CROSS ASSET INVESTMENT STRATEGY

CIO VIEWS

A WAKE-UP CALL FOR MARKETS. REMAIN VIGILANT

THIS MONTH’S TOPIC

ESTIMATING THE IMPACT OF US FISCAL POLICY ON GROWTH, FIXED-INCOME MARKETS AND THE DOLLAR
A wake-up call for markets. Remain vigilant

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

The volatility spike in February is, in our view, a clear wake-up call for investors, and the market correction has partly removed the complacency that characterised financial markets in the last few months. While technical factors (position unwinding of specialised short volatility funds) are the main cause of it, we should not underestimate other factors that deserve attention, and which will potentially will write a new story for financial markets. The financial cycle is becoming increasingly mature after an extended bull market for risk assets; a repricing of inflation expectations is under way (some signs of wage inflation are finally materialising in the US in an economy running at full employment and fuelled by robust fiscal stimulus). While Central Banks (CB) will clearly remain vigilant in order to assess any financial stability risks, a removal of excess monetary accommodation, with different speeds among various CB, is expected to continue, with a progressive tightening of financial conditions, potentially leading to higher market volatility. The recent market correction is, in our view, unrelated to recession concerns: the economic outlook still supports earnings per share growth, and some positive conditions, such as a capex revival and increased global trade, could drive an extension of the business cycle. However, we do not yet see this as an entry point: we believe it is too early to seize opportunities since the correction has been limited and incomplete (not affecting the credit market), and it is too early to tell if we are seeing a regime shift in fundamentals (ie, structurally higher inflation). Moreover, markets are still displaying tight valuations, less than one month ago, but still tight, especially in credit market. They remain vulnerable to any pick-up in inflation data, which should drive a further rapid re-pricing of CB action. We have seen that markets may have limited capacity to absorb higher rates. In our view, a 3% yield for the 10-year US Treasury is a warning level, and 3.5% is clearly an alert threshold. If reached too fast, this is unlikely to be sustained without a second wave of market correction, which cannot be ruled out, in our view. Higher interest rates would impact on asset class valuations, putting pressure on some indebted corporates, on equity earnings, and Emerging Markets (EM) assets, should they aggressively and rapidly rise. Market liquidity in this regard will be a critical factor to watch. As such, the wake-up call should be taken as an opportunity to reassess the robustness of a portfolio entering into a new regime, where volatility will not be extreme, but higher than the depressed levels reached in 2017, and rates will continue to trend higher. Under this scenario, as we highlighted in our 2018 outlook, we believe investors will be exposed to asymmetric gain/loss distribution. To deal with this challenge, we think it is time to both recalibrate risks and implement investment strategies that can benefit from the last phase of the financial cycle (to enhance gain potential) while protecting assets from downside risks (to mitigate losses). In details, we see five appropriate investment strategies. First, on a cross-asset basis, while keeping moderate risk-on positioning to exploit the opportunities of the last phase of the cycle, we believe that equities should remain favourite to credit (high yield in particular). Second, in the equity space, further selection is needed in favouring the markets that offer higher return potential (Europe or Japan, and selective EM), and/or which, through an active approach, can still post value in some sectors/stocks (US). The third theme is related to the recalibration of monetary policy and inflation expectations repricing, and their impact on fixed income. These trends call for a flexible and more diversified approach to bonds (duration, curve, currencies, credit exposure, inflation linked, floating rates, and convertibles). Fourth is related to the resilience of EM assets. Even if not immune to rising rates, stronger economic conditions, and the adjustment in major imbalances, a weak US dollar should mean more robustness regarding the effects of higher interest rates than in the past. Lastly, and even more importantly, in our view, as highlighted by the recent market correction (equity sell-off and rising bond yields at the same time), is the implementation of effective hedging strategies that can help to mitigate the downside if the correction were to continue.
High Conviction Ideas

**MULTI-ASSET**

A combination of high valuations across the board and heavy positions weighted on risk assets in February, especially equities. Macro hedges, such as long volatility positioning, safe haven cross rates (i.e. AUD/JPY) and put spreads worked as expected to protect portfolios. While we are still moderately constructive on risk assets (mainly European, Japanese equities, energy sector in the US, and selectively some EM, like Russia), we believe that structural hedges will remain key in a normalisation of market conditions towards a higher volatility regime.

**FIXED INCOME**

Upgrade of US growth and inflation expectations initiated the sell-off in government bonds. A defensive short duration positioning is still appropriate, even though at the margin, reduced compared to last month. On duration, we remain ready to move to neutrality should 10-year Treasury yields approach 3.5% levels. On credit markets, we remain moderately constructive, mainly on high rated/most liquid securities, while we are becoming more cautious on HY. Credit has been relatively resilient in this phase: on the one hand, this is the result of sound fundamentals; on the other, it can reflect liquidity constraints in the market. This should be monitored very closely. On the USD, momentum has been weak, but we believe higher US real rates will open opportunities for increasing exposure to the USD.

**EQUITIES**

Markets declined from hot levels. Fundamental conditions have not changed. EPS growth is still healthy globally. However, as we are approaching a late phase of the cycle, volatility will remain higher than last year, and influenced by CB communication policies and actions. We expect that markets will be more selective, favouring stocks with superior EPS growth and not excessive valuations.

**REAL ASSETS**

Based on the current market cycle in Europe, with accelerating growth at different speeds across countries and inflation bottoming, we believe that real estate and infrastructure investing can be a source of portfolio diversification, with a selective approach. Both asset classes provide recurring cash flows, often indexed to inflation, which make them valuable hedges to higher inflation expectations.
Two recent events have changed the macro financial backdrop: (1) the rise in equity volatility, and (2) in terms of economic policy, the bi-partisan agreement in the US Congress to increase public spending. The latter agreement is favourable to US growth in the short term, but it is likely to maintain uncertainty (and, consequently, volatility in the markets). This is indeed the first time that a US administration has decided to stimulate the economy while it is close to full employment. While the amounts involved are not exceptional, they add to the actual tax cuts since the beginning of this year, increasing the pro-cyclical nature of the policy mix. The disadvantages are many and well known.

- The surge in expenditure and the fall in tax revenues are never offset ex post by the fueled activity induced. The federal budget deficit will therefore widen further; it is estimated that it will exceed 5% of GDP in 2019, unprecedented in a period of economic expansion.
- At full employment, fiscal stimulus is more likely to lead to inflation, especially on the wage side.
- Against this backdrop, the Fed must rebalance the policy mix by reducing the degree of monetary accommodation. The probability of four rate hikes this year (one per quarter) has increased. And, under these conditions, long-term interest rates are threatening to increase more significantly.

Will rising interest rates support the US dollar?

At the beginning of the 1980s, President Reagan’s expansionary fiscal policy led to a sharp deterioration in fiscal and trade deficits (twin deficits), but also to sharp appreciation of the USD. The economic context is, however, radically different now. At that time, the Fed was determined to raise rates to counter inflation. And, it was the rise in real rates that supported the USD.

