Economic Backdrop and Investment Scenarios: 2018 and Beyond

Resilient growth... but debatable market valuation

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The essential

Global economic conditions are benign thanks to a highly accommodative monetary and financial environment while trade multipliers have magnified the re-synchronisation of the global cycle, the recovery in global investments and corporate profits (and specifically EPS momentum). The weak relationship between growth and inflation marks this cycle as unique.

Going into 2018, we expect a progressive rebalancing between monetary and fiscal policies. Core inflation, while reaccelerating in some regions (namely USA, eurozone), will remain subdued by historical standards.

Within this framework, we expect a smooth transition from an asset reflation regime towards a late financial cycle regime. The main characteristics thereof will be Central Banks progressively removing their excessive accommodation, smoothly reducing global liquidity conditions, maintaining accommodative financing conditions and eventually lower risk-adjusted expected returns.

Looking at the financial markets in fact, absolute valuations on both fixed income and equity are, on average, stretched. However, interest-rate lift will be contained allowing some space for further multiple expansion. This is a risk-asset-friendly environment where relative rather than straight directional positioning in global equity, global fixed income and FX spaces has to be favoured. In fact, the search for profitable investment opportunities should emphasise duration diversification and sector/style/factor selection in equity land.

We believe that inflation surprises, rate increases that exceed market tolerance and drying liquidity against a backdrop of increased geopolitical tensions, are major sources of risk worth hedging.

Base case scenario: a cyclical upswing that has still further to go
Probability 75%

In the base-case scenario, GDP growth rates are expected to stabilise at most around current levels. Under present conditions, we may have already seen the best of it in terms of momentum, but the cyclical upswing (global synchronisation, global investment recovery, global trade rebound) may still go on without a material increase in inflationary pressure. **The more synchronised the recovery, the more robust and resilient the global economy.**

What is puzzling at this stage is the **weak relationship between growth and inflation**. There is a structural slowdown in inflation due to supply factors. Non-energy-industrial goods inflation is persistently low and also declining, due to fierce global competition. In addition, the cyclical component of inflation has weakened (flattening of the Phillips curve). Globalisation, the spread of innovation, weaker unions and rising labour-market flexibility (temporary contracts, etc.) will continue to contain price and wage pressures looking ahead.

Central banks (CBs) are clearly disoriented by the strong growth/low inflation conundrum. They are not only busy encrypting the new set of economic relationships between inflation, unemployment, productivity and wages. CBs also have in mind that they face conflicting objectives: maintaining growth, inflation and financial stability at the same time might prove challenging.

This is indeed a complex and unusual situation for central banks:

- On the positive side, the low level of rates in a widespread benign growth environment creates virtuous conditions to correct imbalances, reduce the public debt burden and converge to improved debt sustainability in the long-term (see eurozone evidence). Should policy be successful in delivering tax reforms and structural reforms in a reasonable time, it would complete the transition towards more sustainable and inclusive growth.
- But on the other hand, excessively accommodative monetary conditions may generate the next financial crisis (multiple asset price bubbles) at a time when the world has hardly started to deleverage (global debt has reached an all-time high).

In other words, while reflation results from the level of monetary accommodation, an excessive level of monetary accommodation may, at the end of the day, pave the way for the next financial crisis and thus for a global downturn that would ultimately prove deflationary (debt-deflation spiral). **Subsequently, CBs are in a delicate position: they need to simultaneously remove excessive accommodation and avoid tightening monetary conditions too quickly.**

Against this backdrop, **we believe the biggest global risk is related to policy implementation or policy mistakes (not only monetary, but also fiscal, trade, reforms). Among the risk factors often mentioned, we believe that a recession in the US or a hard landing in China are unlikely to occur in 2018-2019. From an economic standpoint, we believe that risks are slightly tilted to the upside in the coming quarters.**

