Confidence must be earned

Amundi

Asset Class Return Forecasts

Medium and Long term Return Forecasts | Q2 – 2018 Update

Finalised on April 2018

Global Equities Favoured

Global growth is expected to remain mostly supportive buoyed by robust demand and continues to be the main driver in asset prices for the next few years. Over this period, the risk adjusted returns for the equity class across the major regions remain significantly above that of the fixed income, particularly given the ongoing rate normalization in US followed by ECB. We expect the disparities in risk adjusted returns between equity and fixed income to vary across region in the medium to long term horizon. In the US, equity valuation reflect slowing earnings growth with bond prices stabilizing beyond first few years. EU equity market seems well poised to deliver a robust growth through the medium horizon while the belated start to the rate tightening process will result in subdued returns in the corresponding bond market. Both within EM equities and sovereign bonds, the country/region specific factors remain to be the main driver in addition to the sensitivity to the interest rate environment in the US.

GOVERNMENT BONDS

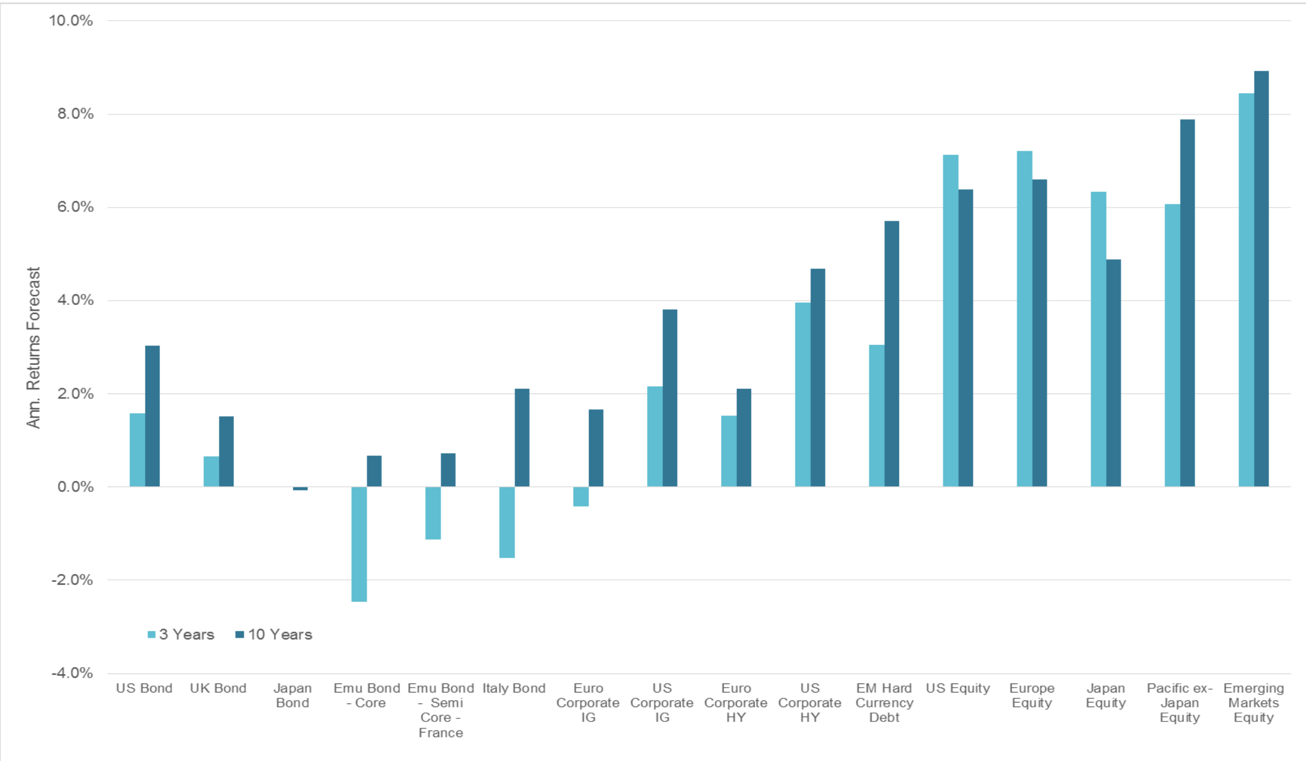
Our strategic view on government bonds is for rising yields. We see confirmation of this trend on both short and medium-term horizons. The normalisation of global interest rates is progressing, albeit at different speeds.

