Risk Factors

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The table below presents 17 risk factors with probabilities assigned.
It also develops the most credible market impacts.

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

ANALYSIS Donald Trump's election undoubtedly represents a great change in the philosophy of America, less determined now by a logic of "world policeman" and more self-centred, according to the new president's statements. Beyond this major shift, the question is also now whether economic policy will be strongly altered, notably through fiscal and tax policy. How will monetary policy accompany these changes? These are all crucial questions. We know that tax cuts and a revival of infrastructure spending are planned, and that the impact on the budget deficit could be very high, with the usual consequences on long rates, public debt and monetary policy. We also know that the American Congress (even if it is a Republican one) will not unconditionally back the new president on these issues, as it is not favourable to large budget deficits. Having said that, even if the changes remain moderate compared to the campaign promises, discounting significant changes would undoubtedly be a mistake. Certain proposals, such as the corporate tax cuts, represent genuine "game changers". If it proves to be substantial, the effects of this tax cut are likely to be felt in many areas, including the repatriation of profits and investment plans on American soil. These developments should be monitored closely.

MARKET IMPACT The victory of Donald Trump brings uncertainty on many points: the international role of the United States, NATO, trade agreements, the climate agreement, anti-migrant policy, trade policy, protectionism and possible tariffs. His future actions, if approved by Congress, represent an additional risk for the financial markets (notably on the dollar, ambient volatility and long rates). A latent conflict with the Fed is also unsettling the fixed-income markets. The risk of a major shift in economic policy, leading to a widening of deficits but also to a surplus of growth, renewed vigour for the dollar and a resurgence of inflation expectations, is not marginal at this stage. Negotiations with Congress will need to be closely followed.

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

ANALYSIS The appointment of a technocratic government (headed by Paolo Gentiloni) and the extension of the ECB's asset purchasing programme have reassured the Italian financial markets, but it is now a matter of reviewing the electoral law as the general elections take shape. Initially planned for February 2018, the financial markets fear, on the one hand, the holding of early elections (during the second half of 2017?), which would lead to the taking of power by the "populist" Five Star Movement, and on the other hand, the holding of a referendum on membership in the European Union ("Italexit"). The rise of populism (which is synonymous with the rejection of the establishment, the rejection of traditional parties, the rise of protectionism, the rejection of globalisation, anger against rising inequalities, the refusal of centralisation, hostility to reforms of social systems, etc.) is also a reality in Italy. There is a risk of major change after 5 years of relative political stability. Such a scenario would undoubtedly be the worst case scenario, which could initially lead to political instability or crisis and undoubtedly result in a suspension of reforms. Let us recall, however, that the Five Star Movement is more anti-establishment than anti-Europe. Nonetheless, the Italian people are among the least enthusiastic in Europe with regard to the euro. That is to say, a referendum on Europe, if it were to take place, would carry much uncertainty.

MARKET IMPACT The prospect of early elections would trigger a phase of political instability. This is bad news for this country, which is lagging behind in terms of economic growth (especially in comparison with Spain, its "comparable" market). Its debt is nevertheless protected by the ECB's QE programme, which helps prevent flight by investors (who are seeking yield and spreads). In the event of a referendum on "Italexit" (still anti-constitutional at present), the Italian bond market would represent a specific risk, and interest rate spreads would further deteriorate due to a "repricing" of Italian risk. Political instability would also strongly weaken its equity and interest rate markets.

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

ANALYSIS The election of Donald Trump introduced a degree of uncertainty: it is doubtful that the new president will confirm Janet Yellen for a second term in 2018, and it is also known that he has criticised the "complacency" of monetary policy. The Republicans also recently expressed hostility toward the Fed's Chair, particularly with regard to her positions on regulations, the reduction of which has been a priority for President Trump. It is difficult to understand the message with regard to interest rates: how do you simultaneously achieve stronger growth, a weaker dollar and a more restrictive monetary policy? A misinterpretation of the intentions and decisions of the Fed had already been a major risk factor. Since the election, the situation has become worse. With GDP growth of around 2%, inflation close to 2% and full employment, the Fed funds rate should be, in a normal cycle, much higher than it is today. The Fed is technically "behind the curve". This is all the more true given that, in half of cases (six out of the last 12 times) since 1945, monetary tightening cycles were followed by a US economic recession within two years. This is undoubtedly what the market fears in the event the Fed moves too quickly and, especially, too strongly. For the moment, the Fed remains cautious. It is well aware

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that growth levels and the current cycle have not warranted a significant increase in rates so far, and that the reversal of an ultra-accommodating monetary policy that has been in place for eight years carries more importance than usual. In the Fed's case, it is looking to keep the dollar from appreciating (the Fed's models show that a 10% appreciation in the real effective exchange rate of the dollar is equivalent to 175 bp in monetary tightening). Inflation indicators are now close to the Fed's target, and the US central bank is expected to raise its rates twice during 2017. However, caution is warranted: the Fed must avoid any communication errors. Markets could react poorly if rates are increased prematurely, excessively or without a sound rationale, or in case of a major surprise.

