Confidence must be earned

Amundi ASSET MANAGEMENT

September 2018

Global Investment Views

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10 years from Lehman: Reality check

The collapse of Lehman Brothers 10 years ago marked the beginning of the 2008 financial crisis. The legacy of the crisis reveals to us a series of paradoxes, with consequences for both the economy and financial markets.

1. The missed deleveraging: If the pace of debt accumulation has slowed down, deleveraging in absolute terms has hardly happened at all post crisis. The prospect of higher rates and the exhaustion of the cyclical upswing open up questions about debt sustainability. Assessing areas of vulnerabilities that could translate into idiosyncratic risks will be key to preventing capital impairment. **2. The two sides of liquidity:** Despite the macro excess of liquidity in the balance sheets of Central Banks (CB), we are facing a micro deterioration of market liquidity due to post-crisis regulations. The challenge for asset managers is to implement strategies to deal with this liquidity paradox**. 3. A medicine with uncertain collateral effects:** The response to the crisis was a massive (cyclical) stimulation of growth, mainly through monetary policy, then followed by the fiscal arm – even in the Eurozone. But the nature of the crisis and its genesis in the credit cycle significantly prolonged the healing process. New imbalances emerged in the form of asset price inflation. Unless some form of productivity shock materialises, in the long term markets will tend to readjust to their fundamentals (for example, equity markets to return to earnings growth) and lower returns. **4. Inequalities and instability have increased, not decreased:** With the recovery involving the financial sphere rather than the real world (asset inflation replacing goods and wage inflation), and the widening of inequalities, the support for populist parties rose in many countries. In addition, the increased importance of China as a global political and economic player has added further complexity to the whole picture. Protectionism is another consequence of the more inward-looking political attitude. The globalisation theme has not run its course, but investors must assess powerful shifts in the structure of global growth towards more “domestic” engines via active global approaches. **With a short-term perspective**, the economic slowdown we see ahead is likely to reveal sets of risks well beyond the classic ones (stronger growth leading to higher inflation and higher rates), such as cracks in the most imbalanced situations, political risk (tariffs/uncertainties regarding US policy action) on the macro side, and liquidity and positioning on the market side. Risk-off sentiment may emerge, triggered by idiosyncratic situations (Turkey and Italy as the most recent examples) reviving the appeal of the “Western core”. Core assets and core rates should receive some support; in equity we should expect to see a rotation of styles versus quality and value. Peripheral bonds and emerging markets could suffer in the short term, however, as the threat of much higher rates and a much stronger dollar are largely behind us, this general repricing should be seen as an entry point (excluding idiosyncratic situations) for long-term investors.

High conviction ideas

- **Multi-asset:** We are neutral on risk assets due to rising uncertainties. In equity, we maintain a preference for the US, with limited exposure to Europe (basic materials), the UK, and Japan. We are cautious on EM. In fixed income and FX, we still play CB divergences with limited duration and inflation-linkers. We are very cautious on credit. Hedges are still in place in case of a deterioration of the current scenario.
- **Fixed income:** We don’t think CBs will change their plans due to idiosyncratic stories, even if spillovers are visible (flows into core bonds and a sell-off of fixed income risk assets), we remain cautious on duration (shorter in Europe than the US), and we have raised our credit quality/liquidity focus. The USD should remain strong in the short term, but most of the appreciation is behind us. Through the year end, this could give some relief to EM assets, currently under pressure.
- **Equities:** We favour strategies to deal with a maturing phase of the market and we focus on quality, less leveraged companies, a reduction in stock/sector concentration risks and a balanced approach between cyclical and defensive sectors. It is not time yet to become outright defensive, in our view, as the earnings outlook is still constructive. However, volatility should trend higher due to trade noise, the approaching US mid-term elections, idiosyncratic stories and tighter financial conditions. We still favour the US market given its superior earnings growth.
- **Real assets:** With lower returns expected ahead for most traditional asset classes, investors should continue to search for sound risk/return potential as well as diversification benefits. In this respect, private debt solutions, especially those focused on the most senior and secure parts of capital structures, could represent attractive ways to complement traditional fixed income exposure.