CREDIT

Credit will deliver subdued returns in the medium to long term with a moderate credit premium (excess return versus govies) as we expect spreads to widen and interest rates to increase.

EQUITIES

We expect investors to benefit from the attractive performance of equity markets, albeit in a normalized volatility environment. Europe retains the highest potential amongst developed countries given an attractive macro backdrop (continued global growth, modest inflationary pressure and low policy rates) and following weak performance.



Source: Amundi Asset Management CASM Model, Amundi Asset Management Institutional Advisory and Strategy and Economic Research Teams, Bloomberg. Finalized on the 20th of April 2018. Macro figures as of last release. Interest rates and spread levels updated as of the 30th March. Equity returns updated as of the 30th March based on MSCI indices. One year forward views and fair values provided by Research team (macro, yields, spread and equity). Please see page 6 of this document for methodology of CASM Model. Forecasts for annualised returns are based upon estimates and reflect subjective judgments and assumptions. These results were achieved by means of a mathematical formula and do not reflect the effect of unforeseen economic and market factors on decision making. **The forecast returns are not necessarily indicative of future performance, which could differ substantially.**

Asset Class Expected Returns

In the following table, we present our return forecasts across different asset classes, calculated as the average of simulated returns, on different forward looking horizons (from 3 Years to 10 Years).

			Annualized Average Total Return at Horizon		
Assets in local currency	**Reference Index**	**Duration**	**3 Years**	**5 Years**	**10 Years**
Cash					
Euro Cash	JPCAEU3M index	0.3	-0.2%	0.2%	0.9%
US Cash	JPCAUS3M index	0.2	2.4%	2.6%	2.7%
Government Bonds					
US Bond	JPMTUS Index	6.4	1.6%	2.2%	3.0%
UK Bond	Customized Index	9.0	0.7%	0.9%	1.5%
Japan Bond	Customized Index	8.8	0.0%	0.1%	-0.1%
Emu Bond - Core	JPMTWG index	7.4	-2.5%	-0.7%	0.7%
Emu Bond - Semi Core - France	Customized Index	8.7	-1.1%	-0.6%	0.7%
Italy Bond	JPMTIT index	7.0	-1.5%	0.4%	2.1%
Spain Bond	Customized Index	9.1	-0.2%	0.3%	1.2%
EMU Bond All Maturity	JPMGEMUI Index	7.3	-2.0%	-0.2%	1.3%
Barclays Global Treasury	BTSYTRUU Index	8.0	-2.1%	-0.2%	1.3%
Credit Investment Grade					
Euro Corporate IG	ER00 index	5.3	-0.4%	0.7%	1.7%
US Corporate IG	C0A0 index	7.2	2.2%	2.7%	3.8%
Barclays Euro Aggregate	LBEATREU Index	6.9	-1.7%	0.0%	1.3%
Barclays US Aggregate	LBUSTRUU Index	6.1	1.9%	2.4%	3.3%
Barclays Global Aggregate	LEGATRUU Index	7.1	0.4%	1.2%	2.0%
Credit High Yield					
Euro Corporate HY	HE00 index	3.9	1.5%	1.5%	2.1%
US Corporate HY	H0A0 index	3.9	4.0%	4.1%	4.7%
Emerging Market Debt					
EM Hard Currency Debt	JPEGCOMP Index	7.1	3.1%	4.4%	5.7%
Equities					
US Equity	NDDLUS Index		7.1%	6.7%	6.4%
Europe Equity	NDDLE15 index		7.2%	6.9%	6.6%
Euro zone Equity	NDDLEMU Index		8.9%	7.8%	7.0%
UK Equity	NDDLUK Index		5.8%	6.1%	6.4%
Japan Equity	NDDLJN Index		6.3%	5.5%	4.9%
Pacific ex-Japan Equity	NDDLPXJ Index		6.1%	7.1%	7.9%
Emerging Markets Equity	NDLEEGF index		8.4%	8.7%	8.9%
World Equity	NDDLWI index		7.2%	6.7%	6.4%
AC World Equity	NDLEACWF Index		7.3%	7.0%	6.7%

