CIO VIEWS

Risk asset temptation

PASCAL BLANQUÉ, Group Chief Investment Officer
VINCENT MORTIER, Deputy Group Chief Investment Officer

Investors have enjoyed a quiet year in 2017, with few bumpier spots, overall record-low volatility and nice returns. Moving into 2018, the temptation for risk assets is still high. The **economic environment remains strong**. In the US, the expected fiscal reform and infrastructure spending should provide a renewed support to an economy that remains buoyant. In the Euro area, employment is rising at the fastest rate in a decade, and robust data point to a continuation of a recovery into 2018. Strong momentum has also been recorded in Japan, and a reacceleration in EM[1] economies is under way, although with differences seen on a country-by-country basis. A revival in global capex is an emerging theme, that could further support the equity markets, as are the stimulative US measures not fully discounted by the market. So far, Central Banks (CB) have maintained an asynchronous rhythm, that has allowed the market and the real economy to absorb the very gradual tightening of the Federal Reserve in an orderly manner. But, **a "Goldilocks" future is priced into financial markets,** so any sign of economies overheating (inflation, wages), or the perception that CB are behind the curve, could lead to sharp corrections in interest rates and volatility in risk assets. Finally**, geopolitical 'noise'** will continue to be an issue. In this context, investors should resist the temptation to aggressively increase risk. While remaining constructive on risk assets, **we expect that 2018 will not be a linear year (directionally positive) like 2017**. We see multiple phases in the market, which could change over the course of the year. The economic sweet spot will likely end up in higher interest rates, therefore reducing windows of opportunities in the most crowded areas of the market. Expensive valuations across the board, areas of complacency, liquidity conditions, the challenges ahead in terms of interest rate normalization, and geopolitical risks could result in a very uneven market performance. So, investors should be prepared to deal with a scenario of asymmetric distribution of gains and losses: focus on rigorous risk control strategies, search for quality, increase liquidity in portfolios, pursue effective risk diversification, and consider that multiple possible scenarios could materialize.

High Conviction Ideas

- **Multi-Asset:** Investors should enter 2018 with a moderate risk-on approach, with a preference for equities in areas that could still benefit in a late cycle phase (Europe, Japan) or from a revival of reflation trade (US). Given market complacency, the focus is to try to reduce interest rate risk by maintaining a cautious stance on duration, credit and liquidity risk, by avoiding companies for which the spread per unit of leverage appears low. Hedging will also remain key in 2018, to protect from fat tail risk and volatility resurgence.

- **Fixed Income:** The rate outlook is for moderate increases in 2018 both in the US and the Eurozone, with possible reratings of inflation expectations and CB normalization. Investors should keep a short duration view for the moment. The US curve has flattened a lot since September. The challenge of a short duration position is that the US curve remains flat and a long-term yield rebound doesn't materialize. The outlook for credit is still benign, with little space left for further spread compression. EM bonds remain attractive, but with lower expected returns than in 2017.

- **Equities:** We are still constructive on global equities. A capex revival and an extension of the US cycle could be supportive themes entering into 2018. EM remain an area of appealing valuations vs. DM[1]. Focus on bottom up stories to capture the sustainability of earnings growth and quality, which will be a key theme for both EM and DM.

- **Real Assets:** Economic conditions remain supportive for 2018: with robust growth and a moderate resurgence of inflation fears, commodities, real estate, private debt and deployment of capital or buyout strategies could be appealing ways to diversify portfolios into real assets, with a strong focus on selection and valuations.

[1] *EM = Emerging Markets, DM = Developed Markets.*

MACRO
CB under pressure given stronger global growth

PHILIPPE ITHURBIDE, Global Head of Research
DIDIER BOROWSKI, Head of Macroeconomic Research
MONICA DEFEND, Head of Strategy, Deputy Head of Research

The global economy has continued to accelerate overall and the signs of renewed investment in capital goods are increasing (in the Eurozone and Asia in particular). The synchronization of the global recovery increases its robustness: global growth looks like it will be promising in the first half of 2018. We are revising upwards once again our growth forecasts for most countries.

