

Risk factors

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The table below presents risk factors with probabilities assigned. It also develops the most credible market impacts.

Risk # 1	20% probability	Pro-cyclical fiscal policy pushes the Fed to raise its rates more quickly than expected
<p>Analysis The tax cuts that were voted in by Congress in December will boost GDP growth in 2018. The misinterpretation of the Fed's intentions has been a major risk factor for a long time now. With GDP growth above 2%, inflation close to 2% and an economy that is increasingly close to full employment, the real Fed funds rate should be much higher than it is now, in a normal cycle. So, technically, the Fed is "behind the curve". The Fed must clearly avoid any communication errors. Markets could react poorly if rates are increased excessively. The most recent example of a bond crash dates back to February 1994 and was triggered by a 25bp increase in rates, which was certainly poorly prepared. However, we note that the short-term positive impact of the tax reform should allow the Fed to continue to raise interest rates without increasing the risk of recession and, as such, without damaging the financial markets.</p> <p>Market impact If the Fed steps up its rate increases, we will have to bet on a sharp downturn in equities and on contagion into the emerging markets. This situation would be conducive to a widening of spreads between Europe and the United States. We expect three rate hikes in 2018. All it would take is for core inflation or wages to pick up more quickly (with still strong growth) to open the door to further rate hikes.</p>		
Risk # 2	10% probability	A Chinese "hard landing" / a bursting of the credit bubble / devaluation of the yuan
<p>Analysis Chinese growth is still solid (and more resilient than many market observers believed on year ago), but the country's economic model is fragile: the excess of credit is visible, non-financial corporate debt has surged since the GFC. The good news is that it has peaked: the NFC debt to GDP ratio has started to drop in late 2017. We will continue to monitor closely the trend in Chinese private debt that currently benefits from the strength of nominal GDP. In the case of hard landing or the bursting of the credit bubble, the Chinese authorities would be unable to maintain the stability of the Yuan, especially since the Chinese currency is no longer undervalued.</p> <p>Market impact A hard landing linked to a burst of the credit bubble would have a very negative impact and its cascading effects would be particularly disastrous: vulnerability of banking systems (in China and elsewhere), vulnerability of the global financial system, vulnerability linked to China's public and private debt, negative impact on regional and global trade, and thus on commodities and emerging countries, impacts on the currencies of commodity-exporting countries, advanced countries and emerging countries.</p>		
Risk # 3	75% probability	The post-Brexit environment permanently weakens the UK
<p>Analysis According to estimates, the UK "could lose" between 2.5% and 9.5% of its GDP in the medium term (depending on the nature of the Brexit). Volume and costs of trade would be affected, especially in the financial services, chemicals and automotive sectors, which are highly integrated sectors in the European Union. The risk for the UK lies in its future ability to trade freely in the single market (the services market, to be more precise), to achieve the desired independence without the EU's constraints. This is the challenge of phase two of the negotiations which are scheduled to begin. There are many issues of tension, not just between the UK and countries in the EU, but within the British government itself, which will become very apparent in the coming weeks and months.</p> <p>Market impact Even though the likelihood of a hard Brexit has dropped significantly, and although some pressure has been relieved with the proposed 21-month transition period (until the end of 2020), negotiations on trade this year are expected to be tense. In the event that the outcome is ultimately unfavourable for the United Kingdom, we will see additional weakening of the pound sterling and trend- GDP growth of the British economy, two factors that could prolong the monetary status quo.</p>		

Risk # 4

70%
probability

Greater financial instability

Analysis | Central banks have made the return of financial stability possible in recent years through lower rates, short and long; maintaining interest rates at low levels across the board; reducing volatility and keeping it low, tighter credit spreads and the virtual disappearance of sovereign risks in some cases... all of which have generated an environment of greater stability. However, monetary policies have now reached their limits, and it is difficult to expect more from them. The macroeconomic response to a potential downturn in activity would ultimately come from fiscal and tax policies, and traditionally public spending has far less stabilising power for financial markets than interest rate cuts.

Market impact | Greater financial instability would translate in particular into a rise in volatility on all financial markets and credit spreads.