The current period stands out in several ways:

- First, the context is much less inflationary: on average in the current cycle, inflation has fallen to its lowest level since the early 1960s.
- The monetary gradualism is necessary because a sudden tightening of monetary conditions would certainly precipitate a bond crash and a new economic and financial crisis.
- In addition, the pro-cyclical fiscal stimulus is likely to lead to a sharper increase in imports - and therefore a greater deterioration of the trade deficit than a counter-cyclical fiscal stimulus.
- Finally, the income balance will deteriorate significantly. Interest payments on debt securities held by foreigners will mechanically rise with rises in nominal rates. US liabilities account for nearly 180% of GDP, of which nearly 60% derives from debt instruments. All else being equal, a 100bp rise in nominal rates would thus have a negative impact on the income balance of nearly 0.6% of GDP (adding to the trade deficit).
- Ultimately, the deterioration of the twin deficits is expected to weigh on the dollar in 2018. This will worry the Fed even more regarding inflationary consequences of fiscal policy pursued in the absence of any reaction on its part. At the end of the day, uncertainty about the Fed’s reaction function should keep volatility high.

The deterioration of the twin deficits in the US could result in uncertainty regarding Fed policy and result in higher volatility.
The Strategist view

Why higher long-term yields are here to stay

We see three factors behind higher sovereign long-term bond yields. All these conditions, we expect, will continue to put pressure on rates in the coming months.

1. A significant upward revision of market Fed funds expectations, in the wake of the adoption of the fiscal reform. Markets are now pricing three rate hikes in 2018, in line with our expectations.

2. A confirmation of the reduction in the accommodative stance of monetary policies. Another driver behind the rise of global long-term yields has been the dramatic reduction of the ECB’s net purchases of sovereign bonds from early 2018 (the pace of the public sector purchasing programme has been reduced by around 60%). This has also contributed to the rise of the term premium in Germany and in other markets.

3. Jump in US Treasury department funding needs. According to our calculations, net issuance of long-term US Treasuries could reach $800bn in 2018 and $970bn in 2019 (higher deficits and Fed’s non-reinvestments) and nearly double the amount borrowed by the federal government in 2017. While these amounts are not unprecedented per se (US Treasuries net issuance accounted for $1tn in 2012 and even $1.6tn in 2010), it is abnormal to see deficits climbing so much at this point in the economic cycle.

According to our analysis, the critical threshold for the 10-year US Treasury yield to initiate a double bear market would be around 3.5%.
Hedging idiosyncratic risks

MATTEO GERMANO, Head of Multi-Asset

Global macro fundamentals have hanged little: our central case remains one of synchronised recovery, fueled by consumption, global capex and still firm trade. Risks to growth and inflation are still slightly tilted to the upside. We expect inflation to remain benign and not to force major CB to act disruptively, but to move further in the recalibration of their policies. On the back of this robust framework, we consider the February turbulence in the stock market as an overshooting from a realignment of stock prices to higher inflation expectations and to higher interest rates. We reiterate our scenario of a smooth transition from an asset reflation to a late financial cycle regime, still in favour of risky assets, but with lower risk-adjusted returns and still easy but tightening financial conditions. While most asset classes still have stretched valuations, strong growth momentum could support further upside from current levels. Tactical factors (sentiment, flows, relative strength index) remain quite influential in the short term and recently encouraged the tempering of overall risk exposure. Therefore, we suggest an increased focus on relative value stories rather than a directional risk-on/risk-off approach. Hedging strategies are also crucial to navigating a phase of higher volatility ahead.

High conviction ideas

In risk assets, we still favour equities – particularly Europe and Japan (broad market and banks), but also the US energy sector vs the S&P 500 – and we prefer equities to HY corporate bonds. In EM equities, we maintain our preference for Russia vs EM and we also favour China in relative terms. In fixed income, we are still constructive on European IG credit which we prefer to govs for carry reasons. On the government bond side, a positive view on inflation-linked bonds (in Europe, US and Japan) remains one of the main conviction ideas, as our macro forecasts call for a moderate upward trend in inflation to

“...transition from asset reflation to a late-cycle financial regime still supports risky assets, but likely with lower risk-adjusted returns for several asset classes..."
continue throughout this year. We are still expecting higher German rates in 2018. Curve movements could also be a source of returns this year. For example, in the US, we expect the 2-10 year segment to steepen to incorporate higher inflation expectations and the future increase of the US fiscal deficit. We still see potential for the Swedish curve to flatten on the back of increasing prospects of a gradual monetary policy tightening. In the UK, we think that Brexit negotiations are going to affect long-term real rates and the GBP. We expect UK 10-year real rates to rise, consistent with the uptrend of nominal rates and also because of a potential slowdown of UK inflation later in the year. We keep a defensive stance on the GBP, which we expect to experience Brexit-related volatility in the future vs both the EUR and the USD. The negative correlation of these two investment ideas – UK real rates set to increase and the GBP to weaken – allow for the diversification of elevated headline risk on this critical and long negotiation process. We see other opportunities in the FX market, in particular in the Norwegian Krona vs the EUR based on oil trending higher and a hawkish Norwegian CB.

Risks and hedging

During equity turmoil, hedging strategies have been crucial to smoothing portfolio volatility. Tactical risk reduction, option strategies, and appropriate cash buffers will continue to help investors to smooth the effects of temporary corrections. We expect linkers and real assets to protect in case of an unexpected and persistent rise in inflation above CB targets. Options protecting from HY spread widening may be useful as liquidity continues to decline and if interest rates continue to rise. FX strategies (i.e., AUD/JPY put options or short USD/JPY) could be helpful in phases when there is no place to hide.

FIXED INCOME

Back to a more “normal” market

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

Overall assessment

The “normal” relationship between strong growth, higher inflation expectations and higher interest rates finally seems to have been restored. This new phase signals a normalisation in fixed income conditions, where fundamentals will regain their key role. The transition has not been smooth: in less than six months, 10-year yields in the US have risen from 2% to 2.9% and the 10-year German bund yield has doubled since December. This environment calls for an active approach to fixed income: active in duration management (short with rising rates, but neutral/long when the economic cycle slows down), active in currency management (as CB policies are not fully synchronised), and active in security selection in credit (overall quite tight) to find the right balance between risk and reward. This also calls for enhancing sources of diversification both to hedge against inflation risk (inflation-linked bonds) and to capture stronger economic growth (convertibles). On the USD, momentum has been weak, but higher US real rates will start to attract capital reverting the recent trend.

DM government bonds

Core govies are adjusting for higher inflation and less dovish CB. Investors should keep a short duration position, in all the core markets (Eurozone, US, UK, Japan). In the US, 3% is a psychological threshold for the 10-year Treasury yield, which we believe will be tested in the short term, while 3.5% would be a level to watch to consider a move to neutrality on duration. Pressure on rates will remain high in 2018. The market will have to absorb a huge amount of net issuance, with higher deficits fuelled by a fiscal expansion, which comes after a long expansion. In the Eurozone, sovereign spreads tightened year-to-date as the ratings of several countries have been upgraded and economic activity remains strong. We remain mildly constructive on peripheral bonds, on Italy in particular, but opportunities have diminished.
DM corporate bonds

Credit has been relatively resilient in this phase, amid strong fundamentals and, in the Eurozone, technical support by the ECB purchasing programme and strong demand. Carry trades, we believe, will remain well supported, even if less so than in the past 12 months. In the EU, we prefer subordinated debt (financial and non-financial). The HY market still offers moderate value: strong growth is a supportive factor, but leverage is high, especially in the US, though less so in Europe. Based on our analysis, one-third of US HY companies remain in challenging situations and could become vulnerable in case of further risk aversion. The Euro HY secondary market is supported by limited net supply, as the loan market is currently more attractive for issuers. Persistently high levels of equity volatility represent the major threat to the market. To deal with this, we believe investors should focus on highly liquid/high-quality securities.

