Asset allocation: Amundi investment strategies

Are markets legitimately fearful?

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Since last summer, things haven't worked out quite the way they are supposed to. Gloom has descended upon the financial markets, covering everything in a negative light. It's easy, then, to understand why we have seen risk repricing, the implementation of portfolio protection strategies and even the liquidation of positions, to the point where the equity markets of the major countries have virtually all fallen by 10% to 15%. Meanwhile, 10-year yields have collapsed, falling to 1.74% in the United States (-55 bps since the beginning of the year) and 0.23% in Germany (-40 bps since January). Credit spreads (corporates and sovereigns) have widened—the iTraxx Main has risen by 45 bps (to 120 bps currently) while the iTraxx Crossover is up 150 bps (to 460 bps)—and profit-taking on companies and sectors that still offer positive returns has increased. Gold has risen by over 12% in the span of a few weeks, a good indication of the scale of risk aversion.

How did we come to this? Do we have to significantly revise our economic and financial outlooks and overhaul our asset allocations? This article seeks to answer these questions, which are so important in the current environment.

1. Why is the decline in oil prices so scary?

The price of Brent crude has fallen 12% since the beginning of January, to its current $33 a barrel. **The financial markets normally respond favourably to lower crude oil prices,** for a number of reasons:

- Lower prices are good for **commodity-consuming countries;**
- They improve businesses' **margins** and **profits;**
- They push price indexes further down, particularly in developing countries, which provides **greater leeway in monetary policy,** etc.;
- They support **growth** and **domestic demand** at a time when the latter is the main driver of growth (excluding public spending).

However, **since mid-2015, the sharp decline in crude oil prices has frightened the financial markets.** What is the reason for this reaction?

- The low prices have weakened **oil-producing countries**, making them vulnerable (Saudi Arabia, the Persian Gulf countries generally, Canada, Norway, etc.) and in some cases exposing them to extreme difficulty (Venezuela, Azerbaijan, etc.). The result is a surge in country risk.
- They have generated concern that companies in the energy sector (see the weight of the energy sector in US high yield) may go into **default or bankruptcy**.
- In this context, **financial securities** (especially in the **banking** sector) have also become much more vulnerable, their exposure to the energy sector becoming critical.
- The drop in crude oil prices has driven down **inflation indicators** just as central banks, especially in Japan and the eurozone, want to see inflation or inflation anticipations rise, compromising the effectiveness of earlier measures.
- They impact the reserves of certain **sovereign funds** (oil funds and SWFs in general), which may have to sell off their portfolios to boost governmental liquidity back-up.

It is important to note that prices have declined for all commodities, in line with lower demand attributable to the worldwide growth deceleration. However, oil has its own unique feature: two thirds of the decline is linked to supply-related developments. Excess production is widespread: an OPEC unable to regulate the market, a United States actively engaged in developing shale oil (US crude production rose 65% in five years), the likelihood of Iran entering the supply

The essential

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The decline in oil prices is scary because it has weakened oil-producing countries, making them vulnerable and in some cases exposing them to extreme difficulty. The same with energy companies with higher default and bankruptcy risks. It also has consequences with banks through exposure to the energy sector. All the positive benefits from the oil counter-shock seem marginal compared to the dangers. Central banks seem unable to reassure financial markets due to the potential lack of mid-term efficiency of monetary policies. China is another concern, with the yuan policy being perceived as a complex and unstable strategy. Moreover, macroeconomic forecasts are for long far too optimistic, and recession fears are now resurfacing in the US.

In sum, it is easy to understand why financial markets were so fragile. The thing is that it is not a problem of fragility anymore, but a question about a possible downfall of world growth and banking systems. We do not think these risks will materialise, but it is evident the macro financial environment has deteriorated sharply in the past months. As a consequence, these fears clearly justify the macro-hedging strategies developed in this publication and in our portfolios over the last six months (long on US Treasuries and German Bunds, long on volatility, long on the USD and JPY, long on USD cash and long on gold).

