CIO VIEWS FOR 2019

Mind the sustainability of returns as the cycle ages

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With late cycle features continuing to materialise and a higher level of vulnerability developing due to the uncertain geopolitical backdrop, 2019 will require investors to embrace a more prudent approach, despite the benign global economic outlook. In our view, this new investment landscape will translate into not only the need for more cautious risk allocation through the year, but also more selective exposure to countries/sectors and names that could prove to be **more resilient**: less indebted, less exposed to geopolitical frictions, and to financial and economic imbalances. **The sustainability of future returns will be the name of the game in 2019.** It will also be a year of higher focus on portfolio construction and diversification to balance risk, avoid crowded trades, and deal with multiple divergences that will likely materialise. Meanwhile, liquidity management will be even more critical as we enter uncharted waters associated with central bank (CB) liquidity tightening for the first time post the last financial crisis. With limited market directionality, and as swings are expected to be frequent, investors should seek tactical opportunities throughout the year that will emerge on the basis of the evolution of **three main themes**, as noted below.

1 - From economic acceleration to deceleration with further divergences, but no drama

The phase of synchronised acceleration that characterised 1H18 has left room for a mild deceleration in the global economy over 2019 and 2020. In particular in the US, the fiscal stimulus that helped to extend the cycle and significantly boost earnings growth should start to lose momentum in the second part of the year. This should lead to a healthy deceleration from the current upbeat outlook, preventing further overheating of the economy in a full employment phase. On the other hand, Europe is already bearing the burden (economically and on financial assets) of Brexit and fragile Italian fiscal discipline, and it is vulnerable to emerging markets (EM) and global geopolitical risks (ie, higher oil prices).

A look back at our 2018 Outlook: What went as expected and what did not

What went according to our expectations?

On the economy

- **Global GDP growth** to stabilise around 2017 levels (above potential)
- **Core inflation**, while accelerating in some region, should remain subdued
- Towards a **rebalancing of monetary and fiscal policies** in some key countries, CB progressively removing excessive accommodation.

On financial markets

- Transition **from an asset reflation** regime **towards a late financial cycle** regime
- **Lower risk-adjusted returns** compared to previous years
- **Interest rates** direction (expected to increase only moderately).

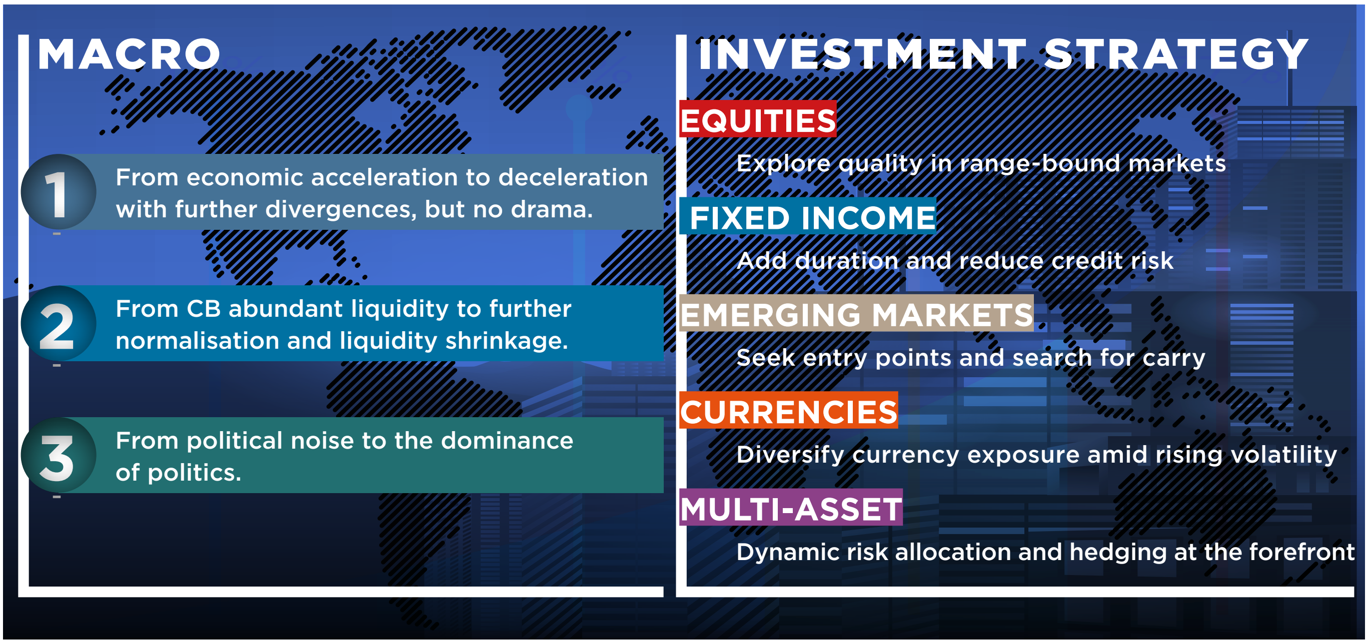
What were the surprises?

