

Key topics, scenarios and asset allocation

Asset allocation: 2017 and beyond

1 Elections in Europe, Brexit, financial stability in China and the direction of budgetary and fiscal policy... four key factors in the years to come?

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A year ago, we were reiterating our forecasts on a 2 to 3-year horizon and, once again, this is the subject matter of this special edition. This exercise is particularly important against a political backdrop that is becoming more complex (a new President in the United States, France, etc.), in a world where monetary policy is extremely accommodative (United States, Eurozone, United Kingdom, Japan, China, etc.), but which for the most part have reached their limits and hence the temptation of budgetary and fiscal stimulus measures in many cases. It is against this backdrop, which is unprecedented in many ways, that our analyses, forecasts and investment strategies have been formed.

A year ago, our main forecasts were supported by the economic backdrop detailed below:

- World growth once again in the vicinity of 3%;
- Economic growth driven in many countries by domestic demand and no longer by world trade, which is now shrinking;
- No hard landing for China but a monetary policy stance (and economic policy in general) that remains highly accommodative;
- The Fed's extreme cautiousness which, although expected, turned out to be far more prudent than figures then suggested. We expected one fed funds rate hike in late 2015 and another in 2016, far fewer than the consensus view;
- The extension of QE (Quantitative Easing) programmes in Japan and in the eurozone;
- Control over rates of inflation;
- An improving growth outlook for the eurozone but a European Central Bank that was expected to stay highly accommodative such that we again stated that we did not expect any monetary tightening whatsoever in the next 3 to 5 years.
- Continuing ultra-low rates, in particular in the eurozone, and the dangers of negative rates;
- A mild recovery in the economic situation of emerging countries, and, in any case, the end of the woes that were besetting these areas for more than 4 years;
- The continuation of the recession in Russia and Brazil;
- A gradual recovery in commodity prices, with a target crude oil price of \$55-60.

The major investment themes discussed were focused on key fundamental trends, in particular:

- The search for yield and spreads as investors' basic motivation in a world of ultra-low interest rates;
- A flattening of yield curves linked to control/lack of inflation and action by the central banks;
- The renewed vigour of the yen;
- An equity market recovery, in particular in the European markets where our

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In an ultra-low or even negative interest rate environment, maintaining an overweight stance in emerging market assets (equities, debt and currencies), in credit (vs. government bonds) still makes sense, while continuing our search for yield and spreads. "Alternative" and "real" assets also remain attractive from a diversification and yield standpoint. 2017 is nevertheless expected to be a more complex year than 2015 or 2016.

However, there is no denying that the negotiations over Brexit, (with the risks on the United Kingdom but also on the political cohesion of the European Union), the situation in China (credit bubble, exchange rate policy and capital account opening policy), the limitations of monetary policy or the prospects for a change in the direction of budgetary and fiscal policies (with the United States probably showing the way with the new leadership), or finally the different elections in Europe (and the rise in populist movements) are likely to bring about meaningful change in current trends. This is what our stress tests clearly show. Anticipate periods of severe stress and the implementation of portfolio hedging. The year 2017 seems to be a pivotal year for financial markets, particularly for bond yields and emerging markets.



With a political backdrop that is becoming more complex, a world where monetary policy is extremely accommodative and hence, there is the temptation of budgetary and fiscal stimulus measures

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recommendation was to focus on value stocks while favouring quality stocks in the United States, taking account of the differences in the maturity of the cycle and valuations between both markets;

- Renewed interest in the emerging markets after three or four years of weakness: the undervaluation of these markets, their underweighting in international portfolios, and the improving overall economic situation should, with the spread levels (an oasis of spreads in a desert of ultra-low or even negative interest rates) and valuation levels reached, draw renewed interest from investors.
- The recovery in emerging market currencies and, more broadly, all undervalued currencies, with the yen and commodity currencies in the lead;
- Continued overweighting of credit, especially high-yield;
- Continued overweighting of peripheral eurozone bonds, protected by the ECB's QE programme (which we expected would be extended to corporate bonds);

With a year's hindsight, we note that our central scenario and our investment recommendations were broadly confirmed by actual events: growth maintained at around 3%, hopeful signs in Europe, the recovery of emerging markets and the appreciation of several emerging currencies, the overweighting of bonds with spreads, interest rates (short and long) holding steady at ultra-low levels, the Fed's extreme caution, no increase in long-term rates, the maintenance of financial stability, etc. were all "winning bets".

What must we anticipate for 2017 and beyond? How do the election of Donald Trump and the forthcoming elections in Europe change the growth outlook and market expectations? Will the negotiations over Brexit really take place and what should we fear at this stage? These are the major questions.

It is still possible to present a number of different scenarios, and the factors that trigger similar growth scenarios may come from highly different events, which generates significant change to market impacts, investment themes, etc. For transparency, as we usually provide this, we are presenting three separate scenarios:

1. Our central scenario developed in detail (see page 24 and following);
2. Our worst-case scenario in terms of global growth;
3. Our best-case scenario in terms of global growth.