MACRO	FINANCIAL MARKETS	INVESTMENT CONSEQUENCES
– Resynchronisation of the global cycle: more robust growth ahead, mostly domestic driven, magnified by trade multipliers	– EPS expand on later cycle mode, corporate profits reduce cash holdings and dividend payout, buy backs, M&A activity cools down	• Positive for risk asset exposure • Risk-adjusted returns lower than previous asset reflation regime
– Toward a rebalancing of monetary and fiscal policies in some key countries. Central banks progressively removing excessive accommodation	– Fixed income and equity absolute valuations are on average stretched, interest rates expected to increase only moderately	• Transition from asset reflation into late financial cycle regime • Gradual rotation from High Yield into global equity
– From excessively low inflation to subdued inflation, risks skewed to the upside	– Fixed income and equity absolute valuations are on average stretched, interest rates expected to increase only moderately	• Relative positioning to replace directional positioning. • Emphasise geographical diversification in duration management. • Global equity positioning articulated on country/sectors/ style/size/factors
RISKS	**– Inflation and rates surprises** **– Geopolitical risks (Brexit, Middle East, North Korea)** **– Oil price spikes and drying market liquidity**	**• Gold** **• Risk sensitive FX cross (AUD/JPY)** **• US linkers**

Large economies at a glance

United States: a mature cycle but no recession in sight. The cycle is ageing (almost nine years) but an extension in 2018-2019 is likely thanks to fiscal policy, low inflation and still accommodative monetary and financial conditions. We forecast growth at – or above – 2% in 2018 and 2019. Given the uncertainty still surrounding the final definition of the tax reform bill, it is difficult to evaluate the impact of tax reform on our projections, both in terms of the short-term boost to GDP and the long-term increase in potential growth. Assuming that the reform is delivered in Q1 2018, we estimate that the resulting boost on our forecast would range from +0.1% (case of low multiplier effect) to +0.5% (case of high multiplier) on top of our base case (see table). If, as we expect, the ongoing cycle continues after mid-2019, it would become the longest expansion phase on record (since 1857).

Eurozone: the "Renaissance". The late-recovery is now broadening to all countries and GDP components. Thanks to accommodative monetary and credit conditions, growth is expected to remain above potential for several consecutive years. Notable progress has been made in implementing reforms at both the EU and national levels and most macroeconomic imbalances have been corrected. Even though some local-risks remain, political stability has improved and uncertainty about the whole EU architecture has diminished. European citizens have become more optimistic about the EU and the euro as a single currency. And we expect a strong commitment from eurozone governments to continue to make reforms and to strengthen the European project. Hence, our belief in the "Renaissance" of Europe.

UK: it's all about politics. The Brexit clock is ticking and the positions of the UK and the EU in negotiations remain far apart. The UK is the only large European economy which has slowed in 2017. The risk of a "very hard" Brexit (no deal) has risen. Even though it is not our central scenario, we expect the Brexit-related uncertainty to weigh heavily on investment decisions, both from corporations and households (the latter regarding real estate in particular). But the UK economic slowdown is not expected to derail the recovery in the eurozone, which is primarily driven by domestic demand.

Japan: Abenomics will boost Japan toward the longest post-war expansion. The economy is not particularly strong by historical standards but this cycle has proved more robust than expected, driven both by domestic demand and global trade. Strong corporate profits should sustain business investment while – following the recent snap elections and the ruling coalition's victory – fiscal policy will turn more expansionist in 2018. Should the expansion continue beyond 2018, as we expect, it would become the longest expansion phase since WWII.

China: resilient growth and more balanced reforms ahead. The economy appears more resilient than previously believed. The (widely expected) coming slowdown is likely to be moderate, as growth drivers are now more broad-based and meaningful supply-side adjustments, including cuts in overcapacity and property inventory reduction, have already materialised. The 19th Party Congress confirmed that among the top priorities were the deepening of reforms and the improvement of governance which would increase the chance of China successfully managing a relatively soft landing.

Global Emerging: less vulnerable than before the Great Financial Crisis (GFC). Most emerging economies are enjoying strong growth momentum, with solid domestic demand. Short-term prospects could prove bumpy (Fed QT, political gridlocks, etc.), but all in all the medium-term outlook remains promising. Since the GFC, external vulnerabilities have indeed diminished in many countries.

