Risk Factors

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The table below presents 16 risk factors with probabilities assigned. It also develops the most credible market impacts.

[RISK # 1] The perception of a significant change in the US policy-mix [PROBABILITY] 75%

ANALYSIS D. Trump's election undoubtedly represents a great change in the philosophy of America, less determined now by a logic of "world policeman" and more self-centred, according to the new president's statements. Beyond this major inflection, the question is also now whether economic policy will be strongly altered, notably through fiscal and tax policy. How will monetary policy accompany these changes? These are all crucial questions. We know that tax cuts and a revival of infrastructure spending are planned, and that the impact on the budget deficit can be very high, with the usual consequences on long rates, public debt … and monetary policy. We also know that the American Congress (even if it is a Republican one) will not unconditionally back the new president on these subjects: it is indeed not favourable to large budget deficits. Having said that, even if the changes remain moderate with regard to the campaign promises, not betting on significant changes would undoubtedly be a mistake. Certain proposals, such as the "Border tax proposal" represent, if they were adopted, genuine "game changer".

MARKET IMPACT The victory of D. Trump brings uncertainty on many points: its international role, NATO, trade agreements, climate agreement, anti-migrant policy, trade policy, protectionism and possible tariffs … Its future actions represent an additional risk for the financial markets (notably on the dollar, ambient volatility and long rates). The risk of a major shift in economic policy, leading to a widening of deficits but also to a surplus of growth, a renewed vigour of the dollar, a resurgence of inflation expectations… is not marginal at this stage. It is all the more important that it will be necessary to wait for negotiations with the Congress before having answers to these questions (taking office on 20 January, then beginning discussions with Congress).

[RISK # 2] Italy: a referendum on "Italexit", the next step? [PROBABILITY] 15%

ANALYSIS The appointment of a technical government (headed by Paolo Gentiloni) and the extension of the ECB's asset purchasing program have reassured the Italian financial markets, but it is now a matter of reviewing the electoral law as the general elections take shape. Initially planned for February 2018, the financial markets fear on the one hand the holding of early elections which would lead to the taking of power of the party "populist" Five Stars, and on the other hand the holding of a referendum on the participation to the European Union ("Italexit"). The rise of populism (which is synonymous with rejection of the establishment, rejection of traditional parties, rise of protectionism, rejection of globalization, anger against rising inequalities, refusal of centralization, hostility to reforms of social systems, etc.) is also a reality in Italy. This would represent a major change after 5 years of political stability. This would undoubtedly be the worst case scenario, which could initially lead to political instability / crisis and undoubtedly lead to a period of stopping for reforms. Let us recall, however, that the five-star party is more an anti-establishment party than an anti-European party, but that the Italian people are among the countries of Europe the least enthusiastic about the euro. That is to say that a referendum on Europe, if it were to take place, carries lots of uncertainties.

MARKET IMPACT The prospect of early elections - if that were to take place - would trigger a phase of political instability. This is bad news for this country, which is lagging behind in terms of economic growth (especially in comparison with Spain, its "comparable" market). Its debt is nevertheless protected by the ECB, which has just confirmed the extension of its QE, which makes it possible to attract investors (seeking yield and spread). In the event of a referendum on Italexit (still anti-constitutional at present), the Italian bond market would represent a specific risk, and interest rate spreads would further deteriorate due to a "repricing" of the Italian risk. Political instability would also weaken - strongly - its equity and interest rate markets.

