> "World trade is no longer a key factor for growth"

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Theme #3. Economic policies: the policy mix is gradually rebalancing more towards budget and fiscal policies

Monetary policies remain accommodating. Out of the ten G10 countries, eight relaxed their monetary policy further in 2016. The Fed, which has so far been raising its rates timidly, continues to reinvest in paper reaching maturity that was purchased during its QE programmes. It has therefore not completely gotten out of QE. The BoJ and ECB are continuing their programmes, and the ECB has just extended its programme from March 2017 to late 2017. It did reduce its purchasing programme (from €80 billion per month to €60 billion), but in 2017 it will still be buying much more than the net issues of the eurozone. This is one factor holding long-term interest rates to a very low level. As for interest rate policy, rates will be kept low in Europe and Japan for a few years more. **In terms of efficiency, it may be said that the ECB's monetary policy has reached its limits**. Negative rates lead to deflation, harm the profitability of banks, do nothing to improve financial fragmentation, fail to ensure an increase in the volume of credits to SMEs, and no longer ensure a depreciation in the euro. QE is no longer achieving anything in terms of wealth effects, impacts on confidence, inflation expectations in the eurozone, or lowering the value of the euro. However, it is anchoring long-term low-level rates, which makes it possible to improve the solvency of indebted agents. But they also reduce liquidity in the fixed-income markets, lead to abnormally low interest rates and volatility, with asymmetric risks. Finally, they distort the break-even values of risky assets, with risks of bubbles or perceived bubbles. By themselves, monetary policies cannot solve growth, employment, foreign exchange, credit, confidence, or debt problems. **The ECB, however, cannot interrupt its asset purchase programme as long as certain exit conditions are not being met**. The prerequisites are as follows:

I. Restored budget solvency in order to be able to withstand the rise in rates;

II. Nominal GDP growth above the nominal interest rate;

III. Deleveraging completed;

IV. The return of investment.

These conditions have not been met for any euro country. Germany would be able to withstand the end of QE, but it would probably be the only country in such a case.

> "The ECB, however, cannot interrupt its current asset purchase programme, not as long as certain exit conditions are not being met"

The Fed will keep tightening its monetary policy. For the first time since the financial crisis, its actions should be in line with its forecasts ("dot plot"). However, this does not mean that it will vigorously raise its interest rates: we will probably see two rate increases in 2017, which will raise the Fed Funds rate to 1.25% by the end of 2017 (0.75% currently). We are still not in the normalization phase. As a reminder, between February 1994 and February 1995, the Fed raised its rates by 300bp (from 3% to 6%); between June 2004 and June 2006, the tightening had been 425 bp (from 1% to 5.25%), i.e. 17 consecutive increases, and + 25bp every 6 weeks. In the current cycle, since the decision to halt the QE (2013) the Fed has only proceeded with two rate increases. 2017 should provide the opportunity for the Fed to recreate some room for maneuver. She will probably use them twice (maybe 3?), And the Fed might be in line with the "dots" for the first time in 10 years. Be careful though: the cycle is already running out of steam, inflation remains under control, the bond market is vulnerable, the dollar is strong, companies are vulnerable (due to the magnitude of the current releve"raging), as well as emerging markets. All this limits the Fed's tightening potential.

> "The policy mix is gradually rebalancing more towards budget and fiscal policies"

The policy mix is gradually rebalancing more towards budget and fiscal policies. We have identified a greater capability for the United States to use these instruments since the election of Donald Trump: although Congress will cut down the new President's requests (in particular, Congress is hostile to budget deficits and protectionism), there will be some stimulus on the budget (particularly infrastructure) and tax (lower tax rates) ends. Expansionist budget policy in the United States will prolong the cycle (which is faltering) but will have no impact before the end of 2017 (we are predicting growth of about 2% in 2017 and 2.2% in 2018, a level substantially greater than potential growth, which currently stands at around 1.8%). Europe is behind relative to the United States:

its ability to use its tax and budget tools will run up against European systems (stability and growth pact, European half-year, six-pack, etc.) and insufficient will (in France, candidate François Fillon is promising a war on deficits). Whether to use budget or tax policy is not an insignificant matter, where impacts on financial markets are concerned.