To be more precise, we are also presenting stressed scenarios (tied to specific events/risks that we believe are the most credible), as well as the related forecasts and expected returns. Five different forecasts and expected returns scenarios are developed on pages 14 and 15.

The following tables detail factors regarding the backdrop, monetary policy directions, the impact on the financial markets (forex, sovereign and corporate bonds, equity and commodities, for advanced countries and so-called emerging markets), investment themes and asset allocation strategies.

Among the risk factors (some of which had already been identified in November 2015), six of them catch our eye (see pages 16-21) for a detailed analysis of all the risk factors identified) because they still represent significant concerns for 2017-2020:

1. **Brexit: the 2016 vote, negotiations as from 2017.** Of course, the idea of a referendum was nothing new: in January 2013, David Cameron, then Prime Minister, promised that if the Conservative Party won the 2015 parliamentary elections, the government would start negotiations with the EU on getting new accommodations before calling the referendum on whether the United Kingdom would remain in or leave the Union. Mention of the referendum was included in the Queen's Speech of 27 May 2015, and was expected to be held before the end of 2017. At the time we identified this event as one of the main challenges ahead and put forth a few possible scenarios. It was only on 17 December 2015 that the European Union Referendum Act received Royal Assent and, on 20 February 2016, the date was set: the

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Winning bets in 2016”

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Macroeconomic and financial scenarios at a glance

The table below details factors regarding the backdrop, monetary policy directions, the impact on the financial markets: forex, fixed-income, credit, equity and commodities, for advanced countries and so-called emerging markets.

CENTRAL SCENARIO AND ALTERNATIVE SCENARIOS		
Alternative scenario 1 (more pessimistic)	Central scenario	Alternative scenario 2 (more optimistic)
Probability: 15%	Probability: 70%	Probability: 15%
Global growth heads toward 2% in 2017 and 2018, or even lower	Growth remains stable at around 3% in 2017 and intensifies slightly in 2018	Global growth picks up to 4% - 4.5% in 2017 and 2018
MACRO SCENARIO		
China and/or the United States are unable to stabilise their growth and the impact on the emerging economies increases. Advanced countries decline, global growth deteriorates while monetary policy, the Fed's included, goes back to being accommodating. The decline in global trade and commodity and industrial prices intensifies, adding to global deflationary pressure.	Reflation continues. World growth is expected to remain close to 3%, without significant acceleration except in some EM countries which should make up the ground lost with the fall in commodity prices (Brazil, Russia). China revitalises its economy without having to resort to a strong depreciation of the RMB. Trump tempers his positions and obtains a modest stimulus package which extends the cycle into 2018.	Governments adopt a more expansionist stance for fiscal policies. The subsequent investment recovery and wage acceleration generate an acceleration of growth (in US and Europe notably). Growth in EM countries accelerates, sustained by external demand.
MONETARY POLICY		
Monetary policy becomes (or remains) accommodating nearly everywhere. The Fed's monetary tightening cycle never gets off the ground. The ECB accelerates the pace of its QE programme and credible rumours of QE4 in the United States become amplified.	The Fed continues to raise its key rates at a gradual pace (fed-funds rate at 1.25%, end 2017). The resulting tightening of monetary conditions (rise in long-term interest rates and dollar appreciation) encourages the Fed to be cautious. The ECB extends its QE beyond March 2017. The ECB, the BoJ, the BoE and the PBoC remain accommodative.	The policy mix is progressively rebalanced in the US: monetary policy becomes more restrictive following the expansionist stance of fiscal policy. The Fed raises its key rates by 100/125bp in 2017 (2 to 3 more rate hikes than in the central scenario). The ECB QE continues so as to avoid interest rate contagion from the US and to maintain real interest rates at low levels in the eurozone.
FINANCIAL MARKETS		
<p>Fixed income markets</p> <ul style="list-style-type: none"> - Long-term yields drop once again, especially in the United States, and the low-rate environment becomes widespread across maturities and countries. Weaker peripheral eurozone countries. <p>Forex market</p> <ul style="list-style-type: none"> - Emerging and commodity currencies are weakened once again. Crisis in the EMG. USD down vs. developed currencies. <p>Corporate bond markets</p> <ul style="list-style-type: none"> - Solvency issues return to front and centre (health of companies in Europe, leveraging in the US, solvency in China). <p>Equity markets</p> <ul style="list-style-type: none"> - EPS recovery reverses. Correction of equity markets. The downside reaction of equities is dampened by the action of central bankers. <p>Commodities</p> <ul style="list-style-type: none"> - Prices decline further, except for gold, which benefits from rising risk aversion. 	<p>Fixed income markets</p> <ul style="list-style-type: none"> - Increase in US bond yields at first (with steepening curve). Bond yields remain low in Europe and Japan (negative rates and QE maintained). <p>Forex market</p> <ul style="list-style-type: none"> - Upward pressure on the US dollar, because of rates divergence. Upward pressure on the euro will appear late in 2017. Heterogeneous performance of EM currencies. <p>Corporate bond markets</p> <ul style="list-style-type: none"> - The expected rebound in US growth is positive for US credit (rising US dollar and long rates two potential handicaps). The CSCP supports the Eurozone market <p>Equity markets</p> <ul style="list-style-type: none"> - EPS recover. The US market rises further in this cycle, which is crucial for other markets. Beware that bond yields rise not too much given the high valuation of the US market. <p>Commodities</p> <ul style="list-style-type: none"> - Bottom out. Continued gradual rebound which nevertheless remains moderate. 	<p>Fixed income markets</p> <ul style="list-style-type: none"> - Rise of LT yields becomes more generalized. <p>Forex market</p> <ul style="list-style-type: none"> - EM currencies, particularly commodity producers, begin to appreciate sharply again. <p>Corporate bond markets</p> <ul style="list-style-type: none"> - Corporate and sovereign credit spreads are maintained at low levels. EMGs and private debt continue to hold appeal, as oases of spreads in a desert of ultra-low rates and spreads. <p>Equity markets</p> <ul style="list-style-type: none"> - Stronger recovery of EPS. The equity cycle moves on. <p>Commodities</p> <ul style="list-style-type: none"> - Rapid rebound in commodity prices (industrial and agricultural, to the detriment of precious metals).