EM bonds

EM bonds held well during the market sell off, with the high beta credit suffering the most, especially in Latin America. Market valuations are still tight, but fundamentals remain strong. A catalyst for a strong reversal in flows could be a strong dollar or US 10-Year treasury yield aggressively raising toward 3.5%. These conditions are not in our base scenario. We still believe that returns of EM debt in hard currency can be in a range of 4-5% this year and that EM debt local currencies could post a high single digit return.

We expect to see more pressure regarding interest rates.

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

EQUITY

A new phase for the market

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

Overall assessment

The February sell off after the prolonged bull run is, in our view, more a correction from overbought levels than the start of a bear market led by a recession. As we are moving towards a late phase of the cycle, with tighter


Source: Amundi Research. Data as of 30 January 2018.
financial conditions ahead, we expect higher volatility. Fundamentals remain strong overall and earnings growth will be the key driver for a continuation of the upward trend.

**Europe**

The European renaissance theme is still intact as confirmed by the positive earnings seasons and 2018 EPS forecasts which are on a strong note in Europe (see chart). The market turbulence of February has been of a technical nature with no rotation within the themes in the markets and no spillover. Some concerns may arise in the future if the strength of the euro that we have seen in recent months will continue. At current levels the headwind is still absorbed by the strength of the underlying economy. For us, the important issue is the reason behind the strengthening of currency that we see mainly in the improving economy and we believe that this will be an offsetting factor for many corporates. Of course this can transform in some headwinds for corporate earnings but we believe is not time to become defensive yet. European index (MSCI Europe), which counts for 50% on cyclical and financial should be favoured with rising (modestly) interest rates (banks) and lasting EPS recovery (software, luxury, food & bev., tobacco, pharma, energy). Diversified financial could be a hedge against a potential short term rebound of bond-like sectors (Utilities, Telco, RE).

**United States**

US equity overbought conditions no longer exist after equity market sell off in early February. We continue to monitor wage inflation, raw materials increases, and other rising costs as an offset to the tax reform windfall. Looking at market valuations, we note that overall market valuations are not a big issue, but the most expensive stocks in the US market are historically as expensive as they were in November 1999. In this “expensive” territory, we can find mega caps, with market caps of more than USD50bn, accounting for about USD3tn in market cap (the total S&P market cap is USD24tn). Many of these companies can be vulnerable to higher interest rates. The rest of growth stocks is reasonably priced versus the overall market. On the other hand, not all value stocks are attractive: consumer staples, utilities and telecoms can be hit by higher rates and inflation which devalue high dividends. Moreover, some of value sectors are under pressure from secular changes (ie, media, consumer staples, telecoms), and they can become value traps. In our view, financials (mega cap banks), energy and selected consumer discretionary should be favoured in the current phase of the cycle. This means to us that going forward, in the new phase in which CB will progressively remove stimulus and financial conditions will become tighter, it will be extremely important to be more selective, both in stock picking and asset sector allocation.

**MSCI Europe: evolution of EPS forecasts**

![MSCI Europe: evolution of EPS forecasts](image-url)
Emerging Markets

The market correction for MSCI EM has been in line with that for MSCI World during the market turmoil, but we think it is worth noting flow resilience: inflows decelerated early after the 2018 record, signaling still good appetites from investors for these markets, which retain attractive valuations vs DM. The reporting season is still in its early phase, but till now is confirming positive momentum: 4Q17 yoy growth (current reporting quarter vs the same quarter one year ago) is +15% in USD. In our view, this momentum is likely to continue, with some deceleration seen mainly in 2H18. The outlook remains quite supportive for the IT sector (in China, internet companies, but also South Korean tech names after the correction). Asia is our favourite area, followed by EMEA (focus on Russia and banks in Central Europe) and LatAm, though this region is more expensive and riskier, due to NAFTA renegotiations and more influenced by political risk (elections in Mexico). A recovery in commodity prices could improve the picture for this area.

REAL ASSETS

Real estate: navigating European market divergences

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

Key factors

The European economic recovery is supporting real estate investment growth in the Eurozone and should make 2018 another good year for rental growth since it will indirectly affect the demand for housing, thus pushing rents upward. In fact, rent trends are likely to become the new driver of real estate performance which will no longer be essentially driven by low rates.

With an outlook of interest rates trending higher in the medium term, the attractiveness of the sector should remain robust (on a relative basis, at least). Furthermore, real estate can structurally be considered as an effective hedge against inflation, particularly thanks to the recurrence of its cash flows and their indexation method. As inflation rises, house values and rental income are expected to rise as well. In addition, real estate investing can also be attractive as a source of income enhancement or as a tool for diversification (low correlated return).

Differences across European countries

Although the European real estate sector is expected to remain strong, due to the improved economic situation, there may be significant differences among countries. For example, in the last five years, house prices have risen sharply in some countries, while they have been contained in others. In this respect, some key trends should be considered. In the short term, there are cyclical trends that may negatively affect the real estate sector, such as high valuations and competition in some major countries and the prospect of rising interest rates. In the long term, however, there are structural trends that look set to drive performance, as population changes and technological innovations are at play. In such situations, the ability to identify those markets that are likely to benefit from these underlying trends and to perform well even in the face of cyclical pressures will be key. For example, France could offer interesting opportunities, as the economic recovery is not yet in full swing, which means there is still room for improvement. In addition to premium locations in Paris or La Défense (France’s premier business district, located a few miles west of Paris) which offer solid returns, investors could exploit opportunities with moderate risk profiles in France’s regions, especially in major provincial cities, which have so far been neglected by institutional investors.

Key success factors

For the future, we think that fund managers will need to take an active and selective approach in real estate investing, with a focus on those markets and areas most likely to benefit from the cyclical and structural trends...
described above. In our opinion, it is time to move up the value chain by proposing value added strategies (e.g. leasing-up, renovating or total refurbishing of properties). Also, we believe it will be crucial to take a flexible approach, notably by understanding the evolving needs of tenants (e.g. ESG criteria). Establishing strategic partnerships could be another strategy to quickly penetrate several European markets with the required nimbleness, and take advantage of local skillsets.

