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Amundi ASSET MANAGEMENT

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Market sell-off requires more emphasis on diversification

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- ***Market sell-off.*** *After more than a year without a significant correction, equity markets declined as interest rates moved sharply higher due to concerns that inflation may be rising. The decline was overdue, in our opinion, and is consistent with our belief that inflation is likely to increase, but should remain subdued.*
- ***Fundamentals****: Macro and micro fundamentals at corporate level are intact as the recent earnings reporting season confirms.*
- ***Volatility*** *bounced back from ultra-low levels. Macro hedges (volatility, gold, safe haven cross rates, options strategies) in this market environment are key.*
- ***Embrace an active approach.*** *An active and flexible approach within a solid macro and micro fundamental backdrop is key to possibly capturing opportunities that this market correction may bring again.*

What are the reasons behind the recent price action in fixed income and, more recently, in equity?

MD: After a long phase without any market correction, in which risky assets have ignored any tight/extreme valuations and heavy positioning on equities and carry trades, inflation fears came back in the equity market, on the back of the release of the January US labour report (with average hourly earnings rising by 2.9%, the highest increase since June 2009), causing a disordered reaction in an overbought market.

The adjustment to higher inflation has been affecting fixed income markets for few weeks (10-year real yields rose from 0.42% to 0.72% at the start of the year, while inflation expectations, as expressed in TIPS break-evens, have increased from 1.98% to 2.11%) and turned out to be a material sell off on the equity side as market technicalities (algorithmic equity trading) triggered relevant stop losses. This might explain also the relatively contained movements in the credit spreads. Macro hedges such as volatility, gold, safe haven cross rates (JPYAUD, USDCAD) and put spreads worked as expected. As indicated in our Outlook, inflation expectations will be key to addressing the investment guidelines throughout 2018. At this stage we don't see risk of inflation spikes in the US, and we confirm our base scenario of rising but subdued inflation.

Do you see changes in economic or corporate fundamentals motivating the correction?

MD: The positive macro and micro fundamentals don't justify the recent market movement. While the economic backdrop improvement is confirmed, the global earnings reporting season proves robust across the board and consistent with our view that EPS cycle is key to pave the way for continued constructive equity returns. So, solidity of fundamentals remains intact.

Do you believe it is a buy opportunity or will this volatility last for a while?

MD: This volatility may well last for a while, likely comeback from the depressed levels that we have seen over the last few years. While for the time being we remain cautious, we will be ready to actively exploit opportunities which could be brought by this wave of volatility resurgence (consistently with a late financial cycle regime transition).

"Solidity of fundamentals remains intact and does not justify the current correction."

Which strategies can investors put in place to deal with this correction?

VM: During the last few months we have been focused on mitigating risk exposure, including macro hedges to balance the moderate risk on stance. Moreover, we progressively switched from directional positioning to a more relative value approach. The transition to a late financial cycle allows us to have a preference for equity markets backed up by solid EPS growth (Europe and Japan in particular, and selectively on Emerging Markets). On the credit side, we believe investors should be extremely selective as valuations are really tight and prefer short maturities

where there is still value, with a strong focus on quality and liquidity. On the government bond side, flexibility in the duration and curve management will be key. While term premia[1] are rebuilding on yield curves a short duration positioning and exposure to inflation linked bonds should be favoured in this phase to mitigate risk.
We believe that investors should continue to be very focused on diversification of risks and on implementing strategies to mitigate the drawdown. At the same time, an active and flexible approach within a solid macro and micro fundamental backdrop is key to catching opportunities that this market correction may bring.

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[1] Term premium is the extra yield required by bond investors to hold on to a long-term bond in place of a series of short-term bonds

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