Update on recent market events

January 19, 2016

Philippe Ithurbide
Global Head of Research, Strategy and Analysis at Amundi

Didier Borowski
Head of Macroeconomics at Amundi

The new year began with a sharp drop in the equity markets, a depreciation of the yuan and another closure of the Chinese market, a repeat of last August. The same fears have reared their heads: a collapse in US and global growth, a hard landing of the Chinese economy, inappropriate monetary tightening by the Fed, a complex geopolitical situation… The list goes on!

As the new year begins, it is worthwhile recalling current major trends. 2015 was a year marked by economic downturns and the further decoupling of the emerging countries from the advanced countries and of the United States from the Eurozone (in the area of monetary policy). 2015 was also a year of greater volatility, sharp exchange rate fluctuations, a further collapse of commodity prices… and an uptrend in credit spreads. Admittedly, rates have remained low and so have the spreads of the peripheral countries of the Eurozone; but the situation for corporate bonds, hurt by widening spreads and less liquidity, has become more complicated.

Overall, all of the major identified risk factors materialised in 2015 to varying degrees, which undoubtedly made it a pivotal year: a European crisis, an emerging markets crisis, concerns about world growth, concerns about a hard landing for China, the return of volatility, specific risks (Russia, Brazil, etc.), a further drop in commodity prices, sharp exchange rate realignments and fears of a currency war, geopolitical risks.

In particular, since the beginning of 2016, two of these themes (commodity prices and China) have come back to the forefront. In the present note, we explain why our broad views have not materially changed over the past few weeks.

Oil price fall: what is it the sign of?

The oil price has fallen by nearly 75% since mid-2014. It is the biggest oil counter shock ever seen. The recent drop, from US$ 50 (end October) to $ 28 on 18 January, is almost entirely supply driven. Indeed, there is currently a supply glut that will inflate further with (1) the new OPEC strategy (in early December, OPEC countries decided to do whatever it takes to maintain their market share) and (2) the imminent return of Iran to the market. By doing so, the major OPEC exporters intend to force the newcomers such as the US to cut their supply. Even if this “price-war strategy” ultimately works, we should keep in mind that it will take time to drain the oil glut. That’s why oil prices will remain under pressure. In the course of 2016, non-conventional oil suppliers are however expected to cut their production. Subsequently, we expect oil prices to rebound and stabilise above $40, but probably not before the end of 2016.

We do not see the fall in oil prices as a threat to the global economy. More likely, lower oil prices should stabilise or even boost domestic demand among oil importers. That being said, the pressure on oil exporters (sovereign states) and oil companies (worldwide) has substantially increased. In addition, given that the USD and oil prices are negatively correlated, all the EM corporates that are heavily indebted in USD have been weakened further over the past two months. Against this backdrop, market participants have become increasingly worried by a potential “wave of credit events” (corporates or even sovereign names) that could derail global growth. **While we acknowledge that corporate defaults will increase this year (in the US energy sector as well as in EM countries), we stick to the view that there is no global recession to come.**

Despite a deceleration, **the global GDP growth rate remained above 3% throughout 2015 for the fourth year running. Even though** signs of faltering in some regions (US, China) have resurfaced in Q4 15, GDP growth should remain close to 3% in 2016-2017. World growth forecasts are probably still too high at this stage, but recession fears are certainly exaggerated. **The decoupling that we saw last year between advanced and emerging economies is likely to continue this year.**