Risk # 5

70%
probability

Political and geopolitical risks maintained

Analysis | Financial markets are now operating against a complex geopolitical backdrop: Syria, Islamic State, Turkey, migrant flows, terrorist attacks, Sunnis vs. Shiites, Arabia vs. Iran, all of which have strained and weakened diplomatic relations between countries. Do not expect a quick resolution of ongoing problems and conflicts. In order to take into account political and geopolitical risks into portfolio constructions on a permanent basis, it is necessary to systematically consider macro-hedging strategies.

Market impact | There is no doubt that there will be regular spikes in tension and volatility. The current geopolitical risks are well identified and specific, but there are many and, by their nature, materialize as often unpredictably. The magnitude of other political risks (including the consequences of the new US diplomacy) is more difficult to assess at this stage. Is this all likely to affect growth prospects and the direction of financial markets? No one really knows it but it is very likely that this is the case, at least occasionally.

Risk # 6

20%
probability

A long-term and significant increase in European long rates

Analysis | The increase in long-term rates can come from at least six sources: (i) a significant upswing in (nominal, real or potential) growth prospects, (ii) more aggressive tightening of interest rate policies, (iii) the “true” end of QEs (the end of reinvesting maturing papers in the US, an even more drastic reduction in the ECB’s asset purchasing programme), (iv) a resurgence of inflation or inflation expectations, (v) a massive reversal of fiscal and tax policies, or (vi) a resurgence of specific political risks. All these factors (reality, announced measures, or fears) have gained momentum in the United States, but it seems premature and excessive to expect a steady and substantial increase in bond yields. This conclusion holds even more in the case of the eurozone. But with growth that is now more robust and more sustainable, and low inflation expectations, debates over the end of negative rates and the ECB’s QE programme, and comments about the need for fiscal and tax measures that are more favourable to growth, it is a safe bet that the risks of a moderate rise in European rates are higher now.

Market impact | A sharp rise in long rates would be bad news in the United States, where the sensitivity to long-term rates has increased with corporate releveraging: this would weaken growth and in itself would sow the seeds for a future decline in long rates. It should also be noted that any rise in long-term interest rates is a hindrance to monetary policy and to the possibility of a rise in the Fed’s key interest rates. This is another reason for not believing in a sustained and ample increase in US – and European – long rates.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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This section provides a reminder of our central scenario and alternative scenarios.

Central scenario (75% probability): continued expansion of global activity

- **Global resynchronisation:** global growth will remain dynamic in 2018 and 2019. 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 resynchronisation of the global cycle generates “multiplier effects” – via trade – that sustain the recovery on a global scale and make it more robust.
- **World trade:** world trade recovered markedly in 2017 (+5% over one year). It continues to be stimulated by the resynchronisation of the global cycle and investment in capital goods. However, this effect is expected to gradually wane this year: we anticipate a stabilisation of the world-trade to world-GDP ratio in the future.
- **United States:** Growth is solidly established as the year begins. Most of the surveys continue to point to above potential growth. Domestic demand was quite strong in Q4 and seems to accelerate further in Q1 (we revised up our GDP forecast for 2.6 to 2.7% in 2018). . The very accommodative monetary and financial conditions (despite the expected hike in the fed funds rate) and the fiscal stimulus voted through in December significantly reduce the risk of a recession in 2018-19. We note that wages have started to accelerate: that was inevitable - at some point- with an economy that operates at or close to full employment.
- **Eurozone** the recovery is widespread, with a pick-up in investment in most countries. Growth is mainly being driven by domestic demand, but is also benefitting from a very robust global backdrop. Political risk has faded considerably, becoming more local (the status of Catalonia in Spain is primarily a domestic issue, while in Italy, the anti-euro parties have no chance of winning an absolute majority in the elections scheduled for 4 March, see the article on this topic in the current edition of the cross assets). The reduction in asset purchases by the ECB is likely to be accompanied by a rise in both long-term interest rates in the core countries and the Euro. Hence the slight decline in growth expected in 2019. Nonetheless, with credit conditions still highly accommodative, growth should remain significantly above potential in 2018 and 2019.
- **United Kingdom:** in December, EU countries followed the Commission’s recommendations according to which “adequate progress” had been made to open trade negotiations between the United Kingdom and the EU. Moreover, EU countries are now accepting the principle of a time-limited transition period up to the end of 2020, during which the UK would retain de facto access to the single market. This being the case, the threat of a hard Brexit is no longer imminent, at least in 2019. Admittedly, uncertainty will continue to weigh down the British economy, but more diffusely. We expect below potential growth but without any abrupt downturn.
- **China:** growth is more robust than expected. The reduction in overcapacity has reduced the downside risks. The economy’s growth drivers are now more diversified. Debt remains essentially domestic and manageable. We expect the gradual deceleration of growth to continue and a slow rebalancing (less growth, less debt). The transition looks to be under control. However, vigilance should still be exercised.
- **Inflation:** core inflation, which is excessively low at this stage in the cycle (especially in advanced economies), is expected to recover gradually in 2018. That said, the slowdown in inflation over recent years is primarily structural (tied to supply factors), while the cyclical component of inflation has weakened (flattening of the Phillips curve). While the pick-up in core inflation promises to be modest, the likelihood of an “inflation surprise” is nonetheless increasing as surplus capacities disappear around the world (we estimate that the global output gap will close in 2018 for the first time since the great financial crisis). The risk is easier to spot in the US (we expect wages to continue to accelerate), given how close the economy is to full employment and how certain temporary factors (such as the drop in mobile phone service prices in the spring of 2017) have disappeared, which will automatically push inflation upward at the end of Q1 2018 (base effect).
- **Oil prices:** we expect (Brent) oil prices to ease back slightly from their current level. At \$68 (Brent), the risk now looks lopsided to us (more risk of prices falling than soaring). In fact, if prices stay much above the breakeven point for US oil deposits, US production will end up increasing sharply..
- **Fiscal policies.** Two countries are in the spotlight this year: the United States and Germany. In the US, the income and corporate tax cuts (among other measures) approved by Congress in December are effective, which will