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Macroeconomic outlook

Global growth is expected to remain above potential in 2018 and 2019 and the current recovery is set to run until 2020. Surveys remain at high levels and their recent deterioration does not signal a reversal of the cycle. The advanced economies (with the notable exception of the UK) 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 (US, Europe, Japan, Asia). The synchronous nature of the global recovery makes it more robust.

Globally, inflation is expected to pick-up due to stronger economic backdrop; overall, we expect gradual uptrend, so outlook to remain benign and risks tilted to the upside. In the US, Inflation is low by historical standards for structural reasons, not for cyclical ones and the pro-cyclical fiscal policy has increased the likelihood of an inflation acceleration.

Assumptions on GDP growth and inflation

REAL GDP	Long Run Level	2018	2019
Germany	1.4%	2.3%	2.1%
US	1.8%	2.9%	2.5%
Italy	1.0%	1.4%	1.2%
Japan	0.7%	1.2%	1.0%
UK	1.7%	1.5%	1.6%
France	1.3%	2.0%	1.7%
EMU	1.4%	2.3%	1.9%

CPI	Long Run Level	2018	2019
Germany	1.7%	1.5%	1.6%
US	2.0%	2.5%	2.2%
Italy	2.0%	1.1%	1.5%
Japan	1.5%	0.9%	1.3%
UK	2.0%	2.6%	2.4%
France	1.7%	1.4%	1.5%
EMU	1.7%	1.6%	1.6%

US GDP growth : 2018-2020

The Tax Cuts and Jobs Act of 2017 (TCJA), a major tax overhaul approved just before the end of the year that introduced significant tax cuts for both individuals and corporations, was followed in early February by the Bipartisan Budget Act of 2018 (Budget Act). This second Act passed by the US Administration further increases government spending on top of the fiscal stimulus. Immediately afterwards, the White House presented the President's Fiscal Year 2019 Budget (President's Budget), which included increased infrastructure spending as one of its priorities.

This stimulus comes at a very unusual point in the economic cycle (near the peak, with the output gap already closed and the economy at full employment), extending the expansion phase beyond what we would have expected in the absence of any stimulus. As of now, we see short-term impacts as being more important than the long-term perspective, although some of the measures were also aimed at boosting potential growth.

Barring any external shock, over the coming quarters we expect the tax cuts to boost disposable income and corporate profits, while incentivising corporate investments through buoyant domestic demand and increased expensing provisions. On top of this, sustainable and synchronised global growth would represent a supportive environment. Against this backdrop, the labour market will keep tightening with unemployment further undershooting the NAIRU. We expect growth to remain above potential for the next eight quarters, at an annual average of approximately 3% in 2018, 2.6% in 2019 and then gradually slowing towards potential in 2020.

The U.S. Federal Reserve must ensure that the economic impact of any gradual withdrawal of its accommodative monetary policy is carefully managed. It must avoid overtightening and, at the same time, ensure that the economy does not overheat. Increased resource utilisation and GDP growing above potential will cause the inflation trend to lift. Core inflation is expected to slightly overshoot the Fed's target but to remain in check.

Central banks

Monetary policies will remain generally accommodative because even if a little cyclical inflation materializes, total inflation will remain well below its historical average for structural reasons (flattening of the Phillips curve, continued downward pressure on the prices of many goods and services).