China is slowing but this is the road to development

In **China**, the slowdown is nothing new, and, in many aspects, was inevitable: it is primarily linked to the country’s demographic characteristics and to a changing economic model, where services have replaced industry. **The economy is only in the middle of an overcapacity crisis and thus will continue to slow in the coming years**. In fact, it is potential growth that is slowing in China (ageing population, lower productivity gains) as well as in the major EM countries. However the good news is that a **rebalancing is already underway, with a shift of activity from the manufacturing sector to the service sector in tandem with a shift from investment to consumption.** Actually, real GDP in the services accelerated somewhat last year (from 7.8% yoy in Q4 2014 to 8.3% in Q4 2015) while it was slowing rapidly in the manufacturing sector (from 7.3% yoy in Q4 2014 to 6.0% in Q4 2015). Thanks to this decoupling between the services and the manufacturing sectors, **GDP growth should stay around 6% both in 2016 and 2017.** We note that services have already become a significant contributor to employment and we believe that the services’ development - which has proved to be closely related to per-capita income in most advanced economies - is currently underestimated by market participants. In light with the major advanced economies’ experience, we expect Chinese growth to be increasingly driven by services. In 2016, the rebalancing which is underway should act as a buffer against a sharper downturn in the manufacturing sector.

In addition, in case of emergency the PBoC and the government would act to smooth the cycle. China has ample room to maneuver. When it comes to QE, the PBoC is a latecomer compared to other major central banks and has hardly acted so far. In particular, we believe that any event that would put at risk the rebalancing of the economy would trigger strong fiscal and monetary response. We expect both the PBoC and the government to do *whatever it takes* to smooth the transition phase.

The question of the yuan (which will be included in the currency basket used for the IMF's Special Drawing Rights as of October 2016) became a focus of concern during last summer and at the beginning of the year. The yuan's sharp appreciation since the 2008 financial crisis on the back of the dollar's rise and the slide of many emerging market currencies have become burdensome for China. **But we should not expect a rapid and massive devaluation of the yuan**: China wants to promote the yuan as an international currency while the economy is not as dependent to the currency as in 1994, when China devalued the currency by 1/3. **The authorities have intervened recently in order to stabilise their trade-weighted exchange rate and, in all likelihood, will continue to do so.** It is likely that the government wants the yuan to become a "regional anchor". Since an outright currency war would not be consistent with that objective, we expect the yuan to only gradually depreciate vs. the USD by the end of the year. However, the Chinese authorities may have to restore capital controls to achieve this purpose.

Concerning the global economy we add that:

- **While the economic slowdown also concerns the US, there is no recession looming outside the manufacturing sector.** On the one hand, net exports will weigh on GDP growth in 2016. But on the other hand, services, which represent the bulk of the US economy, should continue to benefit from resilient consumption**.** That being said, the business cycle is well ahead of that in Europe. With the rapid dollar appreciation, the corporate-profit cycle has probably come to an end. At best, after a soft patch (GDP growth has dramatically slowed in Q4 2015) growth should converge toward its potential, which has dropped significantly since the big financial crisis (potential growth is estimated to be slightly below 2%, due to weaker productivity gains in particular)**. Against this backdrop, the Fed will likely want to wait and see before hiking rates again.**

- **The economic downturn has also been very sharp for all emerging countries**. Over-dependence on world trade and commodities (prices of which have been falling for several years) is not often – or sufficiently – offset by the strength of domestic demand, and some large countries (such as Russia or Brazil) are in a severe recession. Only the commodity consuming countries remain at an advantage, but they have been unable so far to avoid the financial turmoil that has stricken all emerging countries.

- **The case of the Eurozone is somewhat particular: after several difficult years, the area is taking advantage of the low interest rate environment (both short and long rates), the ongoing financial defragmenting process, more accommodative economic and fiscal policies, and a lower euro and, for some countries, a firmer recovery of domestic engines**. Growth is admittedly not spectacular but should remain above its potential in 2016-17.

- Another particularity of the current situation is the **downturn in world trade,** mainly linked to the emerging countries. By all indications, globalisation is losing ground – a relatively new development. Domestic growth drivers will again be decisive, which also means that country risk will be a crucial factor once more.

- In 2015, **political and geopolitical risks** also returned to the fore. Risky elections (Greece, Portugal and, in particular, Spain), complex political situations (Brazil and Turkey), and terrorist attacks have once again laid bare the fragility of the current environment, the effects of which have still not been fully grasped. Tensions between Iran and Saudi Arabia have resurfaced since late 2015. We have long known about the political, diplomatic and religious tensions between these two countries, but the crisis has turned a new corner.