**European commercial property investment volumes**

Source: CBRE, Amundi. Data as of 19 February 2018. Investment volumes comprise office, retail, industrial and hotel sectors, EU-15: Germany, Belgium, France, Italy, Luxembourg, Netherlands, Denmark, Ireland, United Kingdom, Greece, Spain, Portugal, Austria, Finland and Sweden.
### Asset allocation: multi-class outlook

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

### Relative outlook and convictions by major asset class

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<th>3-6 month research view</th>
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### Currency and real assets

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**LEGEND**
- Negative
= Unchanged
+ Positive
❖ Underweight
❖ Neutral
❖ Overweight

Source: Amundi, as of 20 February 2018. The 3-6 month return outlook refers to research views based on expected returns by asset class. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. **This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.**
CROSS ASSET INVESTMENT STRATEGY
March 2018
Asset allocation # 03

THIS MONTH’S TOPIC

Estimating the impact of US fiscal policy on growth, fixed-income markets and the dollar

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The essential

US fiscal policy raises many questions about its impact (on the economy, on monetary policy, on long-term interest rates, the dollar and more generally the US fixed income market). The US authorities have indeed decided to stimulate an economy that is close to full employment, something that has never been seen in American history. This will boost growth and inflation (in the short term) and at the same time lead to an increase in bond supply, just as the Fed is raising its key rates and reducing the size of its balance sheet. We return here to the different scenarios that can be considered on public spending. Ultimately, we find that the economic impact will be substantial but temporary and that it (1) it will have a limited impact on the yield curve, (2) a mixed on credit and (3) could ultimately weigh on the USD.

Introduction

After the Tax Cuts and Jobs Act of 2017 (TCJA), a major tax overhaul approved just before the end of the year that introduced significant tax cuts for both individuals and corporations, in early February the U.S. Administration passed the Bipartisan Budget Act of 2018 (Budget Act) that would add increased government spending on top of the fiscal stimulus. Immediately after, the White House presented the President’s Fiscal Year Budget 2019 (President’s Budget) further pushing, among other actions, for increased infrastructure spending. All these measures would add upside risks to our base case economic projections for growth and inflation for which we provide estimates herein.

The policy mix, in brief

The TCJA is estimated to add approximately $1.456 trillion to the budget in the 2018-2027 decade (or $1.071 trillion, after taking into account the expected positive macroeconomic effects); the Federal deficit would increase by $136bn and $280bn respectively in 2018 and 2019 ($104bn and $246bn when dynamically scored)\(^1\).

The Budget Act is estimated to add approximately $60bn and $140bn to the deficit in 2018 and 2019, respectively (CBO assumptions), due to a widening gap between revenues and spending and increased appropriations caps\(^2\).

The President’s Budget, which was drawn up before the Budget Act and released with an Addendum to take into account some discrepancies in domestic spending that Congress authorised with the Budget Act, would, among other provisions, promote another key topic of the presidential campaign – the Infrastructure plan. Despite much debate and criticism, including by the President himself, the plan is a cornerstone of the Trump administration’s budget and, if the President’s intentions come to fruition, should lead to $200bn in federal spending over the next 10 years to be matched by other private and public funds, in order to total the promised $1.5 trillion. The Budget Act already earmarks approximately $20bn in total for 2018-2019, half of the amount of federal spending included in the President’s budget\(^3\).

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Estimating the macroeconomic impact

**Base Scenario:** On the macro front, we have already priced into our base case the estimated impact of the TCJA. Thanks to the support provided to corporate profits and consumers’ disposable income and some increase in government discretionary spending (which we already anticipated would materialise independently from the Budget Act), growth is expected to remain above potential for the next eight quarters, thus lifting core inflation up to the Fed’s target. A gradual removal of monetary policy accommodation from the U.S. Federal Reserve would inform careful management of the economic impact, without moving into overtightening and at the same time avoiding overheating. In this context, we expect growth to average 2.7% on an annual basis in 2018, with CPI at 2.3% and Core PCE at 1.8% on average.

**Table 1 / Assumed scenarios for Government Spending**

<table>
<thead>
<tr>
<th>USD Billions</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Outlays by CBO</td>
<td>56 171 64 15 5</td>
<td>143 153</td>
<td>193 203</td>
</tr>
<tr>
<td>Total (2018/2023)</td>
<td>310</td>
<td>296</td>
<td>396</td>
</tr>
</tbody>
</table>

Source: CBO, Amundi Macroeconomic Research

**Assessing Risks:** In order to estimate the risks to our economic outlook posed by the implementation of the two additional measures (Budget Act and Infrastructure Plan from the President’s Budget), we assessed the impact of different government spending scenarios through our economic model.

- The selected scenarios range from a gradual implementation over a few years, in line with the CBO estimates (Scenario 1), to a more aggressive pace of implementation (concentrated in 2018 and 2019), where the full appropriations are spent in 2018 and 2019 (Scenario 2); finally, in Scenario 3 we add a partial implementation of the infrastructure plan. For 2018, the three scenarios represent increasing levels of expenditure and therefore allow us to estimate a range of macroeconomic responses.

Among the three scenarios, we attribute the highest probability (70%) to Scenario 1, while we equally weight the likelihood of Scenarios 2 and 3 (15%).

Table 2 details the estimated impact on growth and allows for comparison with the base scenario.

**Table 2 / Impact on economic projections**

<table>
<thead>
<tr>
<th>US Macroeconomic Forecast</th>
<th>base scenario</th>
<th>scenario 1 ex ante</th>
<th>scenario 2 ex ante</th>
<th>scenario 3 ex ante</th>
<th>scenario 1 feedback</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Q4/Q4</strong></td>
<td>2.5 2.5 2.3</td>
<td>2.9 2.4 3.1 2.3</td>
<td>3.3 2.3 2.7 2.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>GDP &amp; Components</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP (QoQ Ann)</td>
<td>2.3 2.7 2.9 2.4</td>
<td>2.7 2.6 2.9 2.7</td>
<td>2.9 2.6 2.7 2.6</td>
<td>2.8 2.4</td>
<td></td>
</tr>
<tr>
<td>Personal Consumption Expenditures</td>
<td>2.8 2.6 2.4</td>
<td>2.7 2.6</td>
<td>2.9 2.7</td>
<td>2.9 2.6</td>
<td>2.6 2.7 2.6</td>
</tr>
<tr>
<td>Government Consumption Expenditures</td>
<td>0.1 1.4 1.7</td>
<td>2.2 3.2</td>
<td>3.6 3.3</td>
<td>4.0 3.3</td>
<td>2.2 3.2</td>
</tr>
<tr>
<td>Fixed Investment</td>
<td>4.1 4.8 4.8 2.0</td>
<td>4.5 1.8</td>
<td>4.5 1.7</td>
<td>4.4 1.8</td>
<td></td>
</tr>
<tr>
<td>Non residential</td>
<td>4.7 5.6 5.5 2.4</td>
<td>5.2 2.1</td>
<td>5.1 2.0</td>
<td>5.0 2.2</td>
<td></td>
</tr>
<tr>
<td>Residential</td>
<td>1.7 2.0 2.0 0.4</td>
<td>2.1 0.3</td>
<td>2.1 0.3</td>
<td>1.8 0.1 0.1</td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>3.4 4.6 4.3 4.0</td>
<td>4.2 3.9</td>
<td>4.2 3.9</td>
<td>4.8 4.3</td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>3.9 4.9 5.0 3.6</td>
<td>5.4 3.7</td>
<td>5.5 3.7</td>
<td>4.5 3.5</td>
<td></td>
</tr>
<tr>
<td>GDP Contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net trade</td>
<td>-0.2 -0.2 0.0</td>
<td>-0.3 -0.1 -0.4 -0.1</td>
<td>-0.4 -0.1</td>
<td>-0.1 0.0</td>
<td></td>
</tr>
<tr>
<td>Inventories changes</td>
<td>-0.1 0.0 -0.2</td>
<td>0.1 -0.2</td>
<td>0.1 -0.1</td>
<td>0.1 0.0</td>
<td>-0.1 -0.2</td>
</tr>
<tr>
<td><strong>Trend Variables (YoY average)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Prices Index</td>
<td>2.1 2.3 2.2</td>
<td>2.5 2.2</td>
<td>2.6 2.2</td>
<td>2.6 2.2</td>
<td>2.5 2.2</td>
</tr>
<tr>
<td>Core PCE</td>
<td>1.5 1.8 1.9</td>
<td>1.9 2.0</td>
<td>2.0 2.0</td>
<td>2.0 2.1</td>
<td>1.8 2.0</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>4.4 5.0 4.4</td>
<td>5.4 4.5</td>
<td>5.6 4.6</td>
<td>5.7 4.8</td>
<td>5.3 4.6</td>
</tr>
</tbody>
</table>