Monetary policies

The Federal Reserve balance sheet will start to gradually reduce over the next four years. Conversely, the ECB and the BoJ balance sheets will continue to rise, albeit at a slower pace. All in all, the global monetary base (central bank liquidity) will continue to expand next year despite a synchronised economic recovery. Such a configuration is unique. Logically, it is in the United States – where the cycle is the most advanced and the economy close to full employment – that the central bank has the most reason to hike rates. However, even there, the level of domestic leverage (in particular for non-financial corporates) requires proceeding with caution. Thus, global monetary conditions will remain accommodative with key real interest rates at exceptionally low levels.

- **Federal Reserve.** We expect the Fed to raise rates once more in 2017 (+25bp in December) and twice in 2018. Should our upside scenario materialise (positive growth surprise coming from a tax reform boost) one (or even two hikes) would be possible: all things being equal, the fiscal easing would indeed call for less monetary accommodation. Nevertheless, for such a policy to be put in place, growth and inflation would need to accelerate simultaneously.

  The appointment of a new Fed chair does not change the outlook. Jerome Powell – who will succeed Janet Yellen in February 2018 – is the candidate of continuity when it comes to QE and interest-rate normalisation, while he is more open than his predecessors on the subject of financial regulation. Like his two predecessors, he thinks that the equilibrium interest rate has fallen and that inflation is not threatening. In addition, he has always supported monetary policy decisions since his appointment at the Fed in 2012, and stressed the importance of monetary and financial conditions (US dollar, long-term bond yields, credit spreads, and equity markets). It turns out that the Fed's «reaction function» will remain flexible and its action opportunistic. Therefore, if an expansionary fiscal policy calls for a rebalancing of the policy mix, with less monetary accommodation, it will be small steps. The risk of a rise in the US dollar and long rates requires a cautious approach.

- **European Central Bank.** The last ECB meeting clarified the monetary strategy. The Asset Purchasing Programme (APP) will continue at €60 bn per month until December and then the size of purchases will be reduced to €30 bn per month starting from January, until September 2018. The ECB Council stands ready to increase the APP in terms of either size or duration, if needed (hence the programme remains open-ended). In addition, the ECB will not end the programme abruptly so there will likely be a phase-out period. The ECB clarified that reinvestments will continue for an extended period of time (after the end of its APP). Regarding forward guidance on rates, Mario Draghi said that they will remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases. **All in all, the ECB's tapering appears quite dovish. We do not expect the first rate hike before 2019.**

- **Bank of England.** While the market is pricing in a continuation of the tightening action next year, we think that the impending slowdown (not a recession but an uncertainty-led slowdown) will prevent the BoE from entering into a tightening cycle. Even though some pressure on prices is likely to persist due to the weakness of the currency, inflation should in any case move down from the current levels.

- **Bank of Japan.** Following Abe's victory in the recent parliamentary elections, Governor Kuroda is likely to be reappointed. The BoJ significantly lowered its inflation outlook and should thus stick to its current policy and maintain the framework of QQE plus YCC (yield curve control). Yet, the promised annual purchase level of JPY 80 trillion is difficult in practice and, in fact, the central bank has already whittled its purchases down to some 60 trillion.

- **People's Bank of China.** The PBoC's stance should be roughly neutral, with possible fine-tuning. It is unlikely to be too tight, as the economy is expected to cool somewhat, while inflation should evolve within the comfortable range. Benchmark rates are expected to remain where they are.

RISK SCENARIOS

DOWNSIDE RISK SCENARIO (10%)

Economic slowdown due to poor implementation of economic policies, to policy mistakes or to a sudden repricing of risks in fixed income markets

RATIONALE	CONSEQUENCES
• Fiscal policy poorly designed and implemented (in the US in particular). • Monetary policy mistakes (the normalisation process proves too fast). • Rise in protectionism. • Poor governance in Europe / no progress on reforms.	• Growth slows and inflation stabilises lower (though not necessarily a case of deflation). • Disorderly deleveraging. • Central banks forced to restart the use of unconventional tools but market liquidity contracts. • Sudden repricing of risks in fixed income markets, with widespread spread decompression (credit and govies, both in advanced and emerging economies).