In the US, the optimism of small businesses (NFIB) reached its highest level since 1983 in November, probably driven by the expectations of tax cuts. In addition, the statistical models of the regional Fed (New York and Atlanta) indicate an acceleration of growth in Q4, with an expansion rate of over 3% (annualized rate) for the third consecutive quarter. It is within these conditions that the Congress has just voted in favour of tax reform. The two most emblematic measures – the decrease in the corporate income tax rate as of 1 January 2018 from 35% to 21% and the shift of the maximum rate of the income tax from 39.6% to 37% – will boost growth in upcoming quarters. All in all, we have revised our growth forecast from 2.1% to 2.6% n 2018 and expect growth at 2.2% in 2019: a slowdown should not materialize, in our opinion, before the 2H19, as the multiplier effects wear out. The pro-cyclical nature of tax cuts – in an economy already close to full employment – increases the likelihood of inflation picking up later in the cycle. Under these conditions, we now anticipate three rate hikes (instead of two) from the Fed in 2018. And we believe the risk of a boom/bust linked to an acceleration of Fed rate hikes during the year should seriously be taken into account.

> “We estimate that the global output gap will close in 2018 for the first time since the great financial crisis.”

In the Eurozone, the recovery is intensifying in all countries: rising confidence, increased profitability of companies and very accommodative financial conditions constitute a very favourable cocktail for investment; the improvement of the labour market supports household demand and exports are driven by the acceleration of world demand. We have revised our growth forecast from 2.0% to 2.4% (2018) and we believe that the expansion phase in the Eurozone still has room to expand.

In the UK, EU countries have decided to open the second phase of negotiations, that of trade negotiations. This second phase is by far the most complicated: negotiations will be strained, particularly as regards the passporting of financial services. But, the British government is weak (the majority is only thanks to the small Northern Irish party, the DUP) and highly divided. That said, the Europeans have opened the door to a 21-month transition period. This means that even in the absence of an agreement, the UK would maintain unchanged relationships with the EU until the end of 2020. This transition period dramatically decreases the likelihood of a Hard Brexit. We have slightly revised upwards our growth forecast for the UK in 2018 (from 1.2% to 1.5%) to the same (low) level as in 2017.

In Japan, growth in Q3 was revised up 0.3% to 0.6% (2.1% yoy) due to a strong rebound in business investment. World trade supports exports. We have revised up our growth forecast for 2018 from 1.2% to 1.3%.

Lastly, in the **Emerging Markets**, buoyant growth in Q3 and continuing strong surveys led us to increase our growth forecast from 4.9% to 5.0% in 2018. At the end of the day, we now expect a slight acceleration in global growth from 3.8% in 2017 to 3.9% in 2018. In this context, we estimate that the global output gap will close in 2018 for the first time since the great financial crisis. All else being equal, this means that the probability of an “inflationary surprise” is increasing by the end of 2018. Against this backdrop, questions about CB strategies will soon return to the forefront.

MULTI-ASSET

Thin risk asset upside calls for relative value

MATTEO GERMANO, Head of Multi-Asset

A coordinated global cycle and recovery in global investment and corporate profits is in place. Going into 2018 we expect a progressive rebalancing between monetary and fiscal policies with core inflation finally reaccelerating in some regions (US and Eurozone). Within this framework, we expect a smooth transition from an asset reflation regime to a late financial cycle one: still in favour of risky assets, but less benign than the current one for several asset classes. Valuations for most of asset classes look stretched, fixed income in particular, while equities have already discounted most of the expected profits growth. As a consequence, the expected upside in equities will likely be more limited than in 2017, in line with the mature phase of the bull market. Hence relative value rather than directional strategies will be crucial to add value to multiasset investments in the year to come.