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Themes and asset allocation

The table below details the themes that we believe are the most appealing based on the different scenarios. It also focuses on asset allocation strategies.

SCENARIOS: OUR BELIEFS		
Alternative scenario 1 (more pessimistic)	Central scenario	Alternative scenario 2 (more optimistic)
Probability: 15%	Probability: 70%	Probability: 15%
INVESTMENT THEMES		
<p>Equity</p> <ul style="list-style-type: none"> - Quality, minimum volatility and sustainable dividends lead. - Defensives outperform cyclicals. <p>Fixed income</p> <ul style="list-style-type: none"> - Search for safe-haven investments (German bonds in Europe, US Treasury bonds in general). - Increase the liquidity bucket. <p>Forex</p> <ul style="list-style-type: none"> - Stay away from commodity and EM currencies. Short USD vs developed currencies. Sharp JPY appreciation. <p>Commodities</p> <ul style="list-style-type: none"> - Buy gold. - Decline in industrial commodities prices 	<p>Equity</p> <ul style="list-style-type: none"> - Financials, Value and Infrastructure thematic rebound first. - Keep some quality and sustainable dividends in portfolio. <p>Fixed income</p> <ul style="list-style-type: none"> - Searching an entry point for US Treasuries. - Performance of inflation linkers will be linked to the amplitude of the fiscal stimulus. <p>Forex</p> <ul style="list-style-type: none"> - Preference for high carry currencies. Long USD vs G3 for some time. <p>Commodities</p> <ul style="list-style-type: none"> - Gradually rebuild long positions on all commodities. 	<p>Equity</p> <ul style="list-style-type: none"> - The rebound of Value is sustainable. - Cyclicals outperform defensives. <p>Fixed income</p> <ul style="list-style-type: none"> - More intense discussions about an ECB tapering, underweight core countries euro bonds. - Search for spread and yields (peripheral debt, high yield, private debt and EMG debt). - Reduce the liquidity bucket. <p>Forex</p> <ul style="list-style-type: none"> - Long EM and commodities currencies. Less CNY downward pressure. More upward pressure on the euro. <p>Commodities</p> <ul style="list-style-type: none"> - Bet on a widespread recovery in prices, favour industrial and agricultural commodities over gold.
ASSET ALLOCATION		
<p>Equity markets</p> <ul style="list-style-type: none"> - Prefer the US market. <p>Fixed-income markets</p> <ul style="list-style-type: none"> - Overweight US and developed countries with higher rates (Australia, NZ) vs Eurozone. - Count on a widening of credit spreads and sovereign spreads in Europe. - Remain outside the «emerging» markets. <p>Emerging debt</p> <ul style="list-style-type: none"> - Favour USD-denominated debt over local debt. <p>Forex market</p> <ul style="list-style-type: none"> - Further depreciation of commodity and EM currencies vs G3 currencies. Short USD vs JPY. <p>Commodities</p> <ul style="list-style-type: none"> - Long on gold. 	<p>Equity markets</p> <ul style="list-style-type: none"> - Rather neutral geographically. - Value markets (Eurozone and Japan) could benefit from the reflation, but this must be accompanied by currency depreciation for them to truly stand out. - At the margin prefer Japan to Eurozone. - More neutral on emerging markets. Buy only if exchange rates stabilize. <p>Fixed-income markets</p> <ul style="list-style-type: none"> - At first, a steepening of the US yield curve. - Overweight Eurozone vs US. - Stay away from BTPs until the political situation gets clearer in Italy. Underweight Ireland. <p>Emerging debt</p> <ul style="list-style-type: none"> - Re-entry points, be selective on local debt. <p>Forex market</p> <ul style="list-style-type: none"> - Preference for high carry currencies (RUB, INR). Long USD vs G3. Long USD vs CNY and low-carry Asian currencies. <p>Commodities</p> <ul style="list-style-type: none"> - Increase global exposure. 	<p>Equity markets</p> <ul style="list-style-type: none"> - Prefer more cyclical markets: Eurozone, Japan or even Emerging markets if US bond yields and the USD don't rise excessively. <p>Fixed-income markets</p> <ul style="list-style-type: none"> - Overweight US vs Eurozone. - Increase exposure on inflation-linked bonds. <p>Forex market</p> <ul style="list-style-type: none"> - Long EM currencies. Long EUR vs developed currencies. <p>Commodities</p> <ul style="list-style-type: none"> - Long commodities.

