Asset allocation: Amundi investment strategies

Concerns over world growth – and China – and geopolitical tensions combined to create a difficult start to the year for the financial markets

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The new year began with a sharp drop in the equity markets, a depreciation of the yuan and another closure of the Chinese market, a repeat of last August. The same fears have reared their heads: a collapse in US and global growth, a crash landing of the Chinese economy, inappropriate monetary tightening by the Fed, a complex geopolitical situation: and what will become of relations between Iran and Saudi Arabia? How can the terrorist threats be managed? What about the future of relations between the United Kingdom and the European Union in the event of a Brexit? The list goes on!

As the new year begins, it is worthwhile recalling current major trends. 2015 was a year marked by economic downturns and the further decoupling of the emerging countries from the advanced countries and of the United States from the eurozone (in the area of monetary policy). 2015 was also a year of greater volatility, sharp exchange rate fluctuations, a further collapse of commodity prices… and an uptrend in credit spreads. Admittedly, rates have remained low and so have the spreads of the peripheral countries of the eurozone, but the situation for corporate bonds, hurt by widening spreads and less liquidity, is more complicated.

Overall, all the major identified risk factors materialised in 2015 to varying degrees, which undoubtedly made it a pivotal year: a European crisis, an emerging markets crisis, concerns about world growth, concerns about a hard landing for China, the return of volatility, specific risks (Russia, Brazil, etc.), a further drop in commodity prices, sharp exchange rate realignments and fears of a currency war, geopolitical risks, etc. In short, it created divergence, overlooked asset classes… and opportunities.

World growth deceleration remains a cause of concern. Admittedly the global GDP growth rate remained above 3% throughout 2015 for the fifth year running but, once again, it is showing genuine signs of faltering in many regions. This is what is happening to China: this development is certainly nothing new, and, in many aspects, it was inevitable: it is primarily linked to a changing economic model and to the country's demographic characteristics. The question of the **yuan** (which will be included in the currency basket used for the IMF's Special Drawing Rights as of October 2016) became a focus of concern during the summer. The yuan's sharp appreciation since the 2008 financial crisis on the back of the dollar's rise and the slide of many emerging market currencies has become burdensome for China. The economic downturn has also been very sharp for all emerging countries. Over-dependence on world trade and commodities (prices of which have been falling for several years) is not often – or sufficiently – offset by the strength of domestic demand, and some large countries (such as Russia or Brazil) are in a sometimes severe recession. Only the commodity consuming countries remain at an advantage, but they were unable to avoid the financial turmoil that has stricken all emerging countries.

Furthermore, the economic downturn is apparent in the United States: the business cycle there is ahead of that in Europe… and the Fed is preparing to initiate a mini-cycle of monetary tightening, which has a tendency to affect economic growth forecasts. Note that in early January the FOMC

The essential

The new year began with a sharp drop in the equity markets and another closure of the Chinese market, a repeat of last August. The same fears reared their heads. We note that major identified risk factors materialised in 2015, which undoubtedly made it a pivotal year (and therefore the reason for our caution for 2016): a European crisis, an emerging markets crisis, concerns about world growth, concerns about a hard landing for China, the return of volatility, specific risks (Russia, Brazil, etc.), a further drop in commodity prices, sharp exchange rate realignments and fears of a currency war, geopolitical risks, etc. In short, an overview of something resembling a worst-case scenario. Indeed, all of these factors created divergence, overlooked asset classes and… opportunities in one fell swoop.

But it also provided a stark reminder – just in case one was needed – of just how fragile the situation remains. While it is true that yields are low – as are the spreads of the peripheral countries of the eurozone – the situation has become more complicated on the credit market, where corporate bonds have been hurt by widening spreads and reduced liquidity. Along with caution, divergence and decoupling continue to be the watchwords for 2016.

> "2015: without a doubt a pivotal year"

> "World growth deceleration remains a cause of concern"

will have some new voting members, and the most hawkish of whom, such as Loretta Mester (Cleveland Fed), believe that the Fed will make a series of four rate hikes in 2016. That is more than the market consensus, which still does not believe in the Fed's dot plots. Janet Yellen will undoubtedly be compelled to settle more internal rifts in 2016 than in 2014 or 2015 especially when the risk of recession begins to loom larger. At best, growth should converge toward its potential, which has been lower these last few years due to weaker productivity gains by the US economy.

> "United States: the economic downturn is readily apparent"

Another particularity of 2015 was the **downturn in world trade**. This downturn is mainly linked to the emerging countries. By all indications, globalisation is losing ground – a relatively new development. Domestic growth drivers will again be decisive, which also means that country risk will be a crucial factor once more.