CB= Central Banks. FI= Fixed Income.

MACRO & STATEGY

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> ***Volatility on BTPs will remain elevated until September, when there will be more clarity on budget law.***

Global growth: still decent but multiple risks ahead

The year began with a synchronised global recovery as most economies benefited from a buoyant environment. The risk of inflation and CB mistakes dominated investors' fears. Since the spring, clouds have accumulated globally. The second half began under less happy auspices than the first, with a less buoyant economic climate and many risk hotspots. On the one hand, growth in the Eurozone was weaker than expected in H1 (after a strong second half of 2017). On the other hand, large EM have seen their macrofinancial situation deteriorate with the USD appreciation, which puts countries where private sector debt is denominated in USD into strong difficulty. For example, Argentina and Turkey are in crisis today. These are idiosyncratic shocks that in theory, should not spread. However, many EM were distrusted by investors during the summer. In addition, Donald Trump's protectionist threats have multiplied. The proximity of the mid-term elections (6 November) is encouraging him to implement his promises of the presidential campaign on trade. Europe has been relatively spared for the moment, but in view of Donald Trump's recent statements, one cannot rule out taxation on auto imports. That said, for now, China remains the subject of the most aggressive protectionist measures.

Added to the threats of a trade war are risks of very different nature:

• US sanctions on Iran, which tend to drive up oil price.

• The fiscal slippage in Italy. Relations are tense in the coalition government on what strategy to follow and the size of the budget deficit (see box below).

• Brexit negotiations are stalling and governments (in the UK and in the rest of the EU) are openly preparing contingency plans in case of no agreement by 31 March 2019 (hard Brexit).

• The Turkish financial crisis may get even worse (we anticipate a recession in the coming quarters).

The multiplication of risks increases global uncertainty. If we continue to anticipate further global expansion, it is at a slightly slower pace in the Eurozone, China and, on average, in EM. The US economy, for its part, remains supported by fiscal policy, the effect of which is expected to weaken in 2019. The risks to growth are clearly on the downside over the next 18 months. As for the upside risk to inflation, without having disappeared, it has weakened (except of course in countries where the currency has fallen). Inflation is a lagging indicator of activity; an inflationary surprise would be short-lived if, as we believe, the world economy slows down.

Political uncertainty weighs on Italian BTPs, as the "moment of truth" on budget law approaches. Italian BTP spreads trended higher in August, reaching levels close to recent highs recorded in May in the 10Y maturity, while **short-term maturities proved more resilient**. **The Moody's announcement to postpone any decision until the end of October**, in order to wait for the fiscal budget to be released in September, gave some relief to BTPs and put more pressure on the government to be more cautious on the fiscal side. Recent data in demand trends saw foreign investors sharply reducing their exposure in May and June, although July saw a slight recovery and a return to lower levels of liabilities. Italian banks increased their holdings of BTPs, offsetting most of the effect of non-residents selling. Net supply pressure in the remainder of 2018 is likely to decline compared with what took place in H1 and should turn slightly negative in H2; the pace of gross issuance is likely to almost halve with respect to the first five months. Mid-month auctions in August have already been cancelled and the same is also likely to occur in December. **Despite lower purchase volumes from the ECB in the coming months, negative net issuance should reduce the pressure on BTPs**. Depending on the outcome of the budget proposals and the targeted deficit on GDP for 2019, a sort of "spread consensus" has been built for BTPs' spreads: a 0.8% deficit/GDP ratio would match an average spread level of 150 bp, a 1.8% would be consistent with a level of spread slightly higher than 200 bp, while 3% would mean a 300 bp spread. A strong confrontation with the EU with a very aggressive deficit projection higher than 6% would lead, according to consensus estimates, to spread levels between 450-500 bp. At the moment, BTPs are implying a deficit closer to the 3% threshold rather than the 1.8% level, which, according to the very latest "leaks" and reassuring statements released by both the PM and the Finance Minister, looks more likely. There seems to be some value in current levels in the case of a responsible budget in the 1.8% area. **Volatility in BTPs is likely to remain until September**, amplified by lower liquidity and political uncertainties. On a positive note, the net non-performing loans of Italian banks saw a strong drop in June to levels not seen since 2010: the noise on the political side doesn't seem to be affecting Italian banks' progress on this path.