[RISK #3] Misinterpretation of the Fed's intentions… or misjudgement by the Fed [PROBABILITY] 30%

ANALYSIS The election of D. Trump blurs the messages a little: it is doubtful that the new president confirms J. Yellen for a second term in 2018, and it is also known that he criticized the "complacency" of monetary policy. It is difficult to understand the message: how to have at the same time stronger growth, a weaker dollar and a more restrictive monetary policy? A misinterpretation of the intentions / decisions of the Fed was already a major risk factor. Since the elections, the situation has gotten worse. With GDP growth of around 2%, inflation close to 2% and a full-employment situation, the Fed funds rate should be, in a normal cycle, much higher than it is today. The Fed is technically "behind the curve". But this is all the more true given that, in half of cases (six out of the last 12 times), since 1945, monetary tightening cycles have been followed by a US economic recession within two years. This is undoubtedly what the market is fearing in the event that the Fed moves too quickly and, in particular, too strongly. For the moment, the Fed remains cautious. It is well aware that growth levels and the current cycle have not up until now warranted a significant increase in rates, and, that the reversal of an ultra-accommodating monetary policy that has been in place for eight years carries more importance than usual. In the Fed's case, it is looking to keep the dollar from appreciating (the Fed's models show that a 10% appreciation in the real effective dollar is equivalent to 175bp in monetary tightening). Inflation indicators are now close to the Fed's target, and the US central bank is

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expected to raise its rates twice during 2017. Beware however: the Fed must avoid any communication errors. Markets could react poorly if rates are increased prematurely, excessively or without a sound rationale, or in case of an important surprise.

MARKET IMPACT If the Fed fumbles, we will have to count on a sharp downturn in equities and on contagion into the emerging markets, which have already been weakened. Such a situation would widen spreads and rates between Europe and the US, and further weakening the euro, two arguments in favour of European risky assets.

[RISK # 4] A "hard landing" for China / the credit bubble bursts [PROBABILITY] 20%

ANALYSIS China's business model has changed in the past decade. Growth is not as export-led as it used to be, and domestic demand has become the key driver for growth. Such an evolution has some drawbacks: there are signs of excessive lending, debt is ballooning, industrial competitiveness has eroded and productivity gains are falling. In simple terms, potential growth is down. The question is not whether future and potential growth will be lower. That is already a given. Rather, it is whether growth risks falling sharply (and far) below its potential (5% at present vs. 10% 15 years ago). In other words, will China experience a large-scale economic crisis? A more severe contraction of Chinese growth would add to an already long list of global deflationary pressures. The most recent indicators have reduced this risk, with annualised GDP growth stabilising around 6.7% for the last three quarters. The introduction of 45% tariffs (as D. Trump promised during the campaign) would be conducive to the initiation of this negative spiral, but we do not believe at all in the adoption of a such a measure.

MARKET IMPACT Such a scenario would have a very negative impact, and its cascading effects would be especially disastrous: vulnerability in the banking systems, vulnerability in the financial system, vulnerability from China's public and private debt, impact on commodities and emerging countries, impact on the currencies of commodity-exporting countries, advanced countries, and emerging countries… The Fed would cut its "tightening cycle" short, and the ECB would pursue its QE.

[RISK # 5] Collapse of global growth [PROBABILITY] 15%

ANALYSIS A hard landing by the Chinese economy would mean a plunge in global growth, but other circumstances are possible. The continued decline in commodity prices and global trade, an excessively restrictive US monetary policy, and the structural weakness of European economic activity are all stirring fears of a decline in global growth. Until now, the slowdown in the emerging world has been a tangible reality, while the "advanced" world has been moving forward for four years now. Another slowdown in the "advanced world" could come from the secondary effect of the EMG countries (drop in exports), another dip in investment, jobs… in short, from domestic demand (mainly private consumption), at present the key driver for growth.

MARKET IMPACT Putting aside the use of expansionist economic policies (especially the fiscal policy), we may fear the return of a currency war, among the emerging countries on the one hand, and between the advanced and the emerging world on the other. Expect a dramatic underperformance by risky assets, equities, and credit.