Included in the forecasts: changes from the Fiscal Bill Approved by the US Congress in December 2017.
As expected, increased government spending would further support growth by boosting domestic demand, likely generating supply-side adjustments; as resource utilisation moves higher prompting further tightening of the labour market, the path of inflation is lifted as the economy keeps growing above potential. However, while domestic demand and GDP are supported by incremental government expenditure, the underlying growth drivers (consumption, investment and the trade balance) show changing dynamics as we move through the three scenarios.

With reference to Scenario 1, we also computed the feedback impact or “ex post” effects when interest rates, exchange rates and the equity market reprice according to the new economic and deficit projections. Rising interest rates and a depreciating dollar would somewhat moderate the upside on growth, while they would have a lesser offsetting effect on the upside inflation risk (due to weaker USD impact).

But all that glitters is not gold: increased widening of the Federal Revenues vs. Expenditure gap, with little offsetting from improved growth dynamics, is likely to lead to a wider federal budget deficit (estimated to exceed 5% of GDP in 2019). Stronger domestic demand could increase imports significantly, thus widening the trade balance deficit. The removal of monetary policy accommodation via balance sheet normalisation, plus the increase in target rates in a context of rising inflation, would lift long-term interest rates, increasing debt service costs; the current account balance would suffer as well.

Some of these consequences are already being seen in the revival on the twin-deficit theme, which is expected to remain a hot topic in the months to come.

**Estimating the impact on fixed-income markets and on the dollar**

To assess the impact of tax reform and the potential infrastructure spending plan on the markets, we have to take into account two important factors: (1) the end of global QE and (2) the lag between the US cycle and the rest of the world.

I - The end of global QE will change the landscape of the fixed-income market in the coming years

Since the financial crisis, developed market (DM) central banks have provided substantial support to the fixed-income market through two important channels:

1. **Unconventional monetary policies.** These measures have aimed to stimulate activity and inflation in a context where key rates were close to their low limit and have consisted of bank loans and, more specifically, asset purchase programmes. Especially:
   - **The major central banks have aggressively bought government bonds.** A large part of the public debt is now held by the central banks of these countries: the United States (20% or $2.432 trillion), Europe (20% or €1.913 trillion) and Japan (30% or JPY 10.46 trillion).
   - **The ECB has also become a major player in the Euro Corporate bond market.**

2. **The “global search for yield”.** Monetary policies have contributed significantly to pushing sovereign bond yields down, especially in Europe and Japan where negative rates were used to stabilise the economy. The United States was the first to emerge from the crisis and raise key rates. The US fixed-income market has since been considered as an oasis in this yield desert. 10% of all debt is still negative yielding. The result:
   - **Strong demand for US assets by foreigners and domestic investors.** USD corporate securities held by foreign residents have increased by 45% since 2012 and foreign investors currently account for 40% of the USD corporate bond market.
   - **Strong demand for Investment Grade products.** Investors motivated by the search for yield have treated IG corporate bonds as a rate product.

In this low inflation and very accommodative monetary policy environment, corporate bond spreads and sovereign yields tightened to near record low levels. The trade-weighted dollar jumped 25% between 2014 and 2016.

**2018 marked a turning point as the global economy is enjoying a significant synchronised upswing allowing DM central banks to pull back collectively.**

1. **In the United States, the Fed has begun to gradually reduce the size of its balance sheet** by not reinvesting some of the securities that are maturing in addition to its cycle of rate increases.

2. **In the euro zone, we expect the ECB to end its QE next September.** The ECB is already buying assets at a rate of €30bn per month, which is half that of 2017.
(3.) In Japan, the BoJ’s balance sheet continues to increase but at a slower pace. In practice, purchases are now around 50 trillion yen annually compared to 80 trillion previously.

The peak of liquidity is behind us. The size of the Fed, ECB and BoJ balance sheets will increase +$220bn this year versus $1.1tr in 2017, $1.5tr in 2016 and $1.2tr in 2015. Fed is reducing its portfolio while the ECB and BoJ are still increasing it. At a global level, net issue volumes of government bonds will no longer be absorbed by central bank purchases as was the case in the last three years.

The upswing in global growth expectations and the reduction in the accommodative stance in monetary policy has already led to an increase in Fed funds expectations, a rise in sovereign bond yields, some outflows on the corporate bond market and a decline in the trade-weighted dollar.

II- What impact will there be on rates, the dollar and credit?

Rates: rates could move around 3%, not as much could be expected from a steepening.

The increased deficit projections in the budget pose questions on how funding needs are going to evolve in the US over the next few years. The tax reform approved at the end of last year (TCJA) would increase the net issuance of long-term treasuries to about $649bn in 2018 and $867bn in 2019. If enacted, such a scenario would have to be increased with the inclusion of the Budget Act effect and the infrastructure plan, which would lift the net issuance to $724bn in 2018 and $1022bn in 2019. The aforementioned set of projections include the Fed’s SOMA redemptions, according to the official schedule, and Amundi’s estimates.

(1.) Despite being a considerable increase relative to the 2016-2017 figures, non-Fed investors have been able to absorb similar amounts in the recent past (i.e. net purchases by non-Fed investors accounted for $1 trillion in 2012).

(2.) Historically the US curve has steepened on increasing budget deficits, as the back end tends to price in a higher term premium. A scenario that accounts for the TCJA would indeed imply a deficit on GDP of -3.36% in 2018 and -4.45% in 2019, which could generate steepening pressures, all other things equal.

(3.) A caveat to the above is that this time around the increase in the deficit is happening at the unusual time of a late-cycle phase, while the FED is normalising rates. Therefore, the steepening effect could be mitigated by the sell-off of the front-end which would continue to price in additional tightening from the Central Bank.

1/ Net Issuance of Notes and Bonds ($ billions)
Credit: improving fundamentals but technical aspects seem more challenging in the medium term.