MARKET IMPACT If the Fed fumbles, we can expect a sharp downturn in equities and contagion into the emerging markets, which have already been weakened. Such a situation would widen spreads and interest rates between Europe and the US and further weaken the euro: two factors that favour European risky assets.

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

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

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

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

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

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

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

ANALYSIS We expect growth of 2% in 2017 (vs. 1.6% in 2016), followed by a slight acceleration in 2018 (2.2%). Growth is therefore likely to remain slightly above its potential over the next two years. At this juncture, a recession in the United States is not a possibility, but the Fed's lack of room to manoeuvre is worrying. The current situation is totally different from 2004-2006. Over those two years, the Fed managed to hike interest rates 17 times—a total of 425 basis points—giving itself leeway, which it was quick to use once the financial crisis hit. Today that context is very remote. The Fed is behind in its economic cycle and financial stability, and to a lesser degree the US dollar, cannot afford such interest rate hikes. What is also worrying is the uncertainty about the future economic policy. Pushed to the extreme, protectionism (and impact on Mexico and China in particular), a strict anti-migrant plan (with a reduction in the labor force and the population, as well as an increase in the cost of labour) and the renegotiation of commercial treaties, could well lead to anticipations of a recession. But it is unlikely that this program will be adopted as it stands, and we should instead focus on a slightly better prospect (at least short term) for US growth.

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

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

ANALYSIS For a few days in the middle of August 2015, China gave the impression that it was abandoning its exchange rate policy, preparing the markets for a major depreciation of the yuan (in 1994, it devalued the yuan by 30%). These same fears reared their heads again in early January 2016. Until now, China has used monetary policy, budgetary policy, fiscal policy, and revenue policy as stimulus tools, careful not to use the exchange rate policy. Moreover, it promised the G20 it would not, and the yuan is now part of the SDR (and has been since 1 October). In 2016, China amended its foreign exchange system, and it is managing a gradual depreciation of the yuan. The implementation of a protectionist policy in the United States would be fatal, the Chinese authorities would be incapable and unwilling to pursue this FX policy, especially since the yuan is not notably undervalued. China does not manipulate its currency, contrary to what Trump says or believes, and the recent situation has forced the Chinese authorities to step up capital controls, a decision that goes against their long-term plan. Beyond the very negative immediate consequences on the financial markets, an abrupt devaluation (of at least 10% in one day) would, without a doubt, be interpreted as an admission of weakness in terms of the economic policy as a whole. A very low risk, but with potentially very great harm, because China's top challenge now is opening its capital account: attracting international investors means accepting a less-independent monetary policy, a more volatile exchange rate, different rules between the onshore market and the offshore market, more volatile capital flows, less easily administrated markets that are more dependent on international investors, greater transparency on the state of businesses, and, specifically, State-owned businesses… in short, a fairly radical change in governance. A strong devaluation of the yuan would be a very bad decision.

MARKET IMPACT In this type of scenario, expect a widespread downward movement in the markets. A surprise devaluation would be the start of a more intense currency war, especially in Asia. Monetary policies would become extremely accommodating to keep currencies from appreciating. A blow to the euro, and to the European economy, because EMG currencies make up more than 70% of its effective rate.

[RISK # 8] A significant slowdown in the emerging economies [PROBABILITY] 20%

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

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

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

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

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

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

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

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

[Risk # 11] **Greater financial instability** [PROBABILITY] **70%**

ANALYSIS In the last few years, action by central banks has enabled financial stability to return. Lower short- and long-term rates, reduced volatility and tighter credit spreads are all factors that have generated an environment of greater stability. However, beware: (i) This stability has a contrived aspect that should not be underestimated. Central banks cannot resolve all of the problems by themselves (jobs, in- vestment, growth, etc.) and, if the current conditions do not improve more significantly, a certain level of disillusion/disappointment may well set in, which could in turn become a source of instability. (ii) Monetary policies have reached their limits, both negative rates and QEs, and it is quite difficult to expect any more from them. The macroeconomic response would eventually come from fiscal and tax policies, and, traditionally, public spending has far fewer stabilising virtues for the financial markets than lower interest rates. (iii) Finally, the elections due to take place in Europe will not be without consequences for the volatility of financial assets.