- Against this backdrop, **monetary policies are still broadly accommodative**, which is keeping interest rates low. The Fed was one of the rare central banks to hike rates in 2015. The US central bank wanted to relay a positive message on growth and to regain some scope of action, was forced to wait until December before implementing what it had announced. Meanwhile, by its actions on interest rates (both directly and indirectly), the ECB has undoubtedly recreated the right conditions to give companies better access to borrowing; however, it has also contributed to the liquidity drought on the corporate bond markets. It will continue its asset purchase programme at least until March 2017. To put it simply, because of the actions of the central banks and particularly those of the ECB, the Eurozone will continue to evolve in an extremely low interest rate environment.

There are five key takeaways:

- **Following the oil price fall and in the absence of wage inflation in most advanced economies, a quick return to the central bank's inflation targets is out of reach in 2016** in the major advanced economies. Subsequently, **monetary policies will remain highly accommodative.** The Fed will "wait and see" before hiking rates again, the BoE first rate hike is nothing but imminent and, last but not least, the ECB and the BoJ are both likely to do more in the coming months. **Monetary policy cannot do everything and if things turn worse, fiscal policy would be mobilized further** (in China, in the US, in Japan as well as in certain European countries).

- **Decoupling and divergence create opportunities in terms of relative pricing and relative attractiveness**. The effect of decoupling is the higher dollar and wider interest rate spreads (short and long) between the United States and Europe. The effect of divergence is the return of risk to the forefront – country risk and specific risk (the energy sector in the US high yield segment (compared to its European counterpart) was one of the most striking examples in 2015).

- **Periods of stress create overlooked regions and asset classes**. Overlooked – or undervalued – today are emerging country assets and inflation-linked assets, the former being more attractive in the short term than the latter due to the total absence of inflation.

- **Caution is dominating our overall strategy**. The downward revisions to growth forecasts are not over, and the current geopolitical situation is probably more delicate than it has been in recent years.

- **The drop in liquidity on the fixed income market continues to be of concern**. We have been insisting on this for more than a year now. Low liquidity, which is being exacerbated by the central banks' unconventional policies, regulatory restrictions, the alignment of major investors' positions (all of which are long on fixed income and spreads) and the relative decline in the number of providers of liquidity is adding to the risk on the bond market, against a backdrop where volatility has already increased.

Global positioning

Pascal Blanqué
Global CIO,
Head of Institutional Investors
& Third Party Distributors at Amundi

Vincent Mortier
Deputy CIO at Amundi Group

- **We maintain our positive stance towards European equities and are keeping our exposure within our multi-asset strategies. We are however cautious on US equities where we feel the profit cycle has peaked and on emerging markets where visibility overall is still poor.**
- **In the credit area, liquidity remains an issue which we account for in our portfolios. We maintain our overweight positions on Financial issuers while on the rest of the credit universe we continue to adopt a selective approach as regards issuers and sectors.**
- **We have reinforced our hedging policies through three main directions: US treasuries, directional volatility and some forex trades.**

Eric Brard
Global Head of Fixed Icome
at Amundi

Fixed Income portfolios

Our portfolios have been reshuffled in order to integrate both our central macro scenario (no disaster for global growth, Central banks still on board...) but also in order to take into account the latest market developments.

1 - We keep a "non-conviction" view in duration overall: flattening of the US curve, long peripherals in the Eurozone and neutral Japan. Our key messages for the beginning of 2016 are almost the same as those at the end of 2015.

2 - We have nevertheless reduced risk in our portfolios: reduced but not cut. The bulk of our effort was to decrease the position in credit securities, particularly bonds that offer the lowest yields (and therefore less spread). This has a double advantage: acknowledging that Investment Grade credit no longer really serves as a shock absorber in times of stress and also freeing up cash, making portfolios more liquid, and thus, more manageable.