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referendum was announced for 23 June 2016. The rest is history. Everyone – or nearly everyone – awaited the referendum with apprehension as the United Kingdom-EU relationship was so beset by emotional and political back-and-forth... The rise of populism and extremist political parties (hailing from the right in the core countries of the Europe and from the left in the peripheral countries) did not escape anyone’s notice, nor did the mistrust or even hostility of the British people toward the EU and the EMU. This is why we never assigned a probability of less than 50% to the eventuality of Brexit. This was undoubtedly a more reasonable stance than some starry-eyed optimists, who were incapable of imagining such an outcome. The Leave vote won, but we are really only at the beginning. The main difficulties have yet to come. In the absence of a reversal (non-compliance with the referendum, new referendum, policy change etc.) it is during the first quarter of 2017 that Article 50 of the Treaty of Lisbon is likely to be invoked, this article specifically giving the green light to the start of negotiations between the UK and the EU. We repeatedly discussed the issues and consequences for both the United Kingdom and the EU (see *Post-Brexit in a Few Questions and Answers*, Cross Asset Investment Strategy Monthly, July-August 2016). Let’s just remember that although the shock of Brexit has quickly receded (decline in volatility, return of financial stress to its pre-referendum level), it will undoubtedly rear its head again in 2017, as negotiations progress and political deadlocks occur. The economic outlook for the UK (and the GBP) will again be challenged by investors, as will the political cohesion (and the long-term vision) of the European Union. This will add volatility to the financial markets and doubts over the future of Europe. Only the presence of QE by the ECB seems likely to contain any rise in sovereign credit spreads. Let’s be fair though: it is currently very difficult to say what will happen and even to be sure that the Brexit will really happen. The lack of any contingency plan in the UK, the lack of negotiations between the UK and the EU countries (pending the activation of Article 50), and the nature of the debate (which opposes pragmatists to ideologists of the Brexit) make the situation rather confused. Do not rule out holding a new referendum in one year.

2. Negative interest rates in the eurozone, and then in Japan in 2016 – situation unchanged in 2017 and the adoption of expansionist budgetary and fiscal policies? We have consistently highlighted the dangers and ineffectiveness of negative rates. We reiterated these in the inset on page 9, which highlights the importance of banks’ profitability and the impact on lending to businesses, notably SMEs. Negative interest rates are also having an impact on the earnings and long-term financial positions of life insurance companies and pension funds, which have to contend with higher liabilities and the deterioration of asset/liability matching. It is an undeniable fact that negative rates act like an adaptation accelerator for some business models... but they also contribute to the chronic weakness of the industries concerned, first and foremost banks (see inset below) life insurers and pension funds (see for example *«Low/negative interest rate environment, secular stagnation... impact for asset management»*, Amundi Discussion Papers Series # 15, April 2016). It comes as no surprise that there have been lower lending volumes to SMEs ever since the financial crisis. While large and medium-sized companies have been able to turn to the financial markets for funding, this low volume represents a real handicap for our economies (in Europe, 80% of net job creation originates from SMEs). All in all, sustained rates in negative territory in the eurozone – which is highly probable – is not good news for the economy. It is for this reason that expectations are now focusing on budgetary and fiscal policy (see inset, page 28). Foresee tensions on US bond yields following the upcoming stimulus policy: improving expectations of growth will go hand in hand with a rise in inflation expectations, which will make the Fed forecasts credible (the «dots»), and this will give a boost to the dollar against the euro. This will be sustainable if GDP growth progresses, which is not fully guaranteed. European bond yields will follow US rates, but at a much slower pace, due to weaker growth expectations and to the presence of the ECB’s EQ. Still, in the budgetary and fiscal sphere, the United States will undoubtedly lead the way and Europe will probably follow. As 2017 is an



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election year in several European countries (including France and Germany), there is little doubt that these themes will soon make their way into the debates. On this theme, Europe is not in the best position, not because of lack of room for manoeuvre (Germany is the best example of this), but due to a less open debate on these policies. Budget austerity has certainly now taken more of a back seat, and budget policy is now fairly neutral. However, it is difficult to do any more: the Stability and Growth Pact, the European Fiscal Compact and the European Semester are strict frameworks that have been strengthened over 2011-2013, and which make any budget stimulus virtually impossible at the national level. The ideological atmosphere in Europe is therefore developing more slowly than in the rest of the world, and it is in the eurozone that budget austerity has been the harshest over recent years. It is certainly in the eurozone that public action is the most needed in our opinion, and it is in the eurozone that this public action lacks boldness, whereas it would be useful to boost the real disposable income of households (high propensity to consume) and rekindle (public and private) investment.