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

[Risk # 12] **Liquidity crisis** [PROBABILITY] **20%**

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

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

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[Risk # 13] **Banks collapse** [PROBABILITY] **10%**

ANALYSIS This risk seems highly exaggerated to us. Still, we are not optimistic: negative rates are penalising the banks, the high cost of capital reflects the weight of past crises, fears of a new crisis, uncertainty over regulation, and the difficulty for investors to discriminate against banks and against banking systems are the primary factors in the banks' underperformance – an under-performance that has been amplified by the UK referendum precisely because it added uncertainties over growth. Nor are we overly pessimistic. The banks of 2016 have nothing in common with the banks of 2008 or 2011: not only have they raised very large amounts of capital, but the ECB's anti-crisis system is now well-established, with banking supervision and stress tests. Moreover, the ECB's liquidity access facilities have drastically reduced specific risk and systemic risk for more than two years. However, it is easy to show the close link between the banks under-performing and long rates dropping into negative territory, and the question that arises is, in fact, how well the banks can contend with rates staying in negative territory. We do not anticipate a collapse, but rather continued pressures on profitability, increased by the issue of digitalisation, which is pushing the banks to reduce their debt and remain conservative on credit. Nonetheless, it should be noted that in the past several weeks—and especially since the election of Donald Trump—much of the fixed-income universe has returned to positive territory, and we have seen a steepening of the yield curve, both of which are clear advantages for the profitability of banks. In short, the situation has improved significantly.

MARKET IMPACT Among the factors causing fragility, the inability to discriminate between banks and between banking systems is no doubt the most concerning: any rumours or difficulties involving banks generate waves of stress, widening spreads, and plummeting bank securities. No need to go into detail on the implications on financial stability or the economies if there should be any bank failures.

[Risk # 14] **Geopolitical risks intensify** [PROBABILITY] **70%**

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

MARKET IMPACT There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are clearly identified and specific. The scale of other political risks, including the consequences of the new direction of US diplomacy, is more difficult to assess at this stage. Is this combination of factors likely to impact on growth prospects or on the financial markets? Nothing is certain at this stage, but the likelihood is very high.

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

ANALYSIS Politically, the markets are now operating against a very difficult backdrop. In 2017, many elections will be held, and some are especially important: general elections in the Netherlands in March 2017, presidential elections (23 April and 7 May 2017) and legislative elections (11 June and 18 June) in France, and general elections in Germany in the autumn of 2017. What's intriguing / concerning is the rise in extremist parties (far right-wing parties in Europe's hard-core countries, and far left-wing parties in the peripheral countries) and populism, which is reflected in protectionist, anti-immigration, and pro-public-deficit issues. Inevitably, some parties will be tempted by these issues, to please an electorate increasingly sensitive to widening inequalities and the tax burden. Historically, such policies (especially protectionism) generally result in phases of very weak (or no) growth and higher inflation. These phases of economic stagnation and strong public deficits inevitably lead to periods of recession and political and financial instability. Europe also faces the prospect of referendums in countries like France and Italy. We are not counting on the seizure of power from populist parties in France or Germany (for Italy, see Risk Factor 2 above), but rather on the possibility of a strengthened Franco-German axis.

MARKET IMPACT The current political risks are clearly identified, but the prospect of major elections in Europe will lead to an increase in volatility and questions on the governance and future leadership of the EU. But will this have an impact on growth prospects or on the financial markets? The answer is yes. The ECB's QE programme will not be able to prevent the persistence of risk premiums on certain European debt obligations, such as French and Italian bonds.