[RISK # 6] A recession in the United States [PROBABILITY] 20%

ANALYSIS We expect growth of 2% in 2017 (vs. 1.6% in 2016), followed by a slight acceleration in 2018 (2.2%). Growth is therefore likely to remain slightly above its potential over the next two years. At this juncture, a recession in the United States is not a possibility, but the Fed's lack of room to manoeuvre is worrying. The current situation is totally different from 2004-2006. Over those two years, the Fed managed to hike interest rates 17 times—a total of 400 basis points—giving itself leeway, which it was quick to use once the financial crisis hit. Today that context is very remote. The Fed is behind in its economic cycle and financial stability, and to a lesser degree the US dollar, cannot afford such interest rate hikes. What is also worrying is the uncertainty about the future economic policy. The analysis and quantification of D. Trump's campaign program leads to the anticipation of a recession: protectionism (and impact on Mexico and China in particular), anti-migrant plan (with a reduction in the labour force and the population, as well as an increase in the cost of labour), renegotiation of commercial treaties, etc. But it is unlikely that this program will be adopted as it stands, and we should instead focus on a slightly better prospect (at least short term) for US growth.

MARKET IMPACT A recession in the United States would be catastrophic for the global economy, and Europe, despite being in better health, would not be spared the impact. Short rates would remain low for a very long time and the Fed, with no leeway in terms of conventional monetary policy, would have no choice but to go ahead with QE4. Do not expect a positive impact on risky assets. The initial impact will be negative, and the lack of credibility of central banks would certainly add volatility and stress. Expect further, and substantial, budget imbalances.

[RISK # 7] Sharp devaluation of the yuan [PROBABILITY] 10%

ANALYSIS For a few days in the middle of August 2015, China gave the impression that it was abandoning its exchange rate policy, preparing the markets for a major depreciation of the yuan (in 1994, it devalued the yuan by 30%). These same fears reared their

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heads again in early January. Until now, China has used monetary policy, budgetary policy, fiscal policy, and revenue policy as stimulus tools, careful not to use the exchange rate policy. Moreover, it promised the G20 it would not, and the yuan is now part of the SDR (and has been since 1 October). In 2016, China amended its foreign exchange system, and it is managing a gradual depreciation of the yuan. The implementation of a protectionist policy in the United States would be fatal, the Chinese authorities would be incapable and unwilling to pursue this FX policy, especially since the yuan is not notably undervalued. Beyond the very negative immediate consequences on the financial markets, an abrupt devaluation (of at least 10% in one day) would, without a doubt, be interpreted as an admission of weakness in terms of the economic policy as a whole. A very low risk, but with potentially very great harm, because China's top challenge now is opening its capital account: attracting international investors means accepting a less-independent monetary policy, a more volatile exchange rate, different rules between the onshore market and the offshore market, more volatile capital flows, less easily administrated markets that are more dependent on international investors, greater transparency on the state of businesses, and, specifically, State-owned businesses… in short, a fairly radical change in governance. A strong devaluation of the yuan would be a very bad decision.

MARKET IMPACT In this type of scenario, expect a widespread downward movement in the markets. 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. A blow to the euro, and to the European economy, because EMG currencies make up more than 70% of its effective rate.

[RISK # 8] **Continued slowdown in the emerging economies (commodity prices fall again)** [PROBABILITY] **20%**

ANALYSIS Falling commodity prices, the dip in Chinese growth, and the coming shift in US monetary policy are all factors that, over recent years, have raised fears of a repeat of the 1997-1998 crisis (when emerging markets collapsed across-the-board). We should remember that emerging markets have been under stress since the US ended its QE programmes. Asia had been able to withstand that stress, driven by the strength of the Chinese economy and its ability to curb difficulties, and because it is essentially a commodity-consuming zone. Corporate defaults and leading activity indicators have occasionally put the markets on high alert, but the resources brought to bear by Chinese officials (cuts in interest rates and in mandatory banking reserves, injection of liquidities, fiscal and tax measures, maintaining currency policy, etc.) ultimately put everything right. The risk is that domestic demand will unravel and economic policies will become completely ineffective. This risk has nevertheless declined during recent months: the rise in oil prices (increased cohesion at OPEC) and the influx of capital (except for China) have, in particular, given these markets fresh colour.