We make the assumption that the Fed will continue its gradual rate tightening cycle to whittle down its accommodative monetary policy, which is excessive in view of the current recovery, by rising 2 other times the fed funds in 2018. The Fed revised upward (from two to three) the number of rate hikes expected in 2019, and expecting two more in 2020. It will continue reducing its balance sheet with a gradual non-replacement of papers reaching maturity. Our expectations are for a more moderate path. The neutral policy rate ie the long-run equilibrium interest rate (R*) is much lower today (estimated at around 0%) than neutral policy rates prior to the financial crisis. We make the assumption that the neutral real Fed funds rate will gradually climb to 1% in the medium term (nominal Fed funds rate around 3%).

Meanwhile, the ECB could put an end to its QE program as soon as Q4 2018, But his recent communication remains particularly accommodating. The end of its asset purchase program is conditional on the recovery of underlying inflation, which remains excessively weak at this stage of the cycle. Moreover, it will start raising its key rates only «well after» the end of the Asset Purchase Program This implicitly means that the first increase in its deposit rate would not occur until mid-2019 (at the earliest). We consider a neutral real rate at -1% since 2009 (approximately equal to ECB estimates) versus 1% before 2009 and we make the assumption of 0-0,5% in the longer-run.

After defining the real policy rate trajectory, our model incorporates our inflation forecast to obtain a nominal expected return on cash. Our projections are for core Eurozone inflation at 1.7% over 10 years and 2% for US inflation.

Expected returns on cash

The expected returns from rolling an investment in cash over the different holding periods are derived from our projected trajectory of policy rates over the medium to longer-term. The monetary policy trajectory is defined by the estimation of an equilibrium real policy rate (defined as the real rate consistent with full employment and stable inflation in the medium-term) and by the projection of a normalisation path toward the equilibrium real rate. Our assessment of the optimal short rate normalisation path is based on central bank guidance and enhanced Taylor rules which captures central bank policy reactions to different growth and inflation environments.

In US, the nominal expected return on cash over 10 years horizon is 2.7% in line with long term level, while in the Eurozone it remains low at 0.9% as a result of very slow path in normalising inflation and by a cautious view on the long term growth prospects.

Interest Rates Assumptions

	Quarter End Update: 30th March 2018		Long Run Level
3M YIELD	30/03/2018	Medium Term Level	
Germany	-0.8%	-0.2%	1.7%
US	1.7%	2.6%	2.8%
Japan	-0.2%	0.1%	1.3%
UK	0.5%	0.8%	2.0%

	Quarter End Update: 30th March 2018		Long Run Level
10YR YIELD	30/03/2018	Medium Term Level	
Germany	0.5%	1.3%	2.4%
US	2.7%	3.3%	3.5%
Italy	1.8%	2.7%	3.7%
Japan	0.0%	0.4%	1.5%
UK	1.4%	1.9%	2.8%
France	0.7%	1.7%	2.9%

Medium term level= Average level till 3 years incorporating the 1 year outlook and some adjustment dynamics to the long run.

Government bonds

The normalisation of global interest rates is progressing, showing different speed and timeline.

As far as the US fixed-income market is concerned, we presume that long-term rates will continue rising. The “normal” relationship between sustained growth, higher inflation expectations and higher bond yield finally seems to have restored to some extent. This is a new phase of normalization in fixed income markets, where fundamentals regain their key role. The transition has not been smooth: in less than six months, 10y yields in the US have risen from 2% to 2.9% and the 10y German bund yield doubled between March and December. According to the Fed staff’s calculations, the 10-year term premium is currently depressed by the Fed’s large balance sheet by 85 bps. In the longer-run, we see the 10-year yield approaching 3.50% as the 10-year term premium gradually normalizes.

The normalisation of EMU interest rate is expected to be longer and slower, in fact current 10 years Bund (@ 50 bps) is far from the long term level (@ 2.4%), we expect a gradual convergence coherent with the monetary policy stance.

Expected returns on government bonds

Our framework projects 10-year US treasuries to return 3% over the next decade while Eurozone government bonds should return 1.2% per annum, a low nominal return given extended valuations and depressed starting yields.