[Risk # 16] **French elections revive fears over the Eurozone** [PROBABILITY] **65%**

ANALYSIS The coming months will undoubtedly highlight the importance of the French elections: the presidential elections (23 April and 7 May 2017) and the legislative elections (11 June and 18 June). Let's be clear: the challenge of the European elections (the Netherlands, Italy, France and Germany) lies in the durability of European integration. We do not bet on the victory of Front

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National (Marine Le Pen), which would certainly give credibility to the Frexit scenario. Mme Le Pen is indeed reforming the EU or leaving the EU remain a major focus. If France is not able to change the ECB's positions on economic policy, immigration policy, etc., within a period of six months, then Marine Le Pen will proceed, as she has promised, to a Referendum on the exit from the EU. There is no doubt that this risk (the Frexit) will continue to have an impact on the EU, and especially EMU: the fragility of the euro, the widening of sovereign spreads in peripheral countries (including France) against Germany... We do not believe in such a scenario. We rely instead on the possibility of a reinforced Franco-German axis. Before this happens, the financial markets will have to face three critical situations:

- First, they will have to live with the prospect of seeing the extreme right party emerge at the top of the first round of presidential elections. According to current polls (Opinion Way, 14 March 2017), Marine Le Pen, would lead Emmanuel Macron (Movement "En Marche!", moderate left), François Fillon (conservative right) and Benoît Hamon (Socialist party), and Jean-Luc Mélenchon (Left) with respective scores of 27%, 24%, 20%, 14% and 13% respectively.

- Then, through the voice reports, and according to the current polls, again, they will live the probable elimination of Marine Le Pen in the second round of the presidential elections .... It should be noted that, due to the ability of right-wing parties to withdraw for left-wing parties, and vice versa, French voters have so far eliminated the extreme right of most elections, national, regional, municipalities...

- Finally, it will be necessary that the newly elected president (presumably E. Macron (leading polls) or F. Fillon) attracts the voters to obtain a presidential majority in the legislative elections, the only way to have a stable government. The two candidates are clearly pro-European and their election would augur a strong Franco-German axis and governments capable of carrying out structural reforms. F. Fillon would enjoy the support of a large party, and the support of the right-wing parties, which is not really the case with E. Macron, considered by many socialist voters as a sort of "dissident." In case of a victory of E. Macron (what the polls are putting more and more), the perceived risk would be to end up with a president without support of a homogeneous party, which would probably be complicated.

MARKET IMPACT French elections represent a major risk for the financial markets because they are emblematic of current trends: rising extreme right-wing parties in the EMU core countries, growing rejection of the establishment, protectionist temptations, hostility towards Europe and / or European institutions… The election of an anti-European candidate or wishing to reform Europe or leave the EU in case of failure (Marine le Pen, or Jean-Luc Mélenchon) would be in the continuity of the Brexit and the election of D. Trump in the United States. Remember though that these elections only had one single round of voting, which is not the case in the French elections, and that makes all the difference. It is primarily for this reason that we do not believe a Front National candidate will be elected. Nonetheless, in our opinion, it would be legitimate for risk premiums (spreads against Germany, volatility, CDS…) to deteriorate and stay high until the outcome of the elections. The French elections revive fears about the euro zone, but these fears seem exaggerated. Bet on improved sovereign spreads and CDS after the elections.

[Risk # 17] **A sustainable rise in European bond yields** [PROBABILITY] **10%**

ANALYSIS Since the financial crisis, long rates not only continued to decline, but they have mostly entered into negative territory, driven by key negative short rates (Europe and Japan in particular) and impacting in the same way high-quality corporate bonds. The yield search in this ultra-low or negative desert favoured three oases of spreads: emerging debt, private debt and high yield debt. The risk of higher bond yields comes from the United States, not from the euro area. The increase in American long-term rates can come from five main sources: (i) a significant upturn in growth prospects, (ii) a more forceful tightening of interest rate policies, (iii) the "genuine" end of QEs (failure to replace maturing bonds), (iv) a resurgence in inflation, or / and (v) a large-scale reversal of fiscal and fiscal policies. All of these factors (except perhaps the third) have increased in the United States. This is why the current debate in the United States or in Europe on fiscal and tax policies is crucial for interest rates. As far as the United States is concerned, we are expecting an extension of the current growth cycle (which has been faltering for several quarters), but not with the advent of a new growth cycle. As a consequence, it seems to us premature and excessive to rely on a permanent rise in US long-term rates, and this conclusion holds even more in the case of the euro area. Nonetheless, we should not underestimate the impacts of the decisions made by the new US administration, which call for higher interest rates. The situation in terms of growth, inflation, the monetary policy cycle, the ECB's QE programme and the reduced ability to re-start the economic engine through budgetary and fiscal policy effectively protect the European markets from rising interest rates in the United States. However, risk premiums are rising as a consequence of political uncertainty. Distinguishing between core countries (like Germany), periphery countries and intermediary countries (like France) is essential.

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

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