The purpose of this article is to discuss the adjustments we have made is our portfolios following the wave or market stress. Downfall of equities, credit spreads widening and contagion to equities, higher volatility, drop in bond yields in safe countries such as Germany and the US… all these events have prompted us to rethink our set-up (macro-hedging, portfolio liquidity, risk, stress tests…), but not necessarily the rationale behind our asset allocation.

market, wildcat production in some countries—in short, plenty of factors to create supply and demand imbalances, although the solution (stabilisation of crude oil prices) will undoubtedly come from the supply side. **It's difficult to predict moves as political in nature as the decision to reduce oil production,** and OPEC's next official meeting isn't until June. "We are not ready to reduce our production" were the words of OPEC Secretary General Abdallah el-Badri following a meeting in Moscow last July. In late January, Venezuela requested an emergency meeting to stabilise prices, but the Gulf countries, led by Saudi Arabia, have so far been opposed. **The fear, then, is that oil prices will remain in free-fall until June, with negative consequences for producer countries and sector companies.**

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2. Why are central banks unable to reassure financial markets?

The central banks appear to have lost their upper hand. The financial markets have been too central-bank dependent for a long time now, and **central banks do not enjoy the same credibility they once had.**

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The **BoJ** has adopted a negative interest rate on new deposits placed by banks with the central bank's facility, a rather obvious attempt at avoiding a sharp appreciation of the yen (a currency that is currently undervalued), and recognising the ineffectiveness of the QQE (Quantitative and Qualitative Easing) programme. Of course, the BoJ is continuing its asset purchase programme ($600 billion in purchases planned for 2016), but it has also admitted that the situation regarding inflation/inflation expectations and growth has deteriorated. Furthermore, the beginning of the trading year in Japan was the worst since 1949, which largely explains the decisions taken by the monetary authorities.

The **ECB** has admitted that it is going to reconsider its monetary policy stance in light of new developments, such as energy prices, the return of volatility, fluctuations in the yuan and the prevailing situation in China and the emerging countries, factors responsible for the further lowering of inflation expectations—both present and future—the euro's renewed vigour and greater export-related risks. Deflationary pressures are increasing. The financial markets did not respond well to decisions made in December (expansion of QE, cut to the deposit facility rate), illustrating the difficulties currently facing the ECB. The ECB is set to take new measures in March.

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Several options are available:

- Extending the current QE programme: lengthening the maturity and/or increasing the size of its asset purchases. It is important to remember that these purchases are already massive: this year alone, the ECB is to buy 140 times total net German issues or twice the size of net Spanish issues. It's hard to imagine an interest rate increase in an environment like that.
- Widening QE to include new asset classes: here we are referring to corporate bonds.
- Changes to the distribution of asset purchases to augment peripheral asset purchases.
- A further reduction to the interest rate on the ECB's deposit facility. We are not the greatest proponents of such a measure, but if the ECB wants to take this argument to the extreme (by testing the level at which banks would no longer be willing to deposit cash with the ECB), it will continue in this direction. The rate cut would be a logical step; however, in our assessment it would be counter-productive for many reasons, not least the fact that it would anchor deflationary fears. Indeed, the announcement of such a measure caused, in both Europe and Japan, instability on the financial markets.
- Recourse to TLTRO to support the financial system, mainly in particular countries at the edges of the eurozone. It is important to consolidate the economic recovery, the defragmentation of the financial sector and bank lending.

Meanwhile, in the absence of inflation and faced with declining growth (GDP grew only 0.7% in the last quarter of 2015), the ***Fed*** will have a hard time actively pursuing any kind of monetary policy tightening cycle. We continue to count on only one round of monetary policy tightening between now and the end of 2016. The Fed is the only major central bank raising its key interest rates, and a higher dollar is undoubtedly unwelcome at this point in time. Moreover, the Fed has no leeway and will undoubtedly have to launch a QE4 if it wants to boost growth and inflation.

3. Why is China still causing the financial markets concern?

China undeniably represents the greatest systemic risk, and the events of the last few months (depreciation of the yuan, temporary closing of equity markets in August and January) have fuelled unease. Is the PBoC still in control? Could China's slowdown become even more brutal? Is economic policy still effective? These are the key questions. In our assessment, the current fears are overblown.