> The impact of the negative interest rates on European banks

YASMINE DE BRAY, THOMAS LAPEYRE, *Equity Analysis*

The prospect of a lower for longer interest rate environment is negative for the banks' revenues and profitability.

Peripheral banks are impacted more rapidly than core banks as their loan book tends to reprice quicker. Italian and Spanish banks have retail mortgage loans with rates directly linked to the level of euribor rates. The core markets (ie French, Benelux, German markets) are priced off the longer end of the curve.

Even if the market does not expect any further rate cuts (which is positive for banks' Net Interest Margins in the periphery), the forward euribor rates are not expected to come back in a positive territory before year-end 2020. This is a continued drag on the banks' Net Interest Margins in the periphery. Each 25bps downward move of short term interest rate in benchmark rates is a negative pre-tax profit impact of 5% for the European banks on average (-9/-10% for Spain and Italy and -2/-4% for banks in core Europe)

The gap between core Eurozone and peripheral countries widened: The required loan growth is higher in the periphery (almost 6%) than in the core countries (2-3%) to offset the pressure on the Net Interest Margin due to low rates. But the current loan growth in the periphery (down in Spain and slightly up in Italy) is much lower than the required loan growth.

The ECB should care about the deteriorated demand in the periphery: last October, the ECB left its policy unchanged, requesting time to make decision on QE, and considering growth conditions as stable and relatively unchanged from the September assessment. In reality, the latest ECB lending survey showed deteriorating demand in the periphery vs core countries.

The ECB policy remains a key influencing factor for the banks' profitability: The negative deposit facility rate applied by the ECB remains a key drag on the banks' Net Interest Margins (questioning the transmission to the lending growth in particular in the periphery) that would be partially offset by the benefit of the TLTRO2 (in particular for banks in the periphery).

The biggest risk is that the European banking sector replicates the Japanese banks experience: Over the past 15 years, the Japanese banks experienced 33% Net Interest Margin pressure but only half of this was offset by volume growth.

3. Change to the yuan exchange rate regime in 2016 - continuing opening of capital account in 2017:

China is opening its capital markets, liberalising its capital account and would like to see the yuan's exchange rate regime become decreasingly fixed. It is a monumental task, considering the weight of China and what has still to be done (for more details, see «*The emergence of the yuan as an international currency : where do we stand now?*» Amundi Discussion Paper Series # 18, October 2016). Whilst the Chinese authorities are moving forward in stages and despite its long-term beneficial effects, the process is undermining short-term financial stability, and we will undoubtedly experience some phases of tension on the renminbi, on growth in China and on capital flows... all the more so since, as we are dealing with China, a hard landing, the real estate bubble and risks of defaulting companies, etc. are recurring themes.



Raising real disposable personal income and rekindling investment have become a necessity. There is little doubt that these themes will soon make their way into political debates in Europe”



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4. The gradual rise of populist movements: we have already mentioned this theme in our publications, a theme that continues to gain ground. What's intriguing / concerning is the rise in extremist parties (extreme right-wing parties in Europe's hard-core countries, and extreme left-wing parties in the peripheral countries) and populism, which is reflected in protectionist, anti-immigration, and pro-public-deficit issues. Inevitably, some parties will be tempted by these themes, to please an electorate increasingly sensitive, and rightly so, to widening inequalities, the tax burden and job precarity. Historically, such policies (in particular turning inward) generally result in phases of very weak (or no) growth and higher inflation. These phases of economic stagnation and strong public deficits inevitably lead to periods of recession and political and financial instability. Some elections are particularly important: Italian referendum early December (and general elections in February 2018 ... or even before in case of early elections), general elections in the Netherlands in March 2017, presidential elections (23 April and 7 May 2017) and legislative elections (11 and 18 June) in France, general elections in Germany in autumn 2017... After the United Kingdom and the United States, the change in leadership continues, and it is now affecting the eurozone. It is not only about seeing the coming to power of parties favourable to fiscal and tax policies and wishing to put an end to budget austerity, but of seeing new leaders that are hostile to globalisation and European Monetary Union. This is why in 2017, the financial markets are entering a very challenging environment on the political front.

5. Risk of a rise in long-term interest rates. Since the financial crisis, expectations on long-term interest rates have always been incorrect. Many observers believed that the pick-up in growth in advanced countries was, with the rise in price indices, a good reason to anticipate a rise in long-term interest rates. This was underestimating key factors such as fears of secular stagnation, the weight of QE programmes, budgetary austerity in Europe, ongoing deflationary pressures ... In short, long-term interest rates have not only continued to decline, but more importantly they have entered negative territory, dragged down by key rates which are themselves negative (Europe and Japan in particular) and dragging with them the yields of high quality corporate bonds. The environment is in the process of changing, due to the United States and the election of Donald Trump. The rise in long-term interest rates can in fact come from five sources: i) a significant rise in the growth outlook, ii) a reversal of interest rate policies, iii) the end of QE, iv) a resurgence of inflation, or v) a reversal of budgetary and fiscal policies. Donald Trump's election will modify, at least initially, growth expectations, which will impact other factors. This is particularly true given the potentially more accommodative budgetary and fiscal policy ahead. The debate underway in the United States or to come in Europe regarding budgetary and fiscal policies is therefore crucial for interest rates. But in Europe, only continued QE can prevent long-term interest rates from following their US counterparts. It should be noted that the continuation of the rise in US bond yields will crucially depend on growth forecasts. We are not counting on an acceleration of the cycle, which means that after 6 months, relying on a fall in bond yields seems reasonable at the time of writing. The level reached by US government bonds should make it a preferred target for all investors who, at that time, will be looking for interest rates and carry.