BTP= Buoni Poliennali del Tesoro, Italian government bonds.

MULTI-ASSET

Cautious and selective

Asset class returns have been mixed this year to date: the persistently robust growth in the US has allowed the equity bull market to continue, posting a 20% EPS growth. Performance has been poor for EMs, as investor sentiment deteriorated on the back of a stronger dollar and higher US rates. Countries more dependent on external financing saw the value of their currencies fall. China suffered the tariff threat from the US administration; particularly weak was the IT/technology sector in Asia. Our central scenario is still for a continuation of this phase leading to a late cycle, global solid growth but we see it decelerating as inflation trends mildly higher, with risks tilted on the downside. We expect CBs to stick to their path of very gradually normalising monetary policy in this relatively favourable macroeconomic outlook. Global trade tensions are set to continue and idiosyncratic issues (such as the crisis in Turkey) will emerge more frequently as the liquidity in the system deteriorates and financial conditions get slightly tighter. We continue to prefer relative value stories and themes rather than directional exposures and we continue to focus on solid fundamentals to better navigate uncertain waters.

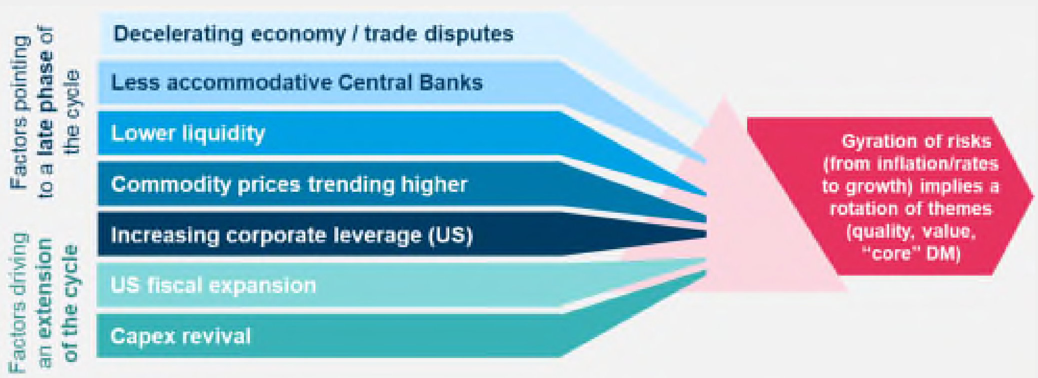
High conviction ideas

From a cross-asset market perspective, we stay close to neutrality on global equities, consistent with the idea of being in a mature financial cycle. It is difficult to see a major correction in equity markets when growth is strong and earnings are good (we anticipate that the US Q2 & Q3 earnings seasons will be good), though positioning is beginning to be a worry, with holdings of US equities close to all-time highs. Investors should play themes that we like to call "the last race for risk assets", focusing on equity markets with stronger earnings growth, with a preference for US and UK equities versus European names. We favour a rotation to value in Europe, with a preference for value stocks versus the EMU index. In fixed income, we look for value in the theme centred on CBs' asynchronies. We have a defensive approach on the German short end of the curve and UK real rates; we have a neutral view on US duration; and we are cautiously positive on corporate IG and inflation-linked bonds (10Y US, EUR, JPY and US 2/10 inflation steepener). We have systematically trimmed our preference for credit. While we keep a neutral view on EM (both equity and bond), identifying "EM winners versus leftovers" remains one of our main themes. We search for the most valuable relative value opportunities, focusing on countries with stronger fundamentals and less external vulnerabilities. We prefer China to the global EM from a positive medium-term perspective. Overall, we consider EM valuations attractive but we prefer to look for entry points after the US mid-term elections, when we expect some easing of trade tensions and when most of the electoral events in EM should be over.

