Risk factors

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

Risk # 1 | 20% probability | Pro-cyclical fiscal policy pushes the Fed to raise its rates more quickly than expected

Analysis | Now that the tax cuts have been voted in by Congress, the question is what economic impact will they have. The misinterpretation of the Fed's intentions/decisions has been a major risk factor for a long time now. With GDP growth above 2%, inflation close to 2% and an economy that is increasingly close to full employment, the real Fed funds rate should be much higher than it is now, in a normal cycle. So, technically, the Fed is "behind the curve". The Fed must clearly avoid any communication errors. Markets could react poorly if rates are increased excessively. The most recent example of a bond crash dates back to February 1994 and was triggered by a 25bp increase in rates, which was certainly poorly prepared. However, we note that the short-term positive impact of the tax reform should allow the Fed to continue to raise interest rates without increasing the risk of recession and, as such, without damaging the financial markets.

Market impact | If the Fed steps up its rate increases, we will have to bet on a sharp downturn in equities and on contagion into the emerging markets. This situation would be conducive to a widening of spreads between Europe and the United States. NB: we are already pricing in one more rate increase than the markets in 2018. All it would take is for core inflation or wages to pick up more quickly to open the door to further rate hikes.

Risk # 2 | 10% probability | A Chinese "hard landing" / a bursting of the credit bubble / devaluation of the yuan

Analysis | Chinese growth is still solid (and more resilient than many market observers believed), but the country's economic model incites caution: the excess of credit is visible, the weight of the debt is swollen, the (weak) competitiveness of industry is declining and productivity gains are insufficient. In short, potential growth continues to decline. Closely monitor the trend in Chinese private debt, some metrics of which have become particularly worrisome in the space of a few years. In the case of hard landing or the bursting of the credit bubble, the Chinese authorities would be unable to maintain the stability of the yuan, especially since the Chinese currency is no longer undervalued.

Market impact | Such a scenario (hard landing, bursting of the credit bubble) would have a very negative impact and its cascading effects would be particularly disastrous: vulnerability of banking systems (in China and elsewhere), vulnerability of the global financial system, vulnerability linked to China's public and private debt, impacts on commodities and emerging countries, impacts on the currencies of commodity-exporting countries, advanced countries and emerging countries.

Risk # 3 | 75% probability | The post-Brexit environment permanently weakens the UK

Analysis | According to estimates, the UK "could lose" between 2.5% and 9.5% of its GDP in the medium term. Volume and costs of trade would be affected, especially in the financial services, chemicals and automotive sectors, which are highly integrated sectors in the European Union. The risk for the UK lies in its future ability to trade freely in the single market (the services market, to be more precise), to achieve the desired independence without the EU's constraints. This is the challenge of phase two of the negotiations which are scheduled to begin. There are many issues of tension, not just between the UK and countries in the EU, but within the British government itself, which will become very apparent in the coming weeks and months.

Market impact | Even though the likelihood of a hard Brexit has dropped significantly, and although some pressure has been relieved with the proposed 21-month transition period, negotiations on trade this year are expected to be tense. In the event that the outcome is ultimately unfavourable for the United Kingdom, we will see additional weakening of the pound sterling and long-term GDP of the British economy, two factors that could prolong the monetary status quo.

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Risk # 4 | 70% probability | Greater financial instability

Analysis | Central banks have made the return of financial stability possible in recent years through lower rates, short and long; maintaining interest rates at low levels across the board; reducing volatility and keeping it low, tighter credit spreads and the virtual disappearance of sovereign risks in some cases... all of which have generated an environment of greater stability. However, monetary policies have now reached their limits, and it is difficult to expect more from them. The macroeconomic response to a potential downturn in activity would ultimately come from fiscal and tax policies, and traditionally public spending has far less stabilising power for financial markets than interest rate cuts.

Market impact | Greater financial instability would translate in particular into a rise in volatility on all financial markets and credit spreads.