Those assumptions are based on a scenario of a gradual rise in bond yields. Our framework for forecasting nominal rates consists of 2 components:

1. the short term interest rate expectation based on an equilibrium real rate, an optimal monetary policy path and the expected inflation over the holding period and
2. a nominal term premium which we assume will remain low leading to gradual rises in bond yields in our scenario. The term premium corresponds to the additional return that investors demand to hold a long-term bond as opposed to rolling over a short-term bond. It can be broken down into the inflation premium and the real term premium, both of which should remain fairly moderate against a backdrop of low real rates and low inflation.

EM bonds

The EM-DM economic growth differential has continued to widen, supported by improving fundamentals with China rebalancing progressing quietly – such that the slowdown appears to be under control, and with rising commodity prices. Nevertheless, we believe that the growth differential has peaked as the latest data indicates a slowing trend in activity throughout the EM universe. In the short term, country specific risk factors should dominate: such as the trade conflict with the US in China, the effect of sanctions in Russia, the credibility of macroeconomic policy in Turkey, upcoming elections in Latin America and the impact of RBI movements in India.

We see EM sovereigns about 40bps tight to fair value and therefore anticipate a widening the next year taking it above that of the long term equilibrium level.

Given the context of US rate hikes and widening spread, we believe the bulk of the total expected return to originate from the carry. With a duration of over 7, the EM hard currency bonds are expected to yield 2.5-3% annually over the short to medium term. Subsequently, as the spread mean reverts and rates stabilise, we calculate a higher annual returns at around 5% underpinning our view of a cautious optimism.

Assumptions on Credit

	Quarter End Update: 30th March 2018		Long Run Level
OAS SPREAD	30/03/2018	Medium Term Level	
Euro IG	0.96%	0.90%	1.05%
Euro HY	3.05%	2.91%	3.50%
US IG	1.16%	1.09%	1.30%
US HY	3.79%	3.90%	4.50%
EMBI GLOBAL	3.26%	3.51%	3.35%

Medium term level= Average level till 3 years incorporating the 1 year outlook and some adjustment dynamics to the long run.

DEFAULT LOSS	Default Short Term	Recovery Short Term	Default Long Term	Recovery Long Term
Euro IG	0.1%	54.3%	0.2%	43.1%
Euro HY	1.3%	50.9%	3.4%	37.7%
US IG	0.1%	54.3%	0.2%	43.1%
US HY	2.6%	50.9%	4.2%	37.7%
EMBI GLOBAL	1.0%	65.0%	1.2%	65.0%

Corporate bonds

For US, the outlook on the corporate sector is not clear cut. On the one hand the latest US economic data indicates it is further along the expansionary cycle and the Fed is already embarking on a progressive rate tightening. On the other hand, data supportive of the US corporate sector include strong earnings and continued accommodative financing conditions despite the aforementioned economic data. For the US IG we expect a slightly tighter spread in the short term, while for US HY universe we expect the spreads to be slightly widening over the short term. The long-run equilibrium levels are relatively close (around 15bp and 70bp higher for IG and HY) – especially when comparing to the historical levels. We assume that the monetary and fiscal policy going forward will prevent the spread levels from spiraling too far beyond the specified equilibrium levels.

Despite the recent moderation in the Eurozone economic growth, Eurozone economy remains firmly in the mid-phase of the expansion cycle. As a further support for corporate spreads, ECB is expected to maintain its asset purchase albeit at a reduced pace at least for the remainder of 2018. Consequently, on the short term, spreads in EU for both IG and HY are expected to remain at historically low levels and even tighten further as prudent behavior from companies is keeping leverage levels under control. Beyond the short term, we assume the equilibrium spread levels for both IG and HY to be relatively close to the current levels (10bp and 45bp higher respectively in the long run), as we assume the underlying factors driving the current low levels to be persistent.

EUR valuations are better than US valuations vs corresponding fair values, but both look rich: however, recent spread widening reduced the gap with fair values, especially for EUR HY and EUR IG.