- **China's slowdown is now a fact,** and a consequence of its higher development. Indeed, economic development is always accompanied by reduced savings, slower growth and lower potential growth. The situation is compounded by poor demographics (China will get old before it gets rich) and reduced productivity gains, which impacts potential growth directly. None of this is new.
- **China will not devalue the yuan.** It has made a number of commitments to the G20 and the IMF (the yuan will be part of the SDR basket starting next October), it hopes to establish the yuan as the regional benchmark currency (exchange rate stability is essential) and today growth is driven more by domestic demand than by net exports (in other words, the yuan is no longer as important in archiving growth).
- **China will not radically change its economic policy.** It will remain a combination of monetary policy, fiscal policy, budgetary policy and revenue policy. China's exchange rate policy (devaluation) will not follow this direction. However, while so far the yuan has been “following” the US dollar, going forward China will manage the stability of its currency relative to a basket of currencies— a difficult task that will rule out neither volatility nor the depreciation of the yuan against the USD. However, since the summer of 2015, it has been genuinely effective.
- **China therefore has the capacity to support growth** if needed. We forecast GDP growth of around 6% in 2016 and 5.8% in 2017.
- **No hard or crash landing in the near future.** It's quite difficult to define what such a “landing” would look like in China, but for reference we can look at Japan in the 1970s, when a hard landing meant growth of 3%.
- China's growth won't hit 3% in the next two years, but **a “landing” of Chinese growth close to its growth potential** (10% about 10-15 years ago, around 5% currently, and undoubtedly lower five to 10 years from now) **is inevitable**.
- **In reality, the growth figure is not that important.** Balanced 5% growth driven by demand is better than 10% growth driven by exports alone. That would be healthier for China, for its partner countries and for financial stability.

4. Should we be concerned about recession in the United States?

We have mentioned on numerous occasions that the market consensus was too optimistic. We are now seeing a major shift in outlooks. Only a few days ago, a major banking institution revised its 2016 US growth forecast from 3.3% to 1.8%. While the downgrade should not surprise anyone, we might well ask whether such a high projection was justified, given that leading indicators are, and have long been, in line with an outlook of about 2%. For our part, we revised our growth outlook in 2014: a significant downward revision to global growth from 3.8% to 3.1% between January 2014 and December 2014, essentially a reflection of the economic slowdown in the emerging countries, a less pronounced downward revision to US growth, which should gradually converge with its growth potential (around 1.8%) and an upward revision to eurozone growth. We are maintaining our stance. As for the United States, we must not forget that consumption (which represents more than 70% of GDP) continues to hold up well and that there is a big difference between the services sector (strong) and the manufacturing sector (weaker). All of this makes us think that growth of approximately 2%, not a contraction, is in the offing. **At this time, a recession in the United States is not a possibility, but what is worrying is the Fed's lack of room to manoeuvre.** The current situation is totally different from 2004-2006. During those two years, the Fed

> “TLTRO, QE extension to new asset classes, new allocative key for countries as regard asset purchases, new deposit rate cut… these are credible options for the ECB”

> “Last summer, China has decided to manage the stability of the effective yuan”

managed to hike interest rates 17 times—a total of 400 basis points—giving itself leeway, which it was quick to use once the financial crisis hit. Today that context is very remote. The Fed is behind in its economic cycle and financial stability, and to a lesser degree the US dollar, cannot afford rate hikes.

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5. Should we be worried about the banking system collapsing?

This is now the question on everyone's lips. It must be said that the drop in banks' market capitalisations has been fairly spectacular: some flagship stocks have lost up to 40% (Unicredit, Credit Suisse, Deutsche Bank), or twice their national equity market index. In all, the sector has lost more than 20% of its value. There are several reasons for this:

- The widespread economic slowdown is, obviously, a negative factor;
- The decline in oil prices and fears over their exposure to the energy sector is worrisome, somewhat similar to the fears over their exposure to sub-primes in 2007 – though in very different proportions;
- Specific factors such as in Italy, where the "bad bank" structure did not win unanimous support, or in other peripheral countries where the banking systems are still fragile;
- Fears/rumours of failure by a large institution are constantly in the news;
- Very low rates are eating into banks' profits. Of course this is not a new problem in Europe, but the BoJ's recent moves and the ratcheting down of expectations for tightening in the US have exacerbated this trend;
- The regulations are not promising for the banks, but this is nothing new.
- Another factor that is, without a doubt, weighing things down is the heft of bank shares in short-term monetary portfolios that have already been hit by very low (often negative) rates and that should generate their performance from bank spreads. Some have probably had to capitulate, which ultimately explains why the rise in bond spreads, after being contagious for equities, is now so for short-term spreads as well.
- There is also a liquidity aspect on bank debt, and fluctuations are easily exacerbated. This liquidity shrinkage is linked to current QE policies and with investors chasing returns (hence the outperformance of Additional Tier Ones), and it also results from regulation which has reduced the number of liquidity providers (and some activities which tended to provide it).