Risk # 5 | 70% probability | Political and geopolitical risks maintained

Analysis | Financial markets are now operating against a complex geopolitical backdrop: Syria, Islamic State, Turkey, migrant flows, terrorist attacks, Sunnis vs. Shiites, Arabia vs. Iran, all of which have strained and weakened diplomatic relations between countries. Do not bet on a quick resolution of ongoing problems and conflicts. The situation in Catalonia is also worrying, while the backdrop remains confused. Pricing political and geopolitical risks into portfolio constructions on a permanent basis (systematically providing macro-hedging strategies) is now more meaningful.

Market impact | There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are well identified and specific, but there are many, and most of them remain uncertain. The magnitude of other political risks (including the consequences of the new US diplomacy) is more difficult to assess at this stage. Is this all likely to affect growth prospects and the direction of financial markets? Nothing is certain at this stage, but it is very likely that this is the case, at least on an ad hoc basis.

Risk # 6 | 20% probability | A long-term and significant increase in European long rates

Analysis | The increase in long-term rates can come from at least six sources: (i) a significant upswing in (nominal, real or potential) growth prospects, (ii) more aggressive tightening of interest rate policies, (iii) the “true” end of QEs (the end of reinvesting maturing papers in the US, an even more drastic reduction in the ECB’s asset purchasing programme), (iv) a resurgence of inflation or inflation expectations, (v) a massive reversal of fiscal and tax policies, or (vi) a resurgence of specific political risks. All these factors (reality, announced measures, or fears) have gained momentum in the United States, but it seems premature and excessive to expect a steady and substantial increase in bond yields. This conclusion holds even more in the case of the eurozone. But with growth that is now more robust and more sustainable, extremely (abnormally?) low inflation expectations, debates over the end of negative rates and the ECB’s QE programme, and comments about the need for fiscal and tax measures that are more favourable to growth, it is a safe bet that the risks of a moderate rise in European rates are higher now.

Market impact | A sharp rise in long rates would be bad news in the United States, where the sensitivity to long-term rates has increased with corporate releveraging: this would weaken growth and in itself would sow the seeds for a future decline in long rates. It should also be noted that any rise in long-term interest rates is a hindrance to monetary policy and to the possibility of a rise in the Fed’s key interest rates. This is another reason for not believing in a sustained and ample increase in US – and European – long rates.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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This section provides a reminder of our central scenario and alternative scenarios.

Central scenario (75% probability): continued expansion of global activity.

- **Global resynchronisation:** global growth has accelerated since the start of the year and will remain dynamic in 2018. The advanced economies (with the notable exception of the United Kingdom) will continue to experience above potential growth. The major emerging economies will also continue to grow at a sustained pace. The ongoing rebalancing in China is progressing quietly – such that the slowdown appears to be under control. The recovery in most economies is being driven by domestic demand, and we note a recovery in investment in many regions (United States, Europe, Japan, Asia). The resynchronisation of the global cycle generates "multiplier effects" – via trade – that sustain the recovery on a global scale and make it more robust.
- **World trade:** world trade recovered markedly in 2017 (+5% over one year). It continues to be stimulated by the resynchronisation of the global cycle and investment in capital goods. However, this effect is expected to gradually wane this year: we anticipate a stabilisation of the world-trade to world-GDP ratio in the future.
- **United States:** Growth is solidly established as the year begins. Most of the surveys continue to improve. According to the regional Feds' estimates, growth stayed above 3% on an annualised basis in Q4 for the third consecutive quarter. Low inflation, the ongoing accommodative monetary and financial conditions (despite the expected hike in the fed funds rate) and the fiscal stimulus voted through in December significantly reduce the risk of a recession in 2018-19.
- **Eurozone:** the recovery is widespread, with a pick-up in investment in most countries. Growth is mainly being driven by domestic demand, but is also benefiting from a very robust global backdrop. Political risk has faded considerably, becoming more local (the status of Catalonia in Spain is primarily a domestic issue, while in Italy, the anti-euro parties have no chance of winning an absolute majority in the elections scheduled for 4 March). The reduction in asset purchases by the ECB is likely to be accompanied by a rise in both long-term interest rates in the core countries and the euro. Hence the slight decline in growth expected in 2019. Nonetheless, with credit conditions still highly accommodative, growth should remain significantly above potential in 2018 and 2019.
- **United Kingdom:** in December, EU countries followed the Commission's recommendations according to which "adequate progress" had been made to open trade negotiations between the United Kingdom and the EU. Moreover, EU countries are now accepting the principle of a time-limited transition period up to the end of 2020, during which the UK would retain de facto access to the single market. This being the case, the threat of a hard Brexit is no longer imminent, at least in 2019. Admittedly, uncertainty will continue to weigh down the British economy, but more diffusely. We are counting on growth to stabilise in 2018-2019 at 1.5%, clearly below the UK's growth potential, but without any abrupt downturn.
- **China:** growth is more robust than expected. The reduction in overcapacity has reduced the downside risks. The economy's growth drivers are now more diversified. Debt remains essentially domestic and manageable. We expect the gradual deceleration of growth to continue and a slow rebalancing (less growth, less debt). The transition looks to be under control. However, vigilance should still be exercised.
- **Inflation:** core inflation, which is excessively low at this stage in the cycle (especially in advanced economies), is expected to recover gradually in 2018. That said, the slowdown in inflation over recent years is primarily structural (tied to supply factors), while the cyclical component of inflation has weakened (flattening of the Phillips curve). While the pick-up in core inflation promises to be modest, the likelihood of an "inflation surprise" is nonetheless increasing as surplus capacities disappear around the world (we estimate that the global output gap will close in 2018 for the first time since the great financial crisis). The risk is easier to spot in the United States, given how close the economy is to full employment and how certain temporary factors (such as the drop in mobile phone service prices in the spring of 2017) have disappeared, which will automatically push inflation upward at the end of Q1 2018 (base effect).
- **Oil prices:** we expect (Brent) oil prices to ease back slightly from their current level. At $67 (Brent), the risk now looks lopsided to us (more risk of prices falling than soaring). In fact, if prices stay much above the breakeven point for US oil deposits, US production will end up increasing sharply.