MARKET IMPACT Even though the drop in oil prices is, and has been, a plus for commodity-consuming advanced countries, it is hard to believe that these countries would be totally isolated. With the decline in commodity prices, we should count on the continued decline in EMG currencies as well as capital flows out of the EMG. Choose asset classes from the advanced countries, and safe havens.

[RISK # 9] **The post-Brexit issue weakens the United Kingdom in a lasting way** [PROBABILITY] **70%**

ANALYSIS *"Brexit means Brexit, and we're going to make a success of it"*. Such was Theresa May's position on the day she was appointed Prime Minister. *"There will be [...] no second referendum,"* she added. *"There must be no attempts to remain inside the EU, no attempts to re-join it through the back door, and no second referendum. The country voted to leave the European Union, and it is the duty of the Government and of Parliament to make sure we do just that."* We now know a little more: the Prime Minister has announced that Article 50 will be triggered in the first quarter of 2017. According to estimates, the impact on the GDP would be significantly negative. The UK could "lose" between 2.5% and 9.5% of its GDP. Trade volume and costs would be affected, specifically in financial services, chemicals, and automobiles, all sectors that are highly integrated in the EU. The risk for the UK resides in its future capacity to trade freely on the single market, to acquire the desired independence without the EU's constraints. It seems unlikely, and in any case that is what is at stake in the negotiations that will begin no later than the second quarter of 2017… and that could last two years (to find out more, read our report, "*Post-BREXIT in a few questions and answers*", Cross Asset Investment Monthly Strategy, Amundi, July 2016). Let's be clear (fair) though: it is currently very difficult to say what will happen and even to be sure that the Brexit will really happen. The lack of any contingency plan in the UK, the lack of negotiations between the UK and the EU countries (pending the activation of Article 50), and the nature of the debate (which opposes pragmatists to ideologists of the Brexit) make the situation rather confused.

MARKET IMPACT In such a case, we would expect additional weakening of the pound sterling and long-term GDP of the British economy, two factors that could prolong the monetary status quo. Without a doubt, we would also see increased fragility in eurozone financial assets.

[RISK # 10] **A new European crisis tied to Brexit** [PROBABILITY] **20%**

ANALYSIS Brexit is unlikely to impact the EU too much, from a purely economic standpoint. Hardest hit would be those with close ties to the UK, especially Ireland, but also Luxembourg, Belgium, Sweden, Malta, and Cyprus, if we look at the nature of exports, direct investment flows, and the financial sector. The risk is primarily a political one: that other European countries might extol a Europe "à la carte,"

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and/or demonstrate deep divisions in terms of how to handle the UK's exit. The European institutions are regularly showing their limits because the "dogma of convergence" did not prepare them for such risk scenarios. The task was to respond to challenges like Europe's governance deficit, the lack of coordination in budgetary policies, the failure of supervision of budgetary imbalances, competitiveness gaps between countries, the unfinished nature of the mechanism meant to support countries facing difficulty and the failure to appreciate the interdependence of member states (while the ECB's anti-contagion mechanism has evolved significantly, the same cannot be said on the budgetary front). The recent UK referendum has added a new layer of uncertainty. Managing the UK's exit from the EU is akin to managing the most complex divorce in history. One thing is sure: this is an important test of Europe's capacity to (once again) manage a crisis, convince Europe that there is a plan for it, and remove any attempts at a Europe "à la carte" that could pop up here or there in the EU. A new European crisis, if it were to occur, could be fatal, unless there is a (highly unlikely) great leap towards federalism. Note that negotiations with the UK will come right in the middle of an election year in France and Germany, which is most certainly not an ideal political configuration. It will be necessary to reconcile the Europeans with the European idea, and in particular to reassure the Eurosceptics. It will not be easy. Before the Brexit and before the US elections, the European situation was already complicated.