One of the most important tax changes in the history of the United States is President Trump's proposal for the "border tax proposal". The idea is to tax US imports at the new corporate income tax rate (20%) and to exempt income from exports from any taxation. Ex ante, this would be equivalent to a 20% USD devaluation (at least if the dollar does not appreciate), with a very positive effect on the US trade deficit. This measure, which is also inflationary and favourable to the dollar, would definitely represent a major transformation of US trade relations with the rest of the world. Follow closely the negotiations with the American Congress, the conclusions of the WTO and the risks of retaliation of the US trade partners. This is without a doubt a potential "game changer" (see article 1 in this edition).

Tax and trade policy are therefore in the process of being (radically?) changed in the United States. This is probably the major challenge of the next quarter. Many proposals/suggestions are appearing, often aimed at stimulating the American production engine to the detriment of imports (customs duties, specific taxation, etc.). These are hard decisions to get from Congress, but the debates will inevitably touch on these subjects. This is positive for the dollar and for US equities (with favourable contagion to the rest of the world, EMG and Europe in particular), positive for American domestic themes (small cap, mid-cap, infrastructure, etc., although valuation is already low), and negative for US Treasury securities (the 10-year bond yield may reach 3%). **Overall, the prospects for 2018 will depend on the capability of governments to rebalance their policies by making greater use of budget policy**: here, the United States has the edge. The growth gap between the United States and Europe will widen over the next two years. At this stage, we are not projecting any real acceleration of the cycle in the United States, "just" an extension.

> "Overall, the prospects for 2018 will depend on the capability of governments to rebalance their policies by making greater use of budget policy"

Theme #4. **Inflation,** which is not yet a risk, but a factor that must now be taken into account

The rise of inflation remains very moderate and highly localised. More than 85% of the 120 largest countries have an inflation rate below their central bank's target, and nearly 20% of them still have negative inflation, a percentage that has never been so high in the time since deflationary fears emerged (in 2008). In other words, the rise of inflation is still more feared or desired than genuine. On the other hand, what is known is that inflation will pass above the Fed's target during the first quarter of 2017, and even though this is primarily due to a base effect from commodities, it's enough to change the interest rate environment, among other things. **Remember, it's important not to confuse inflation expectations due to reflationary pressures with inflation expectations due to forecasts of high(er) inflation.** What we are seeing is clearly the first situation. The reason why inflation expectations (and long-term interest rates) are growing is obvious: This is repricing of growth, due mainly to the use of budget policies (stimulus in certain public expenditures) and tax policies (increase in real revenue available). Although the American growth cycle has been faltering for months, pronounced usage of these policies could allow the current cycle to lengthen and the natural interest rate to rise (i.e. the interest rate that balances savings and investment when growth is at its full potential).

> "It's important not to confuse inflation expectations due to reflationary pressures with inflation expectations due to forecasts of high(er) inflation"

Theme #5. **Bond markets,** which are still "dysfunctional" but sensitive to the new American situation

We are witnessing an initial increase in American long-term interest rates. There are several reasons why: a reassessment of the policy mix (more favourable to growth), repricing of growth, repricing of inflation expectations, and repricing of monetary policy, all of which argues in favour of a rise in the dollar, as well as an increase in American long-term interest rates, at least at first. We are banking on an extension of the current economic cycle (currently nearing its end), rather than a new expansion cycle. In other words, **in mid-**

> "In mid-2017, the US bond market should become attractive for Euro-based investors once more"

2017, the US bond market should become attractive for Euro-based investors once more.