> A banking system collapse is an everyone's lips

There, in brief, are the focal points for the financial markets. We quite understand the prevailing risk aversion, and must protect against it, but we must also keep these points in perspective and identify the plausible support factors:

- Unlike the previous crisis (2008-2009), the banks have no financing problem today:
- Banking system supervision has come a long way since the financial crisis, as has the communication on the subject; the ECB has conducted a large-scale and thorough audit; stress tests have been mostly reassuring, and risks clearly identified;
- Their exposure to the energy sector is fairly well identified. We could posit that, overall, it is only one tenth of the level of exposure to sub-primes in 2008, given that, in addition, the sub-prime damage came from securitisation assets in which there were sub-primes. We are not in the same orders of magnitude here, nor the same securitisation "delusion";
- European banks have raised more than €500 billion in equity since the crisis, and are now well-capitalised. US banks had done the same thing a little while before the European banks. In addition to this large recapitalisation, regulators have clearly toughened capital constraints, both in terms of quality (more core capital) and in terms of quantity : the levels required are now much higher than pre-crisis levels.
- Today, exposure to credit has no resemblance to the level that dominated in 2008: we have moved from a credit bubble to a credit deficit. We cannot at the same time call the banks too cautious on credit (see the arguments in favour of the different QE programmes) and fear for their exposure to the loans, except for those that, potentially, would have had few loans, but

loans highly concentrated on the energy sector. There do not seem to be any systemic large banks in this scenario.

We can never rule out the possibility of a crash, and a crash doesn't require a prior bubble. That being said, without underestimating the banks' difficulties and the economic environment (slowdown, fears of recession), the financial environment (low rates), and the regulatory environment that is unfriendly to the sector, we are not counting on a collapse of the banking system like the one that struck in 2008.

6. Do we need to revise the outlook on the US dollar, and on currencies generally?

So far, the following outlooks have been predominant:

- A weak euro, mainly linked to the actions of the ECB;
- Potential appreciation for the US dollar, which will be limited but noticeable given monetary policy orientations in Europe, China and Japan. However, a stabilisation in oil prices and China's economy would undoubtedly push up emerging currencies and thereby cause the effective exchange rates of the yen, euro and US dollar to fall. But we are not at that stage yet;
- Potential additional depreciation of the yen, limited in scale given its significant undervaluation;
- Gradual and restrained depreciation of the yuan, with China's central bank now seeking stability against a basket of currencies.

The developments of the past few weeks are not really in line with these outlooks. Granted, the yuan is under control, and since last summer we have had stability in the yuan's effective exchange rate, and therefore a disconnect between the yuan and the US dollar. Also, the yen has stopped falling and the BoJ is trying to block its future appreciation. However, the euro has appreciated while the US dollar has fallen. But is this truly surprising? In reality, no.

So far, there are two complementary ways of explaining the euro's appreciation:

- A new factor: what's new is the downward revision of US growth forecasts and of expectations of monetary tightening, which are now both more in line with our own revisions.
- Foreign exchange policy: there is a real, explicit foreign exchange policy in Japan, China and the United States, which is not the case for the eurozone. Since the introduction of the common currency, the euro has been the adjustment currency and ultimately remains the system's "relief currency".

> "The euro has been the adjustment currency and ultimately remains the system's "relief currency""

Ultimately, the yen has genuine potential for appreciation, and the US dollar, like the yen, is an excellent macro-hedging tool. The euro, while shielded by the eurozone's current account surpluses, should resume its downward trend due to the upcoming measures of the ECB. We are maintaining our EUR/USD target of 1.05.