6. Is there a risk of a collapse in emerging markets (and economies)? Emerging markets was our call in 2016, after four difficult years: a drop of commodity prices, fears of hard landing in China, a fall in EMG currencies, the end of the US QE, the (even timid) reversal of the Fed interest rate policy, recurring capital outflows ... and specific risks that are often well identifiable (Russia, Brazil in particular). The renewed strength of these markets was linked to a number of factors: Fed prudence, global growth maintained at a decent level, stabilization of Chinese growth, The stabilization and then the rise in the price of oil, flagrant undervaluation of many currencies, attractive return (an oasis of rates and spread in a desert of ultra-low or negative interest rates and spreads), the underweighting of these asset classes (EMG equities, EMG currencies and EMG debt) over all international portfolios. In

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In Europe, only the continuation of the ECB's QE can prevent bond yields from following US ones, driven initially by renewed confidence in growth, inflation expectations and the credibility of Fed forecasts in the field of monetary policy

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theory, EMG markets do not like short-term rate hikes or long-term rate hikes, and one would be tempted to become negative again - at least for a while - towards emerging assets. It should be remembered that the rise in rates (short and long) linked to an upward revision of growth forecasts is not in itself negative, on the contrary. This does not alter our underlying scenario as regard emerging markets. However, there is a need to remain cautious in the short term, and to reduce exposures in these markets: uncertainty remains about the realization, albeit partial, of D. Trump's program, including (prohibitive) tariffs, negative impact on world trade... Discussions around these themes might destabilise the emerging markets as a whole.

There are multiple extreme risks causing concern on the financial markets

Extreme risk (ER)	Concern	Recent example	Trigger event	Risk level	Probability
ER#1: A radical shift in economic policy	Important impact on exchange rates and long rates	Abenomics in Japan, stimulus policy in France in 1981	Major turning point in budgetary and fiscal policies	Moderate	30%
ER#2: A poorly understood change in monetary policy	Bond crash	February 1994	Poor communication by the Fed or the ECB	Moderate	30%
ER#3: A bursting of the credit bubble in China, with a hard landing (Growth of 3% over the next two years)	Renewed slump in the emerging markets	1997 – 1998	Default of large corporations, an indicator of domestic demand in China	Moderate	20%
ER#4: Collapse of global growth (around 2%)	Widespread stock market crash	2000, 2008	Plunge in demand in China, the United States or in Europe, further weakening of the economies of the emerging countries as a whole	Moderate	15%
ER#5: Substantial and sudden devaluation of the yuan	Widespread stock market crash	1994	Failure by the Chinese central bank to take action to control the depreciation of the yuan	Low	10%
ER#6: Renewed fall in oil and commodity prices	Another downturn in the producer countries	1985 – 1986, 2013 – 2014	Global growth expectations, surplus production (oil)	Moderate	20%
ER#7: A new crisis in Europe post-Brexit	Sovereign crisis or widening sovereign spreads	2011 – 2012	Political dissension following the Brexit negotiations	Moderate	20%
ER#8: Liquidity crisis	Financial crisis	2008	Sales of illiquid assets (credit, bonds)	Moderate	20%
ER#9: The coming to power of parties that are hostile to Europe	Tensions in Europe, expectations of the disappearance of EMU ...	No precedent	Political dissension in Europe, depreciation of the euro, deterioration of sovereign spreads, increase in volatility	Moderate	20%

What are the macro-hedging strategies?

Redesigning/implementing macro-hedging strategies is necessary because the new extreme risk factors referred to above are all potential generators of a major crisis. It is worth recalling that over the course of the past two years, we have heard some alarm bells in all these themes: China changed its exchange rate regime and caused the yuan to depreciate, Brexit laid bare the weaknesses of the UK and Europe (the former had no Plan B and the latter no unity); even

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though the first alarms were raised in 2015 (European crisis, the Fed, China, the yuan, emerging markets, commodities prices, liquidity, volatility), commodity prices plunged and the low liquidity of some markets (regarded as liquid) were the subjects of a good deal of commentary... In short, some risks were well-identified early on but the fact that the probabilities associated with them are low should not give us any reassurance. The probabilities of occurrence are hard to quantify but this is not the main point: the consequences of such risk scenarios are so severe that asset allocation and macro-hedging activities should take them into consideration. Our recommendations are as follows:

Increasing long-term exposure to US Treasury bonds and German Bunds makes sense in terms of protecting the portfolios from risks 3, 4, 5, 6, 7, 8 and 9. The ultimate safe haven, there should be strongly negative correlations with the equity markets in the event of a crisis.