Risks and hedging

Hedging remains an important element to consider in this phase of high geopolitical uncertainty and a maturing financial cycle. We keep gold as a hedge. The JPY (versus USD and AUD) could also contribute to protecting investors' portfolios from trade tensions. It is also worth including hedges to specific risks, such as on the credit market (HY), which could be negatively affected in case of liquidity stress, or to a material deterioration of the scenario (protecting from an S&P500 correction).

Moving to a late phase of the cycle



Source: Amundi, Bloomberg. Data as of 27 August 2018.

Matteo GERMANO
Head of Multi-Asset

> ***We continue to prefer relative value themes and to focus on solid fundamentals to better navigate uncertain waters.***

FIXED INCOME

Eric BRARD
Head of Fixed Income

Yerlan SYZDYKOV
Head of Emerging Markets

Kenneth J. TAUBES
CIO of US Investment Management

> ***Idiosyncratic stories support core bonds.***

Core appeal, but not time to be overly defensive

Overall assessment

The appeal for core bonds continues due to both the geopolitical tensions and erupting idiosyncratic stories in EM. The Turkish crisis is the latest in signalling that conditions have become tougher for EM debt. Selectivity is increasingly the name of the game to limit the effects of country-specific vulnerabilities and imbalances. As the tide that lifts all boats, notably ultra-accommodative monetary policy, is approaching an end and financial conditions become tighter, investors should continue to explore opportunities in credit, but with a more cautious attitude in the areas of the market that benefit most from the buyers of last resort (CBs), notably low quality/low liquidity bonds. We are still cautious on duration, but, especially in the US, investors should consider reducing their shorts as we move closer to a neutral rate.

DM government bonds

The 10Y German bond yield remains anchored to year-to-date lows, benefiting from the flight to quality effect as a response to the Turkish crisis (with a potential impact on European banks) and tensions on Italian govies. The next weeks will be critical for the Italian budget law and noise will remain high. The Italy-Spain spread being close to historical peaks means markets are confident about the ECB's toolkit to reduce contagion risk. We don't believe that these frictions will impact on the ECB's announced plans. Eurozone CPI is close to the CB's target and economic conditions remain sound, despite some challenges. Hence, in the tug of war of idiosyncratic stories and sound economic conditions, we expect core rates to remain in the current trading range.

DM corporate bonds

We have taken a more conservative and selective approach on credit in recent months, even if we do not think it is yet time to be too defensive. Investors have started to price in a peak of global economic activity, less supportive technical conditions and diverging fundamentals between the US and Europe. EU companies continue to be very cautious, with low leverage and high cash ratios. US companies remain confident in the economic cycle, increasing leverage and decreasing their cash ratios.

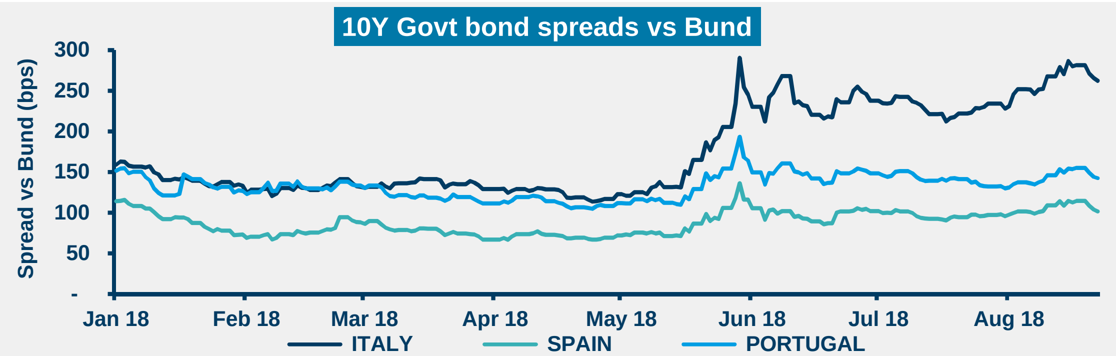
We prefer short-term maturities/floating rates and higher quality bonds. Opportunities are rising in subordinated bonds in Europe, but again a focus on selectivity is paramount.

