Asset Allocation

This month's topic

Trump, Brexit, European elections… not all is going according to plan… Review, scenarios, and strategies

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The essential

The Trump effect, the Brexit effect, and the impact of European elections are probably three of the top risk / opportunity factors for 2017. We have mentioned the risks of these events being mispriced by the financial markets, with a tendency toward indifference to Brexit, optimism on the Trump effect, and pessimism on European elections.

To us, these three attitudes are not reasonable. Of course, these are still major events, but we must be more watchful on the fall-out from the triggering of Article 50 of the Treaty of Lisbon, giving the UK the green light on exit negotiations; and we must be more constructive about European elections, which, one by one, are showing that populism is not powerful enough to be decisive (contrary to the US and the UK). Finally, we must be more cautious about the "Trump effect": do not bet on an acceleration of growth and remain soft on the "repricing" that stems from the current economic policy. The consequences are clear: weaker rate hikes, US equities at risk, European assets less risky, GBP potentially in danger, and emerging asset classes in a good position.

Now to the heart of the matter, with the decision by British Prime Minister Theresa May to trigger Article 50, starting negotiations on the procedures for leaving the European Union, as well as the French elections, because we now know the number and names of the candidates.

Late last year we mentioned the risk of key events, like the Trump effect, Brexit, and elections in Europe, being badly mispriced by the financial markets. This seems to be bearing out. Explanations.

- President Trump is now facing serious difficulties with his Congress, the Fed, his own Secret Service, and foreign partners (China and Mexico especially). There is even a question of possible impeachment proceedings, or rumours of resignation - in short, many unusual and unprecedented situations after six months in charge. Promised measures, some of which are actually important and necessary, and sometimes ardently desired by the markets (specifically infrastructure and tax reform), are late in coming. Defeats, such as the rejection of his Obamacare reform, are solidifying. And plans, such as instituting customs duties, are falling through the cracks. Put plainly, those who were given to optimism after Trump's election will doubtless feel like cold water has been thrown on them by all these recent events as well as the decision by the Fed, which, while it did indeed raise interest rates, also decided not to adjust its own growth, inflation, or interest rate forecasts at all, almost as if Trump's arrival changed nothing about the economic outlook. This backs up the idea that the Trump effect is overestimated and that the impact on growth will be moderate. That's been our viewpoint since the beginning.
- Brexit has not been on people's minds for a few months; it feels uncertain or abstract for some, and like a done deal for others. Indeed, many considered (and perhaps still consider) it to be without great importance, with Britons probably getting what they want, ultimately, given a weak Europe incapable of a single vision, or quite simply incapable of standing firm or making a decision. Nothing is less certain. We think the risk of disappointment is quite real for them too. Just look at the stance of Switzerland, Norway, or Canada toward the European Union, and you will see that no country has obtained independence in their trade policy, independence in their immigration policy, and full access to the single market (goods and services), and all for free, i.e. without contributing to the European budget. It is worth mentioning that the reaction of European countries to the Brexit announcement was quite a bit less chaotic or conflictual than some observers feared, which probably means that negotiations will be orderly.
- And finally, European elections have been a puzzle. Thus far, populist parties have not been able to carry the elections: not in Spain, not in the Netherlands, and not in Austria. And this will very likely be true in France: the National Front, which all investors dread, has already peaked in the polls and is predicted to lose to candidate Macron by a wide margin. Furthermore, Germany has never had two such pro-European individuals as candidates for Chancellor; and people have stopped talking about the extreme right and populist parties, which are being marginalised at this

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> "Brexit has not been on people's minds… Big mistake"

stage. The cherry on top - or the irony - is that ultimately the populist parties did not win in Europe, but they did in the US and UK: the Brexiteers in the United Kingdom (not counting Scotland or Northern Ireland), and Donald Trump in the United States. This calls to mind the periods when European budget deficits of 4-5% were ardently commented on and criticised by members of countries with deficits close to 10% (none more so than the US, UK and Japan)!