Going long on volatility makes perfect sense, particularly in scenarios 2, 3, 4, 5, 8 and 9. We can go long on volatility by creating a diversified long-volatility portfolio (several currencies, including EMG currencies and/or currencies + equities), naturally choosing the lowest volatilities (and the most liquid vehicles). Volatility swaps and variance swaps, which deal in actual volatility, and Forward Vol. Agreement, which deals in implied volatility, or investing in structurally long volatility funds, are the products generally used to buy volatility. Buying equity volatility or currency volatility will provide more protection than buying fixed-income volatility, particularly in Europe and Japan, where the bond markets are administered and would continue to be so in the event of a financial crisis.

Increasing the liquidity of portfolios is in line with risks 2, 3, 4, 5, 7, 8 and 9. This is a natural and legitimate response, except that returns are nowhere near where they should be, and even less so today (with negative interest rates) than a year ago. Favour USD cash over EUR or JPY cash.

Going long on the USD is especially useful in scenarios 3, 4, 5, 6, 7 and 9. During a crisis, the dollar benefits from being a safe haven, which makes it a countercyclical currency (which moves against the equity markets).

Going long on the JPY in scenarios 3, 5 and 6. Like the dollar, but to a lesser degree. The fact that it is still somewhat under-priced could prove to be a valuable asset.

Buy gold in scenarios 2, 3, 4, 5, 7, 8 and 9. With volatility, gold is undoubtedly, in any panic phase, financial crisis, debt crisis or liquidity crisis the ideal macro-hedging instrument. It is indeed the only risky asset class – among US equities, private equity, real estate, hedge funds, and commodities – that rose during the Gulf War, the LTCM failure, 11 September 2001, the 2002 recession, the Great Recession, and the sovereign debt crisis, which truly sets it apart as an asset. It represents a debt to no-one (unlike bonds or equities) which, against a backdrop of a high-debt economic and financial crisis, is undoubtedly extremely valuable.

Conclusion

Overall, maintaining an overweight stance on emerging market assets (equities, bonds and currencies) in credit (vs. government bonds) still makes sense, while continuing our search for yield and spreads. Similarly, “alternative” and “real” assets still look attractive from a diversification and yield standpoint.

However, there is no denying that the negotiations over Brexit, China’s policy (economic policy, but especially exchange rate policy and capital account opening policy), the limitations of monetary policy or the prospects for a change in the direction of budgetary and fiscal policies, the change in leadership in the United States and the forthcoming elections in Europe are likely to bring about meaningful change in current trends.

- Negotiations on the practical aspects of Brexit are expected to weaken the pound and undermine the UK’s growth potential, prompting the Bank of England to maintain accommodative monetary policy for a long time to come.

“ The probabilities of occurrence are still hard to quantify but this is not the main point: the consequences of these risk scenarios are so severe that asset allocation and macro-hedging activities should take them into consideration ”

“ With volatility, gold is undoubtedly, in any panic phase, financial crisis, debt crisis or liquidity crisis the ideal macro-hedging instrument ”

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These negotiations could also substantially weaken European cohesion, which is not particularly good news in an election year.

- The US elections pave the way for budgetary and fiscal stimulus which is likely to have an impact on the dollar and fixed income markets, as well as the election debates in Europe. This change in trend on the other side of the Atlantic is a form of disinhibition towards budgetary stimulus measures, or even towards populist themes.
- The elections in Europe will open against the backdrop of a change in leadership that has started in the United Kingdom and the United States. The increase in proponents of a more expansionary budgetary and fiscal policy, as well as some forms of protectionism (goods and people) is an established fact. What some call populism also goes hand-in-hand with a rejection of the establishment and, in the case of Europe, a rejection of EMU, the euro and the political constraints (loss of sovereignty) that accompany it.
- So far, the financial markets have given carte blanche to the central banks, with QE and lower interest rates working towards financial stability (synonymous with low volatility), greater safety for government debt and low funding costs for businesses. However, the central banks have done the maximum possible (they certainly outdid themselves in the area of interest rate levels), and the growth and employment pictures remain disappointing overall. Resorting to budgetary and fiscal policies alters the long-term outlook for interest rates, but only if QE is halted, which does not enter into our prognosis. Anticipate spikes of volatility nonetheless.
- As has been the case for more than a decade, China remains a major source of concern. Capital account opening continues, and the economic situation (real estate and credit bubble, risk of a hard landing, capital outflows, etc.) is not really that reassuring, even though growth has been steady for three quarters now. However, the improved health of the emerging market economies is a guarantee of stability that cannot be ignored, even if, at the first stage, there is a good reason for the change of leadership in the United States to destabilise these markets.

2017 indeed seems to be a pivotal year for the financial markets, especially for long-term interest rates.



The negotiations over Brexit, China, the limitations of monetary policy, the prospects for a change in the direction of budgetary and fiscal policies, the change in leadership in the United States and the forthcoming elections in Europe are likely to bring about meaningful change in current trends.”