The impact of the increase in American interest rates on European long-term rates must not be ignored. Betting on a widening of spreads between the United States and Europe, over the entire yield curve does seem reasonable at this time, however. **European bond yields (sovereign and corporate) entered negative territory in 2016.** The rise in long-term interest rates in the US, however, has changed the tone: though more than 50% of the European credit universe (sovereign, quasi-sovereign, corporate, and financial) was delivering negative yields in September, this percentage had fallen by year's end to under 25%. The increase in long-term European rates may come from eight primary sources:

I. A significant recovery in growth forecasts;

II. A reversal of interest rate policies;

III. The end of QE;

IV. An increase in inflation;

V. A turnaround in budgetary and fiscal policies;

VI. An increase in spreads (health of banks, public debt solvency, increase of risk premiums, etc.);

VII. A turnaround in excessive positions (reducing interest rates);

VIII. A rise in US Treasury yields and a high correlation with US rates.

Where are we now? In the case of Europe, the first three have not (yet) become a reality, and the fourth is not yet a concern. The fifth is taking shape, but not in Europe, only in the United States... and it will have an impact on the first four. The current debate on tax and budget policies is crucial for interest rates. The sixth (political situation in particular) and seventh (portfolios long positioned for low rate levels) must be closely monitored. Only the eighth is currently highly credible, and with the factors mentioned above, it is driving rates upward.

European bond markets have become dysfunctional, like a barometer that provides inaccurate measurements, with lower liquidity than before, artificially low volatility, artificially low interest rates. In other words, totally asymmetrical (increase vs. decrease) risks. **European bond markets are also at the mercy of the ECB's QE policy**. The abandonment of QE will result in an increase in Bund yields by about 150bp (the current gap between going rates and break-even rates in the absence of QE) and a 250 to 350bp rise in yields in peripheral countries, where yields would more than double! A real financial crisis situation...

We conclude by noting the renewed interest in inflation-linked bonds. The current configuration argues for this asset class, and has been for several months. Here is a long-neglected asset class which is heavily underweighted in international portfolios, and consequently has an attractive valuation. There is also the rise is commodities prices, oil being foremost, which has a particularly marked impact on short-term real bonds. A macro-hedging instrument against the rise in price indices, and an equally attractive instrument in terms of valuation.

Theme #6. **Risky assets** encouraged by the repricing of American growth, at least initially

During the period when growth in the US, its inflation rate, its policy mix, and its monetary policy are being repriced, risky American assets (equities and corporate bonds) and the US dollar have the edge. But be careful: American companies have been releveraging heavily for two years (higher debt levels) and are now sensitive to interest rate increases. The financial health of European companies is better from this point of view. We remain conservative on the lowest-rated segments of the US HY segment. On the euro market, continuation of the CSPP is a major factor supporting the euro credit market. Our models show that the average spreads of CSPP-eligible IG non-financial bonds have become unattractive compared to their break-even values. Financial securities still offer attractive valuation.

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" Inflation-linked bonds: a macro-hedging instrument against the rise in price indices, and an equally attractive instrument in terms of valuation "

In 2016 and continuing in the new year, investors are buying bonds for capital appreciation and equities for income... which is not an ordinary trend, and generally not sustainable. We have identified **four possible scenarios for American equities**.

- **Scenario #1.** A fairly positive scenario (reflation): long-term rates rise, but corporate profits also recover. "Value" equities outperform under such conditions, particularly banks. The eurozone and Japan should benefit from this.
- **Scenario #2.** Another fairly positive scenario (fluctuation): profits do not actually recover, but long-term interest rates remain low. "Quality" equities outperform. Emerging and American markets will outperform the others.
- **Scenario #3.** The most "positive" scenario (pre-bubble): long-term interest rates remain low, while profits start to rise. This situation would be conducive to the formation of bubbles, driving growth stocks to outperformance. Emerging markets would get the most out of such a scenario. The next step (post-bubble) is a problem.
- **Scenario #4.** A negative scenario (relapse): long-term rates recover, but not profits. Adopt a defensive attitude in such a situation. The American market would do better than other developed and emerging markets, and the dollar (countercyclical currency) will add more outperformance.

These four scenarios each encourage radically different positioning. The likelihoods for each scenario are fairly similar over the horizon in question, but it is possible that the situation temporarily moves through scenario 1 (reflation) before continuing on to scenarios 2 (fluctuation) or 3 (bubble), or even 4 (relapse) some time later.