High conviction ideas

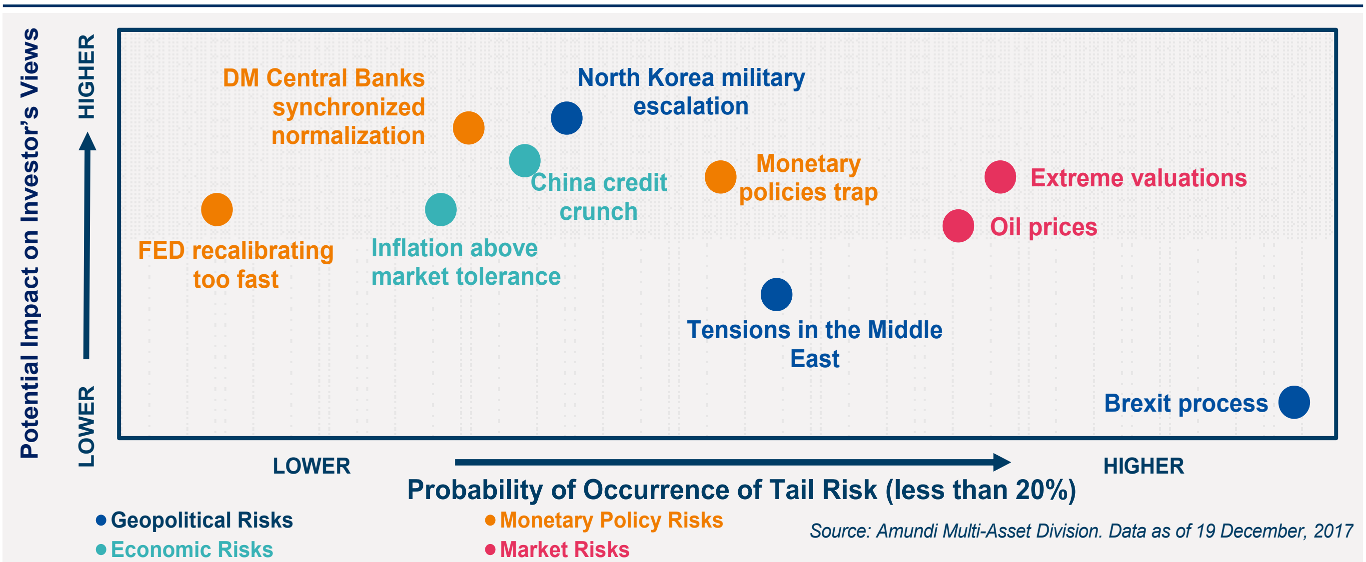
The current late cycle phase leaves some room for upside in DM equities. In the US, the re-rating of the market has already happened but further upside could be supported by a tax bill-led reflation boost. In our view, investors should consider option strategies to play this positive view. In this phase, we confirm our positive assessment on selective EM themes (Russia within EM), but we believe that opportunities in South Korea and in the China transition theme have diminished. In fixed income, we continue to prefer DM credit supported by fundamentals, but we are aware of the tightness of the spreads. Valuations are expensive for German rates, so investors, in our view, should remain short duration. We expect real yields to increase in the UK, as the spread vs the other developed countries is at historical high levels. We see value in the breakeven inflation in EU, US and Japan. In the EU, 10Y inflation expectations are still low in historical terms and also when compared to current headline inflation; core inflation is still depressed. In the US, the increase in oil prices plus the materializing tax bill should support the reflation narrative. We see opportunities in the FX markets, in particular in the Norwegian krona vs the euro based on the expected catch-up with the recent oil rally. We also like the New Zealand dollar (NZD) vs the Australian dollar (AUD) on diverging macro news flow between the two countries and the excessive weakness of NZD post elections. We are negative on the sterling vs the euro and vs the USD as it looks vulnerable to the Brexit news flow.

> “Upside for risk assets is expected to be lower than in 2017. Focus on multiple relative value opportunities to try to increase portfolio returns.”

Risks and hedging

Due to the crowded risk map, investors should try to protect portfolios from negative geopolitical events (through gold and the USD) and sudden risk-off spikes that could cause severe sell-offs in both equity and credit (through options-currencies, protection on HY or S&P500).

The risk map for 2018



Source: Amundi Multi-Asset Division. Data as of 19 December, 2017

FIXED INCOME

Flexible and active: keywords for 2018

ERIC BRARD, Head of Fixed Income
MAURO RATTO, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment Management

Overall assessment

In 2018, we could see a transition in fixed income from the current phase, where predominant buyers (CB) are buying regardless of the level of yields and returns, to the future state in which investors will evaluate risk/return before buying, as in "normal" market conditions. This transition will likely not be linear and will require agility in managing fixed income portfolios. While a very gradual normalisation of monetary policies seems to be discounted by the market, any situation of inflation acceleration and CB behind the curve is not discounted, and could bring sharper and more painful adjustments in the market. In 2018, fixed income investors should embrace a flexible and active approach using all the levers to generate value: dynamic duration and credit exposure, inflation-linked bonds and moving, if possible, along the credit continuum.