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Central scenario and alternative scenarios: Amundi's forecasts

ONE-YEAR FORECASTS							
	Current level	Central scenario	Risk scenario 1	Risk scenario 2	Risk scenario 3	Optimistic Scenario	
		World GDP growth stable at around 3%	Sharp slowdown in Europe	Hard landing in China	US growth significantly down	Stronger world growth	
FX							
EUR/USD	1.08	1.1	1	1.2	1.25	1.15	
USD/JPY	109	110	100	95	95	115	
EUR/GBP	0.86	0.9	1	0.9	0.9	0.9	
USD/CNY	6.87	7.2	7.2	7.6	7.2	7	
USD/BRL	3.43	3.4	3.4	3.8	3.5	3	
MONEY MARKETS							
Euribor 3 Mth	-0.31	-0.30	-0.50	-0.50	-0.4	-0.2	
Eurodollar 3 Mth	0.91	1.4	1	0.25	0.25	1.9	
FIXED INCOME							
2 Yr US	1.01	1.50	0.90	0.20	0.20	2.00	
2 Yr JPY	-0.18	-0.40	-0.40	-0.60	-0.5	0	
2 Yr GER	-0.64	-0.60	-0.80	-0.90	-0.7	-0.2	
2 Yr GBP	0.21	0.10	-0.30	0.00	0	0.5	
10 Yr US	2.26	2.30	1.70	1.00	1	2.8	
10 Yr JPY	0.01	0	0	0	0	0	
10 Yr GER	0.23	0.30	-0.30	-0.30	-0.2	0.8	
10 Yr GBP	1.39	1.50	0.50	0.80	0.8	2	
10 Yr spread France	50	30	70	50	50	20	
10 Yr spread Italy	173	130	250	150	150	80	
10 Yr spread Spain	122	100	250	150	150	80	
INVESTMENT GRADE							
Spread IG Europe	116	70	230	200	180	60	
Spread IG US	135	100	130	230	230	80	
HIGH YIELD							
Spread HY Europe	402	330	800	600	500	300	
Spread HY US	494	380	500	700	900	300	
EMERGING MARKET DEBT							
Spread JPM EMBI Global div	358	370	450	530	500	310	
EQUITIES							
MSCI EMU	189	200	160	150	140	220	
MSCI US	2061	2150	1890	1750	1670	2250	
MSCI Japan	842	880	720	660	660	970	
MSCI EM	839	900	780	600	650	1000	

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Central scenario and alternative scenarios: Amundi's expected returns

ONE-YEAR EXPECTED RETURNS					
	Central scenario	Risk Scenario 1	Risk Scenario 2	Risk Scenario 3	Optimistic scenario
	World GDP growth stable at around 3%	Sharp slowdown in Europe	Hard landing in China	US growth significantly down	Stronger world growth
FX					
EUR/USD	1.85%	-7.41%	11.11%	15.74%	6.48%
USD /JPY	0.92%	-8.26%	-12.84%	-12.84%	5.50%
EUR/GBP	4.65%	16.28%	4.65%	4.65%	4.65%
USD/CNY	4.80%	4.80%	10.63%	4.80%	1.89%
USD/BRL	-0.87%	-0.87%	10.79%	2.04%	-12.54%
MONEY MARKETS					
Eurodollar 3m	1.16%	0.96%	0.58%	0.58%	1.41%
Euribor 3	-0.31%	-0.41%	-0.41%	-0.36%	-0.26%
FIXED INCOME					
2Y Germany	-0.72%	-0.34%	-0.15%	-0.53%	-1.47%
2Y US	0.06%	1.23%	2.59%	2.59%	-0.91%
2Y UK	0.39%	1.05%	0.55%	0.55%	-0.28%
2Y JPY	0.25%	0.25%	0.65%	0.45%	-0.54%
10Y Germany	-0.40%	5.02%	5.02%	4.12%	-4.93%
10Y US	1.88%	7.30%	13.63%	13.63%	-2.64%
10Y UK	0.36%	9.36%	6.66%	6.66%	-4.14%
10Y Japan	0.06%	0.06%	0.06%	0.06%	0.06%
10 Y France	2.03%	4.00%	5.98%	4.99%	-1.93%
10Y Italy	5.38%	-0.27%	9.14%	8.20%	5.38%
10Y Spain	2.82%	-5.63%	3.76%	2.82%	0.00%
INVESTMENT GRADE					
Investment Grade Euro	3.09%	-3.39%	-1.77%	-0.20%	0.90%
Investment Grade US	5.05%	2.87%	3.98%	3.98%	3.03%
HIGH YIELD					
HY Euro	4.57%	-14.68%	-7.51%	-7.10%	4.39%
HY US	7.84%	-2.99%	-7.40%	-14.18%	8.70%
EMERGING DEBT					
JPM EMBI Global Diversified	4.78%	2.86%	2.20%	4.18%	5.44%
EQUITIES					
MSCI EMU	8.1%	-12.9%	-18.1%	-23.4%	18.7%
MSCI US	5.61%	-6.92%	-13.66%	-17.51%	10.43%
MSCI Japan	5.99%	-12.96%	-20.07%	-20.07%	16.66%
MSCI EM	9.55%	-4.71%	-26.10%	-20.16%	21.44%

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