MARKET IMPACT The negative impacts are all too well known: widening of sovereign and credit spreads, rise of volatility—only this time it would certainly be accompanied by a severe weakening of the Euro. A new European crisis could very well confirm the scenarios of the zone breaking apart, or, at the very least, the weaker countries exiting it… unless the exit scenario tempts the most solid of them, which is highly plausible, because they will end up becoming tired – from a political standpoint – of economically and financially supporting the struggling countries.

[Risk # 11] Greater financial instability — [probability] 40%

ANALYSIS Action by central banks has enabled financial stability to return. Lower short- and long-term rates, reduced volatility and tighter credit spreads are all factors that have generated an environment of greater stability. However, beware. This stability has a contrived aspect that should not be underestimated. Central banks cannot resolve all of the problems by themselves (jobs, investment, growth, etc.) and, if the current conditions do not improve more significantly, a certain level of disillusion/disappointment may well set in, which could in turn become a source of instability. Moreover, monetary policies have reached their limits, both negative rates and QEs, and it is quite difficult to expect any more from them. The macroeconomic response would eventually come from fiscal and tax policies, and, traditionally, public spending has far fewer stabilising virtues for the financial markets than lower interest rates.

MARKET IMPACT Greater financial instability would lead to a rise in volatility and credit spreads, particularly in Europe, where the labour market is weaker and the political and social risks are greater.

[Risk # 12] Liquidity crisis — [probability] 20%

ANALYSIS Aside from the risk scenarios outlined above, which could lead to the liquidation of positions and/or portfolios, it is worth recalling once again that the prevailing liquidity constraints call for additional caution. Since the 2008 financial crisis, the decline in investment banks' inventories, the regulatory constraints that have led major players to buy and retain large volumes of bonds, the reduction in proprietary trading and market-making activities and the domination of central banks through QE programmes have all "drained" the fixed-income markets, and closing a position or portfolio now requires more time (seven times longer than before the financial crisis of 2008 if we are to believe the Bank of England). Even though bid-ask spreads have tightened since the financial crisis (due to the drop in interest rates), tradeable volumes are down sharply, as is the speed of execution, two major reflections of liquidity—or the absence thereof. Remember, the less liquid the markets are the less prices reflect fundamentals, the more they can be manipulated, the higher the risks of contagion are, the higher and more unstable volatility is, and the lower their capacity to absorb shocks. Not exactly reassuring.

MARKET IMPACT This needs to be incorporated into investment decisions and should be taken into account in portfolio-building constraints and stress tests. Expect exit or macro-hedging plans for the less liquid portfolio segments or those that are likely to become less liquid in a crisis.

[Risk # 13] Banks collapse — [probability] 10%

ANALYSIS This risk seems highly exaggerated to us. Still, we are not optimistic: negative rates are penalising the banks, the high cost of capital reflects the weight of past crises, fears of a new crisis, uncertainty over regulation, and the difficulty for investors to discriminate against banks and against banking systems are the primary factors in the banks' underperformance – an underperformance that has been amplified by the UK referendum precisely because it added uncertainties over growth. Nor are we overly pessimistic. The banks of 2016 have nothing in common with the banks of 2008 or 2011: not only have they raised very large amounts of capital, but the ECB's anti-crisis system is now well-established, with banking supervision and stress tests. Moreover, the ECB's liquidity access facilities have drastically reduced specific risk and systemic risk for more than two years. However, it is easy to show the close link between the banks under-performing and long rates dropping into negative territory, and

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the question that arises is, in fact, how well the banks can contend with rates staying in negative territory. We do not anticipate a collapse, but rather continued pressures on profitability, increased by the issue of digitalisation, which is pushing the banks to reduce their debt and remain conservative on credit.

MARKET IMPACT Among the factors causing fragility, the inability to discriminate is no doubt the most concerning: Deutsche Bank, bad news on Italian banks, all of it has caused waves of stress, widening spreads, and plummeting bank securities. No need to go into detail on the implications on financial stability or the economies if there should be any bank failures.