- **Fiscal policies.** Two countries are in the spotlight this year: the United States and Germany. In the US, the income and corporate tax cuts (among other measures) just approved by Congress in December are effective as this year begins, which will give growth a shot in the arm over the next 18 months. In Germany, there are also tax cuts slated for 2018. On average, fiscal policies will be neutral, or even slightly expansionist, in the large advanced countries.
- **In 2018, the central banks will continue to whittle down their accommodative monetary policy,** which is excessive in view of the current recovery. The Fed will continue to raise its key interest rates (we now anticipate three 25bp increases in 2018) and reduce its balance sheet at the announced pace (with a gradual non-replacement of papers reaching maturity); meanwhile, the ECB could put an end to its QE programme as soon as Q4 2018, which would potentially open the door to the first increase in its deposit rate in early 2019. That said, monetary policies will remain accommodative overall, because even if some cyclical inflation does materialise later in the year, inflation will stay well below its historic average for the structural reasons we mentioned (flattening of the Phillips curve, continued downward pressure on the prices of many goods and services).

Pessimistic risk scenario (10% probability): economic slowdown due to incorrect economic policy (excessively quick monetary policy normalisation or protectionist measures) or a geopolitical crisis

- The pro-cyclical fiscal policy forces the Fed to accelerate the monetary policy normalisation process.
- Protectionist measures (US) as mid-term elections draw nearer.
- International crisis stemming from acute aggravation of current geopolitical tensions (Middle East, Korea).

Consequences

- An abrupt re-evaluation of risks on the fixed income markets, with a global decompression of spreads (govies and credit, on the developed and emerging markets alike). Decline in market liquidity.
- Risk of disorderly deleveraging.
- With the resulting financial turbulence, the cycle is abruptly interrupted and inflation cannot stabilise.
- Central banks are forced to turn to unconventional tools once again (expanding their balance sheets).

Optimistic risk scenario (15% probability): continued sharp pick-up in global growth in 2018

Several factors, which are likely to generate higher growth, should be closely monitored:

- Sharp pick-up driven by business investment, global trade, and synchronisation of the overall cycle.
- In a very promising environment, the pro-cyclical US tax policy generates a stronger than expected pick-up in domestic growth. Continued acceleration cycle in the eurozone, stabilisation in China, confirmation of the trend in Japan, etc.
- With inflation remaining extremely low, central banks would continue to maintain easy monetary conditions, at least at first, enabling a "mini-boom."