give growth a shot in the arm over the next 18 months. In Germany, some tax cuts are likely this year. On average, fiscal policies will be neutral, or even slightly expansionist, in the large advanced countries.

- **In 2018, the central banks will continue to whittle down their accommodative monetary policy**, which is excessive in view of the current recovery. The Fed will continue to raise its key interest rates (we anticipate three 25bp hikes in 2018) and reduce its balance sheet at the announced pace (with a gradual non-replacement of papers reaching maturity); meanwhile, the ECB could put an end to its QE programme as soon as Q4 2018, which would potentially open the door to the first increase in its deposit rate in early 2019. That said, monetary policies will remain accommodative overall, because even if some cyclical inflation does materialise later in the year, inflation will stay well below its historic average for the structural reasons we mentioned (flattening of the Phillips curve, continued downward pressure on the prices of many goods and services).



**Pessimistic risk scenario (10% probability):
marked economic slowdown due to incorrect economic policy
(excessively quick monetary policy normalisation or protectionist measures)
or a geopolitical crisis**

- The pro-cyclical fiscal policy forces the Fed to accelerate the monetary policy normalisation process.
- Protectionist measures (US) as mid-term elections draw nearer.
- International crisis stemming from acute aggravation of current geopolitical tensions (Middle East, Korea).

Consequences

- An abrupt re-evaluation of risks on the fixed income markets, with a global decompression of spreads (govies and credit, on the developed and emerging markets alike). Decline in market liquidity.
- Risk of disorderly deleveraging.
- With the resulting financial turbulence, the cycle is abruptly interrupted and inflation cannot stabilise.
- Central banks are forced to turn to unconventional tools once again (expanding their balance sheets).



**Optimistic risk scenario (15% probability):
continued sharp pick-up in global growth in 2018**

Several factors, which are likely to generate higher growth, should be closely monitored:

- Sharp pick-up driven by business investment, global trade, and synchronisation of the overall cycle.
- In a very promising environment, the pro-cyclical US tax policy generates a stronger than expected pick-up in domestic growth. Continued acceleration cycle in the eurozone, stabilisation in China, confirmation of the trend in Japan, etc.
- With inflation remaining extremely low, central banks would continue to maintain easy monetary conditions, at least at first, enabling a “mini-boom.”