UPSIDE RISK SCENARIO (15%)

Further acceleration of global growth in 2018

RATIONALE	CONSEQUENCES
• Acceleration driven by business investment, global trade and the resynchronisation of the global cycle. • Fiscal stimulus in the US, continuation of the cyclical acceleration in the eurozone, stabilisation in China, confirmation of the trend in Japan etc. • With still low inflation, central banks would initially maintain soft monetary conditions, fuelling a mini-boom.	• Rise in inflation expectations. • Central banks would, at the end of the day, need to reconsider the pace of normalisation, with a rise in real key rates (in the US notably). • Boom-bust risk (i.e. the bust after the boom).

Keep in mind the structural headwinds

The current global cyclical upswing can last longer than initially expected but cyclical upswings are by essence temporary. It's all the more true that there are numerous headwinds.

While we can be reasonably reassured by the short-term prospects, both governments and investors seem too complacent about the medium-term outlook. Rising debts, rising inequalities, impoverishment of the middle class (with wage stagnation), challenges posed by the ageing population, slow productivity gains, or – in another vein – by climate change, and the accelerated pace of robotisation. The list of "structural headwinds" is long, not to mention geopolitical threats. The world is rapidly changing. Most of these challenges may have huge social and political consequences in the medium term that would inevitably affect the macrofinancial outlook. Global action is needed. But so far, we've seen little will to deal with these issues.

In the medium term – assuming some global action is taken to deal with these structural issues – we would expect GDP growth to stabilise around its potential. On a three-year horizon, global growth would stand at around 3.5%, below the average observed over the past decades.

- **Nominal potential growth is trending lower:**
  - **Real potential growth is trending lower** worldwide due to the ageing populations and slow productivity gains
  - **"Structural inflation" has dropped over the past three decades.** Persistent downward pressure is likely to continue to result from global supply-side factors. Structural factors such as globalisation, the spread of innovation, weaker unions or rising labour-market flexibility (temporary contracts etc.) will continue to contain price and wage pressures looking ahead
- **Global debt** (government, households and non-financial corporates) **has increased to an all-time high at the end of 2016** (265% of GDP for the G7 countries): +100pp over the past 30 years, half of which has occurred since the Great Financial Crisis
  - Very different situations across countries (level and composition of debt). For instance, in China, non-financial corporate debt has jumped while the most advanced economies are struggling with excessive public debts
  - In the US, China, the UK and the eurozone, total debt stands at around 250% of GDP (end 2016)
- **The "global deleveraging" has hardly started.** Thus, financial repression will continue. In addition to the slowdown in potential growth, we expect global deleveraging to drag down GDP growth in the years to come.

- **Against this backdrop, central banks are implicitly incentivised to maintain low real key rates:** a certain dose of financial repression is probably necessary to engineer an orderly deleveraging at a global level (a disorderly or brutal deleveraging would renew deflationary pressure).

Investment themes

Economic backdrop plays a relevant role setting the prevailing financial regimes for the year to come. If we systematically consider growth, price dynamics, monetary policy stance and leverage, we conclude that around late Q2 2018 we should transition from an asset reflation regime into a late financial cycle regime against a backdrop of consolidating growth and subdued inflation.

The key factor driving these regimes' transition will be the central banks "beautiful" normalisation while inflation expectations and rates (both real and nominal) will represent the leit motiv shaping this year's investment consequences both in the base and alternative risk scenarios.