DM government bonds

Financial markets are still too complacent on CB policies. In the US, the Fed upgraded the economic outlook (GDP revision from 2.1% to 2.5% and unemployment from 4.1% to 3.9%) but did not change the expected rate trajectory. This further confirms our view that the Fed is behind the curve and we expect a faster pace of increase in rate in 2018, especially if the tax reform effects start to kick in. The curve has flattened significantly vs. the summer. If markets continue to re-price Fed funds expectations, long-term yields will rebound from the current levels. We believe investors should maintain a short duration view on US government bond market. In the Eurozone, the risk/reward profile is unattractive in core govies. So duration should remain short. Markets are very complacent on the euro short end part of the curve as the first hike is not priced in until end 2019. A re-pricing might lead to a flattening of the yield curve in 2018. We see opportunities in peripheral bonds. Inflation-linked bonds should also be considered. They could provide protection at a low cost when and if the market reacts nervously to CB movements, as they imply still very low break-even inflation.

DM corporate bonds

An acceleration of economic growth remains supportive for the corporate sector, even though valuations are very tight. In the Eurozone we see value in the subordinated debt, both financials and non-financials, and high yield, but we are aware of idiosyncratic risk. Convertible bonds can be a source of diversification in fixed income. In US IG, the focus should be on financials and energy. Future sell-offs in HY could offer good buying opportunities, given strong underlying fundamentals. To mitigate credit risk, a focus on quality and liquidity will be crucial.

> "The transition towards "normal" fixed income market conditions will not be linear and will require a flexible, dynamic and active approach."

EM bonds

EM spreads are tight and total return/flows expectations are very much a function of US treasuries. A key risk would be a 10Y UST reaching the critical threshold of 3.5%. However, this is not our base scenario. We expect 4-5% returns for EM debt in hard currencies and 7-8% in local currencies in 2018. EM bonds in 2018 will likely be an income story, more than a story of yield compression, for global fixed income.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

US yield curve: too much flattening

Source: Amundi analysis on Bloomberg. Data as of 19 December 2017

EQUITY

Watch for capex recovery and US tax reform

ROMAIN BOSCHER, Co-Head of Equities
DIEGO FRANZIN, Co-Head of Equities
MAURO RATTO, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

Overall assessment

The outlook is still constructive, thanks to good economic momentum which should continue to drive earnings growth. A recovery of capex could be a positive surprise still not fully priced into the market, as should a reacceleration of the reflation story in the US. After the 2017 bull market run, valuations look expensive, though not extremely so, if compared to other late cycles. Investors should still look for good value opportunities in some sectors (energy, financials, US retailers, infrastructure and domestic banks). Through the year, the focus will move progressively from earnings growth to sustainability of earnings. Here, Japan offers a convincing case in point.

Europe

The case for a European renaissance is still alive. As highlighted by the substantial revision of GDP figures for 2018 (from 1.8% to 2.3%) at the ECB's December meeting, the economic outlook appears to be further strengthening. Investors should maintain a balanced approach among different themes in the large cap segment. A strong focus on bottom up selection and idiosyncratic risk will also remain key moving into 2018. Defensive sectors, industrial, energy and IT, could offer interesting opportunities. Regarding small and mid caps, we still have a positive view on cyclical themes.

