Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

Letter finalised at 3pm Paris time (Next publication will be September, 1rst) **July 24 - 28, 2017**

Highlights of the week

- **Markets :** bond yields move higher on both sides of the Atlantic; FOMC statement supported a further upside move of EUR/USD; high beta credit segments outperforming again within corporate bond markets; Equity markets in the black.
- **Growth:** as expected GDP growth accelerated in the **United States** in Q2, it surprised on the upside in **Spain**, and remained stable, as expected, in **France**. Surveys point to stronger growth in **Germany** in Q3.

Key focus

US HY default rates: what to expect for H2 after such a strong fall in H1 2017?

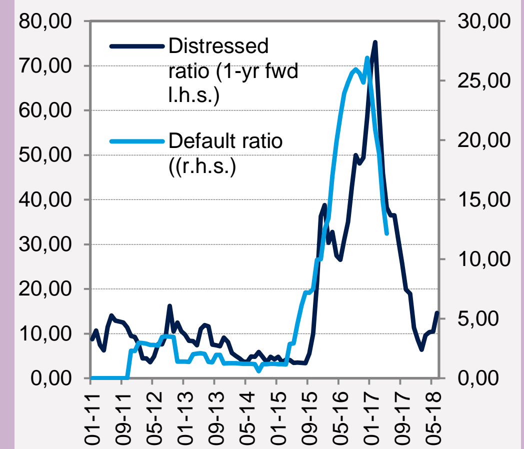
A steep dive in default rates of US HY recorded so far in 2017

2017 H1 saw quite a turn to the south in default rates of US speculative grade bonds: the trend came mostly expected, as all major indicators leading bankruptcies rates of US HY companies were pointing to a peak at the very beginning of the year and to a subsequent, rapid fall. As recent Moody's data confirm, the fall has actually accelerated in the very last months of H1 2017. January saw a 5.9% DR for US speculative grade companies, the peak of what may be referred to as the current default "mini-cycle". Then, the rate fell to 4.7% in March and touched 3.8% in June: rating agency last forecasts point to the 3% area for December this year, very much in line with our own regressed forecasts, based on indicators leading defaults. A more gentle drop should therefore take place in the very next months, as the steep fall of the trailing 12-month default rate by June took place because of the substitution of a very bad H1 2016 with the much better numbers recorded in H1 this year. In terms of defaulted debt, in fact, in the first six months of 2017 US HY recorded less than one third of the amount experimented in H1 2016, while the second part of this year should diverge less with respect to the same period of 2016.

The commodity-driven cycle is closer to its end…

Both upward and downward trends of the current "mini-cycle" were not recession and/or financial crisis-driven but, instead, almost entirely commodity-driven: if energy and material sector companies are excluded from last two years' computation, in fact, default rates remained quite stable and close to the low levels of previous years'. The reported chart shows that the recovery of the energy sector in terms of decreasing number of bankruptcies should proceed in the next quarters, lagging by around one year the massive drop in its distressed ratio. The distress ratio (the percentage of bonds trading above 1,000 b.p. spread over treasuries) of the whole universe of US speculative grade is currently close to the lows of 2014, therefore pointing to a 3% threshold in a 6 to 9-month time. A look at defaults by rating categories is encouraging, too. High quality speculative grade bonds, namely the BB-rated universe, moved down to zero DR since January this year, while B-rated bonds followed to the same level just in the following months. In a nutshell, therefore, default rates are currently concentrated in the lowest rating category only, namely the CCC-rated names.

US HY energy sector:
the fall in distress ratio bodes well for the end of the current cycle



Source: Bloomberg, Amundi Research

…Therefore, what to expect now?