[RISK # 14] Geopolitical risks intensify [PROBABILITY] 70%

ANALYSIS Geopolitically, the markets are now operating against a difficult backdrop: Syria, Islamic State, terrorist attacks and migrant flows are some of the forces weakening diplomatic ties among countries, especially in Europe. The United States officially entered this debate with the election of D. Trump and the anti- migrants plan (11.3 million if one believes in its program) and construction of a wall on the Mexican border. Do not expect these ongoing problems and conflicts to be quickly resolved. Incorporating geopolitical risks permanently into portfolios (systematically providing macro-hedging strategies) has more meaning now.

MARKET IMPACT There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are clearly identified and specific, but will this be enough to have zero impact on growth prospects or on the financial markets? Nothing is certain at this stage.

[RISK # 15] Political risks intensify (electoral calendar, populism, etc.) [PROBABILITY] 70%

ANALYSIS Politically, the markets are now operating against a very difficult backdrop. In 2017, many elections will be held, and some are especially important: general elections in the Netherlands in March 2017, presidential elections (23 April and 7 May 2017) and legislative elections (11 June and 18 June) in France, and general elections in Germany in the autumn of 2017. What's intriguing / concerning is the rise in extremist parties (far right-wing parties in Europe's hard-core countries, and far left-wing parties in the peripheral countries) and populism, which is reflected in protectionist, anti-immigration, and pro-public-deficit issues. Inevitably, some parties will be tempted by these issues, to please an electorate increasingly sensitive to widening inequalities and the tax burden. Historically, such policies (especially protectionism) generally result in phases of very weak (or no) growth and higher inflation. These phases of economic stagnation and strong public deficits inevitably lead to periods of recession and political and financial instability. We are not counting on the seizure of power from populist parties in France or Germany, but rather on the possibility of a strengthened Franco-German axis.

MARKET IMPACT The current political risks are clearly identified, but the prospect of major elections in Europe will lead to an increase in volatility and questions on the governance and future leadership of the EU. But will this have an impact on growth prospects or on the financial markets? The answer is yes.

[RISK # 16] A sustainable rise in European bond yields [PROBABILITY] 30%

ANALYSIS Since the financial crisis, expectations on long rates have always been wrong. At best, the anticipated decline was too low… but many have also believed that the resumption of growth in the advanced countries, with the United States in the lead was, with the rise in price indices, a good reason to anticipate a rise in bond yields. Underestimating the key factors such as - the fear of - secular stagnation, the role and impact of QEs, fiscal rigour in Europe (austerity), maintaining deflationary pressures… In short, long rates not only continued to decline, but they have mostly entered into negative territory, driven by key negative short rates (Europe and Japan in particular) and impacting in the same way high-quality corporate bonds. The yield search in this ultra low or negative desert favoured three oases of spreads: emerging debt, private debt and high yield debt. The risk of higher bond yields comes from the United States, not from the euro area. The increase in American long-term rates can come from five main sources: (i) a significant upturn in growth prospects, (ii) a reversal in interest rate policies, (iii) the end of QEs (failure to replace maturing bonds), (iv) a resurgence in inflation, or / and (v) a reversal of fiscal and fiscal policies. All of these factors (except perhaps the third) have increased in the United States. This is why the current debate in the United States or in Europe on fiscal and tax policies is crucial for interest rates. As far as the United States is concerned, we are expecting an extension of the current growth cycle (which is running out of steam), but not with the advent of a new growth cycle. As a consequence, it seems to us premature and excessive to rely on a permanent rise in US long-term rates, and this conclusion holds even more in the case of the euro area.

MARKET IMPACT The risk of bond yields rising significantly in Europe is low for historical reasons and in view of the European constraints caution in the case of the United States: sensitivity to long-term interest rates has increased with the releveraging of corporates (at its historical high), which weakens growth and pleads for a future decline in bond yields. It should also be noted that any rise in long-term rates is a hindrance to monetary policy and to the potential for higher interest rates. Another reason for doubting in a sustainable and ample increase in US bond yields.

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