Finally, we are still in an environment marked by:

1. The slowdown of the global economy. This is related to the emerging countries, a clear decoupling between regions and a lack of unified blocks of countries. There is no concrete economic reality in the European block, the emerging country block or the dollar block. **In other words, investment opportunities** can be found in the decoupling between developed and emerging countries, between countries with high domestic demand and others and between emerging countries that produce commodities and those that consume them.
2. Growth expectations that are still overly optimistic and fears that are definitely exaggerated over the medium term (they do not justify complete capitulation) but are decidedly present in the short term. Such fears include the fear of a recession in the United States, the risks posed by the oil countershock (for countries and companies), doubts over

> "Slowdown of the global economy, related to the emerging countries, a clear decoupling between regions and a lack of unified blocks of countries"

China's ability to control its situation and finally the inability of central banks to reassure markets. **In other words, these fears clearly justify the macro-hedging strategies developed at Amundi over the last six months (long on US Treasuries and German Bunds, long on volatility, long on the USD and JPY, long on USD cash and long on gold). (see box below).**

> The fears justify macro-hedging strategies

> What are the macro-hedging strategies?

We identified a number of major risks and suggested some macro-hedging strategies. Against the current backdrop, we are often asked about these issues and we reiterate below the risk factors and the corresponding strategies.

- **Risk 1: Poorly understood interest rate hike**
- **Risk 2: Hard landing by the Chinese economy**
- **Risk 3: Collapse of global growth**
- **Risk 4: Sharp devaluation of the yuan**
- **Risk 5: Renewed fall in oil and commodity prices**
- **Risk 6: A new crisis in Europe**
- **Risk 7: Liquidity crisis**
- **Risk 8: A recession in the United States**

US Treasury bonds, Bunds, volatility, US dollars, JPY, cash (in USD in particular) and gold are the best protection against extreme risk. Some of these have been incorporated into the portfolios, either because they are in line with our central scenario, or because they represent a solid macro-hedging strategy, or both.

- **Increasing long-term exposure to US Treasury bonds and German Bunds makes sense in terms of protecting the portfolios from risks 2, 3, 4, 5, 6, 7 and 8.** The ultimate safe haven, there should be strongly negative correlations with the stock markets in the event of a crisis.
- **Going long on volatility makes perfect sense in scenarios 1, 2, 3, 4,7 and 8.** We can go long vol by creating a diversified long-volatility portfolio (several currencies, including EMG currencies and/or currencies + equities), naturally choosing the lowest volatilities (and the most liquid vehicles). Volatility swaps and variance swaps, which deal in actual volatility, and Forward Vol. Agreement, which deals in implied volatility, or structurally long volatility funds, are the products generally used to buy volatility. Buying equity volatility or currency volatility will provide more protection than buying fixed-income volatility, particularly in Europe and Japan, where the bond markets are administered and would continue to be so in the event of a financial crisis.
- **Increasing the liquidity of portfolios is in line with risks 1, 2, 3, 4, 6, 7 and 8.** This is a natural and legitimate reflex, except that returns are nowhere near where they should be. Favour USD cash over EUR or JPY cash. Risk-free assets have, over recent years, become return-free assets, even in the best cases (EUR and JPY cash).
- **Going long on the USD is useful in scenarios 2, 3, 4, 5, 6 and 7.** During a crisis, the dollar benefits from being a safe haven, which makes it a counter-cyclical currency (which moves against the equity markets).
- **Going long on the JPY is appropriate in scenarios 2, 4 and 5.** Like the dollar, but to a lesser degree. Being deeply undervalued as it is currently could turn out to be a key advantage.
- **Buy gold in scenarios 1, 2, 3, 4, 6, 7 and 8.** Gold is the only risky asset class that rose during the Gulf War, the LTCM failure, 11 September 2001, the 2002 recession, the Great Recession and the sovereign debt crisis, which truly sets it apart as an asset. It represents a debt to no-one (unlike bonds or equities) which, against a backdrop of a high-debt economic and financial crisis, is undoubtedly extremely valuable.

As regard the impact on portfolios, we asked our heads of portfolio management to give their views

> It is too soon to enter into a valuation bet at this stage, that would be very dangerous to further reduce risk budgets

Fixed Income portfolios

ÉRIC BRARD, *Global Head of Fixed Income*

The fixed income markets are going through a phase of high volatility; spreads have widened significantly, both on credit and on non-core government debt.