As top down factors point to a further fall of DR and commodity sectors' woes recede, the question is now about which sectors may move to the frontline of defaulted issuers and lead the trend in the next months and quarters. At the moment, excluding commodity, the retail sector is showing some stress, although with just a few defaults recorded in the very last month and a distress ratio at 17%, currently the highest among US major segments. According to the very last number published by Fitch, however, US retail sector is currently suffering from a still very limited DR, namely a 1.8%. Moody's is forecasting a 4.5% DR in one year time for retailers, while Media sector has been recently revised up to the 7% in 12-month time: in a nutshell a very limited rise for the two sectors, respectively representing 3.7% and 4.7% of the US HY bond market debt, a lower weight than the 14% still represented by energy and the 5% by metals & mining. A look at recent trends in debt supply sees refinancing recovering ground with respect to M&A and spending items among the purposes of new bonds: this is an encouraging signal, taking also into account the limited amount of US companies' refinancing needs in the next two years. In conclusion, therefore, default rates are likely to proceed in their falling trend in the US over the very next quarters, although at a slower pace with respect to the trend delivered so far in 2017: this scenario seems to be consistent not only with indications from top down factors but also looking at bottom up and market factors. The return of defaults to lower levels in the US should be accompanied by a scenario remaining quite benign for European High yield: Europe did not join the US in the commodity driven mini cycle of the last few years and remained close to cyclical low levels which should be confirmed also in the next quarters.

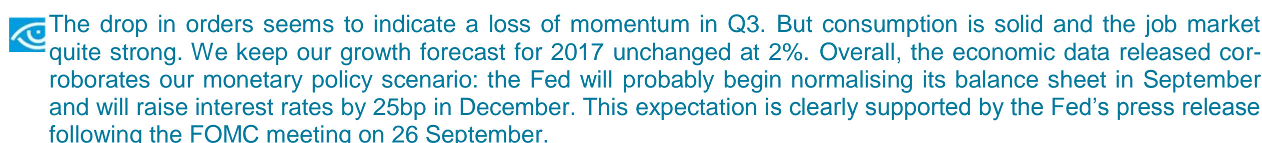
The week at a glance

> Economic indicators

United States >

Growth picked up in Q2, as expected. GDP growth was revised down in Q1 (from 1.4% to 1.2% at annual rate). GDP growth accelerated in Q2 to 2.6% (+2.1% yoy). Primarily driven by household consumption (which contributed 1.9pp to growth), economic activity has also benefited from the unexpected acceleration of investment in capital goods (+8.2% after +4.4% in Q1, revised down).

Durable goods: orders are easing off, deliveries are increasing. Deliveries increased for the 5th consecutive month in June.



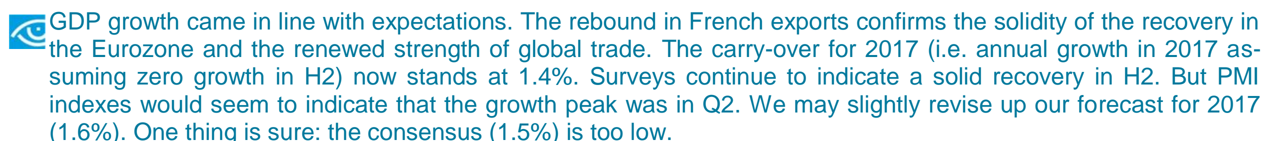
The drop in orders seems to indicate a loss of momentum in Q3. But consumption is solid and the job market quite strong. We keep our growth forecast for 2017 unchanged at 2%. Overall, the economic data released corroborates our monetary policy scenario: the Fed will probably begin normalising its balance sheet in September and will raise interest rates by 25bp in December. This expectation is clearly supported by the Fed's press release following the FOMC meeting on 26 September.

France >

GDP growth stabilised in Q2 at 0.5%. On a year-on year basis, growth accelerates from 1.1% in Q1 to 1.8% in Q2, its highest level since 2011. In Q2, growth was driven both by domestic demand and exports. Consumption accelerated (+0.3% after +0.1% in Q1). Investment slowed (+0.5% after +1.4% in Q1). Exports surged by +3.1%. However, corporate destocking weighed on the performance.

The PMI fell slightly in July. The PMI Composite fell slightly from 56.6 to 55.7. However, this decline hides the improvement posted by the manufacturing sector, where the index rose more than expected (from 54.8 to 55.4).

Inflation remains low, at +0.8% yoy in July (preliminary estimate).



GDP growth came in line with expectations. The rebound in French exports confirms the solidity of the recovery in the Eurozone and the renewed strength of global trade. The carry-over for 2017 (i.e. annual growth in 2017 assuming zero growth in H2) now stands at 1.4%. Surveys continue to indicate a solid recovery in H2. But PMI indexes would seem to indicate that the growth peak was in Q2. We may slightly revise up our forecast for 2017 (1.6%). One thing is sure: the consensus (1.5%) is too low.