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Theme #7. **China:** significant risks and challenges, but situation still under control

No hard landing in China. Certain economists have been expecting a hard landing in China... for 15 years. There's been no emergency landing, but China's business model has changed over the past decade. Remember, growth is not as focused on exports as it was, so domestic demand has become the primary growth driver. This balances out growth and makes it more favourable to global financial stability, but the (still ongoing) transition results in excessive use of credit (more than half the increase in the emerging world's corporate debt has been in China); private debt has soared, industrial competitiveness has eroded, and productivity gains are down. In other words, potential growth has taken a dive (10% 15 years ago, currently around 5%). The question is not whether future and potential growth will be lower. That is already a given. Rather, it's whether growth can sink much lower than its current potential. To put it another way, is China headed for a large-scale economic crisis? The most recent indicators have reduced this risk, with annualised growth in GDP stabilising around 6.7% over the past three quarters. The introduction of 45% customs duties (which is part of President-elect Trump's plan) would be conducive to the start of a strongly negative spiral for China - and for financial stability (this is not our scenario). A forced landing / fears of a forced landing would have a very negative impact, and its cascade effects would be especially disastrous:

I. Vulnerable banking systems,

II. Vulnerable international financial system,

III. Vulnerable private debt in China,

IV. Impact on commodities and emerging countries,

V. Impact on the currencies of commodity-exporting countries (advanced countries and EMG countries), and so on.

VI. The Fed would stop 'tightening', while the ECB would continue/ accelerate its QE.

> "A forced landing / fears of a forced landing would have a very negative impact, and its cascade effects would be especially disastrous"

Opening the capital account is unquestionably China's top challenge for the years to come. China is opening its capital account step by step. It is not a 'big bang' like some Scandinavian countries may have done in the mid-'80s, and this is a wise decision in light of their different pasts. There is still a long way to go due to major consequences on monetary policy, capital flows, and so on. Deregulation of the capital account places constraints on the economic policies carried out. It would certainly lead to:

I. A less independent monetary policy;
II. A more flexible, floating (or almost floating) exchange rate regime;
III. A greater role for international players in determining asset prices;
IV. Mandatory transparency of economic indicators, state-owned companies, monetary, fiscal and foreign exchange policies;
V. Independent statistical offices.

China also clears the path to globalising the RMB. Still a long way to go because of the US dollar's ultra-dominant position. Japan never succeeded in promoting the yen as an international currency. The lessons for China from the Japanese experience are crystal-clear:

I. The liberalisation of capital markets represents a prerequisite for the internationalisation of the currency;
II. Confidence in the economy is crucial;
III. Domestic markets have to be attractive to foreign investors and foreign financial institutions in order to increase the need to use the currency;
IV. Bargaining power in trade invoicing currency helps to install the currency as an international one;
V. Domestic financial centres must be developed as regional centres;
VI. The relative stability of the RMB in Asia is a prerequisite for this currency to be used and accepted as an international currency, and as a substitute for the US dollar.

The yuan will increasingly take on an international role. In this respect as well, the path is still quite long for the renminbi, but progress is visible nonetheless - to the point where many sovereign funds and central banks have diversified their assets in favour of the renminbi (both for their reserves and for their investments) or intend to do so. This is the case for the central banks of Australia, Austria, Brazil, Indonesia, Malaysia, Korea, Thailand, Pakistan, South Africa, Venezuela, Nigeria, Hong Kong and Macau. The Reserve Bank of Australia (Australia is an important trading partner for China) invests around 5% of its foreign currency assets in renminbi securities in China. The Japanese Finance Ministry, the Kuwait Investment Authority and the World Bank also hold renminbi bonds. Our results clearly suggest that the RMB has risen as a major reference currency for EMEs and its influence seems to go well beyond its neighbourhood area. Note that the RMB as a reserve currency held by foreign central banks will increase after the SDR inclusion in October 2016. Some projections conclude that by 2020-2025, 30% of China's trade should be invoiced in RMB (compared to 20% currently), making the RMB the fourth largest global payment currency. Daily RMB FX turnover would exceed $500 billion (three times higher than its current level). The offshore RMB (dim sum) debt market would also amount to $500 billion (up from around $90 billion in 2013). China would represent 30% of global equity market capitalisation (bigger than the US) and 20% of the global fixed-income markets (as large as the euro market). However, there are prerequisites for this, in terms of the RMB's exchange rate regime and capital controls, and it is not as simple as it would seem.