> "The downturn in world trade, a factor which is representative of the ongoing economic downturn"

The case of the eurozone is somewhat particular: after several difficult years, the area is taking advantage of the low interest rate environment (both short and long rates), the ongoing financial defragmenting process, more accommodative economic and fiscal policies, a lower euro and, for some countries, a more firm recovery of domestic growth drivers. Growth is admittedly not spectacular but it is close to its potential and its breakdown is finally more encouraging. Note that the 2015 Greek crisis had a positive outcome, but it was slow and tortuous at the political level. This explains why the performance of European equities was so much better than that of the United States.

> "The United States vs. the eurozone: the eurozone came out with the advantage in 2015"

In 2015, **political and geopolitical risks** also returned to the fore. Risky elections (Greece, Portugal and, in particular, Spain), complex political situations (Brazil and Turkey), and terrorist attacks (notably in France) have once again laid bare the fragility of the current environment, the effects of which have still not been fully grasped. Tensions between Iran and Saudi Arabia resurfaced in late 2015-early 2016. We have long known about the political, diplomatic and religious tensions between these two countries, but the crisis has turned a new corner.

> "Geopolitical risks have returned to the forefront"

In early January the **price of oil** rose as a result of tensions between Iran and Saudi Arabia, but make no mistake: the factors driving the increase are few for now, to the point that Saudi Arabia has taken the direction of economic austerity: there are now plans to diversify sources of revenue and to cut spending... in short, to accelerate the change in economic model already initiated. This has been happening for quite some time, actually, but with fairly mixed results. This time the country no longer has a choice: the fiscal deficit ratio should be along the lines of €90 billion, i.e. approximately 15% of GDP. A 70% increase in the price of water and electricity and an 80% increase in petroleum products is underway. The IMF fears that the country will exhaust its foreign exchange reserves in five years' time. It is therefore matter of some urgency. Note that Saudi Arabia is caught in a dilemma: can it, in the current context of budget deficits, decide to cut its production (and accept the consequent decline in tax receipts) in the hopes of driving up the price of oil, knowing that inventories of crude are at record levels and that the lifting of sanctions will give Iran the opportunity of returning to this market? It is very unlikely in the short term, which justifies keeping crude prices low, at least for the next few months.

> "The price of oil is under downward pressure"

Overall, from a purely economic standpoint, last year was a theatre of the **fast-accelerating decoupling of the emerging countries** (where much uncertainty prevails, with, at the same time, an advantage for commodity-consuming countries) **from the advanced countries** (which offer greater visibility), which has not left inbound FDI and the performance of the corresponding financial assets unscathed.

> "Decoupling and divergence... the two watchwords of 2015"

Against this backdrop, **monetary policies are broadly accommodative**, which is keeping the interest rate environment low: non-standard monetary policy is running full steam in China, Japan and the eurozone and a number of emerging countries have started cutting interest rates – or soon plan to do so. The Fed is one of the rare central banks to initiate a cycle of monetary tightening. The bank was prevented all year long by macro-financial instability and by the – deemed exaggerated – appreciation of the dollar. Overall, the US central bank, which wanted to raise its key rates to relay a positive message on growth and to regain some scope of action, was forced to wait until December before implementing what it had announced: it raised the Fed funds rate 25 bp at the end of the year while at the same time urging caution. Meanwhile, by its actions on interest rates (both directly and indirectly), the ECB has undoubtedly recreated the right conditions to give corporations better access to borrowing; however, it has also contributed to the liquidity drought on the bond markets. IIt will continue its asset purchase programme at least until the end of March 2017.

> "The Fed vs. the rest of the world... or almost"

To put it simply, because of the actions of the central banks and particularly those of the ECB, the eurozone is evolving in an extremely low interest rate environment and, by late November, a record nearly 25% of area's credit universe was delivering negative returns. Be aware, however: 2015 was not a good year for credit. It was not sudden (except for a few emerging countries, which had been hurt by falling commodity prices and their depreciating currencies), but credit spreads finished the year on an uptrend: + 14bp for the iTraxx Main, + 9bp (rising to 77bp) for the iTraxx Senior Financials and + 5pb for the iTraxx Subordinated Financials (rising to 155bp). High yield credit navigated these waters pretty well (the spread narrowed by 30bp (315bp))

> "2015: the beginnings of a credit bear market?"

So what should be done in this environment?