Germany >

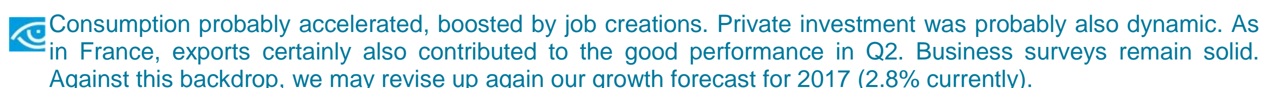
The IFO hit a new record high in July. The German flagship index reached its highest level since reunification. The short-term business outlook improved but still lags behind the current business situation. The index is driven by the manufacturing and construction sectors.

Inflation remains stable. Inflation came out at +1.5%yoy in July (preliminary estimate), at the same level as in June.

Growth appears to be continuing to pick up in Q3, following a probable strong reading in Q2. If this trend is confirmed, we may increase our 2017 growth forecast again (currently at 1.8% vs. 1.7% for the consensus).

Spain >

GDP growth accelerated in Q2! Growth came out at +0.9% in Q2 (after +0.8% in Q1). The breakdown will only be available at the end of August.



Consumption probably accelerated, boosted by job creations. Private investment was probably also dynamic. As in France, exports certainly also contributed to the good performance in Q2. Business surveys remain solid. Against this backdrop, we may revise up again our growth forecast for 2017 (2.8% currently).

> Financial markets

Fixed-income

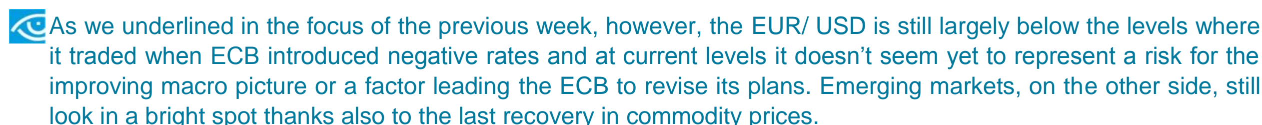
Ahead of the Fed meeting, the very start of the week saw bond yields moving higher on both sides of the Atlantic. Then, the US curve reacted to the FOMC statement with a limited bull-shift, as long-term treasuries generally outperformed short maturities. This reactions seems to show that market players were more impressed by the prudent wording referred to inflation rather than by a clearer indication that the balance sheet normalization is likely to start sooner than later. The focus of the Fed on inflation is likely to keep next data monitoring prices' trends on markets' radar screen in the following weeks. Overall, however, yields just returned closer to weekly opening levels: the same is true also for 10-year bunds. Periphery government spreads stabilized after previous weeks' recovery, while Greece returned to the bond market almost exactly five years after the ECB president made the famous *"Whatever it takes"* pledge to defend euro in July 2012.

European bond yields look more stable at current levels after the last wording and the communication of the ECB and in sight of a more limited trading activity in August. US bond markets seem to be confident that the Fed ap-

proach will remain gradual, as the inflation outlook doesn't look worrying. The next hike (+25bp) is expected in December, but the focus should gradually move from rates to balance-sheet normalization.

Foreign exchange

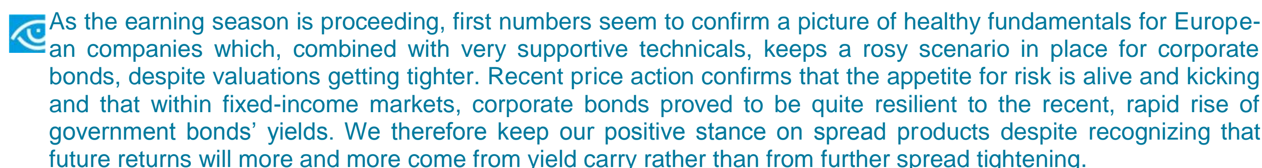
FOMC statement supported a further upside move of EUR/USD, which in fact reached, as we are writing, the 1.17 area. The lack of progress on the fiscal stimulus front adds pressure on the US currency vs Euro, as well, together with relative trends on the macro side and in terms of financial flows. Previous week's ECB statement and wording contributed to stabilize European bond yields, after the sharp rise starting from the end of June, but failed to refrain the European currency from reaching new highs. On this side, the role of US monetary and fiscal policies' perspectives continue to look dominant, despite the more dovish recent signals from the ECB. Among emerging currencies, we underline the positive performance delivered by commodity currencies, supported by quite a recovery in oil and other commodity prices.