There will be no brutal devaluation of the yuan, but implementing a strict protectionist policy in the United States would be fatal, with China becoming incapable of pursuing the current exchange policy (managing a gradual, orderly depreciation of the RMB). It's a very low risk, but potentially a very harmful one, because China's top challenge now is to open its capital account. Attracting international investors means accepting a less independent monetary policy, a more volatile exchange rate, different rules between onshore and

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offshore markets, more volatile capital flows, less easily administered markets (more dependent on international investors), and greater transparency on the status of businesses, and, more precisely, public businesses. A surprise devaluation would be the start of a more intense currency war, especially in Asia. Monetary policies would become extremely accommodating to keep currencies from appreciating. Plan on the euro's appreciation (EMG currencies make up more than 70% of its effective rate), with a negative impact on the European economy.

Theme #8. **Emerging markets:** a triumphant return in the second half?

The emerging markets are still attractive, given their current advantages:

I. For investors - specifically European investors - EMG debt is an oasis of spreads in a desert of low/negative rate securities;

II. A good many EMG currencies are bargains, some significantly undervalued;

III. Exchange rate regimes are flexible, which is an asset for EMG economies. The currencies' depreciation has avoided a sharp internal devaluation (recession/depression) and promoted stronger recoveries compared to past crises;

IV. Debt in USD is much weaker than in the past, and debt's sensitivity to appreciation by the dollar is greatly diminished;

V. The emerging markets' fundamentals are distinctly healthier today than in 2013, when the Fed announced the reduction and end of its asset purchase programme (Fed tapering). The emerging countries' heavy dependence on inflows for financing the current balance deficit has decreased. We are seeing much healthier balances of payments across emerging markets, including in the Fragile Five.

VI. In 2013, the market was in no way prepared for commentary surrounding tapering of QE by the FED. As 2017 dawns, future rate hikes by the Fed are already fully reflected in prices, and discussions about the reduced asset purchases by the ECB and the BoJ are already omnipresent, as is the general debate over the inefficiency of monetary policies as they stand. While the argument for market complacency is worth discussing, we do not think the shock from tighter DM monetary policy would be as significant as it was in 2013.

VII. The three years preceding 2013 saw unprecedented inflows into emerging market assets and very high returns. The emerging markets were heavily overweight. By contrast, the three years preceding 2016 saw three years of almost no inflows, very negative returns on local debt and largely flat returns on hard currency debt. Therefore, the underlying technical factors going into 2017 are healthier than they were in 2013.

All in all, we think that emerging debt could prove to be surprisingly resilient. For the emerging markets, we can distinguish two different scenarios. Either the new US government causes deficits and recession, which will be extremely damaging for risk aversion, volatility and risky assets such as emerging country assets. Or the new government is able to boost growth expectations, which will go hand in hand with a resurgence of some inflation expectations and a rise in long rates and fed fund rates. At first mixed for the emerging countries, this scenario of stronger growth should be favourable to them, and technical factors, fundamental factors and the valuation aspects developed above will return to the foreground. In short, it's not because rates are on the upswing that the emerging markets are suffering. The reason they're rising is much more significant. If this increase is caused by rising growth expectations, the emerging markets will profit from it. That's the scenario we believe in, at least for 2017.

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Theme #9. **Currency markets:** the “adjustment variable” of 2017?