Clearly, we have an overestimated Trump effect (in terms of growth), an underestimated Brexit effect (growth and politics), and an overestimated European election effect (not necessarily a systemic risk to the EU or the EMU)) - it's enough to challenge a good many asset allocations in the world.

What needs revising, in reality? Five essential things must be revisited:

1. **The Fed's monetary policy and the monetary policy environment**: the Fed is not normalising its monetary policy. In an environment that is not conducive to its revising its own forecasts, it is attempting to regain some room to manoeuvre; end of story. Besides, it still has not ended Quantitative Easing, because it continues to reinvest papers that, on its balance sheet, are reaching maturity. While there could still be two rate increases in 2017, we think any more than that is highly unlikely.
2. **The US long-term rates level** depends essentially on monetary policy, inflation, and economic growth. It is hard to imagine a gradual and sustainable increase in the current environment.
3. **The US equity markets** are risky markets: before the elections, their valuation was high. Since then, it has only worsened. Without some improvement in terms of growth or profits, it is a safe bet that tax and budget announcements will be the final boost on this asset class before valuation issues resurface. Caution is a must. While the fixed-income markets have absorbed the Fed's prudence, this is not the case with the equity markets, which have not factored in the lack of upward adjustment in economic and financial forecasts. This lag will probably not last. The question of the scale of the correction is crucial: if it is limited to 10% (due to the immediate reaction of the central banks, economic policies, etc.) and will be manageable for the other markets (specifically European equities and emerging assets)… but if it is large-scale, then it will be another story.
4. **European equities** will regain interest if the election outlook becomes clearer, which we believe it will. Many investors, especially foreign ones, have decided to keep their distance, given election-related uncertainties. When these uncertainties die down, the remaining risk premiums will be seen as excessive… and should be seized. Don't wait.
5. **The outlook on the emerging markets** depends on US trade policy, as well as the prospect of a (long) rate increase and monetary tightening. On all three fronts, the situation seems clearer to us as well. The Fed's attitude and the virtual certainty that American customs duties will not be put in place suggest that the time is right for the emerging markets' upturn to continue

Conclusion

2016 was a fairly negative year, with the United Kingdom's decision to exit the European Union (Brexit and Bremain supporters were all critical of Europe, but recommended two different outcomes: leaving or fighting from within) and the American voters' adoption of a candidate having a protectionist and self-centred plan. 2017 could indeed be a more positive year, with a less negative European scenario than feared. The answer will come in the next few weeks, as French voting results come in… not because we are ignoring the other elections held in Europe, but because never has a national election weighed so heavily on the future of Europe as the upcoming French elections.

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"While there could still be two rate increases in 2017, we think any more than that is highly unlikely"

"US equities: excessive valuation issues will resurface sooner or later. Caution is a must"

"European equities: when the electoral uncertainties die down, the remaining risk premiums will be seen as excessive... and should be seized"

The table below provides a summary of the three key events, each one seen from the perspective of hopes (Trump and Brexit) and fears (Europe), and then from the perspective of what we think the real story will be. Attention: significant differences...