Inflation paths and real rate dynamics will in fact define the pace of CBs calibration of frontline tools, eventually shaping the yield curve and hence the relative valuation case between equity and bonds. Stock markets are expensive in absolute terms but relative valuations to bonds are not extreme. Depending on CBs, liquidity will (have to) remain adequate and we may possibly observe some **selective depreciation in the FX space** as a consequence of how intensely central banks move forward with their normalisation cycles. As rates after all will only increase moderately, the **search for yield** will remain, but in the credit spectrum it will turn more selective on sectors and rating due mainly to valuation considerations. We expect **risk assets** to perform and the **rotation from credit into equity** to occur eventually on broad risk/return and valuation considerations. **Interest rates will moderately rise** on less intense QE, likely above what the market is currently pricing. **Equity markets** will rely on a contained level of unit labour costs that will preserve margins, and EPS consolidation, while the low level of rates keeps the case for relative valuations alive.

However, it is worth considering the **mature phase of the economic and profit cycles**, the **valuation** component and the **gradual QE withdrawal**. On these considerations, risk-adjusted returns will be lower than in the previous asset reflation regime. Therefore, investment opportunities will lie less in the directional space and more on relative value stories at country, sector and size level. In **global equity** land, **quality and value** are the themes that will be recurrent both from a **top down perspective and bottom up selection**. Moreover, different stages of the EPS cycle and valuations will be tilting the regional equity allocation. Initially, the preference will be for Europe, Japan and Emerging Asia in particular, but we will likely rotate regional preferences during the year. In particular, what the FED will deliver (number of hikes, balance sheet shrinkage and resulting USD dynamics) will be key in identifying the spillovers for the global financial markets.

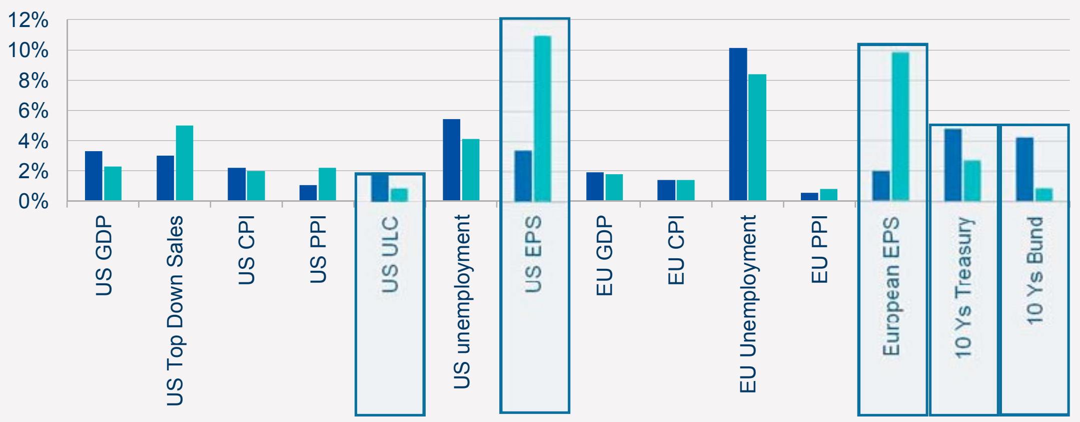
Actually, inflation and rates will also be key when turning to risks and alternative scenarios. In fact, extremely low market volatility and high levels of complacency leave the door open to upside inflation surprises, a snapback of long-term interest rates and eventually to geopolitical risks. The macro-hedging component deserves particular attention, considering the absence of real asset diversifier in the portfolios' allocation.

There are **three main aspects** differentiating the forthcoming late financial cycle regime from the past and turning it into an unprecedented situation. We have to consider them when assessing the potential of the asset class and defining investment guidelines.

The **subdued level of US unit labour costs coupled with the rosy growth scenario** and the tightening conditions on the labour market. While marginally increasing, unit labour costs are far from an accurate gauge of inflationary pressures but they are keeping up the pressure on corporate earnings margins.

The **low level of nominal rates**, in the long end of the developed-market yield curve. They are at barely half the level of historical rates and preserve the relative valuation case for equities versus bonds.

1/ This time is different: Distinctive features of 2018 financial regime



Source: Amundi Research

The **resynchronisation of global EPS and upbeat momentum**, albeit for different reasons in the USA (margins and USD), Europe (top line growth), Japan (restructuring and improving fundamentals) and eventually Emerging Markets (improving but maturing economic cycle).