EM bonds

We remain prudent at the moment, as some political noise is expected ahead of Brazilian elections in October. Our preference is for hard currency bonds over local currencies due to valuations, the risk-off environment and EM FX fragilities versus the USD. Our favourite picks are Mexico (agreement with US on trade and attractive risk/return profile in local currencies (LC) sovereign debt), Serbia (good fundamentals and appealing risk/reward) and Argentina (after the IMF support). We are cautious on Turkey (LC) .We don't expect US sanctions on Russian sovereign debt, but volatility will remain high. Through the year-end, when we expect easing trade tensions and a stabilisation of the USD, EM bonds will be back in focus, with attractive yield premiums for long-term investors.

FX

The USD should remain well supported in the short term versus main currencies thanks to the US economy's strength and CB divergences. However, US elections in November could weigh on the greenback, giving some relief to EM FX.



Source: Amundi, Bloomberg. Data as of 27 August 2018.

[4] Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

Strong earnings season

Overall assessment

Divergences have increased as a consequence of idiosyncratic stories (the Turkish crisis weighed on the EU market, but also EM were strongly hit by the risk-off mood), while the US market is re-approaching historical highs. Earnings are up, also owing to strong growth. Divergences should remain in place in the coming months, softening next year when some of the one-off US EPS growth will be over. For Q3 and Q4, the earnings outlook is constructive for global equities in the context of sound growth, modest rises in interest rates and barring an escalation of the trade dispute into a trade war. The US continues to be our favourite market due to the strong EPS growth premium and improving relative valuations (thanks to EPS growth). As the cycle matures, (higher oil prices and input costs), stock picking will remain crucial, with a preference for quality, less leveraged, companies.

Europe

The outlook remains moderately positive, but with some vulnerabilities. The Turkish crisis could impact EU banks, which have around 150 billion of USD in Turkey. Even if this is not a problem for their balance sheets, from a P&L perspective a jump in provisioning could dent their results and affect MSCI Europe EPS growth. The recent weakness of the EUR/USD is supportive, but this tailwind should prove temporary (until Q1 2019). In trade weighted terms, the depreciation versus the USD was balanced by an appreciation versus EM currencies.

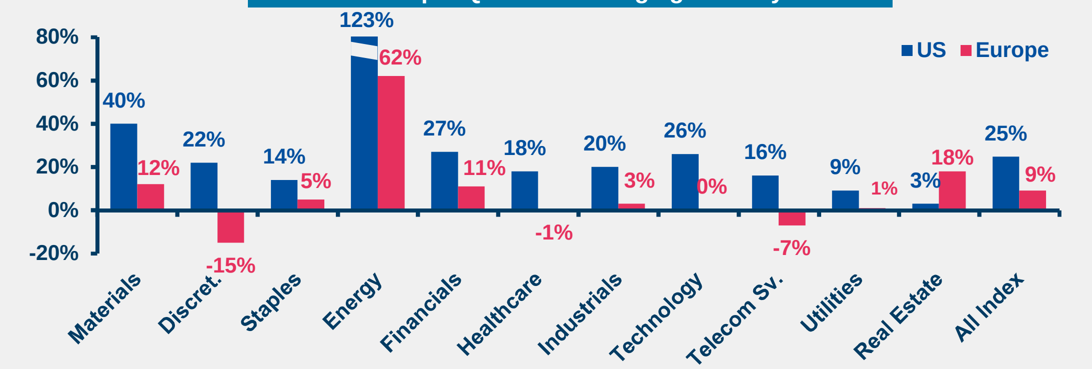
United States

The US market is enjoying one of the longest bull markets in history, but this is not enough to call for an imminent turning point. The economy is growing nicely, small business optimism is solidly close to an all-time high and capex plans are solid. The earnings boom incorporates the tax reforms effect, which added about 8% to this year's EPS growth. The outlook for earnings is still positive for 2018 and 2019. However, we believe that a "quality check" to the portfolios is warranted at this stage, as well as the implementation of more defensive strategies (such as reduced stock/sector concentration or increased focus on valuations and lower volatility). This year most of the S&P's performance is explained by a few sectors (IT, consumer discretionary and energy) and the breadth of the market is decreasing. Areas we view as needing attention are the IT sector, which is exposed to possible retaliation measures just when the growth/value ratio is stretched globally, the strong USD appreciation, which could hurt more global exporters, and the near flat yield curve. Approaching the US mid-term elections, we expect some political noise, but an overall positive backdrop.