	Monetary policies	Long-term rates	Rate spreads in Europe	Equity	Emerging markets	Dollar	Probability
Trump and high hopes for growth	The Fed is able to normalise its monetary policy	Rate increase... change in trend	Neutral effect	Bullish, US and Europe	Looks good, unless restrictive US trade policies	Rather bullish	20%
Trump and harsh reality	The Fed is cautiously restoring some room to manoeuvre, but it is hardly normalisation	No change in regime, US long-term rates still within range	Neutral effect	European equities have the edge	Prudence from the Fed, no customs duties, moderate growth... key assets for the emerging markets	Weaker dollar	80%
Brexit and political high hopes	Low impact	Low impact	Low impact	Low impact	Low impact	Low impact	20%
Brexit and economic reality	BoE staying ultra-accommodating	Risk premium against the British market	Neutral impact	Risk premium against the British market	Limited direct impact if Europe not much affected	Strong dollar and euro vs. GBP	80%
European elections and fears of systemic risk	The ECB is still in ultra-accommodating mode (QE, TLTRO, ultra-low rates, etc.)	Unknown territory, but increase in long-term rates all over Europe (except Germany?)	Substantial widening of rate spreads	Risk premium against European equities	Bad news for the many emerging economies exporting to EU countries	Strong dollar vs. euro	10%
European elections and the upside scenario	No urgency to reversing monetary policy, greater calm at ECB	Low impact on EMU core	Substantial tightening of rate spreads... as long as the ECB's QE lasts	European equities' edge largely ignored until now	More of a relief and a "green light" for capital movements	Rather favourable to the euro and very good for emerging currencies	90%

Asset allocation

Summary tables

Asset allocation: multi-class outlooks and convictions

	1 month-change	---	--	-	0	+	++	+++
Equities/gov. bonds	→						■	
Corp. bonds/gov. bonds	→						■	
Equities/corp. bonds	→					■		
Duration	→				■			
Corporate bonds	→					■		
Oil	→					■		
Gold	→				■			
Cash EUR	→			■				
Cash USD	→					■		

Asset allocation: relative outlooks and convictions by major asset class

		1 month-change	---	--	-	0	+	++	+++
Equities	US equities	→				■			
	Japanese equities	→				■			
	Euro equities	→					■		
	UK equities	→				■			
	Pacific excl. Japan	→				■			
	EMG equities	→				■			
Gov. Bonds	US bonds, short	→		■					
	US bonds, long	→		■					
	Euro core, short	→			■				
	Euro core, long	→				■			
	Euro peripherals	→				■			
	UK bonds	→			■				
	Japanese bonds	→			■				
Corp. Bonds	US IG	→					■		
	US HY	→					■		
	EURO IG	→					■		
	Euro HY	→					■		
	EMG debt hard currencies	→				■			
	EMG local debt	→			■				
FX	USD	→					■		
	EUR	→			■				
	JPY	→				■			
	GBP	→				■			

The table above represents an investment horizon of six to 12 months. The changes reflect the outlooks expressed at our most recent investment committee meeting. The different lines provide relative outlooks for each major asset class and absolute outlooks for forex and commodities. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++). They are independent of the constraints and considerations concerning the construction of portfolios.

Macro Hedging Strategies

	one-month change	0	+	++	+++
Long US Treasuries	→		■		
Long Bunds	→	■			
Long USD	→		■		
Long JPY	→	■			
Long volatility	→		■		
Long cash USD	→		■		
Long Gold	→		■		
Long US TIPS	→		■		
Long puts equities	→		■		

The global geopolitical backdrop, the diplomatic tensions between the United States and other major countries (especially China) and the political backdrop in Europe warrant some protection measures. The US Treasuries markets, volatility, equity market puts, USD cash and inflation-linked bonds are particularly attractive from this point of view. For those who would bet on more serious warnings, long gold positions are becoming essential. For those who wish to protect themselves exclusively from European risks, go long on volatility, long on USD, long on JPY and long on US Treasuries.

The table above represents a short investment horizon of one to three months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our aversion to risk and our macro-hedging strategies. They should be viewed in relation to the asset allocation tables. A negative outlook in terms of asset allocation will not lead to hedging. A temporarily negative outlook (negative in the short term but positive in the medium term) may lead us to protect the portfolio, without affecting our long-term outlooks. The application of the strategy is expressed by a position (+), and the scale of the position is expressed by a graded scale (+/++/+++). These strategies are independent of the constraints and considerations concerning the construction of the initial portfolio subject to protection. These are overlay positions.

Amundi ASSET MANAGEMENT RESEARCH STRATEGY & ANALYSIS

#04

April 2017

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