As we underlined in the focus of the previous week, however, the EUR/ USD is still largely below the levels where it traded when ECB introduced negative rates and at current levels it doesn't seem yet to represent a risk for the improving macro picture or a factor leading the ECB to revise its plans. Emerging markets, on the other side, still look in a bright spot thanks also to the last recovery in commodity prices.

Credit

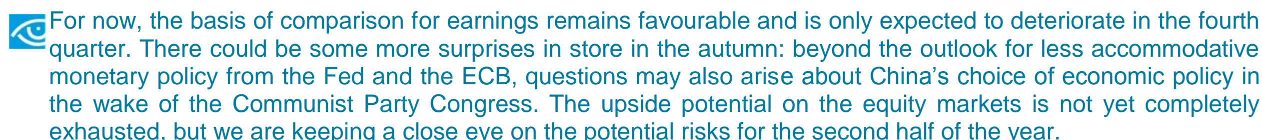
The week saw the "usual suspects", namely the high beta credit segments (HY and subordinated financial debt) outperforming again within corporate bond markets. Both US and European speculative grade, in particular delivered further spread tightening and therefore year to date total returns touched new highs: when we are writing, major broad credit benchmarks respectively register a total return in the 6% area for US HY and close to 5% for European speculative grade bonds. The outcome of the FOMC was in line with expectations and therefore substantially neutral for European credits: however, the confirmation that the prudent approach followed by the Fed in its gradual policy normalization remains in place mildly supported risky assets and the following reaction of forex market looks slightly more supportive for US credits. The further depreciation of the USD looks in fact more friendly for US rather than for European companies' perspectives, but at the same time, given the tight valuations of credit markets on both sides of the Atlantic EUR appreciation vs USD should produce a muted impact on corporate bonds on a relative, regional basis.



As the earning season is proceeding, first numbers seem to confirm a picture of healthy fundamentals for European companies which, combined with very supportive technicals, keeps a rosy scenario in place for corporate bonds, despite valuations getting tighter. Recent price action confirms that the appetite for risk is alive and kicking and that within fixed-income markets, corporate bonds proved to be quite resilient to the recent, rapid rise of government bonds' yields. We therefore keep our positive stance on spread products despite recognizing that future returns will more and more come from yield carry rather than from further spread tightening.

Equity

Equity markets in the black. The US market hit another all-time high. Eurozone markets held up well against the continued rise in the euro, thanks to positive earnings releases. However, it is still too early to analyse the entire earnings season.



For now, the basis of comparison for earnings remains favourable and is only expected to deteriorate in the fourth quarter. There could be some more surprises in store in the autumn: beyond the outlook for less accommodative monetary policy from the Fed and the ECB, questions may also arise about China's choice of economic policy in the wake of the Communist Party Congress. The upside potential on the equity markets is not yet completely exhausted, but we are keeping a close eye on the potential risks for the second half of the year.

Key upcoming events

> Economic indicators

Eurozone : Unemployment rate is expected to decrease in June. **USA:** Manufacturing PMI should remain stable in August.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
July 31	Eurozone	Unemployment rate. June	9.2%	9.3%
	Japan	Manufacturing PMI. July	-	52.2
	Eurozone	CPI. YoY. June	1.3%	1.3%
August 1	US	Manufacturing PMI. August	53.2	53.2
	Brazil	Industrial production. YoY. June	-	4,0%
August 3	Eurozone	Retail sales. YoY. June	2.5%	2.6%

Source: Amundi Strategy

> Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
July 31	France	Court terme, € 6.1 Bn
August 1	Germany	Long-term, € 4 Bn
August 2	Greece	Court terme, € 625 M

Source: Bloomberg, Amundi Strategy

> Key events

Date	Upcoming monetary policy committee meetings
	Bank of Japan (BoJ)
August 3, 2017	Bank of England (BoE)