Consequences

- A marked pick-up in global growth for the second consecutive year would increase inflation expectations, forcing the central banks to consider normalising their monetary policy much more quickly.
- Rise in real key interest rates (in the US especially).
- Given the resulting financial turbulence, the mini-boom of the first half would not last long. There would be a greater risk of a boom/bust (i.e. the bust after the boom).

Macroeconomic picture by area

		Risk factors
Americas	United States <ul style="list-style-type: none"> Government Shutdown briefly occurred, but it should not impact Q1 economic growth. We expect the US to grow well above potential in 2018. Coincident indicators and survey remain upbeat and the Tax Cuts and Jobs Act should boost consumer spending and Capex. The labour market keeps improving, with also tentative yet mixed, signs of pickup in labour compensation. In this framework, inflation should revert gradually to target, with some upside risks and temporary overshoot. The Fed should therefore be able to deliver three hikes in 2018. 	<ul style="list-style-type: none"> Debt Ceiling: Treasury's extraordinary measures extend borrowing till late March 18 Protectionist risk NAFTA negotiations Upside risks to inflation: economy close to full employment
	Brazil <p>Recovery on track and elections noise growing</p> <ul style="list-style-type: none"> Brazilian economic growth recovery is holding well. Households expenditure finds support in Real Wages significant increase and Credit rebounding. Industrial Production in Capital Goods is picking up and it's coherent with a surge in Capex and Credit to Private Corporate looks like having bottomed out. Inflation is still contained thanks to Food Prices, while Transport and Housing components are peaking up. With regard to next general elections, consensus is growing about the impossibility of Lula to run after recent corruption sentence (now in appeal). 	<ul style="list-style-type: none"> Improving economic conditions with unsustainable fiscal path. Pension reform unlikely Rise in political risks with the approaching presidential elections
Europe	Eurozone <p>The recovery continues with a lot of remaining potential</p> <ul style="list-style-type: none"> The series of upside surprises continue to pile up. Q4 GDP growth was +0.6% and business climate indicators were very strong in January. The economy is supported by many factors (recovery in capex, end of austerity policies, declining political risk, strong growth in the USA and Asia). At this stage, the rise in the Euro is not enough to threaten the recovery, although a rapid additional rise could become a serious headwind. Residual political uncertainties in large countries (search for a government coalition in Germany, regional crisis in Catalonia, Italian general elections) do not carry systemic risk. 	<ul style="list-style-type: none"> Rise in the euro Political risk (rise in anti-establishment parties, notably in Italy) External risks
	United Kingdom <p>Slowdown amid major uncertainties around the Brexit process</p> <ul style="list-style-type: none"> The economy has been slowing down since the beginning of 2017. Uncertainties concerning the Brexit process is detrimental to confidence. Sterling-induced inflation should be temporary. Despite the very low unemployment rate, wages are not picking up. The negotiation of a transition period should limit the immediate Brexit shock. However visibility on the future framework of trade relations with the EU is nil and the internal political situation remains tense (no Parliament majority for the Conservative Party, deep divisions within this party regarding Brexit). 	<ul style="list-style-type: none"> Strained negotiations ahead on trade Weak government (no majority without the DUP) Foreign deficit is still very high
Asia	China <ul style="list-style-type: none"> Q4 data show resilience of the economy. Official GDP growth steadied in Q4, better than consensus. Nominal growth held up at double digits, supported by continued supply cut efforts. Part of industry and construction slowed, linked to anti-pollution measures, but offset by stronger services, with exports and high-end manufacturing remaining strong. Property sector looks more resilient than most concerned. Recent strength in RMB reflected, more than just weak dollar, improvements of expectations, particularly locals, which implies risks skewed towards upside for further moderate appreciation of RMB. China's top officials sent strong messages of further reforms and opening-up in World Economic Forum, while worth to monitor Trump's trade policy following recent measures. 	<ul style="list-style-type: none"> Policy mistakes in managing structural transition Geopolitical noises regarding North Korea and with US
	India <p>Growth deceleration in Q4 2017 (CY)</p> <ul style="list-style-type: none"> India recovery in Q4 2017 (CY) has been less brilliant than anticipated. Aside an evident base effect kicking in correspondence of demonetization in November 2016, Private Investments remain quite weak in terms of projects and implementation. We therefore downward revised our GDP expectations for CY 2017 at 6.9% from 7.2%. Budget Law for FY19 has confirmed a pause on the fiscal consolidation path trying to favour penalized sectors of the economy like Rural India (farmers). Inflation has being surprising to the upside and subsidies policies embedded in the budget add further upside risk to inflation. RBI is expected on hold for a while. 	<ul style="list-style-type: none"> Q4 2017 (CY) recovery less brilliant than anticipated. GDP expectations revised down Inflation is increasing faster than expected. RBI on hold Fiscal slippage confirmed
	Japan <p>Toward the longest economic expansion since the early 1960s</p> <ul style="list-style-type: none"> Expansion continues driven by investment (which benefits from very strong corporate profits) and exports (driven by the strength of global trade). Corporate sentiment breached an 11-year high for large companies and a 26-year high for small firms (Tankan). The unemployment rate is at its lowest in 24 years and the "Job offers to applicant ratio" is at its highest since 1974. More companies are confident of a higher sales price. Capital spending plan for this year remain much stronger than historical average. The government encourages companies to raise wage and salaries by more than 3% in the next spring negotiation. 	<ul style="list-style-type: none"> The recent surge of the yen: a further appreciation would weigh on confidence Geopolitical risks (tensions with North Korea)