There are five key takeaways:

- **All these sharp economic downturns have consequences for inflation expectations and monetary policy.** It is difficult to bet on a recovery of inflation and substantial interest for "inflation hedges" which have been largely overlooked until now. It is also difficult to bet on restrictive monetary cycles
- **Decoupling and divergence creates opportunities in terms of relative pricing and relative attractiveness.** The effect of decoupling is the higher dollar and wider interest rate spreads (short and long) between the United States and Europe. The effect of divergence is the return of risk to the forefront – country risk and specific risk (the energy sector in the US high yield segment (compared to its European counterpart) was one of the most striking examples in 2015).
- **Periods of stress create overlooked regions and asset classes.** Overlooked – or undervalued – today are emerging country assets and inflation-linked assets, the former being more attractive in the short term than the latter due to the total absence of inflation.
- **Caution is dominating our overall strategy.** The downward revisions to growth forecasts are not over, and the current geopolitical situation is probably more delicate than it has been in recent years. In contrast to the European crises, which have been extremely localised, we are now talking about global, more systemic risks.
- **The drop in liquidity on the fixed income market continues to be of concern.** We have been insisting on this for more than a year now. Low liquidity, which is being exacerbated by the central banks' unconventional policies, regulatory restrictions, the alignment of major investors' positions (all of which are long on fixed income and spreads) and the relative decline in the number of providers of liquidity is adding to the risk on the bond market, against a backdrop where volatility has already increased.

> "No change in our general direction, but increased caution given the backdrop"

In the fixed income market:

- We are maintaining our long positions on govies as the carry trade effect should continue to offset the exchange rate effect The corporate bonds markets offer strong divergences / opportunities between zones, countries, segments, sectors and issuers. The upsurge in volatility is likely to create the conditions for a rebound in rates for a limited amount of time but the interest rates and bond yields increases should not last, taking into account the current and future monetary policies and the present deflationary pressures. We have started building long positions on emerging market debt (firstly debt in hard currency), and we will stick to this strategy.

In the equity markets:

- We do not plan to change our general direction: i) exposure to domestic demand, ii) highlighting decoupling or at least maturity differences between the United States, Japan and the eurozone (in increasing order of interest); iii) capitalising on the low interest rate environment, which favours dividends and share buybacks in particular, and iv) focusing on anything that is either overlooked or undervalued.

ASSET ALLOCATION SHORT TERM OUTLOOK

	- -	-	●	+	++
CASH					
USD				●	
EUR		●			
SOVEREIGN BONDS					
United States			●		
Eurozone (core countries)			●		
Eurozone (periph. countries)				●	
United Kingdom			●		
Japan			●		
Emerging market debts			●		
CORPORATE BONDS					
Investment Grade Europe				●	
Investment Grade US				●	
High Yield Europe			●		
High Yield US			●		
EQUITIES					
United States			●		
Eurozone				●	
Europe excl. eurozone			●		
Japan				●	
Emerging markets			●		
CURRENCIES					
US dollar				●	
Euro		●			
Sterling				●	
Yen				●	
Emerging market currencies			●		

(--) Significantly underweighted (UW)
(-) Underweighted
(●) Neutral
(+) Overweighted (OW)
(++) Significantly overweighted

PORTFOLIO TYPE

Equity portfolios

- Beta of portfolio around 1
- Prefer Eurozone and Japan
- Underweighted on the US
- Emerging markets: country selection is key

Within emerging markets:

- Overweight India, Thailand, Peru, Europe and Mexico
- Neutral on China, Indonesia, Korea and Russia
- Underweight Malaysia, Taiwan, Chile, Colombia, Greece, Turkey, Brazil and Gulf countries

Bond portfolios

- Maintain overweight position in credit. No major call between IG and HY
- Yield curves flattening trades
- Preference for US vs. core Eurozone
- Emerging debt:
  - prefer hard currencies debt (long USD)
  - prefer local debt only on a case to case basis
  - play thematics on EMG
- Maintain Long USD / Short JPY, Long JPY / Short EUR

Diversified portfolios

- Prefer Eurozone, neutral on Japanese and US equities
- India our favourite amongst EMG equities... Caution on EMGs
- Additional caution on corporate bonds: prefer EUR HY to US HY. Prefer US IG to EUR IG (liquidity)
- Keep overweight position on sovereign bonds of peripheral Eurozone countries vs. core
- Maintain the flattening position on US yield curve
- Reduce positions on emerging debt in hard currencies
- Long USD / Short JPY, Long JPY / Short EUR

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