The fundamentals are improving thanks to the global economic upswing and a more cautious stance by businesses. Leverage at US companies is stabilising or even decreasing in some cases. This trend is likely to improve further on the back of the tax reform. Higher revenues and profits are going to be coupled with a more limited use of debt financing among funding channels.

4/ The size of the US market has doubled over the last years
However, the technical aspects seem more challenging in the medium term. After years of low funding needs and high investor appetite, leverage at US companies is near record highs. The refinancing needs of US companies will increase significantly in the coming years. At the same time:

- The growing net supply by the public sector could cause a potential "crowding effect".
- The need to search for yield may become less apparent if Treasury bond yields continue to move north, finally becoming relatively more attractive vs. corporates, and if in the coming years larger oases appear in the deserts of yield in other jurisdictions on the back of normalising monetary policy.

We remain confident on US IG credit. In the short term, positive factors should keep supply from re-accelerating: cash repatriation, lower M&A and share buyback spending. Challenges on both the technical and fundamental sides seem to be further out than 2018. The risks remain tilted towards higher inflation/higher bond yields and their effects on re-allocation from credit into govies and/or equities.

USD – Growth differential is key

In 2017, the dollar was down 10% against all currencies and has lost 2% since January. This depreciation has even been more pronounced against the euro. This is surprising because the spread between US and European rates continues to grow. The gap at 2 years is 260bp and at 200bp for 10 years. Historically, the USD and the 10y rate have been more pronounced against the euro. This is surprising because the spread between US and European rates has been positively correlated (see graph). So, what has happened?

(1.) The growth differential is no longer in favour of the US. The global economy is experiencing a recovery, and growth in Japan and Europe in particular has been revised upwards much more strongly than in the United States, which is instead in the last phase of its cycle. Monetary policy surprises may come more from Europe or Japan than from the United States. Central banks other than the Fed are currently on the path to monetary policy normalisation. Thus, a downward correction of the USD was expected, given the strong appreciation the currency went through in 2014-2016.
(2.) Regarding the technicals, we note that the cross-currency basis has widened, therefore investing in US Treasuries (on a hedged basis) is not attractive for Japanese or European investors as the dollar hedge is expensive. Moreover, the flattened curve in the US has not helped to keep US Treasuries attractive. It is very interesting to note that the amount of US Treasuries held by foreigners has fallen again since the end of 2017.

(3.) Financing the new fiscal stimulus may drag down the dollar. While it has been argued that the current dollar weakness could be related to the US “twin deficits”, the correlation between higher twin deficits and USD weakness is difficult to prove. This could be explained by the peculiarity of the dollar in its role as the largest reserve currency and a safe haven investment. However, investors are now concerned about the major impact of a large fiscal boost so late in the US cycle, which could lead to increasing inflationary pressures and an aggressive response from the Fed.

2018 marked a turning point. The global economy is experiencing a significant synchronized upswing allowing DM central banks to pull back collectively at different speed. The peak of liquidity is behind us. The technical factors of the Fixed Income market will be less supportive in the coming years. In this context, the large US fiscal boost and infrastructure spending plans raise question. Indeed, a fiscal stimulus is completely unusual at the late phase of the cycle. **We expect the tax reform:**

- **To have a positive impact at macro levels.** We revised our US growth and inflation forecasts upward (Real GDP growth: 2.7% for 2018 and 2.2% for 2019; Inflation CPI: 2.3% 2018 and 2.2% 2019). We do not expect this plan to result in significant inflationary pressure that will force the Fed to raise rates drastically.

- **To have a limited impact on the US curve.** Historically the US curve has steepened on increasing budget deficits, as the back end tends to price in a higher term premium. But the steepening effect could be mitigated by the sell-off of the front-end.

- **To have a mitigated impact on credit.** The technical aspects seem more challenging in the medium term but the fundamentals are improving thanks to the global economic upswing.

- **To weigh on the dollar.** But we think that the evolution of the dollar will remain guided by interest rate differentials. If we expect no significant change in the Fed’s rate hike path, monetary policy surprises may come more from Europe or Japan than from the United States.
## Risk factors

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

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

<table>
<thead>
<tr>
<th>Risk #</th>
<th>Probability</th>
<th>Risk Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>75%</td>
<td>The post-Brexit environment permanently weakens the UK</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Risk #</th>
<th>Probability</th>
<th>Risk Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>#2</td>
<td>75%</td>
<td>Greater financial instability</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Risk #</th>
<th>Probability</th>
<th>Risk Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>#3</td>
<td>70%</td>
<td>Political and geopolitical risks maintained</td>
</tr>
</tbody>
</table>

**Analysis** | Financial markets are now operating against a complex geopolitical backdrop: Syria, Islamic State, Turkey, migrant flows, terrorist attacks, Sunnis vs. Shiites, Arabia vs. Iran, all of which have strained and weakened diplomatic relations between countries. Do not expect a quick resolution of ongoing problems and conflicts. In order to take into account political and geopolitical risks into portfolio constructions on a permanent basis, it is necessary to systematically consider macro-hedging strategies.

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

<table>
<thead>
<tr>
<th>Risk #</th>
<th>Probability</th>
<th>Risk Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>#4</td>
<td>20%</td>
<td>A long-term and significant increase in European long rates</td>
</tr>
</tbody>
</table>

**Analysis** | The increase in long-term rates can come from at least six sources: (i) a significant upswing in (nominal, real or potential) growth prospects, (ii) more aggressive tightening of interest rate policies, (iii) the “true” end of QEs (the end of reinvesting maturing papers in the US, an even more drastic reduction in the ECB’s asset purchasing programme), (iv) a resurgence of inflation or inflation expectations, (v) a massive reversal of fiscal and tax policies, or (vi) a resurgence of specific political risks. All these factors (reality, announced measures, or fears) have gained momentum in the United States, but it seems premature and excessive to expect a steady and substantial increase in bond yields. This conclusion holds even more in the case of the eurozone. But with growth that is now more robust and more sustainable, and low inflation expectations, debates over the end of negative rates and the ECB’s QE programme, and comments about the need for fiscal and tax measures that are more favourable to growth, it is a safe bet that the risks of a moderate rise in European rates are higher now.
### Market impact

A sharp rise in long rates would be bad news in the United States, where the sensitivity to long-term rates has increased with corporate releveraging; this would weaken growth and in itself would sow the seeds for a future decline in long rates. It should also be noted that a sharp rise in long-term rates would be a drag on any hint of Fed interest rate hikes. Another reason not to believe in a long-lasting and wide rise in US long-term rates ... and European should also be noted that a sharp rise in long-term interest rates would slow the monetary normalisation process. This is another reason for not believing in a sustained and ample increase in US – and European – long rates.

### Analysis

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### Analysis

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

### Market impact

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

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MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

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

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

- Global resynchronisation: Despite the recent financial turmoil, global growth is expected to remain strong in 2018 and 2019. Surveys remain at high levels and their recent deterioration does not signal a reversal of the cycle. The advanced economies (with the notable exception of the UK) will continue to experience above potential growth. The major emerging economies will also continue to grow at a sustained pace. The ongoing rebalancing in China is progressing quietly – such that the slowdown appears to be under control. The recovery in most economies is being driven by domestic demand, and we note a recovery in investment in many regions (US, Europe, Japan, Asia). The synchronous nature of the global recovery makes it more robust.