On the economy

- **Stronger growth in the US** thanks to fiscal policy and **desynchronisation of growth**
- **Idiosyncratic stories in EM** (Turkey, Argentina)
- **European renaissance** cooled down with lack of development on reforms and rising populism
- **Trade war** escalation with retaliation.

On financial markets

- **Strong appeal of US assets** (equity market outperformance on strong EPS expansion, USD strength)
- **Interest rates** somewhat higher than expected in US, less so in Europe
- **EM** broad based weakness.



The outlook for Europe remains uncertain and highly dependent from the political landscape, but markets seem to have already priced in most of the bad news. Japan may emerge as a more insulated area among big global players as domestic conditions hold up well and political uncertainty is limited. Deceleration will continue in EM, especially in 1H19 as a legacy of 2018 weakenesses, with further divergences ahead as rising US interest rates and the strong dollar amplify the areas of fragility at a country level. Furthermore, US dollar lending to non-bank EM residents has more than doubled since the Great Recession. The rise in oil prices also creates further divergences within EM, with oil exporters benefitting vs oil importers. Across EM, we do not expect major disruptions, as we believe China's economy will remain resilient and the government will continue to implement fiscal and monetary actions to manage a slowdown in an orderly way. The domestic economic engines and the resilience to global trade deceleration will be key themes to watch among these countries to identify more sustainable stories. **Overall, the global economic picture will be more scattered, leaving room to play different speeds of growth and economic adjustments during the year.**

2 - From abundant liquidity from CB to further normalisation and liquidity shrinkage.

While in 2018, CB were still injecting liquidity into the system, 2019 could be the first year of negative asset purchases by developed market CB. As a result, **financial conditions should continue to tighten** globally, resulting in challenges for more leveraged economies and sectors in a world which continues to see a **high level of debt**. A stronger focus on various CB's different domestic targets will drive more asynchrony in monetary policies. In DM, the Federal Reserve will likely end the hiking cycle in 2019; the European Central Bank will be just at the beginning of it; while the Bank of Japan will remain broadly accommodative. In EM, tighter monetary policies will dominate amid rising inflation expectations, with different intensities. Overall, **uncertainty regarding future CB actions will further increase as the cycle matures, making the overall market environment more vulnerable to possible policy mistakes.**

3 - From political noise to the dominance of politics.

This year has marked the beginning of the era of the dominance of politics in the financial markets. Political factors were generally perceived as a risk or market noise until last year; currently, these represent a **key market driver in a more fragile economic and market environment**. In Europe, parliamentary elections in May 2019 will be crucial to identifying the prevailing political dynamics and to understanding the integration potential and ultimately the potential survival of the euro in the long term. In addition, the protectionist policies of US President Trump will continue to be under scrutiny: even though in the short term, the US has been relatively immune to the effects of tariffs, the consequences of these policies should soon be visible in lower company margins and unintended medium term effects on prices. **A retreat of global trade** is already under way after decades of openness, and **the return to more domestic-focussed trends could be the natural evolution of trade war risk.**

What are the implications of these themes for investors?