Consequences:

- A marked pick-up in global growth for the second consecutive year would increase inflation expectations, forcing the central banks to consider normalising their monetary policy much more quickly.
- Rise in real key interest rates (in the US especially).
- Given the resulting financial turbulence, the mini-boom of the first half would not last long. There would be a greater risk of a boom/bust (i.e. the bust after the boom).

Macroeconomic picture by area

Americas

United States

- Coincident indicators for the US economy point to a very positive momentum for growth in the second half of 2017, with Q4 GDP posed to reach again the 3% range. Business and Consumer optimism remain at high historical levels thus supporting our expectations for a resilient internal demand and upturn in Capex going into 2018. The recent approval of the Tax Cut and Job Act will provide further boost to Personal Consumption and Investments, making the US economy growing above potential again in 2018 and likely in 2019. The labour market keeps improving, although at a slower pace, which is not abnormal at this stage of the cycle. Inflation instead remains subdued, but going into 2018 we expect some of the forces that kept inflation low to dissipate, while some cyclical inflation is expected to materialise, but without any significant and prolonged overshooting.

Risk factors

- Debt Ceiling: Treasury's extraordinary measures extend borrowing till late March 18
- Protectionist risk still present, NAFTA negotiations
- Lower potential growth

Brazil

Recovery well on track

- Brazilian economy is continuing on its recovery track thanks to a vibrant domestic demand. Households have been benefitting from high real wages/low inflation and a deleveraging process well ahead in the schedule. Capital Goods production and imports together with higher earnings will support future Capex. Inflation is stabilizing within BCB target and the easing cycle is almost done. An inflation under control will allow BCB to stay on hold over 2018. Reforms program for current legislature is finishing with many smaller successes but without Pension reform. Such needed reform to put Brazil on a fiscal sustainable path will be likely dealt with in the next legislature.

Risk factors

- Improving economic conditions with unsustainable fiscal path
- Rise in political risks with the approaching presidential elections

Europe

Eurozone

The recovery continues with a lot of remaining potential

- The series of upside surprises continued to pile up. The recovery in investment, solid consumption figures and the drop in unemployment are generating a virtuous circle. Core inflation remains weak. At this stage, the stronger euro (which partly reflects the region's economic improvement) does not put the recovery at risk. Political risk declined sharply after the French election. However, some residual uncertainty remains in Italy (general election due on 4 March.

Risk factors

- Rise in the euro
- Political risk (rise in anti-establishment parties, notably in Italy)
- External economic risk

United Kingdom

Slowdown amid major uncertainties around the Brexit process

- The economy has been slowing down since the beginning of 2017. Uncertainties concerning future access to export markets, slowing investment and real estate dynamics are dragging down confidence. The rise in inflation due to the drop in sterling is expected to be temporary. Despite the very low unemployment rate, wages are not picking up.
- EU countries decided to open trade negotiations. Negotiations will be strained but the Europeans have opened the door to a transition period that would maintain unchanged relationships between the UK and the EU until the end of 2020. There is less uncertainty in the short term. We slightly revised upwards our growth forecast in 2018 (from 1.2% to 1.5%) to the same (low) level as in 2017.

Risk factors

- Strained negotiations ahead on trade
- Weak government (no majority without the DUP)
- Foreign deficit is still very high

Asia

China

Cooling of growth is likely to be moderate

- The latest in-house China Coincident Indicator, PMIs and high-frequency data towards end-2017 suggested a mild slowdown in Q4, with activity recovered slightly after a weak October. The annual Economic Work Conference reaffirmed the reform direction in 19th Party Congress, while also emphasize to carefully manage the pace in balancing "stability" and "progress" of structural measures, to keep growth in reasonable range. The lingering concerns about investments are perhaps overdone, as monthly Fixed Asset Investments (FAI) data are probably distorted due to anti-corruption campaign, while other sources of data implied a less worried picture. According to the BIS, the pace of increase in credit/GDP slowed. Capital outflows remain under control.