- World trade: world trade recovered strongly in 2017 (+5% yoy). It has so far been stimulated by the resynchronization of the global cycle and investment in capital goods. The protectionist measures announced by Donald Trump on steel and aluminium (tariff increases) will lead to retaliatory measures (from EU and China in particular) that are theoretically damaging to trade. However, it should be noted that steel and aluminium account for a tiny share of world trade and partner retaliation is targeted at a few products. We continue to expect a slight decline in the world trade to global GDP ratio in 2018 (i.e., trade growth slightly below that of global GDP). The probability that protectionist tensions will degenerate into a real global trade war is low (see risk scenario).

- United States: growth remains firmly anchored. Surveys still point to GDP growth above potential. The fiscal stimulus voted in December, combined with the bi-partisan plan to increase public spending, will extend the duration of the US cycle. No recession to fear neither in 2018, nor in 2019.

- Eurozone: the recovery is widespread, with a pick-up in investment in most countries. Growth is driven primarily by private domestic demand. The Eurozone is at mid-cycle, with the prospect of catching up for peripheral countries. The political risk has weakened, becoming more local. In Germany, the vote of SPD members in favour of the coalition with the CDU-CSU paves the way for a grand coalition favourable to Europe and a strengthened Franco-German couple. In another vein, the reduction in asset purchases by the ECB is likely to be accompanied by a rise in both long-term interest rates in the core countries and the Euro. Hence the slight slowdown in growth expected in 2019. However, thanks to accommodative credit conditions, growth should remain well above its potential in 2018 and 2019.

- United Kingdom: EU countries and the UK are in the process of concluding an agreement for a transition period (limited in time until the end of 2020) during which the UK will de facto maintain access to the single market. The dissensions on Brexit terms are strong (on the Irish border, the fact of remaining a no in the Customs Union). In her speech of March 2, Theresa May rejects the Customs Union (recently defended in the UK by Jeremy Corbyn), without really clarifying the British approach. Uncertainty will continue to weigh on the UK economy, but in a more diffuse way. We expect growth to remain below potential in 2018-2019.

- China: growth is more robust than expected. The reduction in overcapacity has reduced the downside risks. The economy’s growth drivers are now more diversified. Debt remains essentially domestic and has stabilised. We expect the gradual deceleration of growth to continue and a slow rebalancing (less growth, less debt). The transition looks to be under control.

- Inflation: core inflation, which is excessively low at this stage in the cycle (especially in advanced economies), is expected to recover gradually in 2018. That said, the slowdown in inflation over recent years is primarily structural (tied to supply factors), while the cyclical component of inflation has weakened (flattening of the Phillips curve). While the pick-up in core inflation promises to be modest, the likelihood of an “inflation surprise” is nonetheless increasing as surplus capacities disappear around the world (we estimate that the global output gap will close in 2018 for the first time since the great financial crisis). The risk is easier to spot in the US (we expect wages to continue to accelerate), given how close the economy is to full employment and how certain temporary factors (such as the drop in mobile phone service prices in the spring of 2017) have disappeared, which will automatically push inflation upward at the end of Q1 2018 (base effect).

- Oil prices: we expect prices to stabilise at a level close to their current level. At US$ 66 (Brent), the risk still seems to us to be asymmetric (more risk of seeing it drop). Indeed, if prices stay much above the breakeven point for US shale gas (estimated at around $40 pb), US production will eventually increase and weigh on prices.
In 2018, the central banks will continue to whittle down their accommodative monetary policy, which is excessive in view of the current recovery. The Fed will continue to raise its key interest rates (we anticipate three 25bp hikes in 2018) and reduce its balance sheet at the announced pace (with a gradual non-replacement of papers reaching maturity); meanwhile, the ECB could put an end to its QE programme as soon as Q4 2018, which would potentially open the door to the first increase in its deposit rate in early 2019. Central banks want to reduce their forward guidance, which is not as necessary as before. That said, monetary policies will remain accommodative overall, because even if some cyclical inflation does materialise, headline inflation will stay well below its historic average for the structural reasons we mentioned (flattening of the Phillips curve, continued downward pressure on the prices of many goods and services).

The protectionist measures announced by Donald Trump, coupled with the strengthening of the pro-cyclical nature of the US fiscal policy, raise the likelihood of fall in global trade, and as a result, of a negative reaction from markets (falling dollar, rising long-term interest rates) or ‘a mistake’ in monetary policy. Subsequently, we revise the probability of the downside risk scenario from 10 to 15% (to the detriment of the central scenario revised from 75 to 70%). The probabilities of the downside and upside risk scenarios are now balanced.

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

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

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

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

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

- Sharp pick-up driven by business investment, global trade, and synchronisation of the overall cycle.
- In a very promising environment, the pro-cyclical US tax policy generates a stronger than expected pick-up in domestic growth in the US. Continued acceleration cycle in the eurozone, stabilisation in China, confirmation of the trend in Japan, etc.
- Central banks react late, maintaining excessively accommodative monetary conditions, hence a «mini boom».

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

**United States**
- **although some data came out below consensus, economic growth remains solid with tentative signs of increasing wage pressures.**
- **Business sentiment remains upbeat with the Manufacturing and Services ISM both beating expectations and remaining firmly in expansionary territory.**
- **Inflation data were stronger than consensus, as headline and core CPI indices rose above their recent trend in January.**
- **The minutes of January’s FOMC meeting, when rates were left unchanged in the 1.25%-1.50% range, confirmed a more upbeat outlook for both growth and inflation, endorsing further hikes in 2018.**

**Brazil**
- **Recent Industrial Production figures released for December confirm the recovery in place, with the Consumption sector (Durable Consumption Items) stronger than items related to Investments like Capital Goods.**
- **The BCB is at the end of its long easing cycle: we do expect a long pause on monetary policy, thanks to an inflation rate that is under control.**
- **Pension reform is officially off the radar in this legislature. Other micro reforms are proceeding.**
- **The market is now focusing on the upcoming elections: the polls are fine-tuning the candidate list.**

**Eurozone**
- **The recovery continues with a lot of remaining potential**
- **The recovery remains strong even though some recent business confidence indicators disappointed mildly. The economy is supported by many factors (recovery in capex, lower political risk than in 2017, strong growth in the USA and Asia). Core inflation remains subdued. At this stage, the rise in the Euro is not enough to threaten the recovery.**
- **The indecisive result of Italian election does not carry an immediate systemic risk for Europe. In Germany, the government coalition deal should allow new initiatives to strengthen Eurozone institutions.**

**United Kingdom**
- **Slowdown amid major uncertainties around the Brexit process**
- **The economy has been slowing down since the beginning of 2017. Uncertainties concerning the Brexit process is detrimental to confidence. Sterling-induced inflation should be temporary. The unemployment rate rose slightly in December, wages are only increasing very slowly.**
- **T. May remains in a very difficult position as she is confronted to major divergences within her party and as the EU will be reluctant to grant the UK the close partnership that she seeks (outside of the single market and customs union).**