The combination of rising doubts concerning world GDP growth together with what seems to be a decline in central banks credibility, plus a lack of liquidity in the markets could generate further volatility over the short term.

We do not question the current recovery in developed markets, where corporate credit fundamentals remain sound . However, the higher level of risk aversion will need some time to recede. As a consequence, the market will most likely remain in a risk management mode for a while, and so are we. We do not plan to add risks in the coming days, after having reduced our credit exposure in January. We do not want either to short duration despite the very low levels of interest rates in the core markets, as duration partly contributes to hedge spread risks.

In other words, it is too soon to enter into a valuation bet at this stage, that would be very dangerous to further reduce risk budgets. We continue to closely monitor the level of liquidity in our portfolios, though we have not experienced significant outflows so far.

Equities portfolios

ROMAIN BOSCHER, *Global Head of Equities*

Tipping point or turning point?

Equity markets have reached lows not seen since 2014. Equities are also being impacted by the sentiment that default risk in energy and financials is high and the eventuality that such defaults would spark another crisis. One positive aspect is that the long list of bad news has already been discounted and the economic news flow is still decent, particularly in Europe. In addition, after more than 5 years of underperformance, cyclical stocks are starting to outperform defensive stocks in terms of relative performances.

Could this be a tipping point for more volatile and cyclical names coinciding with a rebound for Equities? If we discount energy and financials, the rest of the market cannot be described as hitting rock bottom, this means that we are keen to buy than to sell and are looking for value stocks more than for growth and defensive names, which should underperform in relative terms.

Multi-Asset Portfolios

LOÏC BÉCUE, *Global Head of Multi-Asset portfolios, Retail Clients*

RAPHAËL SOBOTKA, *Global Head of Multi-Asset portfolios, Institutional Clients*

Over the past few weeks, we have been living through a severe risk-off environment. Equity markets, credit and peripheral debt spreads have been hit hard meaning that there are not many places to hide, except Eurozone Core and US Government bonds. There has been an adjustment of risk factors (e.g. Oil, China, US recession) without much clarity on their causality links and their fundamental impact on the global growth and corporate profits dynamics.

As mentioned before, these risk factors are likely to have been catalysts of a significant deleveraging for some institutions, and we don't believe that global growth dynamics are broken. Therefore we are maintaining our main views and positions: for instance we still believe that Peripheral spreads should stay contained thanks to ECB action, that Eurozone Equities have got potential since profit cycle is less mature than US profit cycle. We had reduced Corporate Credit exposures at the end of last year and in January and, given the major spreads widening and sound fundamentals, it is not clear to us that we should reduce further. We are taking a wait and see stance on this front.

At the same time, we have factored in our portfolios the probability to be wrong. The main risks to our positioning is that global growth is indeed broken and particularly that US growth and corporate profits are going to be significantly revised down. In this scenario, it is very unlikely that European risk assets can decouple. These are likely to rapidly jump from mid-cycle to end -of -cycle and correct further. This explains why we continue to hold and have in fact added US government bonds to protect our portfolios. In addition, we have added put options and volatility strategies to protect portfolios.

**ASSET ALLOCATION
SHORT TERM OUTLOOK (3-6 MONTHS)**

	- -	-	●	+	++
CASH					
USD				●	
EUR		●			
SOVEREIGN BONDS					
United States			●		
Eurozone (core countries)			●		
Eurozone (periph. countries)				●	
United Kingdom			●		
Japan			●		
Emerging market debts			●		
CORPORATE BONDS					
Investment Grade Europe				●	
Investment Grade US				●	
High Yield Europe			●		
High Yield US			●		
EQUITIES					
United States			●		
Eurozone				●	
Europe excl. eurozone			●		
Japan				●	
Emerging markets			●		
CURRENCIES					
US dollar				●	
Euro		●			
Sterling				●	
Yen				●	
Emerging market currencies			●		

(--) Significantly underweighted (UW)
(-) Underweighted
(●) Neutral
(+) Overweighted (OW)
(++) Significantly overweighted

> "The main risks to our positioning is that global growth is indeed broken and particularly the US growth"