3 - We then covered part of the residual risk of portfolios: this took the form of the sale of a basket of Commodities Currency (mostly Asian currencies but including the Canadian Dollar as well) in global portfolios, as well as going long on US rates for European portfolios. The former is also a response to the pressure exercised by China in the region: a number of countries need to implement currency adjustments in order to revive their flagging domestic economies. The latter has to be understood as a hedge and not as an outright long position in US yield (especially when 10Y have reached 2%).

4 - What we haven't done so far: cut back on our risky positions and return to liquidity (TBills) or to neutrality.

Romain Boscher
Global Head of Equities
at Amundi

Equities portfolios

The tumultuous start of the year in equities is certainly not a pleasing one for investors. It would be too easy to extrapolate the performance over the year from a few weeks of trading as there are no statistical powers behind it. Let’s remember that equities also had a rough start in 2015 - admittedly to a different magnitude - but the course of the stock market direction changed radically afterwards.

The magnitude of the fall of commodities is surprising as it generates more volatility and more stress. The bad news is that deflationary pressures are back again; the good news is the consumer in the developed markets is gaining extra purchasing power. The other consequence is that central banks will retain their dovish tone and will provide a lasting supporting environment for risky assets. This time round, the center of gravity has moved towards the ECB and the PBoC which have the most room to maneuver.

Our central scenario remains valid, with the current episode of stress being manageable, but also coming along with more volatility. Within the equity world, we keep our preference for EMU equities where there is the best risk/reward. Admittedly, earnings expectations are starting from a low base this year, contrary to 2015 where they started too high and failed to deliver. However, high single digit earnings growth coupled with the highest dividend yield amongst developed markets, are supportive for the investment case. Our second favorite market remains Japan: recent mutual fund flows have shown that Japan was the only equity market to have seen inflows this year coming from the domestic retail market. In the US, profit growth is fading and we see limited upside. Turning to emerging, we remain cautious but acknowledge that valuations are becoming compelling, yet we have to be extremely selective. The focus here is on countries that are oil-importers, where domestic stories like India are strong… In terms of potential; we could see high single digit returns for Europe and Japan, while in EM we cannot exclude a counter back rally with low double digit returns, but certainly with higher volatility. So in risk-adjusted terms, Eurozone and Japan offer the best risk / return profile.

We cannot exclude a sharper drawdown similar to 1998 or 2011, but these episodes were followed by a significant rebound in a V-shape scenario. While the tactical entry point short term is difficult to time, we are comfortable that 12 to 18-months down the road, returns on equities will be more than comfortable.

Loïc Bécue
Global Head of Multi-Asset portfolios, Retail Clients at Amundi

Raphaël Sobotka
Global Head of Multi-Asset portfolios, Institutional Clients at Amundi

Multi-Asset Portfolios

Financial markets have had a difficult start to the year. Between the financial turmoil in China, geopolitical tensions in the Middle East and the continued decline of oil prices which now stands below the $30bl (its lowest level in 12 years), financial markets remain under pressure.

While we are keeping our medium-term economic scenario unchanged, we are adjusting our investment strategy in the short-term.

We believe greater portfolio diversification is necessary. While central banks will continue to support global growth, volatility will remain high as we have seen early this year. In our allocations, we have reduced the exposure to eurozone private corporate bonds in favour of long-duration US government bonds (10 and 30 years) as the latter are liquid, their yields are attractive and they are resilient to global growth worries. Within high yield bonds, we favour European issuers to US issuers who we feel are too exposed to the energy sector. In the equity universe, we maintain our exposure to euro area stocks. We continue to believe that euro area companies should be sustained by positive profits growth. However, we reduce our exposure to the US equity market whose profits growth expectations still remain high and valuation still expensive.

That said, we remain vigilant to future economic publications that might or might not confirm our central scenario.

Document issued by Amundi, a société anonyme with a share capital of 596 262 615 € - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris www.amundi.com