What's priced in already?

When we compare the expected macro target prices (i.e. the expected fair value price level consistent with our macro base scenario expectations) and the historical returns of the main asset classes in a late financial cycle regime, we conclude that global markets have already priced in a good part of the expected economic dynamics. This is one of the reasons to justify relative trade being preferred over directional positioning, and country, sector, and style rotation (both in the fixed income and equity space). Other factors of tactical nature (i.e. risk sentiment, positioning) have to be considered to improve the risk reward within allocations.

BASE SCENARIO - TOP DOWN INVESTMENT IMPLICATIONS

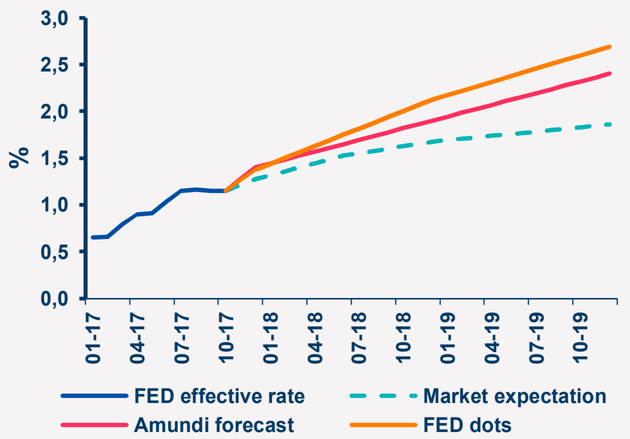
- Risk On with macro hedging on selected key risks (inflation surprises, yield decompression, market sell-off, geopolitical)
- Credit preferred to Govies, EU IG in particular. Selection on sector and rating on the credit spectrum.
- Flexibility in duration management, relative country positioning
- Rotation from credit (US HY) into global equity
- Regional equity preference for Europe, Japan, selective on EM countries but rotation likely. Quality and Value and key investment themes

The economic backdrop (growth, inflation) justifies a risk-on positioning. As cross asset risk/return profiles are likely to be lower than the past, absolute valuations are compressed (with the exception of volatility) and correlations positive and very closed, diversification on relative trades cross asset, regions, sectors, rating and style will be key. Credit valuations fell to quite rich levels: US companies are in a more mature phase of the cycle when it comes both to credit metrics (leverage) or technical. Vice versa, in the eurozone, the ECB via CSPP is likely to remain the big supporter of the IG market, notwithstanding that there is no significant re-leveraging (non-financials) and the level of cash and coverage ratios remain in a bright spot.

DM Long-term yields, still low on an historical comparison, might rise even more than indicated by forward rates on less intense central-bank QE policies. In fact, the speed of monetary policy recalibration will set the pace of the movements: as in 2017, the short and long ends of the curves will likely continue to follow different patterns both in the US but also in Germany. Curve steepening is likely in the eurozone: the short end should remain broadly anchored to the ECB's forward guidance, while we expect some risk premium to be built back, with the ECB gradually moving into a normalisation stance (notwithstanding their assertions on the forward guidance).

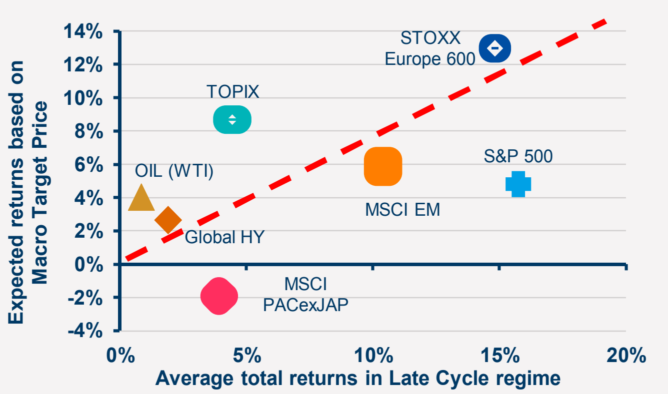
- **In Europe,** the PSPP will remain supportive for peripheral bonds. The increasing deviations from capital key rules will benefit French, Italian, Belgian and Austrian bonds and the maturity of Eurosystem purchases will remain far higher for peripherals than for the purchases of German securities. Political risk needs to be considered (i.e. Italian elections) for short-term volatility or temporary spread widening but the recent ratings upgrades (over the last few months, Italy and Portugal have been upgraded by S&P and Ireland by Moody's) are positive news.