Emerging markets

The recent sell-off improved valuations and, if there is no more negative news on the growth side, EM equity could rebound a bit from its depressed levels. In the last quarter, we revised downwards EM EPS forecasts to a range of 5-9% (versus the previous 6-11%) for FY2018 and we are more conservative than the consensus. We remain prudent on the asset class, with some challenges ahead. World trade growth is set to decelerate for 2018 as well as EM exports, idiosyncratic political uncertainty is high (Brazil/South Africa/Turkey) and there is uncertainty on US policies. On the positive side, we see the commodity outlook as favourable. As investment ideas, we like Greece and oil-related themes. We are also positive on China as most of the concerns on economic slowdown or on trade tensions seem to be priced in, valuations are very compelling, and we see policy reaction supporting the economy.

US and Europe: Q2 2018 earnings growth by sector



Source: Amundi, Thomson Reuters Eikon. Data as of 27 August 2018. US = S&P500. Europe = Stoxx 600.

EQUITY

"US earnings supremacy continues."

Yerlan SYZDYKOV
Head of Emerging Markets

Kenneth J. TAUBES
CIO of US Investment Management

Amundi ASSET MANAGEMENT

REAL ASSETS

Pedro-Antonio ARIAS
Global Head of Real & Alternative Assets

The European private debt market is set to offer compelling opportunities over the coming year, but deep expertise is needed to exploit them.

Private debt: diversified strategies to invest in Europe

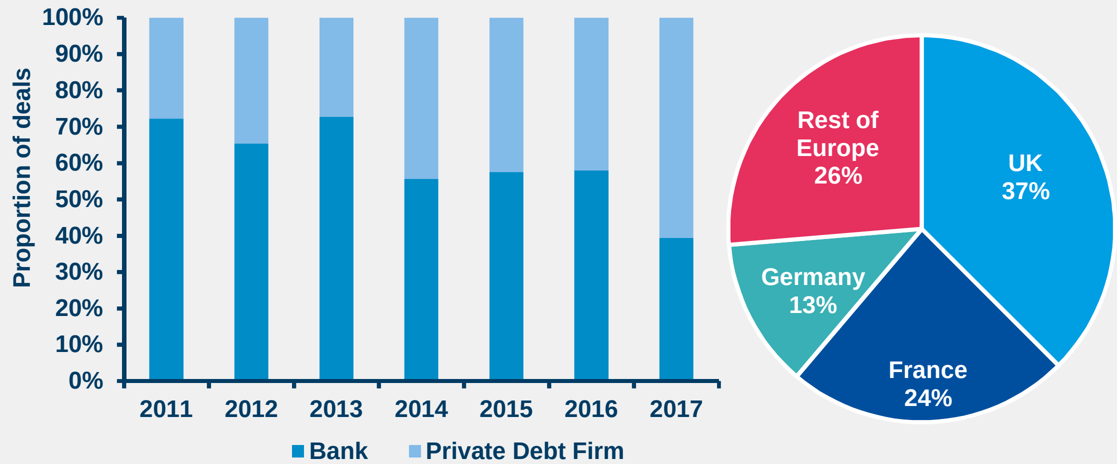
A fast-growing market in Europe

The European private debt market has expanded significantly over the last 10 years. According to Preqin's Private Debt Quarterly Update (Q2 2018), while the largest proportion of private debt fund activity has occurred in North America over the past year, the European market has seen the largest gross growth rate (Q2 2018 aggregate capital target increased by 52% versus Q2 2017). This trend is being fuelled, in particular, by the increased adoption of non-bank lending. Disintermediation is clearly intensifying in Europe, with the proportion of private debt-backed deals in the region gaining traction steadily over time. Across Europe, after the UK, France and Germany were the second and third most disintermediated markets in terms of deals in 2017. Nonetheless, many investors are looking to the European private debt market with increasing attention and interest given the sound risk-return potential, as well as the diversification benefits it may offer their portfolios. Overall, European issuers want to diversify their funding sources and arrangements, while investors are looking for increased yields and diversification. We expect this to be a long-term trend and thus expect the European private debt market to see strong growth and offer compelling opportunities over the coming years.