In the absence of interest rate movements, look for currency fluctuations. It is budget and fiscal policies that will be amended, with the US in the lead. This will have repercussions on inflation growth expectations, and foreign exchange rates. Keep a US dollar bearish bias in the short term. Count on a significant recovery by emerging currencies in the medium term. Expect the euro to first depreciate against the USD, and then the euro's actual price to depreciate during the second half of 2017.

2017 opens with currency misalignments still substantial. Lots of fluctuation in 2016, but it's not over yet... the RUB, the BRL, and the MXN are known to be undervalued right now with regard to our foreign exchange balance models (BEER and FEER). Look for these currencies to appreciate in 2017.

The euro's case is interesting: better fundamentals than two or three years ago, but still with clearly identified weaknesses; a sometimes complex political situation, but **significant current surpluses that have been serving as a parachute for the euro for several years now**. An appreciation of the euro seems difficult in light of the current situation, but counting on sharp depreciation does not seem credible to us either. If the euro does weaken, it will be caused by the emerging currencies' appreciation, which would, furthermore, be a considerable advantage for the European economy and its equity market, both of which are sensitive to the exchange rate.

Theme #10. **Political situation** in Europe and Brexit: complex and crucial issues for financial markets

We are witnessing the rise of populism here and there all over Europe... and elsewhere: Parties that are most often anti-establishment, looking for a bigger fight against corruption, angry about increasing social inequality ("the great divide"), hostile to reforming the health care and pension systems or the job market, sometimes favourable to greater protectionism, promoting anti-EU themes, protectionist/security issues, and so on). **Far-right parties are on the rise in the core European countries, while far-left parties are making gains in the peripheral countries. And 2017 is a crucial electoral year in Europe**: France (April – May), Germany (autumn), and general elections in Italy in February 2018 at the latest. No major risk in France (indeed, we can count on a solid France-Germany pairing if both Fillon and Merkel are voted in), but the risk is higher in Italy, where the "Five-Star" party could come into power (anti-establishment but divided on Europe). A technical government has been appointed, whose goals include overhauling electoral law... just a few months away from the general elections. The other cause for concern is the United Kingdom and its decision to leave the European Union. The **Brexit issue should technically begin** in Q1 2017. European member states are committed for a long process of negotiations, two years or less if an agreement is reached, two years or more otherwise... unless a single country wants to stop negotiations after two years. In substance, the UK wants five things: no customs duties between the EU and the UK; return to an independent trade policy; have an independent immigration policy; have total access to the single market (goods and services), and stop contributing to the Union budget. The UK won't get this: no country has until now, not Switzerland (no customs duties and an independent trade policy, but no independent immigration policy, no single-market access for services, and contribution to the Union budget), not Norway (no customs duties, single-market access for goods and services, but no independent trade policy, no independent immigration policy, and contribution to the Union budget). No doubt the discussions with UK will be handled in light of what has been negotiated with other countries, which, furthermore, is the only way to quickly negotiate an agreement.

Theme #11. **Geopolitics and immigration:** recurring, long-lasting and destructuring factors

Geopolitical risks have become recurrent, and they must be systematically factored into portfolio building and macro-hedging strategies. **International tensions are resulting in unprecedented migrant and refugee flows, which is one of the biggest issues in the years to come for many countries**. Clearly the stakes are political, but also economic (impact on the job market, impact on potential growth for both host and home countries, impact on the major budget equilibria, etc.) and social (rapid integration of migrants,

> "In the absence of interest rate movements, look for currency fluctuations"

> "2017 opens with currency misalignments still substantial"

> "2017 is a crucial electoral year in Europe"

> "Brexit: the UK won't get what it wants"

> "International tensions are resulting in unprecedented migrant and refugee flows, which is one of the biggest issues in the years to come for many a country"

cohesion of societies, etc.). Not counting refugees, **population movements will increase,** and the UN estimates that 80% of the population growth in host countries will be directly tied to these migrant flows. By 2050, the top net receivers of international migrants (more than 100,000 annually) will be the United States, Canada, the United Kingdom, Australia, Germany, Russia and Italy. These migrants are predicted to come from India, Bangladesh, China, Pakistan and Mexico.