The current cycle of US HY default rates in the aftermath of the Great Financial Crisis continues to be the most benign since 1990, as 2017 marked the fourteen year of an extremely low period of bankruptcies. This has certainly to do with an unusual phase of abundant liquidity and search for yield, but it also depends on the low cost at which funding was and still is made available to corporates. In this respect, the current level of US real rates is still a long way from thresholds which proved to be dangerous in the past, coherently with a low growth/low inflation scenario and despite the Fed is moving down its policy normalization path.

Looking forward to next 12-month perspectives, our top down model points to a further "landing" of default rates in the US down to a level of 2.6%, from current 3.3% thanks to the likely positive effect of the fiscal reform. Default rates in Europe remain at historically low levels and, according to the signals of our top down models, are expected to fall in the next quarters in the 1.2%/1.5% area. Among supportive bottom up factors, we underline the dominant weight of high quality BB-rated segment (which makes almost three quarters of the overall debt), reducing potential negative impacts from sudden spikes in volatility or risk aversion.

The HY bonds for both EU and US, after the initial short-term historical low default/high recovery rate period, is seen to be increasingly exposed to the interest rate normalisation across the globe.

Expected returns on IG and HY

On the US corporate sector, the total expected return for both IG and HY is to benefit from the higher carry effect, with their expected returns at 2.2% and 4.0% respectively for the short to medium time horizon despite the upcoming rate hikes.

In the Eurozone, tight starting points on spreads combined with very low yields and higher projected rates mean that credit will deliver subdued returns. Only after the horizon of around 3 years, the IG products are expected to reach positive total return. For the HY, the returns have already reached the positive territory due to the lower duration and higher carry effect from the underlying assets.

Equities

The global scenario remains supportive for equity markets as GDP growth is still expected to come above potential in 2019 (in most countries), albeit slightly decelerating. As well central banks should only very gradually remove the excessive accommodative stance of their monetary policies.

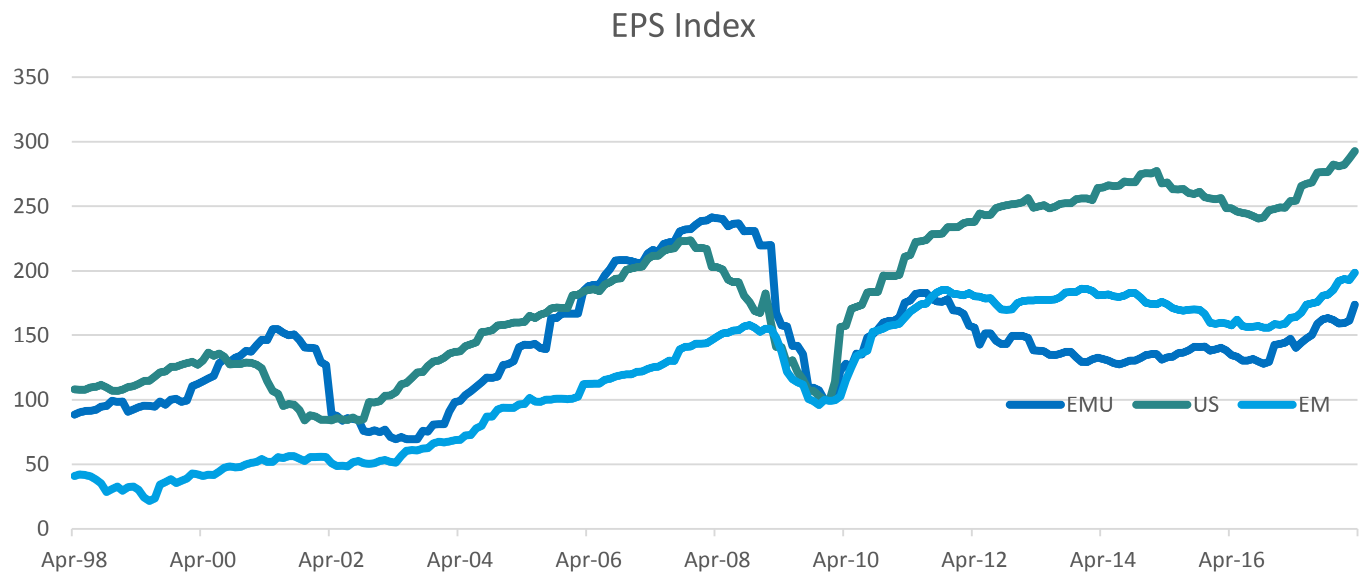
Equity valuations are not stretched in absolute terms versus history and continue to look cheap versus bonds and therefore offer scope for a further reduction in the required equity risk premium. Europe remains undervalued as the stable growth combined with a steepening of the yield curve are likely to support double digit earnings growth expectations, while Pacific ex Japan is still expensive and the more fragile area in a rising interest rates environment. Recent market sell-off weights on the higher targets for US and GEM stocks. But globally, there should be little potential for a further valuation multiple re-rating. In addition to a rising EPS trend, equity returns in recent years have been boosted by higher valuations. But the factors that have supported valuations in recent years will reverse.