Watch out for opportunities

We firmly believe that this asset class can no longer be ignored in strategic diversified allocations.
The European market offers numerous investment opportunities, due to a diversified economic landscape.
However, a broader opportunity set requires fund managers to remain extremely disciplined and rigorous with regard to selection in order to find the appropriate risk-adjusted return transactions. Moreover, the pronounced diversity among European countries (each member state currently still has its own banking regulation and system, fiscal law and insolvency proceedings) makes the combination of strong local roots and intimate knowledge of European countries and of their local players a must-have factor for success. The overall investment situation is made even trickier by the current market players operate in, marked by a combination of unconventional monetary policies, the end of quantitative easing, and expected rising interest rates. In this changing and challenging environment, very deep expertise is needed for building diversified investment strategies that can help address investors' needs and concerns.
We are convinced that investing in the most secure and senior part of capital structures can provide downside protection against a possible turnaround in the credit cycle, while offering attractive long-term returns. In addition, we favour floating rate assets as they can help to protect portfolios from rising interest rates and offer a relatively attractive yield. Finally, we think that portfolios need to be modelled with an optimal allocation to liquid and illiquid assets, and a strong complementarity with traditional fixed income.

Private debt-backed deals in Europe



Source: Preqin, June 2018.

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Amundi high conviction positions

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 on a 3-6 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 (+/++/+++). This assessment is subject to change.

	3-6 month research view	Relative outlook and convictions by major asset class				
		Asset class	1 month change on view	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 curr	→		●	
CREDIT	=	GEM debt loc curr	→		●	
EQUITIES	+	US	↗			●
EQUITIES	=/+	Eurozone	→		●	
EQUITIES	=/+	UK	→			●
EQUITIES	=	Japan	→		●	
EQUITIES	=	Pac ex Japan	→		●	
EQUITIES	=/+	Global EM	→		●	
EQUITIES	+	Convertibles	→			●

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
● (grey)	Neutral
● (teal)	Overweight

Source: Amundi, as of 29 August 2018. 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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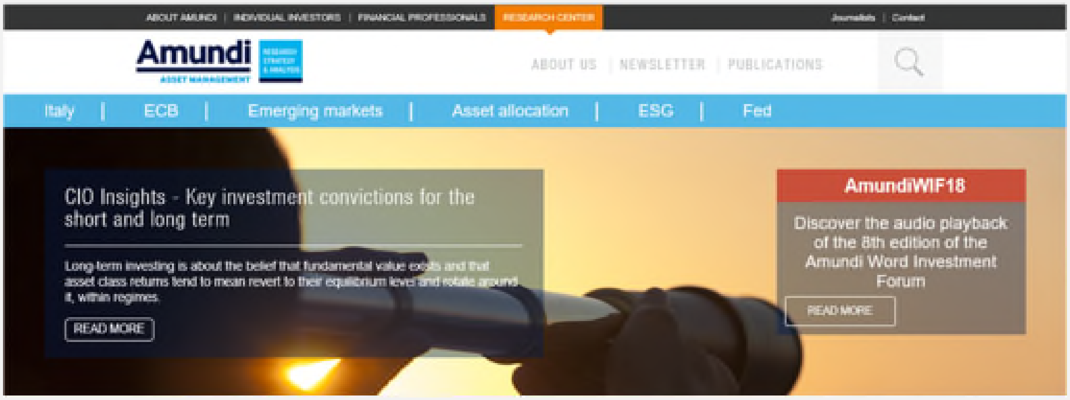
AMUNDI Investment Insights Unit

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs.
In a world in which investors are exposed to information from multiple sources, we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.



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