Theme #12. **Macro-hedging** strategies remain a priority

Redesigning/preparing/implementing macro-hedging strategies is necessary because the new extreme risk factors identified (China, long rates, recession, political crisis in Europe, etc.) are all potential generators of a major crisis. Lest we forget, over the past two years we have had alerts for each of these areas: in 2016, China changed its exchange rate regime and is managing the yuan's gradual depreciation; Brexit has revealed the UK's weak points but also Europe's (number one, no Plan B; number two, no strong cohesion). In 2015, we saw the first warnings (European crisis, Fed, China, yuan, emerging markets, commodity prices, liquidity, volatility); commodity prices fell; low liquidity in some markets (thought to be liquid) drew much commentary; in short, well-identified risks - and the fact that they were given low probabilities is not reassuring. The probabilities of occurrence are still hard to quantify but this is not the main point: the consequences of these risk scenarios are so severe that asset allocation and macro-hedging activities should take them into consideration. Traditional macro-hedging instruments: long vol (the natural habitat of financial crises), long gold (the only asset to appreciate during the different crisis, recession... and inflation phases, and the only one that does not represent any debt to anyone, government or corporate), and long USD (because the dollar is a countercyclical currency: it appreciates when global equities drop).

> Redesigning/preparing/implementing macro-hedging strategies is necessary because the new extreme risk factors identified (China, long rates, recession, political crisis in Europe, etc.) are all potential generators of a major crisis

Asset allocation: how it's (apparently) going to change in 2017

Our asset allocation changed rather markedly in 2016, given the major - and unforeseen - events like the UK referendum and US elections.

> Our asset allocation changed rather markedly in 2016

As the year began, we initially had the following asset allocation: long corporate vs. government, long periphery vs. core, long euro vs. US sovereigns, short banks and financials, long gradually in inflation-linked bonds, long euro vs. US equities, long "quality" in the US, long "value" in Europe, long equities vs. corporate bonds, long EMG equities, long EMG local debt, long EMG currencies, as well as long real estate and long private debt (in an effort to find yield in the low-rate universe). In terms of foreign exchange, we have spent the bulk of the year long USD and short GBP overall.

In response to the US elections, we reduced total risk and adjusted some exposures. The repricing of US growth, the repricing of the Fed, the repricing of inflation expectations, the repricing of the policy mix (less monetary policy, more budget, fiscal, and trade policy), the upcoming debates on customs duties, immigration, and more gave the US the edge and inspired greater conservatism toward the EMG. Our asset allocation quickly became the following:

> Edge to the US

INTEREST RATES

- Long corporate vs. sovereign bonds in Europe, but reduced risk allocation (tense political situation)
- Long periphery vs. core, and conservative on Italy
- Short US sovereign
- Long euro vs. US sovereigns
- Long banks and financials, and conservative on Italy
- Long US vs. Europe corporate bonds (with one reservation: (releveraged) US businesses' sensitivity to ongoing rate hikes)
- Hold long positions in inflation-linked bonds

EQUITIES
• Long US vs. Europe equities • Long Cyclicals, "Quality," domestic factors, Small and Mid-Cap in the US • Long "Value" (and, to a lesser extent, cyclicals) in Europe • Long equities vs. sovereigns
EMERGING MARKETS
• Neutral to short on EMG equities (very high selectivity) • Long EMG hard currencies debt vs. local debt • Short EMG debt (local debt and hard currencies debt) first • Short EMG currencies • Long Russia (exiting recession, outlook for US sanctions to be lifted, undervalued currency) • Short China
Others (some segments favoured by Trump plan)
• Long real estate • Long private debt, particularly Long infrastructure debt (projected to be boosted by Trump plan)
FX
• Long USD: no matter what the outcome of debates with Congress, preliminary debates were turning promising for the dollar and US equities, and favourable to an increase in long rates.

What will become of our asset allocation in 2017?