2/ **FED funds rate**



Source: Amundi Research

3/ **Fair value total returns conditioned on late cycle**



The chart 3 considers the Expected Macro Target Price (or fair value) on the Y-axis as the theoretical price level consistent with our expected macro scenario. The gap versus the historical price (X-axis) calculated on similar past regimes define the upside/downside potential. The 45° row is where target price expectations equals historical total return. Above this line, asset classes have positive potential (negative when below).

- **In the US,** we expect a contained flattening, with the FED continuing its smooth hiking cycle. The main risk to this view is the potential implementation of substantial tax reforms. Should this be the case, the FED will have to temper the increased room for hiking with the significant spillover to the financial markets.

In light of these considerations, flexibility and geographic diversification in duration management to seek out relative value between countries need to be considered.

Break-even rates should normalise in the eurozone from a too depressed level as we expect a gradual increase in eurozone core inflation. Vice versa in the USA, where breakevens are fairly priced. However, they remain a good hedge in case of inflation surprises, a risk listed in our wall of worries.

DM FX will prove once again to be very resilient and implicitly reactive to distortion from policies (Yen, USD) & politics (GBP). The **euro** is expected to remain subdued within the current trading range in the first part of the year and then moderately appreciate towards 1.22 on short-term interest-rate differentials and improving macro fundamentals. The **yen** will remain driven by interest rate differentials, we expect it to stay within the 115-118 range vs. the dollar. Brexit negotiations will drag down the UK economy and the BoE's reaction function. We expect the GBP to remain within 1.26-1.28 vs. the USD. The trade-weighted EUR will appreciate almost 3%, while the DXY will depreciate by almost the same amount.

Global equity markets will rely on the consolidation of the EPS cycle, the contained level of unit labour costs that will preserve margins on average while the low level of rates keeps the case for relative valuations alive.

EPS growth will be key and differences in pace will likely favour country and sector rotation themes. In general, EPS are going to be higher (in Europe and in the US in particular) than what we are used to seeing in similar consolidation phases in the past. The reasons being the supportive financing conditions, buoyant markets that helped foster growth and repair balance sheets, accumulation of cash ready to be eventually allocated to investments (capex), as has started to be the case in the US, recently in Europe and expected to occur in Japan. Then, at regional level:

- In the **US, subdued pressure on wages is underpinning margins,** while the overall **dollar depreciation** in 2017 allowed some further momentum in the most recent reporting season.
- **Europe and the EM are eventually bottoming out.** The latter in particular after four years of negative earnings growth, in 2017 for the first time, company results outperformed expectations. Earnings growth will remain above the historical average in 2018 but with a cooling momentum on a more mature cycle.
- **Japan is surprising on the upside** on tangibly improving fundamentals, independently from the yen (that remains crucial nonetheless).

EM Bond (hard currency) levels are on average expensive, notwithstanding the expectations that the EMBI spread will tighten (from 360 to 340). We reiterate the case for selection and a relative value approach at single country level with improving fundamentals, credible reform agenda, attractive valuation and risk adjusted carry. Positioning is heavy but in the main scenario, we expect outflows to be thin, even if CBs in DMs turn less accommodative. We believe we have seen the best out of EM debt in local currency: going forward valuations and real rates show limited room as inflation will stay around central banks' targets. The correction of external imbalances will avoid downside risk, though it would be better to be exposed to those countries with lower sensitivity to US rates, should they rise more than expected. **EM FX** continues to show attractive carry and, over the medium term, valuations are appealing for the selection of high carry/low volatility currencies with low external vulnerability.