Date	Upcoming important events
24 September 2017	Germany - General Election

Source: Amundi Strategy

Market snapshot

Equity markets	28/07/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2469	-0,2%	1,1%	10,3%
Eurostoxx 50	3461	0,3%	-2,1%	5,2%
CAC 40	5118	0,0%	-2,6%	5,3%
Dax 30	12150	-0,7%	-3,9%	5,8%
Nikkei 225	19960	-0,7%	-0,8%	4,4%
MSCI Emerging Markets (close -1D)	1069	0,8%	5,6%	24,0%
Commodities - Volatility	**28/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	52	8,1%	9,8%	-8,6%
Gold ($/ounce)	1265	0,8%	1,2%	9,8%
VIX	11	1,7	1,0	-3,0
FX markets	**28/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1,17	0,5%	3,1%	11,5%
USD/JPY	111	-0,1%	-1,1%	-5,1%
EUR/GBP	0,90	-0,1%	1,9%	5,0%
EUR/CHF	1,14	3,2%	4,3%	6,2%
Fixed Income markets	**28/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0,36	-	-	-3 bp
Euribor 3M	-0,33	-	-	-1 bp
Libor USD 3M	1,31	--	+2 bp	+32 bp
2Y yield (Germany)	-0,67	-3 bp	-9 bp	+10 bp
10Y yield (Germany)	0,55	+5 bp	+19 bp	+35 bp
2Y yield (US)	1,36	+2 bp	+1 bp	+17 bp
10Y yield (US)	2,30	+7 bp	+8 bp	-14 bp
Eurozone Sovereigns 10Y spreads vs Germany	**28/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+26 bp	+2 bp	-9 bp	-21 bp
Austria	+16 bp	--	-10 bp	-6 bp
Netherlands	+11 bp	-1 bp	-9 bp	-4 bp
Finland	--	+1 bp	-7 bp	-14 bp
Belgium	+28 bp	-	-5 bp	-5 bp
Ireland	+30 bp	-2 bp	-13 bp	-24 bp
Portugal	+241 bp	+1 bp	-20 bp	-115 bp
Spain	+99 bp	+4 bp	-8 bp	-19 bp
Italy	+158 bp	+1 bp	-9 bp	-3 bp
Credit markets	**28/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+52 bp	-	-2 bp	-20 bp
Itraxx Crossover	+235 bp	-2 bp	-2 bp	-54 bp
Itraxx Financials Senior	+51 bp	+1 bp	-2 bp	-43 bp

Source: Bloomberg, Amundi Strategy — *3:00 pm Paris time*

WEEKLY
Research, Strategy and Analysis

In the European Union, this document is only for the attention of “Professional” investor as defined in Directive 2004/39/EC dated 21 April 2004 on markets in financial instruments (“MIFID”), to investment services providers and any other professional of the financial industry, and as the case may be in each local regulations and, as far as the offering in Switzerland is concerned, a “Qualified Investor” within the meaning of the provisions of the Swiss Collective Investment Schemes Act of 23 June 2006 (CISA), the Swiss Collective Investment Schemes Ordinance of 22 November 2006 (CISO) and the FINMA’s Circular 08/8 on Public Advertising under the Collective Investment Schemes legislation of 20 November 2008. In no event may this material be distributed in the European Union to non “Professional” investors as defined in the MIFID or in each local regulation, or in Switzerland to investors who do not comply with the definition of “qualified investors” as defined in the applicable legislation and regulation. This document neither constitutes an offer to buy nor a solicitation to sell a product, and shall not be considered as an unlawful solicitation or an investment advice. Amundi accepts no liability whatsoever, whether direct or indirect, that may arise from the use of information contained in this material. Amundi can in no way be held responsible for any decision or investment made on the basis of information contained in this material. The information contained in this document is disclosed to you on a confidential basis and shall not be copied, reproduced, modified, translated or distributed without the prior written approval of Amundi, to any third person or entity in any country or jurisdiction which would subject Amundi or any of “the Funds”, to any registration requirements within these jurisdictions or where it might be considered as unlawful. Accordingly, this material is for distribution solely in jurisdictions where permitted and to persons who may receive it without breaching applicable legal or regulatory requirements. The information contained in this document is deemed accurate as at the date of publication set out on the last page of this document. Data, opinions and estimates may be changed without notice. You have the right to receive information about the personal information we hold on you. You can obtain a copy of the information we hold on you by sending an email to info@amundi.com. If you are concerned that any of the information we hold on you is incorrect, please contact us at info@amundi.com.

Document issued by Amundi, a société anonyme with a share capital of 1 086 262 605 € - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris www.amundi.com