US government bonds and equities continue to be favoured in 2019, although the strong dominance of the US is likely to fade away as profit growth will converge across major economies. Instead, we expect **the**

repricing of the "large periphery" (EM and Europe) witnessed in 2H18 will **open up new opportunities to diversify risk exposure in 2019** at reasonable prices based on an overall neutral to cautious stance on risk assets. As the reflation trade driven by excess market liquidity is ending, investors will have to lower their performance expectations. **Investors in a 50% equities/50% bonds portfolio should expect low single digit returns**, **especially euro-based investors,** where the investment landscape remains more clouded and investors lack the bond income engine, as rates remain very low. In this area, seeking opportunities across the credit continuum (including liquid and illiquid investment vehicles) and adding uncorrelated sources of returns will help, in our view, to enhance the risk/return profile of an overall allocation. **All in all, we think that 2019 will be the year of focus on fundamentals to find sustainable returns and avoid areas of major risk across asset classes.**

- **Multi-asset - Dynamic risk allocation and hedging at the forefront.** Investors will need to manage multiple risks. CB policy mistakes is one of these, as the unintended negative effects of trade tensions on prices could be underestimated. The slowdown generated by excessive tightening could be particularly challenging for the highly indebted corporate sector, and a potential widening of credit spreads could trigger negative reactions in equity markets, which it is clearly worth hedging against. A deterioration of the macroeconomic environment that could become more evident in 2H19 and into 2020 will instead call for risk reduction in asset allocation.
- **Equities – Explore quality in range-bound markets.** We don't point to any major directional calls, but would focus more on selection, led by sustainability as a parameter, in terms of earnings growth, debt structure and business models. This will be key to navigating the late cycle phase in equities. The outlook for earnings should remain supportive, with some deceleration especially in US, where earnings growth should start to revert from the extraordinary highs of 2018 as higher input costs start to have a negative effect. In a more balanced world, **investors could explore selective opportunities in the cheapest areas of the market**, namely **Europe**. If, as we believe, the Italian situation will be fixed in the medium term, it should become an investment opportunity for repositioning portfolios in European equities with appealing valuations and where most of bad news has already been priced in. In the US market, we expect investors to become more selective, and we favour rotation of styles from the stretched growth style to a combination of quality and value styles. **Risk management becomes crucial here in order to avoid concentration due to higher uncertainty.**

> "In 2019, the focus on alpha generation will be key, as we expect limited directional upside in markets. This will point to the importance of tactically playing rotation of geographies/themes and carefully selecting securities based on their sustainability of returns. There could possibly be a case made for a more defensive stance later in the year, when the extension of the cycle will move closer to its endpoint."

- **Fixed income – Add duration and reduce credit risk.** The upward movement of rates will lose momentum as the Fed moves closer to the end of its tightening cycle. With higher yields in US Treasuries, this area will return to focus in the search for income and investors should add duration to benefit from higher rates (US) and as protection in case of risk-off situations. As liquidity shrinks and CB retreat, investors should adopt a very selective approach regarding credit markets. Among the major risks investors are facing, we see **decreasing liquidity**, the change in the structure of some markets, or monetary policy mistakes (in particular, a more aggressive Fed ahead of an overheating US economy). Defaults are low and should not materially rise in 2019, but this is an area requiring increasing attention as economic conditions progressively deteriorate and financial conditions tighten.
- **Emerging markets – Seek entry points and search for carry.** Emerging markets continue to be key mid to long term areas of opportunity. Some areas of EM that have already repriced offer interesting income sources, but selection remains vital, given different profiles in terms of vulnerability among EM countries. At the same time, the end of the Fed's tightening cycle should bring some relief to oversold EM assets.
- **FX – Diversify currency exposure amid rising volatility.** As currency will be the first mechanism used to make adjustments in flows, we expect volatility to remain high, suggesting a diversified currency exposure among DM. We maintain a cautious view on EM which are more vulnerable in the current phase. The US dollar has been the main beneficiary of investor appetite, due to repatriation of assets, a trend that could weaken later in the year, when fundamentals (ie, larger fiscal deficits) could resurface as the effects of fiscal stimulus will decline.