Macro and Market forecasts

Macroeconomic forecasts (08 February 2018)						
Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2017	2018	2019	2017	2018	2019
US	2.3	2.7	2.2	2.1	2.3	2.2
Japan	1.7	1.3	1.3	0.5	0.7	1.6
Eurozone	2.5	2.4	2.0	1.6	1.4	1.5
Germany	2.5	2.5	2.0	1.8	1.8	1.6
France	1.9	2.0	1.6	1.2	1.5	1.4
Italy	1.6	1.4	1.3	1.3	0.9	1.1
Spain	3.1	2.7	2.6	2.0	1.7	2.3
UK	1.8	1.6	1.7	2.7	2.8	2.6
Brazil	1.0	2.2	2.4	3.5	3.5	4.4
Russia	1.5	1.7	1.7	3.7	3.0	3.8
India	6.5	6.9	7.0	3.3	4.5	4.6
Indonesia	5.1	5.3	5.5	3.8	3.6	4.1
China	6.9	6.6	6.4	1.6	2.5	2.8
Turkey	6.5	4.3	4.0	11.1	9.5	8.5
Developed countries	2.3	2.3	2.0	1.7	1.8	1.9
Emerging countries	4.9	5.0	5.0	3.5	3.7	3.8
World	3.8	3.9	3.8	2.8	2.9	3.0

Source: Amundi Research

Key interest rate outlook					
	01/02/2018	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
US	1.50	2.00	1.90	2.25	2.20
Eurozone	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.50	0.55	0.50	0.70

Long rate outlook					
2Y. Bond yield					
	01/02/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.16	2.00/2.20	2.40	2.20/2.40	2.53
Germany	-0.53	-0.60/-0.40	-0.33	-0.40/-0.20	-0.18
Japan	-0.12	-0.20/-0.00	-0.10	-0.20/-0.00	-0.07
UK	0.65	0.40/0.60	0.87	0.40/0.60	0.98

10Y. Bond yield					
	01/02/2018	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.73	2.40/2.60	2.82	2.60/2.80	2.87
Germany	0.72	0.80/1.00	0.83	0.80/1.00	0.95
Japan	0.10	0	0.15	0	0.21
UK	1.52	1.40/1.60	1.68	1.40/1.60	1.76

Currency outlook					
	01/02/2018	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
EUR/USD	1.25	1.25	1.20	1.25	1.24
USD/JPY	109	112.00	112.50	115.00	110.00
EUR/GBP	0.88	0.95	0.88	0.95	0.91
EUR/CHF	1.16	1.20	1.16	1.20	1.18
EUR/NOK	9.58	9.40	9.30	9.20	9.20
EUR/SEK	9.82	9.70	9.44	9.50	9.35
USD/CAD	1.23	1.25	1.25	1.20	1.23
AUD/USD	0.80	0.75	0.79	0.75	0.80
NZD/USD	0.74	0.70	0.72	0.70	0.73
USD/CNY	6.30	6.30	6.50	6.30	6.45

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