The US economy is more advanced in the cycle than the Eurozone economy and EM, which implies different problematics for the investors and different drivers of returns. US equities posted a strong performance, benefiting from strong domestic demand (with the tax reform, deregulation and higher infrastructure spending) as well as supportive global growth backdrop. Improving corporate earnings also provided support despite the more hawkish Fed and some concerns regarding the late stage of the business cycle and elevated valuations. But the pace of EPS growth is set to slow, and valuations should contract against a backdrop of Fed tightening. The resulting returns dynamics is for US moderating the returns in the medium term reaching the long run level at 6% level.

The Eurozone economy is in the mid-phase of the expansion cycle, it is earlier in economic, earnings and monetary policy cycle than most other regions. Indeed there is potentially more upside to European profitability than elsewhere if the economic cycle continues, the ROE at 9.5% is the lowest of all and has further room to improve. Europe is the only region where EPS is not close to an all-time high and currently stands 22% lower than previous peak. The ECB remains behind most other central banks when it comes to starting to normalise monetary policy, with the first rate hike not before mid-2019. It has the most accommodative monetary policy, therefore leaving room for an improvement in relative valuations which are currently attractive. These dynamics are the reasons why Eurozone retain the highest expected return over 1, 3 and 5 year horizon amongst developed countries

For Japanese equities, we expect a total return of 6,3% on average over the next 3 years. On the positive side, the macroeconomic momentum has been improving, thanks to the continued progress on economic and corporate reform and earnings growth. In the long-term, total return is not looking elevated compared to other regions for the following reasons: lower GDP growth potential, lower dividend yield and lower inflation (4,9% overall total return p.a over the next 10 years).

On GEM equity we forecast still positive earning, but below average, on valuation the recent market correction is the main driver of the upward revision of GEM equity potential. At macro area level, valuation are more favourable for EM Europe, while EM Asia is fairly valued. The combining scenario is positive in the short to medium term.



Source: Datastream, MSCI, Amundi Research

Cascade Asset Simulation Model (CASM)

This long-term return forecast report intends to provide some guidance for investor expectations. The time horizon under consideration is 10 years, a period deemed to be an appropriate timeframe, during which long-term trend factors and issues can reasonably be expected to play out, and thus, market returns should accurately reflect this information. We use a Monte-Carlo methodology in order to generate the possible evolutions of different risk-factors for the time horizon considered, representing the future states of these factors under objective measures. The resulting model is then used to price the instruments in line with these factor scenarios.

In order to determine possible interest rate scenarios, we analyse the evolution of three major economic DM regions: the EU core (represented by Germany), the EU periphery (represented by Italy) and the US. For this, we used a cascade-style modelling technique using risk factors such as the GDP cycle, inflation, real rates and slope for each of the economic regions in question.