AMUNDI INVESTMENT CONVICTIONS FOR 2019

	Asset class	Views	Rationale
Equities	Global equities	=	Global growth of more than 3% is perfectly acceptable for corporate profits. But the economic slowdown, combined with the withdrawal of CB cash injections, is a risky cocktail for equities. Regional diversification, selection of quality companies and tactical allocation based on regional dynamics will be key.
Equities	US	+	The US market is expected to continue to outperform other equity markets in terms of profit growth, even if its outperformance could slow in 2019. However, the climax of the US cycle is an obstacle to a P/E ratio uptrend, so the market should perform in line with EPS growth.
Equities	Europe	=	Political issues will weigh on the markets, calling for a risk premium. Profit growth is subdued in comparison with the US market, but valuations are appealing and could potentially benefit the market should the political risks fade away. Once Brexit is behind us and the cycle matures further, the UK could benefit from high dividend yields.
Equities	Japan	=	The political situation in Japan is a lot clearer than in Europe, but the profit recovery is much more mature and the growth forecast for 2019 is among the weakest of all the major markets. The performance of this market depends significantly on Yen dynamics, thus amplifying risk-on/risk-off market trends.
Equities	Asia-Pacific ex Japan	−	This region (57% Australia, 29% Hong Kong) is highly sensitive to the impact of China, especially on industrial commodity prices and trade. More visibility on the Chinese stimulus package, particularly in terms of infrastructure, could set this market on a rebound during the year (more of a temporary trend).
Equities	Emerging markets	=	Some headwinds will remain in 2019: the tight Fed policy in H1, more hawkish EM central banks, the decelerating global economy and ongoing trade issues. The political agenda will also be busy. Yet, the recent correction on GEM has been too abrupt, so even with a decelerating cycle some upside could be justified.
Fixed income	Global bonds	=	2019 calls for an active and tactical approach in global fixed income with a strong focus on quality. The short duration stance, which has characterised most of 2018, will be replaced by a more constructive view on duration (especially in the US), partly as a hedge to global risks.
Fixed income	US govies	+	In H1 2019 interest rates should stabilise or increase only slightly. Hence, the 10-year yield will remain around current levels in the coming months. In H2 2019 we see some slight downside risk on bond yields, together with the slowdown in US growth and the Fed reaching its target on rates normalisation.
Fixed income	US IG Corporate	=	Valuations look generally more stretched in high beta $US denominated bonds, where the risks of market complacency are higher in case of negative surprises on economic trends and tightening financial conditions. Preference goes to high grade, low duration corporates in the US.
Fixed income	US HY Corporate	−	While the defaults outlook is benign in the near term, elevated corporate leverage increases the negative impact of a turn in the economic cycle. US HY bonds valuations are not appealing in light of the rising risks ahead.
Fixed income	European govies	−	The ECB is likely to stick to its cautious forward guidance on rates. We expect 10Y Bunds to rise but in a limited way. A dovish ECB keeps the search for yield alive in the two to five year curve bucket, the segment in which Italian spreads also offer more chances of normalisation in case of an earlier confrontation with the EU.
Fixed income	Euro IG	=	Political risks and less brilliant macro growth, together with the end of the corporate sector purchase programme, will pose some challenges for European IG credit. Yet this remains more attractive vs Euro core bonds.
Fixed income	Euro HY	+	Euro HY fundamentals remain very strong and also the supply/demand dynamics should be supportive. We seek a tactical approach on financials and Euro HY in general, depending on the evolution of political risks.
Fixed income	Emerging markets bonds	=	After a challenging year, we believe that conditions will progressively improve, especially in the second half of 2019. In local currency debt, we see currency valuations as not being particularly attractive for the asset class. Our preference for the year ahead is for USD debt and with a focus on selective best risk/adjusted yields.
Other	Commodities		The performances of base metals and oil diverged quite significantly in 2018 and we think this will continue in 2019. Our target ranges for 2019 are $65-$75 for WTI and $70-$80 for Brent. On gold we think it should still be considered as a meaningful hedge to protect from a financial crisis.
Other	Real Assets		Against a backdrop of lower expected returns, investors with a sufficiently long time horizon could enhance diversification and return potential through liquidity premium that real assets investment can offer.
Other	Currencies		Brexit and political noise in the Eurozone might weigh on GBP and EUR for some time. We expect the USD to remain strong in the short term, and weaken with a medium-term horizon as, in addition to other factors, the economy might reach the mature phase of its cycle, a situation that usually leads to a weaker USD.

Legend: − − Negative, − Slightly Negative, = Neutral, + Slightly Positive, + + Positive

Source: Amundi, as of 1 November 2018. 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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