Our target is based on **several key assumptions**:

- **US bond yields rise will not last: we are experiencing an episode of range shift, not a regime shift.** The rate differential with Europe or Japan in particular, or term premiums should soon return interest to US government bonds.
- **the Fed will not be aggressive in its rate hikes** (we will still not be in a monetary normalization cycle, which is very different from what Fed had done in 1995 or 2004). It will take advantage of the current situation ("repricing" of growth, of economic policy and inflation expectations) to reconstitute room for maneuver, but real conditions (potential growth, corporate indebtedness, inflation ...) should not allow it to carry out many monetary tightening.
- **While US growth will certainly benefit from a more generous fiscal and fiscal policy, it will not move towards a new cycle of growth.** Betting on an extension of the current cycle is reasonable at this point ... believing in a new cycle of growth or an improvement in potential growth is excessive for the time being.
- **EMGs still have many assets** (valuation, undervalued currencies, underweight in the portfolios, capital flows ...) and we expect a good performance of these markets in 2017.

> "The EMG still offers many opportunities"

As a result, our target allocation for the second half of 2017 (or even before) is as follows:

INTEREST RATES
• Long corporate vs. sovereign bonds in Europe • Long periphery vs. core • Long US sovereign vs. euro core sovereigns • Long Europe vs. US corporate bonds

EQUITIES

- Long Europe vs. US equities
- Long “Quality” in US
- Long “Value” in Europe
- Long euro vs. sovereign equities

EMERGING MARKETS

- Long EMG equities
- Long EMG local debt
- Long EMG currencies (especially vs. euro and USD)

Others (search for yield and market development)

- Long real estate
- Long private debt (acceleration of the disintermediation process, expansion of market and opportunities)

FX

- Short GBP (starting negotiations between EU and UK)
- Neutral USD

The continued increase in US long-term rates, declining diplomatic relations between China and the US, intensified geopolitical risks and tensions (Syria, Turkey ...), a deterioration in the European political situation or the Brexit negotiations that go wrong, are all factors that may prompt us to revise our target ... and to protect our portfolios punctually.

> “Several risk factors still at play”

> 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	→		⊡		

The US elections have delivered their verdict. The election of Donald Trump is a real shock of uncertainty for economic policy, and fiscal and budgetary policy in particular. Repricing of economic growth goes hand-in-hand with a rise in (short and long) rates and an appreciation of the dollar. The post-Brexit stress fell, but we know that the UK is expected to trigger Article 50 before the end of March 2017. The forthcoming negotiations are sure to be difficult and will begin against an increasingly delicate European political backdrop (elections in several countries, including France and Germany). The ECB’s decision to continue, amend or stop its QE will be of paramount importance.

As such, we are maintaining 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

- Preference for US vs. Eurozone equities
- US Sectors:
  - Overweight cyclicals, financials, small and mid caps, domestic plays
  - Underweight global trade plays
- Emerging markets: globally cautious. Within EMG countries:
  - Overweight India, Peru, Philippines, Russia
  - Neutral on Indonesia, Brazil, Mexico
  - Underweight China, Taiwan, Greece, Turkey, South Africa
- Positions in EMG currencies drastically revised down

> Bond portfolios

- Underweight US govies
- Overweight position in Euro credit reduced; overweight position in US credit increased
- Short duration on US, GBP and JPY
  - Duration: globally neutral to short, with a short bias on negatively yielding segments
- Emerging debt:
  - Still prefer hard currencies debt (long USD),
  - Risk on local debt drastically reduced
- Slightly long in GBP vs. EUR (tactical play)
- Long USD vs. EUR
- A few long positions in EMG commodity currencies

> Diversified portfolios

- Overall risk reduction
- Long positions on “value” factor in developed countries
- Overall positive on Japanese equities (JPY hedged)
- Few long positions in EMG currencies, EMG debt and EMG equities
- Keep the overweight in euro peripheral bonds (excluding Italy) vs. core
- Long US govies (carry and macro-hedging purposes) maintained
- Corporate bonds: positive on HY and IG, especially in the US
- Positive views on breakeven inflation (all zones)

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