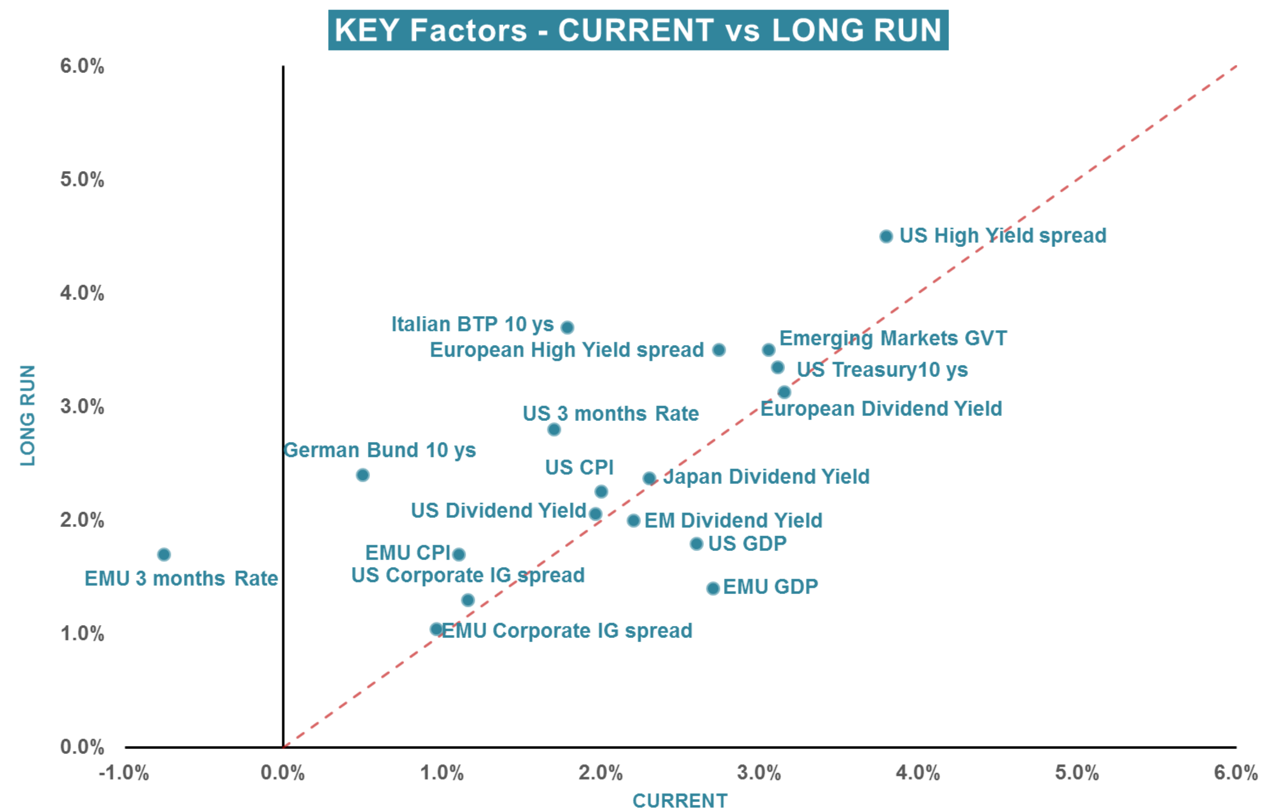
Moving into spread-related assets (EM bonds and corporate bonds), we focus on implied volatility, quality, default and recovery rates, together with economic cycles, to estimate a forward looking path for EM bonds (hard currency), EU corporate (IG and HY) and US corporate (IG and HY).

Our framework on equity focuses on earnings growth and price earnings, as a determinant of capital gains and dividend yields, to represent the income effect; these variables are analysed with the macroeconomic pillars of the model (the economic and inflation cycle).

Our medium/long-term model, known as CASM, is updated on a quarterly basis to incorporate new starting points, our short-term outlook along with long-term trends, the significance of which is verified on an annual basis.

Our CASM model focuses on key factors, which drive this evolution over the medium to long-term; the resulting forecasts look at the comparison between current and long term readings for the key factors included in the model.

Note that these are simulated figures only and may not represent actual asset class returns. Actual returns are based on many factors, and may vary substantially from modeled ones.



Source: Amundi Asset Management CASM Model, Amundi Asset Management Institutional Advisory and Strategy and Economic Research Teams, Bloomberg.
Data as of the 20th of April2018

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