Risk factors

- Policy mistakes in managing structural transition
- Geopolitical noises regarding North Korea and with US

India

A resilient growth but Capex still far from coming

- As in the expectations, Indian economy managed to recover in the second half of CY 2017, after the GST implementation early in July. The recent decision of recapitalizing the banking sector suffering of bad loans exposure will support a more sustainable growth through credit and private investments but it will take time to be effective. Inflation is increasing faster than expected due to Vegetable prices. Our forecast of a peak between 4.5%-5% is so far confirmed. Risk is to the upside. RBI is expected to stay on hold for a while.

Risk factors

- Recovery is proceeding and banking sector funding will help. Private Capex acceleration will take time.
- Inflation is increasing faster than expected. RBI on hold.
- Fiscal slippage likely

Japan

Toward the longest economic expansion since the early 1960s?

- The government revised up Q3 real GDP to annualized 2.5% from 1.4%. Subsequently our GDP forecast for 2017 is upgraded to 1.7% (previous: 1.4%) followed by 1.3% growth in 2018 and 2019. Corporate sentiment breached an 11-year high for large companies and a 26-year high for small firms in the BOJ Tankan. More companies are confident of a higher sales price. Capital spending plan for this year failed to be upgraded albeit much stronger than historical average. The government asks companies to raise wage and salaries by more than 3% in the next spring negotiation, with providing corporate tax break for eligible companies.

Risk factors

- Heightened geopolitical risks with renewed tensions with North Korea

Macro and Market forecasts

Macroeconomic forecasts
(08 January 2018)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2017	2018	2019	2017	2018	2019
US	2.3	2.6	2.2	2.1	2.1	2.1
Japan	1.7	1.3	1.2	0.4	0.6	0.0
Eurozone	2.4	2.4	2.0	1.5	1.4	1.6
Germany	2.5	2.5	2.0	1.8	1.8	1.6
France	1.9	2.0	1.6	1.2	1.5	1.4
Italy	1.6	1.4	1.3	1.3	0.9	1.1
Spain	3.1	2.7	2.6	2.0	1.7	2.3
UK	1.5	1.5	1.2	2.6	2.5	2.5
Brazil	1.0	2.2	2.4	3.4	3.8	4.6
Russia	1.8	2.0	1.8	3.7	3.5	3.8
India	6.5	6.9	7.0	3.3	4.4	4.6
Indonesia	5.1	5.3	5.5	3.8	3.7	4.1
China	6.8	6.5	6.3	1.6	2.5	2.7
Turkey	6.5	4.4	4.0	11.1	10.0	8.5
Developed countries	2.2	2.3	1.9	1.7	1.7	1.7
Emerging countries	4.9	5.0	5.0	3.5	3.7	3.7
World	3.8	3.9	3.7	2.7	2.9	2.9

Key interest rate outlook

	04/01/2018	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
US	1.50	1.75	1.85	2.25	2.20
Eurozone	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.50	0.55	0.50	0.70

Long rate outlook

2Y. Bond yield

	04/01/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	1.96	2.00/2.20	2.12	2.20/2.40	2.18
Germany	-0.61	-0.60/-0.40	-0.51	-0.40/-0.20	-0.40
Japan	-0.14	-0.20/-0.00	-0.12	-0.20/-0.00	-0.10
UK	0.49	0.40/0.60	0.55	0.40/0.60	0.62

10Y. Bond yield

	04/01/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.47	2.40/2.60	2.55	2.60/2.80	2.60
Germany	0.43	0.60/0.80	0.60	0.80/1.00	0.72
Japan	0.06	0	0.11	0	0.16
UK	1.23	1.20/1.40	1.37	1.20/1.40	1.47

Currency outlook

	04/01/2018	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
EUR/USD	1.21	1.20	1.18	1.22	1.21
USD/JPY	113	115.00	114.50	117.00	113.00
EUR/GBP	0.89	0.95	0.89	0.95	0.90
EUR/CHF	1.18	1.20	1.17	1.20	1.19
EUR/NOK	9.74	9.40	9.43	9.20	9.21
EUR/SEK	9.82	9.50	9.61	9.20	9.46
USD/CAD	1.25	1.25	1.26	1.20	1.24
AUD/USD	0.79	0.75	0.77	0.75	0.79
NZD/USD	0.71	0.70	0.70	0.70	0.72
USD/CNY	6.49	6.70	6.65	6.80	6.65

Source: Amundi Research

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