Financial implications of alternative risk scenarios

The bulk of our outlook are central banks smoothly normalising their stance while rates and inflation expectations advance gradually to higher levels.

Asset reflation allowed financial markets to perform thanks to low rates, lowflation and QE. As soon as inflation starts to rise, interest rates will unequivocally prove unsustainable at current levels. This will then challenge equities on higher pressure on margins, consuming the undervaluation gap versus bonds.

The Double Bear Markets Risk

In our base scenario, we are confident that interest rates will increase because of QE withdrawal and likely higher inflation. The alternative scenarios mentioned in the previous pages relates to **how far and how fast** rates will move. This is crucial when gauging the probability of a **bear market in global equity and bond lands** and positioning the portfolios to hedge potential losses on both asset class categories.

According to our analyses and considering past empirical evidence, the **critical threshold for 10-year Treasuries** to initiate a double bear market would be around 3.5% (an increase of 125 bps from current levels). In the past, in such circumstances, both fixed income and equities underperformed while gold proved to be the real safe haven.

WALL OF WORRIES (tail risk events)

FISCAL POLICY MISTAKES **Economic slowdown due to poor implementation of economic policies and/or policy mistakes**			
DESCRIPTION		**MARKET CONSEQUENCES**	**RISK**
US	Fiscal policy too poorly designed	Low growth, low inflation, low rates, drying liquidity. Recession risk	High
EU	Slow progress on structural reforms in some countries		Low
EM	Short term: too early/too fast step out of fiscal support or too quick fiscal consolidation Medium Term: lack of necessary structural reforms		Medium
MONETARY POLICY MISTAKES **Central Banks start normalising but timing & sizing produce financial instability and bear markets**			
Global	Synchronised full normalisation of major central banks' monetary policy	Lower global liquidity, spread widening, rates increasing and fixed income sell-off, competitive devaluations and GEM asset classes under pressure	Medium
Global	Monetary trap: while proceeding in the B/S adjustments, real rates increase on bond supply and demand dynamics not on corroborating growth and inflation. Macro and micro fundamentals decouple and central banks are pushed back into monetary accommodation l	Real rates increase and initiate a bear market in both equity and bond space (Double bear market)	Medium
US	Fed recalibrating frontline unconventional tools too fast: rough B/S adjustments/ hikes too fast/ rates move higher than market expectations	Real Rates increase and initiate a bear market in both equity and bond space (Double bear market)	Medium
ECONOMIC **Inflation surprises in both directions with asymmetric probabilities**			
Lowflation	Getting lower not necessarily to deflation but structurally below CBs targets	Real rates increase above market tolerance but lowflation stays, causing growth to decline when central-bank backup diminished. Sell-off in the equity market to hedge the widening in the credit spreads	High
Higher Inflation	Unexpectedly moves higher and persistently above CBs' targets	Depends on CBs reaction function to normalise policy. Higher volatility in the fixed income space o inflation surprises	Medium
Competitive Devaluations	After a market-driven FX appreciation that proves to be persistent when growth ends up not being strong enough to offset the competitiveness loss	Commodities and profits recession, competitive devaluations, risky asset sell-off	Medium
GEOPOLITICAL			
Brexit process	Uncertainty on final outcome of the negotiations	Weaker UK (economy, financial markets, GBP)	High
Italian elections	Coalition Government weak in the delivery of structural reforms	Sovereign spread widening	Medium
North Korea military escalation	Global conflict	Risk Off	Low
Tensions in the Middle East on Saudi policy	Significant regional conflict with global spillover	Local economies and markets weakening, volatility increase, oil price upside risk	Medium
MARKETS SELL-OFF			
Boom Bust Bubble	Decoupling of fundamentals and asset prices (bubble bust)	Markets sell-off intensified by heavy positioning, volatility increases	High
Oil	Oil prices increase above market tolerance	Tightening financial conditions, out of Central Banks control Inflation increase	High

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