United States

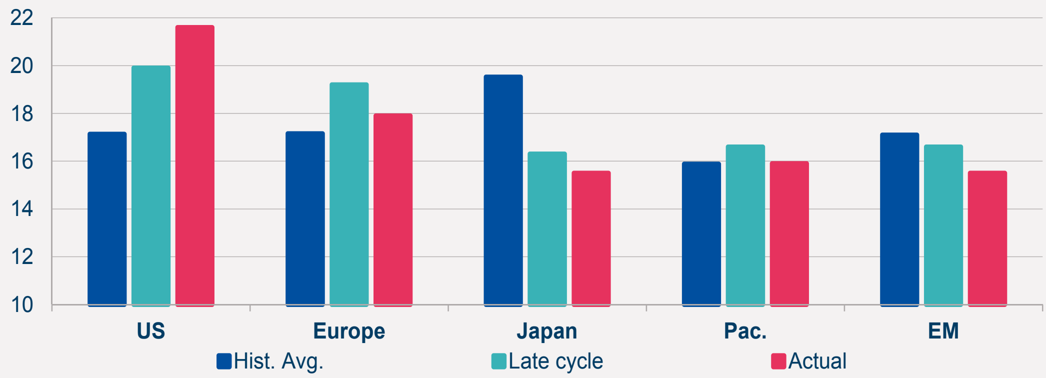
The market ended the year in a final race driven by an agreement on tax reform and expectations of an infrastructure spending boost which could continue to benefit the economy for the next 12-18 months. These are significant events, not fully priced into the market, in our opinion. They will likely bring a rotation towards a cyclical domestic focus and could be particularly positive for financials, consumer discretionary and domestic companies. We like multinationals with large cash repatriations. Looking into 2018, we believe that the concerns about a bubble for US equities are overdone. Compared to past crises (2000, 2007), we don't see excess in terms of flows. M&A will likely revive and support the market now that the tax reform has been legislated. Financial conditions are still benign. We expect that the combined impact of an improving US economy, a stronger global economy and lower taxes will support EPS growth. Due to high valuations, earnings growth is important to support the market. As certain stocks are overvalued, a rigorous bottom-up security selection will be key.

> **"Active selection will be key to find the areas of value left or of superior earnings growth."**

Emerging Markets

Tailwinds for EM equities are apparent. Valuations of EM equities are attractive on a relative basis, given still quite favourable technical positioning (recovery of equity flow but still lagging bond flow), improving productivity which should support earnings growth, improved external accounts supporting growth sustainability, and supply-side policies that should help reduce commodity price volatility. We prefer cyclicals over defensives, and China and Russia are our high conviction ideas entering 2018.

PE: actual vs late cycle reference



The chart compares actual PE (Current Calendar Year) with reference PE investors should expect in a late cycle regime and with historical average (sample: Dec 1987-Nov 2017 for US, Europe, Pac and GEM, sample: May 2002-Nov 2017 for Japan).

Source: MSCI, Factset and Bloomberg. Amundi Research, data as of 19 December 2017.

REAL ASSETS

Real assets still favoured in 2018

PEDRO-ANTONIO ARIAS, Global Head of Real & Alternative Assets

Real assets should continue to be well supported by strong and resilient growth…

We believe the global macroeconomic and financial landscape will remain supportive for real assets in 2018. Growth is around its potential in the United States, Eurozone's renewed strength is spilling over to investments and employment, and EM economies continue to thrive, with Russia and Brazil finally coming out of recession and China showing relatively stable growth outlook. In our view, these cyclical and structural factors will continue to support the demand for real assets in both emerging and developed countries.

…by Central Banks' actions…

Real asset investment should be favoured against traditional assets by a smooth Central Banks' policy normalization and a resurgence of inflation fears. The latter will undoubtedly restore interest in those assets that have proved to be a good hedge against inflation. With this purpose, real estate and infrastructure are among the most appealing inflation-hedged strategies. Infrastructure investing, in particular, has become attractive to investors, thanks to its potential to diversify portfolio risk and provide historically low exposure to default risk (backed by governments).

> "We believe the macroeconomic and financial conditions still appear favourable to real assets in 2018."