**China**
- **The economy perhaps slowed somewhat at the start of the year, but careful to draw strong conclusions given distortions due to Chinese New Year.**
- **Policy agenda is busy, including amendment to the country’s constitution in 2nd Plenum, governance reforms and official reshuffles in 3rd Plenum, and annual targets to be approved in People’s Congress.**
- **To watch further details in reform focuses and policy stance, while to monitor Trump’s trade policy with China’s top officials visiting US.**

**India**
- **The latest GDP figure for Q4 2018 has confirmed the recovery in place after the twin shocks experienced. It is worth noting that the Fixed Investments component has been revised up for Q3 and released strong for Q4.**
- **We are confirming our view that recovery is still subdued and the RBI should remain on hold for the time being, notwithstanding inflation that is higher than RBI’s comfort level.**
- **The recent fraud involving the PNB (Punjab National Bank) has increased the awareness of how vulnerable the banking sector is and the extent to which it is in need of being fixed.**

**Japan**
- **Historical long-running economic expansion has farther to go**
- **The current expansion has entered its fifth year. While the pace of growth will decelerate from the exhilarating level in 2017, business investment to cope with the chronic labour shortage and the Tokyo Olympic games in 2020 will continue to drive the economy.**
- **Meanwhile, investment for the purpose of capacity expansion will taper off on the appreciation of the yen and subsequent faltering exports. On the consumer front, wage growth is likely to remain lacklustre despite the government’s request for a 3% pay raise. Depressed real income will continue to weigh on spending.**

**Risk factors**

<table>
<thead>
<tr>
<th>United States</th>
<th>Risk factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Upside risks to inflation: economy close to full employment</td>
<td>• Improving economic conditions mainly in the Consumption sector.</td>
</tr>
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<td>• Protectionist risk from US-initiated investigations and outcome of NAFTA negotiations</td>
<td>• Pension reform off the radar for now.</td>
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<td>• Monetary policy normalisation during unusual fiscal policy mix</td>
<td>• Rising political noise with the approaching presidential elections</td>
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<td>• Rising political noise with the approaching presidential elections</td>
<td>• External risks</td>
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<th>Risk factors</th>
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<td>• Strained negotiations ahead on trade</td>
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<tr>
<td>• Rise in anti-establishment parties</td>
<td>• Weak government (no majority without the DUP)</td>
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<tr>
<td>• External risks</td>
<td>• Foreign deficit is still very high</td>
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<td>• Recovery confirmed at the end of 2017.</td>
<td>• The recent surge of the yen: a further appreciation would weigh on confidence</td>
</tr>
<tr>
<td>• Banking sector vulnerability still requires a cautious RBI</td>
<td>• Geopolitical risks (tensions with North Korea)</td>
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</tbody>
</table>
## Macro and Market forecasts

### Macroeconomic forecasts (02 March 2018)

<table>
<thead>
<tr>
<th>Annual averages (%)</th>
<th>Real GDP growth %</th>
<th>Inflation (CPI, yoy, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Japan</td>
<td>1.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Eurozone</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>France</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Italy</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Spain</td>
<td>3.1</td>
<td>2.7</td>
</tr>
<tr>
<td>UK</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Russia</td>
<td>1.5</td>
<td>1.7</td>
</tr>
<tr>
<td>India</td>
<td>6.4</td>
<td>6.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5.1</td>
<td>5.3</td>
</tr>
<tr>
<td>China</td>
<td>6.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>6.5</td>
<td>4.3</td>
</tr>
<tr>
<td>Developed countries</td>
<td>2.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Emerging countries</td>
<td>4.9</td>
<td>5.0</td>
</tr>
<tr>
<td>World</td>
<td>3.8</td>
<td>3.8</td>
</tr>
</tbody>
</table>

### Source: Amundi Research

### Key interest rate outlook

<table>
<thead>
<tr>
<th>12/03/2018</th>
<th>Amundi + 6m.</th>
<th>Consensus Q2 2018</th>
<th>Amundi + 12m.</th>
<th>Consensus Q4 2018</th>
</tr>
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<tbody>
<tr>
<td>US</td>
<td>1.5</td>
<td>2.0</td>
<td>2.25</td>
<td>2.35</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.10</td>
<td>-0.10</td>
<td>-0.10</td>
<td>-0.10</td>
</tr>
<tr>
<td>UK</td>
<td>0.50</td>
<td>0.75</td>
<td>0.65</td>
<td>0.75</td>
</tr>
</tbody>
</table>

### Long rate outlook

#### 2Y. Bond yield

<table>
<thead>
<tr>
<th>12/03/2018</th>
<th>Amundi + 6m.</th>
<th>Forward + 6m.</th>
<th>Amundi + 12m.</th>
<th>Forward + 12m.</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.26</td>
<td>2.50/2.0</td>
<td>2.20/2.40</td>
<td>2.66</td>
</tr>
<tr>
<td>Germany</td>
<td>-0.57</td>
<td>-0.41</td>
<td>-0.20/0.20</td>
<td>-0.25</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.15</td>
<td>-0.20/0.00</td>
<td>-0.20/0.00</td>
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<tr>
<td>UK</td>
<td>0.83</td>
<td>0.93</td>
<td>0.8-1.0</td>
<td>1.00</td>
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</table>

#### 10Y. Bond yield

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<tr>
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<th>Amundi + 6m.</th>
<th>Forward + 6m.</th>
<th>Amundi + 12m.</th>
<th>Forward + 12m.</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.89</td>
<td>2.98/3.0</td>
<td>2.8/3.0</td>
<td>3.04</td>
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<tr>
<td>Germany</td>
<td>0.63</td>
<td>0.80/1.00</td>
<td>0.80/1.00</td>
<td>0.89</td>
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<tr>
<td>Japan</td>
<td>0.05</td>
<td>0.10</td>
<td>0</td>
<td>0.14</td>
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<tr>
<td>UK</td>
<td>1.49</td>
<td>1.40/1.60</td>
<td>1.40/1.60</td>
<td>1.74</td>
</tr>
</tbody>
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### Currency outlook

<table>
<thead>
<tr>
<th>09/03/2018</th>
<th>Amundi + 6m.</th>
<th>Consensus Q2 2018</th>
<th>Amundi + 12m.</th>
<th>Consensus Q4 2018</th>
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<tbody>
<tr>
<td>EUR/USD</td>
<td>1.23</td>
<td>1.25</td>
<td>1.25</td>
<td>1.26</td>
</tr>
<tr>
<td>USD/JPY</td>
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<td>105.00</td>
<td>105.00</td>
<td>110.00</td>
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<tr>
<td>EUR/GBP</td>
<td>0.89</td>
<td>0.95</td>
<td>0.95</td>
<td>0.95</td>
</tr>
<tr>
<td>EUR/CHF</td>
<td>1.17</td>
<td>1.16</td>
<td>1.18</td>
<td>1.18</td>
</tr>
<tr>
<td>EUR/NOK</td>
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<tr>
<td>USD/CNY</td>
<td>6.34</td>
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<td>6.30</td>
<td>6.40</td>
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