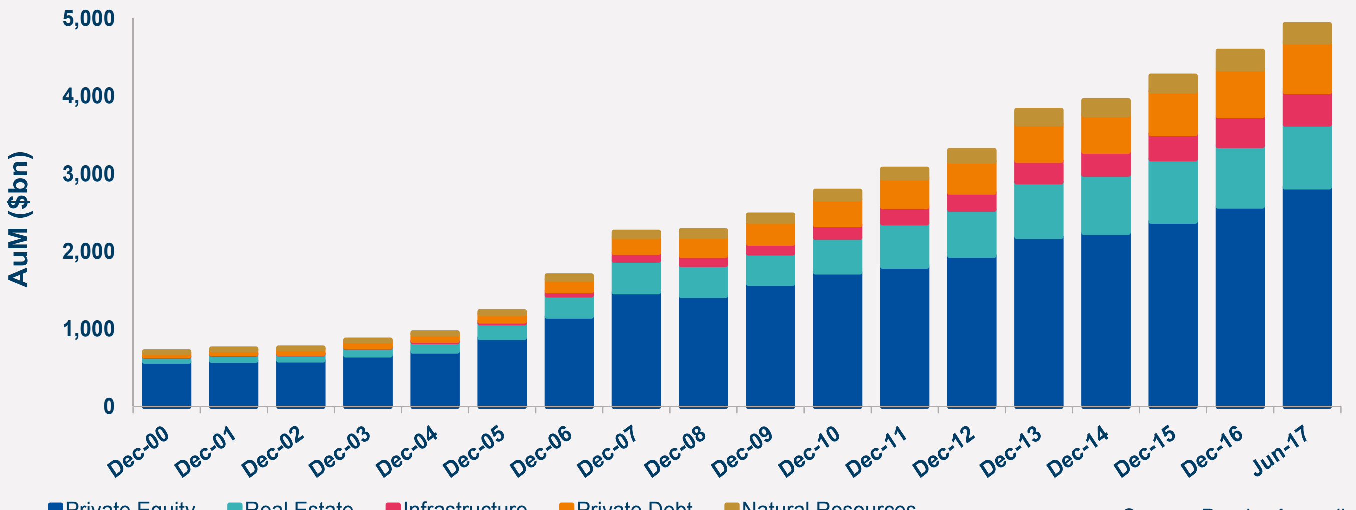
…by a low interest rate environment…

The moderate growth of bond yields and the structurally high demand for income make real assets attractive to investors looking for diversification benefits without sacrificing potential steady returns. As such, private debt can be considered an interesting potential substitute for traditional fixed income as it has a pattern of stable and predictable cash flows, and principal preservation. The private debt asset class captures illiquidity premiums and increases diversification, thus reducing concentration risk to credit portfolios with access to both corporate and real assets not available on traditional debt capital markets. Beyond markets, restrictive regulation, such as the introduction of Basel III, has indirectly favoured private debt within the credit continuum to cover assets resulting from banking disintermediation.

…by the economic cycle.

The economic cycle is moving to a late phase and the bull market is in its maturity phase. As a consequence, valuations of most asset classes look stretched with both equity and bond markets already fairly valued at best. Private equity investing offers the potential of higher returns thanks to an attractive illiquidity premium (up to 400bps versus local comparable listed equity markets). However, investors should keep in mind that value creation in this asset class requires a longer timeframe, and private equity should not be used under a 10Y investment horizon.

Private capital assets under management by asset class, 2000-2017



Source: Preqin, Amundi. Data as of December 19, 2017

Asset allocation: multi-class outlook

	1 month change	---	--	-	0	+	++	+++
Equities vs govies	↘					■		
Equities vs credit	→					■		
Credit vs govies	→					■		
Duration	→			■				
Oil	→					■		
Gold	→					■		
Euro cash	→				■			
USD cash	→					■		

The table above represents cross asset assessment of 3 to 6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++).

Relative outlook and convictions by major asset class

	3-6 month research view	Asset Class	1 month change	Underweight	Neutral	Overweight
GOVIES	--	US	→	●●		
GOVIES	--	Euro core	→	●		
GOVIES	+	Euro peripherals	→			●
GOVIES	-	UK	→	●		
GOVIES	-	Japan	→	●		
CREDIT	+/=	US IG	→		●	
CREDIT	+/=	Euro IG	→			●
CREDIT	-/=	US HY	→	●		
CREDIT	+/=	Euro HY	→			●
CREDIT	+	GEM debt hard cur.	→			●
CREDIT	+	GEM debt loc. cur.	→			●
EQUITIES	+	US	→		●	
EQUITIES	+	Eurozone	→			●
EQUITIES	=	UK	→		●	
EQUITIES	+	Japan	→			●
EQUITIES	+	Pac. ex Jap.	→			●
EQUITIES	+	Global EM	→			●

Currency and real assets

FOREX	+	EUR vs USD	→
FOREX	=	EUR vs GBP	→
FOREX	=	EUR vs JPY	→
FOREX	=	USD vs JPY	→
REAL ASSETS	+	Real estate	→
REAL ASSETS	++	Global Infrastructure	→
REAL ASSETS	+	Private Debt	→

LEGEND

−	Negative
=	Unchanged
+	Positive
● (red)	Underweight
● (black)	Neutral
● (green)	Overweight

Source: Amundi, as of 19 December 2017. The 3-6 month return outlook refers to research views based on expected returns by asset class. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. **This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.**

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January 2018 **# 01**

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